Weekly Market Comment

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A Reprieve from Misguided Recklessness

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An immediate note on market conditions. Last week's market advance cleared out the "predictable" expectation for constructive returns that briefly emerged from the recent market selloff. That doesn't mean that the market can't advance further, but given that the expected return/risk profile of stocks has now shifted hard negative again, any such advance would be a random fluctuation rather than a predictable one. Strategic Growth and Strategic International Equity have shifted from a briefly constructive position back to a full hedge. Our principal investment position in Strategic Total Return remains a 20% allocation to precious metals shares, where the ensemble of conditions remains very favorable on our measures, despite what we view as a welcome correction in the spot price of physical gold. The Fund has a duration of only about 1.5 years in Treasury securities, mostly driven by a modest exposure in 3-5 year maturities.

It is now urgent for investors to recognize that the set of economic evidence we observe reflects a unique *signature* of recessions comprising deterioration in financial and economic measures that is *always and only* observed during or immediately prior to U.S. recessions. These include a widening of credit spreads on corporate debt versus 6 months prior, the S&P 500 below its level of 6 months prior, the Treasury yield curve flatter than 2.5% (10-year minus 3-month), year-over-year GDP growth below 2%, ISM Purchasing Managers Index below 54, year-over-year growth in total nonfarm payrolls below 1%, as well as important corroborating indicators such as plunging consumer confidence. There are certainly a great number of *opinions* about the prospect of recession, but the *evidence* we observe at present has 100% sensitivity (these conditions have *always* been observed during or just prior to each U.S. recession) and 100% specificity (the *only* time we observe the *full set* of these conditions is during or just prior to U.S. recessions). This doesn't mean that the U.S. economy cannot possibly avoid a recession, but to expect that outcome relies on the hope that "this time is different."

While the reduced set of options for monetary policy action may seem unfortunate, it is important to observe that each time the Fed has attempted to "backstop" the financial markets by distorting the set of investment opportunities that are available, the Fed has bought a temporary reprieve only at the cost of amplifying the later fallout.

Recall how the housing bubble started. Back in 2002-2003, Alan Greenspan held short term interest rates at such low levels that investors felt forced to "reach for yield" - and they found that extra yield in mortgage securities, which up until then had never experienced major credit difficulties. Wall Street quickly got a whiff of that, and realized that it could earn enormous fees by cranking out more "product" to satisfy investor demand. Soon, a flood of mortgage securities was created featuring increasingly complex structures (in order to maintain "AAA" status) while the proceeds from issuing these securities were offered to borrowers who were less and less creditworthy. As long as a willing borrower could be found - however unable to actually pay off the mortgage, and as long as a willing lender could be found - pressed to reach for yield by the Fed's distortive low interest rate policies, Wall Street and the banking system got them together, and obscured the gaping chasm between actual and perceived credit risk through "financial engineering" that created slice-and-dice securities with mind-numbing complexity.

Once the housing bubble collapsed, the Fed again responded with policies aimed primarily at distorting the set of investment opportunities through zero interest rates, preserving the misallocation of capital toward speculative investments (on Bernanke's misguided and empirically unsupported belief that consumers spend out of speculative gains). Yet the underlying debt burdens have not been restructured, so consumers - particularly homeowners - continue to pare back spending in order to reduce those debt burdens. As a result, there is little expectation of significant growth in demand, and companies therefore have little reason to hire new employees - all of which reinforces a "low level equilibrium" in the economy.

The way to get out of this is to abandon the misguided belief that economic prosperity can be obtained by encouraging speculation and distorting the set of investment opportunities. Rather, we will eventually find, as was eventually also discovered in the post-Depression stagnation of the 1930's, that the way to get the economy moving again is to restructure hopelessly burdensome debt obligations.

Of course, this same story is playing out on a global scale. It is worth noting that the yield on 1-year Greek government debt surged to 55% last week. At present, the global bond market is expressing a 100% expectation that this debt will default. The only question now is what the recovery rate will be.

