FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

Marshall B. Front
Chairman

Direct Line: (312) 641-9001
e-mail: mfront@front-barnett.com

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THE ECONOMIC OUTLOOK -- AWAITING THE TURN

Economists and financial market savants have been busy debating the finer points of whether we will actually have a recession or just skirt a downturn before the fiscal and monetary medicine Congress and the Fed have administered take hold. Evidence supporting those in the latter camp was found in the figures released by the Commerce Department on April 30th showing first quarter real GDP, the sum of all goods and services produced, expanded at a 0.6% annual rate matching the tepid pace of growth in the previous three months. Spending by households, which represents two thirds of the economy, grew at the slowest rate since 2001 when the US was in recession. The fundamental problem remains slowing consumer spending: Declines in home values and the resulting impact on the financial system are weighing sharply on consumers as they struggle with job loss fears, surging food and fuel prices, and tumbling property values. The GDP figures also show businesses cut back on their fixed investments, which include spending on commercial construction and equipment and software, at an annual rate of 2.5% in the last quarter, the biggest decline since the first three months of 2004. Investment in residential construction projects fell at an annual rate of 27%, the largest drop since 1981, subtracting 1.23 percentage points from GDP. Offsetting these weaknesses, companies added to inventories at a $1.8-billion annual rate, tacking on 0.8 percentage points to growth. Some economists fear this inventory buildup may give way to cutbacks in production in coming months as businesses try to clear unwanted stockpiles. Note that these are only advance GDP figures which will be revised twice in coming weeks as more precise inventory and foreign trade estimates become available, so stay tuned.

The most compelling case for a recession call stems from disappointing employment data since year-end, during which time the US lost a total of 232,000 jobs. Not since the onset of the Iraq war in 2003 has the economy experienced job losses for at least three consecutive months. Meanwhile, the jobless rate rose to 5.1% from 4.8% in February, the highest level in two-and-one-half years. Job losses, which in recent months have spread to many previously strong occupational

70 WEST MADISON STREET • SUITE 4920 • CHICAGO, ILLINOIS 60602-4208
(312) 641-9000 • FAX (312) 641-9009

groups such as finance, accounting, information technology, and engineering, are disturbing as they may portend further weakness in service industries which account for over 90% of GDP. We continue to expect this trend to continue with the unemployment rate reaching 5.5% by mid-year and 5.75%+ by year-end.

Employment gains and wage increases, while not *leading indicators*, underpin US economic growth. Absent a stabilization in the labor market over the next few months, many believe it is likely this period will eventually be judged by the National Bureau for Economic Research (NBER) as having been recessionary. On that score though, it should be noted that initial jobless claims, reported weekly by the Labor Department, fell last week to a two-month low of 342,000 while the four-week moving average, a less volatile measure, dropped to 369,000. Looking back, we find jobless claims invariably top 400,000 during a recessionary period, a threshold we have yet to cross in this slowdown. And, it is also worth noting that we have not had a recession with the unemployment rate below 6.25% in over a generation.

Other carefully parsed monthly economic reports also reflect moderating business conditions. For example, anecdotal reports gathered by the twelve Federal Reserve districts and compiled in the so-called "beige" book for April, indicate a "weakening" in the economic environment since their last report six weeks earlier when conditions were seen as reflecting "slowing growth". The April beige book described consumer spending as "softening" across most of the country. "Rising or steady" retail inventories were seen as prompting retailers in some districts to cancel orders to keep stocks from growing to unwanted levels. One bright spot was tourism where visitors from abroad, using their appreciated currencies, were seen snapping up high priced items such as jewelry, expensive cell phones, and laptop computers.

Elsewhere, *forward-looking* economic data points to stable to continued weak economic growth.

- The Institute for Supply Management (ISM) reported that its *manufacturing index* failed to grow in March, falling *slightly* below 50 (the dividing line between expansion and contraction) for the second consecutive month, completing the weakest quarterly performance for the US economy since the second quarter of 2003. Manufacturers' order backlogs continued to erode as the New Orders Index was stagnant for the fourth consecutive month. Additionally, manufacturers continue to experience heavy cost pressures, as the prices they pay rise despite slower

overall demand. By contrast, US multinational manufacturers are still benefiting from strong export demand and see growth in export orders due to the weak dollar from which they benefit.

- The ISM *non-manufacturing* index, which captures almost 90% of the economy, rose to 49.6 in March from 49.3 in February. A reading below 50 signals contraction. Combined with the group's *manufacturing index*, which showed a smaller decline in February than anticipated, this report indicates overall economic growth is not decidedly weak at this point.

