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THE ECONOMIC OUTLOOK -- BELOW TREND RECOVERY

Last Friday's disappointing but not unexpected labor market report, showing unemployment stood at a 10.2% rate in October, is at odds with other forward-looking data showing the economy recovering from the deepest and most protracted recession in generations. These contradictions are the usual fare at economic turning points. The major issue for both investors and policy makers is, clearly, how well growth momentum will be sustained into year-end and beyond as the economy recovers from a rare combination of a deep economic recession and a severe financial crisis.

In truth, we have had little experience from a public policy standpoint in dealing with this confluence of conditions. When and how quickly to withdraw the unprecedented monetary and fiscal stimulus the economy has received to reverse the downward spirals of 2008 and early 2009 remain unanswered questions. The likelihood of a further moderate deterioration in the job market in the next few months and the prospect of only a muted recovery, further complicates policy-makers' timing decisions as we move toward the crucial 2010 congressional elections.

The Labor Department's *payroll* report showing a 190,000 decline in non-farm payrolls, together with a static 33-hour work-week, clearly represents a stall in job recovery. Cuts in manufacturing, construction, and the retail sector remain intense. However, the *payroll* survey was not entirely downbeat. Business service employment rose for the second straight month. Temporary workers increased 34,000 jobs, the first gain since December 2007, when the recession began, providing a possible harbinger of forthcoming increases in overall employment. Economists are able to show payrolls at temporary-help agencies often turn up before total employment as companies are not entirely certain demand increases will be sustainable enough to justify the expense of taking on permanent staff. Also, the breadth of job-losing industries has narrowed noticeably. With housing activity rising again, losses in residential construction have declined from 70,000 per month to about 10,000 in October, while in areas like banking, real estate, and

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furniture stores, employment has stabilized in the past couple of months. All in all, then, the *payroll* survey is beginning to brighten, presenting a picture not out of line with a gradual move away from business retrenchment.

In contrast, the Labor Department's *household* survey, also released last Friday, presented the third consecutive weak labor market readings showing employment has declined at a monthly pace of 589,000 since July. This report, historically a good indicator of labor market trends, raises a legitimate concern that labor market conditions may be even worse than the *payroll* survey suggests.

The seeming divergence between the *payroll* and *household* data, both *lagging* indicators, suggests looking beyond them for better guidance to *initial jobless claims*, which has proven to be a more reliable predictive indicator of future labor conditions. Currently, these figures show claims to have dropped by 20,000 to 502,000 in the week-ended November 6, the fewest claims in 10 months. Note that earlier this year, weekly jobless claims exceeded 675,000. Similarly, announced layoffs monitored by Challenger, Grey, & Christmas have retreated to near-fractional levels. This trend continues to validate a wide range of positive market-based signs ranging from shrinking risk premia and improving liquidity measures to rising asset prices. As financial stresses are further relieved, so too should real economic strains begin to subside and employment recover.

Interestingly, labor market analysts believe only a further 5% fall in *jobless claims* would be consistent with stable employment. This shapes our conclusion that the disparity among various labor market indicators is not likely to persist for long with employment growth likely to resume by next spring and the unemployment rate peaking at about 10.4%. In the meanwhile, over the short term, lingering job market weakness will not preclude moderate GDP growth. Over the intermediate term, increases in production to meet current demand will, in turn, press firms to increase labor inputs (in terms of both hours worked and headcounts) as productivity is stretched further.

Beyond the labor market, a number of forward-looking indicators suggest a global revival in manufacturing. The most reliable of these metrics are as follows:

1. The US Institute for Supply Management's (ISM) manufacturing index rose 3.1 points to 55.7 in October, the third straight month of growth and the highest level since April 2006. Recall that a reading above 50 indicates expansion for this sector. Moreover, the ISM's employment index rose for the first time in 15 months as manufacturers recalled furloughed workers or

enlisted temporary help to meet expectations of strengthening demand for their products. Manufacturing expansion at October's pace would correspond to a 4.5% annualized increase in overall GDP growth.

