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THE ECONOMIC OUTLOOK - - MOMENTUM REGAINED

Despite a litany of concerns including higher short-term interest rates, $70 crude oil, devastating hurricanes, sluggish growth in inflation-adjusted wages, and predictions the era of rising homes prices is ending, data shows the US economy *post-Katrina* to have been resilient with considerable momentum which we believe will translate into solid growth this quarter and to further gains in 2006. Consider the following:

- Friday's Labor Department report provided evidence the economy emerged relatively unscathed from the most damaging hurricane season in recent history. Non-farm payrolls grew at an annual rate of 215,000 jobs in November -- after adding only 44,000 jobs in October and 17,000 in September in the wake of the storms -- suggesting employers are actively seeking workers in a strongly growing economy despite global competition and corporate layoffs which are weighing on job growth. Hiring last month was widespread, covering nearly two-thirds of the nation's industries, the best showing since May 2004. Interestingly, the Bureau of Labor Statistics reported that at least 900,000 people ages 16 or older evacuated hurricane ravaged areas in August and that only half had returned by last month, presumably to jobs.

- The Commerce Department reported last week that third quarter GDP growth, the broadest measure of US goods and services, was revised upward to a 4.3% annual rate -- the most rapid growth since early 2004 – driven by robust consumer outlays and greater business spending than had been forecast.

- The June to September GDP report also contained good news on inflation. Consumer prices excluding food and energy, the Federal Reserve's preferred inflation gage, rose at a 1.2% annual rate -- the lowest core-inflation reading in more than two years -- despite persistent raw material price pressures and the ability of some firms to finally pass on higher costs to consumers, according to another Fed report.

Other, less widely publicized, reports confirm both the economy's strength and moderating inflation in the *current* quarter.

- Construction outlays rose 1.7% in October, exceeding economists' forecasts, benefiting from a 1.9% increase in public–sector spending -- the biggest increase since February.

- Incomes from wages and salaries increased 0.6% in October, the largest advance in three months.

- Factory activity remained strong in November. The Institute for Supply Management (ISM) reported that its manufacturing index, considered the best real-time gauge of the economy's health, stood at 58.1. (A reading above 50 indicates expansion. This index has been above 50 since May 2003.) Manufacturing activity has clearly rebounded after some scrambling in the wake of the hurricane supply disruptions and, in our view, gives evidence momentum in this sector will carry over into the New Year.

- Factory orders rose 2.2% in October after a 1.4% September drop.

- The November ISM non-manufacturing index also exhibited strength with a positive reading of 58.5.

- The core personal consumption expenditure price index increased only 0.1% in October, bringing its year-over-year increase down to 1.8% from 2.0% in September -- the smallest year-over-year increase in this measure since February 2004. Fed officials have made it clear they want core consumer inflation to remain contained between 1% and 2%. Easing inflationary pressures portend an end to Fed rate increases next spring.

- US non-farm business productivity, a critically important factor in the economy's health, grew in excess of 4.7% in the third quarter, the most rapid rate in two years and two full percentage points above the historical trend. Strong productivity gains should allay inflation concerns because they enable firms to pay higher wages to employees without the need to raise selling prices in order to maintain profitability. Companies may be paying more for raw materials and energy, but these increases are being partially offset by lower unit labor costs.

- Demand for durable goods and big-ticket items meant to last at least 3 years, rose 3.7% in October, outpacing a 0.6% increase in inventories. That pushed the inventories-to-shipments ratio, a measure of how long it would take to deplete supplies at the current sales pace - to 1.17 months, matching a record low reached in August suggesting manufacturers may have to step-up production to keep pace with sales.

While business activity remains strong, the Conference Board reported the consumer confidence index declined again in October to a two-year low reading of 85.0. Concerns appear to have been centered largely on eroding spending power due to high energy bills and, to some degree, on the perceived cooling of the housing boom. In our view, recent sharp declines in gasoline prices should underpin a solid holiday selling season. Barring an unlikely retrenchment in consumer outlays, which account for roughly 70% of economic activity, we expect solid GDP growth of 3.0% to 3 ¼ % in the current quarter and a similar performance in the first quarter of 2006 as consumer spending and manufacturing remain firm and government outlays for rebuilding the New Orleans infrastructure kicks in. Huge corporate cash hoards are likely to be increasingly used for expansion purposes next year. S&P 500 companies have been very conservative in using the $2 trillion of cash they hold for dividend payments, share buybacks, the pre-funding of retirement liabilities, and the retirement of debt. Looking ahead, companies will increase outlays on capital expenditures, strategic acquisitions and hiring with much of the capital spending directed to productivity enhancing technology and communications equipment. Indeed, our firm's proprietary Economic Model (attached), which for months was choppy and trendless, is now pointing to solid growth next year.

