10 market predictions for a glum '08

It'll be a year of stock upheavals, especially in banking, but with great bargains along the way. And if I'm wrong about prognostication No. 10, I'll eat this column on a live webcast.

By Jon Markman

For investors, the new year will be defined by a titanic struggle between governments' efforts to flood the world's faltering financial system with cash and banks' efforts to hoard it all for themselves.

Commercial banks are stashing instead of using the cash infusions because leveraged mortgage bets gone bad are shrinking their capital bases faster than central banks and foreign investors can refill them.

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So what are the prospects for investors in this unhealthy environment? Here are the surprises that I see lying ahead:

1. Bank bankruptcy

Every financial crisis of the past 200 years has resulted in the bankruptcy, merging and closing of many banks. Sometimes even very large ones. This crisis will be no exception. Bankruptcy is an efficient means of clearing deadwood out of the forest, where it is purposelessly hogging resources, so that newer, stronger competitors can thrive.

Expect at least one major bank to fail in 2008 as high-risk mortgage and business loans made in the mid-2000s by more than 2,500 U.S. financial institutions lead to lethal losses. **Citibank** (C, news, msgs), which may already be technically insolvent, is probably too large to be allowed to fail.

But smaller institutions such as **Countrywide Financial** (CFC, news, msgs) and **Washington Mutual** (WM, news, msgs) could certainly go under or be purchased for loose change by larger competitors. The nation has far more banks than it really needs, and these two institutions -- and many others -- could easily have their books of business absorbed by competitors.

2. Banking bargains

Growing fears of bankruptcy will have devastating effect on all financial institutions regardless of their solvency and relative merits. Expect the bargains of a lifetime to develop in the stocks of certain financial companies as babies, plumbing, bathmats and floor tiles are thrown out with the bath water.

A couple to consider are **Leucadia National** (LUK, news, msgs) and **Pzena Investment Management** (PZN, news, msgs). On any big down day or series of them, buy some shares, throw them in a drawer and don't look at them again for three years.

3. Food rules

In 2008, grain will become recognized as the new gold, agriculture companies as the new tech stocks and the Mississippi basin as the new Silicon Valley. Many fertilizer and seed companies' shares did very well in 2007, yet you ain't seen nothin' yet. Farm-focused companies combine innovation with scarcity, and the result is strong growth that's unlikely to abate.

Droughts in Australia, China and Ukraine have slashed crop yields this year, pushing wheat and soybean prices to record highs. Meanwhile, the demand for corn and sugar cane as feedstock for soaring U.S. and South American ethanol use is hitting a wall in the lack of cropland and water. Since ethanol use is mandated by government and has become an increasingly inexpensive alternative to crude oil, thinning supplies are being allocated by price.

Schroders asset manager Christopher Wyke told Bloomberg he believes "we are in the early stages of a rally that could last 20 years in agriculture" as prices "are historically cheap."

Commodity experts say agriculture rallies typically last two to four years and push prices up as much as three times. My list of companies to take advantage of this trend hasn't changed since I first wrote about it last year. On dips only, consider **Monsanto** (MON, news, msgs), **Mosaic** (MOS, news, msgs), **Potash of Saskatchewan** (POT, news, msgs), **Bunge** (BG, news, msgs), **CF Industries Holdings** (CF, news, msgs), **Terra Nitrogen** (TNH, news, msgs), **Deere** (DE, news, msgs), **CNH Global** (CNH, news, msgs) and **AGCO** (AG, news, msgs).

4. Credit crunch, the sequel

We already know that mortgage-payment and home-equity-line-of-credit delinquencies are rising steeply along with home foreclosures. Starved of funds by banks, many strapped individuals turned to credit cards, and now delinquencies in these payments are also rising rapidly. Hedge funds, which heavily borrow to augment returns, are also feeling the effects of credit starvation, as are ordinary folks like dentists, attorneys and manufacturers who depend on easy access to loans to expand and fund their businesses.

Expect credit card companies such as **Capital One Financial** (COF, news, msgs) and **American Express** (AXP, news, msgs) to sink to new lows in the first half of the year as they write off losses from deadbeat customers and announce a shrinking of lending opportunities.

While investors are still wondering how big the losses in the home-mortgage market will get, the problem is spreading to commercial mortgages, MSN Money's Jim Jubak says.

Meanwhile, expect to learn a new term for your growing credit lexicon this year: *Pfandbrief* is the term for a type of European asset-backed security that has long been considered the safest type of bond on the planet. Stresses are developing in its $2 trillion market, however, as home loans sour across the continent, so beware of major German banks, including **Deutsche Bank** (DB, news, msgs), that trade on U.S. exchanges.

