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 -- JOB GROWTH AHEAD

Fed by a surge in inventory investment, exports, and recovering personal consumption expenditures, the US economy last quarter continued its rebound. “Advance” fourth-quarter GDP, which is likely to be revised downward in coming weeks as trade and inventory revisions are made, rose 5.7% following a 2.2% gain in the prior three-month period. These back-to-back quarterly improvements, signaling an end to the Great Recession, followed four consecutive quarters of declining business activity averaging -3.8%. During this time, the US unemployment rate rose to 10.1%, the most visible measure of the depth and duration of the downturn, resulting in over 8-million lost jobs, bringing the total number of unemployed to nearly 18 million. Few forecasts, including our own, envision an early end to the elevated unemployment problem.

The continued extreme weakness in the US jobs market, where weekly over 450,000 people have been applying for jobless benefits, is somewhat puzzling due to the fact that the economy bottomed last summer. A widely accepted econometric model used to forecast the level of unemployment would have predicted an unemployment rate 1.7 percentage points below what we have experienced. The lack of job creation is, we believe, traceable to at least three factors. First, employers undertook massive, preemptive layoffs in reaction to the 2008 financial crisis, adjusting quickly to the likelihood of a deep and protracted recession. Some went further, preparing for depression-like conditions which, of course, never materialized. Second, businesses today face unusual uncertainties in the form of numerous possible higher taxes, additional new taxes, and increased employee healthcare costs stemming from Obama administration initiatives which, if enacted, will need to be funded. These remain unresolved adding to the uncertainty. Third, strong productivity -- up 3% for all of 2009 -- has led to restrained hiring as businesses have been able to grow profits without adding to full-time staffs by increasing hours worked and adding temporary workers. Nevertheless, the history of business cycles suggests that this welcome productivity surge should soon be followed by increased spending as businesses seek to capitalize on profitable new opportunities. Recent encouraging news regarding business capital spending contained in regional Federal Reserve surveys is a precursor to improving labor markets which will lead to hiring increases in the months ahead. *Indeed, it is likely we are on the cusp of beginning to realize these job gains.*

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

While job growth inevitably leads to an expansion in personal income and then spending -- which accounts for over 65% of GDP -- the US economy will continue to face substantial headwinds in the form of credit market tightness, the damage done to household balance sheets and job security, and an unusually large drag on growth from reduced state and local government spending. The recovery ahead will, therefore, be sub par in comparison with prior expansions. Not all indicators will be "strong". Employment and nonresidential construction will lag, as they inevitably do, with unemployment holding high, above 9.0% this year.

FORWARD LOOKING INDICATORS

Nevertheless, we believe this business recovery will prove to be durable, albeit more subdued than most expansions in recent memory. Recently released *forward-looking* economic indicators confirm this view.

- Leading Economic Indicators (LEI), a fairly accurate forward-looking metric, has been signaling expansion since March 2009. Our firm's proprietary Economic Model, a copy of which is attached, first turned up in November 2008 signaling a return to growth six to nine months thereafter. The FBA model continues to flash a positive sign for the period ahead as does the LEI. Stock prices, also viewed as reliable predictors of future business trends, have generally risen since March 2009. The pullback in recent weeks, as sovereign debt concerns overshadowed better than expected fourth quarter earnings from 80% of the reporting companies, does not change the picture.

- The Federal Reserve's fourth quarter survey of Senior Bank Loan Officers showed the increased willingness of banks to make loans, especially for large businesses. This data dovetailed nicely with anecdotal reports on capital spending, such as those from Cisco Systems Chairman, John Chambers, who opined that Cisco's growth "was too uniform across product lines and geographies for it not to signal a greater shift in the economy".

- The Institute for Supply Management (ISM) *Manufacturing index* rose to a solid 58.4 reading in January from 54.9 the prior month. Recall that readings greater than 50 signal expansion. Manufacturing, which accounts for about 12% of the economy, expanded for the sixth consecutive month reaching its highest level since August 2004. Both the new orders and production index components came in above 60, indicating strong current and future performance for this sector. In January, 13 of 18 industries reported growth, up from 9 industries in December, an indication the breadth of the recovery is broadening. Interestingly, the past relationship between the ISM *manufacturing index* and the overall economy indicates the January index reading corresponds with a 5.5% annualized increase in real GDP.

