



INVESTMENT RESEARCH & INSIGHT

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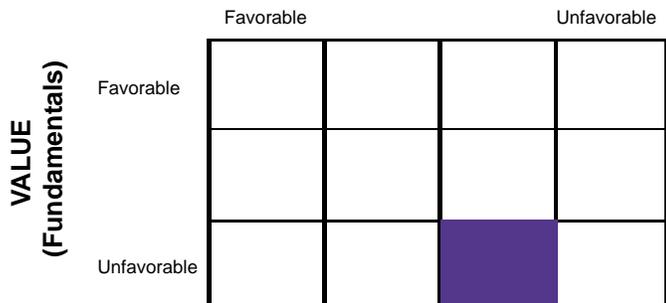
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MARKET CLIMATE

The current profile of valuation and trend uniformity

UNIFORMITY (Prices, Breadth, Yields)



Typical Market Return in this Climate



Typical Market Risk in this Climate

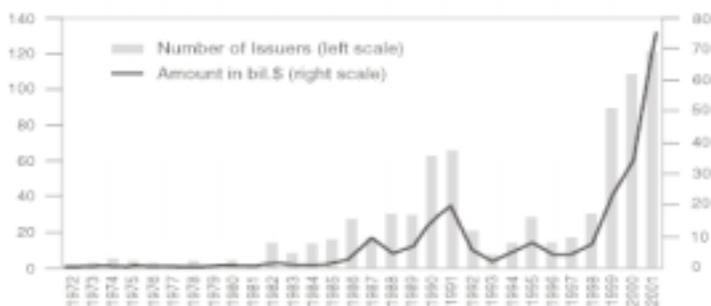


“The way to wealth in a bull market is debt. The way to oblivion in a bear market is also debt, and nobody rings a bell.”
 - James Grant

“Looking forward to 2002 it seems certain that default rates will remain high. The current flight to quality, evidenced by the widening of spreads, will make it difficult for stressed obligors to roll over their debts when they come due. Coupled with the tightening of credit by commercial banks in the last few quarters, many companies in financial difficulties will see their funding sources dry up and be pushed over the brink.”

- Standard & Poors, October 29, 2001

Global Rated Corporate Bond Defaults



* through October 10, 2001

THE TICKER

In the coming year, the most important problem affecting the financial markets is likely to be debt. While investors are currently focused on how effective recent Fed moves will be, and how quickly an economic stimulus will kick in, they are largely ignoring the much more important issue, which is the ability of individuals and companies to service debt.

Both consumer and business debt burdens currently exceed all historical precedent. Until recently, this debt has been serviced thanks to a strong economy and liberal access to new credit. Unfortunately, corporate defaults and personal bankruptcies have soared to record highs in recent months. Inexplicably, these developments remain below the radar for most investors.

The current recession is likely to be deeper and more prolonged than the garden-variety consumer slowdown. Recessions that come off of capital spending booms and speculative frenzies usually trigger "deleveraging" - the reduction of excess debt levels and the write-down of unserviceable debt.

As a rule, profit margins and unemployment are lagging indicators - they often remain weak well after the economy turns higher. Typically, weak profit margins and rising unemployment trigger a cascade of corporate and personal defaults even after the economy bottoms. Given that debt levels are well beyond any historical extreme, this tendency is likely to be magnified. **In a deleveraging recession, which I believe we are in, the tendency toward new defaults is so strong that it cuts short the normal process of recovery.**

Ironically, debt problems have made the growth of money supply figures such as M2 and M3 appear very robust and promising for future economic growth. What is really going on is that the market for corporate debt (especially high yield debt) has evaporated. The volume of new debt issues has collapsed, as have the number of new registrations in the pipeline. As a result, companies that have traditionally found new financing in the credit markets have turned instead to banks. At the same time, investors who have traditionally invested their savings by purchasing corporate bonds have instead fled to the perceived "safety" of money market funds and bank deposits. These savings are still finding their way into the hands of companies, but the money is now passing through banks rather than through the corporate bond market.

Notice how this works. Savers make deposits into banks and money market funds, and those banks and money market funds lend the money to corporations. The savings

deposits are counted in M2, and money market funds are counted in M3. Because of the increased risk-aversion of investors, and their preference for the "safety" of banks and money market funds, we have seen substantial growth in M2 and M3.

