THE WHITE HOUSE

WASHINGTON

August 9, 1974

MEMORANDUM FOR THE PRESIDENT

FROM: WILLIAM J. BARODY, JR.

SUBJECT: ECONOMIC CONFERENCES

The seriousness of our economic problems and the deep-seated concern which exists both here and abroad suggests the desirability of moving quickly to communicate with key elements of the private sector through a series of economic meetings and conferences. These meetings would have three purposes: (1) To define your policies and convey your attitudes and sense of urgency with respect to our economic problems; (2) To request support for those policies, principally in the form of responsible private price and wage behavior; and (3) To seek new ideas and to launch several new initiatives to combat inflation and to meet some newly emerging problems.

I would suggest five meetings over the next two months. For these and all other conferences that may be approved, the policy office involved, in these cases Ken Rush's, will take the lead for substantive structuring of the meetings. My suggestions are as follows:

(1) A two and a half hour White House meeting with labor-management leaders. Your participation could be limited to one hour. (Schedule Proposal attached)

Purpose: To spell out your policies and ask for support in promoting responsible wage and price behavior in the private sector. In addition, you would ask for the participants' ideas on other actions which might be taken to combat inflation.

APPROVED FOR PLANNING _____

DISAPPROVED _____

(2) A half-day White House conference on new approaches to promoting economic growth without inflation. Your role could be confined to a few brief remarks at the opening, with your key economic advisors present throughout. Participants would include prominent academic and business economists as well as financial writers.

Purpose: To develop new ideas and initiatives to meet the current situation, but also to ask for the participants' thoughts on likely economic developments and appropriate policy responses over the next several years.

APPROVED FOR PLANNING _____

DISAPPROVED _____

(3) A half-day White House conference on America and the international economy. Here again your participation could be confined to a brief opening statement, with your key economic advisors remaining throughout. Participants could include leaders of multinational corporations, international bankers and labor leaders, farm organization representatives and academic leaders.

Purpose: To discuss Administration policies and to solicit support and ideas on a wide range of international economic problems -- the monetary system, trade negotiations, relations between the advanced industrial nations and the resource-rich developing countries and the problems of world food availability.

APPROVED FOR PLANNING _____

DISAPPROVED _____

(4) A one-day conference in the field, probably in New York, on capital formation and the future of the American economy. We would ask several private organizations to sponsor such a conference and consult with us on the agenda and format. Administration officials would participate throughout, while you could send a message if your schedule precludes active participation.

Participants would be affiliated with the sponsoring organizations.

Purpose: To focus public attention on a problem of growing importance and critical significance to the economy -- how American business will find the capital required to meet the country's enormous investment needs. Business leaders are writing me on this with increasing frequency and some alarm. It is an excellent area for you to take an important initiative. This topic could also raise to a somewhat higher level of public consciousness the need to re-examine the trade-offs between cleaning up the environment and using our capital resources for productive purposes in order to combat inflation.

APPROVED FOR PLANNING _____

DISAPPROVED _____

(5) A half-day conference on productivity. Again, we could ask appropriate organizations to sponsor such a conference. Again, you could attend for a major address or send a message which might include the announcement of several actions you were taking within the government to stimulate increases in productivity. Jackson Grayson has suggested a number of ideas which might be useful here. Aside from Administration officials, participants would include members of sponsoring organizations.

Purpose: To seek new ideas on how to increase productivity in the private economy, to increase public understanding of the concept, and to mobilize business and labor support behind the effort. This is probably one of the most fundamental things we could do to combat inflation now and in the future.

APPROVED FOR PLANNING _____

DISAPPROVED _____

RECOMMENDATION: That you authorize me to proceed with planning for this entire program.

AGREE _____

DISAGREE _____

THE WHITE HOUSE

WASHINGTON SCHEDULE PROPOSAL

DATE: August 9, 1974
FROM: Bill Baroody, Jr.
VIA: David N. Parker

MEETING: Between the President and key labor and management leaders.

DATE: Wednesday, August 14, 1974 at 10:00am

PURPOSE: To discuss ways in which labor and management can work together with the Administration in helping to solve current economic problems and to give the President an opportunity to ask for their cooperation.

FORMAT: Location: The Cabinet Room
Participants: Top leaders from labor and management. As a core, ten of the 16-18 participants would be the previous members of the Labor-Management Advisory Committee which had been set up during wage/price controls.
Length of Participation: One hour minimum. Preferred option would be for the President to stay for the entire 2 1/2 hour meeting.

SPEECH MATERIAL: Specific talking points to be furnished at a later date. Generally, the President should encourage suggestions, recommendations and assistance in dealing with the current economic situation, emphasizing restraint, the need for increased productivity and other goals to help retard the inflation rate.

PRESS COVERAGE: Photo opportunity only at the beginning of the meeting.

RECOMMEND: William J. Baroody, Jr.

STAFF: William J. Baroody, Jr.
Jeffrey P. Eves

PREVIOUS PARTICIPATION: None. Not Applicable.

BACKGROUND: This would be our third Wednesday Meeting as previously discussed and pursuant to my memorandum to then Vice President Ford dated June 18, 1974.

Participating in the meeting after the President would be several economic advisors such as Messrs. Rush, Stein, Greenspan, Burns and Secretary Simon.

It would be my recommendation that the President kick off the meeting at 10:00am for about an hour. The meeting would continue through lunch.

It would further be my recommendation that the President announce his intention to hold this meeting during his address to the Joint Session of Congress Monday night.

INVITEES FOR "WEDNESDAY MEETING" AUGUST 14, 1974

1.	I. W. Abel	United Steelworkers of America
2.	Frank Fitzsimmons	International Brotherhood of Teamsters
3.	Paul Hall	Seafarers' International Union of North America
4.	George Meany	American Federation of Labor and Congress of Industrial Organizations
5.	Leonard Woodcock	International Union of United Automobile, Aerospace, and Agricultural Implement Workers of America
6.	Saul Horowitz	Associated General Contractors
7.	Arthur Wood	Sears Roebuck and Company
8.	R. Heath Larry	U.S. Steel
9.	Henry Ford	Ford Motor Company
10.	C. Jackson Grayson, Jr.	Southern Methodist University
11.	Sandie Trowbridge	The Conference Board
12.	David Packard or John Harper	The Business Council & Hewlett Packard Corp. The Business Round Table and Alcoa Aluminum Company
13.	Raleigh Warner or John Swearingen	Mobile Oil Company and American Petroleum Institute Standard Oil of Indiana
14.	William Mitchell or Clarence Adamy	Safeway National Association of Food Chains
15.		American Medical Association
16.		The Pharmaceutical Manufacturing Association
17.		The American Bankers Association

August 10, 1974

MEMORANDUM FOR THE PRESIDENT

FROM: WILLIAM J. BARODY, JR.

In my memorandum to you of August 9th on economic conferences, I suggested that the second White House meeting in the series proposed should bring together academic and business economists as well as some financial writers.

Let me elaborate on how such a meeting could be used to neutralize opposition that exists to the so-called "steady as you go" economic policy.

I would suggest that participants in such a meeting include a number of prominent economists identified with the Democratic Party, possibly Paul Samuelson, Otto Eckstein, Walter Heller, Kermet Gordon, and Charles Schultze, among others. We would also, of course, want to include economists identified with Republicans, i.e., Steve Saulnier, Murray Wiedenbaum, Paul McCracken, Milton Friedman and Henry Houthaker.

At the conclusion of the White House meeting, I would suggest that you ask the entire group of economists, which would number from 12 to 15, to act as an ad hoc advisory committee to you with specific instructions to produce a report within, say, a month. This report should take a look at the current economic situation and current policies being followed and how they might appropriately be altered.

The key to this effort would be a specific requirement which you lay on the group to include in their report the basic analysis and recommendations on which they all agree. Beyond this unanimous statement, you would, of course, welcome individual views as well.

I think such a report would make very clear that there is very wide agreement among economists of all persuasions that the policies now being followed -- while perhaps not ideal -- are basically correct and that there is little room to tighten or loosen monetary or fiscal policy without running some very grave risks. This report, and particularly the group's statement of broad agreement, would help to neutralize the statements of those who -- largely for political reasons -- criticize the current policies, but in actuality have nothing new or different to offer themselves.

If you are seriously considering holding an economic "summit" meeting as some in Congress have recommended, it could be called at the end of the series of issue oriented meetings outlined in my August 9th memorandum and after receipt of the above ad hoc advisory committee's report, say sometime in October.

National War College
8-9-74

CURRENCY VALUES AND ECONOMIC RESOURCES ALLOCATION AS INSTRUMENTS OF FOREIGN POLICY

The control of natural resources, economic technology and utilization of capital markets is basic to the influence of the United States in protecting and developing its national interests as well as providing domestic tranquility and world leadership.

What are the current trends particularly as they may differ from the usual extrapolation of the past?

In order to look ahead one must accept the awkward posture of being ahead of the next wave of movement in the affairs of man and nature. The ability to forecast correctly 100% of the time or even 50% doesn't exist; however, the ability to recognize change at an early stage is possible 50% of the time if not 100%.

WHAT ARE THE REALITIES OF CURRENT INTERNATIONAL RESOURCES?

My professional and philosophical background results in a pattern of applying a price to "everything" which I hope will provide a slightly different perspective to this Conference. It will also take me to the periphery of some areas now covered by others in far greater professional detail.

True national wealth should be defined as a store of useful future energy, i.e., minerals, technology, capital and national attitudes. In the case of all factors product prices are essential in determining the size of the energy reserve.

Too many observers usually refer to one raw material or another at a specific price and generalize from there. The real question internationally is the natural resource reserves, production, prices and distribution between four classes of countries and how they relate to world integration and survival.

Industrialized Nations with Reserves - ex: U.S., Canada;
Industrialized Nations without (little) Reserves - Italy, France, Japan;
Developing Nations with Reserves - Mideast, parts of Africa, Asia and South America;
Underdeveloped Nations without Reserves - India, Pakistan.

The United Nations in its recent special session on raw materials divided the world into two parts: developed and underdeveloped. Are they interrelated? Typical commodities exported

by developing countries are petroleum, coffee, sugar, cotton and rubber. From developed countries, wheat, barley, poultry, pigs, mutton, soybeans, milk, cheese, butter, wine, wood pulp, aluminum, coal, furskins, flax and linseed. Leading imports of developing countries are petroleum products, wheat and rice.

The increase of commodity prices in the last two years virtually erases the adverse commodity/manufactured goods price decline in the 1950s and 1960s. Therefore, price increases that "have stuck" will change relations between countries. Since the U.S. does more business with more countries the future price trends are of unique importance in our relations.

Will commodity prices hold? No, not at current levels, but substantially above the old prices. Current prices of most industrial commodities are at levels well in excess of high rates of return on replacement facilities. What could this mean? Trade wars, tariff barriers, civil strife. Expectations have again been raised to excessive levels by non-economic politics in newly developing countries as well as in the developed ones. The dangers of excess expectations were outlined in a Fortune article of May 1968 by Max Ways. He forecast that "frustration, cynicism and anger" would develop as the exaggerated levels of achievement were not reached. The concluding sentence was "without prudence, the expectations that have been set in motion may turn into the worst news ever." Subsequent events have proven him to be remarkably and frighteningly correct.

Much of the current international abrasion and dialogue is based on a struggle for resources; a major change from the 1950s and early 1960s when a perpetual infinite supply of all goods and capital was taken for granted. With raw materials in ample supply the lesser developed countries had no negotiating platform. Now that situation is different.

The U.S. can offset temporary disruptions with its natural wealth but countries such as Italy and Japan have a difficult road ahead. Their alternatives are limited but readily analyzable if a knowledge of raw material balance is the basis of approach.

Underneath all the talk and discussion is the search for the world's future political structure evolving around a reassessment of economic relationships which are now different.

CAPITAL MARKETS - CURRENT STATUS

When one speaks of a nation's natural resources there is a tendency to ignore capital markets. There has always been the assumption of an infinite supply of U.S. capital mainly because there had been from the early 1930s until 1970. (As a matter of fact I've been unable to find any computer forecasting program that assumes a finite limit on the supply; all assume only a question of manipulating demand.)

Sometime in the late 1960s the U.S. exhausted its reserve of capital accumulated from the less than optimum rates of production in the 1930s, 40s and 50s. (Interest rates as a partial reflection of balanced supply and demand were as low as 4½% in 1965.) There was (is?) no worldwide willingness to face up to the limits of excess expectations. Prudence in financial matters is hardly recognized. Thus, the excess demand vs. limited supply (at old prices) has resulted in inflation, social violence, commodity price explosion, nationalism and distorted capital markets. One simple example of the latter is evident in the market value of IBM's 147MM shares which now exceeds the 3.4 billion shares of the 1,360 issues on the American Stock Exchange. I thoughtfully suggest that with all of IBM's brilliance and success that this might nevertheless be a good exchange.

Capital markets provide three purposes: a reservoir of asset values in currency form; a means of exchange with the greatest of liquidity and rapidity (compared to asset barter) and as an allocator of resources through relative price changes. The reciprocal of the latter function is the ability to raise capital. The more liquid the marketplace the greater ease of transfer of money from areas of excess liquidity to those with a greater real or potential return. Thus, the system functions, not perfectly, but better than any other. To date no other system has been able to support the high U.S. level for national defense and a consumer economy.

CORPORATE ENVIRONMENT

Capital needs over $3 trillion in next fifteen years (double the last 15) indicate that the U.S. is again a developing country (energy, minerals, agriculture).

Large dollar needs for basic industrial capacity unlike anything since late 1950s.

Limitation on internal financing -- in 1965 depreciation and retained earnings accounted for 90% of non-residential fixed investment -- now down to 75% and declining sharply as rate of inflation affects current replacement cost. Corporate profits still inadequate despite sharp increase in current dollars; first quarter will be "embarrassingly so" in current dollars due to higher product prices; indicative of large wage demands in the future.

Debt/equity ratios up sharply last 10 years; cannot increase at that rate without financial problems sooner or later; equity must be found.

Where will money come from?

1968-72 from institutional investors who increasingly purchased stock since 1965. Now at a maximum representation with the unweighted index of all markets off some 70% (Chart I).

The public is the major answer since it has liquid savings and has been "a seller" of common stocks for the last decade. (Chart 2)

Why Did Public Go Out of Market:

1. Aggressive willingness to pay rising prices for stocks by institutions.

2. Negative effect of sharp 69-70 speculative decline.

3. Adverse tax changes for stock ownership, i.e., higher capital gains.

4. Wall Street "failures" and concern about "inside knowledge" of institutions.

5. Current speculation in real estate, commodities -- "where the action is" notice recent public advertising for these activities.

6. Attractive alternative of high yields on bonds, savings certificates, CD's, etc.

7. Political unease and destabilization.

Timing Propitious for Return?

1. Good yields on many fine common stocks.

2. Minimum expectation versus excess of late 1960s.

3. Excessive speculation and failures in real estate and commodities will exert a negative impact on these activities.

4. Brokerage community stabilized -- fuller disclosure from institutions.

5. Stocks of large companies already owned by public act better.

6. Most stocks (if not the market averages) have probably seen their lows. The background to encourage a more interested public is now apparent. A tax incentive program could be an effective "trigger" by making the risk involved in equity investment more competitive with alternatives.

Venture Capital

The term refers to private and public investments in small companies and new ideas. All corporations have their prime origin from this beginning.

Some say that most of the great developments have come from small companies or diligent individuals with a "bright idea."

The common denominator for all was a need for money. For the last fifteen years the bulk was supplied by some 14,000 "venture" public offerings supplemented by private funds of wealthy private investors and more recently some institutional investors (e.g., pension funds and banks). Many of the large corporations that entered the arena have retired. It takes an unusual mentality to develop this type of business and it appears that there is too much of a conflict between the demands of large corporate management approach and entrepreneurship. It is today almost impossible to raise such funds and yet the country needs such innovation to keep us competitive through the development of new ideas.

We estimate that there is a real need for perhaps $200 million per year. We must return to public offerings. It is clear that the risk-taking incentive system of the 1950s and 1960s no longer works. New tax incentives are essential. Otherwise we will go down the road of Europe dominated by large companies and large financial institutions which when mixed with the bureaucracy of government equals a type of Japanese "Zaibatsu."

The biggest obstacle to liquid capital markets is economic ignorance. We must educate not only our political leadership but also the constituency starting in the schools. This is even more basic than tax incentives. If the voting constituency understands, so will the political representatives.

With this hindsight, perhaps the market disaster is not too sweeping as measured against the subsequent chaos. Now, however, expectations are minimal with stocks down 70%. It doesn't take a genius to say that the worst is over. Perhaps the market decline was not so surprising as measured against the excess expectations of 1968.

Stock markets are a mirror reflection of the trend of the times. Our society and political economy are more concerned with the accelerating accumulation of minutia for accommodation's sake versus the commitment to a larger amount of time for analysis and straightforward integrity involved in the evaluation of our problems.

The current chaos in the bond markets is a reaction to the excessive debt that has been created relative to capital resources. (Chart 3, 4, 5, 6.)

Super Cycle

The super cycle is the technical term for a world depression. Is this now possible? Yes! Why? - excess expectations fueled by political promises that caused government, business and consumers to borrow excessively from the future. This equals inflation and currency debauchment and if virulent, guarantees a world breakdown at some point.

Politics → Inflation → Frustration → Inequities → Social Unrest → (Central Control)

The pessimistic social and business philosophers like Fromm and Heilbroner allude to population growth, dwindling resources, obliterative weaponry, unrestrained industrialism, moral torpor and an absence of a sense of purpose. The financial pessimist refers to excess and irrational debt accumulation and now a disintegrating confidence.

Conclusion: The U.S. and world cannot grow at the assumed extrapolation of old rate. Not appreciated by most observers; neither economists, business managers nor government. The U.S. rate will be more like 3% than 4½% real GNP growth. The expectation of all the fiscal constituencies cannot be reached. How will priorities be determined?

Why consider capital markets? Suppose stock exchanges were abolished. Are government bureaus better allocators of resources than a price mechanism; history says no but we live in a world that requires government and private sector cooperation. (Anomaly of reverse trend of free and non-free world).

PERSPECTIVE

If we sat here six years ago - July 1968 - and forecast:

A quadrupling of the price of oil

Double digit U.S. inflation

A 200% increase in the price of gold

Violence, hijacking and kidnapping

Another mideast war

"Weak" governments in virtually all of the free world

The possible impeachment of the President and conviction of close advisors

Active economic rapport with China and Russia and deteriorating relations with Europe

The financial failure of major European financial institutions

Last, but not least, that the stock market would decline by some $300 billion (measured from individual stock high prices since 1968) with financial collapse and frauds: from Penn Central, Lockheed, Equity Funding to Consolidated Edison and Franklin National

How many would have forecast that the world would still be operative today?

The precise point is that in today's world we are not very able at forecasting and I've a natural contrarian's reluctance to extrapolate from the current well identified platform of generally accepted assumptions. Stock prices normally discount ahead and in the current position, most sellers appear to have exercised their desire for liquidity (a more palatable phrase than bearishness). Thus, while the tendency is to accept a continuation of the current adverse trends, I believe some new ones are more than apparent.

The financial leader of a major foreign international company, whom I'm proud to have as a close friend, states, "The problem is not one of forecasting, instead it is how to assess the extent of the range of options that we may face and defining what may be common to them all; that can suggest approaches to decisions in the coming years." I know of no better phrase as a guideline for national security planning.

U.S. FOREIGN INVESTMENT

Between 1946 and 1973 some $450 billion has been sent abroad as net foreign aid, military assistance, travel, investments, etc. The structure of the changed political, economic and financial environment in the U.S. will result in a changed moderated pattern: Why? Expropriation of foreign facilities; expensive foreign travel, apparent failure of economic assistance (India), less attractive investment opportunities in developed and undeveloped countries; a growing passive interest in the international scene by Americans.

The billions committed abroad was against an optimistic U.S. national background between 1948 and 1963. The U.S. had confidence in its ability to solve any and all problems. Slowly this has been eroded and support for similar foreign expenditures will not be easily regained in the current pessimistic attitude and desire to find simple scapegoats for complicated problems. The oil companies are the current "patsies".

Attitude of private and political (Congress) investors to foreign investment versus desires of the world will cause abrasives.

Mistaken foreign view: the recent UN session remarked that "the capital to undertake exploration in the developing countries has been running somewhat dry." This they attributed to the desire

of developing countries "to assert their national sovereignty over their national resources." We see it differently.

The attitude of U.S. Corporate Managements: Raw materials - a slow realization that no company can confidently own raw materials in a developing foreign country (specific examples: Argentina, Canada, Venezuela, Chile, Peru, Mideast, Jamaica) with not even a demonstrated alternative of fair compensation for expropriation. The negative reaction of Board of Directors to Prime Minister Wilson's statement. "We shall take into national ownership industrial sectors or individual first within the pharmaceutical, machine tool, construction, and road haulage industries - just for starters"!

Developed countries: increasing socialism and trade barriers added to high wage rates and taxes reduce attractiveness of foreign investment; the slowdown of foreign spending already started. The increased U.S. pressure to bring back foreign earnings is already causing abrasions from some governments.

Congressional attitude: too many domestic problems to focus abroad - voters clearly less interested - only strong courageous administration and congressional leadership can reverse the trend.

Conclusion: foreign countries are overestimating the current capital resources of the U.S. and the willingness and ability of U.S. multi-national corporations to invest abroad, at old rates of expansion let alone at higher levels. Not conducive to good diplomatic relations. Frustration will accelerate!

Regardless of the options of various scenarios, the key word financially is "constraint." We had better recognize its meaning sooner than later and not raise the expectations of the underdeveloped countries unless we are willing to significantly reduce U.S. domestic capital consumption starting with consumer excesses.

It will be difficult to do this. We have created large constituencies with vested interests in the maintenance of organizations geared to allocating U.S. capital to foreign nations. The background now is different since it impacts the U.S. directly - food prices, interest rates, etc. How do such organizations as The World Bank, IFC, and the UN organize for the new political environment? This is still not clear.

Technology

The U.S. was falsely branded in the last five years as having lost its technological advantage. This was based on a superficial conclusion from evidence such as the loss of TV and hi-fi sales, sporting goods and small cars. In a quiet but basic way its know-how in the basic industries (sine qua non) had actually increased:

Electronic Data Processing
Pharmaceutical
Mining Equipment
Offshore Drilling Equipment
Heavy Machinery
Agricultural Machinery
Truck Manufacturing
Aircraft
Road Building
Communications Equipment
Refineries
Seeds, Fertilizer, Herbicides

Russia and China can look only to the U.S. for technology backed up by capital and managerial organization. Europe is socializing. Socialism is the antithesis of economy and efficiency. The mideast settlement with Syria with commitments of U.S. capital and technology is perhaps the modern way of negotiation or at least a different approach.

OIL

"Petrodollars"

There is a tendency to discuss "Arab" money surplus as a unit implying that all of the involved countries will behave as a single mind, e.g., Iran, Algeria, and Saudia Arabia.

Many Arab leaders are suspicious of their past financial relationships with the Western World. They have had an adverse impact from past devaluations when their reserves were small and the devaluation expensive. Among formal currency exchange vehicles they will insist upon inflationary hedge clauses that could be tied to oil prices and a cost of living index.

In terms of industrial investment the first consideration is their own economy. Beyond that are the oil poor Arab states, i.e., Egypt and selected nations particularly where derived oil wealth can be "traded off" for other longer term raw material assets.

The Arabs have made their political point through economic means. They now have played their hands successfully and appreciate the danger of over playing trumps. It will be very easy for the world's sentiment to shift from respect for a political coup to outright hatred if economic distortion sets in. The poor countries will, of course, be the worst off which will make it even harder to explain. There is no way in which Saudia Arabia can even contemplate spending the $20 billion surplus in their own country. Some of the smaller "hawk" countries for higher prices are even now not playing the fixed price game but moving oil at discounts.

The standard estimate of $500-$600 billion surplus for the oil producers won't evolve because of the impossibility for world trade and subsequent economic distortions. It reminds me of the 1969-1970 Wall Street cliche that the U.S. investor would soon not have any common stocks to buy as institutional investors would own them all.

The energy crisis is not hopeless, only confused from the U.S. viewpoint. We choose to create or at least accept the crisis. Near term the best solution is a reduction of current consumer excess consumption (electricity, paper, cans, glass, gasoline, food - could reduce energy importantly. However, cooperative consumer response requires strong leadership from the White House. How long can 6% of the world's population consume 35% of its energy?

Long term it involves the utilization of the various sources of energy for their most efficient purposes. Crude oil should not be used for boiler fuel, nor natural gas for heating homes. Both of these wasteful uses occurred because product prices in the fifties and sixties did not reflect real economic costs. Very obvious in the case of natural gas with its regulated price that encouraged demand and discouraged supply. Less obvious in oil but only in recent years did the producing companies understand the international meaning of cheap oil and how dependent Western civilization has become because of unilateral forecasts which were merely an extrapolation of past trends.

COAL

There is (U.S. Geographical Survey) enough recoverable coal within a 4,000 foot depth in seams at least 14 inches thick equal to 500 times total 1972 energy consumption. The U.S. "ace in the hole" in the international oil poker game. Once again we can choose not to develop our resources but the resources are there.

UNKNOWN AND IGNORED FACTORS ABOUT ENERGY

1. The world has little experience to draw from as to the elasticity of demand vs. price. There are many specific examples of sharply lower demand (office buildings, factories, mines, etc.) which will not quickly reverse the conservation trend. What does the current worldwide surplus imply? Why not lower prices?

2. Capital Market Distortions - short term oil dollar reserves versus long term resource developments - can the distortions be contained? Italy is the current classic case.

MORE "OIL LIKE" PRODUCTS

Yes, wherever the U.S. is dependent, i.e., bauxite, chromium, cobalt, magnesium, mercury, nickel, tin, plus such consumer items as bananas and coffee. (Charts 7, 8, 9)

Other industrialized countries are also more vulnerable to copper, iron ore, lead and zinc shortages. Typical countries with new theoretical "clout" because of product reserves in a short supply environment would include such as Zaire, New Caledonia, Jamaica, Canada, Spain, Thailand, Australia. However, it is often overlooked that communist countries are major producers of cobalt, chromium, iron ore, magnesium, nickel, tin and tungsten. The difference in needs between ourselves and our historical allies will cause each country to reassess relationships.

SOLUTION

1. Advance technological efforts on substitute materials (where theoretically possible).

2. Moderate domestic demand for such products.

3. Diversify source dependency.

4. Add to strategic stockpiles now well depleted.

Attitude of developing nations:

1. Nationalize raw material ownership.

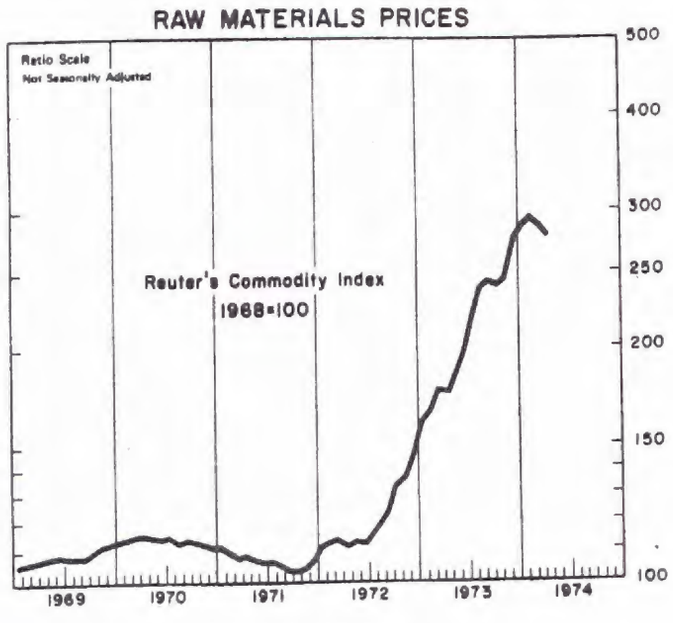
2. Assume technology and managerial abilities will "evolve" somehow.

3. Then raise price like oil cartel.

Will it work? No. Why? Where is capital for development? There are also more reserves than recognized at current price levels.

The entire financial and political world is seeking new solutions for the destabilized money flows and imbalances of resource ownership. Talk is about commodity price agreements (never effective), special IMF loans, levies on international trade.

The accompanying chart is fascinating in the sense of looking at the evidence of an event (price change) that destroyed the old order of the political, economic ans social structure; created strange new economic "friends" reversed political axis with more to come.



mational Monetary Fund, Reuter's Economic Services; The Conference Board

MULTINATIONALS - A brief comment on the financial aspects in discussion of these companies. They (including the large foreign ones: Unilever, Bayer, Philips Lamps, etc.) have done much to create employment and raise standards of living all over the world. Yet their image has been one of destabilizing profiteers. I quote from the summary statement of the UN twenty member panel "The Group of Eminent Persons". "Multinational corporations are not per se agents of development. The technology they employ, the products they market may not always be the right ones for a developing country. Only if the right choices are made can they make a truly significant contribution to a country's development. Hence the crucial importance of being selective. The United Nations should be ready to assist developing countries, on request, in making the right choice and even in assessing the kind of terms on which they should seek the cooperation of multinational corporations."

During all the hearings by the "Group of Twenty Eminent Persons" not one word was emphasized in the financial development that was directed to the free world by multinationals. If the economic and political incentives are no longer there or declining, then we must accept, as a minimum, a slower rate of capital spending. For illogical reasons the foreign critics expect their anti-multinational statements to have no effect on future inputs of capital and managerial talent. I was recently told by an old State Department friend that the typical foreign bureaucracy resents the success of the MNCs.

FOREIGN INVESTMENT IN U.S.

European Management View -

1. Expand in U.S. but limited by lack of capital and managerial expertise.

2. ECM has lost its political "glue" (France, Italy, UK).

3. Japan overrated - raw material vulnerability; sacrifice of social infrastructure to produce low cost export durables; Zaibatsui inefficiency.

4. Is long term strength of the US-China-Russia-Mideast based on the "glue" of raw materials, capital and technology?

The international economic world of private decisions, state monopolies, mixed regulation makes it necessary to have new ground rules for decision making. Private oil companies cannot negotiate with foreign countries. The increasingly socialistic members of the ECM cannot expect continued capital input from U.S. MNCs. The state monopolies of the USSR, China and Saudia Arabia require a completely different approach.

Problems of High Inflation as Related to National Wealth

Minerals - commodity price inflation greater than the old price structure tends to bring new production on stream and make wealth "more real" in terms of extractive economics; a key characteristic of today's world. There is also a very distortive effect on costs of production of manufactured goods. Raw material access dominates economics and long run will change politics.

Capital Markets - borrowing short to lend long equals distortion - distrust of currency is seen in the gold bug syndrone - does oil payment deficit threaten stability in some countries? Yes! Foreign countries and some less developed have borbowed to pay for oil deficits. The danger is in the exhaustion of borrowing capability and unless one assumes a smooth reflux of oil money, the international financial structure is destabilized. Politicians will then act autonomously. There doesn't appear to be enough "trust" to negotiate comfortably. Thus instability is at least the temporary norm.

Commodity Price - higher ones are more beneficial to U.S. than most other countries since we have technology and managerial ability to extract the newly economic reserves. Thus greater U.S. self-sufficiency will be a natural evolvement.

PROBABLE NEW FORCES IN WORLD POLITICAL ECONOMICS ASSOCIATED WITH NATURAL RESOURCES

1. Primary loans to countries that have raw materials versus those desperate with poverty; current lack of interest let alone action for worldwide famine.

2. The possibility of a super cycle theory.

3. Danger of government insurance of foreign investments as an invitation to expropriation.

4. Concept of mutual economic hostage: U.S. has $130 billion invested abroad - how best to protect these assets in a rapidly changing world.

5. Business-government cooperation to supplement international discussions on energy, trade and monetary problems. Some evidence already but not enough.

6. U.S. has much larger raw material reserves at <u>current</u> price levels than we and the world understand - only visible in micro events - powerful political asset when understood.

7. The oil money can only create instability if <u>we</u> so choose by not developing alternative sources of energy that are now economic - coal and Alaskan oil for example.

8. Is it possible to expect the worse scenario, i.e., political violence, destruction of financial relationship, trade wars and isolationism? Yes. Just extrapolate the U.S. economic ignorance and lack of domestic leadership as to capital resources to the international scene and one easily comes to this conclusion - What would the specific scenario be?

    a. Reduced personal taxes and increased government spending will guarantee accelerating inflation. The world's financial structure can't stand the residual distortion.

    b. Permit the ecological extremists to keep a lid on coal, oil and nuclear power without the government restricting consumer consumption.

    c. The concept that if the Arabs won't support underdeveloped countries why should the U.S.? If we ignore world's famine we lose a lot of moral leadership. Yet without strong political leadership how can the people respond.

9. An understanding of past, present and future capital resources and economics is an essential for political diplomacy.

10. Some foreign countries will find it difficult to do business directly with Russia or the Mideast without the U.S. direct or indirect financial involvement and technological direction of the U.S.

In the short run politics determine economics but in the long run economics always determine politics. I assume that there are no more disbelievers. The following perspective comes from a recent speech by Leon Kendall, Director of the Securities Industry Association.

As you look ahead, take heart, lest the ghost of today's political and economic troubles weigh too heavily on you. It is well to recall that our ancestors, time and again, thought themselves to be living in the worst of times. Consider the record:

1810-1840 - Early in the 19th century, the onset of the industrial revolution, with its uprush of factories and cities, also produced a terrible side effect, periodic industrial collapse - depression - 1819, 1829, 1837. The Detroit Free Press said gloomily, "All is darkness and despair. As a nation we are at the bottom of the hill."

1853 - Franklin Pierce takes office. To that point he was the youngest president and viewed as least competent. There is a drift of leadership. In 1857, the Philadelphia Gazette says, "Nothing in this country is safe, solvent or reliable."

1873 - Panic following four years of the presidency of Ulysses S. Grant. Political corruption of high officials was widespread in his administration. The New York World says, "Collapse is a grim reality. The days of the Republic are numbered."

1893 - A decade of waste used up most of the nation's capital. New railroads were delivering so much wheat and cotton to market that prices collapsed; the flood of cheap silver and decline in confidence in gold bring panic. The New Orleans Picayune writes, "On every hand there is depression, wreck and ruin. We can't go much further."

1907 - Investigations of large corporations disclose many abuses and create public distrust leading to a declining stock market, runs on banks. The Wall Street Journal decides, "The old ship of state is sinking."

One can go on and on; 1913, 1929, 1947-49. The point being that change is painful especially to those directly involved.

It is clear that the economy can no longer grow at a real rate of 4½%; perhaps 3% is the figure. Too much has already been borrowed from the future. Leadership can place this change in creative acceptance. The citizenry is waiting to be led. If it isn't done now with morality and integrity, it will be done later with authoritarianism.

Is there no escape? Yes - but it requires leadership and a prompt moderation of the consumer sector to rebuild capital formation and purposeful direction of the use for the factors of production.

ATTITUDES:

Attitudes may be the most important national resource we have - impossible to quantify but not to recognize. What new trends are underway:

1. Surplus of the work force - favorable demographics - excess number of college graduates - lawyers now and doctors by late 70s.

2. Corporate managements - better and broader philosophies.

3. Isolationism - increasing by any poll - prefer reductions of commitments economically, politically and militarily. Low degree of future expectation by the people.

4. Believe in real things - will it persist (real estate, gold, art) versus stock prices (mineral stocks at less than book value let alone replacement)?

5. Quality vs. Quantity - the developed nations can easily reduce excessive consumption but this has no appeal to underdeveloped countries who don't have the luxury of moderating economic quantitative growth.

SPECIFIC RECOMMENDATIONS:

1. Organize the U.S. decision making economic process by starting with a general conference of all the fiscal constituencies to reorganize and establish realistic economic future assumptions for all participants.

2. Moderate excess consumption of energy, food and materials through moral suasions; already evidence that it can be accomplished. Plan temporary financial support for affected industries and personnel. In the terms of the economist to transfer resources from the consumer to producer sector.

3. Use capital resources and tax incentives first to develop new technology for substitute raw materials; barter our capital and technology for the few foreign raw material sources upon which we are dependent; third, develop fall-back stockpiles of strategic materials. Understand the world's need for our capital, technology and managerial organization.

4. Restructure our laws and regulatory authorities to reflect the new socio-economic world. Set the leadership for specific new economic and financial structures.

5. Avoid the temptation to solve our problems by nationalization of industries. Integrate the political power of government with the efficiency of the private sector to deal with raw materials; law of sea use, etc.

6. Last, but perhaps number one, bring together a sense of specific economic purpose and organization in the administration and Congress. The present approach of "doing your own thing" no longer applies in today's interrelated world.

PHILOSOPHY LONG TERM

Most people involved with capital markets and stock prices become slightly mystic since the product they deal with is 50% fact and 50% fiction, and your success or failure is published each day in the paper - not once but twice. My relaxation from statistics and stock prices is cycle theory. One of the foremost people in this area is Professor Ray Wheeler, now deceased, of the University of

Kansas. He was engaged in an immense project to summarize 2,500 years of records in terms of cycles. He came to the conclusion that the most important one was a climate cycle and its influence on human behavior of approximately 100 years' duration. To this 100-year cycle of weather change, he tied the record of human events and concluded that the two facts - weather and human events - were intimately related. There were four phases to each cycle. I won't burden you with it all, but he described in 1949 the period that we would be entering into at the end of the then current cycle. He said that this cold dry period would be the time of general individualism with weak governments, migrations, and mob actions, including race riots and class struggles. Civil wars, ranging from palace intrigues to revolutions, occur during the general anarchy during the cold dry period. People pretend to be cosmopolitan and epicurean, borrowing culture and living by superficial and skeptical philosophy. Mind you, that was written in 1949 about what would happen 15-20 years hence. I'm glad to tell you we are coming out of that period into the next phase, the one we are moving into now - leadership emerges and societies become stabilized, governments mature, and nationalistic spirit revives. In this transition from the cold to the warm period, human energies operate at a high level. Learning is revived, genius appears, industrial revolution occur, crops are good, and times are profitable, and to this I say Amen.

THE REALITY

A great deal of rhetoric will continue to occupy the news as to the solution for BOP problems, inflation, oil dollars, fixed vs. floating exchange rates, the price of gold, etc.

Beneath it all is one basic need: integrity for the U.S. dollar. If that doesn't improve then there is little hope for intelligent international economic relations. The main problem today is the need for a currency that can be purchased and held long term with confidence (by the Arabs especially) since they have been debauched by devaluation and sold second rate Eurodollar issues with sharp subsequent declines. As the dollar's prestige has declined, investors, bankers and foreign businessmen began to prefer things - real estate, the Deutsche mark, gold - which they believed would retain purchasing power at a higher level; and it did.

The oil producers would quickly understand their long term vulnerability to price problems and the enormous imbalance of currency reserves if the U.S. showed leadership to develop immediate alternative sources of energy, reduce consumption, and offer to share with the

free world in an emergency. The Arab leaders do not want chaos. The distortion in Italy, Japan and many underdeveloped countries is a reminder of the danger. The Arabs' achievements have clearly established their world position and influence.

Firm U.S. leadership, based on the facts (not wishes), is an immediate need for the management of the present economic environment. Continuing crisis or an emerging solution is our choice. The blame cannot be passed to other nations.

W. R. Grant

July, 1974

THE WHITE HOUSE
WASHINGTON

Mr. Whitehead:

Ambassador Rumsfeld asked me to pass this along to you.

Barbara
8/16/74

SMITH, BARNEY & CO.
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WILLIAM R. GRANT
PRESIDENT

1345 AVENUE OF THE AMERICAS
NEW YORK, N. Y. 10019

August 12, 1974

Mr. Donald Rumsfeld
The White House
Washington, D. C.

Dear Don:

Welcome back to the confusion!

Enclosed are some recent materials which you may find of interest. The Conference Board Forum has Alan Greenspan's philosophy well stated.

Best regards.

Sincerely,

William R. Grant

WRG:ds
Enc.

CENTER FOR RESPONSIVE TECHNOLOGY

> *I have no need to learn how Congress speaks for the people. As President, I intend to listen. But I also intend to listen to the people themselves--all the people...I wnat to be sure that we are all tuned in to the real voice of America.*
>
> *President Gerald R. Ford*
> *August 12, 1974*

The words of the new President are a fresh breeze, indeed. He really wants to involve the people in their government, listening to concerned citizens directly. But he also recognizes the need to inform the people on possible solutions for such problems as inflation before decisions are made. In calling for a "domestic summit meeting" on the economy involving Members of Congress, the Administration's economic advisors and some of the best brains of labor, industry and agriculture--President Ford made this remarkable proposal:

> *I propose that this summit meeting be held at an early date in full view of the American public. They are as anxious as we are to get the right answers.*

The President is willing to throw up the blinds and let the light in. And he is willing to preside over the meeting himself. But several questions arise. How can a subject which is as complex and arcane as economics--and there seems to be little agreement among the experts on solutions--be put on the nation's center stage for discussion? If the

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proceedings are to be televised, how can long-winded polemics or simplistic solutions be avoided? (Last week, the president of a major union suggested on network television that if General Motors had its taxes increased a billion dollars, the executives still would not be eating dog food.)

Finally, how can the voice of the people be heard after the special interest groups have had their day in court? The "how" is as important as the "what," and there is an innovative--though thoroughly tested--new process which can meet both of the President's stated goals at the same time.

Over the past 18 months, a number of the nation's metropolitan areas have experimented with stimulating broad citizen dialogue on public policy issues. The inspiration derives from the historic New England Town Meeting; it is as old as America. These Twentieth-Century Town Meetings use current communications technology--television and newspapers--to help citizens living in many separate but adjacent communities to consider common problems and alternative solutions. The citizen is given a way to respond by marking a "ballot" published as a public service by newspapers and distributed by citizen groups. These "Town Meetings" are, of course, entirely unofficial. Government is not mandated to act based on ballot returns. But the marriage of the media and the computer with concerned citizens made it possible to create an unprecedented educational experience for the public. It gave elected and appointed government leaders a way to test new public policies, which were often controversial, to find out whether the public was willing to accept some pains to get the benefits of various potential government actions before commitments are made.

The writer of this paper conceived and directed CHOICES FOR '76, the largest Town Meeting experiment to date. The Regional Plan Association, a civic group, sponsored the project which was supported by HUD, 80 corporations and 22 foundations. Ultimately, the Town Meetings involved:

- broadcasting five, one-hour programs on every station in New York, which garnered an average of nearly two million viewers for each Town Meeting;
- publishing a paperback book which sold 100,000 copies and ballots in 26 daily newspapers with two-million circulation;
- organizing 20,000 people in small discussion groups to participate in the Town Meeting by watching the programs, debating the issues, and balloting.

A number of public policies decisively supported by the returned 131,000 ballots have since become law. More important, perhaps, is the fact that other cities--large and small--have created their own Town Meetings patterned on CHOICES FOR '76: Chicago, Milwaukee, Roanoke, and Hartford. New Orleans and Corpus Christi will have some in the fall, and they are likely to get underway in Columbus and North Adams. Here in Washington, Mobil Oil has sponsored dialogues at the Kennedy Center called "National Town Meetings." But they are only broadcast on National Public Radio, though they are expected to go on public television in the fall. They do not involve a year's preparation of content, as did local Town Meetings.

This experience prompts the following suggestions on how the Economic Summit might be organized to clarify complex issues for the citizen, and make it possible (if desirable) to permit citizen balloting on national economic issues:

1. Key organizations representing business, labor, and consumers ought to sit down with Members of Congress and the Administration and develop an agenda for discussion. That agenda ought to be framed around concrete alternatives or "National Choices" for dealing with inflation. Here are two top-of-the-head examples:

   -- To eliminate the federal budget deficit, should:

      A. Federal spending be reduced, and if so, in what areas?

      B. Taxes be increased, and, if so, whose taxes?

   -- To reduce unemployment caused by anti-inflationary measures, do you favor or oppose having the government create jobs for the unemployed? If so, who should get the jobs: the hard-core unemployed or those recently laid off? And what should the wage level be: minimum wages so that more people can be hired, or prevailing wages for similar work?

2. Once a list of the central issues or National Choices has been developed, a second meeting which will be the "Economic Summit" can be arranged. Spokesmen for each point of view will be given time to speak on each side of the precise issues previously agreed upon, but with a 10-minute period for each individual. The President, Congressional leaders and perhaps the press could ask questions of the speakers, and there might be some limited debate by the advocates. It is assumed that it would take two or three days for all the major issues to be explored in depth. Each session could be covered live during the day by one network, and excerpted for evening broadcast by other networks.

3. If the National Choices are released two weeks before they are to be debated in the Economic Summit, all weekly magazines could prepare a series of articles on the issues which would be published during the week of the broadcasts.

4. If desired, IBM card "ballots" could be inserted in all cooperating magazines, giving individual citizens a way to make <u>their</u> voices heard on which painful remedies for solving inflation they are willing to accept.

Because these issues are so complex, and because there is little agreement among the experts on what ought to be done, a case can be made that there should be a more prolonged process than outlined above.

An alternative sequence of events might be the following:

1. The President announces that the opening meeting of the Economic Summit is not designed to get answers, but to frame the issues or National Choices for debate. At that meeting, instead of speeches arguing the issues, a relatively small group works with the President and his advisors to arrive at a list of the Choices to be debated. This could be conducted in private, though it might be better if the meeting were televised and covered by the press, underscoring the openness of the new Administration. (Of course, there could be preliminary briefings of the various sectors in private, so that the leaders of various institutions come to the table with drafted Choices.)

2. A series of regional meetings are held around the country, in which the pros and cons of the choices are debated in a series of one- or two-day conferences. This would give people a chance to see their local leaders getting involved. And it would provide the national press with a basic education on the issues.

3. Finally, an all-day Economic Summit could be held in Washington, with the President presiding. Thinking will have crystallized on the Choices issues, and what could emerge is a consensus on some issues such as the need to moderate wage and price increases, or the need for a tax increase. Of course, there will be disagreement on other issues, such as whether tax increases should come from corporate and upper-income people, or whether they should to be across-the-board.

4. After a suitable period (a week or so), the President could announce his conclusions. Everyone will agree with some of his conclusions, and will disagree with others. But at least, it will have been clear that the President really has listened to all points of view.

Finally, it should be said that balloting by the public on the National Choices is not essential with either of these scenarios, though it is possible with both. A good case can be made that the issues which baffle the experts are likely to baffle the public as well, if not more so. On the other hand, by giving citizens a voice on the issues, the public is given an incentive to watch the programs closely, to read articles in the press, and to think more deeply about the issues. And the President has a way of testing the opinions of an informed electorate on which belt-tightening measures the public is willing to accept in the battle against inflation. Of course, the President could get this information with a scientific poll. But this approach would not stimulate as much citizen education or be as satisfying as "speaking directly to the President" via IBM card balloting.

It might be added that this writer has prepared a detailed Prospectus on how 8-10 National Town Meetings might be conducted in 1975 and up to July 4, 1976 as part of the nation's Bicentennial activities. It is envisioned as a way to show the American people that there are alternatives for tackling the nation's toughest problems, and a way to give every concerned citizen a voice on where they think the nation ought to be headed as we move into our third century of national life. The Urban Institute has tentatively agreed to manage the process of content development working with experts in each field and prhaps 100 major national organizations. A number of very diverse organizations have expressed a willingness to cooperate in developing content and in organizing their constituencies to participate in the National Town Meetings: Chamber of Commerce of the United States, Common Cause, League of Women Voters of the U.S., NAACP, National Municipal League, National Council of Senior Citizens and Forward '76, a coalition of 150 religious leaders from all faiths.

No television network has yet made a commitment to cooperate, but there is substantial interest on the part of a diverse cross-section of national magazines: Business Week, Ebony, National Review, The New Republic, Scholastic, and TIME. TIME's Managing Editor Henry Grunwald, for example, believes it would be possible for the magazine to devote a TIME Essay for each National Town Meeting, plus run the ballot for citizen response. In fact, he published an Essay he wrote on July 8, 1974 which spells out from the media's point of view why the proposed National Town Meetings are needed:

> *A shortcoming of the American press probably graver than any any faults displayed during Watergate is the lack of expertise in many fields, a failure to develop the techniques necessary to inform the public on highly complicated subjects, to lay out alternative choices and possible solutions in an increasingly baffling world. Cliche thinking and reporting are a much greater danger than bias.*
>
> *...the press will have to help rebuild an American consensus, a new agreement as the the country's meaning and goals. That will require a tremendous effort, perhaps some new habits of thought and work on the part of the press, and new, broader ways of giving the public access to print and to the air.*

Thus, I believe that many of the institutions whose cooperation would be needed to create the kind of Economic Summit outlined in this paper---would be willing to get involved along the lines suggested. Of course, the details of the process would have to be worked out with them.

I can think of no better way to create a sustained feeling by the American people that their government is responsive to them, than by creating the kind of process outlined here of informing them of the tough decisions which must be made, and of giving giving every concerned citizen a way to make their voices heard.

