August 2, 2001

THE ECONOMIC OUTLOOK - - STRAWS IN THE WIND

Preliminary second quarter GDP figures reported by the Commerce Department last Friday showed that inflation-adjusted growth had slowed to an anemic 0.7% annual rate - - its lowest in eight years - - well below most forecasts including our own. The economy has been hobbled by a dramatic decline in business investment. In the quarter, non-residential investment tumbled at a 13.6% annual rate, its poorest performance sine 1982, and a steep deceleration from the first quarter's 0.2% drop. Equipment and software spending sank 14.5%, the steepest in almost 20 years. By contrast, spending by consumers, which accounts for two-thirds of GDP, and whose resilience has kept the economy from falling into recession, grew 2.1%. Outlays for housing remained strong and the economy was helped during the quarter by robust state and local government spending. In a nutshell, then, whether the economy can reaccelerate in the months ahead, as we have forecast, will depend importantly upon the combined impact on personal consumption of lower interest rates, declining energy costs and the tax rebate. It remains to be seen whether these stimulants can offset the negative impact that rising unemployment and languishing stock prices have on spending.

Clearly, current information for the recent performance of both the U.S. economy and some of our key trading partners remains downbeat. With inventories in a handful of sectors still a bit too high, orders for capital goods very soft and the effects of depressed tech stock prices and a weaker job market weighing on consumers, the economy may continue to struggle for a while longer. Nonetheless, a number of key factors are in place that should set the stage for a return to stronger growth later this year and in 2002.

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1. *Interest rates* have declined since last fall; these lower rates have helped businesses and households strengthen their financial positions and should be reflected in higher aggregate demand over the months ahead. Interestingly, recent upward revisions to households' income figures show the personal savings rate in the U.S. now positive rather than negative as was thought earlier. Savings rose to 1.2% of disposable personal income in the second quarter from 1% in the first quarter suggesting consumer balance sheets are in better shape then many had feared.

2. The recently mailed *tax rebates* and lower *energy prices* should bolster aggregate demand over the next few quarters.

3. As businesses become more satisfied with the level of their inventories, the *cessation of liquidation* will boost production and, in turn, provide a lift to employment and incomes; the likely subsequent shift to inventory accumulations, in association with the strengthening in demand we expect, should provide additional impetus to production.

4. The rapid pace of technological innovation we foresee augurs well for a continuation of *productivity growth* over the longer term. The efficiency gains enabled by these innovations should spur demand for the capital goods that embodies the new technologies once the current cyclical slowdown abates. This trend will, over time, support consumption by leading to solid increases in real incomes.

5. In the current low inflation environment, where energy prices are falling and global competitive pressures have restricted businesses' ability to raise prices, the Fed is likely, if necessary, to *ease credit conditions* further. At least one, and possibly two, additional reductions in short-term rates are probable. A 3¼% Fed Funds rate by early October would not surprise us.

Over the past several weeks, our Economy Watch has identified a number of encouraging signs amidst the plethora of economic and financial market data we routinely scan. These include:

1. *Leading Economic Indicators*, as well as our firm's proprietary *Economic Model*, have turned up, portending an economic rebound later this year;

2. While layoff announcements continue to rise and the overall headline unemployment rate is likely to rise to 5%+ by year-end, both are usually lagging indicators. The sensitive four-week moving average of *initial jobless claims* appears to have stabilized and is now below 400,000 for the first time since the week of April 20th.

3. *Consumer confidence*, as measured by both the University of Michigan and The Conference Board surveys continues well above its February 2001 lows;

4. *Housing and auto sales remain quite firm* although off from their earlier peaks;

5. *Consumption* rose 0.4% in June, extending a string of increases dating back to last December;

6. *Money supply growth* continues to expand rapidly;

7. Anecdotal evidence indicates the combination of lower *energy prices* and the *tax rebate* is giving consumers an unexpected increase in their disposable income which recent reports show they are spending on discretionary items such as televisions, computers, DVD players and air conditioners, and;

8. *Long-term bond yields*, often a reliable harbinger of future business activity, bottomed in early January and are now well off their lows.

Despite these and other positive straws in the wind, manufacturing activity, which accounts for about 17% of GDP, remains depressed. With no pricing power, sluggish business conditions in Europe and Asia, Japan on the brink of another recession, and a very strong dollar crimping foreign demand for our exports, the U.S. economy will face some formidable hurdles before it returns to more vigorous growth. However, the framework for improved business performance later this year is now in place. As a result, corporate profits reports, which drive equity valuations, should begin to show more favorable comparisons in Q1 2002.

Reflecting the foregoing, we are increasingly optimistic with regard to the outlook for U.S. equity prices and counsel clients to remain fully invested. Currently, stock portfolios under our supervision remain roughly equally weighted between *growth* and *value* shares following the additions we made to economically sensitive stocks early this year. New bond purchases in balanced portfolios were put on hold this winter in the expectation yields would back up as signs of an improving economy emerge. We look for a bond buying opportunity over the months ahead as 10-year Treasury yields, now at 5.12%, approach 6%.

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