Prepare to Defend Yourselves

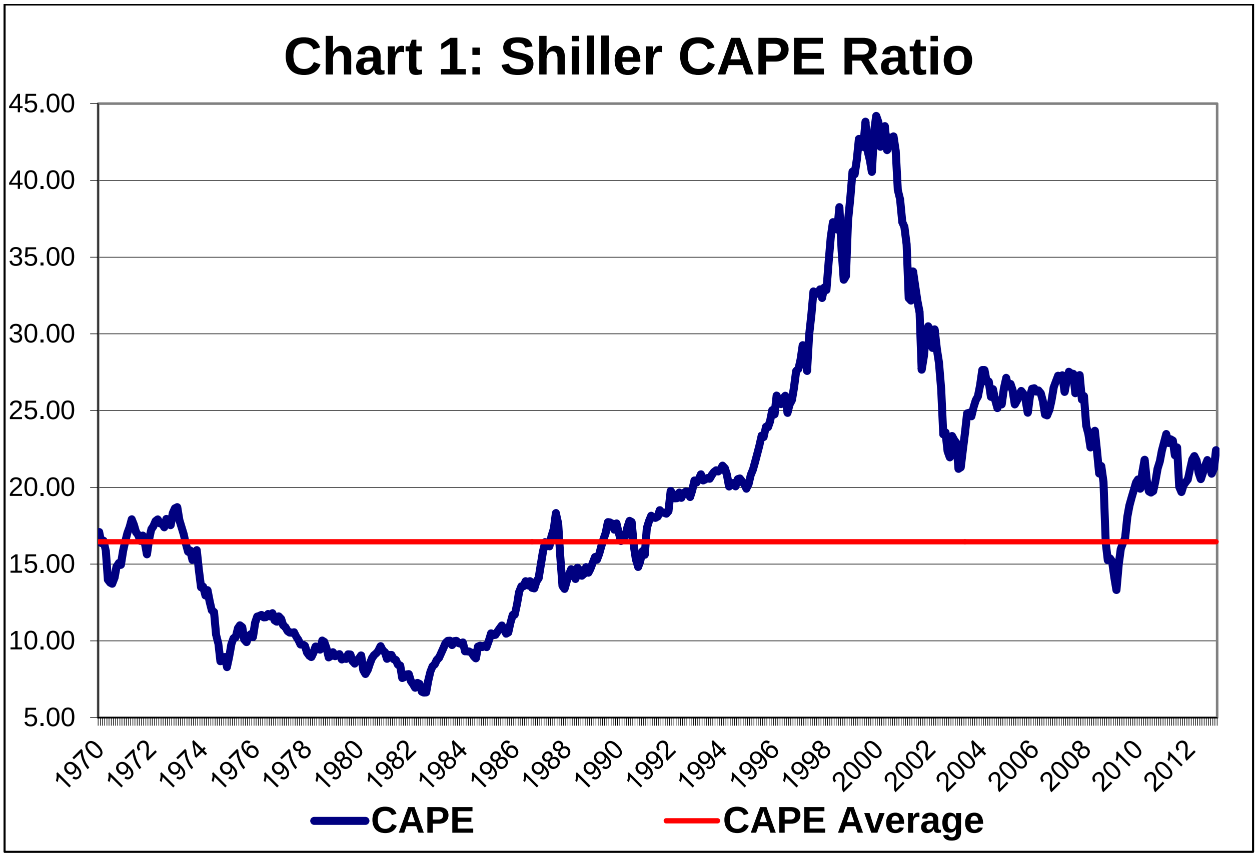
"Anyone who does not understand that the price of every stock and every bond is being artificially altered by the fact that interest rates are being manipulated by the Federal Reserve should not be risking any money in the markets." Michael Lewitt, The Credit Strategist

Hang around with me long enough and you'll hear about John Hussman (and Michael Lewitt, but that's for another time). Hussman is an economist and fund manager who has acquired a "perma-bear" reputation for his concerns that equity markets have become disconnected from underlying fundamentals and that the massive meddling by central banks around the globe will eventually have dire consequences.

You can agree with Hussman or not, but his work is thorough and data-driven. I highly recommend reading his weekly commentary (www.hussmanfunds.com). One of his most interesting pieces of research is a four-factor analysis that looks at valuation (undervalued or overvalued), trading ranges (oversold or overbought), sentiment (overbearish or overbullish) and interest rates (rising or falling). Hussman has shown that it is reliably bad news for the equity markets when his four factors simultaneously exceed certain thresholds of overvalued, overbought, overbullish and rising yields. Since we are staring at one of those times right now, I thought it might be useful to walk through Hussman's analysis in some detail.

