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What's Ahead in the Securities Market

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Market analyst maintains major economic trends are favorable, excepting for the wage-price inflation spiral. Notes problems posed by taxation and financing needs. For the 1957 stock market he envisages a wide trading area in 530-430 range for the Dow-Jones Industrial Average. Stresses need for extreme selectivity, favoring air-conditioning, aircraft, airlines, cement, coal, drug, electrical equipment, machinery, metals, natural gas, oil, and steel groups; comprising defense, labor-saving or wealth-in-the-ground areas. Over the next decade, holds outlook for both business and the market is extremely constructive.

There was once an old Southern preacher whose sermons were noted around the countryside for their complete overall coverage of the subject and their brevity. When asked for the reason for his successful sermonizing, he gave the following formula: He said, "first, I tells them what I'm going to tell them. Then, I tell them. And finally, I tells them what I told them." I think I will use that formula here.


Edmund W. Tabell

I am going to tell you that the long range basic forces that have brought about the enormous increase in economic activity since 1946 will continue to exert powerful pressure on the economy over the years ahead and that these fundamental forces are much more important to the investor than the short term uncertainties that will crop up from time to time. I am going to tell you that I believe that business, labor and government will have to adopt a more realistic approach to the problem of raising the huge amount of capital needed to continue our growing expansion over the next decade. I am going to tell you that interest rates, which have risen sharply in the past two years, will continue to remain high in comparison with the past 20 years of "easy money" and might even move higher.

*An address by Mr. Tabell before the Los Angeles Chamber of Commerce, Jan. 9, 1957.

I am going to tell you that the phrase "what is the stock market going to do" is outmoded and meaningless because the market, dominated by the buying and selling of institutional investors and professional managers, no longer moves as a unit and, therefore, the analysis and study of individual companies and industries will prove far more rewarding than an attempt to anticipate the broad movements of the various stock market averages I am going to tell you that while the stock market is not greatly overvalued at present price levels, neither is it particularly undervalued except in the case of some individual securities and that probably a further resting and consolidating period similar to 1951-1953 is needed.

Dynamic Forces

Briefly, that is what I am going to tell you Now, I will tell you that the powerful forces that have brought about the dynamic increase in economic activity since 1946 are many in number The primary motivating force in 1946 was the pent-up demand created by 10 years of depression and five years of World War II when civilian production was curtailed. This demand was further built up by a steady advance in wages. Since 1940, the nation's wage rate has virtually tripled This has resulted in a tremendous increase in the standard of living particularly by families formerly in the low income brackets Average weekly earnings for production workers in manufacturing industries were $25 20 in 1940 The most recent average was at a level of over $82 weekly. According to David L. Babson & Co., investment counsel of Boston, Mass., discretionary income (after taxes, food, clothing, rent and other basic living expenses) was $26 billion before the war. Today it is well over $160 billion or six times as high. In pre-war days only one family in every 10—or less than four million—had any optional purchasing power. Today over forty million households—or seven in every 10—have incomes in excess of basic living needs [1]

The vast and largely unexpected gain in population since 1946 has created a huge demand for all types of construction that go to make up communities — hospitals, churches, schools, roads, water and sewer systems Major General Bradgon, President Eisenhower's public works advisor, reported that state and local governments are falling behind each year in meeting the $200 billion backlog of roads, education, water and sewerage requirements and he stated that these governmental units will have to spend $20.4 billion annually—twice as much as is now spent—in order to catch up by 1964.[2]

In the field of defense spending it appears that the present high expenditures will continue and will constitute a large portion of the government's budget. There seems to be more reason to expect a pick-up in defense spending than a letdown.

Enormous Spending for New Plant and Equipment

All of these demand factors have brought about an enormous increase in spending for new plant and equipment Business expenditures on new plant and equipment are estimated at between $35 billion and $36 billion

1 "Investing for Tomorrow" — David L. Babson & Co., Investment Counsel, Boston, Mass.
2 Commercial & Financial Chronicle Dec. 13, 1956.

for 1956. This is up from $19.3 billion in 1949.

