The Investment Environment *January 2000*

As we enter the first quarter of the year 2000, it appears certain that the present economic expansion will break the old U.S. record for longevity of 106 months, established in the 1960s. This record has stood for 30 years and will likely be broken in February 2000. Concurrently, the last federal budget surplus our nation experienced was in 1969. Now, 30 years later, we are experiencing a federal budget surplus. Does this indicate that our politicians are more knowledgeable and disciplined or that the rapid growth in a long business cycle overwhelms even the desire of politicians to spend more money than is available? We will, hopefully, choose the former.

Looking ahead, the question becomes … "How much longer can this cycle continue?" The optimistic answer would be "forever" in the present "new era" characterized by robust and rapid technological change, and enhanced economic, financial, and business knowledge in conjunction with a growing global interrelatedness. I say this in somewhat of an Aldous Huxley "*Brave New World*" spirit associated with science fiction. On the other hand, there is no question that we did not get to our present position without the benefit of some knowledgeable (a cynic could argue lucky) macroeconomic decisions at the fiscal and monetary levels, and numerous positive benefits from advancing technology. One major benefit is the technological enablement of improved inventory control. This reduces inventory excesses, which could trigger an economic downturn. This is not to say that the business cycle is eliminated or dead, only to note that certain risks have been greatly diminished. So this leaves us entering a "new era," at least in terms of the duration of U.S. economic advances. How much longer this economic cycle will last is beyond our ability to forecast. We will continue to seek to identify and evaluate the risks and imbalances in the economy, and the world, that could derail this economic expansion. For us, this is not new in that we have been applying the same approach for the last 106 months and, fortunately, have not been able to identify any conditions which were capable of initiating a U.S. recession. So far so good.

Adding to the excitement of a record cyclical advance is the advent of a new century and a new millennium. The Webster's Third New International Dictionary 1966 Edition definition 2b under millennium is defined as "a period of prevailing virtue or great happiness or perfect government or freedom from familiar ills and imperfections of human existence." After looking this up, the thought occurred to me that maybe I have been underutilizing the dictionary as a forecasting tool. So with that for an introduction, let's now turn to look at the current economic environment as we enter the year 2000.

The Economic Environment

The U.S. economy continues to advance at a robust pace, driven by relatively strong consumer spending and very strong spending for business capital investment, primarily for equipment and software. Drivers behind these strong sectors are the tight labor markets, strong equity markets, and the desire by business to utilize the latest technology to enhance productivity and reduce costs.

The major question being debated in today's business economic environment is "How fast can our economy grow, in real terms, before inflation begins to rise in a meaningful manner?" This is a very crucial question, in that once inflation starts to rise meaningfully, we then will likely be faced with a more forceful Federal Reserve tightening which would likely lead to higher interest rates and possibly a cycle-ending recession. Higher interest

levels would also likely diminish the attractiveness of equities, possibly precipitating a stock market decline. A stock market decline could diminish consumer confidence and impact their willingness to spend, as their stock market wealth is threatened.

Should this scenario evolve, the "new era" thinking could come under significant pressure. Consequently, this clearly highlights the continued importance of the Federal Reserve in the new era economic environment. Hopefully, we will be able to capture the essence of the current economic expansion through the use of the following table. While Table 1 may appear to be a bit busy and somewhat intimidating, we will attempt to segment it and comment on the various components in order to piece together the current environment, along with its risks and rewards.

TABLE 1

Year	(A) Real GDP Growth	(B) Personal Consumption Expenditures	(C) All Civilian Unemploy-ment Rate	(D) Consumer Savings Rate	(E) Business Equipment and Software Investment	(F) Total Industrial Capacity Utilization Rate	(G) Change in Consumer Prices	(H) Non-Farm Business Sector Productivity
1999E	+3.9%	+5.0%	4.2%	+2.5%	+12.5%	80.5%	+2.3%	+2.8%
1998	+4.3%	+4.9%	4.5%	+3.7%	+15.8%	81.8%	+1.6%	+2.8%
1997	+4.5%	+3.7%	4.9%	+4.5%	+11.5%	82.9%	+2.3%	+2.0%
1996	+3.7%	+3.3%	5.4%	+4.8%	+11.0%	82.4%	+3.0%	+2.7%
1995	+2.7%	+3.0%	5.6%	+5.6%	+11.5%	83.4%	+2.8%	+1.0%
1994	+4.0%	+3.8%	*6.1%	+6.1%	+11.9%	83.2%	+2.6%	+1.3%
1993	+2.4%	+3.0%	6.9%	+7.1%	+11.3%	81.3%	+3.0%	+0.1%
1992	+3.3%	+3.2%	7.5%	+8.7%	+ 7.4%	80.3%	+3.0%	+4.0%
1991	-0.2%	+0.2%	6.8%	+8.3%	- 2.0%	79.3%	+4.2%	+1.6%

