HUSSMAN
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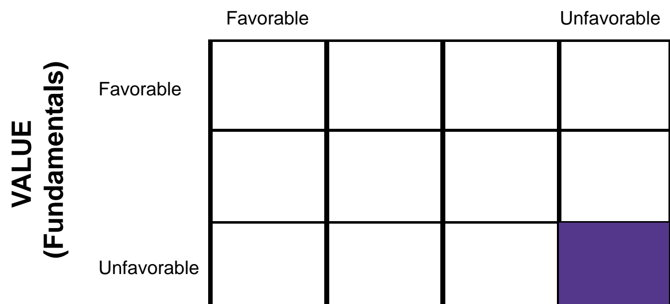
MARKET CLIMATE

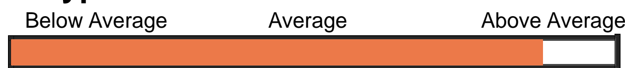
The current profile of valuation and trend uniformity

UNIFORMITY (Prices, Breadth, Yields)



Typical Market Return in this Climate

Typical Market Risk in this Climate



"Troubled commercial & industrial loans continue to grow. Narrower net interest margins (for the sixth consecutive quarter) hurt bank profits. Provisions for loan losses continue to rise, particularly at large banks, in response to increasing levels of troubled loans to commercial borrowers. Loan losses continued to rise in the first quarter. Banks charged-off $7.0 billion in bad loans during the quarter, an increase of $1.9 billion (38.1 percent) from the same quarter in 2000. The deterioration was concentrated among larger banks. Even with the increase in charge-off activity, noncurrent loans -- loans 90 days or more past due or in nonaccrual status -- continued to increase as well. Banks' reserves for losses increased by only $580 million (0.9 percent) during the quarter. This was enough growth to keep pace with sluggish loan growth, but it fell short of the increase in noncurrent loans."

- FDIC Preliminary Bank Earnings Report, June 7, 2001

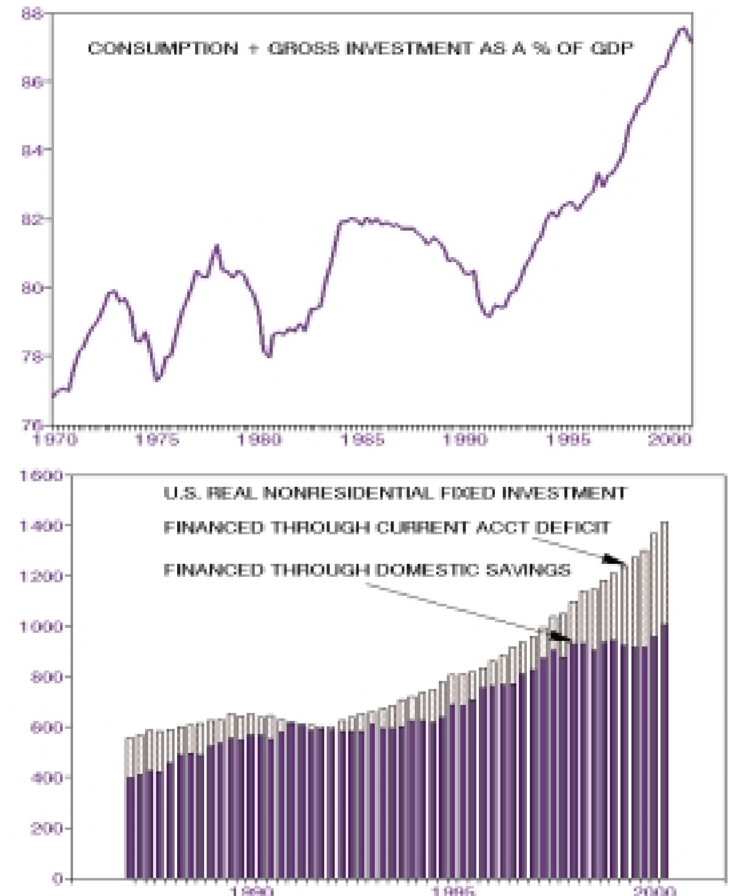
"We are fortunate that our banking system entered this period of weaker economic performance in a strong position."

