**FRONT BARNETT ASSOCIATES LLC**
INVESTMENT COUNSEL

Marshall B. Front
Chairman

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

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# ECONOMIC UPDATE -- REBOUND COMING

While overall business activity continued to recover this spring, albeit at a more moderate pace than some had expected earlier, improving business conditions have failed to translate into increased hiring. Aside from the fact that employment growth is a lagging indicator, telling us little about future hiring, it is difficult to imagine businesses aggressively adding to staff given the uncertainties created by the earthquake in Japan; tax, regulatory and deficit concerns created by a dysfunctional Washington; spiking energy prices; European sovereign debt crises, and; the inability of small businesses -- historically the source of most job creation -- to borrow.

Clearly, some of the factors dampening economic performance appear to have been *temporary*. The run-up in energy prices, especially gasoline, and food has crimped consumer purchasing power. And, supply chain disruptions in US motor vehicle production schedules, have limited the availability of some popular models. Looking ahead, however, the stabilization in the prices of oil and other commodities should ease pressures on household spending. Meanwhile, vehicle manufacturers indicate they are making progress in overcoming parts shortages and expect to recall furloughed workers and increase production substantially this summer.

Nonetheless, beyond the *temporary* factors noted above, the economy will continue to be held back for some time by an array of *structural headwinds* including slow growth in consumer spending due to deleveraging, even after accounting for the affects of higher food and energy prices; continuing depression-like conditions in the housing sector; limited access to credit for many households and small businesses; and, fiscal tightening at all levels of government. For the record, following an increase at an annual rate of 2.75% in the second half of 2010, real GDP rose at about a 1.9% rate in this year's first quarter. New data suggests the pace of recovery remained soft through the spring with GDP increasing by 2.0% -- well below-trend of 3.0% -- in the quarter just ended.

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

Looking ahead, given the combination of temporary factors and continuing structural headwinds, we have trimmed our forecast for 2nd half GDP to average about 2.8%, down from 3.0%+ we expected previously. Indeed, while our firm's proprietary Economic Model signaled the *slowdown* months ago, it continues to forecast a continuation of the *expansion* for the foreseeable future.

## CONSUMER SPENDING

Much of the slowdown in aggregate demand this year has been attributable to the household sector, and the ability and willingness of consumers to spend will be an important determinant of the rate of recovery in coming quarters. Real disposable personal income over the first five months of this year was boosted by the reduction in payroll taxes, but those gains were largely offset by higher food and fuel prices. Households report they have little confidence in the durability of the recovery and about their own income prospects. The ongoing weakness in home values is holding down household wealth and weighing on consumer sentiment. On the positive side, the likely near-term resolution of questions surrounding the debt ceiling and other politically-driven issues would, in our view, serve to buoy consumer confidence which in June fell to a several month low. Further, household debt burdens are declining, delinquency rates on credit cards and auto loans are down significantly, and the number of homeowners missing a mortgage payment for the first time is decreasing. The anticipated pickup in economic activity and job creation, together with the expected easing of price pressures, should bolster real incomes, confidence and consumer spending, which accounts for about 70% of GDP.

## EXPORTS AND BUSINESS INVESTMENT

Exports and business investment in equipment and software have been strengths in the recovery. Demand for US made capital goods from both domestic and foreign firms has supported manufacturing production throughout the recovery thus far. Data on new orders received by US producers suggest that the trend continued over the last few months. We expect the weaker dollar will support export growth. Recent readings of the ISM Manufacturing index, the single most important forward-looking economic indicator, continue to point toward strong manufacturing activity in the months ahead.

## HOUSING

Residential construction activity remains at historically low levels. Sales of existing homes have stagnated. The inventory of unsold homes on the market remains very high, if for no other reason than many homeowners are under water on their existing mortgages. Demand for homes has been depressed by many of the same factors that have held back consumer spending more generally, including the slowness of the recovery in jobs and income as well as poor consumer sentiment. While mortgage rates are near record lows, access to mortgage credit continues to be constrained. Anecdotal evidence shows potential homebuyers concerned about buying into a falling market, as weak demand for homes, the substantial backlog of vacant properties for sale, and the high proportion of distressed sales are keeping downward pressure on house prices. Little improvement in housing is now expected before next spring.

In summary, we see a modest rebound in business activity in the coming quarters which will support further gains in corporate profits. Any improvement in housing will come as an unexpected, welcome plus. For 2011, we forecast S&P 500 earnings per share of about $96.00 and a further gain in 2012 to $106 per share. Inflation has picked up this year with the price for personal consumption expenditures (PCE) -- the Federal Reserve's favorite measure of inflation -- rising at an annual rate of more than 4.0% over the first five months of 2011 and 2.5% on a 12-month basis. Much of the price acceleration was the result of higher prices for oil and other commodities, and for imported goods due in part to the weak dollar. In addition, the price of motor vehicles increased sharply when supplies of new models were curtailed by parts shortages associated with the Japanese earthquake. Most of the recent rise in inflation is likely to prove transitory. We expect the PCE price index to come in at about 2.5% for 2011 as a whole, implying a significant slowing in inflation in the second half of this year. With unemployment likely to remain stubbornly high -- above 8.5% -- and inflation forecast to revert to a level within the Fed's comfort zone, Fed policy is likely to remain highly accommodative with the target range for fed funds unchanged well into next year. QE2 will be unwound only gradually some time following the first increase in federal funds target.

## INVESTMENT POLICY

Despite the recent slowdown in business activity, the favorable macroeconomic backdrop for equity investors remains in place. Financial markets have largely normalized. "Core" inflation remains well contained despite higher food and

energy prices.  Corporate balance sheets are awash with liquidity and companies are returning cash to shareholders by increasing dividends and through share repurchase programs.  So far this year, over 25% of the S&P 500 companies have increased their dividends.  Merger and acquisition activity is beginning to take hold following a dismal three years.  Rising corporate profits remain an underpinning to the equity market despite the high likelihood of periodic corrections.  And, stock market valuations remain attractive with the S&P stock index currently priced at about 13.8 times expected 2011 earnings of $96.00 per share and at 12.5 times estimated calendar 2012 earnings of $106.00 per share.  These, and other measures of stock market valuation we monitor, show US stocks to be attractively priced statistically, particularly when compared with returns expected from cash equivalents and fixed income securities.  With both real GDP and corporate profits at record highs and rising, absent an exogenous shock, it would not surprise us to see the broad US stock market indices register new highs over the next 12 months.

Stock portfolios under our supervision continue to be structured to benefit from the global economic expansion we see unfolding over the next few years.  Clients' accounts are fully invested and remain tilted towards economically sensitive *growth* shares.  Concentrations in industrial, technology, energy, materials, and consumer discretionary stocks should benefit from the favorable macro environment.  Roughly 15% of clients' equity portfolios remain allocated to investments in companies 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, we remain cautious, viewing bonds to be relatively unattractive.  Portfolio durations are targeted at 2.8 years or less -- well below the performance benchmark of 3.9 years.  Conventional US Treasury bonds are largely absent in portfolios as they are viewed as overvalued due to "flight to safety" demand.  Most bond portfolios have broad exposure to investment-grade corporate bonds, municipals (where tax appropriate) and to TIPS (US Treasury Inflation Protected Securities).  The proceeds of maturing bonds are being reinvested in 1-3 year corporate obligations in the expectation of better opportunities to reinvest cash at a later date in longer-dated securities.

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