HUSSMAN

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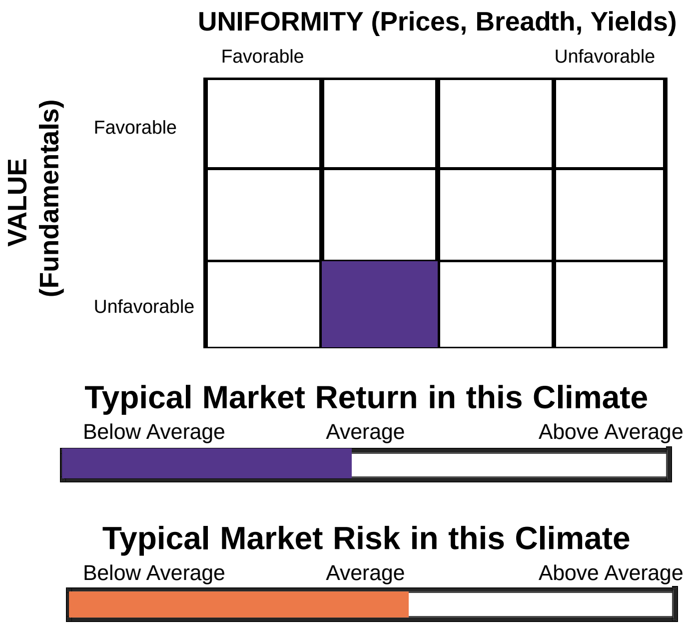
MARKET CLIMATE

The current profile of valuation and trend uniformity



Our econometric models suggest a slowing in GDP growth from the recent 5.2% annual rate to a more restrained 2.7% annual rate. Unfortunately, as is generally the case in the late part of an economic expansion, we expect economic growth to slow and inflation to accelerate. While much has been made of productivity increases in recent years, productivity growth has been isolated to manufacturing in computers and information technology. There has been no measurable productivity "spillover" into areas which should reasonably benefit from technological improvements, such as the service sector or the non-tech manufacturing sector. Indeed, productivity growth in these sectors has slowed in the past 5 years. Moreover, neither GDP nor productivity have accelerated outside of the long-term growth channels (2.8% and 1.6%, respectively) which have bounded their paths for a half-century. In short, we've seen a continuous move from trough to peak, and investors appear all too willing to label it a New Economy. Even if GDP growth slows to 2.7%, it would be reasonable to expect technology earnings to plunge by about 20%. Tech earnings are profoundly cyclical, which is yet another fact that investors have forgotten. The next few quarters will be a refresher course.

THE TICKER

"Arrogance, greed and optimism plus fear of being left out blinded people to the risks. After all, the dot-commers embraced risk. They prided themselves on their willingness to gamble and used it to justify their lucrative stock-option plans. Unfortunately, at the extreme far end of the risk curve, people lose perspective. The difference between a risky but worthwhile business and an idea with no future becomes imperceptible."

- *What were we THINKING?*
Thomas E. Weber, The Wall Street Journal

Last month, Merrill Lynch analyst Henry Blodgett downgraded his recommendations on 11 of the 29 web stocks that he follows. This only after the stocks had plunged -80% from their 52-week highs. Investors seem to have the quaint notion that somehow this devastation is behind us. **Our view is that the massive bubble in tech stocks is only beginning to burst.** The recent dot-com plunge merely skimmed away the foam. As we discuss inside, technology earnings have benefited from a simultaneous increase in revenue growth, profit margins and tax writeoffs arising from a strong economy. Any slowdown in the economy will hit earnings growth in a very magnified way, and at current prices, the tech stocks just aren't prepared for that.

