FRONT BARNETT ASSOCIATES LLC
I N V E S T M E N T   C O U N S E L

June 16, 1997

The Economic Outlook - - Big Picture Remains Favorable

With the first half of the year nearly behind us, a review of the expectations we had at the start of this year is in order. Investors appear to be single-minded in their focus upon the seemingly omnipotent "Fed" for clues as to the future direction of the economy and the financial markets. Forecasters are fixed upon trying to forecast the Fed's forecast and thereby anticipate future interest rate and market swings. Perhaps this attention reflects just how crucial the financial markets have become to consumer confidence, retirement planning, wealth creation, and service sector employment growth. Our approach has always been less frenetic. Success in the financial world, unless one is a short-term trader, is achieved by correctly assessing the "big picture." From that perspective, in our view, nothing has changed since year-end.

In our January 16th letter to clients, we noted that we did not see the "necessary combination of tight money, inventory imbalances, consumer debt burdens, a profit squeeze, or global trade war" that might push us either into a recession or an over-heated economy. In fact, we came down on the side of "more of what we experienced in 1996" -- a favorable economy and friendly financial markets.

Clearly, the first quarter's 5.8% real GDP growth rate was a surprise to us (and everyone else) but the strength shown in inventories, consumer spending and exports is not sustainable. Even the Fed, which left rates unchanged in May, was not moved to action.

The big picture, as we see it, continues to suggest that business cycles will be less volatile in the future than in the past. In our January letter we enumerated nine reasons for this belief. They are worth repeating.

(1) Service sector employment is more important to the economy than manufacturing;

(2) Just-in-time inventory management has reduced the customary huge swings in inventory accumulation and liquidation;

(3) The cyclicality of housing and autos has been muted through financial innovation (i.e. adjustable rate mortgages and auto leasing);

(4) The federal budget deficit has been reduced in both absolute and relative terms;

(5) Capital spending is now dominated by outlays for technology whose replacement cycle is much shorter than that of a machine tool or a new manufacturing facility;

(6) Inflation is benign;

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(7) Globalization provides new outlets for U.S. made goods and services;

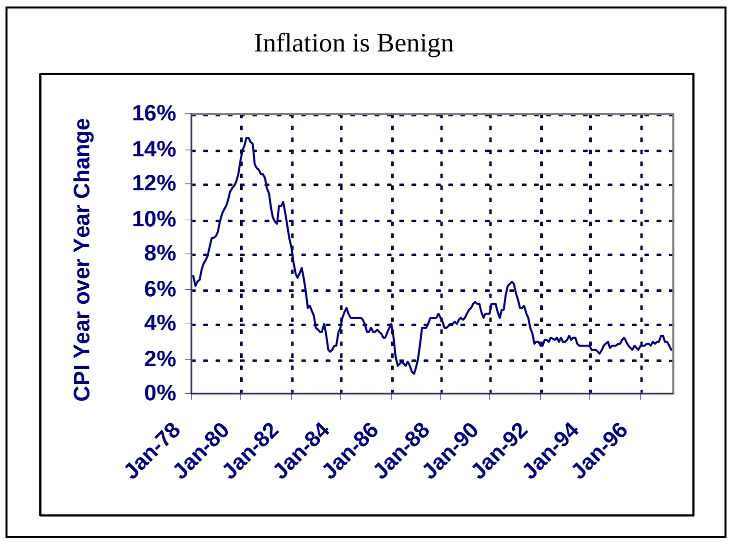
(8) Central bankers seem smarter, more in control and less inclined to follow disruptive "stop-go" policies. The recent declaration of independence for the Bank of England underscores this trend, and;

(9) The financial markets act to buffer the real economy.

We could add to this compelling list of nine factors two additional stabilizing forces:

(1) The granting of consumer credit has become more sophisticated, thanks to technology, and;

(2) The use of temporary help has become widespread giving employers more flexibility in controlling labor costs.



