FRONT BARNETT ASSOCIATES LLC
INVESTMENT COUNSEL

Marshall B. Front
Chairman

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

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THE ECONOMIC OUTLOOK -- TURNING THE CYCLE

The recent spate of disappointing economic data underscores the sharp slowdown the US economy experienced around year end. While the likelihood of a period of no *real growth* has grown, this outcome is by no means a certainty despite the fact a growing number of economists indicate they have sharply increased the odds of a recession this year in their forecasts.

Most importantly, the Labor Department reported payroll employment, after increasing about 95,000 per month on average during the fourth quarter, fell by 17,000 jobs in January, the first monthly decline in more than four years. While the headline unemployment rate, based upon a separate survey of households fell to 4.9% from 5.0% in December, suggesting the jobs decline may be overstating how abruptly the economy slowed from December to January, the overall jobs decline remains troubling. The labor market, which had remained firm in the face of the subprime-mortgage crisis and subsequent credit crunch, may now be headed south as the deepening housing recession finally takes its toll on the overall economy, possibly setting in motion a nasty chain of events: As credit conditions tighten, consumption weakens resulting in slower production. In turn, demand for labor slackens as businesses try to preserve profits or stem losses.

We have long held to the view that so long as *employment* and *wage growth* held up, consumer spending, which accounts for two-thirds of GDP, would underpin the business expansion. However, if the early 2008 employment decline is not revised and is sustained over the next six months, it is likely this period will eventually be declared a recession.

While not all of the recent economic data points to a sharp slowdown, many, including weaker retailer, wholesale, and auto sales, and declining activity signaling in the various ISM surveys in January and early February, do.

70 WEST MADISON STREET • SUITE 4920 • CHICAGO, ILLINOIS 60602-4208
(312) 641-9000 • FAX (312) 641-9009

- US auto sales fell 4.3% in January slumping to their slowest level in years. Two of the Big Three Detroit automakers, Ford and Chrysler, saw declines as did their Japanese competitors Toyota, Honda, and Nissan. Only GM was up 2.6% over a weak January a year earlier, but its figures were still poor by historical standards.

- Shockingly, business activity in the usually stable non-manufacturing sector contracted in January for the first time in 58 months according to the latest Institute for Supply Management (ISM) report. The ISM *non-manufacturing* index stood at 44.6. Readings below 50 indicate contraction. Recall that non-manufacturing business activity amounts to about 80% of GDP.

- Real GDP increased at an annual rate of only 0.6% in the fourth quarter of 2007 compared with an average pace of 2.8% the past five years, according to advance estimates of the Bureau of Economic Analysis. While "preliminary", and subject to revision, the data shows the economy entered 2008 with little momentum.

- Inventories at US businesses in December increased the most in a year-and-a-half as sales posted the largest decline in 11 months, reflecting the slowing economy. Slowing consumer demand has kept goods on companies' shelves longer.

- Consumer credit rose at the slowest pace in eight months in December as consumers cut back on credit card use.

- *Consumer confidence* fell in January to 87.9 from 90.6 the prior month approaching a two-year low reinforcing the concern Americans will cut back their spending which accounts for two-thirds of GDP. The index averaged 103.2 last year.

- *Consumer spending* in the US increased in December at the slowest pace in the six months signaling the economy is likely to remain weak as consumers react to falling home prices, rising fuel costs, and less access to credit as banks tighten their lending standards.

Amidst the signs of weakness, there are, clearly, offsetting bright spots:

- Retail sales in January unexpectedly rose 0.3% (following a 0.4% decline the prior month), a sign US consumers continue to increase spending on necessities including transportation and clothing, despite the housing slump. The report may ease concerns that falling property values and a cooling job market will lead to sustained declines in consumer outlays and push the economy into recession.

- Orders to US factories rose in December by the most since July, indicating business spending on new equipment is growing even as factory hiring falters. The 2.3% increase is the fourth consecutive monthly gain according to the Commerce Department. Exports, supported by the weak dollar and gains in business investment in new plant and equipment, may prevent a downturn in manufacturing as housing continues to slump. Faster growth outside the US has lifted demand from overseas and is helping companies offset some of the slowdown in domestic purchases. Shipments to buyers abroad in November set a ninth consecutive monthly record.

