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March 21, 1998

## The Economic Outlook - - No Recession in Sight

This month the U.S. economic expansion will enter its seventh year. Even more significant than its duration, this expansion shows few signs of coming to an end. In fact, recent events confirm our view that the fundamentals to U.S. economic growth remain quite solid and that the widely discussed problems impacting Asia will cause only a small "nick" in this advance.

Most significant in our analysis is that inflation is moderating rather than rising. In the two postwar expansions that lasted longer than the current advance, 1961-69 and 1982-90, inflation was rising when the expansion turned seven years old. Other leading indicators of an expansion's old age - - a peak in housing activity, declining motor vehicle sales and diminishing consumer confidence are not now in evidence - - portending continued life in the current cycle.

As we have noted in recent client meetings, this may be the best economic environment in modern U.S. history. The so called "misery index" - - the total of the unemployment rate and the inflation rate of consumer prices - - is at a 30 year low; non-farm labor productivity climbed to 1.9% in 1996 and 1.7% in 1997, well above the 1.1% annual rate over the past 17 year period; the federal budget is moving sharply into surplus; polls show the President's job approval rating remains high; and the nation is at peace.

In this favorable economic environment, U.S. equities have soared, more than doubling over the past three years. Although this spectacular rise has created concern in certain circles that the stock market is now overvalued, the rise is not inconsistent with the improvement we have seen in the underlying economic fundamentals. Interestingly, there have been only eight quarters of recession in the past 15 years. In this period, the economy has found itself in recession only 5% of the time. Clearly, investors are increasingly willing to pay more for a dollar of earnings in today's less volatile economic climate. Whether stocks are undervalued or overvalued in today's market, depends upon the durability of the current favorable economic environment. If the causes are transitory then stocks

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may be overvalued, but if they are persistent, equity market valuations could conceivably rise further.

We believe the factors underlying the economy's favorable and more consistent performance, often stated in our client letters, are both structural to the economy and the result of better economic policy.

## **Favorable Structural Changes**

(1) Vast changes in *information technology* have totally altered inventory management making the economy less vulnerable to fluctuations in final demand. Because businesses have better data, they can afford to hold less inventory relative to sales and can react more quickly to shifts in demand. As a result, the big swings in inventory accumulation rates that have often led to past recessions have become more muted, enabling the economy to avoid severe inventory – induced slowdowns.

(2) The *service sector* has grown in importance relative to manufacturing. Service businesses employ nearly 100 million people; goods producing industries engage less than 25 million. Spending for services tends to recur from one year to the next. Services are not subject to inventory cycles and are more difficult to postpone than are capital outlays. In short, this sector is less cyclical than manufacturing.

(3) *Globalization* has been a key factor in muting the amplitude of swings in the business cycle and creating a more open economy. This openness assures that when demand in the U. S. slows, an increasing proportion of the production adjustment is borne abroad. In addition, although globalization means the U.S. is more exposed to demand shocks from overseas, it also dampens the volatility of production by diversifying the source of demand more broadly. For example, Asian consumption is currently weakening, but this slowdown in demand for our exports is being at least partially offset by stronger domestic growth in Europe. A more open economy also has had the benefit of holding down inflation by increasing competitive pressures on U.S. producers.

(4) More *flexible markets* for labor and capital equipment have also helped to improve the economy's performance. On the labor side, flexibility has increased as business managers have become more aggressive about restructuring their businesses and as employees have become more willing to change jobs for new opportunities. Two of the most visible aspects of the more flexible labor markets are the growth of temporary workers and the increase in outsourcing. On the capital equipment side, there has been a significant shortening of the time lag between when an order is placed and when delivery is taken. This has allowed capital equipment to be ordered and placed into production in time to reduce bottlenecks that otherwise might have generated price pressures.

(5) *Deregulation of the financial system* has led to the end of credit rationing to the housing industry, spurred significant innovations (i.e. mortgage securitization and the high-yield credit market) and has helped improve the conduct of economic policy. The capital markets have frequently sent very strong and clear signals concerning the credibility of economic policy, helping to push policy makers in the right direction.

(6) The *shift in corporate governance* has now more closely aligned manager's incentives with shareholder's interests through the use of stock options and other devices tied to stock price performance. This shift has also been key to increasing investment efficiency.

## <u>**Better Economic Policy**</u>

(1) The administration has supported the *trade liberalization* process, helping to encourage the further integration of the global economy with its competition–enhancing and cycle–reducing benefits to our economy.

(2) The *fiscal imbalances of the 1970's and 1980's have been all but reversed*, allowing the revenue windfall from faster growth and higher capital gains tax receipts to be saved rather than returned to the economy via spending increases or tax cuts.

(3) *Monetary policy has been more preemptive*. In the 1960's and 1970's the Federal Reserve typically did not respond until inflation was actually visibly accelerating. Starting in the mid 1980's, monetary policy became more anticipatory.

The confluence of these structural changes and good policy choices have had a huge positive impact on our economy. Competitive pressures have helped hold down inflation, extending the business cycle. The extended business cycle has boosted equity prices and encouraged greater investment. The higher levels of investment have increased productivity, restraining inflation, which, in turn, has extended the business cycle further and given stocks still another boost.

As we noted at the outset, with inflation still falling and early-warning indictors of recession still absent, a business downturn appears unlikely over the next year. The investment environment, therefore, remains positive. However, as we have often warned in the past, the favorable climate for investing does not rule out a 10 to 15% stock market correction along the way, particularly in view of the market's recent sharp run-up.

## Equity Investment Strategy

Over the past six months, the principal focus of the tactical shifts we have made in client portfolios has been to further reduce portfolio exposure to economically sensitive holdings. As the economy is further impacted by Asian Flu and economic growth otherwise moderates toward a more sustainable level, we believe a continued tilt toward *growth* over *value* shares will prove to be warranted. Consequently, we have added the following large cap stocks to client portfolios:

| Issue | Category | Description |
|---|---|---|
| Eli Lilly | Growth | Pharmaceuticals |
| Household International | Value | Consumer Lending |
| Walgreen | Growth | Drug Stores |
| Elan PLC | Growth | Pharmaceutical Delivery Systems |

Most recently, reflecting the sharp drop in crude oil prices and the resulting year-long under-performance of oil and oil services shares, we have selectively added to client holdings of Schlumberger, a leading global oil services firm. While crude oil prices may well remain depressed until Asia begins to show signs of economic recovery and OPEC demonstrates more discipline, we believe our clients will be well rewarded as a result of this increase in their energy exposure. We will consider further increases in energy holdings over the weeks and months ahead should oil prices begin to stabilize.