

As we enter the second quarter of 1999, the economy appears to be growing rather robustly following the surprisingly strong +6.1% advance reported for the fourth quarter and a +3.9% gain for the entire year. This represented the second year in a row of real GDP growth near +4.0%. In addition, the current expansion is now 96 months old and fast closing on the 106-month record for the longest U.S. economic expansion.

Since we have been expressing a degree of skepticism for some time as to whether “ it’s different this time” and whether we are indeed living in a “new economic era,” we will again attempt to discuss the background considerations which contribute to this rapid growth and low inflation economic environment we have been experiencing in the last few years. In terms of the investment environment, we are seeing outstanding results being steadily reported for real economic growth, job creation, consumer and producer price inflation, interest rates, stock market appreciation, and overall consumer confidence and well-being. As noted we are going to attempt to discuss and hopefully to elucidate the environmental factors supporting the positive results being reported month by month. We will also be discussing several other issues such as our growing current account deficit and the outlook for corporate profits.

## The Current Economic Cycle

In our last letter we identified and discussed a number of important factors that we believe contributed to this cycle’s extended duration and uniqueness. Briefly these factors are:

1) The current cycle’s slow- to- moderate rate of real GDP growth in its early years. Typically

business cycle recoveries start off with rather strong real GDP gains in the early years. The slow start in this cycle appears to have had a cleansing effect, which restrained the creation of any major imbalances. The following table clearly illustrates this condition.

1991	-0.9%
1992	+2.7%
1993	+2.3%
1994	+3.5%
1995	+2.3%
1996	+3.4%
1997	+3.9%
1998	+3.9%

- 2) A very ably managed monetary policy environment. Alan Greenspan’s engineering of an economic soft landing in 1995 ranks as brilliant in our judgment. His latest move in 1998 to ease in response to global turmoil again appears to represent a very flexible monetary strategy on his part.
- 3) A fiscal policy that has reduced the government’s role as a disruptive borrower in the U.S. financial markets. While we would argue that the government’s taxing and spending policies are not entirely in balance, we would accept that they are close enough to declare victory for the first time in 30 years.
- 4) The globalization of U.S. economic activity, while not unique specifically to this cycle, has become increasingly significant in the last 96 months. We are currently actively competing with other producers on a worldwide basis. Many of these competitors are operating within

lower wage nations, which places significant competitive pressure upon U.S. producers. This has resulted in a concerted and sustained effort by the U.S. to reduce costs and increase production efficiencies.

- 5) A direct response to the enhanced level of global competitive pressures and the resultant sustained U.S. effort to become more cost-efficient has resulted in a greater reliance on technology in order to enhance productivity and competitiveness.

While we are not yet ready to assert that the business cycle is a thing of the past, one has to be impressed with the economy's staying power as we enter the ninth consecutive year of expansion. Some things certainly are working in a very positive manner.

Before we return to the discussion of why things may be "different this time," we would like to provide a little perspective as to why one would be at all surprised that things are working out so well. After all, President Clinton has been basking in the glory of a strong growth, low inflation economy for some time now. His approval ratings also reflected the economy's performance. However, we would be more inclined to direct significant credit to Alan Greenspan, the chairman of the Federal Reserve, Robert Rubin, the Treasury Secretary, and to the competitive instincts of the American Business Community. Insightful and sound economic policies are certainly a significant contributor to our economic well-being and we will leave it to others to determine who should receive the credit.

In our judgment the biggest surprise in our stellar economic performance centers on the rapid real growth being achieved in conjunction with the low and nearly nonexistent rate of inflation. It was only recently that conventional economic thought associated economic growth above a certain range as being highly correlated with a rising level of inflation. In the last few years the Federal Reserve and many economists felt that our nation's noninflationary real GDP growth rate was in the vicinity of +2.5% annually. This growth rate was roughly determined by combining anticipated labor force growth at a little over +1.0% with

productivity growth estimated at around +1.5% annually. Consequently, it was felt that if real GDP growth exceeded the combination of these two factors by any significant amount, rising inflation would be the likely outcome. If we look back at our earlier Table 1 and add another column showing the annual change in the CPI, we can see that this relationship became suspect in 1997 and even more so in 1998.

