BARRON'S COVER

Barron's Roundtable: Masters of the Game

Our experts predict sluggish economic growth and subdued gains for stocks. Where to find value around the world.

By LAUREN R. RUBLIN
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Whether you favor tarot cards, tea leaves, or crystal balls, it's hard to predict the future. Just ask anyone who correctly forecast that oil prices would fall more than 50% in the past few months -- and good luck finding anyone who did.

Rising to the challenge of divining economic trends, market moves, and especially the actions of the world's central bankers, the members of the *Barron's* Roundtable took their usual seats last Monday at the Harvard Club of New York and gamely got down to the annual business of making sense of the world for investors, notwithstanding some good-natured grumbling about the perils of the forecasting trade. Whether these market seers ultimately get it right or wrong, or get some things right and others wrong, they are worth a serious listen.

In a day-long session that covered everything from macroeconomics to their investment picks for 2015, the Roundtable members debated the causes of crude's plunge and its effect on consumers; euronomics and Abenomics; the limits of leverage; and much, much more. On the whole, they expect interest rates to stay unnaturally low, and the U.S. to lead the world in economic growth. Yet, they doubt that will translate into robust gains for the stock market. Scott Black's expectation that the Standard & Poor's 500 will return 10% this year -- an 8% price advance and a 2% dividend yield -- was as rosy as it got. Marc Faber, we feel compelled to warn you, thinks the market already has made its high for 2015.

If you have taken the time to peruse this year's spiffy artwork, you'll note a new face in the crowd, that of David Herro, Harris Associates' chief investment officer, international equities, and manager of the renowned $28 billion Oakmark International fund (ticker: OAKIX), among other Oakmark offerings. David traverses the globe every year to learn about countries and companies, and wasn't the least bit shy in sharing his common-sensical perspective on Europe, Japan, and China and other emerging markets.

The first installment of this year's Roundtable begins with the macro and concludes with the micro: the top investment picks of Bill Gross and Meryl Witmer. Bill has changed homes since last year's confab, dramatically decamping from Pimco, which he co-founded and ran, and taking up residence at the far smaller Janus Capital Group (JNS), where he manages the Janus Unconstrained Global Bond

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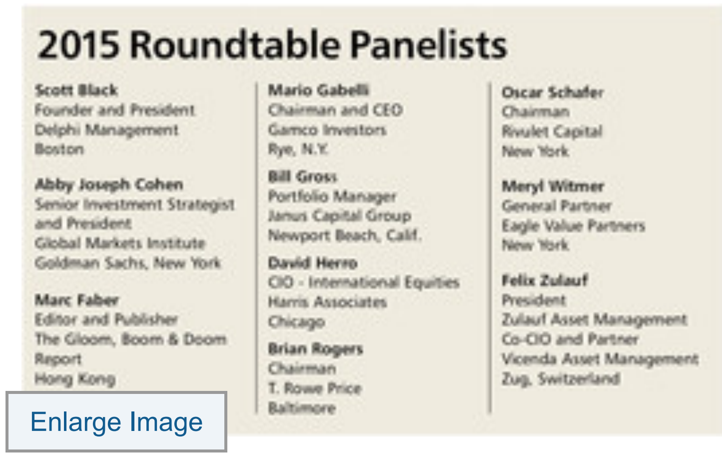
fund (JUCAX). He might have a new business card, but he has the same old smarts and style, displayed to superb effect in his disquisition on the debt supercycle's demise and the bond market's response. He also sang, literally, the praises of four fixed-income funds -- yes, including one of Pimco's -- that will help investors "hang on to what you've got."

There is no dislodging Meryl, a partner at Eagle Value Partners, from her home in the fine print of financial filings, where the truth about companies often lurks if you know how to find it. Meryl understands business just as well as finance, which makes her a formidable analyst and investor. Her picks this year involve underpriced makers of packaging, textbooks, and supersoft underwear. For the juicy details, please read on.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Enlarge Image

Barron's: I*t should be obvious from recent trading that oil's not right with the markets or the world. Take the plunge in crude, a veritable bolt from the blue, which has rattled companies, governments, and investors around the globe. Felix, you accurately predicted last year that economic growth would be sluggish, the dollar would rise, and commodity prices would fall. So tell us, please, how 2015 will unfold.*

Zulauf: Mainstream economists forecast normalization last year, which I took to mean a return to economic growth rates before the great financial crisis of 2008. That didn't happen. Today's mainstream forecast calls for a decoupling, or an acceleration of growth in the U.S., with the rest of the world still sluggish but catching up later this year or next. The consensus has it wrong again. Europe is still in crisis, and policy makers are doing everything wrong. They are talking about purchasing 500 billion euros in government bonds, €100 billion in asset-backed securities, and so on, to add liquidity to the financial system and spur economic growth. Feeding the system with cheap money won't solve Europe's problem.

In Asia, China's big investment and credit boom is slowing. You should probably cut the country's official numbers in half to achieve a realistic picture of economic growth. It is more like 3% or 4% than 7% or 8%. Japan devalued its currency by 50% in the past two years against the U.S. dollar, which is hurting competitors in the region. Now, with oil prices falling 50% in six months, the U.S. fracking industry will be hurt. Instead of accelerating, U.S. growth could revert to a postcrisis trend of 2% to 2.5% per annum.

Aren't you ignoring the positive impact of lower energy prices on the U.S. consumer?

Zulauf: The oil-price slump will hurt the economy dramatically in terms of capital spending and employment, and a lot of oilfield jobs are high-paying jobs. Yes, lower oil prices will bring down the cost of energy, which is good for consumers, but the private sector is going to save this money, instead of spending it.

Japan's yen devaluation is negatively affecting the price of all globally traded goods. Inflation is diminishing even in weak-currency countries. In Europe, it is below zero. It could approach zero in the U.S. this year. At some point, this will hurt the stock market. There will be a crisis in the junk-bond market, where spreads [between junk-bond and Treasury yields] are widening. In the past, when Treasury-bond yields went down and the yield curve flattened, a recession usually followed. I'm not forecasting a recession, but I am expecting the world economy and the U.S. economy to be much softer than the consensus view.

Does anyone care to challenge this gloomy forecast?

Cohen: While I agree with Felix in some areas, he might be too pessimistic about the U.S., and the impact of the decline in oil prices. Yes, the U.S. is an oil producer, but it is also an oil importer. On the negative side, there has been a notable decline in the consensus view of 2015 profits for companies in the Standard & Poor's 500 index. The estimated growth rate has fallen to 8% from 12%, mostly because of the drop in energy prices. A lot of capital spending in the U.S. in the past three to five years has been linked to the oilfield, and Goldman Sachs' commodities team expects that to adjust. The impact on energy supply will be gradual, however. It is hard to see how energy prices could rise sharply from here, except on a trading basis.

But there are big benefits to the U.S. from a decline in energy prices. Assuming crude oil stays around $50 a barrel, that equates to a $150 billion tax break for consumers. It is possible, as Felix suggests, that this will be saved, at least in the beginning, as people are skeptical about whether low oil prices will hold. If our team's view that prices will hold between $45 and $50 becomes the conventional wisdom, the consumer could start to spend. We are seeing other positive trends in the U.S. The labor-market news, while not totally rosy, is a lot better than six to 12 months ago. The unemployment rate is down substantially. Lastly, while it is possible that headline inflation could be zero in 2015, due largely to the drop in energy prices, some other measures of inflation could be closer to 1.5%. Core consumer-price-index inflation was probably 1.8% in 2014. It could be 1.6% this year.

At their annual grilling by the editors of Barron's, the Roundtable members predicted modest gains for the S&P 500 index, but saw pockets of opportunity in individual stocks. *Photo: Jenna Bascom for Barron's*

Zulauf: When the difference is that small, the numbers don't matter. It is the deflationary process that counts.

Cohen: The transportation and utility industries are major consumers of energy, and will benefit from lower oil prices. Energy accounts for 17% to 18% of their total costs. Our U.S. strategy team believes that the decline in energy prices will boost S&P profits in 2015.

Gabelli: What percentage of S&P 500 earnings is tied to energy?

Black: In the third quarter, 12.2%.

Gabelli: Why are the Saudis allowing oil prices to fall? Why aren't they cutting OPEC [Organization of the Petroleum Exporting Countries] production?

Black: The Saudis are holding back for political reasons. They fear both Iran and ISIS [the Islamic State], and this is a way to break Iran's economy. Saudi Arabia has $750 billion of reserves and can tolerate low oil prices for six to nine months. So can the United Arab Emirates and Qatar. While low oil prices hurt our shale business, my sources think there could be tacit consent from the Obama administration.

