

Marshall B. Front

Senior Managing Director
Portfolio Manager

353 North Clark Street

Chicago, IL 60654

t: 312.641.9001

e: marshall.front@mesirow.com

front-barnett.mesirow.com

January 12, 2026

Economic Update

Despite only modest job growth in 2025 and a deceleration in real wage gains, the US economy has remained notably resilient. Most high-frequency indicators we have seen suggest economic activity exceeded trend growth in the fourth quarter of 2025 and is poised to continue expanding at an above-trend rate this quarter. This outcome appears counterintuitive given tighter labor supply conditions, slowing hiring, the impact on the affordability of sticky inflation, restrictive immigration policies, and geopolitical uncertainty. Yet the economy's performance reflects the interaction of several powerful forces, most notably rapid productivity growth, sustained consumer spending, the early stages of the diffusion of artificial intelligence (AI), and a resurgence in business capital investment. Together, these factors have allowed output to grow faster than labor inputs, reshaping the near-term growth outlook and favorably altering the economy's medium-term potential.

Productivity

The most important driver of recent economic resilience has, as we see it, been a sharp acceleration in labor productivity. Measured output per hour worked has been running at an annualized pace exceeding 5%, a rate rarely sustained outside post-recession rebounds or periods of structural transformation. This productivity surge has allowed the economy to grow at an above-trend rate even as employment growth slows and labor force growth stagnates.

At a time when immigration is constrained and deportations are reducing the effective labor supply, productivity gains play a critical stabilizing role. Officially, GDP growth is the sum of labor input growth, capital deepening, and total factory productivity. When labor input is capped, either by demographics, policy, or participation limits, the only way to sustain above-trend growth is through productivity and capital intensity. The current environment exemplifies this dynamic. Firms are working hard to produce more with fewer incremental workers, offsetting labor shortages and preventing output from falling below potential, as well as investing in capital improvements.

Moreover, higher productivity mitigates inflationary pressures that might otherwise emerge from a tight labor market. By increasing output per worker, firms can absorb higher unit labor costs without passing them fully through to prices. This has allowed real output to expand even as nominal wage growth moderates, contributing to a “soft-landing-plus” environment where growth remains strong without reigniting inflation.

Consumer Spending

Consumer spending has remained a second major pillar of economic strength. Although real wage gains have slowed in 2025, households entered this period with relatively strong balance sheets. Excess savings in aggregate accumulated during the pandemic have not been fully exhausted and household debt service ratios remain historically low. These conditions have supported steady consumption growth even as income growth moderates.

Productivity gains indirectly reinforce consumer spending by stabilizing employment and preserving purchasing power. When firms can grow output without aggressive cost cutting, the risk of widespread layoffs diminishes. This supports consumer confidence and reduces precautionary saving, allowing households to continue spending even in the face of slower wage acceleration.

In addition, the composition of consumption has shifted in productivity-enhancing ways. Spending on services tied to technology, health care, and professional support has expanded, while goods consumption has normalized rather than collapsed. This balanced consumption profile reduces volatility and contributes to sustained demand growth into 2026.

Artificial Intelligence

Artificial intelligence has been a key catalyst behind both productivity growth and business investment. AI is increasingly functioning as a general-purpose technology, akin to electrification or computing, capable of raising efficiency across a wide range of sectors. Its impact extends beyond the technology sector itself into logistics, finance, marketing, healthcare, manufacturing, and professional services.

In the short run, AI adoption boosts productivity by automating routine tasks, accelerating decision-making, and augmenting skilled labor. These effects are particularly powerful in an environment of labor scarcity. Rather than replacing workers outright, AI allows existing workers to manage larger workloads, increasing effective labor supply even as headcount growth slows. This is especially important given limits on immigration and demographic aging, which would otherwise constrain growth. Looking into 2026 and beyond, AI's contribution is likely to broaden. As firms move from experimentation to full integration, productivity gains may become more diffuse and persistent. Importantly, AI also raises the expected return on capital investment, reinforcing a virtuous cycle between technology adoption and capital deepening.

Business Capital Investment and Capital Deepening

Business fixed investment has reaccelerated sharply after a long period of uncertainty driven by monetary tightening and global instability. Several factors explain this resurgence. First, the productivity payoff from new capital, particularly technology-intensive capital, has risen. Firms are more willing to invest when capital deepening directly enhances output per worker. Second, resilient demand has reduced concerns about overcapacity, making expansion more attractive.

