RECORD OF SOCIETY OF ACTUARIES
1984 VOL. 10 NO. 3

Vol. 10, No. 3 May-June, 1984

RECORD

THE POST-ELECTION ECONOMY —LATE 1984/85

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MR. FRANK A. CAPPIELLO, JR.: Ordinarily, a topic of the post-election economy, that is, looking ahead to the end of this year and to the early onset of the next administration, would be a fairly easy task. Like many of you, we're in the trenches every day from 10 o'clock in the morning until 4 in the evening. We live or die on the rise or fall of interest rates and security prices. And being in the trenches, we're always fashioning, honing, reshaping our overall battle plan, to come up with the outlook for the economy 12 to 18 months out. We began to do our work for 1984 late last year as we approached the Thanksgiving Day period. This is when we put together a lot of the economic work that we collect, talking to economists and talking to experts in various areas. Out of that, we erect what we think will be the on-going shape of the economy. Typically, it would include gross national product figures, the outlook for inflation and the outlook for interest rates.

But this year it is extremely difficult to do that because this is not only a presidential election year and a year in which the Senate may well be up for grabs, but it is also a threshold year. It could be a year in which we get a continuation of a program that was inaugurated three years ago, or in which we get an abrupt, about face change. Because of this, the uncertainties are more than usual.

Also, things seem to be turned upside down. Typically, in an election year, we can close our eyes and literally guess as to what one party would be saying versus the other party. We would guess the Democrat program to be slightly, if not a lot more liberal, than the Republican program. We know the Democrats like to advocate spending, whereas the Republicans advocate something else. Typically, that standard would be continued. But not this year. This year we've got Democrats out there, Gary Hart, Walter Mondale, who are professing that they are interested in a balanced budget. They are insisting that what we have to do is cut out this wasteful spending. What we have to do is shape up and cut out a lot of the waste.

Now for the Democrats to be out there advocating cuts in spending, to be advocating a balanced budget, is like Orson Welles advertising designer jeans. It doesn't seem the kind of thing that is done. The Republicans are also saying, and quite rightly from the evidence, that we are in a recovery and that this recovery is coming along very well. The Democrats don't deny that. They say, "Sure we're in a recovery, but damn it, we shouldn't enjoy it so much. We should think about all of the fears, all of the temptations, all of the possibilities out there."

It is nice to get back to something bedrock, something solid beyond politics, such as the American economy. There is nothing wrong with the American

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economy right now. The problem lies in the intangibles, relating to possible economic permutations in the beginning of 1985. The economy is really on track.

The clue to how fast this economy was getting on track really began to occur last Christmas. We spend a lot of time on consumer spending, on consumer psychology, on consumer attitudes. Not that we are consumer specialists and not that we are economists of any sort, but if you are running money, if you are managing investments, and if you have any ideas on the economy, those ideas have to be supported by what the consumer will be doing. We all know the consumer is two-thirds of the gross national product. If they belly up to the counter and buy, we have a good economy, if they don't buy we have a lot of good savings long-term, but short-term we probably have a flat economy to a down economy. And in the last Christmas season it was pretty obvious that the consumers were getting their psyche back, they were becoming very confident not only about themselves, but about America's position in the world.

All the consumer attitudes we began to see indicated very high levels of confidence regarding America as well as regarding their checkbook. But there was something else that indicated the force of this consumer good will. That was the quality of the buying we began to see. Consumers typically spend a lot when they are confident, but when they are supremely confident they begin to do two things: they begin to buy up scale, to buy quality, and they also begin to spend frivolously, that is, to spend their money on things they don't really need. We saw a lot of both things at Christmas. That was the tip off that this consumer was going to go on a rampage again. And in January, when everyone was predicting that the consumer would be tapped out temporarily, we were surprised by the violence of the economic upthrust. January recorded surprisingly strong auto sales and housing sales.

And February looked equally strong. The pressure was being applied, the consumer was buying. And why not? They were adding the numbers together, they were looking at their paychecks, they were looking at their future. Their pay increases were averaging 8, 9 and 10 percent last year and they were looking at the rate of inflation of about 5 percent. They could do subtraction and to them that is happiness.

What we are now seeing is a reaction to that hectic pace; the reaction of the Federal Reserve Board, the arbiter, the czar in a sense of our money supply, reacting to this surprising burst of strength. The result has been a 200 basis point increase, a move from 10½% to 12½%, in the prime, and a corresponding move on other rates, to put a drag on the economy. We are already beginning to see the first appearances of a therapeutic slow down in the economy. We will be seeing this slowing pace in the next two quarters, but we are still in the recovery. This recovery that began in the fall of 1982 will continue throughout the year and into the first quarter of next year.