The demand for a safe haven is so strong that short-term interest rates have plunged to 40-year lows, well below long-term rates and even below the rate of inflation. Some see these developments as a sign of "liquidity" that will fuel future economic growth. If the corporate debt markets weren't dominated by the sound of crickets, we might agree. But here and now, the growth we've seen in monetary aggregates such as M2 is simply the result of a shift to the "safety" of banks and money funds.

Yet since the money is still being lent to companies, somebody bears the risks. Primarily, these risks are borne by the deposit insurance system. There's a good chance that banks and the FDIC will find themselves paying for these risks, which explains why we aren't holding many financial stocks in our portfolios.

What will bring debt problems to the forefront? One likely event will be a surge in the unemployment rate over 6% in the coming months. The other will be a further collapse in profit margins - the combined result of flat revenue growth and persistent cost pressures - mainly employment costs. Benefit costs continue to rise briskly, and despite rising unemployment, companies are facing continued wage pressures due to their sudden inability to compensate employees with stock options. These trends are likely to strain the debt servicing ability of consumers and businesses. We doubt that these risks are appropriately reflected in the financial markets.

As always, our views about the economy and the markets are intended to provide background and context. Our actual investment positions are always determined by two factors: valuation and market action (specifically "trend uniformity"). Currently, both of those factors remain unfavorable. **Even if earnings were still at last year's peak, the P/E ratio on the S&P 500 would be 20, matching the price/peak-earnings ratios seen before the 1929 and 1987 crashes. Only favorable interest rate action makes a crash unlikely here.**

With regard to trend uniformity, we saw unfavorable divergences even during the recent rally from the September lows. Interestingly, many of these divergences were in high-debt industries such as utilities and autos. So even without headlines about default risk ahead, market action is already giving its own subtle warnings. Again, we doubt that default risks are fully reflected in market prices, but as usual, divergent market action usually carries information.

Overvaluation means that stocks are priced to deliver unsatisfactory long-term returns, and that stocks are not attractive on an investment basis. Poor trend uniformity is a more immediate sign that investors remain skittish about risk, and that stocks are not attractive on a speculative basis. Even if stocks are overvalued, we are willing to take a modest amount of market risk if market internals show sufficiently uniform strength. But when both factors are unfavorable, as they are now,

we emphasize capital preservation instead of speculating on market risk.

This emphasis may mean that we miss out on occasionally strong bear market rallies, but we simply do not willingly take risks that are associated with poor average returns. The current market remains characterized by such risk. If trend uniformity improves, we will quickly shift to a constructive position, but we remain defensive here.

THE OBSERVATION DECK

"It's not what people don't know that hurts them. It's what they do know that just ain't so."

- Will Rogers

One of the fascinating aspects of the financial markets is how much investor confusion is inflicted by "obvious" but wrong models. More often than not, this confusion results from an attempt to oversimplify the world. The most common error is to focus on supply or demand in isolation, rather than viewing outcomes in terms of equilibrium.

You can hear this working in comments like "There's a lot of money on the sidelines waiting to come into stocks", or "The government should encourage people to spend instead of save", or "Government deficits drive interest rates higher" or "Trade deficits drive the dollar lower." In every case, these statements reflect a failure to understand equilibrium. It's not just that these statements are wrong - it's that they reflect a totally incorrect view of how the world works. To argue for or against these statements is a lot like arguing with Christopher Columbus about whether the trees at the edge of the earth are maples or pines.

Equilibrium can be defined in a lot of ways, but it essentially means that every security bought is also sold, every security issued is also held, every dollar borrowed is also lent, and every good not consumed is invested (if only as "inventory investment"). In short, it means that supply equals demand. The concept is simple, but requires people to hold two things in their mind at the same time. For many analysts, most notably the securities salespeople that often appear on business television, this is evidently far too much to ask.

To get at the idea of equilibrium, you have to understand the difference between production and trading. Production brings a new object into existence, whereas trading is simply a change in ownership. In the economy, production happens when goods and services are created. Trading happens when goods and services are exchanged after already having been drawn into existence.

In the financial markets, the production of a security takes place on the "primary" market, when investors buy a newly issued security and the money goes directly to the company. Trading takes place on the "secondary" market, when an existing security changes hands from one owner to another. If the buyers are very eager, those trades may take place at high prices. If the sellers are very eager, those trades may take place at low prices. Trading doesn't send any new money to the underlying companies. It does not result in new capital expenditures. It is simply a change in ownership. Every share of stock, once issued, must be held by someone.

