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7.9%. On Thursday, the Dow briefly dipped below the level at which it began the year (6,448), but closed on Friday at 6,526, after a 48-point gain on the day.

This weekend many American families will be divided by passionate arguments over whether to stay in the market or get out. More than 43% of all adults now own shares in public companies, according to a recent survey by the National Association of Securities Dealers. Many have never seen a market correction of more than 10% and have come to believe that this remarkable bull run will go on forever. Whatever America's families decide will determine what happens on Wall Street when trading opens tomorrow, and, by extension, to markets around the world. . .

The reason why many analysts believe Wall Street may be in for a severe correction is that the starry-eyed baby boomers may finally wake up to the fact that their recent gains have been largely illusory. While the Dow, Nasdaq and S&P 500 indices have shown impressive gains, average stocks have performed abysmally and the average domestic stock fund (the preferred investment vehicle for most investors) has lost 1.6% of its value in the past three months, according to Morningstar, an information service.

An analysis by Merrill Lynch, the investment bank, before last week's plunge, showed that 37.8% of New York Stock Exchange shares were at least 20% off their highs, and 23.4% were down 30% or more. The situation was even worse on the Nasdaq market, which includes many high-technology firms; 56% were 20% or more below their peaks and 40.5% were off at least 30%. Merrill's Bob Farrell says: "If you strip the financials out of the Nasdaq, the peak was in June. A large section of the market has been in the equivalent of the bear market since then."

A more detailed look at the market reveals some surprisingly big names among the losers. Microsoft was down from its peak by 11% last week. Both Intel and Compaq had fallen 17%, Oracle was off 28% and Cisco Systems 37%. Roger McNamee, a partner of Integral Capital Partners in Menlo Park, California, which tracks 650 technology companies, says the average software company is down 53% from its peak, and hardware companies are down 44%. "Last year a huge number of technology companies were being valued at price-to-earnings and price-to-sales that were almost outrageous," he says. "There was a certain manic nature to the market. The declines happened because the market ran out of new buyers, not because there was anything wrong with the companies. Technology stocks are intensely Darwinian. Corrections winnow out the losers from the herd and make the industry stronger by consolidating it.". . .

Farrell believes a dead-cat bounce may precede a serious market correction. . . . A 10%-15% correction, Farrell believes, will be followed by foreigners rushing into the American market to pick up "bargains." This will drive the market to a new peak before a much meaner decline occurs towards the end of the year. . . .

U.S. stock market in hyper-instability

by Richard Freeman

Over the last few years, 80 million adults, led by the Baby-Boomer generation, lowered their reserves in banks in order to get rich in the stock market. Between January 1992 and the end of the first quarter 1997, investors poured $802 billion into the stock market through mutual fund equity funds. These investors include many average citizens—foolishly lured in by media hype, hot-shot investor newsletters, and overall gossip, touting how one could make the greatest amount of money in the shortest possible time. The rising Dow Jones average of 30 industrial stocks, a jerry-rigged index which rests on multiple layers of fakery, was dangled in front of people's noses, to keep the money flowing in. On paper, huge gains were registered.

Now, the entire process is coming unglued. The fall of the Dow Jones by 8.6% between March 11 and April 3, is a wake-up call. A three- to four-month, broad-based liquidation of the value of thousands of U.S. stocks is poised to set off the biggest financial crash in world history. More than 3,000 stocks have lost 20% or more of their value from their one-year high, and of these, 600 have lost 40% or more of their value. There are frantic efforts under way to hold up the value of the highly watched Dow Jones 30 industrial average, involving outright fakery and the use of derivatives in the attempt to draw more money into mutual funds. Though these operations may get a few unwary persons to put more money into mutual funds that will be invested in the stock market, the efforts are ultimately doomed to failure.

The problem is fundamental: For the past 10 years, especially since 1989, the stock market has been growing at a hyperbolic rate. But, the gains are entirely fictitious. Because of the implementation of post-industrial-society policies, the U.S. physical economy has been contracting at the rate of 2% per year. The value of each stock, and its ability to pay dividends, ultimately rests on the reproductive economic potential of America and its capacity to generate real earnings from real economic activity. Real economic activity has been negative. Thus, there is nothing fundamental supporting stock values.

