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BARRON'S COVER | MONDAY, JUNE 17, 2013

Shifting Winds

By LAUREN R. RUBLIN | [MORE ARTICLES BY AUTHOR](#)

A change appears to be under way in the markets. Our experts explain the risks, and highlight the opportunities.

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Back in the day, a taper was only a candle. Just ask Lady Macbeth.



Now, suddenly, it is cause for convulsions across the financial system. Just whisper the word -- as in, the Federal Reserve might taper its monthly purchase of fixed-income assets -- and *voilà!* billions of dollars of wealth vaporize in stock and bond markets around the world. After months of investment Nirvana, all bets are off for the rest of this roiled year.

How best to navigate the new and more dangerous landscape? Luckily, we have just the guides: the intrepid members of the *Barron's* Roundtable. In our midyear telephone check-ins with these illustrious investment experts, who last met as a group on Jan. 14 in Manhattan, we sought both insights into the current market turmoil and specific ways to profit as the second half unfolds. Our go-to pros didn't disappoint. They also didn't agree.

Tables: 2013 Roundtable Report Card

2012 MidYear Roundtable Report Card

As a result, you'll find a wealth of contradictory opinion in the pages ahead, just as you will in the market, ranging from harsh assessments of the Fed's experiment with too-easy money to applause for the central bank's steps to end the financial crisis and prevent a successor. You'll also find a broadly diverse selection of investment picks and pans, ranging from undervalued equities to overvalued currencies.

The general consensus of the Roundtable crowd is that overseas markets can't hold a candle -- er, taper -- to the U.S. these days. Why, then, are our experts recommending so many European shares? That's just another of the contradictions that will keep you thinking and hopefully make you money in the back half of 2013.



[Enlarge Image](#)

Brad Trent for Barron's

MARIO GABELLI

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3:32

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2:10

**No Jobs Report on
Day 4 of
Government
Shutdown**

0:46

Barron's Roundtable panelists, from left: Oscar Schafer, Felix Zulauf, Mario Gabelli, Abby Joseph Cohen, Bill Gross, Brian Rogers, Meryl Witmer, Fred Hickey, Scott Black.

Barron's 2013 Roundtable

Part 1 -- January 21, 2013

Part 2 -- January 26, 2013

Part 3 -- February 4, 2013

system. The liquidity is helping financial stocks and real estate, but the consumer's real-estate wealth is still about \$5 trillion below where it stood in 2006. Consumer confidence is OK. Oil prices are down, which means spending can improve.



Barron's Roundtable veteran Mario Gabelli shares his best investing ideas.

India and China. State and local government spending is OK, and corporate balance sheets are in good shape.

That is an encouraging assessment. What is happening in the rest of the world?

Europe is a work in progress; nothing has changed there. In Japan, Prime Minister Shinzo Abe appears to be pulling off his experiment to weaken the yen and boost growth. And in China, the government is trying to ramp up consumer spending. The global economy will muddle through, with the normal caveats of political disruption, such as in Syria and Iran.

What, if anything, concerns you about the market?

We wonder whether the economy will be strong enough to provide ballast when the Federal Reserve's inevitable withdrawal of liquidity occurs. There will be a tug of war, and the market won't move much during that period. We see a flattish market in the second half, but it will be up for the full year by much more than I ever expected.



Brad Trent for Barron's

Mario Gabelli

[CHTR]. Hopefully, when the market hits an air pocket, you'll have some dry powder to take advantage of opportunities.

Where are those opportunities now?

Barron's: *How does the second half look to you, Mario?*

Gabelli: The U.S. economy is 20% of the global economy. It is like a train slowly pulling out of the station, trying to gain some speed. The consumer's wealth is at an all-time high, fueled by record amounts of money injected into the financial

While residential real estate isn't an important part of gross domestic product, an improvement is important for psychology and for job creation. Energy is another bright spot in the U.S., particularly with the shale-gas boom.

Commercial aviation is doing well. Now that **Boeing**'s [ticker: BA] Dreamliner is back in production, it is a good way to participate in the rising middle class in

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Featured Comment

‘6 *I have often wondered in the past few weeks why the establishment press has been so pro Yellen and anti Summers. My suspicion is confirmed. Yellen is the driving force behind QE forever and Summers is the skeptic.*

— John Reilly
On [Was Continuation of Bond Buying the Yellen Fed's First Decision?](#)

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I keep recommending **Viacom** [VIA], which is buying in shares. When **CBS** [CBS] and Viacom split in 2009, Viacom had 755 million shares. Now the share count is down to 487 million, and it will drop to 310 million in three or four years. Net debt is \$7.6 billion, and will rise a little in coming years. I am buying the A shares; I want to keep my vote where Sumner's [Chairman Sumner Redstone] is. The stock pays a dividend of \$1.20 a share. Looking out three years, you could see \$10 a share in earnings. The stock trades for \$67, and the company's private-market value could be \$130 to \$140 a share.

[What's the market doing?](#)
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Next, I have recommended bourbon companies in the past, including **Beam** [BEAM].

Davide Campari-Milano [CPR.Ity] is an Italian company with bourbon in its portfolio. It has 576 million shares, and is 51% family-owned. You can buy the stock for less than a Campari and soda; it trades for 5.48 euros (\$7.27) a share.

But is it a better investment?

Mario Gabelli's Picks

Company/Ticker	Price 6/12/13
Viacom/VIA	\$65.87
Davide Campari-Milano/CPR.Ity	€5.55
Tredegar/TG	\$24.92
Cablevision Systems/CVC	13.93
Cohen & Steers/CNS	35.89
Swedish Match/SWMA.Sweden	SEK 240.10
Kinnevik/KINVA.Sweden	173.70

Source: Bloomberg

The company's brands include Campari, Cinzano, and Aperol, among others. I like its Wild Turkey unit, the bourbon maker. The bourbon market is about \$300 billion, and Campari has a 4% market share. The company bought a Jamaican rum maker in December. Including that deal, net debt is €928 million. Revenue will approach €1.6 billion this year. The basic business is flat because of weakness in several core European markets.

Ebitda [earnings before interest, taxes, depreciation, and amortization] will be about €360 million this year, going to €390 next year and more than €400 million in three or four years. Campari could earn €0.33 a share this year, rising to €0.46 in a few more years.

Does Campari have American depositary receipts?

Yes, but they're not liquid. We are buying the ordinary shares in Europe. They are liquid, and the stock is reasonably priced, relative to other booze producers and industry takeover prices. But the family is unlikely to sell.

Tredegar [TG] is based in Richmond, Va., and has 32 million shares, which trade for \$25. The company eventually could be sold. It makes plastic films for diapers and flat-panel displays. It also makes aluminum products that go into nonresidential construction, which is picking up.

Give us the numbers, please.

Net debt is \$80 million. Revenue could total \$970 million this year, going up to \$1.05 billion in 2014. Ebitda is about \$103 million, and could rise to \$132 million in 2015. The company will earn \$1.40 a share in 2013, and as much as \$2 in 2015. Tredegar is a great cash generator, and global demand for its products is rising.

