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ECONOMIC UPDATE -- MIXED SIGNALS

Concerted moves by foreign central banks to raise interest rates underscore the surprisingly upbeat state of the world's major economies which continue to perform well despite the damage done by high energy prices, sagging housing and the imploding subprime loan market. Here in the U.S., as forecast, economic growth remained below trend in the final quarter of last year as companies grappled with working off an inventory overhang, which we expect will linger this quarter. The 2.2% increase in gross domestic product, the sum of all goods and services produced in the US, compares with a 2.0% pace in the third quarter. The figures now show a consistent pattern of slower US growth over the last nine months of 2006 and early 2007 as housing and then manufacturing, which together account for 10% of GDP, slumped. Consider the following figures, which emerged from the recent fourth quarter GDP report, highlighting this slowdown.

- The effort to reduce *unwanted inventory* was the principal reason for last quarter's muted growth rate. Companies added to inventories at an annual rate of only $17.3 billion compared with a $55.4 billion rate of increase in the previous quarter. This decrease subtracted 1.35-percentage points from fourth quarter GDP. Automakers have been prominent among the businesses reducing inventories amid falling sales. Interestingly, weak motor vehicle output subtracted 1.24 percentage points from fourth-quarter growth in real GDP after contributing 0.76 percentage points to third-quarter growth.

- *Homebuilding* also weighed heavily on growth. Residential construction fell at an annual rate of 19.1% compared with an 18.7% drop during the previous three months. This decline, the steepest since 1991, subtracted 1.2-percentage points from GDP growth.

Despite these points of weakness, the US economy grew enough in the fourth quarter to keep unemployment low by historical standards, supporting consumption and allowing inflation to cool.

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- *Consumer spending* the primary driver of economic growth, which accounts for two thirds of the economy, remained an area of strength as purchases rose at a very strong 4.2% annual rate, after growing at a 2.8% pace the previous three months. Spending gains have averaged about 3.7% per quarter over the past decade.

- The Federal Reserve's favorite *inflation* measure, the core personal consumption expenditure price index (PCE), rose at an annual rate of 1.9% compared with a third quarter increase of 2.2%. Nevertheless, core inflation, as measured by both the PCE and the Consumer Price Index (CPI) remain stubbornly above the upper end of the Fed's "acceptable" range.

Since year-end, economic data, some of it forward looking, has remained quite mixed, pointing to continued sluggish business activity at least through mid-year with housing continuing to be a major constraint to overall growth.

- Showing strength, *employment* data for February, released by the Labor Department on March 9th, showed the jobless rate to have fallen to 4.5%, approaching a 5-year low. The labor market remains resilient with 97,000 jobs created last month despite a loss of 62,000 jobs in construction where severe weather played a role. The strong employment figures, combined with continued wage increases, point to continued growth in consumer spending, underwriting future economic expansion.

- *New home sales* in the US fell in January by the most in 13 years, pointing to further weakness in the real estate market. The 16.6% decrease to an annual rate of 937,000 was greater than expected and the pace of sales was the slowest since February 2003. Furthermore, a measure of *housing inventory* rose sharply, signaling that home construction will remain a drag on the economy despite lower borrowing costs and more incentives from builders. The median price of a new home fell 2.1% in January from a year ago and the supply of homes for sale at the current sales rate of 6.6 months' is the highest since last October.

- In addition, fewer Americans signed contracts to buy previously owned homes in January. An index of signed purchase agreements, a leading indicator of future sales, fell 4.1%. This data, compiled by the National Association of Realtors, combined with weak new home sales and mortgage applications, suggests any housing recovery will be very gradual and a meaningful upturn in most markets is not likely until early 2008. We continue to expect US housing prices overall to dip this year and then rise at a rate *below* that of inflation for an extended period.

- The Institute of Supply Management's (ISM) *manufacturing* index rose to 52.3 in February from a January reading of 49.3, which had been the lowest since April 2003. Readings above 50 signal expansion. The ISM report suggests corporate efforts to trim excess inventory may be starting to take hold at the same time as strengthening economies and a gradually weakening dollar abroad lift demand for US-made goods. This rise reinforces our view that there is a reasonably good chance the economy will show signs of a pickup in the second half of this year. We expect a gradual rise in the manufacturing index in the coming months.