- *Consumer confidence* in early April fell more than forecast to its lowest level in 5 years, an indication of high energy costs, fear of job losses, depressed stock prices, and falling property values may prompt Americans to curb spending. The Conference Board's confidence index fell to 62.3, a five-year low, from a revised 76.4 in February, and its gauge of expectations for the next six months slumped to its lowest level since December 1973 when the Watergate scandal gripped the nation and an embargo by a group of Arab oil exporters was in effect. Another confidence measure, the Reuters/University of Michigan Index of Consumer Confidence, fell in April to the lowest level in 26 years. While we are not able to establish a clear correlation between consumer confidence and *future* consumption, the confidence figures, recession or not, clearly reflect the ugly conditions consumers face.

- *Consumer spending*, largely for services, grew at an annual rate of about 1.0% in the first quarter, the slowest pace since the fourth quarter of 1991 when the economy was in recession. Estimates for the current quarter indicate a modest rebound in spending as the first effects of the tax rebates will help cushion the impact of the high gasoline prices forecast for the coming peak driving season.

- *Orders to US factories* fell more than forecast in February, as companies scaled back investment plans on concerns of a faltering economy. The 1.3% decrease followed a 2.3% decline in January according to the Commerce Department. Excluding orders for transportation equipment, which tend to be volatile, demand fell 1.8%, the largest decline since 2007.

As for housing, sales of previously owned homes, confidence among US homebuilders, housing starts and other measures continue to deteriorate with no end in sight. For example, the S&P/Case-Shiller index of home prices in 20 major

cities dropped 12.7% in February from a year earlier pointing to a supply/demand imbalance that shows no signs of abating. Prices will continue to decline as foreclosures push even more properties on to the market just as stricter lending rules limit the number of qualified buyers. A recent Conference Board survey shows fewer consumers are poised to enter the housing market. Only 2.4% of people surveyed said they were planning to buy a home in the next six months, matching the June 1994 level and just above the 2.3% reading in February 1983. In March 2008, that figure was 3.4%.

Clearly, housing remains the weak link with no turn for the better in sight. Consumer spending is sluggish as Americans grapple with the worst housing and credit crisis in decades, a deteriorating jobs market, and soaring food and energy prices. Partially offsetting the softness in housing and consumer spending, US multinational manufacturing companies have been helped by the weak dollar to maintain their overall growth despite flat-to-weak domestic sales. First quarter profits for non-financial companies rose better than 8.0% and are forecast to rise another 10.0%+ in the current quarter -- hardly a recession-like performance. This week, the first of the tax rebate checks were mailed, boosting the economy even if, as some economists forecast, only 30% of the rebates are spent. And finally, the full impact of the Federal Reserve's rate cuts of the past nine months will work their way through the economy. Given this picture, whether we are actually in a recession as defined by the NBER (a significant decline across the economy including inflation-adjusted GDP, income, employment and retail sales that lasts more than a few months) remains an open question. What we do know is that to millions of hard hit families, it feels like we are in a recession and that is what really matters, particularly in an election year.

Credit Market Turmoil

The current turmoil in global credit markets originated in the US market for subprime mortgages -- home loans made available to borrowers whose credit histories were often shaky. As home prices fell, hundreds of thousands of borrowers fell behind in their payments, and banks, Wall Street firms and others who owned securities backed by home loans found themselves taking billions of dollars in losses as they marked-down the value of these obligations on their books. The more these losses grew, the less willing lenders became to lend further, pushing the broader US economy toward a downturn. Now, steps to address this credit crunch are being taken on multiple fronts. Among these are increasing government mortgage insurance, jawboning the home-loan industry to ease up on troubled borrowers before they lose their homes, and enacting a $150+ billion

package of tax rebates and tax breaks to stimulate the economy -- particularly flagging consumer spending.

At the same time, the Federal Reserve has cut interest rates deeply and, in an unprecedented step, opened its discount window to securities dealers in response to last month's run on Bear Stearns. Most European central bankers, however, remain more concerned about inflation than slow or no growth and have been raising interest rates or holding them steady. The resulting widening gap between low interest rates here and higher rates abroad has been one of the principal factors behind the weak dollar which at one point had declined by over 40% against the Euro. The weak dollar has also been a root cause of spiking commodity prices, including oil, which are priced in dollars. Very recently, as investors have come to believe an end of the Federal Reserve's easing cycle is in sight, the dollar has reversed its slide and open market rates have also begun to move higher. We believe these trends will persist as it becomes clear that spreads between open market rates here and abroad are unlikely to increase further and at some point will narrow.

