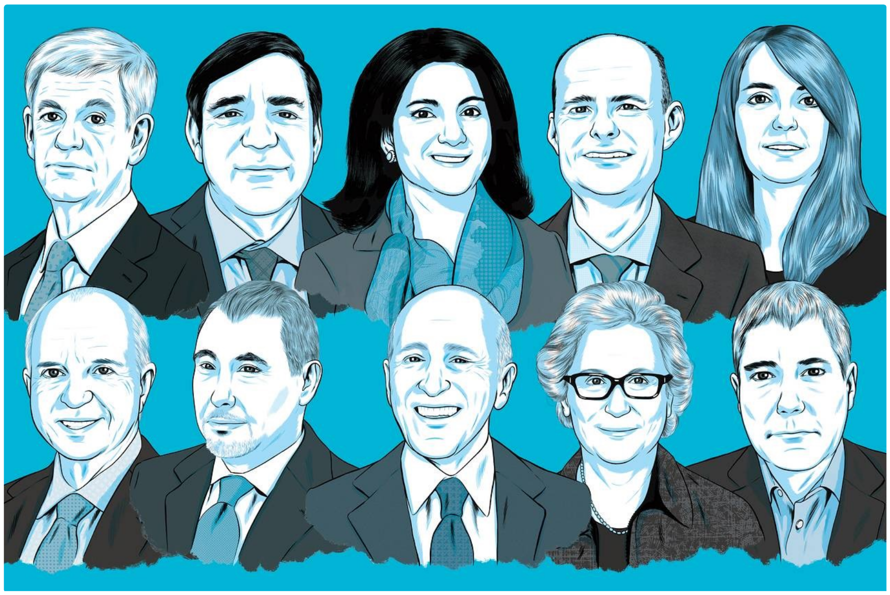
BARRON'S

INVESTING ROUNDTABLE

What’s Next for the Stock Market and the Economy, According to the Experts

By Lauren R. Rublin Updated Jan. 14, 2019 10:58 a.m. ET



Joel Kimmel

It was a dark and stormy day. No, we’re not referring to the weather, which was perfectly chill for early January, but to the tenor of the conversation at this year’s *Barron’s* Roundtable, our annual investment talkfest and stockpickathon, featuring 10 of Wall Street’s smartest investors. Consider the panoply of problems on which our panelists dwelled: a rising ocean of corporate and government debt, a debilitating trade conflict, fake earnings, tech disruption, political paralysis, the withering of the middle class. Might as well cue the demise of the Western world, which, by the way, also came up for discussion.

And yet, for all the gloom-mongering at the gathering, held on Monday, Jan. 7, at *Barron’s* offices in New York, the takeaways are surprisingly reassuring. Almost none of our market seers is predicting a recession in 2019. Almost all expect the U.S. economy to keep growing, President Donald Trump and China’s Xi Jinping to strike a trade deal, and the Federal Reserve to apply a light touch to monetary policy in the months ahead.

While stocks might stumble through the year’s first half, the aforementioned forecasts suggest they will sprint through the second half and into 2020, when everyone and his aunt will be running for president and trying to keep the good times going. Meanwhile, after a disappointing 2018, stock markets here and abroad are cheaper than they have been in quite awhile. In sum, it looks like a grand year to be a stockpicker, as most of our panelists are.

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Jeffrey Gundlach on the Growth of U.S. Debt

You’ll find two new faces at the table this year. One belongs to Todd Ahlsten, chief investment officer of San Francisco–based Parnassus Investments, and lead manager of the Parnassus Core Equity fund (ticker: PRBLX). Also joining us for the first time: Rupal J. Bhansali, chief investment officer, international and global equities, and a portfolio manager with Ariel Investments in New York.

This week, we present the panelists’ big-picture views on the economy and financial markets, and the many forces—social, political, financial, and technological—that are reshaping both. Next week, we’ll share the group’s best investment bets for 2019.

***Barron’s*: What is the stock market telling us now, and should we believe it? Jeffrey, since your forecast a year ago was right on target, please start.**

Jeffrey Gundlach: The market peaked in 2018 a lot earlier than most people think. The New York Stock Exchange Composite Index and non-U.S. markets peaked on Jan. 26. The stock market made a cyclical top initially characterized by a speculative mania for Bitcoin and other cryptocurrencies. There was no fundamental reason for Bitcoin’s price to go vertical in 2017. Although Bitcoin had started correcting in December 2017, the price was still pretty high when we met last January.

Market cycles often end with something insane. Think of Pets.com back in 2000, which had little revenue and no profit, but a stock that exploded in value. It became a symbol of the dot-com collapse. After you see that sort of mania, markets begin rolling over. The Dow transports followed the NYSE Composite lower last year. Then the other major indexes turned down, leaving just a few stocks, such as Amazon.com (AMZN) and Apple (AAPL), to carry the market up. Finally, Apple said it would no longer break out unit sales of its most important products, and that was it. So now we are in a bear market, which isn’t defined by me as stocks being down 20%. A bear market is determined by the way stocks are acting.

Jeffrey Gundlach **Photograph by ioulex; grooming by Gina Marie Picciotto**

Where to from here?

Gundlach: The biggest risk is the corporate bond market. U.S. junk-bond issuance has been prolific, and the quality has been poor. Many issues have been floated with no covenants [legal agreements regarding issuer behavior]. The investment-grade corporate-bond market has also grown massive; it is much larger than it was going into the prior credit crisis. A Morgan Stanley research report suggests that, based on leverage ratios alone, 45% of investment-grade corporate bonds would be rated junk right now. The report further suggests that around 60% of corporate bonds currently rated BBB would be rated junk by the same leverage-ratio metric. That's around $1 trillion of par value, or about 150% of the junk-bond market's value.

