FRONT BARNETT ASSOCIATES LLC

I N V E S T M E N T   C O U N S E L

Marshall B. Front
Chairman

Direct Line: (312) 641-9001
e-mail: mfront@front-barnett.com

September 10, 2014

ECONOMIC UPDATE - - BREAK-OUT?

Economic data released in the past two months have exceeded expectations giving rise to analysts' views the economy is on the verge of a long-awaited break-out. *Forward looking* indicators including the Institute for Supply Management's (ISM) manufacturing and services indices, initial jobless claims, and consumer confidence surveys are pointing toward a solid recovery. The Fed's Senior Loan Officer Opinion Survey on bank lending policies in mid-July showed stronger demand for credit while large banks had eased loan standards, and increased credit limits -- harbingers of stronger capital spending next year. Strength in *coincident* indicators such as auto sales, industrial production, and employment gains appear to confirm new vigor in the expansion. *Open market* indicators including a strong dollar, rising equity valuations, falling gold prices and a steep yield curve are signaling a strengthening economy. Indeed, both our firm's proprietary Economic Model (enclosed) and the Leading Economic Indicators (LEI) portend continued expansion over the next 6-9 months. And, globally, central banks remain highly accommodative, underpinning the recovery, and are expected to continue their easy money policies for an extended period ahead.

JOBS

However, last Friday's weak August employment report has thrown a bit of cold water on some analysts' enthusiasm. The 142,000 reported payroll gain trailed the consensus estimate by 88,000, the largest downside surprise since last December. The unemployment rate, compiled from a separate household survey, was also soft, as a drop in the unemployment rate to 6.1 percent resulted from lower labor force participation amidst negligible job growth. The jobs report clearly illustrates the labor market recovery remains far from complete.

While a bit of digging behind the disappointing headline employment numbers reveals some signs of progress, it also shows serious continuing weakness in the

70 WEST MADISON STREET • SUITE 4920 • CHICAGO, ILLINOIS 60602-4208
(312) 641-9000 • FAX (312) 641-9009

jobs picture. On the positive side, average hourly earnings of nonsupervisory workers rose 2.5 percent from a year earlier, the largest such gain in more than four years. The report also showed declines in both the number of people out of work for more than six months and the share of workers who said they had part-time jobs because they were unable to find full-time work. A broader measure of unemployment (U6), that includes those working part-time but who would like full-time jobs, fell to 12 percent in August from 12.2 percent in July, the lowest level since October 2008. Still, these gauges are much higher than they were prior to the financial crisis. On the negative side, recall the improvement in the unemployment rate was tempered by a decline in the labor force participation rate which measures the number of people who are employed or looking for work. The participation rate fell slightly to 62.8 percent reaching its lowest level in 36 years. These and other measures of labor market health lead us to believe a full normalization in those metrics is unlikely until 2016. Indeed, if the participation rate was at 66 percent, which is about where it hovered for many years prior to the recession, the headline unemployment rate would be over 10 percent, roughly four percentage points higher than is currently reported.

Let's also add a word of caution about reading too much into the weaker than expected jobs numbers: There is a tendency for the August survey to initially understate job gains. In 12 of the past 15 years, August's initial count has been revised upward by an average of 31,000 in the following month.

Most importantly, the surprising hiring slowdown is at odds with other labor market indicators such as first-time applications for unemployment benefits, which are near their pre-recession levels. In addition, ISM manufacturing and service sector surveys showed strong employment growth in August. So in our view, despite the weaker than expected August employment figures, the economy appears to be picking up on a number of fronts. Housing starts and sales have bounced back in recent months, manufacturing activity has soared, demand for capital goods has strengthened, and payroll gains have remained at an elevated pace for most of the year. These signs, in our view, support the case for a faster pace of GDP growth for the balance of this year and into 2015.

CONSUMER SPENDING

Interestingly, consumer spending, which amounts to roughly two thirds of GDP, has been the one lagging sector this year. After surging toward the end of 2013, real consumer spending growth has averaged a tepid 1.25 percent at an annual rate. While frigid weather was an obvious constraint to consumption growth this winter,

the weakness appears to have intensified. The 2.5 percent first quarter rise was followed by a smaller 1.8 percent gain in the second quarter, and July showed a rare decline to start the third quarter. Forecasts are for a pick-up in the current quarter to about 2 percent. Meanwhile, consumer fundamentals have been improving. Disposable personal income has expanded at a 6 percent rate this year, reflecting solid employment gains, and consumer wealth has soared, rising by $10 trillion in the past 12 months as the stock market recovered and housing prices increased at double digit rates in most urban areas. Consumers have delevered (the debt-to-income ratio has declined by 20 percentage points since mid-2009) and now are expanding their use of credit. Debt service is at a 30 year low relative to disposable income. There are fewer signs of financial stress as well: Mortgage delinquencies have fallen to 6 percent and past due personal loans have declined to less than 2 percent. In short, consumers are well positioned to increase their spending. We expect a rebound as the year plays out based, in part, upon improved consumer sentiment figures we have seen in recent months as well as the capacity of consumers to spend.

