THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

March 26, 1964

MEMORANDUM FOR THE PRESIDENT

Subject: Secretary Dillon and Stock Prices

1. Generally I agree with Secretary Dillon (in his March 18 memorandum to you) that stock "prices are clearly on the high side but do not seem high enough to cause concern." The evidence is that:

   -- The outlook for economic expansion is very favorable, and confidence is quite high.

   -- Profits should be up more than 10 percent from 1963 to 1964.

   -- Taking into account the reduced corporate tax bite, the ratio of stock prices to earnings is considerably below its peak of late 1961 (though still above the historical average).

2. However, as you know, stock market prognostication is a risky business:

   -- The stock market is always vulnerable to setbacks in the short-run even while the trend is rising. During 1963 as a whole, the Dow-Jones industrial average rose 17 percent. Yet this rise was interrupted -- in 1963 alone -- by declines of 4, 5-1/2, and 6-1/2%. (The 6-1/2% included the 21 point drop in the Dow-Jones of November 22.) As the market continues to rise, it may be more vulnerable to declines.

   -- Investors have been known to change their idea of a satisfactory price-earnings ratio almost overnight. A sudden "demand" for higher rates of return -- e.g., 20 times earnings in place of 22 times earnings -- could knock the market down 10 percent.

3. We don't look for trouble in the stock market, but we should always be a little gun-shy.

Walter W. Heller