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MACROCOSM

Value and Chaos

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The market's cheaper than it's been in 14-1/2 years. But what will it take to break out of this "reflexive" death-spiral?

The US equity market looks so cheap now that I can barely resist backing up the proverbial truck. But, so far, the lure of value has not been strong enough to overcome the fear of chaos -- and our hedged stance in US equities has been rewarded. We have constrained our small Model Position long the S&P 500 to only a 35% allocation, watching while values have become increasingly compelling -- and we have not yet closed out the last of our Model Position short the NASDAQ 100 and long Treasuries. We continue to look for signs that the time is right to become bolder.

The market is in chaos because the market itself has become a key part of an out-of-control positive-feedback loop in the political domain. The stable political duopoly that was born with **President Clinton's** "triangulation" strategy to marginalize **Newt Gingrich** and the "**Republican** revolution" is over. In its place is a self-accelerating contest to see who can promise the greatest public vengeance on the scapegoats blamed for the loss of $5 trillion in paper wealth since the top in March 2000.

Here's how this new game of "Can You Top This?" works. The **Democrats** propose tough penalties for "corporate crooks" and accuse the Republicans of being "pro-business." The Republicans have to propose even tougher penalties. The Democrats ridicule the Republicans for pandering, and accuse the Bush administration of being tied to corrupt business interests. The Republicans get even tougher to prove their sincerity. At each iteration the market goes down more, discounting for a world in which it is impossible to do business without risking criminal penalties, and mid-term elections in which the delicate balance of power will be upset all over again in unpredictable ways. The very fact that the market goes down is cited as proof that tougher penalties are needed, and the whole cycle starts again.

We are experiencing one of those rare moments of risk (and opportunity) when the market gets caught up in what **George Soros** has called "reflexivity." According to Soros, reflexivity can make "markets enter into a state of dynamic disequilibrium and behave quite differently from what would be considered normal by the theory of efficient markets. Such boom/bust sequences do not arise very often, but when they do, they can be very disruptive, exactly because they affect the fundamentals of the economy."

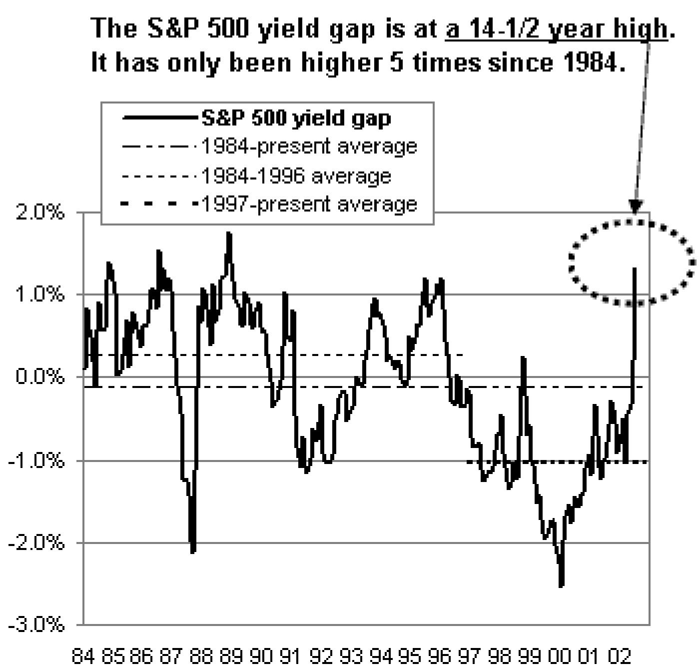
Examples of reflexive situations are the stock market crash of 1987 and the collapse of the European exchange-rate system in 1992 (in both of which Soros played a key role -- as a loser in the former, and as a winner in the latter). The present equity market spiral is a reflexive situation *with a difference* -- now the market is affecting the fundamentals of the *political* economy.

When you're in the middle of a reflexive spiral, there's no telling what it will take to break out of it. At this point there's nothing **George W. Bush** is going to say about corporate accountability or the economy that will reassure anyone. He missed the moment when he could have done that a long time ago -- and he dishonored himself in his speech last week when he made a feeble attempt to invoke the spirit of September 11, saying "I believe people have taken a step back and asked, 'What's important in life?' You know, the bottom line and this corporate America stuff, is that important? Or is serving your neighbor, loving your neighbor like you'd like to be loved yourself?"

But Bush's "get tough" posturing is no better, such as Friday's joint **Food and Drug Administration** and **Department of Justice** criminal action against **Johnson & Johnson** for some regulatory triviality -- it all just drives the spiral deeper. So what choice does Bush have now but to "wag the dog?" Even Bill Clinton was never above bombing Iraq whenever he needed to look a little more presidential -- and *he* didn't even have a war on terrorism to run. **Frank Rich** wrote in his *New York Times* column on Sunday, "If the Bush administration wants to distract Americans from watching their 401(k)'s go down the toilet, it will have to unleash the whole kennel. Maybe only unilateral annihilation of the entire axis of evil will do." I regard something like this as a very real possibility. And history suggests that it just might work.

