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WEEKLY BULLETIN

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RESEARCH REPORTS

COMING EFFECTS OF CURRENT EVENTS

Income-Tax Muddle Begins to Clear

Even though the income-tax measure passed by the House of Representatives last week accepted the principle of the Ruml plan only in part, this action has promoted the chances for an early enactment of tax legislation that will remove some of the uncertainty with which the taxpayer has recently been confronted. The bill can now be revised in the Senate, and there is a basis for hoping that a fairly rational law may result. In fact, the relative simplicity of the Ruml plan may appeal to the Senate Finance Committee, some of whose members have expressed sentiment in favor of less drastic income-tax policies. The vote defeating the Ruml plan in the House was so close (206 to 202) that the plan would probably be accepted if the Senate shows a preference for it and thus brings it up for action again in the Lower House.

Income taxes now constitute such a large proportion of an individual's expenses that it is extremely difficult to make any plans until these tax liabilities can be estimated within reasonable limits. It now appears possible to make a general appraisal. It is virtually certain that a withholding tax will be a feature of the measure and that it may be put into effect as early as July. It also seems certain that income taxes will be put on a current basis without imposing double assessments, except in special circumstances, where the application of simple forgiveness of 1942 income taxes would result in actual losses to the Treasury.

It should be remembered that this action on the form of assessing income taxes is not a revenue measure similar to the Revenue Act of 1942. No action has yet been taken on the President's recommendation for raising more revenue. It is possible that Congress may later impose more excise taxes that will result in working gradually toward the politically unpopular general sales tax.

THE BACKGROUND OF INVESTMENT

Characteristics of Major Fields Of Enterprise

The capital-using group of enterprises classed as financial companies are so defined because, although they perform various other functions, these involve the investment of funds in the earning power of other enterprises (or in the taxing power of political entities that gives value to public obligations). This group of companies includes the commercial banks, the insurance companies, and investment trusts. Companies dealing with mortgages secured by real estate are customarily classed in this group of financial companies in the most widely used investment manuals.

Financial Companies

There are approximately 14,000 active banks in the United States having capital stock of $3,000,000,000 in par value. Most of this stock, as measured by the number of shares, represents liabilities of small banks, and these issues are usually "closely held." However, when measured in dollars, about half of the total par value of bank capital represents the issues of large banks whose shares have a fairly active market even though few are listed for trading on the stock exchanges.

The commercial banks have made important contributions to the commercial and industrial development of the country. It is the function of the commercial banking system to place in circulation the purchasing media needed to represent goods that have been produced and are on the way to market. Commercial loans are ordinarily retired when the merchandise, to finance which the loans were made, has been sold. The employment of the credit-creating mechanism to acquire investment-type assets has not only resulted in the creation of inflationary purchasing media,[1] but has also changed the essential character of the banking business. This change has been especially rapid during the past decade.

The banks' volume of outstanding loans has tended to decrease and the bondholdings to increase. Especially since the wartime expansion in the Government debt, the commercial banks have acquired a large volume of Government securities. In June 1933, 51 per cent of the total assets of the reporting member banks of the Federal Reserve System represented loans and 32 per cent Government securities. In April 1943, 23 per cent of total assets existed in the form of loans and 66 per cent in the form of Government securities. In recent years, the commercial banking system has come increasingly under political control, and the Administration has received many powers for the control of interest rates.

It appears to be inevitable that the predominant holdings of the commercial banking system will be Government securities. Because it is important for the Federal Government to maintain its credit standing to

[1] The process is explained in Chapters I and II of the Institute's booklet WHAT WILL INFLATION AND DEVALUATION MEAN TO YOU?

facilitate the marketing of new debt and for refunding operations, and also because it is essential to maintain the solvency of the commercial banking system, the Government will make every effort to maintain the market value of its debt issues. The Administration has strong powers for the accomplishment of this objective. One of the principal powers is the open-market operations of the Federal Reserve Banks in Government securities, and the System stands ready to support the Government-bond market at any time that the need arises. Another important power is the control by the Board of Governors of the Federal Reserve System of the reserves that member banks are required to maintain. Furthermore, in view of the wide and increasing distribution of Government securities, there seems to be little question that Congress will grant whatever additional powers are needed to maintain the market prices for Government bonds.

If, for purposes of diversification, an investment in bank stocks is deemed advisable, the investor may consider the distinction generally made between the New York banks and those in other parts of the country. It is frequently argued by market analysts that New York's position as money center of the country justifies a preferred rating for the capital stock of the large New York banks. The New York banks have special earnings opportunities provided by the vast sums that they are called upon to handle. On the other hand, the investor should remember that these banks are required to maintain much larger cash reserves (which have no earning power) than the banks in smaller cities. The New York banks' investments in Government securities, which bring a smaller return than do most other types of bank investments, are relatively larger than those held by the banks outside of New York. Finally, the New York banks are the largest depositaries for foreign funds that have sought the haven of the United States in a war-torn world. When peace comes, these sums may be withdrawn within a relatively brief period of time, which might necessitate the liquidation of profitable assets.

