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Economic Update

Incoming economic data shows that in the wake of the gradually slowing US economy inflation eased substantially last month, extending the recent downward drift in consumer price increases, setting the stage for the Federal Reserve to begin easing credit conditions by the end of this summer. Recent spending data points to only modest, possibly below-trend economic growth this quarter and there is likely some modest downside risk to the current 2.0% consensus GDP forecast. This would follow an already soft 1.4% reading in the first quarter. For the Fed, the reports of a gradually slowing US economy do not rise to the "unexpected weakening" Chair Powell has highlighted as triggering a rate cut in the very near term. Nevertheless, the Fed has made it clear that it will not wait until inflation reaches 2.0% to cut interest rates. Instead, officials say they are going to look for "greater confidence" in the data they review over the next few months to confirm inflation is on a path toward its target before they lower their reference rate***. The implication is that should the Fed wait until inflation reaches 2.0% to cut, it will probably have waited too long, increasing the risk of a bumpy landing***.

Inflation

The June Consumer Price Index (CPI), a broad measure of goods and services costs, fell a slight 0.06% from May, dropping the year-over-year inflation rate to 3.0%, the lowest reading since June 2023. The headline figure was depressed by a 2.0% decline in energy prices. Core CPI prices, which exclude volatile food and energy items, a better gauge of underlying inflation, rose 0.1% in June, the mildest increase since January 2021 when the economy was paralyzed by COVID-19. Within the core component, the long-awaited slowing in both tenants' and owners' equivalent rents finally showed up in June as tenants' rents increased only 0.26% and owners' equivalent rent rose a slim 0.28%. Signals in housing industry data regarding new rents suggest the cooling in rental inflation should persist. Incorporating data from the June CPI and PPI reports, analysts forecast the June core Personal Consumption

Expenditure index (PCE), the Fed's preferred inflation gauge, was up 0.17% last month, leaving the year-ago increase unchanged at 2.6%. Beyond the CPI data, recent surveys of inflation expectations have been steady. The NY Fed's measure of inflation expectations for year-ahead inflation slipped 0.02% to 3.0%, while the preliminary University of Michigan gauge for the same period slipped 0.01% to 2.9%. Elsewhere, minutes of the June FOMC meeting indicate that officials generally saw a benign inflation outlook. Should these favorable trends showing inflation on path toward the Fed's 2.0% target persist over the next couple of months, we expect data-dependent Fed officials to commence a rate cutting cycle at its September 18 meeting.

Jobs

Despite adding a solid 206,000 jobs in June, slightly exceeding expectations, there are numerous signs of a cooling labor market. The unemployment rate continued its slow and steady march higher, rising to 4.1% last month, ticking up in each of the last three months. Average hourly earnings were up 3.9% in June from a year earlier, marking their smallest gain since 2021. The number of reported jobs gained for both April and May were revised lower by a combined 111,000 positions. Private payrolls expanded by only 136,000 last month but were revised down by 86,000 in prior months, bringing the net gain to 50,000. The labor-force participation rate, the share of working-age people who were employed or seeking work, rose to 62.6%, an indication that more people (i.e. immigrants, retirees and others whose savings have been depleted) entered the labor market. Another emerging sign of slack in the labor market is that unemployed workers are finding it's taking longer to find a new job. The median duration of unemployment hit 9.8 weeks in June, the highest since January 2023. The rise in the length of time it takes to land a new job is consistent with the recent upward creep in continuing jobless claims reported weekly. In short, the labor market is not a source of inflationary pressure for the economy now, notable because Fed officials have long cited an overheated labor market as a primary risk to bringing inflation back down.

Consumption

Retail sales, which account for 70% of GDP, were unchanged last month, better than expected, as a drop in receipts at auto dealerships was offset by broad strength elsewhere, showing the consumer resilience that has bolstered the economy in the post-pandemic era. Flattish spending signals US consumers, particularly those at the lower end of the income spectrum have pulled back a bit back under the weight of higher borrowing costs after depleting the stimulus funds they received during the COVID years. While nominal retail sales are up 2.3% in the last year, "real" sales are down 0.9% during that time. The

unchanged reading for June followed an upwardly revised 0.3% gain in May. Momentum has, however, slowed from the 7.7% logged in January 2023. After a period of high inflation, households are trading down, seeking cheaper alternatives, as we have seen in earnings reports from major retailers and manufacturers.

The Fed is in a delicate situation. Lowering rates prematurely could risk reigniting inflation, and doing so too slowly could undermine growth. While the central bank has by no means taken its eye off inflation, slowing consumer spending and weakness in interest rate sensitive industries (i.e. housing, commercial real estate, autos and small businesses), along with a cooling labor market and less concern about repeat of the first quarter's inflation bump, have caused the central bank to pivot recently, giving greater weight in its policy deliberations to the risk of a steeper than desired economic slowdown. Should growth significantly undershoot the Fed's forecasts, we could see an earlier, more aggressive loosening of monetary policy than is generally expected. Currently, financial markets are pricing in a rate cut in September followed by additional cuts in November and December.

