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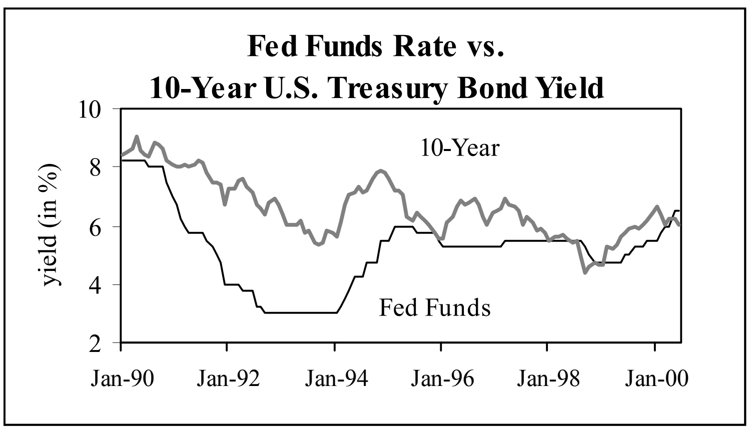


The fed funds rate and 10-year Treasury bond yield have inverted just three times in the past decade. Each time, the inversion has been followed in short order by a Fed rate cut. Currently, the Treasury bond market is sending a clear signal that Fed interest-rate policy is far too constrictive. We see at most one more 25-basis point tightening this year. Equity markets are beginning to price in an end to the Fed rate-hike cycle. This remains a positive environment for equities and debt.

FEDWATCH

Gold at $281/oz. reflects absolutely no inflationary pressures, current or future. Gold is $30 below its five-year moving average.

Benign inflation data are weakening the Lawrence Meyer faction of the Fed. Meyer leads the pro-Phillips Curve faction, which refuses to recognize the fallacy of the alleged relationship between low unemployment and inflation. With each passing month, the argument that strong growth and low unemployment generate inflation is being weakened incrementally.

Federal Reserve Chairman Alan Greenspan's speech at the National Governors' Association this week buttressed the market's guess that the Fed is near the end of its rate-hiking cycle. Two of the Chairman's biggest concerns, wage growth and tight labor markets, largely have been offset by productivity growth. Greenspan made an opaque acknowledgement that technological advances are containing price pressures.

An August rate hike cannot be totally ruled out. Overall, though, there are various factors that should give the Fed pause on further rate hikes in coming months. Core price data show no inflation. Real interest rates are at stratospheric levels. The 2000 presidential elections are nearing and Al Gore's candidacy cannot withstand additional Fed tightening. Congressional Democrats, too, increasingly will be hostile to further credit tightening given the dearth of actual incipient inflationary pressures and the fact that real wages for those at the bottom of the wage scale finally are starting to rise. Continued Fed vigilance will put it at odds with populist and pro-growth political forces.

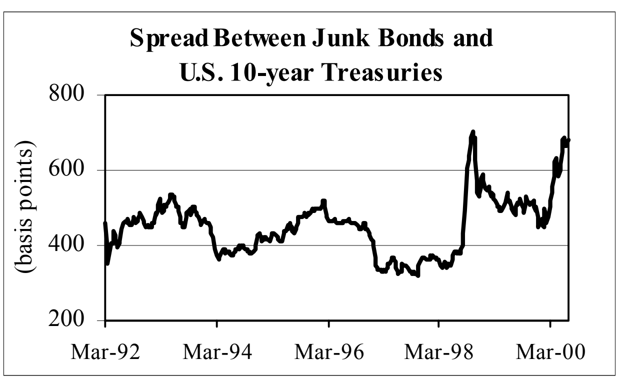
M.D.

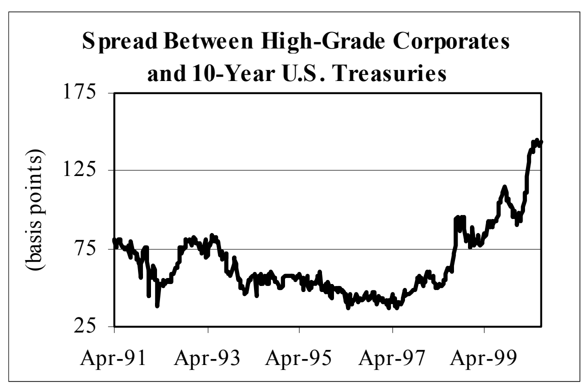
BONDWATCH

Keynesian fears of "excess demand" and "wage-push inflation" will not be borne out by the inflation data in coming months. Today's release of the June PPI data showed a .1% drop in the core -- a direct refutation of the Phillips Curve limits-to-growth model. With no excess dollar liquidity in the banking system, the aggregate price level simply cannot rise, despite increases in certain prices, such as oil or the cost of labor.

