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THE ECONOMIC OUTLOOK -- CONFIDENCE SHAKEN

Confidence in the global economic system has been shaken, putting the credit markets in the US and most other industrialized nations under severe pressure. The cause of the turmoil was a sequence of events stemming from the steep increase and subsequent fall of housing prices nationally, which, together with shoddy lending practices and lax regulation led to large losses on mortgage-related securities held by a broad range of investors. The turmoil is the aftermath of a credit boom which fostered a number of unprecedented excesses including unbridled greed, the underpricing of risk, and excessive leverage built upon an increasing reliance on complex and opaque financial instruments whose behavior under stress proved to be both fragile and unpredictable. The unwinding of this boom and the resulting financial strains caused a broad-based tightening in credit conditions that, in recent weeks, have begun to restrain economic growth.

Over the past few weeks, investors' confidence in banks and other financial institutions eroded and risk aversion rose. Conditions in the interbank lending market worsened, with term lending essentially vanishing. For a few days, prime money market mutual funds, which are important sources of credit to the commercial paper market, severely disrupted that market, and short term credit, when available, became more costly to all borrowers. Households, state, and local governments also experienced a pronounced reduction in credit availability. Financial conditions abroad also deteriorated, pressuring both industrial and emerging-market economies. As confidence in the financial markets fell, and concerns regarding the US and global economies increased, stock markets around the world became extremely volatile and fell sharply, recording losses approaching those experienced in only a handful of financial panics since the 1930's. Below is a sampling of global stock market declines this year through October 10th -- the market's low point-to-date.

Developed Markets	% Change	Emerging Markets	% Change
US	-39%	Brazil	-44%
UK	-39%	India	-48%
Australia	-39%	Iceland	-59%
France	-43%	China	-62%
Germany	-44%	Russia	-63%
Japan	-46%		
Italy	-47%	Emerging Market Index (EEM)	-51%
Developed Market Index (EAFE)	-46%		

Unprecedented Government Actions

The US government, in collaboration with governments and central banks abroad, has undertaken massive, unprecedented actions to unfreeze the financial markets and restore confidence in the financial system.

- <u>First, to address pressures in interbank funding markets,</u> the Fed significantly increased the quantity of term funds it auctions to banks to satisfy heightened demands for funding from banks and primary dealers. Currency swap lines with foreign central banks have been expanded allowing cooperating central banks to supply dollar liquidity in their own countries, helping to reduce strains in global money markets and, in turn, our own markets.

- <u>Second, to deal with illiquidity and the impaired functioning of the commercial paper market</u>, the US Treasury implemented a temporary guarantee program for balances held in money market mutual funds reversing the outflows these funds had experienced. The Fed established a temporary lending facility that provides financing for banks to purchase high-quality asset-based commercial paper from money market funds, thus providing relief for money market funds that were required to sell their holding to meet redemptions.

- <u>Third, the Troubled Asset Relief Program (TARP)</u> allows the Treasury to provide up to $250-billion of cash infusions to institutions. Nine of the nation's largest financial firms have accepted funding from the program to bolster their capital, and other smaller institutions are also expected to participate in this program. The Treasury is authorized to spend an additional $450-billion to purchase or guarantee toxic mortgage-related and other assets held by banks and other institutions. Both these measures will help rebuild confidence in the financial system and improve the ability of financial institutions to raise capital from private sources.

- Other confidence-restoring measures include temporarily increasing the limit on deposit insurance coverage provided by the FDIC and National Credit Union Association from $100,000 to $250,000 per account, providing unlimited insurance coverage of funds held in non-interest-bearing accounts (i.e. payroll accounts) and guaranteeing the senior unsecured debt of FDIC-insured banks.

And currently, the administration is weighing a $40 billion measure to help forestall foreclosures, one of a series of proposals under review designed to address the root causes of the financial crisis. Under consideration are plans to give financial incentives to banks to turn troubled loans into more affordable mortgages and separate proposals to use part of the $700 billion financial rescue fund to directly buy and renegotiate mortgages. A turn for the better in the economy awaits a turn in the housing market.

Given the global nature of the credit freeze, it was critical that central banks abroad cooperated on measures to address the crisis. In fact, it was the actions of the Bank of England with respect to the direct injections of capital into their banking institutions that eventually served as a model for similar action on the part of the US Treasury and other central banks.

While these measures were announced only a week or so ago, there have already been some encouraging signs of improvement in the credit markets as measured by sensitive indicators we monitor daily. For example, the spread between the London Interbank Offered Rate (LIBOR) and the US Fed funds rate has narrowed dramatically. Commercial paper rates have fallen to three-week lows and funds withdrawn from money market mutual funds have begun to return. Interbank lending rates for all maturities from overnight to one year are declining. Regional banks, which had previously reported outflows of deposits to larger money center banks, have begun to experience deposit inflows. And, as tensions in the credit markets have begun to ease, global equity markets, while still extremely volatile and likely to remain that way for some time, have generally rebounded from their October lows. So, it now appears that last week's announcements from policy makers here and abroad to provide banks with capital injections and insurance on debt are gradually breaking the credit logjam.

As we see it, the massive global responses designed to inject liquidity and encourage lending should bear fruit, standing a good chance of short-circuiting what appeared to be a cycle of ever-decreasing confidence and worsening economic impact. That said, the stabilization of the global financial system remains a work-in-process and will not immediately eliminate the challenges facing the broader economy. Moreover, the uncertainties and the unintended consequences of the remedies being applied remain difficult to forecast.

