# HUSSMAN

## INVESTMENT RESEARCH & INSIGHT

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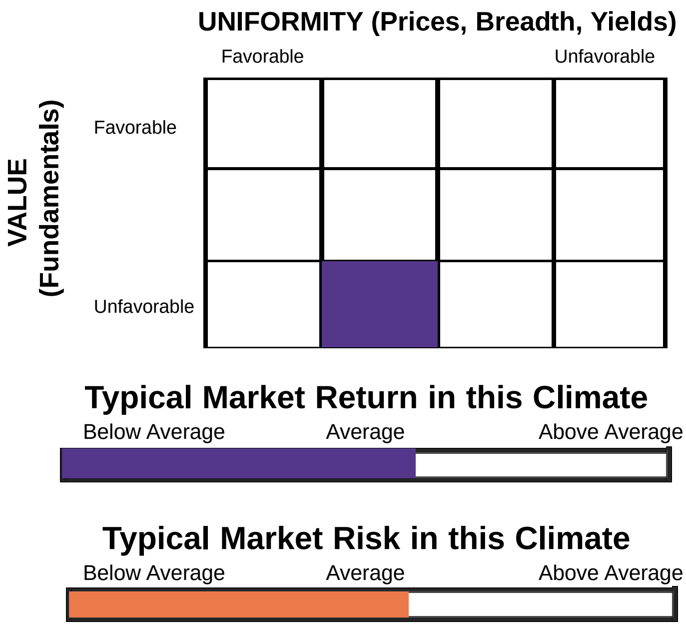
## MARKET CLIMATE

*The current profile of valuation and trend uniformity*




**On Friday, December 28th, the market recruited enough favorable trend uniformity to push us to a constructive position. Our main trend model had been negative since September 1st. The current Market Climate (extremely unfavorable valuations but favorable trend uniformity) has historically enjoyed a reasonably positive return/risk profile. We are modestly constructive, but not aggressive. Stocks are currently in a climate that typically occurs during late bull markets and during bear market rallies. We suspect the bear, but for practical purposes, that opinion is irrelevant. Our discipline is to hold a position consistent with whatever Climate is in effect. Our models are sensitive to any change in internal market action, but our position will shift only when objective evidence is in hand. No forecasts or opinions are required, but if you are interested, here they are. Despite the recent easing by the Federal Reserve, we continue to expect a 20% decline in the earnings of S&P 500 technology companies this year, and significant banking difficulties related to loan losses. We hope to enjoy a rally here, and would certainly welcome a sustained uptrend. Even so, we are skeptical about the omnipotence of the Fed, and about the prospect of avoiding an ultimately more violent bear market.**

**REMINDER:** You can access the online version, as well as our weekly market commentary, in the Research & Insight section of our Fund website www.hussman.net The site includes special reports, and information about the Hussman Strategic Growth Fund (HSGFX) including the Prospectus, application forms, and daily net asset values. You can hear our commentary by phone at 248-788-7096.

## THE TICKER

Enough of their cries of "Why have you forsaken us?" and "Lead us out of the wilderness!" On January 3rd, Alan Greenspan finally descended from the burning bush, holding in his hands two stone tablets. A Fed Funds cut inscribed on one, a Discount Rate cut on the other, together forming a single commandment: "Buy Cisco."

Investors haven't learned their lesson. Despite the brutalization of New Economy stocks over the past year, ignorance and greed obey no master. Following the Fed move, investors went straight for the glamour tech stocks, dumping utilities, pharmaceuticals, consumer staples, hospital stocks, insurance stocks - anything that smacked of safety or value. Investors are behaving like an ex-con, whose first impulse after getting out of the joint is to knock over the nearest liquor store.

In short, the immediate response of investors to interest rate cuts was to create a two-tiered market. And unfortunately, it's exactly that failing “trend uniformity” that places this advance in danger. Historically, sound market rallies are marked by uniform action across a wide range of sectors. At this point, there is still enough uniformity in trends to define a favorable Market Climate. **Unless this rally can broaden out to defensive as well as aggressive groups, the recent move to a favorable climate may prove short lived. While it lasts, we are hopeful for a follow-through.**

We are willing to take on a moderate positive exposure to the market here, but we strongly advise investors to steer clear of popular technology stocks, particularly those sporting high P/E and price/revenue ratios. We would also strongly avoid banks and other stocks whose earnings are sensitive to credit risk.

An increasingly popular notion is that the market is undervalued because the median P/E on the S&P 500 stocks is just 16, the lowest level in 5 years. That argument jolts the needle on the idiot-meter deep into “ignoramus”. True, half of the stocks in the S&P 500 have a P/E lower than 16, but these are unfortunately *not* the stocks that drive the index, which is weighted by capitalization. The big-cap stocks that dominate the index are so overvalued that the S&P 500 has an overall P/E of 25, on record earnings no less.

