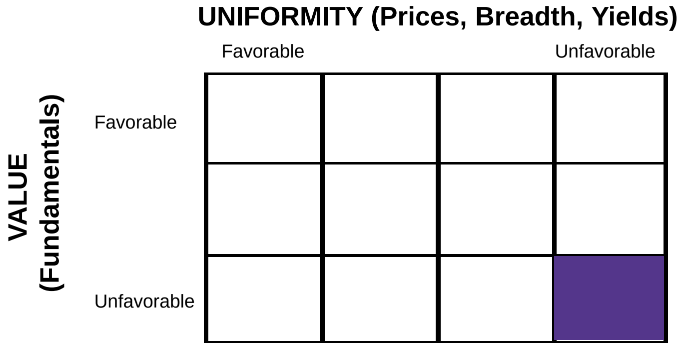
HUSSMAN

INVESTMENT RESEARCH & INSIGHT

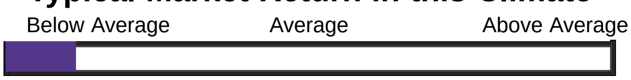
VOLUME 3 NUMBER 2 APRIL 12, 2002

MARKET CLIMATE

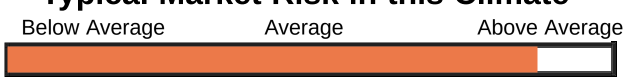
The current profile of valuation and trend uniformity



Typical Market Return in this Climate



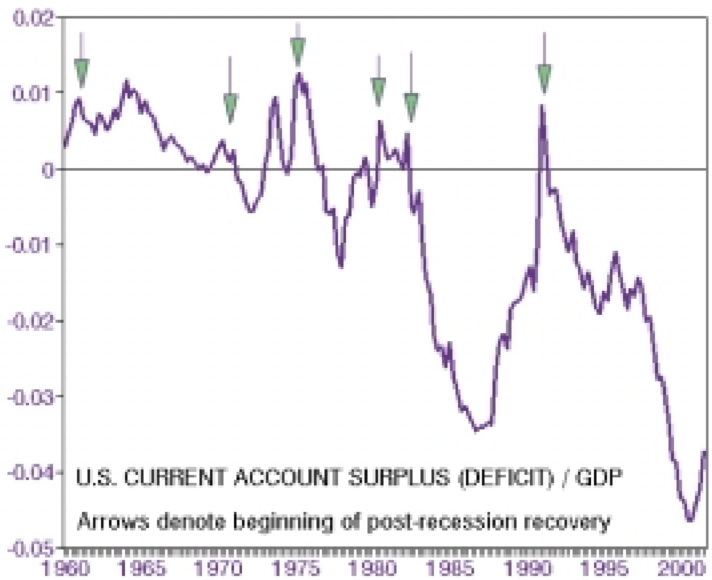
Typical Market Risk in this Climate



JUST FOR KIDS

Draw an arrow at the very right side of the picture.

Then erase it.



Weekly market commentary and online research reports are available at no charge on the Research & Insight page of our Fund website www.hussman.net.

THE TICKER

The stock market and the economy have stabilized from last year's weakness. This is a statement about the *past*. Many analysts are eager to extrapolate the recent rebound into the future as well, with bullish market forecasts and projections of strong economic growth.

But the link between the past and the future is the present. The present is the only point at which action can be taken. It is impossible to know whether stocks are in a bull market or a bear market, except in hindsight. Bull and bear markets *don't exist* in the observable present. We believe that it is insane to set investment positions based on speculation about conditions that can only be verified in hindsight. For us, it is more important to align ourselves with the objectively identifiable conditions of the present.

It is not necessary to forecast the wind in order to sail a boat. You can go anywhere you wish by adjusting the sails to the prevailing wind. When the wind changes, you simply adjust the tack again.

