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

May 10, 1995

U.S. Stock Market Comments

Our year-end letter to clients suggested the U.S. stock market would turn in a "solid" performance this year following a flat year in 1994. While I was positive on the outlook, stocks have done much better - sooner - than I had expected. This favorable performance for the broad stock market indices (up nearly 14% for the year-to-date) has come against the backdrop of a weak dollar and a number of potentially disruptive events around the world that had relevance for the financial markets. Orange County's ill-conceived foray into fixed-income derivatives, the devaluation of the Mexican peso and the virtual collapse of the Latin American stock markets, the Kobe earthquake, and the bankruptcy of the venerable Barings merchant bank were but a few of the shocks our market has absorbed on its way to record territory.

In retrospect, there was abundant fundamental support for the stock market's advance. The economy began showing signs of slowing late last year, confirming a trend our consulting economist, Dave Bostian, had detected months earlier. Further, as evidence of this slowing emerged, investors expectations shifted toward a soft landing scenario where the Fed is now viewed as unlikely to increase rates further, and inflation will remain muted. The resulting decline in open market interest rates has increased the attractiveness of the U.S. stock market which, while no longer cheap, is attractive from a valuation viewpoint as discussed in detail below. Consequently, our client portfolios remain fairly fully invested in equities.

For the near term, the stock market appears to be somewhat overbought and may need a rest before it moves significantly higher. A modest correction (5 to 10%) is also clearly possible. The next surge could come as early as this fall as investors conclude the current soft landing is only an interlude in what has proven to be the most durable business cycle of the Post World War II period and not prelude to either a recession or a rapid reacceleration in business activity bringing with it heightened inflation fears and higher interest rates.

Longer term, there are many *fundamental* reasons to view the stock market constructively. Productivity continues to improve, and interest rates remain low. Common stocks have only partially reflected these favorable conditions. The United States remains the most attractive of the mature equity markets of the world. We are the low cost producer of many manufactured products. The budget deficit has declined and is headed lower. Our trade deficit should show some improvement later this year, creating one of the preconditions for a further strengthening of the dollar. This should attract some of the foreign capital that left our markets for opportunities abroad.

From a *valuation* standpoint, the S & P 500 now trades at about 14.5 times estimated 1995 operating earnings compared with an average of 16.4 times during previous periods of CPI inflation of 3.5 % or less. The currently low dividend yield of the S & P 500 of about 2.8%

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belies corporations' true abilities to return cash to their shareholders. Rather, strong free cash flows are now being used to repurchase shares and reinvest in operations as corporate managers and boards seek ways to enhance shareholders values.

As for the *supply and demand* for stocks, despite pundits' earlier fears of a run on mutual funds, new inflows continue at a strong pace, with most cash finding its way into domestic portfolios. And U.S. corporations continue to repurchase shares and otherwise shrink the aggregate supply of equities at a time when the new issue market remains quite subdued.

The short term movements of the stock market are difficult, if not impossible, to forecast. However, fundamental *valuation* and *supply/demand* analyses both support the view that the U.S. stock market should work higher following a period of digestion and that the long term outlook for equities remains bright.

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I now plan to be out of the country traveling from June 9th through June 23rd. Should you need to talk with me during this time, please phone Diane Kraft (312- 641- 9006), with whom I will be in touch twice daily, and I will return your call promptly. My associate, Phil Lahey, will also be in the office should you wish to discuss an investment-related matter during this time.

MBF/jsc