FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

Marshall B. Front
Chairman

Direct Line: (312) 641-9001
e-mail: mfront@front-barnett.com

December 4, 2007

THE ECONOMIC OUTLOOK -- SLOWDOWN AHEAD

Despite a growing chorus of recession fears, recently released economic data confirms our earlier view the US economy will avoid recession and return to trend growth by the second half of next year. However, falling home prices, tighter credit conditions, heightening energy costs, slower job growth, and a weak stock market will combine to produce very slow real GDP growth over the next six months.

Surging third quarter GDP gains of 4.90% -- the most in four years -- are likely to have taken a toll on fourth quarter growth which we expect to slip to 0.75% - 1.00%. We see sequential improvement in real GDP of 1.50%, 2.50%, 2.75%, and 3.00%+ respectively, during the four quarters of 2008, bringing annual economic growth to 2.20% this year, 2.30% next year.

Returning the economy to trend growth will likely require a series of more aggressive Fed rate responses than previously forecast -- eventually bringing the Fed funds rate (currently 4.50%) down to 3.50% by mid-2008. As business slows, the Fed's inflation concerns will wane allowing it a freer hand to counter financial market restraint with a progressively lower rate structure. This is particularly good news for banking institutions since it will provide much needed relief as their borrowing costs will fall and their margins should widen.

Forward looking economic data and anecdotal information support our view that while the depressed housing market may have begun to spread to other areas of the economy, the current 70 month business expansion will persist, albeit at a muted pace for the next two or three quarters.

- The Institute for Supply Management (ISM) reported that *manufacturing* activity expanded for the tenth consecutive month in November but at a slightly slower pace than October. The ISM index moved to 50.8 from 50.9 in October. (Readings of 50 or more

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

indicate *manufacturing* is expanding; a reading above 41.9 over time generally has indicated the *overall* economy is expanding.) New manufacturing orders and production both increased in November. However, the backlog of orders shrank -- certainly a sign of weakness and that production may be pared in coming months.

- The ISM *non-manufacturing* index grew at a faster pace in October, rising to 55.8, indicating the housing recession has yet to filter into the services sector of the economy, which accounts for nearly 90% of GDP.

- *Employment* in the US rose more than expected in October, suggesting the resilient labor market will steer the economy clear of recession. Payrolls rose by 166,000 following a 96,000 increase in September. Hiring, and wage gains, amounting to 2.8% for the past year, remain strong enough to help shield consumers from falling home prices and rising fuel costs, lessening concerns that consumer spending will falter. More recent data for the month of November, however, shows that the four-week average of initial jobless claims has been drifting upward -- now standing at 335,000 versus weekly readings closer to or below 300,000 earlier this year. We see the unemployment rate continuing to drift upward toward 5.00% by year-end.

- *Productivity*, a measure of employee efficiency, rose at an annual rate of 4.9% in the third quarter -- the most in four years and up from a 2.20% rate in the second quarter -- easing concerns that companies will raise prices to make up for cost increases thereby further diminishing the threat of inflation and strengthening the hand of the Federal Reserve as it mulls additional rate cuts.

- The Index of *leading US indicators*, a measure which points to the direction of the economy over the next three to six months, has essentially been flat in 2007, continuing the year-long pattern in October of alternating monthly increases and decreases. Since May, the index is down at an annual pace of 1%, short of the approximate 4% drop that Conference Board economists believe is required to signal recession.

- *Federal Reserve policy makers lowered their growth forecasts* in October, according to the minutes of their October 31 meeting, as their worries about credit-market losses and the housing recession justifiably intensified. They projected the economy will grow between 1.80% and 2.50% in 2008, "notably below" their prior forecast issued in July. Very recent public statements by leading members of the Fed have acknowledged deteriorating credit market conditions, dwindling money market liquidity, and downside risks to US economic growth which will require further easing in monetary policy. The pressures are also evident in offshore markets. However, the risks today may be smaller than three months ago; US policy makers have already eased the funds rate 75 bp and cut the discount rate 125 bp. While those actions have yet to flow through to economic activity, a string of further rate cuts can be expected.

