BARRON'S

Stocks Could Post Limited Gains in 2017 as Yields Rise

Rising bond yields, rich valuations, and global turmoil could limit the market's gains, our experts say.

By
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This could be the year the movie runs backward: Inflation awakens. Bond yields reboot. Stocks stumble. Active management rules. And we haven't even touched on the coming regime change in Washington, which will usher tax cutters and regulatory reformers back to power after an eight-year absence.

Put differently, 2017 could be a year of seismic shifts for the markets and, quite possibly, the world. Or, as Goldman Sachs strategist Abby Joseph Cohen said at this year's *Barron's* Roundtable, "We are breaking a lot of trends."

The 2017 Barron's Roundtable (left to right): Jeffery Gundlach, Scott Black, Felix Zulauf, Mario Gabelli, Meryl Witmer, Brian Rogers, Oscar Schafer, Abby Cohen, Bill Priest *Brad Trent*

One trend we never break at *Barron's* is rounding up some of the world's best investors in early January and submitting them to a grueling grilling about the prospects for stocks, bonds, commodities, currencies, and more as the new year unfolds. This year's interrogation took place Jan. 9 at the Harvard Club of New York, and featured a dynamic discussion of myriad issues, from China's currency to Europe's bank woes to Donald J. Trump's presidential agenda, all of which could reshape the global economy and investment landscape in 2017 and beyond.

Typically, our market seers thrust and parry from breakfast till cocktails, but this year a remarkably cohesive consensus emerged (contrarians, pay attention). With the bond bull market seemingly ending after 35 years, geopolitical risks growing more pronounced, and the market richly valued, U.S. stocks could have a tough time generating more than mid-single-digit returns. The group generally expects stocks to perform well through the year's first half, but sell off thereafter, posting full-year results that could range from down 5% to up 6% or 7%.

Felix Zulauf: Geopolitical Tension Impacts Markets

Felix Zulauf, member of the 2017 Barron's Roundtable and President of Zulauf Asset Management, feels market will rise in first half of 2017 but geopolitical tensions could result in a 15-20% market decline in second half. Gold could rebound.

Our panelists have a dark view of developments in Europe, from the spread of populism to the persistence of negative interest rates, and some fear the euro's days are numbered. In Japan, however, they say the sun is finally rising on equity investors, and opportunities could surface.

This week's Roundtable installment, the first of three, highlights not only the big-picture backdrop, but the best investment bets of Felix Zulauf and Bill Priest. Felix, ever-analytical and ultra-urbane, helms Switzerland's Zulauf Asset Management, but his gimlet eye takes in the whole wide world. Much about the global economy and political scene worries him, and he expects stocks to have a challenging year—after a robust Trump rally, that is.

Bill, the big cheese at New York's Epoch Investment Partners, notes that rising price/earnings ratios did the heaviest lifting in recent years to catapult stocks to fresh peaks. That will change if bond yields head toward 3%, as expected. Now, he says, the burden will fall on earnings and dividend growth to propel stocks higher. Bill, who is laser-focused on free cash flow, flags four stocks with sparkling profit potential, including Google, which goes by the updated moniker Alphabet (ticker: GOOGL) and sparkles in multiple ways.

Bill Priest: Stocks With Solid Earnings Potential

Bill Priest, a member of the 2017 Barron's Roundtable and CEO of Epoch Investment Partners, discusses stocks with double-digit potential for 2017 including Google, Applied Materials and Hexcel.

To learn more about our experts' outlook and investment ideas, please read on.

Barron's: *The world as we know it is changing, or so it seems, and not only because of Donald Trump's presidential victory. Mario, enlighten us. What do you expect the new year to bring?*

Gabelli: Trump's victory meant a rebirth of capitalism, with all its flaws, and a defeat for creeping socialism. It meant the U.S. would remain a place where capital would be honored, as opposed to impaled. Republican control of Congress means regulations will be reviewed and reformed, because the implementation wasn't practical. Our tax policies could be reformed to make U.S. companies more competitive with the rest of the world. Monetary stimulus is ending; fiscal stimulus is coming, and could include spending on infrastructure and revitalizing the military.

The companies and people I've talked to see American innovation taking center stage. We are witnessing a wave of optimism sweeping the country. The question is: How much of the good news has the stock market already discounted? Financial companies will have good earnings this year. The oil ecosystem will improve. But currency translation will remain a problem for some companies, given the strength of the dollar. I continue to look for companies that have been ignored by the market, or unloved.

Brian, how does this year look to you?

Rogers: I agree with a lot of what Mario said. The most important person now isn't the president-elect, but House Speaker Paul Ryan, who will help draft and push through tax reform. Whatever it looks like, in the short term it will have a pro-growth effect. Corporate and individual tax rates could come down, and taxes on corporate cash held overseas could be reduced, allowing for repatriation of that money. Infrastructure spending will also bode well for economic growth. The fact that Paul Ryan will help craft a lot of this means it will have a sane focus.

2017 Roundtable Panelists

Scott Black
Founder and president
Delphi Management
Boston

Abby Joseph Cohen
Senior investment strategist and president
Global Markets Institute
Goldman Sachs
New York

Mario Gabelli
Chief investment officer
Gabelli Funds
Rye, N.Y.

Jeffrey Gundlach
CEO and chief investment officer
DoubleLine Capital
Los Angeles

William Priest
CEO and co-CIO
Epoch Investment Partners
New York

Brian Rogers
Chairman
T. Rowe Price
Baltimore

Oscar Schafer
Chairman
Rivulet Capital
New York

Meryl Witmer
General partner
Eagle Capital Partners
New York

Felix Zulauf
President
Zulauf Asset Management
Baar, Switzerland

Zulauf: Will tax reform apply to 2017 income, or take effect only in 2018?

Rogers: My guess is that a lot of the changes will be retroactive, impacting 2017. The backdrop, in general, will be positive for the first six months of the year. But with the stock market selling at around 17 times earnings, the jury is out on how much upside equities will have.

Schafer: From the time Ronald Reagan was elected in November 1980 until he was inaugurated in January 1981, the market was up 9%. It then fell about 30% through August 1982. I'm not predicting that, but we have had a lot of euphoria.

