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INVESTMENT COUNSEL

January 16, 2004

THE ECONOMIC OUTLOOK - - A VIRTUOUS CYCLE

At the outset of each new year we review our forecast for the prior year, grading ourselves on how close we came to the mark. At the end of 2002, it was clear to us that an economic revival was highly likely given the enormous monetary and fiscal stimulus impacting the economy. However, with war clouds hovering and business confidence muted, we believed first half growth would remain anemic. Looking back, our proprietary Economic Model (attached) ruled out the "double dip" recession forecast which was prevalent at the time. Our view of the second half of 2003 was for business activity to rise to an above trend growth rate. As it turned out, first half real GDP growth was well within our expectations at 2.4% while second half business growth exceeded our forecast as business activity accelerated sharply following the conclusion of major hostilities in Iraq.

With regard to interest rates, we correctly believed the Federal Reserve would remain accommodative until they were confident the business expansion was sustainable and the risks of global deflation had receded. The Fed has since proven to have been more patient than we anticipated, leaving rates at historic lows despite rapid economic growth, huge budget deficits, the weak dollar and rising commodity prices, which have historically been inflation precursors. Instead, the Fed has chosen to focus on lackluster job growth and few signs of consumer inflation to justify their inaction.

As for the stock market, we strongly believed that US stocks were undervalued. In our March 19 client letter, one week following the market's low, we wrote: "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." Given the backdrop of war, corporate and accounting firm scandals, and three years of bear

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market losses, market analysts were finding receptive audiences for their bearish projections of sub par future stock market performance. Market returns of 5-6% annually were commonly forecast. We disagreed with these dour projections, advising clients to remain fully invested. We wrote: “Market sentiment inevitably swings from euphoria to extreme pessimism and back. Investors would do well not to conclude that sub par short-term returns from equities are a precursor to diminished future returns from stocks.” Indeed, the broad market, as measured by the S&P 500 Index, our performance benchmark, rose 28.7% in 2003, while equity portfolios under our supervision, on average, advanced approximately 32% (after fees).

Lessons For The Future

Last year provided an abundance of lessons which investors would do well to keep in mind during future periods of economic and financial market uncertainty. Among these are the following:

- **Stimulative monetary policy is still a powerful tool**. Despite frequent assertions that the Federal Reserve had lost its effectiveness and by repeatedly lowering rates it was only “pushing on a string”, the economy has, indeed, responded to monetary ease. It is no accident that with rates at 45 years lows we have experienced the largest wave of refinancings in history.

- **Tax policy does influence behavior**. As intended, recently enacted reductions in capital gains and dividend taxes, lower marginal income tax rates and enhanced depreciation benefits for capital investments have combined to spur business investment and boost asset values. Never underestimate the economic impact of Washington’s policies, particularly as we approach a presidential election.

- **American consumers will continue to consume**. Studies show consumer spending growth has for decades been remarkably stable despite the wide range of economic conditions we have encountered. Most recently, forecasts contending consumers would curtail their outlays in the aftermath of 9/11, two wars, ongoing threats of terrorism, weak labor markets and mounting debt loads proved to be inaccurate. Don’t bet against the US consumer.

- **Capital spending and hiring are closely tied to corporate profits**. While there has been apprehension that business spending and hiring would not recover, a review of economic history shows that as corporate profits improve companies eventually invest in new equipment and hire more people. Spending, particularly for technology, has been improving since outlays troughed late in 2001. While hiring has lagged for reasons unique to this cycle (i.e. unprecedented productivity growth and the exporting of jobs), we should soon see improved job growth.

- **The American economy is resilient and dynamic**. American corporations have a record of promptly responding to adversity through restructuring and innovation. This dynamism allows the US economy to better absorb shocks and to quickly resume its growth. Those who feared the US economy was headed into a decade long period of stagnation similar to the Japanese experience ignored both the structural and cultural differences between the two systems.

- **Foreigners will not abandon US assets**. Despite record low interest rates and a depreciating dollar, massive sales of US assets by foreigners have not occurred. Our political stability, the enormous size and liquidity of our financial markets and the integrity of our legal system assures the dollar will remain the world's dominant reserve currency. Indeed, we may have already experienced most of the dollar decline likely in this cycle.

