The Future for Investors

by Jeremy Siegel, Ph.D.

Why Stocks May Climb “Wall of Worry”

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I believe that odds are about five to one against the U.S. falling into a recession over the next year. There is no doubt plenty to worry about, and pessimists point to two major risks in the economy: soaring oil prices and a severe housing slowdown.

Oil prices would soar if the Mideast melts down into open warfare or if an effective terrorist attack struck oil supplies. In this hurricane season, there is also the possibility that another Katrina-like storm could disrupt oil and gas production in the Gulf.

The housing sector is a risk because if house prices decline severely and the consumer responds by sharply curtailing his spending, this would greatly harm the economy. A lot of consumption has been spurred by funds generated through second mortgages and home equity loans. If homeowners see capital gains on their homes turn to losses, it could spell trouble for the consumer sector.

Cause for Optimism

But I think both of these risks are unlikely to occur. Oil producing countries are as addicted to their revenue from oil as we are to using it. They also know if they set the price of oil too high, determined conservation will hurt their long term prospects. Embargoes against specific countries (such as Iran against the U.S.) don’t work because oil is a transferable commodity from a world-wide supply. The total oil pumped, not who sells what to whom, is the critical factor determining the price.

Furthermore, the energy markets have built these risks into prices. Seventy dollar oil already contains a $10 to $20 dollar premium for the grim possibilities mentioned above. That does mean that a disaster won’t send the price of oil soaring. But it means that in the absence of these disrupting events, oil prices will fall (note the sharp decline in such prices when Ernesto veered away from the Western Gulf).

Similarly a housing bust will set into motion events that will limit the impact of reduced housing expenditures on the rest of the economy. Housing is a big user of borrowed funds and a downshift in that sector will reduce loan demand and lower interest rates. A housing decline will also takes pressure off of sensitive commodity prices such as lumber, copper, and other materials used in construction. This will allow the Fed to ease monetary policy if necessary.

And it is very unlikely that a moderate fall is housing prices will send homeowners into shock. Only wide-eyed optimists felt the housing prices would continue their rise (see my article “Is Real Estate a House of Cards” on Yahoo! Finance from last December) and most level-headed homeowners at the peak of the bubble assumed prices would eventually stabilize or even decline. Even if housing starts in 2006 fall 20% below the 2005 level, that would still be well above the average of the last 20 years.

What it Means for Stocks

It’s a well-known (and true) Wall Street aphorism that markets hate uncertainty. Investors do not like to make commitments when there are major risks ahead. Anxious investors claim they will put money in the stock market only when major sources of uncertainty are resolved.

But there has always been uncertainty in our economy. If investors waited until all uncertainties worked themselves out, they will never have bought stocks.

Professionals call the ever present risk facing investors the “Wall of Worry.” History shows that stocks have often climbed this “wall of worry,” amply rewarding investors who stay with equities. Uncertainty is one of the reasons why the stock market has over the long run been such a good investment and why stock returns have sported such a hefty premium return over fixed income assets.

No one knows what the future will bring. There will always be risks in buying stocks and if worst-case scenarios materialize, stock will no doubt fall. But I think the odds favor continued economic expansion and if this turns out to be the case, stocks will no doubt be your best investment.