GSI Market View

1st Quarter 2001

An Odd Year. 2001 started out of balance and continues that pattern. The agony investors have experienced so far this year in the equity markets (especially the NASDAQ) has led to wealth decline rather than wealth creation. It has been difficult to accept. Long-term investment approaches have been tested. Money market funds have grown from defensive posturing as have bond investments. Uncertainty abounds. The question is will it continue, or will we find a bottom in the equity markets leading to better times ahead.

The year began with an election hangover and slowing activity in our domestic economy. High short-term interest rates were biting deeply, and an energy supply shortage was coupled with a bitter cold winter. Also, electric generation in some parts of the country was less than required; deregulation was backfiring in regions that had failed to develop a careful plan. Black clouds had gathered and a thunderstorm of negative happenings came together in lockstep.

In January, the slow process of change was finally set in place. The Federal Reserve reduced short-term interest rates on January 4. This was a change in direction for the Fed. Since that date two further reductions have been made. It is expected that the Fed will continue to lower rates until the economy stops slowing and begins to resume a normal growth path (3%-4%). Remember, in fighting the 1990 recession the Fed lowered short-term rates to 3%. Although we may not reach that level, the current 5% rate is far above the 1990 recession bottom.

Fiscal policy is also about to change. A tax cut is in the works. No one yet knows the size and nature of what the final package will be, but it should be substantial and immediately helpful if it is retroactive to the beginning of this year. One reason a tax cut is so important to stimulate the economy is that higher energy prices in 2000 acted as a huge tax increase for nearly everyone in the country. A portion of consumer spending was diverted to OPEC putting the brakes on a rapidly growing economy.

Therefore, two dynamic forces are in place supporting the probability that domestic economic activity will improve. An expansionary monetary policy is in place, and a helpful fiscal policy change awaits congressional approval. Studies that we have read suggest that the stock market nearly always reacts positively to an expansionary monetary policy (reduction in short-term interest rates).[1] If history repeats itself, there is a good chance that the equity markets (S&P 500) could rise about 20% from the time one month following a change in direction instituted by the Federal Reserve. That means a possible 20% increase from February 4. The stock market has actually declined since February 4, so the possibility of a meaningful upward move could be expected. We hesitate to suggest that a tax

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[1]The Role of Monetary Policy in Investment Management, November, 2000. Published by The Research Foundation of AIMR and Blackwell Series in Finance.

reduction this year will add to common stock market results. Better to think of a tax reduction as an offset to energy price increases. Finally, it is hard to guess when an upward move of the magnitude mentioned will occur. The move could take time. Corporate earnings will have to improve along with the energy issue.

What seems to be taking place in the markets at this time is an asset allocation shift. Most defined benefit pension fund pools contain both bonds and stocks, and are therefore referred to as balanced funds. The sharp decline in the common stock market over the past year has brought equity ratios in these funds down into the mid 40% range from nearly 60% last year according to the publication, Pensions and Investments. The periodical recently stated that managers of these funds have begun to raise their equity ratios (buy stocks) to bring them into more normal balance. Also, we have learned that at least one major financial institution with a large Minnesota presence has recently increased its allocation to stocks.

In addition, several of the publications that we read have recommended that investors increase their exposure to common stocks. Some names that you may recognize are listed below:

	% Exposure			
	Stocks	Bonds	Cash	Type Portfolio
Value Line Investment Survey	80-90*		10-20	All Stocks
The Outlook (Standard&Poor's)	65**	25	10	Balanced
Paine Webber	There is a 95% probability that stocks Will outperform bonds.			

*70%-80%, December, 2000
**Raised from 60% on January 24, 2001

The first cut on equity exposure always relates to a client's objectives. Risk and time horizon are of prime importance. Those with a time horizon beyond 5 years should continue to be strongly exposed to common stocks. Without question, the recent decline in common stock prices has tested our nerves, but in time this period may be viewed as a correction in a long-term uptrend.

As for stock sector emphasis, we have increased our weighting in specialized energy stocks as we believe this will continue to be an area of opportunity. Retail, health care and financials all have emphasis in our portfolios. And yes, we still own tech and telecom stocks after reducing their weightings last year. We think prominent companies in these areas will perform well in the future despite their recent shellacking and degredation by many members of the investment community.

Finally, following the odd year, 2001, comes the even year, 2002. It may bring better balance to our economy and our investment markets. We hope so.