FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

Marshall B. Front
Chairman

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

December 23, 2008

THE ECONOMIC OUTLOOK AT YEAR END

By almost all measures, the economy remains mired in the worst recession since 1982 when unemployment rose to 10.8%, CPI inflation briefly touched 13%, and rates on US Treasury bills neared 14%. At the time, newly elected president Reagan was quoted as saying "we have inherited the worst economic mess since the depression." Sound familiar? While the cause of the earlier recession was runaway inflation fueled by high energy prices, the current malaise was triggered by excessive credit expansion. As it deflated, the credit bubble led to a collapse in real estate which has now infected the broader economy. Forced deleveraging by individuals and financial institutions, and another boom-bust energy cycle have added fuel to the fire. Consumer and business confidence has been badly shaken, putting the global credit markets under severe pressure.

Perhaps the single greatest contributor to the financial market collapse was US policy-makers' decision not to rescue Lehman Brothers in September. The negative, unintended consequences of this failure to act have been staggering. Soon after Lehman's demise, borrowing costs skyrocketed as counterparty confidence plummeted. Important segments of the financial markets ceased to function precipitating another downward spiral in economic activity from which we have yet to recover. Equity and bond markets globally became extremely volatile and fell sharply, recording stock losses approaching those experienced in only a handful of financial panics since the 1920's.

The attached exhibit, No Place to Hide, demonstrates the pervasiveness of the contraction in the stock values and commodity prices during the past year. When viewed from the perspective of stock mutual fund investors, the carnage has been even worse than the broad stock market indices would suggest: Over 70% of large cap stock funds have under-performed the S&P 500 this year. In the wake of this decline, individual investors, who account for roughly half of all stock holdings when their IRA and 401K investments are tallied, have fled the market pulling a record $72-billion from stock funds in October alone following $40-billion of net annual redemptions since 2005.

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

The attached table, 2008 Stock Market Performance Perspective, puts this year's drop in context. In only one other year since 1926 has the stock market suffered as steep a decline as in 2008-to-date. That year was 1931, when the US was on its way to a 25% unemployment rate and a GDP decline of roughly a third from its prior peak.

A broad range of unprecedented monetary measures and other government actions undertaken or signaled over the past two months has had some success in unfreezing the credit markets and beginning the process of restoring investor confidence. Interbank lending rates (LIBOR) have fallen substantially, approaching normal levels. The commercial paper market is now functioning normally. Money market mutual funds have been receiving large cash inflows following a brief but harrowing few days of investor panic occasioned by one fund's inability to meet shareholder redemptions without "breaking the buck." Despite the improved functioning of sectors of the financial markets, particularly those where government has directly intervened, spreads in the corporate and municipal bond markets remain extremely wide by historical standards and the spread between LIBOR and the fed funds rate -- normally 10-15 basis points -- remains at an unhealthy 124 basis points. At best, credit markets remain problematic.

It is no accident that the new round of credit and generalized financial market turmoil since September has coincided with a further deepening of the US and global recession. With it, rising unemployment and solvency challenges among weaker firms and industries (i.e. autos) continue to feedback on financial institutions and markets. This bears down further on real economic activity in a vicious cycle.

As noted above, even the unprecedented policy steps taken to date have failed to fully normalize basic market functioning much less stimulate significant risk-taking in private financial markets. As a result, policy-makers are moving rapidly to arrest economic contraction ahead of all other short- and intermediate-term goals. Additional steps, including the recent dramatic move toward a zero fed funds rate amid other liquidity enhancing and quantitative easing measures, are being taken. Following their last meeting, Fed policy-makers indicated their intention to keep rates low for as long a period as necessary. And fiscal policy-makers are considering a stimulus package approaching $850-billion to create 3-million new jobs to be voted upon when the next Congress convenes in January.

LESSONS FROM JAPAN

The fed funds rate decision last week, and the Fed's vow to pump money directly into the credit markets by buying mortgage-related debt and corporate bonds, brings to mind a similar decision by the Bank of Japan a decade ago as they fought to end a

long economic stagnation. Japan's zero interest-rate policy finally worked after regulators took aggressive action that succeeded in restoring faith in Japan's financial system and their ability to regulate it. We need to take similar steps in confidence-building, and much more quickly than Japan did, if we are to avert a prolonged period of stagnation here.

