

# THE STOCK MARKET TODAY: NOT YOUR FATHER'S CORRECTION

By Marcus W. Robins

Although there are some interesting parallels, things are considerably different today compared to what they were in the early 1970s.

Anyone who suffered through the rising inflation, high interest rates, falling employment, and stock market losses of the early 1970s may very well fear that the U.S. is heading into another period that will be just as awful and just as devastating for stocks.

But history doesn't always repeat itself. Value investors take comfort from the history books—there are big differences between today's market and the one in the early '70s.

## REASONS FOR DOUBT

One really must understand what economic conditions were like then and how pessimistic sentiments were throughout the nation. In 1974, we had endured the culmination of world and national political disasters as well as a reversal of economic fortunes that could only be ranked as one of the three worst in the 20th century.

For starters, the Vietnam War had just ended, and the disgrace and turmoil of the defeat leveled a blow to our populace that couldn't have been imagined. The discredit to our armed forces was so great that almost 20 years later on the eve of the Iraqi assault, many of those who remembered that earlier time believed our forces were unable to win a battle even against a third-rate dictator. Indeed, the Dow Jones and Standard & Poor's 500 both topped on nearly the last day of action, ending a 2½-year rally that started in 1970 and only slightly outreached the peak set in 1966.

As we started to shake off the sting of that sad chapter, the Arabs levied an oil embargo in 1974 that forced Americans to pay incredibly high prices for gas at the pump. Even more humiliating was enduring ration lines on even or odd days to receive what little gas there was to buy. Not since World War II had this condition been experienced, and it certainly riled the citizenry more than any hardship brought on by war efforts.

The last insult that the country suffered during the same period was the disgrace surrounding the Nixon White House in the wake of the Watergate break-in and subsequent subterfuge. Newspapers and broadcasts poured out article after article filled with gruesome details about the many misdeeds, controversies and guilty parties—tainting the entire Washington political arena. (Its mesmerizing effect was similar to that of the O.J. Simpson trial, the Whitewater scandal or the Clinton Oval Office fiasco.) The worst part was that it left the entire country feeling that we weren't the nation of good guys with white hats anymore, and the loss of that John Wayne self-image seemed to drive Americans into a bottomless funk.

To top it off, the economy was in one of its worst declines of the century, which impacted the stock market and drove the Dow Jones to record one of its greatest losses in its history—from about 1,000 at its peak in early 1973 to its low of 550 late in 1974.

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*Marcus W. Robins is president and editor-in-chief of The Red Chip Review, a newsletter that focuses on smaller capitalization firms; 519 SW 3rd Ave., Suite 400, Portland, Oregon 97204, 503/241-1265; 800/733-2447 or visit the Web site at [www.redchip.com](http://www.redchip.com).*

## WHAT'S DIFFERENT NOW?

To place things in perspective, I would like to remind readers about today's conditions. The latest indication from the Federal Reserve is that gross national product (GNP) is running about 1%, which at least indicates that our economy is still in positive territory. Unemployment has just been reported at a still-low 4.3%, up one-tenth of a percent from the previous month. Inflation is 2% to 3%, with interest rates ranging from 4.0% to 5.5%.

Back in 1973 and 1974, inflation was running rampant. It popped from the very stately levels of 2% to 3% during the early to mid-1960s to over 7% in 1974. Years of "guns and butter" policies had had its way with our economy, and now it was time to suffer the consequences. Inflation was such a national problem that President Gerald Ford, when he reached the White House, came up with the WIN (Whip Inflation Now) button in an attempt to use the power of presidential office to persuade citizens not to raise prices or accept higher wages. Federal Reserve Chairman Arthur Burns tried the same medicine that Paul Volcker would successfully employ in the early 1980s and increased interest rates dramatically to slow the economy and drive wage and price inflation out of the system. The result was a very negatively sloped yield curve, which halted investment and slowed the economy. The prime rate, which back then was the best-recognized rate indicator that business watched, rose to 12%. Long-term bonds rose dramatically as well, with long Treasuries increasing their yields to over 7% and triple-A corporate credits peaking above 8%.

Unbelievably, the GNP of the nation had dropped from robust growth experienced during the prior decade to a decline of 3% to 4%. Probably the most disturbing economic factor was the increase in unemployment, which surged beyond 8%. This is nearly twice the

level of the latest government statistic.

