FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

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We are pleased to present below the highlights of Marshall Front's January 11th remarks to the Annual Meeting of the Mid America Club.

THE ECONOMIC OUTLOOK - - SKIRTING RECESSION

In the past month, investors have been confronted with a flood of evidence indicating the U.S. economy has been stalling. Almost overnight, signs of what appears to some observers to be an economy on the brink of recession have emerged.

- Vehicle Sales — U.S. auto makers have laid off thousands of workers and slowed production schedules in reaction to a 16.2% month-over-month decline in auto sales by the Big Three in December.

- Retail Sales — Christmas season retail sales were far below plan despite huge early markdowns. Bradlees and Wards are out of business. Sears is closing 89 stores.

- Consumer Confidence — The University of Michigan consumer confidence index plunged 8.6% month-over-month, and the Conference Board's confidence index has fallen to a 2 year low - - down 3.2% month-over-month and 9.5% year-over-year.

- Manufacturing Purchasing Managers — The most recent NAPM report showed an 8.4% month-over-month drop. Their index now stands at a 9 year low at 43.7, down from 47.7 in November and well below 50 - - a level below which the index indicates the manufacturing sector is contracting.

- Non-Manufacturing Purchasing — The latest Non-manufacturing NAPM report showed a 9.4% decline with anecdotal evidence pointing toward a

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Managers	"hiring freeze".
• Employment	While the December unemployment rate remained at 4.0%, a 31 year low, recent employment report data showed the manufacturing workweek continuing to slip, down 4.4% from its April peak. Non-farm payrolls in the goods producing sector have been falling from their July high, and the number of new non-farm jobs added fell 30% in 2000 from the prior year. Weekly jobless claims are now averaging 350,000 up from 300,000 just three months ago.

Responding to these and other signs of a sharper than expected slowdown, the Federal Reserve departed from its normal practice of implementing its rate cuts following a regularly scheduled meeting, reducing the federal funds rate last week by 50 basis points. This is the first time the central bank has changed policy between meetings since 1998, a time when the world faced a global monetary crisis. Possibly more important than this surprise rate cut, the Fed made it clear its action was likely to be only the first step in a series of easings intended to prolong our economic expansion that became the longest on record last February. We now expect the Fed to further reduce the Federal Funds rate by 25 to 50 basis points when it meets at the end of this month.

The Fed's action and its accompanying statement stand in stark contrast to its expressed position of just last November when *inflation* was its key concern. Last month, the Fed hinted that a rate cut was in the cards, but in taking its action four weeks ahead of its scheduled meeting, and in choosing to cut rates by half a percentage point rather than by a quarter point, its more usual increment, the Fed left the clear impression that it sees economic conditions deteriorating faster than they, we, or most analysts had anticipated. Taken together, the Fed's statement and its action indicates it has been "behind the curve" and is moving to close the gap.

Looking back over the past year, a confluence of factors have contributed to this slowdown in business activity.

- First, the Fed's own overly tight monetary policy, capped by a 50 basis point increase last May, whose lagged impact we are now feeling, is the major culprit;

- Second, sharply higher energy prices have acted as a global tax increase on consumption;

- Third, the reverse "wealth effect" of the NASDAQ's collapse has caused some consumers to pull in their horns;

- Fourth, unusually harsh winter weather and storms across most of the U.S. in December kept people at home;

- Fifth, shoppers were probably paying more attention to pregnant chads than to Christmas shopping last month;

- Sixth, demand for big-ticket consumer items my have been satisfied, for the time being at least, after nearly 10 years of continuous economic growth;

- Seventh, anecdotal evidence of job layoffs among dot com employers and auto manufacturers has probably caused consumers to become more cautions despite the low unemployment rate. In fact, December was the largest job cut month recorded by the Challenger, Grey and Christmas survey, and;

- Eighth, statements by members of the incoming Bush team regarding weakness in the economy have not helped to underwrite consumer confidence.

In our early December letter to clients we projected GDP growth at 2 ¾% to 3 ½% for the first half of this year and then a reacceleration of economic growth in the second half. Having the benefit of recently released data, we have lowered our firm's expectations for GDP growth to 1.75% for this quarter and 2.5% for the quarter ending June 30th.

While there may now be no visible end to the economic slowdown - - just as there was no apparent end to the rapid expansion last summer - - we do not see the economy falling into a recession. If pushed to quantify the possibility we are either in or about to enter a recession, we would assign only a 25% probably to this scenario.

Our forecast envisions at least a ½ point increase in the unemployment rate by mid-year without triggering a recession. This has not happened before, at least since World War II. In fact, increases in the unemployment rate of one-third of a point or more have consistently signaled that a recession was either underway or on the way. However, we see a number of reasons this rule may not apply in the current environment. Monetary policy can be more effective in short-circuiting a cyclical contraction both because financial conditions are not very restrictive to begin with and financial markets are forward – looking. Thus, as contractionary forces build, the market is quick to lean against them. Also, the current low level of inflation allows Fed officials more room to ease aggressively as they have begun to do.

