HUSSMAN

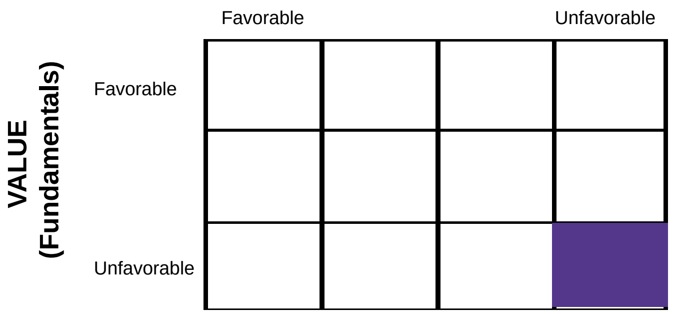
INVESTMENT RESEARCH & INSIGHT

VOLUME 1 NUMBER 3 NOVEMBER 15, 2000

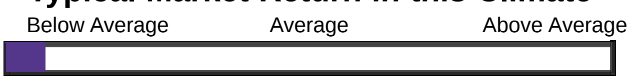
MARKET CLIMATE

The current profile of valuation and trend uniformity

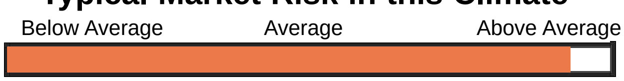
UNIFORMITY (Prices, Breadth, Yields)



Typical Market Return in this Climate



Typical Market Risk in this Climate



“Blue skies, smilin' at me
Nothin' but blue skies do I see
Bluebirds singin' a song
Nothin' but bluebirds, all day long.”
- Blue Skies, Irving Berlin, 1929

"The economic condition of the world seems on the verge of a great forward movement."
- Bernard Baruch, June 1929

"The markets generally are now in a healthy condition. Values have a sound basis in the general prosperity of our country."
- Charles E. Mitchell, Director,
Federal Reserve Bank of New York, October 15, 1929

"I believe the breaks of the last few days have driven stocks down to a hard rock."
- Yale Professor Irving Fisher
October 22, 1929, a week prior to the 1929 Crash

"The fundamental business of the country is on a sound and prosperous basis."
- President Herbert Hoover, October 25, 1929

THE TICKER

A user-friendly overview of the Market Climate

"… Almost everyone believed that speculation could be now resumed in earnest. A common feature of all these earlier troubles was that having happened they were over. The worst was reasonably recognized as such. The singular feature of the great crash of 1929 was that the worst continued to worsen. What looked one day like the end proved on the next day to have been only the beginning. Nothing could have been more ingeniously designed to maximize the suffering, and also to ensure that as few as possible escaped the common misfortune. The man with the smart money, who was safely out of the market when the first crash came, naturally went back in to pick up bargains. The bargains then suffered a ruinous fall."
- J.K. Galbraith, The Great Crash

The U.S. economy and financial markets rest on a house of cards. The stock market, the New Economy, the "productivity miracle", the Federal budget surplus, and the strong U.S. dollar are not pillars of this house, but shingles. And there is evidence that the house is beginning to rock.

The faith in a New Era is exemplified by a recent advertisement from Robertson Stephens, which asks "Do you really believe that technology can make hundreds of years of economic rules obsolete? So do we." Well, count us out. One of the most devastatingly accurate of these economic rules is this: anytime the term "New Era" becomes widely accepted, get the hell out of the stock market.

We have noted for months that capital spending and profit margins are likely to weaken considerably over the coming year. That expectation has now become a persistent trend, as former glamour companies increasingly issue disappointing earnings and lower their guidance for the coming quarters. This slowdown in capital spending and profit margins is very real, and likely to worsen profoundly over the next several quarters. This leads us to the rather unpopular projection that the earnings of S&P 500 technology companies will plunge by 20% in the year ahead.

