HUSSMAN

INVESTMENT RESEARCH & INSIGHT

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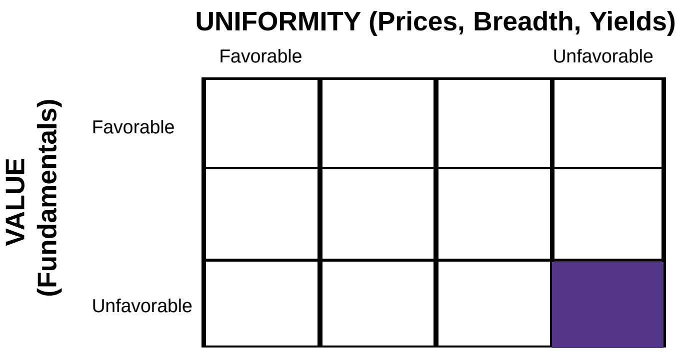
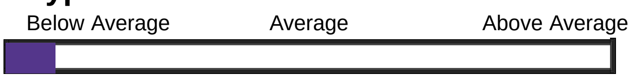
MARKET CLIMATE

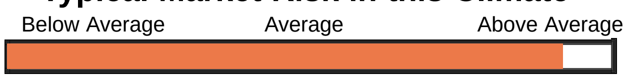
The current profile of valuation and trend uniformity



Typical Market Return in this Climate



Typical Market Risk in this Climate



"Our economy is strong. The stock market isn't as strong as it should be."
- George Bush, June 26 2002

"The fundamental business of the country is on a sound and prosperous basis."
- Herbert Hoover, October 25 1929 (the week before the 1929 Crash)

While many analysts believe that the market is out of sync with the economy, it is much more probable that the widespread forecast of economic recovery is out of sync with the market. Given an economic recovery, the argument goes, the stock market should be performing much better. Unfortunately, when market action disagrees with the optimism of analysts, central bankers, and presidents, it is the market that has the better record of looking ahead.

We're not suggesting that the market must, or should strongly be expected to crash. But with the S&P 500 price/peak-earnings ratio still at the levels that existed at the 1929, 1972 and 1987 *peaks*, and with trend uniformity still hostile, market conditions currently match those seen prior to many major historical market plunges. We certainly can't rule out further market losses here.

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

A cornerstone of our investment discipline is the concept that market action conveys information. This is not to say that prices convey information perfectly, or that prices are always efficient. Rather, prices and trading activity across a wide range of markets reflect the diverse information of millions of traders - information that cannot be observed by any single trader in isolation. If an analyst respects market action, and examines it carefully, the market willingly offers up a great deal of this information - long before it shows up in widely followed economic statistics or earnings reports.

For example, one of the best indications of oncoming economic weakness is a sudden *divergence* between corporate bond yields and default-free government bond yields. When the yield difference widens between these two, that widening conveys information about potential shortfalls in the ability to service debt, and growing potential for defaults. Typically, yield spreads give their warning long before non-market data such as default statistics or credit ratings show signs of trouble.

Similarly, suppose a stock appears to be a tremendous value based on the most careful fundamental analysis of earnings, revenues, cash flows and other factors. But looking at market action, you observe that the stock price is dropping like a rock while the market and other stocks in that industry are stable. In most cases, the price decline does not mean that the stock is a better value ("If you liked it at 40, you've got to love it at 20"). Rather, it tells you that the fundamentals can no longer be trusted. The *divergence* between the market action of that stock and the market action of other stocks conveys information. In this case, negative information. Very simply, it tells you that somebody knows something you don't.

So in our view, there are two pillars of good investing. One is a respect for valuations. The other is a respect for market action. While we can certainly find individual stocks for which both are favorable, the overall market is unfavorable on both dimensions.

We need not make any forecasts at all. Our discipline focuses on the current, observable status of valuations and market action (what we call "trend uniformity"). When both are negative, we hedge away the market risk of our favored stocks. This is not a bet or forecast that the market will decline. Rather, it is an attempt to avoid sources of risk that are not associated with a strong expectation of returns.

Every stock has three sources of risk: 1) risk specific to that individual company, 2) risk tied to general market movements, and 3) risk from purely random day-to-day fluctuations. There remain a large number of stocks having stock-specific risk worth taking, so long as we can hedge away their market risk and diversify away their random fluctuations. So being fully hedged should <u>not</u> be confused with taking a *riskless* position. It's just that the particular portfolio of risks that we are currently taking does not have much relationship with general market movements. We attempt to focus only on risks that are associated with an acceptable expected return.

