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INVESTMENT COUNSEL

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ASEAN FLU

In recent weeks, the U.S. stock market has been incredibly volatile, reflecting, we believe, the confluence of three principal concerns: (1) the currency and stock market free falls first in the ASEAN nations and later the South American markets; (2) Fed Chairman Alan Greenspan's October congressional testimony; and, (3) the October employment report released in early November.

Free Fall In Emerging Markets

Clearly, investor nervousness has mounted since the initial currency upheavals this fall in Thailand, Malaysia and Indonesia which at first seemed quite remote to investors in the United States. After all, as we have pointed out in conversations with clients, only 4% of U.S. exports are destined for the ASEAN bloc. But in recent weeks, the ASEAN flu has spread: first to Korea, then to Hong Kong, and on to Brazil, Argentina and Mexico. The epidemic could no longer be ignored. Japan's stalled economy, which is more closely tied to the rest of Asia than ours, was dealt still another blow. Then, new questions arose: Would China competitively devalue its currency in order to maintain its share of global trade? What would happen to banks in Japan and Southeast Asia if Hong Kong is forced to devalue? Would Brazil plunge into a recession (taking Argentina with it) after its doubling of interest rates in order to defend the Brazilian currency? Meanwhile, back in the U.S., fast track legislation championed by the Republicans and President Clinton was in trouble despite the fact the last thing the world needed was anything that threatened to impede the free flow of goods and capital. These interlinked events, unfortunately, illustrate the potentially dark side of the globalization trend.

Greenspan Effect

In October, with the U.S. stock market elevated and expectations high, Greenspan warned that "if labor demand continues to outpace sustainable increases in supply, the question is surely when, not whether, labor costs will escalate more rapidly." The Fed Chairman had thus put the world on notice that continued strong employment reports were not likely to be ignored by the central bank. Meanwhile, with interest rates rising in the U.K. because of a strong economy, in Europe as a

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step toward monetary "convergence", and in Hong Kong and Brazil in order to protect their currencies, it was beginning to look as if the days of "easy money" had faded.

Strong Employment Report

Soon after Greenspan's warning, the Labor Department released figures for October showing a strong employment picture. The unemployment rate, at 4.7%, set a 24-year low while the climb in hourly wages accelerated to 4.2% year-over-year. Under ordinary circumstances, this news would have caused a bond market swoon and the October bond market rally would have abruptly ended. Instead, the bond market remained firm, as foreign money flooded into U.S. treasuries, the safest global haven for capital. Equity investors, in contrast, had an additional concern - - the possibility of tighter money ahead - - after reading the strong employment report.

The Outlook

We continue to believe the bull market for U.S. equities remains intact. The economy - - and corporate profits - - will continue to expand while interest rate hikes, if any will be modest. But as we (and many others) have warned, expectations have been very high and are unlikely to be fully met. We believe Alan Greenspan was beginning to sight signs of a developing asset bubble, similar perhaps to that of gold in 1979 or Japanese equities in 1989, and thus felt compelled to warn that a market correction would be a "salutary event". We agree, provided it is neither too sharp nor too protracted so as to undermine consumer and business confidence. We share investor concerns over a financial meltdown in Asia, inflation/deflation, the probability of disappointing profits in 1998, over enthusiastic investors, and certain elevated market valuation measures. However, there are offsetting factors that provide a degree of comfort. In the final analysis, we are confident the economy will progress through 1998 without a recession and without a serious acceleration in inflation. In fact, we may actually experience a quarter or so of deflation early next year. More important, though, is the recognition that the U.S. is the world's leader in the four hallmarks of the new economic order:

- Globalization/free trade
- Technology/innovation/productivity enhancement
- Capital Markets/equity preference
- Political Stability

While current correction may have somewhat further to go, the “safe haven” aspects of the United States in a global context and the “equity preference” attitude of the typical mutual fund shareholder will probably cushion any remaining downside. Nevertheless, the widely anticipated 10-15% correction, which we long ago forecast, is finally upon us.

For our part, we continue to believe our client stock holdings are well positioned with strong balance sheets and very well defined growth prospects. However, as our concerns over the ASEAN situation began to mount earlier this fall, we administered a mild flu shot to client’s portfolios by adding three holdings, which we felt, would be relatively immune to developments abroad - - Walgreen, Household Finance and Eli Lilly. All three performed defensively as expected during the market slide of late October/early November and have shown good strength relative to the stock market as a whole during its recent bounce. These new holdings now amount to about 9 percentage points of our typical client portfolio.

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