Over the past three years, Wall Street and the banking system have enjoyed enormous fiscal and monetary concessions on the self-serving assertion that the global financial system will "implode" if anyone who made a bad loan might actually experience a loss. Because reversing this mantra is so difficult, policy makers are likely to continue fitful efforts to "rescue" this debt for the sake of bondholders, through mechanisms that are increasingly distasteful to the broader population. The justification for those policies will therefore have to be coupled with rhetoric that institutions holding these securities are too "systemically important" to suffer losses.

On this note, it is critical to remember that nearly all financial institutions have enough capital and obligations to *their own* bondholders to completely absorb restructuring losses without *customers or counterparties* bearing any loss at all. So keep in mind that the debate here is not about protecting customers or counterparties - it is really about whether the stockholders and bondholders of banks and other financial institutions should bear a loss. The "failure" of a bank only means that existing stockholders and bondholders are disenfranchised - the company simply takes on a new life under new ownership. Existing stockholders lose everything, unsecured bondholders typically lose something, and senior bondholders get any residual obtained as a result of the sale or transfer of the company. If the global economy is fortunate, the financial system two or three years from now will look much the same as it does today, but the ownership and capital structure will have changed almost entirely. A major restructuring of debt is the clearest path to long-term economic recovery, and the accompanying losses to those who recklessly made bad loans would be the highest realization of Schumpeter's idea of "creative destruction."

From that perspective, Warren Buffett's $5 billion investment in Bank of America preferred stock last week was essentially a defense of the old guard. Buffet observed, "It's a vote of confidence, not only in Bank of America, but also in the country."

Yes - to be specific, it's a vote of confidence that the country will bail out Bank of America in any future crisis. We should all hope that Buffett's investment is successful - *provided* there is no future crisis - and we should equally hope that Buffett loses the entire investment otherwise.

A reprieve from misguided recklessness

On Friday, Ben Bernanke gave his long-awaited speech at Jackson Hole, which notably did not include any pronouncement about a third round of quantitative easing. The stock market advanced anyway, largely because investors seemed to take Bernanke's comments as a cue that the Fed will revisit the prospect of QE3 in September. Specifically, analysts focused on Bernanke's observation that "the Federal Reserve has a range of tools that could be used to provide additional monetary stimulus. We discussed the relative merits and costs of such tools at our August meeting. We will continue to consider those and other pertinent issues, including the course of economic and financial developments, at our meeting in September, which has been scheduled for two days (the 20th and the 21st) instead of one to allow a fuller discussion."

Part of the reason for the expanded discussion, of course, is that three FOMC members have already declared mutiny, opposing even the Fed's promise to hold interest rates near zero through mid-2013 (which is the most resistance to a Fed decision in two decades). Still, this opposition unfortunately seems to be for the wrong reason - not because they recognize that QE2 didn't actually work, nor because they understand that consumers don't spend out of speculative gains - particularly in stocks and commodities, nor that they recognize that QE isn't effective in relieving any constraints on the economy - given that interest rates are already low and banks are already awash in liquidity (though not necessarily capital - and there *is* a difference). Rather, the reason for their opposition seems to be that they don't believe that economic conditions warrant further "stimulus."

Look. Imagine that Ben Bernanke announced that he is going to stop spitting watermelon seeds into a can. Should we all become concerned that he is suddenly not doing enough to stimulate the economy? Well, only if you think that spitting watermelon seeds into a can is stimulative to the economy. And this is precisely the point. The successes of QE2 included a brief boost to pent-up demand which has already reversed, a boost to speculation in the stock market that has already reversed, a plunge in the value of the U.S. dollar that has persisted because the increased stock of U.S. dollars has persisted, and a wave of commodity hoarding that injured the world's poor by raising prices of food and energy - because commodities are viewed as currency substitutes when governments are debasing purchasing power through money creation.