- The ISM index of *non-manufacturin*g businesses, which comprise almost 90% of the economy, rose to 50.5 from 49.8 in December, indicating growth for only the third time in the past nine months. Of significance, the new orders index increased 2.7 percentage points to 54.7 and the employment index increased one percentage point to 44.6.

- *Productivity* of US workers kept surging in the fourth quarter increasing 6.2% as companies squeezed more out of remaining staff to boost earnings. Employee output rose to the highest level since 2003. Historically, productivity gains of this magnitude have come just prior to substantial improvements in job growth.

- *Orders placed* with factories rose for the fourth consecutive month in December as manufacturers sought to replenish depleted inventories. Manufacturers had only enough goods on hand to last 1.29 months at the current sales pace, the fewest since August 2008. Factories have seen some real traction in terms of orders and shipments.

- The number of *mortgage applications* rose 21% in late January to the highest level in more than a month as refinancing rebounded. This gain in purchase applications may be the first sign a renewed and expanded government tax credit is stirring demand after sales dropped late last year on expectations the incentive would expire. However, there also may be greater urgency to refinance now because the door to cheap mortgage money may close as Federal Reserve policy makers have reiterated their pledge to withdraw support for the mortgage market by March 31.

- The number of contracts to buy previously owned homes rose 1.0% in December from the previous month and rose 11.0% compared with a year earlier.

- *Consumer credit*, which declined $1.7 billion in the month of December, fell by the smallest amount in over a year. The 0.8% decline compared with an outsized $21.8 billion decline in November.

Even the key US employment report for January (a lagging indicator), which showed the unemployment rate quite elevated, finally moved lower declining to 9.7% of the work force. Additionally, temporary help payroll employment continued to show a slow increase (+52,000 in January) and the production work week increased to 33.3 hours last month.

Also of interest, the US trade deficit widened in December reflecting a jump in petroleum imports that overshadowed the eighth consecutive monthly gain in exports. In fact,

exports climbed to the highest level in over a year. Faster economic growth in emerging markets, and a drop in the dollar's value making American goods more competitive, is spurring gains in sales overseas. These sales will, in turn, require US manufacturers to ramp-up production to meet demand. Efforts to rebuild depleted inventories will probably also draw in goods from abroad, giving global trade a lift. In our view, a wider trade gap implies our domestic economy is improving, a further sign of sustained recovery ahead.

All in all, then, absent an exogenous shock, indicators we monitor confirm we have entered into a period of moderate but sustainable recovery, with subdued inflation for at least the next year. Housing activity has bottomed in most parts of the country and in some areas has been growing again despite the overhang of 7+ months of homes on the market at the current sales pace. Manufacturing businesses are hiring and expanding. Exports have been rising as economies abroad, particularly in the emerging markets, are showing signs of vigorous growth. Monetary and fiscal stimulus in the US and abroad is providing a strong underpinning to the global recovery and is unlikely to be withdrawn any time soon. While consumer spending, which comprises 65% of the economy, remains sluggish, rising at a 2% pace in the last quarter, we expect gains in jobs and wages in the months ahead. A turnaround in the job market should support gradually improving confidence and the ability to spend which will translate into a greater willingness on the part of consumers to make purchases more freely. GDP growth this year is likely to match trend of about 3.0%.

FEDERAL RESERVE POLICY

Over the past 2-1/2 years the Fed has responded to the financial crisis and the recession by developing a number of programs to provide well-secured, mostly short-term credit to the financial system in its role as liquidity provider of last resort. These measures were a critical part of the government's efforts to stabilize the financial system and restart the flow of credit. As financial conditions have improved, the Fed has substantially phased out these lending programs. To combat the recession, the Fed reduced short-term interest rates nearly to zero and provided additional monetary stimulus through unprecedented large-scale purchases of US Treasury and Agency securities. These asset purchases, which had the additional effect of substantially increasing reserves that banks hold with the Federal Reserve, helped lower interest rates, including those on mortgages, thereby promoting the economic growth we now see taking hold. While the US economy is likely to continue to require the support of accommodative monetary policies for some time, at some point the Fed will need to gradually withdraw the monetary stimulus it has provided by raising short–term rates and reducing the quantity of bank reserves outstanding. Despite the fact rate increases are not likely to take place until later this year, at the earliest, investors, politicians and the media have become incredibly preoccupied with the timing of future interest rate increases and the tools the Fed may employ to enable it to firm the stance of policy at the appropriate time.

