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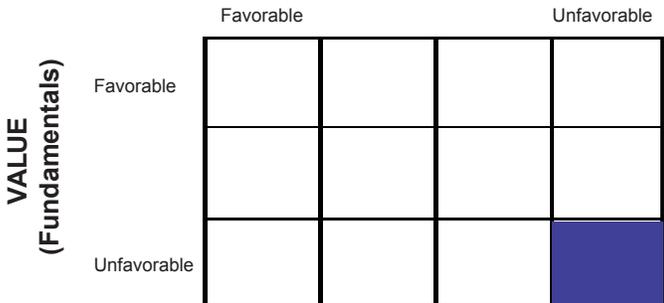
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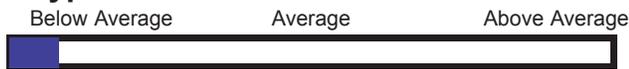
MARKET CLIMATE

The current profile of valuation and trend uniformity

UNIFORMITY (Prices, Breadth, Yields)



Typical Market Return in this Climate



Typical Market Risk in this Climate



“Value has little to do with temporary fluctuations in stock prices, but is the determining factor in the long run. Values, when applied to stocks, are determined, in the end, by the return to the investor.”

- Charles H. Dow, *The Wall Street Journal*, 1902

“The phenomenon of a bull market lasting for over a decade, unprecedented in stock market history, has been instrumental in shaping the thinking of a generation. The opinion now is widely held that new scientific discoveries, institutional buying, and population trends will ensure a permanently high plateau. Many Dow Theorists, however, believe that the entire rise will go down in the history books as part of a single bull market - admittedly greater in duration and extent than its predecessors, but in other ways quite similar. Furthermore, despite the predictions of the economists and money managers, Dow Theorists warn that this bull market, too, will top out, and that a new bear market will correct the entire rise since 1949.”

- Richard Russell, *Barron's Magazine*, July 13, 1959. Over the ensuing 23 year period, the market experienced a series of bull and bear markets, with very little net progress. Despite strong earnings growth, the S&P 500 appreciated at an overall rate of just 2.5% annually, for a total return including dividends of less than 6.5%.

Weekly market commentary and online research reports are available at no charge on the Research & Insight page of our Fund website www.hussman.net

THE TICKER

The U.S. stock and bond markets are in an interesting position. In both cases, they are priced to deliver unsatisfactory long-term returns to investors. **Despite the substantial market decline from the speculative extremes of recent years, simple arithmetic indicates that the S&P 500 is still priced to deliver a probable total return to investors of between 3% and 5.5% annually over the coming decade.** Meanwhile, a ten-year U.S. Treasury bond will deliver a return of about 4% annually with certainty.

Between today and the point that stocks and bonds achieve durable undervaluation, both will certainly enjoy several bull market periods on the basis of market action alone. Regardless of valuations, we expect to participate in many of these periods.

As Charles Dow noted a century ago, value has little to do with temporary fluctuations. Valuation only determines the *long-term* return from a security. But when market action (what we define as “trend uniformity”) has been favorable, investors have typically been willing to drive overvalued securities to even higher valuations, as they did from 1995-2000. While that bubble delivered outstanding short-term returns, it nearly ensured poor long-term ones. The decline since 2000 has only partially reversed these excesses.

Favorable valuation indicates *investment merit*. Favorable market action (trend uniformity) indicates *speculative merit*. These are distinct concepts. Our *Market Climate* approach varies the amount of risk we take, based on the specific set of merits offered by the stock and bond markets at any time.

Currently, stocks and bonds have little investment merit. A buy-and-hold approach is simply not likely to deliver satisfactory long-term returns from current valuations. A selective approach to taking risk will be essential to navigating the markets in coming years.

A simple way to gauge the long-term prospects for the S&P 500 is to examine the price/peak-earnings ratio. We devised this measure based on the observation that earnings typically plunge in a recession, which distorts the raw P/E to ridiculously high levels. When we form P/E ratios for the major indices, we assume that the prior peak level of earnings will be attained again in the future, and that it better measures potential earnings power. **The historical average price/peak-earnings ratio for the S&P 500 is 14. The historical median (half of observations below, half above) is 11. The average bear market low has occurred at a price/peak-earnings ratio below 9.**

At present, the price/peak earnings ratio for the S&P 500 is 18. This is a high level historically, but short of the multiple of 20 seen at the 1929, 1972 and 1987 bull market peaks, and significantly below the year 2000 speculative extreme of 30.

