**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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# ECONOMIC UPDATE -- SUMMER ANXIETY

Following the plunge in economic activity in late 2008 and early 2009, the US economy regained its footing in the middle of last year and now, following a recent loss of momentum, appears to be expanding at a more moderate pace. While the impact of stimulative fiscal policy, as well as firms' inventory restocking are diminishing, a highly accommodative Fed, gradually rising demand from households and businesses should help sustain the next leg of the recovery. In the *household sector*, growth in real consumer spending seems likely to pick up in coming quarters from its recent modest pace as income gains and improving credit conditions provide support to consumption. In the *business sector*, investment in equipment and software has been growing rapidly, in part because of the deferral of capital outlays during the downturn and the need of many companies to replace aging equipment. Coincidentally, rising US *exports*, reflecting the expansion of global economic activity and the revival of world trade, have helped foster growth in the *US manufacturing sector*.

However, despite the improved tone of business, notable headwinds to the recovery persist. *Housing* remains very weak, with the overhang of vacant or foreclosed houses -- approaching a 9-month supply at current sales rates -- weighing on home prices and new construction. Similarly, poor economic fundamentals and tight credit conditions are restraining investment in non-residential structures such as office buildings, hotels, and shopping malls. And the sub-par labor market recovery has created uncertainties which have held back consumption and undermined confidence the economy will improve sufficiently to boost job prospects.

## CONFIDENCE

Without doubt, there is a widespread feeling of uncertainty and nervousness among consumers, investors, and business leaders regarding the economic outlook, legislation both newly enacted and proposed, and how federal, state, and local governments will manage public finances. This uncertainty is holding back

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

spending and investment, leading to slower growth. The Conference Board's Monthly *Consumer Confidence* Index in July reached lows only matched or exceeded on four occasions since the survey originated in 1967 to the start of the current downturn. The National Federation of Independent Business' *Small Business* Outlook Index paints a similar picture. Their index at 89.0 currently, has been below 95 for 32 consecutive months and below 90 for 23 of the past 28 months. Prior to this pessimistic streak, the index had never dropped below 90 since its inception in 1986. Investor's nervousness is reflected in the latest daily value for Rasmussen's *Investor* Confidence Index, 87.9, is below every recorded reading since it began in 2002 until the day Bear Stearns collapsed in March 2008.

Businesses, waiting to understand the impact of new and proposed legislation have deferred hiring new workers and investing in new plants, equipment, and technology. Consumers, uncertain about future tax rates and the possible adverse impact of continued deficit spending will have on long-run economic growth, defer making purchases and continue to deleverage. Amazingly, more than 7 out of 10 Americans say the economy is still in a recession according to a recent Bloomberg poll. Investors, waiting to understand whether or not the economy has really recovered amid talk of a possible double-dip recession and potential deflation, are hoarding cash. Accordingly, the savings rate has reached nearly 6.0% of disposable personal income -- up from below zero only a few years ago. Such paralyses delay the return to a healthy economic growth path.

One other point: The raucous, often politically-driven debate in Congress and in the media by an endless parade of economic savants over whether or not additional fiscal or monetary stimulus should be applied to increase employment, only serves to create confusion and to heighten the uncertainties we are all experiencing.

*Financial conditions*, which are much improved since the depths of the financial crisis, took a somewhat less supportive turn this spring as concerns about the ability of Greece and a number of other euro-area countries to manage their budget deficits and high levels of public debt shook global financial markets. In response to these financial pressures, European leaders put in place a number of strong measures, including an aid package for Greece and a backstop financing plan for euro-area countries. While these measures, together with a recent surge of upbeat economic reports out of Europe and positive stress test results, have diminished concerns, financial markets remain jittery, hostage to the uncertainty du jour.

In step with credit conditions generally, the condition of the banking system has also improved significantly since early 2009. Loss rates on most types of loans appear to have peaked and, overall, bank capital ratios have risen to new highs. However, many banks continue to have a large volume of troubled loans, and bank lending standards remain tight. With credit demand weak and banks writing down problem loans, bank loans outstanding continue to decline. Small businesses, which depend importantly on bank financing, have been particularly hard hit by restrictive lending standards.

Low core inflation -- at 0.9% for the first half of this year -- is likely to remain subdued for the next couple of years as slack in the labor markets has damped wage and price pressures, and rapid productivity gains have helped firms control their production costs. Meanwhile, measures of inflation generally have remained stable.

All in all, then, we appear to be in a muted economic expansion held back by headwinds not likely to substantially subside any time soon. Stimulative government fiscal policies are fading. Inventory rebuilding is largely completed. The hand-off from government to the private sector for impetus to future growth has led to the recent slowdown in the recovery. Moreover, *forward looking* economic data released recently portend more of the same:

- The Institute for Supply Management's (ISM) *manufacturing* gauge, while continuing to signal expansion, declined to 55.5 last month from 56.2 in June. Within the ISM's index, a measure of new orders fell to 53.5, from the 58.5 in June, the lowest level since June 2009, indicating production may ease to a more sustainable pace as the surge in inventory rebuilding that sparked the manufacturing-led recovery winds down.

