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## Hang on Tight!

By LAUREN R. RUBLIN

### ***Our go-to group of investment experts sees tough times for the economy -- but good fortune for stockpickers. (2008 Roundtable Report Card and 2008 Mid-Year Roundtable Report Card)***

**ONCE UPON A TIME, WE LIVED IN A WORLD** where asset-price inflation begat leverage, which begat more asset inflation, in a virtuous circle known as the great bull market. We bought bad art, good wine and vacation homes (many), and stocks "on the dips," which made us rich. And geniuses, of course.

Then the big, bad wolves -- greed and excess -- came and popped our bubble, and the markets', and all the pretty assets fell to earth. The fairy god-mother -- bearing a strange name for a godmother, Uncle Sam -- tried to clean up the mess with great gobs of money, but little success. The pain, suffering and deleveraging continued, inflation went bananas, everyone shopped at Wal-Mart and the Hamptons returned to scrub and sand. And no one lived happily ever after -- except for incredibly savvy stockpickers -- at least for a good five years. And that, kids, was the story they told at this year's *Barron's* Roundtable.

Oh, yes, the details: "They" are the 10 investment experts depicted here, who sat down with the editors of *Barron's* in New York on Jan. 5 to make sense of the epochal events in the economy and financial markets in 2008, predict what will happen in 2009 and share their investment ideas for the new year, which so far looks much like the old. The day was rife with history lessons and warnings -- and optimism, too, that those who find bargains amid the rubble will reap rich rewards. Or, as Meryl Witmer nicely put it, "It is an exciting time to be a stockpicker."

#### **Roundtable Members:**

**FELIX ZULAUF**, founder and president, Zulauf Asset Management, Zug, Switzerland;  
**MARIO GABELLI**, chairman, Gamco Investors, Rye, N.Y.;  
**ARCHIE MACALLASTER**, chairman, MacAllaster, Pitfield, MacKay, New York;  
**MERYL WITMER**, general partner, Eagle Capital Partners, New York;  
**MARC FABER**, managing director, Marc Faber Ltd., HongKong;  
**OSCAR SCHAFER**, managing partner, O.S.S. Capital Management, New York;  
**FRED HICKEY**, editor, The High-Tech Strategist, Nashua, N.H.;  
**SCOTT BLACK**, founder and president, Delphi Management, Boston;  
**BILL GROSS**, founder and co-chief investment officer, Pimco, Newport Beach, Calif.;  
**ABBY JOSEPH COHEN**, senior investment strategist and president, Global Markets Institute, Goldman Sachs, New York.

In the first installment of the 2009 Roundtable, you'll find the unabridged version of our little tale, as well as some first-rate stock picks from Meryl and Fred Hickey. The rest of this illustrious crew will share their wit and wisdom in Installments 2 and 3.

Meryl, general partner at New York's Eagle Capital Management and a value investor in the Buffett mold, brought four names to the 'Table -- an aluminum producer, a utility and two financials, as if she needed to burnish her credentials as a thoughtful contrarian. Fred, who edits the High-Tech Strategist newsletter in Nashua, N.H., made a compelling case for Microsoft and gold.

Want the details? Please read on.

**Barron's:** *Let's forget about 2008 -- and that includes most of your stock picks. With the market down 36% from its highs, the government bailing out everything in sight and a new president coming to town, what is the outlook for 2009? Fred, tell us, please.*

**Hickey:** The government can't cure a disease that has been more than a decade in the making. The U.S has built up gigantic financial imbalances, and debt levels the world has never seen. Massive increases in public debt and

spending can't replace the lost private-sector debt and cutbacks in consumer spending, allowing us to go on our merry way. The stock market is experiencing a snap-back rally, similar to what we saw in 1930, after the Crash of 1929.

*You don't look that old.*

**Hickey:** I wasn't around. They had a name for it, the "little bull market." It came about after the Federal Reserve slashed interest rates to 3.5% from 6%, and later to 1.5%. President Hoover had ordered federal departments to speed up construction projects, and the state governments to expand public works projects. He went to Congress asking for a huge tax cut and a doubling of spending on public buildings, dams, highways and harbors. That sounds familiar. Hoover predicted the crisis would end in 60 days. He received widespread praise for his intervention.

*We see where you're going, but what about today?*

**Hickey:** The market has had its worst crash since the Great Depression, and a new president is promising to pull out all the stops. We'll have massive infrastructure spending on roads and bridges. We'll have more tax rebates, and the government has made bailout commitments of more than \$8 billion to support various markets. It has bailed out almost the entire banking system.



Chris Casaburi for Barron's  
Building up savings and paying off debt will be the operative themes for consumers and corporations in the next few years, say the members of the 2008 Roundtable. That suggests diminished economic growth and lower investment returns. From left: MacAllaster, Faber, Cohen, Black, Hickey .

The stock market has rallied about 20%, and could go up 40% or 50%, as the little bull market did. Then reality is going to set in -- the reality that the economy is terrible, the unemployment rate is going to rise, the Fed's policies are imprecise. The dollar could get killed sometime this year, causing all kinds of problems. We have a more protectionist Congress. Deficit spending is unlikely to work. In sum, we have a date with more traditional bear-market levels. You'll see the single-digit P/Es [price/earnings multiples] that were typical in 1982, '74 even 1930 and '32. The market will go down significantly, and then make a bottom.

**Black:** A lot of the stock market's performance will be contingent on public policy. The consumer is dead. There has been a paradigm shift. The savings rate is going up. People are terrified. It's like my parents' generation after the Depression. Gross private domestic investment won't go up, even if you give corporations tax incentives. There is too much idle capacity already. We can't meaningfully reduce the trade deficit because we don't manufacture enough goods that the rest of the world wants. That leaves government spending to create final demand for U.S. goods and services. Giving a tax cut to people who spend the money at Wal-Mart on products made in China isn't going to do it. Infrastructure and defense spending are the best way out of this mess because by law, defense goods must be made in the U.S. and we have depleted our conventional forces, whether it is tanks or helicopters. Also, cement, concrete and structural steel all are made in the U.S.

