FRONT BARNETT ASSOCIATES LLC
I N V E S T M E N T   C O U N S E L

December 18, 2006

THE ECONOMIC OUTLOOK -- SOFT LANDING AT HAND

The most recent Department of Labor employment report shows the broad US economy remains resilient, weathering sharp down turns in housing and the automotive sector, and that weakness in these industries has not spilled over more broadly to aggregate employment. Payrolls outside of agriculture rose by 132,000 jobs last month, and revisions added 42,000 jobs to previous payroll estimates for September and October. Average gains in the past three months have, therefore, remained close to this year's monthly mean of 149,000. Widely discussed layoffs totaling 44,000 in construction and manufacturing -- in particular the auto industry -- were more than offset by gains in retailing, business services, health care, and tourism. Interestingly, the roughly 126,000 housing related jobs lost since June 2005 have been more than offset by the addition of nearly one million non-housing-related positions in that period.

Until recently, analysts have generally agreed that a normally expanding economy would need to create about 150,000 jobs a month to absorb those entering the expanding labor force. Growth above the 150,000 mark would reduce unemployment. Growth below would add to the jobless numbers. But, with slowing population growth, the work force aging, and women entering the labor pool more slowly, it is now assumed monthly job growth of only 110,000 is sufficient to keep unemployment stable at about its current historically low 4.5% rate. While we expect job growth to moderate somewhat over the next few quarters as the expansion slows, we believe there will remain sufficient job creation and wage growth to underpin rising consumer spending assuring continued economic growth, albeit at a modestly below-trend rate. In short, we see no recession ahead as some fear, but rather a period of moderating expansion followed by a resumption of more rapid economic activity later next year. The "soft landing" to which we referred in our October client letter is at hand.

Beyond the important employment data, other recent measures of business activity remain quite mixed. Consider the following, which signal slower growth for the next two quarters:

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1. The economy expanded at a 2.2% annual rate in the third quarter, the slowest of the year. The decline in homebuilding subtracted about 0.75% from overall real GDP growth -- the most in almost a quarter century. Business momentum coming into the current quarter had clearly slowed from the 3.8% average pace of the prior three years.

2. The Institute for Supply Management (ISM) reported that for the first time in more than three years manufacturing, which accounts for 12% of the economy, contracted in November as inventories grew and orders slowed.

3. The Commerce Department reported that orders placed with US factories fell 4.7% in October following a revised 1.7% September gain that was less than previously reported. Fewer orders suggest the possibility production cutbacks will limit economic growth in the next few quarters.

4. While industrial production in the US unexpectedly rose last month, the increase was largely attributable to a jump in auto manufacturing that may not be sustained as auto makers have announced more production cuts to come.

5. The University of Michigan reported that consumer confidence waned in December. While its preliminary index of sentiment declined to 90.2 from 92.1 in November, it remains above its average of 87.2% for this year. Americans appear to be getting a smaller boost from declining gasoline prices, and the slumping real estate market is making them feel less wealthy raising doubts about future consumer spending.

6. The Commerce Department reported that inventories at US businesses rose at a faster pace in October with unsold goods at factories, retailers and wholesalers climbing 0.4% following a 0.3% gain in September. Last quarter's inventory increase, the largest in two years, signals factories may need to keep trimming bloated stockpiles, suggesting manufacturing may remain a drag on the economy during the current quarter as well as the first quarter of 2007.

7. Borrowings by US households declined in October for the first time since March as demand for auto loans cooled. The ratio of household debt to annual income after tax is the highest ever at 120%.

8. According to RealtyTrac, over 120,000 properties nationwide entered some stage of foreclosure in November, up 4% from October and 68% above a year ago. The national foreclosure rate is one for every 961 households.

Other indicators reflecting strength in consumer spending, which accounts for two-thirds of the economy, remain firm:

1. Consumer spending appears to be poised to grow at a healthy 3.0% annual rate this quarter after expanding at a 2.9% rate in the prior three months. Spending has averaged 3.0% the past four quarters and 3.7% since 1996.

2. The Commerce Department reported that November retail sales were robust, higher than expected, rising 1.0% from the previous month and 5.6% from November 2005. The gain was propelled by improved sales at electronics stores, building material, and automobile dealers. Preliminary readings of holiday season sales provide no evidence of a retail sales slowdown.