Despite a pullback last year, the current market P/E remains higher than at any prior bull market peak in history, including 1929 and 1987, both which hit 20 times earnings at their greatest extremes. There are certainly reasonably valued stocks in the S&P 500 (some of which we own), but they generally do not have large enough market values to significantly affect the index. The reasonable median P/E doesn't indicate that the overall market is undervalued, but rather that the market is split into two distinct tiers.

**With many of the leading internet stocks down 95% or more from their highs, technology investors seem to finally accept that the runup in dot-com stocks was an outrageous bubble. But none of this learning appears to have transferred to their view of glamour tech stocks such as Cisco, EMC, Oracle, and Sun Microsystems, not to mention glamour blue chips such as General Electric. Our impression is that by the time the real bear market is over, investors will recognize that these too have been in an outrageous bubble.**

There is no question that these are outstanding companies in their respective industries. But a good company does not necessarily translate into a good investment. **There is a crucial link between earnings and stock prices: the price/earnings ratio. And it is here where the rubber meets the road. What made these stocks such stellar performers in recent years was not earnings growth alone, but more importantly, the willingness of investors to suddenly attach extreme price/earnings ratios to them (Price = Earnings x P/E ratio).**

For example, Cisco Systems, which never sported a P/E much above 30 during its period of most rapid earnings growth (1990-1998) shot to a P/E of over 100 at its peak last year. EMC was rarely valued at more than 20 times earnings until 1998, when investors began driving the P/E to more than 140, even as earnings growth slowed from rates earlier in the decade. Indeed, much of the growth for these companies has been driven by acquisitions - *buying* the revenues and earnings of other companies using an overvalued stock as currency. Meanwhile, intrinsic growth is slowing in existing lines of business. Yet despite lower quality growth, investors have attached valuations to these companies that are grossly out of line with those warranted by a sober analysis of discounted cash flows. Even General Electric has moved from an average P/E of less than 15 in the years prior to 1998 to a P/E of 50 at its recent high.

Keep in mind also, that the past decade has been a *bull market* period. Valuations typically fall well below average by the end of a bear market. Unwinding these excesses will be ugly. The Market Climate remains constructive for now, but we intend to boost our defenses quickly and strongly if sufficient evidence of a deterioration emerges.

As you may know, we prefer to partition earnings by analyzing revenues and profit margins separately. This often gives an insight into valuations which is not possible using earnings figures alone. Indeed, we expect a 20% decline in S&P technology earnings not because revenue growth will slow markedly, but rather because profit margins are likely to slip. That "modest" slippage in profit margins from current record levels is likely to blindside analysts who are accustomed to looking at earnings in a vacuum.

Even a return to median bull market valuations would be brutal for the most popular tech stocks. We're not even talking about bear market valuations, and we're making the leap of faith, contrary to the evidence, that the quality of current revenues is as high as those generated during the past decade. **To illustrate the probable epilogue to the current bubble, we've calculated price targets for some of the glamour techs, based on <u>current revenues</u> per share, multiplied by the <u>median price/revenue ratio</u> over the bull market period 1991-1999.**

**Cisco Systems: $18 3/4** 52-week high: $82
(revenues 2.87/share, median price/revenue ratio 6.53).
**Sun Microsystems: $4 1/2** 52-week high: $64
(revenues 5.17/share, median price/revenue ratio 0.88).
**EMC: $10** 52-week high: $105
(revenues 3.63/share, median price/revenue 2.77).
**Oracle: $6 7/8** 52-week high: $46
(revenues 1.80/share, median price/revenue 3.84).

Get used to those itty-bitty prices. That's what happens when companies keep splitting their stock during a bubble. Since 1995, Cisco has split its stock 18 for 1, Sun 32 for 1, EMC 8 for 1, and Oracle about 10 for 1. That should make it more understandable how these stocks could fall into the single digits. And hey, we're being optimistic.

# ECONOMIC PERSPECTIVES

Last week, the Federal Reserve made a surprise easing of ½% in both the Federal Funds rate and the Discount Rate. Investors immediately cheered the easing, but as we've noted, trend uniformity gave a very weak follow-through. While the Nasdaq initially soared, there was significant selling pressure in defensive stocks, raising the possibility of a whipsaw back to an unfavorable climate. **Please check our weekly updates (www.hussman.net or 248-788-7096) for any change in the Market Climate. For now, we're constructively positioned, but certainly not aggressive or unhedged.**

Analysts have loudly trumpeted the bullishness of interest rate cuts. Historically, the S&P 500 Index has enjoyed an average gain of about 19% in the year following an initial Discount Rate cut. The only post-war exception was a down year following the August 1968 cut, but this was largely because the Fed was forced to tighten again just four months later.