Most importantly, the Fed was empowered by Congress in October 2008 to pay interest on bank reserves it holds. By increasing the interest rate on these reserves, the Fed will be able to put upward pressure on all short-term interest rates as banks will not supply short-term funds to the money markets at rates significantly below what they can earn by holding reserves at the Federal Reserve Banks. Actual and prospective increases in short-term rates will be reflected in longer-term interest rates and financial conditions generally.

The Fed has developed other tools such as executing reverse repurchase agreements with banks, auctioning term deposits and redeeming or selling securities in the open market, which it will be able to use to reduce the large quantity of reserves held by the banking system. Reducing these reserves will lower the net supply of funds to money markets, improving the Fed's control of financial conditions.

In short, the Federal Reserve has an array of tools with which to withdraw excess reserves from the system. However, the timing and sequencing of steps the Fed takes as it exits from its very accommodative policy is uncertain and will depend upon the pace of the economic recovery. Clearly, Fed policy will be the subject of intense public debate as there is growing concern among inflation hawks the Fed will fail to act promptly enough to forestall a rise in inflationary expectations. Therefore, the danger in the period immediately ahead is that Congress could, through legislation and/or pressure, politicize the Fed's process threatening the independence it has enjoyed since its founding in 1913.

With low rates of resource utilization (i.e. idle manufacturing capacity and unemployed workers), subdued inflation trends and stable inflation expectations, the Fed is likely to continue testing its tools, holding the measures at its disposal in abeyance until later this year, at the earliest, when the recovery has clearly taken root and the time to tighten is at hand.

FIXED INCOME INVESTMENT POLICY

Our view that the economy will experience a moderate, sustainable expansion over the next several quarters, with inflation well-contained, leads us to favor maintaining the current mix of laddered, short-to-intermediate-term high quality corporate and municipal bonds in client's fixed income portfolios. With the exception of Treasury Inflation Protected Securities (TIPS) positions, we have deemphasized US Treasury bond holdings for over a year as we have viewed Treasuries as overvalued and vulnerable to price erosion when the Fed begins to tighten. We are generally limiting purchases to maturities of less than 5 years. As laddered bonds mature, we plan to replace them with short-dated holdings awaiting a better opportunity to extend maturities. We remain cautious given the vast sums of money that have sought the safety of the bond market over the last year or so, driving yields to less attractive levels.

EQUITY INVESTMENT STRATEGY

We view the outlook for equities as generally favorable. The economy is in the early stages of a durable rebound. Reported corporate profits are likely to continue to exceed investor's expectations this year. Stock portfolios are tilted toward *growth* shares whose earnings are expected to rise more rapidly than those of the average company in a slower growing economy. Stocks are priced below mean valuations -- 13.8 times estimated 2010 S&P per share earnings of $77 versus an average multiple of 15 times -- following their recent pullback.

Periodic stock market corrections of 10%+, as new information is digested, are a certainty. These pullbacks serve to wash out excessive optimism and return share prices to more attractive levels, drawing in new investors. Since the March 2009 market lows, we have experienced two corrections of 7%+ despite the fact the longer term thesis of an expanding global economy, rising corporate profits, and low inflation remains in tact. Nevertheless, we are somewhat surprised the recent corrections have not been deeper and more protracted, given the market's 70% recovery. Perhaps this reflects investors' collective view that despite the dislocations of the financial crisis and the lingering effects of the deep recession, prospective returns on equities are more attractive than those expected from low-yielding money market investments and other fixed income instruments.

