

# FRONT BARNETT

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## Economic Update

A sharp drop in public sector spending last quarter, reflecting the longest government shutdown in history, held GDP growth to 1.4%, a far weaker rate of expansion than the 2.5% economists had expected and well short of the 4.3% third quarter gain. During the quarter, Federal government spending declined at a 16.6% annual rate, shaving nearly 1.2 percentage points off headline GDP. The fourth quarter's results capped a volatile year in which consumer spending and an AI investment boom kept growth on track despite tariffs and other policy uncertainties. For all of 2025, inflation adjusted GDP grew 2.2%, slightly above-trend. We expect a reversal of the fourth quarter's drag from government spending in the current quarter, leading to a resumption of more robust growth which will be underpinned by accommodative monetary policy, fiscal stimulus from OBBBA, the normalization in business sentiment from last year's trade war shock and the continuation of the AI boom.

In what was yet another year of uneven economic performance, tech spending surged despite the fact business outlays on non-tech capital expenditure and inventory-building fell in the second half, in part accounting for the late year's slowdown. Business spending on capital goods amounts to nearly 14% of GDP. On the other hand, consumer spending, which amounts to nearly 70% of GDP, held up well, growing a solid 2.4% last year, despite a stall in real income.

The labor market remains a concern, even though the 4.3% unemployment rate is low by historical measures. Job creation stalled in 2025, with only 181,000 net new jobs compared with 1.4 million the prior year, as businesses juggled uncertainties around tariff and immigration policies and rebalanced their workforces following the post pandemic hiring spree. The potential impact of productivity-enhancing AI on the need for workers has left many employers reluctant to hire. January showed green shoots of improved job creation, though most of last month's hiring was concentrated in just one sector: Healthcare.

It is likely the US is now emerging from the late stages of the "rolling recession" of which we have often written. The coming expansion will produce broadening economic growth where

more muted consumer outlays are likely to be offset by a pick-up in job growth and non-tech business investment. While consumers reined in their spending last quarter for durables such as autos in the face of tariffs and expiring EV tax credits, their spending on services remained resilient and is expected to persist. Data shows that to finance their purchases, middle-and lower-income earners dipped into their savings causing the personal savings rate to decline to 3.6% in the fourth quarter from 4.2% in the prior three-month period.

***It's encouraging that following three years of contraction in goods production; the January ISM manufacturing index finally broke above 50, signaling expansion for the first time since January/February 2025; both Conference Board and University of Michigan measures of consumer confidence ticked up in February; non-farm payrolls grew 130,000 last month even as government jobs declined 42,000; services companies in January increased their hiring for the first time since Spring; and industrial production in January registered its largest increase in nearly a year, growing 0.6%.***

## Tariffs

The eventual impact of the recent Supreme Court ruling striking down the IEPPA tariffs and Trump's response imposing a 15% across-the-board tariff by applying emergency provisions under section 122 of the 1944 Free Trade Act, remains unclear. Whether this will result in higher or lower average tariff rates will depend on how details emerge regarding exemptions. We believe the administration, using various legal authorities, will seek to leave unchanged the 9.4% average effective tariff level facing US purchasers and to preserve existing trade agreements.

***This outcome will involve a difficult and likely protracted reworking of existing trade deals struck by the administration and a realignment of tariffs placed on different products from various countries, possibly creating new winners and losers, and ushering in yet another period of policy uncertainty that could undermine the sentiment lift now under way. Fundamentally, though, the SCOTUS ruling does limit risk in that tariffs can no longer be changed as capriciously as was the case last year.***

Regardless of uncertainties surrounding the tariff path, the ruling sets the stage for rebates from collected IEPPA tariffs, estimated to be close to \$150 billion, which would have only a minimal impact on economic growth in our \$31 trillion economy, but could widen this year's fiscal deficit to around 6.6% of GDP, a half-point increase.

