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And more, of course!

*I must correct an egregious typo in last week’s letter. (And no, it was not my awkward use of prepositions.) I wrote: The economy will recover in the second quarter, and indeed it may be the 4th quarter before we see a turn-around. The software gremlins somehow removed the word NOT from that sentence. It should have read: The economy will *NOT* recover in the second quarter, and indeed it may be the 4th quarter before we see a turn-around.

Big difference, and I apologize for that confusion, and thank the many readers who pointed it out.

We are finally getting the bear market rally I have been writing about and hoping for. At least I think it is a bear market rally. Those who are buying this run must see something else in their data than I do. Let me bluntly state my case as to what you should do.

A Walk Through the Economic Forest

This week will be a forest and trees e-letter. By that I mean, we are going to stroll through the economic landscape, looking at individual stories, and then we will step back and look and see what kind of forest we have wandered (or wondered?) through. We will see if we can get a clue as to the direction of the stock and bond markets. I should warn you, fellow traveler, that this forest is full of lions and tigers and that worst of all investment creatures: Bears!

First, let’s survey some gleanings from one of my favorite sources: Greg Weldon. Greg writes 3-4 commentaries a day on commodities and the financial markets, rising at 2 am to start his work. His research is some of the best anywhere, and he is a frequent guest on the TV talk show circuit. I met him for the first time in New York last week. He looks so much smaller on TV. His 6’10” frame is imposing. In fact, he played basketball professionally, but evidently found it easier to wrestle with the financial markets than with Moses Malone and Darrel Dawkins. His letter is $400 per month, and I highly recommend it for serious traders. You can get a free month trial by writing him at g-trader@att.net.

In no particular order:

***US import prices plummeted by a whopping 1.6% during the month of March, the steepest one-month decline since Dec-92. BOTH import prices AND export prices deflated during March and BOTH are now deflating on a year-year basis.

*** The US Labor Department revealed that PPI deflated during March,

*** Initial claims for unemployment benefits rose 9,000 in the latest week as reported this morning, to a total of 392,000, more than expected, and the highest level since March, 1996.
Finally, we MUST mention the news from Putnam Investments, the nation’s fourth largest mutual fund company, who announced yesterday that they will lay-off 4% of their workforce. This marks the second US mutual fund company to announce layoffs, after Janus Capital laid off several hundred employees. Of interest is the fact that the Janus layoffs were centered in the mail room and among telephone operators. Why is that so interesting? Because it reflects the collapse in trading activity, as mail and phone volumes have plummeted. Indeed, Putnam cited the falling stock market as the cause for the 24% plunge in “sales calls” in the last 12 months. (More on Janus later-JFM)

(JFM) could cite a long list of problems from Europe listed by Weldon, but will summarize by saying German retail sales have gone negative and there are a host of other problems beginning to appear. The European Central Bank failure to ease interest rates has put real pressure on the Euro. Yardeni cites a number of problems in Europe, not least of which is plummeting semiconductor sales and deteriorating business conditions throughout Europe and Japan.

from the Richmond Fed’s March Economic Survey: For the Service Sector … though some of the readings reflected a small rise compared to February … ALL of the following components posted their fourth consecutive month of negative readings (reflecting net contraction)— revenues— number of employees— retail sales— shopper traffic— bit ticket sales

One specific service sector component reading piques our interest, as Retail Service inventories rose…Thus it would appear that we have MORE evidence to support our assertion that the economic slowdown in the US is NOT just manufacturing, and is now spreading to the (once) teflon service sector.

Those figures are from just the last two days of Weldon’s commentary. I could do a whole letter on such tidbits if I went back for a few weeks, but you get the idea. The economy is slowing down and there are no signs of it turning around in any data I have seen. Weldon is not a perennial bear, just simply a very honest and forthright analyst and trader. And the numbers he is seeing suggest problems.

A few notes from the Daily Reckoning:

Mortgage delinquencies recently reached the highest level since ’92. Personal bankruptcies are rising, too, and are expected to reach 1.4 million this year, up from 1.2 million last year. Consumer debt is going up at a 10.5% annual rate and household debt payments - at 14.29% of income - are at their 2nd highest level ever.

