FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

January 13, 1998

The Outlook for 1998

Years from now, when financial market savants review 1997, it will appear that a "Goldilocks" economy was firmly in place. Longer term bond investors finally embraced a low inflation outlook and U.S. equities, basking in the glow of three consecutive years of 20%+ gains, appeared as though they would never decline again. The real-time view, as investors actually experienced events of the past year, was quite different. In March, the Fed raised interest rates, usually a harbinger of monetary restraint and, in time, declining stock markets. This past fall, the Southeast Asian crisis swept through the markets, leaping from country to country, its full consequences still unclear at this writing. The U.S. stock market rediscovered day-to-day volatility while the U.S. treasury market benefited from its "safe haven" status and lower than expected inflation. Stocks peaked in late July/early August, tumbled in October, and recovered in November and December as investors continued to "buy the dips". Below is a recap of the returns various domestic and foreign market indices produced last year.

	12/31/96	12/31/97	1997 Total Return
U.S. Treasury Bills	5.1%	5.3%	+ 5.5%
10 year U.S. Treasury Notes	6.4%	5.7%	+11.3%
30 year U.S. Treasury Bonds	6.6%	5.9%	+15.3%
S&P 500	741	970	+33.5%
Dow Jones Industrials	6448	7908	+25.1%
NASDAQ	1291	1570	+21.6%

Foreign Stock Markets (price change, U.S. $)

Britain	+19.7%	Japan	-30.2%
France	+12.2%	Hong Kong	-20.4%
Germany	+25.7%	Australia	-11.6%
Switzerland	+45.9%	Malaysia	-68.7%
		South Korea	-69.6%
Brazil	+34.8%	Thailand	-75.5%
Mexico	+52.4%		

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Early last year, we were among the first to articulate the reasons behind "The New Economic Paradigm", today's jargon for a flatter, friendlier business cycle. By many counts, last year's economic performance was truly extraordinary. Real economic growth averaged close to 4% (far better than we had expected) while inflation, as measured by the CPI, fell to 1.7%, the best performance in eleven years. Moreover, there are, as yet, few signs of maturity in this cycle. A year ago, we were sanguine toward fixed income investments, expecting bond portfolios to produce returns in the high single digits. The widely followed Lehman Government/Corporate Bond Index, indeed, provided a 9.8% return for the year. On the other hand, our stock market forecast, projecting returns in the 5-10% range, was far too pessimistic. The S&P 500 composite advanced more than 33%, all in the first seven months of the year. Fortunately, our cautious forecast did not keep our managed portfolios from generating excellent absolute and competitive returns.

Economic Outlook

We expect the U.S. economy to continue its forward momentum throughout 1998, albeit at a slower pace, particularly in the first two quarters of the year. Recent additions to our nation's productive capacity adds to our confidence in this forecast. By year-end 1998, the current economic expansion will have surpassed the long 1982 – 1990 advance in duration, placing it only a year away from equaling the record-setting 1960's boom of 106 months. Our bias toward a continuation of economic growth at least into 1999 and possibly into the millennium remains a cornerstone of our constructive attitude toward stocks. The reasons for our optimism are as follows:

(1) The *consumer* sector (approximately two-thirds of the domestic economy) remains in good shape. Employment is strong, confidence is at a record high level and real incomes are rising. Even so, after a year of strong spending, evidence suggests that Christmas sales were not a blowout. Discounting was widespread. Possibly, after seven years of expansion, there is not much demand for "things". Service oriented spending is "in". Whatever the reason, we look for no great surprises from the consumer in 1998, perhaps a trend-line 3% increase in real consumption spending.

(2) *Government* spending (amounting to 17-18% of the economy) will advance by a modest 1-1½ % in real terms, a bit faster than during 1996 and 1997. Realistically, this is a mid-term election year and the

goal of further shrinking the budget deficit may now be put aside until following the elections.

(3) *Business spending* for non-residential fixed investment (some 12% of the domestic economy) holds the potential for disappointment. Growth, powered in recent years by spending for high tech items, has been in double-digit territory. However, according to the experts, the Asian crisis will reduce the pace of worldwide growth by ½ of 1% to as much as one full percentage point. The U.S. will not escape unscathed. The world is awash with productive capacity and the dollar's strength will make it more difficult for us to capture the marginal order for exported goods. In addition, an expected squeeze on corporate profits will also have a somewhat dampening effect on capital spending. Interestingly, non-defense capital goods orders (ex aircraft) declined in both October and November. Nevertheless, we expect full year business spending to rise only modestly despite the continued momentum in high tech spending, but not at the double digit pace of recent years.

(4) *Retail* inventory accumulation was on the high side in 1997, especially in light of slightly disappointing Christmas sales. If, as we believe, business remains unconcerned about the possibility of rising costs for raw materials, there will not be an important incentive to tie-up capital in inventories. The pace of inventory accumulation should, therefore, slacken this year.

(5) We remain sanguine regarding *inflation* prospects. Despite the tight labor market in our nation's service sector and fear that labor costs may begin to creep up, the United States is not isolated from price-depressing events in the rest of the world. This is illustrated by recent weakness in commodity prices, particularly oil, which has plunged from a high of $26 per barrel to less than $17 per barrel currently.

Summing up, our broad view of the domestic economy is benign: trend line growth at 2 ½ % and continued low inflation.

