GSI Market View

1st Quarter 1995

- ***The year 1994 is now history. Most investors would prefer to avoid repeating it.***
  Surely bond investors have the most to be upset about. Stock investors fared better, depending on the stocks owned. The economy was, and continues to be, unusually strong. There may be indications however, that the *blastoff* in '94 will evolve into a *slow burn* in '95. It was not politics as usual, domestically or internationally.

- ***Most investors were overwhelmed by market psychology in '94.***
  In February, the Federal Reserve began to rein-in interest rates. That move caught many speculators flat-footed. *Derivatives backfired* and most ordinary and sophisticated investors were puzzled. They simply did not understand how options, options on futures, inverse floaters and reverse repos worked. Eventually, we learned, when cutting through this language, that some hedge funds, "long-term" mutual funds and pooled funds (Orange County) got burned because *they borrowed too much money against underlying assets*.
  Market psychology was also shocked by the dilemmas experienced by many large brokerage houses such as Prudential and Kidder, Peabody. In the case of Kidder, problems ran deep enough to push General Electric to divest itself from the brokerage firm by selling its ownership to Paine Webber. Program traders were at it again as well, often hitting the 50 point "collar" during the last half-hour of the trading day. Individual investors were rocked by these events, and, if one can believe it, *some mutual fund managers quietly panicked.*

- ***Undercurrents were at work, however, in '94 that will influence the new year and beyond.***
  For many companies, earnings were exploding. *Use of new technology began to reveal a renewed efficiency for corporate America.* Employment rose, inflation remained low, and some costs of living adjusted sharply, especially costs related to health care. A new political majority was elected to congress, ushering in an increased wave of conservatism. Promises of a smaller government, less welfare spending and a *capital gains tax cut* were made by those who drew up A Contract For America. Political unrest in foreign lands increased, and an eventual change in China's top leadership has the world concerned.

- ***"By year's end, stocks will be stronger, interest rates will be lower than they are now, and the economy will be poised for substantial growth."***
  So wrote Malcome S. Forbes, Junior, Editor-in-Chief of Forbes, in the January 2, 1995 issue. This is a very optimistic outlook, and it could be right. Along the way however, there may be some jolting bumps. The interest rate issue is still on the table and the economy remains

strong. Commodity prices such as paper, aluminum and chemicals continue to rise suggesting more inflation, *although we feel most domestic market pressures will be contained.* A domestic economic recession might possibly be avoided. More likely, we will hear the words "growth recession" begin to emerge. *To us this means having growth slow to below 3% from the current estimated 4%.*

- ***This could mean that long-term interest rates may be peaking.***
  This is not to say that the fear of higher interest rates is over. In fact, it would not be surprising to see current rates rise again above the 8% level on long Treasury bonds. This could again cause nervousness in the stock market. However, we believe current rates of about *7.75%* on *intermediate-term Treasuries* are attractive longer-term. Also, *6%* rates on tax-exempt *municipal bonds* look good for the long-term.

- ***To us, the stock market also looks good, long-term.***
  A capital gains tax cut would be significant. This could cause a continuing shift to growth stocks and a select list of stocks where corporate restructuring is underway. *Smaller, faster growing companies may benefit the most.*

- ***Our strategy is to be fully invested in our bond, stock and balanced portfolios knowing the short-term could be bumpy.***
  We continue to like technology stocks, but favor using a wide list, because these stocks tend to be more volatile. We want to be participating in the *personal computer and telecommunications (including cellular) revolution.* We also want to be well positioned in *health care stocks,* owning those involved in cost containment and cost saving products. We continue to like *large U.S.-based companies* that are well positioned for growth in foreign lands. Some niche retailers and consumer products companies also appear attractive to us. In addition, there are some *food stocks* that fit from both a defensive and growth point of view.

- ***A word of caution should be made regarding foreign stocks.***
  Political unrest seems to be picking up with recent examples in the former Soviet Union and Mexico. Increasing difficulties in China could also be developing. Although there are impressive opportunities for growth in foreign lands, political uncertainties abound. *Therefore, limited exposures should be determined, and selection should be with care.*

- ***To summarize, we are willing to put up with unpredictable market psychology over the near-term in order to capture the fruits associated with long-term investing!***

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