We identify the "Market Climate" on two dimensions. One is valuation and the other is market action. Specifically, favorable valuation means that stock prices are attractive in relation to the expected stream of cash flows that will be thrown off to investors in the future. Favorable market action requires a quality that we call "trend uniformity" - jointly favorable trends across a wide range of market internals and measures of risk premiums. Favorable valuation indicates long-term investment merit. But stocks can still be attractive if they have speculative merit, and this is largely determined by trend uniformity.

Our investment approach is indifferent to whether the economy is in an expansion or a recession. Historically, when the economy has been in an expansion but trend uniformity has been negative, stocks *have* produced a positive total return. But that total return has averaged less than 1% annualized. When the economy has been in an expansion, trend uniformity has been negative, *and* the S&P price/peak-earnings multiple has been over 14 (it is currently at 21), the total return on the S&P 500 has averaged a *loss* of over 10% annualized. Speculation regarding whether or not the economy is in an expansion has no bearing on our investment position.

Despite widespread expectations for a strong economic expansion and a sustained bull market, we remain defensive. This defensiveness is not because of extreme valuations, but because of the market has failed to generate favorable trend uniformity. Typically, such a failure conveys unfavorable information or vulnerability in underlying economic and market conditions.

Stocks remain strenuously overvalued as well, but the simple fact is that valuation does not drive short-term returns. Buying overvalued stocks is a lot like dropping an anchor with a long chain. Your boat will bob up and down with the waves, and will sail this way and that with the wind. But in the long run, you're not going anywhere.

Overvaluation implies only that the long-term return on stocks is likely to be unsatisfactory. **We are firmly in agreement with Warren Buffett that if current valuations are used as a starting point, stocks can be expected deliver total returns of 7% or less over the long-term. As with any investment, you obtain a higher long-term return by paying a lower price.** But overvaluation doesn't forecast price declines. It merely indicates that prices are so elevated (in relation to expected cash flows) that unsatisfactory long-term returns can be expected.

The most significant loss of trend uniformity in recent years occurred on September 1, 2000. Since then, we have had a few brief periods in which trend uniformity reappeared, but these instances have been rather short and quickly reversed.

Trend uniformity is concerned with the *quality* of market action (not the duration or the extent of an advance). Sustainable market advances (and new economic expansions) are usually accompanied by uniformly favorable action across a wide range of market internals and measures of risk premiums. **When market action fails to display uniformity, the "divergences" tend to convey very strong information signals. Currently, those divergences continue to point to unacceptable credit risk in the economy. A number of emerging divergences (for instance, weakness in transportation stocks) also suggest that recent economic strength is more reflective of inventory rebuilding than of robust final demand.**

In short, our investment discipline is not driven by reacting to the past, or by forecasting the future. We have no forecast about when trend uniformity will turn favorable. If and when it does, we will move to a substantially more constructive investment position, and our economic expectations will become more optimistic. That may occur a week, a month, or a year from now. Until the objective evidence is in hand, however, we will remain defensively positioned and alert to the possibility of a fresh economic downturn.

Weekly comments on the prevailing Market Climate can be accessed from the Research & Insight page of our Fund website: www.hussman.net.

THE OBSERVATION DECK

"Theirs was the future. But you could share in that future if you kept alive the mind… and passed on the secret doctrine that two plus two make four."

- George Orwell, 1984

One of the reasons that we are skeptical of a strong bull market and economic recovery is that two plus two make four. Stock prices can be written as the product of certain underlying parts (for instance Price = P/E x Earnings). A forecast for the whole must be supported by some plausible combination of the parts. The same is true for GDP.

In the stock market, prices can enjoy a sustained advance only if earnings enjoy a sustained advance, price/earnings ratios enjoy a sustained advance, or both. From 1982 through 2000, both were true, as the S&P 500 P/E soared from less than 7 times peak-earnings to a brief extreme near 30 times peak-earnings.

Currently, net earnings on the S&P 500 are at 24.90, resulting in an actual price/earnings ratio of 45. Since this ratio is based on depressed earnings, many analysts simply choose to ignore it altogether. On the assumption that earnings will eventually recover, and that short-term earnings fluctuations do not drive long-term value, we prefer to track the price/peak-earnings ratio for the S&P 500. This filters out the uninformative spike in the P/E when earnings plunge during a recession. Prior peak earnings on the S&P 500 were 53.77, resulting in a price/peak-earnings ratio of about 21. This remains higher than the extreme of any prior market cycle, including 1929, 1972 and 1987.

