HUSSMAN

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MARKET CLIMATE

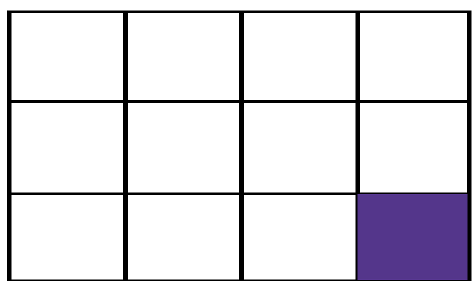
The current profile of valuation and trend uniformity

UNIFORMITY (Prices, Breadth, Yields)

Favorable — Unfavorable

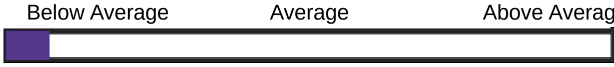
VALUE (Fundamentals)

Favorable — Unfavorable



Typical Market Return in this Climate

Below Average — Average — Above Average



Typical Market Risk in this Climate

Below Average — Average — Above Average

"I can remember having shorted stocks early in December 1929 after having completed a satisfactory short position in October. When the slow but steady advance in January and February carried above the previous high, I became panicky and covered at a considerable loss. I forgot that the rally might normally be expected to retrace 66% or more of the preceding downswing. Nearly everyone on Wall Street was proclaiming a new bull market. Advisory services were extremely bullish and the upside volume was running at the peak in 1929."
- Robert Rhea, The Story of Market Averages, 1934

DJIA bull market peak 9/3/29: 381.20
Low of 1929 crash 11/13/29: 198.70
Recovery high 4/17/30: 294.10
Bear market low 7/8/32: 41.20

We're not suggesting a replay of 1929-32, but there have been many instances of substantial rebounds from deeply oversold bear market troughs, followed by further plunges, continued recessions, and deeper lows. This is simply the worst example. The 1929-1930 period held the previous record for consecutive Fed easings, also with no apparent impact. There were 5 advances of well over 20% on the way to the final low.

*Weekly market commentary and updates are available on the Research & Insight page of **www.hussman.net**. Current and back issues of Hussman Investment Research & Insight (PDF format) are also available for download. There is no charge for these updates.*

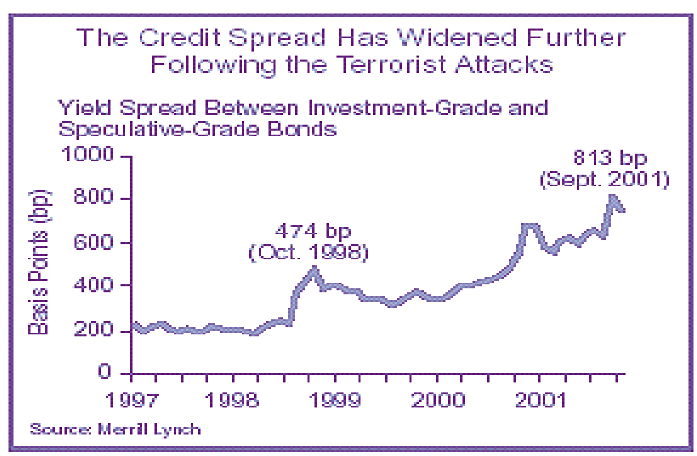
THE TICKER

"A high degree of leverage among consumers and businesses alike raises concerns about their vulnerability to a slowing economy. The ratio of corporate debt to cash flow reached an historic high of 655 percent in second quarter 2001. As cash flow weakens during a slowing economy, highly leveraged businesses may experience greater difficulty in servicing debts. A high level of consumer indebtedness also leaves the consumer sector vulnerable in an economic environment that is characterized by rising unemployment, weaker real personal income appreciation, and lower asset values."
- FDIC Regional Outlook, Fourth Quarter 2001

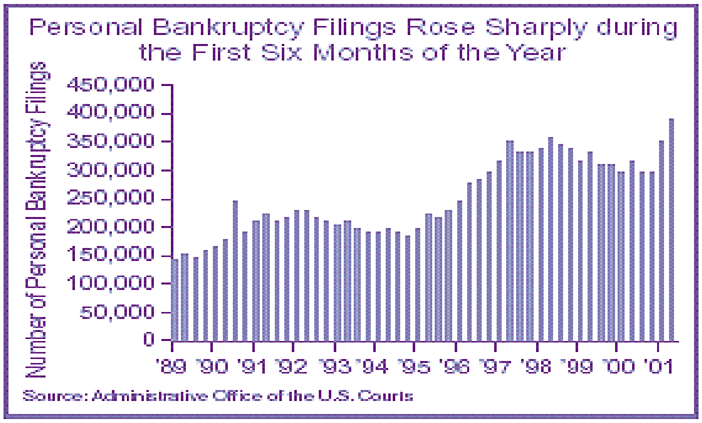
The Market Climate has shifted to a Crash Warning. This climate is defined by three conditions: extremely unfavorable valuations, unfavorable trend uniformity, and hostile yield trends, particularly in long-term interest rates, utilities, and measures of risk premiums.

