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Economic Update

The US economy in the final weeks of the year remains on solid footing, resilient, expanding at a moderate pace. Yet, it is contending with a mixed set of forces as overall growth has notably slowed amid restrictive financial conditions and unpredictable trade policies. Inflation is lower than it was at its peak and the labor market, while cooler, is still functioning near historic norms by most measures.

GDP growth has moderated over the course of the year, moving from a pace near 2% trend to one distinctly slower, as consumer spending and business investment responded to tight credit conditions. Private forecasts for the next couple of quarters generally point to modest growth rather than contraction, but with clear downside risks if financial conditions tighten further or confidence weakens. Markets recognized this cooler backdrop in November, when the broad equity market gave back a fraction of its earlier gains and volatility rose as investors reconsidered earnings and growth assumptions.

In our view, the current environment represents a period of transition from the post-pandemic era of strong, stimulus-supported demand to one in which underlying supply and productivity will play a larger role in driving the path of output. We have characterized this as a rolling recession where the overall economy continues to gain ground despite notable pockets of weakness. Now, there is accumulating evidence that the US economy is moving toward the better balance between demand and supply we have expected, but the adjustment is incomplete and subject to shocks, including from policy, geopolitical, and global conditions.

Household Spending and Consumer Sentiment

Households are feeling the combined effects of higher borrowing costs, past inflation and slower nominal income growth. Delinquency rates on some categories of consumer credit have moved up from unusually low levels, and savings accumulated during the pandemic have been drawn down significantly for many middle and lower-income households. Surveys of consumer confidence and sentiment show a moderately pessimistic tone despite the November uptick in sentiment reported by the University of Michigan. Respondents cite affordability and uncertainty about the economic outlook as key concerns, even as employment opportunities remain plentiful.

At the same time, real wage gains have turned positive for a growing number of workers as inflation has declined faster than nominal wage growth, offering some support to real incomes.

Labor Market Conditions

The labor market has cooled noticeably, with job growth slowing substantially from the pace observed in the previous year and revisions revealing significantly weaker hiring than initially reported. The unemployment rate has edged higher to 4.4% but remains low by historical standards. Other indicators such as job openings, initial and continuing jobless claims, quits, and normal wage growth show gradual easing rather than the sharp deterioration which almost always precedes a major downturn in the overall economy. This combination of slower payroll gains and still-low unemployment reflects a reduction in both labor demand and labor supply, including a deceleration in labor force growth tied in part to tightened immigration policy.

In the absence of official data, surveys of businesses we have seen indicate hiring plans have become more cautious, especially in interest rate sensitive sectors such as construction, real estate, and some segments of consumer services. At the same time, many employers report that it is easier to fill open positions than a year ago, and wage pressures, while still present, have diminished from earlier peaks, suggesting reduced risk of a wage-price spiral.

Inflation

Inflation has fallen considerably from its post-pandemic highs reflecting easing supply bottlenecks, lower goods price inflation, and some moderation in services. Nonetheless, inflation has remained above the Fed’s 2% target for four years. Progress in achieving that objective has been uneven across categories, with housing-related services and some labor-intensive services still showing elevated readings. Market-based measures of inflation compensation and surveys-based measures of inflation expectations remain broadly consistent with longer-run price stability, an important tailwind for the Fed in achieving its inflation goal without causing a severe downturn.

Recent data on producer prices and import prices point to reduced upstream cost pressures, but geopolitical tensions, trade frictions, and energy-market uncertainties pose ongoing risks to price stability.

In this environment, we view the risks to inflation to be tilted somewhat to the upside over the near term, at the same time as the risk of a downturn in employment growth has increased as growth slows.

Financial Conditions and Markets

Financial conditions remain restrictive by several measures, reflecting the cumulative tightening in policy rates and the resulting adjustments in bond and equity markets. Long-term interest rates are higher than in the pre-pandemic decade, increasing borrowing costs for households, businesses, and governments. Equity markets, following strong gains earlier in the year, have recently turned more volatile, with major market indices pulling back in November as investors reassessed valuations in the light of slower growth, persistent inflation and fears a divided Fed would decide in December to forego another rate cut.

Corporate credit spreads have widened modestly, especially for lower-rated issuers, signaling some increased concern about possible future defaults but not yet the kinds of stresses we have seen during periods of economic contraction. Surveys of senior loan officers at major banks continue to show tight lending standards, particularly for commercial real estate and small business credit, limiting access to financing for more marginal borrowers and reinforcing the drag from higher rates.