- Alan Greenspan, June 20, 2001
After suspected exposure to potent hallucinogens.

THE TICKER

The U.S. economy currently has two layers. The key distinction is not "old" versus "new economy." Rather, the distinction is "core" versus "bubble economy." The core economy represents the sustainable bulk of economic activity, and is likely to enjoy real growth of about 2.5-3.5% annually over time, or about 5-6% in nominal terms. Since earnings are a relatively stable fraction of GDP over time, that same 5-6% nominal growth can also be expected for earnings over the long-run. Indeed, over the past 10, 20, 50 and 100 years, S&P 500 earnings have been well contained within a 6% annual growth channel connecting peaks to peaks and troughs to troughs.

Few recessions make a dent in the core economy. Most produce a total loss of only 1-2% in real GDP. Unfortunately, laid over this core, the U.S. has a "bubble economy." This portion of activity has been driven by a binge in consumption and a frenzied buildout of capacity. The financing for this boom has been dependent on an explosion of low-quality bank credit, and a massive import of foreign capital, which we observe as record trade and current account deficits.

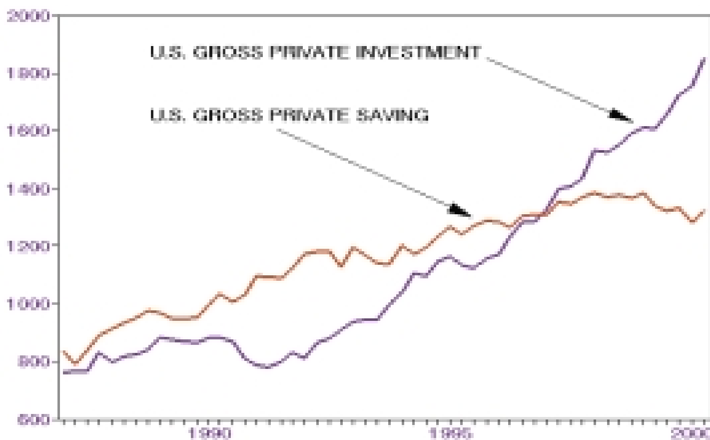


This over-leveraged layer of the economy has grown quite large. Investors have mistaken it as sustainable, and view current difficulties as a mere "speed bump" along a relentless path of exponential growth. In effect, investors believe that the current downturn will be quickly resolved by a return to rapid earnings growth. They continue to price stocks on expectations of 20-30% annual growth in the tech sector.

Much of the hope for future earnings can be traced to the belief in a New Era of productivity growth. A closer look reveals two difficulties. First, the entire increase in measured productivity since 1995 has occurred within the computer and information technology sectors.

As we noted in our November 2000 issue, this apparent growth is largely an artifact of "elastic supply" in these industries, and the productivity numbers can easily turn sharply negative as demand for such technology slows. Indeed, first quarter productivity growth was revised to negative levels, and we expect the same for the second and third quarters. Outside of the I.T. sector, measured productivity growth since 1995 has been negative.

Second, while measured labor productivity has improved in recent years, "total factor productivity" has declined significantly. This illustrates what economists call "declining marginal product of capital." As more and more capital is put into use, the productivity of new capital tends to be lower than what is already in place. So labor is more productive because it has more capital to work with, but investment in new capital is producing diminishing returns. In short, the apparent "productivity boom" derives from an increase in the quantity of capital, at the expense of quality, and at the consequence of untenable debt burdens.