Tame inflation data should ease fears of inflation and additional rate hikes. This should allow yields to hold their current range or move lower still, particularly in the corporate market. If dollar-purchasing power were materially threatened in any way by inflation, the market would not allow the ongoing inversion of the fed funds rate relative to the entire treasury yield curve. The market is telling the Fed that the fed funds rate it totally out of whack with inflation expectations -- meaning it already has been pushed up too high. Incipient inflationary pressure also would cause the dollar gold price to rise and the dollar's external foreign exchange value to weaken. Of course, just the reverse is occurring.

Punitive Fed policy and stratospheric real interest rates have pushed the yield spread between high-grade corporate debt and same-length treasuries above 150 basis points. The spread between junk debt and Treasuries is near its highs of the past decade, at 653 basis points. As we appear to be nearing the end of the current rate-hiking cycle and economic growth remains strong, the risk premium on corporate debt appears set to ease. If the Fed continues to signal that its stranglehold on economic growth is coming to an end, credit and default risks will ease, allowing yields to fall.





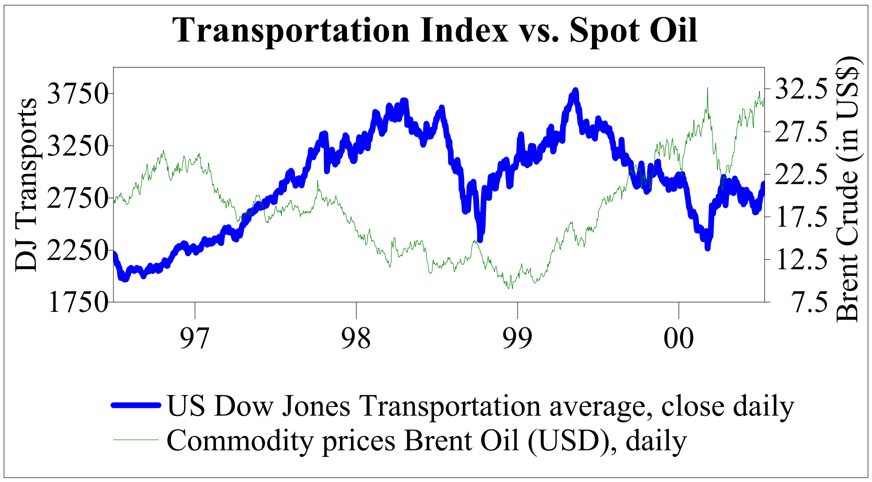
M.D.

EQUITIES

The policy environment is favorable for U.S. equities -- both old economy and new economy.

The tax policy outlook is becoming more encouraging. U.S. budget surplus estimates have grown so large that momentum for small tax cuts finally is building in Congress. We soon could see an increase in the ceiling to $5,000 from $2,000 for annual tax-free contributions to Roth IRAs. Reduction or elimination of the estate tax should occur within the next year.

The case for cyclicals remains solid, and the sector is turning higher. We constantly hear talk of a pending major global economic slowdown, but we simply do not see any reason this should happen. Fiscal and monetary policies are on a generally improving tack around the globe. Interest rate risk is receding in the U.S. Oil is more likely to fall than rise. Global political risk is mild. Foreign currencies have stabilized against the dollar and the Euro is more likely to rise against the dollar than fall.