The Bank of Japan first lowered interest rates to zero in 1999 for a year, then, after a temporary, unsettling reversal in 2000, lowered them again to zero in 2001 and kept them there for five years as they sought to contain a domestic financial crisis not unlike the one now gripping global markets. The biggest lesson learned from the Japanese experience was that cutting rates alone has almost no affect when the financial system has fallen into a deep crisis. Under these circumstances, where borrowers could suddenly go bankrupt, saddling lenders with huge, unforeseen losses, banks simply refused to lend. Instead, commercial banks just let the money pile up.

We face a similar situation in the US following Lehman's abrupt collapse where fears of additional failures have taken hold. Inconsistency by policy makers in dealing with the financial crisis has led to the impression we have no clear strategy for dealing with ailing lenders. In Japan's case, credit began to flow freely again only after 2003 when regulators adopted stringent new bank auditing policies, forcing weak institutions to either raise new capital or accept a government takeover. The audits removed paralysis in the credit markets by convincing bankers and investors that sudden failures were no longer a risk and that the true extent of bank problems was finally being revealed. The lessons for the US to be drawn from the Japanese experience are these:

- Bank and financial companies need to become more *transparent* and regulation needs to be strengthened to reassure investors that there are no more collapses like that of Lehman Brothers in the cards;

- *Consistency* is important. Japanese officials learned that bankers and investors would lend in difficult times only if they believed that rates would stay low for a long period, ensuring them adequate profits.

President-elect Obama has made tougher regulation of financial institutions a priority increasing the likelihood of greater transparency in financial reporting. And the FOMC, in its recent statement, said, "in particular, the committee anticipates... exceptionally low levels of the federal funds rate for some time." The US appears to have moved quickly and, hopefully, learned the lessons of *transparency* and *consistency* from the Japanese experience.

SOME SIGNS OF STABILITY

With building expectations and recent actual steps taken to stabilize the financial markets (including new guarantees on bank debt and announced purchases of government agency mortgage-related debt and corporate bonds) a variety of leading financial indicators have begun to stabilize, a necessary first step toward limiting the toll on the US economy. While yield spreads have widened as Treasury yields have plunged, investment grade corporate bond yields have fallen by almost one full percentage point over the past month. Nevertheless, substantial further declines in business and consumer costs will be necessary to curb retrenchment. Credit remains limited. Current borrowing costs remain well above prospects for income that would justify borrowing. With these financial developments still playing out, estimates for economic activity and corporate profits have been lowered since our October 22nd client letter.

All of the new tools announced by the Fed amount to printing money in vast quantities. The Federal Reserve has already started the process. Since September, the Fed's balance sheet has ballooned from about $900-billion to more than $2-trillion as the central bank has created new money and lent it out via new programs. When the Fed completes its plans to buy up mortgage-backed debt, corporate bonds and consumer debt, its balance sheet will have risen to about $3-trillion. At some point, when it is clear the economy has regained a path toward full employment and trend growth -- without knowing the timing -- the Fed is going to have to sop-up the excess reserves it is creating or risk another bout of severe inflation. Whether the Fed will be sufficiently prescient to shift gears from fighting the risk of *deflation* to curbing incipient *inflation* on a timely basis is clearly open to question given its less-than-stellar track record.

BUSINESS CONDITIONS

Real activity has contracted sharply as falling home prices, rising unemployment and credit rationing have impacted consumer spending. Meanwhile, slowing business abroad and a stronger dollar have dampened demand for US exports which had been brisk until mid year. Below are our observations regarding current and forecast business conditions:

- The decline in *new home sales* shows no signs of abating. Homebuilders' assessments of sales and the outlook for housing demand has not been more dire in almost 30 years. Although the months' supply of unsold new homes remains elevated, builders are making progress in working down the overhang. Moreover, the number of completed homes on the market has declined. At the

current rate of sales, estimates are that the stock of unsold homes will reach long-run norms by mid-2009, when we believe signs of housing market stabilization will begin to emerge.

