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MARKET CALLS

Extremes

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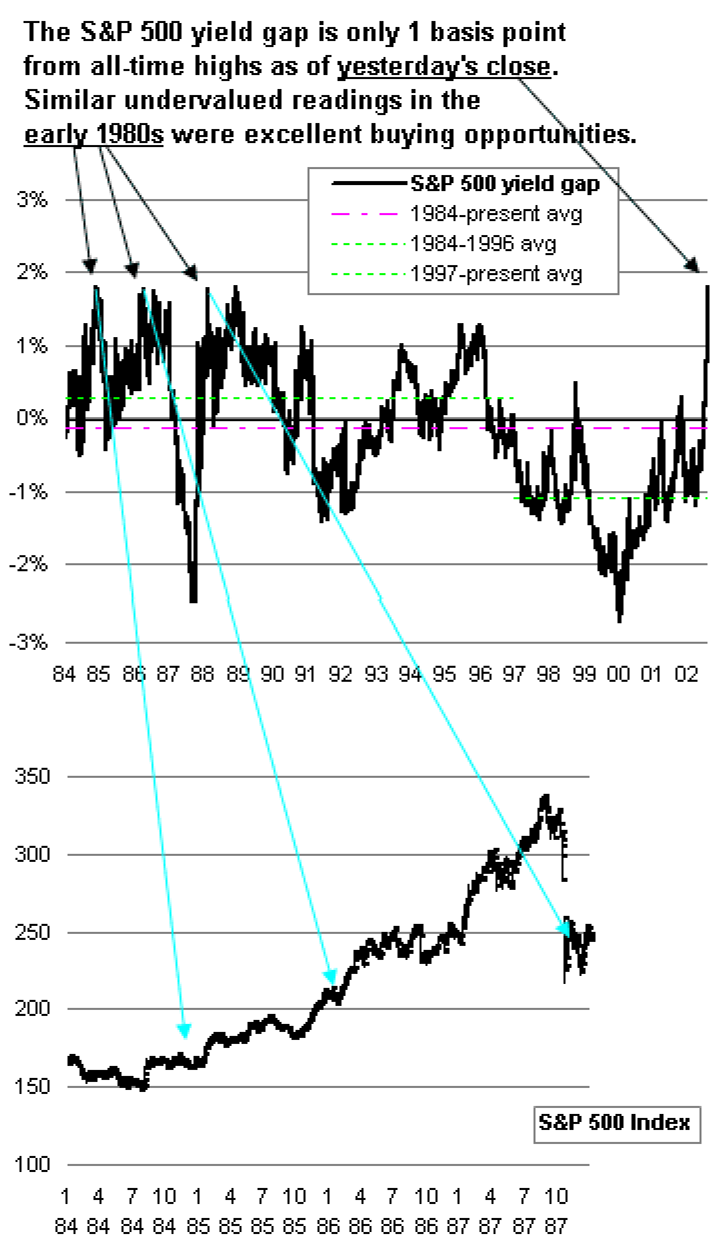
Stocks are extremely cheap and extremely destabilized. But taking a long-term view -- they may really be extremely normal.



As of yesterday's close, the S&P 500 has lost 46.2% on a total return basis (including receipt of dividends) since the top in 2000. That exceeds the loss of 45.1% in the 1973-74 bear market -- but it's still shy of the 49.9% lost in the 1937-38 bear market. If the S&P 500 drops about 8% from here it will tie the 1937-38 drop -- and, incidentally, complete the round trip back to where the index was on December 6, 1996, when Alan Greenspan gave his infamous "irrational exuberance" speech. The NASDAQ Composite fell through its December 6, 1996 levels on Monday.

As a result, our forward-looking measure of equity value, the "yield gap," jumped to all-time highs as of yesterday's close, compared to month-end values from 1984. The forward consensus for the earnings yield of the stock market is farther above the income yield of long-term Treasuries than it has been in 18-1/2 years. That puts stocks in severe value disequilibrium with bonds -- and unless you think bonds are going to literally crash from here, it makes the stock market look very, very cheap.

The yield gap does not show an all-time high if we compare yesterday's close to *daily* historical

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values -- a tougher comparison, since it is unlikely that month-end values would happen to capture the extreme point of any given month. Looking at it this way, there a *single* day in the last 18-1/2 years on which the market was more undervalued -- just *one single day*, and it topped yesterday's value by a *single* basis point. It was November 19, 1984.

November 19, 1984 was an excellent time to buy stocks, as the chart above shows. As the Reagan revolution of tax cuts and deregulation kicked into high-gear, the S&P 500 more than doubled in less than three years.

A series of extreme undervalued readings from the yield gap model offered excellent follow-on buying points as well, including one right after the crash of October, 1987. Incidentally, an extreme *over*valued reading preceded the crash by several months. It offered an excellent selling point, similar to the one at the top of the so-called "bubble" in March 2000.