The demand for new and more efficient plants to offset the increase in wage rates has been further increased by the growing shortage of workers because of the low birth rates of the 1930's. Whereas the civilian working force constituted 42% of the population before World War II, it is now down to 40% and by 1965 is likely to be only 38%. Projections of the age composition of the 1965 population indicate that the number of dependents (those under 18 and over 65) will increase twice as fast as the number of workers (18-65 age groups) [1]

More important, however, to those who are interested in developing the managers, the supervisory personnel, the technical experts, the specialists of tomorrow, is the age range of 25 to 45. Against a total population increase of 28 million or 17% by 1965, there will be an actual decrease of 136,000 people in the age range between 26 to 45 The demands for personnel in this critical age group to carry the tremendously increased burdens of our economy will be intensified.[3] With labor unions pressing for a 35-hour week and even a 30-hour week and with basic wage rates largely beyond its control, management can only keep its labor costs in line and maintain its competitive position in only one way: by improving productivity which means not only using more machines but contriving new ones to do the work now done by men. These underlying forces have been responsible for expenditures of over $145 billion for new plant and equipment over the past five years

The demand for labor-saving equipment and associated goods has gained so much momentum that it may well be the feature of industrial activity over the next two decades Research activity is the most dynamic single force in broadening the market for machines and equipment. The country is now spending $6 billion on research activities vs. $2 billion in 1947 and less than one-half billion dollars as recently as 1940. The number of engineers and scientists engaged in research and development work is over 200,000 —roughly five times the number only 15 years ago. A large part of America's current research activities is concentrated in a few hundred companies in virtually a handful of industries. Out of these vast research efforts are coming the new labor-saving devices—the transfer machines, computers, conveyors, construction equipment, control instruments, continuous miners—which lightens man's labor-load and even do some of his thinking for him.

Roughly three-quarters of corporate research in this country is accounted for by the electrical equipment, chemical and related fields, aeronautics, scientific instruments, machinery and petroleum groups The correlation between the growth in research and the demand for equipment can be demonstrated by the fact that outlays since 1929 for new technological instruments coming from or used by the industries mentioned above has grown three times faster than capital spending for the economy as a whole and these expenditures account for four-fifths of the rise in such spending in recent years

As the nation's stock of labor-saving machinery increases, the replacement requirements for such goods automatically rises Machinery installed after World War II is already growing old The Machinery and Allied Products Institute estimates that the annual rate of such wear is now running in excess of $10 billion at current prices. Whereas only 32% of the

3 An address by Norman Strouse, President, J. Walter Thompson Co. entitled: "Velocity Is the New Dimension."

dollars spent on tools and machinery were for replacement purposes in 1948, the figure has grown to 47% today. Meanwhile, technology and competition are *constantly increasing the rate of* obsolescence.[1] New materials, new products or new processes discovered by one company forces its competitors to obtain like or better equipment. Any company which allows its equipment to be*come obsolete is doomed.*

As a result of the tremendous increases in new and more efficient plant and processes, the output per worker has increased sharply even though it has not increased as fast as wage rates. *It would have been impossible to* produce the gross national product of $412 billion reached in 1956 without the productive equipment installed in recent years. It would have required 60 million more workers to produce this amount of *goods at 1929 rates of man-hour* productivity and 20 million more workers at 1947 rates of man-hour productivity. It will require still greater gains in productivity to achieve the 1965 projections of $550 to $565 billion in gross na*tional product.*[1]

Financing the Boom

The major question today is how we are going to finance this tremendous capital goods boom without creating more inflationary pressures on the economy. It is estimated that American corporations and governmental agencies have to raise capital of $360-$400 billion in the next decade to achieve a 1965 goal of $565 billion in gross national product. The enormity of this amount will be realized when we consider that at end of 1955, the total net debt in the United States was $658 billion of which $388 billion was private debt, $232 billion Federal Government debt and $38 billion in State and Government debt.

The question is who is going to account for this $360-$400 billion in debt to be created in the next 10 years? It is a question much too complicated to be answered in the short period of time allowed for this address, but it would appear quite evident that part of it will be financed by Federal and local Governments unless private borrowers increase their debt at a much greater rate than they increase their income. Some progress in this direction might be made if the Goverment revised its archaic tax laws relating to depreciation allowances for replacement of worn-out equipment and for new equipment for expanding to meet a growing economy. Some change in Government thinking may also be required regarding a balanced budget and a reduction in debt. Debt has borne a fairly definite relationship to gross national product in the past as has also GNP to money supply. It seems improbable that our economy can expand at the anticipated rate without a further increase in both debt and money supply.

