

# Private Wealth MANAGEMENT



## Bulls vs Bears 1 Year Later: Article From Today's WSJ

On the one year anniversary of the current bull market in stocks, it is helpful to examine both sides of the debate on where stocks prices will be headed. Many experts disagree on whether current valuations for stocks make them look cheap or expensive. The following article from this morning's Wall Street Journal describes the views of two prominent Ivy League professors, Robert Shiller of Yale and Jeremy Siegel of Wharton.

We always welcome your comments and questions.

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## Worries Rebound on Bull's Birthday

By [E.S. BROWNING](#)

Investors celebrating the new bull market's first birthday on Tuesday may remember a less happy milestone on Wednesday: the 10-year anniversary of the peak of the technology-stock bubble. The great debate among stock-market analysts these days is whether the market has finally worked off years of excessive prices and can return to steady growth. Optimists argue that two brutal bear markets have left stocks cheap and attractive, especially if the government's economic-recovery initiatives succeed. They say investors who were too optimistic in the 1990s are too pessimistic now, and that a recovery in corporate performance could offer investors happy surprises. But some of those who warned of trouble a decade ago are worried again today. They say government interventions in the economy and the market in 1998, 2001 and 2008 kept stocks from fully correcting. Some see signs of bubbles starting to inflate again, notably in certain developing-country stocks. This uncertainty has fueled a prolonged debate between two old friends, renowned economists Robert Shiller and Jeremy Siegel. They say they've been chewing over the issue during vacations together at the New Jersey shore. Mr. Shiller, a Yale University professor whose book "Irrational Exuberance" warned of the tech bubble just before it burst in 2000, still worries about the market's future. Prof. Siegel of the University of Pennsylvania's Wharton School, whose book "Stocks for the Long Run" was the bible for many investors in the 1990s, is bullish.

Each of them can marshal a slew of data to bolster his viewpoint. Their reputations as forecasters may be affected by which of them winds up being correct. The past decade has been a lost one for stock investors. The Dow Jones Industrial Average finished Monday at 10552.52, up 61% from the recession low a year ago, about halfway back to its record high of 14164.53 in October 2007. The blue chips are trading at a level they first reached in April 1999. One concern of pessimistic analysts such as Mr. Shiller is that despite the two bear markets, stocks have spent almost all their time since 1991 priced above historic averages. History suggests that when stock prices are high, performance in ensuing years is disappointing. None of these analysts is predicting another decade as bad as the last one: The market today is a long way from the price excesses of 2000. They aren't predicting when the market will run into trouble. Sooner or later, they contend, perhaps when the government's heavy stimulus wanes, stocks could face disappointing returns and even some scary ups and downs. "One decade's damage still hasn't brought us back down to historic norms" for stock prices, says Robert Arnott, who warned of trouble in 2000 and whose firm Research Affiliates in Newport Beach, Calif., directly manages \$4 billion. Previous stock bubbles were followed by long periods "with the market priced at deep discounts," when investors gave up on stocks, which hasn't happened this time, Mr. Arnott says. The government intervention dates back to the Russian debt default and stock-market swoon of 1998, when the

Federal Reserve stepped in to cut interest rates and prop up shaky financial markets. U.S. stocks collapsed again in 2000, leading to heavier government support and interest-rate cutting starting in 2001, especially after the Sept. 11 terrorist attacks. Stocks fell even harder in 2008. Central banks world-wide injected trillions of dollars into the financial system, pushing target government interest rates close to zero.

Markets were rebounding last August when Messrs. Shiller and Siegel got together with their wives at Mr. Siegel's beach house on a barrier island, below Atlantic City, N.J. They have been friends since graduate school at the Massachusetts Institute of Technology in the 1970s. As they walked the beach for hours, they discussed the market, its prospects and the best ways to analyze it.



Mr. Shiller worries that the housing market could be turning down after a brief recovery, which could contribute to a decline in U.S. stocks, which already look expensive to him. "I wonder about a return to another break in the market," he says, though he notes the market is far less expensive today than when he wrote his book.

Mr. Siegel scoffs at his friend's concerns—and at his numbers. "This is an extremely cheap market," he says, and its future is bright.

