



INVESTMENT RESEARCH & INSIGHT

VOLUME 2

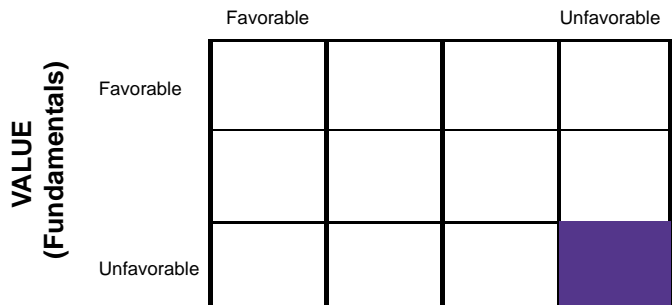
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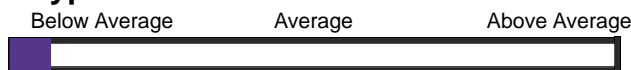
MARKET CLIMATE

The current profile of valuation and trend uniformity

UNIFORMITY (Prices, Breadth, Yields)



Typical Market Return in this Climate



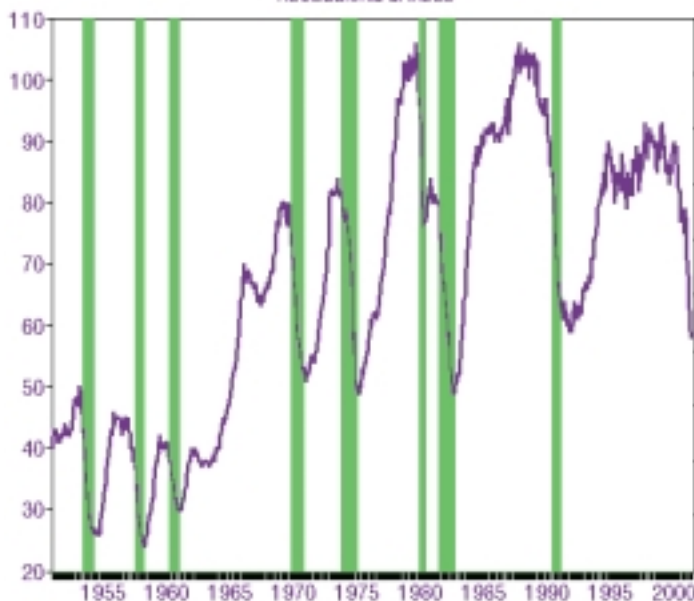
Typical Market Risk in this Climate



JUST FOR KIDS

Draw in the missing recession.

HELP WANTED INDEX
RECESSIONS SHADED



THE TICKER

The Federal Reserve is irrelevant. We don't just mean ineffective, though that is certainly likely to be true here. Rather, because of a change in the application of reserve requirements over the past decade, Fed actions have virtually zero impact on lending activity in the U.S. banking system.

The U.S. economy continues to generate signals that have always and only emerged during recessions. We believe that a U.S. recession is currently in progress, which will ultimately be dated by the NBER as beginning sometime during the first quarter of 2001.

With regard to the stock market, the S&P 500 Index could still fall by half without breaching even median historical valuations. Indeed, based on our internal free cash flow calculations, we arrive at the following target valuations for some of the largest blue chips:

| | | |
|--------------------------|-------------|-----------------------------|
| General Electric: | \$24 | (recent price \$42) |
| Microsoft: | \$34 | (recent price \$61) |
| Pfizer: | \$24 | (recent price \$41) |
| Wal-Mart: | \$32 | (recent price \$50) |
| AOL-Time Warner: | \$23 | (recent price \$40). |

Pressure on profit margins is still very strong, owing to the effect of rising wage and benefits inflation combined with falling producer prices. Last year, we argued that the main danger to the markets would be the combination of overvaluation and relentless erosion of profit margins.