From left: Marc Faber, Bill Gross, Meryl Witmer, Scott Black, and Felix Zulauf. Says Gross: “Capitalism is being distorted.” *Photo: Jenna Bascom for Barron's*

Rogers: I disagree with Scott. The Saudis are out to send a message to the Russians. Interestingly, a year ago, no one saw the decline in energy prices coming. This gets to the issue of forecasting. The world in general isn’t much good at forecasting anything.

In that case, shall we adjourn?

Rogers: It is conceivable that we are just one OPEC meeting away from a rebound in oil prices. The financial system was shocked in the past 12 months by unexpected developments. There is a chance that unexpected things will happen in the next 12 months that will lead to radically different outcomes.

Zulauf: What might have started as a political move also has an economic rationale. In recent years, crude oil, and particularly OPEC oil, has lost market share among energy sources. It is important for the Saudis to ensure that their most precious asset, crude oil, has a good market, long term. Therefore, they have to kick out some of the marginal players to ensure the market share of crude in the energy equation. Natural gas and alternative energy have been gaining share. To be successful, the Saudis will have to keep prices down for at least a year. It has only started. The spot price has fallen, but the effects haven’t been felt through the real economy yet. A lot of production has been hedged. Those hedges will run off by summer.

Gabelli: Unlike some in this room, I fill up my own car with gas. The impact of lower spot prices hits right away by giving consumers more cash in their pockets or lower credit-card bills. It was only around Thanksgiving that the price at the pump collapsed. The effect is appearing on credit-card statements now. The consumer accounts for 70% of gross domestic product. His costs are going down. Food will be the next thing that falls in price. This is an extraordinary after-tax saving, and it will start working in the real economy.

Faber: With low oil prices, you would expect discretionary spending to be picking up. Not so. Of the S&P consumer-discretionary companies that offered earnings guidance for the fourth quarter, 89% issued negative guidance. This is the worst reading in the data series going back to 2006.

From left: Abby Joseph Cohen, Brian Rogers, Oscar Schafer, Mario Gabelli, David Herro. “It’s about time” China slowed, Herro says. *Photo: Jenna Bascom for Barron's*

Gabelli: These are lagging figures, put together by people who don’t go to gas stations. I talk to the guys who are pumping gas, and they say the consumer is buying more beer.

Herro: Lower oil prices also have a positive impact on the emerging world because it is a huge importer of energy. Governments have subsidized it, so either governments are going to save on subsidies, or the consumer will face lower fuel prices. Two major events occurred last year from a global macroeconomic perspective: falling fuel prices and a realignment of currencies. The euro was overvalued for way too long. In fact, oil was overvalued for way too long, as was the yen. We’re finally seeing a realignment that reflects reality and might counter some of the inflationary fears people have.

Gross: When a country devalues, it exports deflation. That is what Japan is doing and what other countries are trying to do, relative to the U.S. They are trying to export deflation and import inflation.

Cohen: Japanese exports are up, and Japanese multinationals that depend on exports have become more competitive. We could see more growth in Japanese corporate profits. This could help with job creation.

Zulauf: If exports aren’t up after you’ve slashed your currency by 50%, something is wrong. But you can’t build a case that that’s why the world economy will do well. Actually, Japan is an exception. Most exports in Asia are down and declining.

Faber: Japanese exports are up in yen terms but down in dollar terms, just to clarify.

Brian, even though you just dissed forecasting, what do you see ahead for the U.S and the global economy?

Rogers: The U.S. has been a true economic engine for five or six years, and has tried to pull other economies up. Our bond and equity markets benefited from a massive flight to quality in 2014. The economy is in a decent place right now. My big worry is: How long can we continue to be the engine, given what is happening elsewhere in the world?

Mario Gabelli, center: "Financial engineering will continue, and activist investors are another spur to specific stocks." *Photo: Jenna Bascom for Barron's*

When I talk to many S&P 500 companies about their businesses in Asia and Europe, there aren't many rays of hope coming from some of those markets. There is a general consensus around 3% GDP growth in the U.S. I wouldn't be surprised to see downward pressure on that estimate as 2015 unfolds. It just feels like too many things are going to drag on us, including a decline in energy prices. One of my Roundtable stock picks, perhaps not surprisingly, is an oil company. You have to buy when things look really bad. That said, the U.S. could have a tougher year than people expect.

Oscar, what is your view?

Schafer: First, in relation to forecasting, I'd like to paraphrase Woody Allen: I'm astounded by people who want to "know" the macro when it's hard enough to find your way around Chinatown.

Perhaps we'll invite him next year.

Schafer: Also, as Seth Klarman [founder of the Baupost Group, an investment firm] put it brilliantly last summer: Is the market nearly triple its spring 2009 low because things are better, or do things feel better because the market has nearly tripled? None of us predicted the oil-price plunge. I expect U.S. economic growth to slow due to the knock-on effects of the energy price decline. A decent percentage of employment growth in the past four or five years came from the oil patch. At the same time, with interest rates so low, central bankers have little powder left to try to help the economy. Even so, there will be pockets of opportunity for investors on both the long and short sides of the market.

Scott Black, left: "Small- and mid-caps did poorly last year, but they are still expensive." *Photo: Jenna Bascom*

Gabelli: I'm going back to the consumer. His net worth is at an all-time high. Wages are starting to rise in certain industries, but the psychology is fantastic. When the consumer buys gas every week, he feels good.

Schafer: You spend a lot of time at gas stations. How many cars do you have, Mario?

Gabelli: You city guys send someone else to fill up your car. Go talk to the guy who fills it up. You learn a lot by asking. Capital investment accounts for 12% of the economy. The government is going to examine ways to improve infrastructure. The midterm election resulted in a Republican-controlled Congress, which has a clear vision of less regulation and improving the rate of return on investment. Capital spending by the major oil companies and the independents could drop below $600 billion this year from an estimated $725 billion last year, which will be a challenge, but it's not a big deal. The housing recovery has traction, and local-government spending is up. The U.S. economy could grow by 2.75% to 3.25% this year, in real terms.

The U.S. is expected to be 22% of the global economy this year. The European Union is expected to be 25%. But, in relation to the oil surprise, what is [Russian President Vladimir] Putin going to do? Is he going to help the Saudis deal with Iran? A year ago, nobody thought about oil, or Putin invading Crimea, or the spread of Ebola. Nobody thought about the psychological impact of these events, which prompted investors to seek refuge in the U.S. bond market, driving down yields. My bet is that U.S.-centric companies do well this year.

Does anyone think oil is going lower?

Zulauf: Yes. The Saudis have a game plan and want to see their goals achieved before they change policy. This will not happen in three months' time. The next OPEC meeting is in June. Perhaps there will be an emergency meeting before that if the Saudis achieve what they want to achieve. The Russian situation is unclear. Putin was expecting to be hit with sanctions for his invasion of Ukraine and annexation of Crimea, but he wasn't prepared for the oil-price decline. It is creating a difficult situation for him. Also, internally, he might come under pressure from the oligarchs. Russia is a wild card, but Russia won't start a war.

Schafer: In July 2008, oil was $147 a barrel. In December 2008, where was oil?

Faber: At $32.

Schafer: Exactly! In six months, the price fell 78%. I got that from your latest newsletter, Marc.

Faber: Thank you. I go occasionally to Saudi Arabia. It would surprise me if they purposely decided to lower the oil price, given how much lower prices hurt the region. The oil price collapsed because of a lack of demand. Suddenly, Asian demand stopped growing. Asia was taking excess U.S. supply. U.S. oil supplies rose in the past five years to 9.3 million barrels a day from five million barrels. Asian demand, and particularly Chinese demand, has slowed considerably.

Black: The Saudis are keeping the price low for political reasons. There is also oversupply because of fracking activity in the U.S. Plus, Libya and Iraq came back into the oil market last year. If the Saudis wanted to, they could put supply and demand back in sync. I would not bet on that this year.

Let's get Meryl's take on the world.

Witmer: Like Oscar, I am more of a stockpicker than an economist. But I would note that a lot of large capital-spending projects, planned and ongoing, that were predicated on using natural-gas liquids from fracking might be put on hold. They would have been stimulative to the economy. Even in Europe, there were a lot of energy-related projects in the works, and they are likely to get put on hold. There was a lot of job growth from the energy industry. To the extent that capital spending is reined in, the U.S. economy probably will be weaker than people think.

Zulauf: With a much lower oil price, fewer petrodollars have been created -- possibly $1.5 trillion less, on an annualized basis. Petrodollars were reinvested in a variety of things. In the past, they financed other countries' current account deficits. Now that money isn't there. Lower oil prices have implications not just for the fracking industry, but for the financial world.

Marc, a petrodollar for your thoughts.

Faber: I look at the investment world in three parts: the Americas, Europe, and the emerging-market bloc from Turkey to the Far East, and to South Africa. I am used to Americans being optimistic about America, especially with the bull market now more than five years old. The economic expansion also is more than five years old, lengthy by historical standards. Consider this data, however, from the Institute for Supply Management: In December 2014, the purchasing managers' manufacturing index fell one percentage point from the prior year. New orders were minus 7.1 percentage points. Production was minus 2.9 percentage points.