There are problems with debt broadly. I keep hearing the president say that this is the strongest economy ever, which isn't true. There was a bump up in second- and third-quarter gross domestic product, but the growth is debt-based. We have floated incremental debt when we should be doing the opposite if the economy is so strong. In fiscal 2018, we increased the national debt by $1.27 trillion. The deficit officially was nearly $800 billion. The difference is phony IOUs from the Social Security system and expenditures on purportedly one-off military operations and natural-disaster relief. U.S. GDP is $20.66 trillion, so a $1.3 trillion increase in the national debt is 6% of GDP.

In addition, the Federal Reserve has engaged in quantitative tightening, or shrinking its balance sheet, to the tune of $50 billion per month. We are talking about the creation of an ocean of debt, while the Fed has raised rates nine times in the current cycle, in addition to quantitative tightening, which, according to some studies, equates to about two more rate hikes. The Fed wants to raise rates two more times this year, based on its dot plot [individual rate projections by the members of its policy-setting committee]. This is a problem for the stock market. U.S. manufacturing data has deteriorated. Mortgage applications are near an 18-year low.

Are you looking for another bad year for stocks?

Gundlach: I'm not looking for a terrible economy, but an artificially strong one, due to stimulus spending. I expect the market to fall further. I see almost a reverse of last year, in that stocks could be weak early in 2019 and stronger later in the year.

William Priest: My thoughts are similar to Jeff's. Our year-end letter to clients discusses four elements that we expect to shape market outcomes in 2019, and none are very positive. First, as Jeff alluded to, is quantitative tightening, or QT, whose impact will be profound. In my view, quantitative easing was necessary after the financial crisis to offset liquidity and solvency issues. We probably should have stopped QE in 2011, but that's hindsight. QE artificially drew down the discount rate for all financial assets and was a fantastic stimulus to the stock market. The rise in stocks since 2012 has largely been propelled by price/earnings multiple expansion. QT will have the opposite effect on valuation metrics.

The second issue is trade wars. No one wins a trade war. Manufacturing profit margins doubled from 1989 through last year, largely due to four factors: labor arbitrage between China and the West, the evolution of sophisticated global supply chains, lower tax rates, and lower interest rates. All but tax rates are turning negative next year. Once you put tariffs on trade, the globalization movie that reflects the 200-year-old-law of comparative advantage runs backward. Global economic growth will slow.

Third is the debt situation, which Jeff explored in detail. I will add that student debt is now $1.5 trillion, and 20% of U.S. student loans are already likely to be in default. The Brookings Institution has forecast that about 40% of student loans will be in default by 2023. This mountain of consumer debt, including student debt, is going to impact home buying and auto purchases, particularly within the millennial generation.

Finally, the global liberal order is coming apart. It was held together for many years by the U.S. and the "United Nations of Europe." With the widespread adoption of technology, which is highly deflationary, a lot of middle-class jobs have gone away and populism is on the rise. Democracy flowers when living standards are rising alongside it. But when you simultaneously challenge social norms and many of the values that anchor people—a sense of home, job security, and the prospects for growth—and amp it up with social-media networks, you get serious blowback, as we are seeing in France and Britain with Brexit. I guess I'm in the negative camp. I expect the stock market to continue to be volatile, and it might well end the year lower than it is now.

Is anyone here feeling positive?

Mario Gabelli: Abby is bullish.

Abby Joseph Cohen: I indicated at last year’s Roundtable that Goldman Sachs valuation models, based on earnings, inflation, and other fundamentals, estimated that 2850 was fair value for the S&P 500 index. The S&P 500 got to 2850. In September, I told *Barron’s* that the risks were to the downside for the market. Mario can portray my views as he wishes, but, the fact is, many of the concerns raised by Jeff and Bill, particularly with regard to bad fiscal and trade policies, and bad regulatory policy, which we haven’t discussed today, were known. The market has recognized belatedly that economic policy matters and elections have consequences. I’ll make one observation on trade: There are real problems with regard to China’s poor protection of intellectual property rights. Forcing multinational companies to do business in China through joint ventures with Chinese entities is another troubling issue. However, the dollar value of the trade deficit, which includes large imports coming from U.S. companies producing in China, isn’t the main problem.

Abby Joseph Cohen **Photograph by ioulex; grooming by Gina Marie Picciotto**

Rupal Bhansali: I’m a rookie at this forum, but a veteran investor, and I see parallels to the late 1990s. I’m not bullish on the market, but I’m bullish on stocks. The market was bifurcated in the late ’90s; the new-economy stocks were going up a lot, but the old-economy stocks were left behind. A similar polarization has developed in the past few months between what is in vogue and what isn’t. Pockets of the market are extremely attractive, allowing us to continue to make money for clients. Investors will not get rewarded for broad exposure to stocks but curated exposure. Therefore, I am also bullish on active management making a comeback while passive investing gets its comeuppance.

Gundlach: As sure as night follows day, passive is going out of favor.

Bhansali: Picking up on what others have said here, investors are focused unduly on one risk—earnings risk—whether companies are going to miss earnings, meet earnings, or beat earnings. Instead, they should focus on balance-sheet risk, which is the highest ever. General Electric stock (GE) collapsed because of the company's balance sheet, not just because of its weak earnings. That is the big cue that equity markets need to pay attention to. There will be a shift among equities. Cash will no longer be a four-letter word. Debt will become a four-letter word. The thing to bet on in coming years is net-cash companies [companies whose cash exceeds their debt]. It is ironic that net-cash companies don't trade at a premium and that indebted companies don't trade at a discount. Net-cash companies are a free lunch. That's an area I'd look to exploit.

