FRONT BARNETT ASSOCIATES LLC

I N V E S T M E N T   C O U N S E L

January 12, 2006

To: Clients and Friends of the Firm

Subject: Talking Points: Winter 2006 Economic Update

Despite dire initial predictions of a sharp post-Katrina economic slowdown, the US economy actually experienced its most rapid expansion since early 2004 in the third quarter of 2005. While the quarter just ended is likely to have shown a more moderate advance, the economy entered 2006 with considerable momentum which will produce yet another year of solid performance led by business spending and, early this year, government outlays to rebuild the Gulf area. Hiring increases will underpin consumer spending, while housing is expected to slow from its earlier unsustainable pace. We expect core inflation to remain at or below 2% allowing the Fed to complete its rate increase cycle this spring.

Attached in outline form are more of the details of our outlook for the economy and the financial markets for 2006.

Happy New Year!!

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Talking Points: Winter 2006 Economic Update

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The Economy -- Momentum Into 2006

Despite a litany of concerns including Fed rate increases and leadership issues, sky high energy prices, a unique confluence of natural disasters, and predictions of an end to the era of rising home prices, the economy remains resilient and has gained momentum following the immediate aftermath of Katrina. The most recent data includes the following:

- **November and December job gains exceeded 400,000, confirming employers are hiring to meet demand in a strong economy despite savage global competition and corporate layoffs. Employment gains in 2005 reached 2.5 million. The unemployment rate at year-end stood at 4.9% -- a recovery low. Employment gains averaging 175,000 monthly are forecast for 2006.**

- **GDP growth in the 3rd quarter was revised to 4.3%, the most rapid pace since early 2004. Fourth quarter GDP is expected to moderate to a 3.25% rate.**

- **Core consumer prices, the Fed's preferred inflation gauge, rose at a 1.2% annual rate in the 3rd quarter -- the lowest such reading in more than two years.**

- **Factory activity was strong on November. The ISM index, the best real-time measure of the economy's health, continues to signal expansion ahead with a reading of 58.1. Meanwhile, factory orders rose 2.5% that month led by a 16% jump in demand for transportation equipment.**

- **US non-farm productivity grew 4.7% in the third quarter, the most rapid rate in two years, two full percentage points above the historical trend. Strong productivity should allay Fed inflation**

fears. Companies may be paying more for raw materials and energy, but these increases are being partially offset by lower unit labor costs.

- **Non-manufacturing sectors grew at a faster pace in December; the ISM index rose to 59.8 up from 58.5 in November.**

- **While housing continues to moderate, there are no balloons popping. Existing home sales, inventories of unsold homes, housing permits and housing starts are well below their prior peaks. The cooling of the US housing sector should dampen consumer spending as 2006 unfolds, but some of this could be offset by strong job growth and a higher stock market.**

- **Demand for durable goods rose 3.7% in October, outpacing a 0.6% increase in inventories, pushing the inventory-to-shipments ratio, a measure of how long it would take to deplete supplies at the current pace, to 1.17 months. This matches a record low reached in August suggesting manufacturers may have to step-up production to keep pace with sales.**

Meanwhile, consumer confidence, which fell to a two year low in October, has since rebounded. The possible reasons:

- **falling natural gas and gasoline prices;**
- **an end to Fed rate increases may be in sight; and,**
- **recent indications the buildup in spending and personnel for the war in Iraq may have topped out.**

Fourth quarter 2005 *real* GDP growth should be in the 3.25% range. We expect similar readings for the first half of 2006 as consumer spending remains firm, corporations begin to spend a portion of their $2 trillion cash hoard on capital expenditures and hiring, and government spending

The Economy -- Momentum Into 2006 (continued)

to rebuild the Gulf infrastructure kicks in. Much of the corporate capital spending will be directed to productivity enhancing technology and communications equipment purchases.

Economic Model

Our firm's proprietary Economic Model (See page 8), which for months remained choppy and trendless, is now pointing to continued growth next year despite a slight housing-related pullback last month.

Housing -- The Bloom is off the Rose

Housing starts, new home 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 our view we have long since passed the peak in the housing boom.

- **Overall, we expect a 5% decline in home sales in 2006.**
- **Price appreciation on existing homes on average will be in the low single digits, *below* the rate of inflation, for a considerable period.**
- **Some regional weakening in house prices is likely where increases have been most pronounced, particularly along the coasts. We do not expect a major home price decline on average.**

Inflation and Interest Rates

- **Earlier inflation pressures due to spiking commodity prices have receded. Recent reports coming out of China indicate excess supplies of a number of industrial commodities including steel and cement. Natural gas prices have fallen 40% due to higher than expected temperatures in December and this month.**

- **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 such increase since February 2004. Fed officials have made it clear they want core consumer inflation to remain contained between 1% and 2%.**

- **Given the easing in inflation pressures, a cooling in the housing market and slower economic growth, the Fed is likely to complete its tightening cycle this winter following two additional quarter point rate hikes bringing the Fed Funds rate to 4.75% by March 28th. Fed policy under Bernanke is likely to be an extension of monetary policy under Greenspan's leadership.**

