FRONT BARNETT ASSOCIATES LLC

I N V E S T M E N T   C O U N S E L

Marshall B. Front
Chairman

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

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ECONOMIC UPDATE -- SEARCH FOR CONFIDENCE

Since Spring, investors have been torn between hope and fear as mixed messages in economic data, unpopular fiscal policies, and uncertainties surrounding the outcome of the mid-term elections, have led to widely divergent economic and market forecasts. Recently, optimists seem to have won the tug-of-war. The S&P 500 stock index returned about 9% in September despite only modest private sector employment growth, little improvement in housing and deteriorating consumer sentiment measures. Equity investors appear to have brushed aside headline news of weak business conditions buying into the notion the Federal Reserve will announce another round of stimulative quantitative easing (QEII) shortly after the November elections in another effort to reflate the economy.

Policy makers have signaled their belief that new, non-conventional, measures are needed to jump-start growth given that inflation remains too low and unemployment too high. Because of the economy's weakness, inflation is currently running below the Fed's informal target of 1.7% to 2.0%. The central bank's most closely watched indicator put underlying core inflation up 1.4% in August from a year earlier. Officials are particularly concerned about inflation falling any further because lower inflation pushes up the inflation-adjusted cost of borrowing for businesses and households -- measured as the interest rate minus the rate of inflation. Elsewhere, the unemployment rate in September stood at 9.6% with 14.8-million people officially out of work and millions more either underemployed or simply not looking for work.

Clearly, there is no assurance QEII will reaccelerate economic growth. In fact, the linkage between putting more money into circulation and greater near-term business activity is somewhat tenuous. Meanwhile, the costs and risks of quantitative easing in a growing economy such as a weak dollar and future inflation are obvious. Keep in mind the Fed only controls monetary policy and monetary policy alone is unlikely to strengthen the economy sufficiently to pull it out of the current rut of agonizingly slow growth. In our view, the missing element in the current equation is business and consumer *confidence* which is now expected to rebound only gradually. Following the elections, government could lift *confidence* by forcefully stating that its overriding objective will be to reenergize the economy to create jobs and that it will prioritize a bipartisan effort to do so. In addition, it should also act promptly to reduce enormous private sector uncertainties created by deferring key income tax rate decisions. Absent measures such as these, *confidence* will languish and the economy, while expanding, is likely to limp along at a subpar rate.

CURRENT BUSINESS CONDITIONS

Our estimates of third quarter *consumption growth* in the 1.5% to 2.0% range reflect a mood among consumers of overwhelming caution. Coincident indicators such as vehicle sales for September posted only a small gain, continuing their slow advance. Along with reports from retailers suggesting a modest 0.4% rise in core sales last month, overall consumer spending, which accounts for almost 70% of GDP, appears to be growing modestly.

On the other hand, *business investment spending*, largely focused on satisfying pent-up demand to replace aging or obsolete capital equipment, has been robust. Recent gains in shipments, especially in computers and machinery, portend a solid gain in capital expenditures of about 12.0% in the third quarter. Fundamentals in the business sector are quite favorable now following a painful adjustment during the recession. Businesses have both the ability and the need to spend on capital goods. Firms slashed payrolls and cut costs preemptively in the downturn, boosting profit margins and earnings generating financial surpluses. Furthermore, business capital has been greatly depleted after years of under-investing. The spending shortfall cuts across high-tech and traditional sectors. The need to rebuild capital implies solid gains for investment for the next year and beyond.

Against this backdrop, last Friday's labor report, showing a decline in overall employment of 95,000, was no surprise. Much of the drag on jobs was in the public sector where the last of the census workers were laid off and teacher terminations occurred prior to the start of the school year. The main themes of the labor report were continued marginal gains in private sector hiring more than offset by larger losses in public sector positions. Among the more sobering aspects of these latest employment data is a leveling in factory job gains as inventory adjustment normalized and a rollover in temporary hiring -- the inevitable result of the slowing in demand and the lack of confidence or visibility across industries in the outlook for a healthier recovery next year. Recently, layoff activity has diminished helping to hold employment within bounds. However, with economic growth falling short of sustainable trends, the jobless rate is likely to edge up a bit near-term unless and until financial conditions -- and a re-engaged policy effort -- can buoy final demand and restore momentum to the recovery.

The current sluggish pace of employment growth has been insufficient to reduce unemployment. While it is commonly understood businesses are delaying hiring until the economic and regulatory outlook becomes more certain, we also believe unemployment is being boosted by *structural* factors including mismatches between the skills of people who have lost their jobs and the skills required in sectors of the economy with job openings. Clearly, the inability of the unemployed to relocate because their homes are worth less than their mortgages is another factor. These structural issues will be overcome only slowly contributing to the difficulty in bringing the unemployment rate down by conventional means.

