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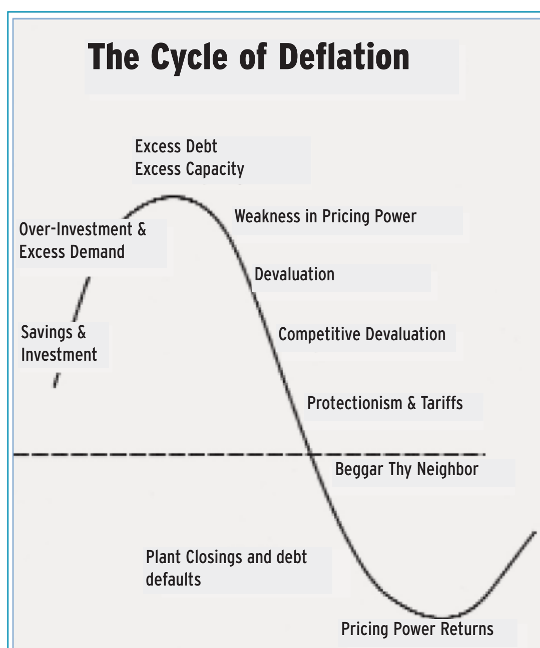
listeningin

'08 Fund Champs

Comstock Partners Long-Standing Bearish Bets Paid Off Big Last Year

That last year was murder on portfolio managers (and their clients) is not news. But that a mutual fund, albeit one long run more like a hedge fund and only $70 million in size, managed to navigate its way through 2008 and end UP just shy of 55% is news. News that the Wall Street Journal*'s quarterly mutual fund extravaganza last Monday for some curious reason chose to bury in its acres of tables — while crowning a fund that ended '08 barely flat the year's sole "winner." Well, I beg to differ, and so do* ***Charles Minter*** *and* ***Martin Weiner****, who together run* ***Gamco's Comstock Capital Value Fund*** *and whose stellar 2008 performance was all-but-ignored by the business paper of record. Long-time bears known for their close attention to the fundamentals of macro-economics and valuation, as well as for their pungent and perspicacious website commentaries, the pair scored big with aggressive short positions in puts, stocks and futures last year. The New Year dawns with Charlie and Marty expecting more of the same, but in a considerably less one-way market environment — and still waiting for multiples low enough to be transformative — and to turn them into bulls.* ***KMW***



I have to ask, guys. Have you complained to the *Wall Street Journal* about essentially leaving you out of their coverage of the best-performing mutual funds for the fourth quarter and all of 2008?

Charlie: It *was* disconcerting to see their *"One Fund in 1,700 Made Money in '08"* story identifying that lone profitable fund as one up all of 0.4% for the year, when we were up better than 50%. As best as I have been able to ascertain, since they *did* include Comstock Capital Value in their lists of biggest winners in the quarter and year, is that either their reporters don't see those rankings or the editors can't figure out how to pigeon-hole us except as a "bear fund" — and didn't want to write about anything so unseemly.

Funny, I see that as the story. You guys were — very publicly — bearish on housing and the financial sectors long before almost anyone had heard of subprime slime — much less of Ponzi schemes for the country club and private jet sets. And you finally profited dramatically from your foresight last year. Yet the kudos are going elsewhere. You're clearly not sufficiently focused on P.R.

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Comstock Partners
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Marty: We have better uses for our time.
Charlie: Isn't it amazing that guy Madoff got away with it for so long? I find it just unbelievable, incredible. But that's only a sideshow. Here at Comstock, we're certainly pleased that our average annual return came in at a positive 54.25% for the difficult year that was 2008, and that it's now 13% (annualized) over the past three years. I do want to stress, though, that we don't consider ourselves "a bear fund" because at any time we could change strategies and become bullish or even very bullish. But right now we are still very bearish and I guess everyone will continue to view us that way until we adopt a bullish stance.
Marty: We concede that we have been bearish for a long time–but if you look at it the way we have, the financial mania of the late 1990s was insane. Then the bear market of 2000 - 2002 was never allowed to finish its business because the Fed pumped up another bubble in housing and stopped the recession before a normal cleansing could take place. We just couldn't turn bullish as debt was exploding throughout the cyclical bull market of 2003-'07. We always felt that the enormous Debt/GDP ratio would eventually bring the financial system down.

Then it *was* a case of your long-standing bearish bets finally paying off big last year, was it not?
Charlie: That is correct. We were 100% or more net short through most of the year. And though we eased back from that aggressive position in early December, we don't think the bear market is over yet.

So you did get out of the way of the rally off of the November bottom?
Charlie: That's right, pretty much because Marty and I had a gut feeling about valuations, a topic we've written extensively on, over the years. Being bearish for so long has been very difficult for us, as you know, and we were determined to preserve our very good performance through yearend.

Your bearish stance did cost you dearly during the internet bubble and again when you refused to jump back into stocks in 2002-'03.
Charlie: It didn't *seem* like many of the things that we were saying were *incorrect* in the late '90s, when we got bearish. But we were clearly early and then just lost so many assets as the internet bubble got bigger and bigger for the next two years. Then we had three good years – well, 2000 was okay, at a plus 9% annual total return, but 2001 and 2002 were great at over 21% and over 35%, respectively. Then our luck turned again. We stayed strategically bearish through 2003, 2004, 2005 and 2006. We just didn't believe that one of the shortest and shallowest recessions in history – or that stock market valuations that, on the broad indexes, only came down to levels that were still higher than they'd been at every earlier stock market peak in history – were enough to correct for what had been the biggest stock market mania of all time. So we suffered through an even longer stretch of being out of sync with the market. Those were just horrendous years for bears like us who *thought* that they understood what was going on. We had to question our sanity many times.

"Those were just horrendous years for bears like us who *thought* that they understood what was going on. We had to question our sanity many times."