As for the market, the current 2009 earnings estimate for the Standard & Poor's 500 stock index is about \$60. The market is trading for 15.5 times earnings. If Congress passes an infrastructure-spending bill and we spend between \$750 billion to \$1 trillion, that could provide enough boost for the economy to turn up by year end. We could be looking at \$70 in S&P earnings for 2010, which suggests the S&P, now in the low-900s, could rally to between 980 and 1,050. But again, it is all contingent on good public policy. That's the only thing that will kick-start the economy in 2009.

		1/2/09
Company	Ticker	Price
Kaiser Aluminum	KALU	\$23.50
Allegheny Energy	AYE	34.24
Assurant	AIZ	30.24
Discover Financial Services	DFS	9.51

1/2/09

Company	Ticker	Price
Microsoft	MSFT	\$20.33
Cadence Design Systems	CDNS	3.84
Mkt Vectors Gold Miners ETF	GDX	33.32
Agnico-Eagle Mines	AEM	50.95
PowerShares DB Agriculture	DBA	26.14
iShrs FTSE/Xinhua China 25 Idx	FXI	31.11

**Faber:** There is no such thing as good public policy, certainly not in the U.S. The current crisis was produced largely by policy measures that led to the formation of Fannie Mae and Freddie Mac, and later the repeal of the Glass-Steagall Act, which had prohibited banks from owning brokers. It all led to increased leverage. Fed policy has been a disaster. Instead of smoothing markets, it has increased volatility. By cutting interest rates the Fed created bubbles - in housing, in commodities. Now that the federal-funds rate has been slashed just about to zero, you're not getting anything for your money when you deposit it in the banking system and buy Treasury bills. There is no such thing as investment; everybody becomes a trader.



Chris Casaburi for Barron's  
From left: Gabelli, Gross, Schafer, Witmer and Zulauf.

With a few exceptions, the U.S. doesn't produce anything. It is a consumption-led economy. When the economy expands, the U.S. imports from other countries, such as China, which increase industrial production and capital spending. From 2002 to 2007 the markets of emerging economies outperformed the U.S. But when the economy slowed in 2008, it was a catastrophe for these economies. They immediately cut spending and production, which affected demand for commodities. Last year, emerging markets were hit much harder than the U.S.

**Cohen:** The P/E ratio of the Chinese market was more than 50 times earnings at the end of 2007, so the issue isn't only fundamental demand but relative valuation.

**Faber:** I'm aware of that. I recommended shorting Chinese stocks last year. It would be best at this point for the U.S. to have 10% less consumption. It would make people save again and follow Christian principles of frugality and humility. I doubt it will happen, but it would be good for the U.S.

*We've had history lessons, and now, religion lessons. What does any of this mean for 2009?*

**Faber:** The U.S. economy fell off a cliff between October and December, and will stabilize at a lower level of activity. Some indicators may look better than expected, which will justify the present rally. Stocks already are up 25%. If they go up 50% from the Nov. 21 low of 741 on the S&P, you'll have the S&P at around 1,100. Afterward, reality will set in and in real terms the market will go much lower for much longer.

Around the world, governments are throwing money at the system to revitalize debt growth. When an economy is credit-addicted and debt growth slows, it is a catastrophe. With the Fed buying up everything and boosting the federal deficit, hyperinflation will be the result down the line. I am pleased that *Barron's* just wrote a cover story about the inflation in Treasury bonds ["Get Out Now!" Jan. 5]. This was the last bubble the Fed was able to inflate, aside from their egos.



Chris Casaburi for Barron's  
Marc Faber: "With the Fed buying up everything, hyperinflation will be the result."

[Laughter]

*So, Marc, you're not too bullish this year.*

**Faber:** Let's put it this way. A true market low will be lower, but in a hyperinflating economy, you can have nominal price gains while going lower in real, or inflation-adjusted, terms. Between the start of 2008 and November, almost every asset market collapsed, but the dollar was strong. After November the asset markets rebounded but the dollar went down again. There's an inverse correlation. Dollar weakness is a signal that the Fed has succeeded in pushing liquidity into the system. Some say the dollar will collapse this year, but collapse against what? The euro? The Russian ruble? These currencies are even weaker. In the very long run, each citizen must become his own central bank. Every responsible citizen must hold some physical gold, platinum and silver -- physically, not through derivatives.



Chris Casaburi for Barron's  
Bill Gross: "We were all children of the bull market, but the bull market is over."

*Bill, what do you think?*

**Gross:** For several years we have said we're in the midst of a generational change in the global economy and the financial complex. About two months ago Barton Biggs [a hedge-fund manager and former Roundtable member] said, "I'm a child of the bull market." He went on to explain that he'd been trained to buy the dips, because assets always eventually went up in price.

For the past 50 years asset inflation has been the context, the foundation of much of the economic growth in the United States and around the world. It led to additional leverage, which led to additional asset inflation. In the past 12 months the global economy and financial complex experienced a forced deleveraging. Assets deflated by \$20 trillion to \$30 trillion. We were all children of the bull market, but the bull market is over. Deleveraging will become the context for the next five to 10 years. It will lead to lower profit margins and higher interest rates.

*And this year?*

**Gross:** It depends in part on the extent to which governments can fill the hole left by deleveraging. Can they take us out of an illiquidity trap that is damaging not only to asset prices but the real economy? If so, there is hope for 2009. More likely, policy will come up short and we'll have a global recession, perhaps into 2010.

The important thing for investors is what happens in 2010, 2011 and 2012. We're setting up for a low equity returns, low economic growth, high real interest rates and 5% to 6% to 7% returns, at most, on all asset classes. The double-digit rebound typical after selloffs isn't going to happen.

*Oscar, do you agree?*

**Schafer:** I agree with a lot of what Bill says. The economy is experiencing a rain delay. Nothing is going to happen for a while. Although the government's spending efforts will help, they won't be enough to cure the two biggest problems. The first is housing. Unsold inventory of houses is more than a year's worth, and prices could go down another 10%-plus. Mortgages have been reduced and prices are down, but 68% of the public still owns a home, versus 64%, the historical trend. The mortgage-equity withdrawals of recent years are over. Consumers spend 14% of their after-tax income on housing, more than they pay for food. No matter what the government does, it may not help housing, and in turn, the consumer.

