October 11, 2006

THE ECONOMIC OUTLOOK -- SOFT LANDING AHEAD

As expected, recently released data add to the emerging tableau of an economy gradually slowed by higher interest rates, costly energy, and a sputtering housing sector. The most current evidence of moderating growth, reported last Friday by the Labor Department, was that employment at *business establishments* grew by only 51,000 jobs in September, the weakest labor report since October 2005. And, even though non-farm payroll growth for the prior two months was revised sharply higher, it now appears that overall job growth has decelerated sharply. Newly available Labor Department figures show that for the twelve months ended March 2006 monthly job growth averaged 236,000. For the last three months, following the above noted revisions, it has averaged just 121,000 as the economy has generated barely enough new jobs to satisfy entrants into the labor market.

Still, neither the job market nor the broader economy may be quite as weak as the September payroll numbers suggested. Not only did the unemployment rate -- based upon a separate survey of *households* that showed more robust employment gains -- fall slightly to 4.6% from 4.7% in August, but employees also received some of their largest wage increases thus far in 2006. Hourly wages for full-time workers rose 4% in September compared with a year earlier -- higher than any month since June 2001 when wage gains were still benefiting from the momentum of the booming dot.com-fueled economy of the late 1990's.

Other data portray the economy slowing to a more sustainable pace from its above-trend rate of earlier this year. Consider the following forward looking information:

- The Institute for Supply Management (ISM), a private group of corporate purchasing managers, reported its manufacturing index fell to 52.9 in September from 54.5 in August, the lowest since May 2005. While readings above 50 indicate expansion, the September measure suggests that factories experienced slightly weaker but continued growth as the third quarter progressed.

- The ISM's non-manufacturing index, which measures the services sector, fell to 52.9 in September, the lowest reading since April 2003, when business sentiment was depressed by the start of the Iraq war. The services sector accounts for about 80% of the economy. Despite the lower headline number, new orders, the order backlog, and the employment component of the LEI all

rose signaling strength ahead. In addition, the prices paid component fell sharply, a sign of lower inflation readings to come.

- Orders placed with US manufacturers were unchanged in August, the second consecutive month without an increase, suggesting a slowdown in production in the months ahead as the economy cools. Additionally, August orders for durable goods unexpectedly fell, signaling companies may be scaling back investments as the economy slows.

- The Conference Board reported its index of Leading Economic Indicators (LEI) fell 0.2% in August for the second consecutive month, portending the slowdown in the economy will continue into early 2007. The index fell at an annual rate of 1.2% in the last six months. It would take a 3.5% annualized decline in the LEI to signal contraction in the economy, according to the Conference Board. The last time the index met that criterion was in September 2000, six months prior to the start of the last recession.

- Consumer confidence rebounded more than forecast in September from a nine-month low as energy prices fell. The Conference Board's index of sentiment rose to 104.5 from 100.2 in August which may bolster spending in the coming months.

- August retail sales rose 0.2% from July, slightly below economists' expectations, and well below the 1.4% jump in July from June. Taken together, the retail sales figures for July and August are consistent with inflation-adjusted consumer spending growth of 3.5% in the third quarter, up from the 2.6% in the second quarter. Interestingly, gasoline prices have fallen at least 50 cents a gallon from their August peak. Each one-cent decline in the price of gasoline, if sustained for a year, frees up about $1.0 billion in extra disposable personal income -- a direct boost to consumer spending power that could provide a strong offset to declines in housing wealth.

Other economic indicators also show signs of a moderate economic slowdown:

- Consumer spending, which accounts for over two-thirds of real GDP, rose just 0.1% in August as consumers found it more difficult to tap the equity in their homes, a major source of cash in recent years. August's increase in outlays was less than forecast and the smallest gain since November 2005. Meanwhile, incomes grew 0.3% in August following a 0.5% increase in July, the smallest monthly gain since last November.

- Construction spending in the US unexpectedly rose in August as companies increased investments in office buildings, factories, and hospitals. Spending rose 0.3% exceeding expectations of a decline of 0.3%. Corporate spending on new facilities is clearly helping to soften the blow to the economy from the slump in home building.

