FRONT BARNETT ASSOCIATES LLC

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

Marshall B. Front
Chairman

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

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ECONOMIC UPDATE - - SECOND HALF PICK-UP?

Business conditions in the US continue to show moderate improvement as the economy struggles to overcome strong headwinds created by restrictive federal fiscal policies, the growing regulatory morass that inhibits business investment and hiring, and weakness in export demand. The economy is clearly being held back by the two percentage point payroll tax increase that took effect in January, by the spending sequester that began in March and the uncertainties associated with the implementation of Obamacare and Dodd Frank.

That said, recently released Labor Department employment data for the month of June, and revisions to figures for the prior two months, are mildly encouraging. Employment increased more than forecast last month, wages picked up 0.4% from the prior month, and the US jobless rate held close to a four year low at 7.6%. Payrolls rose by 195,000 jobs for the second straight month and hourly earnings in the year ended in June advanced by the most since July 2011. On average, non-farm payroll employment has increased by about 200,000 jobs per month so far this year. Despite these gains, the jobs situation is far from satisfactory, as the unemployment rate remains well above its longer-run level, and rates of underemployment and long-term unemployment are still unacceptably high. A separate Labor Department report put this in perspective showing increases in discouraged workers and the number of people working part-time who would prefer full-time employment. Most telling, though, the underemployment rate - - which includes part-time workers who would prefer a full-time position and people who want to work but have given up looking - - rose to a four month high of 14.3% from 13.8% in May.

When viewed over the longer term, despite the four-year economic expansion, non-farm payrolls remain 2.5 million below the peak reached in January 2008. A total of roughly 22 million people remain either out of work, underemployed or forced to work only part-time. And, in part because people are dropping out of the labor force or collecting government benefits rather than working, the employment

-to-population ratio, which peaked at 64.6% in April 2000, has dropped to 56.8%. This translates into a cumulative loss of roughly 10 million jobs from the longer-term trend line - - a huge waste of human capital and talent, as well as diminished economic growth.

Beyond the recently improved employment data, *industrial production* rose in June by the most in four months, possibly signaling manufacturing is improving as we head into the second half of the year. Output at factories, mines and utilities climbed 0.3%, the largest advance since February, after being little changed in May, according to the Federal Reserve. Manufacturing, which accounts for about 12% of GDP, had been weak for several months, mirroring the general slowdown in the overall economy this winter and spring. The June industrial production figures, combined with recent regional reports from the Federal Reserve banks of New York and Philadelphia showing manufacturing gains extending into July, may be the harbinger of stronger activity in the months ahead.

Elsewhere, signs of business sluggishness this spring were evident:

- While conditions in the *housing sector* have generally improved, construction activity remains at a relatively low level by historical standards. Demand continues to be constrained by tight credit standards for mortgage loans. The recent 1% rise in mortgage rates puts them at the highest level in almost two years. Recent declines in mortgage applications for both the refinancing of existing loans and the purchases of new homes could be signaling moderating demand for housing over the near-term.

- *Retail sales*, which account for over 70% of GDP, rose less than forecast in June as demand cooled at building materials outlets and restaurants, showing consumption, the largest sector of the economy, lacked momentum as we entered the second half of the year. Consumer spending, excluding auto sales, was actually flat last month.

- *Business expenditures* on equipment and software slowed going into the second quarter after expanding moderately earlier in the year. Shipments of nondefense capital goods excluding aircraft decreased in April but new orders for these capital goods increased and were slightly above the level of shipments pointing to modest gains in shipments in the near term. Other forward looking business expenditure indicators, such as surveys of business conditions and capital spending plans, also suggest that outlays for business equipment would continue to rise at only a modest pace in the coming months.

- *Federal government purchases* appeared to be declining less rapidly going into the second quarter than they had during the first quarter, as decreases in defense spending slowed, on balance, in April and May.

- While ongoing declines in *state and local government* purchases have moderated over recent months, the payrolls of these governments expanded in April and May. Meanwhile, state and local government construction expenditures continued to decline noticeably.

- Measures of *labor compensation* indicate that gains in nominal wages remain modest, muting consumer's willingness and ability to spend despite improved confidence figures. Gains in average hourly earnings to all employees have been modest.

