

March 21, 2000

**ECONOMIC OUTLOOK: “OLD-ECONOMY VS. NEW-ECONOMY”;**  
**REMEMBER THE FUNDAMENTALS**

Following the economy’s 6.9% growth spurt in the final quarter of last year, which capped a strong 4.1% increase for all of 1999, the current 109 month old business expansion continues to rock along at a very robust pace. Initial data for the current year show both the business and consumer sectors of the economy advancing rapidly. On the business side, industrial production and non-defense capital goods orders exhibit continued strength. Average hourly wage gains, personal income and housing starts, also remain firm in the consumer sector. Only continued weakness in existing home sales, a modest slowing in personal expenditures and smaller than expected employment gains in February signal some cooling in economic activity. For the current quarter, then, we forecast inflation adjusted GDP growth to exceed 5% as consumer spending, fueled by strong employment conditions, favorable wage growth and the “wealth effect” of high equity prices, power the economy ahead. Higher energy prices, which act much like a tax increase, and Federal Reserve rate hikes seem to have had little or no dampening impact upon the economy so far.

Despite continued well above-trend growth and tight labor markets, Fed Chairman Greenspan in recent testimony noted that he could find few signs of inflation outside of the energy sector. Nonetheless, he has clearly and forcefully signaled that the Fed is serious in its resolve to stay well ahead of the inflation curve by raising short-term interest rates in a measured manner until signs of a slowing in the economy actually emerge. Therefore, unless the economy begins to lose steam soon, we face the likelihood of one or possibly two additional 25 basis point increases (beyond those announced today) in both the Fed Funds and discount rates into early summer. We believe the Fed will then pause for awhile to assess the impact of its several rate hikes.

Looking beyond mid-year, we expect economic growth to moderate as a result of the confluence of the following factors:

1. Tighter Monetary Conditions. The liquidity added by the Fed in late 1998 and 1999, in response to the Asian crisis and Y2K concerns, has begun to reverse as evidenced by a sharp contraction in the monetary base since early this year. We expect further Fed tightening in the coming months to drain additional liquidity from the banking system and the economy.
2. Weaker Housing. The housing industry, already dampened by the jump in interest rates, and other interest rate sensitive industries, will be adversely affected by increased borrowing costs.
3. Slower Consumer Spending. Consumer spending will increase at a more moderate rate as employment gains slow, income growth tapers off, and higher energy costs, which act much like a tax increase, as they work their way through the system.
4. Moderating Capital Spending. Capital spending increases are likely to add less to overall growth as corporate profits gains slow from their current pace and the cost of capital rises due to higher interest rates.
5. Stronger Dollar. With the dollar strengthening again, exports are likely to continue to be a drag on the economy.

Given these factors, we see 2<sup>nd</sup> half GDP growth slowing to 3% with inflation remaining benign. In fact, headline inflation numbers are likely to improve in the coming months as energy prices fall in the wake of production increases likely to be approved by OPEC members next week. Clearly, we believe a slowdown is in the making. However, with no recession in sight, and the peak in long-term interest rates for this cycle already behind us, we believe the investment outlook remains favorable for both bond and stock investors, albeit within a continued volatile environment.

### **“Old-Economy” vs. “New Economy”**

“Old-economy” stocks have been in their own bear market over the past two years as investors have increasingly bought “new-economy” companies. This market divergence has dramatically widened since last summer. Since its peak in mid-July, non-technology companies in the S&P 500 index have lost almost 20% of their market value while technology companies now in the S&P 500 have gained an amazing 42%. Thus far in 2000, the Nasdaq composite has added almost 600

points to near 4,800. Meanwhile, the Dow Jones Industrials, arguably the embodiment of the old economy, were down about 1700 points until last week's startling rebound. Absent the recent substitutions within the Dow Jones Industrials of winners such as Intel, Microsoft, Home Depot and SBC Communications for losers including Union Carbide, Goodyear, Sears and Chevron, the Dow's performance would have been markedly worse - - by more than 500 points. While equity portfolios under our supervision continue to outpace the S&P 500 - - up over 10% for the year-to-date versus a flat S&P - - our discipline of combining *growth* and *value* stock holdings in client equity portfolios has sensitized us to the bear market valuations of old economy shares, many of which would fall into our *value* category. Indeed, 78% of the S&P 500 companies sank more than 20% below their 52-week highs by late February. About 79% of all stocks were recently trading below their 200-day moving averages. This is significant because 80% readings have in the past marked a bear-market bottom.

