FRONT BARNETT ASSOCIATES LLC

INVESTMENT COUNSEL

Marshall B. Front **Direct Line: (312)641-9001**
Chairman **e-mail: mfront@front-barnett.com**

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ECONOMIC UPDATE - - STICKING WITH FUNDAMENTALS

Recently released jobs data shows hiring in March cooled following a strong February while wages picked up, returning the labor-market to the more sustainable pace we believe will keep the Federal Reserve on track for further, moderate interest rate increases this year and next. Payrolls rose 103,000 compared with median expectations of 185,000 after an upward revised 316,000 advance in February. Jobs gains over the last two months averaged 200,000, a strong performance for this point in the economic cycle. The jobless rate was 4.1% for the sixth consecutive month, surprising forecasters who expected a decline, while average hourly earnings increased 2.7% from a year earlier, matching projections. Overall, the March jobs numbers were benign.

The slowdown in payroll gains reflected reversals in construction and retail jobs. Construction payrolls fell by 15,000 in March, the first decline since July, following a gain in February. Retailers cut 4,400 workers after a rise of 47,320 in the prior month. Poor weather conditions in many parts of the country may have played a role in the March report. Most important, the participation rate, or share of working-age people in the labor force, decreased to 62.9% after jumping 0.3% to 63.0% the prior month. This rate, still hovering near the lowest level since the 1970s, will continue to face downward pressure as older workers retire. This trend remains a serious headwind to longer-term economic growth. Despite the smaller payroll gain in March, the jobs report is largely consistent with the view of Fed policy makers that the labor market is tight and they see the unemployment rate falling to 3.6% by the end of 2019. These forecasts support the case for 3 or 4 quarter-point rate increases this year and next.

In our view, the strength in manufacturing employment, which has posted the best monthly streak since 1998, bodes well for a near-term turnaround in service-sector hiring. Similarly, the slowdown in construction hiring is likely to be short-lived. So accelerating economic growth in an environment of largely stable wage

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

pressures should result in continued modest acceleration in the pace of hiring over the next several months.

Elsewhere, with central banks continuing to follow accommodative monetary policies and fresh fiscal stimulus from the recently implemented US tax cuts, evidence continues to accumulate that global economic fundamentals remain solid. Adjusted for population growth, US weekly initial jobless claims continue to head lower. Fourth quarter GDP figures showed consumption growing at a strong 4.0% rate, providing momentum for consumer spending coming into this year. US vehicle sales rose 2.4% month-over-month to a near record 17.4 million seasonally adjusted annual rate in March. US factory orders climbed 1.2% in February. Consumer inflation, as measured by the PCE, the Feds preferred metric, remains below target. While the non-manufacturing PMI dipped slightly to 58.8 in March, it remained at a historically high level. True, while some of the recent data from Europe and Japan has been a touch weaker, it remains at elevated levels. This global momentum supports our view the US economy will continue to expand well into next year. And our firm's proprietary Economic Model as well as the Leading Economic Indicators (LEI) continue to signal expansion. There is no recession in sight.

US/CHINA TRADE TENSIONS

In view of the major trade tensions between the US and China, perhaps the most important recent development was the address of President Xi Jinping to the Boao Forum on April 10 where he spoke of China's economic reform, announcing four-point measures to further open China.

Xi's key points were to:

- *Significantly widen market access*. Xi announced that China will launch a number of landmark measures to significantly broaden its market access. China will ensure the implementation of the plan announced last year to raise foreign equity caps in the banking, securities and insurance sectors. China will accelerate the opening-up of the insurance industry, ease restrictions on the establishment of foreign financial institutions in China and broaden their business scope, and open up more areas for cooperation between domestic and foreign financial markets. He noted that China has basically opened up the manufacturing sector with a few exceptions on autos, ships and aircrafts. He announced that China will as soon as possible reduce limits on foreign investment in these industries, autos in particular.

- *Create more attractive investment environment*. Xi noted that China mainly relied on providing favorable policies to attract foreign investors in the past, but it will now have to rely more on improving the investment

environment. He said that China will enhance alignment with international economic and trading rules, increase transparency, strengthen property right protection, uphold the rule of law, encourage competition and oppose monopolies. China will complete the revision of the "negative list" on foreign investments in 1H18 and manage foreign investments nationally based on the revised list.

