

Investment Review and Outlook: The Bull Market Resumes

Stock market performance during the first quarter of 1995 proved true to the adage that "Bull markets climb a wall of worry." Both the Dow Jones Industrial Average and the S&P 500 Index reached new highs, rising 8.4% and 9.0% respectively. The Value Line Index, which is a much broader index with 1700 stocks making it up, increased 5.2% during this period. Interest rates fell as the economy slowed, resulting in a 3.3% total return for short term corporate bonds as well. During the quarter the Federal Reserve shifted its policy stance from a tight money, inflation fighting mode to a more neutral posture, balanced between sustaining economic growth at a targeted 2.5 % rate and limiting further increases in inflation.

The slowdown in the economy has been most apparent in the interest rate sensitive sectors including housing, autos, consumer durables and retail sales. Consumers have maximized most of their borrowing capacity. Installment debt as a percent of disposable income has reached historically high levels. The year long rise in interest rates has added \$200 more to monthly mortgage payments for the average homeowner, as well as inflating interest expense for auto loans and credit card balances. Higher interest rates have done little to dampen investment in technology, however. Capital spending remains robust with exceptional strength in computer and telecommunication equipment and software. We expect GDP growth to slow from last year's 4% rate to between 2 - 3% for 1995.

The wild card among investor concerns is the collapse of the U. S. dollar versus the currencies of our key trading partners. The failure of the Balanced Budget Amendment to pass the Senate as well as the U. S. financial bail out of Mexico have left foreign investors less sanguine about dollar denominated investments. For many years now, foreign investment has largely funded our federal budget deficit. That financial dependency could translate into higher interest rates in order to continue to attract foreign funding. The beneficiaries of the lower dollar are the multinational corporations who gain by the competitive advantage the lower dollar brings to the pricing of their products in world markets, as well as by the translation effect of converting foreign profits back into dollar terms. The very real risk of the low dollar is the potential acceleration in inflation created by consumer reliance on imported goods. Fundamentally, the inflation outlook remains relatively benign with the economy slowing, wage growth still modest and manufacturing capacity running near

peak efficiency. We expect inflation to remain in a range of 3-3.5%. Our enthusiasm for bonds has been dampened, however, given the sharp decline in the dollar and the mounting pressure on the Fed to act in the dollar's defense.

The rally in the stock market over the past three months has been particularly favorable for technology and multi-national consumer product companies. Despite record corporate profits, many cyclical stocks remain in the doldrums. The 9% gain in the large capitalization S&P 500 Index versus the 5.2% gain in the more diversified Value Line Index indicates a narrowing of market breadth, often a precursor to market tops. Earnings have surpassed inflation as investors' primary concern. Strategically, a moderate growth, modest inflation economy is conducive to predictable corporate earnings and therefore to equity investment, especially in growth stocks. Demographic trends also bode well for stocks, driven by the rising savings and investment rate of the aging baby boom population.

Although it would be wonderful to forecast continued momentum in the rates of return achieved so far this year, we don't believe this rate of gain is sustainable. Further deterioration in the dollar could undermine our outlook; however, the current preponderance of evidence points to a modest slowdown in the pace of economic growth, continued inflation of 3-3.5% and stable to declining interest rates, which should lead to attractive returns by year end as well.

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