

As we enter the second quarter of the year 2000, the economy appears quite strong while beginning its record tenth year of uninterrupted expansion since the last recession. This fact in itself would justify a new era designation. However, the true driver of the frequently referenced “new era” of today is the wide and deep impact on the overall economy and the financial markets of the Internet and related technology. While the impact of the Internet is truly wide and deep, the predominant impact on economic activity to date is derived from the creation and application of the technology being applied in the build-out of the Internet and the development of its broad capabilities. We are now starting to see increasing signs of the meaningful implementation of what we consider to be one of the most potentially significant economic aspects of the Internet which we believe is business-to-business e-commerce (B2B). This could have a major impact on the overall economy. We will briefly discuss B2B later in this letter.

The Economic Environment

The economy continues to grow at a relatively rapid pace. The consumer sector which accounts for about two-thirds of real gross domestic product (GDP) continues to advance at an above average pace supported by a strong job market, high consumer confidence, a rising stock market, and a low savings rate. February 2000 retail sales increased by +1.1% for the month and +9.4% year-over-year. Personal spending is not showing any sign of weakening. This makes the Federal Reserve’s job more difficult and it appears they will likely continue to increase the federal funds rate until signs of slowing appear in the numbers.

Consequently, we now believe that there are at least two more federal funds rate increases ahead.

In recent months, auto sales have been extremely strong led by strong demand for sport utility vehicles (SUVs). Rising gasoline prices could dampen this demand somewhat as the gasoline cost is about twice as much for a SUV as for a typical car.

In addition, the Federal Reserve’s Summary of Commentary on Current Economic Conditions by Federal Reserve Districts (Beige Book), which is an informational tool for the Federal Open Market Committee, was released on March 8, 2000 prior to their meeting. It indicated that during late January and February the majority of the twelve Federal Reserve Districts reported strong growth during the survey period, with the remaining reports pointing to moderate growth or continued high levels of activity. It also noted that most districts reported tight supplies and upward wage pressures for various types of labor, both skilled and entry level. However, despite faster wage growth for some workers, increases in the prices of final goods and services were limited overall, although the prices of transportation services and some industrial commodities rose noticeably.

Business fixed investment is expected to continue to advance at a respectable real rate between +7% and +8%. The most rapidly growing segment is expected to continue to reside in the business equipment and software area where real growth is likely to be around +10%.

Overall, it appears to us that the economy’s real GDP growth in 2000 is likely to approximate +4.0%, which is about the same as experienced in

1999. Since many economists have recently raised their first quarter 2000 real GDP estimates to a +4.5% to +5.0% range, the chances of additional Fed tightening moves are increasing unless the rate of economic growth soon slows.

Inflation

It is in the realm of the inflation outlook where the biggest risk for the financial markets may lie. With the economy's overall real growth exceeding the non-inflationary benchmarks of the intermediate past, inflation would seem a logical area for very close monitoring. So far, the reported data have not yet indicated any significant signs of an upward trend in fundamental inflation. This can be seen in Table 1 and in the subsequent comments on the most recent releases for the producer and consumer price indexes for February.

Table 1

Change in Consumer Prices From Year Earlier		
Year	Annual Rate For all items	Core Rate (Excluding Food and Energy)
2000E	+2.7%	+2.2%
1999	+2.2%	+1.9%
1998	+1.6%	+2.4%
1997	+2.3%	+2.2%
1996	+3.0%	+2.6%
1995	+2.8%	+3.0%
1994	+2.6%	+2.6%
1993	+3.0%	+3.2%

In our last letter we indicated that we expected the consumer price index (CPI) to rise at about a +2.7% rate in the year 2000 as compared to a +2.2% increase in 1999. What has been said to represent Alan Greenspan's favorite measure of inflation, i.e. the quarterly employment cost index (ECI), rose by a faster than anticipated +1.1% rate in the fourth quarter or at an annualized rate of +4.6%. The two components of this measure, wages and salaries, and benefits rose during the quarter at annual rates of +4.0% and +5.5% respectively. The increase in the benefits cost segment was by far the highest number reported in recent years. Consequently, there are some

modest signs that the low level of price inflation of recent years may be starting to creep up. It would seem that this possibility is also being given consideration by the Federal Reserve in its current policy of steadily raising the federal funds rates. The Fed wants to behave in a preemptive manner in avoiding an acceleration of inflation.