3. The Non-Manufacturing index of the Institute for Supply Management for November rose to 58.9 from 57.1 indicating a faster rate of service sector growth in November. The ISM cited increased job orders and sustained lower energy costs driving consumer commitment. Non-manufacturing businesses account for over 85% of the US economy.

4. While virtually unchanged in November, the price of regular gasoline has fallen 27% since August buoying the outlook for retail demand during the critical holiday selling season.

FORECAST

Balancing these factors, we conclude that while home builders and auto makers, which account for about 10.0% of GDP, are curbing production to reduce excess inventories, the rest of the economy appears to be advancing at a satisfactory rate. Meanwhile, US exports are benefiting from the weaker dollar and strong growth among US trading partners, especially in Europe. We continue to forecast GDP growth to remain below trend at a 2.0% to 2.5% rate through mid 2007. Since slower economic growth will mean fewer new jobs, we expect the unemployment rate to rise gradually to 5.0% by next summer. Absent an oil shock, we believe *core* inflation will drift down toward the upper end of the Federal Reserve's "acceptable" range of 1.0% to 2.0% setting the stage for the Fed to commence an easing cycle in the second half of next year. Indeed, early signs of moderating inflation have already surfaced. The CRB index of commodity prices has fallen 9.5% over the past six months and consumer prices were unchanged in November, the third consecutive month without an increase. The year-over-year CPI is now running at a 2.0% pace, a very modest gain that is consistent with forecasts suggesting the slowing economy will eventually lower *core* inflation which stands at 2.6% on a year-over-year basis. Corporate profits, which have grown at mid-teen rates for 18 consecutive quarters, will slow to 6.0% to 8.0% growth through the first half of next year and begin to reaccelerate later in 2007.

One further thought on interest rates and recessions: In retrospect, recessions have occurred as the Fed, concerned about rising inflation, increased short-term interest rates excessively -- to the point where they were well above long-term rates, a condition referred to as an *inverted yield curve*. An *inverted yield curve* is viewed by some as a harbinger of recession. Higher interest rates curb the most interest rate sensitive purchases -- autos and homes – and then more broadly consumer spending. Eventually, this chain of events pulls down business investment and job creation triggering a recession. The current cycle is different in our view. Today, short-term rates are not particularly high and who would argue that a 6.0% 30-year mortgage rate is excessive. Rather, the current inversion stems from unusually low bond yields not excessive tightening. Bondholders both here and abroad appear confident US inflation will remain low and stable, and that growth will remain fairly muted. Therefore, they are not demanding as much of a premium to lend money for long periods of time allowing longer-term rates to remain low. We expect an end to the inversion without a recession when the Fed signals an easing of short-term rates and investors begin to anticipate more vigorous economic growth demanding higher bond yields.

HOUSING

The severe correction in the housing market that is now well entrenched follows a boom during the first half of this decade which saw the pace of construction of single family homes rise more than 40%, and sales of both new and existing homes increase by a similar amount. Nationally, home prices increased about 60% over that period -- an average figure that masks considerable variation in the rate of price appreciation across cities and regions, as home prices rose exceptionally rapidly in some "hot" locations (i.e. Florida, California, Arizona, Nevada, and the Northeast) but only modestly in others (i.e. "rust belt" states).

No real or financial asset can be counted upon to pay a higher risk-adjusted return than other assets year after year, and housing is no exception. A slowing in the pace of house price appreciation was, therefore, inevitable. Moreover, the sustained rise in prices, together with some increase in mortgage rates, made housing less affordable sowing the seeds of the correction. Declining affordability ultimately served to limit housing demand, leading to a deceleration in house prices and slowing home purchases. The drop in home sales that began earlier this year has led homebuilders to curtail the rate of new construction. Indeed, single family housing starts are down about 35% since their peak earlier this year. Measuring the decline in existing home prices is more difficult. During a period of weak demand, potential sellers often choose to leave their homes on the market

longer or remove them from the market, rather than accept price offers that are below their expectations. Moreover, the data fail to capture hidden price cuts, as when builders attempt to stimulate sales through the use of "sweeteners" such as paying the customers' mortgage points or upgrading features of the house at no additional cost. Nevertheless, there can be little doubt that the rate of home appreciation has slowed significantly. In some areas, prices have continued to rise -- albeit at a lesser rate than previously -- while other markets have seen outright price declines.

