

## Still Climbing the Wall of Worry

Putting a number on a number of problems

### Highlights

- The stock market confronts a “Wall of Worry”: possible Clinton impeachment, recession in Asia, financial meltdown in Russia, slowdown in Latin America, fears of recession in U.S.
- This resembles other periods when stocks were weak, with worries about political and economic risks. *Yet the market typically scaled the Wall of Worry and eventually hit new highs.* By comparison to previous Walls of Worry, there are many positives today—low inflation, a Federal budget surplus, low bond yields, rising consumer incomes, continued U.S. economic growth.
- Even if fundamental “inputs” are lowered, it seems to be “in the price.”
  - If reduce “normal” mid-cycle earnings 5% (because *either* actual earnings plateau around 1997 levels for the next two or three years, *or* earnings actually fall 10-15% in a classic profit recession) *and* trim *long-term* growth by ¼ percentage point (reflecting global chaos), stocks *then* (i) undervalued when P/E is bogeyed versus inflation (12/99 DJIA 9,100), (ii) significantly attractive versus current bond yields—let alone lower yields on a Fed easing—and (iii) about where they belong versus T-Bills if the Fed *just* cuts 50 basis points.
  - And if earning growth continues uninterrupted, stocks are undervalued by about 25% when P/E is bogeyed versus inflation (12/99 DJIA 11,250), *very* attractive versus current bond yields.
- But with situation still far from stable in many of the world’s emerging markets, a Fed easing may well be the key to maintaining earnings visibility. Lower rates and modestly rising earnings would be a very potent combination.

The ephemeral consensus now sees risk of a global recession! Way back in November 1985, when the DJIA was trading at 1400 and investors were brooding about a weak U.S. economy, disappointing profits, a huge Federal deficit, and a flood of imports from Asia, we wrote a report titled “Climbing the Wall of Worry” (November 1, 1985). Whether it was the harrowing depression of the 1930s or the Cold War of the 1950s, we argued, those times when

investors were most frightened by political and macro-economic problems were precisely the times when investment opportunity was greatest. Today, with stock prices down sharply from their highs and investors fixating on the potential implications of a Presidential impeachment *and* global economic contagion, now seems a good time to revisit and update “Climbing the Wall of Worry.”

### Previous Walls of Worry

- In the early 1930s unemployment was nearly 25% and industrial production was down 50% from its 1929 high. That was the good news; the bad news was that national leaders did not have a clue how to deal with the economic collapse. President Hoover *raised* taxes in 1932 and FDR considered doing the same. But the economy recovered and stock prices rose 288% from 1933 to the 1937 high.
- In the 1950s, Americans feared that the return of peace would mean a return of the Great Depression. When this proved to be untrue and stock prices started to rise, this was interpreted as a repeat of the rampant and ruinous speculation of the late 1920s. Both fears were unfounded—stock prices rose 405% between 1950 and 1966.

The bull market of the 1980s and 1990s has had its own Walls of Worry to climb.

- In 1987 investors feared that America's big budget and trade deficits, which made the country dependent on foreign capital, might lead to a collapse of the dollar and a surge in interest rates as Japanese and European investors refused to buy Treasury bonds. These fears seemed to come true in the weeks before the October '87 crash, as the U.S. squabbled with Germany over monetary policy and threatened to let the dollar slide. Stock prices rose 42% in the two years 1988-89.
- In 1990 America had the worst of both worlds—deflation and inflation simultaneously. Many firms were overleveraged and banks—burdened by bad real estate loans—were becoming more cautious, causing a “credit crunch.” Saddam Hussein's invasion of Kuwait exacerbated these deflationary pressures because rising oil prices triggered a consumer-led recession that would make it tougher for debtors to meet their obligations. Stocks rose 34% from their October 1990 bottom to the end of 1991.

### 1998: Deflationary danger

In 1996 and 1997 it seemed as if we had a “Goldilocks” investment environment—not too hot, not too cold, just right—but last October the porridge became too cold as deflationary winds blew in from Asia. Now some bears expect it to turn to ice.

The more extreme fears that surfaced last fall—a recession in Latin America, a wrenching slowdown in Europe and the U.S.—have not come to pass. But certainly the global response to the Asian contagion has so far not been as effective as one might have hoped, and the contagion has infected new countries. Weakened by collapsing com-

modity prices and a capital flight out of emerging markets, Russia has been thrown into economic turmoil. Latin America now seems threatened too. And the troubled Japanese banking system, already struggling before the southeast Asian collapse, seems to be deteriorating rapidly.

Most worrying perhaps is that the global economic authorities seem unable to halt the turmoil. Bailouts that the IMF has undertaken of struggling economies have shown few signs of success—South Korea, Indonesia and Thailand remain mired in recession; Russia is in financial meltdown. And while policy makers in the U.S. have lectured the Japanese about the painful steps they must take, policy paralysis continues to grip Tokyo even as the economy is in a recession.

Bearish observers also point to a multitude of indicators that could signal the U.S. is slipping into recession:

- Late in August, the yield curve inverted for the first time since early 1990, with the short rates the Fed controls above longer rates set by the market. This, the bears argue, is a classic recession signal.
- The NAPM New Export Orders Index fell to its lowest level ever in August.
- Retail sales declined in July and rose just 0.2% in August, possibly portending weakening in the consumer sector.
- The widely watched National Association of Purchasing Managers index came in below 50% in August, suggesting a contraction in manufacturing.
- The decline in stock prices could hurt consumer confidence.

Further, instead of addressing these myriad economic issues with 100% of his energy, President Bill Clinton is fighting for political survival as Congress considers the report of Independent Council Kenneth Starr. The central issue is whether, after reading Starr's report, Congressional Democrats conclude that he is guilty of impeachable conduct.

If the answer is “yes” Clinton will likely leave fairly quickly, in order to spare himself and the nation an impeachment proceeding that he cannot win. And if President Clinton does ultimately step down, his replacement, Vice President Gore, could have significant legal problems of his own.

If, on the other hand, the charges are not deemed “impeachable,” Clinton will be censured and get back to work, a weakened but functional President. Congressional Democrats recognize that it is in neither the nation's nor their own interest for this matter to drag on indefinitely; therefore, a timely resolution—one way or the other—seems likely.