Next, I'm revisiting **Cablevision Systems** [CVC]. It is facing a lot of head winds, including competition from FiOS, repair of homes damaged by Hurricane Sandy, à la carte pricing, and people cutting the television cord to watch programming on cable. Revenue this year could reach \$6.3 billion; Ebitda is about \$1.6 billion. Pro forma, net debt is \$8.4 billion. The shares are selling for 7.5 times Ebitda, which isn't cheap. But Ebitda will grow, and the company will use cash flow to pay down debt. It pays a 60-cent dividend, and at some point the Dolan family, which controls Cablevision, will sell.

You and others have said that for years.

Cablevision split off **AMC Networks** [AMCX] in 2011 and **Madison Square Garden** [MSG] in 2010. Cablevision investors got a quarter share of both, and they have worked out well. Cablevision's stock has fallen in recent years, while **Time Warner Cable** [TWC] and Charter have done well. There is speculation something will happen, as Malone has re-entered cable, and Charter's CEO is a former Cablevision executive, under whose tenure Charter's stock has gone from the \$40s to \$115.

What is Malone's game plan with Charter?

He owns 27%. He wants to get into high-speed broadband. Through **Liberty Global** [LBTYA], he has become a major player in the global cable market, particularly in Europe and parts of Latin America.

My next pick is a money manager, **Cohen & Steers** [CNS]. The stock has dropped to \$36 from \$44 in the past month or so. There are 44 million shares outstanding. The company has \$176 million in cash. Real estate is a core competency of C&S, but they have also been launching closed-end funds. There has been some concern about tax treatment of real-estate investment trusts, which has been a head wind in gathering assets. C&S could average \$50 billion in assets under management this year. It will do \$300 million in revenue, \$125 million in Ebitda, and maybe \$1.70 in earnings per share, up from \$1.49. Looking out a few years, the stock could do well if inflation accelerates. They could wind up with close to \$12 a share in cash and \$3 in earnings by 2016.

Why did the stock tank?

Rising interest rates are a short-term head wind to real estate, particularly in the REIT structure. But the company is run by smart guys who will figure out how to respond. If the stock gets hit hard, they can buy back shares. C&S pays a dividend of 80 cents a share.



Goldman Sachs' senior investment strategist explains why she likes stocks now, especially Bristol Myers.

Swedish Match [SWMA.Sweden] makes snus, a smokeless tobacco. It has a large share of the Scandinavian market, and is trying to increase its penetration of the U.S. In 2010, it formed a joint venture involving its cigar business with Scandinavian Tobacco Group, and two years from now, it will be able to monetize that part of the business. There could be a good liquidity [money-creating] event.

Lastly, Swedish Match created a joint venture in 2009 with **Philip Morris International** [PMI] to market snus outside of Scandinavia and the U.S. Logically, Swedish Match could be taken over by Philip Morris International.

So there are many ways to win.

Right. In the meantime, the company is using cash flow to buy back stock and pay dividends. Snus is likely to capture a share of the smokeless-tobacco trend. As more people sample e-cigarettes, it could help the market for snus.

Kinnevik [KINVA.Sweden] owns investments in many companies. It is a play on digital commerce in Europe through Zalando, an online retailer. It also has telecom investments. I got involved because it owns 38% of **Millicom International Cellular** [MIICF], a wireless play in Africa and Latin America that is growing, including by creating an infrastructure for mobile banking in less-developed parts of the world. Kinnevik sells for 170 Swedish kronor. I am buying the A shares, which have voting rights. The company is positioned a bit like Malone's **Liberty Interactive-Ventures** [LINTA]. It is tax-efficient, and some of its venture-capital investments could have big payoffs. We value Kinnevik's assets at SEK240 [\$37.20].

Sounds intriguing. Thanks.

MERYL WITMER

Baron's: *How is the market treating you, Meryl?*

Witmer: We're having a good year. Economies are growing, except in Europe, which has little growth. We have always said that slow growth can be Nirvana for the market, and that seems to be the case this year.

Yet, stocks didn't look cheap to me at the beginning of the year, and they're even more expensive now. But we always look for things that have traded down, or special situations that offer opportunity. We're finding things to sell, and things to buy.

What are you selling?

We lightened up on **Macquarie Infrastructure** [MIC], as management did a fantastic job of running the company,



Brad Trent for Barron's

Meryl Witmer

and the market recognized that. We've also sold some **Six Flags Entertainment** [SIX], a great investment for us. Often, we trim positions if stocks trade up, and buy them back if they trade down. We don't get emotional about our holdings. "Bring a sharp pencil and leave your emotions at home" is one of my favorite lines.

Let's talk about what you're buying.

I have one stock to recommend, in a part of the world and in an industry that people aren't happy with. **Lanxess** [LXS.Germany] is a specialty-chemicals company headquartered in Germany, but it has plants around the world. *Barron's* wrote about it two weeks ago **[European Trader, June 3]**. The stock trades for €56 a share, and the market capitalization is €4.6 billion. Net debt is €1.8 billion.

Lanxess was spun out of **Bayer** [BAYN.Germany] in 2005. It was a complicated, highly levered company that has been skillfully managed and trimmed down since then by its superb CEO, Axel Heitmann. I went to the spinoff roadshow and thought that Heitmann was fantastic. But the company was tough to decipher. Our acid test is: If something goes wrong with an investment, are we comfortable writing to our limited partners about it? In the case of a complicated, overlevered company in the chemicals industry, I wasn't comfortable.

What's to like about Lanxess now?

The stock fell to €54 from €70 on weak earnings. The weakness is transitory, but this is a good entry point for investors. Lanxess has three business segments. One of them, performance polymers, mainly produces synthetic rubber for tires, but is also a key supplier to the chewing-gum and pharmaceutical industries.

Yuck! Are we chewing tires?

You're chewing butyl rubber. The same ingredient also is used to make stoppers for glass vials containing drugs.

Lanxess' other businesses are advanced intermediates, which has a terrific agricultural-chemicals business, and performance chemicals, which makes pigments for paints and other specialty chemicals. The earnings weakness has come from the synthetic-rubber business, where several developments have caused a slowdown in demand. First, the price of a key feedstock, butadiene, went up as oil companies moved to refine a lighter oil, which produces less butadiene. Lanxess' customers became worried about supply and started buying more than the usual amount. Then the price came down, and tire producers pulled back on their orders. The de-stocking has affected the company worldwide.



The Barron's Roundtable member -- and Berkshire director -- explains her strategy and makes the case for a little-known stock.

In addition, the European economy slowed, and consumers cut back on replacing their tires. A study done by Bridgestone found that more than 25% of tires in Europe have tread depth below required levels. It had been 11% a couple of years ago. My advice: Stay off the road in Europe, if it is raining.

Several developments in the near and intermediate term could turn Lanxess

around. The first is the end of de-stocking. Second, there is a need for tire replacement in Europe. Third, the European Union is instituting a tire-labeling system. Tires in Europe are rated from A to G for rolling resistance and wet grip. Less rolling resistance means better gas mileage. The difference between an A and a G tire can amount to a 5% to 10% savings in miles per gallon. An A tire more than pays for itself in gasoline savings. The

grading system could prompt a swath of the population that now is buying cheap tires to upgrade.

How will this help Lanxess?

