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ECONOMIC UPDATE – POLITICAL NOISE

Hiring data for April released last week, showing the nation's unemployment rate fell to its lowest level in more than a decade, is further evidence of the economy's resilience following another lackluster winter. In fact, some of the labor forces' weakest areas improved as declines in the numbers of discouraged workers and of those working only part-time, who would prefer full-time jobs, shrank.

The unemployment rate dropped 0.1 percentage point to 4.4% in April, falling to the low point reached in the last economic expansion in May 2007. The pickup in hiring last month was broad-based with particularly strong gains in business services and healthcare, leading to a decline to 8.6% in the broader measure of unemployment referred to as U6. Recall that U6 exceeded 17% in April 2010.

Stepping back from the political noise that seems to dominate the conversation these days, our takeaways from this strong jobs report are:

- With inflation hovering around 2%, the Federal Reserve's target rate, these employment numbers imply the Fed is more likely to remain on course to raise short-term interest rates at least twice more this year before beginning to wind down its $4.5 trillion securities portfolio late in the year. Further rate increases are likely in 2018 if the economy remains on course.

- Despite the strong job numbers, the economy remains mired in a tepid growth trajectory of about 2% this year. The Fed is, therefore, unlikely to push short-term rates to levels as high as they have in previous economic cycles when unemployment reached current levels.

- Businesses added 211,000 jobs in April after an increase of only 79,000 in March. The pick-up in hiring supports forecasts for an upturn in economic growth this quarter. Output grew just 0.7% in the first quarter and is now expected to exceed 3.0% in the current period led by a rebound in spending by consumers who will have the wherewithal to increase their outlays.

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- The early months of the current administration have been a bit of a puzzle to economists because many measures of household, business and investor confidence have surged while overall growth, as measured by GDP, remained lackluster. Though it is still early to conclude the current momentum can be sustained, some signs that Keynes' "animal spirits" are invigorating spending and hiring are emerging.

- So far there is only modest evidence that the low unemployment rate is putting upward pressure on income and inflation. Average hourly earnings rose 0.2% in April, and are up 2.5% over the past year which is in line with the rate of wage growth evident for years. While such wage growth was meaningful when inflation was low, with inflation now near 2.0%, a mere 2.5% gain in pay does not amount to much of a purchasing power increase at this stage of the expansion.

- Less encouraging was a dip in the proportion of adults who have a job or want one. That measure, the labor *participation rate*, edged down to 62.9% last month from 63%, a sign that workers who had been laid-off are not being drawn back into the labor market. As good as the April job report is, it points to how difficult it is to bring in those underutilized workers many of whom have seen their skills erode.

FORECAST

Beyond the April jobs report, forward looking economic indicators we monitor continue to signal the current expansion is likely to persist for at least the next six to nine months.

- While the *Institute for Supply Management (ISM) manufacturing index* for April eased to 54.8 from March's 57.2, the gauge remains well above the 51.5 average for all of 2016 and indicates healthy optimism among factory managers. Recall a reading above 50 signals expansion. The data show manufacturing is settling into a more sustained pace of growth after expanding in February by the most since mid-2014. Also of importance, April's measures of new factory orders and employment showed overseas markets are doing better. The group's index of export orders climbed in April to 59.5, its highest level since November 2013. Furthermore, a gauge of customer inventories dropped to the lowest level since July 2015, a sign bookings and production are likely to remain strong.

- The *ISM's non-manufacturing index* rebounded from 55.2 in March to 57.5 in April. A reading above 50 signals expansion. This was the second strongest reading of this services index covering activity in sectors amounting to 90% of GDP since October 2015. The results are consistent with projections for a rebound in economic growth this quarter coming off the weakest pace in three years as the gauge of new orders climbed to 63.2, the highest reading since August 2005.

- The *Federal Reserve's Quarterly Senior Loan Officer Opinion Sur*vey on Bank Lending Practices indicates that during the first quarter of 2017, on balance, banks left their lending standards on commercial and industrial loans (C&I) basically unchanged and that standards and demand for most categories of residential real estate (RRE) mortgage loans were little changed on balance. Both readings point to further economic expansion.

