HUSSMAN

INVESTMENT RESEARCH & INSIGHT

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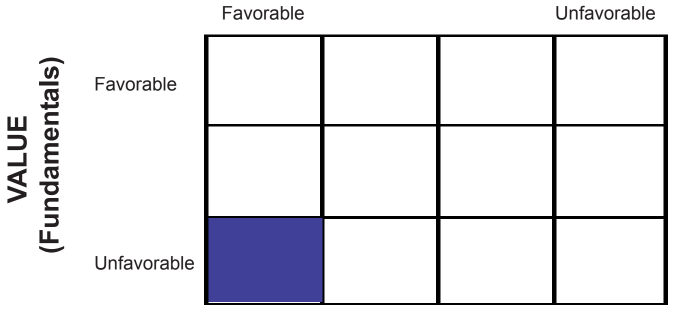
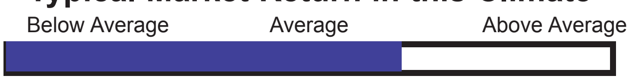
MARKET CLIMATE

The current profile of valuation and trend uniformity

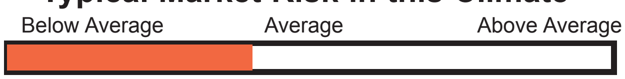
UNIFORMITY (Prices, Breadth, Yields)



Typical Market Return in this Climate



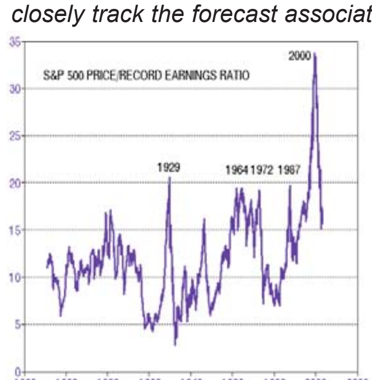
Typical Market Risk in this Climate

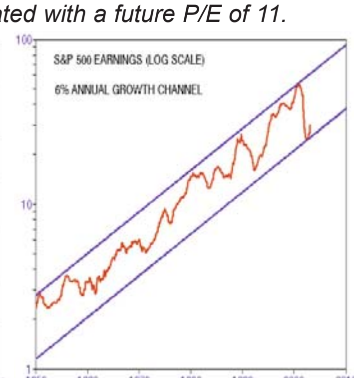


MARKET VALUATION

S&P 500 Index:	933.41
Current S&P 500 dividends:	16.37
Current S&P 500 earnings:	27.39
Record earnings to-date:	53.73
Price/record earnings:	17.37
S&P 500 10-year total return projections (annualized):	
At future P/E of 20 (same as '29, '87 peaks)	8.10%
At future P/E of 14 (average 1950-present)	4.39%
At future P/E of 11 (historical median)	1.96%
At future P/E of 7 ('74, '82 troughs)	-2.45%

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.





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THE TICKER

While the stock market remains priced to deliver uninspiring returns over the long-term, the Market Climate (which considers *both* valuations and market action) has recently shifted to a condition that has historically been favorable toward stocks. As we've noted before, stocks may go nowhere over the coming decade, but they will probably go there in an interesting way.

Last month, we noted in our weekly market comment (www.hussmanfunds.com) that the stock market has recruited enough "trend uniformity" to shift the Market Climate to a favorable condition. This is the first comprehensive shift in trend uniformity since it turned decisively unfavorable on September 1st, 2000. Since then, the S&P 500 has lost over 40% of its value.

Generally speaking, the hallmark of trend uniformity is "lack of negative divergence." We don't measure the extent or duration of an advance - rather, we measure the *quality* of market action in terms of its *agreement* across a wide range of indices, industries, and security types (both stocks and bonds).

When some indices are rising but others are breaking down, it suggests that investors are concerned about risk, and that there are weak spots in the fabric of the market and the economy. ***Uniform* action across a wide range of averages, industries, and security types reflects 1) a robust willingness of investors to take market risk, and 2) favorable information about expected economic and earnings news.**

By our estimates, the S&P 500 is priced to deliver total returns between 2-5% annually over the coming decade, with 8% being optimistic. So favorable trend uniformity doesn't mean that stocks are great values - as measured by the major indices - but it does mean that for now, the downward pressure on stock valuations seems to have abated. **While stocks do not have strong *investment merit*, they have recruited robust *speculative merit*.**

Overvaluation only implies poor *long-term* returns. Current valuations are similar to late-1996 levels, when Alan Greenspan remarked about "irrational exuberance." The reason that stocks were able to continue higher was not measurable investment merit, but measurable speculative merit. Stocks have delivered anemic returns since then, but they've delivered those returns in an interesting way. We believe that the *combination* of valuations *and* trend uniformity is the best way to understand this path.

