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Placid Times Ahead?

By JIM MCTAGUE | MORE ARTICLES BY AUTHOR

The bears were as abundant as the bass on our fourth annual fishing trip to Maine with a group of market-watchers. Some stocks to throw back.

THE SMALL-MOUTH BASS THIS JULY WERE AS delightfully cooperative as they had been on our three previous annual fishing and forecasting expeditions to the remote and lovely Grand Lake Stream, Maine -- where the fish outnumber the people, canoes outnumber cars and you can find more crystal-clear lake surface than paved roadway. We caught about a dozen bass over two days, several over 18 inches in length. We also netted dozens of feisty white perch, several of them more than a foot long -- testament to the robust crop of Maine mosquitoes this year.

On the other hand, the 18 financial experts and one businessman we joined over the weekend of July 20 at Leen's Lodge, a legendary lakeside hunting and fishing camp, were much charier than in past summers. This group's consensus about the U.S. is that a recession is inevitable, given the persistence of inflation, the economic prescriptions of ascendant Democrats and the meltdown of the housing market. The depth of this recession is a matter of debate among the group, although most believe it will be shallow.

Canadian Martin Barnes, managing editor of the Bank Credit Analyst, a renowned purveyor of global economic research, summed up the guarded mood of the gathering when he brooded, "We're now in a more treacherous phase of the bull market."

Barnes -- an enthusiastic first-time fisherman who out-hooked many of the veterans -- sees stocks moving higher in the next six to nine months, because they remain a more attractive investment than either bonds or real estate. But the Scottish-born economist emphasized, in a burr as pronounced as a bagpipe's wail, that there is real danger of the economy building up enough steam to cause the Federal Reserve to pull hard on the interest-rate lever.


Jim McTague

AS IS THE TRADITION, THE ASSEMBLED EXPERTS placed small bets on where they think the benchmarks will be headed over the next year. On average, they saw the Standard & Poor's 500 down to 1468 by Sept. 14 -- it turned they were a bit conservative there, as the S&P slipped below that level last week -- and the group sees the index at about the same level in July 2008.

And in their view, the fed-funds rate will be 5.18%, down from about 5.32% now; the 10-year Treasury will yield 5.53%, up from 4.78%. West Texas Intermediate will go for $68.03 a barrel, down from about $77. Gold will sell for

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$742 an ounce, versus about $665. The euro/dollar spot rate will be $1.37 -- unchanged from the current rate. And the headline consumer-price index will be running at an annualized rate of 2.61%, versus 2.70% now.

The group's cautiousness might be reason for bulls to take heart. Last year's group predicted that by the time of the July 2007 gathering, the Dow Jones Industrial Average would be at 11,286.93; it's closer to 14,000. That group also was a shade high on interest rates and a little low on the value of the dollar. Their average prediction on oil prices was a full 15% below the actual July number.

The annual outings are the brainchild of David Kotok, the gregarious co-founder and chief investment officer of Cumberland Advisors. The money-management firm has been beating bond benchmarks in recent years by sticking with quality rather than chasing higher yields on low-grade bonds.

The rustic setting, the dining and the passionate nightly discussions reflect three of Kotok's infectious enthusiasms: fly fishing, fine wines and lively discussions of market theory and economics.

In the course of two outdoor cocktail hours, we interviewed several of this year's participants, including two asset managers who are bearish on stocks in the short term but are bullish in the long term. Both John Mauldin, president of Millennium Wave Investments, an investment-advisory firm, and Scott Frew, manager of Rockingham Capital Partners, a modest-size hedge fund, anticipate a significant market correction. Until that time, they are avoiding long positions in most equities traded on U.S. markets, with one exception: energy companies.

Frew, a formidable tennis player who joined the fishing group for the first time, admits to getting beaten up by the rising market, until the past couple of months. Betting on price declines, he has sold short financial firms with heavy mortgage exposure like IndyMac (ticker: IMB) and bond insurers MBIA (MBI) and AMBAC (ABK). He predicts that General Motors (GM) will go into bankruptcy. Because he expects growing weakness in consumer spending, he is short Harley Davidson (HOG), CarMax (KMX) and Dell (DELL). In all, he has sold short some 40 stocks.