- **Longer-term rates have remained remarkably stable, as investors have probably concluded the Fed will be successful in heading off a rise in core inflation. Nevertheless, we continue to expect 10-year US Treasury yields to drift upward toward 5% from 4.4% currently as bond investors focus on the impact of our trade and budget deficits, an end to Fed rate increases which should lead to a steeper yield curve, a somewhat weaker dollar, and the possibility foreign holders of US dollars will further diversify their currency holdings.**

Corporate Profits

- **Corporate profit growth is expected to continue to decelerate from 20% in 2004 to about 12% in 2005 and a still healthy 8-10% this year.**

- **Profit margins, which have expanded to record levels in recent years, will be pressured by higher raw energy costs and intense global competition. Strong productivity growth will be an important offset to these margin pressures.**

Market Outlook

- **The 22-year bull market for bonds is likely over. As this business cycle has matured, interest rates have reversed course and concerns over deflation have shifted to inflation fears. We remain cautious on the outlook for bonds, preferring shorter maturities until rates on longer dated bonds become more attractive.**

- **Stock prices have not responded to the surge in productivity and profitability in recent years. Since the third quarter of 2001, after tax S&P operating profits have increased 55%, and yet the S&P 500 stock index has risen only 24% (See page 10). This is surprising since during the period interest rates have fallen. Only recently, stock prices have taken a modest upward turn as investors have begun to sense an end to the Fed's rate increases is near.**

- **Stocks remain reasonably priced at 16.0 times expected 2006 earnings of about $80 estimated per share and, according to the Fed valuation model, are more undervalued relative to bonds than at any time in decades (See page 9).**

Market Outlook (continued)

- **Large Cap, high quality *growth* shares, out of favor for 5+ years, should benefit as investors recognize the sustainability of their earnings growth, the diversification of their businesses, their global reach, and their ability to raise capital in a slowing economy. Equity portfolios under our supervision remain tilted toward large cap *growth* shares.**

- **We have recently increased the weighting of financial stocks in portfolios reflecting compelling valuations and in the anticipation of an end to Fed tightening before mid-year.**