Michael J. McManus
August 14, 1974

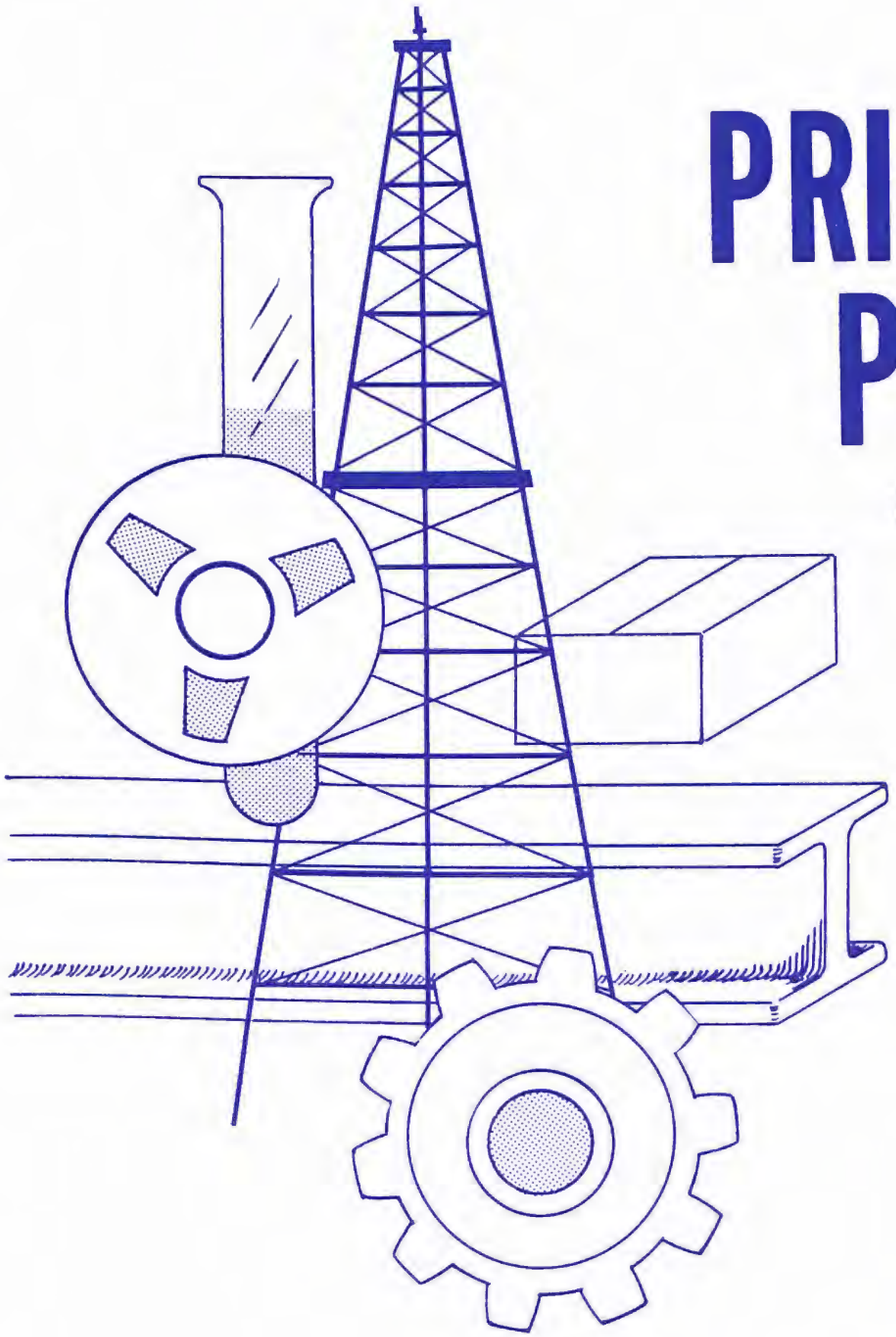
About the Writer of this Paper

After working for small daily newspapers in Connecticut, New York State, and North Carolina, Michael J. McManus was a *TIME* correspondent in Argentina and Washington, D.C., from 1963 to 1968. His assignment in Washington was to cover the impact of the Great Society legislation in health, education, and urban affairs. While reporting a cover story on then HEW Secretary John Gardner, Mr. McManus came across the remarkable Goals for Dallas program which gave thousands of people a voice on 100 public policy goals.

Inspired by the Dallas project and its results, Mr. McManus left *TIME* to join the National Urban Coalition where he wrote case studies on effective local Coalitions and studied how other cities used television in public policy formulation. In 1969, Mr. McManus convinced the Corporation for Public Broadcasting and the White House to co-sponsor "Town Meetings on Hunger" with public television stations in Jacksonville and Washington. The White House wanted to know what the average person felt the federal role should be. So the stations produced programs posing Choices, giving citizens a way to respond with IBM card ballots distributed by churches, PTA's and civic groups organized by Mr. McManus.

With this experience, he persuaded Regional Plan Association, the nation's oldest metropolitan planning agency, to sponsor CHOICES FOR '76, a series of "Town Meetings" which involved broadcasts over all 19 TV stations between New Haven and Trenton, the publishing of ballots by 26 daily newspapers, and organizing 20,000 people in small viewing groups. After directing that project, he became a consultant to Roanoke, Hartford, Washington, D.C., Milwaukee, Corpus Christi and other cities interested in creating Town Meetings.

The J.M. Kaplan Fund, the first foundation to support CHOICES FOR '76, recently awarded a $5,000 grant to the CENTER for Responsive Technology to enable Mr. McManus to work at launching his National Town Meeting idea.



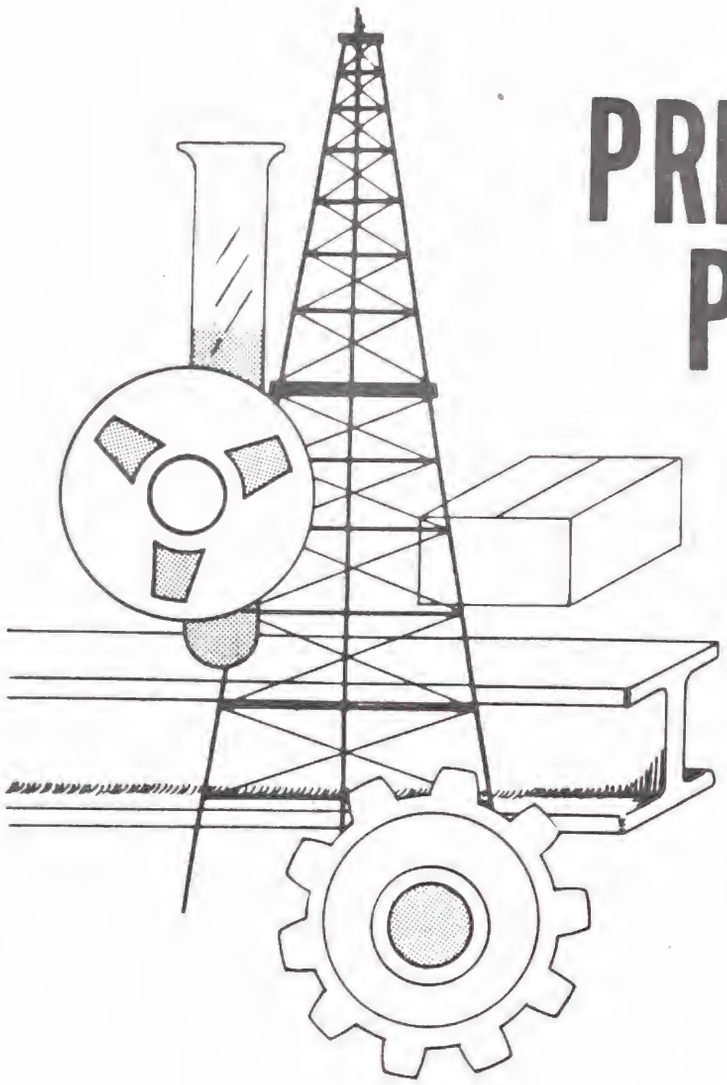
PRICING POWER...

KEY TO THE 1970s

SMITH BARNEY

Summary of
Recent Research Conferences
Given by
Smith Barney

July 1974



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INTRODUCTION

We recognize that some may question the wisdom of devoting particular attention to selected basic industries when the economic outlook is so clouded. Why, they ask, review shortages and capital spending just at the time when weakness in the economy may cause them to subside?

We take a different view of our timing. Indeed, economic conditions may alleviate some shortages for the near term, and some commodity prices may fall. Parenthetically, we discuss the possibility of such declines in our industry analyses. Even if shortages seem to disappear and commodity prices decline in the period ahead, we believe the typical cyclical pattern of sharp earnings erosion is unlikely to follow in 1974-75.

Even more important, we think there is evidence that the basic industries have a new ability to control their prices over the longer run; consequently, the prospects of their achieving significantly higher earnings and profitability seem better than they have for many years. Thus, we believe that investment success in the next 5 years will include these industrial groups which were largely ignored in the past 5 years.

In a historical context, there are certain similarities between the present position of the processing industries and that which existed in the late 1940s. Little capacity expansion occurred during the 1930s--certainly not enough to support the demand for goods that followed the end of World War II. As a result, most of the decade of the 1950s witnessed a substantial increase in capacity, and in the earnings of the basic industries.

We believe much the same *potential* exists for the balance of the 1970s. On the one hand, the demand for goods has increased with the growth of the Nation. On the other hand, operating rates have risen to near capacity because additions to capacity have lagged--on account of inflation, capital investment in nonproductive areas such as antipollution, and low return on investment due to an inability to maintain margins or even to pass on cost increases.

The present monetary policy, if continued long enough, should succeed in moderating inflation--hopefully, without too much dislocation. Price controls have terminated for the most part, and we believe industry now has the opportunity to recover cost increases by raising prices. Further along, margins may be widened by additional price increases or by efficiencies from new capital investment.

Thus, we find that some industries, for the first time in more than a decade and a half, are in a position where aggressive pricing can generate the earnings to finance the capital additions to make the products we believe the Nation will demand as we move through the 1970s.

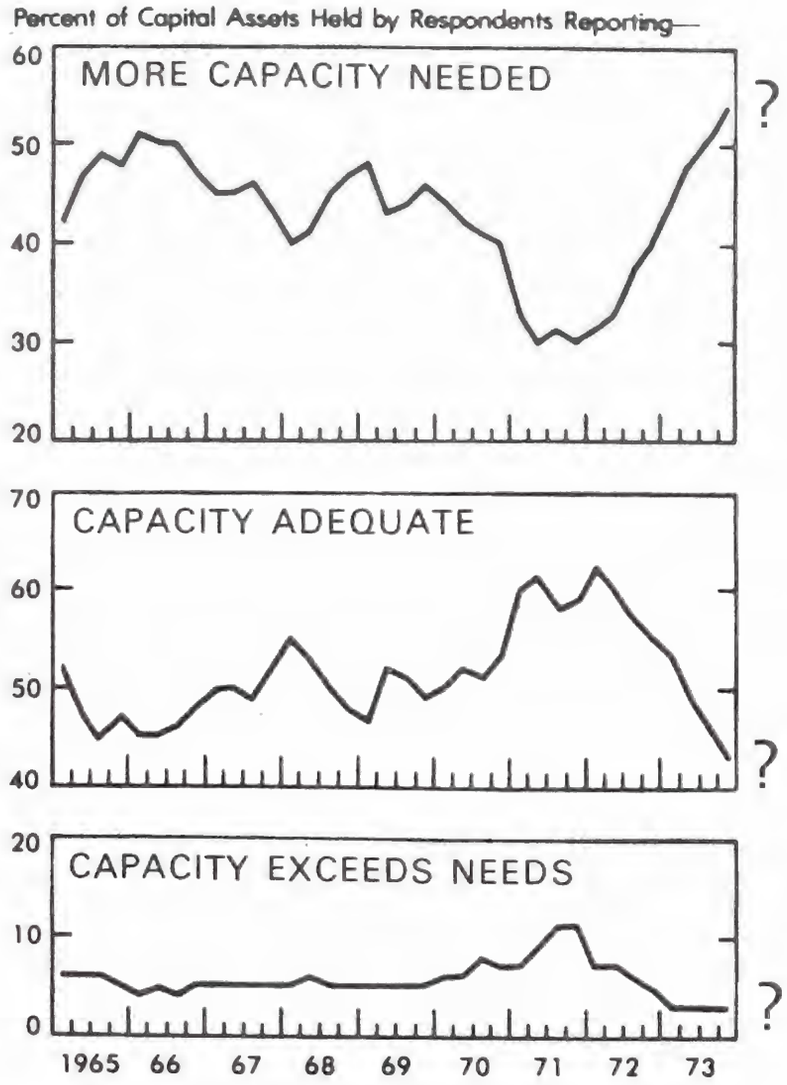
While consternation prevails today regarding near-term prospects for some basic industries, we believe it is more important to analyze the basic trends which are now developing and plan an investment strategy to take advantage of them. Our industry reviews try to bring logic out of confusion and sort out the factors which should be evaluated in a long-term investment strategy. We have never found short-term strategies to be especially rewarding. This seems particularly true for investors who require time to develop and implement a strategy. We do not believe investors should fear a sluggish, stagflated economy during the coming year, but should instead be alert for opportunities to purchase securities at prices which will prove to be attractive in the years ahead. Confusion and economic crosscurrents should be turned to investment advantage in this period.

Three questions frequently surface during a discussion of the basic industries. First, should we buy them? Second, are others buying them? And third, do we *really* believe in the validity of the shortage/pricing concept? Our answer is yes to all three questions. To the first--yes, but the investor must feel comfortable with them. For those who have become investors since the 1950s, the thesis may require time to adjust to--like new shoes. To the second--yes, we find the thesis has gradually gained favor--slowly at first, but more rapidly this year. To the third--yes, because the outlook for the balance of the decade will differ from that in the 1960s, and we believe the difference will favor the industries which we review in the following pages of this report.

Let us first consider the possible economic environment for 1974-75 and conclude our industry reviews with a recommended portfolio that weaves the threads of our pricing thesis into a successful investment strategy for the mid-1970s.

Edmond N. Morse, C.F.A.

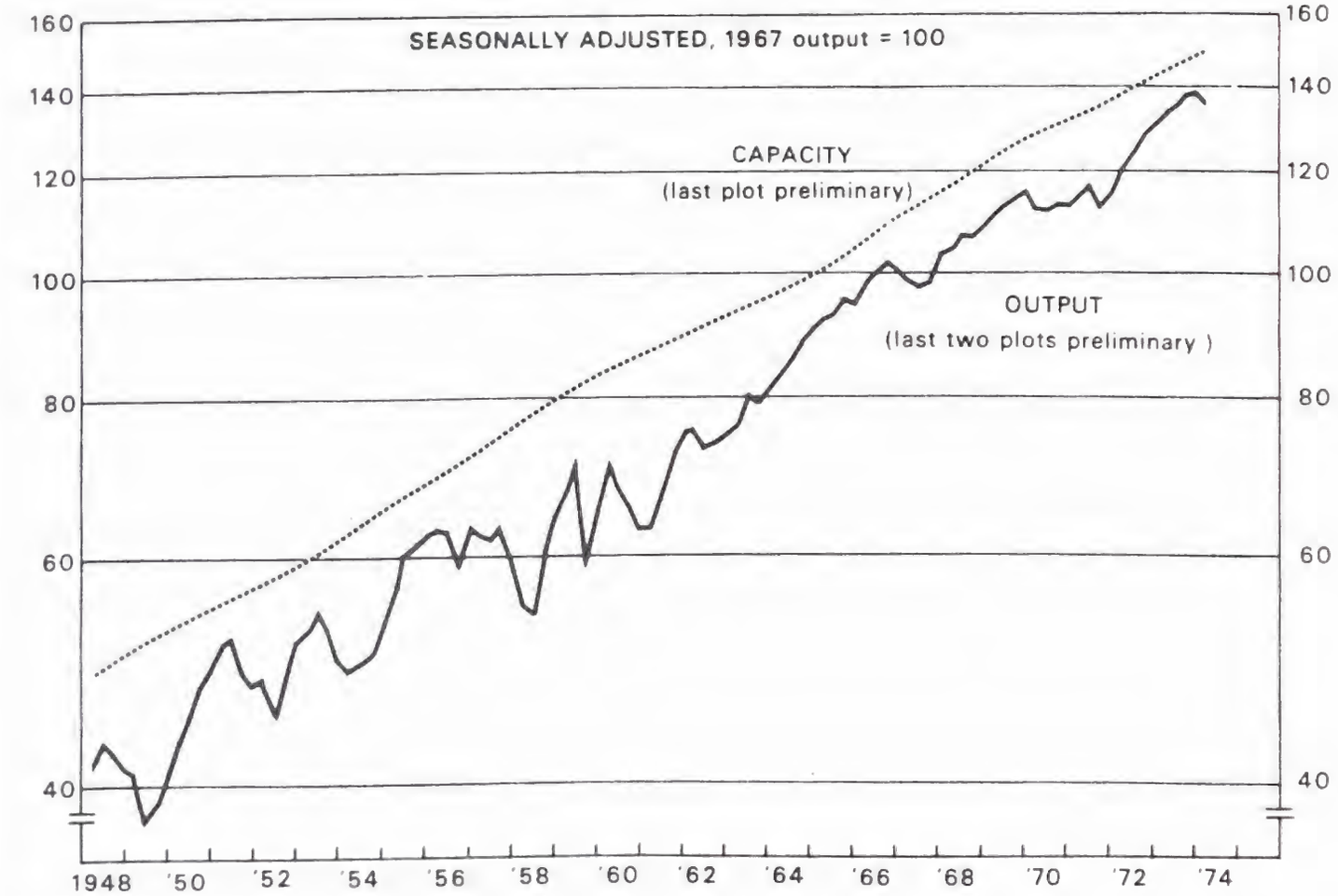
Manufacturers' Evaluation of Existing Capacity *

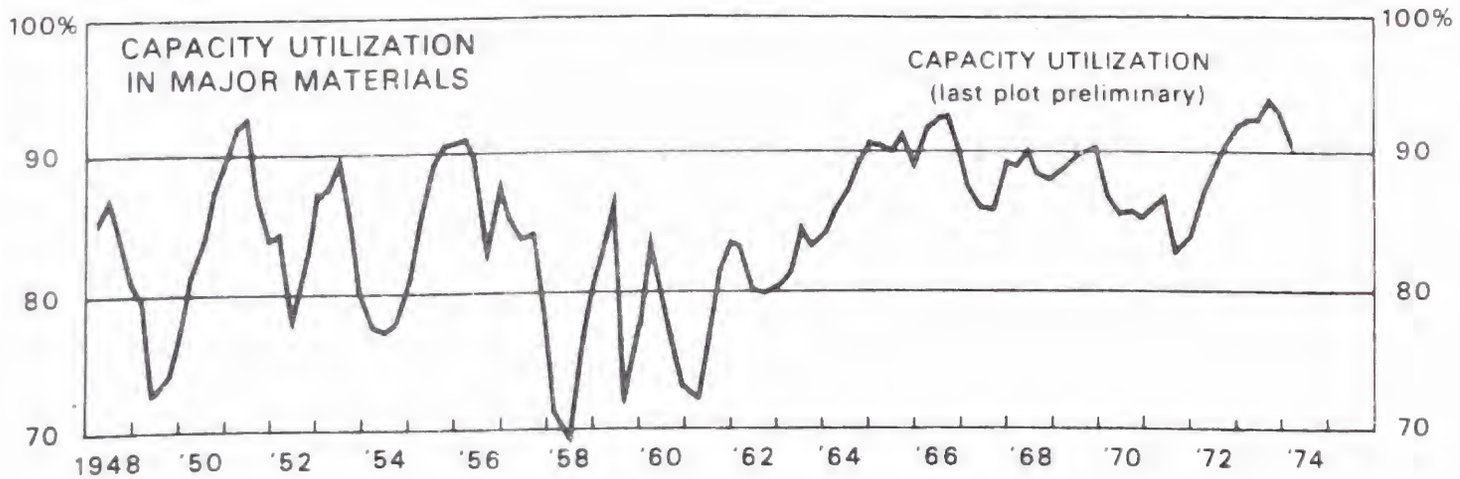


*Relative to prospective operations during the ensuing 12-month period.

U.S. Department of Commerce, Bureau of Economic Analysis 74-3-10

OUTPUT AND CAPACITY IN MAJOR MATERIALS





CAPACITY UTILIZATION
(Major Materials Utilization)

Industries represented: Basic steel, primary aluminum, primary copper, man-made fibers, paper, paperboard, wood pulp, softwood, plywood, cement, petroleum refining, broadwoven fabrics, and yarn spinning. The strategic importance of these industries exceeds their 8% share of total manufacturers' shipments. The important role in the economy played by these industries indicates not only the general relationship between output and capacity in these basic industries, but also the availability of supplies widely used in many manufacturing processes.

The index of capacity utilization is a weighted average of utilization measures compiled for each of the 12 industries. Year-end capacity is used as obtained from either the Commerce or Interior Department, or from industry trade associations based on large-scale surveys. In some instances, annual data are not available and estimates are interpolated from the best available information.

Capacity is defined as the maximum realistic production rate assuming normal product mix, adequate supply of labor and materials, and adequate maintenance downtime to support sustained operations.

	Output 1967=100	Capacity 1967=100	Utilization
1974—I	136.0	149.2	91.2%
1973	138.0	146.1	93.3
1972	126.2	140.8	89.6
1971	115.3	135.1	85.3
1970	112.7	130.7	86.2
1969	113.6	126.2	90.0
1968	107.1	119.9	89.3
1967	99.9	114.3	87.4
1966	100.5	109.1	92.1
1965	93.8	103.4	90.8
1964	87.2	98.4	88.6
1963	79.4	94.9	83.7
1962	74.6	92.0	81.1
1961	69.7	88.4	78.8
1960	67.3	85.5	78.7
1959	66.2	82.5	80.2
1958	58.8	78.6	74.7
1957	62.2	74.6	83.4
1956	62.4	70.7	88.3
1955	60.4	67.7	89.2
1954	50.8	64.6	78.6
1953	52.6	61.2	86.0
1952	48.7	58.4	83.3
1951	50.1	56.3	89.1
1950	46.4	54.2	85.6
1949	39.7	52.1	76.1
1948	42.2	49.9	84.5

Source: Federal Reserve Board.

The FRB does not publish statistics for all of the components except those in the following table:

Capacity Utilization for Selected Groups of Major Materials

	Durable Goods (a)	Non-Durable Goods (b)	Metals (c)	Pulp and Paper (d)	Chemicals and Petroleum (e)
1973–IV	94.3%	93.2%	96.4%	96.4%	91.9%
1973	91.8	93.9	91.7	96.5	93.0
1972	84.7	91.3	82.7	96.9	90.3
1971	78.8	87.6	76.1	92.5	86.6
1970	83.6	87.2	85.1	91.4	86.3
1969	87.6	90.9	89.4	95.5	90.1
1968	83.6	91.5	84.0	91.9	92.1
1967	81.7	89.8	84.0	89.3	90.6
1966	88.4	93.7	91.3	95.2	92.9
1965	88.8	91.6	90.4	94.1	90.1
1964	86.9	89.3	88.3	93.4	87.2
1963	77.8	86.3	77.4	91.0	84.3
1962	72.2	85.3	70.3	89.2	83.0
1961	71.4	82.5	69.0	87.7	79.7
1960	71.5	82.3	69.3	86.6	79.8
1959	70.6	85.2	65.8	87.8	82.9
1958	68.5	77.9	65.0	81.6	76.3
1957	85.3	83.3	87.6	86.1	83.5
1956	88.9	88.7	89.3	93.5	86.9
1955	91.7	88.8	92.6	92.6	88.4
1954	75.3	80.6	73.6	86.7	79.9
1953	87.0	86.5	92.9	89.9	87.4
1952	82.5	84.3	83.5	85.9	87.7
1951	93.2	88.9	97.8	95.3	93.7
1950	87.8	85.8	91.7	90.8	89.1
1949	74.4	77.3	76.7	80.3	84.3
1948	87.3	85.1	90.5	90.7	90.2

(a) Includes plywood and prefabricated products, cement, and metals.

(b) Includes fabrics, cotton and man-made yarns, paper and pulp, and chemicals and petroleum.

(c) Includes pig iron, raw steel, coke and products, copper and aluminum.

(d) Includes wood pulp, paper, and paper board.

(e) Includes plastics materials, synthetic rubber, man-made fibers, basic inorganic chemicals not elsewhere classified and petroleum refining.

Source: Federal Reserve Board.

A CHANGING ECONOMY
AND ITS INVESTMENT SIGNIFICANCE

I would like to start by quoting a student of the investment scene.

> "First, it may be said that stocks ought not to rise before inflation, because the mere prospect of inflation does not increase their investment value; second, that stocks often do not rise during inflation, because the actuality of inflation often hurts corporate earnings temporarily; and third, that stocks will almost surely rise after inflation, because the capital goods they represent are then possessed of greater earning power in terms of depreciated money."

I wanted to bring this to your attention, not because it is a particularly new idea, but rather, because it is an old idea. The quote is from John Burr Williams' *Theory of Investment Value*, copywrited in 1937. I thought it was interesting that this commentary on the effect of inflation on equities was written not in a period of inflation but in one of deflation. I think we have seen in the current inflation that the first two propositions are true. Perhaps we can hope that the last one is also true.

This then brings me to my first subject—inflation. Probably most of you feel, as I do, that only Watergate exceeds inflation as a topic one is growing most tired of hearing about. Nonetheless, it is there, and as long as that is the case, we must consider it when talking about the economic or investment environment.

There has been considerable debate in recent years as to whether inflation is a temporary phenomenon that will eventually recede in the normal course of events or whether it is chronic, resulting from the underlying structural development of our politico-economic system.

The theory that inflation is temporary holds that the inflation we have seen in recent years came about through policy errors on the part of the fiscal and monetary authorities that coincided with several, one-time misfortunes which were unique and not inherently repetitive. Given an absence of such a preponderance of adverse developments, inflation will recede from the recent unprecedented rates and, at least, stabilize under more normal conditions.

The idea that inflation is chronic is attributed partly to structural changes such as the growth of powerful labor unions and the concentration of business. Other facets of the structural argument include the shifting composition of the labor force; the higher costs imposed by better attention to the long-neglected ecological environment; a deterioration in

the work ethic, with its adverse impact on productivity; and diminished productivity growth generally because of the rapid growth of services and government, where productivity gains are modest at best. Finally, and importantly, this idea is also attributed to the commitment throughout the world to fiscal and monetary policies designed to maintain full employment.

My personal view lies somewhere between these extremes. Inflation is not necessarily chronic, in the sense that it is caused by union or corporate power. These do impose increased rigidities in the system, but they did not prevent an abatement of inflation in the early 1960s. It is my opinion that, in spite of these and other rigidities, inflation need not be a problem given the *consistent application of proper fiscal and monetary policy.* If inflation is indeed chronic, it is because social and political pressures are such that it has become impossible to apply proper fiscal and monetary policies on a consistent long-term basis.

What is proper fiscal and monetary policy? One of the forces that may lead to chronic inflation is dispute over just this question. The aim of policy, it seems to me, should be to foster maximum achievable economic growth without creating inflation.

Achieving this aim is not simple. If the steps to foster growth are excessive, then with the growth comes inflation. If the steps to restrain inflation are excessive, growth and the general economic welfare are unduly restricted. Since we cannot know in advance how great an impact specific actions may have, mistakes can be made. There are some who would accept some inflation if it meant maximizing economic growth and minimizing unemployment and its hardships.

I tend to subscribe to a concept of the inflation – unemployment relationship as espoused by Milton Friedman. This theory holds that the Philips curve concept is incorrect – that there is no trade-off of less unemployment for a little more inflation. Instead there is some equilibrium or natural level of unemployment at which the inflation rate will remain constant. That constant rate could be zero, or it could be 10%. If unemployment drops below the equilibrium level, the inflation rate will increase, but not just to a new constant rate: it will continue to increase, accelerating as long as unemployment is below the equilibrium level. A move back to the equilibrium level will not reduce inflation, but will only level it off at the new, higher rate. The rate of inflation will decline only when unemployment is above the equilibrium level for a sufficient time period.

One problem with this concept, of course, is the difficulty of defining the equilibrium unemployment level. Not only do we not know with any precision what it is at any time, it can change from one time to another depending on a variety of forces, including the skill and age composition of the labor force, its psychological attitudes, and the availability of a physical stock of productive capacity in the proper mix.

This problem of definition explains the difficulty of implementing policy through the use of this concept, but it does not invalidate it, in my view. Were policy makers to accept this concept, then an important step will have been taken toward directing fiscal and monetary policy so as to reduce inflation and maintain it at a reasonably low level. The question is whether this will in fact be done. It means inducing or permitting for an extended period of time a higher level of unemployment than is considered desirable, at least by past standards. The longer this action is delayed, the more persistent inflation

becomes, and the time period necessary for restraint to be effective is lengthened. In the 1970–71 recession, we experienced four quarters in which unemployment was above 6%. In my opinion, two more quarters would have done the job of controlling inflation. My own guess is that it will now take at least 2 and possibly 3 years of unemployment over 6% to correct the problem. A higher unemployment level might shorten the necessary time period.

In reality, it is not unemployment per se that is the key; rather, it is the necessity to achieve an equilibrium between expectations and reality. As long as the aggregate expectations of labor and managements for wages and profits to buy goods and services exceed the capability of the economy to produce them, and as long as money is available to satisfy these expectations, the result must be inflation, as prices erode wages and wages then erode profits. A period of above-normal unemployment is required to adjust expectations – not only those of labor for higher wages, but also those of business, that it can automatically produce products and sell them at any price. Business must pay attention to productivity and costs and be realistic in its investment decision making.

The question of whether or not inflation is chronic is thus, in my view, largely a political problem. Are the social and political pressures so overwhelming as to prevent the application of policies, which, in fact, are designed to increase temporarily economic insecurity. If the answer to this is yes, then only a mistake in policy or events external to policy control can finally halt a trend of accelerating inflation.

I might add here that it is my view that until inflation is broken, the secular trend is more likely to accelerate than remain constant. A policy attempting merely to hold inflation constant at, say, 5% or 6% has about as much chance of success as a football team without an offensive backfield. Further, it seems probable that a secular acceleration of inflation eventually must lead to its own demise, along with an economic dislocation far greater than would be required to correct it beforehand. These are not pleasant thoughts, and if this is to be the outcome, it is unlikely that either stocks or bonds are good investments today.

The problem we face, of course, is that we do not have the answer to this longer range question, yet we must continue to make investment judgments. First, even if a major economic dislocation is the long-run answer, the timing is uncertain, and it may be sufficiently far off that we will see one or several more bull markets as inflation periodically appears to abate in cycling around its secular uptrend. Second, inflation may in fact be brought under control for an extended period, in which case Mr. Williams' third proposition, about the very strong performance of stocks after inflation is over, cannot be ignored.

With that rather lengthy theoretical preamble, for which I apologize, but which I thought necessary to explain my thought process before I discussed the current trends, let me now turn to the possibilities for the next year or 2.

I have become somewhat more optimistic of late that at least some chance exists that inflation may be brought under control over the next 2 or 3 years. The odds are not yet very close to 50%, but they seem a little better than they did before, at least to me. Of course, this positive outlook depends on certain things getting worse before they get better – specifically, unemployment and corporate earnings. This outlook results in part from

events that have already occurred, and it results in part from an apparent resolution by the monetary authorities, officials of the Administration, and increasing numbers in Congress to make another serious attempt to control inflation. Public pronouncements seem to indicate recognition that past efforts were not strong enough nor lasted long enough. That the effort is getting under way in an election year, with the next major election 2 1/2 years away, is encouraging.

First, there are certain forces affecting the economic outlook that result from past events, and they are thus not subject to quick reversal by Government action. One of these forces is the sharp decline in real consumer income that has occurred over the past year. (See Chart #1) This decline was due to the unusual bulge in inflation, which, in turn, was caused by the food and oil problems, and, more recently, by price decontrol. The real income decline comes just after a period of strong consumer demand, supported by a surge in consumer credit, the seventh such surge since World War II. It seems premature to expect a quick reacceleration of spending based on credit. In my opinion, consumers are adjusting and will continue to adjust to their lower real income level by spending less in real terms and attempting to rebuild their value-depleted savings. This reaction leads to a sluggish consumer environment which, for the present, I have projected to continue.

A second force resulting from past events is the serious problem faced by several nations abroad in raising dollars to pay for oil at the sharply increased prices. This is a complex problem, and it has yet to be solved definitively. When one cuts through the maze of complexity, it becomes apparent that the oil money that the producing countries cannot use to purchase products or services must be loaned back to the consuming countries on a long-term basis. Until the mechanism for this process is established, including the routing of the funds through acceptable and appropriate intermediaries, more actions like Italy's attempt to restrict imports seem sure to be taken. Restrictive measures to control inflation are also needed abroad, and these, combined with balance of payments problems, undoubtedly prompted the recent announcements of the newly elected French government.

I am hopeful that a solution to the oil payments problem will evolve, but delay in the process seems likely to have some impact on world trade and U.S. exports, which last year were up an extraordinary 24% in real terms in both food and manufactured items.

Housing has been declining because of the 1973 monetary tightness. This year's renewed tightness reinforces this trend, which, because of the high level of construction already in progress, is only beginning to show in total residential construction activity what was seen months ago in housing-start figures.

Thus, the consumer sector, housing and exports are likely to be or remain weak because of events that have already happened.

As I mentioned earlier, the monetary authorities, Administration, and Congress all seem to have an increased resolution to control inflation. Thus I would not look now for new stimulative initiatives to combat the existing, economic weaknesses.

On the contrary, a major threat to the evolution of a weak economy and reduced inflation is the developing trend of wage escalation. Lower real incomes suggest an

enormous pressure for large wage increases, and prior talk of moderation not withstanding, the figures for the three months ending in May show probably the largest rate of wage increase in over 20 years. Should this continue, it would fuel the next phase of the current inflationary cycle and abort any hoped for abatement in it. Inevitably, a sharp rise in wages will continue for a time, as labor attempts to catch up with inflation. Business will not resist as long as its profits are good. The necessary conditions for reduced wage increases are reduced inflation and lower profits. I have assumed that fiscal policy will remain relatively neutral, and monetary policy will remain restrictive until this outcome seems reasonably probable. Actually, because of past events, I believe this outcome will become reasonably probable without much if any increase in the degree of monetary restrictiveness that we are seeing now. It is important, however, that this policy not ease prematurely.

With sluggishness in the consumer, export and housing sectors, and continued monetary pressure, I would expect business investment to become somewhat less exuberant than it might have been.

There has been some dispute over the relative adequacy of present inventories. On the surface, the published numbers indicate that inventories are still relatively low. However, the accuracy of the numbers is suspect because of distortions that may have evolved from the combination of unusual inflation and differences in inventory accounting techniques. Based to some extent on input we have received from individual companies, it is my belief that while shortages of some products may still exist, overall inventories are probably quite adequate. I have assumed that there will be some physical inventory buildup, partially involuntary, in the second and third quarters, but that, thereafter, inventory accumulation will be modest through 1975, thus also contributing to the economy's overall sluggish trend.

Finally, business capital spending which has been gaining strength and needs to continue growing, may well temporarily slip a little in its uptrend. The nonmanufacturing sector, particularly electric utilities, seems most likely to modify its previous spending plans, but some slippage in growth in the manufacturing sector may also result from a moderated overall demand growth for end products, as well as from a continuation of high long term interest rates.

Actually, it would be better for the inflation outlook if capital spending continued quite strong and weakness was concentrated elsewhere. Capacity inadequacy is quite real, we believe, for a number of intermediate products. Some say the shortages result from excessive inventory building. I would point out that the shortages appeared over a year ago, before inventory building—but inventory building probably aggravated the situation later on. With the general sluggishness we envision and some workoff of inventories held by end-product producers, the shortages could seem to disappear. We would regard the appearance of no shortages as the temporary situation—not the shortages themselves.

Policy makers are thus in a dilemma—the economy should be slowed, but capacity additions are needed in certain sectors as rapidly as possible. We believe the pricing mechanism can best solve this dilemma. Stronger pricing for the products in short supply—relative to other products—and here I mean stronger pricing of intermediate products relative to end products—will provide the incentive to expand as well as the cash flow, and where needed, better relative access to external capital.

Some lag in this process may occur, however, and I have assumed, rather arbitrarily, for our current economic assumptions, that the current talk about inadequate depreciation and investment incentives and an increased desire to restimulate the economy next year will lead, by mid 1975, to the adoption of increased depreciation schedules and a higher investment tax credit—retroactive to the beginning of the year. Such moves would increase corporate cash flow and should encourage investment. Also, this explains some rather strange movements in the percentage change numbers for profits on Table III and IV showing our set of economic assumptions.

Before leaving the capital spending sector, I would like to emphasize that although we now see the possibility of slower growth in 1975, the basic need in several industries for added capacity seems far from being satisfied. Thus, we see a probable reacceleration of growth in 1976, which should continue in the following couple of years as well before the current phase of capital expansion is completed.

These thoughts on the economic outlook are summarized in Tables I through IV. Actually, this set of assumptions is more of a hypothesis than a hard forecast. Basically, we think we may be looking at a sluggish trend through most of next year, with some further down quarters possible. Unemployment rises, under these assumptions, to over 7% next year; profits, after rising more than 10% this year, fall 15% next year.

I think we are still in the minority in looking for lower profits next year. The reason we have this view is simply that in a sluggish economic environment, business will find itself unable to sell its products at any price, and in some sectors pricing will become soft. This, after all, is the intermediate objective of any attempt to control inflation. Without some profit pressure there will be little resistance to wage increases, and inflation will not abate as currently expected. It may well accelerate, leading, as I indicated earlier, to much greater problems later.

Price softness is probable, under our assumptions, in various commodities, particularly those that rose sharply in world markets over the last year. For the most part, U.S. producer prices are lower than world prices and should be less affected—though in some cases not completely immune. In any event, lower prices for imported commodities should be of some benefit to domestic costs.

On balance, however, it is our belief that the pricing patterns that will evolve next year and later as well will be different from what we saw in the 1960s. We believe that the relative pricing strength of intermediate products will be significantly better than it was then, at the expense of the relative pricing strength of end products.

Another reason for expecting lower profits in 1975, and one that is tied into our thinking on pricing, is that inventory profits should be down substantially. Indeed, the decline in our estimate of inventory profits from $22 billion this year to $7 billion next year accounts for almost all of the decline in pretax profits. Also—remember—we have assumed that next year depreciation schedules will have been increased. These two items account for more than the $22 billion decline we project for pretax profits. Thus, *real* profits, under these assumptions, will have actually increased.

The rate of consumption growth should begin to improve by mid 1975, and housing should be exerting a positive rather than a negative force. Monetary policy will have eased

well before that time, and the consumer savings rate, perhaps encouraged by reduced inflation, should stop increasing and start declining. Of course, both Federal and state and local spending will have continued increasing, not only for goods and services, but also for unemployment support and social security.

Thus we see growth accelerating in 1976, and higher profits—+20% in our assumptions, without the benefit of an inventory profit increase.

I am sure that many will not like the idea of lower profits next year or unemployment of over 7%—but to me this is a very bullish outlook. It includes unemployment of over 6% at least for 9 quarters—some of them above 7%. This may be enough to do the trick on inflation—and in these numbers, I have assumed this to be the case. Under these assumptions, at the end of 1976 there is still room for above-trend expansion in both productivity and in employment. The wage pressure should have abated, but because of less inflation, real incomes will still trend upward. Thus, in 1977, profits should continue to show good gains at the same time that inflation is dropping below 4%.

Of course, this hypothesis is far from the only possible outcome. Today I would give it as high a probability as any other—but, unfortunately, this is still well below 50%. In an alternative outcome, unemployment and profits would not have to be as poor in 1975, and inflation could still moderate, *if* productivity accelerated more than I have assumed, and *if* wage increases proved to be unexpectedly moderate. I just don't agree with those assumptions.

Second, consumers could spend more of their higher incomes than I have assumed; in that case, business activity would be better, with less if any pressure on prices or profits, and capital spending would be accelerated. If this outcome develops, inflation would not be controlled, the quality of profits would remain poor, economic prospects beyond 1975 would deteriorate, and interest rates would reach new and possibly surprising highs.

Finally, the recovery may have trouble getting started in 1975. I would guess that we may be worring about this in six to twelve months, but I believe the chances do not favor a downward spiral.

With this as background, let me say a few words on interest rates and the equity market.

Until 2 weeks ago, business loans of large commercial banks were about level since the first of May. Prior to that they increased over $12 billion in about 12 weeks. The last 2 weeks have been somewhat unusual in that this was tax and dividend payment time. My numbers on inventory accumulation would indicate pressure for further increases in business loans and thus continued monetary tightness. Adverse news on the wage front, which I think we will be reading more about, may also delay overt ease on the part of the Fed. Against this background, I have a subjective feeling that loan demand probably really has peaked, at least in intensity. For one thing, as I indicated earlier, the inventory numbers are probably misleading, and thus forecasts of further accumulation are suspect. On balance, my guess is that short-term rates will hold around current levels over the very near term—that is, a couple of weeks to a month—and then will ease rather gradually over the balance of the year, with the prime rate late in the year at 8–9% but next year moving below 7%, and, possibly, below 6%.

Long-term rates are another story. Demand for funds will continue to be quite high, as shown in Table V. Uncertainty about inflation will continue. Hopefully, we will see evidence of a downward trend of inflation as the monthly numbers are released, but again, publicity about wage increases may be offsetting, psychologically. In any event, recent levels—prior to the last 2 weeks—of long-term interest rates have already anticipated inflation rates of no more than 5–6%. Thus, except for possible temporary and brief aberrations, (which is what I suspect describes the last 2 weeks) I would expect long-term rates to hold within 50–100 basis points of recent levels for the next six to twelve months; and thereafter, the trend should be downward, given the inflation assumptions I outlined earlier. If these inflation assumptions prove incorrect, and policy makers panic at the prospect of such extended, high unemployment, current interest rates will, in hindsight, appear low—just as last fall's rates now appear low.

I need to add one other hedge on long-term interest rates. In my opinion, the existence of the Regulation Q ceilings on interest rates paid for savings deposits acts as an indirect ceiling on long-term rates, in that at some level, the spread between rates on savings deposits and bonds becomes sufficiently wide to divert some savings of individuals into the bond market. This savings account money typically has a relatively high liquidity preference and would thus prefer short maturities. This preference increases with the degree of inflation expectations or fears. Thus, the spread between savings deposit rates and bond rates will be greater if 1) inflation expectations are high and 2) if there is a large availability of high-coupon short-term instruments.

The proposed offering of floating-rate notes by a large bank holding company could have some influence on the structure of long-term interest rates, particularly if it is followed by a number of other, similar offerings. First, this offering and, possibly, others like it will increase the availability of high coupon short-term debt instruments. This will attract individual savings that might otherwise have moved into bonds. Second, it may become necessary to change Regulation Q so as to permit higher rates to be paid for savings deposits, thus increasing the effective ceiling these rates exert on long-term interest rates. Of course, this latter action would be adverse to the savings institutions, but it might be implemented gradually or there may be other relief provided to forestall serious difficulty at the savings institutions.

In any event, a successful introduction of this new investment vehicle would present a new form of competition for individual savings that may well make it more difficult and more costly for corporations to attract long term money directly from that source.

It is rather difficult to see how the environment for equities could be much worse. Many people are saying the most bullish sign is that everyone is bearish. Unfortunately, I think too many investors may be saying that—thus many are really not bearish.

The market today is highly sensitive to interest rates—particularly short term rates. To the degree this sensitivity is based on the notion that an easing in rates will mean better business conditions, it does not seem appropriate to me. Better business conditions over the near term are not bullish—they are bearish—for they can only mean continued high inflation. Actually, lower short-term interest rates can develop only if loan demand eases considerably—an indication that business is becoming sluggish. In this sense the market is correct to assess lower interest rates as bullish.

The economic outlook I presented today and described as being the most bullish envisions lower earnings next year—albeit much higher quality earnings. Are lower earnings discounted by the market? In the case of many stocks, I would guess anything other than an actual Chapter 11 announcement is discounted. For the most part, these are the

secondary names—or lower—and the utilities. As for the stocks that contribute importantly to the market indices, however, I question that lower reported earnings can be taken in stride without some impact—even if—as will be probably true in many cases—the impact is emotionally inspired and proves to be temporary. Otherwise why the 5 point drop in Honeywell recently on a relatively minor revision of an earnings estimate?

Earlier this month I gave a talk at the Conference Board on the future of price/earnings multiples—as if I really knew. It did force me to rethink the problem, however, as I have done periodically over the past 5 or 6 years. Without repeating that speech or the reasoning behind it, I will try to give you the conclusion.

For the S & P indices I conclude that multiples of the intermediate term future should be in the area of 9x to 13x—toward the higher end with controlled inflation—and toward the lower end or lower if inflation is not controlled. The S & P 425 this year should earn $9.50–10.00. At about 100, it is between 10 and 11 times earnings—really not at either extreme. If my earnings outlook proves correct, earnings next year may be $8–8.50—and the present price level is 12 to 13 times next year's earnings—high enough perhaps, but not clearly excessive and, again, those will be somewhat depressed earnings of substantially improved quality. Finally, if we look out to 1976, the S & P 425 should earn about $10 to $11 to be consistent with my numbers with further recovery still in sight. The normal earning power, at that point, should be at least $12. At 13x $10 to $11 the potential gain for this index from current levels is on the order of 30% to 40%.

Given the outlook that I have described, my guess is that the market is not finished fluctuating in the area established in recent months, and the potential for new lows does exist. However, as we begin to build in expectations of lower earnings in 1975, I would expect that the equity market could begin a recovery that may last longer than any in the last 6 to 8 years. *I am not saying we should ignore the negative possibilities of the failure to control inflation. These negative possibilities should be built into your overall portfolio balance.* What I am saying is that a reasonably decent probability still exists that stocks at today's levels will turn out to be good investments.

In any event, it is our belief that once you make your decision on equity proportions, given the uncertainties of inflation, now is the time to pay particular attention to which stocks you want to own, rather than worrying excessively about near-term market swings or catching that elusive bottom price.

As I have talked, you may have wondered why—if we are looking for a sluggish economy, pricing weakness, and lower earnings—we chose to include some of the basic, historically cyclical industries in a large part of today's presentation. The reason is simple. In every case we are talking about not just next year, we are talking about changes in the fundamentals that will persist, not forever, but perhaps through most of the 1970s. In several cases these have to do with changes in relative pricing strength to which I referred earlier. As this becomes recognized, we expect changes in relative valuations to evolve as well. There has already been evidence that this is occurring. We expect it to continue.

Of course timing is important; but if all of you try to catch the bottom, I assure you, most of you won't.

I hope the balance of the program will give you food for thought on investment trends of the 1970s that are already in evidence.

SMITH, BARNEY & CO.
Incorporated

William W. Helman

SMITH, BARNEY & CO. INC.
ECONOMIC ASSUMPTIONS
(JUNE 17, 1974)

Table I

	(DOLLARS IN BILLIONS)						(PERCENT CHANGE FROM YEAR EARLIER)					
	71	72	73	74	75	76	71	72	73	74	75	76
GNP	1055.5	1155.2	1289.1	1400.7	1503.1	1654.7	8.0	9.4	11.6	8.7	7.3	10.1
CONSUMER EXPENDITURES	667.2	726.5	804.1	875.3	945.7	1035.5	8.0	8.9	10.7	8.9	8.0	9.5
DURABLES	103.6	117.4	130.9	127.7	133.4	151.2	13.4	13.4	11.4	-2.4	4.4	13.4
NON-DURABLES	278.7	299.9	335.9	375.3	402.1	433.0	5.7	7.6	12.0	11.7	7.2	7.7
SERVICES	284.9	309.2	337.3	372.3	410.2	451.3	8.5	8.5	9.1	10.4	10.2	10.0
GROSS PRIVATE DOMESTIC INVESTMENT	153.2	178.3	202.2	206.9	212.6	238.7	12.4	16.4	13.4	2.3	2.8	12.3
PRODUCERS DURABLE EQUIPMENT	66.6	76.6	87.8	93.7	100.8	110.0	3.3	15.0	14.7	6.7	7.6	9.2
NON-RESIDENTIAL CONSTRUCTION	37.9	41.7	48.4	55.3	56.4	61.0	4.8	10.1	16.1	14.1	2.0	8.3
RESIDENTIAL CONSTRUCTION	42.7	54.0	58.0	49.1	49.7	58.4	36.9	26.4	7.3	-15.3	1.3	17.4
INVENTORY CHANGE	6.1	6.0	8.0	8.9	5.8	9.3	33.7	-0.4	32.0	11.6	-35.2	60.9
NET EXPORTS	0.8	-4.6	5.8	7.7	1.7	2.9						
GOVERNMENT PURCHASES OF GOODS & SVCS	234.3	255.0	277.1	310.9	343.0	377.6	6.7	8.8	8.7	12.2	10.3	10.1
FEDERAL	98.1	104.4	106.6	117.8	128.7	140.6	1.9	6.5	2.1	10.5	9.3	9.2
STATE & LOCAL	136.2	150.6	170.5	193.1	214.3	237.0	10.4	10.5	13.3	13.3	11.0	10.6
GNP(1958 DOLLARS)	745.4	790.7	837.4	836.7	844.6	890.2	3.2	6.1	5.9	-0.1	0.9	5.4
FIXED NON-RESIDENTIAL INVESTMENT	104.4	118.2	136.2	148.9	157.1	171.1	3.8	13.2	15.2	9.3	5.5	8.9
EXPENDITURES FOR PLANT & EQUIP.	81.2	88.4	99.6	111.8	119.5	132.0	1.9	8.8	12.7	12.2	6.9	10.5
OTHER	23.2	29.8	36.6	37.2	37.6	39.1	11.4	28.6	22.5	1.7	1.3	3.9
PRETAX CORPORATE PROFITS	85.1	98.0	126.2	140.9	118.9	143.7	14.8	15.3	28.8	11.6	-15.6	20.9
AFTER TAX CORPORATE PROFITS	47.6	55.4	70.4	79.8	67.9	81.3	21.4	16.3	27.1	13.4	-14.9	19.8
GNP PRICE DEFLATOR(1958=100)	141.6	146.1	153.9	167.4	177.9	185.8	4.7	3.2	5.4	8.8	6.3	4.4
CPI(1967=100)	121.3	125.3	133.1	146.8	156.6	164.2	4.3	3.3	6.2	10.3	6.7	4.9
NON-FARM OUTPUT/MANHOUR(1967=100)	107.6	112.1	115.5	114.9	117.5	122.3	4.0	4.2	3.1	-0.5	2.3	4.1
COMPENSATION/MANHOUR(1967=100)	131.8	140.8	151.6	163.9	179.5	193.0	7.0	6.9	7.6	8.1	9.6	7.5
PERSONAL INCOME	863.5	939.2	1035.4	1134.9	1230.8	1345.8	6.8	8.8	10.2	9.6	8.4	9.3
DISPOSABLE PERSONAL INCOME	746.0	797.0	882.5	965.8	1045.6	1140.7	7.8	6.8	10.7	9.4	8.3	9.1
PERSONAL SAVINGS	60.2	49.8	54.8	64.4	72.1	75.3	7.1	-17.3	10.2	17.6	11.8	4.5
SAVINGS RATE	8.1	6.2	6.2	6.7	6.9	6.6						
FRB INDEX(1967=100)	106.7	115.1	125.4	126.2	125.3	131.9	0.0	7.9	9.0	0.6	-0.7	5.3
EMPLOYMENT(000,000)	79.1	81.7	84.4	85.9	85.5	87.1	0.6	3.3	3.3	1.7	-0.4	1.9
UNEMPLOYMENT RATE	6.0	5.6	4.8	5.5	7.1	6.6						
FEDERAL GOV. EXPENDITURES - NIA	221.1	244.6	264.1	300.7	333.7	367.3	8.4	10.6	8.0	13.9	11.0	10.1
FEDERAL GOV. RECEIPTS - NIA	198.9	228.7	265.0	293.2	305.1	344.2	3.6	15.0	15.9	10.6	4.1	12.8
FEDERAL BUDGET SURPLUS(DEFICIT) - NIA	-22.2	-15.9	0.9	-7.5	-28.5	-23.1						
STATE AND LOCAL EXPENDITURES - NIA	148.3	164.0	184.1	207.1	232.0	257.8	11.3	10.6	12.2	12.5	12.0	11.1
STATE AND LOCAL RECEIPTS - NIA	152.3	177.2	194.5	211.2	231.5	254.4	12.8	16.3	9.8	8.6	9.6	9.9
STATE AND LOCAL SURPLUS(DEFICIT) - NIA	4.0	13.2	10.5	4.1	-0.5	-3.4						
AUTO SALES(000,000 UNITS)	10.3	10.9	11.5	9.5	9.8	10.9	21.5	6.6	5.5	-18.0	3.4	11.6
HOUSING STARTS(000,000 UNITS)	2.0	2.4	2.0	1.5	1.6	1.8	41.9	15.9	-13.1	-24.7	2.4	15.0

Figures are actual through the first quarter of 1974.

