December 11, 2001

THE ECONOMIC OUTLOOK – CALLING THE TURNAROUND

The business cycle dating committee of the National Bureau of Economic Research (NBER) has officially decided that the longest expansion in the nation's economic history came to an end last spring. The six economists who comprise the committee concluded the depressed level of employment, industrial production, real sales and personal income warranted the recession call. Of these four metrics, employment is considered the most accurate measure, and since it peaked in March, the committee concluded a recession began at that time.

The just ended expansion was noteworthy for more than its longevity. During the decade, real GDP advanced by some $2.7 trillion, a 3.5% per annum expansion rate, and created an incredible 25 million jobs. As a result, unemployment fell dramatically, from over 7% at the start of the expansion in 1991 to less than 4% by its end. Despite the travails of the stock market since Y2K, the nation's wealth also expanded dramatically. Stockholders still enjoy a $7 trillion or nearly three fold increase in the value of their holdings since the early 1990's. Since mid-1994, the inception of our firm, client's equity investments have grown at about 18% per annum. The home ownership rate has also skyrocketed to a record 67.8% of households, and homeowners have, on average, experienced a $50,000 increase in the value of their property. Inflation and interest rates are also substantially lower than they were a decade ago. Current consumer price inflation is roughly one-half of the 5% it measured in the early 1990's. It costs less today to fill a car with gasoline than it did in 1991. And fixed-rate mortgage rates, currently less than 7%, compare very favorably with the 9%+ rates that prevailed a decade ago.

Now, economic seers have predictably begun to focus their attention on divining an end to this business malaise. A handful of analysts have been quick to declare the recession already ended and that this would be confirmed by the NBER academics early next year. If history is any guide, this group of optimists may be right. Indeed, a decade ago the NBER proclaimed the 1990 recession in April 1991, one month *after* the recovery had begun. At the other end of the forecasting spectrum is a group of dour savants who see no end to the slowdown until early 2003. Most crystal ball gazers are content to simply admit that while we have insufficient hard evidence now to call a turnaround, there are straws in the wind which point to a recovery by mid-2002. Count us in this camp. Among these straws are:

- the statement accompanying today's Federal Reserve rate cut noted that "weakness in demand shows signs of abating…."

- purchasing manager indices indicate manufacturing is showing incipient signs of recovery for the first time in over a year. Meanwhile, the service sector rebounded last month after suffering its worst month on record in October;

- consumption and housing have remained relatively strong, offsetting the weakness in manufacturing. The explosion in housing refinancing will provide a prop to consumer spending;

- initial jobless claims and continuing claims for unemployment insurance appear to have peaked. While unemployment may increase before it improves, unemployment is a lagging indicator and not predictive of future business activity;

- the S&P 500 stock index has rallied 17% over the past 50 days, a performance that has always been associated with the end of past post-war recessions;

- the recent reversal in bond prices is symptomatic of a change in economic direction;

- consumer confidence may have bottomed. The University of Michigan Consumer Confidence gauge came in at 85.8 in December, a point above expectations and up from 83.9 in November. The sub-index of current conditions improved slightly to 95.9 from 95.3 while the expectations component rose more robustly to 79.3 from 76.6, and;

- commodity prices, often a harbinger of future industrial activity, have risen from their cycle lows with copper up 13%, nickel up 24%, aluminum up 12%, zinc up 8%, and DRAM chip prices up 64%.

Notwithstanding these signals, hope for a quick end to the recession were dampened last week when the November payroll figures showed a loss of an additional 331,000 jobs. Since last March, 1.2 million jobs have been eliminated. During the 1990-91 recession, which was far less severe on corporate earnings, the economy lost 1.8 million jobs. During the 1981-82 recession, 2.8 million were lost. It now appears job loss in the current downturn will likely total around 1.8 million as companies continue to shed workers to bring their costs more into line with current and expected levels of demand. With the economy continuing to lose jobs, consumer spending, which accounts for two thirds of GDP, is not likely to strengthen until late winter or early next spring when we expect the labor market to stabilize and we see clearer signs of a recovery.