Historically, S&P 500 earnings have grown at slightly less than 6% annually when measured from peak-to-peak. While earnings growth is typically faster when measured from the trough of a recession, these faster growth rates are never sustained. Whether one looks at the past 10, 20, 50 or 100 years, peak-to-peak earnings growth for the S&P 500 has been nearly equal to the long-term peak-to-peak growth of nominal GDP. And again, this has been somewhat less than 6% annually (representing about 3% real GDP growth and 3% inflation).

Suppose that earnings jump *immediately* back to their year 2000 peak (this alone assumes that earnings will double from their current depressed levels), and grow at a 6% annual rate thereafter. Let us also assume that the price/peak-earnings ratio remains at the current extreme of 21 into the indefinite future. In this event, stock prices would increase at that same 6% annual rate. Add in a dividend yield of 1.4%, and the S&P 500 is currently priced to deliver a long-term annual return of 7.4%. Notable among these assumptions is that the S&P 500 P/E will remain higher than at the 1929 and 1987 bull market peaks, and that it will sustain this extreme level forever.

Two plus two make four. In order for the market to enjoy a sustained advance, either earnings must advance to new peak levels, or the price/peak-earnings ratio must advance. Over the long-term, we can comfortably assume that earnings will eventually reach and surpass prior peak levels. But the argument for a sustained expansion in P/E ratios is much more difficult.

Historically, bear markets have brought the price/peak-earnings ratio to just 8.9. We need not assume anything so dire to conclude that stocks are price to deliver poor long-term returns. Even a constant P/E implies 7.4% annual returns, which we suspect, is substantially lower than most investors anticipate.

In the event that the price/peak-earnings ratio retreats to its historical norm of 14 a decade from now, a 6% peak-to-peak earnings growth rate would result in a return on the S&P 500 of less than 2% annually over the coming decade.

ECONOMIC PERSPECTIVES

"The bubble economy promoted a massive increase in consumer expenditure as people foreswore their frugality. Rising asset prices (producing what economists term the "wealth effect") combined with the stronger [currency] to stimulate a craze for imports. Cuts in income taxes increased personal spending power. Encouraged by low interest rates, people took out fresh loans against the equity of their homes. Credit card circulation increased almost threefold, and consumer debt per head rose. Enormous capital expenditure - the product of cheap capital during the bubble years - had saddled the country with excess productive capacity."

"In the summer, the corruption that had simmered away during the bubble years burst forth in a series of financial scandals. Once again, a scapegoat was needed to purge the collective sins of the community. [Thus began a series of] ritualistic resignations in the financial world intended to appease a vengeful public."

"The stock market did not collapse with a sudden jolt. There was no repeat of the two Octobers, 1929 and 1987. As the authorities refused to allow the prices of stocks and property to sink low enough to find their clearing level (the point at which buyers equalled sellers), they frustrated the market's ability to clear away its own excesses - what Schumpeter called 'creative destruction.' Instead of alleviating the problems, the authorities' mismanagement succeeded only in drawing out the painful aftermath of the bubble (as we have seen, the same accusation has been directed at President Hoover's policies of the early 1930s)."

"Perhaps more than anything the bubble economy illustrates the danger that arises when investors believe that market risk is shouldered by the government rather than by themselves."

- Edward Chancellor, Devil take the Hindmost (1999) regarding the emergence and collapse of the Japanese bubble (direct references to Japan edited).

The argument that two plus two make four explains our expectation for relatively unimpressive economic performance ahead. In order to expect robust economic performance, one must expect sustained strength in one or more components of Gross Domestic Product.

At the risk of startling some neurons long presumed dead, GDP can be written as:

Y = C + I + G + X - M

As long as we assume an inexorable rise in Consumption, Investment, Government spending, or the trade deficit (X - M), we can expect a strong economic expansion. So far, there is no apparent problem.

