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

Marshall B. Front
Chairman

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

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Stock Market Comments

Despair abounds. Soaring energy prices and growing problems in the financial sector are among the most visible causes of investor angst. US stock prices have declined about 14% since year-end and are down roughly 20% since their October 2007 peak, qualifying the current market pullback for "bear market" status. Looking back, on average since 1929, bear markets have occurred about once in three years, declines have lasted 9.1 months and shown losses of 26.6%. The period from 1982 to date has been exceptional in that we experienced fewer than the usual number of downturns. Bear markets have eventually given way to bull markets taking the market indices to new highs. Extended periods of market weakness have occasionally ended in a final, violent capitulation when investors have thrown in the towel and run for cover. Other downdrafts have concluded with a petering-out of both downward momentum and market volume. How this bear will end is not predictable, nor is it possible to identify the confluence of events which will turn market sentiment from negative to positive. But a turn will most assuredly come.

The good news is that the overall US stock market is now beginning to look more attractive based upon a number of metrics we follow. For example, the S&P 500 now trades at a price-earnings multiple of about 15 times this year's expected earnings. The 10-year average is 18.7, covering a period of extreme investor exuberance as well as the 2000-2002 market downturn. The 24-year average P/E ratio is 15, a time frame that includes much higher inflation than we are currently experiencing and generally higher interest rates. This suggests the market is reasonably priced although not yet at the extreme bargain-basement levels last seen in the 1990-1991 period.

Another measure of valuation is the market's earnings yield, or its earnings divided by its price, compared with the yield on safe bonds, as a measure of value. Today, the stock market's earnings yield is about 3.36 percentage points above the yield on 10-year US Treasury bonds suggesting stocks are more attractive than bonds.

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

The earnings yield gap has not been this wide since 1981 when, despite the seeming insurmountable problems at the time, the market went on to a strong three-year rebound.

Also of note is that the market decline earlier this year was triggered by the Bear Stearns implosion when investors questioned the health of the financial system. The Federal Reserves action at the time to extend borrowings at their discount window to large financial firms effectively eliminated the systemic risk which investors feared. Today, investors are dealing with a more traditional bear market where future corporate profits are called into question and how long it will be before consumers and businesses quit retrenching and start spending. At these levels, the market is not pricing in a business recovery but eventually one will occur and be discounted.

Other short-term indicators are beginning to improve:

- *The VIX volatility index* has risen from a low reading of 16.30 on May 16 to 28.78 currently. A sharp rise in this index relative to its moving average has in the past been helpful in predicting a market bottom.

- *The number of initial public offerings* (IPO's) have fallen sharply this year signaling a deep discomfort with stocks, a precondition to a reversal in sentiment.

- *Consumer confidence* levels below 55 (in the past 40 years) have always been associated with market rallies over the following 12 months.

Thus, the news, while generally disheartening, has begun to provide some signs of a turn in sentiment in the making while market valuation metrics have become more attractive. Stay tuned!!

Finally, we remain convinced that diversified portfolios of well-selected equities offer excellent opportunities for long-term growth from current levels and we are maintaining client positions in anticipation of the beginning of the next bull market.

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