Capital investment plays a dual role in sustaining above-trend growth. In the near term, it adds directly to GDP through spending on equipment, structures, and intellectual property. Over time, it raises the economy's productive capacity by increasing the capital-to-labor ratio. In a labor-constrained economy, capital deepening becomes essential for maintaining growth.

AI-related investment deserves special attention. Spending on data centers, cloud infrastructure, advanced semiconductors, and software has surged. These investments not only support current growth but also embed higher productivity into the economy's future. As these assets are deployed more broadly in 2026, they are likely to support continued gains in output even if labor supply growth remains weak. Nevertheless, the explosion in AI poses a number of risks including those around its circular financing and its energy requirements.

Productivity and Labor Constraints

The interaction between rising productivity and restricted labor supply represents a structural adjustment rather than a cyclical anomaly. With immigration limited and deportations reducing labor availability, the economy faces a binding constraint on labor quantity. Productivity growth effectively relaxes this constraint by increasing labor quality and efficiency. In economic terms, higher productivity shifts the production function upward, allowing more output from the same—or even fewer—inputs.

This dynamic has important policy and distributional implications. On the positive side, it allows the economy to grow without relying on rapid labor force expansion, reducing inflationary risks and supporting fiscal sustainability through higher output and tax revenues. On the downside, productivity-driven growth can exacerbate inequality if gains accrue disproportionately to capital owners or highly skilled workers. How these gains are distributed will shape the durability of consumption growth into 2026 and beyond.

In our view, the same forces underpinning recent resilience are likely to remain in place through 2026 and beyond. Productivity gains, while unlikely to sustain a 5% pace indefinitely, appear structurally higher than in the pre-pandemic decade. Consumer spending should remain supported by employment stability and productivity-driven income growth, even if wage gains remain moderate. AI adoption is still in its early innings, suggesting further upside to

efficiency and investment. Finally, capital deepening will remain a critical growth engine in a labor-constrained environment.

In sum, the US economy's ability to grow above trend despite modest job growth reflects an important shift in the sources of growth rather than an anomaly. Productivity, technology, and capital investment have replaced labor expansion as the dominant drivers of output. If these dynamics persist, they suggest that above-trend growth in 2026 is not only plausible but structurally grounded, even in the face of demographic and policy constraints on labor supply.

2025 Equity Market

Despite a bumpy first half, the S&P500 climbed over 17% last year, its third double-digit increase in as many years, gaining 21% annually over that three-year period. Stock market gains in 2025 were largely driven by a combination of factors: Solid fundamentals, better-than-expected earnings, multiple expansion, and the idea that artificial intelligence will be a generational force because of the scale of investment needed to build the infrastructure that powers it, its near-to-intermediate-term impact on productivity gains, and its potential longer-term impact on corporate profit growth as it is used to create and implement revenue and profit enhancing strategies. Delays in threatened tariffs, interest rate cuts by the Fed, better than expected corporate profit gains pushed the S&P500 past previous highs in every month from May to October. New highs for the index were recorded 43 times during the year.

Interestingly, the rally overlooked political and social issues such as the slashing of 317,000 federal jobs, threats by the President to curtail the independence of the Fed, concerns about the \$38 trillion government debt, widespread deportations and restrictive immigration policies, and challenges to the judiciary and the balance of government power. These worries were overwhelmed during the first half of the year by the rise of companies tied directly or peripherally to the AI boom, while gains in other corners of the market were more modest.

As the year wore on, investors began to show concern over how far the rally in AI-related equities had run. Roughly 42% of the S&P's 17% gain in 2025 came from these stocks. Nvidia alone accounted for 20% of the market's return during that period. Had speculators pushed their bets too far? "Trees don't grow to the sky." Over 40% of the S&P500's value was accounted for by AI related stocks, a level of concentration rarely seen, and one that in the past had led to sizable corrections. *Measures of market speculation* were also signaling caution.

By year-end it became clear that stock market leadership had broadened to include many sectors (i.e., financials, industrials, consumer discretionary, and other economically sensitive cohorts) that had previously lagged. The performance of AI-related stocks, which trailed the market indices in the weeks prior to yearend, still accounted for 35% of the value of the S&P500 despite the corrections many high priced, speculative highfliers experienced from their October peaks.