The hyper-instability of the U.S. stock market is characterized by a badly split, two-tier stock market: The top 250, heavily capitalized stocks, led by an upper stratum of 25 stocks, are being pushed up through the stratosphere. Offi-

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cially, these 250 stocks account for more than 50% of the capitalization of the $7.3 trillion-in-capitalization New York Stock Exchange (NYSE), which has 2,590 stocks. These 250 stocks have recorded more than 100% of the gain in value posted by the NYSE of the last few years. In parallel, just a tiny upper stratum 25 stocks has accounted for more than 100% of the gain registered by the Standard and Poor's 500 for each of the last three years. This means that the other 475 stocks on the S&P's 500 have been losing value for the past three years.

July 1987 was 'not such a good time'

The process has become self-feeding. The more that the broad base of stocks fall, the more that there is disinvestment from these stocks, the more that the money is then plowed into the top 250 stocks, and so on. It is now estimated that the heavily capitalized top 250 stocks are sucking in between half and three-quarters of all money flows in the U.S. stock market. But, the prices of the top 250 stocks—as well as all other stocks—are overvalued relative to *earnings from real income streams from industrial and agricultural production.* For example, General Electric, one of the five highest-capitalized stocks in America, obtains more than half of its profits from its finance and entertainment divisions. As the head of stock strategy for a large Wall Street investment bank told *EIR* on April 2, "This has reached its limit. Such a divergent market can't continue. Either most of the smaller stocks go up in price, or the big stocks come down in price." The latter is the far more likely. He added, "During last 25 years, I have seen such a widely divergent stock market only three times—March 1973, July 1987, and May 1990. You remember July 1987? That was not such a good time."

This time the damage will be greater than the 1987 crash; the market may have no bottom, once reverse leverage takes over. Moreover, during the 1920s, according to the best estimates of people who have studied the period, 6-10% of the adult population had ownership of stocks; today, according to a survey conducted by the National Association of Securities Dealers, 43% of adults—79 million people—are exposed, through ownership, to the stock market. The effects of a collapse will be more widespread; it will create an existential crisis for tens of millions of families swept up into the stock market bacchanalia.

The Wall Street forces committed to keeping the market bubble going will say to millions of suckers, "See, we have stabilized the Dow Jones 30; bring your money back into the market."

To refute these fakers, first, we will expose the fakery of the Dow Jones 30 index, as well as the Standard and Poor's 500. Then we will look at the collapse of the broad base of stocks. Finally, we will look at some of the leverage-borrowing that is being used to hold up the stock market, principally the top 250 stocks on which the fate of the stock market now hangs.

TABLE 1

Most recent changes in the companies that make up the Dow Jones index

	Change in stock price since 1991
Company added	
Travelers Group	+628%
Hewlett-Packard	+372%
Johnson & Johnson	+154%
Wal-Mart	+40%
Company dropped	
Texaco	+54%
Woolworth	–27%
Westinghouse	–32%
Bethlehem Steel	–40%

Source: Bloomberg Financial Markets

The jerry-rigged Dow Jones

The Dow Jones 30 industrial stocks average is published by Dow Jones and Company, which owns and operates the *Wall Street Journal.* It is an increasingly *post*-industrial index, which employs multiple levels of fakery. However, it is prominently reported every night on the television news, and its level is emblazoned across the top of the business page of every major newspaper in the world, as representative of how U.S. stocks are doing. But, it is not representative at all.

For example, on March 17, Dow Jones and Co., in a revision of the Dow Jones Industrial Average (DJIA) index, dropped four companies from the DJIA: Bethlehem Steel, Texaco, Westinghouse Electric, and Woolworth—all of which had been part of the DJIA since 1928. It replaced them with Travelers Group (an insurance company), Hewlett-Packard (computers), Johnson and Johnson (health care), and Wal-Mart (retail sales).

The shift in the DJIA achieved two purposes. First, it manipulated the Dow Jones level upward. **Table 1** shows that three of the four companies added have registered huge gains in their stock price since 1991, and were that pattern to continue, it would propel the Dow Jones even higher. And, on the other hand, three of the four dropped companies have registered stock-price losses since 1991, and thus, dropping them will also boost the Dow Jones higher, by eliminating the losers that were pulling the index down. If one adds "winners" and eliminates "losers," one has a much better chance of making the Dow rise.

The second effect of the change was to make the Dow more post-industrial and more speculation-oriented. With the removal of Bethlehem Steel, there are no longer any steel companies listed in the Dow Industrials—U.S. Steel was replaced by Walt Disney in 1991. There are now three bank-insurance companies, constituting one-tenth of the Dow's 30

stocks: the just-added Travelers, J.P. Morgan (added in 1991), and American Express (added in 1982).