It does not take any boldness to predict a continuing recovery. The American economy is like an enormous locomotive. It is on track, and once it gets on track it takes an awful lot to turn it off its course. The pace may be slowing, but the momentum is there. Throughout the year the economy will still be in the recovery phase. That is pretty good news for those people who are worrying about the possibility that we may slide off into a recession in the fall of this year.

The even better news about this economy is that the high interest rates that we are seeing will produce lower interest rates eventually. This upward move in the prime and the corresponding move in all of the other short-term rates will now serve to slow down the economy, to make it more expensive to stock up, make it more expensive to take chances, make it more expensive to expand. Not only do high interest rates act as an anchor, as a drag to the course of the economy, but the loss of appreciation, the loss of asset values both for institutions and individuals in the stock and bond market, begin to make consumers cautious, begin to make institutions cautious.

This erosion of values will have its effect, it will diminish the enthusiasm of the consumer. We expect inventories to be gradually liquidated, we expect more caution to be interjected into the economy and, because of that, we expect pressure will be taken off both the bond and short-term interest rates market and we will see rates come down. A working projection right now is that the prime that is now 12½% will drift downward to the fall of this year when it will probably be back to 10½ to 11 percent. In other words, we are going to re-trace the entire course of the early part of this year.

The best news that we see coming in this economy is the corporate earnings reports. Last year we expected corporate earnings to be good, we felt that way because a lot of companies had done things that eventually would reflect in their profit figures. They improved their efficiencies, they cut staff, they cut production line costs. The first quarter reports showed us not only rising profit margins, but in some cases dazzling earnings per share.

Anywhere from 20 to 30 percent seemed to be the range of most reporting corporations. That is good news for stock prices because they do respond to improving corporate liquidity, to improving corporate earnings. We think that is going to be the case throughout this year, and particularly in the quarter we are now in.

The inflation picture is the second most important economic projection that any of us have to make, the first being interest rates. The inflation picture is about the best news in the economy. The wonder of wonders is not corporate earnings, the wonder of wonders is that the inflation rate has remained stable and has remained in the 5% zone for so long. We are in the second year of this economic recovery and inflation is still relatively low. We see no reason to expect that rate to move up this year. If you look at two components that affect inflation, the labor component and the energy component, both are flat to down. The wage increases that we are seeing are below the productivity increases that we are seeing and that augers well for the future. Oil prices will probably come down and will certainly come down a dollar or so a barrel once the situation in the Middle East begins to cool off.

So our prognosis is that the recovery will continue, but at a slower pace into next year, with corporate earnings, spectacular in some instances, well above average in most, and inflation that is going to be flat and perhaps on the down side.

The question that you may be asking yourselves, given this reasonably optimistic economic projection, is if what I say is what Wall Street expects. The answer is yes. Many on Wall Street believe what I have just said. Then why is it that the bond market and the stock market are in such desperate

shape? Why is it that since early January both of them have been in a downward course? What is Wall Street worried about if they are not worried about the economy? The answer seems to be in four areas. In order of their importance they are: First, the range of possibilities regarding the Federal deficit. Second, the American Presidency. Who is going to be our next leader over the four years beginning in 1985? Third, the strong American dollar. This affects our deficit which has helped produce high interest rates which has produced a strong dollar. Fourth, the international monetary situation; the international debt situation. Argentina, Brazil and Mexico owe collectively $200 billion dollars. (I emphasize dollars because that is one of the bad characteristics of the debt that is owed by these three countries. It is denominated in dollars, and our dollars have gone up and their currencies have gone down in value.)

- The Deficit -

Most of the public believes that Wall Street is worried about the deficit in terms of numbers. That is part of the problem but it is not the biggest part of the problem. The numbers are rather awesome. In 1983 we had a deficit of $200 billion. For this fiscal year, we started off with an equal amount, $200 billion, but we may actually have a deficit of $160 to 170 billion. The reason why it is smaller is because tax collections are better and the government can't spend all the money that was appropriated fast enough. That's sort of good news, but next year the deficits will start creeping up again. They'll be $200 billion and rising to $300 billion throughout this decade if nothing else is done.

