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ECONOMIC UPDATE - - ESCAPE VELOCITY

The US labor market in October achieved its longest streak of job creation since World War II, lending support to our view the economy is rapidly approaching *escape velocity* where the Fed can begin raising rates gradually without fear of stalling the expansion. The addition of $10 trillion of household wealth, stability in the housing market, reduced fears of a government shutdown, and the much improved job outlook provide the underpinning for stronger, *self-sustained* growth.

Employers, who added 214,000 jobs last month, are on track to record the best yearly payroll gains since 1999. Monthly job additions have pushed the headline unemployment rate down to a healthier 5.8% rate. Elsewhere, *forward looking* economic indicators we monitor closely are pointing toward a continuation of the business expansion. The Institute for Supply Management's (ISM) manufacturing and services indices are strong. Initial jobless claims are averaging less than 300,000 weekly and firming consumer sentiment surveys point toward gradual improvement in spending. Consumer sentiment rose in November to more than a seven year high, as falling unemployment and lower gasoline prices boosted views on both current conditions and expectations. Preliminary readings on the overall Consumer Sentiment Index came in at 89.4, the highest reading since July 2007, well above the highest estimates.

One of our favorite indicators, the Fed's Senior Loan Officer Survey on Bank Lending Practices, showed in its October report a further loosening of credit conditions across most commercial and residential loans and that commercial & industrial and commercial real estate loans continued to increase – harbingers of stronger capital spending next year.

Coincident indicators such as retail sales and industrial production confirm the expansion remains on solid footing. Most US retailers reported strong sales in October, a sign American consumers were again spending at a brisk pace. A key

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measure of retail sales, which account for about one-third of consumer spending, snapped back from a weak September, suggesting fundamental strength even as a drop in gasoline prices held the gain in overall sales to just 0.3 percent. Other data shows consumer sentiment has risen to a seven year high this month, also positive for the spending outlook as we enter the holiday shopping period.

Open market indicators including a strong dollar, rising equity markets, falling gold prices and a steep yield curve are signaling the economy is gaining momentum. And, the upward paths of both our firm's proprietary Economic Model (enclosed) and the Leading Economic Indicators (LEI) portend continued expansion. Abroad, recently announced central bank easings in Japan, the Eurozone and Sweden, on top of existing highly accommodative policies, will counter weakness in the euro zone and Japan.

JOBS

Behind the rosy headlines in the October jobs report are a number of disquieting realities. For example, wages have been rising only slightly faster than the rate of inflation. Over the past 12 months, with jobs numbers increasing rapidly, wages are up just 2 percent which helps explain the disconnect between some economist's favorable assessments of the labor market and widespread public discontent with the employment situation. In addition, while the so-called labor "participation rate" rose to 62.8%, it remains well below the historical rate which has been about 68%. The U6, a broader measure of unemployment that includes discouraged job seekers or those who have had to settle for only part-time work, also improved, falling to 11.5%, but it, too, remains much higher than prior to the financial crisis. And the persistent problem of longer-term unemployment showed no signs of improvement in October with 2.96 million people out of work for 27 weeks or more. This group accounts for about a third of those without jobs. It is, therefore, not surprising that election day exit polls found that 78% of those surveyed were very or somewhat worried about the future of the economy; many apparently "voted their pocket books".

There are a few additional encouraging data points regarding the employment situation worth mentioning. Recent data shows that while employers hired workers in September at the strongest pace since the last recession began, more workers quit their jobs than at any time in more than six years, showing Americans may be gaining greater confidence the labor market is improving and that they will find a better job elsewhere. Some 5.03 million employees were added to staff, boosting the hiring rate to a 3.6 percent, the strongest since December 2007.

Meanwhile, 2.75 million people resigned in September, pushing the "quit rate" up to 2 percent, the highest since April 2008. These figures portray a favorable shift in the job market, with more people entering and leaving, indicating the job market is finally looking more *fluid* - - as it does in better economic times.

Balancing the positive and negative labor market factors, we conclude the long streak of job gains does point to a much improved economy which is slowly becoming less fragile and less susceptible to shocks. Narrow debt market credit spreads are a testimony to this fundamental improvement. Ultimately, more people are working which should lead to greater consumption, growing business outlays, higher corporate profits and more jobs. This self-feeding "virtuous cycle" of which we have written so often, is at hand.