- The ISM's *non-manufacturing* index, which covers about 90% of the economy, rose to 54.3 from 53.8 in June. Readings above 50 portend expansion. This report indicated continued growth at a slightly faster pace as the new order index rose to 56.7 from 54.4 in June.

- The index of US Leading Economic Indicators (LEI) fell 0.2% in June, the second decline in three months, signaling a cooling in business activity. This decline has mirrored the fall in our firm's proprietary <u>Economic Model</u>, a copy of which is attached.

- Orders placed with US factories declined in June, another sign manufacturing, which has led the economy's recovery, is likely to settle into a more sustainable pace as inventory replenishment wanes.

Forward-looking *open market* indicators we follow closely are sending mixed messages about future growth. The stock market's 8%+ recovery from its spring/summer correction, higher oil prices, and the recent upturn in the Baltic Dry Index, which reflects changes in daily dry freight shipping rates, are positive. On the other hand, the decline in 10-year US Treasury bond yield to 2.76% and the rise in gold prices, investments considered safe havens in times of uncertainty, are telling us growth may slow further and risk of deflation has mounted.

Recent readings of *coincident* and *lagging* indicators have also been mixed:

- The July *employment* report showed the US added 71,000 private sector jobs following job gains in each of the prior six months. Notwithstanding these monthly additions, which averaged about 90,000, employment growth has been insufficient to absorb all of the new entrants to the labor force which are thought to number 125,000 monthly. Average hourly earnings did rise 4 cents to $22.5 in July and the average work week for all workers lengthened to 34.2 hours in July from 34.1 hours the prior month, both positive signs. However, these figures translate into only modest income growth.

- The US economy grew at a slower-than-forecast pace in the second quarter, expanding at 2.4% after GDP grew at a 3.7% annual rate in the prior three month period. Household purchases climbed at only a 1.6% rate following a 1.9% first-quarter gain. Consumer spending excluding growth in inventories, which has been a driving force behind the GDP expansion, and residential spending, rose at a 0.8% annual rate as consumption slowed and the trade deficit swelled. An encouraging sign is that inventories are at or near record lows when compared with sales, indicating companies have not overbuilt, while orders for durable goods indicated business investment appears to be ramping up.

- Consumer credit in the US declined in June for the fifth consecutive month indicating consumer purchases will remain restrained. Consumers have been restructuring their balance sheets by paying down debt and increasing savings.

- Housing remains very weak. Housing starts fell in June to the lowest level since last October as a slump in sales following the expiration of a government tax incentive caused US homebuilders to cut back. Meanwhile, the number of contracts to purchase previously owned homes also fell in

June, indicating demand kept unraveling after the expiration of a homebuyer tax credit.

## FORECAST

A sustained lift in housing will ultimately require the support of rising incomes and employment, where the trend is up but disappointing.  Hours worked and employment breadth offer a somewhat more encouraging sign of slow healing in the labor markets.  The July work-week matched its high for this cycle, up a full hour from the recession low.  Overall hours worked increased by 0.3% for the month, continuing a steady climb that has prevailed all year.  These trends, though, are consistent with a recovery pace below our earlier forecast of 3.00% to 3.25% GDP growth.  We have, therefore, trimmed our forecast to where growth, absent an exogenous shock, is expected to average 2.50% to 2.75% for the second half of this year.  Similar growth is now forecast for the first six months of 2011.

Despite heated discussions of the possibility of deflation, we see only a very low probability of this occurring.  We forecast core inflation to remain in the 1.00% to 1.50% range through the middle of next year.  Unemployment will stay stubbornly high, remaining near its current level for the balance of this year with only slow progress in 2011, toward an 8.50% rate by year-end.

Federal Reserve Policy makers will keep rates at current levels for the foreseeable future given the recovery’s loss of momentum and less secure financial supports to growth stemming from the Euro-area sovereign debt crisis this spring.  However, over the course of the summer and fall the Fed is expected to reinforce language in its statements that encourages lower forward rates in an effort to avert risks of renewed recession and deflation.  Should the economy weaken further than is currently forecast, the Fed has a number of tools available to it to keep money in circulation, including rolling over its holdings of US Treasury securities as they mature, implementing a new round of asset purchases, reinvesting the proceeds of payments from agency debt and agency mortgaged-backed securities in long-term US Treasury bonds, and lowering the interest rate paid on commercial bank balances held at the Fed.  Unfortunately, earlier high profile discussions of “exit strategies” may have temporarily undercut the credibility of the Fed’s commitment to keep rates lower for a longer period.  Future Fed statements are likely to correct this misimpression.

## FIXED INCOME POLICY

The fixed income portions of balanced portfolios under our supervision remain broadly diversified, including US Treasury Inflation Protected Securities (TIPS), and are largely fully invested in a ladder of maturities with an average duration below 3.0. New purchases are being limited to bonds maturing in less than 4 years as, longer-term, we remain concerned about a flare-up in inflation expectations once the economy picks up and employment growth expands.