Priest: There are only three components of equity returns: dividends, earnings, and price/earnings ratios. In the past five years, the MSCI World Index was up 87%. Of that 87%, 74 percentage points came from P/E-multiple expansion. Earnings were down two percentage points, and dividends were up roughly 15 percentage points. The market was up because quantitative easing [central banks' asset-buying programs] effectively lowered the discount rate applied to earnings and cash flow. It had a profound impact. The election was an inflection point, as we can see from the postelection rise in bond yields. P/E ratios now face a serious head wind. It can be overcome with accelerated earnings growth, and tax reform will be a part of that, if it happens. Also, dividends are going to grow, probably faster than people think.

By the way, Jeff made the greatest prediction at last year's Roundtable—that Trump would win the presidency.

Rogers: What about my Chris Christie recommendation? He looked great last January.

Kudos, Jeffrey. What are you predicting now?

Gundlach: People have forgotten the mood regarding stocks and bonds in the middle of 2016. Investors embraced the idea that zero interest rates and negative rates would be with us for a very long time. People said on TV that you should buy stocks for income and bonds for capital gains. This is when 10-year Treasuries were yielding 1.32%. Someone actually said rates would never rise again. When you hear "never" in this business, that usually means what could "never" happen is about to happen. I told our asset-allocation team in early July that this was the worst setup I'd seen in my entire career for U.S. bonds. It occurred to me that the bond-market rally was probably very near an end, and fiscal stimulus would soon become the order of the day.

Schafer: People were also worried about deflation back then.

Gundlach: Based on a comparison in July of nominal Treasuries to Treasury Inflation-Protected Securities, or TIPS, the bond market was predicting an inflation rate of 1.5%, plus or minus, for the next 30 years. Now, that is implausible, and kind of proves the efficient-market hypothesis is wrong. More likely, the inflation rate would increase not in five or 10 years, but one year, because commodity prices had already bottomed. The Federal Reserve Bank of Atlanta's wage-growth tracker is now up 4%, year over year. Oil prices have doubled since January 2016, to around $52 a barrel, which likely means that headline CPI [the consumer-price index] will be pushing 3% in April.

I expect the history books will say that interest rates bottomed in July 2012, and double-bottomed in July 2016. At some point, the backup in rates will create competition for stocks. Bonds could rally in the short term, but once the yield on the 10-year Treasury tops 3%, which could happen this year, the valuation argument for equities becomes problematic. When the long bond [the 30-year Treasury] was at 2%, bonds had a P/E of 50. Compared with that, a P/E of 20 on stocks didn't look all that bad. But if the 10-year yield hits 3%, you could be talking about 4% on the 30-year, which implies a P/E of 25.

Something else happened in 2016: The Fed capitulated, as I predicted a year ago. The Fed gave up on its forecast for higher interest rates and lowered its dot projections for 2017, just when it might have been right. [The Fed's so-called dot plot shows the interest-rate projections of the individual members of its policy-setting committee.] In December, the Fed had to reverse itself and raise rates.

Priest: For the first time in years, the Fed didn't lower its forecast for GDP [gross domestic product] growth in coming years. Central banks and the International Monetary Fund have been dead wrong for years with their annual forecasts for world GDP growth. The danger now is that pressure on P/E multiples will be negative. Unless we get tax reform and more growth in the real economy, the chances of a down stock market aren't insignificant this year.

Gundlach: Fed Chair Janet Yellen suggested a few months ago that running a "hot" economy might not be such a bad idea. But when unemployment is low, wages are rising, and significant fiscal stimulus is likely, inflation could exceed consensus expectations. Jim Grant, the founder of Grant's Interest Rate Observer, wrote a fantastic article a few years ago likening the current environment to the 1940s and '50s. Short-term interest rates were at 3/8s in the late 1940s, and long rates were around 2%-2.5%. Inflation was running at 2%. Everyone had been predicting higher inflation rates, but after a long period of 2%, they gave up. Then inflation spiked to 8%. It came out of the blue.

Gabelli: Does the strength of the dollar change your thinking?

Gundlach: A strong dollar keeps inflation lower. It is helpful to the bond market. A weak dollar isn't helpful to the bond market. However, I brought along a quote from President-elect Trump today because it makes me think. He said, "While there are certain benefits to a strong dollar, it sounds better to have a strong dollar than it actually is." Is it really a given that Trump will bring us a strong dollar if he is supposed to be helping the forgotten middle class?

Scott, join the conversation and give us your view.

Black: First, it is uncertain what kind of legislation will be passed. Second, the Fed's internal forecast for real GDP growth of 2.2% might not be so wrong. U.S. growth will be much better than that of the euro zone. Some caveats on corporate earnings: In the aggregate, they will rise sharply as energy companies improve, but the impact of lower tax rates might not be as great as people think. It will help companies in the Russell 2000 and Russell 2500, which are largely domestic in orientation, but it won't have such a big impact on the capitalization-weighted Standard & Poor's 500, whose largest components do much of their business overseas. Most multinationals, including Apple [AAPL] and Google's parent, Alphabet, already have low tax rates—well below the nominal rate of 25% that could be passed.

Schafer: The companies in the S&P 500, on average, pay cash taxes of 23%.

Witmer: Trump is talking about a corporate rate of 15%, not 25%.

Barron's has recommended a rate of 22% ["Cut the Top U.S. Corporate Tax Rate to 22%," Nov. 26, 2016].

Cohen: There are many things the president-elect might wish to do, but a lot of these changes come under the purview of Congress, and some require a super-majority. We are likely to see tax reform in 2017, along the lines we have been discussing. Both Republicans and Democrats have been talking for at least five years about the need to reform the corporate tax code. It would have happened sooner, but the Democrats didn't want to enact it in a vacuum; they wanted to pair it with individual tax reform. That constraint is now gone.

Also, the new president could adjust some of the executive orders that President Obama engaged in. There has already been widespread discussion about repeal of Obamacare. That can be done under budget reconciliation, which requires a simple majority. But replacing it most likely requires a super-majority.

