Stock Market Warning: Danger Ahead!*

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Good business mixed with steady inflation has produced a powerful stock-market cocktail which the public is finding intoxicating and most agreeable. Will a hangover follow soon?

The stock market has been advancing with only one significant setback throughout the decade of the 1950's. It has thus established a new record for the length of its rise, although it has not equaled the extent of the record advance of the 1920's: 325 percent in this market versus 450 percent from 1921–1929.

What does this phenomenal upward movement portend for investors and speculators in the future? There are various ways of approaching this question. To answer it, I shall divide the question into two parts. First, what indications are given us by past experience? Second, how relevant is past experience to the present situation and prospects?

As to the first part of my answer, I should be able to make some definite statements—which will be the reverse of encouraging. But as to the applicability of the record of the past to the present, I cannot express a categorical judgment. I shall present certain facts on the one side and certain expectations pointing the other way; I shall state my own opinion as to the probable answer; but in the end, each must resolve that part of the question for himself.

Indications from Past Experience

However, in order to judge today's market level, it is desirable—perhaps essential—to have a clear picture of its past behavior. Speculators often prosper through ignorance; it is a cliché that in a roaring bull market knowledge is superfluous and experience a handicap. But the typical experience of the speculator is one of temporary profit and ultimate loss. If experience cannot help today's investor, then we must be logical and conclude that there is no such thing as investment in common stocks and that everyone interested in them should confess himself a speculator. This is just about what has actually happened in recent years—only in reverse. Everyone now calls himself an investor, including a huge horde of speculators.

This point is neatly illustrated by the opening lines of an article in a recent issue of *Business Week* describing the annual convention of Investment Clubs. The writer says: "Like all investors, large and small, they were mainly interested in which way the market—and particular stocks—would move next." If that sentence accurately describes a *bonafide* investor of 1960, then—to use a phrase made famous by a certain Mr. Krushchev—the shrimps have really begun to whistle on the mountaintops.

Bull Market or New Market?

The main issue before the investor may be expressed this way: Have we been in a bull market or in a new sort of market? If this is a bull market, then the term itself implies a bear market to follow it some day. What could be the probable extent of a decline in a traditional bear market? Here are some figures, which apply the experience of the 12 bear markets since 1874 to the recent high level of 685 for the Dow-Jones Industrial Average.

* This article is based on a talk delivered at the University of California, Los Angeles, on Dec. 17, 1959.

TABLE I
COMPARISON OF TWELVE BEAR-MARKET DECLINES

TIME PERIOD	PERCENT DECLINE	EQUIVALENT LOW FROM 685
1874–77	36	435
1881–84	26	500
1889–97	40	410
1901–03	44	385
1906–07	45	375
1909–14	29	485
1916–17	36	435
1919–21	44	385
1929–32	85	115
1937–38	44	385
1939–42	39	415
1946–49	27	490

The average of these 12 declines (all taken from Cowles-Standard indexes) would indicate a market low of about 400, a fall of over 40 percent from the 685 high. Investors may consider themselves mentally prepared for a 40 percent shrinkage in stock prices, especially if they envisage such a drop as taking place from a level far above today's average. At this point, however, a second factor from past experience becomes relevant. The record shows that declines have tended to be roughly proportional to the previous advanced. Thus, the 6 largest advances averaging 63 percent of the high level reached were followed by declines averaging 46 percent while the other 6 advances averaging 38 percent of the high produced declines averaging 37 percent.

Experience gives us another measure of the possible bear-market decline. This measure is based on the principle that the higher the market advances above a computed normal, the further it is likely to decline below such normal. If this principle—enunciated long ago by Roger Babson—were to hold in the future as in the past, then a further rise of the market from these levels—in itself an alluring probability—would actually carry with it an intensified future penalty.

Let me illustrate this point of experience by some horrifying assumptions—to present the worst of the picture. Let us assume that the market makes everyone happy by advancing fairly soon to that millennial level of 1,000 for the Dow-Jones Industrials, of which some predictions are already on file. Assume further that this is a speculative advance—very like that of the late 1920's—and that the Central Value of the D-J Average at the time is only 400. By applying the old Babson economic law of "action and reaction—equal and opposite," the corrective downswing would carry the average as low as 160, a loss of 84 percent. Impossible, you say, and no doubt you are right. But a condition similar to the one I am assuming actually occurred in 1929, and the ensuing shrinkage in the D-J Average was not 86 percent but 89 percent—from 382 to 42.