- *Consumer confidence* remains close to a 15 year high as steady hiring, along with layoffs that are near the fewest in decades are keeping households upbeat about their finances. Rising stock prices and home values are also behind the optimism with borrowers feeling especially positive in the latest survey.

In addition to these leading indicators of economic activity over the next 6 – 9 months, both our firm's proprietary Economic Model (attached) and the Leading Economic Indicators (LEI) continue to signal expansion.

So while the economy expanded in the first quarter at the slowest pace in three years due to weak consumer spending, GDP is expected to rebound this quarter at a 3.0% pace driven by consumption, investment in housing and energy exploration, as well as exports. Looking back, the GDP slowdown owes partly to factors such as warm weather and volatility in business inventories, supporting our forecast for a rebound as high confidence among companies and consumers, solid job market and pick-up in labor income underpin growth. Even so, the weakness at car showrooms could weigh on the expansion, and further gains in business investment could depend upon the extent of policy supports such as tax cuts, and repatriation of cash balances trapped abroad. Unfortunately, the benefits of those policy measures may be delayed by the many political distractions draining the energy of both the administration and Congress.

For all of 2017, absent a dose of stimulative fiscal policy, we expect the economy to expand at about the 2% rate of the past several years. The Fed will continue to remove accommodation at a measured pace and open market interest rates are expected to drift higher. The 10 year US Treasury yield, currently 2.4%, could reach 3% by year-end. Inflation will remain benign. Corporate profit growth will be sufficient to support the current level of the stock market.

Equity Investment Strategy

Given our conviction the US expansion is on solid ground, aided by improving growth trends overseas, we advise clients to remain fully invested in their equities portfolios. Recession risks remain low. Inflation is expected to remain tame. The Fed has indicated it will stay on a gradual path toward higher interest rates and shrinking its balance sheet, while remaining sensitive to global economic developments. Corporate profits, which grew at about 13% in the first quarter, are likely to continue to expand, with the potential of an upside breakout should corporate tax cuts be enacted. And fortunately, the markets do not price-in political noise of which there is a super-abundance.

Clearly, the post-election euphoria is behind us. While we anticipate lower gains from stocks in the months ahead, returns from stocks are expected to exceed those from high quality, liquid fixed income securities.

Unlike past market cycles, the risk this time around is not from a Fed needing to raise interest rates dramatically in order to choke-off rising inflation. The risk in this cycle comes from the fact there is a less-than-unified governing majority in Washington, D.C. where expectations on tax reform and other measures may not be realized.

As for stocks, the S&P 500 stock index is trading at 20 times trailing earnings per share and 17 times forward per share earnings. While no longer cheap, stocks appear to be reasonably valued given the current level of interest rates, though only a handful of pockets of relative value remain (i.e. energy, health care and financials) in our view. Also, keep in mind that despite the recent unusually muted stock market volatility, corrections of 10% - 15% are not unusual and should be expected.

We believe that in order for the market to sustain its rally there will need to be progress on the fiscal policy front. We’re not anticipating a total tax code overhaul but a reasonable reduction in corporate and personal income tax rates, combined with a plan to repatriate funds trapped overseas. These measures could add a couple dollars per share to S&P 500 earnings in the coming quarters, providing support for higher domestic market valuations. Hence, equity portfolios under supervision remain fully invested with concentrations in economically sensitive sectors including: energy, financials, industrials and technology. Meanwhile, economic growth overseas has been encouraging of late, bolstering the top and bottom-line performance of multinationals. With an improving macro backdrop in many other geographic regions, we continue to target up to 15% of the equity portfolio in investments domiciled in both developed and emerging markets where valuations remain relatively attractive.

Fixed Income

The Fed still plays an outsized role in determining interest rates, but given the steady expansion of the economy over the past several quarters, we've been somewhat surprised that market fundamentals haven't supported a more notable increase in intermediate-term rates. With the prospect of higher normalized interest rates in mind, bond portfolios under supervision remain conservatively laddered with maturities averaging twelve to eighteen months. Preservation of principal remains a key consideration in our fixed income strategy.

