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The Stock Market Outlook For 1956 and Beyond

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Mr. Tabell predicts much higher market levels for long-term, with intervening readjustment period. For 1956, based on statistical, technical, and psychological factors, expects highly selective action ranging from a 520 D-J Average top down to a low of 430-420. Looking ahead to the 1958-1960 period:—with bullish elements of increasing consumer income and demand, population growth, increased money supply, more favorable investment climate, long-term easy money, and technical factors; foresees sensational D-J rise to 750. As most favorably situated groups, suggests oils, natural gas, food chains, automation issues, electronics, airlines, retail stores, better-grade Canadian oils, and natural gas issues.

As the year ends, the stock market and most business indicators are at an all-time high. The Dow-Jones industrial average is again near the September peak of 490 reached before the announcement of President Eisenhower's illness and appears ready to stage the traditional year-end rally and attain new high territory. The Federal Reserve Board index of industrial activity has reached a new high of 144% of the 1947-1949 average which is 16 points above the level of a year ago The great majority of business forecasts for 1956 predict a high level of activity for at least the first six months of the new year

Edmund W. Tabell

With such a favorable pattern as a background, it is difficult to be anything but optimistic If we attempt to look ahead five years, this optimism seems entirely justified. Four of the five long-term construc-

tive fundamental factors that I have *continually stressed in Commercial & Financial Chronicle* articles are still with us. They are roughly—

(1) The increase in consumption demand brought about not only by the increase in consumer income but by a more equitable distribution of such income.

(2) Population growth in general but particularly in relation to the age groups in the population.

(3) The tremendous increase in our money supply since the start of World War II and its effect on earnings, dividends and money rates.

(4) A more favorable investment climate.

The fifth factor—an easy money market — is temporarily unfavorable, but will, *in my opinion*, change in the event of even a *mild business dip. It still must be* considered a constructive factor for the longer term.

In addition to these constructive fundamental factors, my long-term technical work on stock market action also presents a favorable supply and demand pattern. In my last paper in the *Chronicle*, published eight months ago, I predicted the possibility of 600 in the Dow-Jones industrial average in the 1958-1960 period I am now inclined to raise my sights to 750.

1960 Outlook Clearly Bullish

The outlook for 1960 seems reasonably clear. However, at least as far as I am concerned, it is extremely difficult to project the pattern for 1956 by itself. Certainly, it seems highly improbable to expect in 1956, the same rate of increase in business activity that was witnessed in 1955 or to expect the same rate of advance in the stock market that was experienced in 1954 and 1955. The rate of business increase in 1955 was two or three times the long-term rate while the stock market has advanced almost 100% in 27 months. A continuation of the present rate of advance in the stock market would mean a price level of about 1,500 in the Dow-Jones industrials in 1960 which seems a bit fantastic for the long-term trend, even to a confirmed bull like myself.

The price of a common stock depends fundamentally on four main factors. (1) earnings, (2) dividends, (3) bond prices and (4) investor confidence. The first three factors are tangible and change at a relatively slow rate. The last factor — investor confidence, is very intangible and subject to extremes of optimism and pessimism. Investor confidence is generally reflected in price-to-earnings ratios, dividend yields and the spread between stocks and high-grade bonds. At periods of high investor confidence, like the present, the investor pays a high rate for $1.00 of earnings and dividends. The table below shows how much was paid for $1.00 of earnings and dividends in three periods of stock market highs and also during November 1948 and October 1953 as compared with today. Additionally, in the table is the amount needed to buy enough dividend income to equal the income from $10 invested in high-grade bonds.

	—Per $1 00 of—		Same Income
	Earns	Div.	$10 in Bonds
1929	$19.30	$29.90	$15.60
1937	16.60	22.00	10.75
1946	16.80	28.40	9.00
1948	7.82	18.00	5.45
1953	9.28	16.00	6.14
1955	13.37	23.26	7.36

From the above, it can be readily seen that investor confidence today necessitates paying at a much higher rate for earnings and dividends than in September 1948 or October 1953 when my two very bullish articles on stock values were published in the *Chronicle*. While the ratios are still below the three periods of stock market highs of 1929, 1937

Benjamin Graham used in our last *Chronicle* article, the normal value of the market for 1956 is around 400-410. This figure is arrived at by capitalizing the 10-year average earnings of the Dow-Jones industrials at twice the yield on AAA bonds Since the market rarely sells at its normal value, 20% deviation is allowed both up and down for either high or low investor confidence. At present levels, the market is priced right at the top of the 20% overvaluation (480-500) for high investor confidence.

