

Marshall B. Front
Chairman

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

March 13, 2014

ECONOMIC UPDATE - - ON SOLID FOOTING

Despite a business slowdown which began last December and continued through early this month, the US economy remains on solid footing. The first quarter's deceleration in growth appears to have largely stemmed from the temporary effect of poor weather conditions and an adjustment in business inventories which had swelled in late 2013, rather than the beginning of a longer-term downshift in growth.

Aside from weather, there were no apparent unexpected shocks or causes for the winter slowdown. Now, as climate conditions moderate, we expect a snap-back in activity, with second and third quarter GDP in the 3%+ range, well ahead of the 1.0%+ growth we appear to be experiencing in the current quarter. Importantly, the harsh weather in recent months hit discretionary spending especially hard, likely creating significant pent-up demand that will, in turn, boost second and third quarter outlays.

Bureau of Labor Statistics figures show employment gains also slowed abruptly last December and remained extremely low in January when the polar vortex sent freezing temperatures across much of the Midwest and East. While the cold weather has persisted, employment and jobless claims reports have since shown successive improvements with payrolls increasing by 175,000 jobs in February, close to the average gain of the past few years. If we are correct in our forecast of a sharp rebound in overall business activity as the weather moderates, we expect the March jobs gain to normalize payrolls to the underlying trend after months of weather-related disruptions.

As encouraging as it was to see the better-than-expected employment gains in February, with more people finally returning to the labor force, the participation rate remains troublingly low. Indeed, if the participation rate was at 66%, which is about where it hovered for many years prior to the recession, the headline unemployment rate would be about four percentage points higher (i.e. 10.7%) than

is currently reported. While some of the decline in the participation rate is demographic, other aspects of it are somewhat unique to this economic cycle. For example, the participation rate of the youngest, least skilled workers has been falling. This decline appears to be more a barometer of limited job prospects than demographic in nature. Businesses, which have not generally been quick to add jobs, seem to prefer hiring older, more experienced workers who can be productive immediately, rather than bring in younger, inexperienced workers. As the economic cycle matures, the pool of experienced unemployed workers will shrink, improving job opportunities for inexperienced people looking for work, drawing them into the labor force.

CAPITAL SPENDING

Aside from the consumption rebound we expect to play out in the next two quarters, we remain confident, as we discussed in our January Economic Update, business spending will continue to support the expansion. Capital investment *intentions* have increased in the past few months, despite fears of a slowdown amidst weather distortions and regulatory concerns. A recently published review of 724 nonfinancial publicly-traded companies shows an uptick in planned 2014 business outlays, with growth now likely to rise to 5.0%, up from 1.5% when similar data was analyzed in the 4th quarter of last year. This growth comes on top of the stronger than originally expected 4.8% gain in capital spending during 2013 and the fifth consecutive annual increase in Capex. The Senior Loan Officers' survey conducted by the Federal Reserve typically leads corporate spending by about nine months. Currently, this survey is signaling a pickup in business outlays. Furthermore, employment growth tends to be symbiotic with capital investment as companies need to provide workers with the space and tools they require to do their jobs. Looking ahead, credit conditions should also remain supportive of a continuation of this trend.

FED POLICY

At a June 2011 policy meeting, Federal Reserve officials agreed on a long-term plan to eventually exit sometime in the future from their unconventional monetary policies and revert to their interest rate setting regime of the past. That plan is looking increasingly out-of-date and the outlines of a new plan are slowly taking shape.

Under the prior plan, the Fed would systematically remove trillions of dollars it has pumped into the financial system. First, it would let mortgage securities mature

and run off its balance sheet. Over a longer stretch it would sell mortgage-backed securities. Other technical tools, such as encouraging banks to place deposits at the Fed, would further drain reserves in the financial system. Taken together, these money draining measures would help lift the Fed's benchmark Federal Funds Rate as the supply of money in the system shrinks. The Fed would also pay an interest rate on bank reserves to anchor rates where it wants them.

Now, a new plan under consideration by the Fed would leave excess reserves in the system for an extended period, conceivably forever. In addition to paying interest on excess bank reserves, the Fed would anchor rates through a program using reverse repurchase agreements, or "reverse repos", where it trades with firms outside of the banking system and pays them interest on the cash they lend to the Fed. Rather than draining money from the financial system, and setting interest rates by managing its supply, the Fed would set interest rates by managing the *cost of money*. The Fed would, in effect, become the price setter through the interest rate it pays. This change in the Fed's managing interest rates is not yet set. Some Fed officials want to go back to the days of scarce reserves. Moreover, the reverse repo program, which is central to the Fed's new thinking on its exit from its non-conventional policies, comes with costs that could dissuade some officials. Among them, the reverse repo interest rate could overshadow or undermine the fed funds rate, which is the benchmark rate for many other financial contracts.