Over the coming year, margin pressure will continue, but it will be overtaken by a new concern: debt. The economy remains overleveraged at both the business and consumer level, and credit quality is deteriorating rapidly. Heavy debt loads combined with pressure on incomes create significant default risk, which remains poorly recognized. Indeed, with little fanfare, U.S. bankruptcies reached an all-time high in the second quarter.

On the basis of measures such as price/revenue, price/book, price/cash flow and price/dividends, the S&P 500 currently trades at nearly three times median historical multiples. On the basis of earnings, the current P/E ratio of 26 is only about twice the historical norm. Evidently, earnings remain elevated compared to other fundamentals. We observe this as high profit margins (earnings/revenue), high return on equity (earnings/book), and low payout ratios (dividends/earnings), compared to historical norms. Don't take them at face value. The Wall Street Journal explains why:

"In recent years, P/E ratios have become increasingly polluted. The 'E' in P/E used to refer simply to earnings as reported under generally accepted accounting principles, or GAAP. That's what it means when the historical average is

cited... Increasingly, companies are steering investors away from their actual earnings and toward some other numbers. Most common is 'operating earnings.' Another name for that is 'pro forma,' or 'as if,' earnings. Such earnings figures typically are higher than net income, because the companies label certain expenses as 'special' or 'one-time' or 'exceptional' or 'non-cash' - and leave them out of the calculation... Based on earnings as reported under GAAP, the S&P 500 actually finished last week with a P/E ratio of 36.7, according to a Wall Street Journal analysis. That is higher than any other P/E previously recorded for the index. This suggests the overall stock market could be further from recovery than many suppose."

In short, the stock market remains strenuously overvalued, in the context of a still unrecognized economic recession, an ineffective Federal Reserve, and market action displaying very poor "uniformity" (the main factor which might otherwise allow an overvalued market to ignore valuations and sustain a favorable trend). Again, while overvaluation does not require prices to decline in the near term, the current lack of favorable trend uniformity invites the possibility of a 50% plunge in the major indices from current levels, even without breaching historical valuation norms.

Frankly, we doubt that valuations will be corrected in one single plunge. Rather, a return to reasonable valuations will probably occur over a series of market cycles. This is not of much comfort to buy-and-hold investors, but it can benefit our approach of *selectively* taking market risk when valuations are depressed or trends are uniformly favorable, and selectively avoiding market risk when neither is true.

Even taking current S&P 500 earnings at face value and assuming that they continue to grow along the peak of their long-term 6% growth channel, a P/E ratio of 14 even a decade from now would imply zero price growth over the next 10 years. So as in 1929 and 1965, the overvaluation of the market is a long-term problem.

We realize that these are not mainstream views. But then, we are comfortable with unconventional views if they are backed up by careful research and historical data. In the April 2000 issue of Hussman Econometrics, we wrote "In recent months, we have made the rather bizarre assertion that the Nasdaq is likely to lose between 65% to 83% of its value from its recent highs to its ultimate bottom."

In August 2000, we wrote "One of the hard lessons that investors will learn in the coming quarters is that technology stocks are actually cyclicals. We are anticipating a plunge of 20% or more in the earnings of S&P technology stocks in the coming quarters."

A month later, with consensus economic forecasts unanimously optimistic, we wrote "This month, market action produced a recession warning. Since S&P 500 profits are generally quite cyclical, the overall impact of increased labor costs, slowing capital growth, and reduced profit margins is likely to be a sharp and largely unexpected deceleration of earnings."

In January of this year, we noted that if the glamour tech stocks were merely to revisit their *median* price/revenue ratios during the 1991-99 *bull market* run (without even attaining bear market valuations), Cisco would trade at 18.75, EMC at 10.50, and Sun at 4.50 and Oracle at 6.88.

Recent prices: Cisco 16.48 - down from 40.37 in January, EMC 15.50 - down from 77.31, Sun 13.68 - down from 30.88, and Oracle 14.64 - down from 34.56.

Based on more detailed analysis of free cash flows, we arrive at fair values of about \$7 per share for Cisco, \$11 for EMC, \$8 for Sun and about \$7 for Oracle, which gives you some idea of what we think about tech valuations.