Valuation: There are many ways to measure market valuation – price to earnings (PE), price to book value, price to cash flow, etc. Most of these measures are snapshots of a point in time and can be influenced (for better or worse) by short-term anomalies such as earnings that may be significantly above or below average. To address this problem, Robert Shiller of Yale University developed a cyclically adjusted price earnings ratio (CAPE ratio) that averages ten years of past earnings to smooth out the bumps. Specifically, CAPE takes the current price of the S&P 500 index divided by the average of the last ten years of earnings adjusted for inflation.

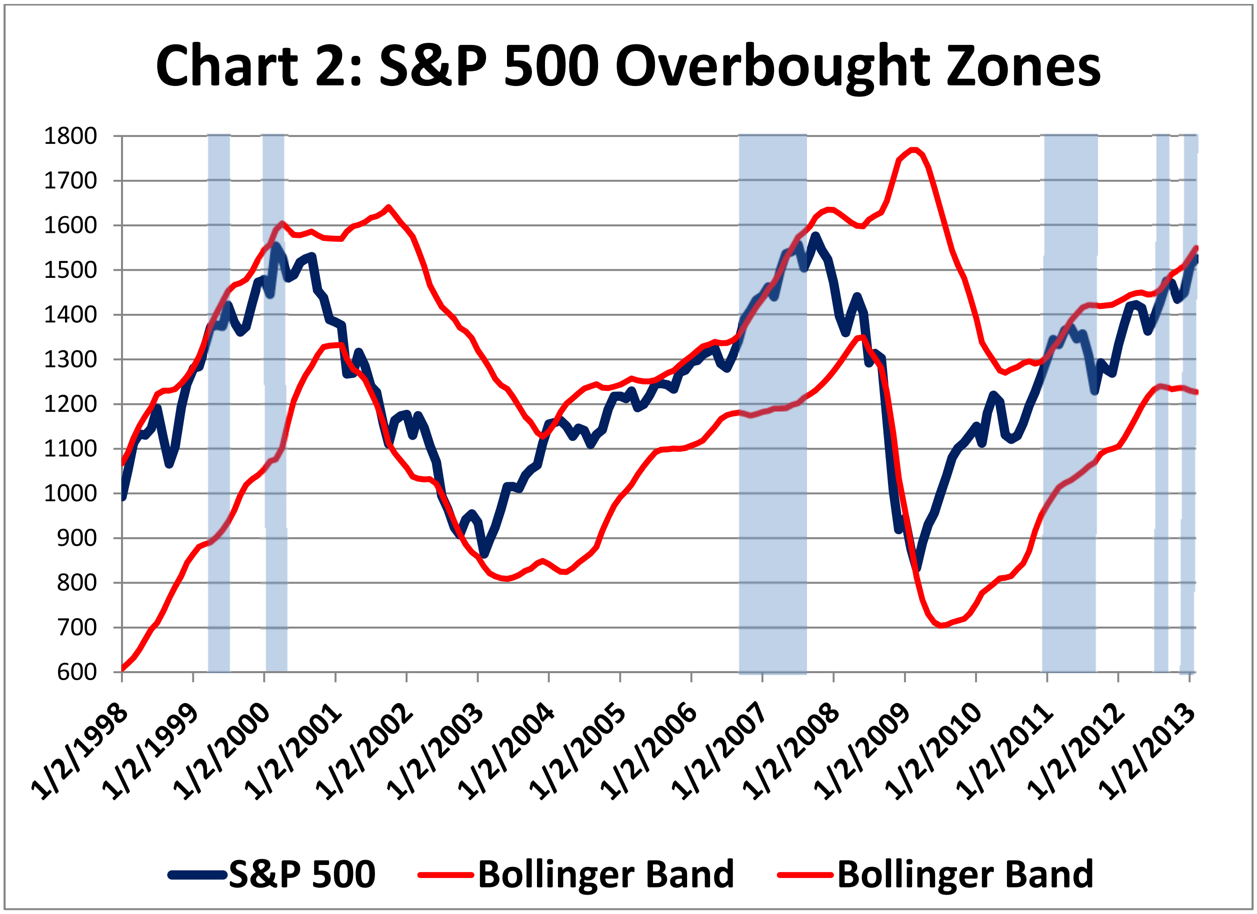
By itself, CAPE is not a very good market timing tool except over very long time horizons. A look at Chart 1 shows that the last major bull market (1982-1999) started with the CAPE at a very low reading below 7. That bull market ended with CAPE reaching an all-time high of 44. But CAPE stayed well above average from 1995 to the top, while the market kept going higher. Exiting the market simply because CAPE was "too high" would have cost you a lot of money and shows that markets can stay overvalued longer than you think. Since the peak in 2000, U.S. equity markets have see-sawed up and down but made no real progress in 12 years. During that time, CAPE has been consistently above average except for a brief time at the market low in early 2009, which turned out to be a good time to buy stocks.