The most important indicator that argues for a broad market recovery, which would encompass depressed "old economy" *value* shares, is the recent revival in long-term bond prices. Since mid-January, both 30-and 10-year bond yields have fallen by more than 75 and 60 basis points respectively. Interestingly, at this writing, long-term bond yields are again below 6%. Fixed income investors continue to debate whether or not these declines in rates reflect some subtle signs of slowing economic growth and inflationary expectations not yet widely recognized. Bond *bulls* point to a possible peak in housing starts, noticeably slower job growth in the first two months of this year, moderating wage inflation, and the strength of the U.S. dollar. Bond *bears*, on the other hand, opine that bond yields are down simply because of reduced U.S. Treasury credit demand. From our standpoint, it matters little which view is correct. In either case, lower bond yields are constructive for equity valuations, particularly depressed *value* shares of companies whose earnings growth rates can be sustained during the slowdown in economic growth we see shaping up later this year.

Given our belief that selected *value* shares will return to favor as the economy slows and open market interest rates edge lower, we have in recent weeks modestly reduced the *growth* stock component in client equity portfolios while adding to depressed financials, pharmaceuticals, and diversified manufacturing companies which offer compelling valuations and which we expect to positively impact portfolio performance in the period ahead.

## **Remember the Fundamentals**

As investors parse daily business developments for their investment implications and fruitlessly try to fathom the stock market's gyrations, it is often worthwhile to step back from the day's headlines and to focus upon the fundamentals, of which we have so often written. Despite all of the talk about stock market valuation, there is considerable substance underpinning today's stock market. Consider the following:

1. The U.S. economy is entering its tenth consecutive year of expansion, the longest on record. Moreover, few "late cycle" imbalances exist. No one is forecasting a recession.
2. Inflation is a no-show. As noted, even the more than tripling of oil prices has had little impact upon the overall inflation rate.
3. Productivity gains are enormous, leading to double-digit gains in profits for most large cap companies. In fact, we expect 20% profit growth this quarter for the S&P 500 companies.
4. The consumer is supremely confident. Why not? Jobs are plentiful; real incomes are rising; asset values are rising – homes and stock portfolios are at or near their peaks for most of us.
5. The U.S. is the world's only superpower; our economic system is the envy of the world. Despite the past travails of Clinton, U.S. leadership has never been more dominant. And both Bush and Gore, more or less centrists in their economic views, will move even closer to the center as the presidential hustings progress.
6. The U.S. leads the world in information technology and innovation at an historic world- changing juncture that compares with the impact of the steam engine, electricity, mass production, the automobile, or possibly the printing press.
7. Equities, as a class of assets, have not had a serious down year since 1974, and only three moderate, widely separated declines since then. Thus, equities are not viewed as "risky" as they once were. There is even a serious debate underway in academic circles as to whether equities are less risky than bonds.

8. The rest of the world has recovered from the Long-Term Capital/Asian/Russian/Brazilian financial crises of 1997 and 1998. International worries are few. Gold is dead!!
9. Mergers and acquisitions, as well as stock buybacks, have tended to offset the supply of shares issued in new stock offerings.
10. Company management compensation is more closely “aligned” with that of stockholders through options and equity ownership. Shareholder value concepts are spreading globally as evidenced, most notably, by the recent, previously unthinkable, takeover of Mannesman by Vodafone.

### **Stock Market Outlook**

Despite the favorable fundamentals, market history shows that investor sentiment over any *shorter period* of time will run the gamut from excessive fear to unbounded greed. Markets, and sectors within markets, inevitably go to extremes which defy precise forecasting. Our best guess is the stock market in general will continue to be range-bound during the first half of this year. Unseasoned, illiquid, high-flying technology and biotech shares will eventually absorb a disproportionate share of whatever correction takes place. Beyond this looming readjustment, though, well run technology companies with solid business models, will strengthen their positions as market leaders. Clearly, we have only begun to see the economic benefits to our society of the computing and communications revolution now underway.

\*                                 \*                                 \*                                 \*

Long term, economic fundamentals remain very favorable with inflation low, interest rates moderate by historical standards, productivity rising rapidly, demographics positive and economies abroad recovering. We, therefore, counsel our clients to maintain, and where advisable, to add to equity positions during periods of market weakness.