FRONT BARNETT ASSOCIATES LLC

INVESTMENT COUNSEL

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The Economy At Mid-Year

The amazing U.S. economy, now in its eighth year of expansion, continues to confound the skeptics by showing healthy gains in real growth with no signs of rising inflation. Clearly, it has taken a major crisis in Asia to act as a buffer between steaming U.S. consumer demand and a manufacturing sector that is slowing sharply in response to weak export demand and bloated inventories. Consumer confidence, at a 29 year high, is one of many barometers of a working consumer enjoying strong real income growth, and because of rising home and stock values, an encouraging balance sheet. Looking solely at consumer demand, the Fed would have been justified in raising interest rates months ago.

The nation's manufacturing sector, however, is flattening. The Asian crisis has crimped exports causing inventories to pile up at a seasonally adjusted annual rate greater than at any time in the past 15 years. Pricing power is almost non-existent and the index of leading economic indicators has been virtually flat for the past quarter. The Economist's index of industrial commodity prices is down 24% year-over-year. And the National Association of Purchasing Managers New Orders Index has been down since the middle of last year. The Fed could, therefore, have decided to lower rates at mid-year had its only indicators been those of the manufacturing sector.

And now, at mid-year, the U.S. economy is at a crossroads, causing analysts to ponder which of the above economic sectors may finally tip the balance and overwhelm the other.

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

The Long Awaited Economic Slowdown

Over the next six to nine months, we expect the economy to slow sharply from the first quarter's 5.4% annualized rate of real growth. A more sustainable 2% - 2 ¼% pace appears likely through year-end reflecting the recent unsustainable pace of inventory accumulation, a deteriorating trade balance, the adverse impact of the General Motors strike, and continued fiscal drag. The above noted standoff between the consumer and manufacturing sides of the economy should continue to cancel each other out. Similarly, any signs of rising consumer prices will continue to be offset by weak commodity prices and savage competition for manufactured goods. Looking at our economy broadly, the widely publicized economic and political instability outside of North America and Europe should underwrite a continuation of a fairly benign economy at home. The Clinton administration has deftly contained a succession of potentially disruptive economic crisis for which they deserve credit.

The Fed is, therefore, likely to remain on "hold" at least for the rest of this year and probably into early 1999. It now appears that the nation's economy will avoid for the foreseeable future either the excessive overall growth or the recession some analysts fear.

Corporate Profit Growth Also Slowing

Despite the strong economy, corporate profit growth continues to slow extending a trend that began in early 1994. Thus far, productivity gains, low interest rates, and low raw material costs have offset modest wage gains, a tough pricing environment, and less robust currency translation gains. We now expect aggregate profit growth to advance in the 2 to 5% range for the balance of this year, considerably below most economists' expectations. These numbers, however, mask a wide divergence among sectors and individual companies. For example, we believe the energy sector - - significantly underweighted in our client's equity portfolios for the past 18 months - - to report double-digit earnings declines. Meanwhile, financials, healthcare and selected retailers should continue to post strong earnings gains while new product introductions will provide positive stimulants to lagging technology company earnings as the year unfolds. We continue to overweight financials, healthcare and large cap technology shares in client portfolios.

Outlook for 1999

Our first pass at 1999, which envisions a re-acceleration in domestic economic growth, is based upon the following assumptions:

1. Japan's economy will react favorably to the initiation of a "bridge" bank and tax reforms and begin showing modest growth.

2. With Japan stabilizing, GDP growth in China will improve from the below expectation 5-6% rate likely for 1998. China will not devalue.

3. Other Asian economies will trough late this year or in early 1999 beginning to recover from current depression-like levels.

4. Russia will not implode.

5. Oil prices, now $14 to $15 a barrel for West Texas crude will recover to $17 to $18 next year. Other industrial commodity prices, recently in freefall, should stabilize.

Given these assumptions, our economy's real growth is likely to rise to a 3-3-½% rate next year along with some upward price movement. Rising prices, though, will stem less from underlying inflationary pressures but more from the absence of temporary factors such as the Asian crisis which has pushed the inflation rate below its "core" level. Under these circumstances, speculation among analysts regarding the likelihood and timing of a Fed rate increase or two will emerge anew. Any Fed rate increases next year are likely to be modest in our judgement. Profit growth is also likely to accelerate from this year's anemic level providing support for the U.S. stock market within the context of a continued favorable fundamental climate for investors.

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