Right now the CAPE ratio is above 22 times - 36% above its long-term average - while the S&P 500 is flirting with all-time highs. For Hussman's analysis, a CAPE ratio above 18 times is in the danger zone if accompanied by warning signs from the other three factors.

Trading range: Another way to evaluate where we might be in a market cycle is to see where the current price sits in relation to average price levels. A stock or sector or market index is considered oversold (cheap) when it's trading two or more standard deviations below its average price and overbought (expensive) when two or more standard deviations above its average. On a price chart, we use Bollinger Bands to show two standard deviations above and below a 20-period moving average of the price. Hussman uses the S&P 500 and looks at three timeframes – monthly, weekly and daily – to see when all three time periods are oversold (bullish) or overbought (bearish). To define an overbought condition, he also looks for the price to be more than 7% above its one –year average and more than 50% above its four-year low.

This combination of conditions doesn't occur all that often. Looking at Chart 2, this overbought syndrome has shown up six times since 1998 and the market experienced a significant correction in the aftermath of each signal. Once again, these are not precise timing signals as the overbought condition may last many months before the market heads down. Nevertheless, they have been useful warning signs.



Investor Sentiment: Investors Intelligence is a subscription service that has conducted a sentiment survey for almost 50 years. Their results show that extremes of bullish or bearish sentiment are good ***contrarian*** indicators. People tend to be overly influenced by recent events, therefore most bullish near market tops and most bearish near bottoms. Hussman considers the market to be extremely overbullish when bullish sentiment is above 52% while bearish sentiment is below 28% - a spread of at least 24 points. I don't have a pretty chart for this one, but the current spread is about 30% in favor of the bulls (54% to 24%) – and that's bearish.

Interest Rates: Low interest rates are great for borrowers and lousy for savers. This flips when interest rates start to move higher. Historically, rising rates have put pressure on stock prices. For his analysis, Hussman looks at the yield on ten-year Treasury bonds to see if it's higher than it was six months ago. Even though interest rates are still nearer all-time lows than all-time highs, the yield on the ten-year Treasury (2.01%) is higher than it was six months ago (1.50%) and many "experts" think rates will continue to move higher.

Putting it all together: As we sit here today, all four factors in Hussman's analysis are glowing red. Chart 3 shows the other times this has happened going back to 1972. As you can see, prior warnings preceded some ugly market action, including a signal well in advance of the Black Monday crash of 1987. Note that the correction in 2011 was relatively small (about 20%) but still painful. It could be different this time but here is Hussman's advice to investors. ***"If you***

are a buy-and-hold investor and are committed to that discipline, or if you are following some other investment strategy with a clearly defined exit criterion, it's perfectly fine to ignore my own concerns. Still, investors who do so should make that decision explicitly, with an understanding of the implications of that choice – as in "I am consciously choosing, here and now, to ignore the potential for the current market cycle to be completed by a bear market, either because I am willing to hold stocks regardless of their future course, or because I will adhere to some well-tested investment discipline that has been reliably capable of avoiding major losses." Our testing goes back to 1996 and the LongRun Absolute Return strategy significantly outperformed the S&P 500 during each of the corrections that Hussman's analysis identified over that period. While the S&P 500 was down 45% from 2000 to 2002 and 51% from 2007 to early 2009, the Absolute Return strategy never dropped more than 13% during those turbulent times. Our Aggressive Growth strategy achieved even better returns but saw a 35% drawdown. These strategies may not work as well in the future but the secret to making money over the last twelve years has been to avoid big losses when the market went through its corrections. If Hussman is right, we may soon have another one of those opportunities.