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BARRON'S COVER

Bright Outlook for the Economy and Stocks

By Lauren R. Rublin January 13, 2018

Top row: (from left) Meryl Witmer, William Priest, Henry Ellenbogen, Jeffrey Gundlach, Paul Wick. Bottom row; (from left) Abby Joseph Cohen, Oscar Schafer, Mario Gabelli, Scott Black.

The members of Barron's 2018 Roundtable arrived at our annual gathering in a jolly mood. And why not? U.S. stocks returned an impressive 20% last year, and are off to the races again this year, propelled by expectations of good economic growth and robust corporate earnings.

Our panelists, who spent Jan. 8 talking with the editors of Barron's at the Harvard Club of New York, generally expect more of the same in the months ahead—more gains for equities, large-cap and small, as the global economy enjoys the most coordinated level of growth since the Eisenhower administration, notes Epoch's William Priest. Few things these days, on Wall Street and elsewhere, merit that comparison.

Helping the economy and profits, say our investment experts, is a spanking-new tax law that will lower corporate rates and encourage companies to repatriate cash that had been sitting overseas, including in enterprises established expressly to hide the dough from the tax man. No more; as the money flows home, expect fresh investment stateside; more mergers and acquisitions; and, yes, more dividend payments and stock buybacks to fatten investors' wallets.

Not everything is rosy, of course. Our resident bond maven, Jeffrey Gundlach, is keeping a wary eye on Treasury yields, which have been creeping higher in recent months. If yields continue to rise—a distinct possibility as the economy strengthens and the Federal Reserve moves to tighten credit—all bets could be off for stocks. Or, as Roundtable newcomer Paul Wick put it, if rates go up, "the discounting mechanism is going to take a chain saw" to stocks with extravagant valuations. Ouch.

Our panelists also worry about a potential resurgence of inflation and credit-tightening on a global scale. They question the future of bitcoin, but not the blockchain technology that underlies it. And they extol the transformative power of technology across industries and markets.

This year's heavy focus on tech is a reflection, in part, of our Faang-driven market, led by the likes of Facebook (ticker: FB), Apple (AAPL), Amazon.com (AMZN), and other platform technology companies. It probably also relates to the Roundtable's newest additions. Wick, a Silicon Valley-based portfolio manager at Columbia Threadneedle Investments, is lead manager of the $6.2-billion-in-assets Columbia Seligman Communications & Information fund (SLMCX), and an expert in semiconductor stocks. Henry Ellenbogen helms the $20 billion-plus T. Rowe Price New Horizons fund (PRNHX), which invests in public companies and private start-ups, and returned a whopping 31.5% last year. Morningstar announced on Thursday that Ellenbogen is a candidate for its 2017 U.S. Fund Manager of the Year award.

In this week's Roundtable installment, we relate the panel's big-picture discussion. In next week's issue, we'll follow up, in print and at Barrons.com, with the panelists' specific investment picks for the new year.

Barron's:Last year was a perfect year for investors in many ways. Will the good times keep rolling in 2018?

Abby Joseph Cohen: Yes, and no. Yes, because the economic fundamentals are good. One of the reasons 2017 was a good year for the markets was because the economy accelerated globally. There are signs of sustainable growth everywhere; the momentum will continue for a while. U.S. gross domestic product is likely to be lifted somewhat this year because of the tax cut. It should benefit economic growth beginning early in the year; we'll find out together whether the impact is lasting. The new tax law also will foul up first-quarter earnings announcements, as companies in many different industries will be affected by changes in the accounting for deferred tax liabilities. Beyond that, we'll get a better sense of what U.S. companies do with the money they repatriate from overseas. If the funds are used for long-term investment and capital spending, that could stand us in good stead for the future.

But I worry that this tax cut is happening at a time when the U.S. economy doesn't need fiscal stimulus. And longer term, what will tax cuts do to the federal deficit? The deficit was going to be rising as a percentage of GDP anyway, partly for structural reasons relating to the aging of the baby boomers. A $1.5 trillion tax cut will add an additional $300 billion to $400 billion interest-rate burden in the next few years.

What is Goldman's GDP forecast for this year?

Cohen: We expect U.S. GDP to grow by 2.7%, about half a percentage point higher than it would have been without the tax changes. We are also positive on the rest of the world. Europe's improvement is sustainable. China's growth will be a little slower this year, partly due to regulatory changes, including a stronger emphasis on pollution control. But that will tamp down economic activity only temporarily.

Abby Joseph Cohen

Advisory director and senior investment strategist

Goldman Sachs

New York

Jeffrey Gundlach: Abby has touched on one of the most important points—the sustainability of economic growth. We can't find a recession anywhere. You never get a recession without the Index of Leading Economic Indicators falling below zero. In the U.S., it is up 5%-plus, year over year, and the trends look to be persistent. The soft data, including the Purchasing Managers' Index and measures of CEO and small-business confidence, are all at high levels. These types of sentiment indicators fall off a cliff in front of a recession.

One of the better indicators of a recession is a widening spread between junk-bond and Treasury yields. The spread has widened a little, but nowhere near the 100- to 200-basis-point type of widening you'd typically see. [A basis point is a hundredth of a percentage point.] Junk bonds usually are highly correlated in performance to the Standard & Poor's 500 index. In 2016, both did about the same. Last year, however, junk bonds were basically unchanged in price, while the S&P 500 rose about 20%. There wasn't a lot of demand for junk, given low yields. In essence, we leveraged up the equity market, the bottom part of the capital structure, which is a bit disconcerting. The reemergence of the Goldilocks economy and market is somewhat reminiscent of 1998-99. The market is priced for a lot of good things to happen. The S&P 500 looks to be entering an acceleration phase this year.

Where are interest rates headed?

Jeffrey Gundlach

CEO and
chief investment officer

DoubleLine Capital

Los Angeles

Gundlach: Let's look to the dollar. One of the biggest mistakes investors made last year was assuming the dollar would strengthen because the Federal Reserve would raise rates and Europe would remain committed to quantitative easing. Yet the dollar was weak. Most investors don't understand that it isn't the near-term move of the Fed that affects the currency. That is priced into the market. The value of the dollar correlates to what the Fed will do in the next 18 months. The market doesn't believe the Fed will raise rates much in 2019. In fact, the bond market believes it is more likely that the European Central Bank will hike rates by a small amount.