- *Existing home sales* continue to slip, reflecting broadening economic weakness and household financial stress. Pending home sales are lackluster and reports show buyer traffic is at an all-time low. As unemployment rises, more homeowners will find themselves unable to pay their mortgages, further distressing the housing finance industry.

- *Consumer sentiment*, based upon jobless claims now averaging well over 525,000 a week, is likely to remain low as the recent moderate improvement in stock prices will likely to be largely offset as the gasoline price drop slows from recent weeks and housing prices continue to fall.

- *Jobless claims* remain near 26-year highs, reaching the levels of the early 1980's recession, and continue to signal significant deterioration in the labor market. Unemployment is now forecast to rise to 8.5%+ by the end of 2009 and reach a peak nearing 10.0%+ by mid-2010.

- The sharp decline in *personal income and consumption*, concentrated in autos and gasoline, portends further weakness in the months immediately ahead. Spending in the current quarter is on track to decline at an 8% annualized rate. Meanwhile, the savings rate is likely to continue to rise rapidly. If the economic stimulus package includes a middle class tax cut, as expected, the savings rate could top 5%, a positive sign for future spending, but a drag on short-to-intermediate term outlays.

- The year-to-year change in the *core PCE deflator*, the Fed's favorite measure of inflation, has edged down in recent months and could go below 2% this year giving the Fed cover to remain very accommodative for a protracted period as it has recently signaled. We believe CPI inflation will approach or sink below 1% for all of 2008 and remain quite muted in 2009.

- *Import prices* fell sharply in November adding to concern about deflation taking hold. However, the worst of the weakness was tied to the commodity prices which, as OPEC members have learned, is closely linked to supply and demand. Year-over-year, overall import prices were down 4.4% for November while, excluding petroleum, the rate was up 2.4%.

- *Industrial Production* fell in November for the third time in four months, led by a slump at automakers, as sales plummeted to levels not seen in 26 years. Capacity utilization, or the proportion of plants in use, fell to 75.4% -- well below 79.6% as recently as last May. By comparison, economists believe operating rates of 82% are near optimal.

And forward-looking indicators continue to signal weakness ahead:

- *Manufacturing* in the US contracted in November at the fastest pace since 1982 according to the Institute for Supply Management (ISM) whose factory index dropped to 36.2. A reading of 50 is the dividing line between expansion and contraction. Similar measures from China, the UK, euro area, and Russia all dropped to record lows last month.

- The ISM *non-manufacturing* index registered 37.3 in November, 7.1 percentage points lower than the 44.4% reported for October, showing contraction in the services sector for the second consecutive month. The sole industry reporting growth in November was health care. Services account for 80% of GDP.

- *Leading economic indicators* fell in November for the fifth time in seven months reflecting the worsening outlook. The Conference Board's gauge of the direction of the economy for the next 3 to 6 months dropped 0.4% after falling 0.9% in October underscoring projections the US recession, already 11 months old, will last well into 2009 -- making it the longest in the post-war era as banks restrict credit, home, and stock prices plunge and job losses mount.

FORECAST

All in all, then, the recession, which the National Bureau of Economic Research Business Cycle Dating Committee has decided began in January, appears to have taken a sharp downturn in October. Anecdotal evidence gathered in conversations with clients, industry contacts, and outside consultants supports the view that in the aftermath of the Lehman failure confidence cracked and consumer demand simply "fell off a cliff". Holiday season retail sales are expected to barely meet downward revised expectations. Export demand has slowed as the global recession intensifies. Business spending plans are being slashed in anticipation of recessionary conditions persisting for at least another two quarters.

A significant area of strength remains government spending, which is forecast to grow sharply in 2009-2010 as the new administration's huge fiscal stimulus package is

