GSI Market View

2nd Quarter 2000

WOW! What an Economy! According to second quarter statistics, the domestic economy continues to charge ahead. The reported 5.2% annualized gain in Gross Domestic Product (GDP) follows a 4.8% gain in the first quarter. Possibly, the second quarter gain will be revised downward, but it still will represent rapid growth for our economy. *A Business Week survey of 900 companies recorded profits up 17% in the second quarter making it the fifth consecutive quarter of double-digit gains*. Productivity gained a whopping 5% holding inflation down to a manageable level. The unemployment rate was relatively flat at 4%. *As Jackie Gleason often said, "How sweet it is." Maybe*.

Some forces have been less than positive. The Federal Reserve continued to raise interest rates by pushing the Federal Funds rate up to 6.5%. This short-term borrowing rate has been increased six times since May, 1999. *Some believe the increases may be finished, but the jury is still out*. Also, energy prices have gone up again after having fallen off following an indication from Saudi Arabia that they would increase production. Although it is argued that energy prices are not as important a factor today as was the case in the late 1970's and early 1980's, they cannot be ignored. Add to that the growing shortage of electric generating capacity in this country and the problem increases. *Already, we are hearing that natural gas prices may be rising sharply this winter and we learn that heat soaked parts of the U.S. are experiencing sharply higher prices for electricity*. San Diego, CA, is an example. Finally, the nagging trade deficit must be dealt with at some point.

It is hard to tell when and how much effect higher interest rates will have on our economy. Eventually, they will bite. Some evidence is surfacing with concerns at the retail sales level, auto sales and housing starts. *But, so far the bite is soft; it has not been enough to dramatically slow or stop economic growth*. There has been little talk about a recession. Minds are focused on the upcoming election; we are hearing the usual outflow of promises coming from both major candidates. So, optimism continues to prevail. Could attitudes change following the election? Although we don't have an answer to this question, we have the market as a proxy to help us out. Bonds have provided more friendly returns this year than have stocks, and the stock market has been volatile. We think this is a time to have investments diversified, portfolios balanced and minds alert to shifts in the overall economy.

The yield curve inverted this year. That is investment language meaning that short-term rates moved to levels above long-term rates. Money market funds now return more than long-term U.S. Treasury bonds. Long-term rates have declined this year while short-term rates have risen. *When this happens, it raises the cost of carrying inventory*. Retailers move to cut inventory back and push it out the door more quickly. This action backs up to the manufacturers and slows their activity. Retailers, auto manufacturers and other makers of consumer products tend to suffer. Already, some retailers have begun to experience sales and profitability shortfalls. Their stocks have fallen in price. *Energy consuming companies have also experienced difficulty*. The price of airline stocks has declined. Some diversified companies have complained that high energy prices have eaten into their profits. On the other hand, energy stocks have done very well.

A few companies have surprised the Street with unexpectedly low earnings. The reaction has been a sharp drop in the price of their stock. Lucent is an example. We think the best protection against this risk is to have a diversified portfolio of stocks. *Concentrations can be rewarding if the investor is right in judgment, but if wrong, the results can be devastating. Stock portfolios we manage have at least 30 names to achieve the diversification we seek.* Also, we practice industry diversification. *Diversification becomes increasingly important when economic uncertainty builds, as it seems to be now*.

We think interest rates will remain in a holding pattern until after the election. It appears that corporate profits will continue to be strong through the year, but surprises will occur. *So, the equity markets will continue to be volatile. Productivity should continue to be a positive*. We found it interesting to read in a recent issue of Business Week that *John Chambers, Cisco's CEO, remarked that, 'Truly efficient companies, particularly in the first couple of waves of change, will be able to drive (overall) productivity at 20% to 40% a year.'* Those are big numbers, but they suggest that there is much productivity improvement yet to come. And, we might add that there are many companies that have not begun to touch the levels of productivity improvement Mr. Chambers forecasts. Sectors such as financial, medical and communications come to mind.

In our minds, post election market activity is less certain. *Market psychology could change and interest rates and corporate profitability could surprise*. We will be monitoring these factors as the year progresses, and make portfolio changes, where necessary.

We have experienced a good year at GS Investments, Inc. Portfolio performance results continue to exceed the averages. New accounts have joined us, and Marlene Bartlett is a new face in our offices, helping with administrative tasks on a part-time basis. *Her help has granted us additional capacity to handle new relationships. Please keep us in mind regarding investment management opportunities. We appreciate your continued referrals.* Have a good summer!

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