Weekly Commentary with Professor Jeremy J. Siegel

Rising Oil and Real Yields Test Equity Leadership

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The market encountered its stiffest test in months last week as rising oil prices, higher bond yields, and renewed scrutiny of AI capital spending combined to pressure many of the year's biggest winners. Easing tensions over the weekend have buoyed stocks. If the Strait of Hormuz was opened, I believe the market would be 5% to 10% higher.

The sharp one-day decline in the Magnificent Seven relative to the broader S&P 500 following earnings from Tesla and Alphabet reflected more than simple profit-taking. Investors are asking a question that has surfaced repeatedly throughout market history: when does extraordinary capital spending cease being a competitive advantage and begin destroying shareholder returns? This current market debate reminds me of the "Capital Pigs" a chapter from *The Future for Investors*, where we documented that over five decades companies spending the highest percentage of revenues on capital expenditures versus sales consistently underperformed their peers over the long run. While every technological revolution feels different in real time, markets eventually demand evidence that enormous spending produces adequate returns.

That does not mean that the AI revolution is over. Far from it. The technology continues to advance rapidly, and lower-cost models could accelerate adoption rather than slow it. But markets are beginning to distinguish between companies building the infrastructure and those capable of earning attractive returns on that infrastructure. As always, valuation matters. Even the greatest technologies can become poor investments if expectations become excessive.

At the same time, the macro backdrop is facing challenges. WTI crude oil has moved sharply higher from the upper $60s toward $90, lifting inflation expectations along with it. While oil today occupies a much smaller share of the U.S. economy than it did during the oil shocks of the 1970s, it is certainly not irrelevant. Higher energy costs work their way through transportation, manufacturing, and consumer sentiment. That is why the easing of the weekend is so welcome, and a renewal of hostilities bearish.

Encouragingly, much of the underlying economic data continues to point toward a fundamentally healthy economy. Weekly unemployment claims recently reached levels not seen in roughly six decades, showing labor market conditions remain exceptionally firm. Growth has moderated but the economy continues to expand at a respectable rate.

The bond market has understandably become more cautious. Ten-year Treasury yields and TIPS yields have both climbed back toward levels reached during the aggressive tightening cycle of 2022 and 2023. The critical question investors should ask is not whether real yields are rising, but why they are rising. If higher real yields reflect stronger long-term economic growth, then corporate earnings should ultimately justify the increase. If instead higher real yields reflect renewed inflation concerns and expectations for tighter monetary policy, then equity valuations become more vulnerable. My assessment is that the recent move reflects elements of both forces.

This distinction also explains why so much commentary about the equity risk premium continues to miss the mark. Investors must compare real expected equity returns with real bond yields—not nominal Treasury yields. Too many discussions mix nominal and real measures, producing misleading conclusions. Even after the recent backup in real rates, forward earnings yields remain 2.5% above inflation-adjusted Treasury yields. The premium has narrowed, but we remain nowhere near the extraordinary inversion that existed during the technology bubble in 2000. At that time, 10-year TIPS yielded more than 4%, while stocks traded at roughly 30 times earnings, leaving investors accepting a lower real earnings yield than government bonds offered. That was fundamentally unsustainable. Today's market looks nothing like that episode.

Attention now shifts to the Federal Reserve meeting. No policy change is expected, and without updated economic projections or a new dot plot, investors will focus almost entirely on Chairman Kevin Warsh's press conference. The key issue will be whether he views higher oil prices as a temporary supply shock that monetary policy should largely look through or whether persistent strength in inflation expectations requires a firmer response. That distinction will likely shape expectations for the remainder of the year. My expectation remains that the Fed stays on hold, but there is at least one dissent in favor of hiking. In addition, the money supply continues to expand at a rate too high to be consistent with the Fed's 2% goal. These facts will have to be reconciled by Warsh and the markets.

Trade policy also returned to the headlines with another round of tariff announcements. While I continue to believe tariffs represent poor long-term economic policy, the latest proposals appear broadly similar to what markets had already anticipated. The average effective tariff rate has changed relatively little, and many exemptions remain in place. Unless negotiations deteriorate materially, tariffs are unlikely to become the dominant driver of financial markets over the next several months. Markets have largely incorporated their economic effects into current expectations.

Looking ahead, investors face a more balanced environment than they did earlier this summer. Earnings growth remains healthy, the labor market continues to support economic expansion, and AI innovation remains a powerful secular force. Yet higher oil prices, rising real yields, and elevated valuations raise the hurdle for further equity gains. The bar for positive surprises has become considerably higher. If energy prices retreat and real yields stabilize, equities could quickly regain momentum. Long-term fundamentals remain favorable, but the path forward is likely to require greater selectivity and more disciplined attention to valuation than investors have needed for much of this remarkable bull market.

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