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THE ECONOMIC OUTLOOK -- GRINDING ALONG

Despite the shaky credit market and weakness in housing prices, solid job market performance this spring and summer, recent signs of strength in manufacturing and better than expected corporate profit growth, signal employment growth will continue to sustain consumers and suggest the US economy is grinding its way through the worst housing slump in a generation. Indeed, our Economic Model, a leading business indicator (attached), points to continued moderate economic growth over the next six to nine months.

Data released last week shows non-farm payrolls rose 132,000 in June while totals for the prior two months were revised upward by 75,000 so that monthly job growth has averaged 145,000 in the first half of the year. While the pace of job gains over the past six months trailed that of last year, it has exceeded most expectations, including ours and those of the Federal Reserve, as 850,000 jobs have been added to payrolls. Meanwhile, average wage growth of production and other non-supervisory workers has remained restrained, suggesting the nation's low unemployment rate is not pressuring labor costs, nor is it forcing businesses to raise prices to maintain their profitability as some forecasters had feared. Nevertheless, wage gains are giving consumers, whose spending accounts for two-thirds of GDP, the means to cope with near-record gasoline prices and declining home values, and will support their spending in the months ahead.

While the US economy grew at an annual rate of just 0.7% in the first quarter, we expect the Commerce Department to report at the end of this month GDP rebounded at a better than a 3.25% rate in the June quarter -- just above the expected long-term trend rate of nearly 3.0%. Clearly, continued employment growth will be an important underpinning for the strengthening economy. Other factors reinforcing evidence for improving business conditions are reflected in the following sampling of *forward looking* economic indicators released in the past few weeks.

- The Conference Board's index of leading economic indicators (LEI), which points to the direction of the economy over the next three to six months, rose 0.3% in May adding to evidence the economy is recovering after growing in the first quarter at the slowest pace in more than four years. Declining claims for jobless benefits, rising stock prices, increased building permits, and improved consumer expectations led the LEI higher

- Manufacturing growth in the US accelerated in June to the highest level in fourteen months, boosted by an increase in production and new orders, according to the Institute for Supply Management's (ISM) factory index, which rose to 56. Readings greater than 50 signal expansion. Gains in factory output should help the economy to strengthen as the slump in homebuilding gradually exerts less drag on growth. Manufacturers are expanding to meet demand and rebuild inventories after drawing them down in prior months.

- Growth in US service industries, which produce the majority of the nations' jobs, accelerated to the fastest pace in fourteen months in June. The ISM index of non-manufacturing businesses, including banks, builders, and retailers, rose to 60.7 from 59.7 in May. As expected, the expansion in service businesses, which make up almost 90% of the US economy, is cushioning the fallout from the housing slump.

- Orders placed with factories rose 0.7% (ex transportation) in June as companies rebuilt inventories and invested in more efficient equipment according to the Commerce Department.

- Confidence among US consumers rose unexpectedly in early July according to a Reuters/University of Michigan survey as gasoline prices fell and unemployment remained close to its lowest level in six years. Rising confidence backs forecasts that consumer spending will pick up from the second quarter trough. This spending lull was reflected in a recent government report showing spending fell in June, hit by rising energy costs and falling home values. Spending is expected to rise 2.5% this quarter from an estimated 2.0% rate in the prior quarter.

- Initial jobless claims have fallen to an average of 312,000 per week indicating companies do not foresee a big slump in demand even as near record oil prices and the housing downturn weaken economic growth.

Notwithstanding the generally favorable indicators noted above, housing remains a drag on the economy and is likely to continue to slow GDP growth at least through year-end.

- Confidence among US homebuilders fell this month to the lowest level in 16 years, signaling builders are likely to continue to pull back on the construction of new homes as inventories remain high due to lack of buyer interest in purchasing now. Permits for future construction fell to the lowest level in more than a decade in June.

- The National Association of Home Builders reported the inventory of unsold homes to be at its highest level since January 1991 causing builders to cut prices, increase incentives, and halt new projects. Rising mortgage rates and stricter lending policies are also impeding a rebound.

The timetable for any recovery in housing starts now appears to be some months off as the huge overhang of new and existing homes, amounting to a 7.1 month supply at the current sales pace, must show signs of clearing before a turnaround emerges. However, falling prices (home values in 20 US metropolitan markets fell 2.1% in April from the same month a year earlier) coupled with rising incomes should allow the market to clear eventually and its possible we may have already seen the worst of the *direct* impact from the housing recession on the economy. Clearly, home sales will ultimately be supported by growth in incomes and employment as well as by mortgage rates that, despite the recent rise, remain reasonably low relative to historical norms.

FORECAST

As for the economy as a whole, consumption expenditures slowed last quarter following two quarters of rapid expansion. Looking ahead, we expect consumer spending to continue to grow, albeit at a somewhat slower pace than in recent years, as the economic expansion remains moderate and demographic shifts lead to a gradual decline in labor force participation. Compensation should continue to rise moderately as demand for labor remains strong and productivity increases.

Like consumption and wages, business fixed investment overall appears poised to increase at a moderate pace following a year in which several industries, notably autos, found themselves with bloated inventories leading them to reduce production to better align stocks with sales. Excess inventories have now been substantially eliminated and should not prove a restraint on growth as they did in the later part of 2006 and the first quarter of this year.