What do you believe?

Gundlach: I tend to believe the market.

Mario Gabelli: In English, what are you saying? Will the Fed hike rates in 2018?

Gundlach: I expect the Fed to hike twice in 2018. Long rates in the U.S.—yields on the 10-year and 30-year Treasury—are near extraordinarily critical junctions. The 10-year yield has already broken above its long-term downtrend line, at around 2.5% to 2.6%, but not terribly convincingly. The 30-year hasn't broken above its downtrend line, at about 3%, although it is close.

Mario Gabelli

Chairman and CEO

Gamco Investors

Rye, N.Y.

Everything hinges, Mario, on the ECB. Will 10-year German Bunds continue to yield just 40 basis points? I have a hard time believing so, because the economic data in Europe have improved greatly. Nominal GDP in Europe isn't that different from nominal GDP in the U.S. Nor is inflation. European manufacturing is doing well, and retail sales in Europe are probably better than here. What I find puzzling is that interest rates are negative on short-term bonds in Europe and the ECB is spending 30 billion euros [$36.6 billion] a month on quantitative easing [buying assets to lower interest rates and stimulate economic growth] while we are hiking rates. A lot of bonds will be coming up for sale here in the next year.

Gabelli: The benefits of the tax cut will be powerful psychologically, as well as economically. Do you buy that?

Gundlach: Yes, but the narrative might evolve as we move toward the third or fourth quarter to concern about the deficit, which Abby touched on. According to some estimates, the U.S. will collect $280 billion less than expected in tax revenue. At the same time, defense spending is increasing; there might be an infrastructure buildout, and we have off-balance-sheet items like student loans. We potentially could be looking at a $1.2 trillion deficit soon, while the Fed is dumping $600 billion of bonds. Nobody wants to call it quantitative tightening. They want to call it normalization, or balance-sheet runoff, but it is quantitative tightening. Come 2019, a tremendous number of corporate bonds will also mature. The supply of bonds coming into the market makes it likely that the downtrends in 30-year and

“If we see an uptick in inflation and interest rates, it could be negative for long-duration technology stocks.” —Paul Wick PHOTO: JEREMY LIEBMAN FOR BARRON'S

10-year bond yields don’t last. The narrative could start to become problematic for the bond market.

The two-year Treasury yield is higher today than the dividend yield on the S&P 500. Eighteen months ago, one argument for stocks was that they yielded more than the 10-year Treasury. Well, now they yield less than the two-year Treasury.

Cohen: There are structural reasons why the VIX [Cboe Volatility Index] has stayed so low. They relate to the role of exchange-traded funds and other passive investment strategies. But the primary reason is complacency.

Gundlach: People are extrapolating the past.

Cohen: I agree that we need to focus on what comes next—and what comes next is concern about the debt, rising interest rates, and the Fed moving in one direction while fiscal policy is going in the other direction.

William Priest: Let me give you another perspective on the VIX. From 2012 to 2016, the MSCI World Index was up 87%. Some 74 percentage points of the gain came from price/earnings ratio expansion. The balance came from the sum of dividends and earnings growth. Driving everything was quantitative easing. QE is now over in the U.S. and is starting to end in Europe. That will result, I bet, in a higher VIX. When a single factor so dominates returns to the extent ongoing QE did, volatility stays low. When that dominating factor starts to fade, volatility could increase.

William Priest

CEO and co-chief investment officer,

Epoch Investment Partners

New York

This year, we are going to have synchronized global growth. We haven't had such a low standard deviation of GDP growth among this many countries since the Eisenhower years. It is amazing. Growth is everywhere.

Only two things drive GDP: growth in the workforce and growth in productivity. Workforce growth is happening, but demographics are destiny, and the global population isn't growing much, except in Africa and parts of Asia. As for productivity, we don't measure it well. The biggest thing happening today is the growing impact of technology. It is affecting profit margins, asset turnover, and leverage. Tech is the new macro. If you can substitute technology for labor, margins go up. If you can substitute technology for bricks and mortar, sales per dollar of assets go up. If you don't need assets, you might not need to keep as much equity in the business as in the past. Thus, payout ratios can go up, via both dividends and stock buybacks. If you don't have a capital-light model embedded in your business strategy, you are going to be left behind. Models based on bits will destroy models based solely on atoms.

Economic growth will be decent this year. I don't expect the rate on the long bond [the 30-year Treasury] to go up that much without higher inflation being embedded in wages. The dollar remains the world's reserve currency, and fiscally we can live with bigger deficits for now.

“After Amazon bought Whole Foods, retail stocks fell dramatically. Then they rebounded. When high-quality companies sell off, investors can take advantage of that.” —Meryl Witmer PHOTO: JEREMY LIEBMAN FOR BARRON'S

Henry Ellenbogen: I agree with Bill on technology. If we double-click on it, it has three major impacts. Since 2010, the Faang stocks [Facebook, Apple, Amazon.com, Netflix [NFLX)], and Google parent Alphabet [GOOGL] have contributed 20% of the S&P 500’s aggregate revenue growth. Exclude health-care inflation and it is closer to 30%. There is a reason why five of the top seven equities in the world are those of the dominant platform technology companies—plus the two in China [Alibaba Group Holding (BABA) and Tencent (0700.HK)].They have an impact far beyond their own robust growth.

First, these global platforms have massive deflationary power. Normally, if we were talking about global growth, we would discuss the likelihood of inflation getting out of control. Instead, the Amazon effect on pricing is deflationary in consumer products and enterprise technology. Second, social media and Google foster global information transparency. Then there is the dispersion of technological change across multiple industries—not only in media but retail, transportation, hospitality, financial services, and more. Amazon’s purchase of Whole Foods Market in 2017 will reorder local commerce. From food to food delivery to car purchases to local commercial real estate, everything is being affected by global platforms with deflationary power.

These platforms reward small and nimble businesses. Increasingly, when we spend time with private companies, we see companies with fewer than 20 people get to $100 million of sales in less than six quarters, with less money that you could open one store in downtown Washington, D.C., or Greenwich, Conn., or Palo Alto. They are basically eliminating the middle man and going straight to the consumer, not only in consumer businesses but in business-to-business.

Henry Ellenbogen

Portfolio manager,
New Horizons fund

Chief investment officer,
U.S. Equity Growth

T. Rowe Price

Baltimore

Regarding the tax bill, I agree with Abby that capital will come back to the U.S. But the second derivative is even more important.

