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I N V E S T M E N T   C O U N S E L

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THE ECONOMIC OUTLOOK: FED HAWKS AND DOVES

Despite the Federal Reserve's recent attempts to cool the U.S. economy, business activity remains robust, again outpacing both our forecasts and those of most Wall Street economists. In a widely anticipated report last week, the Labor Department announced that several measures - - from hours worked to the number of Americans who hold jobs - - indicated continued labor market strength. At the end of August, the 4.2% unemployment rate was the lowest such rate in 29 years.

Surprisingly, the employment report also provided a lift to both bond and stock investors who had feared these employment numbers would once again outstrip the consensus forecast and provide fresh ammunition for Federal Reserve inflation "hawks" who favor further preemptive interest rate increases to cool the economy. The August figures also showed that only 124,000 new nonfarm jobs were created last month, well below the 215,000 forecast, and that average hourly earnings, a key measure of wage inflation, rose a mere 2 cents. On this news, both the bond and stock markets staged "relief" rallies with the major stock market indices now again near their all-time highs and 30 year U.S. Treasury bond yields just above the critical 6% level. The bounces in both markets helped lift the dollar, which has been sliding recently, against both the Euro and the Japanese yen.

A look behind the headline 4.2% unemployment rate shows that employers have been expanding payrolls faster in the last two months than in the first half of the year, by 231,000 a month in July and August compared with an average of 210,000 during the first six months. That suggests to us that the economy has picked up some steam since the spring when GDP growth slowed to a 1.8% annual rate as inventory liquidation and a sharp widening of the trade deficit cut the nation's production of goods and services. Recent reports, meanwhile, point to robust demand for everything from homes and autos to factory orders and exports. We now expect GDP growth for the current quarter to exceed 4%.

This stronger growth leaves the Federal Reserve more or less in the same bind as it has been in all year; namely, having to justify preemptive interest rate increases at a time when, despite rapid growth and a tight labor market, there is almost no evidence that inflation is breaking out - - especially at the consumer level. Of

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course, the Fed will have another reading of consumer inflation, as well as of other important economic statistics, prior to its next meeting. Our guess at this writing is that there is about a 50/50 chance of a third and final 25 basis point fed funds rate increase when the FOMC meets on October 5th. At the same time, the Fed may also decide to raise its discount rate - - in effect "taking back" the three easings it implemented last fall to stem the global liquidity crisis which now appears to be well behind us.

The Fed, of course, has the option of deferring a further tightening step without running much risk to their creditability as inflation fighters. The pros and cons of an October tightening, as we view them, are as follows:

Hawk's **Arguments Favoring Tightening**

- Labor markets are the tightest they have been during this expansion. This can be seen in the gap between people's assessment of jobs easy to find versus hard to find, which is at a 30 year high; the four week moving average of initial unemployment claims remains at a cycle low. Moreover, despite last week's better average hourly earnings figures, recent wage trends have been concerning. Not only did the second quarter employment cost index rise 1.1% but the intermediate trend in average hourly earnings has also firmed. In addition, the manufacturing sector is starting to show greater strength, which should lend support to income and employment through year-end. Finally, foreign economic activity continues to gradually improve. One notable example of this is the upward revision to Japanese first quarter GDP growth to 2.0% (not annualized).

- Until late last week, the financial markets had begun to anticipate another Fed tightening. Despite relatively benign CPI and PPI reports expected for August, market participants are now almost equally divided regarding an October 5th move. To not move in October might be to squander a relatively painless way of taking back last fall's easing.

- The Y2K issue implies a sooner, not later move by the Fed. Although Y2K does not preclude tightening, as emphasized by Fed Governor Kelley in a speech last week, it does certainly raise the bar in two ways. First, Y2K increases the level of uncertainty about the underlying trajectory of the economy - - at least in the short term. When policy makers are uncertain, they are more likely to stand pat. Second, Y2K creates a potential political constraint on a tightening late in the year. Y2K could lead to a slowdown in business activity in next year's first quarter. Fed officials are aware of this and will not want to implement a tightening immediately proceeding a weak growth quarter because that could raise questions regarding the wisdom and timing of their action.

***Dove's* Arguments Against Tightening**

- Fed officials may give weight to last month's below forecast employment and wage inflation numbers and defer any increases, particularly if the soon-to-be released inflation figures remain benign.

- The FOMC may be worried by the strains evident in the fixed income market. Corporate credit spreads and swap spreads have again widened, possibly making the Fed more wary about hiking short term rates.

- The economy already shows some signs of slowing on its own. This probably makes Fed officials more patient, but the evidence on this front is still relatively scant outside of the housing and construction areas.

Beyond this quarter, we believe the economy will continue to expand at an above average 3.0 to 3.5% rate with no signs of a recession despite the Y2K uncertainties noted above.

The elusive slowing in consumer spending we have expected for some time is likely to take hold as higher interest rates, sharply slowing refinancings, and higher energy prices trim consumer's outlays. Offsetting this slowdown will be stronger demand for our exports as the Asian and European economies firm and our exports remain somewhat cheaper due to the lower dollar. Corporate profit growth will continue strong for the balance of this year and into 2000 since earnings comparisons will be with the last two quarters of 1998, when global financial turmoil, set off by the devaluation of the Russian ruble, devastated the profits of many companies, particularly banks and brokerage firms. Operating earnings of the S&P 500 companies are expected to rise 21.2% in the third quarter and 21.3% in the fourth quarter according to a recent First Call summary.

Stock Market Outlook

Given the uncertainties regarding the near term outlook for the economy, interest rates and inflation, it is not possible to say that the current good mood in the financial markets will persist. In fact, the choppy stock market we have been forecasting since last spring is likely to persist for awhile, especially if soon to be released economic data for August are stronger than expected. Since Federal Reserve officials indicated in May that they were raising their short-term interest rate target, the Dow Jones Industrial Average has experienced five distinct sell offs and subsequent rebounds. We may now be entering the sixth. However, longer term, the following favorable fundamentals, which have underpinned this bull market, and of which we have written in the past, are likely to persist:

- low interest rates by historical standards;
- low inflation;
- significant productivity gains due to the pervasive use of new computer and communications technology; and
- excellent global demographics

In our view, the U.S. stock market should continue to provide competitive investment returns relative to the alternatives so long as these fundamentals are in place.

Equity Portfolios Strategy

In our continuing effort to appropriately balance the blend of *growth* and *value* stocks in client's portfolios - - the discipline that distinguishes us from most other advisers - - we began late last year to tilt back from the large overweight we had carried in *growth* stocks for well over a year. This effort was undertaken in anticipation of a steepening in the yield curve which usually favors *value* shares and shares of smaller and mid-sized companies. This steepening emerged in the early spring creating the most favorable backdrop for *value* shares in several years and *value* subsequently out performed *growth* for most of the second quarter.

Since mid-year, we have added to client's holdings in a handful of *growth* shares which had in our judgement, fallen in price to attractive levels as investors took profits in them to raise cash to buy depressed *value* stocks. These stocks have since begun to recover as the yield curve has again begun to flatten. We also continue to favor shares of financial services companies which have been hard hit during the recent period of Fed engineered rate hikes. We believe that when investors sense the Fed is about through with its tightening moves, financial services shares should again perform well as their improving earnings will look strong when measured against their poor showing in last year's second half. Finally, information and communications technology companies, which have been market leaders since early this year, should continue to deliver very strong top line growth and thus are likely to remain strong performers even in the face of a moderate economic slowdown. We, therefore, remain overweighed in this group.

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