Weekly Commentary with Professor Jeremy J. Siegel

Economic Resilience Meets "Higher for Longer" Rates

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As we kick off 2025, the economic landscape showcased a strong economy and resilient job market even as higher interest rates weigh on market sentiment. This week's data underscore the delicate interplay between inflation expectations, real growth, and the Federal Reserve's policy stance.

Let's start with the headline data. Jobless claims fell to the lower end of the 200,000–240,000 range, signaling a robust labor market. The jobs report came in considerably above expectations, but wage growth was actually below expectations. Yet, inflation expectations in consumer surveys spiked, I believe a reflection of concerns over new tariff possibilities rather than a broader inflationary trend.

Meanwhile, commodity prices, led by oil, firmed up slightly. The increased restrictions on Russian oil exports have contributed to recent gains, but broader commodity trends do not signal runaway inflation. On the monetary side, money supply growth reached a healthy 5%—its highest pace in three years—indicating growing credit but this is not inflationary.

The Federal Reserve remains at the center of market dynamics, with its December rate cut sparking some debates about the true neutral rate of interest. I've long argued that the neutral rate is higher—closer to 3.5% to 4%—than the Fed's estimate of 3.0%. The strength of the economy, coupled with the optimism surrounding technology investments and resilient consumer spending, makes me think this equilibrium rate may be at the higher end of the range. The real rate on 10-year Treasury Inflation Protected Securities (TIPS) has climbed to 2.3%, near its 2023 high, which was the highest in more than a decade.

The 10-year Treasury yield around 4.75% is about 40 basis points above the Fed Funds Rate. Historically, back to 1970, this spread in periods outside recessions, averaged 126 basis points, suggesting room for further upward movement in long-term rates if the economy remains strong. A rise to levels approaching 5-5.5% on the 10-year yield would not be inconsistent with a normalizing term structure.

The Fed Funds Futures market, after correcting for the hedging demand of these Futures that I often discuss, at best is now pricing in just one cut in 2025. The market has largely now discounted the Fed being on pause for most of 2025.

Equity markets continue to grapple with higher discount rates, which compress valuations. The S&P 500, trading at 23x forward earnings, reflects overly optimistic growth assumptions. Consensus earnings growth of 16% for 2025 is likely too high; an 8–9% increase is more realistic. Consequently, the market could see a correction as valuations adjust to higher rates and moderated growth expectations.

The Volatility index (VIX) ticked above 20 on Friday, indicating elevated hedging activity and caution among investors. While far from the panic levels seen in bear markets, this reflects growing uncertainty. Historically, such caution is bullish for long-term equity returns as it signals fear being priced in.

Growth stocks, particularly in the tech sector, remain dominant. The AI-driven investment narrative continues to support these high-growth names, with no signs yet of a definitive shift toward value. Small-cap stocks, often seen as beneficiaries of a strong economy, face headwinds from higher short-term rates, which disproportionately affect their financing costs. Large-cap tech companies like Microsoft and Google, with limited sensitivity to Fed rates, maintain their competitive edge despite rising discount rates.

The set-up for 2025 remains one of economic resilience. The economy is far from signaling recessionary weakness, but higher rates will weigh on equity valuations and create challenges for interest-rate-sensitive sectors like small caps. Investors should prepare for volatility and recognize the long-term opportunities from any market dips.

The bond market, too, deserves attention. With potential for further upward moves in long-term rates, fixed-income investors should remain cautious of adding to duration even with the higher rate spike.

As we move through the first quarter, earnings reports will provide clarity on corporate health and help set expectations for the year ahead. We'll continue to monitor these trends closely.

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