I don't buy that all is well in America. If it were, why are home-ownership rates falling, whereas home prices have been going up? There is an affordability issue. Many young people finish college with huge student-loan debts. The labor-participation rate is also down, and it is low-paying jobs that are being created. The growth of high-paying jobs is anemic. Many people can use Facebook and wait on tables, but there is a lack of skilled labor. For these reasons, I recommended 10-year Treasuries a year ago. I thought the economy would disappoint, and it will disappoint this year. Growth will be about 2%, at best, but there could also be a contraction.

There is no growth in Europe. Plus, there is an unpleasant political climate and an entitlement society. It is hard to see how the European economy will grow much, although some companies will do well. In Asia, there has been a meaningful slowdown, although a transition is occurring. The two best whiskeys in the world now come from Asia. One is Yamazaki, a Japanese brand, and a Taiwanese whiskey has been elected the best single-malt. Unlike Mario, who spends a lot of time in gas stations, I spend time drinking whiskey.

Good for you, but what is your point?

Abby Joseph Cohen: "Assuming crude oil stays around $50 a barrel, that equates to a $150 billion tax break for consumers." *Photo: Jenna Bascom for Barron's*

Faber: Even if Asia doesn't grow much this year, economic power is shifting to Asia. The Indian economy could grow by 5%-6% in 2015, although the Indians would say I am too pessimistic. Nonetheless, a 5% growth rate is enormous, compared to zero in Europe.

Gabelli: Is growth in China slowing to 5%?

Faber: It is slowing to 4%, maximum. Exports are hardly growing. Imports are down.

Zulauf: Industrial capacity has been built up, based on 10% growth in China. The corporate sector in Asia is unprepared for this slowdown.

Faber: Unlike the optimists, I believe Japan will contract, as well. The population contracted last year by more than 200,000, the largest contraction since 1947. The population won't increase unless Japan welcomes foreigners, but Japanese culture is unlikely to do that. The currency has weakened significantly. Approximately 50% of food expenditures in Japan are for imported food. Food prices are rising, but wages aren't, so real income has tumbled in the past three months.

Cohen: One outcome of the recession in Japan is that the government suspended plans to tighten fiscal policy. It suspended a plan to raise the consumption tax.

Herro: Gross domestic product is a function of population growth and productivity growth. If you don't have population growth, the way to get economic growth is through productivity increases. The aim of some of the reform initiatives, which have stalled, is to increase the efficiency and productivity of the Japanese economy. Both Europe and Japan have had slow population growth and have been slow to increase productivity. Companies need to have more freedom to hire and fire workers. Hopefully, this is something Japan will tackle. I don't see Japan bouncing back strongly, but it seems to be looking at the right things.

Zulauf: Abenomics [the economic policies advocated by Japanese Prime Minister Shinzo Abe] is based on three arrows: currency devaluation, fiscal stimulus, and structural reform. The first two have occurred, but the third hasn't, because it is difficult politically. Reform means taking away something from somebody. Europe faces the same problem. Germany is moving backward on reform. Italy and France aren't moving at all. Most European governments can't pass necessary reforms. Introducing the euro, which acts as deflationary straitjacket for at least half the members of the European Union, was the dumbest thing they could do. I see no hope for Europe. It is going the way Japan did.

Rogers: Quantitative easing is the only option left to the European Union. It is a Hail Mary pass.

Zulauf: But QE just takes the pressure off politicians to do what is necessary. Only a major crisis will allow European governments to introduce reforms.

Gabelli: Your conclusion is to bust up the euro because the common currency makes no sense. That's where you're going.

Zulauf: Europe will hold on to it for several more years, but people in some countries eventually will say that's enough. A third of all seats in the European Parliament are held by members opposed to the euro and against the centralization of Europe. And the number is growing.

[Barron's checked in with Felix late last week to get his take on the Swiss National Bank's surprise decision to decouple the Swiss franc from the euro, a move that shocked the currency market and came just ahead of likely quantitative easing by the European Central Bank. Via e-mail, he said, "Full support (for franc/euro parity) would have meant that the SNB must pursue the same monetary policy as the ECB, which is completely unnecessary as the Swiss economy has performed well. More monetary stimulus would have had counterproductive effects and inflated assets such as real estate and equities, creating major risks later on. The removal of the euro cap is beneficial as it will force the Swiss economy to become more productive and move into higher-value-added industries. But first, the Swiss economy will most likely –suffer a recession."]

Cohen: European policy makers are hoping that a combination of quantitative easing plus euro devaluation will spur economic growth. It will help nations like Germany, which export beyond the euro zone. But the implementation of the euro has prevented some weaker countries from devaluing their currencies, as they might have done in the past when their economies suffered. As David intimated, nations either have to bolster their labor productivity, as Ireland has done, or devalue their currency.

Faber: May I finish my remarks? In addition to the slowdown in Asia, people overlook what has happened to global oil outlays. With production and prices rising, the world spent $4.2 trillion on oil in 2007, up from $250 billion in 1999. Outlays have since fallen to $2.5 trillion. In other words, $1.7 trillion went back to the consumer. Also important, sovereign wealth funds rose to $6.8 trillion as of September 2014, from $3.2 trillion in 2007. Of that growth, 59% came from oil, gas, and related revenue. As oil prices fall, what will happen to the growth of sovereign wealth funds, which have been buying financial assets around the world? Their funding is going to evaporate, and they might be forced to sell.

Herro: Norway accounts for a big chunk of that money. It is a small country. There won't be a catastrophe because of falling oil prices.

Faber: Norway has a colossal housing bubble and an overpriced economy.

Herro: That's true, but the country has only five million people.

Faber: So declining assets in sovereign wealth funds have no impact on the world?

Herro: You have to look at the net impact of lower energy prices rippling through the global economy.

Gross: The Saudis, Norway, and other sovereign wealth funds bought not only stocks, but bonds with their oil money. Now there is less to spend. What might be the substitute? Quantitative-easing programs in Euroland and Japan, and continued monetary easing in the U.S.?

Rogers: The money doesn't vanish just because the oil producers don't get it. It goes into consumers' hands.

Faber: My point is, assets in sovereign wealth funds won't double again, as they did since 2007. Therefore, one source of demand for financial assets won't be there.

Zulauf: More central banks will buy bonds this year. You can't just declare your currency lower; you have to print more of it. That money must be invested, and it goes primarily into fixed-income assets. That's why interest rates will stay low, and go even lower this year. There won't be any rate hike in the U.S. That's off the table.

Before we continue this fascinating debate, let's hear David's macro forecast.

Herro: Like Marc, I divide the world into broad geographies. Regarding North America, I am not as bearish as some people here. The impact of lower energy prices, an improving labor market, a better feel-good factor, and perhaps a deal on tax reform will mean acceptable rates of growth in the world's largest economy. The euro zone has many maladies and needs structural reform, including the right to hire and fire. It needs to end the defense of the welfare state. But you can't lump all of Europe together; some economies are doing better than others.

The emerging world is led by the China region and India. China is slowing, which isn't tragic but necessary. It's about time. It needs to stop overinvestment and focus on consumption. Reforms being enacted in China hopefully will mean more-sustainable growth down the road. There's a question about how legitimate the reform is, but China's leaders are thinking about the right things and saying them publicly. India wants to do well, but it is a tough place to do business, even if you're the government. India could be one of the bright spots in the next few years. It has roughly the same population as China, but consumes one-tenth the amount of steel and cement. If India grows, it could pick up some of the slack from China's slowing.

Japan technically is the world's third largest economy. They're trying, but don't know what to do with the third arrow. Japan is aggressively changing the asset allocation in its $1.3 trillion government pension fund, and putting more than 50% in equities from 100% Japanese government bonds. It is using the fund as a battering ram against the corporate sloths of Japan, and trying to increase productivity and profitability. This is a good sign. Abe-san [Shinzo Abe] has been aggressive in putting his people on the pension board to make sure that they use that as a weapon. To sum up, the world isn't booming, but led by the U.S., with a little help from emerging markets, we could make up for what is lacking in Europe.

Gross: You think that's a good sign that the government captured the pension fund?
Herro: They didn't capture it, per se.

Gross: They rolled the monetary, fiscal, and pension authority into one.

Gabelli: Oh, stop. Who runs the Social Security lockbox in the U.S.?

Gross: There is nothing in the lockbox.

Zulauf: Japan is discussing whether to dictate that all private pension funds change the asset allocation. It's not about being right or wrong in terms of allocation, but in relation to government interference.

Gabelli: I would use the word "encouraging."

Gross: Doesn't that smell of desperation?

Herro: It was all bonds. Who wants that?