The Ones That Got Away

The predictions from last year proved too high on interest rates, too low on the stock market.

	2006 Forecast	Actual	2007 Forecast
Fed Funds	5.5%	5.25%	5.25%
10-year Treasury	5.39%	4.78%	5.53%
Oil (Per Barrel)	$64.98	$77.37	$68.03
DJIA	11286.93	13417.7	-
euro/$	$1.29	$1.37	$1.37

Source: Bloomberg

One thing he does like: the Japanese yen. He says so many people have borrowed yen -- the so-called "carry trade" -- to purchase U.S. assets, there will be demand for the currency to repay those loans if recession forces them to liquidate investments.

Mauldin, an affable Texan who also publishes a widely read investment newsletter, claims he found less-risky places to put money overseas.

Both men believe that the meltdown of the subprime mortgage market in the U.S. will depress housing more than the 1% to 4% predicted by the futures markets, and that the wave of upward interest-rate readjustments on mortgages over the next 17 months will expand the population of distressed borrowers, depress housing prices in general and result in a mild recession. About $50 billion in adjustable mortgages will reprice every month during this period.

The mortgage meltdown will not be precipitous, like Long-Term Capital's demise, says Mauldin. Rather, "It will be a lengthy process -- death by 10,000 cuts." Mauldin's bets on price appreciation include precious metals and mining and oil stocks.

BARRY RITHOLTZ, DIRECTOR OF EQUITY RESEARCH for Fusion IQ, a new quant shop, told us he has been bearish on the economy for a year and a half, ever since he began to see what was occurring in the housing sector, yet he's been bullish on the stock market because his mathematical model until very recently told him to be 95% invested the stock market. Last week, he and his colleagues began taking profits in some of the biggest positions, peeling back exposure to 50%.

"Nothing is a screaming 'Sell,' " he says. "The market just looks a little tired here." Fusion IQ trades for a couple of hedge funds and also manages about $100 million in individual accounts.

The Bottom Line

The model has kept clients out of the awful sectors, like housing, finance and some of the tech stocks, and placed

The group of 18 financial experts and one businessman thinks the stock market will decline somewhat through September and then change little through next July.

them into the energy sector, especially the "seismic group," with companies like Input-Output (IO), which provides detailed seismic data to exploration companies. "As oil becomes more and more expensive, an oil explorer will have to know not only where it is, but how much he can get out and the quality of the crude," Ritholtz says. Companies in the seismic group provide just that kind of data.

If not for such bright spots, then Ritholtz might be living in a cave, hoarding gold. "The macro perspective is very negative," he tells us. "We see the economy decelerating and GDP slowing, and employment slowing and inflation remaining stubborn. Consumer sales are slowing. The consumer no longer is able to pull as much money out of his house. He is now turning to credit cards, which are a finite source of cash. And we have been watching what we call 'retail slumming.' The Whole Foods (WFMI) customer is going to Costco (COST) instead; and the Costco customer is going to Wal-Mart (WMT); and people are working themselves down the food chains to save a couple of dollars," he says.

Wachovia's chief economist, John Silvia, one of the better fishermen in the group as well as one of the better forecasters, is convinced that Washington is going to botch things by throwing a policy monkey-wrench into the economic machine.

"In terms of investment strategy for the next three to five years, one has to understand the political risks," he says. "At this point, it is more than likely a Democrat will be elected president in 2008. Democratic initiatives -- higher taxes on dividends and capital gains, higher marginal tax rates and greater regulation -- suggest that the effective rate of return on investments in the U.S. will diminish." Those lower returns will have a negative impact on the stock market in general, he maintains.

Next year, Kotok predicts, there'll be the biggest yet group of financial fishermen, and advises early reservations. We understand the appeal: If this year's prognostications come true, fish may be all that are rising.

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