2. Surveys of purchasing managers around the world similarly showed most major global economies growing in October. In the euro zone, the factory sector expanded for the first time since May 2008, with France posting its biggest increase in nine years and the UK showing its strongest growth in two years. Australia produced a third straight monthly increase, while China's manufacturing sector grew for the eighth straight month and at the fastest pace in a year-and-a-half.

3. US business productivity grew at its fastest clip in six years in the third quarter, according to a Labor Department report, suggesting the labor market may soon bottom out. Productivity surged at a 9.8% annual rate, as companies squeezed more output from a smaller pool of workers to hold the line on costs. We doubt the rapid growth in productivity, which measures the hourly output per worker, can be sustained, implying businesses will need to step-up hiring to meet rising demand.

4. Orders placed with US factories for durable goods rose in September for the fourth time in the past six months. The increase in bookings for goods meant to last at least three years is a further sign manufacturers are increasing production to replace depleted inventories.

5. US industrial production in September rose 0.7% -- more than three times forecast -- following gains of 1.2% in August and 0.9% in July.

6. Capacity utilization, which measures the proportion of plants in use, climbed above 70%, the highest level in seven months.

Looking past manufacturing, the ISM index of non-manufacturing businesses, which accounts for about 90% of GDP, came in at 50.6 in October continuing to signal expansion. October's positive reading marks the first back-to-back expansion in non-manufacturing industries since the two months ended May 2008.

HOUSING

Housing is where the economic downturn began and a sustained turnaround in this sector will be important evidence the economy is moving in the right direction. Despite the large inventory of unsold homes in highly publicized, overbuilt areas such as Las Vegas, San Diego, South Florida, New Jersey, and parts of Arizona, foreclosure driven price cuts, tax credits for first-time buyers and near record-low borrowing costs for qualified borrowers have helped home sales and construction to turn the corner after hitting extraordinarily depressed levels earlier this year. For example:

1. Home prices in 20 of the largest US cities rose in August for the third consecutive month according to the Case-Schiller home-price index, which rose 1.0% following a 1.2% increase in July. From a year earlier, this gauge was down 11.3%, less than forecast and a large improvement from earlier this year when it showed 18.0%+ year-over-year price declines.

2. Existing home sales in August stood at a 5.1-million annual rate, the second highest level in the last 23 months.

3. The number of unsold homes on the market dropped 11.0% to 3.6-million in August. At the current sales pace, it would take 8.5 months to sell those homes, the shortest period since April 2007, compared with 9.3 months at the end of the prior month.

4. The homebuilder confidence index stood at 18 in October, the highest reading in a year according to the National Association of Home Builders.

5. Sales of new homes reached a 429,000 annual pace in August, climbing in six of the last seven months. The extension of and enhancement to the $8,000 tax credit is expected to underpin the consumer demand into the new year.

So much for the good housing news. The less favorable points include the following.

1. The overall stock of vacant property, whether for rent or for sale, remains extremely high.

2. Housing affordability has improved, but mortgage availability is difficult for those without good credit scores and substantial down payments. In addition, a major wave of mortgage rate resets will hit over the next two years, threatening to unleash another wave of delinquencies and foreclosures.

3. As far as prices are concerned, the slide appears to be over, but there is no assurance a sustained turnaround has taken place.

So, housing has bottomed in terms of activity, but the pace of recovery from the current depressed levels will be slow and depend upon how well the Fed's easy monetary policy can overcome the headwinds of banks' reluctances to lend.