Peak earnings have the additional benefit in that they are very well behaved. Historically, whether one examines the past 10, 20, 50 or 100 years, S&P 500 earnings have not grown faster than about 6% annually when measured peak-to-peak across economic cycles. While earnings growth rates from peak-to-trough or trough-to-peak can be very unpredictable, the peak-to-peak earnings growth rate of 6% has been very consistent (closely tracking the long-term growth of nominal GDP).

It is simple arithmetic to estimate the probable long-term returns for the S&P 500. Specifically, suppose that earnings quickly recover to their year 2000 peak, and then continue to grow at their historical peak-to-peak rate of 6% annually. Suppose also that the S&P 500 P/E ratio moves from 18 to its historical average of 14 a decade from today. Under these assumptions, the S&P 500 would deliver an annual capital gain of $(1.06)[14/18]^{1/10} - 1 = 3.4\%$ annually. Adding in an average dividend yield of 2.1% would bring the total return over the coming decade to 5.5% annually, even if the P/E ratio never visits below-average levels again.

Statistically, the best-fitting long-term return projection is obtained using the median P/E of 11 rather than the average of 14. This is unfortunate, because in this case, even if the S&P 500 P/E merely touches its historical median of 11 a decade from now, the S&P 500 would deliver an annual capital gain of about 0.9% over that period, and a total return including dividends of only 3% annually.

These are not extreme views, but rather the outcome of simple arithmetic applied to bland, pedestrian assumptions based on a century of market history.

We cannot emphasize enough that the risk of a defensive position here is not the risk of missed long-term returns, but the potential of not participating in periodic short-term advances. This is known as "tracking risk." Given that 90% of bull market periods (identified in hindsight) have exhibited either favorable valuations, favorable trend uniformity or both, we are quite willing to accept tracking risk when the market exhibits neither. Indeed, it is impossible to defend capital against substantial market declines without periodically accepting positions that may not closely track the market.

One might think that peak earnings per share might grow faster than 6% over time, on the argument that companies frequently use earnings to make share buybacks instead of paying dividends, and that productivity growth has slightly accelerated in the past decade. Alas, the bulk of share buybacks do nothing but offset the dilution from option and share grants to corporate insiders. Meanwhile, the low dividend yield (high price/dividend ratio) is not a symptom of strong earnings retention, but of high valuation, which is mirrored in other ratios such as price/book, price/revenue, price/cash flow, price/replacement value (Tobin's Q), and price/GDP.

As for productivity growth, the difference between depressing and amazing long-term productivity growth is only about 0.5% annually. Moreover, except in industries with high barriers to new entrants, competition ensures that over the long-term, productivity growth shows up as "consumer surplus" and improvements in real wages - not as "producer surplus" (profits). Historically, the impact of productivity shifts on long-term profit growth has been minuscule. So 6% peak-to-peak earnings growth it is. Again, this closely tracks the long-term growth of nominal GDP.

If anything, 6% peak-to-peak earnings growth may turn out to be too high. A basic fact of economics is that when something is produced with several factors, such as capital and labor, the "rents" accrue to the scarce factor. Normally, economic downturns feature a very high unemployment rate, so that at the bottom of a recession, labor is plentiful and capital is scarce (relatively speaking). As a result, the economic recovery that follows generates a very strong rebound in corporate profits. The rents accrue to the scarce factor - in this case, capital.

The current economic downturn is different. It emerged as the aftermath of a capital spending bubble that created enormous overcapacity. Yet while the use of this capacity remains near the lows of the recession, labor remains relatively scarce, with an unemployment rate significantly below that of prior recessions. **As a result, a rebound in the U.S. economy, when it arrives, will decidedly favor wage growth over profit growth.** The combination of overcapacity and cheap imports will also restrain pricing power, further reducing the potential for a rapid earnings recovery.

In addition to unfavorable valuations, the stock market currently exhibits unfavorable market action on the measures that are relevant to us. This places us in a defensive position: we are fully invested in favored stocks, but we have largely removed the impact of market fluctuations from our portfolio through hedging. This is not a bet or forecast that the market will decline. Rather, our position indicates that we do not yet have the evidence that would warrant a significant exposure to market fluctuations.

Our measures of trend uniformity can change even from one week to the next (see our weekly comments on www.hussman.net for the current status), so we never rule out the possibility that speculative conditions will improve. Historically, trend uniformity shifts an average of twice a year. But given current valuations, we have little concern about missing out on durable long-term returns when the Market Climate forces us to take a defensive stance.