The argument is fairly straightforward. Technology earnings are driven by capital spending. Swings in capital spending are an exaggerated version of swings in economy-wide profits. When corporate profit growth is strong, capital spending growth accelerates by a multiple of that. When corporate profit growth weakens, capital spending weakens at an even sharper rate. This is supported by decades of historical experience, including past "New Eras" that featured inventions such as the automobile, the radio, the television, and the computer. Moreover, profit margins are an image of capital spending. When spending growth is strong, profit margins move in the same direction, so earnings growth is stellar. When spending growth weakens, profit margins also retreat, so earnings typically plunge. **An examination of history shows clearly that technology earnings are not immune to recessions. To the contrary, they strongly exaggerate economic fluctuations.**

The projected 20% decline in S&P 500 technology earnings assumes 7-8% top-line revenue growth for these companies over the coming year, combined with a retrenchment of profit margins from the current 10% (a near record-high) to a still above-average 7.5% margin. These revenue and profit margin figures would be consistent with 2.7% GDP growth, which is optimistic. If the U.S. economy enters a recession, a 20% profit decline in the S&P 500 tech companies may turn out to have been optimistic.

As we review inside, the most reliable leading indicators suggest that the economy will slow sharply ahead, with a significant chance of a recession. At the same time, we continue to hear analysts projecting earnings growth of 20-50% in a wide range of stocks, and pricing stocks for that expectation. Earnings growth needs only to slow for these valuations to retreat. If indeed earnings growth is negative, as we expect, the Nasdaq could quite reasonably lose half of its value from present levels.

Given the damage already wrought on the Nasdaq, there is a natural inclination to buy the dip. We believe that there is little merit in doing so. The current market climate is characterized by extremely unfavorable valuations, unfavorable trend uniformity, and hostile yield trends. This combination is what we define as a Crash Warning, and this climate has historically occurred in less than 4% of market history. That 4% of market history includes the 1929 crash and the 1987 crash, as well as a number of less memorable crashes and panics.

We prefer to hedge until there is a rational prospect for market gains. When valuations are favorable, stocks are attractive from the standpoint of "investment" - meaning that stock prices are attractive compared to the conservatively discounted value of cash flows which will be thrown off in the future. When trend uniformity is favorable, stocks are attractive from the standpoint of "speculation" - meaning that regardless of valuation, investors are displaying an increased tolerance for risk which favors a further advance in prices. When both valuations and trend uniformity are favorable, stocks typically soar, often earning returns in the 25-40% annualized range. Yet even overvalued markets have historically delivered above-average rates of return so long as trend uniformity has been favorable.

Stocks are currently unattractive not only from an investment standpoint, but also from a speculative standpoint. In this environment, "buying the dip" is an invitation to disaster. Dips are attractive buying opportunities when trend uniformity is favorable. The strategy has worked well in recent years for exactly that reason. But it is crucial to recognize that rules that work in one market environment do not necessarily work in another. As Galbraith wrote about 1929, "The man with the smart money, who was safely out of the market when the first crash came, naturally went back in to pick up bargains. The bargains then suffered a ruinous fall."

Our Market Climate tends to shift about twice a year, on average. At some point in the months ahead, we expect a shift in our market posture. Preferably, this will reflect a move to more favorable valuations as well as favorable trend uniformity. In any event, it will be objective market conditions, not a subjective urge to "buy the dip", that will justify a more constructive position. Unless and until that signal is in hand, a defensive posture remains warranted.

THE DATABANK

One of the most recent bearish signals has come from the lowly Treasury bill. In recent weeks, the yield on three-month Treasury bills has moved decisively above 6%. In post-war history, there are only 5 times when the T-bill yield moved above 6% after averaging less than that over the prior year. Those instances are:

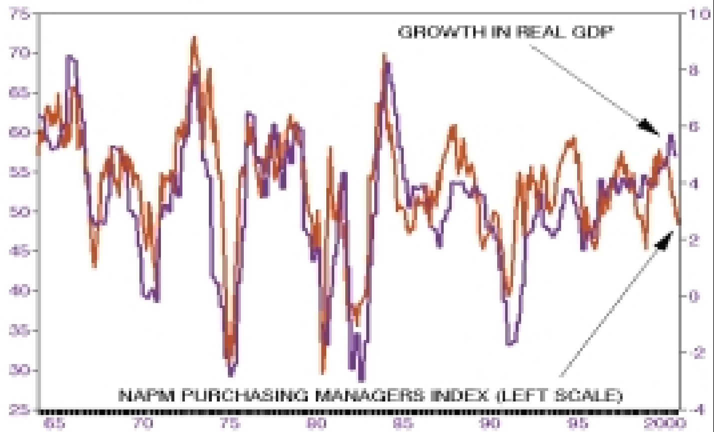
January 1969 (near the start of the 1969-70 bear market)
April 1973 (early into the 1973-74 bear market)
November 1977 (followed by a year of flat returns, despite a 5% dividend yield and a market P/E of just 9)
September 1987 (no elaboration required)
October 2000.