As long as trend uniformity remains constructive, we intend to maintain at least a moderately positive exposure to the market. That said, we believe that the case for optimism is not nearly as clear as the foregoing analysis suggests.

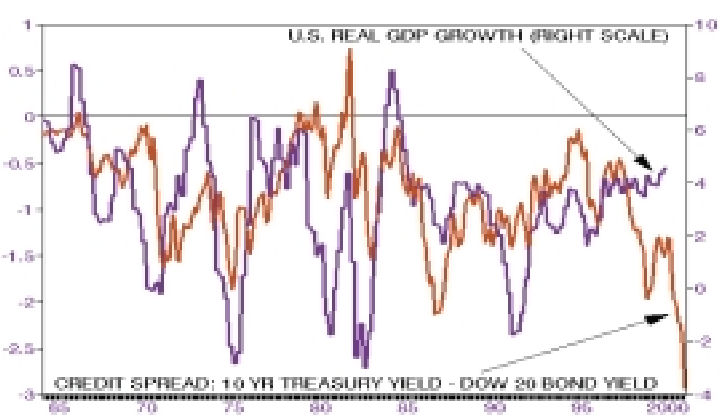
**From the perspective of earnings, there are only two ways for stock prices to rise: either earnings increase, or the price/earnings ratio increases. In the current economic environment, we can essentially rule the first one out as a major source of price appreciation. In fact, following an initial Discount Rate cut, S&P 500 earnings have generally declined, averaging a -2.9% drop over the following year. Which means that for stock prices to rise, the Fed rate cut must induce an increase in the price/earnings ratio of the market.**

Once again, that P/E ratio is where the rubber meets the road. The main reason that Federal Reserve interest rate cuts have historically been good for stocks is that those rate cuts typically occur when P/E ratios are quite reasonable, leaving significant room to increase. **When the Fed has made its initial Discount Rate cut in the past, the S&P 500 has been valued at just 12.6 times peak earnings. Currently, the S&P 500 P/E ratio is double that level. Similarly, initial Discount Rate cuts in the past have occurred at an average price/dividend ratio of 25, compared to the current ratio of 84.**

**But at least the Federal Reserve will be able to avoid recession, right? Again, we're not at all confident. Remember that a Federal Reserve easing simply increases the amount of bank reserves available for new lending. As such, two things are required for an easing to stimulate the economy. There must be an unsatisfied demand for new loans, and banks must be willing to make them.**

Which brings us to the problem. The recent economic expansion has been built on leverage, credit risk, and foreign capital inflows. Growth of capital expenditures has far outstripped the growth of cash flows, and companies have borrowed in order to make up the difference. This has substantially weakened the balance sheets of U.S. companies, and is behind the rather stunning drop in the corporate debt market over the past year. At the same time, banks are facing a troubling increase in defaults, and have been forced to boost provisions for loan losses. The frenzy to invest in network technology and internet services has eased, as the crash in the dot-coms has forced companies to be more realistic about the rate of return from these investments. Foreign capital inflows have begun to pull back, as evidenced by a flattening trade deficit and a decline in the value of the U.S. dollar. **In short, investment demand is pulling back, the willingness of banks to take on credit risk has been stunted, and foreign capital inflows are slowing. We're now in a deleveraging cycle.**

Deleveraging cycles are quite familiar in most of the world, particularly among the Asian economies. Japan learned the hard way that the central bank couldn't turn bad investments into good investments, even when the Bank of Japan drove its interest rates to just 0.25%. And while the U.S. may not face the same aftermath from its leveraging frenzy, the warning signs are there. Most notably, corporate bond prices have plunged, and their yields have soared above those of safe Treasuries. Credit is falling off a cliff.



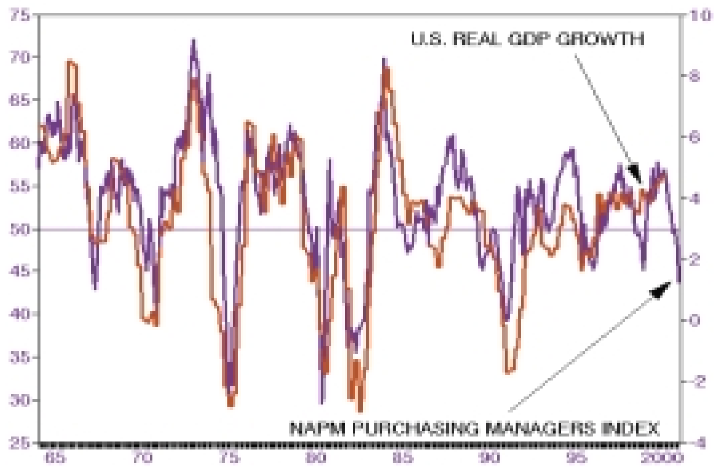

Our Recession Warning composite was triggered in September and is still giving fresh signals. As a reminder, that warning is triggered by 4 indicators:

**1) Credit spreads wider than 6 months earlier, as measured by the difference between the Dow 20 bond yield and 10-year Treasuries.**

**2) Yield curve not steep, as measured by a difference between 10-year Treasury bonds and 3-month T-bills of less than 2.5% (250 basis points).**

**3) S&P 500 Index lower than 6 months earlier.**

**4) NAPM Purchasing Managers Index below 50.**




At this point, credit spreads are wider than at any date for which figures are available (note the chart on the bottom of the previous column). The Fed has never faced such difficulties when it has cut rates. **On average, when the Fed has made its first Discount Rate cut, the average yield gap between the Dow 20 Bond Average (an index of corporate bonds) and the 10-year Treasury bond has been just over 1%. The current gap is nearly three times that level. So the Fed is easing in an environment where credit risk has become dangerously high.**

**Again, Fed easings are effective only if borrowers are eager and unsatisfied, and lenders are willing to take on new credit risks. The current economic environment does not ensure either of these.** The problem is not that the Fed was too tight in 2000, but that it was too loose after the Asian Crisis of 1998, triggering a speculative frenzy in both the stock market and the bank lending market. After all, why do anything defensive if the Fed will always bail you out when the risks go bad? Well, the risks are going bad. The question is whether Greenspan actually has as much power as investors believe, or whether Toto will pull back the curtain to reveal the Wizard of Oz as merely a man.

Our view of the New Economy is simple. There is none. The internet is a useful tool, whose benefits easily accrue to consumers. But in a highly competitive economy with low barriers to entry, it is extraordinarily difficult for companies to capture the benefits of the internet as sustainable cash flow. In the attempt, there has been an extremely high rate of investment in network capacity that threatens never to draw the cash flow required for debt repayment.

Unfortunately, investors continue to view the economy as if it produces a single good, and think it is easy to stimulate demand for that good through monetary or fiscal policy.

**We wish matters were that simple. As we've noted before, recessions are not periods in which business activity declines uniformly across all industries, but are instead periods when the *mix* of goods demanded by buyers becomes mismatched with the *mix* of goods produced by suppliers.** Blindly stimulating aggregate demand does not address the key issue, which is nearly always that capacity has become excessive in some sectors and insufficient in others. This is a more difficult problem because it requires a costly and time-consuming *reallocation* of resources, often involving credit defaults, layoffs, and business restructuring. That's not to say that stimulating aggregate demand can't be helpful in some instances, but preventing a recession certainly isn't the piece of cake that the Fed's cheerleaders might assume.

The bottom line is this. The market has recruited enough trend uniformity to place us in a still-hedged, but moderately positive position. Even so, we strongly advise avoiding many of the high P/E, high price/revenue stocks that dominate the Nasdaq and the S&P. **Value is not measured by how far prices have declined, but by the relationship between prices and properly discounted cash flows. On that basis, the major indices remain stunningly overvalued.** While our client portfolios hold many stocks that we believe are favorably valued, they are generally not the same ones that dominate the major indices.

The main vulnerabilities of the economy still include falling profit margins, credit problems, and slowing foreign capital inflows (which we will observe as a weaker dollar and a *shrinking* trade deficit). The current climate most probably represents a rally within a bear market. We are not inclined to fight any emerging advance when both trend conditions and monetary policy are favorable, but we have no inclination to be aggressive or particularly bullish. We wouldn't risk much based on this positive but mixed picture, and our client portfolios remain largely hedged. If trend uniformity deteriorates, we will boost our defenses further. We have no doubt that there is a further economic and bear market retrenchment ahead, but the evidence suggests that the bear may not be in a great hurry just yet.

Best wishes, *John P. Hussman, Ph.D.*

# MARKET VALUATION

| | |
|---|---|
| S&P 500 Index: | 1320.41 |
| Current S&P 500 dividends: | 15.71 |
| Current S&P 500 earnings: | 53.73 |
| Record earnings to-date: | 53.73 |
| Price/record earnings: | 24.6 |

**S&P 500 10-year total return projections (annualized):**

| | |
|---|---|
| At future P/E of 20 (same as '29, '87 peaks) | 1.23% |
| At future P/E of 14 (average 1950-present) | -2.27% |
| At future P/E of 11 (historical median) | -4.57% |
| At future P/E of 7 ('74, '82 troughs) | -8.73% |

*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.*