With the major indices down or unchanged for the year, both bulls and bears are showing impatience and capitulation. But capitulation for bulls is different than capitulation for bears. For bears, capitulation means increasing stock positions. But the bears have sense enough to know that the popular stocks which drive the major indices are also the most severely overvalued. So the bears are not focusing on those stocks, but instead on stocks offering value and yield. As a result, we've seen strength in utility stocks, high yielding real-estate investment trusts, and a pickup in market breadth, particularly on the NYSE. **Further capitulation by the bears will probably result in further strength in market internals, centered on those stocks offering value and yield.**

Meanwhile, the bulls are beginning to capitulate. But the bulls are predominantly invested in New Economy stocks. On the slightest whiff of revenue or earnings trouble, many of these stocks are being battered 30-40% in a single trading session. There is hope (largely unfounded in our view) that these disappointments are isolated events. But it is clear that the bulls are becoming increasingly skittish about any slowdown in the growth of high-P/E glamour stocks. Accordingly, market breadth on the Nasdaq (as measured by the advance-decline line) continues to hit new lows.

Further capitulation by the bulls will probably result in pronounced weakness in the major averages, centered on the high-tech high-P/E stocks.

In short, patience is wearing thin for both the bulls and the bears, but their capitulation takes on different forms. It would be no surprise to see a split market in the months ahead - resilience in stocks offering value and yield, coupled with further attrition in growth and momentum stocks.

The market picture is equally split. Valuations are terrible, but trend uniformity is at least modestly constructive. **On the valuation side, the S&P 500 Index currently trades at 29 times record earnings. At current valuations, even optimistic assumptions lead to the conclusion that a long-term buy-and-hold approach will underperform Treasury bills during the next decade and perhaps beyond (using today as a starting point).** Of course, stocks may offer excellent returns beginning from some future trough, but from current levels, investors are unlikely to enjoy much reward for the risk they are accepting.

That's a long-term statement. Unfortunately, long-term thinking means little to investors here. At a recent convention of the American Association of Individual Investors (AAII), the most popular question asked by investors was "What can I do on Monday to make money in the stock market next week?"

Bullish sentiment remains high. Although corporate insiders and specialists (i.e. the smart money) are both selling at significantly accelerated rates of late, the average investor is quite optimistic. **The most recent AAII survey indicates that only 11.5% of members are bearish. So investors have evidently decided to eat, drink and be merry atop a keg of explosives. The question isn't whether the keg will explode, but merely how much length remains on the flaming wick.**

With regard to trend conditions, short term price and yield trends are displaying modestly favorable uniformity. While it is unlikely that we will see a significant move higher, we would define stocks as being in an extended top formation. If market breadth remains firm, that top formation may extend for several more months. Fresh weakness in the broad market, or a decline of more than about 6% in the S&P 500 Index, would move trend conditions back to an unfavorable status. For now, the picture is constructive.

In addition, trends in bonds and utilities are favorable. With the S&P 500 currently offering a dividend yield of just 1.1%, declining yield trends may not be as positive for stocks as might otherwise be the case, but while other trends are favorable, the current environment does not advise strongly bearish positions.

The bottom line: as long as trend uniformity remains modestly constructive, we have to view the market as being in an extended top formation. Historically, market crashes have emerged only after trend conditions have deteriorated measurably, and that will require renewed weakness in market internals. The prospective return from a bullish position is unlikely to justify the risk, so hedging is appropriate. We are comfortable holding attractive individual stocks while hedging against market fluctuations. But aggressive long or short positions are not likely to be well-compensated here.

