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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THE ECONOMIC OUTLOOK -- SELF-SUSTAINING MOMENTUM

Economic data and financial market developments since year-end lend support to our view the business recovery, although uninspiring, is gradually gaining momentum and that financial headwinds have quieted down to a point where the recovery is close to achieving *self-sustaining momentum*. The possibilities of building on that momentum will turn on both staying clear of major fiscal policy missteps, as well as avoiding new shocks from Europe having the potential to undermine consumers' and investors' willingness to take risk. From its outset in early 2009, the business recovery has been tepid at best. Its strength has come from normal cyclical forces such as pent-up auto demand and deferred business capital spending. It has been held back by deleveraging, depressed housing, high unemployment, and a shrinking state and local government sector. Now, there are signs these and other headwinds weighing on the recovery have diminished while recent Fed monetary policy actions show some encouraging early effects.

First, and most important, the jobs report for January was considerably stronger than expected on a number of counts with recent payroll growth now within a range that can sustain declines in unemployment. The broadening base of hiring gains reported is especially encouraging for the recovery's durability as the earlier drags from intense job losses in such areas as construction and manufacturing appear to be diminishing. While the better jobs picture suggests that near-term economic growth may be stronger than forecast earlier, we will need to see these job gains translate into strength in consumer demand, which lagged expectations late last year, along with a sustained backdrop of improved credit conditions. Nevertheless, we may be on the cusp of a *virtuous economic cycle* where, finally, employment growth boosts income and consumption. In turn, production and inventories increase to meet growing demand which further adds to income available for both consumption and business investment.

Looking ahead, high-frequency, forward-looking economic indicators released recently uniformly point to continued expansion:

- The Institute for Supply Management's (ISM) US Manufacturing index (PMI) rose to 54.1 in January from 53.1 in December. Recall that fifty is the dividing line between growth and contraction in US Manufacturing. Other PMI reports have shown global manufacturing picked up in January, with factory indices from China to Germany and the UK showing growth. Interestingly, Chinese manufacturing indices rose as the world's second biggest economy withstood weaker exports driven by Europe's debt crisis, and a government-induced property slowdown. In Germany, Europe's largest economy, output grew for the first time since September.

- The ISM's non-manufacturing index rose in January at the most rapid-pace in seven months to 56.8 from 53.0 in December. Recall that service industries account for about 70 percent of the US economy. Together with gains in manufacturing and the 243,000 increase in January payrolls, strength in services will help mitigate the risks to the US economy from Europe's debt crisis. Beyond the overall number, the ISM's non-manufacturing survey's employment gauge jumped to 57.4, the highest reading since February 2006, from 49.8 the prior month and its measure of new orders increased to 59.4, the highest since March 2011 -- signs the recovery will be sustained at least through mid-year absent an exogenous shock, such as military action against Iran or extreme social unrest in one or more of the 59 countries holding elections this year.

- New orders for manufactured goods in December, up for two consecutive months, increased 1.1% following a 2.2% increase in November. Unfilled orders for manufactured goods in December, up twenty of the last twenty months, increased $12.7-billion or 1.4% in December, following a 1.3% November increase.

- Open market indicators have, since year-end, pointed toward continued expansion. For example, the stock market, a reliable leading economic indicator, is up over 7%. (Interestingly, non-dividend paying stocks in the S&P 500 stock index have risen nearly 10% whereas the highest dividend payers have declined 1%. That trend marks a sharp contrast with 2011 when companies paying dividends rose 10.4%, easily outpacing the market and non-dividend payers.) Among stock market groupings, economically sensitive areas have outpaced defensive sectors by a wide margin as shown on the following page:

S&P 500 Stock Sectors*

Outperformers	% Change	Underperformers	% Change
Financials	+12.8	Utilities	-3.4
Materials	+12.3	Telecom	-2.4
Information Tech	+12.4	Consumer Staples	-0.1
Industrials	+9.2	Healthcare	+4.0

S&P Total +7.3%

*12/31/11 through 2/9/12

Also, the yield on the 10-year US Treasury bond has increased from 1.87% to 2.05%. Rising intermediate and longer-term rates, following a period of sub-par economic growth, have generally signaled an expanding economy.

- Measures of US consumer credit growth have been on the rise and the savings rate has fallen indicating a slowing in the rate of deleveraging that followed the 2008-9 financial crisis. Lower interest rates have eased consumer's debt service requirements giving them some comfort in maintaining current debt levels.

- The number of workers filing first-time unemployment claims has fallen to a four-week moving average of 366,000, the lowest level since April 2008. Analysts have shown that declining jobless claims are a harbinger of future job gains.

- Both our firm's proprietary Economic Model (enclosed) and the Conference Board's Leading Economic Indicators (now tracking closely together following recent LEI component and weighting revisions) point to continued expansion.

- Earlier this month, the Federal Reserve released its January survey of senior loan officers on bank credit conditions which showed that while banks have been relatively optimistic about improved asset quality in recent surveys, credit availability generally did not change materially over the latest three month period. For those institutions that lend to businesses with significant exposures to Europe, tightening lending standards was fairly widespread. Nevertheless, there are a number of areas where credit conditions are thawing. The Fed noted that for the first time in five years, there was a net easing in some commercial real estate loan terms, especially narrowing spreads on loans. Also, bank respondents noted a pickup in loan demand from small firms, a sector we have been monitoring closely for a sign of the recovery's breadth. So, credit conditions for small firms may finally be improving modestly.

