The Fed is Caught Between the Dollar and the Economy **Sep 2, 1987**

Significant changes in ASC economic factors and market indexes during August are summarized as follows expressed in standard deviations around the norm:

	August '87	*July '87*	*Change*
Consumer Confidence	1.24	.66	+ .58
Consumer Spending	- .65	- 2.04	+ 1.39
Inflation	1.01	.44	+ .57
International Trade	.78	.26	+ .52
Defensive Market Index	- 1.12	- 2.37	+ 1.25

With the pickup in consumer spending last month, we saw the first significant increase in retail sales this year. Since part of the strength was due to the renewed auto incentives, it is still too early to proclaim that the consumer is back. With pressure on real income and high debt levels we are still not out of the woods. One strong month does not reverse the trend underway since January 1987. It still appears that the consumer is sluggish and has started to show signs of reliquifying. For example, the General Motors auto incentives just instituted boosted domestic car sales from the low seven million units to the middle nine million units. In 1986 when similar incentives were introduced, the rate exceeded fifteen million units. Incentives are not now having the same effect as in previous years. With the pick-uipin consumer spending, GNP in the third quarter will probably exceed 2% as compared with our previous expectation of less than 1%. If the pick-up in consumer spending is temporary, the auto incentives may actually pull part of the normal fourth quarter final demand into the third quarter. Based on current conditions, an increase of less than 1% in GNP still appears reasonable for the fourth quarter of 1987.

Partially offsetting the pick-up in consumer spending was a reversal of an improving trend in the trade deficit. Last month's increase in the trade deficit was disappointing. Based on current dollar flows, interest rates and inflation differentials, the dollar is still fundamentally over-valued. If there is further disappointment in the trade balance, we will have to worry about further weakening in the dollar, a tighter Fed policy and higher interest rates. Last week when the dollar fell to 142 yen, the response by the Fed was to push the Federal Funds rate through 7% with the long treasuries breaking through 9%. As the Fed tightens to protect the dollar, higher rates are continuing to adversely affect the economy, housing in particular.

As WE have stated previously when it comes down to protecting the dollar with tighter monetary policy or fostering growth in the U.S. economy, the Fed will opt to protect the dollar. If the Fed eased in the face of a weak dollar, it would be fueling higher inflationary expectations and defeat its purpose of fostering growth. For now the Fed is caught in between and the risks of a recession are considerable.

ASC's Defensive Market Index made up primarily of electric utilities and foods rebounded last month as shown in the above table which may be a leading indicator of market rotation shifting away from earnings-driven groups into defensive groups.

Although inflation has cooled in the most recent month with increases running at about 3.5% to 4% down from 5.5% previously, inflationary psychology is still very high. As we stated last month, real rates will increase because the bond market is unwilling to accept lower inflation rates at face value. If the Federal Reserve maintains its restrictive policy, lower inflation and higher interest rates should eventually boost the dollar to reach a stable value at a higher level. At that point rates should decline somewhat. We are apparently past the swing effect of energy on inflation. The decrease in crude prices in 1986 and normalization in 1987 shifted about one and a half percentage points of inflation from 1986 to 1987 as we have previously discussed. With a surplus of goods (care in particular), softer commodity prices, availability of labor and weakness in some industrial metals prices, higher inflation fears will soon subside.

Current high ASC economic rankings of telephones, utilities, consumer growth, foods, banks and housing-related companies suggest that we may somewhat early in a trend toward a significant deceleration in the economy. Typically, these groups do well when economic growth is quite moderate. In the past, pre-recessionary conditions have been indicated by the rise in ranks of groups that typically do well when a recession is underway such as foods and utilities and also those groups that are early beneficiaries of the recovery such as housing. Since our move into earnings-driven groups such as semiconductors, papers and chemicals in August 1986, we have been gradually shifting, since early 1987, into more defensive groups such as banks, utilities, hospital management, telephones, foods and insurance. It was encouraging to see some significant strength in defensive groups last month such as insurance, telephones, utilities, commercial banks, foods and weakness in a group we advised underweighting – energy. Some rotation toward lower economic sensitivity groups seems to be underway. Companies that were strong reflecting rotation into defensive groups last month were Allegheny Power, US West Farmer's Group, and Safeco. Companies that were weak showing some movement out of economic sensitive areas were Alcoa, Zurn Industries, Helmerich & Payne and Asarco. Typically, sharp one month changes are not sustainable in the following month but they are useful in determining if rotation is occurring.

While many quantitative analysts have concluded that most models from value to earnings momentum have not been working over the past turbulent year, SAR has worked surprisingly well. The rotation into an earnings-driven climate that occurred last August should have given anyone following ASC's approach a head start over the market in early 1987. More recently we have been staying even with the

S & P 500 while reducing risk exposure. Performance of earnings-driven groups would have provided a handsome excess return as shown in the table below. ASC's top 5% ranked companies in January 1987 have performed as follows since we introduced combined, economic, and market preferences on January 31, 1987.

RELATIVE PERFORMANCE OF BIG CAP STOCKS
TOP 5% (1/29/87 – 8/28/87)

	Top 25 Stocks	Bottom 25 Stocks
Economic Preference	115.80	82.36
Market Preference	113.10	76.96
Combined Preference	112.74	82.48

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EARNINGS-DRIVEN GROUPS RELATIVE PERFORMANCE (8/1/86 – 4/30/87)

Chemicals	102.29
Electronics	129.34
Energy	117.89
Papers	117.68
Specialty Chemicals	119.20
Tire & Rubber	134.12
Average	***120.09***

Based on the current economic climate, groups favored are insurance, consumer growth, foods, banking, telephones, electric utilities, and hospital management. We would continue to underweight energy. Until the Fed gets out of its immediate predicament, we may see interest rates rise and the market under pressure. Cash is king for short term performance.

Subscribers who study this month's group rankings will see that the preference rankings have changed significantly since last month and that the changes in rank may be inconsistent with prior months. The reason for the change and the inconsistencies is that we have just updated the BAR models. Previous ranking of companies and groups have been restated based on the current model. Our studies have shown that in the current economic climate, more frequent updating has led to improved performance. In addition, we have streamlined production of the book so that it can be delivered more promptly and it is now easier to read with an improved format.