FORECAST

While slow job growth, tight credit conditions, and diminished consumer confidence will cap the expansion for some time at a below-trend rate, inventory restocking, massive fiscal stimulus, monetary ease, export growth driven by a weak dollar, rising asset prices, and the housing rebound will underpin the tepid advance. We expect GDP to expand between 3.00% and 3.25% for the second half of this year and between 2.75% and 3.00% next year. Inflation will remain a non-issue as substantial resource slack is likely to continue to dampen cost pressures and longer-term inflation expectations remain subdued. From its peak of 10.4% early next year, we expect unemployment to remain above 9.0% through 2010. Both our firm's proprietary Economic Model (attached) and the Conference Board's Index of US Leading Economic Indicators (LEI) continue to advance, capping the longest stretch of gains since 2004 and signaling expansion for at least the next six to nine months.

As for interest rates, the Fed has restated its intention to keep rates "exceptionally low" for an "extended period" despite the pick-up in business. They will have a tough job trying to determine when the recovery is strong enough to become less accommodative. A combination of signs of rising resource utilization, rising inflation trends and any destabilization of inflation expectations will trigger a tightening response by the Fed. If conditions play out as we see them, we would expect Federal Reserve monetary policy to begin to shift toward less accommodation next summer and that discussions in Congress on ways to reduce the fiscal deficit through higher taxes and other measures will become both more timely and more intense during the same time frame, not withstanding

conventional wisdom that it would be politically unwise for the Fed to tighten credit until following next year's congressional elections.

When trying to gauge the outlook beyond next year, one must bear in mind the fact the post-Lehman collapse in growth was truly extraordinary in breadth and magnitude as was the resultant destruction in asset values. Appropriately, this triggered the unprecedented policy response we detailed in previous client letters. The root causes for the collapse are seen as falling in several areas including: (1) massive global financial imbalances and the associated flood of cheap capital (i.e. the Yen carry-trade) from Asia into the US; (2) flawed incentives for lenders that underpinned the credit-driven housing boom; (3) failure by regulators to recognize and arrest the growing risks being taken by financial institutions; (4) complacency on the part of central bankers regarding the appropriate response to credit market over-expansions, and; (5) a pandemic of greed.

INVESTMENT OUTLOOK AND POLICY

We have been through a catastrophic economic and financial meltdown. Authorities have made only limited progress in dealing with the underlying excesses that were to blame for the crisis. Looking further ahead, we are likely to experience an extended period of credit restraint, further deleveraging by both households and business, uncertainties regarding rising marginal tax rates, government re-regulation of the financial sector, and a myriad of other uncertainties which will tend to dampen business activity and investors appetites for risk-taking.

As for *fixed-income* policy, 10-year US Treasury bond rates are expected to remain range-bound between 3.0% and 4.0% through next year. Since we expect longer-term bond yields to move higher as inflation expectations rise, we are maintaining bond portfolio average durations below 4 years. High quality, marketable, intermediate-term corporate bonds should continue to outperform US Treasuries next year. US Treasury Inflation Protected Securities (TIPS) have been purchased in most portfolios since the beginning of this year and constitute the bulk of clients' Treasury exposure. Over 80% of clients' fixed income holdings remain in corporates or, where appropriate, municipals.

The multiple-expansion phase of the *stock market* recovery is nearing an end. At 15.2 times 2010 estimated S&P 500 earnings of $72 per share, stocks are no longer cheap but not terribly overvalued either. A further, sustained stock market advance will require continued earnings improvement which we expect to play out over the

next phase of the expansion. Corrections of 10.0% to as much as 15.0% are likely and should be expected as normal following the events of the past year.

Discretionary, tax-free equity portfolios under our supervision remain meaningfully ahead of the benchmark S&P 500 stock index for the year-to-date. Portfolios remain well diversified with above-market concentrations in economically sensitive groups such as technology, consumer discretionary, and diversified industrials. Weightings in health care and energy (earlier market underperformers) have been increased. Underweighted sectors include utilities, telecom services, consumer staples, and services and media.

Equity portfolios also include allocations, to which we have been adding, of exchange traded funds (ETFs) which invest in companies domiciled abroad, including the emerging markets. These holdings now approach 12% of the equity portfolio in many accounts as we expect growth abroad, particularly in the Asian emerging markets, to exceed that of growth domestically.