* Data beginning Jan. 1994 not directly comparable with earlier periods

Real GDP Growth

This first component of Table 1, column (A), shows the real growth of the U.S. gross domestic product (GDP) annually, beginning in 1991, with the brief recession of 1990 bottoming in March of 1991. In each of the component columns, the data for 1999 represents our estimate. One interesting aspect of this extended cycle was the rather slow start attained in the first 33 months from the bottom of the recession in March of 1991 through 1993. During this period, the credit imbalances of the prior cycle were being healed. The economy strengthened noticeably in 1994 and the Fed acted pre-emptively to tighten money, to prevent the creation of an environment which might lead to the strengthening of inflation. As can be seen in column (A), GDP growth slowed meaningfully in 1995. The economy strengthened in 1996 and, since then, has grown at a rapid pace. On the surface and, in reality, this would appear quite positive. Prior to the last three or four years, it was widely thought that rapid real GDP growth above a general level of around 2.0%-2.5% would become inflationary once the utilization of physical capacity and human labor penetrated certain levels. Plant capacity utilization became suspect near or above 84% and labor utilization elicited concern as the unemployment rate declined below 5.5%-6.0%. Thus, the warning signals were in place to justify the Fed to move toward a soft landing in 1994. It is our belief that the slowdown in 1995's real GDP set the stage for the superior growth subsequent to that time. Our next segment will discuss the components of the strong GDP growth of recent years. Later, we will discuss the apparent improvement in the important productivity measure.

Components of Recent Strong Growth

59 Racine Street Suite A - P. O. Box 8012 - Menasha, WI 54952-8012
phone: (920) 729-7900 - *fax:* (920) 729-7904 - *website:* www.northstarinvestments.com

At this point, we will reproduce columns (B), (C), and (D), and discuss their role as drivers of recent economic strength.

Year	(B) Personal Consumption Expenditures	(C) All Civilian Unemploy-ment Rate	(D) Consumer Savings Rate
1999E	+5.0%	4.2%	+2.5%
1998	+4.9%	4.5%	+3.7%
1997	+3.7%	4.9%	+4.5%
1996	+3.3%	5.4%	+4.8%
1995	+3.0%	5.6%	+5.6%
1994	+3.8%	*6.1%	+6.1%
1993	+3.0%	6.9%	+7.1%
1992	+3.2%	7.5%	+8.7%
1991	+0.2%	6.8%	+8.3%

Column (B) depicts the annual growth rates of personal consumption expenditures. Since personal consumption expenditures represent approximately 67% of total GDP, the consumer's growth of spending is a significant factor in the overall economy's growth. As can be seen in column (B), consumer-spending growth has been strong in recent years. Supporting this strong spending has been a very robust job market throughout most of this advance. This is graphically illustrated in column (C), which shows the consistent decline in the unemployment rate since 1992. The diminished fear over job availability has increased consumer confidence and spending. On 12/28/99, the Conference Board's Consumer Confidence Index jumped to its highest level in 31 years. Further evidence of this trend is shown in column (D), which presents the steady decline in the consumer's savings rate during most of the 1990s. In fact, prior to a recent revision in the calculation, the consumer had experienced a negative rate of savings since the first quarter of 1999. The lower consumer savings rate is widely associated with the rising stock market's enhancement of many consumers' feeling of well-being through the so-called wealth effect.

The second important component of the strong real GDP growth in recent years is depicted in column (E).

Year	(E) Business Equipment and Software Investment
1999E	+12.5%
1998	+15.8%
1997	+11.5%
1996	+11.0%
1995	+11.5%
1994	+11.9%
1993	+11.3%
1992	+ 7.4%
1991	- 0.2%

The growth of spending in recent years in the business investment sector, as shown in column (E), has been quite impressive. For comparison purposes, this measure grew at around a 3.5% compound annual growth rate from 1984-1989. While this comparison may not be exact, due to revisions in the methods of calculation, it does indicate a meaningful acceleration of spending in this area. This is the sector where the new era's information age resides. It represents 78% of non-residential fixed investment. Since 1990, spending in this area has grown at a 9.7% compounded annual growth rate, while total gross private domestic investment (of which it represents 56%) has grown at 6.9%. Spending for non-residential structures grew at a 0.9% rate, while residential housing spending expanded at a 4.1% compounded annual growth rate over the same period, 1990-1998. This rapid expansion in business equipment and software reflects the desire of businesses to avail themselves of the latest innovative technology and software to control their costs, and to increase their competitive position in a very competitive domestic and global environment. Many companies and industries do not have much pricing flexibility and seek to enhance their competitive position through the application of the latest technological advances, many of which center around the internet and electronic commerce.

