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INVESTMENTS

INVESTMENT PSYCHOLOGY SINCE THE OUTBREAK OF WAR IN KOREA*

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In the post-war period, the philosophy of inflation has again underlined most of investors' optimistic psychology toward stock prices although even in this short period there have been times when the inflation psychology was forced temporarily into the background and forgotten, and the psychology of pessimism prevailed.

Experience indicates that it is difficult, if not impossible, for the majority of investors not to act en masse and especially not to be influenced by emotional news. Most human beings act with the crowd because it appears to be the logical and obvious thing to do. Ever since the New Dealers came into power there have been periods such as 1936–37 and 1945–46 when the threat of inflation was well advertised and the only sensible thing to do was to get out of cash and into common stocks. This type of mass emotional inflationary psychology which at the time appears so rational has developed every time commodity prices have risen sharply and every time sizable federal deficits have existed or been forecast by the Treasury Department. Yet in each case within a short period of time investors reversed themselves completely and stock prices suffered a major decline. The stocks were bought when they were high, as "long-term" inflationary hedges, but were liquidated when they were low.

Practically everyone has a paper profit at the top of bull markets but the percentage that still have profits after a complete market

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cycle is very, very small. History demonstrates that the public which goes all out for the new era inflationary markets such as 1936–37, 1945–46, and 1950–51 has always ended up with heavy losses. Of course, this time it may be different. Perhaps we are on the road to all-out runaway inflation without any intervening deflations and the majority of investors, for the first time, will be right.

Most investors do not seem to understand that stocks have no direct connection with the general price level. Stocks are not commodities and will not rise and fall with the rise and fall of commodity prices. Stock prices over any but very short periods of time (except in the case of runaway inflation when the currency is in danger of complete destruction, will always bear a relationship to earnings and dividends and in a high tax economy to net earnings that can be received by investors after corporate and individual income taxes are paid on these earnings. Of course, the basis for or rate of the capitalization of these earnings and dividends vary considerably from time to time depending upon the relative optimism or pessimism of investors at the moment. Even in the case of runaway inflation in other countries where the currency has fallen to zero, stock prices lagged very considerably behind commodity prices and the stocks which had the best earnings and paid the highest dividends in inflated dollars in general led the market. Many stocks actually decline in price during inflationary periods under conditions of poor earnings or no earnings.

War Record of Common Stocks

Upon our entry in World War I the market began a decline which continued *until it became reasonably clear that our ultimate victory seemed assured*. With the outbreak of World War II in Europe and with the history of our futile attempts at neutrality during World War I still fresh in their minds, many investors correctly anticipated our eventual entry into the world conflict.

As a result of the anticipation of our involvement in the war, the stock market followed a declining trend from 1939 until our actual entry into the war on December 7, 1941. The decline became more serious following Pearl Harbor and continued as in World War I *until the outcome of the conflict seemed to be balanced in our favor*. In this case our victory against Japanese sea power at Midway and the Russians' defeat of the Germans at Stalingrad indicated to the majority of investors that only the ultimate time of victory was then in doubt.

History in this and other countries shows that in spite of the well-known fact that wars, especially their aftermath, are admittedly very inflationary, stock prices decline *until the decisive point of the war appears to have been passed.* This was true in World War II even with the inflationary aftermath of World War I well known to investors. This phenomenon was true in all countries whether they were to win or lose the war, i.e., stock prices turned upward when the decisive point of the war occurred whether it pointed to the victory or the defeat of the country in question.

It is the firm belief of the writer that investors en masse will again act emotionally and pessimistically if the United States again becomes involved in an all-out war, that is, in World War III. The physical as well as the mental shock will certainly be greater as far as people in the United States are concerned than was the case at the outbreak of World War I or II. Logically they may seem to have been prepared for such an event, but when atom bombs start raining down on their cities pessimism will be quite prevalent *until they believe that the decisive stage of the war has been passed.*

There are those who argue that investors, knowing financial history here and abroad and having the inflationary aspects of wars' aftermath very fresh in their minds, will not act again as they did at the time of World War I and World War II. They argue that the stock market will decline little if at all should World War III break out, and that from the very beginning the war will be bullish on common stocks because the inflationary prospects will be so clear to all. Everyone will want to buy stocks, not sell them.

These inflationists point to what actually happened when war broke out in Korea. They grant that there was an initial break in the market but point out that it was extremely temporary and short-lived, and that following this brief break in the market, inflation psychology has been paramount and the market has generally followed an upward trend ever since. The Dow-Jones Industrial average reached 276 in September of this year, the highest point it has reached in twenty-one years. Does anyone need any further proof as to how investors will act during "wartime"? In the mind of the writer, however, there is all the difference in the world between actual all-out atomic war and the conditions under which we are now operating. If you are in Korea or have relations or close ties to those in Korea you feel the emotionalism of war; otherwise, to the cynic at least, it seems that to most Americans it is what the Germans were wont to speak of as the "happy war." Certainly the majority of people in the United States emotionally feel very different now than they will if we become involved in all-out atomic war.

In the opinion of the writer, the market broke at Korea because it appeared to the majority of investors that this might be the curtain raiser for World War III. However, after the initial shock was over it became fairly obvious that if Russia was ready and waiting for an excuse to continue war, the excuse was there. When, however, days and weeks passed and all-out war did not break out, the majority of investors quickly concluded that this was not the beginning of an all-out destructive war but rather that miscalculations on both sides had precipitated an incident which neither side desired to develop into a full-scale war. Rather, it was the beginning of a greatly stepped-up period of rearmament which would guarantee large federal deficits, boom business volume and strong inflationary trends indefinitely into the future. We were going to have the pleasing advantages of an inflationary war boom but except for higher taxes and some controls, we were not to experience the disadvantages of war, particularly its mass destruction.

