HUSSMAN

INVESTMENT RESEARCH & INSIGHT

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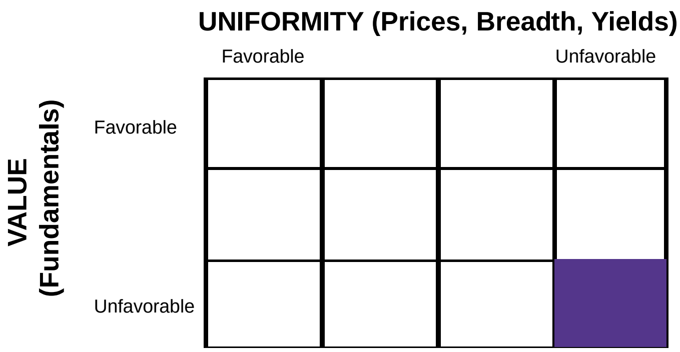
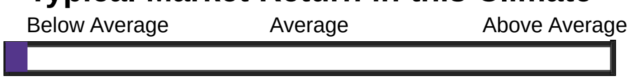
MARKET CLIMATE

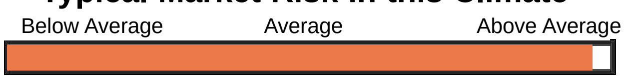
The current profile of valuation and trend uniformity



Typical Market Return in this Climate



Typical Market Risk in this Climate



The information contained in earnings, balance sheets and economic releases is only a fraction of what is known by others. The action of prices and trading volume reveals other important information that traders are willing to back with real money. This is why trend uniformity is so crucial to our Market Climate approach. Historically, when trend uniformity has been positive, stocks have generally ignored overvaluation, no matter how extreme. When the market loses that uniformity, valuations often matter suddenly and with a vengeance. This is a lesson best learned before a crash rather than after one. Valuations, trend uniformity, and yield pressures are now uniformly unfavorable, and the market faces extreme risk in this environment. There are also other risks. Historically, consensus economic forecasts have never correctly warned of an oncoming recession. Market action is profoundly more informative, particularly interest rate and credit spreads. Based on the most reliable set of leading indicators, a recession warning is now in hand. Our investment position does not rely on a recession to be effective, so we hope that this signal is incorrect. With earnings warnings and loan defaults already on the rise, investors should hope for anything *but* a slower economy.

THE TICKER

"And so, armed with a red-hot stock appraised by the market at a price-to-earnings ratio of 100, Randell set out to make his company a giant through acquisitions. Since the companies acquired, almost always with N.S.M.C. stock, had comparatively low multiples, N.S.M.C. earnings automatically went up with each acquisition. And Wall Street reacted as it was supposed to do in such situations; as the earnings rose, so did the bids, and before the year was out, N.S.M.C. stock had skyrocketed from the original price of 6 to a 1968 high of 82.

"The weak link was, of course, the disparity between Randell's promises and his company's real results, which, closely scrutinized, were unspectacular. After having predicted tripled earnings for a given year, Randell found himself forced to resort to creative accounting to make the prediction come true; then, having written artificially high earnings for that year, he was compelled by the game's inner dynamics to predict that those earnings would be tripled again the following year - and then, somehow, goad his accountants to Parnassian heights of accounting genius to fulfill the new promise.

"In early February, N.S.M.C.'s financial vice president gave a dumbstruck group of company executives the jolting news that the actual result for the quarter just ended would be a loss. Having sold at 140 as recently as late December, it was down to 50 and sinking fast; by July it would stand at 3 ½, a loss of more than 97 percent from its peak seven months before.

