FRONT BARNETT ASSOCIATES LLC

INVESTMENT COUNSEL

Marshall B. Front
Chairman

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

February 23, 2017

STATEMENT OF INVESTMENT POLICY

BACKGROUND

The US economy expanded modestly last year with real GDP growth of 1.9% following a similar increase in 2015. On the positive side, consumer spending advanced at a healthy pace, supported by steady income gains, increases in the value of households' financial assets and homes, favorable levels of consumer sentiment and low interest rates. Last year's sales of automobiles and light trucks were the highest annual total on record. In contrast, business investment was soft for much of last year though it posted some larger gains toward year-end in part reflecting an apparent end to the sharp declines in spending on drilling and mining structures. In addition, weak growth abroad and the appreciation of the dollar over the past two years have restrained manufacturing output. Housing construction has continued to trend higher but only at a modest pace in recent quarters. And, while the lean stock of homes for sale and ongoing labor market gains should provide some support to housing construction going forward, recent mortgage rate increases may cause some restraint. So, on balance, we ended 2016 with only enough momentum to expect a continuation of the 2.0% GDP growth of recent years.

More recently, we have seen signs which lead us to believe GDP growth may be ticking higher. For example, the labor underutilization rate, which includes those marginally attached to the labor force and people who are working part-time but would like full-time jobs, has been working its way lower. The pace of wage increases has quickened. Business sentiment has noticeably improved following promises by the new administration of stimulative fiscal policy including lower personal and corporate tax rates, deregulation, repatriation of corporate cash balances trapped overseas, and infrastructure spending. And stock prices, a reliable leading indicator, have risen sharply.

70 WEST MADISON STREET • SUITE 4920 • CHICAGO, ILLINOIS 60602-4208
(312) 641-9000 • FAX (312) 641-9009

Incoming economic indicators we follow support the view we are likely to see somewhat stronger economic growth this year, before any impact from the administration's fiscal policy initiatives. For example:

- Manufacturing accelerated in January for a fifth consecutive month on stronger orders and production. The Institute for Supply Management (ISM) index rose to 56, the highest reading since November 2014. A reading above 50 signals expansion.

- The Institute for Supply Management (ISM) non-manufacturing index for January stood at 56.5. A reading above 50 signals expansion.

- Consumer sentiment rose in January to a 13-year high, reflecting ongoing optimism about post-election fiscal policies and their impact on economic growth. While attitudes will be ultimately defined by proof of economic improvement, the report showed 44% of respondents, the most since 2004, said they anticipate the economy improving this year.

- Both our firm's proprietary Economic Model and the Leading Economic Indicators (LEI) are signaling the expansion will continue for the foreseeable future.

- Leading indicators from the Euro Zone and China have shown recent strength.

FORECAST

Based upon our reading of these and other indicators, and *prior* to the impact of any new fiscal stimulus, we expect the US economy to experience 2.0%-2.25% real GDP growth this year, slightly higher than the average of the past few years. Improved confidence and a better business climate abroad account for the moderate acceleration we expect. Unemployment is likely to drift a bit lower. Higher wages and firming commodity prices will push inflation toward the Fed's 2.0% target. Banks globally are better capitalized than they have been in a generation and the Fed will remain accommodative, raising rates two or three times this year, leaving the *level* of rates well below their longer term average. The odds of a recession, a severe financial crisis or highly restrictive Fed monetary policy, which in the past have precipitated bear markets, remain extremely low.

EQUITIES

The stock market has been on a tear since the election, fueled by a number of factors that reflect a pickup in overall investor sentiment. These include improved global economic data, new cash coming into the market and the expectation that the President's pro-growth announcements will eventually translate into stimulative fiscal policies, supporting higher levels of corporate profits, justifying higher stock prices.

Nevertheless, as the US economy picks up, as we believe it will, and the Fed hikes rates two or three times this year, which also appears likely, the dollar should firm creating a headwind to the expansion. In addition, politics will also play a role as the Trump administration provides the detail regarding its key economic policies in the next few weeks. So, in our view, we are approaching a time when further substantial stock market advances will depend upon whether the administration can actually deliver on its proposed fiscal program as the valuation of US stocks is lofty. Absent the implementation of pro-growth fiscal policies, the US economy is likely to continue on its course of modest growth and stocks are not likely to make much further progress over the near term.

Given our belief there is a strong probability of the enactment later this year of a significant portion of the president's pro-growth agenda, raising the trajectory of the economy and corporate profits, equity portfolios under our supervision remain fully invested, even though stocks are fully valued at 17 times forward S&P 500 earnings and political disappointments are likely to result in market volatility.

Returns on bonds and cash equivalents are not likely to match those of equities over the intermediate term. Investments in economically sensitive sectors including financials, energy, and industrials are significantly weighted as is exposure to technology. We target up to 15% of the equity portfolio in foreign domiciled companies in both developed and emerging markets which, we believe, offer investors excellent relative value. Clearly, following the stock market's advance since the election, there is every reason to expect periodic 5-10% "corrections" along the way. We will view these pullbacks as opportunities to add to equities where appropriate.

FIXED INCOME

Given our view that interest rates are in the process of normalizing, bond portfolios under our management remain conservatively invested with preservation of principal as the overriding consideration. Portfolio durations are below 1.

* * * * *

MBF