Still another level of DJIA fakery involves the deployment of the little-spoken-of Dow "divisor." Full discussion of the divisor requires more space than can be taken up here, and will be covered in a future issue of *EIR*. But briefly, the divisor is a number that is divided into the sum of the closing stock prices of the Dow Jones industrial 30 stocks. The value of the Dow divisor is approximately 0.35. A divisor of less than 1 becomes a multiplier; thus it magnifies the DJIA stock average three times.

The Standard and Poor's 500

To understand the full extent of the fraud of the Dow Jones Industrial Average, one usefully looks at the S&P's 500 index, which includes most of the Dow Jones 30 industrials, plus more than 470 other stocks, and thus is advertised to be a broader index of stock performance. For the past three years, the performance of the S&P 500 has been concentrated in just 25 leading stocks: *In 1996, just the largest 25 stocks in the S&P 500, which account for one-third of the value of the index, rose 37%, accounting for more than the entire gain of 23% that the index registered.* The other 475 stocks in the index lost value. These top 25 stocks have high stock prices and are heavily capitalized, which is why they represent such a high percentage of the overall S&P 500 (see **Table 2**).

TABLE 2

Percentage that the top 25 stocks represent of the S&P 500

General Electric	2.85
Coca-Cola	2.40
Exxon	2.12
Intel	2.09
Microsoft	1.95
Merck	1.75
Philip Morris	1.60
Royal-Dutch Petroleum	1.57
IBM	1.32
Proctor & Gamble	1.26
Johnson & Johnson	1.25
AT&T	1.06
Bristol-Myers Squibb	1.02
DuPont	0.98
Pfizer	0.95
American Int'l Group	0.94
Wal-Mart Stores	0.89
Hewlett-Packard	0.89
Pepsico	0.89
Citicorp	0.87
Mobil	0.86
Walt Disney	0.82
General Motors	0.80
Eli Lily	0.78
Gillette	0.77

Source: Standard and Poor's

The same situation—of the top 25 stocks registering more than 100% of the S&P's gain, while the other 475 stocks lost value—also prevailed in 1994 and 1995. Thus, when the press reports that the S&P 500 average is rising, only a select sub-group of stocks is actually rising. By the same token, of the 25 stocks listed in Table 2, 14 are also in the DJIA 30 stock average, and help account for some of the speculative rise in the DJIA as well.

But while the top 25 stocks (and perhaps another 225 stocks, for a combined total of 250 stocks) are holding up the stock market—for the moment—a wipeout of almost one-third of the remaining approximately 8,000 stocks in America, is under way. When the prices of this small handful of top 250 stocks are put to one side, the actual picture of a sizable collapse of U.S. stock values over the last several months emerges.

Consider the following two stock markets and one closely watched index. First, there is the Nasdaq, which is sometimes called the "over-the-counter" market. It represents 4,708 stocks, which are not represented on the New York Stock Exchange or the American Stock Exchange. Many of the stocks on the Nasdaq are "high-technology" issues (Microsoft, for example, used to be traded on the Nasdaq). The high-tech issues used to be the high-flyers pushing the stock market up. Second, there is the New York Stock Exchange, the major market on Wall Street, where 2,590 stocks are traded. Third, there is the Standard and Poor's 500 index, which is an index of stocks trading on different U.S. stock exchanges.

TABLE 3

Percentage of stocks that have fallen by 20%, 30%, 40% or more, from their one-year high

	Nasdaq	NYSE	S&P 500
20% or more	55%	24%	30%
30% or more	41	15	18
40% or more	30	9	12

Source: Prudential Securities

Table 3 shows the percentage of stocks for each market or index that have fallen by 20%, 30%, 40%, or more, from their one-year high, their highest level during the past 12 months. (Keep in mind, that the 40% or more category is a subset of the 30% or more category, and the 30% or more category is a subset of the 20% or more category.) Some 55%, or 2,682 of the stocks traded on the Nasdaq, are trading

20% below their one-year high. Some 24%, or 632 stocks of the stocks traded on the NYSE are trading 20% or more below their one-year high. Moreover, nearly one-third of all stocks traded on the Nasdaq (America's largest stock exchange in terms of number of companies listed) are trading 40% or more below their one-year high. This is a very significant meltdown.

For certain categories of stock groups, the fall is even greater. For example, Roger McNamee, a partner of Integral Capital Partners in Menlo Park, California, which tracks 650 technology companies, reports that the average computer software company is down 53% from its one-year peak, and computer hardware companies are down 44%.

Widening the split

At this moment, trading mechanisms on Wall Street are kicking in, which widen the split: supporting the top stratum of stocks, while disinvesting from most of the rest of the broad market, accentuating those stocks' fall.

