

# The Investment Environment

July 1999

As we enter the third quarter of 1999, the U.S. economy continues to show a remarkable ability to avoid problems and to generate above-average growth of real gross domestic product (GDP). In addition to growing at a relatively rapid pace, the rate of inflation as measured by the consumer price index (CPI) remains remarkably well contained. With the national unemployment rate at a low level (4.3%) not seen in 30 years, it appears that the basic laws of supply and demand as related to labor have been put on hold, if not repealed in their entirety. At almost any time during the last 30 years, prior to the last few years, one would have thought that tight labor markets (supply) would have resulted in higher wages (demand) to retain and attract labor. Obviously, something is different this time. As discussed in our last letter, there are a number of factors contributing to the present benign inflation environment.

We believe the primary factors influencing the CPI in this tight labor market center around globalization, whose impact on consumer prices was dramatically enhanced by the economic downturn in Southeast Asia during the last 18 months, and new technology which appears to be playing a major role in the robust productivity advancements recorded in recent periods.

## Inflation

After a big scare in April 1999 when the monthly CPI rose +0.7%, representing the largest monthly advance in nine years, the release of the May report that consumer prices were unchanged was positively received by the financial markets. The core rate which excludes food and energy prices rose +0.1% after increasing +0.4% in April. May's positive report reflected a decline in energy,

apparel, and tobacco, all of which contributed significantly to the higher number in April.

On a year-over-year basis, the CPI was +2.1% higher than May a year ago. During the same period, the core rate rose at a +1.8% annual rate. This data positively impacted the financial markets' fear of inflation which was triggered by the April report. While a distinctly positive, short-term occurrence, it does not entirely remove the concerns of the impact of a very tight labor market and the potential global economic recovery's impact on prices.

As mentioned earlier, our reluctance to abandon the laws of supply and demand in the U.S. labor market keeps us ever on the lookout for signs of rising wage costs. To date we have been unable to identify any concrete trends indicating that wage costs are trending upward at a worrisome pace. For example, the quarterly reported Employment Cost Index (ECI) was reported at +3.0%, (as compared to 12 months earlier) in the first quarter of 1999 versus the +3.5% in the fourth quarter of 1999. During the last five years, the December quarter ECI versus the same quarter in the prior year was reported as follows:

Table 1 Year	ECI Rate of Change From Year Earlier
Q1-1999	*+3.0%
Q4-1998	+3.5%
Q4-1997	+3.4%
Q4-1996	+3.1%
Q4-1995	+2.6%
Q4-1994	+3.1%

\* In the first quarter of 1999 both the advance in wages and salaries (+3.3%) and benefits (+2.2) were below the fourth quarter 1998 report.

Looking at this same question from another angle (i.e., in the more generalized comments contained in the so-called Beige Book, which offers a summary of commentary on the current economic conditions by Federal Reserve Districts) presents a somewhat different perspective. The June 1999 issue contained the following comments under the heading, Labor Markets, Wages, and Prices.

- Labor markets were extremely tight last month in almost all districts, with no signs of easing in the foreseeable future.
- Despite the summer influx of student workers, temporary employment firms in many districts have been unable to fill all their job openings.
- Although labor shortages are reported in almost all sectors, some skilled workers have been in especially short supply and many employers have broadened their searches from local to regional and national levels. Information technology workers, in particular, are very difficult to find.
- Persistently tight labor markets have resulted in many reports of increased wage pressures, especially for some specific industries and skilled occupations.
- Many districts suggest that employers have continued to be creative in finding and recruiting additional labor. Employers in the Atlanta district for example, appear to be using more bonuses and incentives as part of total labor compensation, and many companies are using more part-timer workers and consultants as well as allowing employees to work at home.
- Prices remain generally subdued, but many districts report pockets of higher prices for some specific sectors and goods.

In the report's summary, it was concluded that "Labor markets remain very tight in almost all districts, with increased reports of upward pressure on wages in many parts of the country. There have been some reports that labor supply constraints are impeding employment growth in many sectors. Prices, however, with the exception of several construction materials remain well

behaved."

