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ECONOMIC UPDATE - - SLOWING HEADWINDS

The US economy's performance is best described as slow, but steady. Economic growth is being held back by dysfunction in Washington and, recently, the 16-day government shutdown. On the other hand, the recovery is being supported by pent-up demand for autos and housing, the energy boom, firming demand for manufactured exports and the Fed's highly accommodative monetary policy.

On the plus side, reports last week showed monthly employment growth had risen sharply to 202,000 during the last three months, up from the 146,000 average for the prior three month period. Among the most encouraging aspects of the employment report were upward revisions to prior government estimates of job growth in August and September, before the government shutdown, easing worries about a renewed slowdown in the labor market. Despite these improved employment figures, the economy is barely creating enough new jobs for those entering the labor market. At the recent pace of hiring, the economy will not return to pre-recession levels of employment for another six years, adjusting for population growth.

Beyond the impressive jobs report, other US data highlight some weakening in critical areas of the domestic economy. Preliminary third quarter GDP figures released last week showed consumer spending, which accounts for about 70% of the economy, at one of its slowest paces of the five year economic recovery, increasing only 1.5%. This slowing is reflected in weak consumer confidence figures reported recently. Earlier readings had consumption growing at about twice that rate. Businesses also cut back on equipment purchases for only the second time since 2012, reflecting very cautious investment attitudes. In addition, a close examination of the quarter's better-than-expected GDP report, showing growth of 2.8%, reveals a sizable build-up in business inventories which, absent a pick-up in final demand, risks holding back production in the current quarter.

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Despite the mixed picture painted by these key reports, we and others, including Federal Reserve officials, have been expecting a pickup in growth as the fiscal headwinds caused by tight federal spending and this year's tax increases begin to abate. Recently released *forward-looking* economic data support this view:

- The Institute for Supply Management's (ISM) non-manufacturing index for October increased to 55.4 from the prior month's 54.4. A reading above 50 signals expansion. The data indicate companies were looking beyond the political infighting that closed the US government for half of October. From July 2009, a month after the last recession ended, through September, the index had averaged 53.9. This index includes industries that account for 90% of the economy.

- The ISM's manufacturing index expanded at the fastest pace since April 2011, a sign corporate purchasing managers were gaining confidence in the outlook for sales.

- Factory orders increased 1.7% in September, the strongest monthly showing since June, up 3.0% from September 2012.

- September durable goods orders rose 3.8%, a healthy 7.8% above the report a year ago.

- The Federal Reserve's October Senior Loan Officer Opinion Survey on Bank Lending Practices, released on November 4, showed domestic banks eased their lending standards for commercial and industrial loans. History has shown that easing lending conditions are a reliable precursor to stronger business spending with a 9 month lag.

FORECAST

Looking ahead, we expect the pace of GDP to quicken in the new year. GDP growth has been about 1.5% over the last four quarters despite a close to 2.0% fiscal headwind, suggesting underlying growth has been about 3.5%. In 2014, the fiscal drag from reduced spending and higher taxes is expected to fall to about 0.5% implying an acceleration of GDP to 3.0% if, as we assume, underlying growth remains unchanged. In simple terms, absent additional fiscal austerity and further confidence shocks, the economy and corporate profits will trend higher next year driven by an increase in consumer spending, and a pick-up in capital expenditures.

Meanwhile, inflation remains well below the Fed's target. Core PPI and CPI both rose a benign 0.1% in September. CPI inflation is running at about a 1.3% annual rate. The Fed's target of 2.0% for its preferred gauge of inflation, the Personal Consumption Expenditure deflator (PCE), translates into about a 2.3% target for the CPI. So, with inflation well below where the Fed would like it to be, and unemployment unacceptably high, the Fed is likely to extend its QE bond purchases into next year and to maintain its highly accommodative monetary policy well into 2015, and perhaps into 2016, depending upon incoming data.

CHINA

The Communist Party of China (CPC) has pledged to implement major reforms prior to 2020. The 3rd Plenary Session (3PS) of the 18th Party Congress has stated that the ultimate goal of deepening reform is to improve and develop the socialist system with Chinese characteristics, and to modernize the state governance structure. While the details of the reforms are likely to be revealed only over the months ahead, the core of the economic reform will be to redefine the relationship between government and the market with the market playing a "determinative role," different from a "basic role" in the past, in allocating resources. Clearly, China's current economic model, and by extension, its political and social model, is reaching its limits, so reform is imperative in the world's second largest economy.

Broad areas of reforms have been mentioned, though details are lacking. Government reform, fiscal reform, income redistribution, price reform, financial reform, medical reform, environmental policy reform, and the one child per family policy, *hukou,* are all on the agenda of the CPC *lead group* which will design the framework of reform and oversee the reform process over the next 7 years.

The reform process will introduce more market and competitive mechanisms while giving Beijing greater control over the overall structure. The government hopes that by disengaging from constant, restrictive intervention into certain sectors, it will have greater capacity to intervene selectively, focusing on enforcement and compliance rather than dictating every move of state-owned enterprises. There is no guarantee these reforms will work or that they can be implemented effectively or successfully to create a more nimble and adaptive government. In our view, though, the new Chinese leadership has no choice but to recognize the current complex consensus system and entrenched bloated bureaucracy are at the end of their effectiveness and that significant, far reaching reforms are necessary. The

hope is these reforms will boost demand while fiscal, financial and land reforms could enhance investment efficiency over time.

EQUITY INVESTMENT POLICY

Currently, with interest rates on high quality short-term obligations near historic lows, and bond prices likely to fall as open market rates drift higher, stocks remain the vehicle of choice among marketable securities in our view. Despite periodic warnings from some market savants, and the probability of a 5% – 10% correction along the way, we fail to see the classic signs of excessive stock market speculation that would cause us to adopt a more cautious longer-term attitude toward equities. Largely absent are:

- Heavy inflows into equity mutual funds and stock ETF's;
- A big pick-up in Mergers and Acquisition activity;
- A spike in Initial Public Offerings;
- Weakening upward earnings revisions;
- Erosion in the number of stocks making new highs;
- A sustained shift toward defensive leadership;
- Widening credit spreads.

While stocks are unlikely to soon repeat their recent excellent relative and absolute performance, the current benign "macro" landscape should allow for gradually expanding valuations. Monetary policy will remain highly accommodative with short term rates near zero for the next 1 to 2 years. Open market indicators such as the decline in precious metals prices, the steepening yield curve and rising equity prices are signaling the US stock market has further room to rise. An uptick in economic growth to 3.0% is expected to lead to S&P 500 profits of $122 per share next year. At 14.6 times 2014 earnings, the S&P remains priced *below* its mean of 15.5 times of the past 20 years, so valuations are generally not stretched.

With Europe having emerged from recession, Japan following a stimulative fiscal regime and China's economy stabilized at a 7.5% growth rate, equity investments abroad in both the developed and emerging markets remain attractive. Equity portfolios under our supervision are targeted to have 15% + invested abroad.

FIXED INCOME

Finally, we remain in the early stages of a secular rise in interest rates and falling bond prices. Over time, rates will normalize with yields on 10 year US Treasury

notes, now at 2.75%, returning to the 4.0% to 5.0%+ range. While there will inevitably be brief periods during which longer-term rates retreat, the risk of owning longer-dated securities at this time outweighs the possible short term rewards that may accrue during counter-rallies. Bond portfolios under our supervision are, therefore, structured with protection of principal as the overriding objective. Durations of clients' corporate and municipal bond portfolios remain at all-time lows approaching 1 year. The "great rotation" out of bonds is underway.

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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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