HUSSMAN

INVESTMENT RESEARCH & INSIGHT

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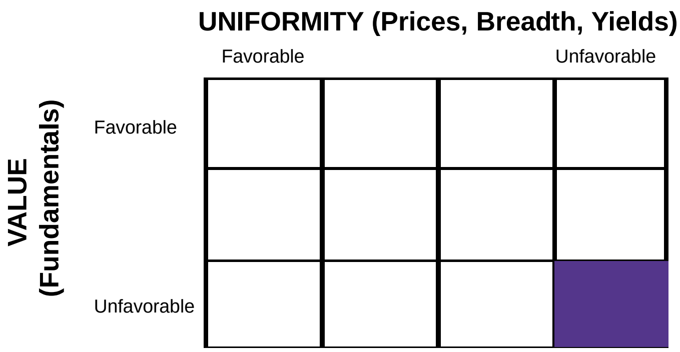
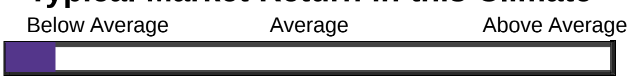
MARKET CLIMATE

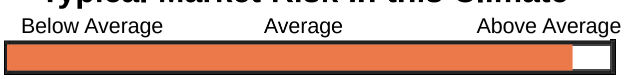
The current profile of valuation and trend uniformity



Typical Market Return in this Climate



Typical Market Risk in this Climate



"Investing is about the long term", Charles Schwab assures us in a recent commercial. We agree. And that's exactly why investors should get the hell out of stocks.

The issue is not where the market will go in the next few weeks or months. The real issue is that at current valuations, the market is priced to deliver very unsatisfactory *long-term* returns. The S&P 500 currently trades at 23 times peak earnings and a dividend yield of just 1.2%. This compares with a historical median of 14 times peak earnings and a 3.8% yield. Moreover, when measured from peak-to-peak (rather than trough-to-peak) over the past decade, or even 20, 50 or 100 years, S&P earnings have grown no faster than 6% compounded annually.

Here's the math. Suppose that the P/E stays constant at current extremes *forever* (so prices and earnings grow at the same rate). In that event, investors are looking at a long-term total return of 7.2% (6% from capital gains, and 1.2% from dividend income). If the S&P 500 P/E contracts even to 20 over the coming decade, that total return shrinks to 5.8% annually. If the P/E contracts to its historical median of 14 (not even below it), the total return over the coming decade would average just 2.5% annually.

Lip service about "investing for the long-term" is nothing but an excuse to keep gambling.

THE TICKER

The market is likely to stagnate over the coming decade, but it will probably stagnate in an exciting way.

While the S&P 500 is likely to underperform Treasury bills over the next 10 years, that period will almost surely include several bull and bear markets. Outperforming the market does not require us to participate in the full extent of every move. Rather, it is sufficient to be more aggressive, on average, during periods of favorable valuations and market trends, and more defensive, on average, during periods of unfavorable valuations and market trends. **The real losers over the coming decade will be investors who insist on holding overvalued stocks as they decline, and who abandon stocks only after the pain of a falling market finally becomes overwhelming. Our strongest assets in the years ahead will likely be discipline, respect for valuation, and a willingness to sit out market rallies that display poor internal strength.**

It is important to note, however, that overvaluation alone does not determine market direction. When the market is able to recruit "trend uniformity" across a wide range of market internals, an overvalued market can easily become more overvalued. This is how the recent market "bubble" was able to achieve such girth. When the market is overvalued but trends are uniformly favorable, we are willing to participate. **Essentially, trend uniformity means that investors are increasingly willing to take stock-market risk. It does not matter *why* they are willing to take more risk, or whether their concept of the world is valid. Historically, it has been fruitless to fight investors when they develop a powerful taste for risk. As Warren Buffett once said, "A group of lemmings looks like a pack of individualists compared with Wall Street when it gets a concept in its teeth."**

But in an overvalued market lacking trend uniformity, investors are skittish. The market may very well rally strongly for a while, but the underlying structure of the market is vulnerable. In that kind of environment, seemingly irrelevant items of news can cause large and sudden price declines. In historical data, we've seen too many examples of seemingly powerful bear market rallies suddenly launching into vertical declines.