Despite the sharp reduction in starts of new single-family houses, inventories of both new and existing homes for sale have increased markedly this year. For example, recent data show homebuilders currently have about 550,000 new homes for sale, about 50% greater than has been typical during the past decade. Moreover, the official statistics likely understate the full extent of the inventory buildup as many homebuilders have reported a sharp increase this year in the number of buyers canceling signed contracts. To reduce this inventory overhang, builders are likely to continue to limit the number of new homes under construction.

Although residential construction continues to remain under pressure, anecdotal evidence suggests, the rate of home purchases may be stabilizing, perhaps in response to recent modest declines in mortgage rates and lower prices in some markets. Sales of new homes ticked up in August and September. The University of Michigan's November survey of Consumers shows an increase in the number of respondents who believe now is a good time to buy a home. Meanwhile, the index of applications for mortgages for home purchases has been trending higher since July. Although these tentative signs of stabilization are encouraging, and the prices of homebuilders shares have bounced 20% to 30% from their earlier 50%+ plunges, we believe the housing correction will continue well into next year as builders seek to further reduce their inventory of unsold homes to more normal levels and to liquidate unneeded investments in land. It will take further production cuts to achieve these objectives. When the rebound finally does occur it is likely to be slow in materializing with demand for new and existing homes returning to rates more in line with population growth and prices generally rising at below inflation rates in many formerly "hot" areas.

FIXED INCOME STRATEGY

The rise in bond rates above 5.0% this spring and summer brought brief opportunities of which we took advantage to extend maturities in client's bond portfolios. In late summer and early fall, as the economy began to show signs of slowing, raising recession fears, and driving US Treasury bond yields down toward 4.5%, we deferred further bond purchases preferring instead to invest funds in higher yielding short-term obligations. Recently, recession jitters have abated somewhat and bond yields have begun to drift higher. While portfolio durations remain below that of our benchmark, we prefer to defer extending maturities awaiting additional bond market weakness to add to portfolio duration. Given the historically narrow spread between yields on corporate bonds and US Treasury obligations, we will confine our purchases to US Treasuries until spreads widen to a point where investors are adequately compensated for the additional risks of owning corporate obligations.

EQUITY MARKET OUTLOOK AND STRATEGY

As noted earlier, despite the clear signs of a slowdown, which is likely to persist well into 2007, we do not expect a recession but rather a period of below trend economic growth. Inflation, a lagging indicator, will eventually drift down toward the upper end of Fed's "acceptable" 1.0% to 2.0% range and job growth will moderate with the unemployment rate rising to 5.0%+ next spring. The Fed, responding to these factors, should be inclined to reverse course and cut rates following mid year 2007. Meanwhile, corporate profit growth is expected to moderate from the double-digit rate we have experienced over the past 18 quarters to a mid-to-high single digit rate until growth reaccelerates in the later half of next year. At current valuations, we believe the stock market indices have already discounted this inventory liquidation driven slowdown and are attractively valued on both an absolute and relative basis. The Fed Model, a copy of which is attached, shows S&P 500 stocks to be 26% undervalued relative to bonds.

The single most important development in the financial markets since mid-year has been the increased pace of central bank tightening which has pinched global liquidity and led to an unwinding of speculative positions in many risky asset classes including real estate, commodities including energy, and to a lesser degree to small and mid cap stocks.

	Price Change Since Mid 2006*
S&P 400 Mid Cap Index	6.9%
S&P 600 Small Cap Index	7.5%
Gasoline	(24.3)%
Light Sweet Crude Oil	(14.7)%
CRB Index	(9.5)%
Gold	1.5%
Russell Top 200	13.9%
S&P 500	12.4%

*Through 12/15/06

The results of the 200 largest US companies, as shown by the Russell 200 Index, and the S&P 500's performance during this period has been driven by investors' renewed preferences for larger, well capitalized, undervalued companies with rising dividends which are presumed to be better able to withstand the effects of a slowing global economy, while smaller companies have lagged. Indeed, concentrations in these securities have lifted our clients' stock performance sharply since mid-year, out-pacing the general market, during a period when other investors have struggled to match the stock market's returns. On a *total return basis*, *which includes dividends*, the FBA model account has increased by 14.3% (13.7% after fees) versus 13.4% for the S&P 500 since mid-year.