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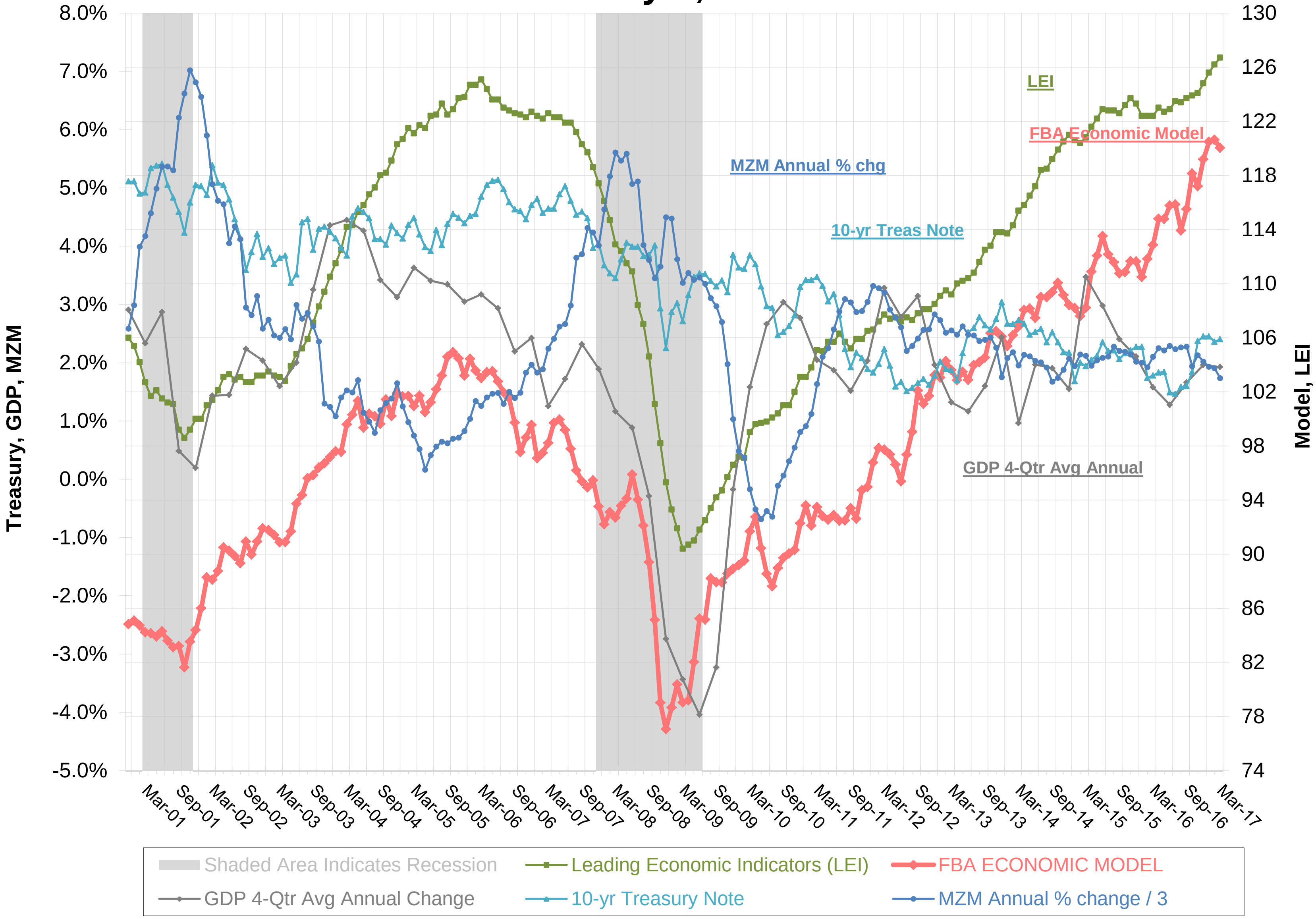
Front Barnett Associates LLC
Economic Model
May 1, 2017



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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.