FORECAST

Looking ahead, we have slightly reduced our projection for the increase in real economic activity over the second half of this year and 2011. We now expect GDP to expand at a 1.75% to 2.0% rate in the quarter just ended and then show a modest uptick in the current quarter. For 2011, we anticipate a further strengthening of the expansion as well as additional pick-up in economic growth in 2012. The muted tone of data received since our August client letter suggested that the underlying level of consumer demand has been weaker than projected at the time of our August forecast. In addition, the outlook for foreign economic activity also appears to be slightly weaker. In the medium term, the recovery in economic activity is expected to receive support from accommodative monetary policy, further improvements in financial conditions, and greater household and business confidence. Over the next 15 months, the increase we forecast in real GDP is projected to be sufficient to slowly reduce economic slack, although excess capacity will still remain elevated at the end of 2012, contributing to our view that inflation will remain subdued.

All in all, then, while the outlook is for sluggish growth absent an exogenous shock, we see no "double dip". Third-quarter GDP growth is likely to come in well below trend -- between 1.75% and 2.0% with a modest uptick in growth to 2.0% to 2.25% expected for the current quarter and 2011. Indeed, our Economic Model, a copy of which is enclosed, continues to signal expansion ahead as does the Index of Leading Economic Indicators. Unemployment will stay stubbornly high, remaining at or slightly above its current level for the balance of 2010 with only slow progress in 2011 toward an 8.5% to 8.75% year-end rate. Inflation, as measured by the CPI, is likely to remain in the 1.0% to 1.25% range at least through next year. Unsatisfactorily low inflation and unacceptably high unemployment will compel the Federal Reserve to maintain its highly accommodative monetary policy with short-term rates remaining near zero for the next several quarters.

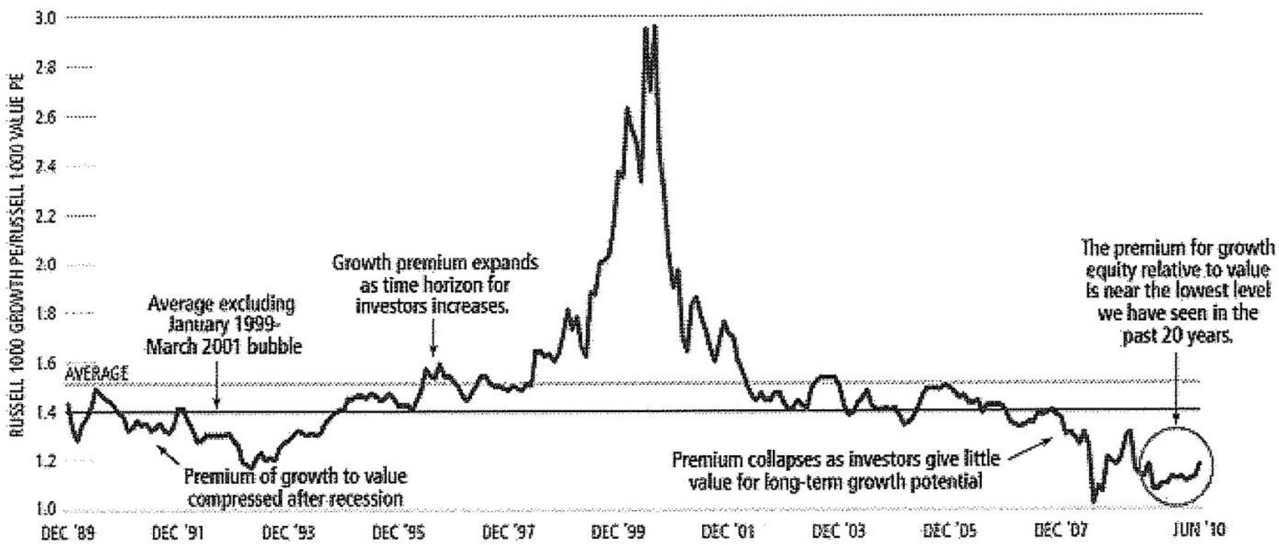
INVESTMENT POLICY

With short-term interest rates likely to remain extremely low for an extended period, investors globally are adding risk to their portfolios, seeking higher returns by extending bond maturities, buying lower quality debt, and adding to equity positions which are low by historical standards. Despite the US Stock Market's 16% rebound from its July 1st low, equities remain attractively priced at just 13 times the consensus of 2011 forecasts of $91.38 per share. Other metrics of equity valuation confirm their statistical attractiveness. Abroad, market valuations of stocks domiciled in emerging markets, which are expected to grow more rapidly (4.0% to 8.0%) than those in developed areas (1.0% to 2.0%), remain extremely attractive. Accordingly, investments in emerging markets have been increased in client portfolios while US-based multi-national companies exposed to emerging markets continue to represent substantial core holdings. We remain fully invested in both the bond and equity segments of client portfolios despite the inevitability of corrections and pullbacks along the way.

