GSI Market View

4th Quarter 1999

<u>What a difference a year makes!</u> Last year at this time the 30 year U.S. Treasury bond was nearly 1% lower in yield than it is today while the shorter term Federal Funds (interbank lending rates set by the Federal Reserve Bank) rate was slightly higher. This is shown below:

	RATE	
	9/16/99	**9/17/98**
30-Year U S Treasury	*6.08*	*5.18*
Federal Funds	*5.25*	*5.50*

At the same time the stock market as measured by the broad market indexes has moved sharply higher. This is shown below:

DJIA	*10801.42*	*7873.77*

From the above, the stock index (without dividends added) is up about 37%, surely not a modest move over a twelve-month period.

<u>Last year about this time, Asian and emerging countries were struggling to regain balance</u>. The European block was doing OK, but surely was not setting a strong pace. The U.S. was doing well, but reeling from the Clinton affair. The U.S. stock market was moving sharply lower. Inflation was a concern then, as it is now.

<u>Then, the Federal Reserve gradually lowered the Federal Funds rate in three ¼% steps to 4.50</u>%. The U.S. economy turned up sharply followed by some Asian countries like Korea, and with government stimulation, Japan. *Now, although it does not surface in the numbers, there is again concern in the U.S. about inflation.* This is the reason for a higher U.S. long Treasury bond yield stemming from two recent ¼% increases by the Fed in the Federal Funds rate. *One more such increase and we would back to the same Federal Funds rate we had one year ago*. The fear now is that the Fed will cause a recession with such increases, corporate earnings will decline and the stock market will continue to tumble. We don't think that is the objective of Alan Greenspan, Chairman of the Fed.

<u>We think that the Fed is trying to slow down the growth of the U.S. economy that is now in high gear</u>. Higher interest rates will bite into the housing market and possibly the auto market reigning in consumer spending which accounts for roughly 2/3 of economic activity in this country.

<u>What about inflation</u>? *The jury has been out on this issue for some time*. The reason that inflation has failed to enter the economic scene as a serious negative factor is **productivity**. It has and probably will continue to be the main force offsetting higher wage rates due to low unemployment. There is no question that unemployment is low. Nearly every consumer service vendor that we use has a help wanted ad in their window. Even seniors are in demand.

Long term interest rates have moved up ahead of the increases in the Fed Funds rate. However, after the last increase, the long term Treasury bond rate moved down to about 6% after hitting 6.27%. *We think that it is unlikely that long rates will move sharply higher as long as the Fed moves to keep the economy on a more normal growth path, close about to 3.5%, annually*. This also could keep the stock market in a valuation range making selection the more important factor.

Two recent Wall Street Journal articles caught our eyes because they related to our thinking on common stock valuation and diversification. *The valuation article talked about valuing intangible assets as well as hard assets*. Hard assets are easier to value because they are visible and they are usually subject to an extended period of depreciation. For example, a new building costs a certain amount and that amount is expensed (depreciated) over several years rather than charging the expense against income in one single year. For some companies buildings and heavy capital equipment represent a major component of their cost structure. For other companies, these assets represent a smaller portion of their cost structure. *The larger portion may be in intangible assets, namely R&D, software, patents and marketing.*

These intangible assets tend to be expensed in the year incurred. It may be unfair to value earnings of all companies in the same way. Companies with high intangible asset expenses might be undervalued while those with large hard asset bases might be overvalued. *Our corporate structures have been moving toward larger intangible asset bases, which might support higher stock valuations for the overall market*. This leads to New Paradigm thinking taken into consideration by Alan Greenspan. The article notes that a study done by two MIT professors concluded**, "the market values a dollar invested in information technology at ten times what it values a dollar of conventional capital."**

The article on diversification cites study done by a Rice University graduate school professor. He concludes that diversification is important in portfolio construction when wanting to keep up with the market. *The article goes on to point out that diversification can be achieved with 25 stocks. We believe in diversification as an outperformance tool and run about 30+ stocks in the average portfolio. We also diversify by industry*. Selection is a key component in the process.

Year-to-date, through August, our performance has been well ahead of benchmark indexes for both stocks and bonds (in excess of two times for each). Stocks have shown significant positive returns while bonds are slightly negative due to higher interest rates.

For clients, we will be sending an update in the fourth quarter regarding our Y2K preparedness. *Of interesting note, Chairman Greenspan, as we write, has indicated that the negative effects of Y2k may be overblown*. Says Greenspan, " The probability of a cascading of computer failures in mission-critical systems is now negligible, given the testing that has been done, the backup plans that are in place and the great adaptability an ingenuity of the American worker." Time will be the ultimate judge of Y2K and its effect of the market.

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