FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

Marshall B. Front
Chairman

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

April 7, 2010

ECONOMIC UPDATE -- NO DOUBLE DIP

Investors remain concerned the US economy will dip back into a recession later this year or next. They cite a litany of obstacles to a durable *expansion* including: painfully slow employment growth, higher consumption-sapping taxes, a struggling housing sector, the difficulties both consumers and small businesses are experiencing in obtaining credit, and huge state and local government deficits forcing layoffs and cutbacks. Add fear of another credit shock, most recently underscored by talk of possible defaults by Greece and Portugal, as well as massive federal deficits projected for the next decade, and the possibility of yet another recession begins to cause investors pause.

Nevertheless, we believe the current *recovery* will soon morph into a sustainable *expansion,* albeit one more modest than those we experienced following the deep recessions of the mid-1970s and early-1980s. However the aforementioned obstacles will certainly restrain this expansion even as many of the usual business cycle dynamics play themselves out positively. Recently released *forward-looking* economic data, show the economy gained further momentum as we entered the second quarter.

- The job market is finally showing signs of life, though its slow rebound suggests unemployment will remain uncomfortably high for a protracted period. Last week's payroll report showed 162,000 job gains in March, the largest monthly increase in three years, and 62,000 additions to payrolls in prior months which were unreported previously. Within the components of the report, construction employment showed a notable month-over-month rise of 15,000 while manufacturing gained 17,000. These sectors had previously been serious drags on job creation. Temporary help, a leading indicator for future job growth, also rose. In our view, this welcome news marks a cyclical turning point in private sector job gains.

- Beyond the employment report, there are additional signs confirming a cyclical turn in the labor market. Initial jobless claims have declined to

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

439,000, the lowest level since September 2008, and layoff announcements are down 55% year-over-year.

- The Institute for Supply Management's (ISM) March index of *manufacturing* in the US rose to 59.6 advancing for the eighth consecutive month. Recall that readings above 50 signal expansion. The rate of manufacturing growth as indicated by the ISM is the fastest since July 2004. Both new orders and production rose above 60 closing the first quarter with significant momentum. Interestingly, the employment index came in at 55.1 -- further evidence manufacturers are continuing to fill vacancies. The inventory index showed growth for the first time following 46 months of liquidation -- a possible sign of manufacturers' willingness to increase inventories based upon their expectations for future demand growth.

- The ISM March index of *non-manufacturing* businesses, which compromise almost 90% of the economy, rose to 55.4, the highest level since May 2006. Readings above 50 signal expansion in the service sector. Job gains were widespread throughout the economy except for financial services.

- The National Association of Realtors reported their index of purchase agreements, or pending home sales, rose 8.2% in March, the second-biggest gain on record and the largest since October 2001, indicating a rebound in sales could soon emerge.

- Stock prices, viewed by many economists as a leading economic indicator, advanced 4.9% in the first quarter, the largest rise to start a year since 1998, after US GDP expanded at the fastest pace in six years. This market rise extended the S&P 500's rebound from a 12-year low in March 2009 to 74%.

- Orders placed with US factories rose in February for the 10th time in the past 11 months, with inventories and order backlogs climbing by the most in more than a year, a sign factory production will continue to lead the economic expansion. Excluding demand for transportation equipment such as cars and airplanes, which tend to be volatile month-to-month, orders rose 0.7%, the seventh consecutive advance of this metric.

- Mortgage applications are at their highest levels since last October, indicating buyers may be re-emerging to take advantage of the extended federal tax credit. The increase in mortgage applications may also be linked

to stabilizing home prices. The S&P/Case-Schiller home-price index climbed 0.3% in January following a similar gain in December. This gauge was down 0.7% from January 2009, the smallest year-over-year decrease in two years.

Elsewhere, among *coincident indicators*, consumer spending, which amounts to over two-thirds of GDP, rose in February for the fifth consecutive month, a rebound we believe will accelerate now that employment growth is strengthening.

