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ECONOMIC UPDATE – FROM SLUGGISH TO TREND-LIKE

Economic data released in the past several weeks has been encouraging, confirming US growth has finally shifted gears, going from sluggish to a trend-like pace. Forward looking indicators such as those from the Institute for Supply Management (ISM) and Purchasing Managers (PMI), as well as consumer confidence have been healthy for some time and remained that way in June. Auto and existing home sales continued to show strength in recent reports. Business capital investment, a weak spot for several quarters, is expected to perk up if surveys taken earlier this year prove to be correct. Abroad, China has recently shown the most progress despite ongoing property issues with GDP growth stabilizing at about 7.5%. And while Europe has lost some momentum, its numbers remain at healthy levels. Globally, central banks remain highly accommodative, underpinning the recovery, and are expected to continue their easy money policies for an extended period ahead.

ENCOURAGING JOBS MARKET

Perhaps the most visible sign of acceleration has occurred in the US jobs market. The Bureau of Labor Statistics' *establishments* report showed non-farm payrolls jumped by 288,000 in June, far exceeding expectations. The unemployment rate declined by another 0.2 to a post-crisis low of 6.1%. Importantly, the share of long-term unemployed persons, which is closely watched by the Federal Reserve, declined to its lowest reading since 2009. On balance, the improvement in the labor market shows that economic slack is being absorbed without stoking inflation as average hourly earnings remained near 2% year-over-year. That data signals the Fed will continue to taper its Quantitative Easing (QE), ending the program as expected in October, and is not likely to raise rates until mid-2015.

June's payroll increase marked the fifth consecutive month of employment additions above 200,000. The revised 304,000 reading in April was the highest such number since January 2012. The reported dip in the jobless rate to 6.1% was

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supported by a 325,000 decline in the number of unemployed people and a relatively small 81,000 increase in the labor force. Meanwhile, the *household survey* showed the number of employed people jumped 407,000 while persons not in the labor force increased by 111,000. So the decline in the unemployment rate was more reflective of hiring than worker discouragement. Also encouraging was the number of long-term unemployed (27+ weeks) declined significantly as a share of total unemployment to 32.8% from 34.6%. This measure has fallen about 5 percentage points since the end of last year and now stands at its lowest level since 2009. This gauge of economic slack has been targeted by Fed Chair Yellen as a vital policy indicator. While the unemployment duration has ebbed, the really good news is that wage inflation has held steady near 2% and the work week has been little changed at 34.5 hours.

Even though recent jobs figures are very encouraging, let's not lose sight of the fact that the so called *participation rate*, which indicates the share of working-age people in the labor force, remains at about 62.8%, the lowest level since 1976. 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 10.3%, four percentage points higher than is currently reported. A simple way to illustrate the true weakness in the jobs market is via the U6 unemployment rate which includes unemployed, marginally attached and underemployed individuals. This measure remains at 12.1%, which is about 2 percentage points above the cyclical norms.

HEADWINDS

So what has been holding back our nation's growth? Why are businesses hoarding over a trillion dollars of cash that could be put to work, adding to plant and equipment, and hiring new workers at a time when there is no lack of access to capital or loans? We believe our tepid expansion is probably traceable to a combination of the following factors:

- Concerns around *excessive regulation* and *red tape*.
- *Uncertainties surrounding Obamacare*. When a massive change to such an important segment of the economy is made, uncertainties are created for many businesses.
- *Lack of leadership* and *political will* in Washington in dealing with our fiscal realities remain an issue.

- *Entitlement spending* -- now 60% of federal spending and growing – is crowding out infrastructure investment and spending initiatives such as research and development and training.

- *Political gridlock* resulting in not only a government shutdown but in two debt ceiling crises was damaging to confidence.

- US *corporate tax policy* is incredibly inefficient, driving American capital overseas.

- US *immigration policy* is driving so called "brainiacs" and entrepreneurs overseas.

In addition to these uncertainties, *hypersensitivity* to risk may be retarding growth. Since the 2008-9 financial crisis and deep recession, we appear to have been living in a time of heightened sensitivity, uncertainty and risk aversion. Can this be cured? Will the Keynesian "animal spirits" encouraging investment and risk-taking reemerge? In our view, constructive collaboration as opposed to divisive finger-pointing is needed. A handful of smart decisions can improve confidence. As confidence builds, businesses and consumers will spend and invest more. Stronger economic growth will create more jobs and higher incomes giving us the resources to address key policy issues closing the loop on the elusive virtuous cycle of which we have often written.

