

July 12, 2000

Attentionspan

The following are excerpts of a recent Donaldson Capital Management investment policy meeting Mike Hull and I had about the economy, interest rates, and the stock and bond markets. It is wide ranging and includes our opinions on a multitude of topics. We believe a Question and Answer format will best provide you with an understanding of our current investment strategy.

Greg: Mike, in our 1999 mid-year Client letter, we said that sharp increases in long-term interest rates, oil prices, and employment during the first six months signaled that the Fed would be on a heightened state of inflation alert. We further explained that we had entered a period of time when the Fed's actions would be less hospitable and predictable to the capital markets. In the last paragraph of that letter, you explained that rate increases combined with less predictability by the Fed would cause the economy and stocks to cool off and take a needed pause in their multi-year bull markets. You used the analogy of making a successful turn on a motorcycle to the work the Fed had to do to turn the economy. You stated that a successful turn on a motorcycle was dependent on the speed and angle of entry, the driving line taken in the turn, and the point of re-acceleration and route taken on the way out. The turn caused the cyclist to slow down because his field of vision was diminished as well as the fact that the laws of physics dictated he could take the turn only so fast without the bike sliding out from under him. Likewise, as the Fed began to turn the economy, investors would need to slow down and rethink their potential rewards in light of a less robust economy and increased odds of financial accidents. Could you think back to July 1999 and explain what convinced you that turning the economy would be much more difficult than the markets were projecting at the time?

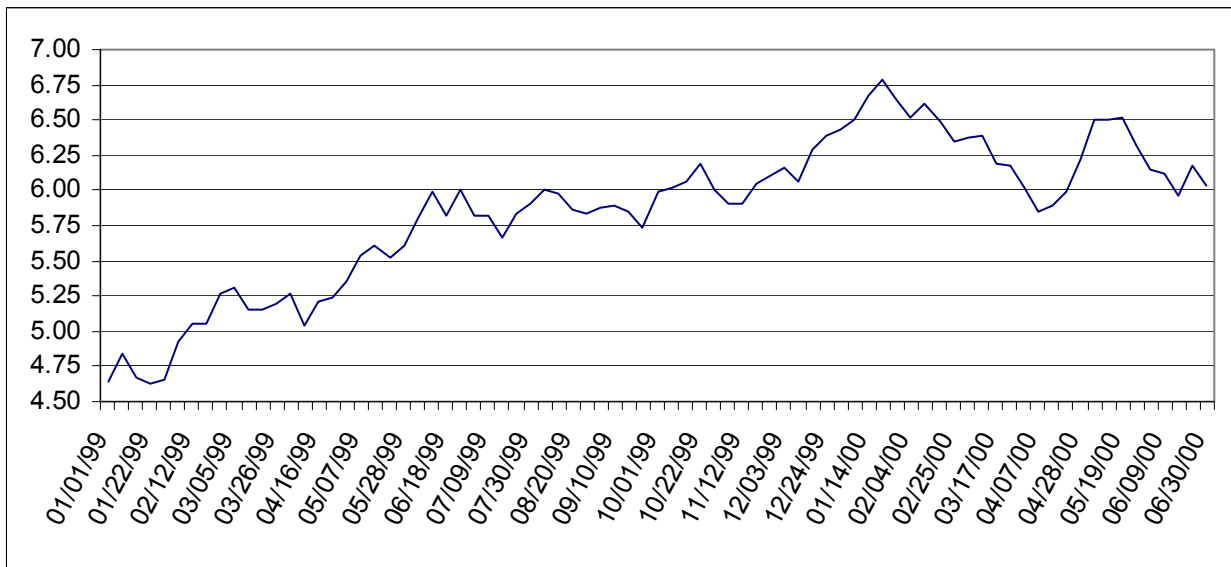
Mike: The obvious answer was that the economy had built up such a head of steam that it would take a long time to slow it down. But you and I both thought the single biggest problem facing the Federal Reserve was the Fed, itself. Alan Greenspan's near mythic status among investors had the potential to produce a kind of "blessed if you do, blessed if you don't" attitude to manifest itself in the financial markets. The essence of this unusual phenomenon would be that the markets would rally whether the Fed raised rates or not. Investors would say, Well if the Fed thinks rates should go up that's fine, let's buy the tech stocks; they aren't sensitive to interest rates. If the Fed left rates unchanged, the market would simply change its chant to, If Alan doesn't think rates need to go up, that's cool, let's buy the whole market because everything is going higher. This potential for the markets to underestimate how long it was going to take to slow down the economy was the reason we made the point in our letter many times that to get and hold the markets' attention Mr. Greenspan needed to be less predictable than he had been in the last few years.