- Recent readings of *forward looking indicators* such as the Institute for Supply Management manufacturing and non-manufacturing indices remain in positive territory, although they have slipped a bit from higher levels reached earlier in the year.

- *Foreign economic growth* remains sluggish. A slower pace of expansion in many emerging market economies (EMEs) including China has offset an increase in the average rate of economic growth in the advanced foreign economies. In Japan, for example, where recent policy measures appear to have boosted household confidence, economic growth picked up noticeably early in the year. Recent indicators of Canadian economic activity have also strengthened. However, measures for the euro-area economies remain weak. The decline in commodity prices and continued lackluster growth has had a significant impact on the economies of commodity exporters such as Australia.

FORECAST

All in all, then, while recent trends in employment, housing, auto sales and industrial production are showing some signs of strength, the US economy remains on a slow growth track. Forecasts for second quarter GDP have now been scaled back to about 1.0% or below - - well short of the 2% pace analysts had expected only a few months ago. Inflation is well contained at a 1.3% rate - - below the Fed's 2% target. Initial jobless claims figures released this week showed a sharp decline pointing to a continuation of the recent more favorable employment gains. The unemployment rate is expected to drift lower, reaching 7% by year-end. Our firm's Economic Model, a copy of which is enclosed, continues to signal moderate expansion ahead as do the Leading Economic Indicators (LEI).

Looking ahead, despite the likely start this fall of the scaling-back of Fed bond purchases, Fed policy will remain on a highly accommodative path. No rate hikes are likely for a long time. Policy efforts may, in time, be overshadowed by the rate boosting affects of growing confidence in the recovery and improved fundamentals. The recent sharp run-up in mortgage rates has drawn special concern given the housing sector's important role in the recovery's next stage. However, borrowing costs remain low, affordability is still high and household surveys indicate prospective buyers see current rates as a good reason to buy.

SECOND HALF PICK-UP?

While recently received data suggest the economy grew very modestly in the second quarter - - possibly as little as 0.5% to 1.0% - - other forward looking data are showing gathering momentum in discretionary consumer spending, capex orders and housing, in addition to improved employment gains. We continue to see GDP growth in the 2.0% to 2.5% range for the balance of this year as fiscal headwinds fade and Fed policy continues to underpin financial conditions. It is also evident that the risks to the economy have diminished since last fall reflecting some easing of financial stresses in Europe, the gains in housing and the labor market noted above, the improved budgetary positions of state and local governments, and stronger household balance sheets. Despite these reduced risks, we remain concerned that tight federal fiscal policy could restrain economic growth over the next few quarters by more than is generally expected or that the coming debate in congress over the debt ceiling will evolve in a way that could hamper the recovery. Moreover, with the recovery proceeding at only a moderate pace, the economy remains vulnerable to unanticipated shocks including the possibility that global economic growth may be slower than currently anticipated, a spike in energy prices could occur, or some other exogenous shock might surprise the global economy. Absent the enactment of pro-growth fiscal policies, a highly unlikely occurrence given the lack of political leadership in Washington and our dysfunctional congress, we expect growth to remain muted for the next several quarters.

THE FED

Following five years of unconventional measures and policies aimed at supporting the economy, first through a severe financial crisis and more recently during a sluggish recovery, Federal Reserve officials in late May signaled that, depending upon data to be released this summer and fall, they may begin to scale back their $85 billion-per-month bond-buying program later this year and conclude it by mid-

2014. Fed officials appear to be taking confidence from the recent resiliency labor markets have shown in the face of the drag on growth from the federal government's tax increases and spending cuts. However, scaling back the bond-buying does not imply the Fed believes the economy has reached "escape velocity" and is able to expand completely on its own. Fed officials, hoping to clarify their intentions, have repeatedly stressed that reducing their bond purchases (referred to as QE3) does not mean Fed officials intend to raise short term rates anytime soon. In fact, Fed members indicated at their June meeting they expect to implement the first interest rate hikes no earlier than 2015.

As to "tapering" their bond purchases, the Fed has made it clear that if the economy proceeds as it expects they will consider reducing their bond purchases when the unemployment rate reaches 7%. The next unemployment rate marker is 6.5% at which point the Fed will consider raising short term rates. The 7% and 6.5% targets are not triggers but thresholds which would occasion a review of their current policy. Fed officials have stressed that hitting these thresholds does not mean they would automatically reduce bond purchases or raise rates.

