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## Unapologetic Bear Believes Market Is Still Overvalued

**Question:** On a scale of 1 to 10, where 10 is most bullish and one is bearish, how do you feel about the market?

**Brett Gallagher:** I'd say we're probably a three, but with the potential to become a one. Right now, the economy is operating on only one cylinder, and that's the consumer. And the fuel for the consumer has been drying up. Rates have gotten so low that everybody who wants to refinance is refinancing. The Fed has very little weaponry left. So what we worry about is that if the economy doesn't catch this time, that there's a chance that we could easily fall off the edge at some point in late 2003, early 2004.

**Q:** So, the markets are still overvalued.

**Mr. Gallagher:** Absolutely. A lot of investors are saying that because this market is down so far there must be opportunities, that a normal bear market lasts X number of months, and we're now that far into it. Yet, if you go back 10 years, the compound annual return for the S&P 500 is still 10.4% per year; with the Dow it's 12.7% per year. That's well above the long-term averages.

**Q:** Where do you think the market is going?

**Mr. Gallagher:** We have fair-value estimates. With the S&P, we come up with anything between 560 and 650 [versus 827.37 points Friday]. Nasdaq's another case. Nasdaq, despite its decline, still remains significantly overvalued. The market is still pricing it as if it's a growth index. But in reality, tech has gone ex-growth in our opinion.

**Q:** "Ex-growth" typically means that it's not going to be growing much more than the economy.

**Mr. Gallagher:** That's exactly what we mean, for the rest of however long you want put on it. Just to get to today's valuation on the S&P, Nasdaq is trading at something like three times sales; S&P is trading at something like 1.3 times sales. We need to see a 50% drop in the Nasdaq [to about 600 points] to put it on par with today's valuations of the S&P, which we think are overvalued.

**Q:** Give us an idea of where we are in terms of price to sales, price to book, price/earnings ratios.

**Mr. Gallagher:** We have a lot of Wall Street people try to make this very complicated, talking about risk premiums and dividend-discount models and Fed models. Let's start with the simple measures: On a dividend-yield basis [a measure of a stock's dividend compared with its stock price], the S&P is currently at 1.89%. Prior to the bubble period, we'd never been below 3%. For the market to get back to the previous lows of 3%, it would require a 58% drop in the S&P, down to 347.

**Q:** But dividends are passe.

**Mr. Gallagher:** That's exactly what Wall Street says: Companies have gotten smarter, because of the double taxation on dividends. So instead of paying dividends, they're returning capital to shareholders through share buybacks. We would agree if it were actually happening. But they're issuing shares on the other end, through stock-option plans and the like. If you look at the 20 largest companies in the S&P 500 from the end of 1987 to the present, the average increase in its share count is over 18%. There are only three companies during this period of time that have made significant reductions in their share account: **IBM, Bank of America and Philip Morris.**

**Q:** You say P/E ratios are high on a trailing-earnings basis. But on a forward-earnings basis, obviously P/Es are lower. And after all, we're talking about a time when earnings are very low.

**Mr. Gallagher:** That's a perfectly valid argument, but the next question you have to ask is: What if earnings were normal, not at the trough, not at the peak? And if we do that, we come up with about \$44 per share on the S&P 500. Now, there are a couple of problems with that number. There's no accounting for stock options as an expense, no accounting that some of that income as noncash pension credits. If we adjust for that, the trend number is about \$39.

**Q:** Compared with roughly the \$59 that Wall Street expects for next year.

**Mr. Gallagher:** So we're already well below their number. If you took that \$59 number forecast for next year, that implies that the S&P 500 companies will account for 91% of all corporate profits in the country. It's essentially implying the rest of America is going bankrupt, so we know with a 100% certainty that \$59 number is wrong.

**Q:** But in the second quarter, we saw big earnings growth in the gross domestic product figures.

**Mr. Gallagher:** Our argument isn't predicated on the economy falling off a cliff. We're just saying that valuations got so stretched out of proportion that even today, and even with normal earnings growth, this market is extremely overvalued.

**Q:** Some people say that according to certain valuation models that we alluded to earlier, namely the Fed model or comparing interest rates to stock yields, the market is undervalued. Why do your valuation ideas clash with that?

**Mr. Gallagher:** The problem is that Wall Street continues to use earnings-growth rates over 9% as a long-term expected rate of growth. The facts are that over the last decades we've never seen a growth rate approaching 9%, in terms of operating earnings.

**Q:** The long-term earnings trend is about 7%, right?

**Mr. Gallagher:** It's about 6%, but that's even overstated because the S&P 500 is a live index. It has replacements. Companies that are slowing down and no longer consequential are moved out; newer and faster-growing companies are put into it. That 6%, or actually 6.5%, growth rate over the last 42 years is for the S&P 500 with replacements.

**Q:** So there's survival bias?

**Mr. Gallagher:** There's a survival bias. If you're really trying to answer the question of what are the 500 companies that are in the index today worth, the highest growth rate we can use is 6.6%. But I know people closer to 10%. You plug that into your model, and, yes, the market is undervalued.

**Q:** It seems to me that any bearish case must be predicated on things getting worse from here. We've had terrible earnings, we've had corporate scandals, we have the threat of war, we have a burst bubble, we have rising unemployment during the past several years. How could things possibly get worse? Sentiment is terrible.

**Mr. Gallagher:** Sentiment is terrible, but the Wall Street spin machine is working overtime and Wall Street is still talking about these elevated earnings figures. Wall Street is corrupt.

Beginning in 1985 to the present, the gap between the operating earnings and net income has exploded. This has been so abused over the last couple of years, yet Wall Street continues to focus on operating news.

There's no question that we're beginning to see the healing process, but I'd say it's beginning. This is not something that takes place over six months; it's going to take years before faith comes back into the market.

**Q:** So your bearishness is not predicated on an economic implosion in the country or a disaster scenario?

**Mr. Gallagher:** That's right. I mean earnings at this point are fantasy.

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