Lanxess makes the chemicals used in higher-quality tires. G tires will be outlawed in Europe in 2014, and F tires a few years later. That should knock low-grade Asian tire manufacturers out of the market. The U.S. is considering adopting a similar policy in a few years. There is also a secular trend toward premium tires in China and Brazil, and a preference by consumers in North America for larger tires that require the more advanced synthetic rubber.

Meryl Witmer's Pick

Company/Ticker	Price 6/12/13
Lanxess/LXS.Germany	€53.70
<i>Source: Bloomberg</i>	

Another bullish trend for synthetic-rubber manufacturers is a huge increase in the number of cars sold in China. This will lead to heavy replacement demand in the next few years. In the U.S., the ratio of replacement tires to OEMs [tires made by

original-equipment manufacturers] is 3.5-to-1. In Japan, it's about 2-to-1, but in China it is 1-to-1. If China moves to 2-to-1, it will mean an increase of 10% to 15% in worldwide tire sales, by volume.

Lanxess, **ExxonMobil** [XOM], and a Russian company are the only companies that make a key synthetic rubber called halobutyl, used in tubeless tires, the predominant tire produced worldwide.

When will Lanxess' earnings recover?

Earnings are likely to drop this year from last year's €6.18. But we see Lanxess earning €8 a share in 2015, driven by capacity additions and natural growth in tire demand. We have a target price of about €100.

Congrats again on joining the board of Berkshire Hathaway this year. What have you learned so far from working with Warren Buffett?

The annual meeting was fun and very informative. It is good to think long term, and you should give good people autonomy. Nobody good wants to be micromanaged. Warren has built a great team of managers by letting good people do their thing.

Thanks for sharing that, Meryl.

OSCAR SCHAFER

Barron's: *What will the second half bring, Oscar?*

Schafer: The general consensus seems to be that the U.S. is the best place to be. Housing has bottomed, employment is improving, and even the deficit is declining. The improvement is slower than we want, and the Federal Reserve is distorting the markets with its interest-rate policy, but everyone agrees that we're in much better shape than the rest of the world. Europe is a disaster. Some of the unemployment figures coming out of the periphery euro-zone countries should frighten anyone who has studied history. China is slowing, and Latin America has an inflation problem in some countries and a growth problem in others.

Yet, the U.S. market has been selling off as bond yields rise, suggesting that many investors don't share your relatively sanguine view.

Rising interest rates need not be a negative for the stock market. As bond prices fall, many people looking in the rearview mirror will flee the bond market and go into the stock market. Also, from a supply-and-demand point of view, the supply of stock is shrinking as companies buy back shares, and demand will rise as companies buy other companies in order to get growth.

So you're investing primarily in the U.S.?

It seems strange to say, but I am finding some of the best bargains where the economic and political situations are most uncertain -- namely, in Europe and Latin America. It's not that I don't think U.S.



Brad Trent for Barron's

Oscar Schafer

markets are heading higher, but there are some great opportunities elsewhere. Recently, my good friend [Blackstone Advisory Partners Vice Chairman] Byron Wien published his latest note about his conversation with someone he calls the smartest man in Europe. The smartest man took a highly contrarian point of view, saying investors had become too bearish on Europe, and that there are reasons to be optimistic. Those words could prove prescient.

I am not a macro investor, so I won't make such bold predictions. However, it is an interesting time to look for companies in these markets that should be able to grow regardless of the environment. Two of my favorite stocks fitting that mold are **InterXion Holding** [INXX] and **DirecTV** [DTV]. Both trade in the U.S.

What does InterXion do?

It is a pan-European, carrier-neutral data-center company, based in Amsterdam. The company operates premium data centers throughout Europe that cater to customers who need high bandwidth, low latency, and carrier diversity. Growth is driven by continued demand for bandwidth, cloud computing, outsourcing, mobile data, and such. I view this as a real estate business, and InterXion owns some strategic Class A real-estate properties. It is important for investors to differentiate between run-of-the-mill data centers and these premium assets.

InterXion has a strong record, and has grown organically in the past decade, but it trades at a discount to its closest peers -- **TelecityGroup** [TCY.UK] in the U.K., and **Equinix** [EQIX] in the U.S. -- on an enterprise-value- to-Ebitda basis.

Oscar Schafer's Picks

Company/Ticker	Price 6/12/13
InterXion Holding/INXX	\$26.87
DirecTV/DTV	60.16

Source: Bloomberg

Because of its focus on continental Europe?

Yes, that is part of the reason. There is also a large private-equity investor who owns shares that may be sold. And the stock is an orphan, because its business is in

Europe, but it trades in the U.S. By my math, the existing data-center assets are trading at only 11 times free cash flow, assuming full utilization. The true cash flow is being masked by significant investments to expand the data-center footprint. Shares trade for \$27, and the stock has 50% upside. Ultimately, InterXion will either be acquired by a global player or make acquisitions to expand its footprint into other regions.

What is the bullish case for DirecTV?

DirecTV is the largest domestic satellite-TV provider, with 20 million U.S. subscribers, and the second-largest pay-TV provider after **Comcast** [CMCSA]. However, most investors don't realize that it is also the largest pay-TV company in Latin America. Its shares are undervalued at less than 12 times earnings, as investors are fixated on the competitive threats facing the core U.S. satellite-TV business. The market is worried that the U.S. pay-TV industry is mature, with nearly 90% household penetration and rising content costs. To make matters worse, there is a growing challenge from over-the-top providers that deliver video to the home via broadband.

But these are valid concerns. How can you argue against them?

The market is overlooking some critical positives in the DirecTV story. First, the company has an excellent track record of creating shareholder value through disciplined capital allocation. It reduced share count by nearly 60% from 2005 through 2012, at a share price well below the current \$60. I expect the company to retire another 13% of its shares outstanding in 2013. Second, in almost any scenario, the domestic satellite-TV business will continue to generate substantial cash flow for a long time.

Finally, DirecTV's Latin American business is a crown jewel in a high-growth region. Subscribers have grown at a five-year compounded annual rate of 26%, to 10 million, excluding Mexico, which means the region represents 22% of company revenue and 25% of profits. Yet pay-TV penetration across Latin America is still only 35%. The mature U.S. business and the high-growth Latin business are worth more than \$100 per share, representing 60%-plus upside.

Thanks, Oscar.

BILL GROSS

Barron's: *Your grim diagnosis of the economy's health, and your skepticism about the Federal Reserve's chosen remedy, have garnered a lot of attention recently. Can you summarize your thesis, Bill?*

Gross: I can sum it up in three phrases. There is too much leverage in the financial markets and the global economy. There is too little "carry," or yield. And there is too little growth. The leverage gets hidden or blamed on hedge funds, but it is everywhere in the private sector. Investors are using leverage to boost yield. Margin debt is rising. And collateralized debt obligations and collateralized loan obligations -- the same old stuff from before the crisis -- are back in play. Given questions about what the Fed might do next, some investors are taking money off the table to preserve year-to-date gains of 10% to 15%. The big question for the next six months is whether growth will substantiate levered positions.

And your answer is?