The Technical Pattern

Since investor confidence or psychology is best measured by technical market factors, it might be instructive to outline the present technical pattern As noted before, the longer term indications remain favorable, but the 1956 pattern is far from certain.

From a partially technical approach to business and banking conditions we note a few signs of a possible change in the business activity pattern. A study of eight business indicators that usually change their trend some six months or so before general business, reveals that a number of these indicators are beginning to show signs of a possible change in trend later in 1956 These indications are as yet far from decisive but do suggest a certain amount of caution

An analysis of bank credit changes also indicate a cautionary attitude. Some of this work indicates that it is quite unlikely that a major new leg to the bull market can develop without either a prior correction or a long consolidation period.

Breadth-of-the-market action, a study of the internal action of the market as evidenced by volume, advances and declines, new highs and lows, odd lots, etc rather than a study of the market averages, indicate that the market shows signs of waning upside momentum despite the fact that the averages are advancing to new highs This divergence usually indicates either a decline or a long consolidating period.

Near-Term Caution

The action of the various market averages also tends toward a somewhat cautionary attitude after the turn of the year. Actually, the market as a whole has made little headway since July. A few stocks have had sharp advances while the bulk of the market has moved sideways. It is entirely possible that the market is forming a broad distributional top. Tops of this sort take a long time to form. The 1929 top needed a year to form, the 1937 top took 10 months and there were seven months of congestion before the 1946 top was formed. The present pattern has the appearance of a diamond or expanding top. Formations of this type usually consist of five phases. Four have already been completed. The present advancing phase may be the final step.

The first phase was the advance to the July top at approximately 470 The second phase was the decline to the August low of 445. The third phase was an advance to the September high of 490, above the July high. The fourth phase was the October decline to 433, a decline below the previous low of August and the first time since the advance started in October, 1953 that a previous low had been penetrated The fifth phase is the present advance from the October low which has equalled the September high of 490.

If the pattern of expanding highs and lows continues, the market should reach new high territory on the present and reach the uptrend line connecting the 470 and 490 highs of July and September. This uptrend line now stands at about 508 but will reach 510 by the year-end and about 520

by early February. If such an advance occurs, it will most likely be accompanied by a heavier volume of trading in the low-priced, speculative issues that hitherto have done little marketwise. Strength in this type of issue has been the missing ingredient in a complete market cycle. During such an advance, the higher grade issues may do little more than churn back and forth and enlarge their potential tops

In all our technical discussion so far, we have considered only the general market and the averages. All of the varied technical approaches of business indicators, bank clearings, breadth-of-the-market graphs of the averages, both on point and figure charts and on vertical line graphs all confirm the fundamental findings that the bull market has reached a mature stage and may be building a major distributional pattern with stocks passing from strong hands to weaker, more speculative holders. If this turns out to be the case, the market will follow one of two possible correctionary patterns before the long-term advance is resumed One possible pattern could be a sharp 1946-type decline of 25% or so, followed by a re-accumulation area. This could carry the industrial average back to the 400-360 area some time in 1956 The other possible pattern could be a 1951-1953-type of consolidation with the averages holding in a broad trading area while individual issues and groups adjust piecemeal with some groups declining while at the same time other issues and groups are advancing but eventually the whole market correcting any temporary overvaluations.

A study of the graphs of over 1 200 individual issues suggests that the 1951-1953 pattern is the more probable one. At the present moment, many individual issues indicate the possibility that they are forming distributional tops that may need some more work to complete. In most instances, these issues are ones which have advanced very sharply in the last year or two and are selling at very high price-to-earnings ratios and extremely low yields that are based on possible future earnings and dividends rather than on the present. They could be quite vulnerable in the event of a change in the high investor confidence prevailing today. This is almost the exact reverse of the situation in October, 1953. At that time we said, "The market is discounting a 15% to 25% drop in earnings. We are in a period in which investors are placing more stress on what they think is going to happen than in what is actually happening"

On the other hand, there are also quite a few issues today that have been more or less neglected marketwise and are still selling at fairly reasonable price-to-earnings ratios. Issues of this type would suffer little marketwise in the event of a general decline and might even move against the trend if fundamentals favored their group.

