The Present Decline in Perspective

The present decline started in mid-March making it 2-1/2 months old now. (Some measure it from a December peak, 2 percent higher, but a considerable rebound preceded the March fall.) In this time, stocks have fallen about 22 percent as measured by Standard and Poor's Composite Index. This makes it a very severe decline, but not without some precedent in a period of prosperity. The closest parallel came in the 4-1/2 months starting the end of May 1946 when, on the threshold of the postwar boom, the index fell 26 percent from its high to a temporary low point.

In terms of recent precedent, this is the only case that stacks up with the present one. And on closer inspection, even this case probably takes second place. Detailed data are not at hand, but it seems that the declines in the month of May (14 percent), and more clearly in the past week (12 percent), and even more clearly yesterday (6 percent with the largest volume since the 1929 crash), are hard to compare with any others. And unfortunately, the present drop is not over, while those we compare it with are. In short, this looks like the worst decline of the postwar years.

The market is a bad predictor of the course of the economy. The 1946 case is one example, and there are many others. A list of postwar declines tells the story:

Stock Market Declines Since World War II

Here are the larger (over 10%) declines that have occurred in the stock market since the war. (Standard and Poor's Composite Index is used. Dates refer to week, month and year. These numbers have not been finally checked.)

Time and Level	Percentage fall	Duration	Months from start of market slide to Start of recession
5 May 1946 (158.6) 2 Oct 1946 (117.8)	25.7%	5 months	_____
2 Feb 1947 (16.14*) 3 May 1947 (14.09) *new base period for index	12.7%	3 months	_____
July 1947* February 1948	over xxxx 10%*	7 months	_____
3 Jun 1948 (17.01) 3 Jun 1949 (13.90)	18.3%	12 months	5
3 Jun 1950 (19.00) 2 Jul 1950 (16.87)	11.2%	1 month	_____
5 Dec.1952 (26.57) 3 Sep 1953 (23.01)	13.4%	9 months	7
4 Jul 1956 (49.44) 2 Feb 1957 (43.04)	12.9%	7 months	12
2 Jul 1957 (49.05) 4 Dec 1957 (39.52)	19.4%	5 months	0
1 Jan 1960 (60.13) 4 Sep 1960 (52.48)	12.7%	8 months	4
3 Mar 1962 ((71.06) 5 May 1962 ( )	22%	2-1/2 months	_____

As for those drops that appear near enough to recessions to warrant the tentative conclusion that they foreshadowed them, here are some dates that show timing.

Peaks in Stocks	Peaks of Cycle	Lead (months)
June 1948	Nov 1948	5
Dec 1952	Jul 1953	7
Jul 1957	Jul 1957	0 *
Jan 1960	May 1960	4 **

* The market had risen sharply from February to July 1957. If July 1956 is used as the peak, it's a 12 month lead. But from Feb 57-Jul 57 there was a 13.9 percent rise. So calling these two separate drops looks better.

**This becomes 10 if we use July 1959 as the market's peak. It looks more reasonable to use the July-October 1959 fall as a case of a false signal (of course, there was the steel strike). From October 1959 to January 1960, it rose from 56.55 to 60.13, or about 6 percent.

Foreign stock markets offer other evidence of big falls in the face of prosperity. As of May 4, the German index was down about 26 percent from its 1960 peak, the Swiss index on May 18 was down 18 percent from its 1962 peak. The Japanese index at the end of April was down 29 percent from its 1961 peak and the May 18 British index was down 21 percent from its 1961 peak. In general, most foreign markets have been more volatile than our own, at least in the past two years since they experienced larger booms.

CEA: May 29, 1962

Why the Market Fell

An explanation of the market collapse must explain (1) why the market was vulnerable; (2) what forces initiated the decline; and (3) what further forces fed and accelerated the drop.

The following account is reasonably consistent with the views of a number of market analysts and writers who have sought to explain the market's tailspin:

1. The vulnerability of the market.

In the bull market of the last decade, investors boosted the price they were willing to pay for $1.00 of annual earnings from about $10.00 in 1953 to $14.00 in 1955-57 to $19.00 in 1959-60 to $24.00 in 1961. Though most investors were simply swept along by a blind faith in the inevitability of further capital gains, the rational basis for their behavior could only have been the expectation of a steady and substantial increase in earnings per share. The fulfillment of these heady expectations required not only high prosperity and rapid growth in the economy, but a brisk inflation as well.

By the end of 1961, a wide gap had opened between expectation and fulfillment.

2. The forces initiating the decline.

The decline began in mid-March.

Starting in the early winter, the press awakened to the remarkable stability of prices in the course of the recovery from the 1960-61 recession. This awakening led to the further discovery that the price level -- as measured by wholesale prices -- has been stable since 1958. The recognition that we have had no significant inflation in four years probably dawned on the investing public in the course of the winter.