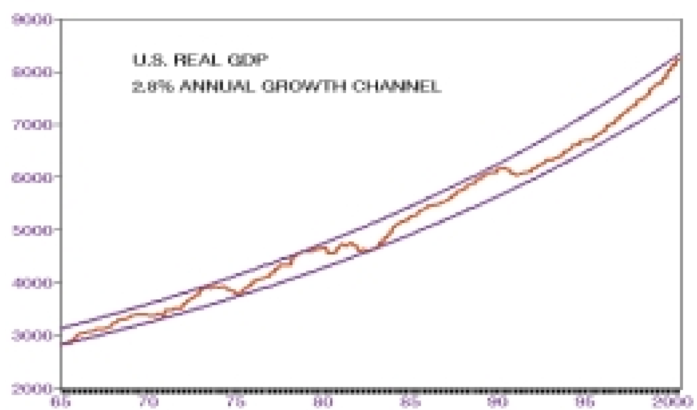
THE DATABANK

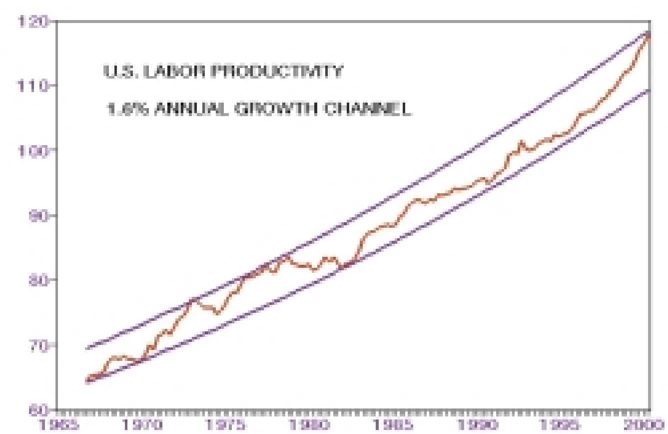
"Already, there are troubling signs on the default front; Standard & Poor's reports that 60 rated or formerly rated companies defaulted on a total of $19.8 billion of debt in the first half of 2000. If the trend continues through yearend, S&P notes, the annual default rate would hit 2.4%, a rate exceeded only by those recessionary years 1990 and 1991. 'Default rates should only get worse this year' predicts Merrill Lynch analyst Martin Fridson. The question, of course, is what happens if the economy slows sharply in the months ahead. If default rates are rising in an environment of 5%-plus growth, tame inflation and healthy corporate profits, what happens if the economy experiences a hard landing in the months ahead? Actually, all it would take for defaults to surge is a sustained slowdown in growth. Many analysts think a growth downshift to the 1.5%-2% range would be enough of a shock to slam credit quality throughout Corporate America."

- *William Pesek Jr., Barron's, July 24, 2000*

The Main Event in the Databank recently has been the surge in GDP growth to 5.2% for the second quarter of this year. While we are anticipating a slowdown to the 2.7% range, it is a slowdown which is unlikely to please anybody. A slowdown in GDP growth is likely to worsen credit conditions and devastate earnings growth in the tech sector.

While economic growth has indeed been rapid in recent years, the more notable feature is that it has been *smooth*. Evidently, investors have confused consistency with speed. Until GDP and productivity break out of well-established growth channels, a “New Economy” will be difficult to spot.

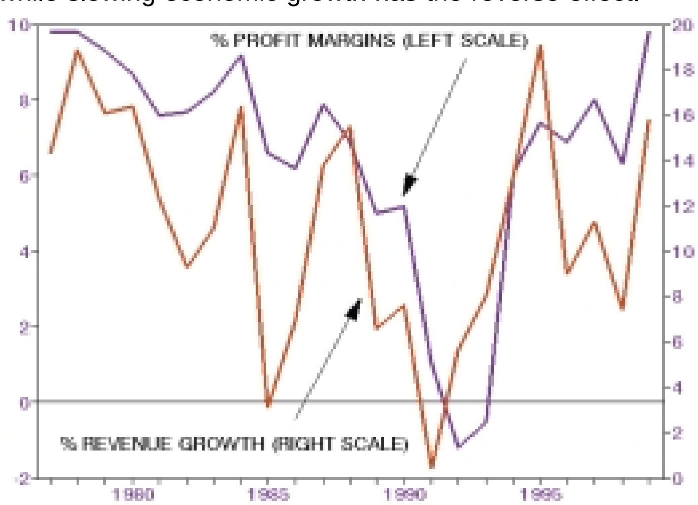




One of the hard lessons that investors will learn in the coming quarters is that technology stocks are actually *cyclicals*. Modest changes in economic growth and overall corporate profitability have highly leveraged impact on the revenue growth and profitability of technology companies. Though economic growth is likely to slow only modestly, we are anticipating a plunge of 20% or more in the earnings of S&P technology stocks in the coming quarters.

