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AMERICA'S EIGHT-YEAR STOCK MARKET BOOM & EXPANSION ARE OVER; ECONOMIC PROBLEMS HURT PROSPECTS FOR THE MARKET & ECONOMY

Stagflation, Double-Digit Inflation To Return?

America's eight-year economic expansion and stock market boom (1982-90) could be replaced by a decade with higher inflation and slower economic growth characterized as "stagflation," warns a stock market analyst at the Georgia Institute of Technology.

Rising oil prices prompted by the Mideast Crisis merely hastened the end of the economic and stock market boom, suggests Dr. Fred Allvine, professor of management in Tech's Ivan Allen College of Management, Policy and International Affairs. His research indicates that the stock high reached in July, when the Dow Jones Industrial Average closed at 2990.75, may not be exceeded over the next decade.

Economic indicators have for several months been signalling an end to the debt-financed boom of the 1980s, says Allvine, director of Tech's Stock Market Project. But the good news, he adds, is that the decade of the 1990s could provide a transition to a strong new economy for the next century -- but only if America takes steps to cure its long-term economic woes.

"Our study shows that even without the Iraqi crisis, we were nearing the end of the boom that was funded by debt," he said. "The oil situation merely exacerbated our economic problem of not saving and not investing for tomorrow. We have been very short-sighted and lived only for today. Time is running out for our debtor economy."

Allvine uses nonlinear modeling and pattern recognition -- part of Chaos Theory -- to predict the stock market for a number of corporate clients. He believes that strong stock market advances are driven by two factors: lower inflation and higher corporate earnings. The stock market is likely to advance when the outlook for both of these factors is positive.

But within the last nine months, both indicators have taken a downward turn, with inflation rising to its highest level since 1981, while corporate earnings have been eroding. The fact that the stock market remained high until recently is explained by a third psychological factor that Allvine suggests can drive stock market prices up for a while: what he calls "excessive optimism." Over the past nine months, the stock market has been very volatile as earnings have turned down, inflation increased, and optimism declined. All these factors suggest that the Bull Market of the 1980s, the most rapid eight-year advance since 1945, is over.

In what Allvine believes could be the first "down leg" of the stock market, the Dow recently dropped 16 percent from 3000 to 2500 as this excessive optimism was eliminated. Although it has rebounded somewhat, Allvine believes the future will see the Dow trading in the range of 2000 to 3000 over much of the 1990s. The market's actual range, he says, will be determined by the levels of energy costs -- and inflation.

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Earlier oil price shocks drove inflation as high as 16 percent. Although he doesn't expect those levels again, Allvine warns that until the United States adopts a sound energy policy, its economic future will be held hostage to the inflationary threats of international oil producers. He views stagflation and near double-digit inflation as part of those threats.

And since high inflation has historically stalled stock market advances, the outlook for the stock market is not good at this time, he says.

Over the past eight years, the Dow Jones Average advanced nearly 300 percent, from about 750 in August of 1982 to near 3000 at its peak in July. Investors may now have come to expect such growth, but Allvine argues that the rapid expansion of the past eight years has been an aberration. He points to the previous 16 years, in which the stock market traded in a "flat" range of 750 to 1000, as a more normal condition (See chart).

"To think that the next eight years are going to be like the last eight years is sheer folly," he said. "What goes up can also go down."

By rapidly pushing up energy prices, the Iraqi confrontation put a sudden stress on the U.S. economy. But even if the problems were resolved tomorrow, Allvine believes oil prices would remain well above their levels of a year ago and the U.S. economy would remain shaky.

What is to blame for America's economic woes?

Allvine cites several problems: excessive debt in government, business and the general public; inadequate savings; and limited investment in research needed to develop new products and new technology.

"This economic expansion has been funded by all elements in our society taking on a higher proportion of debt to finance their standard of living," he said. "The economic expansion supported by debt only delayed getting around to trying to solve our structural problems of too much debt, not enough investment and oil vulnerability. It delayed the realization that we need to do certain fundamental things."

