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ECONOMIC UPDATE - - FINALLY FOCUSING ON THE FISCAL CLIFF

With the election over, it's certain the nation's political leadership will not change significantly, arguing against a sudden burst of bi-partisanship. This, despite the findings of a recent Wall Street Journal / NBC News poll showing 75% of participants want congressional leaders to compromise on the crucial fiscal issues facing the nation. So, post election, President Obama and congress must find a way to avoid the looming fiscal cliff and then put in place policies to encourage international trade and maintain the nation's security while boosting economic growth and job creation; a tall order, indeed, in the wake of the poisonous political environment of the past two years.

The most pressing immediate issue, which is not new news, will be avoiding the fiscal cliff. Should congress fail to act, the Bush-era tax cuts will expire at year-end. At the same time, federal spending cuts will begin. The Congressional Budget Office (CBO) estimates the economy could contract 0.5% and unemployment may rise to 9.1% next year if the tax increases and spending sequestrations occur as scheduled.

In our view, the most likely scenario to play out before year-end or early next year would be for congress to find acceptable middle ground that will include more modest tax increases and spending cuts unlikely to create an economic drag sufficient to put us into recession in 2013.

Following the President's and House Leader's statements last week, we expect both political parties to evidence a willingness to cooperate in an effort to address their policy differences. Both sides understand the need to compromise. Failure to act would create a further depressant to an already weak economy, permanently tarnishing the reputations of those involved. The stock market's weakness immediately following the election has added to the urgency to produce a balanced compromise. Absent significant progress in avoiding the fiscal cliff during the lame duck session, congress is likely to pass a temporary extension of the fiscal cliff issues, allowing the new congress to craft the final deal. The President has promised the leadership required to bring this process to a successful conclusion. Stay tuned!!

THE ECONOMY

Recent economic data show the US economy is continuing to recover slowly. Housing is finally showing signs of life: New housing starts are increasing, the rate of existing home sales is rising, and home prices are higher than a year ago in most markets, drawing in fresh buyers. The supply of unsold homes has fallen sharply, and mortgage applications are up. Led by robust auto sales, consumer spending, which accounts for two third of GDP, is growing at a satisfactory 2% rate. The Institute for Supply Management (ISM) manufacturing and non-manufacturing indices - - highly reliable forward-looking indicators - - are now signaling expansion following weaker readings this spring and summer. Consumer confidence reached a 5 year high in November, improving the prospects of larger spending gains that will help spur the recovery. Recent positive readings of our firm's proprietary Economic Model, as well as the Leading Economic Indicators (LEI), confirm a recession is not currently in the cards.

Based upon the foregoing, we expect the US Economy to expand at a 2% - 2.5% annual rate next year with consumer expenditures, business investment and housing offsetting the drag of some tax increases and spending cuts. It is also possible that businesses might be willing to part with a portion of the $1.7 trillion of cash they hold on their balance sheets - - unleashing the "animal spirits" necessary to jump start a more vigorous expansion - - should congress produce a fiscal plan that clarifies tax and spending policies. Since inflation is likely to remain benign, unemployment unacceptably high and industrial capacity utilization low, the Fed will persist with its highly accommodative monetary policy for the foreseeable future.

INVESTMENT STRATEGY

Given the policy uncertainties, the US stock market is likely to remain volatile until the fiscal cliff issues are resolved, although share prices are likely to be supported by positive seasonality this month and in December if market participants see congressional leaders working constructively to find common ground and a balanced deal. The Federal Reserve's accommodative monetary policy will provide a further underpinning to share valuations. While a 5%-10%+ pullback would not surprise us, US stocks are attractively priced at about 13 times

S&P 500 2013 earnings and are likely to produce higher returns than those expected from high grade bonds or cash equivalents. Client's equity portfolios are, therefore, fully invested relative to their maximum target allocations. Our core stock portfolio is tilted toward shares of *growth* companies which, in a period of subpar GDP growth, should be better able to deliver rising dividends and share repurchases. Equity investments abroad are more heavily weighted toward emerging market holdings where secular growth trends are expected to exceed those of developed market countries.

Bond portfolios remain conservatively structured with short, laddered maturities reflecting our concern the combination of profligate government spending and loose monetary policy will eventually lead to rising inflationary expectations, depressing bond prices. Bond portfolios are targeting a 1.8 duration, well below the benchmark.

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As we approach year-end, we at Front Barnett wish you and yours safe and enjoyable holidays.

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