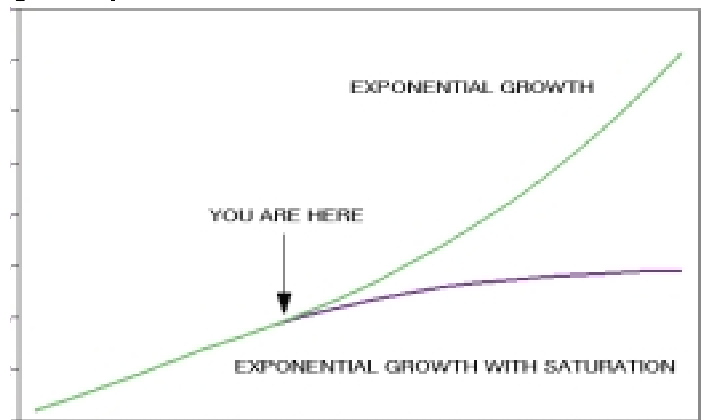


With companies carrying very high debt loads, private saving woefully inadequate, and our dependence on foreign capital at unsustainably high levels, we believe that a resumption of the recent capital spending frenzy is extremely unlikely. With consumers carrying similarly high debt loads, we also doubt that consumer borrowing will increase much. In this environment, the repeated attempts by the Federal Reserve to increase bank lending are likely to have little impact on investment and consumption spending.

Our view is that the current downturn represents not a speed bump, but an "inflection point" - the point which separates a period of rapid growth from a period of slower growth, saturation, and deleveraging. Indeed, for industries such as telecom, the "high-water mark" of recent activity may not be surpassed for years.

The record of every major industrial boom demonstrates that new technology has a familiar pattern of growth. Growth is extraordinarily rapid as the technology is initially adopted. During this period, the path is indistinguishable from an ever-increasing exponential curve. That's what technology investors came to believe in recent years. But ultimately, as expansion plans are completed and customer markets become saturated, growth hits an "inflection point" and slows down dramatically. That's where we are now.

Unless investors anticipate saturation, it is tempting to assume that growth will remain on an exponential path forever. And it is tempting to assume that the inflection point is simply a "stumbling block" along that path. If stocks are priced on the basis of these expectations (as internet stocks were), the resulting overvaluations can be profound. Unfortunately, the inflection point is followed by steady disappointment, as a yawning gap emerges between the imagined exponential growth path and the actual one.



The core economy will remain, even grow, but we expect continued difficulty in the "bubble economy." The amount of froth in this "bubble" layer is enough to produce a deeper-than-average economic downturn as it recedes. It is enough to produce bank credit problems similar to the S&L problems of the past decade. We hope that we are stunningly wrong about this, and regret the continuing need to take such a dour view. But what separates us from other analysts is an unwillingness to substitute glib optimism for evidence. The repeated lip-service calling an end to this economic downturn without evidence reminds us of J.K. Galbraith's account of similar hopes at another point in history:

"In March 1930, following a flood of optimistic forecasts by his subordinates, President Hoover said that the worst effect of the crash upon unemployment would be ended in sixty days. In May Mr. Hoover said he was convinced 'we have now passed the worst and with continued unity of effort shall rapidly recover.' Toward the end of the month he said that business would be normal by fall. The Harvard Economic Society stated on May 17, that business 'will turn for the better this month or next, recover vigorously in the third quarter and end the year at levels substantially above normal'; on June 28 it stated that 'irregular and conflicting movements of business should soon give way to sustained recovery'; on November 15 it said 'we are now near the end of the declining phase'; a year later, it said 'stabilization is clearly possible'…"

As noted in our May issue, the most reliable early-warning indicators have already moved to levels always and only seen during recessions. Ultimately, we expect the NBER Recession Dating Committee to confirm that a recession started during the first quarter of 2001. The fact that GDP growth was slightly positive during the first quarter does not change this assessment. The NBER typically pegs the start date based on peaks in employment, industrial production and trade. It is a fairy tale that two quarters of declining GDP growth are necessary or sufficient to identify a recession.

We expect a significant further slowdown both in capital investment and in consumer spending ahead. The recent weakness in consumer and retail stocks is not encouraging, as it suggests softer consumer demand ahead. The sharp falloff in “help wanted” advertising also indicates that new hiring is likely to absorb fewer displaced workers, suggesting a further rise in unemployment.

