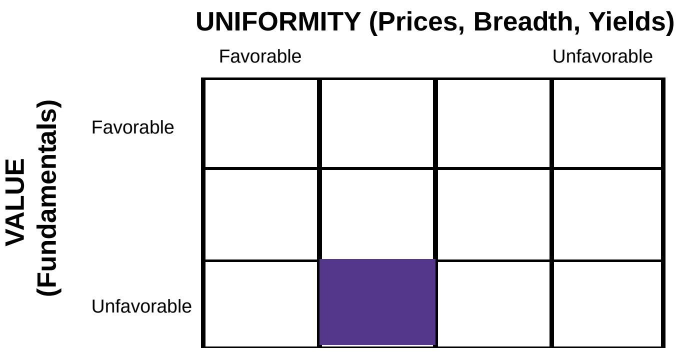
HUSSMAN

INVESTMENT RESEARCH & INSIGHT

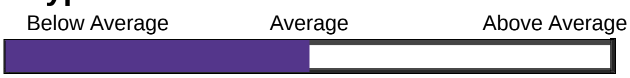
VOLUME 2 NUMBER 2 FEBRUARY 26, 2001

MARKET CLIMATE

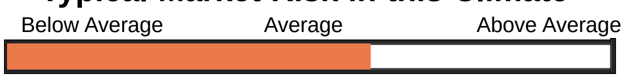
The current profile of valuation and trend uniformity



Typical Market Return in this Climate

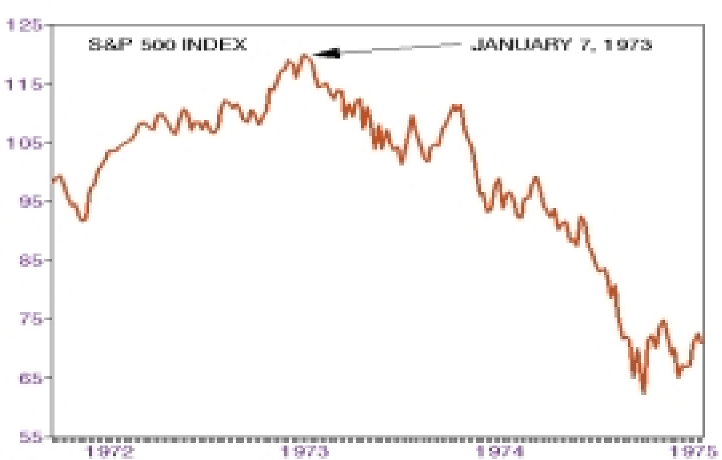


Typical Market Risk in this Climate



"It's very rare that you can be as unqualifiedly bullish as you can now."

- Alan Greenspan, The New York Times, 01/07/73



"At the moment, we are not."

- Alan Greenspan, February 13, 2001, when asked by Congress whether the U.S. is in a recession

Almost makes you sorry they asked.

THE TICKER

The U.S. economy is in a recession, and U.S. stocks are in a bear market. Neither of these will be resolved easily. There is a single problem at the root of these difficulties: the failure of investors to make distinctions.

Over the long term, good investment means making distinctions on the basis of price. "Investment" involves purchasing a security because the price is attractive in terms of the properly discounted stream of cash flows that the security will deliver. For instance, if a security is expected to deliver $100 in ten years, and I can buy that security today for $32, I can expect a return of about 12% compounded annually over the next decade. If instead the security costs $68 today, I can only expect a return of about 4% compounded annually. **It is impossible to know whether stocks are attractive or unattractive as long-term investments without asking "at what price?" In recent years, investors have stopped asking that question.**

The main activity in the financial markets in recent years is not appropriately described as investment, but as "speculation". Speculation simply involves buying a security on the expectation that the price will rise, regardless of whether or not it is priced to deliver good long-term returns. For a while, even we failed to make that distinction. **We used to believe that overvalued markets should go down. In effect, we *assumed* that when stocks are unattractive investments, they are necessarily unattractive speculations. Then we looked more closely. History is clear that stocks can rise for speculative reasons even when they make no sense as value investments. Even profound overvaluation is not enough to drive prices lower if broad market action is uniformly favorable. But when market internals begin to fail, overvaluation can open the way for a particularly violent follow-through.** This distinction is at the heart of our Market Climate approach.