Small wonder, considering that your fund reported *negative* annual total returns of 30%, 13%, 11% and nearly 8% over that span. Granted, the charts now say that those years saw the mother of all secular bear market rallies, but I imagine you rather wish it hadn't wrong-footed you so.
Charlie: Sure. Losing money isn't the idea – and it's never fun. But we had to do what we believed was right, and we never thought that we were seeing anything more than a very strong counter-trend rally in the secular bear market that *had* to follow the truly unbelievable financial mania of the late '90s.

The markets *did* get pretty grim in 2001

and 2002, as I recall.

Marty: They did. By the fall of 2002, the S&P had declined from about 1525 to just under 800, or about 50%, while the NASDAQ had plunged roughly 80%, from about 5000 to 1100. The Dow Jones Industrials had fallen from 11,900 to about 7200 or about 40%. *Under normal circumstances*, that would have been enough damage to believe that the bear market had corrected the excesses of the late 1990s and that we should be off and running with a new bull market.

But? What wasn't normal?

Marty: There were three things wrong with that picture. First, the market trough of 775 for the S&P 500 was still at 26 times earnings (or higher than at every market peak in stock market history until the bubble of the late 1990s). We would have expected the market to trade closer to 10 times earnings or less, since that is where most market troughs traded, historically. Since then, the P/E on the S&P has declined to around 21 times estimates of 2009's *reported* earnings, which is still typical at market peaks, not troughs.

Wait a minute. Turn on bubblevision and you'll hear all sorts of claims that stocks are cheaper today than in years, with the P/E on the S&P closer to 11.

Charlie: That's based on estimates of *operating* earnings. Don't get me started on the folly of using analysts' earnings estimates as the basis for anything. We have actually been tracking their incredible shrinking act for the last year. [See table, page 4.] It would be bad enough if the estimates were merely bullishly biased lagging indicators, but the way estimates are abused on Wall Street just makes us crazy. We've been railing about it for years, to whomever will listen. It simply astounds us that almost nobody but us seems to object to the fashion that took hold on Wall Street about a decade ago of basing valuations on *operating* earnings – which are profits before writeoffs – instead of using reported GAAP earnings, which after all *are* the product of "generally accepted accounting practices."

Marty: Sad, but true. Let's get off that tangent though, before we lose sight of our main point – why we never believed the market bottomed in 2002. Our second reason was that the debt build up during the late 1990s was never liquidated as you would have expected in a recession. Instead, as Charlie mentioned, we experienced one of the mildest recessions in history with minimal impact on the public and no debt liquidation at all.

Third, the bear market of early 2000 to October 2002 never produced the public capitulation that we expected and talked about on our website [www.comstockfunds.com] all through 2002. The liquidation of equity mutual funds in that bear cycle amounted to less than 1% of total equity mutual fund assets – and that was after the largest inflow of money into those same equity mutual funds in the first two quarters of 2000, which coincided with the peak in the market.

Charlie: We were expecting something more typical, like the 8% and 14% liquidations in the market breaks of 1987 and 1973-'74, respectively. It was hard to believe the stock market was on its way to starting a new bull trend after just that relatively minor public capitulation fol-

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lowing the greatest financial mania of all time.

Still, in retrospect it's quite clear that the markets were in no mood to wait around back then for your conditions to be met. What did your analysis miss in 2002?

Charlie: The Fed.

Marty: And the massive real estate bubble

The Big Shrink

Tracking Analysts' Reluctantly Evolving Gloom On Earnings, However Counted

2008 *Operating* EPS Estimates		2009 *Operating* EPS Estimates	
1/08	$97.99	1/08	$N/A
5/08	92.30	5/08	112.16
7/08	89.07	6/08	108.98
8/08	83.55	8/08	108.80
8/25/08	80.08	8/25/08	108.06
9/17/08	78.81	9/17/08	106.49
9/25/08	77.60	9/25/08	104.15
10/13/08	76.73	10/13/08	103.35
10/22/08	75.94	10/22/08	101.90
11/3/08	72.53	11/3/08	94.25
11/10/08	72.77	11/10/08	93.48
11/13/08	69.17	11/13/08	91.85
11/19/08	68.88	11/19/08	89.83
11/28/08	68.21	11/28/08	86.24
12/8/08	67.56	12/8/08	85.56
12/15/08	66.98	12/15/08	83.85
12/22/08	66.21	12/22/08	83.44
1/5/09	65.79	1/5/09	81.80

2008 *Reported* EPS Estimates		2009 *Reported* EPS Estimates	
1/08	$67.90	1/08	$N/A
3/08	63.30	3/08	72.60
5/08	68.93	5/08	68.70
6/08	72.56	6/08	70.13
8/08	72.01	8/08	67.66
8/25/08	63.01	8/25/08	64.66
9/17/08	59.53	9/17/08	58.87
10/13/08	54.80	10/13/08	48.52
10/22/08	54.51	10/22/08	48.52
11/3/08	54.51	11/3/08	48.52
11/10/08	53.70	11/10/08	48.52
11/13/08	48.91	11/13/08	49.15
11/19/08	49.08	11/19/08	49.15
11/28/08	49.04	11/28/08	49.15
12/8/09	48.94	12/8/08	49.15
12/15/08	48.05	12/15/08	42.24
12/22/08	48.05	12/22/08	42.24
1/5/09	48.05	1/5/09	42.24

Comstock's Trend Line Earnings Estimates

2008	2009
$66	$70

everybody now realizes, too late, that Greenspan's incredible series of 14 rate cuts, from 6% to 1%, created. Those cuts - and Greenspan's decision to hold rates at 1% far longer than conditions warranted – not only spurred the stock market to roughly double, but also propelled the prices of homes in many parts of the country to double or more over the next couple of years. But the most astounding thing, to us, was that both the stock and real estate markets started their runs in 2002 from levels that previously had been considered extremely expensive – and *characteristic of tops*, not bottoms.