In the U.S., it doesn't pay to get too bearish. If the economy grows by 1% to 2%, at least it's positive. Japan is stealing growth from other countries. Euro land is a basket case, and we don't know much about what is happening in China. It's the sovereign equivalent of mystery meat. If you throw it all in the hopper, the global economy is growing, but not by enough to propel risk markets, including stocks, high-yield debt, and corporate bonds.

At some point, it will be necessary for real growth to reappear. We can't just depend on check-writing by central banks to continuously prop up asset markets. When the Fed finally tapers its asset purchases or ends them, that won't mean a disaster, and it might not even mean a bear market. But it will mean the end of double-digit equity returns.

Will the tapering begin this year?

It could. If the U.S. Treasury issues only, say, \$600 billion of bonds, and the Fed is buying the same amount in addition to mortgages, it suddenly will corral a larger percentage of existing offerings, which isn't good for the markets or capitalism. At some point, the Fed will have to scale back. It will explain this, but the market will be confused, and investors will sense that it is the beginning of a tightening cycle. At that point, we'll see whether the economy can stand on its own legs and grow.

What is your bet?

It is hard for me to see that the private economy and private markets will ever be able to stand on their own legs, because they are still highly levered. It is a sad commentary, but the only delevering that has taken place globally has been in the U.S. household sector, because people defaulted on a lot of mortgage debt. The markets have built up an addiction to and dependence on the Fed's trillion dollars of cheap money. This means global growth will just limp along, because other central banks are now stepping in with similar practices, including the Bank of Japan, which is writing checks for \$75 billion a month to drive down the value of the yen and spur growth. In proportion to the Japanese economy, that is triple what the Fed is spending. In the long run -- and here's the key



Brad Trent for Barron's

Bill Gross

sentence for me -- you can't solve a debt crisis with more debt, *unless* it produces real growth, and that isn't happening.

What, then, is the proper cure?

We are facing a lot of structural problems. One is demographic: The population is getting older. The ongoing process of globalization also is a problem, because production moves to cheaper ports of call. Technology, too, is a problem because it hampers job growth. We can't solve the demographic problem, or globalization, or the race against the machine. Unfortunately, things aren't like they were in the past 30 or 40 years, at least in the U.S., where baby boomers grew up, bought houses and cars, and led a consumption boom. Our investment committee was discussing just the other day that globalization and technology have led to the end of poverty for billions of people, if you define poverty as wages of less than a dollar a day. We applaud that, but it has also led to losers, primarily in developed economies.

Bill Gross' Pick	
Company/Ticker	Price 6/12/13
Pimco Corp. & Inc.	\$17.60 /
Opportunity /PTY	14.7%
<i>Source: Bloomberg</i>	

There are ways to temper these negatives, as Japan is trying to do with its so-called third arrow of long-term structural change. The U.S. could shift spending to infrastructure instead of trying to boost consumption. Any solutions would have to

be directed at long-term structural improvements, but governments don't seem willing to take those steps.

They might interfere with electability.

If the world wasn't levered, none of this would matter. If the world was financed with equity instead of debt that had to be repaid, I'd say, we'll get over it and check back with me in five years. But when there is too much debt, that's a different story.

Given this state of affairs, how should people invest?

In general, investors should expect low returns. It is hard to find things in this market that can hold their price and pay an attractive amount of income. I am re-recommending **Pimco Corporate & Income Opportunity** [PTY], a high-yielding closed-end bond fund I mentioned in January. It currently trades at a premium to net asset value. Remarkably, net asset value is within 50 cents of its all-time high, displaying the fund's defensive qualities in the recent mini-bear market. I would buy and hold the fund for an expected 8% return, plus the dividend. When you factor in the return and dividend, PTY had a 12-month yield of 14.7%.

Many thanks, Bill.

BRIAN ROGERS

Barron's: *What has been driving this market, Brian?*

Rogers: Corporate earnings have been pretty good. The economic news has been sluggishly better, if that's a word. Unemployment slowly has ticked down, and 2%-ish GDP growth, although not great, is positive. The housing market is improving. Investors have begun to feel a bit better about the future. They've become fatigued with the rhetoric coming out of Washington. They just don't care as much when their personal lives are looking better. A slow migration of money out of money-market funds into riskier assets occurred in the first part of the year. Some bond funds have suffered redemptions, and as people have grown more intrepid about taking risks, equity markets have advanced.

Will the stock market stay the course through year end?

In the next few months, the market could slow. It is up in the first half more than corporate fundamentals warrant. But I wouldn't be surprised to see further gains later in the year. Housing and employment will continue to improve.

So, you'd argue that the Fed's policies have worked?

They have worked, although it is time for the Fed to take the training wheels off a bit, and bring QE3, or the third round of quantitative easing, to a gradual end. I don't know how they will do it, but at this stage in the economic cycle, it isn't clear that we need zero-percent short-term interest rates any more. The financial sector is in better shape. To some degree, the markets will move ahead of the Fed in lifting rates, and that process

might be underway now. Eventually the Fed will announce that, due to continued improvement in economic conditions, it has decided to gradually reduce its asset purchases.

How intrepid are you these days?



Brad Trent for Barron's

Brian Rogers

We continue to look for companies with improving fundamentals, decent valuations, good dividend yields, and good dividend histories. Four of the six companies I recommended in January have increased their dividends in recent months. With money-market funds yielding only a couple of basis points [hundredths of a percentage point] in most cases, companies with good dividend histories and yields of 2% to 4% look like good investment alternatives. The search for yield will continue for a reasonable amount of time.

Before getting into my picks, I'd like to mention a few things going on out there that are of either mild amusement or concern, depending upon your perspective. For example, I never would

have guessed that the condo market in Miami would be on fire again. Back in 2008-09, there were discussions about a 10-year supply of properties. Now, new condos are under construction, and the occupancy rate is surprisingly high. Either we are on our way to a new mini-bubble in certain parts of the real estate market, or it is a tribute to how resilient markets and economies can be.

You're not the first to note a return of animal spirits.

Bitcoin is another example. It is one of the craziest things I've ever seen. Even if you don't like the fiscal and monetary policies of the U.S., at least the Fed has a claim on the assets of the country, and that backs the dollar. There is nothing behind the Bitcoin. Third, there's the news that a subprime lender [Springleaf Finance] is contemplating an initial public offering. The speculation is of a far lesser degree than what we saw in the housing market before the financial crisis, but there are signs of potentially worrisome activity.

Brian Rogers' Picks	
Company/Ticker	Price 6/12/13
Legg Mason/LM	\$32.44
Kohl's/KSS	51.20
General Electric/GE	23.50
Apache/APA	84.45
PNC Financial Services/PNC	70.84
Carnival/CCL	32.72

Source: Bloomberg

I am going to stick with most of my January picks, including **Legg Mason** [LM], which named a new CEO in February. Earnings have improved, asset outflows have declined, the company has continued to buy back stock, and it increased the dividend by 18% in April. It will probably reduce share count by 4% or 5% this year. Everything feels like it's getting better at Legg.

That includes the stock price.

The stock could continue to rise, but at a slower pace than in the past five months.

I'm going to close out my recommendation of **Avon Products** [AVP]. A new CEO, Sheri McCoy, came in about a year ago. The company straightened out its balance sheet and earnings improved, and the stock is up fairly sharply. It makes sense to move on.