A stimulus package also wouldn't speak to the consumer's need to reduce debt. Just as "plastics" was the operative word in The Graduate, "leverage" will be the operative word for the next two to three years in the economy. The world is experiencing a giant margin call. The consumer is deleveraging and increasing his savings. The banks are deleveraging. Stories are rife that banks aren't lending, because they don't have sufficient capital. Further write-downs will continue to impair their capital. This credit contraction leads to a vicious cycle of companies doing poorly, layoffs increasing and foreclosures rising. The economy will be pretty punk into 2010.

*Will the market follow the economy?*

**Schafer:** The market may go up a little. Then it will test the November lows. The big story is 2010 and 2011. The averages won't do much, almost like in 1968-82.

*How does that help the investor who wants to know what to do with his money in 2009? He can't wait until 2011.*

**Schafer:** I can't help him. [Laughter] I don't know what the market is going to do in the next six to 12 months. It will be a stock-picker's market, but the averages won't rise more than 6% to 8% a year, dividends included. For the first time since 1941, the 10-year return on the S&P 500 is negative.

**Hickey:** It's hard to predict the market when you don't know what the Fed will do. The Fed has tripled the size of its balance sheet and is plowing ground we have never seen before. Here are my facsimiles of deutsche marks from Weimar Germany [holds up sheaf of papers]. They collapsed in value when Germany started printing money after World War I. It happened very quickly and it can happen again.

The Germans were successful at reflating. But they weren't successful in saving their economy. [Federal Reserve Chairman Ben] Bernanke is on record saying, "I will not make the mistakes of the 1930s. I will not make the mistakes of Japan in the 1990s." He is pushing the limit right now.

**Gabelli:** So you're saying he's going to make the mistake of the Weimar Republic?

**Hickey:** There is a possibility of that. Every month that there is a horrible employment, report the government prints more money.

**Gabelli:** It took Weimar Germany a brief time.

**Faber:** The worse the economy, the more they will print. It is like in Zimbabwe now, and Latin America in the 1980s. They had large deficits and printed money, and in local currency everything went up. But the currency collapsed.

**Schafer:** Isn't the federal government increasing its balance sheet to offset the private sector?

**Gross:** Exactly. The situation isn't similar. The Weimar Republic basically reflated to get out from under its wartime debts. Zimbabwe is a situation unto itself. In the U.S. there has been asset destruction in the trillions of dollars that has to be repaired. To say the Fed's balance sheet has expanded by a few trillion dollars and that this will create hyperinflation is a miscalculation.

**Faber:** I'm prepared to bet Bill that in 10 years the U.S. has very high inflation. With growing fiscal deficits that may reach as high as \$2 trillion next year, it will be hard for the Fed to lift interest rates in real terms. Once they push up rates again, there will be another disaster.

**Gross:** Marc, you're smarter than that. You know that credit creation is at the heart of economic growth, and to the extent that credit creation has been thwarted, stultified, basically cut by 10% or 20%, economies can't grow.

**Faber:** The U.S. economy is credit-addicted. In a sound economy, debt growth doesn't exceed nominal GDP growth. Would you agree with that, or do you think debt should always grow at a faster pace than nominal GDP?

**Gross:** I'm with you there.



Chris Casaburi for Barron's  
Abby Cohen: "The Fed is acting as the central banker to the global economy."

Faber: We come at this from different perspectives. You run a company that manages money, and I'm an outside observer of the U.S. financial scene, though I have to admit I bought some U.S. stocks for the first time in 30 years.

*Abby, what do you think?*

**Cohen:** First, it is important to recognize that we are not starting from a point of equilibrium, where the economy and the credit markets are working properly. Instead, the Federal Reserve is acting aggressively to provide liquidity not just to the U.S. economy but the global economy. I'm always amused when people, especially those based outside the United States, talk about the terrible U.S. consumer. I recognize the U.S. consumer is over his head in debt. But the impact is seen throughout the world because the U.S. is the world's largest importer. There will be significant consequences when U.S. consumers increase their savings rates rapidly, as they have done in recent months. This impacts other nations that have failed to do a good job of stimulating domestic demand. In many ways, the Fed is acting as the central bank to the global economy.

In 2010 the situation may move back to something more normal. Also, investors helped contribute to the situation we're now in. During several years of below-normal volatility in stock and fixed-income markets around the world, risk appetites reached extraordinary levels. Investors grew willing to take on risk without demanding appropriate levels of return. Some markets have now seen the inverse. There is a fear of illiquidity and risky assets. Thus, some valuation opportunities have been created, though I am not saying the entire market goes up, or goes up dramatically.

*In other words, some stocks and bonds are cheap.*

**Cohen:** In recent months, in addition to the rise in risk premiums in stocks and bonds, there has been a high correlation between different types of assets, and within asset classes. The one exception was U.S. Treasuries. Many investors were selling things largely on the basis of liquidity. If you needed to raise cash you sold what you could, including some securities that perhaps offer reasonably good value. Consequently, we enter 2009 with a real disequilibrium within individual asset categories. It gives careful investors an opportunity.

**Gross:** In a deleveraging process, investors are forced to sell almost everything. The asset of ultimate quality and liquidity -- Treasury bills -- becomes the recipient of demand. On the way down, the most risky and illiquid assets fall most. But even the most liquid, high-quality assets go down for awhile, until the government's checkbook can compensate.

**Table:** [2008 Roundtable Report Card](#)

**Cohen:** I agree generally, but our work indicates some unusual things occurred in 2008. We put together a basket of securities heavily owned by hedge funds, and another of securities that weren't. The stocks owned by hedge funds went down 20 to 25 percentage points more than the others.