Gabelli: You're talking to a bond guy!

Herro: Encouraging the pension fund to be properly diversified is how I would put it.

Cohen: One part of Abenomics is womanomics. In a nation where the population isn't growing and the labor force has been shrinking, women are a good potential source of workers. They haven't been encouraged to be in the labor force, and certainly not in a highly professional capacity. Getting more women into the labor force would be helpful in the years ahead.

Gabelli: The Japanese also have robotics and artificial intelligence.

Cohen: The women have natural intelligence.

Bill Gross: "Is a zero percent real rate of interest a fair return on your money? It isn't, but it might be an acceptable rate in a world where there is too much debt." *Photo: Jenna Bascom for Barron's*

Gross: Human organisms want to grow. The nature of things is to grow. It is interesting to ask, why don't economies grow? Why don't people get hired? Why don't corporations expand? Why don't governments produce real growth? Typically, in the past 30 or 40 years, the answer has always been that inflation got a little too high, central banks raised interest rates to restrict credit, and recessions were produced. Today, it is different because we have no inflation. So why don't we grow?

It is because we are at the end of a debt supercycle. In the past 20 to 30 years, credit has grown to such an extreme globally that debt levels and the ability to service that debt are at risk, relative to the private investment world. Why doesn't the debt supercycle keep expanding? Because there are limits. Interest rates have reached zero, and governments still don't want to borrow for infrastructure investment. Companies still don't want to borrow for private investment. They simply want to buy their own stock at a 15 times earnings because investing in the real economy is too risky. Interest rates are so low and the amount of debt is so high that there are limits to the ability of monetary policy to influence what it has influenced for the past 30 years.

What are the implications of the end of this supercycle?

Gross: The implications are much lower growth, less inflation, lower interest rates, and less profit growth. Barter economies couldn't grow rapidly, but once someone decided to save and invest and extend credit, growth became possible. Well, we overdid it. Now there is a limit not only to lenders' willingness to extend credit, but their willingness to do so at an unacceptably low rate of interest.

I have called this slow-growth, low-inflation environment the new normal. Larry Summers [the Harvard economist and former Treasury Secretary] calls it secular stagnation. It is tied to high debt levels, low population growth almost everywhere in the world, and technology that promotes job destruction. We applaud U.S. growth of 3%, but it is an aberration. Structural growth in the U.S. is really just 1.5% to 2%, and in Euroland and Japan it is zero to 1%. We brought consumption forward and issued one giant credit card for the past 30 years. Now the bill is coming due. Investors need to get used to low returns, and low growth, inflation, and interest rates for a long time.

What is your interest-rate forecast for 2015?

Rogers: There are some glimmers of hope. The U.S. is five years into healing from the 30-year extension of credit you're talking about.

Gross: In the household sector, yes. Corporations are levering up.

Cohen: They are levering up at very low interest rates, often for money they don't need.

Gross: So long as they don't buy back stock.

Rogers: Investment opportunities are limited because global growth is so low. That is why companies are buying back stock. The debt position in the corporate world and the U.S. consumer market is very different from five years ago. But I don't want to trump Bill's rate forecast, which we are all eager to hear.

Gross: The global interest-rate forecast depends critically on what central bankers are now beginning to understand as the natural rate of interest. To forecast where the 10-year Treasury yield belongs, you need to ask where the federal-funds rate [the interbank overnight lending rate on funds maintained at the Fed] will be five years from now. Until now, central bankers have based the policy rate on the so-called Taylor rule, developed by John Taylor, a professor at Stanford University. It posits that the policy rate should be 2%, plus the rate of inflation. Central bankers in the U.S. and elsewhere relied on this rule for more than 20 years, and it worked pretty well. But it doesn't work now because of the structural problems I have outlined.

Enlarge Image

Meryl Witmer: At Houghton Mifflin, the sale of digital education products improves profits. *Photo: Jenna Bascom for Barron's*

A policy rate of 4% nominal growth and 2% real [inflation adjusted] growth is 200 basis points [two percentage points] too high. Once the U.S. economy normalizes, the Fed should be shooting for a policy rate of 2%, not 4%. The real rate should be zero, not 2%. How do I know that? I don't. Goldman doesn't. No one knows it, which is the problem. We are feeling our way, and that is what the Federal Reserve will do this year. It will feel its way in gradually raising rates and seeing how the economy responds. If a 2% nominal rate is about right, the 10-year bond is decently valued at 2%, as well. Is a zero percent real rate of interest a fair return on your money? It isn't, but it might be an acceptable rate in a world where there is too much debt.

Interest rates will be lower than the market thinks. Policy makers at the Fed have indicated that the policy rate will be 3.75% to 4%, longer term. They are dreaming. Money is being stolen from bond holders because of the repressive policies of central banks. That is what happens in a deflationary environment when a debt supercycle ends. The savers pay the price.

Zulauf: In Europe, things are even worse. Institutions have to pay the bank to hold their cash.

Gabelli: That sounds like good, sound banking.

Gross: If the new neutral rate is 2% nominally and zero after inflation, as I am suggesting will be the case for the next five years, it pays to borrow as opposed to lending. You can borrow at 2% in the future (and now even lower at 0.25%) and lever that into a 4% to 5% return.

Cohen: Some of the highest-quality corporations are selling long-maturity bonds. On the consumer side, household balance sheets are in dramatically better shape than five or eight years ago, but some households have big problems. Subprime debt no longer is a problem in the housing market, but is becoming one in the car market, and could have an impact on future auto sales.

Rogers: I'd like to challenge Bill. This is a roundtable, after all. Based on the Taylor rule, if 2% is the nominal yield on the 10-year Treasury, that barely covers the rate of inflation. There is no risk premium. Yet, you ought to be compensated for taking duration risk. Thus, the return can't be zero. Long term, an investor will demand 50 or 100 basis points of return. Maybe the bond won't yield 4%, but it could yield 2.5% or 3%.

Gross: I admit that my premise suggests a distortion of capitalism, but capitalism is being distorted. Money is moving to the financial economy, not the real economy.

Zulauf: The best capital allocator is the free market. In recent years, and probably for a few years to come, central-bank policy has distorted all that. Capitalism won't function as we knew it in the past. We will also see the yield curve flatten as investors move into longer-dated bonds to capture a more attractive return. This is happening throughout the world.

Let's turn to the stock market, which had a good year in 2014, despite all of the *problems we've been discussing. Abby, your 2014 forecast was close to accurate. How will the U.S. stock market perform in 2015?*

Cohen: I gave a somewhat tongue-in-cheek forecast last year that the S&P 500 would end 2014 at 2088. The index hit 2090 a few days before year end, and then sold off. Goldman's forecast for GDP growth in 2015 is a little above the consensus, partly because we expect the decline in energy prices to provide a boost to the economy. Also, U.S. companies took advantage of a lower dollar in the past few years to become more competitive. The economy isn't as sensitive to a higher dollar as many investors think because U.S. companies sell mostly high-value-added goods and services to non-U.S. markets, not commodity-type products.

We expect S&P 500 revenue to rise 4% this year, and earnings to increase 8%. Our U.S. portfolio strategy team is estimating S&P earnings of $122, below the consensus at $125. For 2016, the team is using $131, and the consensus is $140. Our interest-rate view is somewhat different from Bill's, although I take to heart many of his comments. If the U.S. economy performs better than in the past few quarters, the Federal Reserve will seriously consider raising interest rates in the second half of the year, although not by much. But the Fed is unlikely to move unless it sees that the labor market has gotten better, not just in terms of the unemployment rate but job creation and wage improvement. The Fed might also be encouraged to wait to tighten policy because of energy prices.

2014 Roundtable Report Card

Most members of the Barron's Roundtable are active money managers who trade their positions and change their investment opinions as market conditions warrant. For those keeping score, here's how our panelists' 2014 picks and pans performed through Dec. 31. To see the 2014 mid-year Roundtable report card click here. Data include both price changes and total returns.

Based on these estimates, the house forecast calls for the S&P 500 to end 2015 around 2100, which implies a single-digit percentage gain. However, if 10-year Treasuries don't move much this year, we could get to 2300. To be fair, David Kostin, Goldman's chief U.S. equity strategist, thinks the market could be higher during the year, and then fall. His concern is how the market will respond to the first phase of Fed tightening. The risk to this forecast is that interest-rate increases could be pushed further into the future, which would be much better for equity valuations. Picking a point target simplistically, I could say the market will end the year at 17 times our 2016 earnings forecast, or 2233.

You could, but is it right?

Cohen: If there is a risk to the Goldman forecast, it is that share prices will be higher, not lower, based on an improving economy and quiescent inflation and interest rates. Using a dividend discount model, the S&P could have been at 666 in March 2009 only if profits declined by an average of 8% a year in the next five years. That wasn't correct; the recession ended two months later. Priced into the S&P 500 on Dec. 31, 2014, were five years of flat earnings, which doesn't seem right either. The components of the S&P 500 performed well as companies and securities in 2014. One question now is whether investors will rotate away from S&P 500 companies and toward small-cap stocks.