Timing aside, the Fed is clearly preparing the financial markets for the eventuality of higher short term interest rates. Intermediate and longer term bond yields, which are not pegged by the Fed, have already begun to rise. For example, the rate on the benchmark 10 year US Treasury note has risen from 1.62% on May 2nd to 2.50% currently, implying about a 10% decline in the market value of the bond. During the same time period, the yield on the 30 year US Treasury bond has risen from 2.81% to 3.58% today, losing about 17% of its market value in the interim. We continue to expect the Fed to begin to reduce its bond buying before year-end.

INVESTMENT POLICY

We believe we are in the early stages of a secular rise in interest rates which will persist for several years. Over time, interest rates will normalize with yields on 10 year US Treasury notes returning to the 4% - 5%+ range. While there will inevitably be brief periods during which longer-term rates retreat, the risk of owning longer-dated securities at this time outweighs the possible short term rewards that may accrue during counter-rallies. Bond portfolios under our supervision are, therefore, structured with protection of principal as the overriding objective. Durations of clients' corporate and municipal bond portfolios remain at all-time lows. US Treasury obligations, which we have avoided for 2 years, remain unattractive. The "great rotation" out of bonds has begun.

As for stocks, despite the recovery in equities generally, we continue to believe a globally diversified, opportunistic strategy that focuses on quality and growing income generation remains the best way to achieve growth of capital. While we are well along the road to recovery from the US financial crisis and recession of 2008-9, large cap stocks remain attractively priced at about 14.5 times forward earnings - - well below their 15.5 times mean - - given their strong cash flow generation, solid balance sheets and prospects for improving top line growth. Abroad, with a recession in the euro-area and uncertainties over how emerging equities will react to the prospect of higher interest rates, equity valuations are compelling, particularly so in a number of emerging markets. Our clients' equity portfolios are, therefore, fully invested. Between 15% and 20% of clients' equities are invested in companies whose businesses are domiciled abroad.

Periodic stock market corrections of 5% to 10%+, possibly triggered by an unexpected change in Fed policy, a spike in government bond yields or an exogenous shock, could precipitate a temporary pull-back and should be expected.

The supply and demand situation for equities, given the lack of quality alternatives offering competitive yields remains favorable. We expect individual and institutional investors who remain under-committed to equities to raise their allocations over time providing an underpinning to share prices. Corporate share repurchases, merger and acquisition activity, purchases by foreigners seeking the perceived safety of the US dollar and the US financial markets, purchases by foreign central banks and sovereign wealth funds will also add to the demand for US equities lending credence to the view equities could become *scarce* as the bull market plays out.

Domestic equity returns for the year-to-date have led those of both developed and emerging markets abroad as shown in the table on the following page. Despite these areas of relative weakness, the MSCI All Country World Equity Index has returned 10.9% this year. Fixed income markets, on the other hand, weakened in May and June as investors decided to flee the bond market in favor of the safety of either low yielding short- term instruments or for the higher expected returns from the stock market. The dampening impact on all markets of the growing likelihood of a shift in Fed monetary policy is reflected in the figures for the second quarter. Since quarter end, stocks have staged a significant recovery, largely erasing their declines of the May-June period. Bond prices have also bounced a bit but remain well below their May peaks.

2013 MARKET INDEX PERFORMANCE THROUGH 7/17/13*

Market Indices	July-to-Date	Month of June	April & May	2Q 2013	1Q 2013	Year To Date
S&P 500 US Large Cap Equity Index	4.7%	-1.3%	4.3%	2.9%	10.6%	19.2%
S&P 400 US Mid Cap Equity Index	5.3	-1.8	2.9	1.0	13.5	20.6
S&P 600 US Small Cap Equity Index	6.4	-0.1	4.1	3.9	11.8	23.7
MSCI EAFE Int’l Developed Mkt Equity Index	5.2	-3.6	2.7	-1.0	5.2	9.5
MSCI Emerging Markets Equity Index	1.5	-7.0	-0.9	-7.9	-1.8	-8.2
MSCI All Country World Equity Index	4.6	-2.9	3.0	0.0	6.1	10.9
Citigroup T-Bill	0.0	0.0	0.0	0.0	0.0	0.0
Barclays 5-Year US Municipal Bond Index	0.3	-1.6	-0.1	-1.7	0.8	-0.5
Barclays US Aggregate Bond Index	0.3	-1.5	-0.8	-2.3	-0.1	-2.1
Consumer Price Index - Unadjusted	0.5	0.1	-0.6	-0.4	0.7	0.8

