Weekly Commentary with Professor Jeremy J. Siegel



Value Breakout Shows Benefits of Diversification

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There was very little macroeconomic news last week, but there was certainly no shortage of action in the markets. We saw an extraordinarily sharp rotation out of growth and into value, with both the Russell Value Index and the S&P Value Index reaching all-time highs even as the Nasdaq suffered one of its largest recent selloffs. That is a dramatic divergence, but historically it is not unprecedented. After the Nasdaq peaked in March 2000 and subsequently declined roughly 60% over the following year, value stocks actually rose and moved toward new highs. I do not believe we are in anything resembling the 2000 technology bubble today, but the comparison illustrates why diversification remains so important.

The force behind this rotation is increasingly clear: uncertainty surrounding the scale and durability of the AI investment boom. Expectations for enormous data-center construction and AI-related capital spending have created tremendous demand for funds and pushed real interest rates higher. When investors begin questioning whether that spending trajectory can continue, the mechanism works in reverse. The 10-year Treasury yield moved back below 5%, providing support for bonds and rate-sensitive value stocks.

That is why I continue to view bonds and value stocks as natural hedges against the dominant AI trade. If AI investment continues to accelerate, growth stocks should benefit while bonds and many value stocks will face pressure from higher real rates. But if questions emerge over AI demand, data-center requirements, or the returns on all this capital spending, long-term rates should decline and value stocks should outperform. Last week's market action demonstrated exactly that relationship.

Importantly, I do not believe the recent movement in long-term interest rates has been driven by deteriorating inflation expectations or even primarily by the federal deficit. Long-term inflation expectations have actually been edging lower. The movement is coming through real rates, and that tells me the market is pricing growth and capital demand associated with AI. If the AI buildout slows, the effect will extend well beyond technology. There would be less demand for data-center financing, slower economic activity, less inflation pressure and ultimately meaningfully lower interest rates.

This week's Federal Reserve meeting should be rather uneventful. There is no Summary of Economic Projections or dot plot, and I see no change in policy. December remains the more interesting meeting, with markets still pricing the possibility of another rate increase.

I will be watching the trade data very closely because it is the final major piece feeding into third-quarter GDP and can materially move the estimates. Current forecasts are clustered around 3% growth, which remains very healthy. The larger question is productivity. For all the discussion about AI transforming the economy, we still have not seen a decisive AI-driven productivity acceleration in the aggregate statistics. That remains one of the most important missing pieces of the AI story.

Oil prices have remained elevated, but gasoline prices have behaved considerably better as refining spreads have narrowed. Meanwhile, geopolitical developments bear watching, particularly the potential for movement toward a Russia-Ukraine settlement. I see much less evidence of an imminent breakthrough involving Iran.

The main investment lesson from last week is straightforward. The market is no longer trading as one giant AI momentum story. The enormous capital requirements behind AI are affecting growth expectations, real interest rates, bonds and equity leadership simultaneously. Investors who own only the winners of the AI boom are taking more concentrated macroeconomic risk than they may realize. The dramatic strength in value last week is an important reminder that diversification can work precisely when the market narrative begins to change.

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