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An analysis of the stock market as an indicator of investor reaction to selected national and international events

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An Analysis of the Stock Market As an Indicator of Investor Reaction to Selected National and International Events

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By

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An Analysis of the Stock Market

As an Indicator of Investor Reaction

to

Selected National and International Events

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Preface

> Many of the most critical problems in the relationship of the citizen to the polity involve the connections between domestic and foreign policy, the importance of the state in the maintenance of desirable values, the moral role of dissent, bargaining with competitors, and guarding against manifest and potential military threats.
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> --Morton A. Kaplan, "Loyalty and Dissent" in _National Security and American Society_, ed. by Frank N. Trager and Philip S. Kronenberg (Manhattan, Kansas: The University Press of Kansas, 1973), p. 497.

> The stock market's ability to perform, at least most of the time, as a highly reliable leading indicator, no doubt partly reflects its role as a sensitive barometer of investor confidence in the economy's future.
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> --Alfred L. Malabre, Jr., "The Outlook," _Wall Street Journal_, May 21, 1979, p. 1.

The idea for this research originated with the work of Bruce M. Russett and Elizabeth Hanson in _Interest and Ideology: The Foreign Policy Beliefs of American Businessmen_. Their work in attempting to identify businessmen's reactions (and hence, beliefs) to events during the Indo-China War by movements in stock prices is, as far as I have been able to find, unique. After discussion with Dr. John Outland, I undertook to determine if there is a consistent pattern in stock market fluctuations as a result of domestic and international affairs. Can the attitudes of American investors toward specific events be identified through decisions to keep or sell stocks?

If one reflects for a moment, the answer would seem to be obvious: Certainly the stock market reflects investor attitudes toward and beliefs about specific events. Call a broker on any given day -- or read The Wall Street Journal -- and the latest move will be explained, frequently in terms of domestic or international policies. A politician or political analyst may attempt to establish popularity for an individual or an event by citing the "Dow", e.g., the supposed "Carter" market subsequent to the 1976 election. It is almost part of American folklore that the market moves during April-June, 1962, were attributable to the steel price confrontations. Wallace Carroll refers to stock moves in his article on the crisis. A respected professor of political science remarked to me that he recalled the market crash when President John F. Kennedy tested the steel industry. A widely followed investment advisor referred as recently as July 1979 to the "bear market supposedly created by Kennedy's steel industry confrontation in 1962."[1]

[1] Stan Weinstein, The Professional Tape Reader, July 26, 1979 (Hollywood, Fla. By the Author, 1979), p. 1.

However, attribution of the 1962 crash to the steel price crisis is incorrect, as examination of contemporary economic factors later in this study will show. Therefore, I believe any effort such as this study must be made in full consideration of appropriate economic factors. It remains to be seen, then, if the stock market does respond to developing international and domestic events. If there are responses, it further remains to be seen whether such responses are dogmatic or sufficiently variable to provide an insight into investors' perceptions toward and beliefs about the causative events.

This effort is a beginning in a complex subject requiring a great deal more work. The goal is eventual development of a model enabling determination of businessmen's attitudes toward domestic and international events through examination of stock market price fluctuations. I hope that students of political science expanding upon this starting point will have adequate resources to employ computer and research technology. Then, perhaps, we can ascertain with reasonable accuracy the stimuli to which the market responds, the segment of the investing population responding, and the reasons for the response, thereby developing true insight into businessmen's beliefs. Given the animus of many liberals to business, the prevalence of such theories as John Kenneth Galbraith's concept of the dominance and autonomy of giant corporations, the still propounded "merchants of death" theory, and the theortical conflict between Socialism and Marxism on the one hand and Capitalism on the other, it behooves us to understand the capitalist decision making process to the best of our abilities. If our system is to be kept and improved, or if it is to be changed, we need to understand as thoroughly as possible what we are doing, and we will have such understanding only when we know what makes our system of capital formation function.

I am indebted to the Political Science Department at the University of Richmond for interesting courses and hours of stimulating discussions over the years, to Art Gunlicks for his assistance with this work, to Mike Mead and Dianne Fox of Scott and Stringfellow for making statistical information available freely and pleasantly, and to Ellen Tabb for transcribing poor handwriting into a typewritten product. Finally, I am indebted to John Outland for his friendship; his outstanding courses; his thoughts on many subjects; and his advice, assistance, and patience -- all of which were indispensable in the preparation of this thesis.

Chapter I

Introduction

General

Kenneth E. Boulding summarizes the role of ideology in economic development in The Meaning of the 20th Century: The Great Transition. He tells us that until the 1776 publication of Adam Smith's Wealth of Nations, economic development in the West took place in the absence of much in the way of conscious planning. Subsequently, however, development in Western Europe and particularly the United States was more planned than is superficially apparent. "The development of the United States especially was guided throughout by a policy which was quite self-conscious in its emphasis on the role of market mechanism...."[2] Today the major conflicting ideology to that of the market economies is that of socialism, the primary champion of which is the Soviet Union. "Even within these two camps there is of course a great variety of ideological belief and expression."[3]

It would be impossible to detail the many works that have been written about competing and conflicting economic theories, but there can be little doubt that the effort has been extensive.

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[2]Kenneth E. Boulding, The Meaning of the 20th Century: The Great Transition (New York: Harper and Row, 1965), p. 173.

[3]Ibid., p. 167.

There can be little doubt, also, about the increasing interest of political scientists in the work of economic historians (see, for instance, G. David Garson, Group Theories of Politics (Beverly Hills, California: Sage Publication, 1978)). In attempting to evaluate the interaction between economic interests and political policy, however, the student of political science ultimately must agree with Russett and Hanson:

> One major difficulty we faced stemmed from the highly controversial nature of theories about the importance of economic interest in determining foreign policy. Such theories, whether concerned with the military-industrial complex, neoimperialism, or other aspects, deserve careful evaluation. We think, in fact, that they deserve more careful scientific evaluation than they have received from their proponents or from those who would reject them.[4]

Russett's and Hanson's goal was to determine the attitudes of businessmen (more properly, various elites) toward foreign policy and thus to subject selected theories to detailed evaluation. One of the tools they employed was an examination of stock market moves in conjunction with selected events of the Vietnam War in order to establish businessmen's support (or lack thereof) of those events. The work is important for exactly the reasons the authors felt it was necessary. While learned discourses have been written supporting or

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[4]Bruce M. Russett and Elizabeth C. Hanson, Interest and Ideology: The Foreign Policy Beliefs of American Businessmen (San Francisco, California: W. H. Freeman and Co., 1975), p. x.

attacking theories concerning the influence of economic interests on domestic and foreign policies, almost all of them have been developed deductively from certain assumptions on theories of behavior (see, for instance, Walter Adams, "The Military-Industrial Complex and the New Industrial State" in National Security and American Society, ed. by Frank N. Trager and Philip S. Kronenberg (Manhattan, Kansas: The University Press of Kansas, 1973)). Very little effort has been expended to develop a means to prove or to disprove any of these theories through the use of empirical data that would establish whether the constituent elements of economic interests actually behave as the theories hold or have the influence ascribed to them. The importance of a breakthrough in this area would be overwhelming. Imagine the effect if it could be proven empirically that any or all of the theorists did not have the remotest idea of what was actually happening in the world.

The use by political scientists of stock market variations as a tool in evaluating businessmen's perceptions of events is an intriguing and significant approach. Many financial analysts make a continuing practice of attempting to determine investors' attitudes through examination of market action. However, political scientists have largely neglected this rather basic component of a market economy. Upon reflection, this fact is surprising, particularly when one considers that "in the United States, publicly held corporations constiute a much larger proportion of the total value of business enterprise than in most other countries."[5] The stock market in this country certainly should provide a fertile source of data about businessmen's attitudes in a capitalist system. Laurence I. Radway points out that notables react to the manner in which government resolves issues and that they "... may serve as a testing ground"[6] for new governmental policies. Their willingness, or lack thereof, to put their wealth behind a policy certainly is as basic a reaction as could be found -- hence, the importance of the stock market as a testing ground.

The purpose of this paper is to make a contribution toward the development of an analytical approach to determining investors' attitudes towards domestic and international events through investigation of stock market movements. It should be noted that the attitudes determined would be not of approval or disapproval of the events themselves but rather of their perceived effects on the nation's economy. It should be further noted that the development of a credible

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[5]James H. Lorie and Mary T. Hamilton, The Stock Market: Theories and Evidence (Homewood, Illinois: Richard D. Irwin, Inc., 1973), p. 3.

[6]Laurence I. Radway, Foreign Policy and National Defense (Glenview, Illinois: Scott, Foresman and Company, 1969), p. 122.

overall system of analysis would be a major and difficult undertaking due to the complexities of the market. Nevertheless, extensive exploration should be undertaken to construct a computer model capable of being used for comprehensive analyses of the market by political scientists. There are a number of computer programs in use by the financial community that can provide a point of departure. The ultimate objective of such a project is to subject theories concerning the impact of business interests on policy to the scientific scrutiny proposed by Russett and Hanson and, so far, left largely undone.

Random Walk and the Efficient Market

Central to the problem of determining investors' reactions to specific events through stock market analysis is the question of whether stock price changes are systematic or independent of preceding events. Addressal of this question leads to the concepts of the random walk and the efficient market.

The expression "random walk" probably originated in 1905 in Nature. Briefly, the thesis was propounded that a drunk left in an open field will wander in a random fashion. Accordingly, the most unbiased estimate of his position at any given time is the point at which he was left. In discussing the random walk model, Karl W. Deutsch points out there are elements of both determinism and probability in the drunkard's wandering thus permitting mathematical projection of progress. He further points out that

> the random walk of the drunkard has more than a little in common with the policies of great nations and with the march of history on earth. At every step, the walk starts from a position given at that time; it contains an ineradicable random element, which may be either large or small in its effects; and it is subject to modification by persistent deterministic causes, biases, and influences, which can do much to change the distribution of probable outcomes but usually cannot make any single outcome certain. ... Under these conditions individuals and governments ... knowing the limitations of their powers to predict ... can make provisions for possible risks which they can only imperfectly estimate; they can strive to make the risks smaller....[7]

No less do these statements apply to trading in the stock market with buying and selling the mechanism through which risk is reduced. Indeed, since 1960 serious study has progressed concerning the applicability of the random walk model to market reactions. The theory here holdsthat price variations are not systematic and do not follow from events that have gone before but that successive changes are indepednent of one another.

The corollary theory of the efficient market evolved from a growing acceptance by the investment community that price changes were in fact random.[8] This model is comprised of two main elements.

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[7]Karl W. Deutsch, <u>The Analysis of International Relations</u> (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1978, 1968), p. 96.

[8]Russett and Hanson also found substantial evidence that stock prices moved according to the random walk model. <u>Interest and Ideology: The Foreign Policy Beliefs of American Businessmen</u>, p. 146.

First, at any given time a stock's price represents fairly the totality of knowledge that is available concerning the underlying company, the economy, and any other factors that logically would have an influence on the company's financial prospects. Second, any new information that is germane will be known to the investing public quickly, and prices will react rapidly to incorporate the new knowledge. In short, "an efficient market is one in which a large number of buyers and sellers react through a sensitive and efficient mechanism to cause market prices to reflect fully and virtually instantaneously what is knowable about the prospects for the companies whose securities are being traded."[9]

These hypotheses have been neither conclusively proven nor disproven. However, significant persuasive evidence of their validity has been amassed by their proponents, particularly in the case of the efficient market model. It has been "... proven rigorously that independence of successive price changes is consistent with an efficient market."[10] In any event, the bases of the two models are sufficiently solid to use in an examination of stock market moves as a determinant of investor's attitudes toward the economic effects of external domestic and international events. By "external" is meant those factors outside of the direct financial envelopes of publicly held companies whose securities are traded on stock exchanges.

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[9] Lorie and Hamilton, _The Stock Market: Theories and Evidence_, p. 97.

[10] _Ibid._, p. 70.

Statement of Thesis

The hypothesis to be examined in this paper is that the stock market is a credible gauge of investors' perceptions of --and, hence, beliefs about--significant national and international events. However, the market's value as an indicator of investors' beliefs is inhibited by the following factors: The relative magnitude of reactions will be more influenced by the underlying economy and by the degree of surprise associated with the event than by the importance of the event itself. Significant events which are predictable or known in advance of occurrence will have been discounted and, thus, will register little significant reaction. Finally, events threatening direct involvement of the United States in armed conflict will engender uniformly negative response regardless of the nature of the economy.

