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Wall Street's Take on 2000

Six pros make their predictions for the year ahead.

By Suzanne Woolley, February 2000 Issue

As we dip our toes into a new century of investing, investors may be feeling a little wobbly. The past year was both action- and anxiety-packed, a year of Net stocks performing death-defying aerial tricks, of merger mania rapidly reshaping industries, of watching financial markets scramble to interpret Federal Reserve chairman Alan Greenspan's every word. Will the year 2000 give us much to celebrate? In other words--can we relax yet?

To find out what glad or gloomy tidings the year may bring, we caught up with six of Wall Street's elite: Jeffrey Applegate of Lehman Bros., Gail Dudack of Warburg Dillon Read, William Gross of Pimco, Leila Heckman of Salomon Smith Barney, Edward Kerschner of PaineWebber--all of whom we quizzed in our year-end 1998 issue ("Wall Street Sizes Up 1999")--and Steven DeSanctis of Prudential Securities. (He has replaced Claudia Mott, another of last year's experts, as Pru's director of small-cap research.) Along with getting their views on the year ahead, we'll look back at '99 to see whose predictions panned out--and whose flamed out.

RAGING BULL

Jeffrey Applegate, Lehman Bros.' chief investment strategist and one of Wall Street's longest-running bulls, is as gung-ho as ever. Applegate falls into the "new paradigm" camp. He believes that the technology revolution and globalism have rendered old valuation yardsticks useless. He says his model portfolio's "huge overweight" in equities--80%--reflects the 15% average gain he expects from stocks. Applegate doesn't rule out a correction, though, since he expects the Fed to lift interest rates by 50 basis points in the first half of the year.

Looking ahead, Lehman's guru is betting on tech. It sure worked in '99: The tech stocks (America Online, Cisco, EMC, IBM, Lucent and Tellabs) he liked last year gained an average 146% from Nov. 13, 1998 to Nov. 30, 1999. Even without those high fliers, his nine nontech picks (State Street, Walgreen, Chase Manhattan, Citigroup, US Bancorp, BankBoston (now FleetBoston Financial), Morgan Stanley Dean Witter, Alliance Capital and Franklin Resources) beat the S&P 500's 23.4% return.

AOL remains an Applegate favorite ("the premier media brand in cyberspace"). Other names: Solectron ("which basically makes all the hardware for a bunch of tech companies--IBM, Cisco, Sun"); Vodafone AirTouch ("a global play on the explosion in wireless and voice data transmission"); and Siebel Systems (for its "supply chain e-commerce software").

STILL BOOMING

PaineWebber strategist Ed Kerschner remains bullish long term, even if he did turn "relatively cautious" this past July. Inflation can't go lower, he says, so the only way the market goes up is if earnings go up. "If earnings go up 5% to 8%, a good year is a 12% return and a bad year is flat," says Kerschner, who expects a 7% earnings gain for the S&P 500 in 2000. At year-end, he expects a Dow at 12,500.

Kerschner's research tries to anticipate the spending patterns of baby boomers. His '99 picks--AOL, American Express, Compaq, Gap, Wal-Mart and Warner-Lambert--paid off with an average 78.2% gain from Nov. 13, 1998 to Nov. 30, 1999. His only loser: Compaq, down 27.2%. Today, Kerschner cites Carnival, Delta, Home Depot and Bed Bath & Beyond as ways to invest in one important trend, that of affluent Americans spending more money to enrich their home lives and leisure time. To play another major trend, the information revolution, Kerschner likes IBM, Lucent, MCI WorldCom, Gateway and Cisco.

GRIN AND BEAR IT

Warburg Dillon Read chief equity strategist Gail Dudack represents an endangered species: the Wall Street bear. In late 1998, Dudack was calling for a Dow of 8500, tops, by year-end, though she raised her estimate during 1999. "I was too worried about Latin America and the impact of a devaluation on the U.S.," she says. "Instead of those negatives, we had pretty good global economic activity." As you'd expect, Dudack's '99 picks, which were defensive plays, had a tough year. Among the losers: First Union (-36%), American Electric Power (-36.9%), Manor Care (-39.5) and Philip Morris (-51.4%). The average return: -9.3%. Her one true winner: IBM, up 30.9%.