A very positive fundamental in the inflation outlook is the strong advances being recorded in productivity. After growing at about a +1% rate from 1970 to 1990, productivity gains have improved quite nicely in the last three years in the nonfarm business sector, especially when compared to the three prior years as shown in the following table.

Table 2 Year	Nonfarm Business Sector Productivity Gains
1998	+2.2%
1997	+1.2%
1996	+2.4%
1995	+0.6%
1994	+0.5%
1993	+1.1%

The really exceptional gains in productivity have taken place in the manufacturing sector where it has been noted by the FRB of Cleveland that, nationally, the same level of employment in April of 1999 produces +23.6% more output than it did in 1994. That represents a productivity advance of around +4.3% per year from 1994 through 1999. These impressive productivity gains are attributed to significant spending on new technology, machinery, and manufacturing techniques and approaches. This is a real response to the tight labor markets and competitive global economic environment which appears to represent a substitution of capital for labor and which appears to be paying off. The bottom line is that a continuation of these superior productivity advances is a crucial ingredient in the low inflation, "new-era" economic environment.

The foregoing, while pointing in the direction of some cautious watchfulness relative to the inflation outlook, does not yet lead us to conclude that inflation is an imminent problem. Nevertheless, the situation requires very close monitoring.

**Corporate Profits**

After a relatively weak profit experience in 1998, it now appears that corporate profit gains in 1999 will recover and exceed our earlier expectations. A continuing strong domestic economy, an improving global economy, contained labor costs, and strong productivity gains all argue for higher corporate profitability in 1999. Consequently, we are raising our 1999 earnings expectation for the S&P 500 to an +8% increase from our earlier more subdued expectation of +3%-5%. At the present time we are expecting an increase of approximately +6% in S&P 500 operating earnings in 2000.

To put the profit picture in perspective the following table presents the S&P 500 operating earnings per share since this extended economic expansion began in 1991.

<b>Table 3 Year</b>	<b>S&amp;P 500 Oper. EPS</b>	<b>% Change</b>
1999E	\$ 48.37	+ 8.0%
1998	\$ 44.79	+ 0.1%
1997	\$ 44.74	+10.9%
1996	\$ 40.35	+ 4.0%
1995	\$ 38.81	+17.6%
1994	\$ 33.01	+23.9%
1993	\$ 26.64	+18.5%
1992	\$ 22.49	+10.6%
1991	\$ 20.34	-13.6%

Using 1991 as a base, the compound annual growth rate of S&P 500 operating earnings has been +11.9% over the last seven years. This would compare favorably with the longer term trend of profit growth around +6.5%.

Sectors which appear likely to attain above-average earnings growth in 1999 would include technology, telecommunications, health care, and finance.

### Interest Rates

With the outlook for inflation not worrisome and the Federal Reserve signaling a diminished inflation concern after its recent 25 basis point increase in the Federal Funds rate to 5.0%, one can breathe a little easier. Its decision to adopt a

directive that includes no predilection concerning near-term policy action in contrast to their prior "bias toward restraint" now indicates a somewhat diminished concern on the part of the Federal Reserve Open Market Committee concerning an acceleration of inflation. However, in dealing with a situation of uncertainty, they, like us, note that they must be "especially alert to the emergence, or potential emergence of inflationary forces that could undermine economic growth." Looking ahead to mid-year 2000, we expect the long-term Treasury Bond to trade in a range between 5.50% to 6.25%.

### Concerns

In a market "priced for perfection" one must constantly seek to evaluate and understand the risks and uncertainties. In our last letter we discussed the worsening U.S. trade and current account deficits. As long as this is deteriorating, as it continues to do, we become more dependent on foreign investors to continue to finance it. At some point foreign investors may view this as a less attractive option, thus weakening the U.S. dollar and raising U.S. interest rates.

The second potential concern centers around the outlook for the financial markets in a high-confidence, low-savings economy. While one may challenge the accuracy of the measure of U.S. consumer savings, there appears to have been a significant decline in consumer savings in the last few years.