"The 1969-70 loss, including issues listed on the two leading exchanges and those traded over the counter, totaled in excess of $300 billion - the bitter fruits of the go-go years: of the conglomerates and their promoters' talk of synergism and of two and two making five; of the works of bottom-line fiction written by the creative accountants; of the garbage stock dumped on the market by two-a-week underwriters"

\- *The Go-Go Years, John Brooks*

"Another big reason investors are scrutinizing revenue figures: growing skepticism about the reliability of corporate earnings. As more companies boost profits with such things as investment gains and stock buybacks, while persuading analysts to ignore one-time costs that lower earnings, it is getting harder to tell how well a company is really doing. Earnings figures 'have become so distorted by peculiar accounting changes by companies that earnings have become something of a joke'. [S.G. Cowen] predicts more 'perversions' of earnings results."

\- *Intel's Jolt Shows Shifts in Market Dynamics*
The Wall Street Journal, 9/25/00

On Friday September 1st, the S&P 500 rallied to a peak of 1520.77, capping a string of strong advances. Yet due to a deterioration of market action in a number of economically sensitive groups, our price trend model indicated that trend uniformity had shifted to an unfavorable condition, and we moved to defend our portfolios more fully against downside risk. On Friday September 15th, our yield trend model also shifted to a negative position, indicating that the overall trend of interest rates and other yields was upward and potentially hostile. **The combination of all three factors - unfavorable valuation, unfavorable trend uniformity, and unfavorable yield trends - is what we identify as a Crash Warning.** This does not mean that a crash is certain, but it does place the market in a condition which has historically occurred less than 3% of the time, and from which every major stock market crash has emerged.

The recent peak has been accompanied by some of the most extreme sentiment readings in history. During the advance, the percentage of bearish investors surveyed by the American Association of Individual Investors had dropped to less than 12% twice. **At the September peak, the percentage of bearish investors fell even further, dropping to 8.3% - one of the lowest readings in history. Last week, the bearish percentage hit 6.7%.** Jim Stack of Investech (www.investech.com) notes that the last time the bearish percentage was below 12% even twice in any 10-week period was during August 1987.

As we noted in our internet market comments, recent weeks have also generated a rare technical signal which has invariably been followed by significant market plunges. Historically, when the market has exhibited about a month of very narrow breadth (as measured by the number of individual stocks advancing and declining), followed by a sharp downside break, stocks have typically suffered significant downside follow-through. To make these criteria more concrete, Peter Eliades defines his "Sign of the Bear" as a period of 21 to 27 consecutive trading days in which the advance/decline ratio is no greater than 1.95 and no less than 0.65 on any given day. The signal is complete if that flat period is followed by a 2-3 day market break where the average advance/decline ratio is below 0.75.

Based on those criteria, there have been only 7 times in history that the market has generated this signal: August 1929 (-89% drop), December 1961 (-29% drop), January 1966 (-27% drop), October 1968 (-37% drop), December 1972 (-47% drop), April 1998 (-19% drop, but worse than 30% in the Nasdaq and Russell indices) and finally, September 2000. On its own, we would view this signal as an interesting aspect of market history. But given the uniformly negative tone of other indicators, this signal warrants more serious consideration.

In short, our models are on a Crash Warning, supported by a broad backdrop of caution signs. With valuations over twice the historical norm, bullish sentiment at the highest extreme since August 1987, the economy clearly slowing, market action producing a recession warning, rare technical alerts flashing, and a growing trend toward earnings disappointments, we implore our clients not to ignore market risks here.

ECONOMIC PERSPECTIVES

This month, market action produced a recession warning. Except in late 1998, when the Fed forestalled a recession with a massive easing during the Asian crisis, the following 4 indicators have achieved a perfect record in spotting recessions long before the economic data confirm one:

1) Credit spreads higher than 6 months earlier, as measured either by the Dow 20 Bond corporate yield minus 10-year Treasury yields, or by commercial paper yields minus 3-month Treasury bills yields.

2) Yield curve not steep, with the 10-year Treasury yield minus the 3-month Treasury bill yield less than 2.5%

3) S&P 500 Index lower than 6 months earlier, and

4) NAPM Purchasing Managers Index below 50.