Rupal J. Bhansali. Chief investment officer, International & Global Equities, portfolio manager, Ariel Investments **Photograph by ioulex; grooming by Gina Marie Picciotto**

Gundlach: What you just said is absolutely right. The market has it backward.

Mario, what are your thoughts?

Gabelli: A year ago, no one thought the economy could grow by 4% on a real [inflation adjusted] basis. This rate unfolded in the second and third quarters of last year. Forecasters missed the cyclical improvement. Now everyone expects the economy to slow, and some even forecast a recession. I'm in the camp that says we'll see 4% to 4.2% nominal GDP growth this year. Plenty of Democrats and some Republicans are going to run for president in 2020, and everyone is going to ask, "How do we stimulate the economy?" Within that context, job growth is strong, wages are rising, and the consumer is feeling better. The only hiccup is that stock markets took $10 trillion out of global wealth in the fourth quarter, of which $5.4 trillion came out of the U.S. consumer.

In the industrial sector, housing is a challenge. As Bill discussed, student loans crimp the ability to buy houses. But there is latent demand for housing, based on cyclical and secular trends. Then, there is a need to repair infrastructure. We have 614,000 bridges in this country. The American Society of Civil Engineers says 39% are over 50 years old and 9% are structurally deficient as of 2016. The first time a bridge collapses, how will legislators of either party be able to look constituents in the eye and say they voted against an infrastructure bill? I see action on infrastructure spending as a plus for the economy in the second half of 2019 and into 2020.

Meanwhile, stocks are discounting a lot. I’m able to buy companies again at six times Ebitda [earnings before interest, taxes, depreciation, and amortization], a sustainable multiple, whereas nine-times-plus Ebitda wasn’t sustainable, especially if long interest rates are going up. On tariffs, Bill got it right, except for Abby’s comment that the Chinese haven’t played fair. Then, there are interest rates. The 10-year Treasury note yield is down to 2.66% from a high of 3.23% in November. Last year, I thought rates would climb to 3%, and I’m still at 3%.

Corporate tax cuts are a game changer. The U.S. used to collect around $300 billion of taxes from $3.3 trillion of tax revenue. The tax cut has taken out less than $100 billion of that. It isn’t a big drop, relative to the benefits. You have to fasten your seat belt this year and keep it fastened, but at the end of the year, I expect the market to be up.

Henry, do you agree with that?

Henry Ellenbogen: I agree with much of what has been said. Last year gives us a pretty good window onto what the swing factors will be in 2019. Jeffrey is right that the U.S. was the last market to hold up in 2018. A confluence of events beginning in the first week of October knocked U.S. stocks down. First, Vice President Mike Pence gave a speech on China that sent a message to the market that our trade stance on China isn’t only tactical, but strategic. Then the chief financial officer of Huawei was arrested in Canada, which was even more telling regarding the reset of our relationship with China. Another event was Amazon’s disclosure that it is raising wages to $15 an hour. Even though platform technology companies are deflationary, to get people to do many blue-collar jobs, you have to drive wages up. Finally, the Fed talked about further tightening to come. The market fell quickly after all this happened.

Yes, there is increased volatility in many spheres, but the S&P 500 is trading at 14.5-15 times 2019 expected earnings. In a world where the federal-funds rate is around 2.5% and core inflation is about 2%, a lot of concerns seem to have been discounted. The market will have to digest more uncertainty in the first half, but as long as GDP growth stabilizes above 1% and then accelerates in the back half of the year, I expect the market to be good.

Todd Ahlsten, Chief investment officer, lead portfolio manager, Parnassus Core Equity Fund, Parnassus Investments **Photograph by ioulex; grooming by Gina Marie Picciotto**

I am focused on two swing factors in 2019. The first is what happens to our relationship with China, which affects growth in the rest of the world. Emerging markets take their cue from China. I believe we will reach a trade deal with China in the first half. That said, we are on a new strategic plane with China, and the relationship will be chillier. China had its Sputnik moment with the U.S. in 2018. It no longer views the U.S. as a stable counterparty. I wouldn't count on the Chinese to be core customers of the U.S. semiconductor-chip sector or the networking sector or other key building blocks of the 21st century economy. The transition away from our building-block industries will happen faster than people think. I believe that was part of the issue Apple faced in the fourth quarter [the company cut its first-quarter revenue guidance, citing a weakening Chinese economy and lower-than-expected iPhone revenue in China]. Chinese companies are creating significant incentives for their employees to move from iPhones to Huawei phones.

What is the other swing factor?

Ellenbogen: Technology displacement underlies much of the political instability that Bill discussed. The global platform technology companies are deflationary. Consider Amazon's impact, not only on retailers but on business-to-business enterprises and consumer packaged goods. We calculate that 31% of S&P 500 companies are under threat of displacement, which has affected earnings multiples. The threat is coming from the big platform companies and companies that enable other companies to move quickly and compete better. Last year, I talked about Shopify (SHOP). Companies like Stripe [a payments processor] and Checkr, which is disrupting the background-check business, allow companies that most people never heard of to challenge incumbent industries. When you peel back what that means from a societal standpoint, employees feel increasingly uncertain about their futures.

Last year’s 3% wage growth and an unemployment rate below 4% isn’t the type of economic growth that would normally cause populist rhetoric. Yet concerns about job stability and economic growth help to explain the unpredictability of elections and political turmoil, whether it’s Trump’s election in the U.S. or Britain’s Brexit vote, or the rise of the “yellow vest” movement in France. I believe the Fed and other central banks will have to emphasize their mandate to maintain employment over their mandate to control inflation. That is the only way to create any type of global stability, especially in developed markets.

All of this suggests that it will be important to invest in companies that can really pull away from the pack, take advantage of change, and create an environment in which employees feel stable. The ability to excel in these areas will distinguish winning companies over the next 10 years. To Rupal’s point, that favors active management.