## Fed Policy

The implications for Fed policy were telegraphed in the minutes of the FOMC's January meeting which showed a downward revision to the unemployment forecast and an upward revision to the PCE, the Fed's preferred inflation gauge, were behind a hawkish shift. Several FOMC members favor adopting a two-sided description of the Fed's policy outlook reflecting the possibility that upward adjustments to the target range for the Fed's reference rate could be appropriate if inflation remained above target. Prediction markets, reacting to the FOMC and to sticky inflation readings, further reduced the odds for an additional rate cut before mid-year.

## Forward-looking economic indicators we monitor are signaling expansion ahead.

### ISM Manufacturing Index

The ISM Manufacturing index rose to 52.6 in January, exceeding the consensus expected 48.5, signaling expansion. (Levels above 50 signal expansion; levels below 50 signal contraction.) The major measures of activity were all higher in January. Notably, the new orders index jumped to 57.7 from 47.4 the prior month. The employment index rose to 48.1 from 44.8 in December, the highest level in a year. The deliveries index increased to 54.4 from 50.8 the prior month. Following nearly three years of contraction, factory activity accelerated to the fastest pace since 2022, a welcome sign for a sector that has faced a broad array of headwinds in recent years. New orders rose at the fastest pace in four years. One month does not make a trend. It remains to be seen whether this report marks the start of a sustained growth period for manufacturing. Given past false starts, caution is warranted.

### ISM Non-Manufacturing Index

The ISM Non-Manufacturing index was unchanged at 53.8 in January, exceeding the consensus expected 53.5, matching the highest level since late 2024, continuing to signal expansion. (Levels above 50 signal expansion; levels below 50 signal contraction.) While the major measures of activity were mixed in January, they all stood above 50. The business activity index rose to 57.4 to 55.2 in December, a fifteen-month high. The new orders index declined to 53.1 from 56.5 the prior month. The employment index fell to 50.3 from 51.7 the prior month. Services have benefited from increased activity tied to data-center buildout but remain challenged by tariffs and the uncertainty surrounding trade policy. The good news is that some of business uncertainty seems to be easing, as services firms increased their hiring for the first time since last May.

### Consumer Sentiment

Both the University of Michigan and Conference Board's February reports showed an uptick in confidence linked to reports that indicated inflation and unemployment may be

showing signs of improvement though respondents remained cautious as they are still dealing with high prices linked to tariffs and before that, the pandemic.

### Initial Jobless Claims

Initial jobless claims remain well within their recent range, low by historical standards, suggesting layoffs remain limited and the labor market is still relatively tight. Although claims ticked up slightly week-to-week, their most recent 215,000 reading was only slightly above their four-week moving average.

### Front Barnett Economic Model

The February reading of our firm's proprietary [Economic Model](#), using publicly available data, designed to signal a change in the direction of the US economy six to nine months in advance of an inflection point, remained above-trend, signaling expansion ahead.

## Outlook

On balance, we conclude the US economy is fundamentally sound, well financed, and on solid ground. Global growth is good. Inflation is moderating. Central banks are easing. Fiscal and regulatory policy are supportive. Earnings growth is strong and capital markets are wide open, supporting our optimism around accelerating growth and a broadening business expansion over the coming months.

The ongoing recovery in business spending will provide the catalyst for an improvement in labor demand and non-tech business spending. Information gleaned from recent quarterly earnings conference calls and from other sources point to sustained strong growth in tech capital investment.