Rogers: So Goldman is expecting a return of just 3% or 4%.

Cohen: Plus dividends. It also assumes there is no active management. If the Fed doesn't tighten, you could see a more optimistic forecast from Goldman.

Scott Black's Picks

Company/Ticker	Price 1/10/14	Price 12/31/14	Change	Total Return
Express Scripts/ESRX	$72.80	$84.67	16.2%	16.2%
Actavis/ACT	183.32	257.41	40.4	40.4
Bonanza Creek Energy/BCEI	44.33	24.00	-45.9	-45.9
KLA-Tencor/KLAC*	63.62	70.32	10.5	41.4
SanDisk/SNDK	72.60	97.98	35.0	36.6

*Total return includes a $10.00 special cash dividend.

Abby Joseph Cohen's Picks

Company/Ticker	Price 1/10/14	Price 12/31/14	Change	Total Return
iShares MSCI Mexico Capped ETF/EWW	$67.08	$59.39	-11.5%	-10.4%
HollyFrontier/HFC	49.79	37.48	-24.7	-19.3
International Paper/IP	48.24	53.58	11.1	14.4
Wyndham Worldwide/WYN	72.97	85.76	17.5	19.7
Nordstrom/JWN	61.11	79.39	29.9	32.4
Extra Space Storage/EXR	43.57	58.64	34.6	39.2

Marc Faber's Picks & Pans

Investment/Ticker	Price 1/10/14	Price 12/31/14	Change	Total Return
LONG				
10-year Treasury Notes	2.86%	2.17%		
SINGAPORE:				
Wilmar International/WIL.Singapore	S$3.35	S$3.24	-3.3%	-1.1%
SATS/SATS.Singapore	3.21	3.05	-5.0%	-0.8
SIA Engineering/SIE.Singapore	4.99	4.22	-15.4%	-11.1
Hutchison Port Holdings Trust/HPHT.Singapore	$0.68	$0.69	2.2%	10.4
VIETNAM:				
Ha Noi-Hai Duong Beer/HAD.Vietnam	41,800 VND	46,000 VND	10.0%	16.6
FPT/FPT.Vietnam	38,960	48,000	23.2%	28.5
Vietnam Dairy Products/VNM.Vietnam*	138,000	124,000	-10.1%	-8.7
SHORT:				
iShares Russell 2000 ETF/IWM	$115.52	$119.62	3.5%	4.9%
iShares MSCI Mexico Capped ETF/EWW	67.08	59.39	-11.5%	-10.4
Turkish Lira (spot)	$1=2.12 TRY	$1=2.34 TRY		
MOMENTUM STOCKS:				
Tesla Motors/TSLA	$145.72	$222.41	52.6%	52.6%
Netflix/NFLX	332.14	341.61	2.9	2.9
Facebook/FB	57.94	78.02	34.7	34.7
Twitter/TWTR	57.00	35.87	-37.1	-37.1
Veeva Systems/VEEV	32.53	26.41	-18.8	-18.8
3D Systems/DDD	94.45	32.87	-65.2	-65.2

*Closed position. Returns as of 6/5/14.

Bill Gross' Picks

Company/Ticker	Price 1/10/14	Price 12/31/14	Change	Total Return
Pimco Dynamic Income/PDI	$29.21/11.6%	$30.74/13.47%	5.2%	19.1%
Pimco Muni Income Fund II/PML	11.02/6.0	11.88/6.6	7.8	14.6
Reaves Utility Income/UTG	25.10/6.2	32.85/5.1	30.9	38.5
Pimco 0-5 Yr High Yield Corp Bond Idx ETF/HYS	106.68/4.6	100.83/5.4	-5.5	-0.4

Fred Hickey's Picks

Company/Ticker	Price 1/10/14	Price 12/31/14	Change	Total Return
Cash				
Central Fund of Canada/CEF	$13.53	$11.58	-14.4%	-14.3%
Agnico Eagle Mines/AEM	27.26	24.89	-8.7	-7.7
Goldcorp/GG	23.19	18.52	-20.1	-18.2
Market Vectors Junior Gold Miners ETF/GDXJ	32.70	23.93	-26.8	-26.2
Cameco/CCJ	20.27	16.41	-19.0	-17.5

Brian Rogers' Picks

Company/Ticker	Price 1/10/14	Price 12/31/14	Change	Total Return
Applied Materials/AMAT	$17.47	$24.92	42.6%	45.4%
Consol Energy/CNX	36.63	33.81	-7.7	-7.1
Cablevision Systems/CVC	16.88	20.64	22.3	26.5
Entergy/ETR*	61.06	78.61	28.7	31.9
Newmont Mining/NEM	23.80	18.90	-20.6	-19.8
T. Rowe Price Emerging Mkts. Stock/PRMSX	31.19	32.38	3.8	4.8

*Closed position. Returns as of 6/5/14.

Oscar Schafer's Picks

Company/Ticker	Price 1/11/13	Price 12/31/13	Change	Total Return
Northgate/NTG.UK	£5.63	£6.07	7.8%	10.4%
InterXion Holding/INXN	$24.63	$27.34	11.0	11.0
Internap/INAP	7.66	7.96	3.9	3.9
Orkla/ORK.Norway	46.33 NOK	51.15 NOK	10.4	16.3
BioScrip/BIOS	$7.52	$6.99	-7.0	-7.0

Meryl Witmer's Picks

Company/Ticker	Price 1/10/14	Price 12/31/14	Change	Total Return
Wyndham Worldwide/WYN	$72.97	$85.76	17.5%	19.7%
Spectrum Brands Holdings/SPB	69.80	95.68	37.1	39.1
Esterline Technologies/ESL	101.67	109.68	7.9	7.9
Constellium/CSTM	22.98	16.43	-28.5	-28.5

Felix Zulauf's Picks & Pans

Investment/Ticker	Price 1/10/14	Price 12/31/14	Change	Total Return
LONG				
iShares 20+ Yr Treasury Bond/TLT	$104.41	$125.92	20.6%	24.2%
Market Vectors Gold Miners/GDX	22.01	18.38	-16.5	-15.9
Buy U.S. Dollar/Sell Turkish Lira (spot)	$1=2.12TRY	$1=2.34 TRY		
SHORT:				
iShares MSCI Hong Kong/EWH	$20.44	$20.54	0.5%	4.1%
Sell Swiss Franc/ Buy Japanese Yen (spot)	1CHF=¥115.42	1CHF=¥120.46		
	$47.23	$54.31	15.0%	16.8%

Source: Bloomberg

Enlarge Image

Brian, where do you think stocks are headed?

Rogers: I agree with much of what Abby said. It is hard to be precise. If you factor in the loss of some earnings momentum from the energy sector, a gain of 5%, 6%, 7% in corporate earnings seems reasonable. I expect that a move by the Fed to raise rates will be perceived favorably by U.S. investors. It has been well communicated. If the first 25-basis-point increase in the fed-funds rate comes in the spring or summer, it will be viewed by the market as a statement that the Fed sees decent economic activity.

Corporations have a lot of liquidity. Dividend and buyback activity will be strong again this year. The relationship of earnings yields and bond yields is supportive of a good environment for equities, although the market's price/earnings multiple makes me a little queasy. When you look at negligible money-market returns and a 2% yield on the 10-year note, a total return of 5% to 8% on stocks looks good. Investors are unlikely to squeeze another great year out of the Treasury market.

Oscar, do you agree with that?

Schafer: I agree with Brian that multiples are high. But if we agree with Bill that inflation, interest rates, and growth will stay low, we have a TINA market: There is no alternative to stocks. I expect stock multiples to rise. We will see more divergences among equities, as we saw last year with large- and small-caps. In contrast to 2014, this will be a stockpicker's market. The averages won't do much, but within the market, there will be great opportunities on the long and short side.

Marc, what is your market view?

Faber: In the U.S., some stocks were up 10% last year, and some were up 40%. But an equal number were down 10% and down 40%. It has been a mixed bag. A year ago, portfolio managers were universally bearish about bonds. Yet, the 30-year Treasury had a 30% total return. The 10-year had a near-12% total return. Utility shares, which had been shunned, rose 30%, and real estate investment trusts, which no one paid attention to because they were too boring for the Facebook crowd, were up 26%. Active managers underperformed the indexes badly, and hedge funds did exceedingly badly, especially when you consider that they complained about low volatility in the first half of the year. Then, when the euro and yen and oil prices collapsed in the second half and volatility spiked, they did even worse. I don't know what they were drinking.

Schafer: Japanese whiskey.