We focus on defending capital when stocks have *neither* investment merit nor speculative merit. But that kind of strongly negative condition only represents about 25% of market history, notably including the past three years. During the other 75% of history, *at least one* of these merits has been available.

***On average*, stocks perform well when trend uniformity is favorable, and *while it lasts*, this also leads us to expect <u>positive surprises</u> in earnings, the stock market, and the economy.**

WHAT ABOUT THE BEAR?

After nearly three years in a defensive position, carefully reviewing bullish arguments and their limitations, the same careful review of bearish arguments is essential now.

Valuations

While we can certainly find individual stocks and sectors that appear priced to deliver strong long-term returns, the simple fact is that the major indices are still overvalued. Given a deeply depressed level of earnings, we may see some upside surprises over the next few quarters, but in the long-term, S&P 500 earnings have historically grown no faster than 6% annually measured from peak-to-peak. Using that long-term 6% growth channel and applying a range of future P/E multiples, the probable total return on the S&P 500 over the coming decade is likely to be quite disappointing (see Market Valuation on page 1).

Frankly, we used to believe that overvalued markets should go down in the short run. Then we looked more closely at the data. We reasoned that if overvaluation predictably resulted in falling prices, the market could never have reached extreme valuations such as the 1929 or 1987 peaks (2000 had not arrived). So there had to be *something* that distinguished overvalued markets that kept rising from overvalued markets that dropped like a rock. Based on our research, that something is trend uniformity. This finding led to our Market Climate approach. It helps us to understand overvalued runups, including those leading to the 1929, 1987 and 2000 peaks, as well as the subsequent plunges, each which followed a decisive breakdown in trend uniformity. At present, trend uniformity is favorable. While this does not ensure that the market will advance, we have no historical evidence on which to *expect* a decline.

Still, with valuations above normal, how far could an advance really be expected to go? Our opinion is that it would be difficult for a market advance to run much beyond about 20 times prior peak earnings. Except for the most recent bubble, that level has historically put a cap on the market. Still, that's about 15% above current levels. In price terms, a 1/3 retracement of the S&P 500's peak-to-trough bear market loss would take the index to 1027, still 10% above recent levels, and a fairly minimal target even within an ongoing bear market. A retracement of half the S&P 500's losses would take the index to 1152, about 24% above recent levels. This figure would also be within historical precedent for past bear markets, but it would require the market to reach valuations that would be difficult to sustain.

In any event, a constructive market stance does not require investors to assume that stocks are undervalued.

The Economy

Certainly, the U.S. economy is far from clearing the burden of excessive leverage and overcapacity that weighs on future growth. This is important, because even if the economy improves in the coming quarters, that improvement is not likely to take the form of powerful or sustained growth.

Every dollar of real investment in factories, capital spending and housing must be financed by a dollar of savings. Economists know this as the “saving-investment identity.” There are only three types: *private saving* (personal and business saving), *government saving*, and *foreign saving* (what we call a “current account deficit”, which really measures the amount of securities that the U.S. must export to foreigners in order to finance our trade deficit).

Currently, private savings are weak, government savings are negative, and the U.S. now requires the largest sustained inflow of foreign capital in history in order to finance its current account deficit. Needless to say, the prospects for a powerful increase in domestic investment are not strong.

This places the U.S. economy in a position where most of the growth in capital spending and business investment will have to be financed through *shifts* in other forms of spending - either reductions in fixed investment like housing, or growth in consumption which lags income growth, resulting in investable private savings. This contrasts with past economic expansions which have started with a *surplus* in current account, and therefore wide latitude to import foreign savings as an engine of investment growth. Still, our large “external financing burden” does not prevent moderate rates of economic expansion here.

Likewise, low consumer confidence is not a valid reason to avoid market risk. Consumer confidence is a lagging indicator which can be predicted from past changes in economic activity such as employment, factory use, stock prices, and inflation. It does have a modest amount of predictive power for the stock market, but as a *contrary* indicator. I first noted this early in the bull market of the 1990's (leading the <u>Los Angeles Times</u> to dub me “one lonely, raging bull”). The 2000 top created another opportunity to point this out, because at the time, record levels of consumer confidence were being incorrectly cited as a bullish argument.

