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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ECONOMIC UPDATE - - FED POLICY: HAWKS AND DOVES

Judging solely from the stock market's euphoric reaction to the April employment report, which showed the addition of 165,000 new jobs, you might conclude the economy gained 350,000 jobs last month. Yes, the number of new positions exceeded Wall Street's muted expectations as the unemployment rate fell to 7.5% and the February and March jobs gains were revised up by a total of 114,000. But, under more normal conditions, four years into an expansion, you would have expected far more new jobs to have been created than we have seen and better than the 2.5% of real GDP growth recently reported for the first quarter of the year. Perhaps the stock market's giddy bounce was a "relief rally" responding to what some had feared would be a terrible report on top of the dismal 88,000 new jobs originally reported for the month of March.

The good news in April's better-than-expected employment report and revisions is that the pessimistic end-of-the-world forecasters were wrong again, giving under-invested market mavens waiting for a "correction" reason to throw in the towel and bulk-up on stocks. The downside to the report is that the US economy's performance continues to fall further and further behind its long-term trend for jobs and economic growth. Recently, hours worked, an important labor metric, has begun to fall. The April employment report showed a 0.2 hour decline in the average work week to 34.4 hours as 329,000 people worked part-time rather than full-time - - the most for an April in six years. Also worrisome in the employment report is the fact that total private hours worked are declining, falling 0.4% with manufacturing hours dropping 0.2%. Aggregate hours worked for all employees also fell 0.4%. Our concern is that these trends could be a harbinger of the unintended consequences of new government health care regulations in which rising tax, mandate and regulatory costs penalize companies for the 50th worker hired and the 30th hour worked in small businesses. Fearing these new burdens, profitable businesses may be reluctant to invest in the kinds of capital projects that create jobs.

70 West Madison Street • Suite 4920 • Chicago, Illinois 60602-4208
(312) 641-9000 • FAX (312) 641-9009

When viewed in a longer term perspective, despite the four year expansion, non-farm payrolls remain 2.6 million below the peak reached in January 2008. A total of roughly 22 million people remain either out of work, underemployed or forced to work only part-time. And, in part because people are dropping out of the labor force or collecting government benefits rather than work, the employment-to-population ratio, which peaked at 64.6% in April 2000, has dropped to 56.8%. That translates into a cumulative loss of roughly 10 million jobs from the long-term trend-line - - a huge waste of human capital and talent, as well as diminished economic growth.

Beyond the employment situation, the anemic 2.1% real GDP growth of the past 15 quarters has thus far created an output gap of roughly $3 trillion according to economists. The US will need to grow GDP at more than a 5.0% yearly rate for over a decade to close that economic gap. While a 5.0% growth rate would be a stretch, we can take steps to improve the economy's performance with the right public policy decisions which create incentives for work, investment, innovation, immigration, and retirement savings. However, given our dysfunctional government, the chances of enacting a new growth agenda embracing these considerations are slim to none.

THE FED

So, recognizing the existing limitations to growth in the current environment, it appears investors have until now concluded that we will remain in a slow but steady expansion- - fueled in large measure by the Federal Reserve's ultra-accommodative monetary policy. The Fed is viewed as unlikely to take its foot off the gas pedal by raising interest rates until well into next year at the earliest as unemployment is forecast to remain above its 6.5% threshold until then and inflation is expected to remain quiescent, below its 2.0% target.

Beyond its interest rate decisions, the Fed must develop a strategy for winding down its unprecedented $85 billion-a-month bond-buying program which has added $3 trillion to its balance sheet. Financial markets are keenly interested in the Fed's exit strategy. Stocks and bonds rallied following the announcement in September that it would increase its bond purchases with the major stock market indices closing at record highs last week. An abrupt or surprising end to the Fed's unconventional program could drive bonds and stock prices down. Conversely, a delayed end might allow markets to overheat. The Fed's most recent statement on this subject earlier this month indicated it was "prepared to increase or reduce the pace of purchases" as economic conditions dictated, introducing a new element of