- Second quarter GDP slowed to a more sustainable annual rate of 2.6% as slackening business spending, consumer demand, and homebuilding reduced growth following the blowout 5.6% pace in the first three months of the year.

All in all, while the foregoing data point to a slowing economy, we fail to see a recession ahead. Rather, we expect the economy to grow more slowly over the next 3 to 4 quarters with real GDP advancing at a still satisfactory, but below trend, 2.5% average rate. The recent plunge in energy prices, easier financial conditions, more confidence that the economy's job and income generating capacity has improved, and still-healthy foreign demand, supported by a moderately weaker dollar, will provide offsets to weak housing and slower consumer spending enabling the economy to achieve a "soft landing".

While core inflation is running at about 2.5% -- above the Federal Reserve's "comfort range" of 1.0% to 2.0% -- we expect price increases to moderate as the economy slows, obviating the need for further Fed tightening. In fact, we believe the Fed's next move, likely to take place by next spring, will be to reduce the Fed Funds rate in order to stimulate flagging job growth.

HOUSING

New home sales, which account for about 15% of the housing market, unexpectedly rose in August from a three-year low the previous month. Declining mortgage rates and incentives offered by builders undoubtedly helped spur purchases, which rose 4.1% to an annual pace of 1.05 million units. Overall though, housing remains in a corrective phase which we expect to persist for several more quarters in view of the following weak indicators:

- Sales of existing homes, which account for 85% of all home sales, were down 12.5% in August from the previous year.

- Median home prices, which do not reflect concessions to sellers, are down 1.8% from a year ago.

- Housing starts, a measure of the supply of new homes and the outlook for builders, declined in August 19.8% from the previous year.

- The supply of existing homes for sale, which measures inventory in the housing market, is 7.5 months, nearly three months longer than the prior year, meaning that at current prices it would take 7.5 months at the current pace of sales, to sell them all.

- Applications for mortgages, an indication of housing demand, based upon data from mortgage bankers, commercial banks, and thrifts, covering about half of all US retail residential, have declined sharply from the previous year.

- Mortgage foreclosures and defaults are on the rise and several prominent homebuilders have recently warned their profits would not meeting forecasts.

- The percent of "exotic" loans to all home purchases, an indicator of the growth of risky financing, remains high. Borrowers have stretched their finances to buy more expensive homes and now face the prospect of increased servicing costs as their fixed term loans expire and rates reset.

Thus far, outside of the most extended housing markets (i.e. Arizona, parts of Florida, California, and the Northeast) sellers of existing homes have generally been unwilling to cut their asking prices. Among the first signs of stabilization in the housing environment will be a greater willingness on the part of sellers to reduce their offering prices to move their properties more quickly. We continue to expect housing prices, on average, to rise at rates below that of inflation over the next 2 to 3 years and in some areas, where speculation was particularly rampant, to actually show declines.

CORPORATE PROFITS

Corporate profits have grown at double-digit rates for 17 consecutive quarters, enabling the equity markets to overcome the effects of rising interest rates, high energy prices and widely heralded geopolitical risks. With the help of above-average productivity, favorable labor costs, and strong consumer spending, the profits of the S&P 500 companies more than doubled from 2001 to 2005. S&P 500 profits now stand at 8.5% of GDP, a high point in Commerce Department data going back to 1947. Analysts are forecasting 12.8% profit growth this year and about the same for 2007. In our view, profits forecasts for next year are too high. Weakness in housing, slowing consumer spending, lower operating margins, and wage increases that exceed productivity gains will crimp profits growth next year leading to a gradual deceleration of S&P 500 profits growth to 6.0% to 8.0% in 2007.

FIXED INCOME STRATEGY

The rise in interest rates this spring and summer offered brief opportunities, of which we took advantage, to extend maturities in client's bond portfolios as yields first approached and later broke the 5% barrier. In late summer and early fall, as the economy began to show signs of slowing driving bond yields down, we deferred further bond purchases preferring instead to invest funds in higher yielding short term obligations. We plan to take advantage of future opportunities to extend bond maturities during periods of bond market weakness. Given the historically narrow spread between yields on corporate bonds and US Treasury obligations, we will confine our purchases to US Treasuries until investors are adequately compensated for the additional risks of owning corporate bonds.