Moreover, this failure was predictable even before the Fed launched QE2, because with near-zero interest rates, depressed long-term rates, and already massive bank reserves, the policy could not hope to relieve any constraints that were actually relevant to the economy (see The Recklessness of Quantitative Easing); because consumers don't spend out of volatile forms of "wealth" (see Bubble, Crash, Bubble, Crash, Bubble...); and because a monetary easing that creates inflation expectations while pressing down interest rates invariably leads to an "overshooting" depreciation in that currency and a surge in commodity prices that are quoted in that currency (see Why Quantitative Easing is Likely to Trigger a Collapse of the U.S. Dollar). Of course, given that other central banks have also attempted to keep pace through competitive devaluations, the most spectacular collapse of the dollar has been against the currency substitute that cannot be printed by fiat - namely gold.

Even Bernanke seemed to acknowledge that further attempts at monetary intervention could only provide short-term juice, saying "most of the economic policies that support robust economic growth in the long run are outside the province of the central bank."

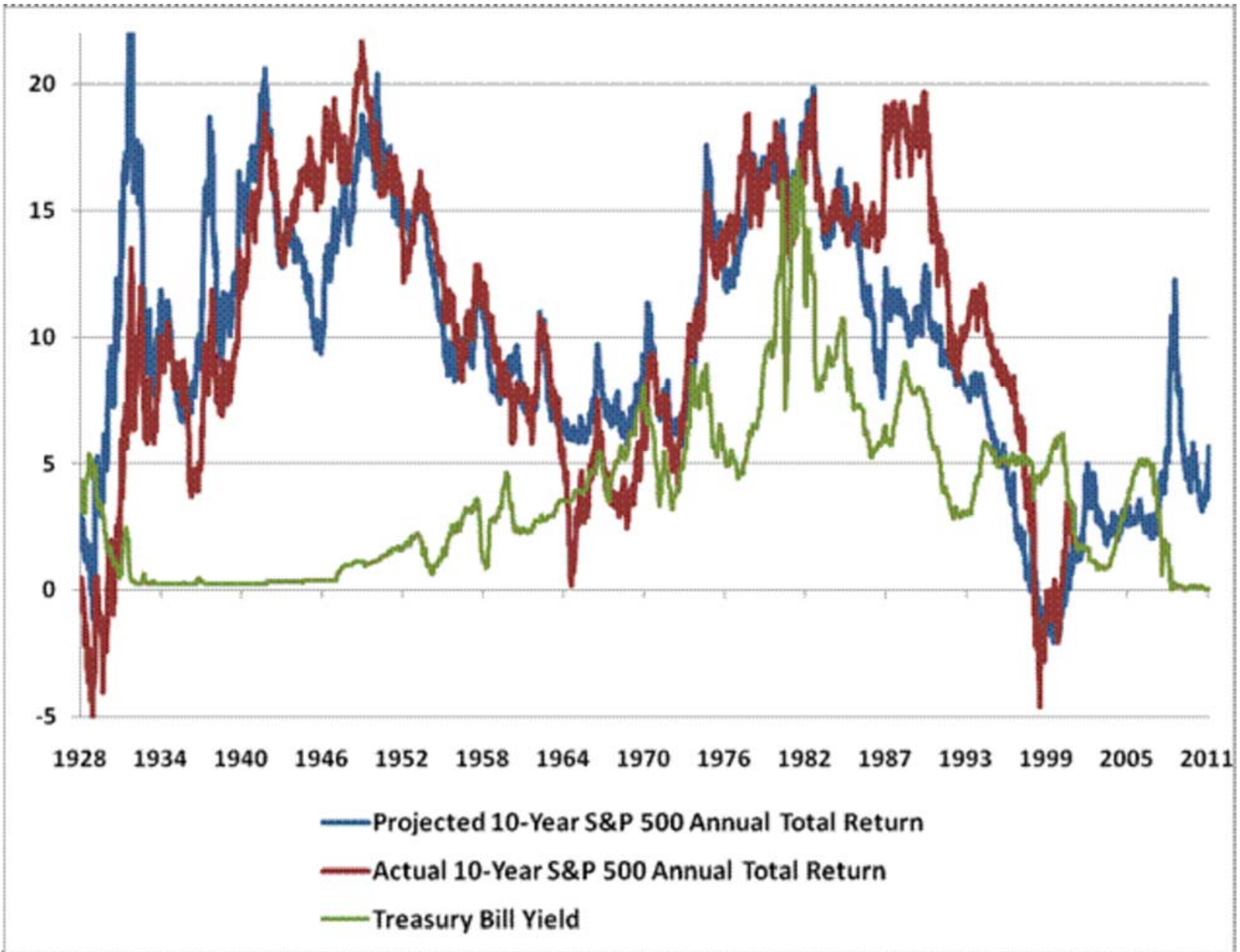
On that subject, Bernanke offered some of the only sound words of his tenure, stressing that "U.S. fiscal policy must be placed on a sustainable path that ensures that debt relative to national income is at least stable, or, preferably, declining over time," and warning against excessive austerity by observing "Although the issue of fiscal sustainability must urgently be addressed, fiscal policymakers should not, as a consequence, disregard the fragility of the current economic recovery."

