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ECONOMIC OUTLOOK - - FINALLY A CORRECTION

Despite the recent stock market turmoil, business conditions in the US remain generally favorable, especially when compared with those of China and the emerging markets. Indeed, our firm's proprietary Economic Model and the Leading Economic Indicators (LEI) continue to signal expansion over the next six to nine months with no recession in sight.

Overall, second quarter GDP rebounded a strong 3.7% following a weak 0.6% first quarter which was impacted by a number of transitory factors including poor weather and port closures. Labor market conditions continue to improve with the unemployment rate now down to 5.3%. The decline is due in part to strong job growth and to a drop in the participation rate. Many job seekers have become frustrated by their inability to find work, opting-out of the work force. In addition, despite the fact there are over five million job openings, many employers have found that applicants lack the training and technical skills needed to perform necessary tasks.

Measures of inflation remain quiescent. Consumer price inflation, as reflected by the PCE (Personal Consumption Expenditures Index), the Federal Reserve's preferred inflation measure, remains at about 1.3%, well below the Fed's 2.0% target. Consumer inflation is being restrained by declines in energy prices and further decreases in non-energy import prices due to the strong US dollar. Over the past four quarters, total consumer prices as measured by the CPI (Consumer Price Index) were little changed while core CPI increased just 1.25%. Measures of expected long-run inflation from a variety of surveys we review remain stable.

Recently reported readings of economic activity show the economy having picked up a bit but still growing only moderately.

- Following five consecutive monthly declines, *industrial production* rose in both June and July. Broad measures of manufacturing production, including readings on new orders from various national and regional manufacturing surveys, generally suggest modest increases in factory output in the coming months.

- Orders for capital goods increased in July by the most in more than a year, showing corporate spending was finding its footing prior to the recent financial market turmoil. Orders for all durable goods meant to last at least three years rose 2%, the largest increase since June 2014.

- Real *personal consumption* expenditures have been growing solidly, with a 0.4% increase in June following a 0.6% increase in May which was the largest in 6 years. Among the factors that influence household spending, real disposable income has risen in line with wage growth, and gains in household net worth were supported by further advances in home values. Moreover, consumer sentiment remains near its highest level since before the most recent recession. The Conference Board's index of consumer confidence rose to 101.5 in August from 91a month earlier. By comparison, readings in the 50's were common during the last recession.

- *Housing* continues to recover. Starts of new single family homes rose 12.8% in July, near an eight year high. The level of permit issuance points to increases in starts in the months ahead. In the multi-family sector, which is tallied only quarterly, starts and permits increased sharply in June, likely reflecting, in large part, an acceleration of activity done due to an expiring tax credit in New York City and a shortage of rental units in key markets. Sales of new homes rebounded in July, climbing 5.4%, the biggest gain this year. Existing home sales also increased while pending home sales were little changed. Also, the Case Schiller index shows home prices in 20 US cities climbed 5% in June from the same month a year earlier. Stronger demand since the spring selling season and a limited number of available properties have helped move up real estate prices. Buyers are getting help from a strong job market, some reduction in bank lending standards and low borrowing costs.

- Real private *expenditures for business equipment* and intellectual property are rising at a moderate rate. Forward looking indicators, such as new orders for capital goods along with national and regional surveys of business conditions, point to further modest increases in business equipment spending in the near term. In contrast, as oil prices have fallen, business spending for drilling equipment and mining structures has declined sharply, consistent with the drop in the number of oil rigs in operation. However, the rig count appeared to be bottoming-out in recent weeks.

- *Federal spending* data through June indicated that real federal government purchases likely decreased while state and local government purchases appeared to have risen last quarter.

- While the decline in *net exports* made a large negative contribution to the change in GDP in the first quarter of 2015, trade data indicate the drag on GDP growth exerted by net exports in the second quarter was considerably smaller. Clearly, the strong US dollar is having an adverse impact on the competitiveness of US exports.

