MORGAN STANLEY Investment Research

Technical Market Comment

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A VIEW OF THE MARKET

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In this report we shall summarize our views concerning the outlook for the stock market during the next six months. Those who have read our reports for several years know our emphasis is on events that precede rather than follow major turns in the market. We attempt to anticipate rather than report.

We feel it was especially important this spring for readers to understand our particular approach to the market. For, throughout the first four months of the year, the "preconditions" that we believe have preceded every sustained market turn in modern times did not develop prior to the explosive rally of mid-April. Three of these "preconditions" never appeared... a slowing of the market's downward price/volume change for several months, New York Stock Exchange Members' covering their shorts with New York Stock Exchange Specialists' becoming heavily long in their inventory accounts, and bearish investor sentiment expressed by downside volume patterns instead of simply bearish talk. Prior to the start of the mid-April rally, the financial stocks were stronger than the general market, but this was the only one of the four "preconditions" that was positive. These four market studies had been reviewed in many of our weekly reports. Thus, when the powerful rally began in mid-April, rather than reporting the volume, current level of the market, etc., we simply stated three of the four preconditions for a real upturn were not apparent, as had also occurred in the abortive rallies of 1969 and 1973. From the beginning of the rally, we called it a move against the basic trend of the market.

As we have stated in most of our meetings with clients during the past few months, we believe the explosive rally which carried the Dow Jones Industrial Average from 766 on April 12 to 833 on April 25 was caused by mechanical factors related to the stock market rather than by a significant change in investors' perception of the fundamentals. In our view, the "nine days in April" were the result of a confluence of three factors: (1) a powerful squeeze on large New York Stock Exchange Member Firms through the option market, (2) record-breaking foreign buying led by British investors influenced by a rally in sterling against the U.S. dollar (see our report of July 3), and (3) nervous cash following these first two stimulants.

Since early June we have stated that we thought the rally was over and that we expected to see a significant decline that would complete the downtrend that began in 1976. Our reasons for this conclusion have been discussed in each of our last five weekly reports.

We expect the remaining six months of 1978 to be difficult ones for the stock market. We do not believe a low was made this spring. Based on the rapidly deteriorating near-term technical structure of the market, we think the bottom of the decline will be seen in late 1978 or early 1979. While we believe the 740 area of the Dow Jones Industrial Average was not its final low, we think the greater risk is in the middle level and secondary listed stocks segment of the market. To illustrate our estimate of risk we chose to employ the New York Stock Exchange Composite Average which is an average of 1,500 NYSE stocks weighted by capitalization. Our downside estimate is around the 45 level of this average. On July 7, this average closed at 53.34. It should be emphasized that this average is weighted by capitalization and that we do not believe the large capitalization stocks are as vulnerable as the middle level and secondary ones. Therefore, much greater declines in the smaller capitalization stocks would be necessary to bring the total average down to the 45 level.

Our policy for the last six months of this year is to stress defensive-type issues that we believe may well outperform a declining market for larger investors. For those investors with more flexibility, we suggest being as defensive as possible. We believe the second half of 1978 will witness the closing innings of the decline that began in 1976. When we write our next summary at year-end, we believe the tone of the report will be much different from these thoughts.

GROUP STUDIES (six-month framework - no near-term opinion is expressed.)

We follow 45 groups based largely on the S&P groups. In line with our current negative outlook for the general market, we define the group headings as follows:

Most Attractive:	groups that have made major lows and are starting important advances.
Attractive:	groups we believe will outperform the the S&P 500. This is our "for those who have to be somewhere" category.
Negative:	groups we would avoid.

Negative (34)		Attractive (10) "for those who have to be somewhere"	Most Attractive (1)
Aerospace	Household Prod.	Autos	Drugs
Airlines	Hotel/Motel	Banks	
Aluminum	Insurance	Beverages	
Appliances	Machinery	Cosmetics	
Broadcasting	Office Equipment	Food	
Building	Oil: Domestic	Forest Products	
Chemicals	Oil: International	Gold	
Coal	Oil Service	Tobacco	
Conglomerates	Paper	Utilities: Gas	
Containers	Railroads	Utilities: Telephone	
Copper	Retail		
Elect. Equip.	REITs		
Electronics	S&Ls		
Farm Equip.	Steel		
Fast Food	Textiles		
Finance	Tire & Rubber		
Food Chains	Utilities: Electric		

NOTE: There are no changes today.

As our readers may recall, from last fall to mid-spring we had listed the Drug, Airline, and Aerospace groups as our favorite sectors of the market. However, on May 8, we suggested taking near-term profits in Airlines and Aerospace, as these groups were losing near-term technical strength. If these two groups continue to correct their recent advances, we shall place them back on our most attractive list. In our view, Drugs continue to be the best group in the market.

Our problem is that we like the same three groups now that we recommended last fall. We have yet to find other major groups building technical strength. This is another reason we do not believe the market has bottomed. Our attractive list is defensive in nature and aimed at large investors that "have to be somewhere." We believe these groups will outperform a declining general market.