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THE ECONOMIC OUTLOOK -- SLOWER SECOND HALF

The outlook for consumer spending, which accounts for two-thirds of GDP, remains questionable with the employment picture darkenening further in July. The number of people out of work last month rose to 5.7% of the labor force -- the highest unemployment rate in over four years -- signaling the US economy continues to grow sluggishly at best. The nation's employers cut the number of jobs for the seventh consecutive month in July, this time by 51,000 according to a Department of Commerce report. Additionally, hours worked were reduced and the average wage rise was less than enough to keep pace with inflation. Particularly hard hit was teenage employment where the unemployment rate rose to 20.3%, an increase of 2.2 percentage points in just a month, and the highest since 1992. Retailers catering to teenagers are having a particularly difficult time during the back-to-school selling season. Initial jobless claims figures released on August 7th confirm the weakening job market as workers filing first-time claims for unemployment benefits rose to the highest level in six years.

While we are not experiencing the kind of job market collapse usually associated with a recession, we are seeing a steady erosion in payrolls and an elevation in jobless claims which we expect to continue at least through early next year when the unemployment rate could exceed 6.25%+. One reason recent job losses have not been even steeper than reported is employment gains during the expansion following the 2001-2002 recession were clearly sub-par as employers were able to increase output through productivity gains while keeping payrolls lean.

Despite the weak labor market, economic growth actually accelerated during the last quarter, albeit at a below-trend rate, as the temporary shot-in-the-arm of federal tax rebates and strong export growth offset the drag from housing and sky-high gas prices. The second revision to 2nd quarter GDP figures showed the economy grew at a 1.9% rate from April through June following a 0.9% first

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quarter gain and a small contraction of 0.2% in last year's fourth quarter. Final upward revisions to second quarter GDP are likely to show growth to have been closer to 3.0% reflecting very strong export trade during the period -- hardly a recessionary figure.

Looking beyond the employment figures, which are *lagging economic* indicators, and the GDP report which tells us we have thus far narrowly avoided a recession, we find a mixed bag of *forward-looking* data suggesting a continuation of weak economic growth.

- The Institute for Supply Management (ISM) reported *manufacturing* activity in the US stagnated in July as businesses scaled back production to protect profits by preventing inventories from growing while domestic demand weakens. The July manufacturing index reading of 50 is at the precise dividing line between expansion and contraction. As an offset, the earlier drop in the value of the dollar made US goods more affordable overseas leading to export gains that are keeping factory output from falling further. Should the recent slowdown in business activity in Europe and Asia persist, demand for US exports could falter.

- The July ISM *non-manufacturing* index, which accounts for almost 90 percent of the economy, edged up to 49.5, higher than forecast, from 48.2 in June. The six-month average has been 50.1. Readings below 50 signal contraction in the services sector of the economy. This data point paints the picture of an economy that remains sluggish but that the pace of contraction is not accelerating.

Respondents to both of the ISM monthly surveys noted that rising fuel, energy, and commodity costs are negatively impacting their respective businesses. Recent sharp declines in oil and other commodity prices, if sustained, may relieve some of the inflation pressures with which these businesses have had to contend over the past six to nine months.

- *Consumer confidence* recovered somewhat in July from a 16-year low in June despite manufacturing job losses, smaller wage gains, falling property values and rising food and fuel bills. The Conference Board's index rose to 51.9 from 51 in June. While we are unable to establish a clear correlation between consumer confidence and *future* consumption, these confidence figures, recession or not, clearly reflect the difficult conditions consumers have been facing.

- *Consumer Spending,* under pressure from higher prices, increased 0.6% in June following a solid gain of 0.8% in May. Falling energy prices and a leveling off in food prices may combine to provide a prop to consumer outlays in the absence of job growth as the stimulus of the government's tax rebate passes.

- *Orders to US factories* remain surprisingly robust, advancing 1.7% in June, the largest gain this year according to a recent Commerce Department report, reflecting strong export demand.

Interestingly, our firm's <u>Economic Model</u>, a copy of which is attached, has begun to signal economic recovery. However, we face at least two or three quarters of further sluggish business activity before stronger growth kicks in.