OUTLOOK

Looking back, the *recovery* appears to have begun last summer, although the National Bureau of Economic Research Dating Committee has yet to opine on this subject. Third quarter GDP turned positive, running at a 2.2% annual rate following four consecutive quarters of negative GDP. Fourth quarter GDP surged 5.6% bringing average growth during the second half of 2009 to about 4%. We now expect similar growth through mid-year followed by a return to trend of 3% in the second half. Underpinning the *expansion* will be: (1) increased consumer spending as job growth continues to ramp up; (2) capital investment from companies which deferred spending during the downturn; (3) net exports driven by robust growth in emerging market countries, and; (4) the lagged effect of both the huge fiscal stimulus enacted last year and monetary accommodation.

At the forecast rate of expansion, we expect job gains to accelerate over the coming months. The unemployment rate of 9.7% in January, down from a peak of 10.1% last October, will work its way lower, but remain above 9% through year-end. Further employment gains are expected in 2011 bringing the unemployment rate down toward 8% by the end of next year.

With low rates of resource utilization, subdued inflation trends, and stable inflation expectations, the Federal Reserve is likely to retain its accommodative monetary policy for the next several months. Nevertheless, as the expansion matures, the Fed will need to begin to tighten monetary conditions to prevent the development of inflationary pressures. The Fed has been testing a number of tools that will enable it to firm the stance of monetary policy as it becomes convinced the strengthening in economic activity is *sustainable* and sufficiently strong to bring down the unemployment rate. At this point in this economic cycle, with unemployment at 9.7%, industrial capacity utilization barely above 70% and inflation, as measured by the Fed's favorite inflation measure, the Personal Consumption Expenditures Index (PCE), at 1.3% and moderating, the Fed is

probably more worried about deflation and high unemployment than an outbreak of inflation. During a recent Fed meeting, members noted that "at the current juncture, the risks of an early start to policy tightening exceeded those associated with a later start" -- Fedspeak for it's too soon to tighten.

INVESTMENT POLICY

Fixed income portfolios remain fully invested in a ladder of high quality short-to-intermediate term bonds. Since their purchase, yields on these securities have declined fairly sharply as credit conditions have normalized causing us to become more defensive given our longer-term concerns over inflation. We are limiting additional bond purchases to obligations generally maturing in two years or less. Bond portfolios now have average maturities of about 3.4 years. Approximately 10% of clients' fixed income portfolios are invested in TIPS, US Treasury Inflation Protected Securities, which represent an insurance policy against rising inflation expectations.

Stock portfolios are broadly diversified and have been fairly fully invested throughout the S&P's almost 74% rebound from its March 2009 low. Concentrations in economically sensitive sectors (i.e. industrials, energy, consumer discretionary, technology) were increased early in the recovery while more defensive sectors (i.e. beverages, discount retailers, pharmaceuticals, communications, and consumer staples) have been deemphasized. Approximately 15% of clients' equity portfolios are invested in companies domiciled outside the US, with an increasing portion of these allocated to the emerging markets.

Stock market measures we monitor closely (including valuation, supply/demand, cash flows, and market sentiment) lead us to believe our current policy will be validated by further market gains -- albeit far less dramatic than those of the past twelve months -- although a correction or two along the way should be expected.

SUMMARY

In short, while numerous well-publicized problems remain to be resolved, we believe we are still in the early stages of an economic expansion. Credit markets are mending. Corporations have the highest levels of cash on their balance sheets (11% of total assets) since 1955. The Fed has now withdrawn many of the extraordinary programs put in place to stem the 2008 financial crisis. Additional measures will be taken to reduce monetary accommodation in the months ahead once employment growth portends a *sustainable* expansion. Our proprietary

