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By John Mauldin

This week we address the question of whether the stock market is forming a top, take further looks at Fed policy and the unemployment rate and see if there is a connection. I think there is. The relationship is less subtle than it might appear. At the end of the letter, I ask for some help from those in the media (or who have friends in the media) in arranging reviews (and interviews!) for my upcoming book. And in response to readers, I start the process of putting a gold information site and links on my web site. I ask you to tell me your favorite gold and precious metal information sites. There's a lot to cover, so let's get started.

Is Somebody Ringing A Bell?

The old line is that no one rings a bell at market tops and bottoms. Of course, in hindsight, we all imagine we heard the bell and wish we had not ignored it. Even Warren Buffett is not immune from Monday morning quarterbacking his own decisions. He tells us this week in his annual letter:

"We've found it hard to find significantly undervalued stocks...The shortage of attractively-priced stocks in which we can put large sums doesn't bother us...Our capital is underutilized now, but that will happen periodically. It's a painful condition to be in, but not as painful as doing something stupid. (I speak from experience)...I made a big mistake in not selling several of our larger holdings during The Great Bubble. If these stocks are fully priced now, you may wonder what I was thinking four years ago when their intrinsic value was lower and their prices far higher. So do I."

Buffet is sitting on a huge hoard of cash, some $36 billion with over $12 billion in non-dollar assets. The world's most successful value investor can't find something he thinks has value, and even openly wonders about the value of the US dollar.

There are a lot of professionals who question the current levels of value. My young English friend James Montier, the global equity strategist for Dresdner Kleinwort writes today in his weekly letter that he has weighed the values in his scale and finds them wanting.

"All of our favored measures of absolute valuation attempt to abstract from the vagaries of the business cycle. Regardless of which one we examine, we reach the inescapable conclusion that the US market is vastly overvalued. For instance, the Hussman PE (prices relative to peak cycle earnings) is currently trading on 21 times, against an historical average of 11.7 times!"

"Even on the basis of the la-la land forward earnings multiples, the US market looks dear. The current 12m forward PE based on consensus earnings is just over 18 times. Inside we show that a rough approximation for the long run average forward PE would be close to 11-12 times. "

What he develops inside his letter is an estimation of forward earnings projections since 1955. Basically, forward earnings projections have been historically way too high. Generally they are about 26% too high based upon what actual earnings turn out to be. As he calculates, by factoring out the clear track record of irrational exuberance of analysts, you find a market historically over-valued by 33%.

The Stock Market – Interest Rate Connection

Ah, I can hear the bulls mutter, most of those years were not ones in which there were low rates. Today's low interest rates justify high P/E valuations. That argument has some surface logic. If interest rates are low, then investors should be willing to take lower earnings yields from stocks, which justify higher valuations.

But the logic breaks down under this fact: If rates rise, and they always eventually rise, then that will be a drag on future valuation levels. It is precisely this lowering of valuation levels which creates the secular bear market. I actually spend a major portion of one chapter in my book detailing the connection. I wish I had seen the two studies Montier also gives us to buttress this fact so that I could have included them, but at least I can give them to you here.

Montier breaks down historic stock market returns into five groups based upon then current interest rate levels and how the market subsequently performs at different levels of interest rates. Before we look at that study, remember that I have shown in previous letters that typically about 80% of the rise of stocks during bull markets can be explained by a rise in valuation or a rising P/E ratio (what some call a multiple expansion). Only a small part of the rise in stocks is due to an actual rise in earnings.

What Montier finds is:

"Your best chance of multiple expansion is when rates are high not low (quintiles 1 and 2). When interest rates are low, the evidence suggests a risk of multiple contraction or stagnation (quintiles 4 and 5**). Low interest rates may explain why we have arrived at high PEs (because investors suffer money illusion), but they say nothing about the sustainability of that PE."**

He also quotes another author, the brilliant Cliff Asness, who does a study for the Fall 2003 Journal of Portfolio Management. Asness likewise divides the market into five periods of interest rate environments, from low to high. He looks at the returns of the market 10 years before and 10 years after the periods.

