ECONOMIC & MARKET UPDATE

October 1999

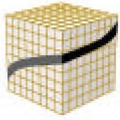
The last several months have marked the beginning of a new environment in the economy and the stock market. The new emerging trends are:

- The worldwide economy is recovering.
- The Japanese stock market is clearly responding to their improved economic policies.
- The U.S. economy is still benefiting from a technological revolution but higher interest rates are beginning to affect traditional industries.
- The Federal Reserve is concerned about inflation and has shifted to a mild tightening bias.
- The political environment is still strongly pro-stocks despite President Clinton's recent veto of a tax cut.
- The U.S. stock market is beginning a slow change in leadership away from the very large cap stocks.
- Y2K has moved from a conceptual concern to a specific event less than three months in the future.

In this paper we would like to focus on the effects of the worldwide economy on the stock market.

We believe a little bit of history is helpful at this point. We believe 1997 and 1998 witnessed a profound transformation in the worldwide economy. The Asian economies, especially Japan, had been the worldwide economic leaders since the end of the Vietnam War. Beginning in mid-1997 the Asian economic model (tight central control, low capital costs, high exports) began to break down. The Japanese economy, long the envy of the Western world, could not sustain its worldwide competitiveness amid its high taxes and the corruption and inflexibility associated with a centrally-managed economy. The breakdown of the Asian economic model was one of the most important economic events of the post-Vietnam War period.

This breakdown in Asia set off an economic chain reaction around the world. Ultimately Russia defaulted on its sovereign obligations. Confidence in the future of the worldwide economy sank to a major low. This economic debacle set the stage for a severe bear market in the U.S. and elsewhere from the middle of 1997 until October of 1998. This bear market was particularly damaging to the vast majority of stocks. Only a few of the largest companies escaped the general carnage; these stocks were favored because of their dominance within their industries, their high liquidity, and flight into dollar-denominated assets. The rest of the market was severely damaged by the near-total collapse in worldwide investor confidence about future earnings.



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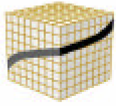
We have written extensively on the unusual market action during that bear market. From August of 1997 until August of 1998 the performance difference between the S&P 500 (a performance proxy for big-cap stocks) and the Russell 2000 (a performance proxy for small cap stocks) was the largest in the 20 year history of the Russell 2000. Other studies have shown that the one-year performance spread between big-cap and small-cap stocks was the third largest in the last 62 years. This is significant market action.

Following such a period of performance divergence it takes some time for confidence in small caps to return. Historically, one year after this extreme divergence there was a 4-in-9 chance that small caps beat big caps. Three years after there is a 7-in-9 chance for small caps; five years after there is a 9-in-9 chance.

The markets have had about one year to digest the effects of the end of the bear market. The results are consistent with our expectations. From 10/06/98 (the market low) until 09/30/99 small cap stocks earned a return approximately equal to that of large cap stocks. The Russell 2000 earned a return of 30.3% while the S&P 500 earned a return of 32.0%. This market action is consistent with our belief that small cap stocks would recover sharply from their bear market lows but not necessarily exceed the large caps during the first year of recovery. If the historical patterns persist the broad market is now likely to enter an extended period of performance superior to the large caps.

During 1999 the absolute performance of the very large cap stocks has slowed dramatically, and the monolithic structure of the very large cap stocks has begun to break down. We have assessed the year-to-date (12/31/98-10/22/99) performance of the very large cap stocks, i.e., those companies entering 1999 with a market cap greater than $50 billion. The average YTD performance of these 64 companies was +3.7%; the median performance was +2.6%. Many seemingly invincible companies saw their stocks crumble. Compaq Computer (-55.5%), Phillip Morris (-53.7%), Bank One (-33.3%), Gillette (-24.7%), and Coca-Cola (-17.5%) were among the casualties. At the same time during 1999 there is a dynamic list of new companies which have moved up into the very large cap category. As of 10/22/99 there were 19 companies whose stock performance this year enabled them to achieve major company status (+ 50 billion market cap). These include such companies as Sun Microsystems, Texas Instruments, and Oracle. We believe this is a significant development, because it shows that investors are beginning to look below the very large caps for performance. We believe this is only the first step in a long process.



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The performance pressures on mutual fund managers is also likely to force them to begin to look more broadly. We looked at the YTD (12/31/98-10/22/99) performance of 1431 growth equity mutual funds. The average YTD performance of these funds was 6.7%; the median performance was 3.6%. Slightly more than 1/3 of these funds were actually down for the year. These results are a far cry from the 20% returns of the last several years. We believe mutual fund managers are already beginning to look for stellar mid-cap companies. Over the next several years we expect mutual fund managers will be seeking to exploit nearly all stocks.

As we enter the year 2000, the stock market is struggling with the worldwide economic recovery, the issues of Fed policy, the Y2K transition, a slight uptick in inflation, and a presidential election. By the end of the first half of 2000, we believe the Y2K issue will be resolved in the stock market's favor. Investors will then be faced with a mildly restrictive Fed policy and excellent earnings by most companies. We do not believe the 2000 election will change the market-friendly policies of the Federal government. We believe the excellent earnings progress will override investors' interest-rate fears and spur a multi-year bull market in the broad list of U.S. stocks. In this environment cyclical stocks, technology, and energy stocks should be favored.

We are committing our efforts at Disciplined Growth Investors to capitalizing on this opportunity.

To receive a complete list and description of Disciplined Growth Investors, Inc.'s composites and/or a presentation that adheres to the AIMR-PPS Standards, contact Cynthia Lennie at Disciplined Growth Investors, Inc., 100 South Fifth Street, Suite 2100, Minneapolis, MN 55402; telephone: 612-317-4108; fax: 612-904-2546; e-mail: cindyl@dginv.com. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities and analyses described in this article. The information contained herein has been obtained from sources that we believe to be reliable, but its accuracy and completeness are not guaranteed. DGI reserves the right at anytime and without notice, to change, amend, or cease publication of the information. The web site has been prepared solely for informative purposes. It is made available on an 'as is' basis. DGI does not make any warranty or representation regarding the information.

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