Method

The basic approach to be followed will be to examine stock price changes accompanying selected events in history. Events initially chosen for examination were those that, upon cursory examination of long term stock market charts, appeared to coincide with a discernible fluctuation in price pattern. They were chosen to represent one of three types of potential stimuli: Actions or decisions having direct, strong economic impact; war, or international tension threatening war, and subsequent peace moves; and national or international events engendering strong reactions, largely emotional, of stress or shock on the part of the American people. Price indexes then were selected from the appropriate tables, the direction of movement determined, and the percentage change calculated. This procedure was the starting point in a relatively long testing procedure. The next step was to establish whether the event chosen did in fact coincide with a significant move in the market, again through calculations from chart data. Research then was conducted of selected readings and press summaries of the period to determine if a rationale became apparent for the event's either causing or failing to cause a price move. The next step was to select events from history that in the mind of the author could have prompted market reaction and to repeat the testing procedure. The problem here was that many of these events turned out to be anecdotal insofar as price moves were concerned; nothing significant happened, as in the case of the steel price crisis of 1962.[11]

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[11]Russett and Hanson also had problems with salience. Events which in retrospect were regarded as critical frequently were not so perceived at the time. Conversely, supposed major crises turned out to be of little or no long term significance. A key point for the political scientist is to develop events that are--or were--significant at the time in question (or to have computer programs that will develop the information). Interest and Ideology: The Foreign Policy Beliefs of American Businessmen, p. 155.

Finally, the testing procedure was reversed. Charts of market indexes from 1928 through 1979 were reviewed to identify significant market break points. Press summaries again were reviewed to establish whether the break was attributable to the economy in general or to a specific external event. Once again direction of move and percent change were established. The year 1979 was used as a cut-off date merely to permit subsequent use of completed recession patterns.

Of the many tests conducted and events developed, a relatively small percentage was included in this work. Those selected are sufficient to establish the trend that soon became apparent. To include more would have served only to belabor the point. I did reinsert some events and add several new ones in response to interest by advisors during discussions about this project. I have also included a brief historical summary of the events selected to permit evaluation of why they did or did not produce a reaction.

Timing is important in the determination of the effect an event has on the market. The choice of when to buy or sell is important to most investors, and it is critical to traders. Accordingly, emphasis should be placed on the immediate reaction,[12] and I have used the market reaction on the day of the event and on the day following. The passage of time inherently encompasses

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[12] I was interested to note that Russett and Hanson came to the same conclusion for the same reasons. Interest and Ideology: The Foreign Policy Beliefs of American Businessmen, p. 156.

additional information or events that will serve to modify or counteract the initial perception of an event. Further, it must be remembered that the market basically is reacting to the underlying economy on a continuing basis. There are times when reaction to an event does not last through a day.[13]

Stock price data used are those from the New York Stock Exchange. While it represents but one of the security markets in the United States, it is " ... by far the most important market for common stocks in the world.... The number of issues on the New York Stock Exchange is substantially less than 10 percent of the number of publicly traded issues of stock in this country, but the value of stocks on the NYSE is about two-thirds of the total. There is a great concentration of value within the list...."[14] Here, then, is where the investing elites can be found in abundance. Also, the overwhelming majority of empirical data on stocks is derived from this exchange.

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[13]Subsequent to preparation of my initial draft of this paper, I read an investment advisor's comments that summarize very well the interaction of news and the market. "... invariably once news has been digested, the market proceeds to do exactly what it wanted to do before the news was announced. News is merely an excuse. In a strong market, bad news causes just a fast short selloff which is followed by renewed strength. Yet in a bear market, bad news is an excuse to drive the market 100-200 points lower." Weinstein, The Professional Tape Reader, p. 1.

[14]Lorie and Hamilton, The Stock Market: Theories and Evidence, pp. 4-5.

The Standard and Poor's Composite Index of 500 Stocks is the source of price indexes used. The Dow Jones Industrial Average is more widely known and is popularly used to gauge market fluctuations. However, the Dow actually is comprised of but 30, albeit 30 very large, industrial companies, the values of which are not market weighted. The S&P 500, on the other hand, includes 400 industrial, 40 utility, 20 transportation, and 40 financial companies. The index is weighted to reflect the market value of each company and is adjusted to reflect such changes as stock dividends and splits. Market values are expressed as a percentage of the average market value during a given base period, which currently is a value = 10 for the base period 1941-43. The S&P Composite Index, then, presents a broad representation of variances in the market as a whole. Such a broad index tends to reflect relatively accurately overall market moves, while changes in a particular group, as in the Dow, necessarily are filtered. As a case in point, many electric utility companies reflected price weakness in reaction to the nuclear plant accident at Three Mile Island. However, this weakness was limited to certain companies and was not an overall market indicator. It should be noted that the use of the S&P 500 may be controversial and that different results maybe obtained with another index such as the Dow Jones.

Unless otherwise specified, closing index values are used throughout. Because of constant price fluctuations during the course of a trading session this practice is the standard, accepted procedure for measuring market changes. If an event occurred, or if the next trading day fell, when the market was closed, next day values are used in each instance. This unfortunate but necessary procedure may dilute investor reaction to the extent that there is additional time for reflection and for subsequent, modifying events to occur.

Finally, the effort has been made to view events and price changes in light of the underlying economic climate extant at the time. To do otherwise is to ignore the fundamental fact that the stock market will be reflecting what is known about the economy at any given moment. If I had to fault the very fine work of Russett and Hanson, it would be because they did not do it with a careful eye toward market trends of the day. For instance, their book contains the statement:

> An examination of the daily closing averages for the Dow Jones industrials indicates there was no major upward trend in the market during the period covered. The average for July 31, 1964, was 841; for December 31, 1970, it was 838. There were of course fluctuations, but these ranged between a low of 631 on May 26, 1970, and a high of 995 on February 9, 1966. All fluctuations were within a range of 25 percent of the mean--not enough to cause any methodological difficulties.[15]

Statistically, the rationale may be valid. However, stock price changes reflect absolute values, not deviations from a statistical

[15] Russett and Hanson, <u>Interest and Ideology: The Foreign Policy Beliefs of American Businessmen</u>, p. 158.

norm. Money usually is made or lost, and the magnitude of change determines how much. Examination of market charts for the period involved reveals that 1964 fell during a bull market that began in 1962 and established a record high in early 1966. A one year major bear market followed, replaced in turn by a major bull reaching yet a new record high in late 1968. Then followed a major bear lasting until 1970. Obviously, something traumatic and very fundamental was happening in the stock market. In fact, the 1969-70 debacle drove a number of investors out of the market and created havoc on Wall Street, resulting in a significant reduction in the number of brokerage houses. Upheavals of this sort reflect a very unstable economy which must be considered in analysis, because such an economy can only affect investors' perceptions of events. The next chapter will deal with some of the economic factors that should be taken into consideration when evaluating the meaning of market moves.

Chapter II

Economic Factors

General

As has been discussed, the stock market primarily is a reflection of perceptions concerning the economy. How the market reacts to those perceptions and within what time period are important factors to be considered in seeking to determine reaction to specific events. In effect, the basic economy and, hence, the major market trend are providing background noise that influences reaction to news. Relatively insignificant news may serve to reinforce perceptions of a bull market and a strong economy and send the market soaring. During a bear market and poor economy the same news could have little or no effect. Mere examination of price moves in each case would tend to produce misleading indications of investor beliefs concerning the basic event. In short, price moves cannot be studied in a vacuum; modifying influences also must be considered.[16] The remainder of this chapter

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[16]This of course was the point Weinstein was making in his comments about news (see supra n. 13, p. 11). As a technical market analyst, he attempts to filter background noise by charting various indexes he has developed, a technique which also would be of value to the political scientist in creating an analytical model for market analysis.

is devoted to the more significant modifying influences that will be used for analysis in subsequent chapters.[17]

The price paid for the stock of a given company basically reflects a prediction of that company's future earnings, the degree of uncertainty inherent in the prediction, and associated risk. The investor must balance against these factors consideration of the return and associated risk featured in alternative potential investments. Affecting the decision are a myriad of economic considerations among which are interest rates, the price of gold, the stability of the dollar, inflation, corporate take overs, unemployment, and investment strategies. There are many more, and at any given time a combination of them will obtain. Subjective consideration will be given to applicable factors during analyses in the following chapters. However, primary use is made of their reflection in market trends over time (Figure 1), the history of gross national product (GNP) (Figure 1), and the history of corporate earnings per share (EPS) (Figure 2).[18] At this time, suffice it to point out that a relationship

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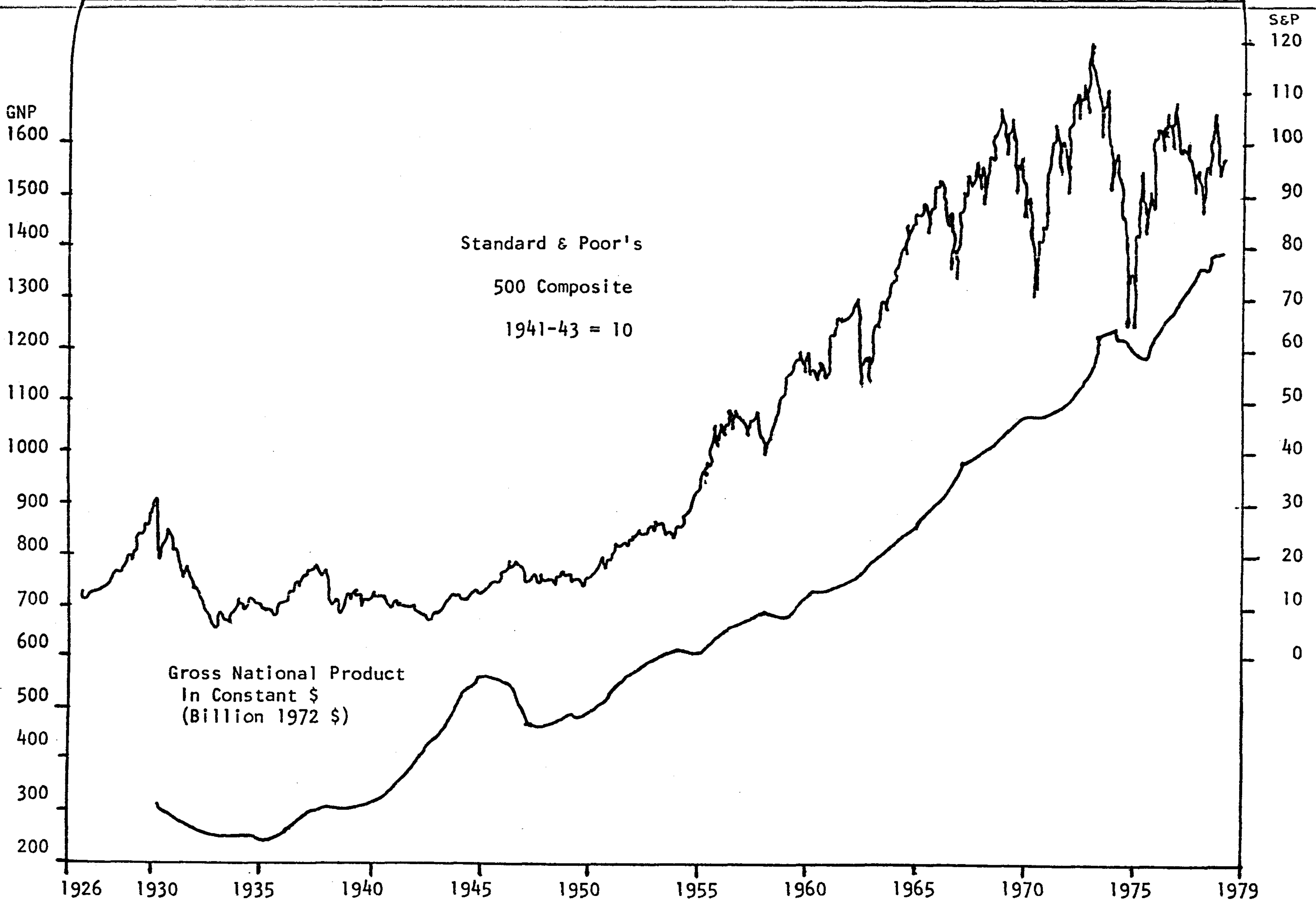
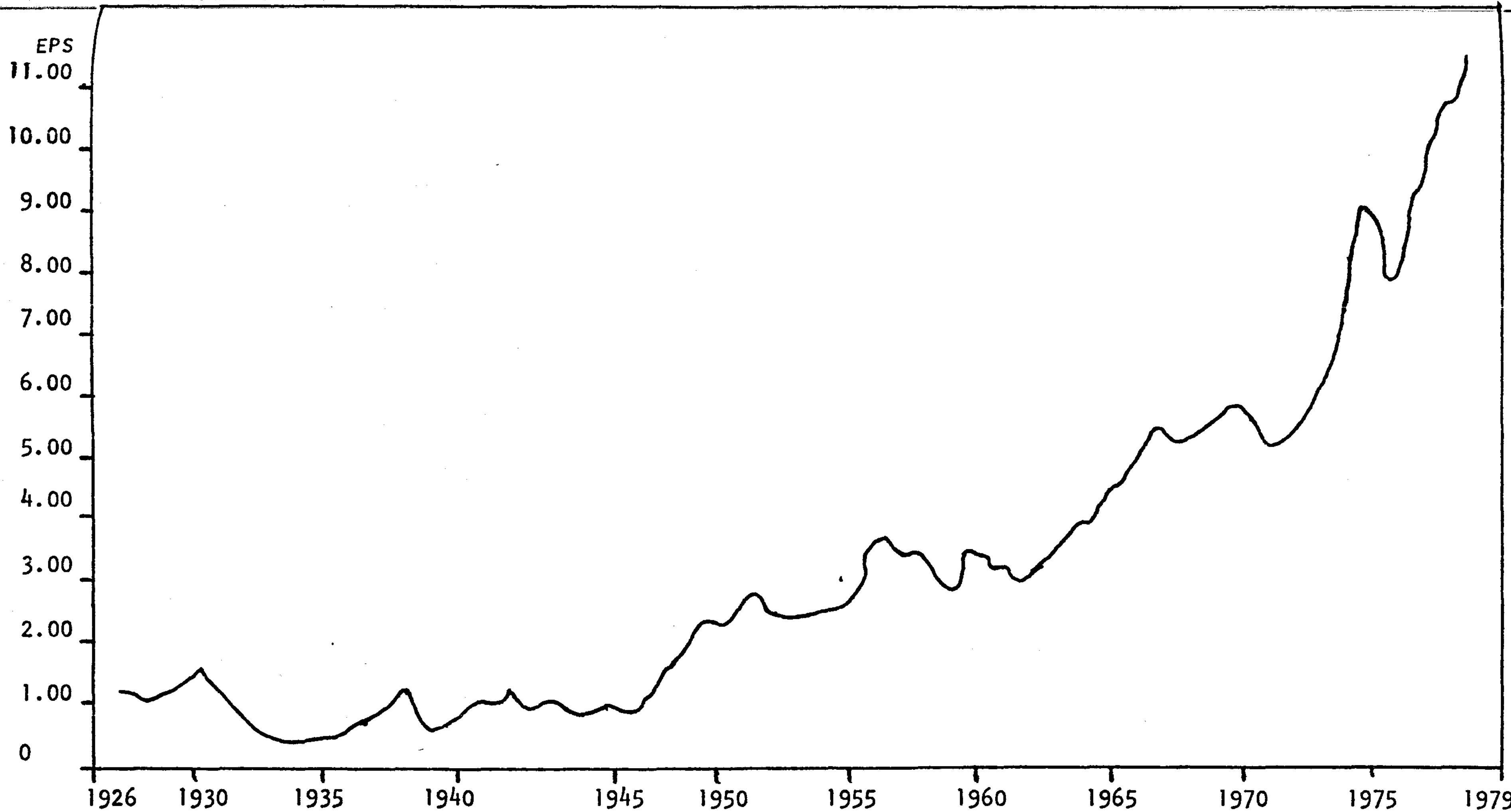
[17]The factors discussed are not intended to cover the many complex forces that constitute background noise but simply to detail the more significant ones to be used in this study. A more comprehensive list can and should be incorporated into more detailed work in this area. Identification here serves to highlight the point for future efforts by the student of political science.