EQUITY MARKET OUTLOOK AND STRATEGY

As noted above, despite the clear signs of a slowdown, we do not expect a recession but rather a period of below trend growth. Inflation, a lagging indicator, will eventually subside as economic growth moderates. The Fed is likely to consider rate cuts early next year to stimulate employment, which will lag during the slowdown. Meanwhile, corporate profit growth is expected to moderate from the double-digit rate we have experienced over the past four years to a mid-to-high single digit rate until growth reaccelerates in late 2007 and early 2008. At current valuations we believe the broad market indices have already discounted this slowdown and are attractively valued on both an absolute and relative basis. The Fed Model, a copy of which is attached, shows S&P stocks to be 26% undervalued when compared with bonds.

In retrospect, with the world awash in liquidity, it paid handsomely to own "risky" assets over the past three and a half years. Emerging market equities, small and midcap stocks, commodities, junk bonds, and Miami condos rewarded investors with outsized returns. Low quality stocks also performed well. Companies with poor balance sheets and sub-par profitability became market leaders, outperforming the majority of high quality equities which represent core holdings in Front Barnett portfolios. This long run of outperformance has depressed risk premia to near record low levels. However, the leadership of risky assets has done a 180-degree turn over the past half year.

The single most important development in the financial markets during the past six months or so has been the increased pace of global central bank tightening which has pinched liquidity leading to an unwinding of speculative positions and the consequent deflation in many risky asset classes including real estate, commodities including energy, emerging markets, and small and mid cap equities as well as more speculative stocks as shown below:

Asset Class	Change in Last Six Months*
MSCI EAFE	0.4%
NASDAQ Composite	(0.5)
Russell 2000 Index	(2.6)
S&P Small Cap 600 Index	(3.7)
S&P Mid Cap 400 Index	(4.3)
MSCI Emerging Markets Index	(6.6)
Gold	(11.2)%
CRB Index (Commodities)	(13.2)
Crude Oil	(16.8)
S&P 500 Index	3.1%
Russell Top 200	3.9
S&P 100 Index	5.5

*Through 10/9/06

In contrast, the S&P 500 has risen 3.1% and the S&P 100 5.5% during the period, as investors have shifted their preferences to larger, well capitalized, undervalued companies with rising dividends which are presumed to be better able to withstand the impact of a slowing global economy following an extended period of relative underperformance.

Six months is a short period to define a trend. However, it is just possible that risk has run its course. It is in times like these where a value investor finds value in growth stocks. In our view, the slowdown in economic growth will significantly change the relative earnings performance of small/midcap value stocks as compared with large cap growth shares in favor of the latter. Moreover, the relative valuations of large cap growth shares have seldom been more attractive (see attached Relative Valuation exhibit). Widespread pricing power in the commodity sector is behind us. The rewards should increasingly accrue to those companies that can generate above average unit growth and high returns on shareholders equity. This remains the focus of our portfolios and our research effort.

The metrics of equity portfolios under our management remain compelling when compared with the benchmark S&P 500:

	2007 P/E	Estimated Future Growth Rate	Dividend Yield	ROE	P/E to Future Growth Rate
FBA Average Growth Stock	18x	13%	1.2%	26%	1.6
FBA Average Value Stock	13x	11%	2.3%	20%	1.5
FBA Total Portfolio	16x	12%	1.7%	23%	1.5
S&P 500	15x	7%	1.8%	20%	2.0

While the earnings of the current FBA stock portfolio are estimated to grow at 12% per annum, S&P 500 earnings are forecast to rise significantly more slowly at 7% per year. Yet, the 16x price earnings multiple of the FBA portfolio is only slightly greater than that of the S&P. This differential is reflected in the P/E to Future Growth Rate shown in the table above.

Finally, since many large cap *growth* stocks are now priced as *value*, our equity portfolios are more closely balanced between *growth* and *value* than at year-end 2005.

