November 15, 2004

THE ECONOMIC OUTLOOK - - BEYOND THE "SOFT PATCH"

Further evidence the U.S. economy is on solid footing and the current business expansion is self sustaining emerged when the Department of Labor's *establishments survey* reported the creation in October of 337,000 new jobs - - the largest monthly increase in employment since March. The government also revised upward its prior estimates of job growth for both August and September by a total of 113,000, bringing the average monthly job gains for the last three months to about 225,000, substantially above the 150,000 needed to absorb new entrants into the labor force that a growing population provides. Moreover, job gains were broad based through the economy with particular strength among health and education workers. Construction also showed large gains, though one-time factors such as the clean up and reconstruction of hurricane damage in the Southeast contributed 71,000 jobs. Stripping out nonrecurring items, job growth exceeded 200,000 - - a number not to be dismissed as insignificant.

The Department of Labor's *household survey,* which we believe more accurately reflects conditions in the broader labor market since it captures employment trends at smaller enterprises, new businesses and among the self-employed, has been signaling labor market strength for months. With both surveys now showing stepped up hiring, our confidence in the durability of the expansion is reconfirmed. We maintain our long held forecast for a year-end unemployment rate of 5.3%.

Some analysts continue to question whether the current pace of job growth will, indeed, persist or whether businesses will again slip into the reluctance to hire that generally characterized their behavior over the past few years. With productivity growth slowing to 1.9% in the third quarter, businesses are approaching the limit in squeezing output from their existing work force and will soon be forced to increase their hiring. Another indication businesses may be feeling short of labor is that employment in the temporary help sector grew by 48,000 in October to its highest level since February 2001. Following a period of rapidly improving profits and relatively little investment in new plant, equipment and people most businesses are

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flush with cash. Now that the uncertainties surrounding the election are behind us, and businesses look ahead with greater clarity to the New Year, the stage is set for an increase in their outlays with some of this spending finding its way into the labor market.

The encouraging employment figures, along with other economic data released since our mid September client letter, indicate that despite high energy prices, the economy has moved beyond the “soft patch” referred to by Alan Greenspan in his Congressional testimony this summer.

- The Commerce Department reported that real GDP expanded at an above trend 3.7% pace in the third quarter, a modest acceleration from the previous period.

- Consumers continue to spend. Excluding the volatile auto sector, retail sales rose 0.8% in September and 0.9% in October - - substantially above both expectations and the levels of prior months.

- Orders for durable goods, ex transportation, which include appliances and personal computers, surged 1.7% in September, well ahead of the forecast of 0.3% growth.

- The Institute of Supply Management’s October reports for the manufacturing and services sectors remained well above 50, signaling continued expansion, albeit at a more moderate rate than earlier this year.

- The Commerce Department reported that new home sales rose 3.5% in September, the strongest advance since May and the third highest level of monthly sales ever, continuing to confound the “experts”.

Looking ahead, we now see GDP growth of 4.0% in the current quarter and 3.0% to 3.5% next year. While the enormous monetary and fiscal stimulus enacted in the last four years is gradually ebbing, it has clearly created sufficient momentum to underwrite the current self sustaining expansion. Despite the inevitable periods of uneven growth, the economy has now expanded at an above average rate for five consecutive quarters. The expansion continues to be led by investment in capital spending, construction and the rebuilding of lean inventories while consumer spending advances at a more normal pace. The dollar’s further decline should bolster exports in the months ahead and provide an increment to fourth quarter corporate profits growth. The inflation scare evident in the first half of the year has subsided with the CPI advancing at less than a 2% annual rate. We see little change in inflation next year and scant need for the Fed to aggressively tighten monetary policy. All in all, the outlook remains positive though not spectacular.

