

December 24, 2002

THE ECONOMIC OUTLOOK – CONFIDENCE IS THE KEY

Despite forecasts of a major economic contraction following the September 2001 terrorist attacks, and painful adjustments for the excesses of the late 1990's, the U.S. economy surprisingly emerged from recession in the fourth quarter of last year. Consumer spending, especially for big-ticket items, remained robust. The commercial banking sector stayed comparatively strong without prominent failures and with no serious rationing of credit to worthy customers. Corporate profits from current operations have improved steadily throughout this year. And labor productivity continued to be impressive throughout the downturn, contrary to prior experience during recessions.

Nevertheless, the pickup has thus far been sluggish at roughly one-half the usual rate of recovery due to an overall lack of *confidence* across the economy. Businesses have been contending with generally lower stock prices and wider yield spreads than a year ago. Print and broadcast media have had a field day reporting on corporate governance issues which, for a handful of companies, have become matters threatening their survival. Since mid-year, war fears have taken center stage as a military encounter with Iraq, now widely expected to commence late next month or in February, could further exacerbate the recent rise in oil prices, particularly if energy production facilities or regional political stability are undermined. As a result of these uncertainties and recent chaotic conditions in Venezuela, businesses have put most hiring and capital spending plans on hold.

In our view, stock market jitters are excessive. Recent upward trends in commodity prices, along with the steeply sloped yield curve, offer evidence the much-discussed threat of global deflation is greatly exaggerated. A year ago, pessimists were anticipating a protracted global recession. In fact, this year the U.S. economy expanded at a 3% rate, more than double the pace of the late-2001 consensus forecast. Stimulative fiscal and monetary policies, along with rapid market adjustments, deserve credit for this better-than-expected performance.

U.S.- like economic dynamism is not present in the euro zone, where public policies present serious barriers to growth, nor in Japan, which must contend with

both structural and financial risks to its economic viability. The U.S. is the engine of global growth and will continue to attract foreign investment, foreclosing any steep decline in the value of the U.S. dollar.

Public debate over key issues such as appropriate fiscal stimulus, inflation and deflation, national security and corporate governance will carry over into the New Year. However, the most important hurdle to be overcome to finally set the stage for a solid, sustainable economic expansion will be the successful conclusion of the likely conflict in Iraq. Clearly, both consumer and business confidence will hinge on the outcome.

Slower Business But No “Double Dip”

Even though business activity has clearly moderated since our October *Economic Outlook*, extending the all too familiar pattern of sawtoothed quarterly advances, the U.S. economy is likely to tread water into the New Year. Limited employment growth, spiking energy prices and little, if any, improvement in business capital spending or inventory restocking in the face of current geopolitical tensions will restrain growth. However, we continue to assign a low probability to the economy slipping into the much discussed “double dip”. Lean inventories, accommodative monetary policy and additional fiscal stimulus likely next year should keep the economy afloat for the next two quarters despite our obvious vulnerability to new negative shocks such as a protracted military engagement with Iraq or additional terrorist attacks.

Beyond the conflict with Iraq, assuming hostilities are brief and limited, we see a strengthening economy as the interplay of the following factors takes hold:

1. *Improved corporate finances.* Since the equity bubble burst in early 2000, U.S. firms have moved aggressively to strengthen their balance sheets and restore their profit margins. Investment spending and payrolls have been slashed and non-core assets have been divested, shuttered, or otherwise restructured. Corporations have improved their liquidity, taking advantage of low market interest rates to extend the maturity profile of their debt. Excluding telecoms and utilities, the ratio of S&P 500 debt service to net income for non-financial corporations remains well below the peak of the previous three recessions.

2. *Obsolescence and inadequate additions to corporations' physical capital stock* since mid-2000, at a time when the prices of new capital goods have continued to decline, augur well for the start of a recovery in capital spending next year.
3. For *U.S. consumers*, lower interest rates and rising home prices have partially offset the negative wealth effect of the 2 ½ year bear market in equities. While consumer spending will not be the primary driver of accelerating growth, it will, though, remain an important underpinning to the expected expansion. Consumer spending is forecast to rise in line with personal income gains.
4. Despite low short-term interest rates *monetary policy* is likely to continue to be accommodative in the first half of next year. Since inflation is not a threat, the Fed will keep rates steady until the Middle East risks have receded and investor risk tolerance recovers. In the event of a severe oil price spike, the Fed is likely to provide further liquidity and stimulus to the economy. The actions and recent statements of the Fed leave little doubt about its willingness to take decisive action.
5. The new Congress is likely to pass as much as a \$150 billion *fiscal stimulus* package by mid-2003 intended to expand both consumer spending and individual investment. Among the changes under consideration are reducing the taxation of dividends; increasing the deduction for capital losses; renewing provisions for accelerated depreciation on capital investments; making permanent the marginal tax rate and estate tax reductions passed last year, and; enacting various measures aimed at lower income workers to stimulate their spending. Interestingly, this fiscal stimulus package is likely to do more to boost growth in 2004 than in 2003 since it will take time to enact the legislation.
6. The *accelerating trend of productivity*, which boosts income and profits and, eventually, aggregate demand, has survived the equity bubble, the recession, the plunge in investment spending and the tepid recovery we have experienced to date. Indeed, the 5 ½ % productivity increase over the past year is the largest in decades. We expect above trend productivity gains to continue.