Where are you moving?

Someplace controversial. **Carnival** [CCL] is a leading cruise-ship operator battered by a series of accidents and self-inflicted operating snafus, beginning with the *Costa Concordia*'s capsizing in Italy in 2012. Recently, there have been malfunctions of water/sanitary and engine-power systems on several cruises. There are few companies with worse PR and press coverage. The stock has dropped by 12% in 2013. Management is in crisis mode in pushing to get things back on track. While actions taken to improve

operations and attract customers are hurting this year's earnings, the company could earn between \$2.50 and \$3 a share several years out. The stock is selling at about book value, with a 3.1% yield. Carnival is an interesting contrarian investment.

Returning to my January picks, I am sticking with **Kohl's** [KSS], which has strengthened its management team by bringing in a chief marketing officer from **Starbucks** [SBUX]. Kohl's merchandising position is better, inventories are down, and earnings have been OK. It is still a cheap stock, and the company buys back stock aggressively. Both Legg and Kohl's increased their dividends in the first part of 2013.

General Electric [GE] has been a laggard, up just 12% since the January Roundtable. Are you keeping it on the list?

Yes. GE sold its investment in NBCUniversal to Comcast. It is contemplating monetizing its stake in GE Capital, whose dynamics have improved. GE Capital will dividend up about \$6 billion to GE this year, some of which will be used to buy back shares. Things are getting better in most of its businesses. In January, when I discussed the aircraft-engine business, I said that no one would remember the battery fires in Boeing's Dreamliner 12 months later. In fact, nobody remembers them six months later, because Boeing's stock, then \$75, is trading above \$100. Investors fixate on things, but a good management team can figure out solutions to problems. General Electric will never be a home run, but its performance will slowly improve.

My real laggard is Apache [APA], which has trailed the market this year. The company raised its dividend by almost 18% in February. It is a 10 P/E stock, with good energy assets, and the company is buying back \$2 billion of stock this year. The balance sheet is clean. They are good operators in the oil and gas business, with a net asset value of \$110 to \$125 a share. The shares are in the low-\$80s. The company will probably earn \$8.50 in 2013, so it can cover the dividend painlessly.

And you're sticking with it?

Absolutely. Apache is compelling. Also, there has been a modest amount of shareholder activism in the energy patch, at **Murphy Oil** [MUR], **Hess** [HES], and **Occidental Petroleum** [OXY]. The folks at Apache know they have to improve their performance, and they are fixated on it. They are highly confident, experienced people, and it is a cheap stock.

Finally, I will stick with **PNC Financial Services** [PNC]. The company increased its dividend by 10% in April. A new CEO came in, in a well-executed transition. And, the wind is at all the banks' backs from a credit standpoint. Everyone's credit exposure is improving, and consequently, they are beating earnings expectations, as is the case with PNC. The bank's capital position is strong, and management prefers stock buybacks to big mergers or acquisitions. Lastly, PNC still owns about 20% of **BlackRock** [BLK], an ace in the hole in terms of valuation.

Thank you, Brian.

FRED HICKEY

Barron's: *What's the good word from New Hampshire, Fred?*

Hickey: It's not so good. There is a massive disconnect between the stock market and the real world, especially among technology companies. I recently reviewed the first-quarter earnings reports and conference calls for a large number of major tech companies, and they all missed earnings expectations or guided future estimates lower. **IBM** [IBM] missed its numbers for the first time in 31 quarters. **Hewlett-Packard's** [HPQ] revenue plunged 10% in the quarter. Personal-computer sales fell 14% worldwide.

But isn't this mainly a consequence of the rise of mobile-computing?

That is only part of the problem. After all, mobile phones and tablets have been around for a while. The bigger problem is a macroeconomic slowdown. That's what companies are talking about on their conference calls.

You mean, customers have stopped spending?

That's what I mean. **EMC** [EMC] saw its slowest revenue growth since 2009. It is a



Fred Hickey

Brad Trent for Barron's

data-storage company and has nothing to do with PCs. Management said that its corporate customers are hanging on to their equipment longer. Information-technology spending is plunging. To attract customers, companies are engaging in price wars, which is hurting profit margins. I recently put together a list of the 32 largest U.S. technology companies, excluding telephone-service providers and electronics distributors. The list represented almost \$1 trillion of revenue in 2012. Revenue growth for these companies was pretty much flat in the first quarter, but pretax income declined 8%. Yet, many of the stocks are up sharply this year.

The stock market is being lifted by money-printing, primarily by central banks in the U.S. and Japan, but really, all over the world. That is why there is a huge

disconnect. We don't have a real market anymore. Bond yields have been manipulated lower, and stock prices have been manipulated higher. This is the biggest disconnect since the tech bubble in 2000. It is worse than the disconnect in 2007, before the financial crisis. It will end badly; money-printing has never worked. When central banks inflate asset prices, the rich get richer and the poor get poorer, but you can't run your economy on the 1%. The latest experiment is doomed to failure.

How will it fail?

Eventually, there will be a global depression. Until then, asset prices will rise whenever central banks print money. That makes it difficult to short this market.

Fred Hickey's Picks

Company/Ticker	Price 6/12/13
SHORT Philadelphia Semiconductor Index/SOX	\$458.33
LONG Central Gold Trust/GTU Agnico Eagle Mines/AEM	\$50.07 30.80

Source: Bloomberg

How should investors protect themselves?

They should hold a lot of cash, and buy gold. It also makes sense to short the Philadelphia Semiconductor Index, or SOX. There are 30 companies in the index, so you're protected in the event one or two names rise sharply. The SOX is up 23%, year to date, but pricing pressures throughout the tech industry eventually will trickle down to component suppliers.

As more technology companies miss earnings expectations -- some already have said things are worsening in the current quarter -- semiconductor stocks will get hit.

Gold hasn't been much of a refuge lately. It is down 16% this year, to \$1,400 an ounce. What's ahead for the yellow metal?

There has been a correction within a secular bull market, but history shows that the antidote to money-printing is gold. The price of gold has risen for the past 12 years. Gold shot up by \$450 an ounce in the summer of 2011, as too many speculators piled in. A correction then ensued. The same thing happened in 1976. Gold had a severe correction within a secular bull market, before rising eightfold to make a new high to \$850 in January 1980. It wouldn't surprise me if we have a 13th consecutive year of gains in gold prices. Prices can go a lot higher from here if the money-printing continues. I am expecting a new high, and more, from the \$1,921 an ounce we saw in September 2011.

*Do you recommend buying bullion, or gold stocks and funds, such as the **SPDR Gold Trust** (GLD)?*

The **Central GoldTrust** (GTU) seems timely now. It is a Canadian closed-end fund established in 2003, and it currently allows you to buy gold at a 3% discount to assets. That's because negative sentiment toward gold is off the charts. Short-selling is at record levels. Also, U.S. holders can receive beneficial tax treatment; the GTU can be taxed like a U.S. mutual fund under certain circumstances, and not at the 28% collectibles rate. And

the expense ratio is only 0.34% -- lower than GLD. The Central GoldTrust owns bullion, which is stored in Canada. The custodian is CIBC.