SMITH, BARNEY & CO. INC.
ECONOMIC ASSUMPTIONS
(JUNE 17, 1974)

Table II

	(DOLLARS IN BILLIONS) (QUARTERS AT ANNUAL RATE)											
	74: 1	74: 2	74: 3	74: 4	75: 1	75: 2	75: 3	75: 4	76: 1	76: 2	76: 3	76: 4
GNP	1352.2	1389.9	1420.0	1440.9	1462.0	1485.1	1513.9	1551.4	1590.5	1632.0	1674.5	1721.9
CONSUMER EXPENDITURES	844.6	867.1	887.2	902.3	917.8	934.0	954.3	976.6	1000.2	1023.3	1046.6	1071.8
DURABLES	125.0	127.2	128.9	129.9	130.1	131.0	133.9	138.6	143.5	148.6	153.6	159.1
NON-DURABLES	362.3	372.6	380.7	385.5	391.7	398.3	405.5	413.0	420.9	428.8	436.7	445.7
SERVICES	357.3	367.3	377.5	386.9	396.0	404.7	414.9	425.1	435.9	445.9	456.4	467.0
GROSS PRIVATE DOMESTIC INVESTMENT	198.9	209.0	211.2	208.5	208.9	211.3	213.0	217.2	224.7	233.8	243.3	253.0
PRODUCERS DURABLE EQUIPMENT	90.2	92.8	94.7	96.9	98.3	100.3	101.4	103.1	105.3	108.2	111.4	115.2
NON-RESIDENTIAL CONSTRUCTION	53.9	55.1	55.8	56.3	56.0	56.2	56.3	56.9	58.1	59.6	61.9	64.6
RESIDENTIAL CONSTRUCTION	49.3	51.1	48.7	47.3	47.6	48.8	50.3	52.2	54.3	57.0	60.0	62.2
INVENTORY CHANGE	5.5	10.0	12.0	8.0	7.0	6.0	5.0	5.0	7.0	9.0	10.0	11.0
NET EXPORTS	10.9	7.8	6.6	5.5	3.8	1.5	0.6	1.1	1.7	2.4	3.2	4.2
GOVERNMENT PURCHASES OF GOODS & SVCS	297.8	306.0	315.0	324.7	331.5	338.3	346.0	356.4	363.8	372.5	381.3	392.9
FEDERAL	112.1	115.9	119.4	123.7	125.2	127.0	128.9	133.7	135.4	138.4	141.4	147.1
STATE & LOCAL	185.7	190.1	195.7	201.0	206.2	211.3	217.0	222.8	228.4	234.1	239.9	245.8
GNP(1958 DOLLARS)	831.0	838.1	839.9	837.9	837.6	840.0	845.4	855.4	868.3	882.8	897.4	912.2
FIXED NON-RESIDENTIAL INVESTMENT	144.1	147.9	150.5	153.2	154.3	156.5	157.7	160.0	163.4	167.8	173.3	179.8
EXPENDITURES FOR PLANT & EQUIP.	107.2	110.6	113.2	116.0	117.0	119.0	120.0	122.0	125.0	129.0	134.0	140.0
OTHER	36.8	37.3	37.3	37.2	37.3	37.5	37.7	38.0	38.4	38.8	39.3	39.8
PRETAX CORPORATE PROFITS	140.1	155.0	138.8	129.6	125.4	123.1	102.9	124.3	130.7	138.7	147.5	157.9
AFTER TAX CORPORATE PROFITS	80.2	88.4	78.4	72.4	68.7	67.4	64.4	71.1	74.0	78.5	83.5	89.3
GNP PRICE DEFLATOR(1958=100)	162.7	165.8	169.1	172.0	174.5	176.8	179.1	181.4	183.2	184.9	186.6	188.8
CPI(1967=100)	141.6	145.5	148.8	151.2	153.4	155.6	157.6	159.6	161.4	163.2	165.0	167.0
NON-FARM OUTPUT/MANHOUR(1967=100)	114.0	114.8	115.2	115.6	116.2	116.8	117.9	119.1	120.4	121.7	122.9	124.1
COMPENSATION/MANHOUR(1967=100)	158.4	161.9	165.6	169.6	173.7	177.8	181.6	185.1	188.5	191.6	194.5	197.2
PERSONAL INCOME	1094.4	1123.4	1149.5	1172.5	1194.6	1218.6	1240.8	1269.2	1300.5	1330.0	1359.6	1392.9
DISPOSABLE PERSONAL INCOME	931.4	956.3	978.3	997.4	1015.9	1035.6	1053.9	1077.2	1103.6	1127.8	1152.1	1179.4
PERSONAL SAVINGS	61.5	63.3	64.8	68.3	70.9	73.9	71.5	71.9	74.3	74.9	75.3	76.8
SAVINGS RATE	6.6	6.6	6.6	6.8	7.0	7.1	6.8	6.7	6.7	6.6	6.5	6.5
FRB INDEX(1967=100)	124.9	127.0	126.9	125.8	125.0	124.7	125.0	126.3	128.3	130.6	133.0	135.6
EMPLOYMENT(000,000)	85.8	85.9	86.0	85.7	85.5	85.5	85.4	85.7	86.2	86.8	87.5	88.2
UNEMPLOYMENT RATE	5.2	5.2	5.5	6.1	6.7	7.0	7.3	7.3	7.1	6.8	6.4	6.0
FEDERAL GOV. EXPENDITURES - NIA	282.3	298.6	306.5	315.4	323.9	330.0	336.1	344.7	354.5	362.5	370.6	381.5
FEDERAL GOV. RECEIPTS - NIA	284.9	296.0	294.9	296.8	302.1	306.0	295.7	316.8	327.9	338.4	349.2	361.3
FEDERAL BUDGET SURPLUS(DEFICIT) - NIA	2.6	-2.6	-11.6	-18.5	-21.8	-24.0	-40.3	-27.9	-26.6	-24.1	-21.5	-20.3
STATE AND LOCAL EXPENDITURES - NIA	197.7	203.7	210.4	216.7	222.8	228.5	235.1	241.6	248.0	254.6	260.9	267.6
STATE AND LOCAL RECEIPTS - NIA	202.2	209.7	214.2	218.7	224.2	229.1	233.1	239.5	245.2	251.1	257.3	263.9
STATE AND LOCAL SURPLUS(DEFICIT) - NIA	4.5	6.0	3.8	2.0	1.5	0.6	-1.9	-2.0	-2.9	-3.5	-3.6	-3.7
AUTO SALES(000,000 UNITS)	9.2	9.5	9.6	9.7	9.7	9.7	9.8	10.1	10.5	10.8	11.1	11.3
HOUSING STARTS(000,000 UNITS)	1.6	1.6	1.5	1.5	1.5	1.6	1.6	1.7	1.7	1.8	1.9	1.9

Figures are actual through the first quarter of 1974.

SMITH, BARNEY & CO. INC.
ECONOMIC ASSUMPTIONS
(JUNE 17, 1974)

Table III

(PERCENT CHANGE FROM PRIOR QUARTER AT ANNUAL RATE)

	74: 1	74: 2	74: 3	74: 4	75: 1	75: 2	75: 3	75: 4	76: 1	76: 2	76: 3	76: 4
GNP	4.5	11.6	9.0	6.0	6.0	6.5	8.0	10.3	10.5	10.9	10.8	11.8
CONSUMER EXPENDITURES	9.7	11.1	9.6	7.0	7.1	7.3	9.0	9.7	10.0	9.6	9.4	10.0
DURABLES	-1.9	7.2	5.6	2.9	0.6	2.9	9.1	14.7	15.1	15.0	14.1	15.0
NON-DURABLES	15.3	11.9	9.0	5.1	6.6	7.0	7.4	7.6	7.8	7.7	7.6	8.5
SERVICES	8.6	11.7	11.6	10.3	9.8	9.0	10.5	10.2	10.5	9.6	9.7	9.7
GROSS PRIVATE DOMESTIC INVESTMENT	-25.2	21.9	4.3	-5.1	0.9	4.6	3.1	8.3	14.5	17.2	17.3	16.9
PRODUCERS DURABLE EQUIPMENT	0.4	11.9	8.6	9.7	5.6	8.6	4.2	7.0	9.1	11.1	12.6	14.4
NON-RESIDENTIAL CONSTRUCTION	18.1	9.4	4.9	3.5	-1.7	1.1	1.1	4.1	8.2	11.3	16.0	18.6
RESIDENTIAL CONSTRUCTION	-30.5	15.3	-17.4	-11.4	3.3	10.3	12.3	16.7	16.9	21.2	23.0	15.3
INVENTORY CHANGE												
NET EXPORTS												
GOVERNMENT PURCHASES OF GOODS & SVCS	18.2	11.5	12.3	12.8	8.6	8.5	9.4	12.6	8.5	9.9	9.8	12.8
FEDERAL	21.4	14.3	12.5	15.3	5.2	5.6	6.4	15.5	5.4	9.1	8.9	17.2
STATE & LOCAL	16.4	9.8	12.2	11.4	10.8	10.3	11.3	11.0	10.4	10.4	10.3	10.2
GNP(1958 DOLLARS)	-6.3	3.4	0.9	-0.9	-0.2	1.2	2.6	4.8	6.2	6.8	6.8	6.8
FIXED NON-RESIDENTIAL INVESTMENT	6.6	11.0	7.2	7.4	2.9	5.8	3.1	6.0	8.8	11.2	13.8	15.9
EXPENDITURES FOR PLANT & EQUIP.	13.8	13.5	9.7	10.3	3.5	7.0	3.4	6.8	10.2	13.4	16.4	19.1
OTHER	-12.3	5.2	0.0	-1.1	1.1	2.2	2.2	3.2	4.3	4.2	5.3	5.2
PRETAX CORPORATE PROFITS	46.2	49.9	-35.7	-24.1	-12.3	-7.2	-51.2	112.9	22.3	27.0	27.9	31.1
AFTER TAX CORPORATE PROFITS	57.4	47.3	-38.1	-27.0	-19.1	-7.2	-16.7	48.2	17.2	27.0	27.9	31.1
GNP PRICE DEFLATOR(1958=100)	11.5	7.9	8.0	7.0	6.2	5.2	5.2	5.3	4.0	3.8	3.8	4.7
CPI(1967=100)	12.2	11.3	9.6	6.5	6.1	5.7	5.4	5.0	4.8	4.5	4.5	4.8
NON-FARM OUTPUT/MANHOUR(1967=100)	-4.4	2.8	1.4	1.4	2.1	2.1	3.8	4.1	4.4	4.4	4.0	4.0
COMPENSATION/MANHOUR(1967=100)	6.8	9.0	9.7	9.8	10.2	9.6	8.8	8.2	7.5	6.7	6.2	5.6
PERSONAL INCOME	5.9	11.0	9.6	8.3	7.8	8.3	7.5	9.5	10.2	9.4	9.2	10.2
DISPOSABLE PERSONAL INCOME	6.1	11.1	9.5	8.0	7.6	8.0	7.2	9.1	10.2	9.1	8.9	9.8
PERSONAL SAVINGS	-29.4	11.9	10.0	23.4	16.3	18.3	-12.6	2.5	13.6	3.7	2.2	8.0
SAVINGS RATE												
FRB INDEX(1967=100)	-6.5	6.9	-0.4	-3.2	-2.7	-0.8	0.9	4.0	6.6	7.6	7.5	8.1
EMPLOYMENT(000,000)	0.8	0.3	0.4	-1.2	-1.2	0.1	-0.3	1.4	1.9	2.9	3.2	3.4
UNEMPLOYMENT RATE												
FEDERAL GOV. EXPENDITURES - NIA	20.2	25.1	11.1	12.0	11.3	7.7	7.6	10.7	11.8	9.3	9.3	12.3
FEDERAL GOV. RECEIPTS - NIA	16.4	16.5	-1.4	2.6	7.3	5.2	-12.7	31.8	14.7	13.5	13.3	14.6
FEDERAL BUDGET SURPLUS(DEFICIT) - NIA												
STATE AND LOCAL EXPENDITURES - NIA	10.3	12.6	13.9	12.5	11.7	10.6	12.1	11.5	11.2	11.0	10.4	10.5
STATE AND LOCAL RECEIPTS - NIA	6.8	15.6	8.9	8.6	10.6	9.0	7.2	11.4	9.8	10.1	10.3	10.6
STATE AND LOCAL SURPLUS(DEFICIT) - NIA												
AUTO SALES(000,000 UNITS)	-23.4	11.3	4.3	4.3	0.0	0.0	5.3	12.9	18.0	11.9	11.6	7.4
HOUSING STARTS(000,000 UNITS)	10.3	-16.9	-12.3	0.0	5.4	8.1	13.5	13.1	18.1	19.9	11.6	11.3

Figures are actual through the first quarter of 1974.

SMITH, BARNEY & CO. INC.
ECONOMIC ASSUMPTIONS
(JUNE 17, 1974)

Table IV

(PERCENT CHANGE FROM YEAR EARLIER)

	74: 1	74: 2	74: 3	74: 4	75: 1	75: 2	75: 3	75: 4	76: 1	76: 2	76: 3	76: 4
GNP	8.8	9.3	8.9	7.7	8.1	6.9	6.6	7.7	8.8	9.9	10.6	11.0
CONSUMER EXPENDITURES	8.4	9.0	8.7	9.3	8.7	7.7	7.6	8.2	9.0	9.6	9.7	9.7
DURABLES	-5.4	-4.2	-2.9	3.4	4.1	3.0	3.8	6.7	10.3	13.4	14.7	14.8
NON-DURABLES	12.4	12.8	11.4	10.3	8.1	6.9	6.5	7.1	7.5	7.6	7.7	7.9
SERVICES	9.9	10.4	10.5	10.5	10.8	10.2	9.9	9.9	10.1	10.2	10.0	9.9
GROSS PRIVATE DOMESTIC INVESTMENT	2.3	5.4	4.6	-2.5	5.1	1.1	0.8	4.2	7.5	10.6	14.3	16.5
PRODUCERS DURABLE EQUIPMENT	5.5	6.8	6.9	7.6	8.9	8.1	7.0	6.3	7.2	7.8	9.9	11.8
NON-RESIDENTIAL CONSTRUCTION	19.0	16.8	12.7	8.8	4.0	1.9	1.0	1.1	3.6	6.1	9.8	13.5
RESIDENTIAL CONSTRUCTION	-16.4	-14.3	-17.7	-12.5	-3.4	-4.4	3.2	10.5	14.0	16.7	19.4	19.0
INVENTORY CHANGE												
NET EXPORTS												
GOVERNMENT PURCHASES OF GOODS & SVCS	10.9	11.2	12.9	13.7	11.3	10.6	9.8	9.8	9.8	10.1	10.2	10.2
FEDERAL	6.3	8.0	11.8	15.8	11.7	9.5	8.0	8.1	8.1	9.0	9.7	10.0
STATE & LOCAL	13.9	13.2	13.6	12.4	11.0	11.2	10.9	10.8	10.7	10.8	10.5	10.3
GNP(1958 DOLLARS)	0.2	0.5	-0.2	-0.8	0.8	0.2	0.7	2.1	3.7	5.1	6.1	6.7
FIXED NON-RESIDENTIAL INVESTMENT	10.1	10.3	9.1	8.0	7.1	5.8	4.8	4.4	5.9	7.2	9.9	12.4
EXPENDITURES FOR PLANT & EQUIP.	11.4	13.1	12.2	11.8	9.2	7.6	6.0	5.2	6.8	8.4	11.7	14.8
OTHER	6.1	2.6	0.5	-2.3	1.3	0.5	1.1	2.2	2.9	3.5	4.2	4.7
PRETAX CORPORATE PROFITS	17.1	20.3	7.6	1.7	-10.5	-20.6	-25.9	-4.1	4.2	12.7	43.4	27.0
AFTER TAX CORPORATE PROFITS	19.9	23.4	9.6	1.2	-14.3	-23.7	-17.8	-1.9	7.7	16.4	29.6	25.7
GNP PRICE DEFLATOR(1958=100)	8.6	8.8	9.0	8.6	7.3	6.6	5.9	5.5	4.9	4.6	4.2	4.1
CPI(1967=100)	9.9	10.6	10.8	9.9	8.4	7.0	5.9	5.6	5.2	4.9	4.7	4.7
NON-FARM OUTPUT/MANHOUR(1967=100)	-1.4	-0.4	-0.6	0.3	1.9	1.7	2.3	3.0	3.6	4.2	4.2	4.2
COMPENSATION/MANHOUR(1967=100)	7.1	8.1	8.5	8.8	9.7	9.8	9.6	9.2	8.5	7.8	7.1	6.5
PERSONAL INCOME	9.8	10.2	9.8	8.7	9.2	8.5	7.9	8.2	8.9	9.1	9.6	9.7
DISPOSABLE PERSONAL INCOME	9.4	10.0	9.8	8.7	9.1	8.3	7.7	8.0	8.6	8.9	9.3	9.5
PERSONAL SAVINGS	23.0	24.0	26.8	1.7	15.3	16.9	10.4	5.4	4.7	1.3	5.4	6.8
SAVINGS RATE												
FRB INDEX(1967=100)	1.5	1.7	0.2	-0.9	0.1	-1.8	-1.5	0.3	2.6	4.7	6.4	7.4
EMPLOYMENT(000,000)	3.1	2.1	1.4	0.1	-0.4	-0.5	-0.6	0.3	0.8	1.5	2.4	2.8
UNEMPLOYMENT RATE												
FEDERAL GOV. EXPENDITURES - NIA	9.2	13.8	15.4	17.0	14.7	10.5	9.6	9.3	9.4	9.9	10.3	10.7
FEDERAL GOV. RECEIPTS - NIA	12.3	12.8	9.4	8.2	6.0	3.4	0.3	6.7	8.5	10.6	18.1	14.0
FEDERAL BUDGET SURPLUS(DEFICIT) - NIA												
STATE AND LOCAL EXPENDITURES - NIA	12.1	12.4	13.3	12.3	12.7	12.2	11.7	11.5	11.3	11.4	11.0	10.8
STATE AND LOCAL RECEIPTS - NIA	6.3	8.7	9.3	9.9	10.9	9.3	8.9	9.5	9.3	9.6	10.4	10.2
STATE AND LOCAL SURPLUS(DEFICIT) - NIA												
AUTO SALES(000,000 UNITS)	-26.2	-22.3	-18.1	-1.9	4.9	2.1	2.4	4.4	8.8	11.9	13.6	12.2
HOUSING STARTS(000,000 UNITS)	-32.2	-29.9	-25.3	-5.3	-6.4	0.0	6.7	10.0	13.2	16.1	15.6	15.2

Figures are actual through the first quarter of 1974.

NONFINANCIAL CORPORATIONS
SOURCES AND USES OF FUNDS

Table V

(DOLLARS IN BILLIONS)

	67	68	69	70	71	72	73	74	75	76
USES OF FUNDS										
PLANT AND EQUIPMENT	$ 61.9	$ 66.5	$ 74.0	$ 75.1	$ 76.8	$ 88.2	$ 100.1	$ 111.0	$ 118.0	$ 131.0
RESIDENTIAL CONSTRUCTION	2.3	2.1	2.9	3.3	4.9	5.7	4.9	3.6	3.6	4.0
TOTAL FIXED INVESTMENT	$ 64.1	$ 68.6	$ 77.0	$ 78.4	$ 81.8	$ 93.9	$ 105.0	$ 114.6	$ 121.6	$ 135.0
LIQUID ASSETS	4.8	8.0	2.3	-1.1	10.6	5.1	7.4	10.0	4.4	15.0
RECEIVABLES	8.6	18.6	23.1	7.8	6.2	21.3	27.4	30.0	22.0	39.9
INVENTORIES	8.4	9.8	11.8	10.5	9.9	13.7	24.1	31.2	12.4	16.4
OTHER	9.3	10.8	6.4	9.9	19.2	19.3	29.2	20.0	20.0	20.0
TOTAL USES	$ 95.2	$ 115.7	$ 120.6	$ 105.5	$ 127.6	$ 153.3	$ 193.2	$ 205.8	$ 180.4	$ 226.3
INTERNAL SOURCES										
PROFITS	$ 39.9	$ 40.7	$ 36.7	$ 30.6	$ 37.3	$ 42.7	$ 54.9	$ 62.9	$ 51.4	$ 63.6
DIVIDENDS	18.8	20.8	20.7	20.0	20.2	21.1	22.3	24.4	25.6	27.0
RETAINED EARNINGS	21.1	19.9	16.0	10.6	17.1	21.6	32.6	38.5	25.8	36.6
DEPRECIATION	41.5	45.1	49.8	53.6	57.7	62.8	67.9	75.0	88.1	95.8
TOTAL INTERNAL SOURCES	$ 62.6	$ 65.0	$ 65.8	$ 64.2	$ 74.8	$ 84.4	$ 100.6	$ 113.5	$ 113.9	$ 132.4
EXTERNAL SOURCES										
BANK LOANS	$ 6.9	$ 9.7	$ 11.6	$ 5.7	$ 4.8	$ 13.8	$ 30.4	$ 20.0	$ 4.0	$ 10.0
OTHER SHORT TERM	1.4	3.6	7.1	3.2	0.7	2.5	2.7	4.0	4.0	6.0
PAYABLES	3.0	20.4	16.5	2.5	5.5	14.4	26.9	29.0	14.5	34.6
MORTGAGES	4.5	5.7	4.6	5.2	11.4	15.6	16.2	14.0	14.0	14.0
BONDS	14.7	12.9	12.0	19.8	18.8	12.2	10.7	20.0	20.0	18.3
STOCK	2.2	-1.5	2.9	4.8	11.7	10.4	5.9	5.3	10.0	11.0
TOTAL EXTERNAL SOURCES	$ 32.6	$ 50.7	$ 54.8	$ 41.3	$ 52.8	$ 68.9	$ 92.6	$ 92.3	$ 66.5	$ 93.9
TOTAL SOURCES	$ 95.2	$ 115.7	$ 120.6	$ 105.5	$ 127.6	$ 153.3	$ 193.2	$ 205.8	$ 180.4	$ 226.3
NEW EQUITY AS A PERCENT OF NEW CAPITAL:										
EXCLUDING BANK LOANS	54.9 %	49.8 %	53.5 %	38.7 %	48.5 %	53.4 %	59.1 %	56.3 %	51.3 %	59.6 %
INCLUDING BANK LOANS	47.2 %	40.0 %	40.4 %	33.5 %	45.0 %	44.0 %	41.5 %	44.8 %	48.5 %	53.0 %

SOURCE: FEDERAL RESERVE SYSTEM; FLOW OF FUNDS
PROJECTIONS BY SMITH, BARNEY & CO., INC.

June 17, 1974

NET PURCHASES AND SALES OF STOCK BY VARIOUS INVESTOR GROUPS
(DOLLARS IN BILLIONS)

Table VI

	65	66	67	68	69	70	71	72	73
NET PURCHASERS(SELLERS)									
PRIVATE PENSION FUNDS	$ 3.1	$ 3.7	$ 4.6	$ 4.7	$ 5.4	$ 4.6	$ 8.9	$ 7.1	$ 5.3
STATE AND LOCAL RETIREMENT FUNDS	0.4	0.5	0.7	1.3	1.8	2.1	3.2	3.0	3.6
LIFE INSURANCE COMPANIES	0.7	0.3	1.0	1.4	1.7	2.0	3.6	3.5	3.6
OTHER INSURANCE COMPANIES	0.1	0.4	0.3	0.8	1.0	1.0	2.5	3.0	2.2
MUTUAL FUNDS	1.3	1.0	1.9	2.5	1.7	1.2	0.4	-1.8	-2.3
MUTUAL SAVINGS BANKS	0.2	0.0	0.2	0.3	0.2	0.3	0.5	0.6	0.4
BROKERS AND DEALERS	0.3	0.1	0.4	-0.2	0.4	0.1	0.1	0.1	0.5
FOREIGN	-0.4	-0.3	0.7	2.1	1.6	0.7	0.8	2.3	2.8
TOTAL	$ 5.7	$ 5.7	$ 9.8	$ 12.9	$13.8	$ 12.1	$20.1	$ 17.8	$16.1
NET SELLERS(PURCHASERS)									
CORPORATIONS	0.3	0.9	2.3	-0.7	4.7	6.9	13.5	12.6	7.3
HOUSEHOLDS	5.4	4.8	7.5	13.7	9.0	5.2	6.6	5.2	8.8
TOTAL	$ 5.7	$ 5.7	$ 9.8	$12.9	$ 13.8	$12.1	$ 20.1	$17.8	$16.1

TOTAL NET INCREASE IN FINANCIAL ASSETS OF SELECTED PURCHASERS OF STOCK

	65	66	67	68	69	70	71	72	73
PRIVATE PENSION FUNDS	$ 5.5	$ 7.2	$ 6.6	$ 6.4	$ 6.3	$ 7.1	$ 7.3	$ 5.7	$ 7.9
STATE AND LOCAL RETIREMENT FUNDS	3.3	4.2	4.1	4.8	5.1	6.3	6.8	7.3	7.7
LIFE INSURANCE COMPANIES	8.7	8.2	8.7	9.8	9.2	9.9	12.7	14.8	16.0
OTHER INSURANCE COMPANIES	1.2	2.1	2.0	3.1	2.9	5.5	6.6	6.2	6.9
MUTUAL FUNDS	2.2	2.5	1.5	3.6	2.6	1.7	0.6	-1.8	-2.2
MUTUAL SAVINGS BANKS	4.0	2.8	5.4	4.6	3.1	4.7	10.4	11.0	6.0
TOTAL	$24.9	$27.0	$28.2	$ 32.3	$29.2	$ 35.2	$ 44.3	$ 43.1	$42.2
TOTAL - EX MUTUAL SAVINGS BANKS	20.9	24.2	22.8	27.7	26.1	30.5	34.0	32.1	36.2
TOTAL - EX MUTUAL FUNDS AND MUTUAL SAVINGS BANKS	$ 16.8	$21.7	$ 21.3	$ 24.1	$23.6	$ 28.8	$ 33.4	$ 33.9	$ 38.4

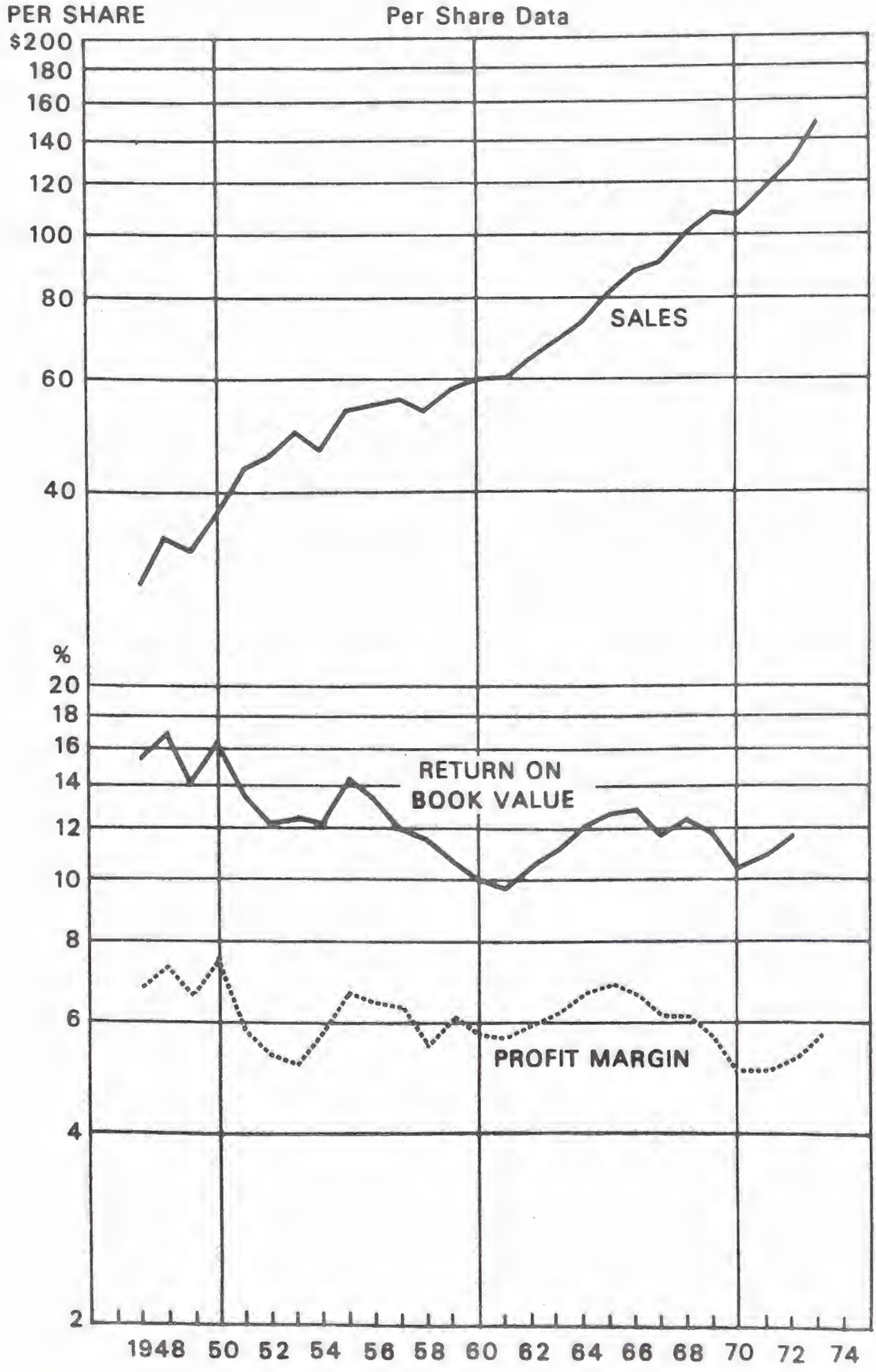
PURCHASES OF STOCK AS A PERCENT OF NET NEW MONEY AVAILABLE

	65	66	67	68	69	70	71	72	73
PRIVATE PENSION FUNDS	56.5%	51.4%	69.5%	73.7%	84.9%	64.0%	122.9%	124.0%	67.2%
STATE AND LOCAL RETIREMENT FUNDS	10.7	11.5	16.4	27.2	35.3	34.1	46.7	40.9	47.4
LIFE INSURANCE COMPANIES	8.1	3.3	11.7	13.9	18.5	20.0	28.7	23.7	22.2
OTHER INSURANCE COMPANIES	7.1	18.4	16.8	24.7	33.4	18.1	37.3	47.7	31.5
MUTUAL FUNDS	59.1	38.4	124.2	70.3	67.3	70.1	76.3	101.7	104.3
MUTUAL SAVINGS BANKS	4.2	1.5	4.1	5.4	7.8	7.1	4.6	5.6	6.1
TOTAL	22.9%	21.6%	30.7%	33.8%	40.5%	31.8%	43.2%	35.4%	30.1%
TOTAL - EX MUTUAL SAVINGSBANKS	26.5	23.8	37.0	38.6	44.3	35.6	54.9	45.7	34.1
TOTAL - EX MUTUAL FUNDS AND MUTUAL SAVINGS BANKS	22.7%	22.2%	30.9%	33.8%	41.8%	33.6%	54.6%	48.6%	38.1%

SOURCE: FEDERAL RESERVE SYSTEM

June 17, 1974
Smith, Barney & Co. Incorporated
W. W. Helman

425 INDUSTRIALS



425 INDUSTRIALS

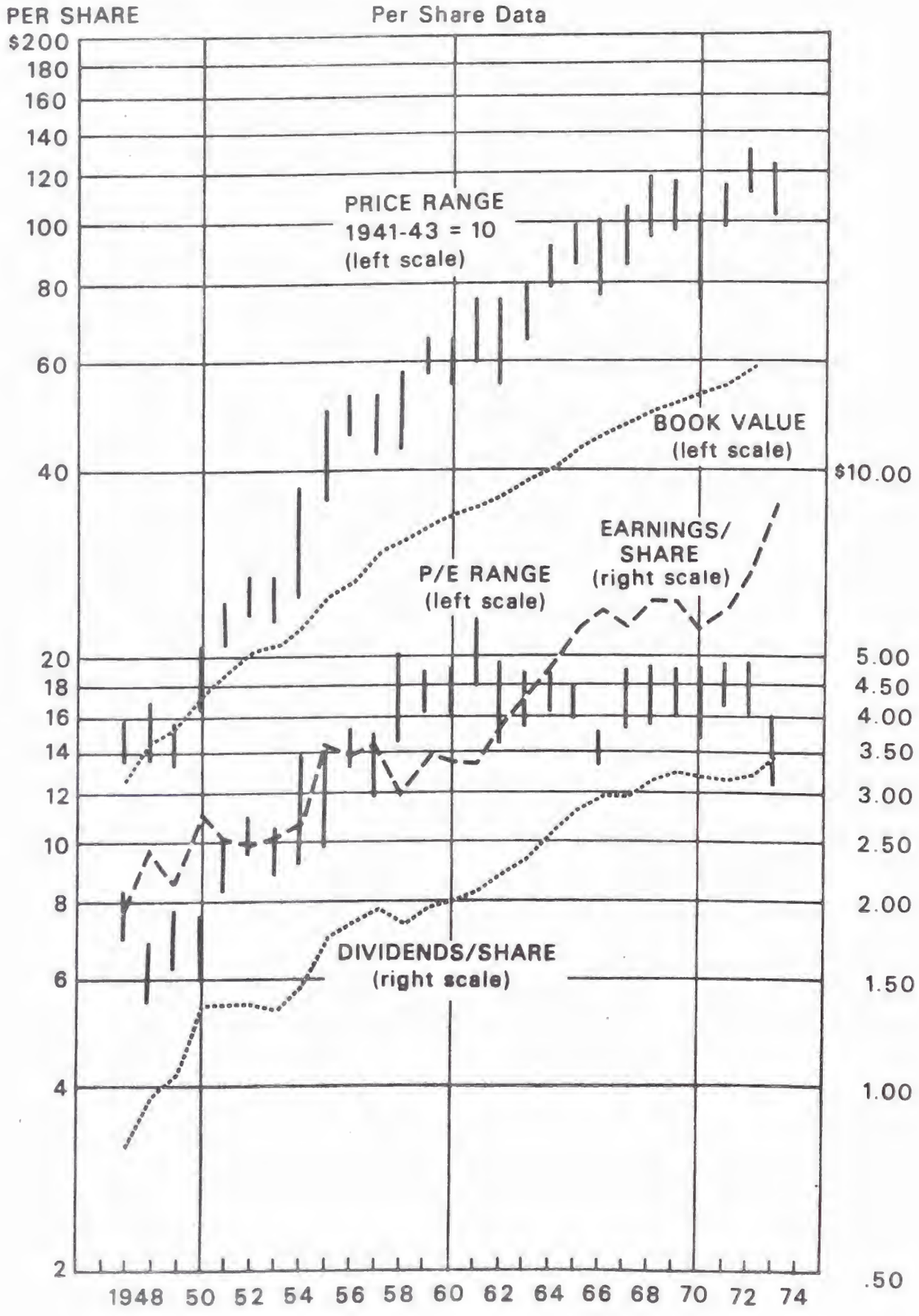
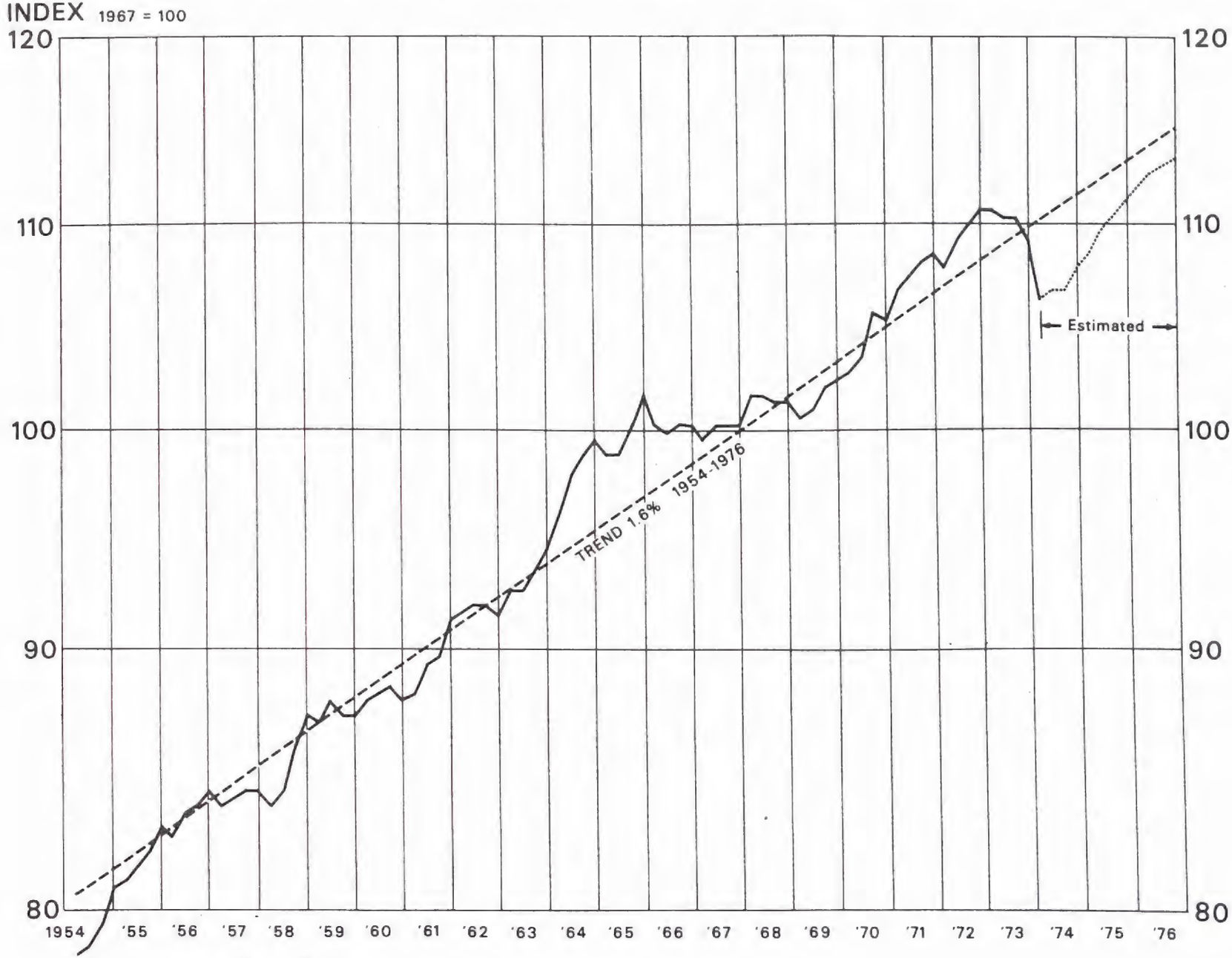


Chart I

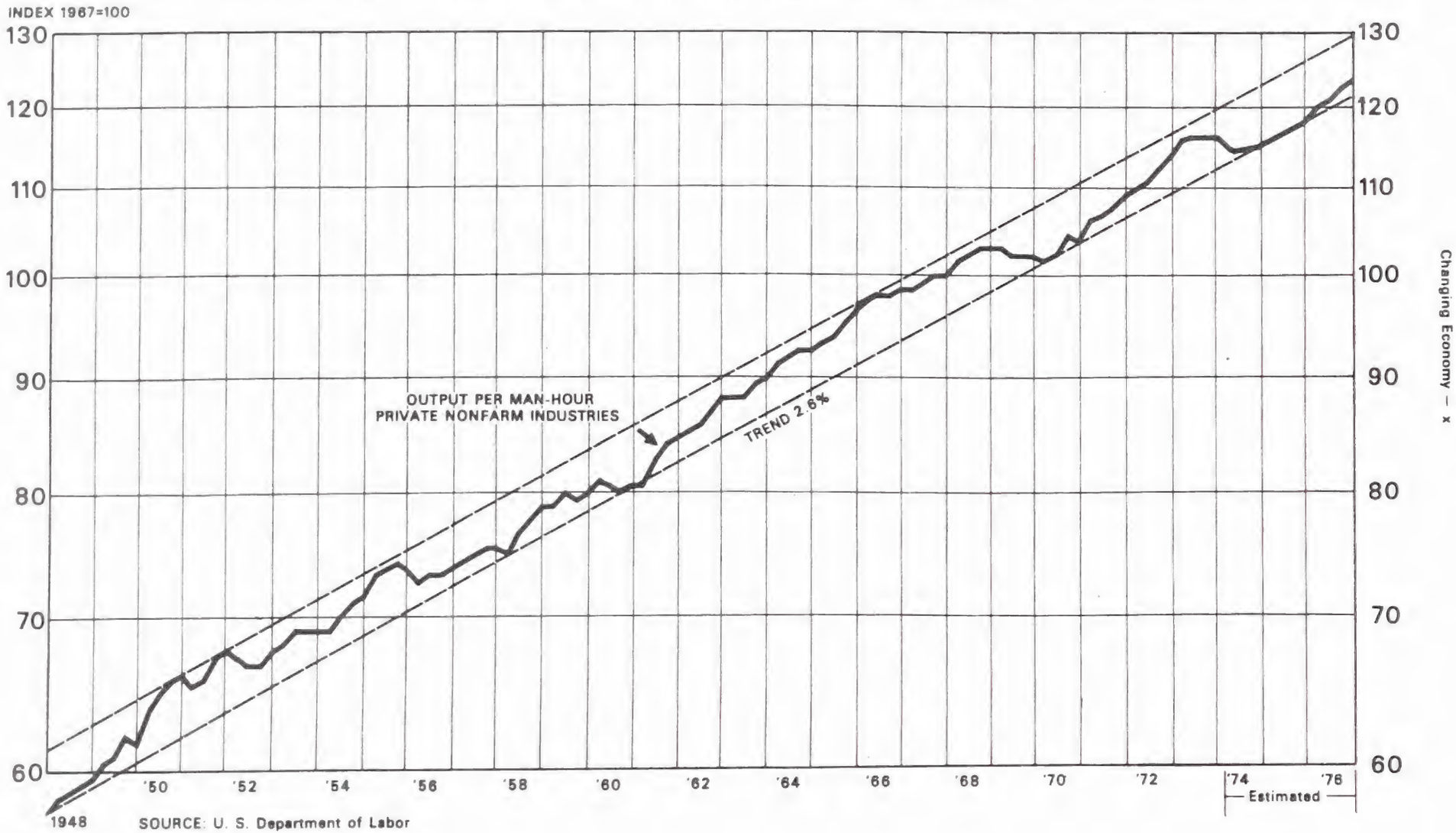
INDEX OF REAL COMPENSATION, AFTER TAXES, PER MAN



Source: Computed by Smith, Barney

Chart II

OUTPUT PER MAN-HOUR PRIVATE NONFARM INDUSTRIES



METALS – A CASE FOR REVALUATION

The metal stocks have had a difficult time since early May. The decline in the London Metal Exchange price led to sharply lower prices for copper equities. The Jamaican announcement of higher taxes on bauxite broke the back of aluminum stocks. Still the great fear overriding these issues is that of a worldwide economic downturn and the impact it may have on the level of metal consumption and prices in 1975. There is near term concern about excess inventories that have been built at consumer levels. The inventory argument is always difficult to either prove or disprove. Very few industries have reliable figures of inventory positions available at the customer level. There is evidence that inventories have shifted from the material suppliers to the customer. The aluminum, copper and steel mills have no additional supplies on hand. Manufacturers' balance sheets show sharp increases in work in process and raw material inventories. During 1973 and early 1974 production of all of these metals fell behind consumption. Sellers controlled the market. Since the latter could not count on overnight delivery from a mill, he had to have material on hand. The burden of maintaining inventories then moved from the metal makers to the metal users. In addition, the tight supply-demand situation drove prices up sharply. It appears to us that a major part of the inventory buildup may well have been price.

Even so, let's concede that there has been an inventory buildup in some commodities. We do not dispute the cyclicality of the major metal makers. Further, our economic scenario anticipates a decline in metal consumption in 1975. That does not change our positive view of the metal industries. The companies making up these industries are not going to develop an unbroken upward trend of future earnings. We propose, however, that the conditions that led to poor profits during the sixties are moderating in favor of new emerging factors that may increase earnings for aluminum, copper and steel companies to a new higher ground around which they will fluctuate in subsequent years. Dividends should increase. Higher earnings and dividends should, we believe, lead to higher stock prices. We do not expect any significant upward price/earnings multiples – although that would be welcomed!

Aluminum

Metal makers experienced poor profits in the sixties not because consumption was disappointing but because supplies were excessive. Free World aluminum consumption maintained a 9% growth rate for the past twenty years. North American productive capacity kept pace with that rate but failed to account for the rapid increase in Western European and Japanese smelters which helped create a surplus in 1971 and 1972. Aluminum makers responded to foreign expansion by reducing North American capacity additions to below 3% in 1972 and 1973. We presently project supply increases of between 5–6% in 1974 and again in 1975 for the Free World. Even if the secular growth rate for

the metal were to fall to 6–8% from its historical 9% level, supplies would not be adequate to satisfy the market. New smelter construction requires 2–3 years. The risk of oversupply in 1975 is dependent upon the level of the economy. Even if 1975 should be sluggish, 1976 could be a recovery year. Based on present plans there is no evidence that aluminum shortages can be alleviated before 1977. In fact, significant new investment must be undertaken by the industry over the near term to assure supply availability in that year. The North American industry is in a much more advantageous position to expand its output than are its foreign competitors. Energy costs in North America are likely to remain a fraction (perhaps 20%) of that of some other countries because of vast quantities of inexpensive power from hydroelectric and coal sources. The North American producers have raw material options unavailable to many other competitors. Transportation advantages exist because of proximity to raw materials and markets. It seems to us that economics dictate that North American producers must at least maintain their share of world markets. If aluminum grows at 6% annually, the four major aluminum companies, Alcoa, Alcan, Kaiser and Reynolds, who account for 70% of North American capacity, will have to add 250,000 tons of new capacity each year at a cost of $500 million annually to maintain their market share and assure delivery of the product. In 1973, the four companies' combined cash flow from operations was $636 million (note Table II).

Debt to equity ratios varied from 63% for Alcoa to 116% for Reynolds and averaged 87%. The prospects of this industry to substantially increase debt even if the market permitted it would seem limited. Only Alcan and Alcoa are selling at close to book value, the two smaller companies are selling at a 55% discount. Thus, the prospects of equity financing are not good. Because of the highly leveraged positions of these companies, debt repayment is a considerable burden on the cash flow – $204 million in 1973. For the four companies interest expense was 36.6% of pretax income in 1973. We can only conclude:

1. The largest aluminum producers now have limited resources to finance expansion.

2. The ability to supply the metal that the U.S. economy requires demands additional cash flow, which can only come from higher prices.

Past cyclical declines of aluminum consumption in the U.S. were 7.5% in the 1959–1960 recession and 2% in 1969 and 1970. In those years foreign demand held up and total Free World consumption did not decline. Investors today expect demand to decline in all the Western countries and we believe have turned away from the stocks in anticipation. A one year downturn in 1975 does not follow sharply increased capacity as it did in 1960 and 1970. The need for increased capacity is real. Higher capital, operating and raw material costs are all exercising upward pressure on prices. We believe higher price levels will be attained which will generate better than expected earnings for several years. We believe **Alcoa (41)** and **Alcan (28)** are the best positioned aluminum companies and their stocks can continue to be purchased.

Copper

Copper companies are not as pressed for capital as aluminums, principally because copper prices have already achieved, indeed even exceeded, the levels that are necessary to support new capital additions. We calculate that $2.00 of capital is required today to add a pound of annual capacity. Operating costs are estimated to fall in the range of $0.45–0.50 per pound of copper delivered, for most of the more efficient miners, and probably exceed $0.60 for some of the marginal producers. To permit an aftertax return of $0.20 a pound, or 10% on the new capital which most miners would consider inadequate, a pretax profit of $0.34 is necessary if present depletion allowances are permitted, $0.40 if mineral depletion were to be removed.