A shift to equity financing would relieve this situation considerably and would reduce the amount needed for debt financing There has been a definite upward trend in the direction of equity financing. Pension funds, mutual funds, colleges and some insurance companies are increasing their portion of assets invested in common stocks. However, a change in tax laws appears needed to ac*centuate this trend.* Tax laws make debt financing more attractive for industry and it appears difficult to see a **major** shift into equities by most insurance companies, banks and savings and loan institutions.

It is in the field of individual investing where great progress might be made if a revision of our present tax laws were possible. Keith Funston, President of the New York Stock Exchange, has stated this point admirably in his *recent address.*[4] *"Aiding the*

4 Commercial & Financial Chronicle, Dec. 27, 1956.

American investor with a better investment climate." He said—"Like all things of value, this future has a price tag. It reads: $360 billion. This is the amount of capital American corporations will have to raise—the financial energy they must generate — to acquire just the plant capacity needed to meet 1965 goals.

"Of this $360 billion, some $60 billion should be raised through the sale of new stock. This is an average of $6 billion a year over the next decade, if our future is to be financed soundly. You might well wonder, where will this kind of money come from? Well, institutional investors can be expected to supply about half of it But the remaining $30 billion should come directly from us, the American people. And this represents a hitherto unknown scale of direct individual investments in equity securities—that is in common stocks It is fully three times the rate of recent years."

The Pressing Tax Problem

"In the financial community, where we are anxious to encourage equity financing and broader shareownership, the tax problem has never seemed more pressing or more immediate. Moreover, we cannot afford a lag in meeting it, or in preparing for the future Someone has got to worry about the investor — and right now. In his behalf, we must take a critical look at existing tax laws, study their effect on the investment climate and determine whether they encourage the flow of capital or dam it up

"What burdens do investors bear? What restrictions confine them? Why, in other words, should we be worried about the investor?

"Since stock is essentially a share in corporate earning power, there are only two ways it can return a profit: It pays dividends or its value in the market increases In America today, we barricade both these avenues to risk-taking—by leveling a double tax on corporate dividends and by imposing a restrictive and inflexible tax on capital gains realized from the sale of stock.

"Double taxation on dividends has a double-barreled effect. Apart from its inherent injustice it places shareholders at a disadvantage compared to the owners of some 3 5 million unincorporated businesses which pay only a personal income tax It places on corporations the burden of earning twice as much in order to put a dollar in a shareowner's pocket as would be required if debt financing such as bonds and loans were used.

"But the real danger in double taxation lies ahead—in the prospect that investors may be discouraged away from stocks, and companies forced into financing their expansion by relying too heavily on bonds, or debt securities.

"The bite taken from dividends, however, is only half the problem. An even greater investment obstacle is the capital gains tax, one of the harshest penalties on success this country has ever devised This tax imposes a levy of up to 25% on the gains realized from the sale of securities held over six months. The effect of the tax poses a very crucial question It is whether the expansion goals we have set for ourselves can be met if we continue to choke the impulse to venture and to gain. The capital gains tax really does just this

"Because it is self-imposed, it can be avoided by taking no action. It therefore locks the present investor in, and reduces the pool of risk capital available for newer and more venturesome projects. It breeds inertia and inaction, instead of providing greater incentives and greater mobility.

"As of this moment, American investors have over $200 billion of unrealized capital gains This is potential growth money that is to a great extent locked-in. Investors are unwillingly substituting the calendar for good judgment and holding some stocks long after they really want to They are inadvertently diminishing supplies of available stock, intensifying price movements, and being discouraged from switching into new ventures.

"What, then, is the solution? The most obvious is the elimination of the capital gains tax. This is perhaps the most constructive and permanent step that could be taken to ease the plight of the locked-in investor and encourage a renewed flow of capital. And this solution is far less drastic than it may sound. Of 55 nations throughout the world that we have surveyed, 46 countries—including the financially sophisticated nations of Canada, Belgium, Switzerland, Great Britain and France—impose no capital gains penalties on the public's profits from securities transactions. Faced with money-raising problems similar to our own, they recognize its harsh and destructive nature"

To enact these changes, the opposition of labor as well as Government must be overcome Labor's opposition is largely emotional. It can be proved that a better investment climate for equities will help provide the $10,000 average cost of providing equipment for each new additional worker. Perhaps increased stock ownership by smaller investors will also help this situation.

