FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

August 14, 2003

THE ECONOMIC OUTLOOK - - GROWING CONFIDENCE

Data released subsequent to our most recent Economic Outlook presents convincing evidence of an acceleration in business activity following the conclusion of major hostilities in Iraq in April. Further, we believe the economy gained additional momentum as we entered the current quarter. The accommodative Federal Reserve policy, fiscal stimulus in the form of lower marginal tax rates and rebates, improved consumer and business confidence, the weaker dollar and a huge wave of mortgage refinancings have combined to provide the impetus for this more rapid growth. Indeed, our firm's proprietary Economic Model, a copy of which is attached, is signaling a strong economic recovery. We have, therefore, revised upward our forecast for third and fourth quarter real GDP growth to 4%+ and we expect this strength to persist into 2004. Among the signs of this more rapid rate of recovery are the following:

- *Preliminary second quarter real GDP growth of 2.4%,* exceeding most analysts' expectations, was well above the 1.4% reported in the prior quarter and is likely to be revised higher by as much as 0.5%. Consumer spending, which accounts for two thirds of GDP, rose 4.6% with outlays for durable goods meant to last at least three years surging 22.6%. Meanwhile, the Commerce Department also reported business spending, which has been a notable drag on the recovery since late 2001, rose 6.9%, the largest increase in three years. A careful analysis of business spending data reveals the bulk of the improvement occurred in purchases of computer equipment and software which has staged a stealth recovery over the past six quarters as shown in the first panel of the chart below:

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

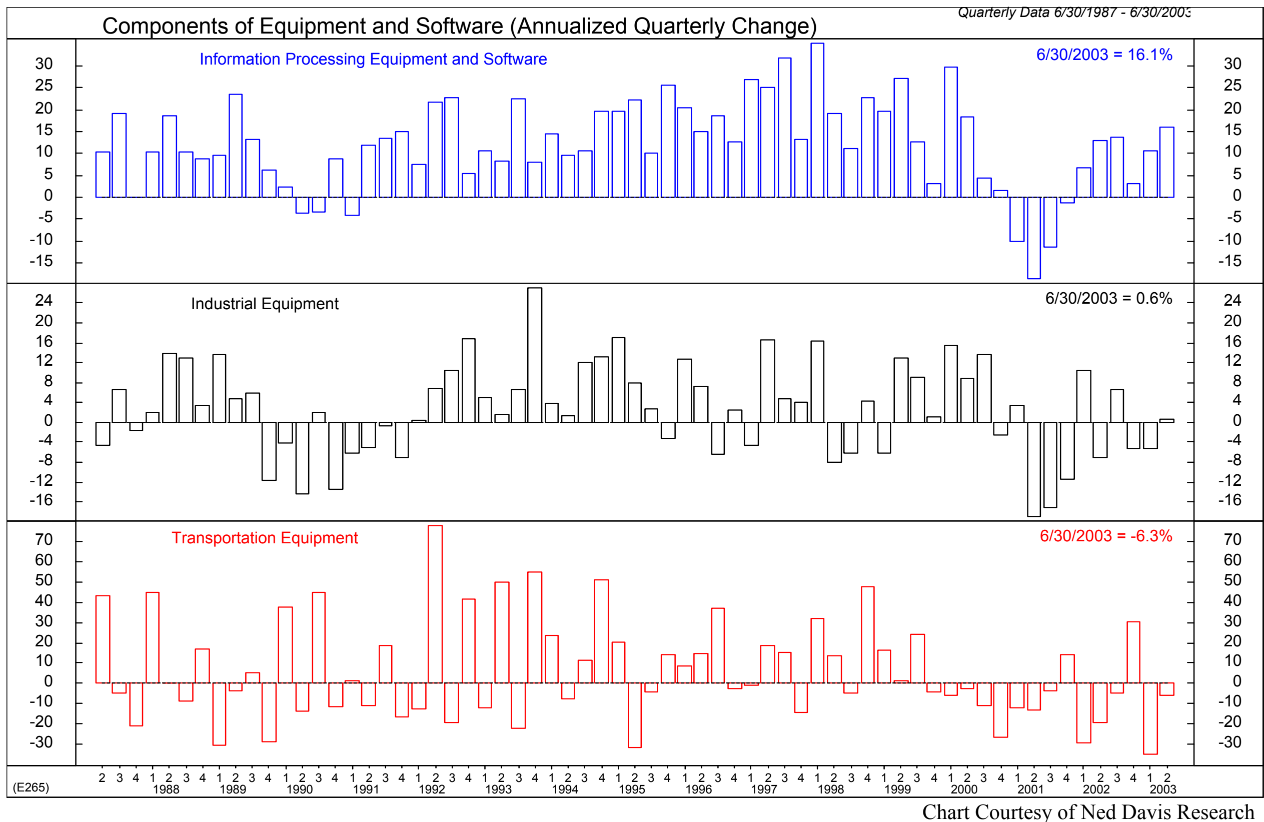

Chart Courtesy of Ned Davis Research

- *The July Institute for Supply Management (ISM) reports for both the manufacturing and non-manufacturing sectors* portrayed the economy as expanding with little inflation. The ISM Manufacturing Index rose for the third consecutive month. Most importantly, the new orders component of this report surged signaling the likelihood of increased future production. The ISM Non-manufacturing Index has improved for four consecutive months reaching a new record high in July, mirroring the strength we have seen in employment growth in the services sector of the economy.
- According to the Department of Commerce, *July retail sales* spurted by 1.4% from June levels, better than most expectations and providing confidence our upwardly revised third quarter GDP forecast will be realized. This increase in spending is, in our view, directly traceable to improved consumer confidence following the war and tax relief in the form of rebates and lower marginal tax rates.
- *US productivity has remained robust,* expanding by 5.7% last quarter - - more than double the long-term trend. Strong productivity gains have almost single-handedly supported the expansion in corporate profits since the end of 2001. Interestingly, analysts estimate that, on average, it now takes only 91 workers to produce the same amount of goods and services as 100 workers were able to produce at the start of the last recession in March