One mechanism is the stock index mutual fund, which is the latest investment rage on Wall Street. These stock index mutual funds effectively go on autopilot: The mutual fund manager of such a fund invests the money in all the stocks in a basket of stocks, like the S&P 500. *However, the investment is weighted.* For example, General Electric accounts for 2.85% of the S&P's 500, while Armco Steel accounts for only 0.007%. So, when one buys an S&P 500 stock index mutual fund, $400 goes into GE for every $1 that goes into Armco. This concentrates more and more money into the biggest stocks. (Stock index mutual funds are distinct from something with a similar name, the stock index options, which are derivatives.)

A second mechanism is the practice of "momentum trading" by large institutional investors, such as insurance companies and pension funds. Once the institutional investor sees a stock doing better than another, it pours large amounts of resources into the better-performing stock, which in turn, enhances its performance.

A third mechanism is the use of derivatives instruments, like futures and options contracts, which overwhelmingly support the most heavily capitalized stocks.

Can the top 250 stocks hold up?

This gets to the question of whether the thin stratum of the top 25 stocks, plus the other 225 top stocks, can continue to hold up all the stock markets and stock indices. If they unravel, then the slide downwards for the entire stock market will be fast and steep.

The problem is that these top 250 stocks have little real wealth backing them up. Some of these stocks have price-earnings ratios of 16 to 1, up to 25 to 1, which is already high by historical standards. The price-earnings ratio is the ratio between the price of a share of stock and the earnings per share. For example, if a stock has a price of $100 per share, and the annual earnings per share is $4, the price-earnings ratio is 25 to 1.

But, as Lyndon LaRouche explains in the preceding article, during the 1960s, the British financier oligarchy imposed on America the post-industrial society, which in the economic sphere unleashed every variety of speculation, including leveraged buy-outs, derivatives, and so on, which have played a role in propping up the stock market. This process created a speculative bubble, which has sucked dry the real underlying physical economy. This post-industrial shift transformed individual companies into post-industrial companies, to the point that much of their purported earnings now come from post-industrial income streams, such as real estate, currency speculation, and entertainment, and do not represent real industrial earnings. Such companies' real industrial earnings are but a fraction of officially posted earnings. This means that the price-earnings ratio, when compared solely to the earnings derived from real production, is much higher than the officially posted one, and therefore very unhealthy.

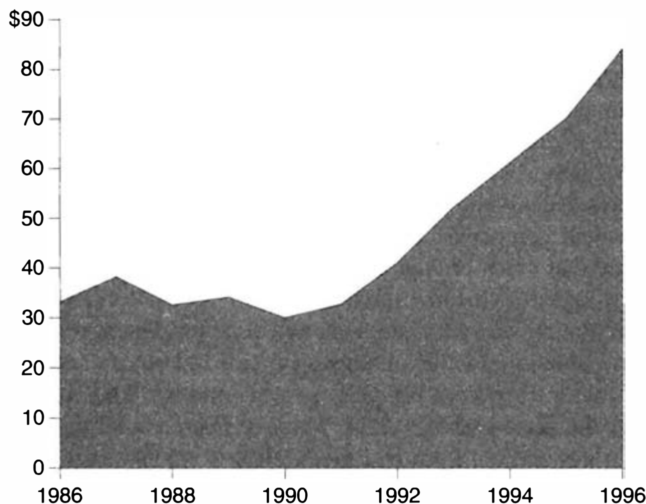
For example, take General Electric Company, which is America's sixth biggest company, and accounts for 2.85% of the S&P 500. GE has a financing arm, called General Electric Capital Corporation. Originally set up to finance the purchase of GE appliances, such as stoves and refrigerators, GE Capital Corp. is now a major speculator in derivatives and an investor in Third World debt. Were it a bank, GE Capital Corp., with $227 billion in assets, would be the fourth largest bank in the United States. At the same time, GE also owns NBC television. In 1996, the parent General Electric Company earned $79.2 billion in revenues, and $7.3 billion in profit (i.e., net earnings). Of this, 48% of revenues and 52% of net earnings came from GE Capital Corp., NBC, and other entertainment enterprises combined. GE is no longer primarily a manufacturing company; half of its net earnings stream comes from post-industrial sources. There is much less physical production supporting its stock than meets the eye. This is true of the stock of many of the top 250 companies which hold up the price of the major stock exchanges in America.

Relative to real industrial and agricultural earning streams from the U.S. economy, the value of all stock traded on the major exchanges is hypothecated many times over.

