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INVESTMENT COUNSEL

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The Economic Outlook

As widely anticipated, the Federal Open Market Committee cut its federal funds rate target by ¼ percentage point to 4.75% in mid November. The FOMC statement accompanying this action signaled that the easing was motivated by two principal concerns: (1) unusual strains in the global financial markets and (2) the expectation that the U.S. economy is likely to slow next year so that an easier monetary posture is now appropriate. Continued turmoil in the commercial paper market and historically wide spreads between the yields on U.S. Treasury obligations and lower-rated corporate bonds were likely additional factors contributing to the Fed's decision.

We now anticipate the FOMC will stand back for awhile and assess whether the three easing steps it has taken over the past 2+ months are sufficient to keep the economy on a moderate growth trend. If, as we expect, the economy slows this winter and into the spring, we believe the Fed will gradually ease further, possibly by as much as an additional ½ to ¾ percentage points by year-end 1999. Our expectation of further easing is predicated upon two conditions that should cause real economic growth to slow to 2-2 ½% from its third quarter 3.9% pace.

- Unsustainably strong gains in the U.S. stock market, coupled with high levels of consumer confidence, have pushed the *savings rate* into negative territory. We believe this trend is not likely to persist for very long, especially if the stock market's advance cools. Should the savings rate then rise, consumption -- a major driver of this economic expansion -- will grow more slowly than income, restraining the pace of economic activity.

- *Investment spending* is vulnerable because the level of capital outlays is already sufficiently high to build plant and equipment capacity at a rate faster than demand growth. Declining capacity utilization rates are

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already evident, and the increasing slack in manufacturing is likely to constrain profit growth and cause businesses to cancel or defer some of their capital spending plans.

Our current best guess is the Fed's next accommodative move will take place in late winter or early next spring. All in all, then, while the economic expansion we have enjoyed will slow in 1999 to a more sustainable pace, we see no recession in the offing. Furthermore, we believe there is little reason to expect our current low inflation climate will change and cause the Fed to have second thoughts about further reducing rates.

Financial Markets

Global financial turmoil finally reached our shores this summer following meltdowns in the Asian, Russian and Latin American markets. The broad U.S. stock market indices declined by almost 20% between mid-July and early October. Meanwhile, prices of small-cap and mid-cap stocks tumbled by as much as 45% from their already depressed levels. Emerging market shares fared even worse where declines of 50% to 60% or more were common. And, as panic gripped the global equity markets, spreads dramatically widened among fixed income securities, demonstrating extreme risk aversion on the part of most investors. The single class of investments to perform well during this period were U.S. Treasury bonds, whose yields declined to a record low level of 4.7% as the global "flight to quality" intensified.

At its nadir, the decline in stock prices reflected an adverse economic scenario we believed highly unlikely to unfold. This view led us to "stay the course" during the market's plunge. Elsewhere, the combination of fear, uncertainty, doubt and despair led many market savants to worry that a paralyzing credit crunch would develop in the U.S., exacerbated by a "negative wealth effect" on consumption spending, which would be followed by a recession in 1999. Their advice was to "sell" before share prices declined still further. In fact, several prominent market analysts turned bearish within days of the Dow Jones Industrial's intra-day low of 7400!

Over the past eight weeks, the likelihood of such a succession of events has dramatically, and appropriately, receded and the major stock market indices have remarkably snapped back to their prior highs. Many technology stocks and health-care issues -- core holdings in our client's portfolios -- have actually made new highs.
We believe the following have contributed to improved investor confidence:

- actions taken by the Federal Reserve and subsequently, by other central banks, to provide liquidity and to restore investor confidence;

- data released revealing on-going economic growth in the U.S., including 3.9% G.D.P. growth in the third quarter as well as strong sales of homes, cars and trucks and general merchandise.

- the gradual, rather than precipitous deleveraging of large “hedged” portfolios (i.e. Long Term Capital)

Undoubtedly, the status quo sentiment of the American voters evidenced in the November elections has also been a factor contributing to the calmer environment we now enjoy.

The shares of many large U.S. companies have now retraced much of the ground they lost this summer. The cross currents of year-end tax induced selling, institutional window dressing, fourth quarter earnings disappointment pre-announcements and seasonally strong cash flows will contribute to a choppy market over the intermediate term. Long term, we continue to believe stock selection will be critical to developing above average investment returns as we seek to create the proper blend of ***growth*** and ***value*** shares in client’s portfolios.

More Stable Global Markets

Many clients have been asking whether the actions this summer and fall of the G-7 policy makers will be sufficient to maintain the recently achieved stability in global financial markets. Analysts have cited six policy changes needed to stabilize those markets and to provide the underpinnings for improved global stock market conditions. These are:

Policy Change	Action
• easier monetary policy in the U.S.	Done
• lower interest rates and easier credit conditions in the EU	Done
• release of U.S. funds for the IMF	Done

• a G-7 package to prevent contagion of emerging market problems to new countries	Done
• a fiscal tightening, pension reform and IMF funding for Brazil	Largely Completed
• a credible banking reform package and fiscal stimulus measures in Japan	Work-in-progress

While the early G-7 response seemed to be ad hoc at best, it has gradually become more cohesive and now appears to be sufficient to significantly reduce the risk of a global recession next year. Examples of those measures are: the 75 basis point cut in the U.S. federal funds rate; the approval of a $41 billion package of international assistance for Brazil; a new debt restructuring initiative for Asia led by Japan and the U.S.; an additional 7 trillion yen fiscal package in Japan (2 trillion yen this year and 5 trillion yen in 1999). These should combine to stabilize the global economy next year, paving the way for a quite vigorous expansion in the year 2000.

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As we approach the holiday season, we are thankful for our many clients, friends and associates whose encouragement and support have been central to our firm's success over the past four and one half years. Trees Front Associates now serves over 200 clients with assets under management of nearly $1.4 billion. For this we are, indeed, grateful.

Seasons greetings and best wishes for the New Year from all of us at Trees Front to you and yours.