But had no one ever told you, "Don't fight the Fed?"

Charlie: Oh, we fully appreciated, when the Fed dropped rates to 1% and held them there for a year, that it was *trying* to start new bull markets in stocks and real estate. But we found it hard to believe it would succeed for long when *both* markets were starting from such historically elevated valuation levels. We've already mentioned the overvaluation of stocks. Well, houses were also already overpriced in '02-'03. Measured by what were, up to that point, the most widely accepted metrics – price to rents and price to wages – houses were *already* changing hands at the highest levels in history. We were so convinced of this that – after Greenspan actually encouraged new home buyers to take on risky adjustable rate and teaser rate mortgages – we published a special report in September of 2003, called *"Real Estate—The Catalyst for the Deflationary Bear Market."* As I said, we always felt that the runaway growth of credit would eventually bring down the financial system.

Marty: We just never imagined it would take another two years for housing to peak, and another four for the stock market to turn back down.

It couldn't have been very comfortable being prophets of doom.

Charlie: It had its moments. But we certainly couldn't deny what we were. We had been hammering away on the debt problem – well, for a couple of decades. I don't even know how often we tried to explain to people that it was taking increasingly more dollars of debt to generate $1 of GDP –

Marty: Frequently.

Charlie: The point is that it took $1.50 of debt to generate $1 of GDP during the 1960s and 1970s, and then it averaged $2.50 to gen-

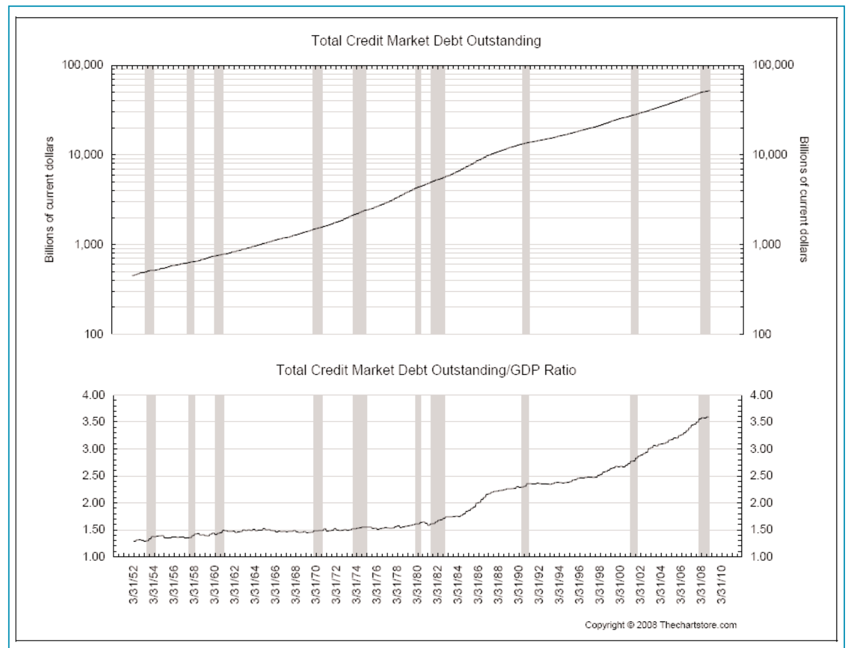
erate $1 of GDP from 1982 to 1997. Starting in 1997 the debt really took off and this economy wound up needing to add a little more than $3.50 in debt to generate just $1 of GDP in 2008. We even asked your friend and ours, **Ron Griess** of **TheChartstore.com** to create a chart [opposite] for our website, to illustrate the relationship. Most investors thought the debt/GDP ratio could continue rising indefinitely without ever overwhelming the economy and corporate earnings. And after a while, I have to admit, even we started wondering if this could also go on forever.

Why couldn't it?

Charlie: Because over the long-term there are onerous restrictions on the growth of debt tied to the inexorable fact that it costs money to service it (to pay interest). The trouble is, this limit to debt only becomes obvious as the weaker links in the system can no longer borrow. Then, as the credit crisis grows, it spills over to the better risk borrowers. This is when either voluntary or involuntary deleveraging takes place. Did you notice that the U.S. had only six AAA-rated companies as of September 2008? Deleveraging is now the rule of the day and most everyone is realizing, now that it's too late, that debt couldn't grow to the sky without triggering the awful mess we now find ourselves in. Over 90% of total credit market debt outstanding has been created since 1980, 75% of the total was created after 1990, and over 61% since 1997. We expect that the *only* debt sector that will grow in the near future will be the government sector, due to all the stimulus packages and bailouts. Not to mention what will happen if the government makes good on the promises that have been made on Social Security, Medicare and Medicaid without finding new revenues somewhere.

Let's leave that can of worms for another time. What got you to focus on the credit bubble?

Charlie: Way back in the early 1980s, my original partners in Comstock, the late **Stan Salvigsen** and **Mike Aronstein,** and I got concerned when we saw the U.S. savings rate peak at over 10% and then just keep going down. It finally troughed in negative numbers a few months back and has upticked slightly, but plenty of damage has been done already. This country was built upon our savings being used to make productive investments to grow the economy at a sustainable rate. We were trying to substitute the accumulation of debt for savings and productive investment, but it seemed



clear to us that it couldn't continue, especially since we became increasingly dependent upon foreign sources to finance that debt.

Marty: It was actually the **Reagan Administration** that kickstarted our massive debt buildup, by borrowing and spending enormous amounts on the U.S. military build-up during the Cold War. Reagan, of course, was intent on bolstering our superpower status and, in the process, effectively bankrupted the Soviet Union. We aren't trying to pass judgment on those policies, merely pointing out they started the secular cycle of lower savings and increased debt.

