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ECONOMIC UPDATE

While readings on the health of the US economy earlier this year were decidedly mixed, giving rise to renewed fears of a recession, a stronger tone emerged in March as employers continued adding to jobs at a healthy pace, factory activity expanded for the first time since last summer, and domestic auto producers completed their best month of sales in a decade. This improvement has carried over into early April supporting our expectation that, absent an exogenous shock, the economy will continue to expand at the roughly 2.0% rate of the past five years. Both our firm's proprietary Economic Model (attached) and the Leading Economic Indicators (LEI) support this conclusion.

The labor market, which has been the bright spot, has added an average of almost 230,000 jobs a month over the past three months. In addition, the unemployment rate has edged down further. More people are joining the labor force as job prospects have improved, and the employment-to-population ratio has increased by almost ½ percentage point. Consumer spending, which accounts for about 70% of GDP, is expanding at a moderate pace, driven by solid income gains, improved household balance sheets, and the ongoing effects of the increases in wealth and decline in oil prices over the past few years. The housing market continues its gradual recovery, and fiscal policy at all levels of government is now modestly boosting economic activity after exerting a significant drag in recent years.

On the other hand, manufacturing and net exports remain under pressure due to slow global growth and the significant appreciation of the dollar since 2014. These same global developments have also impacted business investment by limiting firms' expected sales, thereby reducing their demand for capital goods; partly as a result, recent indicators of capital spending and business sentiment have been lackluster. In addition, business investment has been held down by the collapse in oil prices since late 2014, driving an ongoing steep decline in drilling activity. Low oil prices have also resulted in large-scale layoffs in the energy sector and have adversely impacted oil output and employment in industries that support

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energy production. On balance, overall employment has continued to expand at a solid pace this year, in part because domestic household spending has been sufficiently strong to offset the drag coming from abroad.

LOOKING AHEAD

Looking ahead, we must take into account the likely fall-out from recent global economic and financial developments, which for months have been marked by bouts of turbulence. Early in the year, equity prices fell sharply, oil traded down to about $26 per barrel, and many currencies were depreciating against the dollar. While prices in these markets have largely returned to where they were at the start of the year, in other respects economic and financial conditions abroad appear to be less favorable than they did earlier. Foreign economic growth now seems likely to be weaker this year than previously expected although first quarter GDP and trade data out of China have been encouraging. By themselves, these developments would tend to restrain US economic activity. But those effects have been at least partially offset by declining longer-term interest rates, including mortgage rates, thereby helping to support spending. On balance, the overall impact on the US economy from global market developments is likely to be limited.

All in all, we continue to expect moderate economic growth accompanied by further labor market improvement underpinned by a continuation of the Fed's highly accommodative monetary policy. While we expect one further move this year on the Fed's part to "normalize" interest rates, rates in general will remain extremely low by historical standards for quite some time. Growth will also be supported by a gradual lessening of some of the headwinds that continue to restrain the economy including depressed oil prices, dollar strength, stressed credit market conditions, household formation that has not kept pace with population and income growth (depressing homebuilding) and productivity growth that has been running at a slow pace by historical standards since the end of the recession in 2009.

Of concern to us has been the failure of governments globally, including the United States, to develop and execute *fiscal policies* designed to strengthen long-term growth. This failure distorts the role of *monetary policy*, hurting savers by diminishing their investment opportunities. Comprehensive tax reform, including a path for the repatriation of the $2 trillion+ of profits of US corporations hold abroad, as well as top-to-bottom regulatory reform are clear prerequisites to achieving more rapid, sustainable growth. Absent the enactment of pro-growth fiscal policies, the long-awaited awakening of Keynes' "animal spirits" necessary to drive more rapid growth will be postponed, diminishing the prospects for anything better than the sluggish growth of the past five years. Hopefully, the new administration, coming to office next January, will seize the opportunity to enact a pro-growth agenda.

DEVELOPMENTS ABROAD

Global developments pose ongoing risks which contributed to the financial market volatility last summer and earlier this year. One concern relates to the pace of global growth which is importantly influenced by developments in China. China's growth is likely to slow in the coming years as it transitions away from investment toward consumption and from exports toward domestic sources of growth. There is considerable uncertainty, however, about how smoothly this transition will proceed and how China will cope with any financial disruptions that might accompany it. These uncertainties were underscored by market confusion earlier this year over China's exchange rate.

A second concern relates to the prospects for commodity prices, particularly for oil. For the US, low oil prices, on balance, are likely to boost consumption and economic activity over the next few years as we remain a major oil importer. However, the negative reaction of financial markets to recent declines in oil prices probably reflected market concerns that the price of oil was nearing a financial tipping point for some countries and energy firms. In the case of countries reliant on oil exports, the result of a strong cutback in government spending might lead to social unrest. For energy-related firms, it could entail significant financial stress and increased layoffs. In the event oil prices were to fall back again, either development could have an adverse effect on the rest of the global economy.

Should such downside risks to the economy materialize, they would likely slow US economic growth, at least to some extent, both directly and through financial market channels as investors respond by demanding higher returns to hold risky assets, causing financial market conditions to tighten.