The second derivative?

Ellenbogen: In the past 10 years, American companies made an inordinate effort to think about how to move people or structures outside the U.S. for nonproductive purposes—basically, to increase earnings per share. By moving toward a territorial system of taxation and bringing our corporate tax rate in line with the rest of the world's, we can get back to having managers focus on productive investments, greater efficiency, and value creation. This will unlock the strength of America and drive GDP growth. Simply, the absence of a major negative is a positive. This is a generational change. While inflation potentially is a fear for the stock market, you have to be positive on the S&P 500, even though we are 102 months into an expansion.

Gundlach: What you say about the deflationary impact of tech is corroborated by the dispersion in inflation statistics. The goods component of the consumer price index has been negative, year over year, for about four or five years. The service piece has been running at 3%-plus for years.

“The biggest thing happening today is the growing impact of technology. It is affecting profit margins, asset turnover, and leverage. Tech is the new macro.” —William Priest PHOTO: JEREMY LIEBMAN FOR BARRON'S

(2017 Report Card)

Ellenbogen: Let’s examine that. In the 1970s, a Harvard Business School case study examined how Wal-Mart Stores’ [WMT] and others’ reinvention of the American supply chain helped quell inflation. Amazon has a financial model that allows it to make $1 to $2 of EBIT [earnings before interest and taxes] per box shipped. It is rolling into other industries, including B-to-B. It is going after companies that have made $150 per box shipped. Amazon is taking the mentality of scale pricing into every business I speak with. The Amazon effect is making companies in every industry think more about efficiency.

Gabelli: Going back to taxes, does anybody else agree that the tax law has changed the mind-set of corporate CEOs with regard to where to locate businesses?

Paul Wick: Something Henry said resonated with me. In the past, companies with tons of offshore cash, like Cisco Systems [CSCO], made foreign acquisitions with that cash that looked awful in hindsight—Cisco’s purchase of Tandberg, for instance.

Ellenbogen: Or Hewlett-Packard buying Autonomy.

Cohen: I don’t disagree that a lot of time and energy went into thinking about where to position things for tax purposes alone. But keep in mind that U.S. companies also have customers and supply chains that involve other countries. The statutory corporate tax rate has been 35%. The effective federal tax rate for the S&P 500 was 26%. The decline that will occur is still substantial at five percentage points, but the tax rate isn’t falling from 35% to 21%.

Paul Wick

Portfolio manager, Seligman Tech. Fund Team

Columbia Threadneedle Investments

Boston

Meryl Witmer: It depends on the company. Here's an anecdote to illustrate Henry's point. One company we were talking to paid taxes in the U.S. only. They had come up with a plan to build a warehouse in Europe and move product over there, where it didn't really need to be. As long as the inventory sat there for X amount of time, they could pay taxes at a lower rate on the profit generated when they sold the goods. Then Trump got elected and the company stepped back from this plan. Those are the kinds of things that went on.

Priest: The effective tax rate for most companies has been between 26% and 28%. With the new 21% rate, FDI [foreign direct investment] will rise in the U.S. Wages might be pushed up some, but the deflationary impact of technology is unbelievably powerful. The best book on this subject is Machine Platform Crowd: Harnessing Our Digital Future, by Andrew McAfee and Erik Brynjolfsson at MIT. You will want to own platform companies. They will dominate any industry. The deflationary effects from technology are one reason that the long bond rate has not gone up a lot so far.

Ellenbogen:This is happening at a time when what we call the millennial psychographic has spilled over into everything— into how consumers make decisions and workers think about their own security. These platform companies have created a global consumer base. It is disruptive and deflationary for companies that historically were either national or regional. In addition, the consumer is much more consistent around the globe. If you get something that

works in one area of the country, it is much more likely to work in another. Or something that works in the U.S. is more likely to work in Europe.

Millennials have more trust in reviews and transparency of information than brands. There is a growing psychological awareness of how technology can displace jobs. That is why, even though unemployment is near 4%, the pressure to raise wages isn't what it should be, based on the economics I studied.

Meryl Witmer

General partner

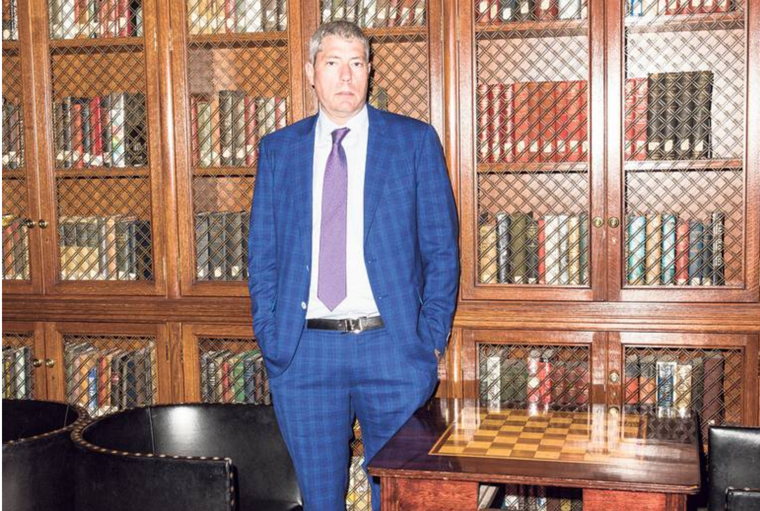
Eagle Capital Partners

New York

Isn't the deflationary impact the very thing that caused people to start asking more questions about technology? Especially in Europe, some big tech companies are facing regulatory pushback.

Ellenbogen: To me, potential regulation of these dominant tech platforms is one of the two big nongeopolitical risks the market is facing. The largest tech companies are growing about 20% a year. That is amazing, because megacaps normally don't grow faster than the S&P 500. They usually grow substantially slower. In 2017, the European Union levied a record antitrust fine against Google. Facebook came under scrutiny over Russian ads allegedly aimed at influencing the election. There is increased local sensitivity to Amazon buying Whole Foods. I would even argue that Amazon's public search for a second headquarters is a statement about the company's concern. It is also possible that shares fall because these companies start competing with one another or their growth rates slow. If that happens, people will worry about inflation reigniting.

Is inflation the other big risk you see?



