ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 8672
150 SCOMM 9: HOUSE SPEC. COMM. ON PERMANENT FUND 1977-78

OPERATIONS

Natural Gas Pipeline Division – (79% of 1975 EBIT–Earnings Before Interest & Taxes)

The entire natural gas pipeline industry until recently has been suffering from a common problem: diminishing supplies of natural gas, the result of restrictive F.P.C pricing practices which have discouraged the search for and development of new gas sources. Although the recent move of the F.P.C. toward higher prices at the wellhead will certainly stimulate increased interest in exploring for natural gas, the possible refund liability still serves to discourage the commitment of new reserves to interstate markets. Until deregulation legislation is proposed by President-elect Carter and enacted by Congress, the prospect of natural gas shortages may continue to plague the industry.

Florida Gas Transmission, incorporated in 1957, is a natural gas pipeline system which extends from the Rio Grande Valley of South Texas to a point 20 miles south of Miami, Florida traversing the States of Texas, Louisiana, Mississippi, Alabama and Florida. The pipeline provides the only natural gas service available in peninsular Florida and serves 33 gas distribution systems and 40 industrial customers. Because of the mild winters and absence of hefty heating loads, the primary markets are commercial and industrial consumers. The largest customer group is twelve electric generating systems of which Florida Power & Light and Florida Power Corp. are the biggest. Gas distribution utilities are the next largest followed by food processors, FLG's liquids extraction plant, pulp and paper plants, and citrus processors.

At the end of 1975 Florida Gas Transmission had 1.34 trillion cubic feet of natural gas dedicated to its system under long-term purchase contract, equal to a reserves/production ratio of 11.2 years based on 1975 sales of 120 billion cubic feet. During 1975 only a small portion of the gas sold was replaced with new reserves and deliverability diminished, a trend expected to be reversed after 1976, since new offshore production committed through its exploration efforts will result in a higher natural gas delivery level.

In 1975, 222 billion cubic feet of gas were delivered to Florida by the pipeline system, including 124 BCF under transportation contracts with Florida Power & Light and Florida Power Corp., 72 BCF sold to distribution utilities for resale, and 26 BCF sold directly to industrial customers for their own use. (Twenty-one BCF were also sold in Texas or Louisiana or used by the system.) Gas sales for industrial use are made on an interruptible basis and curtailments of these deliveries enables the pipeline to meet peak firm requirements.

Table 2

NATURAL GAS SALES VOLUMES

	Trillions of BTU					% Change
	1974	1975	1976E	1977E	1978E	1976 to 1978
Distribution System	23	23	24	26	27	12.5%
Pipeline System						
For Resale	51	49	51	55	58	13.7
For Use	54	26	11	9	6	(45.5)
Transportation Deliveries	124	124	124	124	124	–
Company Use & Other	37	21	9	9	9	–
Total	288	243	219	223	225	2.7%

Most new supplies of pipeline gas will be produced from offshore acreage and as offshore production increases, higher gas deliveries appear likely in the late 1970's. The first major volumes from offshore began flowing in early 1976 from Grand Isle Block #76 in which Florida Gas Exploration has a small working interest.

Until recently, Florida Gas Transmission had several overlapping rate cases pending before the Federal Power Commission; however, a settlement agreement with customers and the F.P.C. staff was reached in the summer of 1976 which will resolve all pending rate matters when finalized by the F.P.C.

As a result of revenue increases, gas transmission earnings were up slightly in 1974 and again in 1975. A rate increase, effective April 15, 1976 included in the recent settlement was designed to provide a 13% return on equity and helped improve earnings in 1976 while in 1977 pipeline income will rise to record levels helped by higher volumes.

Gas Distribution Operations – (8% of 1975 EBIT)

Systems which distribute natural gas at retail to residential, commercial and small industrial consumers are operated by FLG in Miami, Jacksonville, Orlando-Winter Park, St. Petersburg, Daytona, Lakeland and several smaller communities. Together, these systems purchase about one-third of the pipeline system's sales for resale. At year-end 1975, the distribution system was serving about 92,000 customers with natural gas while 9,000 potential customers located beyond the present limits of the distribution lines were served with bottled gas. A warm 1975 winter heating season produced a revenue increment insufficient to offset inflated operating costs and 1975 distribution earnings were down about 16%. The 1976 winter season was slightly colder than normal and this, coupled with a $2.6 million rate increase in August, 1976, should produce a sharp recovery (up 22%) in earnings. For 1977, we anticipate another good earnings improvement (up 10%) under normal weather patterns owing to carryover benefits of the rate increases, cold weather to date, and somewhat higher volumes of gas.

Oil & Gas Operations – (1% of 1975 EBIT)

The direction of future corporate development is best outlined by Florida Gas' capital expenditures (see Table 4) that suggest management believes its most promising future earnings prospects lie in oil and gas production. Net investment in this sector totaled approximately $40 million at the end of 1975, of which $29 million was invested in offshore and $11 million in onshore properties. Despite the success of the exploration programs to date, oil and gas operations continued to show a loss through 1975 because development of the fields has been slow, and overhead and interest costs are expensed. However, the contributions to earnings are expected to develop rapidly as more of the newly discovered fields come into production. Florida Gas Exploration, a subsidiary of Florida Gas, is financed independently of Florida Gas Transmission, the pipeline, and hence, all profits flow to the stockholders. Oil and gas earnings before interest and income taxes should rise rapidly from $1.3 million in 1975 and an estimated $3.0 million in 1976 to a projected $5.0 million in 1977 and $8.0 million in 1978.

In the onshore area, four exploration programs are operated: one in New Orleans; one in Jackson, Mississippi; one in Houston, Texas; and the newest in Midland, Texas. During 1976, Florida Gas participated in 28 wildcat wells (12 successful) and 19 development wells (12 completed as producers.) Efforts in Southern Louisiana have been very successful in locating oil and gas reserves, and results have been exceptional in Mississippi, where FLG has discovered several significant new gas fields. Production from onshore discoveries has been growing for the past two years and is now at a daily rate of about 400 barrels of oil and 12 million cubic feet of gas.

Table 3

OIL AND GAS EXPLORATION AND DEVELOPMENT

			Estimate		
	1974	1975	1976	1977	1978
Daily Production Rate (Year-End)					
Oil (barrels)	250	325	400	500	600
Gas (Million of Cubic feet)	6.3	10.9	21.0	30.0	40.0
Proved Reserves (all Onshore)					
Oil (000 barrels)	457	521	–	–	–
Gas (Billions of Cubic feet)	20.8	20.7	–	–	–

In the offshore area, Florida Gas has interests in fifteen prospects for which it paid $23.4 million. Seven of these leases located offshore Florida with a cost of $3.8 million were abandoned and put into the full cost accounting pool early in 1975. FLG has usually participated in offshore lease activities in partnership with Shell Oil. Presently the most promising offshore exploration areas are:

1) Grand Isle Blocks 75 and 76, where FLG has a 12.5% working interest and a call on 50% of all gas. Natural gas production began in April 1976 and is running about seven million cubic feet per day.

2) Vermilion Block 22, in which Florida Gas has a 4.17% working interest and a one-sixth call on gas, is scheduled to begin production around mid-1977; and

3) the Cognac Prospect (which cost the Shell group $214 million) in which FLG has a 4.17% working interest and a call on 25% of any gas found.

Consideration was given to selling the Cognac Prospect because of the large capital investment but it retained its interest and was rewarded when the promising seismic data was confirmed by the discovery of several feet of oil and gas bearing sands in the first four wells. Cognac is an exciting development based on its prospects for major earnings contributions for FLG shareholders as well as being a potential long-range gas supply source. A drilling platform the height of the Empire State Building has been ordered for Cognac, one of the deepest water prospects in the Gulf of Mexico, and production should begin in 1979. Various estimates of probable Cognac reserves indicate that Cognac is a significant oil and gas discovery.

Land Development – (minus 2% of 1975 EBIT)

Florida Land Company, the company's land subsidiary, now has most of the 1974 and 1975 problems behind. Demand for housing was weak due to overbuilding, inflation, and high interest rates; however, a dramatic curtailment of building activity has reduced housing inventories and a positive recovery is underway. The land development properties of Florida Gas are well situated to participate in the longer term growth of Central Florida, especially the growth that may be derived from Walt Disney World's proposed new World Trade Exposition schedule for operation in 1980. The Exposition would increase Disney employees from 13,000 to 29,000 by 1985 and support an increase in attendance from 12 million in 1975 to an estimated 22 million in 1980, 25 million in 1985, and 30 million by 1990. These land holdings are a valuable asset, but a sustained improvement in Florida's residential construction industry is necessary before an earnings contribution can be realized. Management considers the present near-term growth prospects insufficient to justify further major capital investments in land development and intends to gradually reduce its total $45 million investment in this area. The Company is unlikely to undertake any new development projects and may, in fact, use the cash flow generated by property sales as a source of funds for future oil and gas exploration activities. Sales of the various parcels are not likely to produce material losses. The five major properties in which Florida land currently has interests are:

Orangewood, a 4,500-acre development located between Orlando and Disney World where two major tourist attractions, Sea World and the Stars Hall of Fame, bought land and are developing their activities. Florida Land has completed development of its first commercial and residential section and further development will be undertaken when a stronger recovery in the land market becomes evident.

Winter Springs, a 2,250-acre venture northeast of Winter Park has been developing and selling lots to builders for four years. Half the project has been sold.

Greenwood Lakes, is a 1,500-acre development north of Orlando. Further development has been deferred until a pickup in land operations begins. A new NCR plant has just started operations adjacent to Greenwood Lakes and will employ some 1,500 workers.

Sugar Mill, is a new golf resort community located near New Smyrna Beach, north of Cape Kennedy. Several lots adjoining an appealing golf course have been laid out, and construction is underway or completed on nearly fifty townhouse villas which have sold well.

University Park, is a 450-acre development near Orlando across from Florida Technological University which commenced operations in 1970 and has grown remarkably since. The property has been zoned primarily for garden-type apartments and condominiums to be used by or rented to students and faculty. The property is being held for future development although one tract has been sold.

Hydrocarbons – (12% of 1975 EBIT)

Florida Hydrocarbon's natural gas liquids extraction plant at Brooker, Florida processes the pipeline system's mainline gas stream, removes liquid hydrocarbons and redelivers the gas stream to the pipeline. The liquid hydrocarbons are then processed into propane, butane and natural gasoline; a blending facility produces motor fuel. With the connection to the pipeline system of new gas supplies from the Jay Field in northwest Florida in 1972, the liquid hydrocarbons in the gas stream increased substantially, resulting in significantly greater liquids output. Following the start of our nations' energy crisis in late 1973, prices for extracted products rose sharply and operating earnings rose from less than $1.0 million in 1972 to over $12.0 million in 1974. The Jay Field producers, however, started operating field extraction facilities in May, 1975, and the extraction of liquid hydrocarbons has since declined from a peak annual rate of 109 million gallons in 1974 to the present annual rate of about 32 million gallons.

Production volumes may decline gradually in the future as new gas reserves attached to the pipeline system are delivered in a dry form, the liquids already having been extracted by the vendor, and earnings may decline further from $2.0 million expected in 1976 to $1.0 million in 1977 and beyond. However, the energy shortage has boosted prices for extracted products and over the longer-term, earnings should remain positive.

TransGulf Pipeline — (Potential new earnings source)

The natural gas transmission system is operating at less than 80% of capacity and FLG has applied to the F.P.C. for approval to convert a substantial portion of the original 24-inch pipeline to a petroleum products pipeline which would involve completing the remaining loops of the parallel interconnecting 30-inch pipeline thereby permitting full deliveries of natural gas into Florida to continue. The products portion of the line would extend approximately 890 miles from near Baton Rouge, Louisiana, to Fort Lauderdale, Florida, and would transport gasoline, jet fuel, diesel oil, kerosene, light heating oil and other refined products which presently enter Florida only by truck, railroad tank car, barge or tanker. TransGulf would have an initial delivery capacity of approximately 200,000 barrels a day, about one-half of the current consumption of these products in the Florida market. The initial system is projected to cost $135 million which includes $32 million to purchase the existing 24-inch pipeline system, and the balance for commercial terminals at various locations in the state. Florida Gas Transmission will spend $20 million to complete looping the 30-inch pipeline.

If the F.P.C. approves TransGulf, operations could commence by 1979, at which time the average daily delivery capacity of the natural gas pipeline system would be reduced from 705 million cubic feet to 625 million cubic feet. If it were assumed that the new products pipeline system would be financed with an initial 10% common equity contribution from the parent company and that the return on that equity would be substantially higher than the present return on equity, the earnings contribution could be in the area of $0.50-0.75 per share.

FINANCIAL

Construction

Capital expenditures totaled $19.1 million in 1975, were projected at $22 million for 1976, and for 1977 may be in the $40 million area. If F.P.C. approval is received, construction of the TransGulf pipeline conversion project could be accomplished mostly in 1978; capital spending for 1978 in Table 4 excludes any TransGulf outlays.

Table 4

CAPITAL EXPENDITURES
(millions)

	1974	1975	1976E	1977E	1978E
Division					
Pipeline	$ 7.7	$ 2.8	$ 3.0	$ 9.0	$ 5.0
Distribution	4.1	3.6	4.0	5.5	6.0
Land	14.5	4.1	1.5	2.5	3.0
Oil & Gas	22.5	18.5	13.0	22.0	30.0
Hydrocarbons & Other	0.3	0.1	0.5	1.0	1.0
Total	$49.1	$19.1	$22.0	$40.0	$45.0

Financing

Florida Gas has a $10 million revolving credit agreement (most of which was taken down by the end of 1976) and $30 million bank line; no major permanent financing was undertaken during 1976 except for a $30 million, six and a half year term loan entered into in conjunction with the revolving credit agreement. In 1977, capital spending of $40 million will be funded by $12 million of retained earnings, $31 million from depreciation and depletion and $8 million of deferred income taxes making any permanent long-term financing unnecessary except special project type financing, if suitable. The 5¾% debentures are not likely to be exercised (conversion price $23.41) until the common stock dividend reaches $1.35 per share, a rate we foresee about mid-1979, the same year the debentures initially becomes callable. We do not see the need for equity financing over the next few years.

Table 5

FINANCING AND CAPITALIZATION

	1974	1975	1976E	1977E	1978E
Uses					
Capital Spending	$ 49.1	$ 19.1	$ 22.0	$ 40.0	$ 45.0
Dividends	5.5	6.1	7.0	7.0	8.0
Sinking Funds and Maturity	16.7	22.7	16.0	23.0	40.0
Total Uses	$ 71.3	$ 47.9	$ 45.0	$ 70.0	$ 93.0
Sources:					
Internal:					
Depreciation	$ 16.6	$ 20.7	$ 28.0	$ 31.0	$ 34.0
Deferred Taxes	4.9	9.9	7.0	8.0	9.0
Net Income	17.6	16.2	18.0	19.0	21.0
Miscellaneous	(17.2)	(0.9)	(12.0)	–	–
Internal Total	$ 21.9	$ 45.9	$ 41.0	$ 58.0	$ 64.0
External:					
Short-Term Debt	$ 9.6	$ (0.7)	$ (26.0)	$ 12.0	$ (1.0)
Long-Term Debt	39.8	2.7	30.0	–	30.0
Preferred Stock	–	–	–	–	–
Common Equity	–	–	–	–	–
External Total	$ 49.4	$ 2.0	$ 4.0	$ 12.0	$ 29.0
Total Sources	$ 71.3	$ 47.9	$ 45.0	$ 70.0	$ 93.0
Abreviated Balance Sheet:					
Net Plant	$380.3	$375.4	$369.0	$378.0	$389.0
Capitalization					
Short-Term Obligations	$ 36.4	$ 35.7	$ 10.0	$ 22.0	$ 21.0
Long-Term Debt	204.3	185.7	200.0	177.0	167.0
Preferred Stock	9.0	8.4	8.0	7.0	7.0
Convertible Debentures	14.5	14.5	14.0	14.0	14.0
Common Equity	138.0	148.2	159.0	171.0	184.0
Total	$402.2	$392.5	$391.0	$391.0	$393.0

Earnings—1975

In 1975 Florida Gas earned $2.31 per share, fully diluted, down 8% from the $2.51 earned in 1974. Natural gas transmission and distribution operations and the loss in real estate operations held about at 1974 levels while oil and gas exploration operations reversed from a loss to a modest profit. Although the combined earnings from these three divisions rose, FLG's consolidated 1975 results were down as a result of the anticipated reduction in earnings from Hydrocarbons. The May 1975 start-up of the liquids extraction plant in the Jay Field greatly reduced the product recovery by FLG's plant, and hence, net income from the hydrocarbons subsidiary declined $0.46 per share during 1975. Also, a first quarter modification of an exploration program increased net earnings by $0.09 per share, while in the fourth quarter, FLG chose to write down its foreign oil and gas exploration operations which reduced earnings by $0.06 per share.

Earnings — 1976

Earnings for the first nine months of 1976 were $1.88 per share (fully diluted), 4% over the $1.80 earned in the same 1975 period.

Table 6

QUARTERLY EARNINGS COMPARISON
(Fully Diluted)

Quarter	1974	1975	1976	1977E	1978E
March	$0.74	$0.83a	$0.72	$0.80	$0.90
June	0.67	0.54	0.54	0.60	0.65
September	0.52	0.43	0.62c	0.65	0.70
December	0.58	0.51b	0.62E	0.70	0.80
Year	$2.51	$2.31	$2.50	$2.75	$3.05

(a) Includes $0.08 non-recurring income from exploration program modification.
(b) Includes $0.06 earnings reduction owing to write down of foreign oil and gas exploration investments.
(c) Includes $0.09 income from non-recurring producer redunds.
E — Estimated.

For the full year 1976 we expect gas transmission and distribution operations to contribute greater profits than in 1975, land operations to have bottomed and maybe even show a modest improvement while earnings from oil and gas exploration operations, reflecting initial production from Grand Isle Block 76 and an increase in daily offshore production, should improve strongly. The earnings weakness at Florida Hydrocarbons continued through the first five months of 1976 but, starting in June, production of liquids at the extraction plant was on a basis comparable with 1975; we expect earnings comparisons for the balance of the year were favorable. For the full year 1976, fully-diluted earnings near $2.50 per share are estimated, for Florida Gas.

Table 7

INCOME STATEMENT
(Millions)

	1971	1972	1973	1974	1975	1976E	1977E	1978E
Operating Income Before Interest And Income Taxes								
Pipeline System	$39.0	$33.5	$36.8	$37.0	$37.2	$39.0	$40.5	$41.0
Distribution Systems	3.0	3.9	3.9	4.4	3.7	4.5	5.0	5.0
Hydrocarbons Extraction Plant	–	0.4	3.8	12.4	5.8	2.0	1.0	1.0
Oil and Gas Exploration	(1.7)	(0.8)	(1.0)	(0.5)	1.3	3.0	5.0	8.0
Real Estate	(0.1)	0.2	0.6	(1.4)	(0.9)	(0.5)	–	0.5
Other	(2.3)	0.2	(1.0)	(0.6)	(0.1)	(0.5)	(0.5)	(0.5)
Total	$37.9	$37.3	$43.1	$51.4	$47.0	$47.5	$51.0	$55.5
Fixed Charges	$16.7	$16.1	$17.0	$20.7	$18.1	$16.0	$15.5	$15.0
	$21.2	$21.2	$26.1	$30.7	$28.9	$31.5	$35.5	$39.5
Interest Capitalization and AFUDC	1.0	1.0	1.8	2.3	1.5	1.1	1.0	1.0
	$22.2	$22.2	$27.9	$33.0	$30.4	$32.6	$36.5	$40.5
48% Income Tax	10.7	10.7	13.4	15.8	14.6	15.7	17.6	19.5
	$11.5	$11.5	$14.5	$17.2	$15.8	$16.9	$18.9	$21.0
Miscellaneous and Flow Through Items	0.1	1.2	1.3	0.4	0.4	0.5	0.5	–
New Income	$11.6	$12.7	$15.8	$17.6	$16.2	$17.4	$19.4	$21.5
Preferred Dividends	0.6	0.6	0.6	0.6	0.5	0.5	0.5	0.4
Earnings for Common	$11.0	$12.1	$15.2	$17.1	$15.7	$16.9	$18.9	$21.1
Shares Outstanding	6.25	6.33	6.33	6.33	6.34	6.37	6.37	6.37
Earnings Per Share; Primary	$1.76	$1.91	$2.40	$2.69	$2.47	$2.65	$2.97	$3.31
Earnings Per Share; Fully Diluted	$1.65	$1.80	$2.24	$2.51	$2.31	$2.49	$2.77	$3.08
Dividends Per Share	$0.60	$0.624	$0.65	$0.78	$0.875	$0.975	$1.075	$1.175
Payout Ratio	36%	35%	29%	31%	38%	40%	40%	40%

Earnings — 1977 and Beyond

Less unfavorable quarterly earnings comparisons at Hydrocarbons coupled with higher volumes of natural gas transmitted and sold, increasing oil and gas production and higher prices, and a further recovery of land operations should produce earnings of at least $2.75 per share fully-diluted in 1977.

Over the longer term we expect earnings per share growth to continue at an annual rate of 10% or better assuming increasing profits from oil and gas production, the gradual marketing of land holdings, and (starting in 1979) a profit contribution from TransGulf Pipeline (if approved). In 1980 initial production from the Cognac prospect could add significantly to earnings. By 1980, the mix of earnings before interest and taxes, assuming possible per share earnings that year of $4.00, could be 62% pipeline, 23% oil and gas, 9% products pipeline, 8% distribution, and the remainder land and hydrocarbons.

Dividends

After the original pipeline system started in 1957, nearly ten years passed before cash flow was sufficient to pay the first common stock dividend in 1967. Because of the brief dividend record, there is no firm payout policy; however, management has increased the rate annually since dividends were instituted, a policy we believe will continue. The dividend was increased to $1.00 per share effective with the June 15, 1976 payment. We estimate the dividend could reach $1.40 per share by mid-1980, a 35% payout of that year's possible earnings assuming dividend increases of $0.10 per share each year.

Table 8

FINANCIAL SUMMARY
(Millions)

	1971	1972	1973	1974	1975	1976E	1977E
Operating Data							
Revenues	$109.2	$109.5	$124.7	$135.5	$127.5	$ –	$ –
EBIT	37.9	37.3	43.1	51.4	47.0	47.5	51.0
Fixed Charges	15.7	15.1	15.2	18.4	16.6	14.9	14.4
Income Taxes	9.8	9.5	12.2	15.4	14.2	15.2	17.1
Net Income	12.4	12.7	15.8	17.6	16.2	17.4	19.4
Earnings for Common	11.8	12.1	15.2	17.1	15.7	16.9	18.9
Capitalization							
Debt (Long & Short Term)	$219.4	$213.4	$217.0	$240.7	$221.3	$210.0	$199.0
Preferred and Converts	25.3	24.7	24.1	23.5	22.9	22.0	21.0
Common Equity	107.9	116.5	125.9	138.0	148.2	159.0	171.0
Total	$352.6	$354.6	$367.0	$402.2	$392.4	$391.0	$391.0
Ratios							
Operating Margin	34.7%	34.1%	34.6%	37.9%	36.9%	–	–
Pretax Coverage	2.4X	2.5X	2.8X	2.8X	2.8X	2.9X	3.5X
Effective Tax Rate	44.1%	42.8%	43.6%	46.7%	46.7%	46.6%	46.8%
Return on Investment	8.0%	7.8%	8.4%	9.0%	8.4%	8.5%	8.7%
Return on Avg. Equity	12.1%	10.8%	12.5%	13.6%	11.0%	11.0%	11.5%
Common Equity Ratio	30.6%	32.9%	34.3%	34.3%	37.8%	40.1%	43.7%
Per Share Data							
EPS (Fully Diluted)	$1.77	$1.80	$2.24	$2.51	$2.31	$2.50	$2.75
Dividends	$0.60	$0.624	$0.65	$0.78	$0.875	$0.975	$1.075
Book Value	$16.85	$18.14	$19.89	$21.80	$23.40	$24.96	$26.84
Average Shares (Mil.)	6.25	6.33	6.33	6.33	6.34	6.37	6.37
Price Range	30-20	24-17	22-11	16-7	16-9	–	–
P/E Range	17-11X	13- 9X	10- 5X	6-3X	7-4X	–	–
Average P/E	14.1X	11.3X	6.9X	4.5X	5.6X	–	–
P/E Realtive to S&P500	82%	66%	53%	49%	53%	–	–

VALUATION

Natural gas pipeline companies continue to sell at a price/earnings multiple discount from the market averages. Within the pipeline group, Florida Gas had generally sold at a slight discount based on its P/E multiple and market-to-book ratio; however, the increasing earnings contribution from oil and gas operations should eventually boost the P/E to a premium within the group (natural gas producers typically sell at 11–12 times estimated 1977 EPS), while the market-to-book ratio should also improve as land sales recover. (Florida Gas has sold substantially below book value to recent years, a discount which we attribute to investors' concerns that weak real estate markets may have required a write-off of a portion of the high cost land investments, thereby reducing book value per share.) Based upon a P/E multiple valuation about equal to or only slightly greater than other gas pipelines, Florida Gas appears particularly attractive at current levels for a combination of increased earnings, a modest but gradual upgrading of the P/E and solid dividend growth.

Table 9

FLORIDA GAS INSTITUTIONAL OWNERSHIP

Institutional Category	Number Holding	Shares Held	% of Outstanding Shares
Banks*	9	374,474	5.9%
Investment Companies*	9	516,000	8.1%
Insurance Companies**	5	382,500	6.0%
Total	23	1,272,974	20.0%

Source: * Spectrum —June 30, 1976
** A.M. Best —1976 Edition

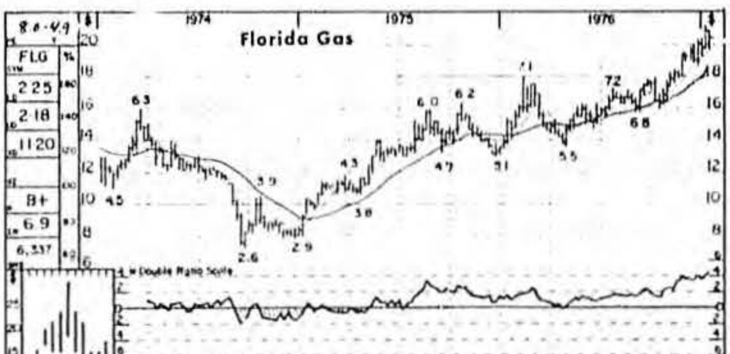
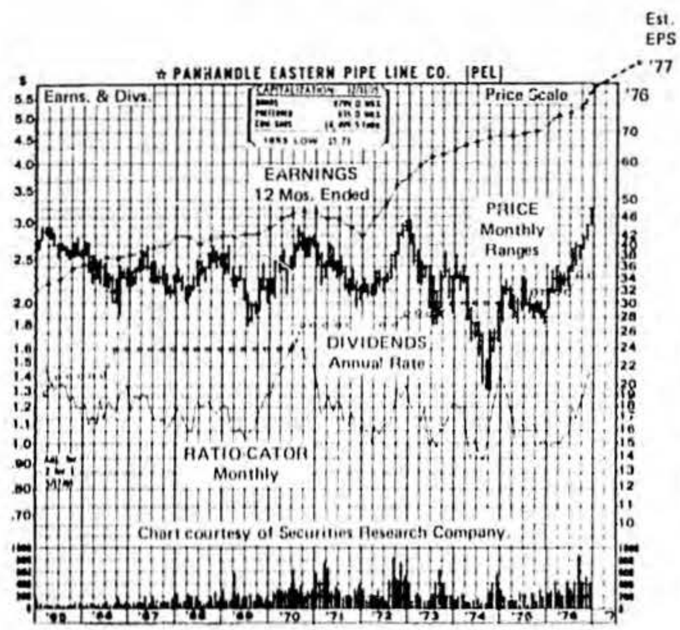


Chart courtesy Mansfield Stock Chart Service.

