Still Bullish on Stocks, Levkovich Predicts 17% Gain (Update1)

By Michael Patterson and Elizabeth Stanton

Sept. 8 (Bloomberg) -- Citigroup Inc.'s Tobias Levkovich wrestles every day with his prediction that U.S. stocks are set to stage their biggest year-end rally in a decade.

``I spend a lot of time questioning our premises, mostly on the drive home at night,'' said Levkovich, 47, Citigroup's New York-based chief U.S. equity strategist. ``Unless something's broken down on the analytical front, you go past it.''

As they watch share prices erode, Levkovich and Lehman Brothers Holdings Inc.'s Ian Scott are sticking to forecasts for the Standard & Poor's 500 Index to climb at least 17 percent by Dec. 31. The last time the market ended the year so strong was in 1998, following the bailout of Long-Term Capital Management.

The strategists say declines of more than 20 percent in oil, corn and copper from records will help cut inflation and spur share gains, even after the benchmark for American equities began September with its biggest weekly drop since May. Thomas Lee, the JPMorgan Chase & Co. strategist who until the end of last week was just as bullish, reduced his forecast after the U.S. unemployment rate jumped to a five-year high in August.

The S&P 500 slid 3.2 percent last week to 1,242.31, erasing most of its gains from a two-year low on July 15. The rebound was spurred by crude's 28 percent retreat from an all-time high and better-than-estimated profits at banks such as Wells Fargo & Co. and Bank of America Corp. The index is down 15 percent this year.

Futures Climb

U.S. stock-index futures rallied today on speculation the government's takeover of Fannie Mae and Freddie Mac, the two biggest backers of home loans, will help financial companies weather the subprime-mortgage crisis. S&P 500 futures expiring in September gained 2.8 percent at 7:55 a.m. New York time.

Scott, Lehman's London-based global equity strategist, says U.S. shares will climb as the inflation rate drops to 1.8 percent in 2009 from 5.6 percent in July. He expects the S&P 500 to reach 1,450 in the next four months, a level that's still 11 percent below his December forecast of 1,630.

``The fact that things haven't gone the way we thought they would at the beginning of the year doesn't necessarily mean the methodologies we employ are invalid,'' Scott, 43, said in an interview. ``We've got the building blocks for a rally.''

Federal Reserve Chairman Ben S. Bernanke, who cut the target rate for overnight loans between banks to 2 percent from 5.25 percent in the past year, said last month that price increases should slow later this year and in 2009. The Reuters/Jefferies CRB Index of 19 commodities tumbled 22 percent from a July record as the dollar advanced.

`Huge Mistake'

John Brynjolfsson, who gave up managing inflation-protected assets at Pacific Investment Management Co. this year to start hedge fund firm Armored Wolf LLC, says it's a ``huge mistake'' to bet lower inflation will spark a stock rally.

``The long-term prognosis is that inflation is still a very, very serious problem,'' said Brynjolfsson, whose company is based in Aliso Viejo, California. ``That's going to create as much of a headwind for equity prices as anything.''

The prices U.S. companies pay for raw materials climbed 4.2 percentage points faster than what they charged consumers for finished goods in the year ended July, Labor Department data show, and economists surveyed by Bloomberg predict the spread widened last month. When the gap grew to more than 4 points in August 1973, inflation accelerated and the S&P 500 fell 31 percent in 12 months.

'Decision-Maker'

The Labor Department's report on Sept. 5 showing employers cut payrolls by 84,000 in August suggests earnings won't justify a 17 percent year-end rally, according to JPMorgan's Lee.

``The jobs number was a big decision-maker for us,'' Lee, 39, said in an interview. ``If the jobs report came in at minus 20,000, we probably wouldn't have touched our estimates, thinking there might have been a recovery much sooner. Didn't really happen.''

Lee called his previous forecast ``a reach'' and said a gain of 11 percent was more likely given the ``overwhelming bearishness'' of investors and his projection that corporate profits will rise in 2009.

Lee's reduction left the average year-end forecast of 10 strategists tracked by Bloomberg at 1,449, a 17 percent increase from last week's close. The last time the S&P 500 surged as much to end a year was in 1998, when the bailout of Long-Term Capital and drop in interest rates sparked a 28 percent rally in four months.

Levkovich says the Fed's rate cuts this year will help fuel gains in banks and consumer companies and push the S&P 500 to 1,475. Financial shares have tumbled 26 percent this year and retailers lost 1.5 percent, defying Levkovich's December prediction that the stocks may ``act as coiled springs'' and lead the S&P 500 to a record 1,675.

The strategist says he gets ``enormous pushback'' from clients on his forecast that financial and consumer companies will lead the year-end rally, and is eating more doughnuts to cope with the pressure.

``You revert back to the analysis, not to how you feel,'' Levkovich said. ``Emotion's your enemy, not your friend.''

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