“Bitcoin represents people who have more confidence in technology and mathematics than the full faith and credit of the United States.” —Henry Ellenbogen PHOTO: JEREMY LIEBMAN FOR BARRON'S

Ellenbogen: Yes. There are structural arguments for inflation to be lower, but cyclical reasons for it to be strong. There is another issue related to technology. Uber and Lyft collectively have about 1.3 million drivers in the U.S., and are on the way to being the largest “employer” in the nation. Within two years, more people will work for these two platforms than Walmart, currently the largest U.S. employer. You can make about $17 an hour driving for Uber or Lyft. If you own a store or a restaurant and pay hourly wages, you’re not focused on an increase in the minimum wage. You’re focused on the Uber effect.

(2017 Mid-Year Report Card)

Gundlach: When I started out in this business, the yield on long-term Treasuries was about 14%, and the U.S. inflation rate was below 4% and falling. I tell my younger employees: Isn’t it hard to believe that 30-odd years ago, there was a 14% return to be had, pension plans were assuming a 9% return, and inflation was 4% and falling? You could have locked in a 10% real rate of return. I have a theory that several years or maybe a decade from now, we will be talking about the exact opposite: Can you believe the German Bund yielded 40 basis points when inflation was in an uptrend moving toward 2%, pension plans were buying bonds yielding 2.5% when their actuarial assumptions were 7.5%, and people believed that inflation would never return?

A number of indicators are already baked in, without this bond-unfriendly tax cut, to suggest that inflation may be heading higher. The Fed’s underlying inflation gauge has climbed to a 3% year-over-year rate. Other things suggest a new paradigm is developing. It is a real risk to the bond market.

Ellenbogen: But unless inflation is embedded in wages, it isn’t sticky enough.

Gundlach: You are starting to see it. Some wage gauges show inflation up 3.5%. Also, if a reduction in corporate taxes leads companies to move business activity back to the U.S., won't that cause a bit of a bump in inflation?

Cohen: That is a possibility.

Scott Black

Founder and president

Delphi Management

Boston

Scott Black: I am going to take issue with that. Energy, utilities, consumer staples, financials, and metals all benefit from the U.S. tax decline. Lower corporate taxes are going to add about $10 to this year's S&P 500 earnings. My initial estimate is $134. After the tax cut, it is $144. Some projections put repatriated funds at around $600 billion. It won't all be reinvested in capital expenditures. Also, as Paul knows, many U.S tech companies have an effective tax holiday in Singapore and Malaysia, where they pay nominal rates of zero to 4%. They aren't going to relocate factories here if they are getting a tax holiday in Asia. I don't see a windfall to GDP from this tax bill. I might be cynical, but a lot of the money will go toward more executive compensation.

Gabelli: Stop! Under the new tax law, companies will get a tax deduction on $1 million of CEO compensation from any source. Previously, performance-based compensation wasn't included. You are going to see a total revamp in how executives are compensated.

Black: OK, the money will go toward more dividend payments and stock buybacks.

Cohen: Shifting research-and-development activity out of the U.S. was partly tax-related. But a contributing factor has been changes or threatened changes to U.S. immigration policy. At one point, 65% to 70% of all Ph.D. candidates in science and engineering at U.S. universities were non-U.S. citizens. Most wanted to stay here and couldn't. Their numbers have fallen dramatically. We are still training these people, but they are leaving for their home countries and other locations where U.S. multinationals have set up research-and-development centers.

Gabelli: Having covered the auto-parts industry for 50 years, I am seeing more companies announce that they are going to relocate to the U.S. And the U.S. is a magnet not only for American, but also for foreign companies locating here because the U.S. is a big market.

Ellenbogen: Just looking at S&P 500 earnings underestimates what this tax bill means. As soon as the private companies we see get to $100 million in revenue or prepare for going public, they spend time creating headquarters in Luxemburg or Ireland. I am not going to name them here, but they are recipients of the advice typically given at this stage of development. There is no reason for a 300-person intellectual-property company based in Silicon Valley or Boston or Seattle to open a five-person office in Ireland. They can't manage it properly, and overseeing it isn't a good use of management's time.

"The Fed has been worried about inflation for many years, but it isn't here. I see animal spirits taking hold." —Oscar Schafer PHOTO: JEREMY LIEBMAN FOR BARRON'S

Second, there are 21 million small businesses in America. Almost none are public. Many are partnerships, and now they might choose to become C corporations as the new rules on partnership taxation are complex. Now, with some simple state-tax assumptions, a corporation will wind up with a tax rate of 23% to 25%, including state taxes. Later, I will talk

about a couple of potential platform companies that will benefit from the vitality of small businesses.

We look forward to that.

Wick: Henry talked about the deflationary impact of tech, but we are starting to see inflation in the semiconductor industry. It used to cost very little for semiconductor makers to shrink process nodes from 45 to 35 nanometers. But that move has run out of gas. The slowdown in Moore's Law is definitely upon us. The industry has had to do double-patterning [a lithography process] since it got to the 25 nanometer node, and quad patterning as it moved to 18 nanometers. The number of processing steps has gone way up, and memory pricing is going up. That never used to happen. You are also seeing inflation in logic-transistor prices, such as ethernet switch chips from companies such as Broadcom [AVGO]. They now go for $1,000 or more, up from around $700. The trend bears watching in the tech industry. Phones are starting to get more expensive. They have a lot more content than in the past.

If we see an uptick in inflation and interest rates, it could be negative for long-duration technology stocks—software-as-a-service companies, and others like Netflix and Tesla [TSLA], where investors expect a pot of gold at the end of the rainbow. Tesla will be cash-flow positive in 15 years? If interest rates go up, the discounting mechanism is going to take a chain saw to the valuations of a lot of these companies.

Cohen: Will that apply not just to the industries you are discussing, but to all high-growth industries?

Wick: It could, especially the ones that are extravagantly valued.

Priest: Paul makes a good point. If rates go up, long-duration assets will be negatively affected. It is evident in the tech world and the bond market, but it is also true in equities. Companies like Netflix and Tesla don't have earnings to speak of. They are essentially options. When rates go up in option models, the present value of expectations goes through the floor.

Getting back to the economy, Mario, what are your assumptions for 2018?