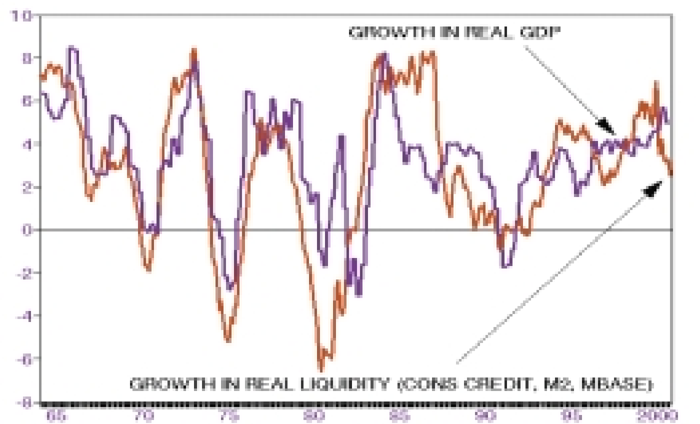
Historically, risk-free yields of 6% have posed significant problems for stocks. The reason, I believe, is that over time, earnings, revenues, cash flows, dividends, and GDP have all been well-contained in a 6% long-term growth channel. Year to year changes in inflation have had very little effect on this long term growth rate, since the Fed tends to move in a way that stabilizes long-term inflation expectations. So when interest rates rise above 6%, likely capital gains on stocks become insufficient to compete with fixed income securities, and investors begin to demand higher risk premiums. In other words, the yield on stocks begins to be pressed higher, and the only way to drive stock yields up quickly is to drive stock prices down. As we have noted on many occasions, the main force behind a market crash is an increase in the risk premium demanded on stocks.

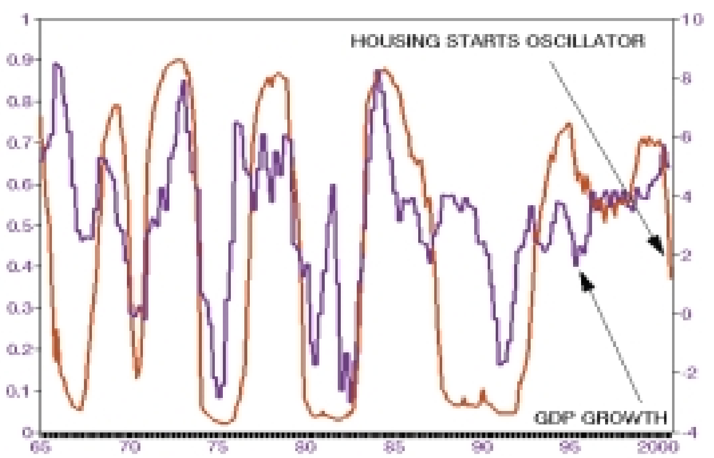
ECONOMIC PERSPECTIVES

The most reliable leading indicators have moved to a clear warning of U.S. recession. This signal includes our own composite of leading indicators (credit spreads, maturity spreads, S&P 500, and NAPM Purchasing Managers Index), as well as reliable confirming indicators such as housing starts and real liquidity growth. Our investment position does not require a recession to be effective, and we do hope that these warnings are incorrect. In a stock market priced for rapid earnings growth and economic perfection, the downside risk will be extreme even if this economic slowing stops short of an actual contraction.

Our econometric models currently project annualized GDP growth of less than 1% over the coming year, slow enough to trigger continued credit problems in the corporate debt market, and a significant deceleration in corporate earnings growth. Given the fact that FDIC bank downgrades and corporate defaults are already running at the highest pace since the last recession, there is considerable risk that modest economic weakness could snowball into something deeper.