It is quite true that consensus economic forecasts remain relatively upbeat here. Unfortunately, most economists have never fully internalized the "rational expectations" view that market prices convey information. Of course, accepting this view does not require one to believe that prices convey information perfectly (which is what the "efficient markets hypothesis" assumes). But where finance economists take this information concept too far, economic forecasters don't take it far enough. As a result, economic forecasts are generally based on coincident indicators such as GDP growth and industrial production, or pathetically lagging indicators such as consumer confidence and the unemployment rate. Even the "leading indicators" fail to live up to their name.

This tendency to gauge economic prospects by looking backward is why economists failed to foresee the Great Depression and every recession since. For example, in December 1972, just before the worst recession and bear market since the Depression, U.S. News & World Report trumpeted "A banner year for business and the stock market is being hailed as a sure thing for 1973 by investment bankers … By an all-but-unanimous vote, bankers predict continued business gains next year." Similarly, Business Week assured readers that "Consumers, businessmen, and investors can plan with confidence - 1973 will be an excellent year for the economy. That is the clear consensus of the vast majority of economists." In January 1973, The New York Times quoted yet another analyst as saying "It's very rare that you can be as unqualifiedly bullish as you can now". That analyst was Alan Greenspan, though we hope that he subsequently learned a thing or two from Manuel Johnson, who was one of the Fed's key proponents of market-based indicators during the 1980's.

In August, we noted that even a modest slowing in economic growth is likely to significantly impair the earnings growth of technology companies. We expect technology earnings over the coming year to be dramatically weaker than expected, with S&P 500 technology earnings actually declining by about 20%.

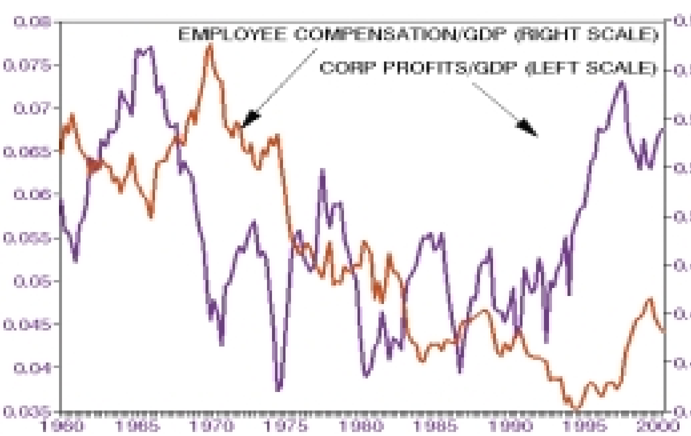
While our investment positions are not dependent on that expectation being right, roughly one-third of the value of the S&P is highly dependent on that expectation being wrong. The evidence is already accumulating on the bearish side.

Since August, the market has suffered earnings warnings and revenue disappointments in Intel, Apple, Oracle, IBM, TRW, and Sprint PCS, along with warnings in companies outside of the technology sector, including McDonalds, Maytag, Gillette, Alcoa, Goodyear, DuPont, Morgan Stanley, and Eastman Kodak among others. Gradually, the names are getting bigger. The trouble is already well advanced in the retail, internet and telecom sectors, but investors insist on believing that these problems are isolated.

We continue to believe that earnings trouble will come primarily from two areas: a slowdown in capital spending, and a significant retrenchment in profit margins. Those are the areas to watch. Of course, getting a company to openly identify these problems will be like pulling teeth. In general, earnings warnings are best blamed on outside factors beyond a company's control, which is why oil prices and the Euro have typically been cited in recent weeks. Even Intel chose to focus on a slowdown in PC sales in Europe, though we're more inclined to believe Ashok Kumar's indication that the slowdown was more widespread. Undoubtedly, oil prices and the Euro will remain the scapegoats as earnings are released beginning about mid-October. This will be easy for consumer companies, who really do have Euro exposure, but for other companies, we expect some far-fetched reasoning why these factors are to blame. At least it may prove entertaining.

