Research Department
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How Now, Dow Jones?

Bears rampaged through Wall Street's canyons during most of 1973, but a few bulls began to emerge late in the year as it became apparent that the world had not yet come to an end. The market climate then brightened a bit more on the first business day of the new year, as the Federal Reserve reduced margin requirements on stock purchases.

Over the past year, the Dow Jones industrial index fell 16.6 percent, and the broader-based (500 stock) Standard and Poor index dropped 17.4 percent, while even sharper price declines were recorded by other market indexes. Most market analysts expect a significant recovery in 1974. But despite recent gains, Wall Streeters are still adopting a tentative view of market prospects, partly because of the nation's continuing economic and political problems, and partly because of certain industry problems which come under the heading of the two-tier market.

Falling margins

The shift in margin requirements has provided some recent stimulus to the market. With the requirement now lowered from 65 to 50 percent, each stock purchaser may borrow up to one-half of the price of his stock while paying cash for the rest. This is the lowest point the requirement has reached in the past decade—lower than in the 1969-70 market break, for example.

The Federal Reserve raised margin requirements in late 1972 (from 55 to 65 percent) on the heels of a credit-fueled upsurge in stock buying, but it faced a completely different situation in late 1973. After eleven consecutive monthly declines, the level of margin debt at brokers and dealers fell 31 percent below the December 1972 peak, to $5.5 billion. As in earlier market slumps, much of the decline in debt was due to the heavy flow of margin calls from brokers, and to the inability (or unwillingness) of customers to put up additional cash, leading to the liquidation of their positions.

In recent decades, each reduction in margin requirements has been associated with a rise in stock-market credit, and ultimately with a rise in stock prices, although sometimes with a considerable lag. Margin requirements were cut in January 1958, July 1960, July 1962, May 1970 and December 1971, and in each case the end result was a sharp reversal of the previous downward movement of credit and stock prices. Of course, other more important factors were present in each case, including a general easing of credit conditions.

Falling prices

A year ago, most analysts forecast a strong stock-price trend in 1973, and they were all proved wrong as one unexpected shock after another overwhelmed the U.S. economy.

(continued on page 2)

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There were the many uncertainties surrounding the price-control program, and in addition, there were (chronologically) Watergate, Equity Funding, the shift of Vice-presidents, and finally the Middle East war, with its exacerbation of the energy crisis. But perhaps the most basic problem was the unexpected upsurge in domestic and world prices, which necessitated a tight-money policy response.

The severe bear market developed in the face of an upsurge in corporate profits, such as would normally have supported an uptrend in stock prices. However, investors' fears about the impact of price controls and other uncertainties on future profit levels obviously offset the favorable impact of current earnings reports. Expectations of future returns always influence what investors are willing to pay, but so many discontinuities affected the 1973 market picture that normal investment yardsticks became suspect.

In addition, the upward push of inflation on interest rates forced investors to reconsider the level of returns that they should expect from holding stocks. These returns over the long run have worked out to about 9.5 percent annually, including both capital gains and dividends, but in 1973 this level may have been inadequate compensation for the added risks of holding stocks. Related to this factor was an unsatisfactorily low level of dividends; until the June liberalization of dividend ceilings, dividend increases were limited to 4 percent annually, considerably below their long-term average increase as well as the current rate of inflation.

Another drag on the market was a plethora of new issues, partly caused by the heavy debt burden of many firms and their consequent inability to go the debt-financing route. Corporations raised $9.2 billion (annual rate) in equity funds in the first half of 1973—not far below the levels of 1971 and 1972, and roughly equal to the total amount raised in the entire 1966-70 period. Equity financing declined in importance in the second half of 1973, however, as many firms withdrew or postponed new stock issues because of what they considered unrealistically low valuations placed on their stock.

