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Economic Outlook: U.S. Growth Picking Up

In our February 20th letter, entitled The Economy: Flirting With Recession, we suggested that despite consumer caution, moderating government spending, excessive business inventories and vulnerable export growth, the economy had sufficient momentum to “narrowly skirt recession” and that business conditions were likely to improve as the year progressed. In recent weeks, various economic reports have revealed that the U.S. economy has, indeed, begun to gather momentum following the settlement of the General Motors strike and the return to work of idled federal government workers. Most importantly, the trend in U.S. international trade has been improving despite earlier weakness probably related to poor weather and recession-like conditions in Europe, Japan and Mexico. Bookings for capital goods have remained on a strong upward track. In the household sector, home sales and housing starts have generally exceeded expectations, as have retail and motor vehicle sales. Job and income growth have also come in well above forecasts, implying additional room for customers to increase their spending further.

Against this backdrop, the surprisingly robust March employment figures indicate that the stronger, more sustainable growth we had expected to materialize during the second half of the year has arrived one quarter ahead of schedule. At the same time, possible early signs of somewhat heightened inflation, of which we also warned in our February 20th piece, may be emerging. The recent surges in energy and agricultural commodity prices must be watched closely since they may be harbingers of higher inflation ahead if they are followed by increases in industrial raw material prices and labor costs which to date have behaved well. Clearly, the improved outlook for economic growth implies slightly larger increases in profits than we had previously forecast.

U.S. Financial Market Comments

Two clear changes have affected the equity market since early 1996: the rise in long-term interest rates and the increase in stock market volatility. Signs of economic reinvigoration have alarmed bond investors, but we believe that much of the damage to bond prices has already occurred.

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Stock price volatility has risen only modestly, although to many this rise appears considerable because: (1) volatility was so abnormally low last year (2) the “optical illusion” associated with point, rather than percentage, swings in prices, and (3) the trading range environment since February.

We expect stocks to remain within the current trading range for awhile until investors accept the view that improved economic growth will not soon generate troublesome inflation. Profit growth is expected to accelerate later this year improving to 10-12% pace in 1997.

Finally, our stock selection in recent months has favored beneficiaries of improved business conditions (Home Depot, Nucor, Willamette) and depressed technology stocks (Intel, Motorola, Molex) with excellent longer term prospects. Financial stocks remain appealing based upon their attractive valuations and our view that the recent interest rate backup is likely to be in part reversed as unwarranted fears of a big jump in inflation subside. Despite favorable longer term prospects, more defensive food, beverage and other consumer non-durable goods issues (PepsiCo, Gillette) appear to have gotten ahead of themselves pricewise and positions in these have been trimmed to allow the additions noted above.

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