Piecemeal Readjustment

The broad economic pattern and the more intelligent approach to investing that has prevailed in recent years, favors a possible piecemeal readjustment over a period of a year or so rather than a sharp decline In the 1951-1953 market, the averages ranged in a 15% trading area for two years while some individual groups were advancing and declining at the same time. For example, the steels reached their highs in January 1951 and declined 33%. The textiles reached their high in February 1951 and declined 40%. The distilling issues reached their peak in October, 1951 and declined over 30%; the coppers their high in January 1952 and declined 33%, the oils their high in March to July, 1952 and declined 25%; the farm equipment issues their

highs in October, 1952 and declined over 30%. The rails did not reach their high until January, 1953 and declined 20% While all of this was happening other groups were resting and slowly forming reaccumulation patterns in preparation for the 1953-1956 rise.

Whether the 1956 pattern will resemble 1946 or 1951-1953 is not certain. I favor the latter at the moment and in such an event, I believe the 1956 range will be a 520 high and 430-420 low as against a present price level of 485. In the event of a 1946 pattern, I believe the range will be 500-520 high and 400-460 low.

The groups that offer the best profit potentials with the smallest amount of downside risk would include oils, natural gas, food chains, automation issues, electronics, airlines, retail stores and, for a speculation, better-grade Canadian oils and natural gas issues.

There will undoubtedly be some excellent buying opportunities during 1956 and it would seem advisable to use current strength to eliminate from your list both overvalued and marginal issues during periods of strength in order to build up a potential buying reserve. Undervalued issues should be retained and added to on minor weakness. 1956 should be a year of extreme selectivity.

and 1946, a certain amount of caution seems necessary at these advanced levels to offset the possibility of a psychological change in investor feeling.

The situation is further complicated by the fact that the figures above relate to an average of stocks and not to individual issues. Today's market, for example, is quite different from 1946 when the advance in the price level was quite general. High-grade and low-grade, investment stocks and speculative stocks all participated in the advance. Today's market has been much more selective. The steepest advances have been in the better grade stocks that have been eligible for institutional investment. Many second-grade and speculative issues have done little marketwise in recent years, and, in many cases, are comparatively undervalued in relation to some of their better regarded neighbors.

It might be interesting to note at what price level six better-grade issues would sell if, for some now unknown reason, investor confidence dropped price to earnings ratios back to the 10-year average ratios or even back to the average p/e ratios of only a year ago. Estimated earnings and present dividends for 1955 on these six issues are:

	Est. Earns	Div
duPont	$9.15	$7.00
General Electric	2 60	2.00
General Motors	4 30	2.50
Standard Oil N. J.	10 50	6.00
Union Pacific	17 00	8.00
U. S. Steel	5.80	2.60

If past average P/E ratios prevailed, the stocks would sell at the following prices on present earnings as compared with present price.

	—On Basis of— 10 Yr Av	1954	Today
duPont	155	165	230
General Elec	33	43	54
General Motors	35	36	47
Stand. Oil N J.	85	105	150
Union Pacific	128	150	180
U. S. Steel	39	46	58

On the basis of present dividends and 10-year average yields and 1954 average yields, the six stocks would sell at the following:

	—On Basis of— 10 Yr Av.	1954	Today
duPont	199	217	230
General Elec	43	52	54
General Motors	33	38	47
Stand. Oil N.J.	111	117	150
Union Pacific	140	149	180
U. S. Steel	35	44	58

The results are approximately the same under both methods with the exception of duPont and General Electric where the dividend payout was a bit above average this year in relation to earnings. These figures are not meant to be a prediction, but simply illustrate what might happen if some now unknown factor caused a lowering of—not earnings or dividends—but simply investor confidence. Such a study is subject to the criticism that recent developments have changed the quality rating of some of the companies concerned and that they are entitled to sell at a higher ratio than in the past This could apply particularly to U. S. Steel but I have attempted to select six companies that always have had a relatively high quality rating To extend this type of reasoning to justify either a relatively high or low general ratio smacks somewhat of "new era" thinking. One possible justification of the present high ratios would be that the long undervaluation might be offset by a relatively long period of overvaluation particularly in a period when earnings and dividends are advancing.

On the basis of the *Central Value* or normal value theory of