PANHANDLE EASTERN PIPE LINE CO. (PEL)

Price (NYSE)		Dividend		EPS		P/E
February 3, 1977:	47	Rate:	$2.30	1978E:	$7.25	6.5X
Range (1976-1977):	49-29	Yield:	4.9%	1977E:	$6.40	7.3X
				1976A:	$5.58	

Common Shares Outstanding:	16.7 million	Return on Average 1975 Equity:	16.6%
Market Value:	$785 million	Book Value Per Share (9/30/76):	$34.02
% Owned by Institutions:			
31 Banks	18.7%		
22 Investment Companies	9.2%	Number of Brokers Covering	
31 Insurance Companies	3.3%	PEL (Nelson):	13



DESCRIPTION

Panhandle and its subsidiary, Trunkline Gas, buy gas in the Gulf Coast, in the Anadarko Basin, and in Rocky Mountain areas for resale in Michigan (36% of sales), Indiana (19%), Illinois (18%) and Ohio (17%). Energy production related subsidiaries include: Anadarko Production—which produces oil and gas from onshore and offshore sources; Pan Eastern—which is a drilling fund that sells the gas from reserves formerly owned by the pipeline; Y&O Coal—acquired mid-1976, which mines underground coal and sells it for electric generation; and Century Refining—an oil refinery and marketer in the Great Plains. Other operations include offshore drilling, dividends from National Distillers and Chemical Co. and sales of liquids extracted from the gas stream.

CONCEPT

As recently as a year ago, investors believed natural gas pipelines were a declining business. They were incorrect.

Natural gas pipelines began to search for gas themselves in the late 1960's when their supplies dwindled as traditional producers searched for other energy sources whose unregulated prices offered greater profitability prospects. The shift to their own gas exploration and production is paying off much more handsomely than previously thought due to a better than six-fold increase in gas prices since then and is giving the gas industry a significant new earnings dimension which should last for years to come.

Panhandle Eastern, one of the first to identify this need for vertical integration, acquired interests in several offshore leases as early as 1970, which are just coming into production and developing into a significant new earnings source. Moreover, earnings prospects for PEL's traditional pipeline operations have also improved due to higher anticipated gas volumes transmitted through the Trunkline system. Overall, we believe PEL can sustain EPS growth of 11% per annum into the early 1980's.

The combination of growing production income and expanding pipeline earnings suggests that PEL could command a P/E ratio a bit closer to natural gas producers. Currently, pipelines as a group are selling at 7.7 times estimated 1977 EPS and yielding 4.8%, while gas producer multiples range from 9 to 12 times 1977 estimates. PEL should continue as one of the principal beneficiaries of investors' increasing recognition of changing pipeline fundamentals. We continue to recommend purchase.

POSITIVES

1. Natural gas deliveries by the pipeline system will rise in 1977 after declining in each year since 1972.
   a. Trunkline has connected new Gulf of Mexico production and its volumes will rise sharply in 1977.
   b. Panhandle volumes will drop only slightly due to new deliveries from Trunkline; most of its gas supply now comes from areas with active intrastate markets.

c. Stingray's location positions the pipeline systems to contract for new Gulf reserves as developed.

d. Delivery curtailments in 1977 should be down by 20% for Trunkline.

e. Higher volumes mean earnings growth will be less dependent upon rate increases.

2. Earnings from energy production materializing rapidly.

   a. Purchase of Y&O Coal Co. in August 1976 adds steam coal as an earnings base and gives PEL coal expertise for the future.

   b. Pan Eastern's gas search program has been extended through 1986. Pan Eastern uses the proceeds from the sale of old gas at the prevailing F.P.C. national rate to develop additional gas reserves. Since customers provide the funds, the new gas will be sold at discount prices.

   c. Anadarko Production has a long history of production in the Hugoton and Anadarko Basins, traditional gas supply area of the Panhandle system. Anadarko is also PEL's entry into the exciting offshore areas.

   d. Anadarko's offshore leases include 86,388 acres offshore Louisiana; 72,577 acres offshore Texas; and 22,772 acres in the Baltimore Canyon offshore Atlantic.

   e. Platforms have been installed on four Louisiana blocks and three Texas blocks, two of which are producing, one will start flowing by mid-1977 and four others by 1978.

3. Other Panhandle ventures provide diversified opportunities for earnings expansion.

   a. PEL owns 3,000,000 shares of National Distillers & Chemicals, a $74 million investment carried on the books at only $7 million.

   b. PEL is a partner in a proposed LNG project that would import an average of 420 million cubic feet daily from Algeria using five LNG tankers.

   c. Archon, which in December 1976 announced plans to acquire Dixilyn Corp., an offshore contract driller, now owns a two-thirds interest in two semi-submersible rigs.

4. Financing needs are modest.

   a. Capital outlays of approximately $200 million are expected for 1977 and a slightly higher $220 million in 1978 (versus $200-245 million in 1974-76).

   b. Internally generated funds are rising from an average $145 million per year for 1974-1976 to a projected $185 million average per year for 1977-1978.

   c. The acquisition of Y&O Coal in August 1976 for stock raised the equity ratio from 36% to 40%, obviating any future need to sell new common equity to the public. Other acquisitions for stock (such as Dixilyn) will serve to boost the equity ratio further.

5. Earnings growth should benefit materially from higher gas volumes carried by Trunkline and the rising production income from Anadarko's offshore acreage.

6. Payout ratio was 45% for the period 1971-76.

   a. The present $2.30 dividend is only 36% of 1977 estimate.

   b. We believe the greater risks of oil and gas exploration may mandate a payout lower than 45% but probably not below 40% of earnings. Maintenance of 40% payout could produce 10-12% dividend growth.

7. In an economy that is likely to be energy-short well into the future, we believe those companies producing energy will tend to increase their relative P/E ratio while the heavy energy-consuming industries should experience a further decline in their P/E's relative to the market.

CONCERNS

1. There has been some concern as to the soundness of certain diversification efforts. While each could be questioned as an isolated move, together they provide exposure to the development of new energy resources.

   a. PEL acquired Y&O Coal despite reserves nearly all being high sulfur steam coal offering little prospect for growth and weak spot markets. Furthermore, coal gasification feasibility still appears years away.

   b. The Dixilyn acquisition is being achieved while offshore drilling companies are running into excess capacity, reducing rig rates and shrinking profits.

2. The stock price is about 65% above its 1976-1977 low and some are questioning the degree of remaining upside potential. However, in view of the still modest 6.5 multiple on estimated 1978 EPS, the current yield of 4.9%, and favorable EPS and dividend prospects, we believe PEL will continue to outperform the market.

Earnings per Share by Division

	1975	1976E	1977E	1978E
Pipeline				
Panhandle	$0.71	$0.90	$0.90	$1.40
Trunkline	1.78	2.15	2.30	2.00
Stingray	0.41	0.20	0.20	0.20
Total	$2.90	$3.25	$3.40	$3.60
Energy Production				
Anadarko	$0.62	$0.95(x)	$1.45	$1.95
Pan Eastern	0.36	0.50	0.50	0.60
Y&O Coal	-	0.10	0.25	0.30
Pan Western	0.04	0.05	0.05	0.05
Century Refining	0.19	- (x)	0.15	0.15
Total	$1.21	$1.60	$2.40	$3.05
Other Sources				
Archon	$0.13	$0.15	$0.05	$0.10
National Distillers	0.25	0.25	0.25	0.25
National Helium	0.09	0.10	0.10	0.05
Other (Miscellaneous)	0.25	0.25	0.20	0.20
Total	$0.72	$0.75	$0.60	$0.60
Earned Per Share	$4.83	$5.58	$6.40	$7.25

E = Estimated (1976 division results are estimated, total EPS actual).
x = 1976 writeoffs incl. $0.29 in Century; $0.27 in Anadarko.

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RESEARCH WIRE

Non-ferrous outlook

28 February, 1977
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Copper industry trouble; strike too
Coal strikes hurt--trouble making in
Washington--aluminum 1st quarter low--
but long run better--molybdenum strong
Nickel, zinc, copper weak--company briefs

If there is a long U.S. copper strike earnings in 1977 of the copper companies will be less than shown here. Some will be less affected since not all labor agreements end June 30. Chance of a strike is good.

If coal strikes and slow downs are severe this year, companies with coal properties may have lower earnings than shown here.

Trouble from Washington

A courts' decision that Atlantic Richfield could take over Anaconda, though the FTC opposed it, may have wider significance. It may open the way for other large companies to acquire U.S. metals companies. On the other hand, some of these metals companies are in coal, oil, gas or uranium. Noises in Washington suggest the government is considering prevention of horizontal integration of companies in the energy industries. This would inhibit exploration for and development of energy resources. Washington might even decide to dis-integrate those now integrated. This could hit Amax--partly via St. Oil of California's some 20%, but Amax also is in coal, oil and gas. St. Joe Minerals is in coal, oil and gas. Utah International is in coal, oil and gas, and it has an "independent" uranium company. It is possible the Utah (General Electric) pattern might satisfy Washington's need to make things difficult for the economy--require separate and outside boards for each energy industry operation.

Freeport Minerals is in oil and gas and is getting into uranium. Newmont is in oil and gas and indirectly coal, and now will be more directly in coal.

Washington I think will hold hearings on these matters in April or May. I guess all the anti-growth, anti-business types will be there. More reasonable people tend to be discouraged by such things and are dis-inclined to testify. In addition it is always assumed they are biased--rarely is it realized how important are the ideological biases of the pro-government interventionists. Dis-integration would not necessarily reduce total market value. In fact, two separate companies might be worth more than one.

1977 a poor year

Heavy over-supply in most metal industries, but also much greater costs associated with pollution abatement; will mean a poor year for many of these

W/01P/19

companies. Extremely high wages in recent years will make strikes and slow-downs more practical, and termination of labor agreements this year will most likely lead to widespread strikes. Aluminum will do well; over-supply is disappearing, and molybdenum markets are strong and will probably strengthen further. Lead prices have spurted owing to heavy Russian demand evidently following plant break downs, and a long strike of an Asarco-smelter in Missouri Lead might ease later. Zinc and nickel are quite weak, and copper is not quite a disaster; it is for some companies.

Aluminum looks good

I felt two ALUMINUM price increases would occur in 1977--one would be the elimination of price discounts and the other would be a regular price increase. Most prevalent has been the view there would be two of the latter. That is possible but even without it, with a shipment rise to about 13.6 billion pounds, the companies will do much better in 1977-- and 1978 will be better still--the latter is the year for fancy earnings in aluminum. The notion there would be regular price increases early in 1977 was slapped by David Reynold's remark that RLM would have a small increase after setting new wage agreements. This means probably in mid-year. It is still possible the companies would do it twice in 1977 though. U.S. shipments in 1976 were about 12.8 billion pounds and that is far ahead of 1975's some 9.9 billion, but well under 1973 and 1974's two year average of about 14.3 billion. That though included some 2.6 billion from the now denuded U.S. stockpile.

The most recent set of aluminum and aluminum product price increases went through only partly and certainly the primary producers backed in buyers at less than full list on many products. The weakest as usual have been soft aluminum extrusions used widely in the building industry but elsewhere too. Wire and cable products have also been soft and prices may be even lower than those of a year ago. The slowness in the building industries and in utilities is largely responsible. The probable pick-up in residential construction will help aluminum in 1977.

The companies expect 1977 shipments of about 14 billion pounds.

First quarter low earnings

Fourth quarter 1976 shipments were low and the early part of the first quarter of 1977 also looks low. Some of the aluminum companies will have a bad first quarter. The second and rest of 1977, shipments and prices will probably be very good. New orders during the first six weeks were high; they averaged 14.6 billion pounds annual rate. Product prices are firming and flat rolled products are getting tight. Power caused output cuts will probably further price firming. About a third of U.S. primary aluminum capacity is in the North-west. About 10-12% of that capacity is now down owing to power problems. It will likely remain down all year--and a little more may be added. Alternative power sources look less good now than a month ago.

A peculiar accident has cut out some capacity at Alcoa's Indiana smelter. Evidently frozen and wet coal was put into boilers--the boiler tubes then sprang leaks; I don't know how long production will be down. Natural gas based plants of Alcoa and Reynolds remain closed--only intrastate gas could be found for these and the power costs per pound of aluminum would be about 20¢--so I think they will remain closed. Kaiser's eight lines at Louisiana (the ninth is being opened) get gas I think at 64¢ per MCF and that probably means a power cost of about 6-7¢ a pound of aluminum--and that is not bad.

You ought to own some aluminums.

Nothing but trouble for copper

Copper wire bar prices charged by U.S. merchants were ½¢ above the producers' 68.6¢ a pound February 24. London spot was about 65.8¢ and three months 66.8¢. As we get closer to the U.S. copper strike July 1 further small increases are likely and they could lead the U.S. producer price to 70¢ and possibly even higher. Some U.S. mines will continue to lose money at 70¢. If there is no strike, all copper prices will probably fall considerably this summer. World excess copper inventories are about equal to one year's U.S. copper mine output, about 1.4 million tons. There is a notion around that much of that copper in inventory is of such poor quality it can't be used. Well, that is a lot of b.s. Much of it can't be used to make wire, but it is plenty good for other uses and it can be swapped to non-wire makers for 1¢ off, or some such. There is over capacity in the world copper industry and the higher cost mines may have to close. Some already have.

ZINC prices were folded back 3¢ a pound to 37¢ a few months ago. When they were raised in August it seemed a hopeless move. Nickel is soft while lead is better and molybdenum is much better.

Company briefs

ALCAN's fourth was better than I expected and in part reflected the great price improvement especially out of N. America. But it has become more obvious that the Quebec political victors are against the free sector and want to expand the coercive sector. Will Alcan try to get protection via increased investments in Quebec? Its plants badly need rehabilitation.

Directly or indirectly the Quebec government (or Canadian government) might get a measure of control. Put people on the board, and or get "workers" on the board? It could thus "force" Alcan's development and expansion in Quebec, even if other places are better. Remember Texasgulf--30% owned by a Canadian government agency. Why did Texasgulf back away from the Peabody Coal deal? Need it put more of its development into Canada? What would prevent a law requiring "public" representation on boards' of larger companies?

ALCOA's fourth quarter diluted was 89¢ before adding 20¢ per share from FASB #8, well off from the third. Shipments fell to 396,000 from 441,000. Will close another line at Vancouver. The industry in the N. W. will be 11% closed. If steel has really developed a steel can top Alcoa will feel it most; some 20% of its metal goes into can tops most of it on steel cans.

AMAX's strong position in molybdenum is paying off. If no strike this July, Amax's moly sales will be about equal to those of 1976 when 12 million pounds were sold from inventory. Production will be up in 1977. Its other goody is coal which will provide increased income in future years. In 1976 coal earnings A/T were down perhaps $2 million from 1975's $40 million, though sales were up 3 or 4 million tons. It is having some trouble getting sales contracts for the additional coal it can produce. I don't think it has been able to get some expiring contracts renewed either. A 4% tax rate helped much in 1976. That rate will rise to 15-20% in 1977.

ASARCO's best is the 49% owned M. I. M. in Australia. For various reasons much of its other stuff is of doubtful value. In a good economic year it will do very well though. It has probably been increasing its custom smelting income. Lead price increases will help it and others.

COPPER RANGE - Louisiana Land seems prepared to buy CPX for $50 million.

CYPRUS MINES' hopes hang on the 50,000 ton Bagdad copper expansion. The copper price it needs for that is probably 85¢. Getting cash from Peru's government. Anvil is coming back into full production. It is a good lead-zinc mine. Marcona's problems are being reduced, but not eliminated.

ENGLEHARD MINERALS did 90¢ in the fourth, about as expected. Philipp Bros. division in 1976 did slightly less than in 1975, but the other two divisions were at a record. Replacement cost accounting would hurt ENG less than other companies.

FREEPORT MINERALS made 41¢ in the fourth. It lost 8¢ PS on its copper property. Sulphur earnings were low and will probably remain low as the fertilizer industry lags. Gas and oil financing costs will hurt earnings. Its by-products uranium production may produce 50-70¢ PS by 1979-80 assuming the plant will work.

GENERAL CABLE needs improvement in building and utility activity. A diversification move by getting 93% of Sprague Electric for $19.50 per share--about $63.5 million--seems wise. For the first nine months Sprague made about 41¢ per GK share, about half as much as GK made. Sprague's integrated circuit subsidiary, Mostek, seems rather juicy.

INSPIRATION CONSOLIDATED COPPER will be helped by the January copper price rise. But it needs more.

INCO made 82¢ in the fourth. With a ballooning of nickel sales and some good earnings from other things one would have expected a better quarter. Nickel prices remain weak. It is starting up Indonesian nickel--where can it sell the metal? It already has a heavy inventory. Indonesian costs I think will be high.

KAISER would have shown $4.76 PS for 1976 except for $2.62 of write-downs. But 75¢ was from FASB #8. Before write-down it made $1.52 in the fourth quarter. There were some inventory profits. The first quarter will be low. But the long run fundamentals for aluminums are very good.

KENNECOTT appears to be selling Peabody Coal to a Newmont group for a present value of some $925 million, about $27 per KN share. That will give it considerable cash. Will it pass out some of it? I expect the FTC to accept the proposal. KN is too cheap to sell in part because its replacement value is at least twice its share value. It lost 15¢ PS in the fourth.

NEWMONT MINING was hit in the fourth by lower U.S. and foreign copper prices. But its dividend is not in danger. It will evidently get 35% of Peabody Coal.

It paid high for that! It will probably sell to Utah Power, from Peabody, one of the major losers. Peabody may be a cash drain for Newmont. Are long term buyers of coal in the drivers' seat? They are being offered much coal by many miners. Made 35¢ PS in the fourth, partly with portfolio sales.

PHELPS DODGE's fourth was a bust. From copper mining and manufacturing it made only about 15¢ PS. From aluminum it got 11¢ and 22¢ from ITC; wrote down 41¢ PS. Though PD is better off than other U.S. coppers, the industry situation is just too bad. Though it may get 60¢ PS from aluminum, I doubt it will get any dividends this year. Conalco has some heavy capital expenditures ahead.

REVERE COPPER moved from about $11 to $21 as Martin Marietta and National Steel appeared interested in acquiring part or all of the company. The improving aluminum situation will help Revere but its brass mill operations will likely remain a drag. It hopes to get over $80 million from OPIC for its closed Jamaican operations.

REYNOLDS METALS' made 94¢ PS in the fourth and sold 293,000 tons aluminum down 5% from the 3rd and 9% from the 2nd. Though prices are firming, the first will be low largely owing to weather problems; but also a large FASB #8 loss. RLM's Canadian smelter and 40% owned hydro power plants are in Quebec-- that is not good, but it would be stupid for Quebec to antagonize industry anymore than it has.

ST. JOE MINERALS made 87¢ in the fourth; this was helped by a large amount from subsidiaries. Earnings from zinc, iron ore and coal were rather low. Lead has been good and prices are high. Earnings for the first will be well under the 75¢ of 1976's first.

TEXASGULF made but 35¢ in the fourth quarter. Low prices and volume for its products suggest little improvement. Improving lead prices will help a little. With 30% ownership by the Canadian government, I wonder how much freedom management has to put investments outside Canada? Who killed Texasgulf's participation in the Newmont Peabody Coal deal?

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Industry Outline

Coal Industry
Presentation by William N. Walling 3/10/77

Recommendation: Accumulate Coal Stocks Between Now and Mid-Year

I. Industry Fundamentals
  A. Steam Coal (80% of industry volume)
    1. Demand
      a. for electric utilities (70% of industry volume)
        (1) demand for electricity
          (a) demand has historically doubled every 10 years (about 7.2% per annum growth) with gains of 2-3% in "bad years"
          (b) 1974-75 hiatus in demand growth reflected the deep recession, steep price increases, and conservation
          (c) 1976 kilowatt-hour production gain was 6.5% but demand was up about 10% in the October 1976-February 1977 period
          (d) expect long term kilowatt-hour growth of at least 5% per annum in future (other estimates are more optimistic--6%)
        (2) demand for steam coal by electric utilities
          (a) coal gaining market share with increase in demand for steam coal in 1976 of 9.4%, about 50% greater than increase in electricity usage
          (b) expect long-term ratio of steam coal demand/electricity usage of about 1.3/1 giving average annual growth of over 6% for steam coal demand
          (c) FPC forecast sees 90% increase in steam coal use by 1985
          (d) lead times of 5-8 years in the construction of generating capacity gives unusual visability to future demand forecast
      b. for industrial markets (10% of industry volume)
        (1) demand characteristics -- inherently quite cyclical reflecting changes in industrial production
        (2) market share trends -- FPC policies call for shift from natural gas to coal
        (3) outlook -- expect 4% per annum average growth over next 5 years, given the potential for some cyclicality
      c. overall demand - steam coal should grow about 6% per annum over next several years
    2. Productive capacity -- expected to grow at about 5% per annum between now and 1980
    3. Prices -- expected to improve in 1977 (coal sells at 50% BTU discount to oil), if not in 1978 as well
  B. Metallurgical Coal (20% of industry volume)
    1. Demand
      a. used almost exclusively for steel production
      b. expect 2 1/4% annual growth for steel demand in U.S. over next 5 years vs 1 1/2% historic rate
      c. look for slowdown in overseas demand growth from 5%, but rising real income and population growth should provide continued forward momentum - economic development in OPEC countries should provide an additional increment to demand
      d. expect overall per annum growth of 4% during next 5 years

1/65

2. Productive capacity of high-grade met coal -- expect per annum growth to approach 4% through 1976-1980 (though much faster in 1977-1978) but, with older mines being increasingly depleted, growth will slow after 1980 and shortages should appear
3. Prices -- expected to show significant improvement in 1978 for first time since 1974

II. Investment Considerations

A. Important Events in 1977

1. Announcement of Carter energy program -- April 20, 1977
   a. do not expect a complete presentation (may be less dramatic than some expect), but rather a gradual unfolding of the policy over time
   b. it is doubtful that coal stocks will react sharply to the speech in the absence of major proposals, but some buying could occur if investors perceive a real (and realistic) energy policy taking shape
2. United Mine Workers election -- mid-June 1977
   a. expect hard-fought election and 1-2 weeks of production should be lost to wildcat strikes (sporadic strikes have already occurred)
   b. investor interest in coal stocks should pick up after conclusion of election disruptions, especially as 1978 general economic outlook, which we expect to be favorable, becomes clearer
3. UMW contract expiration -- December 6, 1977
   a. expect strike resulting in 2-5 weeks of lost production
   b. strike should be fully anticipated and is not likely to have a significant negative impact on coal equity prices from current levels
   c. reduced supply should improve price environment in 1978 and set the stage for an even better market performance for coal stocks

B. Valuation

1. Price/earnings multiple
   a. a P/E of 8.0 (based on 1977 projections) for the 8 coal and coal-oriented stocks we follow versus 9.1 for S&P 500 implies the upside-down situation of the market awarding higher multiples to issues which will be fighting higher fuel prices than to those likely to benefit from higher fuel prices
   b. expect coal stock multiples to improve and align with the general market multiple over time
2. Yield
   a. average yield of 3.5% for coal stocks is lower than the 4.0% return for the S&P 500 but represents a payout of only about 25% of earnings versus a 41% payout for the S&P 500
   b. as cash flows should exceed capital needs, significant dividend increases are likely over the next few years
3. Market performance outlook
   a. expect annual EPS growth of 10-15% over next 3-4 years -- combined with an improvement in P/E multiples relative to the market (advance to market multiple would be 14%) and a 3.5%+ current yield -- to give a total return in the area of 20% per year
   b. coal stocks should outperform the overall market averages over the next few years

III. Company Recommendations

A. Metallurgical Coal Issues - a play on a recovery in the steel industry

1. Pittston - 90% of earnings derived from met coal
2. Eastern Gas & Fuel - 50% of earnings derived from met coal
3. Westmoreland Coal - relatively small capitalization makes EPS and stock more volatile; vast bulk of earnings come from met coal

B. Steam Coal Issues - beneficiaries from changes in overall fuel mix and availability, electricity growth, and Carter energy program

1. Falcon Seaboard - renewals of contracts over the next 3 years could result in a doubling of prices for its low-sulphur coal while the possession of 250 million tons of lignite deposits improves the outlook beyond 1980; non-union, surface producer
2. North American Coal - as a producer of relatively high sulpher coal (a negative) with longer-term potential tied to development of coal gasification in the mid-1980's, the rich price/earnings multiple for NC appears a function of its very small float and possible takeover (chronic--although we know of none currently being discussed)

C. Coal-Oriented Issues

1. Occidental Petroleum (coal will account for 50% of earnings) - leveraged company with high grade coal deposits and increasing production of North Sea oil; shipped 18 million tons in 1976
2. Continental Oil (coal accounts for 40% of earnings) - second largest coal producer in U.S. (50 million tons; 87% steam, 13% met) with oil and gas production in uptrend (growing North Sea operations an important factor)
3. MAPCO (coal accounts for 40% of earnings) - 16 consecutive years of EPS growth at average 20% rate and superior coal operation (non-union and productivity triple that of coal industry) are reflected in premium multiple relative to other coal stocks, produced 3.8 million tons in 1976 - expect 9.0 million tons 1980

	Price	EPS		P/E	Indicated	
	3/10/77	1976	1977E	1977	Div.	Yield
Continental Oil (CLL)	33 3/4	$4.38	$4.75	7.1X	$1.20	3.6%
Eastern Gas & Fuel (EFU)	25 7/8	3.01	3.10	8.3	.80	3.1
Falcon Seaboard (FSD)	38 3/4	4.16	4.50	8.6	1.00	2.6
MAPCO Inc. (MDA)	42 5/8	3.00	3.70	11.5	1.10	2.6
North American Coal (NC)	53 3/4	4.37	4.50	11.9	.90	1.7
Occidental Petroleum (OXY)	25 7/8	2.26	3.25	8.0	1.00	3.9
Pittston Co. (PCO)	33 7/8	3.92	3.75	9.0	1.25	3.7
Westmoreland Coal (WMOR	50 1/4	7.07	5.00	10.1	1.70	3.4

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SRL-77-18

White, Weld & Co.
Incorporated

Progress Report

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December 10, 1976

HALLIBURTON COMPANY (HAL)

Price (NYSE)		Dividend		EPS (Dec.)		P/E
Current:	65 3/4	Rate:	$0.80*	1977E:	$5.85	11.2X
Range (1976):	70-44	Yield:	1.2%	1976E:	$5.20	12.6X
				1975E:	$3.84	17.1X

Average Shares Outstanding:	58,572,361	Return on Average 1975 Equity:	22.8%
Market Value:	$3,763 Million	Book Value Per Share (9/30/76):	$22.31

*Includes the special dividend of $0.24 declared 11/18/76.