Charlie: But we do believe that President Reagan made a mistake in replacing **Paul Volcker** as Chairman of the Fed with **Alan Greenspan**. Then, of course, during the 1990s and the first six years of the new millennium, the debt problem just kept growing. The Democrats, with the Republicans' blessing, did everything possible to get every American into a home – whether they could afford it or not. They shunned regulation and put pressure on **Fannie Mae** and **Freddie Mac** to promote "affordable housing." Meanwhile the independent mortgage companies such as **Countrywide** caught the disease (or saw the opportunity) of making loans to anyone who could sign their name on the mortgage applications.

And Wall Street was only too happy to facilitate all the securitizations and derivatives that greased the wheels. There's loads of blame to spread around.

Marty: The big investment banks poured gasoline on the debt bubble after convincing the

Perspicacious Views

Early last year, a client wrote to Comstock Partners' Charlie Minter and Marty Weiner, "in reading and listening to the financial news over the last few months, I had the feeling that I had read all of this before. Then I remembered where. I had read it all on your site long before it all hit the headlines." Here's a sampling of what he was referring to.

September 22, 2003–

One of the amazing aspects of the massive refinancing of homes, which is effectively piling on consumer debt at record levels, is the fact that this is being done with the blessings of our esteemed Federal Reserve Chairman, Alan Greenspan. In various testimonies he has stated that borrowing the equity in consumers' homes is helping the economy and he supports it. Imagine the head of the Central Bank of the world's largest economy becoming a cheerleader for individuals to continue borrowing on the equity of their homes while they have already incurred a record amount of debt and the homeowners' equity is falling to record lows. Could the Fed Chairman actually think it is appropriate to use ones' home as an ATM cash machine? Real estate bubbles bursting are different than stock markets bubbles bursting because bubbles in the stock market only affect the owners of stock and maybe a few brokerage firms that don't adhere to strict margin requirements. A collapse in real estate, not only affects the borrower, but it also the lender. Over the past few years poor macro economic fundamentals have diminished the demand for commercial and industrial loans, causing commercial banks to seek other avenues of profit. In particular, the banking sector has increased its exposure to consumer, residential mortgage and commercial real estate (CRE) loans. The irony of banks currently fighting "tooth and nail" over generating loans to real estate is amazing since the spread between home prices and incomes are the widest ever, and the spread between the cost of owning a home to the cost of renting a home is the largest ever. The price versus rent in real estate is similar to the price-earnings ratio of common stocks and presently in RE this ratio is the highest level in history. This is where we were with stock market P/Es at the beginning of the century...

In summary, we believe that real estate will be the main catalyst for the deflationary environment we expect is inevitable. This is the result of the tremendous demand for RE since the mid 1990s driving valuations through the roof. The prime driver of the appreciation was the liberal lending policies of banks and mortgage institutions. The combination of the lax lending and the demand from homeowners to continue to borrow against the equity in their homes, have placed RE in a vulnerable position. The rising prices have moderated substantially, while until just recently the borrowing and lending continued at record levels. This dropped homeowners' equity to record lows. Since every valuation ratio of real estate is presently at record highs, if the slowdown in appreciation turns into an actual decline in values, the present economic recovery and stock market recovery could reverse and be potentially devastating to the financial environment.

Continued on Page 9

SEC to let them increase their maximum leverage from 12-to-1 to up to 40-to-1. They then poured that liquidity into all the CDS's and CDO's and the rest of their toxic derivative creations. But don't forget the enormous contributions of the outgoing **Bush Administration**, either, in lowering taxes (mostly for the wealthy) just before entering a very costly war. I've seen estimates from some respected economists that the cost of the Iraq War could reach $2-3 trillion, when the cost of continuing health care for the returning servicemen is included – and they sure deserve it.

Charlie: About the best you could say is that everyone was oblivious to how the ideology of affordable housing and structured finance would combine to inflate the debt-to-GDP ratio, and eventually to bring down much of Wall Street amid the worst bear market and economic downturn since the Great Depression.

"Oblivious" is awfully generous. You weren't entirely alone in seeing trouble brewing, you know.

Charlie: You're right, a number of other voices did emerge, especially after Greenspan let rates decline to 1% and then held them there for a whole year, while encouraging things like ARMs mortgage securitizations and derivatives. He really provided the accelerant that created the housing bubble, driving home prices from the prior peak of just under 3 times household median income to 5 times.

Marty: That multiple is only back down to 3.6 times, so there's about another 25% drop in housing prices yet to come, if you assume the multiple will decline to around 2.7 times, which has been the norm going back to 1965.

More great news. But since when does anything correct just to the norm?

Marty: Good point.

None of this sounds like stuff that will get the poor consumer spending again –

Marty: No, but consumers, too, share the blame for this fix. They contributed mightily to the credit bubble by going on a credit card binge over the last decade, and especially by using their plastic to buy imports from China, Japan and elsewhere. In fact, our external debt almost doubled from $7 trillion in 2003 to just under $13 trillion! We had better hope, as such a large creditor, that our trading partners don't give up on us.

Okay, what do you see happening now?

Charlie: Now that it has started, the panic to pay off debt and deleverage as much as possible, we believe, is sparking a global cycle of deflation [See illustration, page 1]that will dominate 2009. The governmental response – bailouts and easy money – will be global in nature and will probably someday cause a massive inflation. It's too soon to worry very much about that but we are monitoring many indicators to determine when to invest more heavily in inflation hedges, and do already have a small position in inflation hedges. More immediately, we're concerned that deflation will make 2009 very painful for world economies and world equity markets.

You're not anxious to jump over to the bull side, even though the recession is now officially a year old and the S&P was down almost 50% from its October '07 peak to its low last November?

