FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

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THE ECONOMIC OUTLOOK - - DOWNSHIFTING TO SUSTAINABLE GROWTH

The comments of General Electric CEO Jeff Immelt, which accompanied Friday's release of the company's second quarter results, are as instructive regarding current business conditions and the outlook as are the reams of economic data we parse daily. From his vantage point atop one of the world's largest companies with dominant businesses ranging from jet engines and consumer appliances, to medical devices, financial services, plastics and the NBC Network, Immelt is uniquely well positioned to gauge the tempo of economic activity. He noted that "this is the best economy we have seen in years" and characterized prospects for global business as quite favorable. Our firm's proprietary Economic Model (attached), conversations with business leaders, and economic data confirm Immelt's positive view.

- GDP is forecast to grow at an above trend rate of about 4.3% for the second half of this year, according to a recent Wall Street Journal survey of 55 leading economists, slightly above 3.9% in the first quarter.
- Corporate profits for the quarter just ended are expected to have risen by 22% year-over-year, and prospects for the back half of the year average 14% growth.
- The June readings of the Institute for Supply Management (ISM) surveys showed strong growth with the manufacturing index registering 61.1 and the services index at 59.5. For manufacturing, this was the 8th consecutive reading above 60, a pace not seen in a generation. The services index has been in an expansionary mode for 14 consecutive months.
- US construction spending climbed to a record level in May, pushed by strong gains in home construction.
- Wholesale inventories of goods rose 1.2% in May, exceeding forecasts, growing for the ninth consecutive month. Inventory building has shifted into high gear as producers scramble to catch up with expected demand and businesses gain confidence in the duration of the expansion.

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While the US economy continues to perform well, signs of a possible *downshift* in the overall pace of activity from the unsustainably high rates of late 2003 and early 2004 have emerged. Most notably, job growth showed a steep slowdown in June, pulling back from a recent period of strong employment gains. The Labor Department on July 2nd reported that employers had added only 112,000 jobs last month, less than half the average monthly increase of the first five months of the year and well below the 250,000 forecast on average by Wall Street economists. While this headline number has cast some doubt on the vigor of the expansion, a close reading of other data released by the Labor Department at the same time shows job growth continuing to be strong, with the household survey reporting 259,000 new jobs and continuing unemployment claims having fallen to a three year low. Moreover, a number of forward-looking labor market indicators suggest the June slowdown is likely to be more of a pause in hiring than a reversal in trend. Among these are: (1) growing newspaper help wanted ads; (2) a Manpower, Inc. quarterly hiring survey showing one third of its respondents intending to add to staffs, and; (3) an American Express study showing 46% of its small business customers intending to increase employment in the next six months.

However, beyond the jobs market, other evidences of moderating growth have also emerged. Among these are:

- Automakers reported sub par June sales following several strong months.
- June sales at bellwether retailers Wal-Mart and Target grew more slowly than previously expected, possibly reflecting poor weather conditions, the lagged impact of energy price increases, and the diminished benefit from last year's tax cuts and mortgage refinance activities.
- Some portion of the rapid wholesale inventory growth cited above as a sign of economic strength may turn out to have been involuntary and manufacturers may need to trim production later to bring inventories back into better balance with sales should final demand falter.
- Durable goods orders, notoriously volatile when viewed month-to-month, posted modest declines in both April and May following outsized increases earlier this year.
- A raft of software companies have preannounced second quarter earnings shortfalls citing decisions by customers to defer purchases around midyear.

Whether these indications of slower growth are anything more than the *downshift* to which we referred earlier or something more serious remains to be seen. This apparent slowing has stoked a heated debate among financial market savants. On the one hand, some view the slowdown as a harbinger of more muted growth to come as Federal Reserve policy becomes restrictive and consumers pull back under the weight of heavy debt loads. At the other end of the spectrum are those who believe the Federal Reserve has not acted quickly enough to dampen emerging inflationary pressures. They opine that while the economy will continue to grow, the Fed is merely postponing the day of reckoning when it will be forced to "crunch" the economy, as it has in past cycles, to quell excessive inflation. What these seemingly contradictory views have in common is an early and abrupt end to the current expansionary cycle. In our view, neither of these extreme forecasts carry a high probability of coming to pass. Instead, we see a more long-lived expansion with the economy continuing to grow at an above trend rate - - vibrant enough to support satisfactory profit growth while not so strong as to produce the kind of rapid inflation which would warrant anything more than the "measured" rate increases the Fed has telegraphed. Stay tuned!!

Looking at the broader picture, investors have been bombarded with a series of very rapidly changing and extreme views regarding the outlook as media hungry "experts" vie for airtime. Pundits have lurched between deflationary and inflationary forecasts within a matter of just a few months. The media and politicians fretted over the "jobless recovery" just as job growth was taking off. In our view, investors would be well served to recognize that economic conditions generally change only gradually and that these shifts are often far more muted than the best or worse case would imply. Applying this observation to the current investment climate, we believe declaring a near term end to the current expansion based solely upon a handful of data points is both premature and unwarranted.