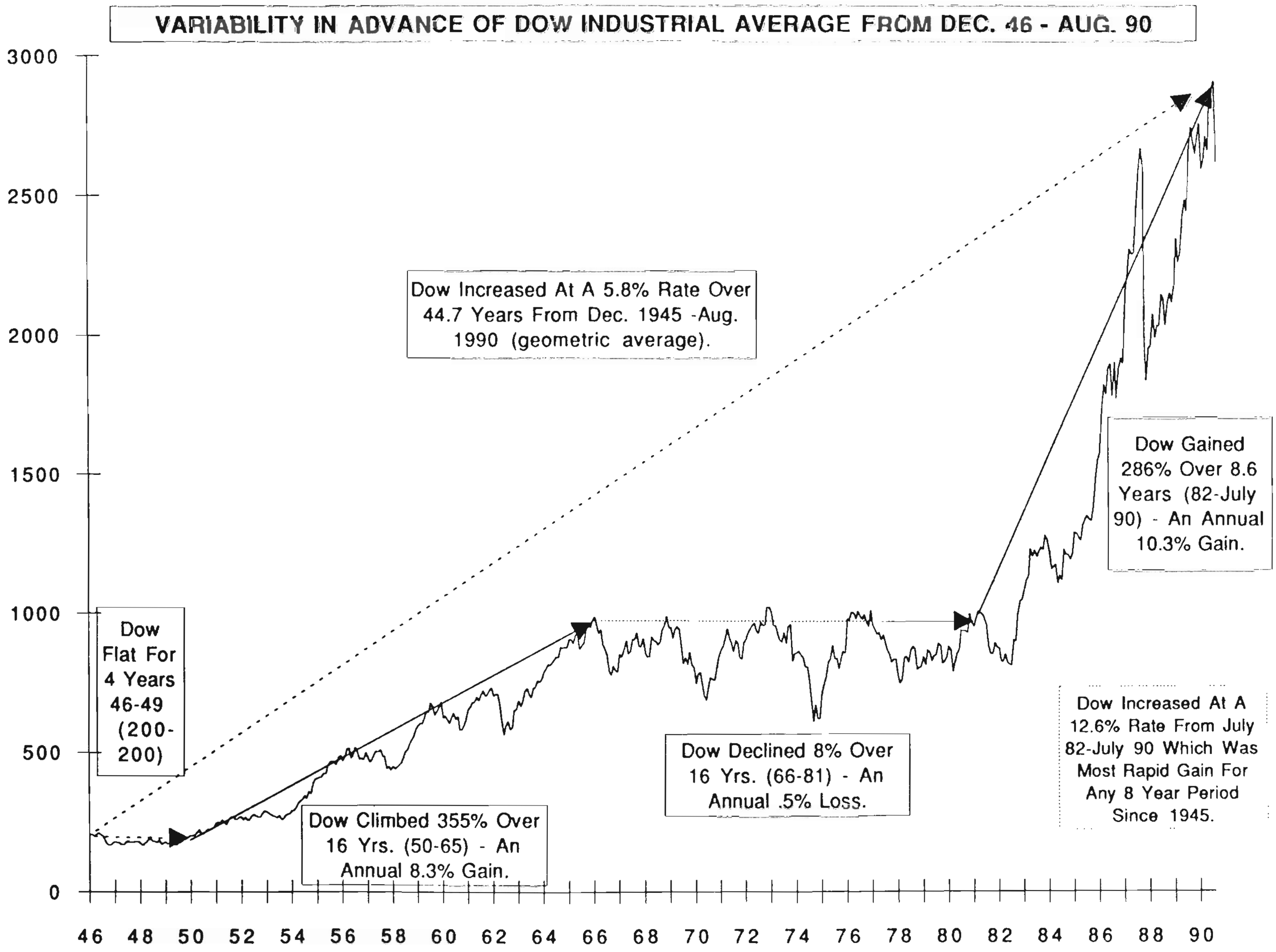
Allvine suggests tax code changes to encourage savings and reduce consumption. Doing that would reduce the amount of consumer borrowing, bringing lower interest rates and reducing the cost of capital improvements necessary to revitalize American manufacturing. Such improvements, coupled with investments in research and development, could help build a solid foundation for economic growth, he argues.

"It will be a major change for society, but we have no choice except to give up our consuming ways. It is essential to save and invest more to have a sustained increase in our standard of living," said Allvine. "Unless we do this, the economic might of the United States is going to be considerably diminished."

