May 29, 1962

Honorable Walter W. Heller
Council of Economic Advisers
Washington, D. C.

Dear Walter:

With respect to the draft of May 29 we are enclosing changes suggested by the Securities and Exchange Commission -- noted in ink.

At page 3, Item (b), it is interesting to note that most thoughtful commentators in the press have either not mentioned the Securities and Exchange Commission market study at all or referred to it subsidiarily, as a factor in the current market decline. It is surprising, therefore, to find a draft by a government official giving it such immense prominence.

If you have any further questions, please let me know.

Sincerely yours,

William L. Cary
Chairman

Enclosure

WLC/hh

CEA: May 29, 1962

Why the Market Fell

An explanation of the market collapse must explain (1) why the market was vulnerable; (2) what forces initiated the decline; and (3) what further forces fed and accelerated the drop.

The following account is reasonably consistent with the views of a number of market analysts and writers who have sought to explain the market's tailspin:

1. The vulnerability of the market/

In the bull market of the last decade, investors boosted the price they were willing to pay for $1.00 of annual earnings from about $10.00 in 1953 to $14.00 in 1955-57 to $19.00 in 1959-60 to $24.00 in 1961. Though most investors were simply swept along by a blind faith in the inevitability of further capital gains, the rational basis for their behavior could only have been the expectation of a steady and substantial increase in earnings per share. The fulfillment of these heady expectations required not only high prosperity and rapid growth in the economy, but a brisk inflation as well.

By the end of 1961, a wide gap had opened between expectation and fulfillment.

2. The forces initiating the decline.

The decline began in mid-March.

Starting in the early winter, the press awakened to the remarkable stability of prices in the course of the recovery from the 1960-61 recession. This awakening led to the further discovery that the price levels -- as measured by wholesale prices -- has been stable since 1958. The recognition that we have had no significant inflation in four years probably dawned on the investing public in the course of the winter.

On top of the crumbing of inflationary expectations, the economy suddenly slowed to a canter in the first quarter of 1962. The full statistical story of the disappointing January-February period was unfolded in the first half of March. Though the economy then began to pick up steam, the January-February lull was probably enough to reverse the direction of a vulnerable market and to trigger a sharp drop.

3. The forces accelerating the tailspin.

A sharply declining market manufactures its own psychological fuel. Disappointment can lead to fear, and fear to panic. But in an atmosphere of collapsing optimism, external events can speed up the deterioration of confidence. Three such events were:

(a) The steel crisis -- which was interpreted as evidencing Governmental hostility to business and as foreshadowing policies which would limit business profits.

(b) The SEC investigation -- which weakened investors confidence in the integrity of brokerage firms.

(c) The gold outflow -- which was seen as a harbinger of dollar devaluation and thus -- contrary to logic -- as a bearish influence on stock prices.

In addition, the revision of Regulation Q, and the widely advertised competition between commercial banks and other savings institutions to attract deposits by offering higher interest rates, brought forcefully to the attention of small stockholders an attractive alternative to the risks of holding stocks -- i.e., the availability of yields of up to 4.8 percent in insured savings and loan accounts. There has in fact been an exceptionally heavy flow of funds into savings accounts this year.

We suggest that the reference to the SEC investigation be omitted as per the Chairman's letter. If, however, there is insistence upon referring to the investigation, it is suggested that the following statement be used:

> "The SEC investigation which may have directed investor attention to certain unfavorable practices in the brokerage industry"

Also, if used, the statement should be placed last.