BUSINESS OUTLAYS

While consumer spending this year has been muted, we believe a rebound in consumption will spur businesses to invest and hire workers. This should feedback to demand and provide another leg to the recovery. Indeed, this "virtuous cycle" appears to be underway. Non-defense capital goods shipments increased by 1.5 percent in July following a 0.9 percent rise in June. This put the July level at 8.8 percent annualized above the second quarter average, which suggests a solid start to third quarter investment spending. Also, non-residential construction spending, a laggard for many quarters, has been especially strong lately, rising by 6.7 percent annualized above the second quarter average. Looking back, overall industrial capacity utilization troughed at 66.9 percent in 2009, at the end of the recession. The latest reading is 79.1 percent, up 1.7 percent from a year ago. As companies encounter capacity restraints, they will eventually need to invest in new plant and equipment in order to meet demand.

CHINA

Despite a number of well-publicized headwinds, China's economy has stabilized, growing by 7.4 percent in the first half 2014 with an unemployment rate of just 4.1 percent. Net income of rural residents per capita increased by 9.8 percent in the same period while disposable income of urban residents rose 7.1 percent from January to July. A total of 8.58 million jobs were added, 140,000 more than during

the same period in 2013. Inflation, measured by the consumer price index, increased by only 2.3 percent, well below the annual target of 3.5 percent. Total retail sales of consumer goods increased 12.1 percent in the first seven months of this year while fixed-asset investment rose 17 percent, of which investment in infrastructure rose 25 percent.

This record of economic growth would normally be the envy of the most developed countries. However, the ongoing process of wringing out the excesses of China's property boom, the uncertainties created by government reforms and the weak global recovery has cast doubt on the sustainability of the advance. The central government is implementing economic policies and reforms such as improved public service, encouraging private capital to invest in the service sector, eliminating administrative barriers to private investment in new industrial enterprises and other reforms of which we have previously written positively. In response to the apparent stabilization, China's stock market has risen sharply since mid-year. We expect further increases over time as investors gain confidence in China's ability to grow its economy sustainably at a well above-average rate, close to their target of 7.5 percent.

FORECAST

All in all, with consumption likely to rebound, business spending accelerating, and a reduced drag from government fiscal policies, we expect real GDP to grow at 3+ percent in the second half of this year and in 2015. Inflation is likely to remain well contained due to the slack labor market and ample unutilized manufacturing capacity. Accordingly, Fed policy will remain highly accommodative for the foreseeable future. Abroad, the Eurozone is experiencing very sluggish growth and falling inflation. The ECB recently reduced borrowing rates and announced a program to purchase asset-backed securities from European banks providing further stimulus. These monetary policies should promote a mild rebound in Eurozone business activity later this year. Domestic corporate profits are expected to rise sending S&P 500 operating profits to $120 per share this year and $130 in 2015, another 8+ percent increase.

EQUITY INVESTMENT STRATEGY

With the US economy gaining momentum, yields on high quality bonds non-competitive, the Fed focused on the weak job market and likely to keep interest rates low for a considerable period, and no recession in sight, equities remain the

investment of choice in our view. From a valuation standpoint, S&P 500 stocks, while no longer under-valued, are currently fairly-valued, in our opinion, as shown in the following comparative table:

		--- Historical Averages ---		
	Latest	1 Year	10 Years	25 Years
Price/Earnings	15.6X	13.9X	13.8X	15.6X
Dividend Yield	1.9%	2.0%	2.0%	2.1%
Price/Earnings to Growth	1.4	0.7	1.7	1.4
Price to Book	2.8	2.6	2.4	2.9
Price to Cash Flow	11.0	10.6	9.7	11.3

As to the supply/demand for equities, we believe investors are likely to rotate capital from low-yielding fixed income securities to equities once there is greater confidence the economy will expand at a more rapid rate and open market rates rise. In addition to this expected rotation, corporations will continue to repurchase shares at a record pace, sovereign wealth funds will carry through with their announced intentions to increase their equity exposure, foreigners will buy US equities as the dollar strengthens, and institutions and individuals who remain under-committed to equities will add to their positions.

Nevertheless, as we have often stated, stock markets are subject to periodic corrections which wring-out excessive enthusiasm and/or adjust to the inevitable surprises. We, therefore, would not be surprised to see a 5 - 10 percent correction along the way. For example, a significant risk currently to the short-term stability of the financial markets remains how well the Federal Reserve is able to communicate its monetary policy in a manner that avoids serious credit market disruption, a skill which in the past, it has failed to demonstrate. Geopolitical risks, too numerous to list, if not contained could also send tremors through the markets.

