QUARTERLY Q&A WITH PROFESSOR JEREMY SIEGEL

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Every quarter, we hold a quarterly review and outlook conference call with our Senior Investment Strategy Advisor, Wharton Professor Jeremy Siegel, where listeners can submit questions ahead of time and help drive the content of the call. In this blog, we review the most pressing economic and market issues that were discussed during this quarter's call. **Question: A major question has been central bank activities and how that impacts the markets. What are your current thoughts? J. Siegel:** Yes. Very important. Does anyone doubt how important the U.S. Federal Reserve (Fed) is to what moves the markets? Every little hint on what they're going to do, every little move on who's going to be the next Fed chairman, with Janet Yellen being seen as more of a continuum of Bernanke's easy money policies and Larry Summers being tougher on that score, which might actually not be as true as thought. Nonetheless, these are the market-moving issues. Let me say to start—and I've said this now for over a year and a half—the Fed is important for stock prices, but this bull market in my view is driven by valuation and earnings, particularly valuation. What I believe is going to move the market up is not so much earnings—and earnings growth is up a few percent; ok but not great. I believe it is going to be valuation improvements that drive the market. The reason is because alternative investments, even with the recent increase in interest rates, are still extremely low from a historical standpoint. I believe the current environment justifies valuations of 16, 17, 18 on the market; not just the historical 15. **Question: Who do you prefer to be the next Fed Chair to replace Bernanke? J. Siegel:** First of all, I could live with either Larry Summers or Janet Yellen. I think both of them are extremely good economists. I know Larry Summers very well. I don't know Janet Yellen as well, but I've read almost everything she's written. I prefer Janet Yellen. I think she's much better at bringing a sense of commonality to the Federal Open Market Committee (FOMC), which is something that Bernanke has really done a great job with. Almost everyone, whether they're hawkish or dovish, has praised Bernanke's willingness to be all-inclusive in the discussions. The major problem with Larry Summers is that he's extraordinarily bright but often goes off on his own opinion and runs the risk of not listening closely to other FOMC members. I believe that Bernanke himself will recommend Yellen and the FOMC will recommend Yellen. I think that will carry the day. Regarding the timing of the change: Although Bernanke's term as chairman is over on January 31, his position on the board is not over for another six years. Now, when he leaves the chairmanship, he will not become a regular member of the Board. No one does that. He will leave the Fed. The reason I'm bringing this up is that if there is a fight in the Senate and the Senate cannot make a decision by year-end or even in January, the tradition has been that the chairman stays on as chairman until the new choice is confirmed. Bernanke, potentially, could still be chairman well past January 31. I'm just mentioning that as a possibility. **Question: When do you believe the Fed will begin to slow down, or taper, its purchases of bonds? J. Siegel:** It is my belief that tapering will begin in September; that's the most likely outcome. I think the economy is going to show stronger growth in the second half ; that's why I believe tapering will begin then. I think tapering will be announced in September and begin in October and pretty much as planned—about $20 billion a month being cut from the purchases until it is all wound down by the middle of 2014, and that's pretty much the most likely scenario

that Bernanke spoke of during his news conference. The great thing about introducing the possible tapering of quantitative easing (QE) is that it gives a huge option back to the Fed. If the economy does not progress as quickly as anticipated, the tapering will either be cut back, delayed or canceled outright. Without this option, there wouldn't be many bullets left in Bernanke's holster to stimulate the economy. Now that the market expects tapering, he could always delay it to provide an additional boost to the economy. **Question: How do you see the Fed being able to wind down the balance sheet now that it has gotten so large? J. Siegel:** Step one is just to stop the buying, to stabilize the balance sheet. Step two is to bring down the balance sheet to make sure all those excess reserves do not flow into credit and become inflationary. I think this will be accomplished in two ways. The first way is, they will stop reinvesting the cash flows they receive from the mortgage-backed securities, and maybe even Treasuries. Also, I believe that we're going to get an increase in formal reserve requirements. The banks are already holding nearly $2 trillion in excess reserves. A reserve ratio increase will absorb excess reserves and control the amount of loans that are made by the banks, which is, of course, the inflationary potential of these excess reserves. This is well down the road.

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DEFINITIONS

Central bank : Refers to the the monetary authority of any country.

Easy money policies : Policies that have the goal of stimulating economic activity.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Dovish : Description used when stimulation of economic growth is the primary concern in setting monetary policy decisions.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Purchases : Refers to the ongoing monthly purchases of both U.S. Treasury and mortgage-backed securities of over $80 billion.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Excess reserves : bank reserves in excess of a reserve requirement determined by local central bank. They represent reserves of cash more than the minimum required amount.

Mortgage-backed securities : Fixed income securities that are composed of multiple underlying mortgages.

Reserve requirements : Mandated amounts of cash that banks must hold on hand to cover their liabilities.