[18]Reference of course is to earnings per share of common stock, a basic gauge of corporate profitability.



Data developed by
S&P's TRENDLINE division

Figure 1 - Standard & Poor's 500 Composite & Gross National Product



Data developed by
S&P's TRENDLINE division

Figure 2 - Earnings Per Share of S. & P.'s 500 Composite

Quarterly earnings at annual rate

among the three is readily discernible. Examination of the curves in the two figures readily shows a close correlation between market moves and gross national product and particularly between market moves and earnings per share.

There is an old adage about the securities industry that whenever a trade takes place, one-half of those involved is wrong. While very simplistic, the statement does illustrate that there must be two parties to a trade, and motives obviously differ since one buys and the other sells. It is not feasible to interview the many traders to establish their reasons and the factors to which they are responding.[19] When there is a preponderance of action on either the buy or sell side, we can identify the market response as positive or negative. The reasons usually are developed by market analysts, frequently after the fact, based upon evaluation of applicable factors extant during the session in question.

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[19]The determination of exactly which of the investing populations is trading at any given time is beyond the scope of this paper and will be used only when such information is available. While such knowledge would be invaluable in determining beliefs of various elites, it is extremely difficult to gain with accuracy. The various populations include such disparate groups as retired persons, businessmen, day traders, foreigners, and institutions, each of which may have quite different motivations. Institutions, in particular, have been having increasing influence, controlling over two-thirds of the NYSE volume by the late 1960's. While they are considered "strong hands" and not expected to react emotionally, the magnitude of their portfolios is so great that dramatic effects can attend even so routine a function as portfolio adjustment.

In short, market movement provides the mathematics of change and subjective analysis provides the operative stimulus. A complication for the observer is the fact that frequently the same factor will be cited for up markets and for down markets. Prior to government actions to support the dollar in 1978, increasing interest rates were deemed to indicate continuing inflation, were bad, and caused down markets. For a period after government intervention, increasing rates were considered evidence of dedication of support for the dollar, were good, and caused up markets. By the summer of 1979, the rationale had reversed again. This kind of interaction lends further support to the random walk and efficient market models, which in turn support the validity of subsequent analysis.

Business Recessions

The most basic factors indicating the health of the economy and, therefore, affecting securities markets are business recessions and periods of prosperity. Despite this fact, identification of those two conditions is far from simple. The conventional wisdom holds that a decline in the inflation adjusted gross national product for two successive quarters constitutes the start of a recession. In actuality, recessions do not merely "happen" in this manner; they are formerly declared by a committee of the National Bureau of Economic Research. This nonprofit organization is comprised of economists, all of whom are prominent academicians from several major universities. Their committee meets at least every six months to determine the state of the economy through analysis of preceding activity. Evaluation is made of literally dozens of indicators among which are statistics covering employment, unemployment, factory output, retail sales, and personal income, a much more complicated process than the widely held notion of decline in GNP. Accordingly, recessions are not so designated when they start but rather after (frequently long after) they already are in existence. In August 1974, Arthur Burns, then Chairman of the Federal Reserve Board, stated that the economy did not "... have ... the characteristics of a cumulative decline in business activity..... In a typical business recession, all or nearly all comprehensive indicators of economic activity move downward simultaneously; this is not the case presently."[20] The worst recession since the 1930's was then nine months old; it was not officially identified until early 1975. Small wonder that the investing public is likely to err on the conservative side in hedging against recessions.

As we shall see, perceived recessions, whether real or imagined, significantly affect the market. Recessions since 1929 are listed in Table 1 for the purpose of establishing actual economic conditions during the period.

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[20]Alfred L. Malabre, Jr., "Tracking a Trend," Wall Street Journal, May 16, 1979, p. 48.

Table 1

Business Recessions

1929 - 1933
1937 - 1938
1948 - 1949
1953 - 1954
1957 - 1958
1960 - 1961
1969 - 1970
1973 - 1975

Most recessionary periods are readily discernible in the GNP curve in Figure 1. It should be noted that the 1945-46 GNP decline resulted because of a shift from a war to a peace economy and did not result from a business recession; earnings were rising. (Figure 2).

Major Market Moves

The purpose of identifying boom and bust economic periods is to determine if there is a rationale for major market moves, which in turn affect consideration of individual events. Examination of Figures 1 and 2 already has established a correlation among the curves. Further review in conjunction with Table 1 reveals that major market trends predominantly are business recession and recovery oriented. Trends traditionally anticipate business cycles, peaking well before a decline in business activity begins and reaching a trough before the recovery is underway. When one considers that the dates of cycles are unknown until well after the fact, one must wonder at this clairvoyance. The answer of course is that investors must incorporate economic changes into their decisions as those changes become known (i.e., the efficient market hypothesis). Market prediction of business recessions has been so consistent that a major bear is considered by many to be a prime--and necessary--leading indicator. The last time a bear market did not perform its role as an indicator was when the market crash of 1929 was accompanied by an almost simultaneous business slump. Since 1953, market down turns have preceded business recessions by from six to 13 months. As we shall see, Paul A. Samuelson essentially was correct in saying that "the stock market called nine of the last five recessions."[21]

In order to derive specific dates of major market moves for use in further analysis, the S&P 500 Composite curve in Figure 1 was examined to establish break points. Price index

[21]Paul A. Samuelson, "The Uneasy Case for Stocks," Newsweek, June 11, 1979, p. 84.

charts then were consulted, specific dates and index values were extracted, and percentages of change were calculated. The results are detailed in Table 2, which establishes not only major bear markets and associated values but also indicates relative severity. Bull markets of course fill the intervening dates between troughs and subsequent peaks.

Table 2

Major Bear Markets

Dates				Values		% Change
Top		Bottom		Peaks	Trough	
September	1929	June	1932	31.92	4.40	86
*February	1934	March	1935	11.82	8.06	32
March	1937	March	1938	18.68	8.50	54
*November	1939	April	1942	13.79	7.47	46
May	1946	June	1949	19.25	13.55	30
January	1953	September	1953	26.66	22.71	15
August	1956	October	1957	49.74	38.98	22
August	1959	October	1960	60.71	52.30	14
*December	1961	June	1962	72.64	52.32	28
*February	1966	October	1966	92.63	73.20	21
November	1968	May	1970	108.37	69.29	36
January	1973	October	1974	120.24	62.28	48
*September	1976	March	1978	107.83	86.90	19

By checking Table 2 against Table 1 we see that those market trends indicated by an asterisk in the former were not harbringers of recession--as Samuelson indicated (see supra, p. 23). Investigation shows, however, that each of those periods except one contained troubling economic indicators that would cause investors to consider that difficult times were ahead.[22] The exception was 1939-1942, to which we shall return in Chapter IV.

Conclusion

The stock market represents an economic environment and, therefore, responds to a multitude of economic stimuli. The degree of response establishes atmospheres of optimism or pessimism. These atmospheres color reactions to individual events and, therefore, must be considered during analysis of those reactions as signifying approval or disapproval of the events. The most basic forms of stimuli are represented by periods of business recession and business prosperity, and the most basic forms of associated atmospheres are represented by bull markets and bear markets. These factors may be quantified, and examination of their interaction shows that investors tend to anticipate periods of economic

[22] Comparison of the curves in Figures 1 and 2 readily shows a GNP drop associated with the 1934-1935 slump and EPS dips associated with 1961 and 1966. The economic difficulties of 1976-1978 should come readily to mind, to include the fact that the period precedes what has become known as the most publicized recession in history, even though as of this writing it still has not been declared.

boom and bust, producing major market trends that lead their related periods of business activity. Despite the many factors that influence prices at any given time, then, if we accept that major market trends are expressions of the random walk and the efficient market models, we can still draw correlations between individual events and market reaction. We must, however, examine objective results in conjunction with subjective analysis of the economic environment to maintain perspective.

The next step logically is to subject specific events to examination to determine if there are in fact market reactions that may be interpreted to signify approval or disapproval. In the next chapter, we shall begin with events that are directly economic in nature to provide some sort of a yardstick by which to gauge other types of events.

Chapter III

Economic Events

General

Economic events were selected as the first group of specific occurrences to be analysed because of their obvious direct relationship to economic health. The events chosen, while resulting from political actions, all could have been expected to have a direct cause and effect relationship with the economy, as opposed to other types of events whose economic effects would be indirect (e.g., appointment of a chairman of the Federal Reserve Board). If the stock market could be expected to react to any specific event in a manner likely to indicate approval or disapproval, it certainly should do so in these cases. A pattern of responses to events indicating that businessmen's attitudes in fact were reflected in those responses logically would indicate that further examination of other kinds of events could be rewarding. The absence of such response would clearly indicate that further analysis would be futile. Consideration of economic events, then, provided a sort of go-no go gauge for the remainder of this study.

There are several other potential areas of interest to the student of political science in this category. If there is a pattern of response, then analysis could be used as a tool in testing the validity of theories about businessmen's attitudes toward specific initiatives in similar areas, such as income redistribution, social security, and the minimum wage. Next, if one has had no particular familiarity with the market, this category provides an opportunity to gain some insight into its actions and reactions in a direct economic environment. Finally, we can gain some perspective of the magnitude of market response --and circumstances under which it occurs--to matters we know should be of significant interest within the financial community. These insights are necessary to make realistic appraisals of the strengths of response to other events which are of more indirect impact on the business world.

Events

The procedures used in the selection-testing process to develop events to be examined already have been detailed (see supra, p. 8). Events to be investigated in this chapter, together with calculated index moves and percentage changes, are tabulated in Table 3. Note that the major market trend extant when each event took place is indicated to aid in analysis. Trends were developed from data in Figure 1 and Table 2.