This deficit each year adds to the national debt. The national debt is the accumulation of all of the deficits since George Washington's time and, at the end of this fiscal year, the national debt will total $1.6 trillion. This awesome figure has an average maturity of less than five years. Between now and the next five years, if we don't add another dollar to the debt, we are going to be rolling over $1.6 trillion at various points, and the points at which the debt is rolled over are usually very bad periods for the bond market. The bond market can't take this kind of refinancing. There won't be anything left for private enterprise; there won't be any bond buyers left. The bond market is saying to Congress, is saying to the Administration that there needs to be an end to this enormous roll over in the capital markets. Sooner or later we must narrow the budget deficit and thereby reduce additions to this enormous debt that has to be refinanced constantly.

There are two viable ways to handle the debt. One is to cut spending and the other is to increase taxes. There is a third alternative that increasingly will become more attractive if we don't do the first two. That is, of course, to monetize the debt. The third alternative means that we don't cut spending and we don't increase taxes. We go on as we are. Then at some point the Federal Reserve throws up its hands and they begin to pump out the money. And when they begin to pump out the money that will be the end of our tranquility in financial markets and inflation.

We don't think that will be the case as we come into January, but January, February and March of next year will be the key periods.

- The Presidency -

Then, whoever is in the White House will have to make the decision on how to

handle problem number one, the deficit. That is why the problems of the deficit and the American presidency are intertwined. If it is a Democrat that sits in the White House next year, Wall Street perceives a program as one of raising taxes.

The amount of tax increase or the amount of cuts in spending that will be needed to satisfy the bond market is about $40 billion. That is, we are going to have to reduce the budget deficit from $160 billion this year down to $120 billion. That has to come by a combination of tax increases and/or spending cuts. A $40 billion increase in taxes will hit our economy in the third year of recovery. It will probably hit some time next spring or summer. The result will probably be a flat economy to a down economy and a risk of a recession would be very high. With a recession we get short instant relief from the problem of the deficit in 1985. But in 1986, the budget deficit will balloon up to $250 billion, because in a recession, tax collections go down and welfare and other costs go up. So Wall Street worries that a tax increase could enhance the possibility of a recession in the third year of a recovery. On the other hand, Wall Street would opt for a $40 billion cut in spending, and they think if Reagan is re-elected and sits in the White House for another four years this will be the result.

- The Dollar -

The third problem is more parochial for Wall Street. It depends on which side you're on in terms of investing and it depends on what groups of stocks you are investing in. The third problem relates to the American dollar. Now if you have been an investor in Caterpillar Tractor, in Deere, in any agricultural producer company, you've seen the American grain exports muscled out of the market place by cheaper Argentina wheat or cheaper Canadian wheat or cheaper Australian wheat. It's not that they produce it cheaper, it's the fact that Western Europe or the Orient, when faced with a purchase of American wheat versus, let's say, Argentina wheat, look at the relative value of the currencies. They're buying from a diminished devalued lira or a franc and they're looking at an ultra strong dollar. It is a much easier choice to look at an equally weak Argentina pesos or Australian dollar. That has been the case for the American farmer. It has even been more devastating for a Caterpillar Tractor in competition with some of the other foreign manufacturers. Exporting in this country is about 20% of the gross national product, and a good part of the export business has been devastated by this ultra strong dollar over the past two years, a dollar that has gone up fifty to sixty percent against most of the baskets of European currencies.

Now we think that the dollar is also peaking and this is in sync with our estimates on interest rates. If rates are peaking then indeed we may begin to see the gradual and very slow but perceptible progress downward of the dollar. We look for the dollar to decline anywhere from 15 to 20 percent this year versus the West German mark which is growing relatively strong. We think that not only falling interest rates in the United States produce this, but we also look for the rise in other world economies, not only West Germany but a good part of Western Europe. As those economies begin to improve, this should take some of the pressure off the dollar. So our prognosis on the dollar is that it will be a long time before we get a weak dollar such as what we had in the 1970's, but we are seeing the last stages of a super ultra strong dollar. From here on in a slightly weakened dollar would be very good news not only for Caterpillar but especially for a lot of drug companies whose stocks have suffered because, while they've done good

business in Western Europe, their profits have been eaten away by the translation into weak currencies.

It wasn't too long ago (in the early 1970's) when the economists were telling us that the worst thing for America is a weak dollar. It shows in our loss of importance, it shows our lack of productivity. Now that we have a strong dollar they're telling us that the only thing worse than a weak dollar is a strong dollar. Somewhere in between is where we should be. We don't think we are going to be in between, we think we will still be in the upper ranges of a strong dollar but not quite as strong as it's been.

