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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

Last week's nonfarm payrolls report confirmed the US economy continues to expand, albeit moderately, despite months of aggressive Fed credit tightening and serious liquidity issues at a handful of regional banks. While the employment report for April showed a larger-than-expected gain in nonfarm payrolls, up 253,000, revisions to the previous two months' figures reduced overall gains by 149,000. Except for the large upside surprise in January, monthly gains remained below 300,000 over the past six months. The three-month-moving average of monthly payroll gains has been trending down over the past year, reaching 222,000 in April, the lowest level since early 2021. Recall that monthly payroll gains had averaged close to 500,000 in 2021 through early 2022.

The March Job Openings and Labor Turnover Survey (JOLTS), released last week, also suggests labor demand is gradually cooling, as job vacancies declined each month in the first quarter, bringing the total number of job openings to the lowest level since April 2021. The March ratio of job-openings-to-unemployed persons, one of Fed Chair Powell's favorite gauges of labor market tightness, moved down to 1.6, off the peak of 2.0 the same month last year, but still well above the level (1.0-1.2) consistent with a less inflationary job market. Another favorable development last month was the decline in the number of quits to 3.851 million, the lowest since May 2021, implying workers are less optimistic about prospects in the labor market. Meanwhile, the government's April household survey showed the unemployment rate falling to 3.4% after jumping in March. The number of people losing jobs last month declined 307,000 to 2.642 million, evidence of labor market strength. And finally, initial jobless claims, a reliable forward-looking labor market indicator, increased 13,000 for the week of April 29 to 242,000, leaving that measure at the upper end of its recent range since early March.

Also worth noting, recent surveys and data on spending point to growing caution in the manufacturing sector and the business environment in general. The forward-looking ISM manufacturing survey increased slightly from 46.3 in March to 47.1 last month, though it remains below 50, the threshold for expansion, for the sixth consecutive month. March factory orders declined 0.7%, a little more than expected, on weaker than forecast orders

and shipments of nondurable goods. And capital spending figures appear to be weakening, pointing to likely softness in equipment investment in the current quarter. More than offsetting this weakness in manufacturing, non-manufacturing business activity, which accounts for nearly 80% of GDP, remains strong as consumers continue to shift their purchases from goods to services which were unavailable during the pandemic. The ISM non-manufacturing index increased to 51.9 in April as the new orders index surged to 56.1 from 52.2 in March, signaling strength in that sector.

In summary, the combination of unprecedented Fed tightening over the past year and the impact of recent regional bank liquidity issues, is finally slowing overall US economic growth. Economists agree the full impact of tightening credit conditions will only become evident in the months ahead. While consumers continue to spend on services, job gains have moderated. Manufacturing has been in contraction for months. High interest rates have adversely impacted housing and other interest rate sensitive industries. Fed policies are also behind the notable contraction in M2 money supply over the past few quarters, a likely precursor to a further economic slowdown or recession. Readings of our firm's proprietary [Economic Model](#) remain below trend signaling the probability of a slowdown. So, the odds of a mild recession have, indeed, increased to better than 50/50 absent a sooner-than-expected pivot in Fed policy.

THE FED

Prior to the April jobs report last Friday, the FOMC acted as expected, raising its reference rate by 25 bp to 5.00%-5.25%, signaling a pause may be coming, albeit with latitude to hike at its June meeting, should incoming data warrant such action. Interestingly, Powell's revised post-meeting statement suggested Fed policy may already be tight enough to get inflation down over time to its 2% target, remarking that *real* interest rates are now meaningfully above neutral, and then, "You put credit tightening on top of that" and the Fed may have exerted sufficient restraint on the economy to accomplish its objectives. Interestingly, the bond market appears to be pricing in an early end to Fed tightening and at least two interest rate cuts before yearend, with further reductions thereafter. This is not surprising as the ongoing regional banking crisis has resulted in tighter lending conditions doing some of the Fed's heavy lifting. Furthermore, echoing Powell, with inflation at 5%, the real Fed Funds rate will be restrictive, turning positive for the first time since 2019, suggesting the Fed may be ready to pause. How soon after the pause can we expect the Fed to lower rates is open to question.

INVESTMENT POLICY

Despite multiple headwinds facing equities, and many prominent market analysts predicting a severe downturn leading to new stock market lows for this cycle as we

entered the year, large cap stocks performed surprisingly well through the end of last month, recouping a sizable portion of last year's declines. The S&P 500 returned 9.17% and the NASDAQ earned 21.32% for the year-to-date through April. Small Cap US stocks have fared less well this year as investors have opted for the relative safety of larger, well established, dividend paying companies with strong financials and favorable earnings prospects during uncertain times. By contrast, the S&P Small Cap 600 index returned -1.02% through April. Outside of the US markets, equities performed well with the All-World Ex US index reporting an 8.94% gain.

