FRONT BARNETT ASSOCIATES LLC

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

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STATEMENT OF INVESTMENT POLICY

Since the release of January's inflation reports showing growing wage gains and an increase in consumer prices, there has been a rising undercurrent of concern among investors that our economy, operating at full employment and about to receive a jolt of fiscal stimulus from the recently enacted tax reform package, will begin to experience higher than forecast inflation causing the Federal Reserve to become more aggressive than previously expected in its withdrawal of monetary accommodation. There are some recent signs of increased inflation in the Consumer Price Index (CPI):

- Tangible increases in many basics, particularly clothing, led to a strong 0.5% *month-over-month* jump in consumer prices in January. This is the highest monthly CPI reading since early in the economic expansion nearly 5 years ago. The more closely watched core CPI, which excludes food and energy, showed a 0.35% increase. This is the highest core CPI reading since the peak of the prior expansion, 12 ½ years ago.

- However, the *year-on-year* inflation rates, the common language for inflation, demonstrate less pressure, holding just above the Fed's 2.0% goal at 2.1% with core CPI inflation slightly more favorable at 1.8%. The Fed's expectations, outlined in their January FOMC statement which marked the opening move in the inflation scare, call for inflation to move up and "stabilize" around 2.0%. The slight upward drift for the core CPI would appear to be in line with the Fed's outlook and consistent with gradual rate increases this year.

- The Fed's preferred inflation gauge, the Personal Consumption Expenditures Index (PCE), is running several tenths below the CPI, and below the Fed's 2.0% target.

- FOMC minutes for the meeting that concluded January 31 signaled officials agreed that a gradual approach to raising the target range for federal funds remained appropriate and that there were few signs of a broad-based pickup in wage growth.

- A primary source of price influence on consumer prices is the wholesale sector. Here the readings are even less than striking with current Producer Price Index (PPI) rate near its best reading since early in the expansion when yearly comparisons, against depressed prices, were easy.

The minority of analysts who believe we are likely to see more rapid rate increases note that the January 31 minutes may be somewhat stale as they reflect a Yellen-led Fed and provide insight regarding a meeting that preceded the release of higher January inflation readings. The markets had anticipated 3 rate increases prior to the minutes. Recently compiled data show that assumption has not materially shifted.

While investors are experiencing an inflation scare, we are not alarmed over one month's inflation numbers which are subject to revision. We are not revising our firm's inflation expectations as we are unconvinced the facts governing inflation have changed. Just as there was transitory weakness in inflation last year, it is likely some of the strength in early 2018 is also transitory.

Nevertheless, as we get further into the later stages of this economic cycle the likelihood of more rapid price increases, more or less in line with the Federal Reserve's forecast, grows. This is consistent with an economy where we are seeing diminished inventories, strengthening labor markets, solid growth and rising energy prices. Inflation pressures may be firming, to be sure, but not as much as the media headlines would suggest, nor more rapidly than the Fed's forecast, nor enough to have been the sole cause of the steep equity market fall-off of early February.

EQUITY MARKET VOLATILITY

The inflation scare triggered a sharp stock market sell-off in early February with 10 year US Treasury bond yields spiking toward 3.0%. Intraday market volatility reached historic proportions. Risky investments totaling as much as $500 billion of notional value that depended upon tranquil markets turned sour. Many large institutions, for years betting on calm markets, have engaged in investment strategies involving the writing of risky, complex options contracts. Some of these institutions were forced to unwind their risky trades incurring steep losses in the process. While the bulk of the unwinding of strategies gone wrong is largely behind us, we expect higher market volatility to persist for a while as investors reposition their risk to accommodate gradually rising rates.

The good news is that market volatility is occurring against the backdrop of solid economic fundamentals. Deregulation has helped, encouraging businesses to increase their capital spending plans. Despite higher prices, prolonged delivery times, some inventory shortages, and the scarcity of skilled labor, the Purchasing Manager's Indices (PMI's) globally are enjoying an extraordinary, synchronous expansion. Corporate CEOs have been reporting record fourth quarter profits and revenue increases, well above expectations, and their guidance for the rest of the year is, on balance, positive. Meanwhile our firm's proprietary Economic Model (attached) and the Leading Economic Indicators (LEI) point toward continued expansion.

The combination of stronger global growth, estimated at 3.8% for this year, and the effect of the recently enacted corporate tax reform are prompting analysts to increase their estimates for S&P 500 earnings per share to $160 for 2018. US stocks have become more reasonably priced during the recent 10% correction, now selling at 16.9 times earnings. We see attractive *value* in financials, depressed energy stocks and certain late-cycle global shares. Many large-cap technology companies, whose earnings gains exceed 10% per annum, remain attractive in the *growth* component of equity portfolios. We have added to stocks where appropriate during the recent downturn. Investments domiciled abroad in developed and emerging market economies remain attractive and are targeted to represent up to 15% of a client's equity portfolio.

