TABELL'S MARKET LETTER

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"It Ain't Necessarily So"
Ira Gershwin, Porgy and Bess

Technicians get understandably tired of tilting at the same old windmills but it is, unfortunately, time to have a go at another one. As we enter 1975, the fact that the U.S. economy is in a recession is known to just about everyone. The corollary that corporate profits will be down in 1975 is just about as well known, and again, just as in every period of declining profits in the past, we see the endlessly repeated litanies about the declining profits picture having unfavorable implications for stock prices. The financial community spends millions of dollars in attempts to forecast earnings on the implicit assumption that, somehow, aggregate earnings and aggregate stock prices are, in the short run, correlated. Not only ain't it necessarily so, it just ain't so at all. Switching from Gershwin to Al Smith, let's look at the record.

Earnings for the Dow-Jones Industrial Average were first measured on a quarterly basis starting in 1929. Thus we are able to measure percentage changes in 12-month earnings starting with the first quarter of 1930 running through the third quarter of 1974, a total of 178 quarters. For four of these quarters, in 1932-33, earnings were negative and comparisons are thus distorted. This leaves us with 174 quarters which can be studied.

Of those 174 quarters, 12-month earnings for the Dow declined in 60 of them. Was this bearish for stock prices? Hardly, and indeed, the scale is tilted slightly in the opposite direction. In slightly more than half of those quarters, 33 of 60, prices rose rather than fell. Thus, paradoxically, a forecast of declining earnings is, however marginally, bullish for stock prices. (A bit of the same tendency is manifested on the upside. Of the 114 quarters in which earnings rose, 46, or more than a third, saw declining prices).

The reason for all this, of course, is that the market anticipates rather than follows. It is, sensibly, willing to pay higher prices for recessionary, below-normal earnings and is less willing to place a premium on rising, above-normal earnings. Thus, Dow-Jones earnings have been expanding steadily for three years through the third quarter of 1974, having almost doubled in the process. Yet, in 10 of those 12 quarters, the P/E ratio, the price paid for those earnings, has declined, the net result for the three years being a 280-point drop on the Dow. This is a fairly graphic example of the fact that multiples tend to move in a direction opposite to earnings.

This is amply borne out by the record. In the 174 quarters since 1930, the quarter-to-quarter change in the P/E ratio has been in a direction opposite to the change in earnings in 125 of those quarters. In the 60 quarters in which earnings were down, the multiple increased 45 times and decreased only 15. The fourth quarter of 1974 is a perfect example of this sort of tendency. Although the final figure is not yet in, 12-month earnings will probably be down for the first time in three years. Stock prices, nonetheless, rose over the quarter and will probably wind up doing the same in the first quarter of 1975.

It can be shown, moreover, that the multiple is a great deal more important in determining the course of prices than are earnings. As noted above, falling earnings produced falling prices less than half the time and rising earnings, rising prices only about two-thirds of the time. Yet, in 129 out of 174 quarters, multiples and prices have moved in the same direction.

To forecast multiples, as we have noted in the past, it is necessary to turn to technical work and, in our own view, at least, that work suggests higher prices, at least over the intermediate term. Such higher prices, a product of the market's willingness to place a higher valuation on the below-normal earning power of a recession, would be a phenomenon totally consistent with the historical record.

Dow-Jones Industrials (12:00 p.m.)	733.26	ANTHONY W. TABELL
S & P Comp. (12:00 p.m.)	81.68	DELAFIELD, HARVEY, TABELL
Cumulative Index (2/13/75)	455.37	

AWT/jb