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June 11, 2010

THE ECONOMIC OUTLOOK -- HEADLINES AND HEADWINDS

In retrospect, forecasting the direction of global business activity over the past year has been relatively easy. The paths of economic indicators in the US and emerging Asian markets have risen in tandem so the favorable turn in these economies in early 2009 was a reliable indicator of the direction of overall global growth. Except for a few interruptions, the improvement has been accompanied by rising equity values and narrowing credit spreads which have served to reinforce positive growth momentum.

HEADLINES

Now, a series of factors abroad have emerged to complicate the forecasting process. First, while the overall trajectory of global activity remained positive through May, and the current quarter appears to be on track to deliver the strongest global GDP growth thus far in the expansion, this upbeat news is being tempered by signs the torrid pace of expansion in emerging Asia is cooling a bit in response to a policy-induced slowing in China. Clearly, it is too early to gauge how long and deeply this cooling will go. Second, coincidentally, the recovery in the Euro area is being threatened by a sovereign debt crisis in which Euro area banks' access to market financing has been sharply curtailed. The resulting hit to investor's risk appetites over the past month reflects concerns over these two issues. Additionally, this risk aversion has the potential to reverse the positive impact the real economy has experienced from improving financial market valuations. While not our view, some analysts have concluded another dip in global economic activity is a possibility between now and year-end due to these emerging trends.

Given the uncertainties abroad, the US economy's performance in the coming months will importantly impact the degree to which the global economy slows in the next two quarters. In our view, resilient US demand will increase the probability that Asia's slowdown will turn out to be modest. Interestingly, China reported yesterday that its exports grew 48.5% in the month of May. Signs the behavioral shift away from retrenchment, which was so evident during the period immediately following the 2008 collapse of Lehman, remains intact in the US.

Nevertheless, slower overall private sector job growth in May was a disappointment even though looking behind the headlines shows there was no slowdown in labor market income growth. Businesses are using their workers more intensively as they lengthen the workweek. As a result, labor income growth rose at a 6.6% annualized pace over the past three months, its most rapid pace in three years.

More specifically, supporting our view the US economy will continue to expand in the next two quarters, are the following recently released *forward-looking* key data points:

- The Institute for Supply Management's (ISM) *manufacturing* index expanded in May for the 10th consecutive month, reaching 59.7 -- close to the highest level in almost six years. Readings in excess of 50 signal expansion. The ISM's customer inventories index remained low and new export orders rose to a reading of 62.0, underpinning expectations for continued expansion in manufacturing.

- The ISM May index of *non-manufacturing* businesses registered 55.4 in May indicating continued growth. The ISM's non-manufacturing business activity index increased to 61.1, the sixth consecutive positive monthly reading.

- Orders placed with US factories rose 1.2% in April for the eighth consecutive month, a sign of strength in manufacturing at the start of the second quarter. New orders for manufactured durable goods in April rose for the fifth consecutive month. Both time series are signaling manufacturing will continue to propel the expansion.

CONSUMPTION AND BUSINESS SPENDING RECOVERING

The 3.0% increase in real GDP in the first quarter primarily reflected contributions from personal consumption expenditures, private inventory investment, exports, and non-residential fixed investment that were partially offset by negative impacts from state and local government spending and housing. Consumer spending, which accounts for about 70% of the economy, rose at a healthy 3.5% pace last quarter, above 1.6% gain in the prior three months. The first quarter's increase was the largest since the first quarter of 2007. Consumption has been benefiting from the wage gains noted earlier and improving consumer confidence. Larger job gains would further support consumer outlays as the business recovery plays out.

In the business sector, real outlays for equipment and software posted another solid gain in the first quarter, and the increases were more broadly based than in late 2009; the available indicators point to continued strength in the current quarter. Looking forward, investment in new equipment is expected to be supported by healthy corporate balance sheets, relatively low costs of financing new projects, increased confidence in the durability of the recovery, and the need of many businesses to replace aging equipment and expand capacity as business prospects brighten. More generally, US manufacturing output, which benefited from strong export demand, rose at an annual rate of 9% over the first four months of this year.

HEADWINDS REMAIN

At the same time, significant restraints on the pace of recovery remain in place. In the housing market, sales and construction earlier this year were temporarily boosted by the homebuyer tax credit. However, looking through these temporary movements, underlying housing activity appears to have firmed only modestly since mid-2009, with activity being weighed down, in part, by the large inventory of distressed or vacant existing houses and by the difficulties many smaller builders and home buyers face in obtaining credit. Spending on non-residential buildings also is being held back by high vacancy rates, low property prices, and strained credit conditions. Meanwhile, pressures on state and local government budgets, though tempered somewhat by ongoing federal support, have led these governments to make further cuts in employment and construction spending.

The labor market, particularly hard hit by the recession, has recently shown only modest improvement in employment, hours worked, and labor income. While payroll employment rose by 431,000 in May, that figure importantly reflected an increase of 411,000 in hiring for the census. Private payrolls have risen an average of 140,000 per month for the past three months, and expectations of both businesses and households about hiring prospects have improved since the beginning of the year. In all likelihood, however, a significant amount of time will be required to restore the nearly 8½-million jobs that were lost during the 2008-2009 period.

