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April 20, 2022

ECONOMIC UPDATE

OVERVIEW

Currently, the US economy is locked in a battle between forces boosting and those restraining GDP growth. The gradual reopening of the economy, a strong labor market, still-loose monetary policy, negative real interest rates, strong consumer and corporate balance sheets, and relatively low tax rates are stimulative to growth. Sky high inflation crimping consumers' purchasing power, fading consumer confidence, rapidly rising housing costs, the Russia-Ukraine war, lockdowns in China and other supply-chain disruptions are headwinds to continued growth. Balancing these factors, we conclude real GDP is expected to advance about 2.5% this year, decelerating sharply from the 5.5% pace of recovery in 2021, with slower growth in 2023-2024 as monetary policy tightens and the benefits of reopening the economy eventually run out. Currently, we see no signs over the forecast horizon of the recession that some economists are predicting will commence this year.

The recession narrative promoted by several Wall Street firms is that inflation will curtail spending, weakening growth, while Fed tightening policies push the nation into a recession. Some analysts point to an "inverted yield curve", where last month yields on shorter term US Treasuries briefly spiked above those on longer-dated obligations, as evidence for this view. They see a recession commencing as early as the current quarter. In our view, if we were about to enter a recession, we would likely see signs of consumer distress as well as deterioration in corporate balance sheets. We see no evidence of either. As for the yield curve, the Fed has shown that the shorter segment of the yield curve, where spreads are actually *steepening*, is a better predictor of a recession. Other indicators we regularly parse, including delinquency rates and charge-offs across credit cards, consumer loans, mortgages and business loans, all currently show readings that are distant from those usually associated with economic stress.

US real GDP rose 5.5% last year, the most rapid growth for any calendar year since the Reagan boom in the mid-1980s. Despite its extraordinary performance in calendar 2021, data shows the economy grew just 1.6% annually during the two years ended December 2021, well below its pre-pandemic trend, as shutdowns and other disruptive government actions drove uneven growth. For example, goods consumption rose at an annual rate of

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7.5% in the past two years, while services consumption declined 0.4% during that period. Due to rapid growth in investment during the second half of last year, investments (including inventories and home building) increased an annualized 5.9% during the past two years. Going forward, we expect these growth disparities to balance out as the economy fully reopens and market forces assume a more dominant role in the direction of the economy.

More recently, real GDP growth appears to have settled down to 1.5% in the quarter just ended, a far cry from last year's stellar pace. Adding to GDP growth in the March quarter, real consumer spending on goods and services was solid, business investment is estimated to have grown moderately, and home building accelerated. Meanwhile, government spending likely shrank a bit, inventories appear to have grown at almost the same pace as in the prior quarter, making no impact on 1Q GDP, and imports continued to soar while exports have not grown as quickly, exerting a temporary drag on real GDP growth in the US. For the current quarter and the second half, we expect growth to accelerate but by how much will depend upon whether the current COVID-19 wave passes quickly, without the necessity of imposing new mandated shutdowns.

INFLATION

The consumer price index (CPI) jumped 1.2% in March, one of the strongest monthly gains in recent decades, unsurprisingly propelled by an 11.0% surge in energy prices, as gasoline prices jumped about 18.0%. Food prices also climbed at a rapid rate, up another 1.0% last month, and other inflation data released since month-end point to firm price increases in March. Excluding food and energy, "core" CPI, moderated in March coming in below expectations, in part due to a greater-than-expected 3.8% fall in used car prices. "Core" CPI increased 0.32% in March, a change that was stronger than pre-pandemic norms but the softest reading since last September. Overall CPI inflation rates pushed higher again in March as headline CPI surged 8.5% and the "core" rate rose 6.5% year-over-year.

A deeper dive into the March CPI data shows the underlying composition of consumer price inflation is concentrated in the most inertial categories of consumer spending. Notable categories of CPI inflation that tend to exhibit a high degree of persistence are tenants' rent and owners' equivalent rent, both of which increased 0.43% in March, faster than pre-pandemic norms. It's quite likely shelter inflation will remain firm in the months ahead and otherwise offset the moderation we expect in other categories of "core" CPI inflation already occurring in parts of the auto sector. That said, it's likely the Fed will have a difficult time taming inflation in the near term given the blunt weapons it has at its disposal. Nevertheless, despite the blistering pace of headline inflation in March, it's a positive sign that consumer inflation expectations were unchanged this month, according to the University of Michigan's preliminary survey of consumers in April. The median

one-year-ahead inflation measure came in at 5.4% and the median five-year-ahead measure came in at 3.0%.