Housing

We have long contended that until the housing market shows some signs of stabilizing, the economy will remain under pressure as falling housing prices, tightening credit conditions, and the risks associated with failing financial institutions weigh on both consumer spending and business investment. However, most housing indicators (with the exception of traffic of prospective buyers) have now begun to show *sequential* improvement. In July, housing turnover improved for the fourth consecutive month. Various measures of the Case-Schiller Index of 20-City Home-Prices show that while housing prices continue to decline, their rate of descent has slowed in each of the past four months when compared with the prior year. Other housing metrics show similar year-over-year improvement which are encouraging:

	Year-Over-Year Change	
Indicator	**June**	**May**
New Home Sales	(33.2)%	(37.8)%
Existing Home Sales	(15.5)%	(15.9)%
Total Housing Turnover	(17.6)%	(18.6)%
Median Home Sale Price	(1.95)%	(7.06)%
Citi Housing Market Index	(33.3)%	(35.7)%
Housing Inventory	426,000	450,000
Traffic of Prospective Home Buyers	(36.8)%	(27.3)%

Source: Citi Investment Research

The near-term challenges for the housing market remain formidable and we do not expect it to stabilize until late this year or early 2009 as there remains an excess of homes on the market, prices are falling, the economy remains weak and credit conditions are tightening. Any general trend toward a return to home price rises is unlikely to occur until 2010.

Forecast

All in all, then, we forecast GDP growth to slow from the 2nd quarter of near 3.0% following revisions to come, averaging 1.25%-1.50%+ in the second half of this year as consumer spending will remain muted. Slowing growth in net exports is also likely as the dollar's recovery continues and business abroad slows. Government spending will remain a stimulus. Unemployment is likely to exceed 6.25%+ of the workforce before next spring and wage growth will remain low raising the possibility of calls from the new Congress for another round of tax rebates and/or other fiscal stimulus. With the dollar strengthening and commodity prices, including oil, finally in retreat, the Fed will have room to remain accommodative longer than most forecasts currently incorporate providing some relief for consumers and the stock market. We expect the Fed will remain on hold before raising rates until well into 2009 when some stability in housing finally emerges, the unemployment picture begins to brighten, and an uptick in the overall growth of the economy is more clearly in prospect. The dollar is expected to strengthen further as business conditions abroad weaken and foreign central bankers ponder interest rate cuts to prop up their flagging economies. From their low point of 2.0% in 2009, the Fed funds rate could climb to 3.5%+ by year-end. And finally, with oil and commodity prices moderating, and the dollar strengthening, headline inflation rates are set to slow by the end of this year. "Core" CPI inflation is likely to end 2008 close to 2.0%, the top of the Federal Reserve's "desired" range of 1.5%-2.0% while headline inflation, including food and energy, is expected to recede from its recent rate above 4%.

One other point on inflation: employers eliminated 165,000 jobs last quarter to shore up profits, and still managed to increase output with fewer workers. Gains in productivity help lower inflation supporting the Fed's notion inflation will moderate as payrolls are pared further this year amid a weak labor market.

Global Economy

A number of closely followed *market-based* indicators show the global economy may slow more than is generally expected. These include:

- Emerging market equities are generally underperforming developed market and US equities year-to-date. For example:

	2008 % Change*
India	(25.23)%
China	(48.35)%
Brazil	(11.45)%
Russia	(21.07)%
Thailand	(19.51)%
Malaysia	(22.47)%
Indonesia	(20.3)%
South Korea	(17.31)%
EAFE (Developed Markets)	(16.73)%
S&P 500	(11.8)%

***through 8/8/08**

- Global debt is outperforming global equity year-to-date despite inflation fears.
- Commodity prices, the basis for GDP growth in many developing countries, have collapsed. The S&P GSCI index is down over 20% from its peak this spring.
- The US dollar has strengthened since April against almost all major currencies portending an earlier recovery here than abroad.
- TIPS spreads, which reflect inflation expectations, are collapsing, pointing to diminished inflation expectations.
- High yield bonds are underperforming US Treasuries this year.
- Emerging market sovereign debt is underperforming US Treasuries this year.

