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MARKET CALLS

Eyeing the Hurricane

Wednesday, July 31, 2002

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The market's "reflexive" spiral has burned itself out for the moment -- leaving the S&P 500 still significantly undervalued.

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MODEL POSITIONS

Buy S&P 500
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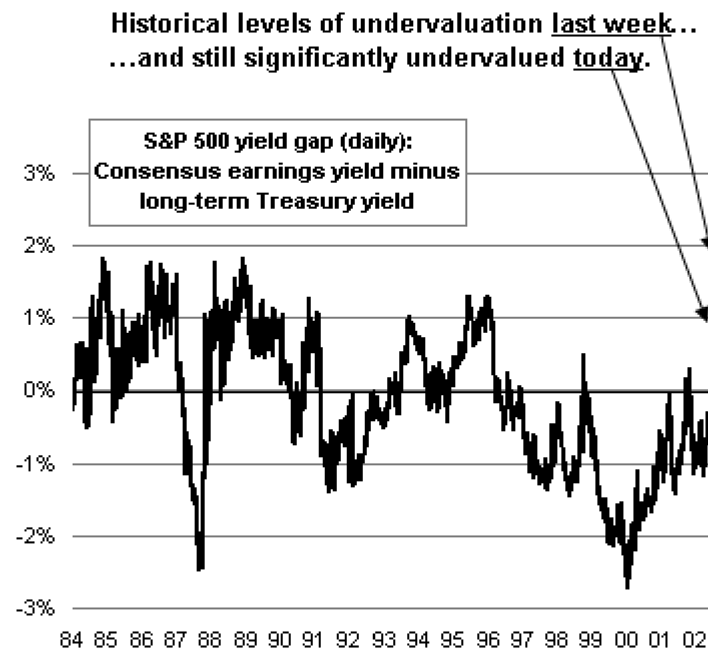
During last week's equity market crisis we pointed out that the S&P 500 had become more deeply undervalued (according to our "yield gap" valuation analysis) than at any other time since November, 1984 (see "Extremes" July 24, 2002). Yet we were hesitant to get more aggressive in our hedged Model Positions in equities (one a small long position in the S&P 500; the other a small short position in the NASDAQ 100 paired against a long position in Treasury bonds). We saw the market in a self-perpetuating "reflexive" spiral, and were waiting for either a news catalyst or a desperate wash-out to indicate its end (see "Value and Chaos" July 22, 2002). Now with the dramatic recovery since Wednesday's lows, the worst energy of the spiral seems to have been dissipated.



But why?

Was there a news catalyst? The only news catalyst was the completion of the **Sarbanes-Oxley** Bill -- which indicated that, at least for a while, the legislative *jihad* against "corporate crooks" had reached a resting point. For those of us who fear that this may represent the leading edge of the wedge of massive re-regulation, the lead editorial in the *Wall Street Journal* put the best possible spin on it this morning: "It could have been worse… capitalism will live to fight another day." But that's faint praise indeed: capitalism will live, but it works best when it doesn't have to fight -- better to leave it free to produce. Yet fight it must. Despite the lovely bipartisan tableau at yesterday's White House bill signing ceremony, the partisan exploitation of the corporate corruption theme heading into the November elections will surely intensify. There will be more enforcement actions, some of them dubious. There will be more

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restatements ahead of the August 14 CEO/CFO certification deadline, most of them trivial but all grabbing headlines. There will be more proposed legislation, all of it costly and counter-productive.

Was there a desperate wash-out? Perhaps there was. The NASDAQ did trade through the 1287 level, my long-standing "whisper price target" based on its level of December 6, 1996 when **Alan Greenspan** first warned of "irrational exuberance." And at last Tuesday's close, the S&P 500 was as undervalued as it's been for 18-1/2 years. On a valuation basis, the potential rewards were obvious -- our yield gap model gave a great buy signal, loud and clear.

Now with a week of recovery under our belts, the S&P 500 is less undervalued than it was in the depths of last week's panic, but it's still significantly undervalued. And risk is considerably reduced, if only because the market's stabilization will now play positively into the cycle of "reflexivity" -- a crashing market is now removed as a real-time impetus to increasingly draconian re-regulatory initiatives.

Therefore we are adding another 10% tranche to our Model Position long the S&P 500, bringing its total commitment up to 45%. The trade-off of compelling valuations against somewhat reduced risk is attractive, and we continue to see an Old Economy earnings rebound marching forward against he backdrop of a tepid economic recovery.

But we still see no earnings recovery whatsoever in technology and telecom companies. And because the Information Technology sector remains overvalued (and, indeed, never became undervalued even in the worst moments of last week's panic), we are leaving in place the remainder of our Model Position short the NASDAQ 100 paired against long Treasury bonds. TM