FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

September 21, 2000

THE ECONOMIC OUTLOOK - - THE FED IS DONE

Recently released economic data have increased our conviction that the business slowdown we first forecast in our May 31st letter to clients has taken hold and will be sustained through early 2001. In fact, our firm's proprietary Econometric Model, a copy of which is attached, signaled this slowdown as early as March. The Fed engineered decline in real monetary aggregate growth commencing in the fourth quarter of 1998, a doubling in energy prices this year which acts as a tax increase, and the seeming satiation of pent-up demand for big ticket consumer goods have combined to slow growth in housing, auto and retail spending, as well as employment and durable goods outlays. We now expect this consumer-led business slowdown to resemble the three quarter "growth recession" that occurred following similar Fed credit tightening moves beginning in April 1994. We now project GDP growth to moderate to the 3.00%-3.25% range for the balance of this year and early 2001 from the 5.3% reported for the 2nd quarter of this year, 4.8% in the first quarter, and 4.2% for all of 1999. We see no recession on the horizon.

Consumer spending, which accounts for over two thirds of GDP, is now forecast to rise by a healthy 3.0%-3.5% in the current quarter, sharply below the torrid pace of 7.6% in the first quarter of 2000 and the 5.4% rate of the past year. Housing demand continues to reflect sluggishness in that sector, although residential construction should stabilize as fixed-rate mortgage rates work lower. The peaking in housing since mid-1999 will further mute consumer durable goods purchases in the months ahead. Longer term, though, personal consumption will remain a solid underpinning of the U.S. economy. Aging baby-boomers, who have helped raise the underlying trend of consumer spending since early 1998, will continue to power the economy over the next ten years.

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Signs of slowing economic activity have also emerged in the latest survey of small businesses by the National Federation of Independent Businesses (NFIB). Earlier this month, the NFIB reported that small businesses, which tend to react more quickly and sharply than larger firms to changes in the economy, reported slower sales, earnings and capital spending in August. Interestingly, the NFIB also noted smaller companies are having a harder time raising prices. Fewer than 20% of the companies surveyed have been able to raise prices over the past three months, the lowest level since January. Meanwhile, the Federal Reserve's Beige Book, released yesterday, confirms that while U.S. businesses have been unable to raise prices due to savage competition, they have maintained their profitability as productivity has continued to soar.

Above trend business equipment spending will partially offset the consumer spending slowdown. Real business equipment spending has accelerated, rising 16.5% over the past year, compared with the 13% increase in 1999, as outlays for information technology equipment have surged. We continue to expect better than 10% gains in productivity enhancing equipment outlays for the balance of this year and into 2001.

Inflation

Economists and Wall Street seers continue to search, without success, for signs of inflation outside the oil patch. Industrial commodity prices actually peaked at the end of 1999 and are down 6% in the past three months. Meanwhile, oil prices, now at about $37 per barrel, are probably near their highs for this cycle. Higher energy prices will eventually lead to increased exploration, production, and refining capacity, putting pressure on oil prices at a time when OPEC production is likely to be on the rise and global economic activity is slowing. In addition, election year politics are also pressuring the administration to release a sizeable amount of oil from our Strategic Petroleum Reserve now to avert a heating oil price crisis should we experience an unusually cold winter. We expect oil prices to work lower during the weeks ahead, surprising some pundits who are now forecasting $40 and even $50 per barrel oil. Outside of the energy area, the National Association of Purchasing Managers (NAPM) measure of prices, new orders and vendor performance have declined sharply this year, as have sensitive materials prices. And, despite the tight labor market, there has been only a moderate pick-up in compensation costs, allowing our nation's 5.2% non-farm productivity growth rate to produce the first year-over-year decline in unit labor costs since the first quarter of 1984. The ongoing momentum in business investment should sustain strong productivity growth and keep inflation in check.

Interest Rates

Following the current period of slower growth, which we believe will extend well into next year, we expect more rapid economic activity to resume by mid-2001. This resumption of stronger GDP growth will stem from a number of factors including continued double-digit increases in capital spending, further gains in exports as global growth expands by an expected 3½+ %, a slower pace of import growth, and a more accommodative Fed. Given the slower growth we anticipate in the months immediately ahead, and a peak in the key inflation indicators, the Fed is probably done raising rates. Indeed, the U.S. Treasury yield curve and the recent behavior of the bond market now portend a likely *decline* in short-term interest rates over the next year. Longer term rates now appear to be at an appropriate level, near 5.8%, given the likelihood of 2.5% inflation in 2001.

S&P Earnings Outlook

Currently, slowing domestic business activity is likely to adversely impact corporate profit growth over the next two or three-quarters. However, we expect the positive effects of the ongoing productivity boom, as well as the continuing shift of the S&P 500 to younger, faster growing companies, to produce profit growth in excess of 10% for 2001 with the trough in earnings comparisons occurring in next year's second quarter.

U.S. Equity Market

In our early 2000 equity market forecast, we foresaw "choppy" market conditions in the first half, gradually giving way to a more favorable environment as the elections drew near. It was our belief that an earlier than expected end to Fed tightening and growing investor confidence that a "soft landing" was in the cards would work to shift investor sentiment into forward gear following a stalled stock market for much of this year. Earlier this month, market savants began to question whether the recent unexpected spurt in oil prices to levels not seen since the 1990 Gulf War, coupled with the weak Euro, would trigger a "bumpy landing" causing already nervous investors to scurry for cover. We believe these concerns are overblown and will be resolved favorably over the next several weeks as help in the form of increased OPEC oil production, now on the way, will push energy prices back toward the mid $20's per barrel before year end. Furthermore, the Euro should also soon begin to firm as oil prices stabilize supporting corporate profit forecasts by Wall Street analysts for multinational companies whose share prices have been hardest hit in the recent market pullback. We, therefore, remain optimistic that the U.S. stock market will end the year on a more favorable note as

investors begin to look toward to a reacceleration of economic growth by mid-2001.

Equity Investment Strategy

Clients will recall that equity portfolios under our supervision have benefited from a blend of *growth* and *value* stock holdings, an approach which both defines our investment style and distinguishes us from most other firms. Earlier this year, we reduced the *growth* component in favor of increasing the proportion in *value* shares to insulate portfolios from a possible correction in technology stock valuations which, at the time, appeared to be excessive. The bulk of the proceeds of these modest position reductions was reinvested in *value* shares to further overweight the financial component and to add to the then depressed pharmaceutical and diversified manufacturing company shares. We intentionally avoided economically sensitive holdings within the consumer spending sectors since we viewed these areas as particularly vulnerable to the negative impact of tight credit conditions and higher energy prices. We are maintaining this somewhat more defensive posture until we are able to gauge with greater certainty the extent and duration of the current consumer spending retrenchment. Longer term, weakness in these areas will undoubtedly create new investment opportunities.

The largest concentrations in our equity portfolios remain in the financials, high quality technology and pharmaceuticals, which when combined, account for nearly 60% of the portfolio. We also favor selected diversified manufacturing companies capable of sustaining strong top line growth through the current economic slowdown. Portfolios under our supervision since year-end continue to show double-digit gains upon which we hope to build as market conditions turn more favorable.

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