FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

February 10, 2004

ECONOMIC UPDATE - - FIRING ON ALL CYLINDERS

Labor Market Trends

On the surface, the Labor Department's January employment report released last Friday shows employment growth has improved moderately in recent months but is still falling short of economist's optimistic expectations. While most recent indicators of economic activity point to a continuing robust expansion, the economy has added only 73,000 jobs a month since September according to the Bureau of Labor Statistics (BLS) *payroll* survey. Overall, this survey shows 776,000 jobs have been lost since the current business expansion began in November 2001. However, another monthly BLS survey, that of *households*, reports that 2.2 million jobs have actually been created during this same period. Many economists, including those at the bureau, continue to regard the *payroll* survey as a better indicator of employment growth because of its broader sample size. But, as we have pointed out in earlier client letters, the *payroll* survey does not capture the self employed - - a group that grows in periods of weak labor markets - - nor does it adequately survey new and smaller businesses. So, while the *payroll* survey showed 112,000 new jobs last month, the *household* survey indicated a jump of 496,000 jobs in the same period. - - more consistent with the economy's vigor. Now that productivity (2.7%) has fallen below GDP growth (4.0%), companies will need to add to staffs in order to accommodate incremental business. The differential between the two surveys should then begin to narrow.

Meanwhile, the headline unemployment rate has now dropped from a peak last year of 6.3% to 5.6% in January. We continue to forecast a 5.3% unemployment rate by year end. The payroll survey should show monthly gains of 200,000 to 300,000 later this year, despite the continued migration of jobs overseas. The fact that employment growth at large establishments has lagged in this cycle has positive implications for investors. First, the Federal Reserve has leeway to leave rates where they are for awhile longer. And second, slack labor markets limit cost pressures and enhance profitability.

Recent Economic Data

Economic data released since our last client letter in mid-January supports our view that the momentum with which the US economy entered the new year continues unabated and that for the first time since the mid 1990's a broad global expansion is unfolding. Consider the following:

- Both the Index of Leading Economic Indicators (LEI), assembled by the Conference Board, and our firm's proprietary <u>Economic Model</u> have improved for eight consecutive months signaling continued economic expansion for the balance of this year;

- Fourth quarter 2003 real Gross Domestic Product (GDP) has been initially reported at 4.0%. As expected, while growth moderated from the third quarter's torrid 8.2% reading, it remains well above trend;

- The Federal Reserve Board's Senior Loan Officer Opinion Survey on Bank Lending Practices reported that during the past quarter domestic banks experienced strengthening demand for commercial and industrial loans from firms of all sizes and that banks had eased their lending standards. This represents a considerable change suggesting corporate balance sheets have strengthened and capital spending and expansion plans are being executed;

- S&P 500 corporate profits in the fourth quarter appear to be on track for surprisingly strong 26% growth. As we noted in our January <u>Economic Outlook</u>, companies are finally benefiting from unit growth in addition to the cost cutting that drove much of their profit improvement last year. Indeed, the S&P 500 companies are likely to report 9% revenue growth for the recently completed quarter. We expect a further rise of 12% to 15% in corporate profits in 2004 providing the underpinning for double digit stock market gains;

- Weekly initial unemployment claims continue to trend lower, averaging just over 340,000 for the past four weeks. As a point of reference, claims peaked at approximately 525,000 in late September 2001. Many economists have pointed to 400,000 as being the dividing line between a growing labor market and one shedding jobs. Interestingly, we have not had a reading over 400,000 since September 2003, and the Labor Department has reported net job creation in its non-farm payrolls report each month since last August;

- The Institute for Supply Management's (ISM) manufacturing index rose to 63.6 in January. This marks the third consecutive month with a reading in excess of 60, momentum not seen in a generation. A subcomponent of this index, reflecting new orders, stood at 71.1- - near its highest level in 30 years. Finally, on the all important issue of future job creation, the employment component of this index remained above 50 signaling expansion for the third consecutive month;

- The ISM non-manufacturing index surged to an all-time high of 65.7 in January. This reading, portending expansion for the tenth consecutive month, suggests a resurgence of momentum in the dominant services sector of our economy. In retrospect, this index troughed at 40.5 in October 2001, one month prior to the official end of the recession;

- The University of Michigan Consumer Sentiment Index, continuing its uptrend from its March 2003 lows, surged to 103.8 in January. This is a level consistent with readings for most of the 1997-2000 period, an era of well-above trend economic activity and confidence. The Conference Board's Consumer Confidence Index also confirms this improving trend, though their survey remains at a level below that registered in the late 1990's;

- The Semiconductor Industry Association reported that 2003 revenues from chip sales rose 18% to $166 billion. Perhaps more important, the industry entered this year with considerable momentum as sales during the final three months of 2003 grew by 30% over the prior year. Demand is coming from a variety of product categories and geographies, and pricing has firmed;

- Japanese machine tool orders rose 25.9% in 2003, the first annual growth in three years. Demand grew approximately 26% both domestically and for exports, providing encouragement the Japanese economy, moribund for a decade, is now contributing to global growth, and;

- US machine tool consumption rose 15.4% in December to $220.9 million indicating a turnaround from a multi year period of erosion.

On balance, the economy's performance is impressive and well balanced - - firing on all cylinders.

Equity Portfolio Strategy

Overall, we see real US GDP growth at a 3.75% to 4.25% rate in 2004, inflation remaining quiescent and strength broadening out from the consumer sector to business. Stock portfolio concentrations in the technology, industrial capital goods, and consumer discretionary areas - - all economically sensitive - - should continue to benefit from the robust expansion we forecast. Additionally, we have made further purchases of pharmaceutical company shares where high returns on equity, reduced regulatory risks, compelling market valuations and possible dividend increases make them particularly attractive. Financials remain important core holdings given the likelihood the Federal Reserve will move only slowly and cautiously when it begins to raise rates later this year. Following last year's impressive snapback in investor confidence and strong stock market performance, a period of consolidation is to be expected. Furthermore, election year politics tend to magnify the short-term economic hiccups which inevitably crop up. Beyond this period of consolidation, stock prices will eventually reflect the favorable outlook for corporate profits.

Current stock portfolio concentrations are as follows:

Top 5 Sectors	# of Holdings	FBA Portfolio Weightings	S&P 500 Weightings
Technology	7	24.8%	17.8%
Financials	5	17.5	20.9
Consumer Discretionary	6	17.4	11.0
Health Care	5	15.1	13.6
Industrial Capital Goods	4	13.3	10.8
Total	27	88.1%	74.1%

We remain underweighted in energy, utilities, and consumer staples.

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We are pleased to announce that Brad R. Peterson became a member of our Limited Liability Company on January 1, 2004

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