Now, once again, analysts are using low levels of consumer confidence as an argument to avoid stocks, particularly in the consumer area. These arguments are empty of research. **Consumer spending, even when it slows, has always been the most stable category of economic spending**. This is true both empirically (nominal consumer spending has never declined on a year-over-year basis) and theoretically (see the work of Modigliani and Friedman on the “permanent income hypothesis”).

As a practical matter, all of this implies that while the economy may enjoy reasonable growth in the next few quarters, capital spending is not likely to *boom* anytime soon. It also means that technology companies that perform well are more likely to be those that have at least some exposure to consumer markets. But nothing in this suggests that stock prices must fall over the near term.

Deflation

In the latest policy statement from the Federal Reserve, the FOMC did not actually refer to deflation, but did indicate a belief that the risk of falling inflation outweighed the risk of rising inflation from a resurgence of economic growth.

This statement can clearly be taken as evidence that the Fed has no intent to raise the Federal Funds rate anytime soon. But as a statement about inflation prospects, we believe that the Fed is looking into the rear-view mirror. Recent concerns about deflation are likely to end up in Moot Issue Hell, joining such concerns as how to spend the massive federal surplus.

Inflation essentially measures the extent to which the growth in government liabilities - money, as well as government debt - exceeds the willingness of individuals to hold them. Both matter, because to the extent that excessive government debt drives up interest rates, it also reduces the willingness of individuals to hold currency (which doesn't bear interest), resulting in inflation nonetheless. So at its root, inflation is always a fiscal phenomenon, not simply a monetary one.

In contrast, deflation essentially measures the extent to which the growth in *demand* for government liabilities exceeds their supply. So for example, bankruptcies, credit concerns, bank runs, and other factors that create a demand for “safe havens” are typically deflationary triggers.

In recent years, the growth in government liabilities (currency and Treasury securities) has been explosive. The only factor preventing this explosive growth from resulting in inflation has been a *strong demand for safe havens* stemming directly from credit concerns, weak economic growth, plunging stocks, and geopolitical risks. The likely outcome today is not deflation. To the contrary, the risk is that increased economic stability will lead quickly to rising inflationary pressures and higher interest rates, even barring tightening moves by the Fed (which remain unlikely).

Oncoming economic downturns and deflation risks generally reveal themselves through fairly specific market action such as widening credit spreads for risky corporate debt, and a flattening yield curve. Barring these signals, it does not follow that poor long-term fundamentals must express themselves in short-term economic weakness, much less deflation.

Technical Conditions and Seasonality

Certainly the market is overbought here, to an extent equal to what we've seen at the peaks of several failed bear market rallies in recent years. Moreover, the market has just entered the seasonally unfavorable May-October period. Don't these factors support a bearish stance?

The answer is simple. **The market's response to valuation, overbought conditions and seasonal factors is markedly different when trend uniformity is favorable than when it is negative.**

It's very true that the market has typically performed better during the November-April period (18.1% annualized total return in the S&P 500, since 1945), than during the May-October stretch (7.4% annualized). But this performance breaks into a much different profile when the status of trend uniformity is considered. During the seasonally favorable November-April period, weeks when trend uniformity was favorable (as of the prior Friday) historically generated an average annualized return of 27.8%, while unfavorable trend uniformity produced an average gain of just 0.4% annualized. Likewise, during the seasonally unfavorable May-October period, favorable trend uniformity produced an average annualized gain of 17.6%, while unfavorable trend uniformity produced an average loss of -8.5% annualized.

In short, seasonality has historically had a measurable impact on market returns, but it is not sufficient to reverse the favorable or unfavorable implications of trend uniformity. Similarly, unfavorable valuation creates only a modest drag on returns when trend uniformity is favorable, even in combination with unfavorable seasonality.

The trading behavior of the market also differs depending on the Market Climate. The recent market advance has clearly placed the market in an "overbought" condition. In a Climate characterized by both unfavorable valuations and unfavorable trend uniformity, overbought conditions are often followed by vertical plunges, while oversold conditions are at best points to close out a few shorts - rarely to establish long positions.

In contrast, the current Market Climate tends to be kind to a buy-on-dips approach, while overbought conditions tend to be followed by flat periods rather than deep declines. That's not to say that the market can't sell off substantially, but the rare oversold conditions that do occur in the current Market Climate tend to be good buying opportunities.

Geopolitical Risks

Clearly, the most difficult risks to assess are those involving war and peace. Still, it is important to think out loud on the subject, both generally and in the context of the financial markets.