Jeffrey, will central banks follow Henry’s advice?

Gundlach: They might end up being accommodative. When the Big Four central banks [the Federal Reserve, European Central Bank, Bank of England, and Bank of Japan] were engaged in quantitative easing, global stock markets rose in lockstep. Last year, I said the Big Four cumulatively would go into balance-sheet-shrinkage mode, led by the U.S. As they did, the stock market tipped over, because the correlation still holds.

There will have to be pain to get these banks to reverse QT. The U.S. bond market is pricing in zero rate hikes from the Fed this year. Last year was the year the Fed won. The Fed said it would hike rates four times, the bond market said “No, you won’t,” and the bond market was wrong. But the Fed is already starting to capitulate. The bond market says there’s a greater chance of a rate cut than a tightening this year. Backing off on quantitative tightening would be a big help to the markets, but it won’t happen with the S&P down less than 20%. Stocks would have to fall 30% from their peak for the U.S. central bank to consider this.

Henry Ellenbogen, Portfolio manager, New Horizons Fund, chief investment officer, U.S. Equity Growth, T. Rowe Price **Photograph by ioulex; grooming by Gina Marie Picciotto**

Meryl Witmer: Jeff, some say that the staff at the Fed has a huge amount of animosity toward the president and because of that the staff is pressuring [Fed Chairman Jerome] Powell to continue hiking rates, even as the president pressures him to stop. While lacking any diplomatic touch, wasn’t Trump right to complain about what the Fed has been doing?

Gundlach: It is fine to disagree, but the manner in which you disagree has consequences. In this case, an irresistible force might be meeting an immovable object. We have the same problem with China. The guy who runs China doesn’t want to back down, either.

Cohen: The fellow who runs China is president for life. Let’s back up a minute and recognize that this Federal Reserve is in a difficult position. Monetary policy became a tool of choice following the financial crisis, not just in the U.S. but around the world. The Fed thought that it would be able in the past two or three years to get back to what it considers a normal balance sheet and normal interest rates. Instead, we had a fiscal-policy explosion. As Jeff indicated, it is quite unusual to apply a trillion-dollar deficit to an economy that is doing well.

In steering the economy, the Fed has to try to offset some of the other things going on. It is easy for people to try to blame the Fed, but I would come to the staff’s defense. My first job was as a junior economist on the Fed staff. In my experience, their analysis has been apolitical. When Powell and others talk about reconsidering rate hikes, they are looking at not just the stock market but financial conditions overall and some of the other things discussed here, including the availability of credit to corporations and consumers. They will be looking at lending surveys that came out in recent weeks that indicate some sectors of the economy are having problems.

Some people have benefited from structural changes in the economy and others have been harmed. This can be seen in the enormous geographical disparities that have developed in the U.S. In rural areas, 20% of households are living below the federal poverty level, and 15% qualify for food stamps, which they might not get if the government shutdown continues through the end of January.

Let's use New York City as an anecdote of success. Twenty years ago, New York was viewed as a high-crime area, people were moving out of the city, and unemployment was high. Then came the 9/11 attacks, which can be viewed as an inflection point for the city. An urban revival and enormous growth followed. Michael Bloomberg became mayor a few weeks after the attacks, and applied a businesslike approach to fixing the city for the long term. He recognized the need to diversify the industrial base away from financial services. He wanted to bring not just high-paid jobs and new industries to the city, but lower-paid jobs, because he recognized there was a great deal of hurt here.

New York's population has increased by 1.2 million people, to 8.6 million, a record. The city has added high-value jobs, but there has also been enormous job creation for people who make lower wages. We have seen growth in service industries like hospitality and health care. If you have a growth strategy, you can create an environment in which people without high-level skills and education can do better. There is a huge disparity between communities that consciously have developed growth plans and those that haven't.

So you're nominating Bloomberg for president?

Cohen: He could be very effective, but I don't know whether he could be elected. He understands economic issues, incentives, and how to use tax policy effectively.

Scott, let's get your two cents.

Scott Black: I see two possible outcomes for stocks this year. If the U.S. and China come to a trade agreement before the March 1 deadline, the market could explode upward. No pun intended, but an agreement would trump the Federal Reserve's actions and other economic issues. If the trade issue isn't resolved, however, the market will continue to languish and decline. Part of my thesis has to do with earnings. Last year, S&P 500 operating earnings were up 26%. Yet, among the companies in the Russell 3000 index, 92.4% fell 10% or more; 74.7% were down more than 20%, and 52.3% were down 30% from last year's highs. In other words, earnings really weren't important. Rather, the political backdrop—and President Trump's unilateral approach to the trade conflict—hurt. Instead of playing a game of chicken with China, the president should have allied with the European Union, which has similar problems with China, and sat down face-to-face with the Chinese to try to reconcile differences in a gentlemanly fashion.

Cohen: A gentleperson fashion.

Meryl Witmer, general partner, Eagle Capital Partners **Photograph by ioulex; grooming by Gina Marie Picciotto**

Black: To quote President John F. Kennedy, “Let us never negotiate out of fear, but let us never fear to negotiate.” What was said in 1961 is still true. The Trump administration took the wrong tack, slowing economic growth and disrupting supply chains across a wide swath of the economy—technology, auto supplies, logistics, and general manufacturing. Let’s assume we get some sort of a trade deal. S&P 500 earnings could be up 6%-7%, to about $167 this year. The big risk to earnings is energy prices staying low, as energy represents 5.89% of S&P earnings, or about $9.25 per S&P 500 share. Based on an estimated $157, the index is trading for 16.1 times earnings, or fair market value based on historical norms. Under my first scenario, the price/earnings multiple could drop to about 15. The Russell 2000 and Russell 2500 value indexes are trading around 15.3 times earnings. A year ago, they were priced at 21-22 times expected earnings. Jay Powell can be as accommodative as he wants, but it isn’t going to matter to the market unless the trade conflict with China is resolved.