Easy now. Let's introduce taxes and rearrange:

I = (Y - C - T) + (T - G) + (M - X)

This one is called the "saving-investment identity". That first term (Y - C - T) is *private savings* (what you have left of your income after you consume and pay taxes). The second term is *government savings* (usually an oxymoron, but the amount left over after government spends out of its tax revenues). If the government runs a deficit, this number is negative. The third one is *"foreign savings"* - whenever we import more goods and services than we export, we've got to make up the difference by exporting securities to foreigners. So trade deficits are ultimately financed by the savings of other countries.

Put this all together and it says that all domestic investment (capital spending, housing investment, etc) has to be financed by savings - either private savings, government savings, or foreign savings.

And here is where the rubber meets the road.

In every prior recession, U.S. domestic savings increased strongly. Private savings (Y - C - T) were actually more than we needed to finance our own domestic investment. **At the beginning of every prior economic recovery, foreign savings (M - X) was negative, meaning that a portion of our savings was being sent to other countries. Our large pool of savings gave us more than enough resources to finance big increases in both consumption and investment**. As the economy grew, we typically went from exporting savings to importing foreign savings - helping consumption and investment to grow even faster.

In contrast, the U.S. current account is presently near the deepest deficit in history, which means that (M - X) is very positive since we are importing enormous amounts of savings from other countries. Not only does the U.S. lack a deep pool of domestic savings, even worse, our spending habits are more dependent on foreign savings than ever before. Let's rearrange the equation to put the focus on the massive amount of foreign savings (M - X) currently financing U.S. economic activity.

(M - X) = I - (Y - C - T) - (T - G)

From this perspective, it is easy to see why our reliance on foreign savings (which is observed as a huge U.S. trade deficit) threatens U.S. economic growth.

In order to reduce (M - X) from positive levels, one of three things must occur: 1) domestic investment must fall, 2) domestic savings must increase, or 3) the government surplus must increase. This is not a theory. It is an accounting identity.

The savings-investment identity shows why it is unlikely that consumption and investment will continue to grow substantially faster than GDP (as they did through 1995-2000) when the U.S. is already deeply reliant on foreign savings.

The recent jump in domestic investment worsened the U.S. trade deficit, because it was financed with foreign savings. **We suspect that most of this increased investment represented *inventory rebuilding* rather than increased final demand for capital goods.** Capital spending is likely to remain weak much longer than most economists assume.

Housing investment is also vulnerable. Indeed, we view housing as being in a bubble. As the London *Economist* points out, "Over the past year average house prices in America have risen by 9%, their fastest-ever in real terms. For most people, housing is by far their largest form of wealth. Two-thirds of Americans own their own homes, and gains in the value of those assets have encouraged them to keep spending… Those capital gains have in turn been converted to cash as households have taken out bigger mortgages. In both America and Britain home-equity withdrawal (the increase in borrowing in excess of new investment in housing) has been running at record levels. The lesson which consumers - and also many over-sanguine economists - have to learn is that spending cannot outpace income forever." This is particularly true when the excess of spending over income is already heavily dependent on foreign savings.

Weakness in the U.S. dollar would probably be the first sign that foreigners are pulling back on their willingness to finance our buying spree. For this reason, a decline in the U.S. dollar will be an important warning of any fresh weakness in the U.S. economy.

