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ECONOMIC OUTLOOK - - SOFT LANDING AHEAD

Economic growth in the U.S. has been incredibly strong - - too strong for the Federal Reserve which remains on inflation alert. Following the fourth quarter's rapid 7.3% advance in real GDP, the first quarter produced a 5.4% gain powered by the largest surge in consumer expenditures in 17 years, well above-trend business investment and solid housing starts. However, a sour note in the GDP figures was the unexpected acceleration in the Implicit Price Deflator to 2.7%, which, when combined with the CPI's 3.8% first half increase, provided the impetus for the Fed's 50 basis point rate hike on May 16th. Government pay increases and higher oil prices were widely cited as the culprits behind these worrisome first quarter inflation numbers.

Meanwhile, other gauges of inflation paint a more favorable picture. For example, the core Consumer Price Deflator rose just 1.7% in the past six months and the core Producer Price Index ticked up only 1.0% during the same period. Productivity gains, which have slowed from the boom readings of late 1999, remained strong enough to have kept unit labor costs at a very modest 0.7% for the 12 months ending March.

Our forecast for a "soft landing" with slower GDP growth of 3-3 ½% and the moderation of headline CPI inflation to 2.3% in the second half of this year are based upon our analysis of newly released economic statistics, anecdotal evidence gathered from contacts, and the following considerations:

1. The liquidity added by the Fed in late 1998 and 1999 is being reversed. Growth in MZM (the broadest measure of transaction balances in the United States) has been contracting for 16 months, from a peak of 15% in December, 1998 to 6.6% by early May of this year. And the six-month growth rate of the monetary base has plunged from 10% and 12% in September and early November, 1999 to just 2% in early May.
2. Key leading economic indicators are already turning down. Recently, analysts have noted slackening inflation pipeline pressures in the National Association of Purchasing Managers Prices and Vendor

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Performance Index which measures bottlenecks and delays in the delivery of goods. Also, interestingly, truckload carriers are now reporting that their usual seasonal surges in April and May are among the lowest in the last ten years. And just today, the Chicago Purchasing Managers reported a decline in both their Business Barometer and their Prices Paid Index for the month of May.

3. Bank lending policies have tightened and business loan demand has fallen by over 25% in recent months. These trends are classic precursors to a business slowdown.

4. Housing has peaked. The last years' sharp rise in short and long-term interest rates, with mortgage rates now at their highest levels in over 5 years, has already produced a peak in housing starts and other construction activity. Moreover, sales of existing homes have also slowed with April transactions dropping by 6.2% to a seasonally adjusted annual rate of 4.88 million units down from a 5.2 million pace in March.

5. Capital spending will be less stimulative to overall activity because of somewhat slower corporate profit growth and a higher cost of capital resulting from higher interest rates. Recently released data confirms that growth in corporate profits slowed in the first three months of the year, while profit margins improved only slightly, suggesting the bottom line at many firms may be squeezed in the months ahead. We believe the peak rate of profit growth for this cycle is probably now behind us.

6. Demand for big-ticket items, a target of Fed policy, has moderated. April figures registered the steepest decline in durable goods orders since late 1991, and consumer spending rose at its slowest pace in nine months - - additional new indicators of a slowing in the economy. The unexpected 6.4% decline in orders for durable goods was paced by a record 20.1% plunge in orders for electronics and electrical equipment including semiconductors. Meanwhile, slower growth in consumer spending in April helped lift the personal savings rate (savings as a percentage of after-tax income) to 0.7%, the best showing since January.

7. The strong dollar, in part a legacy of the 1998-1999 currency crises, will remain a drag on net exports according to conversations with industry contacts who report they continue to face a savagely competitive global environment.

8. The current *cyclical* inflation scare appears to us to be less threatening than that of 1994. In contrast to that period, industrial and sensitive metals prices have fallen this year, the dollar remains strong, and productivity is booming.