*Total Return

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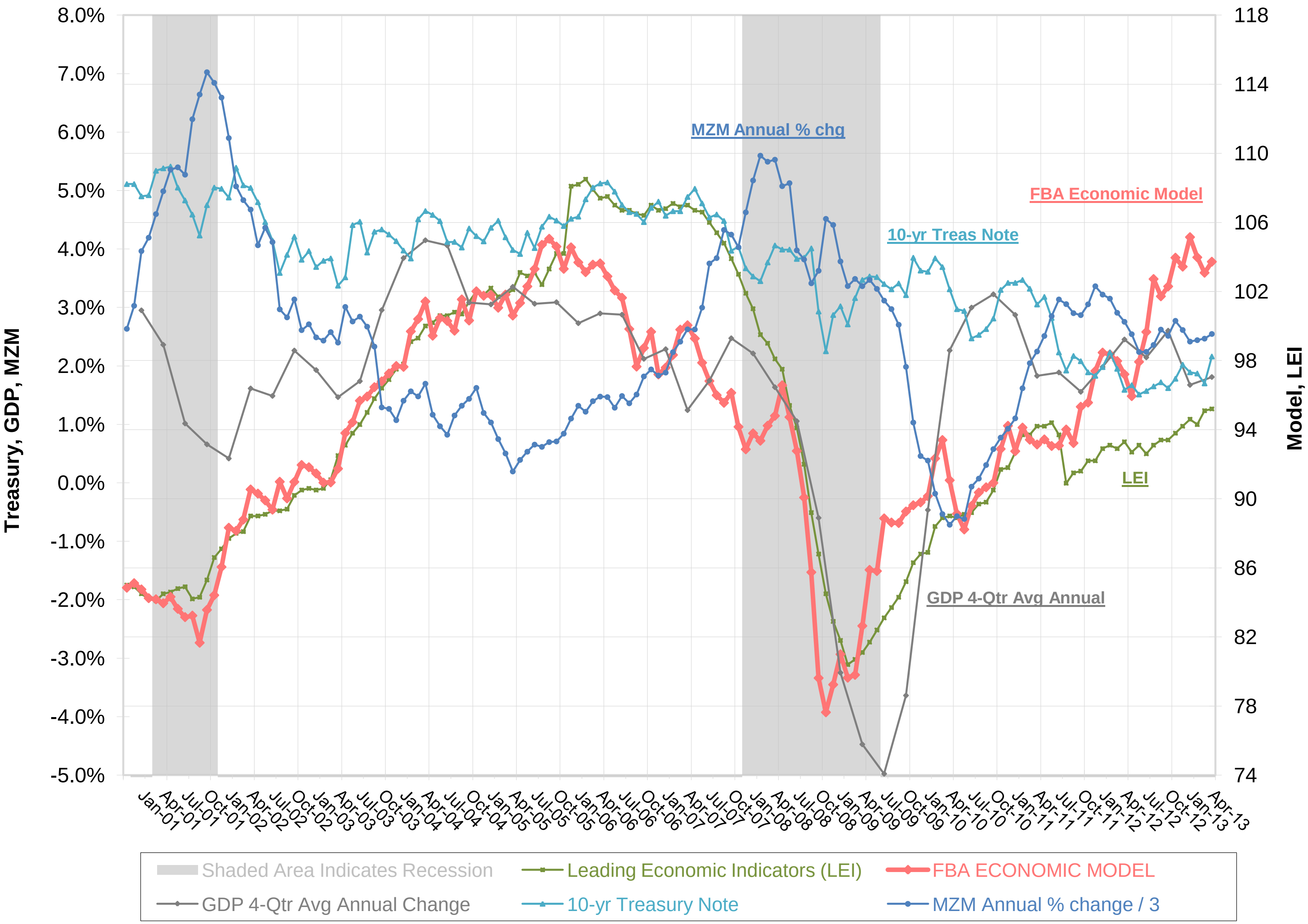
Front Barnett Associates LLC
Economic Model
June 27, 2013



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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.