Generally speaking, banks are unsatisfactory media for investment purposes, especially for the small investor. This is primarily because the published information is inadequate for proper analysis. The outsider has no means of knowing the actual values of the figures given nor the amount or adequacy of the reserves.

Although the life insurance companies have great sums available for investment, which can be made to yield profitable returns as a reward for skillful management, most of the companies in the field are mutual companies. However, there are a few large stock companies and numerous smaller ones.

The earnings of stock life insurance companies are primarily dependent on the interest rate that they receive from their investments. Premiums are calculated on the basis of mortality experience tables, together with an assumed rate of return on the unused portions of premiums that are available for investment. It is therefore apparent that life insurance stocks are generally profitable when interest rates are rising and, conversely, are in an unfavorable investment position when interest rates are declining or remain at a low level.

The situation with respect to fire, casualty, and marine insurance companies is somewhat different from that in the case of the life insurance stock companies. The former companies issue policies of relatively short duration. For example, fire insurance policies are customarily written for either a one- or a three-year term. The companies' liabilities end with the expiration of the policies, and most policies are cancellable on notice and return of unexpired portions of the premiums. The companies therefore are not required to set up so large a reserve against policies in force as are the life insurance companies.

The fire insurance companies have been recommended as being in a favorable position to overcome the adverse effects of inflation. It is contended that premiums can be raised within reasonable periods of time that will offset increases in costs of operation. The volume of business may also increase, because property values are rising, thus increasing the face amount needed for full protection.

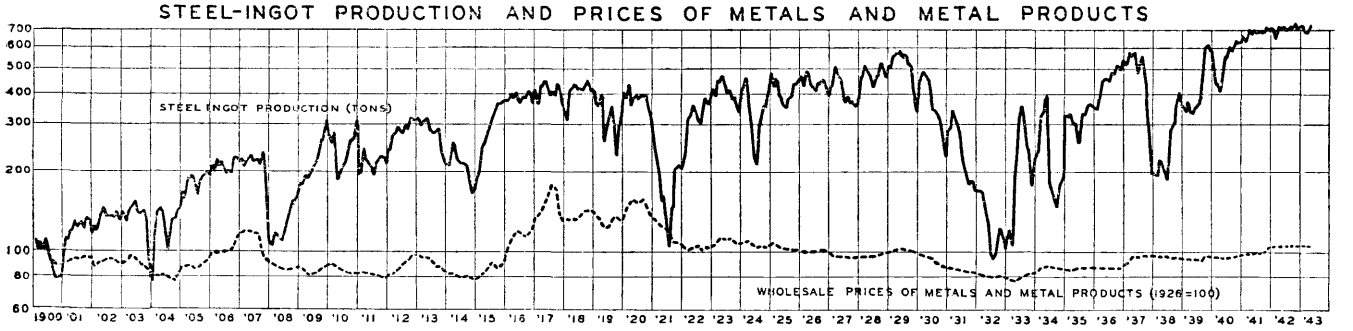
Although the funds accumulated by fire insurance companies are not so large as those accumulated by the life insurance companies, they are nevertheless substantial. Inasmuch as the income from investments is an important factor in their earning power, fire insurance companies from the investor's point of view may be considered as investment trusts with additional leverage provided by the insurance underwriting business. The investor should realize, however, that insurance companies must divide their attention between both phases of their business, underwriting and investing. We believe that, inasmuch as their attention is divided between these two functions, their supervision of investments may be inadequate and the investor might generally do better to forego the possible benefits provided by the leverage factor and place his funds in well-managed investment trusts. Furthermore, a factor seldom considered by the average investor in fire insurance stocks is that possible capital loss may result from a major disaster. Although such an event may seem improbable, insurance stocks involve this additional element of risk.

The two important functions of investment trusts are to provide diversification for moderate-sized investment funds, and, in the case of management-type trusts, to offer expert supervision of the funds. There are approximately five hundred investment trusts in the United States. There is an extremely wide variety of investment trusts, so many different types that a description of even the major classes requires a separate treatise.[1]

Except in cases where the managements of investment trusts are outstandingly successful, the cost involved in the organization, management, and distribution of the shares is so great as to curtail substantially the income of investors in their issues. We therefore recommend that investors who have funds of sufficient size to diversify in accordance with the principles described in the April 5, 1943 Research Report bulletin should accumulate and hold direct investments in income-paying securities. The stocks of investment trusts having favorable performance records are suitable for the investment of a portion of the funds of individuals having small savings accumulations.