Faber: In the U.S., people think the market did well. But in dollar terms, the Indian market rose 34%. Pakistan was up 32%-plus; Sri Lanka, 23%; Philippines, 22%; Thailand, 15%; Indonesia, 20%; Vietnam, 20%. Shanghai did poorly until June, and then went ballistic. Don't ask me why. Lots of things are difficult to explain because the free market has been distorted by central-bank actions to stimulate economies, lower currencies, and such. This year, we have already seen the high for the S&P 500. That was also the case in January 1973. This market is similar to the Nifty 50 market of the early 1970s, in that just a few stocks are driving strong growth in the indexes. International Business Machines [IBM], Amazon.com [AMZN], and General Electric [GE] were all down last year, but Apple [AAPL] was up 38% and has the biggest weighting in the S&P 500. Ideally, the S&P will go to 3500 and then collapse 50%. Then, everybody will be right.

Stocks haven't had a correction of more than 11% since October 2011, which is unusual. Yet, the uptrend isn't supported by the real economy. Policy makers have created an environment in which a corporation with a lot of cash isn't going to build a factory or a business. It is going to buy back shares or take over another company. In each takeover, staff is eliminated and there is no capital spending. Mario likes this because he is an activist investor, but the real economy can't rebound because it is easier to make money in trading, financial assets, and real estate.

Meryl, how does the market look to you?

Witmer: It isn't easy to find a lot of undervalued stocks. Usually, when we have trouble finding cheap stocks, the market doesn't go up much. This market is pretty fully valued.

Scott?

Black: Small- and mid-caps did poorly last year, but they are still expensive. The Russell 2000 [a small-cap benchmark] is trading for 22 times expected earnings. The Russell 2500 is trading for 21.1 times. There is better value in the larger names. S&P 500 revenue has grown by 4.9% to 5.5% in the past few quarters, and will continue to grow. There will be more stock buybacks. Earnings could come in around $126 this year, up 8%. Operating profit margins have been at a record high of 10.1%, and some improvement is possible. Based on Friday's close [the S&P 500 closed on Jan. 9 at 2044.81], the market is selling for 16.2 times this year's expected earnings. It is fairly valued. For deep value investors like Meryl and Delphi, it is increasingly difficult to find good stocks.

I agree with Bill that Fed Chair Janet Yellen will be highly accommodative, and that interest rates will remain low. We might get 8% appreciation in the S&P 500 this year, and a total return of 10%, compared with 13.7% in 2014. The problems in Europe and Asia won't derail economic growth here, but it might slow it. I am moderately constructive on the year.

Felix, we have a hunch that doesn't describe you.

Zulauf: In the past 100 years, stocks have been up in the fifth year of the decade with only one exception: 2005. In the third year of the presidential cycle, the market has been up 70% of the time. Combining the two, stocks were up at least 20% in 1915, 1935, 1955, 1975, and 1995. The caveat is that none of those years had a lame-duck president. To find the same combination with a lame-duck president, you would have to go back to 1875, and the market ended down that year.

Forget about 1875. Just tell us about 2015.

Zulauf: The biggest thing going for stocks is paltry bond returns. If I am right that the economy will struggle, equity investors could be disappointed. The major U.S. stock indexes haven't declined by 10% for the past 3½ years. Extreme readings of investor sentiment reflect a lot of complacency, which usually makes a market vulnerable. A lot of multinational growth stocks are extended on the upside, and cyclicals are extended on the downside. Usually, this situation ends in a big correction. I expect a decline of 15% or so moving into the spring. It could be worldwide, and probably triggered by earnings disappointments in the U.S., due to the strong dollar. I assume central-bank monetary policy will get even easier in the face of this decline. Thereafter, markets could rally, perhaps into 2016. There will be a lot of volatility. It will be a trader's dream, but an investor's hell.

Gabelli: I'm looking at the moving parts. The euro is $1.18 today. It was $1.37 a year ago. For S&P 500 companies operating in Europe, the currency will be a drag. Energy earnings will be a big drag. On the other hand, if interest rates go up in the spring, that will help banks' net interest margins. Companies are going to maintain profit margins as best they can. With the Republicans gaining control of the Senate and the House, the rest of the world is saying this socialist president won't gain any more traction. Thus, the U.S. is a good place to put your money. A lot of money is moving into the U.S. market, and it isn't going into small-caps. It is going into large-caps. Foreign investors are sector allocators. Financial engineering will continue, and activist investors are another spur to specific stocks. Putting it all together, the market could rise 2% or 3% this year.

David, how does the year look to you?

Herro: I'm a bottom-up value investor, focusing mostly -- although not exclusively -- on international markets. I see better value outside the U.S., but there are good places to look here, too. Mario talked about the negative effect a strong dollar will have on multinational earnings for American companies. On the flip side, European-based multinationals struggled for a long time with a strong local currency. The pressure is easing on those companies, and they could record higher profits in their home currencies. The macroeconomic problems we have been discussing have hit European equity valuations. No one wants to invest in European companies, even though many generate sales and cash flow all around the world. Therefore, Europe is probably the most fertile market for value, and its stocks could perform best in the next 18 months.

European multinationals have a big presence in the emerging world, which is undergoing more of a cyclical than a structural downturn. Structurally, emerging markets have a long-term growth story, as more and more people from the lower and middle classes move into the middle and upper-middle classes. There are speed bumps; this doesn't happen in a straight line. But India and China will eventually find their footing. It could happen in two or three years. That will be good for the corporate earnings of companies exposed to Asia.

Are you bullish on emerging-market shares?

Herro: Shares of quality companies based in emerging markets are too expensive. State-owned companies in these markets look cheap, but low price alone doesn't determine value. We have very little direct exposure in emerging markets.

In a nutshell, it will tough for the U.S. to keep performing well, as valuations are stretched. Europe has done poorly but will benefit from weaker currencies, lower energy prices, and perhaps a recovery in emerging markets. Investors must be highly selective in emerging markets. The Japanese market has doubled in the past few years. It has benefited from a weaker currency. There isn't much room for growth left.

Gabelli: One more thing: The combination of lower interest rates and new U.S. mortality tables, as people are expected to live longer, will crimp cash flow as companies put more cash into defined-benefit retirement plans.

Bill, you predicted in your latest outlook that there could be minus signs in front of many asset classes this year. Does that include stocks?

Gross: It is possible. Rather than dissecting valuations, let me note that liquidity is decreasing. The Fed has ended its quantitative-easing program. This reduces the liquidity that helped drive price/earnings ratios higher and helped investors get in and out of the market. Liquidity is becoming increasingly at risk for the stock market, and even more so for the bond market. At some point, it could get harder to sell assets, so be careful about getting out at the appropriate time. I would put a bit of a minus sign on stocks this year, if only because the liquidity premium is increasing.

We have talked today about the difficulty of forecasting, and the fact that nearly every market prognosticator missed the swoon in oil last year. That begs the question: What could you be missing this year?

Cohen: The U.S. economy could show sufficient momentum to override the impact of central-bank tightening and a strong dollar. We know from history that when central banks first begin to raise interest rates, equity markets, at least in the U.S., get a new lease on life. A rate hike is a sign that the economy doesn't need that much help anymore. That isn't true of Europe. While valuations are appealing, the European banking system hasn't been fully repaired. While the U.S. could look a lot better, the impact could be mixed around the world.

Zulauf: There is the potential for many black swans when the world economy is growing insufficiently. The risk of conflict goes up. The war cycle is rising. There could be potential conflicts in Eastern Europe, and in the South China Sea. That could scare away investors.

What do you mean by the war cycle?

Zulauf: You measure conflicts over the course of history, and give them ratings according to degree. When you smooth out the numbers, you find a repeating cycle.

We are in the rising part of the cycle now.

Gross: A low-probability event but a possible one might be a one-two punch of debt defaults in Ukraine and Greece. That would lead to widening yield spreads on Europe's periphery. Also, there is a small chance that the Chinese might devalue their currency. The renminbi has been appreciating against the dollar for a long time.

Zulauf: A Chinese devaluation would be horrible for the world economy.

Gross: But the Chinese might view it as a form of self-defense.

Schafer: If we knew what we were missing, we wouldn't miss it. That said, everyone seems to believe interest rates are going down. A big spike in rates would be shocking. Likewise, no one is predicting that the economy will fall into a deep recession.

Rogers: I'll be surprised if we have two quarters of 4%-plus growth in the U.S. in the year's first half and the Fed raises short-term rates three times in the second half. I'll be surprised if the yield on the 30-year bond rises to 3.5%.

Won't we all?

Gabelli: Interest rates could rise faster than we anticipate. Also, we are assuming that U.S. banks are in solid shape, despite the sudden drop in oil. What if a bank unexpectedly goes bust in the U.S.? Third, there are natural disasters. There hasn't been a really good hurricane season for a long time, or a big earthquake. Bill, you had your own earthquake about 60 days ago.