All in all, then, the data we have reviewed show the economy expanding moderately through early summer with further modest gains expected over the balance of this year and into 2016. Forward looking, high frequency indicators we monitor continue to point toward expansion. The ISM Manufacturing and non-manufacturing indices, expected out next week, are thought to show further expansion ahead.

FORECAST

Looking ahead, we expect real GDP growth in the second half of this year to be in the 2.0% to 2.25% range, little changed from the *underlying* rate of the first half. Consumer spending, which accounts for over two thirds of GDP, is expected to pick-up as continued gains in employment and income, high household net worth, and low gasoline prices support consumption in coming months. Consumer credit conditions remain favorable. Housing is expected to fare well as the higher levels of sales and prices point to continued recovery in that sector. An easing in lending standards for residential mortgages, reflected in the Fed's most recent Senior Loan Officers' survey, should underpin further expansion in housing. Elsewhere, business fixed investment is expected to remain soft. And, importantly, Fed policy is likely to remain highly accommodative even if the Fed Fund rate is increased this September or December.

We also expect labor market conditions to continue to improve with solid job gains and declining unemployment. The year-end unemployment rate should fall below 5%. Inflation has continued to run below expectations, and is expected to rise only gradually over the medium term toward the Fed's 2% target as the labor market improves further and the transitory effects of earlier declines in energy and import prices fade.

S&P earnings are likely to reach $118 per share this year and increase by about 7% in 2016 to $126.50.

FED POLICY

Federal Reserve officials have recently noted that, while they have seen progress in the economy, employment and inflation conditions warranting an increase in the target rate for federal funds had not yet been met. While labor markets have firmed, inflation has remained below expectations and they are not yet *confident* inflation, as measured by the PCE, will move back to 2.0% over the medium term.

For most of this year we believed the odds the Fed would begin rate normalization in September were better than even. More recently, we have had second thoughts as Fed members consider the following: The risk of missing the Fed's 2.0% inflation target would be increased by tightening policy in September. Currently, more than half of the components of the Core Consumer Price Index (CPI) are rising at less than 1%, and the most recent comprehensive measure of inflation costs rose at an annual rate of only 0.7% over the past quarter. Market-based measures of inflation expectations we monitor suggest that it will be well under 2.0% for some time. If, as now seems likely, the currencies of China and other emerging markets depreciate further, downward pressure on US inflation rates will increase. Tightening Fed policy will also adversely impact levels of unemployment as higher rates make holding on to cash more attractive relative to hiring or investing. Higher rates will also increase the value of the US dollar, making domestic producers less competitive and pressuring the economies of our trading partners.

There may have been a strong case for raising rates earlier this year, as low rates then seem to have been encouraging investors to take on risk and businesses to borrow money to engage in financial engineering. With credit spreads rising significantly, the Chinese outlook less certain, emerging markets tanking, the US stock market in correction, widespread concerns about liquidity and expected volatility having increased at a near record rate, markets are self-correcting any euphoria or excessive confidence. In short, the Fed may have missed its opportunity to raise rates earlier this year as it does not have to do the job of dampening enthusiasm by tightening at this fragile moment. Tightening now also increases the possibility their action will trigger some unintended adverse outcome, possibly tipping some part of the financial system into crisis. The Fed is mindful of these factors which may convince them to delay "lift-off". On balance, given the recently heightened global uncertainties, we believe the case for a rate increase now is less compelling and that the odds of "lift-off" in September are now a bit less than 50/50, with the first increase more likely to occur in December or next January.

MARKET CORRECTION

This month, US stocks suffered their sharpest decline in four years amid growing fears over China's seeming inability to implement coherent policy decisions to counter its economic slowdown and to stabilize its falling stock market, which has given up all of its 60% gain of earlier this year. Last Friday, an important gauge of Chinese manufacturing activity signaled contraction, falling to the lowest level in more than six years, suggesting the economy will need further policy support to stem its deepening slowdown.

