

The Investment Environment

October 1999

As we enter the fourth quarter of 1999, the current economic expansion continues to amaze as it moves resolutely toward a new record for the longevity of a U.S. economic expansion. With 102 months (eight and one-half years) of growth, it only needs four more months to equal the old record of 106 months, set in the 1960s. At this point, barring a significant unforeseen event, it seems very likely that early in the year 2000 the U.S. economy will be in an unprecedented position relative to the duration of an economic expansion. This observation is in no way intended to indicate that the present up-cycle will soon end. It is only noted to point out that we are in new territory. And even that observation almost appears to be redundant with the constant referral to the economy as representing a “new paradigm” or a “new era.”

Could this be a fair representation of the present environment? Yes, it could. In fact, we believe that the economic influencers such as the Federal Reserve (through monetary policy) and the U.S. Government (through fiscal policy) along with the key participants in the business and consumer sectors are all expanding their knowledge and capabilities in what is becoming known as the “information age.” In other words, if we, as a nation, are more capable through our accumulated and readily available knowledge base, why would it not be possible that we could eliminate or at least greatly diminish the majority of economic errors or imbalances which negatively impacted our economy in the past and cumulatively led to economic weakness, instability, and recessions.

This is certainly not meant to proclaim the death of the business cycle. However, in a knowledge-based, information-age environment, why would it be logical to expect an economic recession every four years or so? We can learn from our mistakes through the application of new information and

technology. One example apparent today is the greatly improved control by businesses over the level of their inventories. In the past, prior to the greatly enhanced inventory monitoring systems, inventories were often found to be excessive in the face of any unforeseen downturn in demand. Their subsequent draw down to a more realistic level, reflecting current demand, would contribute significantly to an economic downturn or recession.

Another example would involve the management of monetary policy by the Federal Reserve and particularly by Alan Greenspan. In our view, he has personified the information age as it applies to economics because he is a knowledgeable and practical guy. We have long admired his knowledge and his approach to dealing with uncertainty in managing our nation’s monetary policy to preclude an acceleration of inflation by ultimately falling back on the premise of “erring on the side of restraint” in the creation of money. It may be somewhat of a stretch to credit the “information age” for Alan Greenspan’s success, but the point is that with greatly enhanced information availability, we will have more capable people at every level throughout the economy. Therefore, by enhanced understanding and learning from history, we may be nearing the point where we can soon render George Santayana’s famous quote, “Those who cannot remember the past are condemned to repeat it,” irrelevant.

This is not to imply that there will not be economic recessions in the future. However, through the application of knowledge and an understanding of history, it would seem quite plausible that economic downturns in the future would be less frequent and less severe. The soft landing in 1995 engineered by the Federal Reserve at a cost of much higher interest rates in 1994 must be given some credit for the health and longevity of the current expansion.

In addition, we believe that, in the context of Alan Greenspan's repeated warnings over the last several years that the U.S. equity markets are becoming rather fully valued, one might reasonably ask "What does a high priced equity market have to do with monetary policy?" Our answer would be that perhaps Mr. Greenspan would prefer to see a modest corrective adjustment in stock prices (i.e., a soft landing which could build a base for sustainability of appreciation) in contrast to a possible larger downward adjustment in stock prices (i.e., a hard landing which could negatively impact the wealth effect and even precipitate an economic recession). At this point, he is attempting to influence the market through his words, "jaw boning," rather than through the use of monetary policy. Many disagree with his approach on this issue. Many also disagreed with his approach when he raised interest rates in 1994 to set up the soft landing. Sometimes knowledge and understanding are not readily apparent to the average economist. Obviously, we prefer "erring on the side of restraint."

We are not the only ones who respect and admire Alan Greenspan. It was recently reported in the *Christian Science Monitor* that "In New Zealand, some politicians have even talked recently about hiring Alan Greenspan for their own nation - particularly after they discovered that he is paid less than his New Zealand counterpart." If he submits a résumé, we would advise Congress to quickly increase his pay.

