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Watch Your Step

BY JACK WILLOUGHBY

Investors have popped the corks this year, but they're not quite ready to drain the champagne. That's the message of our latest Big Money poll, which finds nearly 60% of America's money managers bullish about the stock market's prospects through the end of the year, but muted in their expectations of how high stocks can rise from here.

There are reasons for optimism, including evidence that the economic recovery is pressing forward and the unemployment rate is starting to fall. And there are reasons for concern, too, brought home most clearly last Monday by the news that Standard & Poor's has taken steps that could result in the loss of Uncle Sam's cherished triple-A credit rating if the nation can't get its financial house in order. The markets relayed the mixed message last week, as stocks made a new post-crash high—while gold, the asset of choice among the anxiety-ridden, topped $1,500 an ounce.

The Big Money bulls see the Dow Jones industrials climbing just 5% more this year, to 13,066, and 2% in the first half of 2012, to 13,358. They expect the Standard & Poor's 500 to reach 1412 by December, and 1446 by mid-2012, up from 1337 last week. Their mean Nasdaq Composite forecast calls for a gain of 8% in the next 14 months, or a rally to 3048, from Thursday's 2820.

All things considered–and there is a lot to consider lately, from America's towering deficit to Europe's sovereign-debt woes to soaring oil prices–the outlook could be much worse. "The path of least resistance is upward," says Jacob Gottlieb, chief investment officer of Visium Asset Management, a New York hedge-fund manager with assets of $3 billion. "Right now, the market isn't particularly expensive, and, for the most part, the fundamentals have been pretty good. Interest rates remain low."

In keeping with that forecast, Gottlieb expects the industrials to clear 14,000, and the S&P 1550, by the middle of next year.

ONE CAUSE FOR CELEBRATION is U.S. corporate profits, which continue to rise, defying skeptics. Investors rejoiced midweek at the upbeat earnings reports from Intel (ticker: INTC), IBM (IBM) and United Technologies (UTX), and more good news could follow. The Big Money managers see a 15.5% increase this year in S&P 500 profits, and a rise of 12% in the first half of 2012.

"We've said time and again this is a business cycle playing out," says Charles Lemonides, founder of New York-based ValueWorks, which manages $200 million. "Cyclical elements like autos and housing that have been a drag will add something nontrivial to growth in the next 12 months."

Lemonides expects the Dow to hit 13,450 by the end of 2011, and 14,000 by June 2012. He sees the S&P 500 closing in on 1500 by the middle of next year, and the Nasdaq reaching 3200.

His advice: "You don't need to get clever or cute. Buy quality names such as Corning [GLW], Cisco Systems [CSCO] and Dow Chemical [DOW]. There are great returns to be made in big-cap, blue-chip equities in the coming quarters."

Patrick Kaser, a portfolio manager at Brandywine Global Investment Management in Philadelphia, which handles $30 billion, agrees. Last year, Kaser notes, the smallest 20% of stocks in the Russell 1000 Value Index returned a total 26%, while the largest 20% returned only 5%. "I am optimistic, because these things tend to snap back dramatically," he says. "Large-cap stocks could rise another 20% and still be cheap." Kaser expects the Dow to reach 15,000 by mid-2012.

In keeping with their more modest expectations for stocks, only 39% of Big Money managers think the market is undervalued. That is down sharply from the 53% who said they saw ample bargains last fall. Almost half of our respondents now consider the market fairly valued, while 13% say stocks are overvalued.

About two-thirds of poll participants expect stocks to suffer a correction of 10% or more by the end of this year. About a fourth suspect that evidence of a weaker economy or a double-dip recession will be the cause, while 16% view geopolitical crises as the eventual rally killer. Another 16% say the blame will lie with weaker corporate profits.

In an era when alternative assets are garnering more respect and investor dollars, it is notable that almost two-thirds of the Big Money pros expect equities to be the best-performing asset class in the next six to 12 months. Some 12% think that pre-

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cious metals will do best, while 15% are putting their money on commodities other than precious metals.

Bonds get little love in our latest survey, with only 1% of managers expecting fixed-income securities to outshine other asset classes. As for U.S. Treasury bonds, 87% of Big Money investors are bearish on the government's debt.

Scott Schermerhorn, principal of Concord, N.H.-based Granite Investment Advisors, with $550 million in assets, worries, in particular, about target-date mutual funds that have been popular with savers. Such funds invest in bonds slated to mature around the time the holder expects to retire. Like all bond owners, target-date-fund investors could be hurt as inflation perks up and interest rates rise. Besides, such investors could be getting a much better deal in today's equity market, he notes.

Schermerhorn is bullish about stocks. "Excluding financials, corporate balance sheets are in better shape than they've been in decades," he says. "Earnings are growing. So are returns to shareholders." He expects the Dow to return more than 13% between now and June 2012.