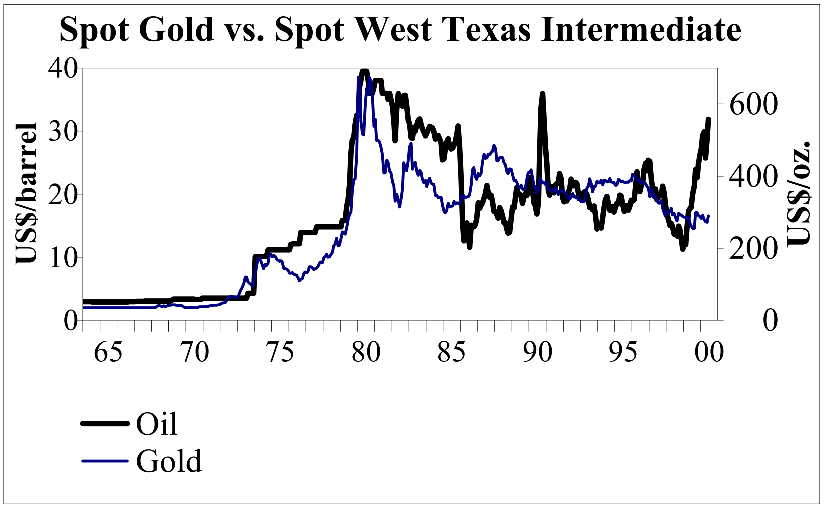
Tech and Internet stocks have snapped their bear trend. Despite robust industry data, semiconductors and other nuts-and-bolts techs had been suffering from worries of a pending global slowdown. As these concerns ease, and as quarterly results come in strong, the stocks are moving higher. The trend should continue. In the Internet sector, Yahoo's great quarterly results quelled recent fears that the new economy is a mirage. The Internet will remain the most volatile tech sector, but that applies on the upside as well.

M.C.

GOLD, COMMODITIES AND FOREIGN EXCHANGE

The vast bulk of commodities are flat or down from one year ago and far below five-year highs. Grains, in particular, have been weak. In the past two months, corn, wheat and soybeans have declined 25%, 13%, and 15%, respectively. Copper remains stalled at 80-85 cents per pound. Weak commodity prices simply add to the vast body of data suggesting the absence of inflationary pressures in the price stream.

Oil remains far above its equilibrium price and should fall. Supply-side analysis holds that the gold/oil ratio is far out of alignment and will revert, in time, to its traditional trading locus of 15-to-1. This would imply an oil price of $19/bbl. at the current gold price.



We are slightly bullish on the euro and slightly bearish on the yen. Demand for euro liquidity should rise going forward as tax cuts in key eurozone economies improve growth prospects. However, with U.S. monetary and fiscal policy also improving, it becomes difficult to predict a strong advance by the euro relative to the dollar. On the yen, there really is no strong dynamic in play to push the yen very far either way.

Currency Forecasts

	now	end-2000	end-2001
Euro	0.93	0.98	1.05
Yen	108	111	115
UK Pound	1.5	1.48	1.45
Can $	0.67	0.67	0.67

M.C.

WASHINGTON WATCH

IRA Expansion: There is movement on the Portman-Cardin bill (H.R. 1102) which would increase the annual ceiling on IRA contributions to $5,000 from $2,000. The bill was voted positively out of House Ways & Means Thursday and could come up for vote on the House floor next week. The bill has broad bipartisan support. In fact, there already are more Democrat co-sponsors for this bill than for either marriage penalty relief or death tax repeal. Earlier squawking by the Treasury Department about its "concerns" relative to the bill's cost has subsided.

Electricity Deregulation Gets a Push from Silicon Valley: Recurring brownouts on the West Coast and elsewhere have given new legs to electricity deregulation on Capitol Hill. Silicon Valley firms claim to be losing millions of dollars per day. A portion of the tech industry has become engaged on the issue, arguing that electricity demand could greatly outpace supply this summer. Firms increasingly are building their own facilities to generate electricity and are turning to new technologies that make them less reliant on traditional producers. Even if the House approves a deregulation bill, though, the Senate only wants a targeted "reliability" measure. Odds are that the Senate approach will win out.

Regulating the Trial Attorneys: Rep Chris Cox (R-CA) is taking aim at trial lawyers who wish to milk the new economy. The "Right to Choose Your Lawyer" act will require class-action lawyers to obtain express authorization form each and every consumer they want to represent in class action suits. The bill is partly a response to recent class-action suits filed against Amazon, RealNetworks, and other tech firms claiming the companies secretly collect personal data on their Internet users. The bill has a good chance of passage in the House if it can get on the calendar, but odds are not as good in the Senate. The bill's symbolic value, though, may be more important than its passage. It is another in the series of bills already passed by the House or signed into law that demonstrates the new economy's clout over the powerful trial attorneys.

Regulating Internet Firms' Sale of Customer Data: Patrick Leahy (D-VT) and Robert Torricelli (D-NJ) have co-sponsored a bill in the Senate to bar inclusion of customer records in asset sales by Internet firms that liquidate. The bill follows in the wake of an FTC lawsuit against former e-tailer Toysmart, which included customer records in its asset sale after making a pledge that it would never share such data. Rep. Spencer Bachus (R-AL) will introduce a companion bill in the House. Opposition to the initiative will be difficult to muster even though friends of e-business concede it’s a "slippery slope."

