

Economic and Financial Commentary

BY JEREMY SIEGEL

The first quarter of 2012 is starting out with stocks even more attractively priced than a year ago: earnings and dividends are higher and interest rates are lower, yet stock prices are mostly unchanged. There are two reasons for the more favorable valuation of stocks: (1) the fear of a European financial crisis spilling over to the United States, and (2) the disappointing pace of the United States' (and the world's) economic recovery.

EUROPE

In my commentary for the fourth quarter, I gave recommendations to the European Central Bank on how to stem the financial crisis. Although the ECB did not explicitly guarantee the deposits as I advised, they did provide a large liquidity lifeline to the banks, and this lifeline has, at least for the near term, quieted the markets. Greek bondholders are ready to accept large discounts on Greek debt, and the interest rates on the sovereign debt¹ of the peripheral countries (save Portugal) have declined. Furthermore, European corporate and interbank risk spreads have narrowed recently. I firmly believe the ECB will provide the liquidity needed to stem a crisis, but a recession in Europe is a foregone conclusion, and the European periphery will be depressed for many years.

For this reason I see no choice but for the ECB to let the euro continue to depreciate, and I would not be surprised to see the euro sink to parity with the U.S. dollar or even lower. Such a depreciation will help European exporters and cushion Europe's downturn. European stocks are attractive to dollar investors even with the prospective decline in the euro; if investors hedge that decline, European stocks are even more enticing.

HOUSING

In the U.S., economic growth might surprise on the upside this year. Most economists are estimating about 2% real growth in GDP for 2012, a disappointing rate with the economy still operating so far below full employment. But there are favorable signs not only on the jobs front but also in the hugely depressed housing sector. Although the recent upturn in housing starts and the NAHB (National Association of Homebuilders) index of housing sentiment may be only temporary, it is likely a harbinger of better times ahead. With record low interest rates, the cost of owning is lower than the cost of renting, a situation that historically has led to increased housing activity.

There is no doubt that the continued extremely depressed state of housing, the worst since the Great Depression of the 1930s, is largely responsible for the weakness of the current recovery. Housing starts had been running at only 500,000 units per year since early 2009, a level that is one-third the number economists say our economy needs to house our growing population.² If the upturn in housing is for real, expect better economic conditions in short order.

INTEREST RATES AND DIVIDENDS

Last August the Federal Reserve pledged to keep short-term interest rates low until the middle of 2013, and there are signals that the FOMC may push back that end date. In any case, inflation is decelerating, and if economic growth is sluggish and the unemployment rate stops falling, expect further easing by the Fed. In any case, we are beginning to see an increase in loan activity, which is also a harbinger of a better economy.

A stronger economy and continued low interest rates provide the ideal climate for the dividend investor. Many investors are aware—and concerned—that the current 15% tax rate on dividends expires at the end of this year and will revert to that on ordinary income.

However, neither the Republicans nor the Democrats advocate a return to ordinary income tax rates for stock dividends. President Obama has always set a maximum rate of 20% on dividend income, which is still far lower than the rate on ordinary income and from bond interest. For this reason, I expect that dividend-paying stocks will remain strong performers through 2012.

¹ Sovereign debt, also known as government debt or public debt, is the debt owed by a central government.

² Source: Bloomberg

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