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The Bond Bubble and the Case for Stocks

By JEREMY J. SIEGEL

AND JEREMY SCHWARTZ*

A year ago in these pages, in a piece called "The Great American Bond Bubble," we wrote that yields on Treasury bonds were unsustainable and those rushing into bond funds were in for a rude awakening when interest rates rose. Long-term rates did in fact rise sharply last fall, but recently, on the heels of the economic slowdown and the Federal Reserve's "pledge" to keep interest rates low for the next two years, U.S. Treasury rates plunged to even lower levels than last summer, reinflating the bubble to the bursting point.

One market that now makes no sense to us is the popular Treasury Inflation Protected Securities (TIPS), where recent yields should be enshrined in Ripley's "Believe It or Not!" The yield on the benchmark 10-year TIPS turned negative for the first time in history, meaning investors are now lending money to the government with the hope of receiving a sum 10 years from now that is worth less in purchasing power than the dollars they fork over today.

This astounding situation can only be justified by extraordinary pessimism about the prospects for the U.S. economy. Economic theory predicts that the real yield on long-term TIPS should approximate the real growth in the economy. And when these securities were first floated in 1997, investors received a 3.4% yield, which was very close to the 3.6% average GDP growth over the previous 50 years. The average yield on the 10-year TIPS since it was floated has been 2.5%.

To be sure, real growth since 2000 has been a much lower 1.3%, but there have been two recessions over the past decade, the last one being the most severe since the Great Depression. Even those forecasters who believe in Pimco's pessimistic "New Normal" for the U.S. economy predict real growth at 2%.

Given the rise in U.S. population at nearly 1% per year, the zero GDP growth expectations now embedded in the 10-year TIPS prices would require both that productivity growth fall to zero (which is more than two percentage points below its long-term trend), and the labor participation rate decline over the next decade at

twice the rate it has over the past 10 years—a decline which in itself was unprecedented in our history. Our view is that productivity growth is more likely to accelerate in the future, not decelerate, as the global economy becomes more connected and firms use their resources more efficiently.

Investors, of course, do not have to accept the Treasury market's dismal outlook and meager returns. Despite the slow growth over the past decade, U.S. corporations, as typified by those in the S&P 500 Index, have been making record profits by enhancing productivity and deriving nearly half their sales from growing overseas markets.

The dividend yield on the S&P 500 index exceeds 2%, and these dividends represent less than 30% of profits these firms earn. This gives management a huge cushion to maintain dividends if indeed the U.S. economy experiences a double-dip recession.

Investors have flocked to inflation hedges like TIPS and gold out of fears about out-of-control government debt and deficits. The S&P downgrade of the U.S. credit rating heightened concern that the Fed would turn on the printing presses. But equities, like precious metals, are also real assets whose return has compensated investors for inflation. Per share dividends of the S&P 500 firms have grown at 5% per year over the last half-century, which handily beat the average rate of inflation of 4% during the period. In fact, dividend growth has beat inflation both during the low inflation periods of the 1960s, 1990s and 2000s, and the high inflation periods of the 1970s and early 1980s.

Some investors who avoid dividend-paying stocks point to the 2007-09 debacle, when the high-dividend financial stocks crashed. But a close look at the data indicates that was a unique event that we see having very little chance of repeating.

Prior to the recent recession, there were only five years in the S&P 500's history when dividends declined, and the maximum yearly decline was just 3.3%. In the 2000s, financial companies paid increasing dividends out of unsustainable profits, and S&P 500 dividend growth accelerated. When the housing bubble burst, these financial firms' profits and dividends collapsed. Yet it is little known that the entire decline in dividends of U.S. stocks during the recession was due to the fall of the financial sector. The sum of the dividends paid by firms in the other nine sectors of the U.S. equity markets was actually higher in 2009—at the bottom of the worst recession and bear market in the past 75 years—than it was in 2007, when stocks and the economy were at their peak.

Today the aggregate dividends paid by the nonfinancial sectors are about 20% higher than they were at the 2007 peak. Furthermore, the dividends of financial firms today comprise only 16% of the total dividends paid, less than half their proportion in 2007. In other words, another financial crisis cannot have the same impact on either the earnings or dividends of the U.S. equity markets. Finally, dividend growth in the last two years has averaged over 10% per year, more than twice the long-term dividend growth rate, as firms rightly begin to return their record cash balances to shareholders.

Despite the recent surge in bond prices and fall in the stock market, portfolios of dividend-paying stocks that we recommended a year ago have matched the returns of both the standard and inflation-protected Treasury 10-year bonds. We believe that when investors awake from their depressed state, they will realize that they don't have to lend the U.S. government money for 10 years at a negative real yield.

Despite the sluggish economy, the corporate sector is churning out record profits and increasing dividend payments. We believe dividend-paying stocks are the answer to a Treasury bond market that looks more dangerous than ever.

Mr. Siegel is a professor of finance at the University of Pennsylvania's Wharton School and a senior adviser to WisdomTree Inc. Mr. Schwartz is the director of research at WisdomTree Inc