- Foreign Debt -

This brings me to the fourth point and the one that disturbs us the most. The $200 billion owed by Argentina, Brazil and Mexico are ever much in the news. A large part of that debt is owed to the West and a large part of what is owed to the West is owed to American banks. If one of these nations defaulted, Argentina, Mexico or Brazil, the debt is large enough to impair the capital and surplus of most of the major banks in our financial system. The fear has always been that one of these nations will not just say, "We want to renegotiate," but, "We repudiate the debt." Would say, "Hell no, we don't owe you." That would mean that the banks would have to write down the debt in one fell swoop.

If you look at what these nations have been doing and if you take a look at the resources of these nations, you would know that we are not talking about poor nations, devastated nations. We are talking about nations that have a lot of resources. Argentina among the three is the most blessed by the good Lord. Argentina is an exporter of food products, particularly wheat. It is in balance in terms of its oil needs, it has produced and continues to produce all the oil that it requires. It's a rich nation. So is Brazil with great reserves of iron ore and other raw materials. Mexico, of course, is one of our major oil nations and one in which the United States is developing an on-going dependency for oil imports.

But each one of these three nations have gotten into trouble politically as well as economically by poor planning and by poor administration. The way to look at these countries and I include not only Argentina, Brazil and Mexico but Bolivia and all the other countries where we may have problems; a way to look at them is as companies. Suppose, for example, you looked at Argentina as a company and said Argentina is like International Harvester. Think back two years ago. International Harvester was in considerable trouble. Like Argentina it had done a lot of things that were not appropriate; it had poor management, it misdirected resources, it had a lack of discipline in financial planning.

The banks were also on the line with International Harvester and they had a choice; should they cut loose and salvage what they could or should they loan the company even more money, renegotiate the loans, and inject a measure of discipline in the operations, and then hope that this, plus the eventual rise in the economy would enable the company to recover. They chose the latter; they injected more money into the company, renegotiated the loans and also put in new layers of management, added some advice and waited. The economy turned around and International Harvester is restored at least to the ranks of the reasonably healthy companies.

The same thing is going on in Argentina, Brazil and Mexico. Each one of these three nations is in a process of renegotiating their loans. Each one is in the position of injecting a note of discipline into their operations. We've had a change in the administration in Argentina. We've got a very thinking, a very profound economist leading Mexico. And in Brazil, we've got the beginnings of an attempt to curb the appetite of their growth. All of these are very necessary steps. What remains now is what remained for International Harvester. We are waiting for the world economy to improve. If it does improve, and we think it will, then gradually these nations will get off the critical list and will be restored to reasonable health, but it is going to be a long time.

When people tell me about the international monetary situation, I tell them the market has already adjusted; we've seen the stock prices of most of our major banks come down substantially. We've seen a lot of other effects that relate to the international monetary problem already recorded in the price of commodities and in the price of financial instruments that relate to the crisis. So this will be with us for a while, but its impact is already in the market. Short of a repudiation, and we don't think a repudiation is likely, we think the situation will gradually improve.

I wanted to give you the four problems that Wall Street worries about in some detail to balance them against the pluses, to give you a perspective. If you add up the pluses and then look at the minuses, I think you will agree as we've agreed that the pluses far outweigh the minuses. A lot of the things that we're worried about have already been discounted by the stock and bond markets. Put another way, there are opportunities out there. This is one of the reasons why we think both the bond and stock markets are terribly over-sold. The disasters probably will not happen.

But you must have perspective. You can't just read the front pages of the Wall Street Journal every morning. You have got to go between the pages; you've got to see the gradual improvement in the financial liquidity of American corporations; you've got to see the fact that Argentina, Brazil and Mexico are better off than they were a year ago. There is perceptible change, we are going through a difficult period but things are improving.

I want to end with a 20-second lesson in balance and perspective and how you should view the pluses and minuses as we enter 1985. You will be seeing a lot of good news and a lot of bad news in the media. How to adjust, and how to make a rational and long lasting conclusion can, perhaps best be illustrated in a letter that was written about a year ago. It was written by a young college student to her parents. The letter reads: "Dear Mom and Dad: I am sorry that I haven't written to you for so long but all my stationery was lost the night the dormitory was burned down by the demonstrators. I'm out of the hospital now. The doctor says that my eye sight should be back to normal sooner or later. The wonderful boy who rescued me from the fire kindly offered to share his apartment with me until I found a new place to live. You always wanted a grandchild so you will be glad to know that you will be grandparents next month. Love, Mary." Then she added this postscript. "Please disregard the above exercise in creative writing. There was no fire, I haven't been in the hospital, I'm not pregnant, in fact, I don't even have a boyfriend. But I did get an F in French and I wanted you to receive this news in perspective."

