better comparative value than we would have realized by matching some of the acquisition prices we saw. Through share repurchase, we were able to reduce the number of common shares outstanding by nearly 8 percent.

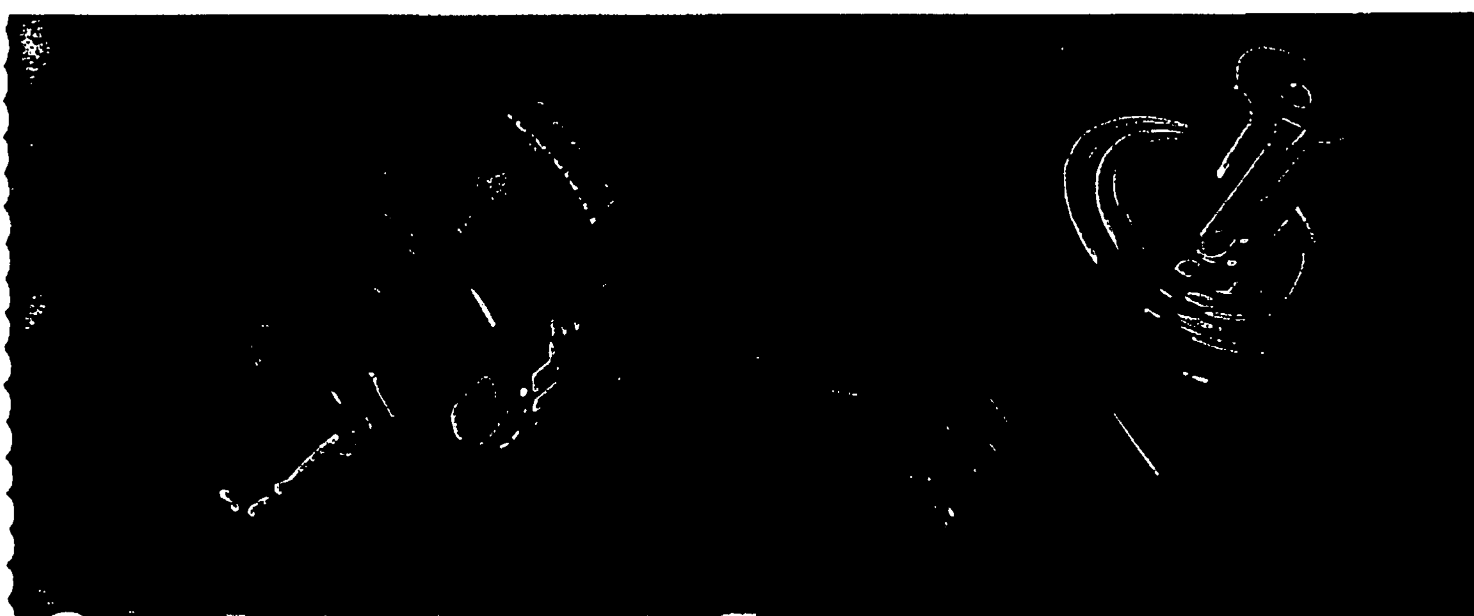
Last year, we felt grateful that most of the security analysts who follow us showed relative patience with our earnings and focused instead on the importance of the action steps that were being undertaken. While we continue to be disappointed with our valuation discount to the overall market, we are heartened by indications that at least some investors have begun to change their perceptions about Eaton: 1. We see more and more recognition of the economic thesis that we have discussed for a decade: Within the United States, industrial production will outpace the growth of consumption for the foreseeable future. 2. U.S. manufacturers have regained competitive advantage in many key global industrial markets. 3. Eaton is no longer simply a diversified vehicle components producer. Our stable of other businesses is impressive and highly competitive: from electrical and electronic equipment to hydraulics to semiconductor equipment. In addition, these globally competitive enterprises are complemented by some attractive specialty businesses. This diversification is a major plus for us. 4. Our businesses are fertile. We are committed to at least 10 percent annual earnings growth in all of our major operations. The opportunities exist if we can execute our plans well. 5. Eaton is far beyond being a company committed to change. We have already changed markedly. Our pace of change is accelerating, and we are committed to even more dramatic change in the future in order to compete effectively in global markets.

While our confidence and enthusiasm have increased, we are mindful of the enormous challenge we have taken on. It is hard to execute fundamental changes when business is at record profitability. Human nature resists moving from the proven to the relatively unproven. It has never been more difficult to compete for outstanding talent than it is today. We have to fashion compensation opportunities that are competitive and yet not fracture the spirit of teamwork that is a great Eaton strength. While we must focus more effectively on long-term strategic opportunities, we must accomplish our goals without impairing our traditional operational strengths. Overriding all of these considerations is the consensus that, while we must change some facets of our culture, we do not want to change those basic values that have served us well. Most important, the record sales, earnings and earnings per share of 1997 are evidence of the fact that we're devoting ourselves both to current performance as well as to strategies that assure long-term prosperity.

The best way for me to sum up our collective mood is that we no longer talk about strategic objectives. Rather, we reference our commitments to dynamic and accelerating change as we continue to strengthen and build Eaton's formidable competitive position.

Sincerely,

Stephen R. Hardis
Chairman and Chief Executive Officer



...nsmission gears and shafts (facing page, left) are being manufactured by Eaton in Brazil for the General Motors Corsa program. A new $70 million dollar manufacturing plant in Brazil will allow Eaton to double volume as the company enters phase two of a multi-year contract with GM. Cutler-Hammer's Arc-Fault Circuit Interrupter (facing page, right) recognizes and mitigates dangerous arcing faults in electrical circuits, a major cause of residential fires. For European automakers, Eaton manufactures an electrically piloted vacuum motor with integrated solenoid (above, left) that permits actuation of the recirculation door in automotive air conditioning systems. Automotive controls is a rapidly growing Eaton business worldwide. Eaton's Valve-in-Star 30 hydraulic motor (above, right) is only six inches in length but develops more than 17,000 pound-inches of torque. It provides power for skid steer loaders, crop sprayers and other agricultural and construction equipment.