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 - - ANOTHER WINTER SLOWDOWN

Information received since our last client letter suggests economic growth has cooled from the pace of the third and fourth quarters of last year despite improved labor market conditions. This flurry of weaker growth, in part due to poor weather, the port shut down, and the strong dollar, is showing up in a slowing in retail sales, the stalled housing recovery and reduced exports.

While the economy has failed to achieve the elusive "escape velocity" of which we have so often written, the slowed pace is by no means prelude to a sharp downturn. Anecdotal signs of upward wage pressure continue to surface while the principal headline inflation indices remain tame. Monetary policy, overall, remains extremely accommodative and expectations for the onset of the expected Fed tightening cycle have been pushed out following last week's dovish comments from Fed Chair Janet Yellen. Leading Economic Indicators (LEI) as well as our firm's proprietary Economic Model continue to signal expansion. And high frequency economic indicators, including the PMI indices, remain positive.

Consequently, we have reduced our expectations for first quarter GDP growth to 2.25% from 3.0%+ previously. This downward adjustment is based upon our view that consumer spending, which accounts for 70% of GDP, has slowed and construction has probably dipped due to poor weather.

For the second consecutive year, unseasonably severe winter weather appears to have hit retail sales, which contracted 0.6% month-over-month in February and have declined for three consecutive months. The lack of evidence of a pick-up in consumption growth is somewhat disappointing given the boost to purchasing power from lower energy prices. However, despite the lack of immediate feed-through, we do still expect to see acceleration in consumer spending over the next few quarters with consumption growing at a healthy 4% pace. Our forecast of 3% real GDP growth for the full year remains unchanged.

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

JOBS

The most recent Labor Department report showing 295,000 new jobs were created in February was the latest in a twelve month streak during which the US economy added more than 200,000 new positions, its best performance since 1995. The February unemployment rate fell to 5.5%, its lowest level since May, 2008. These improvements in the *headline* employment figures put the jobless rate not far above the 5.1% rate Federal Reserve officials now seem to believe to be full employment, or the rate at which the economy can grow without fueling inflation.

While the rapid job growth is one of a number of important indicators of the health of the economy, there remain caveats. Overall wage growth, while showing some signs of improving, remains tepid. The share of Americans working is near the lowest levels since the 1970s. More previously unemployed Americans left the Labor market in February than found jobs. And economic slack remains abundant even after more than five years of economic expansion. So despite the strong *headline* improvements, we are uneasy about concluding the economy is close to the Fed's goal of "maximum employment." High payroll employment growth and declining unemployment rates alone may lead some analysts to conclude the headwinds from the Great Recession have dissipated and the need for interest rate normalization is at hand. However, in our view, less obvious sources of hidden labor market slack should temper Fed action for an earlier-than-appropriate step toward interest rate normalization. Recent Fed statements support this view.

In fact, at its recent meeting, and in comments from Fed Chair Yellen, FOMC members actually downgraded their growth outlook noting the expansion was vulnerable to derailing, especially by the strong dollar, despite the potential for a reacceleration of projected growth. Notwithstanding strong payrolls and an unemployment rate of 5.5%, there remains sufficient slack in the economy for the Fed members to lower their inflation outlook as well, suggesting a later lift off to the Fed funds rate.

COMMENTS ON THE FED

Financial market concerns about the global impact of an eventual tighter Fed policy are likely to resurface later this year. In our view, even when rates are actually hiked this summer or fall, US monetary policy will remain loose by historical standards. The coming global recovery should be able to withstand Fed tightening as outside the US, monetary policy is likely to be loosened further. Both the ECB and Bank of Japan will keep rates at historically low levels and continue with or accelerate their versions of QE. Growth and inflation in both the euro-zone and Japan remain very weak. Central banks in a number of other European countries, including Sweden and Switzerland, are slated to cut rates further. China has cut its rates twice this year and is likely to continue to ease.

It is worth noting that previous Fed tightening cycles have not usually been associated with a slowdown in global growth. The last three periods when the US was raising interest rates were 1994-1995, 1999-2000 and 2004-2006. Global growth actually accelerated between 1994 and 1995 and between 1999 and 2000, and it also picked up in 2007. The last time US monetary policy tightening caused widespread problems, particularly in emerging economies, was in the early 1980's. However, recall that during that period the Fed funds rate reached double digits. That is not likely this time around.

Certainly, the Fed's comments around the recent FOMC decision to keep rates near zero were more dovish than anticipated. Reduced expectations for economic growth and downgrades to the interest rate forecasts made by Fed officials reinforced the impression that any tightening campaign would be a slow and gradual one. The catalyst for those downward revisions appears to have been a change in the Fed's view of where the economy's long-run equilibrium unemployment rate (NAIRU) is. Officials now believe that the equilibrium rate is between 5.0% and 5.2%, whereas previously the range was estimated to be 5.2% to 5.5%. We assume the downward revision stems in part from the fact we have not seen a more vigorous pick-up in wage growth. In our view, the lack of a pick-up in wages is just a matter of timing. It often takes some time for shifts in unemployment to feed into wages, so the fact the shift has not happened yet does not mean it will not show up soon. Accordingly, the Fed may eventually be forced to back-track on this change in view. Stay tuned!!

EQUITY INVESTMENT POLICY

Clearly, uncertainties surrounding the near-term course of corporate profits and fears over possible market volatility leading up to the first Fed rate hike might temporarily cap the advance of the broad market indices. Nonetheless, we continue to view equities to be the asset class of choice for long-term investors. Equities remain more attractive than the alternatives of high quality fixed income securities or cash equivalents. Stocks as measured by the S&P 500, while no longer statistically cheap, remain reasonably priced at 17.5 times this year's expected per share earnings of $120. The US economy is improving, albeit at a more moderate pace than previously expected, but prospects for a long-lived expansion remain good. Fed policy makers appear to be committed to raising rates later this year as a zero Fed funds rate is inappropriate given the economy's recovery. Further rate increases will be measured leaving rates low for a considerable period.

Abroad, GDP growth is expected to be modestly higher in 2015 as Japan expands, Europe emerges from its recession, and problems in the emerging markets are not significant enough to diminish the global outlook.

Stock portfolios under our supervision remain fully invested despite the likelihood of a 10%+ stock market correction along the way. Shares of companies domiciled abroad, which we target at 15% of the stock portfolio, remain significantly less expensive than their US counterparts. Core equity holdings are well diversified, balanced between *growth* and *value* shares.

FIXED INCOME POLICY

We continue to invest clients' fixed income portfolios with preservation of principal as the overriding consideration. Durations of these portfolios approach 1 year. Portfolios are largely structured with an ultra-short ladder of high quality corporate obligations.

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