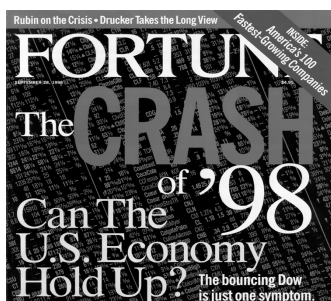
Figure 1  
The 1998 Wall of Worry



September 13, 1998



September 10, 1998



September 28, 1998



September 14, 1998



September 13, 1998

It's always darkest before the dawn

We do not deny that these are serious concerns—just as the concerns weighing on the stock market in the 1930s, 1950s, 1987 and 1990 were serious. But the history of these earlier occasions points up some things that should be kept in mind. Most important, when stock prices have fallen and investors are staring at the Wall of Worry, they tend to overlook the positives, which in the present situation are rather impressive by historical standards.

- Inflation is under control and in fact is lower than it was back in 1994, when the unemployment rate was 1.6 points *higher* than it is now.
- For the first time since 1969 we will have a budget surplus in the current fiscal year—about \$63 billion—and another surplus is likely in fiscal 1999.
- Therefore—and not necessarily because a recession is imminent—bond yields are at 30-year lows.
- *Real* average hourly earnings—which were much in the news in the mid-1990s after they had been falling for 20 years—have climbed 2.6% over the past year. Rising consumer income—fueled by rising employment and rising real wages—is the key to continued U.S. economic growth.
- The U.S. economy grew at a 3.9% pace in the first half of 1998 and should grow at about a 2.5% pace in H2 1998 and in 1999. Low inflation and a budget surplus mean that Washington can cut interest rates, reduce taxes, and/or increase government spending to prevent a recession.
- U.S. corporations are resilient and well managed. Although profits have been disappointing and below our forecast this year, they should nevertheless be up slightly despite a recession in Asia, a collapse in oil prices, an inventory correction in PCs and semiconductors, a very strong dollar and a strike at GM. While we have repeatedly emphasized the global composition of S&P earnings, the fact is that 55-60% is domestic U.S., with another 20+% in Europe. With both regions growing next year, S&P earnings should be up versus fairly easy 1998 comparisons.

Putting a number on a number of problems

In a recent commentary we wrote that “stocks are now discounting much lower normal earnings and/or much slower earnings growth than seems plausible excepting a (unlikely) recession” (see “Just How Bad Is It?,” August 31, 1998). We went on to argue that it seemed difficult to make a case that our current estimate of “\$51 in normal earnings is overly optimistic” or that “our secular growth rate assumption of 6.5% is *much* too high.”

However, we did caution that:

—With 75-80% of S&P profits coming from the U.S. and Europe, this market is cheap “absent a U.S. and European recession”;

—“. . . a *prolonged* period of economic turmoil in many of the world’s important emerging markets could trim 25-50 basis points off the S&P’s long-term earnings growth.”

- The market, even after rebounding modestly off its recent lows, is very attractive *assuming the current inputs to our quantitative models remain sound* (Table 1—Column A, Chart 1).
- However, with the economic situation still far from stable in many of the world’s emerging markets, a Fed easing may well be the key to maintaining earnings visibility. Lower rates and modestly rising earnings would be a very potent combination (Column B, Chart 2).
- But if a Fed easing is not forthcoming *and* if the global economic crisis continues to worsen, then the “lower inputs” in Table 1 (Column C) and Chart 3 could well become operative. (These “lower” numbers assume a 5% cut in 1999 normal EPS *and* a 25 basis point cut in the secular earnings growth of the S&P 500. Reducing “normal” mid-cycle earnings 5% would suggest *either* that actual operating earnings plateau around 1997 levels for the next two or three years, *or* that earnings actually fall 10-15% in a classic profit recession pattern.) Even under such a scenario all of our quantitative gauges—except the short-term interest rate relationship—are positive.
- The other scenario illustrated: inputs are lowered and the Fed cuts rates [Table 1 (Column D) and Chart 4].

This analysis suggests that even if inputs are lowered, it is probably already in the price. In the “lower” scenario (Table 1—Columns C and D), stocks are (i) undervalued when their P/E is bogeyed versus inflation (12/99 DJIA 9,100), (ii) significantly attractive versus current bond yields—let alone lower yields on a Fed easing—and (iii) about where they belong versus T-bills if the Fed *just* cuts 50 basis points and stops.

And if earnings growth continues uninterrupted, stocks are undervalued by about 25% when their P/E is bogeyed versus inflation (12/99 DJIA 11,250) and near historically attractive levels versus current bond yields.

(Under either case, liquidity, which we now gauge as slightly positive, turns a bit more positive on just one Fed easing, and earnings power [which is mildly negative now], would improve should normal earnings be reduced, as actual earnings are compared with the lowered normal earnings level.)

Either way, it looks like 1998-99 will be another period when stocks will have to climb the Wall of Worry, as they have repeatedly done in the past.

Table 1

### Quantitative gauges

	(A)	(B)	(C)	(D)
	Current Inputs		Lower Inputs*	
	no rate ch	easing	no rate ch	easing**
Stock vs. bond probability	83%	91%	74%	85%
Stock vs. cash probability	45	56	38	48
P/E valuation	+23	+23	+5	+5
Liquidity	+43bp	+93bp	+43bp	+93bp
Earnings Power (1yr fwd)	-1.1%	-1.1%	+4.3%	+4.3%
Secular earnings growth	6.50	6.50	6.25	6.25
'99 S&P 500 Normal EPS	\$51.00	\$51.00	\$48.50	\$48.50
Normal inflation rate	2%	2%	2%	2%
Calculated normal P/E	28x	28x	24x	24x
Calc. 1999 DJIA value	11250	11250	9100	9100

\* A 25 bp cut in secular earnings growth rate; 5% cut in 1999 normal EPS.

\*\* In addition to above, also assumes 50 bp declines in bond and T-bill yields as, following Fed cut, market anticipates next easing.

Source: PaineWebber.