Currently, stocks represent very poor long-term investments, at least as represented by the major indices such as the S&P 500 and Nasdaq Composite. As for speculation, we try to maintain at least a modestly constructive position as long as internal market trends are sufficiently favorable (e.g. a rising advance-decline line, increasing number of new highs, rising corporate bond prices, strength in retail, transports, brokerage, utilities and other sectors). Such trends have been tenuously favorable since late December, but we are already seeing deterioration. As a result, we are largely hedged, but not fully defensive. That may change in the coming weeks. **You may access our weekly updates in the Research & Insight section of our website www.hussman.net, or by calling 248-788-7096.**

The proportion of bullish investment advisors recently soared to the highest level since 1987. No doubt, this is because of the aggressive easing by the Federal Reserve, which is assumed to be enormously positive for stocks. But as we noted in the last issue, past Fed cuts have helped stock prices not by stimulating earnings growth, but rather by inducing an increase in the price/earnings ratio of the market. **When the Fed has cut rates in the past, the P/E ratio on the S&P 500 has averaged just 12.6. It is an open question whether P/E ratios will respond so well starting from a level of 25, when earnings expectations are being aggressively revised lower.** Again, investors have failed to make such distinctions.

Several analysts have noted that bear markets tend to have three phases. First, stocks decline despite good news, as the speculative froth is removed from the market. Second, stocks decline on bad news, as it becomes clear that business conditions are eroding. Finally, stocks capitulate on the fear that the bad news will never end. From our perspective, we are relatively early in the second phase.

No doubt, most investors holding stocks here are doing so because they honestly believe that "stocks are a good long-term investment". Regardless of the price. To support the case that stocks always do well, investors simply point to recent decades. In doing so, they are relying not on analysis, but on superstition. They fail to make the distinction between price gains due to earnings growth and price gains due to an increase in the price/earnings ratio.

Since 1982, the P/E ratio on the S&P 500 has increased from 7 to a current level of 25 (the 1929 and 1987 pre-crash peaks never exceeded 20 times record earnings). Meanwhile, the peak-to-peak growth rate for S&P 500 earnings since 1990, 1980, and even 1950 has been slightly less than *6% compounded annually*. Faster estimates are only obtained by measuring from the 1992 recession trough.

In other words, the main reason stocks have done so well since 1982 is that they have moved from profound undervaluation to profound overvaluation.

Overvaluation does not mean that prices must decline immediately. It simply means that stocks are priced to deliver poor *long-term* returns. It is not of much consequence to a long-term investor whether this occurs by a crash followed by a recovery, a further advance followed by a crash, or a prolonged period of stagnant prices. Trend uniformity is useful in distinguishing between these possibilities, but for long-term investors, stocks are currently priced to underperform Treasury bills over the coming decade (even if the S&P 500 P/E moves no lower than 20).

In recent years, buyers of technology stocks have rigidly assumed that a good company is necessarily a good investment. **These people stopped being "investors" the moment they stopped asking "at what price?"**

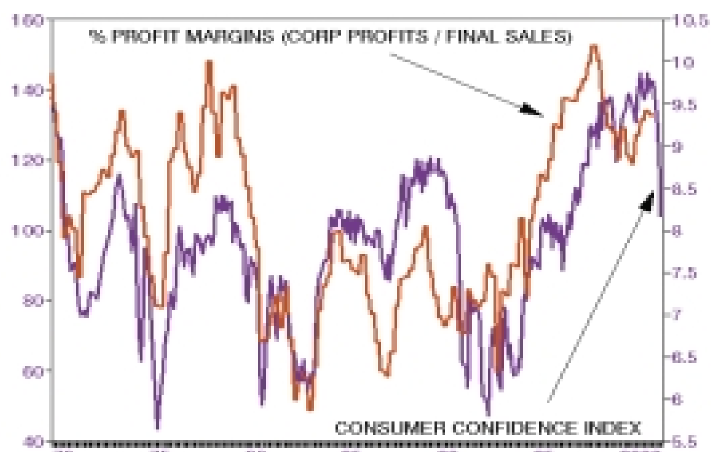
Frankly, we never quite understood how investors could believe the wild-eyed growth estimates of Wall Street analysts in the first place. Even at the peak of the dot-com frenzy, we repeatedly noted that profits require not only a *useful* product, but a *scarce* one. The complete absence of barriers to entry made it clear that any profitable dot-com business model would quickly be replicated, driving profits to zero. So profitability in the dot-coms could only come from an implausible level of brand loyalty. Hence the tremendous waste of money on advertising, to the extent that the sock-puppet became the most valuable asset of Pets.com.