Investors are in a panic to identify every emerging rally as a new bull market, afraid of missing a durable, long-term rebound that might make them whole again. These investors simply do not understand the concept of peak-to-trough. Historically, when stocks begin a period at a high level of valuation, one can always find a point substantially later in time when the market touches a trough valuation. Between those two points (historically spanning between 4 and 17 years), the total return on stocks has always been well below average - typically less than the Treasury bill yield - regardless of the rate of intervening earnings growth.

Still, many analysts are willing to characterize the stock market as "undervalued" on the basis of low interest rates and inflation rates. The most popular argument is based on the "Fed Model", which compares the earnings yield on the S&P (S&P 500 projected earnings / S&P 500 Index) to the 10-year Treasury bond yield. Given the very low level of bond yields, this model characterizes the stock market as slightly "undervalued."

As we've noted before, overvaluation or undervaluation on the basis of the Fed Model has literally zero correlation with subsequent market returns. While it is true that very extreme readings on the Fed Model have generally worked out well, these extreme readings are all captured by a much simpler model: buy when stock yields are unusually high and interest rates are plunging, and sell when stock yields are unusually low and interest rates are soaring. But nothing in the data suggests that low stock yields are well rewarded, even in low interest rate environments.

Happily, all is not lost. Although the Fed Model is useless as a stock market indicator, we've discovered that it's actually not a bad bond market indicator. Specifically, the typical way that the Fed Model generates a buy signal is for 10-year Treasury yields to decline to unusually low levels. This is nicely correlated with a subsequent plunge in bond prices. In other words, when the Fed model suggests that stock yields are "too high" in relation to bond yields, stocks don't adjust, bonds do.

Our second answer to the Fed Model (which analysts have tracked only since the late 1970's) is that interest and inflation rates were regularly lower in data prior to 1965, yet examining pre-1965 data, only the 1929 market peak exhibited valuations similar to the present.

Third, the use of the word "undervalued" with the Fed Model involves a subtle sleight-of-hand. To say that stocks are "undervalued" on the basis of low interest rates is not a statement that stocks are priced to deliver an attractive long-term return, but is instead a statement that a low long-term return on stocks is OK. We strongly doubt that investors hearing that "stocks are undervalued on the basis of the Fed Model" grasp this distinction. Normally, one equates the term "undervalued" with "likely to deliver satisfactory returns, at least in the long-term." Undervaluation on the basis of the Fed Model has no such implication.

ECONOMIC PERSPECTIVES

The consensus forecast among U.S. economists calls for an economic rebound in 2003, buoyed by a stimulative combination of monetary and fiscal policy. Of course, on a historical basis, the reliability of such forecasts ranks below the accuracy of a fortune cookie, coming in on the list just under the Magic 8-Ball and Electronic Talking Yoda.

The greatest obstacle to a strong economic rebound is something called the "savings-investment identity." Specifically, every dollar of new investment (capital goods, computers, manufacturing plants, equipment, housing, etc) must be financed by a dollar of new saving. This is not a theory, but an accounting identity. Since GDP (Y) is equal to consumption (C) plus investment (I) plus government spending (G) plus exports (X) minus imports (M), we can

introduce taxes (T) and rearrange to obtain the savings investment identity:

$$(Y - C - T) + (T - G) + (M - X) = I$$

The three terms on the left are private savings (after-tax income minus consumption), government saving (the excess of taxes over government spending - usually negative), and foreign saving (the amount of foreign capital which must flow into the U.S. in order to finance any current account deficit).

At present, private savings are depressed due to a consumption binge, government saving is negative and becoming more so, and the U.S. is already running the largest current account deficit on record, making it very difficult to finance large jumps in domestic investment from any of these sources.

In general, rapid growth in the U.S. economy is driven by rapid growth in consumption and investment (specifically, autos, housing, and capital spending). With consumption near the highest ratio to GDP on record, and personal bankruptcies accelerating, it is unlikely that the economy can enjoy much of a sustained boost from further consumption growth. Meanwhile every past economic expansion has started with a surplus in the U.S. current account, indicating that the U.S. had a great deal of room to increase its import of savings from foreign countries. Unfortunately, that is not the case today, suggesting that the U.S. economy is not likely to enjoy an investment boom either.

The best case for growth in capital spending would be a substantial increase in private saving due to a sharp dropoff in consumption growth, but this would largely be a reallocation of output from consumption to investment, rather than an engine of growth.