As we always emphasize, overvaluation simply implies unsatisfactory long-term returns. It does not imply that prices must fall in the short term. Indeed, overvaluations - even extreme ones - can be sustained for years. When market trends are uniformly favorable across a wide variety of internals (small stocks, large stocks, utilities, financials, transports, retail, breadth, corporate bonds, Treasuries, etc), overvaluation exerts very little influence on market direction. Unfortunately, the market continues to display poor trend uniformity.

When overvaluation is combined with poor trend uniformity and rising yield trends (e.g. on long-term bonds and utilities), valuations can matter with a vengeance. We identify this combination as a Crash Warning. Not every Crash Warning results in an actual crash. But every historical crash of note has emerged from this one set of conditions.

If the market can recruit favorable trend uniformity, we will establish at least a modestly constructive position regardless of valuations. For now, however, current market conditions keep us very defensive. No forecasts are required.

ECONOMIC PERSPECTIVES

Back to our assertion that the Fed is irrelevant to the economy. **First off, the main job of the Federal Reserve is to determine the mix of government liabilities held by the public.** When the Fed "eases monetary policy" or "cuts interest rates", it accomplishes this as follows. The Fed goes into the open market, buys a bunch of Treasury securities from banks (who have drawers full of them), and pays for them by creating new bank reserves.

Pull a dollar bill out of your wallet. Look at the very top line on the front. It says "Federal Reserve Note." That dollar bill is essentially a liability of the Federal Reserve. The Fed also has a corresponding asset - the Treasury securities it buys. **When the Fed "cuts interest rates", what it is really doing is replacing one government liability held by the public - Treasury securities - with another government liability: currency and bank reserves (monetary base). That's all the Fed does. It determines the mix - but not the total amount - of government liabilities held by the public.** Since the operations of the Fed are executed by buying or selling securities on the open market, the group at the Fed responsible for these decisions is called the Federal Open Market Committee, or FOMC.

Banks are required to hold reserves as a percentage of all *checking accounts* outstanding. These reserves prevent overdrafts, and provide for day-to-day withdrawals of currency and the like. On any given day, some banks will have a reserve shortfall, while others will have excess reserves. These excess bank reserves are lent back and forth between banks on an overnight basis, at an interest rate known as the Federal Funds Rate.

Essentially, the Fed lowers the Federal Funds rate by purchasing Treasuries from banks and increasing the "monetary base" - bank reserves plus currency in circulation.

The only thing that the Fed can control with certainty is the monetary base. Alternately, it can *try* to control the Federal Funds rate (and passively adjust the monetary base by whatever amount is required to keep Fed Funds on target). However, the Fed cannot control the Federal Funds rate with certainty. For example, if inflationary pressures were high and interest rates were moving up, the Fed could not predictably lower the Fed Funds rate by easing monetary policy. Not surprisingly, central banks always target money growth, not interest rates, when inflation is high. That's why Volcker targeted money supply, while Greenspan targets interest rates. But ultimately, the only thing that the Fed can directly control is the monetary base.

Alright. So when the Fed is easing, it increases the monetary base by purchasing Treasuries on the open market. When the Fed is tightening, it reduces the monetary base by selling Treasuries on the open market. Now that we're clear on what the Fed does, let's take a look at why it is irrelevant.