Charlie: No, even though we really do have a whole lot of respect for sharp strategists like Steve Leuthold, who believe that the odds are that this bear is over. We just don't. We still think that we're in a secular, not cyclical, bear market that is not going to end until we get this capitulation from the pub-

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lic and until we get down below a 10 P/E on our trendline earnings.

You made your skepticism about earnings estimates quite plain earlier. But we cut short our discussion before I could ask about your trendline earnings in that big table of yours [page 4].

Charlie: It's pretty simple. We feel that the best way to make sense of earnings is with a measure that smoothes out present earnings and future earnings over long periods. There's tons of history and research that shows that earnings can only grow at approximately 6% a year over the long term, because the trend is limited to the growth in real GDP plus inflation. And long term, real GDP cannot grow faster than the increase in the labor force plus the increase in productivity. To see this, just look at a long-term chart of earnings and draw a 6% growth line through it. Earnings will sometimes rise above the line and sometimes fall below it, but they will always revert to the 6% mean. So to come up with our trendline earnings estimates we essentially just take the last nine years of reported earnings, take the average of those, and then start our trendline four and a half years back, and draw it forward at 6%. Anyway, our trend line earnings estimates on the S&P are $66 in '08 and $70 in '09.

And they're a better basis for valuations than any of analysts' estimates, you said, because you don't stoop to using operating earnings —

Charlie: It just doesn't make any sense to us whatsoever why virtually all of Wall Street uses operating earnings, which only came into existence in the late '80's or early '90's when the trend of annually recurring "non-recurring" write-offs got so great that everyone started looking for ways to exclude them.

Sure it does, they paint a more flattering picture of earnings.

Charlie: Well exactly. But it's not only that. The S&P estimates are always being revised. That table lists all the changes in S&P's earnings estimates for the index just since we started recording them at the beginning of last year. In January or '08, they were essentially $98, on an operating basis, $97.99. Now they are $65.79. On a reported earnings basis, they started at $67.90 and are now down to $48.05. The '09 estimates have also been ratcheted down.

So the estimates everybody uses for valuation purposes are lagging indicators, and bullishly biased. That's not exactly news.

Charlie: Except that what happens at times like these – it happened, too, in 2000-2002 – is that when the analysts finally get scared and bearish, their estimates get ratcheted down really fast; basically sliced in half in a matter of months. My point is that's why, for valuation purposes, we prefer to use our trendline estimates. We don't want to put a trough P/E on the S&P's trough earnings estimates because we know how fast they get ratcheted down.

Market Timing Clues

Stock Mkt Low	Economic Cycle Low	Market's Lead Time Months	Smoothed Reported GAAP P/E Ratio
Jun-49	Oct-49	-4	6.3
Sep-53	May-54	-8	8
Oct-57	May-58	-7	12.3
Oct-60	Feb-61	-4	15.4
May-70	Nov-70	-6	11
Dec-74	Mar-75	-3	7.4
Mar-80	Jul-80	-4	7
Aug-82	Nov-82	-3	7.1
Oct-90	Mar-91	-5	14.1
Oct-02	Nov-01	11	15.5
Average		-4.9	10.4
Median		-4	9.5

In other words, putting your market bottoming 10 P/E on the S&P's latest estimate of '09 reported earnings, which is $42.24, would result in way too pessimistic a target?

Charlie: Let's hope so. That would be saying we had to wait for the S&P to hit 420 before turning neutral to bullish, and it doesn't work that way. Ten times our trendline estimate for this year, which is $70, produces a somewhat more palatable target. That would be 700 on the S&P on this year's earnings, or 660 on 2008's. But the fact is that we're coming off a period in which companies reported record profit margins and earnings. And, going back to 1950, every period in which actual earnings rose above trendline earnings has been followed by one in which actual earnings fell well below trendline earnings. What Marty and I believe is that we're entering another such period of below trendline earnings. And so as long as the market continues to trade at an elevated multiple of trendline earnings, it will be difficult to make money in the market.

Marty: We're not only looking at P/Es, but also at the timing involved. Our work shows that the stock market has generally bottomed, on average, about five months before the end of a recession and at a median P/E of around 10, but with some telling variability. I've put some useful indicators in a table [nearby] that

shows the dates of all post-World War II market lows that were accompanied by recessions. The second column marks the date of the associated economic cycle low as determined by the National Bureau of Economic Research. The third column indicates the number of months by which the market low preceded (or, in one case followed) the economic low. The fourth column shows the price-earnings ratio on smoothed reported S&P 500 earnings at the market lows. While the range of trough P/Es shown on the chart seems at first glance to be pretty wide, at 6.3-15.5, a closer look at the data hints at whether this market will eventually bottom in single or double digits.

How so?

Marty: Consider that table in the context of market history. Specifically that a secular bear market ended in 1949 and that the subsequent secular bull market lasted until 1966. The market then remained in a secular bear market through 1982, followed by a bull market until 2000, when the current secular bear market started. Since secular bear markets comprise periods where P/E ratios are declining, while secular bull markets are periods where P/Es are expanding, it is logical to assume that cyclical P/E ratios are low at the end of secular bear markets and in the first few years of bull markets. In contrast, cyclical P/E ratios are high in the last few years of bull markets and at the beginning of bear markets. It is not a stretch to say that this is exactly what the data in our table shows.

And that tells you?

Marty: I'd also point out that at 5 of the 10 data points in the table, the P/E bottomed at 8 or less, and that sort of multiple would entail a big decline, even from this point. What's more, those very low multiples occurred either during secular bear markets such as the one we are in now or early in secular bull markets when investors did not yet recognize the new uptrend. It also noteworthy that in 24 of the 38 years preceding 1987, the market sold at a multiple lower than the current P/E at some point during the year.

It sounds like you're reaching for reasons to stay bearish.

