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INVESTMENT COUNSEL

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2000 Update

Despite the year-long hand wringing of financial market gurus over tight labor markets, incipient inflation, preemptive Federal Reserve interest rate hikes, Y2K, adverse balance of trade figures, the weak dollar, the short lived rebound in gold prices, and the bifurcated stock market, equity investors enjoyed an unprecedented fifth consecutive year of returns in excess of 20% as measured by the S&P 500. In fact, since 1994 this index has returned an astounding 28.5% per annum as compared with about an 11% annual return since 1926. Calendar 1999 equity results in client portfolios continue to substantially exceed the benchmark S&P 500 Index.

As we pointed out in our December letter to clients, the *long-term* fundamentals remain quite favorable, with no recession in sight. Over the *intermediate term*, the equity market will continue to benefit from strong productivity-led economic growth. In addition, low inflation and election year politics will keep the Federal Reserve from changing monetary policy to such a degree that this could become a significant negative for the stock market. This year's strong economic growth will be led by manufacturing firms as they restock unusually low inventories and as demand for exports increase. Thus far, almost without exception, business statistics released since year-end portray the economy as very strong with few signs of inflation.

Inflation and Energy Prices

In the 1970's and 1980's it was a forgone conclusion that sharply higher energy prices would cause the stock market to plunge. The economy would weaken, or fall into recession, and the inflation rate would rise alarmingly. This time around, oil prices have more than doubled since their lows early last year, with very little perceptible impact upon the nation's overall inflation rate as measured by the Consumer Price Index (CPI). Yes, gasoline prices are up and so is the price of heating oil. Shipping rates are also higher. But, the CPI is rising at a still low 2.6% annual rate, up from 2.1% last Spring when the deflationary impact of the Asian crisis was peaking. The reasons for oil's diminished impact upon inflation are as follows:

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(1) Spending on oil products today amounts to just 3% of GDP, down from 8.7% in the 1970's.

(2) Oil consumption, currently 19.9 million barrels a day, is barely above the 18.8 million total in 1978.

(3) Americans are driving more today, but their autos are far more fuel efficient, even allowing for gas guzzling sport utility vehicles. While gasoline prices jumped sharply last year, the outlay for gasoline amounts to only 3 cents of every dollar spent, down from 6 cents in 1980, according to the Bureau of Labor statistics. That 3 cents is up only marginally from the 2.5 cents spent on gasoline a year ago, prior to the doubling of oil prices.

(4) Natural gas has also become a major substitute for oil not only in home heating but also as a raw material for petro-chemical products like plastic and as fuel for electric power generation. Natural gas prices also rose last year, but by only 50%. The U.S. gets almost all of its natural gas domestically or from Canada, while crude oil is a global commodity whose production is subject to O.P.E.C. quotas. By limiting supplies, quotas can drive up prices as they did in 1999 - - to about $25 a barrel today from less than $12 last winter.

Against the backdrop of 27 years since the 1973 oil boycott, $25 a barrel crude is not shocking. The entire increase only retraces the ground lost since January, 1997. In fact, oil prices today, even at $25, are below their levels through most of the 1970's and 80's.

Stock Market Outlook

Despite the favorable fundamentals, market history shows that investor sentiment over any *shorter period* of time will run the gamut from excessive fear to unbounded greed. Markets inevitably go to extremes which defy precise forecasting. Our best guess is that the stock market in general will cool somewhat during the first half of this year with unseasoned, illiquid, highflying technology stocks eventually absorbing a disproportionate share of whatever correction eventually takes place. Longer term though, well run technology companies with solid business models, will strengthen their positions as market leaders. Clearly, we have only begun to see the economic benefits to our society of the computing and communications revolution now underway.

Finally, the current two tier market has, in our judgement, driven financial services, pharmaceuticals and certain industrial company shares to very attractive levels from which they should advance once investors' fears over higher interest rates abate. Despite their under- performance in the last few months of 1999, we continue to maintain and increase holdings in *value* shares as a balance to our clients' already large positions in high quality, large cap technology and telecommunications shares which remain important *growth* components in portfolios under our supervision.

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