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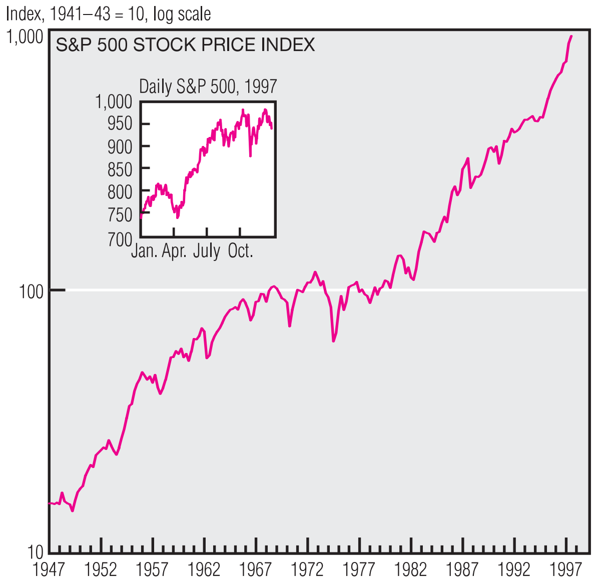
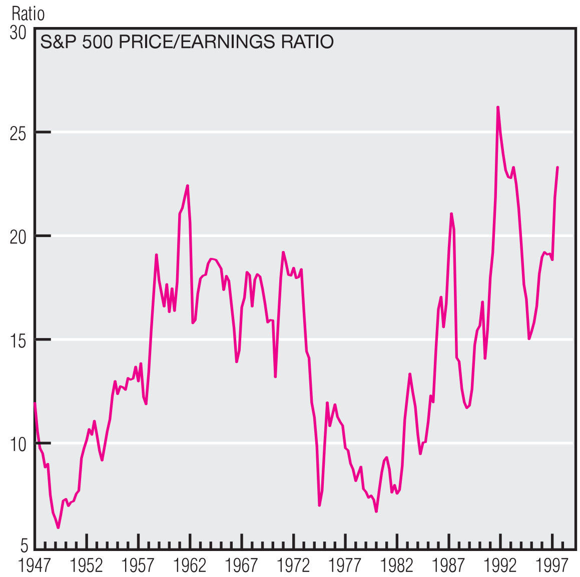
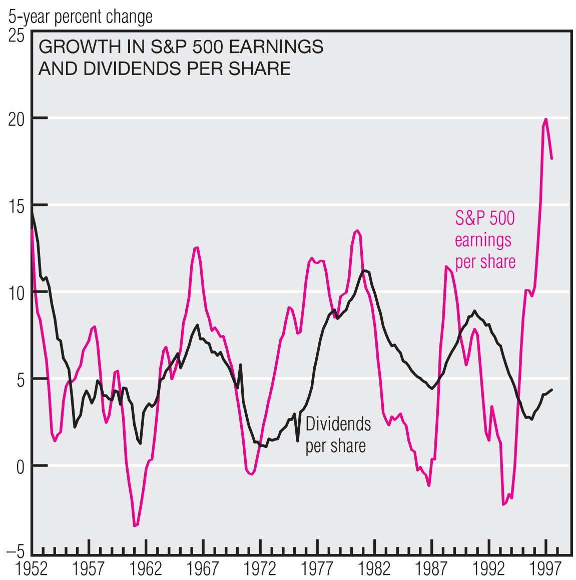
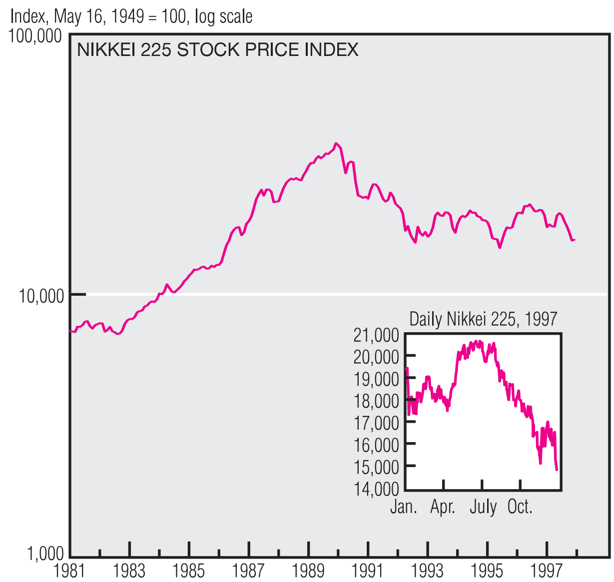
The Stock Market









SOURCES: Standard & Poor's Corporation; and DRI/McGraw–Hill.

After climbing more than 25% between January and July 1997, the S&P 500 index swung widely over the balance of the year. A sharp drop in stock prices on October 28 marked the largest single-day decline since October 1987. Within a month, however, the market reversed the loss. This recent increase in stock price variability was triggered by the heightened uncertainty associated with turmoil in Asia's financial markets. The Nikkei 225 stock price index in Japan, for example, has fallen about 25% since midyear.

Fundamentally, a stock's price equals the discounted value of its expected future dividends. Future dividends, in turn, derive from future earnings. When prospects for earnings growth are good, stock prices tend to rise. The price/earnings (P/E) ratio—simply the stock price divided by earnings per share—gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying and hence the more earnings growth they are expecting. Earnings growth has been extraordinary in recent years, and reports in the first half of 1997 indicated that analysts expected profits to accelerate in 1998.

Asia's financial crisis has raised questions about the level of optimism embedded in U.S. equity prices. Recent actions taken in Asian countries, designed to correct excesses, will ultimately reduce the demand for U.S. goods. Thus, many analysts have begun to scale down their earnings forecasts for U.S. companies that export to Asia. Nevertheless, American firms remain in strong financial shape.