Greg: I hear three separate elements in making the turn. (1) Where you enter and how fast you are going, (2) the smoothness of the driving line while in the turn, and (3) when to get on it on the way out. We are now 12 months down the road from the Fed's first rate hike. How would you rate their progress so far?

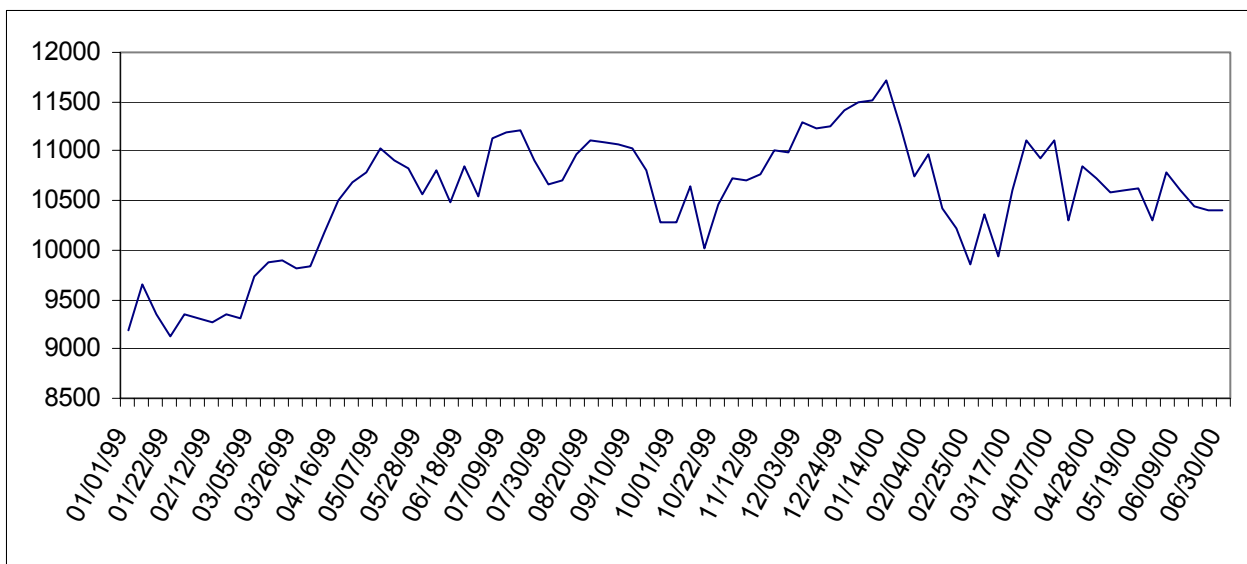
Mike: Quite frankly, I would give them a very mixed rating. Let's eliminate point 3 because it's clear the Fed is nowhere near exiting the turn yet. Regarding point 1, I think we both agree that the Fed began the process of slowing the economy in good shape. They began their rate increases early before any inflation uptick was apparent, so I would give them a good grade on that point. They started off by gradually increasing rates and the markets responded very quickly. The charts below show the Dow Jones Industrial Average and long-term bond yields for the period between December 1998 and June 2000. Look carefully at the period of time beginning at the end of June 1999 extending through the end of October 1999. Stocks, which had been in a strong bull market, appeared to

be cooling off, and bond yields, which had been rising for six months, also flattened out. This was a clear sign that the Fed had the markets' attention. In this case, the chart of long-term bond yields is the more important of the two. As we have said many times in the past, long-term bond yields are seen as a leading indicator of inflation. Thus, bond yields flattening out coincident with the Fed's raising rates was a clear sign that the Fed was on the right track.

