Box 2 Bourses in troubles

Strong tremors have been shaking major stock exchanges on both sides of the Atlantic in the past few weeks. The EURO STOXX 50 index went down by 16% in three days in July, which is the sharpest decline since it was first compiled in 1998. The slide began on the US Stock Exchange after mid-May and was exceptionally sharp, especially in July. The main US equity indices have gone down by 18-21% over the past 60 days (before July 26), with more than half of the decline concentrated in the past 30 days. By comparison, the drop since the beginning of this year is in the range 17-25%. The decline in US equity prices since their historical peak in 2000 is unusually large. Nasdaq has plummeted the most, by almost three-quarters, while other indices have gone down by 30-45%.

This development must be seen in the context that equities had previously risen way beyond what was justified by economic fundamentals, especially in the USA. When prices peaked in 2000 they were almost twice as high as the average over the period 1995-1998 and three to four times higher than over 1990-1994. In part, this huge rise in equity prices was driven by unrealistic expectations, optimism and blind faith in the future of the high-tech industries and IT companies. This can be seen from the very sharp rise in the price to earnings ratio (P/E), which is in fact still high in historical terms. Despite a slump over the past two years, share prices are now similar to or higher than the average during the period 1995-1998. This fact and various other indicators could suggest that equities are still rather highly priced.

Accordingly, it can be argued that the reduction in equity prices was an inevitable adjustment to long-term normality. Sizeable over- or undershooting of equity prices is a familiar phenomenon. Compounding the decline due to weak fundamentals and inevitable correction of overinflated equity prices was a breach of confidence between investors and shareholders in the USA on the one hand and board members of listed corporations on the other hand, in the wake of scandals and exposure of dubious accounting practices. This breach of confidence may not be the main cause of the price slump in recent weeks, but rather the catalyst of price adjustment which could have been expected anyway.

Prices of European equities have dropped in sync with the US market. Links between national equity markets appear to have grown in recent years, partly because of the highly global nature of technology sectors. The EURO STOXX 50 index has gone down by 25% over the past 60 days and since the New Year it has fallen by just over 27%. Similar setbacks have taken place in the Nordic exchanges. The Swedish equity index has dropped by 30% in the past 60 days and by more than 18% over the past 30 days. However, the problems in the USA are not the sole culprit. The recovery of the continental economy seems to be anaemic and the performance of some major corporations has been disappointing. The recent rise of the euro may also be slowing down the euro zone export sector.

So has the recent slump in equity prices bottomed out and will the losses be recouped? Repeated attempts by the US authorities to calm the market and boost public confidence in corporations has not yet produced convincing results. Major factors in equity market mechanisms are trust, confidence and expectations, and these appear to be lacking. Until confidence has been restored a sustained recovery is unlikely. It is virtually impossible to predict when such subjective changes will occur. Equities do not appear to have become particularly inexpensive, judging on the basis of the P/E ratio from a historical perspective. For example, the calculated P/E ratio on the Dow Jones is 22.1, while the estimated value based on profit forecasts for this year is 15.5. The same goes for the P/E ratio of other equity indices. This suggests that pricing is still on the high side.

It is a cause of some concern that the slump in equity markets may have a negative effect on economic developments in the next few months, just when the US economy is recovering. The fall in share prices in the USA since 2000 is estimated to have amounted to as much as 6,500-7,000 billion dollars. This erosion of asset value can be expected to reduce private consumption and investment. On the other hand, housing prices, which are considered to have a stronger impact on private consumption than changes in equity prices, have remained strong.

Overview of equity price developments and P/E ratios in foreign markets

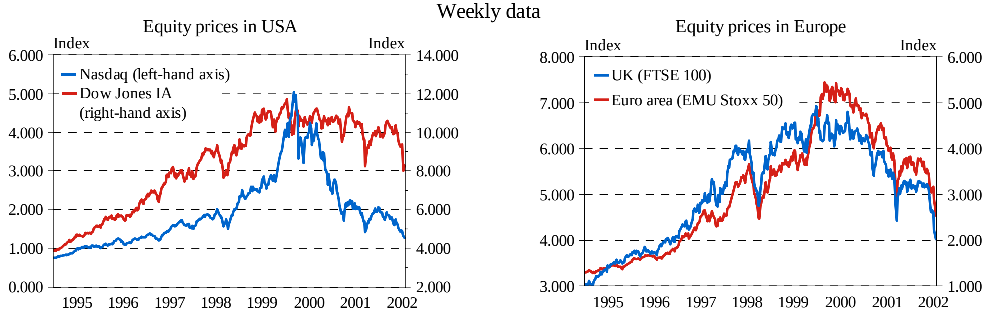
Region	*Sweden*	*UK*	*Germany*	*Euro area*	*USA*			*Japan*
Equity price index	*OMX*	*FTSE100*	*DAX100*	*DJ EURO STOXX 50*	*S&P500*	*DJ Indus. Average*	*Wilequity 5000*	*Nikkei 225*
Price change to July 26, 2002 (%)								
From highest value since 1995	-68.5	-42.0	-53.3	-53.6	-44.2	-29.5	-45.1	-54.0
From December 31, 2001	-42.8	-23.0	-29.6	-33.3	-25.7	-17.5	-25.2	-9.0
Past 30 days	-17.6	-11.4	-12.6	-14.0	-12.4	-9.4	-12.3	-4.8
Past 60 days	-29.9	-22.3	-26.6	-27.0	-21.3	-18.2	-22.0	-19.9

Region	*Iceland*	*Denmark*	*Sweden*	*UK*	*Germany*	*USA*		
Equity price index	*ICEX-15*	*KFX*	*OMX*	*FTSE100*	*DAX*	*Dow Jones*	*S&P500*	*Nasdaq*
P/E[1]	13.2	32.1	25.8	56.8	22.5	23.1	31.5	(negative)
Estimated P/E[2]	...	14.6	18.2	19.8	18.8	16.5	16.7	41.9

1. Based on profits in past 12 months and prices on July 25, 2002. 2. Based on profit forecasts for 2002.
Sources: EcoWin and Kaupthing Bank.

Equity price developments in foreign markets 1995-2002

Weekly data



Source: EcoWin.