I want to emphasize that the events in Table 3 represent only a portion of those tested. Since I was not attempting to establish a statistically valid sample, I eliminated many calculations that were merely reinforcing trends already determined. Most such calculations never even were recorded on paper; I dropped them as soon as their import became clear. My purpose, after all, in conducting a large number of tests was to determine if I could find events that produced results deviating significantly from the trend. Accordingly, those events included in Table 3 are intended only to be representative of what I was discovering. My primary criteria were that they be significant events in history,[23] that they cover an extended number of years, and that they represent salient points of analysis that were emerging in my study.

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[23]The problem of saliency surfaced in the Introduction (i.e., an event was perceived at the time to have the importance that it subsequently did have). I was interested to note that there was a higher correlation in this chapter than in those following between events I thought would have a significant market effect and those that did. This correlation no doubt may be attributed to the fact that all events had a direct impact on the economy.

Table 3

Economic Events

Event Number	Date	Event	Index Move	% Change	Next Day Move - %	Market Trend
1	4/20/33	Embargo on gold exports	.68	+ 10	- 5	+
2	4/28/42	Price control regulations issued	.07	- 1	+ 2	Trough
3	11/9/76	Wage price controls removed	.18	+ 1	- 1	-
4	1/1/54	Excess profits tax expires	.14	+ 1	+ 1	+
5a	4/10/62	Steel prices increased	.15	- (0)	- 1	-
5b	4/13/62	Price increase rescinded	.30	- (0)	+ (0)	-
6	2/25/64	Tax cut bill enacted	.03	+ (0)	+ (0)	+
7	8/29/66	Truman warns of recession	1.88	- 2	+ 2	-
8	10/12/66	Administration bars price controls	2.13	+ 3	- (0)	+
9	8/15/71	Wage/price freeze; gold standard terminated	3.07	+ 3	+ 1	- *
10	11/1/78	Dollar decline stemmed	3.70	+ 4	- 1	-

*Period represented a downward correction from April 28 until November 26 in an overall bull market.

Discussion

Each event will be examined and identified with sufficient history to permit judgment as to why it should have been of importance to the market. Analysis in light of applicable economic circumstances then should determine the meaning of the response or lack thereof.

Before beginning analysis of events, however, we may see clearly in Table 3 another facet of the market that tends to distort efforts to deduce reactions to events. The propensity to sell on strength and buy on weakness is discernible from a comparison of first and second day changes in events 1, 3, 10, 2, and 7. Profit taking during an upward move is apparent in the first three while using weakness as a buying opportunity shows in the last two. These two market techniques are fairly common and lend weight to the point that the immediate reaction to events should be sought.

Events 2, 3, 4, 6 can be seen in Table 3 to have caused some reaction but none of any major significance. Each of these events was "telegraphed" well in advance, and, accordingly, the effect of each already was discounted by the time of actual occurrence. Congress enacted and President Roosevelt signed the basic legislation for war time price controls (Event 2) in January 1942. Therefore, when the Office of Price Administration issued implementing regulations three months later, they were no surprise.

Although the most drastic regulations of that nature in the nation's history to that date, the market discounted their effects over time during the legislation process. Similarly, removal (Event 3) was discounted, because President Truman signalled his final action by prior removal of other controls. It is noted that initial market response was negative for imposition (2) and positive for removal (3).

In the case of Event 4, businessmen supposedly would have welcomed the expiration of the excess profits tax with enthusiasm hardly represented by two one percent up days during a bull market. However, Congress had extended the tax for six months in July 1953, making the extension retroactive to June 1. The surprise would have been if it had not expired.

Not only was President Kennedy's now famous tax cut bill (Event 6) very old news by 1964, but also the economy had reversed completely. When he first proposed a tax cut in June 1962, the country still was nearing the bottom of a bear market (Table 2) and the biggest one day market drop since 1928 had occurred about a week previously. However, there never was an opportunity to test business reaction to the cut in the market. By the time a bill was enacted, it had been thoroughly and publicly chewed over, and a bull market was over a year old; thus, no reaction.

The "Kennedy steel crisis" of 1962 (Events 5a-b) often is credited with causing that crash of 1962, as has been discussed.

There certainly is reason to believe that businessmen would register disapproval of strong, direct government interference in business affairs. The crisis began late on April 10 when Roger Blough, Chairman of the Board, informed President Kennedy that U. S. Steel was raising prices, thereby setting off a general industry increase. It ended almost exactly three days later when U. S. Steel rescinded its increases followed again by the other companies. In the interim the administration did everything but mug the steel industry. Feeling the increases inflationary, Kennedy had been enraged and had thrown the weight of government into his "jawboning." Briefly, the following actions were taken: Four antitrust investigations conceived, a bill to roll back steel prices seriously considered, a bill to control steel industry wages and prices discussed, Department of Defense purchases diverted from U. S. Steel, and FBI agents dispatched in the middle of the night to question reporters as their recollections of comments by steel industry leaders. By winning out "...the administration maintained its right to look over the shoulders of capital and labor...."[24] Market reaction was nil.[25] Why? First, the incident did not cause the crash; the bear market already was well underway, having started the preceding December (Table 2). Second, there

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[24]Wallace Carroll, "The Steel Price Crisis of 1962," in Readings in American Political Behavior, ed. by Raymond E. Wolfinger (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1966), p. 123.

[25]Note that a reaction is reflected if the DOW or similar index (i.e., small composition and including U. S. Steel) is used.

apparently was no reason at the time to believe that business would be seriously affected beyond the effect of other economic factors. The consumer price index was rising and the monetary gold stock was at its lowest level since 1939, but GNP was continuing to rise (Figure 1), as were earnings per share (Figure 2).

The two events in 1966 (Events 7 and 8) did engender significant reactions in the market. Neither event was anticipated, and each reinforced an atmosphere prevalent at the time. Accordingly, each represents an example of a relatively insignificant event causing a reaction out of proportion to its importance. Considering Event 7, note that February-October 1966 produced a major bear market (Table 2). The business outlook was gloomy largely due to rising inflation and a heating up economy. The December rise in the consumer price index (not reported until March) was the highest since 1950. Banks' prime interest rates and government backed mortgage rates were rising. The Dow Jones Industrials on March 7 recorded the largest drop since President Kennedy's assassination. Cost of living and wholesale price indexes were rising, and the stock market decline on July 25 exceeded the March 7 drop, with the S&P 500 Composite index falling off 2% for August. The Wall Street Journal reported that France had been converting dollars into gold for 18 months and that the United States stock of monetary gold was falling. In short, a bearish sentiment was pervasive by August. Accordingly, when ex-President Truman warned that rising interest rates could lead to " ... a serious depression,"[26] he reinforced a trend already well underway, even though he was speaking as a private citizen, and a significant drop was recorded.

Subsequently, circumstances began to develop for Event 8. Inflation eased, balance of payments deficits fell, the wholesale price index stabilized, and the Administration announced plans to help reduce interest rates. Concurrently, the economy (Figure 1) and earnings (Figure 2), although easing, were still on the rise, and indicators were pointing away from a recession. The market was looking for an excuse to turn and recorded a significant rise on September 12. When Commerce Secretary John T. Connor said in October that he thought there would be no imposition of controls on the economy, he simply reinforced a bullish view that already was rising in the market, and an up market occurred.

The other three events (1, 9, and 10) were sudden, dramatic and unanticipated. Each of the three had, on its own merits, a significant impact on the market when it occurred. Each was perceived as a strong action necessary to correct a serious economic

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[26] Facts on File (New York), XXVI, No. 1352 (1966), p. 367.

problem. After Franklin D. Roosevelt took office in 1933, he initiated a series of steps aimed at bringing the country out of the Great Depression. His embargo on gold exports (Event 1) followed gold anti-hoarding measures and preceded fixing the price of gold at $35 an ounce. Economists still debate the effectiveness of the steps, but at the time they were perceived to be bold and imaginative, which, indeed, was the plan.

The economy under President Nixon in 1971 was similar to the one under President Johnson in 1966 (see Event 7). Gross National Product (Figure 1) and earnings (Figure 2) both were rising. However, so were inflation and unemployment --accompanied by a succession of balance of payment deficits and massive speculation against the dollar. Without warning, on August 15, President Nixon (Event 9) ordered a 90-day freeze on wages, rents, and prices; ended the traditional convertibility of the dollar into gold, effectively devaluing the former; ordered a $4.7 billion cut in federal expenditures; and proposed tax incentives for industry. The markets responded with a significant rise.

The largest one day market rise in history took place on November 1, 1978 (Event 10). The economy had been strong despite warnings of a recession, the predicted onset of which was delayed with each successive report of business indicators. The major economic problems facing President Carter were rising inflation and a dollar falling steadily against world currencies under heavy speculation. Following a long period of "benign neglect" of the dollar, the Administration announced suddenly a policy of strong support: the United States would intervene massively in currency markets, quintuple the sale of gold, and increase the federal discount rate sharply. The dollar and the stock market responded strongly, the former rising against world currencies and the latter marking its record increase. Many economists and world bankers felt the effort was too little, too late. However, generally in financial markets the event was considered a positive initiative to correct an uncertain and deteriorating situation.

Conclusion

The stock market will respond to single economic events in such a manner that investors' attitudes of approval or disapproval may be determined. Further, such response is not dogmatic (reaction to price controls appears as negative in Events 2, 3, and 8 and positive in Event 9). There are, however, inhibiting factors in analysing market moves to determine attitudes.

Overall economic conditions can create atmospheres that cause reactions to be stronger than causative events actually warrant, indeed to the extent that insignificant events may engender strong responses. Events creating the strongest reactions are those that are surprises to the public. Conversely, very significant events may be thoroughly discounted in the market and engender little apparent reaction if they are known about well before they occur. Strength and duration of response may be affected by profit taking or bargain buying. Accordingly, there is little likelihood of a sustained response to a single event. Briefly, the economy, the amount of prior knowledge, and market strategies all will filter responses to events.

Having established that there are responses to economic events, the next step is to determine the nature of response, if any, to events not of direct economic effect. In so doing, it may be possible to determine businessmen's attitudes in a given area, since the next chapter will address one category of events, i.e., war and peace.

Chapter IV

War and Peace Events

General

> In the hard-core ideological literature, it is often asserted that war is good for business, and that the roots of American military intervention can be traced to Wall Street and the interests of finance capital. In the business community, on the other hand, it is commonplace that the efficient conduct of international exchange requires domestic and international economic stability, making capital inherently an ally of peace rather than war.[26]

The ideological conflict enunciated by Rosen certainly is central to the theories representing socialist and market economies, to include variations in between. Russett and Hanson provide a comprehensive version of the "merchants of death" side of this conflict: " ... The aggregate level of demand in the entire capitalist economy can be maintained only by 'excessive' military spending, and that, in turn, requires a level of international tension and even active hostilities."[27] This attitude they trans-

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[26]Steven Rosen, "Testing the Theory of the Military-Industrian Complex," in Testing the Theory of the Military-Industrial Complex, ed. by author (Lexington, Mass.: D. C. Heath and Company, 1973), pp. 15-16.

[27]Russett and Hanson, Interest and Ideology: The Foreign Policy Beliefs of American Businessmen, p. 12.

late as a simple Marxist perspective imputing "...to businessmen a belief that war is good and necessary for the capitalist American economy."[28] Radway broadens the constituency for this side of the ideological argument: "It is taken as an axiom, not only by Marxists but by intellectuals the world over, that the 'hard line' in contemporary American policy stems from the self-interest of a profit-seeking elite...."[29] The literature on this subject is voluminous; yet, the debate rages on, without resolution and with very little scientific testing.

It is not the primary purpose of this paper to test businessmen's beliefs, but rather to test the validity of using the stock market as an indicator of their beliefs. However, by concentrating only on the issues of peace and war in the chapter, a reflection of investors' attitudes should appear if the market does in fact function in accordance with the random walk and efficient market models. Again, the intent is not to develop the actual economic effects of war and peace but rather to develop a measure of investors' perceptions about those economic effects. Certainly, such an effort--and this is but a beginning--is necessary if the ideological conflict identified by Rosen (see supra, p. 39) is to be

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[28] Ibid., p. 147.

[29] Laurence I. Radway, Foreign Policy and National Defense, p. 128.

tested. As Hanson and Russett have stated,

> Any effort to understand the causes of contemporary American military activity abroad must address itself to the perceptions and preferences of American investors; analysts of every ideological persuasion must face the evidence of these questions openly.[30]

Certainly, if the "merchants of death" or related philosophies have any validity, a reflection of investors' perceptions should indicate that international tension, or even war, is considered desirable.

