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When the Bear Will Stay Awhile

Winning money manager tells how to profit from continuing weak times in the economy

An Interview With Raj Gupta-- Our quest to find the right man to invest for these times led us to venture out in last week's blizzard, on a holiday no less, for an audience with Raj Gupta, the principal of RHG Capital and overseer of about $500 million of other people's money. The 19% a year on average he and his team have delivered after fees since 1997, with never a down year and very few down quarters, is an achievement that surely puts him in the ranks of the exalted. He hit his stride working with Leon Cooperman at Omega Advisors, making big directional bets on currencies and interest rates and stocks, before striking out on his own in 1999 and never missing a beat. Without a doubt, the investment world's gain is academia's loss. Before embarking on his Wall Street career, Gupta was co-author of "Controlling the Greenhouse Effect: Five Global Regimes Compared" and penned "Defense Positioning and Geometry: Rules for a World with Low Force Levels," both published by the Brookings Institution. For what direction he thinks the U.S. economy is heading in, please read on.

--*Sandra Ward*

Greg Martin

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Barron's: *You seem to have single-handedly revived the art of macro investing. Are you the new George Soros?*

Gupta: No, definitely not. I find it very scary to even be considered in the same arena as George Soros. I'm just a struggling investor. To be a macro investor is really about the business cycle, and there's always been a business cycle and there always will be a business cycle, and what we mainly do here is figure out which way the business cycle is heading. That means, increasingly, now our job is to figure out what's going to happen to the U.S. consumer, which has so far been relatively immune to the economic downturn, and what the consequences will be for the economy.

Q: *Where is that exercise leading you?*
A: What's unique about the current time is that we are in a structural, or secular, bear market. In the history of the broad stock-market indexes, there have only been two declines of a magnitude comparable to what we have seen since 2000: the declines of 1973-74 and 1929-32, both of which were fairly extraordinary events. They were both precursors to major structural shifts, both in the economy and in the investing climate, and so that has to be a consideration in any analysis of what will happen in the world in the next 12 to 15 months. In the next 12 months or so we are likely to see some stabilization in capex [capital expenditures], but we are very, very reluctant to bet on any growth. The bulls on the economy would say replacement demand is going to drive capex in the next 12-to-18 months. But consider a sector like microprocessors. It is a simple sector to look at because one supplier is so dominant, in effect it's the entire market, and that's Intel. If you take Intel's revenues since the beginning of its history in the early 'Eighties and presume some percentage of revenues each

year comes from replacement demand of the installed base and the rest from new sales, you end up with a very simple model of how the personal-computer market has developed. In 2002, Intel had sales of about $27 billion. If you assume the PC has an average life of four years, that means every year roughly 25% of the installed base gets replaced. The $27 billion revenue number in 2002 is almost exactly 25% of the installed base. That's telling. It shows there has been no real growth. PCs are being replaced at the rate at which you would expect them to be replaced. The idea of getting a surge in capital expenditures because of replacement demand could well be a myth. It is very unlikely to happen.

Q: *So business spending is out as a driver. What about consumer spending?*
A: The only factor that really matters at this time in the U.S. economy is the consumer. It will be critical to what happens in the next 12-to-18 months. There are a few factors that are impacting the consumer in a negative way at least on a medium-term basis. One is clearly the cumulative negative wealth effect. Secondly, the labor market is weak and job prospects are very dismal. Aside from other negatives impacting consumer spending, there is also rising energy prices. Some of this has been offset by tax cuts, and we might see more of those and I would argue that would be a positive. The larger offsetting factor, though, has been lower interest rates and the appreciation in home prices that has led to a mortgage refinancing boom. But now it appears the vast majority of consumers who are going to refinance have refinanced. The consumer had a chance in 2002 to capture almost the entire appreciation in home pricing that has occurred. To liberate more stimulus from refinancing you are going to need house prices to keep rising. Yet, there is increasing evidence that the rate of increase in house prices is slowing and in some regions falling. It is not a good bet to expect rising house prices to provide more fuel for refinancing. There might be another refinancing boom if rates fall another 100-150 basis points [1-1.5 percentage points], but if rates fall 100-150 basis points from these levels we have a problem. Something will have had to have gone really, really wrong for rates to fall by that much from here. Logic suggests the stimulus is exhausted.