Beyond the US, we continue to believe a "hard landing" in China will be avoided in 2012 despite our expectation their economy will decelerate further and hit a

"soft patch" in the current quarter. With inflation contained, due to stable commodity prices and easing food inflation, likely monetary, fiscal and property policy easing should help foster a rebound in the second half of this year, barring extraordinary geopolitical tensions or exceptional natural disasters.

Investors remain on edge as they await Greek political leaders to finally reach a durable agreement on further austerity and economic reforms. Until Greek politicians concur on further cuts and economic reforms, the PSI (voluntary debt exchange) agreement cannot be finalized and the first tranche of aid from the next bailout package cannot be released. A vote will be taken this Sunday night in the Greek parliament to approve that agreement. Greek leaders must come to a consensus quickly as they face a March 20 deadline when €14.5 billion of bonds is set to mature. Should Greece not receive the bailout package, they will surely default. Default is not in anyone's interest and we believe an agreement will eventually be reached. Meanwhile, fallout from the sovereign debt and bank liquidity crises has cast a shadow over European business activity with many forecasts now calling for a quarter or two or more of negative growth. An early settlement of the Greek crisis might lift spirits but may come too late to avert a recession. Under these conditions, the ECB is likely to continue its accommodative monetary policy indefinitely.

Risks to the global recovery, stemming from failed public policy decisions, abound. For example, a major fiscal drag on the US economy would occur in 2013 should Congress and the White House fail to extend the Bush era tax cuts and permit $1.5-trillion of spending reductions to go into effect at year-end. The impact of these policy decisions could reduce GDP by a full percentage point next year. Extreme populist agendas and dysfunctional government in this country, and disruptive movements abroad have the potential to destabilize the fragile global economy.

FORECAST

On balance then, we expect a continued sluggish global economic expansion this year supported by accommodative central bank policies, the likelihood of a "soft landing" in China and the resolution of the current crisis in Greece. Emerging markets will continue to be an engine for global growth. For the US, below-trend GDP growth in the 2¼% to 2½%+ range is likely. Based upon recent data, the risk to this forecast is that it understates expected growth. Unemployment is forecast to continue to drift lower reaching 7.8% by year end -- slightly better than our forecast last December. Housing, in our view, is in a bottoming process and the

pace of deleveraging is slowing. Inflation will fall below the upper end of the Fed's desired 2% rate. Corporate profits growth will slow from its torrid pace of 2011. We now expect the S&P 500 companies to report $104 of earnings per share this year -- up from about $97 per share in 2011. And Fed policy, as promised, will remain accommodative for an extended period of time, keeping short-term interest rates at historically low levels. Rates on a 10- and 30-year US Treasuries are expected to drift higher as market participants increasingly come to the view that the expansion will persist and they demand higher interest rates to be compensated for future inflation risks.

EQUITY INVESTMENT STRATEGY

With an end to year-end tax related selling, equity markets around the world have staged a sharp recovery in 2012, as investors have begun to look beyond European sovereign debt problems and focus instead on data which shows the global recovery continuing despite the probability of a brief recession in Europe.

Country	Index	Equity Market Price Returns YTD*
Brazil	BOVESPA	15.5%
Germany	DAX	15.1%
China	Hang Seng	14.0%
Taiwan	TWSE	11.9%
Korea	Kopsi	10.3%
France	CAC 40	8.4%
US	S&P 500	7.3%
Japan	Nikkei 225	6.5%
UK	FTSE 100	5.8%
Australia	ASX 200	5.6%

* Through 2/9/12

On the whole, US stock valuations remain cheap by historical standards at about 12.5 times calendar 2012 earnings -- well below the 15.0 times mean multiple of the past 20 years. Stocks are extremely attractive when compared with low-yielding bonds. Other measures of valuation we monitor confirm stocks to be statistically under-valued. Flows-of-funds studies show institutional stock portfolio ratios at generational lows. Individual investors have been net sellers of stocks for 4 years, liquidating about $500-billion of securities in that time. Corporations, by far the largest single source of demand for equities over the past few years, have nearly $2.0-trillion of cash on their balance sheets. Households hold nearly $8.0-trillion of cash. Both represent potential sources of demand for

equities as conditions brighten. Client portfolios are, therefore, fully invested in equities relative to their allowable maximum positions. The mix of stocks remains tilted toward *growth* shares with concentrations in sectors likely to benefit from the economic recovery at hand including technology, diversified industrials, transports, and energy. Investments in financials represent the largest exposure within the *value* portion of clients' equity portfolios. We have executed two tactical moves over the past six months to increase portfolio exposure in *emerging market equities* where growth is expected to exceed that of the developed markets.

FIXED INCOME STRATEGY

The bond portion of clients' portfolios remains laddered out to 3 years, conservatively invested with a duration of about 1.8 -- well below the benchmark. The proceeds of maturing bonds are being invested in other high quality corporate bonds maturing in three years or less. US Treasuries and agencies remain overvalued, in our judgment, and are largely absent from portfolios. US Treasury Inflation Protected Securities (TIPS) were eliminated last year from client portfolios based upon valuation/price risk considerations.

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