In addition to the slow housing rebound and tepid job growth -- barely sufficient to absorb those newly entering the labor market each month -- uncertainties over future tax rates, mounting federal deficit spending, likely employee benefit cost increases, tight credit conditions, and the unintended consequences of the rapidly growing web of Federal regulation (i.e. financial services, offshore drilling and healthcare industries, among others) have caused individuals and business to defer spending decisions. Many of these headwinds will persist for an extended period of time.

FORECAST

Looking beyond the painfully slow job market recovery and only modest improvement in housing, US fundamentals continue to improve. Importantly, confidence reports from the University of Michigan show their May readings for consumer confidence, economic conditions, and the economic outlook near twelve-month highs. Manufacturing levels are up and depleted inventories are being rebuilt. Interest rates and inflation are low. With financial market turmoil in the Euro-area likely to persist for some time and the still-fragile state of our recovery raising concerns about a double-dip, the Fed is not expected to raise rates any time soon -- probably not until early next year. The service sector of the economy, which accounts for over 80% of GDP, is expanding. The *recovery* that took place last year with the help of a huge government stimulus program is evolving into a self-sustaining, albeit moderate, *expansion*. Indeed, our firm's Economic Model (attached) continues to forecast an expanding economy. And, to put this expansion into perspective, real GDP is likely to reach an all-time high by the third quarter of this year. Recall that from the inception of the Great Depression, it took the US 15 years to return to its prior peak GDP level. Japan's growth took nearly as long to recover following its "lost decade" of the 1990's. But in just a few quarters, our economy has taken monumental strides toward health. This achievement is extraordinary.

Specifically, despite growing worries about Europe, the lack of vitality in the US job market and slow housing recovery, we continue to forecast steady 3.0% to 3.25% GDP growth for the balance of this year through mid-2011. This implies gradual additions to employment rolls with the unemployment rate, now 9.7%, at a still elevated 8.5% rate by the end of 2011. Trend-like consumer spending, export growth, and business investment will underpin the expansion. State and local government spending cuts and weakness in non-residential construction will weigh on the economy's ability to grow more rapidly than trend.

DEVELOPMENTS IN THE EURO-AREA

Since late last year, market concerns have risen over the ability of Greece and a number of other euro-area countries (i.e. Portugal, Italy, Ireland, Spain) to manage their high budget deficits and high levels of public debt. By early May, financial strains had mounted significantly as investors focused on several interrelated issues, including whether the fiscally stronger euro-area governments would provide financial support to the weakest members, the degree to which growth would be slowed by efforts at fiscal reform, the extent of exposure of major European financial institutions to vulnerable countries, and the extent to which euro-zone financial turmoil would impact global economic expansion in general.

In response to these concerns, European leaders have enacted a number of strong measures. Countries under stress have committed to address their fiscal problems. Some have already enacted austerity budgets. A major assistance package has been established jointly by the European Union (EU) and the International Monetary Fund (IMF) for Greece. To backstop near-term financing needs of its members generally, the EU has set up a Financial Stabilization Mechanism in tandem with IMF support. In addition, to address strains in European financial markets, the European Central Bank (ECB) has begun purchasing debt securities in markets that it sees as malfunctioning, and has resumed auctions of three- and six-month loans of euros in unlimited quantities to borrowers with appropriate collateral. To help ease strains in U.S. dollar funding markets, the Federal Reserve has reestablished temporary U.S. dollar liquidity swap lines with the ECB and other major central banks. To date, drawings under these swap lines remain quite limited and far below their peaks reached at the height of the financial crisis in 2008, but they are nevertheless providing an important backstop for the functioning of dollar funding markets. While these measures were initially greeted by some market participants with extreme skepticism, each of the financially weakest euro-zone countries has recently successfully marketed sizeable short-term debt offerings at rates well below those seen a month ago. Spreads between yields on weak Euro-area sovereign debt and German debt have come in sharply. Finally, overnight LIBOR lending rates have begun to normalize -- all good signs.

Clearly, the fall in equity prices and weaker economic prospects in Europe will leave some imprint on the U.S. economy. Potentially offsetting factors include declines in interest rates on Treasury bonds and home mortgages as well as lower prices for oil and some other globally traded commodities. All in all, the impact of the euro-area crisis on the US is likely to be quite modest, shaving less than 0.50% from US GDP over the next year.

INVESTMENT POLICY

For *equities*, the month of May and June-to-date have been tough. The major stock indices responded to global economic headlines, most notably the European sovereign debt crisis, with a number of outsized daily price swings. Market confidence was shaken early in May with an intra-day drop ("flash crash") in the Dow Jones Industrial Average of nearly 1,000 points before recovering two-thirds of that loss almost immediately. We view the market's nearly 15% pullback, although not pleasant, as a necessary correction following its 70%+ rebound from the March 2009 lows.

