Domestic Credit by Richard Freeman

A bear-market shakeout?

Prepare for a huge downward skid in the U.S. stock market, because of profit and dividend shrinkage.

In the first six months of 1981, with President Reagan newly arrived in office, and predictions that the U.S. economy was "impervious" to effects of the high interest rates of Fed Chairman Paul Volcker, the Dow Jones industrial stock average was on easy street. Confidence was high, and investors from around the world were pouring money into the stock exchange. The Dow opened the year around 960, quicky went above 1000 and stayed there for six months. In June, after some ups and downs, the Dow was at 1012 and most Wall Street analysts saw this as the floor from which the Dow would leap off toward another plateau.

But starting in August of last year, the economy entered the second phase of a double dip recession, because of the high interest rates of Volcker. By September, the Dow reflected this fact and had crashed below 900, and while it flirted with the 900 level in December, it closed out the year in the 870 to 880 range.

The prospect for the rest of 1982 looks grim. Leading economist Lyndon H. LaRouche predicted this week that the Dow could lose between 100 and 200 points in 1982, and that under a worst-case condition, involving mass bankruptcies along the line of the 1930s depression, it could plunge to the 200 mark. What would justify such a dire prediction?

The coming bear market is defined by one ingredient: high interest rates, which wipe out manufacturing, agriculture, and construction activity, and must correspondingly slash profits. And because most people buy stocks to earn dividends, stocks become unattractive.

When combined profits of U.S. corporations hit $145 billion in the fourth quarter of 1981, they had fallen to their lowest level since the third quarter of 1978. Moreover, on an "inflation-adjusted" basis, they plunged even further. At the start of the first quarter of 1980, they were $140 billion. By the end of the fourth quarter of 1981, they were down to $96.4 billion, a fall of 31.4 percent.

There is nothing to indicate that the profit picture will get better, and much to indicate that it will get worse.

The auto industry, despite rebates of $1,000 or more per car, announced that auto sales for the first 10 days of February fell by 7 percent. Consumers are scared stiff of what they see happening to the economy, and even heavy discounts cannot lure them to buy cars. Recognizing this fact, the General Motors Corporation announced Feb. 15 that it is closing two plants in California, its Southgate and Fremont plants, for an "indefinite" period. These plants produced, respectively, the front-wheel drive A- and J-cars, which were supposed to save the auto industry.

Kaiser Steel, the nation's ninth largest steelmaker, announced Feb. 8 an extraordinary $563 million loss for the fourth quarter of 1981, while the U.S. steel industry has been skidding along at 60 percent of capacity for the first six weeks of the year.

International Harvester has announced that it will close *all* of its U.S. farm machinery production for two months starting March 8, while John Deere, another farm implement maker, announced Feb. 9 that it is laying off 2,000 workers and closing three plants in the Midwest.

This is not an environment in which to expect growing profits. Moreover, over the last two years, the nation's corporations maintained artificially high dividend pay-outs in order to keep the confidence of the common investor, and will not be able to continue that level of pay-out. According to a study done by Manufacturers Hanover Trust, in 1981 corporate cash dividend pay-outs totalled $65 billion, which was $15 billion higher than in 1979, even though in 1979 after-tax profits were $20 billion greater.

As a result, the ratio which divides dividends by after-tax profits rose to 42 percent in 1981, the highest level since 1971. In other words, 42 cents of every after-tax dollar in profits was paid out in dividends. If the same level of cash dividend payouts were made in 1982 as in 1981—that is $65 billion—but if profits in 1982 fall by even 10 percent, the cash pay-out ratio will be a staggering 50 percent.

Corporations cannot maintain this. But if they cut dividends, there goes the value of their stock. This is what is most likely to happen.