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INVESTMENT COUNSEL

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The Economic Outlook – Solid Growth Ahead

The slowdown in domestic business activity we forecast in our June letter to clients appears to be on track. Real Gross Domestic Product (GDP) growth slowed to 3.6% in the three months ended June 30th from 4.9% in the prior period. And, recently released data indicates a continuation of decelerating but still solid business advances this quarter. Key leading economic indicators now point to real GDP growth in the 3.0% area through year-end, with the current expansion continuing well into early 1998. Meanwhile, inflation remains quite subdued. In fact, producer prices have fallen in seven of the last eight months, and inflation, at the consumer level, has been halved to 1.5% per annum over the past six years. Broader inflation indicators have also remained positive: the dollar has risen, spot materials prices are flat and gold has declined. This benign inflation environment, coupled with the ongoing deflationary turmoil in the Asian currency markets, will, in our opinion, create little impetus for the Fed to raise interest rates when its Open Market Committee meets next at the end of this month. Clearly, if stronger economic growth, rising capacity utilization, and upward wage pressures emerge later this year, the Fed will be forced to act. At this point, however, we fail to see the need for a succession of rate increases, which would both adversely impact our financial markets and further weaken the Asian currencies.

A review of final second quarter earnings results indicates U.S. companies, large and small, are continuing to surprise analysts with their ability to deliver impressive profits. In fact, nearly 60% of the S&P 500 companies earnings exceeded expectations in the 2nd quarter – the highest percentage in the last 5 years - while only 23% failed to meet analyst's estimates - the lowest percentage over the last half decade. Interestingly, these better-than-expected earnings have not been limited to the large-capitalization stocks that constitute the S&P 500 Index. A look at the broader S&P 1500 companies reveals similar results: 57% of the mid-caps beat consensus estimates and 53% of the small-caps posted positive surprises. Less than one quarter of the S&P 1500 companies registered negative earnings surprises. Strong earnings estimate revisions by Wall Street analysts have been one of the primary factors behind our firm's bullish earnings outlook this

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year. On this score, we continue to be impressed and given a continuation of this trend, it is difficult to envision an imminent downturn in profits.

Financial Market Valuation

At today's 6.41% yield, long term U.S. government bonds adequately reflect our estimate of fair value. Signs of slower growth around mid-year helped bring yields down to 6.3% at the end of July. Since then, indications in August that stronger growth was resuming helped take long bond yields back to the 6.5-6.7% range from which they have only recently declined. We now expect bonds to trade within a 6.25% to 6.75% range through year-end unless evidence surfaces that economic growth is surging or there are signs of an uptick in leading indicators of inflation such as industrial commodity prices or higher wages.

Stock market valuation models we follow suggest the broad market indices to be slightly overvalued at current levels. However, a study of these models reveals that in past periods stocks have remained either significantly over or undervalued for long periods of time. Given the current level of interest rates and our forecast of profits for the S&P 500 companies, we would expect a rise in short term rates to trigger the completion of the 10-15% correction in stock prices begun in August. Conversely, a further drop in rates could precipitate a "relief" rally with stocks returning to or exceeding their July highs.

The continuation of strong business activity, rapid monetary growth, a low bond-stock yield spread and lower capital gains tax rates all favor stocks over bonds. Longer term, within the context of the extraordinarily favorable environment for financial assets, of which we have written numerous times, the outlook for both bonds and stocks remains quite favorable.

A recovery in share prices of smaller capitalization stocks from depressed levels commenced in late spring, along with indications that a budget deficit agreement that included a significant cut in capital gains tax rates was increasingly likely. The actual conclusion of the budget agreement with an even more favorable 18% tax rate for long-term holders and indications of stronger economic growth spurred a rotational shift out of the blue-chips into shares of both smaller and economically sensitive companies. A handful of negative earnings preannouncements from the large cap market leaders (i.e. Coca Cola, Gillette, Motorola, Eastman Kodak) has served to accelerate this trend. This short term shift in investor emphasis is likely to persist until fresh signs of a slowing in business activity emerges.

Clients of our firm are well aware of our belief that by balancing the equity portion of their portfolios between *growth* and *value* stocks we can enhance returns and produce more consistent results. This approach continues to define our investment style. While our *growth* and *value* selections are primarily larger capitalization issues, we are by no means wedded to the so-called “nifty fifty”. In fact, several of our larger domestic and foreign core holdings (described below) are likely to fare well in a moderate growth environment.

Technology

In the technology sector, where both risk and reward are high, we remain concentrated in the largest companies: Microsoft, Cisco Systems and Intel. In this sector, we are willing to forego some potential reward in order to reduce risk. Thanks to short product cycles and ready access to capital, product leadership in technology is often fleeting. One way to mitigate this risk and lessen the potential exposure to product obsolescence is to invest in companies with dominant market shares. Microsoft, Cisco Systems and Intel fit that profile. Their competitive advantages include depth of management, awesome financial and marketing power, and critically, products that have become industry standards. While these companies are hardly undiscovered, they do allow us to fully participate in the economy’s most dynamic sector without the assumption of a great deal of business risk.

Molex

Molex, the second largest manufacturer of electrical connectors, is growing at twice the industry rate. Faster growth is achieved through its ability to offer customers a global presence, a broad product line, and an accelerated new product development cycle.

Molex has outstanding fundamentals as evidenced by its low debt, mid-teens return on equity, and double-digit net margins. The company will benefit from the trend toward supplier-based consolidation. With only a 5% market share, there are enormous opportunities for further share gains.

Monsanto

Monsanto is a reinvented life science company powerhouse. CEO Bob Shapiro has shed non-core, slow growth businesses and has made acquisitions, investments, and strategic partnerships to concentrate on ag-biotech and pharmaceutical operations. Recently, the company spun off its cyclical chemicals division, which should eventually lead to a stock revaluation that reflects the new Monsanto’s higher earnings growth potential. Biotechnology-driven new products in the agricultural division such as insect resistant crops and an improving outlook in the Searle pharmaceutical division are drivers for growth.

Novartis AG

Novartis, the world's second largest drug company, was formed in 1996 from the merger of Ciba and Sandoz. We believe this merger will produce approximately $2 billion Swiss Francs in cost savings by 1999. Novartis' product pipeline is strong with 23 scheduled new launches by the year 2000. Key products include Exelon for Alzheimer's Disease and Femara for breast cancer. These new product introductions, along with potential merger savings, translate into margin expansion and strong double digit earnings growth over the next several years.