

October 17, 2025

Statement of Investment Policy

Background

Data, surveys and anecdotal evidence we have cobbled together since the government shutdown confirms the US economy remained “stable” over the past several weeks, perhaps growing a bit more moderately overall, according to the latest Fed Beige Book. Underlying strength continues to come from the usual suspect, consumer outlays, which accounts for nearly 70% of GDP. Household spending has exceeded expectations in most recent months, suggesting firms are still able to sell into demand, notwithstanding inflation. Business investment, especially in computing, AI infrastructure and capacity expansion in some secular growth sectors has been a tailwind. Business investment amounts to 15% of GDP. The US Coincident Index, published monthly by the Federal Reserve Bank of Philadelphia, which measures variables that move more in step with the economy, showed moderate growth pre-shutdown. Interestingly, many business-leader sentiment surveys remain more sanguine than consumer sentiment as measured by the Conference Board, though uncertainties around public policy, tariffs and supply chain disruptions are mentioned as key constraints to growth by business survey respondents.

Consumer sentiment as surveyed by the University of Michigan remains subdued, depressed, showing little increase in early October as Americans expect scant improvement in the job market or inflation. Anecdotal reports note many firms are deferring investment, and credit-stressed households are dipping into reserves to sustain spending. Interest rate sensitive sectors, including housing, real estate and small companies without direct access to the capital markets, continue to suffer.

That economic pattern, showing visible patches of consumer resilience masking broader softness, presents a cloudy picture, characteristic of a rolling, sector-by-sector recession rather than a synchronized downturn.

Looking ahead, within the context of what we see as a fundamentally sound economy, we expect consumer outlays to remain soft for a while. Uncertainties around escalating tariffs have soured sentiment. Restrictive immigration policies have curtailed labor force expansion, slowing labor income growth which has been essentially flat or negative on an inflation-adjusted basis for the last quarter. A large portion of consumer spending has been on autos as the electric vehicle tax credit and the front-

running of tariffs pulled forward purchases. And the experience of 2018-19 showed that tariffs had a large negative effect on domestic manufacturing that persisted for well over a year, but the onset of that drag had a lag of about two quarters. These factors signal some possible softness in consumption ahead.

The Labor Market, Inflation and the Fed

Absent the availability of government data prior to the FOMC meeting on October 29, policy makers at the Fed will be deliberating in a fog of uncertainty when they gather to decide whether to cut interest rates. The Fed's dual mandate is to foster maximum employment and price stability. While the unemployment rate is close to the Fed's estimate of full employment, cracks have appeared in the labor market. For example, August non-farm payrolls rose only 22,000, well below what has historically been thought to be the number of new jobs needed to absorb market entrants and to maintain momentum. Earlier months' data have also been revised downward, further weakening the trend. Private data from ADP and other labor market trackers indicate that job growth in September was nearly flat or possibly slightly negative. The official unemployment rate climbed to 4.3% in August, its highest rate in four years. Longer durations of unemployment have ticked up as more people are remaining jobless for extended periods. The labor force participation rate has drifted downward, notably the prime-age and working-age populations are not entering the labor force at rates needed to sustain past growth. Part of this is structural (aging and retirement), and part may reflect discouraged workers opting out until conditions improve. The number of job openings in the JOLTS survey has been trending downward. In July 2025, for the first time in years, the number of unemployed people surpassed the number of open jobs, leading to fewer openings per unemployed person. Manufacturing has lost jobs for multiple months. Other sectors such as wholesale trade, business services and government are shedding jobs or seeing weak hiring. Worker turnover (quits, job switching) has cooled somewhat, a sign that confidence in finding better opportunities is fading. And the term "bed rotting" is being used metaphorically to describe a labor market with very little movement — few quits, few firings, stagnant transitions.

As for inflation, various measures of consumer prices have been above the Fed's 2% target for four years. The Consumer Price Index (CPI) for "all items" rose by 2.9% year-on-year in August, up from 2.7% in July. Excluding food and energy, core CPI prices rose 3.1% in August. The Fed's preferred inflation gauge, the Personal Consumption Expenditures index (PCE) increased to 2.7% in August, the highest reading in six months, and the PCE core index, which excludes volatile food and energy components, stood at 2.9%, indicating persistent inflation. By contrast, surveys of future inflation have not budged, remaining well-anchored.

How much of the recent upward push in the inflation measures can be attributed to the impact of President Trump's tariffs remains to be seen. Whether the weakening labor market reveals a threat to the current expansion is an open question. Despite the uncertainties, a majority of FOMC members concluded last month that the balance of risk has shifted from inflation to unemployment, voting to pivot policy by lowering their reference rate a quarter percentage point to address labor market weakness.

Fed critics will accuse policy makers of ignoring the inflation risks while acting on what they believe to be unreliable data. They will argue that a decade or two ago, the US population, particularly the working-age population, was growing more quickly. Economists then estimated that about 100,000 to 150,000 new jobs per month were needed simply to absorb new entrants to the labor force. Now, because of aging demographics, lower birth rates, and slower immigration, the labor force is expanding much more slowly. The Bureau of Labor Statistics and Congressional Budget Office data show labor force growth of only about 0.3–0.4% annually, compared with roughly 1% in the 1990s–2000s. That means the “breakeven” level of job creation (i.e. the number needed to keep the unemployment rate stable) has fallen to around 30,000–70,000 jobs per month. Millions of baby boomers have retired, particularly after the pandemic. Many have not reentered the labor force. As a result, there are fewer people competing for jobs, so employers do not need to add as many positions to keep the jobless rate steady. Immigration slowed sharply during the pandemic years, further constraining workforce growth. Although immigration has rebounded since 2023, labor force participation among older workers remains below pre-pandemic levels, reinforcing the slower overall growth trend. Higher productivity, aided by technology and AI adoption, also means the economy can produce more output with fewer workers, reducing the number of new hires needed to sustain growth. In short, the economy no longer needs to add over 100,000 jobs per month to maintain stability because the labor pool itself is barely expanding. The new “neutral” rate of job creation, roughly 30,000–70,000 per month, reflects an older, slower-growing, more productive workforce.

