October 16, 2001

THE ECONOMIC OUTLOOK

When the financial markets reopened in the aftermath of the September 11 tragedy, they reflected both the shock and sadness of the events themselves and the increased uncertainty regarding their meaning in geopolitical and macroeconomic terms. The first week's decline in the Dow Jones Industrial Average was the greatest in percentage terms of any week since the Depression with the single exception of the week France fell to the Nazis in 1940. The markets have now recovered most of the 15% they gave up in the five trading days following the attacks. Correctly forecasting the very short-term market course is beyond anyone's predictive capability even under the best of circumstances. Certainly, another event would send the markets spiraling lower, just as signs of a successful action against Osama bin Laden would lead to a large rally. The near term course of the market, therefore, remains quite uncertain.

Prior to the terrorist attacks, there had been a number of positive signs - - particularly a sharp decline in manufacturing inventories, improvement in manufacturing activity and a leveling off of initial jobless claims - - lending some credence to the view the economy would narrowly avoid recession and show early signs of recovery this quarter. However, with steadily declining manufacturing capacity utilization, consumer spending remained the economy's sole underpinning. Therefore, the economic recovery we had expected to commence in early 2002 would have been tepid, leading to several quarters of modest growth while the economy completed working off the hangover of the excessive investment in technology and telecommunications of the late 1990's.

With precious little hard data available for the period since September 11 to gauge the extent of the subsequent slowdown, forecasting business conditions for the next quarter or two remains problematic. Anecdotal evidence initially indicated a severe impact on the travel, retail and leisure industries. However, it is worth noting that recently released economic data have not confirmed dire predictions made immediately following the tragedy of a collapse in consumer confidence. More recent measures show leisure hotel reservations, Broadway show attendance and auto sales have recovered and in some cases are above preattack levels.

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

Consumer confidence did not collapse, and some surveys actually show an increase. It remains to be seen whether consumers will shrug off likely additional terrorist attacks and growing layoffs.

Notwithstanding the near term uncertainties, looking beyond the next quarter or two, the events of September 11 have changed the economic outlook in a perversely positive way. The apparent further deceleration in economic activity in a number of sectors will allow the Federal government the leeway to counter the current slowdown with a broad set of fiscally stimulative spending and tax policies unthinkable earlier when economically pointless social security "lock boxes" preoccupied the economic debate in Washington. If large enough (1.0 – 1.5% of GDP) these measures, when combined with the aggressively accommodative policy of the Federal Reserve, lower energy prices and the record level of housing refinancings will assure this slowdown remains relatively shallow. Furthermore, we believe the weakening will not be excessively prolonged and that the subsequent recovery will be far more vigorous than had been previously expected. Interestingly, the recent strength of the U.S. dollar and the steepening yield curve, where the spread in yields between 3-month Treasury Bills and 30-year Treasury Bonds has risen to 320 basis points, a seven- year high, are evidences the global markets have begun to share this view.

Investment Outlook

There is no doubt that the stock market bubble of the late 1990's severely distorted the average investor's estimate of his potential future income. Consumption grew at an unsustainable pace compared to income growth. Private balance sheets are stretched, savings have been depleted and there is finally a stark realization that 20% annualized returns from equity investments are not likely to be achieved. As we move forward, and consumers more soberly assess their income potential, total consumption is likely to remain broadly steady but luxury demand is likely to contract, perhaps sharply. For producers of goods and services at the upper end of the spectrum, from high-end luxury cars to "spec" builders of 15,000 square foot mansions, this is likely to be a difficult period. However, for value oriented mass-retailers such as Wal-Mart or Home Depot any change in consumer buying patterns should have positive medium term implications.

Given the likelihood of a stronger economic expansion by mid-2002 than forecast earlier, we have taken another step to marginally increase portfolio exposure to companies whose businesses are poised to benefit from an expected improvement

in consumer spending next year. We have now added to partial commitments we made earlier in Viacom and Omnicom. Funds for these purchases were generated by a small reduction in overweighted financial sector holdings which had produced positive returns during the period of market weakness of the past 18 months. Stock portfolios remain fully invested.

While the Federal Reserve has room to reduce administered short-term rates by at least another 50 basis points, we continue to believe open market interest rates are in the process of troughing and will work higher once the economy begins to show signs of stabilizing. We are, therefore, maintaining larger than usual cash positions earmarked for bond purchases in the expectation patience will be rewarded, as higher rates become available over the next several months.

Finally, in our continuing process of blending *growth* and *value* shares within client's equity portfolios, we remain fairly equally balanced between the two disciplines. *Value* stocks, which have dramatically outperformed *growth* shares for the past 18 months, following almost three years of underperformance, now appear to be faltering as investors may have commenced discounting a stronger business environment next year. We expect to maintain the current *growth/value* mix until the recovery is more clearly in view. In taxable portfolios, an important task over the balance of this year will be to reduce or eliminate, where possible, realized capital gains without disturbing portfolio diversification by tax trading holdings showing unrealized losses.

* * * *

We are please to welcome Brad Peterson, CFA to our client relationship staff. Brad comes to Front Barnett Associates from The Northern Trust Company where he worked for 6 years in portfolio management.

© 2001, Front Barnett Associates LLC