Goelzer Investment Management
Economic & Market Review and Outlook

April 3, 2000

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The end of March in Indianapolis brings not only another opportunity for our fair city to show its stuff to the nation in hosting the NCAA Final Four but also the close of one of the strangest first quarters for the financial markets in recent memory. Continuing a trend witnessed in spades during the fourth quarter of 1999, America's love affair for all things technology continued, as the tech-heavy NASDAQ, representing the 'new economy', roared ahead while the Dow Jones Industrials, representing the 'old economy', lost ground. Highlights (and lowlights) from the just-concluded quarter include:

The Economy

- Despite five interest rate increases since June 1999, the U.S. economy posted exceptionally strong growth during the opening months of the new century, fueled by tax refunds, rising wages and improving export markets.
- Unemployment, at 4.1%, remains at the lowest level in nearly 30 years. Tight labor markets in many areas of the country are continuing to be of concern, as many employers are simply unable to fill vacant positions.
- As mentioned, the Federal Reserve remains committed to its fight against any building inflationary pressures, real or perceived, raising its targeted federal funds rate for the fifth time since June 1999, to 6.00%. Most banks followed suit, raising their prime rate to 9.0%. While the magnitude is certainly open to debate, the combination of rising interest rates and higher fuel prices is beginning to impact the economy and will likely lead to more moderate growth as the year progresses.
- Inflation on both the wholesale and retail levels remains remarkably low despite a more than doubling of oil prices since this time last year. While signs of cyclical inflationary pressures are clearly present in the form of higher wages and prices of certain industrial commodities, profound structural *disinflationary* forces remain firmly in place. The most notable of these is the explosive growth of the Internet as a driver of phenomenal increases in productivity.

Outlook: It is our belief that U.S. economic growth will moderate as the year unfolds, following a strong first quarter of 2000. The traditional lag of 6-9 months before rising interest rates begin to impact the economy is now upon us, and the seasonally strong cash flows from tax refunds will soon be behind us as well. Domestic consumer spending will moderate and tight labor markets may ease, as productivity growth continues and more companies embark on cost reduction initiatives in the face of slowing economic growth.

Stock Market

- Despite the roller coaster ride, technology stocks continued to lead the market. While the NASDAQ Composite, representative of the 'new economy', experienced three separate corrections of 10% or more during the quarter, the index finished the first quarter with a gain of 16.05%. By contrast, the Dow Jones Industrials, representing the 'old economy', lost ground during the first three months of 2000, declining by .17% for the quarter.

- We have begun to see better action from many of the lagging sectors of the market in recent weeks, as investors weigh the favorable growth prospects and relatively low valuations afforded by many of America's leading domestic and multi-national companies outside of the high flying technology and telecommunications sectors.
- Despite this tug of war between old economy and new, we look for companies that can demonstrate a combination of above-average top-line revenue growth and consistent earnings growth to reward shareholders. Our strategy remains to focus on companies that are enabling others to increase productivity while also looking to take advantage of very attractive valuations in other, more traditional 'old economy' sectors of the market, such as financials and healthcare.

Outlook: As 2000 plays out, the great battle for the stock market will be whether technology-driven productivity gains can provide enough of an offset to margin pressure from rising labor costs and intense competition to support continued strong gains in corporate earnings. We expect the seesaw action to continue through the summer as the market digests what we believe will be two additional quarter-point increases in interest rates. Signs of a moderating economy will allow psychology to improve as investors develop a sense that the Fed tightening for this cycle is nearing an end. Hence, as the year unfolds, expect market action to broaden and share prices to advance modestly for the remainder of the year.

Bond Market

- The bond market was slightly less hostile to fixed income investors during the first quarter, despite Fed actions to raise interest rates. The Salomon Broad Investment Grade - Intermediate Index produced a total return of just under 1% for the quarter. Longer-term bonds did even better, as a combination of technical factors, including the government's decision to shrink the supply of long-term Treasury Bonds coupled with a growing consensus that the Fed will ultimately succeed in slowing the economy enough to curtail inflation, led to yields on 30-year Treasuries declining by ½ % to under 6% by the end of March.
- Our decision to reinvest maturing bonds and extend maturities to the 7-10 year range as yields peaked in early March had a positive impact on results, as we were able to lock in attractive returns at the highest yields in nearly three years.

Outlook: A strong first quarter economy and lingering cyclical inflationary concerns will likely hold bonds in a narrow trading range in the near term. However, a moderating economy in response to recent Fed actions, improving investor psychology and continued positive news on inflation will make intermediate-term bonds attractive investments for conservative investors as the year unfolds.

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