uncertainty. It gave comfort to both market "doves" who believe more aid for the economy might be needed as inflation has fallen well below the Fed's 2.0% objective, and to "hawks" who are convinced the economy is on track and are not concerned about inflation thus favoring an end to the program. Clearly, future Fed decisions will be dependent upon incoming economic data over the next several months. Bond purchases could be tapered if the economy shows signs of bouncing back from the spring slowdown, particularly if unemployment trends lower. Continued sluggishness would prompt the Fed to stay the course. Few economists expect the Fed to increase the amount of bonds it buys. In our view the economy will soon show signs of rebounding and that unemployment will drift-down toward 7.0% by year-end. There is, therefore, reason to believe we will see some reduction in the Fed's monthly purchases later this year. In any event, any change in the current Fed regime will be well-telegraphed to the financial markets to minimize bond and stock market dislocation.

THE INDICATORS

The boom in shale oil and gas production, dramatically improved manufacturing competitiveness versus Asia, the upturn in new home and auto sales and generally steady consumption are underpinning the current expansion, with business picking up in the second half as some of the fiscal headwinds abate.

Looking ahead, the high frequency, *forward-looking* economic indicators we monitor confirm the continuation of the expansion, albeit at a modest pace, following this spring's slowdown.

- *The Federal Reserve's April Senior Loan Officer* Opinion survey on bank lending practices, the single most reliable indicator of future business conditions we follow, showed that banks eased their standards and terms on loans to businesses while experiencing stronger demand in several loan categories. The fraction of banks easing standards for business loans was described as "relatively large." Clearly, the increased availability of bank credit for households and businesses is critical to continued economic expansion.

- While *The Institute for Supply Management's (ISM)* Manufacturing Index continued to signal expansion in its April report, the index fell to 50.7 from 51.3 the prior month - - the slowest pace in four months as across-the-board federal spending cuts began to impact manufacturing which accounts for about 12% of the economy. Readings of this index above 50 signal expansion.

- The *ISM Non-Manufacturing* Index also held above 50 - - the dividing line between expansion and contraction - - in April, decreasing to 53.1 from 54.4 in March. Service industries account for almost 90% of the US economy.

- *Factory orders* fell 4% in April as companies felt the effects of slowing growth in Europe, Asia and the US where higher taxes and across-the-board federal budget cuts have restrained consumer spending. It is widely believed that orders will pick up as manufacturers prepare for the improved demand expected in the second half of the year as employment strengthens, the fiscal headwinds fade, and global demand regains its footing.

- *Consumer sentiment,* as measured by the Conference Board, climbed in April to a five month high as gains in stock prices, an increase in property values and cheaper gasoline prices are helping to stabilize household wealth.

- While slipping a bit in April, the Conference Board's *Index of US Leading Economic Indicators (LEI)* continues to signal expansion in the months ahead.

- Mortgage applications rose for a fifth week as lower borrowing costs prompted the biggest increase in home refinancing in two months.

- *Initial Jobless Claims* have dropped sharply in the past two weeks, reaching the lowest level in more than five years, sending investors a reassuring message about the outlook for the jobs market. The four week moving average of claims, a less volatile measure, dropped to 376,750, the lowest level since November, 2007, the month prior to the onset of the "great recession". Initial jobless claims reflect weekly firing and tend to fall as job growth - - measured by the monthly non-farm payrolls report - - accelerates.

Concurrent and lagging economic indicators we have parsed in recent weeks show a slowing in economic growth early this winter and spring due to the combination of increased payroll taxes in January, poor weather, the effects of sequestration and weakness in exports to Europe. However, the most recent flash retail sales report is encouraging, showing an unexpected rebound in April. Not only were core sales stronger than most forecast, but there were large upward revisions to prior month's figures. GDP growth for the current quarter is now forecast to be below that of the first quarter, in the 1.75% to 2.0% range. As noted earlier, we expect a rebound in the US economy in the 2nd half of the year, bringing GDP growth for the full year to 2.0% to 2.5%+.