Similarly, we believe the industrial sector of the economy is a quarter or so away from bottoming. Since peaking 18 months ago, manufacturing output has declined by 8%. Despite the recent uptick in the purchasing managers' index, factory hours worked dropped 1.5% in November, pointing to another sizeable decline in production. Ultimately, the declines are likely to come close to the 10.5% decline that occurred in the 1981-82 recession, the worst showing since the 1930's.

Capital spending, particularly for technology, is the most difficult sector to call. Investors, sensing a recovery, are clearly becoming more optimistic, with tech shares significantly outperforming the broad market since the end of September. We are convinced tech spending will rebound strongly by the second half of next year with unit growth rising at a 15-to-20% annual rate. While the broad economy does not have an excessive technology base, the tech producing industries themselves continue to have massive excess capacity. In fact, capacity utilization in these industries is at a record low 59.5%. This sector needs further restructuring and consolidation, which will take several quarters. While tech earnings should recover strongly in 2002 from very depressed levels, they are likely to remain below the 2000 peak for quite some time.

For the current quarter, then, we see a decline of a bit less than 1% in real GDP followed by a flattish to slightly higher first quarter 2002. The quarter ending June 2002 should show GDP rising at a 3% rate, and second half 2002 GDP will grow at a strong 5% rate. Full calendar year 2002 GDP growth will amount to approximately 3.0%. For 2003, we could see above trend GDP growth of 4% or more. With regard to corporate profits, we expect S&P 500 operating earnings to drop 32% to $38.00 this year - - the worst performance since World War II. For 2002, we look for a moderate pick up of 13% to $43.00. However, earnings momentum, which drives stock prices, will look increasingly strong as the year progresses. By the fourth quarter of 2002, earnings should be 30% higher than the current period.

The underpinnings of the business expansion we see commencing late this winter or early spring are as follows:

- an aggressively accommodative Federal Reserve monetary policy, which has produced negative real short-term interest rates, and 20%+ year-over-year money supply growth;

- a substantial fiscal stimulus package likely to be enacted by Congress totaling over $75 billion;

- lower energy costs which act as a tax cut to consumers;

- substantial savings on home mortgage payments resulting from the recent record wave of refinancings totaling over $50 billion;

- massive inventory liquidation which will give way to restocking as demand strengthens next year, and;

- continued low inflation.

Investment Strategy

Since the stock market typically bottoms during a recession, and has consistently rallied in the last three months of a downturn, *leading* the economy, (as shown in the accompanying table) our equity investment strategy in the past few months has focused on repositioning client's stock holdings to take advantage of both the coming economic recovery and the new cyclical bull market for stocks which began in late September. Accordingly, we have added to positions in "early cycle" stocks which typically perform well as investors begin to *anticipate* an economic rebound. Consequently, we have built positions in

S&P Performance During and Years Following Recessions

	1970	1974	1982	1990	Average
S&P Advances During Last 3 Months of Recessions	16.2%	30.4%	39.6%	18.6%	26.2%
	1971	1975	1983	1991	Average
S&P Advances During Year Following Recessions	20.4%	4.7%	24.6%	5.9%	16.3%
Total	36.6%	35.1%	64.2%	24.5%	42.5%

Viacom and Omnicom. In addition, smaller holdings in technology shares and Wal-Mart have been increased as needed.

Funds for these purchases have come from the partial sales of a number of defensive holdings in the financial and healthcare sectors which held up well during the weak markets earlier this year. As a result of these tactical changes, the reclassification of Intel from the *value* to the *growth* category and the sharp advances in the share prices of technology holdings since the end of September, the *growth/value* mix, which distinguishes our investment style, has now risen to about 60/40 as compared with a 50/50 blend at mid-year. We remain fully invested in the equity portions of client portfolios.

On the fixed-income side, we concluded this fall that the bull market in bonds is over and that yields across-the-board are likely to trend up once the Federal Reserve completes its current easing cycle, perhaps with today's 25 basis point cut. Both 10 and 30 year U.S. Treasury yields have advanced by roughly 75 basis points since their early November lows. Municipal bond yields have experienced a 50 basis point rebound during this time frame. In the anticipation of significantly higher yields, we have reduced bond portfolio durations by reinvesting maturities in cash equivalents and we have increased cash reserves earmarked for future bond purchases in the anticipation of better buying opportunities ahead.

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All of us at Front Barnett Associates wish you and your loved ones a joyous holiday season and a prosperous New Year.