SUMMARY & CONCLUSION

Halliburton's outlook over the next several years is for earnings growth in a range of 12-15%, with 1977 earnings gains estimated to be at the lower end of this range due to the long-anticipated slowdown of marine construction activities. However, new orders for offshore development, either second round North Sea fields or new discoveries offshore the U.S., are a likely prospect in 1977-78, and should limit investor concern about the current slowdown. Additionally, Halliburton Oilfield Services is expected to have superior performance, due to strong drilling, especially for gas in the U.S. and development work in the North Sea and Middle East.

Halliburton stock is selling at the low end of its multiple range for the past five years and thus should not be adversely affected by the slower earnings growth in prospect for 1977. (EPS have expanded at a 37.3% rate over the past five years. We expect a 12.5% rise in 1977). Earnings gains in future years should again move up; the company's financial position is greatly strengthened; and rapid dividend increases are likely. We regard the issue as one which will outperform the market over the next several years.

THIRD QUARTER RESULTS

Halliburton's third quarter results of $1.56 versus $1.17—a 33% gain—were ahead of our estimate ($1.35) and were the result of a surge of margins in the company's Oilfield Service and Engineering and Construction groups.

1. **Oilfield Service** revenues increased 26% to $275 million; operating income jumped 38% as margins went from 23% to 25%. Management indicated that these margin gains resulted from continuing efficiency increases, better trained crews and

continued high operating rates. Revenues also benefited from market share gains. Halliburton believes it is capacity short, therefore, despite its market share gains, it may still be losing some business to competitors–a potential area for continued improvement.

2. **Engineering and Construction** margins increased to 9.5% versus 7.1% in the year ago period, which accounted for the 34% gain in operating income despite a $10 million decline in revenues (to $934 million). This decline was primarily the result of the sale of Ebasco Services early in the quarter. We estimate Ebasco had revenues of about $45 million in last year's third period. Thus, net Ebasco, E&C Group revenues increased moderately. A strong platform outfitting business in the North Sea was a major component to strong Marine Construction operating income and margins.

3. **Specialty Products** showed a good improvement, reflecting strong rail car component business (which should continue next year). **Highlands Insurance's** (not consolidated) net income increased reflecting better investment income despite continued underwriting losses. All in all, it was a strong quarter, reflecting Hallibruton's excellent position in the U.S. oilfield service sector, and continued good results in marine construction.

FOURTH QUARTER OUTLOOK

We are projecting fourth quarter earnings for Halliburton of $1.35 (a range of $1.30 to $1.40)–an increase of 31% over last year's fourth quarter. We expect revenues to increase by about 3% to $1.1 billion. Thus, for the year we have raised our estimate by $0.35 to $5.20 (in a range of $5.15–5.25). During the fourth quarter, Oilfield Services should continue the strong trends of the year with revenues increasing by 21% to $295 million and margins remaining strong at 24.5%. Engineering and Construction revenues should encounter their usual seasonal decline to about $750 million–primarily industrial construction activities in the USA, but also Northern Hemisphere marine construction. On the other hand, work on the High Island pipeline project in the Gulf of Mexico by the BAR–347 should extend into December, boosting marine revenues. Margins should remain strong; we are estimating margins of 8.7% for E&C in the quarter.

1977 PROSPECTS

In 1977 we estimate Halliburton will earn about $5.85 (in a very broad range of $5.50-6.15), an increase of 12.5% versus 1976; revenues are expected to post a 7.5% gain to roughly $5 billion. The outlook is for strong drilling activity in the U.S., benefiting Halliburton's oilfield service group, a response to increasing oil prices, and higher interstate gas prices. We expect Oilfield Service revenues to increase substantially. Marine Construction revenues, on the other hand, despite high levels of activity in the Gulf of Mexico and the Middle East, may be flat to down, reflecting a decline in North Sea and South East Asia activity. We have taken a conservative tack on estimating Engineering and Construction results in 1977, despite continued revenue increases from engineering, power plant construction, and industrial construction.

HALLIBURTON COMPANY
CONSOLIDATED FINANCIAL STATEMENTS–DIVISIONAL
(\$ in Thousands)

	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.	Year 1975	1st. Qtr.	2nd Qtr.	3rd Qtr.	Est. 4th Qtr.	Year 1976E	1977 Estimate Ranges Low	Medium	High	% Change on Med. 1976–77
Revenues														
Oilfield Services	$188,500	$ 207,000	$ 218,600	$ 244,000	$ 864,942	$ 237,600	$ 256,100	$ 275,500	$ 295,000	$1,064,200	$1,320,000	$1,320,000	$1,320,000	24.0%
Engineering/Construction	691,000	838,000	943,500	780,000	3,254,742	928,400	878,100	933,600	750,000	3,450,100	3,500,000	3,500,000	3,900,000	0.2
Specialty Services	21,600	24,400	21,800	22,000	89,918	26,300	30,200	25,700	26,000	108,700	122,000	122,000	125,000	12.2
TOTAL	$901,159	$1,069,439	$1,183,936	$1,046,068	$4,209,602	$1,192,797	$1,164,276	$1,234,950	$1,071,000	$4,663,023	$5,014,000	$5,014,000	$5,345,000	7.5
Operating Income														
Oilfield Services	$ 40,650	$ 44,500	$ 50,200	$ 56,800	$ 192,189	$ 56,900	$ 61,200	$ 69,200	$ 72,280	$ 259,580	$ 317,000	$ 323,400	$ 331,300	24.6
Engineering/Construction	32,650	62,600	66,610	54,800	216,719	52,100	68,600	89,000	65,250	274,950	245,000	274,950	300,100	0
Specialty Services	2,750	3,500	2,700	2,600	11,549	4,400	4,900	4,300	4,300	17,900	20,200	20,200	20,600	12.8
TOTAL	$ 76,041	$ 110,647	$ 119,513	$ 114,256	$ 420,457	$ 113,316	$ 134,835	$ 162,412	$ 141,830	$ 552,393	$ 582,200	$ 618,550	$ 652,000	12.0
Operating Margins														
Oilfield Services	21.5%	21.5%	23.0%	23.3%	22.2%	23.9%	23.9%	25.1%	24.5%	24.3%	24.0%	24.5%	24.5%	–
Engineering/Construction	4.7	7.4	7.1	7.0	6.7	5.6	7.8	9.5	8.7	7.9	7.0	7.8	7.7	–
Specialty Services	12.7	14.3	12.4	11.8	12.8	16.4	16.2	16.7	16.5	16.5	16.5	16.5	16.5	–
Interest Expense	$ (4,196)	$ (7,424)	$ (7,697)	$ (7,880)	$ (27,197)	$ (7,504)	$ (7,149)	$ (7,411)	$ (7,400)	$ (29,464)	$ (29,000)	$ (29,000)	$ (29,000)	(1.6)
Interest Income	2,083	2,825	2,911	3,619	11,438	3,603	2,634	4,813	5,000	16,050	20,000	20,000	20,000	24.6
Other Inc. (Exp.) (Net)	742	(867)	(1,459)	2,779	1,195	(1,839)	1,868	550	500	1,079	1,500	1,500	1,500	39.0
Income Before Taxes & Equity Items	$ 74,6[illegible]	$ 105,181	$ 113,268	$ 112,774	$ 405,893	$ 107,576	$ 132,188	$ 160,364	$ 139,930	$ 540,058	$ 574,700	$ 611,050	$ 644,500	13.1
Margin	8.3	9.8	9.6	10.8	9.6	9.0	11.4	13.0	13.0	11.6	11.5	12.2	12.1	–
Provision For Taxes	34,685	46,615	48,298	51,725	181,323	49,407	58,241	71,962	62,969	242,579	261,490	278,030	293,250	14.6
Tax Rate	46.5%	44.3%	42.6%	42.1%	44.9%	45.9%	44.1%	44.9%	45.0%	44.9%	45.5%	45.5%	45.5%	–
Inc. Before Equity Items	39,985	58,566	64,970	61,049	224,570	58,169	73,947	88,402	76,960	297,478	313,210	333,020	351,250	12.0
Minority Interest	$ 61	$ (441)	$ (267)	$ (292)	$ (939)	$ (1,641)	$ (336)	$ (512)	$ (550)	$ (3,039)	$ (3,000)	$ (3,000)	$ (3,000)	(1.3)
Net Income–Highlands Ins.	1,915	907	1,875	(377)	4,320	2,128	1,740	2,542	2,000	8,410	9,500	9,500	9,500	13.0
Other Companies	705	997	1,292	402	3,396	754	544	1,133	600	3,031	3,500	3,500	3,500	15.5
Amortization of Goodwill	(497)	(7,453)	(443)	(442)	(8,835)	(441)	(442)	(221)	(111)	(1,215)	(440)	(440)	(440)	(63.8)
Net Income	$ 42,169	$ 52,576	$ 67,427	$ 60,360	$ 222,512	$ 58,969	$ 75,453	$ 91,254	$ 77,889	$ 304,665	$ 322,771	$ 342,580	$ 360,810	12.5
EPS	$0.73	$0.91	$1.17	$1.03	$3.84	$1.01	$1.28	$1.56	$1.35	$5.20	$5.51	$5.85	$6.16	12.5

OILFIELD SERVICES AND PRODUCTS

This group's revenues should increase substantially (by about 24%). The current high level of drilling activity in the U.S. is expected to extend into 1977 (after a normal seasonal decline in the winter months, February through April). The significance of enlarged natural gas development programs to Halliburton is that greater stimulation sales result from gas completions. Stimulation, a good profit business, could accelerate revenues by more than just the additional number of wells drilled. However, as Halliburton Services believes it is still restrained by capacity limitations from achieving its normal market share, 1977 growth could be limited by the rate of capacity additions. The company has budgeted more than half of its 1977 capital expenditure commitments for the oilfield services and products group, i.e., about $140 million, a significantly larger percentage than in the past five years. The variance in our operating earnings estimate indicates a range of increase from 22% to 25%. We are tentative about margins for several reasons: 1. Margins are at an historical peak from which further gains are less likely. While activity may show a strong increase, the rate of gain may not be as steep as in recent years. 2. Equipment operating rates have been unusually high. Some older equipment may be due for replacement and personnel have been working at above sustainable levels. On the other hand, the experience gained over the past several years has resulted in efficiency increases as workers went down the learning curves, and the company's equipment has been more optimally located to service customers. Over the longer term we expect HAL's oilfield service group to record above average results as the positive trends for higher natural gas prices continue to accrue to the company's benefit. If massive hydraulic fracturing is developed to the point where the technique is more broadly utilized to release gas from tight reservoirs, (more a question of fluids and propping agents used in specific reservoirs than HAL's pumping technology) revenues could expand dramatically.

IMCO's drilling mud sales, which have been soft in 1976, a result of softer drilling activity and a shift of drilling to simpler wells, should improve in 1977 due to increased drilling of difficult, deep wells and the general uptrend in U.S. drilling. Otis' sales continue on a par with the group as a whole.

ENGINEERING & CONSTRUCTION

Forecasts of Halliburton's Engineering & Construction activities are, by the nature of the business, normally subject to greater error, both in revenues and margins. 1977 is no exception, and due to the decline of pipeline work in the North Sea—the area of greatest expansion over the past five years—even more difficult to call. 1977 could be a year when total revenues grow modestly, margins decline somewhat from recent peaks as operating rates of marine equipment decline (especially in the North Sea), and hence operating income may range between modestly down (our conservatism—management expects flat results) to moderately upwards. Much may depend upon *bread and butter* marine projects taken on a short term basis, capital spending on industrial plants in the U.S., and enlargement of engineering work. Backlogs continue at high levels (primarily power plants and industrial projects) and totaled $7.2 billion as of September 1976.

Nevertheless, 1977 could be a period of improving marine backlogs—perceived as well as signed. As the first round North Sea development projects is brought to completion, the oil industry's cash flow will improve as production comes on stream. While we would expect that second round development will have a more leisurely pace, the volume could be substantial as there could be more medium sized fields, each needing production systems and, at least, gathering pipelines. Thus, as volume of work completed declines, the offset, at least in regard to investor expectations would be new orders for future work.

An example is the award of the Statfyjord *B* platform engineering and management project to HAL's Brown and Root group, a member of a consortium that includes Norwegian firms. Similarly, B&R is a member of another Norwegian consortium bidding on the Statfjord oil pipeline project. Other recent contracts to Brown & Root have included a several hundred million dollar gas processing plant in Canada and the construction portion of a contract for a $4-500 million petrochemical complex for Exxon in Baytown, Texas. Discovery of commercial hydrocarbon reserves offshore the U.S. East Coast (exploratory drilling should start in early 1977) or the Gulf of Alaska could initiate another major marine development phase.

SPECIALTY PRODUCTS

This small, but profitable group, sells spinoffs of Halliburton's oilfield products to general industry. In addition, its manufacturing facilities have been used to augment Halliburton's Oilfield Group's plants when their capacity was strained. In 1977, we expect another fine year, particularly in rail car construction, helped by government guarantees.

FINANCES–DIVIDEND POLICY

Halliburton's financial structure has been improving substantially. Funds generated by operations in 1976 will exceed uses by about $130 million compared to a negative figure of $8 million in 1975. This figure's increase will amount to over $190 million in 1977. Long term debt of $315 million, was 18% of total capitalization (as of 9/30/76) as compared to 21% at the end of 1975. Cash and equivalents stood at $440 million on 9/30/76 versus $195 million on 12/31/75.

The 1977 capital budget commitment recently announced was for $262 million (when the 1976 budget was first announced it was for $250 million but grew to $317 million as the year progressed). Thus, judging from prior events the 1977 budget commitments should expand as well.

We expect capital spending in 1977 to total about $335 versus $350 million in 1976 and $336 million in 1975. More than half of 1977 expenditures will be used for the expansion of Halliburton's Oilfield Service capabilities; other major projects include modification of Brown and Root marine construction barges and a new launch barge for platform installation. On November 18, 1976, the company announced a special dividend of $0.24–making the total dividend payment for the year $0.80. Given the company's strong cash flow and financial position, we would expect the regular dividend rate to be raised to at least $0.80 for 1977, (a payout ratio of only 14-17%) and perhaps even higher to $1.00, thus 1977 total payment ought to exceed total dividend payments in 1976. In our 1977 source and application of funds analysis we have assumed a dividend rate of $0.80.

HALLIBURTON COMPANY
SOURCES & APPLICATIONS OF FUNDS
($ in Thousands)

	1975	1976	1977E
Operating Sources (Uses)			
Net Income	$222,513	$304,665	$336,000
D, D&A	116,437	167,000	175,000
Book Value of Equip. Retired	6,308	9,000	10,000
Deferred Taxes & Other	50,369	58,000	55,000
Sources – Subtotal	$395,627	$539,000	$576,000
Capital Expenditures	$(335,568)	$(350,000)	$(335,000)
Other (Net)	(838)	–	–
Dividends	(25,460)	(46,880)	(47,000)
Investment & Advances to Related Companies & Other	(41,288)	(13,000)	–
Uses - Subtotal	$(403,154)	$(410,000)	$(382,000)
Net Operating Sources (Uses)	$ (7,527)	$129,000	$194,000
Non-Operating Sources (Uses)			
Stock Issued - Net	$ 28,385	$ 170	–
New Long Term Debt	150,785	5,000	–
Less Repayments	(33,841)	(4,700)	(5,000)
Goodwill & Net Property of Subsidiary Sold	–	53,752	–
Net	145,329	54,222	(5,000)
Working Capital Increase	$137,802	$183,222	$189,000

INSTITUTIONAL HOLDINGS

Halliburton's stock is broadly held by institutions. On september 30, 1976, investment company's and bank trust departments held about 30.8% of Halliburton's stock (18.1 million shares). With institutions more yield conscious, and given HAL's relatively low current yield, this could be a problem. On the other hand, Halliburton's strong cash flow, increasing capability for dividend increases and above average expected growth rate should coalesce for a better than average stock performance.

RR-76-178 —Research Department--

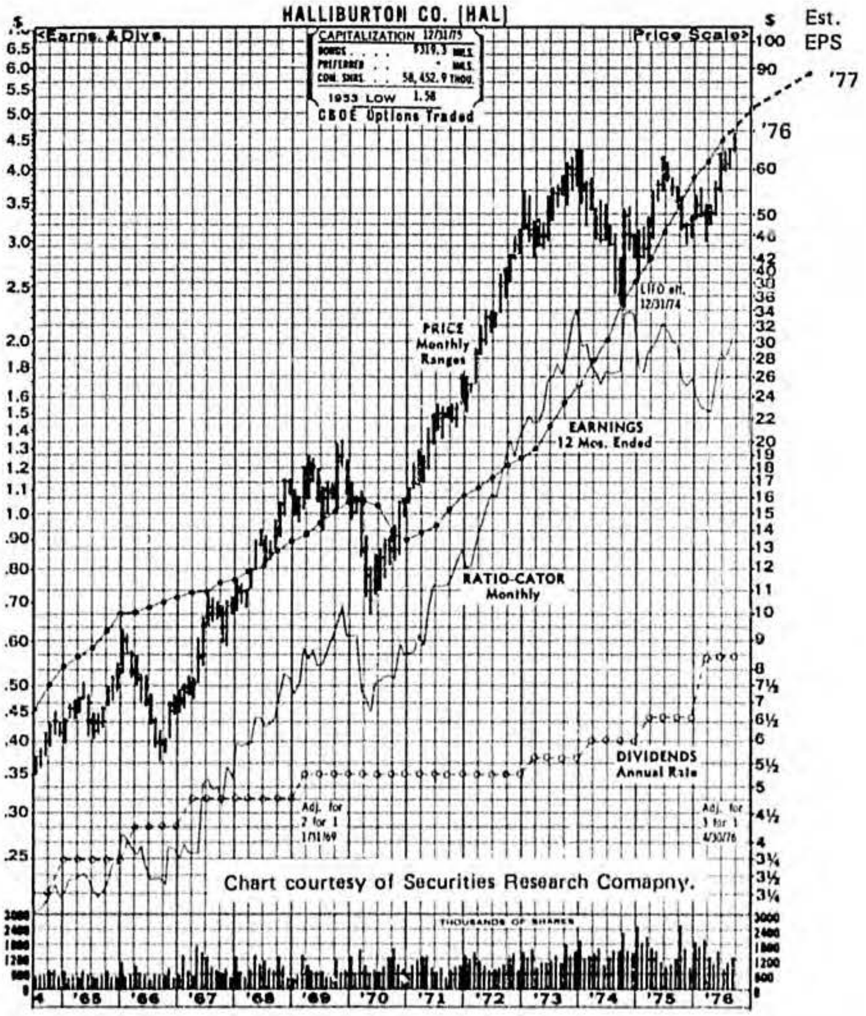

Chart courtesy of Securities Research Comapny.

HALLIBURTON COMPANY

CAPITALIZATION (9/30/76)

	Amount (000,000)	Percent
Long Term Debt	$ 314.9	18.0%
Deferred Taxes	131.3	7.5
Common Equity	1,306.9	75.5
Total Capital	$1,753.1	100.0%

STOCK OWNERSHIP

	Amount (000)	Percent
Management	460	0.8%
Institutions	18,054	30.8
Other	40,058	68.4
	58,572	100.0%

FINANCIAL SUMMARY

Fiscal Year	1971	1972	1973	1974	1975	1976E	1977E
Operating Data (000,000)							
Revenues	$1,299.4	$1,422.3	$2,131.0	$3,098.4	$4,209.6	$4,663.0	$5,014.0
Depreciation	41.8	51.0	65.4	86.6	116.4	170.0	160.0
Pretax Income	97.6	114.6	152.5	271.8	405.9	540.0	611.1
Taxes	41.7	48.6	62.0	120.2	181.3	242.6	278.0
Net Income	55.9	66.0	90.4	146.2	222.5	304.1	342.6
Operating Ratios							
Pretax Margin	7.5%	8.1%	6.9%	8.8%	9.6%	11.6%	12.2%
Tax Rate	42.7%	42.4%	42.4%	44.2%	44.9%	44.9%	45.5%
Net Margin	4.3%	4.8%	4.2%	4.7%	5.3%	6.5%	6.7%
Equity Turnover	3.6X	3.4X	4.2X	3.8X	4.3X	3.8X	3.3X
Receivables/Sales	13.8%	16.7%	16.9%	15.4%	14.5%	–	–
Return on Average Equity	15.4%	15.9%	17.8%	18.1%	22.8%	24.7%	22.4%
Per Share Data							
EPS	$1.08	$1.26	$1.68	$2.54	$3.84	$5.20	$5.85
Dividends	0.35	0.35	0.375	0.40	0.44	0.80*	0.80
Price Range	26-15	47-22	65-41	64-34	63-38	70-44	–
P/E Range	24-14	38-18	39-25	26-14	16-10	13-8	–
Average P/E	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Shares Outstg. (000's Avg.)	51,963	52,791	53,817	57,606	57,879	58,583	58,650
Balance Sheet Data							
Working Capital	143.3	187.0	226.7	336.1	473.9	660.0	–
Current Ratio	1.7X	1.8X	1.7X	1.8X	1.8X	1.9X	–
Long Term Debt	99.0	203.2	113.6	201.2	318.2	312.0	307.0
Common Equity	389.9	438.1	749.7	876.1	1,103.3	1,363.5	1,652.0
Total Capitalization	489.0	641.3	863.3	1,563.8	2,092.1	2,500.0	–

*Includes special dividend of $0.24 per share.

White, Weld & Co.
Incorporated

ANALYST NOTES

February 3, 1977
John H. Hayward, Jr.

BAKER INTERNATIONAL
HIGHLIGHTS OF MEETINGS WITH MANAGEMENT
Baker Corporation – January 17, 1977
Reed Tool Co. – January 14, 1977

POLITICAL ENVIRONMENT OF OIL INDUSTRY – E. H. Clark Jr.

OPEC—still foresee 25% crude price increase between 12/76 and 12/78. Clark sees North/South Conference as being more important than Mid-East Peace as there is concern over loans to less developed countries (to pay for oil). Oil discovery rate falling in some OPEC states—the more finite the total reserves the higher the price—this might lead to rationing in the late 70's due to lack of ability of some OPEC countries to absorb capital.

Foreign Exploration & Production—exploration drilling in international waters expected to remain in doldrums in 1977. Risk is takeover after many years of negative cash flow during exploration and development. Risk is too great for private oil companies—but development of existing fields is healthy and international workover market is beginning to show it's head. E&P spending outlook flat in foreign markets by private companies.

U.S. Outlook—feel Carter is O.K. on Natural Gas—but see no deregulation during his first term (N.B.—this was before the current gas shortage). Problem is to change attitude of American people—can't be done just by leader's exhortations. Also foresee relief on old/new oil problem. U.S. oil company cash flows in best shape for a long time—conclusion of North Slope and North Sea cash drain. See U.S. E&P up 20%+ in 1977—Next 5 years in 15-25% corridor (8% inflation assumption—so this is 7-17% real growth).

Old oil price and entitlements hurt remedial work in U.S.—14% growth expected in 1977 versus 20% for total E&P. With incentives for remedial work as they are, some find it better to leave oil in ground and import foreign crude. A backlog though for the future.

BAKER INTERNATIONAL– CORPORATE DEVELOPMENTS

Baker Oil Tools Group (Clark)—prior to marketing restructure in 1976, product line had grown too broad for one man to sell all products effectively. In fact, product grouping had already taken place on a defacto basis. Found that sales organizations could be split up without great overhead penalty as margins of Sales Units with $600,000 to $2 million in volume about same. Reorganization reduced customer confusion and focus attention on unit which could now be held more accountable. Benefits—after reorganization sales of Bakerline primary cementing tools about tripled in 1976. Baker Packers have lost market share to Otis over past 7-8 years as Otis expanded into Baker's market, but Baker has taken market share from Otis' traditional area—downhole flow control and safety equipment, in same time frame.

Drilling Services Group (Joseph Sheldon)—mud sales should increase at a good rate in 1977—but inability to pass on cost increases due to lower prices of independents (U.S., U.K., and Norwegian) will keep profit gain well below corporate average. Don't see price pressure off until late 1977. Barite (the weighting agent in mud) reserves are much more satisfactory at Milchen (Baker) now than when purchased in 1971. Have as good sales/reserve ratio as any in industry—but Dresser's Macrobar still by far the largest total reserves. New high quality reserves help in blending. Smaller mud companies get bentonite and barite from the majors (Macrobar, Baroid [National Lead], Milchen, and IMCO [Halliburton]).

Exploration Logging (Mud Logging)—revenue growth rate much faster than wireline logging—but total market only a *very* small fraction of total wireline revenues.

Reed Tool (Clark—1/16/77)—(Sidney A. Shuman—1/14/77)—Reed—the great disappointment of 1976. Market share loss due to less hard rock and deep drilling (Reed's strong suit). Quality control was poor in 1975 and early 1976 as old Reed management pushed all the bits it could out the door. BKO management rapidly worked to eliminate this problem soon after the acquisition—and instituted double quality control checks. Hurt Reed's image short-term—management does not believe it will hurt on a long-term basis.

Clark looks to good 1977—deeper drilling—a less than normal seasonal decline in activity—a trend back to premium bits. Clark feels problems at Reed—manufacturing, quality, cost and inventory control—are on their way to being solved by new people at Reed. All this has already helped Reed's margins in BKO's first fiscal quarter. Growth in late 1970's could be limited by U.S. rig availability.

Management does not fear overcapacity—real five year growth of 5% should fully utilize capacity (even new Security [Dresser] plant by 1979.) (Present capacity worldwide of *nominal* bit production—HT—125,000 units, SII—100,000 units, Reed—70,000, Security—50,000 (plus 30,000 for new Louisiana plant in 1978). Marketing opportunities exist for Reed in geographical expansion—HT only one with 100% worldwide coverage. Reed still has its problems—but big ones behind it—earnings should improve dramatically in 1977—to *much* better than company did in 1975.

Tool Joint capacity increased by 30+%—Backlogs 16-18 months (about 30-35% of this may be hedge ordering). Does not fear Smith Tool entry into business.

Mining Clark—(Warren Kane)—Warren Kane, formerly President of Fluor Utah, but was on the Board of Baker since 1971, joined the company to head its Mining group in late 1976. His goal is to come up with a plan of attack for this area which offers good long-term potentials.

1976 was not a good year. Revenues were down 9%. Operating income down 24%. 1977 look for good revenue increase despite poor outlook for copper, iron ore and delays in coal development. Gain from instrumentation sales, better use of present facilities, more sampling of coal (as a basis for payment), and improved inventory control of Reed's mining bits.

Future concentration will be on coal—which is destined to be the big swing fuel as the energy problem hits in the 1980's.