- Our favorite measure of future global business activity and future inflation, the Baltic Dry Index, peaked on May 20 at 11,793 and has since declined to 6,992 -- a drop of over 40%. This index measures day rates for dry cargo shipped on the North Sea.

China is a case in point. Its post-Olympics economic slowdown started even before the games began. New orders at Chinese factories plunged last month. Exports are barely growing, after adjusting for inflation and currency fluctuations. Their real estate market is weakening with apartment prices sinking in southeastern China, the region hardest hit by economic troubles. While China's economic growth is not likely to end any time soon, any significant slowing below its recent pace of 11%+ per year will make it difficult to find jobs for the millions of people moving each year from rural areas to cities in search of work. Earlier estimates of 9.0% to 10.0% growth are coming down. Decelerating growth will have a ripple effect elsewhere. For example, reduced demand for oil, copper, tin, zinc, and aluminum will allow commodity prices to fall further as Chinese factories have to cut back production. Beyond the immediate economic slowdown and impact on world commodity prices, slower growth could cause political unrest among those in China, India, North Africa, and elsewhere where job expectations are not being met.

During the past five years, China has put a series of brakes on its economy to keep inflation under control. These are now being eased to cushion the economic slowdown. After allowing its currency to rise sharply against the dollar in the first half of this year, China's central bank has actually pushed down the yuan against the dollar on several recent occasions hoping to preserve the competitiveness of Chinese exporters. Chinese authorities have also raised export tax refunds for garment manufacturers and have reportedly moved to ease lending limits on banks. Weak demand from the US over the past year, and recently from Europe as well, is part of China's emerging problem which will not soon go away.

Fixed Income Policy

With the recent decline in inflation expectations due to falling commodity prices and tepid wage gains, the yield curve has begun to steepen again. Short-term rates have fallen toward the 2% Fed Funds rate and long-term rates have risen, discounting an eventual improvement in business and greater medium term inflation risks. Nevertheless, rates on intermediate-term bonds still remain unattractive. We have, therefore, remained largely on the sidelines awaiting higher rates before committing clients' capital to these maturities preferring instead the safety of very short-term investments. While yield spread between US treasuries and lower grade bonds have risen, the differential is still insufficient, in our view, to compensate clients for the increased risk they would assume in owning these obligations.

Equity Investment Strategy

Our July 9th Stock Market Comments noted the attractiveness of US equities based upon a number of metrics including price/earnings multiples and earnings yields. The attached copy of the so-called Fed Valuation Model shows stocks to be as undervalued relative to bonds as they have been in decades. While this model is not intended to be a market-timing device, it confirms the potential of equities given a continuation of trends toward lower commodity prices, a stronger dollar, and the eventual stabilization of the housing market we expect.

As the US stock market pulled back this spring, we began to deploy 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 client portfolios were shares of technology companies whose earnings are expected to remain relatively strong as global growth slows. We also added to two other groups: retailers, whose shares were depressed by concerns over consumer spending and financials, which were selling at valuations not seen in at least 15 years. Sector concentration in our diversified core equity portfolio currently is as follows:

Sector Concentration %		
	Portfolio	**S&P 500**
Basic Industries & Transportation	**1.82**	**6.70**
Technology	**17.81**	**16.04**
Industrial Capital Goods	**9.32**	**8.58**
Discretionary Consumer Goods	**9.49**	**5.79**
Services & Media	**2.27**	**6.68**
Telecom Services	**3.87**	**3.22**
Consumer Staples	**12.53**	**9.86**
Healthcare	**13.98**	**12.10**
Energy	**7.51**	**12.98**
Financial	**12.70**	**13.96**
Real Estate Investment Trusts	**NA**	**0.40**
Utilities	**NA**	**3.34**
Foreign	**8.70**	**NA**

Finally, the metrics of our core equity portfolio remain compelling when compared with those of the S&P 500 stock index.

