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Statement of Investment Policy

Background

The Federal Reserve's decision last week to lower its reference rate by 50 basis points, choosing to unleash its long-awaited credit easing cycle more aggressively than many economists had anticipated, represents a major recalibration of monetary policy, away from a rigid focus on inflation to a broader effort to assure a recent weakening of the labor market does not spiral out of control leading to a hard landing. This is a pivotal moment for the central bank, moving it into a new phase in its battle to tame inflation, while working toward extending the economic expansion. Fed officials, armed with greater confidence inflation is on track to achieve its target 2% goal, have shifted their focus to preventing the lagged effects of past rate increases, which drove borrowing costs to two-decade highs, from further weakening labor market conditions. The rate reduction will provide some immediate relief to consumers whose spending accounts for 70% of GDP, and to small businesses with variable rate debt. Longer-term borrowers have already seen declining borrowing costs in the anticipation of a series of rate cuts following Fed Chair Powell's comments at Jackson Hole last month.

Now that the Fed has pivoted, investors are asking how much further will short-term interest rates fall? While Fed Chair Powell earlier this year told Congress that the era of near-zero interest rates is likely over, projections show Fed officials have penciled in the equivalent of four quarter point rate cuts next year, assuming the unemployment rate does not spike and inflation continues to decline, in addition to quarter point rate cuts at each of the Fed's two remaining meetings in 2024. These actions, if taken, would bring the fed-funds rate, currently 5%, to just below 3.5% by the end of next year. Additional rate cuts in 2026 and 2027 are also forecast. Recall that the Federal Reserve's intermediate-term goal is to steer the fed-funds rate toward its so-called "neutral" interest rate, defined as the rate that is neither stimulative nor contractionary in a stable economy at full employment. The "neutral" rate is thought to be 3.0% or lower, well short of the current target fed-funds rate.

The outsized first move by the Fed signals the central bank's commitment to not falling behind the curve, as it did during the early phases of the last tightening cycle, and their confidence in the disinflation narrative. Chair Powell stressed the cadence of future cuts will be based on incoming data, adding, "This recalibration of our policy stance will help maintain the strength of the economy and the labor market and will continue to enable

further progress on inflation as we begin the process of moving forward to a more neutral stance."

Looking ahead, an important, often overlooked, factor driving the economy is, in our view, the money supply. The M2 measure of money has been rising at a moderate 2 to 3% rate after declining for much of 2022-23. How rapidly M2 grows going forward will dictate how much room the Fed has for rate cuts without risking rekindling inflation. Should M2 growth remain modest, both inflation and economic growth will slow, and the Fed will have leeway to continue cuts. If, however, rate cuts lead to a rapid rise in M2 growth, the Fed may risk a return to higher inflation readings down the road should they continue to cut rates.

State of the Economy

Indicators show that overall activity, driven by strong consumer outlays, has continued to expand at a solid pace despite some labor market softness. GDP rose at an above trend annual rate of 2.2% in the first half of the year, gaining momentum in the second quarter and available data point to a roughly similar, above-trend pace this quarter. Consumer spending has remained resilient, and investment in equipment and intangibles has picked up from its anemic pace last year. The housing sector, burdened with high interest rates and lack of inventory, fell back in the second quarter after rising strongly earlier in the year. Improving supply chain conditions have supported resilient demand and the strong performance of the US economy in the past year. Interest rate sensitive sectors of the economy, including housing, autos and commercial real estate, as well as small cap companies, have lagged but are expected to be beneficiaries of declining rates next year. Labor market conditions have continued to cool. Payroll job gains averaged 116,000 per month over the past three months, a notable stepdown from the pace seen earlier in the year. The unemployment rate has moved higher but remains low by historical standards at 4.2%. The uptick in the unemployment rate is largely attributable to the increase in the labor participation rate, not firings, as immigrants pour into the labor force and many retirees, their savings depleted, look for work. Nominal wage growth has eased over the past year and the Job Openings and Labor Turnover Survey (JOLTS) jobs-to-workers gap, a measure of tightness in the labor market, has narrowed significantly from better than two-to-one at its COVID peak to about one-to-one currently. Overall, a broad set of indicators suggest labor market conditions today are less tight than just before the pandemic in 2019. The labor market is not a source of elevated inflationary pressures and there is no evidence in the forward-looking weekly initial jobless claims or continuing claims data of a sharp pickup in terminations.