FORWARD-LOOKING INDICTORS

The job market continued to improve at a rapid rate in March giving the expansion further momentum. Nonfarm payrolls rose 431,000 for the month and were revised up 95,000 for prior months. Meanwhile, civilian employment, an alternative measure of jobs that includes small business start-ups, increased 736,000. As a result of the increase in employment, the unemployment rate dropped to 3.6%, a new low for the economic re-opening, even as the labor force participation rate rose to 62.4%. The recent increase in the labor force participation rate gives credence to the view large numbers of workers remained on the sidelines longer than would have been expected under ordinary circumstances, living off the generous unemployment benefits they received during the pandemic, until those benefits ran out. Nevertheless, the participation rate is still below the 63.4% pre-COVID rate but is at its highest level since the re-opening. Notably, the median duration of unemployment fell to 7.5 weeks, lower than pre-COVID-19, meaning workers who lose their jobs are not out of work for long, another sign of the vigorous labor market.

Beyond the strong employment data, other key forward-looking inputs we have reviewed over the past month confirm the economy's overall strength and momentum, and the likelihood of further economic expansion over the months ahead. Below is a sampling of that data and comments on each.

ISM MANUFACTURING INDEX declined to 57.1 in March, missing the consensus expected 59.0. (Levels higher than 50 signal expansion; levels below 50 signal contraction.) The major measures of activity were mixed, but all stand above 50, signaling growth. The production index fell to 54.5 from 58.5 while the new orders index declined to 53.8 from 61.7. The employment index rose to 56.3 from 52.9, and the supplier deliveries index fell to 65.4 from 66.1. The prices paid index rose to 87.1 from 75.6 in February.

The manufacturing sector continued to expand in March, though at a slightly slower pace than in February, with fifteen of eighteen industries reporting growth. The two most forward-looking indices, new orders and production, led the overall index lower in March. In fact, new orders posted the largest monthly decline since the early days of the COVID pandemic, most likely a result of short-term customer uncertainty in the immediate aftermath of the Russian invasion of Ukraine. Respondents' comments in March highlighted strong ongoing demand from customers while also reiterating supply-chain problems related to shortages of key inputs and transportation services. These issues have combined to keep manufacturing activity from rising quickly enough to meet demand. However, there has been progress recently as the supplier deliveries index fell for the fourth time in five months and is well below its recent high in May 2021, signaling supply-chain issues are easing. It also appears that the

manufacturing sector is seeing some progress in filling positions. Job openings are now down to over 100,000 from the earlier peak but remain twice what they were pre-pandemic. Finally, the highest index reading in March was prices paid which posted its largest monthly gain in over a year, surging to 87.1 in March. It appears that the Russian invasion of Ukraine temporarily boosted input prices last month.

ISM NON-MANUFACTURING INDEX rose to 58.3 in March, slightly below the consensus expected 58.5. (Levels above 50 signal expansion; levels below 50 signal contraction.) The major measures of activity moved mostly higher in March, and all stand well above 50, signaling growth. The new orders index rose to 60.1 from 56.1, while the employment index rose to 54.0 from 48.5 the prior month. The business activity index rose to 55.5 from 55.1, while the supplier deliveries index fell to 63.4 from 66.2.

The service sector continued to expand rapidly in March, with the index rising to 58.3 for the month, reversing a string of declines since the index peaked at an all-time high in November 2021. Gains were broad-based, with seventeen of eighteen industries reporting growth. Survey comments continue to cite supply-chain challenges surrounding inflation, material shortages, and extended lead times as problems businesses have faced when seeking to meet demand, since the re-opening. The most forward-looking indices, new orders and business activity, both posted gains for the month of March. Meanwhile, the inventories index expanded for the second straight month, suggesting businesses are starting to re-stock their shelves. Lastly, the prices paid index increased to 83.8 and remains less than a point below its record set last December. All eighteen industries reported paying higher prices for materials. No matter what measure you favor, inflation is high, and it looks like the invasion of Ukraine temporarily boosted inflationary pressures over and above the pre-existing level.

INDUSTRIAL PRODUCTION increased in March 0.9%, easily exceeding the consensus expected gain of 0.4%. Auto production jumped 7.8%, while non-auto manufacturing rose 0.4%. Overall capacity utilization increased to 78.3% in March from 77.7% in February.

Industrial activity continued its V-shaped recovery in March, rising for the third consecutive month. Moreover, gains last month were broad-based, with every major category posting gains. Notably, most of the gain came from the volatile auto sector, where activity surged 7.8%. That said, manufacturing beyond autos also rose 0.4% in March, posting a third consecutive monthly gain. Meanwhile, the mining sector (i.e., oil rigs in the Gulf of Mexico) continued to make strong progress, rising 1.7% in March. We expect continued gains on mining in the months ahead with oil prices above $100 a barrel. Overall, we expect a continued upward trend in industrial production in 2022. Business inventories are lean, order backlogs are elevated, and demand continues to outstrip supply. Ongoing issues with supply-chains and labor shortages are holding back a more robust rise in activity, with job openings more than double pre-pandemic levels. The mismatch between supply and demand, where too much money is chasing too few goods, is the root cause of the accelerating inflation we are experiencing.

