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December 15, 1999

THE ECONOMIC OUTLOOK: STRONG MOMENTUM HEADING INTO 2000; REMEMBER THE FUNDAMENTALS

As we approach the new millennium, the U.S. economy continues to perform superbly. Driven by strong results in computing and communications technologies, improving global economic growth, and relentless productivity improvements in corporate America, fourth quarter real GDP growth is expected to exceed 5% - - well above most economist's expectations. Standard & Poor's corporate profits are now projected to grow 20% this quarter and an additional 18% in the first quarter of 2000.

Following the explosive rise in consumer outlays that began in mid-1998, retail and auto spending appeared to slow a bit early this fall due to weather related issues. However, recent upward revisions to retail sales figures for the months of September and October show consumer spending actually remained vigorous - - up 9.2% year over year. In addition, checks with industry contacts indicate continuing strong consumption overall in December which should carry over well into the first part of 2000. The modest weakness in housing and construction since mid-year, attributable to the three Federal Reserve rate hikes and hurricane Floyd, should be more than offset by an export driven recovery in manufacturing which is still in its early stages. We continue to expect strong real GDP growth of 3.5% + next year.

The highlights of our forecast for 2000 are as follows:

1. The very tight labor market, high consumer confidence and rising real incomes will keep *consumer expenditures* strong.

2. Real *business fixed investment*, led by vibrant growth in technology equipment and software, should exceed 10%.

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3. *Inventory spending* will increase at a rapid rate into Y2K and the need to rebuild depleted inventory levels should maintain inventory investment at high levels next year. Contributing to this inventory building will be the global economic rebound which began earlier this year.

4. We project *export growth* to rise sharply from 3.8% this year to close to 10% next year, easing pressures on the U.S. dollar and providing support for the U.S. bond market.

5. *Inflation* is likely to remain tame by historical standards. Despite a strong labor market, employment costs are well contained. More important, the continuing productivity boom remains the key to restraining inflation. We expect the inflation rate to rise only slightly from 2.3% this year to 2.5% in 2000.

6. The Federal Reserve is likely to remain on "hold" due to Y2K concerns until the February 2nd meeting of the FOMC. However, newly available economic data showing the economy to have been stronger earlier this fall than was previously thought, increase the odds of one, or possibly two, additional rate increases in the first half of next year. Whether the Fed does actually tighten will importantly depend upon economic statistics to be released following year-end.

Premature Inflation Concerns

Investor's expectations have been battered for much of this year by premature concerns over rising inflation. In fact, the GDP price deflator, the broadest measure of inflation in our economy, is running only slightly above 1%. Recently released PPI and CPI figures for November show no inflationary uptrend. And capacity utilization in the U.S. is currently only 81% - - well below the 85% rate generally associated with rising inflation in prior economic expansions. Instead, financial markets have focused on domestic labor market trends, favorites of Fed Chairman Greenspan, where the dwindling pool of workers seeking jobs may suggest less flexibility ahead. To date, strong productivity trends have allowed excellent control of unit labor costs in most industries. The recent revision of historical Department of Commerce data indicates that productivity growth actually accelerated during the 1990's contrary to prior government reports. Moreover, we continue to believe that in a world where major U.S. manufacturers routinely move production abroad, where unemployment rates are commonly above 10% and where wage rates are materially lower than in the U.S., focusing solely on our low domestic unemployment rate to assess future inflation prospects could be misguided.

As expected, the rebound this year in some commodity prices from depressed levels reached during the height of the Asian crisis, has had little impact on the economy as a whole. While the rise in oil prices, the most visible of these price retracements, has created serious cost pressures for airlines and other energy sensitive business, energy now represents only about 3% GDP from a high of 8.5% in 1981. This decline from earlier periods is due to lower fuel prices and the shifting of the American economy away from certain energy intensive forms of manufacturing toward service activities which consume less energy. Interestingly, fuel-guzzling manufacturers accounted for only 17% of our economy in 1997, down from 22% twenty years earlier.

Repeal of Glass-Steagall

Much has been written about the repeal of the depression era Glass-Steagall Act. While enactment of the Financial Services Moderation Act confirms in part changes which have already occurred within the financial services industry, it also signals that U.S. financial firms will be allowed to vastly expand the range of services they provide. This should be a major positive for both the domestic and international activities of banks and insurance firms. For this reason, we believe financial services stocks will be among the market leaders once investors perceive the Federal Reserve has finished its current round of tightening. In the coming months, commercial banks, which have in the past two quarters underperformed the overall equity market and now trade at price/earnings ratios 40% below the S&P 500, should shine. We, therefore, continue to maintain large weightings of financial services companies as core *value* holdings in client portfolios.

Remember the Fundamentals

As investors parse daily business developments for their investment implications and try to fathom the stock market's gyrations, it is often worthwhile to step back from the day's headlines and focus upon the fundamentals, of which we have so often written. These favorable factors have driven our economy since mid 1994 and have been important contributors to the stock market's incredible rise over the past five years. These include:

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 restrictions are removed on branch banking and traditional structures that previously kept banks, brokerage firms and insurance companies from competing in each other's 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 less than 10% of economic output, these figures do not include such expensed items as semiconductors in cars, appliances or industrial control systems nor does it embrace genetically enhanced seeds and, until recently, 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 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.

In our view, so long as the fundamentals remain positive and corporate profit growth remains on track, stock market returns will compare favorably with yields obtained from shorter duration (i.e. bonds and cash equivalents) investments. Let us be clear: stock market corrections of 15-20%, reflecting short-term swings in investor sentiment, are inevitable given current market valuation levels and should be expected to occur periodically. We continue to counsel clients to remain fully invested in equities and to build bond positions, where appropriate, as interest rates approach the upper end of their recent trading range of about 6.4% on U.S. Treasury obligations.

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From all of us at Front Barnett Associates LLC we wish you and your family a happy holiday season and a healthy and prosperous New Year.