It should also be noted that our firm's proprietary *Economic Model,* (a copy of which is enclosed) which has accurately forecast six to nine months in advance each change in the *direction* of the US economy since the inception of our firm in 1994, continues to signal expansion. While not a stock market timing tool, the *Economic Model* has provided timely insights into the outlook which have helped shape our investment policy.

BEYOND THE FED

Abroad, central banks have been busy cutting interest rates. By our count, there have been a total of 513 reference rate reductions since 2007, the most recent of these occurring in Israel, India and Poland. Slowing global growth this spring, moderating inflation and the desire to thwart unwanted currency gains almost assure further monetary ease in the months ahead. While the liquidity created by these actions has sent stock markets surging, it has yet to prove effective in generating stronger economic growth. And with commodity costs in decline due to the strong dollar, the lackluster growth is also weakening inflationary pressures, forcing central banks to protect against further disinflation by cutting rates further. Meanwhile, in many countries, the notion of continuing the current *austerity* regime is running into strong headwinds as unemployment rates have reached alarming levels. Easing *austerity* measures, and adopting a more growth oriented approach to fiscal policy, particularly in the euro zone, is likely over the immediate term despite German opposition.

CHINA

China's economy has begun to show tentative signs of reaccelerating following the policy-induced slowdown in 2012 that brought GDP growth down briefly below 7.0%. China's exports and imports rose in April by 14.7% and 16.8% respectively, from a year ago, both stronger than market expectations. Construction equipment orders showed their first year-over-year increase last month and auto sales increased 19.7% from a year ago. Nevertheless, as inflation does not appear to be a short-term threat and the basis for a resumption of generally stronger economic growth is not yet assured, the PBOC is likely to continue with its accommodative policy, especially in a global environment of quantitative easing (QE) and rate cuts. The current PBOC policy stance should support investment and growth momentum in the next two quarters with GDP rising toward 8.0%.

JAPAN

Japan has stagnated for almost two decades. In the last four months, the nation's new Prime Minister, Shinzo Abe, has pushed policy makers and other officials to take aggressive steps to revive the economy. One bit of evidence "Abenomics" is working is a weaker yen which has fallen nearly 14% against the dollar this year. Normally, a weakening exchange rate would be taken as a sign of economic decline. But in Japan's case, it signals that policies put in place by Mr. Abe are beginning to work. A weaker yen makes Japanese exports more competitive. The most immediate impact of the weakened yen has been the boost in profits of the major exporters: Toyota has reported net income jumped threefold in the past twelve months, and Sony recorded its first annual profit in five years. Both companies are likely to post further profit increases largely because of the weaker yen. More important for the people of Japan, who have suffered from a long period of falling wages and prices, the yen's devaluation will trigger welcome inflation in the once moribund economy.

The Bank of Japan has taken aggressive steps to reinvigorate the economy and fight deflation. Rather than focusing on keeping overnight interest rates close to zero, which seemed to be having little effect in reviving growth, the central bank has targeted doubling the amount of money in circulation, seeking to produce annual inflation of about 2%. The efforts by the Bank of Japan to continue to flood the economy with liquidity is likely to keep downward pressure on the yen in the coming months. The Central Bank is following an asset purchase program to inflate the economy by buying longer-dated bonds and doubling its government bond holdings in two years. While the depreciation of the yen may stimulate some growth, the country faces many stiff challenges until it breaks out of its period of deflation, as an aging and shrinking population and cumbersome regulations make the economy inefficient.

Clearly, the weaker yen is good for Japanese exporters. However, it makes imports more expensive. That in turn can make selling foreign goods there more expensive and harder to move. Too weak a currency could bring dislocations to the country which is dependent on imports for its energy and food. The Fukushima nuclear crisis, which shut down Japan's nuclear power program, has already led to sharply higher oil and gas imports and rising energy prices. The key to the success of Abenomics will be how much exporters and other corporations buoyed by the weaker yen will pass on their windfall to consumers by hiring more workers and raising wages. If wages rise, then the return to inflation will be good news. Should wages remain flat or decline, the result will be stagflation. Ouch!!