Is the market pricing in flat earnings next year?

Black: The market doesn’t know what to expect. If Trump decides to impose an additional $267 billion in tariffs on Chinese imports, as he has threatened, that could be disastrous. Goldman Sachs dropped its 2019 U.S. GDP forecast to 2% recently from 2.3%. The euro zone is expected to grow by around 1.5%. China’s real growth could be 6%, and the world economy could grow maybe 3%. Two years ago, we were talking about synchronized global growth. Now we are talking about synchronized deceleration.

Mario Gabelli, Chairman and CEO, Gamco Investors **Photograph by ioulex; grooming by Gina Marie Picciotto**

Cohen: You can use a dividend discount model backward to figure out what kind of growth the market is pricing in. At year-end 2018 levels, stocks were pricing in very modest five-year earnings growth. However, there is a wide disparity, and some sectors were pricing in a 10% annualized decline in earnings, on average. Others were pricing in an 8% to 10% annualized growth rate. The market's December selloff was likely not based on a sudden sharp deterioration of fundamentals, but a belated recognition of issues ignored during the year. Volatility was increased when investors who wanted to raise cash at year end sold their winners, and securities that are liquid. This will sort itself out.

Let's remember that trade disputes have been fouling up economic data for several quarters and making it more difficult to interpret. Several things boosted reported GDP in 2018. The tax cut may have been a temporary boost. It is also now known that companies were building inventories ahead of the imposition of tariffs. Measures of economic activity could therefore be much more volatile, even if underlying aggregate demand doesn't move around much. Unfortunately the government shutdown means that several agencies aren't releasing critical economic data now.

Gundlach: GDP, excluding inventory, was up only 1.1% in the third quarter.

Let's get estimates for 2019 U.S. GDP growth.

Witmer: I would expect growth to be less than last year, call it 2% real.

Gabelli: 4.2% nominal, 2% real.

Ellenbogen: GDP growth decelerates in the first half of 2019 to sub-2%. Then it picks up, and we exit the year around 2.25%-2.50%.

Gundlach: I see real GDP growth of 0.5%.

Bhansali: I'll stick my neck out: We run the risk of a recession in late 2019, but what matters to equity markets isn't GDP but earnings.

Black: I see 2% real growth, and 2.2% inflation.

Cohen: The Goldman Sachs forecast for real growth is above consensus at 2.4% and the consumer price index is at 1.5%, with nominal growth around 4%. Economic growth outside the U.S. could decelerate notably. China's reported growth has been decelerating and will continue to do so. It was about 6.5% in 2018, and could be closer to 6% this year. And let's not forget Europe, which, in addition to structural issues, is dealing with supply-chain disruption tied to the U.S.-China trade conflict. The German auto makers are among those most affected by what is happening with the trade talks.

Oscar Schafer: Last year, almost no one but Jeff talked about quantitative tightening. They talked about earnings per share, interest rates, and China. Now that QT is happening, it will ripple through the economy. I expect growth to slow in the first half, but accelerate in the second half. The financial markets will do less well than the economy in the first half, and better in the second half. For the full year, real GDP growth could be 2%.

Oscar Schafer, Chairman, Rivulet Capital **Photograph by ioulex; grooming by Gina Marie Picciotto**

Bill, you're next.

Priest: I see 3.5% nominal growth, and 1.5% real growth. The canary in the coal mine was FedEx 's [FDX] fiscal-second-quarter earnings report, released last month. The quarter’s earnings weren’t the problem; rather, the company lowered its guidance for future quarters’ earnings growth. The news was received badly by the market. Only three factors determine equity returns: earnings, dividends, and P/E ratios. P/Es will be under pressure because of QT. It will be interesting to see this month’s earnings commentary and guidance from companies as they report fourth-quarter earnings. I expect many to lower 2019 expectations. When you reverse the aforementioned law of comparative advantage, profit margins will decrease.

Todd Ahlsten: The semiconductor business is another canary in the coal mine. Last March, we saw the first signs of weakness in the semiconductor industry. During the summer, automotive trends softened, and now handset sales are slowing. Semiconductor demand started falling off a cliff in October as the trade conflict heated up. That’s our gauge for economic growth.

We probably have one to two more quarters of significant inventory and demand adjustments for semiconductors. Then the rubber hits the road. During the April-June-quarter time frame, chip inventory should become more normalized and the trade situation is hopefully more understandable. We expect the first half of the year to be tougher for the markets, after which we see a little lift. Demand growth could return in the second half.

Cohen: We are trying to have a rational discussion about supply, demand, and business decision-making. But when a trade war is raging, the economy doesn’t necessarily follow the economic model we might expect. Buying phones other than Apple isn’t the only issue. The Chinese also aren’t buying U.S. soybeans, cheese, and other protein. China is the largest export market for U.S. agricultural products, and it isn’t buying. Brazil announced in December that year-on-year soybean exports to China had doubled. The Chinese are going elsewhere for other products. Going back to the urban/rural divide, the president’s trade policies are impacting U.S. farmers. And now, because of the government shutdown, they aren’t receiving the payments the government promised to offset tariff-related issues.

How long do you think the shutdown could last?

Cohen: It’s hard to predict on anything other than game theory. The package of bills to reopen government put forth and passed last week by the Democratic House of Representatives leadership was nearly identical to the package passed unanimously by bipartisan voice acclamation in the Senate in December. Yet, Senate Majority Leader Mitch McConnell is now unwilling to bring the package back to the Senate.