The Fed's latest policy statement told us two important things: The U.S. economy is growing, and the labor market is improving. GDP growth will probably improve from well below 2% last year to something in excess of 2%. Goldman's estimate for this year is 2.3%. With global capacity tightening, you would expect inflation and interest rates to rise. But the Fed also told us there is a lot of confusion about the possible impact of policy changes in a growing economy. Some proposed changes might notably enhance— and I don't mean that in a good way—the budget deficit. The federal budget deficit could double between now and 2020, and the economy isn't going to grow fast enough to close the gap. We see the deficit going from about 2.5% of GDP to about 5%.

Brian Rogers: In the U.S., "we like large-cap growth, but not small-cap anything." *Photo: Jenna Bascom*

Won't significant spending on infrastructure help to boost the economy?

Cohen: On the infrastructure front, the easy stuff is most likely to get approved in the short term, as part of a corporate tax-reform package. Projects could be funded in part through tax credits or public/private partnerships. Congress is unlikely to approve massive spending on infrastructure, which has been discussed, in the next year or so.

Rogers: The good news is, Jeff is young enough that he still has time to convert and become an equity investor. This discussion raises the specter of crowding out [government borrowing stifling private-sector borrowing]. I am only halfway facetious in wondering whether bonds might become “certificates of confiscation” [as they derisively were called in the 1980s, when yields reached double digits]. It almost sounds like a multiyear bear market is developing in bonds.

Cohen: But we’re starting today at very low yields. In many countries, yields are negative. As I have said in the past, negative interest rates are a fool’s errand. They have not worked to spur growth. The nations that have benefited from negative interest rates have done so mainly through the transmission mechanism of a weak currency, relative to the dollar. They have seen benefits in terms of trade. Negative rates have led to enormous disruptions and haven’t helped the banking systems in various places.

Gundlach: Negative rates are toxic to banking systems. Also, they don’t motivate consumption. They necessitate savings. A 60-year-old who hopes to retire in 10 years and have a 20-year life expectancy beyond that has to save twice as much when interest rates are at zero than when they’re at an old-school 5%.

Nominal GDP is the single best indicator of the secular trend in interest rates. Nominal GDP rose for a couple of decades into the 1980s. Interest rates, as we know, rose in the early ’80s. GDP has been falling annually, with few exceptions, since around 1982. Last year, real [inflation-adjusted] GDP probably grew 2.1%. If fiscal stimulus lifts the growth rate this year to 2.5% to 3%, and you throw an inflation rate of 2% to 3% atop that, conservatively you’re talking about nominal GDP around 5%. How can bond yields stay at 2.4% in that environment?

Cohen: Let’s state the obvious: We are approaching a period of global fiscal stimulus at a very peculiar time. Normally, you would have had fiscal stimulus applied in a more dramatic fashion when the global economy was in recession. Instead, there was a heavy reliance—I would argue undue reliance—on monetary policy. It was the only game in town. A better time to have invested in infrastructure would have been 2009-’10, when the unemployment rate was high, construction workers were looking for jobs, and interest rates were lower for longer. The recession ended in the summer of 2009. It is odd to apply this sort of fiscal stimulus now.

Mario Gabelli, far right: There’s “a wave of optimism. But how much of the good news has the stock market already discounted?” *Photo: Jenna Bascom*

Gabelli: Except that our bridges are defective and there are potholes everywhere.

Cohen: As a country, we have underinvested in capital and labor. On the capital side, we haven't invested in public infrastructure, and capital spending has been insufficient in many industries. On the labor side, we haven't done what is needed in terms of education. Normally, economic growth is related to labor-force growth. Many people believe that one reason economic growth has slowed is because the labor-force participation rate has fallen. Also, there hasn't been enough investment in innovation. In the golden period of the 1950s and '60s, the U.S. spent approximately 4.5% of GDP on basic research and corporate research and development. Now, we spend 2.5%. Much of the decline owes to government defunding at the National Institutes of Health, the National Science Foundation, NASA, and other agencies. Companies have picked up some of the slack, but investments aren't where they need to be.

Priest: It is very hard to get real GDP in developed countries rising by much more than 2.5% a year. The two components of real GDP—growth in the workforce and productivity—are rising at very low levels. Workforce growth is just 1%, and productivity, as measured, is running at well under 1%. But there is a positive outlook for equity markets, provided earnings grow in line with revenue, or better.

Most of you are familiar with the DuPont formula: return on equity equals profit margins multiplied by asset utilization, multiplied by financial leverage. If you substitute technology for labor, profit margins will rise, other things being equal. If you substitute technology for capital, asset requirements will fall, so sales per dollar of assets will rise. The leverage factor measures assets per dollar of shareholder equity. If you don't need all those assets, that capital can be paid out. Payout ratios could surprise on the upside in the next couple of years, because capital's best friend is technology—i.e., robotics and AI [artificial intelligence]. One caveat is that robots don't buy anything, so what you might get on the productivity side, you could lose on the consumption side.

Let's go back to Scott, whom all of you interrupted.

Black: Thank you. I'm not a macroeconomist, but productivity was enhanced from the Industrial Revolution up until about 2006 by waves of technological innovation. As you look at where venture-capital dollars and Wall Street are going now, there has been an orientation toward technological innovation in social media and gaming. Neither has a real effect on boosting productivity.

Meryl Witmer: "I have been impressed by Trump's cabinet picks." *Photo: Jenna Bascom*

They usually hamper it.

Black: We need a new growth wave in technology to push us to a different level.

I believe we are mired in a slow-growth economy. Regarding the strong dollar, 44% of S&P 500 revenue comes from overseas. Non-U.S. profits are about 20% to 25% of the total. If the dollar remains strong, that will depress S&P earnings. The Wall Street Journal published an interesting article recently showing that presidential administrations whose appointees have a lot of experience, especially in business, don't always produce the strongest economic growth. The Kennedy administration's top officials had the least amount of experience, but the highest growth rate of per-capita GDP, at 4.2%. Reagan and Bill Clinton had more people with experience, and GDP rose 2.5%. The administrations of George H.W. Bush and

George W. Bush had people with the most experience, but posted the worst growth, at 0.7% to 0.8%. While Trump might do good things like deregulate parts of the economy, there is no guarantee that America is going to return to an earlier, more robust growth rate.

Gabelli: You are missing the psychological impact: the notion that success will no longer be stepped on.

Scott Black: “While Trump might do good things like deregulate parts of the economy, there’s no guarantee America is going to return to an earlier, more robust growth rate.” *Photo: Jenna Bascom*

Black: We have had a euphoric rally.

