

Investment Guide: Stocks and Bonds

Leon Levy Says Sell on Strength

Robert Lenzner, 12.09.02



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If power is destined to shift to Asia, do you want most of your wealth in U.S. equities?

Age can turn a man bearish. For the greater part of the past half-century Wall Street financier **Leon Levy** has been an optimist. Levy believed that the U.S. economy would, through a succession of business cycles, reignite and spark the higher profits that are the fuel of rising share prices.

Today, at 77, worn but wealthy and still active as an investor, he is more pessimistic about the U.S. economy and stock market than ever before in his adult life. "The outlook for profits is disappointing," Levy says. "It's very hard to tell how bad the economy will be. Still I feel it will be worse than any time since World War II."

Don't dismiss Levy as a stopped-clock bear who stumbled onto the right side of the ticker tape only since March 2000. He amassed a fortune of \$750 million, currently ranking him 313 on The Forbes 400, by making bets on the long side. He helped build **Oppenheimer & Co.** into a successful securities firm and created the Oppenheimer Group of mutual funds (current assets of \$125 billion). After selling Oppenheimer to the U.K.'s Mercantile House for \$162 million in 1982, Levy multiplied his fortune as a founding partner of Odyssey Partners, a private investment partnership.

Levy's newfound bearishness is the result of lessons learned as a young man from his economist father, **Jerome Levy**. Levy senior used basic economic statistics to predict the direction of the stock market. "Look carefully at the economy, and you will see that the main props for growing profits are not going to be here," Levy junior says.

Those missing struts are the hundreds of billions of dollars represented by the drop in business investment and the trade deficit. Levy also worries deeply about the utter lack of shortages of consumer goods and the degree to which the consumer is in debt.

Take capital expenditures first. From a peak of \$1.34 trillion (annualized rate) in August 2000, corporate spending on new plant and equipment had shriveled by 11.9% to \$1.18 trillion by last May. "It means less money invested in building factories and other commercial enterprises that will pass through to other companies and the consumer and be translated into profits," Levy says. It foreshadows, he adds, weaker profits for companies in the years to come.

Levy also views the U.S.' record current account deficit--\$520 billion on an annualized basis in the second quarter--as an inevitable drag on U.S. companies' profits. The largest chunk of this deficit is in trade in goods and services, at \$110.6 billion for the quarter, up from \$88.9 billion the same quarter a year earlier. Another piece of the deficit has to do with the fact that the U.S. pays more to foreigners in profits, royalties and interest than we receive from them. In other words, a growing fraction of the returns to capital is going to foreign suppliers of capital and not to the bottom line of U.S. companies. (The last item in the current account has to do with government spending.)

To be sure, trade--and foreign investment in U.S. factories--makes U.S. consumers better off. You benefit when Honda offers terrific cars at low prices, even if you end up in a Chevrolet priced to compete with an Accord. But the presence of Honda is bad news either way for your General Motors dividends.

Third, and here Levy cannot be too emphatic: "Nothing is in short supply. I keep asking that question of everyone. And they have no answers." He rattles off consumer products in excess--"autos, fiber optic cable, computers, cell phones, trucks, airplanes, steel, even food."

"It won't get back to the way it was," he says darkly. "If nothing is in short supply then how can profits rise?" More supply than demand triggers a deflationary spiral of lower prices and profits. He doesn't see a replacement source of higher profits on the horizon to break the spiral. "Where is the compelling force for growing profits?" he asks. The consumer not only lacks for nothing, but also is paying down debt or building up personal savings. Wealth is shifting from corporate savings (i.e., profits after taxes and dividends) to households, he emphasizes.

Levy predicts that all the factors reducing profits will prolong the bear market. The ratio of household debt to gross domestic product stands at 77%; this ratio was 61% at the onset of the last recovery a decade ago. Corporate profits have fallen from a peak of \$613 billion in August 1997 to \$491 billion by August of 2001--a decline of 20%, despite round after round of fearsome cost-cutting by U.S. companies. "It's wishful thinking to predict another bull market," says Levy.

For all these reasons, Levy is keeping more than 50% of his assets in Treasuries, and advises using any rally in the stock market to unload equities, including once-high-flying tech stocks that have fallen like lead. Levy is short the Nasdaq stock index. Had that index grown by the historic average of 6% since 1990, it would only be at 650 today, Levy notes in his new autobiography *The Mind of Wall Street* (see our Web site for a review, www.forbes.com/levy).

Reflecting his analysis of the U.S. balance of payments deficit, Levy owns a large position in the euro. His bet is the dollar will decline against the European currency because Europe's trade balance is healthier than the U.S.'

Is there anything to buy? Being a value investor in the Graham and Dodd style, Levy would like to own shares of a company whose products are in great demand, but only if that company is selling on Wall Street at lower than replacement value. He sees few likely prospects. He recently took a position in **Loews Corp. Carolina Group** (nyse: [CG](#) - news - people), the spunoff unit of **Loews Corp.** (nyse: [LTR](#) - news - people) that produces Lorillard tobacco products. It controls 9% of the cigarette market and is selling at \$19.30, or 5.3 times earnings.

Levy has also bought into **Caremark Rx** (nyse: [CMX](#) - news - people), which manages employee prescription benefit plans and is one of the biggest mail-order houses for prescription drugs. Caremark had revenue of \$5 billion for the nine months through September, and is selling at 17 times trailing earnings.

"Sooner or later there will be another bull market," Levy says. But it won't be in technology. It will be in some other area, maybe even another geographic area, like Asia. "If you were planning to build a factory now, where would be the best place?" he asks. "South Carolina? Or China, India or maybe even Russia?"

"Economic power is shifting to Asia," he asserts. That could mean the U.S. stock market is not the place to invest your money for some time to come. Through a hedge fund, L-R Global Partners, Levy owns **Kookmin Bank** (nyse: [KB](#) - news - people), the South Korean bank that is Asia's 17th largest ranked by assets (\$150 billion); **Hurricane Hydrocarbon** (nyse: [HHL](#) - news - people), a Canadian company with huge energy assets in Kazakhstan, and **Pacific Corp.**, the largest Korean cosmetic company. He directly owns a piece of the Russian gas company, **Surgutneftegas**.

Levy is a renowned collector of Roman and Greek antiquities. We ask him if he believes that the U.S. is experiencing a secular decline like that experienced two millennia ago in Rome and, before that, in Athens. It is, he says, not a relevant comparison. The U.S. economy still has the strength to recover. But, he adds, "No one ever stays number one forever. Not Holland. Not Spain. Not England. That's the way the world is."

SMOKE, SCRIPTS-AND ASIA

Wall Street eminence Leon Levy likes these companies' prospects for their value or their proximity to hot growth spots in the East.

Company/business	PRICE		P/E
	recent	52-week high	
Caremark /drugs via mail order	\$18.26	\$21.95	17.0
Hurricane Hydrocarbon /natural gas	10.96	16.05	5.2
Kookmin Bank* /banking	33.10	54.10	18.0
Loews Corp. Carolina Group /tobacco	19.30	34.05	5.3
Pacific Corp. /cosmetics	101.08	140.82	8.8

Surgutneftegas/natural gas

0.35

0.47

7.1