rolled out. Given the usual lag, the impact of this unprecedented fiscal stimulus, combined with the various liquidity enhancing and quantitative easing steps promised by the Fed and Treasury, are likely to begin to be reflected in improving business conditions by mid-2009. We now expect GDP to have fallen at a 5.0%-5.5% + rate in the current quarter during which the bulk of the "credit shock" is being absorbed. Put in perspective, this quarter's expected decline is the economy's worst performance since the 6.4% setback during the 2nd quarter of 1982. GDP is also expected to be negative sequentially in the coming two quarters, albeit at lesser rates -- 2.5% to 3.0% in Q1 and 1.5%+ to 2.0% in Q2. Beyond mid-year 2009 the economy should begin to snap back with GDP rising at a 2.0%-2.5% rate in the second half. However, a sustained return to trend growth (3%+) is not anticipated until 2010. Unemployment, a lagging indicator, is projected to rise to a peak of 10%+ by mid 2010. S&P 500 corporate profits are now forecast to decline to about $64 per share this year, but begin to stabilize and then edge up in 2009 as financial company write-offs abate and overall profit margins stabilize. We expect 2010 S&P profits to rebound significantly from the cycle low. The long awaited housing turn-around should show signs of emerging in 3Q 2009 as the supply of unsold homes on the market finally returns to more normal levels, housing prices in some regions stabilize encouraging bargain hunting, mortgage rates remain low, and, through new government-sponsored programs now being considered, financing becomes more widely available. Business conditions abroad, which, in developed countries, began to slow only well after the US recession had begun, are expected to lag the US by at least a quarter or two. With a slow global recovery, demand for commodities, including oil and related products, will remain muted assuring reduced inflationary pressures and a more protracted slowdown in many emerging countries economies which are heavily dependent upon the revenues from commodity exports.

FIXED INCOME POLICY

We see great value and opportunity in high-grade corporate and tax-exempt bonds, which have been adversely impacted as investors fled to the safety of US Treasuries.

As yield spreads between US Treasury and corporate obligations spiked this fall to unprecedented levels, reflecting the ongoing credit crunch, we began to redeploy a sizeable portion of the short-term US Treasuries and cash equivalents we have been holding in reserve for future purchases. Additions of Aa and A rated industrial and financial obligations maturing between 4 and 7 years were implemented broadly. As a result, yields on bond holdings have been sharply increased and durations extended. For example, in a typical switch, short-term US Treasury notes yielding 0.6% to maturity, and/or cash equivalents with current yields of less than 1%, were exchanged for a diversified list of corporate bonds yielding 5.5% to 6.5%. As noted above, many

of these bonds have since risen in price with their yields falling by as much as one full percentage point, as the worst of the credit crunch seems to have passed.

In portfolios managed for high tax bracket clients, we continued to purchase high quality tax-exempt bonds with maturities of up to 6 years as tax-exempt bond yields have exceeded those on comparable maturity US Treasure obligations. This is a rare occurrence of which we have been taking advantage using the proceeds of the sales of cash equivalents and short-term US Treasuries to fund the purchases.

Finally, we have also begun to purchase US Treasury Inflation Protected Securities (TIPS) for a broad range of clients. These bonds, obligations of the US Treasury due in 5 or 7 years, are also selling at historically low valuations relative to straight treasury bonds of comparable maturity and offer both higher yields and an inflation protection feature which may become valuable once we move beyond current fears of deflation and refocus on longer term inflations threats stemming from the fiscal and monetary steps now being taken to reflate the economy.

EQUITY INEVSTMENT POLICY

The attached chart, Risk and Opportunity, summarizing the range of emotions investors experience over a market cycle, is worth examining closely. Barring some currently unforeseen exogenous shock to the global financial system, we appear to be at or near the point of maximum financial opportunity having already experienced the fear, desperation, panic, and capitulation which has driven stock investors to their current catatonic state. While stock market technicians continue to duel over such arcane questions as whether the market has hit bottom, and talking heads opine on whether there will be another test of the November lows before we are out of the woods, stocks in general appear to be as attractively priced as they have been since the early 1990's.

The almost 50% decline in the S&P 500 stock index from its peak in October 2007 to its likely trough last month has more than discounted the expected drop in S&P earnings. By most measures of valuation, including price-to-book ratios, price/earnings ratios, price/earnings multiples compared with US Treasury bond yields, price/earnings multiples compared with earnings growth rates and dividend yields compared to bond yields, stocks look statistically cheap. We are, therefore, maintaining our clients' stock positions in anticipation of a substantial stock market rebound next year. As to the question of the timing of the stock market recovery, the enclosed chart, Stocks Rebound as the Economy Emerges from a Recession, shows that stock prices have tended to discount a recession well in advance of its actual occurrence and then begun to rebound before the recession has concluded. On

average, since 1946, markets found a bottom about 8 months into a recession which would put this market's bottom in late this summer or this fall, if the past relationship holds this time around.