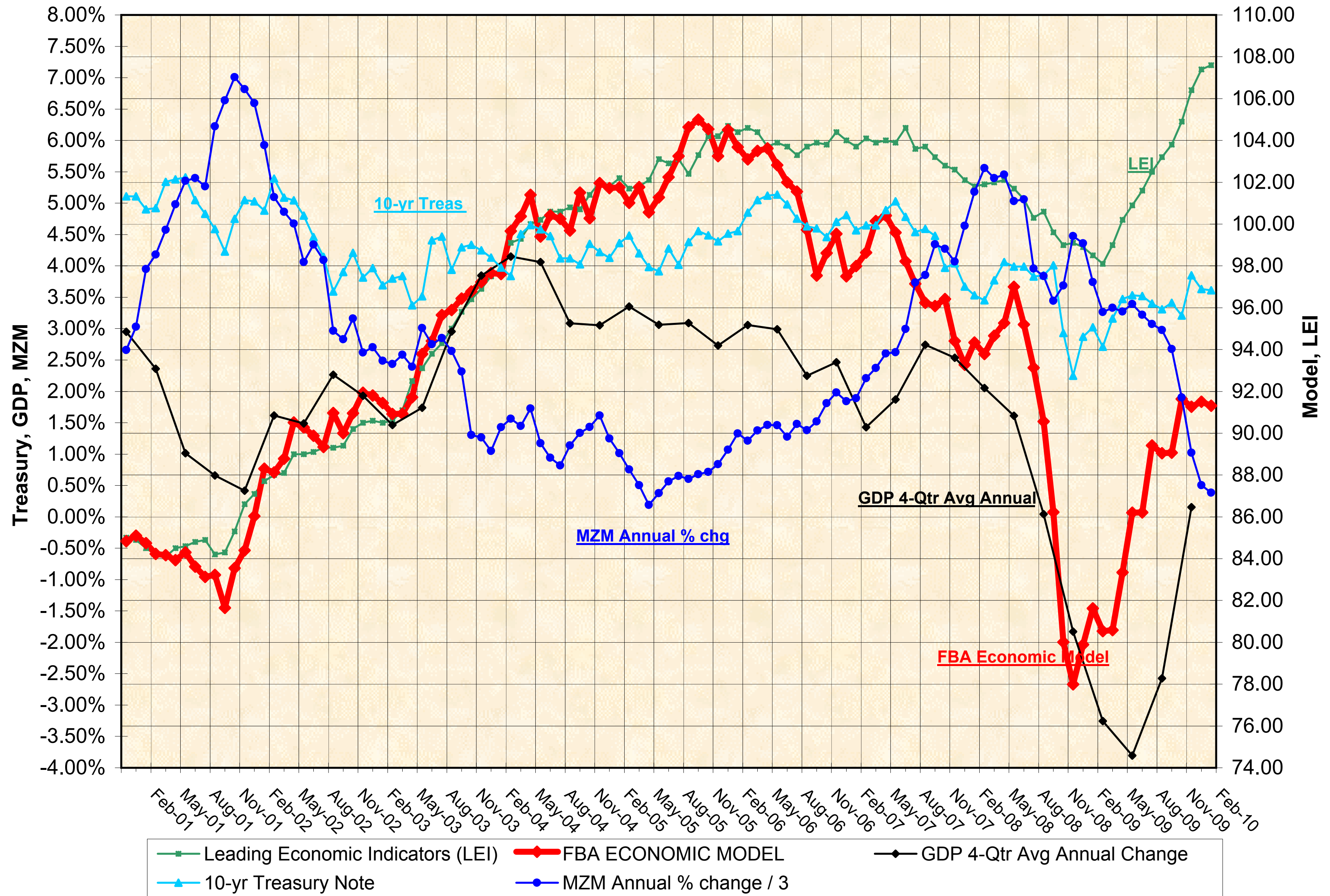
Economic Model (attached) continues to signal expansion. Corporate profits have rebounded sharply and are expected to expand further. S&P 500 earnings per share are likely to reach $78 this year and are forecast to exceed $90 in 2011, resulting in a 15.3x price/earnings multiple for 2010. This multiple is not far from the mean market valuation over the past two decades. Wall Street earnings estimates may still be too low. Economic activity abroad, particularly in emerging markets, is providing the impetus for expanding global trade. And, finally, expectations for stable inflation and growing corporate profits will pave the way for higher levels for the broad stock market indices and only slowly rising bond yields.

*   *   *   *

Enclosure: Economic Model

MBF

Front Barnett Associates LLC
Economic Model



Last Updated 4/7/2010