A low cost producer should then be induced to bring in new capacity if copper were at $0.79 a pound. A moderate-cost producer would require a price of close to the present $0.85 a-pound quotation. Of course, the return required for existing mines is usually not calculated on replacement cost. Investors, however, fear that copper prices will retreat to the $0.50–0.60 area in a flat economic environment. We regard this fear as unlikely even if supplies were to prove excessive over the short term.

Copper prices, while volatile, have been trending upward because of higher operating and capital costs, which are unlikely to decline in the near future. Producers' prices on average have increased each year from 1963, the end of price stability, until 1971 and 1972 when annual average prices declined 10% and 1.3%, respectively, following an economic dip. World prices, as measured by London Metal Exchange quotations have a more volatile record. They reflect speculator activity, while the producers' price reflects economic activity. The low LME price rarely dropped to much more than $0.03 below the U.S. price (a spread that represents the cost required to deliver metal to the U.S., which remains a net importer of copper).

We believe there are reasons that copper prices must remain at higher levels than we have been accustomed to. Unlike aluminum or steel, copper production can only be brought on stream if an orebody exists. The material is rare and geological successes have been few and far between. The new property usually takes 5 years to become productive. Most of the new production capacity, projected at 5% annually for the Free World between now and 1978, will come from expanded, existing orebodies. New known properties have ore grades as much as 50% below producing mines. The cost to bring them into production is 30–40% higher than the estimates quoted above. The 5% annual increase in mine production, does not, however, take smelter availability into account.

The U.S. and Japanese copper industries must conform to new stringent pollution control programs that have reduced smelter capacity. Existing plants are old and are not now operating at full capacity. There is one new smelter under construction in the U.S. today. Plans for another were recently tabled because of high costs. A Canadian expansion program at Texas Gulf is in limbo because of uncertainties regarding Canadian tax rates. As a result, new copper availability may only be 4% per year, not enough to meet the growth in Free World copper consumption which we project at 4.5% over the longer term. Needs for new copper, in our opinion, can only be met by realistic current returns.

In addition, there is the real possibility that the Third World copper producers may put a floor under copper prices to support their copper revenues.

We believe that U.S. prices will not retreat from current levels any further than they did in the 1970—71 period. At a level of $0.70 a pound for copper **Kennecott (33)** and **Phelps Dodge (34)** can still show profits of $6.00—7.00 a share. Even if earnings fall to that level (which we are not now projecting), dividend increases for both companies still seem probable in the near term. Payouts of 40% of earnings at a $0.70 per pound copper price seem a realistic prospect. This would mean that present stock prices provide yields of 8—9% on future dividends. Further, little investment consideration is given to the fact that Phelps Dodge has new U.S. capacity under construction that will be available in 1975 and that Kennecott has the ore reserves necessary to expand its output by 50%. The reserves of both companies are located in the continental U.S. We conclude that these two issues represent undervalued collections of vitally important domestic raw material resources. We recommend their purchase.

Another company that we classify with copper stocks, although it is a diversified mining company, is **American Metal Climax (42).** Its long term program to develop new U.S. reserves of copper, coal and molybdenum and its strong position in iron ore should generate a rising trend of earnings of about 10% annually from the $4.80 level we now estimate for 1974 for much of the present decade. The 1975 gains may not be as great because of unusually strong results this year. We regard the issue as a very attractive longer term commitment.

Steel

During the sixties and through 1973, the steel industry's profits were, both as a percent of net worth and as a return on sales, near the bottom of U.S. industry. During that period, the steel industry spent more than $17.6 billion on improvement and modernization and added almost no new steelmaking capacity. Thus, the U.S. can produce about 150 million tons of steel a year, about as much steel as it could produce 10 years ago. However, today's steel is produced in modern plants that are about 25% more productive than the plants of a decade ago. Still, no new capacity has been installed.

U.S. steel consumption over the 1963—73 period has grown at a compound rate of 3.8% while steel shipments have grown at a rate of 2.8%. At the same time Japanese steel production increased almost four fold from 32 million to 119 million metric tons. European steelmaking capacity did not rise sharply over the 10-year period but it did increase. It has been a concerted government policy for the Japanese and for some nationalized steel industries to expand their steel output, particularly for the export market. Since the U.S. provides a large unrestricted steel market, we became a price target. Consequently, much of the growth in U.S. steel consumption over the past ten years was supplied by foreign producers. In addition, the rapid buildup of capacity abroad created an over capacity that put continuous pressure on price. U.S. steelmakers lost volume which prohibited optimum operating rates, and led to higher unit costs, and inadequate prices. The results were the poor earnings so familiar to followers of the industry.

During 1973, conditions began to change. European demand for steel increased. The Japanese determined that Asian markets were part of their future, and steel that had been

earmarked for U.S. markets went to China. The dollar was devalued, and foreign steel became more expensive than the U.S. product. The oil embargo brought sharply higher transportation costs. Finally, the poor raw materials position of the Japanese and some Europeans opened a worldwide bidding contest for coal and iron ore. By early 1974, foreign steel prices were $60–100 a ton above U.S. quotations versus discounts of $20–40 in 1972.

The balance of payments deficits reflecting the rise in imported petroleum and a potential decline in steel consumption in Europe and Japan has led to fears that the present decline in imports will be replaced by a flood of steel into U.S. markets. We do not deny a "worst case" possibility of a flood of cheap steel into the U.S. but believe the threat is less severe than in the recent past for several reasons. First, some U.S. steel customers found themselves cut off from foreign supplies entirely in 1973 and 1974 and were faced with a scramble for U.S. sources, and may not be willing to depend on foreign sources in the future as in the past. Second, foreign steel has become much more expensive to manufacture and deliver to the U.S. market. Foreign producers, particularly the Japanese, have insured their raw material supplies from a variety of sources most often using long term take or pay contracts at fixed prices that, while below present spot quotations, are much higher than U.S. costs which usually only rise with the increased cost of mining since the reserves are owned by the steelmakers. U.S. raw materials are generally close by, while foreign makers must import over ocean routes. Recent price increases in bunker C fuel have increased transportation costs sharply. U.S. labor is high in the absolute, but wage increases abroad are escalating much more rapidly. The new U.S. labor contract is estimated to raise wages 11% a year over the three year life of the contract. In Japan, for example, a 30% increase in wages was recently negotiated for a single year. New foreign steel mill capacity built in the past 10 years was often financed by government supported loans. Heavy debt loads contribute to higher operating costs. Finally, a major loss of U.S. steel markets to foreign producers could well encourage legislation to restrict imports. The Japanese have been sensitive to any change in the political picture particularly since American steel managements have carefully developed better government relations in the past several years.

We expect imported steel to be a far smaller factor in the future than in the past and expect the U.S. industry to expand at least as fast as the 2.5% growth rate we project for U.S. steel consumption between now and 1980. To do that, to maintain present facilities and to meet environmental requirements, about $3.5 billion must be invested in the U.S. industry each year through 1980. In 1973, the industry's cash flow from operations was $2.5 billion (see Table IV). Debt is 34.5% of equity, up from 25% ten years ago. The cyclical nature of the industry discourages heavy debt, and stock prices that average less than 60% of book value discourage equity financing. Higher product prices provide the only means to generate the capital necessary to put the needed capacity in place. In 1973 the industry reported aftertax profits of about $11.70 a ton. To provide a 10% return on investment and to justify new capacity ranging in cost from $300 an annual ton for expansion of existing facilities to $500 a ton for a new greenfield plant demands an aftertax profit of from $30 to $50. In order to achieve that, steel price increases must cover all costs plus 10–20%. Price increases thus far in 1974 have merely offset costs.

Increases of this magnitude should generate profits of close to $7.00-8.00 a share for **Bethlehem Steel**† (29) and above $10.00 for **U.S. Steel** (43). Inasmuch as both companies would be required to invest more than their cash flow after dividend payments for several

years in order to meet their capacity needs, external financing will be necessary. Fear of an increasing debt ratio and a reluctance to sell equity at less than book value will, we believe, motivate the companies to pay out at least 40% of their income; at that dividend rate and if their stocks are priced to yield 6% (approximately where they are selling now), the market price will equal book value, and equity financing may be possible. For the investor, such a payout would yield more than 10% on Bethlehem and U.S. shares at current prices. It appears to us that both issues are undervalued, and we recommend their purchase. We expect other steel stocks to benefit in similar ways and see no objection to adding them to portfolios. These two, however, are our first choices.

In summary then, we look to higher earnings for all metal groups as the prices move to levels necessary to finance needed expansion. We recommend purchase of **Alcoa (41)** and **Alcan (28)** in the aluminums. **Kennecott (33), Phelps Dodge (34)** and **American Metal Climax (42)** in the coppers, and **U.S. Steel (43)** and **Bethlehem Steel† (29)** in their industry.

SMITH, BARNEY & CO.
Incorporated

Peter L. Anker,C.F.A.

† Within the last 3 years, Smith, Barney & Co. Incorporated or one of its affiliates was the manager (comanager) of a public offering of the securities of this company and/or has performed other investment banking services for which it has received a fee.

Table I

Metal Prices
(Per Pound)

	Steel	Aluminum	Copper	
			U.S. Producers	LME
1974 (4 mos.)	$0.0970	$0.298	$0.60	$1.145
1973	0.0938	0.25	0.596	0.808
1972	0.0901	0.265	0.514	0.486
1971	0.0844	0.29	0.521	0.493
1970	0.0765	0.287	0.581	0.641
1969	0.0709	0.272	0.474	0.675
1968	0.0660	0.256	0.412	0.569
1967	0.0646	0.25	0.381	0.522
1966	0.0639	0.245	0.36	0.703
1965	0.0637	0.245	0.354	0.598
1964	0.0637	0.237	0.324	0.448
1963	0.0627	0.226	0.31	0.299
1962	0.0620	0.239	0.31	0.299
1961	0.0620	0.255	0.303	0.292
1060	0.0620	0.272	0.323	0.314
1959	0.0620	0.269	0.31	0.304
1958	0.0606	0.269	0.263	0.253
1957	0.0580	0.275	0.302	0.279
1956	0.0536	0.26	0.42	0.419
1955	0.0498	0.237	0.375	0.447
1954	0.0471	0.218	0.299	0.318
1953	0.0452	0.209	0.291	0.327
1952	0.0424	0.194	0.245	0.329
1951	0.0413	0.19	0.245	0.28
1950	0.0386	0.177	0.216	0.228
1949	0.0371	0.17	0.195	0.223
1948	0.0342	0.157	0.223	0.245
1947	0.0302	0.15	0.213	0.239
1946	0.0269	0.15	0.14	0.141

Source: American Bureau of Metal Statistics.

Table II

1973 Flow of Funds for Four Aluminum Companies

(Alcan, Alcoa, Kaiser & Reynolds)
(thousands)

Source of Funds:	
Net Income	$276,512
Depreciation, Depletion and Amortization	385,129
Deferred Taxes	(2,985)
Equity in Unconsolidated Subsidiaries	(13,720)
Decrease in Deferred Income	(3,685)
Other	(5,374)
Income from Operations:	$635,877
Sale of Investment	$ 15,141
Property Disposal	38,240
Common Stock Issued	10,901
Debt	190,312
Other	5,295
Return on Investments and Advances	9,842
Total Funds Available	$905,608
Uses:	
Capital Additions	$456,922
Investments	36,950
Debt Repayment	204,300
Increase in Deferred Charges	17,388
Dividends	100,006
Other	(7,150)
Stock Repurchase (1)	3,361
	$811,777
Increase in Working Capital	93,831
Total	$905,608

(1) Includes Kaiser sale of assets.

Table III

Debt and Interest Expense

	Debt as a % of Equity	Interest Expense (000)	Pretax Income (including interest) (000)	Interest as a % of Pretax
Alcan	78%	$ 79,064	$189,000	41.8%
Alcoa	63	58,261	247,846	23.5
Kaiser	94	55,821	124,459	44.9
Reynolds	116	56,862	120,892	47.0
	87%	$250,008	$682,197	36.6%

Table IV

United States Steel Industry Selected Financial Data
1964–1973
(Millions of Dollars)

	Net Income	Depreciation And Amortization	Total Cash Flow	Cash Dividends Paid	Net Cash Flow	Capital Expenditures	Long Term Debt	Percent Debt To Equity
1973	$1,303	$ 1,247	$ 2,550	$ 445	$ 2,105	$ 1,381	$4,992	34.5%
1972	772	1,168	1,940	400	1,540	1,164	5,230	38.2
1971	563	1,077	1,640	390	1,250	1,425	5,144	38.7
1970	532	1,044	1,576	488	1,088	1,736	5,134	39.6
1969	879	1,042	1,921	489	1,432	2,047	4,608	35.9
1968	992	966	1,958	452	1,506	2,307	4,601	36.4
1967	830	1,202	2,032	481	1,551	2,146	4,205	34.6
1966	1,075	1,172	2,247	483	1,764	1,953	3,782	31.4
1965	1,069	1,102	2,171	467	1,704	1,823	3,120	25.9
1964	992	1,062	2,054	462	1,592	1,600	2,874	25.2
Total	$9,007	$11,802	$20,089	$4,557	$15,532	$17,582		

Source: American Iron and Steel Institute.

Table V

U.S. Foreign Trade In Steel Mill Products

1964-1973
(Millions of Net Tons)

	Net Shipments by U.S.A. Steel Producers	Exports	Imports	Apparent Consumption	Imports as % of Apparent U.S.A. Consumption
1973	111.4	3.1	15.2	123.5	12.3
1972	91.8	2.9	17.7	106.6	16.6
1971	87.0	2.8	18.3	102.5	17.9
1970	90.8	7.1	13.4	97.1	13.8
1969	94.0	5.2	14.0	102.7	13.7
1968	91.9	2.2	18.0	107.6	16.7
1967	83.9	1.7	11.5	93.7	12.2
1966	90.0	1.7	10.7	99.0	10.9
1965	92.7	2.5	10.4	100.6	10.3
1964	85.0	3.4	6.4	88.0	7.3
Compound Growth Rate 1964-1973	2.8%			3.5%	

Source: American Iron and Steel Institute and Department of Commerce.

METAL: ALUMINUM
(P.L. ANKER)

SMITH, BARNEY & CO. INCORPORATED

6/11/74

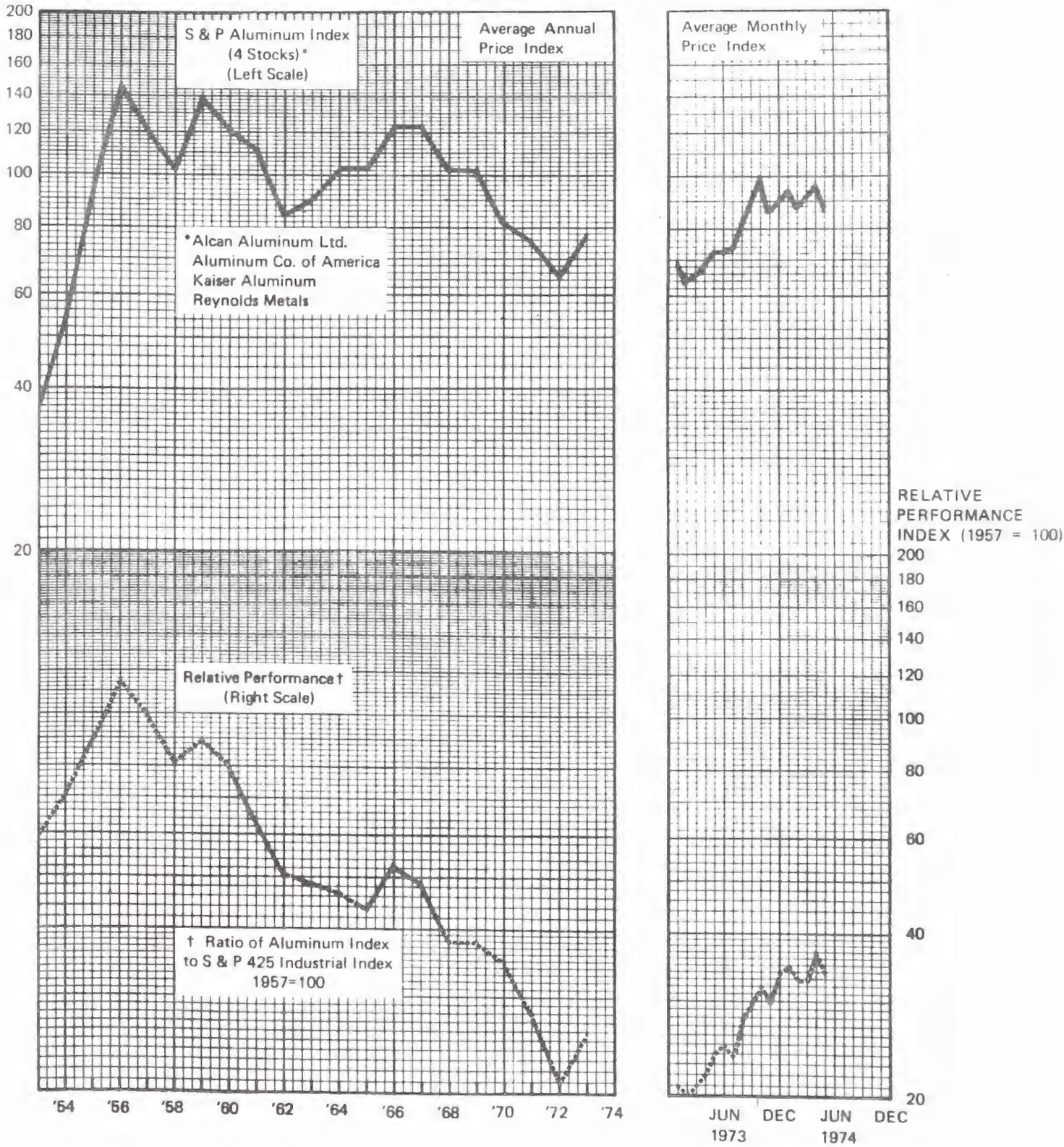
COMPANY AND FISCAL YEAR-END	TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL. TO S&P 425
ALCAN ALUMINIUM	AL	$ 30	$ 41- 27	12- 8X	8X	$ 4.00	$ 2.42	$ 1.78	65%	-2%	2%	$1.20	4.1%	-25%	78%
ALCOA	AA	44	53- 39	11- 8	8	5.50	3.09	3.07	78	-3	2	1.34	3.0	-9	95
HOWMET CORP	HW	16	17- 13	8- 6	6	2.50	1.64	1.33	52	-3	25	.70	4.4	17	122
KAISER ALUMINUM	KLU	18	27- 17	9- 6	4	4.50	2.17	.62	107	-20	-7	.75	4.1	-8	96
REYNOLDS METALS	RLM	20	27- 18	8- 5	4	4.50	2.44(a)	-.19	84	-13	0	.50	2.5	5	109
**FULLY-DIL(6%)EPS					5	4.23									
INDUSTRY AVERAGES					7X				45%	-8%	4%		3.6%	-4%	100%
383 COMPANY AVERAGE					12X				10%				3.3%	-3%	101%

FOOTNOTES

(a) Includes $10,500,000 or $0.61 a share from initial payments from Texaco Inc. relating to certain Wyoming coal properties purchased by Texaco.

Chart I

Trend of S & P Aluminum Industry Stock Index And Performance Relative to The S & P 425 Industrials 1953 - May 1974



SMITH, BARNEY & CO. INCORPORATED

METAL: COPPER
(P.L. ANGER)

6/11/74

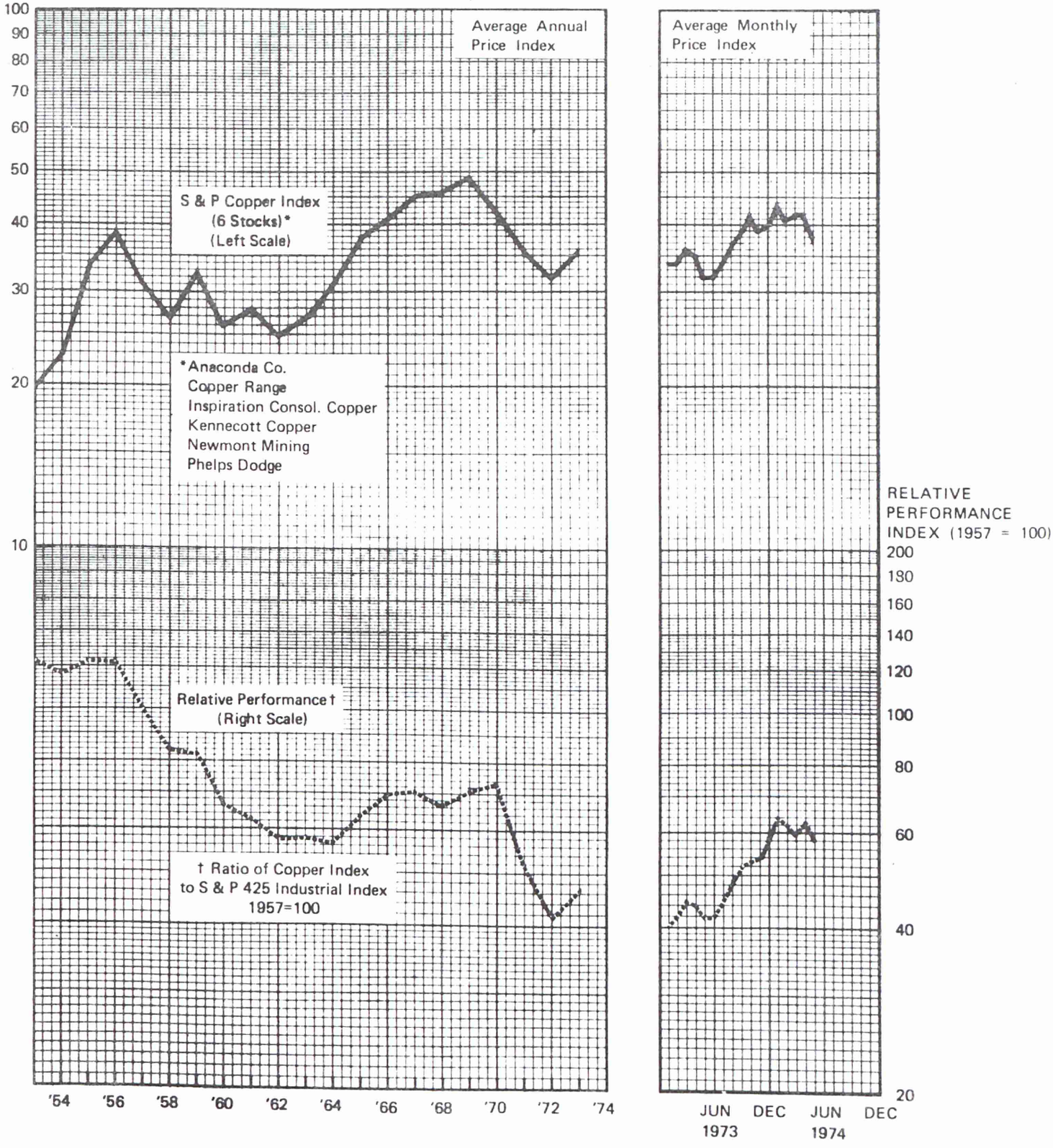
COMPANY AND FISCAL YEAR-END	TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL.TO S&P 425
AMER MET CLIMAX	AMX	$ 39	$ 53- 36	12- 8X	9X	$ 4.55	$ 4.03	$ 2.62	13%	2%	3%	$1.65	4.2%	-25%	79%
AMER SMLTG&REFG	AS	21	27- 20	5- 4	4	5.50	4.25(a)	1.75	29	-3	0	1.50	7.1	-9	95
ANACONDA	A	24	30- 21	5- 3	4	6.50	3.16	2.00	106	-15	-3	.80	3.4	-15	88
COPPER RANGE	CPX	28	35- 21	5- 3	3	10.00	4.49	-1.01	123	-19	17	.50	1.8	23	128
GENERAL CABLE	GK	9	10- 7	7- 5	6	1.45	1.27	1.07	14	3	-4	.50	5.3	23	128
INSPIRATION	IC	40	49- 39	4- 3	4	11.25	6.05	5.06	86	-2	11	2.60	6.4	-0	104
KENNECOTT	KN	35	50- 31	6- 4	4	8.25	4.81	2.63(b)	72	-8	5	2.00	5.7	-23	80
NEWMONT MINING	NEM	26	37- 23	6- 4	4	6.25	4.10	1.70	52	3	28	1.60	6.1	-23	81
PHELPS DODGE	PD	36	50- 35	6- 4	4	8.75	5.31	4.01	65	0	6	2.20	6.1	-22	81
INDUSTRY AVERAGES					5X				41%	-4%	7%		5.1%	-8%	96%
383 COMPANY AVERAGE					12X				10%				3.3%	-3%	101%

FOOTNOTES

(a) Includes $10 million ($0.37 per share) special charge for close down of refinery and zinc plant.
(b) Before extraordinary charge of $1.20 per share resulting from the expropriation of Chilean Mines, loss on settlement of El Teniente notes, and closing of Chase tube mill.

Chart II

Trend of S & P
Copper Industry
Stock Index
And Performance Relative to
The S & P 425 Industrials
1953 - May 1974



SMITH, BARNEY & CO. INCORPORATED

METAL: STEEL
(P.L. ANKER)

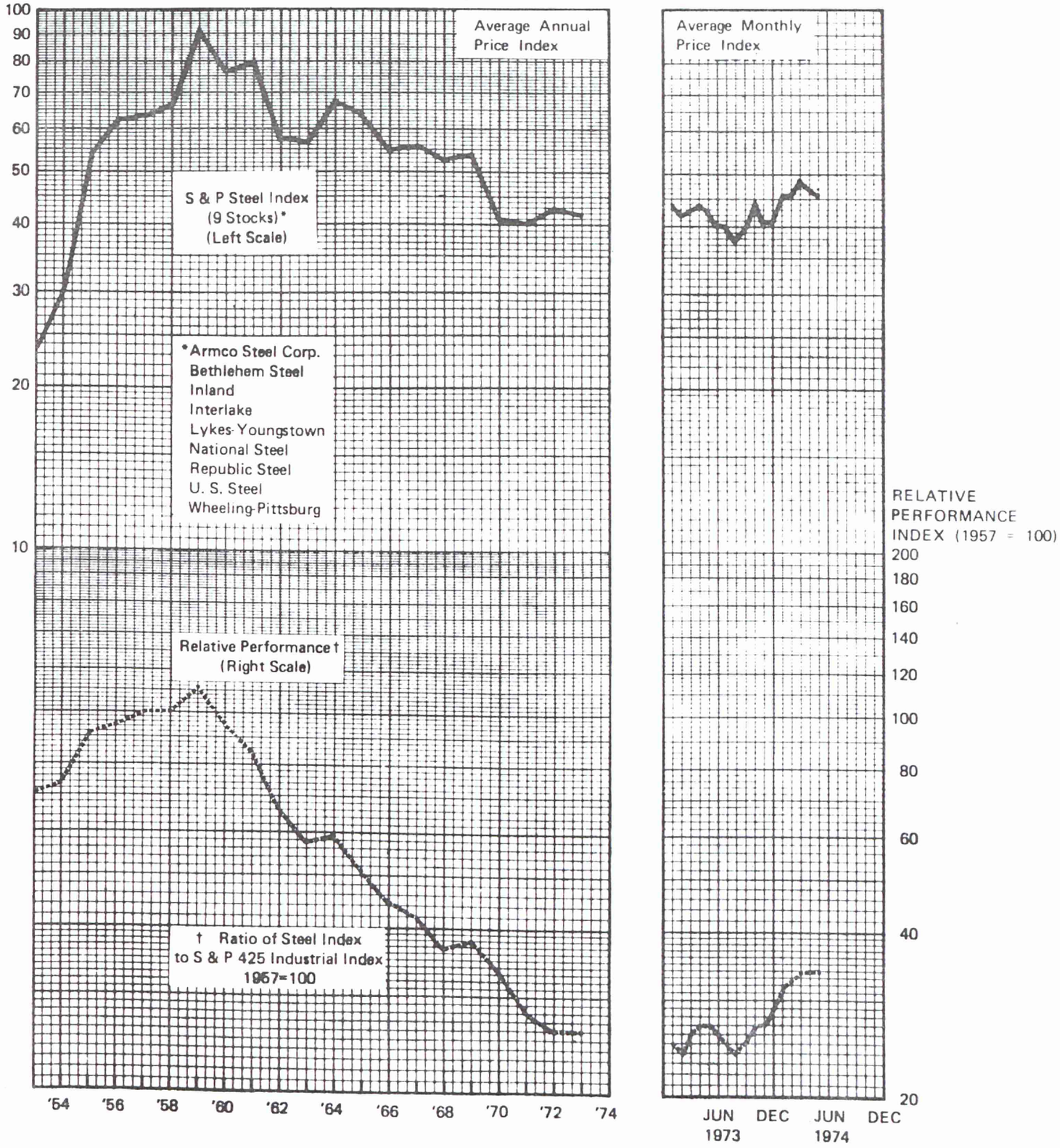
6/11/74

COMPANY AND FISCAL YEAR-END	TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL.TO S&P 425
ALLEGHENY LUD	AG	$ 29	$ 33- 27	7- 6X	7X	$ 4.50	$ 4.79	$ 2.45	-6%	18%	-7%	$1.40	4.8%	6%	111%
ARMCO STEEL #	AS	20	25- 19	8- 6	5	4.00	3.38	2.28	18	6	-2	1.20	6.0	-6	98
BETHLEHEM#	BS	30	36- 28	7- 6	6	5.00	4.72	3.02	6	10	1	1.60	5.3	-7	98
CARPENTER TECH JUN	CRS	24	31- 23	8- 6	6	4.00	3.31	1.64	21	0	-3	1.60	6.6	-15	89
INLAND STEEL	IAD	32	34- 28	7- 6	5	6.00	4.39	3.43	37	10	-1	2.40	7.4	12	117
JONES & LAUGHLIN	JL	20	21- 18	7- 6	5	4.00	3.12	2.43	28	42	-8	1.60	8.2	8	113
NATIONAL STEEL	NS	34	36- 31	9- 8	7	5.00	5.27	3.59	-5	6	-4	2.50	7.3	12	117
REPUBLIC STEEL	RS	24	28- 22	6- 4	5	5.00	5.36	2.66	-7	6	-20	1.25	5.3	-2	102
UNITED STATES	X	43	47- 37	6- 5	6	7.25	6.01	2.90	21	9	-1	2.00	4.6	16	121
INDUSTRY AVERAGES					6X				-0%	11%	-5%		6.0%	4%	109%
383 COMPANY AVERAGE					12X				10%				3.3%	-3%	101%

Metals — x

Chart III

Trend of S & P
Steel Industry
Stock Index
And Performance Relative to
The S & P 425 Industrials
1953 - May 1974



SMITH, BARNEY & CO. INCORPORATED

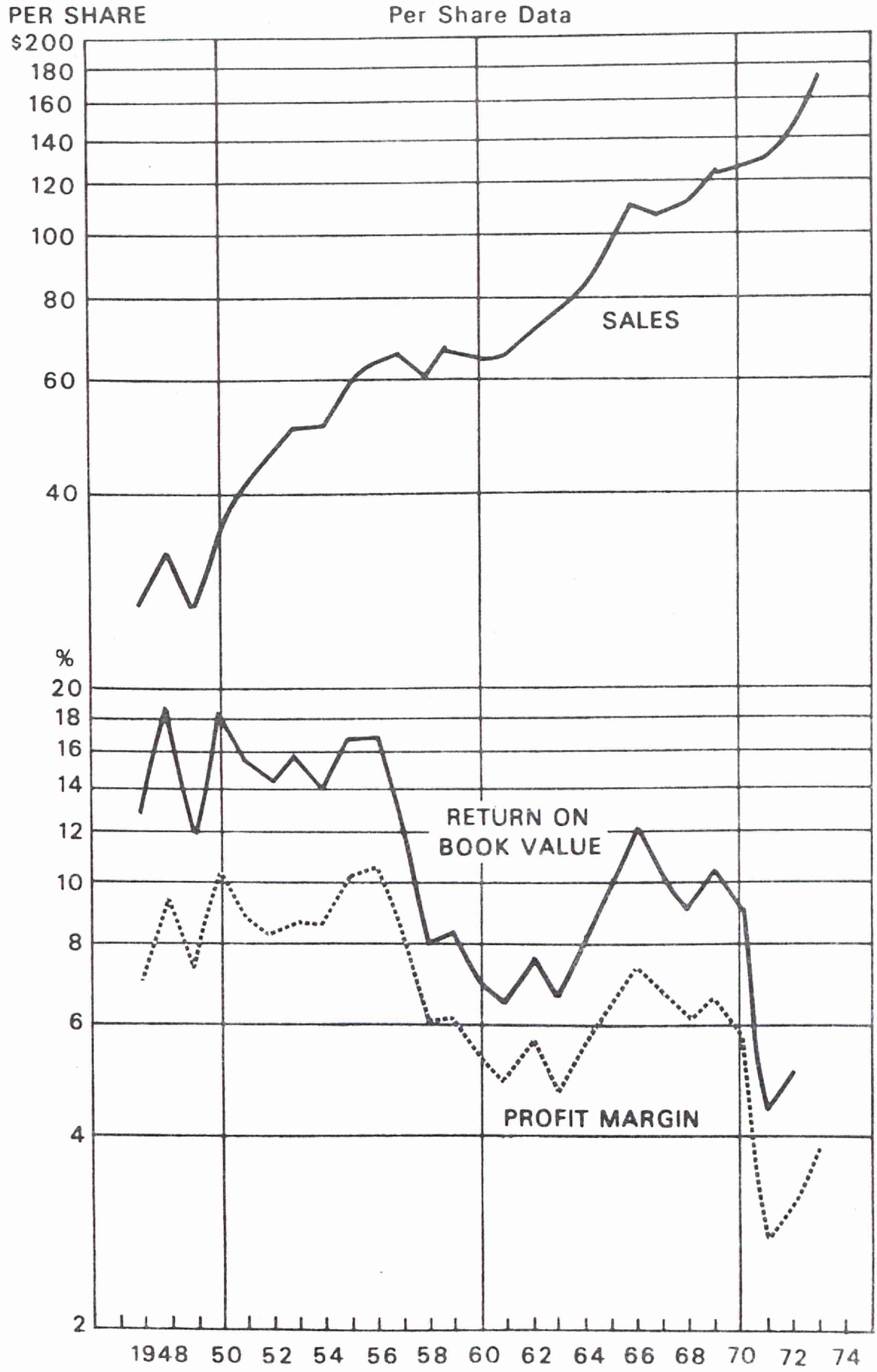
METAL: OTHER
(P.L. ANKER)

6/11/74

COMPANY AND FISCAL YEAR-END	TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL.TO S&P 425
HANNA MINING	HNM	$ 25	$ 55- 25	24- 11X	17X	$ 1.50	$ 2.67	$ 2.30	-44%	-3%	6%	$1.35	5.3%	-50%	53%
INTL NICKEL	N	28	40- 27	13- 9	8	3.50	3.04	1.47	15	7	1	1.40	5.0	-20	84
ST JOE MINERAL#	SJO	34	44- 30	9- 6	5	7.00	3.69	2.86	90	-3	4	2.00	5.9	-12	92
INDUSTRY AVERAGES					9X				6%	0%	4%		5.4%	-27%	76%
383 COMPANY AVERAGE					12X				10%				3.3%	-3%	101%

ALUMINUM

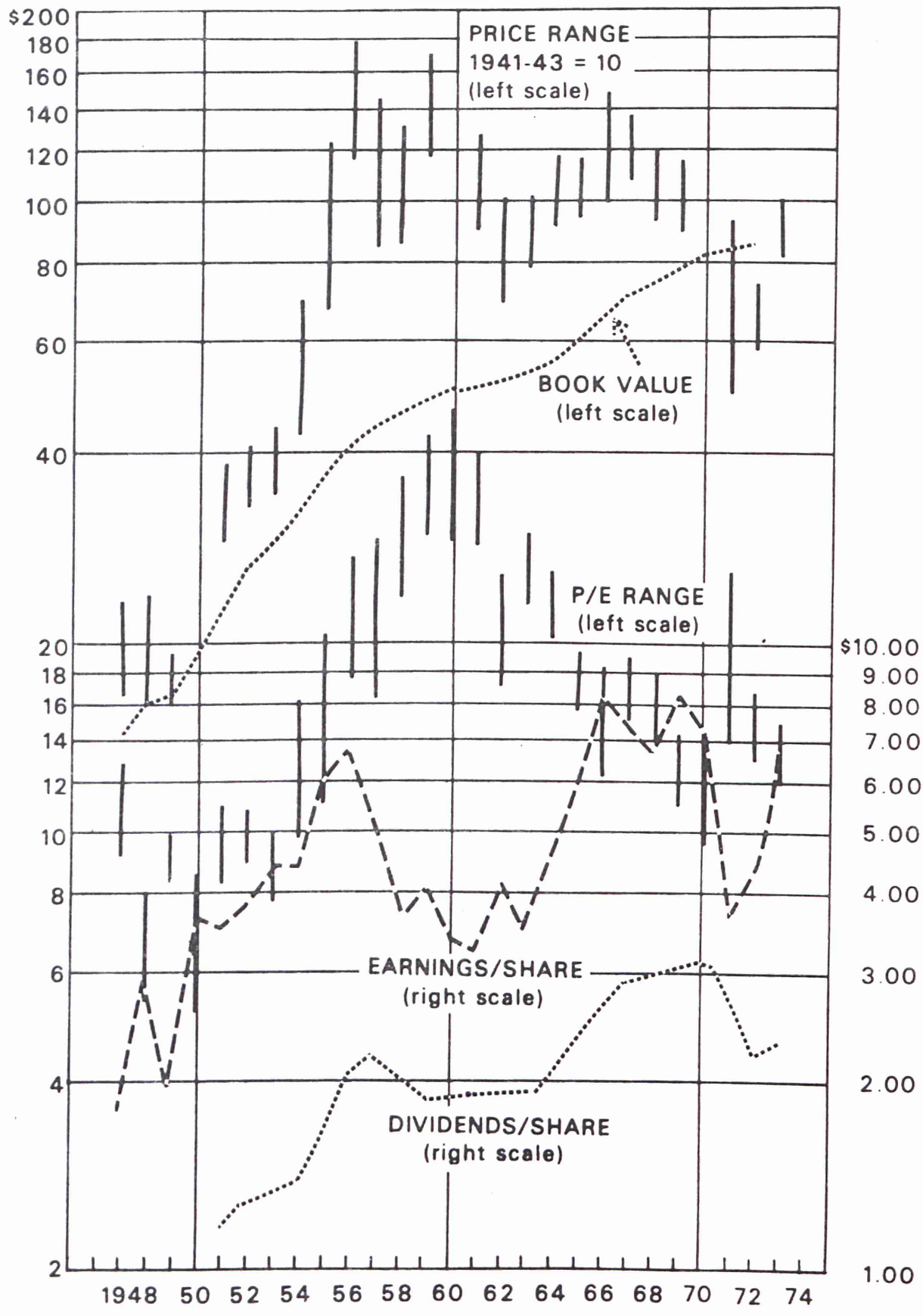
S & P 4 COMPANY GROUP



ALUMINUM

S & P 4 COMPANY GROUP

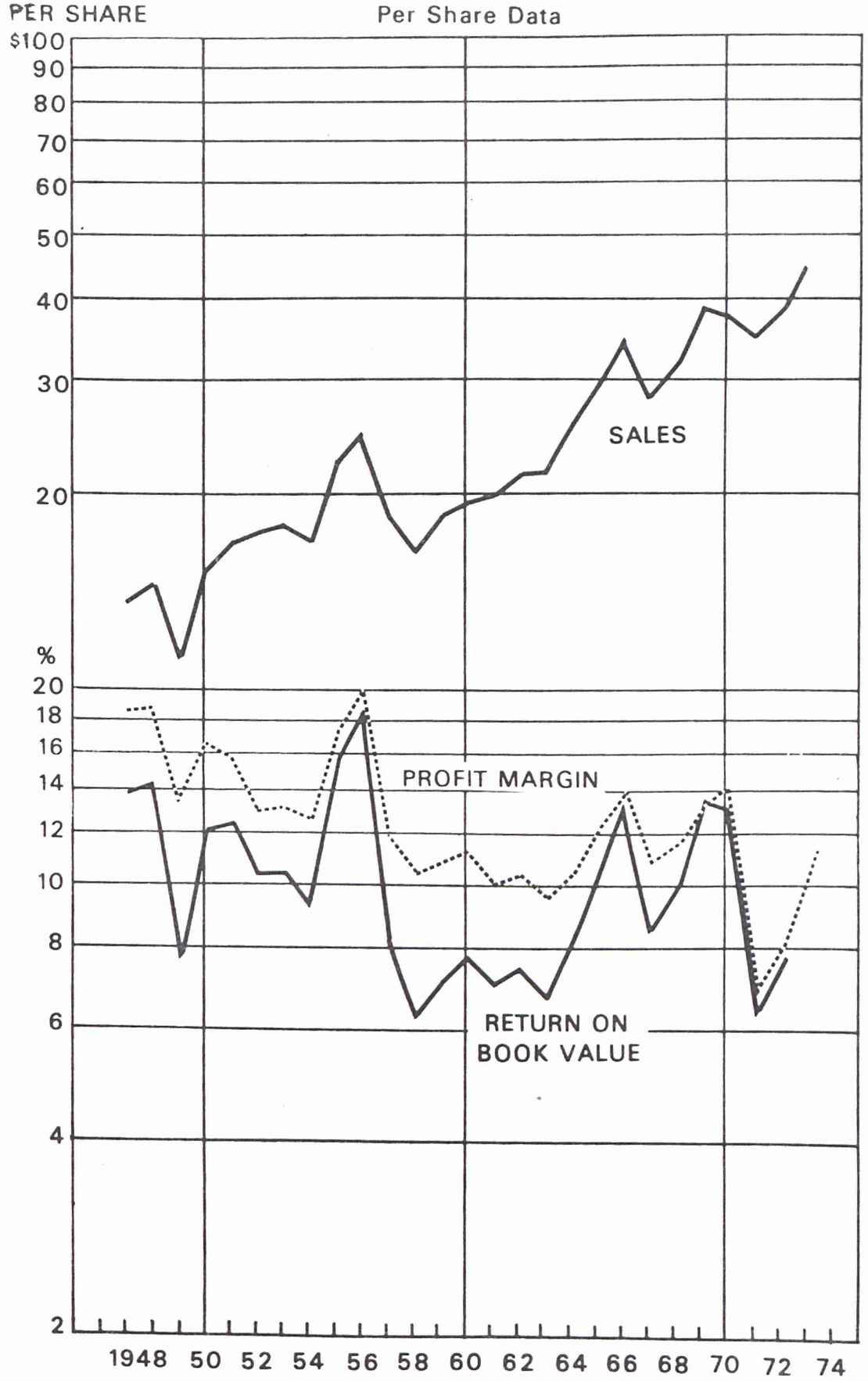
Per Share Data



COPPER

S & P 6 COMPANY GROUP

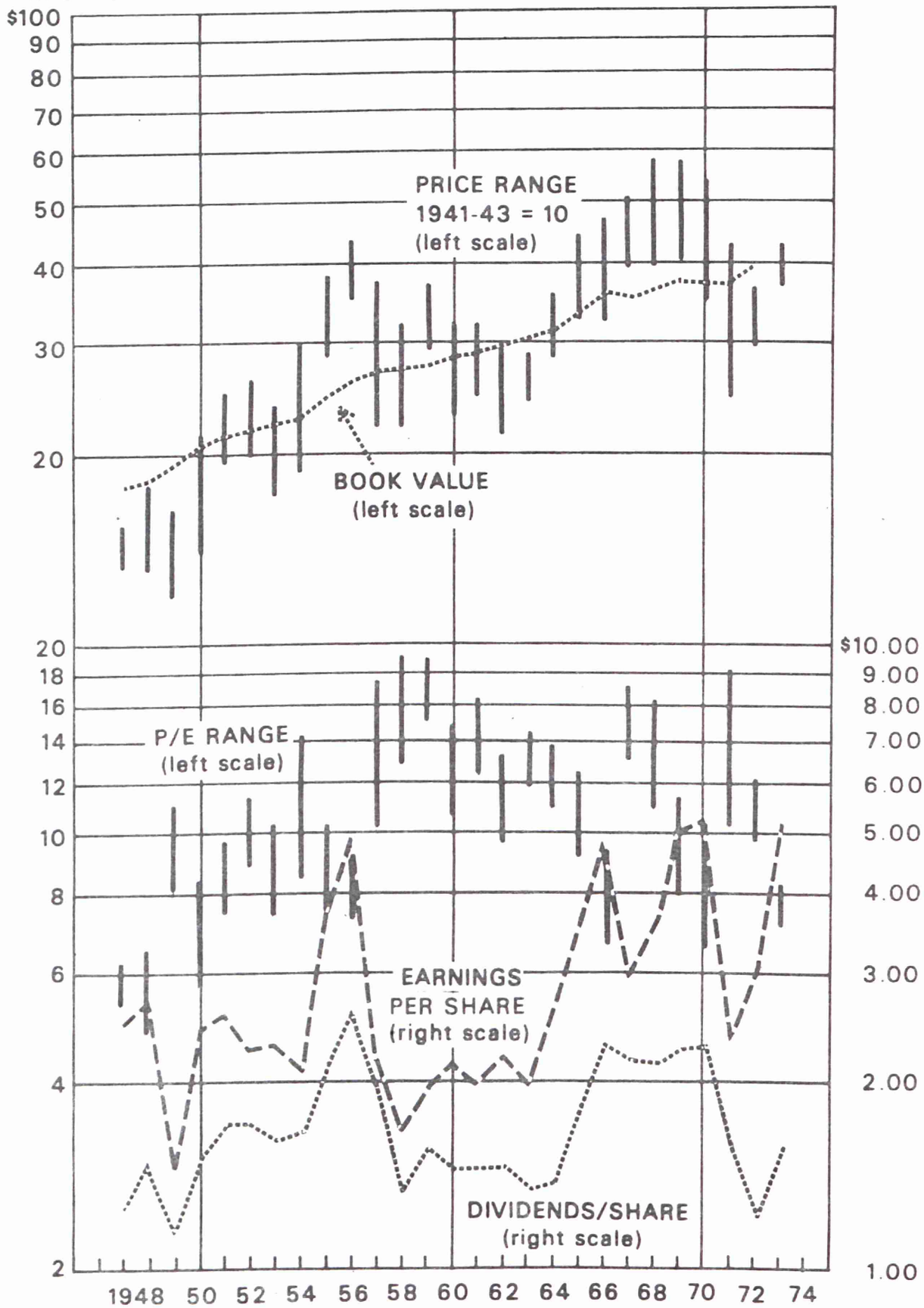
Per Share Data



COPPER

S & P 6 COMPANY GROUP

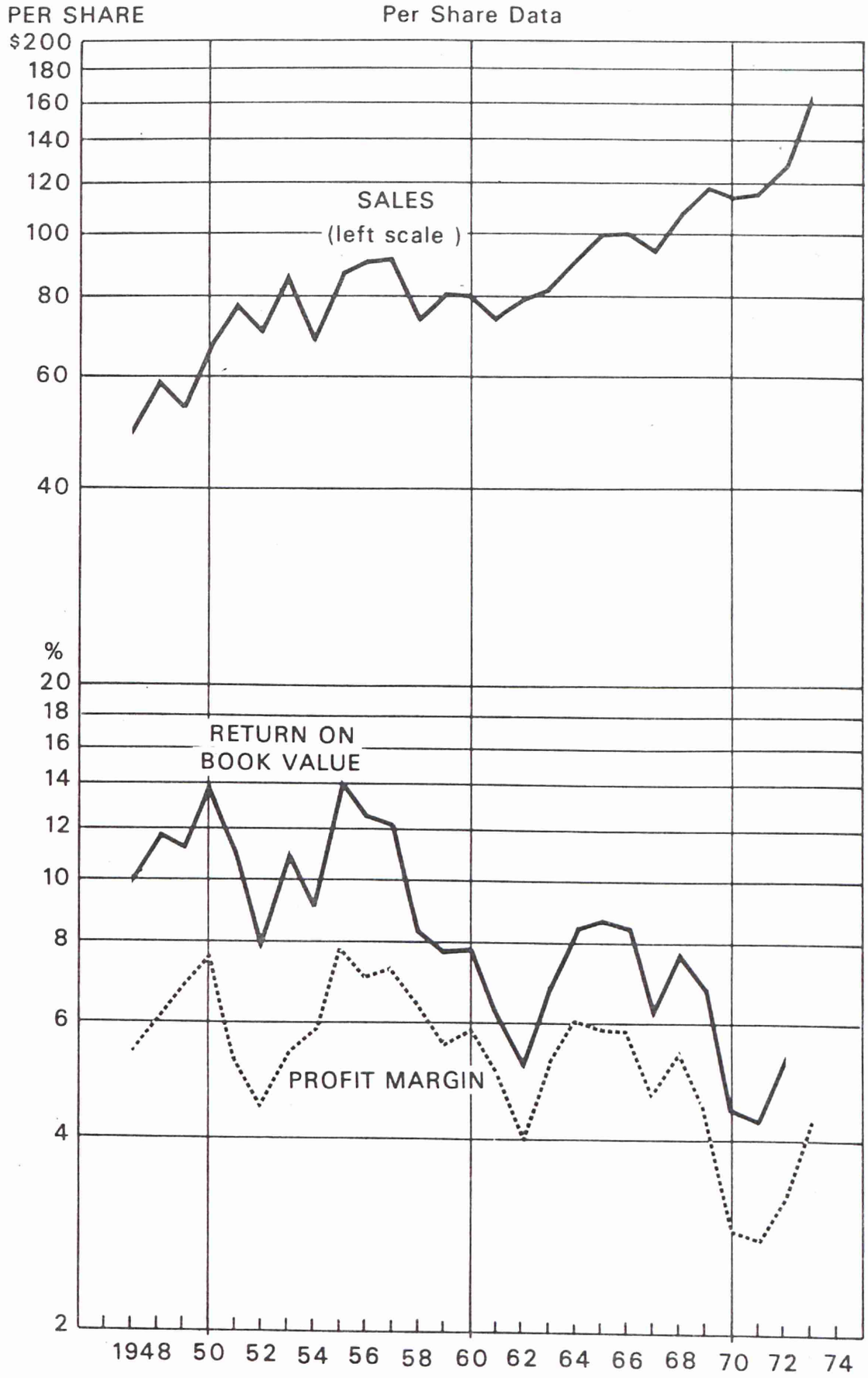
Per Share Data



STEEL

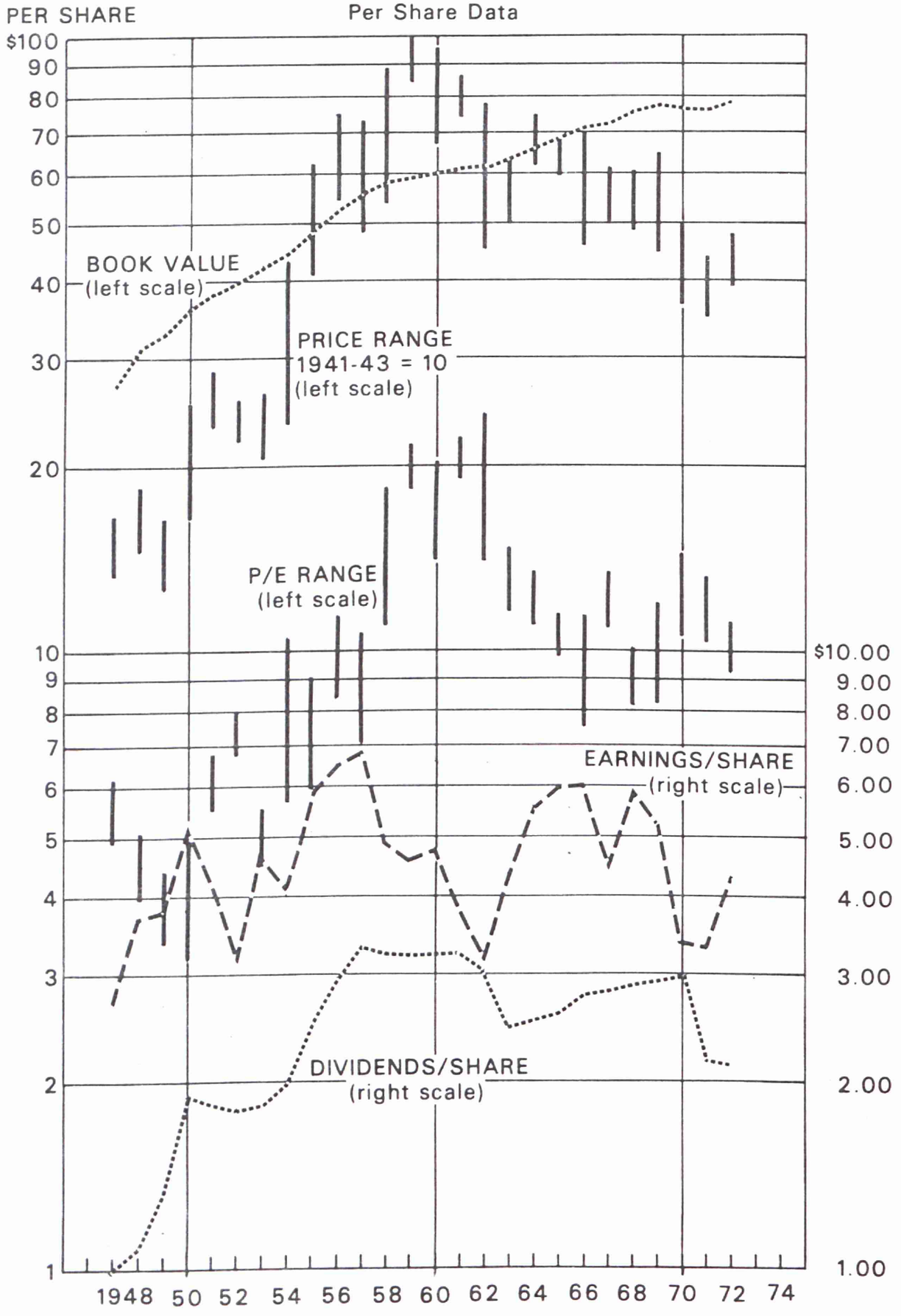
S & P 9 COMPANY GROUP

Per Share Data



STEEL

S & P 9 COMPANY GROUP



CHEMICALS

The frequent upward revisions of estimated 1974 chemical company earnings, despite the extremely sharp increases in raw material and energy costs, and only modest gains in output, make it clear that manufacturers have been able to raise their selling prices considerably now that price controls have been lifted. For example, Dow Chemical recently indicated that its worldwide selling price index was about 50% higher in the 1974 second quarter than in the same 1973 period.

