FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

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ECONOMIC UPDATE: FALL MARKET JITTERS

Business activity in the U.S. remains very strong, continuing to run well ahead of most forecasts. Driven by corporate spending for productivity enhancing information and communications technology, low unemployment and high consumer confidence, growing real incomes and the "wealth effect", the economy remains in the virtuous cycle of which we have written many times. Adding to the favorable outlook, S&P 500 profit growth, which has also outpaced Wall Street forecasts, is projected to increase by 20% year-over-year last quarter and should show similar strong growth in the current quarter.

Over the next few months and into 2000, we believe economic growth will remain favorable, but slow to 2 ½ to 3% for the following reasons:

(1) Business inventories are lean; an increase to more normal levels, in addition to precautionary strategies related to Y2K, will add to real growth.

(2) Consumer spending will continue to grow, albeit at a more sustainable pace. However, because of higher interest rates and energy costs, we forecast consumption gains will moderate compared with the torrid pace of 1998 and early 1999.

(3) Capital spending may moderate by mid 2000 providing less stimulation to GDP as corporate profit growth slows.

(4) Rises in both short-term and long-term rates this year suggest a moderation in the demand for housing and reduced growth in other interest rate sensitive areas.

(5) Because of past strength in the U.S. dollar, net exports are likely to continue to be a drag, although less so than in the recent past.

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Inflation, which is hard to detect in the developed countries, should remain low for the foreseeable future. While recent monthly headline inflation statistics have been affected by energy price increases, inflation, excluding food and energy, remains well behaved. Core consumer inflation will remain stable, in our view, reflecting fierce global competition, ample production capacity, intense corporate focus upon cost reduction, and high productivity gains resulting from the increased use of computing technology. Importantly, we believe the current period more and more resembles the inflation-free late 19th century, which benefited from new production techniques and technologies, and the opening of the U.S. frontier.

Meanwhile, our stock market has made little net progress since April, fluctuating in a volatile pattern within a trading range during this period. In fact, we have experienced seven distinct mini-advances and subsequent retreats. These "roundtrips" reflect investors' fears of too much Fed tightening on the one hand and unexpectedly good corporate profit news on the other. In the end, though, we are convinced the Fed will act in a restrained manner and inflation will remain low by historical standards.

Short Term Concerns

At this writing, U.S. investors are faced with a number of short term concerns:

(1) The price of *crude oil*, propelled by oil cartel production cuts, has more than doubled from its winter lows. Some see this price rise as a harbinger of higher general inflation in the economy. Cartel leaders are, of course, aware that an increase in benchmark crude much beyond the current level of $23 per barrel would be counterproductive. It would encourage additional exploration and increase production elsewhere, curtail consumption, and stimulate cheating by OPEC members, who have been remarkably disciplined since the production cuts were implemented last year. Norway has already said it would boost its output by 20% in the year 2000; Venezuela, Mexico and Saudi Arabia have agreed to meet next month to discuss production quotas; and for humanitarian reasons, the U.N. Security Council has allowed Iraq to substantially raise its monthly sales.

(2) The U.S. *trade deficit* is now running at a $24+ billion a month rate as a result of U.S. consumers' voracious appetite for imports at a time when economies abroad are relatively weak. U.S. multinationals source abroad aggressively for cheap labor. This is financed by

foreigners who recycle the dollars they receive into our financial assets. Stronger economic conditions abroad, higher U.S. interest rates, and the weakened dollar will gradually work to improve this imbalance.

(3) The *Japanese Yen* has strengthened against the dollar recently. We believe the renewed interest in the Yen reflects internal Japanese conditions. With their economy improving, significant tax cuts implemented earlier this year, and an apparent recent easing in Bank of Japan monetary policy, returns on investment have risen in Japan, heightening the attractiveness of the Yen. Given these factors, we believe the Yen's strength will not be an important element in the Fed's deliberations to raise rates in the U.S.

(4) *U.S. consumers spend more than they earn*, including the appreciation of their stock portfolios and the increased values of their homes in their savings. As an offset, total government (federal, state, and local) surpluses now amount to the equivalent of 3% of GDP.

