



INVESTMENT STRATEGY UPDATE

September 28, 2000

INFLATION MATTERS

The outlook for inflation is a critical component in any investment decision making process. Bond prices move inversely to changes in the rate of inflation. For instance, if inflation increases, interest rates rise and bond prices decline. Stocks also react to changes in inflation. Typically, the stock market performs well during periods of moderate inflation or disinflation. But during periods of rapidly rising inflation, hard assets such as real estate and precious metals are preferred by investors, and stocks often struggle - as seen in the 1970s. And within the stock market, sector and industry group performance varies widely under differing inflationary outcomes. Clearly, inflation matters.

For several years now we have espoused the case for continued low rates of inflation. When first suggested, this view of the future was generally non-consensus and in marked contrast to the behavior of prices during previous U.S. economic expansions. Our inflation outlook was based on several factors, including a more-than-capable Federal Reserve Board and our belief that split-party governmental gridlock would effectively rein in excess federal spending. But more than anything else, our case for contained rates of inflation was based on our conviction that we had entered a new era of greatly increased industrial competition. A more competitive pricing environment was being brought about by both the global spread of capitalism and the significantly enhanced availability of information, as fostered by improving technologies and the Internet. In effect, the buyers of goods and services were being empowered by a growing capability to compare prices from an increased number of potential suppliers.

And so it has come to be. Despite the longest U.S. economic expansion in history, and rates of growth far in excess of those which the Fed had previously considered inflationary, there has been almost no outbreak of inflation -- that is, at least as is being shown by official government statistics.

In recent weeks several of our clients have raised questions regarding those statistics. How can there be no inflation when oil prices have skyrocketed, home prices are on a tear, health insurance costs are rising at double-digit rates, and parking in San Francisco is up to \$30.00 per day? And have you checked out the cost of home remodeling? What is the government measuring?

Consumer Price Index

Government statistics track a number of inflationary measures. These range from the Employment Cost Index to a variety of commodities and imported goods prices. But, by far the most closely watched measure of inflation is the Consumer Price Index (CPI). The CPI is structured to track the price of a market basket of goods and services purchased by an average household. These goods and services range from food, housing, and medical care, to the cost of haircuts and vehicle tolls. Individual CPI components are weighted in the Index as they are believed to be weighted in the average household budget. So that, for instance, footwear is weighted at 0.8% of an average household's expenditures, within an apparel category which, as a whole, accounts for 4.7%.

Consumer Price Index Weightings and Impact			
	Weighting	Year Ended August-00	Impact
Food	15.3%	2.7%	0.4%
Beverages	1.0%	3.2%	0.0%
Housing (ex Energy)	35.8%	3.1%	1.1%
Apparel	4.7%	(1.7%)	(0.1%)
Transportation (ex Energy)	14.3%	2.1%	0.3%
Energy	7.0%	13.1%	0.9%
Medical Care	5.8%	4.2%	0.2%
Recreation	6.0%	1.7%	0.1%
Education &	5.4%	1.6%	0.1%
Other Goods & Services	4.7%	5.4%	0.3%
All Items	100.0%		3.4%
All Items less Food & Energy			2.5%

Over the twelve months ended August 2000, the CPI rose 3.4%. Excluding the more volatile food and energy sectors, the core rate of inflation, as it is generally called, increased by a more moderate 2.5%. While gasoline prices were up 19% from last year, apparel costs declined nearly 2% and computer and related equipment prices fell an astounding 22%. No doubt, the CPI includes some imponderable calculations, such as that of "owner equivalent rent of primary residence" which, accounting for more than 20% of the Index, rose 2.8% last year. But, the lack of inflation showing up in the CPI is well backed by other measures. The Producer Price Index, an index of the cost of goods to manufacturers and wholesalers rose at an even smaller rate of 1.5%, excluding food and energy, over the same period. And while oil and gas prices have been very strong, most other commodity prices have not. In fact, through August, the CRB Raw Materials Price Index is almost a full percentage point below its level at year end.

Well What About...?

Despite the numbers, questions remain. What about energy costs and wages? And, won't the continuing rapid pace of economic growth eventually cause inflation?

Yes, energy costs have risen substantially. Prior to last week's government announcement that a portion of the Strategic Petroleum Reserve was to be released, a barrel of oil was selling for close to \$35, up from the \$20 level only one year ago. Yet the effect of rising energy prices on consumers has been more moderate. While the direct costs, such as at the gas pump, have been passed through to consumers, a significant portion of the indirect costs has not. Manufacturers and service providers have had to absorb much of their energy cost increases, as they have had little flexibility to raise prices. Thus far, the rising cost of energy has acted more to slow the global economy than it has to raise the rate of inflation.

As we look forward, we think it unlikely that energy prices will rise much further, regardless of government intervention. In fact, we expect quite the opposite and believe the price of oil should soon be heading lower. The reason is simple -- supply and demand. On the demand side, higher energy costs are already resulting in both slower economic growth and increased energy conservation. Were energy prices to remain at current levels for too long, the rate of global economic growth would slow, crimping demand even further. On the supply side, as has always happened before, the prospects of higher energy profits are serving to increase exploration and production activity.

Regarding employment costs, very low rates of unemployment and, therefore, labor availability, are indeed resulting in rising wage costs. Wage inflation would be even higher, were it not for the increasing use of stock options as an alternative form of compensation. Yet driven by technology and the continuing effort to reduce costs by substituting capital for labor, productivity gains have been buoyant. In fact, productivity growth has been outpacing the growth in real wages, thereby resulting in declining unit labor costs. In other words, labor compensation has been accounting for a smaller slice of the growing economic pie. That is not inflationary.

The economy has grown rapidly in recent quarters. If the pace of economic growth continues to exceed the non-inflationary rate, say 4%, for a long enough period of time, inflationary pressures will grow. It is fear of that outcome which drove Alan Greenspan and the Federal Reserve Board to raise interest rates. Now, as a result of those measures and the dampening effect of higher energy costs, the economy has begun to slow. But, if growth doesn't slow sufficiently, the Fed will take additional steps to ensure that it does. It is rather like a tightrope walk. Too little action to slow the economy will result in a buildup of cyclical inflationary pressures, while too much will bring recession. And in this delicate balancing act, no one can know for sure how it will turn out.

Now What?

In our opinion, cyclical inflationary pressures will come and go, but there is little evidence to indicate that inflation will become more than a temporary problem. It is a tough competitive world, and few companies have a sustainable competitive advantage. Therefore, neither do they have pricing flexibility. Furthermore, capital is abundant and readily available to fund new business entrants seeking to capitalize on perceived profit opportunities. The bottom line is that, for now, we see little in the way of longer-term inflationary risk. Yet, we admit to being somewhat uncomfortable that our inflation outlook has become consensus.

What does this all mean for stock market investors? With contained inflation and continuing governmental budget discipline, interest rates should remain relatively low. Add to that the positive effects of an ongoing U.S.-led technological revolution, an aging baby-boom generation that continues to save and invest for retirement, and a reasonable economic outlook, and the long-term backdrop for stocks remains quite positive. On the other side of the ledger, many of the largest capitalization stocks currently carry excessive valuations. Recent calculations showed the fifty largest U.S. stocks were selling at 52 times forward earnings. These are the stocks that dominate the popular stock market indices. But most stocks are not that expensive, with the vast majority quite reasonably priced at 15 times earnings or less.

So, inflation is likely to remain moderate. And while stock market volatility seems here to stay, most stocks should fare quite well in coming years.

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