In previous issues, we have stressed that in contrast to typical post-recession markets (which took the S&P price/peak earnings ratio to an average of just 8.9), even an economic recovery would not provide much help to a stock market priced at 20 times peak earnings (the same multiple seen at the 1929, 1972 and 1987 market tops).

Our April 2002 issue noted "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. 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."

In recent weeks, the U.S. dollar has indeed plunged. And while this decline looks fairly deep on short-term charts, it is clear from a long-term perspective that U.S. dollar weakness is in its fairly early stages.

So while many analysts believe that the market is out of sync with the economy, it is much more probable that the widespread view of an economic recovery is out of sync with the market. And it is the market, not these analysts, that has the better record of looking ahead. We cannot stress enough that market action conveys information. Poor stock market action is underscored by weakness in the U.S. dollar and a widening in the spread between corporate and government bond yields. Taken together, market action suggests that an economic disappointment is increasingly likely.

THE OBSERVATION DECK

Recent problems in the stock market are not due to poor accounting. They are due to poor *ethics*. In general, the difficulty is not that items are left out of the financial statements, but that they are intentionally misclassified. Worldcom, for example, made a business of classifying expenses as "investments." Those who focus on "free cash flow" rather than "operating earnings" avoided the debacle. The reason is that free cash flow measures what is actually available to shareholders after all other claims have been satisfied (including the provision for growth). Since free cash flow subtracts off capital investment anyway, it is not affected when expenses are misclassified.

Similarly, Enron captured investor enthusiasm by reporting very strong "net cash provided by operating activities", and this cash flow was vaunted as an indication of the "quality" of their earnings. The problem, for anybody who cared to look, was that these strong net cash figures were produced by depleting working capital by running down inventories, and allowing huge increases in accounts payable. Sure, that will leave cash in your account, but ultimately, this is the road to insolvency.

In the years ahead, earnings are likely to be depleted by another claim - pension liabilities. Many companies continue to make assumptions about the probable return to stocks that has no relationship with the rate of return that stocks are actually priced to deliver (currently about 7.5% - see *Valuation Notes* below). The probable shortfall between actual and assumed pension returns means that future earnings will have to be diverted toward underfunded pension obligations.

As long as managements, brokerage analysts, and the financial media encourage investors to focus on "operating earnings" to the exclusion of everything else, investors will continue to suffer confusing and devastating losses. In many companies, the entire amount of operating earnings is currently dedicated to debt service, leaving nothing available as a residual to shareholders. The problems of the telecom industry are largely rooted in this enormous burden of debt service.

The gap between operating earnings and free cash flow currently could hardly be wider. There is no wonder why managements prefer to highlight operating earnings, when they can be manipulated simply by misclassifying items as “investments” and “extraordinary items.” The real wonder is why investors, brokerage analysts, and the financial media all refuse to wise up.

JUST FOR KIDS

OK, boys and girls. It's been pretty hot out lately. So we're going to start our own lemonade stand!

What? Jimmy, Sally, and Bobby all have lemonade stands just on your block alone? See, this is why I'm a professional money manager and you're not even out of middle school. I only have two words for you: *Global Warming*. It's a New Era. That's all you need to know. Now go and borrow $100 from your Mom.

... I'll wait.

Got it? Great. Now you're deeply in debt, far beyond your ability to earn income, in an industry ridiculously overburdened with capacity. Hey, we haven't been at this more than 30 seconds and you're already qualified to run a telecom company! See how much you've learned already?

Now let's go public. Go to your Dad and offer to sell him your business for $100. We'll still have to pay Mom back, but Dad will have a claim on everything else.

... I'll wait.

Holy smoke, you're a natural. Alright now. Let's take that $200 of investor money to buy some stuff: a lemonade stand, pitchers, spoons and ice buckets. Since the lemonade stand is cheap, you'll have to spend another $10 a week to fix it as it "depreciates," but we'll deal with that later.

You'll also have to pay for some other things before we show a profit. The lemonade mix and paper cups will be part of your "cost of goods sold." Since you've got a credit rating of about F-, Mom wants $10 a week "interest" on her loan. Finally, there's the big kid. For every dollar of profit, you've got to give him 40 cents or he'll give you a wedgie until you cry "Uncle." We'll just call him the Uncle.

You're off to a great start! In the first week, you've sold $50 of lemonade. Subtract off $20 as "cost of goods sold" and the $10 that you've stuffed into your pocket as "selling, general and administrative expenses." Congratulations, you've earned $20 in "EBITDA" - earnings before interest, taxes, depreciation and amortization. Now subtract that $10 of depreciation, and you have $10 in "EBIT," otherwise known as "operating earnings." Call CNBC. Also, make sure to buy the lemonade mix and cups with an IOU and don't replace the depreciation, so when Dad looks into your cash register, he'll actually see $40 in "cash flow from operations," underscoring the "quality" of your earnings. Sweet.