Corporate Profits

We continue to focus upon corporate profits because over time stock prices follow both the level and trend of profitability. At times, profits may command a high valuation (when interest rates and risk are low) and at other times profits are worth less (when interest rates and the level of uncertainly are high). Profits are critical in the short run, as well, because they provide clues toward longer-term growth rates, capital deployment and perceived risk. Thus, investors carefully parse reported profits vs. expectations. Often, the stock market reacts foolishly, providing the patient, alert investor with an opportunity to buy or sell shares at a favorable price. But sometimes, when reported profits differ from expectations, they signal a change in trend that investors ignore at their peril. Professional investment management, in part, is about differentiating an opportunity from a change in trend.

This year, we believe, will be a challenging one for corporate profits. Wages are firming, pricing power is weak at best, and growth is slowing – not a favorable backdrop. However, productivity gains can come to the rescue once again, but it will take an extraordinary boost in productivity to meet today's consensus profit expectations for 1998 – up 8%. We believe that "aggregate" corporate profits in 1998 will be about the same as in 1997. We are likely to see massive restructuring charges this year as companies struggle to reduce costs. Even GE and Citicorp, arguably among the best-managed global concerns, have signaled that huge charges in the months ahead are necessary to drive costs even lower. Fortunately, the profit outlook for investors in public companies is not quite as bleak as we might have suggested above. Most of the time, as management has discovered, restructuring write-offs are ignored by most investors. In fact, stock prices often rise in response to such "decisive" action. Investors value companies on the basis of their recurring "operating" earnings, not the bottom line. Thus, it is likely that companies in the large and mid-cap public domain will report "operating" profit numbers better than the "aggregate" to which we have referred. Large companies, to their credit, generally have superior, highly incentivized management teams. They will buy back shares, acquire/dispose of assets, restructure operations, defer taxes and call upon hidden reserves. Thus, we think "operating" earnings for the S&P 500 will advance some 5% or so, even as "reported" earnings (after write-offs) show little improvement.

Fixed Income Outlook

We are optimistic about fixed income returns in 1998, especially during the first half of the year. The factors that drove yields lower in the last few months of 1997 will continue in the months ahead. We believe long term U.S. treasury bond yields could decline further, possibly to about 5 ½%. We expect the Fed to "stand pat" for the time being reflecting the absence of inflationary signposts, the Asian turmoil and what appears to be a mild pause in consumer spending. The ongoing stock market consolidation, which began last summer in response to lowered earnings expectations, has also resulted in a modest shift in new money flows from equities into bonds. We expect a reversal of these flows once the Asian crisis abates and confidence improves.

The Stock Market

Following three excellent years in the stock market that more than doubled the price of the S&P 500, it is hard to be unambiguously bullish. However, the overwhelming positives are unchanged.

- no recession in sight
- virtually no chance of the Fed raising rates anytime soon and the possibility of a rate cut or two if our economy continues to weaken
- continuing favorable demographic factors favoring equities
- a high level of merger and acquisition activity

Either inflation or deflation, boom or recession, could upset the flow of funds. Neither bet should be taken now, but "Goldilocks" will not live forever.
Our concerns are few but worth bearing in mind. Corporate profits will come under pressure this year and are not likely to meet expectations. The other curveball in the outlook is the "Asian Flu". South Korea has been rescued while the ASEAN countries (Thailand, Indonesia, and Malaysia) are likely to stabilize over the next few months. Hong Kong and Brazil have successfully faced down the currency speculators while the Japanese stock market appears to be finding support near the critical 15,000 level on the Nikkei 225. However, no one knows for sure how the Asian crisis will play out. At one extreme, rescue plans could prove inadequate. Should more banks fail in Southeast Asia and Korea, Japan would appear more vulnerable, and markets might panic. We would put low odds on the "extreme" version of these scenarios but a milder version cannot be ruled out.

In recent days, as the year-end relief rally has run its course, the reality of slower growth, possibly disappointing earnings, and importantly, a riskier world "out there", has begun to set in. Given this background, we would be pleasantly surprised if stocks again provided double-digit returns in 1998. Then again, prior to 1995 – 1997, we never had three consecutive years of 20% + gains. Our best guess is that the Dow Jones Industrial Average will be range-bound for the first half of this year, trading between its prior high of about 8250 and its recent trough of about 7200.

Equity Strategy

Last year our emphasis upon large capitalization companies paid off. While we favored *growth* over *value*, we were able to find on both sides of the portfolio companies that promised, with a fair degree of assurance, double-digit earnings gains at a reasonable price. Financial shares comprised the core of our *value* stocks; healthcare and technology issues dominated our *growth* list. As the Asian turmoil began to take hold, we added new investments which we believed to be largely immune from the impact of the Asian crisis (i.e. Household International, Walgreen and Eli Lilly). We start the New Year in a similar portfolio posture. We also remain positive on investment opportunities outside the U.S. Non-U.S. global leaders such as L.M. Ericsson, Novartis, Roche Group and Vodafone performed well in 1997. Other global names will undoubtedly come to mind in 1998. Europe is at an early stage of both its economic and restructuring cycle, especially in the run-up to a single currency. Latin America appears promising, while bottom fishers will undoubtedly have a field day in Asia.

Best wishes for a happy, and once again, a prosperous New Year.

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On an administrative note, we are pleased to announce that Tracy M. Rhawn became a Principal and shareholder of our firm on January 1, 1998. Tracy continues to work in client portfolio management and related services.