THE DATABANK

With the S&P 500 P/E still at 27, there is no evidence that the market weakness over the past year has wrung much froth from the stock market. Certainly, the garbage internet stocks have plunged, but valuations remain extreme by any measure, particularly for large-cap growth stocks.

Consider the most liquid 3000 stocks in the market, and separate them into groups of 300 according to size. You will find that valuations such as price/revenue and price/earnings ratios are actually fairly reasonable except for the largest two groups. Yet these 600 stocks account for about 85% of the total market capitalization of the market. They are priced at extreme valuations, because investors have assumed implausibly high future earnings growth for these companies. We expect that over the coming year, a yawning gap will emerge between actual earnings, and the path required to justify current stock valuations.

Unless trend uniformity recovers, this relentless disappointment is likely to produce a continued bear market ahead. Moreover, the stocks that dominate the S&P 500 are priced at levels which imply returns below the Treasury bill yield over the coming decade. Indeed, 6% annual S&P 500 earnings growth, combined with still-extreme P/E of 20 a decade from now, would produce this result.

For anyone with a sense of market history, there is little to like about the S&P (particularly given poor trend uniformity). We feel like Bernard Lasker, NYSE Chairman in 1972, who remarked before the S&P dropped in half: "I can feel it coming… all the familiar stages in order - blue chip boom, then a fad for secondary issues, then an over-the-counter play, then another garbage market in new issues, and finally the inevitable crash. I don't know when it will come, but I can feel it coming, and damn it, I don't know what to do about it."

In short, the overwhelming majority of dollar losses in the stock market ahead will be suffered by large-cap growth stocks. That said, we do not expect smaller value stocks to post strong relative performance overnight either, but we do believe that over the next decade, the bulk of capital appreciation opportunities will be found in the broad market, not in the narrow list of glamour stocks which are the obsession of investors here.

It is important to note that while our current investment position is consistent with these views, it is not tied to them. Our market position is based not on forecasts or opinions, but on the objectively identified Market Climate (valuation and market action) prevailing at any given point in time. Currently, this climate is on a Crash Warning, defined by extremely unfavorable valuations, poor trend uniformity across internal market action, and hostile interest rate trends, particularly in long-term interest rates. Historically, market risk has produced a poor expected return in this environment, so we are defensive. No elaborate forecasts or opinions are required. The current action of the market is sufficient to keep us defensively positioned.

THE OBSERVATION DECK

The amount of disappointment ahead has no doubt been increased by the creative accounting in recent years, designed to boost reported earnings. As Burton Malkiel wrote in 1973 about the late-60’s “Go-Go” market:

"Part of the genius of the financial market is that if a product is demanded, it is produced. The product that all investors desired was expected growth in earnings per share. And if growth wasn't to be found in a name, it was only to be expected that someone would find another way to produce it. In fact, the major impetus for the conglomerate wave of the 1960s was that the acquisition process itself could be made to produce growth in earnings per share. Indeed, the managers of conglomerates tended to possess financial expertise rather than the operating skills required to improve the profitability of the acquired companies. By an easy bit of legerdemain, they could put together a group of companies with no basic potential at all and produce steadily rising per-share earnings. The trick that makes the game work is the ability of the [conglomerate] to swap its high-multiple stock for the stock of another company with a lower multiple."

Now compound this "growth" through acquisitions with aggressive dilution of shareholder interests through option grants to employees and executives, while simultaneously using the tax benefit from those option transactions to boost retained earnings. Then meet your earnings targets by repeatedly excluding "extraordinary losses" (as if this turns them back into cash), including gains in employee pension accounts as "income", and inflating revenues through "vendor financing" to customers without a shred of creditworthiness. Congratulations, you're now a Nasdaq 100 company.

As we've repeatedly noted, when you buy a stock, you buy one thing only: a stream of future free cash flows. You do not get reported earnings. You only have a claim on what's left after everything else needed to run and grow the business is deducted. New capital investment for growth, over and above what is required to replace depreciated capital, gets deducted. Increases in required working capital (inventories, receivables, etc) get deducted. To be accurate, the value of stock issued to employees and management through options grants (over and above paid-in strike prices) should also be deducted.