CORPORATE STRATEGIES—Clark

Longer range *anticipation* of markets has been of key value to Baker (as opposed to companies who only have proprietary skills or technologies). Management's early warning systems enable them to *respond quickly* to problems and avoid getting too deep into a hole—especially important in acquisitions, for example: BKO was instituting major changes at Reed within several months of its acquisition.

BKO's current net margins and policy of 50% debt to equity ratio will finance a 22-24% growth rate. Future, as the past, will be a blend of acquisitions and developments of existing lines of business—Most acquisitions in current lines of business—but mining will be a stepout.

Earnings—Management would not quarrel with a $4.25 EPS estimate for 1977. Management suggested that quarterly progression could be as follows:

FY Ended 9/30	1976	1977E	% Change
1st Quarter	$0.85	$0.90A	5.9%
2nd Quarter	0.85	1.05	23.5
3rd Quarter	0.87	1.10	26.4
4th Quarter	0.95	1.20	26.3
Year	$3.52	$4.25	20.7%

White, Weld & Co.
Incorporated

RESEARCH WIRE

February 8, 1977
John H. Hayward, Jr.
(212) 285-2032

HALLIBURTON COMPANY (HAL)

Price		Dividend		EPS		P/E
2/7/77:	58 5/8	Rate:	$0.80	1977E:	$5.85	10.2x
1976-77 Range:	69-48	Yield:	1.4%	1976A:	$5.22	11.5x

1976 FOURTH QUARTER AND ANNUAL RESULTS

Halliburton reported earnings for it's fourth quarter of $1.37 per share - a gain of 33% the prior year period and in line with our estimate of $1.35 per share. Revenues increased 22% to $1,275 million. Earnings for the year were $5.22 per share versus $3.84 - a gain of 36% on a revenue increase of 15.6% to $4.86 billion, despite an increase in HAL's tax rate to 45.4% from 44.7% (ITC added about $0.30 per share to earnings versus $0.23 in 1975).

DIVISIONAL ANALYSIS

Oilfield Service revenues increased about in line with expectations (18% in the quarter to $289 million and 22.3% for the year to $1,058 million - see Table 1). However, while fourth quarter operating margins were expected to decline from the third quarter (a normal seasonal variation except in 1975) the drop to 22.3% (versus 23.3% in 1975 and 1976's third quarter margins of 25.1%) came as somewhat of a surprise.

Management indicates that some of this decline was due to year end adjustments, including extra compensation to U.S. Nationals employed abroad to make up for increased U.S. taxes due to the Tax Reform Act of 1976. However, this may not explain the entire decline. The company states that it has not experienced price or operating rate softness, and is currently working up detailed analysis of the Oilfield Services quarter. One factor that could have affected the quarter is a decline in reported U.S. well completions relative to a year ago (about 10-12% down) possibly reflecting the softness in the rig count in the late winter and spring of 1976. U.S. well completions for 1976 as a whole are expected to be up 5-6% versus the 14% gain reported through the first nine months (given the current rig count and other indicators we would expect 1977 to be a banner year). On the other hand, since revenue items were on target, some in the company suggest that the fourth quarter should not be construed to indicate a downward trend in margins, but rather HAL got caught by some material cost increases it did not pass on. The first quarter margins

TABLE 1

HALLIBURTON COMPANY
CONSOLIDATED FINANCIAL STATEMENTS - DIVISIONAL RESULTS
($ In Thousands)

	WW Est. of 12/10/76		Actual		1977 Estimate Ranges			% Change on Med.
	1976 4th Qtr.	1976 Year	1976 4th Qtr.	1976 Year	Low	Median	High	1976-1977
REVENUES								
Oilfield Services	$295,000	$1,064,200	$288,800	$1,058,000	$1,320,000	$1,320,000	$1,320,000	24.0%
Engineering/Construction	750,000	3,490,000	960,900	3,701,000	3,500,000	3,500,000	3,900,000	0.2
Specialty Services	26,000	108,700	25,100	107,800	122,000	122,000	125,000	12.2
TOTAL	$1,071,000	$4,663,023	$1,274,800	$4,866,294	$5,014,000	$5,014,000	$5,345,000	7.5%
OPERATING INCOME								
Oilfield Services	$ 72,280	$ 259,580	$ 64,300	$ 251,600	$ 317,000	$ 323,400	$ 331,300	24.6%
Engineering/Construction	65,250	274,950	68,700	278,400	245,000	274,950	300,100	0
Specialty Services	4,300	17,900	3,000	16,600	20,200	20,200	20,600	12.8
TOTAL	$ 141,830	$ 552,393	$ 136,000	$ 546,600	$ 582,200	$ 618,550	$ 652,000	12.0
OPERATING MARGINS								
Oilfield Services	24.5%	24.3%	22.3%	23.8%	24.0%	24.5%	24.5%	-
Engineering/Construction	8.7	7.9	7.1	7.5	7.0	7.8	7.7	-
Specialty Services	16.5	16.5	12.0	15.4	16.5	16.5	16.5	-
Interest Expense	$(7,400)	$(29,464)			$(29,000)	$(29,000)	$(29,000)	
Interest Income	5,000	16,050	$1,874	$8,598	20,000	20,000	20,000	
Other Inc. (Exp.) (Net)	500	1,079			1,500	1,500	1,500	
Income Before Taxes & Equity Items	$139,930	$540,058	$137,874	$538,002	$574,700	$611,050	$644,500	13.1
Margin	13.0%	11.6%	10.8%	11.1%	11.5%	12.2%	12.1%	-
Provision For Taxes	$ 62,969	$242,579	$ 64,795	$244,405	$261,490	$278,030	$293,250	14.6
Tax Rate	45.0%	44.9%	47.0%	45.4%	45.5%	45.5%	45.5%	-
Inc. Before Equity Items	76,960	297,478	73,079	293,597	313,210	333,020	351,250	12.0
Minority Interest	$ (550)	$ (3,039)			$ (3,000)	$(3,000)	$ (3,000)	
Net Income - Highlands Ins.	2,000	8,410	$6,725	$11,883	9,500	9,500	9,500	
Other Companies	600	3,031			3,500	3,500	3,500	
Amortization of Goodwill	(111)	(1,215)			(440)	(440)	(440)	
Net Income	$77,889	$304,665	$79,804	$305,480	$322,771	$342,580	$360,810	12.4
EPS	$1.35	$5.20	$1.37	$5.22	$5.51	$5.85	$6.16	12.5

will be telling, especially since it's Oilfield Services that are expected to perform well over the next year or so while marine construction is in the doldrums.

HALLIBURTON OILFIELD SERVICE MARGINS

	1975	1976
1st Quarter	21.5%	23.9%
2nd Quarter	21.5	23.9
3rd Quarter	23.0	25.1
4th Quarter	23.3	22.3
Year	22.2%	23.8%

Engineering and Construction revenues were about $200 million higher than our estimate, but the variance was mainly low margin industrial construction items (i.e. customer supplied material). Marine construction revenues in the fourth quarter were about $65 million higher than last year's fourth quarter - after being about flat for the nine months (up 7% for the year as a whole to about $990 million), a result of the High Island project in the Gulf of Mexico, and continued good work levels in the North Sea. Operating income results were about as expected - though margins were below our estimates due to large amounts of customer supplied items and a low engineering content in industrial construction revenues.

Specialty Products margins down below earlier quarters in the year - operating income ran about $1.3 million behind our estimate for quarter. Highlands insurance profit for the quarter, $4.4 million, brought yearly results to $10.7 million (up 149% from 1975). Fourth quarter results were almost double next best prior quarter.

1977 OUTLOOK AND STOCK EVALUATION

We have not changed our estimate of $5.85 (in a range of $5.50-$6.15) for the current year. Though we will be watching first quarter Oilfield Service margins closely. We expect that given the current U.S. drilling activity and new F.P.C. gas prices (not to mention the possibility of decontrol), revenues in this area should be strong.

The stock at 58 5/8 is selling at 10.0x our median estimate, or a 6.4 premium to the S&P 500 multiples. Not a large premium for a company with a favorable long term outlook. On the other hand, with more institutional investments being made on an indexed basis, and with HAL comprising (as of 9/30/76) 0.88% of institutional holdings (Spectrum Banks & Investment companies) versus 0.56% of the S&P 500, institutional buying could be limited. In a time of flux regarding it's near term earnings outlook (the marine construction question - basically) - we are only neutral on the stock for the near term.

RW 77-35

White, Weld & Co.
Incorporated

Industry Survey

John H. Hayward, Jr.
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February 14, 1977

OFFSHORE DRILLING INDUSTRY

	Price 1/10/77	1976-77 Range	EPS 1975	1976	1977E	1978E	P/E 1977	Div.	Yield
Ocean Drilling & Exploration (ODECO) (Dec)	26 3/4 bid	35-23	$3.24	$2.35[2]	$2.5[illegible]	$4.00	10.5x	$0.20	0.8%
SEDCO (June)	34 7/8	36-22	3.69	4.34	5.00	5.40	6.9x	0.30	0.9
Western Company of North America (Dec)	18	18-12	2.72[1]	2.46	2.80	3.25	6.4x	0.40	2.2

We believe that significant opportunity for capital appreciation exists in the offshore drilling industry. Specifically, we believe the common stocks of ODECO (26 3/4 bid), SEDCO (34 7/8) and (where appropriate) The Western Company of North America (18) are attractive.

We believe that the large over capacity problem that has hurt margins and earnings is on it's way to being worked off. We believe the period of greatest over capacity will occur in the present quarter (new rig additions are minimal after April), that with the broadening of the offshore drilling market (see below) spot day rates may have already reached their nadir and are rebounding. Consequently, operating rates should improve as the current year progresses. Therefore, margins, earnings and stock prices may move to anticipate this. By 1979 (if not 1978), normal operating rates (93%) are a possibility and hence, better day rates should return to the industry. The stocks of the offshore drilling companies have been battered over the past several years, and are selling at depressed levels both on an absolute basis (roughly 50% below their highs), and also relative to earnings, cash flow and book value.

Thus, it is timely to invest in offshore drilling contractors. The group is still out of fashion, but the outlook is improving. In addition, ODECO's oil and gas production and Western's stimulation services will be additional plusses to those companies.

1 Operating Earnings - exclude earnings of $1.93 per share from sale of two offshore drilling rigs.

2 Fully diluted earnings from operations - excludes gains totaling $1.05 per share from sale of 50% of company's interest in diving subsidiary and gain from excess of insurance proceeds over book value of drilling rig lost in 1975.

M/01/22/51

BACKGROUND

For the past several years, the offshore drilling industry has been in a period of cyclical decline. 1) Oil industry exploratory cash flows were strained by large capital investments in several projects of major proportions and yielded no current return (i.e. the development of the North Slope and the initial phase of development in the North Sea.) As these projects come on stream, available cash flows should expand. 2) Political uncertainties in many countries and changes in U.S. tax laws increased the risk of exploration in many parts of the world. 3) The deferral of U.S. frontier Offshore Continental Shelf lease sales and perhaps just as importantly, the discovery of only a few oil and gas formations of sufficient size to attract broad scale industry exploration activity. All these factors lowered the demand growth for mobile offshore drilling rigs.

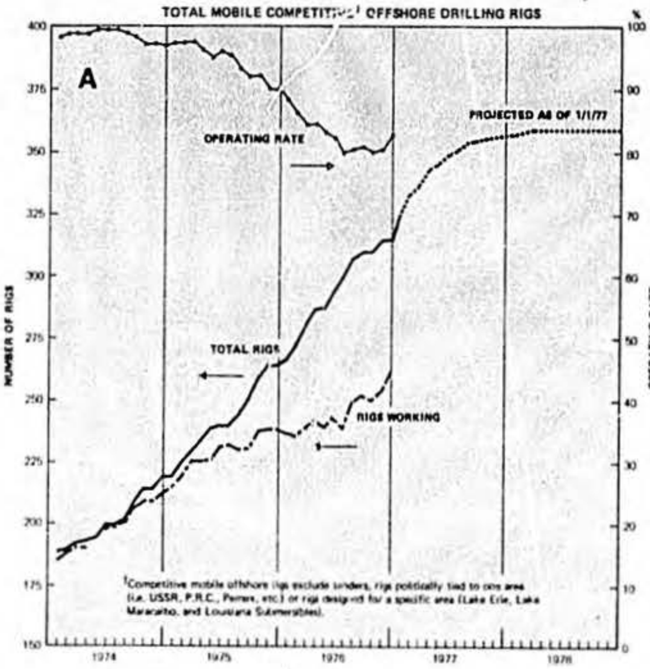
While we estimate that Exploration and Production budgets worldwide have grown at a 26% rate between 1974 and 1977, most of these new funds have gone towards development, particularly the U.S. onshore, or been consumed by inflation. Between January 1975 and January 1977, active "competitive" offshore rigs increased at only a 19% rate (revenues grew somewhat faster due to the use of more expensive rigs and inflation) while "competitive" rigs available increased at a 29% rate, consequently, the fleet operating rate declined and was accompanied by an inevitable decline in rig day rates.

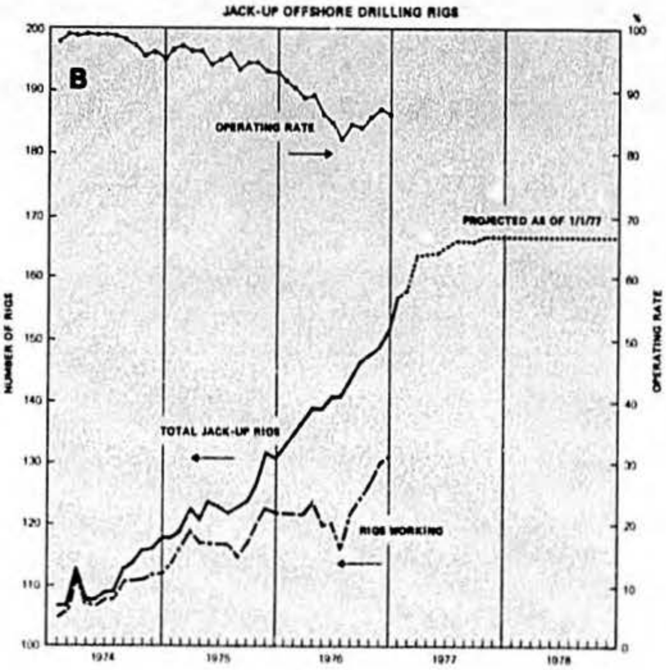
It is fair to say that the current problem of the Offshore Drilling Industry is not lack of demand (growth), but rather result of over capacity brought about by over building. Some would place the blame on new foreign entrants, many of whom had certain tax advantages. On the other hand, one could argue that the extraordinary returns available and the high operating rates would have attracted many new entrants even without tax breaks.

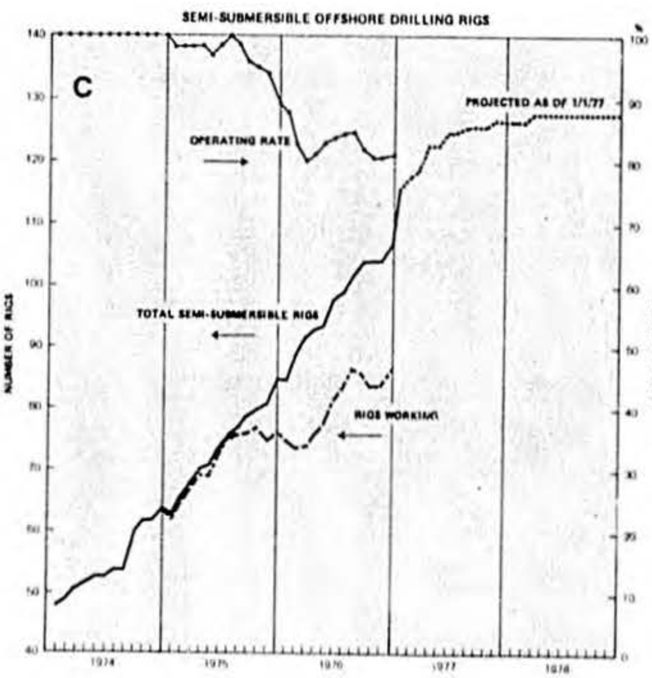
It should be noted that most of the established contractors stopped ordering rigs in early 1974 - unless a firm multi-year contract was in hand though others did not do so. Rig order rates in recent years were as follows:

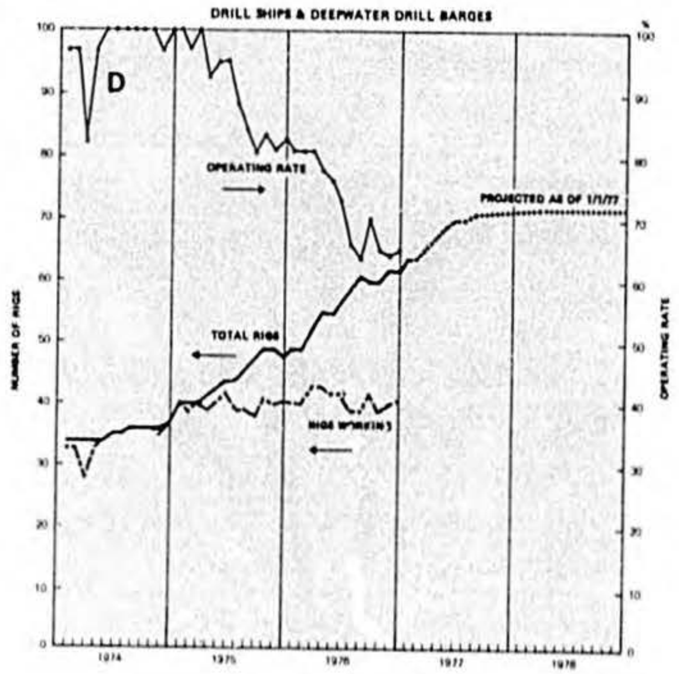
1973	1974	1975	1976
58	112	24	6

1976 saw only 6 new orders placed (four by national oil companies - U.S.S.R., Brazil, Abu Dhabi and U.K., and two jackups ordered by Rowan). If rig orders since late 1974 had not been made, the industry would be in equilibrium. However, at present, there are 65 units idle (no contract) out of a total of 435 (85% operating rate) and 56 units idle out of 316 so called "competitive" rigs (an 82% operating rate). These "competitive" rigs exclude tenders, rigs tied to one country (i.e. U.S.S.R., China, Pemex, etc...) and rigs designed for a specific area (i.e. Lake Maracaibo, Lake Erie, and the Louisiana Submersibles). It is in the total competitive rigs that most of the new additions are being made, in Chart A we have graphed the total competitive rigs, rig additions, rigs operating and operating rates. Charts B, C, and D depict the supply/demand balance and operating rates of jackup rigs, semi-submersible rigs, and drill ships and deepwater drill barges respectively.









The effect of this over supply has now been felt. Contractors with idle rigs lowered prices to improve their competitive position - day rates plummeted. For example, a $30 million semi-submersible getting $40, 000 per day in 1974 (about a third more than historical industry norm), might currently lease for between $20-25, 000 per day.

The decline in rate was compounded by the thinness of the market - especially in mid 1976. As many of the oil company's already had the rigs under contract to drill thier programmed wells, the few new projects drew a host of competition. This situation is improving, as long term rig contracts entered into in 1974 and 1975 expire - the oil company is free to choose from many contractors. Thus, while there are more rigs idle than a year ago when ten rigs may have been bidding three contracts, today there may be 30 rigs bidding for 20 or 25 projects. The contractor knowing there are more jobs available may not be so desperate to cut price.

INDUSTRY OUTLOOK

Predicting demand for drilling rigs is a chancey art. The problem comes down to how one takes into account; political changes, incentives and government tax policies, acreage offerings, concession expiration dates, availability of cash for exploration.

Perhaps for short term projections, intuitive reactions are best. When all are saying there "isn't going to be over supply" sure enough there are too many rigs. When gloom and doom prevails - the market may turn up. However, we believe the bottom is at hand, the number of active offshore drilling rigs will continue to increase based on trends of the recent past. The Gulf of Mexico should continue strong, and gradual improvement will occur in overseas and U.S. frontier areas. The rate of this improvement will depend on several factors including: 1) fifth round licensing in the North Sea, 2) resolution of U.K. participation on present licenses (which could accelerate exploration work for the selection of the portion of past license tracts to be returned to the government in 1978), 3) U.S. OCS activity (new lease sales, successful exploration in frontier areas, and the rate of issuance of drilling permits in new areas).

The current quarter appears to be the one with the greatest oversupply. After this quarter, new fleet additions flatten out dramatically. A continued increase in operating rigs, will increase industry operating rates. Thus, we believe we have seen the low in "spot" day rates. Though contractors who are still operating under "old" long term contracts may see their rates decline but for the industry as a whole, one will see an improvement.

COMPANY COMMENTS

Ocean Drilling & Exploration Company, is the largest drilling contractor in terms of number of rigs (40), and has significant oil and gas interests. Oil and gas revenues in 1976 were $42 million (22 % of the total), but are expected to climb to the $100 million area in 1978 - excluding ODECO's 7% interest in the Ninian Field in the North Sea (which could add about $80 million to the total by 1980).

Earnings from Operations declined in 1976, despite a good improvement in oil and gas results, due to a sharp decline in the company's rig operating rate (from 98.5% in 1975 to about 85.1% in 1976). The company had seven long term rig contracts expire all at once (July 1976). In the market environment it was difficult to put all these rigs back to work on a timely basis. However, today ODECO has work contracts on all but three of it's rigs and has mobilized several rigs into markets where the market outlook is better. We believe the worst may be behind, and given ODECO's good reputation in the oil industry, are looking for an improving situation from here.

While earnings could have been held to better levels by cutting back exploration efforts in 1976 a time of poor drilling earnings, ODECO continued it's aggressive exploration policy. Exploration costs increased from $14.5 million in 1975 to about $16 million in 1976 (The company conservatively expenses all unsuccessful wells). As management believes it must develop opportunities in which to invest the large cash flows expected from oil and gas operation in the late 1970's and early 1980's, we would expect ODECO to continue to maintain it's exploration effort at a high level.

Earnings in 1976 were boosted by about $1.05 per share due to the excess of insurance proceeds over the book value of a drilling rig lost in 1975 and the sale of 50% of ODECO's interest in it's diving subsidiary. Looking ahead, we project earnings in 1977 will be $2.50 per share fully diluted (a 6% convertible Preferred was issued in 1976) in a range of $2.00-3.00. The broad range is necessary due to uncertainties to the timing - and rate of the expected drilling turnaround. Earnings in 1978 are tentatively estimated at $4.00 per share in a broader range of $3.00-5.00.

FINANCIAL SUMMARY
OCEAN DRILLING & EXPLORATION COMPANY
($000's)

	1976	1975	1974	1973	1972
Operating DATA (Dec)					
Revenues	$212,800	$201,690	$131,615	$ 90,837	$ 71,1[illegible]
Pre-Tax Net	NA	50,318	39,663	22,391	16,7[illegible]7
Net Income	41,000[1]	36,663	27,866	18,762	15,039
EPS	$ 3.40[1]	$ 3.24	$ 2.46	$ 1.66	$ 1.31
Balance Sheet Data	9/30/76				
Working Capital	$ 47,671	$ (110[illegible])	$ 23,627	$ 28,175	$ 18,008
Current Ratio	1.6x	.9[illegible]x	1.3x	1.7x	1.4x
Long Term Debt	178,778	193,[illegible]68	199,952	71,080	51,295
Common Equity	275,920	204,408	170,036	145,764	129,295

[1] Includes $14,291,000 gain from excess of insurance proceeds over book value of drilling rig lost in 1975 and sale of 42.5% of ownership (50% of ODECO's share) in diving subsidiary;without these items EPS would have been about $2.35.

SEDCO, the third largest offshore drilling contractor (25 rigs) has done an admirable job in keeping it's string of rising earnings untarnished in this difficult time for the drilling industry. Earnings over the past 5 years (through 6/76) have grown at a 33% rate. The pattern has been:

Year Ended June 30	EPS	% Change from prior year
1972	$1.39	15.8%
1973	1.75	25.9
1974	2.36	34.9
1975	3.69	56.4
1976	4.43	20.1
1977E	5.00+	12.9
1978E	5.40 ($4.50-6.00)	8.0 (.10% to 20%)

SEDCO's success can be attributed to several factors: 1) A strong marketing effort emphasizing the largest oil companies as customers. 2) Building new rigs under multi-year term contracts, not on speculation. Adding to earnings in 1978, SEDCO has two semi-submersibles coming into it's fleet in the first half of calendar 1977 (one has no contract but SEDCO is a 50% partner with Royal Dutch Shell). Also, two dynamically positioned drill ships and a semi-submersible service vessel are to be added to the fleet in late 1977. 3) It's land pipeline construction company turned in a strong performance in fiscal 1976 (22% of SED's pretax income in 1976, or $13.2 million vs. the $3.0 million reported in fiscal 1975). 1977 should be a continuation of this trend - but 1978 pipeline results will be dependent upon landing new contracts in the Persian Gulf area (principally Iran) - hence, the possibility of a slight decline in earnings for next year. 4) Foreign onshore drilling added to the drilling group's earnings consistency.

SEDCO's strong marketing effort has been aided by the fact it did not have more than a few rigs available at any one time. But considering that it's day rates tend to be at some premium to the going market, and it's operating rates are in excess of the industry average, we regard the record as outstanding.

Looking toward the long term future - SEDCO has several partnerships in which it is developing the technology for floating production systems, and deep sea mining. While the commercial viability of either is not yet known, we admire SEDCO's adventuresome prospects for developing long term new business opportunities.

FINANCIAL SUMMARY
SEDCO, INC.
($000's)

	1976	1975	1974	1973	1972
Operating DATA (June)					
Revenues	$337,437	$229,875	$169,715	$125,470	$127,407
Pre-Tax	58,947	43,256	29,463	18,847	14,714
Net Income	44,347	37,594	23,964	17,347	13,231
EPS	$ 4.34	$ 3.69	$ 2.36	$ 1.75	$ 1.39
Balance Sheet					
Working Capital	$ 38,170	$ 25,396	$ 33,318	$ 13,410	$ 7,921
Current Ratio	1.4x	1.3x	1.5x	1.4x	1.3x
Long Term Debt	210,346	157,190	148,320	134,605	90,086
Common Equity	251,383	208,661	171,629	148,447	100,573

The Western Company of North America is one of the newer entrants into the offshore drilling industry (1971), expanding from it's base of oilwell stimulation and cementing services in the southwestern U.S. Now about the 12th largest company in the business (8 rigs), it's overly rapid expansion almost put the company in a financial squeeze in 1975 when it sold two rigs to generate cash. Today, it's debt load (long term debt and present value financing of leases) is still high; as of 9/30/76 it stood at about 73% of total capitalization. We estimate interest and lease coverage to have been 1.7 times in 1976.