You also have to keep in mind that the degree to which unemployment affected families in the early 1970s was economically more brutal. Today, with unemployment at 4.3%, this measure of folks *out of work* really needs to be compared with the adult population that is *in* the work force. Although we may still see "help wanted" signs despite the softening economy, the percentage of the population of adults in the work force is in the low 70% level. Translation: Most men and women who want jobs are in positions that they find satisfactory. Back 30 years ago, the 8%-plus unemployment level was comparable to an employment level at the low 60% level.

## BARELY HALF AS BAD

My point is this: We have enjoyed a string of nearly uninterrupted economic and equity market gains over the last decade. This wonderful experience is very similar to that enjoyed during the 1960s. Stock prices have also enjoyed appreciation rates heretofore unknown by professional and individual investors. As the reality of life began to catch up with the aura of nirvana 30 years ago, as averages regressed back toward their mean (that's how economists like to express less-than-glorious good luck), the economy, personal income, and the stock market were less attractive, and the nation experienced a very hurtful recession and downdraft in the market.

Although there are some interesting parallels, things are considerably different today compared to what they were in the early 1970s. Yes, the market today has really taken a whacking—particularly the new "Nifty Fifty" stocks that are now down substantially from their highs; stocks that ended with ".com" have dropped from the sky like those of 30 years ago that either ended with "x" (For instance, Xerox, Tektronix,

Ampex), or had the term "rocket" in their names (Rockcorp, Rocketdyne); there is an energy shortage with high fuel prices; inflation, interest rates, economic growth, and unemployment seem to be going in the wrong direction. But not really.

The differences are really substantial this time around. Inflation, interest rates, and unemployment are half what they were 30 years ago. The economy is slower, but not grossly negative like it was. In addition, the U.S. corporate productive capacity is far leaner and more quality-oriented and efficient than it was, and we are exiting a period of strong capital spending rather than entering a period of capital asset neglect as experienced throughout the remainder of the 1970s and into the next decade.

There is also a substantial difference in the shifting demographics during the two periods—a factor that has great impact on economic growth. Women were really coming into the workplace 30 years ago, and the economy experienced a meaningful updraft of young workers that had been released from the war effort. Combined, this diverted capital investment from steel plants and roadways to office space, desks, and business machines.

The real point here is that those who entered the workforce 30 years ago are now seasoned employees. The World War II baby bulge is now in the most productive period of its life. We have established our professions as well as our homes, families, and futures and are now saving for our children's education or our own retirements. This means an effective, prosperous, and frugal bracket of the population that is generating substantial income and funding corporate capital needs.

Incidentally, think about the implication of government surpluses now versus the damage of deficits during the past many decades.

## STOCKS: WHAT THIS MEANS

With all the various differences

between the two time periods, one outcome will be very similar—the shift in emphasis in the stock market. After the very hot market conditions experienced during late 1998, 1999, and the beginning of 2000, value investors, and particularly small-cap value investors, will benefit. Already we are seeing this area of the market outperform growth names and in particular the much-touted media favorites. A quick survey of small-cap investment managers shows that small-cap value funds seem to be keeping their heads above water versus their growth brethren.

Interestingly, the market had a similar experience back 30 years ago. After the tragic sell-off of the old “Nifty Fifty”—the end to an era of “one-decision stocks”—value names, and particularly small-cap value stocks did outperform for several years. And as always, as investors became more comfortable with raising equity prices, they began to

expect capital appreciation from the market and turned more and more to growth-oriented operations.

Indeed, the tough economic climate and poor market conditions of 1974 fostered the base of the longest small-cap rally—from 1974 to 1983—in the post-crash history of the market.

This time around, it will be similar, but with some meaningful differences. I really believe that a value orientation for the rally will last longer that it did in the 1970s—not just a year or two, but possibly four or five years of relative strength. Growth has been so overemphasized and the resultant crash in value so disastrous that, as in the early 1980s with biotech stocks, the market will most likely ignore the dot-com, IT, wireless telecommunications, and PC names for quite some time. There will still be a role for “special situation”

stocks just like in the past, but even more so.

From a “what works” standpoint, I think that we will see an even greater emphasis in the buyout arena—again, small-cap value names should benefit first off.

Right now, watch for strategic acquisitions from large companies that need added marketing punch from technology or product categories whose synergistic transactions will help make the first meaningful swings in market performance.

Then much later on, financial acquisitions will broaden and quicken the pace of activity.

All in all, while you may look unhappily at today’s market returns, especially compared to the eye-popping double-digits of recent years, this downturn is not in the same league as the truly devastating bear of the ’70s. In short, this is surely not your father’s market correction. ♦

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