FRONT BARNETT ASSOCIATES LLC
_I N V E S T M E N T   C O U N S E L_

January 20, 1999

Investing Toward The Millennium And Beyond

Uncertainties abound – (At least 18 - - by the latest count)

- Economic imbalances
- Devaluations
- Deflation
- Dollar/Euro/Yen
- Corporate Profits
- Commodity Prices
- Y2K Issues
- Politics
- Impeachment
- Japan
- Brazil
- Russia
- China
- Indonesia
- Korea
- Thailand
- Hong Kong
- Argentina

But, uncertainty is not the same as despair. Some companies will thrive while others will falter. There will be greater separation between the winners and the losers, the large and the small - - and more opportunity to employ one's investment skills.

My hope is that my remarks tonight will enable you to clearly focus your investment efforts as we look ahead to the new millennium and to the investment challenges and opportunities it will surely present.

Looking beyond this year and into the new century, we believe many of the major global trends which have powered the current economic boom, now closing in on the 106 month record peacetime expansion of the 1960's, will remain firmly in place. Among these mega-trends are:

a. ***low inflation and interest rates;***

b. ***more moderate business cycles which provide a more stable***

70 WEST MADISON STREET • SUITE 4920 • CHICAGO, ILLINOIS 60602
(312) 641-9000 • FAX (312) 641-9009

backdrop for the financial markets;

c. ***better economic policy.***

But before examining these important positives, a look at how our economy will end the century and enter the next.

The Pre-Millennium Year

1. The pre-millennium year will be another year of reasonable growth and very low inflation. In aggregate, corporate profits growth of domestic corporations will probably continue their slide of recent years during the first half of the year. Profits growth during the second half of the year should turn better, first stabilizing and then advancing as business conditions in Asia and Latin America improve.

1. Alan Greenspan and company will continue to provide sufficient global liquidity to assure the economic advance carries through to the millennium.

2. The U.S. consumer is key not only to our economy but that of the entire world. Our insatiable appetite for goods and services, imported and domestic, has been the important underpinning to this expansion. In the last four reported quarters, real consumer spending has advanced at better than a 5% annual rate, bringing the officially reported savings rate to close to zero.

3. Some commentators argue that the consumer is spending (or borrowing against) his stock market gains. To be sure, the "wealth effect" has contributed to confidence and spending. But incomes have been rising as well. Moreover, despite record levels of layoffs, the job picture is still robust.

4. Also worth noting is the fact that there have been several technical changes in the definition of savings which have lowered the reported savings rate by nearly two percentage points vs. the previous definition.

5. Make no mistake about it, employment, jobs and job security are critical. If the unemployment rate stays below 5%, and we think it will, the consumer may soften but he won't melt.

6. More worrisome is capital spending which was very strong in 1998. In a world awash with over-capacity and with corporate profits under some pressure, it is not surprising that we are seeing more and more announcements of cutbacks in capex.

7. The NAPM's survey data for capital spending by manufacturers indicates only a 3-½% increase for 1999. For non-manufacturing such spending is slated to decline by 7%. However, the steady trend in high tech spending is expected to continue.

8. Whether it's the Y2K fix (lets put in a whole new system – why bother trying to fix something we probably ought to junk anyway) or the need to spend more to become globally competitive, high tech capex by industry will continue unabated.

9. Will it slow? Eventually, yes. Will it slow in 1999? Probably, as we approach the millennium and corporate priorities turn toward making sure that all the newly – purchased technology is working as it should. New projects can wait.

10. Inventories are often an important swing factor in determining the quarter-to-quarter pace of economic expansion. While the often-cited inventory/sales ratio looks well balanced now, it can get out of wack where sales slow, not because of a rise in inventories. Our best guess is that consumer spending will slow a bit, exposing a slower rate of inventory accumulation which will subtract a few tenths of a percentage of real GDP growth during the 1st half of 1999. Following that, you might want to stock up on canned tuna, dried fruit and the like. One never knows what will be in short supply come January, 2000.

11. All in all, the most plausible economic outlook is comfortable: a growth slowdown for a couple of quarters, lower interest rates, virtually no inflation, a difficult environment for profits and then a growth spurt heading into 2000.

