GSI Market View

2nd Quarter 2001

An Odd Year. 2001 has been a year of political and economic imbalance. 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*. Defensive posturing has caused money to flow from stocks into bonds and money market funds. 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; half-hearted attempts to deregulate have backfired in regions that had failed to develop a careful plan. Black clouds have gathered and thunderstorms of negative happenings have come 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%). (As we write, the fed has just announced another 50 basis point reduction, bringing the federal funds rate down to 4.5%). *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. *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 one. Another is a helpful fiscal policy change. This 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% annualized. *That means a possible 20% increase in the year following 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 reduction this year will add to common stock appreciation. 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 may have to improve along with the energy issue.

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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.

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, <u>Pensions and Investments</u>. 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
Salomon, Smith Barney	70	25	5	Balanced
Paine Webber	There is a 95% probability that stocks will outperform bonds.			

* Raised from 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 disagree with some wildly popular, but misguided notions. The first is that all tech and telecom stocks are overvalued. Most have seen their valuations crushed, brought on, in large part, by the Fed's overly aggressive attempt to bludgeon non-existent inflation. This has only served to ill-liquefy the market, thereby restraining economic growth and choking-off capital expenditures. The result for many Competitive Local Exchange Carriers (CLEC's) has been an inability to borrow and/or service debt. Subsequently, the inventories of suppliers have ballooned and corporate earnings have been decimated. When capital expenditures pick up (perhaps over the next 6 to 18 months), we expect many of these companies to do well. If that is the case, a rise in respective valuations should follow. The second misguided notion is that the debacle in the CLEC area-see misguided notion number one- is directly related to past and future IT (Information Technology) spending. In fact, we view IT spending as a completely separate issue and are treating our buys and sells of tech and telecom companies accordingly. The third misguided notion is that no tech and telecom company will ever again experience the dramatic growth rates previously seen. Some would actually have you believe that the build-out of the Internet (and all that is tied to it) is complete. Simply put, we feel that this perspective is naïve as we feel we are only in the "infant" stages of the Internet's expansion. *In short, we think prominent companies in these areas will perform well in the future despite their recent shellacking and degradation 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!

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