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IMPLICATIONS OF A STRONGER DOLLAR

In conversations with clients this year, we have made the point that the U.S. dollar seemed to have bottomed on a trade-weighted basis last fall. Now, the dollar also appears to have reversed its decline, at least temporarily, against both the Japanese yen and German mark. Last month, the central banks of Germany, Japan and the United States, in a bold, well-coordinated move bought the dollar, driving it higher against foreign currencies. Both Germany and Japan had their own economic reasons for taking this action. Here, the falling dollar was becoming a political embarrassment and was potentially destabilizing to our financial markets. Obviously, no one knows with certainty what will happen next, but in today's interdependent world, the dollar's value, relative to the currencies of its trading and investing partners, is one of those key variables that has ramifications far beyond the day's currency trading action in London or New York. Below are a few of the implications we see for investors.

First, so far as *trade flows* are concerned, by definition, a stronger currency means our exports will be somewhat less competitive (i.e. it takes a greater quantity of foreign currency to purchase the same goods/services priced in dollars). However, several points related to *trade flows* should be noted. First, while the dollar may be higher than in mid-August, in the broader scheme of things, the dollar's rally is hardly notable. A German tourist will not cancel plans to visit Disney World merely because it now takes 1.5 marks to purchase a dollar rather than 1.4 marks. Second, there is a considerable lag between changes in exchange rates and resulting real world reaction. Industrial export orders can take months to move through the pipeline. Third, a stronger dollar/weaker yen will help to stabilize Japan's weak economy and its fragile banking system. Japan's condition, which has been under-reported in the popular press, is good for no one, and a stronger Japanese economy is more important to many companies selling into Japan than moderate changes in exchange rates. Finally, many U.S. exports have no good substitutes. Consumers will continue to buy Intel's Pentium microprocessor, Microsoft's Windows '95, and Lion King videos almost regardless of most exchange rate considerations. The exporters that we own are expected to continue to do well.

With regard to the financial market implications of a stronger U.S. dollar, there are two considerations: *corporate profits* and *portfolio flows*. The weak dollar has been an important stimulant to *corporate profit* growth. Going forward, we will need to focus upon determining which and to what extent multinationals developed their strong earnings because of product, marketing and cost controls, and which were benefited by currency translation gains to achieve their earnings progress. Results for companies like Pepsico, Gillette, and Abbott Labs have been driven by strong fundamentals, and in addition, they are sophisticated currency players. Reported earnings for this class of company will not likely be materially hurt because the dollar has strengthened.

Smaller companies, in general, have less foreign exposure than multinational giants. Thus, some market strategists are advocating a shift away from recent "large cap" market leaders. At the

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margin, we have added to client holdings of Federal Signal, Nucor, Home Depot, Alco Standard, Gaylord Entertainment and regional banks, all businesses with no or below average currency exposure. However, with most foreign economies ready to recover from a year of stagnation, this is not the time to abandon international exposure completely.

Portfolio flows are also impacted by the stronger dollar. To experienced global investors abroad, the currency decision generally precedes the market decision. It takes a very bullish outlook to override near-term expectations for a weak currency. With Japanese bonds yielding about 2%, and a recent directive from the Ministry of Finance allowing companies to invest more funds abroad (a means of weakening the yen), dollar-denominated bonds should look attractive to portfolio managers in Tokyo. This is one of several reasons we expect domestic interest rates to decline over the coming six months -- subject of course to the timing and resolution of U.S. budget negotiations. Global managers in other financial centers should also be more positively inclined toward our equity market if they come to believe that the dollar will not erode whatever gain they achieve. In general, foreign investors have been underweighted in dollar-based assets, and there is considerable room for them to add U.S. equities. However, an important precondition to a solid move into U.S. equities is believable progress in federal deficit reduction. Shares of the big multinationals will probably receive most of the portfolio inflow. These securities are highly liquid, well researched and known to foreign portfolio managers and their clients. Thus, any shift during a stock market "correction" by domestic investors away from the large capitalization multinationals is likely to be offset by foreign capital inflows.

All in all, the stronger dollar, if sustained, is positive for both the global and our domestic economy. While export growth may slow somewhat, we will gain as foreign economies gather momentum. A stronger currency also helps to relieve whatever domestic inflationary pressures may have been building. As for our bond market, favorable capital flows, likely further cuts by the Federal Reserve to stimulate our economy, and continued low inflation point toward lower rates. The impact upon U.S. stocks will be mixed as some exporters' profits may be negatively affected. However, global investors should find U.S. shares more appealing, and lower interest rates would be a positive.