- *Strengthen intellectual property rights protection*. Xi said IPR protection would provide the biggest boost to the competitiveness of the Chinese economy. He noted that stronger IPR protection is a requirement for foreign enterprises, and even more so for Chinese companies. He indicated that China is re-instituting the State Intellectual Property Office to step up law enforcement, significantly raise the cost for offenders and fully unlock the deterrent effect of relevant laws. China will encourage normal technological exchanges and cooperation between Chinese and foreign enterprises and protect the lawful IPR owned by foreign enterprises. He hopes that foreign governments will also improve the protection of Chinese IPR.

- *Proactively expand imports*. Xi articulated that China does not seek a trade surplus and has a genuine desire to increase imports and achieve greater balance of international payments under the current account. China will significantly lower import tariffs on vehicles and some other products. Referring to the first China International Import Expo to be held in Shanghai, he said that it is not just another ordinary expo, but a major policy initiative and commitment to open up its market. China will seek faster progress toward joining the WTO Government Procurement Agreement. Broadly, Xi stated that the dialogue is the way to resolve disputes, while the cold-war and zero-sum mentality is "out of place".

Xi Jinping's speech signaled a conciliatory tone. This is a positive step, but only a first step. Many of these measures only reiterated prior pledges, some already implemented. How President Trump will react remains to be seen. Will Xi's proposal to lower tariffs on vehicles lead to reduced trade tensions? Financial market's initial reactions have been positive. Trump's initial tweet was positive. Stay tuned.

EQUITY INVESTMENT STRATEGY

Stock market volatility is a normal condition. The US stock market has experienced pullbacks of 10% or more in 21 of the last 38 years. Yet the full-year market return was positive in those 29 of 38 years, suggesting that remaining invested over the long-term has paid off. Unfortunately, a study of fund flows shows investors often decide to sell during the dips, often missing the recovery. While markets are likely to have disappointing short-term periods, history suggests

investors are less likely to suffer losses over longer periods, especially in a diversified portfolio. While rolling 12-month stock returns have varied widely since 1950, a blend of stocks and bonds has not experienced a negative return over any five years rolling period in the past 67 years.

With the above market wisdom in mind, and the global economy on solid ground, we have maintained fully-invested equity positions in clients' portfolios despite the recent political chaos and the resulting market volatility. Instead, we have chosen to focus on fundamentals rather than speculate on the impact of possible tariffs. Among these fundamentals are the following:

- Real GDP in the US is forecast to accelerate to 3.0%+, up from 2.3% in 2017, as the impact of fiscal stimulus and deregulation are about to be felt.

- Earnings growth is expected to be strong. S&P operating earnings were roughly flat at about $118 for three years ending 2016. For 2017, operating earnings rose 10.8% and are forecast to expand a further 12.6% to $148.50 this year when fiscal policies are factored in.

- Tax cuts, tax reform and regulatory easing of the financials and energy sectors are well underway.

- Financial markets may be under-appreciating the amount of infrastructure spending that will come from already-approved budget appropriations.

- Immediate and full expensing of capital spending should prompt companies to invest in capital rather than engage in financial engineering, enhancing productivity, sustaining low inflation and encouraging the Fed to tighten gradually.

- The Keynesian "animal spirits" necessary to sustain the expansion are evident in improved capital spending, which could extend the current economic cycle beyond most expectations.

- Small business and consumer confidence are surging.

- The "great rotation" from bonds into stocks has not yet started. Recall that the 10-year US Treasury yield jumped from 3.1% to 4.6% in the six weeks following the 2003 tax cut.

- We believe *value* shares are particularly attractive (e.g. financials, energy and industrials) having under-performed over the past several years.

- Shares of companies domiciled abroad in developed and emerging markets remain cheap and are targeted to represent 15% of clients' equity portfolios.

As for stock market valuation, the 12%+ decline in the S&P 500 stock index from its February intra-day high of 2872 to its recent 2532 intra-day low has brought the market's valuation down to a more reasonable multiple of 16 times earnings. We believe equities are attractively priced, particularly when compared with returns expected from either cash equivalents or high quality bonds.

FIXED INCOME INVESTMENT STRATEGY

Capital preservation remains the overriding consideration in structuring fixed income portfolios under our supervision. Consequently, we have maintained the durations of portfolios close to 1 year with laddered high quality corporate bonds as the principal investment 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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