There are two reasons why technology earnings are cyclical. First, technology companies derive the bulk of their revenues from capital spending outlays of non-tech companies. And capital spending is typically done when earnings are robust. So when the overall economy is strong, capital spending and tech revenues grow at an even faster rate. But when economic growth slows, tech revenues slow even more strongly.

Second, the bulk of costs in any corporation are largely fixed in the short run. Employment compensation, administrative costs, overhead and debt service all vary significantly less than revenues do. So a 1% increase in revenues produces much more than a 1% increase in profits, and vice versa. In short, relatively small changes in economic growth induce very large movements in revenues and profit margins, both in the same direction. Since earnings are simply the product of revenue and profit margin, strong economic growth has a profoundly favorable impact on tech earnings, while slowing economic growth has the reverse effect.



The graph above illustrates historical revenue growth for S&P 500 technology stocks, along with profit margins for these stocks. **Notice that tech revenue growth has been highly variable over time, and slows considerably during recessions, as we observed in 1991-92. Notice also that profit margins fluctuate widely, *and in the same direction as revenue growth*.** Together, this leads to extremely wide swings in technology earnings growth (note that profit margins, and by extension earnings, were actually negative for tech stocks during the 1991-92 recession). While the consistently strong economic growth of recent years has allowed investors to forget, ignore or otherwise overlook these facts, the truth is about to hit home.

As we have noted for months, our models have indicated that economic growth was probably peaking during the second quarter of 2000. Though we are mindful of indicators such as yield curve inversion and widening credit spreads, we do not currently anticipate a recession. Rather, we anticipate a slowing in economic growth to a 2.7% annualized rate in the quarters ahead. That may not seem like a harsh slowing, but it is likely to devastate technology earnings. Among S&P 500 technology companies, we are anticipating an earnings plunge of 20% over the coming year. This result is implied by two expectations: a slowdown of technology revenue growth to 7%, combined with a contraction in profit margins from the current 10% level to a still robust 7.5% margin (the historical average over the past quarter-century has been 6.6%).

With S&P technology stocks trading at average price/earnings ratios near 65 (compared to a historical norm of 17 during the past quarter-century), it is also clear that tech stocks are priced for a perfection which is unlikely to be sustained. Moreover, because of distortions caused by stock option plans, that P/E of 65 understates the overvaluation in tech stocks. As a recent Bear Stearns report notes, the cost of stock options granted to employees isn't reflected on the income statement (even though it represents compensation to employees), but it *is* recorded as an expense on corporate tax returns, generating a tax benefit which boosts reported cash flow. Last year, for example, that tax benefit accounted for 9% of the operating cash flow of Sun Microsystems, 17% for JDS Uniphase, 19% for Cisco, 26% for Dell Computer, and fully 79% for Qualcomm.

Options granted to employees either dilute the earnings available to existing shareholders, or require the company to offset them by buying back stock at market prices with real money. A study by UBS Warburg indicated that option gains accounted for 14.6% of wages and salaries paid by companies in the S&P 500 last year. One has to assume that absent those options gains, employees would demand commensurately higher salary payments, which would reduce net income. Six technology companies accounted for about 30% of option gains to employees last year: Microsoft, Cisco, Yahoo, America Online, Sun, and Broadcom. The net cost to buy back enough stock to offset options granted to employees is more than *15 times* what these companies earned collectively last year. So for the largest technology companies, future earnings will either be diluted, or diverted to offset stock options granted for work that was done in the past. Accounting rules do not require these costs to be reported, but they can't be ignored when you evaluate the investment: option grants lower the cash flows that will be received by existing shareholders.