New management, installed last year, has recognized the danger of the balance sheet in our opinion. Their strategy has been to insure adequate coverage of drilling rig debt service by keeping it's rigs working - even if this meant aggressive pricing. This has resulted in a 23% decline in drilling operating profit in 1976 versus 1975 despite the delivery of two new rigs, and a full year's operation of two other rigs. In essence, the company has kept it's fleet working and intact awaiting better times. In late 1977 Western, with it's 50% partner Exxon, took delivery of the Alaskan Star - a new $50+ million semi-submersible. Western financed it's $26 million position entirely by debt (7 years @ prime plus 2%). Over the initial 6 year contract period with Exxon (which management indicates has broad escallation clauses), Western's cash flow will pay down 90% of its debt plus interest expenses. In 1977, we calculate the Alaskan Star could add about $1.5 million to earnings. We expect Western's drilling groups to report operating income levels about equal with 1976 results of $9.2 million (1976's first quarter results were quite strong). The earnings gains will come from the company's petroleum services group.

Western's Petroleum Services Group (stimulation and cementing) is the fourth largest competitor in this sector of the oilfield services industry. Halliburton, Dowell, and Hughes - BJ are the others. We expect this area to prosper as oil and gas is developed in more difficult reservoir conditions. Growth over the 1972-76 period has been impressive (revenues and operating income at a 32% compound rate). The company has expanded it's geographical areas of operation, and eroded the market position of some of it's competitors (Dowell and BJ). With improved gas prices and a high incentive price for oil, we look for operations to grow at a 14-15% rate over the next 5 years - excluding geographical expansion. WSN's growth in 1977 should be about 14-17%.

We look upon Western Company of North America to be a risk situation due to it's high balance sheet leverage. However, its strong position in one of the more attractive oilfield service markets (stimulation services) and its apparent defusing of the risk inherent in it's too rapid offshore drilling expansion, awaiting better times, makes the stock attractive, in our opinion, at 6.4 times estimated earnings.

FINANCIAL SUMMARY
THE WESTERN COMPANY OF NORTH AMERICA
($000's)

	1976	1975	1974	1973	1972
Operating DATA (Dec)					
Revenues	$132,774	$ 99,646	$ 61,753	$ 40,439	$ 31,772
Pre-Tax Net[1]	12,028	15,151	5,167	3,589	2,683
Net Income[1]	10,086	11,186	2,961	2,372	1,744
EPS[1]	$ 2.46	$ 2.75	$ 0.71	$ 0.58	$ 0.48
EPS (as reported)	2.46	4.70	0.71	0.58	0.48
Balance Sheet DATA	9/30/76				
Working Capital	$ 16,950	$ 15,900	$ 8,184	$ 4,195	$ 3,929
Current Ratio	1.8x	1.7x	1.7x	1.5x	1.7x
Long Term Debt & Present Value of Leases	144,570	111,002	68,413	34,751	11,609
Common Equity	44,600	38,197	19,765	16,663	13,801

[1] Operating Earnings - exclude gains from sale of Offshore Rigs in 1975

RR-77-29 Research Department

White, Weld & Co. Incorporated

Economic Comment

A. Gary Shilling

December 13, 1976

THE BUSINESS OUTLOOK *

Are Supercycles and Hyperinflation Dead or Alive?

Summary and Conclusion

Most forecasters continue to view the current U.S. business recovery as not only typical of those in the postwar period, but also as the prelude to a renewed supercycle with hyper-inflation. The recovery to date, however, has been anything but normal because it has been dominated and, in our view, will continue to be dominated by two quite different forces: first, the unwinding of inflation and other imbalances built up in the 1965-1975 decade, and second, by the reaction of conservatism and retrenchment to the turmoil and trauma of that period and the resulting distrust of the political process in general.

These factors suggest that despite the election of Jimmy Carter and the continuation of an overwhelmingly Democratic Congress, no massive economic stimulus is likely in coming years, and Federal government expenditures will continue to grow more slowly than the economy. Consumer and business spending growth is also likely to be restrained in the remainder of the 1970's as a reflection of continuing caution. The foreign area of the U.S. economy is also likely to expand only moderately in the years ahead because a similar attitude of retrenchment is being felt in major countries abroad, and because the rapid postwar rebuilding and catching up in Europe and Japan has been essentially completed. Furthermore, the use of import

* We apologize for the length of this paper, but many clients have requested a rather complete rundown on our business outlook, and the reasons why we continue to expect more stable growth and less inflation than most forecasters.

quotas and other barriers to free trade by industrialized countries are likely to continue for some time as they attempt to unload their unemployment problems on others by increasing their exports and reducing their imports -- much to the detriment of everyone's economic performance.

Between now and the end of the decade, the U.S. economy should be growing moderately but above trend, which implies gradual increases in the employment of men and machines. Continued caution throughout the nation should prevent speculative, unsustainable spending patterns and the resulting recession for a number of years. With the economy expected to stay below full utilization of resources in the foreseeable future, inflation rates are likely to decline to a norm of 2% to 3%. The failure of many basic industrial price increases to stick in recent months indicates that now, as in the past, inflationary momentum cannot sustain itself in conditions of economic slack.

With moderate spending growth, the current surplus of funds in the economy as a whole should continue. This, plus lower inflation rates implies still lower long-term interest rates, and our earlier, eventual target of 6% or less for quality bond yields still seems valid.

This seemingly rosy forecast is not without its caveats. First, contrary to our assumption, Washington may attempt to rapidly reduce unemployment through massive economic stimulus. Excess demand, renewed inflation, and another round of economic controls could well result late in the decade, but could be anticipated much earlier in price and wage actions and in security markets.

Second, a worldwide financial crisis could stem from the huge balance of trade deficits of the underdeveloped countries. These nations require a constant infusion of new money from international lending agencies, and also from the world's major commercial banks. Anything, such as a large increase in OPEC oil prices, that caused a number of them to default on international debt repayments could rapidly spread financial difficulties all over the globe.

This forecast of stable, sustainable economic growth in an atmosphere that is relatively free of inflation is not accepted by many, but it is this disbelief and caution which should prevent any near-term deterioration into exuberant economic speculation and the resulting problems of serious inflation and recession. We believe that hyperinflation and supercycles are dead for a number of years, but only because most people see them as very much alive.

In assessing the economy in 1977 and beyond, it is probably useful to ask, "where are we in the business cycle," or perhaps more properly, "what kind of cycle are we in?" Most forecasters view the business recovery, now 1½ years old, as a typical postwar expansion. Furthermore, they see this recovery as only one more step on a never-ending treadmill to disaster. Starting in the mid 1960's, they note, each recession has been more severe than its predecessor, and each recovery has started with a higher rate of inflation. Following this train of thought to its logical -- or perhaps illogical -- conclusion, the economic machine will suffer more and more volatile oscillations until ultimately it is shaken to pieces by these supercycles and hyperinflation.

This sort of outlook is to be expected inasmuch as most forecasts of the future really boil down to projections of the recent past. Most of the times this approach works -- tomorrow usually is like today only hopefully a bit better. There are, however, times when the economy is crossing a watershed, and then this approach simply doesn't work. Now, in our opinion, is one of those times.

The Recovery - Dominating Factors

This does not suggest that we see the last ten years as irrelevant to our forecast, but rather that we do not see the future as a straight-line projection of the past decade. Instead, we think that two factors, very much relating to the 1965-1975 period, have been dominating the recovery to date, making it anything but a typical postwar affair, and are likely to continue to dominate for the rest of the decade.

First, is the unwinding of inflation and other imbalances developed during the 1965-1975 era. The momentum of inflation was initially built by the excess demand created by Vietnam spending and Great Society programs in the late 1960's. This momentum got another kick in 1971-1972 from the monetary and fiscal stimulating efforts that accompanied Nixon's bid for reelection. The resulting long-term pattern of accelerating inflation had, by 1973, created the impression among businessmen that shortages and inflation were here to stay. These impressions became convictions with the oil embargo which came on the very eve of the 1973-1975 recession. Even further inflationary forces were unleashed when economic controls were completely removed in 1974 -- during the recession itself.

With this pattern of ever increasing inflationary momentum, it is small wonder that the worst recession since the 1930's did not wipe out inflation, and as a result, that recovery started with inflation rates far from the low levels that would reflect the unemployment and slack industrial capacity conditions that prevailed at the end of the business correction.

The second factor that has influenced the recovery so far, and is likely to continue to do so, is the reaction of the conservatism and retrenchment to the turmoil of the last ten years that is now seen throughout the nation. This, of course, is a logical response to the unpopularity of the Vietnam War, the campus unrest, the race riots, disappointments with the Great Society programs, and distrust of politicians at all levels. People now seem to feel that political leaders can't run much of anything, whether it is foreign policy after Vietnam, the economy after the last two recessions and near runaway inflation, or even the political process after Watergate. Furthermore, the time distance that has now been put between us and the depression, as well as the recent inflationary surges, have reversed people's priorities, and the majority now put inflation ahead of unemployment as their number-one concern.

This last decade, then, was a very disruptive, experimental, and ultimately disappointing one -- one that generations of yet unborn candidates for PhD's in economic history will probably be culling over long after we are all dead and gone. The idea that we are now reacting to it not only makes good sense but also fits in beautifully with the 50-year Kondratieff Wave, named after an otherwise obscure Russian economist who, in the 1920's, first studied these fifty-year cycles in industrial countries. As a result of his studies, Kondratieff correctly predicted difficult times for the capital countries in the 1930's, but he made a strategic blunder for a Russian by suggesting that the capitalist countries would survive. The Soviet government's reaction was predictable. Kondratieff spent the rest of his career in Siberia, and his experience does serve as a constant object lesson with regard to making forecasts that are unpopular with the powers that be.

The exact rationale for a fifty-year cycle is not at all clear, and one should be cautious about suggesting that we all should be retired by 1982 -- the equivalent of 1929. Parallels are, however, intriguing. Fifty years ago the trauma of the first World War, the worldwide commodity boom that followed, and the severe inventory correction in 1920-1921, were followed by a decade of retrenchment in the 1920's. Similar circumstances surrounded the Civil War, the nation's greatest trauma, fifty years before World War I, and the War of 1812 fifty years preceding the Civil War.

Even Watergate had its parallels in the Teapot Dome scandal of the Harding Administration, and the scandals of President Grant's time. The swine flu made an appearance fifty years ago, although this may be pushing the analogy too far. The best explanation we can find for the fifty-year nature of the cycle, is that in a half century, everyone who indelibly remembered the last one, is dead or retired so everyone is convinced it can't happen again. Given the relative constancy of human nature, this means that people's attitudes are then set up for a rerun.

It Ain't Typical

In any event, the dominance of these two factors -- the unwinding of inflation and other excesses developed during the 1965-1975 decade, plus the reaction of retrenchment to that period -- explains why the ongoing business recovery has been anything but typical of the postwar experience. Inflation rates, rates of wage increase, loan demand, and interest rates are all below the levels reached at the trough of the recession -- anything but normal recovery behavior. Cautious attitudes explain why corporate bond issues remain heavy this late in the recovery as businessmen continue to rebuild liquidity, and to try to get away from their friendly bankers who weren't so friendly in 1973-1974.

The atmosphere of retrenchment also helps explain why plant and equipment spending has undershot businessmen's planned levels for six consecutive quarters. In a typical recovery, they spend more, not less than they planned. These cautious attitudes, as well as the inventory excesses of the early 1970's explain why inventory liquidation lasted through a full year of recovery, much longer than normal, and why inventory rebuilding since then has been extremely moderate.

Political Evidence of Unwinding and Reaction

The legacy of the last decade -- the unwinding and reaction to it -- can be seen at work in a number of areas. In the political arena, a shift to the right first became visible in the summer of 1975. Then, despite a 9.2% unemployment rate recorded at the time, the President vetoed two obvious pump-priming bills -- a job-creating bill and a housing bill -- and both vetoes were sustained by Congress. This was, and still remains, extraordinary. When we first suggested in late 1973 that unemployment rates might top 8%, we were told "there is no way the government can possibly stand for it, there would be riots in the streets."

Further vetoes of spending bills, even in an election year environment, also suggests that the long, liberal swing starting in 1933 has ended. The same is true of the recent surprisingly conservative actions of many Congressmen, Senators and Governors who were elected in 1974 as flaming liberals in reaction to Nixon and Watergate.

Despite this evidence of a political shift to the right, many now fear that the election of Jimmy Carter and the continuation of an overwhelmingly Democratic Congress will touch off another round of massive economic stimulus from Washington, particularly in light of the current economic pause. We do not feel, however, that Carter is a burning New Deal liberal with a global if not cosmic economic strategy, but rather see him as a pragmatic businessman without any overriding economic philosophy, as indicated by the flexibility of his economic policy positions since last spring.

In the presidential primaries, a rather conservative economic policy, plus an anti-Washington image, allowed Carter to knock off the New Deal Senators and other assorted liberals. With the nomination acceptance speech, however, he shifted to the left and assumed the role of a traditional Democrat, obviously an attempt to win the liberal wing of the party, and avoid the McGovern mistake of winning the nomination but not the party's backing. In the summer, he shifted back to the right when the polls showed that three-fourths of the voters considered themselves moderates or conservatives. At that time, Carter was emphasizing unemployment and inflation as coequal problems. Late in the campaign, the economic pause afforded him an opportunity to advocate an economic policy that differed from President Ford's and that, plus an opportunity to appeal to low-income, traditionally Democratic voters were probably responsible for his emphasis on unemployment and slow economic growth.

Since the election, Carter's economic policy appears to have again shifted back to the right with his suggestion that it might be four years before unemployment drops below 6% -- hardly in line with the very liberal Humphrey-Hawkins bill targets.

It is true that Carter owes political debts to the big city mayors, the blacks, and the labor unions, but he will probably want to be President of all the people and win the backing of the 49.5% of the voters who preferred somebody else on election day. It is also true that if, contrary to our view, the economy goes nowhere between now and early next year, a tax cut or other form of economic stimulus will probably be proposed and whisked through Congress. This, however, would also probably be true under Ford or anyone else in the White House, including Goldwater. On balance, though, we expect no massive stimulating programs to be proposed by the Administration, but rather that Carter, with a businessman's background, will react to economic events as they unfold.

Congress may also prove to be surprisingly stable and moderate in its actions. Despite the pledges of cooperation with the Administration, there is considerable skepticism of Carter on Capitol Hill, and any radical proposals for substantial economic policy changes might lead to considerable confrontation. Furthermore, Congress is likely to be careful of what bills it sends to the new President for signature. Under President Ford, the Democratic majorities in Congress knew they could send anything to the White House knowing that dear old Jerry would veto it, but now Carter might just sign some of those bills, much to the embarrassment of everyone, including their Congressional sponsors. Furthermore, Congress has shown more independence in the last several years than since the New Deal began four decades ago.

The new budget-making process which not only gives Congress overall responsibility for federal government spending and receipts, but also pretty well locks in the budget for a full fiscal year ahead, is a prime example of this.

The Federal Reserve, the third element in the Washington economics triangle, should also continue to be an instrument for holding down economic stimulus, now that Chairman Burns has decided to stay at least until his current term expires in early 1978. Despite some signs of willingness to cooperate with Carter and Congress, and hence preserve the independence of the Fed, Burns' overriding concern still appears to be control of inflation.

Overall, then, we feel that Federal economic stimulus will continue to be moderate and Federal spending will continue to grow more slowly than the total economy. State and local spending which has also been underperforming the economy lately -- for the first time in decades -- is also likely to continue this slower rate of growth as a result of voters' continuing rejection of the vast majority of bond issues and the lack of any big spending needs such as were required when the postwar babies flooded the education system.

Consumers and Businessmen - Continuing Caution

With government spending at all levels expected to grow more slowly than the economy, the private sector must, of course, grow more rapidly than overall activity, but this does not imply runaway activity by consumers and businessmen. Quite the contrary, consumers will probably continue to remain cautious and only slowly reduce their saving rates as they build confidence and liquidity. Businessmen will probably continue to improve their balance sheets and liquidity as memories of the burning they took in the recession continue to dominate their thinking. Inventory-sales ratios in real terms are still about 10% higher than in the mid 1960's, and are likely to work lower as businessmen increase inventories more slowly than sales. Plant and equipment spending will probably continue to grow faster than the economy, but not at runaway rates as a result of excess capacity, and the desire to improve liquidity and balance sheets.

Foreign Problems

A final component in the economy, the foreign sector, is not a big one for the U.S., but is important to the thinking of all of us, particularly because of some rather significant problems abroad. Over a year ago, we argued that the period of much more rapid growth outside the U.S. was over, and that the lack of strong upward momentum implies periodic recessions in Europe and Japan, as well as in the U.S. in the years ahead. However, the current slowdown abroad, after only several quarters of economic recovery from the first major worldwide recession since the 1930's, is not exactly what we had in mind by "periodic recessions".

Economic revival in Europe, Japan and Canada started late last fall as a result of the spreading influence of the U.S. recovery, and an ending of inventory liquidation throughout the world and the resulting growth of real incomes and consumer spending. This spring, however, recovery gave way to much slower growth as a result of deceleration of the U.S. expansion, but also because of a number of coinciding factors abroad which acted principally to reduce growth and real incomes and, hence, consumption.

Governments in Europe and Japan, with their strong pro full-employment policies, have reacted strongly to the renewed economic weakness and rising unemployment rates. Fearing both already large budget deficits and the future inflation that may result from continued rapid monetary growth, their main emphasis has been on increasing exports and reducing imports in order to spur domestic economic activity.

Unfortunately, this foreign trade game is one that everyone can't win. Although quotas and other non-tariff barriers to trade are being used in place of tariff walls, current actions today do resemble the trade wars of the 1930's. It is interesting to note that those tariff walls were erected by people who we now regard at best as too stupid to realize that their actions were detrimental to trade overall and to economic growth to each individual country, and at worst as absolutely evil. However, human nature does not change rapidly, and we now see people reacting to similar circumstances in similar ways.

Examples of these barriers are rampant -- quotas have been put on everything from steel to turkey wings and legs. The European Common Market's zeal to restrain imports from Japan is particularly conspicuous. Even in the United States, hardly a week goes by that some industry does not ask for quotas or other measures to get relief from import pressures, or request the Treasury to commence an anti-dumping investigation.

These actions, sad but true, are to be expected in times of domestic unemployment in the world's major industrialized countries, and, unfortunately, are part of the general retreat from internationalism that has resulted mainly from rising domestic economic problems in the past ten years. Currency value declines in Mexico, Australia, New Zealand and Canada that look suspiciously like competitive devaluations are symptomatic of the same disease. Politicians are, after all, elected by their own constituents, not by international referendum, so when troubles develop at home internationalism goes by the boards.

True, economic recovery abroad is expected to resume as a result of improving U.S. demand, and rising real incomes and improving consumer spending should follow from receding inflation rates throughout the world. Nevertheless, no runaway expansion abroad is expected, and unemployment rates should remain high enough to continue the current aggressiveness in foreign trade in the foreseeable future.

The overall effects on the U.S. of foreign trade battles and lower growth in other major countries should continue to be small because of limited American exposure to foreign trade. U.S. imports or exports, as a percentage of GNP are about 8%, while in Europe the number runs to 50% and higher. Furthermore, the U.S., like other lands, is progressively moving toward isolationism, and cutting herself off from foreign exposure -- consider, in the contest of internationalism, the nationwide zeal to be independent of foreign energy supplies! Like in the 1920's, the last comparable period in a Kondratieff Wave sense to what we may be going through, the U.S. may well enjoy a period of stable and substantial growth, while the rest of the world is experiencing severe problems. Let's hope that any parallel stops there and doesn't extend to the militarism of the 1930's which eventually resulted from unemployment and economic unrest in a number of countries.

Floating exchange rates provide another buffer to foreign exposure. Despite universal declines in inflation rates, price increases are likely to remain smaller in the U.S. than in most other countries, as has historically been the case in periods of peace. The reason, in our view, is that the U.S. has the least commitment to maintain full employment. There is, after all, a trade-off between full employment and inflation--the fuller the employment, the higher the inflation rate. Some fear that higher inflation rates abroad will spread to the U.S. domestic economy, but floating exchange rates are likely to offset these inflation differentials among countries, as we have seen so well illustrated by the U.K. and the value of sterling in the past year.

An improving value of the dollar is also likely to limit foreign borrowing in the U.S. despite the fact that interest rates will probably continue to be lower here than abroad. As recently seen with the collapse of the Canadian dollar, loans in U.S. dollars that appear to be less expensive than in the borrower's own currency can prove to be anything but cheap when that currency declines significantly. Furthermore, nervousness about foreign loans by U.S. lenders, as well as slower economic growth abroad than many earlier believed, are likely to limit borrowing in the U.S. by foreigners.

Key Forecast Elements -- Moderate Growth

In any event, the prospects for moderate growth abroad in the longer run as well as in the near future, coupled with moderate domestic expansion in the government and private sectors in the years ahead suggests that the U.S. economy is not likely to expand at runaway rates. We expect 5% growth in real GNP in 1977 and in the rest of the years of the decade. This is above the trend or supply-side growth of 3 1/2% to 4% per year, so unemployment rates should gradually decline and industrial utilization rates should gradually increase, but emphasis is on the word "gradually." This is, after all, a moderate rate of recovery and expansion considering the depth of the recession the economy has just endured. The reason, of course, is caution and moderation in all areas of the economy.

But, Sustainable Growth

This expansion, however, will probably be more sustainable than most. We are not suggesting that recessions have gone out of style. Far from it -- another one is lurking out there somewhere in the underbrush, but is likely to be postponed longer than normal because of the tremendous caution that we expect to continue to dominate spending decisions.

Contrary to the fears of those who see the current pause deteriorating into renewed recession, history shows us that economic expansions end with a bang, not with a whimper-- not because people simply stop spending, but because spending gets unsustainably strong. People get so far from the last recession that they forget about it and embark on an inventory building surge, a plant and equipment spending boom, or a consumer goods spending spree. This unsustainable spending then collapses into recession when either people run out of dough or the Federal Reserve steps in to call the party to a halt. Considering the severity of the past recession and the continuing caution that resulted from it and from the turmoil of the last ten years, more time than normal will probably pass before people again embark on speculative forms of behavior. We may very well have an expansion that will last not the more normal three years, but maybe five -- something like the extended growth phase of the early 1960's during which people were also cautious for an extended period.

No Early Return to Full Employment, and Implications for Inflation

Another consequence of our forecast is that full employment of men and machines is unlikely before the early 1980's, given the modest rates of economic expansion we expect to continue and the considerable amounts of excess resources that are currently available in the economy. This leads to a very important forecast -- lower rates of inflation.

History shows very clearly that even though the momentum of inflation can outlive the excess demand that created it, it cannot continue to feed on itself indefinitely in an atmosphere of considerable economic slack. Rather, the momentum sooner or later fades and inflation works down to the structure or basic level which we believe to be 2% or 3%. This range could well be reached by late next year, and is likely to remain the inflation norm until excess demand appears again and generates renewed price and wage pressures.

These rates of inflation may sound ridiculously low, but they are actually extremely high by historical standards. If we strip Vietnam and its aftermath, as well as Korea, out of the postwar period, inflation rates during the remaining peacetime years averaged 1% as measured by consumer prices, and 1/2% on the Wholesale Price Index. 2% or 3%, then, is two or three times the rates of those earlier postwar years and should account, in our view, for any structural changes since then, such as pollution and energy costs whose inflationary effects have not yet fully worked their way through the system.

Inflationary Momentum - Evidence of Unwinding at Last

Up until recently, the historical precedent for unwinding inflationary momentum was the sole basis of our forecast. Now, however, we have concrete evidence that the normal historical pattern is again being repeated. To see this it is necessary to go back to last spring and examine the situation then facing the steel, aluminum, paper, and other basic industries. At that point these producers saw that their customers -- the users of steel, aluminum, etc. -- were completing their inventory liquidation, so orders for these basic commodities were picking up.

Furthermore, those producers of basic manufactured goods, as almost everyone else, thought that we were in a typical postwar expansion and consequently expected an almost immediate surge in plant and equipment spending. They also thought that inflation rates would pick up in their normal postwar cyclical pattern, and furthermore, that supercycles and hyperinflation were very much alive, so sooner or later, the economy would again be hit by shortages and hedge buying. Many of these businessmen also believed that Jimmy Carter would be elected President, and feared the reimposition of price controls as he had hinted. The reaction to all these factors was, of course, a rash of announced price increases in steel, aluminum, chemicals, paper, cement, etc.

The steel industry went one step further, warning customers to buy ahead because steel shortages would be upon them by the end of this year. Steel-using customers were further encouraged to hedge steel purchases by a series of announced price increases which were to take effect not immediately but always two or three months down the road.

This series of price increases in basic industries, and the inflationary hedge-buying atmosphere that many thought it would create, fell flat on its face about midyear, and provided the first concrete evidence that inflationary momentum could not survive in conditions of business slack. Users of these basic commodities had been so badly burned by excess inventory holdings during the recession that they were unwilling to build stocks excessively, despite their fears of accelerating prices. On the other side of the coin, excess capacity was so rampant that suppliers were willing to make under-the-counter deals, agree to discounts from listed prices, and also to cheat on announced price increases. The results, of course, were the rescinding of price increases and the development of price discounts in steel, aluminum, copper, zinc, cement, paper, plastics, chemicals, etc.

Additional unwinding of inflationary momentum is likely. Purchasing agents who six months ago were accepting price increases as a way of life, now have the taste of blood -- they are looking for discounts and are unwilling to accept price increases. Furthermore, these attitudes are unlikely to change any time soon, since given our forecast of modest economic growth in the quarters and years ahead, it is unlikely that fears of shortages and inflationary hedge buying will be rekindled. In particular, the newly announced price increases in aluminum and steel are being discounted and are unlikely to have significant impact on transaction prices.

Failure of Price Increases - Some Ironic Profits Implications

Interestingly, the failure of basic industry price increases to stick is probably in the long run in the best interest of those very industries. Had they been successful in their price increase attempts, then inflationary momentum would have, for the first time ever, shown signs of self-perpetuating during conditions of significant economic slack. The result could well have been economy-wide hedge buying, shortages, an inventory bubble, and ultimately a very severe recession, detrimental to everyone, especially these basic industrial material producers.

Their inability to raise prices in the face of economic slack, however, suggests that business caution and competitive forces are very much at work and likely to prolong a steady economic expansion. Historically, this has been the ideal time for these industries, as demonstrated by the long, stable expansion in the early 1960's. In these circumstances, volume expansion spreads overhead costs over more and more units of output. The resulting above-trend productivity growth acts to offset the great majority of labor cost increases and results in only modest growth in unit costs.

Consequently, annual price increases in these industries of even 3% or 4% in 1977 and beyond are likely to result in substantial, prolonged profit-margin improvement of the sort not seen since the early 1960's. This, plus the expansion in sales to which higher profit margins are applied should push earnings in basic industries up by 10% to 20% annually in coming years, and the same mechanism should move economy-wide profits up by 10% to 15% per year in 1977 and beyond.

Surplus, Not Shortage of Funds

Just as our forecast calls for no early return to shortages of goods, it also foresees no revival of shortages of funds in the economy. Both shortages in the early 1970's, in our view, were products of the worldwide boom which, if history is any guide, will not be repeated for fifty years -- except during any future wars. Instead, we expect that the overall surplus of funds which has been around since early 1975 will continue in the balance of the decade.