There is a paradox in this economic law which makes it virtually impossible for it to find acceptance in practice. For the almost universal optimism that accompanies the great advances in the stock market precludes even the most conservative observer from imagining a decline so drastic as these figures illustrate.

Current Optimism

Let me turn now from this Cassandra-like utterance to the picture of the future stock market that is strongly etched in the minds of most investors and speculators and of their expert advisors. Past experience may not be entirely eliminated from this picture, but it enters in a very muted way. The keynote, of course, is optimism. We are enthusiastic about business prospects for the next decade. In fact, that period received its name in many quarters—the Fabulous Sixties—even before it had begun. Herodotus recounts a saying of Solon the Wise that rich King Croesus sadly recalled before his execution—namely that no man's life should be accounted a happy one until it is over. Perhaps the more prudent time to characterize the 1960's would be when they are over rather than when they have just begun.

Most people are equally optimistic about the stock market. One of my friends—a brilliant analyst—was quoted recently in the Wall Street Journal as saying that the bull market is about to enter its 19th year and soon will be able to vote. Translated, that means he is carrying the bull market both backward in time to include 1942—ignoring the 1946–49 setback and doldrums—and confidently forward in time to 1963.

The optimism about both business and the stock market is founded on a host of favorable facts and expectations, including as an important "favorable factor" the likelihood of continued price inflation. I shall discuss these a little later.

Investors accept in theory the premise that the stock market may have its recessions in the future. But these drops are envisaged in terms of the experience of the past 10 years when the maximum decline was only 19 percent—from 521 to 420 in 1957. The public is confident that such setbacks will be made up speedily, and hence that a small amount of patience and courage will bring great rewards in the form of a much higher price level soon thereafter.

Investors may think they are basing this view of the future on past experience, but in this they are surely mistaken. The experience of the 1949–59 market—or of all bull markets put together—reflects only the sunny side of investment. It is one thing to say airily that the market has always come back after declines and made new highs; it is another to reflect on the fact that it took 25 years for the market to reach again the high level of 1929, or that the D-J Average sold at the same high point in 1919 as it did in 1942—23 years later.

The Present Bull Market In Relation to Past Ones

Up to now I have been talking only in terms of past fluctuations on the one hand, and present confidence and optimism on the other. It is time to fill in the picture with certain financial and economic data which will place the present stock market quantitatively in relation to past bull markets.

We have a number of authoritative measures of the factors of earnings, dividends, and asset values in relations to price, as applied to the market as a whole—with most emphasis placed on the industrial list. My data will apply to the industrials only. There are the figures for the 30 D-J issues published by Barrons; on 125 issues of Moody's; and the very comprehensive group of 425 industrials of Standard-Poors. Rather strangely, all three indexes give very much the same indications, both currently and over the last thirty years. At the high levels of 1959, the dividend yield on all three indices was just about 3 percent, and the ratio of price to earnings of the past 12 months was about 19 times. Let us compare these ratios with some figures for the high levels of past bull markets:

TABLE II

	Moody's 125 Industrials		Long-Term Bond Yield (Moody's AAA Corporates)	Standard-Poors 425 Industrials	
	Price-Earnings Ratio	Dividend Yield		Price-Earnings Ratio	Dividend Yield
1959 High	19.0x	3.06%	4.55%	18.2x	2.95%
1949 Low	(Av) 7.1	(Av)6.82	2.65	5.6	7.50
1946 High	15.9	3.58	2.49	16.1	3.55
1937 High	17.3	4.15	2.27	17.6	4.08
1929 High	19.4	3.23	4.95	19.0	3.10

And now compare them with the situation just before this bull market started in 1949:

TABLE III

	Dow-Jones 30 Industrials			Standard-Poors 425 Industrials		
	Earnings	Dividends	Price	Earnings	Dividends	Price
Cal. Year 1949......	23.54	12.79	Low 161	2.46	1.03	13.9
12 mos. Sept. 1959..	35.14	20.00	High 678	3.50	1.92	65.3
Percent Increase....	49	57	322	42	86	370

These figures illustrate two important points. The first is that the ratios of price to dividends and to earnings are just about where they were at the top of the markets in 1946, 1937, 1929, and about 2½ times what these ratios were ten years ago. The second point is that the actual increase in earnings between 1949 and 1959 was very modest—only about 50 percent or less. During this period, the interest rate on highest-grade bonds advanced from 2.65 percent to 4.55 percent, or about 75 percent. This means that if the proper rate of capitalization of current earnings should vary with long-term interest rates—a not implausible theory—then common stocks would actually be worth less now than in 1949, although they are selling 4 times as high.