Events for this chapter are displayed in Table 4. They were selected using the same testing procedures described previously. Again it should be noted that many more occurrences were tested than were finally chosen. I used the same rationale in choosing that I used before: I retained a cross-section of events I considered representative of trends that developed during testing, and I discarded additional events the pattern of which merely reinforced those already selected. I specifically wanted to include however, those events that signalled the direct involvement of the U. S. military forces in each of the last three wars as well as the events that terminated those wars. Also, in a few cases, I have included several incidents generally considered to be part of the same

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[30]Betty C. Hanson and Bruce M. Russett, "Testing Some Economic Interpretations of American Intervention: Korea, Indo-China, and the Stock Market," in <u>Testing the Theory of the Military-Industrial Complex</u>, p. 23.

crisis. I took this approach, because I felt there was value in determining if there were significant differences in reactions to successive events during a crisis. Note at the outset that in no case did any of the events coincide with the start of a market trend (Tables 2 and 4 and Figure 1); hence, none caused either a bull or a bear market.

Table 4

War and Peace Events

Event No.	Date	Event	Index Move	% Change	Next Day Move - %	Market Trend
1	9/29/38	Munich pact	.42	+ 4	+ 3	+
2	9/ 1/39	Poland invaded	.12	+ 1	+ 2	+
3	6/22/40	France surrenders	.07	+ 1	+ 1	-
4	6/22/41	Russia attacked	.16	+ 2	- (0)	-
5	12/ 7/41	Pearl Harbor attacked	.41	- 4	- 3	-
6	5/ 7/45	German surrender	------- flat ---------			+
7	8/ 6/45	Hiroshima bomb announced	.04	+ (0)	- 1	+
8	8/ 9/45	Nagasaki bomb dropped	.24	+ 2	flat	+
9	9/ 2/45	Japanese surrender signed	------- flat ---------			+
10a	6/25/50	South Korea attacked	1.03	- 5	- 2	+
10b	6/27/50	U.S. force authorized	.2	- 1	+ 1	+

Table 4 - War and Peace Events - continued

Event No.	Date	Event	Index Move	% Change	Next Day Move - %	Market Trend
11	7/26/53	Korean fighting ceases	.16	- 1	+ (0)	-
12a	4/17/61	Bay of Pigs invasion	.31	+ (0)	- (0)	+
12b	4/20/61	Bay of Pigs fails	.01	+ (0)	- (0)	+
13a	8/13/61	East German border sealed	.33	- (0)	- (0)	+
13b	8/15/61	Berlin Wall begun	.17	- (0)	+ (0)	+
13c	8/18/61	Kennedy orders troops to Berlin	.18	+ (0)	+ (0)	+
13d	8/20/61	U.S. troops arrive Berlin	.14	+ (0)	+ (0)	+
13e	8/22/61	Berlin foreign travel restricted	.01	+ (0)	- (0)	+
13f	8/23/61	USSR accuses allies	.46	- (0)	- (0)	+
14a	10/22/62	Cuban crisis - quarantine	1.47	- 3	+ 3	+
14b	10/28/62	Cuban crisis - resolution	1.18	+ 2	+ 1	+
15a	8/ 4/64	N.Vietnam attacks U.S. destroyer	1.04	- 1	+ (0)	+
15b	8/ 7/64	Tonkin Gulf resolution passed	.52	+ (0)	- (0)	+
16	1/30/68	Tet offensive	.65	- (0)	+ (0)	+
17a	8/ 3/68	USSR Czech confrontation	.22	+ (0)	+ (0)	+
17b	8/10/68	USSR announces combined manuvers	1.00	+ 1	+ (0)	+
17c	8/20/68	Czechoslovakia -- invaded	.04	- (0)	- (0)	+
18	1/27/73	Paris peace agreement	.44	- (0)	- (0)	-
19a	5/12/75	Mayaguez seized	.08	+ (0)	+ 1	+
19b	5/14/75	Mayaguez crew rescued	.69	+ (0)	- 1	+

Peace Events

Review of Table 4 quickly shows that peace events associated with the ending of open hostilities were of no particular significance insofar as market response is concerned on the days during which they occurred. For example, and using the two most extreme cases, in spite of the spontaneous, public jubilation that accompanied the formal signing of the German and Japanese surrenders ending World War II (Events 6 and 9), stock market reaction was nil. During the period of both surrenders, the economy was sound, and a bull market was in full sway (Table 2 and Figure 1). More significantly, an allied victory had become increasingly apparent during the preceding year, and knowledge of surrender ceremonies was known to the public well in advance of the actual signing. Similarly, the formal ending of the Korean and Vietnam Wars (Events 11 and 18) elicited no significant response, certainly nothing not in keeping with the bear markets already extant in each case (Table 2 and Figure 1).[31] Also in each case, the formal agreement on the termination of hostilities followed a protracted period of negotiations, and the final acts largely were non-events, at least from the standpoint of the stock market. In any case, there is little doubt that the four incidents reviewed were major events in history, but their

[31]Event 11 illustrates yet another difficulty in measuring the meaning of responses in the absence of subjective analysis. When an event has been known (or even rumored) well in advance of its occurrence, frequently investors will "sell on news" when the event actually happens, thereby actually producing a negative reaction to an event that in reality is perceived as good for business.

effects already had been discounted in financial markets by the time they took place. A better picture of the market's reactions to peace, as opposed to reaction to one event, is seen in Figure 1: the market continued its rise after Events 6 and 9, began a rise immediately after Event 11, and dropped after Event 18. In the latter case, however, the market was reacting to indicators showing that an overheated "guns and butter" economy was leading into the worst recession since 1930.

Events 7 and 8, unlike the previous four, were developments that led to peace. The dropping of an atomic bomb on Hiroshima was announced to the American public on August 6, 1945, followed by the announcement of the Nagasaki bomb three days later. The first, not just a surprise but unique at that time, elicited little response. The second, while no longer unique but still a surprise, elicited a strong, positive reaction. The second bomb injected a new factor into contemporary thought in that it indicated, although incorrectly, that the United States possessed not one but an arsenal of atomic horrors. As such, the Nagasaki bomb probably engendered hopes of shortening the war that were missing in the first explosion.

Signing of the Munich pact (Event 1) in 1938 by Germany, Great Britain, Frace, and Italy was not a peace treaty and ended no hostilities. Intended as a war avoidance pact, it ceded a large part of Czechoslovakia to Germany and is widely regarded today as an act of appeasement actually contributing to World War II. However, the "peace in our time" promised by Great Britain's Prime Minister at the conclusion of the conference came as a welcome surprise to the American people. Review of Figures 1 and 2 shows that this country was still pulling itself out of the Great Depression and the market was on the rise. It is highly possible, therefore, that the event reinforced market optimism, engendering an unduly high, positive response out of keeping with the strength of actual perceptions.

The "merchants of death" thesis does not necessarily lead to a corollary that capitalists dislike peace after an actual period of hostilities. In any event, there is nothing in the reactions to the incidents examined to indicate a predisposition for war. Quite the contrary. Predictable events were discounted in the market prior to occurrence; bold, surprise events registered strong reactions; and all reactions were in keeping with their existing major market trends.

War Events

The German invasion of Poland (Event 2) officially began World War II. However, there was no way that the investing public could have been aware of that fact at the time. The market ostensibly showed a mild positive move, but it is entirely possible that the reaction was more in response to the underlying bull market and recovering economy than to the invasion. Americans, still feeling close to the Great Depression, were very sensitive to the state of the economy, and as the EPS and GNP curves in Figures 1 and 2 show, the economy had troughed and was in a strong upward trend. The United States was strongly isolationist at the time, and the Congress already had passed several neutrality acts. There was a prevalent feeling that the affairs of Europe should not affect the United States. While " ... the majority of American public opinion was in favor of the Allies, there was not much inclination to side with them actively. Experiences after World War I had a sobering effect, and too, it was widely believed that Allied victory was assured anyway."[32] Additionally, the invasion, while unwelcome, was no real surprise; Germany had been building pressure overtly against Poland since the preceding March.

The German attack on Russia (Event 4) was a different situation. There was no warning of the attack, and there was no bull market to encourage price increases. Further, the United States did not feel itself as removed from European affairs as before. The market response to Event 4 was a fairly strong up move. I can not rationalize this move except through my personal belief that it represented approval of dual perceptions: the threat to the United States was lessened by a split between the two former allies, and Nazism and Communism conceivably could render one another ineffective.

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[32]"World War II," Encyclopedia Americana, 1949, XXIX, 556p.

The French surrender to the Germans in 1940 (Event 3) was not a peace event to the United States, but a war event. In retrospect, it should have been a major act disabusing the rather wistful U.S. feeling that the Allies would prevail. The evacuation of British forces from the continent in early June and the fall of France certainly neither lessened the chances of American involvement nor indicated an early end to the war. The market, again ostensibly, gave a minor positive response. However, the political and military collapse of France increasingly had been assured for well over a month, and the surrender ceremony merely confirmed what was already a fact. "War is bullish" advocates should note that during the latter part of May and early June, while the fate of France was being determined, the market dropped 3.13 or 26%.

When the Japanese attacked Pearl Harbor without warning (Event 5) in 1941, it was a profound, unexpected shock to the American people. There now was no question that the United States was in the war. The Japanese declaration of war was December 7, and the U.S. followed suit the next day. The collapsing market, clearly identifiable in Table 4, indicates investor response. In fact, this point begs examination of the 1939 - 1942 bear market, the only one in this study that does not seem to follow economic indicators. There was some inflation, but, as Figures 1 and 2 show, the economy was strongly upward during the period. However, as the upper curve in Figure 1 shows, investors obviously were showing a very bearish reaction, a reaction for which I have no explanation except for pessimism about the increasing likelihood of war and the early military setbacks once the U.S. was in the war. It was not until the Allies stemmed, and then began to reverse, Axis successes in North Africa and the Pacific in 1942 that a bull market began. In any event, the entire period is an exception to the rule that the stock market tracks economic indicators.

Although preceeded by terrorism, border incidents, subversion and propaganda barrages, the overt North Korean attack on the Republic of Korea (Event 10) was an unwelcome surprise. The likelihood of American involvement was perceived to be strong from the outset in light of officially expressed concern prior to the attack. In spite of a strongly recovering economy and a bull market (Figures 1 and 2), market response was extremely negative to the attack (10a) and continued to register negative reactions for the succeeding two days, to include the day President Truman authorized the use of U.S. military forces against the North Koreans (Event 10b).

The Cuban missile crisis (Event 14) began for the United States on October 16, 1962, when President Kennedy first learned of the implacing of Russian missiles and nuclear weapons in Cuba. Between then and the time of Kennedy's televised address to the nation, on October 22, the American people became well informed concerning the situation as it existed. However, the president's address still came as a shock: The United States was imposing a naval and air quarantine on the shipment of offensive weapons to Cuba, and U.S. forces were making " ... all the preparations for further military action."[33] Now, from the President of the United States, the full ramifications of the crisis were made clear, and the world knew that the nuclear superpowers were engaged in a direct, military confrontation for the first time, bringing " ... the world to the abyss of nuclear destruction and the end of mankind."[34] A strong economy and a bull market did not prevent a strong, negative initial reaction. Subsequently, after recovering, the market emulated the rest of the world by doing nothing while the crisis developed, ending the period about where it began. Then, on October 28, President Kennedy announced the USSR decision to dismantle and withdraw its offensive weapons from Cuba. (Event 14b). Market response was sharp and positive.

The last crisis eliciting a discernible response, albeit slight, was the Tonkin Gulf incident (Event 15) when there was a slight drop in a strong bull market. Perhaps the reason for the relatively mildly disapproving reaction to the North Vietnamese PT boat attacks on U.S. destroyers was that American involvement in

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[33] Robert F. Kennedy, _Thirteen Days: A Memoir of the Cuban Missile Crisis_ (New York: W. W. Norton & Company, 1971), p. 33.

[34] _Ibid._, p. 1.

Vietnam had been growing steadily since 1962. U.S. facilities in Vietnam had been attacked previously, frequently with resulting casualties. There was no way that the public could forsee that either this event or the subsequent passage of the Tonkin Gulf resolution (Event 15b) would develop into the morass of the Vitenam War with its massive deployment of U.S. land, sea, and air forces. No particular significance was attached to an attack by a country with essentially no Navy against U.S. destroyers nor to subsequent retaliatory air strikes. It is interesting to note that while it cannot be directly attributed to increasing involvement, the market dipped 4% between November 20 and December 16, 1964, as growing military intervention became apparent. Of course, it could have been but a "technical correction" during a bull market.