Chart 1

### Stock market gauges—(A) Current inputs

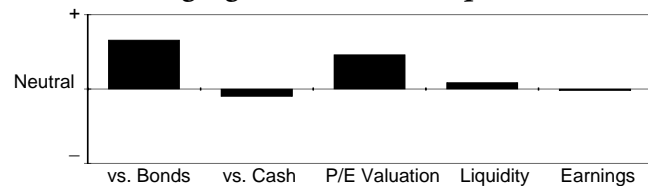


Chart 2

### Stock market gauges—(B) Current inputs + easing

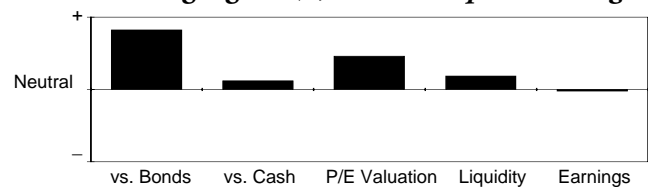


Chart 3

### Stock market gauges—(C) Lower inputs

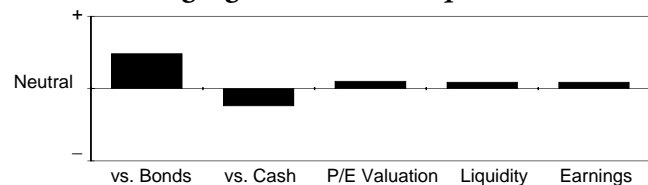
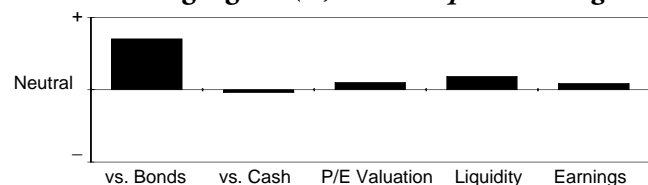


Chart 4

### Stock market gauges—(D) Lower inputs + easing



## Terror and opportunity in the 1930s— DJIA up 372%

Much like today's emerging markets, after climbing steadily to unimagined financial heights during the 1920s, U.S. stocks fell off a cliff between 1929 and 1932. The DJIA declined from a peak of 381 to a low of 41 in 1932, but many glamour issues fared still worse. RCA fell from 574 to a low of 12; GM from 1075 to 40. The market slide was so prolonged and catastrophic that even market operators savvy enough to recognize 1929 as a market top almost invariably bought in too soon and, if they were operating on margin, were wiped out in the end anyway. But past trading losses were only the first of a long litany of woes that tormented American investors in 1932. The U.S. economy seemed to be grinding to a halt. Historian John Brooks describes the macroeconomic carnage:

"In early 1932 unemployment was above ten million and heading for twelve million, or not quite a quarter of the civilian labor force; industrial production nationally was down to half its 1929 rate; industrial stocks listed on the stock exchange were worth about one-fifth of their 1929 peaks; foreign withdrawals of U.S. gold were running at a rate of \$100 million a week; and more than a billion dollars worth of currency and coin, much of it gold, was being hoarded by terrified Americans—in sum, a nation in the throes of economic disaster."

That was the good news. The bad news was that no one in power had a clue as to how to end the depression. Insisting that "we cannot squander our way into prosperity," President Hoover in 1932 raised taxes in order to balance the Federal budget (see Figure 2).

Figure 2

**THE LITERARY DIGEST**  
MARCH 19, 1932

**ONE BILLION DOLLAR TAX**

**ONE BILLION DOLLAR TAX**

**Taxing the Masses to Balance the Budget**  
REPENTANT DEMAGOGUES require desperate remedies.

The Democratic plan to balance the budget is a masterpiece of financial engineering. It is a plan that will raise \$1,246,000,000 in additional revenue in 1933. It is a plan that will raise \$500,000,000 in additional revenue in 1934. It is a plan that will raise \$500,000,000 in additional revenue in 1935. It is a plan that will raise \$500,000,000 in additional revenue in 1936. It is a plan that will raise \$500,000,000 in additional revenue in 1937. It is a plan that will raise \$500,000,000 in additional revenue in 1938. It is a plan that will raise \$500,000,000 in additional revenue in 1939. It is a plan that will raise \$500,000,000 in additional revenue in 1940. It is a plan that will raise \$500,000,000 in additional revenue in 1941. It is a plan that will raise \$500,000,000 in additional revenue in 1942. It is a plan that will raise \$500,000,000 in additional revenue in 1943. It is a plan that will raise \$500,000,000 in additional revenue in 1944. It is a plan that will raise \$500,000,000 in additional revenue in 1945. It is a plan that will raise \$500,000,000 in additional revenue in 1946. It is a plan that will raise \$500,000,000 in additional revenue in 1947. It is a plan that will raise \$500,000,000 in additional revenue in 1948. It is a plan that will raise \$500,000,000 in additional revenue in 1949. It is a plan that will raise \$500,000,000 in additional revenue in 1950.

*Literary Digest, March 19, 1932*

Figure 3

Manufacturers' (and importers') sales tax (2 1/4 per cent.)	\$595,000,000
Increases in individual income taxes (higher rates and lower exemptions)	112,000,000
Corporations (12 to 13 per cent.)	21,000,000
Estate tax increases and new gift tax	35,000,000
Admissions to amusements (10 per cent. on tickets costing 25 cents and over)	90,000,000
Stock transfers (increase from 2 to 4 cents per share and 4 cents on shares borrowed by "short" sellers)	28,000,000
Lubricating oil (4 cents a gallon)	25,000,000
Malt sirup (35 cents a gallon), grape concentrates (40 per cent. ad valorem), worts (5 cents a gallon)	50,000,000
Telegraph, radio, telephone messages (5 cents on messages costing 31 to 49 cents, and 10 cents on messages costing over 50 cents)	35,000,000
Imported gasoline, crude and fuel oil (1 cent a gallon)	5,000,000
Administrative changes in tax law	100,000,000
Post-office Department savings	25,000,000
Congressional reductions in Budget Bureau estimates	125,000,000
<b>Total</b>	<b>\$1,246,000,000</b>
Needed to balance budget	1,241,000,000
<b>Surplus</b>	<b>\$5,000,000</b>

Literary Digest, March 19, 1932

Figure 4

## THE LITERARY DIGEST JULY 9, 1932

### The Chicago Bank Failures

"LADIES AND GENTLEMEN," he began, addressing a nervous crowd of depositors, "my name is Traylor, the chief executive of this bank at this time. Naturally, I am delighted to see so many of our customers here, but I am really sorry that they are afraid of me."