Whenever the price of gold declines, gold-mining shares decline by more. The miners, as measured by the GDX, or **Market Vectors Gold Miners** ETF, are down 35% this year. Some stocks are trading below their 2008 lows. I still like the two stocks I mentioned at the January Roundtable -- **AuRico Gold** [AUQ] and **New Gold** [NGD]. There have been good developments at both companies. Plus, AuRico yields 3%. Now I am recommending **Agnico Eagle Mines** [AEM], which I also recommended last June. The shares rallied more than 30% in the second half of 2012.

But then they fell more than 30%.

They could have a strong second half this year, too. Agnico Eagle has mines in Canada, Mexico, and Finland, so there is no risk of government expropriation. Location is the first thing I look at when picking mining stocks. In addition to the benefit of a potentially higher gold price, the company has two mines coming on. As the mines ramp up, and as the gold price rebounds, earnings will improve. Second-half earnings are expected to be 57% higher than earnings in the first half.

Agnico also is increasing production, a rarity in gold-mining. It will produce 990,000 ounces in 2013, rising to 1.2 million ounces in 2015. If you are a contrarian, as I am, this is when you want to put your cash to work. Finally, Agnico Eagle pays an annual dividend of 88 cents a share, for a 3% yield. It has paid a cash dividend for 31 years, and has been raising the dividend. Investors are looking for yield, but they would never think to look at mining companies.

Thanks for reminding them, Fred.

ABBY JOSEPH COHEN

Barron's: *The market has practically followed your script this year. What lies ahead, Abby?*

Cohen: In January, my two key messages were that equities were likely to surprise in a positive way, and that bonds might prove disappointing. The official Goldman Sachs forecast has moved up to 1750 from 1575 for the Standard & Poor's 500. We always begin with valuation. I've been using discounted-cash-flow models. One of the most important things driving the recent bullishness in the equity market is the ongoing dynamism in the U.S. economy. At the beginning of the year, we saw significant improvements in areas such as housing and autos. Also, consumer balance sheets had improved dramatically. We were concerned that developments in Washington, such as the end of the payroll-tax holiday and the beginning of the sequester, would create fiscal drag, but that has been delayed. The next debate over raising the debt ceiling in early autumn could create renewed concerns for financial markets.

The sequester might cause a bigger hit in the future, as well, because it didn't become effective at many government agencies until April 1. Some economists think that the sequester could impede economic growth by half a percentage point a year. We are expecting an uneven impact by region, because so many budget cuts are falling on the Defense Department and will affect communities and states with military bases and military contractors.

What is your GDP estimate for the year?

We are looking for 2% economic growth this year and 3% next year, once we get past the impact of the sequester and the next debate about the budget ceiling. Various sectors of the economy are all pulling in the same direction at the same time, and while we have reservations about austerity on the Federal level, state and local spending has begun to improve. State and local governments are benefiting from the improvement in overall economic activity, and the improvement in housing.

Some of your Roundtable colleagues are deeply pessimistic about the Fed's ability to jump-start economic growth via quantitative easing. You're in the opposite camp. Why?



While no policy implementation has been perfect, the Fed has done a phenomenal job, especially as it is working against a fiscal policy that is moving in the wrong direction. We now know that the severe recession that followed the financial crisis was much more dramatic than expected, and the fiscal stimulus supplied at the time was effective. It would have been nice if it had been a little larger or lasted a little longer. Also, until recently, most of the other central banks weren't providing much help in increasing liquidity, although the Japanese are stepping in now, and everyone is waiting for the European Central Bank to do something.

The second area in which the Fed and the Treasury together did a great job was the repair of the U.S. financial system. They imposed significant stress tests in 2009 that led to additional consolidation in the

financial-services industry, and forced the remaining companies to ensure they were properly capitalized. As a result, our banking system is doing much better. In the U.S., unlike in some other nations, there has been significant deleveraging, and lending has increased.

Abby Joseph Cohen's Picks

Company/Ticker	Price 6/12/13
Applied Materials/AMAT	\$15.25
Novo Nordisk/NVO	167.75
Trulia/TRLA	29.35

Source: Bloomberg

Interest rates finally have begun moving up. Will they continue to climb?

Our economics team believes that the Fed is engaged in serious discussions about how to gradually adjust its interest-rate policy. We have already begun to see the yield curve steepening. The Fed doesn't

want to change policy dramatically anytime soon. In using language like tapering, they are talking about a change in the rate of change.

Some investors think that when yields start to rise, they'll just move up in a nice, gradual way. History doesn't support that sanguine view. When markets reverse, they tend to do so in a choppy way. One thing that happened in the past month is that bond mutual-fund managers were selling in anticipation of redemptions. That intensified the selling pressure on bonds, and increased volatility. The increased volatility in the equity market has been linked to increased volatility in the bond market.

Doesn't the added volatility create good investment opportunities?

I do have some new stocks that our analysts are recommending, and there have been recent positive developments at two companies I mentioned in January. **Bristol-Myers Squibb** [BMY] will continue to benefit from trends in cancer treatment. The recent ASCO [American Society of Clinical Oncology] meetings highlighted the promise in immuno-oncology treatments, including the combination therapies that are part of the Bristol-Myers franchise. Current data suggest that these likely improve patients' survival and may be effective across a variety of tumor types. Bristol-Myers is increasingly viewed as a biotech company, and could benefit from the higher valuations normally associated with such companies. Although the stock has performed well since January, it still offers a 3% yield. Our analysts forecast 2013 earnings of \$1.80 a share, followed by \$2.07 in 2014.

Noble Energy [NBL], another January pick, has reported that production trends are favorable at new projects, include the Tamar field in the eastern Mediterranean. Production began in the spring, and there are discussions regarding regional options. In addition to producing natural gas in Israel, liquefied natural gas might be exported to other countries. Goldman Sachs estimates that Noble could earn \$3.30 a share in 2013 and \$3.76 in 2014. These are below-consensus estimates. Our analyst rates the stock a Buy.

What new names do you have?

Brad Trent for Barron's

Abby Joseph Cohen

Applied Materials' [AMAT] execution has improved strongly in recent quarters, as the company is benefiting from a senior management team that joined from Varian, which Applied bought in 2011. An earlier focus on solar has been reduced. Gross margins increased in the first quarter, beating Goldman's estimates by 2.2 percentage points, and earnings surprised on the upside, leading analysts to revise their estimates upward. Our 2013 earnings estimate is 59 cents a share, rising to \$1.09 in 2014. The stock yields 2.6%.

Novo Nordisk is a large European-based pharmaceutical company. The stock trades in Copenhagen [NOVOB.Denmark] and in the U.S. [NVO]. The company is a significant participant in the global insulin market, and offers several versions of diabetes treatments, representing almost three-quarters of its revenue. Other products include human-growth and hormone-replacement therapies. Our analyst estimates earnings of 48.88 Danish kroner [\$8.72] this year and DKK55.58 in 2014. The stock yields 1.9%.

Dividends, it seems, remain an important part of your investment strategy.