Within portfolios under our supervision, recent tactical decisions have resulted in increased exposure to companies: (1) leveraged to the business recovery; (2) whose businesses will benefit from a further expansion in global trade; and, (3) located in emerging markets. We have modestly trimmed holdings of stable growth companies to accommodate new purchases. Cash positions remain modest.

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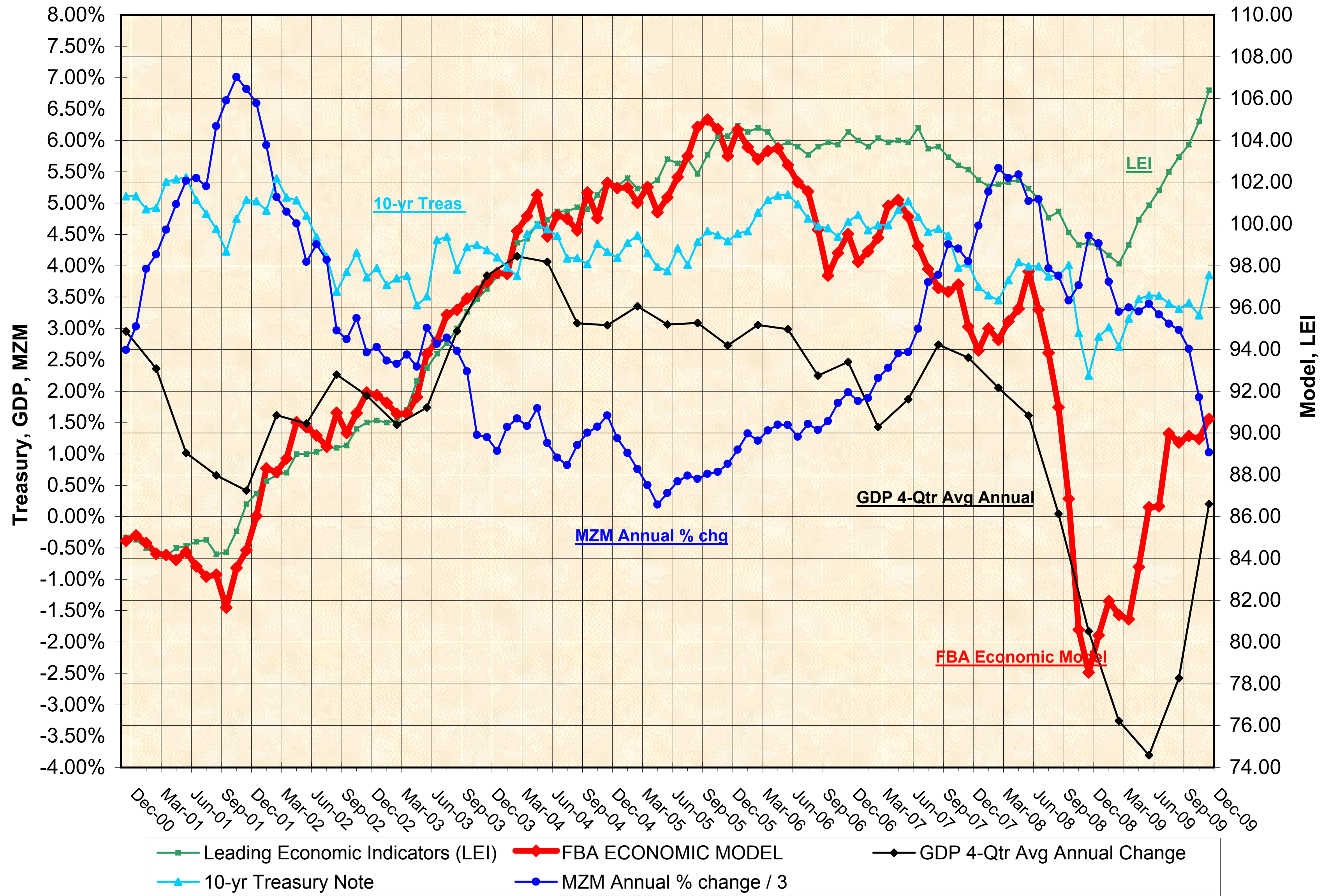

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