The highest returns are for periods of falling rates. When rates are at their lowest, the stock market returns have been the best for the past ten years.

Montier concludes: "Here the fallacy of low rates being good for equities is clearly exposed. Your best chance of high real returns is buying when interest rates are high, not low. Indeed, buying when rates are low has on average resulted in a negative real return over the next decade!"

Let me repeat that: for the ten years following low interest rate environments such as we are in today, stock market returns are actually negative. Not surprisingly, the conclusion is that the best time to invest is when rates are high and the worst time is when rates are low. This is just one more reason to believe that we are in a long term secular bear market.

Dow Theory Sees a Bear

Those of us who follow Richard Russell see him as the dean of Dow Theory. There are no hard and fast rules for Dow Theory, as it was based upon editorials written in the Wall Street Journal in the first 30 years of the last century. Those editorials were written by one William Peter Hamilton, then the editor of that newspaper, based upon conversations he had with Charles Dow (the founder of Dow Jones & Co.), the newspaper's publisher.

But over the years, it has come to be venerated on Wall Street (as has Russell). It involves having the either Dow 30 or the Dow Transportation making a new high or low, and then the other index confirms the move. Exactly what the time frame or percentage move for the high or low was not revealed, thus it was left to the practitioners to determine those moving targets.

There are basically three steps which must happen to turn a follower of the Dow Theory bearish: As Mark Hulbert explains from CBS MarketWatch:

"Consider what those three steps must be when the trend changes from bullish to bearish:

"Step No. 1: Both Dow Averages must undergo a significant correction from joint new highs.

"Step No. 2: In their subsequent rally attempt following that correction, either one or both of the Averages fail to rise above their pre-correction highs.

"Step No. 3: Both Averages must then drop below their respective correction lows.

"Richard Russell, editor of Dow Theory Letters, thinks the last of these three pieces fell into place on Wednesday. Here's his rationale. From their January highs (set on Jan. 26 for the DJIA and Jan. 22 for the DJTA), both averages suffered a correction that lasted until Feb. 4, when the DJIA closed at 10,470.74 and the DJTA closed at 2,822.11. That fulfilled Step No. 1. Step No. 2 was satisfied by the rally that began from those Feb. 4 lows, since in that rally only the DJIA rose above its January high. The DJTA did not.

"Then, this past Tuesday, the DJIA closed below its Feb. 4 low, followed on Wednesday by the DJTA. That was Step No. 3. Based on this, Russell believes that the market rally that began in October 2002 is now over.

"Russell's track record makes it hard to disagree with him. His market timing performance since 1980, when the Hulbert Financial Digest began tracking newsletters, places him at or near the top on a risk-adjusted basis."

But it is not just my good friend Richard. Dennis Gartman, one of the more well followed traders around the world, turned bearish recently, having been bullish for quite some time. Now, Dennis is a trader and can turn on a dime, but the accompanying language to his trades makes me believe he is clearly worried about the direction of the markets.

Tony Sagami, a trend follower who has been timing the markets quite profitably for his clients over the years, went short this week. Greg Weldon has become decidedly bearish.

I had lunch yesterday with one of the more astute long-short hedge fund managers I know. "Last year at this time," I said, "you were complaining about not being able to find any stocks that you could comfortably short. I'll bet you this year you have plenty of candidates for short-selling and that your only concern is timing." He looked at me and laughed and said I had it exactly right. That is a sentiment you see more and more from the hedgie world.

Van Hedge Fund Consultants has started compiling a hedge fund market sentiment number. Hedge funds on average are much more bearish than they were three months ago. Fully 40% are outright bearish (up from 20%) and another 20% are neutral.