The Federal Government, for example, should see steadily declining deficits, assuming no substantial tax cuts. Government spending, as noted, is expected to continue to grow more slowly than the economy, but Federal receipts, dependent as they are on personal and corporate profit tax collections, should grow about in step with the economy. The resulting declines in the deficit will, of course, reduce the Treasury demand for funds in an absolute sense. Corporations, since early last year, have been essentially in financial balance as their spending on inventories and plant and equipment has about matched their retained earnings and depreciation, even after correcting for inventory profits and under-depreciation. This situation is expected to continue as rapid profits growth and growing depreciation allowances should continue to about match the modest growth we foresee in inventories and stronger but contained advance in plant and equipment expenditures.

Individual saving is likely to continue to grow in dollar terms. The expected steady growth in incomes should more than offset the modest decline in saving rates that is expected as confidence and liquidity are rebuilt. Putting all these elements together, and despite our extremely strong housing forecast, which suggests a doubling or more in housing starts between now and 1980, the domestic economy overall should continue to have an ample supply of funds. One interesting indicator of this surplus currently is the difficulty that life insurance companies are now experiencing in investing their funds without further reducing the quality of private placements they will accept. Some are seriously considering reentering the residential market for the first time in many years, a move that could quickly reduce mortage rates.

Interest Rates - Down Further

The lower inflation rates we expect as a norm in coming years, coupled with a continuing surplus of funds obviously suggests anything but rising interest rates. We continue to believe that with inflation rates of 3% or less, quality bond yields, now about 8%, will work down to 6% or less -- not immediately but in the two or three years it takes investors to become completely accustomed to a new inflation rate and hence to fully adjust the inflationary premium they demand on long-term bond yields.

Assuming a normal yield curve with short-term rates below bond yields, money market rates in this scenario would not be expected to move up appreciably from current levels in the years ahead. Furthermore, the bank prime rate will probably decline appreciably. The spread between the bank prime rate and commercial paper and other competiting interest rates has been held unusually wide as banks rebuild their capital and cover current and expected losses on real estate, foreign, and other troubled loans. After loan-loss reserves are fully taken care of, however, banks could well shrink this spread between interest costs and charges without any appreciable effect on the bottom line, and probably will want to do so in order to retain their best business clients. Some such accommodation seems necessary if the prime rate system is to survive. In the past year, some banks have been making loans at below prime with no compensating balances in order to accommodate their business customers, a practice which could endanger the entire prime rate system if it continues indefinitely.

Two Caveats

This rather rosy forecast is, like any, not without its caveats, and two should be mentioned. First, contrary to our assumptions, rapid monetary and fiscal expansion could become the rule in Washington as the new Administration and Congress attempt to reduce unemployment rapidly. Such actions would probably not result in significantly greater economic growth until 1978, and would not be likely to push the economy back to full employment and perhaps into excess demand until 1979 at the earliest. Under normal circumstances, the resulting new round of inflation and the controls which would undoubtedly result would not be expected until late in the decade. This time, however, with the surging inflation and controls of the early 1970's still fresh in people's minds, any expected rerun of these problems could be anticipated much earlier by attempts to raise prices and wages, as perhaps has been the case with some recently announced price increases. Furthermore, securities markets could react negatively soon after it became apparent that massive government stimulating efforts were underway.

The more dangerous risk comes from abroad, not so much from the trade battles now being carried on by developed countries but by the underdeveloped countries which continue to experience huge trade deficits as they import more than they export. Consequently, a continuing infusion of new money from international lenders such as the World Bank as well as from the world's commercial banks, largely through the Euromarket, is necessary just to keep those countries financially alive. In some ways the situation is worse than the REIT loans in this country. There are many questionable real estate loans outstanding in the U.S., but at least no new ones are being created. In the underdeveloped countries, much good money is perhaps being thrown after bad.

Furthermore, the solution to these trade imbalances is not in sight. While it is true that the underdeveloped countries collectively have smaller deficits this year than the horrendous levels of 1975, the stronger demand for their goods by developed countries that resulted from the first burst of worldwide economic recovery is unlikely to be repeated. Furthermore, in the longer run, the prices of the raw materials that these poorer nations export are declining in relation to the manufactured goods they import as the world's manufactured goods contain more and more technology and less and less raw materials.

The dire conditions now faced by these countries have historically often been solved by cartel formation. This time, however, there are no "Big Daddies" -- such as the British or Dutch with their vast colonial empires in earlier times -- who would set up the cartels, police them, and bank-roll the members while supplies were being cut back and prices of raw materials pushed up. Only in the case of oil has a recent raw materials cartel worked, and only there because the Saudi's serve as "Big Daddy". Other recent cartel attempts in bauxite, copper, etc., have failed miserably.

The financial condition of underdeveloped countries has certainly not improved demonstrably recently. A year or more ago when we and others first called attention to this problem, it was pointed out that nobody had lent very much to the Bangladeshes of the world, but rather to safe, stable, high-growth countries such as Brazil, South Korea, and especially Mexico. Now, even these countries are experiencing difficulties.

A critical test for the underdeveloped countries may come from the widely expected increase in OPEC oil prices in the near future. A large price hike would greatly increase the balance-of-trade deficits of underdeveloped countries and could cause a wave of voluntary defaults on international debt repayments as they saw no way of ever working their way out of their financial holes. Alternatively, their creditors could reach the same conclusion and cut off further advances, thereby leaving no alternative but default. Such a wave of financial failures could rapidly and severely impact the Euromarket, and create a worldwide financial crisis.

The Saudi's, the leaders of OPEC, are obviously aware of this, and have a great deal of money tied up not only in the Euromarket but throughout the world, which they obviously would not like to see in jeopardy. This, plus their concern about the economic health of the developed countries and fears that a huge oil price increase may not stick in conditions of oil surplus and slack demand may temper their willingness to go along with a huge oil price increase.

Of course, the underdeveloped countries would not be impacted by a huge oil price increase if OPEC simultaneously announced a program to recycle the funds back to these emerging lands. This, however, would not solve their basic financing problems. Furthermore, other creditors might curtail further loans, reasoning that since the Arabs were providing essential oil to these countries, they would get first crack at any foreign debt repayments. Another alternative would be lower cost oil for underdeveloped countries, which has been suggested many times since the oil embargo of 1973--particularly by the underdeveloped countries themselves. OPEC has consistently rejected this proposal and we think for good reason. A boatload of cheap oil could be headed for India, for example, but ships captains sometimes get their orders mixed up at sea, and, who knows, it might end up in New York harbor.

Our Forecast - Very Much Doubted, Therefore Likely

The atypical nature of the current expansion is clear enough, but has only recently been perceived by many. As late as last spring, most forecasters and a number of businessmen saw nothing unusual about the recovery, and the latter were gearing up to deal with a capital spending boom, accelerating inflation, inventory hedge buying, credit shortages, etc. Perhaps the recent economic pause was caused, at least in part, by the realization that this strategy wasn't working. As in 1962, the current pause may serve as the transition between those earlier, unrealistic expectations and actions, and the much more sustainable stable business expansion in an atmosphere relatively free of inflation that we foresee for the balance of the decade.

Even now, however, our forecast is not accepted by many, and, ironically, its success depends on that disbelief continuing. It is, after all, this healthy skepticism and the resulting caution throughout the economy which postpones those speculative imbalances which ultimately call a halt to the expansion -- imbalances which are seen first in securities markets, and then in the economy itself. We believe that supercycles and hyperinflation are dead for a number of years to come, but only because most people see them as very much alive.

EC-76-4

White, Weld & Co.
Incorporated

Economic Comment

January 31, 1977

ECONOMIC FORECASTS

This month we are presenting two sets of economic forecasts; one excluding the Carter Administration's fiscal stimulus proposals, and another which includes it. The effect of the program is to raise economic growth this year from about 4 1/2% to 5 1/2%. This is a maximum expectation and, given the probable delays in implementing the program, in reality growth would fall somewhere in between the two forecasts. We do not believe the proposed increase in the investment tax credit will affect capital spending this year, but the issuance of $11.4 billion in tax rebates in the second quarter and a $4.0 billion permanent tax reduction starting in the third quarter would result in a sizable increase in personal consumption in the year's second half. We are assuming that a total $9 billion increase in federal spending on job-creation projects will be implemented, but this aspect of the program is the most controversial and the one most likely to be changed by the Congress, therefore we have delayed its implementation by three months to the fourth quarter of this year.

Although the package of fiscal stimulants has a demonstrable effect on economic activity in general, it does not in our view portend any acceleration in inflationary pressures. The reason is that any step-up in commodity prices resulting from faster output growth would be offset by faster productivity growth stemming from volume expansion and the spreading of overhead costs. This would also result in a sizable gain in corporate profits which on an after-tax basis we expect to rise about 17% this year versus only a 13 1/2% gain without the fiscal program. In 1978, the increased production and employment resulting from the spending of tax rebates would boost economic growth further and result in about a 15% gain in after tax profits.

The first quarter 1977 estimates reflect our assessment of the effects to date of the extreme winter weather.

EC-77-1

A. Gary Shilling

Sp/55/56/65

U.S. ECONOMIC FORECAST
(Billions of Current Dollars)

	1976	1977		1978		Percent Change				
						1976	1977		1978	
	Actual	A	B	A	B	Actual	A	B	A	B
GNP Data										
Consumption Spending	1,078.6	1,178.6	1,199.2	1,270.1	1,329.1	10.8%	9.3%	11.2%	7.8%	10.8%
Durables	156.3	172.1	178.5	188.0	205.2	18.7	10.1	14.2	9.2	15.0
Nondurables	440.3	476.9	486.4	506.2	529.8	7.6	8.3	10.5	6.1	8.9
Services	482.0	529.6	534.4	575.9	594.1	11.5	3.9	10.9	8.7	11.2
Plant and Equipment	160.0	176.2	175.7	194.5	193.7	8.8	10.1	9.8	10.4	10.2
Housing	67.8	87.6	87.6	102.0	102.0	32.4	29.2	29.2	16.4	16.4
Inventory Change	14.8	14.8	15.0	21.2	24.3	-	-	-	-	-
Net Exports	6.9	4.9	4.9	6.9	4.5	-	-	-	-	-
Federal Government	133.4	143.3	144.7	150.5	154.3	7.2	7.4	8.5	5.0	6.6
State and Local Government	232.3	247.3	248.4	263.9	267.6	8.3	6.5	6.9	6.7	7.7
GNP (Current Dollars)	1,692.4	1,852.1	1,875.5	2,008.1	2,075.3	11.6	9.4	10.8	8.4	10.7
GNP (1972 Dollars)	1,265.0	1,320.1	1,336.6	1,382.9	1,429.1	6.2	4.4	5.7	4.7	6.9
Price Indices (1967 = 100) (Year Average)										
GNP Deflator	133.8	140.3	140.3	145.2	145.2	5.1	4.9	4.9	3.5	3.5
Consumer Price Index	170.6	178.7	178.7	184.8	184.8	5.8	4.7	4.7	3.4	3.4
Wholesale Price Index	182.7	192.3	192.3	198.4	198.4	4.5	5.3	5.3	3.2	3.2
Corporate Profits										
Pretax Operating Profits	119.0	137.5	142.1	156.2	170.0	29.8	15.6	19.4	13.6	19.6
Capital Consumption Adjustment	15.5	17.8	17.8	19.8	19.8	-	-	-	-	-
Inventory Valuation Adjustment	14.6	12.8	12.8	7.8	7.8	-	-	-	-	-
Total Pretax Profits	149.1	168.0	172.7	183.7	197.5	30.1	12.7	15.8	9.3	14.4
After Tax Profits	84.4	95.9	98.7	105.6	113.8	29.2	13.6	16.9	10.1	15.3
Other Statistics										
Housing Starts	1.57	2.0	2.0	2.22	2.22	34.2	27.4	27.4	11.0	11.0
Industrial Production	129.8	137.9	138.6	148.1	149.5	10.2	6.2	6.8	7.4	7.9
Unemployment Rate	7.7	7.5	6.3	7.5	6.3	-	-	-	-	-
Federal Government Deficit (Calendar Year)	-58.3	-55.0	-63.0	-45.0	-52.0	-	-	-	-	-

Quarterly Data (Annualized Rates of Change)

	1977								1978							
	I		II		III		IV		I		II		III		IV	
	A	B	A	B	A	B	A	B	A	B	A	B	A	B	A	B
Real GNP	4.7	4.7	5.3	7.3	4.6	10.3	4.6	10.2	4.7	6.3	5.0	5.3	4.7	4.5	5.1	5.0
Inventories	12.0	12.0	14.0	14.0	16.0	16.0	17.0	18.0	19.0	23.0	20.5	23.5	22.0	24.5	23.3	26.0
Industrial Production	7.5	7.4	8.3	8.2	7.2	9.6	7.1	9.8	7.3	7.7	7.4	6.4	7.3	5.6	7.7	5.9
After Tax Profits	8.6	8.6	13.8	18.5	9.3	20.4	8.4	22.3	7.1	11.3	11.4	12.1	13.8	13.6	13.6	13.8
Real Disposable Income	3.7	3.7	4.7	20.5	3.6	4.9	4.9	6.2	5.0	4.9	3.7	3.7	3.6	3.8	3.4	3.7
Consumer Price Index	5.5	5.5	4.1	4.1	3.8	3.8	3.5	3.5	3.4	3.4	3.3	3.3	3.3	3.3	3.0	3.0
Productivity	3.2	3.2	4.9	4.9	4.9	4.9	4.5	4.5	3.0	3.0	4.0	4.0	4.3	4.3	4.0	4.0

A = No Stimulus B = Stimulus

A. GARY SHILLING

White, Weld & Co. Incorporated

Economic Comment

Outline of Taped Discussion of Economic Outlook by A. Gary Shilling 3/4/77

I. Basic forecast unchanged - recovery, like recession, not typical
   - A. Cautious reaction to excesses of last decade continues to dominate
   - B. Further unwinding of inflation (to 3% annual rate) still expected
   - C. Moderate (5½%) real GNP growth over next several years
   - D. Economic slack not eliminated before 1980, even with Carter stimulus and above-trend (3-4%) GNP growth over this period

II. Components of Inflation - Near term outlook
   - A. Compensation (wages & fringes) increases declined from 9% in 1st Qtr '76 to 7% in 4th Qtr (& vs 15% rates 2 yrs ago)
     1. Reflects high unemployment and unwinding of inflationary expectations
     2. Expect further decline to 6½% rate of increase by yearend '78
   - B. Productivity (output/man hour) - offset to higher compensation
     1. Improving at 5% annual rate (vs 2½% trendline) so far in recovery
     2. Should continue to show strong (4½%) gains through end of decade because of continuing
        - a. slack
        - b. volume gains (spreading of overhead)
        - c. cautiousness towards adding to overhead
   - C. A & B above seen as guts of inflation
     1. 6½-7% rises in compensation
     2. 4½% productivity gains
     3. Nets to 2-2½% rises in unit labor costs; this is your structural inflation and key to profits
     4. A 3½% rise in prices more than offsets higher unit labor costs and expands margins
   - D. Material prices (commodities)
     1. Hoarding inventories and shortages sent these prices up dramatically in early '70's
     2. Excess capacity (both here and abroad) and long memories of last inventory bubble should prevent repetition
     3. Look for recent 4% annual rate of increase to continue
     4. Assuming 10% increase in energy costs
   - E. Food
     1. Weather key factor - has reduced '77 crop expectations
     2. But for bad weather, surpluses would have piled up (esp. wheat, corn, oranges)
     3. Look for 3% annual increase in '77
        - a. assumes 50% increase in Florida fruits and vegetables in 1st Qtr
        - b. no adjustment for California drought
   - F. Service
     1. At consumer level - lags other inflationary moves
     2. Slower to unwind, but continuing to do so from current 5% rate
   - G. Aggregate Rates (CPI)
     1. 7½-8% in 1st Qtr '77
     2. 5½% in 2nd Qtr
     3. 3½% in 2nd half
     4. 3% by yearend '78

III. Financial Markets
   - A. Continue to see surplus of funds through end of decade but for 2nd Qtr '77 (tax rebates bulge)
   - B. Federal spending shortfall - if it continues - will reduce deficit

H/65

C. Assuming present stimulus pkg is it, not first in series

D. Concerns over next few months
   1. Weather and possible inflationary impact
   2. Rebates - how financed
   3. 1976 tax clean-up -no effect on financial markets
   4. Fed Policy - will Fed again nullify rebates as in 1975? (not likely)

E. If inflation drops to 3% and surplus of funds endures, interest rates should fall
   1. 6% on quality long term bonds eventually (vs 8.25% today)
   2. Lower short term rates as well (at minimum, no big increases)

IV. Caution the key - long memories of both inflation and recession
   A. Lack of general acceptance of our forecast is reflective of this caution
   B. Gyrations of sentiment over last 2 years - self-correcting micro-cycles (instantaneous reaction to developments)
   C. Severe winter likely to reinforce caution; this lingering deflationary impact should more than offset the initial inflationary effects
      1. Businessmen in no rush to replenish Xmas-depleted inventories
      2. Consumers' high fuel bills

V. Carter Administration
   A. Policy evolving - not just another free-spending Democratic Administration
      1. Carter's background as small businessman a factor
      2. Focus shifting from unemployment to inflation
   B. Appointees mostly professional managerial types
      1. Emphasis on efficiency in delivery of government services
      2. High degree of awareness of limitations of what government can do (contrast JFK's academics)
   C. Newcomers distrusted by both Capitol Hill and bureaucracy
   D. Independence of Congress not likely to diminish
      1. Stimulus package may be augmented
      2. Passage delayed by multiplicity of committee hearings
      3. Congressional budget process should keep stimulus within reasonable limits
   E. Administration still committed to balance '81 budget
   F. New awareness that public reacts to stimulative actions; may in fact nullify them
   G. Stimulus package may get us to full employment by 1980 (vs '81 or '82 without it)
      1. Rebates likely to be spent gradually, not all in 2nd Qtr
      2. Additional output reduces inflationary pressure by spreading overhead
      3. Doubt it will refuel inflationary expectations

VI. Other concern - financial stability of lesser developed countries
   A. Massive trade deficits problem remains
   B. Commercial banks' burden being shifted to other institutions
   C. Our forecast assumes this problem not aggravated sufficiently to spark financial panic

VII. Miscellaneous points from questions and answers
   A. Carter's energy program to focus more on supply; little can be done politically or effectively on conservation point; coal should benefit
   B. No big capital spending boom in offing for several years (similar to recovery of 1960's); such spending continues to fall short of surveys; current expenditures focused on modernization, labour saving, and pollution control
   C. Remain bullish on housing with expectations of 3.5 million units annual rate by end of decade; equivalent dollars historically spent on durable contents of houses

William F. Boyd
Sales/Research Liaison

SRL-77-15

White, Weld & Co.
Incorporated

March 10, 1977

Below are our updated economic figures which show single estimates for 1977 and 1978 rather than case A and B.

U.S. ECONOMIC FORECAST

(Billions of Current Dollars)

	1976 Actual	1977	1978	Percent Change 1976 Actual	Percent Change 1977	Percent Change 1978
GNP Data						
Consumption Spending	1,079.7	1,193.7	1,301.8	10.9%	10.6%	9.0%
Durables	156.5	171.4	183.9	18.8	9.5	7.3
Nondurables	440.4	482.3	519.5	7.7	9.5	7.7
Services	482.8	539.9	595.6	11.7	11.8	10.3
Plant and Equipment	160.0	176.0	195.1	8.8	10.0	10.9
Housing	67.7	82.0	95.0	32.2	21.1	15.9
Inventory Change	11.9	14.5	22.5	–	–	–
Net Exports	6.4	4.5	4.5	–	–	–
Federal Government	133.4	144.3	151.7	7.2	8.2	5.1
State and Local Government	232.2	249.8	274.3	8.3	7.6	9.8
GNP (Current Dollars)	1,691.4	1,864.5	2,044.4	11.5	10.2	9.6
GNP (1972 Dollars)	1,264.6	1,323.4	1,397.4	6.1	4.7	5.6
Price Indices (1967 = 100) (Year Average)						
GNP Deflator	133.8	140.9	146.3	5.1	5.3	3.8
Consumer Price Index	170.5	179.9	186.3	5.7	5.5	3.6
Wholesale Price Index	183.0	191.8	197.7	4.6	4.8	3.1
Corporate Profits						
Pretax Operating Profits	118.6	141.8	167.6	29.5	19.5	18.2
Capital Consumption Adjustment	15.5	17.8	20.8	–	–	–
Inventory Valuation Adjustment	14.6	10.7	6.0	–	–	–
Total Pretax Profits	148.7	170.3	194.4	29.8	14.5	14.1
After Tax Profits	84.2	97.3	112.0	29.0	15.5	15.1
Other Statistics						
Housing Starts	1.56	1.80	2.20	33.3	15.4	22.2
Industrial Production	129.8	138.4	149.5	10.2	6.6	8.0
Unemployment Rate	7.7	7.2	6.6	–	–	–
Federal Government Deficit (Calendar Year)	-58.7	-65.0	-55.0	–	–	–

Quarterly Data (Annualized Rates of Change)

	1977 I	1977 II	1977 III	1977 IV	1978 I	1978 II	1978 III	1978 IV
Real GNP	3.4	7.0	7.4	5.8	5.2	5.2	4.3	5.6
Inventories	9.0	14.0	19.0	15.0	18.0	22.0	24.0	26.0
Industrial Production	4.0	14.2	8.4	7.6	7.1	8.2	6.6	7.9
After-Tax Profits	4.4	24.5	17.1	19.2	8.9	13.6	16.5	18.4
Real Disposable Income	2.7	20.2	0.9	3.4	3.5	3.7	3.8	2.3
Consumer Price Index	7.6	5.3	4.3	3.4	3.6	3.1	3.5	3.1
Productivity	1.8	5.4	4.6	4.5	3.1	4.1	4.4	4.0

RW-77-72

A. Gary Shilling

White, Weld & Co.
Incorporated

Economic Comment

A. Gary Shilling

March 10, 1977

ECONOMIC FORECASTS

Below are our updated economic figures which show single estimates for 1977 and 1978 rather than case A and B.

U.S. ECONOMIC FORECAST

(Billions of Current Dollars)

	1976 Actual	1977	1978	Percent Change 1976 Actual	Percent Change 1977	Percent Change 1978
GNP Data						
Consumption Spending	1,079.7	1,193.7	1,301.8	10.9%	10.6%	9.0%
Durables	156.5	171.4	183.9	18.8	9.5	7.3
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Housing	67.7	82.0	95.0	32.2	21.1	15.9
Inventory Change	11.9	14.5	22.5	–	–	–
Net Exports	6.4	4.5	4.5	–	–	–
Federal Government	133.4	144.3	151.7	7.2	8.2	5.1
State and Local Government	232.2	249.8	274.3	8.3	7.6	9.8
GNP (Current Dollars)	1,691.4	1,864.5	2,044.4	11.5	10.2	9.6
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Price Indices (1967 = 100) (Year Average)						
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Corporate Profits						
Pretax Operating Profits	118.6	141.8	167.6	29.5	19.5	18.2
Capital Consumption Adjustment	15.5	17.8	20.8	–	–	–
Inventory Valuation Adjustment	14.6	10.7	6.0	–	–	–
Total Pretax Profits	148.7	170.3	194.4	29.8	14.5	14.1
After Tax Profits	84.2	97.3	112.0	29.0	15.5	15.1
Other Statistics						
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Industrial Production	129.8	138.4	149.5	10.2	6.6	8.0
Unemployment Rate	7.7	7.2	6.6	–	–	–
Federal Government Deficit (Calendar Year)	-58.7	-65.0	-55.0	–	–	–

Quarterly Data (Annualized Rates of Change)

	1977 I	1977 II	1977 III	1977 IV	1978 I	1978 II	1978 III	1978 IV
Real GNP	3.4	7.0	7.4	5.8	5.2	5.2	4.3	5.6
Inventories	9.0	14.0	19.0	15.0	18.0	22.0	24.0	26.0
Industrial Production	4.0	14.2	8.4	7.6	7.1	8.2	6.6	7.9
After-Tax Profits	4.4	24.5	17.1	19.2	8.9	13.6	16.5	18.4
Real Disposable Income	2.7	20.2	0.9	3.4	3.5	3.7	3.8	2.3
Consumer Price Index	7.6	5.3	4.3	3.4	3.6	3.1	3.5	3.1
Productivity	1.8	5.4	4.6	4.5	3.1	4.1	4.4	4.0

EC-77-3

Sp /55/56/65

White, Weld & Co. Incorporated

Commodity Price Monitor

Jeanne M. Gallagher

March 23, 1977

INDICES (1967 = 100)	1975 Dec.	1976 Feb.	1976 March	1976 June	1976 Sept.	1976 Dec.	1977 Jan.	1977 Feb.
Consumer Price Index	166.3	167.1	167.5	170.1	172.6	174.3	175.3	177.1
Wholesale Price Index	178.7	179.4	179.8	183.1	184.7	187.1	188.0	190.0
Dow Jones Spot*	296.33	313.50	306.64	368.34	340.91	369.70	393.12	416.84
Journal of Commerce Spot Index**	165.0	174.5	176.2	190.1	175.5	172.9	177.3	177.2
Dow Jones Futures	287.88	306.85	299.54	354 25	342.86	366.71	385.36	405.42
Dept. of Labor 22 Commodities	190.8	195.9	197.1	210.9	199.8	201.9	211.6	212.5
The Economist Commodity Index†	212.4	220.3	223.5	263.1	251.1	284.2	295.4	321.6

†(Dollar Based)
*Based on average prices prevailing in 1924-26. **1947-49 base.

Though Spring is here, the effects of earlier cold weather linger on in the form of higher prices for consumer and wholesale items. The WPI gained 0.9% in February (10.8% annualized) with farm product prices jumping 2.2% and industrial goods up 0.6%. The CPI rose at a 24% annual rate, and food prices contributed to most of this gain as well. Since we really can blame a lot of this on the weather, the Administration feels confident that this is not the beginning of a trend but will inevitably pass. Whatever the cause, the effect on the consumer dollar is the same. Most of the other indexes were also higher in February, with the largest percentage gain in *The Economist* indicator.

ENERGY

Not surprisingly, oil prices continued to edge upward though Rotterdam heavy fuel dropped 3¢ to more normal levels after registering a big gain the prior month. Coal and gas prices were unchanged. During the early weeks of March, however, the upper end of both the high and low quality steam spot price range reached $21 per ton (a parity we don't expect to hold for long). The 17% decline in coal production during the first nine weeks of 1977 combined with strong weather-induced demand is pulling coal prices out of their one year slump.

GRAINS AND FOOD

Though February average prices were higher, many spot prices began to decline later in the month. Most grains were down a few cents. The Carter Administration faces a tough challenge in trying to resolve the problems of U.S. wheat producers. Countries like Argentina, which is trying to regain its status as a major wheat producer, are undercutting U.S. prices in the world market. The Administration has discussed with Canada the possibility of setting floor prices for U.S. and Canadian wheat. However, with stocks at a five year high prices are likely to remain depressed despite cutbacks in plantings and switching to more profitable soybeans.