But if those Chicagoans had been afraid, their fears were quickly allayed when Melvin A. Traylor, president of the First National Bank and the First Union Trust and Savings Bank, finished his speech.

he said, in view of to thirty-nine

Literary Digest, July 9, 1932

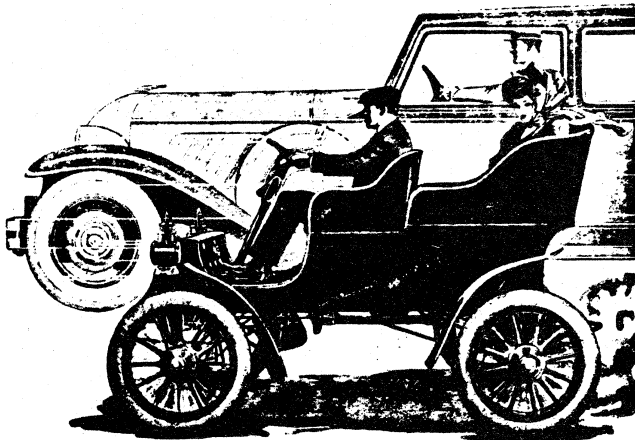
The theory was that recovery depended on a revival of business confidence, which depended on balancing the budget. In the campaign of 1932 Franklin Roosevelt promised to do the same thing if he became President. A variety of inflationary schemes was discussed within the Roosevelt camp, as was social planning and more vigorous trust busting, but no one in power seriously contemplated large-scale deficit spending to stimulate aggregate demand.

At the microeconomic level, the American banking system was seriously damaged. Upon taking office Roosevelt declared a ten-day banking holiday and passed emergency legislation ordering regulators to decide which banks were healthy, which banks could be saved with an infusion of funds and which banks should be allowed to collapse. Eventually several hundred banks were shut down. As for Wall Street, it was not merely restructured during the New Deal but chastised and dishonored. The Glass-Steagall Act of 1933 forced all banking firms to split themselves into an investment bank and a commercial bank, and still more severe legislation ended Wall Street's tradition of self-regulation by creating the Securities and Exchange Commission. In highly publicized hearings the Pecora Commission delved into the transgressions of dozens of Wall Street luminaries, while 5,000 unemployed veterans marched on Washington and clashed with the U.S. Army.

One can understand why Joseph Kennedy later remarked, "I am not ashamed to record that in those days I felt and said I would be willing to part with half of what I had if I could be sure of keeping, under law and order, the other half." Investors were concerned about the "unprecedented" problems of the day—ranging from the Federal budget deficit (see Figure 2), with a *deja vu* Democratic plan to balance it (see Figure 3), to the Chicago bank failures (see Figure 4), the growth of consumer credit (see Figure 5), and the arms race (see Figure 6).

Figure 5  
THE LITERARY DIGEST

## The 1902 Model



... a great car in 1902

**COMMERCIAL CREDIT COMPANY**  
COMMERCIAL BANKERS



HEADQUARTERS • BALTIMORE  
WHEREVER YOU ARE • WHATEVER YOU MAKE,  
SELL • OR BUY • INVESTIGATE COMMERCIAL CREDIT SERVICE •

*Literary Digest*, March 19, 1932

Figure 6

THE LITERARY DIGEST JULY 2, 1932

### World Reaction to the New Hoover Arms Plan

**C**OURAGEOUS; CLEAR-CUT; TRENCANT; easy to understand.

With such adjectives and similar words of praise the liberal dailies of London, Berlin, and Rome greet Mr. Hoover's "magnificent gesture"—his proposal to cut all world armaments one-third.

To counterbalance the chorus of praise, Paris voices an almost unanimous opposition.

After five months of quibbling and dawdling, the Disarmament Conference was suddenly and emotionally galvanized into

This bold plea for "common action, generously in the interests of all," as the *New York Herald Tribune* characterizes it, evokes a squall of praise and protest from the press of Europe. Italy, through its spokesman at Geneva, Foreign Minister Dino Grandi, accepts entirely and promptly, winning praise for this promptness and unreserved eagerness to join.

A cable poll of the European press, undertaken by THE LITERARY DIGEST, indicates, however, the discord and divergence of opinion. The French press repeats its expected refrain—its cry for security.



Our Tower of Babel!  
—Cable in the *Los Angeles Times*.

now life when, on June 22, Ambassador Hugh Gibson, the American delegate, read the President's plan for definite concrete reduction of the land, sea, and air forces of the Powers.

Its discordant response to the President's main points:

and large mobile guns.

It had armies over

abridgment of number

The note of distrust, of suspicion, of incredulity, is reiterated with endless variations throughout the Paris dailies from *Right to Left*. Most of them doubt the sincerity of Mr. Hoover. No sooner had his words been read by Hugh Gibson in Geneva than the Paris afternoon papers were interpreting and misinterpreting the motives behind this American arms-cutting proposal.

"A grandstand play—a coup de théâtre to insure his reelection," announced the widely circulated *Internationale*. "Geneva needed a sensation to keep it alive," proclaimed the *Paris-Ber*, an organ of the Left. "Will the words of President Hoover have any value six months from now? Need we recall President Wilson and his effort?"

The influential and conservative *Journal des Debats* springs into action by condemning the Hoover gesture as "an American ultimatum," interpreting the suggestions as conveying the threat that unless European—and specifically French—armaments are materially reduced, no further concessions on war debts may be expected from the United States.

A political expert of *L'Information*, a financial daily of Paris, typifies a large section of French editorial opinion in his contempt for all suggestions emanating from this side of the Atlantic. He writes:

"The time is past when Europe can attach any considerable importance to American suggestions as long as which can not be kept. However, this is not an ultimatum to Europe. It is a proclamation to American voters."

The *Nationalist Figure* calls the Hoover plan "slashing a sword through the water," and predicts its failure:

"The United States Government could not have done better if it had deliberately set out to torpedo the conference."