The following, column (F), depicts that the rapid technology spending has reduced the nation's capacity utilization rate, thereby diminishing the pressure on prices due to tightening supply constraints.

Year	(F) Total Industrial Capacity Utilization Rate
1999E	80.5%
1998	81.8%

59 Racine Street Suite A - P. O. Box 8012 - Menasha, WI 54952-8012
phone: (920) 729-7900 - *fax:* (920) 729-7904 - *website:* www.northstarinvestments.com

1997	82.9%
1996	82.4%
1995	83.4%
1994	83.2%
1993	81.3%
1992	80.3%
1991	79.3%

Inflation and Productivity

A "new era" essentially means that things do not currently work as they did in the past. The characteristics of today's "new era" would seem to center around a number of economic outcomes being evidenced at present which appear to be inconsistent with what one would have expected based on prior relationships.

Probably the most dominant of these current outcomes is the low level of inflation being evidenced (column (G)) in conjunction with a steady decline in the unemployment rate (column (C)) representing a level which, by past standards, would have been deemed to be highly indicative of rising inflation.

Year	(G) Change in Consumer Prices
1999E	+2.3%
1998	+1.6%
1997	+2.3%
1996	+3.0%
1995	+2.8%
1994	+2.6%
1993	+3.0%
1992	+3.0%
1991	+4.2%

The "Phillips Curve," named after A. W. Phillips of the London School of Economics, postulated that below a certain level of unemployment the rate of wage increases would rise. Since wages represent a large cost of doing business, the Phillips Curve relationship came to relate labor tightness with inflation. This relationship has clearly not applied in recent years as can be seen in columns (C) and (G). On the other hand, the industrial capacity utilization rate, shown in column (F), is consistent with supply and demand analysis. Consequently, the "new era" breakdown between supply and demand relative to inflation seems to center around the increasingly tight labor markets in the U.S. The major question one must ask in the current tight labor market is "What has changed to explain why inflation is not accelerating?" This is a relevant question based on modern history and, as is clearly seen in column (G), the CPI has yet to show meaningful signs of increase. One answer could be that many businesses do not have a lot of pricing power, due to a competitive domestic and global environment. However, another significant part of the answer is that the rapidly growing level of business capital spending is having the positive impact of increasing the productivity of labor. This is shown in the very important column (H) of Table 1.

Year	(H) Non-Farm Business Sector Productivity
1999E	+2.8%
1998	+2.8%
1997	+2.0%
1996	+2.7%
1995	+1.0%
1994	+1.3%
1993	+0.1%
1992	+4.0%
1991	+1.6%

As shown in the column, recent productivity gains have been in excess of 2%, which is significantly above the approximate 1% level which the U.S. seemed to be mired in during the 1970s, 1980s, and early 1990s. This data clearly supports the contention that the rate of productivity gain has improved significantly. If, indeed, we are embarking on a period where productivity advances at a yearly rate of around 2.5%, it would seem fair to identify that as a "new era." The internet, enhanced communications, and the related hardware and software technological advancements would seem to be the key drivers of our improving productivity results. This is still not an entirely provable contention, but the weight of evidence seems to be moving in that direction. Faster growth in productivity supports accelerated, non-inflationary wage increases, which enhance the well-being of workers and, at the same time, allows corporations to increase profitability with modest or no price increases. Based on the experiences in the U.S. economy during the period from 1970 through

59 Racine Street Suite A - P. O. Box 8012 - Menasha, WI 54952-8012
phone: (920) 729-7900 - *fax:* (920) 729-7904 - *website:* www.northstarinvestments.com

1995, acceleration in the rate of productivity growth to the 2.5% range would justify the term "new era."

Inflation and Interest Rates

As indicated in the foregoing, we do believe that we are in the early stages of acceleration in the trend rate of productivity versus the approximate 1% rate of increase from 1970 to the mid-1990s. This indicates that the U.S. economy can grow at a faster real rate without a major increase in the CPI inflation rate. Nevertheless, we are unable to completely dismiss the effect of a tightening of supply and demand for labor and, therefore, expect a gradual increase in CPI rate of inflation to somewhere in the 2.5%-3.0% range in the year 2000. If we are correct in this directional move, we do not believe the Federal Reserve's tightening role is yet completed. Consequently, the fixed income market will still face some uncertainty. With the rate on the 30-year Treasury at 6.48% presently, we could see a rate of 6.75% sometime in the next six months, in conjunction with a couple of Fed rate increases.