As for the glamour internet companies such as Sun, Oracle, EMC and Cisco (which have all plunged since the analysis in our January issue), it is essential to distinguish between "buildout" and sustainable growth. Apart from acquisitions, the bulk of the tremendous growth in these companies has been from *buildout* - the one-time surge of investment required to put servers, routers, and other infrastructure in place. Increasingly, companies have noted that their buildout is largely complete, and as a result, we've seen many more order delays and cancellations.

When we select stocks, we are always more cautious about companies that have enjoyed explosive growth. This is especially true when earnings have grown much faster than revenues, which calls the sustainability of profit margins into question. More often than not, parabolic earnings patterns tend to break down or flatten out. A stock with an extremely high P/E multiple on peak earnings nearly always encounters disaster. Unfortunately, these are the same companies that many investors have selected as the chariots of their financial security.

THE DATABANK

The U.S. stock market is in for a shock in the coming months. We are anticipating a sharp dive in profit margins, driving S&P 500 earnings to a negative year-over-year growth rate, and causing many glamour technology companies to post sudden earnings losses (not just negative growth). This is an expectation that has not been voiced by Wall Street analysts, but is likely to become the center of market attention during the next few quarters. And we doubt that stocks are priced to handle it well.



The S&P 500 would *still* have to decline by nearly half just to reach a historically normal P/E of 14, not to mention the P/E of between 7 and 11 usually seen at bear market lows. Though we are not currently at our maximum defensive position, we are well-hedged even here, and we are quite sensitive to any further deterioration in market action.

Over the past year, we have been adamant that both revenues and profit margins are cyclical. When economic growth is strong, revenues accelerate, particularly for companies that benefit from rising capital spending. Costs also rise, but at a slower rate, the result being a significant increase in profit margins. So, economic booms generate both faster revenue growth and widening profit margins, and earnings enjoy extremely rapid growth. These facts are clear from decades of historical data, and were certainly true during the recent economic boom.

In a recession, these factors reverse. Revenue growth falls short, and profit margins slide. In 1991-92 the result was a 40% plunge in S&P 500 earnings, while earnings for the Dow Industrials dropped by more than half. The S&P 500 technology sector actually posted earnings losses. This was the natural result of slowing revenues slamming against rising costs.

It's about to happen again, and this time, P/E ratios are dramatically higher than they were at the 1990 peak. In recent months, we've seen a clear slowing in capital spending, as well as a pullback in the capital spending plans announced by major corporations. And while consumer inflation has been reasonably well behaved, we've seen significant cost pressures in three areas: wage costs, benefit costs (particularly healthcare related) and energy costs. The massive jump in the January Producer Price Index and the more modest jump in consumer prices were both important, not because they will prevent the Fed from easing (they won't), but because they illustrate the extent to which profit margins are likely to collapse. Note in particular that operating costs have been pressured higher, without the ability to pass these costs on to the consumer. Among technology companies, the recent decline in stock market values has made option grants a less attractive form of compensation, leading to higher demands for cash compensation.

In the decades of historical data that underlie our stock selection approach, it has been disturbingly common for companies with very rapid earnings growth to suddenly generate not only slower growth, but actual losses as soon as economic growth has cooled. The most extreme examples were the performance stocks of the late 1960's "Go-Go" market. We are strongly convinced that such sudden losses will appear in many of today's glamour tech stocks.