One of the most striking examples was early 1930. Even after the 1929 crash, economists widely expected a business downturn to be avoided. After all, the Federal Reserve had slashed the Discount Rate four times in quick succession. This was one of the only occasions when stocks were at an above-average price/earnings multiple at the time of a fourth rate cut. Even then, the dividend yield on the S&P

was 3.9%. The market had advanced about 30% from its low, leading many observers to expect a resumption of the pre-crash bull market. Alan Abelson of *Barron's* reminds readers of the warnings published at that time: "public preference for stock is … as marked as ever", highlighted by "the prompt return of huge speculation, and the liberal manner in which current earnings are again being discounted." Within a few weeks, the U.S. dollar plunged, and with it both the economy and the stock market.

One may protest that surely the economic environment is different from 1930. True. They had electric power, radio, and the automobile as their "New Era" inventions. We have the internet - cable television with a mouse. Unfortunately, in the areas that matter - overvaluation, an emerging economic downturn roundly denied by economists, poor trend uniformity, and an unusual dependence on margin debt and corporate leverage, the early 1930's market has much in common with the present. That's not to say that we expect a depression ahead. But we do believe that the U.S. is already in recession, and that stocks remain in a bear market likely to generate much more serious losses.

Again, if the market can recruit sufficient trend uniformity, we will quickly establish a constructive position. Trend uniformity is not something that most investors consider, but it is critical, particularly when placed in the context of valuations. One very useful version of trend uniformity is “Dow Theory”, which most investors dismiss as antiquated, at their peril. The best Dow Theory analyst we know is Richard Russell (www.dowtheoryletters.com) who notes, “we now have a non-confirmation by the Transports, and the beginning of a breakdown in the Utility Average. These are both phenomena that are overlooked or ignored by most analysts, since the art or skill in ‘reading the averages’ seems to be lost today.” History indicates that these divergences are more important than investors realize.

Given that we have been defensive during the recent bounce, it is natural to ask why we don’t respond to shorter term moves - even ones that fail to establish uniformity. Wouldn’t it be better to be constructive during shorter term uptrends until they fail? Why can’t we be positively positioned both when trend uniformity is positive, *and also* when the market is in an “uptrend”? Unfortunately, trends are easy to identify in hindsight, but we’ve found no method to improve upon our existing models in *foresight*. The question presupposes that it is possible to identify short-term “uptrends” using some criteria that allows you to ride them higher, *on average*, without producing offsetting losses.

We actually went back over decades of history to check, using a wide range of variants to define an “uptrend”: the S&P above its 4-week, or 9-week, or 13-week moving averages, MACD criteria such as the 50-day moving average above the 89-day moving average, and a wide range of other alternatives. Unfortunately, no variant generated a higher return, or risk-adjusted return, either alone, or when combined with our existing model. Even the ones that allowed more participation in uptrends were failures in the sense that the extra returns gained by holding stocks were on average *less than the Treasury bill rate*. Indeed, the only change that has been essential to our trend models in recent years was to drop a “whipsaw” filter that prevented us from taking bullish signals in overvalued markets.

We are quite willing to be constructive if positive uniformity is restored here, but we simply will not substitute seat-of-the-pants trend-following methods without evidence they are profitable when used *consistently*.

Until trend uniformity is restored, we have a Market Climate characterized by extremely unfavorable valuations, unfavorable market action, and rising yields, including long-term interest rates. This is a combination that historically occurs only 4% of the time, but from which every major crash of note has emerged. Our investment position is not based on the expectation of a crash, however. We simply would not rule one out.

