ADVISOR PERSPECTIVES

Shall We Dance?

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“One ought to become concerned about risk when investors become convinced that it does not exist. There are certainly times when it appears easy, in hindsight, to make money in the stock market. The difficulty is in keeping it through the full cycle. The fact that over half of most bull market advances are surrendered in the subsequent bear doesn't sink in until after the fact. It's all fun and games until someone gets hurt.

“If the parents or the children of Wall Street analysts were to ask for wise investment advice, would the first thought of these analysts really be to encourage stock purchases at a multi-year market high, in a long-uncorrected and strenuously overbought advance, at a multiple of over 18 times earnings on unusually wide profit margins, with wages and unit labor costs rising faster than inflation, while interest rates are rising, bullish sentiment is unusually high, and corporate insiders are selling heavily? Would the potential for further gains in that environment exceed next inevitable correction by an amount that would make the net gains worth the risk? Would they encourage using trend-following systems in an overbought market, even though a decline to simple moving averages already implies substantial losses?

“Uncorrected market advances give a voice to the idea that ‘this time it's different.’ They invariably produce alternate valuation measures (like EBITDA multiples in the 90's, or price/forward operating earnings today) to replace the ones that suggest stocks are overvalued. These new-era arguments prevail despite the fact that the most recent evidence; the most recent market cycle; confirms the relationship between rich valuations and unsatisfactory long-term returns.

“No. We've been here before, and the consequences – though not always immediate – have invariably been bad. There is not a single instance in historical data since 1871 when the S&P 500 traded above 18 times record earnings and there was not a low a year or more later that erased every bit of advantage over Treasury bills. Not one.”

It’s All Fun and Games Until Someone Gets Hurt – February 5, 2007 Weekly Market Comment

Note – the same observation holds for each point that the Shiller P/E (the ratio of the S&P 500 to the 10-year average of inflation-adjusted earnings) was at or above its present level (22.6). *Every* prior instance in *every* prior market cycle was followed by a point – at least a year later – where the entire advantage of the S&P 500 over Treasury bills in the interim period was entirely erased. Please understand that that “erased” does not simply mean erased by a margin of 5% or 10%. Rather, the typical resolution put the S&P 500 down 30-60% relative to Treasury bills from the point of overvaluation to the eventual low.

Last week, Investors Intelligence reported that the percentage of bullish investment advisors increased to 54.3%, with bears contracting to 22.3%. Vickers reported that corporate insiders are again selling at a nearly frantic pace of 9.2 shares sold for every share purchased, and the NAAIM survey reported that the average overall equity exposure reported by active investment managers reached 104.25% at the end of January – a leveraged position, and the highest figure in the history of the survey. Indeed, among individual survey participants, the lowest allocation was 60% - the most bullish exposure ever for the most bearish participant in the survey. The previous record in the survey’s history was 96% in early 2007.

As a reminder, early 2007 is when the NYSE floor reporter on the most-watched business channel on television waxed rhapsodic about the market’s resilience, saying “There’s a floor to the market – every time they try to sell the market down for the past seven months, it goes down for two days and it comes back. Buyers are there just below the last sale. People who keep talking about this real estate bubble don’t understand. Commodities and transports have been rallying partly on the theory that the ‘soft landing’ would be successful and indeed it has been successful. This disaster that the bears have been talking about hasn’t happened.” (h/t ZeroHedge for the video walk down memory lane)

The S&P 500 was down nearly 7% within about 2 weeks, though it took another 2 years for the S&P 500 to lose half its value.

But… but… the Fed is still easing. Yes, it is, and yet when we actually relate monetary actions to the stock market, including interest rate measures, monetary base growth, and other factors, we find that the impact of quantitative easing is

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reasonably reliable only when the market is coming off of a significant decline over the prior 6-month period. In that case, there is a strong tendency for QE to reduce risk premiums and assist stocks in recovering that preceding loss, though not to generate significant novel gains (see the discussion of QE and stock market returns in Capitulation Everywhere). Moreover, we find no evidence that Fed easing has encouraged S&P 500 total returns in excess of Treasury bill yields, on average, when the Shiller P/E has been at present levels or higher. When bullish sentiment has exceeded 45%, any Shiller multiple above 20 is still associated with zero S&P 500 returns in excess of T-bills, on average, despite Fed easing (about 11% of market history falls into that bin).

Nearly every New Years Eve and Fourth of July, you'll read news stories about boats that capsized, often with terrible consequences. Why? Everyone was so eager to watch the fireworks that they all piled along one side of the boat. At that point, even a modest shock, like the wake of another passing ship, became enough to flip the boat over. It's a predictable phenomenon, but tragically, people don't seem to learn from it.

The fact is that *investors would learn* to avoid stocks in conditions that are measurably overvalued, overbought, and overbullish – except that in each individual case, there is *always* some factor that encourages investors to believe that this time is different. It's precisely that confidence in some special factor that produces the high, and makes investors eager to join the crowd in a richly valued market, despite their knowledge that joining the crowd in a mature, strenuously overbought advance has had tragic outcomes on previous occasions.