A Crash Warning does not imply that stocks must, or should strongly be expected to crash. Rather, it means that market conditions match those seen in only 4% of historical data. Every historical market crash of note has emerged from this single climate.

<u>Market crashes are driven first and foremost by a spike in the *risk premium* demanded by investors on stocks</u>. Risk premiums on stocks remain low, while rising risk premiums in competing assets such as bonds are creating pressure. We don't want to overemphasize the risk of a crash, but the risk of substantial losses should be considered seriously.



Over the coming year, the most important economic concern will be *debt*. This includes corporate debt, personal debt, and international debt. Default problems are always driven by a mismatch between two factors - the burden of servicing the debt, and the cash flows available to do so. The mismatch between these two continues to increase, and was well on the rise even before September 11th.



In the coming year, the mismatch between debt burdens and cash flows is likely to widen even further. We expect the unemployment rate to rise above 7%, while corporate earnings stagnate.

If we avoid all of these difficulties and the economy instead launches into full recovery, we would still expect stocks to underperform T-bills over the next several years.

With many economists and analysts predicting a strong recovery (having failed to identify the downturn anyway), we wish we could be more cheerful about the economy. But most of the arguments being advanced today are based not on analysis but on *superstition*.

In order to separate analysis from superstition, one needs to identify the *mechanism* that links cause and effect, and then determine from the evidence that this mechanism can be reliably expected to operate.

One of the popular notions on Wall Street here is that bull markets are the natural offspring of recessions. In a naïve sense, that is true. But in order to separate analysis from superstition, we have to ask *why* stock prices advanced following past recessions. From the standpoint of earnings, there are only two sources of gain: either earnings increased and/or the price-earnings ratio increased.

Many analysts are making bullish forecasts on the expectation that earnings will soar in a new recovery, as they believe is typical. Unfortunately, in the year following the past 5 recession troughs, S&P 500 earnings actually *fell* an average of about 10%. This effect is particularly strong for industries such as technology that are dependent on capital spending. Capital spending is driven by high profit margins and strong earnings. In the early part of a recovery, technology earnings typically continue their decline.

So bullish hopes rest squarely on <u>rising price/earnings ratios</u>. Currently, the P/E ratio on the S&P 500 is 39. But this is somewhat misleading. Weak earnings during recessions can cause an uninformative spike in the P/E ratio. For that reason, we generally analyze P/E ratios based on the highest level of earnings achieved over the prior 10-year period. This *price/peak-earnings ratio* is currently at 21.

It is quite true that the stock market typically sets its low within 6 months before a recession ends. But most striking is that the price/peak-earnings ratio at these points historically averaged just *8.9*. Over the following year, that ratio typically expanded to 11.6 - still well below the historical average of 14. T<u>he powerful bull market rallies following recessions universally emerged to bring stocks from *deeply* undervalued levels to still *moderately* undervalued levels.</u> They never began from overvalued levels, and began only once from average valuation levels.

That single exception in over a century of data was the rally that began in September 1960 (prior to the Feb 1961 recession trough), which started from a price/peak-earnings ratio of 14.5. Though stocks did rally initially, they actually underperformed T-bills in the two years after that low.

More recent market troughs have followed the more typical case, with market lows occurring within 6 months of the economic trough, at price/peak-earnings ratios of 7.4 at the 1974 low, 6.9 at the 1980 low, 7.0 at the 1982 low, and a relatively high but still undervalued 11.4 at the 1991 low.

The current price/peak-earnings ratio on the S&P 500 is 21. Prior to the market bubble of recent years, the S&P 500 price/peak-earnings ratio never exceeded 20. It reached that extreme on only 4 occasions: the 1929 peak (pre-crash), the 1964 peak (the Dow was actually lower 18 years later), the 1972 peak (prior to the 73-74 plunge) and the 1987 peak (pre-crash). So if stocks are launching into a new bull market here, they are doing so at valuations higher than any market *peak* in history.

Why do we insist that stocks are priced to deliver poor <u>*long-term*</u> returns? Simple. In order for prices to increase, either earnings or price/earnings ratios must increase over the long-term. At extreme P/E ratios, one of these engines is lost. Price gains are then dependent on earnings growth, while *requiring* P/E ratios to remain high indefinitely.

