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ECONOMIC UPDATE -- SELF SUSTAINING RECOVERY

Despite meager job growth and depressed housing conditions, the US economy continues to recover with overall output last quarter finally regaining pre-recession levels. Real GDP -- a broad measure of all goods and services produced domestically -- grew at a 3.2% trend-like annual rate in the fourth quarter, up from 2.6% the previous quarter. A quick analysis of the data shows that last quarter's expansion was led by a jump in consumer outlays which had lagged earlier in the recovery when growth relied heavily on business investing and inventory accumulation. Final sales, a metric which reflects underlying demand in the economy, recorded its largest increase since 1984, growing at 7.1%. Reviving consumer spending, which accounts for over 70% of GDP, should encourage businesses to restock their inventories and, if sustained, eventually encourage hiring. Rising exports from US companies also added to growth last quarter. Imports declined and trade added 3.44 percentage points to GDP. And, business spending continued to grow, albeit at a rate slower than its surge early in the recovery.

It has now taken 12 quarters for the economy to recoup its recession losses and, on a per capita basis, it is still not as large as it was prior to the onset of the recession in 2007. Such a prolonged recovery is unusual. It took only eight quarters for business conditions to rebound fully from the deep recession of the 1970's. Improved, but still fragile consumer confidence, continued deleveraging and the unwillingness of businesses to add to staffs unless they are pressed to do so by stronger than expected demand, have constrained the rate of recovery and will remain a drag for an extended period.

SELF-SUSTAINING RECOVERY

Notwithstanding these headwinds, and the recent confusing employment reports showing a sharp decline in the unemployment rate while job creation remained disappointing, most data and financial market developments suggest the economic recovery was gaining breadth and momentum as we entered the new year. In fact, there is a growing body of evidence that the long awaited *self-sustaining* recovery in consumer and business spending may be taking hold. Notably, households increased their spending in the fourth quarter, in real terms, at an annual rate of over 4.0%.

While a significant portion of this pick-up reflected strong sales of motor vehicles, recent gains in consumer spending appear to have been broadly based. Businesses' investments in new equipment and software grew over most of last year, as firms replaced aging equipment and as demand for their products and services expanded. In contrast, in the housing sector, the overhang of vacant and foreclosed homes continues to weigh heavily on both home prices and residential construction. Overall, however, improving household and business confidence, accommodative monetary policy, and more supportive financial conditions, including an apparent increase in the willingness of banks to make loans, seems likely to lead to a more rapid pace, self-sustaining recovery in 2011. Indeed, our firm's proprietary Economic Model, a copy of which is attached, confirms the durability of the expansion.

CONFUSING JOB PICTURE

While indicators of spending and production have, on balance, been encouraging, the job market has improved only grudgingly. Following the loss of about 8.5-million jobs in 2008 and 2009, private-sector employment showed gains last year. However, these gains were barely sufficient to accommodate the inflow of recent graduates and other new entrants to the labor force and, therefore, not enough to sufficiently reduce the overall unemployment rate. Recent data, though, does provide some grounds for optimism on the employment front. Initial claims for unemployment insurance, which lead the Bureau of Labor Statistic (BLS) *establishments* employment data, have generally been trending down. Layoffs have reached multi-month lows, and indicators of job openings and firms' hiring plans have shown improvement.

Much softer than expected employment growth and hours worked in January likely reflected temporary weather-related delays in hiring and activity at a time when other data are pointing to an underlying acceleration in growth. Retail and factory employment have been surprisingly strong and private industry job patterns have achieved levels consistent with more solid gains than those reported by the BLS for January. Nevertheless, the sharp plunge in the unemployment rate to 9.0% in January probably over-stated the pace of labor market improvement. Although *household* employment surged in January, the larger story remains a puzzling collapse in labor force participation, particularly among adult men. A healthier job market should boost adult male participation but the uncertainties surrounding the size of the labor force and its growth from month-to-month undermine the jobless rate's usefulness as a guide to the general level of business activity. We are, therefore, inclined to look elsewhere for further evidence of the strength of the recovery.

Newly released data have been remarkably positive, ranging from increasing auto sales, robust factory orders, solid manufacturing reports and exceptionally strong *forward-looking* surveys of purchasing managers serving both manufacturers and non-manufacturers. Revenue from individual retail stores for the month of January jumped over 4.8% from year-ago levels, according to the International Council of Shopping Centers, far above expectations. US Consumer borrowing rose in December for the third consecutive month, led by the first increase in credit-card charges in more than two years. The thawing of credit makes it more likely that consumer spending will continue to advance after climbing last quarter at the most rapid rate in four years. One caveat: the data and corporate reports we parse show that input costs are clearly on the rise, which could potentially short-circuit the recovery by raising prices and cutting demand. Stay tuned.

