TABELL'S MARKET LETTER

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As of noon today the stock market still continued its refusal to confirm a short-term uptrend by moving through the 950 level on the Dow. If such a penetration were to take place, a short-term upside objective of 980-995 would be indicated, whereas a failure to move through this level would suggest a continuation of the intermediate term downswing from the April-May highs.

A fortnight ago we devoted this space to a general discussion of the relationship between earnings and stock prices, suggesting that a forecast of the former was only a partial step on the road to forecasting the latter. We would like to expand on this subject a bit further by trying concretely to relate a forecast for the Dow-Jones Industrial Average to its earnings prospects for 1972 and beyond.

To begin with, it is well to keep our eye on the ball. The name of the game is to forecast prices, for it is prices that produce capital gains and losses. A price can be viewed as the product of two factors, first, earnings and, second, the multiple which the stock market is willing to apply to those earnings. The financial community spends a great deal of time and effort, by and large successfully, forecasting the former and relatively little effort trying to forecast the equally important second half of the equation -- the multiple at which earnings will sell.

The present instance can be cited as a specific example. For the 12 months ended June 30, 1972 (estimating the last quarter) the Dow-Jones Industrial Average earned $58.57. Our own estimate calls for earnings to continue to increase throughout 1972, and we are currently looking for earnings of $64.50 for the 12 months ended December 31, which figure will constitute a new all-time record and a substantial advance from the recession-low figure of $51.02, for the year ended December, 1970. Further improvement, although probably not at as great a rate, is likely for 1973.

So much for the first half of the equation. What about the second -- the multiple? It is of more than passing importance. Assuming our earnings forecast to be correct, were the multiple to remain unchanged from the figure of 15.9 which obtained at the end of June, the Dow in December will be 1025, a worthwhile but unspectacular advance from current levels. However, quite different multiples are part of the record of the most recent past. At the high for the 1967-1968 bull market, for example, the Dow sold for 17.6 times earnings and, were this multiple to be achieved again, it could sell as high as 1135 at the end of the year. More recently, at the 1970 low, it sold for as little as 12.8 times earnings, and this multiple would produce a price of 825, better than 100 points below today's figure. If we broaden our historical perspective somewhat, an even wider range of valuation appears possible. The record high p/e for the Dow of 24.2, achieved in the third quarter of 1961, would produce a price of 1560. Conversely, a return to the multiples of the early fifties would have the Dow around 525. Clearly, any forecast pretending to be worth anything must give some hard thought to forecasting p/e ratios as well as to forecasting earnings.

Luckily, in this area, there is some historical precedent to guide us. One of the most important principles is that <u>changes in the multiple tend to be in the opposite direction from changes in earnings.</u> For example, in the 169 quarters since 1929, earnings have increased 107 times. In 72 of those 107 cases, the multiple has moved downward. The converse is true in periods of declining earnings. 62 quarters since 1929 have shown a quarter-to-quarter earnings drop and, in 46 of those 62 cases, the multiple rose.

Even more interesting is the fact that exceptions to the rule tend to occur around earnings turning-points. A perfect example is the recovery from the recent recession. In the first three months of 1971, Dow earnings increased by 2%, but a jump in the multiple from 16.4 to 17.3 produced a healthy 8% advance in stock prices. As earnings continued to advance through 1971 and 1972, the multiple almost steadily decreased quarter-to-quarter, with the result that, while earnings for June, 1972 had advanced 12%, the Dow was ahead by only 3%. In other words, the clear-cut probability is that the price earnings ratio for the Dow will be lower at the end of the year than it is today.

This projection is reinforced by a look at the historical pattern since 1961. Since that time, the multiple applied to equity earnings has been decreasing steadily, with each successive peak lower than the previous one and each successive bottom recording a new low. Thus, the 1970 low multiple of 12.8 constituted a 13-year nadir, and the recovery from that figure failed to equal the high reached in 1967 before it began turning downward again. Thus, on a purely statistical basis, it would not be unusual to see multiples move below their 1970 low figure some time in 1973 or 1974.

We have outlined in the past our reasons for thinking that the multiple trend since 1961 is not a transient one or a random phenomenon. It constitutes one of the reasons for continued skepticism regarding the likelihood of substantially higher prices, despite a highly optimistic near-term economic outlook.

Dow-Jones Industrials (12:00 p.m.) 947.92
S&P (12:00 p.m.) 110.13
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