On top of the crumbling of inflationary expectations, the economy suddenly slowed to a canter in the first quarter of 1962. The full statistical study of the disappointing January-February period was unfolded in the first half of March. Though the economy then began to pick

up steam, the January-February lull was probably enough to reverse the direction of a vulnerable market and to trigger a sharp drop.

3. The forces accelerating the tailspin.

A sharply declining market manufactures its own psychological fuel. Disappointment can lead to fear, and fear to panic. But in an atmosphere of collapsing optimism, external events can speed up the deterioration of confidence. Three such events were:

(a) The steel crisis -- which was interpreted as evidencing Governmental hostility to business and as foreshadowing policies which would limit business profits.

(b) The SEC investigation -- which weakened investor confidence in the integrity of brokerage firms.

(c) The gold outflow -- which was seen as a harbinger of dollar devaluation and thus -- contrary to logic -- as a bearish influence on stock prices.

In addition, the revision of Regulation Q, and the widely advertised competition between commercial banks and other savings institutions to attract deposits by offering higher interest rates, brought forcefully to the attention of small stockholders an attractive alternative to the risks of holding stocks -- i.e., the availability of yields of up to 4.8 percent in insured savings and loan accounts. There has in fact been an exceptionally heavy flow of funds into savings accounts this year.

CEA:5/29/62

Differences Between '29 and '62

1. The Stock Market

1. Margins: In 1929, margin requirements were not regulated by the Federal Reserve Board as they are today. Margins common in 1929 were much lower than today's 70 percent -- we will get the figures.

2. Security credit: Loans to brokers on the part of New York weekly reporting member banks were $6.8 billion in mid-October 1929. The current figure is $3.0 billion on a much larger value.

3. Investment trusts: In the 1920's there was much activity on the part of the so-called investment trusts. Their stock was bid up far above the portfolio value of the owned stocks. The collapse of the market meant a far greater loss to the owners of the investment trusts. Today's mutual funds are valued at portfolio value.

4. SEC: One of the results of the speculative excess of the 1920's and the sharp reaction in 1929 was the establishment of the SEC, which regulates brokerage activities and security practices. The current SEC hearings are an example of how this agency nips dubious practices in the bud.

5. Speculative excesses:

a. In 1929 the rate of interest at which "call money" could be borrowed for the market reached 20 percent per year as against 5 or 6 percent today.

b. During 1928, RCA (which had never paid a dividend) appreciated 500 percent.

c. We can get more examples of this sort.

6. Price earnings ratio: In August 1929, the price-earnings ratio of Moody's industrials was 17.5. Last December, the ratio touched 20.

CEA:5/29/62

Differences Between '29 and '62

2. In The Economy

1. Residential construction: In late 1929, housing had been declining for two years -- from $5.2 billion in 1927 to $4.8 billion in 1928 to $3.6 billion in 1929.

Today, housing has been rising for the past 15 months (with a brief interruption in January and February of this year.)

2. Consumption: Gains in consumer incomes slowed down in the late 1920's and consumer markets were further affected adversely by a spurt in personal saving.

Today, disposable personal income has been rising strongly during the expansion, and saving has remained about 7 percent of income.

3. Investment in plant and equipment was very strong in the late 1920's. In retrospect, it appears that investment was based on an expected rate of expansion of consumer buying that just wasn't in the cards. Consumer incomes were lagging because profits were so buoyant.

Today, excessive investment has certainly not been our problem. Investment policies for plant and equipment and inventories have all been very cautious in the present expansion. While we could use more zip in these areas, the caution certainly has helped to insure us against any excesses which might lead to an investment collapse.

4. The direction of the economy: The stock market crash in 1929 came two months after recession began. Industrial production, e.g., peaked in July and fell over 3 percent by October. The Babson Index of business activity fell 7 percent from June to October. As a British economist, Thomas Wilson put it:

"…there were signs of recession before the stock market crash and the latter was not merely the nemesis of speculative excess; it reflected, in the main, the change which was already apparent in the industrial situation…"

Today, all major segments of the economy are moving up.

5. Foreign economies: Much stronger today (data forthcoming).

CEA:5/29/62

Differences Between ’29 and ‘62

3. The Shock Absorbers in the Economy

a. New Deal reforms of our financial system -- deposit insurance, government credit agencies, loan and mortgage guarantee programs, and the regulations of the SEC -- have insured the economy against the aggravating influence of bank failures, foreclosures, and defaults on any possible economic decline. (Even in “good years” like 1927-29, there were 500-670 bank “suspensions” per year involving deposits of $140-230 million.)

b. In recessions, our fiscal stabilizers -- through rising unemployment compensation and social security payments and falling tax collections -- support incomes of consumers, increase deficits, and cushion declines. And we benefit from improved understanding of how spending is influenced by budget deficits. In 1929-33, the push to balance the budget intensified the decline.

c. Larger government budgets today -- stabilizing influence.

