

# *The Investment Environment*

*July 2000*

As we enter the third quarter of the year 2000, the economy seems to be showing some signs of slowing which would be consistent with the Federal Reserve's policy of monetary restraint. Should the pace of real Gross Domestic Product (GDP) growth slow to around a +3.5% rate of growth, it will likely be perceived as attractive for the financial markets, both fixed income and equities. It would also very likely extend the duration of this record economic expansion, which is currently in its tenth consecutive year. Alan Greenspan's reputation as a monetary manager will be raised farther into the stratosphere.

The only problem with declaring victory over inflation and bestowing knighthood on Alan Greenspan is that it may still be too early in the game to declare victory and celebrate. Consequently, while we are encouraged by recent developments, we continue to believe that forthcoming results must be evaluated in a very critical manner.

## **Real GDP Growth and Inflation**

The growth rate of real GDP is a key point of focus in the monitoring of the Fed's monetary policy in meeting its inflationary objectives. This is because growth of real GDP significantly in excess of the sustainable growth components of real GDP, namely labor force growth and the growth rate of output per worker (i.e. productivity) is, over time, likely to lead to a rise in the level of consumer prices due to demand exceeding supply. For example, if the labor force is growing at a rate of around +1.0% and productivity is increasing by a rate of approximately +1.5%, as they did from 1990 through 1995, then the non-inflationary rate of real GDP is thought to approximate +2.5% (1.0% + 1.5%) once the utilization of productive resources becomes rather full. The non-inflationary benchmark utilization rates of these productive resources in the early 1990's was thought to be around a 5.5% unemployment rate and an 83% capacity utilization rate. From 1990-1995 the unemployment

rate averaged 6.4% and the capacity utilization rate averaged 81.6%. At those utilization rates, it would not appear that inflation would have been much of a problem. The Consumer Price Index (CPI) averaged +3.5% and was actually declining during most of the period. Nevertheless, the Federal Reserve tightened money significantly in 1994, raising the federal funds rate from 3.00% to 6.00%. The objective was to tighten preemptively to prevent an acceleration of inflation though the creation of a "soft landing" intended to create some excess productive capacity prior to the existence of anticipated worrisome tighter conditions. This preemptive tightening seemed to work quite well and it was a key factor contributing to the record business cycle we are currently experiencing.

However, if we look at the data since 1995, we can clearly see a number of conditions which have developed in totally unanticipated ways. First, the unemployment rate, which averaged 6.4% in the 1990 to 1995 period, averaged 4.8% in the 1996 to 1999 period, and in April 2000 the rate was 3.9%. This, by any standard, represents a tight labor market and is a major factor behind the Fed's current tightening posture and its May 2000 increase in the federal funds rate of 50 basis points from 6.00% to 6.50%. Continued strong spending for equipment and software has kept the capacity utilization rate stable averaging 82.1% during 1996 to 1999 and registering at 82.1% in April 2000.

Consequently, while physical capacity utilization does not appear to present an imminent inflation problem, the low level of unemployment and the tight labor market would appear to contain some inflation risk. Thus, the Fed has continued to tighten monetary policy through May. The wild card in this entire equation, which has surprised meaningfully on the upside, is the growth rate of productivity.

## **Productivity Increases**

Productivity is defined as the physical output per unit of productive input. As noted earlier, productivity is a crucial input into the equation which is used by the Federal Reserve's Open Market Committee to determine what the nation's approximate non-inflationary growth rate is and to provide a real GDP target to focus upon in its management of monetary policy. In essence, as the Fed raises interest rates through its increases in the federal funds rate under its control, it is attempting to either reduce the growth rate of real GDP or to stabilize it in order to prevent an acceleration of inflation. While the cause and effect relationship of the Fed's increasing the federal funds rate is quite complex and difficult to project on an instance-by-instance basis and works with a lag of up to a year or longer, the direction of the change in the federal funds rate will ultimately be reflected in the real GDP growth rate. This is why Federal Reserve tightening moves are usually extended procedures requiring a significant number of increases prior to completion. For example, the present tightening experience has been underway for a year and has included five increases of 25 basis points each with the most recent sixth increase being 50 basis points. And now, as this is written, the difficulty of forecasting the Fed's future moves can be summed up in the views of the economic forecasting teams of two leading Wall Street firms, one of which does not expect any more increases while the other anticipates as much as 100 basis points increase (+1%) over the next 12 months. With this wide variance in expectations, we will try to evaluate the variables.