Charlie: Not really. In fact, for the first time in many years there has been some change in the way we are thinking about the stock market. We *are* in the 8th year of a secular bear market and the market has plunged since its October 2007 peak. When it recently closed at 873, the S&P 500 was selling at 13.2 times 2008 trendline reported earnings, the lowest P/E ratio since 1987, and below the long-term average of about 15. Then too, the average low trendline P/E ratio in bear markets associated with economic recessions is 10.4, not far below the 11.2 reached at the 741 S&P low on November 21. Therefore it is possible–though not probable – that the bear market low actually was made on that date.

Yet you're not rushing to get bullish?

Marty: That's right. There are two major reasons we think the market can bottom at significantly lower levels well into 2009. First, in 5 of the last 10 bear markets connected with recessions, the P/E ratio bottomed at 8 or under. That is a strong possibility this time as a result of the severe nature of the current global credit crisis and recession–and the likelihood that this is a secular bear market. A P/E ratio of 8 on next year's trendline S&P 500 earnings of $70 would bring the index down to the vicinity of 560. Second, stocks have tended to bottom about 5 months *before* the economy, as I noted, and we would be surprised if the economy bottomed 5 months from now. Therefore, if the economic bottom is pushed out beyond the 2nd quarter of 2009, the market probably won't trough until well into the year.

You said at the outset of our talk though, that you did get a bit less bearish in December?

Charlie: Mostly, we just had a feeling that things were going to get very difficult for the bears. However, the market has now gotten somewhat undervalued for the first time in many years. The thing is, we still think the credit crisis is ongoing and that the economy is contracting at an alarming rate. So the market is subject to a tug of war between a more reasonable valuation on the one hand and the prospect of a long and deep recession on the other. Further complicating matters here is that if the market bottom eventually occurs well into 2009 as we expect, a bear market rally is a strong possibility between now and then. The upshot is that while we expect that the market lows are still ahead of us, the road to the bottom is likely to be choppy and highly volatile, ending finally in a massive capitulation on the downside.

Marty: In other words, there's a good chance that managing a portfolio this year will be even tougher than last.

And you're not as aggressively positioned, either?

Charlie: Well, we started out at 122% net short at the beginning of 2008, with index puts and short futures and equity shorts, and remained over 100% net short into late fall, before lightening up to the point where we were just 13% net short before the holidays, but we're now back to a net short position probably three times that size because we have been concentrating lately more on our belief that the market will decline substantially this year. However, we do worry that there seem to be more investors worried about missing the next bull market than are worried about losing more money. This could possibly drive the market up another 100 to even 200 points on the S&P 500. But if that were to happen, we'd most likely just continue to add to our short position since, it would look like a selling opportunity to us. As I said, we have already built our net short position backup fairly significantly, and if the market does continue rising, we'd expect to add further to our put position as we approach resistance areas. With that said, we really are more focused on the likelihood of the market declining further.

Marty: We still think the market multiple could go down as low as 7, but at least to somewhere between 10 and 7, when this secular bear bottoms. And make no mistake about it, we'd love it to get there – because we'd love to be able to get a lot more positive before we end our careers.

Wouldn't we all. Thanks Marty and Charlie.

Perspicacious Views*...continued*

June 23, 2005–

In our view a housing bubble with national implications definitely exists, and the risks to the economy are enormous. The Fed and other depositories are acutely aware of the situation leaving them with the dilemma of what to do about it. If they tighten enough to really halt the rapid rise in home prices the economy could very well go into a nosedive, a particularly scary situation, considering that all the debt still remains on the books. On the other hand if they do little or nothing, the boom could get even further out of hand, making the eventual economic and financial unraveling even worse. So far the Fed is raising the fed funds rate at the so-called "measured pace", and, along with other agencies, recently started a policy of moral suasion. If this doesn't work the question is whether the Fed will follow through with more actual tightening. If Paul Volcker was still heading the Fed we would know the answer, but given Greenspan's consistent reluctance to pull away the "punchbowl" we just don't know. Either way the outcome is likely to be extremely unpleasant for the economy and for stocks.

August 25, 2005–

Since 1999, when the financial bubble was in full bloom (due in large part to the Fed), we have been saying that the central bank faced a dilemma with limited choices–none of them good. They could either kill the bubble, let the economy and markets take the hit and come out of it ready to resume healthy growth–or they could keep extending the bubble for a while longer with far worse consequences down the road. The Fed, under Greenspan, chose the latter course, resulting in a dangerous housing bubble following the financial bubble of the late 1990s. This is evident in the fragile unbalanced recovery, the massive trade deficit, low consumer savings rate and record household debt. The standard measures of the economy indicate to many that Greenspan has won his bet, and the Jackson Hole symposium will probably be full of praise for his long tenure. We hope that they are right, but we believe that the final word on Greenspan's reign as Fed Chairman is not yet written, and history may not view him kindly.

October 27, 2005–

It is indeed ironic that Ben Bernanke, upon his appointment as the next Fed chief, found it necessary to promise a continuation of the Greenspan policies that are likely to cause him a great deal of grief during his coming tenure. While Wall Street is narrowly focusing on Bernanke's qualifications for the job and whether he is an inflation hawk or dove, the important point is that the new Chairman will be inheriting a mess that is probably beyond the capacity of any Fed chairman to solve without a damaging recession and financial crisis. It seems that after 18 years of cheerleading, the Chairman, in his last months in office, is now acknowledging the potential negative consequences of his policies. He leaves, however, with the knowledge that cleaning up the mess will fall to his hapless successor, and not to him. Whether Bernanke, despite his acknowledged brilliance, knows what's awaiting him is not known, but he will find out soon enough.