A major complicating factor in forecasting the level of inflation at the end of 2000 in an environment containing a high probability of continued Fed tightening is the lack of a clear trend of rising inflation. While noted earlier that we expect the CPI to advance by +2.7% versus +2.2% last year, this is not yet assured; and it is not a major increase if it materializes.

The most recent price releases for the producer price increase (PPI) and the consumer price increase (CPI) were both significantly higher on an all-inclusive basis in their March 16 and 17 releases. The PPI rose by +1.0% in February, which was the biggest gain since October 1990. February's increase was +4.0% on a year-over-year comparison with February 1999. Energy prices were the driving factor in the large increase. The core rate, excluding food and energy, rose +0.3% during the month. The core rate was up only +1% over February 1999. Stocks surged and Treasury Notes rose as investors focused on the core rate.

The next day, on February 17, the CPI was released showing an increase of +0.5%. The core rate, excluding food and energy costs, rose +0.2%. For the 12 months ending in February the overall CPI rose +3.2%, which was the biggest year-over-year increase since December 1996, and the core rate rose +2.1%.

The price of energy was the dominant factor in the larger overall rises for both indexes. On March 29, 2000, OPEC announced that its members would collectively raise their output by 1.45 million barrels a day or +7% as of April 1, 2000. In addition, OPEC oil ministers agreed to establish a price band whereby supply levels would be changed automatically when certain undisclosed prices were reached. This should provide OPEC with much greater control over oil

prices. Consequently, we do not believe that it makes good sense to dismiss the inflationary impact of oil entirely. Energy prices actually declined during much of the 1990s and that may now be changing.

A condition also worrying Alan Greenspan is the strong growth of real GDP which exceeded +4% in each of the last three years and averaged +4.3%. Adding to this concern is the fact that a number of economists have increased their first quarter 2000 estimates to around +4.5% to +5.0%. This type of continued strong real GDP growth in conjunction with a very tight labor market would seem to make a preemptive inflation fighter very nervous. To a degree, wages for some are rising through such methods as offering signing bonuses and stock options, which are not captured in the wage data. However, the big factor enabling a tight labor market to coexist with modest wage increases is the rather dramatic pickup in productivity gains which have been averaging close to +3% in recent years. This is a dramatic increase from the approximate +1% increase in productivity from 1970-1990. Productivity increases of this magnitude would certainly ease the inflationary impact of rising wages through moderating unit labor costs. Alan Greenspan expressed some skepticism regarding this ideal solution as indicated from his following comments from a recent speech – “At some point in the continuing reduction in the number of available workers, wage increases must rise above even impressive gains in productivity. This would intensify inflationary pressures or squeeze profit margins, with either outcome capable of bringing our growing prosperity to an end.” Consequently, it would seem that short of strong new evidence supporting the existence of continuing large productivity gains, Alan Greenspan will likely continue to apply monetary policy in a preemptive manner by additional federal funds rate increases. Consequently, we now expect two more interest rate increases by the Fed in 2000. However, they are likely to be sooner rather than later, due to the presidential election environment.

Interest Rates

Historically, when the Fed has been in a concerted mode of raising short-term interest rates, long-term rates have also risen in unison. Conversely, it would seem logical that, if the Fed is seriously determined to preclude rising inflation from gaining a foothold in our economy, even at the risk of slowing the economic advance by more than may be deemed necessary by many critics, longer maturity bonds would not have to rise significantly in such an environment. Alan Greenspan has clearly demonstrated his willingness to act “preemptively” in the past as demonstrated by his stated willingness to “err on the side of restraint” in the late 1980s.