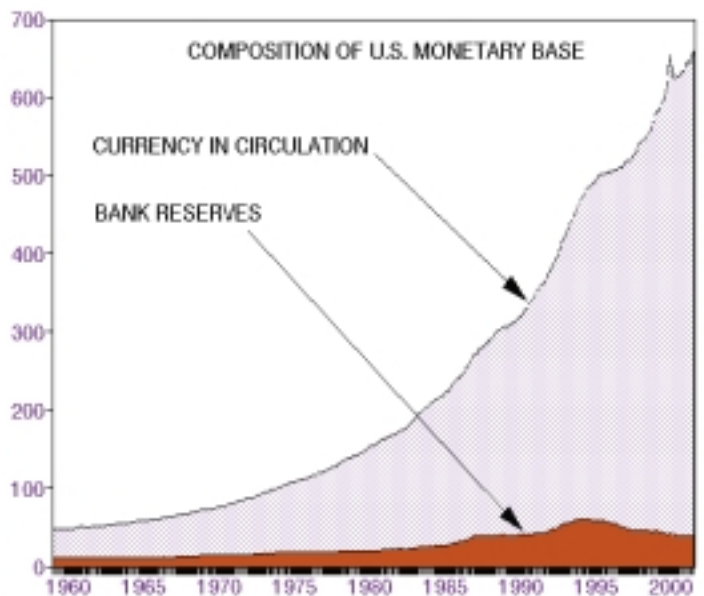
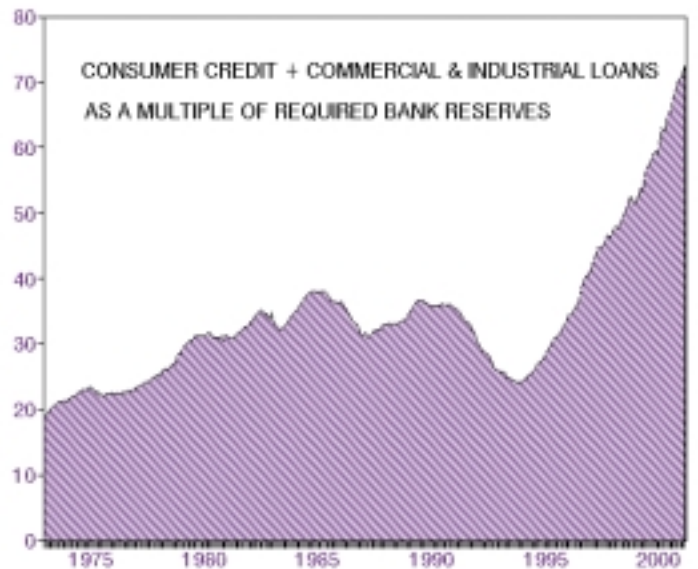
Activist monetary policy is based on the assumption that there is a predictable relationship between bank reserves and bank lending. The operative notion of easy money is that the Fed creates new bank reserves, and banks lend them out. These loans get spent, and the proceeds get deposited at other banks as new checking accounts. Whatever is not required to be held as reserves is then lent out again, and through the magic of the "money multiplier", loans and bank deposits go up by many times the initial injection of reserves.

That's the theory. But a change came in the 1970s with the emergence of money market funds, which require no reserve requirements. Then in the early 1990s, reserve requirements were dropped to zero on savings deposits, CDs, and Eurocurrency deposits. **At present, reserve requirements apply only to "transactions deposits" - essentially checking accounts. The vast majority of funding sources used by banks to create loans have nothing - *nothing* - to do with bank reserves.**

These days, commercial and industrial loans are financed by issuing large denomination CDs. Money market deposits are largely used to lend to corporations who issue short term commercial paper. Consumer loans are also made using savings deposits which are not subject to reserve requirements. These loans can be bunched into securities and sold to somebody else, taking them off of the bank's books.

The point is simple. Commercial, industrial and consumer loans no longer have any link to bank reserves. Since 1995, the volume of such loans has exploded, while bank reserves have actually declined. Look at the one monetary aggregate that the Fed can directly control - the monetary base. Every bit of increase since January 1994 is accounted for by currency in circulation, *not* bank reserves.

Over the past year, the Fed has eased very aggressively, buying about \$32 billion in Treasuries, with a corresponding \$32 billion increase in the monetary base. Now look closer. Total bank reserves actually *declined* by \$1 billion while currency in circulation has increased by \$33 billion.



Alan Greenspan isn't the "Maestro". He's Oz. A guy behind some curtains, shouting into a microphone, pressing buttons that blow smoke and fire, but having no power at all. Scarecrow already *has* a brain. For the past several years, commercial and industrial loans and consumer credit exploded quite simply because rabidly eager borrowers were able to find rabidly eager lenders. And now, both forms of credit (as well as commercial paper issuance) are declining because borrowers are saturated with debt and lenders are increasingly skittish of credit risk.