THE DATABANK

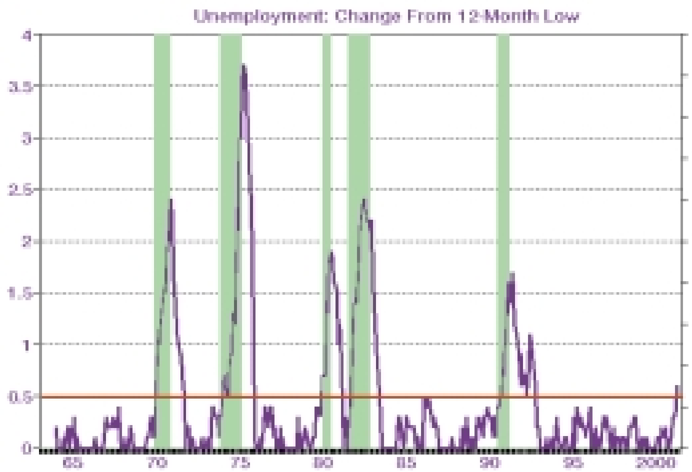
We believe that the U.S. economy is in a recession, which will ultimately be dated as beginning in the first quarter of 2001. The recent "advance" GDP estimate of 2% convinced investors and economists that a recession will certainly be avoided. Unfortunately, these advance estimates are subject to so much revision that 2% is easily within the range of error. In other words, it would not be surprising to see this figure revised to a negative rate of growth.

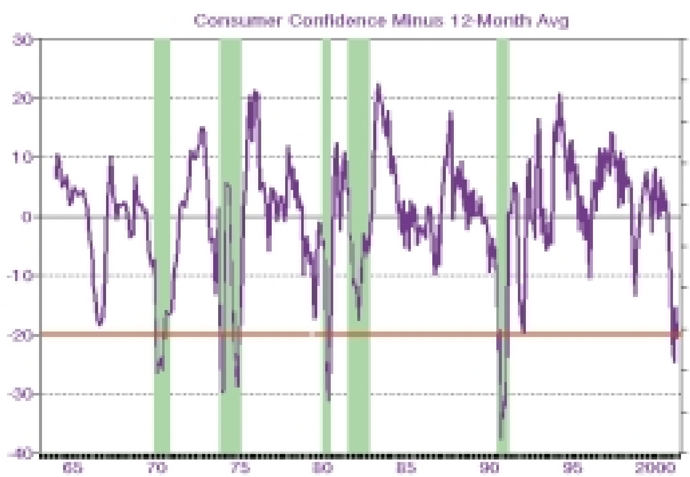
It is commonly thought that a recession is defined by two quarters of negative GDP growth. Just as it is commonly thought that a bear market is defined by a 20% market decline. Really, who thinks these things up? In both the economy and the market, downturns are identified not by a cookie-cutter definition, but by the depth and breadth of the damage. Technically, recessions are dated by the NBER Recession Dating Committee, headed by Dr. Robert Hall of Stanford University. The NBER sets the official start date of a recession only after a downturn well-recognized. It does not attempt to predict recessions, or to identify them in real time. Dr. Hall assures us that a recession is "defined" as "a period of significant decline in total output, income, employment and trade, usually lasting from six months to a year, and marked by widespread contractions in many sectors of the economy." In other words, a recession is defined by what might be called "negative trend uniformity" across a broad range of internals. That's exactly how we define bear markets. Currently, we have both.

In any event, the starting date of a recession is heavily influenced by the unemployment rate. **By the time that the three-month average unemployment rate has increased by 0.3% from its low, the economy has always been in an official recession. That event occurred in the March data. So regardless of the advance GDP number, we expect the recession start-date from the NBER to be March 2001 at the latest.**

Our Recession Warning composite first signaled an oncoming recession last September. As of April 30, that composite continued to give fresh signals. We use a wide range of other indicators to confirm a recession in progress. The three-month average unemployment rate is one of them. That average only needs to increase by 0.3% to warn. In contrast, the raw unemployment rate has to increase by 0.5% from its low in order to signal a recession. That signal occurred with the April unemployment rate. Unemployment has always soared once it crosses this threshold.