The bottom line is this. Unlike past economic expansions, the current rebound is accompanied by a massive U.S. trade deficit. **To a large degree, past booms in consumption and investment have been financed by increasing the trade deficit, and that option is much more limited here. We expect continued weak capital spending, and believe that the U.S. housing boom is very much at risk. These risks are associated with higher risk of debt problems and credit defaults than is widely anticipated.**

The excessive capacity that resulted from the recent investment bubble means that capital is relatively more abundant than labor. **In an economy where labor is the scarce factor, most of the gains from economic growth will accrue to labor rather than capital. As a result, we expect wage gains to continue outpacing inflation. The combination of poor capital spending growth and relatively high wage gains is likely to limit improvement in profit margins. Even if the economy does expand, we expect relatively weak follow-through in earnings.**

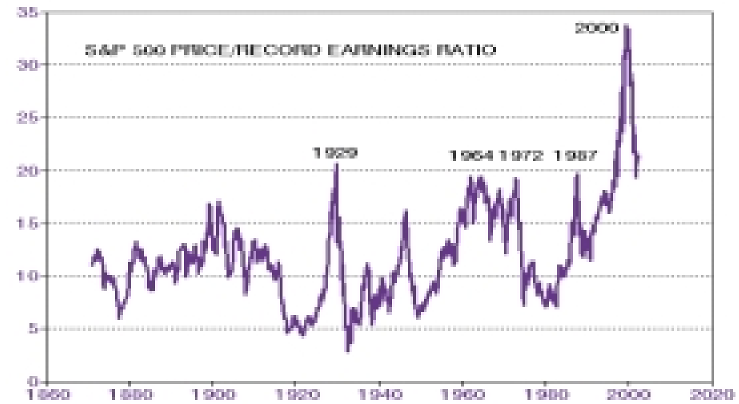
A resumption of favorable trend uniformity would not substantially improve these difficulties, but could put the market in a position where speculative pressures might outweigh them for a while. For that reason, we will move to a moderately constructive investment position if favorable trend uniformity emerges, regardless of our views on the economy.

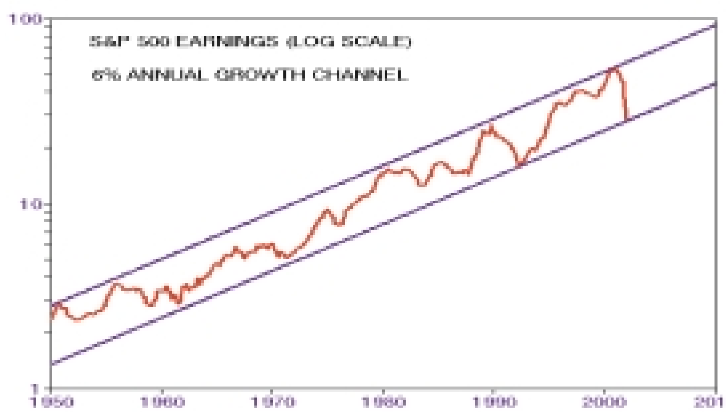
- John P. Hussman, Ph.D.

MARKET VALUATION

S&P 500 Index:	1130.47
Current S&P 500 dividends:	15.83
Current S&P 500 earnings:	24.90
Record earnings to-date:	53.77
Price/record earnings:	21.0
S&P 500 10-year total return projections (annualized):	
At future P/E of 20 (same as '29, '87 peaks)	4.76%
At future P/E of 14 (average 1950-present)	1.15%
At future P/E of 11 (historical median)	-1.22%
At future P/E of 7 ('74, '82 troughs)	-5.51%

Long term S&P 500 return projections assume earnings grow to the midpoint of their long-term channel a decade from now. This level would represent a record high. Historically, actual returns most closely track the forecast associated with a future P/E of 11.





Hussman Investment Research & Insight is published for clients of Hussman Econometrics and shareholders of the Hussman Strategic Growth Fund. This report is not available by subscription. Published twice each quarter by Hussman Econometrics Advisors, 3525 Ellicott Mills Drive, Suite B, Ellicott City, MD 21043-4622, 410-750-3900.

If you are interested in the **Hussman Strategic Growth Fund (HSGFX)**, please call **1-800-HUSSMAN** (800-487-7626) to obtain a Prospectus and account application materials. The Prospectus contains information about the Fund in a detailed, easy-to read format, including information about fees and expenses. Please read the Prospectus carefully before you invest or send money. You may also visit the Fund website at **www.hussman.net** for these materials. The minimum investment in the Fund is $1000, or $500 for IRA accounts and gifts-to-minors.