Dudack maintains that the Net stock rally is a bubble. She notes that while market indexes had an up year in '99, a handful of stocks accounted for much of the advance, while a stealth bear market was unfolding for many issues. For 2000, she predicts an S&P 500 earnings gain of 9% and two more interest-rate hikes.

Stocks that can weather any market environment relatively well and absorb Fed-induced rate hikes are Dudack's focus now. She also wants to avoid "accounting landmines." Her picks: IBM ("solid accounting standards, exposure to the Net through website consulting"); Bell Atlantic ("I expect it to get approval to offer long-distance service in New York State and gain 25% market share within five years"); Johnson & Johnson ("core products are well established with reliable revenue streams"); and Exxon Mobil ("I see five-year earnings growth averaging 14%").

THINKING SMALL

If Dudack feels out of vogue, well, she has company in Steven DeSanctis. Someday--yes, someday--small-caps will enjoy a prolonged advance. They're rallying now, but after so many head fakes, no one wants to bet that this is the big one. DeSanctis cites a sign of hope: strong cash inflows into small-cap growth mutual funds. Then there are the typically rosy forecasts rounded up by IBES and others predicting profit increases of 30%-plus for small-caps.

DeSanctis worries, however, about the deluge of initial public offerings. "When deals per month increase," he says, "performance tails off because people put money into the hotter IPOs rather than existing small-caps."

The Prudential small-cap picks we featured last year delivered mixed results. There's staffing firm Select Appointments (recently bought by a Dutch firm), up 59.2% from Nov. 13, 1998 to Nov. 30, 1999, and biotech firm Gilead Sciences, which had a 67% gain. Linens 'n Things rose 12.5%. Then there's Consolidated Graphics, which fell 58.4% and Orthodontic Centers of America, which slid 38.3%. Average gain: 8.4%, about half the Russell 2000's 16.6% advance.

Small-caps that Pru analysts think will do better than that this year include $638 million (market cap) Digital River, an e-commerce outsourcer that went public this past August. "They signed up their first top 10 desktop-software publisher, which tells me that they're gaining momentum," says Internet retailing analyst Mark J. Rowen. Another Pru pick is Gentex, which designs and manufactures a type of self-dimming mirror for cars and trucks. Other ideas: Station Casinos, which operates casinos targeting Las Vegas residents, and graphics-technology leader Nvidia.

BONDS: THAT OTHER ASSET CLASS

Stocks, stocks, stocks. It's easy to forget that there's a whole other asset class out there--bonds. And when it comes to bonds, a lot of investors rely on the index-beating expertise of Bill Gross, manager of the $30 billion Pimco Total Return fund. What does Gross foresee in 2000? For starters, an acceleration in the core rate of inflation to 3%, because of a pickup in the global economy and low levels of unemployment. The yield on the 30-year Treasury bond shouldn't go above 6.5%, he says (it's now around 6.4%). When yields reach 6.5%, Gross will begin buying longer-term bonds.

For investors in high-tax states like New York and California, Gross likes municipal bonds, which offer yields that can top 6%, rivaling those on long-term Treasuries. He also likes mortgage bonds like Ginnie Maes.

LOOKING ABROAD

Leila Heckman, Salomon Smith Barney's head of global asset allocation, gathers data such as forecast earnings growth and and price momentum for stocks in a slew of countries. She then treats countries as stocks and ranks their relative appeal. Lately, she likes what she sees: "I'm pretty bullish about everyplace around the world."

In emerging Asia, she expects the best performances from South Korea and Singapore, citing high growth and falling interest rates. Her ranking also favors Brazil ("cheap") and Mexico. It's not that Heckman dislikes developed markets. It's just that, relatively speaking, they don't offer as much opportunity. Sounds good to us. Emphasizing the best ideas is, after all, what investing is all about.