HUSSMAN

INVESTMENT RESEARCH & INSIGHT

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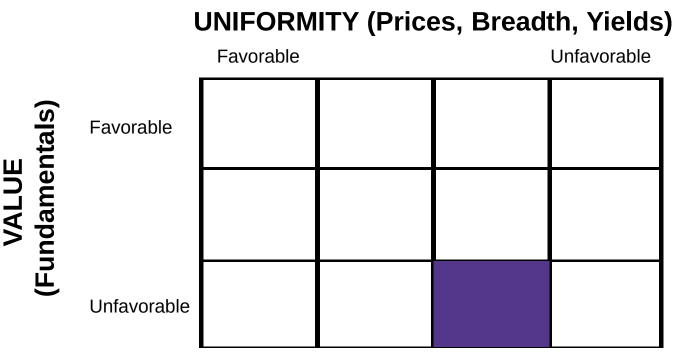
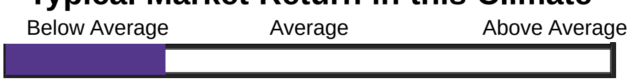
MARKET CLIMATE

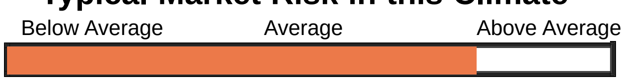
The current profile of valuation and trend uniformity



Typical Market Return in this Climate



Typical Market Risk in this Climate



THE TICKER

"The economic upturn is nowhere in sight."

- New York Times, August 15, 1982
(the week of the final bear market low)

Bear market bottoms typically do not occur when investors are focused on spotting the bottom, but when investors give up hope that there even *is* a bottom. They do not occur when investors deny the existence of a recession. They occur when recessions are *fully recognized*, when there seems to be no end in sight, and when nothing seems to be helping. And historically, they have occurred at about 11 times peak earnings or lower. Currently the S&P 500 is at 21 times peak earnings.

In recent weeks, a number of analysts have pointed to bearish magazine covers as a sign that the market is bottoming. *Barron's* even ran a piece arguing "Doom depicted on magazine covers could spell boom in stocks."

Look closer. *Time's* recent magazine's cover is already "Looking Beyond The Bear." Indeed, the bear in the cover photo is nicely dressed and carrying a bag, as if it's just visiting Grandma for a few weeks. The subhead confides "Yes, it's scary out there, but recession isn't a sure thing." *U.S. News & World Report's* cover cries "Bear Trap", but the story inside is headlined "Young or old, just sit tight." *Newsweek's* cover asks "How Scared Should You Be?" Inside, the magazine answers "The markets may seem hazardous to your health, but for long-term investors, the diagnosis is actually much improved."

In short, a recession is anything but *well-recognized*, and the news coverage certainly contains none of the pessimism seen at past bear market lows. Alan Greenspan, quoted at the low of the 1969-70 bear market (Business Week, June 27, 1970) illustrates the typical sentiment at market bottoms: "What's bothering me is that the risks are all on the downside."

With the P/E on the S&P 500 currently still higher than the 1929, 1972 and 1987 pre-crash peaks, there's room for magazine covers to become much gloomier.

When does the media typically recognize a recession? Historically, headlines of recession have always lagged the official start of the downturn by anywhere from 3-12 months. And the accompanying bear markets have *never* ended until after - sometimes well after - those headlines have appeared.

A wide range of factors can contribute to the realization that the economy is in recession, including falling consumer confidence and slowing industrial production. But historically, the media has not actually put itself on the line with "Recession" headlines until the rate of unemployment has increased by 0.6% to 1.4%. What's interesting is that historically, even an increase of 0.5% has always been accompanied by recession.

So effectively, the media has only pronounced a recession when there has been absolutely no room for doubt. The recent low in unemployment was 3.9%, so we don't expect recession headlines until that rate hits at least 4.5%. As we reviewed in the February issue, the most reliable economic indicators already confirm an oncoming recession, including many with historically perfect records. What is missing is not evidence, but recognition. Until that happens, talk of a market bottom is purely speculative.

What caused this bear market? Many investors are intent on blaming the Federal Reserve for the tightenings during the year 2000. But that is a lot like a three-year-old blaming the last block on a wobbly tower for its collapse. As a rule, the most likely cause of any collapse is a weak foundation. A stock market dependent on margin debt, hype, and ignorance of valuation is on a weak foundation. A frantic capital investment boom financed through debt, and accompanied by a negative savings rate is also on a weak foundation. Blame the bubble for the bust.

As we have noted frequently in the past few years, our only disagreement with the Federal Reserve during this cycle was the inappropriately aggressive easing that it pursued following the Asian Crisis in 1998. That easing threw the financial markets from an overvalued bull market into a full-scale bubble. It fueled an aggressive expansion in capital investment that has resulted in overcapacity. It made investors believe that the Fed was "on their side."