We will now turn from the broad, theoretical overview to take a more specific look at some of the determining variables in the economic and investment outlook. In this group we would include real Gross Domestic Product (GDP), physical employment and wages, productivity, inflation, corporate profits, interest rates, the current account, and Y2K.

Gross Domestic Product

We will start with real GDP because it is the broadest of the variables and is, therefore, a crucial representative of the condition of the overall environment. In recent years, the performance of real GDP has been consistently strong and provided a very strong backdrop for the enhancement of

financial well-being. In a general sense the faster the growth rate of real GDP, the more attractive the economic environment, as long as inflation and interest rates are not simultaneously accelerating. It is this trade off which puts the spotlight on the Federal Reserve in its mission to encourage growth while containing inflation. Theory has it that a non-inflationary growth rate in real GDP is in the range of 2.5% - 3.0%. This range is roughly determined by combining the growth rate of 1.0% in the labor force with a 1.5% - 2.0% increase in the growth of productivity. In addition to the foregoing, other general relationships which historically have forewarned of rising inflation would include the economy's capacity utilization rate and the unemployment rate. Warnings of incipient inflation historically have flashed when the capacity utilization rate was around 84% and above. A labor unemployment rate below 5.5% was, until recently, thought to be a forerunner of rising wage increases and ultimately inflation.

To put the foregoing into its current perspective, it quickly becomes apparent that things are not working as they used to in the past. First, as shown in the following table, real GDP has grown at a faster rate than that thought to be non-inflationary.

Table 1				
Year	Real GDP Growth	Total Industry Capacity Utilization Rate	All Civilian Unemployment Rate	Business Sector Productivity
1999E	+3.8%	80.5%	4.3%	+2.0%
1998	+3.9%	81.9%	4.5%	+2.4%
1997	+3.9%	82.9%	4.9%	+1.5%
1996	+3.4%	82.4%	5.4%	+2.6%
1995	+2.3%	83.4%	5.6%	+0.3%
1994	+3.5%	83.2%	6.1%	+0.6%
1993	+2.3%	81.3%	*6.9%	+0.1%
1992	+2.7%	80.3%	7.5%	+3.4%
1991	-0.9%	79.3%	6.8%	+0.6%

* Subsequent data not directly comparable

An offsetting factor is that the capacity utilization rate has remained well behaved, as shown in column two. Then we have the unemployment rate, presented in column three, which would appear to be highly conducive to rising wages as a result of tight labor markets. Help-wanted signs are becoming the most common form of advertising in many businesses today. At least to date, tight labor

markets have not yet resulted in rapidly rising wage levels which would likely result in profit margin pressure from higher wages or inflationary price increases as the wage increases are passed through in the form of higher prices.

Productivity gains represent a very powerful offset to tight labor markets and inflation as well as fostering the enhancement of corporate profitability and the economic well-being of the work force. Productivity growth has improved meaningfully in recent years as shown in column four of the previous table. Strong growth in capital spending by corporations to avail themselves of the latest technologies stimulates the overall rate of GDP growth and enhances the rate of productivity growth in the economy.

So here we have the “new paradigm” relatively complete, with one major omission. That omission is globalization. Globalization involves expanding economic markets beyond traditional national borders. Globalization is a powerful economic concept. It has been growing steadily over the last 20 years, and it seems to be accelerating with a major boost as a result of the “information age.” It is one thing for a Wisconsinite to buy low-cost apparel at the mall exported from a low-wage manufacturing facility in Asia or Central America. It is a major step toward “one world” when a Wisconsin buyer can competitively shop for specific goods throughout the entire world via the Internet. Globalization would seem to argue in favor of pricing pressure and lower inflation.

