

December 11, 2000

**THE ECONOMIC OUTLOOK - - FED EASING AHEAD**

Readings of recently released economic data provide further hard evidence that growth in U.S. business activity, slowed by a series of six Fed credit tightenings, a weak stock market, higher energy prices and the seeming satiation of pent-up demand for big ticket consumer goods, has since mid-year moved to a more moderate rate.

Last Friday's closely watched monthly jobs report showed that American businesses continued to add to their payrolls in November but at a slower pace than in the first half of the year, presenting yet another sign the economy has cooled but that it is nowhere near the recession some pessimistic seers fear. The reported unemployment rate, which remained roughly flat last month, rising to 4.0% from 3.9% in October, has now remained between 3.9% and 4.1% for 14 consecutive months, reflecting the tightest labor market since 1970. The jobs report, which also showed work weeks shortening, comes on top of earlier declines in the Conference Board's index of Leading Indicators, measures of durable goods orders, consumer confidence, the growth of business investment, and retail sales. Indeed, the latest Federal Reserve survey of business conditions - - the so called beige book - - revealed eight of the Fed's twelve regions cited anecdotal evidence of slower overall growth led by weakness in manufacturing; weak auto sales, which prompted steep discounts and temporary plant closings; and a slight easing in the ultra tight labor market.

Taken together, the data portray an economy that has moved into a new stage of its decade-long expansion, buffeted by slower consumer spending and weak manufacturing activity but sustained by resilient services industries, which account for over half of GDP, and a still robust housing sector buoyed by falling mortgage rates and refinancings. Overall, we see GDP growth slowing to a 2.75% to 3.5% rate during the current quarter and through mid 2001 before a reacceleration of activity commences. For 2001 as a whole, we see GDP growth of 3.8%. The picture is one of an economy that has slowed without any significant indication of a pick-up in core inflation - - exactly the "soft landing" Fed policy makers had hoped to engineer through their earlier interest-rate hikes - - and one quite

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consistent with our forecasts earlier this year. Indeed, our firm's proprietary Econometric Model, a copy of which is attached, is now indicating the economy is likely to level off at a 3- 3 ½% growth rate after having correctly anticipated the current slowdown as early as last March.

### Interest Rates

The economy's evident slower growth, and comments made by Fed Chairman Greenspan last Tuesday in New York, indicate open market interest rates are likely to continue to fall in the weeks ahead. Chairman Greenspan's comment that with the economy losing steam, "one must remain alert to the possibility that greater caution and weakening asset values in financial markets could signal or precipitate an excessive softening in household or business spending" virtually assures the Fed will abandon its bias toward tightening credit, despite the tight labor market, when it meets later this month. Actually, a small but growing minority of rate watchers are now predicting a rate cut as soon as the next Fed meeting on December 19<sup>th</sup>. It is our belief the Fed will reduce short-term rates to encourage spending at least twice during the first half of the New Year bringing the Federal Funds rate to 5.75%. Benchmark 10 year U.S. Treasury bond rates, now at about 5.4% are currently forecast to decline to about 5% and may briefly overshoot this level. As the Fed begins to ease credit conditions following the New Year, yield spreads between high quality Treasury bonds and medium quality corporate bonds are likely to narrow from the current historically wide 175-200 basis point spread allowing smaller companies and less credit worthy borrowers to obtain financing on more favorable terms. Interestingly, both Federal Funds futures and the shape of the Treasury yield curve now portend several rate cuts early next year.

### Inflation and Oil Prices

Thus far, the much publicized jump in energy prices has not triggered a broader increase in core inflation, which remains subdued. Since earlier this fall, crude oil prices have fallen about 25% from their peak of \$37.15 per barrel. Although the medium term path for oil prices through 2001 and 2002 is subject to enormous uncertainty, we believe the next several weeks, through early 2001, will mark the period of maximum vulnerability to oil price spikes. Seasonal demand is certain to increase at a time when crude oil production, refinery runs, and transportation are all operating at or near full capacity, while inventories remain at or near record low levels. Once the weather in the northern hemisphere begins to warm, however, demand is likely to decline substantially, reducing the world's exposure to possible supply disruptions and price spikes. We continue to expect oil prices to trend

lower, declining to about \$25 per barrel by this year-end, as we had earlier thought. Furthermore, we would not be surprised to see crude oil prices retreat to the low \$20's per barrel next spring as speculators and hedge funds unload crude positions and some businesses unwind excessive crude holdings - - many at losses.