Mr. Shiller has compiled market data back to 1881, measuring stock prices month by month relative to corporate profits. To avoid short-term profit distortions, he uses an average of profits over the previous 10 years. Over the long run, by his measure, stocks trade at an average of about 16 times annual corporate profits—that is, their price-to-earnings ratio, or P/E ratio, is about 16.

He has found that when this ratio has gotten above 20, as it is today, it has signaled that the market was expensive and sooner or later would hit a stretch of subpar returns.

Adjusted for inflation, stocks have declined on average about 2% a year in the decade after they hit a P/E of 20,

Mr. Shiller has calculated. When dividends are factored in, they have notched a small positive return. Eventually, the P/E ratio has always fallen back below the average level, after which the market becomes cheap, paving the way for above-average performance.

The way Mr. Shiller sees it, the problem today isn't just that the current P/E is above 20. It is that since 1991 it has spent only seven months, in late 2008 and early 2009, below the average level of 16. At the start of 2000, it was above 40. No one can say how much longer the P/E can keep rising or when the past year's bull market might end, especially with the government providing heavy stimulus. But past trends, and the law of averages, suggest that at some point the P/E is likely to fall below 16, pulling stocks with it.

Mr. Siegel, for his part, strongly disagrees with this kind of analysis. He argues that his friend's use of 10-year average profits works poorly in the current environment, because big financial companies took such heavy write-offs in 2008 and 2009. Such write-offs, he argues, won't be repeated, so earnings including them shouldn't be used for forecasting. "AIG's \$80 billion write-off is going to pollute those figures for 10 years," as long as they contribute to the 10-year earnings average, he says.

Mr. Siegel prefers to look at analysts' projections of future earnings, adjusted to exclude special write-offs and charges that he and the analysts think are unlikely to recur.

Mr. Siegel's book also looks at long-term stock performance back to the 19th century. He finds that of all investments, stocks turn in by far the best long-term results, with an average inflation-adjusted return of 7% a year.

At times like the present, with profits rebounding, they do even better than average, he says.

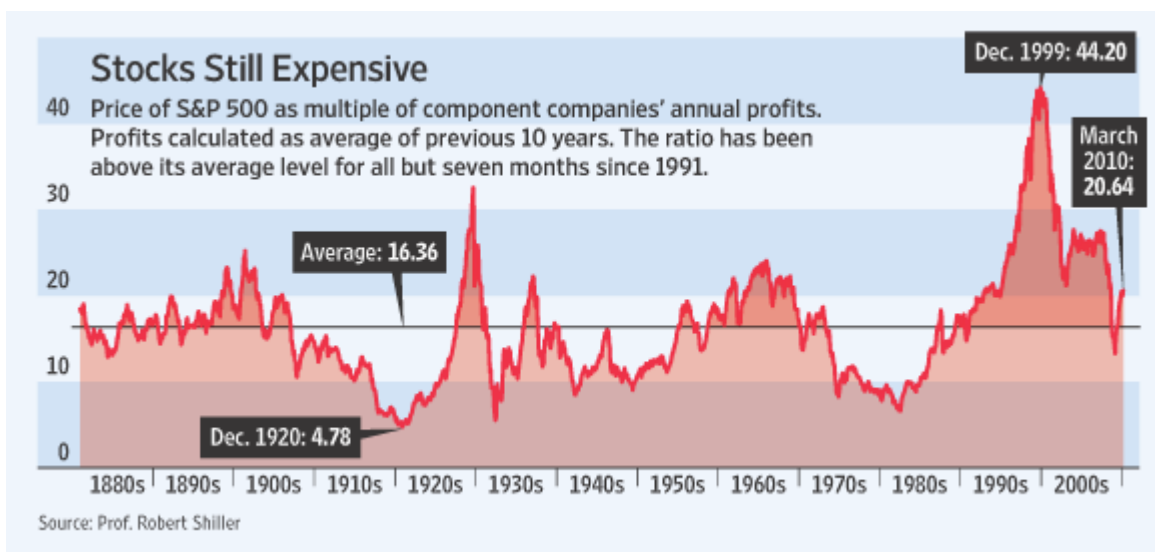
"My research shows that the common P/E is 18.5" when the economy is coming out of a recession, he says. The way he looks at it, the market now is trading at about 14.5 times forecast 2010 profits, making it cheap compared with the typical P/E of 18.5. If stocks rise to 18.5 times profits, the S&P 500 could rise to 1400 this year, a 23% gain from today's level, he notes. "We could easily see 10% to 12% stock returns with low inflation" in future years, he says.