Gundlach: Since we’re talking about legislative packages, the Democrats put forth a bill in the House to couple additional spending with an automatic increase in the debt ceiling. That means there would be no need for a debt-ceiling vote. Once and for all, we’d be admitting that we don’t even have a debt ceiling. If Congress passes $10 trillion of infrastructure spending, the debt ceiling automatically would go up by $10 trillion. I have a lot of concern about bond supply and spending, and have been noodling over a theory for years: That is, when the economy weakens or the stock market tips over, as has happened, yields on the long end of the Treasury curve just might go up.

Scott Black, Founder and President, Delphi Management **Photograph by ioulex; grooming by Gina Marie Picciotto**

Black: The Congressional Budget Office has forecast that government revenues will average 17.5% of GDP annually for 2019 through 2028, and outlays will average 22.4%. They are forecasting a structural deficit of 4.9%, year in and year out.

Gabelli: How will this be solved?

Gundlach: You have to monetize the debt—or default on it. USDebtClock.org is worth looking at. It spins like a Tokyo taxi meter. Based on its calculations, you can see that the unfunded liabilities of the U.S. are $122 trillion. That's six times GDP.

Black: For every 1% increase in the interest rate, interest expense goes up by $200 billion.

Gundlach: Mario loves to bring props to the Roundtable, so I brought one this year. It is a book written in 1992 titled *Bankruptcy 1995: The Coming Collapse of America and How to Stop It*, by Harry Figgie with Gerald Swanson [holds up book]. The authors were early. They were intentionally hyperbolic in their cries of doom because they wanted to shock people into action. We keep talking about a trillion-dollar deficit, but it is higher than that. If the Fed raises rates, as Scott notes, a tremendous fraction of the federal budget will go toward paying interest on the national debt. In a couple of years, the interest on the debt will exceed the U.S. military budget. People tend not to see a crisis until it stares them in the face.

Cohen: This was forecastable years ago. In 2022, entitlement spending will increase notably. The peak year for baby-boomer births was 1957, and 65 years later you get to 2022.

Gundlach: To make matters worse, corporate treasurers understandably and inappropriately took advantage of low interest rates and tighter spreads and lengthened companies' debt maturities. Last year, about $50 billion of corporate investment-grade and junk bonds matured. This year, maturities will total $700 billion.

Ahlsten: My dad was a captain at TWA, where he was a pilot for 32 years. The company went through three Chapter 11 bankruptcy filings; he got laid off twice, and then the airline disappeared. That was my childhood. That's credit problems. As dire as this conversation is, the U.S. is home to the greatest innovations in the world. Look at the Googles and Amazons and Apples and Nvidias [NVDA]. We are still a creditworthy nation with great talent. We have diversity and population growth, and we still have immigration. I get that the numbers don't look good, but this country has a lot going for it. Our banks are a lot better than some of Europe's banks. They look better than Japan's banks, and China's. I'm going to bet that the diverse people in this room find great companies in which to make money.

A breath of fresh air! But Jeffrey, how do we get out of the crisis you've described?

Gundlach: I don't know exactly when it will happen, but we'll be surprised by how easy it is to remedy the entitlement problem once we understand that we have one. The so-called Greatest Generation that fought World War II would have forced the government to pry Social Security payments out of its cold, dead hands. The baby boomers are very different, and unusual. Once they realize the dimensions of the problem, they'll roll over like a puppy, and the government will be able to make changes easily, by raising the eligibility age for Social Security or taking other steps.

Bhansali: I want to bring this economic discussion back to the fact that just as there has been a resurgence of fake news, there has been a resurgence of fake earnings. I track at least 50 countries, and the U.S. has the worst corporate governance on that front. GAAP [Generally Accepted Accounting Principles] and non-GAAP earnings disparities are the widest ever here, and we keep calculating P/Es on fake earnings; we don't incorporate legitimate expenses, such as stock-option compensation and restructuring charges.

Second, corporate debt levels are very high compared with the past. To look at P/E ratios, or market capitalization divided by earnings, is a mistake. Instead, we should be looking at enterprise value, or market cap plus net debt and other liabilities, such as underfunded pensions, divided by earnings —EV/Nopat [net operating profit, after tax]. Looking at the wrong metrics has led to the misleading notion that markets are cheap. If you use EV/Nopat, the real multiple might be closer to 20 times earnings, which isn’t cheap.

Priest: How does that compare with the past?

Bhansali: It is hard to go back in time because in the past, companies weren’t as indebted as they are today. Nor did a sector as large as technology have such an egregious disparity between GAAP and non-GAAP earnings. We are in uncharted territory, which is why history has never been the only guide to understanding what might happen in the future.

Investing is ultimately about figuring out the unexpected because the expected is already in the price. That’s why corporate leverage isn’t just a problem for fixed-income markets, but is a bigger one for equity markets. Equity investors need to remind themselves of their status in the corporate structure, where they are at the lowest end of the totem pole. They have claims on the most residual portion of a company’s earnings and free cash flow. If the debt holders can’t be repaid, equity holders will be wiped out. That happened in the banking sector, and it is going to happen in the corporate sector. I agree with Jeff’s points. There has been rampant grade inflation in corporate debt. A lot of companies are being treated as above-investment-grade when they don’t deserve to be. Markets are extremely richly valued, particularly in the U.S. because U.S. companies are the most indebted.

Cohen: A question for Rupal: Corporations have been taking advantage of low interest rates to issue debt. Do you have a way to assess how much of that debt is really needed for operations?

Bhansali: The vast majority of debt has been taken on either to fund expensive takeovers or do share buybacks. There has been a gigantic equity-for-debt swap in the markets.

Meryl, what is your market view?