Gabelli: I’m not talking about the stock market. I’m talking about the people in the street.

Witmer: As companies grow and build new plants, and see a 15% tax rate and fewer burdensome regulations, there could be a sea change.

Black: Consumer confidence is at the highest level since January 2004, based on the University of Michigan Consumer Sentiment Index. There is some euphoria built into expectations. Whether new policies are realized or not remains to be seen.

Rogers: Scott, I read the same Journal story. It seemed to me that so much had to do with the environment when a president took office.

Cohen: That would suggest that Democrats generated much more jobs growth because the Republicans who preceded them didn’t do a good job.

Abby Joseph Cohen: “We are approaching a period of global fiscal stimulus at a very peculiar time.” *Photo: Jenna Bascom*

Witmer: Or the Democratic Congress preceding them didn’t do a good job.

Rogers: Jeff talked about the risk in bonds. In equities, too, there is a big misunderstanding of risk, almost globally. Everything looked good in early January last year. Then there was a growth scare regarding China, and U.S. stocks fell by more than 10%. Scott referred to euphoria, and it feels like there is a bit of that baked into the financial markets right now, maybe not in fixed income as much as equities.

Gabelli: What is risk? Do you equate it with volatility?

Gundlach: No. People are underestimating the risk of loss right now.

Felix, you have been too quiet. Where do you see the markets, and the world, heading this year?

Zulauf: I agree that bond yields have bottomed on a secular basis. The bottoming process historically takes a long time, whereas peak periods for bond yields are relatively short. The last secular peak occurred between 1979 and 1984. I see high expectations for, and even euphoria about, the new president, and I believe Trump is serious about many of the things he discussed in his campaign. He is a businessman; he will do a lot for business. President Obama was antibusiness, but the stock market tripled during his two terms because he had a great starting point—and the central bank was working for him. Trump is starting out with a highly valued stock market, and the Fed won't be working for him to the same degree. That suggests a different outcome. Future returns for equities will be much lower than what we have seen.

Gundlach: The people whose names have been bandied about as potential Fed chairs under Trump are all pretty hawkish on interest rates.

Zulauf: Bill discussed valuation expansion. The U.S. stock market now is valued higher than it was 95% of the time in the past 100 years. That is a pretty bad starting point for valuation expansion. The Trump era might be much better for Main Street and not so good for Wall Street.

The world is changing dramatically. There are many similarities now to the period before World War I, an unstable time when a new power rose. Germany challenged and provoked Great Britain and France. There was a weak institutional architecture as well, with Austria and Hungary under one roof. Today, China is the up-and-comer. We are exiting a stable bipolar world that had checks and balances. The U.S. and Russia controlled each other, and each controlled its satellites. We had the Pax Americana, a 15-year period in which the U.S. dominated and could do what it wanted.

Under Obama, the U.S. started to reduce its function as the global policeman, and Trump will continue the trend. That creates geopolitical vacuums, and others move in. It happened in Syria, and to some degree in Turkey. Iran is gaining power, too. The world will be much more volatile. Trump's trade initiatives will reinforce the trend toward a reduction in global trade and globalization in general. Trade declined ahead of both world wars.

What is happening in China?

Zulauf: China did everything right until 2008. It had a wonderful period of 10% growth or more for 25 years. Since 2008, policy makers have gone wild, making one mistake after another to keep the economy growing. The growth rate has broken down; it is now between 6% and 7%, or whatever the government publishes. It will continue to slow, because once an economy reaches the size of China's, it can't grow at the same rate as before.

The Chinese are trapped in a debt bubble. Wealthy Chinese have discovered they need to invest outside the country, because business opportunities and returns on real estate and other assets aren't as great in China as they once were. Although there have been tremendous capital outflows, the wealthy probably have less than 10% of their money invested externally. Normally, for an economy at China's stage of development, outside investment would total 25% to 40%. That means there will be more capital outflows, which will weaken the currency, the renminbi.

Next fall, the Chinese Communist Party will hold its 19th National Congress. President Xi Jinping needs to stabilize the currency and economy before then. The government has used its foreign exchange reserves to buy renminbi; reserves are down 25% from the peak. China has only two options: Stabilize the currency by tightening monetary policy, which would lead to a recession, or shut off capital outflows, which, with credit expansion at 40% of GDP annually, could lead to rapid inflation.

Which course will China choose?

Zulauf: They will try a little of both. But the pain for the economy will be too great, so eventually they will let the renminbi go. It could slide to eight or nine to the dollar from about 6.90 now.

The other problem is Europe. As I have argued for many years, the European Union made a mistake by implementing the euro. It strangulated many economies and killed a few million jobs. The centralization of Europe's economy is inefficient, but the European political leadership won't change it. They are married to their idea, as it was designed on a piece of paper. The failure of the common currency has led to the rise of populist movements throughout Europe.

There will be an election in the Netherlands in March; the populist party is leading so far. The more important election is in France; the first round will take place at the end of April, and the two winners will move to the second round. There are four candidates who matter: Marine Le Pen represents the far-right Nationalist Front party. She has a socialist economic agenda. François Fillon, the conservative, has a terrific, almost Thatcher-like reform program. He wants to get rid of half a million government jobs and increase the workweek. He won't be elected in France on that platform. The third candidate, Emmanuel Macron, is pro-EU and wants to further economic integration. That doesn't ring a bell with most people in France. The fourth candidate, not yet chosen, will represent the Socialist party. I predict the Socialists will drop out in the first round.

And the winner is?

Zulauf: Le Pen has a much better chance of winning than most people think. If she is elected, she has said she will launch a referendum on membership in the EU and the euro zone both. Le Pen would tear down the institutional architecture of Europe, and chaos would ensue. In the first half of the year, the market will focus on Trump and celebrate his moves. But there are many risks outside the U.S.

Cohen: The creation of the euro hasn't been an impediment to Germany. It has benefited in terms of trade. Given that backdrop, are you surprised by the political tension within Germany?

Zulauf: Germany superficially is a big beneficiary of the current structure. It has doubled its exports to 50% of GDP since the introduction of the euro. But it will lose out on Target2 [a European payment system enabling the settlement of transactions with central bank money]. Germany has claims on 750 billion euros [$797 billion] against other EU countries, with Spain and Italy each accounting for more than €300 billion of those liabilities. If the currency union breaks apart, do you really believe they will pay Germany?