Equity portfolios under our supervision remain well diversified, and slightly tilted toward growth shares. Reflecting our view, the current economic expansion could continue unabated for several years, economically sensitive companies (i.e. industrials, technology, financials and energy) represent roughly 60 percent of domestic equity exposure. Investments in companies domiciled abroad represent about 15 percent of the equity portfolio. We remain fully invested.

FIXED INCOME STRATEGY

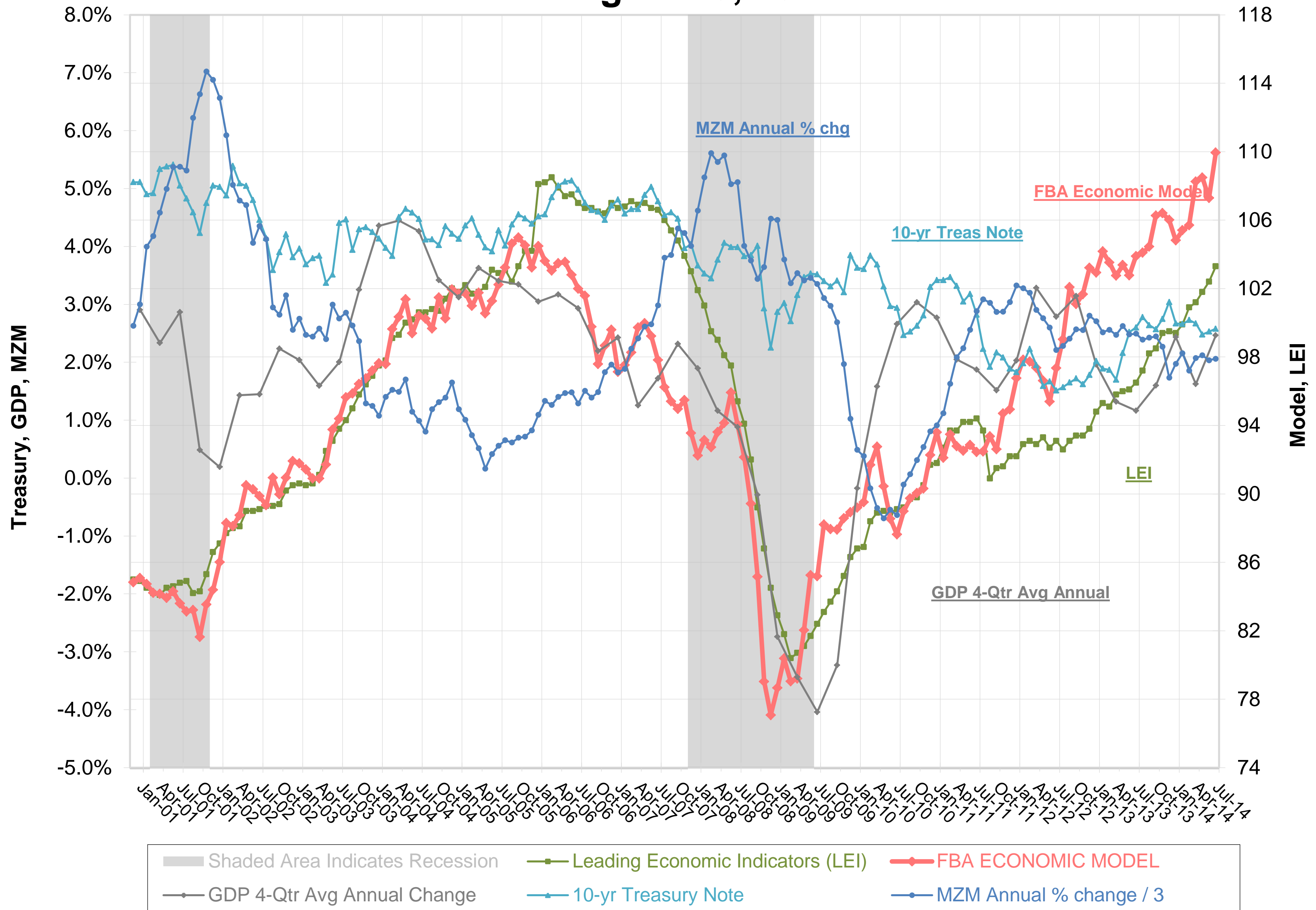
We continue to invest the fixed income portion of client's portfolios with capital preservation as the primary objective as we believe we are in the early stages of the normalization of interest rates. Accordingly, portfolios are structured largely with an extremely short ladder of high quality, marketable corporate obligations. Durations currently approach 1.

*   *   *   *

MBF

We are pleased to report Kevin Burke joined our firm this summer as senior equity research analyst, a member of our Investment Committee and a Principal of the firm. Kevin, a Chicago area native, has over 15 years of prior experience in both portfolio management and securities analysis.

Front Barnett Associates LLC
Economic Model
August 29, 2014



Last updated 8/29/2014

There are inherent limitations in economic modeling. There can therefore be no assurance that our Economic Model will accurately predict future directional movements in the U.S. economy.