From the standpoint of equilibrium, money never goes "into" the stock market. Except for the initial public offering, when the money of new investors goes directly to the company issuing the stock, every share of stock that is bought by one investor is sold by another. Every dollar that a buyer puts into the market immediately goes out of the market in the hands of the seller. In effect, money doesn't go *into* the market, it goes *through* it. It's not as if the market is a balloon that gets bigger as more money is put in.

Let's put together a simple economy, and you'll see how equilibrium works. Suppose that you produce \$100 worth of output, consume \$90 of it, and save \$10. There are 10 people in the economy (including you) who all do the same. Well, in aggregate, the 10 of you have produced \$1000 of stuff, consumed \$900 of it, and have \$100 in savings. The economy also has exactly \$100 of stuff left over. In the real economy, output that isn't consumed - directly by consumers or indirectly through the government - is classified as "investment." Only savings - output that has been produced and not consumed - is available for investment. By definition, savings always equal investment.

Now let's say that everybody invests their savings. They put \$90 of those savings into a money market fund, and \$10 into newly issued stock of Acme company (each person buys 1 share at \$1 each). Acme then goes to the money market, issues some commercial paper, and borrows the \$90 as well. So Acme gets the \$100 of savings, and buys the \$100 of investment goods in the economy. Everything is now accounted for. \$1000 of stuff has been produced. \$1000 of stuff has been purchased. \$100 has been saved, and \$100 has been invested. All securities issued are also held. We've got "General Equilibrium."

Now suppose that people get optimistic. They decide that Acme's prospects are outstanding. The stock shoots to \$3 a share, giving Acme stock a market value of \$30. Joe sells the \$9 in his money market fund and buys 3 shares: one from Al, one from Betty, and one from Charlie. Joe is now a heavy investor in Acme, while three other investors have cashed out. Maria Bartiromo reports breathlessly on CNBC that this cash is just sitting on the sidelines, waiting to drive Acme shares even higher. True? Nope. See, we have a problem. The money market fund had to sell \$9 of Acme's commercial paper to satisfy Joe's redemption. Who did the Fund sell it to? You guessed it. Al, Betty and Charlie. In equilibrium, every security must be held. Did Acme get any money from these transactions? Nope.

Now there's a flood, and Acme's building goes floating down the river and sinks into the deep blue sea. The stock goes to zero. The market value of the shares drops from \$30 to nothing. Did anybody "get" this \$30? Nope. \$20 of it was simply capital gains that evaporated. \$10 of it was initial capital that got written down to zero. Acme defaults on \$90 of commercial paper. The economy as a whole writes down \$100 of hard-earned savings as losses and moves on. Evidently, Acme was an internet company.

In recent years, many analysts have argued that capital gains should be counted as savings. Not in equilibrium. Savings finance actual investment in capital goods, plant, equipment and so forth. Stock purchases

and sales merely transfer ownership. Regardless of whether they occur at high prices or low prices, they do nothing to finance new investment or new consumption. In equilibrium, only savings finance economic activity. The prospect of capital gains does create an *incentive* to save, but the gains themselves are just a way of keeping score between various investors.

When you look at the market in equilibrium, it is clear that money market funds are not simply a pool of liquidity "waiting" to go into stocks. Money market funds hold securities such as commercial paper, which have been issued by companies to finance their operations.

If Mickey sells a money market fund to buy stocks, the money market fund has to sell commercial paper, and Nikki has to buy it with her cash. At the same time, the stock Mickey bought has to be sold by Ricky, who gets Nikki's cash. In equilibrium, all that has happened is that Mickey now holds the stock that Ricky used to hold, Ricky now holds the cash that Nikki used to hold, and Nikki now holds the commercial paper Mickey used to hold. It is nonsense to believe that money shifted "out" of money market funds and "into" the market.

An understanding of equilibrium is also essential for analyzing the economy. Much economic confusion can be blamed on Keynes, who originated a whole line of theory based on the notion that demand is all that is required for output to be produced. The world, to Keynes, is one big demand curve. Supply adjusts passively. The best way to increase income is to have people consume 99.99% of it (99.999% would be better, though). In the Keynesian world, the act of spending is an act of production, which warps the whole concept of equilibrium. If you think of economics as the study of how scarce resources are allocated, Keynesian theory is quite simply not economics.