Inflation

Inflation has eased notably over the past two years but remains above the Fed's 2% target. Estimates based on the Consumer Price Index (CPI) and other data indicate that total Personal Consumption Expenditures (PCE), the Fed's preferred gauge of inflation, rose 2.2% over the twelve months ending in August; and that, excluding the volatile food and energy categories, core PCE prices rose 2.7% during that time. Longer term inflation expectations appear to be well anchored, as reflected in a broad range of surveys of households, businesses and forecasters, as well as measures from financial markets.

Absent an exogenous shock, we see no reason to change our soft-landing forecast given the economy's momentum, likely Fed interest rate cuts, easing inflation, rising consumer sentiment and the ability of households to spend, as evidenced in September retail sales, and the absence of signs of any serious deterioration in labor market conditions.

Forward Looking Economic Indicators

Forward looking economic indicators we monitor are signaling mixed business conditions ahead.

ISM Manufacturing Index increased to 47.2 in August, lagging the consensus expected 47.5. (Levels higher than 50 signal expansion; levels below 50 signal contraction in this diffusion index.) The major measures of activity were mixed last month. The new order index declined to 44.6 from 47.4, while the production index dropped to 44.8 from 45.9. The employment index rose to 46.0 from 43.4 in July, while the supplier deliveries index fell to 50.5 from 52.6 the prior month.

Activity in the manufacturing sector, which accounts for about 11% of GDP, has now contracted for twenty-one of the last twenty-two months. Overall, twelve of the eighteen major manufacturing industries reported contraction in August while five reported growth and one reported no change. Despite an uptick in the overall index last month, the two most important indices – output and demand – both worsened in August. The new orders index fell to the lowest level since May 2023, marking the twenty-second month in the past two years where the index has been below 50. Manufacturing companies have been able to scrape by despite weakening demand by running down their order backlogs which were artificially boosted during the COVID era. Now, with backlogs dwindling, manufacturers are taking cost reduction actions which are reflected in the employment index, which remains near its lowest levels at 46.0 since the pandemic lockdown months at.

ISM Non-Manufacturing Index, which accounts for about 70% of GDP, increased to 51.5 in August, ahead of the consensus expected 51.4. (Levels higher than 50 signal expansion; levels below 50 signal contraction in this diffusion index.) The major measures of activity were mixed. The business activity index declined to 53.3 from 54.5 while the new orders index increased to 53.0 from 52.4. The employment index fell to 50.2 from 51.1 and the supplier deliveries index rose to 49.6 from 47.6. The prices paid index increased to 57.3 in August from 57.0 in July.

Activity in the services sector continued to signal expansion in August in what has been an uncertain period for the ISM Non-Manufacturing index. The overall index rose slightly, a tenth of a point, while industry growth was split, with ten of the eighteen major industries reporting growth while seven reported contraction. The new orders index rose to a three-month high at 53.0, while the business index fell to 53.3. These are roughly in-line with their monthly 2024 averages but are lower than the monthly averages of 2022 and 2023. Service companies have taken note of slowing activity as they begin to cut back on hiring. The employment index has been showing contraction for six of the last nine months. Employment comments note hiring freezes and some companies are no longer backfilling positions when people leave or retire. Despite signs of slowing activity, inflation remains a dominant theme in comments from survey respondents. The prices paid index rose to 57.3 in August, the highest reading of any category in the report, underscoring the stickiness of inflation in the services sector.

Jobless Claims, unlike an array of economic data that has mostly pointed to slowing growth in employment and rising unemployment, remain subdued, indicating the job market remains healthy despite a slowdown in hiring. The four-week moving average of initial claims continue to hover around 230,000, which is roughly unchanged from August 2023. Continuing claims, a proxy for the number of people receiving benefits, fell to its lowest level in three months, are sending a less worrying message than they were at the start of summer.

Front Barnett Proprietary Economic Model, designed to signal a change in the direction of the US economy six to nine months in advance of an inflection point, bounced in August, remaining above its one-year trend, signaling expansion.