AMONG EQUITY MARKETS, 45% of Big Money respondents favor the U.S., up sharply from 27% in our fall 2010 survey. Pick No. 2 is emerging markets, excluding the big ones: China, India and Brazil. Nearly 13% of the managers think Japan will outperform other markets in the next six to 12 months, a vote of confidence for the beleaguered nation, which has weathered an earthquake, tsunami and nuclear crisis in recent months. Only 7% of poll respondents are betting on China to carry the torch, down from 15% six months ago.

"The only things we much like are high-quality stocks and emerging equities," says Ben Inker, director of asset allocation at Boston-based Grantham Mayo van Otterloo, which oversees $109 billion. "Europe isn't bad, but it isn't cheap enough. REITs [real-estate investment trusts] have become too expensive."

What would it take for the market to fall? "Some unknown political event, or a squeeze on profit margins," Inker says. "We see no strong evidence of it happening this year or even next, but the market is 30% overvalued."

The Big Money Poll is published twice yearly by Barron's, in the spring and fall. The latest survey, prepared with the aid of Beta Research in Syosset, N.Y., drew responses from a record 152 money managers nationwide. Some run small investment firms, while others manage billions of dollars for banks, mutual funds, endowments and other institutions, as well as private clients.

OUR LATEST POLL FOUND ONLY 11% of managers bearish or very bearish on stocks, down from 15% last fall. But the ranks of the fence-sitters, or those who are neutral on the market's prospects, have swelled to 30% of respondents, from 25% last November. The bears worry, in part, that stocks' progress will be stalled when the Federal Reserve stops its controlled buying of Treasuries in June; the central bank undertook a second round of so-called quantitative easing, or QE2, last year, in an effort to lower interest rates and boost the economy. The move also served to heighten the appeal of risk assets, prominently including equities.

The Big Money bears expect the industrials to backtrack to 11,182 by year end, which would put the blue chips in the red for the year. They look for the S&P 500 to fall to 1204, and the Nasdaq to sag to 2429. Their consensus forecast for mid-2012 has the Dow at 11,236, the S&P at just under 1200, and the Nasdaq practically unchanged, at 2424.

John Toohey, a portfolio manager at USAA in San Antonio, calls himself neutral on stocks, and sees the major averages rising only about 4% through June 2012. "The markets don't have a lot more upside in the near term," he says. "Earnings will be fine, but [growth will be] decelerating. That will lead to multiple compression."

It will be critical for strong bank lending to substitute for the Fed's support. "To some extent, we are seeing consumer credit grow," Toohey says. "Banks are starting to make [more] commercial and industrial loans. We would like incomes to pick up. We need firings to slow."

USAA, with assets of $47 billion, originally was established to serve the military, but its mutual funds are open to the public.

Kenton Russell, of the brokerage Sterne Agee, used to be bullish, but now makes no bones about being a bear. "The primary assumption people are making is dollar stability," he says. "If you don't pay attention to the dollar while being long bonds and stocks in the U.S., you are not paying attention to the most crucial element of the trade."

Based on the declining value of the dollar, which hit a 15-month low Wednesday against the euro, the market is "right back at the lows" seen before the financial crisis, Russell says. He expects stocks to drop about 20% in the next year or so, with investors selling the DJIA down to 9500 and the S&P to 900 as they come to realize the U.S. has "reached the limits of fiscal and monetary policy."

A 20% correction "is no collapse," Russell says, although some might argue it will feel like one. He recommends shorting the iShares Russell 2000 exchange-traded fund (IWM) and buying the iShares MSCI Emerging Markets ETF (EEM), as he thinks Asian currencies are undervalued.

Russell might be comforted to know that 68% of Big Money participants expect the dollar to strengthen against the euro in the next 12 months, while 71% see the buck bucking up versus the yen.

THE BIG MONEY MANAGERS are bullish on oil, and expect crude prices to stay above $100 a barrel in the next 12 months; oil closed Thursday near $112. No surprise, then, that many think energy will be the best-performing industry sector in the months ahead. The managers also are bullish on health care and technology, but bearish on utilities, financials and consumer-cyclical stocks.

"QE2 might advance the day's news, but what is going to drive the market's advance is earnings," says Douglas McEldowney, senior vice president of Northern Trust, and co-manager of the $230 million Northern Large Cap Value Fund. McEldowney likes technology companies such as Cisco, Hewlett-Packard (HPQ) and SanDisk (SNDK) because of their

earnings potential.

Mark Luschini's top sector picks include energy, health care, tech and consumer staples, all of which, he notes, are benefiting from growth in emerging markets. Luschini, chief investment strategist at Philadelphia's Janney Montgomery Scott, worries that consumer-spending trends might not be able to support current price/earnings multiples on consumer-discretionary stocks such as retailers and restaurants. His top pick, Kimberly-Clark (KMB), is a consumer-staples play that trades for just 12 times 2012 earnings estimates, and offers a dividend yield of 4.2%.

