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THE ECONOMIC OUTLOOK- - MUDDLING ALONG

The US economy continues to muddle along, growing only modestly in the third quarter. We estimate GDP expanded at an anemic 1.5% rate, well below the 3.9% second quarter's pace, but roughly in-line with the 2.0% *underlying* growth rate of the past few years. The strong US dollar weighed on manufacturing and tourism while housing and consumer spending remained firm. Below are a handful of key September/October data points and take aways:

- *Consumer spending*, which accounts for 70% of GDP, continued to expand moderately as households tempered their purchases in September, retaining some of their savings from lower fuel costs. Consumption trends remained consistent with modest GDP growth. Auto sales continued to be robust as low gas prices drove demand. The adverse impact of the strong dollar was notably felt by New York City retailers whose foreign customers frequently travel to the city to purchase luxury items.

- *Manufacturing* turned in a weaker performance in September as factory output fell 0.1% for the second consecutive month. High inventories and lukewarm demand from overseas customers restrained production. Clearly, the surge in the dollar since mid-2014 has made US products more expensive in foreign markets. At the same time, the oil industry has retrenched so that manufacturing companies with energy exposure are contending with bloated inventories. Weakness in manufacturing generally is only partially being cushioned by steady purchases of autos that have led consumer spending, underpinning the economy. Third quarter conference calls for companies we monitor confirm the difficult operating environment and lack of earnings visibility energy-related companies face.

- Both *housing and commercial real estate* showed improvement. Home prices and sales volumes increased with relative strength in

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the market for lower or moderately priced homes. Both the residential rental and commercial real estate markets were stronger. Commercial and residential multi-family construction showed further strength. Single family construction edged higher but in some parts of the country was constrained by the lack of available skilled labor.

- Reports on the *banking and finance* sector have been positive with lending activity increasing, loan quality steady-to-improved and lending standards somewhat easier.

- *Labor market* conditions are tightening a bit, particularly for skilled construction workers. Wage growth is subdued. Prices have remained fairly stable outside of energy where prices have continued to fall.

FORWARD LOOKING INDICATIONS

Looking ahead, high-frequency, leading economic indicators we follow indicate a continuation of only modest growth in the months ahead, but with no recession in sight.

- The Institute for Supply Management (ISM) summary of US *manufacturing* conditions for September showed their index declining for the third consecutive month to 50.2, the weakest level in over two years. Recall that readings of 50 or above signal expansion. The report showed export demand fell to the lowest level since July, 2012. While resilient spending by US consumers is helping to support manufacturing, particularly autos, the stronger dollar is making it more expensive for foreign buyers to purchase made-in-America merchandise. Similar to the ISM report, several regional factory surveys have shown weaker results, fueling concerns that international threats (i.e. China) to growth are having an impact on US production.

- The pace of growth in US *service industries*, which make up the lion's share of economy, is also slowing. The ISM's non-manufacturing index declined to 56.9 in September from 59 the prior month. A gauge above 50 denotes expansion. Demand for services has held up in the face of financial market volatility and a slowdown in international markets as consumers remain willing to spend.

- *Consumer confidence*, as measured by the Bloomberg Consumer Confidence Index, improved to 44.8 in the week-ended October 4, pushing the index above this year's average. This measure has advanced 4.6 points over the last 2 weeks, the biggest gain for any comparable period since May 2009, shortly after the nation emerged from "The Great Recession."

- Confidence among US *homebuilders* climbed in September and October to a 10 year high, a hopeful sign demand for housing will remain solid in the months ahead. The National Association of Home Builders Housing Market Index climbed to 64 this month. Readings above 50 mean most builders generally see conditions in the single family housing market as positive. This index has been positive since late 2014 and in recent months has risen to levels last seen in 2005. With firm job creation, economic growth, historically low mortgage rates and the release of pent-up demand, housing is expected to maintain its momentum into next year.

- The number of Americans submitting applications for *jobless* benefits, a good predictor of economic activity, has fallen to match the fewest claims in four decades. The number of people continuing to receive jobless benefits declined to 2.16 million in the week of October 3, the lowest level since November 2000.

- Our firm's proprietary Economic Model, a copy of which is attached, as well as the Leading Economic Indicators (LEI), continue to signal expansion in the months ahead with no recession in sight.

- One point of discussion among those looking for a recession has been the current elevated level of high yield credit spreads. (i.e. the difference in yield between the 10-year US treasury note and a comparable maturity junk bond) The credit markets, in our view, are no better at predicting recessions than any other asset market. We believe credit spreads tend to widen on clear and present danger, and are often as current or backward-looking as they are forward-looking.