12. Our base case expectations are straightforward and noncontroversial. But it hangs together by assuming none of the following 4 imbalances change the favorable balance we currently enjoy and, making matters worse, a dislocation in one area is likely to trigger reactions in others.

a. Slower growth in the trade sector has put manufacturing here and abroad into a virtual recession despite strong growth in domestic consumer spending. So far, the cries for protectionist policies have been muted - - but they are surely going to be louder.

b. Capital spending has remained strong despite the weakness in profit growth and signs of global over capacity in most tradable goods. Corporate free cash flow is shrinking.

c. Because the American consumer's wants are insatiable, imports are rising and our current account deficit is ballooning. This necessitates massive foreign capital inflows. So far, the impact on the dollar and/or interest rates has been minimal, but this imbalance cannot continue indefinitely.

d. Supported by ample liquidity, the stock market has soared despite disappointing profits, thereby giving consumers both the confidence and the wherewithal to keep on spending. Sooner or later, the stock market needs profit growth.

13. If, as we expect, growth in the rest of the world begins to accelerate later in 1999, the U.S. consumer will be off the hook, manufacturing sector exports will increase, the current account deficit will stabilize or shrink, profits will begin to grow again, and stock prices will be more firmly supported by earnings. Stay tuned.

14. So much for 1999. Now on to the longer term outlook, the new millennium and the mega-trends I mentioned at the start of my remarks:

a. Low inflation and interest rates;

b. More moderate business cycles which provide a more stable backdrop for the financial markets;

c. *Better economic policy.*

Low Inflation

1. *The end of the cold war* has permitted governments, particularly in developed nations, to reduce non-productive inflation-inducing spending on defense. This, combined with growing voter disapproval of inflationary spending by

politicians, is causing government spending growth and budget deficits to shrink and, in the case of the U.S., budget deficits are turning into surpluses.

2. *Government deregulation* in the U.S. and other developed nations has removed many price floors that previously served to institutionalize inflation by creating what Barnard College economist Robert Heilbroner described as "floors without ceilings." For the past 20 years, the U.S. government has allowed competition to lower airline fares, trucking rates, natural gas prices, electrical rates and long-distance and local telephone charges. In addition, new cost efficiencies are being realized in financial services as states remove restrictions on branch banking and traditional structures that previously kept banks, brokerage firms and insurance companies from competing in each others markets.

3. *The aging of the population* in the U.S., Japan and in other developed nations implies some slowdown in consumption spending following years of strong growth, particularly in the U.S., when Baby-Boomers were forming families and purchasing homes. These Boomers will have little choice but to reduce their spending in the years ahead as they save more of their disposable income to secure their retirement.

4. *Corporate restructuring*, first in the U.S. in the 1980's, and now in Europe seems a permanent strategy for businesses globally. Flattening organization structures, cost saving, outsourcing, pay-for performance and the refining of work processes are ongoing activities that continuously seek to cut costs and drive enhanced productivity.

5. *Technological advances* are also spurring deflation by cutting costs and increasing productivity. While high-tech capital spending still appears to be a small part of the U.S. economy, accounting for only about 7% of economic output, this 7% does not include such expensed items as semiconductors in cars, appliances or industrial control systems nor does it embrace genetically enhanced seeds or spending devoted to software. The deflationary impact of technology extends far beyond the constant declines in computer prices, memory chips and microprocessors. Technology enhances the efficiency and reduces the operating costs of almost every activity, from telecommunications to oil prospecting to financial services.

6. *The deflationary impact of the Internet* on business is most obvious. The Internet practically eliminates the cost of comparison shopping for airline

tickets, books, cars or life insurance. Whole layers of middlemen and showrooms will disappear in this virtual marketplace and the resulting savings will translate into lower prices for consumers and at the same time they mean higher profits for manufacturers.

7. *The opening of the world to the free flow of capital*, the advance of modern telecommunications, deep tariff cuts and relaxation of capital controls allow U.S. corporations and other multinationals to globally search out the cheapest labor, real estate, productive capacity and support services.

8. *The Asian economic crisis* has intensified the deflationary trend by creating a glut of unused industrial capacity, raw materials and manufactured products. Commodity prices have fallen not only because of reduced worldwide demand but also because developing nations are hard pressed to boost their exports so they can pay for their imports and retain as many jobs as possible. In fact, the need for foreign currencies has become so dire in some developing nations that there is an incentive to operate at a loss and increase commodity production thereby causing their prices to fall still further.

More Moderate Business Cycles

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 fewer inventories 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.

Better Economic Policy

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 I 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. In fact, we see stronger global growth commencing later this 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.