**Schafer:** Goldman Sachs did a great disservice to the hedge-fund business. People were shorting the basket of hedge-fund stocks. This caused heavily owned hedge-fund stocks to go down, creating bad performance for the funds, leading to redemptions and forced selling, a vicious cycle. In the past six months the fundamentals of many stocks have taken a back seat to who owned them. Long term, that isn't good.

**Gabelli:** That is her point. There are bargains around. Stocks fell below intrinsic value.

**Cohen:** In the search for liquidity, the funds sold simple assets traded in public markets, because the markets were open. The more liquid securities were the hardest hit. In 2009, investment vehicles that are more complex, highly structured and less liquid may not recover as quickly as those that are publicly traded.

*How do you look at valuation, Abby?*

**Cohen:** We use seven different models to evaluate the S&P 500, based on earnings, book value, cash flow and such. We also do detailed return-on-equity analysis. Using a composite of those models, we think fair value for the S&P

500 is somewhat above where the market stands now -- and we have one of the lowest earnings forecasts on Wall Street. We estimate the S&P will earn about \$55 this year.

*With all these models, why was your '08 forecast so far off?*

**Cohen:** We anticipated a sluggish economy at the time of last year's Roundtable, but changed our forecast to a recession a few weeks later. We adjusted our S&P targets downward. We didn't see the liquidity crisis that developed in the summer.

*Is anyone worried about deflation?*

**Zulauf:** The whole process of deleveraging is deflationary. It will last several years. Where most economists will probably err is in how the corporate and household sectors react to this. They probably have built into their models expectations that private households and corporations react to fiscal stimulus as they always did. That is wrong. In previous deep recessions the household sector lost about 5% of its net worth. This time around, it has lost about 20%. Households will become much more cautious for years. Instead of spending, they will save.

There will be changes in the corporate sector, too. S&P earnings peaked at about \$100 or so. This year they could slump to \$20 or \$40. The consensus estimates are way too optimistic. Much depends on whether the problems in the real economy hit the financial industry, causing it to relapse. The behavior and thinking of corporate executives will change dramatically. Companies will repair their balance sheets instead of spending and expanding, and that's why the deleveraging process will take years and years and years. Government and central-bank stimulus won't have the multiplier effects we used to see. Economic growth will be much lower in the next five or six years.

*And this year?*

**Zulauf:** We are in a synchronized global slump. Peak to trough, U.S. GDP probably goes down by five percentage points.

*Could it be worse than Japan?*

**Zulauf:** It could be worse. Deleveraging usually means return on equity drops below previous cyclical lows. Return on equity for the corporate sector peaked around 15%-16%, and previous cyclical lows were about 8%-9%. ROE probably drops below that in this cycle, which will lead to much lower earnings. That feeds into valuations, which means stocks eventually will go much lower, to single-digit-type P/Es and high dividend yields.

In the past 10 or 20 years risk was high, but perceived risk was low. That is why everyone bought the dips and took on leverage. Now we are moving into a world where perceived risk is high but real risk will eventually turn out to be much lower. This will lead to a different valuation of equities and bonds. In two or three years there will be tremendous bargains in the market. But we are not there yet. We are in a structural bear market. This is a transitional year. We'll have bear-market rallies, and then go down more.

**Gross:** Typically we think of financial leverage, but corporations have been levered in two additional ways. The lower tax rates of the past 10 to 20 years have to [go] back up. Then there is operational leverage, which is no more obvious than in the auto industry. Corporations have been geared to a high level of global consumption, and now they must eliminate plant, labor and such. Based on tax, financial and operational leverage, the outlook for corporate profitability and profit margins isn't good.

**Gabelli:** Right after Christmas, layoffs will go up sharply.

*Archie, you're usually optimistic.*

**MacAllaster:** I can't believe you people can't find one good thing to say about the market, and at its low last year the market was down more than 50%. The bad news is in the market. Earnings are going to come down hard, but the market has come down even harder. Some bargains are out there, though they are hard to find because P/Es

are difficult to determine. Still, a lot of companies are selling for well under book value, and some have high yields. The stock market is probably the place to be, particularly financials. Leverage is coming out of companies, and that will continue. But the process has created bargains.

The corporate bond market also is cheap. There are good bonds yielding 9% and 10%. That compares with 10-year government bonds, which yield 2% or 2.25%.

*What do you think about bonds, Bill?*

**Gross:** When we talk about the bond market we typically focus on Treasuries. At today's yields, don't touch them.



Chris Casaburi for Barron's  
Archie MacAllaster: "A lot of companies are selling for well under book value."

**MacAllaster:** And play the stock market in a conservative way. Don't buy stocks on margin. Keep some cash around, as I have. The Treasury secretary was right to bail out the banks first, though. They should go back to the old way of doing things -- lending money to people who are going to pay it back.

The old story in banking was three, six and three: Pay 3% on deposits, charge 6% on loans and hit the golf course at 3 p.m. Now it should be three, six and 20. Don't let anybody with a handicap under 20 get to be head of a bank.

*Meryl, how does the market look to you?*

**Witmer:** I agree that this is a stockpicker's market. There are some incredible values, and some incredibly overvalued shares.

**Faber:** What is overvalued?

**Witmer:** I have stocks at five times earnings, and then there is [Amazon.com](http://Amazon.com) [ticker: AMZN] at around 40 times earnings. Amazon has an attractive business, but not that attractive. There is a real divergence in value. There are opportunities, as well, in the corporate-bond market -- first-mortgage bonds on baseload electric-utility companies, for instance, that were priced recently at 8%-8.5%. And this is five-year paper. That's a lot more than you can get in the government-bond market. Down the quality spectrum you'll find bonds yielding 14% and 15%. Let's say the underlying company goes into bankruptcy; you would be creating it at 30 cents on the dollar of replacement value. There are a lot of opportunities out there. It is an exciting time to be a stockpicker.

*Mario, care to say something?*

**Gabelli:** In 15 days we will have a new leader who is going to re-brand America. His first priority as CEO of the country is to create jobs and insure that no adult is left behind in this economic system.

