

Marshall B. Front
Chairman

Direct Line: (312) 641-9001
e-mail: mfront@front-barnett.com

April 6, 2011

ECONOMIC UPDATE -- BRIEF SLOWDOWN AHEAD

Additional confirmation the US economy has finally morphed into a self-sustaining expansion emerged last week as the Bureau of Labor Statistics' reported 216,000 net new jobs were created last month. For weeks, *leading* labor market indicators, including jobless claims, profit trends and lending standards have been signaling growth in private sector job creation. On Friday we learned 230,000 new private sector positions were added in March and that the two previous months' reports had been revised upwards. Additionally, the unemployment rate surprisingly fell to 8.8% -- a full percentage point below a year ago. Combined with recent strong manufacturing data, the March job gains suggest to us the economic recovery remains on course, and that the business sector is showing further improvement. More importantly, jobs growth -- at above 200,000 a month -- is finally gaining sufficient traction to help shift the economy to the self-sustaining track we have been expecting.

The jobs report also showed that despite strong growth in business output and profits, we have not seen these factors translating into sustained pay increases. For the second consecutive month, hourly wages were flat, while hours worked were also unchanged. Stagnant wage growth, of course, remains a concern because workers have seen more of their disposable income eaten up by higher costs for fuel and food with less available for discretionary purchases and savings. On the other hand, it augers well for continued tame inflation over the months ahead. While higher energy costs have been an increasingly worrisome exogenous source of demand risk for the expansion, the lack of "second round" wage effects make it clear that inflation does not have an internal, income-driven impact.

FEDERAL RESERVE POLICY SHIFT

The positive jobs data set the stage, in our view, for a shift in Federal Reserve policy. With the labor market on a more solid footing, the much debated \$600 billion QE2 program of Treasury bond purchases appears likely to end on schedule in June. This will effectively mean the Fed has moved from an easing monetary

policy to a neutral posture of no longer easing but not yet beginning to tighten. In our view, given the Fed's dual mandate of fostering maximum economic growth and low unemployment, the headwinds of 13.5-million unemployed, depression-like conditions in housing, spiking energy prices and European sovereign debt uncertainties, the Fed is likely to keep its ultra-low fed funds rate unchanged through year-end.

BRIEF SLOWDOWN AHEAD

Indeed, the encouraging jobs data comes amid worries about the pace of the recovery as consumers and businesses react to high energy prices, geopolitical risks in the Mideast, periodic bouts of panic in the European sovereign debt markets, and the short-term fallout from Japan's recent disasters. Consequently, some forecasters have now justifiably downgraded their estimates for growth in the first quarter, citing unfavorable winter weather leading to weaker-than-expected consumer spending amid higher prices for food and energy. Recently released data appears to validate the view that global industrial activity may now be poised for a further slowdown due to drags this quarter in industrial production and consumer spending. In the aftermath of Japan's tragic natural disasters, Asian regional performance is set to deteriorate. For example, the Japanese economy is expected to contract this quarter with industrial activity falling by over 15.0% during the March and April period. While the impact on the rest of the Asian region is likely to vary widely, supply disruptions and weaker Japanese demand will be apparent this month and felt most strongly in the ASEAN manufacturing centers in Taiwan, Malaysia, and Thailand.

The other temporary drag on global growth comes from rising energy prices which are crimping consumer spending. This is evident in the US where consumption gains are estimated to have slowed to a 1.50% annualized pace in the first quarter. Global auto sales also appear to be moving lower. This consumption slowdown will be reinforced by Japan's demand shock. Forecasts are now incorporating a softening in global consumption into mid-year but rising energy prices are threatening to dampen consumption even further, possibly magnifying a projected slowdown in industrial activity. The March global Purchasing Managers (PMI) survey, as well as weaker than expected *forward looking* US PMI Manufacturing and non-manufacturing readings, appear to confirm this slowing trend. Indeed, our firm's Economic Model signaled some softness in its latest reading. (The Model can be found on our firm's website, www.front-barnett.com)

Despite the enormous human tragedy, the factors currently depressing Japanese activity are likely to turn quickly by mid-year as the restarting of shuttered production will lead to a sharp rebound in economic activity from its depressed levels in the wake of the disaster. The rebound will be amplified by the start of a major restoration and reconstruction effort partially initiated by the private sector and boosted by government support. Japan's fiscal response to the earthquake and tsunami will amount to about 2.0% of GDP, the first installment of which will come this month. A much larger supplementary budget is expected to be announced in July. In short, the recovery effort in Japan is widely expected to reignite global economic activity in the second half of this year.

All in all, then, we expect moderate 2.5% to 2.75% growth in the first half of this year followed by a reacceleration to 3.0%+ in the second half with momentum building toward year-end. Core inflation will remain tame -- below the Federal Reserve's desired range of 2.0%+. The Fed is not expected to raise short-term interest rates before early 2012. Housing, plagued by a huge overhang of unsold homes, will remain in the doldrums for an extended period. The unemployment rate will continue to drift lower toward 8.0% by year-end. S&P reported earnings are forecast to rise to \$95.00 per share this year. Early readings point to a further advance to about \$105.00 per share in 2012. Also, note that both the level of GDP and S&P 500 earnings have now moved above those of the peak in the last business cycle with no end to the expansion in sight.

INVESTMENT POLICY

Although stock prices have now doubled since their secular low in March 2009, we continue to believe that the macroeconomic backdrop remains favorable for further stock market gains despite the likelihood of periodic market corrections. The Federal Reserve will remain accommodative even though the economy is gaining traction. Core inflation remains well contained despite higher food and energy prices. Financial markets have largely normalized and economic improvements are continuing with the recent recovery in the labor market being a particularly encouraging development. Corporate balance sheets are awash with cash and merger and acquisition activity is beginning to take hold following a dismal three years. Rising corporate earnings remain an underpinning to the equity market. And, stock market valuations remain attractive with the S&P 500 stock index currently priced at about 14.0x expected 2011 earnings of \$95.00 per share and at 12.5x estimated 2012 earnings of \$104.00 per share. These and other measures of stock market valuation we monitor show US stocks to be attractively priced, particularly when compared with returns from cash equivalents and fixed income

securities. Investors have only recently begun to shift portfolio allocations to reflect this potential return differential pushing the supply/demand equation further in favor of equities.

Stock portfolios under our firm's management continue to be structured to benefit from the global economic expansion we see unfolding over the next few years. Portfolios are fully invested and remain tilted toward *growth* shares. Concentrations in industrials, technology, energy, materials, and consumer discretionary shares should benefit from the favorable macro environment. Financials, currently selling at or near their book values, are market weighted as we expect bank earnings to rebound sharply over the next two years. Additionally, dividend increases and share repurchase programs will be authorized by the Fed, enhancing the attractiveness of these investments. Roughly 15.0% of clients' equity portfolios is allocated to investments domiciled abroad. Roughly half of that amount represents investments in emerging markets with the balance in developed markets outside the US.

As for fixed income investments, we remain cautious, viewing bonds to be relatively unattractive. Portfolio durations are targeted at 2.8 years -- below the performance benchmark of 3.9 years. Conventional US Treasury bonds are largely unrepresented in portfolios as they are viewed as overvalued. Most bond portfolios have broad exposure to investment-grade corporate bonds, municipals (where tax appropriate) and TIPS (US Treasury Inflation Protected Securities.) The proceeds of maturing bonds are being reinvested in 1-3 years corporate obligations in the expectation of a flattening yield curve where intermediate-term bond yields rise as the current business cycle plays out, providing a better opportunity to reinvest cash at a later date in longer-dated securities.

*

*

*

*

MBF