TABELL'S MARKET LETTER

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We noted last week that, based on the past 30 years' experience, the market configuration produced by the sharp October decline was a constructive one in terms of the probability of an effective low having been reached. We felt it necessary, however, to insert the mildly cautionary note that it was, to say the least, unusual for an oversold condition of such virulence to manifest itself so shortly after a new cylical market peak. We promised, at that time, to explore some of the possible reasons for such an occurance, and, although any explanation at this stage must be tentative, it is worth starting on an examination of possible causes.

It is now apparent, based on a number of sources, that, as the drop reached it most vicious stage during the last week in October, margin liquidation was an important, if not the major, contributing factor. Our colleague, Robert J. Simpkins, Jr., explored in this space last summer the phenomenon of the four-year rise in margin debt, a manifestation which continued unabated through the end of September, at which time total NYSE margin debt had reached a level three times what it had been in December, 1974. With an almost uninterrupted rise over those 44 months, margin debt figures had been behaving in a manner which could be correlated with our Cumulative Index rather than the Dow. The level of margin borrowing is normally a statistic which moves up and down coincidentally with the trend of the market, and the period December, 1976-February, 1978 was the first time since the figures had been compiled that it rose in the face of a sharply-declining Dow Jones Industrial Average. During that period, of course, the more broadly-based indices hardly declined at all, thus pointing to the not-implausible conclusion that a large part of the rise in debt had gone to finance the purchase of secondary stocks.

In the light of this rise, the mechanics of margin regulation are worth reviewing. Maintenance margin, the point at which a lender chooses to ask for additional funds to support declining portfolio collateral value, is at the discretion of the lending broker, subject to an NYSE minimum. That level is generally around 30-35% equity, and it is the movement of large numbers of accounts below this equity which actually triggers margin calls. Initial margin, the funds which must be deposited when a stock is first purchased on margin, on the other hand, is set by the Federal Reserve Board. Although these Federal levels have no direct relation to collateral calls, the two factors, initial and maintenance margin, are inextricably intertwined as we shall see in a moment.

It may well have been forgotten that the Federal Reserve is indeed responsible for initial margin requirements, and there is some evidence to suggest that the Federal Reserve may have forgotten it also. The Fed has not seen fit to change those requirements since they were set at 50% on January 3, 1974, a period of almost five years. This is the longest time the authorities have left margin requirements alone since they were kept at 40% from 1937 to 1945.

It has normally been the tendency of the Federal Reserve Board to raise margin requirements progressively as the market rises, and the Fed's record in inadvertantly forecasting tops by this device is one that might be envied by prognosticators. In the bull market of 1946 for example, margin was raised three times starting 15 months before the top and culminating in a rise to 100% four months before the market peak. There were two raises, 19 and 16 months before the top, in the 1953-56 bull market, two prior to the 1961 peak, one prior to the 1966 market high, and one each prior to the market highs in 1968 and 1972. In general, the tendency of the Fed has been to drop margin requirements to around 50% shortly before or shortly after major market bottoms and to raise them succesively as the market moves ahead. Thus, in the broad-based indices at least, we have just gone through the first bull market in memory when the Federal Reserve has chosen to leave margin requirement set at the 50% level throughout the entire rise.

Now the difference between 50% and 70% margin is not at all a miniscule one. With 70% initial margin requirements, an investor may purchase a margin portfolio and see it decline 57% before he is subject to a margin call, assuming a 30% maintenance requirement. If, however, initial margin is 50%, a drop of only 28% will produce the 30% equity figure and trigger a request for additional collateral. It is not too hard to envision portfolios purchased last summer undergoing declines of this magnitude.

What may have been seen in late October, in other words, is a normal correction after a four-year advance being sharply exacerbated by levels of margin equity we now know to have been less than conservative. We will try to explore these levels and their implications in subsequent issues.

Dow-Jones Industrials (12:00 p.m.)	808.13
S&P Composite (12:00 p.m.)	94.84
Cumulative Indes (11/9/78)	666.41

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