It was encouraging that Bernanke did outline several elements of a more promising policy response not involving monetary interventions, which were consistent with our own views: "To the fullest extent possible, our nation's tax and spending policies should increase incentives to work and save, encourage investments in the skills of our workforce, stimulate private capital formation, promote research and development, and provide necessary public infrastructure. We cannot expect our economy to grow its way out of our fiscal imbalances, but a more productive economy will ease the tradeoffs that we face," adding that "Good, proactive housing policies could help speed that process."

The upshot is that it remains unclear whether the Fed will revert to reckless policy in September, or whether the growing disagreement within the FOMC will result in a more enlightened approach - abandoning the "activist Fed" role, and passing the baton to public policies that encourage objectives such as productive investment, R&D, broad-benefit infrastructure, and mortgage restructuring - rather than continuing reckless monetary interventions that defend and encourage the continued misallocation of resources and the repeated emergence of speculative bubbles.

Valuation Review

As of last week, we estimate that the prospective 10-year total return for the S&P 500 is back down to about 5.1% annually. To put this expected return in perspective, the chart below reviews the prospective return estimates from our standard methodology, going back to just before the Great Depression. The chart also presents the actual subsequent 10-year total returns achieved by the S&P 500. Note that a 5.1% prospective return is certainly not the worst level we've observed in history, but it is far from the 7.5-13% range of prospective returns that has characterized the bulk of historical data (and of course nowhere near the 20% prospective returns that have marked "secular" market lows).