That said, it is difficult to pinpoint which of the glamour techs will post negative earnings. As Warren Buffett once said, "It's only when the tide goes out that you learn who's been swimming naked". In recent years, the true operating performance of many technology companies has been masked by acquisitions, vendor-financed revenues (basically, firms such as Cisco and Sun Microsystems selling products on a deferred-payment plan), and tax benefits from options granted to employees (these option grants do not appear as an expense, but do result in a tax deduction). As Barron's reports, these tax benefits accounted for *all* of the reported earnings of Cisco and Sun Microsystems in the 3rd quarter of 2000, so we have our guesses as to which companies may post losses ahead. In any event, the next few quarters will tell.

The bottom line: combine slowing revenue growth with rising cost pressures and you've got the recipe for plunging profit margins. Meanwhile, Wall Street analysts continue to post relatively firm earnings projections. It is beyond us how the likelihood of collapsing profit margins has escaped these analysts. It is not likely to escape them for long.

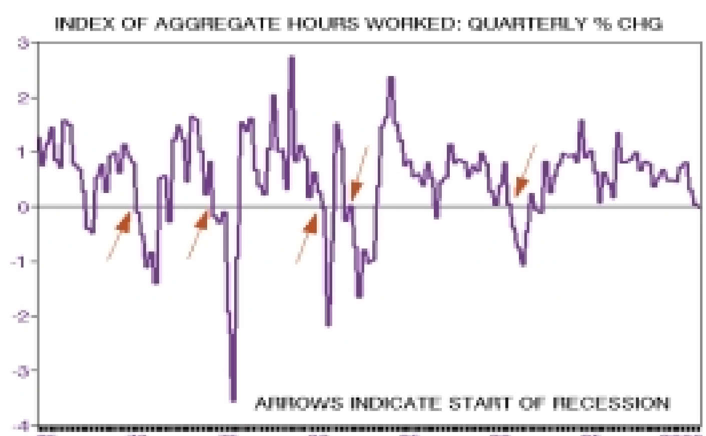
ECONOMIC PERSPECTIVES

Bullish analysts are quick to point out that good buying opportunities generally occur when economic news is quite bad. Which begs the question of why they were aggressively touting stocks at the market peak, when the economic news seemed flawless. In any event, bear market lows do tend to occur during the middle of well-recognized recessions. Unfortunately, very few observers have even conceded that the U.S. has *started* a recession.

Alan Greenspan also recently stated that "at the moment, we are not" in recession. But this is an intelligent man. Intelligent enough to avoid any hint of "talking down" the economy and taking blame for a "self-fulfilling prophesy". Our opinion is that Greenspan is fully aware that the U.S. is entering a recession. The aggressiveness of recent interest rate cuts makes that plain.

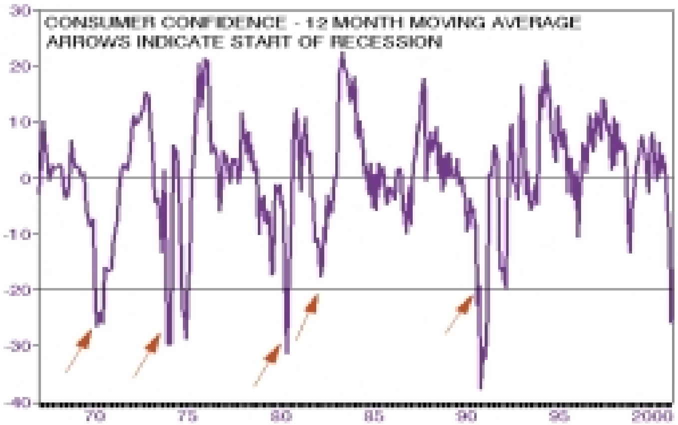
Our assertion that the U.S. has entered a recession is based on warnings from a diverse set of reliable indicators. As we noted last year, the earliest warning of an impending recession came in September from our composite of 4 leading indicators: widening credit spreads (corporate bond yields minus Treasuries), a flattening yield curve, the S&P 500 below its level of 6 months earlier, and the NAPM Purchasing Managers Index below 50. This combination has always occurred during or just prior to recessions.