FED POLICY

Although economic growth will increase this year, the unemployment rate is generally expected to remain stubbornly high and inflation to remain persistently below the levels Fed policy makers believe to be consistent over the longer term with their mandate from Congress to foster maximum employment and price stability. Under such conditions, the Federal Reserve would typically ease monetary policy by reducing the target for its short-term policy interest rate -- the federal funds rate. However, the target range for the funds rate has been near zero since December 2008, and the Fed has indicated that economic conditions are likely to warrant an exceptionally low target-rate for an extended period. As a result, for the past two years the Fed has used alternative tools, most notably purchases of longer-term securities on the open market and signaling to financial markets additional accommodation was likely (QE2). Until the Fed sees a sustained period of job creation, short-term rates are expected to remain low.

At the same time, both domestic and foreign financial markets appear to be growing increasingly concerned about inflation pressures accumulating as a result of rising food and energy prices. This is particularly true in emerging markets where outlays for food and fuel can consume as much as 40% of disposable personal income. In fact, in the US, the yield on the 10-year Treasury note has increased almost 40 basis points over the past few weeks while the yield on the two-year US Treasury note has backed up only 10 basis points. This steepening of the yield curve suggests to some the Fed is falling behind the curve and will need to accelerate the process of normalizing short-term interest rates and soaking up the large pool of excess reserves that have been made available to the US banking system since the 2008 financial crisis. The markets' unease stems from a view that the Fed's focus on "core" inflation rather than "headline" inflation is flawed and will allow rising food and fuel prices to become imbedded in wage and price trends, bringing about a sharp inflation spike. One of the key concerns of these "inflation hawks" is that the size and composition of the Fed's bloated balance sheet will make it impossible for the FOMC to keep excess liquidity from being reflected in rising prices as the recovery accelerates. Recent readings of economic data feed the hawks concerns as they imply the recovery has not only reached a sustainable pace but may be expanding even more rapidly than the most optimistic projections.

As we see it, the lack of employment growth to validate the more rapid expansion some forecast is an important consideration suggesting the Fed has not fallen behind the curve as the hawks suggest. Keep in mind, the economy remains awash with unused capacity -- both labor and production -- which will serve to check cost pressures. Moreover, the Fed has articulated a viable exit strategy using their new policy tools that should be able to keep excess reserves from becoming an inflation problem. In fact, the Fed has already executed the first phase of its exit strategy without a glitch by letting their special liquidity programs expire last year. The Fed has other new tools for draining reserves from the banking system which it is likely to employ once the FOMC feels the unemployment rate has declined to a level where it can begin tightening without the risk of the recovery faltering.

FISCAL POLICY

Government spending remains a deep concern and fiscal policy makers face significant challenges. The Federal budget deficit has expanded to an average of more than 9.0% of GDP over the past two years from an average of 2.0% of GDP during the three years prior to the recession. This deficit largely reflects the weakness of the economy along with the actions the Administration and Congress took to ease the recession and steady financial markets. However, even after economic and financial conditions normalize, the federal budget will remain on an unsustainable path, with the budget gap becoming increasingly large over time, unless the government enacts significant changes in fiscal programs. The long-term fiscal challenges confronting the nation are especially difficult because they are largely the product of underlying trends, not short-term or temporary factors. The aging of the US population and rapidly rising health care costs are the two most important derisive forces behind our fiscal imbalance. Rising costs associated with medicare, medicaid, social security, and defense department spending must be addressed to restore fiscal sustainability. Plans recently put forward by the National Commission on Fiscal Responsibility and Reform provide useful reference points for an urgent national dialogue on fiscal reform.

FIXED INCOME STRATEGY

Reflecting our inflation concerns, fixed income portfolios were restructured earlier to reduce interest rate risk to below benchmark levels with emphasis on marketable, short- to intermediate-term corporate obligations rated baa or better. US Treasury Inflation Protected Securities (TIPS) were added to portfolios as an insurance policy against the possibility of rising inflation. Portfolios remain underweighted to conventional US Treasury obligations we view to be over-valued despite the recent rise in their yields.

As short-term bond holdings mature, the proceeds are being reinvested in similar short-term corporate obligations maturing in the next two years or less. Rising inflationary expectations will drive open market rates higher, in our view, providing a better opportunity over the next year or two to lock-in higher rates.

EQUITY INVESTMENT STRATEGY

A number of favorable trends have provided a strong tailwind for US equities over the past several months. Following a strong finish to 2010, the broad market indices have advanced an additional 5.0% since year-end propelled by strong earnings and higher forecasts which now peg 2011 S&P 500 earnings near $95 per share. While job growth remains sluggish, strong, and improving economic trends have been confirmed by recently released forward-looking indicators. Data compiled monthly by the Investment Company Institute (ICI) show investors beginning to move back to equities and reducing fixed income exposure. Mergers and acquisitions activity remains robust. The White House and Congress appear to be less hostile to business interests following the November elections and an accommodative Fed policy is likely to remain in place through at least this year. This favorable backdrop for the equity market should persist.