Gabelli: Global GDP will be about $83 trillion in 2018. The U.S. is about 25% of that, and Europe is about 25%. China and Japan combined are more than 22%. The global economy is growing, but Mario Draghi [president of the European Central Bank] will have to pull back the punch bowl at some point, much as we are doing here [through Fed rate hikes]. At some point, the ECB and the Bank of Japan will do the same.

I am optimistic about the U.S. economy. I expect real GDP [adjusted for inflation] to grow by 3%. Many companies I speak with have been paying an effective cash tax rate of 35%. Lower tax rates will drive growth. The U.S. consumer will have gross assets of about $117 trillion at year end, and debt of about $17 trillion, of which two areas are troublesome: car loans and student debt. Outstanding car loans will result in a significant slowdown in the growth of car sales. Student loans are a major social problem.

We talked about rising wages. I see it, too. Also, higher heating bills this winter will have a short-term impact on consumer spending, but could have a bigger psychological impact. We haven't talked yet about the new rules allowing full expensing of certain capital investments, effective on Sept. 27, 2017. In the last week of December, even used planes were being bought.

Now that the tax bill has passed, is an infrastructure bill next?

Gabelli: It could be announced in the next two weeks. It will be a powerful stimulus to certain sectors of the economy, including inland waterways, the railroad industry, surface transportation, and avionics—even airport construction.

Oscar, you've been too quiet. What is your outlook for 2018?

Oscar Schafer: One thing that worries me, not only here but generally, is the narrow dispersion of people's GDP estimates for the year, and everyone's bullishness. I don't have a specific number, but I expect the economy to grow faster than most people think. I expect companies to bring cash back to the U.S., which will help to fuel growth. Inflation is less than people think. Even health-care costs aren't rising as much as in the past. The Fed has been worried about inflation for many years, but it isn't here. I see animal spirits taking hold. Corporations are starting to spend money.

Gabelli: If you think animal spirits are here, do you want my bitcoin?

Gundlach: When bond futures were first listed, the yield on the long bond was around 8%. Six weeks later, it was 11%, and a year later, 13%. When uranium futures were listed, uranium had been in an unbelievable bull market. The price hasn't been close to the bull-market high since. Now that bitcoin futures have been listed, the price has come down. The pattern seems to be holding.

Perhaps that's why the futures were listed.

Gundlach: It wasn't a coincidence.

Oscar Schafer

Chairman

Rivulet Capital

New York

Ellenbogen: I got more questions over the holidays about bitcoin than the stock market. The ratio was at least 10-to-1. Bitcoin searches are consistently in the top 10 of Google searches. Interestingly, given the strength of the bull market, initial public offerings were constrained in 2017, and have been constrained for a while. We aren't seeing the classic signs of speculation in the public markets. We are seeing them in more exotic markets, like bitcoin.

Cohen: A good deal of the money flowing into bitcoin isn't coming from the U.S. It is coming from East Asia, including Korea.

Wick: Much of the price gain in bitcoin has been propelled by South Korea and Japan. Korea's Kosdaq index is going vertical.

Gundlach: Which is another sign of global growth acceleration.

Are any of you believers in the long-term viability of bitcoin and cryptocurrencies generally?

Priest: Money is the combined effects of three variables. It is a medium of exchange, a unit of account, and a store of value. Bitcoin is a medium of exchange for those who want to play outside the system of fiat currencies. It can be dangerous, depending on the price when you buy and sell it. It is going to end in tears.

Black: It is backed by the full faith and credit of air.

Cohen: You mean the full faith and credit of electrons. Bear in mind that whatever happens to bitcoin, the underlying math and data science are real. Whether you call it blockchain or ledger systems, we are moving into the next generation of data systems. They are a lot faster than the systems we used for the past 30 years. I am not giving a seal of approval to bitcoin, but pointing out that the math underlying cryptocurrencies will have many applications.

Black: The underlying technology has many security applications. It is excellent for encryption.

"The biggest thing happening today is the growing impact of technology. It is affecting profit margins, asset turnover, and leverage. Tech is the new macro." —William Priest PHOTO: JEREMY LIEBMAN FOR BARRON'S

Ellenbogen: I have two things to say in bitcoin's defense: Supply will be limited; only 21 million bitcoin can be "mined." That's a powerful notion. Second, millennials don't have confidence in traditional institutions. We are seeing this across industries. They have confidence in technology. Bitcoin represents people who have more confidence in technology and mathematics than the full faith and credit of the United States. They can understand the rules of the game.

Gold has survived as a store of value through multiple wars and depressions. While I don't pretend to understand the intricacies of the gold market, gold has a relatively low discount rate because it has been through many tests of its competitive moat. Bitcoin hasn't been through an economic crisis or wars. It has a high discount rate, but people increasingly are putting lower discount rates on it.

Jeff, what is your view of the bitcoin phenomenon?

Gundlach: It is a mania. A CryptoKitty coin—it has an animated picture of a cat— sold for $100,000, and is being reoffered for $400,000.

You didn't buy it?

Gundlach: No. I don't know when the mania will end. I turned negative on the Nasdaq on Sept. 30, 1999. You would have thought that was a great time to short, but the Nasdaq went up about 80% from there to the March 2000 peak. It sank the next year.

Do any of you own bitcoin?

Gabelli: We traded it just to see what it is all about. We paid $6,228 and sold at the same price, just paying a commission to the brokerage, Coinbase. I lecture at various universities. This is what the students want to talk about: blockchain, cryptocurrency, and bitcoin. They don't want to talk about stocks.

Is there a way to invest in the underlying blockchain technology?

Ellenbogen: We invest in foundational technologies at an early stage. We cannot find a public company currently using blockchain to lower its cost of sales or improve its relationship with customers, although several are testing it.

Cohen: You are seeing some applications in financial services and medical research. Any company that has to deal with huge blocks of data is experimenting with it. But I agree with Henry that it is hard to find a public way to invest in it.

Now that we've probed the mysteries of bitcoin, let's get back to the stock market. No one here foresaw 2017's powerful rally. Nonetheless, we'll give you another chance.

Schafer: Warren Buffett once wrote in his annual letter that the only value of stock forecasters is to make fortune tellers look good. That said, I predict the stock market will be higher by the end of the year than most people think.

Notwithstanding geopolitical risks, such as the threat of a North Korean nuclear attack?

Schafer: There are a lot of risks, from North Korea to the Middle East. Wealth inequality and social unrest are also potential risks. Will the tax cut benefit the bottom 99%? Yet, despite perceived political risks, the market goes up.