<b>Table 2</b>	<b>Real GDP Growth</b>	<b>CPI Annual Rate of Change from Year Earlier</b>
<b>Year</b>		
1991	- 0.9%	+ 4.2%
1992	+ 2.7%	+3.0%
1993	+2.3%	+ 3.0%
1994	+3.5%	+ 2.6%
1995	+ 2.3%	+ 2.8%
1996	+ 3.4%	+ 3.0%
1997	+ 3.9%	+ 2.3%
1998	+ 3.9%	+ 1.6%

The data in Table 2 shows in broad scope that the historical relationship evidenced significant signs of becoming outdated or unreliable in 1997. As evidence of the force of this relationship on economic policy, the Federal Reserve raised the federal funds rate from 3% to 6% in 1994 in an effort to implement a soft landing in 1995 to preclude an expected subsequent rise in the CPI inflation rate. As noted above, this relationship appeared to become invalid in 1997 when real GDP advanced by 3.9% and the CPI inflation rate declined significantly from the prior year and rose by only +2.3% for the year. The next year, 1998, was another year of strong real GDP growth and even lower inflation with the CPI increasing +1.6%. Hence, "it's different this time" or the "new era" thinking gained broader acceptance.

To continue this recent historical evaluation of the U.S. economy, we will add several more columns to create Table 3. We are adding the nation's Total Industry Capacity Utilization Rate and the Labor Unemployment Rate for all Civilian Workers.

<b>Table 3</b>	<b>Real GDP</b>	<b>CPI Annual Rate of Change From Year</b>	<b>Total Industry Capacity Utilization</b>	<b>All Civilian Unemploye</b>
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Year	Growth	Earlier	Rate	nt Rate
1991	- 0.9%	+ 4.2%	79.3%	6.8%
1992	+ 2.7%	+3.0%	80.3%	7.5%
1993	+2.3%	+ 3.0%	81.3%	*6.9%
1994	+3.5%	+ 2.6%	83.2%	6.1%
1995	+ 2.3%	+ 2.8%	83.4%	5.6%
1996	+ 3.4%	+ 3.0%	82.4%	5.4%
1997	+ 3.9%	+ 2.3%	82.9%	4.9%
1998	+ 3.9%	+ 1.6%	81.9%	4.5%

\* subsequent data not directly comparable

By adding these two columns to Table 2 we are now getting to the heart of the issue. The reason that real GDP growth, significantly in excess of a combination of labor force growth and productivity growth, is thought to be inflationary is that it results in a tightening of the utilization rates of physical plant and human capacity. Historically, physical plant capacity utilization above 83% was thought to signal a tighter availability of supply of production capacity just as did an unemployment rate of 5.5% and lower.

The capacity utilization rate of 83.2% began to signal a warning in 1994 when the Fed began to tighten to slow down the overall economy in 1995. And it was successful as real GDP growth did slow in 1995 and in effect resulted in a very effective “soft landing.” The capacity utilization rate has effectively slowed since 1995 as additional capacity has come on stream. This will be discussed later.

The unemployment rate has continued to decline steadily subsequent to 1994 to levels which would have earlier been viewed as very ominous indicators of imminently rising inflation. However, that has not happened, as lower unemployment figures have gone hand in hand with lower inflation statistics.

So we presently find ourselves in an economic environment where we are experiencing rapid real economic growth in conjunction with low and declining inflation rates, which has caused many to conclude that we are in a “new era.”

At this point, we will attempt to shed some light on some of the reasons behind the “new era” and its sustainability. In other words, is the “new era” somewhat analogous in an economic sense to the prospects facing the elderly people in the movie Cocoon when going to the alien planet where they were “never going to get sick and never going to

die” or are we still in Wisconsin having experienced a “mild winter with a low incidence of flu” only to return to reality in the not too distant future.

### The “New Era” – Technology

In our judgment a “new era” may be a bit strong in hyperbole to describe the U.S. economy as good as it is. And, if it turns out that we are too conservative in our evaluation, it will likely be because we have underestimated the impact of new technology on our economy. On the other hand, based on the price appreciation of many technology stocks, our risk of underestimating the potential of technology does not seem to represent the risk assumption that the overall market is making.

Nevertheless, technology has had a very positive impact on our economy in two important ways. First, business spending on producers’ durable equipment has been very strong during the last six years. This has contributed to the strong real GDP growth. This is clearly shown in the following Table 4.