Gentle reader, these guys are professional traders. They are not congenital bears. Unrelenting bulls and bears eventually get slaughtered in the trading pits. They simply follow their system or market readings and trade accordingly. Take note.

Even the equity strategists at Citigroup/Smith Barney are bearish. Quote:

" Our main rationale for a weaker market rests on the concern that equity market bullishness is excessive (in our opinion), analysts' earnings estimate revisions have now established new higher hurdles that may limit upside earnings per share surprises and provide fodder for disappointments… Layered on top of [this] is the likelihood that 10 year Treasury yields will climb by year-end, [thereby] compressing earnings multiples, and that high oil prices may represent a challenge to consumers this summer, with some forecasters beginning to worry about $3.gallon gasoline. As a reminder, every penny per gallon change equates to roughly $1 billion of annualized spending that arguably could be spent on other items."

Their conclusion? "…we continue to believe that the equity market [the S&P 500] may end the year at 1,025, down 11% from current levels. However, in our view there is a fairly decent probability that we are down more than that by the summer…"

While I am not certain if we have seen the top or if there is yet another gasp of this dying bull rally, I do think we are in for a rough period this summer for a number of reasons.

It typically takes years for valuations to fall in bear markets to levels from where a new bull market can begin. Why does it take so long? Why don't we see an almost immediate return to low valuations once the process has begun?

Because investors overreact to good news and underreact to bad news on stocks they like, and do just the opposite to stocks that are out of favor. Past perception seems to dictate future performance. And it takes time to change those perceptions.

This is forcefully born out by a study produced in 2000 by David Dreman (one of the brightest lights in investment analysis) and Eric Lufkin. The work, entitled "Investor Overreaction: Evidence That Its Basis is Psychological" is a well written analysis of investor behavior which illustrates that perceptions are more important than the fundamentals.

Let's go with Dreman and Lufkin (DL) then come to the meat of their analysis. For them, underreaction and overreaction are part and parcel of the same process. The overreaction begins in the years prior to the stock reaching lofty heights. As Nobel Laureate Hyman Minsky points out, stability leads to instability. The more comfortable we get with a given condition or trend, the longer it will persist and then when the trend fails, the more dramatic the correction.

The cause of the price reversal is not fundamentals. It is not risk, as numerous studies show value stocks to be less risky.

"We conclude," they write "that the cause of the major price reversals is psychological, or more specifically, investor overreaction."

But DL go on to point out that when the correction comes, we tend to underreact.

While we do not like the surprise, we tend to think of it as maybe a one time thing. Things, we believe, will soon get back to normal. We do not scale back our expectations sufficiently for our growth stocks (or vice-versa), so the stage is set for another surprise and more reaction. It apparently takes years for this to work itself out.

As they note in their conclusion, "The [initial] corrections are sharp and, we suspect, violent. But they do not fully adjust prices to more realistic levels. After this period, we return to a gradual but persistent move to more realistic levels as the under-reaction process continues through [the next five years]."

The studies clearly show it takes time for these over-valued portfolios to "come back to earth" or back to trend. Would not, I muse, this apply to over-valued markets as a whole? Might not this explain why secular bear market cycles take so long? Is it not just an earnings surprise for one stock which moves the whole market, but a series of events and recessions which slowly change the perception of the majority of investors?

Thus my contention that we are in just the beginning stages of the current secular bear market. These cycles take lots of time, anywhere from 8 to 17 years. We are just in year four, and at nosebleed valuation levels. The next "surprise" or disappointment will surely come from out of nowhere. That is why it is called a surprise. When it is followed by the next recession, stocks will drop one more leg on their path to the low valuations that are the hallmark of the bottom of secular bear markets.

If It's Not One Thing

The next surprise will find an environment that is not in a good mood. Even though the total wealth of the US citizens went to an all-time high at the end of last year, as housing continues to roll and the markets have come back, consumer sentiment is dropping.

