FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

October 16, 1996

Economic Expansion Continues: No End Yet In Sight

The current U.S. business expansion is now half way through its sixth year. This has been the second longest peacetime upswing in U.S. economic history, having lasted almost 50% longer than the post-war norm. And, no end is yet in sight.

This period of uninterrupted growth owes its durability in part to structural changes that have reduced the amplitude of cyclical fluctuations in the U.S. economy in recent years. These changes include 1) financial market deregulation, 2) the rising importance of international transactions, and 3) changes in corporate management practices that reduce the likelihood of excessive inventories and bloated payrolls--- the two imbalances most visibly corrected in recent past cyclical downturns in economic activity. With regard to the later, this expansion remains remarkably well balanced despite its advanced age. Moreover, recent declines in both agricultural commodity and industrial raw materials prices, and savage global competition are assurances of a continuation of low inflation. With the economy slowing and inflation under control, last month the Federal Reserve opted to leave interest rates unchanged. We now see little reason for the Fed to change course when it next meets following the November elections. By early next year, with economic growth possibly falling below trend, analysts may begin to ponder the timing and magnitude of a reduction in rates. Indeed, our Econometric Index has, for months, been forecasting this slowdown.

Financial Market Outlook

Long-term U.S. Treasury Bond yields, which peaked at about 7.2% late this summer, have now fallen to 6.8% as inflation fears have subsided. In our view, the bond market is likely to continue its recovery. We expect yields to drift down toward the lower end of their recent 6.5% to 7.2% trading range by year end. Further moderate declines in rates are possible early next year within the context of the slower growing U.S. economy we are forecasting. Bond portfolios under our supervision remain fully invested following the maturity extensions we implemented earlier when rates spiked above 7%.

Common stock market indices have moved to record highs following their early summer 10+% corrections. Further gains are likely later this year as Wall Street analysts shift their focus to 1997 earnings prospects and investors begin to discount these earnings. However, we believe the stock market is likely to become far more selective over the near term, rewarding companies with highly assured growth prospects and ignoring those whose prospects are less certain because of their sensitivity to slowing economic growth.

In balancing our client's stock portfolios between *growth* and *value* shares, the strategy which defines our investment approach, we have tilted toward *growth* for the past several quarters.

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Among the *growth* stocks we favor are issues with dominant franchises and exposure to the recoveries we forecast in Europe and Japan (i.e. Molex, Intel, Mattel). On the *value* side, we maintain large positions in financials (i.e. banks, insurance companies, diversified financial services businesses) which should perform well in the stable to lower interest rate environment we see ahead. Finally, two fallen growth stocks, Motorola and Pepsico, represent compelling values at current levels despite their near term earnings uncertainties.

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On an administrative note, I am very pleased to report that Tracy Rhawn has joined our firm as an associate in the portfolio management/client relationship area. Born in Louisville, Tracy earned her BA degree from the University of Kentucky in 1983 and received her MBA from the Kellogg School of Management at Northwestern University in 1988. For the past eight years, she has been employed in the Chicago office of First Boston Corporation, a global investment banking and securities research organization, most recently as Vice President of Institutional Equities Sales.

The addition of Tracy Rhawn and others to our staff, which now numbers twelve, reflects our firm's continuing dedication to its founding objective of providing a combination of superior investment results and related client services not generally available elsewhere. After considerable analysis and forward planning this summer and fall, we have concluded that our firm can accommodate significant additional growth without detracting from our ability to continue to deliver the kind of investment results and services our clients have come to expect from us.

Accordingly, we have leased additional space adjacent to our existing offices and we plan to add further to our staff as necessary to digest the growth we anticipate over the months ahead in client assets under supervision. These assets now total over $700 million.

Finally, our firm's success since its founding in May, 1994 is due in large measure to the referrals of existing clients, friends, and our contacts in the community. We do no marketing nor do we advertise. We are, therefore, most grateful for your support and we will work hard day-by-day to justify the confidence and trust you place in us.

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