FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

March 19, 2003

2003 ECONOMIC AND MARKET UPDATE

Following a choppy performance last year, we expect the U.S. economy to commence a more consistent, sustained expansion in 2003 upon the conclusion of hostilities in Iraq. As we have noted in the past, the economy surged in the first and third quarters of 2002, with growth of 5% and 4% respectively. The second and fourth quarters produced anemic activity averaging just under 1.5%. This irregular pattern took its toll on both business psychology and investor confidence. Businesses were and remain reluctant to spend on capital improvements and to make permanent additions to their employment rolls because of demand uncertainties. Meanwhile, investors grappled with the quality and quantity of reported corporate profits and heightened geopolitical risks from Iraq to North Korea to the Mideast.

For this year, assuming a reasonably quick end to the Iraqi war, we expect real GDP to advance at an annual rate of 2.0 – 2.5% in the first half, modesty below our prior forecast, and to accelerate to above 3% during the balance of the year, in line with our earlier expectations. While ongoing global uncertainties make forecasting unusually difficult, as the Federal Reserve noted earlier this week, continued gains in real disposable income and stable employment trends should support growth of 2.5 – 3.0% in consumer spending, which accounts for approximately two thirds of total U.S. economic activity. Continued improvement in corporate profits, which have been growing at a rate of 12% during the past two quarters, and the need in some business sectors to replace obsolete equipment, will support a moderate but notable recovery in capital spending. Since corporate managers continue to maintain inventories at record low levels, future gains in consumption should translate into a pick-up in industrial production.

Moreover, with inflation in check, the Fed will continue its accommodative policy which is conducive to an extension of the current economic expansion. The Fed is likely to keep short-term interest rates low until the economy is able to demonstrate both sustainable job creation and GDP growth above 3%. As for prices, we find little justification to fear the broad deflation risks certain dour market savants surfaced only a few months ago. Rather, we see prices, as measured by the CPI, rising at a benign 2% rate this year.

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Given the recent trend of uneven, subpar employment growth, we expect the administration to press for additional fiscal stimulus this year. While the eventual shape of the tax bill will hinge, to some degree, on President Bush's clout following the current Gulf war, we believe it is unlikely his proposed tax bill will be enacted as originally presented. The most likely outcome of the political process will be a modification of the dividend tax relief proposal.

Stock Market Outlook

While over the very near term, both the economy and the stock market are likely to remain hostage to the ebb and flow of our fortunes in the war with Iraq, we believe equities have over the past nine months been in the process of forming a broad base from which a significant recovery is highly likely. This rebound should be supported by the following factors:

- Recovering economy and corporate profits
- Benign inflation and interest rates at 40 year lows
- Accommodative Fed monetary policy
- Substantial fiscal stimulus
- Attractive stock valuations particularly when compared with bond yields (Exhibit A)
- Falling energy prices
- Huge cash positions poised to seek higher returns
- Depressed sentiment consistent with major stock market bottoms

In addition, we have enclosed Exhibit B which shows market returns since 1926 from which we draw two inferences of importance. First, the market has already suffered a material decline rare in both magnitude and duration. Historical precedent for further major deterioration is lacking. In fact, an eventual reversion to the mean from these depressed levels is likely. Second, long-term stock returns have averaged 10.2% per annum, inclusive of major bear markets. Changes in the

business outlook and in investor sentiment have always caused sharp swings in stock market returns over shorter periods of time. Market sentiment inevitably swings from euphoria to extreme pessimism and back. Investors would do well not to conclude that subpar short-term returns from equities are a precursor to diminished future returns from stocks.

Equity Strategy

As for the mix between *growth* and *value* shares in client's portfolios, which defines our investment approach and distinguishes us from other advisers, we increased *growth* stock holdings last year to 60% with the remaining 40% in *value* stocks. This tactical shift was implemented in recognition of the tendency for *growth* to out perform *value* following the inflection point in the corporate profits cycle. Interestingly, while the entire stock market has declined over the past nine months, large cap *growth* has outperformed large cap *value* by almost 9½ percentage points following a period of over two years in which the advantage went to large cap *value* by a wide margin. Our continued commitment to high quality, dominant technology companies within the *growth* category has positively impacted portfolio performance since the market lows of early last October and year-end 2002 as the following table demonstrates:

	Performance Since	
Sector	Market Low (10/9/02)	12/31/02
Technology	+36.7%	+7.3%
Utilities	+20.5%	-4.8%
Telecommunications	+15.1%	-12.4%
Basic Industries	+14.5%	-4.3%
Financials	+14.1%	-3.8%
Diversified Industrials	+10.3%	-3.3%
Consumer Discretionary	+8.4%	-0.4%
Energy	+7.8%	+0.4%
Health Care	+3.1%	-0.4%
Consumer Staples	-6.7%	-5.7%
S&P 500	+11.6%	-1.5%