## EQUITY INVESTMENT STRATEGY

Based upon projections for S&P 500 earnings, the broad stock market, as measured by the S&P 500 stock index, is selling at 13-times this year's earnings and 11-times next year's forecast earnings. In the current low interest rate environment, stocks are 25% to 30% undervalued according to the "Fed Model" and other metrics of stock market valuation we monitor confirm their statistical cheapness. Accordingly, despite the inevitability of periodic pullbacks and "corrections", we remain fully invested in the equity portion of balanced portfolios we manage. The mix of stock holdings includes about a 15% exposure to developed and emerging markets abroad through exchange traded funds (ETF's) and international mutual funds. Well-diversified domestic stock holdings are tilted toward *growth* shares which largely represent investments in global businesses with prospects of above-average growth. Larger sector concentrations remain unchanged and include technology, diversified manufacturing concerns, and health care.

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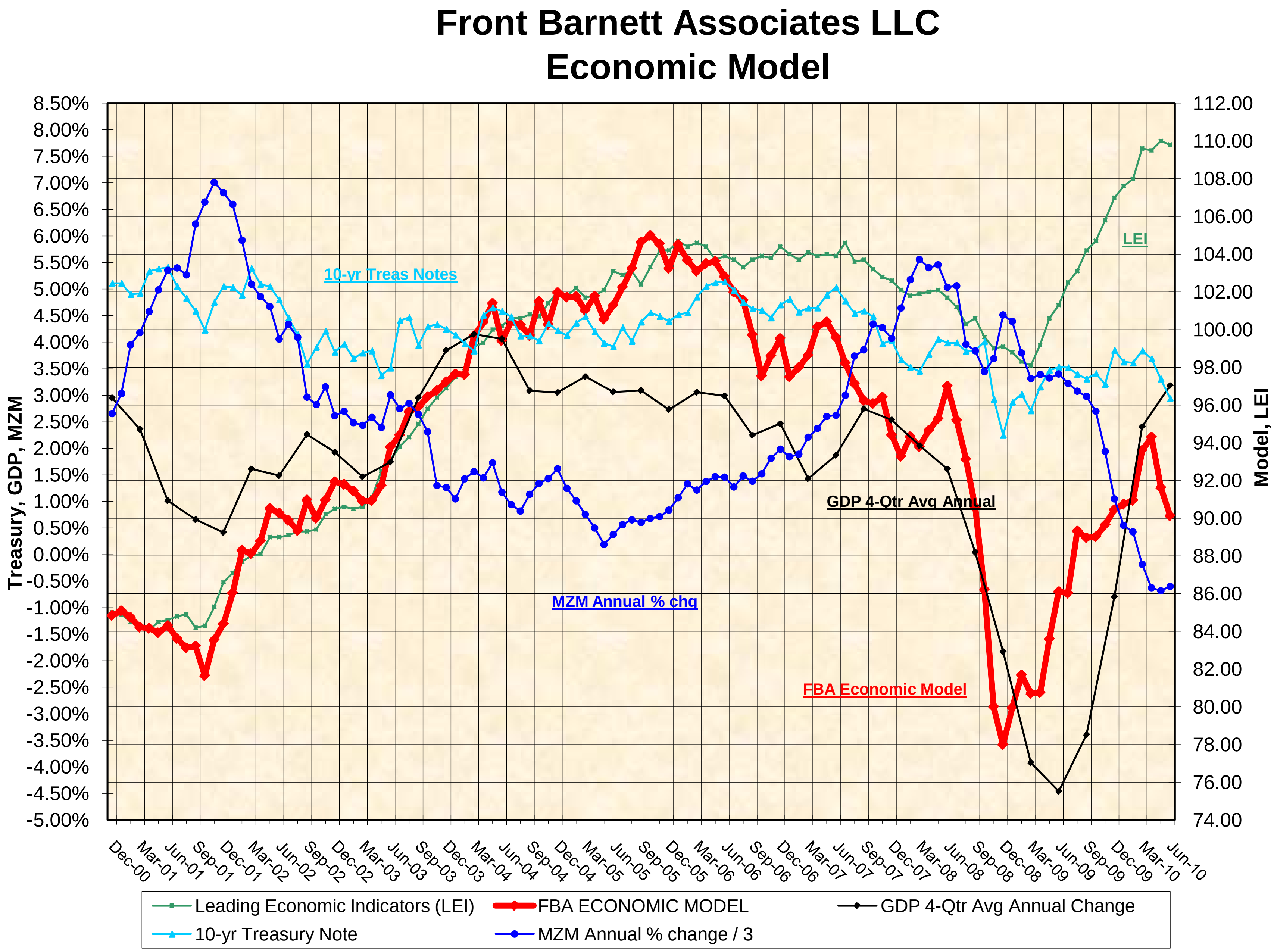


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