There is a whole laundry list of signals which have always and only emerged during recessions, and the best early-warning signals are already in place. For example, Consumer Confidence has never declined more than 20 points below its 12-month moving average except during recessions. Non-farm employment has never grown at less than 0.5% year-over-year except during recessions. The NAPM Employment Index has never declined below 40 except during recessions. The ratio of corporate bond yields to commercial paper yields (a measure of back-ended default risk) has never increased by 0.5 except during recessions. In short, on the basis of indicators that actually lead or quickly confirm a recession, there is already sufficient evidence to confirm a recession in progress.

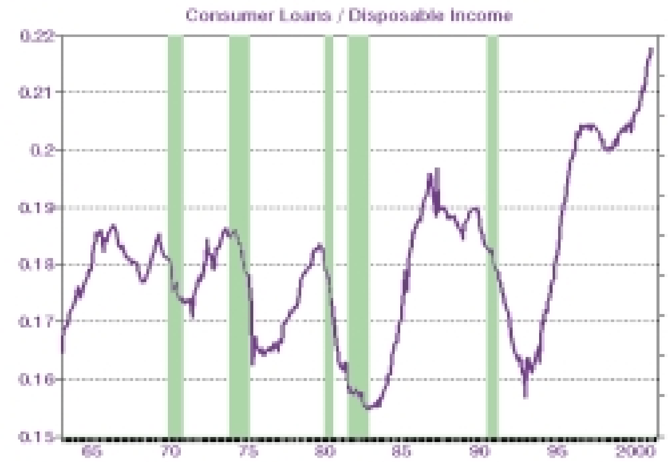




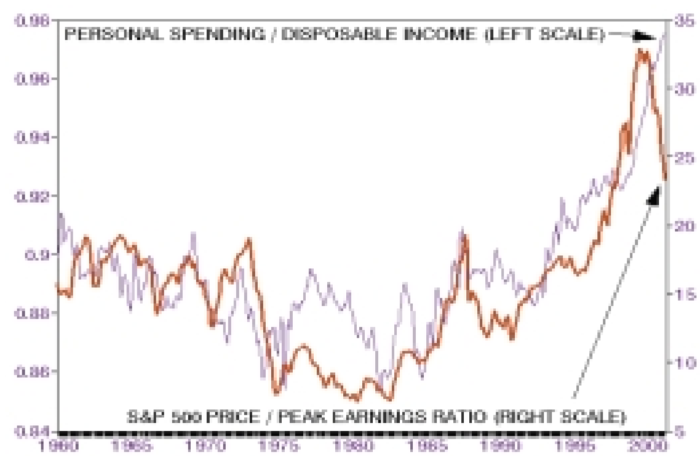
We have noted before that the current economic downturn is unusual in that it was not triggered by soft consumer demand. Instead, the frenzy for capital investment in recent years has resulted in overcapacity and a subsequent slump in new investment spending. The historical and international evidence is clear that such problems are not easily resolved through loose monetary policy. Encouraging more debt is not the solution to a debt frenzy gone bad, and it is virtually impossible to revive a "bubble" in capital spending.

Until recently, we believed that consumer spending was unlikely to slow precipitously, largely because nominal personal spending *never* declines on a year-over-year basis, even during recessions. The decline in output during a recession is typically just a runoff in inventory investment.

The current downturn is different not only because capital investment is weak, but also because consumers are borrowing more and saving less than at any time in history. While the Fed frantically cuts interest rates and loosens credit, it might be useful to ask "Do consumers *really* need more debt here?"



In the original version of this letter, we planned to include a graph of personal spending as a fraction of disposable income to show how little consumers are saving. Then we realized, "we've seen a graph like this before." Suddenly, the immediate danger to this economy became clear.



Here is your wealth effect. It turns out that there is an over 80% correlation between stock valuations and personal spending as a fraction of income. The two generally move together, but when they are out of sync, stock valuations lead changes in personal spending rather than the reverse. This effect is highly significant statistically. In the context of falling consumer confidence and rising unemployment, the sharp dropoff in stock valuations over the past year should be a source of great concern. We believe that personal spending is at risk of a steep retrenchment.