Gabelli: At the end of 2016, the market exploded upward on the premise that Donald Trump's presidential victory would mean less regulation and business-bashing. Capitalism was again at center stage. After that run-up, we anticipated a slowdown.

Ellenbogen: But we started last year with global growth. In addition to the U.S., Europe and Japan were improving.

Cohen: That's right, and the growth has been sustainable. Corporate earnings and cash flow have been stronger than expected, and interest rates and inflation have been subdued for longer than expected.

Gundlach: But now the Fed is starting to allow $30 billion of Treasuries, more or less, to mature into the market each month. There is a chance—I'd call it a base case—that the rhetoric and actions of the ECB will have to become more hawkish, given economic growth in Europe. That means the ECB might start to pull back on quantitative easing. Central-bank balance sheets could start to decline, in the aggregate, sometime during 2018. If that happens, the stock market will go down. Quantitative easing, cumulatively, has been highly correlated to the gains in the S&P 500 and global stock markets. Central-bank footings, or assets, went from $6 trillion pre-financial-crisis to $22 trillion subsequently. Bankers are talking about bringing that down to $16 trillion or $17 trillion. Maybe it drops more quickly. It is undeniable that central-bank asset buying has been a prop for the markets.

Today, the markets are exuberant. The momentum is great. It would be difficult to say today is the top, and momentum could take stocks higher. But I believe equity markets will roll over later this year and close the year down.

Do you expect a brief pullback, after which the rally reignites?

Gundlach: I don't know. Let's worry about the next couple of moves in this chess game. Last year, I said the 10-year Treasury yield would move up toward 3% again. It got as high as 2.64%, and then bonds rallied. The yield fell to 2.02% intraday, but is rising again. There is a chance that interest rates will break out to the upside on the long end. I'm not predicting it; I let the market do the talking. If current levels hold, things will be copacetic. But if these yield levels break, the base in yields is enormous.

Meaning what, exactly?

Gundlach: If the 30-year bond yield breaks convincingly above 3%, that would be a massive break in the chart. It would mean something big has changed. You would then expect a 200-basis-point move to the upside. Interest rates fell for 30 years. They have been basing for 10 years. There is a coiled-spring aspect to rates. You want to be focused on these levels in the bond market.

I have also said for months that the new tax package isn't bond-friendly. We are looking at trillions of dollars of bond supply in the next few years. The net supply of sovereign bonds in the developed world was negative for the past few years, due to quantitative easing. It isn't going to be negative this year, and next year the corporate bond market will join the party. We are trained like Pavlov's dog to think that long bonds are the place to be when a recession

hits. But what if the next recession leads to an explosion of bond supply? There will be no place to hide. We are in uncharted waters. Negative interest rates have never been sustained. Central banks have never financed budget deficits, and now things are moving the other way. We are putting a lot of faith in the central banks to get this exactly right.

Witmer: Abby, if the economy grows by 4% this year instead of 2.7%, what does that do to the deficit?

Cohen: I don't have a big enough envelope to do the calculation. The economy could grow by 4% in any given quarter, but that type of growth typically is sustained in the aftermath of a recession. Right now, the economy doesn't have a lot of slack. Also, you had that kind of growth in the 1960s, a time of significant population growth. Now, three-quarters of our population growth comes from immigration, and the government is talking about cutting that back. Maybe we could get stronger growth from productivity gains, or capital spending, or an infrastructure bill, or investments in worker training, but it won't happen in the short term.

Priest: You can pull real GDP growth forward, as the tax law does. It is going to pull demand into 2018 and 2019. But 4% real GDP growth is a stretch.

To circle back to Jeff's comments, only three things matter in determining total return for stocks: corporate dividends, earnings, and the change in the price/earnings ratio. The S&P has a cash yield of 2%. You can pick your number for earnings; they will be up. But as the Fed goes from QE to QT, the big issue is the P/E. A backup in bond yields from 2.4% to 3% might not sound like a lot, but it will have a highly negative impact on P/Es. There is a 20%-to-25% chance that the market will be down by double digits this year.

In that case, what would be your defensive asset class?

Gundlach: I would use commodities, which I will discuss later today. Nominal GDP is a good cornerstone to think about where the 10-year Treasury yield is supposed to be. In 2016, when the 10-year bottomed at 1.32%, nominal GDP was pretty weak. Inflation was low and oil prices were down. It made quasi-sense to have a 2%-ish 10-year yield. Today, nominal GDP is at 5%. If it gets above that—DoubleLine's inflation model says the CPI is going to go into 2.3%-to-2.4% land—we could be looking at 6% nominal GDP. If so, it seems hard to believe the 10-year yield will stay around 2.4%.

Why is it still in the 2.4% range?

Gundlach: Some people argue that our rates are being held down by lack of competition. Ten-year Japanese rates are near zero, and German rates are 0.4%. If our economic reality isn't dissimilar to Germany's, and it isn't, maybe our rates should be the same. German rates

are pulling down our yield, and nominal GDP is pulling it up. It isn't a coincidence that the 10-year yield is right in the middle. Two things could go wrong. German rates could go up, which has to happen, and nominal GDP could rise.

Black: The stock market is trading at nosebleed valuations. The S&P 500 is trading for 19 times my 2018 earnings estimate of $144. Based on the CAPE, or cyclically adjusted P/E ratio [which measures the index's price, relative to average inflation-adjusted earnings for the past 10 years], the market trades around 30 times earnings. The Russell 2000 index has a P/E of 26.5 times this year's estimated earnings. Homogeneously, stocks are expensive. The offset is that earnings are growing; the consensus estimate for this year is $145.79, implying a 15.2% gain from 2017 estimates.

Also, some $465 billion was invested last year through Dec. 20 in U.S. exchange-traded funds. This is a self-fulfilling phenomenon. Most of the money is going into the S&P 500 and pushing up Apple, Alphabet, and such. The market could keep rising because investors are ebullient, earnings growth is accelerating, and funds keep flowing into ETFs. The caveat, as Jeff notes, is a potential backup in bond yields toward the end of the year. If that happens, stocks might sell off.

Yet, even though stocks are expensive, the punch bowl is available for most of 2018. I wouldn't be surprised to see the S&P 500 up another 8% to 12% on the year.