Specifically, we forecast real GDP for the current quarter will total about 2% - - below our earlier 3% forecast - - largely due to lackluster holiday spending. For 2003, we are projecting first half GDP growth of 2 ½ - 3 %, with the pace of activity likely to pick up in the second half. Fed monetary policy will err on the side of easing until the situation in Iraq is resolved. Following the war's conclusion, improving consumer and business sentiment could be a precursor to tightening by the Fed. While inflation will likely remain a non-issue in 2003, the focus will shift to the growing budget deficit and the amount of fiscal and monetary stimulus already in the pipeline, pushing intermediate and longer-term bond rates higher. It is, therefore, likely that we have already seen the lows for the current cycle in all but short-term interest rates.

Most analysts' forecasts for corporate profits failed to keep pace with their actual decline from mid-2000 through the end of 2002. Now, as corporate profits enter a rebound phase, we believe these same analysts will fail to correctly gauge the extent of the profits recovery and will again find themselves behind the curve. And, finally, unemployment, now at 6% will probably edge somewhat higher early next year reaching 6.2 - 6.3 % as businesses remain reluctant to add to their payrolls until improvements in profitability are firmly entrenched.

Investment Policy

Our late 2001 and early 2002 stock market forecasts, were, in retrospect, overly optimistic. Geopolitical worries and damage from perceived corporate and Wall Street dishonesty turned out to be worse than we had expected. While global terrorism captured the headlines, we did not see the possibility of a military engagement with Iraq, its impact on energy prices or its depressing effects on global growth. We also failed to correctly anticipate the impact of corporate disclosures regarding fraudulent accounting, which inflated reported results, and the corrupt self-enrichment practices of a few very high profile executives. We, therefore, did not foresee the breadth and intensity of the resulting backlash against much of the corporate world and the subsequent retreat by many from equity investments. As the year wore on, business leaders increasingly turned their attention to internal operating matters such as corporate governance rather than business expansion opportunities. In short, a unique, difficult-to-forecast confluence of negative factors combined to create greater economic uncertainty and loss of confidence than we expected. The

result was one of the most vicious bear markets in modern times, with no stock market sector escaping the carnage. As the decline played out, the largest, most marketable blue chips were liquidated as investors fled the market for the relative safety of fixed income securities.

Improving corporate profits, a very steep yield curve which in the past has been an accurate harbinger of a cyclical rebound in economic activity, and the gradual restoration of confidence in the integrity of corporate financial reports now underway should combine to create a more favorable investment climate in the year ahead and beyond. Furthermore, the excesses of the bubble market have now largely been wrung out so that equities are more reasonably valued. In fact, the attached S&P 500 Earnings Yield model shows U.S. equities to be as attractively priced as they have been for over a generation. In addition, the aforementioned scandals over the past year so enraged investors that fundamental changes in oversight were inescapable. Consequently, government regulation, market scrutiny and board governance have been strengthened. Today, market participants are far more diligent in monitoring top executives' compensation, corporate strategy, and accounting practices. While additional new shocks may surface, the increased oversight reduces the likelihood of future behavior that would seriously undermine confidence.

Equity portfolios under our supervision remain generally fully invested. We are maintaining the 60/40 *growth/value* tilt described in our August 28th client letter. Among the *growth* holdings, portfolio concentrations are focused in pharmaceuticals and related health care companies where favorable demographics, good new product flows and generational low valuations provide attraction. Improving capital spending trends next year will positively impact the portfolio's technology investments which are debt free and have dominant market shares in the industries they serve. The strengthening business environment next year should also have a positive impact on the media and advertising companies. On the *value* side, the largest concentration remains in financials. Low valuations by historical standards, decent dividend returns and the likelihood of improving earnings trends as business conditions improve support overweighing this component. Balanced portfolios managed by our firm hold significant cash reserves earmarked for additions to their bond holdings as higher interest rates next year will present better opportunities to add to intermediate-term fixed income positions.

The attached exhibit, showing the returns achieved by various classes of financial assets annually and over the long-term, remains of great interest in

understanding the inevitable migration of investment styles from laggard to top performance over short periods of time. Indeed, the performance of large cap *growth* stocks since mid-year has had a positive impact on the performance of our client's equity holdings particularly during the current quarter where returns are in line with those of the S&P 500 benchmark following below market returns during the first half of the year.

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As the New Year approaches, the entire team at Front Barnett Associates LLC sends greetings and best wishes for a year of happiness, good fortune and peace.