FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

The Economic Outlook

The current economic expansion is now well into its fifth year, a rather long advance when measured against previous post-war cycles. In recent weeks, economic reports have suggested that further weakness lies ahead confirming the economic "soft landing" message our macro-economic model has been signaling for months. Bonds have rallied while the stock market's most recent rotation has favored those companies likely to experience trendline earnings growth, regardless of the business climate. While we are not forecasting a recession, we strongly believe that if one were to occur in 1996 it would be mild by recent standards. Clearly, a number of structural changes in the economy have combined to both flatten out and prolong economic cycles. Therefore, we believe economically sensitive equities should become less cyclical relative to the rest of the stock market, implying higher valuations for cyclical issues due to their perceived increase in earnings stability.

Studies show that over the past half century, business cycles have become less intense. This is a result, in part, of more sophisticated monetary policy, economic safety nets that have been erected and rising budget deficits which tend to prolong expansions and shelter the economy during periods of contraction. For entirely new reasons, we believe the smoothing process will carry even further in the future. This view is based upon our judgment that three of the most cyclically sensitive economic sectors - *autos, housing and capital goods* - have become less so. The *auto* industry is now the beneficiary of new financing schemes (e.g. leasing now accounts for nearly 25% of the total auto/truck market). *Housing* has benefited from adjustable rate mortgages and more easily financed 90-95% loan-to-value mortgages. The *capital goods* sector is also less likely to experience as much volatility. Today, about 50% of producers' durable goods spending (equipment and machinery) is high tech: computers, communications equipment and instrumentation gear. While high tech is not likely to be immune from future economic ups and downs, we believe personal computers with relatively short replacement cycles, are far less cyclical than long-lived machine tools. During the 1990-1991 recession, these three sectors alone accounted for almost 70% of the drop in real GDP. If each sector, for its own unique reasons, was to become less cyclical than before, the entire economy will experience less of a bumpy road. In the long run, this muted volatility has many favorable consequences for policy making, planning and for the financial markets. If the Fed no longer has to drive interest rates into the stratosphere to rein in a booming economy, financial assets will be less volatile. And, specifically, the earnings of *autos, housing,* and high tech *capital goods* companies may be perceived as less risky compared with other economic areas.

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Over the nearer term, we continue to expect the Fed to lower interest rates a notch or two once a deficit reduction accord is reached in Washington. The combination of very high real interest rates, slow economic growth, benign inflation, a more stable dollar and election year politics will drive the Fed to reduce short term rates to stimulate the economy. By next spring, signs of stronger business conditions should emerge with housing , business investment and exports adding new vigor to the nation's economic growth.

Our current investment strategy gives important weight to our **no recession** forecast and the likelihood that in the future slowdowns will be less extreme. We have, therefore, begun adding to stocks which should recover as investors shift their buying focus from defensive issues (drugs, foods, tobaccos) to companies that will benefit from the coming improvement in the economy. Among these are Home Depot (housing), Morton International (autos and specialty chemicals), Alco Standard (office supplies and equipment) and Nucor (steel). We continue to maintain significant positions in technology and capital goods which will also benefit from a stronger business climate.

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Let me take this opportunity to wish you and yours a joyous holiday season, happiness, good health and prosperity in the New Year.

November 21, 1995

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