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_I N V E S T M E N T   C O U N S E L_

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ECONOMIC OUTLOOK: THE ACCOMMODATIVE FED

Recently released economic data show the U.S. economy has now completed its eighth consecutive year of expansion. On April 30th, the Commerce Department reported that real GDP rose at a robust 4.5% annual rate in the first quarter of 1999, as final domestic sales accelerated to a 6.8% growth rate. Both of these figures topped analysts' expectations. Both also exceeded their trends of the preceding four quarters. Meanwhile, the previous day, the Labor Department reported the smallest increase in the 18-year history of the widely followed Employment Cost Index - - a mere 0.4% rise in total hourly pay for all civilian workers during the first quarter, barely half of what market participants had expected. Publication of these reports followed news that consumer prices had risen only at a 1½% annual rate in the first quarter, both overall and excluding food and energy.

Economists and market analysts are now debating whether these glowing reports and others herald a new regime, in which the U.S. economy can continue to grow at a rapid pace without inducing inflation despite the tightest labor market in over 20 years. And, what do these reports imply concerning the outlook for interest rates? Our views are as follows:

1. U.S. economic growth has clearly exceeded our forecasts and those of most economists, even after a number of upward revisions in recent months. The principal reason for this strength appears to have been the emergence of the most accommodative financial conditions in more than five years as the Federal Reserve responded to the turmoil in world financial markets last fall. Since these conditions are unlikely to change anytime soon, we now expect 1999 GDP growth to exceed 3.5% and year 2000 growth to approximate 2.5%. Both figures are significantly above our January expectations.

2. The very near term prospects for U.S. inflation may not be quite as benign as suggested by first quarter data. Looking ahead, we expect

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

the recent sharp run-up in oil prices to push the headline rate of consumer price inflation (CPI) higher in the next few months. However, over the intermediate term, continued ample industrial capacity and fierce global competition should limit the pass–through of oil-related costs to core inflation. We now expect the core inflation rate to run at a favorable 2.1% this year and possibly a shade higher next year.

3. Market interest rates are likely to remain range-bound until the economy slows or inflation picks up. Despite its recently announced bias toward tightening, the Federal Reserve appears to have shifted to a passive policy stance, waiting for signs of inflation to emerge before actually boosting short-term interest rates. If growth slows, open market yields should drift down, with market volatility remaining low. On the other hand, if growth remains strong, at some point inflation is bound to pick-up, prompting rates to move above the upper-end of their recent range and market volatility will rise. We believe the Fed is likely to continue its wait-and-see posture, avoiding a fed funds rate increase through this spring and early summer.

While the economy's strength has been a surprise, the reason for this strength is no mystery. Last autumn's credit easing signaled that the Federal Reserve would do whatever it could to avert a cyclical downturn in the United States. That message came through most forcefully in the Fed's surprise rate cut on October 15th - - the first policy move between meetings of the FOMC since April, 1994. Since that rate cut, most major stock market indices have risen about 30%. To the average American family, this means a continued sense of well being and confidence. Their real income continues to rise at a sturdy pace and the value of their financial assets and homes are also showing gains. As a result, confidence has returned to the record territory it occupied prior to last summer's financial-market disruption, and real spending has stayed on a solid growth track.

Financial accommodation has also kept residential construction activity at buoyant levels, existing home sales remain brisk, and capital spending in the past six months firmer than expected. Meanwhile, the stabilization of financial markets worldwide has improved the prospects for growth abroad. In fact, the weakness in Latin America has proven to be less severe than many had feared. And although conditions in Europe - - primarily Germany - - currently look sluggish, analysts are now detecting signs of encouraging strength from companies they follow. Thus, with no clear change in financial conditions in sight, we look for continued economic expansion at an above-trend rate again this year and only a modest short term energy-related uptick in inflation which will remain benign by historical standards.

Longer Term Outlook for Inflation Remains Positive

In was only six months ago that financial analysts were preoccupied with the prospect of *deflation* as they pondered the implications of the Asian financial crisis. Now, the same group of seers are busy fretting over the chances of economic overheating and *inflation* as they parse the daily releases of economic data. Lest we forget the fundamental reasons we believe inflation will remain low, we have restated below the forces, which have been and are at work globally to keep price increases in check.

These fall into two categories. First, forces tending to reduce prices by *reducing demand* and second, forces tending to reduce prices by *increasing supply*.

Forces Tending to Reduce Prices by Reducing Demand

- Reduced government expenditures and deficits in many developed nations.
- Persistent anti-inflation policies by G-7 central banks.
- Favorable demographic trends stemming from:
  - increasing numbers of retirees with lower levels of income and spending growth and;
  - increasing numbers of pre-retirees, with associated shifts from borrowing and consumption to saving and investing.
- Lower levels of consumption and imports of commodities and other tradable goods stemming from economic difficulties in Japan, non-Japan Asia, and other Emerging Market countries.

- Corporate restructuring leading to employment layoffs, cost reduction pressures applied to suppliers, and the shift of purchasing to low-cost domestic and international sources.
- Companies have invested in information technology resources to substitute capital for labor (i.e. ATM machines have replaced bank tellers).

Forces Tending to Reduce Prices by Increasing Supply

- Deregulation and increased competition, due in part, to the emergence of transnational economic zones such as NAFTA and the European Economic Union.
- Public and private sector resources are being shifted from defense-related to non-defense production.
- Competitive currency devaluations put cheaper priced goods into local and global markets.
- The rise of market economies in the so-called Large Emerging Markets- - including China, India, Indonesia, Brazil, Russia, Mexico, Nigeria and Pakistan - - has been projected to add 150 million new low-cost workers to the global labor force *annually* until the year 2009.

The Favorable Big Picture

So long as the economy continues to perform as it has, with core inflation well contained, the Fed policy/interest rate backdrop is likely to remain positive for investors. Under these conditions, the recent rotation into cyclical stocks and the better relative performance of mid and small cap issues appears justified. In fact, it could extend for a while longer, as indications of an impending pick-up in factory activity translate into better business conditions and improved profits for this depressed economic sector. Of course, to maintain forward momentum equity investors will require fresh evidence that profits are, indeed, recovering from their poor showing in 1998. We believe the profit cycle trough has now passed and that companies which have a higher concentration of their operations in manufacturing, where price, cost, and productivity trends are moving in directions more friendly to the bottom line, will show improving performance.

Earlier this month, 30 year U.S. Treasury bond yields spiked toward the 6% level following the release of disappointing April CPI figures and the announcement the Fed had decided to tilt toward raising rates if conditions warranted such a move. Rates have since fallen back toward 5.7% continuing a seesaw pattern we expect for the next several months as the bond market digests the release of conflicting statistics showing both signs of strength and slowing in the economy.

Equity Portfolio Strategy

In meetings with clients and in our January letter, we forecast that a rotation from *growth* stocks to *value* shares was likely to commence once investors began to anticipate that a revival in U.S. corporate profit growth was at hand. This rotation began in earnest at the start of the current quarter. In anticipation of this shift in investor appetites, we initiated late last year and earlier this year, new purchases and additions to existing holdings in companies likely to benefit from this change. While client portfolios remain tilted toward *growth* shares, the recently augmented *value* portion of client's equity portfolios should remain a positive contributor to performance in the period ahead. And clearly, with equities at high levels of valuation, any disquieting domestic economic development or global disruption could trigger a stock market correction of 10-15% without any change in the favorable fundamentals.