Stock prices have been supported and good relative performance has been achieved by the earnings revisions, but the market has, by and large, reduced the valuations of chemical earnings almost to the same extent that P/Es in general have been reduced since early 1974 (see, for example, our "Chemicals: Some Current Observations on Stock Performance," *Research Briefs,* June 3, 1974.) This suggests that investors view current earnings levels as transitory, or, even if more or less normal, think that future earnings growth will be no more than average. We do not think this is the case, believing that chemical stocks continue to offer good capital appreciation potential.

We will examine the genesis of the current industry supply/demand situation and pricing strength, the factors affecting its future, and the derived implications for chemical stock-price performance.

The domestic chemical industry has moved from a condition of general overcapacity, which was particularly severe in 1967—70, when operating rates were below 80%, to one of generally inadequate capacity. Abroad, overcapacity appeared about 1970 but generally disappeared in 1972. In 1973, severe shortages of chemical products were experienced in all parts of the world market.

Overcapacity developed because investment costs and manufacturing costs per pound of product came down sharply during the 1960s. This was due to technological improvements permitting the construction of ever larger plants (with little inflation in the prices of equipment and construction) and price competition among oil and natural gas companies to dispose of their excess hydrocarbon products. These suppliers also contributed to the chemical industry's overcapacity by attempting to upgrade their excess hydrocarbons in chemical plants of their own. The investment returns on new chemical ventures appeared very good at then-prevailing selling prices, but not everyone could have a market share large enough to permit operation of the large new plants at a high rate of capacity utilization. Hence, price cutting, either before or after the completion of plant construction, became a way of life. These sharp price declines had a rather small impact on market growth since the demand for chemical products seems to be inelastic over short time

periods because customers cannot adjust their consumption pattern quickly to accommodate larger material usage regardless of lower prices. After 1966, margins declined to the point where it became difficult to justify new investment, and the industry's capital spending rate declined sharply.

Rising demand finally lifted operating rates to a point where managements felt no further need to cut prices. In 1971 most chemical product prices stabilized, although fiber prices continued to decline. Markets tightened further in 1972 and in 1973, but price controls kept the domestic industry from doing much in the way of raising prices; earnings increased in both years largely because of output gains and price improvement overseas.

Because of the wide variety of chemical products, an industrywide measure of excess demand is difficult to develop. Using the chemical component of the FRB Industrial Production Index as a measure of aggregate chemical industry output, we estimate that 1973 output would have risen by about 13—14% over the 1972 level, rather than the 10.8% actually experienced, based only on demands arising in the domestic market. It would have been up even more if a free response to unfilled overseas demand had been possible. In 1974, given the decline in real gross national product from the rate prevailing at yearend 1973, and with some evidence of softening overseas markets, we estimate that the amount of excess demand still in the market now exceeds the industry's ability to supply by only a few per cent, if that. We think, however, that this excess demand is spread fairly evenly across product lines, and, since there is no evidence of any particular market segment having clearly excess supplies, we may still be conservative in our estimate. Using Smith Barney's economic outlook for the remainder of 1974 and 1975, which suggests only modest growth from current levels, we forecast moderate increases in demand for chemical products, perhaps in the order of 4—5% over year-earlier demands.

After 1975, rising economic activity should produce greater year-to-year gains in demand for chemical products, perhaps 10% or so in 1976. Although chemical companies have accounced plans for a substantial increase in spending for capital additions, the list of specific projects, along with their anticipated startup dates, suggests that serious and pervasive overcapacity will not develop in the industry in the 1975—77 period although 1974—75 additions will be slightly ahead of projected demand growth if startup schedules are met. Because of considerable inflation in the cost of new plants, the dollars expended, while high by past standards, are only in line with what we see as necessary to sustain the world industry's longer term growth rate, which we forecast to remain at about 8% per year.

Overseas, shortages are so prevalent that, despite difficulties in the United Kingdom and other European countries and Japan, chemical producers plan to substantially increase spending over the very depressed rates of the past 2 or 3 years. But the specific projects so far announced do not appear to unbalance the world-wide supply/demand relationship.

In our opinion, investors are probably most concerned that overcapacity will again plague the chemical industry, that margins will again come under pressure, and that current

earnings will prove to have been abnormally inflated. It is, we think, very important to recognize that the forces which produced overcapacity in the past are no longer present (principally declining investment cost per pound of capacity and declining raw material costs), so new forces to produce overcapacity must appear if a problem is to be experienced. The probability that these will appear can be balanced against existing restraints on overinvestment to determine if a problem really is likely.

Potential developments leading to excess supplies, and, presumably, to profit margin pressure, include:

1) Substantial investment by oil-producing countries in petrochemical facilities. These countries have talked a great deal about using their resources to develop a domestic petrochemical industry. We fully expect such industries to develop. We think, however, that substantial additions to world petrochemical supplies will not be possible over the next 5 years because of the logistics of constructing large chemical complexes in the difficult and distant Mideast environment. Moreover, if Arab managers are economically rational, they presumably will not sell their oil in western markets by offering it in the form of cut-rate chemical products which represent a net back per barrel of oil less than they could receive by selling it as oil. On the other hand, we think that Arab and other foreign producers can play an important role, perhaps in partnership with Western and Japanese companies, in providing the capital-intensive petrochemical intermediates which the more sophisticated downstream chemical processes require, saving the downstream producers the necessity of making large investments in raw material manufacturing facilities.

2) Chemical companies seem to have plenty of cash and improved balance sheets, so that they could spend substantially more on plant investment than is currently projected if it seemed prudent to "build now and beat tomorrow's higher costs." A funds flow statement for 12 major chemical companies (representing 2/3 of the U.S. industry) is given in Table I. Note that our 1975–76 earnings forecast does not include an allowance for further inflation in plant costs, clearly a conservative assumption. However, if we added to earnings to compensate for this we would also have to look for increased capital spending needs.

3) Demand growth may not meet expectations, so that even current investments could produce excessive supplies. There are two reasons why this could occur. First, it is possible that higher chemical product selling prices could inhibit demand, so that past relationships with economic activity would be invalidated. Despite sharply higher chemical selling prices here and abroad, customer resistance has not been encountered so far. It should be kept in mind that the chemical product generally represents only a small portion of the final cost of a finished product, and that the prices of competing natural products have also moved up substantially. Recent studies by ICI and Royal Dutch/Shell concluded that oil would have to rise to $20 per barrel before

derivative prices would be forced high enough to cause a slight, but noticeable, decline in the growth rates of fibers and plastics. Alternatively, it is possible that past relationships will continue but that economic activity itself will be worse than we project. It should be again emphasized that oversupply arising from such a cause would be fundamentally different from that of the 1960s, and would, we believe prove much more transitory.

4) A sharp decline in the inflation rate and/or oil prices could leave present chemical selling prices above the point at which they provide only an adequate return and therefore, if not adjusted downward, lead to overinvestment. Also, technological improvements reducing the investment cost per pound of capacity despite inflation could have the same effect (in other words, a replay of the sixties). We think both developments are quite unlikely during the next several years.

More important than these forces, in our opinion, are the following restraints on excessive investment.

1) Difficulties in obtaining hydrocarbon raw materials and fuel supplies. Long-term supply contracts at fixed prices are a thing of the past; consequently, a potential supplier cannot offer his customer a lower than market price in return for base-load business in a new plant. The premise in the past was that a fixed cost and fixed selling price, regardless of what they were, would "lock in" the desired investment return. Today, with the inability to forecast costs, the supplier usually can do no more than seek an arrangement under which he promises to supply, leaving the price open and depending upon his variable raw material and other costs.

2) If companies continue to follow what seems to be a practice of raising prices only to the point where they produce adequate investment returns on new investments, there will not be a widespread inducement for others to enter the business. This implies they are not now taking advantage of shortage situations. While it is difficult to say whether or not the rather substantial domestic price increases of the past 2 months are excessive or only adequate, it seems clear that their magnitude should not make them suspect, owing to the very large cost increases incurred during the past 6—12 months. Hydrocarbon raw materials, such as naphtha, have tripled or quadrupled in price since 1972. The cost of new plants has also moved up sharply: a plant scheduled for completion in 1976—77 may cost 50% more than the same plant finished in 1971—72. The larger dollar sales volume and inventory needs also means that more money must be tied up in working capital. Hence the need to expand margins in order to maintain adequate returns on the increased total capital required. To the extent that some producers have different return goals, or different raw material cost structures, prices may be adjusted from current levels but we do not think that price action has as yet produced the possibility of widespread unusually good returns from new plants and the concomitant threat of excessive new investment, even though price increases have run ahead of direct cost

increases. Note, for example, that depreciation is 56% of 1974 planned capital spending (Table I). If depreciation charges are inadequate to cover replacement needs to maintain the earning power of existing facilities because of inflating equipment and construction costs, and if, as we think, companies are seeking something in the order of 15% aftertax returns on new investments, then the earnings generated by capital spent to expand the earnings base would only be just adequate for a "normal" 8% increment to projected 1974 earnings.

3) Inadequate engineering, construction and equipment-fabricating capacity around the world make it difficult for even the presently planned level of plant construction to be accommodated while still meeting customary lead times. In other words, a rapid buildup of capacity would be physically difficult even if producers decided to spend the money. We are seeing this even now in the statements of some companies that they doubt they will be able to spend all of the money budgeted for capital expenditures in 1974.

4) Managements seem much more aware of the need to practice restraint than in earlier periods. An emphasis on profitability rather than pure volume or market share prevails. Whether this is due to still sharp memories of the bitter experiences of the late 1960s, or to the character of the many new men in top positions is not clear, but the effect is salutory, nonetheless.

Our summary of the preceding factors relating to the industry's ability to avoid overcapacity and pricing problems is as follows: We expect that the period of rapid price increases, covering past cost increases and also designed to meet the target of adequate returns on those expansions now definitely needed, is almost passed. The unusual benefits to earnings will, of course, appear in quarterly comparisons through the 1975 first quarter. In line with our economic forecast, we look for increased chemicals demand, sales, and earnings in 1975–76, after a very strong 1974 for which we forecast an industry earnings gain of 30% or better. We continue to forecast long-term growth in world demand for chemical products at 8% per year or so.

We believe that 1974 earnings for the chemical industry are not "above normal" and, in fact, may even be somewhat below normal because of the sluggish state of the economy and the industry's inability to respond even to this level of demand. Consequently, we believe it is reasonable to project that the industry's earnings growth will at least follow along with growth in demand for its products after 1975. If inflation persists, and the industry does not overinvest, therefore maintaining control over its prices, the compensation for the inflation in plant costs which cannot be offset by productivity gains will produce earnings growth above that generated simply by growth in physical demand.

This favorable outlook has resulted from developments which transcend economic cycles and suggests that a longer period of time will be required than is spanned by a typical business cycle for excesses to develop. The investment questions to be asked are, do investors already perceive this and hence are valuing chemical stocks appropriately? or do opportunities still remain for chemical industry investments to provide superior performance?

It is our opinion that investors either do not believe that current earnings represent a normal situation, or believe that future dividend growth from the current payment level will only match earnings growth, which is very much the same thing. If investors are correct, then today's stock prices probably do not offer unusual opportunities for capital appreciation despite the apparent discount of the group's P/E to the market P/E.

We believe, however, that for a time dividend payments can rise faster than earnings as the industry recognizes that, because of the improved ability to control prices and hence margins, it can afford to share some of the improved earnings from existing investments with the equity holders without impairing the ability to invest for expansion and plant replacement even at inflated costs. In Table II, we present data to indicate that dividend payments could be 30–50% greater than at present without impairing the ability of the companies to maintain strong balance sheets and provide for expansion. While our dividend payment and debt addition forecasts are provided as examples, the net effect by 1976 would be the same no matter how we chose to arrange the numbers year by year.

Averages, of course, are not the whole story, and even though the industry appears to be in strong financial shape, financing needs and dividend-paying ability varies. It appears that the companies with the best growth prospects are the ones that will most likely do the most financing (e.g., Dow, DuPont, Hercules, Rohm & Haas). The largest cash balances and relatively restrained capital spending programs are associated with the second-tier companies. They apparently do not see as many opportunities for profitable investment as do the industry leaders. Let us hope their funds-flow excess goes into dividends as we project, or even into acquisitions, rather than into unnecessary and possibly disruptive capital investment.

It should be evident that we remain convinced that chemical stocks in general can provide above-average longterm performance even from today's prices. As evidenced by price behavior during the past several years (Chart I) the market has distinguished sharply between groups of stocks within the industry, a phenomenon arising more from the two-tier market than from wide inter-company difference. We expect that these distinctions will be less sharp in the immediate future as investors again appraise the overall industry prospects, as was the case coming out of the 1970 market low, but over the longer term, believe that the companies with the best growth prospects will generally outperform the rest of the industry. These are our 'Group I' companies. Consequently, our major recommendations continue to be drawn from this group, and include **DuPont (167)**, **Dow† (67)** and **Hercules (42)**. We believe that both **Union Carbide (40)** and **Monsanto (65)**, with their strong petrochemical operations, will be in a position to sustain their now sharply increased earning power. We do not think the longterm earnings growth of UK and MTC will be as great as that of the Group I companies, but we would look for significant dividend payout increases and consequently expect superior stock performance. We recommend purchase of both Union Carbide and Monsanto.

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† Within the last 3 years, Smith, Barney & Co. Incorporated or one of its affiliates was the manager (comanager) of a public offering of the securities of this company and/or has performed other investment banking services for which it has received a fee.

Table I

Funds Flow for 12 Major Chemical Companies
1972 — 1976
($ Millions)

	Actual		Estimated		
	1972	1973	1974	1975	1976
Sources:					
Net Income	$ 1,413	$ 2,014	$ 2,617	$ 2,620	$ 2,890
Depreciation	1,627	1,693	1,845	2,000	2,200
Other — Net[1]	278	270	300	300	300
	3,318	3,977	4,762	4,920	5,390
less,					
Additions to Working Capital[2]	699	762	757	700	830
Available for Investment and Dividends	2,619	3,215	4,005	4,220	4,560
New Permanent Capital	175	261	?	?	?
Total	2,794	3,476	4,005+	4,220+	4,560+
New Plant Investments	1,986	2,505	3,300[3]	?	?
Other Investments	38	151	?	?	?
Dividends	770	820	890[3]	?	?
	2,794	3,476	4,190+		
Sales	$21,542	$25,749	$30,670	$35,270	$39,680

[1]Except new permanent capital.

[2]1974-1976 estimated needs based on Smith, Barney sales forecasts.

[3]Based on most recent company announcements.

Table II

Funds Flow For 12 Major Chemical Companies
1972 – 1976
($ Millions)

	Actual		Estimated		
	1972	1973	1974	1975	1976
Sources:					
Net Income	$ 1,413	$ 2,014	$ 2,617	$ 2,620	$ 2,890
Depreciation	1,627	1,693	1,845	2,000	2,200
Other – Net[1]	278	270	300	300	300
	3,318	3,977	4,762	4,920	5,390
Uses:					
Capital Spending[2]	1,985	2,505	3,300	3,650	3,700
Other Investment	38	152	200	210	220
Working Capital:					
Cash (Net)	612	822	(143)	(370)	(400)
Non-Cash	85	(60)	900	1,070	1,230
	2,720	3,419	4,257	4,560	4,750
Funds Available from Operations	598	558	705	400	640
New Financing:					
Debt	108	191	110	570	575
Equity	67	70	75	80	85
Total Funds Available	770	820	890	1,050	1,300
Dividends	770	820	890	1,050	1,300
Sales	$21,542	$25,749	$30,670	$35,270	$39,680

Net New Debt as % of Retained Earnings, 1974–1976

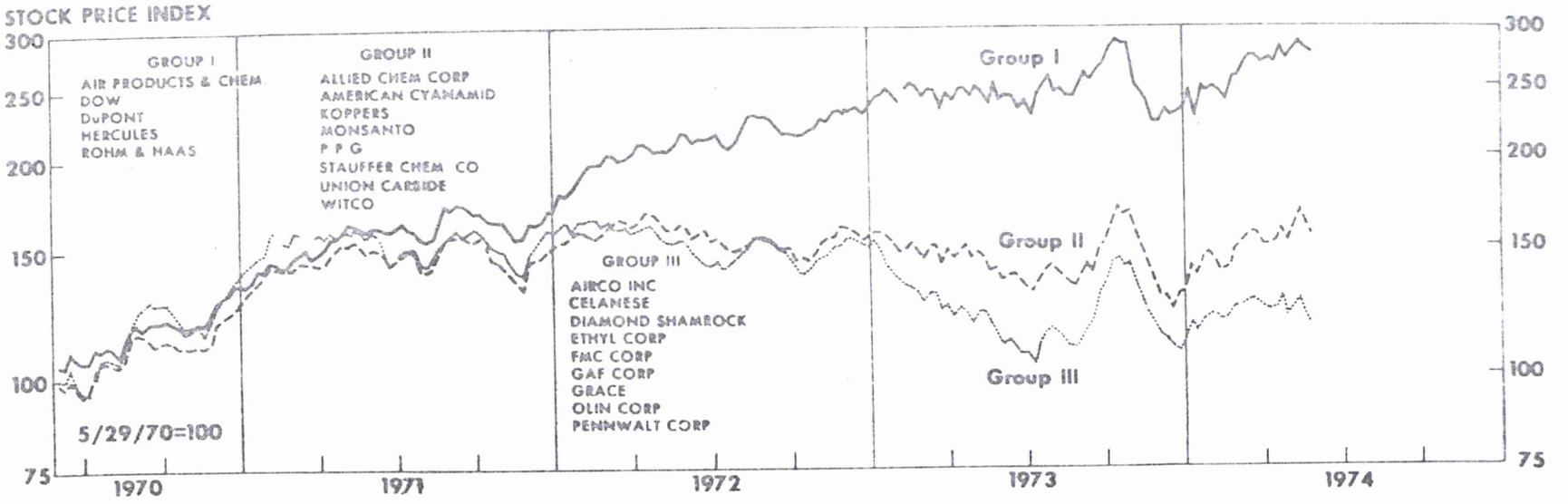
Total Income	$8,127
Dividends Paid	3,240
Earnings Retained (A)	4,987
Net New Debt (B)	1,255
(B/A) x 100	25.2%

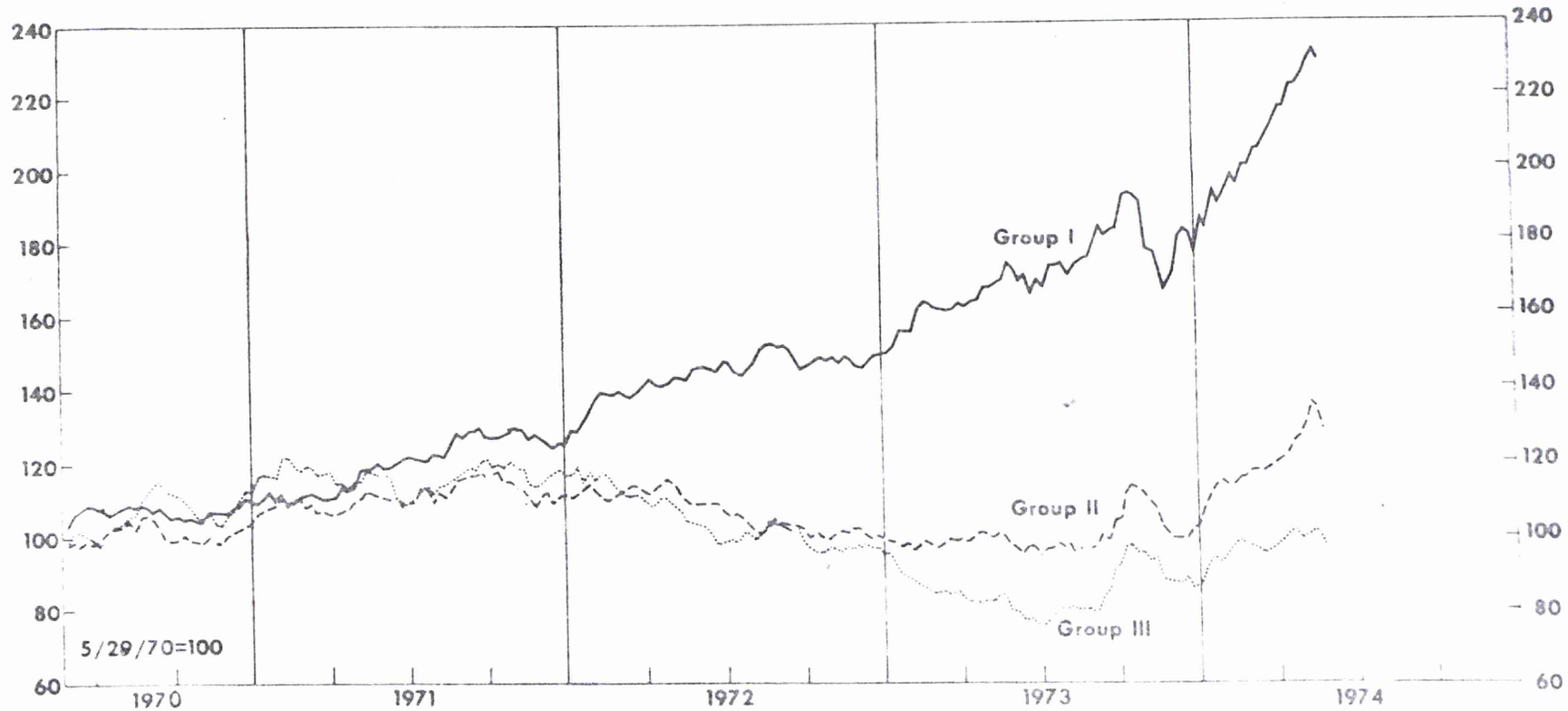
[1]Except new permanent capital.

[2]1974–1976 based on company announcements and U.S. Dept. of Commerce surveys.

Note: Changes in working capital net cash, new permanent financing, and dividends paid in 1974–1976 are not specific forecasts but are examples of how companies may choose to act, given the variety of alternatives available to them.

CHEMICAL STOCKS PRICE PERFORMANCE





CHEMICALS
(R.W. SCHULTIS)

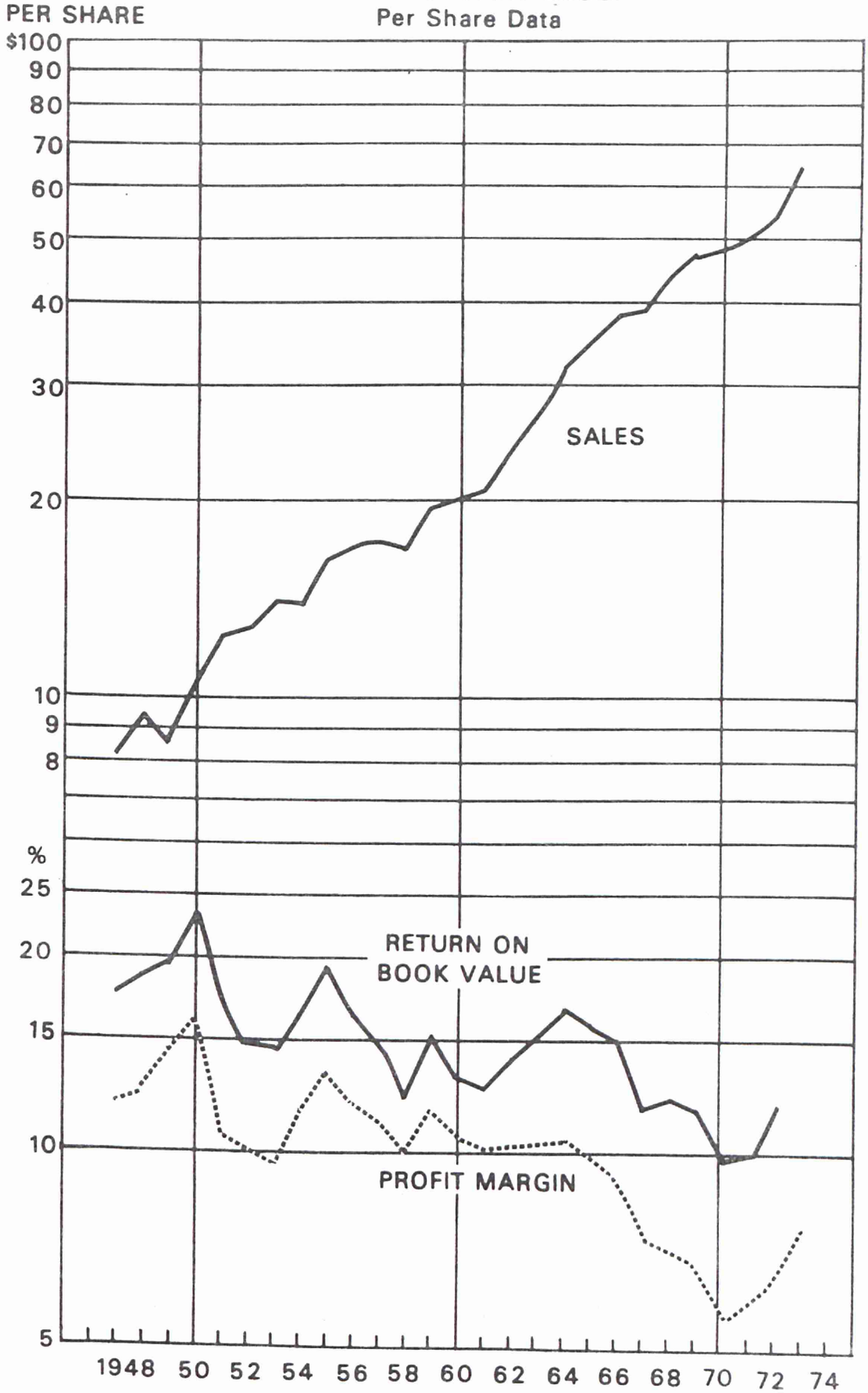
SMITH, BARNEY & CO. INCORPORATED

6/11/74

COMPANY AND FISCAL YEAR-END	TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL.TO S&P 425
AIR PRODUCTS SEP	APD	$ 54	$ 58- 39	24- 16X	21X	$ 2.55	$ 1.83	$ 1.40	39%	-3%	6%	$ .20	.4%	30%	136%
AIRCO INC	AN	12	15- 11	10- 7	6	2.00	1.66	1.53	21	0	-5	.80	7.0	-14	90
**FULLY-DIL(6%)EPS					6	1.88									
ALLIED CHEMICAL	ACD	42	54- 39	15- 11	9	4.50	3.45	2.38	30	7	-1	1.50	3.5	-14	90
AMER. CYANAMID	ACY	22	25- 19	10- 7	8	2.80	2.37	2.24	18	5	2	1.40	6.4	10	115
BIG THREE INDS.	BIG	53	58- 46	19- 15	16	3.40	2.50	2.06	36	17	12	.60	1.1	5	110
CELANESE CORP	CZ	32	35- 28	7- 6	6	5.50	5.12	3.39	7	-4	-4	2.00	6.3	14	119
DART IND	D	19	23- 16	8- 6	6	2.95	2.69	2.34	10	0	8	.40	2.1	12	117
DOW CHEMICAL #	DOW	66	67- 50	15- 12	15	4.35	2.94	2.07	48	20	9	1.20	1.8	16	121
DU PONT	DD	172	179-153	102- 87	14	12.45	12.04	8.50	3	-22	-8	5.00	2.9	7	112
GRACE W R	GRA	26	28- 23	9- 7	7	3.70	2.80	2.15	32	13	-5	1.50	5.9	4	109
**FULLY-DIL(9%)EPS					8	3.37									
HERCULES INC	HPC	42	43- 31	20- 14	17	2.45	2.18	1.75	12	17	7	.80	1.9	25	130
INTL MINERALS JUN	IGL	35	46- 29	11- 7	8	4.40	2.10	1.64	110	22	-4	.52	1.5	-9	96
KOPPERS CO	KOP	48	55- 42	8- 6	7	7.00	5.14	3.98	36	14	7	1.88	3.9	13	118
MONSANTO CO	MTC	69	69- 49	6- 4	6	11.50	6.90	3.49	67	24	1	2.40	3.5	26	132
PPG INDUSTRIES	PPG	26	29- 21	7- 5	7	4.00	4.48	3.99	-11	24	5	1.70	6.5	15	120
PENNWALT CORP	PSM	23	26- 20	12- 10	9	2.55	2.13	1.58	20	7	-5	1.20	5.1	11	116
ROHM AND HAAS	ROH	93	94- 71	18- 13	15	6.10	5.14	3.62	19	19	4	1.12	1.2	26	132
STAUFFER CHEM.	STF	49	51- 39	10- 8	8	6.55	4.69	3.35	40	12	2	2.00	4.1	16	121
SYBRON	SYB	22	30- 20	14- 9	10	2.15	1.80	1.65	19	8	6	.72	3.3	-22	81
UNION CARBIDE	UK	42	44- 32	9- 6	7	6.00	4.78	3.42	26	12	0	2.20	5.3	23	128
WITCO CHEMICAL#	WIT	$ 27	$ 26- 17	8- 5X	5X	$ 5.00	$ 3.05	$ 2.30	64%	14%	5%	$1.20	4.4%	54%	161%
INDUSTRY AVERAGES					10X				30%	10%	2%		3.7%	12%	117%
383 COMPANY AVERAGE					12X				10%				3.3%	-3%	101%

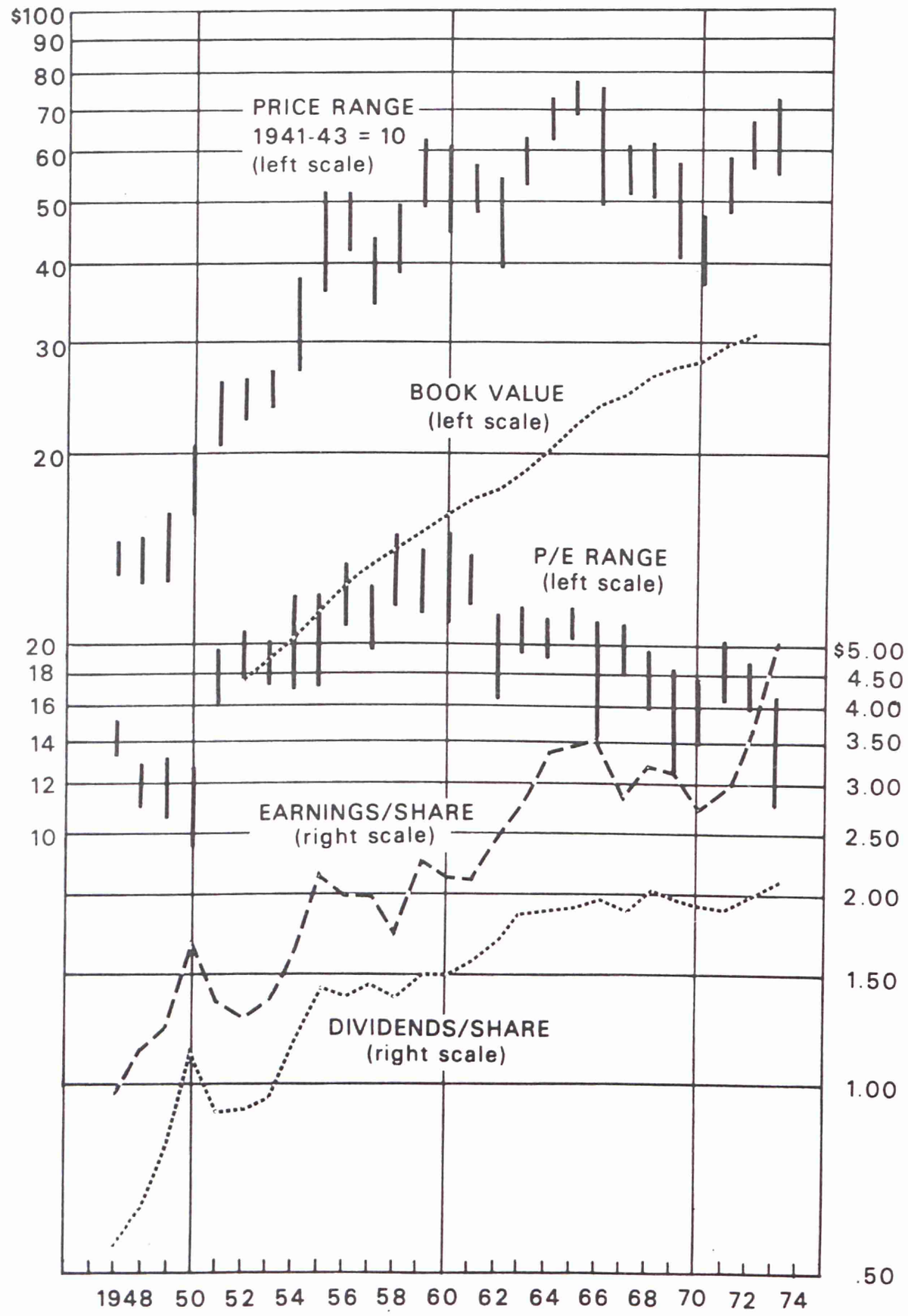
CHEMICALS

S & P 11 COMPANY GROUP
Per Share Data



CHEMICALS

S & P 11 COMPANY GROUP
Per Share Data



THE OILS AFTER THE EMBARGO

During the past year, the economics of the oil industry have undergone an extreme change. So great has this change been, in fact, that current conditions of price, demand and supply hardly resemble at all the patterns that prevailed as recently as a year ago. Furthermore, the political environment in which the oil companies operate has also changed radically, both in the producing countries and in the consuming countries.

This being the case, it is perhaps not surprising that oil stocks have undergone wide swings in investor favor during this difficult transition. In this report, we will outline our views of the economic outlook for oil, and the investment opportunities and problems among oil stocks, looking forward in the post-embargo period.

Since the origins of the recent oil disruptions are foreign, we will look first at the international picture, and then return to the outlook for domestic oil profits.

The main motivating force in international oil economics since the early 1960s has been the rising power of the producing country cartel, OPEC. The increasing influence of the oil exporters has been due to a long-term rise in the dependency on imported oil of Europe, Japan, and, more recently, the United States. Since 1964 OPEC has capitalized on its strong position by forcing periodic increases in taxes on oil production, thereby gradually raising world oil prices. This trend reached a climax last October when the Arab members of the organization sharply reduced output, within the context of an already tight world supply situation.

In the train of these events, international oil prices skyrocketed, spurred by quantum jumps in the tax-paid costs of production in the OPEC countries. In Saudia Arabia, for example, the average tax-paid cost of oil f.o.b. has increased from $1.75 per barrel early last year to just over $8.00 per barrel at present. Furthermore, if the 60% government participation arrangement becomes the standard, as now appears likely, the price may further increase to somewhat over $9.00 per barrel. These figures represent only tax-paid costs of oil to the oil companies, and therefore are not actual prices. True prices, based on third party sales and auction sales increased even more sharply at the shortage peaks last winter, rising to $16–17 per barrel in the Persian Gulf and to over $20 per barrel in Libya and Nigeria.

During this period, of course, refined product prices downstream in foreign markets also rose strongly, and integrated margins of the international companies increased dramatically. Foreign oil profits in 1973 more than doubled from $3.2 billion to $7.4 billion. In the first quarter, foreign earnings for the international companies remained strong, although FIFO accounting for foreign inventories distorted comparisons in both periods.

Looking forward, it appears that this recent strong international profit pattern may begin to erode shortly. On the one hand, OPEC has increased the supply of oil substantially since the lifting of the embargo, thereby intensifying competitive price conditions downstream. Second, the very large oil price increases in international markets appear to have substantially dampened foreign demand. Foreign oil consumption in the first quarter declined about 6% from a year ago, and for the full year 1974 now seems likely to be moderately below 1973.

At present, there appears to be an oversupply of crude oil and refined products in major Eastern Hemisphere markets, and inventories are quite heavy, particularly fuel oil inventories. Given this easier supply situation and weakened demand pattern, refined product prices have been trending downward in Europe since early this year from the extremely high levels reached during the embargo, a trend that is likely to continue somewhat further. Also, third party crude prices in the Persian Gulf have declined from $16–17 per barrel, to about $10 per barrel at present. This downward price trend may also continue, although as long as current tax and participation formulas prevail, it appears that a $9 per barrel cost figure will tend to support prices at or above that level. While it is very risky to forecast OPEC actions, or even whether the cartel will remain effective, it appears probable that OPEC will endeavor to regulate output to maintain an adequacy of supply at near current crude price levels, but not to create an excess that would break the tax underpinnings of the price structure. If OPEC can successfully manage policy toward this end, we may well see further declines in refined product prices in foreign markets, while tax costs on crude oil remain constant or even move moderately higher.

This, of course, suggests a developing margin squeeze on the foreign operations of the international companies, a squeeze which we believe will become evident in second quarter earnings of the internationals. Furthermore, foreign earnings in the fourth and first quarters were distorted by large inventory profits due to the use of FIFO accounting, and these inventory profits are likely to be sharply lower, or absent, in subsequent periods. Due to these influences, we believe that the foreign components of the international companies' earnings are likely to decline, perhaps sharply, later this year from recent high levels. It is this weakening profit pattern, plus continuing uncertainties as to the terms of trade in the producing countries, and in fact the future role of the international companies in the oil industry, that makes us cautious on investing in international oil stocks even at current depressed prices.

On the other hand, the oil outlook in the United States, we believe, is more promising. First, we must look at the outlook for the key parameters of demand, supply and price.

Prior to the embargo, U.S. oil consumption growth averaged 5.4% in the five years before 1973. In the first nine months of last year, demand growth averaged 7.3%. Beginning last October, however, mandatory and voluntary restraints on consumption, plus the demand dampening effect of higher prices, reduced consumption. In the first quarter of 1974, U.S. oil consumption declined by 8.4% from the year-earlier period. Since late March when the embargo was lifted, U.S. consumption has recovered slightly. April oil consumption was

down only about 1%, but May demand declined about 7%. Supply has been rising due to increased imports, and in a weakened demand environment, inventories have been building up. At the end of May U.S. refined product inventories were about 14% higher than last year.

Prices of oil and oil products are, of course, still largely controlled in the United States. Presently, crude oil prices average about $6.50–7.00 per barrel domestically, compared with foreign crude currently landed in the United States at average prices of $12–13 per barrel. U.S. gasoline prices, currently average about $0.54 per gallon at the pump, which although 50% higher than a year ago, is still dramatically below price levels virtually everywhere else in the world. In Western Europe for example, gasoline prices at the consumer level average between $1.40 and $1.80 per gallon. We stress these disparities between controlled U.S. prices and world levels to indicate the degree of insulation of U.S. markets from price erosion that may occur in world markets where crude prices are at least $5 per barrel higher than the domestic average. While we do not believe, therefore, that international oversupply will undercut U.S. prices, we do expect some competitive softening in U.S. oil prices through the summer months due to local competitive forces, if demand does not increase substantially. If prices soften, however, we believe that the effect will be relatively minor, and of short duration.

The outlook for price controls must also be addressed. Under the Emergency Petroleum Allocation Act, U.S. oil prices are scheduled to remain controlled by the Federal Energy Agency until the end of February 1975, unless extended by Congress. While we cannot forecast the elimination of oil price controls at that time, we point out that if it were to occur, U.S. crude prices would probably rise to the area of $10 per barrel, the current level for new crude, compared with the present controlled price of $5.25. Furthermore, refiners' margins would probably improve in a decontrolled environment.

While we do not presently expect this to occur within this short a time frame, we think it is important to recognize the unrealized earnings potential in the U.S. industry when the authorities ease or dismantle the price control program. We estimate that price decontrol could increase U.S. oil industry earnings 75% from 1974 levels, all other things being equal, compared with 1974 U.S. oil earnings gains estimated at about 50%. In the domestic area, incidentally, earnings gains have not been affected significantly by inventory profits, since LIFO accounting is the standard accounting policy in the U.S.

Unfortunately, however, all other things, and particularly taxes, are not likely to be equal. As to the tax outlook in Washington, we cannot forecast the shape of new tax legislation which may affect the oil industry, although we are inclined to believe that the House Ways and Means Committee bill represents a reasonable approximation of the cost impact of probable new tax rules. The cost of the Mills Bill is estimated at about 7% of U.S. oil industry earnings in 1974 and about 16% of earnings next year. We do not think that the more radical tax proposals, such as the immediate elimination of the depletion allowance and foreign tax credits, are a likelihood; but in the current anti-oil atmosphere in Washington, they must be considered a possibility.

In summary, in appraising the price control and tax outlook for the oil industry in 1975, we believe that the probabilities favor a further moderate earnings gain for the U.S. oils next year, incremental to this year's expected strong earnings showing. This assumes a tax increase along the lines of the Mills Bill, and at least a moderate easing of price controls. Under extremely adverse political circumstances, however, including both elimination of the depletion allowance and continuation of price controls, U.S. oil industry earnings would decline next year. This must be recognized as a risk in the domestic oils, but not, we believe, a large one.

Analyzing the outlook for oil industry supply capacity, the uncomfortable fact is that nearly all of the world's incremental productive capacity is in the OPEC countries.

In the U.S., the oil industry is significantly under-invested in both the production sector, where reserves have been declining since 1970, and in downstream operations, particularly refining. No upsurge in capacity in either of these functions is expected in the U.S. for at least the next 2–3 years. The Trans-Alaskan pipeline is not scheduled to be completed before mid-1977 and, until then, U.S. crude oil production appears likely to continue to decline at a 2–3% annual rate. Likewise, in the refining sector little incremental capacity is under construction, although surplus foreign capacity does exist which can supply U.S. markets. This ongoing lag in oil capacity in the U.S. takes into account fully the 40% increase in capital spending planned by the oil industry this year.

From the standpoint of adequacy of return on investment, the improved profit climate has created attractive capital investment opportunities for the oil industry. We estimate that in 1974 the oil industry's rate of return in the U.S. will average about 16%, the highest rate since the 1950s, and up sharply from last year's rate of return of 11.5%. In the international sector, a return also of about 16% is expected, down from last year's unusually strong showing of over 20%.

There is little doubt that these rates of return are adequate to stimulate investment, unless political influences alter these economics. Oil industry spending is expected to rise sharply this year, particularly in the U.S. and in the more stable foreign political areas, such as the North Sea. We stress, however, the long lead times related to this investment, and believe it is very unlikely that new capacity from current spending is likely to significantly impact supply for at least three years.

The industry is, of course, enjoying a large increase in cash flow this year, estimated at 30% or more in the U.S., and despite higher spending, cash accounts appear to be being built up. By and large, the U.S. integrated oil companies are in a relatively strong financial position although some public financing, mainly of a debt nature, may occur this year and next to finance unusually large capital spending projects.

Moving on to the outlook for oil stocks in the post-embargo environment, the best earnings potential combined with the best prospects for political stability are to be found among the domestic integrated oils. This group has declined sharply since the first of this

year, following a strong showing in 1973. At present prices, the domestic integrated group is currently selling at less than 8x earnings, a level which appears to reflect fears of severe tax changes, and to give little or no recognition to more favorable probabilities.

Our recommendations within the group are positioned to benefit optimally from the impact of current higher U.S. crude prices, and from further longer term price gains which may occur. In particular, we are recommending **Atlantic Richfield†** (90) and **Standard Oil (Ohio)** (53) for their large reserves and prospective new production from the North Slope when the Trans-Alaskan pipeline is completed at about mid-1977. By 1978, we expect Arco's earnings to at least double and Sohio's earnings to at least quadruple from 1974 levels. Present multiples, relative to these potentials, we believe are modest. In addition, we recommend **Standard Oil (Indiana)** (82) and **Shell** (46), the two leading investment grade domestic integrated companies.

We do *not* recommend purchase of the international oils at present in the belief that foreign margins will erode for the next several quarters, and that overall comparisons for this group may be unfavorable in the second half and in 1975. We recognize their extremely low multiples and attractive yields, however, and feel that holdings of **Exxon** (71), **Mobil** (40) and **Standard of California** (27) may be maintained for yield and longer term recovery.

Oil companies historically have followed relatively consistent dividend policies, and in periods of favorable earnings have steadily increased dividends. As oil earnings have moved sharply higher recently, payout ratios have dropped. The S&P Domestic Integrated Oil Index currently has an indicated payout ratio of about 25% compared with a historical range of 40–50%. While these companies will be under some dividend restraint during the next several years due to heavy capital spending plans, we believe that a generally increasing dividend pattern can be anticipated from the better grade domestics, and that in this sense, the stocks may represent relatively attractive income vehicles.

William E. Ainsworth
333–5737

† Within the last 3 years, Smith, Barney & Co. Incorporated or one of its affiliates was the manager (comanager) of a public offering of the securities of this company and/or has performed other investment banking services for which it has received a fee.