The consumer is getting an enormous cash-flow benefit from lower oil prices. There are 240 million cars in the U.S. and 800 million in the world that are saving around \$2.50 a gallon on gasoline. People with high credit scores and equity in their homes are saving money. The missing element is confidence. New tax laws are going to help with that. The working person is going to get a financial stimulus, and even under the most bearish scenarios 91% of those who can will be working in December 2009. You're going to see an investment-tax credit and a change in depreciation, encouraging small businesses to make capital investments. On Sept. 15 somebody shut off the lights for the business person. It has been hell since. We need to go from this hell for businesses to a kind of purgatory. More



Chris Casaburi for Barron's  
Mario Gabelli: "[Obama's] first priority as CEO of the country is to create jobs."

spending on investments and the possibility of a lower tax rate for corporations would send an interesting message to the business world.

*That's nice, but what happens now?*

**Gabelli:** Come April or May, the numbers will be a lot better than in the fourth quarter. Car dealers tell us they are starting to sell cars, but the buyers still need financing. Yes, unemployment is going to rise. But once a new president comes in and enacts fiscal stimulus and promises tax cuts, things will start changing. Once businesses see some stability, they can start planning and looking at cost efficiencies.

As far as corporate earnings go, an enormous tsunami hit the economic world. It is no different than labor strikes in the 1960s. When the steelworkers struck, did you base stock multiples on the absence of earnings, or step back and ask what normalized earnings would be over an economic cycle. And shouldn't the P/E multiple expand to account for depressed earnings?

*Is this a good year to buy stocks?*

**Gabelli:** I'm going back to what I think will work: POSP. Plain old stock-picking. It will be a good trading market. The markets won't do much more than 5% up or 5% down, but there are plenty of opportunities for financial engineering and value enhancement -- buying and selling, spinning off companies, selling divisions.

**Cohen:** This will be an interesting year for consolidation in a number of industries. Some companies are under distress because of balance sheets. Others in the same industry have had more financial success.

**Gabelli:** The natural-gas industry is one example.

**Cohen:** To the extent there are good opportunities from a valuation perspective, M&A [mergers and acquisitions] could perk up.

**Gabelli:** Contrary to the conventional thinking that companies don't have liquidity and won't do deals, there will be substantial activity by corporate buyers. But private-equity is handcuffed. Buying and selling businesses and spinning off of divisions will allow capital to flow to where returns are highest, even with an administration that will take a different approach [than the Bush administration] to antitrust issues.

*It is going to be harder to borrow money to buy businesses.*

**Gabelli:** It won't be harder for [Johnson & Johnson](#) [JNJ], but it will be harder for Steve Schwarzman [CEO of the private-equity firm Blackstone Group (BX).]

Now that we've solved the problems of the economy and the market, let's move on to your picks for '09. Meryl?

**Witmer:** I have four. Two are asset-heavy, and two are financials. [Kaiser Aluminum](#) sells for 23.50 a share. It has 20 million shares. Kaiser's main business is rolling high-quality, heat-treated plate and sheet aluminum used in the aerospace and defense industries and in general engineering. It also produces forged aluminum products for industrial and automotive uses.



Oscar Schafer: "The economy is having a rain delay. Nothing will happen for awhile."  
Chris Casaburi for Barron's

*How big is the automotive business?*

**Witmer:** It represents about 8% of revenue. Auto-related profits will be down this year, but that will be manageable. The company has gained market share. Except for an insignificant subsidiary, Kaiser doesn't take on price risk in aluminum. It converts aluminum into usable form for customers and hedges out the metal-price risk. Demand for aluminum plate in the aerospace industry is driven partly by airplane growth, but more by the new monolithic construction of aircraft parts.

Monolithic construction involves carving shapes from steel plate. This has created a sea change in demand for Kaiser's product. The benefit for the airlines is lighter, stronger aircraft. Kaiser is paid by the pound, and producing monolithic parts often requires multiples of the actual weight because as much as 90% of the plate ends up on the machine-shop floor as waste. Kaiser has the only mill with excess capacity, so it will be the major beneficiary of the trend. An expansion project started a few months ago.

*Kaiser spent some time in bankruptcy court. How is the balance sheet today?*

**Witmer:** It's strong. Kaiser has \$50 million of debt. Book value is \$950 million, or \$47 a share, twice the stock price. About \$16 of book is a tax asset allowing the company to pay no tax on earnings for many years. I put a multiple on taxable earnings and add back the value of the NOLs [net operating losses on which tax credits are based]. The company probably earned about \$3.50 a share in 2008, similar to 2007. This year is tricky because they are moving around some plant, and spending a little money to make the forged-aluminum business more efficient. They think they'll be able to put some competitors out of business by becoming the low-cost producer. This business makes no money. If they shut it down there will be a cost. If they lower their costs, it will add significantly to earnings.

*How much of their defense business is vulnerable to changes in Pentagon priorities? There is talk of shutting or replacing programs.*

**Witmer:** A major product for them is the plate to protect people in military transport vehicles. That's a growing business as vehicles are sent to Afghanistan. It has made up for some weaknesses in other areas. The airplane build that is ramping up will take up almost all their capacity in monolithic construction.

**Schafer:** Despite the oil-price decline, have there been any cancellations of aircraft?

**Witmer:** There are cancellations, but there are fill-ins from the large waiting list. In 2010, earnings could grow from around \$3.50 to as high as \$6 a share.

*Do they supply parts for corporate jets?*

**Witmer:** They do, although this business is small. There are a lot of orders outstanding from airlines, and a lot of planes getting built are using a lot more product from Kaiser. The company will be in the sweet spot for years to come. Let's say they make \$5 a share and trade for 10 times earnings. Add back the value of the tax assets and you get a target price of more than \$60. Kaiser has a market capitalization of \$500 million. Their rolling mill alone, not including other assets, would cost \$1.5 billion to replace. The company is selling at a huge discount to replacement value.

