***FRONT BARNETT ASSOCIATES LLC***

***INVESTMENT COUNSEL***

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**The Mid-Year Outlook: Slower Growth Ahead**

Our financial markets remain in nervous limbo as economists and market savants analyze with microscopic intensity each newly released business survey or statistic to help shed light on how strong business conditions are likely to be over the months ahead. Interestingly, analysts in *both* the strong growth and slowing growth camps are frequently able to cite the same set of statistics to support their forecasts, thereby adding to the confusion.

We believe growth in the U.S. will slow for several reasons. First, the rise we have already seen in open market interest rates, possibly followed later this summer by a Fed tightening, will eventually impact the credit-sensitive sectors of the economy (autos and housing). Second, banks earlier this year responded to higher credit losses by tightening lending standards. Third, inventory rebuilding should return to a more normal pace. Fourth, sensitive industrial commodity prices have been falling for much of 1996 portending weakness, not strength. Fifth, our consulting economist's Macro Economic Index has for months signaled caution confirming the slowdown we expect. If the economy slows to a more sustainable pace (2-3%) as we forecast, the financial markets still have room to run well into 1997.

As we see it, there is probably only modest near-term risk in the U.S. bond market. On the negative side, recently released employment data has encouraged economists to increase their GDP forecasts for the second quarter to 4% or more. The upcoming political hustings are likely to produce promises of tax cuts by both candidates, not deficit reduction; and investor's asset allocation decisions have tended to favor equities. On the other hand, inflation remains moderate, *inflation adjusted* bond yields are attractive (4% + on the ten year U.S. treasury bond) and several high profile bond managers have reportedly thrown in the towel. The U.S. growth rate is probably already slowing from the 4% or so GDP rate expected for last quarter, although the extent of inventory accumulation is a wild card in terms of the reported number for the current quarter. It would not take too much of a business slowdown for the long-term U.S. Treasury bond to rally by fifty or seventy-five basis points (1/2 to 3/4 of a percent) from its current level of 7.2%.

Some observers are cautious regarding the U.S. stock market, primarily on valuation grounds. Admittedly, certain valuation measures (e.g. current yield, price/book) are high by historical standards. But, as we have noted before, these measures are not as meaningful as they once were. Share buybacks have given corporate managers an alternative to dividend increases while price/book ratios are distorted by write-downs and the shift in growth toward economic sectors that are not very capital intensive (e.g. technology, services). Valuation measures that look at earnings and cash flows remain at much more reasonable levels.

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We continue to believe that there remains much potential in many of the larger capitalization, high quality, globally-oriented companies which will benefit from economic recovery in Europe and Japan and huge new opportunities that are opening up in Latin America, Asia, Eastern Europe, India, and Russia.  In the latter regions, growth will almost certainly accelerate next year.  Moreover, these globally-oriented companies are not excessively priced relative to either their past history or to many of the speculative shares that have doubled or even tripled in recent months but have declined in recent weeks.  Among our favorite holdings are American International Group, Citicorp, Disney, G.E., Motorola, Intel, Microsoft, Abbott Labs, Pepsico, and Crown Cork and Seal.

Finally, as we have warned for over a year, a stock market correction of 5-10% could commence at any time.  Such a development, as we noted in our May 15th Financial Market Update, "would not be surprising, unusual, disturbing, or undesirable when viewed in a longer term prospective".  Stronger than expected economic data, a stock market blow off to the upside or an exogenous shock, among other developments, could well serve as the catalyst for such a dip. Stay tuned.