

TABELL'S MARKET LETTER

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June 20, 1986

It is now almost sixteen years since this letter adapted the practice of submitting final copy to the printer at noon on Friday, thus publishing without knowledge of the course of trading during the final hours of the week. This has caused fewer embarrassing moments than might be expected. However, the recent advent of the "triple witching hour" renders any comment on the short-term course of the market in this issue totally superfluous. We will, therefore, resort to what some wag once called the last refuge of the technician, and talk about fundamentals.

What stimulates this discussion is a headline which appeared a week ago in the business section of the New York Times, explaining a thirty-six point rally in the Dow on the previous day. The headline read "Weak Economic Data Spur Bonds and Stocks". It is not our intention to criticize that particular head. Indeed, to the extent that daily stock market swings can be ascribed to particular events, it, and its following story, are probably perfectly true. It is, however, necessary to note that a "Rip-Van-Winkle" financial analyst, returning after a sleep of less than a decade, would have been certain that it was a misprint. There was indeed a time, when, at least according to the conventional wisdom, stocks were supposed to go down on weak economic data rather than put on exceptionally strong rallies.

The Times story definitively explained the rationale. It noted that "Interest rates fell early in the day after the Government reported that industrial production declined by six-tenths of a percentage point in May. The larger-than-expected decline, combined with recent reports of sluggish retail sales and declining manufacturing employment, was enough to revive speculation that the Federal Reserve might try to stimulate the economy by easing monetary policy and encouraging lower interest rates."

This is, of course, an excellent distillation of the current, as opposed to the old-fashioned, conventional wisdom. The stock market, we are told, has become the handmaiden of the bond market, and lower interest rates are the sole requirement for leading the market higher. Such lower rates, in the Wall Street view at least, are the product of efforts on the part of the gnomes of Liberty Street to stimulate, or at least not to restrain, the economy. Thus a drop in industrial production suddenly becomes bullish for the stock market. Taking this logic to its reductio ad absurdum, of course, means that what the country really needs is a major depression which would promptly produce 2% bond rates and a Dow of 5,000.

~~The point is that the traditional and the modern stock market theories must, at some point, come into conflict.~~ They are reasonably close in our view, at the moment, to doing so. Let us hypothesize for a moment that continued economic weakness were to produce yields on AAA Industrials of 8% verses the current level of around 9 1/4 %. The current ratio of the triple-A yield to the Dow yield is roughly .37. Thus, theoretically, an eight-percent triple-A might support a DJIA yield of 2.96%, which would equate roughly to a Dow of 2180 at current dividend rates.

This is all very well, but it is at this stage that we begin to run afoul of tradition. For the twelve months ended March, the DJIA turned in earnings of \$96.43. This brings the price/earnings ratio at current levels uncomfortably close to the twenty level. The Dow has previously sold above that level for only four quarters in 1961-1962, historically the peak of a major upward cycle for p/e ratios.

The Dow's yield, moreover, currently finds itself at around the 3 1/2% level. The so-called "yield ceiling" which tends to come into play somewhere around 3 to 3 1/2% on the Dow can be better documented historically than can the stock market's relationship with the bond market. DJIA yields at around that level accompanied market tops in 1973, 1968, and 1961 to name just a few instances.

Meanwhile the stock market's supposed relationship with the bond market can be historically documented just about as far back as the last couple of market swings. The great take-off from August, 1982, was of course accompanied by falling bond yields, and a turnup in yields between mid-1983 and mid-1984 did indeed produce a fairly important downswing. It is, however, difficult to carry this relationship very far back in time. It can be argued, of course, that, with bonds currently yielding so much more than stocks, equities should today be a great deal more sensitive to competition from senior securities. However, in one sense, all financial history since 1949 can be viewed as a swing from stocks providing a yield 2.75 times as great as bonds to a stock-bond yield ratio of around .31 today.

Our own view, for what it is worth, is that the conflict will ultimately be resolved by a renaissance of the traditional view. We would, in other words, regard an economic environment in which stock earnings were able to increase by the 30-40% not so long ago envisioned by analysts for the major averages as being a more bullish one than a period of earnings decline and concomitant lower interest rates. The ultimate synthesis of the two stock market views will be interesting.

AWT:vfl

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Dow-Jones Industrials (12:00 noon) 1859.30
S. & P. 500 (12:00 noon) 244.34
Cumulative Index (6/19/86) 3155.67