FRONT BARNETT ASSOCIATES LLC
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ECONOMIC UPDATE - - BUSINESS DRIVES EXPANSION

Following a long period of caution, US business leaders have thrown off their prior conservatism and are adding to their staffs, making capital investments and acquiring other companies. This increases the likelihood most analysts' prior expectations for business growth will turn out to be short of the mark. In fact, recent surveys show forecasts for first quarter GDP growth have moved up to 4.0% from about 3.5% and that full year GDP estimates have risen to 3.8% from 3.6% only a few weeks ago. While full year results are likely to trail the 4.4% pace of 2004, business activity remains well above-trend and supports continued profits improvement.

Until recently, the economic rebound from the brief 2000 recession was largely driven by consumer spending stimulated by tax cuts and a very accommodative Federal Reserve. Now, newly released data confirm business has become the nation's expansion engine as newly confident companies, flush with cash, add to payrolls and buy machinery to meet expected future demand. The weaker dollar is also aiding US manufacturers by making exports more competitive, thus providing an additional impetus for increased capital investment and hiring.

Government data provide the following evidence of this change in business attitudes:

- Employers added 262,000 jobs in February, double January's pace, and materially higher than the average monthly job creation of 182,000 during the past six months, according to the Department of Labor.

- The Department of Commerce reported orders for non-defense capital goods (excluding aircraft) grew 2.9% in January. Economists had expected a decline in orders following the December expiration of a temporary tax break for business investment. Interestingly, spending on equipment and software rose 13.5% last year, including an 18% surge in the fourth quarter - - the best annual performance since the late 1990's technology boom.

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The strong employment and durable goods reports are among a series of positive business indicators released since the start of the year including:

- The Institute of Supply Management (ISM) non-manufacturing index continues to signal expansion rising to 59.8% in February. The employment component of this index rose 7.4 points to a record 59.6%, while new orders increased to a strong 61.6% reading.

- The ISM manufacturing index stood at 55.3% in February, with the export component, driven by the weaker dollar, increasing to 57.4%.

- US construction outlays exceeded most expectations with 0.7% growth in January. Importantly, the Commerce Department reported activity broadened out to non-residential as well as residential construction.

- Chain store sales were surprisingly strong in February despite high energy prices. For example, Wal-Mart, the nation's leading retailer, reported 4.1% same stores sales growth, its strongest performance since last May.

- Fourth quarter GDP was revised up to 3.8% from 3.1% by the Commerce Department, with exports and business spending more robust than originally reported.

While we expect consumer spending to remain steady, we believe it is unlikely to play as much of a leadership role in overall economic growth this year despite continued job gains. Budget deficit concerns make additional fiscal stimulus unlikely. Additionally, elevated energy prices, modest wage growth, little pent-up demand, and higher interest rates should preclude a surge in consumer spending.

All in all, this economic data supports our earlier forecast of above-trend 3.5% to 4.0% GDP growth for 2005, with the actual results likely to come in toward the upper end of the range. In our January client letter, we presented our expectation of 8% to 10% S&P 500 company profit growth, which, at the time, was above the consensus view of 6% profit expansion. Recent economic data, along with anecdotal evidence from many companies, increases the likelihood analysts will be raising their earnings estimates toward our view over the months ahead.

Interest Rates

Over the past month, the long awaited rise in longer-term interest rates has finally commenced. The yield on the 10-year US Treasury obligation has risen by over

half a percentage point to 4.51%. The initial catalysts for this run-up in yield were comments from Alan Greenspan who viewed the then current yield of 4.0% to be a "conundrum", and unconfirmed rumors of foreign central bank plans to hold fewer dollars. In addition, inflation readings and forecasts, while still moderate, have ticked up. Commodity and energy prices remain in an up-trend and the labor market appears to have tightened a bit with job growth accelerating. Lastly, the Fed's most recent "Beige Book" report noted that manufacturers in a number of districts have been finding it increasingly easy to raise prices. Taken together, there is enough of a whiff of inflation in the air to shake the complacency of bond investors who are now demanding higher yields. This comes as no surprise to us as we have been forecasting higher bond rates for some time. We continue to believe 10 year US Treasury bond yields will rise to the 5.0% level as the Fed hikes short term rates to our target of 3.5% by this summer. While we continue to maintain large cash reserves for bond purchases at higher yields, the time to extend maturities may be fast approaching. Stay tuned!!

Equity Investment Policy

Given our expectations for a mix of above-trend economic and corporate profit growth, the strengthened financial position of US corporations, and rising interest rates, we believe equities are likely to outperform both cash and bonds. Confirming this view is the Fed Valuation Model, to which we have referred in the past, which shows stocks to be 26% undervalued at current levels. By another measure of valuation, the stock market is currently selling at about 17 times this years expected earnings, in line with historical norms and low when compared with earlier periods of benign inflation. Absent a geopolitical shock, we believe there is limited risk in the stock market from current levels, though we are mindful stocks may mark time until investors see with greater clarity an end to the current round of Fed tightening. In many ways, this is reminiscent of last year where, against the backdrop of a favorable economic environment, the stock market went nowhere until the major uncertainty (i.e. the outcome of the Presidential election) was resolved. By the time the year is over, we expect stock prices to have advanced in line with corporate profits growth.

In our January client letter we discussed in detail the rationale for our current sector allocations which overweight technology, health care and consumer discretionary shares - - all out-of-favor groups. We see no reason to materially alter this strategy which translates into a 61/39 tilt toward *growth* shares. Our two largest underweights are financials, which face the headwinds of rising interest rates and a flattening yield curve, and energy where we believe speculation has driven prices to unsustainable levels. Despite this concern, we have concluded that the major international oil companies are likely to remain more profitable than we had previously anticipated, even if oil prices decline in the open market as we expect they will. Therefore, we initiated modest positions in two major integrated oil companies which sell at reasonable valuations and pay dividends averaging just above 3% as a hedge against prices remaining higher for a longer period than we anticipate.

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