The Fed's mistake was in providing *too much* cheap credit, and allowing investors to believe that Alan Greenspan had the power to stimulate the economy and the stock market at will. We've said this all along. Predictably, investors are now furious that he can't or won't save them, even though the Fed has launched an unprecedented easing of monetary policy in recent months. **The main difficulty is that cheap credit will not fix what cheap credit has caused.** Greenspan never had the power to control the economy in the first place. Sure, throwing grease on the road will make all the cars go faster for a while. But once they start spinning out of control, more grease is hardly the solution.

THE DATABANK

As with prior bear markets, terrible losses are being suffered by investors who do not understand what is happening around them. The current cycle is in many ways worse, because investors have been given much more frequent bullish assurances by celebrity financial journalists and star analysts on CNBC. You can't hold an audience by analyzing discounted cash flows. You hold them by giving them the market-as-sport. Breathless coverage of the opening bell. Half-time reports. Play-by-play commentary. One of the terrible consequences of this market-as-sport mentality is that investors have become ignorant of what constitutes normal valuations, much less bear market valuations.

The New York Times analysis at the 1982 bear market low is instructive: "When the Dow Jones industrials hit 577.60 in 1974, their price/earnings ratio was 5.8. Today, with the Dow 200 points higher, the P/E ratio is only 6.5. The S&P 400 industrials are lower than in 1974. Their P/E is currently 7, compared with 7.2 in 1974. But virtually every professional investor believes that Wall Street's earnings estimates are too high. 'The market didn't anticipate how lousy earnings would be,' said Ronald A. Glantz, who heads investment strategy at Paine Webber Mitchell Hutchins Inc.

"A better yardstick is book value, which shows that today's market is no higher than the darkest days of 1974. 'The S&P 500 hasn't sold below book, and the Dow hasn't sold more than 20 percent below book since 1932,' pointed out Morgan Stanley's Barton Biggs. In 1974, the S&P's price divided by the book value of its component companies was 1.0 while the Dow's was 0.8. Today the S&P's is again 1.0 and the Dow's is a shade lower, 0.78."

The S&P 500 currently trades at 5.8 times book. The Dow trades at 6.0 times book. Now, we do not expect stock prices to decline anywhere close to book value in the current bear market. That said, we do believe that revenues, book values and dividends are currently a much more appropriate benchmark for stock valuation than earnings are. The reason is profit margins.

Over the past several years, profit margins have soared to the highest - and least sustainable - levels in history. As a result, earnings growth has been dramatically faster than growth in revenues, dividends, and book values. If there is one theme that we have emphasized over the past year, it is that profit margins are in danger of collapsing. Recent earnings figures will be difficult to match in the foreseeable future, particularly in high-margin businesses such as technology, where discounting has become necessary simply to avoid excess inventory. By extension, that means that for most tech stocks, the appropriate valuation benchmarks are not price/earnings ratios, but price/revenue ratios. And price/revenue ratios look a whole lot more like price/book and price/dividend ratios here: abominably high.

Case in point: Cisco, Sun, Oracle and EMC - which have declined by half since our analysis in the January issue. Over the past decade, the combined revenues of these companies have increased 11-fold. In contrast, the earnings have increased 40-fold, driven by rising profit margins. The combined market capitalization of these stocks grew even faster. By last year's peak, the valuations of these 4 stocks had soared 200-fold from their levels a decade earlier. Needless to say, the recent declines in these stocks have erased some of the froth. But if price/revenue ratios of these companies moved even to median *bull market* levels of the past decade, the stocks would have to fall by more than half from current levels. We don't even want to contemplate bear market valuations.

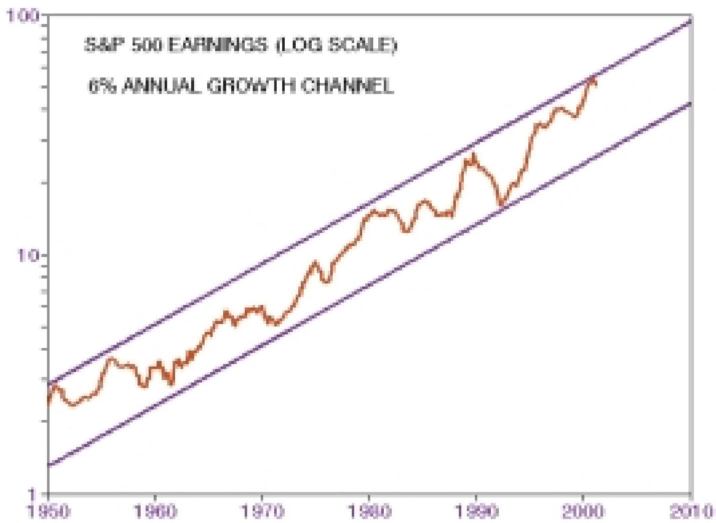
In short, price/earnings ratios should not be considered as reliable benchmarks of value here. Over the past decade, many historically reliable benchmarks such as price/revenue, price/book and price/dividend have been discarded as antiquated. Rising profit margins drove earnings out of line with these other fundamentals, and enthusiasm about soaring earnings drove stock prices to fantastically high price/earnings ratios. We are now on the reverse side of this spike. Revenues, dividends and book values will continue to grow, but as profit margins normalize, earnings are likely to decline and stagnate, as they come back in line with other fundamental benchmarks.