Equity Investment Policy

There has been no change in equity investment policy. As long-term investors, looking beyond the near-term economic uncertainties and the volatility to be expected ahead of the November elections, portfolios remain fully invested within their guidelines, diversified, balanced between core, large cap domestic growth and value shares, tilted toward growth which is our bias. Our investment platform also includes small cap domestic equities as well as modest allocations to international developed and emerging market investments. Recall that our firm blends core, high quality, large cap growth and value investments in structuring equity portfolios, thereby positioning them to grow over the course of cycles during which the broader market may favor either the growth or value investment style for a time, potentially smoothing returns over the longer-term.

The economy remains on solid footing and is fundamentally sound. The US banking system is extremely well reserved, and consumer’s balances sheets remain strong. Weakness in interest rate sensitive and cyclical industries (i.e. manufacturing, housing, autos, commercial real estate and in small cap companies’ dependent upon bank financing) has been more than offset by strong consumer spending. The prospect of lower interest rates increases the odds of a soft landing for the US economy where broad economic growth is expected to reboot and move higher in 2025. We expect the improved outlook will underpin the shift in investor preferences away from the handful of high priced mega cap growth stocks which have dominated the market. The beneficiaries of this shift will be a broad range of cyclical and interest rate sensitive stocks whose performance has lagged year-to-date.

Current stock market valuation measures show the S&P500 is richly valued at near 21x forward earnings, near its highest reading since 2021, when interest rates were near zero, suggesting the stock market is significantly overvalued. Top tech stock valuations are even more stretched, sporting an average P/E of over 30x. Contrast those multiples with the 17x forward valuation of the average stock as measured by the S&P500 Equal Weight Index, which treats the returns of lesser capitalized stocks the same as those of their larger cohorts, a valuation closer to historical norm. This leaves room for a further broad market rerating as investors shift focus, discounting improving earnings expectations for 2025.

In view of the disproportionate impact from a handful of AI-related mega cap tech stocks (i.e. NVDIA, META, Microsoft and Amazon) on the S&P500 benchmark, where returns measured at the end of July from just these four behemoths, accounted for over 40% of the index's 2024 return, it is not at all surprising that results from broadly diversified equity portfolios such as those we supervise, have generally trailed the S&P500 cap weighted index this year, performing more in line with the S&P500 Equal Weight index.

Yet another feature of this year's bifurcated stock market has been the disparity in performance between growth and value shares where growth stocks have gained 26.4% while value has returned only 12.8%. Such a large differential is rare and, in our view, likely to narrow sharply as confidence in the economy, supported by lower interest rates, will achieve a soft landing.

While the pivot in monetary policy, the first since the COVID induced recession, is significant, last week's 50 basis point rate cut is not an immediate game changer for many households and smaller businesses as mortgage rates and borrowing costs remain high when compared with where they have been for most of the past 15 years. But, for investors, more important than the rate cut itself is the signal from the Fed that significant additional easing can be expected, unleashing the Keynesian animal spirits where, aside from the mega cap AI-related tech stocks, have been largely absent from the broader stock market in 2024.

In summary, we have entered a new investment cycle driven by falling interest rates and broadly accelerating profits which will drive a shift in the flows of money within the stock market. Market leadership will broaden as earnings estimates are marked up. Money will migrate away from the mega cap techs, viewed by some as the "only game in town", toward statistically cheaper, cyclical sectors, such as manufacturing, finance and discretionary goods, as well as to smaller businesses more sensitive to borrowing costs. Fed cuts will weaken the US dollar boosting international stocks, including emerging market shares. Well diversified portfolios under our management are positioned to take advantage of this change.

Fixed Income

As for fixed income, our strategic decision in mid-2023 to increase the duration of clients' laddered, high quality corporate bond portfolios from less than 1 year toward a 2.5+ year target has proven timely as open market interest rates have since fallen sharply. Corporate obligations purchased late last year at a 5.5% yield-to-maturity are currently priced to yield less than 4.3% if held to term. Our policy calls for maintaining current durations, reinvesting the proceeds of coming maturities and cash additions to fill out clients' bond 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.