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January 15, 2014

ECONOMIC UPDATE - - VIRTUOUS CYCLE?

As last year drew to a close, the global economy appeared to be gaining sufficient traction to usher in a period of modest but sustainable recovery and growth. Global GDP looked poised to strengthen to about 3.25% from an estimated 2.5% in 2013. For the US, growth this year of 3.0% +, up from about 2.5% in 2013, had become an increasingly common forecast among Wall Street economists. Government data showing steadily rising economic output, a greater willingness on the part of bankers to extend loans to less-than-prime borrowers, private surveys reporting healthier payroll gains, improved measures of consumer confidence, a growing manufacturing sector, and increased exports supported growing optimism for healthier economic growth this year. In addition, various open market indicators we monitor closely, including the price of gold, the steepening yield curve and a stronger dollar confirmed the likelihood of stronger domestic business growth in 2014.

However, at the very moment it appeared the US economy was finally poised to accelerate, moving beyond the supports put in place following the 2008-2009 recession, poor December jobs figures released on January 10th called into question forecasts of better days ahead. The Bureau of Labor Statistics (BLS) reported that employers had added only 74,000 jobs in December, far fewer than had been expected, reversing months of steadily rising hiring that had persuaded many economists and Fed policy-makers the labor market had finally turned allowing the economy to attain “escape velocity”.

The one bright spot in the otherwise dismal employment report showed the unemployment rate had dropped from 7.0% to 6.7%, though that decline was in part due to people leaving the work force. Consequently, the labor force participation rate dipped slightly to 62.8%, close to a 36-year low. Prior to December, the economy had been averaging more than 200,000 new jobs per

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month. The December total reflected the lowest number of jobs added in a single month since January 2011.

While the weak December employment readings were probably partly attributable to distortions caused by bad weather, and statistical noise, the report may temper the Federal Reserve's recent optimism about the health of the economy. However, on its own, the report will not alter the Fed's course in reducing its bond-buying program scheduled to end later this year. We believe it will take considerably more evidence than one weak labor-market report to convince the Fed to change policy. In fact, it is entirely possible that revisions to the December data will show the month to have been an outlier, a statistical anomaly not likely to be repeated in January and not supported by other data from the Institute for Supply Management (ISM), for example, which suggested a faster pace of job creation, closer to November's revised 241,000. How often in the past two years has the most current employment report suggested a slowdown only to be followed by a catch-up and subsequent upward revisions? Stay tuned.

BUSINESS SPENDING

Looking beyond the dust-up over whether the weak December employment data is a reliable harbinger of yet another bout of slower growth or just a statistical aberration, we believe the global economy has slowly emerged from beneath the negative overhang of a possible paralyzing event, reducing so called "tail risk". Yes, the euro zone has yet to produce a structure capable of effectively dealing with its fiscal and monetary issues. China's economy, while stable at 7.5% GDP growth, has not shown signs of a sustained upturn. Dysfunction and lack of leadership in Washington expose the US economy to fiscal risks and geopolitical surprises. However, enough progress has been made to render these issues less important and less threatening than they seemed a year ago, providing a more predictable environment and clearing the path for a pickup in business investment.

Several considerations will drive the increase we expect in business spending: First, business outlays generally follow increases in consumer spending. If the economy now shifts into a higher gear, as we forecast, businesses will expand their capacity to meet demand. Second, companies will also need to replace old and out-dated machinery in the same way as consumers are replacing aging cars. Businesses have retained older equipment longer than usual during an expansion, pushing the average age of such gear to the highest level since the mid 1990's. And, third, money remains very cheap and corporations are flush with cash. So, with economic and political risks easing, more US companies are likely to invest in expansion, taking advantage of the fact they have excess cash or they can borrow cheaply.

Rising stock prices and real estate values, stronger household balance sheets and lower gas prices should underpin increased consumer spending in the months ahead. The two year budget deal worked out in Congress last year should reduce the risk of another Washington-made crisis when lawmakers address the nation’s borrowing limit next month. The larger picture in the labor market has been one of steady growth. Against this backdrop, more companies are likely to increase their spending. One gauge of business investment, new orders for non-defense capital goods, excluding aircraft, grew 4.1% in November, the biggest jump in a year, after shrinking for two months. A broader measure of business spending that includes buildings and software grew at an annual pace of 4.8% in the third quarter of last year and 4.7% in the previous quarter. Forecasts for broad measures of business spending this year show an increase to as much as 5.3% versus 2.5% in 2013.