But let's take a closer look at what Dad can actually claim if you actually intend to stay in business. $50 revenue, minus $20 cost of goods sold, minus $10 administrative expense, minus $10 interest, minus $10 to replace depreciation, gives $0 in "net earnings." The good news is that you don't owe anything to to the Uncle.

Hmmm. Which number should you report to Dad? $20 of EBITDA or $0 of net earnings? Hmmm.

Wait. Even better. Let's classify the lemonade mix and cups as an "investment." We can also underdepreciate the lemonade stand. And we'll write both off as "extraordinary losses." After all, the stand wouldn't have worn down had it not been for the existence of time, and our investment in lemonade mix and cups would have survived had it not been for the existence of customers. That leaves us with EBITDA and operating earnings equal to $40. Yes, that's much better.

Week two. Unfortunately, the novelty of lemonade has worn off in the neighborhood, and it's a little cooler out too. As it turns out, you'll only be able to take in $25 a week in revenue from now on. Now we've got $10 in cost of goods sold, $10 in administrative costs, $10 of interest costs... Oops! We can't even make our interest payment, much less replace depreciation. And nobody wants to buy a used lemonade stand. Suddenly, Dad's investment is worthless, and we've got to default on our debt to Mom.

But hey, we can still report $5 in EBITDA! Maybe nobody will notice.

VALUATION NOTES

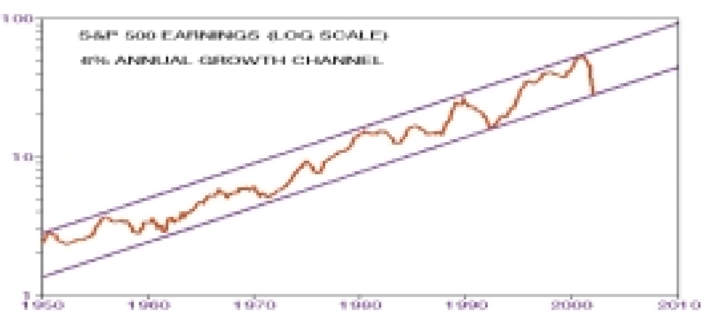
In addition to a misleading focus on operating earnings, one of the main "hooks" keeping investors in stocks is the repeated assurance by brokerage analysts like Abby Joseph Cohen that stocks are "undervalued."

In order to understand how we can argue that stocks are overvalued, and other analysts can argue they are undervalued, one must understand that the concept of value is subjective. When anybody talks about value (including us), they are implicitly assuming some particular long-term rate of return that they believe is reasonable.

Consider a bond that promises to pay $100 a decade from now. If an investor believes that bonds should be priced to deliver a 4% long-term return, the "fair value" for that bond is about $68. In contrast, if an investor believes that bonds should be priced to deliver a 12% long-term return, the "fair value" for that bond is about $32. Which view of "value" is correct? It depends on what you believe about other investors and their willingness to accept 4% versus 12% as a sustainable rate of return.

The same is true for stocks. The price of a stock is also the discounted value of the future cash flows it will throw off to investors, only there is an additional issue since the cash flows are growing and uncertain. Still, the problem is much simpler than widely believed, and the range of plausible outcomes is much narrower than widely believed. As Warren Buffett has noted, among the 100 leading stocks in the market, you can wager a tidy sum that only a handful will achieve 15% earnings growth over a 20-year period.

Earnings for the S&P 500 as a whole are even better behaved, since earnings growth simply does not differ much from nominal GDP growth over the long-term. From year-to-year, of course, earnings vary a great deal, so trough-to-peak growth can be extremely high, and peak-to-trough growth can be horrifyingly negative. But regardless of whether you look over the past 10, 20, 50 or 100 years, *peak-to-peak* earnings growth for the S&P 500 has been strikingly well behaved, growing at a nominal rate of 6% annually with great consistency.



Given that fact, the question of "fair value" comes down to the model you use. Take the "dividend discount model" for example. This model says simply that the long-term rate of return on stocks is equal to the long-term growth rate of dividends, plus the dividend yield. (As long as you take dividends as per-share values, this model is valid even in the presence of stock repurchases). The real problem is that some people make frighteningly implausible assumptions about the "fair" long-term return that stocks should be priced to deliver.

