GSI Market View

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We are living in a global economy. Mexico did not transmit this message two years ago as effectively as Asia has today. It is now clear that a far off part of the world does affect us directly.

Money flows throughout the world with the flick of a computer key. Billions of dollars change hands quickly as currency traders rebalance positions. Nations trade with each other freely. Banks facilitate commerce. The capitalistic system has taken on a world presence.

We, in the United States, tend to think that our system should work in foreign countries as it does in ours. It may, but it is now evident that it will take time---more than we expected. **The primary reasons that our system did not translate seamlessly to Asia are 1) we regulate our commerce and 2) we have a stable, well-managed banking system.** At least it is working effectively at this time.

On the other hand, **Asia blew up because of corruption, scandal and an unwillingness by governments to set up financial systems to accommodate change.** So, the bailout will be up to the United States, the International Monetary Fund and corporations throughout the world. It will take time and discipline to put the pieces back together. **Too bad McArthur was not a banker.** He may have helped Japan and South Korea more if he had strong financial training.

No one really knows how much the Asian turmoil will affect the United States and other countries. Daily, we hear news of corporations being affected by operations in Asia. Certainly, technology companies are being hit hard in the marketplace. Portfolio managers seem to be selling stocks as a group**. We think that all technology stocks are not equal and after a sorting out process, some will turn out to be successful as they were before the crisis.**

There are two havens now for investors. One is **bonds** and the other is **consumer stocks**. Also, **utility stocks** have been rediscovered.

Long Treasury bonds recently broke through the 6% barrier like a warm knife through butter. **This decline in interest rates has been dramatic and has set a number of forces in motion**. **Mortgage refinancings** continue at a rapid pace placing more money in the hands of the consumer. The **cost of capital is declining** and that is favorably affecting corporate financing and refinancing. Uncle Sam is paying less for his money through **lower interest rates** and the same is true for states and municipalities. Could this lead to lower taxes? We hear rumblings to that effect.

From all of this, the consumer should benefit. Both unemployment and inflation are historically low. Some would argue that inflation is negative. Productivity is at a high rate. Wages are up. All of these factors suggest strong consumer spending.

Also, many goods should be cheaper due to Asian manufacture. **Autos**, **clothing** and **tennis shoes** come to mind. In addition, **computers** should continue to attract consumer dollars.

One issue that we think about is the prospect for **deflation.** This country has been inflating for so many years that deflation tends to be ignored. The Asian crisis has brought the possibility of deflation into sharper focus because, as we mentioned before, we live in a global economy. On your clothing label, you may find that manufacture was in China, Taiwan or another Asian country. Their currency is down relative to ours and that allows us to spend fewer dollars on their goods. **Unless they solve their financial problems, a downward spiral could occur.** This would not be healthy for our corporations or markets. This kind of thinking prompts the bond bulls to snort and arouses common stock market bears. We don't see the risk of a downward spiral soon, but we will watch for developments.

The other issue that has concerned investors for over a year has been the level of the stock market. Valuations are high relative to past norms and there are those who fear a market top each time we move to higher levels. An article appeared in the Wall Street Journal on November 3, 1997 that impressed our minds. It was written by a partner of McKinsey and Associates with help from other colleagues from that firm.

Their thesis is that higher market levels may be justified because accounting conventions have not kept up with changes that have taken place in the way corporations now do business. Corporations have many intangibles-people, patents, brands, software, alliances, etc. that are not given value using traditional accounting standards. Also, they feel that the cost of equity capital for corporations has declined, because investors have come to favor stocks over alternate investments. Finally, many corporations have a global presence and are able to capture opportunities throughout the world. This fact gives additional value to such companies.

In summary, Asia has underlined the fact that we are living in a global marketplace. It will be up to the strong countries **to bail out Asia and avoid excessive deflationary pressures**. Perhaps our equity markets are not overvalued due to accounting conventions failure to measure corporate intangibles, and the cost of equity capital may stay low.

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GS Investments, Inc.
Glenn and John Steinke
920 Second Avenue South, Suite 600
Minneapolis, MN 55402
(612) 371-0590
JNBR65A@Prodigy.com