Interest Rate Rise

The unprecedented demand for money to finance our expanding economy has caused a sharp rise in interest rates and a concomitant drop in bond prices Moody's corporate bond yield on AAA bonds has advanced from an average yield of 2 90% in 1954 to a recent high of 3.74% or a 30% rise in the cost of borrowing for highest quality companies over a two-year period As we look at the continued demands for capital over the next decade, it appears difficult to visualize a sharp drop in interest rates. It rather appears that with a background of a Federal Reserve policy of both maintaining full employment and also the purchasing power of the dollar, that interest rates, subject to interruptions during mild business recessions, will move gradually higher over the years. They are high today only in relation to the "easy money" days of the 1930's, and 1940's when an entirely different background existed. During the 1920's, the yield on Moody's AAA Bond Index averaged 5%, and in periods before that interest rates were higher than they are today.

Inflationary Pressures

Most of the factors we have enumerated should result in continued inflationary pressure. It is hoped that the Federal Reserve Board will continue to use its power of money control to take some of the inflationary steam out of the economy But in its struggle to maintain a stable dollar, the Board has no control over the most important ingredient of prices—wages Sumner Schlicter of Harvard University summed this up rather nicely in a recent address to the New York Society of Security Analysts.[5] He said

"All in all, the trends that I have described must be regarded as favorable—they help improve the economy. The one exception, of course, is the creeping rise in prices. It would, of course, be nice if prices would not rise, but the dire predictions that one reads every now and then about the consequences of a slow inflation strike me as ridiculous, particularly when the inflation is initiated by a rise in labor costs to which commodity prices more or less sluggishly adjust themselves In this imperfect world we are often compelled to choose be-

5 Commercial & Financial Chronicle, Nov. 15, 1956.

tween evils, and if the choice is between enough unemployment to halt the rise in labor costs, direct controls of wages and prices and creeping inflation, let us by all means have the creeping inflation. It is the least of the three evils."

The Stock Market and Selectivity

That brings us up to the stock market. As I said earlier, the stock market no longer moves as a unit There are several reasons for this I will mention two. For the first, I will again quote Sumner Schlicter.[5] "But these planned efforts to limit the business cycle are considerably less important than developments that have not been originated for the purpose of affecting the business cycle Indeed, some of them have not been planned at all. What are some of these changes? The first is the increase in the number of *important industries. Among the* industries that have come into existence or that have grown greatly in importance during the last 20 or 30 years are the airplane industry, commercial aviation, the natural gas industry, the plastics industry, the various parts of the electronics industry, the aluminum industry, the chemical industry, the road building industry, the air-conditioning industry, the frozen foods industry, and various industries making durable consumer goods.

"An increase in the number of *industries* tends to dampen the effects of any favorable or unfavorable developments upon the *economy because such develop*ments affect different industries in different degrees and at different times. The point is well illustrated by the effects of inventory adjustments. From time to time some industries are bound to make mistakes in judging markets and to allow their inventories to become too large or too small relative to sales. In an economy of a few industries, the efforts to correct such mistakes may be quite disturbing to the entire economy. The larger the number of industries in the economy, the less seriously will the economy be disturbed (stimulated or depressed) by the efforts of some industries to restore the best ratio between inventories and sales. For example, during the last year, when the automobile *industry made the mistake of* accumulating too large inventories and then went through the pain*ful process of reducing them, the* effects on the economy were remarkably small."

The second reason is the growing role of the institutional investor. The sharp increase since the war in the number of families with sufficient incomes to create savings is an important reason for this trend These new savers, unfamiliar with direct investing, are channeling their surplus funds into life insurance companies, savings banks, loan associations and mutual funds to be collectively invested by professional *management There has also been* widespread adoption of pension programs, profit-sharing plans, *etc The professional managers* who control these funds are primarily interested in dominant companies with financial resources adequate to maintain the huge research programs necessary for continued progress. These professional managers are now the dominating force in determining market price, not the individual investor or trader.

