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# THE ECONOMIC OUTLOOK - - RECOVERY AT HAND

Recently released data support the view that an economic recovery is at hand. Consumer and business demand have held up better than anticipated. Fiscal stimulus from both increased government spending and the residual impact of last year's tax cut is gaining momentum. And forward-looking demand and inventory indicators signal further improvement in business conditions in the months ahead. Indeed, both our firm's Economic Model, a copy of which is attached, and the Conference Board's widely followed Index of Leading Economic Indicators, point

to a turnaround in business conditions. Among the economic data validating this outlook are:

1. GDP grew at a 0.2% annual rate in the fourth quarter - - well above most expectations;

2. Retail sales ex-autos for the month of January were up a surprising 1.2% and December's figures, originally reported at -0.1%, were revised upward to +0.7%;

3. U.S. productivity rose at an annual rate of 3.5% in the fourth quarter and 1.7% during the slowdown. By way of comparison, output per hour of work fell by 0.6% on average during post-World War II recessions. Analysis of productivity trends during prior recessions reveals above-trend productivity during such periods has inevitably led to very robust productivity gains in the ensuing recovery phase;

4. Inventory liquidation is showing signs of abating after reaching massive proportions - - $120 billion - - in the fourth quarter, reducing GDP by 2.2%. While lower business inventories portend future production increases, simply arresting the inventory contraction will be additive to GDP;

5. Initial jobless claims continue to moderate. The recent four-week moving average of these claims has fallen from its peak of 505,800 in mid October

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2001 to 376,000 as of February 9th. While overall unemployment, a lagging indicator, is likely to drift somewhat higher from its current 5.6% rate, the economy has moved well beyond the peak level of employment loss for this cycle and we are not likely to experience the 6.5% or 7.0% unemployment levels previously seen as likely by some forecasters;

6. The manufacturing sector continues to rebound with the Institute of Supply Management (formerly NAPM) Index rising to levels not seen since August 2000;

7. Consumer sentiment has also improved as shown by the University of Michigan Consumer Sentiment Index which reached 93.0 last month - - up from 88.8 in December and 81.8 following the September 11 terrorist attacks;

Interestingly, the *Wall Street Journal* recently reported that the U.S. economy, "though still suffering, is proving so impressively resilient that there is muttering inside the Fed that this downturn does not qualify as a recession". We and others share this view.

## Constraints on Recovery

While our indicators point to an economic recovery, there are a number of economic and financial constraints which are likely to reduce the near-term vigor of this expansion. Despite the push from massive monetary and fiscal stimulus, logic tells us that the short, shallow recession from which we are emerging is likely to give birth to a moderate rebound. With housing remaining at near record levels, auto sales continuing relatively strong thanks to bargain – rate financing, and overall very strong consumer spending throughout the fourth quarter, there remains relatively little pent-up demand for housing or new vehicles to provide the kick-start often seen in the early stages of a recovery. Financial constraints are also a governor on the speed with which the economy accelerates. For example, the Federal Reserve's January Senior Loan Officer Survey shows that banks continue to tighten their lending standards and the terms for loans to both businesses and households, although the percentage of respondents reporting tightening has declined from last October's survey. Also, the dollar, on a trade- weighted basis, has risen to a sixteen-year high causing U.S. export prices to soar and giving imports a competitive edge. We, therefore, now expect GDP growth to expand in the range of 2.00% to 2.50 % during the first half of this year accelerating to 3.75% to 4.00% by year-end absent another serious terrorist attack.

## Corporate Profits Recovery

Ample global manufacturing capacity and the strong U.S. dollar will translate into little corporate pricing power - - a condition with which businesses have had to contend for years. Corporations will respond by continuing to cut costs and boost productivity. With the burden of excess capacity largely reduced, the benefits of operating leverage during the expansion will largely fall to the bottom line of corporate income statements. We, therefore, expect quite healthy sequential gains in corporate profitability commencing this quarter. S&P 500 operating earnings are expected to rise 13% this year following an estimated 30% drop last year. Gains in S&P 500 operating profits next year should approach 25%, which will still leave them a shade below their peak in 2000. Analysts expect the technology and telecommunications sectors to experience the biggest turnaround in 2002, albeit from very depressed levels, as tech spending begins to revive. However, earnings in both areas will likely to remain well below their 2000 peak until 2004. Industrials and healthcare will also experience double-digit earnings growth. But other sectors are likely to see earnings rise in the single digits, though momentum will build as 2002 progresses.

## Energy Prices

Energy prices were materially lower in 2001 than in 2000, concluding the year near their lows. As the global recovery gains traction, energy prices should firm. However, likely increases in Russian exports, as well as substantial excess capacity within OPEC, leading to renewed "cheating" by its members, will most likely limit any crude oil price recovery to the $25 to $27 per barrel range.

## Fixed-Income Outlook

Over the very near term, the stronger economy we forecast, plus any additional fiscal stimulus, should not provoke an immediate reaction from the Federal Reserve or the financial markets. However, between now and mid-year, as the recovery gathers momentum, markets will begin to anticipate an adjustment in monetary policy away from its accommodative stance. (Fed watchers believe it is unlikely the Fed will move to tighten credit until Fed Chairman Greenspan has had an opportunity to outline the logic of resetting monetary policy back toward neutrality at his July Congressional testimony.) Interestingly, the Fed began to quietly drain liquidity in mid-December but reversed course a month later when growing fears over accounting scandals caused substantial dislocation in corporate

bond and commercial paper markets. Nevertheless, we continue to expect the yield curve to flatten over the balance of this year as short-term rates move up more than long-term yields. Low inflation and the likely mix of net Treasury issuance will probably limit the rise in ten-year note yields to 5.75% this year as buybacks continue and issuance is concentrated in shorter maturities. By year-end we expect short-term rates to rise in anticipation of the Fed "taking back" some of the 175 basis points easing it provided in response to the 9/11 attacks. We continue to maintain reserves in fixed-income portfolios with which to add to bond positions as yields become more attractive.

## Equity Outlook

Despite the recovery, clouds over the accuracy and quality of reported corporate profits may cause equities to trade defensively for awhile longer. But as the expansion gathers momentum, and concerns about earnings quality recede, stock investors will find it increasingly difficult to ignore the improving fundamentals. We believe our clients' equity portfolios are well positioned to participate in the improved equity markets we see ahead. In the expectation of a recovery in depressed *growth* shares, this category now represents about 60% of client's equity holdings with 40% allocated to *value* stocks. Concentrations in diversified manufacturing companies sensitive to economic activity, technology companies with strong financials and dominant positions in their markets, early-cycle companies engaged in advertising, broadcasting/media and "big box" retailers should be beneficial to our clients' stock performance.

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We again call to your attention our website www.front-barnett.com, where we post client letters as well as provide frequent updates to our Economic Model and our business outlook. Since we now alert clients to postings via email messages, we ask that you provide your email address if it is not already on file with us so we can include you among those receiving these notifications.

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