With several years of back-to-back earnings jumps, it is easy to imagine that earnings growth has moved to a persistently higher track. From a longer-term perspective, however, it becomes clear that this powerful growth in earnings really represents a move from the trough to the peak of a long-term earnings growth channel that extends back to 1950. Measuring earnings growth from peak-to-peak or trough-to-trough, S&P 500 earnings have been very well contained in a 5.7% annual growth channel. You can even draw the channel to squeeze out a 6% growth rate, depending on the thickness of your pencil. While short-term earnings growth has indeed been spectacular, earnings are cyclical over the longer-term, and growth is more modest.

As we noted in August, revenue growth and profit margins tend to move in the same direction, so when the economy is strong, the impact on earnings growth is powerful. Unfortunately, both revenue growth and profit margins are depressed even during modest economic slowdowns. This effect is particularly strong when wage pressures are high. Since employee compensation accounts for about two-thirds of all business expense (even in high-tech companies), relatively small shifts in employment compensation can put substantial pressure on profit margins.



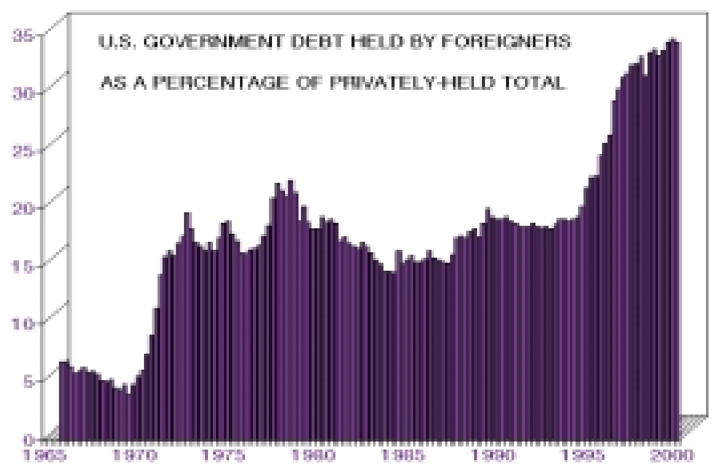
The accompanying graph depicts corporate profits and employee compensation as percentages of GDP. Note that profits are stated for the economy as a whole. Profits in the S&P 500 tend to be significantly more cyclical, rising faster during economic expansions, and declining further during recessions. For the economy as a whole, profit growth peaked in the third quarter of 1997. Since then, corporate profits have grown at less than 3.4% annually. The main reason for this slowdown has been upward pressure on employee compensation.

With the labor market still unusually tight, wage pressure is likely to continue. In recent years, publicly traded companies have been able to report very strong earnings growth because employees have been compensated using stock options rather than cash, and the cost of those stock options does not appear on the income statement. With the weaker performance of the stock market, employees may place increasing pressure on companies to raise their cash compensation. 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.

THE DATABANK

In recent months, the European currency - the Euro - has suffered deep losses. We believe that the Euro is substantially undervalued here. Moreover, the forces which drove the Euro lower are largely exhausted, and that could prove very bad news for the U.S. economy. Here's why.

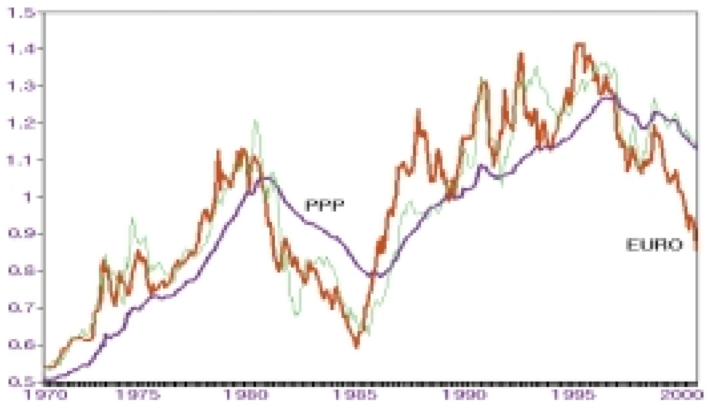
During the past decade, the U.S. has become extremely dependent on foreign capital to finance a spending boom here at home. We've been on a consumption and investment binge, which our domestic savings have not been able to finance. As a result, the U.S. has run record trade deficits, and has imported record amounts of foreign capital. The percentage of publicly held U.S. Treasury bonds held by foreigners has soared, as have foreign holdings of U.S. stocks and corporate debt.



