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Statement of Investment Policy

Background

Recent employment, consumer spending, and inflation data confirm the US economy remains on pace for the soft landing we have been expecting. December core CPI ticked lower while retail sales continued strong. The December jobs report showed labor income rising at a robust rate last quarter and December retail sales indicate consumption grew steadily during the holiday season. Expectations are for GDP to have grown at better than a 2.5% rate last quarter.

Disquieting signs that the disinflation process had stalled last year were, to a degree, belied by a set of constructive inflation figures for December showing monthly changes in both core CPI (0.2%) and core PPI (0.0%) were below expectations, implying core PCE growth, the Fed's preferred inflation gauge, in the second half of last year was only modestly above target, slowly drifting lower. Should this favorable trend persist, Federal Reserve officials, under pressure to cut elevated real interest rates, are likely to announce a further 25 basis point reduction by mid-year. Financial futures readings now show an increase in the odds of two rate cuts in 2025.

In view of the economy's resilience and the uncertainties surrounding deportation and tariff policies of the new administration which are inflationary, faster central bank rate cuts are more likely to be triggered by renewed weakness in the labor market than from small further declines in reported inflation. Furthermore, even if inflation should fall sooner and more rapidly than expected, the FOMC would likely prefer to remain patient and confirm that inflation has moved sustainably to its 2% target before easing further.

A survey of economic activity at the start of this year, the S&P Global Flash US Composite PMI, a gauge of activity in the manufacturing and services sector, showed a modest slowing despite signs of recovery in the factory sector which has been in contraction for two years. The January reading, which was above 50 signaling expansion, suggests overall activity continues to increase but at a slower pace than a month earlier. The decline was led by the services sector, the driver of economic growth last year, which slipped to 52.4 in January from

55.4 in December. By contrast, the manufacturing sector showed increased activity for the first time in six months as both new orders and production advanced, with employment levels at factories rising.

By many measures, the tragic LA wildfires are likely to be the costliest climate disaster in US history, reflecting both the size and the high value of the residential real estate they are destroying. Experts estimate damage-to-date as high as $300 billion with 14,000 residences destroyed,150,000 people under mandatory evacuation orders and horrific damage to the lives of those who have lost their homes. Nonetheless, we believe the short-term impact on overall GDP growth, employment, and inflation will be noticeable but small and contained as the damage estimates largely reflect losses to existing residences. Destruction of homes, while undesirable, is less likely to be disruptive to business activity than destruction of commercial space or critical infrastructure. Nevertheless, the fires will have a significant economic impact locally. The principal concerns will be temporary inflation pressures and employment disruption. It is also worth noting that Los Angeles County which represents 25 percent of California's economy, could see economic activity reduced by as much as 50% near term. And it will take years and hundreds of billions of dollars to rebuild that community. Longer-term, there will be a positive boost to growth over several years as rebuilding occurs.

The 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, remained above trend in December, signaling continued expansion ahead.

Summary

We find the US economy to be fundamentally sound and on solid footing, having achieved a soft landing. Momentum is strong on the consumer side and there are early signs manufacturing may be bottoming out. The biggest uncertainty is around the path of US policy. The incoming administration has signaled its desire to reduce taxes and the regulatory burden on US firms, while planning to tax consumers and raise business costs through higher tariffs and reduced immigration. Keep in mind that fiscal policy must go through Congress, and the late-December battle around a continuing resolution point to a drawn-out process to reach final agreements on new fiscal measures. Just a few defections among House Republicans could lead to long delays. Meanwhile, the direction of monetary policy is clear: rates are headed lower but the timing of further easing will depend upon how the Fed interprets incoming data. Forward-looking economic indicators and surveys point to above-trend economic expansion this quarter.

Equity Investment Policy

Equity Investment Policy remains unchanged. Portfolios under our supervision remain fully invested within their policy guidelines, having participated in the equity market's robust performance through the end of 2024. As long-term investors, so long as the economic fundamentals remain sound and corporate profits are expected to rise, we look beyond the near-term political and economic uncertainties, as well as the short-term volatility inherent in

equity investment in structuring portfolios. Clients' accounts are well-diversified, balanced between large cap *growth* and *value* investments. Our investment platform also includes small cap domestic equities as well as modest allocations to developed and emerging market investments. Recall that Front Barnett management uniquely blends core, high quality, large cap *growth* and *value* investments in a single portfolio, positioning it to grow over the course of market cycles during which the broader market will rotate favoring either the *growth* or *value* style for a time. This strategy seeks to smooth returns over the longer-term.

Despite elevated valuations for a small group of high-flying mega cap AI related tech stocks which have driven the cap weighted stock market indices to new highs, the case for equity ownership remains compelling with no recession in sight. The US banking system is extremely well-reserved and is expected to benefit from a more friendly regulatory regime under the incoming administration. An expected wave of consolidations will further strengthen the banking industry's financial position. Corporate balance sheets are strong. The society is awash with cash and lenders abound. Despite questions regarding timing, interest rates are headed lower, a tailwind for risk assets. Policy changes including deregulation, new incentives for capital investment, and lower corporate tax rates will support future profits growth. Merger and acquisition activity will recover as the business-friendly administration ignites long dormant Keynesian "animal spirits." And the benefits of innovative technologies, including AI, will begin to filter through to the broader economy, enhancing productivity, and by some estimates, eventually add as much as 0.8% to GDP growth.

Although we have seen weakness in interest rate sensitive industries such as housing and autos, where existing home sales in December fell to a level not seen for nearly 30 years, the US economy continues to grow at an above-trend rate, driven by resilient consumer spending, underpinned by stimulative fiscal policies and a return to growth of the M2 measure of money. S&P500 profits have exceeded expectations since the current expansion began post-COVID. The prospect of further monetary easing, albeit at a pace slower than expected earlier, increases the odds of a broadening out of economic growth this year. As that expectation takes hold, we expect to see a shift in money flows away from the handful of high-priced mega-cap AI related stocks tech stocks which have dominated the equity market. Beneficiaries of this shift, the timing of which remains uncertain, will include a broader range of stocks including industrials and small caps whose performance has lagged.

Stocks are not cheap. The S&P500, where mega-cap tech stocks represent about a 37% weight in the index, is richly valued at about 23x forward earnings, its highest reading since 2021. Valuations of AI related mega-cap tech stocks are even more stretched with an average p/e of 37x earnings. The S&P500 Equal Weight index is less expensive but not cheap at 18x earnings, though more reasonably priced, leaving room for further rerating as the market's leadership broadens out. That said, with the market registering new record highs daily, we would not be surprised to see a 5-10% sentiment-driven pullback in the S&P500 in the weeks ahead.

Fixed Income Investment Policy

Bond yields have risen sharply since last fall. The US 10-year Treasury has surged over three quarters of a percentage point since last September coinciding with the Federal Reserve commencing its rate-cutting program. Bond market history shows that government bond yields rise in response to: rising inflation expectations, higher growth prospects and growing fiscal budget or sovereign debt concerns. The latest backup in US Treasury bond yields appears to be largely due to worries about political developments and their impact on government debt and deficits. Profligate spending policies that might be adopted by the incoming administration that could add substantially to the deficit are of concern to the bond market which is already wary of US debt levels. Higher rates have put policymakers on notice that bond market vigilantes will no longer tolerate out-of-control spending.

The recent backup in rates has given us an opportunity to add to clients' ladders of high quality, highly marketable corporate bonds at rates exceeding 5%. Funds for these purchases have come largely from maturities of existing holdings. We now target portfolio durations of 2.75 years.

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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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