*Le Republicain*, organ of the young radicals composing the extremist wing of Herriot's party, realizes the importance of the issue:

"The task of the French delegation at Geneva suddenly becomes most delicate. An undeniably active and powerful minority favors the Hoover plan. The frantic evasion with which the delegates received Grandi's announcement of Italy's unqualified adherence to the Hoover suggestions shows that this is the most formidable problem which the French Government has faced since the Armistice."

*Literary Digest*, July 2, 1932

In the midst of all this disorder Jackson E. Reynolds of New York's First National Bank did a remarkable thing, recounted by his assistant as follows: "At that period in 1933 ... Mr. Reynolds called me into the bank and told me that a lady, who was a writer and a friend of Mrs. Reynolds, was pestering him for investment advice. The lady's estate consisted of \$100,000 entirely invested in U.S. Treasury 4.25% bonds. Her income derived from her writing and the interest on the bonds. 'Prepare for me a list of good common stocks. We'll go over them, and then you can sell the governments and use the proceeds for the common stocks,' he ordered. 'Mr. Reynolds,' I exclaimed, 'You're not serious! Selling the primest of investments at a time when stocks have dropped through the floor, and no one knows what's going to happen or when the end has been reached.' He replied, 'I certainly mean to do this. Run along and get the list ready.'"

Jackson Reynolds was not clairvoyant; he could not have known that U.S. economic conditions would not deteriorate further. But that was precisely what investors feared, and these fears were already reflected in stock prices. In an exact reverse of the 1929 pattern, virtually any surprise was likely to be a positive one. As events unfolded, there were indeed some positive surprises. Roosevelt turned out to be a mediocre economist but a superb leader who reinstilled a sense of direction in the nation. By virtue of deficit spending, the natural dynamic of the business cycle and inflationary monetary policies, the U.S. economy recov-

ered significantly during FDR's first term. *The New York Times* Weekly Index of Business Activity, having declined from a 1929 high of 115 to just 64 in March 1933, rose to 111 by August 1937. GNP grew at a 9.5% annual rate between 1933 and 1937 and the U.S. unemployment rate dropped from 25% to 14%. And although the economy experienced another recession in the late '30s, the 1933-1939 GNP growth rate was still 6.8%. For investors like Mr. Reynolds who bought stocks in 1933, returns were spectacular; the Dow rose 288% from 1933 to its 1937 high.

**The bull market of the fearful fifties (1950-66)—DJIA up 405%**

World War II, like World War I, greatly strengthened the American economy, both relatively and absolutely. Real GNP grew faster in the 1940s than in the 1920s, and by the late '40s industrial production was running at nearly twice its 1935-39 average. Between 1950 and 1955 real GNP grew at a robust 4.3% rate. The international prestige of the U.S. was unprecedented in this period, and after 1952 Republicans controlled the White House.

But investors viewed these favorable developments with nervous skepticism. In the late 1940s NYSE volume was low by historical standards, the S&P 500 stood about where it had during the mid-1930s, and the market P/E multiple was about 8. Noting the divergence between economic boom and stock market lassitude, *Fortune* in 1948 ominously asked, "Is the Market Right?" (see Figure 7). Five main concerns weighed on the market to produce conservative valuations:

- Most important was the fear that a new depression would strike the economy once demobilization was completed.
- Moreover, high inflation had induced aggressive investors to speculate in real estate and commodities rather than stocks.
- Investors also feared that corporate profits were lower than they appeared to be because inflation was creating illusory gains via inventory profits and under-depreciation of plant and equipment.
- Moreover, the tax programs of the New Deal and World War II had made income taxes steeply progressive, thereby relieving wealthy Americans of funds that might have been invested in equities.
- Finally, the onset of the cold war, dramatized by the "loss" of mainland China in 1949 and the outbreak of the Korean War the following year, required burdensome defense spending, which in 1953 claimed nearly 13% of GNP.

Figure 7

**IS THE MARKET RIGHT?**

WHILE BUSINESS BOOMS, WALL STREET SLUMPS • IS THE MARKET NOW A SOUP BUSINESS INDEX? A REVIEW OF THE STREET'S NEWEST PERPLEXITIES



back in January when the great chimneys of all Trinity Church, the timespiece of Wall Street, temporarily ceased to resonate, many members of the financial community found themselves particularly apt. If Wall Street's fire had not stopped entirely, it could certainly be said that it was exceedingly heavy. The financial community was "to skill..."

judgment against the underwriters common liquidation of the business to meet needs. And there was the ornate and eye-pleasing Tucker automobile, whose stock offered at 5 and, as of our going to press had reached 4. No question about it, the great days of the Street's golden effluvia become largely a matter of nostalgic chat by its older aborigine concessionaires, elevator operators, and those traders who cling to memories of the Coolidge era as old men clasp to the recollection of turn-of-century sleeves at Princeton or New York. But Wall Street's old-time less sentimental bro...

*Fortune*, March 1948

The stock market did not easily shake off such fears, even after the Korean War ended in 1953 and the U.S. economy made a smooth transition to steady, non-inflationary economic growth. NYSE market volume between 1951 and 1956 merely matched volume in the mid-1920s, when the U.S. economy was less than half as large. When in January 1955 the Dow Industrials began to explore the uncharted territory above 400, the Senate Committee on Banking and Currency thought it prudent to hold hearings on the dangers of Wall Street speculation (see Figures 8, 9). To Democratic critics of the Eisenhower Administration the stock market's ebullience, if not quite a replay of 1929, looked suspiciously like 1927 or 1928. During the hearings, Harvard Professor J.K. Galbraith unsettled the market by drawing parallels between the '20s and the '50s, prompting such newspaper headlines as "Egghead Scrambles Market." When in 1959 the market experienced its first postwar boom in small high-technology stocks, authorities at the NYSE contrived to curb the speculation by imposing 90% margin requirements. Three decades after the trauma of 1929 investors were still keenly aware of the uncertainty of the economic future.

So were policymakers in Washington. The operative word in the Fed and the Treasury Department during the 1950s was "balance." Economic policy benefited from a tension between the competing goals of avoiding recession on the one hand and inflation on the other. Aided by the much discussed "automatic stabilizers" introduced into the economy by the New Deal, Washington guided the economy through the recessions of 1949, 1953 and 1958 with considerable finesse. To maintain business confidence, government officials held the hands of business leaders who spied a new depression on the economic horizon. As the Korean War wound down in the spring of 1953, for example, Secretary of the Treasury George Humphrey stated emphatically: "There is no reason to fear peace. We have achieved greatness in peacetime—inflation, debt and high taxes from wars. Adjustments yes, but no depression."