2001. Improved productivity also allowed employers to increase employees real incomes during the business slowdown which explains the resilience in consumer spending during the period.

- *Initial jobless claims,* though volatile from week to week, have shown an improving trend with claims now below the important 400,000 level for four consecutive weeks. This trend signals the likelihood we are close to a turnaround in the lagging jobs market.
- *Corporate profit growth has continued the recovery* which commenced at the end of 2001. This measure advanced at an estimated rate of 13.5% in the second quarter, ahead of analysts' expectations of roughly half that amount and nearly twice the 7% long-term trend of corporate profit growth.

The media and Presidential aspirants, skeptical of the unfolding economic recovery, have highlighted the lagging labor market. While job creation has traditionally trailed improvement in the overall economy, factors unique to this current business cycle have caused the labor market to remain weaker than normal for an extended period of time. To sustain and strengthen the economic recovery, we will need to see a resumption of employment growth. With inflation quiescent, the Fed has promised to cooperate by keeping monetary policy stimulative for the foreseeable future. Bank lending to businesses is on the rise. Corporate profits are improving rapidly. Corporate decision makers now appear to be more confident as is evidenced by the recent awakening of interest in mergers and acquisitions. And, the recent tax bill provides powerful new incentives for business investment. We believe these factors lay the groundwork for an increase in hiring this fall.

Fixed Income Strategy

Bond investors have experienced a sea change in expectations over the past three months. During May and the first half of June, fixed income investors bid up bond prices, driving yields to 40 year lows in reaction to the spreading belief the Federal Reserve would resort to "unconventional measures" (i.e. purchasing long-term bonds in the open market) to avert deflation. Ten year US Treasury bond yields fell from about 4.00% at the end of April to 3.10% by mid-June. Yields then abruptly reversed course on June 16th and have risen by 1.5 percentage points since, reflecting growing evidence of the economic recovery, mounting budget deficits, continued rapid money supply growth and the realization (since confirmed by Fed Chairman Greenspan during his semi-annual Congressional testimony on monetary policy) that the Fed would *not* buy long term US Treasury bonds to stem deflation. Adding to the bond market's volatility during this period has been the portfolio hedging moves by mortgage lenders responding to the abrupt changes in

yields. To put this in perspective, the recent backup in rates only returns us to yield levels of a year ago which, at the time, were viewed as relatively low and stimulative to the economy. In fact, 30 year fixed rate mortgages, currently at 6%, remain below year ago levels which fostered record home sales. Contrary to some analysts' views, we do not see the recent rise in rates choking off the nascent economic recovery.

In the anticipation of higher bond yields, we have for months been reducing portfolio duration and retaining cash earmarked for bonds. At current yields, bonds are closer to fairly compensating investors for the interest rate risk they take in holding these securities. Any further general weakening in bond prices will, we believe, provide an opportunity to lengthen bond portfolio duration.

Equity Strategy

Equity portfolios under our supervision remain fully invested and tilted toward *growth* shares, with the current mix approximately 62% *growth* and 38% *value*. Presently, large sector concentrations are being maintained in consumer discretionary, financial, technology, and industrial goods companies whose earnings, we believe, will be positively impacted by the business recovery. For example, in recent weeks we have added to holdings in the retail and manufacturing areas. Conversely, we have underweighted energy and consumer staples shares which performed well during the bear market but have lagged this year. This strategy has positively impacted performance for the year-to-date with our typical equity portfolio now ahead 17.0% after fees as compared with the benchmark S&P 500 Index up 13.9%.

The recent change in the tax law, reducing tax rates on both dividends and capital gains to 15% has occasioned questions from clients as to whether we plan to alter our stock selection criteria in favor of issues providing higher current yields. While we view this tax policy change as being favorable for investors, we do not believe a change in stock selection strategy is warranted. Academic studies and our own analysis show companies providing a growing stream of dividends generally produce superior long term total returns as compared with firms providing high, but static, current yields. Since the inception of our firm, we have had a preference for those companies whose shares have provided superior dividend growth reflecting the underlying strength of their businesses. In fact, the stocks currently held in client's portfolios under our supervision have delivered 10.6% annual dividend growth over the last five years as compared with a -0.8% annual decline in dividends for the S&P 500 Index companies.

As we noted in our June 10 client letter, we expected a period of stock market consolidation following the rapid snap back in stock prices this spring. That consolidation continues while corporate profits move higher. We expect the US stock market to resume its advance as investors gain increased confidence in the durability of the rising corporate profits cycle.

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Economic Model