- The ISM's January *manufacturing* index unexpectedly rose to 50.7 from 48.4 in December. Strong international sales and a sizeable backlog of orders is supporting manufacturing growth although the reading is barely above 50, the dividing line between contraction and expansion.

- US durable goods orders rose 5.2% in January, the biggest increase since July as orders from abroad helped sustain the manufacturing sector.

- The average 30-year fixed rate mortgage has fallen to about 5.6% compared with 6.05% at the end of 2007. At the current rate, monthly borrowing costs for each $100,000 of a loan would be $574.71, or about $81 *less than* in June 2006 when it reached a four-year high of 6.86%. Lower mortgage rates are clearly driving refinancings and will make housing more affordable for those with good credit records and enough for a down payment. Lower rates will also ease the refinancing burden looming for homeowners who face resets of their subprime ARMs set to peak in March as well as pay-option ARMs which crest in June 2010.

- Worker efficiency grew more than forecast in the fourth quarter as businesses, reacting quickly to the slowing economy, reduced employee hours at the fastest pace in almost five years. Productivity rose at an annual rate of 1.8%, according to the Labor Department. Businesses are trimming staff to prevent a slowing in productivity and to control expenses in order to avoid having to raise prices.

- Compensation for each hour worked increased at an annual rate of 3.9% in the fourth quarter of 2007, showing a healthy gain in wages while employment growth has waned, at least temporarily.

Meanwhile, fiscal and monetary steps are being taken to turn the cycle. The most significant of these is not likely to be the fiscal easing that will result in $110 to $120 billion of tax rebates to be mailed at midyear. It's worth noting that while these rebates are large when compared with the much smaller rebates of 2001 and 2003, those earlier steps were part of the more comprehensive and longer term structural changes in tax rates which expire in 2010. Looking back, the rebates of 2001 and 2003, when taken alone, do not appear to have played a key role in turning the economic tide. Assuming they are not repeated, this year's rebates are likely to create a spending bulge in the third quarter, temporarily cushioning any downturn in consumption growth.

More important, we believe, the turn from a mildly restrictive monetary policy to one of ease should, as always, lead to a cyclical turning point. This was the case in 2002 when many financial market savants were claiming the Fed was "pushing on a string". The Fed has now cut short-term interest rates by 2.25 percentage points since mid 2007. Additional easings are forecast to bring the federal funds rate down to 2.00%-2.25% by mid-year from its peak of 5.25% last year and 3.0% currently.

But neither the turn from restrictive to accommodative monetary policy nor the tax rebates are the most important developments along the road toward an eventual economic recovery. Rather, the 57% decline in both new home sales and single family housing starts represented a huge decline in activity even before the onset of the broader slowdown we are now experiencing. Existing home resales have declined a more modest 31% from their peak and prices have fallen somewhat improving affordability. While a further weakening in housing is expected over the next several months as delinquencies, defaults, and foreclosures rise, prior speculative excesses are being washed out and will eventually create the preconditions needed for a broad recovery as the inventory of unsold homes shrinks, prices are cut, and mortgage rates remain very attractive.

The financial sector has also absorbed a lagged but swift hit for the excesses in mortgage lending earlier this decade. The huge losses reported by many financials last quarter show that this is not an issue reflecting current profitability but rather a payback for past mistakes. The first half of this year, in particular, will present difficult earnings comparisons for many major banks as weak economic conditions and increasing credit delinquencies spread from mortgages to credit cards to commercial real estate to student loans and beyond. But, to a degree, this was also true of the 1990-1991 and 2001-2002 periods from which financials' earnings eventually recovered sharply as the early phases of the subsequent expansions unfolded.

