***FRONT BARNETT ASSOCIATES** LLC*

I N V E S T M E N T   C O U N S E L

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STATEMENT OF INVESTMENT POLICY

BACKGROUND

Information received since our July client letter shows the US economy has been expanding at the moderate 2.00-2.25% rate which we have been expecting, with no end to the expansion in sight. The jobs market has continued to shine as individuals' payroll gains have topped forecasts in five of the past seven months, putting the 2017 average increase of 184,000 almost on par with last year's 187,000 average and above levels typically seen during later stages of an economic expansion. Data shows demand for workers is pushing down unemployment, attracting people who were not actively looking for a job. Household spending has been expanding at a steady, moderate rate and growth in business fixed investment, a laggard over the past few years, has picked-up in recent quarters.

In our view, a confluence of factors including steady consumer spending, bullish business sentiment based upon the hope tax reform will boost growth, stabilization in oil prices and improving export markets explain the strong jobs market. Meanwhile, weak wage gains suggest employers are adding workers who can be terminated at a hint of a downturn, rather than making fixed investments in technology, something reflected in sluggish productivity gains. And recent hiring has been driven by typically low-paying high turnover jobs in industries such as restaurants, home health-care services and leisure.

As for inflation, on a 12-month basis, overall price increases and the "core" measure which excludes volatile food and energy prices, have declined this year and are running below the Federal Reserve's 2% target. Other market-based measures of wage inflation remain low and survey-based measures of longer-term inflation expectations are little changed, giving the Fed cover to moderate the pace of future interest rate increases should business activity begin to soften.

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FED POLICY

Following its meeting on September 20th, the Federal Reserve left interest rates unchanged but signaled it still expects to implement one more increase by year-end, despite recent weak inflation readings. New economic projections released after the Fed's recent meeting showed 11 of 16 officials see the "appropriate" levels for the federal funds rate, the central bank's reference rate, to be in a range between 1.25% and 1.50% by the end of 2017, a quarter of a percentage point higher than the current range. As recently as two weeks ago the futures market in federal funds was signaling only a 20% chance of another rate hike this year. Just prior to the release of the Fed's statement the odds were roughly 50%. Now, the odds of another quarter point rate increase are in the 70 – 75% range and likely to rise even further in the months leading up to the Fed's December meeting.

In the meantime, the Fed will begin reducing its balance sheet at a pace of up to $10 billion per month during the fourth quarter, increasing that to a $20 billion monthly pace in the first quarter of 2018, $30 billion in Q2, $40 billion in Q3 and $50 billion in Q4. Following that the Fed is projecting it will maintain a $50 billion monthly pace until it is satisfied with the size of its balance sheet. That anticipated pace of balance sheet reduction is no different from what the Fed said it would do three months ago at a meeting in June.

While some may still fear the effects of the Fed normalizing its balance sheet, we believe this process is long overdue and could actually be accelerated without harming the economy. Could these actions gradually push long-term rates up? Yes, they could and probably will have that impact. But, in our view, long-term rates should have been higher already given the economy's steady underlying fundamentals.

OUTLOOK REMAINS FAVORABLE

The aforementioned steady trend in hiring comes as other forward-looking measures of economic vitality have picked-up.

- *Factory activity* hit its highest level in six years last month, according to the Institute for Supply Management (ISM), coinciding with increased manufacturing and construction hiring in August. The ISM manufacturing index jumped from 56.3 to 58.8 in August. Readings above 50 indicate expansion ahead.

- The University of Michigan gauge of *consumer sentiment* rose in August and is trending near its highest levels since 2000. The sentiment index rose to 97.6 from 93.4 in July. Interestingly, the report also showed how people are approaching their spending decisions. Confidence in the jobs market and incomes are playing a greater role in determining outlays than low prices and borrowing costs.

- The ISM *non-manufacturing* index rose from 53.9 to 55.3 in August. While upcoming ISM readings may be clouded somewhat by Hurricanes Harvey, Irma and Maria, readings above 50 signal continued expansion.

Positive readings we have from the forward looking indicators we monitor are supported by comments we have heard during recent earnings conference calls. In addition, both our proprietary Economic Model and the Leading Economic Indicators (LEI) point to continued expansion. Absent the enactment of pro-growth economic measures, real GDP is expected to average 2.0%+ in the third and fourth quarters of this year and advance at about the same pace in 2018. Strong consumer spending, exports driven by a weak dollar and rising demand abroad, steady housing activity, outlays to repair the damage caused by tropical storms, and accommodative Fed policy will lend momentum to the economy. Following projected low double digit gains in 2017 S&P 500 corporate profits are forecast to rise another 8%+ next year.

EQUITY INVESTMENT POLICY

Even with the major stock market indices at record highs, anecdotal evidence we have seen shows investors are questioning the sustainability of the advance, finding reasons for a sharp market correction or even an end to the eight-year bull market. Some are concerned that stocks have risen with few prolonged interruptions, especially given the sometimes uneven pace of the expansion in GDP. Others are nervous that actions of the Fed, which is on course to gradually raise rates and shrink its bloated balance sheet will result in a sell-off as rising bond yields become more competitive with prospective returns from stocks. Fears an escalation in the conflict between the US and North Korea and the possibility of catastrophic damage from tropical storms have led to brief but unsustained sell offs.

Investors' lukewarm attitude toward equities is also reflected in the share of fund managers who have positioned their portfolios to be underweight US stocks – or holding a smaller share of US stocks in a portfolio relative to its benchmark which rose to a 10 year high this month, according to a recent Bank of America global fund manager survey. Some see greater relative growth opportunities and cheaper equity valuations abroad. Others cite the fact that S&P constituents have reduced their share of buyback activity this year by about 12% relative to the first half of 2016. Others fear a market correction will trigger shareholders' redemptions and are holding cash to accommodate these possible withdrawals.

We fully recognize that any combination of the above noted factors could set off an overdue correction of as much as 10%+. However looking beyond this short-term market risk, we believe stock valuations will, over time, reflect the upward trend of corporate profits.

With interest rates likely to remain low by historical standards and expectations that corporate profits for the S&P 500 stock index will rise by about 8% next year, stocks selling at 17.5 times estimated 2018 earnings remain attractive when compared with expected returns from fixed-income alternatives. Consequently, equity portfolios under our supervision remain fully-invested.

Equity portfolios are broadly diversified with a target of 15% invested in developed and emerging market-based companies. Undervalued financials and energy-related shares are well represented among *value* investments. Technology and industrial/cyclicals remain core holdings.

FIXED INCOME INVESTMENT POLICY

The principal investment objective we have in the management of fixed-income portfolios is *preservation of principal*. Hence, portfolio durations are at or below1year, with individual investments largely in high quality, highly marketable corporate bonds laddered out to about 18 months in the expectation of higher interest rates over the intermediate term.

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