The Economy

Despite positive GDP readings during the past three quarters, economic activity had shown considerable signs of slowing. In particular, businesses cut 168,000 jobs in September, bringing total job losses in the private sector since January 2008 to nearly 900,000. Meanwhile, the unemployment rate at 6.1% in September had risen 1.2 percentage points since the first of the year. Looking ahead, we see the unemployment rate, a lagging indicator, approaching 8.0% by the end of 2009 as *consumer spending*, *housing,* and *business inventories* have all shown significant slowing over the past few months and the underpinnings of consumer spending, which accounts for two-thirds of GDP, have deteriorated. Stock and housing prices have fallen sharply, growth abroad has slowed considerably, and credit conditions have tightened. Consumer sentiment remains quite low reflecting job concerns, the elevated level of gasoline prices, the state of the housing market, and possibly, to some degree, uncertainties over the coming elections. An offset to the slowing consumer economy is that substantial declines in energy prices and other commodities should have a favorable impact on household purchasing power going forward.

In the *business sector*, orders for shipments of non-defense capital goods have generally slowed and forward looking indicators such as those compiled by the Institute for Supply Management (ISM) for both the manufacturing and services sectors, and factory orders portend further declines in business investment in the coming months. Outlays for nonresidential construction, which had been strong over the first half of the year, appear to be decelerating reflecting the less favorable outlook for sales as well as reduced credit availability from banks and other lenders. As for housing, there are few signs of stability, let alone an upturn. For example, single-family housing starts fell 12% in September, permit issuance dropped sharply with demand for new homes remaining at a depressed level, mortgage applications continue to fall, and the backlog of unsold homes remains near record highs. Residential construction is likely to continue to contract through the middle of next year when we expect the housing market to show some signs of stabilizing. A broader recovery benefiting homebuilders is not likely until 2010.

International Trade was an engine of growth for the US economy over the first half of this year. Domestic output was driven by the weak dollar and strong foreign demand for a broad range of US exports, including agricultural products, capital goods, and industrial supplies. While trade should continue to be a positive factor for the US economy, its contribution to our growth is likely to diminish somewhat as global growth slows and the dollar strengthens.

Inflation and Short-Term Rates

The prices of goods and services rose rapidly earlier this year as steep increases in oil and other commodities led to higher retail prices for fuel and food, as firms were able to pass through a portion of their higher production costs. These effects have now shown signs of reversing as commodity prices have declined substantially since summer. Moreover, import prices are decelerating and market-based indicators such as falling yields on inflation-indexed US Treasury bonds (TIPS) and the price of gold suggest inflation expectations are easing. These trends, together with the likelihood of negative business growth for two or three quarters, should bring inflation down to levels where the Fed will be comfortable reducing interest rates further -- possibly by another 25 basis points following their meeting later this month. We would not be surprised to see the Fed Funds rate dip below 0.5% during the current easing cycle. We also expect foreign central banks to reduce their reference rates substantially over the months ahead providing additional support for the US dollar. Interestingly, the US dollar index has risen 20% since its low on April 14th as investors have withdrawn funds from emerging markets and cut other risky, leveraged investments bringing them to the US to which many investors retreat in times of stress. The dollar stands at a two year high versus the euro and a five year high against the British pound.

Forecast

While it is still too soon to forecast the extent and duration of what now appears to be a recession, a number of factors are likely to foster the eventual return to gains in economic activity and employment. Among those factors are: (1) the stimulus provided by accommodative monetary policy; (2) the inevitable stabilization in the housing market that will occur as prices steady next year and the number of unsold homes dwindles; (3) improvements in our credit markets as the new programs gain traction; (4) the growing likelihood of a second fiscal stimulus package, and; (5) the resilience of the US economy. The time required for an economic turnaround will, in our judgment, depend greatly on how quickly the financial and credit markets normalize. Because it is difficult at this point to judge how long it will take for this normalization process to unfold, the uncertainties surrounding the outlook remain unusually large. Clearly, two or three quarters of negative GDP are likely.

Equity Investment Policy

Investment opportunity inevitably follows disillusionment when confidence is shaken. That opportunity is at hand for *patient* investors despite the uncertainties regarding the depth and duration of the current slowdown and the difficulty of forecasting the course of the eventual recovery. US equities have fallen to valuation levels last seen in the early 1990's, selling at about 11 times estimated 2009 earnings, providing a 3% yield, and are priced at a modest multiple of their book value by historical standards. Given the difficult macro-economic backdrop, resilient *growth* companies that are less reliant on raising capital from outside sources (i.e. companies able to self-finance their growth) and have a record of strong growth and high returns on capital should perform well as investors are likely to re-engage the markets through higher quality companies as confidence is eventually restored.

We continue to favor broad diversification and, despite outsized declines in developed markets, favor allocating 10%+ of stock portfolios to companies domiciled abroad.

Large financial institutions, which will be important beneficiaries of recently enacted government programs, remain attractive despite their obvious problems and potential shareholder dilution.

Fixed Income Investment Policy

Municipal bonds, whose yields remain above those of comparable maturity US government bonds, are particularly attractive at this time. We are actively adding to shorter-term municipal bond positions.

We remain cautious with regard to generally extending fixed income maturities, awaiting better opportunities to do so. However, we have found instances of shorter-term corporate offerings to be attractively priced now and we have selectively added these issues to portfolios.

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Finally, these are difficult and uncertain times for us all. At Front Barnett Associates we are mindful of the investment risks and opportunities the markets present. We encourage clients with questions regarding how we are applying our investment perspective to their portfolios in these volatile markets to be in touch with us.