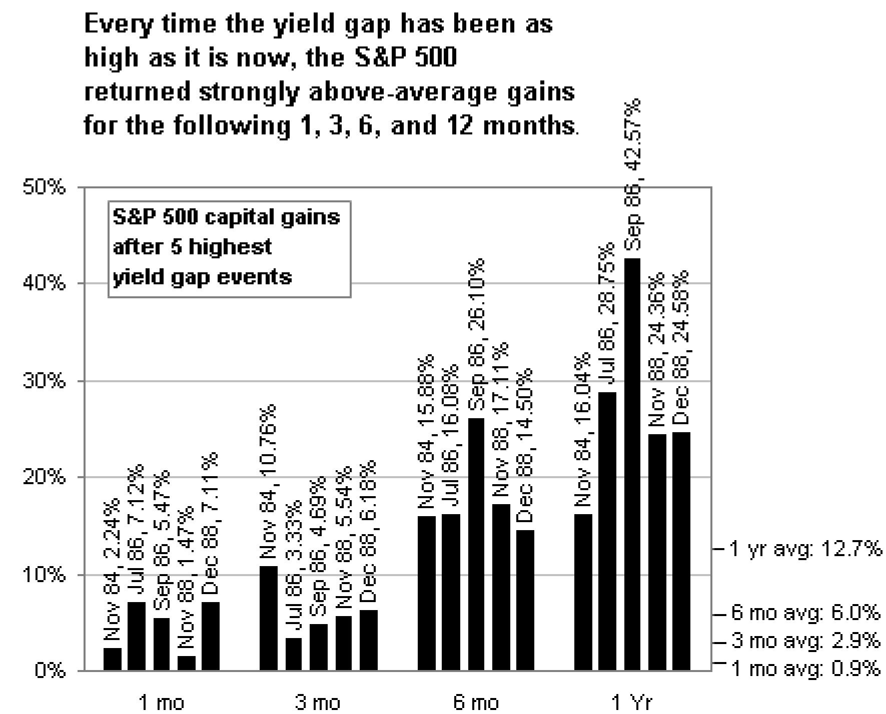
Without some exogenous factor, though, the reflexive spiral may have no alternative but to resolve itself in a catastrophic selling climax, one that more than discounts any possible risk of corporate malfeasance *or* its supposed cures. A 1000-point or more down day on the Dow Jones Industrial Average is no less a probability here than is an attack on Iraq.

Even without such a climax, the S&P 500 is *already* more undervalued now than it has been in 14-1/2 years. Our metric for value is the "yield gap," the amount by which the forecast earnings yield of stocks exceeds the income yield of long-term Treasury bonds. Friday the yield gap stood at 1.33% -- there have only been five times since 1984 (based on month-end observations) that it has ever been higher.



Let me anticipate the usual objections. Yes, it is of some real concern that this measurement is predicated on optimistic earnings forecasts, which may themselves be predicated on historical earnings that will eventually be restated lower. But earnings forecasts are almost always too high -- that's baked into the way this measurement is calibrated. And market-wide, the value of cumulative restatements is likely to be quite small, especially in proportion to the public outcry about it.

If such concerns can be set aside, then the opportunity here is already quite compelling -- even though it may get better still. In all five cases since 1984 in which the yield gap was as high or higher than it is right now, the subsequent 1, 3, 6 and 12 month periods provided strongly above-average performance. Every one of these times was a significant buying opportunity.

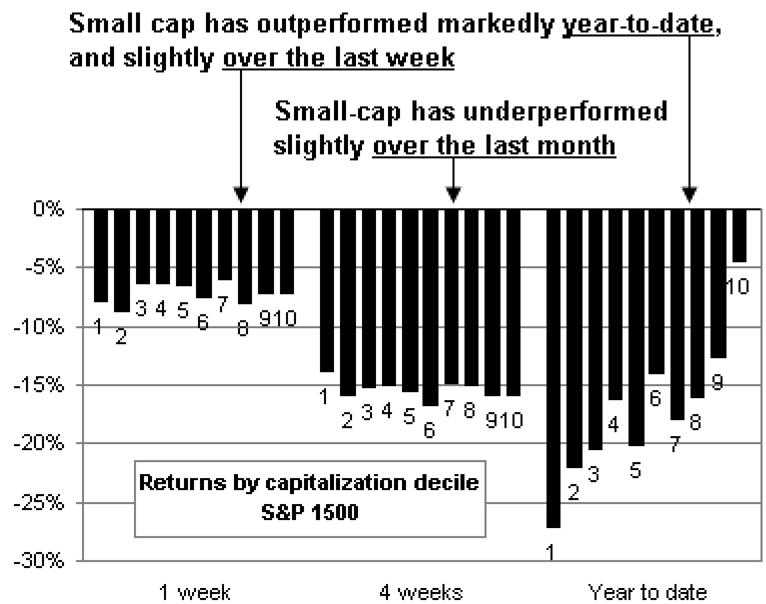


Note that within the five cases there are two closely related pairs -- July and September 1986, and November and December 1988. That is historical precedent for the idea that extreme valuations are not necessarily resolved instantly -- in these two cases the opportunity lingered for two to three months. In both cases, being patient paid off. But in neither case was getting in early punished.