All in all, then, we have begun to see some early, yet quite promising signs of a welcome cooling in the economy and we have reason to believe the recent pick-up in inflation will soon abate. The Fed is likely to view these developments favorably as they unfold. While we still expect an additional 50 basis point increase in the Fed Funds rate, an end to the Fed rate increases this summer prior to the Presidential campaign is quite likely. Stay tuned!!

Favorable Longer Term Trends

Despite the recent uptick in *cyclical* inflation, we see no disturbance to the longer-term *secular* trend of lower inflation that began 20 years ago and no important deterioration in the favorable economic fundamentals of which we have frequently written. These fundamentals include:

1. Monetary policy has been preemptive with the goal of reducing inflationary risks.

2. Demographics are constructive and are projected to remain favorable for at least the next 8 years with a declining number of people in the 25-49 year age range.

3. The growth in the use of technology and the Internet continue to portend solid productivity gains and cost reduction opportunities for business. At last count, only 1% of all business-to-consumer and business-to-business transactions were conducted via the Internet. As the use of the Internet spreads and its penetration increases, it will prove to be a powerful global deflationary force.
4. Budget surpluses here and abroad are deflationary with defense outlays and government spending in check.

5. The competitive positions of U.S. companies in expanding international markets have strengthened reflecting enlightened government antitrust policies. While disconcerting, we do not view recent Department of Justice antitrust actions against Microsoft and the Worldcom/Sprint merger as a serious threat to this trend.

6. The aggressive global consolidation of major industries via mergers and acquisitions enhances productivity improvement, marketing and distribution opportunities.

7. Managements are more highly motivated to create increased shareholder value because of the wider use of stock options as incentives.

These favorable forces are still at work. Once the near term uncertainties are clarified, positive fundamentals should drive the stock market to new highs, but probably in a less dynamic manner than in recent years.

Fed Rate Risk

As noted earlier, we expect real GDP growth to slow to a 3-3 ½% rate in the second half of this year and then hold at near that level well into 2001. In line with this forecast, we see S&P operating earnings slipping from their 16% growth this year to about 10% in 2001. The risk to this forecast is that the Fed moves too aggressively, the outcome of which would likely be economic and earnings growth somewhat slower than the forecast. However, we see little chance of a recession on the horizon.

Financial Market Outlook

Just how our equity market will react to the slower earnings growth we expect will depend upon the course of inflation and real bond yields, the key underpinnings of stock market multiples. For example, in the aftermath of the 1995 "soft landing," S&P earnings growth dropped sharply from 21% in early 1995 to just 6% by September 1996. However, the S&P, which fell a modest 1.5% in 1994, rose 34% in 1995 as inflation fears receded and bond yields fell from over 8% to 6%.

In the months ahead, we expect bond yields first to remain at or about their recent levels and then to decline significantly, as signs of a slowing in economic activity become more widespread. Further hikes in short term rates would, in our opinion, be favorable for bond performance. Stock prices, particularly those of "old economy" shares, should continue the recovery they began in mid-February as

their price/earnings ratios rise. We see continued tough sledding for unseasoned, speculative "new economy" shares without the prospects of sustainable earnings. Nasdaq leaders, bellwethers for the general market, have seen their multiples cut by a third or more in the past two months. While we do not expect the valuations of these market leaders to contract much more, their *infallibility* has been called into question and their *momentum premiums* may not quickly return. Rather, their *individual* performance will be driven by their earnings growth prospects which, by and large, appear to be excellent as the Internet is built out and the use of new communications technology continues its torrid growth pace.

Portfolio Strategy

Our March letter described the modest reduction we made in the first quarter of this year in the *growth* component of client's equity portfolios. The proceeds of these sales were largely reinvested in *value* shares which have since recovered from their earlier depressed levels, in some cases approaching their previous 12-month highs. We plan to maintain the balance between *growth* and *value* we achieved through these changes until the impact of the expected slowdown in corporate profit growth works its way more fully through the stock market. While the current correction in the broad market indices has probably already run its course, we believe the market will remain choppy and volatile within its range of the past 6 months until investors gain greater confidence that the last of the Fed rate increases is at hand.

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