As for the balance between *growth* and *value* shares, equity portfolios remain tilted toward *growth*. The chart below shows the premium for *growth* stocks relative to *value* shares is near the lowest level we have seen in two decades.

FIGURE 2. LITTLE PREMIUM FOR GROWTH

RUSSELL 1000® GROWTH INDEX P/E RELATIVE TO RUSSELL 1000® VALUE INDEX P/E, DECEMBER 1989–JUNE 2010



Source: FactSet and Cap IQ

Fixed income portfolios remain invested in a ladder of short- to intermediate-term bonds with a duration just shy of 3 years. We have avoided US Treasury bonds which we believe to be overpriced when compared with high quality corporates and, where appropriate, municipal general obligations. Bond portfolios also include US Treasury Inflation Protected Securities (TIPS), an inflation insurance component.

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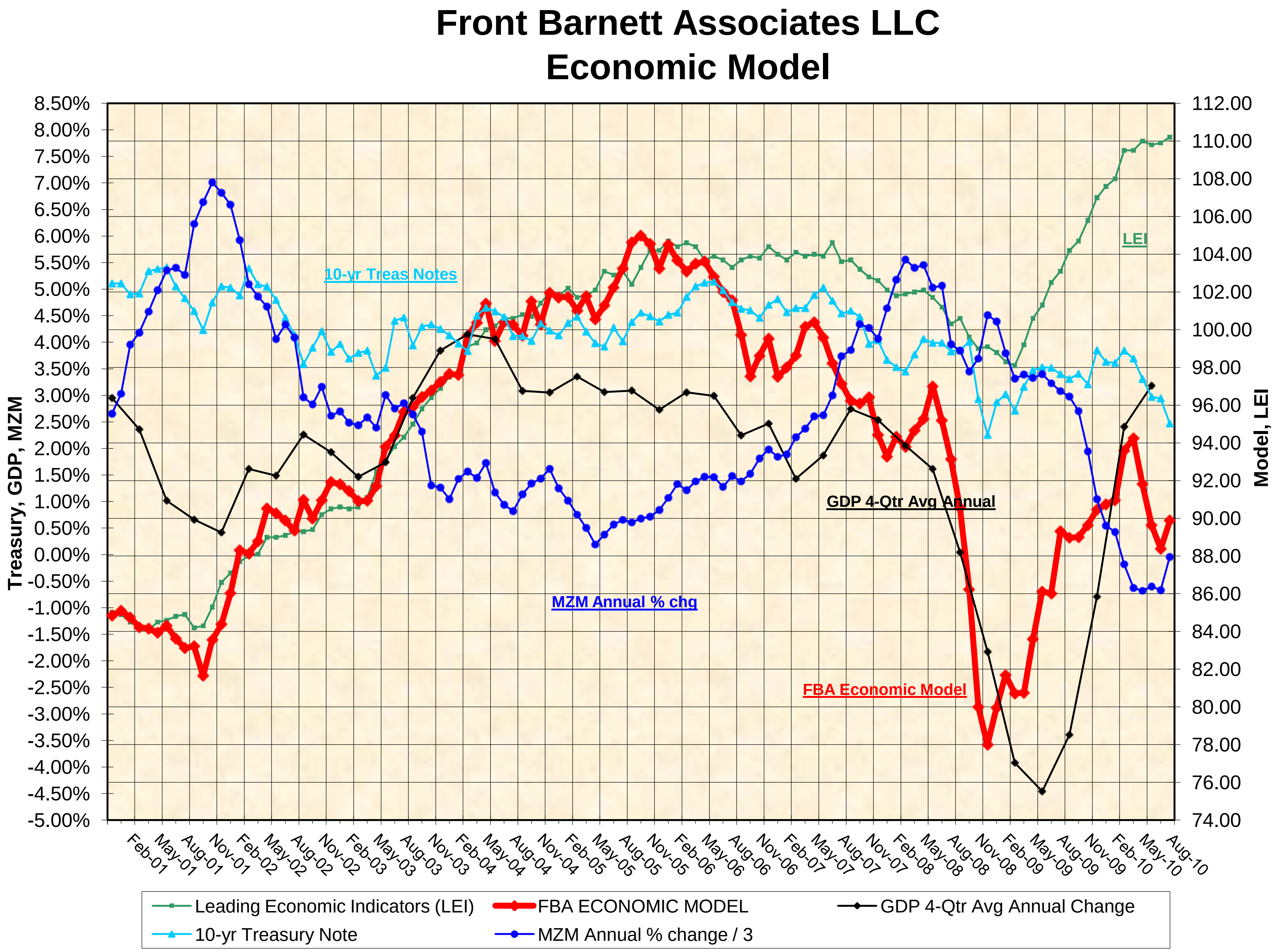

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