Market crash — merely bursting of bubble?

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finances and you
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The price break of October 1987, followed an historically rapid increase in U.S. and world equity prices. From January 1986 until its peak in August 1987, the DJIA increased about 200 percent.

On Oct. 1, 1986, the index stood at 1782 and barely a year later at 2600. The price-earnings ratio for the S & P 500 averaged 22 in October, compared to the 30-year average of 14.

Equity prices on most of the world's exchanges moved upward during this period as well. The most dramatic increases were on the Tokyo and Singapore exchanges, where share prices increased 220 and 250 percent, respectively, from the beginning of 1986 until the peak in 1987.

Others were only slightly less dramatic. In the same period, London's index increased by 171 percent; Toronto's by 148 percent; and Switzerland Swiss Bank Corp. index by 138 percent. None of the world's major exchanges experienced a downturn during this period.

The price decline in the U.S. began on Tuesday, Oct. 12, when the DJIA declining by 10½ percent by the end of the week. Individual day declines were large, but not record-breaking.

Following the weekend of Oct. 17-18, the U.S. stock indexes declined sharply, with the DJIA falling by 23 percent to 1738 on Monday, Oct. 19. Sharp declines followed on all other world exchanges, with the Australia and singapore exchanges falling most abruptly (by nearly 50 percent). The high-flying Japanese market fell modestly in comparison, declining less than 15 percent.

The accompanying chart shows the magnitude of the price break in the DJIA, as well as the bumpy recovery of share prices since then. The DJIA now stands at around 2000.

The key question now is: Is the uncanny relationship between the October '87 and October '29 price movements simply the bursting of two bubbles or do they reflect similarities of the fundamental economic environment?

Fundamental Vs. Technical Factors

A stock price can fluctuate because of "fundamental" or "technical" factors. (For details consult Sid Mittra, Investment Analysis and Portfolio Management, Chapters 9 and 12).

Fundamental factors are those that alter the present discounted value of the future earnings and, hence, the value of a stock. These factors might include rising uncertainty about the outlook for the dollar and the trade balance, uncertainty about whether the federal budget deficit would be resolved, and legislative attacks on leveraged takeovers.

Technical factors are quite different in nature. These factors consist of those that affect the price-setting processes of the market, but not necessarily the assessment of the underlying value of individual firms.

Fundamental factors have been affecting the U.S. stock market for years. These include, as mentioned, budget deficit, a weak dollar, and a sluggish recovery. It is therefore difficult to square the abrupt movements in the stock market indexes with the fundamental factors.

The story of the technical factors is different. One technical factor frequently mentioned is the behavior of portfolio insurers. Portfolio insurers provide institutional investors with "insurance" against the value of their portfolio dipping below a specified minimum.

The insurers provide this protection by determining an appropriate balance between stock and cash in the portfilo. Carrying out portfolio insurance strategies generally involves selling equity futures into falling markets.

As the market began to fall in October, portfolio insurers sold equity futures heavily, as their strategy dictated. Another practice, index arbitrage, which exploits pricing disparities by entering into opposite transactions in the future and cash markets, then transmitted the downward pressure on stock futures prices to the stock market itself.

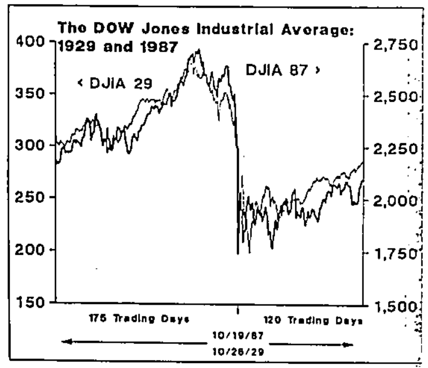
Portfolio insurers, however, argue that their strategy is no different in concept then the stop-loss orders that have been employed routinely in the securities markets for a century.

In addition, they argue that their sales — roughly $10 billion during the market decline — were trivial compared to the 'total values of shares outstanding (roughly $3 trillion).

Consequently it is argued that even the technical factors did not cause the 1987 crash.

Speculative Bubbles

The concept of speculative bubbles offers a third way of thinking about the October crash. A speculative bubble is a movement in the price of an asset that is unjustified by changes infundamental or technical factors. Some economists argue that speculative bubbles can exist in markets that are otherwise "efficient."



*Many economists have run statis*tical experiments on the nature of the October 1987 market crash in order to determine whether or not it was the result of the bursting of this speculative bubble. although not conclusive, many of these statistical measures strongly suggest that the Oct. 19, 1987, crash was indeed the bursting of a speculative bubble.

To conclude, if the uncanny relationship between the October 1987 price movements and those of October 1929 movements (see accompanying chart)is simply the result of the bursting of two bubbles, then the similarity of fluctuations in the DJIA during these two periods may say very little about the similarities of the fundamental economic environments existing during these two time periods.

Woman taking a stronger role in work world

focus: small business
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In its recent study, "The Changing Life Course of American Women," Cosmopolitan Magazine indicated that there is one fundamental demographic trend that has significantly altered the life course of today's woman. This trend relates to the role and participation of women in the work world.

There was a gradual increase in women's labor-force participation beginning in the 1920s that was fueled primarily by young unmarried women. Up to and through 1940, there was an increase in the number of clerical jobs and a corresponding increase in the wages offered for these jobs. After 1940, older and less well-educated women dropped out to get married and raise families.

Between 1940 and 1960 the percentage of women under age 35 who were employed outside the home declined — while the number of women over 35 entering the labor force increased dramatically. After 1960 and continuing today, this pattern has been reversed. Now we see younger, more highly educated women entering the workforce in greater numbers. The result is that both the education and experience levels of today's female worker has begun to increase at a faster rate than those of the male labor force.

IN TERMS of earnings power, from 1960 to 1980, the average hourly wages of full-time women workers remained at about 60 percent of male hourly wages. By 1983 the ratio had increased to 64 percent; by 1986, the ratio increased to 70 percent. Younger women are closing the gap at a much faster rate than older women, indicating the importance of higher educational levels for commanding higher wages.

This trend is expected to continue through the year 2000 as the female labor force becomes better educated and more experienced. The skills levels and wages of women are catching up to those of men; today's woman is much more likely to be a "career" woman who attains an education in order to work and plans to remain in the workforce throughout most of her adult life. Research also indicated that today's women are planning their lives around a commitment, acquired early on, to work.

This new role of women in the labor force has had and is expected to have significant effects on the purchasing power and behavior of households. The impact of women's earning on a household's demand for products and services depends on the type of household and the amount of other income available to it. For married couples where the husband is the primary wage earner or where the female heads the household, the relative contribution of women's earnings has remained unchanged. As a result, women who are married and work full time along with their spouses are a primary market now being pursued by both large and small businesses alike.

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