I think this is directly related to concerns over the job environment. Very few feel safe, either from being out-sourced to foreign climes or being replaced by technology. As I noted last week, it is the latter that is the real culprit in the jobless recovery.

Business Week tells us that for each 1% rise in productivity we lose up to 1.3 million jobs a year. Of the 2.7 million jobs lost over the past three years, foreign out-sourcing has only been responsible for around 300,000 jobs, or around 11%.

But foreign out-sourcing has been responsible for about 90% of Democratic presidential candidate's rhetoric. John Kerry's line is the "Benedict Arnold CEO's."

Anyone who thinks this rhetoric has not had an effect on the mood of this country is kidding himself. That is not to say that Kerry is causing some kind of national malaise (except among Republicans), but that continued focusing on the negatives of a very real jobless recovery will have a psychological effect. It is in fact a valid issue for the campaign, but continually talking about how bad the economy is will eventually have

more and more people asking themselves if they should be concerned. If the answer they come to is "yes" then that will turn consumer sentiment down and make investors more wary.

Given that investors and especially Baby Boomers have already seen how a stock market can retreat, will they be as willing to stand by and hold this time after the market begins to drop, or will they be more willing to hit the sell button?

To repeat, **"We conclude," DL write "that the cause of the major price reversals is psychological, or more specifically, investor overreaction."**

The Fed in the Box

Trying to fit the final piece of the puzzle into the picture, let's look at the call by Stephen Roach (one of my favorite analysts and thinkers at Morgan Stanley) for the Fed to raise short-term rates to 3% immediately. The Economist magazine notes that such a move might precipitate a recession, but agree that the Fed should start to raise rates soon. Those calls are coming from more and more quarters.

It won't happen. Put this fact into the Fed interest rate equation. Home values are largely a function of cash flow and how much a person can afford to put toward a mortgage payment. Let's say a person buys a $250,000 home and puts down $40,000 as a down-payment and finances the remaining $210,000 at 5.5%. If interest rates were to rise to 7.5%, the same payment that financed his $210,000 mortgage now only sustains a $170,000 mortgage and a $210,000 price on his home, all else being equal. Either the new buyer must pay a higher percentage of their income for the mortgage or incomes must rise. Incomes are not rising very fast so it might take some time for the effects of inflation and rising national incomes to allow a new buyer to purchase the home on the same terms as the original buyer.

If mortgage rates were to rise too precipitously, it would hurt home values. There can be no argument with that. If interest rates rise, we demonstrated above that equity values would likely drop. Now, in a robust recovery with normal new job and income growth, it all balances out and rising rates become less of an issue.

But we are not in a normal recovery. If Greenspan or the Fed were to signal that rates would soon rise, the markets would quickly price in not just one Fed rate increase, but would project increases forward for some time. Rates would quickly rise and stifle the recovery, and as the Economist noted and as I have written on numerous occasions, it would probably lead to a recession, given our current fragility.

Remember Pascal's Wager? Pascal noted that the cost of believing in Christianity and God and finding out there was no God was far less than the cost of not believing and being wrong and being subjected to eternal punishment. Far better and safer, he averred, to wager on the side of belief. The cost of being wrong is too high.

Greenspan understands Pascal's Wager. He told us in what I think is his most important speech ever last August: "Rules by their nature are simple, and when significant and shifting uncertainties exist in the economic environment, they cannot substitute for risk-management paradigms, which are far better suited to policymaking."

Greenspan told us that human beings run the Fed, and they have to make judgments. The best way to do that is to try and avoid the big risks. In essence, the Fed is like a giant economic insurance company, trying to avoid the big risks which could wreck the economy (like deflation, in their view) and thus are willing to take smaller risks (like inflation, again in their view).

If there were a 20% risk (to pick a number out of thin air) of a recession and thus deflation resulting from the Fed raising rates, it is better to hold rates down until we are more confident than to take the 50% probability that the markets would absorb such rate increases without a problem.