The most significant factor in this entire endeavor is the anticipated future growth rate of productivity. As noted, productivity increased at an average rate of +1.5% during the five years from 1990 through 1995. Subsequently, it has improved significantly to average +2.5% during the four years 1996 through 1999. In the last two years it has averaged +2.9%, recording gains of +2.8% in 1998 and +3.0% in 1999. During the first quarter of 2000, productivity increased by +3.7%. Labor force growth appears to have increased slightly in the last four years to an average growth rate of around +1.3%. Assuming that productivity growth can continue to increase at around +3% and the labor force grow around +1.3%, the U.S. economy would appear to have a non-inflationary real GDP growth potential around +4.3%. During the four-year period of 1996 through 1999 the U.S. real GDP growth averaged +4.1%. During those same years the change in consumer prices averaged +2.3% recording

advances in those years of +3.0% in 1996, +2.3% in 1997, +1.6% in 1998, and +2.2% in 1999.

Based on the foregoing, it would appear that our economy has behaved quite well. The major enabling factor in this performance has been the significant improvement in productivity, which goes a long way in permitting faster growth in conjunction with moderate inflation. Consequently, the major question in the economic environment today is, "Can productivity growth continue at a pace of +3%, or even faster, or is this recent experience just a short-term aberration?"

The Federal Reserve's Open Market Committee acts in a pre-emptive manner, which is necessary due to the long lag between their federal funds rate increases and the impact upon economic activity. We have long admired Alan Greenspan's willingness to "err on the side of restraint." However, we are certain that he would much prefer not to "err" on either side. Dr. Greenspan appears to be in the process of being convinced that a rise in productivity may not be a temporary phenomenon.

The primary factors that appear responsible for the acceleration of productivity growth seem to center around strong spending for equipment and software in the 1990's, enhanced information availability via the Internet, and enlightened management techniques to control costs in a competitive global environment. Some economists question the sustainability of strong productivity growth in a slowing economic environment. However, the enhanced use of information via the Internet and managements' desire to control costs in a competitive environment would seem sustainable. Capital spending for computing equipment and software may slow somewhat but it certainly has shown a strong resiliency in the 1990's. The equipment and software segment of non-residential fixed investment has advanced at a +9.9% rate in the nine-year period 1990 through 1999. It increased by +11.5% in the soft-landing year of 1995. It advanced by +12.0% in 1999 and by +13.4% in the first quarter of 2000 versus the same quarter in 1999.

Unfortunately, we are unable to speak with a high degree of certainty as to the future level of growth of productivity. However, recent evidence certainly points in the direction of a sustained improvement in the rate of productivity growth from the +1.5% range into the +2.5% to +3% range. And we hope that we are being conservative in this forecast. Using the low

end of our productivity growth expectation would give us a sustainable, low inflation real GDP growth expectation around +3.8% (1.3% + 2.5%) which seems to be within the environs of the general consensus of forecasts.

### **Fed Policy**

Since the real GDP reported growth averaged +6.2% in the last three quarters (3Q-99 +5.7%; 4Q-99 +7.3%; 1Q-00 +5.5%), it does not seem unreasonable that the Fed has been attempting to dampen real GDP growth by its series of federal funds increases. A +6.2% rate of real GDP growth would seem to be conducive to an accelerating inflation rate. On the other hand, the yearly real growth rate of GDP over the last three years (1997 through 1999) has averaged +4.2% (1997 +4.2%; 1998 +4.3%; and 1999 +4.2%), which is not that worrisome within the context of our forecast range of productivity increases. Also, within the last month or so a number of economic releases have been indicating a slowing in economic growth. These releases have largely been related to housing and retail sales and could be signs that the one-year lag in monetary restraint may be beginning to show up in the numbers.

Consequently, based upon our expectation for a continuation of the recent higher productivity advances in the +2.5% to +3.0% range, and some moderation of forthcoming real GDP increases as a result of the Fed's preemptive tightening moves thus far, we do not foresee that the Fed has a lot more tightening ahead of it if, indeed, any more at all.

### **Risks To Our Forecast**

A major risk would arise should the current signs of a moderating rate of economic growth be replaced by a return to the rapid (5.5%+) real growth rates experienced in the last three quarters. This would undoubtedly extend the Fed's current rate increasing posture.