Source: Baseline Financial Services

Bond Market Outlook

We continue to believe that intermediate and long-term interest rates will reverse their downward course, putting an end to the 20 year secular bull market for bonds, as expectations for a firmer economy take hold and investors begin to discount the longer-term possibility of higher inflation. For that reason, we have substantially shortened bond portfolio maturities to protect clients from future losses in their bond portfolios. In the short term, however, because geopolitical uncertainties remain high, interest rates are likely to remain at or near their recent levels. The Federal Reserve will maintain its current Federal Funds rate target at 1.25% until further evidence of a durable pick-up in economic activity accumulates. Once the fog of war lifts, as we expect it soon will, investors will shift their focus to the continuing economic recovery, which should drive rates higher providing a better opportunity to invest the fixed income reserves we have been building in client's portfolios.

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Finally, while we recognize this has been a difficult and unsettling time for investors, we remain confident that the fundamentals for the long-term prosperity of our economy remain intact. We remain committed to our investment approach which has served our clients well in the past and, we believe, will serve them well in the future.

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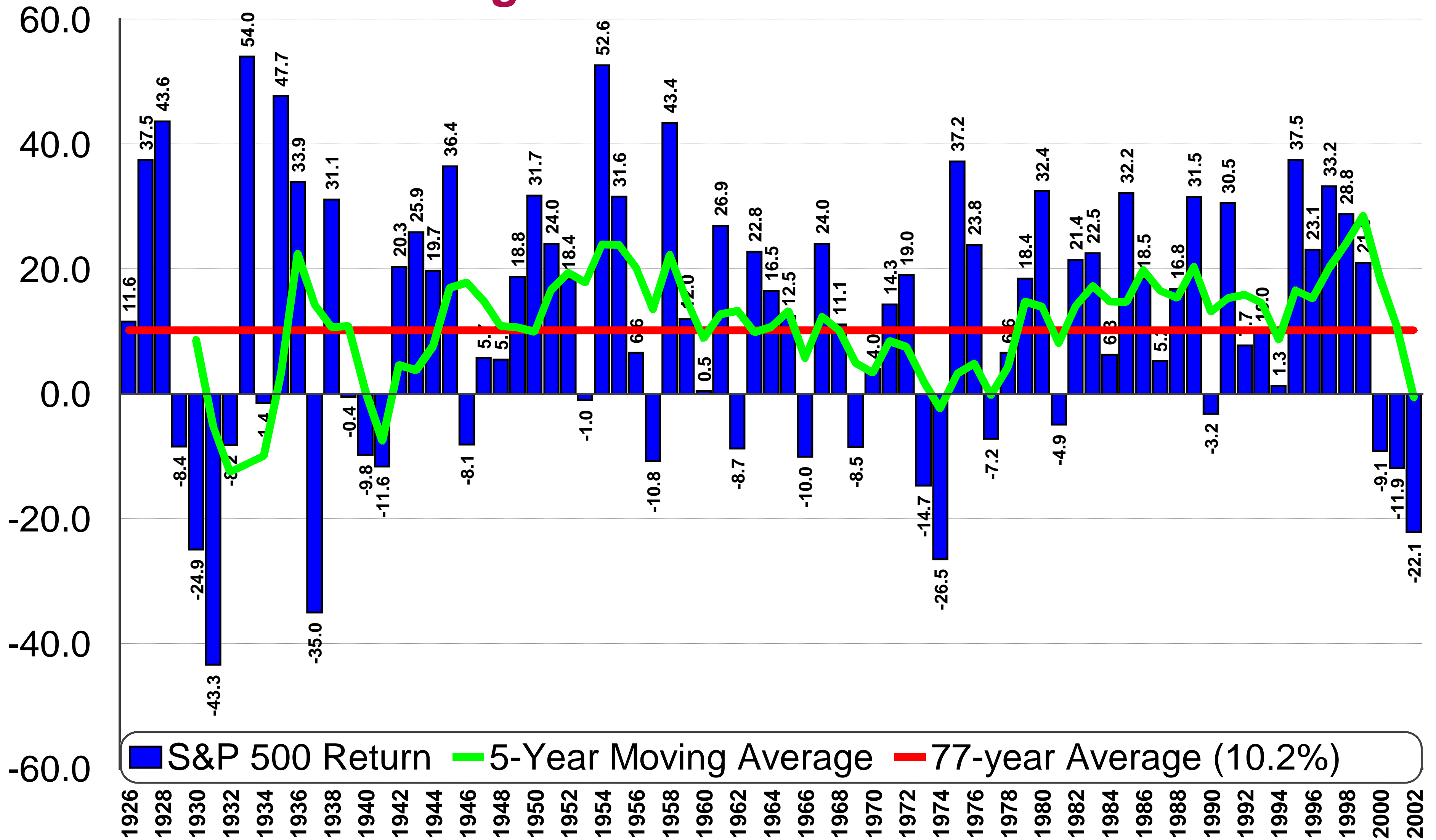
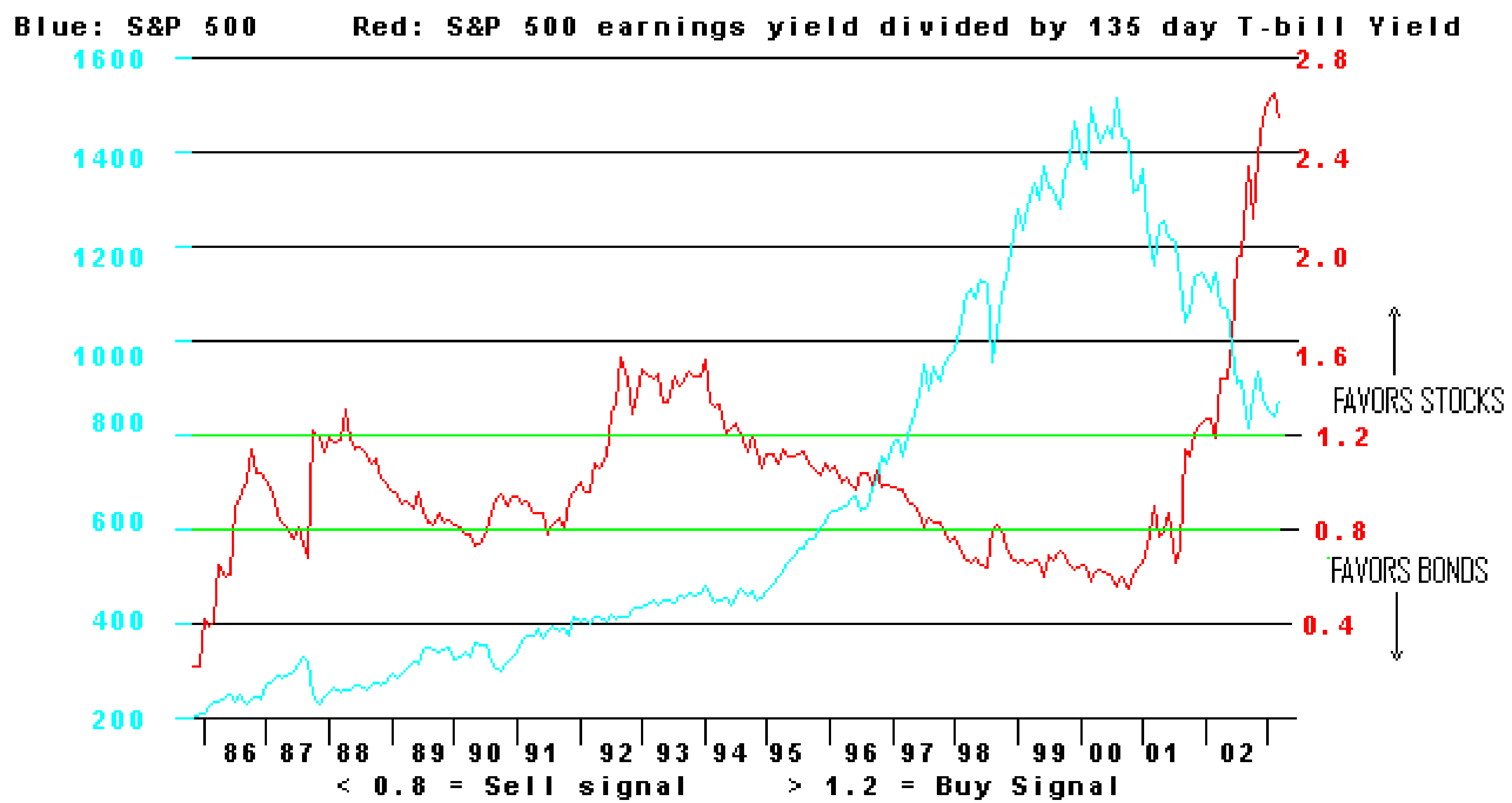
Historical Market Perspective

Regression to the Mean?





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Source: Bridge Information Systems