FORECAST

In summary, the softer labor market, together with factors including higher energy prices, lower equity prices, and declining home values, seem likely to weigh on consumer spending in the near term. On the other hand, growth in US exports should continue to provide some offset to the softening in domestic demand, and the recently approved fiscal stimulus package should help to support household and business spending during the second half of this year and into 2009. While it remains to be seen whether the economy actually slips into a recession, we must admit recent data has somewhat diminished our confidence we will avoid a downturn. Nevertheless, we remain in the camp of those who expect the economy to narrowly skirt an outright decline. Instead, we now see two quarters of sub-par growth of no more than 1.0%. Stimulated by the coming tax rebates and the growing impact of sharply lower interest rates, third and fourth quarter GDP should rebound, to average 2.0%+. Beyond that, growth will gradually trend higher in 2009 as conditions in the housing industry stabilize. We continue to expect unemployment, which, at 4.9%, remains low by historical standards, to rise to 5.5% by this summer, effected more by businesses' reluctance to hire rather than massive layoffs. The US dollar has stabilized somewhat in recent weeks as investors have begun to discount the likely end to progressively lower interest rates in the US by mid-year and the probability rates abroad will be cut as economies there slow and central bankers move toward accommodation. We believe the dollar will rally under this set of conditions.

INFLATION

A key development over the past year has been the steep rise in oil prices. Food prices also increased exceptionally rapidly by recent standards, and the foreign exchange value of the dollar weakened. All told, over the four quarters of 2007, the price index for personal consumption expenditures (PCE) increased 2.4% up from 1.9% during 2006. Excluding the prices of food and energy, PCE price inflation ran at a 2.1% rate in 2007, down slightly from 2006. Despite benign PCE and CPI readings over the past five years, many consumers have been stung by rising commodity prices. For example, heating oil has risen 290% and wheat is up 256% during this period. Commodity prices continued to rise in 2007 with oil briefly touching $100 a barrel -- up 57% for the year. Gold, silver, and other precious metals benefited from financial market uncertainties and the declining dollar. Fed rate cuts also raised inflation concerns which led investors to buy commodities as a hedge against rising consumer prices. Now, with the US economy barely growing, economies abroad are also likely to slow and inflation, as measured by the PCE, is expected to moderate, but remain near the upper end of the Federal Reserve's "preferred" range of 1.0% to 2.0%. Nevertheless, we believe the Fed will remain, for the near term, focused upon the downside risks to the economy, to alleviating the current credit crunch and to turning the economic cycle. The Fed will remain accommodative until the economy clearly shows signs of regaining traction.

FIXED INCOME STRATEGY

We have continued to restrict fixed income purchases to high quality short-term government and agency obligations as yields on medium to longer-term debt are insufficient to adequately compensate investors for the inherent interest rate risk in owning longer duration obligations. Beyond high quality bonds, the contagion from the subprime mortgage market turmoil has now driven spreads significantly wider so that spread product has become relatively more attractive. We are likely to include some investment grade corporate obligations among the securities we purchase when buying opportunities present themselves as this cycle unfolds.

EQUITY INVESTMENT STRATEGY

Most portfolios under our supervision ended 2007 with larger than usual cash positions which we have maintained in the face of the unfolding economic uncertainties outlined above and the renewed stock market weakness early this year. To gain further global diversification, we increased exposure last year to companies domiciled abroad to the point where they represent close to 20% of the value of equities under management. Core domestic stock holdings represent investments in larger companies, which can better take advantage of a weak dollar and strong global GDP growth. These companies, on average, are trading at attractive relative valuations when compared with riskier assets (i.e. small cap, emerging markets), which we are avoiding at this time. Note that large cap stocks underperformed small cap stocks in seven of the last eight years. Historically, decelerating corporate profit growth, slowing domestic economic growth and directionally flat interest rates have favored growth stocks which we overweight in our portfolios.

Equity portfolio diversification remains largely unchanged from year-end with significant sector *overweights* and *underweights* relative to the benchmarks S&P 500 as follows.

Sector	Portfolio	S&P 500
Basic Industries & Transportation	1.8%	6.7%
Discretionary Consumer Goods	9.0%	5.6%
Services & Media	2.0%	6.6%
Energy	7.2%	12.6%
Utilities	-	3.4%

The metrics of our equity portfolio 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	**16x**	**13%**	**1.6%**	**28%**	**1.3x**
FBA Average Value Stock	**13x**	**11%**	**3.1%**	**16%**	**1.2x**
FBA Total Portfolio	**15x**	**12%**	**2.2%**	**22%**	**1.3x**
S&P 500	**14x**	**7%**	**2.0%**	**17%**	**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 only marginally higher than that of the S&P and the P/E to future growth rate is a historically low 1.3x versus 2.0x for the S&P.

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