In addition, the enclosed chart, Historical Market Perspective, shows that there have been only four previous times since 1926 when the 5-year moving average of stock prices has fallen below zero: 1929-1932, 1939-1940, 1974, and 2004. As you will quickly see, stocks have experienced sharp recoveries following these 5-year periods of zero returns. We expect the current period to give way to another period of recovery.

Finally, our warning early on (see our October 11, 2006 client letter) that excessive leverage, when combined with sometimes illiquid and risky assets such as real estate, commodities, emerging market shares, and highly leveraged hedge funds, would lead to trouble for investors who indulged, have unfortunately come to pass. Sadly, the risks inherent in these trades are generally revealed in periods of financial stress. This cycle is no different than those preceding it. That said, the current market decline has spared no one and it remains to be seen how these alternatives will perform when the credit crunch eases. Stay tuned.

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P.S. To help those in need during these difficult times, we have made a contribution to the Greater Chicago Food Depository in lieu of sending holiday greeting cards to clients and friends of the firm.

We extend season's greeting and best wishes for a happy and prosperous New Year to our clients and associates whose friendship over the past fourteen years has been an important foundation for our success. We are, indeed, grateful for your continuing support.

MBF

NO PLACE TO HIDE

(2008 through 12/19/08)

Indexes	YTD	Decline From 52 Week High
S&P 500	-39.4%	-41.3%
NASDAQ Composite	-40.9	-42.5
Russell 3000	-39.7	-41.6
S&P Small Cap Index	-33.9	-36.4
S&P Mid Cap Index	-39.0	-41.6
REIT ETF	-41.9	-48.1
Foreigns		
EFA	-44.8%	-48.6%
EEM	-49.3	-52.4
Commodities		
Crude Oil	-53.6%	-48.6%
Gold	-3.9	-16.8
Copper	-56.4	-67.3
CRB Index	-38.9	-53.7
Corn	-21.3	-58.6
Natural Gas		
Gasoline		
S&P Sectors		
Financials	-63.1%	-66.1%
Materials	-50.8	-55.3
Industrials	-45.8	-47.4
Technology	-46.9	-48.3
Consumer Directory	-44.3	-47.5
Telecomm	-38.4	-39.8
Energy	-37.3	-43.5
Utilities	-32.3	-34.7
Health Care	-31.9	-34.5
Consumer Staples	-19.5	-21.4
Growth	-39.7%	-41.0%
Value	-46.3	-48.6