- The ISM *non-manufacturing* index, while continuing to portend expansion, fell in February to 54.3, its lowest level since April 2003. The underlying details remain favorable as the important employment sub-index actually rose to 52.2 from 51.7 in January, supportive of generally steady employment. The non-manufacturing index, though, suggests the housing slump may be filtering through to other sectors of the economy. Recall that the services sector accounts for 80% of GDP.

- Orders placed with US factories for *durable goods* fell more than expected in January as excess inventories prompted companies to limit spending. The 5.6% decline suggests reluctance among companies to invest carried over into 2007 after fourth quarter spending on capital equipment fell by the most in six years. Automakers and construction related companies are slashing inventories they accumulated last year after overestimating demand as the economy cooled. Inventory reductions, together with a decline in capital goods orders, will remain a drag on growth this quarter.

- *Personal income*, which grew at a solid 4.8% annual pace in the fourth quarter, increased 0.8% in January boosted by several special factors including bonus payments and gains on the exercise of stock options. Excluding these special factors, personal income, which drives future consumption, increased 0.4% in January after rising 0.4% the previous month.

- *Personal spending* increased 0.5% in January after a 0.7% increase in December. Gains in spending are key to sustaining the expansion now that housing and manufacturing remain weak.

- *Confidence* among US consumers rose the highest level in more than five years in February according to the latest Conference Board survey probably attributable to a strong job market. However, another survey, by the University of Michigan, showed a decline in confidence as respondents cited rising energy prices as a cause for concern. Weakness in housing, shocks in the subprime mortgage lending market, and recent stock market turbulence may trim confidence in March.

- The Conference Board's index of *Leading Economic Indicators* (LEI), which points to the direction of the economy over the next 3 to 6 months, rose for the second consecutive month in January. The expanding job market is stoking consumer spending.

- US worker *productivity* last quarter grew less than expected and labor costs accelerated more than forecast, suggesting inflation pressures persist. Productivity, a measure of how much an employee produces for each hour of work, rose at an annual rate of 1.6%, after increasing 2.4% in the previous three months. Meanwhile, labor costs, which account for two-thirds of the cost of goods and services, jumped at a 6.6% rate. These figures make it less likely Fed policy makers will reduce interest rates in the short-term even though economic indices remain mixed, growth remains below trend, and there will undoubtedly be calls from Congress to bail-out the subprime lending market

- The Federal Reserve Board's Summary of Commentary on Current Economic Conditions, also known as the Beige Book, characterized the economy as showing "modest expansion" based upon anecdotal data collected in February.

FORECAST

Balancing this economic data, we continue to believe the odds of a recession remain low and have made few changes to our business forecast as presented in our December Economic Outlook. We expect GDP to advance at a 2.00% to 2.50%+ rate through mid 2007 with growth firming in the second half to a 2.50% to 3.00%. Some stabilization in housing and construction, an end to the manufacturing inventory liquidation, and strong export growth on the back of a gradually weakening US dollar, will underpin a reacceleration of business activity toward trend-like growth following mid-year. Absent an oil shock, we expect core inflation to remain moderate -- approaching the top of the Fed's "acceptable" range of 1.00% to 2.00% as the indirect impact of energy prices fades and the flattening out of home-ownership costs and rent rises take hold. While we have expected the Fed to begin easing by this summer, we are a bit less certain of the timing of a policy reversal despite the fact investors are currently placing high odds on an early rate cut. In fact, the Fed could remain on hold a while longer than anticipated if economic growth picks up, employment continues resilient and inflation fails to moderate as expected. Corporate profit growth, which had achieved double digit rates for 19 consecutive quarters, is expected to slow to 7.00% to 9.00% over the balance of the year as profit margins ease from their record levels of 2006.

All in all, ours is a benign forecast made at a time when a good number of business and financial market savants are fretting over the possibility of a recession by year end due to the fallout from failed subprime real estate loans to less credit worthy borrowers. We fail to see that outcome.

