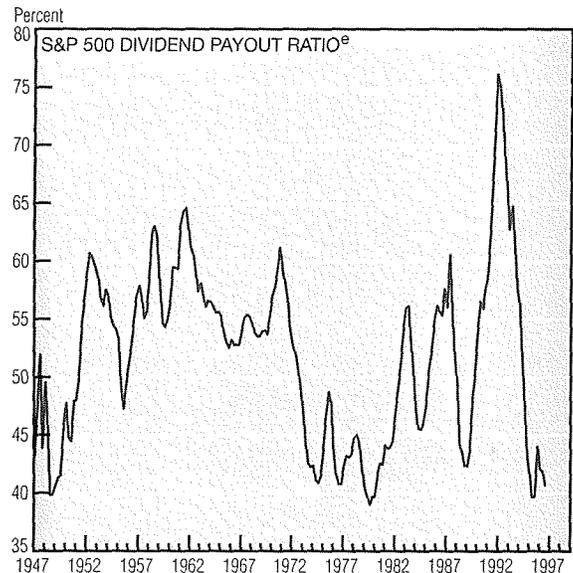
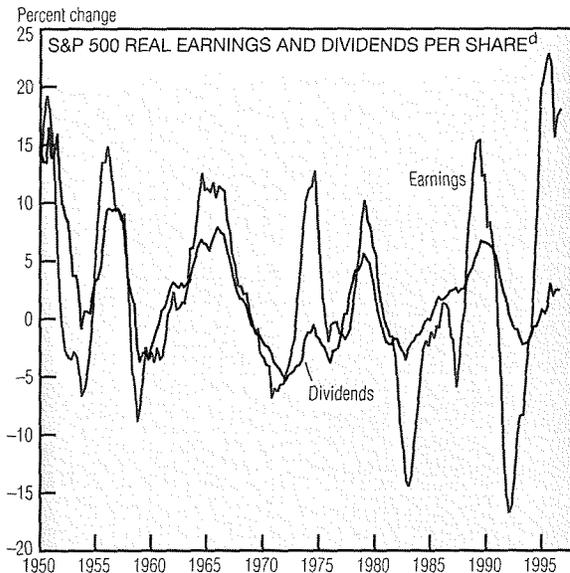
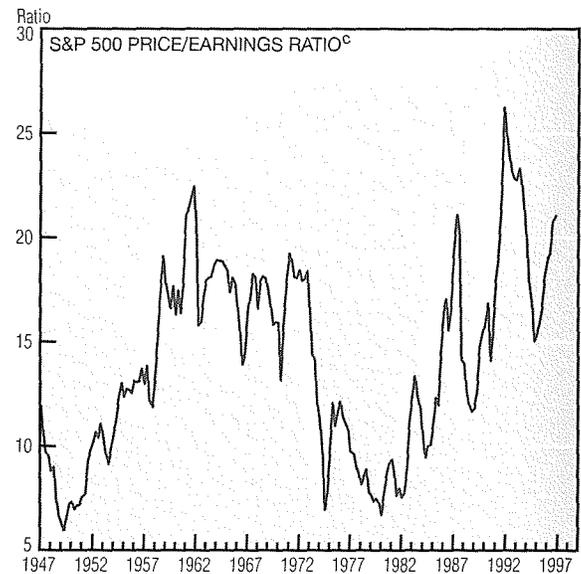
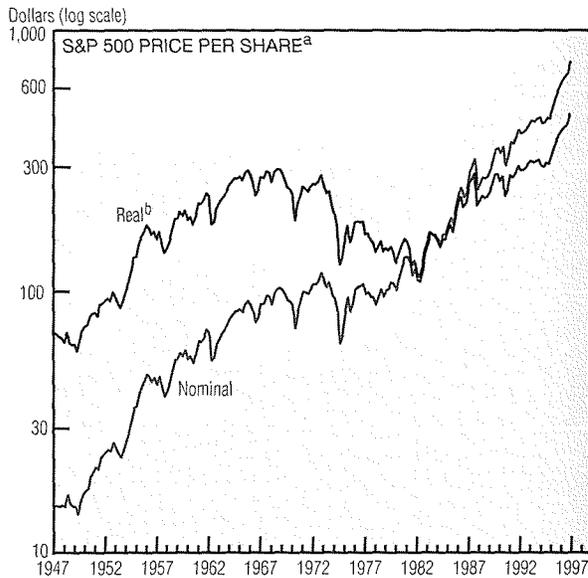


The Stock Market



- a. Last plot is the December 31 closing price.
 b. Real S&P 500 is the nominal S&P 500 divided by the Consumer Price Index.
 c. Last plot is the December 31 closing price over 1996:IIIQ preliminary four-quarter total earnings.
 d. In 1983 dollars. Last plot is 1996:IIIQ preliminary earnings and 1996:IIIQ dividends. Real earnings growth is the compounded growth rate of four-quarter total real earnings divided by four-quarter total real earnings three years earlier. Real dividend growth is the compounded growth rate of the current-quarter real dividend divided by the real dividend three years earlier.
 e. Last plot is 1996:IIIQ dividends over 1996:IIIQ preliminary earnings.
 SOURCES: DRI/McGraw-Hill; and Board of Governors of the Federal Reserve System.

Although volatile, stock prices have been trending upward since 1982. The Standard & Poor's (S&P) 500 index stood at 741 on December 31, 21% above its year-end 1995 level. Measured in constant-dollar terms, the index has risen 54% since 1994, compared with an ascent of 91% in the two-year period ending September 1955.

The recent surge in stock prices has been associated with especially strong earnings growth. Fundamentally, a stock's price is determined as the discounted value of its ex-

pected future dividends, which ultimately derive from future earnings. When prospects for earnings growth improve, stock prices tend to rise. The recent price/earnings level of the S&P 500 suggests that investors expect the strength in earnings to persist.

Since 1980, the variability of earnings growth has increased substantially, while the variability of dividend growth has remained essentially unchanged. Consequently, the dividend payout ratio (measured as dividends per share divided by

earnings per share) has swung widely in recent years. It now stands near its post-World War II low of 0.41, falling from a period high of 0.76 in 1992. Even if earnings growth moderates, dividend growth could accelerate if the payout ratio returns to its postwar average. Moreover, many firms have used earnings to buy back shares in lieu of paying dividends. This would explain part of the increase in earnings per share. It also bodes well for future dividends, because future earnings will be distributed among fewer shareholders.