Mr. Shiller doesn't agree with his friend's analysis of P/Es and write-offs. The impact of recent write-offs on the 10-year averages is small, he argues. As for trusting analysts' forecasts, adjusted to exclude write-offs, he says: "Those are famous last words."

Another market analyst who was correctly bearish in 2000 backs up Mr. Shiller's views. Ben Inker, director of asset allocation at Boston money-management firm GMO LLC, crunches the data in a way that avoids the debate over 10-year averages and write-offs. He uses historical profit margins to forecast future corporate profits.

One problem in forecasting earnings, he says, is that the Internet and real-estate bubbles pushed corporate profit margins to 7%, above the historical level of 6%. The higher profitability was due to exceptional borrowing and investment by corporations and consumers. While that one-percentage-point difference seems small, it represents a 17% jump in profitability, which Mr. Inker considers unsustainable.

Using the historical 6% margin and applying it to an expected rise in corporate revenues as the economy recovers, he finds that stocks today trade at almost 19 times expected profits, making them expensive. To be reasonably priced, he calculates, the S&P 500 would have to fall 21%, to about 900 from Monday's 1138.50.



"The market should spend a good portion of its time trading below fair value, to match the time it spends trading above fair value," Mr. Inker adds. "We would bet that something is going to happen to push the stock market below fair value in the next few years."

One possible catalyst for trouble is the withdrawal of government stimulus, which put a floor under stocks a year ago. The worry is the market has grown so dependent on government help that any effort to wean it off that aid, no matter how slow, will expose its weak underpinnings. Another worry is that before the stimulus can be withdrawn it will set off another destructive bubble.

Some investors see signs of bubbles in developing markets, particularly in China. "The history of emerging markets is filled with booms and busts. You can't rule out the risk of a new bubble," says Keith Walter, who helps manage \$53.5 billion at Artio Global Investors, formerly known as Julius Baer Investment Management. He's begun trimming his funds' once-heavy exposure to developing countries such as China and Brazil.

The emerging-market bubble, if there is one, is just beginning to inflate. Mr. Walter is particularly worried

about China's effervescent property market, where investors are flipping unoccupied apartments in a way reminiscent of the U.S. housing bubble. He fears that local banks with real-estate loans could suffer. "We are worried that it has already gone too far, and that it is going to be a bubble that bursts," he says.

The Chinese stock market is another cause for concern. Shares of Baidu, often called China's Google, have quintupled since their late-2008 low and now trade in the U.S. at 85 times the company's profits for the previous year. Google Inc. itself, a more sophisticated world-wide competitor, trades at 27 times profits, having merely doubled in price from its late-2008 low—and some U.S. analysts consider that excessive.

PetroChina, China's version of Exxon Mobil Corp., has a market value of about \$345 billion based on its Shanghai price, above Exxon's \$315 billion, though it is half as big in terms of revenue.

Yet many investors talk of China's prospects in a way reminiscent of the tech and real-estate bubbles.

Deutsche Bank has nearly doubled its forecast for Chinese export growth to 30% this year, from 16%. "China is arguably one of the most promising investment cases in today's global equity market," said a Goldman Sachs report in late February.

Mr. Walter counts himself a long-term emerging-markets bull. Even if the stocks decline, he says, he expects them to move higher eventually.

But economic prospects are different than stock prospects. Back in 2000, tech-stock bulls argued that Microsoft Corp., Cisco Systems Inc. and Intel Corp. deserved enormous stock prices because they would be lasting world leaders. The companies indeed have remained world leaders, but their stock prices on average are about 60% below their 2000 highs.

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