My next pick is an electric utility, [Allegheny Energy](#). It trades for \$34 a share. Allegheny operates in Pennsylvania, West Virginia, Virginia and Maryland. Its terrific CEO, Paul Evanson, took Allegheny from the brink of bankruptcy in 2003 to investment grade as of May 2007. The company's generation capacity consists of 48 million megawatt hours, sold to 1.6 million customers. Its plants are mainly coal-fired, and its new scrubbers should be in service by the end of 2009, giving it relatively clean electricity production. It is worth owning some electric-utility assets, especially with the focus on electric-powered cars.



Chris Casaburi for *Barron's*  
Meryl Witmer: "There are incredible values, and some incredibly overvalued shares."

Allegheny could earn about \$2.20 to \$2.30 a share in 2008, so on the face of it, it's not cheap. But a series of events should take place in the next three years that have earnings progressing to \$2.90 in '09, \$3.60 in 2010 and \$5 to \$6 in 2011. The events are largely locked in: agreed-to rate increases in Pennsylvania and Virginia and a guaranteed return on its investment in a transmission line that links its western Pennsylvania capacity to power-deficient suburban Washington, D.C.

**Gabelli:** The grid system Obama is planning will help all the utilities.

**Witmer:** And create jobs. Allegheny had a lot of trouble getting this transmission line through. In the end, the unions talked to the governors of the states involved about the jobs it would create. In 2011 the electricity Allegheny generates in Pennsylvania will start selling at market rates, which accounts for the large range of my earnings estimates for that year. The stock could trade for a minimum of 10 to 11 times earnings at that point, giving us a two-year target of 50 to 60 a share. The dividend yield is a relatively modest 1.7%, but the company should be able to increase it.

Most of Allegheny's production will move to market rate, except in West Virginia. In Pennsylvania they get 7 cents per kilowatt hour, which is very low. In New York utilities get 13 to 14 cents. They cut a deal years ago to bring rates up to market over time, and the benefits are finally kicking in. They are installing the scrubbers this year. After that, in 2010, the cash starts coming in.

*And your financial picks?*

**Witmer:** [Assurant](#) is a diversified insurance company. It trades for 30 a share and has 118 million shares outstanding. Its premier business is creditor-placed insurance policies. It is hired by mortgage-servicing companies to monitor homeowner compliance with home-insurance payments. If those payments stop, Assurant places a policy that is billed to the home owner, but whose payment is guaranteed by the mortgage servicer. The rate is about the same as what the homeowner was paying, but the policy insures only the home, not its contents. It is a relatively lucrative contract.

Its home-insurance business has benefited from the current environment. If people aren't making their mortgage payments, they likely aren't making their insurance payments, either. This business has a combined expense ratio of 70%. In other words, it has 30% margins, due to surging business from the housing crisis. Assurant is implementing a similar program with auto insurers, which has good growth potential.

*What are the other business lines?*

**Witmer:** It issues warranty-service contracts on appliances, consumer electronics and the like, another attractive business. It also has a nice employee-benefit business, which focuses on helping small and mid-sized businesses provide insurance for employees. It has a health-insurance business for individuals and small businesses.

Trailing earnings per share is more than \$6, so the stock trades for less than five times earnings. Even if you take out what may be excess earnings from the home-insurance business, which we estimate would bring earnings down to \$4.25, the stock trades for seven times earnings. But the high level of earnings could persist for many years. Plus, Assurant has other growth initiatives, such as the auto business, and some international opportunities. Book value

was more than \$31 a share as of Sept. 30, after taking write-downs on the portfolio. Assurant traded above 70 per share in the past, but 50 is a reasonable target in the next year or so.

*Archie, do you know this company?*

**MacAllaster:** Not well. There are a lot of low P/Es among insurance companies. Some even sell for under book.

**Witmer:** Assurant's book value is solid. It owns high-quality corporate bonds. My final pick is Discover Financial, the credit- and debit-card company spun out of Morgan Stanley [MS] in June 2007. It trades for 9.50.

*It has a lot of things going against it.*

**Witmer:** That's why the price is low. The company has about the most conservative management in the industry, and has managed its capital well. Discover wisely stopped adding cardholders aggressively in California and Florida years ago, unlike other card issuers. Another lender really should buy this for its ability to assess risk.

Discover has its own credit-card network, like Visa [V] and [American Express](#) [AXP]. It has made great strides in getting more acceptance at retailers. It also has a consumer-credit-card lending portfolio and a nice debit-card network. It has a solid balance sheet, with equity to managed assets of 11%. Managed assets include credit-card debt both on the books and securitized.

*How has the loss experience been?*

**Witmer:** Better than competitors. Tangible book value at the end of the Nov. 30 quarter was \$11 per share. The company also won a large antitrust settlement from Visa and MasterCard [MA] that will add about \$2 to book value. The stock is trading for 75% of adjusted tangible book. It's not news to anyone that they will have some credit losses. But with a loan portfolio of about \$50 billion and net interest income of \$4.4 billion, there is room to fund write-offs. We adjust the quarterly provision for loan losses on the income statement to the amount that Discover actually charges off. The company has been building its loan-loss reserve and taking reserves well in excess of its charge-offs. You need to make this adjustment to get apples to apples comparisons over the quarters.

Adjusting for all one-time items, we get annualized earning power of \$1.80 to \$2 a share consistently over the past eight quarters. The stock is trading at about five times our view of earnings and at a significant discount to book value.

*What are they going to report this year?*

**Witmer:** There is noise in the numbers, and they are building reserves. They could earn \$1.70 to \$2 a share, excluding one-time stuff. As the U.S. consumer continues righting his balance sheet, Discover will trade closer to 15 to 20 a share.



Chris Casaburi for Barron's

**Scott Black:** "A lot of the market's performance will be contingent on public policy."

**Black:** What is the growth in receivables year to year, and what is the delinquency rate as a percentage of the portfolio?

**Witmer:** Receivables growth is about 5% to 6%, and the delinquency rate is 4.56% of managed loans. Next year delinquencies could rise toward 6%, but their net yield spread is about 8.5%, so they'll still have income.

No short-sale recommendations? Amazon.com sounds tempting.

still, though Amazon is a good company.