<u>Inflation</u>

Following a long period of muted price increases, inflation has accelerated raising questions as to whether the Fed would become less accommodative than is generally expected. Alan Greenspan's favorite measure of inflation, the chain price index for personal consumption expenditures (PCE), has risen from 1.4% in 2003 to an annual rate of 3.0% during the first four months of this year. While a portion of this increase is, of course, due to higher energy costs, the strengthening in prices has not been confined to the energy markets. PCE prices *excluding* food and energy have risen at an annual rate of 1.7%, up from 0.8% last year. The consumer price index (CPI) has registered a similar advance. As we see it, the inflation process is influenced by four key factors: (1) the degree to which the economy's productive capacity is being utilized; (2) shocks in product prices; (3) changes in productivity growth, and; (4) inflation expectations. We are convinced each of these are signaling continued moderate inflation.

Capacity and Labor Utilization: Most indicators suggest the economy continues to operate with an appreciable margin of slack. For the past six months the unemployment rate has averaged about 5¾%, declining from its peak of about 6¼% in mid 2003. At current levels, based upon the experience of the past decade, the available pool of labor appears to be consistent with stable inflation. Meanwhile, capacity utilization in manufacturing has recovered to about 76% in recent months, remaining well below its long-term average of 80%. Given persistent gains in productivity and ongoing global competition, only a gradual diminishing of the slack in the economy is likely, restraining the overall trend in inflation.

Price Shocks: Many product prices have recently been pushed higher by special influences on the supply and demand for various raw materials. It is well known that increases in commodity prices generally occur as an expansion gains momentum. However, they have been unusually large in the current period for three important reasons. First, there has been a synchronous global strengthening in business for the first time in a generation. Second, petroleum prices have been under particular pressure, reflecting not only stronger demand but also risks that supplies could be disrupted by terrorism or political turmoil. And, third, the decline in the foreign exchange value of the dollar has contributed to import price increases. In recent weeks many commodity prices have, in fact, retreated from their peaks possibly reflecting an actual or expected moderation in growth in Asia and ongoing supply responses to higher prices. In addition, the dollar has stabilized as optimism has increased about the strength and durability of the US

expansion and the certainty of higher US interest rates. If these trends continue, commodity price shocks should no longer be adding to inflationary pressures.

Productivity: We believe productivity growth will remain strong on a sustained basis, even though it is unlikely to match the outsized gains of recent years. Productivity improvements underwrite continual moderate inflation since businesses are not driven to raise prices in order to improve their profitability.

Inflation Expectations: A rise in inflation expectations tends to become self-fulfilling as people seek to protect themselves in the process of setting wages and prices. Importantly, the Fed is now taking the actions necessary to stem future inflation before it becomes ingrained.

Interest Rates

Given the moderation in economic growth to more sustainable but above trend levels, and the likelihood of inflation plateauing over the coming months, we believe the Fed will, as promised, maintain its "measured" pace of Fed Funds rate increases. These administrated rates should rise from 1¼% to 2¼% by yearend and to 3¼% to 3½% by the end of next year. Longer term rates, as measured by the 10 year US Treasury note, should rise to between 5.25% and 5.75% next year providing bond investors with an opportunity to add to bond positions at more attractive yields. We, therefore, continue to defer most longer dated bond purchases, instead favoring shorter term instruments.

Investment Policy

We remain fully invested in equities despite the possibility of the stock market continuing its consolidation for a while longer following its stellar returns in 2003. Through this period of relatively flat equity returns, with surprisingly little volatility, corporate profits have advanced at a 25% annual rate, compressing valuations and setting the stage for a further market advance. By our reckoning, stocks are reasonably valued at 16 times 2005 earnings and the Fed market valuation model shows stocks to be 25% undervalued at current levels of interest rates and earnings.

Over the past six months, many market pundits have advised investors that stocks would be hard pressed to advance in the face of the decelerating profit growth and

higher interest rates likely to play out. A review of how markets have behaved during recent cycles of decelerating profit growth and rising interest rates is instructive. For example, from 1996 through 1999 the Fed Funds rate ranged from 4 to 7%. During this period, corporate profit growth decelerated from 20+% to an average of about 8%. Meanwhile, the S&P 500 Index rose by more than 20% in each of those four years. Looking back further to 1989, when the Fed Funds rate rose to 9% and profits actually declined by 12%, the S&P 500 Index advanced approximately 31%. With this experience in mind, we believe investors should not fear a moderation in profit growth, particularly while rates remain low by historical standards.

So far as the balance between *growth* and *value* shares in client's portfolios, a discipline which distinguishes us from other investment advisers, we remain tilted toward *growth* with it accounting for about 62% of the equity portion of portfolios under our supervision. Strategically, we reduced weightings in financial and industrial shares on two occasions this year to fund three new positions, two of which are closely related to consumer discretionary spending and the third, a beneficiary of the growth we see in the processing of electronic payments. Overall, client's equity holdings are forecast to have earnings growth twice that of the average stock while valued only slightly higher than the market on a price/earnings basis.

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We are pleased to note that this June our firm celebrated its tenth anniversary. We are, indeed, grateful to our clients and friends for their support which has made our success possible.

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Front Barnett Associates Economic Model