FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

April 7, 2004

THE ECONOMIC OUTLOOK

So much for the "jobless recovery". Last Friday, the Labor Department's monthly *payroll survey* showed the economy added a surprising 308,000 jobs in March, ending a pattern of tepid employment growth, to record the largest number of new jobs in a month since April 2000. The Labor Department also announced that it had revised upward its total of jobs created in January and February to 205,000, almost double the previous estimate of 118,000. These revisions brought average monthly job growth in the first quarter to 171,000, the most vigorous rate since the second quarter of 2000, soon after the dot.com bubble burst. While we recognize this short-term employment surge does not conclusively establish a trend, we believe it confirms the view we have held since late last year that it was just a matter of a few months before the US economy's strong underlying growth (6.2% in the second half of 2003 and probably 4.25% in the quarter just ended) reflected itself in a notable pick-up in job creation.

Until now, we and other forecasters have been surprised that job creation had lagged so far behind other economic variables, ranging from economic growth to new claims for unemployment. These indicators had almost universally pointed to a strong economy and a recovering labor market. Indeed, as we noted in our February Economic Update, the Labor Department's less widely followed monthly *household survey* has for months been signaling a sharp increase in employment growth. The eventual convergence of the two data series was, in our judgment, inevitable.

Some analysts, in their review of the economic data available prior to last Friday's job report, concluded the sluggish job growth evidenced the economy was growing more slowly than generally believed. Others argued that because of outsourcing and other factors unique to this business cycle, the traditional connection between economic recovery and job growth had broken down. This new job report suggests to us that with the economy firing on all cylinders, the labor market is finally returning to a more normal pattern.

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It is worth recalling that long after the economy emerged from recession in November 2001, fierce domestic and foreign competition kept a lid on hiring as companies, seeing little top line growth and much unused production capacity, struggled to contain costs in order to maintain their profitability. Meanwhile, their previous heavy investments in advanced technology allowed them to increase the productivity of their existing workers. Now, as profits have soared to record levels and confidence has returned, businesses have begun to add to payrolls in earnest.

The expansion in hiring, if sustained, should translate into stronger income growth and consumer spending, providing the basis for a self sustaining economic expansion as the stimulus of last year's tax cut wanes and the Federal Reserve begins to tighten monetary policy this summer. That said, there remains a large number of skeptics who believe the current economic strength will ebb as the impact of the aforementioned stimuli diminish later this year. Stay tuned as this has emerged as a major political issue in this election year.

Recent Economic Data

Looking beyond the payroll numbers, recently released economic data, as well as our proprietary Economic Model, point to continued above-trend growth in the months ahead. On the business side, most readings show an acceleration in activity:

- The Institute of Supply Management (ISM) manufacturing index, which rose in March to a reading of 62.5, has now been flashing expansionary readings for 10 consecutive months. Moreover, this index has in recent months gained momentum and its strength has broadened to encompass virtually all industries included in the survey. Interestingly, the January to March results are consistent with real GDP growth well in excess of both the current consensus of expectations and our own forecast.

- The ISM non-manufacturing survey for March surged to a record reading of 65.8, well above most forecasts. This barometer of the service sector of our economy has now been expansionary for 12 consecutive months with its key subcomponents, namely new orders and employment, signaling continued strength.

- The Conference Board's quarterly report on CEO confidence through March shows the highest reading in a generation. Also noteworthy is the fact that half of the CEO's now anticipate an increase in employment levels in their respective industries, up significantly from less than 16% a year ago. Furthermore, only 12% of those surveyed expect headcount reductions. A year ago, roughly half of the survey participants anticipated payroll cuts.

- A broad array of rising commodity prices, ranging from metals to lumber to DRAM chips, portend solid business growth ahead.

Meanwhile, the consumer side of the economy remains solid:

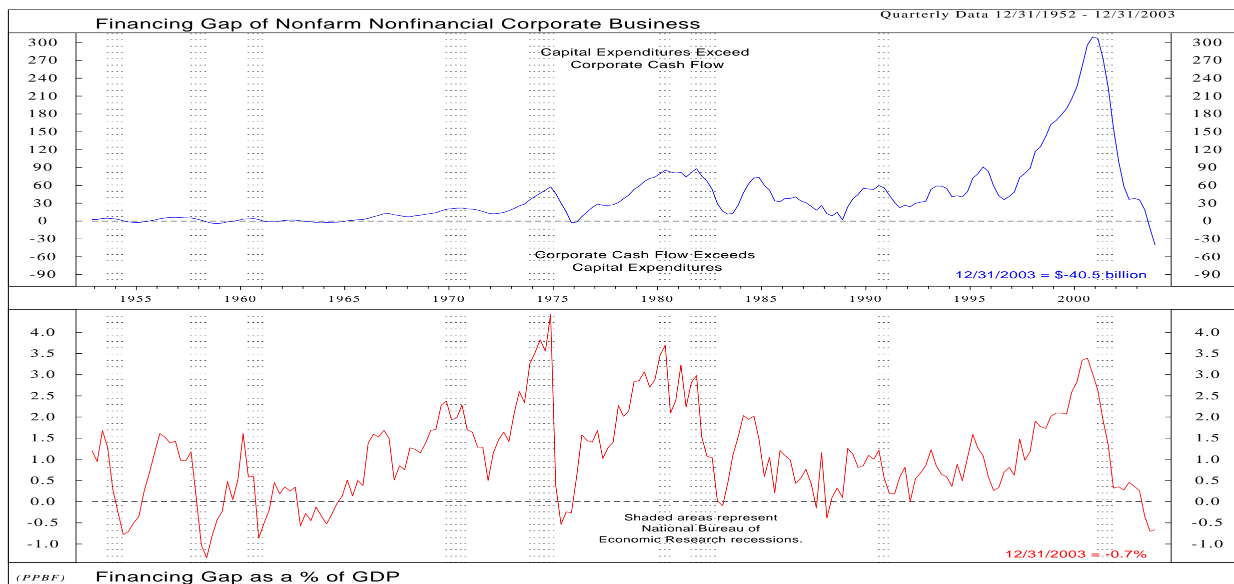
- Spending appears to be on firm footing. February year-over-year real disposable income rose 4.1% with real consumer spending up 4.3%. And in recent days, leading retailers have boosted sales estimates to reflect stronger than anticipated demand due to better weather and income tax refunds.

- Auto sales ended the quarter on an upswing and residential home sales and permits for new homes remain robust.

Finally, S&P 500 company profits continue to surprise analysts. Early this year, the consensus for first quarter profit growth was 13.4%. More recently, expectations for the quarter have centered around 17%. Our best guess, given the paucity of negative pre-announcements, is for profit growth to approach and possibly exceed 19%.

The Financing Surplus

Over the past year or so, we have been monitoring what we believe to be a significant, yet underappreciated, trend in corporate finance that has several positive investment implications. In simple terms, corporations have become cash rich, in part due to restrained capital spending during a time when corporate profits have risen sharply. The exhibit below illustrates just how much corporate cash flows now exceed capital outlays.



Courtesy of Ned Davis Research

For investors, the takeaways are as follows:

- Corporate balance sheets will continue to strengthen, credit upgrades will proliferate and corporate bond spreads are likely to remain tight - - good news for bond investors.

- Corporate bond issuers, flush with cash, are unlikely to "crowd out" the US Treasury in seeking funding, moderating the eventual upward pressure on rates - - more good news for bond investors.

- Increasingly, cash is being returned to investors in the form of higher dividends, share repurchases or both - - good news for stock investors.

- Merger and acquisition activity is likely to accelerate further, improving earnings at the investment banks and encouraging generally higher valuations for businesses, both public and private.

- Businesses will have the wherewithal to increase capital spending as confidence grows, as idle capacity is utilized more intensively, and as older equipment becomes obsolete - - good for capital goods and technology companies.

- Commercial and industrial loan demand is likely to remain sluggish as many enterprises choose to self finance future projects - - a headwind for lending institutions.

The Outlook for 2004

Reflecting the resurgence in job growth, the broad based momentum we see in the US economy and signs of a nascent global recovery, we have increased our forecast for 2004 real GDP growth to 4.00% - 4.25%. Year-over-year comparisons with 2003 will be strongest in the first two quarters. As we move beyond mid-year, with monetary and fiscal stimulus fading, growth will moderate but remain well above-trend. Our forecast of a 5.3% unemployment rate by year-end remains unchanged. Against this backdrop, our February forecast for corporate profit growth of 12%-15% in 2004 is likely to be exceeded.

Inflation, as measured by the CPI, has run at a low 1.8% rate over the past 12 months. Given the weaker dollar, higher than expected energy and commodity prices, the cost of our involvement in Iraq and the maturing business cycle, we see inflation rising to 2.25% for 2004.

With both an improving job market and an uptick in inflation as catalysts, the Federal Reserve is likely to begin gradually raising rates this summer. Fed Governors in their recent public statements have begun to prepare the financial markets for this change in policy. The bond market has already reacted by pushing 10 Year US Treasury bond yields to 4.18% from 3.65% as recently as March 17th. We would not be surprised to see these rates at 5.00% by year-end.

Clearly, there are risks to our positive forecast for 2004 and beyond. Politically driven proposals to alter tax and trade policies, ever-present geopolitical concerns, high energy prices and increasing consumer debt levels present challenges. While these and other now unforeseen hurdles will surely arise, we remain impressed with the resilience of the US economy and its ability to quickly adapt.