MONETARY AND FISCAL POLICIES

We expect 2014 to be a year of progress on a number of economic policy fronts. Monetary and fiscal policies, supportive of global growth and stability are likely to emerge. While some countries may turn less accommodative, the pace of tightening of fiscal policy among the world’s advanced economies is expected to slow. Structural reforms in the euro area periphery, China and Mexico, are likely to continue, in most cases, at a measured pace.

Despite the tapering of Fed bond buying programs, US monetary policy is likely to remain highly accommodative and expansionary as the Fed’s balance sheet will likely expand through most of the year. And from Fed statements, it is clear that policy makers fail to see rate hikes as a serious possibility until well into 2015 given the high rate of underemployment, idle manufacturing capacity and well anchored inflation expectations.

CHINA

China’s path to reform stemming from its plenary session is likely to be gradual as the country faces challenges of bringing its credit and housing bubbles under control without precipitating a financial crunch and a significant cyclical slowdown in economic growth. China also needs to make further progress in achieving a change in its growth model, rebalancing from an investment-led economy concentrated in high-profile infrastructure and state-owned enterprises (SOEs) to growth-driven by private and public consumption and investment in service sectors (including health and utilities) and private businesses. As we have written previously, the Third Plenum of the Communist Party has provided a broad roadmap toward these objectives, but we have yet to see with any clarity how or when the long-term rebalancing challenges will be met. With regard to avoiding a cyclical slowdown, Chinese authorities have central planning instruments and institutions that give them considerable control over the exit process from the financial excess of the past five years, but there remains a risk that despite the incredible dynamism of the nation, a sharp correction could occur.

EQUITIES

Domestically, equity returns last year clearly exceeded expectations despite a dysfunctional government, subpar economic growth, unacceptably high unemployment and uncertainties regarding Federal Reserve policies. As the year progressed, investors began to shift their focus from deflation and fears of another financial crisis and recession, to the prospects of improved global growth. Many previously pessimistic individual and institutional investors found themselves under-invested in equities and began to shift their allocations, increasing their stock holdings while reducing their cash and, in some cases, bond positions, driving many of the major stock indices to all-time highs without a meaningful correction. Bond market indices generally fell modestly in the wake of higher rates.

Looking ahead, we expect economic growth to broaden and gain some momentum as this year plays out. We are currently forecasting US GDP growth to accelerate to 3.0%+ from about 2.5%+ in 2013. Macroeconomic risks have declined as economies have improved, strengthening consumer and business confidence. The US fiscal drag is diminishing. Europe has emerged from recession, Japan's deflationary headwinds are lessening, and China's economy has shown signs of stabilizing. Improving sentiment for US corporations, along with growing consumption, should lead to an increase in capital spending and hiring, creating conditions for the "virtuous cycle" of which we have written countless times. The transition to self-sustaining growth should translate into better than expected revenue and corporate profit performance.

As for monetary policy, Federal Reserve tapering will be slow and incremental. US and global policies will be expansionary, geared toward stimulating growth, driving open market interest rates gradually higher and bond prices lower. Rising bond yields are not expected to be a headwind for equities as long as economic conditions continue to improve, profits grow and inflation remains contained below Fed targets.

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 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. Stock positions remain fully invested.

While stocks are unlikely to soon repeat their recent relative and absolute out-performance, the current benign "macro" landscape should allow for gradually expanding valuations. US manufacturing cost competitiveness, the remarkable shale gas and light oil revolution, technological mobility, the housing and auto rebounds and improvement in government spending and revenue balances should combine to underpin expanding price/earnings multiples. An uptick in economic growth to 3.0% is expected to lead to S&P 500 profits of $122 per share this year. At 15.0 times expected 2014 earnings, the S&P remains priced near its mean 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 where valuations are compelling, 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 2.87%, 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 continues.

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