In many cases, yes. But my last selection, **Trulia** [TRLA], came public only last September, and offers no yield. The Web-based company provides information on the housing market. The ability to easily access market data is proving essential to agents, sellers, and potential home buyers. The economic backdrop for housing has improved, as demonstrated by stronger demand and rising home prices in most regions around the U.S. Trulia's revenue is expected to reflect this recovery. The company is likely to move into the black in the second half of 2013. For the full year, our analyst expects the company to lose four cents a share, followed by earnings of 62 cents in 2014.

*What is the attraction of Trulia, relative to **Zillow** [Z], a popular competitor?*

Both stocks are projected to generate about 35% annualized revenue growth in the next three years. But Trulia is selling at a discount to Zillow on a variety of metrics.

Thank you, Abby.

FELIX ZULAUF

Barron's: *How does the world look to you, Felix?*

Zulauf: The general perception is that the U.S. economy is improving, and that the Fed will begin to reduce its quantitative-easing program later this year. The consensus in Europe is that things are stabilizing and will improve later this year and into next year. In Japan, the view is that the experiment to boost economic growth will work, at least in the short term. So the general perception is that the global economy is healing, and that is making the banking system nervous.

Explain why, please.

The banking system, including the shadow banking system [nonbank financial institutions], is fully loaded with bonds because it received free money from the central banks. If the general perception that things are improving is right, bond yields will go higher. As a precautionary measure, banks are beginning to sell bonds, which is helping to drive yields up. The yield on the 10-year Treasury could rise to 3% as this plays out.

When banks sell bonds and return the money to the central banks, they are shrinking their balance sheets. This is the reverse of quantitative easing. It means that liquidity is drying up in the global credit system, and when that happens, the borrowers at the periphery of the system get hurt because they can't finance their funding any more. We could have debt crises in countries such as Turkey, Mexico, and Poland if the general perception is correct.

We have a hunch you disagree with that perception.

I do. I lean toward the view that the world economy is weaker than people think it is, which means that bond yields won't rise



Brad Trent for Barron's

Felix Zulauf

and might come down in major countries, particularly those with current-account surpluses, by late summer. Noncyclical stocks -- I call them teddy-bear stocks because you can sleep well owning them -- could continue to do well, and cyclical sectors could deteriorate. Commodities and emerging-market equities and currencies are likely to keep disappointing. The world economy won't heal because financial repression, currently favored by the authorities throughout the industrialized world, isn't going to work.

If I am right, volatility will pick up. It is likely the stock market will have another rally in the summer, but it is all part of a topping pattern wherein stocks become detached from corporate fundamentals. That has already happened. Corporate earnings have been flat for the past 12 months, yet stocks have rallied. It is time

to reduce portfolio risk. You have to trade; you can't buy and hold positions for the long term. I would buy volatility insurance. The VIX [Chicago Board Options Exchange Market Volatility Index] is trading around 16-17. I would go long VIX futures.

What else would you trade?

I would also be active in currencies because emerging-market countries with current-account deficits will come under mounting pressure. It makes sense to short the Turkish lira against the dollar and the euro. The country reformed its currency in 2005, and its private-sector loans have tripled since 2008. External debt amounts to 40% of GDP, and most of that is private-sector debt. And now Turkey has political unrest, which is coming at the worst possible time.

Felix Zulauf's Picks

Company/Ticker	Price 6/12/13
LONG	
CBOE Volatility Index (VIX) Futures*	\$18.25
Market Vectors Gold Miners(GDX) Options spread trade:	
Buy Dec 30 Strike,	2.56
Sell Dec 40 Strike	0.54
SHORT	
iShares MSCI Hong Kong / EWH	\$18.79
Turkish lira vs. U.S. dollar	\$1 = TRY 1.88
Turkish lira vs. euro	€1 = TRY 2.50
Mexican peso vs. U.S. dollar	\$1 = MXN 12.93
Polish zloty vs. euro	€1 = PLN 4.26
*June contract	Source: Bloomberg

A lot of hot money moved to Mexico in recent years, and the situation there is similar to Turkey's, but not as extreme. I would short the Mexican peso against the dollar, as the peso is likely to come under pressure.

Are you shorting stocks, too?

The U.S. market has a chance to bounce back after its recent selloff. But emerging markets are a different story. I would short the Hong Kong market. Hong Kong is a real-estate-based economy. Real estate companies have a big influence on the Hang Seng index. The authorities recently tightened the real-estate market. There are restrictions on buying by foreigners. Taxes

have been increased. The Hong Kong dollar is pegged to the U.S. dollar. If it were allowed to float freely, it would come under pressure. The monetary authorities would have to defend it, which would lead to higher interest rates. You can short Hong Kong by shorting the EWH [**iShares MSCI Hong Kong** index]. It is trading at \$19. It could have a bounce, giving you an opportunity to short it at \$20 or higher.

A more speculative opportunity involves gold miners. Mining-company shares were clobbered when gold declined and look to be putting in at least a medium-term bottom. Instead of buying the Market Vectors Gold Miners exchange-traded fund, you could set up a GDX options spread trade, buying December call options with a strike price of \$30 and selling December calls with a strike of \$40. If the GDX rallies in the next six months from a current \$29 to \$38 or \$40, you could triple or quadruple your money.

This suggests you're still bullish on gold.

I still own physical gold. The price is making a medium-term bottom in the \$1,300s. The downside isn't dramatic from here, but we'll need another global crisis for gold to start rising in earnest. The disappointing thing is that gold didn't behave well, despite all the money-printing. The major forces in the world economy are still deflationary, not inflationary. The money isn't flowing into the economic system. It is contained in the financial system and leading to bubbles -- in bonds, emerging-market bonds, junk bonds, emerging-market currencies, and such.

Let's return to Europe. What is your perception of the euro zone these days?

Europe is a disaster and will remain one. The problem remains that countries with different economic structures and cultures have been yoked to a common monetary policy and currency. It won't work unless Europe creates a political union. As things stand, Germany will assist the Continent's weaker players only on a piecemeal basis, so a recovery in these countries can't really take place. The next crisis could occur in France, which has become highly uncompetitive. Its trade and current-account deficits are deteriorating by the day. The French can't sell their products in the marketplace, and are unwilling to introduce important structural reforms.

The European crisis could drag on for a number of years, although the shares of many European companies look attractive from a valuation standpoint. But, as I see another crisis coming, provoking a big central-bank push, it isn't time yet to jump into European equities. Because depositors took a hit in the rescue of Cyprus' banking system, the next crisis could be much bigger. For sure, there will be a run on the banks. Wealthy people must fear confiscation of their assets. Europe is moving in the wrong direction. It is a wonder the euro is holding up so well.

Why is that the case?

The euro zone has a current-account surplus. But I wouldn't be surprised if Europe had another crisis before January.

One thing I regret is recommending emerging-market ETFs at the January Roundtable [see **Roundtable Report Card**]. I sold these investments in my own account a while ago because they didn't work out, despite efforts by the monetary authorities to create more liquidity in the market. I have also exited my Japanese trades, but plan to re-enter the Japanese market when timing dictates. Americans should stick to the U.S. market for now.

Thank you, Felix.

SCOTT BLACK

Barron's: *What a month it's been! Where to from here?*

Black: Ironically, the market could go up from here. For one thing, stocks aren't expensive. Based on my estimate of \$104 this year in S&P 500 earnings, the market sells for 15.6 times earnings. The average postwar price/earnings multiple is 16, but with much higher nominal interest rates. I expect Bernanke to keep the pedal to the metal, and refrain from tapering.