MANUFACTURING RENAISSANCE

The US manufacturing renaissance continues. This sector, which accounts for 12 percent of the US economy, expanded in October at a faster pace than forecast, indicating it remains a source of strength. The Institute for Supply Management's factory index increased to 59, matching August as the highest reading since March 2011, after 56.6 in the prior month. Recall that readings above 50 indicate expansion. In addition, the production sub-index, which stood at 64.8, was the strongest in a decade. This pickup signals US factories are able to offset slower global demand with domestic sales as the improved financial condition of US households and companies underpins their spending. The stronger job market and the cheapest gasoline prices since 2010 are providing an added boost to consumer spending. While we have been concerned the strong US dollar and weakness in Europe and elsewhere would depress exports and hurt manufacturing, the driving force behind the US manufacturing recovery has clearly been domestic demand which we see improving in 2015.

Interestingly, American factories are expanding more rapidly than their counterparts abroad. European manufacturing barely grew last month as output in France and Italy actually shrank, while factories in China showed some signs of cooling. A final reading of a Purchasing Managers' Index for manufacturing in the euro area stood at 50.6 in October while up from a 14-month low of 50.3 in September, barely above the mark of 50 signaling expansion. Meanwhile, China's official gauge of manufacturing eased to 50.8 from 51.1 in September.

JAPAN

Last month, the bank of Japan announced in a surprise move an increase of its money supply from JPY 60 trillion to 80 trillion at an annual rate. That is the equivalent of approximately a $700 billion increase per year. The amount of the increase is significant as the Japanese economy is only about one-third the size of the US economy. This increase was in response to the fact "Abenomics" has not worked to stimulate the economy as desired by Prime Minister Abe. The economy has now contracted for two consecutive quarters and is officially in recession. Abenomics consists of three arrows – quantitative easing by the bank of Japan through purchases of Japanese Government bonds, weakening the value of the yen in the foreign exchange markets, and structural reforms. Thus far, the first two arrows have been fired, then increased, but reforms are far short of plan.

Japanese consumers were hurt by a consumption tax and by the weaker yen which caused higher import prices. Household incomes are not rising as planned as the corporate sector is slow to raise wages. So private consumption is not supporting Abe's economic plan. However, the corporate sector is benefitting, as it retained part of the benefits of cheaper currency, as profits and the corporate sector's cash is clearly rising.

Structural reforms are still lacking, which has much to do with the traditional structure of corporate Japan and its political clout. There is a great deal of rigidity in the Japanese system, a hangover from the organization of the economy post WWII when the manufacturing sector dominated the economy.

The outcome of the new stimulus plan is unclear in the short term, but in any case, Abe wants a weaker yen, higher inflation, and may at some point launch fiscal stimulus to support the economy. Scrapping a planned increase in the consumption tax is a real possibility. The implementation of the entire plan will be bearish for the yen, bullish for Japanese equities and, if successful, positive for both the Japanese and the global economy.

OUTLOOK

Business conditions are expected to continue their modest but steady improvement for the balance of 2014 and 2015. Labor market conditions have improved and there remains significant underutilization of labor resources and industrial capacity to accommodate future growth without impacting inflation. Economic activity will, in our view, increase at a pace sufficient to lead to a further gradual decline in

the unemployment rate. Inflation, currently 1.3 percent as measured by the PCE, will continue to run below the Fed's longer-run 2% objective. Key factors affecting the outlook:

> *Household Spending:* Consumption will continue to rise moderately spurred by continued gains in household wealth, improved household balance sheets, low loan delinquency rates, a high savings rate, and rising confidence in employment and income prospects. However, uncertainties remain about prospects for yet stronger gains in real income necessary to sustain still higher growth.
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> *Housing:* The recovery in housing remains slow and is likely to remain so in all but a handful of areas of the country despite relatively low mortgage rates, rising home prices, and improvements in household wealth. New construction has been held back in some places by a variety of headwinds including shortages of skilled workers, materials and lots available for development, or by the overhang of vacant homes not on the market. Households with relatively low credit scores are having difficulty obtaining mortgage loans. This is particularly true among younger households who have high levels of student loan debt or poor job prospects. One bright spot is the relative strength in construction and demand for multifamily units, which possibly is due to a shift in lifestyles among younger home buyers away from single-family homes to rentals or condos.
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> *Business Conditions:* There has clearly been an improvement in business conditions stemming from rising confidence in the economic outlook and increased willingness to undertake new investment projects. National surveys show a planned strengthening investment in transportation, energy, and services, including higher levels of new orders and shipments of capital goods, strong interest in technology, and the need to replace aging capital. The improvement in business is reflected in increased demand for loans at banks.
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> *Fiscal Policy:* The restraint on economic activity from fiscal policy will continue to diminish. Nonetheless, the cutbacks in both defense and nondefense federal outlays, as well as state governments' budget restraint, will continue to weigh on jobs and income in some parts of the country. Fiscal policy,

therefore, will, at best, be a neutral factor for economic growth over the next several years.