Energy

High oil prices, the major economic headwind, have declined by almost 15% from their October peak, lending credence to our view that the 2004 energy crunch may be running its course. This follows 18 months during which a confluence of global events and massive speculation, in part facilitated by negative real interest rates, pushed energy prices up by 120%. The recent decline has been driven by surging oil inventories, higher OPEC production, growing exports from Iraq, and the soon-to-be full restoration of supplies from the hurricane ravaged Gulf of Mexico. Now, just as supplies are rising, global energy demand has slowed. For example, China's energy consumption, which was reported to have grown by a stunning 14% in the second quarter of this year, has since moderated significantly. Meanwhile, many hedge funds and other speculators, major forces in this year's run up in prices, have closed out huge trading positions in the oil futures market as their worst case scenarios, fueled by election year rhetoric and news hungry media outlets, failed to materialize. The springtime flare up of terrorism in Saudi Arabia has abated, at least for now, without harm to the kingdom's oil facilities. Oil production in Russia, the second largest exporter, has been unaffected by the government's much discussed tax dispute with Yukos, a company that accounts for 2% of global output. And, threatening strikes in Norway and violence in Nigeria have so far failed to derail production in these large exporting countries.

Clearly, the oil market remains vulnerable to periodic price shocks for the same reason that has dogged energy consumers since last year: The global oil industry currently has little spare capacity to produce, transport and refine additional oil in the event of a serious supply disruption or an unexpected surge in demand. Absent these occurrences, we expect oil prices to work their way lower boosting business profitability, adding to consumer's buying power and underpinning investor confidence the current expansion is, indeed, durable. While supply/demand fundamentals argue for a decline in the price toward $30/barrel, timing the end of the "shortage psychology" is nearly impossible. Our decision to avoid the energy sector, while a short term negative to equity performance, reflected our view that many of the factors contributing to the run up in oil prices were transitory in nature.

Growth* and *Value

Clients are well aware that since the inception of Front Barnett Associates over a decade ago, we have firmly believed both *growth* and *value* styles provide opportunities to generate returns in the equity markets. More importantly, we have high conviction a properly diversified investment program will benefit from allocations to both investment strategies. While identifying the precise timing of periods where one style has an advantage over the other is not possible, our approach has been to make marginal shifts in allocation between these styles, believing the *growth* style has certain inherent advantages.

- *Lower Turnover* – Sound *growth* strategies focus on longer term trends and opportunities, and thus will allow for longer average holding periods. In contrast, *value* strategies attempt to exploit short-term under-valuation and ultimately require the timely selling of positions when the valuation discount has been reduced.

- *Lower Tax Rates* – While we are not adverse to income producing equity strategies, the high income and shorter holding periods that tend to be more prevalent in value strategies invariably result in reduced after tax returns.

Historically, *growth* and *value* indexes and managers tend to have negative correlation, making them very suitable complements in a long-term asset allocation policy. As can be seen in the attached exhibit, until more recent years, the cycles where one strategy out-performed the other tended to be short, typically lasting an average of only 7-8 months. This negative correlation has become even more pronounced in the past several years, starting with the inflation of *growth* stock valuations in the late 1990's followed by the more recent period of strong *value* stock performance. The recently exaggerated cycles have been long lasting by historical standards. For example, the current *value* over *growth* run is now about 45 months long. Large cap *value* has out-performed large cap *growth* by a stunning 16.3% annually over the last four year period. There has never been since 1979 a wider differential between these styles of investment over a comparable period. Interestingly, abnormally long cycles are usually followed by cycles of comparable length with the reverse relationship. We believe yet another rotation favoring *growth* is at hand which should be quite substantial in both time and magnitude.

From our perspective, there are four principal factors which help guide our process of "tilting" from one style to the other.

- *Valuation.* While traditionally trading at a price/earnings multiple discount to *growth* stocks, *value* shares no longer look as cheap as they should, based upon their underlying growth fundamentals. When we look at forward price/earnings ratios compared to long-term future growth expectations (the so-called PEG ratio to which we often refer in client presentations) the two styles have shown remarkable parity. In September 1998, both styles traded at PEG ratios of 1.4. But starting with the multiple expansion of *growth* stocks in the late 1990's, there has been a divergence of the two styles as measured by this metric. At the peak of the *growth* stock run, the Russell 1000 Growth Index reached a 2.0 PEG ratio while the Russell 1000 Value Index remained at 1.4. This variance quickly corrected in early 2001, with *value* out-performing *growth* since that time. The *value* index has now actually built a valuation premium over the *growth* index, with PEG ratios of 1.4 and 1.3 respectively, a relationship unlikely to persist.

