EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS

Date: 8/4

To: The President

From: Walter Heller

Subject: Stock Prices

Here's a little memo responding to your question on the stock market.

THE CURRENT SPURT IN THE STOCK MARKET

The "Berlin Rally", as it is now called on Wall Street, has been led by aircrafts and electronics, a predictable and quite sensible reaction on the part of the market to the Berlin speech. Other issues, especially those cyclically-sensitive, are benefiting from the now widely diffused bullish sentiment, which was in the air previously but which has been crystallized since the speech.

In the weeks prior to the speech sentiment was much more divided than it is now. There were those who felt that the prospect of rising earnings and dividends plus the May-June correction of earlier speculative excesses would form the basis for a run-up in prices. But some brokers were peddling caution. Fears of a tax increase now, fears that prospects for a 1962 tax cut would come to nought, and a bad taste in the mouth from the declines which had been occurring since May all combined to strengthen the cautious camp. In the last two weeks, the bullish contingent has been rapidly gaining adherents, although the cautious campfire is by no means completely deserted, even now.

The following comments from this week's Wall Street Journal seem to sum up current feeling on the part of the majority:

"One leading stock market analyst said the sharp rise in stock prices in the past week marked 'an important and significant change in the attitude of the public toward stocks.' He explained that it reflected the hope of 'a more vigorous recovery in business,' following the Administration's call for additional men and arms to meet the Soviet threat while keeping tax rates unchanged. In addition, there's the belief such a program will cause renewed inflationary pressure. One analyst noted, however, 'any inflation is likely to be more psychological than arithmetical since there are no shortages.' He also minimized the possibility of scare buying because of war threats. Another analyst pointed to the sizeable gains among stocks that move up and down sharply with business, such as the chemicals, and asserted the rise was caused by the view that these issues would stand to benefit most from the projected upturn in business."

. . . .

"Optimism in Wall Street rose last week as the Dow Jones industrial average climbed steeply. But there are still analysts who, noting that the Dow Jones industrial average stopped rising last week when it reached the year's previous high, doubt it has embarked on a new stage of advance beyond its trading range of the last three months. . . . Others believe President Kennedy's report on Berlin brought home to many investors the already substantial bullish aspects of the trend in business. The new factor, of course, was the inflationary implication of stepped-up Federal spending without any immediate rise in taxes. But recent news had already shown general business to be in a favorable trend." (Italics ours).

> (This article goes on to review machine tool orders, electricity use, retail auto sales, all of which it finds encouraging. It also goes on to predict that dividends and the number of dividend rate increases may set records this year.)

It must be noted that the word "inflation" comes easily to the lips of Wall Streeters, and by some it is used almost as a synonym of "boom." They look forward to it with enjoyment, tinged with guilt. In the past two weeks, a few brokers have been fulminating about "a grand scale of lavish Government spending which must surely fan the smoldering fires of inflation" but much of the comment and most of the responsible comment has stressed the existence of ample excess capacity and the unlikelihood of a repetition of the Korean scramble for inventories and consumer goods. The associate editor of the Journal of Commerce went so far as to headline his front-page column "Budget Deficit Need Not Be Inflationary," (August 1), a very radical departure for a paper catering to the business and financial community.

Of course, even if Wall Street did anticipate inflation, this does not mean that we should anticipate it. Regardless of the season, the phase of the business cycle, or the phase of the moon, the market for clouded crystal balls is always brisk in lower Manhattan. The day before the Berlin speech the Wall Street Journal quoted a broker as saying: "The coincidence of the Berlin situation with a technically weak stock market does not augur well for the weeks ahead."

To sum up, the current spurt in the averages is due in the main to:

1. New defense expenditures raising the expected profits of aircraft and instrument makers.
2. Previously held and now strengthened anticipations of good earnings as the recovery proceeds.
3. Removal of fear of an immediate tax increase, which had been a depressing factor.

4. Previous correction of speculative excesses in glamour stock and new issues.
5. A more bullish tone from the compound effect of all of the above factors.