FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

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THE ECONOMY AT MID-YEAR: INTEREST RATES AND THE FINANCIAL MARKETS

In his semi-annual Humphrey-Hawkins testimony before congress last week, Fed Chairman Alan Greenspan strongly signaled that the central bank will raise interest rates late this month to prevent the galloping U.S. economy from igniting inflation - - even though, he conceded, inflation remains inconsequential. "Pre-emptive action can obviate the need of more drastic actions at a later date" he told Congress. Both the U.S. stock and bond markets reacted positively to Greenspan's testimony which served to calm investor's fears that the Fed might need to engineer a succession of economy crunching interest rate increases in order to head off a bout of inflation.

We continue to believe that surging inflation is highly unlikely, especially if the Fed tugs on the monetary policy reins once, or even twice, in the coming months. Most of the indicators we follow that condition the long-term inflation rate simply are not pointing to accelerating inflation and, some are actually showing signs of improvement. These indicators include:

- **Industrial materials prices are bottoming - - not booming**. Most indices of industrial commodity spot or futures prices remain depressed despite modest single – digit rebounds from their recent lows.

- **Capacity utilization remains low**. At 80%, industrial capacity utilization is well below the 85% or more levels normal associated with a push to higher prices.

- **The U.S. dollar remains strong**. On a trade-weighted basis, the dollar has risen over 30% since 1995. Moreover, it has fully recovered from the Clinton impeachment-related break last summer. As a consequence, import prices have been falling.

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

- **Wage inflation has moderated**. Despite last month's uptick, wage inflation, now at 3.5%, is well off the 4.4% peak reached early last year.

- **Productivity remains strong**. On a three-year trend basis, non-farm productivity has risen steadily since 1995, reaching its best reading since 1984-1986. Continued investment by businesses in advanced computing and telecommunications devices will underwrite further above average productivity gains.

- **Vendor performance shows few, if any, bottlenecks or delays outside the very tight building materials area**. The National Association of Purchasing Managers index of supplier delivery lead times is in neutral territory at 51.9.

- **Global competition remains fierce**. Latin American and Pacific Rim countries, struggling to recover from their recessions, will be fierce competitors as they seek to increase market share through competitively priced exports.

- **The internet remains a major global force for deflation**.

Looking ahead to the second half of 1999, we believe U.S. consumers will, finally, moderate their spending. Higher interest rates, acting through mortgage rates, refinancings and lease terms will dampen consumer outlays. Construction for both residential and non-residential use is already slowing, albeit from a very high level. With jobs plentiful and confidence high, consumer purchases will not grind to a halt. On the other hand, we expect the long depressed manufacturing sector to gain growing strength and to keep the economy moving ahead. Rising export demand, occasioned by gradual recoveries in Asia and Latin America, and possible Y2K inventory building, are the principal reasons for renewed manufacturing activity. If this scenario - - slowing consumer spending and strengthening manufacturing - - plays out, there is virtually no chance of a repetitive series of rate hikes as was the case in 1994, particularly heading into the uncertainties of the new millennium and the forthcoming U.S. Presidential election sweepstakes.

Interest Rates

Our best guess is that the 30-year U.S. treasury bond will remain close to its current 6.0% rate until the upcoming FOMC meetings at month end. Following those meetings, assuming a 25 basis point increase in the Federal Funds Rate and a slowdown in consumer spending long bond yields could trade back toward 5½% by year-end. We would not rule out an even steeper fall in rates if there is another "flight to quality", as global Y2K uncertainties emerge. Second half strength related to increased production ahead of Y2K could actually "borrow" activity from early 2000, further reinforcing the outlook for lower rates. Adding to our conviction that bond rates will ease are the realties that the government is now running a huge budget surplus and that the outstanding supply of treasury debt is rapidly shrinking. Reduced supply, high interest rates relative to the rest of the world, and a strong dollar will in our judgment, cap the upside on bond yields.

Equity Leadership Change

As for equities, we continue to believe that a 10+% stock market correction from the all-time high levels we experienced in the first and early second quarters of the year is a possibility. This retracement of earlier gains would not, in itself, impair the favorable fundamental outlook for stocks. Internally, though, the stock market's leadership clearly changed in early April from a small group of large capitalization growth stocks with high P/E's to a broader list of companies that can potentially benefit from either a sustained global economic recovery or sharply higher cyclical earnings. The shifts we began implementing late last year to reposition the stock portion of client portfolios were made in anticipation of this change in market leadership. Such leadership shifts often take place during corrections when "new" market leaders show their strength by superior relative performance. Within the recent churning and shifting markets, we have, for example, seen declines in the higher P/E pharmaceutical sector of the market as investors have focused on slower new product flows, significant patent expirations which loom ahead, and the uncertainties of how the government is likely to deal with the issue of providing and paying for drugs for those enrolled in the medicare program. Meanwhile, sharp gains have been recorded in many basic materials groups such as paper, aluminum, oil and oil services. Capital goods, formerly a very weak market sector, has also come to life. Furthermore, responding to the fear of higher interest rates, and despite excellent earnings, some consumer cyclicals (such as autos and housing) and financial services, insurance, banking, consumer finance and brokerages have all shown declines. Telecommunications suppliers and service providers have continued to perform well while other technology groups have remained mixed, with companies tied to personal computers and the internet experiencing difficulty. Since early this month, with the share prices of many of the "former" market leaders off by as much as 30%+ from their earlier highs, we have detected still another internal market shift.

Investors have begun to "rotate" back to some of the former leaders which they now view as being bargain priced on a longer term basis. We must also note that in the continuing process of balancing our client's equity portfolios between the *growth* and *value* sectors of the market, which is a fundamental discipline of our firm, we remain tilted toward growth but somewhat less so than at the end of last year.

Finally, one or even two 25 basis point hikes in the Fed Funds rate, in our opinion will do more to sustain the current economic expansion than would keeping short-term rates at their current levels. We suspect Alan Greenspan also has this in mind. Modest rate increases are not to be feared but should be viewed as beneficial flu shots to prevent economic overheating. To an important degree, these increases have long ago been discounted by both the bond and stock markets. Recent financial market volatility, though, serves notice that the time for unqualified optimism may be over. From here on, too much froth in the economy or the markets should become a cause for investor caution and concern.

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