	2008 P/E	Estimated Future Growth Rate	Dividend Yield	ROE	P/E to Future Growth Rate
FBA Average Growth Stock	**18x**	**14%**	**1.6%**	**32%**	**1.4x**
FBA Average Value Stock	**14x**	**10%**	**4.6%**	**17%**	**1.4x**
FBA Total Portfolio	**16x**	**12%**	**2.8%**	**25%**	**1.4x**
S&P 500	**14x**	**7%**	**2.2%**	**15%**	**1.6x**

While earnings of the current FBA stock portfolio are estimated to grow at 12% per annum, S&P earnings are forecast to rise significantly more slowly at 7% per year. Yet, the 16x price earnings multiple of the FBA core portfolio is only moderately higher than that of the S&P 500, and the P/E to future growth rate is a low 1.4x versus 1.6x for the S&P.

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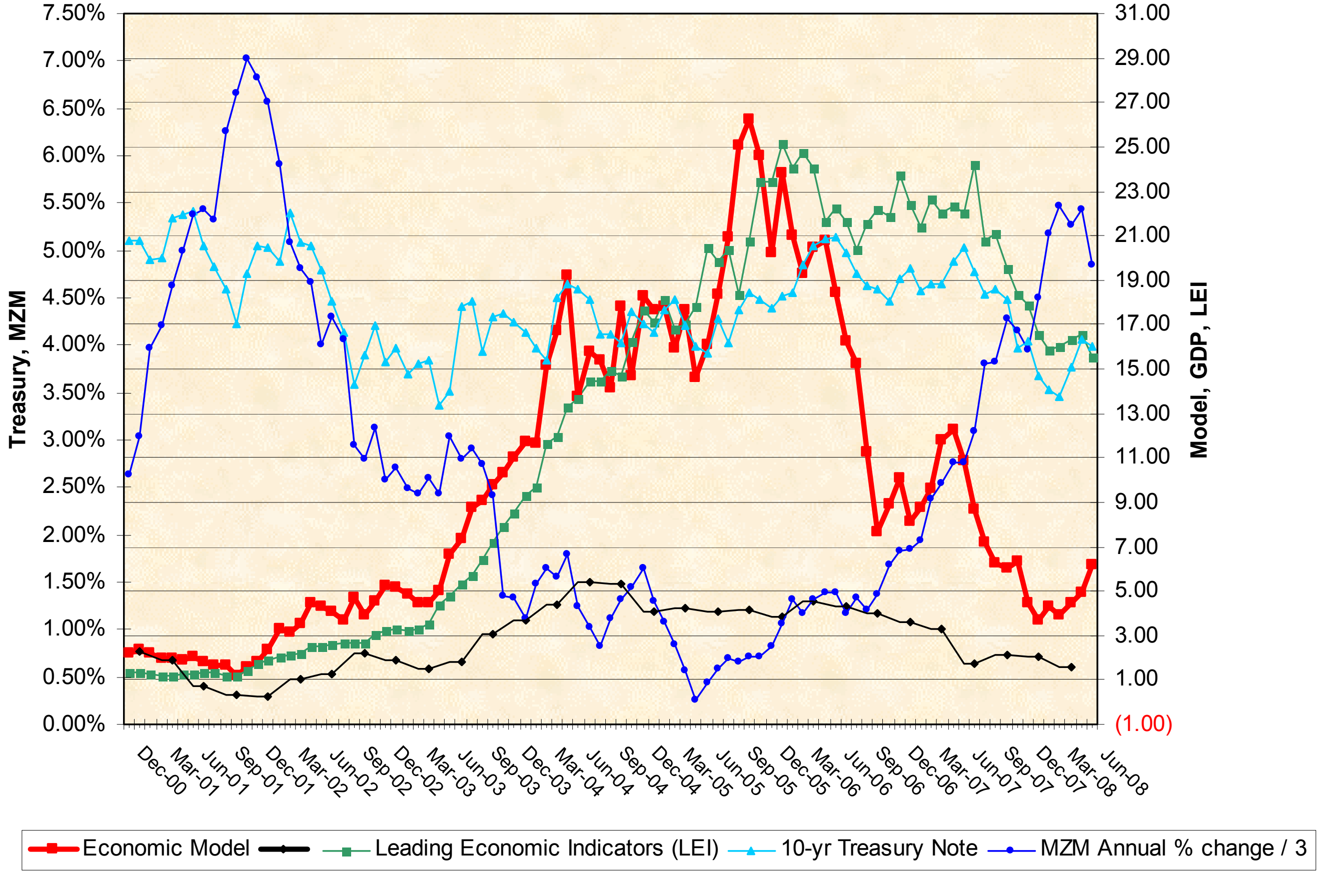
Front Barnett Associates Economic Model



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.

