FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

September 20, 2005

To: Clients and Friends of the Firm

Subject: Talking Points: Fall 2005 Economic Update

Attached is an outline of our preliminary views regarding the economic outlook post Katrina. Clearly, it is far too soon to see with any clarity how the economy will respond to the storm's devastation and dislocations.

As we learned following the September 11 attacks, conventional wisdom and early dire predictions often prove incorrect. We will continue to closely monitor the situation and, as more information becomes available, we will prepare an update of our Economic Outlook.

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

Talking Points: Fall 2005 Economic Update

The Economy

Since spring, the US economy has experienced choppy, slower growth as spiking energy prices, rising short term interest rates and slower business activity abroad impacted demand. Our Economic Model, attached, confirms this trend.

Hurricane Katrina, an incredible human tragedy, has further clouded the near term economic outlook.

- **Over the short term, the storm will pare economic growth, curb payroll increases, and will pressure government budget deficits at all levels.**
- **While the Gulf region accounts for less than 3% of GDP, storm related dislocations will have a broader impact. Food and industrial commodity distribution, as well as oil production and refining, are concentrated in this region and will be particularly hard hit over the near term.**
- **Over the intermediate term, distribution bottlenecks will be cleared. Many commodity prices, which shot higher in the wake of the storm, will begin to ease.**
- **The negative political fallout is likely to diminish the chances of enactment of permanent income tax cuts and other administration initiatives.**

***Real* GDP growth, which had already moderated prior to Katrina, is likely to slow further in the second half to about 3.0% from 4.0% in the first half.**

- **Diminished consumer confidence, high fuel prices, fewer new jobs, and stagnating housing prices will curb growth.**

- **Unemployment is likely to remain at about 5%. Wage gains will remain modest.**

- **While housing starts should continue to be elevated by historical standards, the peak for this cycle has probably passed. The rapid housing price appreciation of the past five years is unlikely to persist.**

- **Manufacturing activity, which has cooled recently, is likely to expand at a moderate rate over the next few months as auto incentives come to an end. We expect a pick up late in the year as the stimulus of storm related reconstruction spending begins to gain traction.**

Inflation and Interest Rates

- **While near term inflation pressures are mounting due to sharply higher commodity prices, wage pressures remain muted. Core inflation should be well contained near current levels as manufacturers have difficulty passing through their cost increases.**

- **Energy prices have far exceeded most forecasts and futures contracts signal a continuation of this trend in part due to the damage from Hurricane Katrina.**

- **While higher energy prices may be dampening business activity, the Fed will give more weight to their potential inflationary impact and, therefore, continue to reduce its accommodation. A Fed funds rate above 4% is highly likely.**

- **10 year US Treasury bond yields will rise toward 5.0% from their current 4.25% rate. We remain cautious on the outlook for bonds, preferring shorter maturities, where yields have risen about 2 3/4 percentage points over the past year, until longer term rates offer a more favorable risk/reward profile.**

Corporate Profits

- **Profit growth, while substantially exceeding analysts' projections, is expected to slow to 10 – 12% from 20% in 2004, remaining well above trend.**

- **Profit margins, which have expanded to record levels in recent years, will be pressured by higher raw materials costs, intense global competition, moderating productivity gains and the stronger dollar.**

Market Outlook

- **The 22-year bull market for bonds is likely over as the course of interest rates appears to have reversed with concerns shifting from deflation to inflation.**

- **Stock prices should end the year on a firmer note as investors begin to sense an end to Fed rate increases. Gains will be limited, though, to the forecast 10 – 12% profit growth.**

- **Stocks appear to be reasonably priced at 15.5 times expected 2006 earnings and are undervalued relative to bonds by about 30%.**

- **Large Cap, high quality *growth* shares, out of favor for 5+ years, should benefit as investors recognize the sustainability of their earnings growth in a slowing economy. Equity portfolios under our supervision remain tilted toward *growth.***

- **We have recently increased the weighting of financial stocks in portfolios reflecting compelling valuations and in the anticipation of an end to Fed tightening.**

***   *   *   ***

MBF

9/20/05

Front Barnett Associates Economic Model