FED POLICY

For some Fed watchers, the recent drop in the unemployment rate to 6.1%, the lowest level in more than five years, may bolster the case for Federal Reserve officials to raise interest rates earlier than forecast just a few weeks ago. Note that the Fed has not expected to see the 6.1% level prior to year-end. In our view, the Fed will be looking beyond the unemployment rate alone, watching a broad "dashboard" of labor market metrics including payrolls, the jobless rate, underemployment, labor force participation and the share of long-term underemployed to guide monetary policy. While US inflation measures are a bit firmer, driven by a handful of agricultural commodity prices, the Fed's preferred inflation measure, the Personal Consumption Expenditures price index (PCE), now stands at about 1.2%, well below the 2.0% level which would cause the Fed to materially shift its policy stance. In addition, the Fed has intimated it will have a higher tolerance for inflation than was the case previously. We, therefore, continue to expect the Fed to wait until mid-2015 before raising rates. In the meanwhile, a greater risk to the stability of the financial markets remains how well the Fed is

able to communicate its monetary policy in a manner that avoids serious credit market disruption, a skill which in the past, it has failed to demonstrate.

CHINA

China's economic activity quickened in the second quarter from the prior three months as modest, selective government support measures helped to boost overall growth. To lift China's flagging economic growth, which had an 18 month low of 7.4% in the first quarter of this year, authorities have cut taxes, ordered regional governments to accelerate spending and reduced the amount of cash some banks are required to hold on reserve. Use of these "targeted measures" is intended to assist areas of the economy with real business needs, a significant departure from the past where officials would cut rates or reserve requirements for all banks and ramp-up spending across all sectors within the country.

Recently, a series of surveys of China's manufacturing and services sectors suggest that growth in China, the world's second largest economy, may have stabilized in recent months, though a slowing property sector is now viewed as the biggest threat to more rapid growth. We expect the government's growth target of around 7.5% will be met, providing another building block for the global expansion we see ahead.

FORECAST

Directionally, our forecast, unchanged from mid-May, calls for economic activity to pick up steam as the year progresses. By the fourth quarter we expect real GDP growth to reach a trend-like pace of 3%+. High frequency, forward looking indicators including initial jobless claims, consumer confidence, ISM manufacturing and non-manufacturing indexes, Leading Economic Indicators (LEI) and our firm's proprietary Economic Model support our view. A copy of the Economic Model, which has taken a strong turn upward in recent months, is enclosed. Meanwhile, financial conditions have eased further as Treasury yields remain low, credit spreads remain tight, and equities continue to make new highs. And, importantly, the transmission of the Fed's accommodative monetary policy stance to the financial variables that actually matter for the real economy has also made a significant amount of progress.

With consumption expected to remain strong and manufacturing to rebound from the level of the frigid weather-plagued first quarter, we expect to find GDP snapped back to a 2.5% rate in the second quarter and for it to inch up over the

balance of the year toward 3%+ in the fourth quarter. The Fed will remain highly accommodative through mid-2015 and thereafter raise rates only very gradually. Inflation will remain quiescent keeping pressure off the Fed to move prematurely. S&P 500 operating earnings will exceed $120 per share this year and are expected to rise to $130 per share next year.

EQUITY STRATEGY

In our view, stocks remain the asset class of choice despite their sharp price advance last year and this year-to-date. Economic growth is accelerating, translating into generally better-than-expected earnings for last quarter and the second half of the year. As for stock market valuations, the S&P 500 is trading at about 16.5 times this year's expected operating earnings and 15.3 times 2015 forecast per share operating earnings, valuations not far above their long-term means.

Despite the sharp bond market rally during the first half of this year, when yields on 10 year US Treasury bonds fell from 3.0%, to below 2.5% briefly during the second quarter, we believe there is a high likelihood bond yields will rise over the intermediate term giving rise to negative returns to bond holders, prompting money flows into equities. However, rallies are not linear and there will be periods of consolidation along the way. Recall that bull markets have inevitably experienced setbacks as we saw in 1984, 1987, 1990, 1994 and 1998 but did not preclude further gains. At some point there will be an event that causes a meaningful decline in the broad indexes but it should not derail the overarching bull thesis.

