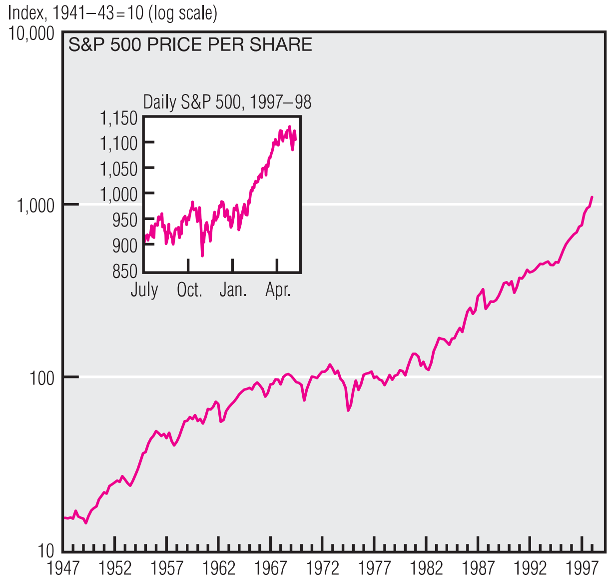
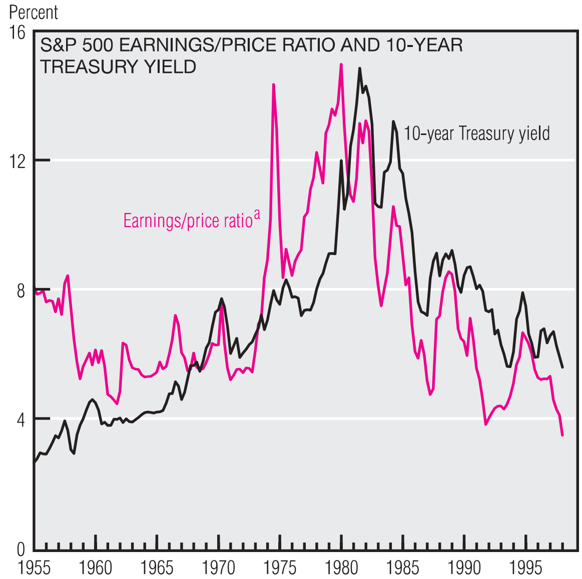
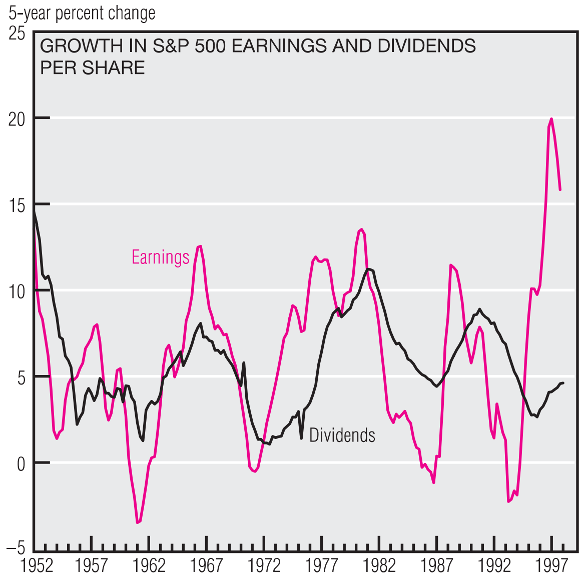
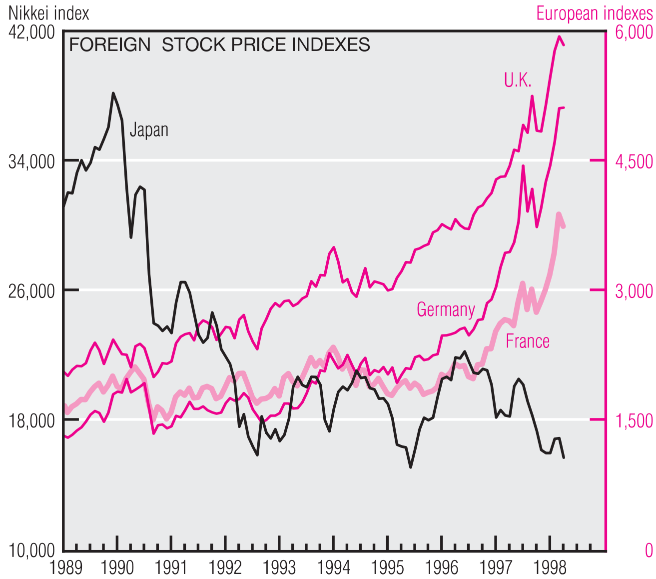
The Stock Market









a. The final earnings/price ratio observation is a preliminary estimate.
SOURCES: The Federal Reserve Bank of Cleveland; Standard & Poor's Corporation; DRI/McGraw–Hill; and Bloomberg information services.

The U.S. stock market continues to amaze most observers. Early April was characterized by a number of record highs for the major stock indexes, including the S&P 500. Although reported first-quarter earnings have increased only modestly, optimism abounds for horizons over a year or two. Recently, however, some nervousness has surfaced.

Pessimists fret that the earnings/price ratio (E/P) has fallen to a record low. Optimists, however, note that the decline in the E/P since 1982 largely mirrors the downward trend in bond yields, which is based in falling inflation expectations. Declining expected inflation effectively produces higher stock prices for a given level of earnings and hence has been a key element in the 16-year bull market. Continued low inflation is essential to support the current E/P.

A low E/P may also reflect an expectation of high earnings growth. The stock market's extraordinary performance in recent years reflects pervasive optimism about higher future earnings—a belief that has been largely validated since 1994. Recent skittishness in the market can be attributed to both concerns about rising bond yields and moderation in expected earnings growth.

In today's global economy, capital moves much more freely than in earlier years. Financial troubles in Southeast Asia have led many investors to redirect their capital from Asian to U.S. markets, thus supporting higher U.S. stock prices. Improving economic conditions in Europe, however, could make those capital markets even more attractive.