The Fed certainly played an important *psychological* role in recent years, and *certainly* has a role to play during bank runs and other crises where the demand for monetary base soars. But the rest of the time, open market operations are almost completely sterile. In recent years, the irrelevance of open market operations has also been argued (for slightly different reasons) by academic economists renowned for their work in the theory of "rational expectations", including Thomas Sargent and John Muth.

One might respond that even if the Fed doesn't affect credit, surely changes in the monetary base affect inflation. But if you look at the statistical evidence, the relationship between monetary growth and inflation is very weak. Instead, our research indicates that *inflation is primarily the result of growth in unproductive forms of government spending* (basically entitlements and other expenditures that fail to stimulate the supply side). The evidence both from the U.S. and other countries clearly demonstrates this relationship.

As Milton Friedman has noted, the burden of government is not measured by how much it taxes, but by how much it spends. The impact is particularly severe when growth in entitlements is high and growth in productivity is low. This is why inflation exploded after the late 60's, and why it came down after the early 1980's. This is why the Germans suffered hyperinflation after World War I when its government decided to keep paying workers who had gone on strike.

Always and everywhere, rapid inflation is produced by excessive creation of government liabilities without a corresponding increase in the amount of goods produced by the economy. The Fed doesn't control this. It doesn't even matter much what form the liabilities take. If the Germans had decided to issue bonds to striking workers instead of money, bond prices would have been driven to ridiculously low levels, driving interest rates to extremely high levels, creating an unwillingness to hold non-interest bearing money, resulting in a rapid deterioration in the value of money, and hyperinflation just the same.

Except for the Federal Funds rate, the Fed does not determine short-term interest rates. Most of the time, it simply follows them. Statistically, the Federal Funds rate consistently lags market interest rates such as Treasury bill yields. Indeed, changes in market rates have far more predictive power to forecast the Federal Funds rate than vice versa.

The main exception is the Prime Rate. Banks change the Prime Rate following Federal Funds rate changes largely because competition forces equality of lending rates, the Fed Funds rate tracks other short term rates, and changing Prime in unison at any other time than a discrete Fed move would be considered evidence of collusion among banks.

So forget about the Federal Reserve. Again, in a banking panic, where the demand for the monetary base soars, the Fed is essential. But here and now, the Fed is, and probably will be, hopelessly ineffective. We continue to believe that the U.S. economy is in a recession that will ultimately be dated as starting some time in the first quarter of this year.

In his recent testimony to Congress, Alan Greenspan described his job as difficult. In our view, he might as well have quoted Prime Minister Giovanni Giolitti. When asked in the early 1900's whether it was difficult to govern Italy, Giolitti replied, "Not at all, but it's useless."

With the economy responding little to interest rate cuts, there is widespread hope that the recent tax rebates will stimulate the economy. Here again, one has to think in terms of government liabilities to understand why this is a sterile policy. Without changes in government spending, a tax rebate increases the amount of cash held by the public, but simultaneously requires the government to borrow an identically offsetting amount (or retire less debt than it would otherwise). This is a wash. Moreover, since the tax rebates are based on income levels, the bulk of these rebates are going to individuals who have the highest propensity to save. In essence, all that happens is that the government issues more bonds, and then gives the money to individuals who, in equilibrium, must buy those bonds.

In general, the proper tax policy in a recession is to change tax rates in a way that stimulates investment. The problem here is that we've already got a glut of capacity. With the saving rate already close to zero, debt levels untenable, and a fiscal surplus which will disappear during this economic downturn, there is little hope for a spending stimulus. As we noted in the last issue, the vast core of this economy will remain unharmed, but there is a "bubble" layer - a few percent of the economy, which was an unsustainable, one-time capital spending binge. Most recessions represent only a 1-2% decline in real GDP. As that bubble layer vanishes, the U.S. economy is likely to experience a deeper than average recession. This is simply unfortunate.

Best wishes,

John P. Hussman, Ph.D.

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