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Economic Outlook - -The Wealth Effect

The U.S. economy continues to exhibit persistent strength. Rather than slowing, as we earlier forecast, real GDP growth edged up to a 4.8% annualized rate in the first calendar quarter - - the sixth consecutive quarter it has exceeded 3%. This performance is remarkable given the drag on the economy exerted by the government's passively restrictive fiscal policy, a strong dollar, relatively high *real* interest rates, and weakening export demand occasioned by the Asian crisis.

In our judgement, a key reason for this impressive showing has been the momentum of the U.S. equity market and the unprecedented creation of wealth in recent years. By boosting consumer confidence and household net worth, the stock market has stimulated spending. Increases in wealth affect spending in two ways. First, stock market movements that usually generate the most dramatic changes in household net worth are taken as a barometer of the economy's well being causing confidence and spending to rise and fall in their wake. Second, significant gains in net worth bring households closer to their ultimate savings goals (i.e. children's education, retirement) and, therefore, reduce the amount they need to set aside out of current income to meet those needs, while setbacks in net worth have the opposite effect. The sharp rise in equity prices, analysts believe, has generated sufficient wealth to have boosted consumer spending by about $20 billion per year over the past three years, with the gains cumulating to about $60 billion. This is the equivalent of .25% per year increment to real GDP growth.

Another avenue by which the rising equity market lends support to economic activity is by spurring business investment. A rising stock price/earnings ratio implies a lower equity cost of capital. All else being equal, this should lead to stronger investment patterns. Analysts estimate the *real* cost of capital has declined about 24% over the past three years increasing capital outlays by about 12%. This assumption implies that nominal business investment spending has been increased by $100 billion. This is equivalent to about 0.4% of GDP per year for three years.

Together the impact of higher equity prices on household wealth and on the cost of capital may have enhanced real GDP growth by about 1/2- 3/4 percentage points per year *directly*. If one assumes that such spending has a multiplier effect, as

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spending leads to greater job creation and more income, the impact would be even greater. Assuming a multiplier of 2, for example, implies that increased outlays induced by the rising equity market may have augmented real GDP growth by 1-1½ percentage points per year over what it otherwise would have been. This goes a long way to explaining why the economy has not slowed as expected but instead has exceeded a 3% annualized growth rate for six consecutive quarters, driving the unemployment rate down to 4.3%.

Looking ahead, the most likely scenario is for moderating but still above-trend economic activity as the so-called *wealth effect* continues to feed the expansion. However, we expect corporate profit growth to continue to slow in part due to a relapse of the Asian "flu" over the next two quarters. Clearly, bull markets in equities do not normally end spontaneously when corporate profit growth moderates. In fact, earnings growth has already slowed substantially over the past two years, yet the stock market has continued to move higher. Moreover, history shows that equity bull markets are generally resistant to moderate rises in interest rates. It is, therefore, likely to take several quarters and a significant rise in rates to end this bull market in stocks. With inflation virtually non-existent and the fear that a Fed rate increase will only exacerbate Asia's already severe economic problems, a series of aggressive Fed tightenings seems unlikely anytime soon. Rather, we believe clear evidence of an upturn in inflation will be needed before Federal Reserve officials implement anything more aggressive than one or possibly two upticks in the federal funds rate. In short, there is no end yet in sight for either this business expansion or the bull market.

Our confidence in the favorable long term outlook for U.S. stocks is supported by several factors which should make the equity investment environment more stable than it has been at any time in the post war period. Among these diverse factors are:

- The world had been dramatically changed by technological advances. Productivity is by historical standards growing more rapidly and entire new industries have emerged. As we have pointed out in the past, economic cycles should be longer and downturns less severe.

- The U.S. has been in a business expansion since 1991, and to date no serious economic excesses have surfaced. Inventories have not surged because computerized inventory controls enable businesses to better align inventories with final demand. Moreover, there is no impetus for businesses to stockpile raw material because they do not expect prices to

rise. In fact, the Commodity Research Bureau/Bridge index of 17 commodities has slipped to its lowest level in more than four years. Futures prices of copper, silver, oil, nickel, wheat and other commodities have been in a long term decline that has further been aggravated in recent days by Indonesia's political turmoil and the Asian economic collapse. Capital spending programs, while ambitious in this expansion, have primarily been for productivity- enhancing equipment and not for capacity- increasing manufacturing facilities. In the past, the Fed has felt compelled to increase short-term rates to control these excesses, but since they do not appear to be a major threat today, their focus is on the potential for a rise in inflation, which remains quite remote.

- There is less threat now than at any time in the past half century of world conflict. The degree of international cooperation is unprecedented. NATO has been expanded. The International Monetary Fund moves swiftly to quell financial distress. And, capitalism is recognized everywhere as the system of choice.

- Many historical economic rules are being broken. For example: monetary expansion and consumer price inflation were thought to go hand-in-hand. Global money supply has been growing rapidly during this decade, mostly in double digits, but in all of the industrialized countries inflationary pressures remain muted. Low levels of unemployment were also considered inflationary. However, unemployment has been below 5% for months and wage pressures have yet to find their way into consumer prices due largely to intense global competition. Finally, our relatively high long-term *real* interest rates are generally traced to the soaring budget deficits of the 30 years from the 1960's through the early part of the Clinton administration. If the budget is truly in balance, as it now seems to be, then we might look ahead to a prolonged period of lower *real* interest rates. Lower rates, low inflation and continued growth will, over the longer term, support a more stable stock market.

Not withstanding the favorable economic fundamentals for our economy and our belief that the U.S. equity market may have become less volatile, a broad stock market "correction", triggered by the depressing effects of the Asian crisis on U.S. exports and corporate profits, could commence at any time. This is particularly relevant now with stock prices at historically high valuations. We would view a 10+% stock market correction as a healthy and normal development for investors.

Stock and Bond Market Strategies

In the current economic environment, where corporations have little pricing power and economic growth is expected to moderate, our *growth/value* model remains tilted toward *growth* stocks. Companies expected to record strong top line growth (i.e. Home Depot, Gillette, L.M. Ericsson, Microsoft and Pfizer) remain core holdings. Earlier this year, positions in Motorola were eliminated reflecting our concern that the company's turnaround will be more protracted than we had previously thought. Shares of Elan ADR, a rapidly growing Ireland based developer of pharmaceutical delivery systems, have since been added to increase clients' exposure in western Europe.

As for fixed income policy, we believe long term U.S. Treasury yields will remain within their recent 5.6% to 6.25% range over the next several months. We have added to client bond positions when U.S. Treasury rates have edged above 6%. With these rates now at about 5.8%, we are less aggressive bond buyers.

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