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

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Business Outlook - - Lower Rates and a Soft Landing Ahead

The U.S. economy has thus far withstood turmoil in world financial markets and recession in Asia with little or no impact on growth outside of its manufacturing sector. Several factors creating momentum in the consumer sector of our economy - - decade-high housing starts, strong factory orders, near record consumer confidence, continued gains in personal income and spending, and declining claims for jobless benefits - - portend good GDP growth for the remainder of this year. Thus, we have made no change in our earlier forecast of 2 to 2 ½%+ of annualized economic growth for the second half.

However, looking beyond year-end, it now seems reasonable to reduce our estimate of U.S. economic growth for 1999 from about 3% to 2.0 to 2 ½%. Tightening domestic financial conditions, coupled with lowered estimates of growth in Latin America and Canada and a spreading recession in Asia, imply slower growth and a larger trade deficit than we had previsouly projected.

Moreover, even though we believe the U.S. stock market is unlikely to meaningfully penetrate its August-end lows, its heightened volatility may noticeably dampen U.S. domestic spending over the months ahead. As we noted in our May 28th letter to clients, the sharp rise in U.S. equity prices over the past three years has fueled spending by consumers and businesses to levels that make such spending vulnerable to a stock market setback. In short, we may, over the next six months, witness a “reverse wealth effect” which curbs spending.

But beyond the turmoil in financial markets and a mixed set of manufacturing indicators, little hard evidence can now be found that growth in the economy is about to materially slow. Quite the contrary, as noted above, most indicators point in the direction of continued growth. This view raises the obvious question: What signs should we look for to signal the slowing in growth we now expect for 1999?

Analysts might list the following domestic indicators for monitoring:

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1. ***A sharp drop in U.S. consumer confidence***. While a decline in confidence would probably be the earliest warning of a downward shift in the growth rate of consumer spending, any interpretation of shifts in the confidence indices may be obscured by domestic political developments.

2. ***A spike in initial jobless claims***. Increasing layoffs would be a warning that strong personal income growth - - an important underpinning to this economic expansion - - might be waning.

3. ***A decline in capital goods orders***. This could portend either weakening in U.S. capital spending or further trade deterioration.

Outside the U.S. analysts will watch four broad areas:

1. ***Latin America, especially Mexico and Brazil***. If Brazil's "crawling – peg" regime for its *real* collapses in a disorderly way, growth in the region could be flat, and volatility in financial markets would be aggravated. We expect Brazil, with IMF help, to successfully defend the peg.

2. ***Asia***. Japan and China are key. Japan should stabilize and begin to recover next year as its long awaited fiscal stimulus package and banking reforms are finally put in place. China will not devalue.

3. ***Capital Controls***. Should other countries follow Malaysia's lead and impose capital controls, the outlook for direct foreign investment in developing countries would worsen, with adverse consequences for both the long-term earnings growth of U.S. multinationals and the U.S. equity market.

4. ***Oil prices***. Oil price weakness has been a major blow to Russia and Venezuela. Prices have suffered from an abrupt drop in Asian demand, the warming effects in the Northern Hemisphere of El Nino, and increased supply from Iraq. We expect a recovery in oil prices to $15 - $17 per barrel as the current low level of prices closes down some of North American production and as weather patterns become more normal.

Benign Inflation

With slower growth ahead and labor costs continuing to rise, businesses may attempt to selectively raise prices to maintain their profit margins. We believe that in the current intensively competitive environment these efforts are unlikely to succeed. In fact, further weakness in the goods sector of the economy is likely to cut inflation as measured by the Consumer Price Index to about 1.4% next year - - down from 1.6% thus far in 1998.

Corporate Profits Will Suffer

If we are correct in our expectations for slower growth and continued lack of corporate pricing power, then the slowdown in after-tax corporate profit growth, which began in early 1994, is likely to extend into next year. Clearly, this measure of corporate profit growth may actually show a decline for the first two quarters of 1999 before rebounding. Hardest hit because of the global glut of manufacturing capacity could be traditional capital goods producers in industries such as machine tools, heavy machinery and transportation equipment. By contrast, spending on information technology should hold up well given the intensive use of computers in the economically less sensitive service sector of the economy, the collapse in the relative price of computers, and their rapid rate of depreciation.

Fed Easing

Until recently, it seemed to many analysts that Federal Reserve officials would eventually opt to *tighten* interest rates to restrain an overly exuberant domestic economy where the balance of risks appeared tilted toward higher inflation. However, the tone of chairman Greenspan's recent remarks strongly suggest he is increasingly inclined toward *ease*. The business slowdown we expect in coming quarters will most likely pave the way for short-term interest rate reductions of as much as one full percentage point or more by year-end 1999. With growth slowing and inflation already low, chances have improved that long-term inflation expectations will also remain low. Thus, we expect long-term U.S. Treasury yields will be contained in a 5 to 5 ½% range over the next several months even if the current "flight to quality" among foreign and domestic investors eases.

In summary, then, we see U.S. growth slowing to a "soft landing" in 1999. Inflation should remain very low by historical standards giving the Fed a great deal of latitude to begin easing credit conditions soon, possibly as early as next week, through cuts in both the Fed Funds and Discount rates.

Large cap U.S. equities experienced a sharp correction from mid-July through the end of August with the broad market indicators falling almost 20% from their bull market highs. From their intra-day lows on August 28th, these indices, as well as client equity portfolios, have recovered about one third of the losses they had sustained earlier. Market volatility has been very high. We expect this condition to continue until investors can, with some greater clarity, see how much of a slowdown the U.S. economy will actually experience in 1999. Investors can expect a *sustained* recovery in share values to commence only after financial markets are convinced the Fed is on course toward significantly easing credit conditions and signs emerge that Japan has taken credible steps to meaningfully stimulate its economy as the engine for an Asian recovery.

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On an administrative note, I am pleased to report that Laura J. Clark has joined our firm as an Associate in the portfolio management/client relationship area. Born and raised in suburban Milwaukee, Laura earned her BS degree in Engineering from Cornell University in 1985 where she was a Cornell Tradition Fellow. From 1985 until earlier this year, Laura held a variety of positions with J. P. Morgan Securities, most recently as Vice President in Institutional Equity sales.

The recent addition of Laura Clark and others to our staff, which now numbers 17, reflects our firm's continuing dedication to its founding objective of providing a combination of superior investment results and related client services not generally available elsewhere.

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