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 -- SIGNS OF STABILIZATION

Whether you prefer "straws-in-the-wind", "green shoots" or some other horticultural reference, there are growing signs that the "great recession" is winding down. Supporting this view, the Labor Department reported last Friday that non-farm payrolls fell by 345,000 in May, far less than April's 504,000 drop and the smallest decline since September during which time monthly payroll declines have averaged 643,000. Clearly, the freefall the job market experienced earlier this year is finally beginning to taper off.

The easing in job-losses comes at a time when other economic indicators we parse have also improved from their worst levels, but remain in recessionary territory. Measures of consumer confidence, while still depressed, have rebounded from their historical lows. Forward looking surveys of both manufacturing and service industry purchasing managers conducted by the Institute for Supply Management (ISM) for the month of May suggest the economy is contracting far more slowly than had been the case in the months following Lehman's collapse last September. Orders placed at US factories in April rose for the second time in three months, according to the Department of Commerce. And, most economists, including those at the Federal Reserve, now forecast the economy will be growing again before year-end -- a view we share.

Interestingly, while the economy lost 345,000 jobs last month, bringing the headline unemployment rate up to 9.4%, some industries fared far better than others, portending the turnaround we expect by year-end. Looking back, service companies, which employ 86% of all US workers, were especially quick to trim staffs at the onset of the economy's current slide. These companies reported a slowing of losses in May to 120,000 jobs, far fewer than April's decline of 230,000 and the average monthly drop of 334,000 in the six-months ended March 31, 2009. The number of service jobs has fallen more in this recession than at any time in 70 years due, in part, to steep financial industry job losses, but also because many companies which had been relatively immune to prior economic cycles,

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

preemptively shed workers last fall and winter in response to financial market stresses unique to this cycle.

SIGNS OF STABILIZATION

Below is just a small sampling of other recently released domestic economic data which present a growing body of evidence supporting the notion the economy has stabilized:

1. The Federal Reserve's latest "beige book", covering data assembled ahead of the June 23-24 meeting of the central bank's interest-rate setting committee, shows that while the economy continued to weaken during April and May in many parts of the country, recessionary winds are abating. One new glimmer of hope cited was that temporary-help companies reported moderate signs of recovery. An increase in the hiring of temporary workers typically precedes improvement in the overall labor market. Technology companies also reported business was picking up, and real estate agents in eight of the Fed's twelve districts reported an uptick in home sales.

2. Although many investors have begun to worry that, as the economy begins to recover, inflation could resurface, the April-May beige book reported that with few exceptions, prices at all stages of production were generally flat or falling. At the retail level, pricing was very soft and wages were generally flat or lower. These anecdotal observations offer little reason to fear a rise in inflation any time soon.

3. Retail sales rose 0.5% in May for the first time in three months as lower taxes and government transfer payments supported consumer purchases. This may be an early indication the government's fiscal stimulus is beginning to kick in.

4. Confidence among US consumers, which took a huge hit following the Lehman failure, rose in May to the highest level since last September, according to a University of Michigan poll, increasing to 68.7 in May from 65.1 in April. Rising confidence, while not yet at a level considered to be optimistic, limits the risk that consumer spending will peter out following its rebound in the first quarter of this year.

5. US manufacturing, which failed to grow for 16 consecutive months, shrank in May but at the slowest pace since October according to the ISM, as more companies have moved beyond the severe cuts in output and payrolls that characterized the financial meltdown last fall.

6. Pending home sales, boosted by low mortgage rates in April, rose for the third consecutive month, with some benefit coming from the first-time buyer tax credit. This forward looking indicator, based upon contracts signed in April, rose 6.7% and is now 3.2% above the April 2008 level.

7. While the economy shrank at a 5.7% pace in the first quarter, capping its worst six-month performance in 50 years, there are signs manufacturers' efforts to purge their inventories may be close to done. The ISM index showed new orders rose in May for the first time since the recession began in December 2007 and, at the current sales pace, it would take only 1.3 months for distributors to ship the amount of goods on hand.

8. The ISM non-manufacturing index, which accounts for almost 90% of GDP, rose to 44, the highest level in seven months, from 43.7 the prior month. Recall that ISM readings below 50 signal continued recession.

