Order Code RS21011
September 14, 2001

CRS Report for Congress

Received through the CRS Web

The Stock Market's Response to Dramatic Historical Events

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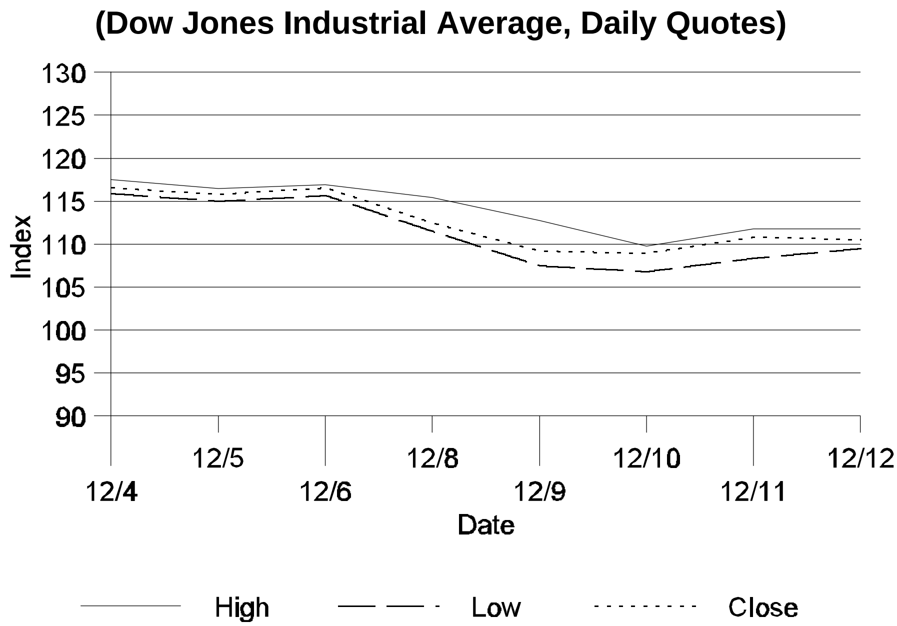
Summary

The events of September 11, 2001 have caused speculation that the U.S. stock market may crash when trading resumes. History, however, suggests that there is no uniform pattern in which bad news is followed by a stock market plunge. This report presents data on the stock market response to four episodes: Pearl Harbor, the Kennedy assassination, the October 1987 stock market crash, and the Asian financial crisis of 1997. There is, of course, no guarantee that the market will behave now or in the future as it did then.

Following the attacks on the World Trade Center and the Pentagon on September 11, 2001, there was much speculation that U.S. stock prices would plunge when the markets reopened. The stock market is of course highly unpredictable, but the historical record suggests that a price drop need not occur, and that, if it does, the effect may be short-lived. The charts on the following pages illustrate the behavior of the Dow Jones Industrial Average on the days before and after four disparate historic events.

After the attack on Pearl Harbor in 1941, stock prices declined by about 5% and then recovered slightly, as figure 1 below shows. Since the market was experiencing a generally downward trend during the months before and after the U.S. entry into the war, the long-term effect of Pearl Harbor on stock prices appears to have been minimal.

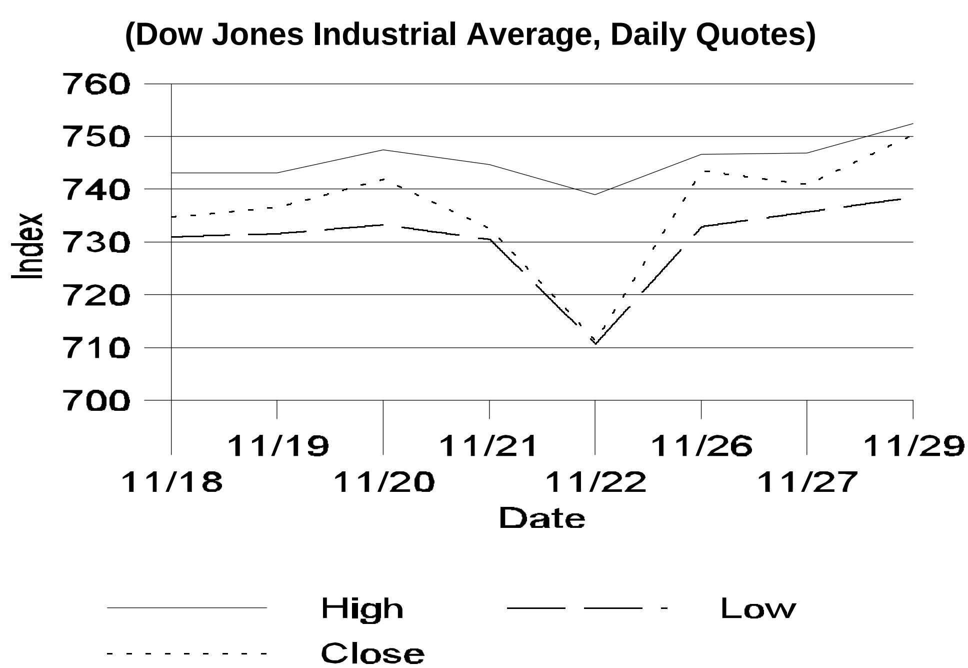
Figure 1. Pearl Harbor: December 7, 1941



Source: Dow Jones & Co.

On the day President Kennedy was assassinated, the Dow fell by about 3%, but prices recovered within a week. The effect on prices was largely confined to the day of the assassination itself.