Gundlach: The U.S. market is expensive, relative to other markets. Emerging markets had a great year, but their Shiller P/E is roughly half that of the S&P 500. [Yale professor Robert Shiller invented the CAPE ratio, also known as the Shiller P/E.]

Cohen: The Shiller ratio has a bad track record of forecasting market turns.

Wick: And Goldman Sachs talks about normalized valuations of semiconductor stocks. That is rubbish.

You guys can thumb-wrestle later. Where do you think the market is headed?

Wick: While interest rates might go up, they don't explain everything. I am sympathetic to the arguments Scott made. One thing no one has mentioned is that the number of public companies has been cut in half since 2000. The supply/demand ratio is positive. There is a lot of money in private-equity funds. There has been a lot of consolidation among public companies, and that tends to be fairly positive for the companies left standing. We are seeing higher profit margins, as a result, for many U.S. technology companies. Whether you are looking at disk drives or semiconductors or semiconductor capital equipment, there are fewer companies to compete against. Profit margins have been rising.

Because of repatriation stemming from tax reform, companies like Oracle [ORCL], Microsoft [MSFT], Cisco, and Lam Research [LRCX] are going to put more cash to work on mergers and acquisitions, share repurchases, delevering, and dividends. This will be very positive for tech stocks. The tech indexes could go up 10% to 15% this year, barring some sort of geopolitical issue. I don't have a good feel for the S&P 500.

Gundlach: There are obvious positives that can be enumerated. But the fact that we can enumerate them means we know all about them. What is the incremental information that will drive positive momentum? What isn't priced into the market?

Does subdued IPO activity tell us anything about where in the cycle equities might be?

Ellenbogen: There are three things to consider: This is the third-longest upcycle for the U.S. stock market in 100 years. Yet the public hasn't jumped in with both feet. Look at fund-flow data or the lack of excitement around the IPO market. The energy has gone into other markets, whether bitcoin or private commercial real estate. Second, the power of large platform companies is restraining the market's excitement about early-stage growth companies that might have competed against them. E-commerce is $500 billion, and grew between 15% and 16% in 2017. Yet Amazon probably accounted for a 60% share of incremental growth. The dominant tech platforms are consolidating share across new areas of innovation. The market is becoming increasingly concerned about their power. Third, private capital markets have provided the ability for companies to stay private longer. And the public markets have demanded more information from companies.

Gabelli: You're speaking of Sarbanes-Oxley section 302, which requires the CEO and finance officers to certify that quarterly and annual reports are accurate. It costs a lot of time and money to be public.

Wick: Also, companies have stayed private for longer, partly because mutual and hedge funds are bidding up private-market valuations to unbelievable levels. Softbank Group [9984.Japan] has pledged to spend $90 billion, investing in private start-ups.

Tintri [TNTR], for instance, was viewed a few years ago as a hot memory/storage technology company. Its last private round of investments valued the company at $785 million, or roughly $37 a share. The stock went public at $10 and now trades around $5, after missing two quarters' numbers.

Ellenbogen: Tintri competes against the big public cloud providers. As a public-market investor, do you really want to own a storage provider, competing against Google, Microsoft, and Amazon's cloud?

Wick: Whether we're talking about Snap [SNAP] or Blue Apron Holdings [APRN] or Tintri, companies are less likely to want to go public because their prior venture-capital round put an excessive valuation on the company. Also, late-stage private investors often impose onerous terms, dictating that if a company goes public at a discount to the last round in question, it would have to make such investors whole. Those make-whole provisions often spell doom for earlier-stage investors, who can get significantly diluted or wiped out.

But back to the question: Can we have a market top without a frothy IPO market?

Ellenbogen: Yes, because the froth could be showing up in other places.

Cohen: In the 1990s, the froth showed up in Asian markets.

Ellenbogen: I agree with Jeff: If everyone is aware of something, it is probably factored into the market. I'm positive on the market in 2018 because we are going to have real earnings growth of around 8%. We will get an additional 7% from tax reform. The question is whether the market will hold its multiple.

There are three major risks. Will the dominance of the technology platform companies continue? Yes. Will inflation resurface, beyond the deflationary impact of these companies? The outlook is more mixed. Third, companies' tax benefits get competed away over time because capitalism works. But I am still positive on the power of the tax bill to unlock the energy of business and lead to more-productive growth.

"Central-bank balance sheets could start to decline in the aggregate sometime during 2018. If that happens, the stock market will go down." —Jeffrey Gundlach PHOTO: JEREMY LIEBMAN FOR BARRON'S

Meryl, do you have a market outlook?

Witmer: I don't. But I expect a lot of sector rotations, and investors can take advantage of those. For example, after Amazon bought Whole Foods, retail stocks fell dramatically. Then they rebounded. When high-quality companies sell off, investors can take advantage of that.

Gabelli: A good example is Walmart. The day of the Whole Foods announcement, Walmart dropped from $79 to $73. But the company had already bought Jet.com, to help its e-commerce efforts. In the past four months, Walmart has rebounded to $99.

Another thing to consider this year are the midterm elections; 33 Senate seats are up for grabs, including about 25 held by Democrats and eight held by Republicans. If the House, Senate, and presidency are all controlled by Republicans after the election, will that lead to further changes in the tax code, providing another boost to capitalism?

I expect the market to be flat to up 5% for the year from here; stocks are already up 3% year to date. Like Meryl, I believe individual stocks will work well.

Cohen: If the economy stays strong, the party in charge typically does well in midterm elections, losing only a few seats. But some important things will happen before the election. We believe the tax cuts will mechanically add about five percentage points of growth to the S&P 500 earnings per share in 2018. On this basis, Goldman has a year-end forecast of 2850 for the index. We expect markets in China, India, and Japan to continue to rise. Where are the risks? At the top of my list, and others', are rising interest rates. We have gotten so accustomed to low interest rates that even small changes could be highly disruptive, especially to individual investors who haven't been buying equities. They have been buying fixed-income assets since the financial crisis, and many don't understand the mathematics of what happens to a bond price when yields go up. Further, many don't understand what happens to the net asset values of bond mutual funds. If bond funds lose value, consumer confidence might suffer.

Gundlach: That is a good point, because money has been flowing into corporate bond funds at about double the prior record. Corporate debt-to-GDP is at a high level. A lot of this money came into bond funds in the past 20 months, and interest rates have risen in that period. The return on Treasury bonds since February 2016 has been zero. Investment-grade corporate bonds are up by double-digits, leading the naive investor to think they have no interest-rate risk.