While the stock market may test its February lows once or twice before the recent volatility recedes, we expect returns from equities to exceed those of bonds or cash equivalents over the intermediate-to-longer-term, supporting our decision to remain fully invested.

FIXED INCOME

Capital preservation remains the overriding consideration in structuring fixed income portfolios under our supervision. Consequently, durations of bond portfolios are targeted at 1 year with high quality corporate bonds as the principal vehicles. We expect yields on medium and longer-term obligations to rise gradually providing an opportunity to extend maturities, capturing higher yields, as the current economic cycle plays out.

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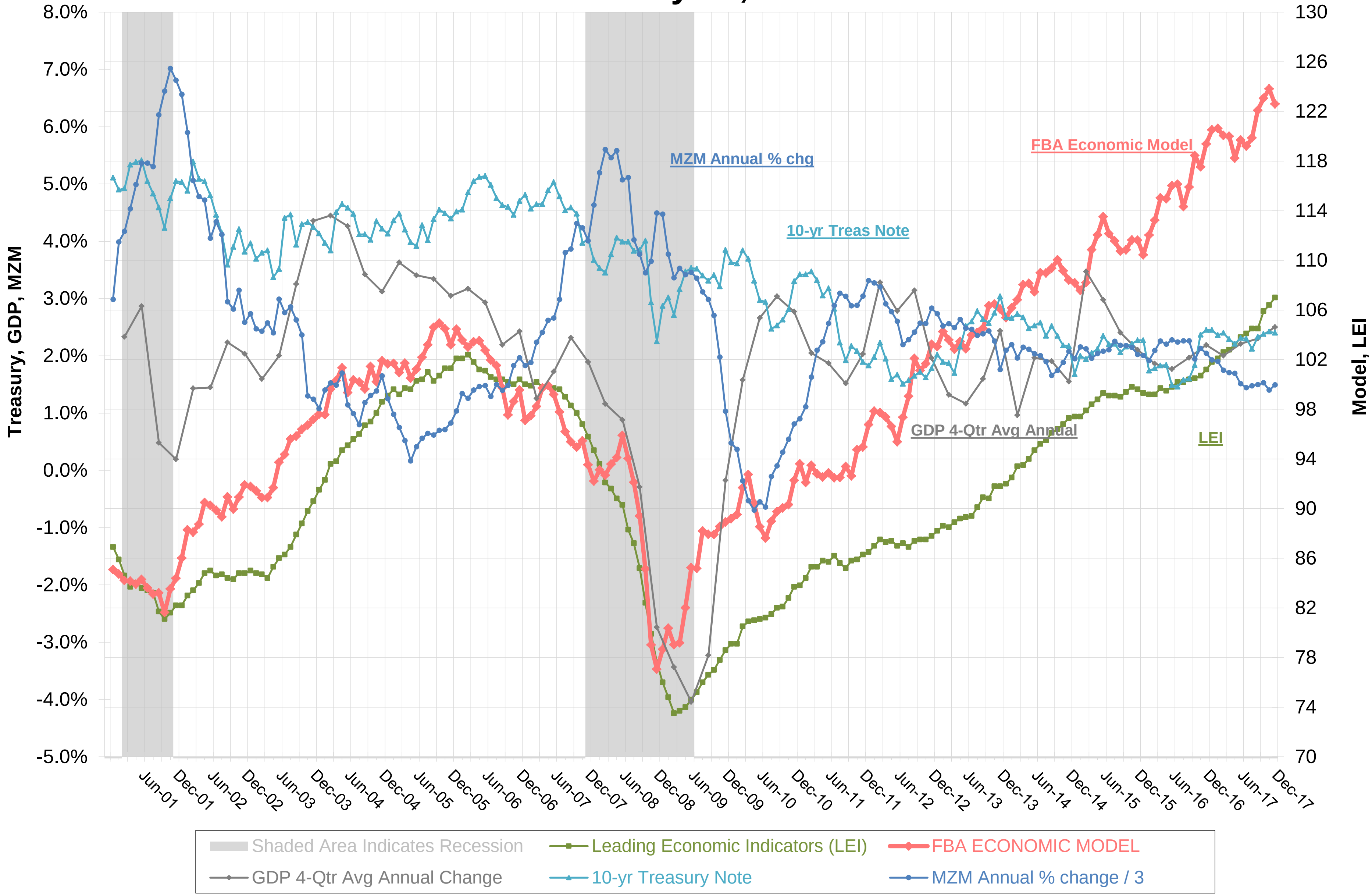
Front Barnett Associates LLC
Economic Model
January 29, 2018



Last updated 1/29/2018

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.