- *Earnings.* Jeremy Siegel, a highly regarded professor at the Wharton School, has performed a great deal of work on active portfolio management. Among his conclusions he indicates that *growth* managers are more likely to out-perform passive indexes when economic growth is decelerating. With lower levels of earnings *growth*, the ability of active managers to find exceptional *growth* stocks is well rewarded. Similarly, *value* managers are more likely to out-perform when valuations are stretched and they are able to identify cheaper stocks in a market that is generally considered to be rich. In the current environment, with stocks quite reasonably priced and expectations for slower but still positive growth in 2005, we conclude *growth* is more attractive than *value*.

- *Sector Preference.* The most compelling and arguably successful determinant of calling the rotation between the *growth* and *value* styles of investment is to consider the relative attractiveness of various key sectors within each group. Technology shares, for example, which produced stellar performance in 2003, have corrected this year and until recently, remained under pressure. Unlike other sectors (e.g. energy, financials and utilities) technology shares came into 2004 with fairly high expectations for accelerating profit growth. Fortunately, they have generally met those expectations but few management teams have been willing to raise their guidance for 2005. As a result, the tendency has been for analysts to reduce their technology stock growth expectations for next year from +20% this year to only modest growth in 2005. Consequently, technology shares now trade at forward P/E multiples that are below long-term historical averages. We believe technology stocks will benefit from the weaker dollar we forecast, from increased capital expenditures and from a new product replacement cycle. The attractive valuations of these shares, coupled with likely slowing growth within a number of the *value* sectors, has set the stage for a period of technology share out-performance. In fact, the technology heavy NASDAQ Composite has advanced at twice the rate of the more value oriented Dow Jones Industrial Average over the past month.

- *Sentiment.* Two sentiment factors have caused investors to favor *value* shares during the current cycle. First, global uncertainties have led to increased risk aversion and *value* shares are generally considered to be less risky because of their lower P/E multiples. Second, since the Bush tax cuts on dividends were enacted in early 2003, stocks of companies willing to return cash to shareholders in the form of dividends have become more attractive. For example, because of the propensity of energy and financials to pay dividends, these shares have been favored. More recently, sentiment has shifted as investors appear to be willing to assume greater market risk. This emerging tendency has already begun to benefit *growth* shares. Meanwhile, many cash laden technology companies such as Intel and Microsoft have either initiated dividends or raised them sharply, enhancing their relative attractiveness. Interestingly, dividends of the S&P 500 companies have grown at 12.5% this year while those of technology shares have increased at twice that rate.

On balance, then, the four factors we view as helpful in providing guidance in finding opportunities to fine tune our *growth/value* "tilt" now point to yet another reversal in performance, this time favoring *growth*. While our premature "tilt" toward *growth* has not helped equity performance so far this year, we believe the odds of *growth* out-performing *value* are now unusually high and we, therefore, continue to maintain our *growth* stock overweighting at 64% *growth* and 36% *value*.

Fixed Income Investment Strategy

By almost any measure *real* short-term interest rates remain low following the Fed's fourth Fed Funds rate increase this year. With the benchmark short-term rate at 2%, the Fed has now taken back the emergency easing it put in place following 9/11. This rate is also generally in line with current inflation readings, addressing the widely held fear that keeping short-term rates below the inflation rate could sow the seeds of future inflation, particularly with the dollar weak, industrial commodity prices rising and oil prices remaining elevated. We believe the Fed will continue to reduce its accommodative stance over the months ahead and that there is a good chance of another ¼% rate increase when the Fed meets next month. Assuming continuing labor market strength, we expect the Fed Funds rate to reach 3½% by the end of next year. As for long-term rates, we see the 10 year US Treasury bond yield rising toward 5% by year-end and then adding an additional 50+ basis points to its yield in 2005. With the prospect of both higher short and long-term interest rates we continue to maintain substantial short-term maturities with which to extend bond durations as rates become more attractive and the risk/reward ratio improves.