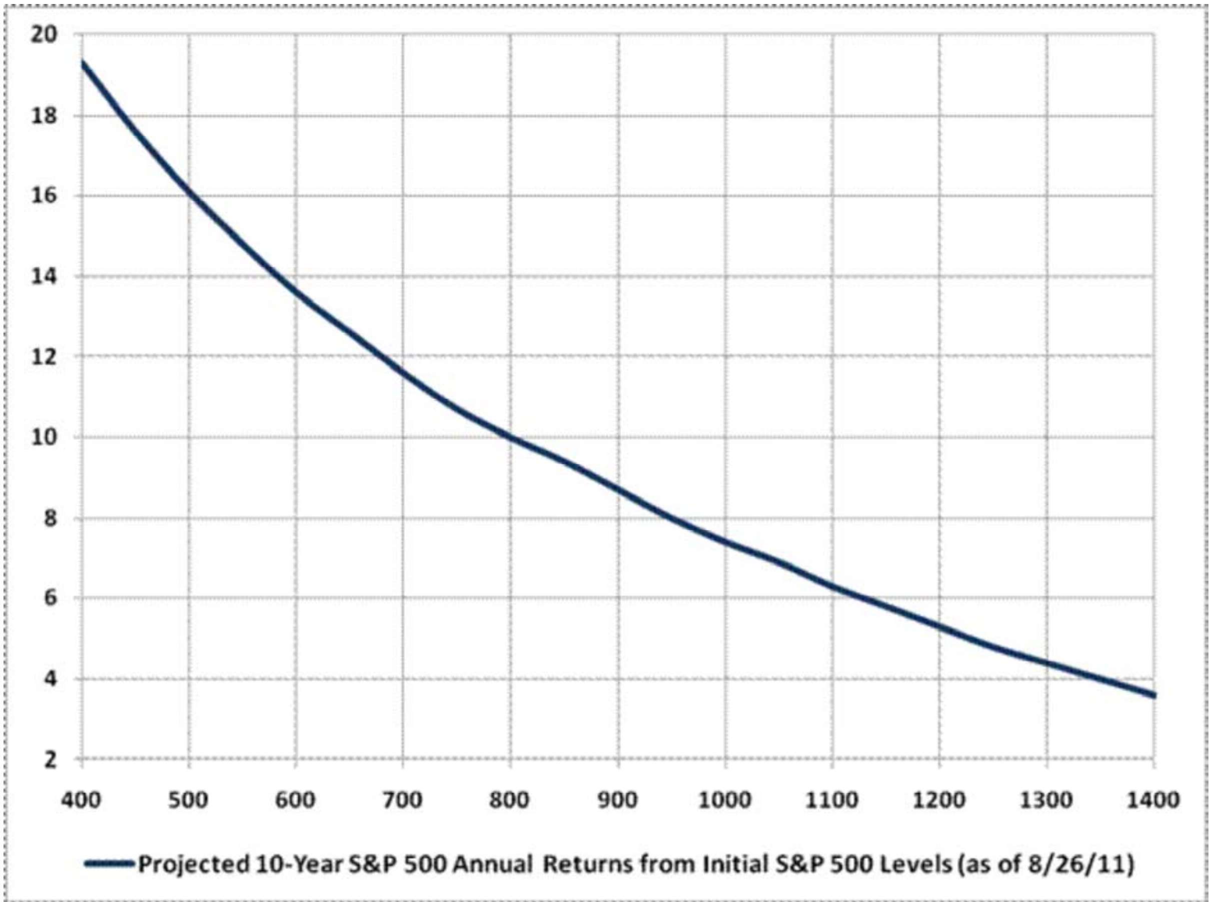


Notice that the historical data is not particularly sympathetic to the idea that low Treasury bill yields should be accompanied by high market valuations and low prospective returns on stocks. While it is true that very high interest rates and inflation rates seem to be accompanied with depressed prices and accordingly high prospective market returns, it is clear that history contains long periods of near-zero interest rates coupled with depressed valuations and very high prospective market returns. As investors, we should hope for such opportunities, and I expect that we will eventually see them. Unfortunately, the transition from here to there would not be pretty.

There are certainly alternative methods of valuation embraced by Wall Street analysts. In particular, many analysts view the market as "cheap" based on forward operating earnings, without any consideration for the fact that stocks are a claim on a very long-duration stream of deliverable cash flows (not a single year's results), and even less consideration for the fact that those forward operating earnings incorporate the assumption that profit margins will achieve and sustain the highest levels seen in U.S. history.

Before accepting conclusions based on a given valuation model, investors should demand similar evidence of its historical reliability. That evidence should be easy to produce, of course, and yet analysts typically don't produce it. Hint - for many of these approaches, this is because evidence linking those methods to subsequent market returns does not exist.

The chart below provides a more comprehensive view of the prospective returns that would be associated with various levels of the S&P 500, based on the fundamentals we presently observe. As a rule-of-thumb, this curve shifts to the right at a rate of about 6% annually, which is the approximate growth rate of long-term normalized fundamentals (earnings, dividends, book values, revenues, and even nominal GDP).