A high priority for Janet Yellen, the new Fed Chair, will be to get officials to agree on an approach in the months ahead. Clearly, investors will need to be aware of how that regime will work as it will include important signals on how the coming rate-hike cycle will play out. Meanwhile, the rebound in February's job numbers assures the Fed will not deviate from its course in reducing its quantitative easing (QE) program, eliminating it entirely by year-end.

Immediately ahead, the Fed will likely decide at its meeting next week to scrap their 6.5% threshold unemployment rate for considering a rate rise. Instead, the Fed will embrace new language that is less quantitative and more qualitative about when to expect tighter policy. This shift in guidance has the potential for heightening financial market uncertainties unless the Fed is able to recraft its policy statement without changing market expectations that a rate increase will not occur until mid 2015. Stay tuned!

FORECAST

While data provided mixed signals on the US economy in January data, the global recovery continues to strengthen. Most surveys for February indicate expansion in global economic performance. The UK is in its eleventh consecutive month of growth, while the Euro zone is in its eighth month of expansion. Here in the US, the February ISM Manufacturing index, a highly reliable leading indicator, regained some of the momentum it lost in January due to weather as the new orders and supplier deliveries components of the index rebounded. The ISM Non-Manufacturing index for February continued to signal expansion in the services sector which accounts for about 90% of GDP.

We referred above to a swelling in inventories early this year. Rising inventories could be a concern as they often reflect a slowing in demand. Given our view that poor weather was behind the outsized inventory increase, we conclude that some factories held inventory longer than usual setting up for a period of self-correction over the course of the next month or two as the polar vortex retreats northward.

All in all, then, with consumption and manufacturing poised to rebound, business spending continuing to expand at a better than expected pace, the global economy improving, and diminishing fiscal headwinds, we now expect GDP growth to expand at about a 3.0% rate for all of 2014. The Fed's favorite gauge of inflation, the Personal Consumption Expenditures index (PCE) remains well below the 2% target, assuring interest rates will be kept low until well into 2015 as unemployment is expected to drift down only slowly. Finally, our firm's proprietary Economic Model, structured to forecast changes in the direction of the economy 6 to 9 months in advance of a turning point, continues to signal expansion as does the Leading Economic Indicators (LEI).

EQUITIES

Our firm's current equity portfolio strategy is based upon our belief that a synchronous global economic recovery, led by an uptick in US business growth, will continue to unfold this year bringing S&P 500 operating earnings up to \$122 per share. Well-diversified investments in companies likely to benefit including financials, industrials and technology companies are over weighted, amounting to over 50% of clients' core large cap domestic equity exposure. As the global recovery spreads, equity investments in companies domiciled abroad in both developed and emerging markets should also benefit. Investments abroad are targeted at 15% of client's overall equity positions.

The case for maintaining current equity positions despite last year's 32%+ S&P 500 total return following four prior years of rising stock prices, rests on our belief that stock *valuations* are not stretched at about 15.3 times forward earnings. Their 15 year forward average P/E ratio is 16.0. Currently, with rates on high quality short-term obligations near historic lows, and bond prices likely to fall as open market rates drift higher, we believe stocks remain the investment vehicle of choice among marketable securities.

Despite the inevitability of a 5% to 10% correction and the constant chatter among some perennially bearish headline-hungry market savants predicting the next "crash", we fail to see the classic signs of excessive stock market valuation or speculation that would cause us to adopt a more cautious longer-term attitude toward equities. While returns are not linear and stocks are unlikely to soon repeat their 2013 performance, US manufacturing cost competitiveness, the remarkable shale gas and light oil revolution, technological mobility, the extension of the housing and auto industry rebounds and improvement in government spending and revenue balances should combine to support expanding price/earnings multiples.

With Europe having emerged from recession, Japan following a stimulative fiscal policy and China's economy stabilized at about a 7.5% GDP growth rate, equity investments abroad in both developed and emerging markets, where valuations are compelling, remain attractive.

FIXED INCOME

In our view, we are in the early stages of a secular rise in interest rates. Fed policy will be normalized and inflation expectations will eventually rise as the pace of business quickens. Rates on the 10 year US Treasury note, currently at 2.73%, are expected to return to the 4.0% - 5.0% range over the next 2 - 3 years. While there will inevitably be brief periods during which longer-term rates retreat, the risk of loss of principal due to holding longer-dated securities during a period of rising rates outweighs the possible short-term benefits that may accrue during counter-rallies. Bond portfolios under our supervision are, therefore, structured with protection of principal as the overriding consideration. Consequently, durations of corporate and municipal bond portfolios remain at all-time lows approaching one year.

* * * *

MBF