Figure 2. The Kennedy Assassination: Nov. 22, 1963

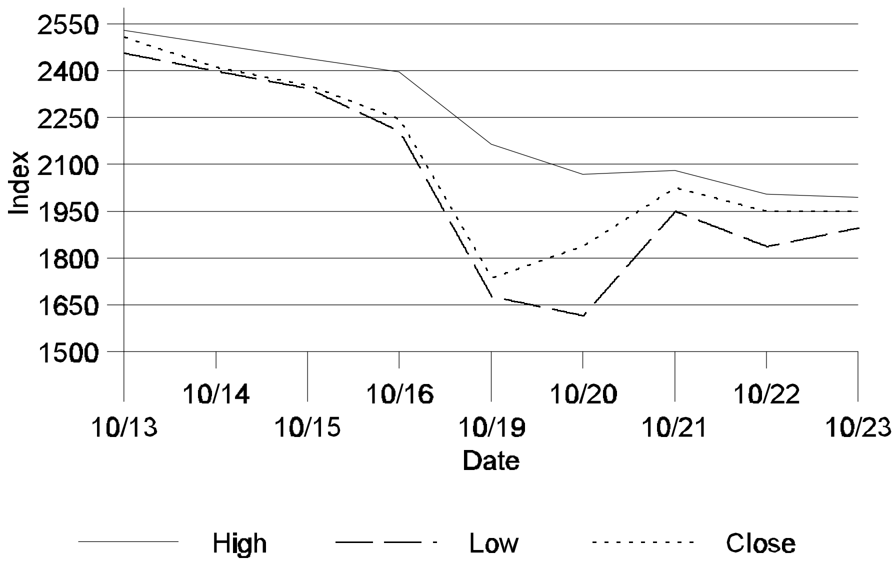


Source: Dow Jones & Co.

The stock market's worst day was October 19, 1987, when the Dow lost 23% of its value. The index recovered sharply over the following two days, but remained below pre-crash levels for many months. A puzzling aspect of the 1987 episode is the absence of any concurrent historical event to justify the magnitude of the price drop.

Figure 3. Black Monday: October 19, 1987

(Dow Jones Industrial Average, Daily Quotes)

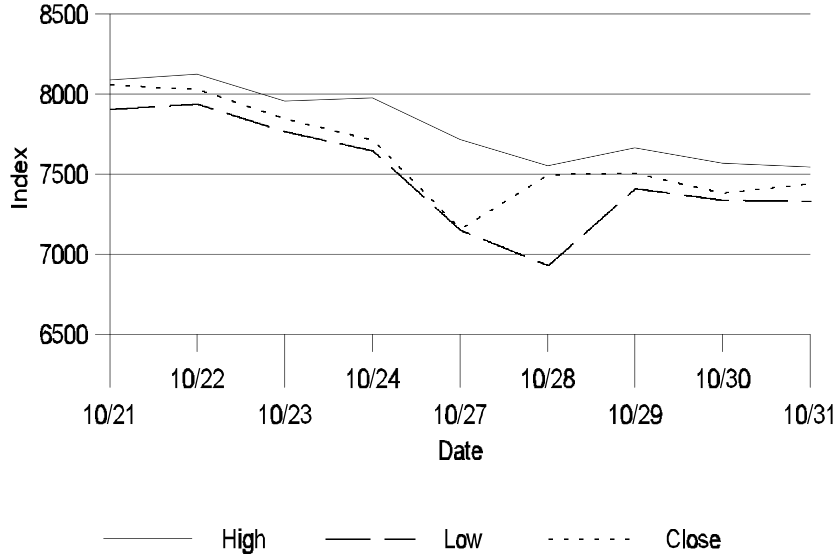


Source: Dow Jones & Co.

Finally, on October 27, 1997, when it appeared that the Asian financial crisis had spread to Hong Kong, the Dow fell by a record 554 points (7.2%), but climbed 337 points (another record) the next day. The most plausible explanation for this "yo-yo" market behavior is that investors in U.S. stocks fell victim to a brief panic. Certainly the Asian crisis could be reasonably construed as a threat to the U.S. economy (although, in fact, U.S. economic growth continued unabated), but the reaction of the market appeared to be out of proportion to the dimension of that threat.

Figure 4. The Asian Financial Crisis: October 27, 1997

(Dow Jones Industrial Average, Daily Quotes)



Source: Dow Jones & Co.

These selected examples, while not a guide to the future, suggest that calamitous news need not provoke a plunge in stock prices, and that the dramatic drops that do occur are often brief and soon reversed. Sharp price fluctuations may take place without any dramatic triggering event in the economy or the world, as for example in October 1987. Similarly, long, deep declines in stock prices (as in the late 1920s or early 1970s) generally coincide with economic downturns and do not begin with any particular piece of bad news.

Often, sharp market movements are attributed to investor panic. After the 1987 crash, the stock and futures markets imposed "circuit breakers" – trading halts that are triggered when prices fall by specified percentages. The intention is to prevent panic by giving investors time to assess the situation. The decision not to open the stock markets on September 11, 2001, and the forced closure on the following days, have given traders an involuntary, extended breathing spell.

Many believe that the events of September 11, 2001 represent a shock to U.S. economic prospects that will translate into a significant drop in stock prices. Others hold the contrary view: that the long-term impact on the economy will be small. The historical episodes presented here, while not a sure predictor of the future, indicate that the stock market's response to terrible news is not always dramatic.