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Growth and Inflation

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Growth and Inflation

Growth and inflation are phenomena of special interest to investment analysts--but also to finance ministers, central bankers, economic planners, and professional academic economists, governments, and international institutions. For these individuals and many others, growth and inflation, as well as the relationship between growth and inflation, are of vital concern. They are also of vital concern to the man in the street--on whom the benefits and costs ultimately fall.

We have learned in the postwar years that neither growth nor inflation, nor the linkages between them, are simple matters. They are, in fact, exceedingly complex. Many a finance minister, economic planner, professional economist, not to mention investment analyst, has learned at great cost that popular rules of thumb regarding the inevitability of growth or inflation, or both, are likely to be spurious.

We have learned, for example, that bumper crops of babies do not assure economic growth; that old, tired, and apparently rigidified economies can spring to life and exhibit rapid growth (France in the past decade); that, although higher investment frequently leads to faster growth, it failed to do so in the United States in 1955-57 and subsequent years.

We have also learned to distinguish between demand-pull and cost-push inflation. We have seen that inflation can occur without either rapid monetary expansion or budget deficits and that budget deficits need not breed inflation.

Finally, growth can occur with and without inflation. And inflation can be accompanied by economic advance or by stagnation.

Simple, popular, and comforting rules of thumb on these complex matters are quite unreliable.

What are the inflation and growth implications for the analysis of stock market valuations? To discuss this question, I will border on your area of special competence, but I have no intention of attempting to talk with you on questions of judging the market. I fully realize that many intermediate fluctuations in stock prices are related mainly to shifts in investor psychology and to short-run business cycle developments where knowledge of individual stock and industries is indispensable to a profitable operation and position. But it also seems clear to me that the general level of stock valuation is in the long run dependent upon the total economic environment, and that the particular mix of growth and inflation projected by market participants has relevance to that valuation.

First of all, it seems readily apparent that the popularity of common stock investment in recent years has rested in part on the widespread assumption that equities provide at least a partial hedge against inflation. The presumption is, of course, that corporate profits as well as product prices will tend to rise during periods of inflation, while the income from fixed dollar investments will suffer directly from any decline in real purchasing power. But it is also evident that a basic motivation for buying and holding equities has been and continues to be the chance to participate in the economic growth of the nation, its leading industries and companies.

These two aspects of investor rationale have in practice become so intermixed that it seems impossible to separate their relative influences on recent levels of market valuation. Usually the inflation argument has been heard as a generalized inducement to equity investment, while the prospects for growth have been associated with the analysis of specific industries and firms. But I believe that the extent to which expansion in a company's sales reflects real growth rather than price inflation should make a great deal of difference to its stockholders. In short, the prospects for real growth should induce far more sanguine expectations than the automatic consequences of inflation.

Among the numerous analytical "explanations" of the level of stock prices is the view that the prices prevailing at any time are basically a reflection of the forces of supply and demand. In this concept, net additions to the market supply of equities, resulting from new issues and also from portfolio reductions by present holders, are matched against the volume of funds likely to be supplied by the major participating investor groups. But this simple aggregate concept conceals a wide variety of factors.

On the supply side, for example, are the needs for external financing and the institutional rigidities, such as the demonstrated hesitance of established corporations to issue new stock and the reluctance of individual stockholders to realize long-term capital gains and incur taxes thereon. On the demand side, in addition to immediate business prospects and market psychology, are longer-run developments such as the rapid growth in market participation by institutional investors and the enhanced attractiveness of equities generally, in the less volatile postwar economy.

Such considerations as these are usually cited to help explain the dramatic upward revaluation of stocks which has occurred in the course of the postwar period. This may be a substantially correct interpretation, but it is important to note that a continuation of current valuations would depend upon an additional assumption--that the changed supply-demand situation is permanent. But what if corporate managements come to look more favorably on stock issues as a supplement to capital, as debt to equity ratios continue to mount? And, on the demand side, there is always the possibility that investors may become increasingly attracted to alternative outlets for funds, if yield relationships favor these and if prospects for growth do not appear sufficiently promising.

In terms of current return, it is clear that the relative attraction of equity investment has declined substantially over the postwar period. Thus, dividend yields on average dropped from nearly 7 per cent in 1950 to less than 3 per cent in 1961 and not much more than that currently. During the same period, interest yields on top quality corporate bonds rose from under 3 per cent to 4-1/4 per cent or more in recent years. Bond yields have, in fact, consistently exceeded stock yields for nearly five years, often by a full percentage point or more.

If the yield on equities is stated in terms of total earnings, on the theory that reinvested income will sooner or later accrue to the benefit of the stockholder, the comparison with bonds has been more favorable. But even here, the earnings yield ratio dropped from 15 per cent in 1949 and 1950 to below 5 per cent in 1961; it is currently well under 6 per cent, based on record fourth quarter 1962 earnings. Some investors seem to have come almost to prefer that earnings be retained rather than paid in dividends, because of the tax advantages of taking income in the form of possible price appreciation rather than current dividends. Still, I think we would agree that some discount should be made in earnings yields, on the grounds of volatility and uncertainty as to the timing and size of the benefits to be realized from funds retained in the business.