With the global economy remaining strong, US exports are expected to expand further over the balance of this year. As we have noted in the past, the weaker dollar, particularly against the euro, has made US exports more competitive price-wise than they have been for years. US based multinational companies, many of which derive over half of their earnings from abroad, will remain important beneficiaries of this set of conditions.

On balance, the financial market environment remains favorable and has been supportive of economic growth. However, conditions in the subprime mortgage sector have deteriorated significantly as delinquencies have mounted on adjustable rate loans made in late 2005 and 2006. Recently, we have also seen increased investor concerns about credit risks as evidenced by about a 70 basis point widening in the yields of lower quality bonds relative to US treasury obligations and a tightening of terms for some leveraged business loans. However, even after their recent rise, credit spreads remain near the low end of their historical ranges.

Overall then, in our view, the economy is now well past the trough in economic activity, which occurred in the first quarter of this year, and will probably show moderate growth of 2.25% to 2.50%+ for the balance of this year. Unemployment is expected to rise toward 4.75% by year-end and drift upward to 5.0% next year. Core inflation, which excludes food and energy prices, has moderated slightly over the past few months, with core PCE inflation, the Fed's preferred measure, now at 2.0% -- the top of their comfort zone -- and likely to fall to 1.75% to 2.0% next year. Given the fact that unemployment is expected to remain relatively low, that manufacturers are operating at a high 81% of capacity, that inflation risks remain high given the recent increases in food and energy prices, and that economic growth is accelerating, the Fed is unlikely to reduce short-term rates in the foreseeable future. Any eventual easing by the Fed will require several months of data showing core inflation is improving, a cooling off in headline inflation (now running at close to 4.0%), a higher unemployment rate, clear evidence the housing downturn is spilling over into consumer spending, and signs the subprime mortgage problems are spreading more tangibly to other asset classes. None of these conditions are currently present.

FIXED INCOME STRATEGY

While bond yields have risen in recent weeks, expected returns remain insufficient to adequately compensate investors for the additional risk of owning longer dated securities. We have, therefore, largely restricted fixed income purchases to high quality bonds with maturities of about one year or less where we have been able to pick-up about 45 basis points of yield when compared with returns on money market funds. Elsewhere, while spreads on lower grade bonds have begun to widen as global credit conditions have tightened, their yields continue to be inadequate relative to the risks entailed in owning lower quality, less marketable spread product.

EQUITY MARKET OUTLOOK AND STRATEGY

During the past quarter, investors gave greater weight to better than expected reported corporate profits than to fears of tightening credit conditions and concerns over the deteriorating subprime mortgage market. The trend of the past four years, where corporate profits have exceeded financial market expectations, is likely to persist, particularly for large, multinational companies whose earnings are expected to benefit from the weak dollar.

For the second quarter, on average, equity returns in portfolios under our supervision, gross of fees, largely matched those of the benchmark S&P 500 stock index as large cap US equities outperformed other classes as follows:

	3/31/07-6/30/07 Total Return
S&P 500	+6.3%
S&P Mid Cap	+5.4%
Russell 2000 (Small Cap)	+4.1%
EAFE (International)	+3.4%

Equity returns net of fees averaged 5.97% during the quarter.

Looking ahead, further tightening of global credit conditions is expected to drive investors to reduce their exposure to risky, highly leveraged and less marketable assets. This tendency strengthened at the end of the last quarter, has continued into the current period, and is likely to persist as risk premiums rise. Likely interest rate increases in Japan, China, and the EU as the year progresses will reinforce this trend. This is not good news for risky emerging market shares, shares of small cap companies, and highly leveraged investments (stellar performers in 2006 and early 2007) which thrive on liquidity.

We continue to believe that the markets are in transition from a liquidity-driven speculative phase to a more fundamentally-based one which will benefit the high quality, large cap growth and value shares that represent core holdings in our clients' portfolios.

Despite the advances in price of many of our core equity positions, the metrics of our equity portfolios remain compelling when compared with the benchmark S&P 500.

	2008 P/E	**Estimated Future Growth Rate**	**Dividend Yield**	**ROE**	**P/E to Future Growth Rate**
FBA Average Growth Stock	**18x**	**13%**	**1.4%**	**25%**	**1.6x**
FBA Average Value Stock	**13x**	**11%**	**2.4%**	**18%**	**1.6x**
FBA Total Portfolio	**16x**	**12%**	**1.9%**	**22%**	**1.6x**
S&P 500	**16x**	**7%**	**1.7%**	**19%**	**2.1x**

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 of client's stock holdings 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 portfolio equities allocated to companies domiciled abroad. The likelihood of strong earnings growth and lower price/earnings multiples make these holdings relatively attractive as US growth is expected to remain at or below trend for some time.

Finally, even though we are experiencing a slowing of US corporate profit growth to the 7.0% to 8.0% range this year, we remain positive on the outlook for the broad US market indices whose price earnings multiples remain at about their average for the past generation. Stock returns are expected to rise in line with corporate profit growth plus dividends of about 1.8%. Clearly stock market investors should expect normal corrections of 5.0% to 10.0% along the way as markets react to changing perceptions of geopolitical risk, liquidity issues, and political developments.

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Front Barnett Associates Economic Model