In our view, 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 are able to generate above average unit growth and high returns on shareholder's equity. This remains the focus of our portfolios and the adjustments we have made to client accounts during the current quarter.

Despite the recent run-up of many of our core positions, the metrics of our equity portfolios 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	19x	13%	1.3%	26%	1.7
FBA Average Value Stock	14x	11%	2.1%	19%	1.5
FBA Total Portfolio	16x	12%	1.7%	23%	1.6
S&P 500	16x	7%	1.7%	21%	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 identical to that of the S&P. This differential is reflected in the P/E to Future Growth Rate shown above, underscoring the relative attractiveness of the portfolio.

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We extend special season's greeting and best wishes for a happy and prosperous New Year to our clients and friends whose support over the past twelve years has meant a great deal to all of us at Front Barnett Associates and for which we are, indeed, thankful.

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.

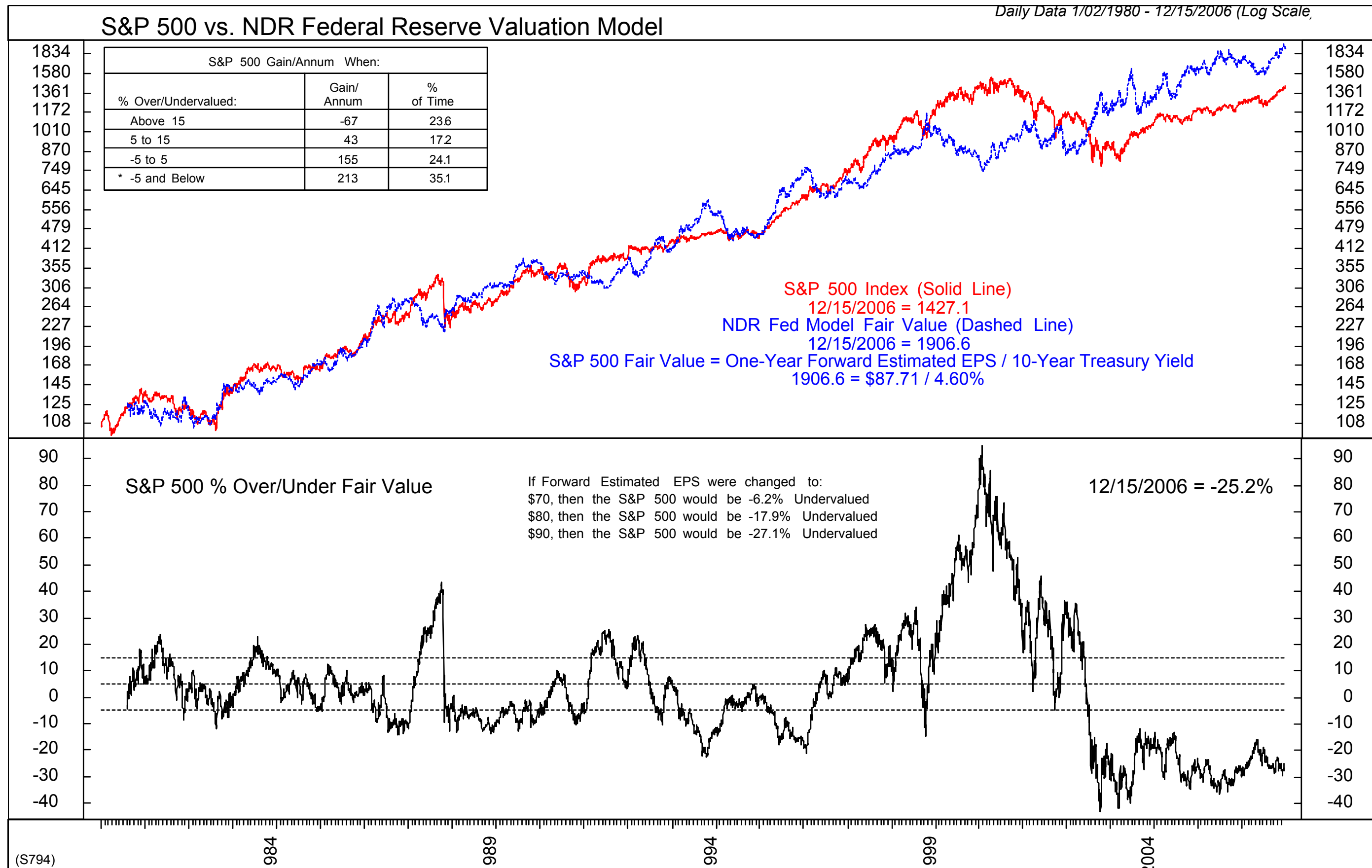
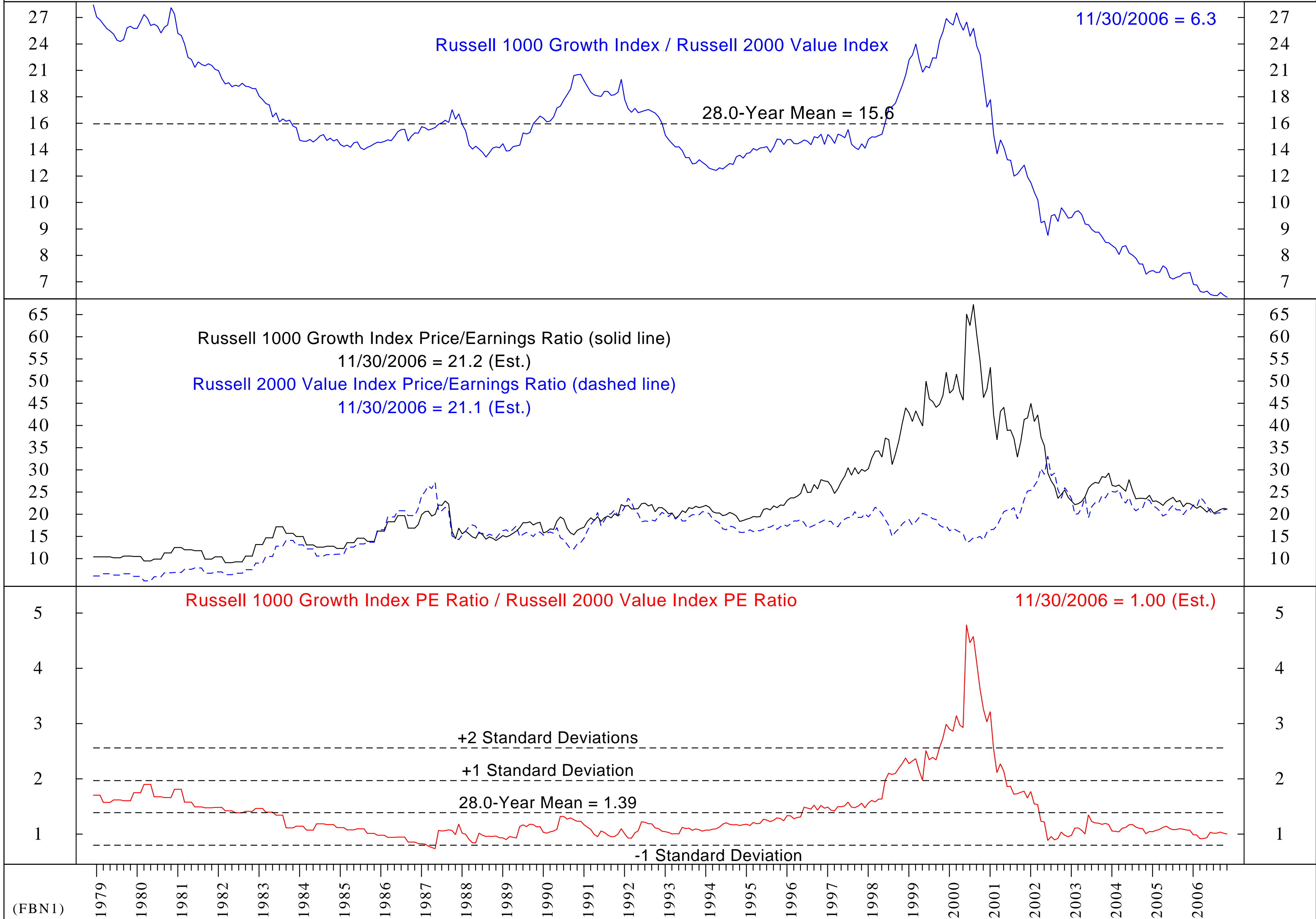


Chart Courtesy of Ned Davis Research



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