Note that this chart does *not* say that higher stock market wealth alone causes consumers to spend more of their income. When stocks and earnings grow at the same rate, the price/peak-earnings ratio does not change. **It is only when stock prices *outpace* their underlying earnings growth that consumers accelerate their spending, evidently because these *abnormal* capital gains convince them to save less out of income. When the assets fall, the debts remain, and consumers increase their saving.**

If capital spending is relatively healthy, more saving leads to more investment. So normally, when consumption slows, investment increases, and overall economic activity can stay firm. The problem is that capital spending is weak here, so the result is likely to be more “Keynesian” - a sharp drop in GDP. This is particularly likely because the U.S. slump is matched by weakness in Japan and Europe, the first time we’ve seen such a concerted downturn since 1974.

Consumers have mistaken their mountain of overvalued stocks as permanent assets, and have taken on a mountain of debt liabilities to match. Not a sound balance sheet.

The “bright” side? Greater U.S. saving coupled with weak domestic investment implies less reliance on foreign saving. So expect a stunning “improvement” in the trade deficit.

Can the Fed save us? Ask it another way. Can loose money and easy credit fix what loose money and easy credit has caused? We’re not optimistic. And we hope that we are profoundly wrong on that. If market action produces sufficient evidence that we’re wrong, we’ll simply miss a few percent in gains and we’ll move back to a constructive position. If we’re right, there will be far too much misery around us to go singing “I told you so.”

Unfortunately, when a recession accompanies a bear market in stocks, the bear market has never reached its low until the recession is well recognized in the popular press. Indeed, the typical headline not only recognizes the existence of a recession, but the probability that it will become much worse. The late-1974 headline "The Real Recession is Yet to Come" exemplifies the tone generally seen at bear market lows.

What we see instead is complacency. Indeed, the Wall Street Journal reports "Though economists are expecting this year to be the economy's worst since 1991, only a tiny percentage think the economy is in a recession." The WSJ view on the stock market is similar: "In the market-crash month of October 1987, stock-fund outflows equaled 3% of stock fund assets, according to the Investment Company Institute. In August 1990, stock-fund outflows amounted to 1% of assets. By contrast, February's outflow was equal to less than 0.1% of stock-fund assets. Maybe small investors have learned something over the years."

Or maybe the bottom isn't in.

THE OBSERVATION DECK

One of the most fascinating spectacles on Wall Street is the announcement of quarterly earnings. Lately, the reports sound roughly like this: "Last quarter, the company lost 37 gazillion dollars, but excluding this ordinary cost item here as 'extraordinary' (because it was so big), not counting the enormous cost of options we granted ourselves, overstating revenues because our lawyers assure us that jail time will be minimal if we're caught, and adding in the Gross Domestic Product of Belize (as we insist you should), our hypothetical pro-forma earnings actually beat drastically lowered analyst estimates by a penny."

You can be certain that the analysts who cheer these announcements are unwashed by even a droplet of investment education. The price of any stock is not based on a single quarter of earnings, but on a properly discounted stream of future "free cash flows" (earnings that can actually be distributed to shareholders or used to buy back stock after all capital investments are made for growth). A single quarter is relatively unimportant, unless the results of that quarter call the assumed *long-term* growth rate of earnings and cash flows into question. And that's exactly why recent earnings reports are so disturbing.

For valuation purposes, sustainable growth figures should be estimated not from past growth, but from *drivers* of growth such as sustainable return on equity, the fraction of earnings plowed back into new investments, and other factors. Growth attributable to acquisitions should *never* be the rate plugged into a valuation formula, or compared to a P/E.

It is very difficult to obtain either theoretical or actual long-term growth beyond about 15%, even for very profitable companies. As Warren Buffett notes, "Examine the record of, say, the 200 highest earning companies from 1970 or 1980 and tabulate how many have increased per-share earnings by 15% annually since those dates. You will find that only a handful have. I would wager you a very significant sum that fewer than 10 of the most profitable companies in 2000 will attain 15% annual growth in earnings-per-share over the next 20 years." Of course, investors *are* making this bet. The facts already suggest they’re wrong.

- John P. Hussman, Ph.D.

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