The value situation is not as bad as that, however. On the one hand, we find that dividends have increased more than earnings, and have nearly doubled in the ten years—at least for the Moody's and Standard indexes. Again, if we capitalize average earnings, say of the past ten years, rather than the last 12 months' earnings, we would find an increase of about 120 percent between the 1940–49 and 1950–59 decades. What is most important, perhaps, is that the 1947–49 price level was clearly too low. But even making allowance for these three factors, the actual figures would probably not produce an increase of more than 100 percent in value from the 1949 year-end figure of 200 for the D-J index.

If the rise of interest rates is not taken into account—and most of the valuation methods applied to the D-J index do not do so—the various techniques will produce, for the most part, higher figures. These figures cover a wide range, but they all have one thing in common: they are appreciably lower than the present market price. Let me summarize a few of the valuations referred to in the 1959 edition of "The Intelligent Investor," which apply to the beginning of that year: Gerstein—383; Molodovsky—560; Value Line—471; Weston—600; Graham—365. Not all these methods have been applied consistently in the past—the high ones are definitely influenced by the new and more favorable attitude towards common stocks. I would estimate that the older valuation methods—i.e. those in use prior to 1955, let us say—would yield a current average figure of no more than 450, or one-third less than the present level.

Two of the large financial-counsel firms have made valuations applicable to the year 1963—four years ahead of their valuation date. One found a value for the D-J of 664, the other of 634. These were based on rather optimistic assumptions of earnings growth in the next four years. If we assume that their conclusions are sound, we then should have to observe that the stock market is already paying a full price for the much better earnings and dividends expected in 1963. (Note that these 1963 valuations cannot properly be said to derive from past experience, in the manner of the other figures presented.)

This ends my presentation of the direct implications of past experience as applied to the current market level. My conclusions are not favorable. They would imply that the current bull market is repeating the excesses of past bull markets and is destined to pay a penalty correspondingly severe. But now I must approach the second part of my review, and raise the companion question: "How relevant and useful is past experience as applied to the present situation?"

New Economic Factors

Most investors, businessmen, and economists are convinced that the business world we find outselves in now is radically different and more favorable than that of the past. The improvement is of two kinds: First, the positive drive towards an expanding economy. This is powered by rising population, more research, more sustained capital investment, broader consumer spending, etc.—in other words, by a confident and aggressive attitude in all the important sectors of the economy. Then we have new defenses against recession, which will guarantee us more stability than in the past. These include the Government's obligation to maintain high-level employment, assumed in the 1946 Act, and the automatic built-in stabilizers, such as unemployment benefits, social security, farm supports. Two other factors—not as respectable as those just described—are also counted on by many to help maintain and expand the economy. One is price inflation, considered as beneficial to business if not overdone. The other is the Cold War, with the huge defense spending that it entails.

This array of favorable factors is most imposing, and it has captured the imagination of many, perhaps most, experienced economists. The case for very good business in the 1960's is made energetically in a current book *New Forces in American Business* by Dexter Keezer and the McGraw-Hill economics staff.

The optimism about business is no doubt the chief factor in producing the present optimism about the stock market. But here the factor of inflation plays a stronger and almost separate role. People tell themselves, on the one hand, that the inescapable inflation of the future guarantees ever-higher earnings and prices for common stocks—and, conversely, that if their funds are held in bonds or other cash equivalents their real value, in terms of purchasing power, will dwindle constantly. This combination of prospects for the 1960's—good business mixed with steady inflation—has produced a powerful stock-market cocktail which the public—young and old, experienced and inexperienced—is finding intoxicating and most agreeable.

The Rosy View of the Future

Now what can past experience tell us about the validity and dependability of this rosy view as to the future of business and common stocks? Its verdict cannot be conclusive, because no prediction—whether of a repetition of past patterns or of a complete break with past patterns—can be proved in advance to be right. Nevertheless, past experience does have some things to say that are at least relevant to our problem. The first is that optimism and confidence have always accompanied bull markets; they have grown as the bull markets advanced, and they had to grow, otherwise the bull markets could not have continued to their dizzy levels—and they have been replaced by distrust and pessimism when the bull markets of the past collapsed.