Priest: Italy is the Achilles heel on the European economic front. It is the eighth-largest economy in the world, and it has the fifth-largest amount of sovereign debt outstanding. Its Target2 balances are astonishing. Money has flooded out of Italy, and the banking system is sitting on a crisis.

Zulauf: Germany looks like the big winner. But when you look more closely, and include Target2, things won't actually work out as they seem.

Gundlach: And the German population doesn't quite understand this. According to ,a poll by Pew Research Center, 38% of Germans disapprove of the EU's handling of economic issues. In France and Italy, two-thirds-plus of the population are dissatisfied with the EU. In polling terms, that is enormous. Those countries have almost maxed out on dissatisfaction.

Gabelli: Then there is Europe's immigration issue, and the fact that these countries always bailed themselves out by devaluing their currencies, which they are currently unable to do.

Zulauf: The immigration problem is just the tip of the iceberg. It isn't the key problem. Protests against the establishment are growing throughout Europe, but the establishment has no rules on how to break up the European Union purposefully. When it happens, chaos is guaranteed.

How smoothly will Britain be able to exit the EU, now that it has voted to do so?

Zulauf: Discussions will start in the spring, and they will be nasty. The EU will be tough and seek to demonstrate to all members that exiting is not an option. It is very costly. The process will create a lot of turmoil, which isn't good for global economic growth. Global trade will continue to decline.

The U.S. stock market sold off momentarily after the Brexit vote and then recovered and went to new highs. How will U.S. stocks respond if anti-euro parties gain more power in Europe?

Zulauf: As soon as there is a greater-than-50% risk of the euro's failure, the markets will sell off, and not just for a day. Capital doesn't want to get involved in chaotic situations.

Gundlach: U.S. stocks took off on the upside for real in 2012 when Mario Draghi [president of the European Central Bank] largely pushed aside fear of euro-zone breakdown by saying policy makers would do "whatever it takes" to preserve it. There is empirical evidence for what you said.

Zulauf: I expect the dollar to remain strong, not because the U.S. is so powerful, but because the other options are so weak. You can't put your capital in China or Europe or the U.K. In the U.S. you have a pro-business president and a relatively free market.

Gabelli: And rule of law for capital.

Meryl, what excites you about 2017—and what worries you?

Witmer: For corporations, lower taxes, and less regulation are absolute heaven. If the corporate tax rate falls to 15%, as President-elect Trump has proposed, why would you do business anyplace else? And if business ramps up as I expect, companies will need to hire more people. There are a lot of underemployed people in the U.S. who would like to work. Also, we might see an increase in allowed immigration.

On the other hand, equity valuations are stretched somewhat, although there are pockets of value in the market. I don't see the market taking off this year, but things could look good if Congress doesn't screw them up. I have been impressed by Trump's cabinet picks. Hopefully he will do well, and if so, longer-term, the markets will do well. It is fascinating that Trump can be so effective simply by tweeting.

Gundlach: The shift in sentiment to positive from negative, regarding the efficacy of Trump is one of the biggest I've seen in my career. I wonder if sentiment can swing just as quickly the other way. Many people who voted for him think something is going to change for them. They expect their wages to rise, and America to be "great again." What will happen by July or August if nothing has changed? Put that together with the timing of an interest-rate rise, and we potentially could see a very different psychological environment.

Rogers: The pushback could come in the midterm elections. Trump might get a free pass for two years. But you could almost fantasize—or hallucinate, depending on your leanings—a Democratic resurgence if he doesn't deliver for the people you described. The Republican majority might hold in the House and Senate, but the party could lose many seats.

Oscar, where do you stand on these issues?

Schafer: Ray Dalio [the founder of Bridgewater Associates] might have put it best when he asked: Will the Trump administration be aggressive and thoughtful or aggressive and reckless? There are so many uncertainties this year. Higher earnings and higher interest rates are yin and yang. It could be a tough year for the market, but a good year for stockpickers.

We've heard that one before.

Cohen: But this year, it will be correct. I'm with Oscar on the importance of stock selection.

Let's put some numbers on all your market pronouncements. By how much will U.S. stocks rise in 2017?

Schafer: The averages will be up 4% from the start of the year. But there will be big winners and big losers.

Black: I like to go by the numbers. At this time last year, the consensus forecast for 2016 S&P 500 earnings was $126. The consensus is predicting that actual results will come in at $108.84. The consensus for 2017 is $130.84, which would imply a 20% increase. There is no way, with 4% nominal GDP and a strong dollar, that earnings will get there, even with energy-company profits improving. My forecast is closer to $123.

The market currently trades for 18.5 my expected earnings for this year. The historical average is closer to 16.5. The small-cap Russell 2000 index and the mid-cap Russell 2500 finished the year, respectively, at 28 times and 24 times 2016 estimates, and 23 and 21 times forward earnings estimates. Small- and mid-cap valuations are in nosebleed territory. That said, there is the potential for more gains because of bullishness about the Trump administration.

I expect the S&P 500 to rise about 5%. Add a dividend yield of just under 2%, and you get a total return of about 7%. I agree that it will be a stockpickers' year. Many sectors are ahead of themselves. For example, regional banks generate an 8% to 10% return on equity. After a huge rally, they are selling at 16-17 times earnings. Shares of Deere [DE] and Caterpillar [CAT] went way up, while their earnings power went down. You have to be value-oriented. Value will outperform growth again.

Zulauf: Stocks could easily rise another 10% into the middle of the year. But after a soft period, bond yields will rise again, with the 10-year Treasury yield hitting 3% or going a little above it. That will trigger a big correction in equities, just when everyone is fully invested after buying into the Trump rally. I expect the S&P 500 to be slightly negative for the full year.

Gundlach: Did I give you my notes? That is almost exactly my view.

Rogers: Almost every year, the S&P 500 is off at least 10% at some point. With a starting P/E of about 17.5 times expected earnings, it is tough to argue for a gain of much more than 6% or 7%, especially in a rising-interest-rate environment. There are a lot of head winds this year. We could have another China scare, or something else that knocks stocks down a bit in the first half.