FORECAST

So despite signs we saw last quarter of a slowdown in economic growth, particularly in energy-related manufacturing, forward looking indicators point to a continuation of the expansion at about the 2.0% *underlying* rate. Furthermore, absent an exogenous downside shock or an unlikely stimulative fiscal policy initiative, we expect GDP growth to remain on about a 2.0% track well into 2016. Fed policy will remain highly accommodative for an extended period. Inflation, as measured by the Fed's preferred metric, the Personal Consumption Expenditure Index (PCE) is forecast to remain below their 2.0% target while the headline unemployment rate should drift lower, ending the year below 5.0%. Broader unemployment and underemployment measures indicate there still remains considerable slack in the labor market. Corporate profits will rise modestly next year with S&P earnings forecast to increase from $118 per share this year to $126 per share, a gain of about 7.0%. Short term interest rates are expected to increase by 50-75 basis points in 2016 and rates on 10 year US Treasury notes are expected to drift upward to the 2.50% to 2.75%+ range by year-end 2016.

THE FED

As expected, the Fed put off an interest rate increase in September because of growing risks to their outlook for economic growth, mainly from China, and inflation even as they continued to say they were on track to raise their target fed funds rate later this year. The likelihood of a Federal Reserve interest-rate hike this year has since diminished amid recent signs of economic sluggishness. Uninspiring data on consumption, inflation and jobs have virtually eliminated the chances of lift-off this month. With two scheduled policy meetings remaining this year, in late October and mid-December, futures markets have built in only a 1-in-3 probability of a move by year-end.

Fed officials' interest rate decisions remain hostage to incoming data which have not been encouraging. Consumer price inflation has been running below the Fed's 2.0% target for more than three years and policy makers want to feel *confident* it is heading higher prior to lifting rates. The Labor Department reported earlier this month the pace of job creation slowed in September and revisions to data released previously for July and August were weaker than first thought. In addition, wage gains stalled, the labor force shrank and employers created fewer positions than they had been averaging in recent months. Recent comments from some Fed officials, including the head of the New York Fed, show that, at this point, the central bank will need more convincing evidence before raising rates. While it remains a close call, we now believe the Fed will defer lift-off until early next year, further extending the period of uncertainty surrounding interest rates.

CHINA

One of the drivers behind the US stock market's 13% correction and the nearly 60% fall in Chinese share prices this spring and summer was the fear that a hard landing in the Chinese economy would adversely impact global economic stability and hammer the profits of US corporations. These concerns added to a long list of worries including China's mountain of debt and malinvestment, suspect economic data, policy whipsaws, a stock market bubble and bust all in less than one year, and the sudden August currency devaluation, that have long dogged investors.

Fears over an imminent China collapse have since faded as data showing a substantial improvement in several economic metrics, including a weaker Chinese RMB which helps exports, large increases in money supply growth, improved loan demand, central bank asset growth, strong auto sales and the prospect of improving import and export growth have emerged. The industrial economy has clearly slowed and China's commodity consumption is waning too, but consumer and service-driven sectors are doing well as the leadership deliberately shifts the drivers of growth. Overall, GDP climbed 6.9% in Q3 but services rose 8.4% and for the first time ever accounted for over 50% of GDP growth.

The minor Chinese devaluation should also be a positive development for other emerging market economies. While third quarter 6.9% GDP growth also points to some stabilization in the country's economic momentum, China is by no means out of the woods as the intended transition of its huge economy from a manufacture/export model to a consumption model while undertaking major political and social reforms will take time and is fraught with execution risks.

EQUITY INVESTMENT STRATEGY

The US stock market has largely rebounded from its summer "correction" as investors appear to have concluded that China is stabilizing, third quarter corporate profits will be no worse than feared, and the Fed will defer lift-off, possibly until March. During the sell-off we tactically added to equities in client portfolios where stock positions were below their target allocations. In those cases, we made additions to depressed energy, industrials and financials we see as offering great *value*, as well as to investments abroad. Despite the certainty of future corrections and expected heightened market volatility, equity portfolios generally remain fully-invested as the practical alternatives for our clients to stocks are relatively unattractive when viewed from an intermediate to longer-term perspective. We continue to target up to 15.0% of clients' stock portfolios for investment in non-US domiciled developed and emerging markets. Forward stock market valuations are only slightly above their averages for the past decade. Various other valuation metrics show equities to be priced near their historical average levels.