Equity Investment Strategy

Equity portfolios under our supervision have been fully invested and tilted toward *growth* stocks throughout the market recovery of the past year. Given our outlook, we see no important reason to alter our strategy at this time. First, while stocks have already experienced significant recoveries, bear in mind their upward moves have come from overly depressed, fear-driven levels reached in early 2003. Second, a review of prior major stock market washouts shows that a substantial multi-year recovery is likely to develop as sentiment reverses and business conditions improve. The attached exhibit, showing annual stock market returns over the past 78 years, demonstrates this point. Third, with stocks now priced at about 18 times 2004 expected earnings, they appear to be reasonably valued. Further, according to the Fed Valuation Model, stocks are approximately 23% undervalued when compared with 10 year US Treasury bonds. Finally, corporate profits have now moved well into record territory and we and others have probably underestimated their future growth. We continue to expect double digit equity returns, in line with corporate profit growth, this year.

Our major portfolio concentrations in technology and industrial capital goods are supported by our expectations for outsized earnings gains this year. Interest rate sensitive financials have been core holdings for some years. Expecting higher interest rates, we have begun to reduce our exposure to this sector and plan further cuts over the months ahead.

Fixed Income Investment Strategy

The outlook for bonds remains problematic. We continue to focus on the risks associated with holding longer dated bonds during periods of rising rates, particularly, as now, when the bond market is being driven by speculators employing record amounts of leverage. Specifically, hedge funds and bond dealers have been engaging in the so-called “carry trade” - - borrowing massive amounts of short-term money at very low rates to invest in longer-term bonds with higher yields. Bear in mind that in 1994 as the Fed raised rates, the unwinding of this trading strategy contributed to a collapse in bond prices, the result of which was the worst year ever for bond investors. We would not rule out a repeat in some form of the 1994 experience.

To protect the principal value of client's bond portfolios, we have reduced durations and deployed funds earmarked for future bond purchases in short-term instruments which provide returns two to three times those available from money market funds, both taxable and tax-exempt. Events of the past week, where US Treasury bonds lost almost 3% of their value in response to the favorable jobs data, demonstrate the need to keep durations short until rates adequately compensate bond holders for the risk they are assuming.

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Quarterly Data 12/31/1952 - 12/31/2003

Financing Gap of Nonfarm Nonfinancial Corporate Business

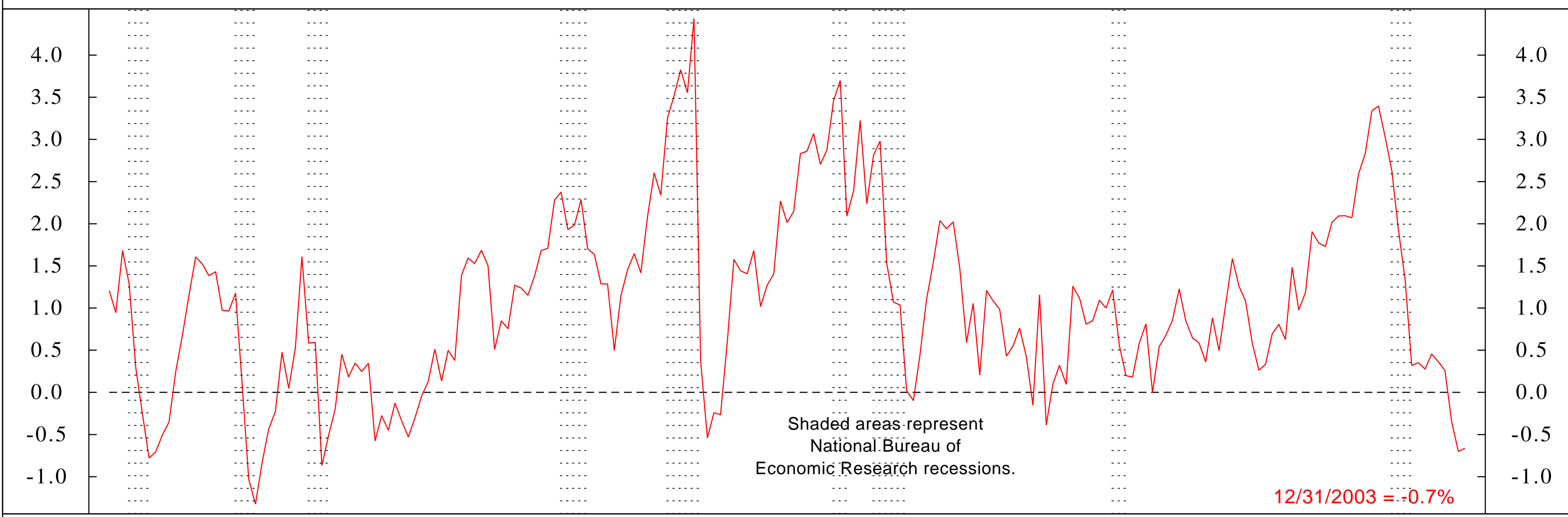
300 270 240 210 180 150 120 90 60 30 0 -30 -60 -90

Capital Expenditures Exceed Corporate Cash Flow

Corporate Cash Flow Exceeds Capital Expenditures

12/31/2003 = $-40.5 billion

1955 1960 1965 1970 1975 1980 1985 1990 1995 2000



(PPBF) Financing Gap as a % of GDP

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