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ECONOMIC UPDATE - - OUTLOOK UNCHANGED

Despite the lack of business investment and weak exports, newly released economic data shows the economy continuing to expand moderately but not at the blockbuster pace the June payrolls report might imply. Following the addition of 265,000 jobs in June, the largest increase in industrial production in 10 months and reports of solid, broad-based retail sales, recession fears have clearly subsided, propelling the US stock market, a reliable leading economic indicator, to new all-time highs. How long and how far the market can advance will, in our view, depend upon the future course of corporate profits. Second quarter earnings reports received so far show profits exceeding marked-down expectations. Earnings reports and company guidance over the next few weeks will shed some additional light on the outlook. The consensus forecast projects a 4.7% decline in second quarter profits. Anything short of that will be further fodder for the bulls.

Several forward-looking indicators we monitor closely point to further expansion.

- The *Institute for Supply Management's (ISM) non-manufacturing index* for June jumped to 56.5, exceeding most expectations. Readings above 50 for this index, which includes industries that account for almost 90% of the economy, signal growth. Fifteen of 18 industries reported growth last month.

- The *ISM manufacturing index* for June indicated a nascent recovery in the beaten-down manufacturing sector may also be taking shape. The index climbed to 53.2, the highest level since February 2015. Readings above 50 of this index portend expansion.

- *Consumer spending*, which accounts for over two thirds of GDP, is estimated to have grown at a 4.5% annual rate in the 2nd quarter. If

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confirmed, this would be the biggest gain in consumer outlays in more than a decade. That strength bolsters the case the economy will shake off any spillovers from the Brexit vote. With the stock market at record highs, mortgage rates near all-time lows and gasoline prices trending lower, consumers are expected to continue to spend. For businesses, the spending strength could be a reason for making additional hires and to finally step-up capital spending with the objective of boosting productivity and offsetting future labor cost increases. For the Fed, it may be a reason to put the possibility of a September rate increase back on the table.

- *US industrial production* rose in June by the largest amount in 10 months. The Federal Reserve reported industrial production increased 0.6 percent last month, the best showing since a similar gain last August.

- The number of *applications for US unemployment benef*its has been holding near the lowest level since mid-April, further evidence of a strong labor market. Jobless claims were unchanged at 254,000 in the week ended July 9, close to the four-decade low of 248,000. Weekly claims have been below 300,000 for 71 straight weeks, the longest period since 1973 and consistent with robust employment conditions. Employers have been more willing to add to jobs than increase capital spending to accommodate increased demand due, in part, to uncertainties over tax policies, regulation and currency fluctuations.

- *US small business optimism* increased in June, according to the National Federation of Independent Businesses (NFIB), for the third consecutive month following earlier declines. Small business hiring accounts for a major fraction of US jobs growth. Interestingly, of the 735 employers surveyed for the NFIB's June report, 29% reported they had job openings they could not fill and 26% saw increased capital spending rises ahead.

- Various measures of the health of the *housing industry* have been important components in our firm's Economic Model (attached) from the start in 1994. The residential construction industry has remained in a steady but tepid recovery in the eight years since the last recession, underpinning the expansion. Builders have struggled to make further progress as they have run up against scarce land supply, tight credit standards and a shortage of work crews. Despite these headwinds, stable job gains and prospects for faster wage growth, and an accommodative Fed should buoy real-estate demand in the months

> ahead. For example, sales of previously-owned homes climbed in June to the highest level in over nine years. Meanwhile, the inventory of available properties dropped to the lowest amount for a June since 2001.

Among the *economic indexes* we monitor, the widely followed Citi US Economic Surprise index rose to its highest level since early 2015. Both our firm's Economic Model and the Leading Economic Indicators (LEI) are flashing green lights. And, the Chicago Fed National index, which draws on 85 economic indicators, was positive 0.16 in June, its highest reading since January. A reading above zero indicates above-trend growth ahead.

So, despite the continued weakness in exports and business investment, we expect the US economy to revert to its mean 2.00% to 2.25% growth path of the past five years led by consumer spending, a moderate resurgence in manufacturing and the bottoming-out of energy sector investment. *Absent significant growth-oriented fiscal policy stimulus, which we view as highly unlikely until mid-2017, we see the trajectory of the US economy as generally remaining on this same modest growth path.*

FED POLICY

With the US economy on more solid footing and global financial markets stabilizing following Britain's vote to depart the European Union, we believe the Federal Reserve is now more likely to raise interest rates later this year than when they last met in June. While the weak May jobs report and June Brexit vote seemed to reduce the probability of a rate hike, June's improved jobs numbers, strong retail sales including autos, a more stable US dollar, and the strong balance sheets of global banks acting as a "firewall" against a Brexit-induced financial crisis, put a September move by the Fed back on the table. Market pricing for another Fed rate hike has now risen to just above 40% for December.

