Investment Outlook

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1977 was a poor year for the stock and bond markets. From beginning to year end, the Dow Jones Industrials fell 173.48 points or 17%. Both short and long term rates increased, with the rise in short rates approximating 200 basis points and the hike in long rates almost 60 basis points. From a total rate of return standpoint, (price + interest or dividend income) cash was clearly the best investment, returning over 5½% for the year. Bonds, as measured by the Salomon Brothers Index returned 1.7%, and the DJIA a negative 12%. It should be pointed out, however, that many stock indices did rather well for the year. The Dow Jones Utility Average, for instance, appreciated 3% and the American Stock Exchange index advanced 16% to a five year high of 127.89.

The disparate performance of numerous stock market indices was really indicative of the type of year that 1977 was. It was atypical, confusing. It ran counter to general business cycle theory which suggests that increasing corporate profits combined with steady inflation and moderate interest rates should be bullish for equity prices. Stocks went down, however, in the face of higher earnings, record dividends, and numerous tenders at substantial premiums to market value. Many explanations for such performance have been alluded to in previous Investment Outlooks. A two part series in July and August outlined the flight of the individual investor and the long term structural problems inherent in higher oil prices. April's "Outlook" highlighted the lack of capital investment and its longer term implications. All of these arguments pointed to one elementary conclusion: long term economic growth in the United States is slowing down and the potential for profit growth is diminishing. Accordingly, investors are demanding a higher rate of return from stocks, and prices have reflected the adjustment. 1977 was a year in which long term secular forces overwhelmed short term cyclical movements and the failure to understand that fact has left many investors bewildered and perplexed.

What of 1978? It is certainly very difficult to know whether the secular connection alluded to above has run its course. That process may have begun in the early 1970's and could still have some time to go. Despite that uncertainty, cyclical economic forces do not appear to favor stocks over the next 12 months. Real economic growth in '78 should be lower than in '77 and will likely dissipate throughout the year. Housing starts have probably peaked and the consumer will be hard pressed to repeat his spending patterns of the 4th quarter. Only government spending appears to offer optimism and that should not be enough to sustain real growth of 5% +. In conjunction with slower economic and profit growth, inflation and interest rates appear poised to head higher. Substantial government deficits promise near record levels of Treasury financing, which, when combined with