FIXED INCOME STRATEGY

Bond yields, as measured by the benchmark 10 year US Treasury bond, have remained well below 5% -- the point at which we would consider extending maturities -- since last summer. We have, therefore, largely restricted fixed income purchases to very short-term obligations where yields remain above those on bonds and notes maturing beyond one year. Given the historically narrow spreads between yields on corporate bonds and US Treasury obligations, we have confined purchases to US Treasuries until spreads widen to the point where investors are adequately compensated for the additional risks of owning spread product.

EQUITY MARKET OUTLOOK AND STRATEGY

Worries about the global economy rattled financial markets earlier this month as investors sold stocks over concerns about a broad economic slowdown and anxiety over defaults among subprime borrowers. In just one trading session, stocks, as measured by the S&P 500 Stock Index, declined 3.5% giving up their gains for the entire year. A warning a few days earlier by former Fed chairman, Alan Greenspan, that the economy might slip into a recession by year's end added to investors concerns as have endless media comparisons with previous painful mini panics.

The world is, of course, a different place than it was ten years ago when the devaluation of the Thai bhat, on July 2, 1997, triggered a wave of currency collapses across East Asia and beyond that eventually led to currency depreciation of about 75 percent on average. Today, developing countries are in much better financial condition, mostly growing rapidly and running trade surpluses rather than deficits. Many have repaid much of their foreign debt and have accumulated large currency reserves.

Moreover, despite the slowdown here in the US, the global economy remains firm. Growth in Europe and Japan has picked up. The International Monetary Fund expects the world economy to grow around 5% in 2007, about the same pace as last year. Still, the financial market turbulence earlier this month underscored the extent to which markets globally are supported by the same elements that have played a prominent role in events leading up to past market hiccups: overconfidence and complacency about risk. With low yields on high quality assets like US Treasury bonds, and diminishing expectations for returns on stocks in industrialized countries, investors have delved further afield in pursuit of higher returns often leveraging their bets with borrowings in countries like Japan where interest rates remain exceptionally low. More than $500 billion was invested in "emerging markets" in 2006 on top of similar amount in 2005. At its peak, on February 8, the Bombay stock market index had risen 49 percent over the prior year. The Mexican index was about 55 percent higher than a year earlier. Despite it's 9 percent pullback on February 27, the Shanghai stock market index had doubled over the previous 12 months. Closer to home, investors seeking "yield" have rushed to buy junk bonds with a relatively high risk of default. For example, in 2006, in the face of a weakening housing market, investors snapped up $483 billion of bonds backed by subprime mortgages issued to the riskiest borrowers following $500 billion of purchases in 2005.

Since February 27th, economists, analysts, and cable television talking heads have been busy opining on how this will be resolved. Our guess is the unwinding of excess risk-taking will cause a very healthy and warranted correction in many of the markets where leveraged speculation has been most pronounced. We expect the fallout will be well contained and not impact the *real* economy. If we are right, investors can expect the current period of heightened stock market *volatility* to persist over the near term. As for the intermediate and longer term, stock prices should reflect the outlook for corporate profits, which we view as quite favorable. We anticipate US stock returns for 2007 to mirror the advance in corporate profits, which we peg at 7.0% to 9.0%

Despite the run-up in price of many of our core positions in the later part of 2006, the metrics of our equity portfolios remain compelling when compared with the benchmark S&P 500.

	2007 P/E	Estimated Future Growth Rate	Dividend Yield	ROE	P/E to Future Growth Rate
FBA Average Growth Stock	**19x**	**13%**	**1.4%**	**26%**	**1.5x**
FBA Average Value Stock	**14x**	**11%**	**2.4%**	**19%**	**1.4x**
FBA Total Portfolio	**16x**	**12%**	**1.9%**	**23%**	**1.5x**
S&P 500	**16x**	**7%**	**1.7%**	**21%**	**1.9x**

While the earnings of the current FBA stock portfolio are estimated to grow at 12% per annum, S&P 500 earnings are forecast to rise significantly more slowly at 7% per year. Yet, the 16x price earnings multiple of the FBA portfolio is identical to that of the S&P. This parity is reflected in the P/E to Future Growth Rate shown above, underscoring the relative attractiveness of the portfolio.

Also notable has been the increase we have made to almost 20% in the percentage of equities allocated to companies domiciled abroad. The likelihood of more rapid earnings growth and lower price/earnings multiples make these holdings relatively attractive as US growth is expected to remain at or below trend for the balance of this year.

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