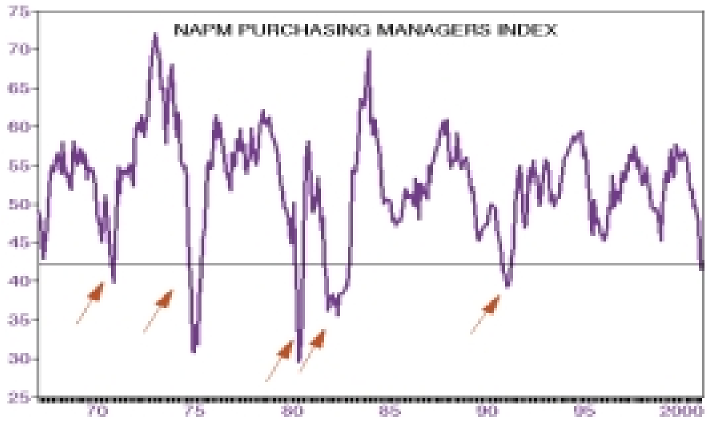
Since then, we have seen further erosion in accurate gauges. The growth rate of real liquidity (real monetary base, M2 and consumer credit) is near zero. On the employment front, aggregate hours worked have declined. A quarterly decline in this index has accompanied the beginning of every post-war recession, with very few false signals. Mass layoffs (50 or more employees terminated at once) have soared in recent months, and the 6-month change in initial unemployment claims has jumped to a level last seen during the 1991-92 recession.



Consumer Confidence has never plunged more than 20 points below its 12-month moving average without an accompanying recession. The Business Confidence Index is also collapsing. And both the NAPM Purchasing Managers Index and the New Orders Index have plunged to levels seen only during recessions.

In short, the weight of the most reliable indicators is now on the side of recession. Despite their historical accuracy, we do hope these warnings are wrong.





It is widely expected that the Federal Reserve can and will avoid recession simply by being aggressive enough with its interest rate cuts. Once again, this faith is based on a failure to make distinctions. Most U.S. recessions have been what might be called "inventory runoff" recessions. For some goods, production is discontinued. For others, production is reduced by enough to run off unwanted inventories. As this process runs its course, the economy regains its footing, because the underlying fundamentals - consumer and investment demand - never really collapse.

The current economic cycle is somewhat different. It has been paced by an extraordinary appetite for capital investment and debt. As such, the current economic downturn is not an "inventory recession" but a "deleveraging cycle". Both the frenzy for capital spending, and its sources of financing, have suddenly collapsed. The IPO market has frozen, with many new issues cancelled or postponed. Risk premiums in the corporate bond market have soared, making financing much more expensive. Bank lending has tightened sharply. Enormous amounts of vendor financing are now being written down as losses (which also means that part of the "revenue" reported by the techs in recent years was never actually realized). Foreign capital inflows are also slowing, which we will continue to observe as a weakening U.S. dollar and a *shrinking* U.S. trade deficit. Meanwhile, consumers and businesses are saddled with a large overhang of debt, much of very poor credit quality.

As we've noted before, a Fed easing simply provides a larger amount of bank reserves to the banking system. **In order to be effective in stimulating the economy, two things are required. Borrowers must eager to borrow, and the banks must be willing to take on new credit risks. The current economic downturn is problematic in that neither of these conditions is true.** Evidently, investors have long forgotten economic phrases like "liquidity trap" and "pushing on a string". These refer to the inability of monetary policy to stimulate the economy when bank lending or capital investment are unresponsive.

We do not take solace from the Federal Reserve's latest report on bank lending. **The Federal Reserve found that over the past quarter, 60% of domestic banks surveyed had tightened credit standards, the largest proportion since mid-1990, when the economy last slipped into a recession. Meanwhile, about half of the banks reported weakening demand for loans. Indeed, the net percentage of lenders reporting stronger loan demand has already plunged far below the worst levels of the last recession.** So companies are demanding fewer loans, and banks are much less willing to provide them. This is the type of environment in which monetary easing is ineffective.

When businesses and investors call for the Federal Reserve to cut rates again, what they are really asking is for the Fed to bail them out of bad investments. But as a general rule, bad investments go bad, particularly when they were never more than speculations in the first place.

A true investor always asks “at what price?”

- John P. Hussman, Ph.D.

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