More broadly diversified portfolios, such as those under our firm's supervision, showed performance that reflected the broadening market leadership during the second half of the year, performed exceptionally well. We expect the broadening trend to continue as expectations for relative earnings growth among non-AI-related businesses gain traction.

Equity Investment Policy

All things considered, we see the overall US economy as fundamentally sound, well financed, gradually emerging from the rolling recession of the past couple of years, and providing a favorable backdrop for equity investment. While pockets of weakness, particularly in interest rate sensitive and goods producing sectors cloud the outlook for the next quarter or two, the broadening economy will give these industries a lift. Meanwhile, the overall economy will be driven increasingly by declining interest rates, moderating inflation, stimulative fiscal policies, particularly those supply side measures written into OBBBA, improving consumer sentiment, and well-above trend productivity gains.

Looking ahead, in addition to the strengthening economy, we see several related tailwinds underpinning the equity market in 2026. These include: *strong S&P500 earnings growth* of about 15% driven by operating leverage, and pricing power; *deregulation* that will unlock bank capital; *Fed accommodation* and other measures bringing borrowing costs down; *rising benefits from AI* will boost profit margins; *lower rates and a broadening earnings expansion* will drive a cyclical expansion, and; *a weaker dollar and declining energy prices* will help strapped consumers.

While current elevated stock market valuations (i.e. 23X estimated forward S&P500 earnings) can be supported by better-than-expected earnings growth and rising animal spirits, we believe equities will remain volatile, vulnerable to a 10%+ correction should sentiment deteriorate. High flying speculative tech stocks, which have already experienced significant pullbacks from their October highs, are likely to fall further in a general market correction. That said, a correction would not diminish the relative longer-term attractiveness of risk assets.

Equity portfolios under our firm's management remain fully invested within agreed upon account guidelines, balanced between large cap *growth* and *value* investments. Allocations to small cap equities and international developed and emerging market stocks 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.

Fixed Income Investment Policy

While both short-term and long-term interest rates have drifted lower since the late December Fed rate cut, they remain range bound. Absent an exogenous shock or a dramatic change in the direction of fiscal or monetary policies, we see little reason for rates to violate their 2025 lows nor to move significantly above their recent highs. Accordingly, we maintain our 2.75-year

target duration for the high quality, laddered corporate bond portfolios we manage. We view bonds as providing income producing ballast in times of stock market turbulence and a source of liquidity. They serve as a key component of a conservative, balanced investment program.

* * * *

MBF

This communication may contain privileged and/or confidential information. Nothing contained herein constitutes an offer to sell or a solicitation of an offer to buy an interest in any Mesirow or Front Barnett investment vehicle. The information contained herein has been obtained from sources believed to be reliable, but is not necessarily complete and its accuracy cannot be guaranteed. The views and opinions expressed are not necessarily those of Mesirow and may differ from the views and opinions of other departments or divisions of Mesirow and its affiliates. References to specific securities, asset classes and financial markets are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations.

Front Barnett is not providing any financial, economic, legal, accounting, or tax advice or recommendations in this report. The information contained in this report does not constitute investment advice or an offer to buy or sell securities from any Mesirow entity to the reader and should not be relied upon to evaluate any potential transaction. This material may contain "forward-looking" information that is not purely historical in nature. Such information may include, among other things, projections, forecasts, estimates of market returns, and proposed or expected portfolio composition. Any changes to assumptions that may have been made in preparing this material could have a material impact on the information presented herein by way of example. Past performance does not predict or guarantee future results. Investing involves risk; principal loss is possible.

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.

Front Barnett is a division of the Wealth Management business of Mesirow Financial Investment Management, Inc. ("MFIM"). Mesirow refers to Mesirow Financial Holdings, Inc. and its divisions, subsidiaries and affiliates. The Mesirow and Front Barnett name and logo are registered service marks of Mesirow Financial Holdings, Inc. © 2026, Mesirow Financial Holdings, Inc. All rights reserved. Any opinions expressed are subject to change without notice. Past performance is not indicative of future results. Advisory Fees are described in Front Barnett's Form ADV Part 2A. Advisory services offered through Mesirow Financial Investment Management, Inc., an SEC-registered investment advisor.