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July 12, 2012

# ECONOMIC UPDATE - - MISSING ANIMAL SPIRITS

At midyear, our readings of the US economy show GDP growth to have moderated from the first quarter's 1.9% rate, with very slow employment growth, and easing inflation due to lower energy and other commodity prices. Recent evidence of overall slowing, while concerning, has likely been overly dramatized by the media as earlier pent-up vehicle demand is leveling off and the effects of a mild winter have exaggerated swings in hiring. Housing is bottoming, and in some key areas, (i.e. Miami, Phoenix, Seattle, Dallas) construction is actually growing again. Interestingly, nearly 10% more existing homes were sold in May than in the same month last year, and surprisingly, the inventory of existing homes for sale has fallen to close to the normal level of six months' worth of properties. And, consumers, who account for two thirds of GDP, are benefiting from falling fuel prices that will add about $75 billion to discretionary income.

Nevertheless, June's disappointing increase of just 80,000 jobs, only slightly better than the paltry 77,000 positions added in May, is yet another indication of the economy's still fragile recovery. Last Friday's monthly Labor Department report provided further, clear evidence that job growth has slowed markedly from earlier this year, when, on average, over 200,000 jobs were being created monthly. The US has gained just 225,000 jobs in the past 3 months combined, making it the weakest quarter of employment growth since the labor market began to recover in early 2010, and the weakest monthly showing in 10 months.

The weak Labor Department report echoes other data showing decelerating economic growth. For example, the Institute for Supply Management's (PMI) factory index fell to 49.7 in June from 53.5 a month earlier. (Recall that readings of less than 50 signal contraction in manufacturing. A PMI over 42.6 indicates an expanding *overall* economy.) The June reading showed manufacturing shrinking for the first time in almost 3 years. Abroad, manufacturing is also weaker with factory output contracting in the euro-area in June for the 11th consecutive month.

Adding to the generally weaker picture, surveys show business confidence in the economy has been waning. US small companies' confidence dropped in June to its lowest level since October according to the National Federation of Independent Business' (NFIB) Optimism index which fell to 91.4 from 94.4 in May, the biggest monthly decline in two years. Last month fewer company owners said they would hire, invest in new equipment or expand their businesses than in May. The decline in small business sentiment probably means employment growth will remain slow as employers overall are relying on existing workers and temporary hires to avoid growing their payrolls in the face of looming tax and healthcare benefits uncertainties.

## FORECAST

In light of the slump in jobs growth, and other factors noted above, we expect the US economy to continue to expand but only moderately in the next two quarters, in fits and starts, at a slightly slower pace than forecast earlier. Retail sales are likely to be more subdued. Personal income will grow more slowly. Government spending at all levels will show a bit more restraint than previously forecast and net exports will be weaker than previously projected due to the deepening European recession and slower growth in China. The expansion will be supported by highly accommodative monetary policy globally. The forward looking Institute for Supply Management's (PMI) index of non-manufacturing businesses, which covers about 90 percent of the US economy, eased to 52.1 in June from the prior month's 53.7, signaling slower but continued expansion. Increases in consumer outlays are forecast to grow at a 2.0% to 2.5% rate. Factory output is expected to rebound modestly as orders placed with US manufactures rose 0.7% in May, the first increase in 3 months, somewhat easing our concern that manufacturing is faltering. In addition, housing has bottomed and energy prices are falling adding to consumers' ability to spend in the face of slim wage increases. Business fixed investment in shorter-lived assets is also likely to support the moderate GDP expansion of 1.75% to 2.0% we see during the next few quarters. The unemployment rate will probably remain above 8.0% through year-end. Inflation is subdued and expectations are well anchored.

Confirming our top-down forecast, our firm's proprietary Economic Model continues to signal expansion as do the Leading Economic Indicators (LEI). Our firm's Economic Model has had an unblemished record, since its formulation in 1994, of calling changes in the direction of the economy at least six months in advance of such shifts.

## ESCAPE VELOCITY

It's troubling that after three years of recovery, the US economy has failed to reach what economists call "escape velocity" - - the rate of improvement a slow-growing economy must achieve to move beyond fits and starts and into a durable expansion. Clearly, with the economy growing slowly, any further shock(s) could tip the fragile recovery into a recession. For example, should Congress fail to avert the year-end "fiscal cliff," the resulting scheduled spending cuts and tax increases will shave 1.5% from GDP.

In our view, the most important reason this recovery has been subpar is that there has been a serious loss of public confidence in the stewardship of both the administration and Congress. Their seeming inability to learn from their mistakes in dealing with last year's debt ceiling crisis, their procrastination in resolving the spending and tax policy issues we face at year-end, and, their inability to craft a credible long-term, pro-growth fiscal plan have eroded confidence to the point which people are very reluctant to spend and invest. In short, the "animal spirits" that normally drive a more vigorous economic revival are largely absent this time around.