Felix Zulauf: "Europe offers value, but is probably a value trap. U.S. investors should stay away. Japan has much better fundamentals." *Photo: Jenna Bascom*

Zulauf: It might not be a scare. It might be the real thing.

Priest: Start with what you know. The cash yield on the S&P 500 is 2%. Add nominal GDP of 3% to 5%. Given the current level of P/E ratios and the head winds coming from rising rates, I'm in the 5% to 6% category regarding the market's potential gain. Geopolitical risks are higher now than they have been in many years, and volatility may well be above average this year as well.

Gabelli: I use a somewhat different model. If inflation rises to 3% and real GDP growth rises 3%, we're talking about 6% nominal revenue growth for U.S. companies. The gross margin will decrease, due to rising labor costs. But selling, general, and administrative costs won't rise as quickly, so operating-profit margins might improve slightly for many companies. Lower tax rates will help earnings dramatically.

With interest rates rising, the discount rate on pension plans will rise, leading to reduced cash contributions. I expect cash flow at U.S.-centric companies to exceed reported earnings by a significant amount in the next few years. I also expect increased mergers and acquisition activity. More challenging is how to address the deficit and other structural issues. I see zero to 5% growth for the stock market.

Are you concerned that the deductibility of interest expense might be eliminated?

Gabelli: No, because any change would likely be grandfathered in debt. Let me ask you: A guy from Queens will soon be president. He has been trained in the world of New York real estate. What do you do think he thinks about leverage?

What does Paul Ryan think about leverage?

Gabelli: As Abby said, both parties have been discussing tax reform for years. They are going to get a bill passed, starting with individual taxes. They will increase the earned income credit and recycle money back to the worker.

Cohen: This is the toughest year to forecast. We have a good sense that the economy will grow by 2% to 2.5%. We're pretty sure that corporate earnings will be up about 10%. But we don't have a good sense of the geopolitical environment or tax and regulatory changes in the U.S. There are questions about repatriation of corporate cash. My forecast for stocks assumes the first half of the year will look pretty good because economic forecasts are baked in the cake. But questions arise about the latter half, particularly as geopolitical uncertainty outside the U.S. intensifies.

Goldman Sachs forecasts that the S&P 500 could spend much of the year trading in a range of 2300 to 2400. Last year, in giving the house forecast, I said I thought the risks were skewed to the upside. It turned out that was the case. This year, the risks are skewed to the downside. Good things could happen with regard to corporate tax reform, but other things that aren't so pleasant could occur in the interim.

Zulauf: None of your forecasts include the possibility that if Trump gets tough on trade with other countries, there will be retaliation. It isn't a one-way street.

Gabelli: China is dumping steel through Vietnam and other countries. This isn't fair trade.

Zulauf: I am not saying Trump is wrong, only that he could start something that might affect U.S. companies negatively. The Western capitalist model promotes corporate profit. The Chinese model is designed to promote employment. The conflict is growing between the two models. That is the problem.

Gabelli: The reality is that this country was run by people who had no clue how to trade. They didn't know how to bargain. As that Nobel Prize-winner Bob Dylan said, "The times they are a-changin'."

Felix Zulauf's Picks

Investment / Ticker	Price 1/6/17
BUY	
Vanguard Value /VTV*	$93.88
iShares Russell 2000 /IWM*	135.69
Financial Select Sector SPDR /XLF*	23.54
WisdomTree Japan Hedged Equity /DXJ	51.19
SHORT	
Investment	**Price 1/6/17**
10-yr. Italian Govt. Bond Future**	€134.11
10-yr. German Govt. Bund Future**	162.84

*Sell at mid-year. **Mar. 17 contract. Source: Bloomberg

Based on your forecasts, the good news isn't good for stocks, and the bad news is worse for stocks. Do you see any scenario that could produce a double-digit return?

Cohen: Historically, there have been periods when both interest rates and stock prices moved higher, because the rise in yields reflected a strengthening economy.

Gundlach: GDP growth has been unbelievably stable at 2% for the past six or seven years, despite quantitative easing and other nutty interest-rate policies. At last year's Roundtable, I said the easiest forecast was that the Fed wouldn't raise interest rates four times during the year. We are going to break out of the land of stability this year, and certainly by 2018, and there will be an inflation surprise. That isn't going to be helpful for equity valuations.

Like Felix, I look for the stock market to make new highs in the first part of the year, but when rising interest rates bite, stocks will fall. I see a single-digit decline for the full year.

How do you build a portfolio to handle such a wide dispersion of possible outcomes?

Gundlach: Some things should be avoided in a major way because they have risk without rewards. One of the greatest trades of the year could be shorting German Bunds, but I will share more details later. Portfolios need to diversify away from deflation-oriented trades, which worked for a long time.

Zulauf: On the Bunds, a lot of money is flowing from southern to northern European banks within the euro system. The ECB is paying a negative rate on deposits. There has been heated discussion about the problem within the ECB, and it is conceivable that the ECB will remove negative-interest-rate charges earlier than people expect.

Cohen: The underlying theme of a portfolio has to be reflation. In an environment in which rates are likely going up and yield spreads have narrowed dramatically, fixed- income markets are a dangerous place to be. The stock market, in our view, isn't as expensive as some people think. Using certain discounted-cash-flow models, it looks high, but on an earnings-yield basis, not so much.

The durability of the economic expansion matters, too. If you believe that GDP will grow by at least 2% in the next year or two, and that S&P profits will rise, the stock market doesn't look overpriced. There are bigger pockets of opportunity within the stock market.

One big change in our industry in the past 20 years has been the move to passive investing. According to Zacks, there have been four new exchange-traded funds launched every day since the end of 2014. According to The Wall Street Journal, Vanguard passive funds held a 5% ownership stake in only three S&P 500 companies in 2005. That number is now 468. Given the incredible shift of money into index-

oriented ETFs, I wonder, where is the price discovery? Where is the valuation discovery? Stockpickers have been waiting for this trend to reverse. The chance is high that we will see some sort of reversal this year. We are breaking a lot of trends this year. We are breaking trends about a multidecade bull market in bonds, and trends about equities. The easy work on P/E multiple expansion has been done, as Bill noted. There could be a real advantage to good active management this year.

