By 1999, we estimate the ratio has fallen to 3.8 percent. This change represents over a $200 billion per year reduction in the level of Federal government spending by 1999 and is a big part of the shift in the Federal budget from deficit to surplus.

Finally, the explosion of communication and information processing technologies has profoundly changed the economy in the last two decades. One dramatic measure of the magnitude of this force is growth in real investment by firms in these technologies. Since 1982, real expenditures for communication and information processing equipment have grown at an average annual rate of almost 13 percent. Clearly, it has been the lead sector throughout this extraordinary period.

These three forces remain important for the future as well as an explanation of the past. The growth of information technologies and the trend to globalization of business are far from complete. The fall of Communism will not be reversed, and while further defense cuts are problematic, major increases seem unlikely as well. That means that the good news powering the current expansion is not over and, as a result, the fundamental outlook for next year and several years thereafter is bright. Our estimate is that the trend rate of growth of real GDP has risen to the 2.75 to 3.00 percent range from just over 2 percent a decade ago.

The past few years real GDP has grown at a rate well above trend. Last year the economy grew almost 4 percent and we estimate that growth for all of 1999 will average just under 4 percent. The basic reasons are that the underlying growth in the economy has been augmented by a surge in consumer spending and a residential investment boom. Real consumer spending is expected to grow by over 5 percent in 1999 with consumers spending virtually all of their non capital gains income. Part of this growth is undoubtedly due to the extraordinary increases in consumer wealth brought about by the stock market boom of the 1990s. The housing boom, which produced an increase of real residential investment of nearly 9 percent in 1999, is probably also related to the rise in equity markets.

We believe both the consumer goods and housing sectors will slow next year. The Fed has engineered two increases in interest rates this year and one or two more moves are likely. Housing markets are already beginning to show signs of slower growth. Predicting where equity markets will go is always hazardous, but interest rate increases typically cool equity markets, and the tremendous growth seen in the past few years seems unlikely to continue.

With housing weakening and consumer spending growth slowing, we anticipate real GDP growth will slow to around 2.8 percent next year, very close to a trend rate. Any inventory accumulation in late 1999 in anticipation of Y2K troubles will be worked off in early 2000 thus lowering the year 2000 growth rate. Since the underlying sources of growth continue, particularly for investment in computer and information technologies and for exports, we believe a recession is not in the cards,

The Bureau of Economic Analysis in the U.S. Department of Commerce released a set of major revisions to the National Income and Product Accounts in late October. Included in the revisions were several changes in methodology that produced significant changes in GDP over the past few years. Business and government expenditures on software are now included in GDP. They had been treated as intermediate goods in the past and not included in GDP. The effect is to raise the level of real GDP. Government retirement programs are now treated in a similar fashion as private plans. The result is to raise measured income and saving. Improved methods of measuring the real value of bank services have been adopted which tends to raise real GDP.

The net effect of these revisions is to raise estimates of real GDP for the past several years and to raise our estimate of the trend rate of growth in the U.S. economy. In summary, the new economic notion show an economy stronger through out the 1990s, with a greater capacity for growth. Our outlook for 2000 is that we will reach but not exceed that growth rate and so continue the expansion without producing major inflationary pressures.

Financial Outlook for 2000

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After taking a year off to atone for my sin of caution in a world of exuberance I am back attempting to peer into the future.

First, we must appreciate the past five years. The operating earnings for the Standard and Poor's 500 is up nearly 60% and the P/E ratio on trailing 12 month earnings have expanded from 15.3 to 29.3 and the P/E on 12 month future earnings have grown from 12.7 to 25.2. Thus operating earnings have grown at a 13.9% rate while the multiple has doubled!! The 13.9% is well above the long-term growth rate and is

above any sustainable rate this side of nirvana. On top of this many forecasts are calling for an even higher growth in earnings, 16% for the next year. In the shorter run forecasts are calling for 3rd and 4th quarter results to top 1998 figures by 24% and 21% respectively. Corporations have generated profits at an extraordinary rate and the market is currently expecting and pricing an even better performance.

The other part of the evaluation puzzle is the expectation for interest rates. An analysis of the yield curve and futures markets is indicating that rates are expected to rise to around 7% for long-term instruments and to about 5.65% for the short end. This represents about a 90 basis point rise on the long end and 40 points on the short end.

It is important that we realize that the Federal Reserve had to operate as a World central bank after the Asian crisis. With the flight from local currencies to the dollar the Fed was very expansive and is now returning to a more normal policy. This should not be mistaken as tightening. Their performance over the past 6 years has been masterful. Can we count on such performance in the future? The market is betting heavily that this mastery will continue.

Are the markets right? I believe that long rates will not go as high as 7% but that short rates will edge up about 50 basis points. Inflation is a monetary phenomenon. It results from mistakes in policy, usually because of bad information or a misinterpretation of good data and only rarely as a policy of "the lesser of two evils."The biggest difficulty, as I see it, is still the problem of predicting the strength of the recoveries in Japan and Europe. If the Fed underestimates the pace of these overseas economies then we will face rising inflation and ultimately higher rates.

The market's optimism about earnings is more troubling. I don't think that we will get the growth in operating earnings that it seems to be expecting. By no means am I expecting a contraction in the general economy but any disappointment could cause a significant decline in stock prices since there is no margin for error built in to these high P/Es.

Finally, the next 12 months should see returns on stocks in the single digits with a fair amount of volatility. The total return in the long-term bond market may not even achieve positive returns. Given the market's past performance this is not bad but it may not feel good.

The International Economy

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Economic growth around the world in 1998 fell below long-run trend; 1999 will not be better than 1998. **Table 1**, based on data available in May 1999, indicates that world output is growing below the average growth rate of the last twenty years. The proximate reasons are that, while the United States is booming, the rest of the world is not. Japan has been in a deep recession and is now struggling to make a come back. The South East Asian economies, swept by a currency crisis in 1997, suffered a sharp growth slowdown. The Russian economy imploded after its government defaulted on its debt and could not prevent a massive devaluation of the ruble in 1998. Brazil as well had a currency crisis in 1999, although with modest consequences on the real sector. Finally, a couple of critical countries (Germany and Italy) of the European Union were scoring disappointing performances.

The outlook for 2000 is good for economic growth. **Table 1** reproduces the real GDP forecast for next year by the International Monetary Fund (IMF). The forecast was made in May 1999. Since then news has been positive for economic growth. Activity is picking up in Japan, although hampered by a tight monetary policy by the Bank of Japan. Improved conditions are emerging in Germany and Italy. The South East Asian economies, in particular South Korea, have made an impressive recovery fueled by expansive fiscal policies and devaluation-led export growth. Finally, economic growth in the United States shows no sign of abating.

The *Economist*'s poll of forecasts (see **Table 2**) suggests that the world will have at least two growth locomotives in 2000: the United States and the 11 countries that have formed the European Monetary Union (France, Germany, Italy, Spain, Portugal, Belgium, Luxembourg, Netherlands, Austria, Finland, and Ireland). Both areas will be running close to their sustainable pace. For Japan recovery appears still slow, but there is growing optimism that the country is seeing the light at the end of a long tunnel of disappointment and under performance. For almost 10 years the Japanese economy has been a pale resemblance of mighty Japan Inc. The long crisis started with a deflation of a real estate bubble, which led to a