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THE BUSINESS OUTLOOK: SLOWING CONSUMER SPENDING

With the overall economy growing at an astounding 5% annual rate in the first half of this year, it's easy to miss the fact that a slowdown is under way, at least in some key sectors. The year long rise in short-term interest rates and the accompanying contraction in real monetary growth, coupled with the satiation of pent up consumer demand, foreshadow a continuation of the slowdown in consumer spending that commenced this spring. In conversations with clients, we have highlighted statistical and anecdotal evidence of slower growth trends in previously ebullient interest rate sensitive industries including housing, home furnishings, autos and other consumer-related durable goods. These patterns, along with moderating employment growth, support our view that the U.S. economy has entered into a period of less robust consumer spending growth which should persist well into the new year. This is reminiscent of the ten-month slowdown that occurred in 1995 following a similar contraction in money supply growth and a doubling in short-term interest rates.

Confirming this incipient slowdown was last week's GDP report that showed consumer outlays, which account for over two thirds of total economic activity, increased at a rate of only 3% in the second quarter, the slowest pace since 1997 and less than half of the 7.6% growth rate registered in the prior quarter. Clearly, the Fed's tightening, which can affect the economy with a long and variable lag, typically 9-18 months, has begun to have an impact which, we believe, will lead to the "soft landing" we forecast in our May 31st letter to clients.

Partially offsetting the moderation in consumption in the second quarter was strength in business spending which accounted for nearly one third of the 5.2% increase in GDP in the April-to-June period. Rising investment by business underpins the hope of continued rising productivity. New equipment, in effect, enables workers to increase their output and enhances business revenues. These added receipts are then available to grow profits or to raise wages, or both, without an increase in prices. In fact, labor pay and benefits continued to rise in the second quarter but at a mild, less-than-expected 1.0% rate down from the 1.4% increase in the first quarter. And finally, industrial production excluding computers, telecommunications equipment and semiconductors, was flat through the first half

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of the year. Clearly, monetary policy is working exactly as expected: raising the cost of capital to the point where many consumers and investors are restraining their spending.

Inflation Remains Benign

Inflation has risen slowly and remains benign. The second quarter GDP report showed the deflator, the broadest measure of prices covering almost every price change in the economy, rising at a 2.5% annual rate. While this rate was higher than last year's levels, partly because of higher gasoline prices, this measure actually declined from a rate of 3.3% during the first quarter. Other important indicators of inflation "pipeline" pressures maintained by the National Association of Purchasing Managers (NAPM) appear to have seen their highs for this cycle. These include statistical series of prices, new orders, backlogs, and vendor performance. In addition, sensitive materials prices such as lumber and scrap and spot metals have been in their own bear market since last year. We also believe that crude oil prices, which reached $34 a barrel earlier this year, have probably peaked and should move lower as the recently announced OPEC oil production increases work their way into the system. Finally, the cresting in May of long-term bond yields continues to suggest the earlier inflation scare is largely over.

Given continued slower growth in consumer spending, the "tops" in cyclical inflation indicators and moderate increases in worker's pay, we believe the Fed is near the end of its tightening mode. If it does raise rates again at its August 22nd meeting, reacting to possible strong employment figures for July to be released this Friday, we believe the hike will be only 25 basis points. Financial market reaction to such an increase should be muted, as was the case at the end of the interest-rate cycle in early 1995.

Consumer Spending

From a long-term perspective, the aging of the "baby-boomer" segment of the population has helped to raise the underlying trend of consumer spending since early 1998, an effect that should persist in coming years. We also take issue with the widely held view that recent gains in consumer spending were mainly propelled by a direct "wealth effect" (which excludes 401(K) and retirement plan investments) related to rising equity prices and that a plunge in share values would depress consumer spending. Indeed, analysts have noted that half of American households own no equities, and the concentration of equity ownership is highly skewed to wealthier households. Specifically, the wealthiest 10% of households

own 90% of all equities held by the household sector, and the wealthiest 1% of households hold 50% of them. The direct "wealth effect" may have had an impact on purchases of luxury goods and expensive homes, but the surge in personal consumption and residential ownership in 1997-1999 was more broad based. The positive impacts of job security and growing family incomes should not be understated.