A More Intelligent Market

These factors have combined to make for a more intelligent market in which the outlook for individual companies and industries is more important than the broad general movement of prices. It has resulted in extreme selectivity The Dow-Jones Industrial Average closed 1956 at a level about 3% above the 1955 closing but during 1956 quite a few stocks advanced over 50% and quite a few suffered sharp declines. Many

issues today are still below levels reached 10 years or more ago in 1946 despite the fact that the Dow-Jones average of 30 leading industrial companies advanced 177% during the same period. This selectivity and **diversity will** continue.

The market, as measured by the averages, held in an extremely narrow trading range during 1956. The high of 524.37 in the Dow-Jones Industrial Average was reached in April. The low of 458.21 was reached in January but closely tested on three other occasions during the year. Despite the wide moves in individual issues, the trading range of 12.7% for the Dow-Jones Industrial Average was narrowest interyear price move since 1897. Yield on the equities in the industrial average have held relatively steady for the past two years with a range of from roughly 4% to 5%. Price-to-earnings ratios have also remained relatively stable for the same time period. At the year-end, the P/E ratio was approximately 14.3. ($14 30 to buy a $1 00 of earnings.) These indices are not particularly high as compared with past ratios but they are certainly not low.

In terms of central or normal value, the market is in the upper range of an area of high investor confidence with investors willing to pay a high price for equities because of the very favorable long-term outlook. When the stock market is in a high investor confidence area it is, of course, vulnerable to a sudden change in the confidence factor, temporary as that change may be. The possibility of such a temporary development is cited in the December issue of the "monthly bank letter" of the First National City Bank of New York.[6] Which reads —"the basic problem of the capital goods boom is simply stated, but not as simply answered: are we trying to do too much too fast? Efforts to grow too quickly have unstabilizing effects: they lead to mistakes, miscalculations, and maladjustments. Carried to an extreme, they may end in lack of balance between productive facilities and consumer wants and in overcapacity in specific lines.

"When the demand for capital exceeds the rate of saving, and productive facilities for capital goods are as fully engaged as they are now, inflationary pressures result. Some capital demand, some borrowings, and some projects must be postponed. At the same time, the community at large must be induced to lay aside more of its income, abstaining from consumption in order to finance growth. The solution of the problem requires attack from both sides. . . ."

Extreme Irregularity Possible

The current uncertainties may result in an extremely irregular stock market over the coming year. The majority of recent economic forecasts indicate a higher level of GNP in 1957, but probably a temporarily lower level of profit margins that may hold down earnings on the Dow-Jones Industrials to about the same level as both 1955 and 1956. This should result in a prolongation of the trading range in the averages that has already prevailed since mid-1955.

Looking at the stock market from a strictly technical viewpoint, an approach in which I have attempted to specialize, I find that my graphs on the Dow-Jones Industrial Average indicate a rather wide **potential** on both sides of the market The closing 1956 level was 500. The possible upside **potential** of the technical pattern formed over the past six months is 580 to 600. The downside **potential**, on the other hand, is an initial 440-420 followed by a possible 360. A speculative advance to 600 would be hardly

6 Commercial & Financial Chronicle, Dec. 20, 1956.

justified at this juncture unless earnings move much higher in 1957 than is currently anticipated. Probably the most dangerous thing that could occur, at this time, from a technical viewpoint, would be an unjustified over-all speculative boom. If this occurs it might set back our long-term schedule by several years. On the other hand, a decline to as low as 360 also seems improbable considering the extremely constructive long-term outlook.

The extremes of 600 and 360 also appear improbable when the graphs of 1,500 individual issues are examined. These graphs of individual issues show a probable continuation of the diverse price movements that have been the pattern over a considerable period of time. The technical patterns of individual stocks are a combination of excellent, good, fair, neutral, mediocre, poor and unfavorable. The sum of all of these is an average that is meaningless when applied to individual issues. This diversity is not new and it will most likely continue for the foreseeable future. In view of this probability, I envisage neither a sharp advance nor a sharp decline, but rather a wide trading area in the Dow-Jones Industrial Average. The 1957 range will probably be wider than the 524-458 range of 1956. My projection would be 530-430 with individual issues showing both above and below average price action.