Economic Activity Abroad: The foreign exchange value of the dollar has appreciated, particularly against the euro, the yen and the pound sterling. The persistent shortfall of economic growth and inflation in the euro area is likely to lead to further appreciation of the dollar and have adverse effects on US exports. Growth in the Eurozone is faltering, in part because of contractions in the economies of its three largest members. Germany's economy, Europe's growth engine, shrank at an annualized 0.6 percent rate in the second quarter. France, the bloc's second largest economy behind Germany, was largely flat for the second straight quarter. Spain and Netherlands posted some growth but not enough to offset weakness in the German and French economies. Moreover, a slower pace of economic growth in China, Japan or unanticipated events in the Middle East or the Ukraine, poses possible future risks.

FED POLICY

The timing of the first increase in the federal funds rate and the appropriate path of this policy rate thereafter remains the subject of vigorous debate among financial market savants. The Fed has repeatedly indicated its policies would depend upon incoming economic data and their implications for the outlook. Some Fed members have expressed their concern that the current forward guidance regarding the federal funds rate suggested a longer period before rates are raised, and perhaps also a more gradual increase in the federal funds rate thereafter, than they believe was likely to be appropriate given economic and financial conditions. Other members say it would be premature to raise rates now or in the weeks immediately ahead. In their view, while there has been considerable improvement in the economy, it is still premature to begin to normalize rates as there remains slack in the labor market and the inflation rate is still too low. They believe that if all goes well, the time to begin short term rate increases will be sometime in the middle of next year. Given the still high level of long-term unemployment, there could be a significant benefit to allowing the economy to run slightly hot for a while in order to get people back to work, in their view.

While Fed administered interest rates are almost certain to rise next year, absent some unanticipated shock, the debate over timing is likely to drag on into 2015

without resolution as incoming data will remain inconclusive. The immediate risk remains how well the Fed is able to communicate its monetary policy in a manner that avoids serious credit market disruption which, in the past, it has failed to demonstrate.

FORECAST

All in all, with fiscal policy neutral and the Fed remaining highly accommodative, we expect strength in consumption, manufacturing, services and business investments to offset possible weakness in exports. GDP is forecast to rise at an above-trend 3%+ rate next year. Inflation will remain below the Fed's 2% target rate. Corporate profits should rise sending per share S&P 500 operating profits to $130, another 8% gain. The risks to this forecast are largely those associated with possible disappointing growth in the euro zone, Japan and China, and the impact of an exogenous shock (i.e. weather-related, natural disaster or spillover from a conflict in the mid-east).

EQUITY INVESTMENT POLICY

In our view, with the US economy likely to grow at a 3%+ rate next year, yields on high quality bonds non-competitive, the Fed likely to begin by mid-year to normalize rates, albeit at a very slow pace, credit growth growing slowly and no recession in sight, equities remain the asset class of choice.

From a *valuation* standpoint, S&P 500 stocks, while no longer under-valued, are currently fairly priced as shown in the following comparative table:

		- - - - Historical Average - - - -		
	Latest	**1 Year**	**10 Years**	**25 Years**
Forward Price / Earnings	15.7x	13.9x	13.8x	15.6x
Dividend Yield	1.9%	2.0%	2.0%	2.1%
Price / Earnings + Growth	1.4	0.7	1.7	1.4
Price to Book	2.8	2.6	2.4	2.9
Price to Cash Flow	11.0	10.6	9.7	11.3

From a *supply/demand* perspective, we expect investors will rotate from low-yielding fixed-income securities into equities once there is greater confidence the economy is on solid footing and, as open market rates rise, they begin to experience losses in their bond portfolios. Beyond this reallocation, corporate buy-backs will continue but at a more moderate pace. Sovereign wealth funds will implement the announced increases in their equity ratios, foreigners will increase

their dollar denominated stock exposure, and undercommited individuals and institutions will add to their stock holdings.

Nevertheless, as we have often stated, stock markets will inevitably experience corrections of 10% or more. These pullbacks wring-out excessive enthusiasm and/or adjust to inevitable surprises. The stock market's October 9.8% pullback was such an event as a confluence of factors (i.e. Ebola scare, ISIS beheadings, Ukraine violence, election uncertainties, worries over deflation and a global economic slowdown) led some investors to reduce their equity exposure. Looking ahead, other corrections could occur around the possible destabilizing impact of the shift in Fed policy next spring/summer or the emergence of a new rash of geopolitical risks.

