THE WAR ECONOMY AND STOCK VALUES

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When the Korean crisis burst upon us last June, Wall Street analysts rightfully began to forecast a near-war or full-war economy, complete with price controls, at least some rationing, and a heavy excess profits tax. Granting that the volume of business would be tremendous, they still were inclined to anticipate a serious reduction in corporate net after taxes. This prospect, combined with the war situation itself, led to widespread predictions of lower stock prices.

STOCK MARKET HAS GONE UP

The stock market, proceeding with its usual disregard of the majority views of experts, has gone up instead of down in the past six months. By this behavior it has displayed two characteristics hitherto rather foreign to the security exchanges. The first has been the absence of panicky or deeply pessimistic reactions to international developments of the most disquieting sort. We cannot ignore the fact that the United States faces the new and harrowing danger of large-scale physical destruction and civilian casualties of inestimable magnitude. This possibility would justify—by past traditions it would almost demand—a severe and prolonged case of jitters among both speculators and investors. Secondly, the market seems to have been subordinating medium-term to really long-term considerations. For it is fair to assume that the recent rise in stock prices has reflected essentially the public's conviction that a war economy is an inflationary economy, and that, *in the long run, inflation means higher average prices for common stocks.*

GIVES RISE TO TWO QUESTIONS

This interpretation of the recent course of the market gives rise to two questions: First, is the long-term bullish view of stock values a valid one? Second, even if it is, how did it happen that stocks have been acting in a response to this view, instead of giving way first to short-term pessimism and even to panic? In this short article I shall try to find answers to these two questions.

Historically the broad pattern of war—with which this generation is now all too familiar—is that of inflation followed by deflation. The inflation may be "contained" by rigid controls during the period of hostilities, as it was during World War II and is likely to be during the present imbroglio. But, at the war's end, controls are relaxed, and then the pressures generated by deficit financing are likely to vent themselves in an explosive rise of general prices. War weakens and cheapens the dollar—especially if it is a paper dollar.

Is it not reasonable to expect that stock prices as a whole must rise, sooner or later, to reflect this cheapening of the dollar? The course of the stock market from 1900 to date shows a fairly close *over-all* correspondence between the rise in stocks and in general prices, although there have been significant divergencies for fairly long periods. Business has been able to adjust itself not too badly to higher costs, notably higher wage scales, and even to a progressively increasing burden of income tax. But the combination of a sharp increase in the normal tax rate plus a drastic excess profits tax now appears certain to reduce corporate earnings below the average of recent years. Thus not only is it easy to imagine the tax take rising to a level that will prevent corporate net from keeping pace with inflation but also one can even envisage a decline in earning power, despite an ostensible increase in the value of business assets. Since earnings have a far greater influence on stock prices than have asset values, such a development would apparently justify a bearish view on the long-term course of the stock market.

WEIGHT OF PROBABILITIES

That war conditions *could* be destructive of stock values is hard to deny, but the mere possibility proves nothing of significance. It is the weight of *probabilities* that we are interested in. In reflecting on this question, we would do well to start with past experience. We have been unfortunate enough to have undergone two world wars in our own lifetimes; the least we should have to show for this travail is some added knowledge and perhaps some access of wisdom. It is fashionable to insist that a third world war will be completely different in its economic impact from the first two. This is a statement that requires proof. In its absence, it is better to take our cue from what has gone before.

EARNING POWER WAS HELD DOWN

During World War II, the earning power of our leading companies was held down by price controls, renegotiation, and the excess profits tax. Nevertheless the Dow-Jones industrial unit averaged earnings about 20% higher than in the prewar period. Secondary or smaller companies showed, in the main, a much larger expansion of net profits. The *postwar* earnings of business as a whole proved unexpectedly large and well maintained. Conservative analysts, who allowed for a considerable falling off of long-term profits from the 1946–50 rate, were still compelled to assume a new plateau or average for earning power at least 50% above the 1936–40 figure. Thus for the Dow-Jones unit there was a tendency to estimate average peacetime profits at about $15, against $9 odd in the prewar years.

The average price of the Dow-Jones unit in 1936–40 was 135; in 1946–50 it was about 180. My own calculations of its central value (made as of 1947) set it at about 215.

If this over-all pattern is assumed to hold good for the looming war economy, we should then anticipate the following: (1) restricted but substantial earnings during the period of mobilization or hostilities, (2) an appreciable rise in the basic dollar earning power in the next

postwar period, as against the prewar "normal," (3) irrational or at least unpredictable fluctuations in stock prices in the next few years, (4) no sound reason to believe that stock *values* would be diminished by war conditions, (5) persuasive reasons to expect that the ultimate central level of stock values would be well above our recent calculations.