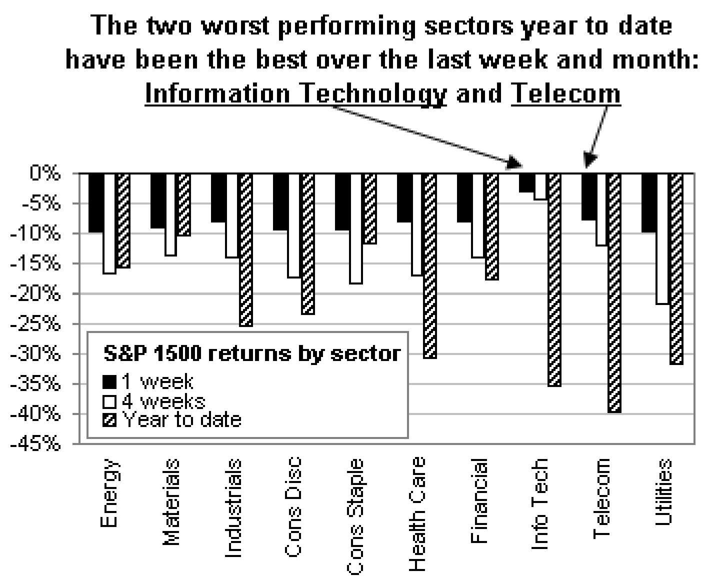
In trying to anticipate which stocks will enjoy the best appreciation when the reflexive cycle is finally broken, it is probably wise to look at who has suffered the worst on the way down -- and why.

On a year-to-date basis, capitalization has been the key to performance. It's been almost perfectly monotonic down the cap deciles -- small was better. But as the reflexive spiral has spun up over the last month, and especially the last week, there really hasn't been much of a capitalization effect one way or the other -- large cap has done slightly better over the last month, and small cap has done slightly better over the last week.

On the one hand, we might have expected smaller companies to do better in the reflexive spiral, because their relatively simple accounting and tax environments make them less vulnerable to changes in regulation, and their lower public profiles make them less interesting scapegoats. But balancing against those advantages, smaller companies always have a harder time profiting in highly regulated environments -- they can’t afford to spend as much on lobbyists or compliance. If there’s increasing regulation ahead, it’s better for large companies. So, all in all, we’ll call it a wash.



Sector returns, on the other hand, have shown a profound shift over the last month. The Information Technology and Telecom sectors, which have been the two worst performers year-to-date, have been the two strongest performers over the last month and the last week -- with Info Tech winning by a very wide margin. Symbolizing this was last week's eclipse of **General Electric** as America's most valuable company by **Microsoft**.



This is counterintuitive on almost every level. First, Info Tech is the highest beta sector. It would normally be expected to be the biggest winner on the upside and the biggest loser on the downside. To have it win by being the smallest loser on the downside is quite unexpected. Second, Info Tech is the most overvalued sector. In a time of eroding confidence in equities, it would be expected to get hit the hardest. And third, as earnings season has unfolded, guidance from technology companies has been almost universally disappointing -- while many Old Economy companies have guided higher.

It's tempting to explain Info Tech's recent resiliency simply by the fact that it's been so terribly beaten up year-to-date. But that's only true in price terms, not in value terms. As hard as it has been hit, the fact remains that it is still overvalued even by its own historical norms, and at a time when the market overall is quite undervalued.

Another possibility is that the market is signaling that the long-awaited tech recovery is at hand. The government's official industrial production statistics do show that year-over-year growth in various tech sectors has come back to life. But this is totally contradicted both by reported earnings that continue to make new lows, and by a virtually unanimous chorus of tech CEO's and CFO's who say that they still have no visibility, and see no recovery.

Yet another possible explanation (which makes little sense rationally, but that resonates with me emotionally) is that the crisis in corporate malfeasance has, at least for a while, sidelined techstocks as a media story -- and investors have simply neglected to pound the bejeezus out of them. The tech ball is simply, for the moment, out of play.

My final candidate explanation -- and the one I like the most -- is that technology companies are emerging as at least the relative winners in the legislative *jihad* against "corporate crooks." First, mandated options expensing rules and changes in the tax treatment of options have been taken off the legislative agenda -- this is a relative win for tech companies because they are by far the largest users of options. Second, while tech companies may have accounting issues like anyone else, it is certainly the case that they are, by and large, less regulated than Old Economy companies (we are making a distinction here, of course, between technology companies and telecom companies). That means that they are less rigidly adapted to an existing regulatory environment, and are perhaps more adaptable to a future regulatory environment that will be determined by sudden legislative shocks.

All this suggests to me that when today's reflexive spiral finally breaks, the relative advantages that have accrued to overvalued Info Tech over the last month will evaporate. If the updraft is big enough and long lasting enough, Info Tech may show the best raw returns simply by virtue of its high beta. But on a risk-adjusted basis, the best bets will be the undervalued, big, Old Economy sectors that have been hit so hard over the last couple of weeks, and that are showing substantial earnings recovery. TM