Year	Real GDP Growth	%Change Real Producers’ Durable Equip.	Total Industry Capacity Utilization Rate	Business Sector Productivity
1991	-0.9%	-4.13%	79.3%	+0.6%
1992	+2.7%	+6.1%	80.3%	+3.4%
1993	+2.3%	+10.5%	81.3%	+0.1%
1994	+3.5%	+11.0%	83.2%	+0.6%
1995	+2.3%	+11.5%	83.4%	+0.3%
1996	+3.4%	+10.9%	82.9%	+2.7%
1997	+3.9%	+12.1%	82.9%	+1.5%
1998	+3.9%	+16.6%	81.9%	+2.3%

This strength has continued and accelerated in recent years even as the total capacity utilization rate has declined and corporate profitability has been more restrained. Second, it appears that corporations are channeling large sums of money into technology and investments to improve efficiency and substitute labor for capital. Enhanced productivity is a hallmark of a growing and prosperous economy. This is also shown in Table 4.

At present, we seem to be well endowed as we appear to be approaching the payoff stage of the

Internet after a near generation developmental stage. The Internet holds enormous potential for change and opportunity. Nevertheless, it is imperative that both the government and the private sectors emphasize and support the crucial role of research and development, patent protection, and an overall sponsorship of new ideas and technology. In an ever increasingly competitive global economy (our next section) we must be constantly focused on the future as well as the present.

### The “New Era” – Globalization

As mentioned earlier, “Globalization” is not exactly a new phenomenon. However, the Asian economic meltdown of the last year and one-half or so has certainly highlighted the volatility and competitive characteristics of competing in an increasingly competitive global environment. Global competition is definitely a prime variable in the current very low inflation environment. U.S. corporate pricing power is very much constrained by the global competitive environment. Conversely, global competition has awakened the U.S. competitive instinct to implement the changes necessary to become an effective global competitor. Remember that in the mid-1980s the U.S. mid-western region was known as “The Rust Belt.” It was this type of competitive wake-up call which resulted in the ongoing U.S. corporate restructurings, downsizings, outsourcings, and relocations necessary to become “lean and mean” global competitors. The endorsement of the latest technologies and management approaches are all a part of the enhanced competitive environment of globalization. The U.S. has responded aggressively and as a result has become a very effective competitor in the global environment. The weakness in Asia and other global markets has created significant pressure on global commodity prices. The Bridge-CRB Index at around 192 is not far above its 24-year low of approximately 183 which it hit on 2/26/99. These developments and our increasing participation in our ever more global, inter-related economic environment is a major consideration in concept of the “new era.”

In summary, we believe that technology and increasing global interrelatedness are two primary considerations in explaining our current

environment of rapid real growth in conjunction with low inflation, i.e., the “new era.”

### U.S. Current Account Deficit

With the U.S. representing an “oasis of prosperity” in a volatile global environment, our role as the buyer of last resort has enabled the troubled nations to export to the U.S. and permitted U.S. consumers to buy at depressed prices. This is not a bad situation up to a point. The question is “where is that point?”

The current account deficit in 1998 widened to a record \$233.45 billion up from \$155.22 billion in 1997. In the fourth quarter the deficit declined to \$63.77 billion from \$65.69 billion in the third quarter. The current account measures transactions including goods, services, and investment income. The nation has to finance a current account deficit by borrowing money from foreigners. The U.S. can sustain a widening current account deficit only as long as foreign investors are willing to lend or invest in U.S. assets. Because of the relative strength of the U.S. economy in a volatile global economic environment, foreign investors have been willing to lend money to the U.S. Global economic instability will likely continue to place upward pressure on the U.S. current account deficit in 1999 as many nations try to export their way out of their economic problems and are unable to afford many U.S. goods. U.S. import prices fell by 0.1% in February.

To put this situation in perspective the following data in Table 5 depicts the U.S. current account numbers on an annual basis since 1993 and on a quarterly basis since 1996. The Asian turmoil began during the second half of 1997.

Table 5 - Balance on Current Account (Billions \$)		
Yearly	Quarterly	
1993 - \$ 86.1	1996 I - \$28.2	1998 I -\$46.7
1994 - \$123.8	II - \$33.0	II -\$56.7
1995 - \$115.3	III -\$48.4	III - \$65.7
1996 - \$134.9	IV - \$33.3	IV - \$63.8
1997 - \$155.2	1997 I - \$37.0	
1998 - \$232.9	II - \$35.1	
	III - \$38.1	
	IV - \$45.0	

Until Asia and some of the other trouble spots in the world stabilize and begin to grow again, our current account deficit will likely continue to increase as relatively cheap foreign goods are exported to the U.S. and also as these troubled nations buy fewer of our goods exported into their countries. A reasonable estimate for the current account deficit in 1999 is near \$300 billion.