The current yield on the S&P 500 is 2.52%, measurably higher than the 2.03% yield on the 10-year US Treasury note. History shows that when stocks are priced to yield more than the 10-year Treasury, returns are invariably above-average in subsequent periods.

FIXED INCOME STRATEGY

Fixed income investment strategy remains unchanged. Protection of principal is the overriding consideration as the coming rising interest rate environment is likely to be hostile to longer-dated securities. Clients' portfolios are, therefore, structured with an ultra-short ladder of high-quality corporate obligations. Durations of these portfolios are below one year.

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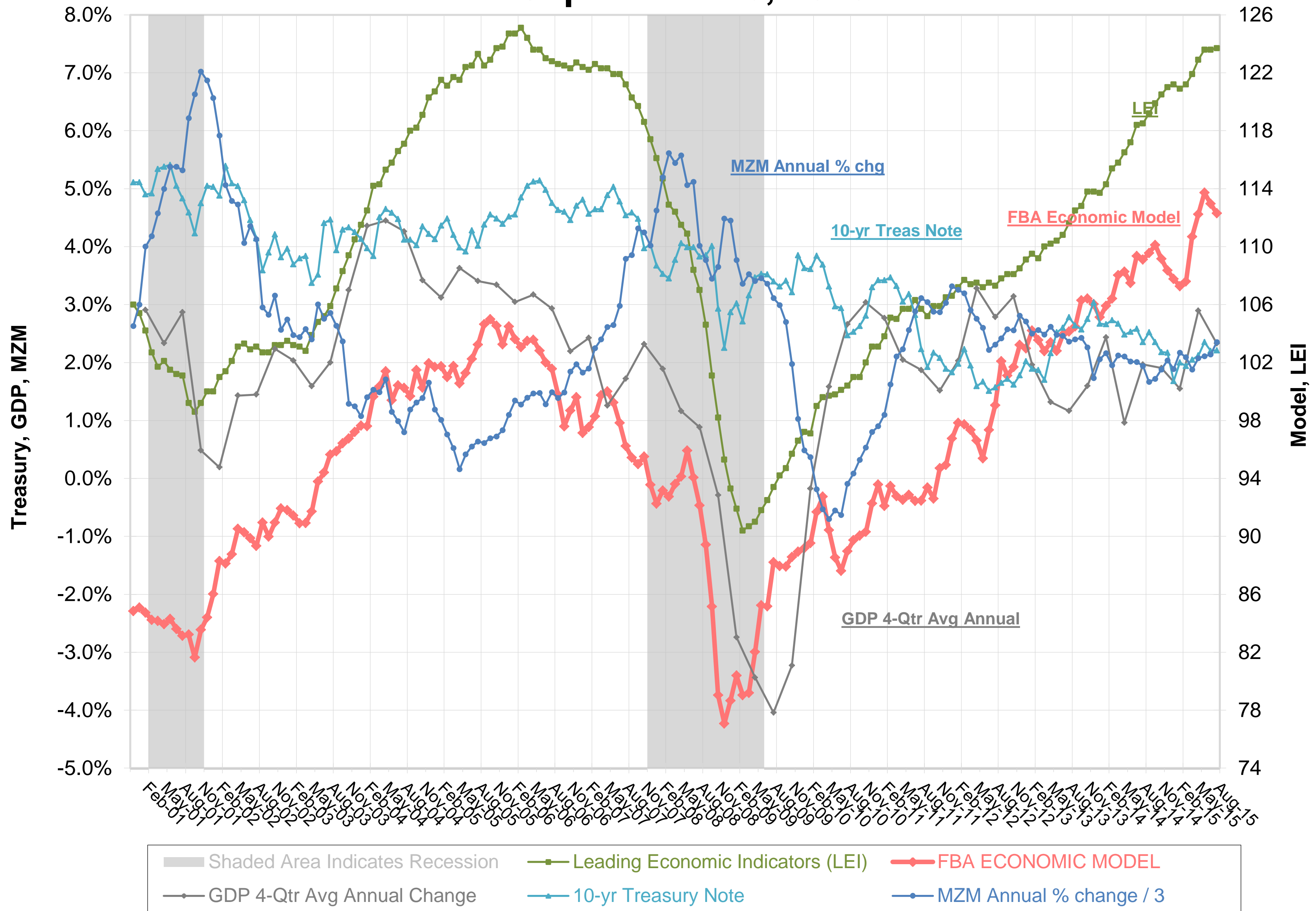
Front Barnett Associates LLC
Economic Model
September 28, 2015



Last updated 9/28/2015

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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