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INVESTMENT COUNSEL

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The Economy and Financial Markets: Irrational Exuberance?

For the five decades following World War II, stocks produced an average annual return of about 12.5%, approximately 5% representing dividend yield and 7% capital appreciation -- the later figure being nearly in line with long term corporate earnings growth. Stock market returns over the last ten years have averaged about 15% per year. More recently, the pace of advance has accelerated. The S&P 500 Composite Index has climbed over 60% (excluding yield) in the last two years alone, more than double the advance in profits over the same time span. Is it surprising, then, that Federal Reserve Chairman Alan Greenspan has warned about "irrational exuberance" in the equity market? Clearly, his carefully timed utterance was intended to dampen investor enthusiasm now rather than find it necessary to deflate a much larger financial bubble later. Our hats are off to Chairman Greenspan for this effort. An ordinary gain in 1997, perhaps 5-10%, might spare us a more painful correction further down the road.

Fixed income investors faired less well last year. Much of the bond market posted low-to-mid single digit returns for the year as a mid-year "inflation scare" cooled interest in debt instruments. The return on a 10-year U.S. Treasury was close to zero while the 30-year long bond lost 3.5%. For mutual fund management companies, 1996 was a fabulous year. Equity funds drew well over $200 billion of new money while bond fund outflows nearly matched inflows.

Our 1996 Forecast Revisited

Early last year we forecast 1996 real GDP growth to fall in the 2-2.5% range. It is now likely that the actual number when released will fall toward the upper end of that range. We projected growth to be slow early in the year and then to accelerate through year-end. The actual quarterly pattern turned out to be erratic and trendless. We believed that the inflation rate would remain low but, by year end, there might be some apprehension about the prospects for inflation in 1997. Indeed, now, many are concerned that tight labor markets will begin to work their way into wage costs and then into prices. Thus far, though, there is little evidence that this potentially vicious cycle has commenced to any notable degree.

As for the markets, we anticipated a decline in short term interest rates. They were essentially flat, although the Fed did lower the federal funds rate in February. We thought bond investors would do well to earn their coupons. Only the intermediate bond sector, where the bulk of our clients' fixed income investments are clustered, came close. As for stocks, we concluded that "1996 will be another satisfactory year for stockholders with modest profit growth and, given a

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break or two, some P/E expansion." In retrospect, we were a bit too cautious regarding stocks which sparkled, returning 23%.

Looking Ahead

As for 1997, the battle among economists rages on between the camp that expects the economy to strengthen and pressure wage rates and the opposition who believe the economy could well fall into recession. Our bias is toward weakness, not strength. However, we do not see the necessary combination of tight money, inventory imbalances, consumer debt burdens, a profit squeeze, or a global trade war that might push us into a recession. On the other hand, we find little evidence of gathering strength in business activity. In short, we expect more of what we experienced in 1996 over the months ahead.

In reality, what the economy has achieved is the long sought after "soft landing". In fact, we believe soft landings and growth recessions are the likely course of economic activity for the foreseeable future for a number of reasons.

First, the service sector has grown in importance relative to manufacturing. Service businesses employ nearly 100 million people; goods producing industries engage less than 25 million. Spending for services tends to recur from one year to the next. Services are not subject to inventory cycles and are more difficult to postpone than a capital outlay. In short, this sector is less cyclical than manufacturing.

Second, sophisticated inventory management at all levels of manufacturing has dampened the all important inventory cycle. Companies, employing the just-in-time ordering approach, can now carry smaller inventories per dollar of sales than has historically been the case. Sales data are now more timely and accurate so inventory levels are more easily finely tuned to actual sales rather than lurching from one extreme to another. Low inflation also removes the incentive for both consumers and businesses to stock up on goods before prices rise.

Third, the housing and auto sectors are less cyclical than earlier thanks to adjustable rate mortgages and auto leasing plans. Slow moving demographics and the replacement cycle have supplanted the credit cycle as the primary driver of sales trends.

Fourth, the federal budget deficit has been reduced dramatically relative to the size of the economy. Five years ago, the deficit was 4.5% of GDP, today it is only 1.5% of GDP. Shifts in government spending now have less impact upon the economy than earlier. Deregulation has also resulted in an economy that is more flexible and agile as it adjusts to changing global demand.

Fifth, capital spending is now dominated by outlays for technology, not new manufacturing plants or machine tools. We are still very early in this long wave cycle so that most businesses do not turn their technology spending on and off as sharply as they may have in the past. Technology has a shorter production life span than traditional capital goods and replacement is continuous rather than episodic.

Sixth, *inflation* is under control, not only in the U.S. but elsewhere in the developed world. Inflation and fear of inflation result in distortions, hoarding, and high capital costs-- all contributors to economic volatility. *Deflation* may be the greater economic risk to us going forward.

Seventh, globalization, more open trading patterns, and a robust transportation infrastructure, mean that unmet needs in one country are quickly filled by products from another. Capacity is global, not local. The lack of a synchronized global expansion has freed up resources for use in developing countries where growth is more rapid than here in the U.S., Japan, or in other developed economies.

Eighth, enlightened monetary policies in the developed world have favored a steady course rather than the "stop-go" methodology followed in earlier periods. This measured approach is an important contributor to predictability and steady growth.