Luschini expects the S&P 500 to rally about 8% in the next 12 months. But unlike many investment pros, he looks for oil prices to fall. They were bid up, he says, by political turmoil and speculation, and could retreat to about $90 a barrel in 2012.

The Big Money crowd's favorite stocks include familiar picks such as Apple (AAPL), Microsoft (MSFT), Cisco and Berkshire Hathaway (BRKA), as well the more speculative Bank of America (BAC), which has struggled to lift earnings and recently was denied permission by the Fed to increase its dividend. The attraction of BofA? "The stock is trading very cheaply on potential earnings," says Brandywine's Kaser.

James Roumell, head of Roumell Asset Management, which oversees $350 million in Chevy Chase, Md., says the best investment bets lie in beaten-up large-caps and special situations followed by few on Wall Street. Sierra Wireless (SWIR), a Canadian provider of wireless technology, is one underfollowed issue he likes. The stock trades for 11.50, or about 12 times next year's expected earnings.

Roumell also likes specific high-yield bond plays, including Goodrich's 8 7/8% bonds due 2019, and StoneMor's 10.5% bonds due 2017. He thinks the stock market is overvalued, and could fall about 5% by the end of the year.

There is a broader consensus among the Big Money managers about the most overvalued stocks, a list topped by Netflix (NFLX) and Salesforce.com (CRM). Both have been subjects in recent months of skeptical Barron's stories; they sport oversized P/E multiples. Netflix is trading for 54 times this year's estimated earnings, while Salesforce has a P/E of 108.

THE U.S. ECONOMY, AND THE stock market, will face a big test this summer, if the Fed ends its latest quantitative-easing program as planned. Some, like Robert Medway, managing partner of New York-based Royal Capital, expect stocks to tumble when "government support" runs out. "You can't fight the Fed in the short term," says Medway, who manages $1.3 billion. "But within six months after the Fed stops buying, the market will collapse."

More managers, however, would agree with James Paulsen, chief investment strategist at Wells Fargo's Wells Capital Management, that the economy has gathered enough momentum to keep growing, even if interest rates rise.

A quarter of our respondents expect gross domestic product to grow by 2.5% this year, and 58% see GDP rising 3% or 3.5%. Some 78% of managers think it is unlikely the U.S. economy will suffer a second, or double-dip recession, although 22% consider the prospect somewhat or very likely. The managers are split as to whether Japan's recent nuclear catastrophe will slow global growth; 63% doubt so, but 37% fear so.

Two-thirds of Big Money pros expect the Fed to end QE2 as of June 30, while 25% think Fed Chairman Ben Bernanke will extend the Fed's purchases for another three to six months. Most managers look for the Fed to raise its federal-funds rate target sometime within nine to 18 months, and about half expect 10-year Treasury bonds to yield 4% six months from now. The 10-year ended Thursday with a yield of 3.4%.

Some 57% of managers think inflation will pose a risk to the economy in the next 12 months, while 25% say the bigger threat is stagflation—the dreaded combo of a stagnant economy and inflation.

Horacio Valeiras, chief investment officer of Allianz Global Investors, expects companies with global brands, such as food and pharmaceuticals concerns, to perform best in an inflationary environment. "These companies can more easily pass on inflation, and grow faster than the economy," he says.

JUST AS THE U.S. ECONOMY ISN'T firmly out of the woods, European economies continue to struggle, with investors weighing the threat of sovereign-debt defaults. About 37% of Big Money respondents see continued crises in the euro zone's weaker members. "It is getting to the point where extend-and-pretend is no longer an option," one poll participant wrote. "I am starting to believe that the average citizen of one of the PIIGS [Portugal, Ireland, Italy, Greece and Spain] is more concerned with his taxes and well-being than with being a member of the European Union."

The managers largely are skeptical that state and local governments in the U.S. will default on their debt, although one noted that "municipal debt has been the ultimate extend-and-pretend."

The same could well be said for the federal government's debt, which now has become the focus of intense Congressional and White House attention, not to mention that of S&P. Only 15% of the Big Money managers expect the U.S. to achieve meaningful debt reduction this year. Others think real action won't come until after the November 2012 elections, or "until the markets riot... several years in the future."

The Big Money managers don't think Donald Trump has any chance of becoming the Republican presidential candidate in 2012, although 36% expect former Massachusetts Governor Mitt Romney to head the ticket. Our respondents aren't as confident as they were six months ago, however, that the GOP will wallop the incumbent, President Obama. In our newest poll, 47% of managers indicate the president will win another term, up from 29% who thought so last fall.

The president's fortunes could well be determined by the economy's prospects and the stock market's performance in the year ahead. And those, in turn, depend increasingly on Washington's actions. No wonder America's money managers are cautiously bullish, but not exuberantly so,

these days.

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