Corporate Profits

After a slight decline in 1998, corporate profits have recovered nicely in 1999, and it appears that a more moderate gain is likely in the year 2000. Table 2 shows the history of the S&P 500 operating earnings per share during the 1990s. Earnings from overseas operations contributed strongly to 1999's results, as the Asian crisis bottomed out. Foreign profits will also contribute to earnings in the year 2000, but at a more moderate pace. In a weak pricing power environment with a tight labor market and, what we believe will be an increasingly less accommodative Fed, productivity advances become all the more crucial. In addition, if the global economy continues to recover, there could be some margin pressure from strengthening commodity prices. Consequently, while we expect corporate profits to increase in 2000, we expect the advance to be somewhat less than that expected by the consensus shown in Table 2. We are more comfortable projecting approximately an 8% earnings increase, which is still quite respectable at this stage of the cycle.

Table 2

Year	S&P 500 Operating Earnings Per Share	% Change
2000E*	$56.07	+11.6%
1999E*	50.24	+13.4%
1998	44.30	- 1.7%
1997	45.06	+ 9.8%
1996	41.05	+ 8.3%
1995	37.92	+18.1%
1994	32.10	+18.1%
1993	27.19	+14.3%
1992	23.79	+13.5%

* Consensus Estimates

Financial Markets

Strong economic growth in the second half of 1999 has been both a blessing and a curse as it resulted in a rejuvenation of healthy corporate profit growth and a sharp fourth quarter rebound in stock prices but also caused upward pressure on interest rates which could come back to haunt the equity markets in the first quarter of 2000. Economic growth of around +5% forced the Fed to raise interest rates in November and will likely lead to even tighter monetary policy in the months ahead.

The fourth quarter rally in the equity markets was intense but rather narrow in focus as much of the gain came from the technology/telecommunications sector. Relatively weak areas included energy, banks, and pharmaceuticals The total return from the benchmark for larger capitalization stocks (S&P 500) was +14.9% while the returns from smaller issues (Russell 2000) and foreign equities (EAFE Index) were +18.6% and +18.0%, respectively. For all of 1999, the total return for the S&P 500 (capitalization-weighted) was +21.0%, a record fifth consecutive annual return in excess of +20%. However, the limited breadth of the market was evidenced by the fact that the equal-weighted return for the S&P 500 last year was +3.1% while the gain for the average S&P 500 stock in 1999, excluding technology issues, was only +2.0%. The Russell 2000 and EAFE Index also generated impressive full-year gains of +21.4% and +25.3%, respectively, but were far short of the S&P 500 over the past five year period.

Strong economic growth took its toll on the bond

59 Racine Street Suite A - P. O. Box 8012 - Menasha, WI 54952-8012
phone: (920) 729-7900 - *fax:* (920) 729-7904 - *website:* www.northstarinvestments.com

market in the past three months, pushing interest rates up for the fifth consecutive quarter. The long-term U.S. Treasury Bond rate climbed to 6.48% at the end of the year, up from 6.05% at the end of the third quarter and 6.09% at the end of 1998. This rise in interest rates led to negative returns from our benchmark, the Salomon Broad Investment Grade Bond Index, for both the fourth quarter (-0.1%) and all of 1999 (-0.9%). Our bond portfolio duration target remains approximately equal to that of our benchmark.

Conclusion

We have tried, in this letter, to discuss some of the key economic ingredients in the so-called "new era." In total, the overall economic picture appears quite positive. On the less positive side, our biggest concern centers on the large and growing current account deficit with the rest of the world. Since we need to attract large sums of foreign investment to the U.S. to sustain this imbalance, it would seem to be, ultimately, an unsustainable condition. With the rest of the world's economies recovering, it is possible that we may be able to increase our exports to alleviate the problem. On the other hand, the strength in other economies could create investment opportunities, which could attract foreign investment from the U.S. and weaken the dollar and increase interest rates. We are monitoring this situation closely. Nevertheless, we are certainly experiencing an environment consistent with the dictionary definition of a millennium as we enter the year 2000.

Neil T. Braun, CFA

In accordance with SEC Rule 204-3(b), our Form ADV Part II is available upon request. Please call or write to Susan C. Beaver, North Star Asset Management, Inc., P.O. Box 8012, Menasha, WI 54952-8012.

59 Racine Street Suite A - P. O. Box 8012 - Menasha, WI 54952-8012
phone: (920) 729-7900 - *fax:* (920) 729-7904 - *website:* www.northstarinvestments.com