Favored Groups

The groups I favor for 1957 would include air-conditioning, aircraft, airlines, cement, coal, drug, electrical equipment, machinery, metals, natural gas, oil and steel. It will be noted that most of these groups are either in defense, labor-saving or wealth-in-the-ground groups.

I believe that common stocks will continue to be more attractive vehicles for long-term investment for the individual investor than bonds even though the recent rise in bond yields has placed bonds in a more competitive position with stocks. However, with the possible exception of investors in high tax brackets who can buy tax-exempt municipals, the return on high-grade bonds over the past 10 years has not kept up with the depreciation of the dollar.

From the monthly letter of the First National City Bank:

"Since World War II, slow-burning inflation has been the order of the day, afflicting almost the entire world. This is due mainly to political pressures to sustain full employment at constantly rising wage levels. One hears more and more competent observers projecting this drift indefinitely into the future, warning that 'we are in a long-term cycle of inflation' or that 'we shall experience a rising price level for the rest of our lives.' There may be interruptions, we are told, and the average rate of rise in prices will be modest—possibly no more than 2 or 3% a year.

"Two or 3% a year, on the average, has seemed quite harmless to many political leaders and economists. It does not seem harmless to savers trying to accumulate resources for retirement, education of their children, and family emergencies. They have been alerted to their perils by noting how their past savings have depreciated in real value and by the many predictions that the future will hold more of the same. They want better returns, and governments, with greater or less reluctance, have submitted to their demands and let interest rates rise, recognizing that a nation that systematically steals away the citizens' savings is inviting an uncontrollable holocaust of inflation.

"In most countries, the saver of 10 years ago has suffered serious losses in purchasing power: rather more than indicated since interest income is often subject to taxation

that waters down the rate and retards the working of compound interest. In the United States, for example, assume a capital sum invested 10 years ago at 3.4%, with all interest reinvested at the same rate. This sum would have grown enough in nominal value to keep up with the average rate of depreciation of the dollar only if the interest were free of income tax. A person in the 20% income tax bracket would have required a taxable interest rate of 4.3%: in a 40% bracket 5.7%: in an 80% bracket 17%. And all this simply to hold even with the depreciation of the dollar and avoid actual loss."

Now I am going to tell you what I told you. I told you that the long range basic forces continue favorable I told you that a more realistic approach must be taken by business, labor and government to the problem of raising the huge amount of capital needed to continue our growing expansion. I told you that interest rates will remain high and might even move higher over the longer term, even though some near term stabilization is indicated. I told you that the stock market no longer moves as a unit and is a much more intelligent market than those of the past and that the study and analysis of individual issues will be much more rewarding than an attempt to measure the broad swings of the various averages. I told you that I look for neither a broad advance nor a broad decline in the stock market in 1957, but rather a trading range a bit broader than in 1956 but probably holding in an area bounded by 530-430 as compared to the 524-458 range of 1956. However, individual issues will show both above and below average price action during 1957. I told you that I believe common stocks will be a more attractive investment medium than bonds over the longer term.

The Outlook Over the Very Long Term

In conclusion, I believe the long term outlook for both business and the stock market is extremely constructive over the next decade and I would like to close by quoting from a recent address by Murray Shields senior partner of Mackay-Shields Associates of New York.[7]

"So much for the outlook for the year 1957. The longe-range outlook—say for the next decade as a whole—is for record breaking expansion. A glorious new America is on the drawing boards of our builders, in the pilot plant stage in the laboratories of our research scientists and in the solid planning of our aggressive business leaders. The surge in population is almost certain to continue for many, many years and starting in the early sixties, the rate of family formation will spurt upward. Our $6 billion per annum outlays for research will produce a whole new series of huge new industries and a long list of fabulous new ways of producing goods at lower and lower real cost so that markets can be widened with consumption and production increased correspondingly.

"The road ahead will be a bumpy one and there will be interludes of recession and of merciless competition But the prospect is that by 1966 our Gross National Product will be reaching for $690 billion in 1956 dollars which would mean that we would attain new standards of economic wellbeing not ever dreamed of by even our wildest optimists."

7 Commercial & Financial Chronicle, Nov. 8, 1956.