Ralph Acompara, chief strategist at Prudential Securities, predicted 2 years ago that the Dow would hit 20,000. Now he says that “all of us just got carried away.” And we’ll have to wait until 2006 for a Dow of 20,000. (I spoke at the same investment conference in 1999 with Acompara. Wow, was he bullish.)

Consumer debt now equals 71% of GDP and 85% of personal incomes - a record on both points. And Moody’s says that households’ liquid assets fell 13.2% in the first quarter of this year, compared to the same period last year.

If you read Bonner regularly, you know he is an ever-ready source of gloomy numbers. Likewise, I could fill up a whole report just going back a few weeks with such stats as above
Foreign Currency Monopoly Money

Over to our left, I notice some Japanese Maples and Chinese Purple Plums, plus a few Eucalyptus from Australia. They all seem to be shrinking. In fact, the entire world seems to be playing a game in which the object is to lower or devalue their currency so they can make their products seem cheaper to US consumers, who are rewarding such lunacy by buying less.

I have a friend who manufactures and buys tremendous amounts of products from China. Last week, I asked him what would happen if for some reason the hostage crisis over there forced us to cut off trade with China. He simply replied he would move to other countries, notably Thailand. I asked him how much more it would cost. His reply was almost nothing as the Thai Baht has dropped enough to even up the costs with China.

Of course, this makes investments in Thailand (in terms of dollars) perform poorly and makes products from other countries cost more, hurting local companies who need to buy products for their businesses. It becomes a vicious circle.

There are a lot more trees in this forest, and maybe we will return one week. But I think we can now get the measure of this forest.

Dropping Back

As we walk out and look back at the forest, it seems to be slowly shrinking. But then, this is a rarely seen Recession Forest. For most of our fellow travelers, it is a new experience.

I have combed the data for some good news, but there is precious little. The only thing that seems to be in plenty of supply is happy talk from investment bankers and mutual fund managers.

Sidebar: The large investment banking houses, the brokerage firms and mutual fund companies, all have access to the same data Weldon does. Indeed, many of them are his readers. But do you hear any of the above from them? All you get from these cheerleaders is a reason to buy more stocks of companies whose earnings are dropping. And especially those companies and funds which are linked to their income.

Many of Janus's funds are down 50% or more. So what do they do? They send their investors a letter with the following verbalized investment garbage:

Quote: “You’ve probably heard us talk about our intensive company-by-company research, the core of our entire investment approach. It’s actually in times like this that sticking with the discipline that’s delivered time and time again that matters most. No matter how appealing market timing might seem today, we know that the only thing that will deliver for you over time is our collective hard work and dedication to learning everything we can about individual companies.

“You have our word that our focus on each company we have in our funds is more intense than ever. Because of our exhaustive research, we can tell you that right now we’re actually very optimistic about the prospects for those companies we own on your behalf.” Etc. Etc.

The letter was very well crafted to make nervous investors fell good. But it makes me want to ask a few questions.
Like, if Janus was so focused on the companies, why are their portfolios down 50%? I grant you Cisco is a great company with enormous prospects in the future. But you are not buying Cisco. You are buying STOCK in Cisco. When a stock of one of the largest market cap companies in the world grows to a P/E of 200, that is NOT a great stock. It is an over-priced stock. **Never in the history of the world has a large-cap stock maintained the growth necessary to sustain a 200 P/E ratio.** I don’t care how much research you do, when you fight odds like NEVER, you are taking too much risk. In the last 12 months, Cisco’s market value has dropped more than $450 BILLION. Keep talking to me about research.

All the research in the world makes no difference if you don’t exercise some market discipline and pay attention to the fundamentals like value and position size. Janus let their position in Cisco and other big techs grow to such an huge extent that they could not sell those stocks, even if they wanted to, without destroying the stock price. Their only option was to be cheerleaders.

On the way up, you are a genius. You start to believe your own press coverage. You believe that your superior research was the reason the stocks you picked went up. You especially believe that in a bubble market.

Where was their research six or even three months ago that said tech sales were slowing and that meant earnings would be hit and therefore stock prices would drop? Today, Cisco has monstrous inventory problems. And I am not talking about just the inventory in the company. All the routers and such they sold to all the busted dot-coms are now on the used equipment market selling for as little as 10% of the Cisco listed price on E-bay. And more supply is on the way as more dot-coms get liquidated. (Talk about putting pressure on profit margins. And Cisco is still a pricey 31 times earnings.)