Gross: It was one of the biggest, and I survived.

Herro: One surprise could be strong growth from ICI -- India, China, and Indonesia -- in the second half. These countries are home to almost a third of the world's population. My extra-credit answer is that better cooperation between the U.S. president and U.S. Congress brings forth meaningful tax reform.

Faber: By far the biggest hypothetical shock mentioned would be a devaluation of China's currency. If China lets the currency go, prices will plummet and corporate margins will fall apart.

Black: I see two potential surprises. The drop in energy prices could have a deleterious effect on the housing market in states such as Texas and Colorado, which have seen big gains. Outside the U.S., we must consider the destabilizing effect of ISIS. The U.S. is providing air cover for bombing, but doesn't have a dog in this fight. ISIS intends to seize leadership of the Muslim world from Saudi Arabia. It is well organized. Iran is another potentially destabilizing player, and it produces 2.8 million barrels of oil a day. In the event of a wider Mideast conflict, oil prices could run up instantaneously.

Cohen:ISIS is not only well organized but well financed, because it establishes itself as a tax authority in the territory it seizes. It is also active in the kidnapping and ransom business.

Zulauf: A lot of fighters who have joined ISIS from other countries are trying to leave. They have had enough. The group also has a financing problem because of the drop in oil.

Cohen: You talk to people who left ISIS?

Black: My sources have a different view. They say the Europeans joining ISIS might be thugs, but the people running the organization are well educated and intelligent. They have established local and provincial governments, and issued passports. If ISIS' attacks spill over into Saudi Arabia, the United Arab Emirates, and Kuwait, the U.S. will have to act.

Witmer: My surprise is something on my wish list. Even environmentalists now agree that ethanol isn't good for the environment. The government could reduce the amount required to be added to gasoline. If that happens, it might help the oil price, but corn prices could be hurt, leading to lower prices for farmland.

Faber: Many surprises could occur in the next 12 months. The president, for whatever reason, might not finish his term. China's president, Xi Jinping, doesn't speak as much as Obama, but when he speaks, he makes sense. He is a powerful person. In the past 45 years, China has pursued a policy of nonintervention in other countries' domestic affairs. But that might change because of its oil interests in the Sudan. China is the largest supplier of troops to the U.N. peacekeeping forces. Its troops are conveniently placed next to Sudan's oil facilities. China also has a large interest in the Iraqi oilfields. If ISIS moves toward southern Iraq, which it currently can't do, China will protect its interests. The Chinese are becoming more assertive in their geopolitical ambitions. They must ensure a supply of natural resources, such as oil, copper, and iron ore. In their view, the Americans have no interests in Southeast Asia and eventually will have to move out. It is unclear how this will be achieved, or when, but it probably won't happen peacefully.

On that note, let's move on to your investment picks. Bill, since you were kind enough to state in your latest investment essay that you've been reserving your 2015 picks for the Roundtable, you can go first.

Gross: It is possible that the Fed will nudge the fed-funds rate higher in late 2015, as Goldman predicts. While the Fed would like to focus on inflation, it is perhaps more concerned with the potential for inflating financial assets. It would like to normalize interest rates to the extent that it can, which could mean a 25-basis-point increase in the fed-funds rate, or maybe a 50-basis-point increase in the next 12 months. A small increase won't threaten the bond market so long as the Fed uses the right language, which Janet Yellen has tried to do in communicating Fed policy to Wall Street. Mario Draghi [president of the European Central Bank] is the master of verbal manipulation. He has manipulated European interest rates down and into negative territory merely by talking. He deserves an award.

Bill Gross' Picks

Fund/Ticker	Price/Yield 1/9/15
Janus Flexible Bond / JFLEX	$10.62/3.0%
Pimco Municipal Income / PMF	14.41/6.7
BlackRock Build America / BBN	22.40/7.0
SchwabU.S. TIPS / SCHP	54.68/1.0.*

*Estimated

Source: Bloomberg

Given this backdrop, the 10-year Treasury is attractive at a yield a bit below 2%. At some point, there will be a bear market in Treasuries, but not in 2015. Investors are more likely to be threatened this year by credit quality than interest-rate movements. I am going to recommend high-quality investments that could provide a 4%, 5%, 6%, 7%-type return. You can skip the guffaws, but one of my picks is a Janus fund.

We're shocked, shocked.

Gross: It isn't the Janus Global Unconstrained Bond fund, which I run, but the Janus Flexible Bond fund [JFLEX], a total-return fund run by Darrell Watters and Gibson Smith. It has done well in the past few years, and performed well during the credit crisis. The managers focus on credit quality, instead of taking a macro approach, as I do. The fund has $9 billion, and the management fee is only 61 basis points. It typically yields 3% to 3.5%, but the total return is dependent upon credit selection and interest-rate changes.

I like closed-end funds that provide steady income. To prove I am not biased, my next idea is the Pimco Municipal Income fund [PMF]. It is a closed-end municipal-bond fund. There are a lot of closed-end municipal funds that sell at surprisingly solid discounts to net asset value and yield 5% to 6%. Some have Puerto Rico bonds, but this one doesn't. I own this fund. Since inception in 2001, Pimco Municipal Income has maintained its dividend rate. You can't find many closed-end funds that have done that.

What does this fund own?

Gross: It holds an assortment of municipal bonds from across the country. None have the poor credit quality of Puerto Rico. The fund currently yields 6%, and it is tax-free. Typically, muni bonds are yielding 2%, 3%. 4%. The fund's yield is higher because like most closed-end funds, Pimco Municipal Income uses leverage. Leverage is dangerous if credit quality falls or interest rates rise. If the fed funds rate jumps to 1% or 2% next year, this wouldn't be an attractive holding, but that is not my bet. The fund sells at an 8% premium to net asset value, as most Pimco closed-ends do.

Next, I like the BlackRock Build America Bond Trust [BBN], which I have recommended previously. It is a levered closed-end fund that owns Build America bonds, which were issued in 2009 and 2010 to fund construction projects. Build America bonds were an Obama administration initiative. Although the bonds aren't government guaranteed, the government provides 35% of the interest expense.

Witmer: If a project goes under and an issuer defaults, does the investor still get 35%

of the interest payment?

Gross: No. You get 50, 60, 70 cents on the dollar. These bonds aren't completely risk-free. The fund typically trades at an 8% discount to net asset value, and the 7% yield is taxable. Build America bonds have provided a fairly consistent dividend stream since they were issued. These are long-term bonds, and you might ask how they compare with 30-year Treasuries. They yield a lot more than a 30-year Treasury. Also, because they are corporate bonds, they don't appreciate as much as Treasuries when rates go down, or fall as much when rates rise.

Black: Have there been any defaults in the fund portfolio?

Gross: Not that I know of, although some marginal Build America bonds have defaulted and are expected to default.

Rogers: How much leverage do these closed-end funds have?

Gross: The Pimco fund has the potential to leverage 35% of the portfolio, as does BlackRock Build America. It really went for the fences, and that is why it yields 7%.

My last pick is a Four Seasons pick. I am not referring to the hotel, but Frankie Valli and the Four Seasons. Remember when they sang [snaps his fingers and sings],

"Let's hang on to what we've got

Don't let go, girl; we've got a lot…"

Gabelli: Can you do that again?

Gross: Go see the play [*Jersey Boys*]; it's good. You won't be impressed by the potential return of this pick, but there is a twist; it offers a free call option on oil. It is the Schwab U.S. TIPS exchange-traded fund [SCHP]. It is a $500 million fund that invests in a potpourri of TIPS [Treasury inflation-protected securities] with typical maturities of five to seven years, although it has some long- and short-term TIPS. The fund charges only seven basis points. A five-year TIPS is yielding only 15 basis points. TIPS are sensitive to inflation. The fund hasn't done well in recent months as the price of oil has come down and the expected inflation rate has fallen to 1.3% or 1.4% from 1.8%.

A five-year TIPS trades at 99 cents on the dollar. The U.S. guarantees that an investor gets back 100 cents on the dollar. That is a nice guarantee. Because of the inflation sensitivity, if oil rises to $60 or $65 a barrel from current levels, the fund will appreciate 2% or 3%. Is that a big deal? No. But the fund does just what Frankie Valli advised: It lets you hang on to what you've got. It yields more than a money-market fund and charges almost nothing.

Thanks, Bill. If these don't work out, you have a future on Broadway. Meryl, you're next.

Witmer: Gildan Activewear [GIL] manufactures basic family apparel, such as T-shirts, underwear, fleece, and socks. Its market capitalization today is $6.7 billion, and it has $100 million of net debt. At a current $55, the stock offers long-term investors an attractive entry point. Gildan has two segments. Print-wear is two-thirds of revenue and has mid-20% operating margins. It is growing by mid-single digits. Gildan supplies distributors who then sell the products to screenprinters, who imprint them with logos.