The Tet offensive (Event 16) could have been expected to engender strong disapproval in financial markets. It was totally unexpected and created widespread dismay in the United States. Although now recognized as an overwhelming military disaster for the North Vietnamese, at the time, largely because of exploitation by Senator Eugene McCarthy and others, it was widely perceived as a decisive Communist victory. During the night of January 30, 1968, Communist forces launched their most coordinated offensive of the war. While suffering heavy casualties, they attacked major cities, provincal capitals, a number of district towns, and U.S. and Republic of Vietnam military installations. John Spanier summed up the reaction: "It was the beginning of the end for the United States in Vietnam, as American opinion, already beset by doubts about the wisdom and costs of the war, became increasingly disillusioned."[34] Market reaction was nil. Apparently the operative words in Spanier's summation were "beginning" and "increasingly." Lorie and Hamilton, in their analysis of the effects of the Vietnam War, point out that " ... dissatisfaction did not seem to be as acute and violent prior to 1969 as it did in 1969 and 1970,"[35] when, of course, severe economic strains were evident. In any event, at the time of Tet, the event was not perceived as having strong economic consequences. The market was willing to wait and see.

The same "wait and see" attitude is reflected in all of the remaining events (12, 13, 17, and 19). While important incidents in the affairs of nations, they were not considered necessarily to lead to war or to have significant ramifications for financial markets.

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[34]John Spanier, Games Nations Play: Analyzing International Politics (New York: Praeger Publishers, 1972), p. 185.

[35]Lorie and Hamilton, The Stock Market: Theories and Evidence, p. 9.

Irving L. Janis tells us that "the Kennedy administration's Bay of Pigs decision ranks among the worst fiascoes ever perpetrated by a responsible government."[36] (Event 12). After a brigade of Cuban exiles invaded Cuba at the Bay of Pigs, everything went wrong, and within three days all of its members either were killed or captured. While undoubtedly it was a fiasco, at the time the American people had no reason either to know that the United States was backing the scheme with military and CIA resources or to believe that there were economic consequences for the U.S. The invasion was unexpected, but it did not have perceived relevancy to those involved in the stock market.

Several incidents associated with the "Berlin Wall" crisis (Event 16) were examined: East German sealing of the border to East German travel (Event 13a), beginning work on building the wall itself (Event 13b), President Kennedy's ordering U.S. troops to travel by autobahn from the West Zone of Germany to Berlin (Event 13c), Vice President Johnson's greeting American troops upon their arrival in Berlin (Event 13d), East Germany's restricting foreign travel to but one Berlin crossing point (Event 13e), and the Soviet Union's accusing the three Western powers of abusing their rights of air access to Berlin (Event 13f). There were other incidents leading up to those

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[36] Irving L. Janis, Victims of Groupthink (Boston: Houghton Mifflin Company, 1972), p. 14.

listed and more following, all of which were contributors to a high level of international tension. These six were selected to reflect the manner in which the market reacts to events in a crisis which does not appear directly to entail major armed conflict by American forces. The relevancy was there and the potential for war was there, but obviously investors did not believe there would be a military clash. Public statements on all sides carefully avoided threatening armed conflict, and similar incidents had occurred before (e.g., the Berlin air lift). The market felt reasonably secure in waiting and seeing.[37]

The incidents surrounding the 1968 invasion of Czechoslovakia (Event 17) also had a potential for U.S.—USSR military confrontation, but such a possibility was remote and would have entailed a Russian invasion of Western Europe. Further, the Soviets had invaded a satellite, Hungary, before without causing

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[37]Russett and Hanson also found evidence of the "wait and see" attitude during periods of international tension directly involving the United States. As they discovered, once the situation became clear and uncertainties removed, investor decisions on trading would be based upon perceptions of the effect of the clarified situation on corporate profits. These findings, I feel, support the conclusion that stock market response is not systematic in favoring international tension. See Russett and Hanson, Interest and Ideology: The Foreign Policy Beliefs of American Businessmen, pp. 146-147.

a confrontation with the United States. Again several events representing the crisis were selected from among the many, leading up to and including final, open conflict. The three selected were the confrontation in Prague between representatives of the Dubcek regime and the Warsaw Pact (Event 17a); the Moscow manuvers adjacent to Czechoslovakia (Event 17b); and the subsequent invasion of that country by elements of the Soviet, East German, Polish, Hungarian, and Bulgarian armies (Event 17c). As before, the purpose of this sequential analysis was to portray a pattern, if any, of market response to significant events during the crisis.

The Mayaguez (Event 19) incident did involve direct combat action by U.S. military forces. A Cambodian gunboat seized the United States ship and its crew of 39 in international waters in the Gulf of Siam 60 miles off of the Cambodian coast. Two days later 200 Marines supported by carrier-based air strikes on Cambodian gunboats and an air base landed on Tang Island and boarded the now empty vessel. The crew subsequently was rescued at sea from a Thai fishing boat. Each of these events came as a surprise to the public. However, the U.S. military operation, a raid, was so swift that by the time it was made public it was practically over. President Ford through his press secretary even offered during the initial announcement of the raid to cease operations if the crew were released. There also was a precedent, at least for the seizure, in the North Korean capture of the U.S.S. Pueblo. No one was concerned that Cambodia would attack the United States, and administration handling of the incident together with its short duration avoided raising the specter of "another Vietnam." In an event, there was no market respone to either the seizure or the raid.

Conclusions

The stock market reacts to individual events of international tension, permitting a judgment as to investors' beliefs concerning the economic effects of war and peace. However, reactions may be filtered by an atmosphere associated with attitudes toward the underlying market trend, by market strategies, and by the degree of surprise associated with the event. Therefore, price fluctuations must be considered in light of prevalent economic conditions, particularly in making judgments as to the strength of reactions.

Formal peace events involving the United States (i.e., the signing of treaties) tend to be known well in advance, are thoroughly discounted in the market, and engender no reaction significant enough to gauge investors' attitudes other than to indicate that they are not considered undersirable. Incidents leading to peace or to avoidance of involvement of the United States in a major war elicit strong, favorable responses, particularly if unexpected. Alternatively, incidents either involving the United States directly in significant, armed conflict, or seriously threatening to do so, engender strong, negative responses. In this respect stock market responses to acts of war involving the U.S., either real or perceived, tend to be systematic in that such responses uniformly are strong and negative. Other events of international tension not perceived as significantly affecting the U.S. produce no significant reaction. Rather, the stock market continues to register fluctuations in keeping with its recent history and the major market trend extant. Accordingly, as regards this work, the "merchants of death" theory is without validity. Capitalists as represented by American investors do not regard war and international tension as beneficial for the economy and, therefore, do not find them to be desirable.

Having determined that the stock market exhibits efficient market characteristics for events of international tension as it does for economic events, it remains to be seen if the market can be used as a barometer of businessmen's attitudes toward other occurrences that do not have such obvious, high impact potential. Accordingly, responses to lower potential events will be considered in the next chapter.

Chapter V

Miscellaneous Events

General

> If it happens once in the stock market, it's a trend; if it happens twice, it's a tradition.
>
> ---Saying

Events directly affecting the economy understandably may evoke strong reactions of pessimism or optimism from the investing public. We have seen that war and the threat of war, equally understandably, evoke strong negative reactions, which may be quite divorced from actual economic conditions and market trends. But what of traumatic and/or highly significant events that, while of great impact on contemporary society, do not threaten war or have discernible economic ramifications? The purpose of this chapter is to examine such significant, often emotional, events in an effort to determine if businessmen's reactions to them may be identified from their stock market decisions to hold, buy, or sell. The random walk and efficient market models permit such determination if there is a pattern of price change fluctuations responding to selected events.

Events

Events selected for examination are in Table 5. I used the same select-test-retain-discard process that I have de-

Table 5

Miscellaneous Events

Event No.	Date	Event	Index Move	% Change	Next Day Move - %	Market Trend
1	4/12/45	Roosevelt dies	.01	- (0)	+ 1	+
2	9/24/55	Eisenhower heart attack	3.02	- 7	+ 2	+
3	6/ 8/56	Eisenhower ileitis	.85	- 2	+ 1	+
4	10/ 4/57	Sputnik launched	.35	- 1	- 1	-
5	1/31/58	Explorer I launched	.02	+ (0)	+ 1	+
6	11/22/63	Kennedy assasinated	2.01	- 3	+ 4	+
7	3/31/68	Johnson declines to run	2.28	+ 3	+ (0)	+
8a	7/15/71	Nixon announces China visit	.06	+ (0)	- (0)	+
8b	2/21/72	Nixon arrives Peking	.01	+ (0)	+ (0)	+
9a	9/16/73	OPEC price increase	.29	- (0)	- (0)	-
9b	10/16/73	Arab-Israeli War	.38	+ (0)	- (0)	-
9c	10/17/73	Oil price/tax hike	.22	- (0)	- (0)	-
9d	10/18/73	Arab oil embargo	.04	flat	+ (0)	-
9e	11/25/73	Embargo countermeasures	2.86	- 3	- 1	-
10	8/ 8/74	Nixon resignation	1.08	- 1	- 1	-
11a	11/15/77	Begin invites Sadat to Israel	.61	+ (0)	- (0)	-
11b	11/17/77	Sadat accepts	.29	- (0)	+ (0)	-
11c	11/26/77	Sadat arrives	.08	- (0)	+ (0)	-
12a	8/11/78	Camp David Summit announced	.30	+ (0)	+ (0)	+
12b	9/ 8/78	Talks begin	1.37	+ 1	+ (0)	+
12c	9/17/78	Documents signed	.91	- (0)	- (0)	+
12d	9/18/78	Accord made public	Same - 17th on Sunday			+

scribed in previous chapters. My intent deliberately was not to concentrate on a category of incidents or even on incidents similar in nature. Rather, I specifically wanted to examine a variety of events to determine if there was a pattern of market reactions, thereby validating judgments as to investors' attitudes. I found myself being led by curiosity in my search more in this chapter than in the others, however. Having calculated one response to the death of a "sitting" President, I found that I wanted to examine similar episodes (to include death scares) in order to establish whether the single instance was an aberration or symptomatic. (A glance at Events 1, 2, 3, and 6 in Table 5 readily reveals why I felt these reactions were worth retaining as a group.) I then found myself mystified as to the significance of the market response pattern that developed. The next logical step seemed to be to explore the possibility that the pattern would be repeated for an unexpected incident of a serving President's simply leaving office under crisis circumstances before his generally anticipated departure. This search, in turn, led me to test President Nixon's resignation and President Johnson's decision not to run for another term.

Although I was not seeking events with strong economic overtones, some (e.g., the Arab oil embargo) obviously have such connotations. My basic intent was to use a representative sampling of events considered "block busters" by contemporary political scientists.

Presidential Health

Under the heading of "Presidential Health" are those events (1, 2, 3, and 6) either involving the death of a President in office or threatening the death or disability of such a President. It is interesting to note the similarity of market reactions to President Eisenhower's illnesses (Events 2 and 3) and President Kennedy's assassination (Event 6), and the startling contrast between those and President Roosevelt's death (Event 1). There is no reference material bearing specifically on this phenomonon of which I am aware. Accordingly, my analysis must be subjective in a search for an explanation.

Franklin D. Roosevelt (Event 1) was controversial throughout his career. There were few neutrals concerning him; most people either idolized him or detested him.[38]

[38] Vermont Royster, retired editor of The Wall Street Journal and still a frequent contributor, was a journalist during the terms of the last eight Presidents. Accordingly, I feel his views are germane: "Of the eight, FDR was certainly the most popular in terms of votes. He was also among the most excoriated of Presidents. Though in a voting minority, those who hated him were legion and they made no secret of their dislike for the man as both person and President. They were vociferous, even vicious; the mere mention of his name would throw many of them into near apoplexy." See Vermont Royster, "Thinking Things Over," Wall Street Journal, Sep. 13, 1979, p. 26.

The only man to be elected to the Presidency more than twice, he was in his thirteenth year and fourth term in office when he died, quickly and unexpectedly, of a cerebral hemorrhage while on vacation in Warm Springs, Georgia. At the time, the country was still at war, and the Vice President, Harry S. Truman, was little known nationally and had been in office for just over three months. Furthermore, he "... looked and talked like ... a failed haberdasher." Merle Miller summed up the reaction: "... I was feeling ... frightened. I remember saying ..., 'My God, now we're left with Harry Truman. Are we in trouble?'"[39]

From insights gained thus far into the financial market's reaction to news, all the elements would seem to have been in place for a strong reaction. There actually was little time for reaction the day of his death, as he was striken about 1:00 P.M. and died at 3:35 the same afternoon. However, review of market activity for the two-day period shows that there was no discernible interruption in the steady, upward trend that characterized the entire year. The question is, "Why?" I must rely on conjecture to develop the answer, but I feel that it is important to do so in light of reactions to Events 2, 3, and 6.

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[39]Merle Miller, Plain Speaking: An Oral Biography of Harry S. Truman (New York: Berkley Publishing Corporation, 1974), p. 206.