The Outlook for 2004

We expect the current positive momentum in the US economy to continue resulting in above trend GDP growth of 3.75% to 4.25% this year. This view is confirmed by our Economic Model. Corporate profits should expand at a mid-teens growth rate as companies have larger volumes of business to run through their leaner operations. Whereas in 2003 profit gains were largely attributable to cost reduction efforts, companies this year will also have the benefit of volume growth with operating leverage on full display. While the unemployment rate has fallen from 6.3% last summer to 5.7% currently, new job creation has lagged. We expect job growth to accelerate as the year progresses with the unemployment rate falling to 5.3% by year-end. The Fed will remain on hold at least through mid-year although open market interest rates should begin to creep up before the Fed actually begins to tighten. In short, over the next several months, we expect a

business climate robust enough to generate above trend profit growth without the kind of inflation that would cause the Fed to take the proverbial "punch bowl away."

A Virtuous Cycle

We believe we have transitioned from an economy driven by fiscal and monetary stimulus to one in which corporate profits are generating self-sustaining growth. The attached flow chart illustrates this *virtuous cycle*. Resurgent profits are strengthening corporate balance sheets, providing businesses with both the confidence and wherewithal to invest in new equipment and to hire additional workers. Orders for new equipment then stimulate demand at all levels of the economy. Newly employed workers, along with those already employed, spend their wages creating further demand for goods and services. Profits continue to grow and the economy expands until a major shock reverses the momentum.

Investment Policy

Given the favorable economic and corporate profits backdrop described above, we believe the prospects are favorable for further gains in the equity market this year. While equities had a substantial recovery in 2003, stock market valuations remain attractive - - particularly when compared with returns expected for fixed income securities. The attached copy of the Fed Valuation Model confirms this viewpoint. The principal risk to our favorable forecast for stocks, aside from the obvious geopolitical issues, is a sharp and sustained rise in interest rates, to which we now assign a low probability for the next several months. We, therefore, remain fully invested in equities.

Despite the high likelihood that fourth quarter 2003 earnings will generally exceed Wall Street expectations, providing encouragement for investors with large uncommitted cash positions to add to their stock holdings, we are likely to experience a consolidation of last year's outsized gains over the near term. Short term market indicators we regularly monitor, particularly those measuring the over-the-counter market, appear to be temporarily overbought. However, as the year progresses and reported profits move further into record high ground, we believe high quality large cap stocks will outperform the smaller cap lower quality shares which last year enjoyed stellar recoveries. Given this change in market leadership, we expect the broad US stock market indices to make new highs over the next 18 to 24 months. Interestingly, it was less than a year ago that conventional wisdom among many investors and Wall Street savants that the 2001

recession and subsequent corporate governance scandals had caused so much damage to investor's willingness to take risk that it might take as long as a decade for shares to recover their 2000-2002 losses. Stay tuned.

So far as the blend of equities between *growth* and *value* shares, the investment approach which distinguishes us from other advisors, we remain tilted toward *growth* stocks which currently represent about 62% of our equity position. In search of operating leverage in an improving environment, we have allocated a substantial portion of our equity portfolio to leading companies in technology, diversified manufacturing and media. Additionally, we have been building positions in high quality health care companies which we view as undervalued. We remain underweighted in energy, utilities, and consumer staples.

The outlook for bonds remains problematic. While bond yields may remain at or near current levels for some time, we continue to focus on the risks associated with holding bonds during periods of rising rates. To protect the principal value of client's bond portfolios, we have reduced durations and continue to hold funds earmarked for bond purchases in short term instruments in the expectation of opportunities to extend maturities as rates rise later this year. While this conservative bond strategy has caused us to forgo some modest amount of income which longer maturities would have captured during this period of low rates, we believe it remains prudent.

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PROFITS ARE DRIVING A VIRTUOUS CYCLE

LOW INTEREST RATES AND STIMULATIVE FISCAL POLICY "PRIMED THE PUMP" AS WAR FEARS RECEDED.

PROFITS RECOVER TO RECORD LEVELS AND CONFIDENCE RETURNS.

BUSINESSES INVEST IN NEW EQUIPMENT AND BEGIN TO HIRE.

FACTORY ORDERS RISE, CONSUMER SPENDING GROWS, STOCK APPRECIATION AUGMENTS WEALTH, AND CORPORATE AND INDIVIDUAL BALANCE SHEETS ARE STRENGTHENED.