S&P 500 stocks are now forecast to earn $80 per share this year and $93 per share in 2011. On average, equities are now selling near the low end of their historical price/earnings multiple range -- 13.4 times this year's estimate and 11.5 times 2011 estimated earnings per share. Following this decline, stock market valuations have become cheap, investor sentiment has taken a decidedly negative turn and liquidity remains extremely high -- all favorable underpinnings for the market. Many high quality, large cap stocks with excellent growth prospects and fortress-like balance sheets provide generous yields when compared with short-term fixed income alternatives yielding next-to-nothing. While there remains the near-term risk of a further contraction in valuations as investors react to unsettling headlines, we believe equities -- domestic, developed market, and emerging market -- to be very attractively priced for the long-term. Accordingly, we believe equity portfolios should be fully invested and broadly diversified.

As for *fixed income*, given our longer-term inflation concerns, we remain cautious limiting new investments to high quality, marketable instruments maturing in less than 3 years, and TIPS. We believe that over the intermediate term, as the global economy continues to expand moderately and financial markets become more stable, rates will gradually rise creating opportunities to extend portfolio duration.

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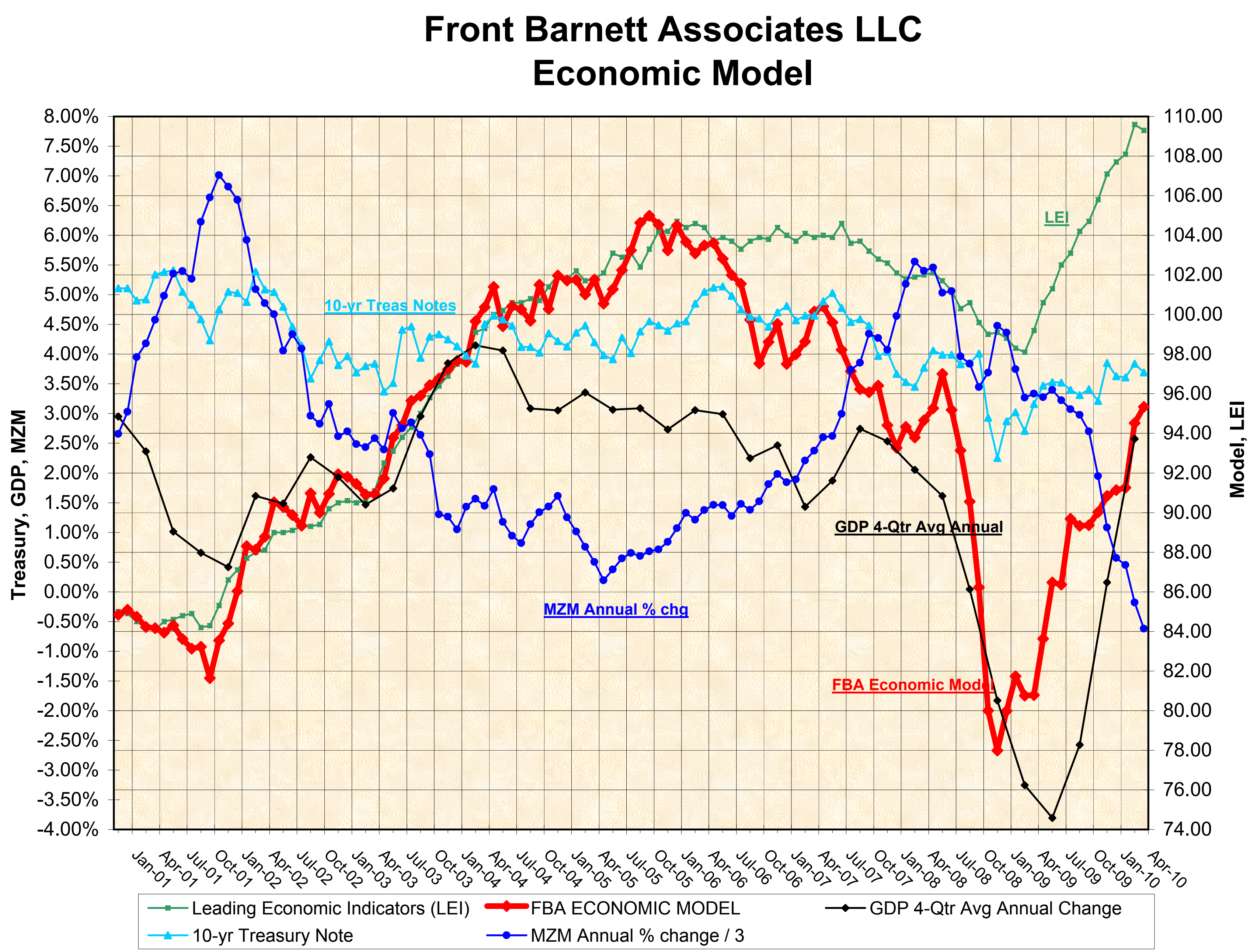

Last Updated 6/1/2010