February was a good month for meat eaters. With transportation routes open again after the thaw, more beef and pork are coming to market. Estimates are that hog slaughterings will be 15-20% higher through June. Some herd liquidation is also fattening beef supplies now, at the expense of lower prices later. Large supplies pushed egg prices down 19¢ per dozen.

METALS

The continuing gains in soybeans, coffee and cocoa appear to be fueling speculative fever in other commodities, even where fundamentals may not justify the gains. The higher prices go, the more speculators buy and few, at least yet, seem willing to back off. Copper, for example, is in ample supply and, though there has been some strike-anticipated stockpiling, it would take a very long strike this summer to make a dent in inventories. If there were no strike or even one lasting a month, the price would very likely collapse.

Gold and silver prices are moving into higher ground as concern over inflation deepens. President Carter has said he wants a moratorium on sales of silver from the U.S. stockpile.

OTHER

Cotton prices were a little stronger last month on increased purchases from the Far East and nervousness over the dry growing areas in the West. Cotton growers in the Delta may also be contemplating a switch to soybeans. Nylon and polyester yarn prices, though unchanged in February, were raised early in March. These new prices, needed to cover basic production costs, say the manufacturers, are about the same as they were a year ago. Drought, power shortages and optimism over housing starts helped boost lumber and plywood last month.

CPM-77-03 —Research Department—

	PERIOD ENDING							
	1975	1976					1977	
	Dec.	Feb.	Mar.	June	Sept.	Dec.	Jan.	Feb.
Energy								
Fuel Oil (gallon N.Y. Harbor, 0.3%)	$ 0.31	$ 0.32	$ 0.32	$ 0.30	$ 0.32	$ 0.34	$ 0.37	$ 0.38+
Gasoline, U.S. Regular (gallon ex tax)	0.47	0.46	0.45	0.48	0.49	0.48	0.48	0.50+
Rotterdam 3.0% Heavy Fuel (gallon)	0.21	0.24	0.24	0.23	0.25	0.27	0.30	0.27-
Arabian Light Crude (barrel)	11.51	11.51	11.51	11.51	11.51	11.51	12.09	12.09
U.S. Natural Gas (MCF)								
– Weighted Avg. Total	0.36	0.40	0.40	0.44	NR	NR	NR	NR
– Interstate Regulated								
Post 1974	0.52	0.52	0.52	0.52	1.42	1.43	1.44	1.44
Pre Jan. 1973	–	0.235	0.235	0.235	0.295	0.295	0.295	0.295
Coal–Metallurgical (ton)								
– Long-term Contract	49.00	49.00	19.00	48.00	48.00	49.00	49.00	49.00
– High Quality Spot	51.00	51.00	51.00	51.00	51.00	51.00	51.00	51.00
– Low Quality Spot	35.00	35.00	35.00	35.00	35.00	36.00	36.00	36.00
–Steam (ton)								
– Long-term Contract	25.00	25.00	25.00	25.00	25.00	26.00	26.00	26.00
– High Quality Spot	15.00	15.00	15.00	16.00	16.00	16.00	18.00	18.00
– Low Quality Spot	13.00	13.00	13.00	15.00	15.00	15.00	15.00	15.00
Uranium U308 (pound)	21.00*	32.50*	32.50*	40.00	40.40	41.00	41.00	41.35+
Grains and Oils								
Alfalfa Pellets (ton)	$ 92.00	$ 98.00	$100.00	$ 86.00	$105.00	$100.00	$100.00	$ 97.00-
Barley (bushel)	3.45	3.35	3.35	3.75	3.50	3.40	3.25	3.05-
Coconut Oil (pound)	0.16	0.16	0.17	0.20	0.23	0.26	0.26	0.29+
Corn (bushel)	2.56	2.74	2.68	2.87	2.59	2.51	2.59	2.55-
Corn Oil (pound)	0.29	0.27	0.24	0.24	0.27	0.26	0.32	0.31-
Cottonseed Meal (ton)	134.00	118.00	120.00	175.00	187.00	188.00	189.00	183.00-
Cottonseed Oil (pound)	0.23	0.27	0.26	0.23	0.23	0.23	0.24	0.24
Flour (cwt)	8.60	10.10	9.10	9.00	7.20	6.85	7.05	7.00-
Oats (bushel)	1.67	1.68	1.60	2.02	1.63	1.68	1.85	1.84-
Rice (cwt)	21.00	21.00	21.00	21.00	21.00	21.00	21.00	21.00
Rye (bushel)	2.80	2.95	2.85	3.35	2.75	2.75	2.95	2.90-
Soybean Meal (ton)	121.00	131.50	126.00	190.50	162.00	203.00	209.50	218.00+
Soybean Oil (pound)	0.16	0.17	0.16	0.19	0.21	0.20	0.22	0.23+
Soybeans (bushel)	4.46	4.71	4.58	6.57	6.12	6.94	7.08	7.49+
Wheat – Soft Red (bushel)	3.25	3.95	3.33	3.38	2.64	2.70	2.70	2.66-
Food								
Beef (pound)	$ 0.73	$ 0.58	$ 0.59	$ 0.61	$ 0.54	$ 0.61	$ 0.60	$ 0.56-
Broilers (pound)	0.45	0.41	0.44	0.46	0.38	0.36	0.39	0.42+
Butter (pound)	1.00	0.85	0.90	1.01	0.93	0.90	0.90	0.90
Cocoa (pound – Accra)	0.78	0.74	0.78	1.09	1.37	1.54	1.92	2.10+
Coffee (pound – Brazilian)	0.92†	1.10	1.12	1.50	1.52	2.25	2.25	2.85+
Eggs (dozen)	0.73	0.59	0.61	0.63	0.73	0.77	0.87	0.68-
Hogs (cwt)	46.50	47.65	46.10	49.25	34.80	37.75	40.50	38.80-
Pork Bellies (pound)	0.67	0.67	0.66	0.76	0.56	0.51	0.55	0.46-
Steers (cwt)	44.45	37.90	37.30	39.25	36.10	39.80	38.05	36.50-
Sugar Cane – Raw (pound)	0.16	0.15	0.16	0.15	0.10	0.11	0.11	0.11
Sugar Cane – Refined (pound)	0.21	0.21	0.21	0.21	0.17	0.16	0.17	0.17

Note: Prices – All quotations are cash prices on or about the last day of the quarter or month; an asterisk (*) indicates the quote is the midpoint in the range of the last day.

†Colombians.

NR – Not yet reported by F.P.C. Earlier figures not representative because of rapid escalation of current field prices.
Sign in last column indicates direction of change from previous month.

	PERIOD ENDING							
	1975	1976					1977	
	Dec.	Feb.	Mar.	June	Sept.	Dec.	Jan.	Feb.
Metals								
Aluminum Ingot (pound)	$ 0.41	$ 0.41	$ 0.41	$ 0.44	$ 0.48	$ 0.48	$ 0.48	$ 0.48
Copper (pound) — N.Y. Merchant	0.57	0.61	0.65	0.75	0.63	0.64	0.66	0.70+
Copper (pound) — LME	0.53	0.58	0.62	0.74	0.63	0.61	0.64	0.66+
Copper (pound) — U.S. Producer	0.63	0.63	0.66	0.71	0.75	0.66	0.67	0.69+
Lead (pound)	0.19	0.19	0.21	0.23	0.25	0.26	0.28	0.29+
Molybdenum (pound)	2.62	2.62	2.62	2.90	3.20	3.20	3.45	3.45
Nickel (pound) — N.Y. Merchant	2.20	2.09	2.09	2.13*	2.17*	2.17*	2.17*	2.17*
Nickel (pound) — U.S. Producer	2.20	2.20	2.20	2.20	2.20	2.41	2.41	2.41
Pig Iron (ton)	180.00	180.00	180.00	178.00	180.00	180.00	180.00	180.00
Steel (cwt)								
Bars	10.75	10.75	10.75	11.50	11.50*	12.25	12.25	12.25
Sheets	11.55*	11.55*	11.55*	12.45*	12.45	13.25	13.25	13.25
Plate	12.98*	12.98*	12.98*	12.85	14.10	14.10	14.10	14.10
Scrap (ton)	64.33	79.90	86.70	84.70	70.23	69.04	73.00	73.46+
Zinc (pound) — U.S. Producer	0.39	0.37	0.37	0.37	0.40	0.37	0.37	0.37
Zinc (pound) — European Producer	0.36	0.36	0.36	0.36	0.36	0.36	0.36	0.36
Zinc (pound) — LME	0.32	0.31	0.34	0.35	0.31	0.30	0.32	0.33+
Precious Metals								
Gold (London — Troy ounce)	$140.25	$132.30	$129.60	$123.80	$116.00	$134.75	$132.30	$142.75+
Silver (U.S. Equiv. — Troy ounce)	4.18	4.16	4.11	4.83	4.39	4.37	4.45	4.73+
Chemicals								
Acetone (tank)	$ 0.15	$ 0.15	$ 0.15	$ 0.15	$ 0.15	$ 0.15	$ 0.15	$ 0.15
Acrylic (pound)	0.55*	0.55*	0.55*	0.55*	0.57	0.57	0.57	0.57
Alcohol, Ethyl (gallon)	0.93*	1.15	1.15	1.15	1.15	1.15	1.15	1.15
Ammonia (ton)	172.50*	165.00	172.50*	172.50*	172.50*	172.50*	172.50*	172.50*
Benzene (gallon)	0.80*	0.80	0.80	0.85*	0.85	0.83	0.83	0.83
Caustic Soda (cwt)	12.00*	12.00*	12.00*	12.00*	12.00*	12.00*	12.00*	12.00*
Chlorine (cwt)	6.88*	6.88*	6.88*	6.88*	6.88*	6.88*	6.88*	6.88*
Ethylene (pound)	0.12*	0.12*	0.12*	0.12*	0.12*	0.12*	0.12*	0.12*
Methanol (pound)	0.05	0.05	0.05	0.05	0.05*	0.05	0.05	0.05
Polyethylene (pound)	0.30*	0.30*	0.31*	0.31*	0.32*	0.32*	0.32*	0.32*
Polystyrene (pound)	0.27	0.29	0.29	0.29	0.26	0.26	0.26	0.26
Polyvinyl Chloride (Pound)	0.23*	0.23	0.24	0.24	0.26*	0.26*	0.26*	0.26*
Soda Ash (cwt)	4.20	4.05	4.20*	4.20*	4.20*	4.20*	4.20*	4.20*
Sulfuric Acid (ton)	47.23*	47.23*	47.23*	47.23*	47.23*	47.23*	47.23*	47.23*
Fabrics and Fibers								
Burlap (yard)	$ 0.17	$ 0.18	$ 0.18	$ 0.17	$ 0.17	$ 0.18	$ 0.18	$ 0.18
Cotton (pound)	0.57	0.59	0.54	0.85	0.77	0.70	0.71	0.74+
Nylon (pound) — 40 Denier Yarn	1.45	1.45	1.45	1.45	1.30	1.25	1.40	1.40
Polyester (pound)								
— Staple	0.55	0.55	0.55	0.55	0.55	0.55	0.60	0.60
— 150 Denier Feeder Yarn	0.87	0.87	0.80	0.60	0.50	0.50	0.50	0.50
— Textured 150 Denier Yarn (dyeable)	1.15	1.05	0.95	0.80	0.70	0.75	0.75	0.75
Wool (pound)	1.80	1.78	1.78	1.83	1.85	1.90	1.90	1.90
Other Commodities								
Fertilizers								
Anhydrous Ammonia (ton)	$200.00	$150.00	$140.00*	$150.00	$125.00	$130.00	$130.00	$140.00+
Phosphoric Acid (unit ton)	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50
Potash Muriate (unit ton)	0.68*	0.68*	0.68*	0.68*	0.68*	0.68*	0.68*	0.68*
Hides (pound)	0.28	0.36	0.39	0.38	0.37	0.43	0.44	0.44
Lumber (2x4) (M. bd. ft.)	140.00	156.00	144.00	137.00	161.00	188.00	188.00	190.00+
Newsprint (ton)	360.00	360.00	360.00	360.00	360.00	360.00	360.00	360.00
Paper (cwt)	30.35	31.40	31.40	31.40	31.40	31.40	31.40	31.40
Plywood (M. sq. ft.)	136.45	147.50	145.65	147.45	166.57	175.29	172.50	184.50+
Rubber (pound)	0.33	0.37	0.38	0.42	0.41	0.40	0.40	0.41+
Tallow (pound)	0.15	0.16	0.15	0.15	0.16	0.17	0.18	0.18

Source: *Journal of Commerce*, *Wall Street Journal*, various industry sources.

White, Weld & Co. Incorporated

Industry Survey

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April 11, 1977

THE FINANCIAL SURVEY

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WHAT IS THE QUESTION?

Today, in discussing companies I follow, I often think of Gertrude Stein's alleged response to *What is the answer?* namely, *What is the question?* This is especially true regarding commercial banks where many questioners seem to convey a vague sense of uneasiness which almost by definition precludes a positive response. By any measure, the economies and banks of the world have emerged from a period of unprecedented strains and numerous surprises. Although serious concerns abound, much improvement has occurred in the past two years. Some of the current skepticism is undoubtedly justified given the recent shocks, but we suspect that some of the new-found skeptics are the same extreme optimists of yesterday who, once again, may be over reacting.

We have come a long way from the early 1970's when banks were described *as money making machines*, loan loss reserves were considered as *unnecessary* and loan loss provisions almost *irrelevant*. We also suspect that some bankers got carried away with their rave notices (and high P/E's) and overestimated their own positive achievements while underestimating the boost they got from favorable economic developments (low inflation, a gradually rising prime rate and increasing balance sheet leverage).

We remain positive on the prospects of most of the groups we follow as indicated on our recommended list on page 4. Our approach to the four financial groups we follow is summarized below:

BANKS 1. **Cycle in Upswing**–We still want to have a full weighting in this group as the earnings cycle turns upward and progress continues on problems from the 1973-1975 recession.

a. **Loan volume rebounding** see page 11.

b. **Spreads**–Should continue to be under pressure but price discipline should be reinforced by capital considerations. Severe rate cutting is likely to be avoided.

c. **Problem loans**–Continued economic progress should result in lower loan loss provisions and a declining drag on 1977 and 1978 earnings. The biggest problem area, real estate, is expected to improve (see page 14).

2. **Overseas worries–especially the LDC's**–We believe banks are in the third year of a six year problem. Some progress has occurred, but new problems are likely to arise in 1977. IMF help likely in 1977. Don't expect huge losses from this area, but concern with this issue affects P/E multiples. *Predictable catastrophes seldom happen.* We don't look for one here.

3. **Interest on Consumer Demand Deposits**–The *if, when,* and *how* of this issue are still unsettled, although it has an aura of inevitability. Although a possible near-term negative when implemented, most likely it would negatively impact certain bank earnings by only 5-10%. Longer term, it could be a positive... it serves to improve pricing.

4. **Stock Prices**–Discounting all the worries. Earnings are likely to show a good improvement in 1977 (major banks up 15%+). Stocks are technically attractive according to John Mendelson. Downside risk is probably limited to dull near-term performance.

S&L's Continued strong near-term fundamentals point to earnings increases of 30%+ in 1977 and a good gain is likely in 1978. A significant move towards a meaningful dividend is under way. This should attract new shareholders and reduce stock volatility. The issue of speculative buying of homes in California is a cloud. Believe this is limited. (See page 8).

REIT's Slow portfolio improvement (see page 14) should lead to dividend increases in 1977. Selected REIT's offer 9-10% yield and 30-50% appreciation prospects over the next two years. Certain other REIT's offer lower current yields and more upside over this period.

PMI's Still like MGIC and AMIC. Fundamentals remain strong. A play on strong single family market, mortgage availability and recovery of real estate markets. Risk is that high inflation produces a weak mortgage market.

STOCK PERFORMANCE SINCE LAST SURVEY . . . FIRST QUARTER OF 1977

The 43 companies we follow in the Monthly Research Review declined less than the averages in the first quarter . . . they showed a 7.6% decline versus an 8.4% decline for the S&P 500 and an 8.5% decline for the DJIA.

Banks—The 22 banks stocks generally moved in line with the market declining 8.1% in the quarter. Interestingly New York City bank stocks, helped by some high yields, did better than banks outside New York. Worst performers were **Bank America (-17.8%), Wachovia (-16.7%), Citicorp (-14.1%), First Chicago (-13.7%)** and **First International (-13.5%).** Best performers were **Wells Fargo (-0.5%), NCNB Corp. (-2.1%), Chase Manhattan (-2.4%), Republic of Texas (-2.6%)** and **Manufacturers Hanover (-3.2%).**

S&L's—The best performing group was the five S&L's which were up 1.3% in the quarter. Helped by a meaningful yield, **United Financial** appreciated 7.3% and Gibraltar was up 6.1%. A significant dividend trend got started in the first quarter as **First Charter** declared a cash dividend producing a 4% yield on the then price. Although First Charter was off 2.9% in the first quarter it had been off 16.9% at the end of February before the dividend was declared and appreciated 16.8% during the month of March.

REIT's—Helped by high yields, our eleven REIT's performed well in the first quarter. . . off only 3.7%, which was nearly offset by dividend income. The best performer was **RAMPAC** (+13.3%) and the worst performer **MONY Mortgage** (-9.8%).

PMI's, Miscellaneous—These five companies were the worst performers . . . off 19.8% in the quarter following big gains in the second half of 1976. This was due to a lack of meaningful yields together with revived inflationary concerns, which have an adverse impact on PMI companies—**MGIC** (-30.0%), **AMIC** (-25.2%) and **United Guaranty** (-18.3%). **Rouse** is an interesting sleeper, with an adjusted book value of over $11 a share.

SELECTED LIST

Our recommended list remains pretty much the same. We have added an REIT, **MassMutual Mortgage**, on a price basis and **NCNB** as a recovery candidate in the regional bank area. **Wells Fargo** is restricted because it is in registration.

Table 1

RECOMMENDED STOCK LIST

	Recent Price	EPS 1975	EPS 1976	EPS 1977E	Current Yield
S&L'S					
First Charter	$16	$1.70	$2.42	$3.10	3.6%
Gibralter Financial	11	1.18	1.95	2.70	3.6
Great Western Financial	23	1.53	3.30	4.35	2.2
Imperial Corp.	17	2.06	2.98	3.60	1.4
United Financial	13	1.40	2.30	3.20	3.1
PMI's					
AMIC	$14	$1.07	$2.50	$3.10	0.4%
MGIC	15	0.10	1.15	1.80	1.3
REIT's					
Conn. General–May	$18	$1.40	$1.25	$1.60	9.0%*
Equitable–Oct.	24	1.85	2.07	2.40	9.4 *
Lomas & Nettleton–June	15	1.16	0.90	1.40	5.4 *
MassMutual–Oct.	15	1.17	1.09	1.30	8.8 *
Northwestern Mutual–May	13	0.79	0.90	1.30	7.8 *
PNB Realty–Sept.	8	0.30	0.46	0.75	4.8 *
Regional Banks					
NCNB	$11	$1.10	$1.20	$1.40	4.8%
Seafirst	34	3.61	4.05	4.50	3.8
Wachovia	21	1.96	2.00	2.10	3.1
Money Center Banks					
BankAmerica	$25	$2.19	$2.40	$2.75	3.2%
Citicorp	28	2.73	3.08	3.50	3.8
Manufacturers Hanover	38	4.59	4.82	5.30	5.1

* Based on last quarterly dividend times four. Actual yield is likely to be significantly higher as earnings increase.

MACRO VIEW–SAVINGS INFLOWS AT THRIFTS, CONTINUED STRENGTH (Table 2)

Propelled by consumer caution and relatively low interest rates, thrift institutions continued to show strong savings inflows in January and February of 1977. Preliminary indications for March suggest another strong month. Although new dollar inflows in January and February were down 8% from a year ago at S&L's and 23% at the mutual savings banks, dollar inflows were still at relatively high levels. In fact, January 1977 inflows at S&L's were the second highest volume on record.

1976 Wrap-Up

Total savings inflows in the S&L's were up 17.7% in 1976 and amounted to $49.7 billion ($34.4 billion before credited interest). We had been expecting a strong year in 1976 but results were about 12% ahead of our estimates at the beginning of the year due chiefly to lower than expected interest rates.

1977 and 1978

In 1977, we anticipate a lower rate of savings increase than in 1976 . . . a 15.2% increase in savings versus the 17.7% increase in 1976. For 1978, we are tentatively projecting a more moderate rate of increase of 12.7%. Interestingly, if our expectations prove correct, the dollar savings increases in 1977 and 1978 should match the all time record set in 1976. Furthermore, given the likelihood of steady loan repayments during this period, total funds available for mortgage lending should remain at high levels. Hence, sufficient mortgage funds are likely to be available to sustain the real estate recovery begun in 1975 and likely to continue through 1978. Underlying our positive projections is a 5-6% inflation assumption which we feel should not cause long-term interest rates to increase significantly though short rates should rise somewhat as the economy regains momentum.

CALIFORNIA S&L'S, STRONGER THAN THE REST OF THE U.S. (Table 3)

Both savings trends and mortgage activity have been stronger at the California S&L's than in the rest of the United States. Savings increased 19.8% in 1975 and 21.2% in 1976. Net savings inflows in January 1977 were up 18% from a year ago while loans closed were up 75% and set a new high for January. In February savings were off 7% from a year ago, while loans closed were up 61%.

Strong Savings Inflows Fund Record Loan Volume

Despite the explosive mortgage volume in California in the past two years (loans closed increased 170% from 1974 to 1976), California S&L liquidity ratios have actually improved during this period. In 1975 and 1976, the $28.8 billion in loans closed by California S&L's was exceeded by $29.5 billion in savings inflows and mortgage repayments (the two principal sources of lendable funds).

Table 2

SAVINGS FLOWS AT S&L's AND SAVINGS BANKS

($ in Millions)

Date	New Savings S&L's	New Savings Mutuals	Savings Flow After Interest Credited S&L's	Savings Flow After Interest Credited Mutuals	Savings Flow After Interest Credited Total	S&L Savings Inflow: Versus A Year Ago	S&L Savings Inflow: Rate of Increase from Yr. End (monthly annualized)	Average Rates (90 day) Treasury Bills
1969	$-1,001	$ -729	$ 3,884	$ 2,511	$ 6,395	–	–	6.67%
1970	5,294	941	10,843	4,516	15,358	+179%	+ 8.0%	6.39
1971	20,653	5,693	27,332	9,648	36,980	+152	19.3	4.33
1972	23,884	5,451	31,956	10,067	42,023	+ 17	18.9	4.07
1973	10,507	-442	19,943	4,815	24,758	- 38	9.9	7.03
1974	4,668	-2,823	15,595	2,907	18,502	- 22	7.2	7.84
1975	29,298	4,757	42,052	11,070	53,122	+170	17.8	5.80
1976	34,375	5,265	49,727	12,262	61,989	+ 18	17.7	4.98
1977E	33,000	5,500	50,000	13,000	63,000	+ 1	15.2	5.80
1978E	30,000	4,500	48,000	12,500	60,500	- 4	12.7	–
1975								
January	$ 3,094	$ 250	$ 3,201	$ 471	$ 3,672	+ 51%	+16.2%	6.26%
February	3,114	708	3,213	909	4,122	81	16.3	5.50
March	3,690	1,029	6,331	2,052	8,383	56	32.1	5.49
April	2,673	395	2,787	626	3,413	+*	14.1	5.61
May	3,690	930	3,798	1,143	4,941	632	19.3	5.23
June	3,089	746	6,073	1,871	7,936	132	30.8	5.34
July	2,865	264	2,980	508	3,489	+*	15.1	6.13
August	1,326	-21	1,436	197	1,633	+*	7.3	6.44
September	631	-338	3,607	785	4,392	161	18.3	6.42
October	2,086	131	2,208	348	2,556	417	11.2	5.96
November	2,072	549	2,191	765	2,956	84	11.1	5.48
December	968	114	4,226	1,394	5,620	28	21.4	5.44
1976								
January	$ 5,108	$ 810	$ 5,245	$ 1,037	$ 6,282	+ 64%	+22.6%	4.87%
February	3,719	787	3,850	1,118	4,968	+ 20	16.6	4.88
March	3,687	864	6,903	2,029	8,932	+ 9	29.7	5.00
April	2,583	352	2,731	586	3,317	- 2	11.8	4.86
May	2,835	561	2,977	801	3,778	- 22	12.8	5.20
June	1,353	(55)	4,924	1,200	6,124	- 19	21.2	5.41
July	3,289	350	3,442	625	4,067	+ 16	14.8	5.23
August	1,967	75	2,113	315	2,428	+ 47	9.1	5.14
September	1,944	110	5,466	1,360	6,826	+ 52	23.5	5.08
October	3,224	575	3,386	800	4,186	+ 53	14.6	4.93
November	2,381	625	2,520	775	3,295	+ 11	10.9	4.74
December	2,285	350	6,159	1,250	7,909	+ 46	26.5	4.36
1977								
January	$ 4,944	$ 625	$ 5,121	$ 860	$ 5,981	- 5%	+18.3%	4.58%
February	3,173	600	3,329	850	4,179	- 16	12.2	4.67

*Change from a minus to a plus

Table 3

CALIFORNIA S&L's — SELECTED FLOWS OF FUNDS

	Sources				Uses			
	Net New Savings	Net Savings Inflow (After Credited Interest)	Loan Repayment	Net Savings Inflow & Repayments	Loans Closed	Net Loan Purchases (Sales)	Loans Closed + Purchases & - Sales	Net Savings & Repayments ÷ Net Loans Closed
1968	$ (122)	$ 814	$2,395	$ 3,209	$ 3,914	$ 78	$ 3,992	0.80%
1969	(1,395)	(396)	2,308	1,912	3,845	89	3,934	0.49
1970	115	150	2,244	2,394	3,517	196	3,713	0.64
1971	3,776	5,014	3,678	8,692	6,576	757	7,333	1.19
1972	4,114	5,600	4,478	10,078	8,809	959	9,768	1.03
1973	475	2,175	4,180	6,355	7,732	346	8,078	0.79
1974	(349)	1,523	3,762	5,285	6,413	(6)	6,407	0.82
1975	5,565	7,787	4,785	12,572	10,689	(563)	10,126	1.24
1976	7,218	9 956	6,928	16,884	18,074	(1,731)	16,343	1.03
1975								
January	$ 528	$ 528	$ 251	$ 779	$ 341	$ (52)	$ 289	2.70%
February	614	616	237	853	421	(38)	383	2.23
March	783	1,283	336	1,619	564	17	601	2.69
April	427	428	387	815	856	(59)	797	1.02
May	847	849	427	1,276	1,151	(65)	1,086	1.18
June	658	1,198	524	1,722	1,215	(40)	1,175	1.47
July	507	508	463	971	994	(19)	975	1.00
August	261	263	417	680	1,046	(43)	1,003	0.68
September	157	732	439	1,171	1,053	(57)	996	1.18
October	494	495	473	968	1,118	(48)	1,070	0.90
November	316	318	361	679	776	(54)	722	0.94
December	(30)	569	469	1,038	1,136	(108)	1,028	1.01
1976								
January	$ 929	$ 931	$ 419	$1,350	$ 830	$ (96)	$ 734	1.84%
February	727	729	358	1,087	916	(69)	847	1.28
March	725	1,354	534	1,888	1,333	(26)	1,307	1.44
April	414	415	551	966	1,571	(29)	1,542	0.63
May	661	662	576	1,238	1,547	(140)	1,407	0.88
June	344	1,009	721	1,730	1,984	(247)	1,737	1.00
July	901	902	645	1,547	1,727	(115)	1,612	0.96
August	528	530	649	1,179	1,632	(228)	1,404	0.84
September	446	1,144	605	1,749	1,564	(165)	1,399	1.25
October	742	744	581	1,325	1,549	(213)	1,336	0.09
November	515	517	584	1,101	1,539	(167)	1,372	0.80
December	285	1,018	704	1,722	1,881	(239)	1,642	1.05
1977								
January	$1,097	$1,101	$ 539	$1,640	$ 1,456	$(184)	$1,272	1.29%
February	676	679	498	1,177	1,472	(281)	1,191	0.99

Recent Trends Up

Based on selective checks with major California S&L's, it appears savings inflows have accelerated in March after a slowdown in February. Furthermore, it appears that much of the inflow has been in stable savings certificates and has more than offset declining large denomination CD's, which have been allowed to run down.