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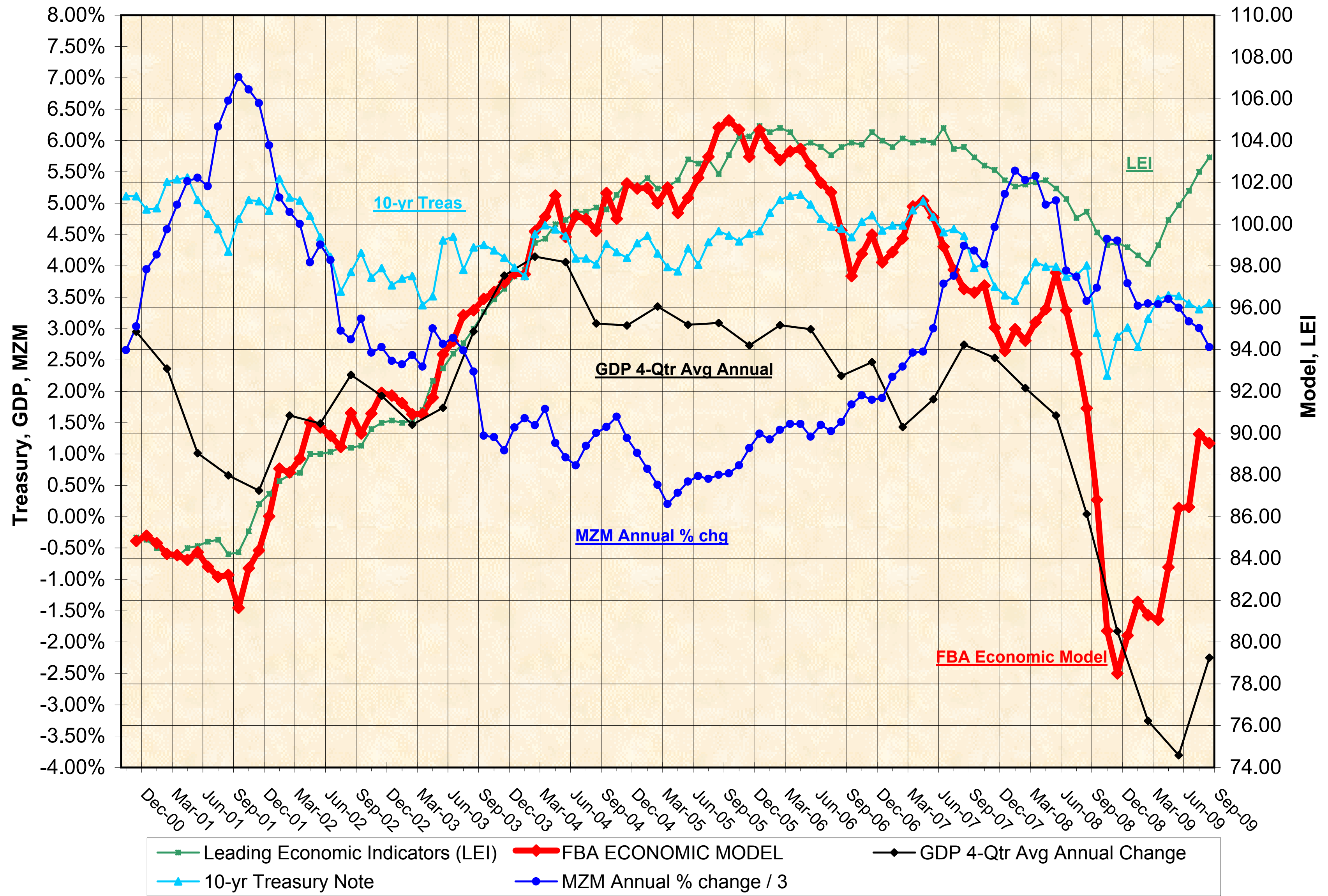
Front Barnett Associates LLC
Economic Model



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