Witmer: There are a lot of moving pieces, and who knows what the Fed will do? Corporate debt is definitely an issue. We check total enterprise value to Ebita, or earnings before interest, taxes, and amortization. It is pretty rare now to find a company trading below 10 times Ebita, which is just an OK value, not a huge bargain. Most are 12 to 14 times this pre-tax measure. On the other hand, from what I understand, the retail investor is holding more cash, and has some dry powder to invest. If you buy good companies with good managements that generate free cash flow and have decent balance sheets, and if you get them at a decent valuation, over the long run you will make money. Rather than a market call, I stick with this approach.

Ellenbogen: There’s one more wild card in 2019. U.S. companies are leaders in innovation. We are home to the leading technology platforms in the world, with the exceptions of China’s Tencent Holdings (700.Hong Kong) and Alibaba Group Holding (BABA). For the most part, despite the stocks’ weakness in the back half of the year, tech leaders continue to gain share in their markets. Facebook (FB) and Alphabet’s (GOOGL) Google surpassed TV as advertising platforms last year. Amazon continues to gain share in e-commerce. Netflix (NFLX) continues to gain share and has forced a restructuring of the media landscape.

Nonetheless, talk of regulating these companies increased last year after rising in 2017. When Google CEO Sundar Pichai testified before Congress in December, both political parties were critical of him. One side criticized him for allowing the Russians to get Trump elected, and the other side criticized him for not allowing conservative views to get into the mainstream. It is clear that both sides of the aisle think these platforms have too much power. Europe has been on a faster regulatory track in recent years. One thing to watch as we head into the 2020 election is what the narrative is going to be on the tech leaders, and on the innovation that is driving the U.S. economy. There is a school of economists and politicians that is trying to move U.S. antitrust law much closer to Europe’s. If we become overly regulatory, we will start to stifle economic growth. I’m not saying it’s going to happen, but it’s a key question as we head into 2019.

Will the market for initial public offerings be a referendum on these companies?

Ellenbogen: The 2019 IPO market will be a referendum on two things: the outlook for market volatility, and investors’ belief in the strength of technology innovation. It is expected to be a big year, building off 2018, which, despite market volatility, was a good year. Names like Uber and Lyft are expected to come public this year. If the markets are solid in January, companies will stick to their plans, and we’ll see a fair number of IPOs in the front half of the year. If Uber comes public, we could see IPOs, especially in the area of self-driving cars.

Will the FAANGs [Facebook, Amazon.com, Apple, Netflix, and Google-owner Alphabet] resume their market leadership?

Ellenbogen: In a bear market, blue-chip companies hold up best and longest. Eventually, they fall, and when they do, they fall hardest, because they were trading at such a premium. That’s what the FAANGs experienced in the fourth quarter. When the market gets through its current rebasing process, the leaders of the next up cycle will be fantastic stocks. They will have a new acronym and it won’t be FAANG, as one or two FAANGs will fall out. Research In Motion was a market leader back in 2007; no one talks much about the company [renamed BlackBerry; BB] today. I look at the FAANGs as individual stocks. Netflix and Amazon have continued to power through. There are more questions about Facebook and Google because of regulatory concerns, but their core businesses are solid. I believe Apple's issues relate as much to a lack of innovation as geopolitics. Google is increasing its focus on its phones by integrating into chips and aggressively creating reference phones. Increased competition is another of Apple's problems.

Bhansali: Throughout this conversation, we have been assuming that disruption happens only in Silicon Valley. Even a boring business like utilities in Europe was disrupted by wind renewables. One of the sectors most vulnerable to price disruption is consumer staples. Consider Gillette, which continued raising prices for razors and blades. But at some point, even with innovation in the product, how many blades do you really need, and how much are you going to pay for them? In 2016, the consumer finally balked and many defected to alternative shaving-products companies. Gillette was then forced to lower prices instead of raising them, overturning decades of conventional wisdom around the pricing power of branded consumer-staples companies. The consumer-staples sector hasn't prepared itself for the onslaught of price transparency in an online, digital, e-commerce world, which is the opposite of the bricks-and-mortar world in which one can price-discriminate by customer segment and distribution channel. The industry's yesteryear playbook of relying on distribution strength, brand and pricing power, and customer segmentation is going to get upended. The market isn't paying sufficient attention to this long-term risk.

So why does Procter & Gamble (PG), which owns Gillette, still command a high P/E multiple?

Bhansali: Because we all listen to Warren Buffett, who has been the North Star of investing for so long, and God bless him, we needed one. But we need to stop living off the past. The concept of consumer staples being great franchises with high-quality earnings and pricing power is well known and in the price of the stocks. As I said this morning, investing is about figuring out what is unexpected. Equity markets need to rethink the notion of risk in every sector. The consumer-staples sector is revered for its high returns but not feared for its high risk exposure—whether it's disruption risk, valuation risk, or whatever. There is going to be a whole reset of risk premiums across these vectors. The less attention we pay to them, the more they will come back to haunt us.

Ellenbogen: We have learned that every dollar you spend online creates price transparency at a rate of five to seven times offline purchase. That also creates a host of challenges for local retailers, and has disrupted local commerce and traditional Main Street America. Real estate brokerage is being changed by companies like Redfin [RDFN]. Pioneering food-delivery platforms such as Grubhub [GRUB] are changing the restaurant business. We’re an investor in Vroom, an online sales platform for used cars. It and Carvana are changing the car-dealership business, which was the bedrock of many local economies. The transparency fostered by online transactions is a major cause of a lot of the socioeconomic uncertainty that Abby and Bill have talked about today.