Consequently, it would appear that the “bond vigilantes” have currently placed their faith in Alan Greenspan’s words and his past actions in their willingness to bid aggressively for U.S. Treasury bonds. This may be an enlightened response to the bond market’s extreme move from a 6.15% yield to a yield in excess of 8% on the 30-year U.S. Treasury bond during the Fed’s tightening moves in 1994 to effect the successful economic soft landing which materialized in 1995.

One other complicating factor in the present environment is the significant recent change in the price and yield behavior of the 30-year U.S. Treasury bond due to the announced intention of the U.S. Treasury to utilize at least \$30 billion dollars of the federal budget surplus to repurchase and retire various portions of long-term U.S. Treasury bonds in 2000. This created a perceived scarcity value in the long Treasury bond sector which resulted in a buying panic relative to the new long-term Treasury bond benchmark, which is now widely accepted to be the 10-year U.S. Treasury bond. Illustrative of this dramatic shift is the fact that the yield-to-maturity on the 30-year Treasury has declined from around 6.75% in mid-January 2000 to 5.84% at present, while the 10-year Treasury has declined from about the 6.75% level to 6.02%. This reflects the perceived scarcity of long-term Treasury bonds. At the present time, the 2-year U.S. Treasury bond offers the highest return at 6.48% yield-to-maturity.

As a result of the foregoing, we will focus our interest rate forecast on the 10-year Treasury bond. We do not foresee the CPI inflation rate rising above +3% based upon improved productivity gains, a competitive economic environment, and the Fed's desire to contain inflation. Consequently, in the second half of 2000 we would expect to see a high in the 10-year Treasury around 6.25%.

Corporate Profits

The consensus estimates for the S&P 500 operating earnings for 2000 are shown in Table 2.

Table 2

Year	S&P 500 Operating Earnings Per Share	% Change
2000E*	\$56.44	+10.9%
1999E*	50.88	+14.9%
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

The consensus profit estimate for the S&P 500 for the year 2000 represents a very respectable increase in corporate profits, especially at this advanced stage of the economic cycle. In fact, the percentage change column clearly shows that corporate profitability growth has been quite strong during most of this long cycle. This has provided a strong underpinning for the bull market in stocks. The nearly +11% increase being forecast by the consensus for 2000 continues this trend.

While domestic pricing power still appears restrained, strong productivity advances and extensive cost control and restructuring in a growing economy should support increasing profitability. In addition, an improving global economy should provide stronger profits from

foreign operations. Overall, led by very positive comparisons expected from the energy sector, the consensus is forecasting a +18% increase in corporate profits in the first quarter.

Business-To-Business Commerce (B2B)

B2B involves the movement of information electronically between businesses over computer networks. By extending the benefits of computers to the exchange of information between suppliers, manufacturers, and retailers, business-to-business electronic commerce may give companies the added advantage that they need to achieve measurable cost reductions and productivity gains. The electronic exchange of information with suppliers, distributors, and retailers, allows companies to better direct the production, inventory, and distribution of goods and more promptly alter prices and production strategies.

B2B e-commerce is commerce through aggregation – indirect contact between multiple suppliers and multiple buyers – not unlike a stock exchange. In these auction-like markets companies are finding that they can achieve considerable savings on the costs of inputs by purchasing supplies over the Internet.

There are two types of e-markets, horizontal and vertical. Horizontal e-markets cover a given type of goods, such as office supplies or excess inventory, providing a marketplace for these goods across all industries. Vertical e-markets service a particular industry, facilitating the buying and selling of the range of goods and services used in that industry.