Assuming 2011 S&P 500 earnings of $95.00 per share and $104.00 in 2012, stocks remain statistically reasonably priced at 13.9 times 2011 earnings and 12.8 times next year's earnings. Other metrics of valuation confirm the attractiveness of equities relative to bonds and cash equivalents. Portfolios, therefore, remain fully invested and titled toward *growth* shares despite the likelihood of as much as a 10.0%+ correction along the way. We continue to emphasize sectors likely to benefit from the economic expansion including energy, technology, transportation, manufacturing, and financials. Health care, consumer staples and utilities are underweighted.

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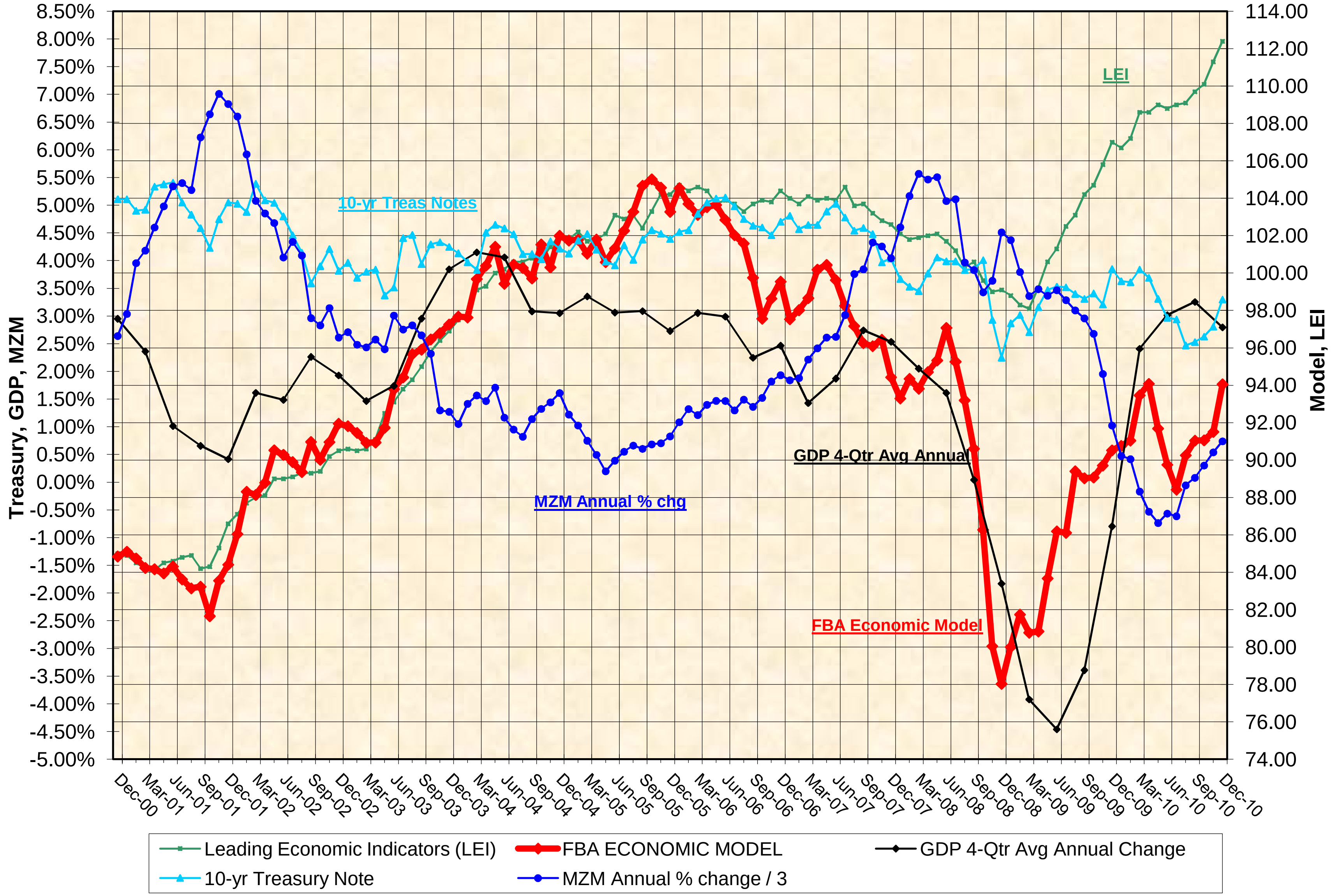
Front Barnett Associates LLC
Economic Model



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