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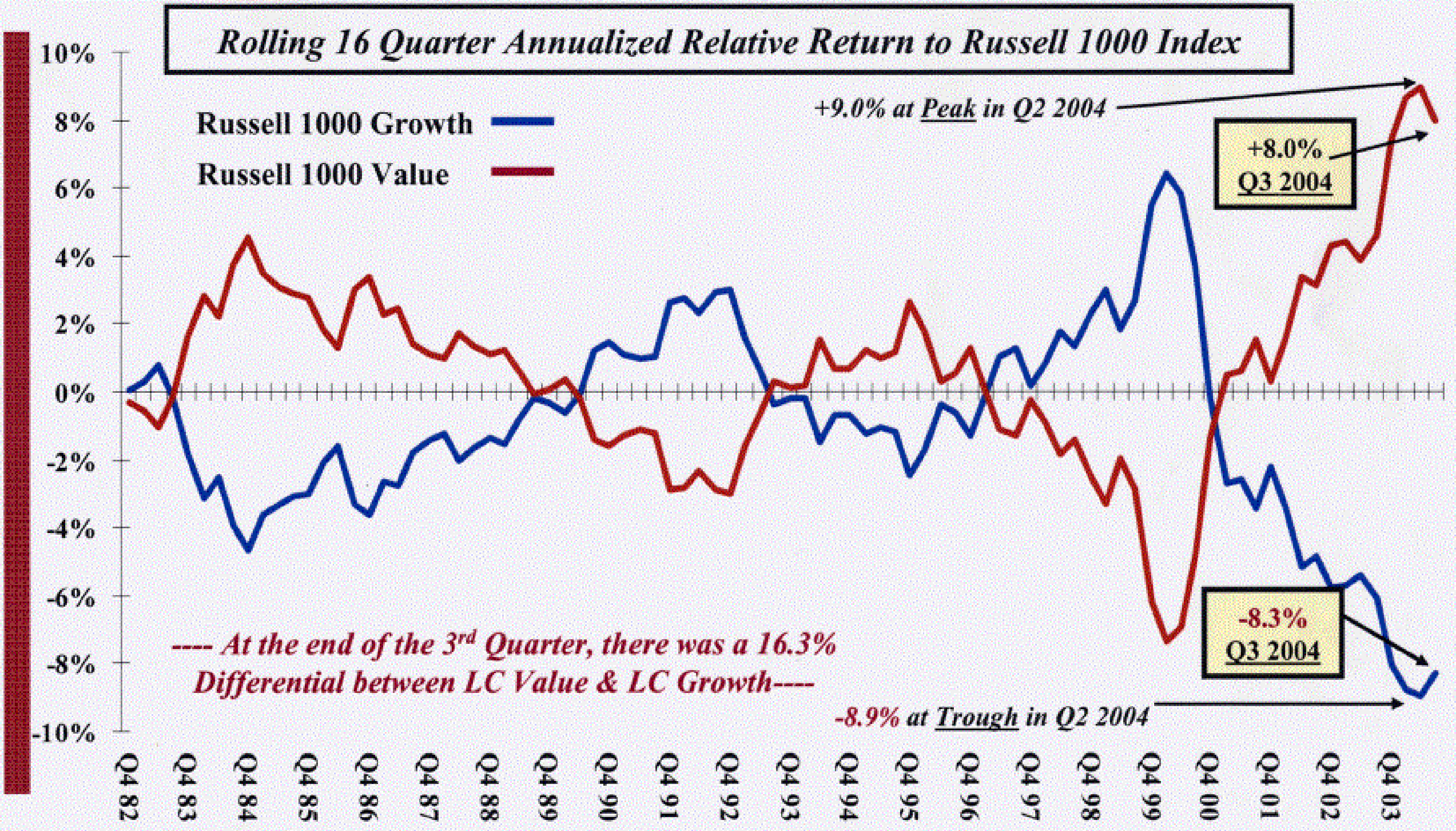
Large Capitalization Comparison

Growth vs. Value



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