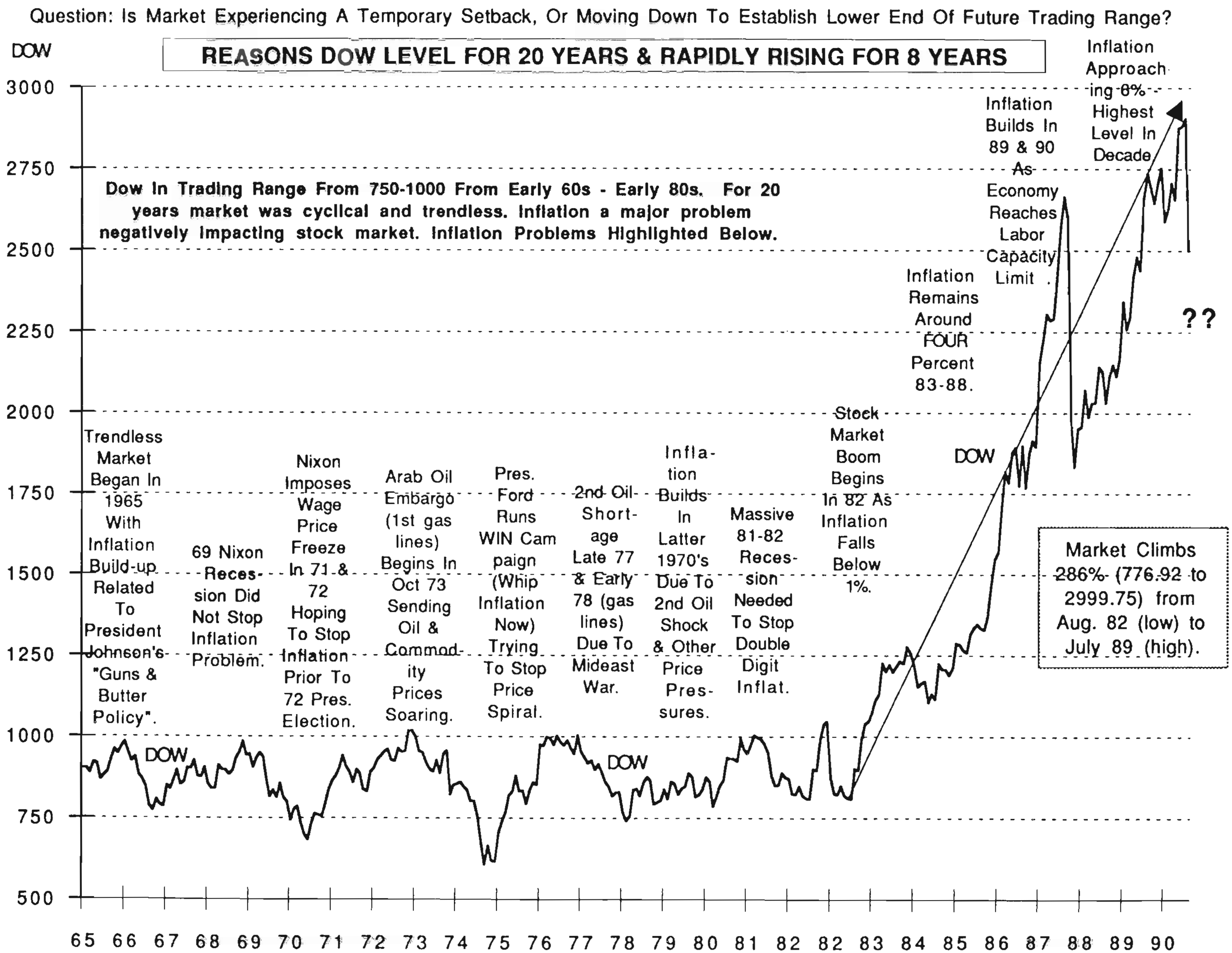
One part of that foundation will be an energy policy which includes development of alternative fuels. With the cost of oil between $25 and $30 a barrel, Allvine believes the alternatives may become competitive. But should oil prices dip again, he warns that the U.S. "should not be lulled into energy complacency again. With the third energy crisis since 1973, we must stop talking about energy problems and implement energy policies appropriate for the year 2000 and beyond."

NOTE: This material is based on four recent special reports of the Stock Market Project over the past four weeks. Their titles are: "End of the Eight Year Bull Market?" "Worst Case Scenario for Stock Market," "Prospects for Stock Market over 1990 Decade," and "Rising Unemployment is Bad for Stock Prices." These reports are available.

Figure 4 - SPECIAL STUDY OF FUTURE DIRECTION OF STOCK MARKET



Stock Market Project, School of Management, Georgia Institute Of Technology.



By Prof Allvine, Director Stock Market Project, School of Management, Georgia Institute of Technology.