5. Default swap snafu

A relatively new security called the credit default swap, or CDS, is the bond market's equivalent of homeowners insurance. If you own a corporate bond and worry that it might default, you buy CDS contracts to hedge your exposure. If the bond fails, an investor to whom you've been directly paying the equivalent of insurance premiums owes you, typically, $10 million per contract. Hedge funds have run the market for these puppies way past the $1 trillion range because they've also become a way of betting on the potential for bonds' default.

Yet there's one teeny-tiny problem: CDS contracts are largely unregulated and have never been tested in a crisis. No one really knows if they are enforceable or what will happen if counterparties suffer bond losses so great that they're unable to make good on their CDS obligations. If CDS contracts are not fulfilled, banks' exposure to losses might be much higher than anyone has anticipated.

That's just another reason to continue to avoid the bank stocks this year orbet against all of the banks in the **S&P 500 Index** ($INX) by shorting **Select Sector SPDR-Financial** (XLF, news, msgs), an exchange-traded fund.

6. Alternative lifestyles

Adding the word "alternative" to your business plan these days is the equivalent of adding "dot-com" a decade ago. Makes you sound like you're swingin' with the cool kids. Alternative energy, one of the biggest areas for faddish investor behavior, is likely to have its comeuppance before too long as outlandish claims for making material amounts of energy out of algae, ocean waves, sun, wind and animal droppings are laid to waste. Solar is likely to be the only longtime solution, since it does the most efficient job of turning the energy of the sun directly into power, but valuations of companies in the sector are overheated.

Expect a brief surge in alt-energy stocks at the start of the year followed by a long period of sideways action as proponents lose steam. To play it safe, buy ETFs such as **Market Vectors Global Alternative Energy** (GEX, news, msgs) rather than individual companies in the sector -- but only on significant dips like the ones in August and November.

7. Equity abyss

Even though earnings growth for major U.S. companies in aggregate came in at a lousy 2.3% in 2007, annualized growth estimates for 2008 are perched at 14%. That's setting up the market for a huge disappointment just as the virtual elimination of two key props of the market last year -- corporate share buybacks and private-equity buyouts -- are felt the most acutely.

Expect stocks to surge on undue optimism at the start of the year but then sink during at least the remainder of the first half as earnings growth continues to slide, the country slips into recession, energy costs remain stubbornly high and new threats to financial companies emerge.

The key moment will come when the major market indexes approach their August lows and investors hold their breaths wondering whether central banks and major value-seeking buyers will ride in to save the market with the S&P at 1,400 and the **Dow Jones industrials** ($INDU) at 12,500. Those levels may hold for a day or two, but the best opportunities to make money on the downside will come as those levels are breached and a great sucking sound takes the two indexes down to 1,250 and 11,500 or below.

8. Submerging markets

One of the most optimistic views of world equities these days contends that the rise of the middle class in the emerging markets of China, South America, India and Eastern Europe has "decoupled" their markets from those of the developed world. This is absolute rubbish that will bring great pain to those who believe the suppliers of raw materials will not be affected if demand for finished goods wanes.

The middle classes of these countries are definitely strengthening but are in no way capable yet of standing in for U.S. and West European customers.

Derivatives expert Satyajit Das, who lives in Australia, calls the decoupling hypothesis a narrative fallacy in which a "convincing but meaningless story is shaped to fit unconnected facts." The exchange-traded fund **Short MSCI Emerging Markets ProShares** (EUM, news, msgs) delivers the inverse return of the main emerging-markets index, so consider it if you want to make a targeted speculation on this theory's demise.

9. Dow bow

Top stocks in the Dow industrials this year are likely to be the least economically sensitive, so place your bets on **Johnson & Johnson** (JNJ, news, msgs), **Altria** (MO, news, msgs), **Merck** (MRK, news, msgs) and **McDonald's** (MCD, news, msgs), and possibly, as long shots due to their construction exposure, **Honeywell International** (HON, news, msgs), **United Technologies** (UTX, news, msgs)and **3M** (MMM, news, msgs).

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10. A pledge

If Citigroup or **JPMorgan Chase** (JPM, news, msgs) beat any of the above-mentioned defensive stocks this year in a freakish turnaround, I will eat this column on a live webcast at noon Wednesday, Dec. 31, 2008.

Sorry to sound so glum, but I just don't see the market discounting an earnings slowdown yet. I'll update my view in six months, on June 26, and would be absolutely delighted to concede then that my forecast was way too dour.