TABELL'S MARKET LETTER

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This letter has made note in the past of the inordinate amount of space devoted in stock market commentaries to attempts to forecast the economy. We have repeatedly taken issue with the conventional wisdom which states that the stock market's behavior must, somehow, be related to changes in the statistics on business activity and have attempted to demonstrate that such exercises were, indeed, irrelevant to a stock market forecast. We have, perhaps, for purposes of emphasis, overstated this view, since, we think, the economic outlook does bear a certain limited application to the course of stock prices. We would like, however, once more to devote some space to discussing just how limited that application is.

What prompts all this was Wednesday's announcement that the Commerce Department's Index of Leading Indicators fell by nearly 2 percent in January, which fall was seized upon in some quarters as a convenient explanation of why the stock market took its latest plunge to new lows. It is perhaps, therefore, worthwhile to walk, step by step, through an analysis of just what this particular data might mean insofar as decisions for the stock market are concerned.

First of all, the leading indicator composite, as its name implies, is precisely designed to lead, and what it is designed to lead is the advent of an economic recession. It has relevance, therefore, only to the degree that it forecasts such recessions. Since we are talking here about recessions, one fact must be firmly kept in mind, that is, that recessions are a phenomenon officially identified by the National Bureau of Economic Research. It is worthwhile, then, to ask at what point in time recessions tend to be so identified by the Bureau, and the answer is that, in the case of the last two at least, they were not officially so identified until after they had taken place. It is, in other words, important to distinguish between past recessions, which are precisely dated, and future recessions which will be events, in the early stages, at least, of which we will not be aware even while they are happening.

In this light, it is necessary to ask ourselves just what the downturn in the leading indicators means. The first possible answer is that it means nothing at all. One factor which has been noted is that the series, as presently constructed, seems to have a downward bias in January due, prosaically, to the fact that, in that month, it often snows a lot. Not unexpectedly, this tends to have some effect on building activity which constitutes an input to the series. However, even without snowstorms, the index has moved down for fairly protracted periods in the past without that downward movement proving to be the harbinger of a recession. The most recent instance was April of last year when the series moved lower for three months and did not score a new high until August. However, there are much more extended instances on record. In 1966, for example, the indicator series moved down steadily from March through December and then, finally, by August of the following year, 18 months after the temporary peak, recovered to a new high. Long drops of almost as great a magnitude are fairly common.

All this tells us, of course, is that the leading indicators speak in somewhat less than clarion tones. At least a few more months of continually lower numbers will be required before we are able to determine with any degree of certainty whether the index is, in fact, giving us any signal at all, and, even then, it will not be totally certain that the signal is not, in fact, a false one. Let us, however, for the moment, ignore these problems and assume that the composite continues to move lower over the next few months to the point where we have some certainty that it is, indeed, trying to tell us something. What, then, will it be telling us?

Unfortunately, the only thing that we will know for a certainty at that time is the fact that the index scored a peak in December, 1977. Since the index is expressly designed to lead, that fact will simply point to the probability of a business cycle expansion peak sometime after December, 1977. Looking at the past six recessions, we find the lead times have varied from four to 23 months and that the average lead time is a bit over one year. This lead, of course, will have to be carried forward from December, 1977.

In summary, then, the significance of the January downturn can be summarized as follows. It is possible, although by no means certain, that, by late this spring, we may have a fairly hard idea that the leading indicators are saying something about the possibility of an end to business expansion. That end will have taken place no earlier than the time of the signal, say May or June, and may, indeed, be as late as sometime during 1979. This all may be modestly useful information, but it is necessary to examine its relevance in some detail as far as stock prices are concerned. This we propose to do next week.

Dow-Jones Industrials (12:00 p.m.)	746.36
S & P Composite (12:00 p.m.)	87.30
Cumulative Index (3/2/78)	649.15

AWT/jb

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