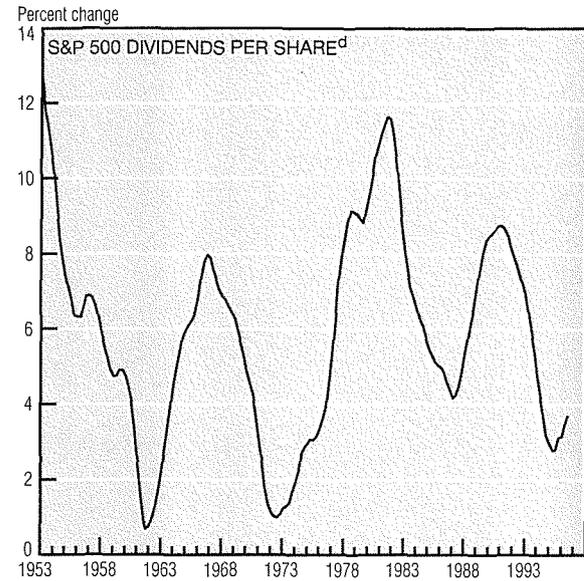
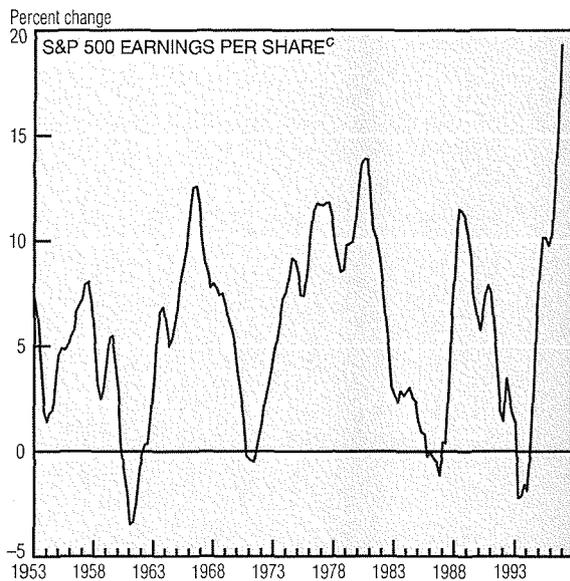
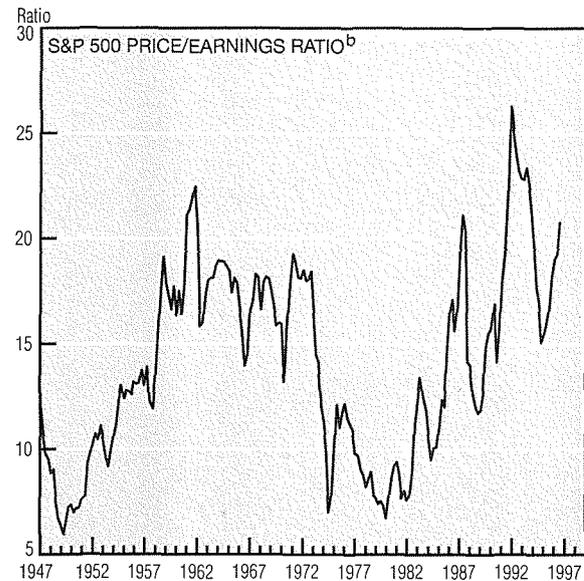
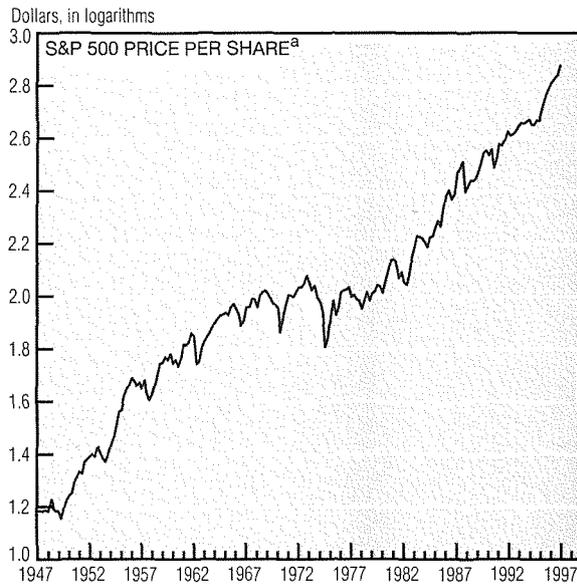


The Stock Market



- a. Last plot is the December 2 closing price.
b. Last plot is the December 2 closing price over preliminary 1996:IIIQ earnings.
c. Last plot is preliminary 1996:IIIQ earnings.
d. Last plot is preliminary 1996:IIIQ dividends.
NOTE: Growth rates are five-year moving averages of the four-quarter sum.
SOURCE: DRI/McGraw-Hill.

In recent months, much attention has been given to the stupendous ascent of the stock market. The rise in the Standard & Poor's (S&P) 500 index of more than 60% since December 1994, however, is not unprecedented in the post-WWII period. Between September 1953 and September 1955, for example, the S&P index increased more than 90%.

Fundamentally, a stock's price is determined by the discounted value of its expected future dividends. Future dividends ultimately derive from future earnings. When prospects for earnings growth are good, stock prices tend to rise. The price/

earnings ratio (P/E)—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. Although the P/E of S&P 500 stocks has been rising over the past two years, it is not unusually high.

The one clearly extraordinary fact has been the phenomenal earnings growth over the past five years, which is viewed largely as a product of corporations' widespread efforts to cut costs and become more effi-

cient. Current stock prices suggest that although earnings growth may slow, prospects remain good. This reflects an underlying expectation that economic expansion is sustainable with low inflation. Strong growth in private domestic investment in recent years has created a foundation on which to base such beliefs. Moreover, yields on fixed-income securities, such as Treasury bonds, suggest that inflation expectations are well contained. Historically, low inflation has been associated with balanced economic growth and a strong stock market.