MS. JANE A. CRISE: Do you see any possibility for cuts in spending in entitlement programs?

MR. CAPPIELLO: Yes, in 1985 they will start making some changes in Medicare. Those changes will consume most of the newspaper and television coverage over February, March and April of 1985. The changes will be tough to make, but I think they must be made. Most Congressmen know that they are going to agree to these changes but only after they are elected so they can have two more years to take the flack. We cannot afford to pay for what we are giving out in terms of medical care. The question America hasn't answered is: What are we willing to pay to maintain quality of life? The governor of Colorado touched a raw nerve, but he set the stage.

Future medicare costs are going to be greatly affected by our aging population; the over 55 and particularly the over 65 age group. They represent a big block of votes and that presents problems for a Congressman. But some changes will be made. We're hoping that those changes will be substantial, but they may not be initially.

MR. LEONARD E. TANDUL: You mentioned the two obvious solutions, that is to cut spending or to increase taxes. Are not increases in taxes only a stop-gap solution? Doesn't it follow that employees will increase their wage demands to make up for the loss and, if they are successful, cause an increased inflation?

MR. CAPPIELLO: This is a statement and not a question, but I agree with that statement. That is why many in Wall Street really go for cuts in spending. We've had increases in taxes up until about two years ago and we haven't solved our budget problem. Increases in taxes are no long-term answer, and that's why we don't think the Democrat's solution is appropriate to our problem.

QUESTION: Would you care to comment on the Canadian Economy briefly and how the Canadian Dollar is likely to fare vis-a-vis the U.S. Dollar over the next few years?

MR. CAPPIELLO: We don't do much business in Canada, but we do keep abreast of the Canadian Economy. The Canadian Economy is a resource-based economy, resource-based meaning raw materials based. The prices of most raw materials, not only oil, but also gold, for example, are all still in down trends. This is the most distressing part about the good news of what we are seeing on the charts. Most raw materials are still in down trends. That means good news for inflation, but bad news for raw materials based economies like Canada. My guess is that the Canadian Dollar is going to stay about where it is: 77 cents to the Dollar or maybe drift even further down to 75 cents on the Dollar. Until we get an idea of the new Canadian Administration and what this new Administration does, it could go even further down to 72 cents on the Dollar or it could start to turn back up to 80 cents. Initially 77 cents down to 75 cents looks like a good bet.

Canada is an important trading partner for us. Their recovery is still in its initial stages, and if we in the U.S. can extend our recovery into 1985 and well into 1986, that would mean slow steady progress for the Canadian Economy as well. Projecting further ahead, sometime around mid-1985, we expect the inflation rate to gradually creep up in this country; maybe get to 7 percent. That, in turn, should help the raw material base that Canada

relies on and give some improvement to prices. The problem that Canada has right now is that the price of their raw materials is too low.

MR. DAVID J. FISHBAUM: Regarding your problem number four of international debt, I know it is easy with 20-20 hindsight to look back, but at the time the loans were actually made, were they bad? My second question is: After the crisis is over, how is third world development going to be financed?

MR. CAPPIELLO: When these loans were made they looked perfectly good. Instead of giving you statistics, let me give you an actual situation. Somewhere in the 1981-82 period, a major bank here in New York had the option of lending money to Chrysler, I think it was something like $600 million to Chrysler, or lending money to Mexico. They talked to Iacocca, they talked to the Mexican Officials, and their decision was Mexico. The rate was high and resource-based economy resources, in this case oil, were in fashion. So they made the loan, they made a mistake.

The last time the banks were in trouble was in the 1970's. The Franklin National Bank went belly-up. I think it was the 18th largest bank in the United States right here on Long Island with offices here in New York. The bank began to lend money in the early 1970's on real estate, particularly Real Estate Investment Trusts. No one told them that the real estate market eventually cools off and by 1974 or 1975, all these real estate loans in REIT's were bad loans. It took the banks three or four years to work through that. Then they discovered overseas lending. The Third World, which had an enormous appetite for funds, was paying great rates. Now we are suffering through this. We think the next big stage is leverage buyouts. We think the banks could well get into trouble there. We also think a lot of the lending institutions are going to be in trouble with adjustable mortgages if they don't curb their appetite.