Our concern centers around the potential impact on consumer confidence and spending behavior should some unforeseen development negatively affect the U.S. equity markets. With consumer confidence at the highest level since 1968 and consumer expenditures accounting for nearly 69% of total GDP, any threat to the consumer's willingness to spend could dramatically slow overall economic growth. This negative impact would then likely be magnified by the declining savings rates of the American consumer in recent years. This decline in savings can be clearly seen in the following table.

<b>Table 4 Year</b>	<b>Savings as a Percent of Disposable Personal Income</b>
1998	0.5%
1997	2.1%
1996	2.9%
1995	3.4%
1994	3.5%
1993	4.4%
1992	5.7%
1991	5.6%

The clear decline in the percent of income saved in the last few years is thought to be related to the dramatic equity returns since 1995, a related general feeling of well-being, and an associated willingness to spend and consume derived from a condition referred to as the “wealth effect.” Its continued enhancement, primarily resulting from rising equity prices, has provided a strong underpinning to the economy’s overall growth. The high returns derived from equity ownership have attracted broader equity ownership within the general population, thereby perpetuating this virtuous cycle, i.e., where equity values rise, owners feel wealthier, they buy more goods and services which strengthens the economy, which enhances equity values and so on...

The focus of our concern lies in when or what brings this virtuous cycle to an end, assuming that it will not continue indefinitely. The May savings rate was -1.2% which was reported as being the lowest recorded level in history. It also was the sixth consecutive month that the savings rate was negative. The situation may self-correct on its own over time. We will continue to monitor it closely.

### **Financial Markets**

After several years of relatively narrow focus on large capitalization companies, equity investors finally embraced a much broader array of stocks during the second quarter of 1999. The rotation into previously underperforming sectors of the market such as natural resources, cyclicals, small cap stocks, and emerging market issues represented a very healthy broadening of investor interest and display of overall economic

confidence. The fact that this broad advance in equity valuations occurred as long-term interest rates rose by 35 basis points serves as a tribute to the very positive impact that improving corporate profitability has on stock prices. As noted previously in this letter, corporate earnings growth estimates for 1999 have doubled or even tripled from the relatively modest expectations of just 3-6 months ago. This strengthening earnings picture contributed to the healthy second quarter gain of +7.1% for the S&P 500 Index (dominated by large capitalization stocks) and the even more impressive return of +15.5% for the Russell 2000 (small stock benchmark). The EAFE Index (equities of developed countries other than the U.S.) lagged with a gain of +4.0% as modest returns from Europe offset a strong Japanese market. For the first half of 1999, the total return for the S&P 500 Index was +12.4% while the Russell 2000 and EAFE Indices produced returns of +9.2% and +4.2%, respectively.

The continued strength of the U.S. economy and the reemergence of growth in the economies of Southeast Asia along with the rebound in oil prices led to a third consecutive quarter of higher interest rates. The long-term U.S. Treasury Bond rate rose from 5.62% on 3/31/99 to 5.97% by the end of June. This resulted in negative returns of -1.0% and -1.4% from our fixed income benchmark, the Salomon Broad Investment Grade Bond Index, for the second quarter and the first six months of 1999, respectively. Our bond portfolio duration target continues to mirror that of the benchmark as interest rates are near the top end of the range anticipated for the next 6-12 months.

### **Conclusion**

Looking ahead from this point, we must conclude that the investment environment remains positive. A monetary policy managed by Alan Greenspan continues to provide us with a sense of confidence. The attempt to be “preemptive” in the recent 25 basis point Federal Funds rate appears prudent. For the first time in 30 years the fiscal policy debate is centered around what to do with a surplus. This debate confirms distinct positives as

long as the political motivations do not get out of control. The NATO bombing war is over and hopefully the next stage will unfold in a peaceful and orderly manner. The global economic environment seems to be improving. The domestic economy is growing nicely in a low inflation environment and we have modestly raised our corporate profit expectation. There are always things to worry about and we will do our best to identify them. Overall, we continue to view the investment environment as constructive.

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