CALIFORNIA HOME SPECULATION

An emerging worry regarding S&L's concerns speculative elements in the California home market and the fear that this has added fluff to home prices. Given the rapid escalation of home prices in certain California markets, it is feared that some future price shake-out is likely which could harm lenders. The recent issue of the Residential Research Report shows that home prices in Southern California increased *on average* 22% in 1976 . . . on top of a 16% increase in 1975. Dr. Maurice Mann, head of the Federal Home Loan Bank in California, recently voiced concern about this problem.

The Positive Position: In Perspective, Speculation is Less of a Concern

Those who discount the seriousness of this issue state that worrisome speculation is limited to two areas . . . Orange County and San Francisco . . . where it may account for 35% of the total purchases of single family homes. More important, fundamental factors such as 1) a slump in construction in 1974-75 due to the recession, 2) general inflation, 3) a scarcity of available land due to local environmental restrictions and 4) additional buyers from Canada, Latin America and elsewhere overseas, can explain much of this price increase. Furthermore, S&L lenders have been making mostly 80% loan-to-value mortgages giving them a substantial cushion in the event of price declines. The assumption underlying this positive approach is that although some specualtion is present in the market, home values are not likely to decline sharply. Furthermore, it is emphasized that most speculation is occurring on completed single family home and income producing real estate . . . not raw land . . . and hence, downside should be limited, especially for lenders with a build in cushion.

Bearish Argument

This position assumes that real estate markets are cyclical and, hence, excesses at some time are only a matter of course. Furthermore, it is generally conceded that S&L's cannot absolutely avoid lending to speculators. Speculators are believed to represent 50% or more of the buyers of single family homes in certain areas, and it is felt that many speculative syndicates are carrying homes on a negative cash flow basis. Hence, simply a slowing down of the rate of *increase* on home prices could flush these owners out and produce a decline in home prices and losses for some lenders.

Conclusion

We view this problem as potentially significant but believe the amount of speculation has been exaggerated by some, and that a worrisome decline in home prices is unlikely over the near-term. Continued publicity regarding speculative buying is likely to encourage increased diligence by lenders. Many S&L managements formed their basic approach to lending in the troubled California real estate market of the mid-1960's. Furthermore, as long as mortgage money remains reasonably available, home prices are not likely to show worrisome declines. Thus, underlying our relatively positive outlook is an assumption of moderate inflation and interest rates.

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Incorporated

Table 4

HOUSING STARTS, BUILDING PERMITS AND COMPLETIONS (SA)
(Millions of Units)

Year	Private Housing Starts	% Chg. from Prior Month	Building Permits	% Chg. from Prior Month	Housing Completions	% Chg. from Prior Month
1971	2.052		1.952		1.702	
1972	2.357		2.219		1.971	
1973	2.045		1.820		2.014	
1974	1.338		1.074		1.692	
1975	1.160		0.924		1.296	
1976	1.536		1.281		1.361	
1975						
January	1,005	+ 6.9%	0.718	-17.4%	1.547	- 0.6%
February	953	- 5.2	0.729	+ 1.5	1.350	-12.7
March	986	+ 3.5	0.721	- 1.1	1.314	- 2.7
April	982	- 0.4	0.843	+16.9	1.244	- 5.3
May	1.085	+10.5	0.903	+ 7.1	1.269	+ 2.0
June	1.080	- 0.5	0.938	+ 3.9	1.202	- 5.3
July	1.207	+11.8	1.016	+ 8.3	1.261	+ 4.9
August	1.264	+ 5.1	0.998	- 1.8	1.267	+ 0.5
September	1.304	+ 3.2	1.092	+ 9.4	1.315	+ 3.8
October	1.431	+ 9.7	1.111	+ 1.7	1.115	-15.2
November	1.381	- 3.5	1.127	+ 1.4	1.386	+24.3
December	1.283	- 7.1	1.091	- 3.2	1.329	- 4.1
1976						
January	1.236	- 3.7%	1.147	+ 5.1%	1.213	- 8.7%
February	1.547	+25.2	1.165	+ 1.6	1.299	+ 7.1
March	1.417	- 8.4	1.188	+ 2.0	1.399	+ 7.7
April	1.367	- 3.5	1.082	- 8.9	1.266	- 9.5
May	1.422	+ 4.0	1.158	+ 7.0	1.360	+ 7.4
June	1.510	+ 6.2	1.150	- 0.7	1.373	+ 1.0
July	1.382	- 8.5	1.215	+ 5.7	1.307	- 4.8
August	1.537	+11.2	1.296	+ 6.7	1.401	+ 7.2
September	1.840	+19.7	1.504	+16.1	1.390	- 0.8
October	1.813	- 1.5	1.492	- 0.8	1.317	- 5.3
November	1.705	- 6.0	1.585	+ 6.2	1.399	+ 6.2
December	1.889	+10.8	1.514	- 4.5	1.435	+ 2.6
1977						
January	1.386	-26.6%	1.307	-13.7%	1.373	- 4.3%
February	1.791	+29.2	1.514	+15.8	–	–

HOUSING STARTS, TEMPORARY IMPACT OF ADVERSE WEATHER (Table 4)

In January, housing starts dropped sharply from December levels due to the extremely cold weather in the Northwest and Midwest which greatly affected housing activity in those areas. The rebound in February was quite pronounced and underscores the temporary nature of a weather induced slowdown. For the moment, we are sticking with our 1.9 million start estimate for the year although we note that many higher estimates have been cut back and the consensus view is probably in the 1.7-1.8 million area. Reduced start estimates have generally been due to the depressed levels in January and revived inflation fears which raise the prospect of higher interest rates.

Interestingly, total housing production in 1976 of 1.8 million units (including mobile homes) is a level that, prior to the super-boom begun in 1968, was exceeded in only one year since World War II and this was in 1950 during the Korean War boom.

Seasonally adjusted building permits continued to run significantly ahead of a year ago . . . up 14% in January and 30% in February, underscoring the temporary nature of the January set-back in starts.

Finally, 1-4 family starts (chiefly single family) continue to account for a preponderance of total starts. In 1976, they were 81% of total starts and for the first two months of 1977 they were 80% and 84%, respectively. Strong single family activity reflects the availability of mortgage money at relatively attractive rates and some pent up demand from the recent recession. Multifamily starts are expected to increase as 1977 progresses and as the economics of rentals improves due to higher rents, lower mortgage rates and lower vacancies.

EXISTING HOME SALES, NEW RECORDS (Table 5)

Sales of existing single family homes (seasonally adjusted) continued to show strength in the first two months of 1977, up 22% and 12% in January and February, respectively. Although running well ahead of last year's record pace, volume has declined substantially from the levels reached in the last four months of 1976.

Table 5

UNIT SALES VOLUME–EXISTING SINGLE FAMILY HOMES

(000)

Annual		1975 (SA)		1976 (SA)		% Increase 1976/1975	1977 (SA)		% Increase 1977/1976	
1968	1,569	January	1,970	January	2,610	+32.5%	January	3,190	January	+22.2%
1969	1,594	February	2,150	February	2,750	+27.9	February	3,080	February	+12.0
1970	1,612	March	2,210	March	2,800	+26.7				
1971	2,018	April	2,330	April	2,790	+19.7				
1972	2,252	May	2,350	May	2,910	+19.6				
1973	2,334	June	2,410	June	2,990	+24.1				
1974	2,272	July	2,350	July	2,900	+23.4				
1975	2,452	August	2,490	August	3,070	+23.3				
1976	3,002	September	2,650	September	3,330	+25.7				
		October	2,750	October	3,290	+19.6				
		November	2,830	November	3,220	+17.3				
		December	2,940	December	3,560	+21.0				

Sales volume set an all-time record in 1976 of 3,002,000 units as is illustrated in Table 5. Volume was up an impressive 22% from the previous record year in 1975 due to a relatively attractive mortgage and economic situation.

It is this high level of activity plus inflation in the price of homes (and hence mortgage amounts) together with a high level of single family construction which has resulted in an attractive operating environment for *S&L's* and *PMI Companies.*

Nationwide, single family mortgage rates have declined noticeably from year-end levels due to strong savings flows. The nationwide effective mortgage rate (including fees) declined from 9.10% in December 1976 (the high month of the year) to 8.98% in February. We do not expect significant further declines and, in fact, in areas of high mortgage activity such as California, we expect the next move in mortgage rates to be upwards.

COMMERCIAL LOAN DEMAND . . . THE CYCLE IS ALIVE AND WELL (Table 6, Charts 1 and 2)

Until quite recently, wherever one inquired one could hear about weak loan demand. Bankers in the midst of a prolonged dry spell constantly bemoaned the lack of commercial loan demand and implied it was likely to continue for some time. Also, corporate comptrollers, sitting on huge sums of cash, generally did not anticipate borrowing from banks in the foreseeable future. Furthermore, bank pricing in the United States seemed to preclude a meaningful pick-up in loan demand. The slight pick-up in C&I loan demand begun in the summer of 1976 was discounted as artificial (primarily bankers acceptances) or seasonal.

Table 6

DOMESTIC LOANS AND SELECTED COMMERCIAL PAPER OUTSTANDING

($ in Billions – Not Seasonally Adjusted)

Date	All Banks Total Loans	Large Commercial Banks Total Loans	Large Commercial Banks C&I Loans	Large NYC Banks Total Loans	Large NYC Banks C&I Loans	Non Financial Commercial Paper	C&I Loans Large Banks & Non Financial Commercial Paper
12/5/73	$495.0	$271.0	$110.0	$65.0	$31.0	$ 8.4	$118.4
3/27/74	$497.0	$275.0	$116.0	$65.0	$34.0	$ 9.3	$125.3
6/26/74	519.0	273.0	121.0	71.0	36.0	10.0	131.0
10/2/74	530.0	300.0	129.0	75.0	39.0	12.7	141.7
1/1/75	547.0	303.0	132.0	78.0	41.0	12.7	144.7
3/26/75	$528.0	$286.0	$126.0	$72.0	$39.0	$14.3	$140.3
7/2/75	530.0	284.0	122.0	71.0	38.0	12.0	134.0
10/1/75	526.0	277.0	119.0	69.0	36.0	12.2	131.2
12/31/75	540.5	283.9	120.7	70.1	36.7	10.1	130.8
3/31/76	$530.9	$275.8	$114.6	$70.4	$35.0	$11.6	$126.2
6/30/76	543.7	278.7	112.8	68.8	33.4	12.7	125.5
9/29/76	550.8	279.0	112.3	67.1	32.9	12.0	124.3
12/29/76	575.9	289.0	116.5	71.0	35.1	12.3	128.8
1/26/77	$563.7	$284.1	$114.5	$67.3	$33.7	$13.8	$128.3
2/23/77	568.7	285.1	115.3	67.4	33.6	14.9	130.2
3/23/77	571.9	287.8	117.2	66.8	33.9	15.0*	132.2

* As of 3/16/77

Seen from a different perspective, however, we feel that a significant, however gradual, pick-up in commercial and industrial loan demand began in the summer of 1976 and is likely to continue to build momentum in 1977. Our conclusion is based on the following assumptions.

1. The severe 1973–1975 recession produced an environment beyond most businessmen's experience . . . nothing like this had been seen in 30 years. However, we feel the chief difference is in degree not in kind.

   a. It is normal that an unusually severe decline should produce extraordinary business caution concerning inventory levels and capital expenditures.

   b. Also, emphasis on increased corporate liquidity is understandable.

   c. In this context, the precise timing and rate of the pick-up in business loans is impossible to predict with any precision. There is nothing within the past 30 years to relate to regarding fine tuning estimates of loan demand.

   d. However, given an economic recovery, it is only a matter of time before business loans increase. The recovery was a year and a half old when business loans appeared to bottom out in September 1976.

2. Loan activity is dynamic . . . not static. The cycle is alive and well.

   a. Negative momentum bottomed out in spring of 1976 and turned positive in late summer of 1976 (see Chart 1 on page 13)

   b. Given a continued economic recovery, positive momentum is likely to accelerate rather than diminish.

   c. People on the firing line often have the worst perspective . . . and perspective is everything in a cyclical situation.

      (i) Bank lending officers and corporate comptrollers are not always the best sources of meaningful insights.

      (ii) The build-up in loan demand is likely to feed on itself (positive momentum). Inventories and capital expenditures are first increased by a few special businesses and/or businessmen (more aggressive or entrepreneurial).

3. Evidence to date seems to support our thesis (see Chart 1).

   a. Major bank business loans have clearly begun a meaningful upswing.

Chart 1
C&I LOANS

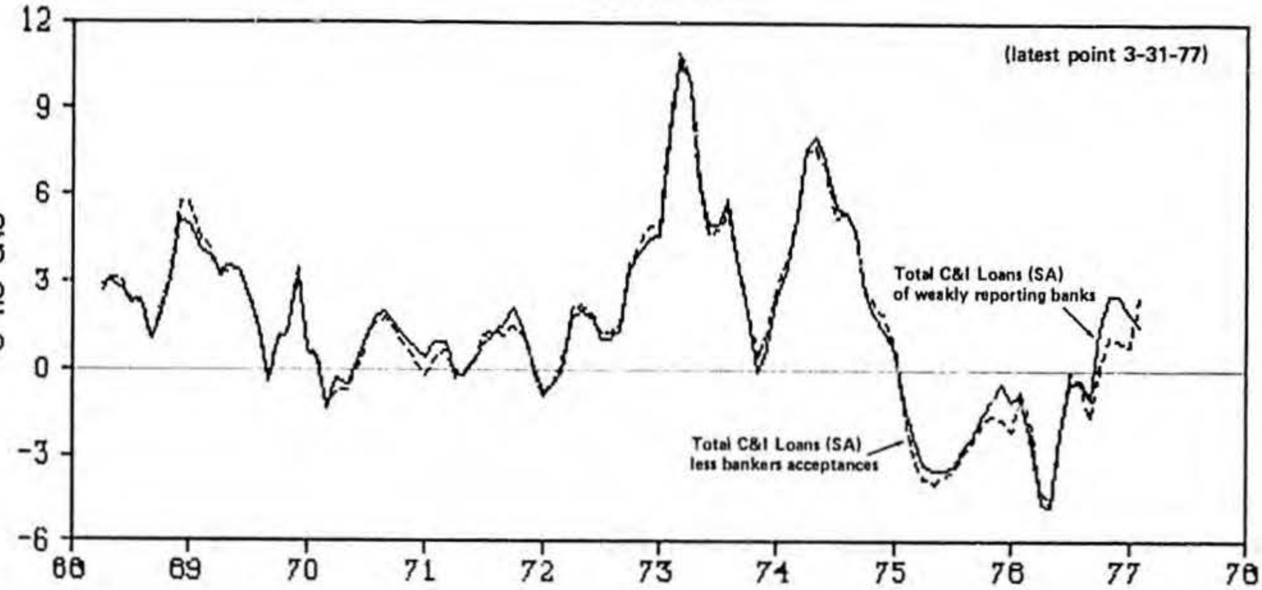
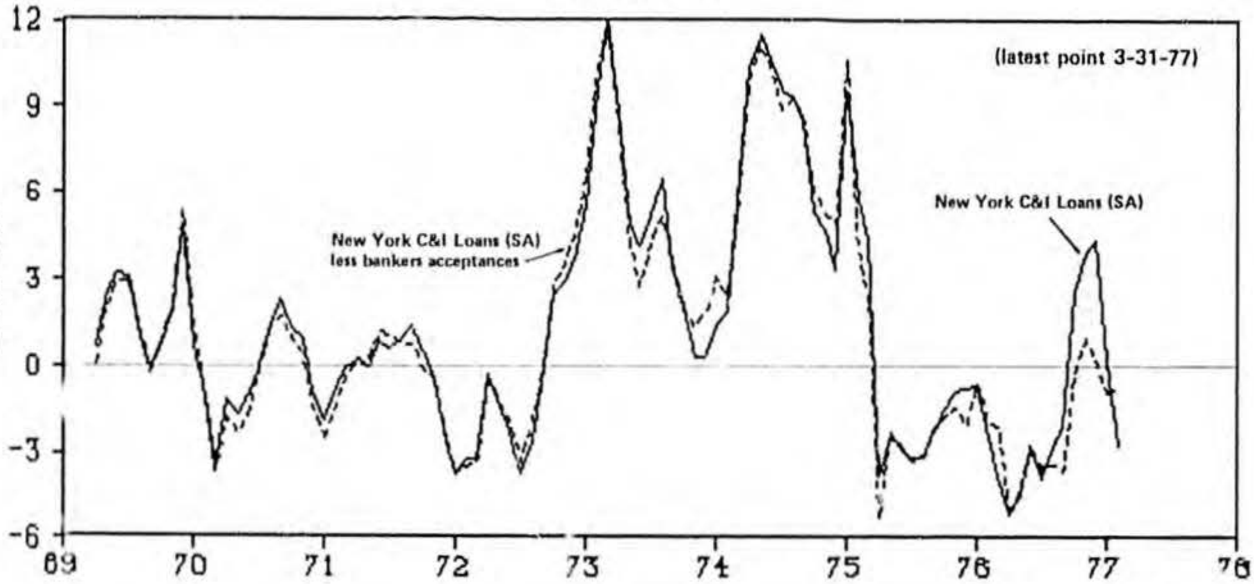


Chart 2
C&I LOANS NY



b. The delayed upswing of business loans at the New York City banks is understandable, although at least the decline has slowed and C&I loans less acceptances show a smoother progression (see Chart 2).

(i) Domestic lending by NYC banks competes with the Eurodollar markets where lower borrowing rates have enabled U.S. corporations to borrow cheaper. Thus, to some degree, New York banks' overseas loan demand may have been strong at the expense of domestic loan demand.

(ii) NYC banks compete to a greater degree with the bond and commercial paper markets.

(a) Record 1976 bond market volume (both in the public and private markets) reflects both relatively attractive rates and a corporate need to refinance short-term debt with long-term debt.

(b) Commercial paper, although competitive on a price basis, has probably drained off a limited amount of bank business. The paper market has also been relatively sluggish, reflecting business caution and bond refundings.

4. What could go wrong with our positive scenario is a significant slowdown in the economic recovery or another recession which would obviate the need for additional borrowing. We do not presently feel these are likely prospects.

SLOW PROGRESS ON REAL ESTATE PROBLEMS. . .A LESSON FOR BANKERS (Table 8)

Recently, at the Annual Banking Symposium, we were struck more by audience reaction to a panel on real estate than by any particular comments made by the panelists. The gist of the panelists' remarks supported our feeling that a significant and broad-based real estate recovery was underway in the United States. Many bank stock analysts we talked to after the session seemed somewhat surprised by this conclusion. . . surprise that is understandable given the lack of apparent progress made by most banks with their real estate problems. In fact, although some banks have shown improvement recently, the general trend of real estate problems over the past two years has been upwards. All of this simply serves to underscore the persistent nature of problem real estate loans. Once a loan has gone on non-accrual, it is generally a sign that a traumatic event has taken place. . . a bankruptcy or personal financial catastrophe. . . which seriously disturbs the *"value creating process"* of real estate development. Once this traumatic point has been reached, there is seldom a bounce back to health but more often than not, a painful and gradual change in ownership occurs, often through a foreclosure proceeding. This legal transfer of ownership usually involves new management which is forced to pick up the pieces left by an entrepreneur. In the very specialized and highly leveraged area of real estate development, this is always tricky and generally time consuming.

All of this is by way of introducing Table 8 (page 16)—which indicates the substantial progress made by five major REIT's with their problems over the past 21 months. *We feel this progress illustrates the type of progress that to a lesser degree is occurring in banks' real*

Table 7

CORPORATE CASH FLOW ITEMS
($ in Billions)

	Internal Funds			(–) Operating Requirements				(=) Internal Cash Flow	
					Fixed	Inventory			
Annual	Net Profit	Capital Cons. Allow.	Total	Dividend	Investment	Change	Total	Net Cash Flow	Sufficiency Ratio
1960	$ 25.8	$ 27.5	$ 53.3	$12.9	$ 47.7	$ 3.8	$ 64.4	$-11.1	82.7%
1961	25.8	28.4	54.2	13.3	47.1	2.2	62.6	- 8.4	86.6
1962	29.6	29.3	58.9	14.4	51.2	6.5	72.1	-13.2	81.6
1963	31.5	30.4	61.9	15.5	53.6	6.0	75.1	-13.2	82.4
1964	36.7	31.7	68.4	17.3	59.7	5.8	82.8	-14.4	82.6
1965	$ 44.3	$ 33.7	$ 78.0	$19.1	$ 71.3	$ 9.5	$ 99.9	$-21.9	78.1%
1966	47.1	36.7	83.8	19.4	81.4	14.3	115.1	-31.3	72.8
1967	44.9	40.4	85.3	20.1	82.1	10.1	112.3	-27.0	76.0
1968	46.2	44.4	90.6	21.9	89.3	7.7	118.9	-28.3	76.2
1969	43.8	49.4	93.2	22.6	98.9	9.4	130.9	-37.7	71.2
1970	$ 37.0	$ 55.1	$ 92.1	$22.9	$100.5	$ 3.8	$127.2	$-35.1	72.4%
1971	44.3	60.6	104.9	23.0	104.1	6.4	133.5	-28.6	78.6
1972	54.6	65.4	120.0	24.6	116.8	9.4	150.8	-30.8	79.6
1973	67.1	68.1	135.2	27.8	136.0	17.9	181.7	-46.5	74.4
1974	75.2	80.8	156.0	30.8	149.2	10.7	190.7	-34.7	81.8
1975	65.3	96.6	161.9	32.1	147.1	-14.6	164.6	- 2.7	98.4
1976E	$ 84.4	$107.9	$192.3	$35.2	$160.0	$14.8	$210.0	$-17.7	91.6%
1977E	95.9	119.5	215.4	40.0	175.7	14.8	230.5	-15.1	93.4
1978E	105.6	136.0	241.6	45.2	193.7	21.2	260.1	-18.5	92.9
Quarterly									
1975									
1Q	$ 54.0	$ 90.8	$144.8	$31.7	$148.0	$-22.2	$157.5	$-12.7	91.9%
2Q	61.0	95.0	156.0	31.9	145.8	-30.0	147.7	+ 8.3	105.6
3Q	72.1	98.7	170.8	32.6	146.1	- 2.0	176.7	- 5.9	96.7
4Q	74.1	101.9	176.0	32.2	148.7	- 4.3	176.6	- 0.6	99.7
1976E									
1Q (A)	$ 79.7	$104.2	$183.9	$33.1	$153.4	$ 14.8	$201.3	$-17.4	91.4%
2Q (A)	82.7	106.8	189.5	34.4	157.9	16.0	208.3	-18.8	91.0
3Q (A)	85.1	108.9	194.0	35.4	163.0	15.1	213.5	-19.5	90.9
4Q (P)	90.2	111.6	201.8	37.7	166.0	13.2	216.9	-15.1	93.0
1977E									
1Q	$ 91.1	$114.6	$205.7	$38.4	$169.5	$ 12.0	$219.8	$-14.1	93.6%
2Q	96.1	117.6	213.7	39.5	173.9	14.0	227.4	-13.7	93.9
3Q	97.3	120.8	218.1	40.6	177.5	16.0	234.1	-16.0	93.2
4Q	99.2	124.8	224.0	41.5	181.9	17.0	240.4	-16.4	93.2

Note: Economic statistics from Series A Economic Forecast.

Basic Assumptions	1975A	1976P	1977E	1978E
Real GNP	-1.8%	6.2%	5.0%	5.0%
CPI	9.1%	5.8%	5.7%	5.0%

estate portfolios. To a lesser degree, because banks probably have somewhat riskier loans than these insurance company sponsored REIT's and are probably less able to deal with the problems. Nonetheless, the type and degree of progress illustrated here is likely to be similar to that of the banks over the next two years.

Table 8

PROGRESS ON REAL ESTATE PROBLEMS OF FIVE* REIT'S
($ in Million)

Quarters**	Loans on Non Accrual	Foreclosed Real Estate Non Earning	Foreclosed Real Estate Earning	Foreclosed Real Estate Total	Total Non Earning (Loans & RE)	Total Non Earning Loans & Foreclosed RE
Fiscal 1975-76						
No. 2	$ 97	$ 27	$ 7	$34	$124	$131
No. 3	119	27	7	34	146	153
No. 4	118	40	7	47	158	165
Fiscal 1976-77						
No. 1	$104	$ 49	$31	$ 80	$153	$184
No. 2	95	58	34	92	153	187
No. 3	79	65	46	111	144	190
No. 4	72	67	47	114	139	186

*Conn. General, Equitable, MassMutual, MONY and Northwestern Mutual.

**Since the five trusts have different fiscal years, the quarters have been arranged as follows: No. 1 (qtrs. ending March, April, May), No. 2 (qtrs. ending June, July, August), No. 3 (qtrs. ending September, October, November), and No. 4 (qtrs. ending December, January, February).

The above table illustrates how persistent real estate problems become once they surface. Accepting the fact that the statistics only show *net* rather than *gross* changes, we know from following the progress of individual properties that the net changes generally reflect gross changes.

Overall problems (non-earning loans and foreclosed real estate) rose during six of the past seven quarters from $131 million to $190 million. Only a modest decline occurred in the latest quarter (from $190 million to $186 million). However, the change in mix during this period has been *very* positive. A significant progression has occurred from *"non-earning loan"* to *"foreclosed but non-earning real estate"* to *"foreclosed earning real estate"*. On foreclosure, the lender obtains legal title to the property and can then begin making improvements with confidence. *"Foreclosed earning real estate"* means that after operating costs (but before any interest expenses) the property is earning money. Once a property is generating an attractive return (10-12% in most cases) it can usually be sold or mortgaged to produce an optimum long-term return to the owner. Basically, Table 8 underscores how long it takes to gain title and improve a property to the point that it can be disposed of at a "profit" (or at least at a minimum loss).