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The Business Outlook --Eyeing the Big Picture

Investors have become increasingly concerned that a continuation of the strong economic growth we have experienced over the past six months coupled with tight labor markets will eventually lead to higher inflation and cause the Federal Reserve to execute a painful series of interest rate increases to cool both the economy and inflation expectations. As a consequence of this slower growth, investors fear corporate profits, which drive stock prices, could disappoint and lead to lower share prices. To date, the data we have reviewed suggest these fears are overblown: profits remain solid, inflation continues under control, and economic growth may be moderating.

First, *economic growth* was, indeed, rapid in the first quarter building upon the momentum established in last year's final period. Among the factors accounting for this stronger than expected business activity were high consumer confidence, milder than usual weather, and possibly a new seasonal pattern in personal consumption linked to bonus payments. Analysts point out that many Americans now receive a portion of their annual compensation in the form of a year-end incentive often paid in January for tax reasons. The cumulative effect of these cash flows for at least the last two years has impacted mutual funds during the first 6 to 8 weeks of the new year. It is entirely possible that a similar pattern of seasonally high consumer spending in January and February has developed. We now expect first quarter GDP growth, fueled by soaring consumer outlays, to have been better than 4.0%-- above the preceding quarter's 3.9% rate of increase.

More recent weekly and monthly data shows a somewhat mixed picture. While industrial production and factory data remain on the strong side, housing starts have fallen, retail spending has sharply decelerated and initial jobless claims have begun to rise. Moreover, weakness in the Journal of Commerce index of industrial raw material prices, now at a 32 month low, higher interest rates, the strong dollar, and the recent sharp declines in gold, energy and agricultural commodity prices, present strong arguments for low inflation and/or slower growth. Currently, we expect second quarter GDP growth to slow to about 2.5% and remain moderate for at least the next two quarters.

Second, *corporate profits* for the first quarter have been largely on target. While it is still too soon to draw any meaningful conclusions, early results – particularly those for many of the financial and technology companies represented in client portfolios – made good reading and have triggered upward revisions in earnings estimates. Stay tuned.

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Third, *recent inflation* reports show no signs of a meaningful acceleration. We continue to closely monitor labor costs given their relative importance to overall inflation and total business costs. Through the last quarter of 1996, most companies indicated little pressure associated with rising labor compensation, owing largely to the productivity offsets of which we have often written. Longer term, fierce worldwide competition, a non-synchronous global expansion, ample natural resources and continued productivity improvement will, in our judgement, keep a lid on inflation.

Going forward, with the economy continuing to expand more moderately, and inflation in check, we believe further Federal Reserve tightening will be limited to one or possibly two additional rate hikes serving to extend the current business expansion well into 1998 without “crunching” the economy into an unwanted recession. While corporate profit growth will also moderate, we are confident that the level of profits actually achieved will be sufficient to support stock prices within the Dow 5800-7050 trading range we projected early this year. It is important that we not lose sight of the favorable big picture.

In discussions with clients regarding our current investment strategy and tactics, we have emphasized that despite recent high bond and stock market volatility, the case for investing in longer duration assets (stocks and bonds) remains valid. However, until investors sense with some confidence that the economy’s growth has begun to moderate to a slower more sustainable, non-inflationary pace, both the bond and stock markets are likely to remain choppy. Looking ahead, we believe signs of this slowdown will emerge more clearly this summer or early in the fall buoying investor confidence. By that time a retreat in open market interest rates should have steadied the stock market.

As for fixed income strategy, with bond yields spiking above 7.0% for the third time in a year, we are again adding to client bond positions and have modestly extended bond portfolio durations where appropriate.

In the equity portion of client portfolios, where a blend of *growth* and *value* defines our investment approach, we remain tilted toward growth. In fact, over the past three or four months that concentration has been modestly increased as we have selectively reduced client exposure to financial issues and eliminated Nucor whose earnings progress could be impaired by a slowing economy. Purchases during this period have focused on a number of defensive issues including global healthcare leaders Norvartis and Pfizer as well as Kimberly Clark and Monsanto whose earnings growth will likely remain strong despite the economic slowdown we see ahead.

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