***While deterioration in business sentiment in the fourth quarter stemming from the US government shutdown appears to have receded, business planning will remain cautious, mindful of the risk of shocks such as those disruptions we have already faced this decade (i.e. COVID, Russia's invasion of Ukraine and last year's trade war). Additional shocks are inevitable. However, beyond the short-term, the translation of the risk of shocks uncertainty to business behavior is likely to be limited.***

### The Great Rotation

If you've been keeping an eye on the stock market in recent months, you have seen a notable rotation within the technology sector, which at one time last fall represented over 40% of the value of the S&P500. Many publicly traded software companies, household names, long regarded as durable compounders with recurring revenue streams, high profit margins, and strong free cash flows have experienced share price declines, their P/E significantly

compressed. The cause of these declines has been investor's reassessments of how advances in artificial intelligence may change the competitive landscape. Some investors' fear that AI will erode moats, compress pricing, and disrupt traditional software subscription models. Others contend that these fears underestimate the adaptability of many major software firms and the expansive nature of technological progress. They also contend the recent declines in software companies substantially discount those risks.

The appropriate conclusion may lie between the extremes. Yes, AI represents a meaningful technological advance with the potential to alter cost structures, competitive dynamics, and value capture within software. It would be imprudent to dismiss these risks. Companies that fail to adapt, underinvest, or misprice AI capabilities could see a long-term erosion in returns. At the same time, the wholesale assumption that AI will commoditize all application software appears grossly overstated. The enterprise landscape is characterized by heterogeneity, regulatory complexity, and most importantly entrenched customer relationships. These features provide a buffer against rapid displacement. Many firms are already embedding AI into their offerings, turning a potential threat into a source of differentiation.

In assessing the rotation in software equities, we attempt to distinguish between business models that rely primarily on user interface convenience and those that function as enterprise mission-critical systems of record with proprietary data assets. The long-term impact of AI is unlikely to be monolithic. It will vary by vertical, by customer base, and by management execution.

The current debate, therefore, should not be framed as a binary choice between inevitability of decline and assured resilience. Rather, it demands careful analysis of incentives, competitive positioning, and adaptability. Such an approach, grounded in evidence, attentive to risk, and open to revision, that offers the best prospects for navigating a sector in transition.

## **Equity Investment Policy**

With no signs of a broad economic contraction ahead, the February above-trend reading of our firm's [Economic Model](#), and the factors noted in the Outlook section above, we've made no change to our equity investment policy. Portfolios under our supervision are fully invested within agreed-upon account guidelines. High quality, core, large cap domestic equity investments are well diversified, balanced between *growth* and *value* shares. Our investment platform also allows for small cap equities and international developed and emerging market investments. Recall that by blending *growth* and *value* investments in a single portfolio, a style of investment unique to Front Barnett management, we seek to smooth portfolio returns over a market cycle.

The S&P500, a cap-weighted stock market index, is dominated by high priced mega cap tech and telecommunications services shares, which now account for about 35% of its value, remains fully valued at 22X forward earnings. Further S&P500 gains will come over time as reported earnings eclipse consensus estimates. Growth stocks, particularly those with a direct connection to the AI theme, remain most vulnerable to sharp pullbacks in the event of a sentiment driven 10%+ general market correction. On the other hand, the forward P/E of the S&P500 equal weight index, with only a 17% concentration in tech and telecommunications services shares, is more reasonably priced at less than 18X forward earnings, only moderately above its average valuation. The broadening economic expansion we foresee is likely to drive a narrowing in the P/E differential, leaving room for further gains in the cohorts of the S&P500 equal weight index.

### **Fixed Income Investment Policy**

Heightened geopolitical tensions, recent stock market weakness, concerns about a potential slowdown in growth due to AI-linked disruptions, and lower inflation expectations are some of the factors behind the recent demand for safe haven US Treasury bonds where yields on the 10-year maturity have fallen below 4% for the first time since last October. Meanwhile, very short-term rates have given little ground as the Fed has signaled a pause in further accommodation. Corporate bond yields in the one-to-four-year maturity range we favor have also declined, causing us to focus bond purchases for clients' portfolios toward the shorter end of the maturity range.

The target duration for the high-quality corporate bond portfolios under our supervision is 2.75 years. The proceeds of maturing bonds and cash additions to portfolios are currently being reinvested to fill out clients' 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<sup>®</sup> 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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