SOME ACTUAL FIGURES

Some of the actual figures relating to the Dow-Jones unit will point up our conclusions. For 1946–49, the earnings before taxes averaged about $30, leaving about $18 after taxes. At the end of 1950, they appear to have been running at a rate as high as $60 before taxes and more than $30 after taxes. The present maximum overall tax rate is 62%; in World War II, it was 72%. If we assume wartime earnings before tax of, say, $50 per unit, and an effective over-all tax of 70%, then the unit would show net profits of $15—the same figure that was projected for average peacetime earnings after 1945. If a "normal multiplier"—related to the interest rate and the quality of the Dow group—were applied to these earnings, the result would about support the initial price level of 1951. Actual figures would probably be better than this projection. Though the effective tax rate may well rise above 70%, the earnings before taxes are also likely to exceed $50 for the unit.

TAX SHELTER FOR RAILROADS

The excess profits tax shelter now accorded the railroads, coupled with their heavy traffic, give them possibilities of fantastically high net profits. This situation is too favorable to last, but it seems likely that the principle of tax preference will remain to their benefit, as it has for oil and mining companies through many changes in the scale of rates. The public utilities are not likely to be war beneficiaries; but they too have been given a tax shelter, and the stability of their earning power does not appear seriously threatened.

The calculations just made reflect wartime business activity rather than war-induced inflation. Judging from the past, most of that inflation will be experienced when peace is restored. No one has enough foresight to project the economic conditions that will confront us then, but I believe enough in logic to predict that stock values will stand up better than the value of the paper dollar.

THE PRICE LEVEL, ASSET VALUES, AND EARNING POWER

The pessimistically minded can easily conjure up a picture of high wages and crushing taxes, which together will hold down corporate profits to a figure "lower than any assignable quantity," in spite of an extremely inflated general price level. It should be pointed out that such a result would be incompatible with the American system —which, in spite of growing governmental controls and other obstacles, has remained essentially one of free *investment choices*. The core or keystone of that system is the voluntary investment annually of huge sums in additional capital goods. Large-scale commitments of this kind will be made continuously *only* if the existing capital investment by and large is showing an adequate profit. This profit, in turn, must be measured to some degree against the *replacement value* of the existing plant. In other words, an inflated price level, which raises the replacement cost of capital goods, must needs reflect itself also in a corresponding increase in the dollar profits produced by past investment.

RELATION OF ASSET VALUES AND EARNINGS

This relationship between asset values and earning power is neither precise nor uniform. In fact, the variations in earnings on invested capital are so extraordinary as to suggest that the idea of *any* relationship is a fallacious one. But, when the economy is viewed broadly, we can see that large-scale new investment presupposes adequate earnings on the *composite* or the *typical* old investment. In fact, we may suggest the rule that, as the quantity of annual new investment increases, the relationship between the earnings on old capital and the earnings on new capital tends to become closer and more logical.

ENCOURAGEMENT OF NEW INVESTMENT

The emphasis by Government on maintaining full employment makes the encouragement of new investment a primary element of state policy. This in turn sets practical limits to governmental interference with the making of a "fair rate" of profit after taxes. Here we may have in part the explanation of the paradox that, while American business was complaining in recent years about the hostile attitude of Washington, it was registering the largest recorded rate of earnings on invested capital, computed at original cost.

CONCLUSION

Our conclusion is that the public is instinctively right in its present emphasis on the inflationary aspects of the developing war economy, and its consequent bidding up of stock prices just when the rule book called for near-panic selling. It is interesting to conjecture why investors and speculators are acting logically in the present crisis, whereas under similar conditions in the past they have been dominated by the more obvious psychology of fear. Let us venture the suggestion that what we are witnessing is the maturing of inflation consciousness, which—by an awkward but not too surprising coincidence—is about contemporaneous with the maturity of the first Series E Savings Bonds. There can be such a thing as a panic to buy as well as a panic to sell. The stock market since last June is far from resembling a "buyers' panic"; but the definite signs all around us of uneasiness concerning the value of the paper dollar, and of investments tied to the dollar, suggest that a definitely new guiding force is entering into the psychology of the investing public.

The spectacular and ill-fated New Era stock market of the 1920's began about 1924 with an analogous and quite soundly documented realization of the long-term superiority of stocks over bonds. Other conditions, however, were as different from today's as one could imagine. Perhaps that is a good reason for repeating the French maxim that was made to order for Wall Street: "The more it changes, the more it's the same thing."