I am concerned about Europe's long-term growth rate and political risks. One market that might do better is Japan. Government policies are having some benefit. Fund outflows have stopped, and inflows are growing. Many investors view Japan as a way to participate in growth in Asia without being exposed to accounting concerns and disclosure issues in places like China.

Would you buy Japan on a currency-hedged basis?

Cohen: Currency hedging isn't a part of my recommendation. The yen has already weakened significantly, relative to the dollar.

Priest: The index-fund trend has been turbocharged in the past five years. When most of the market's return owes to multiple expansion, indexing is an ideal way to win. If we have entered a new regime, with earnings and dividends starting to drive total return, the opportunities for active management are only going to get better. Lower correlations are good for active management.

Gundlach: People say bonds are in a bubble, that they are over-owned. I agree with that. But anything that is momentum-driven is in a bubble. This passive stuff is in a bubble.

Gabelli: So what is your portfolio mix?

Gundlach: I'd recommend about 30% in fixed income, but you need a fixed-income allocation that is unlike a bond index. I'd also recommend a higher allocation to real assets, maybe as much as 20%. You could buy a commodity fund. Then I'd put 50% in equities, with a tilt away from the U.S. Valuations are out of control here based on the CAPE Shiller P/E ratio [price divided by inflation-adjusted earnings for the previous 10 years]. U.S. investors are provincial. Now is the time to move off your zero non-U.S. allocation. I like Japan and India. It is the new China.

Cohen: India is going through a difficult period because of some anticorruption efforts, including the withdrawal of high-value bank notes from circulation. But the secular growth rate there is approaching 8%.

Gabelli: To hitchhike onto Abby's comments, inflation is picking up. That means you want to own companies with pricing power. Getting inflation-indexed assets into your portfolio is the way to maintain purchasing power. Also, utilities have done well. If rates go up, maybe the industry will see another round of consolidation. We like companies that could be the object of corporate lovemaking. A proposed reduction in the tax rate on dividends is an interesting dynamic.

Rogers: Regarding portfolio construction, we love short-duration high-yield bonds, but be security-specific. We like floating-rate bonds, vehicle bank loans, and emerging market bonds. We like frontier markets and developed markets outside the U.S., including Japan. Within the U.S. equity market, we like large-cap growth, but not small-cap anything.

Because of the valuation, presumably.

Rogers: Yes. We haven't talked too much about real estate. There are some unusual things going on in the real-estate world. There is overbuilding in the apartment sector across the country, which is worrisome. Over the weekend, I heard a radio commercial related to house-flipping. It brought back bad memories from the prior decade.

Let's go quickly around the room. What will we be talking about at this time next year?

Gabelli: We will be discussing the successful reform of regulations that made no sense, that our taxes are being lowered, and that sanctions on Russia will be removed.

Priest: Europe has gigantic geopolitical issues.

Rogers: There will be a renewed focus on the coming midterm elections. Also, an unexpected but positive development could be improved relations between China and North Korea and the U.S.

Cohen: The bloom will be off the rose regarding expectations for policy changes. In some categories, government is moving in a better direction, but progress will be spotty.

Witmer: We might be talking about increases in productivity at U.S. companies because of reduced regulation, and how that will be good for stocks in the following year.

Gundlach: Trouble in the euro zone.

Schafer: We'll be talking about how right we were at the 2017 Roundtable, and that despite what happens in Congress and with the presidency, America stays on course.

Black: We'll have to see how Trump's proposals are implemented. We need to see the notion of American exceptionalism re-emerge. Our geopolitical leadership must improve.

Zulauf: We will ask ourselves whether gold will offer protection from the geopolitical turmoil into which the world is sliding. I suspect it will, but I won't be a part of the discussion, as I have decided to step down from the *Barron's* Roundtable after 30 years. [Sustained applause]

Felix, Barron's can't thank you enough for your generosity and thoughtful contributions over the years. Before you go, where do you advise putting money in 2017?

Zulauf: Again, I expect animal spirits to take global equity markets higher into midyear. Then you have to get out. Markets could decline in the second half, probably falling below where they started the year. The best approach is to play sectors and groups and markets that have been performing well since the presidential election. They are all a little extended and could pull back, but then rally again. I recommend buying the Vanguard Value ETF [VTV], a value index, and the small-cap iShares Russell 2000 [IWM]. Value stocks and small stocks could do well.

Schafer: We just heard that the Russell 2000 trades for 23 times forward earnings. Do you think it still has room to rise?

Zulauf: Yes, into the middle of the year. The same goes for financials. They will benefit from the steepening yield curve. They also need to pull back a little, but could then do well into the top I see. I would buy the XLF [Financial Select Sector SPDR].

Europe offers value, but is probably a value trap. U.S. investors should stay away. Japan has much better fundamentals. The economy is doing well. The corporate sector has strong balance sheets after 20 years of deflation and restructuring. The trigger for a market rally is that the Bank of Japan has declared that it will freeze the yield curve, which guarantees, at least for a while, easy money and more money-printing than in other parts of the world. The government is actively encouraging the purchase of Japanese stock. The central bank buys about $10 billion a year of Japanese equities and has been encouraging institutions to shift from fixed income into equities. Stock ownership in Japan has been low since 1990.

Are institutional investors doing as told?

Zulauf: They will buy stocks once the currency weakens and fixed-income returns turn negative. The Japanese stock market and the yen are both extended and could pull back. The dollar/yen exchange rate could retreat to 112. Once that happens, it could break out to the upside and go to 125, the high in the prior cycle. The currency ratio is critical for the corporate sector's earnings power because Japan has a lot of multinational corporations. Japanese corporate earnings have grown about three or four times as much as U.S. earnings in the past five years. The Japanese market is underrated. I would buy the WisdomTree Japan Hedged Equity ETF [DXJ]. It is currency-hedged.

I would short 10-year Italian bonds and German bunds in the futures market. The Italian bond futures trade at €134, and the German bund futures at €163. Yields on both bonds are correcting a little after the recent rise and have more to go. Inflation in Germany is at 1.7% and probably will top 2%. The yield on the 10-year is 25 or 30 basis points [100ths of a percentage point]. Italian 10-year bonds yield 1.90% to 1.95%. If the euro system begins to decay and Europe eventually reverts to national currencies, the Italian bond market will get destroyed. Shorting it is a hedge against European turmoil.

