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ECONOMIC UPDATE AT YEAR-END

Underpinned by enormous public policy supports and unprecedented stimulus, the longest and most serious financial crisis and worst recession since the Great Depression appears to have ended. Although the economic stress faced by many families and businesses remains intense, with jobs difficult to find and credit still hard to come by, the financial system and the economy have retreated from the brink of collapse they faced last winter. Economic growth has clearly returned. Last quarter saw GDP growth rise at about a 3.0% annualized rate and it is likely the economy will record another solid increase this quarter. However, the recovery has yet to produce a convincing shift in private sector behavior sufficient to generate job gains that will be necessary for a self-sustaining expansion.

Recently, data has shown a pickup in economic activity, reflecting, in part, the receding of some forces that had been restraining the economy during the preceding several quarters. The collapse of final demand that accelerated in the final months of 2008 left many firms with excessive inventories of unsold goods, which in turn led them to cut production and employment very aggressively. This was particularly true in the auto industry where production was temporarily suspended at many plants. By mid-2009, however, inventories had been sufficiently reduced to encourage firms in a broad range of industries to begin output again, contributing to the recent upturn in GDP. While the runoff of inventories encouraged production, a sustainable recovery will require renewed growth in final sales which we have begun to see in demand for homes and consumer goods and services. In the housing sector, sales of new homes have risen appreciably over the course of the year and prices in many markets have firmed. At the same time, the inventory of unsold new homes has been shrinking, encouraging homebuilders to increase the rate of new construction from the depressed levels of the past few years.

Consumer spending also has risen since mid-year, reflecting a temporary surge in auto purchases that resulted from the “cash for clunkers” program. Spending in other categories has increased as well. In the business sector, outlays for new equipment and software are showing signs of stabilizing, and improving economic conditions abroad have strengthened demand for US exports, made more attractive by the weak dollar.

Though we have seen improvement in economic activity, many analysts remain unconvinced the recovery will be self-sustaining. At issue is whether the recovery will

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be strong enough to create the large number of jobs needed to materially reduce the unemployment rate. Encouragingly, employment data released on December 5th showed for the first time in two years employers not only have stopped eliminating large numbers of jobs, but appear to be on the verge of rebuilding payrolls in the anticipation of improving demand. The report revealed unemployment had dropped to 10.1% and that more than 50,000 temporary workers were hired in November, the first such surge in months, and often a precursor to companies hiring permanent workers. Also encouraging was the fact employees worked more hours and, reflecting the increased hours worked, average weekly wages rose by nearly two-thirds of a percentage point. It appears that many companies have now reached the point where they are unable to extract more production from their existing employees and need to add hours for existing workers or to add people.

FORECAST

Given the foregoing data points and anecdotal evidence, it is our view that the shift in private sector behavior has begun to take hold. The business sector is responding to this year's surge in profitability, the improvement in financial market conditions, and synchronized global growth. A modest change in business psychology from depressed levels of activity should produce sustained growth. We, therefore, expect a gradual but broad-based end to the inventory liquidation cycle (in both manufacturing and retail and residential construction) along with increases in investment spending as well as strong export demand to support 2.75% to 3.00% GDP growth next year.

GDP growth of 2.75% to 3.00% might be viewed as disappointing since the economy has historically generated 5.0% to 6.0% growth following a deep economic downturn. As this economic cycle plays out next year and beyond, credit market tightness (which is expect to limit the recovery in investment and consumer durables spending), the damage done to household balance sheets, and job security, and an unusually large drag on growth from reduced state and local government spending, will provide substantial headwinds to growth.

Specifically, we believe corporations will continue to exercise tight spending control which, in the expanding economy we expect, will generate surprisingly strong increases in profits and cash flows. The weak dollar and growth abroad will further boost export activity. Unemployment is likely to remain stubbornly high. We forecast the unemployment rate, currently 10.1%, to decline next year but to remain above 9.0% in 2010 and improve only modestly to an 8.5% to 9.0% rate by late 2011, roughly four-and-a-half percentage points above the average during the past expansion.

Inflation will remain muted as high residential vacancy rates, elevated unemployment, moderate wage pressures, and low manufacturing operating rates restrain price pressures.

With unemployment likely to remain uncomfortably high, the Fed has signaled it is unlikely to raise policy rates until at least late next summer or fall, although they are likely to begin withdrawing some liquidity from the system earlier.

Finally, high unemployment, elevated profit margins, and persisting budget deficits amounting to over $1.0+-trillion, are likely to elicit public policy actions to reduce the budget deficits, spur employment growth, and increase the availability of credit to small businesses through greater social insurance and higher taxes on corporations and the wealthy. Longer term, these policy decisions will undoubtedly bring with them unintended adverse consequences to the economy in the form of reduced incentives to hire, more muted medium-term growth prospects, stubbornly high budget deficits, and elevated inflations risks.

INVESTMENT STRATEGY

Against the backdrop of a broadening US economic recovery as well as the likelihood of a sustained period of monetary accommodation, the outlook for US equities remains favorable. In fact, stocks should gain in their relative attractiveness to fixed income securities and cash alternatives given their greater leverage to GDP growth. With price levels for many bonds now having recovered to pre-recession levels, following their stellar performance this year, potential returns from fixed income securities are now diminished compared to equities. Moreover, the volatility of equities has been steadily declining this year, a likely harbinger of greater future inflows from low-yielding money market funds.

As we see it, the steep 2008-2009 recession has resulted in overly conservative forecasts for S&P 500 profits. While we currently estimate S&P 500 earnings of $75 per share in 2010, Wall Street estimates have been rising with some analysts now forecasting $80+ per share earnings for next year and profits approaching their prior peak of $92.15 by 2011. The S&P is currently trading at about 14.7 times our 2010 estimate, below its average valuation over the past twenty years. In short, stocks look attractive at current levels, despite the inevitability of a correction from time-to-time.

Our stock selection has increasingly favored companies which stand to benefit from the ongoing cyclical expansion, have strong balance sheets and low financing costs. Currently, our largest sector weightings in core equity portfolios are technology, industrials, healthcare, financials, and energy. We have underweighted telecom services, utilities, and staples. We continue to maintain substantial allocations to investments domiciled abroad in both developed and emerging markets. While recognizing their inherent greater volatility, we expect to increase investments in emerging markets over time as opportunities present themselves.

Within the fixed income portion of balanced portfolios under our management, we shifted the bulk of the very short-term US Treasuries we held last year into a combination of high-quality, medium-term corporate bonds and US Treasury Inflation Protected Securities (TIPS). We plan to maintain the current fixed income portfolio structure, which now has an average maturity of less than three years, well into the New Year.

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We are pleased to announce that Sandy Goldman will be joining our firm on January 1st as a Principal, Senior Portfolio Manager, and a member of our Investment Committees.

I have known and respected Sandy since our years together at Stein Roe & Farnham where he was a Senior Research Analyst, head of the Investment Committee and very successfully managed the Stein Roe Special Fund from its inception. Upon leaving Stein Roe, Sandy established his own firm, Goldman Asset Management, which he ran for many years. Sandy brings to Front Barnett Associates a broad range of investment experience, knowledge of complex client situations and a valuable perspective on economic and business matters from which the firm and our clients will benefit.

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

In closing, we extend Season's greetings and best wishes for a happy and healthy holiday season to our valued clients and associates whose friendship and support over the past fifteen years has been an important element in our firm's stability and success.

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