First quarter earnings and company guidance for the year, while not as weak as feared, did expose weakness in corporate operating fundamentals. Earnings revisions continued to move lower with the consensus S&P 500 forecast for 2023 revised down to about \$220 per share. Even though large cap balance sheets remain healthy, small caps could experience material earnings deterioration in a weaker economy, a factor behind their relatively poor market performance year-to-date. While we believe much of the bad news on large cap earnings has already been factored into equity valuations, we would not rule out one final test of last year's lows, implying as much as a 10% pullback in the S&P 500 from current levels. *Although stocks are not cheap at about 17.5x earnings, expectations for a sharp recovery in profits next year should cushion any decline.*

Reflecting the considerable near-term economic and policy uncertainties, including the debt ceiling standoff we see as being resolved in the eleventh hour, we expect equities to remain volatile, particularly around the release of key inflation and employment data and leading up to Fed meetings, until the Fed firmly signals it has reached the end of its credit tightening cycle. Until then, the ebb and flow of market sentiment is likely to drive sharp market swings. Looking a bit further out, the end to Fed tightening is in sight in our view, setting the stage for the next economic expansion and the onset of a new bull market for equities.

Beyond favorable fundamentals, we believe investors should keep in mind several positive market-based developments and conditions. First, it has been more than six months since the stock market's low last October. Following WWII, once the market remained above its low for six months, the S&P 500 has been higher six and twelve months later 12 of 13 times. Second, extreme negative investor sentiment, a positive sign for the market, is evident in Conference Board surveys and American Association of Individual Investor (AAII) polls where bearish sentiment has experienced a record 44 week streak. Third, given the global nature of large cap US equities, a rising dollar hurts their profits. The dollar's rally in 2022 coincided with the bear market for stocks. The dollar's peak last October occurred as the S&P 500 bottomed that month. A lower trending dollar, which we forecast, will be a tailwind for corporate profits and share prices as the year unfolds. Fourth, peak inflation has passed, and core inflation is clearly easing. Even housing, where rental price increases have been extreme due to by-design lags in the way actual rental market conditions are reported, has seen some improvement.

Fifth, in our view, the shift from ever-higher levels of interest rates to stable-to-lower rates is another tailwind for equities and market psychology. Sixth, the sharp declines in energy prices, where natural gas has fallen 75% from its high last August and WTI crude is off almost 50% from its peak level last year, acts as a tax cut for consumers who have more to spend elsewhere.

Equity portfolios under our supervision remain fully invested despite the short-term risks noted above, broadly diversified between *growth* and *value* investments, tilted slightly toward *growth* which is our long-term bias. Our platform includes small cap US equities as well as investments domiciled abroad in both *developed* and *emerging* markets. Portfolio turnover remains intentionally low, consistent with our long-term investment horizon and focus on producing competitive after-tax returns for taxable portfolios.

The sharp rise in interest rates over the past year has made bonds investable once again. Accordingly, we have extended fixed income portfolio durations in clients' laddered corporate bond portfolios, selectively deploying funds generated by maturing bond holdings, increasing yields significantly. Lower yielding money market fund investments have been replaced with higher yielding US Treasury bills maturing in less than a year.

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Indexes are unmanaged, do not include fees or expenses and are not available for direct investment. Definitions: Personal Consumption Expenditures Index (PCE): A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior. Conference Board's Confidence Index: The Consumer Confidence Survey[®] reflects prevailing business conditions and likely developments for the months ahead. ISM Manufacturing Index: The ISM manufacturing index or purchasing managers' index is considered a key indicator of the state of the U.S. economy. It indicates the level of demand for products by measuring the amount of ordering activity at the nation's factories. ISM Non-Manufacturing Index: The Institute of Supply Management (ISM) Non-Manufacturing Index is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives. S&P500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. S&P500 Growth Index: The S&P 500 Growth Index is a stock index administered by Standard & Poor's-Dow Jones Indices. As its name suggests, the purpose of the index is to serve as a proxy for growth companies included in the S&P 500. S&P500 Value Index: The S&P 500 Pure Value Index refers to a score-weighted index developed by Standard and Poor's (S&P). The index uses what it calls a "style-attractiveness-weighting scheme" and only consists of stocks within the S&P 500 Index that exhibit strong value characteristics.

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