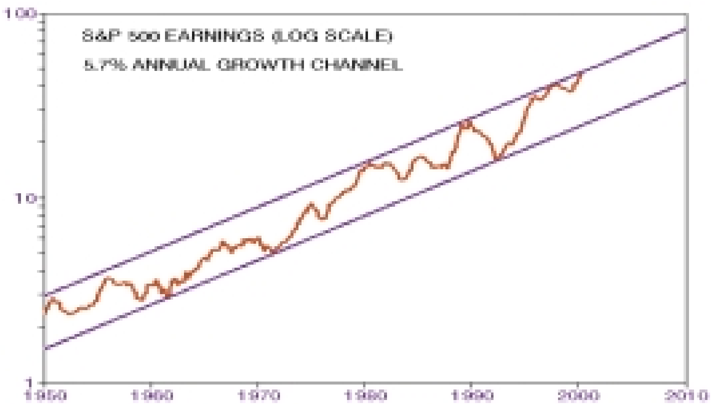
Investors evidently believe that corporate earnings are being "well spent" through share repurchases instead of dividends. But these share repurchases do not benefit shareholders - they are simply employee compensation that doesn't show up on the income statement. A stock buyback is only attractive if the stock is undervalued and the repurchased shares are retired (increasing the per-share earnings on the remaining float). That's not what's happening.

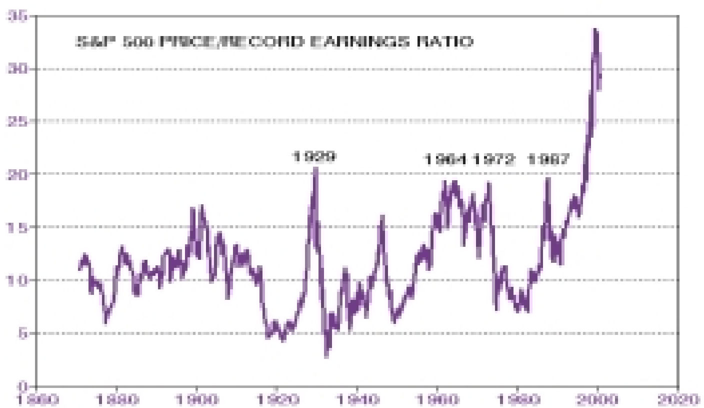
So again, we would not be surprised to see resilience in stocks offering value and yield, coupled with weakness in growth and momentum stocks trading at high P/E multiples. In recent years, value stocks have lagged the market terribly, while growth stocks have soared. In the coming quarters, we expect that performance gap to close significantly.

MARKET VALUATION

S&P 500 Index:	1500.00
Current S&P 500 dividends:	16.11
Current S&P 500 earnings:	50.94
Record earnings to-date:	50.94
Price/record earnings:	29.45
S&P 500 10-year total return projections (annualized):	
At future P/E of 20 (same as ‘29, ‘87 peaks)	-0.34%
At future P/E of 14 (average 1950-present)	-3.79%
At future P/E of 11 (historical median)	-6.05%
At future P/E of 7 (‘74, ‘82 troughs)	-10.15%

Long term S&P 500 return projections assume earnings grow to the midpoint of their long-term channel a decade from now. This level would represent a record high. Historically, actual returns most closely track the forecast associated with a future P/E of 11.





CURRENT TRENDS

The trend condition of the market is currently modestly favorable overall. Favorably rising trends include the S&P 500 index, long term Treasury bonds, and utility stocks. As for divergences, we have concerns about short-term Treasury yields, corporate bonds, oil prices, and retail stocks. One important and widely overlooked risk factor: U.S. real long term interest rates are declining. With the U.S. dollar well above “parity” on the basis of purchasing power and the U.S. trade deficit at record levels, there is risk of a sharp selloff in the U.S. dollar that could adversely affect bonds. Despite these concerns, the overall trend picture will be essentially constructive until more pockets of weakness emerge. At these levels, this could occur suddenly. A constructive, but moderately hedged stance is appropriate here.