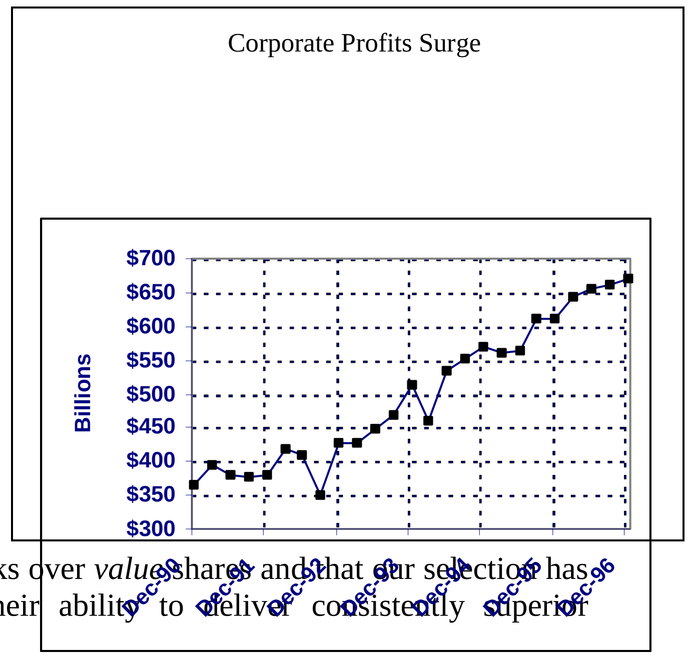
Clients frequently ask what might upset the apple cart. Our unemployment rate, currently at a 4.8%, is lower than at any time in the past quarter century. In the past, low unemployment has led to rising wages and higher *inflation*. Despite much concern, there is scant evidence that wage growth is accelerating - - except, possibly, in the high tech sector where the generous use of stock options may serve to hold big pay increases in check. Corporate profitability has remained stronger than most forecasts. Analysts trace this strength to improving productivity. Ordinarily, productivity declines as the economic cycle matures and less efficient resources are utilized. Possibly, the decade long spate of high tech spending is finally paying off. Another explanation for subdued pricing pressures is global competition. In 1989, imports amounted to 10% of GDP; today it is over 14%. Even without global pressures, competition is keen in every endeavor. In the new competitive paradigm, the unemployment rate could conceivably drop still further before wages start to tighten. Inflation is not a major concern today.

Consumer Spending, accounting for more than two thirds of GDP, is another key issue for the economy. Some savants say the consumer is too much in debt; bankruptcies are climbing; credit card issuers are becoming cautious. With the tax refund boost and year-end bonus payments behind us, retail sales, especially for cars and homes, sagged in April. But confidence remains high, jobs are plentiful, the stock market's wealth effect is pervasive and attractive new products and services abound. Consumer spending tends to follow a sawtooth pattern, with a strong quarter or two followed by one or two weak periods. We believe the trend of consumer spending remains at about 2 ¾% despite periodic swings around this mean.

Summing up, we see little change in the outlook from where we were six months ago: we are still in the middle of a long, relatively modest expansion with little price pressure. Periodically, it may appear the economy is moving ahead too rapidly given the available resources. At other points, it may seem as if a meaningful slowdown is finally in the cards. While the Fed may well decide to raise rates another notch in July or August, such a move will probably not change the "big picture".

Volatility will remain high in the financial markets as perceptions continue to shift more rapidly than the underlying reality. Bonds will be especially sensitive to employment and productivity reports, retail sales figures, inflation numbers, yen-dollar exchange rates, rising interest rates in Japan, budget deficit progress and the relative attractiveness of equities. Despite periodic roller coaster rides, interest rates will remain not far from their current level (6 ½ - 7% for the 30 year U.S. treasury bond and 5 – 5 ½% for the 3 month U.S. treasury bill).

If, as we believe, bonds will remain rangebound, then stock performance will depend upon corporate profit growth. To date, profit performance has exceeded most expectations. Over the last couple of years, it would have been reasonable to expect the lack of corporate pricing power, coupled with robust employment growth and some commodity price upticks, to have narrowed profit margins by now. Possibly, all those years of restructuring, productivity gains and globalization have paid off: corporate profitability has been nothing short of amazing. In our view, if slower growth and little inflation comes to pass, some companies earnings will fall short of Wall Street's profit expectations as has recently been the case with Nike and Intel. Clearly, the prospect of a quarter or two of generally disappointing earnings later this year or early 1998 could trigger the long awaited stock market correction. In a muted cyclical environment in which share prices are already adequately valued, stock selection must, therefore, follow earnings growth. It is for this reason that our client's equity portfolio's remain tilted toward *growth* stocks over *value* shares and that our selection has favored companies which have demonstrated their ability to deliver consistently superior earnings growth.



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One administrative note: I now plan to be away from the office on vacation from June 25th through July 8th. In my absence please do not hesitate to call either Tracy Rhawn (312) 641-9585 or Phil Lahey (641-9004) should you have questions regarding your portfolio. Diane Kraft (641-9006) will be available to arrange remittances during this time.