Source: Reuters

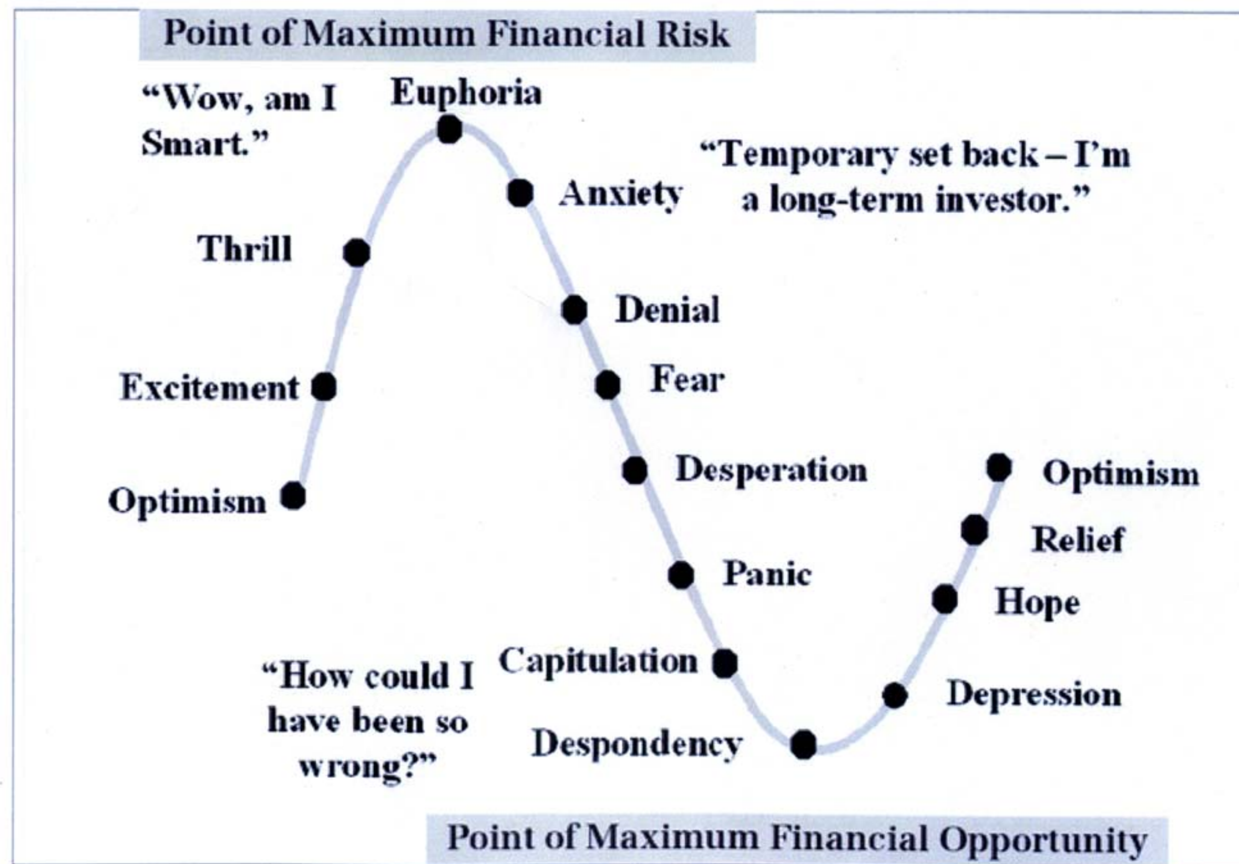
2008 Stock Market Performance Perspective

Positive years : 129 (70%)
Negative years : 54 (30%)