Real-estate bonds, issued by mortgage companies, and commercial building management companies are customarily included in discussions of financial com-

[1] The reader is referred to INVESTMENT TRUSTS AND FUNDS FROM THE INVESTOR'S POINT OF VIEW, American Institute for Economic Research.



panies. Although real-estate mortgages should afford an inherently safe type of investment, they have frequently failed to prove so in actual experience. The reason is that the mortgage liability of properties has frequently been too large in respect to the properties' average earnings over the period of years covered by the indentures.

During a period of inflation, such as the present, the position of real-estate mortgages is greatly strengthened, and therefore the status of this type of investment is now relatively favorable. However, these bonds are never suitable for the average investor, because they have no active market, and, if it is necessary to dispose of these issues before maturity, it may be necessary for the investor to accept a loss on his transaction.

Federal, state and municipal bonds as investments will be discussed in next week's bulletin.

Steel-Ingot Production and Metal Prices

Steel-ingot production, shown by the solid line in the accompanying chart, is unusually significant at present, because semifinished steel products are the prime essentials for fashioning the equipment for making war. The production trend of the basic steel industry affords an important indicator of our success in producing the necessary materials for our fighting forces.

During the forty-two-year period covered by the chart, the activity of the steel industry has fluctuated widely, but the peaks in production shown during periods when the industry has been active reflect the consistent gains in the industry's capacity during the first three decades of this century. In spite of the difficulties encountered by the steel industry during the great depression of the 1930's, improved methods and production facilities made possible a new high record in tonnage output during the present war period.

At the present time, the industry is turning out semifinished steel products at an average rate in excess of 7,000,000 short tons per month. This is double the rate achieved during our participation in the first World War, but it is only moderately higher than the rate that prevailed throughout 1941. The current production rate can probably be maintained during the remainder of the year but probably cannot be materially increased. Our current production should be sufficient to provide the steel necessary for the prosecution of the war, but there will be little steel available even for important civilian requirements.

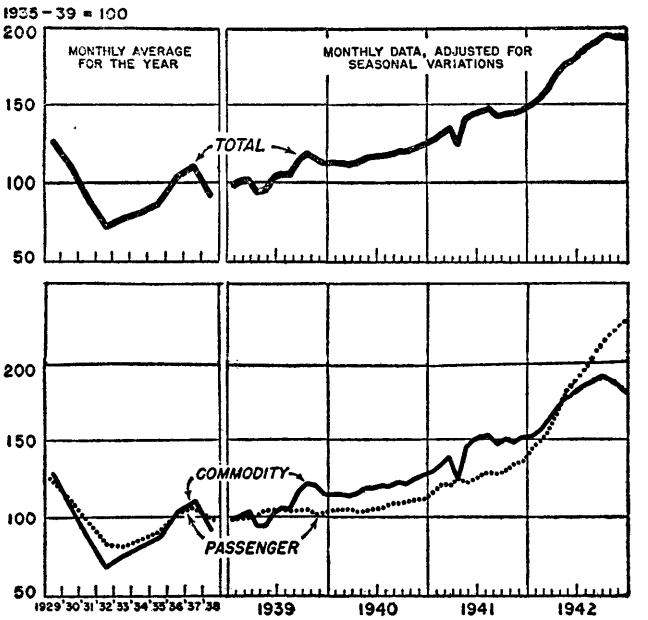
The index of wholesale prices of metals and metal products (plotted in the broken line on the chart) advanced during the early part of the war period but has remained unchanged since we entered the conflict actively. The technological progress that has been achieved by the metal-producing industries during the past twenty-five years has made it possible for the industry to maintain a more reasonable price level than was possible during earlier periods when the wage level was high, as it is at the present time.

BUSINESS

Transportation Indexes

When the United States Bureau of Foreign and Domestic Commerce published its new statistical series that measures the volume of total commercial transportation traffic in the United States, we published the chart in the October 12, 1942 bulletin. There is several months' delay in publishing these indexes, because there is a substantial mass of data to be obtained before the indexes can be calculated. The following chart shows the trends of the combined index and the two separate indexes for commodity and passenger service during the period for which data are available.

INDEXES OF VOLUME OF TOTAL, COMMODITY, AND PASSENGER TRANSPORTATION



The most significant feature of the chart that has become evident since it was published last is the great increase in passenger traffic. Preliminary data for January 1943 indicate that there was another increase in the passenger-transport index, which advanced in that month to 228 per cent of the base period 1935–1939 monthly average. The preliminary commodity index for January 1943 was 189. There has been a substantial increase in the number of passengers carried by

local transit lines, but by far the largest gains in passenger transportation have occurred in railroad travel and in air transport.