Just as we analyze P/E ratios based on peak-earnings, the appropriate way to analyze long-term earnings growth is to measure from peak-to-peak. Over the past 10, 20, 50 and even 100 years, the peak-to-peak growth rate in S&P 500 earnings has never significantly exceeded 6% annually. Indeed, the whole history of earnings is well contained in a 6% growth channel connecting peaks to peaks and troughs to troughs. Not surprisingly, this is close to the long-term growth rate of nominal GDP.

The fact that we give valuations the benefit of the doubt by using peak-earnings also means we've *already allowed for a recovery* to peak-earnings. Suppose that the economy launches into an immediate recovery, and S&P 500 earnings soar from their current level of 28.52 to their bubble peak of 53.77. Then assume that earnings continue to grow at a 6% annual rate into the indefinite future. And now that we've re-established peak earnings and have peak earnings growing along the top of their 6% long-term channel, let's also assume that the price/peak-earnings ratio remains at its current extreme of 21 forever.

There. We've made all the assumptions required in order for the S&P 500 to deliver long-term capital gains of just 6% annually. Kick in a 1.5% dividend yield, and stocks are priced to deliver long-term total returns of about 7.5%.

We doubt that investors realize how bullish the assumptions must be for stocks simply to deliver 7.5% long-term returns in the years ahead. Moreover, we doubt that they realize how dependent long-term returns are on P/E ratios *remaining extreme into the indefinite future*.

Suppose, for instance, that we retain the assumption that earnings shoot back to the peak of their long-term growth channel and grow along that peak indefinitely. But now assume that instead of remaining at 21, the price/peak-earnings ratio falls to its historical norm of 14 a decade from now. In that event, the S&P 500 would deliver capital gains of just 1.8% annually over the next decade. Simple algebra. If it takes 30 years to hit a P/E of 14 again, stocks would earn capital gains of 4.6% annually over those 30 years (for a total return of about 6% annually including dividends). **Buy-and-hold investors expecting even modest long-term returns must rely on P/E ratios to remain extreme - not just for the next few years, but *forever*.**

Though inflation and interest rates are low compared to the past few decades, they were lower through most of historical data prior to the mid-1960's. In contrast, no other market cycle in history has seen the price/peak-earnings ratio at 21. It is important to understand that analysts claiming that stocks are “undervalued” are assuming that stocks should be priced to deliver an *extremely* low long-term rate of return. Claims that stocks are fairly valued due to low interest rates are also based on *limiting the data set* so that current interest rates are the lowest in the entire sample. That's just careless analysis when more complete historical data is readily available.

We can always find individual stocks that satisfy our criteria for favorable valuation and market action, but we believe that *selectively* hedging our market risk, especially when both valuations and trend-uniformity are unfavorable, can improve expected returns and lower the risk of loss.

In short, overvaluation implies poor *long-term* returns. It does not necessarily imply that stocks must decline over the short term. Indeed, if trend uniformity is favorable, overvalued markets typically become more overvalued. So stocks can sometimes have speculative merit even if they lack investment merit. Presently, they lack both. We are defensively positioned here.

ECONOMIC PERSPECTIVES

1) Things are really bad out there. They've got to get better sometime.
2) We've got a tingly feeling that the economy will bottom in the next quarter or two.
3) Bull markets typically begin less than 6 months before the end of a recession.
4) Therefore stocks must be in a new bull market *now*. Better get in before it runs away from us.
5) Stocks are rallying. That's proof that the recession will end soon.
6) In case of fresh bad news, go back to number 1).

Investors are currently tangled in pretzel logic. Every hope that the economy is about to recover results in stock buying, and the stock buying is then taken as evidence that the economy is about to recover.

At the heart of this problem is a set of eagerly accepted proverbs about cause and effect. "Fed actions kick in with a 6-12 month lag", "Bull markets start 6 months before a recession ends", "Rising bond yields signal a recovery", "Lower rates put money into the hands of consumers."

And a fool and his money are soon parted. These are not serious tools based on analysis of current conditions, or tight logical arguments linking valid premises to conclusions. They are superstition.

In the past year, we've argued strongly that investors should not count on any significant impact from Fed moves. Unlike past recessions, the current downturn is driven by a collapse in capital spending and profit margins on the heels of a speculative boom. Unless that boom fully revives, the profit margins attained in recent years will be very difficult to restore, much less the near-panic of businesses to invest in information technology and networking capital. Unlike most consumer slowdowns, the current recession originated from excess capacity and unusually large debt loads. It is the pounding hangover from a binge of misallocated investment and credit-driven consumption.

So new capital spending and consumption expenditures are likely to be unresponsive to increased Fed liquidity. Our August issue noted that the *entire* increase in the monetary base over the past year has been drawn off as currency in circulation, that bank reserves are no longer even essential to bank credit, and that non-bank credit such as commercial paper issuance has collapsed. The main effect of this string of Fed easings is that investors are holding fewer Treasury securities and more currency.