I believe the basic answer is that the people of the United States were superbly confident and close to being unshakeable in April 1945. A massive American military machine was bringing World War II to an end. The Great Depression was well into the past, and the economy was strong with corporate earnings having not yet peaked (Figure 2). The stock market (Figure 1, Table 2) was in the midst of a four-year upturn. Americans perceived their country to be in fact the strongest nation on earth, militarily and economically.

Dwight D. Eisenhower (Events 2 and 3) was relatively popular as a President, a father figure to many and a war hero to most.[40] The nation had been at peace since shortly after his taking office. His Vice President, Richard M. Nixon, was relatively well known, although not well liked and vaguely not trusted by many.[41] In light of the reaction to Roosevelt's death these facts do not set the stage for the stock market's reaction to each of Eisenhower's sudden and unexpected illnesses. Despite a bull market (Table 2 and Figure 1), the response in each case was a very strong, downward movement, at least on the first day. Later in the first day and on the second in each case, bargain buying

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[40]"It seems that personal attractiveness is an asset in getting elected.... Eisenhower had it...." See Royster, Wall Street Journal.

[41]"Introverted, cold, aloof, his winding path ... was strewn with enemies, political and personal." See Ibid.

into the sharply dropping prices took place. Reaction to his heart attack (Event 2) was the more severe of the two. However, the figures do not give a comprehensive picture of true response to Event 3. He was stricken with ileitis on June 8, 1956, and emergency surgery was performed at 2:59 A.M. the next morning, a Saturday. By Monday, the next market day, medical reports were favorable. Nevertheless, after two days for investors to digest the news, the price index closed down 2%, and that did not tell the true story, since the market " ... regained about 60% of lost ground later June 8 and June 11."[42] Again, the question is, "Why?" Again, I believe the answer lies in the confidence level of the American people.

The basic uncertainty in both Events 2 and 3 was, of course, reflected in the questions of survival, death, or incapacitation. The circumstances of Eisenhower's heart attack were further complicated by constitutional questions not associated with Events 1, 3, and 6 in that, in the event of his incapacitation, procedures had not been established either for formal determination of incapacity or for delegation of Presidential powers. Another uncertainty that did not become a consideration in Events 1 and 6 was the question of whether the incumbent would be able to seek a second term, and, of course, that point was of greater

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[42]*Facts on File*, XVI, 815, 192.

significance in Event 3 than in Event 2, due to the proximity of the election. However, these issues do not seem sufficient in themselves to explain an extreme reaction that ran contrary to the major market trend.

Economically, the country had seen two recessions since World War II, one of them during Eisenhower's tenure as President (Table 1), and was about to slide into another in August 1957. However, it was in the international arena that the greatest uncertainty--and fear--lay. The United States had adopted a strategy of deterrence under which "...the United States decided to try to deter or dissuade hostile governments from attacking in the first place ... (and) ... the weapons most likely to accomplish such a goal seemed to be ... nuclear bombs."[43] However, the Soviet Union had detonated a nuclear weapon in 1949 and had "...achieved the capacity to inflict terrible damage on the United States in any nuclear exchange."[44] In short, the American monopoly in atomic weapons had been broken, and the world had entered the era of bi-poliarity in military capabilities with the U. S. at the one pole and the U.S.S.R. at the other. John Spanier tells us: "In a bipolar system, given the sense of insecurity, fear and suspicion that the

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[43] Radway, Foreign Policy and National Defense, p. 36.

[44] Robert E. Osgood, "The Reappraisal of Limited War," in National Security and American Society, p. 345.

great powers feel, ... the avoidance of crisis is particularly difficult."[45] It was the aura of impending crisis and the terrible knowledge of the possible catastrophic consequences of confrontation that made uncertainty and concern a prevailing condition. "Both superpowers drew the same conclusion from their common fate of being, in Robert Oppenheimer's words, 'two scorpions in a bottle.' Churchill called this the 'balance of terror' and said survival would be the twin brother of annihilation.... In 1955, President Eisenhower proclaimed that there was 'no alternative to peace'"[46] In short, I believe that the stock market's reaction to the possible death or incapacition of the President of the United States was an emotional reaction based upon fear of the unknown. An economic justification certainly is difficult to fathom.

I believe that the same rationale explains the market's strong negative reaction to the assassination of President Kennedy (Event 6).[47] Kennedy was popular enough as a President.[48]

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[45]Spanier, Games Nations Play, p. 145.

[46]Ibid., p. 83.

[47]As a matter of interest, it should be noted that the reaction, while strong, was less than half of the response to Eisenhower's heart attack.

[48]"Jack Kennedy rubbed a lot of people the wrong way in his brief time; Camelot was a creation of martyrdom." See Royster, Wall Street Journal.

His Vice President, Lyndon Johnson, was well known and considered capable, although he was not particularly loved.[49] The economy had seen difficult times during 1962, setting three adverse records for activity up to that time: Monetary gold stocks reached their lowest levels since 1939 in May; the market registered its greatest one day drop since October 28, 1928 on May 28; and the Consumer Price Index registered a record increase in March. However, at the time of the assassination, economic conditions were in an upturn accompanied by a steadily rising market. (Figures 1 and 2).

It must be recognized that conditions surrounding the assassination were considerably more chaotic than those associated with the issuance of medical bulletins by Eisenhower's doctors. Radio and television bulletins reflected the initial crisis atmosphere.[50] Representatives of the news media were accompanying the Kennedy motorcade in Dallas and coverage, accordingly, was instantaneous, contributing to the prevailing confusion generated by uncertainities over the following: The number of assassins; conspiracy rumors; and initial location and condition, not only of the President, but also of several other members of his party, to include the Vice President.

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[49]"'Affection' wasn't exactly the word for Lyndon Johnson, who never shook off the image of a political wheeler-dealer." See Ibid.

[50]The crisis aspect of constitutional succession was resolved quickly. Kennedy was shot at 12:30 P.M. CST, and Johnson was sworn in at 2:39 P.M.

Presidential Withdrawals

In 1968, President Lyndon Johnson withdrew from the race for the Democratic nomination for President (Event 7). Stock market reaction was evidenced by an obvious rise. In August 1974, President Richard Nixon announced that he would resign from office, the first U.S. President to do so (Event 10). The reaction was a slight drop, but it was not wholly out of line with normal fluctuations in the continuing bear market that existed at the time. (Table 2, Figure 1).

Neither event was entirely unexpected. Political pressure on President Johnson had been building from challengers threatening to deny him the nomination. His announcement was made on Sunday, so there was ample time for reflection prior to the market's opening the next day. Further, the magnitude of the response is not as great as it might appear. A new bull market (Table 2, Figure 1) had begun on March 5 in reaction to announcement of economic indicators indicating a cooling of the economy, so while a favorable response was recorded, it was not contrary to the market trend. Since the identity of the next President could not be known, there was no reason to believe that the improving economy would worsen. Further, the transition, almost a year away, would be a traditional and orderly process. The fact that there was a strong positive response undoubtedly reflects a dissatisfaction with Johnson, upon whom had been placed much of the blame both for the Vietnam War and for the resulting economic quagmire during his administration.

In Nixon's case, it had been apparent for sometime that he was increasingly unable to govern effectively because of his preoccupation with the Watergate issue. His administration had been embroiled in Watergate for over a year and a half, and by August 1978 assistants to Nixon were perceived to be controlling the reins of government. When he finally announced his resignation, there was nothing to alter an already pessimistic market.

The Space War

The first visible signs of the "space war" between the United States and Soviet Union began with the coded beeping of an 184 pound earth satellite. The first evidence to the world that the Russians had launched Sputnik I was the radio interception of those beeps (Event 4). The event was traumatic to the United States whose technical superiority was to serve as a counterbalance to Soviet superiority in tanks and manpower. Now, America's belief in its technological superiority was shaken. More importantly, it suddenly realized that it was vulnerable to direct nuclear attack as never before. "... The launching of the Sputnik satellite in 1957 ... revealed the full extent of the challenge which the United States had to meet from Soviet technology. For the first time in its history the United States felt itself in danger of physical attack...."[51]

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[51]Michael Howard, "The Classical Strategists," in National Security and American Society, p. 289.

President Eisenhower's administration, stung and embarrassed, responded to Sputnik 1 and Sputnik 2, which was launched November 3, 1957, by permitting Wernher von Braun to proceed with a satillite under the U.S. Army program. In fact, "That dramatic example of Soviet technology (Sputnik) ... provided a new sense of urgency with regard to all aspects of advanced military technology ..."[52] Almost three months after Sputnik 2, the American Explorer 1 was fired into orbit (Event 5). Of course, preparation for, and execution of, the launch was conducted with full publicity; there was no surprise, only pleasure that "the bird flew."

Each of these events engendered strong American emotional responses, both of national pride and of perceived susceptibility to what would become known as "nuclear blackmail."

Event 4 was unexpected, Event 5 was not. Market reaction to Sputnik (Event 4) was a mild drop, not out of keeping with the existing bear market (Table 2). Obviously, while creating some uncertainity and concern, Sputnik was not perceived as signifying an immediate threat of war. Market reaction to Explorer (Event 5)

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[52] Alain C. Enthoven and K. Wayne Smith, <u>How Much Is Enough: Shaping the Defense Program 1961-1969</u> (New York: Harper & Row, 1971), p. 184

was nil. Neither event, then, was perceived to have strong economic ramifications.[53]

Nixon's China Visit

"President Nixon announced to an astonished American public July 15 that he would visit Peking before May 1972 ... 'to seek normalization of relations between the two countries....'"[54] There was reason for astonishment. No Chinese government had ever received any American President.

No American government has ever extended recognition to the Communist Chinese government. Further, in American strategy "the purpose of containment ... (had been) ... to contain Russia and, after late 1949, Communist China as well."[55] Of course, the United States had "... negotiated formally or informally with Peking whenever Washington felt its interests were involved ...,"[56] but for an American President to announce that he would visit China was

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[53]While neither event was perceived to have strong economic ramifications, we know now that they did. John Kennedy made an issue out of the "missile gap" during his run for the Presidency. After he took office, "... the number of strategic bombers and missiles was built to a level three or four times the size of the Soviet Union's ...." See Radway, Foreign Policy and National Defense, pp. 38-39.

[54]Facts on File, XXXI, 541.

[55]Spanier, Games Nations Play: Analyzing International Politics, p. 356.

[56]Ibid.

abruptly to alter a United States policy that had existed since the Communists seized power on the mainland. For the stated purpose of that visit to be "normalization of relations" was to imply a completely revised equation in U.S. relations not only with China, but by implication also with the Soviet Union. Investors apparently saw no economic consequences in the visit. There was no market response either to the announcement (Event 8a) or to the actual visit (Event 8b) despite an underlying bull market during each.

I believe the reason for no market reaction in spite of the visit's unexpected and dramatic nature was that businessmen were unwilling to invest then in the possibility that significant changes _vis-a-vis_ China actually would develop. After so many years of virulent anti-Americanism from Communist China, a cautious wait and see approach appeared to be the wise choice. Significantly, however, there was not a negative response.

The Arab Oil Embargo

Events 9a-c include the 1973 Arab oil embargo and selected closely related incidents. I felt the embargo should be examined in light of what we now know were its severe economic effects. I included the other events as I did in the preceding chapter in order to develop a representative pattern of response during the course of a crisis, and, I included the October War because it was an integral part of the crisis. It was not in my opinion a war event threatening direct involvement of the United States. "At the time of the Six Day War in 1967, it would have been difficult for the United States to become a direct participant in the conflict. And yet in 1967 there was a good deal more going for such an action than exists today (the October War)."[57]

No single event in recent history has had the effect on the American economy as did the Arab oil embargo of 1973. The effective result of the embargo was a world-wide shortage of oil and an increase in its price from $2.70 to $10.00 a barrel. Already galloping inflation combined with economic reaction to the embargo led to the worst U.S. recession since the early 1930's (Table 1). It should be noted that the shortage of oil and the quadrupling of its price both resulted not from basic laws of supply and demand but from Arab political acts constituting an international power play.

Tension between the Arabs and the Israelis built steadily during 1973, culminating in October in war between Israel and Egypt, soon joined by Syria and other Arab states (Event 9b). Throughout, the Arab oil producers brought increasing pressure to bear against the Western industrialized nations to influence their policies toward Israel. Saudi Arabia, considered a friend of the

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[57]Lucius D. Battle, "Peace - Inshallah," Foreign Policy, 14 (Spring 1974), 114.