Ninth, the financial markets act as a buffer for the real economy. While debt burdens may be high, so are financial asset values. As the economy slows, rates decline, and there is an immediate move to refinance mortgages, thus adding to consumers' disposable income.

Can our slower, well-balanced, non-inflationary expansion continue? For the reasons enumerated above we believe there have been enough structural changes in the economy to keep us moving forward at a moderate, sustainable pace, albeit with some unpredictability from one quarter to the next.

Will there be another recession? Absolutely. What will trigger a downturn? Another oil price shock, an economic implosion in Russia, a natural disaster, or perhaps an equity market "correction" that temporarily dampens consumer spending and impacts the real economy could trigger a recession. Excluding such shocks, the outlook remains benign as far ahead as we dare forecast. The 1997 economy should be much the same as 1996.

Fixed Income Outlook

The fundamentals appear to be good for bonds going forward into the New Year. Economic activity is not forecast to reach levels that will pressure the capital markets. In the U. S., a year of 2-2.5% real GDP growth should be bond-friendly. Economists and market strategists are likely to point to each new economic statistic as evidence of the economy heating up or cooling down. Short term traders will exacerbate the already high bond market volatility by attempting to ride each short term swing for what it is worth.

It is also clear that the new Congress and President Clinton have put deficit reduction at the top of their priority list. While there will surely be intense jockeying between the Administration and Congress with regard to entitlement spending and tax reduction measures, we expect to be closer to the elusive goal of a balanced budget by 2002.

Looking abroad, growth rates among the G7 should also be subdued, except perhaps for the U.K. and Canada. In contrast, the emerging markets, boasting faster growth rates and proportionally greater capital needs, raised a record amount of capital in 1996. The desire to increase yield in the developed countries played right into the available supply from the emerging markets. Even Russia was able to float a $1.0 billion five year bond issue in the U.S. at a 9.36 % yield.

Specifically, we expect the 30-year U.S. Treasury bond rate to remain within a 6.125%to 7.0% trading range for the year. From the current 6.8% level, rates are likely to drift lower as fears of a Fed tightening diminish.

Stock Market Outlook

Since the inception of our firm in May, 1994 we have been optimistic regarding the U.S. stock market . A year ago, despite the 37% return stocks provided in the preceding year, we believed the strongest companies in our research universe were still reasonably priced relative to the market and relative to interest rates. This year the outlook is less certain for several reasons:

- The market is priced higher, especially shares of the strongest companies;
- The profit outlook is less robust than a year ago as we pointed out in our letter to clients this fall:
- Long term bond rates are higher than they were a year ago. While we are forecasting lower rates, this is not a universally shared view;

Fortunately, though, there are a number of positive factors which make us sanguine:

- A recession is not in sight;
- Tight money, the most frequent cause of bear markets, is extremely unlikely;
- While inflation may rise a bit, we see no sustained pick-up in prices generally; Washington remains investor-friendly; deficit reduction is likely; a capital gains tax cut is possible; more talk of privatizing Social Security will surface; Clinton's new advisors are thought to be more "pro-business" than those who have departed;
- While there are numerous potential trouble spots around the world, none appear particularly ominous;

- High valuations do not cause bear markets, and;

- Since future recessions are likely to be mild, corporate earnings are at less risk of substantial decline. Thus, equities as a class of assets may be considered less risky in the new economy than in the older, more cyclical times. Less risk, in turn, means common stocks should sell at a smaller risk premium to bonds. Perhaps, then, valuations are not as stretched as conventional, historic norms would imply.

Balancing out these positives and negatives, we arrive at an outlook that is *cautious* but not pessimistic. Specifically, we would expect the Dow Jones Industrial Average will trade between 5800 and 7000 ending the year near the upper end of this range. This trading band implies a possible 14+% correction this year from current levels. The modest overall gains forecast for 1997 means investors will continue to seek out industries and companies whose performance is better than average.

We continue to favor the financial and technology sectors, two broad areas that produced superior returns for our clients last year. On the *value* side, the financials are still reasonably priced. Most benefit from low inflation rates and from the baby boomers reaching their savings years. Technology, is the classic *growth* area. Whether it is microprocessors, data networking equipment, wireless communications devices or electronic commerce, opportunities (and risks) are plentiful. Careful stock selection is crucial.

Investors, particularly those following so-called “momentum” disciplines, have manhandled the shares of companies that have produced disappointing quarterly earnings. For investors with a somewhat longer term time horizon, sharp reactions to a “light” quarter can provide a unique buying opportunity-- if the long term fundamentals are, indeed, on track. Examples of recent buying opportunities of which we took advantage in beaten down shares of companies with good long term fundamentals include Motorola, EDS, and Pepsico.

Finally, if our forecast for the economy and the financial markets comes close to the mark, 1997 will be a volatile year with overall returns in a more normal range. Some investors will undoubtedly be disappointed with only single digit gains in bonds and stocks. We would be pleased.

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We are pleased to note that Philip F. Lahey became a shareholder of our firm on January 1, 1997. Phil has been with us since the founding of our firm, working closely with me in portfolio management and investment research.