December 22, 2005 –

There is no longer any doubt that the housing market has started to slow down. The NAHB Housing Market Index, covering more than 400 home builders, is down significantly. The University of Michigan Survey indicates that the percentage of people saying this is a good time to buy a house has plunged to 57 from 75 in just a few months. The Housing Affordability Composite Index has fallen sharply to its lowest level in 15 years. Traffic this month has undergone its largest decline since 9/11. The NAHB indicated that about 75% of the builders it surveyed saw buyer resistance to current home prices, and that a lot of them were offering concessions to help move inventories of unsold houses. Although the latest monthly report on housing starts was still strong, the units being built may partly be a result of previous orders, with the remainder going into already burgeoning inventory.

In our view the situation is likely to get worse. The Fed recently offered a proposal for more restrictive lending standards and requested comment from banks. The Fed and other national bank regulators are concerned that interest-only and other types of non-traditional mortgages pose risks to the financial system, and are proposing that the banks tighten lending standards. In a joint statement they said that, "The agencies are concerned that these practices can present unique risks that institutions must appropriately manage...They are also concerned these products and practices are being offered to a wider spectrum of borrowers." The new lending guidelines are likely to become effective early next year, and will result in a reduction in the number of new mortgages being issued. In addition the housing market will be adversely affected by Fed tightening and the high level of energy prices.

A slowdown or actual decline in housing prices will have dire effects on the economy. In the absence of vigorous increases in wage and salary income during the current economic expansion, consumers have used the soaring values of houses to maintain their rate of spending and drastically lower their savings rate. The values have been turned into cash through home turnover, mortgage refinancing cash-outs, and home equity loans. A recent Federal Reserve staff study--significantly co-authored by Greenspan himself–estimated that "discretionary extraction of home equity accounts for about four-fifths of the rise in home equity mortgage debt". They further estimated that about 1/4 to 1/3 of the so-called mortgage equity withdrawals (MEW) directly financed personal consumption expenditures. Other estimates run as high as 50 or 60%.

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Perspicacious Views*...continued*

The Greenspan study went on to say that if mortgage rates rise and loan affordability drops further, MEW would decline and the subsequent fall in consumer spending would lead to a drop in consumer goods imports as well as the intermediate goods associated with them. He estimated that MEW was about $600 billion in 2004, an amount equal to 7% of GDP, and that the accumulative MEW accounted for the entire decline in the household savings rate since 1995.

It is therefore easy to see that a drop in home prices would have highly negative consequences for the global economy as well. For the last few years the global economy has been held together by a delicate balance in which soaring U.S. home prices supported domestic consumer spending that pulled in imports from abroad resulting in rapidly rising trade deficits for the U.S. and big trade surpluses for the rest of the world, particularly China and Japan. As is by now well known, most of the huge store of dollars accumulated by the nations running the surplus has been constantly recycled into the U.S. largely through the purchase of Treasury securities, resulting in the so-called "conundrum" of unexpectedly low long-term rates. These relatively low long rates were reflected in the low mortgage rates that goosed housing prices and allowed for the positive feedback loop in which both the U.S. and its trade partners benefited.

The real issue that separates the bulls from the bears at this point is this—how long can the positive feedback loop last? The bulls feel that this relationship is so advantageous to both sides that no one will want to see it end, and that the world, therefore, has found a new economic balance that will go on indefinitely. We disagree. The housing boom is clearly ending, and this is the glue that holds the balance together. Without continually rising U.S. home prices consumer spending declines, the savings rate climbs, U.S. imports drop, foreign economies soften and what was a positive feedback loop suddenly reverses and becomes a negative loop. In other words, without the U.S. housing market to support it, the fragile balance holding the global economy together unravels with disappointing results for the economy, corporate earnings and the stock market. Judging from the tone of his research study, speeches and testimony, Greenspan seems to understand the gravity of the problem, but, in the end, always concludes that the imbalances can be resolved gradually over time. In any event, in another month it will no longer be his problem, and poor Bernanke will be around to absorb the blame. In the meantime we believe that the risks to the stock market are far higher than the complacent majority recognizes.

February 2, 2006—

Don't be lulled into a false sense of security by the near unanimous gushing over Greenspan's legacy. In our view the Chairman's legacy is still open to question, and upcoming economic and market developments are likely to result in a much harsher assessment of his lengthy tenure—unless, of course, future historians blame his hapless successor instead.

March 2, 2006—

In our view the derivatives mess described above is another potential time bomb (among many) that could throw the financial markets into a severe crisis. In the last 30 years every period of monetary tightening has eventually led to financial crisis. These included the Penn Central bankruptcy in 1970; the Franklin National Bank failure in 1974; the First Pennsylvania Bank failure in 1982; the Continental Illinois Bank failure in 1984; the savings & loan crisis in 1990, the Mexican Peso crisis in 1994; the Asian, LTCM and Russian crises in 1998; and the bursting of the Nasdaq bubble in 2000. The derivatives market is a leading candidate to trigger the crisis on this cycle, although there are obviously many other candidates as well.

August 31, 2006—

Although the conventional wisdom has only recently caught onto the fact that the housing boom is over, a spate of recent company announcements indicate that the problems are rapidly spreading to the companies involved in mortgages. H&R Block's sub-prime lending subsidiary had to set aside $60 million due to borrowers falling behind in payments. Countrywide Financial stated that customers were slow in paying their loans. Similar statements were made by Impac Mortgage and Accredited Home Lenders. First Horizon National said it would miss its earnings targets because of declining mortgage volume. The problem is that the housing decline has just started and the above revelations are most likely only the tip of the iceberg. With home prices likely to move lower, a lot of homeowners are going to be in real danger of defaulting with widespread foreclosures a distinct possibility. This is in addition to the coming diminution of mortgage equity withdrawals that have been so pivotal in spurring recovery from the 2001-2002 recession. The great danger is the potential unwinding of the massive debt that has built up over the past decade and the accompanying threat of damaging deflation that was averted after 2002 only with the help of the housing boom that is now definitely over.