Q: *And the savings rate is climbing. Has the consumer stopped responding to stimulus?*
A: Compare how the consumer responded to the 2001 refinancing boom and the 2002 boom. In 2001, the consumer responded by doing three things: He went on a massive spree buying homes. He went on a massive spree buying autos. And he went on a monster buying spree in retail stores. Same-store sales in the U.S. went from about 1% before Sept. 11 to 5% in the spring and summer of 2002. Companies went on a massive inventory rebuilding surge. That explains why the economy felt so good in the first half of 2002 and why things like the ISM survey surged to new highs. The refinancing boom in the second half of 2002 was twice the size of 2001. Housing has stayed strong, but auto sales are still stuck between the 16-18-million unit range they hit in the first refinancing boom. The zero-percent financing for autos has been on for such a long time that it is no longer a draw. The retail same-store-sales picture is downright negative. Comparable-store sales have gone from running at about 5% in the summer of last year to around 1% currently. There is no pickup. There are two possible explanations. One is that consumers are holding out to see how the Iraq conflict evolves. The other possibility is that the consumer is now concerned about the cumulative negative wealth effect and the cumulative weakness in the labor market and, as a result, is starting to increase discretionary savings. That means this money from refinancing is being used to reduce other forms of leverage, which carry higher interest rates. There is evidence of that with credit-card companies all showing a substantial slowdown in installment debt. While all this helps the consumer's balance sheet, it really does not help the economy much.

Q: *So how dire is all this?*
A: I'm not sure it is dire. There are two ways it could play out. We could just keep muddling along. Under that scenario, I would not expect the Federal Reserve to raise interest rates. In that case, 30-year bonds yielding 4.8% and maybe backing up to 5% will be a very attractive investment. The other environment is one in which the steady influx of bad news leads to some attrition of the consumer. The stock market, being forward looking, would anticipate repercussions from that and weaken substantially. Fitting into this would also be the view that Iraq's role in stalling an economic recovery might be overstated and that the problem with the economy is structural, and that might provide reinforcement for a move to the downside.

Q: *How do the Iraqi tensions now compare with the last go around?*
A: The geopolitical goals at stake are more grandiose. In the 1990 conflict we wanted to simply remove Saddam Hussein from Kuwait, a country he recently occupied in a clear act of aggression, and we had the unified support of all our allies. In 2003 our goal is to find weapons of mass destruction in Iraq, bring an end to Saddam Hussein's control over Iraq and gain control of Iraq's military arsenal, all of which is proving to be extremely difficult. And we are struggling to hold our allies together. These are goals that won't be as easily achieved as in 1990. But the biggest difference is the way in which the investment community perceives the conflict. The majority of Wall Street strategists were quite bearish on the market the last time around, not only because of Iraq but because we were in recession and oil prices were high. This time around, strategists have gone from being "extremely bullish" to "mildly bullish." The Investors Intelligence Survey of bulls and bears shows exactly the same phenomenon. Where you had extreme bearishness in 1991, you have extreme confidence in this period. There was also more buying power available when the conflict began in 1990 -- mutual funds had raised their cash position to 12% of assets. Now mutual funds have 4%-5% in cash, which is the minimum level necessary to manage day-to-day inflows and outflows. There isn't the same kind of concern and there isn't the same kind of buying power. This suggests that if there is a favorable outcome to the Iraq situation, it is unlikely we'll see the same kind of tremendous rally we saw in 1991. Conversely, if things don't turn out as well as expected, or if there is simply no resolution over a prolonged period, then there is the potential for more downside, in which we challenge the lows of July and October of last year.

Q: *What are you leaning towards?*
A: The risk is on the downside because we are in a structural bear market. In 1991, we were in a structural bull market.

Q: *What else is tilting you to the downside?*
A: Financials as a percentage of the capitalization of the S&P 500 is about 20%-21%. It's the highest-weighted sector in the S&P. This is quite rare. This is a peak weighting. The last time this happened was in early 1998, preceding the financial crisis that came with the unraveling of the Long-Term Capital Management hedge fund and the default by Russia on its debt and the devaluation of the ruble. I would not make too much of this one statistic alone. But the banks have had a lot of things going right for them, and what happens from here? The net-interest-margin game is pretty much over, because banks can't reduce deposit rates meaningfully any further. Credit deterioration is ongoing and chargeoffs are rising. Overall, financials appear vulnerable, especially because of the enthusiasm investors continue to show for the sector.