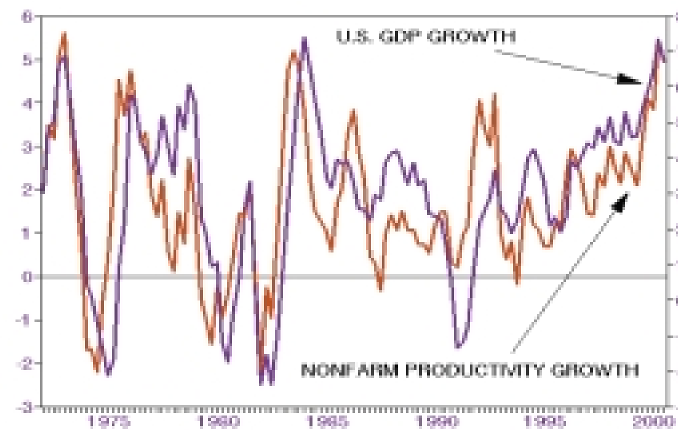






Why are we so reluctant to believe in a New Era in the face of the U.S. "productivity miracle"? The answer is simple - the growth in measured productivity since 1995 has been confined to the technology sector. One of the leading productivity economists in the country, Robert Gordon of Northwestern, recently noted the following: "The entire trend acceleration is attributed to faster multi-factor productivity (MFP) growth in the durable manufacturing sector, consisting of computers, peripherals, telecommunications, and other types of durables. There is no revival of productivity growth in the 88 percent of the private economy lying outside of durables; in fact when the contribution of massive investment in computers in the nondurable economy is subtracted, MFP growth outside of durables has actually decelerated." Stated simply, the "productivity miracle" has occurred only within the high-tech capital goods sector.

So what's wrong with that? Two words. "Elastic supply". Most of the growth that we've seen in recent years has been in industries that are highly automated and easily scaled higher. In those industries, productivity growth is little more than a measure of demand growth. For example, suppose that you have a machine that can punch out little wax statues of Mickey Mouse virtually on demand. If it's a rainy day in Disneyland, you probably won't be selling many of these, so your output per worker - your productivity - will be fairly low. On the other hand, if a busload of pre-schoolers parks in front of your stand, those little Mickeys will be flying out of the machine, and your productivity will be extremely high. When supply is very elastic, productivity growth is largely a measure of *demand* growth. And as soon as demand slows, that so called "productivity" goes away. A glance at history demonstrates that most of the movements in productivity are cyclical. **Even with the "miracle" of recent years, U.S. productivity remains within a well-defined 1.6% growth channel that extends half a century.**

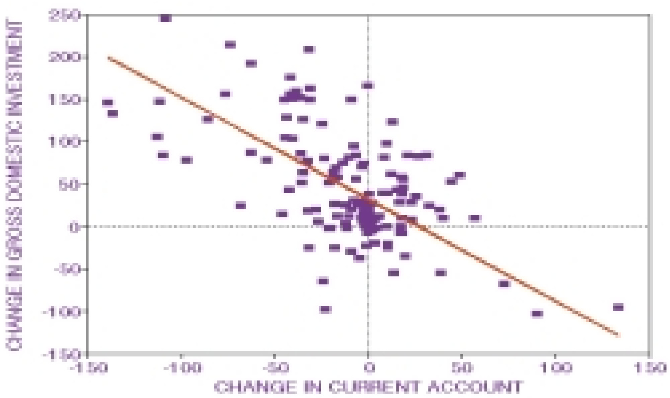


Sure, the internet is a tremendous invention, as are many of the other technology advances of recent years. But that doesn't imply fantastic and sustainable profitability for the companies which deliver this technology. There are real gains, but they show up largely as what economists call "consumer surplus" rather than as profits. We won't get into the analytical details, but in general, this happens when producers are competitive and supply is elastic. The most extreme example of this has clearly been the dot-com companies. In order to earn a profit in an environment with virtually no barriers to entry, these companies have resorted to frantic advertising in an effort to create brand identity. But what they've really created is brand confusion, burning up billions of dollars of capital in frivolous ad campaigns. In the end, the competition is still only a click away. The internet delivers a great deal of "consumer surplus", but it's extremely difficult to defend the competitive advantage needed for sustainable "producer surplus" or profit. For all of its much vaunted growth - largely from portfolio gains, tax deduction of option expenses, and acquisitions - even Cisco's operating results are uninspiring.