Other recently reported indicators present clear evidence of the business slowdown:

- *Durable goods orders* for October fell 0.40% -- more than anticipated -- signaling businesses may be losing confidence the expansion will be sustained. The drop followed a revised 1.40% decrease in September. Bookings were down for a third straight month, the longest such trend in more than three years. The collapse in subprime mortgages has made it more difficult for borrowers to access financing, including bank loans and commercial paper. Slackening demand for items meant to last at least three years, combined with credit market turmoil, may prompt businesses to rein in spending, contributing to slower economic growth.

- *Confidenc*e among US consumers continues to fall as Americans struggle with surging fuel costs, falling home prices, and a very volatile stock market. The gloomier mood raises the risk holiday sales, which account for over 20% of retailers' annual revenue, will fall short of retailer's modest expectations. The Conference Board's confidence index fell in November to 87.3, the lowest reading since the aftermath of Hurricane Katrina in October 2005, from a revised reading of 95.2 the prior month. The index averaged 105.9 in 2006.

- *Spending* in October on US construction projects fell almost three times as much as forecast. The 0.80% decrease followed a 0.20%

gain in the prior month. Declining sales and rising foreclosures are contributing to the glut of properties already on the market, prompting builders to scale back projects.

Housing. The decline in housing, which represents about 5.00% of GDP, remains the cause of serious concern as, without exception, indicators paint a grim picture of current conditions, offering little in the way of encouragement for a near term reversal. Fewer-than-expected new homes were sold in the US in October, even as prices dropped by the most in almost four decades. A total of 728,000 new homes were purchased at an annual rate -- the lowest in almost twelve years, according to the Commerce Department. The collapse in subprime lending and turmoil in the financial markets are projected to extend the housing slump well into 2008. The median price of a new home dropped 13% year-over-year, the most since 1970. At the same time, the number of homes for sale fell 2.3% to a seasonally adjusted 516,000. The supply of homes at the current sales rate improved only marginally to 8.5 months' worth from 9 months in September.

Housing is likely to remain mired in its own recession until: (1) the huge overhang of unsold homes is pared back to a more normal level (i.e. about four month's supply); (2) homes become more affordable through a combination of lower prices and reduced mortgage rates; and (3) mortgages are more easily obtained by a broad range of potential buyers. We expect conditions in housing to remain very difficult at least through the middle of next year.

Investment. Decreased credit availability has begun to impact non-residential building. This, along with the uncertain and muted outlook for the economy, should be reflected in moderating capital spending intentions. Rising capital costs and slowing profit growth will contribute to this slowing.

Inflation. As noted earlier, inflation concerns should moderate as prospects for economic activity are tempered. Core CPI inflation has come down to a relatively low level -- below the upper end of the Federal Reserve's preferred 1.0% to 2.0% range. And, the latest reading on the core Personal Consumption Expenditures (PCE) index, the Fed's preferred inflation gage, stands at 1.90% -- within the defacto long-term inflation target range of 1.60%-1.90% outlined by the Fed last week.

Consumer Spending. Real personal consumption expenditures, which account for over two-thirds of GDP, increased 2.70% in the third quarter, compared with 1.40% in the prior period. We expect consumer spending to moderate to closer to

1.50% in the current quarter and 2.25% in the first quarter of 2008 as lower home values, higher energy prices, and credit restraint finally impact consumer's spending appetites. For the next few quarters, more moderate wage and employment growth will crimp real disposable income growth, putting pressure on spending.

In short, economic growth is expected to decelerate sharply over the near term. Strong export demand will offset housing weakness, but slowing consumer spending growth and an easing in the rate of increase of business investment will provide a drag on overall growth. Robust economic activity abroad, coupled with the lower dollar, which we see remaining weak so long as interest rates in the US are declining relative to those abroad, will fuel the export trade of US multinational companies.

Federal Reserve Policy

The latest personal consumption expenditures report released last Friday will be important in the Fed's interest rate deliberations this month. Both personal income and spending were weaker than expected rising by only 0.20% in October. This data will resonate with the Fed. In a broadly dovish speech on November 29th, Fed Chairman Ben Bernanke, wary of further financial market turmoil and further housing market distress, noted, "the committee will have considerable additional information on consumer purchases and sentiment to digest before its next meeting. I expect household income and spending to continue to grow but the combination of higher gas prices, the weak housing market, tighter credit conditions, and declines in stock prices seem likely to create some headwinds for the consumer in the months ahead." As we see it, weaker incomes and consumption data, against the backdrop of contained inflation, will support a series of further rate cuts over the months ahead underpinning the gradual, sequential improvement in business conditions next year.

