September 17, 2004

THE ECONOMIC OUTLOOK - - GAINING TRACTION OR STAGFLATION?

The downshift in economic activity we forecast in our mid-July letter to clients appears to be centered around slowing consumer spending which has spurred the economic recovery since its upturn in late 2001. The combination of sharply higher gasoline prices, fewer mortgage refinancings, the absence of the tax rebates which fueled consumer purchases in 2003 and renewed geopolitical fears have contributed to the slowdown. Sales of automobiles, personal computers and goods at chain stores all lagged earlier expectations causing a modest buildup of excess inventories. Managers in a number of key industries - - most notably automotive and semiconductors - - are now working to better align their inventories with the slower than initially expected demand they experienced during July and August, portending somewhat slower manufacturing growth for the balance of this year.

We are encouraged that businesses have reacted quickly to what we view as a normal moderation in demand at this point in the economic cycle. Their more conservative behavior this time around stands in stark contrast to the experience of the late 1990's when their lack of discipline led to enormous inventory overbuilding and excess manufacturing capacity which soon drove a sharp, protracted drop in production accompanied by massive inventory write downs. While a number of Wall Street analysts have viewed the current reduced production schedules with some concern, we see this development as likely to contribute to a more even and long-lived expansion in the quarters ahead. Other continuing signs of business prudence include cautious hiring, restrained capital spending and retention of vast hoards of cash as protection for another "rainy day".

In recent weeks we have noted anecdotal evidence and a number of economic data points portending an uptick in economic activity as we move into the fall. These include:

- Federal Reserve Chairman Alan Greenspan, in his testimony to the House Budget Committee last week, stated that, "the most recent data suggest that, on the whole, the expansion has regained some traction." In addition, he noted "business investment remains on a solid upward

70 WEST MADISON STREET • SUITE 4920 • CHICAGO, ILLINOIS 60602
(312) 641-9000 • FAX (312) 641-9009

trend." Confirming this appraisal, the Federal Reserve reported this week manufacturing output increased 0.5% in August from the month before, erasing all of the ground it lost during the downturn that began four years ago.

- The Institute for Supply Management (ISM) indices of both the manufacturing and service sectors signal continued expansion despite modest retreats from their recovery highs.

- Job creation has re-accelerated with the Labor Department reporting non-farm payrolls grew by 144,000 in August. In addition, the June and July payroll additions, while still sub par, were revised higher by a total of 59,000 jobs. Interestingly, the most recent survey of hiring intentions conducted by Manpower Inc. shows 28% of the 16,000 respondents plan to add to payrolls in the fourth quarter - - when hiring typically slows - - the healthiest pace since 1984.

- High oil and gasoline prices, driven to some degree by unprecedented futures speculation, have pulled back from their August peaks despite supply disruptions and weather related fears.

- Personal spending growth of 0.8% in July, as reported by the Commerce Department, coupled with recent commentary by leading retailers, suggest consumption is now trending higher than the second quarter's pace.

We agree with the consensus view that economic activity is likely to regain some of its lost momentum as the inventory correction runs its course and energy prices edge lower. Real GDP growth, in our view, will accelerate to 3½% - 3¾% in the third and fourth quarters of this year, as compared with the 2.8% rate of expansion in the second quarter, but well below the torrid pace of the second half of 2003. Inflation, driven earlier this year by rising commodity prices, now appears to be well contained at about a 2% core CPI annual rate. Stiff global competition, additions to supplies of raw materials which had been in short supply earlier, and falling import prices have contributed to greater price stability which we see continuing in the months ahead. As business activity strengthens and the impact of productivity growth wanes, employment and income growth will regain momentum, building on August's uptick. We continue to see the year-end unemployment rate improving further to our long held forecast of 5.3% or better from 5.4% currently. It is also worth noting that the two major concerns of market

savants as we entered this year - - deflation and the "jobless recovery" - - have vanished from the radar screen only to be replaced by inflation worries coupled with the possibility of a serious dip in overall economic activity - - a.k.a. "stagflation". This is yet another example of how quickly sentiment can shift from one extreme to another.

Fixed Income Investment Strategy

With inflation moderating, some slack remaining in the labor force and closer-to-trend GDP growth, the Federal Reserve is not likely to become more aggressive than it has been in raising rates. That said, we see the Fed funds rate rising to 2% by year-end for three principal reasons. First, at this level the Federal Reserve will have largely taken back the emergency easing it put in place following the 9/11 terrorist attacks. Second, a 2% Fed funds rate would be in line with current inflation readings, addressing the widely held fear that keeping short term rates below the inflation rate (a *negative real* Fed funds rate) sows the seeds of future inflation. Lastly, higher rates are necessary to give the central bank some leg room to lower rates, if necessary, in response to an unforeseen future shock to the economy.