Most of the force of Keynesian theory comes from the assumption that greater attempts to save don't translate into greater investment. Suppose for example that total income is \$1000 and individuals save and invest 10% of this (\$100). Now suppose that investors attempt to save 20% of their income. Keynes quietly assumes that investment is still fixed at \$100. Well, *duh*. If investment is fixed, then we already know by definition that saving is fixed. So the attempt to save 20% of income must still result in \$100 of savings. Which can only mean that income plunges from \$1000 to \$500. **Quite simply, Keynes concludes that greater saving hurts the economy because he assumes that these savings are not lent to anybody else.** With this subtle assumption, Keynes trivializes the whole savings and investment equilibrium and concludes that government spending is our only way out.

Now consider government deficits. **It is often taken for granted that *deficits* (not just spending) drive long-term interest rates. Yet there is no statistical evidence to support this belief. The reason is clear as soon as you consider the situation in equilibrium. Suppose the government decides to reduce its borrowing by raising taxes. Yes, the government will have to sell fewer bonds to the public, but the public will also have less to lend. There are no new funds released by this change in policy, and no reason for interest rates to change.**

Once the government decides to spend money, it has to be financed. Period. It is the quantity of government spending (and particularly the growth of entitlement spending), not the quantity of borrowing, that affects inflation and interest rates.

The U.S. government has recently proposed selling savings bonds to help finance military expenses. The immediate chorus has been "No, no, the government shouldn't encourage people to save, they should encourage people to spend." The idiocy of this objection is clear when you think in terms of equilibrium. Simply, if government is going to spend money on military costs, and we agree that that is a reasonable thing to do, then by definition that money has to come from somewhere. There aren't a lot of choices. Either the government diverts money from other programs, or it raises taxes, or it prints money, or it borrows it. There are no other alternatives.

Since people seem to want the government to spend more overall here, cutting back other programs is out. Raising taxes isn't actually much different from selling bonds in that you get the money from the economy and then turn around and spend it, except that taxes introduce all kinds of distortions and make it much more difficult to cut the spending in the future. Since the government is trying to cut taxes here, raising them is evidently out. As far as printing money goes, the Federal Reserve is already doing this with great alacrity. As long as individuals are willing to hold dollars as a useful means of making payments and storing value, the government essentially receives "revenue" from its production of these pieces of paper. It then spends that revenue. If government produces too many of these pieces of paper, their value begins to decline, which we observe as inflation (essentially a tax on holders of existing money). In any event, once money printing is already in full throttle, the only remaining alternative is to borrow money.

"But savings bonds will encourage people to save money. Don't we want them to spend money?" To which one can only answer, "The money is being spent! It's being spent by the government on military operations. And every dollar that the government spends has to come from somewhere." That's equilibrium.

Similarly, the "economic stimulus plan" boils down to the government borrowing money from the public by issuing bonds, then giving that money to the public, who must, in equilibrium, use it to buy those bonds. Government is a zero-sum game. It does not "put money into the hands of consumers." It simply reallocates money between them.

For government actions to have an effect, they have to change incentives to consume or invest, or remove barriers that existed in the absence of the intervention. The actions must draw *idle capacity* into production in a way that could not be achieved privately. They assume that consumers and businesses are not *choosing* to spend less, but instead are faced with constraints that *prevent* them from spending in the absence of government intervention.

In our view, the proper way to analyze both the stock market and the economy is to forget all the "money flow" and "stimulus" arguments and focus on fundamentals. **Recessions are not simply periods of low demand. They are fundamentally a mismatch between what is produced and what is demanded. Resolving this mismatch requires *adjustment and time*.**

Though consumption makes up about two-thirds of GDP, consumption typically doesn't decline in a recession. Most of the decline in a recession is due to plunging investment (the corresponding decline in saving largely shows up as less saving imported from abroad - which means that *the trade deficit shrinks* in any economic downturn).

Recall that the only reason savings are undesirable in Keynesian theory is that the attempt to save more is not matched by an increase in investment. ***Changing incentives and removing constraints to investment (capital gains reductions, flatter taxes, lower regulatory barriers) are the most appropriate responses to recession. The goal is to encourage investment and shift production to eliminate the mismatch, but this takes time.***

Still, attempting to prop up a market that improperly values stocks and misallocates capital is not useful. Nor is the attempt to derail saving behavior. The Fed wants to give us free credit. Congress wants to give us free money. But in equilibrium, there is no such thing as a free lunch.

- John P. Hussman, Ph.D.

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