I think the Continental Illinois situation has made a great change in the way banks are going to be viewed. The Federal Reserve and the FDIC have done something that they have never, ever done. They have given government guarantees to all creditors, not just lenders, of Continental Illinois. When the government does this they extract a payment. They don't save a bank without getting something back. What we are going to get in the next session of Congress, probably right after the election, is some hard looks at the banking system and, finally, some legislation on the banking system. Congress will make a decision on what kind of banking system we want and are willing to regulate and monitor. Some views on Wall Street are the more regulation the better.

I think banks are special. They shouldn't be deregulated, and I think the Federal Reserve Board said that when they rescued Continental. If they are not special, they should be deregulated. Then Continental Illinois should have gone to the wall, and everyone should have paid the price that Milton Friedman likes to talk about in our capitalistic system. "Don't tell me about your profits, tell me about the quality of your losses."

As to what is going to happen with the third world, I don't know. The money is going to have to come from somewhere; it's not going to come from the banks, I think that era is over. It's not going to be recycled from the oil rich shiekdoms either. It's going to have to come from another refurbished international monetary system maybe a strengthened IMF. But the money is going to slow down, which means a third world recovery that is not going to be

as vigorous as it was in the 1970's. We have an increasingly unstable world out there. Raging inflation would solve all of our problems short-term, would help Canada, would help Brazil, would help Mexico, would help Argentina. In the long run, of course, it would kill us all. But there is going to be a temptation to inflate and that temptation world-wide is going to start occurring around the middle of 1985.

MR. DALE S. HAGSTROM: Would you be willing to speculate on interest rates, say a 20-year corporate bond and a 20-year treasury bond, over the next year? What is likely to happen to rates in the market place, and what is the yield to maturity under two scenarios: President Reagan and some Democrat?

MR. CAPPIELLO: Let me give you a qualitative rather than a quantitative answer. We think that the long-term rates, the yields to maturity, are about as high as they will be for the next six months. From there on, those yields will gradually come down. Put another way, bond prices should start to go up. It's either that or we destroy the bond market, and I don't think the bond market is going to be destroyed. So short-term, right into the election, we should see somewhat lower rates and a reasonably good bond rally. If President Reagan is re-elected, I think you will see a very strong bond and stock market rally initially. Then I think gradually the bond rally will peter out and the stock rally would continue. If a Democrat gets in, I think initially you will see a pretty big sell off in the bond market and perhaps a slightly smaller one in the stock market. Then gradually, as things begin to sort out, the stock market would base out and start to go up again, particularly those companies that would be benefited by inflation, and the bond market would go into a long term downward slide. I think the election of a Democrat would hurt the bond market and maybe really change the bond market for a long time. The change would be pretty final in that we will not be able to do any more long financing. The only thing that will save our long term financing market would be the re-election of Reagan for four years and the primise that we will get our house in order.

I don't think the demise of the long term bond market is necessarily a disaster. I think we would all adjust. I think it would hurt a lot of people and I think you would have to change your investment programs, but I think most of us have already changed our investment programs so this would only be a final capstone to it.

MR. LAWRENCE P. MOEWS: The current spread between junk bonds and high grade corporates right now is probably the narrowest it's ever been; probably about 150 basis points. It was only a few years ago where it was maybe four or five hundred basis points. A lot of that is due to the recovery and also the demand for junk bonds. Do you see that spread widening again in the future and perhaps getting back to where it was before?

MR. CAPPIELLO: Yes, I see the spread widening again at the first indication that the economy is slowing down. If the next recession looks likely, the quality spreads would begin to widen again. What's happened in the junk bond area is exactly correct as you described it. Typically we see as we go into a recovery, the spread between high grade bonds and junk bonds does narrow. All of us reach for yields by going down in quality. I think what has happened recently has been investment people going even further down into the junk bond area.

The second factor has been something new. There have been so many success

stories on junk bonds that we have had a lot of junk bond funds develop, both public and private. This has soaked up a lot of the junk bonds that were floating around and narrowed the spreads. As we go into a slow down, that spread will widen. You really begin to search for quality when you think the economy is going to be slowing down. If I were in junk bonds, I would want to get out early. I would think about getting out perhaps after a Reagan triumph if that occurs, or if it looks like a Democrat is going to be triumphant, I may jump the gun. I don't think I would be waiting around until 1985. I think I would want to go into quality before that.