To one degree or another, investors in US equities have been reacting to events that occurred in the past two weeks that have added to the anxiety over China's slowdown. First, China's August 11 surprise currency devaluation cast serious doubt that China could maintain a 7% GDP growth rate, or something close to that, and be successful in engineering a soft landing to its economic slowdown. Second, was the release last week of the Federal Reserve's minutes which revealed a Fed deeply divided on whether it should raise rates. Markets had been relatively calm prior to the publication by the Fed. Following the release of its statement, metrics of stock market activity including volume, volatility and sentiment indicators, ballooned, culminating in a mild panic on Friday, August 21. The panic selling carried over to the following Monday's session when at the opening the broad market indices experienced further declines until they stabilized and began to recover later in the session. Tuesday's session was another rollercoaster with stocks giving up earlier gains at the close. And Wednesday's 4% rebound, while welcome, reinforced the sense among seasoned market mavens we are in for an extended period of heightened volatility.

As for China's growth, the immediate catalyst for the correction, we expect the US economy to avoid contagion and continue to expand. On Tuesday, the People's Bank of China announced a 50 basis point bank reserve requirement reduction, a 25 basis point interest rate cut and it removed the rate ceiling for deposits of more than one year. Today, the government pumped $22 billion into the banking system. The decision by the Chinese government to take these actions should be reassuring to investors who were beginning to get the impression Chinese policy makers were starting to rely more heavily on potentially destabilizing currency rate manipulation as a way to stimulate demand rather than taking additional domestic policy measures. These measures and others certain to come should curb that impression and also take some pressure off China's highly stressed trade partners and commodity exporters.

The other question behind the recent turmoil is when will the Fed raise rates? The growing view is that global growth and general financial market conditions are not conducive to a rate hike. Much can happen between now and the September 17th FOMC meeting. The odds of a September lift-off have diminished. It remains a tough call for the Fed. Meanwhile, the stock market is likely to remain skittish until the Fed makes its rate decision known.

EQUITY INVESTMENT STRATEGY

We believe the stock market's correction is justified as the impact of China's slowdown to commodities, currencies, global capital spending and trade will likely be a drag on S&P earnings growth that has yet to be quantified. We believe this pullback, which we have been expecting and about which we have written in previous client letters, will be contained and run its course as it becomes evident the US economy will avoid contagion from the economic slowdown in China and the timing of the Fed's first rate increase in 8 years is clarified. In the aftermath of the recent decline, the market is likely to experience heightened volatility for some time.

As for stock market valuation, the S&P 500 index has declined about 7% this week. By comparison, the Shanghai composite has dropped by 16% during the same time period. The S&P 500 sells at 14.8 X our forward top-down forecast and about 15.6 times the bottom up consensus forecast for calendar 2016 earnings. Market valuation, close to its average over the past decade, shows stocks not overpriced. Various other stock market metrics also show stocks to be priced near their historical levels. When viewed from an intermediate term perspective, stocks look attractive to us.

The yield on the S&P 500 as of yesterday's close was 2.7%, measurably higher than the 2.15% yield on the 10-year US Treasury note. History shows that when stocks are priced to yield more than 10 year US Treasury notes, returns are invariably above average in subsequent periods.

Clients' stock positions remain fully invested and well diversified within pre-established portfolio guidelines. In portfolios where cash has recently been added, we are selectively building stock holdings, bringing ratios up to target levels. The sectors offering greatest *value* are financials, industrials and energy. Large cap technology shares remain core holdings. We continue to target up to15% of clients' stock portfolios for investment in non-US domiciled developed and emerging markets.

FIXED INCOME STRATEGY

We continue to invest the fixed income portion of clients' portfolios with protection of principal as the overriding consideration. Since the coming rising interest rate environment will be hostile to longer-dated securities, clients' portfolios are structured with an ultra-short ladder of high quality corporate obligations. Durations of these portfolios are below one year.

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