Equity portfolios under our management remain fully invested within established portfolio guidelines with the balance between *growth* and *value* shares tilted modestly toward *growth.* Reflecting our view that the current expansion will persist unabated for several years, large cap economically sensitive companies' shares (industrials, technology, financials and energy) represent roughly 60% of clients' equity portfolios. Companies domiciled abroad are targeted to represent about 15% of the equity portfolio.

FIXED INCOME STRATEGY

Fixed income investments under our supervision are viewed largely as a "safety net," invested with capital preservation as the overriding consideration. We believe we are in the early stages of the normalization of rates and that bond portfolio durations should be maintained at minimal levels. Currently, portfolios are structured with an extremely short ladder of high quality, marketable, corporate obligations. Portfolio durations currently approach 1.

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As we approach year-end, we at Front Barnett wish you and yours safe and enjoyable holidays.

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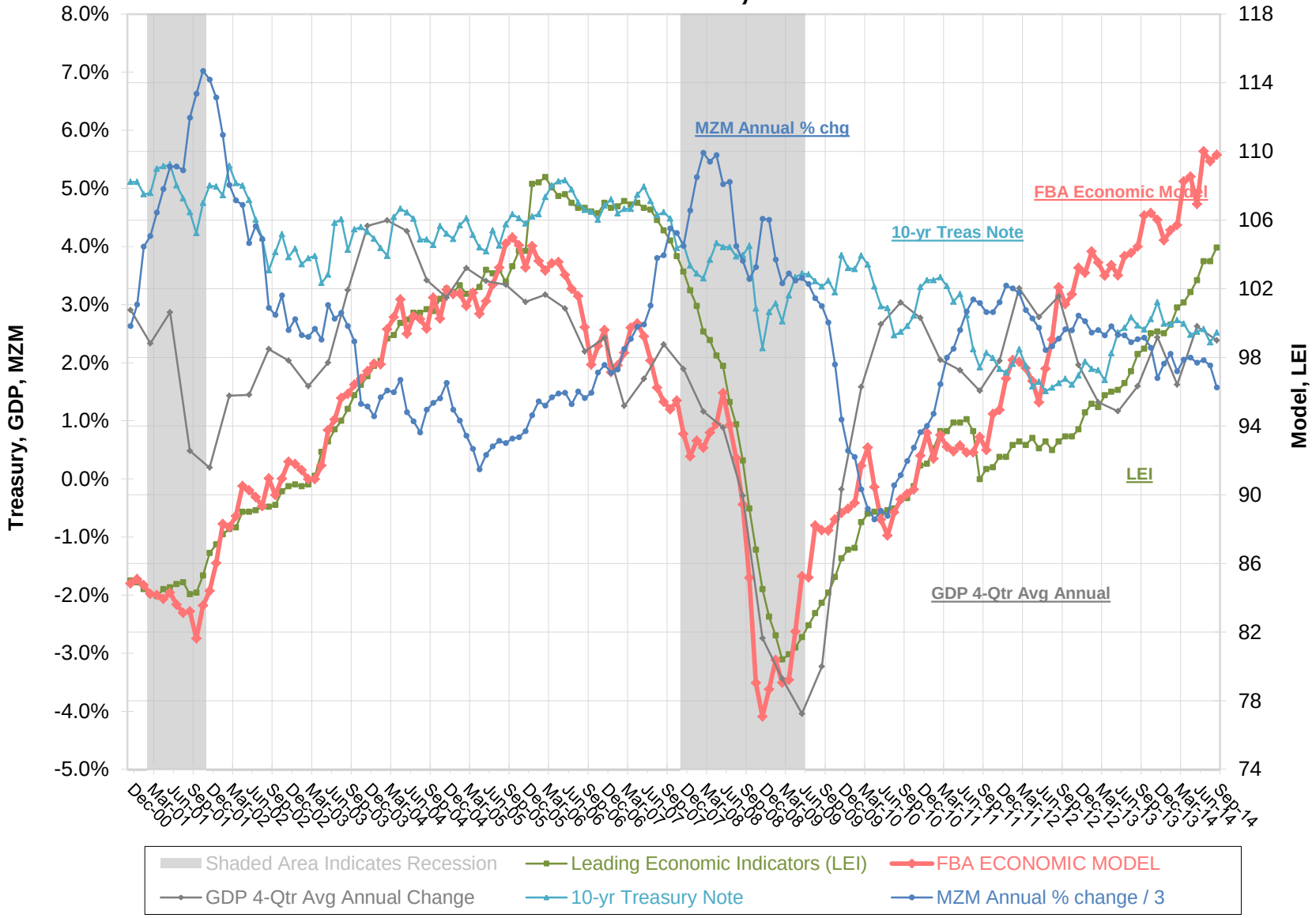
Front Barnett Associates LLC
Economic Model
October 31, 2014



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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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