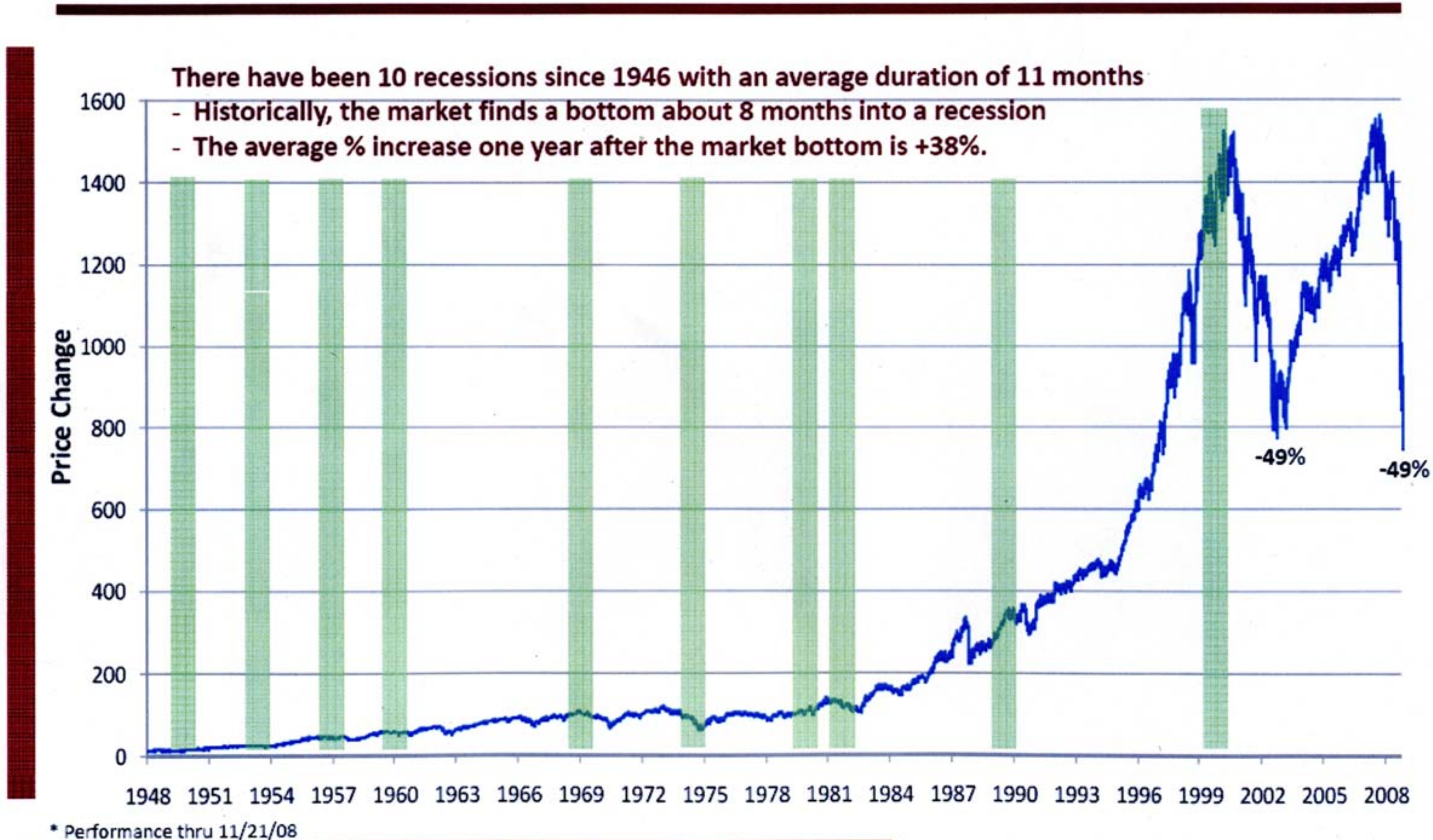
Percentage Total Return	Years
-50 to -40	2008 YTD; 1931
-40 to -30	1937
-30 to -20	2002, 1974, 1930, 1907, 1857, 1839
-20 to -10	2001, 1973, 1966, 1957, 1941, 1920, 1917, 1910, 1893, 1884, 1873, 1854, 1841, 1837, 1831, 1828, 1825
-10 to 0	2000, 1990, 1981, 1977, 1969, 1962, 1953, 1946, 1940, 1939, 1934, 1932, 1929, 1914, 1913, 1903, 1890, 1887, 1883, 1882, 1876, 1861, 1860, 1853, 1851, 1845, 1835, 1833, 1827
0 to 10	2007, 2005, 1994, 1993, 1992, 1987, 1984, 1978, 1970, 1960, 1956, 1948, 1947, 1923, 1916, 1912, 1911, 1906, 1902, 1899, 1896, 1895, 1894, 1891, 1889, 1887, 1881, 1877, 1875, 1874, 1872, 1871, 1870, 1869, 1868, 1867, 1866, 1865, 1859, 1856, 1844, 1842, 1840, 1836, 1826
10 to 20	2006, 2004, 1988, 1986, 1979, 1972, 1971, 1968, 1965, 1964, 1959, 1952, 1949, 1944, 1926, 1921, 1919, 1918, 1905, 1904, 1898, 1897, 1892, 1886, 1878, 1864, 1858, 1855, 1850, 1849, 1848, 1847, 1838, 1834, 1832, 1829
20 to 30	2003, 1999, 1998, 1996, 1983, 1982, 1976, 1967, 1963, 1961, 1951, 1943, 1942, 1925, 1924, 1922, 1915, 1909, 1901, 1900, 1880, 1852, 1846
30 to 40	1997, 1995, 1991, 1989, 1985, 1980, 1975, 1955, 1950, 1945, 1938, 1936, 1927, 1908, 1830
40 to 50	1958, 1935, 1928, 1863, 1843
50 to 60	1954, 1933, 1885, 1879, 1862