Prices and tiers

The decline in the major price indexes was severe in 1973, although not as bad as the 1969-70 slump. For example, the Standard and Poor index dropped 17.4 percent during 1973, compared with a 28.6-percent decline during the 1969-70 bear market. But the dollar-weighted averages tell only part of the story. Altogether, 1,278 of 1,481

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issues on the New York Stock Exchange dropped in price, and almost half of them lost 40 percent or more of their value; 1,052 of 1,155 issues on the American Exchange declined, and over two-thirds of them lost 40 percent or more of their value. A simple average of all NYSE stock prices was already one-third below its earlier (1968) peak level when the Dow and S&P indexes peaked in January 1973, and at the low point it was about three-fifths below the 1968 peak.

This situation gave rise to considerable press and Congressional comment. The problem reflected the nature of the two-tier market, with price weakness in the overwhelming number of stocks and strength in only several dozen institutional favorites. Those favored few "Vestal Virgins" were the ones which "everybody"—that is, the major institutional investors—happened to be buying, to the exclusion of hundreds of other stocks. The institutions (bank trust departments, pension funds, insurance companies, mutual funds, etc.) control about 50 percent of all U.S. stockholdings and account for 80 percent of all trading.

Hardly had the two-tier thesis been accepted, however, than it appeared to be discredited, since by year-end the Vestal Virgins began to look somewhat shopworn. The price of IBM ("everybody's" favorite stock) dropped from a high of 340 to a low of 235 during the year. In addition, over two-thirds of a list of 30 major growth stocks—many of which had increased 5 to 10 times in price during the 1960's—dropped significantly between the end of 1970 and the end of 1973. Indeed, only six stocks on that list recorded substantial price increases over that three-year period.

At the very least, the market during 1973 witnessed substantial shifts from tier to tier. Throughout the tumultuous year—especially during the late-year energy crisis—a change in investment strategy appeared to develop, as institutions and other investors searched hard for an "energy play." They pumped substantial funds into domestic oils, coal, rails, metals and firms making power-generating equipment, meanwhile pulling their funds out of import-dependent oils, builders, retailers and firms dependent on gasoline usage (hotels, campers, boats and fast-food franchisers). Aluminum and copper firms advanced as domestic and worldwide shortages developed for their products, and gold- and silver-mining stocks also did very well, reflecting the international monetary turmoil and investors' doubts about the health of inflation-ravaged currencies.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/26/73	Change from 12/19/73	Change from year ago	
			Dollar	Percent
Loans adjusted and investments*	78,601	+ 365	+8,855	+ 12.70
Loans adjusted—total*	60,043	+ 443	+8,706	+ 16.96
Securities loans	1,385	− 25	− 737	− 34.73
Commercial and industrial	20,846	+ 270	+3,099	+ 17.13
Real estate	18,158	+ 27	+5,823	+ 38.76
Consumer instalment	8,995	+ 36	+1,267	+ 16.39
U.S. Treasury securities	6,202	+ 45	−1,012	− 14.03
Other securities	12,356	− 123	+1,161	+ 10.37
Deposits (less cash items)—total*	74,241	+ 839	+6,822	+ 10.12
Demand deposits adjusted	22,407	+ 623	+1,165	+ 5.48
U.S. Government deposits	1,013	+ 197	−6,201	− 85.96
Time deposits—total*	49,630	+ 200	+5,793	+ 13.21
Savings	17,378	+ 24	− 848	− 4.65
Other time I.P.C.	22,476	+ 151	+5,426	+ 31.82
State and political subdivisions	69.92	+ 184	+ 734	+ 11.73
(Large negotiable CD's)	10,699	+ 18	+3,732	+ 53.57

Weekly Averages of Daily Figures	Week ended 12/26/73	Week ended 12/19/73	Comparable year-ago period
Member Bank Reserve Position			
Excess reserves	115	24	− 30
Borrowings	172	166	108
Net free (+) / Net borrowed (—)	− 57	− 142	− 138
Federal Funds—Seven Large Banks			
Interbank Federal funds transactions			
Net purchases (+) / Net sales (—)	+1,804	+1,653	+ 936
Transactions: U.S. securities dealers			
Net loans (+) / Net borrowings (—)	+ 491	+ 180	+ 544

*Includes items not shown separately.

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