TABELL'S MARKET LETTER

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Those who have been following our technical comments on the action of the stock market have, we hope, been able to infer our belief that its behavior is, at least, unusual and to some extent unprecedented. What we have had, for some nine months now, is a stock market which, while it has stubbornly refused to go up, has not, on the whole, declined all that much. This behavior tends to produce a certain disorientation on the part of those of us who have observed the stock-market scene for the past three decades. We are accustomed to markets which, with at least some degree of directness, proceed to wherever they are going and then, rather quickly, reverse course and, correcting the excesses of the prior swing, move in the opposite direction. This, of course, is totally non-descriptive of the market's behavior since last September.

Another unprecedented factor on the financial scene has been the current level of interest rates. Fixed-income returns in the vicinity of 15% --- a rate, be it remembered, at which money doubles every five years --- are totally outside the realm of experience of anyone currently in the securities business. Since we are currently experiencing two items essentially without precedent, there has existed a tendency to link them together --- witness Thursday's market in which a sharp rally in the bull market stimulated a like reversal in stocks. This linkage has led to three pieces of conventional wisdom regarding interest rates and the stock market which may be summarized as follows:

1. There exists a so-called real interest rate, supposedly relatively stable, which can be computed by subtracting from nominal rates something called inflationary expectations for which past inflation is often used as a proxy. With inflation, at least over the past nine months, significantly below previous experience, this theoretical real interest rate is now approaching record levels. It is thus concluded that either inflation at the 1970's rate will reemerge or that interest rates will shortly decline.
2. The pernicious effect of high interest rates, especially on such economic sectors as the housing market is well known, and recovery from the present recession is, therefore, impossible until rates come down. This is a view that has been repeatedly expressed in official Washington circles.
3. Stock market recovery is impossible until such time as interest rates, which provide competition for potential equity money, move significantly lower.

Our view is that all of the above three pieces of conventional wisdom are demonstrably false.

The real-interest-rate theory is one beloved by economists, who, for some 50 years, have espoused it based on *a priori* reasoning that this is the way interest rates should behave. It has recently been reenforced by the *a posteriori* fact that, for the past 25 years or so, this is how they have, in fact, behaved. Over that quarter-century, both interest rates and inflation have been rising, but the lesson, taught in Statistics I, that correlation does not imply causation has apparently been lost. When one examines the relationship of interest rates and inflation from the Declaration of Independence to the mid-1950's the correlation vanishes into thin air. The real interest rate has in fact varied widely, and it is quite possible to find protracted periods during which it remained, for much of the time, not all that different from levels currently prevailing.

As far as the necessity of lower interest rates as a precondition for economic recovery is concerned, this also tends to vanish in the light of historical reality. There exist numerous periods on record when vigorous economic expansion has gone on totally oblivious to high interest rates. What high rates do accomplish is to shift benefits from one group of beneficiaries to another. It is hard to argue that savers (not a miniscule group considering the $200 billion in money funds) are being destroyed by high interest rates. Borrowers, particularly recent mortgage borrowers, or those overextended, i.e., Braniff, are, quite obviously, hurt. However, it is hard to argue that a home, in addition to providing shelter, should simulataneously provide instantaneous riches, and the penalties for improvidence in a free market have always been, and probably should be, harsh.

As far as the third conclusion is concerned, it is again demonstrable that high real rates of interest have existed concurrently with some of the largest bull markets of the past 200 years. Analysts who correlate interest rates with the stock market have a tendency to view both stocks and senior securities as similar financial instruments, both purchased with an eye toward financial return properly adjusted for risk. This is, at best, an inadequate explanation of what motivates investors to buy common stocks. This, however, is sufficiently complex to be the subject of another letter.

What is, in our view, unsustainable over the next ten years is the continuance of a 1970's rate of inflation. This is something that the record tells us has never occurred and which current political auguries suggest that the American people quite simply will not put up with. Periods of relative price stability following long rises in prices in the past, have been regularly accompanied by relatively high real interest rates, suggesting that those who are forecasting significantly lower rates at any time during the near future may well be misled. What such periods do tend to produce is sharply rising stock prices. The "impossible" combination, i.e., a rising stock market accompanied by continuing high interest rates, is something that historical analysis with a sufficiently long perspective tells us is not only a possibility but a probability.

Dow-Jones Industrials (12:00 p.m.)	808.89
S & P Composite (12:00 p.m.)	108.20
Cumulative Index (7.8.82)	1070.63

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