This course of events is not a problem as long as the U.S. is viewed as a safe haven. If the U.S. debt continues to rise relative to GDP and the foreign markets continue to stabilize, the point may come when foreign investors become more cautious over holding U.S. debt. At that point we may see pressure on the dollar's strength and a rise in U.S. interest rates relative to the rest of the world.

In addition, there are some ominous signs that free trade tensions are rising. Issues at hand involve charges of selling steel in the U.S. at less than production cost against Russia, Brazil, and Japan. The EU and the U.S. are in a trade embargo over the EU's favoring imports of bananas from its former Caribbean colonies over South American bananas grown by U.S. companies. In retaliation the U.S. started imposing 100% duties on such luxury imports as cashmere sweaters from Scotland, French handbags, Italian pecorino cheese, and German coffee makers. These represent small and isolated products, but this contention must be followed very closely. It is hard to believe the world leaders would again repeat the mistakes of the 1930s.

### **Corporate Profits**

While a global abundance of low priced, imported goods are containing inflation, this condition is also putting pressure on corporate profit growth. With many business sectors having little if any pricing power due to the competitive global environment, the equity market has clearly become stratified by rewarding those few companies demonstrating the ability to deliver above-average, consistent earnings growth and conversely punishing those who do not deliver. This has begun showing up dramatically in the poor breadth reading of the over-all market. Consequently, 1998 was essentially a year of flat-to-modestly-down earnings overall. Superior

investment returns were provided by the large capitalization companies capable of delivering strong earnings gains. Companies of any size, especially smaller ones, which fail to meet expectations generally delivered subpar returns.

So far in 1999 a similar market pattern is playing itself out. We anticipate that the overall economy will continue to advance in 1999 with real GDP increasing around 3%. We also anticipate that S&P 500 earnings growth will increase, but at a relatively modest 3%-5% rate. We will continue to strive to identify those companies capable of delivering consistent earnings growth through our efforts of research and analysis.

### **Financial Markets**

As mentioned above, the relatively narrow focus of equity investors continued during the first quarter of 1999 with a handful of large capitalization stocks (primarily the technology sector) producing most of the gain in the S&P 500 Index while thousands of small and mid-sized issues languished with negative returns. The sluggish earnings environment seems to have created a two-tiered market with large cap companies that are still able to generate reasonable earnings growth selling at price/earnings multiples of 30-60x while multiples of 10-18x are the norm for most others. In addition, there are the Internet stocks with valuations far above either of these two categories since they are driven more by psychology than fundamentals similar to other investment manias of the past, i.e., railroads in the 1830s, telegraph in the 1880s, radio in the 1920s, and Japanese real estate and biotechnology in the 1980s.

The two-tiered nature of the market is reflected in the diverging returns of the various market indices. For example, the S&P 500 Index, which is dominated by large capitalization stocks, produced a return of +4.9% for the first quarter of 1999 while the Russell 2000 (small stocks) and the S&P 400 Mid-Cap Index both showed negative returns of -5%-6%. The divergence in returns in comparing small capitalization stocks to large cap stocks over the past 15 months has been an unprecedented -42.6%. The quarterly return of the EAFE Index (equities of developed countries other than the U.S.)

was a modest +1.1% as a recovery in Japanese stocks was offset by lower equity prices in Europe.

Recent strong economic growth contributed to a backup in interest rates to the top end of our expected range for the year. Long-term U.S. Treasury rates rose from 5.09% on 12/31/98 to 5.62% by the end of the first quarter. Although this increase in rates resulted in negative return of -0.5% on our fixed income benchmark, the Salomon Broad Investment Grade Bond Index, we do not believe that it signals a trend of rising interest rates in the future. Our bond portfolio duration target which is similar to that of our fixed income benchmark is a function of this expectation for relatively stable interest rates.

### **Conclusion**

Based on the foregoing analysis of the “new era” we anticipate that the investment environment will remain positive. Our nation’s strong motivation to be a leading competitor in a global market, as well as our leadership role in many of the existing and emerging technological areas should position us to continue to do well in the global environment. Although global market volatility has increased significantly during the last nine months, we are seeing some early signs that a bottoming and more stability may be developing in Asia and other emerging markets. Continued low inflation in conjunction with improving global economic conditions should provide solid support for the financial markets.

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