Look, I get it – I turned a solid reputation to Jell-O – at least for the *advancing* portion of the current cycle – when I insisted in 2009 on stress-testing our models against Depression-era data, avoiding risk until I was convinced that our methods could navigate that period successfully in out-of-sample tests. We unfortunately sat out the 2009-early 2010 advance in the process because of the "two data sets" uncertainty. If we had not, I doubt that anyone would second-guess the hostile market conditions we observe here. The two alterations in our approach that we introduced in 2010 and early 2012 address those stress-testing uncertainties and the more frequent attempts by the Fed to provide virtual "put options" – but nothing in the historical record alters our concerns since March of 2012, and nothing removes our defensiveness at present. Put simply, ignoring the messenger because of the challenges we faced in the most recent cycle, particularly our self-imposed stress-testing, is not a valid reason to dismiss the hostile conditions that investors face at present.

What is *essential* here is that we have no indication that our defensiveness was misplaced back in 2000, or in 2007, when we observed similar conditions. Even trend-following and Fed-following measures are insufficient to offset the standard overvalued, overbought, overbullish, rising-yield syndromes we define, much less the extreme versions that we observed in 2000 and 2007, as well as 1987, and 1972, and 1929, and in 2011 before a near-20% decline, and today.

This isn't to say that the market will fall apart immediately, or that it can't move higher, or extend its advance beyond current levels (though I doubt that it will do so durably). But I remain convinced that investors are accepting historically elevated risks here, and that it is misguided to reach for speculative returns in an overextended market, simply out of repugnance for zero interest rates. As for valuations, our present estimates indicate the likelihood of sub-4% 10-year total returns (nominal) for the S&P 500 – with unusually large downside exposure along the way – and negative total returns over horizons of 5-years and shorter.

Keep in mind how market returns are *distributed* over time. We estimate a likely nominal total return for the S&P 500 over the coming decade of about 3.8% annually, but it is unlikely that the market's return will be achieved smoothly. Instead, based on present conditions and typical market cycle norms, the base case would be something like two market cycles along the following lines: a 40% bear market decline (about the average cyclical bear in a secular bear), followed by an 80% bull market advance (about the norm for cyclical bulls in secular bears), followed by a 33% bear market loss (about run-of-the-mill), followed by a 100% bull market recovery by the time the 10-year mark rolls around. There are nearly infinite alternatives, but a smooth path with the absence of deep interim losses is not one of them. Very large cyclical variations aren't implausible – they're actually the norm, and it's unlikely that the Fed can permanently eliminate those cycles. That's a good thing, because while it implies greater risks than investors presently assume, it also implies a far wider range of opportunities in the coming years than investors presently imagine.

On the subject of valuations, the supposedly "reasonable" valuations of stocks based on "forward operating earnings" are an artifact of profit margins that are about 70% above historical norms, and are tightly linked to the size of the federal deficit (the deficit of one sector must be offset by the surplus of another – see Too Little to Lock In). Even short-term can kicks of the deficit problem will not meaningfully the fact that stocks are priced on the assumption of significantly and permanently larger cash flows than they are likely to deliver over time.

Shall We Dance?

I'll emphasize again that our concerns about market risk here are *independent* of our economic concerns, and would

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remain even if we anticipated broad growth in the U.S. economy (indeed, our estimates of prospective market returns *assume* nominal GDP growth at a rate of about 6% annually over the coming years, and would be much lower if they did not). Still, it's striking how confident Wall Street seems to be to that there's a nearly riskless "floor" to the market, and how eager analysts are to celebrate the global economy simply for remaining suspended at the edge of recession – hanging by its nails to massive stimulus from all corners – without concern that organic, productive growth remains terribly limited.

As a sign of how warped this celebration has become, Gordon Chang appeared on CNBC on Friday, noting the troubling difference between exports reported by China *to* other countries and imports reported by other countries *from* China, as well as the inconsistency between low cargo numbers and high reported export numbers. In response, the CNBC anchor said – and I am not making this up – "You know Gordon, I agree with you, but let me take a different tack on this, alright? Let's say you believe that China is making up the numbers. But if the stock market there keeps going up because of it, and you believe the government will keep priming the numbers, isn't that sort of a reason to bet on the Chinese stock market?"

… and that's why we're all gonna die.

That question is like encouraging people to invest with Bernie Madoff because he keeps "putting up the numbers." The troubling similarity between the late-1990's bubble, the housing bubble, and the present central-bank induced advance is that the speculative nature of each was largely recognized, but people took the same attitude: "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance – We're still dancing." Those were the famous last words of Citigroup's former CEO Chuck Prince at the mid-2007 peak, just before the financial markets began to implode.