FORECAST

All-in-all our view of the economic outlook is little changed since our mid-March client letter. Based upon available data, we expect the US economy to continue to expand at a moderate 2.0% - 2.5% pace this year. Growth in the second half is likely to pick up a bit following the weather-induced slowdown this winter and spring. Inflation is forecast to remain well below the Fed's 2.0% target and its 2.5% trigger-point for tightening. The Fed has pledged to remain accommodative until at least 2015. Don't fight the Fed! While corporate profits for the first quarter appear to have exceeded Wall Street's expectations by 6%, many companies' sales were flat providing little impetus for adding aggressively to employee payrolls. Well below-trend job growth, combined with only modest wage gains, will restrict gains in consumption which accounts for 70% of GDP.

US Treasury bond yields have been range-bound for the past several months, fluctuating between 1.6% and 2.0%. Currently, the 10 year US Treasury yields 1.92%. Over the coming three quarters, as the economy picks up, we expect the upper end of the range to expand to 2.25%+. The unemployment rate will decline only stubbornly, possibly falling to 7.0% by year end from 7.5% currently. Europe, now in recession, will show indications of stabilizing this summer and early signs of an upturn may emerge by late in the year. Rising economic activity in Japan and China should add marginally to global growth which we forecast to be about 3.0% this year.

INVESTMENT POLICY

In our view, bonds are generally unattractive given their low current yields and the risk of principal loss when interest rates rise. For example, should the rate on the 10 year US Treasury bond normalize, investors would experience a 25% loss of principal from current price levels. US Treasury obligations are uniquely overpriced due to Fed monetary policies and should be avoided. Durations of clients' laddered bond portfolios, at all time lows, are being managed with the goal of principal protection.

With regard to equities, we believe a *globally diversified*, opportunistic, strategy that focuses on quality and growing income generation remains the best approach for long-term growth of capital. The road to global economic recovery, while bumpy, will continue. Stock market advances are not linear. Periodic corrections of 5% + are to be expected. For example, a perceived possible change in the Fed's

bond buying program, a spike in government bond yields or an unexpected exogenous stock could precipitate a temporary pull-back. Fundamentally, despite the strong equity market advance since last fall, we believe large cap US equities remain attractively valued at about 14.5 times earnings given their strong cash flow generation and solid balance sheets. Other metrics of stock market valuation we follow confirm the statistical attractiveness of US equities.

As to the supply and demand for equities, given the lack of quality alternatives offering competitive yields, we expect individual and institutional investors who remain under-committed to equities to raise their allocations to stocks providing an underpinning to share prices. Corporate share repurchases, M&A activity, purchases by foreigners seeking the perceived safety of the US dollar and the US financial markets, purchases by foreign central banks and sovereign wealth funds and a dearth of stock splits will also add to the demand for US equities lending credence to the view equities could become *scarce* as the bull market plays out.

Finally, analysts at the Federal Reserve Bank of New York have recently analyzed 29 separate economic models finding that most predict extremely high stock returns for the next five years "mainly due to exceptionally low US Treasury yields at all foreseeable horizons". This may be the prevailing view among analysts but mutual fund flows suggest the great mass of investors have not yet acted on it. In fact, over the last seven years, mutual fund investors worldwide have poured a net $1.1 trillion into bond funds while liquidating $900 billion of stock fund investments. In the US, while investors began moving some money back into stock funds in January, they poured significantly more into bond funds - - $85.4 billion compared with only $73 billion into equity funds. And in the week ending May 1, the Investment Company Institute's (ICI) preliminary figures show the outflow from stock funds had resumed, with a net withdrawal of $4.4 billion. Clearly, individual investor's portfolios remain heavily allocated to fixed income securities suggesting there is ample fuel for further stock market rallies.

