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INVESTMENT COUNSEL

February 20, 1996

THE ECONOMY: FLIRTING WITH RECESSION

At midwinter, the economic outlook is, in our view, poised between future strength and current weakness. Despite recent Federal Reserve easing moves, its policy continues to lag behind open market interest rates, but it is still ahead of the business cycle. The three easing steps to date have been taken long before signs of recession became irreversible. But the current delicate balance could easily tip toward recession if the Fed does not follow up with further stimulative rate cuts this winter and spring. This is especially critical as the federal budget deficit continues to shrink and budget and deficit reduction uncertainties have heightened business and consumer caution.

Early last year, you will recall, we pointed to consumer debt burdens, excessive inventories, and vulnerable exports as reasons for expecting the then buoyant economy to cool. The first two factors will continue to keep a lid on growth in 1996, as well. Exports, on the other hand, may turn out to be a surprising source of strength later this year. Capital spending, one of the more economically- sensitive sectors will continue to grow at a rate faster than the economy as a whole but possibly only half as fast as last year.

To be sure, the consumer debt load and an increased desire to save will keep consumer spending subdued in 1996 with housing starts rising only modestly and auto sales weakening a bit. However, it is too soon to declare a recession is at hand. A new round of mortgage refinancings will help out. Currently, 30-year fixed rate mortgages can be made for slightly over 7%. Consumer behavior in 1996 may not differ much from last year: sluggish in the aggregate, but ebullient in such areas as personal computers, books and home furnishings, and entertainment, for example. As for retailing in general, there is still far too much inventory on hand that will need to be worked down. A severe shakeout in this area over the next few months is a high probability. The inventory “correction” currently under way will negatively impact the first half growth rate, but a gradual reversal commencing this summer will extend the expansion phase of this cycle into 1997 and possibly 1998.

Despite the dramatic decline in our exports to Mexico, which we forecast a year ago, overall export growth has remained strong -- up 10% in real terms. Fortunately, the U.S. is a globally competitive giant at a time when world trade is itself a growth sector. With Europe, Japan and Mexico likely to begin their own economic recoveries this year, export growth should remain strong.

In 1995, capital spending - of which half is technology related, was a cornerstone of our economic expansion. At this writing, the indicators that usually lead capital spending (lower interest rates, strong corporate cash flows, moderately high capacity utilization) are still looking good. And corporations have only now begun their Pentium chip and Windows NT upgrades.

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Recent corporate surveys of capital spending plans, however, show only modest increases this year tempering somewhat our near-term enthusiasm for the productive side of the economy.

On the whole, then, we envision another year of modest growth, averaging possibly 2 - 2 1/2 % in real GDP terms, but with the second half of the year stronger than the first half. Despite the near recession readings of our consulting economist Dave Bostian's macroeconomic model, our best guess is the nation will narrowly skirt a recession. Currently, inflation prospects remain benign, but resource utilization should tighten as global expansion gets into gear following mid year. By year-end 1996, there may be rising concerns about the inflation outlook for 1997. Strongly rising grain prices and the food needs of the developing world must be watched closely. And the recent sharp rise in gold prices, possibly a harbinger of future inflation, should not be totally ignored.

INTEREST RATES

In recent meetings with clients, we have noted the outlook for interest rates continue to be moderately positive. Deficit reduction issues, which will be resolved in one way or another, will lead to further reductions in government spending. Fed easing will continue, particularly if business activity is as sluggish as we expect during the first half of the year. As for short-term rates, they generally move in the direction of the economy's growth. With nominal GDP growth well below 5% and heading lower, the direction of short-term rates is clear: down!! Longer term rates are more difficult to call since they are subject to more divergent currents this year. On the positive side will be lower short-term rates and weak domestic economic activity early in the year. Capital will not be in strong demand. Historically, 10-year U.S. treasuries have yielded a premium of 2 1/2 - 3% over the inflation rate. Using this measure, they are currently fairly priced. However, as global business activity begins to firm this summer, there is a possibility inflation trends may surprise us unpleasantly, and rates could be headed higher by late this year. One cautionary sign has already emerged: several commodity indexes have broken out on the upside.

THE OUTLOOK FOR STOCKS

1995 was one of the best years for U.S. equities share prices in the past 50 years. It will be difficult to beat. The Dow Jones Industrials and S&P 500 had price appreciation of 33.5% and 34.9% respectively. Since WWII, there were only two years (1954 and 1958) in which the S&P 500 price increase surpassed 1995's performance. However, measuring return differently, the market offered a somewhat lower return. On an *equal-weighted* basis, the average price return of the stocks in the S&P 500 was 29.3%, 5.6 percentage points less than the index actually reported. Of the 500 S&P stocks, only about 40% outperformed the *cap-weighted* S&P 500 index while 60% of these stocks underperformed the index. The largest 100 stocks outperformed the smallest 100 by a whopping 13 percentage points. Clearly, it paid handsomely to be invested in the largest companies last year.

Currently, we believe the U.S. stock market is adequately valued given current levels of interest rates. Such developments as a capital gains tax cut, aggressive Fed easing , a firm dollar to bring in foreign equity money and a continuation of the inflows of public money into equity mutual funds could cause stock P/E ratios to expand. Even an increase from the current 17 times trailing earnings to as high as 20 times trailing earnings would still be within the bounds of historically normal valuation parameters. Such P/E's were, in fact, the norm during much of the 1960's long economic expansion. There is, therefore, some room for P/E expansion even if interest rates remain flat or drift slightly higher.

But for 1996, corporate profits are the big unknown. Profits last year advanced 15% with the rate of increase decelerating as the year progressed. Certain sectors did well (technology, financials, health care, and energy, for example) while others were in profit recessions of their own. Currently, the consensus of economists expects that profits will expand 5-10% this year. We expect results to come in at the low end of this range. We will, therefore, need to be selective as there are likely to be disappointments and earnings shortfalls along the way. We conclude that 1996 will be another satisfactory year for stockholders with modest profit growth and, given a break or two, some P/E expansion.

In the balancing of *growth and value* within each portfolio, we continue to tilt toward *growth*. In a slow growth world, companies that produce superior growth and earnings will find favor. Among *growth* holdings widely represented in our clients' portfolios are multinational companies, exporters and companies on the "producer" side of the economic spectrum (technology, for example) We also suspect that, as 1996 matures, we will gradually shift our equity balance toward *value*, reflecting the more robust environment we see for 1997 and the steepening yield curve (which has historically favored value shares). Watch for this shift in emphasis to play out gradually over the next two quarters.

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Two administrative notes: First, I am pleased to report that several clients have already requested and have received access to daily valuations of their portfolios via the internet. Please let me know if you would like to do so, and we will make the necessary arrangements. Second, please note that you can now write to me via E Mail at tre05@cookie.secapl.com.

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