Historically, bear market lows have typically occurred with stock prices between 0.75 - 1.0 times revenues, 1.0 - 1.5 times book value, and 20 - 25 times dividends. Severe bear markets have occasionally taken stocks to even lower extremes. Currently, the S&P 500 trades at over 3 times revenues, 6 times book value and 75 times dividends. In other words, if revenues, book values and dividends are the appropriate benchmarks (and we believe they are), stocks would have to fall by about two-thirds from current levels to achieve typical bear market valuations. More likely, valuations will be corrected in part by long-term growth in fundamentals, so prices need not fall so hard.

We do not expect stocks to reach normal valuations in a single bear market. Rather, we expect that normal valuation will require a series of market cycles which achieve lower lows, much like the 1969-70 and 1973-74 bear markets did. Investors intent on "holding stocks for the long term" evidently forget that the Dow hit 1000 in 1965, but ultimately bottomed at 777 in 1982.

Remember, overvaluation does not mean that stocks must decline in the near term. It means simply that stocks are priced to deliver poor *long-term* returns. As we wrote in the February issue, the higher the price paid for some set of future cash flows, the lower the long-term rate of return earned by the investor. If a security will pay $100 a decade from now, you can expect a 12% annual return if you buy the security today for $32, but only a 4% annual return if you buy the security for $68. The fact that you pay $68 for it doesn't mean that the price has to fall immediately. It simply means that you've locked in a low long-term rate of return. If that's the return you're happy with, fine. Pay $68 and plan your retirement. Our impression, however, is that investors currently have no idea what a poor long-term return they are locking in at current prices.

Think of it this way. Mathematically, are only two ways for stock prices to advance. Either earnings grow or the price/earnings multiple increases. There is no third way (price = price/earnings x earnings). During the past decade, as well as since 1980, 1950, and even the late 1800's, the long-term growth rate of S&P 500 earnings has been less than 6% annually when measured from peak-to-peak or trough-to-trough. Given that we are coming off of an earnings peak here, one can form a reasonable expectation that earnings will grow by less than 6% annually in the future. This rate of growth is suggested both by recent history and by long-term evidence.



Now, if the market P/E ratio stays constant at the current extreme (21 times earnings, which is still higher than at the 1929 and 1987 peaks), stock prices will by grow at the same rate as earnings: 6% annually. Kick in a 1.3% dividend yield, and you're up to a 7.3% annual total return over the long-term, *if* the price/earnings ratio indeed stays at current levels indefinitely.

But let that P/E ratio slip to even 18 over the next decade, and that total return falls to 5.7% annually. At a P/E ratio of 14 a decade from now (which is the historical median), the total return falls to just 3% annually. **In short, very reasonable assumptions about earnings growth and P/E ratios suggest that the S&P 500 will underperform Treasury bills over the next decade. No strenuous assumptions are required.**

Of course, reasonableness is not a job requirement of Wall Street analysts, who are eager to paint stocks as undervalued here. Consider the following comments in the April 2, 2001 issue of *Barron's*, profiling the views of Morgan Stanley's Byron Wein:

"Wein's model currently places the fair value of the S&P at 1326 - some 14% higher than Friday's close of 1160.34 - using a dividend-discount model that assumes a 10-year earnings growth rate for the index of 9.8%, slower growth thereafter, a 4% increase in the operating earnings for the S&P this year to $57 a share, and a bond yield of 4.96%. In addition, Wein bakes an equity-risk premium of 2% into stocks, on the theory that fair values for stocks should be clipped some in relation to government bonds because of stocks' greater uncertainty of return."

Sounds almost like careful analysis. Until you examine those assumptions more closely. Looking back to 1871, the S&P 500 has *never* generated a 10-year earnings growth rate close to 9.8% starting from a point of record earnings. In the few instances that the S&P 500 has delivered such earnings growth, it has been because earnings were coming off of a severe trough, on average 28.3% below their prior highs (as was the case after the 1990-91 recession). And despite the lip-service given to "baking in a risk premium", look again at those numbers. Wein uses a bond yield of 4.96%. Adding 2% brings the assumed long-term return on stocks up to a juicy 6.96% annually.

