TABELL'S MARKET LETTER

Delafield, Harvey, Tabell
909 STATE ROAD, PRINCETON, NEW JERSEY 08540
DIVISION OF
Janney Montgomery Scott Inc.
MEMBER NEW YORK STOCK EXCHANGE, INC
MEMBER AMERICAN STOCK EXCHANGE

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We cited in last week's letter the fact that the Wall Street Journal chose to ascribe one particularly bad stock market day a fortnight ago to the reporting of lower earnings by one of the Dow components. On Wednesday, the Journal's lead article was entitled "Bottom Line Blues", and it named a host of companies whose fourth-quarter earnings were likely to be disappointing, raising, in the process, the question of what effect the disclosure of these earnings might have on the stock market. We have always had the greatest respect for the Journal's financial reportage, but we must confess to some degree of skepticism as to the effect of quarter-to-quarter earnings changes as far as the stock market as a whole is concerned.

Although we personally belong to that small minority of analysts whose professional specialty is the analysis of price action, we have never felt that the huge resources devoted by the financial community to fundamental analysis were less than worthwhile. Indeed, we have always subscribed to the belief that stock prices, over the long run, are a product of a stream of future earnings and dividends. There is, however, another factor that goes into the determination of prices. That is investor confidence, which, in one sense, can be expressed by the amount the market is willing to pay at a given time for a given dollar of earnings. We think it can be documented that this latter is the more important variable in determining stock price changes over the short-to-medium term.

We have buttressed this thesis by a recent study. If earnings and stock prices both change in the same direction over a given time period and the earnings change is equal to or greater than the price change, then it can be said that all of the price change can be ascribed to the change in earnings. If both price and earnings change in the same direction but the price change is less, then only a portion of the price change can be ascribed to earnings change, and the rest must be ascribed to a change in price/earnings ratio. If earnings and prices move in opposite directions, then, obviously, the entire change is due to a change in investor confidence. Our study examined the quarter-to-quarter price change on the Dow starting in 1930 and compared it with the quarter-to-quarter earnings change. In 84 of 184 quarters, changes in the P/E ratio explained 100% of the change in stock prices during the quarter. In only 47 quarters were earnings changes able to account for the entire price change during the quarter. On average, changes in the P/E ratio accounted for 62.7% of all quarter-to-quarter price change while earnings changes accounted for only 37.2% of quarter-to-quarter price change. The results hold good even when longer periods are examined. In 22 of the past 46 years, all of the change in prices on the year has been explained by a change in multiples. As we all recall, this was especially true in the last three years, when, in 1973 and 1974, the market declined sharply in the face of rising earnings, after which it rose in 1975 in the face of sharply lower earnings. Changes in the P/E ratio have accounted for 62.4% of the annual variability of the Dow and changes in earnings only 37.6%.

Another way of determining the relative impact of earnings changes and P/E ratio changes on the Dow is to undertake the following exercise. Envision two hypothetical analysts whose task is to forecast price change over a given time period. Suppose that, in the beginning of each period, one analyst has exact foreknowledge of what earnings are going to be for the period. However, he has no means of ascribing a proper P/E to these earnings so is forced to use the P/E ratio for the prior period. Let us, by contrast, take another analyst who presumes absolutely no foreknowledge of earnings but who somehow is able accurately to forecast the P/E ratio which will exist at the end of a given period. For his earnings estimate, he simply uses the latest twelve months earnings --- in other words, assumes no earnings change whatsoever.

We compared the results of the two above approaches on a quarter-to-quarter basis starting in 1930. The analyst who was able to forecast the P/E ratio at the end of a given quarter and used the earnings ending at the beginning of that quarter had an average forecast error of 5.62%. By contrast, the hypothetical analyst who was able to predict earnings with 100% accuracy but who applied the previous quarter's P/E ratio thereto had a forecast error of 8.15%. On an annual basis, foreknowledge of the P/E ratio for the next year coupled with no foreknowledge of earnings produced an annual forecast error of 19.5%. The forecast error for the opposite case was just under 24%.

All this only reinforces a point we have made for some time --- that investor confidence is a crucial ingredient in determining the intermediate-term course of stock prices. We suspect the present market has reached a point in the cycle where such will be particularly the case. We hope to have the opportunity to discuss this in future issues of this letter.

Dow-Jones Industrials (12:00 p.m.)	957.70
S & P Composite (12:00 p.m.)	102.81
Cumulative Index (1/20/77)	665.05

AWT/jb

ANTHONY W. TABELL
DELAFIELD, HARVEY, TABELL