In the past few years, the flow of foreign capital into the U.S. has been aided by legal changes in Europe. Those changes allowed pension funds and insurance companies to invest in non-European assets. And as a result, European acquisitions have soared from 0.5% to fully 7% of the area's Gross Domestic Product.

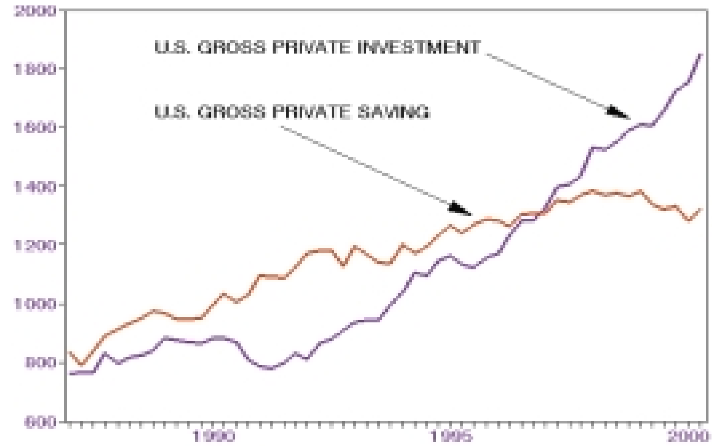
According to Bridgewater Associates, a firm that manages funds for institutions and central banks, this process of reallocating assets to the U.S. has now reached the dollar allocations allowed by law. This is problematic, because the capital spending boom enjoyed by the U.S. has largely been financed through these foreign capital inflows (which we observe as merchandise and current account deficits). Normally, this process would have slowed long ago.

Meanwhile, the huge capital flows of recent years have bolstered the U.S. dollar, and have driven the Euro to levels far below the value justified by relative price levels and interest rates (for a full discussion of this, see "Valuing Foreign Currencies" on the Research & Insight page of our Fund website, www.hussman.net).



Again, we believe that the Euro is substantially undervalued. That said, foreign currencies can often take many years to move from extreme undervaluation to extreme overvaluation, so ours is not a statement about short-term timing but of long term relative value.

European investors now find themselves holding overvalued U.S. assets denominated in an overvalued U.S. currency. A sustained advance in the Euro (and a corresponding decline in the value of the U.S. dollar) would create risks for U.S. bonds, particularly for U.S. Treasuries. But because the U.S. equity market is also vulnerable here, and defaults are rising in the U.S. corporate debt markets, slower capital flows could strongly impact all U.S. financial markets. From a European perspective, future losses could be gruesome, accelerating any downturn once it begins.



If foreign capital flows do slow, the so-called "good news" would be that our trade deficit would shrink quickly and dramatically. This is because the gap between U.S. saving and investment would narrow. The bad news is that a quick and dramatic decline in the trade deficit is always accompanied by a collapse in domestic investment like capital spending.

In short, the binge in domestic consumption and investment is in danger. With our models generating both a Crash Warning in the financial markets and a recession warning for the economy, market conditions dictate a strong emphasis on capital preservation.

John P. Hussman, Ph.D.

MARKET VALUATION

S&P 500 Index:	1436.51
Current S&P 500 dividends:	15.95
Current S&P 500 earnings:	51.92
Record earnings to-date:	51.92
Price/record earnings:	27.67
S&P 500 10-year total return projections (annualized):	
At future P/E of 20 (same as '29, '87 peaks)	0.18%
At future P/E of 14 (average 1950-present)	-3.29%
At future P/E of 11 (historical median)	-5.56%
At future P/E of 7 ('74, '82 troughs)	-9.68%

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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