Federal Reserve Policy Shift

Further reductions in the Fed Funds rate are likely to be of limited value as the economic recovery will require resolving credit market problems, dealing with the millions of homeowners who may now be tempted to default on mortgages that exceed the value of their homes, and reducing the risk that the ongoing decline in house prices will force millions of additional homeowners into a negative equity position. A lower fed funds rate will not solve these problems. We, therefore, believe the Fed's cut in its benchmark rate on April 30th to 2.0% will lead to a pause as the Fed focuses on other means to improve liquidity through additional targeted measures and discount window innovations. The Fed's decision to change its policy at this juncture is supported by signs of an easing in the credit crisis that gripped the financial markets this winter. Stocks have risen 9.0% from their March lows and yield spreads between US Treasury debt and mortgage-backed securities have narrowed by almost 75 basis points. At the same time, the spread between yields on medium grade corporate bonds and US Treasuries has fallen by 60 basis points lending credence to the view that the systemic risks facing the credit markets in February and March, addressed by earlier Fed moves, have receded.

Short-term rates have already begun to rise in anticipation of this change in Fed policy. For example, yields on two-year US Treasury notes have risen from 1.4% on March 17 to 2.3% currently. Further increases in the yield on short to

intermediate term US Treasury obligations are expected over the next several months.

Inflation

While many factors have contributed to the recent rise in the prices of oil and food, especially increased demand from China, India, and other rapidly growing countries, plunging interest rates have also added to the upward pressure on these commodity prices by making it inexpensive for commodity investors and speculators to hold larger inventories of oil and food grains. Attractive rates have also induced some investors to add commodities to their portfolios. When rates are low, portfolios managers bid up the prices of oil and other commodities to levels at which their expected future returns are in line with the lower rates. An interest rate-induced rise in the price of oil also contributes indirectly to higher prices of food grains by making it profitable for farmers to devote more farm acreage to corn for ethanol. The resulting reduction in acreage dedicated to producing food crops causes a decline in the supply of those commodities and their prices to rise. Rising food and energy prices can contribute significantly to inflation and the US cost of living. The 25% weight of food and energy in the US CPI means that a 10% rise in food and energy prices adds 2.5% to the overall price level. In lower-income, emerging market countries, food and energy are generally a larger part of consumer spending. A rise in commodity prices can, therefore, add proportionally more to the cost of living in those countries reducing real incomes to a greater extent than in the US, creating unwanted hardships and civil unrest in some recent cases such as Haiti and Indonesia. The anticipation of higher interest rates we expect are, therefore, likely to relieve some of the pressure on both energy and food prices as investors' appetites for commodities wane, the dollar rallies, and global economic activity cools.

Fixed Income Policy

Tax exempt bond prices came under severe pressure this winter and spring as turmoil in the credit markets caused hedge funds and other leveraged investors to liquidate positions. As yields on high quality tax exempts spiked upward, we used a portion of client's reserves earmarked for bonds in tax sensitive accounts to make purchases at taxable equivalent yields not seen in at least a decade. In the process, we have substantially increased the average maturity in most taxable portfolios while still maintaining significant cash reserves to purchase additional issues to fill out client's bond maturity ladders as future opportunities present themselves.

During this time, investors have preferred the safety and liquidity of US Treasury bonds driving prices up and yields lower. We will continue to defer purchases of taxable bonds until higher yields are available.

Equity Investment Strategy

As the US stock market pulled back this winter in response to credit market uncertainties and worries about the depth and duration of the current slowdown, we began to redeploy a portion of the excess cash reserves with which we came into the year. Recall that we entered 2008 with larger than usual cash positions. Among the additions to portfolios were shares of technology companies whose earnings are expected to remain strong as global growth slows. Two depressed groups, consumer discretionary and financials, were also increased during the period so that group concentrations are currently as follows within our diversified core equity portfolio:

Sector Concentration %		
	Portfolio	S&P 500
Basic Industries & Transportation	1.86	6.94
Technology	16.10	14.95
Industrial Capital Goods	9.35	8.84
Discretionary Consumer Goods	9.94	5.80
Services & Media	2.37	6.54
Telecom Services	4.11	3.53
Consumer Staples	11.50	9.12
Healthcare	12.62	10.81
Energy	7.77	13.80
Financial	15.10	15.91
Utilities	0.00	3.34
Foreign	9.28	NA

The metrics of our core equity portfolio 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**	**14%**	**1.5%**	**29%**	**1.4x**
FBA Average Value Stock	**16x**	**11%**	**3.4%**	**18%**	**1.6x**
FBA Total Portfolio	**17x**	**12%**	**2.3%**	**24%**	**1.5x**
S&P 500	**15x**	**7%**	**2.0%**	**17%**	**1.7x**

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 17x price earnings multiple of the FBA portfolio is only marginally higher than that of the S&P and the P/E to future growth rate is a low 1.5x versus 1.7x for the S&P.

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