(5) The downside of the incipient global recovery we are experiencing is that liquidity from weak Asian markets and central bank stimulus, which previously fueled U.S. financial markets, will now be diverted to finance economic activity abroad. The *liquidity cycle* has, therefore, temporarily shifted from positive to neutral.

(6) *Gold prices*, which are reportedly followed closely by Fed Chairman Greenspan as a gauge of future inflation, have recently risen from about $251 per ounce to about $318 per ounce. This has caused some investors to worry that the rise might be viewed as another reason for the Fed to "take back" the third credit easing move it made last fall to stem the Asian crisis. In fact, gold's recent rise comes not from any change in global inflation fundamentals but because of a massive unwinding of hedge funds' speculative short positions in gold and central bank decisions to defer sales of gold from their hoards. Recent reports by hedge fund managers indicate that several large funds were once again caught in an unprofitable "trade" and this time needed to unwind their gold positions or face possible further huge losses on their short sales. One such hedge fund, run by the legendary Julian Robertson, is said to have lost 20% of its market value during the month of September alone. Total assets of his Tiger Fund have

shrunk from $20 billion at year-end 1998 to $8 billion at the end of last month due to a combination of market losses and redemptions by disappointed investors.

(7) Some analysts have warned that the Federal Reserve might be tempted to *target rising stock prices* in its effort to forestall future inflation. The analysts cite repeated cautionary statements by Chairman Greenspan regarding the high level of stock prices. However, in recent comments, Federal Reserve governors have gone out of their way to play down suggestions that the stock market is in a "bubble" that needs to be pricked. Influential Fed Governor Lawrence Meyer recently noted that "one could argue that structural changes in the economy (could) justify at least a substantial portion of the rise in equity prices". Meyer added that the Fed "should not target asset prices or try to guide them". He concluded that this view was "the conventional wisdom inside the Federal Reserve - - -about how monetary policy should or should not respond to suspected asset-market bubbles."

Fall Market Jitters

Last summer and fall, the U.S. stock market experienced a sharp correction as Asian recession worries, the Lewinsky affair, Russia's debt default, Latin American currency problems and the Long Term Capital Management fiasco triggered a 19% correction in the broad market indices. This fall, despite better fundamentals, the stock market has been grappling with a number of the above noted short-term issues and the broad market indices have fallen about 13% from their highs. Over the very near term, the U.S. stock market's direction remains hostage to the interplay of the stream of excellent third quarter earnings announcements now being played out and the good possibility of a third preemptive Fed funds rate increase on November 16th. While we are likely to see large daily fluctuations in stock prices, the favorable course of corporate profitability should limit the market's downside.

Over the intermediate and longer term, however, the driving forces of global economic recovery, the ever accelerating progress in computing and communications technology, and the disinflationary impacts of the internet offer tremendous opportunities to successful U.S. based multinational companies and their shareholders. The economic recovery abroad and

continued re-acceleration of these economies will underpin further global economic growth well into the year 2000, stimulating a broad range of industries and broadening the stock market. Multinationals active in emerging markets, dominant in their industries, and able to gain market share, will capitalize on this trend. The challenge to investors will be to find these future leaders and to increase their exposure to them.

A Fed rate increase of 25 basis points next month, which is a distinct possibility, would probably roil the stock market for a brief time. However, it is likely to be viewed favorably by bond investors and would be a positive for the U.S. dollar. Stock investors should eventually find these developments quite encouraging, particularly if, as we anticipate, inflationary prospects remain fairly benign, and the Fed were to signal that further tightening of monetary policy is not needed.

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On an administrative note, we are very pleased to report that Michael MacMillan will join our firm later this month. Mickey previously spent seven years with J.P. Morgan in their New York and Chicago offices in private client relationship management. He will be working with Laura Clark and Suzanne Carrier in the portfolio management area with us. Mickey grew up in Delaware and earned his BS degree from Mount Saint Mary's College in 1992. He is currently enrolled in the MBA program at the University of Chicago.

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