In other words, if you're willing to assume implausibly high earnings growth having no historical precedent, and in the face of such earnings growth, you're willing to accept a long-term total return on stock investments of just 6.96%, then good news. Stocks are a whole 14% undervalued. We suspect that this model would be of little comfort to investors if they stopped to analyze the assumptions.

To put it another way, the S&P 500 currently trades at over 21 times record earnings. The 1929, 1972 and 1987 pre-crash peaks never reached more than 20 times record earnings. So it's safe to say that the market decline from this point forward will probably be no worse than the 1929, 1973-74 and 1987 crashes.

Again, we suspect that this is of little comfort. Which shows how little comfort one can expect from an overvalued market without support from favorable trends. If trends were favorable, stocks might at least have speculative appeal, if not investment merit. Currently, the market has neither.

The point is not that the market must necessarily decline in the short-term, or even restore favorable valuations during the current bear market. The point is that stocks are currently priced to deliver very poor *long-term* returns.

Investors often justify holding stocks here by saying that they are long-term investors with a horizon of 10-15 years. It is exactly over this horizon that investors are likely to find stocks terribly unrewarding. We hope that if valuations improve, stocks could offer an attractive buying opportunity even at some point within the next year or two. But at current prices and valuations, stocks are simply not priced to offer a satisfactory return to buy-and-hold investors.

Finally, it is important to notice the wide valuation gap between the average stock and the handful of large-cap giants that drive the major indices. When we comment on the poor long-term prospects of the S&P 500, we are talking about the index itself (which is capitalization weighted) and the stocks that dominate it. As a broader matter, however, most stocks are not nearly as overpriced as the S&P.

If you divide the largest 3000 stocks into the market into groups of 300 - smallest to largest - the majority of these groups have median price/earnings ratios of less than 15. But that P/E ratio spikes higher for the largest two groups. Unfortunately, the largest 600 stocks account for 90% of the market's total value. The concentration is similar in the S&P 500. Currently, the largest 25 stocks in the S&P 500 account for nearly 44% of total capitalization. Prior to 1998, the largest 25 stocks accounted for just 33% of the index.

Which suggests that the large-cap stocks that drive the indices could suffer much more than the average stock, if a bear market decline also corrects the valuation skew. In order for the largest 25 stocks to revert back to 33% of index capitalization, a 30% decline in the S&P 500 would have to hit the largest 25 for a 48% loss, while the remaining stocks would only take a 16% loss. In a 40% S&P 500 decline, the largest 25 would have to suffer a 55% loss, while the remaining stocks would take a 28% hit. **Again, when we discuss the unfavorable long-term prospects for the S&P 500, we are discussing the index specifically, and the largest capitalization stocks more generally - particularly those at high price/revenue ratios.**

THE OBSERVATION DECK

In our weekly internet updates (available on our website at www.hussman.net), we regularly distinguish between opinion and strategy. **Our strategy is fairly straightforward. We focus on two dimensions - valuation and trend action - in both our stock selection and market allocation.** As much as we may comment about the market, and even make projections, these views do not determine our investment stance. Our positions are based on objective evidence about valuation and market action.

The goal of our strategy is not specifically to avoid risk, but rather to concentrate our investments in those areas where risk is expected to be well rewarded, and to avoid, hedge, and diversify away those risks that are not attractive.

Yet all around us we see investors doing nothing of this sort. They continue to pile into overvalued stocks with bad market action, trying to catch the bottom in yesterday's bubble stocks. They insist on taking market risk regardless of its prospective return. They are unwilling to sell positions that offer *intolerable* tradeoffs - "heads I win, tails I'm wiped out" - because they fear regret. When the market falls, they promise that they will sell on the next rally. But when the rally comes, they hold on, because "Hey! It's coming back."

These investors are doomed to sell at the bottom, when the losses *actually become* intolerable, because there is no other natural point at which they will sell to reduce their risk.

In a bull market with favorable trend uniformity, dips are an opportunity to buy, and it is generally not attractive to sell on rallies. In a bear market, the rules change. Rallies are an opportunity to sell, and it is generally not attractive to buy on dips. Unfortunately, investors continue to treat this bear market as if it was a bull - buying the dips without selling the rallies. This is why margin debt has contracted by a surprisingly small amount. Investors continue to buy the dips, even if they have to go into debt and endanger their long-term financial security to do it. This is just so sad, and it isn't over.

Meanwhile, corporate insiders have increased their selling activity to the highest pace in years. It is unusual to see insiders selling into a market decline, but the latest Vickers reading shows 2.83 shares sold for every one purchased. Perhaps they know something.

- John P. Hussman, Ph.D.

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