PaineWebber

Investment Policy
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Happy Anniversary

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On this day in 1987, shares of Procter & Gamble were a tad weak, trading down 23 1/4 to 61. Philip Morris was off 15 1/8 at 87 1/2, Disney fell 19 1/8 to 46 and shares of Dupont were also under pressure, falling 18 1/2 to 80. The DJIA dropped 508 on volume of 605 million shares. The (perhaps apocryphal) story is told that Fed Chairman Greenspan -- not wishing to unsettle jittery markets by altering his published schedule -- flew from Washington to the West Coast during trading hours on October 19. Upon disembarking from his plane, an aide told Greenspan that the market had dropped "508" and the Fed Chairman replied, "$5.08 -- that's not bad!" Unfortunately he was off by a couple of decimal points!

Over the next week, the global financial markets nearly went into cardiac arrest. From Europe to North America to Asia, world equities were on a tumultuous, non-stop merry-go-round: The NYSE came close to shutting down on "terrible Tuesday;" the Hong Kong market suspended operations; mutual fund companies could not handle the avalanche of calls; and, in a single day, Wall Street's consensus economic forecast for 1988 changed from strong growth to recession. (Remember the "wealth effect"?) Shell-shocked individual investors were net sellers of equity mutual funds throughout 1988 -- even though it was actually the most profitable year of the 1980s for U.S. corporations.

All of which raises the unhappy question, could it happen again? Nothing is impossible, but economic and financial conditions today are strikingly different from 1987.

An over-confident consumer in '87

In 1987, the U.S. economy was plagued by an over-confident consumer -- the precise opposite of today. Consumer confidence was high, housing prices were rising rapidly on the East and West Coasts, and consumers were borrowing freely against the equity in their homes. The result: Strong demand for imports, which led to alarmingly high trade deficits in the summer of 1987, even though the dollar had been dropping for two and a half years. The trade deficit was the statistic-of-the-month that preoccupied Wall Street in 1987, much as the employment numbers do now.

Today, by contrast, we have a different situation -- an anxious consumer who refuses to go out and buy that new refrigerator no matter how low interest rates fall. Confidence is low, housing prices are weak, consumers are paying down debt, demand for imports is restrained, and so the trade deficit is much lower than in '87. True, the dollar is also weak today, but this reflects imbalances in *Germany* (i.e., the cost of unification) leading to very high real rates there, *not* excesses in the U.S.

An over-heating economy in '87

The economy was "heating up" in 1987, again the opposite of today. After very slow growth and low inflation in 1985 and 1986 (with the crash in oil prices curbing inflation in 1986), economic growth accelerated in 1987 as a buoyant consumer sector was reinforced by a resurgent industrial sector, which benefited from the weak dollar. Real GDP growth was 3.1% in 1987, versus an estimated 1.2% in 1992. The CRB index rose 12% in the first nine months of 1987, sparking a bond market sell-off in the spring. Though inflationary pressures were fundamentally under control, the 220 basis point rise in bond yields in the first nine months of 1987 was decidedly bearish for stocks, whose P/Es still reflected the more benign interest rate backdrop of 1986.

International monetary friction in '87

These two areas of excess in 1987 -- an over-confident consumer and over-heating economy -- created dangerous trans-Atlantic friction between policy makers. Germany wanted a tighter U.S. monetary policy to curb excessive demand growth. On the weekend before the crash, Treasury Secretary Baker appeared to imply that he would prefer to see the dollar fall further, rather than follow West Germany's advice. With the current account deficit running at 3.6% of GDP (versus 0.8% today), the stock market was haunted by the image of foreign investors bailing out of Treasury bonds, causing a collapse of the dollar and the U.S. bond market. To defend the greenback, the Fed would have to raise rates -- not a pleasant prospect for an overvalued stock market.

Better profits in '87...

Not all the '87 / '92 contrasts are in favor of the present. In 1987, the twin economic pressures of strong domestic demand and a weak dollar generated superb profit growth. S&P 500 operating profits rose 11% in 1987 and 37% in 1988, and these increases were not from a deeply depressed, recessionary level in 1986. By contrast, earnings this year will rise about 17% from last year's depressed levels, to a figure ($23.80) that is actually 4% lower than in 1988. Next year earnings will rise 11% if we get a moderate economic rebound. So earnings in the two years 1991-93 will rise about 26%, versus 51% in 1986-88.

...but excessive valuations

Unfortunately, investors were willing to pay too much for this favorable profit background. There were telltale signs of a mania as pundits concocted novel reasons why already-expensive stocks should rise still higher in price. A favorite was that stocks should trade at their takeover or LBO value -- as though every stock in the DJIA were going to go private. Another was that U.S. stocks still looked cheap to Japanese investors who were used to paying much higher P/Es; this was merely an updated version of the greater-fool theory -- stocks are pricey, but someone else will buy them from me at a still-higher price.

Using these rationalizations, investors bid up stocks 33% in the first eight months of 1987 -- following a hefty rise of 15% in 1986. By October 1, the stock market was grossly overvalued in absolute terms, trading at 129% of normal P/E valuation and 132% of normal dividend yield valuation. And with bond yields climbing through much of 1987, stocks also looked increasingly expensive relative to other financial assets. On October 1, 1987, the probability that stocks outperform bonds was 8%, and the probability that stocks outperform cash was 40%. If the Fed raised rates like Germany was demanding, these relationships could quickly become even worse.

Stocks are more fairly valued today

Today, the rate background for the stock market is far more benign. For example, during the month of September 1987, the yield on the 10-year U.S. government bond rose 60 basis points to 9.6%, while T-bill yields rose 40 basis points to 6.8%. By contrast, in September 1992 bond yields fell 25 basis points to 6.4%, while T-bill yields fell 48 basis points to 2.7%. Today stocks sell at 97% of normal P/E valuation and 100% of normal dividend yield valuation. And compared to the returns available in the fixed income markets today, stocks look quite attractive. The probability that stocks outperform bonds is 70%, and the probability that stocks outperform cash is 92%. Furthermore, today the likelihood is that interest rates will continue their decline, especially if BuBa eases, because inflation is low, credit demands are low, the nation is deleveraging and the current account deficit is much less onerous than in 1987.

Prices of companies mentioned as of 10/15/92:
duPont(El)deNemours* DD ($46 7/8)   Philip Morris Cos* MO ($79 7/8)   Procter & Gamble PG ($50 3/4)

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