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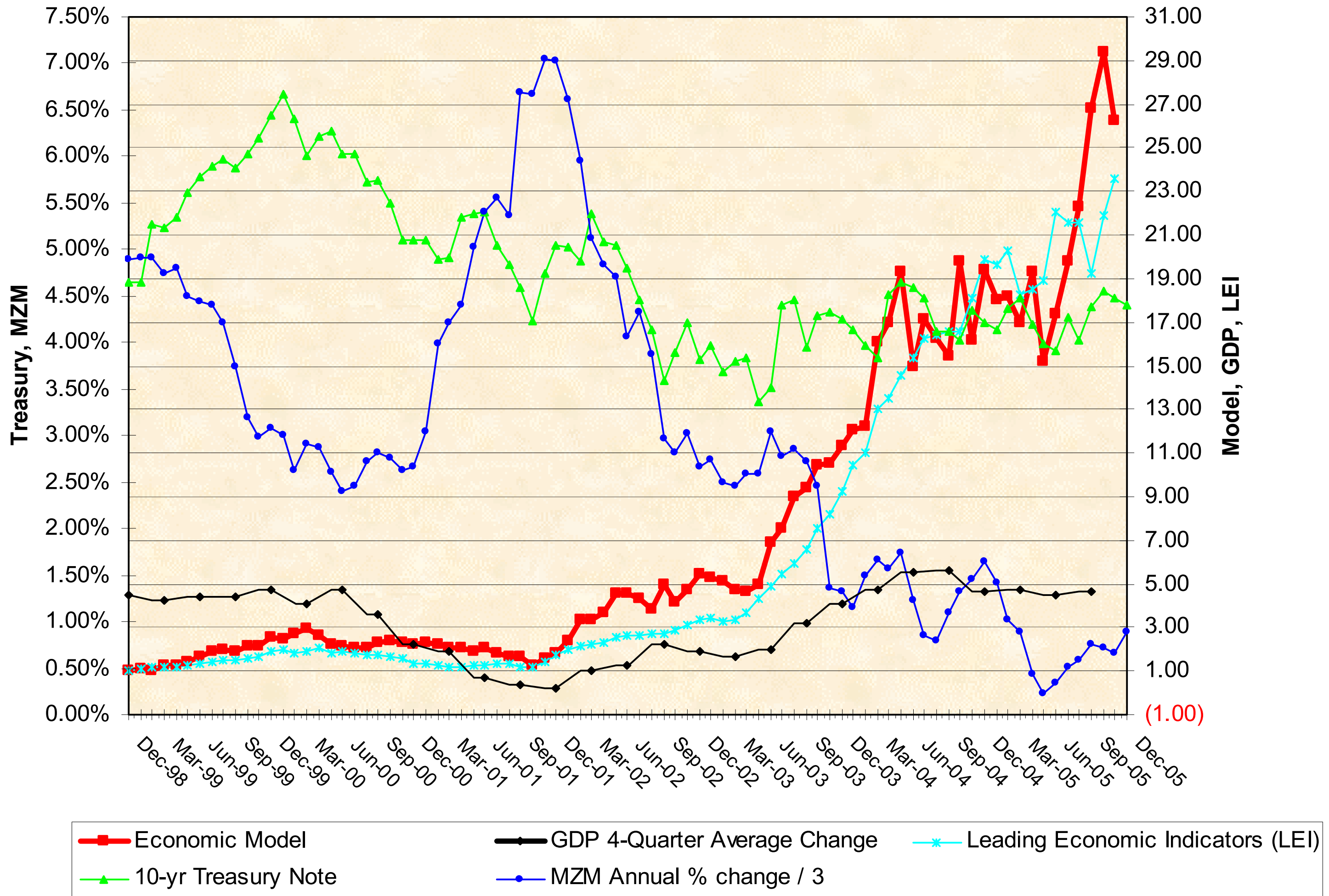
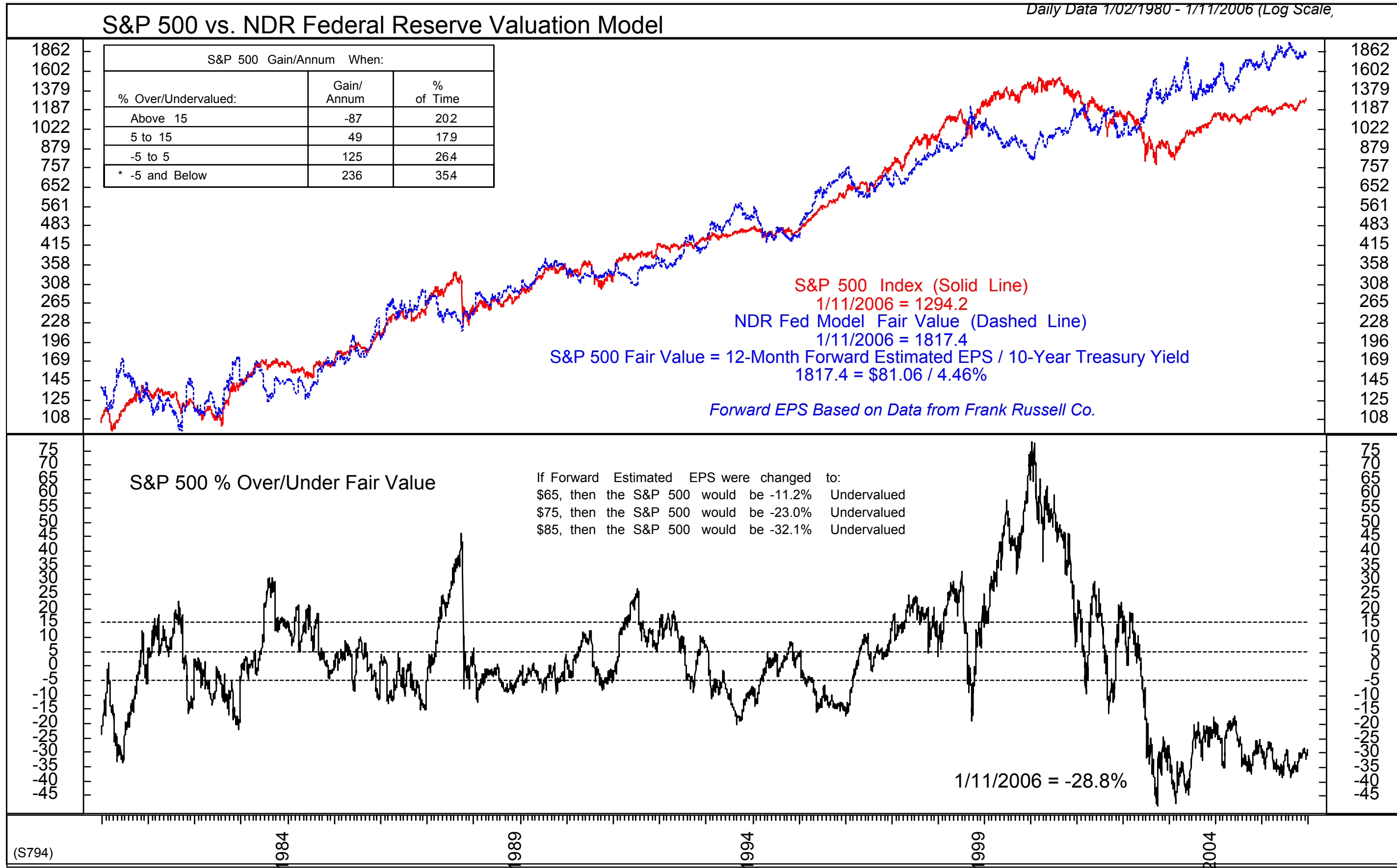
Front Barnett Associates Economic Model



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.



% Over/Undervalued:	Gain/ Annum	% of Time
Above 15	-8.7	20.2
5 to 15	4.9	17.9
-5 to 5	12.5	26.4
* -5 and Below	23.6	35.4

Chart Courtesy of Ned Davis Research

S&P 500 vs. Consensus Earnings Estimate for the S&P 500