

As we enter the fourth quarter of 2000, the current economic expansion, which is at a record-breaking nine-and-one-half years in duration, has recently begun to show signs of slowing which would be consistent with the objective of the Federal Reserve's monetary policy. The Fed began increasing the federal funds rate 15 months ago and has been on hold since its last increase of 50 basis points to 6.50% in May 2000. The Fed's objective is to slow the growth rate of real Gross Domestic Product (GDP) and thereby reduce the likelihood of an increase in the rate of inflation. A broadly based acceleration of inflation at this advanced stage of the economic cycle would be very worrisome for the financial markets and the economy in general. The key factors playing crucial roles in the current economic and investment outlook would include the rate of real GDP growth, the tight labor market, the outlook for productivity growth, the direction of the price of oil, the U.S. trade deficit and the strength of the dollar, and at this point, we will even include the outcome of the forthcoming national election. That's a pretty full plate, but we will try to briefly discuss each of them.

Real GDP Growth and Productivity

We will start with some perspective on real GDP growth and the important role of productivity in restraining inflation. Productivity is defined as the physical output per unit of productive input. It plays a crucial role in the outlook for inflation and consequently in the formulation of the Federal Reserve's monetary policy. For example, if the

U.S. economy, as measured by real GDP, were growing at a rate in excess of +4.0% as it is now and has been since 1997 (as shown in Table 1) the Federal Reserve, based on historical experience, would likely be very nervous about the outlook for inflation and the degree of appropriateness of its current monetary policy position.

The reason that the Federal Reserve is far less nervous with its present monetary policy (even considering its recent statement of "a bias toward restraint" at its last meeting when federal funds rate was left unchanged) is that the rapid growth in productivity being experienced enables a relatively rapid rate of real GDP growth without a pickup in the rate of inflation.

Table 1

Year	(a) Real GDP	(b) Produc- tivity	(c) Compen- sation Per Hour	(d) Unit Labor Costs
---- Non-farm business sector ----				
1996	+3.6%	+2.5%	+3.0%	+0.5%
1997	+4.4%	+1.8%	+2.8%	+0.9%
1998	+4.4%	+2.6%	+5.1%	+2.4%
1999	+4.2%	+2.9%	+4.8%	+1.8%
2000 Q1	+4.8%	+1.9%	+3.9%	+1.9%
2000 Q2	+5.6%	+5.7%	+5.3%	-0.4%

The acceleration of the growth of productivity means that more goods and services are being produced per unit of labor, which results in a greater supply of goods and services and also permits an increase in the wages of workers and the profits of corporations without accelerating a trend of rising prices, i.e. inflation.

To provide some historical perspective, productivity growth in the non-farm business sector averaged +1.5% per year in the five-year period 1991 through 1995. The data presented in Table 1, columns (b), (c), and (d) support the following conclusions. In the four following years, 1996-1999, productivity growth averaged +2.5%. The most recent release for non-farm business sector productivity for the second quarter of 2000 was +5.7%. The Bureau of Labor Statistics release showed hourly compensation rising +5.3% from the prior quarter and unit labor costs declining by -0.4%. This recent example demonstrates how enhanced productivity can contain inflation and support profits in a tight labor market.

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 +10.3% annual rate in the nine-year period 1990 through 1999. It increased by +11.5% in the soft-landing year of 1995. It advanced by +14.1% in 1999 and by +16.1% in the first half of 2000 versus the same period 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 +1.5% in the early 1990's to a range of +2.5% to +3.0%. 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% labor growth and +2.5% productivity growth) which seems to be within the environs of the general consensus of forecasts.

Labor Market Utilization

The tightness of the labor market can be clearly seen from the following Table 2. The unemployment rate at 4.1% in August 2000 is significantly below the 6.1% rate in 1994. Also, the Employment/Population ratio in 2000 is at a relatively high level, while down from a peak earlier in the year. This is why you see so many "help wanted" signs all over and so much TV advertising of jobs available. This would seem to argue for rising wages and again emphasizes the important role of rapid productivity growth.

Table 2

Year	Labor force participation rate	Employment/population ratio	Unemployment rate
1990	66.5	62.8	5.6
1991	66.2	61.7	6.8
1992	66.4	61.5	7.5
1993	66.3	61.7	6.9
1994	66.6	62.5	6.1
1995	66.6	62.9	5.6
1996	66.8	63.2	5.4
1997	67.1	63.8	4.9
1998	67.1	64.1	4.5
1999	67.1	64.3	4.2
2000: Jan	67.5	64.8	4.0
Feb	67.6	64.8	4.1
Mar	67.4	64.7	4.1
Apr	67.5	64.9	3.9
May	67.1	64.3	4.1
June	67.2	64.5	4.0
July	66.9	64.2	4.0
Aug	67.0	64.3	4.1

The September 20, 2000, Beige Book's summary of Commentary on Current Economic Conditions for the Federal Reserve noted that, "labor markets remained tight in most of the 12 Districts, although signs of some easing were

reported by Boston and Kansas City. Reports of wage increases were widespread and some firms indicated that higher labor costs were an increasing problem. Nevertheless, there were few indications that higher wages were being passed through to consumers as higher productivity and competitive pressures held firms' prices in check." It was also noted that recent sharp increases in the costs of health care and energy might eventually be passed through to consumers. Several Districts also noted that prices of some metals, lumber, and other basic commodities had declined recently.