**Witmer:** No shorts. The irrational can get more irrational

Fred, you must be shorting something.

**Hickey:** I'm not, for the first time in years. I've been riding the gold bull market, which has gone up for eight years, and staying out of technology. Tech has been killed. Nine years later, the Nasdaq is 70% below its March 2000 peak. Many top tech companies -- [Microsoft](#), [Dell](#) [DELL], [Intel](#) [INTC] -- are at 1998 levels. Most of the damage has been done. My put options on [Research In Motion](#) [RIMM] and Amazon.com worked fabulously last year. I got rid of my puts in the fall and started buying tech stocks, though I plan to sell them after the Obama inauguration. But some names you could hold through the end of the year. Microsoft is one. At 20, it is lower than 10 years ago, when the company did \$12 billion in revenue. Now it does \$60 billion.

**Witmer:** Same market cap?

#### Meryl Witmer's Picks

Company	Ticker	1/2/09
		Price
<a href="#">Kaiser Aluminum</a>	KALU	\$23.50
<a href="#">Allegheny Energy</a>	AYE	34.24
<a href="#">Assurant</a>	AIZ	30.24
<a href="#">Discover Financial Services</a>	DFS	9.51

Source: *Bloomberg*

**Hickey:** The market cap is similar because they have been buying back shares to offset the dilution due to stock options. The dividend yield is 2.7%. The trailing P/E is 10, something you've never seen for Microsoft. Operating cash flow is \$19 billion a year. Gross margins are 81%, which gives them a lot of flexibility to offset any weakness in the top line. As the economy weakens, Microsoft is able to cut costs.

The market misperceives Microsoft. Its most visible part -- PC [personal computer] operating systems -- is shrinking. Windows is just 28% of sales. Less visible, and growing rapidly, is the server and tools business, at 23% of its revenue, up 17% in the latest quarter. The SQL server database business is gaining market share, and a new virtualization product, Hyper-V, is one of the hottest technologies in the market. The real jewel is the business division, which now contributes a third of revenue. It grew 20% in the quarter. This is Office and SharePoint, a content-management product, and Unified Communications. Information Week called SharePoint a juggernaut. Companies like Pfizer use it to develop wikis and blogs. Microsoft is making a lot of money as a pick and shovel provider to the industry.

**Gabelli:** Why was the case made that they needed [Yahoo!](#) [YHOO]?

**Hickey:** They want to be in the search business. Luckily they didn't get it at the price they first offered, but [CEO Steve] Ballmer is on record saying he'd like to buy Yahoo!'s search-advertising business.

**MacAllaster:** How would you compare [Google](#) [GOOG] to Microsoft?

**Hickey:** Google's stock went from 700 to 300. Even so, I would rather own Microsoft. The stock could go back up to 30 within a year, though it depends if the market makes a bottom in the fall.

**Schafer:** What about technology generally?

**Hickey:** It's a cyclical business, and today it is a part of everyone's life. It is very much exposed to the decline in consumer and business spending. Lots of hardware companies are in trouble. Too many semiconductor companies are still being propped up. There will be a lot of consolidation, and bankruptcies. That's why you want to buy cash-flow-generating businesses.

My second pick is [Cadence Design Systems](#). It fell 80% last year. The company has been around a long time. It is No. 2 in software used to design and develop semiconductors and electronic systems. Competitors are [Mentor Graphics](#) [MENT] and [Synopsys](#) [SNPS]. Cadence sells for under 4 a share. The company had a revenue-recognition problem and several top executives left, including the CEO. There was a failed attempt to take over Mentor. The

company looks to be in disarray, but as with Microsoft, it has lots of flexibility. Gross margins are 78%. Cadence recently announced a significant cost-reduction program, including a 12% cut in its workforce. Up until 2008 it was profitable. Now it's a matter of right-sizing the company, reducing expenses. The stock hasn't been this low since 1994. Five officers and directors bought stock in December, including the interim CEO and CFO, who bought 100,000 shares each. The market cap is around \$1 billion. Conservatively, revenue will be about \$850 million this year, including \$500 million in recurring maintenance and service revenue. The forecast for product revenue is small. There is more cash than debt: \$560 million, versus \$500 million in convertible notes that aren't due until 2011 and 2013. The stock could double.

**MacAllaster:** How could they lose money when gross margins are 78%?

**Hickey:** That's why the CEO is gone.

**Gabelli:** Why did they go after Mentor?

**Hickey:** I suspect they were trying to mask revenue deterioration. When things get desperate, companies typically do things like try to buy other companies.



Chris Casaburi for *Baron's*  
Fred Hickey: "We have a date with more traditional bear-market levels."

On to gold. You have to protect yourself against potential hyperinflation. All the central banks are printing money now. The bull market in gold was rather orderly for the first eight years. We haven't seen the blow-off phase you get in all bull markets. That's coming. In dollar terms, gold was up 5% or so last year. In Indian rupees it was up nearly 30%. The price of almost all other commodities collapsed. I own bullion, the gold ETF [ [SPDR Gold Shares](#) (GLD)], some gold stocks and coins. I couldn't get them as the year progressed because demand was so great. But my first pick today is Market Vectors Gold Miners, an ETF. It sells for 32 and mirrors the NYSE Arca Gold Miners Index, a modified market-capitalization-weighted index of publicly traded gold companies. The top five components are [Barrick Gold](#) [ABX], [Goldcorp](#) [GG], [Newmont Mining](#) [NEM], [Kinross Gold](#) [KGC] and [Agnico-Eagle Mines](#) [AEM].

*How has it performed?*

**Hickey:** The ETF dropped 26% last year, so while gold held up, the stocks didn't do as well. One reason is that oil prices were so high; oil is a key component in production costs. Now crude is falling, which will be a help to gold miners in 2009. The fund has \$2 billion in assets. It has been around since 2006, and the expense ratio is 0.55%. It gives you broad exposure to the gold-stock business.