Would you buy gold as a turmoil hedge?

Zulauf: The gold price just had a pop, but gold is in a long-term bear market that started in 2011 at $1,920 an ounce and bottomed in December 2015 at $1,046. A counter-trend rally took the price up to $1,350. Gold is now in the process of falling out of favor again. This is the wrong time to buy gold because nominal and real interest rates are rising. We'll need to see more turmoil, as well. And India's recent moves could put a damper on gold. The government took the two largest bank bills out of circulation. Some of those bills had gone into the black market and were used to buy gold. Later this year, or early next year, it will be time to buy gold again on a long-term basis.

Once again, Felix, thank you. Let's move on to Bill.

Priest: Earlier today, we talked about drivers of total return. The S&P 500 rose 98% in the past five years, and, as I noted, two-thirds of the increase came from P/E multiple expansion. The rest came from earnings growth and dividend payments. The P/E multiple went from 12 times forward earnings in 2012 to more than 18 times in 2016. Now we are going to start to see the movie run backward. P/E expansion will be under pressure, and earnings growth and dividends will have to offset the impact of declining P/Es.

There has been a substitution of technology for capital and labor. Profit margins are expanding, and return on assets is rising as a result. If companies don't need to pour so much capital into the business, payout ratios will rise. Whether the money is used to pay dividends or repurchase shares or pay down debt doesn't matter to me. All are forms of capital being returned to shareholders. Rising payout ratios will be a plus for the market. At the end of the day, it is all about capital allocation. There are only five uses of free cash flow: You can pay a dividend, buy back stock, pay down debt, make acquisitions, and invest in the business.

Witmer: Or let the money sit on the balance sheet as dry powder.

Rogers: You could increase compensation!

Priest: But not for long. Sooner or later, that cash is going to be distributed. If you can reinvest capital at a premium to the cost of that capital, you should reinvest in the business or make acquisitions. If you can't, give the money back to shareholders or pay down debt. We expect to see a continued high level of merger and acquisition activity, although it will start to diminish if interest rates keep rising, because of the premium that can be earned over the cost of capital is going to shrink. That's my investment backdrop. I want to be U.S.-centric. Japan is a favored non-U.S. market. Europe appears to be in trouble.

And your favorite stocks?

Priest: Alphabet, the parent of Google, is one name we like. Google is the largest search-engine advertising service, and YouTube, which it owns, is the leading online video service. The company has a market capitalization of about $560 billion, and trades for 17 to 18 times earnings, after deducting net cash on its balance sheet. The free-cash-flow yield is on the order of 7% looking out to 2018, also after deducting net cash. The shares have a lot of upside given the double-digit cash-flow rates we expect.

Bill Priest: “Alphabet’s, or Google’s, shares have a lot of upside, given the double digit cash-flow rates we expect.” *Photo: Jenna Bascom*

Applied Materials [AMAT] is another stock we like and have owned for a while. The company supplies semiconductor-manufacturing equipment. It is a capital-intensive business. *The Second Machine Age*, by Erik Brynjolfsson and Andrew McAfee, is one of my favorite books. It was published in 2014 and deals with how technology is transforming our economy. Consider Moore’s Law, which stipulated that the performance of a semiconductor chip would double every 18 to 24 months. That has occurred and enabled cloud computing and other advances, including driverless cars. Applied Materials is in the sweet spot. We believe the company will generate $3 a share in cash flow in fiscal 2019. At a 14-times multiple, that suggests a stock price of $42. The stock is at $32 a share now.

A third stock we like is Universal Display [OLED]. The company develops OLED [organic light-emitting diode] materials used in next-generation cellphone screens, TVs, and other applications, and obtains royalties and license fees when companies make OLED screens. It has a monopoly on phosphorescent emitters used in next-generation displays. Our one-year price target is $85; the stock trades around $57 today. There is a long runway to growth; as penetration increases, the stock could top $100 a share over time.

Witmer: Is any company close to being able to compete with Universal Display?

William Priest's Picks

Company / Ticker	Price 1/6/17
Alphabet / GOOGL	$825.21
Applied Materials / AMAT	32.04
Universal Display / OLED	57.50
Hexcel / HXL	51.09

Source: Bloomberg

Priest: That is debatable, but right now, no. The company has deals with LG Display [034220.Korea] and Samsung Electronics [005930.Korea] and others, which use a lot of its products. Its patents are good. The next challenge is getting the color blue right, or so experts tell me. That is what Universal Display is working on. This is an unusual name for us. The stock appears expensive, based on current cash flow, but we expect cash flow to triple over the next few years. Epoch has a significant position, although we don’t own more than 10%.

Thanks for the disclosure.

Priest: Another pick is Hexcel [HXL], one of the few suppliers of high-grade carbon fibers and advanced composite materials, primarily for aerospace applications. The company has a market capitalization of just under $5 billion, and a modest amount of leverage, equal to about 1.5 times Ebitda [earnings before interest, taxes, depreciation, and amortization]. The management team is solid. The stock trades for 17 to 18 times 2017 expected earnings of about $2.75 a share, and 16 times 2018 estimates of $3.15. There is an eight-year backlog at Boeing [BA] and Airbus [AIR.France]. Production will ramp up in the next few years. Hexcel is a play on the aircraft industry working off that backlog. Its annual revenue could grow by the mid- to high-single digits, given the increasing penetration of composite materials, not only in the main body of a plane, but also the wings and engines. As revenue and earnings rise, Hexcel will probably buy back more shares.

In last year's second half, the high-flying FANG stocks— Facebook, Amazon.com, Netflix, and Alphabet— were defanged. Do you expect the shares to lift off again this year?

Priest: We aren't believers in "dream" investing. Tesla Motors [TSLA] is an example. They have no free cash flow. You can look at stocks as you do bonds. When interest rates go down, a 30-year bond goes up more than a 10-year bond, which rises more than a two-year bond. When that discount rate is falling, growth stocks go up the most. Now that rates are starting to rise, there is pressure on growth-stock multiples. We expect value and cyclical stocks to outperform. But we happen to think Google and companies like it that possess rapidly rising cash flows can offset the impact from rising interest rates on their valuations.

Thanks, Bill.