Obviously, US election uncertainties, continuing deleveraging and concerns over Europe and China have dampened businesses willingness to take on added risks. In fact, the ratio of cash on the balance sheets of US corporations to their investments in long-lived assets (i.e. structures) is at the lowest point it has been since 1935. Perhaps less obvious is that while housing is finally turning around, its improvement is not yet sufficiently broad-based nor vigorous enough to lift the overall economy as single family housing starts remain 60% below their prior peak.

Some of these uncertainties will naturally disappear with the passage of time. Others are structural, demanding difficult policy decisions which will require patience and the political will to resolve them. The clearing of any one or more of these issues could buoy confidence, unleash some animal spirits, and help the economy achieve "escape velocity."

## CHINA

A decline in economic growth in China, (which accounts for 12% global GDP) from 10% + a few years ago to about 7.3% currently is being countered by new, aggressively stimulative fiscal and monetary policies. The 0.6% decline in consumer prices month-over-month in June and tame 2.2% increase year-over-year provide room for further monetary and fiscal easing. Following last week's rate cut and the lowering earlier of bank reserve requirements, we expect further monetary accommodation shortly. In addition, state spending is being ramped-up to counter China's sharpest decline in growth since the 2008 financial crisis. Premier Wen Jiabao recently reiterated the goal of "stimulating consumption" as being his "main task" prior to the government turnover this fall, and announced the approval of construction of two new steel plants and increased the pace of approval for wind-power projects. These policy measures should be a catalyst for growth to recover in the second half and for a rebound in the Chinese stock market which has underperformed most emerging markets over the past year.

## FED POLICY

Friday's disappointing jobs report increases the likelihood the Federal Reserve will launch a new bond-buying program this fall in order to promote what they have termed a "sustained improvement in labor market conditions." While the jobs numbers were probably not weak enough to spur the Fed to take more vigorous action when it next meets, this third month of tepid jobs growth provides the Fed with sufficient justification to ease further should weak employment growth continue through the summer and/or if Congress fails to avert tax hikes and across-the-board spending cuts that will kick-in at year end. Clearly, the adverse impact of an escalation of Europe's debt crisis on the US financial system will also be factored into future Fed decisions, if necessary. That said, with rates already at historically low levels, it is unlikely that further Fed easing will materially impact rates although a further slight flattening in the yield curve may take place over the summer as investors anticipate QE3. Low US Treasury yields will continue to be supported by investors seeking the safety of dollar denominated US Treasury bonds as well as low inflation expectations.

## FIXED INCOME INVESTMENT STRATEGY

The fixed income portion of clients' portfolios remains invested in high quality corporate and, where appropriate, municipal bonds laddered out to 3 years, with durations of about 1.8- - well below the benchmark. The proceeds of maturing bonds are being reinvested in other high quality corporate bonds. The obligations of financial companies are currently viewed as most attractive. US Treasury and agencies are overvalued, in our opinion, and are largely absent from portfolios. TIPS (US Treasury Inflation Protected Securities) were eliminated last year reflecting their unattractive prospective returns.

## EQUITY INVESTMENT STRATEGY

US equities have been volatile but resilient year-to-date despite the foregoing economic and political uncertainties. On a relative basis, stocks have performed well as shown in Table I.

TABLE I

| ASSET CLASS | % RETURN * 12/31/11 – 7/11/12 | ASSET CLASS | % RETURN * 12/31/11– 7/11/12 |
|---|---|---|---|
| US EQUITIES | | COMMODITIES | |
| NASDAQ Composite | +10.50% | Gold | +0.01% |
| S&P 500 | +6.36% | CRB Index(Commodities) | -4.75% |
| US Small Cap | +6.31% | Natural Gas | -12.88% |
| | | Oil (West Texas Intermediate) | -13.9% |
| FOREIGN EQUITIES | | | |
| Developed Markets (EFA) | -1.77% | | |
| Emerging Markets (EEM) | -2.10% | | |
| FIXED INCOME | | | |
| Lehman Intermediate Bonds | +2.84%** | | |
| Lehman Municipal Bonds | +1.80%** | | |
| US Treasury Bills | +0.02%** | | |

*Principal Change
**Total Return

Looking ahead, we believe stock valuations, now at about 12.9 times forecast S&P earnings of $104 per share for 2012, remain attractive - - well below the 15 times mean multiple of the past 20 years. Other measures of valuation we monitor confirm stocks to be statistically undervalued. When compared with yields on short term instruments and bonds, expected returns from stocks are significantly higher.

Despite the certainty of periodic market corrections of 5% to 10%, client's equity portfolios are generally fully invested relative to their maximum target allocations. We continue to emphasize companies likely to benefit from moderate economic growth, favoring *growth* over *value* shares. Banks, selling at a fraction of their tangible book values, represent the largest exposure among *value* shares held.

Beyond our exposure to US equities, our investment platform includes both developed and emerging market equities, currently weighted more heavily toward the more rapidly growing merging market segment.

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