Our November issue emphasized the notion of equilibrium - every dollar that the government "puts into the hands of consumers" must be taken from somebody else. Every security must be held, so every dollar "shifted" from bonds to stocks must be offset by a shift in the opposite direction elsewhere in the economy. Every dollar that a borrower saves through lower interest rates comes at the expense of some lender in the economy.

There is no reason to believe that either fiscal or monetary policy "puts money into the hands" of anybody. These policies simply redistribute money. Their effectiveness depends entirely on whether these redistributions are successful in reducing constraints to production and investment that would otherwise exist.

Fed moves are effective when banks are constrained by a lack of liquidity, corporations are eager to borrow, and banks are eager to expand their portfolio of credit risks. None of these conditions are true here. Yes, there are 11 Fed moves "in the pipeline." Unfortunately, that pipeline, like every road to Easy Street, runs through the sewer.

The recent surge in long-term bond yields has also been taken as a signal of an impending recovery. Several weeks ago, with bond yields at their lows, we urged investors considering mortgage refinancing to lock in their rates immediately. This advice had nothing to do with expectations of an impending recovery. Rather, bond yields had become so low that they no longer offered adequate compensation for maturity risk (risk of price fluctuations in response to interest rate changes). Evidently the bond market agreed.

In short, the surge in bond yields has nothing to do with expectations of rising inflation or economic recovery. What we are seeing is simply a normalization of risk premiums on Treasury securities following an extreme flight to safety due to the September 11th attacks.

The repeated view that rising bond yields signal recovery might lead one to believe that the bond market has behaved similarly prior to other recession lows. Not so. In the 6 months prior to the past 5 recession lows, bond yields fell in every instance. The reason is not surprising. The inflation rate always falls well into a fresh economic expansion.

While bond yields do show a slight tendency to rise in the 6 months *following* a recession trough, even this tendency is not statistically significant. Yields are nearly as likely to fall as to rise. Recent bond market action has literally nothing to say about the probability of an economic recovery.

A number of other important indicators also weigh against a near-term economic recovery. Help-wanted advertising has fallen off of a cliff. The year-over-year change is now the sharpest in history, and this change is tightly correlated with changes in the rate of unemployment. Remember that unemployment is not driven simply by new layoffs but by a sharp reduction in the rate of new hiring. On the basis of the help-wanted index, we are expecting the rate of unemployment to surge over 7% in the months ahead.

Historically, no economic recovery has emerged with the "future expectations" measure of consumer confidence below the "current conditions" measure. Among market indicators, no recovery has emerged with the Dow Utility average below its 12-month average. Those indicators offer additional reasons for caution here.

While the NAPM indices have increased slightly in the past month, these indices are a measure of change *from one month to the next*. Given the terrible downturn in September and October, it is not surprising that the NAPM indices improved in November. Even with that bounce, the composite index was still below 50, indicating *continued contraction*. The bounce merely showed that the *rate of decline* was not as rapid as in September and October.

The NAPM Purchasing Managers Index will be important to watch in the next couple of months. A fresh decline toward 32 would be a clear signal of major economic deterioration. A sharp drop in the value of the U.S. dollar would also be an important signal of economic weakness.

It strikes us as unreasonable to believe that the speculative bubble of recent years has been completely resolved, when the S&P 500 still trades at 21 times record earnings and *real GDP has not even declined year-over-year*. While most analysts are focusing on the possibility of a rebound in business investment, our concern is that consumers will instead join in this downturn. The risk is not that consumer spending will collapse (it never does, even in recessions), but simply that its growth rate will slow, failing to offset declines in capital spending, housing, and other forms of fixed investment.

Bankruptcies, layoffs and unemployment continue to increase, and the surge in mortgage refinancings is most probably complete. It is beyond us why analysts continue to ignore both default risk and the risk that consumers will accelerate (rather than continue to offset) this downturn.

It is certainly possible to construct bullish arguments by appealing to one or two indicators, or some toy model having no record of historical accuracy. But based on a broad evaluation of economic data, and information from market action that is historically reliable, there is no compelling case for a strong near-term recovery in the economy.

As a final note, no economic recovery has ever emerged with our measures of trend uniformity still negative. So one event that would significantly improve our outlook would be a shift to favorable trend uniformity. We do not have such evidence at present, and we only change our investment position when the evidence is in hand. But there's always hope. We would greatly prefer the chance to offer a positive outlook, over the responsibility of giving a negative one.

With the holidays approaching, I want to thank our clients and shareholders. Not only for your business, but always most importantly, for your trust. Lisa, J.P., Julianne and I wish you a very merry Christmas, a happy Hanukkah, and God's blessings for the New Year.

- John P. Hussman, Ph.D.

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