INVESTMENT OUTLOOK

Investors continue to face uncertainties fueled by slowing growth, technological disruption and social and geopolitical uncertainty. Of particular concern this winter was the adoption of negative interest rates by central banks (i.e. Japan) attempting to reignite economic growth, punishing savers, and creating incentives to reach for yield, pushing investors into less liquid asset classes and heightened levels of risk, with potentially dangerous financial and economic consequences. These uncertainties, combined with the sharp rise in the US dollar, collapsing oil prices, and stressed credit market conditions, were enough to trigger an almost 13% decline in the broad equity indices during January and early February. In retrospect, the winter "correction" gave investors yet another opportunity to take advantage of attractive market valuations here in the US and abroad in both the developed and emerging markets, as equity markets have since largely recovered their lost ground, oil prices have bounced by about 40% and credit market spreads have receded.

While no longer cheap, US equities appear to be reasonably valued at about 16.7 times estimated 2016 earnings. Other market valuation metrics we follow confirm this view. Shares of leading businesses in the energy, industrial and financial sectors remain undervalued and are particularly attractive based upon their earning power under the more favorable economic conditions we expect. Shares of companies domiciled abroad, though more volatile, remain statistically cheaper than their US counterparts, and also attractive. Accordingly, equity portfolios under our supervision remain fully invested as fixed income alternatives to stocks are unattractive. Investments domiciled abroad are targeted at 15% of equity portfolios.

Fixed income portfolios are defensively structured, with principal preservation as the overriding objective, in the anticipation of higher interest rates as the Fed normalizes. Durations of our fixed income portfolios approach 1.

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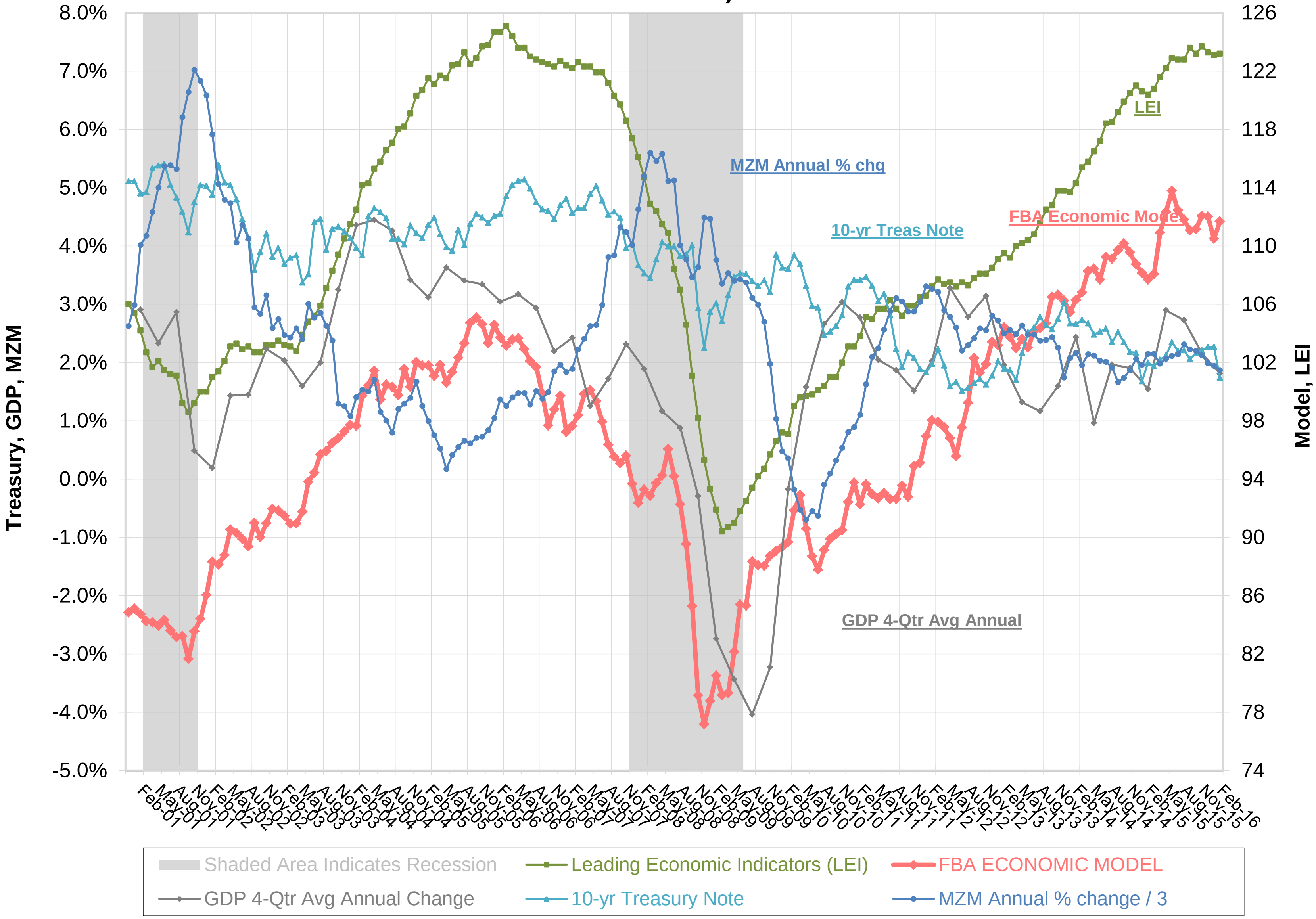
Front Barnett Associates LLC
Economic Model
March 28, 2016



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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.

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