S&P 500 Earnings Prospects

The slowing domestic economy and resulting more difficult year-over-year comparisons are likely to create some headwinds for corporate profitability just as higher interest rates have generally held stock prices in check over the past twelve months. However, we do not expect a sharp deceleration in S&P 500 company earnings growth. In fact, the current backdrop should produce double-digit gains through year-end as the positive effects of the productivity boom and the continuing shift to the S&P 500 of younger, faster growing companies help fuel profit growth. Indeed, the greatest risk to our constructive profit outlook would, as some fear, be a sudden, premature resurgence of rapid economic growth in the second half of this year with the Fed then tightening more aggressively than is currently expected.

NAIRU

In his latest round of congressional testimony, Fed Chairman Greenspan seemed to abandon a venerated principal of economics, one that the Fed still invokes as its justification for tightening credit conditions to slow the economy. This principle, known by the acronym NAIRU, maintains that full employment and low inflation are incompatible. When the unemployment rate falls below a certain level, inflation is likely to accelerate. One goal in slowing the economy is to increase unemployment to its "natural" level, the one at which the inflation rate neither rises nor falls. In his testimony, the Fed Chairman said that "NAIRU, which served as a very useful statistical procedure to evaluate how the economy was behaving… like so many types of temporary models which worked, is probably going to fail in the years ahead as a useful indicator."

NAIRU, or the *non-accelerating inflation rate of unemployment*, is really a description through equations of a set of conditions that link unemployment to inflation. Those conditions seemed a lot clearer in 1967 when Milton Friedman,

the Nobel laureate, first described a natural rate of unemployment and enumerated the several factors that must be "embedded" in these equations. In the early 50's and 60's, the math worked. A low unemployment rate signaled robust demand for goods and services. Emboldened by this, a group of workers in one industry would negotiate a so-called "bellwether" settlement that became the pattern for millions of other workers across many industries. Employers, as a matter of course, raised prices to help pay for the higher wages. Strong demand made the price increases stick; today's flood of quick-to-discount competitors was not yet on the scene.

Since 1995, demand has been similarly robust, but raising prices has not been easy. Wages have risen only modestly in response to low unemployment. The old NAIRU links from unemployment through wages to inflation have not kicked in. It may be that rising productivity, falling computer prices, less-expensive imports, low-wage immigrants, weak unions, corporate mobility and/or job insecurity are the cause. The list goes on, and the natural rate of unemployment, thought to be 6.5% in the 1980's, has been lowered today to 5% or less. Possibly, NAIRU no longer works. Certainly, Mr. Greenspan's seeming disavowal of it makes it harder for the Fed to invoke tight labor markets as a reason to slow the economy in anticipation of rising inflation. The Fed is, therefore, under increased pressure to wait for inflation to actually accelerate before it acts.

Equity Investment Strategy

Earlier this year, we moved to anticipate both the consumer spending slowdown referred to above and the eventual end to Fed interest rate hikes. Positions in companies whose businesses are viewed as sensitive to slowing consumption, such as broad-line retailers, have been avoided and shares of financials, which should receive renewed investor interest once an end to the rate increases is at hand, have been emphasized. Holdings of pharmaceuticals, whose earnings are viewed as insensitive to the economic cycle, have also been augmented. And among industrial enterprises, we have built holdings in diversified manufacturing companies such as Illinois Tool Works, Tyco International and SPX Corporation where we believe top line growth will remain strong despite the economic slowdown. Client's technology stock holdings were trimmed in order to accommodate these tactical shifts. These sales have resulted in a better balance between *growth* and *value* holdings in our client's equity portfolios.

Finally, the broad stock market indices have been flat to lower since April, 1999 when the Fed began its tightening. In our letter to clients early this year, we forecast "choppy" stock market conditions through mid-year 2000 and then a better

stock market environment in the second half as an end to Fed interest rate hikes came into clearer view. While we continue to believe the year is likely to end on a positive note, investors' enthusiasm may be tempered in the weeks ahead by unfounded fears of a "bumpy landing" stemming from a premature pick-up in business activity this fall and the possibility of overly aggressive Fed tightening to cool the economy. We would assign less than a 40% probability to this scenario. Currently, we anticipate better stock market conditions as we approach the Presidential elections and prospects for the candidates clarify.

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