During the last 15 months or so, we have experienced a very positive impact on our CPI inflation rate directly related to globalization. When the Asian crisis occurred, the U.S. was viewed as a safe haven and large sums of money flowed in. The Federal Reserve lowered its Federal Funds rate by 75 basis points in three increments. Foreign imports flowed into the U.S. at record levels and at low prices. This benefited U.S. consumers. Foreign exports helped the troubled nations stabilize their economies. This was not mainstream globalization, but it was a dramatic impact of increasing global interconnectedness.

We now seem to be in the early stages of reversing the effects of the global crisis. Countries around

the world seem to be showing signs of economic recovery. The U.S. has reversed two-thirds of its reduction in the Fed Funds rate. The U.S. dollar has been showing signs of some softness as money begins to move from its perceived safe haven in the U.S. This is where a problem may arise, since the U.S. must attract in excess of \$300 billion of foreign funds to cover the growing current account deficit.

Current Account Deficit

As of the release of the latest data on September 21, 1999, the U.S. continues to voraciously absorb foreign imports in that the U.S. trade deficit rose to a new record of \$25.2 billion in July topping the June revised record deficit of \$24.6 billion. While the rest of the world is recovering economically, the U.S. economy’s strength continues to attract an excess of imports relative to exports. However, U.S. exports have been rising for three straight months. The problem is that imports are growing faster.

The U.S. dollar has recently been showing signs of weakness relative to the Japanese yen. This would indicate that, in total, foreign investors view Japan as a more attractive place to put their money. Should this continue, the U.S. may eventually have to raise its interest rates to attract foreign money to cover its \$300+ billion current account deficit.

Year	U.S. Current Account Billions \$	% of GDP
1999E	-\$325.0	3.6%
1998	-220.6	2.6%
1997	-143.5	1.8%
1996	-129.3	1.7%
1995	-113.6	1.6%
1994	-121.7	1.8%
1993	- 85.3	1.3%
1992	- 50.6	0.8%

This would not be a positive development for the U.S. financial markets. Therefore, it does appear that we are reaching a point where we may no longer be able to tolerate rising trade deficits without negatively impacting the value of the dollar or interest rates. It may be that as the growth in the

GDP of the rest of the world rises that the growth of GDP in the U.S. may have to slow more toward the ranges indicated in the earlier part of this discussion.

Corporate Profits

The growth in S&P 500 corporate profits in the 1990s has been quite supportive of rising stock prices. This can be clearly seen in the following table.

Year	S&P 500 Operating Earnings Per Share	% Change
2000E*	\$54.88	+10.0%
1999E*	49.91	+12.7%
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

We have underestimated the gains likely to occur in 1999 having raised our early estimate of +4% to +8% at mid-year. It now appears that we are still on the low side. Before we raise our estimate, we would like to briefly discuss why we seem to be behind the curve in estimating profit growth.

While we have been expecting the overall growth of real GDP to slow from the +4.0% level in 1999, it currently appears that it will be close to that level when the year is completed. If so, that will provide a strong underpinning for corporate profit growth.

In addition, it is not unusual for corporate profit growth to slow as the economic cycle matures which would seem reasonable in an economic expansion which is eight and one-half years old. With the unemployment rate at 4.2%, the lowest in 30 years, it would seem that profitability would be losing some ground in its battle for available dollars with labor. Labor also does not seem to be winning its share of the pie resulting from the productivity gains being attained.

Rising corporate debt to support capital and technology enhancement and share buybacks do not seem to be negatively impacting profitability as we had anticipated.

It was recently reported that corporate tax payments will likely be down by approximately 6½% in 1999. Tax departments are becoming profit centers through the use of tax shelters. An example would be issuance of stock options which understate payroll expenses.

A final factor which will contribute to 1999 earnings is the swing in some commodity prices with the recovery beginning in Asia. Oil is a major swing factor this year driven by the effective restraint applied by OPEC and the oil producers. Consequently, profits are coming in above our expectations and we will increase our 1999 expectation to +10% which is still on the more conservative side. A stronger global economy should benefit earnings in the year 2000. The U.S. economy will likely slow and the comparison will be more difficult, therefore, we anticipate a slowdown to +7-8% in corporate profit growth next year.