CHART I

S&P DOMESTIC OILS VS. S&P 425

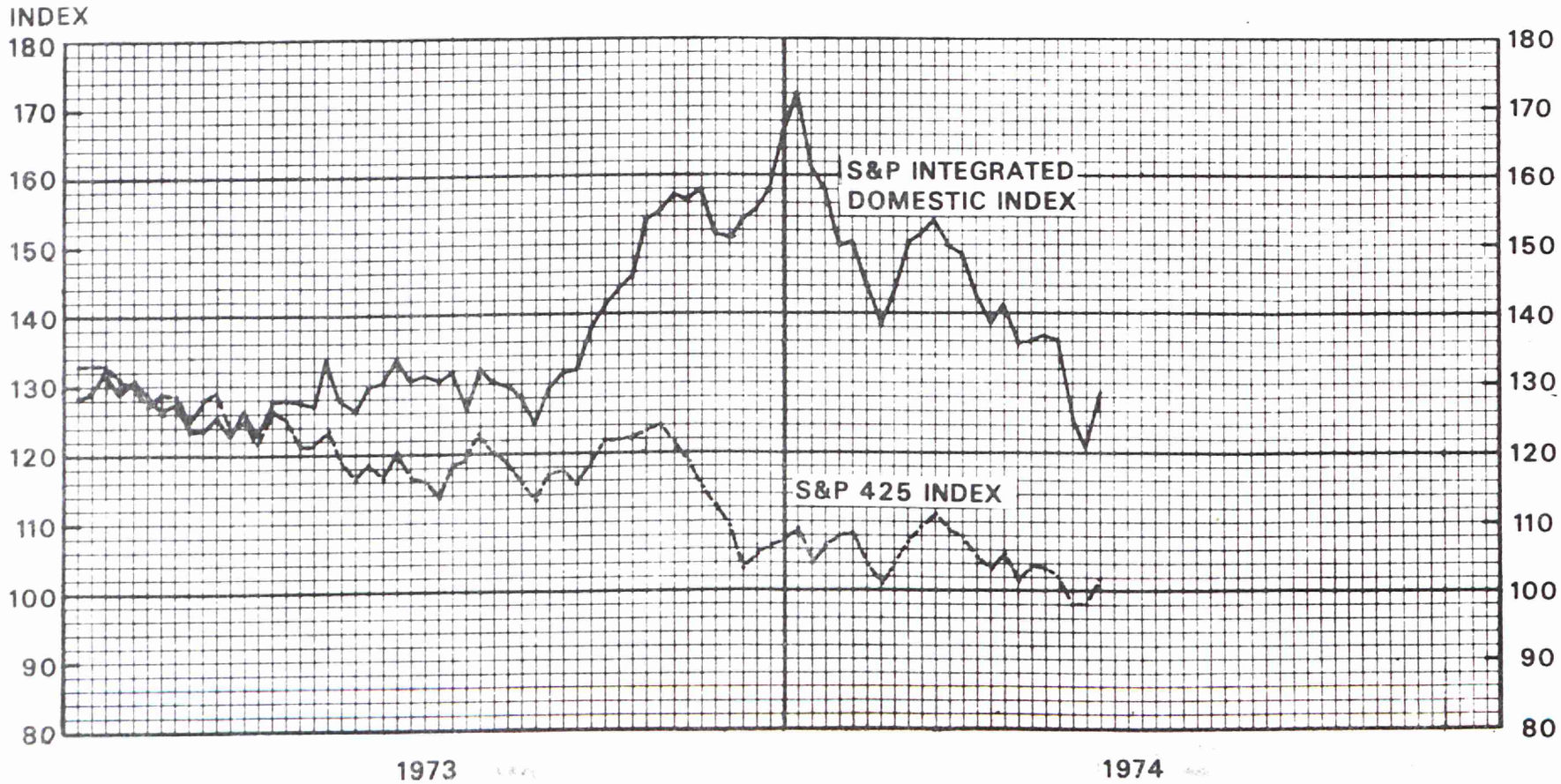
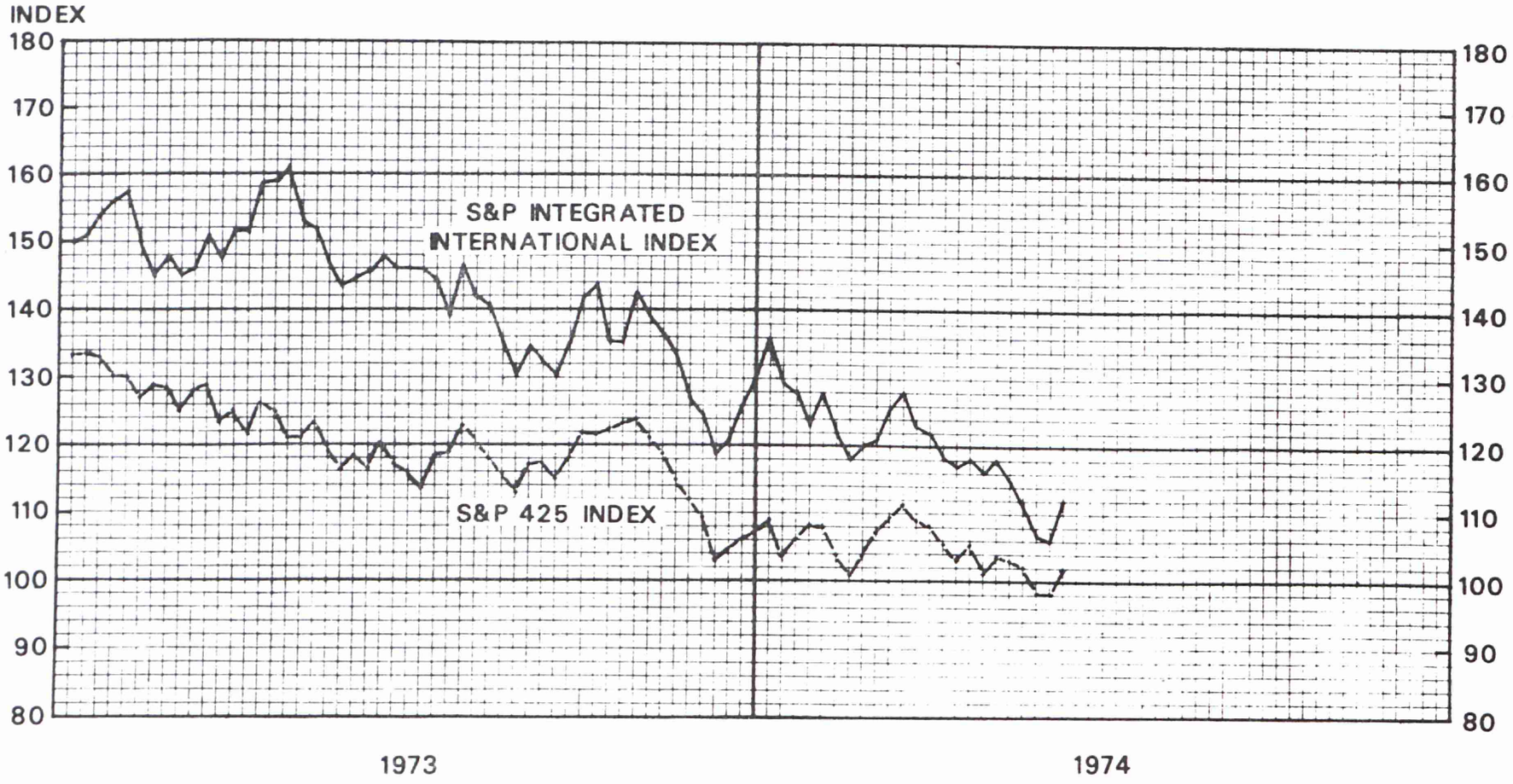


CHART II

S&P INTERNATIONAL OILS VS. S&P 425



SMITH, BARNEY & CO. INCORPORATED

6/11/74

OILS: DOMESTIC-INTEGRATED
(W.E.AINSWORTH,JR.)

COMPANY AND FISCAL YEAR-END		TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL.TO S&P 425
AMERADA HESS		AHC	$ 22	$ 40- 22	8- 4X	4X	$ 5.00	$ 6.59	$ 2.22	-24%	21%	14%	$ .30	1.4%	-44%	59%
ASHLAND	SE	ASH	20	27- 19	7- 5	5	4.00	3.37	2.65	19			1.40	7.0	-21	83
ATLANTIC#		ARC	91	114- 84	16- 12	13	7.00	4.76	3.40	47	2	6	2.00	2.2	-18	86
CITIES SERVICE		CS	39	60- 36	9- 5	6	7.00	5.05	3.72	39	8	7	2.20	5.7	-34	69
CLARK OIL-REF		CKO	16	22- 16	4- 3	3	5.00	4.29	1.17	17			.50	3.1	-12	92
CONTINENTAL		CLL	39	59- 33	10- 5	7	6.00	4.81	3.38	25	13	7	1.60	4.1	-28	75
KERR MCGEE		KMG	73	93- 65	26- 18	21	3.50	2.51	2.04	39	-6	0	.70	1.0	-19	85
LOUISIANA LAND		LLX	31	55- 25	20- 9	11	2.80	1.94	1.74	44	8	9	1.04	3.4	-42	61
MARATHON		MRO	35	55- 31	12- 7	7	4.75	4.32	2.67	10	7	6	1.60	4.5	-27	76
PENNZOIL COMPANY			19	24- 19	7- 5	5	3.50	1.92	1.80	82	-3	8	1.00	5.3	-27	0
PHILLIPS		P	54	71- 45	16- 10	12	4.50	3.05	1.98	48	14	2	1.40	2.6	-21	83
SHELL		SUO	52	73- 47	10- 7	7	7.00	4.94	3.86	42	4	2	2.40	4.6	-24	79
STD. OIL INDIANA		SN	84	110- 74	110- 74	84	11.00	7.33	5.37	-86	9	10	3.20	3.8	-20	84
STD. OIL OHIO		SOH	55	86- 49	36- 20	23	2.40	2.02	3.26	19	9	3	1.36	2.5	-29	74
SUN OIL #		SUN	40	62- 34	10- 6	7	6.00	5.25	3.21	14	-5	3	1.00	2.5	-29	75
UNION OIL CALIF		UCL	39	57- 35	9- 6	6	6.00	4.40	2.98	36	8	4	1.98	5.1	-24	80
INDUSTRY AVERAGES						14X				27%	6%	6%		3.7%	-26%	77%
383 COMPANY AVERAGE						12X				10%				3.3%	-3%	101%

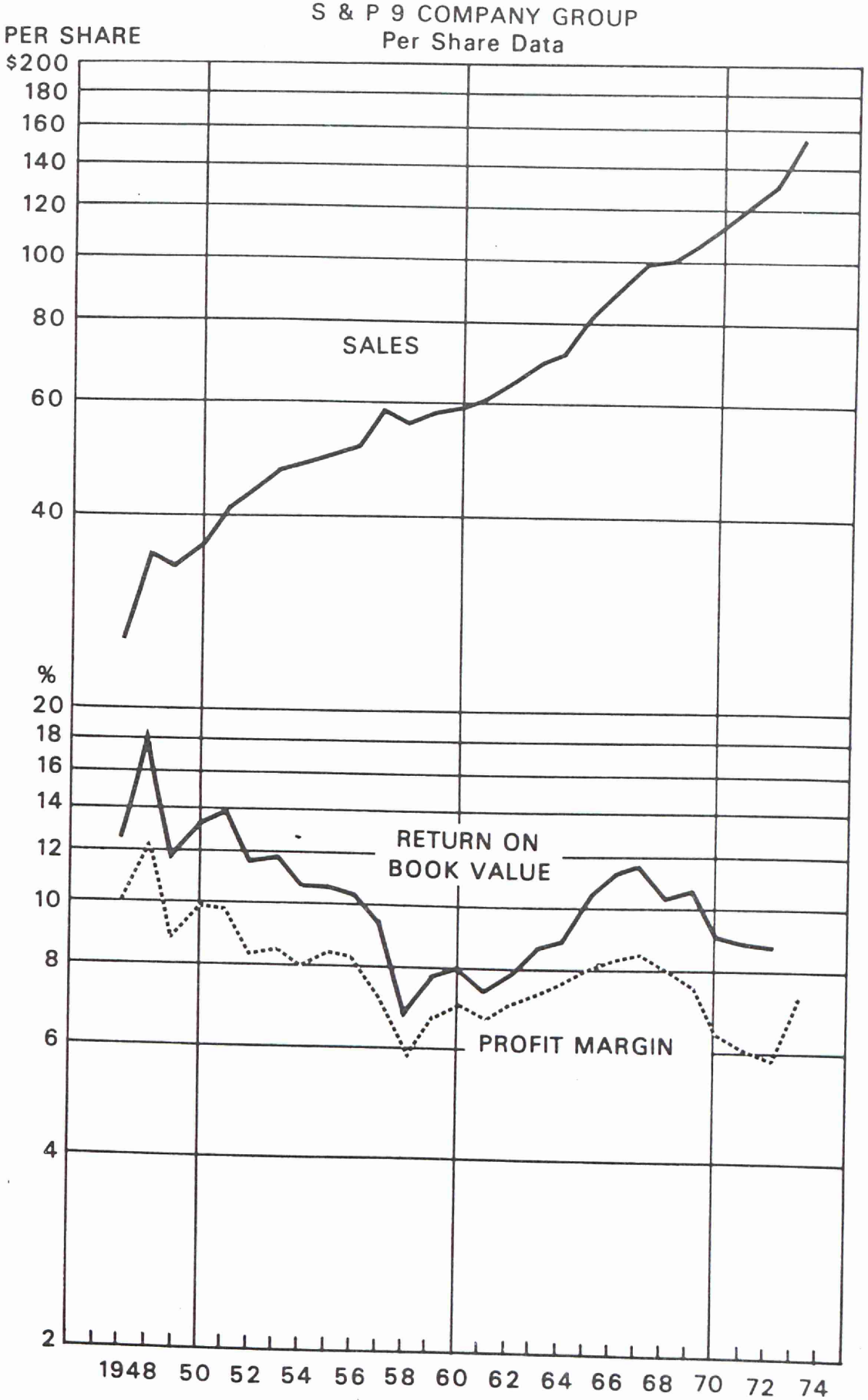
SMITH, BARNEY & CO. INCORPORATED

OILS: INTERNATIONAL
(W.E. AINSWORTH, JR.)

6/11/74

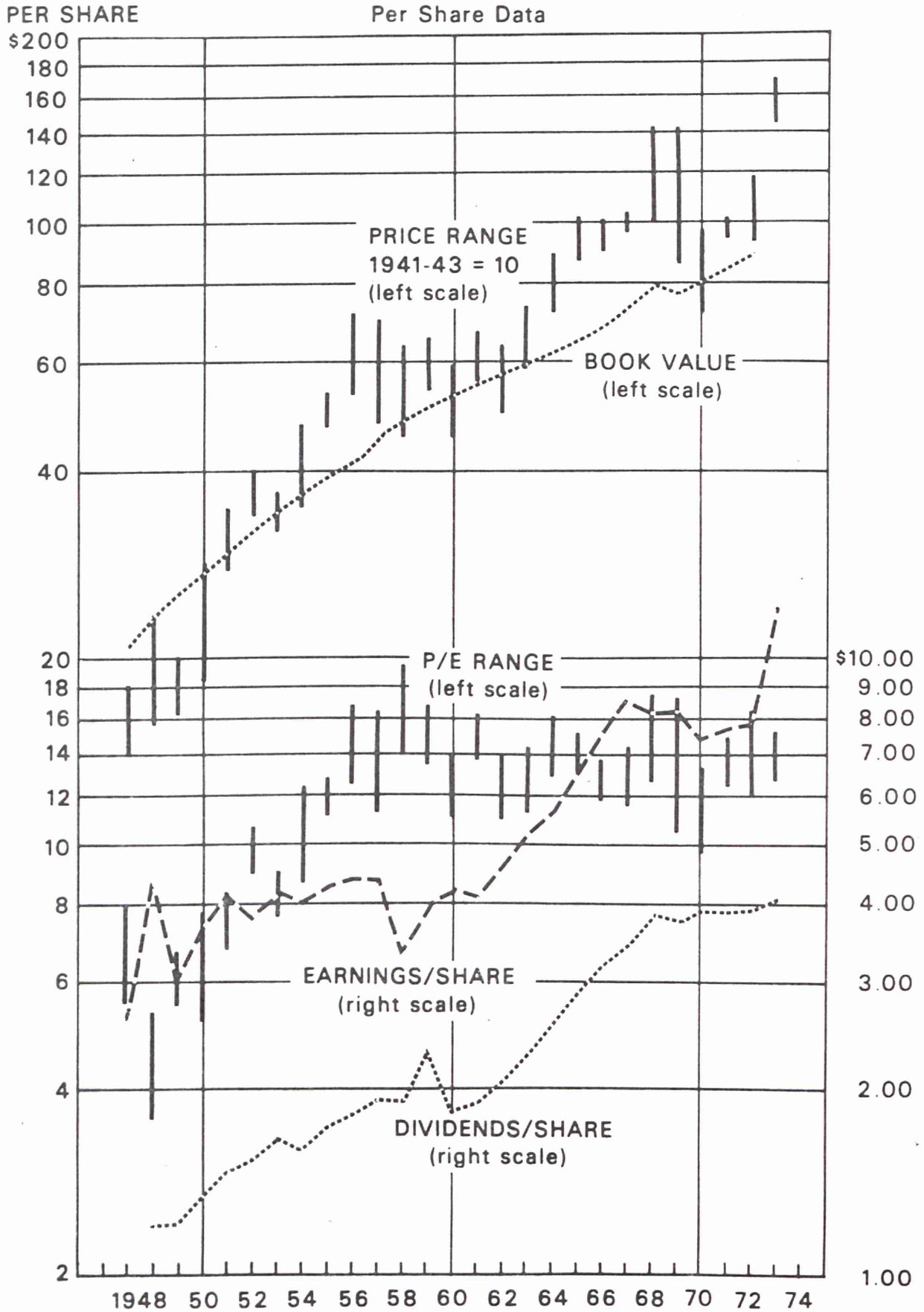
COMPANY AND FISCAL YEAR-END	TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL.TO S&P 425
EXXON	XON	$ 77	$100- 70	9- 6X	7X	$11.50	$10.89	$ 6.83	6%	-30%	-6%	$4.40	5.7%	-20%	84%
GULF	GO	21	25- 20	5- 4	5	4.65	4.06	2.15	15	5	5	1.50	7.1	-14	90
MOBIL	MOB	44	57- 40	6- 5	5	8.70	8.28	5.65	5	14	10	3.00	6.9	-18	86
ROYAL DUTCH	RD	31	36- 29	5- 4	4	7.50	7.95	3.35	-6	12	9	2.64	8.6	-9	95
STD. OIL CALIF.	SD	28	37- 26	7- 5	5	5.25	4.97	3.23	6	15	9	2.00	7.2	-20	83
TEXACO	TX	27	33- 25	6- 4	5	5.60	4.75	3.27	18	12	8	2.00	7.5	-0	95
INDUSTRY AVERAGES					5X				7%	5%	6%		7.2%	-15%	89%
383 COMPANY AVERAGE					12X				10%				3.3%	-3%	101%

OIL—INTEGRATED—DOMESTIC



OIL—INTEGRATED—DOMESTIC

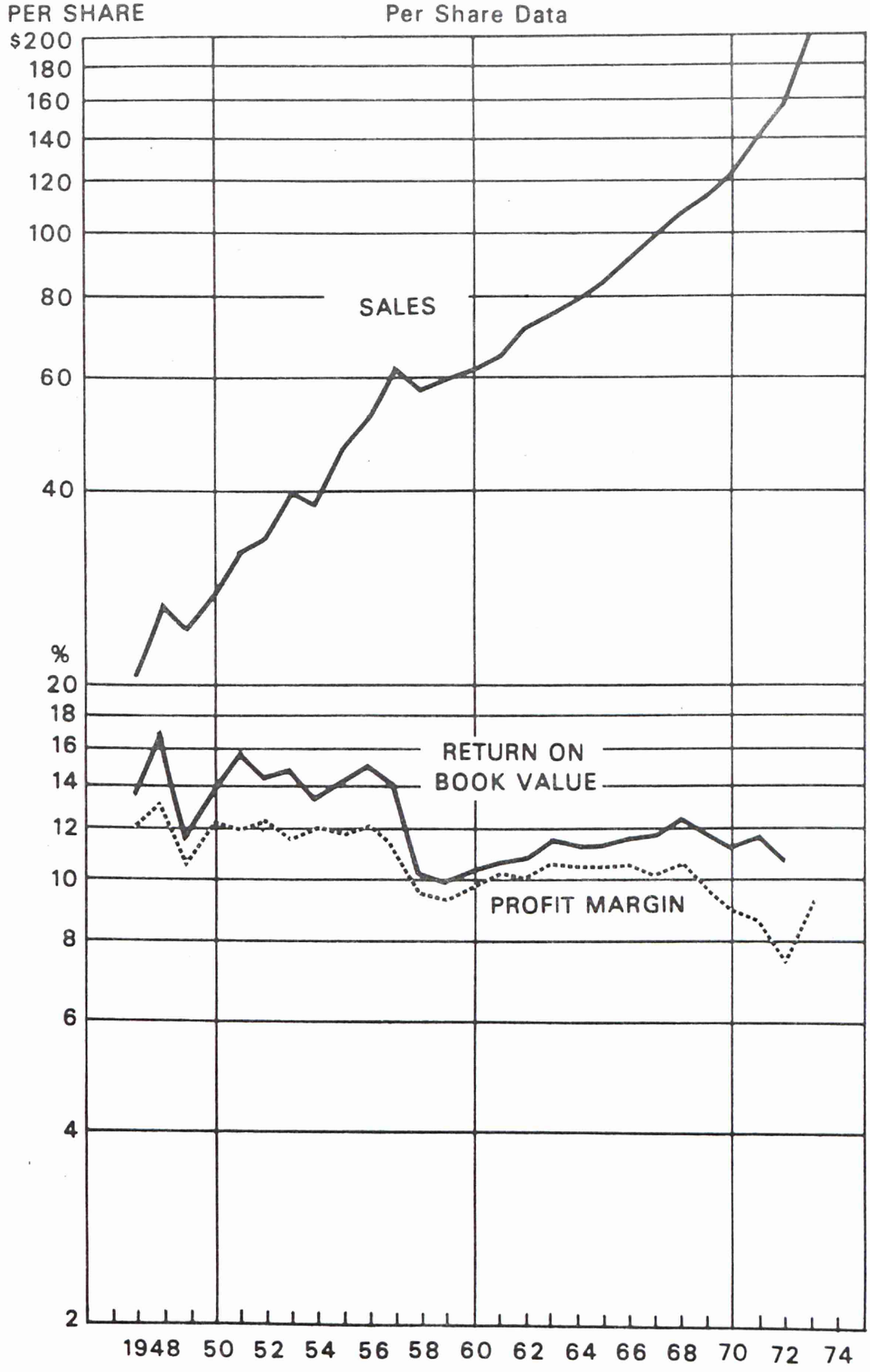
S & P 9 COMPANY GROUP
Per Share Data



OIL—INTEGRATED—INTERNATIONAL

S & P 6 COMPANY GROUP

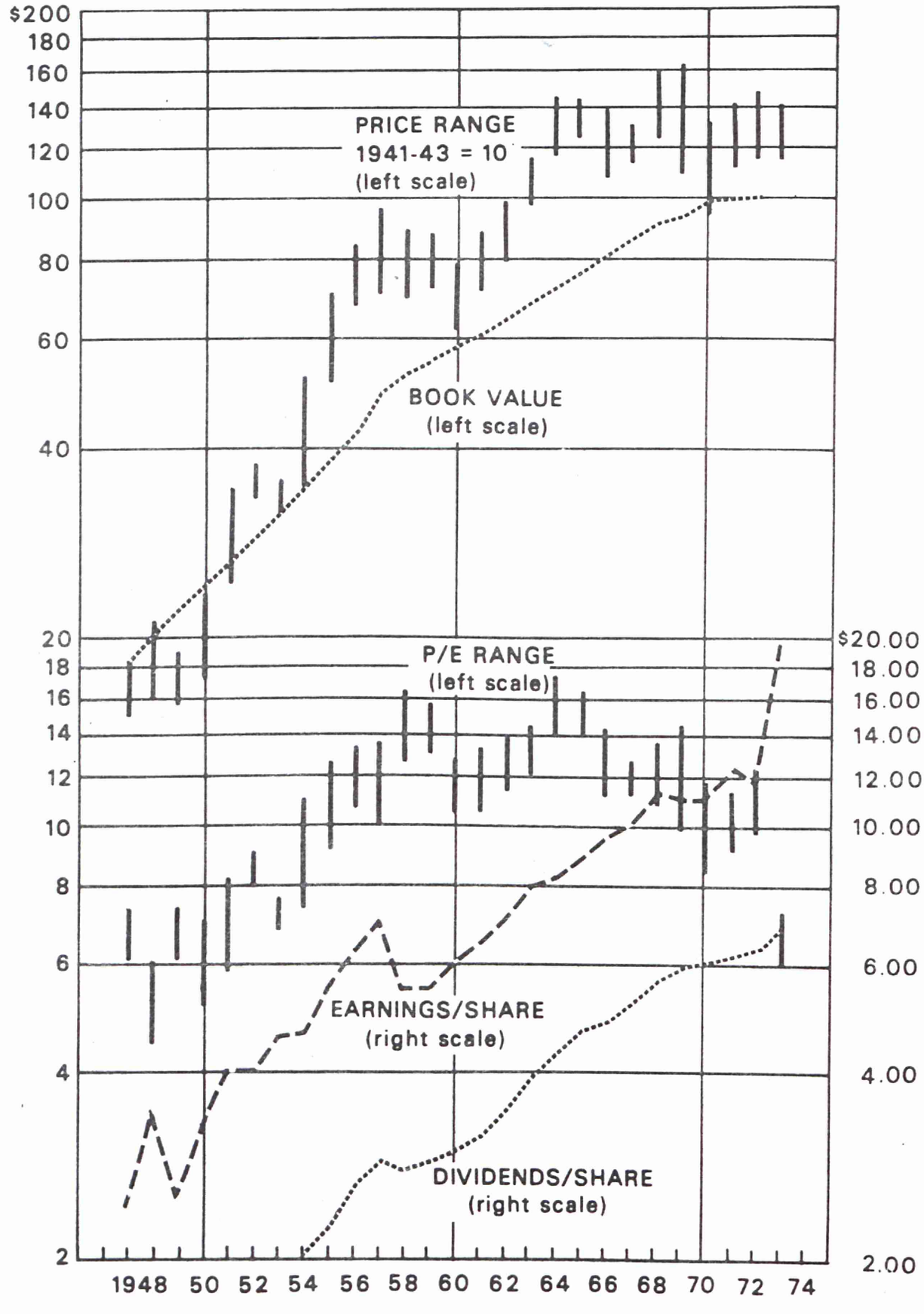
Per Share Data



OIL—INTEGRATED—INTERNATIONAL

S & P 6 COMPANY GROUP

Per Share Data



THE OUTLOOK FOR CAPITAL SPENDING AND THE MACHINERY INDUSTRY

We believe that capital spending will continue to be a strong sector of the economy through the mid-1970s. To emphasize this message to you we will concentrate on three topics:

I. The areas of capital spending that should be strong, and the expected duration of the uptrend.

II. Areas of major capital investment needs and the potential for their fulfillment.

III. Problems that could alter the favorable prospects for the capital goods industry.

We also will discuss the companies that we believe hold the greatest potential for earnings growth and stock market appreciation during the positive capital spending environment that we foresee.

I. Categories and Timing of Capital Spending

We believe that the greatest growth in capital investment will occur in the manufacturing industries, where an upward trend should last at least through the mid-1970s. Table I, on page i, identifies domestic capital spending by its major components. It shows that, after several years of little growth, the percentage increases in spending by manufacturers in 1973 (+21.2%) and estimated for 1974 (+19.7%) exceed the gains in total capital spending. We think manufacturers' spending will increase by 12-15% annually in 1975-76 and will continue to surpass the growth rate of other major sectors of the economy.

There are several reasons for the strength in manufacturers' expenditures for new plant and equipment. From 1966 to 1972, this category of spending grew very slightly. Moreover, after adjusting for inflation in these six years and for the considerable expenditures to meet pollution control requirements, it is clear that real additions to manufacturers' capacity actually declined in this period. The result has been increasingly tight capacity in several industrial sectors. Furthermore, demand continues to be strong in a number of industries, despite the well-publicized weakness in the automobile and housing areas. Tight capacity and favorable prospects for further growth in demand have persuaded many manufacturers to increase their investment in new plant and equipment. Even in the

face of a generally flat economy, many companies base their investment strategy on the assumption that they cannot time their expansion precisely with the next upsurge in demand. If a company earns an adequate return on capital, is producing at close to capacity today, and expects to grow in the 1970s, it must begin to spend to expand its manufacturing facilities.

It appears to us that the current uptrend in manufacturers' capital spending may last for several years. Table I shows that such spending turned upward only about 18 months ago, after being fairly flat for six years. Thus the upcycle is still relatively young. Moreover shortages of some materials and components and, in certain cases, problems of financing expansion may stretch out some spending programs. This could result in the upward trend slowing moderately next year and being extended into the late 1970s. The large investment programs that are now underway are also not increasing capacity as much as it might seem, because approximately 11% of current capital expenditures are for pollution control equipment, which does not augment productive facilities. Such expenditures were only 1% of the total in 1967. Finally, we are confident of further growth in manufacturers' capital spending in the years to come, because certain major industries are only just beginning to consider expansion programs. Such traditionally low return-on-investment industries as paper, steel and nonferrous metals until recently had suffered from overcapacity and underpricing, and they could not justify large expansion programs under these conditions. With the removal of price controls, these industries have become significantly more profitable. In the last year, moreover, they have been operating at close to maximum capacity. Companies in these fields are now starting to announce major capital expansion programs, and we believe that their spending will be an important factor in extending the high levels of capital spending into the mid-1970s.

II Areas of Major Capital Investment Needs and the Potential for their Fulfillment

In order to develop a sense of the magnitude of growth in manufacturers' capital spending, we think it is useful to examine the prospects for investment in several major industries. The automobile industry is frequently singled out as an important area where capital spending is being reduced because of the dislocations due to the energy crisis. This industry accounts for about 6% of all manufacturers' capital spending, and its 1974 expenditures are currently forecast to be flat to up moderately. We know of no other important manufacturing industry with such limited spending plans, and we would point to several other areas where the capital investment programs are quite dynamic:

1. The *steel industry's* capital spending constitutes 5% of total manufacturers' spending. To provide the steel-making capacity required in the United States by 1980, we estimate that this industry's capital investment will have to average $3.5 billion annually for the next 6 years, or double the $1.7 billion annual average of the last 6 years. The return on investment in the steel industry has been improving recently, and the companies are starting to announce expansion programs. The prospects for a significant increase in capital spending in this industry are favorable.

2. Despite some uncertainties concerning supplies of petroleum feedstocks, the *chemical industry* is forecast to increase its expenditures for new plant and

equipment by 36% in 1974 and by another 11% in 1975. This industry accounts for 12% of manufacturers' capital spending.

3. To meet the worldwide demand for many types of capital goods, *machinery companies* are investing extensively. The spending of electrical and nonelectrical equipment companies totals 9% of manufacturers' capital spending. Some varied examples of machinery company expansion programs include Caterpillar Tractor, which is planning to spend $1.1 billion on new plant and equipment in the next 3 years, versus $520 million in the last 3; Deere & Co., whose spending should reach $300 million in the 1974-76 period, up from $112 million in the 1971-73 period, and, as an extreme example, Bucyrus-Erie, which plans to invest $60 million in plant and equipment in the next three years, compared with $9.3 million in the last 3.

Bucyrus' capital spending plans are an interesting indication of the impact of the capital spending of the *energy-related industries.* These include electric and gas utilities, coal mining, and petroleum production, transportation, and refining. Their capital expenditures are estimated to be $30 billion in 1974, up 20% from last year. This amount is expected to be approximately 25% of the total capital investment of American industry this year. While there is considerable debate about which are the proper areas to emphasize to solve our nation's energy shortage, we think there is little doubt that total capital investment in equipment to produce more energy will grow significantly in order to reduce our dependence on foreign suppliers.

Expenditures on such an enormous scale as $30 billion are certain to have a ripple effect throughout the economy, stimulating demand for materials and equipment and encouraging manufacturers of these products to increase their capacity. This is the case at Bucyrus-Erie, where the very large demand for strip coal mining equipment has encouraged a vast expansion program. We believe that the effort to develop new supplies of energy for the United States will stimulate strong demand in steel, machinery, ship building, and railroad cars. The capital spending in these fields will contribute further to total capital spending growth during the next several years.

III. Problems that could Change the Favorable Prospects

We are confident of the growth in capital spending in the mid-1970s, but certain problems could slow this growth or limit the appreciation of the stocks of major capital equipment producers. Among these are:

1. High Interest Rates

The current high interest rates could cause the postponement of some marginal projects. However, the average return on the existing investment of American industrial companies is 12% aftertax, and the current aftertax costs of long-term debt for most companies is 4-6%. We realize that due to inflation the return on new investment is lower than the historical average. However, we think that most manufacturers can still justify borrowing at the present rates, if debt is required to finance an expansion program.

2. Availability of Funds

There is some fear that there will be insufficient funds to finance the expected increase in capital spending. It is important to recognize this potential problem and the possibility that it could slow the growth in capital investment, particularly for those companies who need to raise money through equity financing. However, for most companies we believe the funds will be available. There is considerable institutional money available for long-term loans, and, as we noted previously, most companies can afford the current high interest rates. Profits and retained earnings are substantial in many industries, providing the cash flow for much of the expansion. Furthermore, there is some discussion in Congress and the Administration of additional investment incentives – a higher investment tax credit and more rapid depreciation – as a means of providing the funds to stimulate capital expansion. Certianly there are some companies that can expand only by selling equity because of high debt ratios. However we do not believe that this is a sufficiently common situation to deter the growth of capital spending.

3. Pricing vs Costs

Throughout Phase IV of Federal price controls, the prices of most types of machinery lagged the costs of materials and labor. The result was that profit margins of machinery companies slipped materially. Now we have returned to free pricing, and capital equipment producers, finding themselves in a strong sellers' market, are pricing aggressively. Price increases for most capital goods have averaged 8-15% since April. There is frequent use of escalator clauses on long leadtime products, and customers whose orders are placed in backlog are usually told to expect to pay the price that is in effect at time of shipment. We look for further price increases for most capital goods in the next year. It is still too early to know for sure if prices for machinery will be able to keep ahead of costs, but we are optimistic that this will be the case in the expected period of strong demand. This is an area we plan to watch quite closely in the coming months.

The principal investment appeal of capital goods companies is as follows: profit margins should improve moderately in the next two years because of better pricing, some operating leverage, and more efficient production, as the material shortages ease; because of the strong demand for most types of machinery, sales gains should average 12-15% per year, and such growth, combined with improved profit margins, should produce earnings gains averaging 15% annually in 1975-76. The earnings of capital goods companies in general are about on trend or slightly below. In most cases, machinery company earnings began to increase in 1972-73 after being flat or down since 1966. We believe the next 2-3 years will be a period of above-average growth in machinery earnings. Most capital goods companies are conservatively financed and can fund their own expansion with retained earnings and some additional long-term debt. They typically have healthy payout ratios, and we look for a growth in dividends in the machinery industry of at least 10% annually in the mid 1970s.

Stock Participation

We continue to believe that the best way to participate in the expected strong growth in capital spending is to invest in companies whose product lines serve a broad range of manufacturing industries. We would avoid companies that specialize in machinery for one or a few industries, as recent events have shown that the capital investment plans of any one industry (e.g., the auto industry) can change rapidly. We have more confidence in the uptrend of manufacturers' capital spending in general than we do in the investment intentions of any one industry. There are two categories of machinery that are used in almost every type of manufacturing: pneumatic machinery (pumps and compressors) and material handling equipment (industrial lift trucks). The correlation between the sales of these two classes of machinery and the total capital spending of manufacturers has been quite close historically. We believe that this correlation will remain close, and our recommendations in the capital goods industry are concentrated in these two areas.

Ingersoll-Rand† (75)

This is the largest and most diversified of the industrial capital goods companies. Its 1974 sales of approximately $1.2 billion are divided into the following markets: a broad range of manufacturers (40%); a variety of energy-related markets, including petroleum, electric utilities, and coal mining (26%); mining and construction (19%); and other small industries (15%). Its mix of business appears particularly attractive, as two-thirds of its sales are of equipment to meet manufacturers' capital spending needs and machinery to provide more energy. These two markets appear to have significant growth potential in the next several years. Ingersoll's varied markets and the fact that about 50% of its sales are expendable items have allowed the Company to achieve a smoother earnings pattern than have most capital equipment companies. Thus, unlike many other machinery manufacturers, Ingersoll is less likely to suffer a sharp earnings decline after the current capital spending surge slows. This quality could attract investors who normally are not comfortable with companies in cyclical industries. The stock may achieve a premium multiple to its industry because of this attribute and the fact that it has the largest capitalization of any industrial capital goods manufacturer.

Ingersoll-Rand has had a favorable earnings performance in recent quarters, a period that was quite difficult for many manufacturers. It has the capacity to meet the very strong demand for its products; and, while it has felt certain material and component shortages, they have restricted its shipments less than those of many other manufacturers. Ingersoll's prices lagged its costs during the period of price controls, but since the latter have been removed, the Company has raised prices and moved to maintain greater pricing flexibility through escalation clauses and the elimination of price protection on long-lead-time orders. For the rest of this year, and in 1975, we look for sharp sales gains. Profit margins may slip slightly in 1974 because of the lag in prices, but we think profitability could improve next year to above 15% pretax. Its return on equity would then be about 16%. The Company earned $4.91 per share in 1973; our estimates for 1974-75 are $5.50 and $6.50, respectively. We believe earnings gains will average at least 15% annually through 1976 and may continue into the late 1970s. Ingersoll's long-term growth rate should average 8-10% per year.

We think Ingersoll-Rand's dominant position in the capital goods industry and its above-average earnings potential in the 1970s are undervalued at 14x our 1974 estimate. The stock is our strongest purchase recommendation in the capital spending area.

Gardner-Denver (23)

This Company has many of the same qualities as Ingersoll-Rand. Its wide line of pneumatic machinery is sold to manufacturers (42%), construction (29%), mining (16%), and petroleum (13%). Including the estimated 5% of its sales that go to coal mining companies, approximately 60% of Gardner-Denver's equipment is used either to expand manufacturers' capacity or to help produce energy resources. Because about 50% of its sales are repair parts and other expendable items, its historical growth rate of 10% per year has had a less cyclical pattern than many other capital goods manufacturers. Gardner-Denver has developed a strong reputation for its high quality products and its good financial record. Its 1973 pretax margin of 18% was one of the highest in the machinery industry, and its return on equity has averaged 17% in the last 10 years. We believe that the Company should benefit significantly from the strong demand for capital goods that we see in the 1970s from manufacturers, mining companies, and petroleum producers. Earnings in 1974 are being restricted by the startup costs of a major new foundry the Company is building in Oklahoma and by a seven-week strike at its Quincy, Illinois compressor plant. These costs should be limited to 1974, and we expect Gardner-Denver to achieve record earnings in 1975 of at least $2.15 per share. The Company's growth rate in the last half of the decade should average at least 10% per year. As a result of the disappointing 1974 earnings, which may be somewhat less than the $1.64 per share of 1973 (our estimate is somewhat imprecise, because we do not know how long the strike will last), Gardner-Denver's stock has been weak recently. We remain convinced of the strength of its principal markets during the 1970s and of the Company's ability to capitalize on these favorable economic conditions. Consequently, we believe that Gardner-Denver, at 11x our 1975 estimate, is an excellent investment in the capital goods industry. When the current strike is settled, the stock could provide attractive near-term appreciation, as well as favorable long-term growth. We continue to recommend purchase.

Caterpillar Tractor (62)

This Company is frequently investor's first choice in the machinery industry. At the current price, however, we are less enthusiastic. It is important to emphasize that, including Caterpillar's lift truck and engine divisions, probably no more than 25% of the Company's sales are directly affected by manufacturers' capital spending. Perhaps another 20% is related to various energy markets. This leaves approximately 55% that is directly influenced by worldwide construction activity. This is a booming business today, and the demand for construction machinery so greatly exceeds supply that we expect sales to continue strong through 1975. However, by the end of next year, the sales of construction equipment will have expanded for four consecutive years. This industry has always been cyclical, and despite such potentially strong markets as coal mining and the economic development of the Middle East, we believe a slowdown in demand will come sometime in the next few years. Some obvious contributors to such a deceleration could be less highway building in

the United States, high interest rates as a deterent to some forms of construction, and slower economic growth in Europe and Japan, caused by the high price of oil. We cannot estimate precisely when the demand for construction equipment might ease, but the potential for such a slowdown in 1976, combined with Caterpillar's current large expansion program, makes us conservative about the Company's earnings growth in the next few years. Its longer term growth, however, will probably average 8-10% per year. Our investment strategy for Caterpillar is to assume that in a period of generally lower multiples its stock may not be valued at more than 15x. Our 1975 earnings estimate is $5.10 per share, and we would recommend purchase only at a price from which a move to a 15 multiple would provide adequate appreciation. At the current price, we consider the stock a hold.

There are three additional manufacturers of industrial capital goods that should be mentioned. We will outline our thoughts on them briefly.

Clark Equipment (33)

This is a major manufacturer of various types of capital goods, principally lift trucks, transmissions and axles, and construction equipment. All of these products are in strong demand worldwide. Its earnings growth this year is restrained by capacity limitations and prices that have lagged its costs. Despite the 11% earnings decline in the first quarter, we believe improved profit margins resulting from higher prices wil allow Clark to achieve a small earnings gain in 1974 to $4.20 per share, versus $4.08 last year. Demand should continue strong for most of its products next year, and Clark will have additional capacity by early 1975. We believe earnings could approach $5.00 per share next year. In analyzing Clark, however, it is most important to recognize the change in investor sentiment that has occurred regarding this stock. Investors have become more aware that much of the Company's growth has come through acquisitions and that some recent purchases have produced inferior results. The losses in the Baldwin-Lima-Hamilton construction equipment division and in the English lift truck plant have continued since 1971, tarnishing Clark's former quality image. We believe that until management suceeds in turning these operations around and persuades investors that the Company has above-average *internal* growth potential, investors will award Clark only an average multiple. This suggests that the stock has some recovery potential to perhaps 40-45 on a $5 per share earning power. We consider the stock a hold, but do not recommend purchase at this time.

Hyster* (15)

This Company is our choice in the materials handling industry. If manufacturers' capital spending is likely to grow in 1975-76, so should the demand for materials handling equipment. Hyster is a leading manufacturer of lift trucks, with strong market positions in the United States and overseas. During the last two quarters, its earnings were restricted by the three-day workweek in Great Britain and parts shortages in the United States. Both of these problems have been corrected, but a series of strikes closed most of Hyster's domestic plants for three weeks in June. These have been settled, and we believe as production increases for the remainder of 1974, the Company can earn close to $3.00 per share this year. Earnings should grow 12% per year in 1975-76. We look for a dividend

increase towards $1.00 per share in the next year from the current $0.75 level. From a price of 15, Hyster offers good recovery potential on the basis of favorable earnings prospects.

Sullair* (14)

Sullair is an outstanding stock for investors seeking unusual smaller growth companies. It has achieved a 30% per-year growth rate in earnings since 1967 by concentrating on a new type of pneumatic machinery, the rotary screw compressor. This machine offers significant economies over the standard reciprocating compressor. Although other companies manufacture the rotary screw models, Sullair has achieved leadership in this field through total concentration in this innovative product and aggressive marketing techniques. Management has shown in the past year that its early success is likely to be sustained. While continuing to sell rotary screw compressors for a wide range of manufacturing, construction, and mining applications, the Company has developed important new marketing relationships that should allow it to benefit materially from the need for airpowered drills to build the Alaskan pipeline and from the strong demand for compressors on offshore oil rigs. Sullair is also establishing a German subsidiary that should allow it to penetrate the European industrial market beginning in 1975. We believe Sullair can achieve earnings growth of at least 20% per year during the next several years as a result of the increase in capital spending and the Company's ability to develop new applications for the rotary screw compressor. Our earnings estimates are $1.70 in 1974, up from $1.29 last year. In 1975 Sullair could earn $2.10 per share. Its current multiple of 8x reflects the disfavor of companies with small capitalizations. If investor interest returns to smaller companies, Sullair could provide major appreciation.

In summary, we are optimistic about capital spending by manufacturers in the mid-1970s. The growth rate of this spending will have fluctuations, but the trend should continue upward for several years. The superior capital good manufacturers should be able to take advantage of this opportunity and achieve earnings gains averaging 15% per year in 1975-76. Our recommendations are *Ingersoll-Rand, Gardner-Denver, Hyster* and *Sullair.*

Bruce M. Babcock

* Smith, Barney & Co. Incorporated usually maintains a market in the securities of this Company.

† Within the last 3 years, Smith, Barney & Co. Incorporated or one of its affiliates was the manager (comanager) of a public offering of the securities of this Company and/or has performed other investment banking services for which it has received a fee.

Table I

Expenditures for New Plant and Equipment by U.S. Business, 1959-74
($ billions)

	All Industries	Manufacturing Industries	Durable Goods	Non-durable Goods	Non-Manufacturing
1974 1Q E	$107.18(1)	$42.74(1)	$22.12(1)	$20.62(1)	$64.44
1973 4Q	103.74	40.61	20.48	20.13	63.12
1973 3Q	100.90	38.81	19.73	19.08	62.09
1973 2Q	97.76	36.58	18.64	17.94	61.18
1973 1Q	96.19	35.51	17.88	17.63	60.68
1972 4Q	91.94	33.64	16.86	16.78	58.30
1972 3Q	87.67	30.98	15.67	15.31	56.70
1972 2Q	87.12	30.37	14.77	15.60	56.75
1972 1Q	86.79	30.09	15.06	15.02	56.70
E 1974	111.96	45.52	22.49	23.03	66.44
1973	99.74	38.01	19.25	18.76	62.07
1972	88.44	31.35	15.64	15.72	57.09
1971	81.21	29.99	14.15	15.84	51.22
1970	79.71	31.95	15.80	16.15	47.76
1969	75.56	31.68	15.96	15.72	43.88
1968	67.76	28.37	14.12	14.25	39.40
1967	65.47	26.51	14.06	14.45	36.96
1966	63.51	28.20	14.96	14.14	35.32
1965	54.42	23.44	11.50	11.94	30.98
1964	46.97	19.34	9.28	10.07	27.62
1963	40.77	16.22	7.53	8.70	24.55
1962	38.39	15.06	6.79	8.26	23.33
1961	35.91	14.33	6.31	8.02	21.58
1960	36.75	15.09	7.23	7.85	21.66
1959	33.55	12.77	5.81	6.95	20.78

(1) Quarterly numbers are seasonally adjusted quarterly totals at annual rates.

Source: *Survey of Current Business*, U.S. Department of Commerce.