The great increase in passenger travel by public transportation systems, shown in the chart, emphasizes statements by Government officials of the Office of Defense Transportation that civilian travel on the railroads may be restricted.

THE FUNDAMENTALS

Supply

The steel-ingot production rate last week declined from 100 (revised) to 98 per cent of theoretical capacity. The curtailment of production was attributed to the effects of the bituminous coal-mine shutdown. *The Iron Age* stated: "Last week's shutdown of captive mines which in some cases amounted to four days and the loss of two to three days' production of beehive coke were serious threats to the steel industry. Meanwhile, evidence continues to accumulate that munitions making programs are undergoing adjustments, with output by some sections of the industry being curtailed. . . . The railroads are scheduled to suffer a blow on their third quarter requirements for steel, and the oil industry also may not receive the steel it wants unless adjustments are made by all interested parties."

	1929	*1932*	*1937*	*1938*	*1942*	*1943*
Per Cent of Capacity	97.0	22.0	91.0	31.0	99.0	98.0

(Latest 1943 weekly data; corresponding week earlier years)

The seasonal trend of the power industry is downward in the spring, and last week there was a more substantial decrease in power production than can be accounted for by seasonal factors. The decrease was probably associated with coal-mine shutdowns that forced many industries to cut down on fuel consumption as a precautionary measure.

	1929	*1932*	*1937*	*1938*	*1942*	*1943*
Billion Kilowatt-Hours	1.69	1.43	2.18	1.94	3.30	3.87

There was a decrease in lumber production last week when the trend was seasonally upward, and the adjusted index declined from 111.2 in the preceding week to 108.6 per cent of the 1935–1939 monthly average. Production was substantially below the level that existed a year ago.

	1929	*1932*	*1937*	*1938*	*1942*	*1943*
New York Times Index	124.4	40.7	92.0	61.0	119.7	108.6

Demand

The dollar volume of department-store sales last week was five per cent smaller than it was in the corresponding week of 1942. Decreases were concentrated in the Eastern sections of the country. Sales were greater than they were a year ago in Southwestern cities and in the West Coast region.

Prices

Average prices of commodities quoted on the exchanges remained within a narrow range last week. Moody's Spot Commodity Price Index was 246.4 on April 29 and 246.8 on May 6. The Dow-Jones Index of Commodity Futures closed at 91.60 on April 29 and at 91.88 on May 6.

FINANCE

Success of Second War Loan Drive

Last month's War Loan drive was successful beyond the most optimistic estimates published before the returns were tabulated. The Treasury sought $13,000,000,000, not more than $5,000,000,000 of which could come from banking sources that would involve the creation of inflationary purchasing media. Inasmuch as total subscriptions exceeded $18,000,000,000, the whole $13,000,000,000 originally sought was in effect obtained from nonbanking sources.

Public response to the drive was apparently more favorable than the Treasury had anticipated. When it again becomes necessary for the Treasury to undertake a major borrowing operation, it might well adopt the policy of seeking all funds from nonbanking sources. Treasury officials deserve credit for endeavoring to obtain a large proportion of the funds necessary to finance wartime budgetary deficits from nonbanking sources. The funding of Government debt through the commercial banks, although resulting in the creation of inflationary purchasing media, involves much less work on the part of Treasury officials than is involved in conducting a widely publicized drive, such as was undertaken last month. If the Treasury's attitude toward income-tax policy had been equally rational, uncertainties regarding future tax liabilities would have been less acute during the period of the drive, and the results probably would have been even more favorable.

SECURITIES

Bonds

Although the volume of transactions in corporate bonds listed on the New York Stock Exchange was reduced during the period of the Second War Loan drive, prices remained steady, and in the case of some railroad issues tended to improve. After the drive had been concluded, the general list began to improve and subsequently recorded a substantial advance. The Dow-Jones average of forty bonds advanced from 95.40 on April 29 to 96.29 on May 6.

Stocks

After the decline in the stock market following the announcement of the President's "freeze" order, the volume of transactions was moderate for about three weeks while stock prices crept upward again. Early in May, speculative interest in the market became active again, as evidenced by a considerable increase in the volume of transactions, and stock prices advanced to a new high level for the year. The New York Stock Exchange's action in eliminating stocks selling below $5 per share and bonds selling below five per cent of face value for margin-account collateral was apparently not very effective in discouraging speculation. During the explosive stage of an inflationary progression, such regulations that are imposed in an effort to control speculative activity usually have no more than temporary effects.

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