SELF-SUSTAINING GROWTH

SELF-SUSTAINING GROWTH

Fed Valuation Model

The Fed stock market valuation model, which incorporates the yield on 10 year US Treasury Notes and estimated S&P 500 profits, shows stocks remain undervalued.

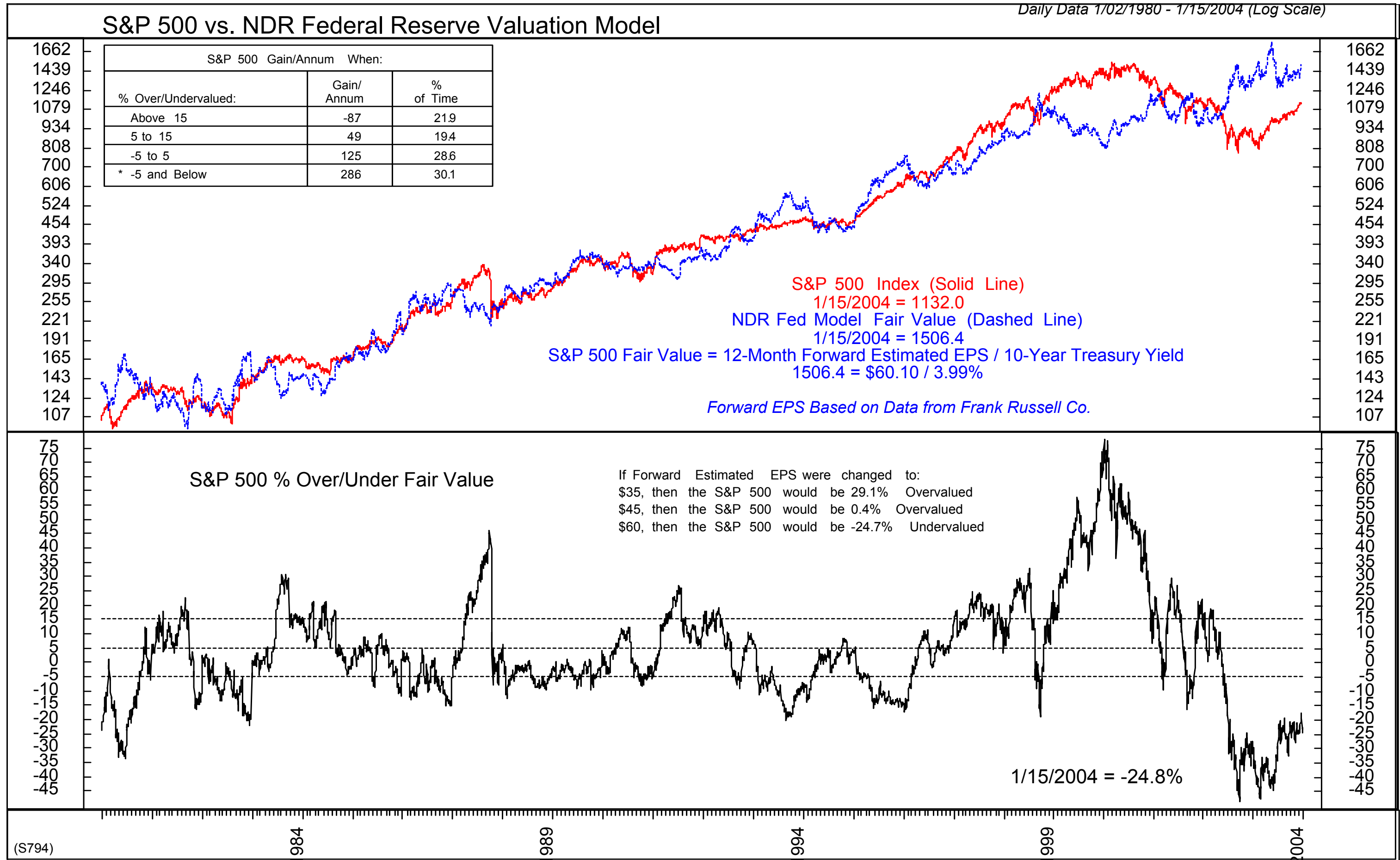

Chart Courtesy of Ned Davis Research

Economic Model