Near-term, the most probable difficulty will be governing Iraq. As Italy learned after its 1911 invasion to change the regime in Libya, even after a decisive victory, Muslim tribes in the interior proved frustratingly resistant to Italian rule. As Historian Martin Gilbert wrote, the resulting peace provided that "the Italians would administer Libya, but it would remain under Turkish sovereignty. In this way, the Koranic law which forbade the cession of the lands of Islam to the 'infidel' would not be broken.”

If force, or the threat of it continues to be the tool of choice in foreign policy, *long-term* prospects are also unclear. War, escalation, suffering and resentment tend to foster extremism *on both sides*. They polarize and concentrate power into the hands of hard-liners, at the expense of moderates who might be capable of diplomatic solutions. Very often, the unintended consequence is the rise of extremist leaders who promise to improve the world by "purifying" it.

***Of course* those actually responsible for criminal evil have to be punished, and a just and discriminate use of force is an essential part of this, but the best way to reduce future risks is to *simultaneously* cut these extremists off from their sources of broader support - to fill the void of moderates.**

This is accomplished by rooting policies not in the threat of force, but in a respect for history, cultural tradition, diplomacy, perceptions of injustice, and the rule of law. It is accomplished by addressing the suffering, fear, resentment and hopes of those who might otherwise *become* our enemies; by adopting a Marshall Plan of sorts - spending as much to build allies and relieve suffering as we spend on war. It is accomplished by resisting the autocratic urge to punish dissent, such as sanctions against European allies who showed genuine doubt that the grave prerequisites for war in Iraq had been satisfied; by refusing to dehumanize our enemies - a tendency that has always been responsible for the worst acts in history; and by being *faithful* to liberty, justice and human rights as principles of foreign policy in *every* instance, even when they do not immediately serve strategic interests.

Understanding, even-handedness, human rights, and diplomacy are not among the actions that constitute appeasement. Indeed, to eliminate a deadly virus requires a careful understanding of how it spreads, how it can be inflamed, how it can be isolated, and how to immunize those that would otherwise be vulnerable. The elimination of terrorism requires a similar approach. We can do better.

From an investment perspective, perhaps the greatest concern about taking market risk is the ever-present possibility of a terrorist attack. Even though major market declines have historically been preceded by a deterioration of trend uniformity, there is clearly a risk of events that might abruptly destablilize the market without notice.

As in the case of overvaluation and other blemishes in the fundamental picture, the market's likely response to a given event depends on the *predisposition* of investors toward risk. The saying "in a bear market, everything that *can* go wrong *will* go wrong" is really a statement about this predisposition. When investors are inclined to avoid and punish risk, even good news becomes bad news. In contrast, bad news has seemingly little effect on the market when investors are inclined toward taking greater risk. By our measures, investors currently have this inclination.

Stocks are a claim on a very long-term stream of future cash flows. Market plunges are typically not due to an expected reduction in these cash flows, but instead to a sharp increase in the risk premium demanded by investors. Negative trend uniformity is an indication that investors are skittish and very likely to drive risk premiums higher, which is why market crashes have historically been restricted to periods of negative trend uniformity. At present, we have favorable trend uniformity, which suggests that stocks may be less vulnerable to spikes in the risk premium, even in response to abrupt shocks.

In summary, the overall profile of market and economic conditions has shifted to the constructive side. This *doesn't* mean that long-term fundamentals have improved measurably. Rather, favorable trend uniformity changes the way that these fundamentals can be expected to evolve over the near-term.

None of these comments are an assurance that stocks will perform well in this particular instance. Our investment discipline is heavily based on the *average* market behavior in each Market Climate we identify. Since shifts in trend uniformity cannot be predicted in advance, it is difficult to make forecasts about future market conditions even a few weeks into the future. So we align our position with the *prevailing* Market Climate we identify. When the Climate shifts, so does our position.

We believe that the *average* expected return and risk of the market *vary*, depending on the particular Climate we identify. But once we identify a particular Climate, we make no attempt to predict or "time" short-term movements. **Based on current, identifiable conditions, we are constructively (though not aggressively) positioned in stocks, and relatively neutral (though not strongly defensive) in bonds.**

As usual, *we don't forecast, we identify*. If the Market Climate becomes favorable, we remove a portion of our hedges. If it becomes unfavorable later, whether after a week or after a year, we replace the hedges. No forecasting is required. Our view is not that stocks *must* advance, nor that the economy must expand. Rather, current conditions match those that have historically generated favorable market returns, *on average*. As long-term investors, this evidence is sufficient to take a constructive stance for now.

- John P. Hussman, Ph.D.

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