Housing

Housing starts, new house sales, mortgage applications and building permits are all flat to negative on a year-over-year basis for the first time since July 2000, confirming the view we've expressed in earlier client letters that the peak in the housing boom is behind us. As noted above, this is one reason consumers' confidence may have failed to pick up despite the gasoline price decline since Labor Day and the stock market rebound over the past 5 weeks. This may also, in part, explain why retailers such as Wal-Mart resorted to unprecedented price discounts to lure customers into their stores on Black Friday. The cooling off of the housing market remains an important risk to our forecast of continued above trend GDP growth next year. A study co-authored by Fed Chairman Alan Greenspan found that the combination of home equity lines of credit, capital gains from home sales and mortgage equity cash-outs added significantly to economic activity last year. The implication is that a notable portion of the increase in nominal GDP in 2004 can be traced to the vibrant housing market. With mortgage refinancing activity down 43% in the past four months, the home equity cash-out effect on spending is beginning to diminish.

Meanwhile, total homes sales have leveled off as affordability has deteriorated, due in large part to the extraordinary run up in home prices particularly over the past six months. Since 1990, there has been a very close correlation between total home sales and median prices. If mortgage rates remain at or near current levels, we expect home sales to decline about 5% next year and for price appreciation to slow to the very low single-digits, below the rate of inflation. Historically, changes in existing home prices have varied sharply by region, and there have been several instances of regional price declines in recent decades. The most notable were in Houston in the mid 80's, the Northeast in the late 80's, and California in the early 90's. Although speculation played a role in the inflation and deflation of these localized "housing bubbles", regional economic dislocations (the mid 80's energy bust, and defense spending cutbacks to name two) were key factors in past instances of regional home price declines. Although we may experience some weakening in home prices in selected regional markets, we do not expect major home price declines on average. Overall, the slowing of housing will subtract about 0.2% from GDP in 2006.

Interest Rates

While the economy has been expanding since the last quarter of 2001, few signs of the increase of core inflation one would expect at this point in the business cycle have emerged. Credit savage global competition, productivity growth, worldwide overcapacity in many manufacturing industries and slower than normal employment increases during this expansion for this development. Should core inflation remain muted over the next quarter or so, as we expect it will, and GDP growth settles into a 3% - 3 ¼% range, we believe the Fed will be done raising short-term rates following its March 28, 2006 meeting. Specifically, we expect three additional one-quarter point increases by then, bringing the Fed Funds rate to 4.75%.

As for long-term interest rates, we continue to expect the 10-year US Treasury bond yield to drift up toward 5.0% over the next few quarters from its current 4.5% rate. We plan to deploy cash currently invested in short-term bonds into longer maturities as rates move higher.

Equity Investment Strategy

For large cap *growth* stock investors, it has been a tough half-decade. Shares of companies growing more rapidly than average have not only failed to recover fully from the bear market of 2000 but have also underperformed *value* stocks in each of the last five years. Currently, reflecting this underperformance, the top 10% of S&P 500 stocks as measured by market capitalization have the highest growth rates and lowest price/earnings multiples of stocks which comprise the index.

But after five years of being dominated by *value* shares, *growth* stocks have begun to reassume their market leadership. Clearly, *growth* stocks, which led the bull market of the late 1990's, still trail *value* by a slim margin this year. However, since the end of March, *growth* stocks have begun to shine. Large cap blue-chip *growth* stocks, for instance, have advanced 10.8%, surpassing the gain of 8.2% for large cap *value* shares. We expect this trend to continue as economic growth slows from its torrid pace of 2004 and early 2005 and investors intensify their search for and exhibit a willingness to pay a premium for companies whose earnings growth is likely to remain above average even in a more subdued business environment. Equity portfolios under our supervision are accordingly tilted toward *growth*: 55% *growth* and 45% *value*.

Additionally, in recent weeks, in anticipation of an end to the Fed rate hikes next quarter, we have added further to holdings of financials which now represent 22% of clients' equity portfolios -- slightly overweighting this component relative to its S&P 500 weighting. Financial stocks generally underperform during periods of rising rates and then outperform as investors begin to anticipate an end to Fed rate increases. This cycle should be no different.

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As the holiday season approaches, we extend special season's greetings and best wishes for the New Year to our clients and friends whose support over the past eleven years has meant a great deal to all of us at Front Barnett Associates and for which we are, indeed, thankful.

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Front Barnett Associates Economic Model