I recognize that after a decade of bubble valuations (which has predictably resulted in near-zero total returns for the market), the implications of this chart may seem preposterous. Considering the historical accuracy of this approach in projecting subsequent market returns, however, we have to remember that *unthinkability* is not evidence. It seemed equally unthinkable in 1999 that stocks might underperform Treasury bills for more than a decade (see The Importance of Measuring Returns Peak-to-Peak), and that valuations in 2000 could actually imply a decade of negative total returns, as our models were then projecting (see the August 2000 Hussman Funds investment letter). Yet that's precisely what we observed.

Historically, the typical bull-bear market cycle has produced a range of 10-year prospective returns in a band between about 7.5% and 13%. That band presently corresponds to a range for the S&P 500 index between 600 and 1000. A 10% prospective return is right in the middle, at about 800 on the S&P. Once you recognize that profit margins are in fact cyclical, that range is about right, as uncomfortable as it may be to contemplate. Jeremy Grantham of GMO estimates that fair value is "no higher than 950." A tighter norm for prospective return between 9-11% maps to an S&P 500 between 750 and 850.

Finally, while I certainly would *not* expect it in the absence of extreme macroeconomic upheaval, major *secular* undervaluation as we observed in 1950, 1974 and 1982 would presently map to about 400 on the S&P 500. When you think of "once in a generation" valuations and "*secular* bear market lows" - that number, not anything near present levels, should be what crosses your mind. I am well aware that even discussing numbers like these, given the present mindset of investors, is likely to be dismissed as utterly ridiculous. Frankly, I would rather risk the ridicule of those who pay lip-service to research, cash flows, fundamentals, and value than to pretend these outcomes are impossible, when the historical record (and even the experience of the past decade) strongly indicates otherwise.

As Howard Marks of Oaktree Capital has noted, "We hear a lot about 'worst-case' projections, but they often turn out to be not negative enough.. most people view risk taking primarily as a way to make money. Bearing higher risk generally produces higher returns. The market has to set things up to look like that'll be the case; if it didn't, people wouldn't make risky investments. But it can't always work that way, or else risky investments wouldn't be risky. And when risk bearing doesn't work, it *really* doesn't work, and people are reminded what risk's all about."

Market Climate

As I noted at the outset, the Market Climate for stocks shifted from a briefly positive constructive stance back to hard negative last week. Accordingly, we closed our modest constructive position in Strategic Growth and Strategic International Equity. Both are fully hedged at present. In Strategic Total Return, the primary source of day-to-day fluctuations continues to be our allocation to precious metals shares, at about 20% of assets. The Fund also holds just over 4% of assets in utility shares, and has a duration of about 1.5 years in Treasury securities of short- and intermediate-maturity.

Among the important factors to watch here, yields shot above 50% on 1-year Greek government debt, suggesting an acceleration of liquidity and default concerns there. IMF chief Christine Lagarde spoke at Jackson Hole, saying that European banks "need urgent recapitalization. They must be strong enough to withstand the risks of sovereigns and weak growth. This is key to cutting the risks of contagion... we risk seeing the fragile recovery derailed."

Meanwhile, the corporate bond market, which has held up until recently, saw a sharp but very initial selloff of about 2% early last week. Junk bonds have also dropped by about 5% so far this month. As Jeffrey Gundlach of DoubleLine Capital observed, "something funny is going on in the world of corporate bonds now. Something looks broken. It seems there's less willingness all of a sudden to be lending money to corporations, maybe because the absolute yields are so low." Even so, he argued against reaching for yield too early into this emerging weakness in corporate and speculative-grade debt, saying "I want fear. I want to buy things when people are afraid of it, not when they think that it's a gift being handed to them." Suffice it to say that in nearly every asset class, we are not there yet.
