

# ***FRONT BARNETT ASSOCIATES LLC***

**I N V E S T M E N T      C O U N S E L**

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*Below are comments prepared by Marshall Front for his appearance at the May 18<sup>th</sup> University of Chicago Mid-Year Economic Forecast Conference.*

Market events of the past few years reconfirm the fundamental principals of investing promulgated long ago by such luminaries as Graham & Dodd do, indeed, matter.

- ***Diversify*** broadly within and among asset classes - - do not bet the ranch
- ***Valuation*** is important
- ***Market timing*** is tempting but rarely fruitful
- ***After tax returns*** are what count - - low turnover is key

Our own disciplines, which embrace these and other well tested principles, also emphasize careful attention to both what our Economic Model is telling us about how the economy is likely to perform and where we should be in our balance between *growth* and *value* stocks. This approach, which defines our equity investing style and distinguishes us from other advisers who follow a growth only or value only mantra, has been central to our success over the past seven years in producing above market returns in clients' equity portfolios.

Our proprietary Economic Model, which is designed to forecast changes in the direction of the economy six to nine months in advance, began to signal in March 2000 a business slowdown, which later materialized as a series of Fed credit tightenings and over-spending in the technology and telecommunications sectors finally took their toll. Throughout 2000, portfolio exposure to consumer spending was carefully limited. Technology holdings were pared early in the year as valuations went parabolic. At the time, we viewed dot coms as an "accident waiting to happen". *Growth* shares were significantly reduced following a three-year period of out-performance in favor of depressed *value* stocks, particularly financials.

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This winter, our forecasting model began to signal the likelihood of an incipient economic recovery by mid-2001. An important driver of this model is monetary growth, which accelerated beginning in late 2000. Consequently, over the past 4 months we have implemented a number of strategic shifts in portfolios under our management to increase their exposure to economically sensitive issues. In mid-March we began rebuilding positions in depressed technology holdings given their attractive valuations when viewed beyond the current slowdown.

### U.S. Stock Market

Beyond the favorable quantitative message our model was delivering this winter, we were further encouraged about the prospects for US stocks by a number of other factors as follows:

First, our analysis showed there to be a very high correlation between Federal Reserve easings and stock market performance. Since the early 1970's, on average, stocks have advanced 10% in the first six months following an initial Fed rate cut, 14% nine months later, and 20% one year from the first Fed rate reduction. As we see it, the aggressiveness of the current series of rate decreases raises the odds of a repeat of the past relationship between rate cuts and stock market advances.

Just as the stock market labored under the weight of Fed tightening during much of 2000, the wind is now at the market's back as the Fed eases. We now believe the Fed Funds target rate could reach 3 ½% before this cycle of easing runs its course.

Second, as the winter drew to a close, we noted very aggressive *sector* liquidation in former high flying technology and telecom shares despite the best valuations we had seen in almost two years. Toward late March, it was quite apparent that wholesale *asset class* liquidation was under way. The latter, often referred to as panic selling, precipitated phone calls from a handful of our clients whose inclination was to bail out of the market. In the past, similar calls had almost always been coincident with a market bottom.

Other signs the stock market was approaching its eventual low for this cycle included the sudden appearance of daunting bears on the covers of leading weekly news magazines, telephone calls of which we were aware to CNBC anchors blaming them for the market's drop, sharply declining viewership of financial news programming on cable television and stories in the *Wall Street Journal* and

the *New York Times* glorifying short sellers. Market psychology, driven by the media, could not have been worse.

Third, liquidity was building at a vary rapid rate as a result of the Fed's actions and the growing risk aversion of professional investors. Money market mutual fund balances exceeded \$1.2 trillion for the first time. The cash positions of equity mutual funds stood near decade highs, defined benefit plan cash balances were reported by *Pensions and Investment* to have exceeded 10%. Margin debt was being slashed. Meanwhile, the yield curve had been steepening and spreads between high-grade corporate bonds and US obligations had narrowed - - all positive signs for equities.

In summary, the stage was now set for a massive reversal in investor psychology even as Wall Street pundits continued to counsel their customers to batten down the hatches because Dow 7500 was just ahead. In retrospect, the markets made their lows in late March and early April and have not looked back since. Despite the inevitable testing of these lows, a further substantial recovery in equity share prices lies ahead. This move will be driven first by the enormous liquidity build-up I noted a moment ago and, later on, as signs of recovering corporate profit growth are more fully discounted.

A question likely to be raised by analysts over the coming months will be whether we actually experienced a "bear market" for equities in 2000-2001. When viewed from intra-day peak to intra-day trough, all of the major indices appear to have fallen sufficiently to have qualified for bear market status by the traditional 20% decline test. However, while the S&P 500, for example, fell 25.4% from its March 23, 2000 high to its low one year later on March 22<sup>nd</sup>, its decline, excluding technology and telecommunications shares, was only 10.9% during the period - - hardly a disaster for a well diversified portfolio - - a mere zephyr in a storm for most cautious, conservative mid-western investors.

Appearing here today with this distinguished panel of economists, I hesitate to interject my own views on the outlook. However, for those of you who know me,....

- We continue to believe there will be no recession in this cycle despite the hand wringing of many Wall Street analysts whose last worry was inflation.

- Anecdotal evidence will emerge by mid-year of a better balance between inventories and final sales in many of the manufacturing industries hardest hit by the slowdown.
- Because unemployment will remain low by historical standards, the consumers will continue to spend on housing, autos, non-durables and services despite record low confidence survey readings which have never been shown to be useful predictive tools.
- While higher energy costs will pressure businesses to raise prices to maintain their profit margins, the highly competitive environment during this period of weak economic growth will limit their pricing power.
- Beyond the next few months, energy prices are projected to fall with crude oil prices retreating to the mid \$20's per barrel. Increases in production from non-OPEC sources and the conclusion of the build-up of gasoline stocks for the peak driving season will help.
- Inflation will remain a non-starter. Capacity utilization is low at 78.5%, industrial raw material prices have collapsed and gold, the best inflation indicator we know, is dead.
- Capital expenditures, which are less sensitive to lower interest rates than they are to profit prospects, will recover only slowly commencing early 2002.
- We are nearing the end of this interest rate cycle. Long rates have already seen their lows. Short rates are probably within a quarter to a half point of their bottoms.

We see real economic growth expanding from a 1½% to 2% pace in this year's first half to 2¾% to 3% in the third and fourth quarters. Interest rates and fiscal stimuli in the form of a tax cut and increased government spending will drive this reacceleration of economic activity. 4%+ GDP growth is expected for 2002, a constructive backdrop for the financial markets going forward.

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