9. Weekly initial jobless claims continue to edge lower, signaling the most acute phase of job losses may be over, lowering the risk consumer spending, which accounts for over two-thirds of GDP, will again retrench, delaying the forecast economic recovery. Moreover, recently circulated academic studies show a high correlation between the abatement of jobless claims and the end of recessionary periods. Note that jobless claims peaked in mid-March

10. Despite the rise in home financing rates during the past three weeks, with the average 30-year fixed rate mortgage rate now at 5.8%, housing prices and borrowing costs continue to remain below year-earlier levels, making housing more affordable to prospective buyers. In addition, new financial incentives lower the cost of home ownership for first-time buyers who receive a $7,500 tax credit.

11. Non-farm business productivity, or workers' hourly output, rose at a 1.6% annual rate in the first quarter. Productivity usually *falls* in a recession because firms are slow to fire workers when business declines. This productivity increase suggests many firms were engaging in "preemptive firing" last fall and winter and may need to add staff more rapidly as business begins to recover. Nevertheless, keep in mind that unemployment is usually a *lagging indicator* and that the unemployment rate is likely to continue to climb until well after the recession ends. We continue to forecast the unemployment rate to peak at 10%+ early next year.

12. Construction spending in the US unexpectedly rose in April as the housing slump eased and more commercial projects got under way. The 0.8% gain was the biggest advance since August 2008. Interestingly, architects in the US recently reported a growing number of potential public projects arising from federal stimulus funds.

13. The port of Long Beach has reported that shipments to China of raw materials have resumed in the last two months, the first signs of life after exports collapsed in October.

In summary, then, recent data suggests that the pace of economic contraction is slowing. Most notably, *consumer spending*, which fell sharply in the second half of 2008, has been roughly flat since the turn of the year while consumer sentiment has improved. In the months ahead, households' spending power will be augmented by the largest fiscal stimulus program on record. Nonetheless, a number of factors are likely to continue to weigh on consumer outlays, among them the weak labor market, the declines in equity and housing wealth that households have experienced over the past two years, and improved but still tight credit conditions for many borrowers. *Continued efforts on the part of both consumers and businesses over the months ahead to deleverage their balance sheets will also constrain the recovery and remain an unfortunate legacy of the credit bubble which burst last fall.*

Housing activity, following a long period of decline, has also shown some signs of bottoming. Sales of existing homes have been fairly stable since late last year, and sales of new homes have troughed in the past few months, though both remain at depressed levels. Meanwhile, new home construction has been sufficiently restrained to allow the inventory of unsold homes to decline -- a precondition for any recovery in homebuilding.

Businesses remain very cautious and continue to reduce their work forces and defer capital investments. More positively, firms have made progress in paring unwanted inventories accumulated following last fall's sharp downturn in sales. The Commerce Department estimates that the pace of inventory liquidation in the first quarter accounted for a sizable portion of the reported decline in GDP in that period. As inventory stocks move into better alignment with sales, firms should be willing to increase production.

FORECAST

We expect overall economic activity to bottom out this summer and then turn up later this year as consumer spending and housing stabilize, and the pace of inventory liquidation slows. Final demand will be stimulated by the enormous fiscal and monetary stimulus which has been applied, and US exports should benefit if recent signs of stabilization in foreign economic activity, particularly in China, prove accurate and the dollar remains around current levels. Clearly, the outlook depends upon our forecast that the financial system will mend and there will be a further improvement in credit conditions. Any relapse in the financial sector would create a significant drag on economic activity and cause the incipient recovery we expect to stall.

Even after the recovery gets under way, the rate of growth in economic activity is expected to be muted for at least two or three quarters, implying the current slack in resource allocation will increase further. The recovery will only gradually gain momentum and the economic slack will diminish only slowly. Businesses are likely to remain cautious about hiring, so the unemployment rate is likely to rise further, even after economic growth resumes. In this environment, we expect *inflation* to remain low. The slack in resource utilization remains sizable, and, despite recent increases in the prices of energy and other commodities, cost pressures will remain subdued. As a consequence, inflation over the next year or so is likely to remain at or below the levels of 2008. That said, improving economic conditions and stable inflation expectations should limit further declines in inflation beyond 2010.

FINANCIAL MARKET CONDITIONS AND BOND STRATEGY

Financial market conditions have improved since last winter, reflecting a combination of Federal Reserve policy actions, measures taken by other government agencies and the improved economic outlook. That said, financial markets and financial institutions remain under considerable stress. Low asset prices and tight credit conditions continue to act as restraints on economic activity.