RETAIL SALES rose 0.5% in March and are up 6.9% versus a year ago. Sales excluding autos rose 1.1% last month and are up 9.1% from a year ago. Excluding

gas, sales declined 0.3% last month but are ahead 4.4% from a year ago. Ten of the thirteen major sales categories were up in March, led by gasoline stations and general merchandise stores. But it's clear from the data that inflation is taking a bite out of consumer purchasing power and will be a significant headwind in future consumer spending. Recall that retail sales are not adjusted for inflation. Sales at gas stations rose 8.9% in March due to higher prices. In fact, average gasoline prices increased 19.7% in March, or 71 cents per gallon. Adjusted for the consumer price index, overall retail sales declined 0.7% last month. In the months ahead, the path of retail sales will be a battle between several opposing factors: Rising wages, jobs, and inflation will all be tailwinds for retail sales, while the dwindling impact of the temporary and artificial boost from stimulus checks and other government benefits doled out during COVID will be headwinds. But real, inflation-adjusted, sales will struggle while the services sector of the economy picks up the slack due to reopening.

INITIAL US JOBLESS CLAIMS, the number of people seeking unemployment benefits for the first time, a reliable forward indicator of future employment gains, has remained at an historically low level for weeks. Two years after the coronavirus sent the economy into a brief but devastating recession, American workers are enjoying extraordinary job security. Weekly applications for unemployment benefits, a proxy for layoffs, have consistently remained below the pre-pandemic level of 225,000. This year, employers have added an average of 560,000 jobs a month after increasing employment by a record 6.7 million jobs last year. The resilience of the job market and, indeed, the overall economy is striking considering the pandemic, the economic consequences of the Russian invasion of Ukraine, and the highest consumer inflation in forty years. Fewer than 1.48 million workers were collecting traditional unemployment benefits in the week of April 2.

In addition to the above key indicators, our firm's proprietary Economic Model, designed to signal changes in the direction of the US economy six to nine months in advance of an inflection point, is pointing to continued expansion. Although the Economic Model remains above-trend, it has made little headway in recent months and bears close monitoring as additional data becomes available.

EQUITY INVESTMENT POLICY

In our view, a recession in the next year remains unlikely, and consequently corporate profits will continue to grow, albeit at a more moderate rate as margins erode, supporting equity valuations. Despite the exogenous shock this year and other economic blows the economy has absorbed, including the prospects of higher interest rates, S&P 500 earnings are expected to grow 10.1% in 2022. S&P 500 stocks are estimated to earn $235 a share this year and are currently selling at less than 19 times forward earnings, down significantly from the mid-20's multiples of last summer. Equity valuations are, therefore, again relatively attractive in our view. Also, we judge the US economy to be fundamentally sound. Leading economic indicators are flashing expansion. Supply-chain bottlenecks are slowly being worked out. Consumers have unprecedented liquidity and strong balance sheets, as do US corporations. Reflecting these favorable fundamentals, and more attractive stock valuations, we have added selectively to stocks in clients'

portfolios which may have been under-invested during recent periods of market weakness.

Accordingly, there has been no change to our firm's investment policy since our March client letter. Portfolios under our supervision remain fully invested within their guidelines, well balanced between domestic *growth* and *value* shares, tilted toward *growth* which has been our long-term bias. Our equity investment platform also includes investments in equities domiciled abroad in both *developed* and *emerging* markets.

This year, following three years of double-digit gains, large cap equity markets have seen a choppy correction of close to 10% while other market indices have experienced similar or greater drawdowns. Hardest hit have been shares of small cap technology equities with little to no prospects of earnings in the foreseeable future. These shares have declined as much as 75% from their 2021 midyear highs. Large cap stocks were sold from the opening bell in January through the end of February only to recover 50% of their losses in March. The first half of April has so far seen the S&P successfully retest its February 24th low. Where and when this correction will end is anyone's guess. Rather than devote our energies to forecasting the depth and duration of the stock market's inevitable gyrations, a hopeless task in our view, we prefer to focus the energies of our staff on longer term economic fundamentals, benefiting from years of experience navigating the inevitable economic cycles, monitoring the investments we have made for clients and to finding promising companies in which to invest.

FIXED INCOME INVESTMENT POLICY

Despite the significant rise in bond yields since their trough in mid-2021, we believe the outlook for fixed income securities remains relatively unfavorable. Interest rates are forecast to rise further as the economic cycle plays out and the Fed works to control inflation while normalizing interest rates. Therefore, since preservation of principal and maintaining liquidity are our primary objectives in managing clients' bond investments, fixed income investments are defensively invested in a ladder of highly marketable corporate obligations with a target duration of 1. However, should short term rates continue to rise, we plan to gradually extend maturities.

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