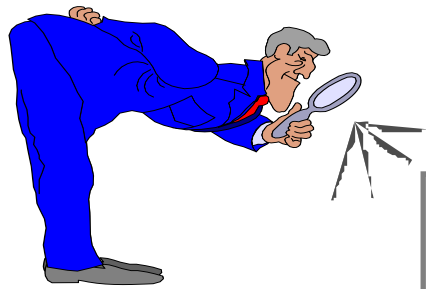
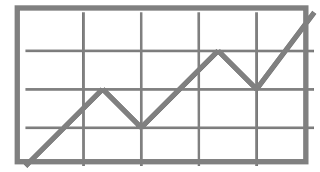
GSI Market View



3rd Quarter 1997



How long can this possibly last? This seems to be the $60 million question for both investment managers and individual investors alike. From January 1, 1997 through July 31, 1997, the S&P 500 is up roughly 30%. This comes on the heels of a 23% gain in 1996 and a 38% increase in 1995. Many pundits had predicted flat to modest gains for 1997. *What are the dynamics behind this dramatic climb? Will the climb continue? Is the market now overvalued? What could bring the advance to an end? Finally, are there any advantages left for the average investor in today's volatile marketplace?*

Perhaps one reasonable explanation can be found in <u>The Great Boom Ahead,</u> by Harry S. Dent Jr. In his book, Mr. Dent analyzes demographic trends, particularly one pertaining to US births in this century. In addition, Dent examines spending and savings patterns of individuals, highlighting the fact that the average individual enters his/her “peak” savings years in the 47-49 year range (many “baby boomers" just happen to fall in this range). Finally, Dent ties all of this information together by showing a striking correlation between the movement of the S&P 500 and the savings tendencies of the US population, 47-49 years old, since 1920. Not only does this provide support for what has transpired over the past years in the stock market, it lays sound groundwork for a further climb in the years ahead. For more charts and/or information pertaining to this matter, please call either Glenn or myself.

Another explanation surrounding this extended bull run is put forth by Tom McManus, US Investment Strategist at NatWest Securities. *McManus feels that technology has been a prime driver of this upturn.* Referring to the S & P 500 Index, McManus says, “The S & P 500 portfolio is higher growth, more global, less cyclical and more diversified than it ever has been and therefore deserves a higher multiple.” James Weiss, deputy chief investment officer at State Street Research, has a similar perspective. He firmly believes that *the current economic expansion has been due to innovation* rather than the more traditional economic upturn or business cycle. He also feels that it could continue as long as inflation remains moderate and global markets expand. *We at GSI have long believed in these contentions. It is for this reason that we continue to overweight the equity portions of our portfolios in technology stocks.*

Other factors supporting the current market valuation have been mentioned previously in our newsletters. These factors include, a strong prospect for continued low inflation, strong productivity, low bond yields, better-than-expected tax collections by federal and local governments and controlled government spending. Finally, better corporate management and global expansion by many domestic companies have resulted in stronger growth and improved profit margins. Consequently, stock valuations have risen.

So, is the market fairly valued or is it overvalued? As with many other questions, it really depends on whom you ask. *The only issue of consensus at this time seems to be that the market does not appear undervalued*. In a recent article in Barrons, Harold Seneker examined the relationship between the yield of the S&P 500 and the 10-year, US Treasury note yield. This relationship has been used by some since 1983 to determine the fairness of the market's value. The latter divides the S&P 500 earnings by its price to determine an earnings yield. He found that the S&P 500 earnings yield has ranged between 65% and 85% of the 10-year Treasury note yield since 1983 and is now roughly 69%. Therefore, he concludes that the stock market, as measured by the S&P 500, remains within a reasonable valuation range. *We at GSI feel that although the market is fairly valued, it is probably not overvalued*. Given the cases built by Messers Dent and Seneker, a low interest rate environment, little inflation, and a lack of unforeseen cataclysmal occurrences, there is no reason to believe that the market can't continue to climb.

The increasing popularity of index funds may have caused some common stocks to be overvalued. Over the past 4-5 years, more than 80% of money managers have underperformed the S&P 500 index (*GSI has been fortunate to be excluded from this group*). In response, many of the large mutual fund houses, such as Fidelity, have adopted the old adage, "If you can't beat them, join them." Consequently, these mutual fund houses have moved in the direction of index funds. Simply put, index funds are mutual funds designed to mirror a specific index, most often, the S&P 500. This may explain why many of the "large cap" stocks found in the S&P 500, are trading at such high multiples (i.e., Coca Cola is trading at 42 times next year's earnings). *The more important question may be, will the "pendulum" eventually swing back, signaling a move out of index funds? Only time will tell when or if.*

What could cause a general market selloff? Obviously, there are a number of different factors, many of which we have outlined in previous writings. Inflation continues to be a threat to any further market advance. One factor receiving little attention however, is the potential for deflation, not inflation. According to James Paulsen, Chief Investment Officer at Norwest Investment Management, the relationship between real rates of interest and the "flation" factor is currently out of whack. *Simply put, the author contends, interest rates, in general, need to come down to accurately reflect the absence of inflation found in the economy today*. The contention here is that if real rates are too high, corporate profits (earnings) will be adversely affected, causing a general selloff in the market. This may add further challenges ahead for the Fed and Mr. Greenspan.

Given these current market dynamics and the associated volatility, is there an advantage for the average investor today? The answer is a resounding YES, and can be best described with two words, *courage and patience*. To be a successful investor today, one must invoke the courage to owning those companies whose fundamentals and earnings have been and remain consistent. One must then exercise the patience to hold these companies over the long-term, despite the bumps and bruises that may occur along the way.

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