Q: *Are you concerned with inflation or deflation at this point?*
A: Housing has important implications for the macro outlook on inflation and deflation. The Center of Economic and Policy Research put out a paper comparing the cost of renting a home to the cost of owning a home. Starting somewhere in the mid-'Nineties, there has been a pretty sharp increase in the real cost of owning a home compared with renting a home. It is the largest gap since 1975, and it is among the largest gaps ever, and in absolute terms it is very large. To correct this gap requires some decline in house prices. House prices in the U.S., other than in the 1930s, have never really declined. The rate of appreciation slows, but prices have tended to be stable. It will be very hard to close the gap between the two by having rental prices go up. The rental market is in bad shape and vacancies are rising. By definition, housing prices have got to weaken. That's the key to what happens next on the inflation front. When housing prices weaken, we will enter into a lower inflationary regime than we are currently in.

Q: *So you're more worried about deflation?*
A: If housing prices weaken, the core CPI index will weaken meaningfully from here. Even if you see a brief period of deflation, it could be a deflation that might not be so economically damaging. Clearly, people are going to be quite negatively surprised by the decline in value of their homes, but it may not

become a deflationary spiral. It could simply be a period when the CPI is very close to zero and stays there for a while. It is not deflation in itself that's a problem, it's the deflationary spiral that sometimes develops that's the problem. The good news is that a CPI close to zero would help increase real disposable income. The bad news is we've seen the last wave of mortgage refinancing at a time when housing prices are at elevated levels, and any decline in the CPI would be a consequence of falling home prices, and that's not a pretty picture.

Q: *What do you like?*
A: It is very boring and unsexy, but we actually think that long-term bonds in the U.S. might be a decent investment. If you get some kind of a backup in the long end, maybe up to 5%, it could be very attractive, especially if you don't envision a great bull market from here and expect subpar returns, and also factor in the risk of a serious downward market collapse from these levels if the consumer falls under its own weight. If for instance, in 1929-1932, you had invested in 30-year bonds yielding 5% when the market was down 50% from its highs, you would have outperformed the stock market when the bonds matured. The stock market went down a lot more, had many furious rallies in between, but returns still didn't add up to 5% on an annualized basis.

Q: *That's interesting because a lot of people have declared the bull market in bonds over.*
A: At 5%, it's hard to get excited about bonds. But the majority of the investment community seems to have abandoned the asset class, which makes it quite interesting. Rising state and local budget deficits mean rising state and local taxes, and that makes U.S. Treasuries more attractive because they provide a tax shield. Bond bears point to the large and potentially record-setting federal budget deficit. But in a weak economic environment where government spending is displacing private-sector spending, the budget deficit doesn't matter very much. An added bonus under the current administration is that it is very unlikely you will see any more 30-year bond issuance. The added gravy is that currently the yield curve is extremely steep, fed-funds rate is 1¼% and 30-year-bond yields could easily back up to 5%. There's about 3¾% points of protection if you do get any kind of modest rate increase. In the recession of the early 'Nineties, the spread between the 30-year and the fed-funds rate bottomed at 2¾%. If you assume the same thing happens now, it could mean that 30-year yields can fall to 4% and that would give you a return in the high teens on an annual basis. It is pretty hard for people like us to resist that bet.

Q: *Are you still shorting the dollar?*
A: Yes. Since 2002 there's been a pretty meaningful drop in foreign portfolio investment in the U.S. At the same time, the U.S. current-account deficit is 5% of gross domestic product and headed to 6%. The U.S. needs almost the world's entire savings to finance the deficit. And the U.S. is offering one of the lowest interest rates in the world, at least at the short end. One should do well being long the euro and long the yen against the U.S. dollar. The case for the yen is that all the substantial current-account surpluses are in Asia. They are in Japan, in China, in Taiwan, Korea and Singapore, and because of their large current-account surpluses, they've accumulated reserves at a fantastic rate. The fact that such an enormous imbalance is building up creates potential for some kind of scenario being unleashed in which these currencies, which all target the yen and the dollar, might strengthen sharply against the dollar at some point.

Q: *What stocks do you like?*
A: Our investment approach is highly directional. We have tended to use stock bets as a high-beta version of our macro ideas. And so our most interesting ideas are all on the short side. Technology is still extremely expensive, but I can't get excited about any fresh ideas here. We have more ideas in the consumer sector and financials. **Charles Schwab** is one that stands out. In 2001 and 2002, Schwab earned 29 cents a share. I see no reason why it is going to earn more than 29 cents a share this year, but the Street expects slightly higher earnings. The stock is trading at around $8 a share and has a multiple of about 27 times. The average broker-dealer is trading at 13 times earnings. Schwab is trading at 2.6 times book while the average broker-dealer is trading at 1.5 times book. These valuations are true in spite of the fact Schwab shares are off 35% from their highs in January, a good part of which we've

captured. It is hard to understand why the stock trades where it does.