Headwinds and Tailwinds

Recent data, surveys, anecdotal evidence and market pricing point to several meaningful tailwinds supporting continued economic activity and demand, as well as a set of headwinds that have gained intensity in recent weeks.

Tailwinds

The *Services sector*, which accounts for about 70% of GDP, the lion's share of US employment and output, has continued to expand in recent months The ISM Services PMI showed an expansionary reading in November, with business activity and new orders remaining above the 50-threshold that separates expansion from contraction, suggesting underlying consumer and business demand for services remains intact. Services activity underpins payrolls and household income, which in turn buttress consumer spending.

Consumer balance-sheets remain strong. While headline measures of consumer sentiment are subdued, spending and household balance-sheet strength have continued to support retail and services spending through the fall though anecdotal reports captured in the Federal Reserve's Beige Book point to some scattered softening as lower-income households retrench. Meanwhile, aggregate spending has retained its momentum.

Lowered inflationary pressures are evident in the Fed's preferred gauge of prices. Though affordability remains a problem for many consumers, the Personal Consumption Expenditures index (PCE) shows that while elevated at 2.8%, relative to the central bank's 2% target, prices have not accelerated in ways that would cause the Fed to abandon its plan to guide its reference rate toward what officials believe to be the neutral rate.

Market Expectations of Fed easing, reflecting both softer incoming data and market participants' assessment that policy is restrictive enough to bring inflation down, could produce a well-telegraphed tailwind to growth, encouraging the Keynesian animal spirits, while preserving the Fed's longer-run inflation credibility.

Headwinds

Labor market softening and evidence of job losses we have seen in recent weeks have shifted labor market perceptions in a sobering direction. Private payroll measures reported notable weakness: ADP's November estimates have implied a roughly steady-to-slightly-weaker private payrolls number, showing a loss of 32,000 private-sector jobs, and some alternative trackers and regional indicators have pointed to further softness. The Chicago Fed's real-time and alternate-data implied a slightly weaker unemployment rate around 4.5%. Payroll provider reports, layoffs announcements, and slower help wanted indicators point to growing slack relative to earlier in the year.

Manufacturing contraction and weakness in goods, which represents as much as 14% of GDP, extended through November according to the Manufacturing PMI which remained below 50 for the eighth consecutive month. This weakness has been broad-based across several durable goods industries and has coincided with softer global demand and ongoing inventory adjustments in some sectors. A manufacturing pullback can weigh on business investment, exerting a negative influence on overall growth.

Fragile consumer sentiment disproportionately concentrated among lower-income households, while showing a small uptick in November, remained near historically depressed levels. When large swaths of consumers curtail durable goods and discretionary spending, aggregate demand growth is at risk.

Data lags and statistical uncertainty due to the recent government shutdown complicates real-time assessment of the economy, a clear headwind to policymaking and to private-sector planning.

Liquidity and Fed balance-sheet normalization effects over the past year can amplify volatility in money markets and short term funding costs, which can pass through to broader financial conditions and credit availability.

Balancing these factors, the picture that emerges is one of diminishing, but still present, balance-sheet and services-driven support to the economy, juxtaposed against rising signs of weakening in labor from private providers, contraction in manufacturing and pockets of consumer stress.

The combination of softer payroll readings from private providers, contraction in manufacturing PMIs, yet-resilient services activity, and ongoing uncertainties in inflation metrics, produces a narrow band in which we believe the outlook is for moderate growth with increasing downside risk, providing the Fed with leeway to continue easing.

The Outlook

All things considered, we conclude the overall economy is sound, well financed, growing moderately, at or below 2.0% trend. The near-term risks are tilted toward slower growth over the next one to two quarters. Further interest rate cuts, moving the currently restrictive Fed Funds rate toward the so-called neutral rate which we assume to be 3.5%, are likely in 2026, though the timing of additional accommodation is uncertain given the current tug-of-war at the Fed. Interest rate sensitive sectors of the economy, which have been in their own recession, are likely to benefit from eventual further easing, as will small companies which lack direct access to the public debt market for financing. Strong household balance sheets and favorable labor market conditions argue for continued consumption growth as sentiment improves following the reopening of government.