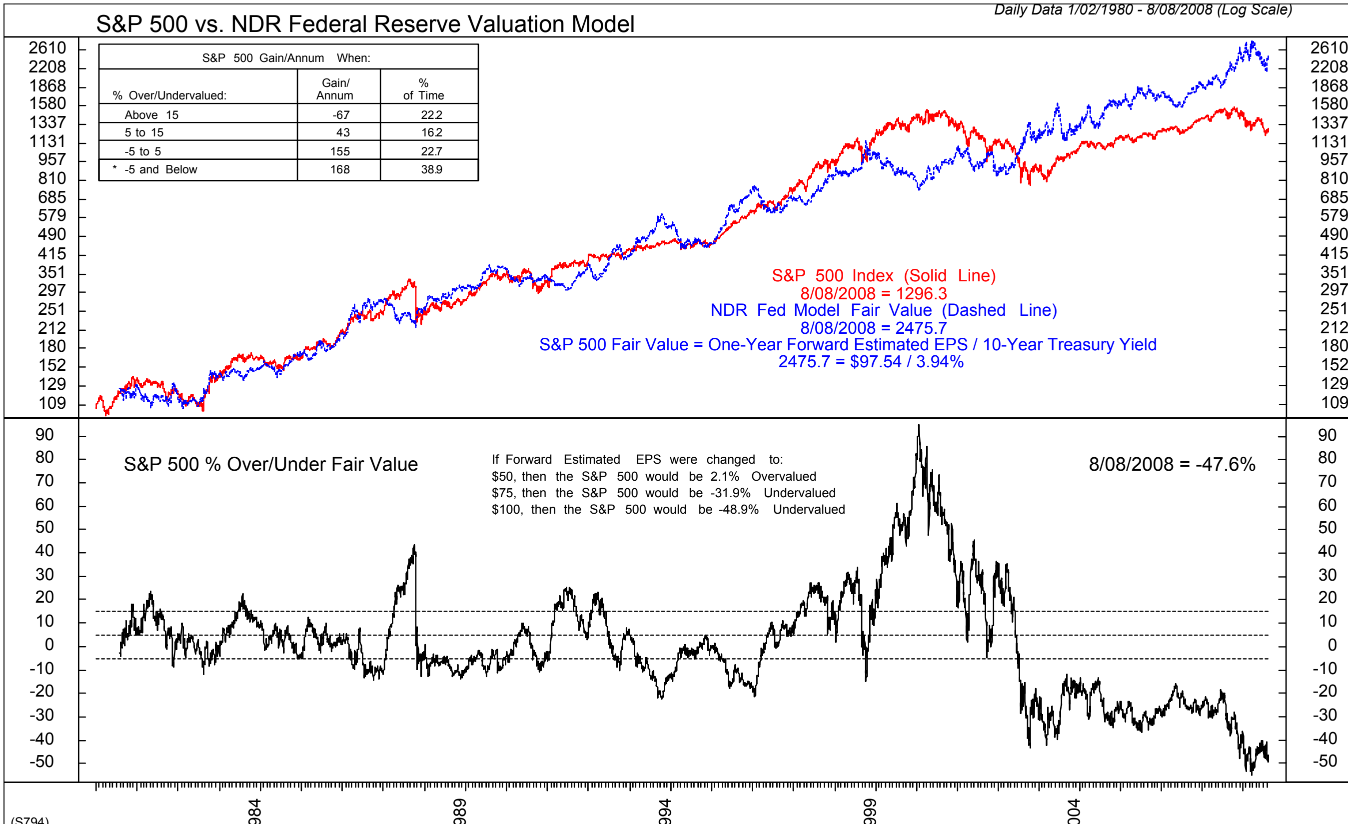


Chart Courtesy of Ned Davis Research