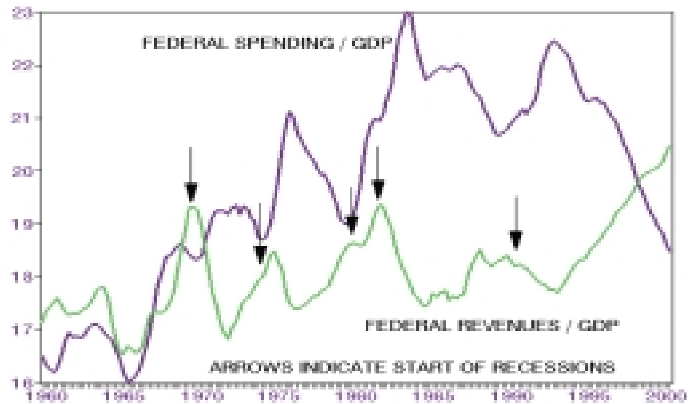
In addition to a deterioration in capital spending and profit margins, there is one other factor to watch carefully in the coming months: the U.S. trade deficit. This is going to sound strange, but absolutely the *last* thing the U.S. economy and stock markets need is a reduction in the trade deficit. And we're about to get one.

Gross domestic investment can be financed by three types of savings: private savings, government savings, or an import of foreign savings. As an accounting matter, the trade deficit is essentially equal to the amount of foreign savings being imported into the United States. Think of it this way. Everything we buy, we have to pay for. And if we import a bunch of foreign goods and don't pay for them by exporting U.S. goods, we have to export something else, and that something else is securities. We sell foreigners stocks, bonds, and claims on real U.S. assets. And in recent years, this kind of activity has gone wild. We've exported an enormous amount of securities to foreigners, and have imported a huge amount of foreign savings. Those foreign savings are the source of the capital spending boom we've enjoyed.

So what now? As we noted in the October issue, there is a strong likelihood that foreign investors will reduce the pace of investment in U.S. securities. This means that there is a strong likelihood that the U.S. trade deficit will shrink, and with it, the value of the U.S. dollar and the financing source for U.S. capital spending. Armchair economists often think that a smaller trade deficit implies faster GDP growth, but this ignores the feedback on U.S. capital spending. Historically a $1 reduction in the trade deficit translates to a $1 reduction in U.S. gross domestic investment. So as the trade deficit contracts, expect capital spending to contract.



Finally, government "savings" are likely to contract in an economic downturn as well, further pressuring capital spending. For the record, the government "surplus" does not really exist. The U.S. is running a "surplus" only because Social Security revenues that are not paid as current benefits are counted as revenue to the Treasury. But Congress likes to perpetuate the idea that Social Security actually has a Trust Fund, so the Treasury gives Social Security a bunch of bonds in return. This is why, even though the government is running a "surplus", the outstanding amount of U.S. government debt is higher this year than last year, and indeed, higher than at any time in history. What makes this actually funny is that when the bonds held by the Social Security Trust Fund earn interest, the Treasury takes that too (counted in the budget as "undistributed offsetting receipts").



That said, the financial position of the U.S. government is likely to worsen ahead. The dramatic improvement in government finances in recent years is owed to two factors. First, the 1990 budget deal, which sharply slowed the growth of government spending. Second, the recent economic expansion, which raised tax revenues as a share of GDP. With both houses of Congress arguing only about how much of the "surplus" to spend, and a historical tendency for the revenue share of GDP to fall during recessions, we expect the U.S. to be back to good ol' deficit financing fairly soon. And that means less money available to finance capital spending.

All of which is why we don't believe the "New Era" will last, and neither should you.

- John P. Hussman, Ph.D.

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