An additional element holding the stocks of these 250 top companies up, is leverage. This can be seen in two ways. On the simplest level, there is the amount of margin debt that is being used to buy stocks. **Figure 1** shows the level of margin debt outstanding, as kept by the NYSE just for purchases of stocks on the NYSE. An investor can borrow up to 50% of the value of a stock through margin debt. Notice that the margin debt has increased two-and-a-half-fold during the last 10 years.

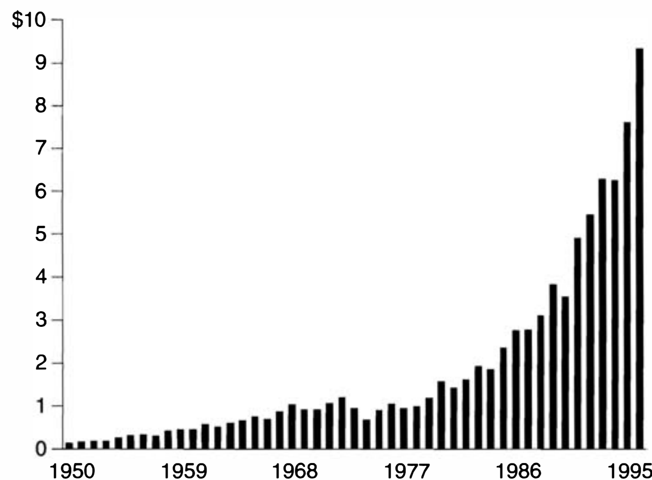
Second, is the use of options and futures, both for individual stocks, and for stock indices, like the S&P 500 index

FIGURE 1
New York Stock Exchange customers' margin debt
(billions $)



Source: New York Stock Exchange "Fact Book," years 1995 and 1996.

FIGURE 2
Capitalization value of all stocks traded on U.S. stock markets, 1950-96
(trillions $)



Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

future. A preliminary count shows that 350-500 million stock futures and options, including "puts and calls," were traded on all U.S. exchanges during 1996. The amount of notional stock value commanded by these futures and options totalled in the trillions of dollars. Yet, a purchaser of stock options has to put down only 3-7% of the total value of the stock contract he is buying, which gives him 20 to 1, up to 33 to 1 leverage. Through trading stock futures and options on the Chicago and New York futures and options exchanges, speculators can manipulate the underlying NYSE and other stock markets. The practice is called "updrafting," when the market is deliberately lifted up (which is used frequently), and "downdrafting" when the market is pushed down.

In the final analysis, it is these multiple levels of leverage which are holding up the top 250 or so stocks, not their earnings from real production.

A many-trillion-dollar meltdown

The value of all of a company's stock is called its capitalization, which is equal to the price of a share of the company's stock times all the shares outstanding. The capitalization of all stocks in America reached $10.3 trillion in the fourth quarter of 1996 (although the average for the year was $9.4 trillion). **Figure 2** shows the capitalization of all stocks in America, since 1950. The hyperbolic growth in this curve since the mid-1980s, especially since 1989, is unmistakable. This was facilitated through huge leverage, mergers and acquisitions, capital gains tax cuts, and several of the other mechanisms described earlier.

Already, a broad-based evaporation of value of thousands of U.S. stocks is under way. This has spooked investors, many of whom took losses, unless they were invested in the "golden 250." The mutual fund mania is showing signs of coming to a halt in key sectors. Equity mutual funds, which invest in stocks, suffered a net outflow of $328 million for the week ending April 2. According to AMG Data Services, which tracks the flow of money into mutual funds, this was the first outflow in a long while. Equity mutual funds that invest exclusively in so-called "growth stocks" suffered an outflow of nearly $1 billion for the week ending April 2, the third consecutive week of outflows for that category of mutual fund.

If the outflow from mutual funds intensifies, and the top 250 stocks can't attract new suckers as investors, or attract funds from other sources, the only thing standing between themselves and disaster is the high levels of leverage which prop them up. But, were a loss of nerve to occur, or some disaster, that leverage can unwind very quickly. At ratios of 20-33 to 1 leverage, the effects of reverse leverage will be fierce. At that point, we are not looking at a few-hundred-billion-dollar correction, but the possibility of values going back to mid-1980s levels. That means a loss of $5-7 trillion in capitalization. The Dow Jones 30 fake index will become burnt toast. That magnitude of loss, which would trigger developments within the bankrupt banking system, means the biggest disintegration of all financial markets in 500 years.