I continue to make this point: Greenspan will not raise rates until we have at least three months of robust job growth (probably over 200,000 per month) and capacity utilization in the economy is much higher. OK, if inflation were to come roaring back, he would be forced to raise rates, but that is not today's problem. (and yes, I know the problems with the CPI calculations.)

Yes, that risks an asset bubble in housing and equities. But he has been very clear about this principle: First, do no harm. If rising rates posed even a nominal risk to the economy, a central banker has to ask himself, "Why take the risk?" The criticism of the Fed would mount to new highs if he raised rates and the economy began to stall.

I wrote in late 2000 or early 2001 that Greenspan had raised rates for the last time in his career. I thought then he would step down in June of this year. If he stays on for another term, I still think it will be far longer than most market participants think before he raises rates. My guess is 2005 at the earliest, and that is if everything goes well and we start to see job growth. My gut guess is that he raises rates not in response to a healthy job environment, but to inflation that comes back after the next recession. I hope I am really, really wrong.

Summing up, whether the market has made the top in what I believe to be a bear market rally or it fakes everyone out again and renews its upward trend, I think we are in the final innings of this rally. I would keep my stop-loss numbers very close. This latest rally has been driven by the mo-mo's (momentum traders), and what they give, they can take away.

Getting by With a Little Help from My Friends

My book, Bull's Eye Investing, will soon be at the printers and should be in the bookstores in the latter part of April. (In a world of the internet, everything to do with a book, including the writing, seems to take so long.) Wiley and Sons, my publisher, has

asked me to enlist some of my longer time readers in the marketing effort. If you are in the media and would like a review copy, let me know. If you know someone in the media, can you recommend they look at the book and consider a review? I hope to be doing a lot of interviews in late April and May.

If you have a website, would you consider putting a review and/or a link on your web site? If you have your own list, would you like us to send you an ad you can forward with your own comments? I should note that you can set up an account with Amazon or Barnes and Noble and they will pay you for any sales you send to them.

In short, any help you can be would be sincerely and deeply appreciated by me. Or any suggestions for new and creative ways to market.

Gold Bugs of the World, Unite!

I am probably posted on more gold related web sites than that of any other specialty. I know many of my readers have a great deal of interest in gold and gold stocks. I am still bullish on the long term prospects for gold. Because of numerous requests, I have asked my publisher to set up a section on the newsletter website giving links to the best of the gold and precious metals websites and letters. I have my own, of course, but am more interested in what you find useful. Drop me a link and a quick review. If you have a site, let me know. I am going to try and get this up within the next few weeks.

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Life is going to get very busy. I will be in New York on CNBC with Ron Insana on Wednesday March 24. His show starts at 2 and I do not yet know the exact time, but if I know before next week, I will put it in the letter.

I will be in Las Vegas speaking at The Money Show from May 11-13. This is a massive event. They expect over 10,000 attendees, and you can register for free at http://www.moneyshow.com/main/main.asp?site=lvms04i&cid=default&sCode=002868.

I will be speaking at the Dynamic Asset Allocation conference in San Diego March 30, and on Evaluating Hedge Funds at Texpers (an organization of public pension plans in Texas) in Houston on Sunday, March 28.

My bride requires my presence in Puerto Vallarta over the Easter break and my boys demand a Spring Break trip to San Antonio tomorrow morning. Plus, I speak in San Antonio on the 15th of April.

We move offices next weekend, so phones are subject to problems after Thursday. And my own conference for accredited investors with Richard Russell, George Gilder, Martin Barnes and Rob Arnott is April 22-24 in La Jolla. Think about a panel with

Russell, Barnes, Gilder and yours truly. What fun! I can't wait. My book will hopefully be in the stores by then, so that will be the official launch party.

As my Dad would say, it's time to get on my pony and ride. There is lot's to be done.

Your getting by with a lot of help from his friends analyst,

John Mauldin