Q: *But that has always been true for Schwab.*
A: For the first time, retail mutual funds are seeing sustained outflows. The retail investor will not be leading the next bull market. It is hard to see how Schwab's positioning is all that ideal.

Table: Gupta's Picks and Pans[1]

Another area, and many shorts are focused on it, is consumer finance. We were lucky enough to be short **Ameri-Credit**, **Providian** and **Metris**, which all focus on the subprime areas of consumer finance. But these three stocks are bombed out. The two that are still at high risk are **Capital One Financial** and **MBNA**. Clearly their shares are down. Clearly on a P/E basis, neither stock is expensive. But in both cases the following things are true: Chargeoffs and delinquencies continue to rise, the net interest margin has stopped expanding. Furthermore, corporate-bond investors have become wary of increasing their credit exposure to these names. The shutdown in the capital markets was so serious for Household International that it made sense to sell themselves to HSBC. With unemployment at 5.7% and potentially rising to 7%, companies like Capital One and MBNA could start to be affected. What is prime and what is subprime is a function of the unemployment rate. Capital One is trading at 1.5 times book value and MBNA is at 2.2 times book value, so there is substantial room to fall further despite the already large declines.

Q: *Any other financials?*
A: There are companies that are extremely well-run, but investors have bid them up to levels that leave them very exposed. **Wells Fargo** has been a real darling of investors. These days, I'm more inclined to focus on price-to-book value. At the top of the cycle you look at price-to-earnings. In an imperfect world one must pick one imperfect measure over another imperfect measure. For a while people claimed book value was completely impaired because of all the write-offs and goodwill charges. Well, they discovered last year that earnings are completely impaired, too, because of the pension costs and option expenses and outright fraud. Wells Fargo is trading at 2.6 times book value. About 75% of Wells Fargo's business is consumer-based. It is hyper-exposed to the consumer by design, and that was the correct strategy during the past two to three years, hence the premium valuation and performance. But do you really want to stay with this bet?

Q: *Where else does your top-down approach lead you?*
A: There is a lot of confusion about homebuilders. The bulls point to P/E ratios in the mid-to-high single digits. They're cheap on a price-to-book basis. But it's instructive to look back at the 1990 recession, when the peak-to-trough decline in housing starts, which is a good gauge of volume for these companies, was more than 50%. If you assume a housing downturn comparable to 1990, these companies will have very substantial declines in their revenues, and that means, given their relatively low margins, negative earnings. The sector is extremely vulnerable. How far can this go? Well, in 1990 at the trough, they were trading at 50% of book value.

Q: *Do you short a basket of them or selected companies?*
A: A basket. They trade so tightly together and have historically traded so tightly together, I'm not sure there is much value in doing work on each individual company, though we have done that.

Q: *Is that it on the homefront?*
A: It was shocking to me that after the biggest refinancing boom in history, **Home Depot**, the premium home-improvement retailer, weeks later announces comparable-store sales figures in the negative double-digits. This is partly due to competition with Lowe's, but it is partly a reflection of consumers saving more. We are searching for companies that have premium valuations and weak comps. Home Depot is trading at 14 times earnings, even though it's been quite beaten up. **Lowe's** is trading at 20 times expected '02 earnings, and comps there are decelerating. Lowe's posted 7% comps in the first half of 2002 and now they are at 4%. If this was the last of the big refinancing booms, the probable outlook

is simply not very positive for housing-related retailers.

A company that falls in the same related category is **Williams-Sonoma**, a high-end retailer focused on housewares. The company is trading at 24 times 2002 earnings and their same-store comps are decelerating from the 6% level reached in the summer of 2002 to almost zero currently. An added negative is that the CEO who engineered a major turnaround there left a few weeks ago.

Q: *What else?*
A: We think Wal-Mart is extremely vulnerable. The numbers at **Wal-Mart** are pretty unattractive. Wal-Mart is at 27 times 2002 earnings just reported. Wal-Mart had comp sales in the first half of 2002 that were in double-digits and now they are at 2%. Earnings held up reasonably well, but that is pretty normal, especially in a company the size of Wal-Mart that can initially offset the slower revenues with cost cutting. But if the consumer starts to weaken, that game doesn't work.

Another retailer, Kohl's, is trading at 29 times earnings. **Kohl's** comps were running at furious levels in 2002, then decelerated very sharply and are now at the 5% levels. Kohl's is entering California, one of the most competitive markets for their kind of department stores. At 29 times earnings, you have a real chance of a problem.

Q: *Thanks, Raj.*

E-mail comments to editors@barrons.com[2]

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