Figure 8

BUSINESS WEEK

NUMBER 1323 JAN. 8, 1955

Bull Market vs. Washington

- The rise is worrying the Administration.
The Fed hikes margin requirement to 60%.
But this mild boost was not meant to be a heavy brake, and may have negligible effect.
Certainly, it was not the prime cause of the mid-week spate of selling.

At 1955 begins, the Administration faces a problem: Sometimes, it must find a way to control the stock market boom without damaging the business boom in the process.
The bull market is not a docile creature. Look at its activities, for instance, in the first three trading days of the year.
Monday: General Motors spurted 7 1/2 points to \$105.12 on the New York Stock Exchange on rumors of a stock dividend. It led a general advance, and trading volume totaled over 4.5-million shares.

ness recovery. At the same time, because of its concern with business, it was sensitive to anything that looked like a speculative outburst. The nightmare it saw was that of a market letdown coming before business was strong enough to ignore it.
Thus, the board wanted to fit a clear warning signal for the stock market—but it must be only a signal, not a heavy-handed clampdown that might in itself weaken stock prices. The Fed remembered 1937, when its attempt to halt speculation through a general tightening of credit brought on a business slump.
Other margin changes in the past have been 25% at a whim, and the market has seldom been bothered by them—at least over the short term. This time, apparently, the board wants to make doubly sure its change would bring no unlooked-for consequences.
• Politics—Some members of the board may have had one eye on Congress when deciding on the move. Democrats have talked about a "continuing study" of the stock market rise—something that could easily turn into a full-dress investigation of, and perhaps attack on, the Administration's pro-business investment tax policies. By showing an active interest in controlling the flow of credit in the market, the Fed puts some of the strings out of any such future investigation.
The future investors may still argue, however, that the increase in down payments for stocks is merely a variation of the open month policy. It is a stronger gesture than a speech, but its effect is largely psychological rather than mechanical. Most securities in today's market are being bought with cash; the margin increase itself will not automatically brake stock trading.
• Resentment—On Wall Street itself, many old hands feel that the Fed's move will do nothing to thwart the

Business Week, January 8, 1955

Figure 9

Heating Up the Market Hearings

- The lines are drawn now. Republicans—and exchange presidents—see the boom as a mark of Eisenhower prosperity; Democrats, as speculation.
Both sides agree we have reached no 1929 situation—yet. But Democrats liken it to 1927-28.
New ideas are coming out of testimony—about capital gains and dividend taxation, federal regulation, promotion of wider stock ownership. More will come.

The Senate Banking & Currency Committee's "friendly study" of the stock market moves along this week pretty much on the expected course. All committee members, on both sides of the table, were cautious in their approach, determined not to upset the sensitive market.
However, on the same day that economics professor John Kenneth Galbraith of Harvard—an expert on the 1929 crash—told the committee this may be the only season of "boom and bust cycle" and

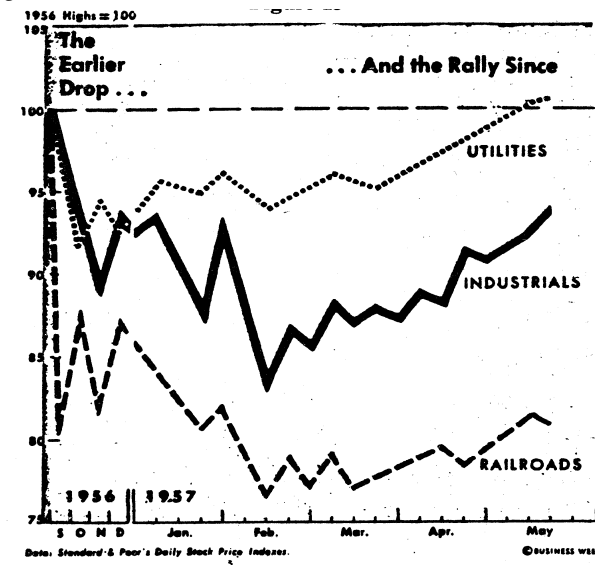
York or American exchanges is a lot mark of quality, McCormick said. "Let's not kid ourselves—there are big on both exchanges."
• Who's to Blame?—Wall Street gerts who blamed Galbraith for the first big sell-off during the boom, found a skeptic in Winthrop, the bank managing partner of Merrill Lynch, Pierce, Fenner & Beane, began a curly dealer.
"Sometimes it sells up, some days it sells down," he said. "Sometimes I think we know why; some days we don't. This time I don't know why, but I doubt very much if it was Mr. Galbraith's testimony."
Only unexpected development in the opening phase was the committee's decision to ask the Defense Dept. for a list of the 100 leading companies in defense contracts. The aim: to determine, if possible, what effect the "indirect government subsidy" had on market prices.
Public hearings will continue at least Mar. 23.
I. Is the Market Too High?
Sen. John J. Sparkman asked the first day of the hearing: "Do you think the present level of stock prices is high?"
Funston's reply was a model of honest market.

Business Week, March 12, 1955

But in preventing depression the Eisenhower Administration did not ignore the danger of inflation, in part because sensitivity to the problem was heightened by rapid price increases after World War II and again during the Korean War. In a 1956 press conference the President cautioned, "If this country is going to prosper and be strong at home it's got to have a sound dollar. If you don't have a sound dollar, this, my friends, is what happens: all of your pension schemes begin to fall to the ground." An official of the New York Fed likened inflation to a pernicious habit-forming drug: "The longer a nation resorts to it the more its awareness of its presence and its dangers is dulled, until

it reaches the point where it has become so used to inflation that it accepts it as a necessary evil." Fostered as it was by heavy military spending, strong unions and limited foreign competition, inflation was not easily controlled, hitting an annual rate of 3% in 1957. But Eisenhower was up to the task. He managed to balance the Federal budget in 1960 and was willing to trade national income for stable prices—even if it cost Richard Nixon the Presidency in 1960. Between 1955 and 1961 GNP grew at an annual rate of just 2.1%, but consumer prices were quite stable (and the DJIA was up 50%). Fully cognizant of the dangers of inflation and recession, investors bid up stock prices cautiously in the 1950s (see Figure 10).