Oil Price Impact

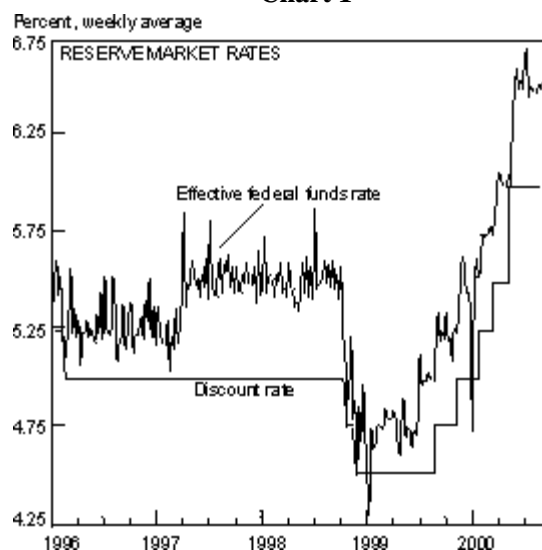
Oil represents a clear example of the basics of supply and demand. However, supply is primarily controlled by OPEC and demand is largely determined by the strength of economic activity in the major industrial nations of the world. Historically, high oil prices restrain economic activity. However, the economic impact of higher oil prices has diminished in recent years due to the increasing contribution to total economic activity of services and information technology. The last U.S. recession in 1990 was related to a rapid rise in the price of oil to \$40 per barrel and the turmoil between Iraq and Kuwait. Subsequent to that \$40 peak, the price of West Texas Intermediate Oil averaged around \$18 per barrel over the next five years, with a peak around \$26 per barrel at the end of 1996. Oil prices declined sharply in 1997 and 1998 reaching a low around \$11 per barrel at the end of 1998. This low was triggered by the Asian financial crisis, and by OPEC over-production due to market share conflicts. A sharp upward spike began in 1999, with a peak and a 10-year high at \$37 per barrel in recent weeks. Near the end of September, the Clinton administration made the decision to tap the Strategic Petroleum Reserve to release 30 million barrels from the 570 million barrel reserve. The U.S. currently is using about 19 million barrels of oil per day. Subsequent to this decision, the price of oil dropped to around

\$31.50 per barrel. From the standpoint of the Federal Reserve's efforts to slow the economy's rate of growth to forestall inflation, the high oil price is a supporting factor. However, at some point, high oil prices could be viewed as a negative, which could lead to overkill in trying to craft a soft landing. At this point, we would expect oil prices to settle around \$25 per barrel or slightly less in 2001, which is in-line with OPEC's objectives.

Federal Reserve Monetary Policy

The Fed has been raising the fed funds rate since June 1999. As shown in the following Chart 1, the rate has been increased six times and by a total of +1.75%. The first three increases represented a return to the 5.50% level which was in effect at the time of the Asian/Russian financial crises in 1997 and 1998 when the Federal Reserve felt impelled to reduce rates to stabilize markets and to forestall a worsening financial crisis.

Chart 1



The last three federal funds increases to the current 6.50% level were aimed at slowing the growth of the U.S. economy and effecting a soft landing and containing inflation. As mentioned earlier, the Fed is currently "on hold" with a "bias toward restraint" while waiting for more data and also the conclusion of the presidential

election. While it is not yet possible to conclude with high certainty that the Fed is completely finished raising rates, it appears that if the economy slows in the forthcoming quarters, as we are expecting, the Fed will remain in this “on hold” position. Should the GDP numbers come in weaker than expected, the Fed’s tightening would be behind us and the next change would be a reduction in the federal funds rate.

U.S. Trade Deficit and the Dollar

The U.S. has been experiencing a steadily deteriorating current account deficit since 1991 (\$6.6 billion surplus) with a brief pause during 1995 (\$109.5 billion deficit) through the first half of 1997. To put this into perspective, the \$140.5 billion current account deficit in 1997 represented 1.7% of the nation’s GDP. Today the estimated 2000 current account deficit of \$430 billion would represent approximately 4.3% of this years’ estimated GDP. Therefore, our current account deficit, relative to GDP, is at a historically unprecedented level.

The Asian/Russian financial crises accelerated the growth of the current account deficit as the U.S. economy and a strong, stable currency came to be viewed as a safe haven and an attractive global investment opportunity.

Due to these factors, money and manufactured goods flowed into the United States. Consequently, our current account deficit increased by nearly +55% in 1998 to \$217.1 billion and by almost +53% in 1999 to \$331.5 billion. Our estimate of \$430 billion in 2000 would represent a major slowing but still a +30% increase.

As things now stand, the entire world has, to a degree, benefited from the foregoing. The crisis nations have had an opportunity to stimulate their economies by selling their goods in the U.S., and also by investing in the U.S. through stocks, bonds, and direct investments (mergers

and acquisitions). The U.S. has benefited via a strong dollar which created cheap imports, restrained inflation, and attracted foreign investment funds which enhanced the demand for stocks and bonds.