My second gold pick is [Agnico-Eagle Mines](#). It fell about 6% last year, so it did relatively well. It trades for 51. Not every stock fell in the 1930s, either. Homestake Mining went from 65 a share in 1929 to 500 in 1935. It had two things going for it: rising production and an increase in the price of gold, against a devalued dollar.

**Zulauf:** The U.S. was on the gold standard. It devalued the dollar and revalued gold relative to the dollar, and the price went up to 35 an ounce from 28.

**Hickey:** Gold could go to \$2,000 an ounce this year, or next. The Fed is going to pump all kinds of money into the economy and it won't help. It won't get to corporations or the consumer. But it might get to gold and cause yet another bubble. Gold is one of the few assets that has performed well. And, there is a tremendous shortage of physical gold. In times of turmoil it is a classic hedge against inflation.

**Gabelli:** People withdraw their cash from banks and buy safes and guns and gold.

**Zulauf:** You can't get a safe at a Swiss bank anymore because they are all rented out.

**MacAllaster:** Agnico-Eagle doesn't make much money and pays almost no dividend. It earned more than a dollar a share in 2006 and '07. Earnings were cut in half in 2008 because one mine produces zinc and the price of zinc collapsed. The real kicker is that Agnico will quadruple production, from 300,000 ounces in 2008 to 1.2 million ounces in 2010. Capital expenditures will decline to \$146 million by 2010 from \$900 million in 2008. They have five new mines, in Canada, Mexico and Finland, countries with low political risk. Production costs are around \$300 an ounce.

**Zuluaf:** The industry's break-even is about \$430 an ounce. There is a limited amount of gold in the earth's crust, and most of it is in politically unstable places. It is cheaper to buy mining stocks than build new mines. Hickey: Very few gold miners will grow production or earnings this year and next. Agnico's earnings are going up by orders of magnitude. They'll do 40 or 50 cents this year, and \$2 to \$5 when the new mines come on. Because there is excitement about this company, they were able to do a stock offering in December. There are still a lot of momentum investors. This stock will have momentum.

I also own **PowerShares DB Agriculture** Fund, an ETF and another play on inflation protection. Assets are equal-weighted among four commodities: wheat, corn, soybeans and sugar. The index is rebalanced every November to maintain the weighting. The management fee is 0.75 basis points [three-fourths of a percentage point].

**Gross:** It's not worth 75 basis points.

**Hickey:** It is hard for retail investors to buy futures. It is worth it to them to pay professional managers. The DBA sells for 26 a share. It was down 21% last year.

*If you buy this now, when do you sell?*

**Hickey:** After commodities double. Farmers in Brazil and Argentina are having credit problems. They can't buy fertilizer and tractors. Argentina's wheat output may be down 37% this year. There are issues of supply and demand.

My last pick is the **iShares FTSE/Xinhua China 25 ETF**, which Marc shorted last year. Chinese stocks plummeted 65% in 2008. The bubble burst and they are in a major bear market. This index holds 25 of the largest-cap stocks in China. The fund's top holdings are **China Mobile** [CHL], **China Life Insurance** [LFC], **Industrial and Commercial Bank of China** [349.Hong Kong] and **PetroChina** [PTR]. This is the most liquid China ETF, with \$6 billion of assets. The current price is \$31. The average P/E ratio of the stocks is 11.9, and price to book value is 1.7 times. The management fee is 0.74 basis points and the dividend yield is about 2%. As the world emerges from recession, I want to be invested in China. Unlike the West, it isn't burdened by massive debts.

**Zuluaf:** You don't know that yet. There is a dramatic real-estate overhang, and it was all financed by Chinese banks.

**Hickey:** There may be more problems coming, but the Chinese pay cash for cars. They have \$2 trillion of reserves. There is more opportunity there for growth.

**Faber:** The Chinese economy is in a recession. Emerging markets will have bad economies for some time. But they are reasonably attractive on the basis of valuation.

**Zuluaf:** The Chinese have this mix of a command economy and a capitalist system. It has advantages over our system of free markets and socialism. They are much better at setting long-term goals.

**Faber:** Asian and Arab countries also have a different concept of time and endurance. Nobody has talked about today's horrendous geopolitical situation. There is a huge mess in Afghanistan, Pakistan, India. The Chinese and Russians won't send divisions with tanks to attack U.S. troops in Afghanistan, but they are very good at channeling weapons into the area.

**Hickey:** Good reasons to own gold and food.

**Faber:** I would also consider owning defense-related stocks. There is a transition of power in the world, and countries like China and India are becoming more important. This will lead to tremendous tensions.

**Zulauf:** China's big mistake was gearing almost all of its manufacturing base to the industrialized economy. In the next 10 years it will try and probably succeed at developing more domestic demand. Many countries that have been dependent on the U.S. consumer are realizing they have to change and go their own way. In the next decade you will see different blocs building. This isn't good for the world.

#### **Fred Hickey's Picks**

		<b>1/2/09</b>
<b>Company</b>	<b>Ticker</b>	<b>Price</b>
<a href="#">Microsoft</a>	MSFT	\$20.33
<a href="#">Cadence Design Systems</a>	CDNS	3.84
<a href="#">Mkt Vectors Gold Miners ETF</a>	GDX	33.32
<a href="#">Agnico-Eagle Mines</a>	AEM	50.95
<a href="#">PowerShares DB Agriculture</a>	DBA	26.14
<a href="#">iShrs FTSE/Xinhua China 25 Idx</a>	FXI	31.11

*Source: Bloomberg*

**Faber:** The U.S. had a credit bubble. China had an oversupply bubble and an investment bubble. Suddenly the exports aren't there, so there's a double whammy.

**Cohen:** China's stimulus plan looks a lot like what we expect the Obama administration to put forward. The Chinese are worried about unemployment because thousands of factories have been closed in the Pearl River Delta. They have a shortage of infrastructure. There is a green orientation -- a focus on being more energy-efficient. One big difference is that the long-term focus of government policy here will be raising the savings rate. In China it will be pushing the savings rate down.

**Hickey:** Here's another difference: They can afford the stimulus plan, and we can't.

*Thanks, Fred.*