As might be expected, the previous period of greatest enthusiasm about the economic prospects of the U. S. coincided with the tumultuous bull market of the late 1920's. Then, as now, nearly everyone was convinced that we had entered a "New Era" of continued and dynamic prosperity which made all past market experience worse than useless. You all know that the phrase "New Era" became almost the official description of the American economy of 1928–29. It is a bit ironical to note that today nearly everyone is again convinced that we have entered into a new era of sustained and dynamic prosperity, but also that everyone is careful not to use the convenient words "New Era," because they would remind us too uncomfortably of what happened in and after 1929.

In the 1920's, also, the new idea that good common stocks are intrinsically sounder than bonds gained ground rapidly. The financial services explained away the apparent dangers of stock yields below bond yields on the ground that the growth factor would eventually more than repay the stock buyer for his present sacrifice of income return.

Influence of Price Inflation

The factor of price inflation did not enter into the market of the 1920's, since the price level remained steady throughout. However, it did enter into the thinking of investors and speculators in 1936–37; for between the June 1932 low and the March 1937 high, wholesale prices advanced about 90 percent. (This may be compared with an advance of just 19 percent between the 1949 low and the recent 1959 high). You may be interested to know that between 1901 and 1910, wholesale prices advanced steadily to a total of 27½ percent—quite a bit more than in the 1950's. Nevertheless, in that decade, the market experienced two declines of about 50 percent each, and the rise to March 1937 was also followed by a decline of nearly 50 percent.

Past experience shows us two things about commodity-price inflation as a stock market factor. First, inflation has existed most of the time in this century, and often at a much greater average rate than we have seen since 1949. But this has not prevented the stock market from falling disconcertingly after large advances. Secondly, the investor-speculator view as to the significance of inflation has varied greatly in this period. Paradoxically, three of the six *bear* markets since 1914 have been accompanied by *rising* wholesale prices—two of them very substantial. Arnold Bernhard in his recent book, *The Evaluation of Common Stocks*, points out that in the bear-market lows of 1949, many financial experts were writing about inflation as an unfavorable factor for common stocks—this at a time when the price level had advanced nearly 40 percent in the three years 1946–49.

The past record shows clearly that inflation has been chiefly a *subjective* stockmarket factor. It has exerted an important bullish influence only when wholesale prices and the stock market happened to be rising at the same time. Investors seem to forget about inflation when stocks turn definitely downward.

An arithmetical aspect of the inflation element was brought to my attention recently by William Miller, Executive Secretary of Town Hall. At current levels, tax-exempt bonds returned fully twice as much to most investors as representative common stocks, after allowing for income tax on the latter. The investor in tax-free bonds could accordingly set aside about 2 percent per annum out of his bond interest as a fund to take care of future inflation, and still remain in as good a net-disposable-income position as he would with common stocks today.

There are some factors in our present economy which were not duplicated in previous bull markets. Most of you will think of the great advance in the popularity of common stocks—especially with pension funds and other institutional holders—as one of these new factors. There could be some doubt on this point; for the popularity of common stocks in 1929 may have been not very different from that of today. The New York Stock Exchange points to the approximate doubling of the number of shareholders—from 6 to 12 million—as an indication of the greatly improved standing of common stocks; this, too, is a phenomenon characteristic of a long bull market. No doubt the number of holders had scored a similar advance in the bull market running from 1921 to 1929. In fact, simon-pure experience suggests that the increase of small shareholders may be more of a danger than a strength for future stock markets.

Increased Stability

The factors I would recognize as new relate mainly to economic stability—as exemplified by the Government's commitment under the Employment Act of 1946, the institution of unemployment insurance, old-age pensions, and the like. There are few predictions I am willing to make—but one is that the intensity of future business recessions or depressions will be less then it has been in the past. And this is an important bullish factor. Another new factor in today's balance sheet is the Cold War—a really unparalleled phenomenon in former times. My view—not held by many authorities—is that the Cold War has contributed a good deal on balance to stimulating our economy during the 1950's. To what extent it will continue in the 1960's is a matter of opinion; it is also a matter of opinion as to whether or not the related military expenditures will carry the same weight in the total economy as in the last decade.

Possibilities of Decline

If the last two factors I have mentioned are both new and favorable to the business climate, it is proper to ask whether they also guarantee investors a favorable stock market experience indefinitely in the future—more specifically, whether they guarantee him against those market declines on the order of 40 percent or more which we have had so often in the past. To answer this question even tentatively requires me to depart to some extent from consideration of past experience and to indulge in some more abstract reasoning. If business is to have more stability in the future than before 1950—as seems likely—then common stock earning and dividends should also be more stable. This, in turn, should entitle them to be valued more liberally than in the past, which means that a higher normal or central value for common stocks generally may well be more justified than would be indicated solely by past experience. How much higher? If the D-J, judged solely by past experience, is worth 450 today, would it be worth 670 or more in the light of these new stabilizing factors? I don't know—and I don't think anyone else knows. My own guess is that under the bull market conditions of today; most financial experts would be inclined to answer yes—thus justifying the present level. But if the market should decline to 450, the same experts will persuade themselves that the old valuation relationships are still valid and that the new ones were only a bull-market mirage.