### Corporate Profits

As the U.S. economy slows, corporate profit growth is likely to moderate as well. For the corporate sector as a whole, the slowing is apt to be quite sharp. For 2001, for example, after tax corporate profits are forecast to grow at only a 2.5% rate, down from the 11.0% increase likely in 2000. This slowdown stems from three factors in addition to the slowing in output growth. First, labor productivity will probably decelerate as business growth moderates. Second, the trend in hourly compensation has been rising in a lagged response to an energy-driven acceleration in consumer prices. In combination with a slowing in productivity, this will cause unit labor costs to rebound. Third, interest expense will continue to grow rapidly as companies finance a large portion of their capital spending with externally generated funds. Fortunately for the equity market, which correctly focuses on the profits of publicly traded companies, this deceleration should be more moderate for the earnings of S&P 500 companies. These firms are more dependent upon manufacturing, where the productivity trend remains quite strong. In addition, recent changes to the S&P, where a number of slower growing, "old" economy stocks have been dropped in favor of more rapidly growing technology shares thereby enhancing the index's growth. Further, S&P 500 companies, due to their global exposure, stand to benefit from the weakness in the U.S. dollar we anticipate, particularly against the Euro which has already begun to strengthen. Thus, we now expect to see S&P 500 company profits rise about 8% on an operating basis in 2001, following an increase of over 10% for 2000, with the toughest comparisons occurring in next year's second quarter.

### Favorable Longer-Term Trends

Despite the current Fed engineered cyclical slowdown in business activity and its slowing impact upon corporate profit growth, 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 secular economic fundamentals of which we have frequently written. To recap, 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 continues to pretend solid productivity gains and cost reduction opportunities for a vast number of industries in the “old” economy. At last count, only 1% of all business-to-consumer transactions were conducted via the internet. Business-to-business transactions will also be materially impacted by internet initiatives over time. As the use of the internet becomes more pervasive, and its penetration increases, we believe it will prove to be a powerful deflationary force.
4. Budget surpluses here and abroad are deflationary with both defense outlays and other government spending in check.
5. The competitive positions of U.S. companies in expanding international markets have strengthened reflecting generally enlightened government antitrust policies.
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 factors remain firmly in place. Once the very near term uncertainties surrounding the Presidential election, the depth and duration of the current business slowdown, and the weakness in the Euro are clarified, positive fundamentals should drive the U.S. stock market to new highs, most probably in a less dramatic manner than in recent years.

### U.S. Equity Market

In our early 2000 equity market forecast, we foresaw “choppy” market conditions in the first half, gradually giving way to a more favorable environment as the elections drew near and the year-end approached. It was our belief that an earlier than expected end to Fed credit tightening, combined with growing investor confidence that a “soft landing” would play out, would shift investors sentiment into forward gear following a stalled stock market for much of this year. Following Labor Day, market savants began to question whether higher energy prices, not seen since the 1990 Gulf War, coupled with the weak Euro and tight credit conditions would precipitate a “hard landing”. Nervous investors scurried for cover and remain on the sidelines, preferring to first see a resolution of the Presidential election and further signs the Fed will, indeed, ease before adding to positions. Meanwhile, equity mutual fund cash positions have ballooned and money market mutual fund balances have risen to record levels, approaching \$1.9 trillion, indicating the existence of substantial potential demand for equities when the uncertainties are clarified.

With oil prices already retreating, the Fed signaling it will be more accommodative in the months ahead, the Euro moving toward parity with the U.S. dollar and the Presidential election likely to be settled soon, we expect the stock market to firm before year-end in anticipation of better corporate profit comparisons in next year’s second half.

### Equity Investment Strategy

Clients will recall that equity portfolios under our supervision have benefited from our discipline of blending *growth* and *value* stock holdings, an approach that both defines our investment style and distinguishes us from most other investment advisers. Earlier this year we reduced the *growth* component in favor of increasing the proportion in *value* shares to insulate portfolios from a possible correction in technology stock valuations which, at the time, appeared to be excessive and unsustainable. The bulk of the proceeds of these position reductions were reinvested in then depressed shares of pharmaceuticals, financials and diversified manufacturing companies. We intentionally under-weighted portfolio exposure to economically sensitive holdings within the consumer spending sector since we viewed these areas as particularly vulnerable to the negative impact of tight credit conditions, reduced consumer confidence and higher energy prices. Until recently, we maintained this somewhat more defensive posture. In the last few days, however, we began initiating positions in depressed economically sensitive shares by making an initial, partial commitment in Wal-Mart. It is our intention to move further in this direction over the weeks and months ahead. To make room for these

new holdings, we plan to gradually reduce positions in a number of the portfolio's defensive holdings which have been strong performers during this year's uncertain market.

Portfolios under our supervision since year-end 1999 continue to show positive returns despite the declines in the broad stock market indices, including our benchmark, the S&P 500 Index. We believe current portfolio concentrations in financials, which historically have benefited from easier credit conditions, depressed high quality technology stocks, well diversified industrial companies with strong top line growth, and pharmaceuticals position client portfolios to participate in the market's recovery as conditions turn more favorable.

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As the holiday season approaches, we wish all of our clients and friends good health and good fortune in the New Year.