CEA: May 29, 1962

Basis for Confidence: Strength of the Economy

The stock market decline is not associated with weakness in the economy. The recovery has been a good one so far and prospects for continued economic expansion remain very favorable.

1. The record of recovery

a. GNP rose 9.5 percent from first quarter 1961 to first quarter 1962 -- from $501 billion to $548 billion. (In constant prices, an 8.1 percent rise.)

b. Industrial production rose 15 percent from February 1961 to April 1962.

c. Personal income increased almost 7 percent from first quarter 1961 to first quarter 1962.

d. Labor income increased over 10 percent from February 1961 to April 1962; corporate profits before taxes rose by about one-third from the first to fourth quarters last year.

e. The unemployment rate fell between February 1961 and April 1962 from 6.9 percent to 5.5 percent. Some 1,300,000 more workers have jobs today than a year ago.

f. The wholesale price index is lower today than it was last February; the consumer price index has risen only about 1 percent.

g. The balance of payments deficit shrank in the first quarter of this year to an annual rate of $1.8 billion against $6.0 billion in fourth quarter 1961 ($2.5 billion for 1961 as a whole).

2. Consumer and Business Confidence

Waning confidence in the stock market has not been paralleled by lack of confidence in the economy on the part of consumers or investors.

a. Consumer confidence. Retail sales expanded from January to April at an annual rate of 13 percent. Auto sales have been running at annual rate of around 7 million for several months -- a near-record level. Other durable purchases are less encouraging.

b. Investors' confidence. Dun and Bradstreet and National Association of Purchasing Agents surveys indicate that most businessmen expect further gains in sales and earnings this year. These optimistic expectations are reflected in investment and construction plans. The recent McGraw-Hill survey of investment institutions indicates investment plans for 1962 are 11 percent over 1961 levels -- better than the 8 percent Commerce-SEC survey of January and February. The F.W. Dodge forecast of construction awards in 1962 had to be revised upwards from November to March to show a 10 percent increase over 1961 rather than the 7 percent increase earlier anticipated. Housing starts figures are beginning to bear out these forecasts -- in April they rose to an annual rate of over 1-1/2 million units, the highest figure in nearly three years.

3. Grounds for Confidence about Continued Economic Expansion

a. Neither consumer nor investment expenditures have yet caught up to the flow of cash to consumers and corporations. Both consumers and businesses are financially primed for further expansion. In 1961 consumer holdings of liquid assets rose over $20 billion, while consumer debt rose only $1-1/2 billion. Similarly, corporate after-tax profits and depreciation allowances rose during 1961 by some $7-1/2 billion.

b. While total manufacturing and trade inventories at the end of March 1962 had risen 3.8 percent over their February 1961 level, sales had increased 10.2 percent over the same period. The resultant fall in the inventory-sales ratio foreshadows strength in inventory demand in the months ahead.

c. Monetary conditions have not tightened. The money supply is up substantially from February 1961 and bankloans increased from April 1961 to April 1962 by 8 percent. Long-term interest rates have been remarkably stable; yields on government bonds have

held steady; those on new corporate and municipal bond issues are at their lowest point since 1958.

d. Federal, State and local expenditures are all scheduled to rise throughout 1962. While Federal receipts will also increase, no precipitous fiscal turn-around is scheduled this time -- unlike the last recovery.

e. Still to come is the stimulative impact of the investment tax credit and the revision of depreciation guidelines. Together these will add some $2-1/2 billion to corporate cash flow in 1962 -- and give solid support to investment plans.

4. Questionmarks

The groundwork has been laid for continued expansion. But neither consumer nor investment activity has yet shown any real zip. Consumers are still maintaining their savings at near recession proportions. Business fixed investment has not risen as a share of GNP as it typically does in expansions. There is a lot of corporate liquidity -- but not enough urgency to spend in preparation for good times ahead.

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Possible Government Action

A. A Reduction in Margin Requirements

A reduction in margin requirements by the Federal Reserve Board under Regulations T and U is very much in order at this point. Following the precedent set in January 1958 -- and there is merit in following such precedent -- the reduction should be from the present 70 percent to 50 percent.

1. What it can and can't do.

A reduction in margin requirements will not produce any miracle. It will not directly stem the margin calls set off by the breaching of margin maintenance requirements which are set by the New York Stock Exchange at a minimum of 25 percent and by the brokerage firms themselves up to 40 percent. Nor will it directly counter the fundamental forces making for a re-evaluation of stock prices -- including the stability in commodity prices, the realization that technological change does not of itself assure ever-expanding profits to business firms, and the generally low stock yields relative to yields of fixed-value securities.