October 9, 2006—

Widespread reports that the housing industry is stabilizing are just too incredible to believe. Affordability remains at a 15-year low; inventories are at record levels, new housing permits are plunging; and industry executives are telling us every day how bad things really are. All in all, the evidence indicates that the decline in housing still has a long way to go. This is likely to have significant adverse effects on both consumer spending power and the large percentage of the labor force directly and indirectly dependent on the housing industry for jobs. In our view, therefore, the odds on a rare soft landing for the economy remain quite low.

February 8, 2007—

Contrary to those who assert that that the housing decline is over, the worst is yet to come and the ripple effects are becoming increasingly evident. A significant tightening of mortgage lending rules is likely to lead to a dangerous rise in foreclosures. Over the past few years the banking system has sold off hundreds of billions of dollars of mortgage loans and these have been sliced, diced, distributed and resold to a point where nobody knows who is actually at risk and by what amounts.

Perspicacious Views*...continued*

This could result in a major financial crisis for the banks and anyone else in the intricate financial system holding these risks. Today, strategists, economists and bubble TV went to great lengths explaining how the HSBC and related sub-prime problems are isolated events and that the macro economy looks great. We wish that things were really that simple.

February 15, 2007–

Major banks and Wall Street firms are trying to force mortgage originators to take back loans that they purchased in the past few years. It is likely that many of these firms cannot take back all of these loans without going under. In addition the banks and Wall Street firms made loans to the sub-primes that are in great danger of not being paid back. Much of the loans were chopped up and sold to various investors throughout the world. All of this is probably only the tip of the iceberg, and has the potential to develop into a full-fledged financial crisis comparable to some we've witnessed in the past.

April 5, 2007–

Although the consensus of strategists and economists vigorously insist the subprime woes are just a headline scare story that will quickly be forgotten by the stock market, we think their case is weak. In our view they fail to explain to why the substantial drop in housing starts combined with the subprime lending problem will be isolated this one time, when a major housing decline alone was enough to cause a recession in the overwhelming majority of past cycles. The subprime lending problem is not an isolated event, but merely the first crack in an unprecedented boom that is in the process of becoming a bust.

June 21, 2007–

The near-collapse of two big Bear Stearns hedge funds heavily invested in highly-speculative packages of subprime mortgages indicates that the severe housing recession is spreading to the financial arena and is threatening the occurrence of systemic fallout. There are undoubtedly a large number of other hedge funds with portfolios similar to those of Bear Stearns, and it appears that, in the vast majority of cases, the securities have not been marked to market. The big fear is that any auction of the Bear Stearns holdings will expose the true price of all these holdings and result in immense losses with an unknown, but potentially dangerous chain reaction throughout the financial system.

August 16, 2007–

The carnage is far from over. Amazingly, one guest on bubble TV today casually referred to the recent market turmoil as "financial gamesmanship" as opposed to what he termed "solid economic fundamentals." This is a widely-held view that has minimized the market decline so far and has prevented widespread capitulation. The implication is that the credit problems and stock market decline is merely a tempest in a teapot caused by some panicky investors who can't see a great buying opportunity. In our view, nothing could be further from the truth.

July 3, 2008–

Our prediction is that the second half of this year will produce a global recession. The catalyst for the global recession is the U.S. consumer hitting a wall due to their record debt, low savings rate, rising cost of food energy and health care, stagnant wages, and most of all, the wealth effect of the housing depression. We also predict that when the global recession becomes obvious to most observers, the destruction of demand will break the back of the commodity bull market including energy.

Sept. 18, 2008

We have been going out on a limb this year making predictions that seemed to be outrageous when they were made but don't look so bad now. In all honesty, we wish that we were wrong. We have predicted that this country will go into a severe recession that will spread abroad and wind up throwing us into a global recession. We also predicted that this global recession will cause unprecedented "demand destruction" causing a collapse in commodity prices. While most market observers will take the collapse in commodity prices to be very positive for the stock market (since most observers thought the reason the market peaked in October 2007 was caused by the rise in commodities -especially energy prices). We expected the S&P 500 to decline below 800-900 (see "What is the Real P/E" in our special reports or the latest article from Barron's in "Comstock in the News" on our home page). The S&P analysts just lowered their earnings estimates this week, so we may be too optimistic. The next prediction we would like to make is that soon you will be hearing more and more about the two concepts of "competitive devaluations" and "beggar-thy-neighbor" that we have been discussing for some time.

W@W Interviewee Research Disclosure: Charlie Minter is a Director and Co-Portfolio Manager and one of the founders of Comstock Partners. Marty Weiner is President and Co-Portfolio Manager of the Comstock Capital Value Fund and the Comstock Partners Strategy Fund since 1999. Comstock Partners, Inc. analyzes economic and financial conditions from a long-term macro-economic perspective and makes adjustments based on cyclical and shorter-term considerations. Comstock Partners is a unit of Gabelli & Co. Inc. This interview was initiated by Welling@Weeden and contains the current opinions of the interviewee but not necessarily those of Comstock Partners, Inc. Such opinions are subject to change without notice. This interview and all information and opinions discussed herein is being distributed for informational purposes only and should not be considered as investment advice or as a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but is not guaranteed. In addition, forecasts, estimates and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, or as an offer or solicitation for the purchase or sale of any financial instrument. No part of this interview may be reproduced in any form, or referred to in any other publication, without express written permission of Welling@Weeden. Past performance is no guarantee of future results.

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Charles Minter and Martin Weiner are co-Portfolio Managers for The Comstock Capital Value Fund. The views expressed in this article reflect those of the Portfolio Managers only through January 9, 2009. The Portfolio Manager's views are subject to change at any time based on market and other conditions.

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