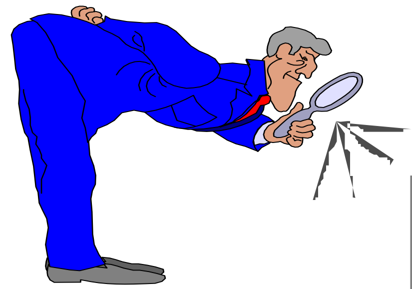
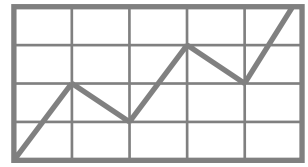
GSI Market View



1st Quarter 1997



"I sold all my stocks." During the holidays when at a large reception, a conversation was begun with an old friend. This was a recently retired professional person, very bright and very successful. Hardly into the conversation, he told us that he had sold all his stocks. He was receiving adequate income from high quality municipal bonds and felt the stock market was high. "All your stocks?" we asked. "Yes" was the response. As we began to visit about this decision, we were interrupted by another acquaintance. The topic was changed, but it has revisited our minds several times since that meeting.

The stock market has been good to investors for several years. The bond market was good in the 1980's by providing appreciation and offsetting inflation. For the past five years it has settled down to providing about a coupon return, that is, little capital appreciation. *One intermediate maturity Government bond index shows a 7.13% return compounded annually over the last five years, 1992-1996. On the other hand, the stock market as measured by the S&P 500 has returned 15.22% compounded annually for the same period.* These are total return numbers combining price change with dividend or interest income.

In 1996, the bond market faltered. Its total return was 3.62% as measured by the Salomon Broad Intermediate Government Bond Index. Prices were down for the year, so no appreciation occurred. The stock market continued its climb, up nearly 23% total return, as measured by the S&P 500. *It was a narrow market for stocks meaning only a limited number of stocks outperformed the averages.* Smaller companies struggled and growth stocks were not necessarily favorites. As interest rates rose, some growth stock prices were questioned. *On average, growth stock managers failed to beat the market.*

Now, the markets are focused on two factors, corporate earnings and interest rates. Fourth quarter earnings reports have been very good. *The snag in the marketplace has been rising interest rates.* There is a fear that wages may rise at a pace that would cause the Federal Reserve to "put on the economic brakes" by raising short term interest rates. Theoretically, this would not be positive for stock prices. Such an action by the Fed may cause them to decline. *There is the argument that earnings may take over, putting interest rates on the back burner, but it hasn't happened yet.*

Rising interest rates are tied to expectations for higher inflation. We have argued for some time that inflation may increase slightly, but not enough to drive up interest rates to the point that would force a recession. We feel the U. S. economy remains on a *controlled slow growth path*, but it is unlikely that it will travel a perfectly straight line. As it waivers above and below the trend line, uncertainty will surely develop. *That uncertainty will translate into market fluctuation*. Indeed, we are experiencing that now.

On January 28, employment data was announced that resulted in a positive market tone. Interest rates declined sharply, and stock prices rose more than 100 points as measured by the Dow Jones Industrial Average. A ***rumor*** hit the street that the data was flawed. *The rumor was eventually determined to be false, but not before it caused interest rates to reverse direction and the DJIA to end the day minus 4 points.* It is this kind of volatility that may be an unfolding pattern for 1997.

But back to our friend who sold all his stocks in late 1996. Obviously, he was afraid of market valuations and the future. *If some of his funds were taxable, he probably paid substantial capital gains taxes.*

That rate is still 28%. He had to reinvest after tax proceeds in something, and our guess is that it was money market funds or municipal bonds. Such securities don't provide much of an offset to inflation. The only way to prevent inflation erosion with these investments is to reinvest the interest income, a portion of which he was spending. *As we know, stocks tend to provide a better offset to inflation than bonds. Growth stocks paying low but increasing dividends tend to be the most favored.*

Did this person make a mistake in judgment? We don't know. Surely if the stock market sells off sharply, and he reinvests his funds near the bottom, it would be a brilliant move. However, that in itself is a big risk, and his decision was probably based on risk avoidance. *Only time will tell, but this is not the approach we propose in investing long term funds.*

What do we think now? *We think that stocks are high, but not overvalued.* We still think bonds are in a trading range somewhere between 6%-7%, as measured by the 30 year U.S. Treasury bond. We think that inflation is under control, although it could move into the 3% range. *We think that corporate America is in excellent financial condition.* One example: both Intel and Microsoft have more than $8 billion in cash and short term securities on their balance sheet. We think that inventories are in good control partially helped by just-in-time ordering. We think the U.S. Government and some state debt situations are improving. *Most important, the political attitude toward spending has changed and this is a large benefit to the marketplace.* Finally, we think the demographic argument remains in place. *That is, the baby boomers will continue to grow relative to other age groups and they will continue to provide the marketplace with strong savings streams. There is a positive correlation between savings growth of this age group and stock price movements.*

What are we doing? *We are staying fully invested.* We are buying bonds, but are trying to do so on price breaks. We are doing the same with stocks. Market volatility permits this approach. One shift we made in 1996 is now completed. *Within the telecommunications industry, we decided to give up on the local and long distance companies due to severe competition and heavy capital expenditure requirements and focus on the equipment suppliers.* The long distance and local companies have a voracious appetite for new equipment and the suppliers should benefit. We see this as a long term opportunity.

Otherwise, we are staying with our emphasis on technology, health care, financial and energy with common stocks. We are well diversified in our common stock exposure in order to avoid the risk of one company developing problems.

Our friend who sold all his stocks may be right, but it is a big bet and a costly maneuver. *We prefer to invest for the long term by riding out the ups and downs of the marketplace.* We think this is the best approach to wealth generation.

Referrals. They are the life-blood for this and any other service-oriented business. Please keep us in mind when uncovering potential investment management opportunities. Our experience, flexibility and strong performance record could be a benefit to those who wish to work with us.

GS Investments, Inc.
Glenn and John Steinke
920 Second Avenue South
Suite 600
Minneapolis, MN 55402
(612) 371-0590