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Fed Valuation Model

The Fed stock market valuation model, which incorporates the yield on 10 year US Treasury Notes and estimated S&P 500 profits, shows stocks remain undervalued.

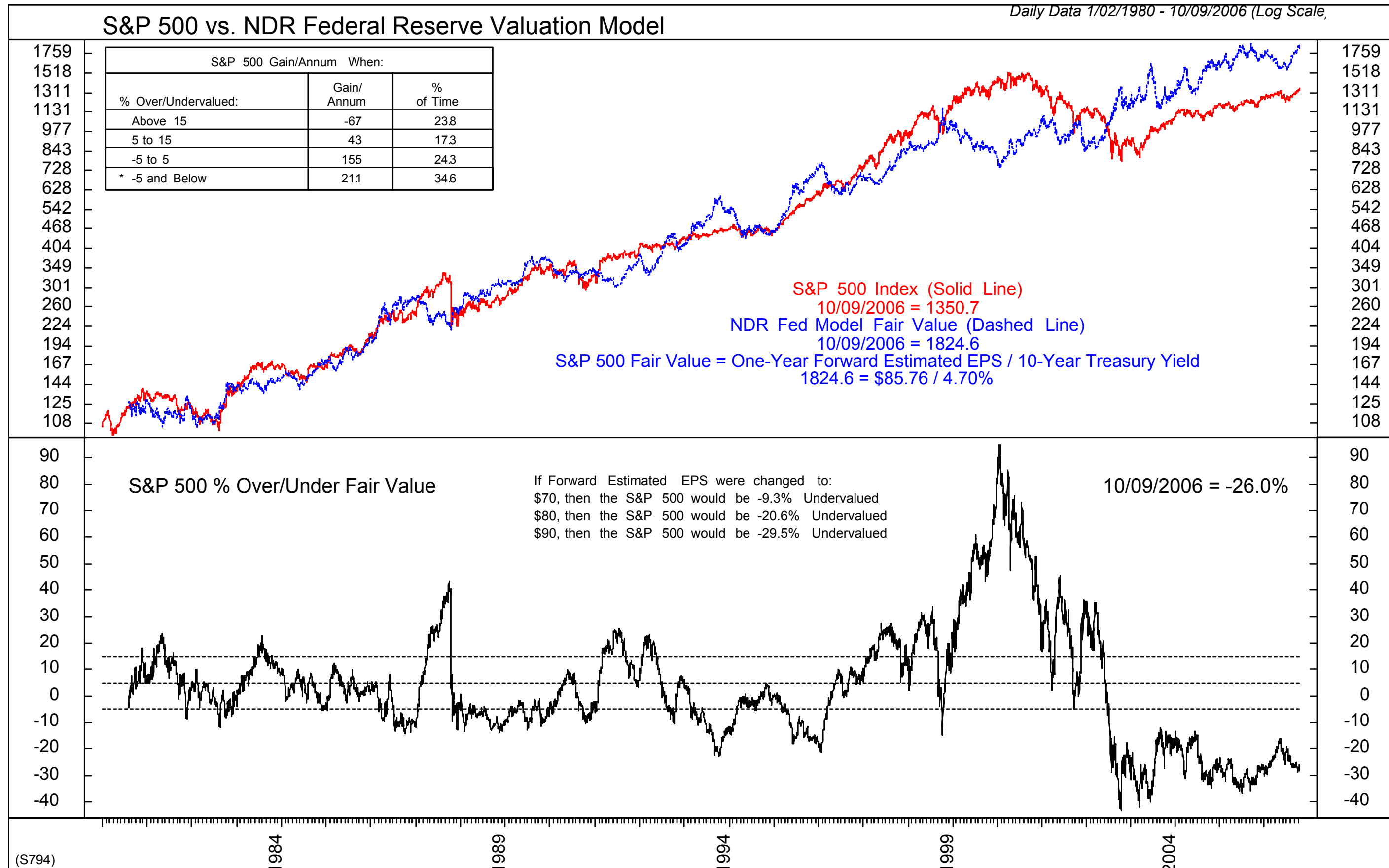
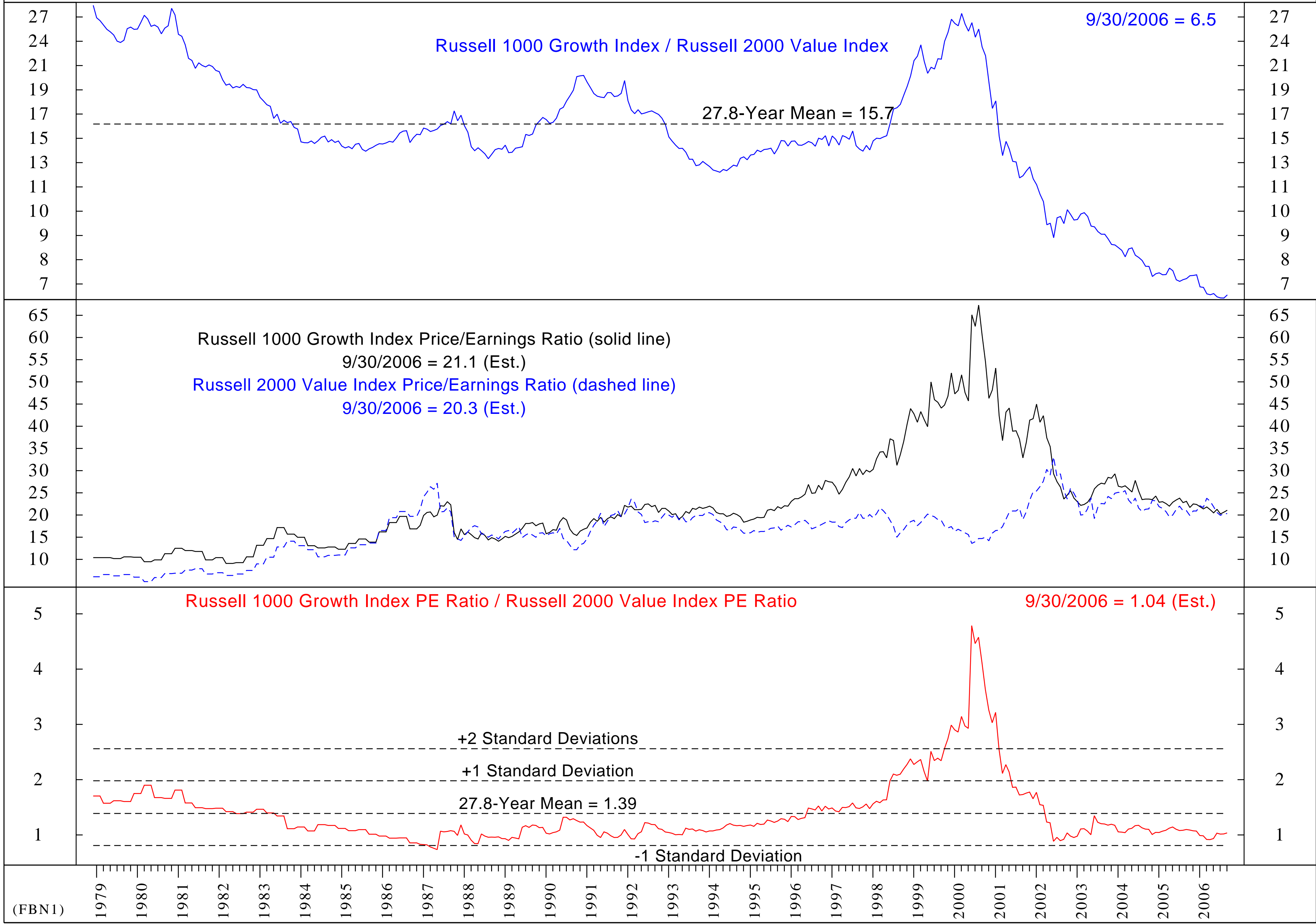


Chart Courtesy of Ned Davis Research



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