Table II

SMITH, BARNEY & CO. INCORPORATED

MACHINERY: FARM EQUIPMENT
(P.ANKER-B.BABCOCK)

6/11/74

COMPANY AND FISCAL YEAR-END		TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	DIVIDEND YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL.TO S&P 425
DEERE	OCT	DE	$ 41	$ 54- 34	10- 6X	7X	$ 5.65	$ 5.75	$ 3.82	-2%	37%	7%	$1.60	3.9%	-19%	84%
INTL HARVESTER	OCT	HR	26	29- 24	7- 6	6	4.30	3.86	3.18	11	18	-3	1.50	5.7	-2	102
MASSEY-FERGUSON	OCT	MSE	18	21- 16	6- 5	5	3.40	3.20	1.76	6	38	-5	.80	4.3	1	106
INDUSTRY AVERAGES						6X				5%	31%	-0%		4.7%	-7%	97%
383 COMPANY AVERAGE						12X				10%				3.3%	-3%	101%

Chart I

Trend of S & P Agricultural Machinery Industry Stock Index And Performance Relative to The S & P 425 Industrials 1953 - May 1974

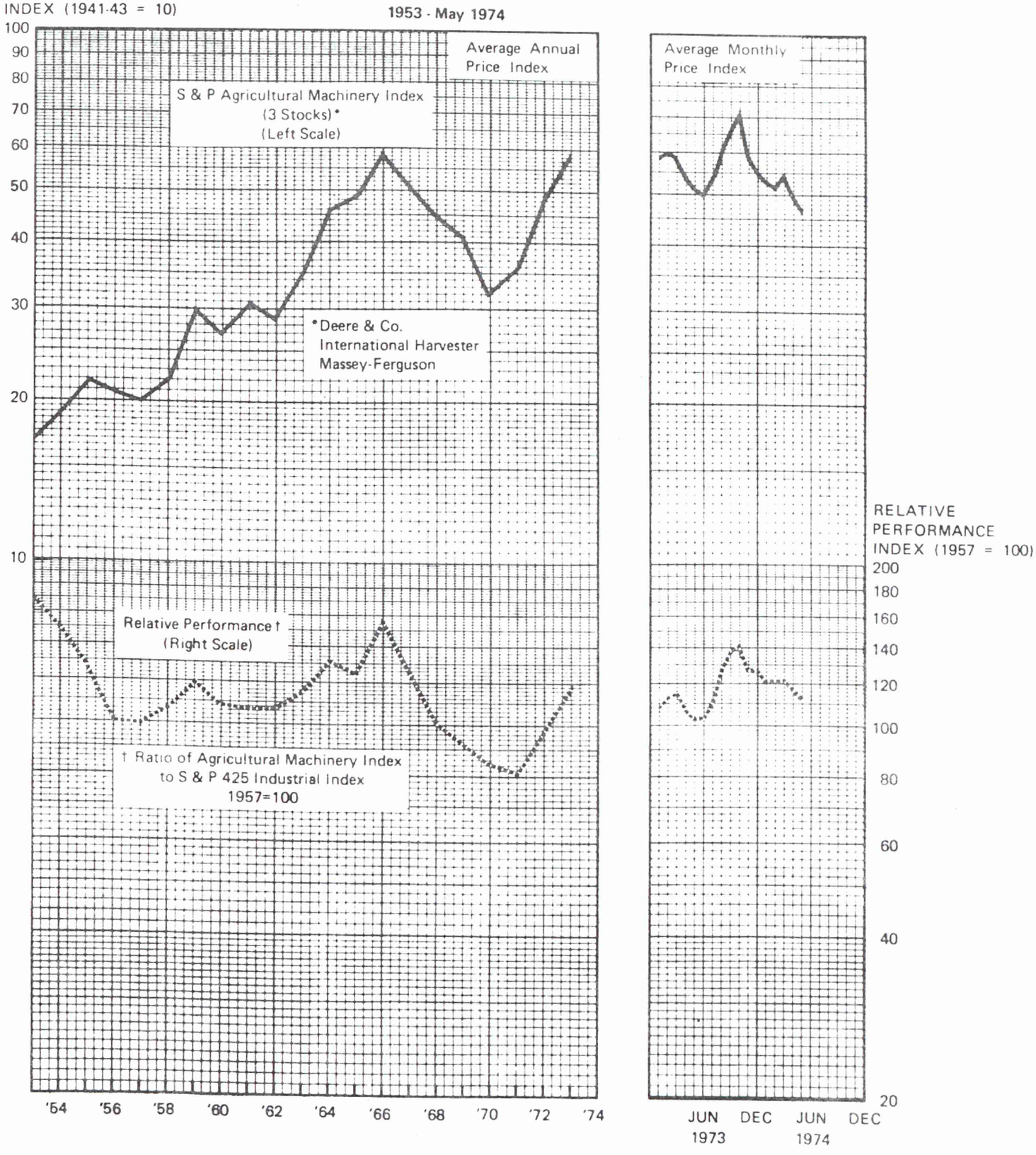


Table III

SMITH, BARNEY & CO. INCORPORATED

MACHINERY CONSTRUCTION
(B. M. BABCOCK)

6/11/74

COMPANY AND FISCAL YEAR-END	TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL.TO S&P 425
BUCYRUS-ERIE	BY	$ 28	$ 47- 24	23- 12X	14X	$ 2.05	$ 1.86	$ 1.66	10%	9%	2%	$1.00	3.6%	-38%	65%
CATERPILLAR TRAC	CAT	65	70- 55	16- 13	15	4.30	4.32	3.62	-1	16	5	1.60	2.5	-3	101
CLARK EQUIPMENT	CKL	35	47- 29	11- 7	8	4.20	4.08	3.00	3	5	6	1.60	4.6	-24	80
INDUSTRY AVERAGES					12X				4%	10%	4%		3.5%	-22%	82%
383 COMPANY AVERAGE					12X				10%				3.3%	-3%	101%

Chart II

Trend of S & P
Construction Machinery Industry
Stock Index
And Performance Relative to
The S & P 425 Industrials
1953 - May 1974

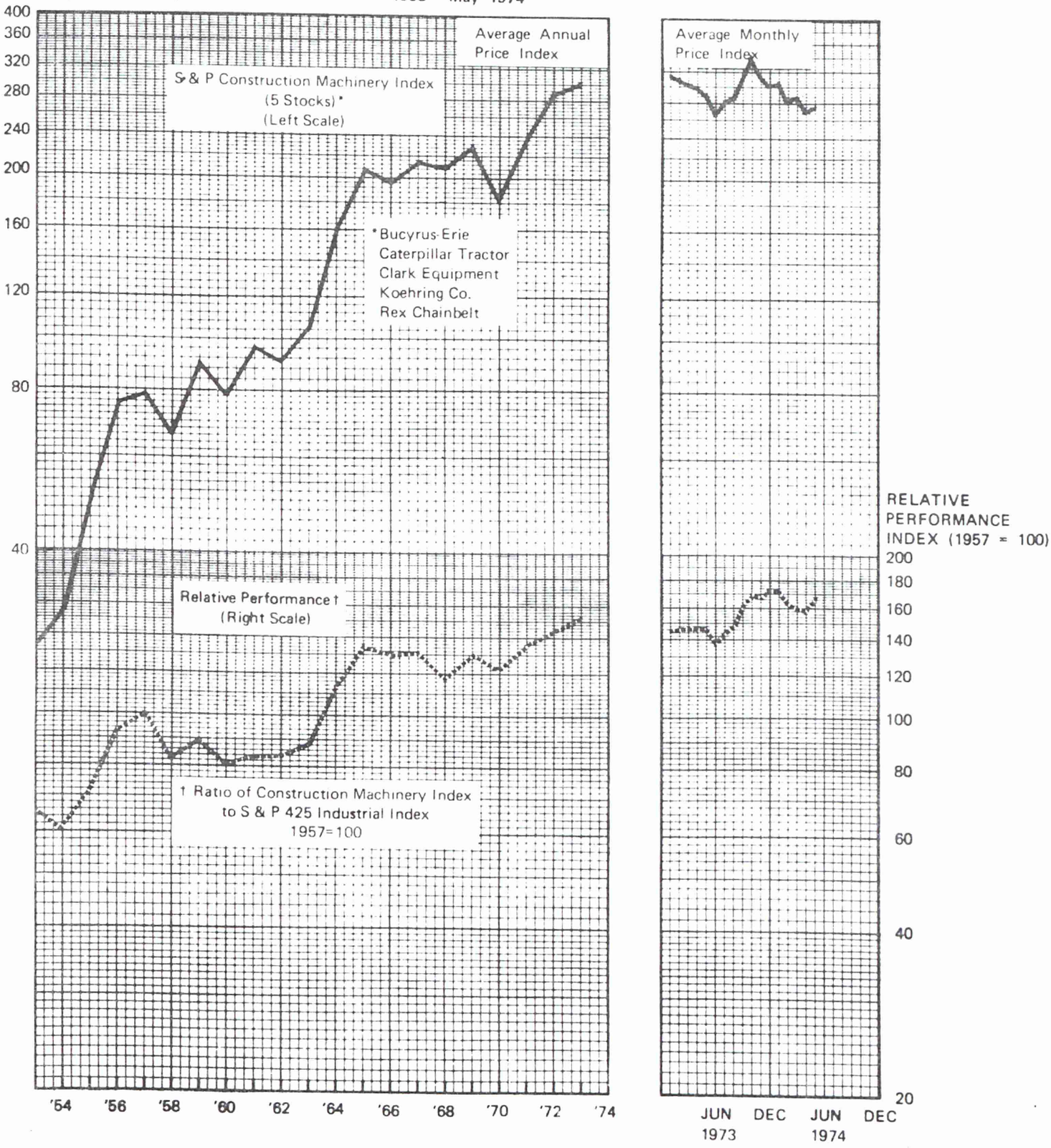


Table IV

SMITH, BARNEY & CO. INCORPORATED

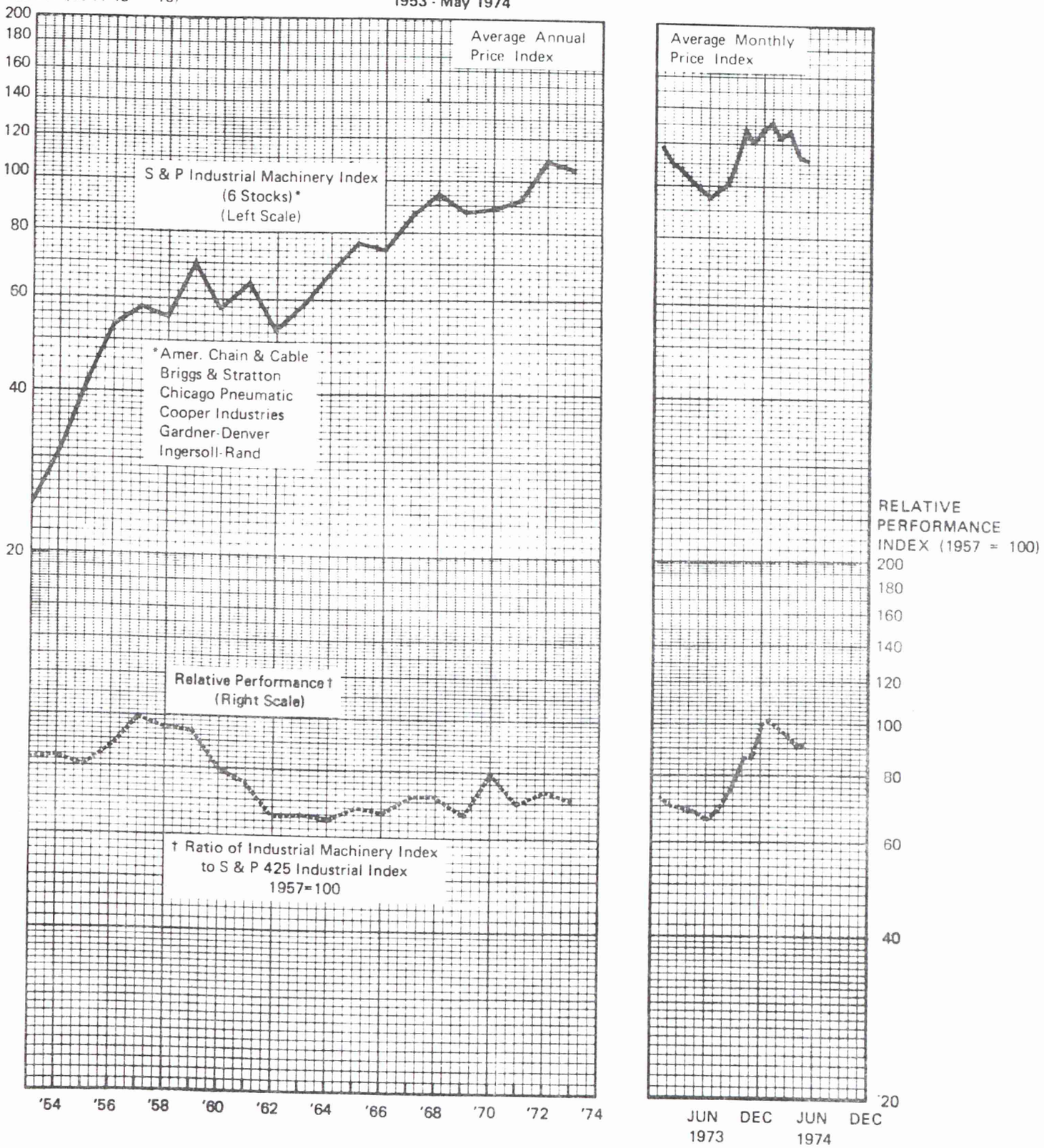
6/11/74

MACHINERY: INDUSTRIAL
(B. M. BABCOCK)

COMPANY AND FISCAL YEAR-END		TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL. TO S&P 425
GARDNER-DENVER		GDC	$ 24	$ 36- 25	21- 14X	14X	$ 1.70	$ 1.64	$ 1.39	4%	3%	7%	$ .76	3.1%	-31%	73%
HYSTER CO.*	MAR	HYST	15	22- 15	7- 5	5	2.90	2.52	2.33	15	7	3	.75	5.1	-30	73
INGERSOLL-RAND *		IR	76	98- 73	18- 13	14	5.50	4.91	4.16	12	5	5	2.32	3.0	-21	83
NATL. MINE **	JUN	NMNE	13	17- 12	16- 11	12	1.10	.76	.97	45	20	16	.40	3.1	-5	100
SULLAIR		SULL	14	17- 13	10- 8	8	1.70	1.29	.90	32	21	30	.00	.0	-5	99
INDUSTRY AVERAGES						10X				22%	11%	12%		2.9%	-18%	86%
383 COMPANY AVERAGE						12X				10%				3.3%	-3%	101%

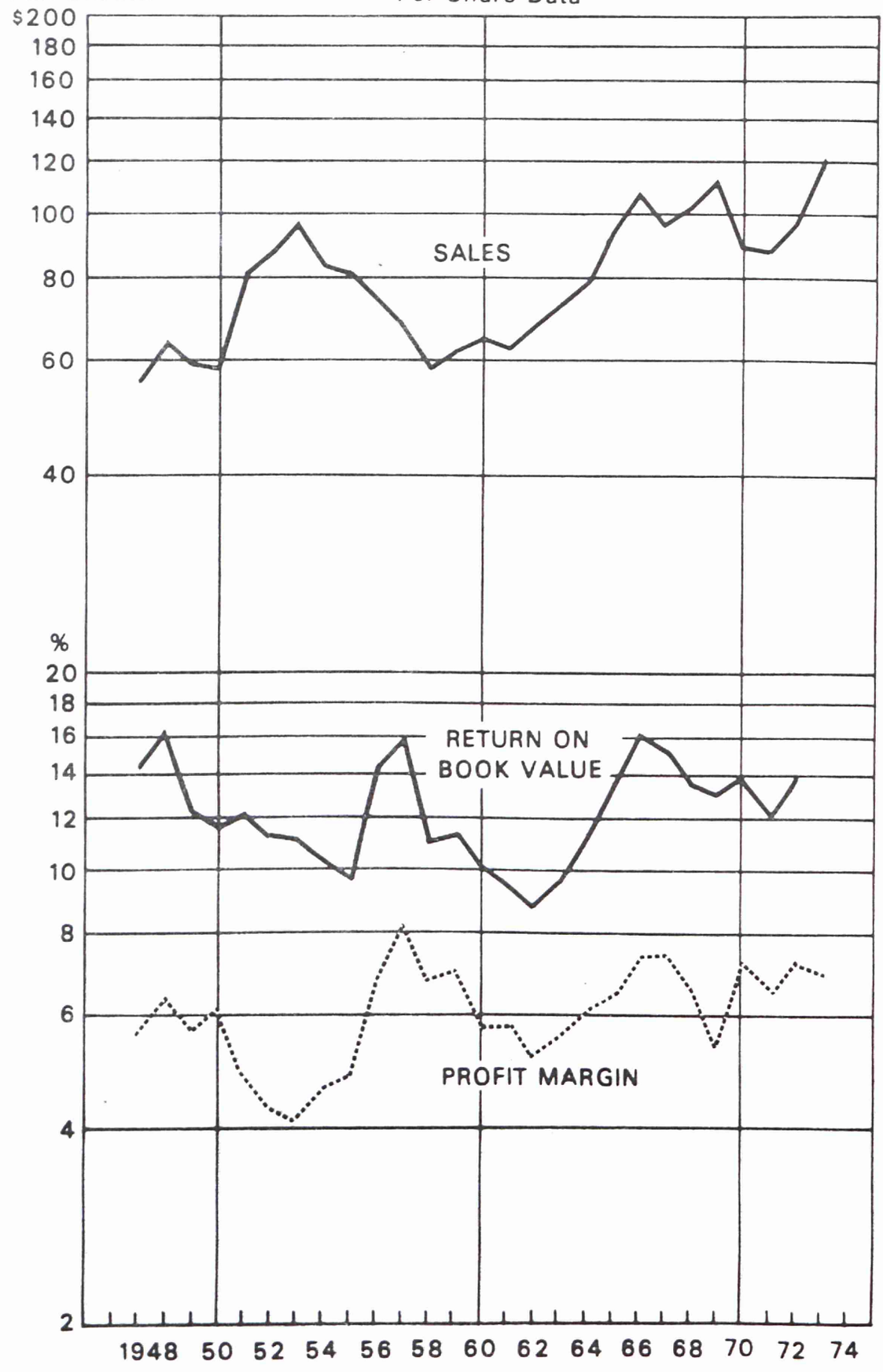
Chart III

Trend of S & P
Industrial Machinery
Stock Index
And Performance Relative to
The S & P 425 Industrials
1953 - May 1974



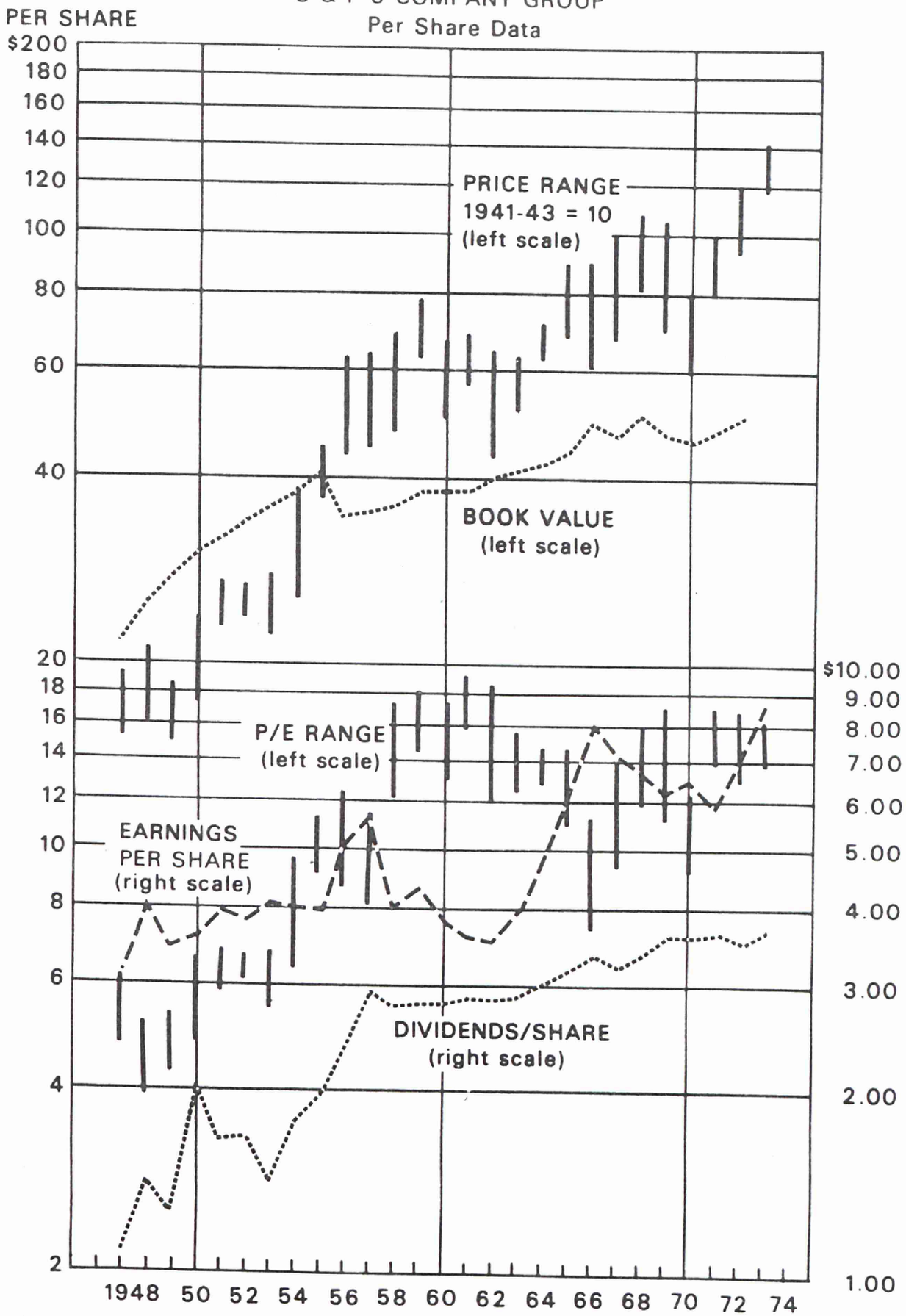
MACHINERY—INDUSTRIAL

S & P 6 COMPANY GROUP
Per Share Data



MACHINERY—INDUSTRIAL

S & P 6 COMPANY GROUP
Per Share Data



A CURRENT APPRAISAL OF THE DATA PROCESSING INDUSTRY

In order to approach a current appraisal of the data processing industry with proper perspective, what questions should we ask ourselves in 1974 about this group? Here is our list --

1. First, are we entering a period similar to 1970–71? One can recall, perhaps all too vividly, that entering that period of time we had an economy with a high rate of capacity utilization and with what then was considered very high interest rates and capital shortages. The ensuing two-year period was disastrous for computer companies and was certainly not foreseen by them.

2. Second, has the international economic and political situation changed? A corollary question is, if it has changed, should we reconsider our attitude towards multinational companies, of which the computer industry is a major example? Some of the issues here include economic nationalism, taxation, balance of payments, currency changes and last but not least, international economic growth.

3. Third, what is the effect of inflation on the data processing industry? Double-digit inflation is a new factor, clearly. The questions here might be, how will inflation affect demand for the industry's products, and will inflation impact costs and create profit margin pressure.

4. Finally, have investor opinions shifted, and if so, are these shifts favorable or unfavorable to the computer stocks? Some of the cross-currents might include growth stocks vs. other types of stocks, high yields vs. low yields, multinational vs. uninational, plus a heavy sprinkling of fairly broad competition from other types of securities.

We do not suggest that this is an all-inclusive list--we have excluded antitrust matters, for example--and of course some of these questions overlap and are interrelated. Despite these shortcomings, this is perhaps a working list to start from.

It would be presumptuous to say that we have all of the answers to these questions, but let us try to grapple with them.

There are, in our opinion, several distinguising features in this economic cycle as compared to the 1970–71 period. The favorable factors are as follows:

1. Computer equipment acquisitions in the years 1972–74 and those planned for 1975–76 and in current backlog, have been cost-justified and are not in excess of needs. This is a significant difference from 1970–71, when the excess of computer equipment shipped during the 1960s was returned.

2. The computer companies have not themselves overexpanded this time, have greatly improved their balance sheets, and have adopted a "rolling" new product introduction strategy rather than a massive line change such as we had in 1970 in the midst of the recession.

3. The capital spending sector of the economy is projected to be much stronger in 1974–75 than was the case in 1970–71.

While these are all significant pluses for the industry, there is one minor and one fairly major negative factor that we see ahead in this cycle. The development of lesser importance is that in the past 2½ years there has beeen somewhat greater outright sale activity in the industry than in the past as contrasted with leasing, and accordingly, there may be somewhat greater sensitivity to economic fluctuation. Of far greater importance are developments on the international scene, which we listed as the second important question to be addressed in looking at this industry.

In order to set the stage for this discussion, the computer industry derives roughly 50% of its revenues and earnings from foreign sources, and within that framework, Europe and Japan account for perhaps 2/3 of foreign activity.

The first point to be made is that while we consider Canada and Latin America to be areas of relative strength, the outlook for Europe and Japan over the next two years is one of real GNP growth at perhaps *one-third* of the real GNP growth experienced by these economies in 1970–71, when substantial growth abroad was an important "plus" in offsetting weak domestic computer activity at that time. This outlook may only be partially mitigated by expected continued high levels of capital spending abroad in 1974–75.

Coinciding with this diminished outlook are growing foreign economic nationalism, some degree of political instability abroad, and increased concern with the role of multinational companies. Whether these concerns manifest themselves in increased taxation or new regulations is yet to be determined and for today we will merely note them as potentially adverse background factors.

International operations, of course, involve currency exchange rates. This is not new, as in the past 3 years especially there have been quite wide fluctuations. We expect more such fluctuations in the future, but the computer companies have a good record in being able to dampen the effect of the changes on their income statements and we expect this to continue. Exchange rates are, however, one factor in anticipated reduced foreign economic growth, since the floating rate system of today tends to reduce the competitive advantage from currency valuations that were enjoyed by Europe and Japan in 1970–71.

The remaining consideration in the international outlook is the double-digit inflation rates in principal European countries and Japan. This is of course a broader question, since we are experiencing a high rate of inflation in the United States.

A paradox appears if we look at the effect of inflation, the third major issue raised for the industry, and start with demand for computer systems. As a generalization, in the long

run inflation is a favorable factor for the computer industry. Computers are designed and used for efficiency and cost-saving which becomes even more important in such a period. In the short run, however, computer users tend to worry about their data processing budgets in a period of escalating costs. We do not believe this latter factor will become unusually important unless an actual business recession is experienced.

In looking at the impact of inflation on costs, the computer industry is in a enviable position in its manufacturing operations. The largest element by far of raw material costs is accounted for by electronic semiconductor devices. Despite the inflationary times, the cost per function of these devices remains in a long-term downtrend. Other areas of cost, principally those of developing hardware and software, and accomplishing the extensive marketing and maintenance support that is characteristic of this industry, should bear the full brunt of inflation.

We expect the computer industry to address this problem purely and simply by raising prices. Prices have been raised by most companies in the early part of 1974, and we expect further price increases all over the world including the United States in the next 18 months.

We can make this blanket statement because the data processing industry is a mature industry and not truly competitive. Users are locked in to their vendors by their years of programming and experience on their systems.[1] There are no competitive factors which can forestall price increases.

The major problem is whether prices can be raised enough, particularly abroad. Relatively small increases are comparatively easy to accomplish, but large increases run the risk of user resistance; confront price controls in a number of foreign countries; and, in addition, international prices cannot run too far ahead of prices in the United States. We conclude that if high rates of inflation persist abroad, they will outstrip the ability of the computer industry to raise prices. We are in fact forecasting declining profit margins for the international business of the computer industry in 1974–75.

The fourth and last issue is investor attitudes towards the computer group. The largest single factor behind the relatively low multiple structure of the stock market as a whole. The special factors that may be applicable to the computer stocks over and above general market forces we list as follows:

First and foremost, the multinational character of this industry;

Second, to some extent industry valuations are tied to IBM and its special problems, of which we'll have more to say later;

Third, there is no clearly defined industry concept, and the intermediate term outlook is perhaps one of a flattening of earnings growth, even though this may be a superior record as compared to many industries.

And fourth, the industry is characterized by low dividend yields and the stocks have great competition from alternative investments.

[1] We quote: "Technological lock-in arises from the close inter-relationships of hardware and software in a complex computer system and the close integration of the computer system with most users' operations. By making a change in suppliers uneconomical, this distinctive phenomenon of the computer industry ties customers to suppliers....." Joint Position of Control Data Corp., Honeywell, NCR, Sperry Rand Corp. re Relief Matters in U.S. v. IBM, p. 6.

Having gone through this exercise, how do we come out? The Smith, Barney & Co. unweighted composite of the 6 large computer companies today shows an average multiple premium of 30% over the S&P 425 Stock Index multiple. This compares with an average premium of 70% for the past 5 years, or 77% for the past 10 years, and is well below the normal range of roughly 50% to 90%. We believe that the current valuation essentially discounts most of the problems confronting the industry and that it is therefore attractive from a long-term point of view. A case can be made for most of the stocks in the group on this basis. Over the near- to intermediate-term, we feel that a great deal should not be expected from the industry, partially because of the competition from other securities, but mostly because of its multinational characteristics. If there is one thought to be considered, it is whether "the other shoe" is dropping in 1974–75. Perhaps one shoe dropped in 1970–71 when the shibboleths about the domestic industry were exploded; perhaps now it is international's turn.

Given this framework, we have tried to take our cue from the anticipated intermediate term economic outlook. Our two major recommendations over the past year have been **Digital Equipment Corporation (107)** and **NCR Corporation (33)**. We consider Digital a prime beneficiary of the strong capital spending outlook and of efforts of users to cut costs in an inflationary period. In the case of NCR, we believe that the management changes and restructuring of the sales force will enable the Company to hold its position in the industry while at the same time NCR is in a superior position compared to most companies in combating inflation. This position comes about from the phasing out of high cost, older mechanical products and the phasing in of lower cost, new electronic products.

Let us now proceed from the general to the specific and briefly discuss each sector of the computer industry, starting with the minicomputer industry where stock prices are actually up in 1974 in a down stock market, but more importantly, this is where the action is in the computer industry today.

The near- to intermediate-term outlook is exceedingly good for minicomputers despite an anticipated sluggish economy, and we foresee that by the end of 1977 minicomputer installations will more than triple from yearend 1973 levels. Factoring in normal unit price declines, which contributes to the favorable unit volume outlook, we believe industry revenues may increase nearly 2½ times from those of 1973. The forces propelling such an increase are the cost-saving aspects of these useful, inexpensive machines with wide applications. Most importantly, acquisition of minicomputers does not fall under the purview of user data processing budgets with its attendant restrictions, but rather is tied to the manufacturing, distribution, laboratory, engineering, and other operating departments of businesses.

Two issues which appear to confuse investors are the relationships of the minicomputer industry to its larger cousin, the data processing industry, and to its smaller cousin, the semiconductor industry. From time to time investors worry about IBM entering the minicomputer industry. We believe that IBM will maintain its traditional marketing approach and offer specific application equipment, such as the finance and grocery terminals. IBM is very unlikely to offer small, outright sale general purpose computers which might affect its own base of very expensive rental equipment. In fact, we consider the minicomputer industry to represent a limiting factor on the main computer industry, as increasingly

sophisticated users turn to lower cost alternatives.

The development of microprocessors by the semiconductor industry in effect gives a user who might buy large numbers of units of small computational power another alternative. It is important to recognize first that such a user has had such an alternative all along by combining integrated circuits, and second that the number of such customers presently is minuscule. Such a large user, or potential large user, is not a customer for the minicomputer industry. We believe the microprocessor will enter a separate, new market and coexist with minicomputers. In our opinion, fear of microprocessors has been greatly exaggerated.

We have consistently recommended just one stock for participation in the minicomputer industry, Digital Equipment Corporation. Aside from being the biggest and the best, and the industry leader, we believe it has the best long-term prospects. Further, should there by any hesitancy in the economy, or should IBM become more active in industrial computer markets, or should the semiconductor industry's microprocessor developments create any marketing problems, this Company's strength and diversity should offer the investor relatively good protection. Our current earnings estimates are $3.75 per share for the fiscal year to June 30, 1974, and $4.75 for fiscal 1975. We foresee rapid growth well into the 1980s. Please don't be misled by the stock's relatively strong performance to date; this stock is still an outstanding buy.

We turn next to the large computer companies, which we refer to as the Main Frame group. As a group, these stocks have been about average performers in the first five months of 1974. The group is down 9%, which compares with declines of 9.4% for the S&P 425 and 5.6% for the Dow Jones Industrials. In view of widespread ownership of these large companies, we offer capsule comments on each.

International Business Machines (213) offers today what can only be described as extraordinary value by almost any yardstick. The stock sells for about 17x our estimate of $12.50 per share this year, and about 15x our appraisal of $13.50–14.00 for 1975. For a dominant company in a growth industry with the strength and assets it holds, such a valuation can only be justified by expectations of the most dire outcome of the legal problems confronting the Company. The present valuation goes far in our view towards discounting possible unfavorable disposition of IBM's appeal in the Telex case and the Justice Department antitrust case.

We believe IBM's long-term growth rate is in the area of 11–12%, and because of its dominance of the computer industry, use this as an indication of the industry growth rate as well. IBM's strategy broadly speaking is first, to gain a larger share of customer data processing budgets by enabling him to operate with fewer people, and second, through telecommunications, bring the computer to far more applications than before and bring it within the grasp of even unskilled personnel. The former would be accomplished through software, and IBM's development projects in software are well known. The latter would be accomplished through hardware, both terminals and the new "FS" central processors, now under development.

Adding to this outlook is IBM's increased emphasis on small systems as shown by reorganization of its marketing earlier this year, and the potentially explosive growth of the lesser known Office Products Division, which is pointed in the direction of the all-electronic

office of the 1980s.

We believe a domestic growth rate of 8–10% per annum will be well maintained but that international growth may slow to the 12–14% range. International growth had been 30% a year in the early years, and about 20% a year since the early 1960s.

From a stock market viewpoint, investors have been reluctant to initiate new positions in IBM primarily for legal reasons. Even if we consider the Telex case currently in the Court of Appeals as not being crucial to IBM. The antitrust suit of the Department of Justice is much more troublesome. A Consent Decree over the near- to intermediate-term appears unlikely because of the political situation in Washington, and because the Justice Department has now gone so far as to be committed to trial. If this view is accurate, we are unable to construct a scenario favorable to the investor short of IBM winning the case. While we do not rule out such a result, the prospect of long drawn-out legal proceedings over the balance of the decade, we believe, is the principal reason institutional investors are unwilling to become overcommitted to this stock, and accounts for its bargain price. We continue to rate IBM as a long term buy, but consider it unlikely to outperform the market over the near- to intermediate term.

Burroughs Corporation (103) holds a unique position because of its design innovation and still existing technological leadership in the industry. It also benefits from concentration on basically computer-type equipment. While we are not so enthused over Burroughs' manufacturing and marketing support, we presently see no impediments to continuation of the strong growth trend this Company has exhibited in recent years. We are using earnings estimates of $3.45 per share for this year and $3.90 per share next year. The major investment problem with Burroughs is the stock price. Burroughs is alone among the major stocks in widening its premium over the market multiples. The current price represents a multiple 170% above that of the S&P 425 as compared to an average of 119% for the past 5 years. Investors appear to be paying a premium for the lack of visible problems. We consider Burroughs a sound core holding for the long pull but do not recommend its current purchase. In our opinion, the price leaves little room for disappointment and we believe it is statistically expensive.

Honeywell, Inc. (56) has suffered a severe downward revaluation in the past two years, a revaluation that we have at least partially agreed with. Earnings growth in this cycle has not been particularly dynamic, expecially if adjustment is made for the change in income tax rates, which last year were more than 10 points below those of 1970. The Company is engaged in multiple lines of business, including some related to housing; it has been one of the least profitable computer companies; its accounting is somewhat liberal; and it has an important French subsidiary that from time to time has been considered a target for nationalization. We are using an estimate of $5.30 per share for 1974 excluding tax credits, and believe 1975 could be plus or minus 10% from these levels depending on the economy. Most of these factors appear to us to be discounted in the present stock price, which is again back to the lows of the 1970–71 recession, and at prices which the stock sold for as far back as 1964, 10 years ago.

On the positive side, we are today much more optimistic on the Company's potential for long-term growth. The introduction in April of the new Series 60 computer systems, which we discussed in considerable detail in a published report dated May 16,[1] is extremely significant in this regard. This Series,while not an advance from a technological

[1] "New Honeywell Series 60 Computer Systems," *Topical Research Comment* No. 23–74, May 16, 1974.

standpoint, solves many of Honeywell's problems with its user base. We also believe it has a better revenue yield and lower costs than previous Honeywell products, which over a period of time should permit considerable improvement over the current low levels of profitability in computer operations. We think the stock is attractive as a long-term investment, although we would be surprised if it is an outstanding performer in 1974, and there may still be some near-term risk in it.

Sperry Rand (37), is a stock we began recommending in 1971 when it was announced that the Univac computer division was acquiring the RCA user base. Although the present stock price is nearly double the lows of the 1970–71 recession, it has been a disappointing performer in recent months.

We attribute this performance to two factors: (1) the Company has not been able to shed its "conglomerate" image, and (2) operations in farm equipment, hydraulics and computers are at record levels from which it is difficult to see further improvement over the intermediate term. While earnings should be well maintained over the next 2 years becuase of ultra-conservative accounting, and our estimate is $3.70 per share for fiscal 1975, we think it will take a new broad-based advance in the economy before this stock can achieve the recognition it should have in terms of price/earnings ratios. We consider the stock an excellent long-term value but unlikely to outperform the market averages in 1974.

NCR Corporation (33). We have already alluded to the conceptual framework for investing in NCR. In addition to the changes taking place as outlined earlier, the Company has redefined its goals and strategy and is concentrating on small electronic business equipment, a field we consider appropriate for it. While we consider NCR a slightly higher business risk than the other companies, particularly if there is a business recession, we believe that there is a high probability its plans will be successful. This stock, too, is not selling appreciably above the lows of the 1970–71 recession.

We are using earnings estimates of $3.60 per share this year and $4.10 per share next year, relying on corporate momentum from new products and new management and continued reductions in cost to carry NCR through this period. We note that new electronic products may account for 70% of product revenues next year, as compared to only 45% last year. We consider the stock attractive for current investment.

Control Data (26) has evolved over the years to a computer and financial services company, although it has a position in the large scale computer market, a position it is sustaining through introduction of the new CYBER 170 Series in April.[1] We are uncertain as to the quality and longer term growth rate of the Company's business mix but consider the current stock price unduly depressed. The stock is far below its lows of 1970–71 and sells at a steep discount from book value. We believe the stock should be held but on a rally investors should consider a switch to an issue whose long-term prospects are better defined.

We are using estimates of $4.00 per share this year and $4.50 next year; we consider these "floating" estimates. The near- to intermediate-term outlook is heavily dependent on short-term interest rates, which are hard to predict.

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[1]Please refer to our recently published review of this product line, a Topical Research Comment entitled "Control Data Corporation CYBER 170 Series Computers" dated June 7, 1974.

Peripheral Equipment

So much for the Main Frame Group, now for a few comments on that group of companies we generally classify as being in the peripheral equipment business. No company has ever been successful in this business on a long-term basis, and few, if any, investors have been successful in this area. Further, we think that it would be sheer foolishness to speculate on a favorable settlement of the IBM-Telex case as a rationale for investing in this group.

Nevertheless, the maturity and size of the data processing industry are such that there is potential for several $300–500 million peripheral equipment companies. We have not seen one yet, because it takes a combination of managerial, engineering and marketing skill not often found in small companies, and because such a company will have to be a multi-product company and one that is is active in subsystems both inside the computer room and in remote locations.

In our opinion, **Storage Technology Corporation (12)*†** is the one company in this field that offers that kind of potential. Although highly speculative, we are continuing to recommend purchase of the stock on this basis. Our present earnings estimates are $1.45 per share this year and $1.90 next year.

The remaining sector of the computer industry that we have not discussed includes the computer-based service companies. This group has been a disaster area in 1974, with the Smith Barney unweighted average of the 3 leading stocks down 39% in the first 5 months of the year. We consider this decline well taken, as these popular growth speculations have been overpriced in the last three years. Even though excess expectations of investors have been substantially washed out by the recent price declines, we are still not especially attracted to the group.

Although we do not recommend present investment in this group, it is our opinion that **Electronic Data Systems Corporation (15),** is by far the best value in the group. The Company has been able to absorb abandonment of a large business with Wall Street brokerage firms while still reporting higher earnings, and the overall outlook now appears to have improved. We estimate $1.30 for the year to June 30, 1974 and $1.45 for the year following.

Given this broad background sketch of the four principal areas of the data processing industry, we would now like to develop a portfolio strategy.

We consider *Digital Equipment,* and where already held, *IBM* and *Burroughs* **Corporation,** to be core holdings for long-term growth, which we would not disturb. Where positions are inadequate, or if a portfolio does not contain an adequate minicomputer position, we recommend purchase of *Digital Equipment.*

Stocks below this calibre have not been standout performers, and are struggling for investor attention in a manner reminscent of the competition for shelf-space in a supermarket. There is no question that a much broader-based stock market, and possibly a better defined general economic outlook, will be required for profitable investment in the

lesser companies. We believe that ultimately such a development may come about, and that there are presently good values in this group on a long-term basis. If we are right that 1974–75 may represent fruition of investor fears regarding the interantional scene, it may prove to be a good period in which to accumulate some of these stocks. We have already mentioned that, in our opinion, *NCR* is attractive for current investment and that *Honeywell* and *Sperry Rand* are candidates for accumulation in the months ahead. At the present scale of values, we favor *Honeywell* as being slightly the more attractive longer term. We would be willing to recommend *Burroughs* at lower prices.

SMITH, BARNEY & CO.
Incorporated

Peter Labe, C.F.A.
333–5738

* Smith, Barney & Co. Incorporated usually maintains a market in the securities of this Company.

† Within the last 3 years, Smith, Barney & Co. Incorporated or one of its affiliates was the manager (comanager) of a public offering of the securities of this company and/or has performed other investment banking services for which it has received a fee.

Chart I

MAIN FRAME STOCK INDEX
RELATIVE TO S & P 425 INDUSTRIALS

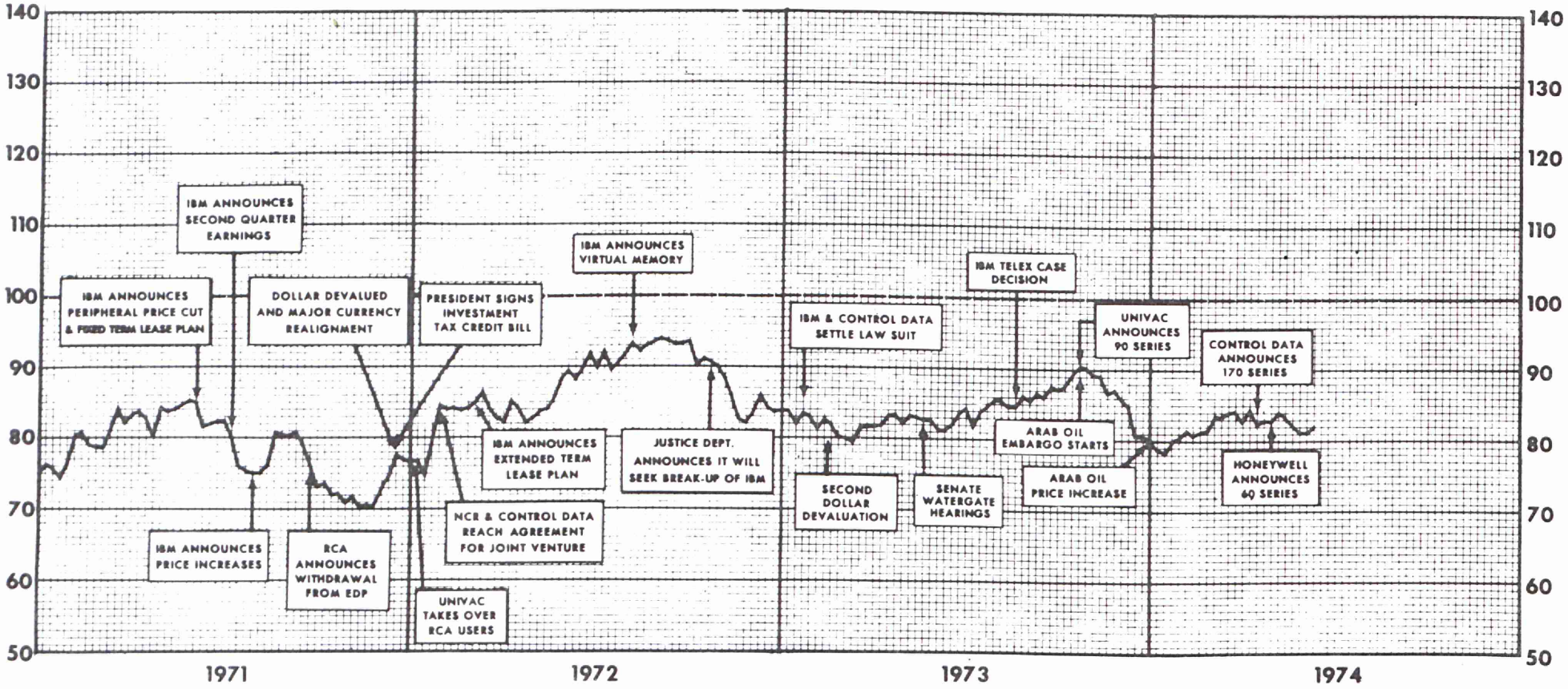


Table II

Data Processing Stocks in the First Five Months of 1974

	Close 5/31/74	Close 12/31/73	Change in 1974	% Change in 1974	1974 High	1974 Low
S & P 425 Stock Industrials	98.59	108.95	- 10.4	- 9.5%	111.65	98.13
Dow-Jones Industrial Avg.	802.17	850.86	- 48.7	- 5.7	891.72	795.37
NASDAQ Industrial Ind.	77.36	83.57	- 6.2	- 7.4	89.78	76.36
Main Frame						
Burroughs	102 1/4	104.1875	- 1 7/8	- 1.9%	108 1/4	85
Control Data	27 1/2	33 5/8	- 6 1/8	- 18.2	39 1/8	26 5/8
Honeywell	67 3/4	70 1/8	- 2 3/8	- 3.4	86 1/4	66 1/2
IBM	212 1/2	246 3/4	- 34 1/4	- 13.9	254	209 5/8
NCR	32 7/8	32 3/8	+ 1/2	+ 1.5	40 1/2	28 5/8
Sperry Rand	37 1/4	44 1/4	- 7	- 15.8	44 5/8	35 3/4
Main Frame Group				- 9.6%		
Peripherals						
Calcomp	8 3/4	8 1/2	+ 1/4	+ 2.9%	11 3/8	7 1/2
Datapoint	12 1/2	13	- 1/2	- 3.8	15 1/2	11 3/4
Decision Data	7 3/8	7	+ 3/8	+ 5.4	13 3/4	6
Milgo	10	14 7/8	- 4 7/8	- 32.8	18 3/4	8 5/8
Storage Technology	12 1/8	13 3/4	- 1 5/8	- 11.8	15	10 1/2
Peripheral Group				- 11.2%		
Minicomputer						
Data General	35	37 3/4	- 2 3/4	- 7.3%	39	27
Digital Equipment	112	101 7/8	+10 5/8	+10.4	122 3/4	84 1/2
General Automation	35	34 3/4	+ 1/4	+ 0.7	40 1/2	28 3/4
Modular Computer	15 1/2	8 1/4	+ 7 1/4	+87.9	18	6 3/4
Computer Automation	12 1/2	13 7/8	- 1 3/8	- 9.9	14 3/8	8 3/8
Minicomputer Group				+ 7.1%		
Services						
Automatic Data	32	54 1/4	- 22 1/4	- 41.0%	56 7/8	28 1/2
Bradford Computer	13 1/4	23	- 9 3/4	- 42.4	25 3/8	13
Electronic Data Systems	15 7/8	23 1/4	- 7 3/8	- 31.7	25 3/8	12 1/4
Service Group				- 39.2%		

Table III

Relative Multiple Analysis – Major Computer Stocks

	Price 5/31/74	P/E 1974 Est.	P/E Premium (Discount) to S & P 425	Average P/E Premium (Discount) to S & P 425	
				1969-73	1964-73
Burroughs	102 1/4	29.6x	172%	119%	86%
Control Data*	27 1/2	6.9x	(37)	47	116
Honeywell	67 3/4	12.8x	17	74	80
IBM	212 1/2	17.0x	56	107	119
NCR**	32 7/8	9.1x	(16)	74	50
Sperry Rand	37 1/4	10.1x	(7)	(4)	11
6-Stock Composite		14.3x	31%	70%	77%

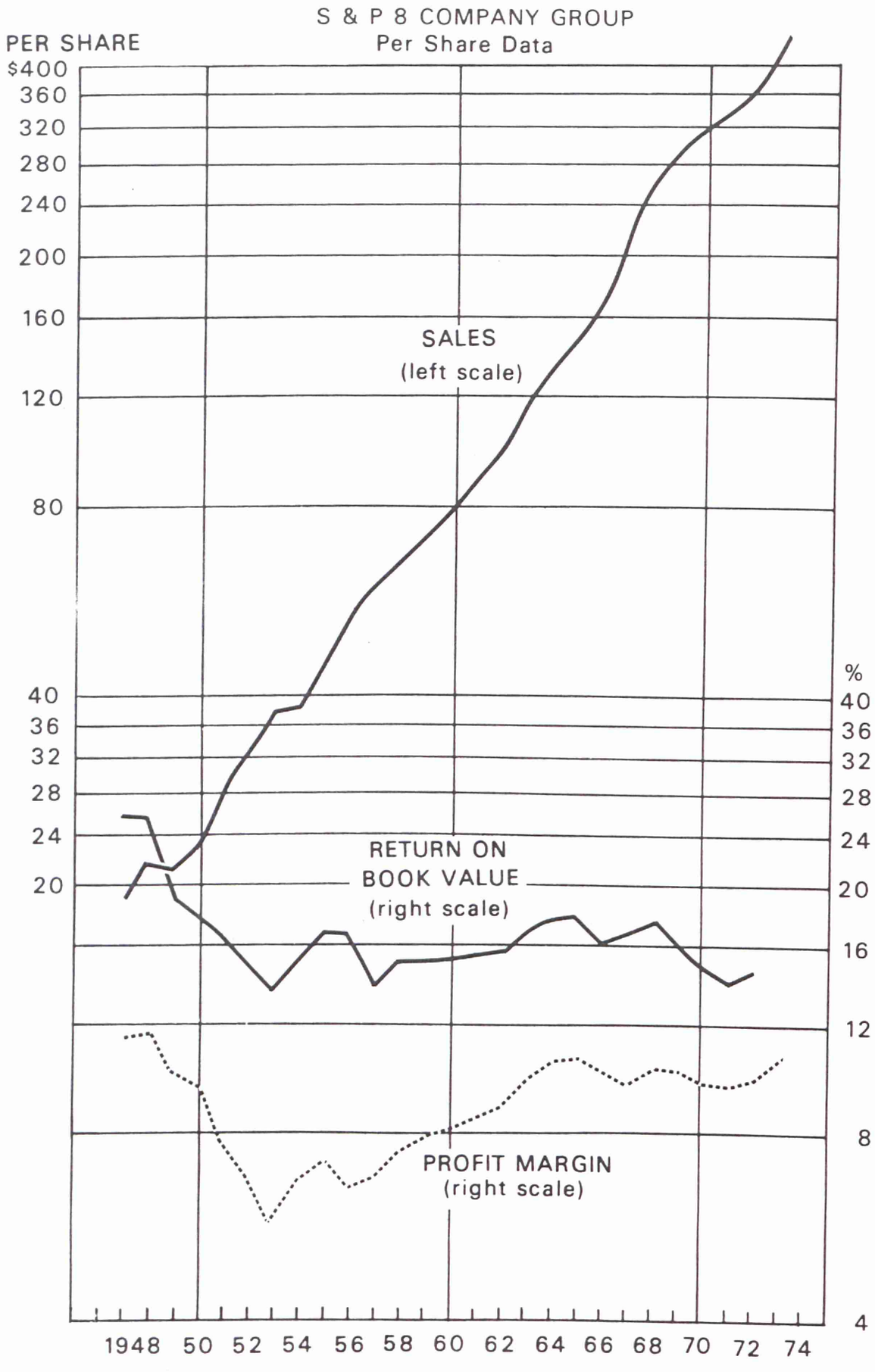
Notes

* Ignores loss years 1966 & 1970 in all computations.

** Ignores loss years 1971-72 in all computations.
earn. $9.00 in 1974.

S&P 425 Index 98.25, est.