On February 25, 2000, signaling unprecedented industry collaboration, Ford, GM, and DaimlerChrysler announced that they were joining forces to create an online trade exchange designed to allow the Big Three to consolidate their purchasing power to drive down costs in the auto industry. In addition to the likelihood of allowing the auto companies to save billions of dollars annually on their purchases of materials, some of which will flow to the bottom line and some of which will result in lower automobile

prices, they will also benefit as owners in taking the new Auto Trade Exchange public.

This seems to us to be a major step forward by leading companies in an endeavor, which would seem to have broad beneficial effects for the overall economy, as well as the industry participants. This is likely to be followed by other major companies in other major industries. Consequently, while we are early in the evolution of B2B e-commerce, it would seem to carry profound implications for future national and global economic activity.

Financial Markets

In the past three months, the U.S. Treasury bond market was positively influenced by continued low inflation and by the Treasury's announced long bond repurchase plan. The 30-year U.S. Treasury bond rate declined to 5.84%, down from 6.48% at the end of 1999, providing a total return of +10.6%. The Salomon Broad Investment Grade Bond Index, which we use as our fixed income benchmark, had a first quarter return of +2.2%. Our bond portfolio duration target remains approximately equal to that of our benchmark, which is 4.9 years.

The equity market, which has experienced rather high volatility in the first quarter, continues to be characterized by a large valuation and investor preference difference between the new-economy and old-economy stocks. The NASDAQ market (representing many of the new-economy companies) was up +12.6% in the first quarter while the Dow Jones Industrial Average (representing many of the old-economy stocks) had a -4.7% return for the quarter. There was not a clear-cut distinction in the performance between large and small companies as the S&P 500 increased by +2.3% while the equally-weighted S&P 500 return was -3.5% implying that large stocks outperformed small stocks. However, the Russell 2000, a small stock index, outperformed the S&P 500 with a +7.0% return. The best performing sectors were once again technology and telecommunication-related with many other sectors flat or negative for the quarter.

The new-economy stocks are related to technology in one form or another and the old-economy stocks represent almost everything else. Many of the new-economy companies are selling at rather inflated valuation levels and, in many instances, have created new approaches to valuation. The old-economy stocks offer relatively low price/earnings ratios and some even provide attractive yield. The new-economy stocks provided superior investment returns while the old-economy stocks provided below-average returns. Since many investors are driven by immediate gratification, there is a great deal of pressure to own new-economy stocks, the high valuations notwithstanding.

We are currently seeing signs of what may represent somewhat of a convergence between the new-economy and old-economy stocks. It is too soon to tell if this is a sustainable move, based on a favorable economic and interest rate environment, to correct the apparent under-valuation in the old-economy stocks. Or is this a market adjustment which will soon base and allow the new-economy stocks to move to their next level of enthusiasm? We doubt that anyone knows the exact answer to this question. Consequently, a diversified portfolio containing both new-economy and old-economy stocks based on research and insightful stock selection would appear to be the appropriate approach.

While the current volatility in the equity markets is rather unnerving at times, the overall environment for the financial markets is still being driven by a number of positive factors. These would include a growing economy, in conjunction with a low inflation rate, attractive profitability gains, strong productivity advances, a federal budget surplus, and an improving global economic environment. For the present, at least, the current rebalancing of the new-economy and old-economy components can be viewed as a healthy development and conducive to sustaining the overall advance. This is certainly the objective Alan Greenspan is seeking to attain.

Summary

- The real GDP will increase by +4% in 2000.
- The Fed will raise rates by 50 basis points, probably in two increments.
- CPI inflation will increase to +2.7%.
- The 10-year U.S. Treasury benchmark bond is likely to approach 6.25% yield-to-maturity in 2000.
- The tug-of-war between richly valued new-economy stocks and reasonably priced old-economy stocks is likely to continue.
- B2B e-commerce is likely to have a major impact on the way business is done in the

future with positive implications for inflation and corporate profits.

- Corporate profits will increase by +12% this year.
- Equity markets will remain volatile, but prices will trend upward as earnings progress is rewarded.

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.