U.S., issued several warnings linking oil supplies and Middle East policies. In April, Saudi Arabia publicly tied the flow of oil to United States policy toward Israel. The Organization of Petroleum Exporting Countries, citing inflation, announced higher oil prices for Western countries on September 16 (Event 9a). On October 16, the October War erupted (Event 9b). On October 17, 11 nations of the Organization of Arab Petroleum Exporting Countries agreed to a coordinated program to control both oil production and export to force a change in U.S. Middle East policies. Concurrently, the six largest Persian Gulf oil producers announced a 17% increase on taxes paid by Western oil companies operating in their countries (Event 9c). On October 18, Saudi Arabia announced that she would reduce oil production by 10% immediately and would cut all shipments to the U. S. if America continued to supply arms to Israel. Abu Dhabi joined with an announcement stopping oil shipments to the U.S. and any other country supporting Israel. These were the first steps in the embargo (Event 9d). On November 25, President Nixon on national television ordered countermeasures to offset a predicted 17% shortfall in winter fuel supplies. (Event 9c). Included were a reduction in supplies to retailers, a 50 mile per hour speed limit, a reduction in jet fuel supplies, and the allocation of heating oil.

None of these incidents qualified as a surprise, except possibly the actual timing of the war. The crisis in the Middle East had been building for an extended period. The U.S. Senate gave some warning of President Nixon's order by passing a mandatory fuel allocation system bill on November 14 and by passing an energy bill that was enabling legislation for the executive order on November 19. The details of the President's message were not known in advance.

Stock market reaction to the embargo and its associated Arab events was negligible (Events 9a-d). The response to Event 9e, the countermeasures, was strong and down. The market already had dropped 9% between January and Event 9a, largely in response to steadily dropping economic indicators and rising inflation. However, probably the real reason there was little reaction to the Arab initiatives is that investors were not getting the message. They obviously did not perceive a threat of U.S. involvement in war, and it is also probable that they did not perceive that the Arabs would carry through with their oil weapon. Morgan Guaranty Trust Company has gone on record as saying that, " ... there was every expectation that the shortages created by the (oil) embargo would end within a period of several months...."[58]

Between October 18 and Event 9e, the market had dropped another 12%, reacting to continuing poor economic indicators and

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[58]Richard F. Janssen, "The Outlook," Wall Street Journal, July 2, 1979, p. 1.

the now obvious economic impact of the shortage of oil. Accordingly, President Nixon's countermeasures reinforced pessimism that already was building in the investing community. More importantly, I feel that the strong, negative reaction can be attributed to the fact that, since the President of the United States was addressing the nation, investors now were getting the message.[59]

Sadat-Begin Summits

If President Nixon's visit to China was astonishing, Egyptian President Anwar Sadat's visit to Israeli Prime Minister Menahem Begin begs description (Events 11a-c). The centuries old hatred of Arab for Jew and Jew for Arab is well known but imperfectly understood by alien cultures. Perhaps an Arab can give it some expression: "Two cultures, historically rooted and obsessed, are pitted against one another and they seem most willing to sacrifice the future and the present at the alter of the past." "Israel has become a fixation, an obsession, and a proxy for all the problems that plague Arab society."[60] It literally was inconceivable that the leader of the Arab nation that most bore the brunt of wars with Israel would hint that he would visit and even more inconceivable that he would be invited. Nevertheless these events occurred. It

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[59]There was also discernible, negative reactions to the bills passed by the Senate on November 14 and 19.

[60]Fouad Ajami, "Middle East Ghosts," Foreign Policy, pp. 96, 102.

would be difficult to overestimate the ramifications for stability in the Middle East, world peace, and resolution of the oil crisis with its associated impact on Western democracies if this first visit by an Arab leader to Israel since its establishment as a nation in 1948 were to result in peace.

The Sadat-Begin meeting failed to produce lasting results. Subsequently, the White House announced on August 11, 1978, that a summit meeting between the two moderated by President Carter would be held at Camp David, Maryland (Event 12a) to resolve the Middle East deadlock. The meeting began September 8 (Event 12b) and terminated September 17 (Event 12c) with a treaty signing ceremony at the White House. Since all discussions at Camp David were held under conditions of an effective news blackout, details of the treaty were not known until President Carter addressed a joint session of Congress on September 18 (Event 12d). Prime Minister Begin and President Sadat had agreed to the framework for a peace treaty and settlement of the West Bank and Gaza Strip issues and to conclude a peace treaty within three months. This step toward peace was very much in keeping with objectives of the United States, because, as Lucius Battle has said, "... Increasingly American interests necessitate a settlement.... We cannot face isolation with the Israelis...."[61]

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[61] Battle, Foreign Policy, 113.

Considering both Events 11 and 12, the elements were again in place for a strong market reaction: Surprise, particularly for Events 11a and 12d; highly significant incidents; and, the obvious potential for significant effects on the economy. Nevertheless, there was no discernible stock market reaction. It is tempting to explain the lack of reaction in terms of market trends. Event 11 occurred when the market was approaching the bottom of a bear (Table 2). However, Event 12 took place in conjunction with an upward moving market. The only logical explanation that can be offered is that after so many years of Middle East turmoil and failed expectations, investors were cynical that peace actually would be forthcoming. Given the prevalent attitudes of the PLO and radical Arab states, their conservatism is understandable.[62]

Conclusions

The stock market reacts to miscellaneous events in accordance with the random walk and efficient market models. Accordingly, investors' perceptions as to whether such events are good or bad

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[62] I was in a brokerage house during both of these events, and some sort of market reaction was expected. The only explanation that analysts could provide was the one given here. So far as I know, no other answer has been forthcoming since.

for the economy may be deduced. However, international events perceived not to have a reasonable probability of success do not cause the market to deviate significantly from its contemporary pattern in spite of the fact that such events might be of extreme potential importance in the affairs of nations. Investors' reactions to these events apparently reflect a judgment concerning probability of success and a willingness to wait for other clarifying events. In such cases market reaction may not be used to determine attitudes of approval or disapproval.

The stock market reacts most strongly to surprise events and particularly to those creating a feeling of uncertainty. The magnitude of reaction is proportional to the degree of uncertainty and/or perceived threat induced in investors toward their total environment, even though the event in itself seems to portend no significant economic consequences. In this regard, market responses since World War II to the death, even the potential death, of a President in office have tended to become almost systematic in that such responses have been both very strong and negative. The tentative conclusions to which I am led from this fact is that Americans tend to regard a President in office as a father figure in their innermost beings and when that image is threatened by sudden destruction, the reaction is one of unreasoning emotions of total insecurity.[63]

No such extreme, systematic response is associated with a President's simply removing himself from office, whether the removal is traumatic, as in President Nixon's resignation, or in accordance with routine procedures, as in President Johnson's decision not to run. In these cases, the market reacted to each on its individual merits. Market response may be filtered by an emotional atmosphere, however, as in the case of President Johnson's decision. Americans apparently do not feel threatened by the orderly transfer of power, even if done quickly in a unique manner.

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[63] It would be interesting to evaluate the results of a study made to determine which of the investing populations did the selling and which did the bargain buying in incidents associated with the death of a President. Such a study would be extremely difficult, particularly at this late date. The last time of which I am aware that an analysis of trading populations was made, the NYSE did it under pressure from Treasury Secretary Dillon to determine the sellers in the May 28, 1962 crash. However, I suggest that results would be illuminating if a student of political science were prepared to conduct such a study at the time any future crisis occurs.

Perceived relevancy filters market response. Further, investors seem to assign a relatively low probability factor to the worst case in regard to international events with the potential for significant effects on the economy, as in the case of the oil embargo. Reaction to such crises follows a pattern of erosion over time both as the crisis develops and as its effects actually begin to register on economic indicators. However, formal, decisive actions directed at the crisis by either the Executive or the Legislative branches of government do engender discernible response. This fact is particularly apparent when the President addresses the nation. The conclusion to be drawn is that investors' perceptions toward a continuing crisis may be reinforced or altered on a one-time basis by Presidential or Congressional actions, particularly the former, and even if the actions do not alter the basic nature of the crisis. Subsequent perceptions of the crisis will be on the anticipated merits of each action as it unfolds.

Chapter VI

Conclusions

It is not my intent to reiterate previous conclusions, but I feel a summary of salient points is warranted. To begin, daily fluctuations in the stock market may be used as one tool to assist the student of political science in determining investors' attitudes toward the economic aspects of international and domestic affairs. Such knowledge would in turn assist in putting many theories of national and international relations through a scientific testing process. However, developing a model for the requisite analysis of market moves will be difficult and complex. The mere quantification of magnitude and direction of daily movements will not suffice, particularly if the daily indicator is not out of line with the indicator for any other given day. All of the many factors that influence market activity and filter its results must be an integral part of the analysis. Obviously, what is required even to begin is a great deal of work with the NYSE and with financial analysts. There is sufficient validity to the random walk and efficient market models for the work to be undertaken, even though those models do indicate that the market will discount many significant events in advance and will refuse to react to others pending development of new information.

The strongest investors' reactions developed in this study were associated with issues of war and peace and with issues of the death of a President. Responses to these two issues tended to be almost systematic and in the case of the Presidency largely emotional. Strong reactions opposed to war developed as did strong negative reactions of what can best be described as uncertainty associated with the death, or threatened death, of a President. Unfavorable reactions also developed when Americans felt that their security from military attack was threatened. The strength of all responses grew as the amount of associated surprise increased and was directly proportional to the amount of uncertainty or fear of the unknown that prevailed. The conclusion to which I am drawn by these facts is that American investors really do not consider this a safe world in which to live, militarily or economically. They really are basically uncertain and insecure and tend to react emotionally when their basic senses of security, military or economic, are threatened.

Obviously there is much comprehensive effort remaining to make the stock market a truly useful analytical tool to the political scientist. This has been a beginning, and I hope that someone with the necessary resources will undertake to carry on.

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Biography

Benjamin F. Harmon III was born 7 December 1928 at Fort Monroe, Virginia. He was graduated from the Virginia Military Institute with a B.S. in Civil Engineering in January, 1949. Concurrently, he was appointed a second lieutenant of Armor in the U.S. Army and reported for duty at Fort Riley, Kansas. During the ensuing years, he held a variety of command and staff positions in the United States and in Germany, Korea, England, and the Republic of Vietnam, where he commanded the Second Squadron of 11th Armored Cavalry Regiment. He then reported to the Department of Army Staff in Washington, D.C. where his duties included Chief of the Volunteer Army Division, and Acting Director and Deputy Director of the Directorate of Discipline & Drug Policy, Office of the Deputy Chief of Staff for Personnel. He was promoted to colonel in July, 1970, and assumed duties as Chairman of the Military Science Department, University of Richmond in September, 1971. He retired from the Army in August, 1975 and served as Registrar, University of Richmond until taking a position as a Registered Representative with Scott & Stringfellow in July, 1976.

He is a graduate of the Army Command and General Staff College and of the Armed Forces Staff College.

He is married to the former Anne Page Violette of Hampton, Virginia. They have two sons: Navy Lieutenant Benjamin F. Harmon IV, and Michael H. Harmon.

His decorations include the Legion of Merit with two clusters, the Air Medal with four clusters, the Bronze Star, the Army Commendation Medal, the Vietnamese Cross of Gallantry with Palm (two awards), and the Vietnamese Cross of Gallantry with Gold Star. He is entitled to wear the Army General Staff Identification Badge.

FOOTNOTES

1 From the clipping file on Charles McDowell at the Richmond Times-Dispatch. The clipping files on McDowell in different sources are unevenly documented. Where it has been possible to determine the original appearance of an article, this has been placed in the footnotes and the bibliography.

2 "A Former Fan, Full of Guilt," Richmond Times-Dispatch, July 13, 1978.

3 "Computer Technology Comes To Congress," Richmond Times-Dispatch.

4 "Virginia Politics:A Short History," Richmond Times-Dispatch, August 23, 1977.

5 "Some Reflections On The Space Age," Richmond Times-Dispatch, June 17, 1977.

6 "Lexicon of Politics," Rural Virginia, January 1964, pp. 10-12.

7 From personal letter from McDowell to this writer dated April 8, 1977.

8 One Thing After Another, Charles R. McDowell, Jr., (Richmond: Dietz Press, Inc., 1960), p. ix.

9 Ibid.

10 Ibid., pp. 34-36.

11 "We Present: 'One Man's Views of Elvis Presley,'", The Northern Virginia Daily, 1955.

12 "Tom Wolfe! Terrific!" The Alumni Magazine of Washington and Lee University, Spring 1965, pp. 18-21.

13 One Thing After Another, Charles P. McDowell, Jr., (Richmond: Dietz Press, Inc., 1960), p. 15.

14 Personal letter from McDowell.

15 Richmond Times-Dispatch, April 21, 1977.

16 Richmond Times-Dispatch, Dec. 6, 1977.

[17] "Miss Philly Gives Gas-Saving Rules," R-T-D, 4-21-77.

[18] "Aunt Gertrude At Summer's End," Richmond _Times-Dispatch_, September 12, 1978.

[19] "Aunt Gertrude On Being Angry," Richmond _Times-Dispatch_, November 17, 1977.

[20] Personal letter from McDowell.

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