Inflation and Interest Rates

As discussed earlier, we believe that the Asian crisis contributed significantly to the very low level of consumer price increases occurring in 1998 and so far in 1999. Weak commodity prices and a strong dollar resulted in very attractive prices for imported goods. These conditions appear to be changing. Therefore, as we move into the year 2000, we expect to see inflation beginning to move up to the 2.5% to 3.0% range. While this would represent a meaningful increase from the +1.6% change in the CPI in 1998, it would be consistent with the +2.2% increase expected in 1999 and the +2.9% average from 1992-1996.

If we are in the ballpark in our inflation expectations, we would expect the 30-year U.S. Treasury bond to trade in a range of 5.75% to 6.25% over the next six to nine months. In addition, we would anticipate that the Federal Reserve may have a couple of rate increases yet ahead of it.

Year 2000 Computer Problem

With the turn of the millennium less than 90 days away, we are likely now in the period of maximum uncertainty regarding this issue. Some of the extremists who fear a major computer shutdown are stock piling money, food, and guns, while most of us are simply looking forward to an extremely interesting New Year's Eve party in that the beginning of a new century is a significant milestone with or without computer problems.

Since the market has been quite volatile in the last few months, and the market is viewed as an efficient discounting mechanism, it is our view that most of the Y2K concerns are already priced into the market. To the best of our knowledge, only one well-known economist is calling for a Y2K related recession. Actually, it is quite likely that anxiety over the uncertainty may have caused more volatility than the actual problem itself. Since we do not anticipate major Y2K computer problems at year-end (thanks to the huge amount of time and money spent preemptively), if investor nervousness over Y2K does lead to some downward pressure on stock prices during the fourth quarter of 1999, we would view it as a good buying opportunity.

Financial Markets

Another Fed rate hike and the threat of more, a continuing rise in oil prices along with a sharp jump in the price of gold, record trade deficits, and a tight labor market which jeopardizes price stability, all contributed to the downward pressure on prices of financial assets during the third quarter of 1999. Even an improving outlook for corporate profit growth could not stop the price erosion as the benchmarks for large capitalization stocks (S&P 500 Index) and smaller capitalization issues (Russell 2000 Index) both showed negative returns of -6.3%. The technology and energy sectors were among the few areas of strength along with foreign equities as the EAFE Index (equities of developed countries other than the U.S.) produced a gain of +2.3%. For the first nine months of 1999, the total

return for the S&P 500 Index was +5.3%, while the Russell 2000 and EAFE Indices generated returns of +2.3% and +6.6%, respectively.

Strong economic growth in the U.S. along with concerns over the rise in commodity prices and the tight labor market pushed interest rates up for the fourth consecutive quarter. By the end of September, the long-term U.S. Treasury Bond rate had increased to 6.05% from 5.97% three months earlier. This limited the return from bonds, represented by our benchmark (Salomon Broad Investment Grade Bond Index), to +0.6% for the quarter. However, the return from bonds for the first nine months of 1999 was still negative at -0.7%. Our bond portfolio duration target remains similar to that of our benchmark.

Conclusion

Our nation's real GDP appears to be solidly on track to set a record for the longevity of an economic expansion early in the year 2000. Within the economy we have low unemployment, high consumer confidence, modest inflation, and rising profit growth. The stock markets have become more volatile as the Federal Reserve has preemptively raised its Fed Funds rate over the last several months, thereby reversing two-thirds of the rate reductions made during the Asian crisis in the second half of 1998. The global economic recovery, which appears to be in its early stages, is causing some concern to arise as to how the global adjustment will occur with regard to the financing of the U.S.'s \$300+ billion current account deficit. This could have a negative impact on U.S. interest rates and warrants very close monitoring.

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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.