Bond Yields 10-Year Treasury



Dow Jones 30 Industrials



Greenspan appeared to have sold the markets on the belief that the Fed would, indeed, be raising interest rates but they would be moving slowly. The consensus of most economists was that the Fed wanted to slow economic growth to a range of between 3.0% to 3.5%, down from the 4.0% to 5.0% rate. The thing that gave this approach its uncertainty, and therefore the Fed its power was the reality that no one knew how many gradual increases it would take to ultimately slow the economy, so the markets all shifted into neutral, including the tech-heavy Nasdaq.

But, after having gotten off to a very good start going into the turn, Mr. Greenspan and the Fed made a blunder. In retrospect it was a move I'm sure they knew might back fire and it did. The blunder was this: They all but took out an ad in the Wall Street Journal to announce that after the November 16th meeting they planned no further rate actions for the year. There is no question they did this because of Y2K issues, and I'm sure they were under tremendous pressure from other branches of government and business to do so, but it backfired just the same. Almost immediately, the orderly, gradual turn they were making started to come apart in the financial markets. With the Fed out of the way, and with at least some gurus on Wall Street saying the Fed might not have to make

many more rate increases, the stock and bond markets exploded. The charts show that from approximately the end of October through the early part of February 2000, the movement in stocks and bond yields was flat out amazing. The Nasdaq rose almost 50%, the S&P 500 jumped 15%, and the Dow Jones moved higher by almost 10%. But again the bond market registered the most important move. Yields on 10-year US Treasury bonds rose from approximately 6.0% at the end of October to just under 7.0% in January, a rise of almost 18%. By January the bond market for all practical purposes took out its own full page ad in the Wall Street Journal which had only one word on it: Wrong!

In motorcycle terms, the second element of a good turn, riding a smooth line, was now in jeopardy. The wheels were starting to break loose and the Fed knew it and so did everyone in the financial markets. Gross Domestic Product (GDP) for the fourth quarter of 1999 grew at an astounding 7.1%, almost twice as fast as the Fed's target. Although inflation remained relatively benign, the early warning signals of mounting inflationary pressures were flashing red. Long-term interest rates and oil prices were shooting higher and the unemployment rate stayed stuck near its 30-year low of 4%.

Greg: Your theory of “blessed if you do, blessed if you don’t” could explain why the markets exploded in November. Even though Mr. Greenspan and his colleagues had begun the tightening process, it seemed as though in every speech he gave he always included the words, “these rate increases will keep inflation under control and extend the strong economic expansion of the past several years. These are boilerplate words and strictly speaking are true, but, uttered from the lips of a man who has a legendary reputation among investors for being able to handle tough situations, created a false sense of security.

Let me recap what I am saying in simple terms. The economy was too strong and risked igniting inflation. The Federal Reserve began raising interest rates to slow the economy and diminish potential bottlenecks in the economy where inflation could take hold. Now, slowing the economy is a violent act. It is just not possible to slow the economy without hurting some companies and individuals. This is where the problem arises. Economic growth is the source of corporate earnings growth. Corporate earnings growth is a primary determinant of the value of a stock. Thus, it should come as no surprise that a slowing economy may well push stock prices lower. Moreover, corporate earning growth is also the determinant of jobs and capital budgets and so forth. One of the main worries of the Fed and most economists was the 30-year low in unemployment rates. This again is relatively simple. Consumer spending is roughly two thirds of GDP, and wages are the largest component of the consumer portion of GDP. Thus, it is not rocket science to realize that to slow the growth rate of the economy it is necessary to slow the growth of employment. There is just no getting around it. But it is simply political suicide for the Fed to say: “Look we need to put 500,000 people out of work. That will raise the unemployment rate from 4.0% to 4.5%.” When it’s statistics it’s fine, but when it’s people it won’t play. But no matter what you call it, that is the only way to slow the economy.

