FRONT BARNETT ASSOCIATES LLC

I N V E S T M E N T   C O U N S E L

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Comments on Portfolio Strategy

Clearly, the economy has achieved its much heralded soft landing. However, a number of seemingly contradictory economic indicators and comments by government officials have heightened investors' anxieties regarding the vigor of the current expansion causing increased volatility in both the bond and stock markets. Strength in housing, commercial real estate and somewhat better initial jobless claim figures have largely been offset by continuing weakness in retail sales, very modest reported employment growth and diminished near term export hopes in the face of Mexico's continuing economic crisis and poor business conditions in Japan.

David Bostian, our consulting economist, notes that his macroeconomic model continues to signal more weakness ahead. Our own observations and comments from outside sources confirm this view. Consequently, we have concluded that further easings of interest rates by the Federal Reserve will be required to assure that the expansion many are forecasting for later this year or early in 1996 actually occurs. At this writing, we assume additional cuts of 1/2 to 3/4 % in the fed funds rate over the next 2 to 6 months. We expect:

- a moderate but sustainable reacceleration in general economic activity commencing early next year, coming on the heels of this year's forecast 2 to 2 1/2% real growth;

- benign inflation in the neighborhood of 3% for 1996;

- stable long term U.S. Treasury bond yields in a range of 6 1/2 to 7% through this year-end;

- short rates to fall to the 4 3/4 to 5% level reflecting further fed rate cuts;

- extension of the current business cycle and corporate profit expansion through next year, albeit at a moderate pace, as policy makers will not be required to reapply the monetary brakes any time soon to douse inflationary fires.

As for the U.S. stock market, over the near term, returns are likely to be notably below those achieved during the past eight months, and volatility will remain high. Stock selection will continue to be critical to achieving above average results. Among our favorites are:

- companies with strong secular growth and favorable product cycles;

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- financial service companies despite their already strong price performance in 1995;
- highly visible, large capitalization issues with global franchises to which foreign investors might be attracted if the dollar remains stable;
- companies that will benefit from this year's decline in interest rates -- particularly where there appears to be significant pent-up consumer demand -- such as housing and related businesses.

Clearly, following the recent sharp advance in stock prices, the stock market is more vulnerable to a "technical" correction of 5-10% at any time. However, for the longer term, there remain powerful secular trends which should favor both the bond and stock markets. Among these are the following considerations which we have been discussing with clients in recent meetings:

- attitudes in Washington are more favorable to business' needs and to wealth building;
- the U.S. stock market remains fairly valued. Emerging markets are cheap;
- the expansion of free market economic systems abroad creates enhanced global marketing and distribution opportunities;
- momentum to balance the budget continues to build. Deficit reduction will remain a high priority item;
- foreigners will eventually step up their purchases of U.S. assets using their overvalued currencies;

Therefore, despite near term uncertainties regarding the economy and the ever-present possibility of a stock market correction, we remain fairly fully invested and optimistic as long term investors.

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