Meryl Witmer's Picks

Company/Ticker	Price 1/9/2015
Gildan Activewear / GIL	$55.52
Graphic Packaging /GPK	13.93
Houghton Mifflin Harcourt / HMHC	18.87
Cengage / CNGO	23.00*

*As of 1/8/15

Source: Bloomberg

What is the second segment?

Witmer: It is branded apparel, which Gildan sells under its proprietary Gildan and Gold Toe labels, and under licensed labels such as Mossy Oak, a camouflage brand, and Under Armour. This business is growing by 20% to 30% a year. Because it is in investment mode, operating profit margins are only in the high single digits now. We see the branded business reaching margins north of 20% as it grows and captures the benefits of its investment in cost reduction, lower cotton costs, and the leveraging of SG&A [selling, general, and administrative] expenses. Gildan's key competitive differentiator is its low-cost, vertically integrated manufacturing. By continually investing in manufacturing facilities, it has been able to increase capacity and reduce costs while also improving quality. Its North Carolina ring-spun cotton facilities, which opened last year, will be the largest globally.

What is ring-spun cotton?

Witmer: It is a thin, soft cotton used in many fashion brands. Gildan's Anvil brand will drive the company's penetration in fashion-oriented basics and further differentiate its branded products. Evidence of the strategy's success can be seen in the underwear business, where Gildan has captured 7.8% of the market since November 2013. Its market share could reach 10% this year.

In December, Gildan provided 2015 guidance of $3 to $3.15 a share in earnings, better than 2014's $2.94, but below the Street's estimate of $3.50. The stock traded down more than 10% on the news. Gildan decided to take strategic pricing action to reinforce its leadership and to help it get into segments of the print-wear market it hadn't previously served. The pricing action is costing it around 70 cents a share. While the market reacted negatively, the company's moves have enhanced its long-term prospects. Gildan also announced plans to buy back 1.5 million shares.

Co-founder and CEO Glenn Chamandy is one of the best operators we have encountered. He is concerned with long-term earnings, Gildan's market position, and the success of its customers. In addition, his ownership of six million shares keeps his incentives aligned with ours.

What will Gildan earn in 2016?

Witmer: Gildan can earn $3.85 to $4 a share in 2016 and grow by at least a mid-teens rate from there. This earnings momentum could start to show in the third quarter of this year. Given Gildan's pristine balance sheet and growth outlook, we apply an 18 price/earnings multiple to future earnings to get a target price of $70 a share in one year and $80 in two years, up from $55 now. There is upside potential from acquisitions and the continued deployment of free cash.

Gildan is based in Montreal. It trades on the Toronto Exchange and in New York. Most of its operations are in Honduras, and some are in the southeastern U.S.

Black: Does the company benefit from the depreciation of the Canadian dollar versus the U.S. dollar?

Witmer: No. Only its corporate headquarters is in Canada. But it could benefit from more money in the consumer's pocket and lower energy costs. My next name, Graphic Packaging [GPK], is a vertically integrated paperboard manufacturer. The stock is $14, the market cap is $4.4 billion, and the enterprise value is $6.5 billion. Graphic Packaging makes boxes for cereal, beer, detergent, and other branded consumer goods. While the container itself costs little, the value is in the brand marketing and protection of the contents. Graphic's customers are reluctant to switch suppliers, so there is good stability to the revenue and earnings stream.

Graphic's mills are some of the lowest-cost in the industry. The company has two virgin-paper mills and four recycled-paper mills producing 2.3 million tons of paper annually. It also has more than 40 converting plants located near customers in the U.S. and Europe, where it converts paper produced in its mills into packaging. Graphic is only one of two producers of stronger virgin paper, with a market share of 55%. MeadWestvaco [MWV] is the other. It's a leader in the recycled-board market, with a 35% share. CEO Dave Scheible is a long-term thinker who has been with the company since 1999. He has been CEO since 2007. He has done a fantastic job of integrating acquisitions, paying down debt, and disposing of noncore businesses.

What do the financials look like?

Witmer: In the past few years, Graphic has transitioned from a highly levered company to one that is appropriately capitalized. The company has nearly $900 million of net operating-loss carryforwards, which could allow it to shield earnings from taxes for the next 2½ years. In our base-case model, Ebitda [earnings before interest, taxes, depreciation, and amortization] can grow 5% a year organically. We assume that the cash simply builds up on the balance sheet. Even though Graphic won't pay much in corporate taxes until 2017, we use a 35% pro forma tax rate to get $1.45 a share in after-tax free cash in 2016. Plus, there is a buildup of $3 a share in excess cash. Using a 12 multiple and adding the excess cash gets us a target price of about $20 a share in two years.

The company will likely redeploy the cash to make opportunistic acquisitions, repurchase shares, and implement a dividend. The CEO seems to have a knack for making $1 worth at least $2. Plus, with the decline in energy prices, the consumer could add a tail wind to our growth assumptions. Our upside two-year target is north of $23 share.

My next picks, Houghton Mifflin Harcourt [HMHC] and Cengage [CNGO], publish textbooks and other educational material. Both have come out of bankruptcy protection.

You have invested successfully in other companies coming out of bankruptcy.

Witmer: It is a good place to look. Houghton is focused on pre-K to 12th grade, and Cengage, on college students. Houghton has a market cap of $2.7 billion and an enterprise value of $2.3 billion, and about $2 a share of excess cash. Cengage has a market cap of $1.8 billion, an enterprise value of $3.6 billion, and some debt. Both companies are benefiting from the conversion of educational materials from print to digital. Given the complexities of GAAP accounting [accounting based on generally accepted accounting principles], this change is being overlooked by the market. Reported earnings are also greatly obscured by noncash amortization charges.

What led to the companies' bankruptcy filings.

Witmer: In the middle of the past decade, private-equity firms purchased and levered up textbook publishers, including Houghton Mifflin and Cengage. The money for textbook purchases comes primarily from state and local tax revenue, and the recession forced a sharp pullback in spending in pre-K-12. The college-textbook market was challenged by the growth in online textbook-rental companies. Given their leverage, both Houghton and Cengage were forced to declare bankruptcy and restructure. It was your classic example of "good business meets bad balance sheet." Houghton came out of bankruptcy protection in 2012 and came public in 2013. Cengage emerged in the middle of 2014.

The K-12 and college markets each have three competitors with most of the market. This is an attractive industry structure. Schools and professors are rapidly accelerating their use of digital materials in the classroom. In Texas, 70% of Houghton's best-selling math program was sold as digital content. At Cengage, digital content was 19% of total sales in 2014. According to professors and research studies, students learn better using digital content. In the college market, many classes have required purchases of digital material for homework and at-home quizzes. The shift improves profitablity as you don't need to print and warehouse books.

How does the GAAP accounting work?

Witmer: When a print textbook is sold, the revenue and costs are recognized in today's income statement. When a digital product is sold, revenue must be deferred over the lifetime of the contract, usually six years, while most of the cost is incurred in the current period. In the first three quarters of 2014, Houghton's GAAP revenue has increased 3%. Billings, which combine reported revenue and deferred revenue, are up 25%. As a significant part of deferred-revenue growth comes from digital-product sales with minimal incremental costs, reported earnings significantly understate true earnings power. The correct adjustment is to add back most of the increase in annual deferred revenue, less estimated costs and taxes.

GAAP also penalizes the reported earnings of these companies with large amortization charges. These are accounting charges and don't involve the outflow of cash. They are tax-deductible. We add back the charges, resulting in a 2014 estimate of $1.60 to $1.80 a share in after-tax free cash flow for Houghton Mifflin. The company has said that it will generate close to $2 share in cash in 2014.

What are reported earnings?

Witmer: They were a negative 20 cents for the first nine months of 2014.

Demand for textbooks in 2014 was higher than industry expectations. But national spending per student in the K-12 market is near historic lows. Spending is about $55 per student, up from a postrecession low of $47, but below a 10-year average of $62. With 55 million students and a market share of 42%, an incremental $5 per student could add 30 cents a share to Houghton's earnings. A $5 increase is reasonable as municipal budgets improve. Houghton is also working to sell supplemental learning materials directly to parents. This could be a big and profitable business. We value Houghton at 14 to 15 times adjusted earnings. Our target price is $26 to $28 a share, up from $18.50.

Cengage's adjusted earnings are about $2.60 per share. The stock is $23. The company recently paid a special dividend of $3.85 a share dividend. We value the business at 12-13 times earnings, or $31 to $34 a share.

Black: Does Houghton still have a trade-book division?

Witmer: Good memory -- they do. This pick is really about the growth of digital revenue, with 20% fewer associated costs, and the drought of spending reversing in pre-K to 12.

Thank you, Meryl.

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