Among the markets where functioning has recently improved are those for *short-term* funding, including the interbank lending markets (LIBOR) and the commercial paper market, where risk spreads have narrowed and lending is taking place at longer maturities. Also encouraging is that the private sector's reliance on the Fed's programs has declined as market stresses have eased. The issuance of asset-backed securities backed by credit card, auto, and student loans has picked up and asset backed securities rates have declined.

In markets for *long-term* credit, bond issuance by non-financial firms has been relatively strong and spreads between US Treasury yields and rates paid by corporate borrowers have narrowed, but still remain wide by historical standards. We have used this period of renewed corporate issuance to shift the mix of bonds held in clients' fixed income accounts from about 80% US Treasuries and 20% corporates and cash equivalents a year ago to 80% high grade medium term corporates and 20% US Treasuries and cash equivalents currently. Inflation Protected Treasury bonds (TIPS) now represent a significant portion of clients' US Treasury holdings.

Mortgage rates and spreads were also reduced by the Federal Reserve's program of purchasing government agency debt and agency mortgage backed securities earlier this year. However, in recent weeks, yields on longer-dated US Treasury obligations have risen as concerns about large federal deficits, greater optimism about the economic outlook, a reversal of earlier flight-to-quality money flows, technical factors related to the hedging of mortgage holding have impacted bond prices, and a normalization of rates. For example, the yield on the benchmark 10-year US Treasury bond has risen from 2.46% on March 20th to 3.95% currently -- a remarkable rise. We believe that while the back-up in yields on longer-term US Treasury bonds may continue for a while longer, inflation fears are overblown for the reasons cited earlier and that rates are not likely to experience a protracted nor substantial rise from current levels.

EQUITY STRATEGY

After falling to levels not seen in over a decade, the US stock market has staged a huge recovery from its March 6th intraday lows as early evidence of a likely bottoming in the recession began to surface and financial market conditions showed signs of stabilizing. This came as no surprise to us as market history shows that market troughs generally occur six to eight months in advance of an economic turn. The S&P 500 stock index, while still about 40% below its October 2007 all-time high, has rebounded almost 40% from its March 2009 low. For the calendar year-to-date, the broad stock market indices are now positive as follows:

Index	% Change*
S&P 500	+3.97
NASDAQ Composite	+17.50
S&P Mid Cap	+10.55
S&P Small Cap	+2.98
EAFE (Developed Markets)	+6.69

*through 6/10/09

The calendar 2009 total return performance of equities in tax-free accounts under our supervision, as measured by our model account, remain well ahead of the S&P 500.

While periods of market correction are inevitable and should be expected, stocks are reasonably priced at 13.4x's estimated 2010 S&P 500 earnings per share of $70. Client's equity portfolios remain fairly fully invested in the anticipation of higher stock prices as the markets give greater weight to the likelihood of an improving economic picture, rising corporate profits and further easing in credit market conditions.

From a supply/demand standpoint, the $3.69-trillion mountain of cash on the sidelines, to which we have frequently referred, remains a source of potential demand for equities as investors who find themselves underinvested are squeezed and short sellers cover positions to avoid further losses.

Stock portfolios remain well diversified. Recent changes reflect our effort to better position portfolios to participate in the economic recovery we expect. Principal sector concentrations currently are as follows.

Sector Concentrations %		
	FBA Portfolio	S&P 500
Basic Industries & Transportation	5.7	6.5
Technology	19.3	17.3
Industrial Capital Goods	10.6	7.7
Discretionary Consumer Goods	8.4	6.3
Services & Media	3.2	7.2
Telecom Services	3.1	3.3
Consumer Staples	11.8	10.3
Healthcare	10.0	12.6
Energy	7.6	13.6
Financial	9.8	11.3
Utilities	1.9	3.3

Significant positions in basic industries, technology, industrial capital goods, and discretionary consumer goods, which represent 44% of the FBA stock portfolio, reflect our optimism regarding the likelihood of improving business conditions and profits of economically sensitive companies leading to better than average market performance for these sectors as the recovery unfolds. In addition, portfolios continue to have allocations of investments in companies domiciled abroad both in developed countries, where we currently have exposure, and over time in developing countries where growth is expected to outpace global growth in general.

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