The question one must answer is, “Can this trend continue indefinitely?” Probably not! However, if the adjustment back to more normal relationships takes place gradually as the rest of the world gets its economic and financial affairs back in order, the current situation can be corrected without a financial crisis. As long as the U.S. remains the most attractive investment market in the world, the current account is likely to continue to rise. This must be closely monitored.

Presidential Election

Our point in including this category is to identify the most positive election outcome for the financial markets. It appears that the major differences in approach between the candidates reflect their own views and their party’s philosophies and center around tax policy and health care. Bush is more aggressive in the tax-cutting area and Gore in health care. Theoretically, a massive tax cut could be overly stimulative in a rather fully utilized U.S. economy. By the same token, a massive government-administered health care program could be very expensive and disruptive to the existing health care system. Implementation of either could result in higher inflation. The positive aspect of a party split between Congress and the White House is that gridlock would likely forestall the passage of any extreme tax or spending programs. In other words, in our current economic and political environment, ‘gridlock is good’ for the future of the financial markets. As things now stand, we expect gridlock to continue as it has for the last six years when it contributed to a positive economic and investment environment.

Financial Markets

The overall stock market continued to stagnate during the third quarter as rising energy costs and European currency weakness led to a number of corporate earnings warnings. Particularly hard-hit were the technology and telecommunication sectors as evidenced by the -7.4% decline in the technology-oriented NASDAQ Index during the third quarter. However, the financial, utility, and energy groups performed very well during the period and helped offset the negative impact of the high-tech sector.

This mixed bag of sector performance resulted in a slight decline of -1.0% in the S&P 500 Index (large capitalization stocks) and modest gain of +1.1% in the Russell 2000 Index (small capitalization stocks) for the September quarter. The currency problems in Europe dragged the total return from the EAFE Index (foreign equities) down to -8.0% for the past three months. The same trends were apparent in the year-to-date performance figures as the S&P 500 and Russell 2000 total returns for the first nine months were flattish at -1.4% and +4.2%, respectively, while the NASDAQ and EAFE returns were very weak at -9.6% and -12.6%, respectively.

The growing perception that an economic "soft landing" was occurring and, therefore, the Federal Reserve was done raising short-term interest rates led to actual declines in rates along the rest of the yield curve during the third quarter. The yield on the 10-year U.S. Treasury Note dropped from 6.02% at the end of the second quarter to 5.80% at the end of September. The decline from the beginning of the year when the 10-year U.S. Treasury Note rate was 6.44% was even more impressive. The total return from our fixed income benchmark, the Salomon Broad Investment Grade Bond Index, was +3.1% for the third quarter and +7.1% for the first nine months of 2000. Given our expectations for a near-term range of

5.50-6.25% for the 10-year U.S. Treasury Note yield, our bond portfolio duration target remains approximately equal to the benchmark duration of 5.0 years.

Historically, the stock market has performed well in Presidential election years but not until the latter part of the year. The financial markets also tend to produce strong results *after* a period of prolonged tightening of monetary policy (i.e. short-term interest rate hikes) by the Federal Reserve. Considering these factors, along with our expectations that real GDP growth will moderate to a more sustainable +3-4% rate in 2001, and that corporate profits will grow by +8-10%, we expect attractive returns from the financial markets in the quarter and year ahead.

Summary

A brief summary of our views, based on the foregoing, is outlined below:

- ▶ We expect to see some slowing in GDP growth in the just concluded third quarter, and subsequent quarters, consistent with the Fed's objective and monetary restraint. A confirmation of this expectation was contained in the October 2, 2000, release of the National Association of Purchasing Management's factory index for September which was modestly below 50 for the second consecutive month. A reading below 50 signals a contraction. A slowing economy and continued real GDP growth at a more moderate pace around +3-4% would likely satisfy Alan Greenspan very much.
- ▶ While likely to vary on a quarterly basis, we expect annual productivity gains to average +2.5-3.0%, which would be very positive.
- ▶ We would expect the labor market to remain tight with gradual upward pressure on wage compensation. This further emphasizes the importance of productivity advances in containing inflation.

- ▶ The Federal Reserve, which is currently on hold, will likely continue to maintain its “bias toward restraint” until the economy slows significantly and/or some concrete signs of less intensive resource utilization or productivity gains appear.
- ▶ The current account deficit of approximately \$430 billion, or about 4.3% of the current years’ estimated GDP, is at a record historical high. As long as foreign money continues to flow into the U.S. at an accelerated pace, this does not appear to represent a problem. A significant weakening of the dollar could be a warning sign.
- ▶ We are remaining with our CPI inflation forecast from our last letter of +3.3% in 2000 and around +3.0% in 2001. The rise in oil

prices in 2000 is the primary factor in our higher CPI expectation in 2000.

- ▶ Political gridlock will continue and limit the government’s implementation of extreme tax or spending programs.
- ▶ The materialization of a “soft landing” and the subsequent ending of restrictive monetary policy will be positive for the financial markets.

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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.