For many companies, nothing actually remains after these deductions. When free cash flow is likely to remain negative for the foreseeable future, you have a garbage stock. Most

of the dot-com companies were garbage stocks from the instant they were issued to investors. And even after their recent decline, most glamour technology stocks are priced at levels that cannot be reconciled with cash flow analysis without assuming ridiculously high future growth rates. We believe that this matters, and that these stocks will trade down to more reasonable values.

The question then becomes, "What is a reasonable value for a technology stock?" A proper answer would be framed in terms of cash flows, market saturation, investors' required rate of return, duration of competitive advantage, and other factors. But the fact is that most investors consider nothing but the P/E. So our assertion is this. **Except when a company is expected to multiply its earnings *several-fold* in the next few years, the P/E ratio for a technology stock should generally not be significantly higher than the P/E ratio for the overall market.**

The reasons are simple. Technology is cyclical. It is subject to rapid obsolescence and saturation. Tech companies require much heavier capital spending outlays, and cartoonish increases in working capital as they grow. Tech companies also have an irritating habit of diverting shareholder value to management and employees through option grants and other "incentive" programs. In some cases, these grants are so large that the *tax benefits alone* exceed reported earnings. So technology earnings typically translate into minuscule amounts of free cash flow. And while earnings growth in some years can be very rapid, the sustainable horizon for this growth is much shorter than for the typical blue-chip company. If you look at S&P 500 technology companies, you will find that they have historically averaged a P/E ratio of 17, compared to an average P/E of 14 for the S&P 500 as a whole. In our view, this is about right.

This from Cisco Systems' latest 10-Q filing:

"The company's income taxes currently payable for federal and state purposes have been reduced by the tax benefits of employee stock option transactions. These benefits totaled $705 million and $930 million in the first nine months of fiscal 2001 and 2000." Cisco's net income for the nine months ended April 29, 2000 was $1,872 million. Net *loss* for the nine months ended April 28, 2001 was $1,021 million. Add it up.

The only thing that gives such enormous value to companies like this is ignorance.

That said, we paid a P/E multiple of 35 for Cisco Systems in 1991. But we were willing to pay a P/E of 35 because that P/E was on *emerging* earnings, rather than mature earnings. Indeed, earnings and revenues were expected to triple over the following 1-2 years, and given that the networking market was not at all saturated, such growth prospects were very reasonable. The company also had not yet demonstrated its unethical habits of managing earnings and diluting shareholder interests. After we sold the stock, it underperformed our replacement stock selections until 1998, when it launched into a bubble. Yet despite the recent plunge from 82 to 17, we still wouldn't touch Cisco with a pole. In general, mature tech companies rarely warrant above-market P/E multiples. **The disappointment of technology investors will not be complete until they are fully disabused of the notion that tech stocks inherently deserve premium P/E multiples.**

In short, when you buy a stock, the property you own is a future stream of cash flows. There are many reasonably priced stocks in the market, but they are generally not the ones that dominate the S&P or the Nasdaq. These indices are not at current valuations because of sober analysis of fundamentals, but because of thinly supported hope for future gains. As Galbraith remarked about the 1929 peak:

"At some point in the growth of a boom all aspects of property ownership become irrelevant except the prospect for an early rise in price. Income from the property, or enjoyment of its use, or even its long-run worth is now academic. What is important is that tomorrow or next week market values will rise - as they did yesterday or last week - and a profit can be realized."

If trend uniformity were favorable, we would be willing to take on at least some market risk in order to speculate on such gains. But without trend uniformity, and with long-term interest rates in a rising trend, we have the most hostile of all investment climates. Our views about the economy and the market are intended to provide context and texture. But in the end, all we need to know here is that the current, objectively identified Market Climate is defensive.

- John P. Hussman, Ph.D.

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