INVESTMENT POLICY

Our June 30 Brexit Comments, forecasting only a negligible impact on the US economy from the UK vote to leave the EU, noted our decision to maintain our clients' fully-invested equity portfolio positions. Despite the stock market's 3.5%

advance this month, and the certainty of a market pullback along the way, we remain fully-invested. Most importantly, low interest rates driven by aggressively accommodative central bank policies, make US equities, which we view as reasonably priced, attractive when viewed against their fixed income alternatives.

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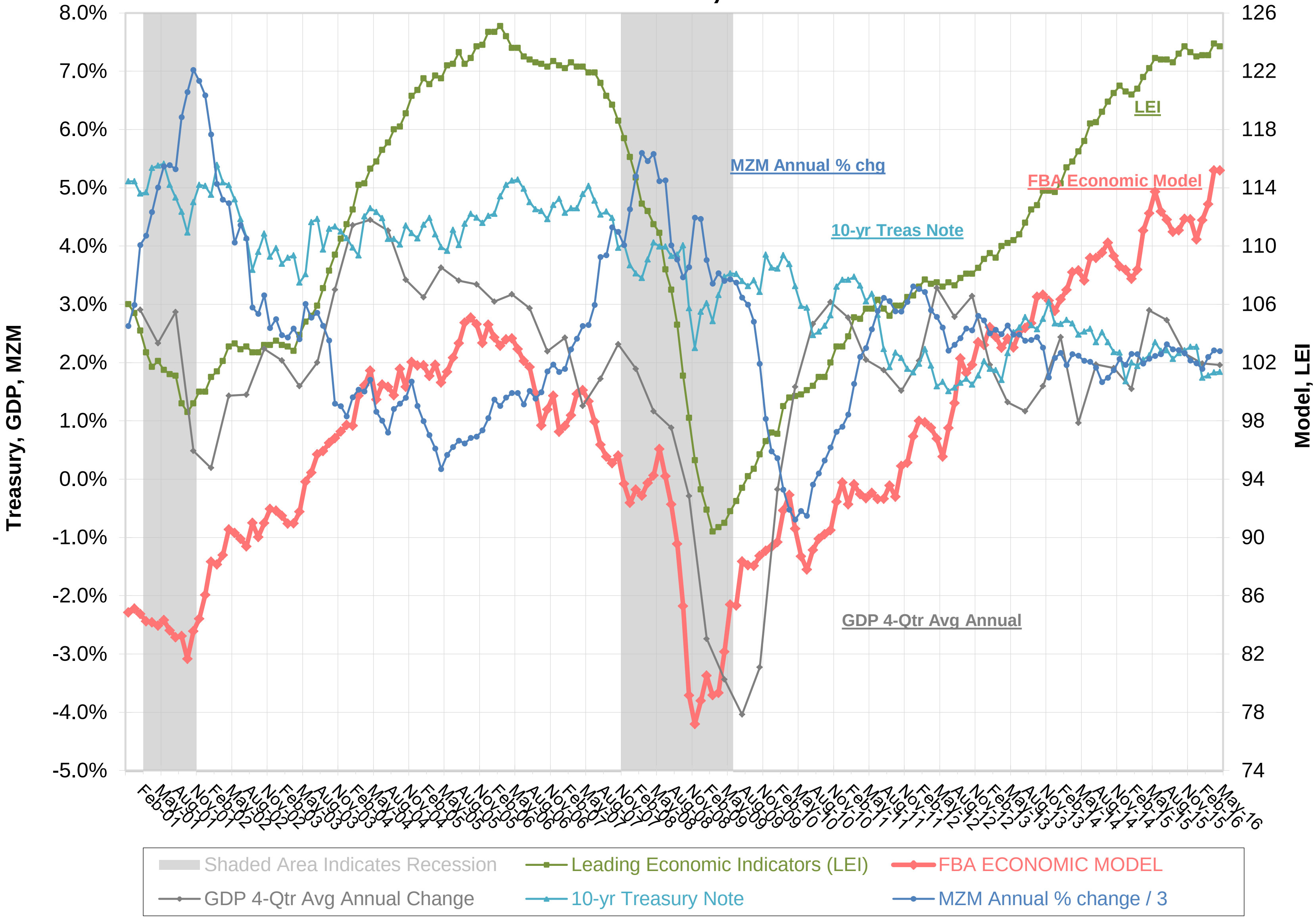
Front Barnett Associates LLC
Economic Model
June 29, 2016



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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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