Figure 10



A High, But Few Cheers

Stock indexes reach a peak for this year. But Streeters remain cautious in predictions.

ON MONDAY, the stock market resolutely stopped the backing and filling of recent weeks. Standard & Poor's daily indexes of industrial and utility prices moved to their highest levels of the year (chart).
At midweek, though, the breakthrough had aroused nowhere near the expected enthusiasm among brokers, or among traders and investors generally. Few analysts seized Monday's news to speed "buy, buy, buy" advice to their clients.
—since mid-February—to recover 61% of all the ground lost since the bull peak of the 1956 market. And as one market pro points out, "a recovery of such proportions alone would justify a pause for consolidation or technical correction," especially since there has been no such pause before in the post-February rally.
It must also be remembered that since February the market has pushed back into the much advertised "zone of resistance" which it had repeatedly failed to pierce in earlier upthrusts. It's a moot point whether this resistance zone will prove as impenetrable as ever, but in recent weeks the market has markedly lost momentum as it has pushed closer to the zone.
Gap in Yields—Bullish enthusiasm doused with cold water from the sharp narrowing of the yield spread between yields available on government bonds and yields on stocks.

Business Week, May 18, 1957

## The crash of '87: 1929 repeat? Stocks up 42% in two years

What if they held a Treasury auction and no one showed up—at least no one who spoke Japanese or German? That was the gruesome question that haunted U.S. investors in the mid-1980s. They got their answer during two terrible weeks in October 1987, and it scared some of them out of stocks in the final quarter of 1987, before a 42% rise in stock prices over the next two years.

In the mid-1980s many investors took a jaundiced view of the U.S. that went something like this: Profligate and undisciplined, led by an amiable Hollywood actor who embraced the dubious discipline of “supply side economics,” the U.S. had slashed taxes without cutting spending—indeed, defense spending went way up. The predictable result: a huge budget deficit, high real interest rates, and excessive consumption that undermined U.S. competitiveness. With the rest of the world—particularly the dynamic, well-managed, far-sighted economies of East Asia—following far more sensible policies, the U.S. developed a huge trade deficit.

To curb the trade deficit, world financial leaders met at the Plaza Hotel in New York in the fall of 1985 and tried to talk down the dollar. Much to their chagrin, only half of the strategy was successfully implemented. Worse still, it was the wrong half. The dollar fell, but the trade deficit did not. In 1986 and the first nine months of 1987, the dollar plummeted 20%, but the trade deficit held steady at a lofty \$13 billion monthly level. For U.S. investors the monthly trade number was the critical statistic that indicated how overheated, how mismanaged, how dependent on foreign capital the U.S. economy was.

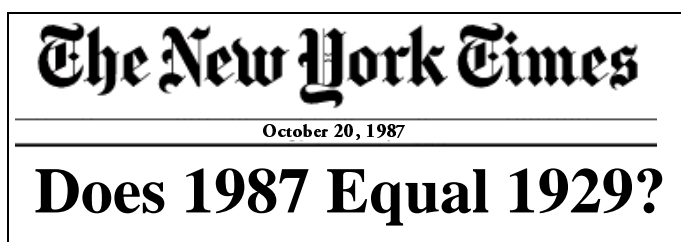
Despite this shaky financial background, U.S. stocks surged in the first half of 1987. With the U.S. economy strong and American business starting to benefit from a weaker dollar, profits were growing strongly. Traditional buyers of stocks were joined by increasingly aggressive LBO funds and deal-makers. Stock prices rose 37% in the first nine months of 1987—even though bond yields soared from 7.4% to 9.6% as the U.S. economy strengthened, the dollar sank, and the trade deficit remained high.

Finally in the fall, America's financial imbalances caught up with the stock market. In September the Fed tightened, which was interpreted as an effort to “prop up the dollar.” But in October the dollar, bond prices, and stock prices slid lower. No one in Washington seemed to care. Financier Peter Peterson noted, “Talk about the budget deficit is a form of political AIDS, because if you mention it, you have to offer a solution.” Meanwhile, Treasury Secretary Baker was pressuring foreign governments, par-

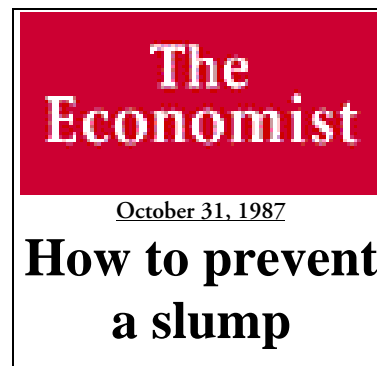
ticularly the Germans and Japanese, to stimulate their economies to boost global demand for U.S. exports. But inflationary pressures within Germany—not global demand—were the first priority of the Bundesbank. Instead of easing interest rates, the Germans subtly raised them in mid-October. James Baker was infuriated, warning on Sunday, October 18, “We will not sit back in this country and watch surplus countries jack up their interest rates and squeeze growth worldwide on the expectation that the United States will follow by raising its interest rates.”

Figure 11

### Headlines from 1987



November 2, 1987



October 26, 1987

This was not what investors wanted to read in their newspapers on Monday morning, October 19. The previous week had been terrible, with the market sliding 235 points, or 9.5%. With the U.S., Germany and Japan pulling in different directions, the global financial system was in disarray. U.S. stocks crashed 22.6% on Monday, and the New York markets almost stopped functioning on “terrible Tuesday” when stock prices closed up after reversing intraday. Stock prices had fallen by a third in just six trading sessions.

The Wall Street economic consensus immediately shifted to a shallow recession in 1988 caused by the “wealth effect” of the crash. Analysts searched for parallels with 1929 and found all too many—the lack of international financial cooperation, the risk of protectionism, the debt-driven takeover boom on Wall Street, the debt overhang in developing nations, the lack of effective leadership in Washington. Wall Street officials demanded, with little effect, that Washington finally get serious about the budget deficit.