In addition to help from the Fed in the form of lower interest rates, a US Treasury-led plan to freeze interest rates on troubled subprime mortgage loans to stave off the possible foreclosure next year of US subprime home mortgages is being negotiated. A large number of subprime home mortgages with adjustable rates are due to reset in 2008 at higher rates, risking another wave of defaults by borrowers unable to afford the new payments. That could trigger a wave of write-offs by investors who now own these mortgages. Fears that the problems could accelerate has led the treasury and the mortgage industry to develop a plan that would postpone rate resets for as long as two or three years or more for some borrowers.

Financial markets' initial reaction to the initiative was positive reflecting the hope the government's plan might put a floor beneath collapsing mortgage debt.

About 2-million homeowners have subprime mortgages with low "teaser" rates that are scheduled to jump 30% or more over the next two years. Federal officials predict that about 500,000 of those families could lose their homes. Other forecasts warn the number could be significantly higher. A freeze of two to three years would give homeowners time to build equity in their property or improve their credit ratings, both of which are crucial to obtaining lower, more affordable long-term rates. But a long-term freeze would be costly to investors who will probably argue for a shorter freeze. In the end, lenders and investors stand to lose less by modifying many mortgages than they would by foreclosing. Stay tuned!!

Fixed Income Strategy

Overall, our fixed income policy has remained largely unchanged. However, in the anticipation of falling short term rates, commencing late this past summer and in early fall, we began to divert a small portion of the high yielding short term reserves we have held in clients' portfolios in favor of two year government agency obligations (or municipal bonds) when, at a minimum, we were able to maintain or even increase yields. In the intervening period, money market rates have, of course, fallen by well over 50 basis points, whereas the higher rates we obtained on these purchases remain locked-in.

We continue to restrict fixed income purchases to high quality, short term obligations as the yields on medium to longer term debt are insufficient to adequately compensate investors for the risk inherent in owning longer duration obligations. While spreads on lower grade bonds have widened significantly during the recent period of credit market turmoil, we believe their yields presently to be inadequate relative to the risks entailed in owning lower quality, less liquid spread product. We are inclined to extend maturities only during periods of heightened inflation fears or extreme credit market turmoil. We expect these opportunities to present themselves as the current cycle unfolds.

Equity Investment Strategy

Financial markets remain in transition from a liquidity-driven speculative phase to a more fundamentally-based one in which high quality, large cap growth and value shares that remain core holdings in our portfolios.

The sharp declines this fall in the shares of large money center banks presented us with what we believe to have been a unique opportunity to increase client's positions in financials from underweighted (vs. the S&P 500 stock index) to market weighted. Shares of money center banks also offered yields of between 4.50% to 6.00%+ and sold at their lowest valuations since the last housing crunch in the 1990-1991 period.

Composition-wise, equity portfolios remain largely unchanged from the end of the third quarter with the following significant sector *overweights* and *underweights* relative to the S&P.

	Portfolio	S&P 500
Basic Investments & Transportation	1.80%	6.33%
Technology	17.19%	14.86%
Industrial Capital Goods	10.12%	8.83%
Discretionary Consumer Goods	7.53%	5.35%
Consumer Staples	12.27%	9.19%
Energy	7.12%	11.67%

In addition, to achieve broader diversification at a time when the US economy is slowing, about 20% of our equity securities represent investments in companies domiciled abroad. We have also avoided "deep cyclicals" and remain underweight in energy as we expect commodity and oil prices to fall.

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

	2008 P/E	**Estimated Future Growth Rate**	**Dividend Yield**	**ROE**	**P/E to Future Growth Rate**
FBA Average Growth Stock	**18x**	**13%**	**1.4%**	**28%**	**1.6x**
FBA Average Value Stock	**13x**	**11%**	**2.7%**	**18%**	**1.4x**
FBA Total Portfolio	**15x**	**12%**	**2.0%**	**23%**	**1.5x**
S&P 500	**15x**	**7%**	**1.8%**	**19%**	**2.0x**

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 15x price earnings multiple of the FBA portfolio is identical to that of the S&P. This parity is reflected in the P/E to Future Growth Rate of client's stock holdings shown above, underscoring the relative attractiveness of the portfolio.

* * * *

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

MBF