Notwithstanding inflation concerns and job market uncertainties, comments by Fed Chair Powell buttressed expectations that more interest rate cuts are coming due to job market weakness. So, there is almost certainty the Fed will cut rates by a quarter point later this month and likely ease policy again in December.

Outlook

The US economy appears poised for a period of more modest growth through the next two quarters as the Federal Reserve prepares to cut interest rates twice more this year. These expected quarter-point reductions should ease financial conditions and provide some relief to borrowers, but the effect is likely to be gradual. Inflation remains stubbornly above the Fed’s 2% target, with the core PCE index still near 2.9%, suggesting that real interest rates will stay mildly restrictive and prevent a stronger rebound until mid-2026.

Consumer spending, which has been the main driver of growth, shows some signs of fatigue. Retail sales are up only modestly once adjusted for inflation, and consumer sentiment has fallen to near 55 on the Michigan index, reflecting anxiety about prices and the job market. The labor market itself is cooling, with unemployment edging above 4%, yet layoffs remain limited, indicating a slow rebalancing rather than a broad-based pullback.

Given these crosscurrents, the outlook for late 2025 and early 2026 points to slow, uneven growth, perhaps in the 1–2% range, with inflation easing only gradually. A “soft landing” is likely if the Fed manages to sustain demand without reigniting inflation, but risks of a shallow recession persist should consumers retrench more sharply than we expect. Indeed, our firm’s proprietary [Economic Model](#),

using publicly available data, designed to signal an inflection point in the economy 6 to 9 months in advance of a change in direction, remained above trend in September, signaling expansion ahead.

That said, a broad increase in productivity, driven by the adoption of artificial intelligence, could substantially reshape the near-term and medium-term economic outlook. Over the next two quarters, the effects would likely be gradual but increasingly visible as firms implement AI to streamline operations, reduce labor needs, and improve efficiency. Higher productivity can help offset rising labor and input costs, enabling businesses to protect or even expand profit margins despite slowing demand and sticky inflation. This could, in turn, stabilize corporate earnings and support equity valuations, especially in technology, finance, and logistics sectors where AI integration is advancing most rapidly.

For the broader economy, improved productivity allows for higher output without commensurate increases in labor or capital costs, effectively expanding supply capacity. If sustained, this dynamic can help ease inflationary pressures even as growth continues, potentially giving the Federal Reserve more flexibility to reduce rates without reigniting price instability. However, the benefits may be uneven: firms that fail to adopt AI efficiently could see margins squeezed, and displaced workers may weigh on household spending in the near term. Beyond early 2026, if AI-driven efficiency gains spread across industries, the economy could enter a period of more robust, more sustainable growth, with rising corporate profitability and slower inflation than generally forecast, hallmarks of a genuine productivity-led expansion.

Equity Investment Policy

There has been no change in equity investment policy. Portfolios under our supervision remain fully invested within their guidelines reflecting clients' risk tolerances. They remain well diversified, balanced between large cap *growth* and *value* investments, domestic small cap as well as holdings abroad in developed and emerging markets. Recall that by blending *growth* and *value* investments in a single equity portfolio, a style unique to Front Barnett management, we seek to smooth out returns over a market cycle.

Buoyed by sound fundamentals, lower than feared tariffs, the all-but-certain Fed pivot, and rising earnings estimates, the benchmark S&P500 index has rebounded over 30% from its April correction lows. Year-to-date, the S&P500, a cap weighted index, has risen 12.3%. The tech-heavy NASDAQ has gained 16.6% in 2025. The S&P equal weight index, whose performance is more representative of the average stock in its universe, is ahead 6.7% this year. Since mid-year, well diversified portfolios, such as those we manage, have benefited from the long-awaited broadening of US stock market leadership, away from the small group of AI related mega-cap tech and communications services stocks which at one point this summer accounted for over 40% of the S&P500's market cap.

From a valuation standpoint, US equities remain highly priced, vulnerable to a 10%+ sentiment driven correction should market-leading tech stocks stumble, creditable signs of credit market deterioration emerge, and/or tariff wars seriously escalate. The cap weighed S&P500 is selling at a rich 23X forward earnings. The average stock, as measured by the S&P500 equal weight index, is more reasonably priced at 18X forward earnings, not far above its average 16X multiple. So, over time,

there is likely further room for the overall market to move higher as rising earnings estimates for 2026 are discounted. We see falling interest rates, positive earnings momentum, operating leverage and cash tax savings, as likely tailwinds for equities.

Fixed Income Investment Policy

Clients' high quality laddered corporate bond portfolios are managed to a 2.75-year target duration, unchanged since early this year. We continue to reinvest the proceeds of maturing bonds to fill out clients' ladders, preferring to add bonds maturing in 5 years or less. We continue to recommend clients who require liquidity for substantial near-cash reserves positions they may hold away from Front Barnett management to selectively extend the maturity of these holdings to match the durations of their obligations.

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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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