But—as is often true after a financial panic—investors focused on the risks while ignoring all positives. Most obviously, stocks had become much cheaper but earnings were still rising strongly. And by reducing consumer confidence, the stock market crash could cool off consumer demand, thereby alleviating the trade deficit. And no one seemed to notice that the budget deficit was shrinking dramatically—from \$181 billion in fiscal year 1986 to \$137 billion in 1987. Ignoring these bullish factors, many individuals steered clear of equity mutual funds, making 1988 the only year since 1952 that equity mutual funds were net sellers of equities (other than the high inflation extended bear market period from 1972-1981). This was the wrong time to sell. Economic growth was solid in 1988, corporate profits rose over 30%, inflation remained moderate, and both the budget deficit and trade deficit shrank. As investors discounted this positive news, stock prices rose 12% in 1988 and 27% in 1989.

### **1990: The Saddam Hussein market Stocks rise 34% in 14 months**

In the autumn of 1990 investors suddenly found themselves squeezed between deflationary and inflationary pressures. On the deflationary front, all the sins of the debt-driven 1980s were weighing on the economy. Even after eight years of economic expansion, the Federal government still had a deficit of \$144 billion, which was being increased by the gigantic S&L bailout. The nation was still running a monthly trade deficit of \$9 billion, and America’s creditors, the mighty Japanese, were buying up some of America’s choicest assets, ranging from Columbia Pictures to a majority interest in Rockefeller Center to a

large chunk of downtown Los Angeles. Worse still, some major corporations were weighed down by heavy debt incurred to finance leveraged buyouts. The bankers who had financed these aggressive deals were getting nervous—particularly because they had also bankrolled a real estate building binge that littered the American landscape with half-empty buildings.

An overextended banker is a cautious banker. Already in the summer of 1990 there were signs of what would come to be known as the “credit crunch,” prompting Federal Reserve Chairman Greenspan to suggest that it might be necessary to lower interest rates. As *The New York Times* reported, “Shifting from a long-held position that tight credit conditions were confined to real estate, Mr. Greenspan pointed to slow growth of the money supply and rising rates for commercial loans as evidence of a restriction of credit that poses a threat to continued economic expansion.”

The threat posed by these deflationary pressures increased dramatically in August 1990 when Saddam Hussein invaded Kuwait, raising the specter of a lengthy war that might interrupt the flow of oil from the Persian Gulf or even destroy some of the world’s most productive oil fields. With the news dominated by the deployment of U.S. troops in Saudi Arabia, oil prices rose and consumer confidence sank. A consumer slowdown would compound the problems of heavily leveraged corporations, real estate developers, and their bankers. By October a recession was looming and banks—whose stock prices had been declining for over a year as loan losses mounted—reported horrendous earnings. Many of them slashed dividends, and Citicorp had to boost the yield on its short-term paper to attract lenders.

All in all, the news for U.S. investors could not have been much worse—war, recession, rising oil prices, an over-leveraged U.S. economy, a bank credit crunch, a real estate glut, and big budget and trade deficits. What better time for investors to reduce their exposure to equities? Actually, the market bottomed on October 11, 1990 and was 34% higher by the end of 1991, as it correctly discounted victory over Saddam Hussein, the survival of the U.S. banking system, and a resumption of economic growth in the second half of 1991.

Figure 12  
Headlines from 1990

**BusinessWeek**  
 Business Economists Predict Gloom  
 – And They’re the Optimists

October 8, 1990

**The New York Times**  
 September 18, 1990  
 Oil Prices Climb on War Fears  
 \$1.87-a-Barrel Jump, to \$33.63,  
 Breaks 7-Year-Old Record

**The New York Times**  
 September 7, 1990  
 Profits Off By 15.9% At Banks  
 Second Quarter Hurt by Bad Realty Loans

**THE WALL STREET JOURNAL**  
Bad Hangover  
**Many Firms Find Debt They Piled On in 1980s  
 Is a Cruel Taskmaster**  
 They Now Yearn for Equity  
 As They Slash Expenses,;  
 Plead With Bondholders  
 Little Sympathy From Banks

October 9, 1990

**THE WALL STREET JOURNAL**  
Growing Gloom  
**A Severe Recession May Be Developing,  
 More Economists Say**  
 They Cite Debt and Deficits;  
 Oil Prices Increase Confusion

October 10, 1990

**BusinessWeek**  
 This Recession Likely to be  
 Around For A While

October 15, 1990

**THE WALL STREET JOURNAL**  
**Citicorp Forced To Boost Rate On Share Issue**  
 Higher Yield of 9.4% Shows Investors’ Nervousness About Firm’s Securities

October 23, 1990

Additional information is available upon request.

Prices of companies mentioned as of 9/18/98:  
Citicorp\* CCI \$96 3/4  
General Motors GM \$57 1/16

\*PaineWebber Incorporated has acted in an investment banking capacity for this company.

## If

*by Rudyard Kipling*

**If you can keep your head when all about you  
Are losing theirs and blaming it on you;**

If you can trust yourself when all men doubt you,  
But make allowance for their doubting too;  
If you can wait and not be tired by waiting,  
Or, being lied about, don't deal in lies,  
Or, being hated, don't give way to hating,  
And yet don't look too good, nor talk too wise;

If you can dream—and not make dreams your master;  
If you can think—and not make thoughts your aim;  
If you can meet with triumph and disaster  
And treat those two imposters just the same;  
If you can bear to hear the truth you've spoken  
Twisted by knaves to make a trap for fools,  
Or watch the things you gave your life to broken,  
And stoop and build 'em up with wornout tools;

If you can make one heap of all your winnings  
And risk it on one turn of pitch-and-toss,  
And lose, and start again at your beginnings  
And never breath a word about your loss;  
If you can force your heart and nerve and sinew  
To serve your turn long after they are gone,  
And so hold on when there is nothing in you  
Except the Will which says to them: "Hold on";

If you can talk with crowds and keep your virtue,  
Or walk with kings—nor lose the common touch;  
If neither foes nor loving friends can hurt you;  
If all men count with you, but none too much;  
If you can fill the unforgiving minute  
With sixty seconds' worth of distance run—

**Yours is the Earth and everything that's in it,  
And—which is more—you'll be a Man my son!**

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September 20, 1998

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