Bhansali: But changes and challenges don’t have to result in a dystopian world. Look at Switzerland, Germany, Taiwan, or Japan. All went through difficult demographic changes, and faced the headwind of high labor costs. Yet they overcame those higher costs through higher productivity to become the manufacturing powerhouses of the world. There is always a way out. Companies, like human beings, adapt. We are short-selling our corporate and private sectors in thinking they can’t adapt to new realities. Even France, with its high-cost labor pool, punches above its weight in global competitiveness in many industries. Safran [SAF.France] supplies the engines that power Boeing (BA) planes, while Airbus (AIR.France) planes compete globally despite high wage in Europe. There is also Michelin (ML.France), a market leader in tires; L’Oréal (OR.France), in personal-care products; AXA (CS.France), in insurance; and BNP Paribas (BNP.France), in banking. Instead of wishful thinking about how the world ought to be, we should focus on how the corporate world is adapting.

Priest: Henry, Facebook’s market cap last summer exceeded the market value of all publicly traded securities in India’s stock market. Would you rather own Facebook, which you can purchase for less today, or the publicly traded value of the Indian stock market?

Ellenbogen: First, they are two different opportunity sets. But the larger point is, when you look at industries like advertising, in which Facebook and Google are the dominant platforms, or content spend, with Netflix, or major cloud platforms like Microsoft ’s and Amazon’s, you find these platform companies account for 50% to 70% of all revenue growth in their end markets. These virtual platforms also have network affects, and produce an immense amount of data, which they harness with machine learning. And they’re distributed on mobile phones around the world. These platforms aggregate share at a rate not possible in the physical world.

Cohen: What do we do about the impact of technological change? As a nation, we offered free public education at the end of the 19th century. After World War II, we encouraged college and vocational education through the GI Bill of Rights. We invested heavily; In the 1960s 12% of U.S. government outlays were aimed at research and development. Now we spend about 2%. How do we turn this into an opportunity instead of something dystopian?

Ellenbogen: The answer relates to our strategic confrontation with China. In the U.S., technology investment in critical areas like machine learning sits in our private companies and our universities. In China, it is funded by the public sector. Here, the government recognized the contributions of these companies and let them go global and monetize their ideas. They will enable us to compete with China over the next 50 years. Again, regulation of tech companies would be a problem, and it would concern the market over time.

Getting back to markets, what’s your view of gold?

Gundlach: It is going up because the dollar is going down.

Schafer: Also, gold is underowned.

Are emerging markets attractive?

Gundlach: They are going up because the dollar is going down.

Gabelli: About 20 years ago, Goldman Sachs came up with the notion of CRIBs, only they called it BRICs: China, Russia, India, and Brazil. These markets are oversold; there are a lot of opportunities. I expect China’s president, Xi Jinping, to make a deal with Trump this spring.

Bhansali: I’m negative on emerging markets and have been for the past decade, during which they significantly underperformed developed markets. Emerging markets benefit most from quantitative easing. As interest rates collapsed, they became prolific borrowers on both a country and corporate basis. Second, liquidity risk in these markets is significant. A lot of money is chasing very few stocks and bidding up allocations, even if EM allocations haven’t gone up. There are very good companies in, say, India, but I own none because they don’t compete from an investment standpoint. Hindustan Unilever (500696.India) trades for 62 times March 2019 earnings. HDFC Bank (HDB) is a great bank, but you have to pay 27 times March 2019 earnings for the shares, and the company issues equity every three years to fund its loan growth. This is not a recipe for making a lot of money as an investor.

William Priest, CEO and Co-chief Investment fficer, Epoch Investment Partners **Photograph by ioulex; grooming by Gina Marie Picciotto**

Has the growth of exchange-traded funds exacerbated valuation distortions?

Bhansali: Yes. ETFs or passive investments give you exposure to themes; a lot of inferior companies—companies with inferior business models, balance sheets, and corporate governance—get a free pass. But when these shortcomings come to the fore, these “prepackaged themes” will underperform and individual security selection will shine.

Yet, you own Chinese companies.

Bhansali: There are always exceptions. It isn’t a stock market, but a market of stocks. I am negative on China from a macroeconomic perspective, but China Mobile (CHL) is my top pick. It is the cheapest stock in the world, and it happens to be in China. Equity investing has always been about not paying up for what you get, and right now you’re not getting a lot. There is a growth scarcity, and the world has decided to pay up for it.

OK, lightning round: What will we be talking about here a year from now?

Priest: Populism.

Schafer: How the market will be good in 2021 because it was good at the end of 2020, just as today we have talked about how bad it is going to be because it was bad at the end of last year.

Cohen: Politics, for sure. But for investors there will be at least two other issues. First, momentum and passive investing will lose performance ground to capable active investors in both equity and fixed income. There will also be questions about some alternative investment strategies, including private equity, which, if you strip out leverage, haven't generated much in the way of excess returns.

Second, there should be increased attention to cross-border investments. Many U.S. and non-U.S. investors focused entirely on the U.S. during the first 50 weeks of 2018. The valuation gap that opened between the U.S. and emerging markets is a signal that there may be good opportunities outside the U.S.

Black: A recession, and what its duration will be.

Bhansali: People will say, "What was I thinking?" So much of the status quo and accepted wisdom will be questioned in the coming year.

Gundlach: We'll be talking about a presidential election with more than two political parties, which might lead to it being decided by Congress.

Ahlsten: We'll be talking about how high-quality blue-chip companies with low leverage that used technology to transform their businesses created opportunity for investors. We didn't have a recession, and the stock market was up on the year.

Ellenbogen: We'll be discussing the disruption of companies and employment anxiety spilling over into developed-market elections. The focus will be on the U.S. presidential election. Second, we'll be talking about how central banks globally are returning to a more accommodative stance because we need more growth to create greater economic stability among populations. Third, we'll continue to see a greater divergence of performance between investors who understand the systemic changes taking place and can analyze companies under this lens, and those who can't.

Gabelli: Elections: politics on a global basis.

Witmer: The presidential election.

Thanks, everyone. Let's talk over lunch.

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