Why do you hold that rather contrarian view?

Look at the numbers. Nominal GDP is growing by only 3.6%. Unemployment is 7.6% and U-6, a broader measure of unemployment, is 13.8%. Inflation is tame at only 1.1% a year. Bernanke has said that the Fed won't pull back until unemployment is at 6.5% and unless inflation accelerates. The Fed made a mistake in discussing tapering. With the economy just above stall speed, it doesn't make a lot of sense.

Despite low valuations, the market will rise only because of liquidity. The Fed's balance sheet is up 19%, year over year, to \$3.4 trillion. Monetary easing has overcome most of the negatives in the economy. And, even if the yield on 10-year bonds backs up again to 2.21%, that isn't much competition for stocks. But let's not ignore the problems, including euphoria about corporate earnings.

What do you mean?

The official consensus -- \$109.69 -- implies 13.3% growth in S&P operating earnings, which is ridiculous, given



nominal GDP. Sales growth is minimal among S&P 500 companies, although first-quarter operating profit margins were 9.58%, a record high. Also, there is no political will in Washington to reduce the deficit, even though debt is at 1.04 times GDP, the highest ratio since the end of World War II. The consumer is in trouble, with personal income up only 2.75% this year, lagging nominal GDP. People are defending their standard of living by saving less, and consumer installment debt is skyrocketing again.

So you're bullish about stocks, but bearish about everything else?

Again, look at the numbers. The manufacturing sector isn't as robust as it was a year ago. Durable-goods orders are up only 3.6%. Factory orders are up 1%. The rig count is down 13.4%, and the latest

reading on the Purchasing Managers Index is 49, which is contractionary. The one bright spot in the economy is housing, but the housing stocks are fully priced. Yet, so long as the Fed prints money, the market could sell for 16 to 17 times earnings. A P/E of 17 implies 9% upside from here.

Looking at market sectors, financial stocks are up 19.3%, year to date, but the sector's profits were down \$2 billion in the first quarter. Health care is up 20.7%, yet there is almost no top-line growth at the big pharmaceutical companies. Consumer staples, too, are way overrated by investors. One of the areas that has lagged is technology. My two picks are tech stocks, and plays on data storage. Measured in gigabytes, storage will grow by 40% this year and 40% next, driven by growth in enterprise and cloud computing. What else in tech is growing by 40%? **VMware** [VMW] is a play on cloud computing and virtualization, and I am buying it through EMC.

To clarify, EMC owns 80% of VMware.

VMware is the growth engine of EMC. VMware is trading for \$71 a share. The company has \$10.38 in net cash per share. Assuming that it will earn \$3.28 a share this year, it trades for 18.5 times earnings. As a value investor, I couldn't pay 18.5 times earnings. EMC is a much less expensive way to buy it.

Scott Black's Picks

Company/Ticker	Price 6/12/13
EMC/EMC	\$24.33
SanDisk/SNDK	58.93

Source: Bloomberg

Based on my model, EMC could have \$23.4 billion in revenue this year, up 7.8%. Operating income, not including stock-option expense, will be \$5.967 billion. Subtracting nonoperating expenses of \$280 million, you get profit before taxes of \$5.687 billion. Taxed at 23.5%, that's

\$4.35 billion in net income. Subtract the minority portion of VMware's profits, or 20%, and net is \$4.065 billion. Divided by 2.19 billion fully diluted EMC shares, you get \$1.86 a share in earnings, up 9.4% from the prior year. It isn't correct to measure VMware's value per EMC share. It is correct to measure what you're paying for earnings.

OK, walk us through the math.

EMC trades for about \$24.67. It has \$4.30 a share in net cash. Subtract that, divide by \$1.86, and you get a multiple of 10.9. EMC pays the equivalent of 30 cents a share in stock-based compensation, and we believe, like *Barron's*, that that cost ought to be reflected in earnings (see **"Beware the Hidden Costs in Tech,"** June 3). Therefore, EMC's true estimated operating earnings are \$1.56 a share, which means that EMC holders are paying 13 times earnings. On a pro forma basis, return on equity is 16.5%, and return on total capital is the same.

VMware got punished earlier in the year because revenue was supposed to grow by 17% to 18% this year. Instead, it is growing by 12%. But it is important to understand that the company formed a joint venture with EMC and General Electric called Pivotal, and

offloaded \$300 million of revenue to that. If that sum were added to expected revenue of \$5.18 billion, the growth rate would be 18%. This means that EMC holders are getting no value for Pivotal right now.

What is ahead for EMC?

The company could earn \$2.10 a share next year, implying a stated P/E of 9.7. Subtract stock-based compensation, and the multiple is 11.3. Remember, the market multiple is 16. The company initiated a 40-cent dividend at its most recent annual meeting, for a 1.6% yield. The board also authorized a \$6 billion stock-buyback program through 2015. I didn't include the buyback in my calculations, so my earnings estimates could be conservative. To reiterate, this is a poor man's play on VMware and virtualization.

My other pick, **SanDisk** [SNDK], is the leader in NAND flash memory. It also makes controllers and software, so it offers an integrated solution. It has about a 50% global market share. The stock trades for \$59, and the market capitalization is \$14.6 billion. The company doesn't pay a dividend, although it is sitting on \$4.3 billion, or \$17.51 a share, of net cash. Revenue could rise 15% this year, to \$5.8 billion. Pretax profit margins of 24.5% get you to \$1.421 billion in pretax profits. Taxed at 29%, the company will earn \$1.009 billion, or \$4.10 a share. My estimate is a little below the consensus, and it is up 72% from last year's \$2.38 a share. Production capacity is 2.5 million wafers a year, via a joint venture with Japan's Toshiba [6502.Japan], and production is sold out through this year.

Tell us more about the business.

The retail market accounts for 38% of revenue, and SanDisk has a 30% market share worldwide. Selling to OEMs -- namely, the Apples of the world -- contributes 62% of revenue. The fastest-growing part of SanDisk's business is flash-memory storage solutions. Prices have come down sharply, and flash has been replacing hard-disk drives. The company has three major product offerings. Solid-state drives, or SSDs, could account for 30% of the overall mix by 2016. SanDisk also makes removable storage cards, which is about 35% of the business, and embedded memory for mobile devices, digital cameras, and the like. Because manufacturing is denominated in yen and sales are denominated in dollars, the yen's decline has been a big windfall. Every 10% decline in the price of the yen, from 78 yen to the dollar, adds about four percentage points to gross margin.

SanDisk is a technology leader, and the low-cost producer. The company dedicates 70% of its free cash flow to repurchasing shares. Excluding net cash, the shares trade for 10.2 times expected earnings. Subtract 35 cents a share in stock-based compensation, and the multiple is 11.1. Either way, it's a cheap stock, and earnings are exploding this year. Return on equity is 13%, dragged down by all that cash. With cloud computing driving huge demand for storage, primary demand is working for the company.

Overall, technology has been left at the starting gate. Tech stocks are up 8.4% this year, compared with a 15.1% rise in the market.

That's reason alone to take a closer look. Thanks, Scott.

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