Profit ruse buoys stocks

The money managers artificially boosted the market, but profits will be heading for a fall.

The Dow Jones industrial average settled down the week ending Aug. 10, rising only 16 points on the week, after an 86 point rise the week before. A record 755 million shares changed hands.

A number of people have been left scratching their heads. Why did the 100 point run-up in the market over two weeks happen, and will it continue?

We don't know and don't really care, but since many of you are interested, we'll say what we can about it. The stock market functions like the New York City subway system: Whether you get from one place to the next on time, or even at all, is a matter of daily chance.

Surely, the fall in interest rates, triggered by the ridiculous line that "inflation has been licked," had something to do with it; 30-year Treasury bonds, which traded at 13.6% at the start of July, were down to 12.5% by the first week of August, a 110 basis point drop in 30 days. Falling interest rates would indicate that inflation a few months hence should be lower (were higher inflation expected, according to conventional wisdom, then interest rates would rise).

Aside from market forces, there is also the more likely possibility that institutional investors—the large insurance companies and pension fund managers, such as Lazard Frères and Goldman Sachs—wanted to create a market rally for political reasons.

Reagan's inner cabinet has been urging the President to claim that the stock market boom is the result of his economic policies. But what if this rally were pure fluff, so that once the President took credit for it, say in his keynote address at the Republican National Convention, the rally were aborted promptly and the President were made to look like a fool.

This would not be the first time that the insurance companies and investment bank pension managers had pulled such an operation. Keep in mind that 60% of all stocks are owned by money managers—corporations, pension funds, and insurance companies—and on any given day they trade 90% of all stock.

Lending credence to this view is the so-called Volcker element in the rally. Paul Volcker presented testimony July 25 which the press played as a refusal to tighten interest rates—a good sign for the stock market. But what Volcker actually said was that the Federal Reserve will lower the M1 and M2 monetary targets for 1985, which will tighten credit, and he warned that current "relatively rapid rates of growth in M3 and domestic credit are flashing cautionary signals."

The press somehow managed to interpret this as an endorsement of easing credit, which, in turn, helped ignite the rally.

The third element in the stock market rally is that with energy prices falling and with commodity prices in the doldrums, European and American investors found the stock market one of the few places they could put money short-term.

Most worrisome is what nobody is willing to talk about. The profits and dividends upon which the market rally was based are not real. Perhaps as much as one-tenth to one-fifth of corporate profits are based on stock market manipulations. In the first quarter of 1984, companies bought back $60 billion of their own stock, and repeated this process for an additional $15 billion in the second quarter. Low stock prices helped this process, suggesting that the market might have been artificially depressed to facilitate its occurrence.

Why should corporations be retiring their stock in the midst of a supposed recovery rather than issuing new stock? Because this way they could inflate earnings. Take the case of "leveraged buy-outs": If a company borrows from an outside lender, proceeds of the purchase of its own stock are booked as a gain on the income statement. If the company takes back its debt, then interest paid on it is chalked up to earnings.

Another trend of the first half of the year was mergers, in which companies traded or sold divisions. Often a company would sell its own division, only to lease it back. In this way the company could count the proceeds of the sale as earnings, and count any debt required to lease back its operations as an operating expense, thereby reducing, artificially, its debt-equity ratio.

Hence earnings were artificially inflated, debt-to-equity was artificially reduced, and with millions fewer shares because of buy-backs, the dividends distributed among fewer shares were higher per share.

In the market rally of the last three weeks, the corporations took advantage of the artificial situation they had set up. But these phony profits will soon evaporate, and the leveraged stock market will fall.