Looking ahead, while we now believe the economy will have a somewhat "bumpy" landing, we think it will skirt recession this winter and then begin to revive by mid-year. The 7 reasons for our optimism are as follow:

1. The first of the Fed's interest rate cuts should begin to impact the economy soon after mid-year. As I noted earlier, we now expect the Fed to move again at the end of this month to reduce the Fed Funds rate by another 25 to 50 basis points. Additional rate reductions in mid-March and at the end of April are also likely. In total, we would not be surprised if the Fed cut rates by a total of 150 basis points - - giving back all of its rate hikes during the previous 2 years.

2. Financial markets have become far more anticipatory in their behavior. For example, prices of fixed income assets at year-end had already incorporated more than 75 basis points of rate cuts by mid 2001. Thus, some of the effects of the monetary easing we expect have been in the pipeline since late last year.

3. The sharp drop in home mortgage rates is likely to unleash a strong wave of mortgage refinancing this winter and spring, putting more money in consumers' pockets.

4. The economy should also get a boost from fiscal stimulus. At a minimum, the increase in federal budget authority that had a stealth inclusion in the fiscal 2001 budget, only to be put on hold pending completion of the appropriations bills, should begin to hike government outlays early this year. Moreover, proposals for tax cuts or spending increases that were floated during the campaign could be accelerated if the economy continues to

weaken. In this regard, the conventional wisdom that gridlock will prevail given the ultra-tight balance of power in Congress may not be correct. President-elect Bush has strong incentives to score quick successes as proof he can govern effectively and work with the opposition, and large prospective upward revisions to surplus estimates will create plenty of room to satisfy competing objectives.

5. Two structural changes should also help the economy avoid recession. Importantly, U.S. companies have improved their inventory management techniques, and, to date, this has prevented a serious overhang of unsold goods from developing. Although companies have lately had difficulty keeping the *rate* of inventory accumulation in line with the weakening growth trend in demand, the *level* of inventories is not excessive. Also, the ratio of stocks to sales has picked up only slightly from levels that are quite low in historical perspective. Obviously, this could eventually change if the accumulation rate is not brought into line fairly soon, but at this point the inventory problem is minor when compared with past cycles.

6. The deregulation of financial institutions, especially those specializing in mortgage finance, has helped make the U.S. housing industry less cyclical by removing artificial constraints on demand that formerly would kick in during periods of high interest rates. As a result, both existing home sales and new housing starts have moved in a much narrower range than before. Builders have also proven to be more adept at adjusting their production to demand, with the result that inventories of unsold homes are also quite low. Thus, while we expect housing demand to drift lower, the magnitude of the drag on real GDP is not as large as it has been in previous cycles.

7. If oil prices, now down 25% from their 2000 high, do not retrace their recent fall, their lower prices should begin to *support* economic growth going forward. This is because most of the constraints on oil supply reflect short-term disruptions rather than fundamental imbalances between demand and supply. We continue to expect crude oil prices to slide further once we move beyond the current period of peak demand for heating oil in the northern hemisphere. Natural gas prices should follow a similar pattern. Such a reversal could boost the growth rate of real wages significantly, providing a valuable cushion for income growth to offset some of the effects of the slower hiring now evident in the jobless claims figures released each Thursday morning.

Clearly, the next few months is likely to be the period of maximum risk for the economy. If the weakening in labor market conditions and confidence is severe enough to push the economy into recession, this should become evident quickly. But if the economy is still growing by early spring, as we think it will, then the effects of recent and prospective declines in interest rates should begin to take hold, and energy prices will turn from a threat to a support.

As for the stock market, our historical analysis shows that markets perform well during periods of declining rates and following Fed easings. Interestingly, during the last 50 years, 90% of the stock market's gains have been achieved during periods of falling rates. And, since the Korean War, markets have consistently risen following Fed rate cuts - - by an average of 10% six months after the initial rate reduction; by 14% nine months later and by over 20% a year after the initial rate cut by the Fed. We are, therefore, optimistic that stock market performance will begin to improve as we progress through the current quarter.

In the all important tug-of-war between *growth* and *value*, which defines our firm's investment style, and which allowed client portfolios in 2000 to significantly outperform our benchmark index, the S&P 500, we have been leaning toward *value* - - seeking undervalued stocks where there may be a catalyst for an upward revaluation. Last year, *growth* led the market in the first half and *value* strengthened in the second half and, as it turned out, for the full year. Typically, once a *growth* or *value* trend gains relative momentum, it can stay in favor for a protracted period. Also, a central belief of our firm is that a steepening yield curve - - which we are now seeing - - tends to favor the *value* style.

Additionally, if the dollar continues to weaken, as we have been forecasting, multinational companies that suffered from weak economic conditions and weak currencies in 2000 will be obvious beneficiaries in 2001. In a year when profit growth will be hard to achieve, currency translation gains will be a significant plus.

For this year, we expect moderate gains in the broad equity market averages. As was the case last year, active management should be rewarded through emphasis and stock selection. As the Fed cuts rates further and as a tax bill works its way through Congress, the equity markets will probably perk up and begin discounting brighter prospects for 2002.

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Two administrative points:

We are delighted to announce that Claudia Gutierrez, who many of our clients know, has become a member of our LLC.

We are also pleased to welcome Marc Intigliata to our client relationship staff. Marc, who has 7 years of prior investment experience, will be working with Phil Barnett and Laura Clark.

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