FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

June 18, 1998

The Justice Department vs. The Bull Market ?

Conversations with clients invariably lead to a discussion of what might precipitate an end to the current bull market. Will it be the Fed executing a series of preemptive interest rate hikes, or will it be a profit margin squeeze as labor costs rise more rapidly than selling prices? Or might the cause, in Alan Greenspan's phraseology, be "irrational exuberance" that carries stock market valuations to unsustainable levels? Possibly an event in the Far East such as the collapse of the Japanese banking system, sinking under the weight of its non-performing loans, or perhaps Indonesia and/or Korea will implode financially and explode politically/socially. Any of these could be the catalyst but none would be a huge surprise to the financial markets. Meanwhile the big picture, as we have written numerous times, remains positive for U.S. investors.

Clearly, there is no definitive answer to the question of when and under what circumstances this bull run will end. Indeed, we have long avoided trying to call market tops and bottoms, and have focused instead on client portfolios and trends that will affect those portfolios over meaningful time horizons. In that endeavor, we note another less recognized yet potentially potent negative issue that bears watching. We are increasingly concerned that the government's recently renewed aggressiveness in the antitrust area and a coincident willingness of companies in the private sector to litigate against "bigness" in their competitors (i.e. PepsiCo vs. Coca-Cola) could slowly undermine one of the most critical underpinnings of this bull market. This possible, although still-evolving change in the governments' attitude toward big business, is an important development that requires careful monitoring.

Clearly, the headline cases that underscore this shift in attitude are the Justice Department's suit against Microsoft and the Federal Trade Commission's complaint against Intel. But also significant is the fact that the Lockhead Martin/ Northrop Grumman and the KPMG/Ernst & Young mergers have also been rejected. Airline alliances and telecom deals have come under intense and still

pending scrutiny. Interestingly, Europe's antitrust enforcer, the European Commission in Brussels, also seems to be taking a tougher line against mergers. Banking has thus far escaped the governments' attack, perhaps in recognition that

70 WEST MADISON STREET • SUITE 4920 • CHICAGO, ILLINOIS 60602
(312) 641-9000 • FAX (312) 641-9009

bigger banks are better able to diversify their risks and compete globally. President Clinton, interestingly, has not heartily endorsed the thrust against Micrososft, perhaps not wanting to be perceived as being against innovation or, possibly, now recognizing that his self-inflicted wounds have rendered him less influential vis-a-vis the Justice Department. Instead, he has chosen the politician's route- - appointing a high powered committee to look into the impact of mergers.

This attack on bigness is, of course, reminiscent of the cases against IBM in the 1970's and AT&T in the 1980's. Both matters were long and drawn out. The uncertainty of their outcomes resulted in significant underperformance of both IBM and AT&T shares during their travails. Fortunately, for Microsoft and Intel, their pending cases are, at this point, quite limited in scope and the companies' fundamentals and basic structures are not at risk. Ironically, in the former instances, the natural evolution of both new product cycles and the marketplace proved far more effective than the government in stimulating new competition.

We will not venture an opinion on whether Microsoft's integrated Web Browser and Windows 98 operating system is anti-competitive. However, we can make the following general observations:

- Microsoft is a world class company- - *a global leader*.
- Globally competitive companies in the U.S. and abroad have flourished, along with their employees and their shareholders.
- Competition in virtually every arena has never, in our experience, been more intense.
- To compete globally takes ever-larger amounts of capital and relentless attention to driving costs down.
- Global leaders have led the equity markets higher.
- Mergers and acquisitions have created additional global leaders.
- The excitement of premium bids and the transfer of huge sums by acquirees from the "private" market to the "public" market has pushed listed stock prices higher.
- Attacking global leaders will inevitably distract them from what they do best and ultimately weaken their competitive standing.
- Weak competitors are more likely to depend on price increases.
- Weaker competitors will lose market share and market value.

Price fixing, central selling organizations, bribery, flagrant cross-subsidies, and other forms of trade restraint or hidden reciprocities are harmful to the economy. If Microsoft is guilty of these or other illegal practices, they should be punished.

But companies that win by virtue of being better performers should be allowed to compete and grow. Quite conceivably, incumbents' sheer size, and the inflexibility and commitment to the status quo that it often engenders, will allow new competitors to make inroads and eventually assume the lead. Alternative telephone service providers are a prime example, and the personal computer itself is another instance of this virtuous cycle. Mergers, too, can only go so far before egos clash or prices offered advance to levels that depress the buyers' own share price rather than to cause it to advance. The rising level of the stock market since the mid-1990's has been centered on strong competitive *global leaders*. If this trend is seriously called into question, the longevity of the bull market may well be at risk. Only time will tell.

*   *   *   *   *

Two administrative matters: First, I will be out of the office travelling in Europe from June 26th through July 14th. During this time please phone Tracy Rhawn (312/641-9585) or Phil Lahey (312/641-9004) with your investment questions. Diane Kraft (312/641-9006) will be available to handle routine administrative matters, such as cash remittances, during my absence.

Second, our firm has taken additional adjacent floor space to make room for the new staff additions we expect to complete in the months ahead. Visitors to our office later this summer will find that we have relocated our reception area to the north end of the 49th floor elevator lobby. We encourage you to stop by this fall to see our new space. In the meanwhile, enjoy the summer.