Beyond the next quarter, as 2026 unfolds, we expect to see a significant broadening and strengthening in economic growth driven by the tax cuts and supply side incentives written into law as part of the One Big Beautiful Bill Act (OBBBA). The OBBBA makes permanent the lower tax rates enacted in 2017's Tax Cut and Jobs Act, eliminates taxes on tips and overtime, increases the standard deduction for single and married filers, introduces deductions for seniors and those who pay interest on car loans, and raises the cap on the SALT deduction for those paying state and local taxes. Equally important, will be benefits to the economy from the supply side impacts of OBBBA which include increases in the small business tax deduction, increases the thresholds and makes permanent the Qualified Business Income Deduction, and allows for 100% immediate expensing of new investments in factories and production facilities.

In short, the US economy will benefit from a favorable policy mix of stimulative fiscal policies, further Fed easing and regulatory relief. Tax cuts are likely to boost consumer spending and the incentives for increases in capital investment should provide the basis for long-term economic growth, just as the US celebrates its semi-quincentennial.

Equity Investment Policy

Equity investment policy remains unchanged: Portfolios under our supervision remain fully invested within their established guidelines which reflect clients' risk tolerances. We believe we are in the early innings of a new, highly innovative economic cycle fueled by AI and robotics-driven productivity gains, supported by favorable monetary and fiscal policies. Near term, softening labor market conditions, stable inflation and falling energy prices will provide cover for further Fed accommodation, though the timing of rate cuts next year is uncertain.

We expect the broadening US stock market leadership we have seen since mid-year, evident in the performance of broadly diversified portfolios such as those we manage, will continue into the New Year as further signs of a widespread economic expansion emerge.

Portfolios under Front Barnett management are well diversified between core large cap growth and value shares. Domestic small cap equities and international developed and emerging market investments are also components of our investment platform. Recall that by blending *growth* and *value* investments in a single portfolio, a style unique to Front Barnett management, we seek to smooth portfolio returns over a market cycle.

By most measures, US equities are richly valued following years of outsized gains. Since the stock market's pandemic low of March 2020, the S&P500 has shown a major rebound, delivering almost a 15% total return per year through November. During the same period, the tech heavy Nasdaq increased 23% per annum. These outsized returns dwarf the 10% annual returns stocks have returned historically. More recently, during the almost three years through the end of last month, the S&P500 earned 18% per annum on a total return basis while Nasdaq grew about 25% per year.

These gains were driven by investors' excitement over the prospects for AI as well as fundamental factors such as ample liquidity, declining interest rates, operating leverage, supportive and pro-cyclical fiscal policies, a rebounding economy where consensus revenues and earnings estimates proved to be too conservative, and this year, by the current administration which grades itself on a rising stock market. Clearly, the backdrop for risk assets has been favorable.

As for current stock market valuation, the S&P500, a cap-weighted index, carries a rich 22.5X P/E while the P/E of the S&P500 Equal Weight index is more reasonably valued at 18X. The difference in valuation between these two indices reflects the near 40% weighting in the S&P500 cap-weighted index of tech and telecommunicates services shares. Nvidia alone represents 8% of the market cap of the S&P500. This high concentration ranks among the most extreme examples of such disproportionate weightings in memory, creating a vulnerability for the index should investor sentiment toward tech, in general, sour.

High equity valuations raise the question of whether stocks in general are being driven by an unsustainable speculative wave that will end badly. Several market-based indicators commonly used to detect speculative excesses are elevated, though less so than prior to last month's 3% pullback in the S&P500 and 6% drawdown in the Nasdaq. When aggregated, these indicators show materially higher speculative activity than during ordinary market expansions. These metrics are not definitive proof that a market downturn will follow, but they do represent hallmarks of prior speculative episodes. Caution is advised: "Trees do not grow to the sky" and sentiment-driven corrections are inevitable.

Given the stock market's rich valuation, we believe equities will remain volatile, vulnerable to a 10%+ pullback should sentiment deteriorate. High-flying speculative tech shares, some which have already experienced significant pullbacks from their October highs, are likely to fall further in a general market correction. That said, a 10%+ correction would not diminish the longer-term attractiveness of risk assets.

Fixed Income Investment Policy

Laddered corporate bond portfolio target durations have been held steady at 2.75 years for most of this year. Short-term yields have drifted lower as expectations for further Fed rate cuts have been priced in. Longer-term rates have been range bound as fears of future inflation and negative sentiment regarding US fiscal policies cloud the outlook for the US dollar. We see short-term rates continuing to decline along with Fed policy decisions while longer-term rates are expected to be little changed over the intermediate term. We view bonds as providing income producing ballast in times of stock market turbulence, and liquidity. They serve as a key component of a conservative, balanced investment program.

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To you, our valued clients and friends, we send our warmest holiday greetings and best wishes for a happy, healthy and prosperous New Year.

MBF

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.