For example, suppose you believe that stocks should be priced to deliver 2% more than long-term bonds over the long term, and long-term bonds are yielding 5%. Well, you're now looking for the level of stock prices at which stocks will be priced to deliver 7% long-term returns. If dividend growth is 6% annually, the dividend discount model will then tell you that the "fair" dividend yield is 1% (i.e. 7% total return = 6% growth + 1% yield). With dividend yields currently at 1.5%, you will conclude that the S&P 500 is undervalued here, and that "fair value" is 50% above current levels.

But let's test the robustness of this model. Suppose that bond yields rise by 1%. In that case, we need to get an 8% long-term return, with only 6% contributed by dividend growth. Suddenly, we need the dividend yield to be 2% instead of 1%, implying a 50% decline in "fair value" in response to a little 1% rise in interest rates. This result should bring the careless use of the dividend discount model into question when very low risk premiums are being assumed. Essentially, the Glassman and Hassett "Dow 35000" garbage is essentially an irresponsible contortion of dividend discount.

Now consider the so-called Fed Model, which holds that the prospective earnings yield on the S&P should be equal to the 10-year Treasury yield. As long as you're willing to forecast a wildly optimistic level of operating earnings for the coming year (Abby's specialty), you'll also be willing to call stocks undervalued.

Of course, operating earnings include not only claims of shareholders, but also interest owed to debt holders and taxes owed to the government. And even including good signals from two extreme readings (positive in '74, negative in '87), deviations from the Fed model have absolutely *zero* statistical relationship with subsequent returns. We fully believe that the Fed model lacks any usefulness as an investment management tool. In fact, the raw, unadjusted earnings yield on the S&P 500 is statistically more reliable.

In short, if you're willing to assume that stocks should be priced to deliver long-term returns of less than 7.5%, then it is fair to say that stocks are "fairly valued' or "undervalued." The catch, however, is that you must then be fully willing to hold stocks for that low long-term rate of return, and you must believe that *future* investors will also be happy with that rate of return into the indefinite future.

It is lunacy to believe that the word "undervalued" necessarily implies a favorable long-term return. This is really an area where analysts can play games with investors by failing to disclose their assumptions.

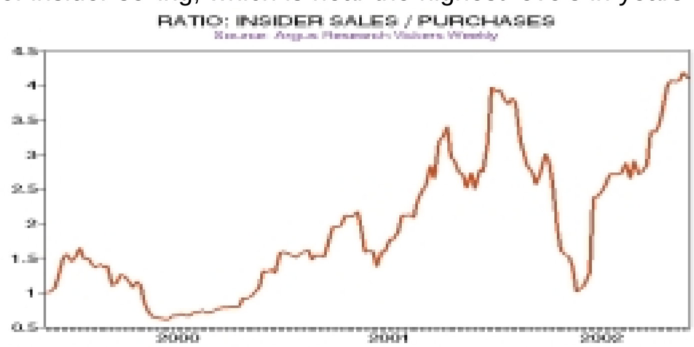
Very simply, we believe that the S&P 500 would be "fairly valued" if it were priced to deliver long-term returns of about 9%. On the historically sound assumption of 6% long-term growth in fundamentals, a 9% long-term total return implies a 3% dividend yield. The actual yield is half that level today.

No plausible decline in interest rates would justify a market dividend yield of 1.5% (compared to a historical average of 4%), a market price/book ratio of 5 (compared to a historical average of about 1.5) and a price/peak-earnings ratio of 20 (compared to a historical norm of 14 and average bear market lows below 9).

If you believe that investors will ultimately demand a long-term return near 9% on stocks, the S&P is about 50% above the level required to deliver it. *This is not a forecast*. Overvaluation means only that stocks are currently priced to deliver an unsatisfactory *long-term* rate of return. It implies little about short-term returns.

The bottom line is simple. The term "fair value" always incorporates the assumptions of the analyst. Currently, stocks are priced to deliver a long-term return of something like 7.5%. If you are a long-term investor, and think that 7.5% is a great return, and that future investors will agree that 7.5% is a great return far into the indefinite future, then go ahead and buy stocks. If 7.5% seems implausibly low as a sustainable long-term rate of return, the conclusion is that market risk does not have *investment merit*, and the only rationale for buying stocks on an unhedged basis is *speculative merit*. On that front, trend uniformity is unfavorable, so market risk currently lacks that merit as well.

One indication that valuations remain extended is the rate of insider selling, which is near the highest levels in years.



With our approach indicating a lack of both investment merit *and* speculative merit to taking market risk, we remain fully (and comfortably) hedged. That position will change when the prevailing Market Climate changes.

- John P. Hussman , Ph.D.

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