The American Civil Liberties Union and House Majority Leader Dick Armey (R-TX) criticized the FBI's use of the "Carnivore" system, which lets it monitor e-mail in search of criminal activity. Internet companies are nervous about a potential precedent that ultimately might infringe on all Internet users' privacy. We anticipate the "Carnivore" controversy will be heaped on many other issues to be addressed by a future commission on privacy.

K.K.

POLITICAL WATCH

A Bush Presidency and a Democratic House

The political establishment is gearing up to give George W. Bush the White House and to give the Democratic Party control of the House of Representatives, which the GOP now holds by a margin of only six seats. Gore is changing costumes week after week trying to swim against these forces and make connection with the electorate, but shows no sign that he will ever be able to click. If the election were held today, he would lose in a landslide, perhaps even in his home state of Tennessee. Meanwhile, the *NYTimes* reports that cash is flowing into the coffers of Democratic House candidates at twice the rate it is flowing into GOP war chests. At the end of June, Democrats had $37.4 million in the bank and Republicans had $15.2 million.

Clearly, the electorate is preparing for another four years of divided government, unwilling to give the Republicans the White House and both houses of Congress. The U.S. Senate will remain safely in Republican hands, it appears. This will enable a President Bush to have sufficient leverage in Congress to advance his programs to a degree, but the Democrats will be able to check his excesses in the House. It is my personal guess that the anti-ballistic missile system will be the issue that tips the House to the Democrats. With the failure of the latest ground-based ABM test, the advantage shifts to the Democrats, who can argue that there are better things to do with $60 billion than throw it away on a national missile shield that will never work and is unnecessary as currently conceived.

Polls indicate the national electorate would like a national shield, but the likely voters in November have not yet heard a debate on the costs and need between the major candidates. The minor candidates -- Ralph Nader and (probably) Pat Buchanan -- are even less disposed to a gold-plated military-industrial boondoggle. The electorate probably would not mind spending some amount of money on a mobile fleet defense, which could be moved here and there -- Asia or the Middle East -- if trouble developed, and could dispose of one or two incoming missiles. This is the kind of program Russian President Putin has indicated Moscow would be willing to cooperate in developing. Why Gore doesn't jump at this idea is a mystery. In a head-to-head debate, this is one issue where Gore clearly could be persuasive. The electorate has no interest in cranking up an arms race with Moscow and Beijing on this kind of "risky scheme." It might not be enough to get voters to go for Gore, but it could be enough for some to vote Democratic on the congressional lines.

It is highly likely that the real reason Pennsylvania Gov. Tom Ridge is being badmouthed as a Bush running mate is not that he is "pro choice" on abortion, but because, as Bush's Veep, he probably would talk the President out of a hardline ABM strategy. In 1995, when it appeared Colin Powell might seek the GOP presidential nomination, Republican right-wingers held a press conference to oppose him because he is "pro choice." The real reason for opposition to Powell was that the intellectual warriors in the GOP establishment knew they could control Dole, but not Powell. They could hardly hold a press conference saying they opposed the General because he was soft on bombings or Iraqi "turkey shoots" -- so they pounded at him on the abortion issue.

Bush practically has announced Powell will be his Secretary of State, but there he would have less influence than Ridge would a few feet from the Oval Office.

USNews&WorldReport this week lists in "Washington Whispers" that the "final five" on Bush's list of running mates are: Oklahoma Gov. Frank Keating, California Rep. Chris Cox, Ohio Rep. John Kasich, Indiana Sen. Richard Lugar, and Nebraska Sen. Chuck Hagel. Of the five, Cox, Lugar and Hagel are among the most hardline members of Congress on national security. Like Bush, Keating has no special interest or experience in foreign affairs. Nor does John Kasich, per se, although he is always skeptical about military pork, like the B-1 bomber. The list cannot really be taken as definitive as it clearly was "whispered" to *USNews* by one of the hardliners in Austin, probably to throw Chris Cox's name into the mix. It is the first time we have seen it and it suggests the hardliners are pitching him to Bush's veep headhunter, former Defense Secretary Dick Cheney. There are so many Cold Warriors in Austin it would be a surprise if Ridge got the nod, although a Bush-Ridge ticket would be the most likely to pull in a GOP House. Why? Because the electorate would not need protection against the hardliners if Ridge were at the President's side. With Cox as Veep, the Cold Warriors would have one of their own in the West Wing, able to deal with any offsetting influences that might come from Colin Powell at State.

J.W.