Percentage Total Return

Risk and Opportunity

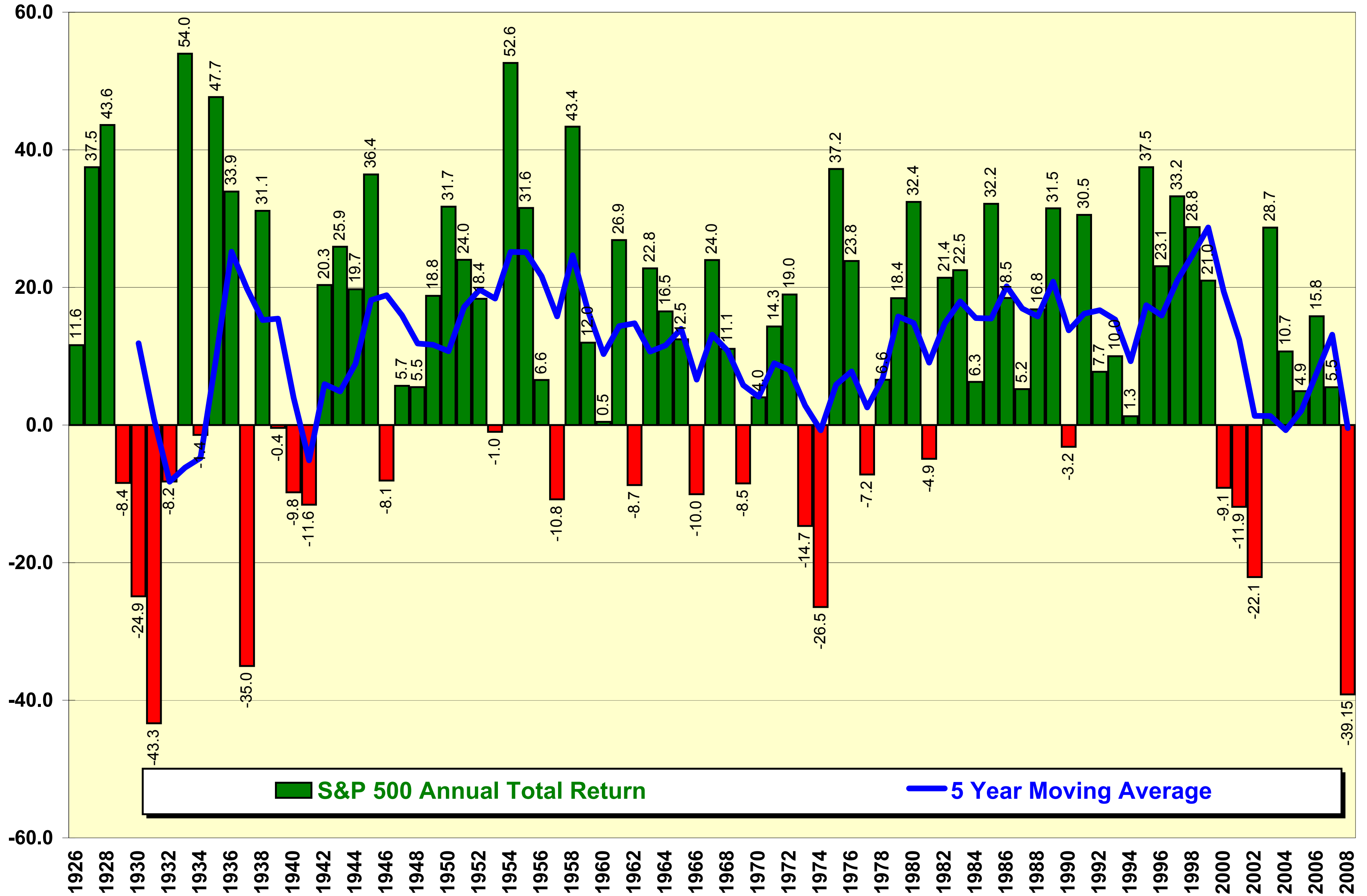


Stocks rebound as the economy emerges from a recession



* Performance thru 11/21/08

Source: Bloomberg L.P. and NBER



Historical Market Perspective
(2008 through 12/19/08)
S&P 500 Annual Total Return
5 Year Moving Average
60.0
40.0
20.0
0.0
-20.0
-40.0
-60.0