A second risk to the financial markets resides in the fact that nearly two months of economic statistical data will be released prior to the Fed's next meeting on August 22. The inflation statistics will almost certainly be influenced on the upside by the high level of oil prices. While we believe that this will not be a sustainable condition, it could be very unsettling for the inflation outlook and the financial markets.

It probably goes without saying that should the release of the second quarter productivity data be significantly below reasonable expectations (+2.5% to +3.0%) that it would likely act to undermine confidence in a significant manner. We are not expecting this to occur.

### **Financial Markets**

The ongoing efforts of the Federal Reserve to slow the rate of economic growth and control inflation by raising short-term interest rates took its toll on the stock market during the second quarter of 2000 as the S&P 500 Index experienced a "correction" of -11% from late March through mid-April. The technology-oriented NASDAQ Index suffered a much greater decline of -36% during the March-May time period. However, both indices proceeded to recover about 2/3 of their respective declines by the end of June as the economy finally started to show signs of slowing down to a sustainable level which is a prerequisite to a much welcomed end of monetary tightening by the Fed.

These gyrations netted out to moderate declines during the second quarter for most of the stock market indices. The S&P 500 (large capitalization stocks) return was -2.7% for the last three months while the returns of the Russell 2000 (small capitalization stocks) and the EAFE Index (foreign equities) were -3.8% and -4.1%, respectively. The sharper decline of -13.2% experienced by the NASDAQ Index (technology stocks) in the second period offset its strong first quarter gain, producing a decline of -2.5% for the first six months of 2000. First half results were also negative for the S&P 500 (-0.4%) and the EAFE index (-5.5%). An exception was the Russell 2000 which produced a gain of +3.1% for the first half of the year.

With history and logic as a guide, the end of Fed tightening for this cycle (no more short-term interest rate increases) should pave the way for healthy stock market returns over the next 12 months. During the past two decades, three significant Fed tightening cycles occurred, two during the 1980's and one during the mid-1990's. The average stock market advance occurring within 12 months after the last Fed rate boost in each of these cycles was +23%. The best performing sectors during these three periods included health care, financials, telecommunications, and consumer staples.

The bond markets also experienced significant volatility during the quarter as the yield on the 10-year U.S. Treasury Note moved within a relatively wide range of 75 basis points (5.75-6.50%) before ending the period at 6.02%, the same level it was at the end of the first quarter of 2000. Obviously, bond investors experienced some of the same anxiety and relief over economic growth rate trends and monetary policy as equity investors did during the past three months. The net effect on bond performance was that returns were derived primarily from coupon payments with very little price change for the quarter. The total return from our fixed income benchmark, the Salomon Broad Investment Grade Bond Index, was +1.7% for the second quarter and +3.9% for the first half of 2000. Our bond portfolio duration target remains approximately equal to our benchmark duration of 5.0 years.

### **Summary**

Based on our expectations outlined in the foregoing pages, we conclude that the economic environment will provide a positive environment for investors. The conclusion of the Fed's tightening posture should encourage the markets that this record expansion can continue into the foreseeable future. In terms of specifics, we will briefly summarize our views below:

- ▶ We continue to expect that real GDP will increase by +4.0% in 2000. This would compare favorably, relative to inflation expectations, with the +5.5% increase reported in the first quarter.
- ▶ Our interest rate outlook is unchanged in that we expect to see a 6.25% high on the benchmark 10-year Treasury over the next 12 months. However, the ultimate success of the Fed's tighter monetary policy should be contained inflation and lower

interest rates trending down toward the 5.50% level.

- ▶ We are raising our CPI inflation rate for the year to +3.3% from +2.7% previously. This increase is primarily due to the continued high level of oil prices which will be reflected in the data over the next few months. While higher oil prices will increase the inflation reports, they also are likely to act as somewhat of a restraint on overall consumer spending. This would restrain GDP growth which would be consistent with the Fed's objectives. We expect inflation to fall back to under +3.0% in 2001.
- ▶ The Zacks consensus estimates for the S&P 500's operating earnings for 2000 and 2001 are \$58.19 (+13.9%) and \$63.08 (+8.6%). While the 2001 estimate reflects a slowing in growth, it is still a very respectable increase at this unprecedented stage of the economic cycle.
- ▶ The valuation tug-of-war between the old and new-economy stocks is likely to continue. Consequently, the equity market may remain volatile. However, both categories should benefit from a positive economic environment. Earnings progress will be paramount in each segment.

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*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.*