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Front Barnett Associates LLC
Economic Model
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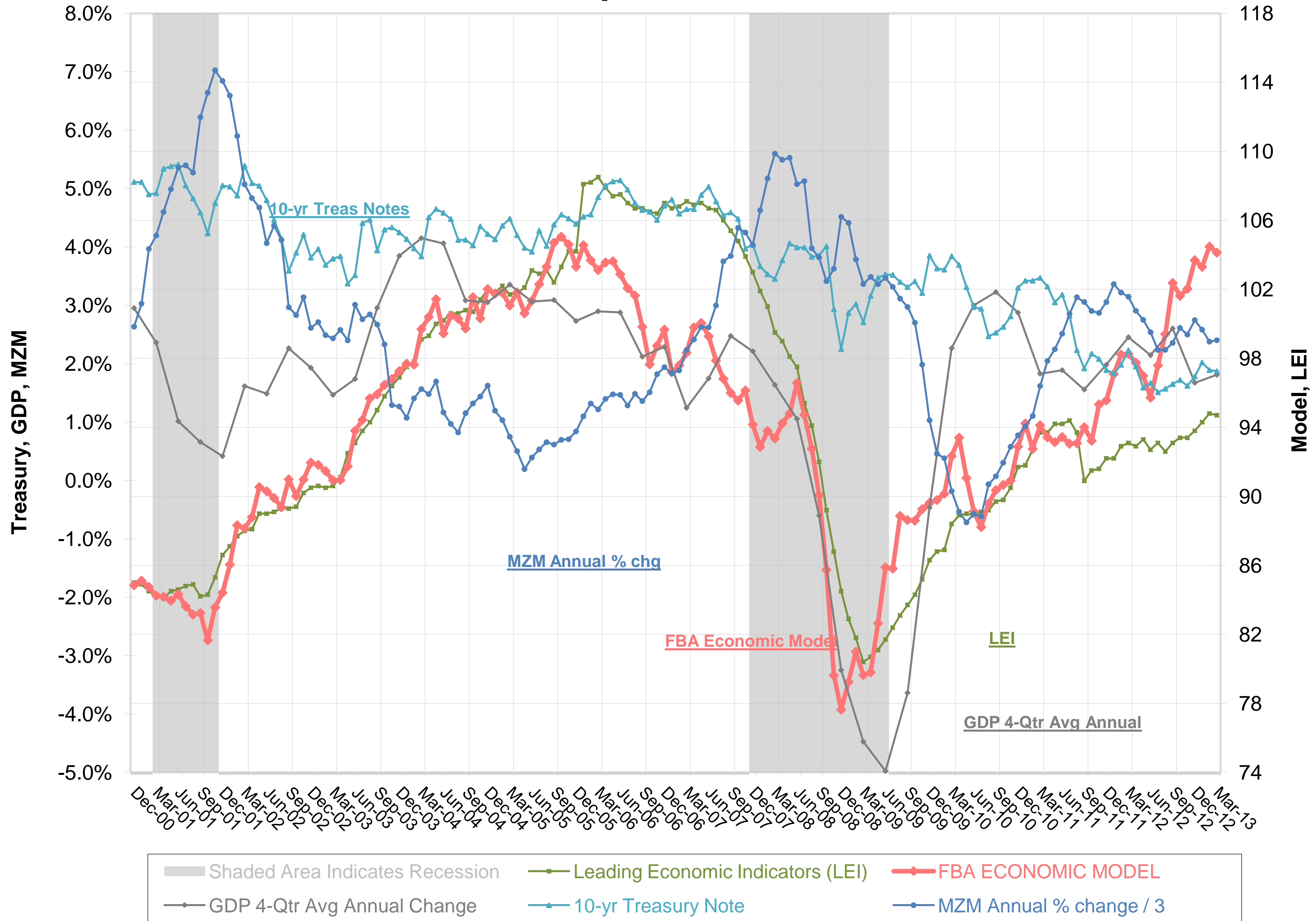

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