There are certainly times when market risk is well worth taking. For our part, we expect to eagerly encourage market exposure at the point where at least a moderate improvement in valuations is followed by an early improvement in market action. We certainly don't need a major market plunge as a prerequisite, though we wouldn't rule one out. In early 2003, that sort of opportunity was comfortable to endorse, despite still-rich valuations. In 2009, we admittedly missed that opportunity because the crisis raised stress-testing concerns (despite anticipating and avoiding most of that downturn). Our miss in this cycle is what it is, but it would be terrible discipline and abominable risk-management to attempt to make up for it by accepting risk despite an overvalued, overbought, overbullish, rising-yield syndrome that has historically been followed by uniquely brutal outcomes. As I noted in 2007, one ought to become concerned about risk when investors become convinced that it does not exist.

The foregoing comments represent the general investment analysis and economic views of the Advisor, and are provided solely for the purpose of information, instruction and discourse. Only comments in the Fund Notes section relate specifically to the Hussman Funds and the investment positions of the Funds.

Fund Notes

As of last week, market conditions remained characterized by a syndrome of overvalued, overbought, overbullish, rising-yield conditions (see A Reluctant Bear's Guide to the Universe) matching a handful of other market extremes, including 1972, 1987, 2000, 2002 and 2011 (the last of which was followed by a less memorable market decline of nearly 20%). I continue to believe that present conditions create a poor and probably reckless point to accept significant market risk, and I expect that it will be far more appropriate to accept market risk at the point when at least a moderate improvement in valuations is followed by an early improvement in market action. While each marginal new high amplifies the pressure on investors to abandon all concern for risk, it's worth a constant reminder that the small handful of similar instances in the historical record have ended quite badly for investors.

Of course, the outcome of these conditions may be different in the present instance, and they don't necessarily imply negative near-term market outcomes. Still, my impression is that the worst investment outcomes have typically followed appeals to the idea that "this time is different," and "you've got to dance as long as the music is playing."

I strongly expect that there will be frequent and much more favorable opportunities to accept risk over the coming market cycle, and I am convinced that our approach is even better suited to identify those opportunities than it was during the 2000-2009 period (when an investment in Strategic Growth Fund grew to about four times the value of a similar investment in the S&P 500 – see The Funds page for more complete performance information). We've long resolved the stress-testing concerns that prevented us from accepting market risk in 2009. While our return/risk estimates have been largely unfavorable since April 2010, there were certainly some points in 2010 and 2011 when a modest addition to our hedging criteria would have been helpful, and we've addressed that as well (see Notes on an Extraordinary Market Cycle for a discussion). I continue to view the period since March 2012 as one of extreme risk, despite the moderate advance in the market from that point to-date, and I continue to doubt that any of those gains will prove durable. Suffice it to say that I expect the future to present far better exploitable investment opportunities than the Fed has currently debased investors to

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accept, but here and now, my concerns about market risk are not measured in single-digit percentages, but in fractions ranging between one-fifth and one-half.

Strategic Growth remains fully hedged, with a staggered strike position that raises the strike price of its index put options somewhat closer to market levels, at a cost of about 1% of assets in additional time premium, looking out to springtime. On a day-to-day basis, we can also expect some positive and negative fluctuation based on how our stocks perform relative to the indices we use to hedge. Though none of the stock positions in Strategic Growth presently exceed 2% of assets, even “niche” surprises related to ratings agencies, cloud computing, pharmaceuticals, and other areas can account for a few cents of positive or negative fluctuation in day-to-day NAV. Meanwhile, Strategic International remains fully hedged, Strategic Dividend Value is hedged at about 50% of the value of its stock holdings, and Strategic Total Return continues to carry a duration of about 3.5 years (meaning that a 100 basis point change in interest rates would be expected to affect Fund value by about 3.5% on the basis of bond price fluctuations), with about 10% of assets in precious metals shares, and about 5% of assets in utility shares.

Prospectuses for the Hussman Strategic Growth Fund, the Hussman Strategic Total Return Fund, the Hussman Strategic International Fund, and the Hussman Strategic Dividend Value Fund, as well as Fund reports and other information, are available by clicking "The Funds" menu button from any page of this website.

Estimates of prospective return and risk for equities, bonds, and other financial markets are forward-looking statements based the analysis and reasonable beliefs of Hussman Strategic Advisors. They are not a guarantee of future performance, and are not indicative of the prospective returns of any of the Hussman Funds. Actual returns may differ substantially from the estimates provided. Estimates of prospective long-term returns for the S&P 500 reflect our standard valuation methodology, focusing on the relationship between current market prices and earnings, dividends and other fundamentals, adjusted for variability over the economic cycle (see for exampleThe Likely Range of Market Returns in the Coming DecadeandValuing the S&P 500 Using Forward Operating Earnings).

Past performance does not ensure future results, and there is no assurance that the Hussman Funds will achieve their investment objectives. An investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than the performance quoted above. More current performance data through the most recent month-end is available at www.hussmanfunds.com. Investors should consider the investment objectives, risks, and charges and expenses of the Funds carefully before investing. For this and other information, please obtain a Prospectus and read it carefully.

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