The initial rise in the stock market after the outbreak of war in Korea was based quite largely on the inevitability of inflation in the minds of investors and the optimism that all equities would have a substantial rise based on the strong inflation that was developing as indicated by rapidly rising commodity prices and estimated federal deficits.

The more selective investors picked those securities which had the best record in the World War II excess profits economy like the railroads or those which appeared the best inflationary hedge like the oils and metals, and sold securities like the utilities which had suffered under excess profits taxes. In spite of the gospel of inflation, however, the fact that stock prices are related to earnings and the earnings outlook and, while affected by inflation, are not tied to the price level became more and more evidenced. The stocks that lead the rise, and this has been especially true in 1951, have been those stocks such as the oils and chemicals which were expected to have the best earnings and dividend record. If they looked like long-term inflation hedges as well, they were especially good.

On the other hand, such stocks as the automobile group which were admittedly going to be the recipients of large war orders but whose best net earnings after taxes were behind them reached their highs in the fall of 1950, and have never bettered those highs to date. Therefore, in spite of all the talk about inflation, those who purchased just any stocks a year ago on the basis that all equities were better than cash, rather than on careful selection of inflation equities whose earnings trends were upward, have already learned a lot by experience. There are plenty of stocks in which it has been easy to establish losses in the last two years. Those who purchased low-grade or medium-grade railroad stocks because of their World War II record a year ago, are the wiser for their experience if they bought them a year ago and still own them.

If earnings, at least as much as inflation, have been the basis for the bull market, why have stocks been considered cheap from June, 1950, until today on the basis of earnings? During the entire postwar period and especially during the last year and one-half not only have the inflationists argued that stocks were cheap because the value of the dollar was in a long-term declining trend, but most analysts have been trying to convince investors that stocks were cheap on the basis of existing price earnings ratios. There, of course, can be no argument that stocks have been selling at price earnings ratios historically low for a period of boom business such as the present. Ever since the hostilities in Korea began analysts have convinced the majority of investors that stocks were and are cheap not only because of the gradual trend toward inflation, but because the defense boom (short of war) would guarantee good business volume without the destruction of plants and equipment. Price earnings ratios based on current and future earnings prospects are historically low even when adjusted to prospective net earnings after taxes. That investors have been convinced of this is one reason, the main reason, why stock prices have risen in the past year and one-half from 196 to 276, Dow-Jones.

The analysts and investors who accept this premise are convinced that pre-World War II price-earnings ratios are the all-time basic standards which have been temporarily overlooked in the postwar years, but which must sooner or later come into their own with resulting higher stock prices. These individuals are unwilling to admit that in the unsettled world in which we live price-earnings ratios may not have been low from 1947 to 1951 by accident.

Those investors who state that stock prices are cheap because of their low price-earnings ratios do not seem to be aware that the quality of present earnings is not as high as pre-1939 earnings because of the following factors:

1. The possibility of postwar depression if by some miracle near peaceful conditions are restored throughout the world

2. The possibility of a socialized state following a war or a depression

3. The fact that earnings and dividends must be evaluated in the terms of a depreciated dollar. Furthermore, these investors overlook

or consider only temporary the fact that the relatively low market pricing of common stocks in terms of other boom periods may be partly the result of heavy taxation of the capitalistic classes, of the reduction of profits by taxes paid by the owners of equity securities when they receive these earnings in dividends, and of the squeeze on profits by the continuous wage cost and tax spiral. None of these factors are temporary and therefore those investors who justify purchasing stocks at current high levels because they are selling at price-earnings ratios historically low for boom periods may be operating on a very unsound premise.

Since last spring a few investors have begun to question the inevitability of continually rising inflation uninterrupted by any deflation. There have been enough of these to develop a strong utility market in recent months. A few have realized that even though inflation may be inevitable in the long run that a careful analysis of long-term inflationary periods in other countries prove that it is not a one-way street and that investors have frequently been whipsawed during such periods by intervening periods of deflation in business and stock prices. Investors in those countries, and United States investors, have proved to be at least as emotional, temporarily forgetting their philosophy or psychology of inflation, and became emotionally obsessed by the immediate deflation.

The occurrence of any significant deflation would come as such a shock to most investors that it will drive all thoughts of inflation from their minds. Those investors and businessmen who have gone all out in their preparation for inflation will be ill prepared emotionally and liquidity wise for any important deflation should it occur. At least this is what history tells us about the record of inflation-minded investors of which there have been many in the United States and in France in the deflationary periods that have occurred in what has been a long-term inflationary period—1937–51.

If the output from our tremendous and rapidly expanding productive capacity has made the inflation appear, to some at least, more than a little tired in the last nine months, might not the boom which rests as always on the continued expansion of our productive capacity be a little vulnerable to some deflation? If capacity for both butter and guns does not prove as short as was expected, perhaps it will not need to be increased as much as was expected—but this boom, as all booms (except those connected with all-out wars) is basically dependent on the continued large-scale expansion of our capital goods.

Few investors today have real doubts in their minds and they do not believe that any downward trend in business or stock prices can be more than very temporary if it could occur at all. They still believe that inflation and good earnings in a boom-guaranteed defense economy is the order of the day.

The bulls quite readily admit that in general the best earnings are behind us for some time. However, they still believe that inflation is guaranteed and they expect earnings and dividends after taxes to be very good. If the outlook for the next year or two should change and point to a really sharp reduction in earnings and dividends, we can be sure that the mass of investors will forsake their "long-term" inflation psychology and optimism, will turn sharply to pessimism, and stock prices would be adjusted downward in terms of the unexpected deflation and new earnings picture. Finally, if all-out war should break out it would be very far from bullish on common stocks in its initial stages.