

Box 1

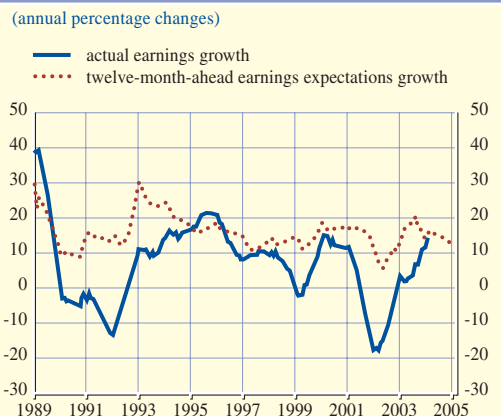
**WHAT IS THE INFORMATION CONTENT OF STOCK MARKET EARNINGS EXPECTATIONS HELD BY ANALYSTS?**

In theory, the price of financial assets is determined by the present value of the future cash flow that investors expect to derive from holding the asset. Applied to the valuation of shares, the price of a share should equal the sum of expected future dividends discounted by a risk-free interest rate and the risk premium which investors require for holding the share. Earnings expectations can replace expected future dividends in the valuation, if it is assumed that a certain fraction of earnings will be paid out as dividends. While investors' true expectations are not observable, earnings expectations by analysts in financial markets are usually available, notably for the very large corporations included in broad-based stock price indices. This box tries to assess the information content of these expectations. For this purpose, analysts' earnings expectations are compared with the corresponding outcome in actual earnings for broad-based stock market indices in the euro area and in the United States.

Chart A Earnings expectations and actual outcome for the MSCI euro area stock market index



Chart B Earnings expectations and actual outcome for the Standard & Poor's 500 stock market index



Sources: Thomson Financial Datastream and ECB calculations.  
 Note: Actual earnings extracted from January 1989 to February 2004 and expected earnings extracted from January 1989 to February 2005 on a monthly data basis.

One of the main data providers of analysts' earnings expectations is the Institutional Brokers Estimate System (I/B/E/S) of Thomson Financial. This database contains analysts' earnings-per-share forecasts for more than 18,000 companies in 60 countries. It is possible to calculate forecasts of earnings for all major international stock market indices over various horizons by aggregating the I/B/E/S earnings expectations for individual firms.

Charts A and B show the twelve-month-ahead earnings growth expectations and twelve-month actual earnings growth for the broad-based Morgan Stanley Capital International (MSCI) euro area stock market index and the Standard & Poor's 500 index, respectively. The expected earnings growth has been shifted twelve months forward to enable a direct comparison with the realised earnings outcome.

Three features are evident from the charts over the sample period January 1989-February 2004:

- Actual earnings growth generally tends to exhibit a more volatile pattern compared with analysts' twelve-month-ahead earnings growth expectations.
- Actual and expected earnings growth figures broadly move in tandem, i.e. upward and downward movements in earnings expectations tend to be followed by similar movements in actual earnings. This suggests that analysts tend to correctly anticipate the future direction of changes in corporate earnings.
- On average, expected earnings growth has been somewhat above actual earnings growth. This would seem to suggest that on average over the last 15 years analysts have provided a somewhat overly optimistic outlook for corporate earnings.

Finally, both charts show an impressive rebound in actual earnings growth in the course of 2003, following a relatively long period of negative earnings growth. At the current juncture, analysts expect a continuation of positive earnings growth in the future, and at levels that are, for the euro area, relatively high by historical standards.