FIXED INCOME STRATEGY

Client's fixed income investments remain cautiously invested with preservation of principal the overriding consideration. Bond durations in fixed income portfolios under our supervision approach 1 year. Fixed income portfolios are largely structured with an ultra-short ladder of high quality, liquid, corporate obligations in the expectation that there will be opportunities ahead to reinvest the proceeds of maturities in higher yielding instruments over time as interest rates normalize.

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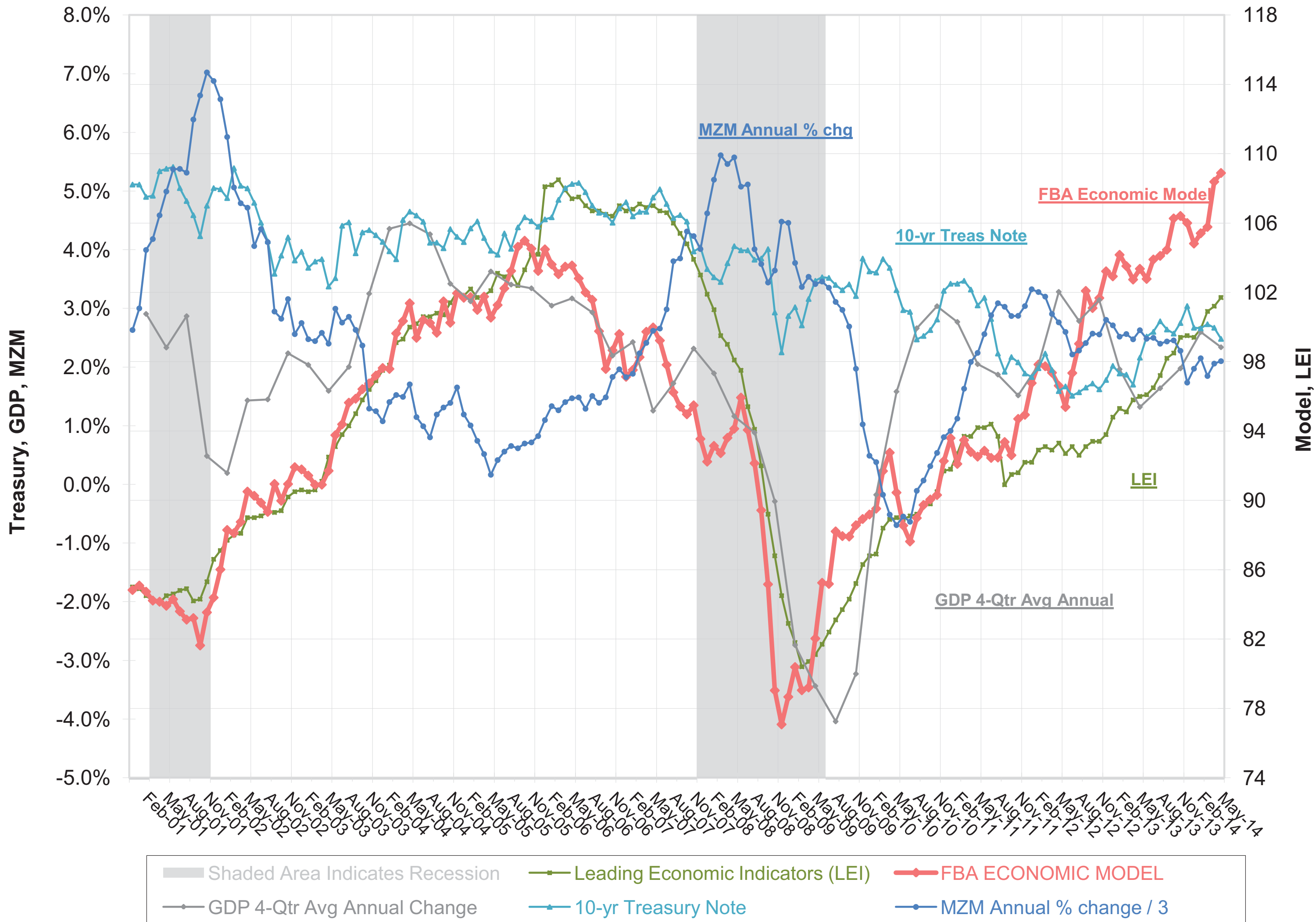
Front Barnett Associates LLC
Economic Model
June 26, 2014



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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.

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