Beyond the 2% level, we believe further short-term rate hikes will be driven by Fed expectations for inflation and employment on the one hand, and oil prices on the other. Since high oil prices act as a drag on the economy, crimping consumer spending, a continuation of elevated oil prices will limit the Fed's ability to aggressively raise rates without smothering economic growth. With our forecast for a continuation of the business recovery next year, we believe the Fed funds rate will rise further to 3¼% to 3½% by the end of 2005. As for long term rates, we see the 10 year U.S. Treasury bond yield rising toward 5% by year-end and adding an additional 50+ basis points to its yield in 2005. Given the prospect of both higher short and long-term interest rates, we continue to maintain substantial short-term reserves with which to extend bond maturities as rates become more attractive and the risk/reward ratio improves.

Equity Investment Strategy

Stocks have been locked in a narrow trading range this year as the market first consolidated last year's outsized gains and then discounted an inevitable slowing in corporate profit growth from the remarkable 25% rate recorded during the first half of this year. The deceleration in earnings gains to a more modest, but sustainable low double digit rate, coupled with a benign interest rate and inflation backdrop, sets the stage for a rise in stock prices in the coming months.

Investors have long held the view that stock prices eventually follow the course of corporate profit projections. The attached exhibit shows that while S&P 500 earnings estimates have surged this year, stock prices have failed to follow. A similar divergence occurred in 2002 only to be corrected by the stock market's 28% rise in 2003 as war fears and corporate scandals receded and investors turned their attention to the robust profit recovery. We believe the current divergence will also be resolved in favor of higher stock valuations as fears of sharply higher oil prices, aggressive Fed tightening and pre-election terrorism diminish.

As for valuation, at 16 times next year's expected earnings, stocks are reasonably priced when compared with their multiples over the past 20 years. The Fed Model, which adjusts stock price/earnings ratios for the current level of interest rates, shows stocks to be better than 30% undervalued. In the past, the Fed Model, which should not be viewed as a market-timing device, has been helpful in determining the course of stock prices during the subsequent 6 to 18 months.

Potential catalysts for a trading range breakout include a number of seasonal as well as special factors unique to this year. Among these are:

- Inflows into defined contribution plans, augmented by year-end bonuses and commission payments;
- Rolling forward of earnings expectations to the rapidly approaching new year;
- End of the acrimonious presidential election campaign and its related uncertainties. (This failed to materialize in 2000, given the protracted and vitriolic manner in which the presidential election ended).

- Successful completion of Sarbanes-Oxley compliance by most large U.S. companies and a reduction of the related distraction and cost of implementation.

In light of the foregoing we believe returns from equities will outpace those of fixed income instruments. The balance between *growth* and *value* shares, an investment style which distinguishes us from many other advisers, remains at 62% *growth* and 38% *value*. We believe *growth* shares, representing businesses able to sustain greater than average earnings and dividend growth during periods of slowing earnings momentum, are likely to be among the leading market performers. We continue to favor high quality larger capitalization companies whose performance has trailed that of small and mid cap shares over the past four years. Among the largest sector concentrations, and their approximate weightings, are depressed high quality technology stocks (21%), dominant financial services companies (17%), leading pharmaceuticals selling at their lowest valuations in a generation (12%), diversified manufacturing companies (11%) and consumer discretionary companies (12%).

Returns from equities have now been flat over the past five years, disappointing many investors who, based upon their experience of the prior half decade, had been unrealistically conditioned to expect mid-teens returns. (Equities under our supervision during this period have mirrored the broad market indices). Many individual and institutional investors have reacted to these lower than hoped for returns, as well as to the perceived heightened volatility of the stock market, by paring their stockholdings. Some have retreated to the safety of larger cash equivalent positions. Others, casting about for higher returns, have sought out "alternative" investments such as leveraged hedge funds or real estate, where results are thought not to be correlated with those of the stock market whose prospective returns are viewed by some as unattractive. Today, a number of large equity mutual funds are thought to hold as much as 20% or more of their assets in cash equivalents. We believe the pessimistic appraisal of the prospects for equities embedded in these decisions, coupled with a paucity of new stock offerings, limits the market's downside risk. Conversely, a reversal in sentiment could set off a surprisingly strong rally given the market's reasonable valuation and the favorable business outlook.

*   *   *   *

© 2004, Front Barnett Associates LLC

S&P 500 vs. Consensus Earnings Estimate for the S&P 500