Mike: Greenspan’s code word in the past year has been the wealth effect. He says it has added perhaps as much as 1% annually to GDP over the last five years. The wealth effect is the supposed additional consumption Americans have made as a result of the capital gains they have accumulated from the long bull market in stocks. The theory goes that because stocks have risen and Americans feel wealthier, they save less and consume more. I’m sure these capital gains play some role in economic growth, but the numbers just don’t hang together very well. First of all only 40% of Americans have investments in the stock market, and most them have their stock investments in retirement plans where they have only limited access. In our judgment, the wealth effect is real, but it consists only marginally of stock gains. The real wealth effect is the 30-year low unemployment rate of 4.0%. This near full employment gives a level of financial security to the average worker that he or she has ever known. The employment rate reaches nearly everyone in one way or another. So again, the economy has become the benefactor of a virtuous cycle. Jobs are plentiful, and jobs create wages, which create consumption, which creates economic growth, which, oops! can cause inflation if the growth produces the bottlenecks we spoke of earlier. Thus, Mr. Greenspan has chosen a politically correct adversary—the stock market—with which to do battle. In our judgment, however, his real target is employment growth because employment growth is such a large part of GDP growth.

Greg: Let’s get back to the turn the Fed is trying to execute and bring Mr. Greenspan and his colleagues up to the present. After they realized that they had lost control of the economy and the stock market how did they regain their balance and get things righted again?

Mike: Just the way we thought they should all along—by becoming less predictable. At the February 1st meeting the Fed raised rates by a quarter of one percent, but in their comments about future moves, they were very pointed—inflation forces appeared to be building. The tone of their comments had more of an edge to them. But the biggest surprise was two weeks later when Mr. Greenspan gave his semi-annual Humphrey-Hawkins report to the House and Senate Banking committees. The whole financial world was watching to see if he gave any hints of future Fed moves. He did not disappoint those looking for a surprise. In fact, his comments literally caused some analysts that we follow to question his sanity. An Alan Greenspan speech is often like reading the Bible. You have to keep track of the nouns and verbs, and what is the subject and the object, and the modifiers, and at the end just guess at what he really said. But in his February 17th speech to the Congress, he made an astounding comment. He said that increases in technology and productivity, which he had long praised as being responsible for producing the strong growth with low inflation the US economy had enjoyed, were now the problem. Let me read you the part of the speech in which he explained this new line of thinking.

Yet those profoundly beneficial forces driving the American economy to competitive excellence [technology and productivity] are also engendering a set of imbalances that, unless contained, threaten our continuing prosperity. Accelerating productivity entails a matching acceleration in the potential output of goods and services and a corresponding rise in real incomes available to purchase the new output. The problem is that the pickup in productivity tends to create even greater increases in aggregate demand than in potential aggregate supply. This occurs principally because a rise in structural productivity growth has its counterpart in higher expectations for long-term corporate earnings. This, in turn, not only spurs business investment but also increases stock prices and the market value of assets held by households, creating additional purchasing power for which no additional goods or services have yet been produced.