Cohen: The credit premium and term premium in bonds have been shrinking. There is no margin for error, which is bad for bond prices and leads me to also worry about equity valuations. The stock market has room to rise from here, but valuations don't provide much margin for error. If inflation and interest rates go up a full percentage point each, history says that P/E multiples would go down three points, say from 18 to 15 times earnings. The current

mechanistic view of equity price targets assumes no P/E multiple contraction or bond-market disruption. This may prove overly optimistic. We have been assuming that earnings go up X percent and the P/E stays the same, which means stock prices can go up X. That might not be the case.

I am also concerned about rising protectionism. One reason the U.S. economy has done so well in the post–World War II period is that we were at the helm of a global economy that was expanding and creating wealth in many nations. Now, the U.S. is stepping out of the discussions about the Trans-Pacific Partnership. That will prove to be an error. The TPP could help protect us and other trade partners from China. In addition, discussions about Nafta [the North American Free Trade Agreement] are beginning in March. Now I will be provocative and say that the new tax law, budget expenditures, and infrastructure proposals (hinted at, but not yet released) all have an anti-urban and anti-education bias.

Gabelli: They are anti-blue-state.

Cohen: Yes, but much of the economic growth in the U.S. since the financial crisis has been heavily concentrated in a few major metro areas. That isn't surprising, as economic growth typically is found in places that have made a significant investment in public education, infrastructure, and so on. Millennials like to live near urban centers; that's where the job growth is. During the recovery from the financial crisis, job increases were roughly eight to 10 percentage points in major metropolitan areas, versus only two or so percentage points in other communities. Proposed changes in federal expenditures suggest dramatic reductions in support for basic research and higher education. That is problematic, because it could affect the country's long-term growth prospects. So, one concern is interest rates, another is protectionism, and a third is this anti-urban, anti-education bias.

Are you also concerned that the prevalence of passive investment strategies could exacerbate a market selloff?

Gundlach: Yes. The move into ETFs and robo-advisors has been marked by momentum and herding activity. When the market goes the other way, there will be herding activity, as well.

Ellenbogen: After Trump was elected, global markets weren't positioned for Republicans controlling all three branches of power in the U.S. They weren't prepared for the country to enter a phase of lower taxes and deregulation. After initially falling, markets went long the U.S. The highest-beta way to do that is to buy the Russell 2000 index, because it is a pure play on U.S. companies with high tax rates. Between Trump's election and the end of 2016, the Russell 2000 rose 14%, and ETFs had net flows of 15% of net assets, driving up the market. However, small-caps not included in the index were unchanged.

“Energy, utilities, consumer staples, financials, and metals all benefit from the U.S. tax decline. Lower corporate taxes are going to add about $10 to this year’s S&P 500 earnings.” —Scott Black PHOTO: JEREMY LIEBMAN FOR BARRON'S

“I worry that this tax cut is happening at a time when the U.S. economy doesn’t need fiscal stimulus. And longer term, what will tax cuts do to the federal deficit?” —Abby Joseph Cohen PHOTO: JEREMY LIEBMAN FOR BARRON'S

My fund, which is uncorrelated to the indexes, significantly lagged behind. I sold my marginal companies that had significantly underperformed and bought the companies that didn’t participate in the rally. This all reverted in the first quarter of 2017, as companies reported results.

This is an indication of the risk of ETFs on the downside. It is much easier to source supply into a market than to source demand. In a market downturn, that will be exacerbated by ETF flows, quant funds that follow momentum, and potentially the high-yield market, which is correlated. The downturn will be even more severe—until active managers in equity or new

buyers are attracted to the discounted prices. The discounts will have to be wide to attract unnatural buyers.

Gundlach: Amen to that. When this big bond supply comes into the market, where will the buyer be? Show me the buyer. It won't be central banks, which will be selling, at least initially. Companies with repatriated cash aren't going to be buying Treasury bonds. It won't be the people who piled in when rates were declining. Who will buy?

> **Ellenbogen:** Significant discounts are required to bring unnatural buyers into the market.

Priest: If we are entering a world in which P/E-multiple expansion shrinks, it will be a very positive period for active management. Security selection will matter greatly.

If rates rise and stocks fall, where should an investor seek refuge?

Gabelli: It depends on the individual's age, but people who try to time the stock market and sell never get back in at the right time. I suggest buying Treasuries on a non-repo [repurchase agreement] basis and moving to Florida or another state without state and local taxes.

You can call in from Florida next year.

Black: Buffett has long said that the U.S. is the best place to invest because of its long-term secular growth. If you maintain equity participation and screen out the short-term swings, you can ride out the cycles.

Gabelli: You want to buy good companies with pricing power at a reasonable price.

Gundlach: Are there no votes for cash? There is nothing wrong with a two-year Treasury. It is boring as can be, and yields about 25-30 basis points less than a 10-year bond. But it comes due in two years, and you could reinvest the money.

Cohen: Let it be noted that the people around this table are nodding their heads.

Noted. None of you have said much today about emerging markets, which outperformed the U.S. significantly last year. Do these markets still offer value?

Cohen: Absolutely. China will have slightly lower GDP growth this year, as discussed, but long-term growth will exceed 6% a year. You have to pick stocks carefully there. The growth of the Chinese middle class offers interesting opportunities. India also looks interesting, but many Indian stocks look fully valued. The Korean market is undervalued.

Gundlach: Emerging markets have done well, but don't lose sight of the forest for the trees. Overall, these markets are cheap, and fundamentals are good. If you compare the percentage of global GDP that emerging markets represent to the market capitalization of emerging markets relative to the global market cap, you'll see that they were the same for years. They started to diverge sharply in 2011 because of quantitative easing, a strong dollar, and weak commodity prices. The gap became quite large but started to close recently. These markets stopped underperforming. They aren't value traps any more.

If you were lucky and got into emerging markets at the end of 2015, stay with them. The next big move in the dollar is down, which removes one of the primary risks to emerging markets. I've been a huge India bull for years; I recommended an Indian fund last year [iShares MSCI India (INDA)]. It did well. I am not recommending it now, but I wouldn't sell it because, as Mario says, you might not get back in at the right time.

Thanks, Jeff, and everyone. Time for lunch!

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