Whether one relates stock prices to dividends or to total earnings, then, equities have become substantially more expensive over the postwar period. The implication would seem to be that stocks were either a very good buy 15 years ago, or that they are relatively dear now. Alternatively, there may have been some basic intervening change in the relative attraction of equities as against other investments. I do not propose to speculate which proposition is the more nearly correct--perhaps each has some degree of merit. The point of the exercise is simply to demonstrate that stock valuations at any time rest upon the market's assessment of the future as well as of the present.

The unique attribute of equities, as contrasted with bonds and savings accounts, is the latitude for future changes in the rewards investors may receive. The fact that dividend and earnings yields have dropped so substantially, both absolutely and in relation to the interest returns available on fixed dollar investments, must mean that the market anticipates significant future growth in returns on equity, either through increased dividends or price appreciation. But with the average dividend payout at 60 per cent and stock prices at about 18 times current earnings, there would seem to be relatively little room for further liberalization. Therefore, this must mean that a sizable advance in corporate earnings is expected over time.

Profits fluctuate widely over the business cycle, and so one's assessment of earnings prospects depends partly on the stage of the cycle he believes the economy is in. And since profits are related to rates of capacity utilization, which are currently still below optimum levels, there is a presumption that full economic recovery would bring more than proportionate earnings gains. Abstracting from these cyclical factors, however, I think it is reasonable to assume that any substantial uptrend in earnings over time would require proportional or larger increases in the dollar volume of sales. Competitive innovations and improvements by individual companies might tend to raise total earnings relative to sales, but a sizable general increase in profit margins would appear quite unlikely on the basis of historical precedent.

Given the market's implied assumption of a substantial long-term uptrend in sales volume, does the particular mix of real growth and inflation which produces the expansion make any difference to stockholders? I think that the record shows it does. In the strongly inflationary periods associated with wars or other major economic upheavals, equity owners do seem to have benefited. Thus, corporate profits after taxes more than tripled between 1940 and 1948, reflecting a 40 per cent advance in the real GNP and an 80 per cent increase in the prices of goods and services embodied in this measure. Though submerged for a time by price and wage controls, this is a clear case of the classic inflation environment, where the total demand for goods and services far exceeds the nation's ability to produce and where wartime financing had provided the liquid assets to fuel this excess demand.

But the kind of inflation experienced after 1951 in the United States has not reflected inordinately strong aggregate demands or clearly excessive increases in purchasing power. This more recent brand of inflation appears to result more from structural problems. These include not only the strong upward bias in wage settlements, but also the persistence and growth of inefficient organization, the resistance to price and cost reductions even in declining industries, and the development of temporary supply-demand imbalances in strategic areas. Such factors tend to increase unit costs of production, putting upward pressure on average prices even though total production capacity may be sufficient. In such an environment, the impact on profits is more likely to be downward than upward, despite sizable increases in the dollar volume of sales.

To support this assertion, I refer to recent United States history. In the period since 1955, we have experienced a slowing in our average rate of real economic growth, but the first part of this interval was marked by some price inflation while the latter part has witnessed reasonable price stability. What has the changing growth-inflation mix done to profits? Both from 1955 through 1957 and from 1959 through 1962, the dollar volume of the nation's output of goods rose by about one-tenth. In the earlier period, however, only 30 per cent of this increase reflected real growth, while in the latter period real growth contributed nearly 80 per cent. And, for the Standard and Poor's index of 425 industrial stocks, after-tax earnings per share <u>dropped</u> 7-1/2 per cent between 1955 and 1957, while in the 1959-1962 period they <u>rose</u> by a like proportion.

The real reasons for this difference in performance, of course, lie behind the behavior of the price indexes. In the 1955-57 period, the forces of vigorous national and international competition were emerging for the first time in the postwar economy. But we were not fully aware of the implications of this; business permitted costs to rise substantially, and was then able to pass only part of the increase along in price markups. In the later period, vigorous competition ruled throughout and cost increases were moderated.

For the nation, the price of this belatedly recognized lesson in economics has been to contribute to an environment in which our resources have been inadequately utilized. At the Federal level, changes in the level and structure of taxation and special remedial programs in the key problem areas are clearly indicated. But success is also likely to depend upon continuing close attention to costs and competitive relationships by the business community, and upon a willingness to undertake investment opportunities as they are recognized.

For the stock market, the lesson of our recent experience--as evidenced by the sharp break in prices a year ago--is to avoid the easy assumption that stock valuations will sooner or later be validated by inflation. Just as in the review of individual securities, a careful analysis of the forces affecting our economy is required to provide a sound basis for over-all market evaluation. I am confident that any such analysis will show that the stock market has as much of a stake in the achievement of vigorous, healthy economic growth as does any other sector of our economy.

The stock market has recovered strongly in recent months, and prices are now within 5 per cent of the previous peak reached in December 1961. I hope that this recovery has been based upon renewed investor confidence in the nation's prospects for more vigorous growth, rather than on the assumption that generalized inflation will prevail. The United States economy today will not readily support any appreciable degree of inflation, and I strongly doubt that it will do so in the foreseeable future. But even if an inflationary trend were to resume, it is a moot question whether its composition would be likely to provide fundamental support to stock market valuations.