Forward looking economic indicators are showing some weakness:

ISM Manufacturing Index ended the first half of the year on a weak note at 48.5, compared with 48.7 a month earlier, signaling contraction for the nineteenth time in the last twenty months. (Levels above 50 signal expansion; levels below 50 signal contraction). Manufacturing accounts for about 11% of GDP. Only eight of the eighteen major manufacturing industries reported growth in June, while nine reported contraction. Production softened and fell into contraction for the first time in four months while the new orders index, the most-forward looking metric in the report, has remained below 50 for twenty of the last twenty-two months. As demand has weakened, companies have turned to reducing their order backlogs. The backlog index, which fell to 41.76 in June, has been signaling contraction for twenty-one consecutive months. Survey comments from manufacturing companies warned of dwindling backlogs and they have begun to furlough workers in response. This can be seen from readings of the employment index which fell back into contraction in June, the eighth time below 50 in the last nine months. In retrospect, manufacturing was artificially boosted during the COVID lockdowns, but as the economy reopened, consumers shifted their spending preferences back to services and away from goods. One bright spot in the June report, prices paid for materials fell 4.9 points to 52.1, the largest decline since May 2023 and the slowest growth in costs this year.

ISM Non-Manufacturing Index declined to 48.8 in June, well below consensus expected 52.7. (Levels above 50 signal expansion; levels below 50 signal contraction). With last month's abrupt decline, activity in the services sector which accounts for about 80% of GDP, has contracted in two of the last three months. Eight of the eighteen industries reported growth for the month with an equal number reporting contraction. The causes of the decline in the overall index were lower business activity as well as slower new orders. Interestingly, the indices for both new orders and business activity fell into contraction territory, the first time they have been below 50 since December 2022 and May 2020, respectively. The report's most discouraging readings came from the prices index which declined to a still high 56.3 in June. Although that index is lower than the shocking pace of 2021-22, prices are still rising in the services sector where inflation remains a major problem and is abating only slowly. Services, which have been a driving force for the US economy for the past few years, now appear to be slowing.

Front Barnett Economic Model, designed to signal a change in the direction of the US economy six to nine months in advance of an inflection point, remains above-trend, signaling expansion ahead.

Balancing these and other factors we take into consideration when assessing the investment outlook, we conclude the US economy, while slowing under the weight of a highly restrictive monetary policy, is fundamentally sound and financially strong. In our view, there remains sufficient momentum from consumption to underpin a slower paced but sustainable expansion. With the recent progress in further moderating inflation, the Fed is on track to begin lowering interest rates in September. Easing credit conditions will support a broadening out of the expansion and lead to the emergence of a more inclusive stock market leadership.

Investment Policy

As we enter the second half of 2024, many investors are calling the US stock market overheated. While that may be true for NVIDIA and a handful of other speculative mega cap AI-related stocks where price-to-earnings ratios are stretched, the S&P Equal Weight index, which treats the returns of smaller capitalized stocks the same as those of larger ones is up only about 8.7% year-to-date. That compares with a gain of 18.8% for the cap-weighted S&P500 where nearly 35% of this year's gain has come from the performance of a handful of mega cap stocks. This narrow market advance creates challenges for active fund managers who are concerned with protecting

portfolios they manage from the excessive risks associated with highly concentrated portfolios and are restricted by diversification requirements and other risk-management practices. Among the 50 largest actively managed US large-cap mutual funds, representing nearly $1.7 trillion in assets, not one outpaced the S&P500 over the first half of this year.

Given the disproportionate impact of these few mega caps on the S&P500, where only ten stocks account for 35% of the index, it is not at all surprising that broadly diversified equity portfolios such as those we manage have generally failed to keep pace during the past six months with the Cap Weighted index performing more in line with the Equal Weighted index in this bifurcated market.

We believe the anticipation of a Fed rate cut will provide the catalyst for broader equity participation. Interestingly, year-to-date the S&P500 *growth* index is higher by 27.9% while the S&P500 *value* index has risen only 8.8% in that time. Such a huge disparity in performance has occurred only rarely and is likely to narrow sharply as confidence the economy is headed for a soft landing, supported by easing credit conditions, grows.

As for stock market valuation, the S&P500 price-to-earnings multiple is now over 21 times forward earnings, its highest reading since 2021, when interest rates were near zero. The top tech stocks are even more expensive, showing an average P/E of 34x. The 10-year, BBB rated bond yield of 5.53% at the end of June, a useful equity market yardstick, implied a fair forward P/E of about 18x, suggesting the market was about 15% overvalued. However, the forward P/E of the average stock is 17x, a valuation closer to fair value. Interestingly, between 2000 and 2001, when the tech bubble burst, the S&P500 cap-weighted index lost 20% of its value while the S&P500 Equal Weight index gained nearly 8%. So, despite the speculation surrounding the AI stocks, the average stock is insulated due to its reasonable valuation.

Looking beyond the near-term uncertainties, equity portfolios under our supervision are fully invested within portfolio guidelines, broadly diversified between *growth* and *value* shares, tilted slightly toward *growth*, which is our firm's bias. Recall that as long-term investors, Front Barnett combines high quality, large cap *growth* and *value* investments in a structuring clients' equity portfolios, allowing portfolios under our supervision to potentially gain throughout economic cycles in which the broader market favors either the *growth* or *value* investment style, smoothing returns over time. In addition, opportunistically, our investment platform allows for small cap investments as well as investments in developed and emerging markets domiciled abroad.

Clients' high quality, highly marketable, laddered corporate bond portfolios have seen an increase in duration since last fall toward our target of 2.5+ years. Yields-to-maturity on the new purchases, where yields have exceeded 5%, were funded from cash equivalents, the proceeds of maturing bonds, and the sale of some existing shorter-dated holdings. The proceeds of future bond maturities will be reinvested to fill out the aforementioned ladders.

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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 US 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&P 500 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 US. **S&P 500 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&P 500 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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