In support of this rather cynical opinion, let me refer once more to conditions in 1949 just before our great bull market started. The Employment Act was three years old, but it was completely ignored as a stabilizing factor—indeed, organized business was violently opposed to it. What is more to the point is the fact that, as recently as ten years ago, the multipliers or valuation rate for stock earning were the *lowest* for any three-year period in history since the Cowles records began in 1871, except for the World War I years 1916–18, when everyone recognized the earnings to be temporary. Now let us see what one of the leading investment services said about the stock market in September 1949—just before the rise began—when confronted with the current price level of less than 6 times earnings. I summarize their remarks: "Historically the price-earnings ratio is extremely low. Stocks are intrinsically cheap. But the governing factor is public sentiment. Renewal of confidence is needed. Because of these problems, we have for some time recommended that a portion of investment funds be in the form of reserves." The last sentence is a professional way of expressing a generally bearish view on the stock market.

Now let us contrast this analysis of the record low price-earnings ratio of 1959 with the reaction of another leading service to the near-record-high multipliers in 1959. This service lists the variations in these ratios from 1929 to 1959, and points out that "stocks are now in the upper reaches of the valuation scale." But then the report adds that business prospects are favorable for 1960, that earnings and dividends should rise further, and "they should support new market pushes." The service does suggest that during future periods of strength, the investor should move away from stocks to a more balanced position between stocks and bonds. This is a mildly cautionary view, and certainly not to be criticized. But the point I do want to make is how weak and equivocal was the reaction of one service to the record-low price-earnings ratios in 1949 and of the other service to the record-high multipliers of today. All my experience goes to show that most investment advisers take their opinions and measures of stock values from stock prices. In the stock market, value standards do not determine prices; prices determine value standards.

Let me return to the question of whether new economic conditions justify higher multipliers of earnings and dividends than in the past. Let us assume, as is likely, that the answer is yes. Would that fact assure the investor against a costly and discouraging bear-market experience? It seems to me that this is most improbable. The central level of values will be raised, but the fluctuations around these levels may well be just as wide as in the past; in fact one might expect even wider fluctuations. For since no one has any clear idea of just how the new central values are to be determined, it will be done by a process of trial and error in which speculative excesses on the upside and undue pessimism on the downside may play an even greater part than in most market cycles of former years.

Speculative Excesses in the Current Market

In this connection, I arrive finally at a "law" about human nature that cannot be repealed and is unlikely to be modified to any great extent. This law says that people without experience or superior abilities may make a lot of money fast in the stock market, but they cannot keep what they make, and most of them will end up as net losers. (This is true even though the long-term trend of stock prices has been definitely upward.) This is a particular application of a much wider natural law which may be stated simply as: "There is no such thing as a free lunch." A "free lunch," for those too young to remember, was offered in the good old days to patrons of the corner saloon.

The stock market has undoubtedly reached the stage where there are many people interested in free lunches. The extraordinary price levels of stock of rather new companies in the electronics and similar fields, the spate of new common-stock offerings of small enterprises at prices twenty-five or more times their average earnings and three times their net worth (with immediate price advances upon issuance), the completely unwarranted price discrepancies such as those established by speculators between the three issues of Studebaker-Packard—all indicate reckless elements in the present stock-market picture which foretell serious trouble ahead, if past experience means anything at all.

Let me conclude with one of my favorite clichés—the French saying: "The more it changes the more it's the same thing." I have always thought this motto applied to the stock market better than anywhere else. Now the really important part of this proverb is the phrase, "the more it changes." The economic world has changed radically and will change even more. Most people think now that the essential nature of the stock market has been undergoing a corresponding change. But if my cliché is sound—and a cliché's only excuse, I suppose, is that it *is* sound—then the stock market will continue to be essentially what it always was in the past—a place where a big bull market is inevitably followed by a big bear market. In other words, a place where today's free lunches are paid for doubly tomorrow. In the light of experience, I think the present level of the stock market is an extremely dangerous one.