TABELL'S MARKET LETTER

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We recently found ourselves in a mild dispute with a local professional gentleman regarding the amount of his fee. Basically, the practitioner was asking for a sum exactly twice what we considered appropriate. In defense of this position, he noted that the amount we thought reasonable had been the going rate as long ago as 1986.

That claim initiated, on our part, an entirely unrelated train of thought. Quite obviously, our antagonist considered it absolutely normal that a fee being charged today, in 1992, be double that charged as recently as six years ago. The implicit assumption was that most prices had doubled in those six years. It was an assumption of which, had we chosen to put on our economist hat, we could have disabused him.

The latest figure for the Consumer Price Index, which uses 1982-1984 as a base of 100, is its June level of 140.2. The corresponding figure for June, 1986 is 109.5. The overall price level for the past six years, therefore, has increased, not by 100%, but by 28.04%. The magnitude of this difference becomes even more apparent when one converts the six-year change to an annualized percentage rate. A 100% increase over six years translates to an annual rate of increase of 12.24%. The actual increase over the six-year period was at an annual rate of 4.2%. In other words, an educated, literate citizen was implicitly assuming the inflation rate over the past six years to have been almost three times what it had actually been.

The difference between the two approximate rates is particularly significant when one projects them over an extended period of time, say ten years. At a four-percent rate, prices will increase by a bit under 50% over a decade. This can hardly be called stability, but it is a great deal better than the tripling of prices which would take place at an annual inflation rate of twelve percent.

Now this may simply be taken as an example of what mathematician John Allen Paulos has called, in the title of his book, "Innumeracy". There are, however, other implications. Most of us know, indeed, that the rate of inflation in recent years has been approximately four percent. If asked, this is probably the answer we would give. Is it possible, though, that imprinted in our thinking, albeit unconsciously, is the implicit assumption of a higher rate?

There is some reason for such an imprint. We have, on occasion in the past, experienced double-digit inflation---12.2% in 1974, 13.31% in 1979, and 12.4% in 1980. These, however, are the only years since the end of World War II that greater-than-10% increases in the CPI have occurred. The rate has been under five percent in all but one of the past ten years and in 30 years of the past 44. Nonetheless, the thought seems to persist in the minds of many that a high rate of inflation has reguarly been the case in the past and/or is likely to be the case in the future.

All this raises the question of whether many investment decisions may in fact be being made under unconscious assumptions that, rationally, we know not to be true. The current steepness of the fixed-income yield curve may be an example of an unconscious assumption regarding inflation. Investors, at the moment, demand an interest rate for 30-year bonds more than twice the current rate on Treasury Bills. Certainly there is, in this sharply positive slope, an assumption of some sort regarding a future high rate of inflation.

Indeed, as far as interest rates are concerned, investors seem to be operating on a number of assumptions which are contrary to most recent experience. In terms of an historical framework, current long-bond yields---seven-plus percent for governments, correspondingly higher for high-grade corporate debt----are on the high side, suggesting the existence of a built-in assumption that the long-term trend of interest rates is upward and of bond prices, therefore, down. Yet over the past ten years precisely the opposite has been the case. For the decade of the 1980's, the total return on long-term corporate bonds was actually slightly greater than the corresponding return on common stocks despite the fact that the decade saw one the the great common-stock bull markets of the century. Somewhere in the investor's mindset, in other words, is the assumption that normal bond market behavior is that of the 35 years through 1980, during which time, a generation long, bond prices headed generally south. Sidney Homer, of course, pointed out years ago that the most recognizable interest-rate cycle is the very-long-term one---twenty years or more. Yet how many analysts have forecast that the bond market trend of the past ten years is likely to continue in the same direction for the next ten?

What implicit assumptions, then, are being made regarding the stock market? It is certainly a matter of common knowledge that, on an historical basis, current equity prices are at record levels vis-a-vis present earning power. There certainly exists an assumption here of increasing earnings and a conventional recovery from the recession. This indeed may yet take place, but its likelihood is not supported by the most recent data. S&P 500 earnings declined for nine of ten straight quarters through the end of 1991, rose only marginally in the first quarter of this year and are not expected to increase all that much in the second quarter. Investors are willing to pay prices for common stocks which strongly suggest that the trend of the last two-and-a-half years is about to be sharply reversed.

To be fair, this argument can be turned around. The current high valuation levels for equities do not constitute a new phenomenon. They have been in effect for some years now. There is at least some justification to the view that supply-demand factors currently justify higher price levels for stocks than those that have prevailed in the past.

It has been said that the market discounts and, at times, appears to display foreknowledge of future events. There is also evidence, though, that it tends to ignore recent history, continuing to believe that what has been true for long periods in the distant past will continue to be true in the future, despite an abundance of contrary evidence.

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Dow Jones Industrials (12:00) 3327.59
Standard & Poors 500 (12:00) 414.16
Cumulative Index (7/16/92) 7514.68