Excess inventory is not just a problem for Cisco, of course. It is in the whole industry. Dell tells us that because they can price products lower than their competitors, they will be picking up market share in a shrinking market. That is supposed to encourage us? That means the rest of their competitors are going to be in a real bind, and Dell’s profit margins will shrink.

Don’t even get me started about Lucent. Or Motorola. AT&T, the widows and orphans stock, is a basket case. Intel is stopping a lot of new construction and slowing new projects in anticipation of slowing demand which they think could last for almost a year.

Back to Janus. They tell their investors to trust their research. We’re optimistic now. Translation: please don’t take your money away, because our income is down so much already because we failed to see this tech bear market, that we will start to have to lower salaries and bonuses of management. We will do better. Honest. We will dump these dogs and find new stocks. We will buy and sell companies but please don’t buy and sell us, because market timing doesn’t work.

They were optimistic when the NASDAQ was at 5,000 or 4,000 or 3,000. Nothing has changed. They were cheerleaders then and they are cheerleaders now. If you invest “for the long term” with cheerleaders, you are going to eventually get hammered.

My less than sainted Dad had appropriate words for this type of logic. But this is a family letter.

Bulletin: My associate just handed me a note that says that the elm tree over to our right is diseased. The University of Michigan Consumer Sentiment Index fell to 87.8 in April from 91.5 in March, almost 3 points lower than expected.
How Low Can the Market Go?

I have often cited Yale Professor Robert Shiller's powerhouse book, Irrational Exuberance. No investor should buy a stock or mutual fund today without reading the first and last chapters of that book.

He shows how markets for the last century have tended to revert to the means in terms of P/E ratios. Today, the P/E ratio of the S&P 500 is roughly 20. Historical average is 15, though in bear markets it can easily go lower than 10.

S&P Earnings estimates are dropping every month. Mainstream cheerleader – oops, I mean analyst – estimates are for $57 of earnings for 2001. Yardeni is at $53. They also think that 2002 earnings will grow 15%+. But let's use Yardeni's more “conservative” number of $60 for 2002 earnings.

Typically, the market invests with an eye to the future. So if at the end of the year, the P/E ratio is still 20, that implies an S&P 500 price of 1200, roughly a 1.5% gain from where we are today.

But what if it went back to the mean of 15? That would mean an S&P price of 900, or another 25% drop.

What if earnings don't grow another 25% over the next 21 months? What if (gasp) earnings are flat? And stay at an expected $53 for 2002? At a 20 P/E that would be 1060 and at 15 it would be 795.

But if we get into a bear market and the P/E ratio drops to 10, which it often does in bear markets, that could imply an S&P 500 of less than 600!

Unthinkable you say? Preposterous? The bull argument is that long before we got to such lows there would be too many stocks that would be screaming buys and the markets would turn back up. I must say, I would agree to the extent that many stocks would be screaming, “Buy me! Buy me!”

But just as now nearly everyone agrees that buying Yahoo at 1000 times earnings was not rational, there is no rule that says investors have to be rational at market bottoms. In fact, my older investor friends say fear can be an even stronger emotion than greed, though the last few years certainly make me wonder.

Investor Sentiment Says to Sell

Our various Investor Sentiment indexes continue to erode. Let me focus on one index, the Sentiment Percentage Uptrends Index. For new readers, this is the index that measures the number of stocks that are hitting on all 8 cylinders. That means nearly everything we measure about a stock, and that is quite a lot, is in an uptrend. Only very rarely does this index get above 40, or below 10. When the index is rising, or very high, that is good. When it starts to drop, that is bad. It has dropped from over 29 to almost 22 in just a few months or so. That is a quick and disturbing drop. Objects in motion tend to stay in motion, and this index tends to keep right on dropping, and in bear markets can get into the low teens. This Index is screaming bear market!