At the root of this statement is his theory of the wealth effect. He is basically saying, that increases in productivity are producing an increase in corporate earnings, and the increase in corporate earnings is producing a rise in stock prices that is faster than the increases in productivity. This imbalance between the supply and demand of goods is the essence of a bottleneck and leads to you guessed it—inflation. Needless to say, on the day he gave this speech he was probably the only person in the financial world who was not surprised by its conclusion. One senator haltingly said, “You are now saying that increases in productivity are bad, when for the last several years you have said they were good?” Mr. Greenspan answered something to the effect that they were, indeed, bad if they produced a sharply rising stock market. Investors concluded two things as a result of the Humphrey-Hawkins testimony; neither of them was good for the stock market. (1) If productivity is now bad, that means that the Fed may target the booming stock market as a potential cause of inflation. And (2) productivity is an extension of technology; thus the prime targets within stock market are the technology stocks. Say it ain't so Alan!

Greg: Maybe one day Alan Greenspan will write a memoir and say he was just kidding about his speech. Maybe he really believes it. But very few other people in the financial world do, and the fact that he chose this platform to give this speech with this theme was very unnerving to the financial markets. Uncertainty seized the day, because the strongest conclusion that one could make was that the tech stocks were now in the gun sights of the Federal Reserve.

Mike: No sooner had Mr. Greenspan reinitiated his tough inflation talk than he was greeted with that which he feared the most—a real dose of inflation. Even though the early warning signs of inflation had been signaling that pressures were building since early in 1999, reported inflation had remained extremely low. Indeed, many politicians and labor unions were castigating the Fed because it was raising rates in the absence of any significant uptick in the CPI. But the February data (reported in mid-March) showed that inflation grew at an annual rate of 6.0%. Most economists were predicting about a 2.5% annualized increase. Some run-up in inflation was expected because of the spike in oil prices, but now the alarm bells were sounding, and the markets very quickly concluded that inflation was on the loose and bond yields jumped higher. March's CPI was even worse. The annualized rate of 8.4% was again affected by surging oil prices. The Federal Reserve responded to the inflation spikes by increasing rates by a total of .75% in their March and May meetings. Even though subsequent month's data has shown a return to lower rates of inflation, investors have been much sobered Finally, investors were beginning to see that, even with the benefit of very high productivity growth, the very strong economy had tripped off inflation. As this realization became more widespread the markets shifted into neutral were they have remained for the last several weeks.

Greg: Mike, this is too ironic. To describe the Fed's success a year ago, you said, "they got the markets' attention...and the markets shifted into neutral." I'm hearing you use the words "attention" and "control" almost interchangeably. Is that what you really mean? Do you believe the Fed is back in control of the markets?

Mike: You walked me into that one, didn't you? I really hadn't thought of it in those terms. But we have come full circle. Not only has the Dow Jones ended up just about where it was a year ago, but we have gone from the Fed taking control, to losing control, to taking control again. During this time, the markets have gone from shifting into neutral a year ago, to exploding ahead from November through February, to shifting back into neutral a few weeks ago.

Greg: I agree that the Fed is back in control. Tell me what you think this means for the economy, and the markets in the next six months.

Mike: Let me take the easy one first. With unemployment rates at 4.0%, it is a near certainty that the economy cannot slow very rapidly. So, I think the economy will continue to be a little stronger than the consensus estimates, which is growth of about 3.0% in the fourth quarter. With the economy being a little stronger than the consensus, it is difficult for me to imagine that short-term bond yields could come down very much, especially in the near-term. But I do think long-term bond yields will be modestly lower by year end as a result of the economy trending lower. With those two pieces of the puzzle in place, the odds are that stocks will continue to be pulled back and forth between strong earnings and inflation fears. Having said this if long-term bond yields do fall by year-end, stocks should trend higher. I think stocks can still produce double digit gains, but most of it is likely to come in the last quarter of the year.

Greg: I think you have backed us both into this view of the markets. If we have been reminded of anything or learned anything over the past 12 months it is "don't fight the Fed." Thus, even though we would like to see the markets have a big rally in the coming months, it would almost certainly raise the ire of the Fed, who would likely very quickly get the market's "attention" again.

Blessings to you and your families,

Gregory C Donaldson, Chairman

Michael D Hull, President, CEO