FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

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THE ECONOMIC OUTLOOK - - STAY THE COURSE

The February employment report released last Friday presented the first broad reading of how the U.S. economy behaved last month. The report showed far more jobs were created than Wall Street forecasters had expected, easing the fears of some analysts that we were sliding toward recession. In fact, this employment report painted a quite different picture. It showed the economy's slowdown appears to be troughing following its unexpected plunge late last fall and early winter and that the apparent collapse in manufacturing has not spread significantly to the rest of the economy.

Looking back to last year, several predictable factors encouraging slower growth now stand out. These include: (1) *the year long rise in U.S. interest rates*, as the Federal Reserve tightened monetary policy through last May; (2) *the "dark shadow" of Y2K,* in which capital spending surged in 1999 and then sharply decelerated; (3) *slower growth rates for housing and big ticket consumer durable items,* following significant expenditures in these areas in 1997 through early 2000; and (4) *higher energy prices which act as a tax increase on the economy*. In addition, a number of one-time, surprise factors also conspired to brake the economy's advice: (1) *the coldest November/December in 105 years*, following the warmest November/December in 105 years, which discouraged economic activity; (2) *the "CNN effect"* associated with the contested Presidential election; many Americans remained at home to watch cable TV news, disrupted the normally hectic Christmas shopping season; (3) *statements made by President Bush emphasizing weakness in the economy* have no doubt had a depressing impact on consumer confidence, and; (4) *the 65%+ drop in the NASDAQ* market from its high a year ago has triggered a sharp wave of consumer pessimism - - so much for the so-called "wealth effect".

While some forecasters argue the weakness in manufacturing may soon engulf the consumer sector of the economy, others share our view that once manufacturing, which is typically very cyclical and now appears to be bearing the brunt of the

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inventory adjustments, completes its correction the nation will experience a return to more normal, sustainable growth. Indeed, the Front Barnett Economic Model (a copy of which is attached), which correctly identified the current slowdown as early as last March, began late last year to point to a business recovery commencing this summer. Lower energy prices, a continued strong dollar, increased government spending, prospects of a tax cut, tumbling interest rates, a huge wave of mortgage refinancings and a gradual recovery in stock prices will combine to lift the economy to a 3%+ real GDP growth rate in the second half of this year following 1% growth this quarter and 1.8% growth in the second quarter.

An analysis of the very important employment data released last week strengthens our view that the sharp drop in manufacturing, which accounts for less than 20% of GDP, explains most of the general business slowdown. The 135,000 new jobs recorded in February came despite a loss of 94,000 additional manufacturing positions. The cutbacks, which earlier this winter were centered on autos, computers and telecommunications, have now become much more widespread. Only 24.1% of the nation's manufacturing companies increased their payrolls in February, the lowest percentage since 1990, a recession year. A sharp decline in capital spending for new machinery and computers has resulted in layoffs and hiring freezes at many companies making this equipment. Outside of manufacturing, however, the picture was far better. For example, gains were registered in construction, healthcare, retailing, mortgage banking, lodging, real estate, airlines, trucking, insurance, brokerage houses and government. Even the sensitive temporary help sector, which has lost 178,000 jobs since last September, regained a bit of ground, adding 3,000 jobs. Should the business slowdown remain largely confined to the manufacturing sector, as we believe it will, we see the economy avoiding recession.

Inflation

The rises reported last month in both the January PPI and CPI indices, along with a 4.1% increase since November in hourly wages, have rekindled inflation fears among some observers. It should be noted, however, that both the PPI and CPI are *lagging* indicators during periods of business slowdown, not harbingers of future increases in inflation. The danger arising from surging wages, some economists say, is that inflation will rise, too, as companies increase prices to cover higher labor costs. However, productivity, or the average worker's output per hour, has risen rapidly enough since 1995 to allow companies to raise wages without having to resort to price increases in order to maintain their profitability. Competition is likely to remain savage, and at this point in the economic cycle businesses have

little, if any, pricing power in the face of strong global deflationary pressures. We, therefore, continue to forecast a benign inflation environment for the balance of this year and well into 2002.

Interest Rates

With residual late cycle inflationary forces ebbing, still lower energy prices on the horizon, manufacturing likely to remain on the weak side for at least two additional quarters and global business conditions softening, the Federal Reserve is certain to continue to ease credit conditions aggressively over the months ahead. The Federal Funds rate, which closed the year 2000 at 6.5% and has since been brought down by a full percentage point, will eventually fall to 4% in a series of further rate cuts. Rates on short-term instruments will also be under pressure at least through mid-year. On the other hand, intermediate and longer dated U.S. Treasury bond yields are approaching their lows for this cycle. We would be surprised to see yields on these issues decline by more than an additional 35 basis points. At best, this would bring yields on benchmark 10-year U.S. Treasury bonds down to about 4.45% and 4.90% on 30 year Treasury obligations. As the Fed continues to reflate, spreads between U.S. Treasury bond yields and those of high grade corporate obligations, now at about 150 basis points, will narrow, affording corporate bond owners superior returns over the next year or so.

The Stock Market

The combination of the decline in the benchmark 10-year U.S. Treasury bond yield, now below 5%, and the decline in the S&P 500 stock market index has placed the market in an undervalued position by about 8% according to analysts' dividend discount models. In terms of investor sentiment, some surveys show significant and growing bearishness - - a positive sign. In our view, many of the stock market's prior imbalances, which increasingly concerned us during the past year, have now been largely corrected. Risk tolerance has been replaced by risk aversion. Gun slinging day traders are largely gone and America's love affair with equities has decidedly cooled, at least for the time being. Margin debt has decreased. Equity mutual fund cash positions have grown and money market fund balances now exceed $2.0 trillion. Earlier wide disparities in relative valuation have narrowed as fundamental factors, rather than share price momentum, have asserted themselves as stock price drivers. The best-performing hedge funds are actually hedged, rather than aggressively leveraged. While market risks are ever present, we believe the greatest risk has shifted from one of further substantial price decline to the timing of the inevitable market recovery. Recent waves of

indiscriminate selling and sector capitulation, in our judgement, confirm this view. We continue to advise clients to stay the course in the anticipation of a firmer equity market in the weeks ahead.

As long-term investors, we believe rebuilding positions now in high quality technology, media, and telecommunications shares will be well rewarded over time. We are convinced that secular spending in these sectors will grow more rapidly than the overall economy and that valuations have once again become attractive for many of the high-quality companies in these areas. To make room for these additions, we have selectively reduced positions of pharmaceuticals and financials, which are over-weighted due to last year's superior performance. Further reductions in these two groups are planned as new investments likely to benefit from the improving economy we forecast are introduced into clients' portfolios.

Finally, in the continuing process of blending *growth* and *value* shares within a single portfolio, which both defines our investment style and distinguishes us from other advisers, we have begun to add to *growth* stock positions. While equity portfolios remain evenly balanced between the two disciplines at this time, increases in the *growth* component are likely as opportunities present themselves.

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