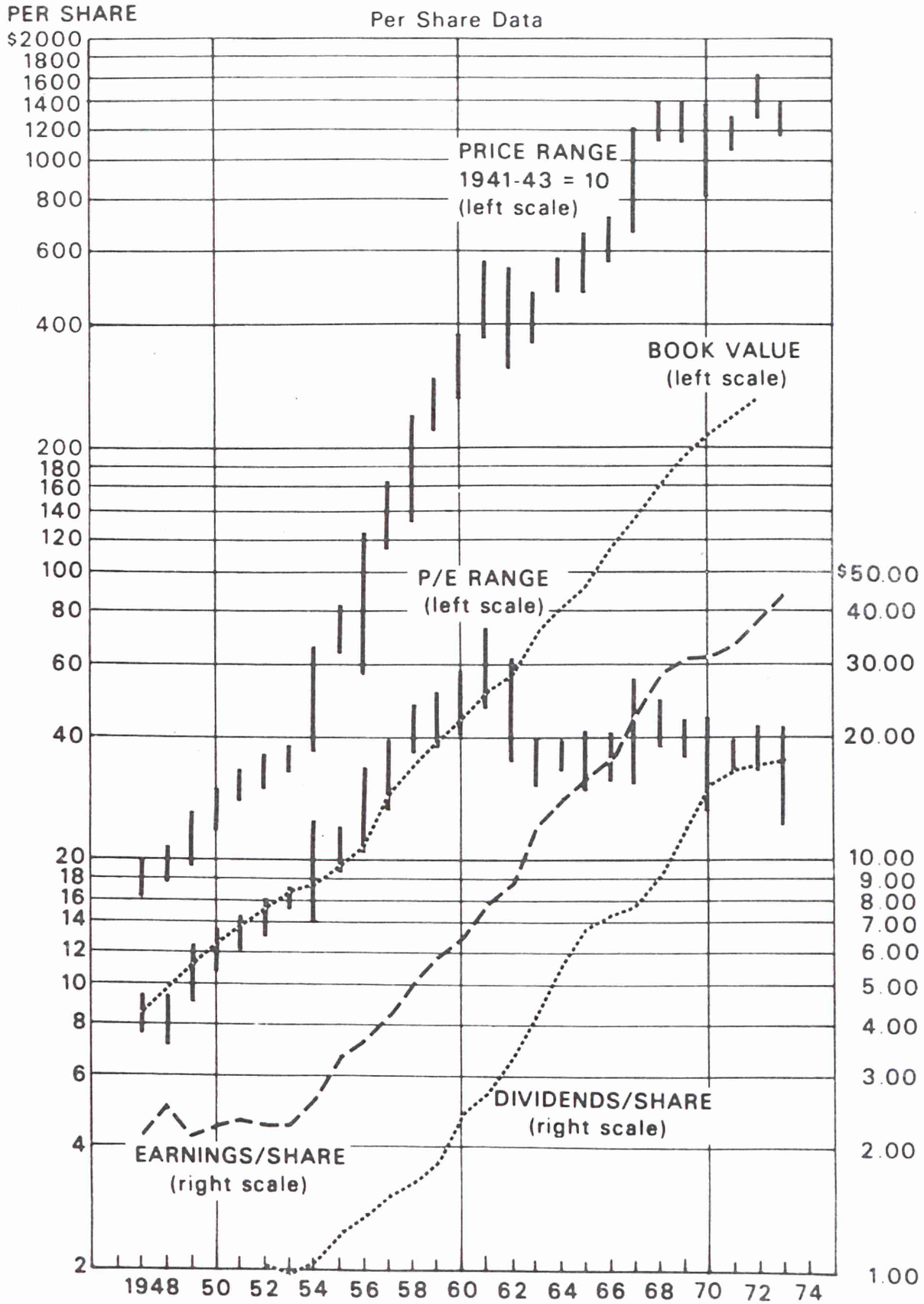
OFFICE and BUSINESS EQUIPMENT



OFFICE and BUSINESS EQUIPMENT

S & P 8 COMPANY GROUP

Per Share Data



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6/11/74

COMPANY AND FISCAL YEAR-END		TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974*	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL.TO S&P 425
BURROUGHS		BGH	$109	$109- 85	32- 25X	31X	$ 3.45	$ 3.01	$ 2.30	15%	15%	23%	$ .50	.5%	6%	110%
CONTROL DATA		CDA	30	39- 27	10- 7	8	4.00	3.70	3.93	8	11	25	.00	.0	-12	92
HONEYWELL		HON	70	86- 70	16- 13	13	5.30	5.12	4.08	4	8	8	1.40	2.0	-3	101
IBM		IBM	227	254-210	121-100	21	12.50	10.79	8.82	13	-58	-13	5.12	2.3	-7	97
NATIONAL CASH		NCR	35	41- 29	19- 8	10	3.60	3.00	-2.68	20	-22	-14	.40	1.1	10	115
SPERRY RAND	MAR	SY	41	45- 36	12- 10	11	3.70	3.27	2.62	14	10	18	.66	1.6	-5	99
XEROX		XRX	125	125-105	30- 25	30	4.25	3.80	3.16	12	16	20	1.00	.8	3	108
INDUSTRY AVERAGES						17X				12%		10%		1.2%	-1%	103%
383 COMPANY AVERAGE						12X				10%				3.3%	-3%	101%

SMITH BARNEY & CO. INCORPORATED

INFORMATION PROCESSG:MINICPTS
P PETER LABE

6/11/74

COMPANY AND FISCAL YEAR-END	TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E vs. 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL.TO S&P 425
COMP. AUTOMATION JUN	CAUT	$ 13	$ 15- 9	13- 8X	11X	$ 1.10	$ .63	$ .24	75%	17%	17%	$ .00	.0%	-5%	99%
DATA GENERAL SEP	DGN	35	39- 27	34- 23	30	1.15	.83	.49	39	0	0	.00	.0	-5	99
DIGITAL EQUIP JUN	DEC	108	123- 75	35- 24	29	3.75	2.16	1.49	74	16	40	.00	.0	11	116
INTERDATA	IDAT	18	23- 8	20- 7	18	1.10	.63	.24	75			.00	.0	129	234
INDUSTRY AVERAGES					23X				66	1,%	18%		.0%	32%	138%
383 COMPANY AVERAGE					12X				10%				3.3%	-3%	101%

SMITH, BARNEY & CO. INCORPORATED

INFORMATION PROCESSING: SM COS
P PETER LABE

6/11/74

COMPANY AND FISCAL YEAR-END		TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL.TO S&P425
AUTOMT DATA PROC	JUN	AUD	$ 34	$ 57- 34	33- 20X	20X	$ 1.65	$ 1.40	$ 1.14	18%	32%	49%	$ .40	1.2%	-39%	64%
CALIF CPTR PROD	JUN	CPI	10	11- 8	9- 6	6	1.60	.16	4.72		-17	14	.00	.0	15	120
ELECTN DATA SYST	JUN	EDS	16	25- 12	20- 9	12	1.30	1.27	1.05	2	41	99	1.00	6.3	-31	72
INFOREX		INFX	2	6- 2	14- 6	10	.20	.28	.20	29			.00	.0	-54	48
MILGO ELECTRONIC	SEP	MI	11	19- 11	8- 5	5	2.20	1.89	1.32	16	63	49	.00	.0	-26	77
MOHAWK DATA	APR	MDS	2	- 2			-.15	-.05	.18		97		.00	.0	-6	99
REDACTRON	JUN	RDAC	4	6- 4	23- 14	15	.25	.25	-4.32	0			.00	.0	-29	75
SAVIN BUS MACH	APR	SVB	3	6- 3	20- 10	10	.30	.43	.59	-30	-30	13	.00	.0	-25	78
STORAGE TECH *		STAG	13	15- 11	10- 7	9	1.45	1.25	.72	16			.00	.0	-5	99
WANG LABS	JUN	WAN	14	20- 11	17- 10	12	1.15	.82	.77	40	3	43	.00	.0	-19	84
INDUSTRY AVERAGES						10x				12%	15%	34%		.7%	-22%	82%
383 COMPANY AVERAGE						12X				10%				3.3%	-3%	101%

PRICING — WATCHWORD FOR PORTFOLIO STRATEGY

The well-known response by realtors to questions about real estate selection is location, location, location. In the final analysis, location is the important determinant of value, potential appreciation, and risk. We strongly suggest that pricing, pricing, pricing be the key element in portfolio policy during the years ahead. Our discussion today will center on two aspects of pricing: product pricing as possibly the most influential criterion in equity selection, and stock pricing, as it relates to value and risk.

Product Pricing and Other Stock Selection Criteria

We have discussed at length product pricing and its relevance to profitability. To summarize the essence of our thesis, the expected combination of a sluggish economy and rising costs, particularly of labor, in the months ahead could strain the ability of many industries to control their prices. We believe pricing will be acutely difficult for some companies producing end products, particularly in the consumer area, where we suspect some overcapacity exists. The intermediate-product companies, on the other hand, should be able to exert far more strength in setting prices than they could in previous economic slowdowns. Their prices should remain sufficiently strong to permit profit gains, or to maintain profitability at high levels from which further increases can occur as the economy turns upward.

Earnings progress can be made in other ways, too:

1. Declining raw material costs may offset the pressures on product pricing. Food processing, as an example, is a potential beneficiary from lower food commodity costs.

2. Demand is highly elastic where prices are declining over a period of time. The minicomputer industry is an example of this relationship.

We recognize that other criteria are usually applied to stock selection. Some of these are low labor content, overseas business, and consumer orientation. In our opinion, the *reliability* of these criteria in portfolio construction may not be as good as in the past.

Low labor content is certainly a plus, but if nonlabor costs are also rising, will the market environment support higher pricing? Moreover, a number of labor-intensive industries

have already negotiated wage contracts. Prices have been adjusted to absorb higher wages and other benefits. This scenario is different from the 1960s when overcapacity in these industries prevented sufficient price increases to offset rising labor costs.

Overseas operations are an area that is very much underanalyzed. Some markets may be more exploited than realized. Entry into others may not be successful. Growth may be uneven, which could become very evident if European economies recover slowly. Political forces abroad are becoming more complex.

Emphasis on the consumer is certainly appropriate, because a major part of our gross product comes from this area. Demographics are attractive for consumer goods with the post war babies entering their high consumption years. However, a high rate of inflation together with increased unemployment may not allow a very good consumer spending environment for some time.

Nevertheless, there is an increased interest in the major growth stocks, particularly consumer-oriented ones. It is not difficult to find reasons for this renewed attention.

- Some commodity prices are falling. The extent of their decline is uncertain. We believe that minimum replacement cost will limit their fall in some industries.

- Inventory levels are difficult to identify. The consensus is that they are higher than the aggregate statistics indicate. It is our belief that inventories may be high in some of the finished goods industries.

- Labor is becoming more restive. Strike activity is increasing, and demands are rising. Wage costs are beginning to rise at a greater rate.

- The prospect of sluggish economic activity into 1975 is becoming more generally accepted.

- Consumer spending *appears* to *some* observers to be stronger than had been expected. We find aggregate statistics on expenditures are heavily impacted by inflation.

- The valuations of some growth stocks have become more reasonable in the absolute as time has passed allowing earnings to catch up with multiples. Relative valuation, in our opinion, still appears high for some of the nifty fifty.

While some growth stocks could continue to do *relatively* well over the near term, we believe the risks involved (to be discussed later) may limit their upside appreciation.

As the outlook for commodity prices, inventories, labor and the general economy becomes clearer, we believe a more balanced equity market climate will prevail. Indeed, the recent favorable stock price action of Dow Chemicalt and U.S. Steel, as well as J. C. Penney and Johnson and Johnson, may be a forerunner of this trend. Therefore, we continue to advise a balanced equity portfolio for the next 18 months.

Stock Pricing

In our opinion, too much time is being spent on determining where and when the popular market averages will bottom. There are several shortcomings inherent in this approach.

- The end of a market decline is not clear until it is past.
- Usually, investors begin to fear even lower levels when a predetermined bottoming point appears imminent.
- Investing at a market nadir may be unfeasible because of administrative factors or because at that point investors often decide to stay in short-term securities and see what happens.

This attempt to call the market bottom is complicated by the fact that market liquidity is low at the time when portfolio liquidity seems to be remarkably high. Market rallies, such as the recent 50 point plus rise in the Dow Jones Industrials, increase the discomfort of portfolio managers because they cannot put new funds to work in a major way. They find that the illiquidity tax is as severe on the upside as it has been on the downside.

To surmount the problems of calling the market and illiquidity, we advise following a *strategy of gradualism*. In essence, we suggest focusing on stocks and groups, rather than on the market. Be stock price conscious. As an example, investment in the chemical industry over the past six months would have yielded a performance better than the market. If one had waited for the market bottom, he might not have participated in such favorable action. We believe other groups and stocks will perform in this manner in the months ahead, because it appears that groups and stocks are bottoming over time, rather than at a single moment in time. In our opinion, a policy of gradualism should permit a fully-invested position by the time the last group and the market have seen their lows.

While a trading market is assumed likely to continue for some time, we think that it will be difficult to trade in it. Smaller portfolios may accomplish a trading strategy, but larger ones will have to focus on price. Indeed, at the price levels of many issues today, a case can be made for the *one-decision* approach. This would not be limited to growth stocks. We believe that if the tight rope of economic policy is successfully negotiated, one-decision investing might prove to be better than the trading strategies which have worked well in recent years.

Our earlier discussion of growth stocks raised the question of risk. While the apparent rationale for purchase of growth stocks may be accepted, we must be cognizant of risks. On the other hand, risks in other stocks cannot be ignored. We assume, however, that their stock prices reflect a number of uncertainties. In the case of the major growth stocks, little return comes from dividends. Therefore, any rise in these issues over the near to intermediate term has to be justified on the basis of high expectations about further multiple expansion, if earnings forecasts have generally remained the same (we see very few

instances where the profits outlook is better than had been expected). In order to "beat" risk-free assets (short-term securities), one has to expect returns on these stocks to be at least 11% from current levels. Yes, investing in some of these companies might be construed as a "defensive" strategy in a period of greater unpredictability. Indeed, this was an approach in the early 1970s. But that was a time of more favorable economic activity than we now foresee, particularly in the consumer sector. In addition, other risks exist. One example might be the impact of an unfavorable resolution of the Hoffmann La Roche suit on the drug industry. These things seem to occur at the most unlikely times--usually after stock prices have risen. Our point is to be price sensitive in purchasing all stocks.

Before turning to portfolio construction, our discussion so far can be summarized as follows:

- Be conscious about price as it pertains to both products and stocks.
- Re-examine all stock selection criteria. Some do not appear as reliable now as in the past.
- Don't try to guess the market bottom. Gradually work money into groups and stocks.
- One-decision investing may now have validity for a broad range of equities.
- Portfolios should be more balanced and diversified than in the past.

Portfolio Construction

Two portfolios, one exemplifying an ongoing situation and the other the use of new money to structure a portfolio, are presented below. Ranges are given in the former case in order to recognize varying portfolio requirements, such as income, growth with income, etc. The weightings remain the same as those given in *A Portfolio Strategy Dialogue* dated April 15, 1974.

The cash and equivalent portion of the new money for investment should be divided in the future: 5—10% fixed income and 20—25% equities.

	Ongoing Portfolio	New Money
Cash & Equivalent	10%	30%
Fixed Income	20-40%	30%
Equities	50-70%	40%

In the equity section of our recommended portfolio, we are using three general headings: *growth, intermediate materials and capital equipment spending*, and *consumer.*

These categories and their weightings, in our opinion, facilitate a review of our investment policy. Together these three groups equal 100% of the equity portion of our suggested portfolio. There is some overlap in the use of stocks. As an example, J. C. Penney Co. is included under growth and not under consumer. This reflects the superior record and prospects of this situation. At times, the growth category will contain a separate industry category, such as data processing. This is done when we believe group emphasis is justified on the basis of fundamental and technical considerations. If industry weighting is considered undesirable, an individual stock representing our best recommendation in an industry might be placed in either the major or submajor growth categories. Finally, we advise a dollar cost averaging approach to the names suggested under the current growth heading, because some do have further risk exposure. On the other hand, we believe these stocks are good situations over the longer term, and the timing of their precise bottoms may be difficult in a market that continues to stress the use of a relatively few issues of high quality.

SMITH, BARNEY & CO.
Incorporated

A. Marshall Acuff, Jr. C.F.A

† Within the last 3 years, Smith, Barney & Co. Incorporated or one of its affiliates was the manager (comanager) of a public offering of the securities of this company and/or has performed other investment banking services for which it has received a fee.

EQUITY PORTFOLIO

(Current industry weightings are on the left and indicated in bold type. Previous industry weightings—from *A Portfolio Strategy Dialogue*—are on the right. The drug group has been deleted due to a transition in coverage.)

GROWTH (37%)

Major Growth (15%) (15%)

Eastman Kodak (108)
Marriott (20)
J. C. Penney (74)
PepsiCo (60)

Submajor Growth (14%) (15%)

Big Three Industries (50)
Capital Cities Communications (35)
Economics Laboratory (37)*
Government Employees Insurance (23)*
Heller International (29)
Raychem† (255)*

Data Processing (8%)

Digital Equipment (107)
IBM (213)
NCR (33)

INTERMEDIATE MATERIALS & CAPITAL SPENDING EQUIPMENT (38%)

Chemicals (8%) (8%)

Dow† (67)
DuPont (167)
International Minerals & Chemical (34)
Monsanto (65)
Union Carbide (40)

Oils (8%) (7%)

Atlantic Richfield† (90)
Shell (46)
Standard Oil (Indiana) (82)
Standard Oil (Ohio) (53)

Metals (6%) (6%)

American Metal Climax (42)
Kennecott Copper (33)
United States Steel (43)

Paper (6%) (6%)

International Paper (48)
St. Regis (26)
Union Camp (54)

Electrical Equipment (5%) (6%)

General Electric (48)
Harvey Hubbell (28)
Reliance Electric† (15)

Machinery (5%) (5%)

Gardner-Denver (23)
Hughes Tool (64)
Ingersoll-Rand† (75)

CONSUMER (25%)

Airlines (2%) (4%)

Braniff (10)
Delta (50)
UAL (25)

Automotive & Truck Manufacturing (4%) (4%)

Champion Spark Plug (12)
Cummins Engine (31)
General Motors (50)

Building (3%) (3%)

Armstrong Cork (27)
Masonite (35)

Consumer Appliances (3%) (3%)

Hobart (20)
Maytag (24)

Food (3%) (3%)

Campbell Soup (29)
Kraftco (40)
Quaker Oats (23)

Media (5%) (5%)

CBS (36)
R. R. Donnelley (21)
Knight Newspapers (35)

Retail (5%) (5%)

Associated Dry Goods (26)
Federated Department Stores (31)
Marshall Field (19)

* Smith, Barney & Co. Incorporated usually maintains a market in the securities of this Company.

† Within the last 3 years, Smith, Barney & Co. Incorporated or one of its affiliates was the manager (comanager) of a public offering of the securities of this company and/or has performed other investment banking services for which it has received a fee.

PAPER

The paper industry is a major area of the economy where product shortages exist, even at this high level economic plateau. There is, however, some confusion over just exactly what is short. Some have implied that the shortage is in the raw material, trees. We disagree, for while there are areas in the world (e.g., Japan and the Scandinavian countries) where timber growth is a constraint on local pulp and paper production, there is *no* worldwide shortage of trees. Furthermore, with more extensive use of wood waste materials in the future, combined with more intensive forest management programs, the international wood fiber supply should be adequate for many years to come. There is a worldwide shortage of the *manufacturing capacity* necessary to convert the raw wood into pulp and paper. It is, therefore, more a worldwide shortage of investment in pulp and paper manufacturing equipment than a shortage of wood fiber.

The "why" of the pulp and paper manufacturing capacity shortage is basically twofold: 1) The return-on-investment economic incentive to encourage new investment in paper mill expansions has been absent in North America, and particularly the United States, in the 1970—74 period. Initially, the 1970 recession caused substantial declines in paper industry profits in that year and early 1971. Return on "book value" investment fell as low as 3—4% for some companies. Then, as product prices and profits started to rise, the 1971—74 period of price and profit-margin controls held earnings far below levels necessary to encourage new investment. Also, the high level of short-term interest provided an attractive investment alternative to capital investment, especially during the uncertain period of product price and profit margin controls and the worrisome business outlook. Pollution-control legislation and the threat of even more stringent regulations further discouraged new investment.

2) Other uses drained capital from potential industry expansion. Pollution-control legislation required expenditures that in some cases reached 20—30% of a company's yearly capital budget. The increased capital cost required for pollution-abatement equipment also raised the investment base on which the return on investment (ROI) was computed, without contributing to the income stream. Cash flow was directed into lumber and plywood, mineral development, and other activities where the return on investment was not controlled at an unacceptable level, or was not controlled at all. Shortages of capacity, the result of these two fundamental factors, developed in the 1970—73 period, but only became obvious to the stock market in the latter months of 1973.

To place this shortage in perspective, a few basic points should be made about the paper industry. 1) The paper industry is an international industry, with product usages and quality similar around the world. Tariffs exist in some cases, but they are not disruptive to world trade. 2) Paper is a "derived demand" product having little consumer identity, price

consciousness, or intrinsic value by itself. People seldom buy paper per se. They buy products packaged in paper; they purchase products made from paper; they buy services of paper or printed on paper; i.e., they buy paper to serve a function. The key is that the price of the product being packaged or transmitted is important to consumers rather than the price of the packaging or printing material. Unless a substitute substance can be found that is readily available, cheap, and disposable, and can be processed in present packaging or printing machinery, *availability* of paper is much more important than price.

We know from experience that very little price elasticity exists in the demand for paper when product prices are falling. Paper usage does not change significantly because the product is cheaper. We doubt that in today's environment, with capacity short in many industries such as chemicals and plastics, that there is much price elasticity when product prices are rising. Consumer evidence supports this observation. Many products cannot be easily or efficiently sold without some type of sophisticated packaging.

3) While our domestic markets *may* be mature (per capita consumption of paper in the United States exceeds 600 pounds per year), markets for paper products in other countries are still developing. In West Germany and the United Kingdom per capita consumption is 285 pounds; in Japan, it is 275 pounds; and in France, it is 230 pounds.

4) The United States and Canada have much more control over the growing natural resource, trees, than do most of their competitor countries. And trees are a self-replenishing raw material. Other countries are, and will be, eager to buy pulp and paper from us because we have the raw material, the capital, and the know-how to produce the product relatively cheaply.

It is clear that paper is a very necessary product, both domestically and internationally, and we think worldwide demand will continue to grow with the growth and development of worldwide economies.

In this period of uncertain commodity markets, two questions need to be answered. How real is the pulp and paper shortage? Is it possible that this is merely an inventory problem, as was the case in the 1970–71 period when market pulp inventories declined from an unusually high level? Briefly, our answer is that the shortage is critically real, and not an inventory cycle swing.

About 70–75% of the world's market pulp is produced in the United States, Canada, Finland, Sweden, and Norway. Paper-grade wood pulp inventories in these countries *declined* to 700,000 short tons on 12/31/73, from 1.3 million short tons a year earlier. Since the pulp mills in these countries were operating at or near capacity last year, mills shipped about 600,000 tons in excess of productive capacity in 1973. The yearend 1973 market pulp inventory of 700,000 short tons was about as low as is practical. It is not surprising, therefore, to see the market pulp shortages of 1973 intensify in 1974. Because the worldwide industry does not have the inventories to draw down in 1974, supplies are very tight in the United States, and many European customers have been placed on allocation by their Scandinavian suppliers, in spite of noticeably less robust economies in 1974 than

in 1973. Paper-grade market pulp production in North America and Scandinavia probably fell in a 16—17 million metric ton range in 1973. With producers collectively shipping about 4% above their capacity last year and market pulp capacity in North America scheduled to grow at only 2% annually in 1974—75, it would seem that producers will probably not be able to keep up with orders, much less produce to oversupply.

The pulp and paper shortage is real. Inventories of some white papers are slightly higher than normal levels for the past 15 years, but there has been virtually no inventory building in pulp, the critical raw material for paper and paperboard. There is no futures, or commodity, market to hedge pulp or paper. It is apparent, then, that while there may have been speculation in other commodities, there has been little or none in pulp, paper and paperboard.

The degree and duration of the imbalance between supply and demand depends on the rate of demand growth in the world economy and the rate at which new pulp capacity is constructed. While world pulp capacity (the limiting factor in paper production) is scheduled to grow by 2.8% annually in the 1974—76 period, industry authorities regard some of this capacity as suspect, because it represents intentions more than actual announcements, and if announcements have not been made by now, capacity would almost surely not be on stream by 1976. Because of the long lead time between the decision to add capacity and the actual startup (18—48 months), worldwide paper and paperboard capacity and, therefore, production cannot grow at a rate greater than 3% annually before 1977, at the earliest.

A serious worldwide economic recession could cause enough slack between demand (which generally parallels growth in real Gross National Product) and the potential 3% annual supply growth to halt the rise in pulp and paper prices, and could even cause some temporary price weakness. The lack of large new capacity additions makes it unlikely, in our opinion, that any production excess or product-price weakness would be more than temporary.

The key to how rapidly the paper industry expands in the 1977—80 period is "return on investment". With today's high interest rates offering a high rate of return on alternative investments for funds *not* invested in paper manufacturing equipment, and a very expensive cost of capital should funds need to be borrowed, a major paper mill expansion is considered more expensive and risky today than it was 5 or 10 years ago. It is not surprising that today's more financially aware managements are reluctant to undertake major capital projects for pulp, paper and paperboard manufacturing facilities. To encourage substantial new expansion in the late 1970s, the paper industry needs a 10% aftertax return on new (or replacement value) investment. The paper industry earned about 4—5% aftertax on the *replacement* value of plant and equipment in 1973. The return should rise to 5—6% in 1974. To reach the desired 10% aftertax return on new investment would require probably an additional 30—40% increase in prices beyond those in effect in late June 1974. For a company like International Paper, whose size and breadth of product line typifies the industry, this would mean an approximate doubling of earnings from our $5.00 per share estimate for 1974.

Such an earnings gain seems dramatic when looked at initially, but it is not so surprising when viewed over a longer time period. Assuming IP could earn about $10 per share in 1977–78, it would represent only about an 8% compounded annual rate of growth over the years since 1956. This would, in turn, approximate the industry's historic 4–5% annual volume increase and an additional 3–4% annual inflation factor. The paper industry, and IP, sell now at about 4–6x this earnings level.

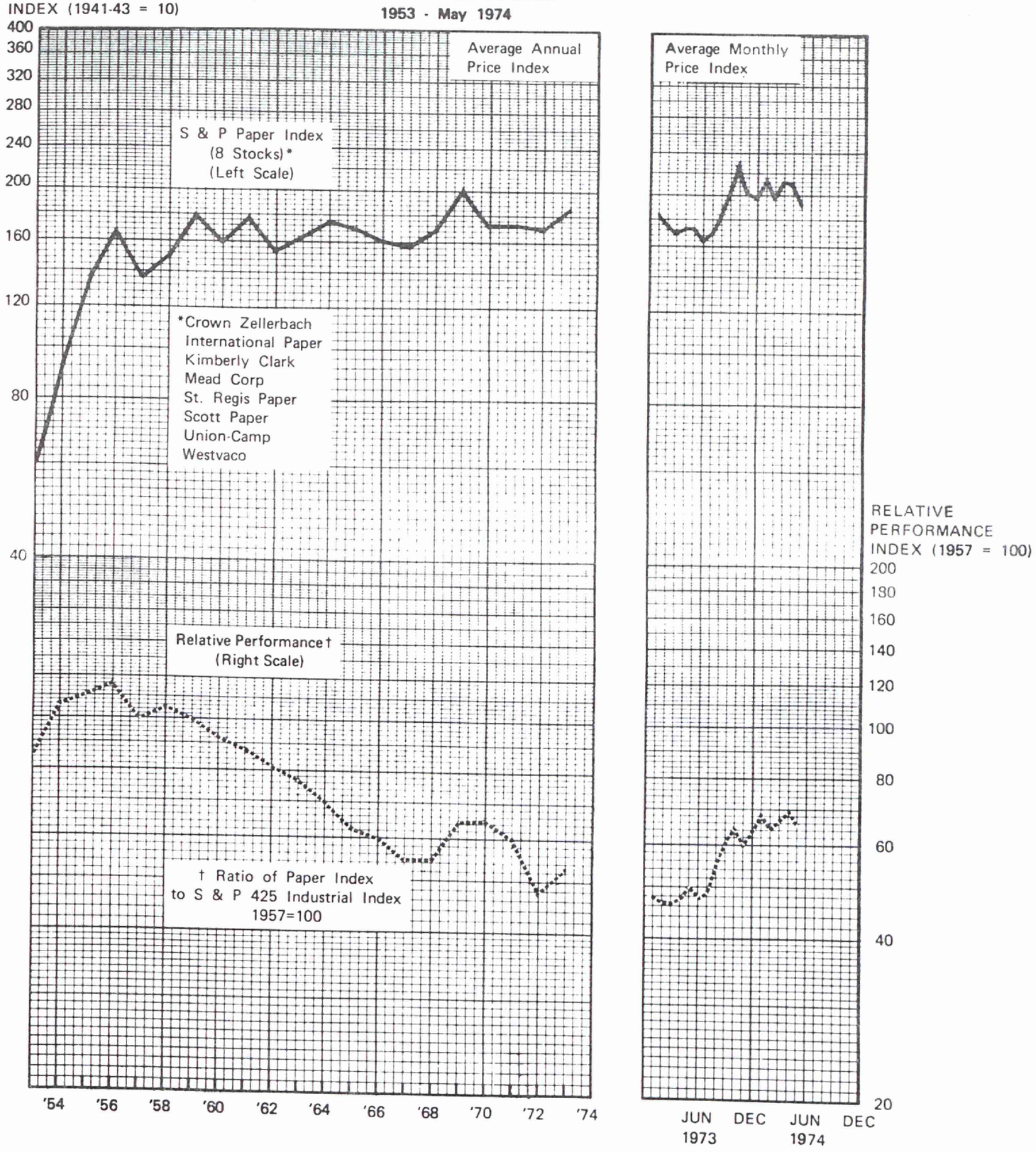
A 10% aftertax return on *new* investment would represent a significantly higher return on *book value* investment in plant and equipment. It is important to understand, however, that investment decisions are based on current, not historic costs. The hard facts of inflation are that it costs twice as much to build 1000 tons of daily capacity today as it cost in 1967, and probably 2.5–3.0 times as much to build capacity today as the "average" book cost of capacity for the paper industry. The degree of success in achieving higher product prices is the most important single factor in appraising the outlook for the paper industry. Not only will this success, or lack thereof, bear importantly on the future level of earnings, but also on the industry's ability to finance its growth. Ultimately, the consumer must pay the price for expansion, or suffer increasing shortages.

Paper industry product prices have risen by 25–100% in the last 3 years, although the 1970–71 industry price level was not realistic either by historic standards, or by the standards necessary to encourage new capacity additions. The unusually low product prices had been caused by competition following the completion of the 1960–70 expansion program. Of course, recent price increases have also been necessary because costs are rising. Further price increases of 10–20% for major grades like newsprint and linerboard have been announced for this summer. Higher product prices are probable in 1975 even if economic activity is sluggish, and almost certain once economic activity accelerates again. The pressure for higher product prices is likely to continue because of a change in the international competitive situation. During the 1950s–60s, the European paper companies were the low-cost producers and what little product price leadership that existed came from North American producers. The situation is entirely different in the 1970s. The North American producers are now the low cost producers and product price leadership is being exerted by Scandinavian producers. With our larger, more efficient facilities and superior wood resources, it is doubtful that this favorable situation will change near term.

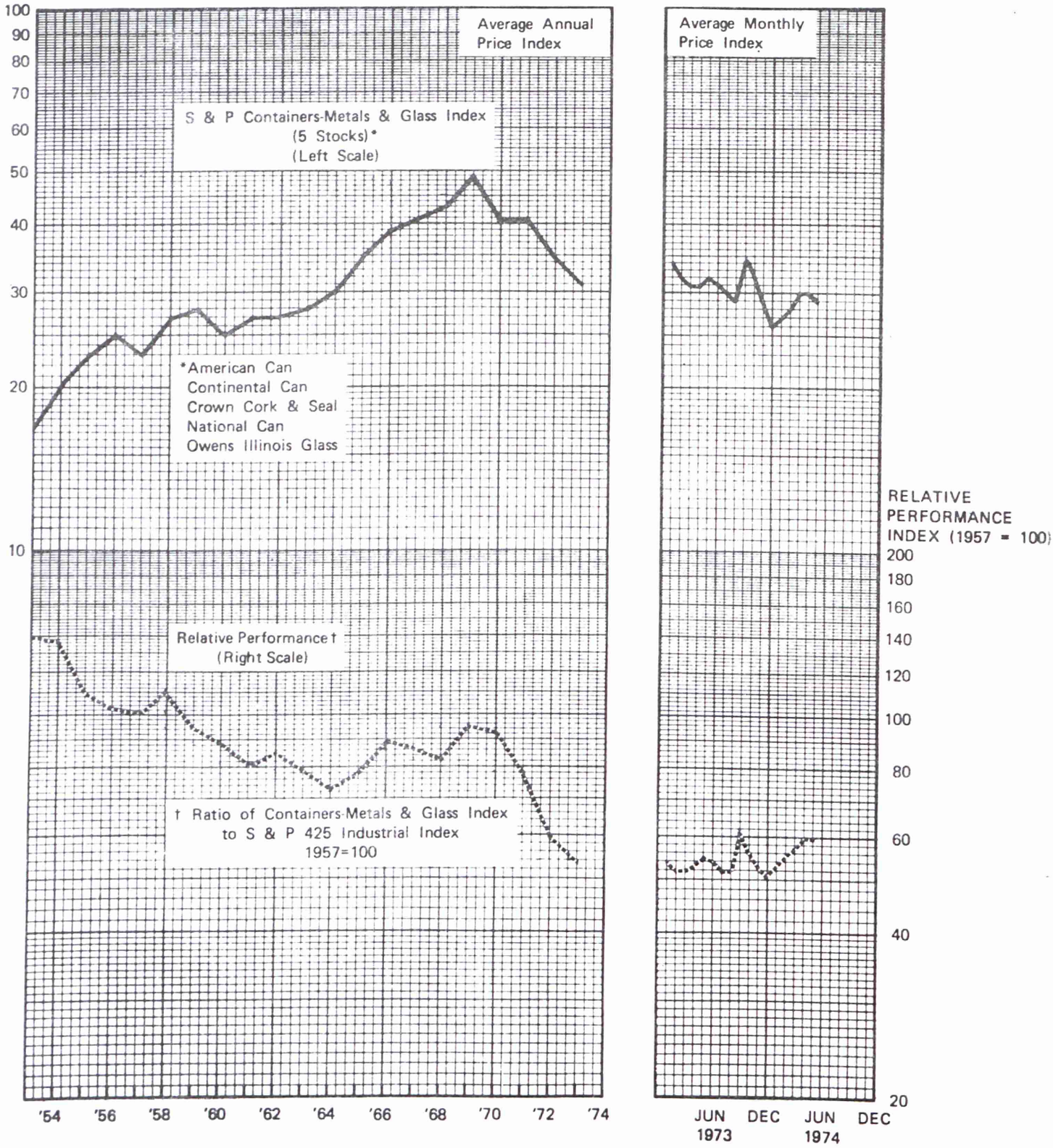
Our specific choices within the paper industry have several common characteristics: (1) strong management, (2) large timberland holdings, (3) good cash flow and a strong financial position to finance most of the expansion internally, and (4) international exposure so as to exploit lucrative overseas markets. The three companies about which we have written extensively have all of these characteristics. We continue to recommend **Union Camp (54)**, **International Paper (48)**, and **St. Regis (26)** to accounts for capital appreciation.

Robert F. Wulf, C.F.A.
333–7285

Trend of S & P Paper Industry Stock Index And Performance Relative to The S & P 425 Industrials 1953 - May 1974



Trend of S & P Containers-Metals & Glass Industry Stock Index And Performance Relative to The S & P 425 Industrials 1953 - May 1974



SMITH, BARNEY & CO. INCORPORATED

6/11/74

PAPER & FOREST PRODUCTS
(R.E. WULF)

COMPANY AND FISCAL YEAR-END	TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL.TO S&P 425
BOISE CASCADE	BCC	$ 16	$ 19- 14	7- 5X	6X	$ 2.75	$ 2.89	$ 1.29	-5%	22%	-5%	$ .50	3.1%	16%	121%
BROOKS-SCANLON	BRKS	16	22- 12	9- 5	7	2.40	2.22	1.67	8	15	19	.60	3.7	38	144
CHAMPION INTER.	CHA	17	21- 15	9- 6	6	2.65	2.71	1.71	-2	12	5	1.00	5.9	3	108
**FULLY-DIL(12%)EPS					8	2.37									
CROWN ZELLERBACH	ZB	32	40- 30	9- 7	7	4.65	4.26	1.87	9	14	5	1.60	5.0	-12	92
DIAMOND INTL.#	DN	28	31- 27	9- 7	8	3.60	3.74	3.17	-4	5	5	2.00	7.2	-4	101
EVANS PRODUCTS	EVY	8	13- 6	7- 3	5	1.50	1.81	1.64	-17	15	12	.50	6.3	-18	86
**FULLY-DIL(10%)EPS					5	1.62									
FIBREBOARD	FBD	17	19- 14	7- 5	5	3.75	3.54	1.82	6	17	9	.90	5.3	13	118
**FULLY-DIL(15%)EPS					5	3.26									
FT HOWARD PAPER	FHP	18	21- 14	19- 13	16	1.10	1.08	.98	2	15	14	.35	1.9	20	125
GEORGIA-PACIFIC(1)	GP	39	46- 35	14- 11	12	3.20	3.13	1.81	2	23	13	.80	2.1	3	108
GLATFELTER(2)	GLT	18	21- 16	5- 4	4	4.70	3.27	1.59	44	7	-5	1.10	6.1	14	120
**FULL-DIL(15%)EPS					4	4.10									
GREAT NORTHERN	GNN	41	51- 36	8- 6	6	6.50	5.02	3.35	29	3	5	1.80	4.4	-7	97
INTER. PAPER	IP	48	56- 41	11- 8	10 (+)	5.00	3.60	2.30	39	10	3	1.50(3)	3.1	-9	95
KIMBERLY-CLARK	KMB	31	35- 27	10- 8	9	3.75	3.30	2.39	14	12	7	1.44	4.7	-5	99
MEAD #	MEA	17	20- 15	7- 6	5	3.25	2.66	1.08	22	14	-3	.80	4.8	-8	96
**FULLY-DIL(10%)EPS					6	2.88									
ST. REGIS(4)	SRT	27	37- 24	11- 7	8	3.35	2.88	1.94	16	-20	-5	1.20	4.4	-19	84
**FULLY-DIL(7%)EPS					9	3.12									
SCOTT#	SPP	15	18- 14	11- 9	9	1.60	1.63	1.11	-2	-4	-3	.56	3.7	2	106
UNION-CAMP	UCC	55	63- 49	13- 10	11 (+)	5.00	4.01	2.57	25	17	9	1.60	2.9	-6	98
WESTVACO OCT	W	28	39- 26	8- 6	6 (+)	4.75	3.28	1.22	45	6	-2	1.10	3.9	-22	82
WEYERHAEUSER (5)	WY	40	46- 33	20- 15	16	2.50	2.74	1.18	- 9	24	18	.80	2.0	2	106

Footnotes

(1) Earnings in 1973 before special charge of $0.07/share.
(2) 3-for-2 stock split, June 1973.
(3) Plus $0.25 extra in 1973.
(4) 3-for-2 stock split, December 1973.
(5) 2-for-1 stock split, December 1973

SMITH, BARNEY & CO. INCORPORATED

PAPER & FOREST PRODUCTS
(R.F. WULF)

6/11/74

COMPANY AND FISCAL YEAR-END	TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL. TO S&P 425
INDUSTRY AVERAGES					8X				7%	11%	5%		4.2%	0%	105%
383 COMPANY AVERAGE					12X				10%				3.3%	-3%	101%

Paper – iv

SMITH, BARNEY & CO. INCORPORATED

CONTAINERS: METAL AND GLASS
(R.F. WULF)

6/11/74

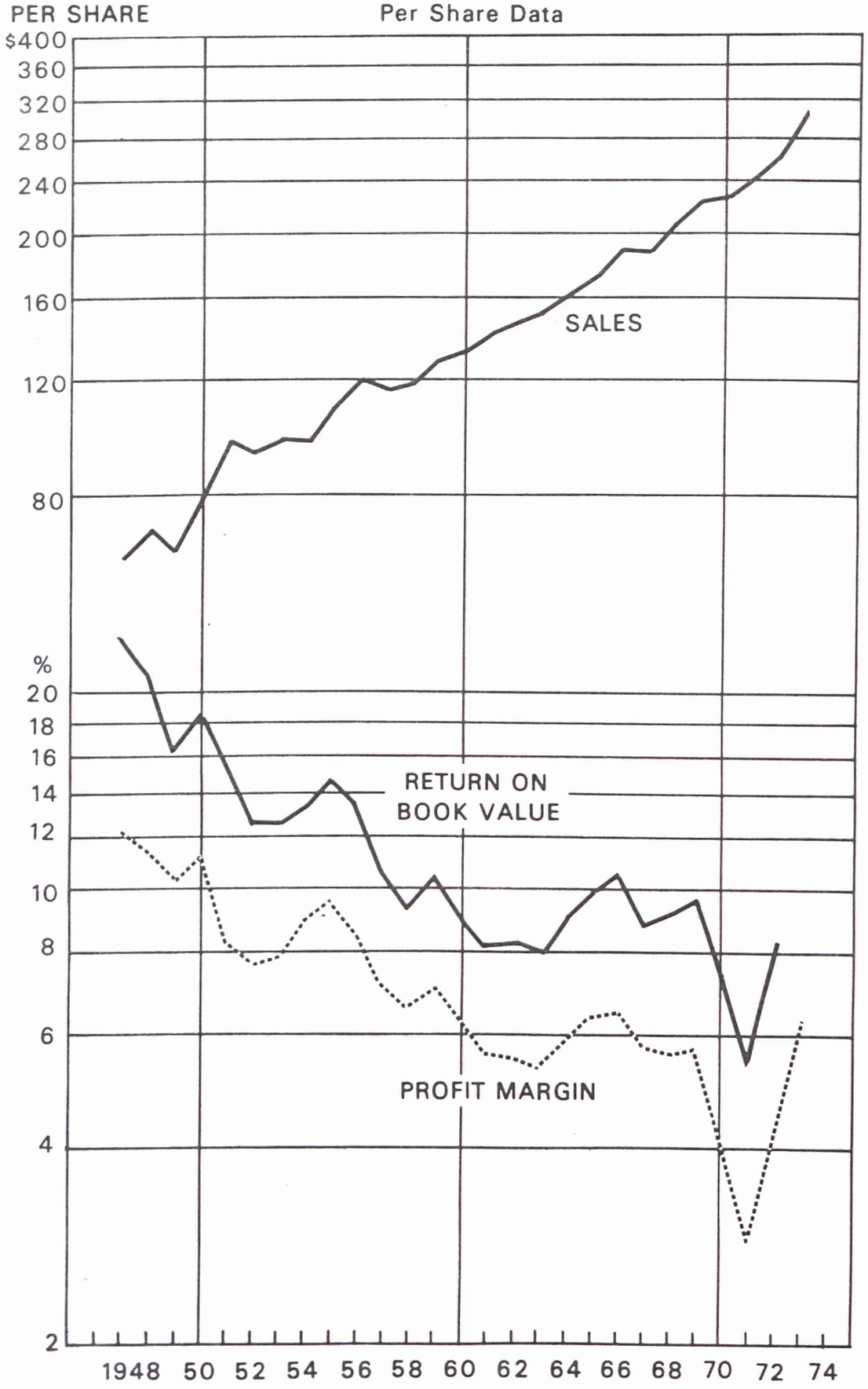
COMPANY AND FISCAL YEAR-END	TICKER SYMBOL	CLOSING OR BID PRICE AS OF 6/11/74	1974 PRICE RANGE	1974 P/E RANGE	PRICE/ EST. 1974 EPS	EARNINGS PER SHARE 1974E	1973	1972	EPS GROWTH RATES 74E VS 73	69-73	64-73	DIVIDEND RATE	YLD	STOCK PRICE PERFORMANCE FROM 01/02/74 % CHG	REL.TO S&P 425
AMERICAN CAN	AC	$ 29	$ 30- 26	8- 7X	8X	$ 3.85	$ 3.58	$ 2.95	8%	-1%	-1%	$2.20	7.6%	8%	113%
BROCKWAY GLASS	BRK	12	14- 10	6- 4	5	2.30	2.12	2.97	8	-6	14	.78	6.5	14	119
CONTINENTAL CAN	CCC	25	26- 20	7- 6	7	3.60	3.25	2.77	11	-1	5	1.60	6.3	21	126
NATIONAL CAN*	NAC	9	10- 7	5- 4	5	2.00	1.84	1.80	9	-1	10	.45	4.9	22	127
OWENS-ILLINOIS	OI	42	42- 30	8- 6	8	5.50	4.70	3.95	17	3	6	1.60	3.8	34	140
**FULLY-DIL(6%)EPS					9	5.17									
INDUSTRY AVERAGES					7X				6%	-1%	7%		5.8%	20%	125%
383 COMPANY AVERAGE					12X				10%				3.3%	-3%	101%

Paper 1 <

PAPER

S & P 8 COMPANY GROUP

Per Share Data



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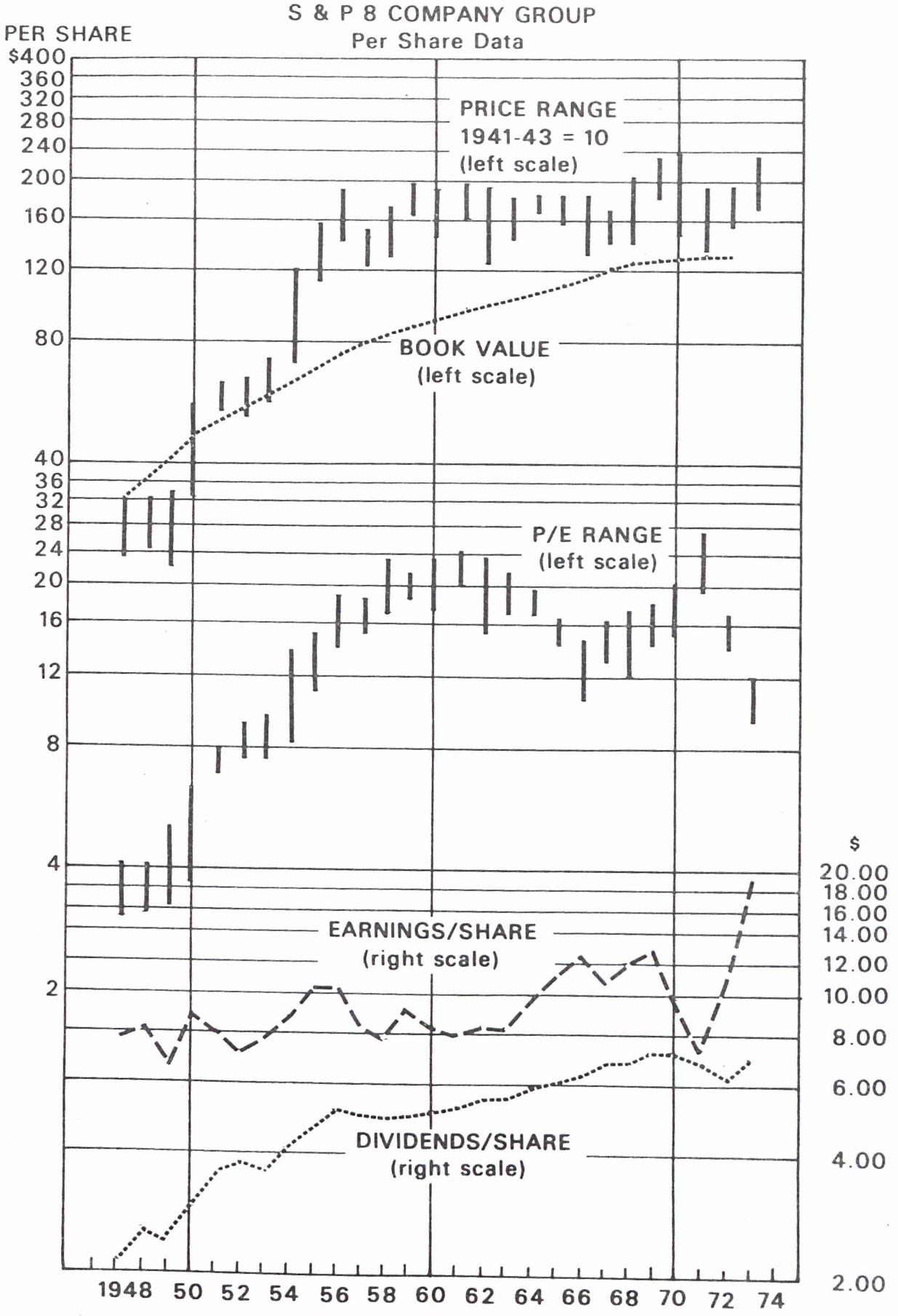
S & P 8 COMPANY GROUP
Per Share Data
PER SHARE
$400
360
320
280
240
200
160
120
80
40
36
32
28
24
20
16
12
8
4
2
PRICE RANGE
1941-43 = 10
(left scale)
BOOK VALUE
(left scale)
P/E RANGE
(left scale)
EARNINGS/SHARE
(right scale)
DIVIDENDS/SHARE
(right scale)
$
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18.00
16.00
14.00
12.00
10.00
8.00
6.00
4.00
2.00
1948 50 52 54 56 58 60 62 64 66 68 70 72 74

Corporate Headquarters

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