Substantial growth in the economy here requires both an increase in available savings and an increased willingness of businesses and individuals to invest in new plant, equipment, homes and buildings. On the savings side, the U.S. is constrained by both fiscal and current account deficits. On the investment side, the U.S. is still working off the effects of its prior bubble in capital spending, which has created a large amount of unused capacity. Very simply, economic downturns that follow a capital spending binge are much slower to resolve than downturns that follow a more balanced growth path. Unfortunately, capacity utilization remains near the lowest levels seen in this downturn, which implies that there are very few catalysts for a powerful increase in demand for new capital.

What about fiscal and monetary policy? Can't government stimulate the economy? Depends on the policy. **The iron law of government intervention is this: a policy that relaxes some constraint on the economy is only useful if that constraint is actually binding.** This is why Federal Reserve rate cuts have been so powerless. It is not useful to make bank loans easier to obtain if in fact corporations are not willing to borrow. Likewise, government policies seeking to increase the amount of money available to consumers are doomed to failure. Consumers *already* have an excessive ability to finance new consumption through credit cards and cash-out mortgage refinancing. With consumption already representing the highest fraction of GDP on record, it is lunacy to encourage a further expansion.

This from the recently released FDIC Quarterly Banking Profile: *“Charge-offs of credit card loans totaled \$3.9 billion in the third quarter, an increase of \$1.0 billion (35.5 percent) compared to a year ago, and \$128 million (3.4 percent) more than banks charged-off in the second quarter. The annualized net charge-off rate on credit card loans in the quarter was 6.04 percent, slightly below the 6.08 percent rate in the second quarter, but above the 5.20 percent rate of a year earlier. This is the fourth consecutive quarter that the loss rate on banks’ credit card loans has been above 6 percent, a level never previously reached in any quarter during the 19 years that banks have reported credit card charge-offs. Despite the high level of charge-offs, the amount of credit-card loans that were noncurrent increased by \$685 million (13.6 percent) during the quarter... The increase in noncurrent loans caused the industry’s “coverage ratio” to decline from \$1.28 in reserves for every \$1.00 of noncurrent loans, to \$1.24, the eleventh consecutive quarter that this ratio has declined.”*

Most of the government intervention in this economic downturn has focused not on stimulating the economy, but on redistributing income. When the Fed cuts rates, analysts often act as if money has been put into the pockets of consumers. No it hasn't. It has been *redistributed* from savers, who now earn lower interest rates, to borrowers, who now pay those lower interest rates to the savers. Economic value is not created by this transfer of income.

Similarly, when the government hands out tax rebates, it runs a larger deficit, and thus must issue new bonds to finance it. In equilibrium (which considers the economy as a whole), the dollars that go out in the form of tax rebates are used to buy the new bonds that the government must issue. The only result is a *redistribution* of purchasing power. The people who receive the rebates increase their purchase of consumption goods, while the people who use their savings to buy the newly issued government bonds reduce the amount of private investment they would otherwise make.

Why do people believe that government spending “stimulates” the economy? Blame Keynes. In the Keynesian world, investment is simply a type of spending that has no function different from consumption or government spending. Savings do not result in new investment, because

investment is *assumed* to be constant. As a result, any attempt to save leads to economic weakness. The only hope is for government to consume.

Having spent considerable time in the ivory towers of academia, it was always a disappointing spectacle to watch highly trained economists, well versed in general equilibrium, growth theory, and rational expectations, quickly reduced to pod-people spouting elementary Keynesian idiocy whenever they were asked about the actual economy. One might as well have asked a freshman in Econ 101.

Again, the only effective government policy is one that relaxes constraints that are actually binding. At this point, the most binding constraints on the economy are on savings and investment. Investment can be encouraged through policies such as research & development credits (to create new innovations which might promote a long-term stream of new investments), investment tax credits, and accelerated depreciation. Savings can be encouraged through policies such as elimination of the double-taxation of dividends, capital gains relief, and flatter marginal tax rates. Note that these have more to do with changing incentives than redistributing income between borrowers and lenders, or savers and consumers. If the government is serious about encouraging economic growth, it has to focus on policies to ease constraints that are actually binding.

Probably the two most important signs that would confirm an emerging economic rebound would be 1) a sharp increase in capacity utilization, and 2) a sharp increase in the Help Wanted Advertising Index. With one notable exception, these indicators have always surged sharply near the start of an economic rebound. Persistent weakness in these two indicators was virtually the only warning sign that the short-lived 1980 recovery would slip into a fresh recession within 12 months. Unfortunately, both of these indices remain depressed. Indeed, the Help Wanted index has just plunged to a new low of 40, which is the weakest level since the 1960's. Until the demand for capital and labor improve substantially, economic growth is likely to be disappointing, and with it, the prospects for durable growth in corporate profits.

- John P. Hussman, Ph.D.

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