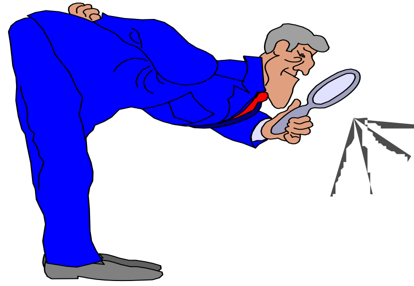
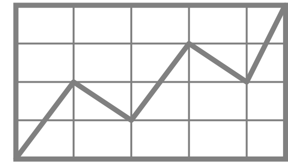
GSI Market View



4th Quarter 1996



What do you think? This is a common question that is asked on a variety of topics. Now, it is frequently posed about the influence of election results on the economy. Surely, it is often raised when discussing the financial markets. *Frequently, the response to this question relies on history, because history tends to provide a guide to the future.* One has to be careful placing too much weight on historical evidence, however. Straight extrapolations can be dangerous.

When attending an investment conference early in this decade, we happened to be discussing bank stocks with another portfolio manager. The Federal Reserve had just started to raise short-term interest rates, and bank stocks were beginning to slip in price. We argued that, for a variety of reasons, the outlook for bank stocks was good even if interest rates moved up and stayed within a reasonable range. But, the market was conditioned to the "rates up, banks down" argument and these stocks along with other financial stocks declined. *However, bank earnings continued on their upward trend, vindicating us shortly thereafter with rising bank stock prices.* In this case history failed to be a good guide to the future. We think certain bank stocks are still attractive for the very same reasons we used when debating with the portfolio manager mentioned above.

Following Clinton's dramatic victory in 1992, health care stocks took a tumble. This was due to the Administration's effort to significantly change the approach to health care delivery in the United States. Consequently, the prices of Medtronic and Merck fell in half because of the fear that these great companies would no longer maintain their earnings growth rates. We all know what has happened since then. Off their '93 lows, Medtronic has split twice and quadrupled, while *Merck* has more than doubled in value.

Early this year, there were forecasts that health care stocks would repeat 1993 results based on a Clinton reelection. The election is now history. Health care stocks have moved sharply upward after a shaky start this year. *We think carefully selected health care stocks should continue to make up an important part of a growth stock portfolio. Saying it another way, we don't think that the 1993 experience will be repeated.*

These are but two examples of extrapolating history and not detecting changes that result in investment opportunities. Another ties rising interest rates and inflation to a recession. *The contention is that higher inflation results in higher interest rates which, in turn, choke off an economic expansion and spur a recession.* Correspondingly, a knee-jerk reaction often occurs in the market, sending prices of stocks and bonds lower. This line of reasoning has credibility, but market participants are now trying to anticipate this succession of events without considering what we think are important structural changes in the economy.

Throughout most of this year, there has been a fear that interest rates would be increased. Bond prices suffered, and in July when interest rate fears were most severe, stock prices corrected. In August, the Federal Reserve passed on the opportunity to raise interest rates, and held them steady. *As it turned out, there was not clear evidence that inflationary factors were present, and that evidence remains absent.* Anticipation did not turn into reality.

Fortunately, Fed Chairman Alan Greenspan was viewing the economy differently than were some Federal Reserve colleagues who wanted higher rates because, again, they were extrapolating history by looking at traditional statistics such as employment numbers and wage rates. *We think those interest rate hawks failed to recognize the dampening effect of an important improvement in productivity due, in part, to capital investment in computers and related software*. We think that improvement will continue. *That is one reason we like technology stocks and have kept an over-weighting of these stocks in our portfolios.*

Other factors that seem to be influencing the Fed to hold steady on interest rates are 1) a policy to let the economy resolve shorter term changes in economic growth, and 2) an apparent willingness to accept inflation rates at current levels rather than trying to achieve a zero rate of inflation. *Getting down to that level could cause a recession.* If this is an intentional shift in policy, history failed to forecast the change. *Also, the actual rate of inflation may be lower than reported using traditional economic statistics* due to the difficulty in measuring productivity improvements in the service sector. *If more recognition is given productivity improvements in the service sector, reported inflation might be lower.* If so, increases in COLA's (cost of living adjustments) could be reduced. For example, a 1% reduction in annual Social Security increases could result in significantly lower pay-outs from the Social Security Trust Fund.

So, what do we think about 1997? The election is history and has resulted in a political balance between Congress and the Administration. Business Week recently noted that this was the first time in history that a presidential election resulted in a Democrat in the White House and a GOP controlled Congress. *We think moderation in terms of spending and other government policies will result from this combination.* Also, the Federal Reserve might be able to achieve a lower profile and be more independent in its policies. *This could lead to an interest rate range of about 6%-7% on long-term Treasury bonds in 1997.* Although our economy is slowing down from the torrid pace experienced earlier this year, it appears that the chance is good for resumption of economic growth at a more normal 3% rate in 1997. Corporate earnings may be up about 10%.

A client recently asked us what returns we expect the financial markets to provide in 1997. We responded that they would probably provide a coupon return for bonds and the corporate earnings growth rate for stocks. *This works out to about 6% for bonds with medium term maturities and about 10% for stocks.* The assumption here is that stock price earnings ratios will stay about the same. With the economic outlook suggested above, we believe stock price earnings ratios are reasonable, although near the high end of the range.

Outlooks are fraught with uncertainty. One thing we can be sure of, unexpected events will take place next year. They will influence the financial markets. *More than likely, these markets will be volatile. Traders will try to catch the ups and downs; we will not. We will stay fully invested and seek returns higher than those produced by the popular averages.*

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