A reduction in margin requirements will assure the public that the Federal Government is concerned about the need for action -- and is now taking the one immediate form of action available to it. It will also serve the more modest, but still useful, purpose of stimulating some new purchases of stock with credit: bargain hunters would now be able to buy $100 worth of stock, by putting up only $50 instead of &70 of their own funds.

There is no other action by which the Federal Government can deal directly with the stock market. Psychological assurances can go only so far. And while expansionary economic measures -- whether through general monetary or fiscal policy -- are vital for dealing with sluggishness in output and employment, their beneficial effects via the stock market are clearly of secondary importance.

2. Risks of action versus risks of delay.

Like all economic policy actions, a reduction in margin requirements could have some adverse impact through the implied admission that things are bad enough to require action. However, to delay action might have even worse consequences. Postponement of margin reductions could build up public pressure for action if the market slide continues. If such a reduction is to take place, it can surely do the most good now, not later when more rampant pessimism might dull its favorable psychological effects.

3. Past experience.

Since margin requirements under Regulations T and U have been put into effect, the Board of Governors has reduced these requirements six times. It is not easy to disentangle the effect of these reductions from the many other factors at work in the stock market. For what it is worth, however, a simple test that compares the change in stock prices for the six months preceding the reduction in requirement with the six months following produces the following result: Each reduction in margin requirements was followed by either (a) an advance in stock prices or (b) a slackening in the rate of decline of prices.

A different choice of time periods could, of course, produce different results. And any test of this type fails to produce anything conclusive about the effects of the reductions in margin requirements themselves. However, this simple test at least serves the negative purpose of demonstrating that reduction in margin requirements are hardly fraught with peril. It lends support to the view that the risks of immediate action are outweighed by the risks of delay.

Possible Government Action

B. A Quickie Tax Cut?

A tax cut would be the most effective governmental action that could be taken in the present situation to support the economy and bolster consumer and investor confidence. With Congress still in session, it would be possible to push through the necessary legislation in a matter of weeks. This memorandum indicates briefly the major considerations involved in the implementation of a tax cut decision.

1. How quickly can a tax cut be put into effect?

The last time Congress was requested to take emergency tax action was during the first month of the Korean War. When hostilities began in Korea, the Senate Finance Committee was considering a tax reduction bill that had already passed the House. On July 25, 1950, the President requested the Finance Committee to substitute a tax increase of close to $5 billion for the tax cut. The Senate passed the revised bill on Sept. 1. All told, only 60 days elapsed between the Presidential recommendation and the date the bill became law. (Sept. 23)

If tax action is needed in the next few weeks, the best way to proceed is to amend the Tax Rate Extension Bill. The tax cut could be tacked on to this bill either in the House, or, somewhat later, in the Senate. The bill must be passed by the end of June, and there is no reason why the time schedule needs to be upset if a tax cut were tacked on to it, provided, of course, that the Congressional leaders would be convinced of the need for this action.

2. What form should tax reduction take?

A cut in income taxes would have the most immediate impact on private spending. In the present context, the cut should apply to both individual and corporate income, because it is essential to stimulate business as well as consumer spending.

A quick tax cut should be made in a form that would minimize questions of distributional equity. The best way to achieve this objective is to cut individual income tax rates across the

board by the same number of percentage points, e.g., by 3 or 5 percentage points. Each point in the individual income tax would cost $2 billion at an annual rate.

The corporate rate cut should apply to the normal tax of 30 percent, since small corporations do not pay the 22-percent surtax. Each point of the corporate normal tax would cost $500 million.

3. How much tax reduction?

If a tax cut is requested by the President, it should be large enough to provide a substantial stimulus to spending. A small reduction would give the impression that the Administration is undecided and timid. To meet these requirements, the tax cut should be between $5 billion and $10 billion at an annual rate. The following are some alternatives:

Amount of tax Reduction	Percentage-point reduction in: Individual income tax rates	Corporate income tax rates
$5 billion	2%	2%
$6 billion	2	4
$7 billion	3	2
$7.5 billion	3	3
$8 billion	3	4
$10 billion	4	4

4. Should the tax cut be temporary or permanent?

Consideration of a permanent tax cut at this time would trigger off a national debate which would delay enactment of the tax cut and also jeopardize the tax reform proposals scheduled for consideration next year. A temporary tax cut would give the Administration and the Congress the necessary flexibility to coordinate the proposed permanent tax reform with permanent tax reduction, i.e., the temporary across-the-board reduction could, in 1963, be translated into a permanent, more carefully tailored, tax cut.

Given the present calendar, it would be desirable to extend the temporary tax reduction until after Congress is in session next year, so as to give the President an opportunity to ask for an extension if necessary. A termination date of either March 31, 1963 or June 30, 1963 would seem to be most appropriate from this standpoint.