Further, I keep telling you that the large institutions have left the room. The “Big Boys” now account for less than 14% of the market activity, down from over 20% average. That is a huge drop. One day last week, they were less than 11%! The average is dropping each week. That is NOT GOOD! This Index is screaming bear market!
Ah, you say, that must be the day the market went down. No, it went up about 1% that day. But it did so because small buyers made up 33% of the market share, up from 22%. Pay attention, fellow travelers!

Who do you think has a better idea of where the economy is headed? Who do you think has a better idea of where the markets are headed? If you vote for the little guy, then go buy some more Cisco and ignore me.

**What Should You Do This Week?**

If you think that the economy is not going to go into recession and/or that earnings will grow 15% this year and next, then sit tight. The markets will be choppy, but you have probably seen the market lows.

**But if you think the economy is going into recession, and/or that earnings are going to suffer, then you need to sell every stock and equity mutual fund that is not nailed down. You have been given a classic bear market rally opportunity. Do not miss this one, as I think this is the last train out.**

**I cannot say it any stronger than that.**

I get a lot of letters from readers which make me want to cry. A lot of older couples or widows have lost a great deal in the last year or so, are worried and confused and seem afraid of doing anything.

Do not let some broker or mutual fund manager give you “invest for the long term” garbage. If you are over 70, the long term is now. You do not want to wait for 15 years for this market to come back. Get out this week, go to cash or bonds. If you are young, richer or aggressive, maybe even buy some index puts or short the QQQ or SPY.

(I remember my Dad, when I helped him run a hostile takeover of a small privately held cellular telephone company. He wanted to cash out. They wanted to wait for the long term. At 84, he told the other shareholders he did not even buy green bananas. He won.)

Even if you are younger, why are you taking the risk? If you are in cash, and the market drops, then when you get back in, you will have more upside. Averaging down in a bear market, as the brokers call it, is dumb. It makes great sense in a bullish climate, but not today.

You are risking a 20%-30%-40%-50% downside for a 5 or 10% upside. That is a bad risk to reward. You are betting your future on increasingly bad economic data.

(I know there are some stocks you cannot sell for some reason. I have one stock I own that is selling for 30% of its fire sale liquidation value. I call it my stupid stock. It is a mini-microcap, and I could not find enough buyers to get out at even its listed price. L-o-o-o-n-n-g story. I will hold that stock, knowing it will be a few years before management finds a way to sell the company, which they largely own, and we get out with (hopefully) a nice profit of 5-10 times above this price. But that is the only stock I own. By the way, for legal reasons, since I own the stock, I cannot mention it in this letter.)

If I am wrong, what do you lose? Maybe 10% growth? If the economy is turning around, it will start showing up in the mounds of data I churn each week. I will humbly, hat in hand, tell you I was wrong and we will jump back in.

(Note to clients: We have taken new positions this week, and anticipate further new positions. A letter is in the mail to you explaining details.)
Now, before you slit your wrists, let me remind you that this is just a recession and it will pass. We will get new opportunities in the future for growth. The day will come when we will sell our bonds and buy stocks. I just don’t think it is going to be this summer, or even this fall. But it will come, traveler, it will come.

Seeing that I may have given some of you cause for concern about your portfolio, I think it is only fair that if there are those who would like to talk about their portfolios, I or my associate Wayne Anderson will be available to talk next week. You can call us at 1-800-829-7273.

Etc. Etc.

The yield curve has finally completed its normalization. This typically happens before the recession starts, so everything is still pointing to the recession beginning this summer.

For those who asked for our cassette tape on bonds (last week’s letter), it will be going into the mail Monday. There was a problem at the printer. It seems even old technology can occasionally fail. Next week, I will again talk about bonds, and why on the very day I tell you they are such good investments, they immediately proceed to drop 3% the next week. I would be tempted to say something like that just makes them 3% better bargains, but after my ranting above about marketing talk from Janus, I think I will show some forbearance and simply make the case next week.

By the way, I did not think it could be done, but DirectTV has demonstrated successfully that they can have even poorer customer service than Sprint. I marvel at the level of collective incompetence in what passes for customer service these days.

I will be giving the message at my wife’s church this Sunday. As I think about this week and its meaning, I am once more reminded that there is more to Life than work and investing. I wish for you all to have a blessed Passover/Easter season, and to enjoy this time of year.

Your fellow traveler and selling analyst,

John Mauldin

John@2000wave.com

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