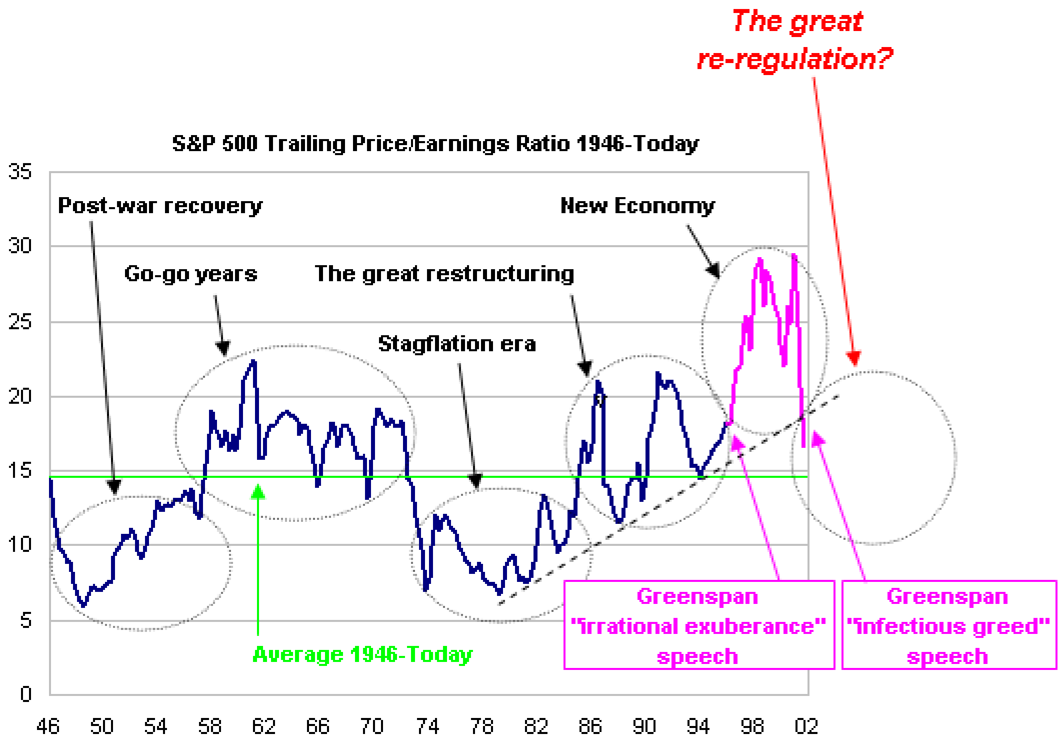
With these extreme values on the table, why are we extremely hesitant? Why do we cling to our conservative stance in equities, with a modest Model Position long the S&P 500 constrained to only a 35% allocation, hedged by the remainder of our Model Position short the NASDAQ 100 and long Treasuries? Perhaps it's because there is something that feels less than fully contrarian about a valuation argument for stocks when **President Bush** is using just that to try to jawbone the market higher. As Bush said to reporters on Monday, meandering in that aphasic manner he adopts when he's trying to discuss anything having to do with the economy, "But I know -- I always knew -- that you needed to buy on value; that the price relative to the earnings of the company needed to be in line with what they considered value. And I believe the values are improving." Maybe I'd more comforted by this if he didn't say, in the same breath, that he has total confidence in **Treasury Secretary Paul O'Neill**.

We are also hesitant because we see the market and the national political consensus caught up together in a self-accelerating "reflexive" spiral (see "Value and Chaos" July 22, 2002) -- and now, with gold heading back toward $300, there is the risk that new deflationary monetary policy error by **the Fed** will add its own spin to the spiral. The resulting destabilization has no natural braking mechanism -- it can only be stopped by an exogenous shock or a complete breakdown. The arrival of either the shock or the breakdown will provide an opportunity for us to increase our exposure to equities.

And in the meantime, there is another longer-term cause for caution. And that is the idea that perhaps the extremes we are seeing in the market aren't really so extreme at all, but represent instead, a return to long-term normality. A little more than two months ago, before all the current tumult began, I noted that stocks were extremely *richly* valued by historical standards -- that for all we'd been through, we were still in the epoch of high valuations that followed Greenspan's "irrational exuberance" speech. After examining and discarding several candidate explanations, I concluded by saying, "...when valuations are as high as they are today compared to historical standards -- for no apparent good reason -- even the most optimistic forecasts for underlying business growth have to take into account the risk that valuations may compress back toward the long-term norms" (see "The New High Plateau: The Valuation Conundrum" May 10, 2002).

Exactly *that* has happened. The epoch of high valuations ended this week. The 22-year uptrend in multiples that began in 1980 is broken.

Yet while the yield gap metric shows us now at the opposite extreme, simpler metrics with longer histories suggest that conditions aren't actually so extreme at all. The chart below shows the simple trailing price/earning ratio of the S&P 500. By this relatively unsophisticated tool -- it doesn't use forward-looking earnings estimates, and it doesn't take interest rates into account -- everything's pretty much normal. Today's trailing p/e is still actually just slightly above the post-war average. Normal.



In the chart above I've defined five past post-war valuation epochs. I've given each a name, to evoke the *zeitgeist* of its times. If the trends set in motion by today's legislative *jihad* against corporate crooks continue, the coming epoch could be "the great re-regulation." And if that's what it means to go back to normal, than *normal is not good*. To have had the superlative growth prospects of a technology-driven economy first throttled by Greenspan's deflationary monetary errors in 1999 and 2000, and now to be potentially throttled *again* by a wave of re-regulation just as recovery is at hand, is a great tragedy of missed opportunity for growth.

These are longer-term concerns. In the short-term, the market is extremely cheap -- but extremely destabilized, as well. We remain on high alert for the right opportunities to take advantage of it. In the meantime, we stay hedged. TM