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Statement of Investment Policy

Background

Recently released economic data shows that overall, the US economy has remained resilient in the face of the Federal Reserve's highly restrictive monetary policy, continuing to expand at a solid rate, but showing some signs of deceleration from last year's torrid pace. This slowing trend is reflected in disappointing consumer spending data, pressures on interest rate sensitive sectors, some welcome easing in tight labor market conditions and in the resumption of last year's trend toward moderating inflation. The US equity market's reaction to this weakening trend is reflected in a renewed upsurge in the valuations of a small group of high cash flow generating, richly-priced, mega cap tech stocks with ties to AI and whose earnings growth is viewed as immune to swings in the business cycle. Meanwhile, the rest of the stock market, *value* shares in particular, has been largely treading water, awaiting the elusive Fed rate cut.

While GDP growth moderated from 3.4% in the fourth quarter of last year to 1.3% last quarter, private domestic final purchases, which excludes inventory investment, government spending, and net exports, a reliable measure of underlying demand, grew at 2.8% in the first quarter, almost as strong as the second half of 2023. While the growth of consumer spending has clearly slowed from last year's rapid pace, it has remained fairly solid. Investment in equipment and intangibles has accelerated from its tepid pace last year. As supply chain issues stemming from the pandemic have cleared, improved supply conditions have accommodated resilient demand and supported the generally strong economy over the past year. By contrast, sectors most directly impacted by high *real* interest rates, including autos, housing, office real estate and small businesses, are notable pockets of weakness in the overall economy. Economists generally now expect GDP growth in 2024 to moderate from last year's 2.5% pace to a slightly above-trend consensus projection of 2.1% this year.

Jobs

Tight labor market conditions, a major source of inflation concerns, are showing a better balance between supply and demand and are easing. Payroll job gains have averaged 218 thousand jobs per month during April and May, a pace that remains strong but below that seen in the first quarter.

Beyond the payroll numbers, there are other signs of a slowly cooling jobs market. For example, the US unemployment rate edged higher to 4.0% last month, up from the 3.4% cycle low seen in April 2023 and 3.9% this April. The number of US job openings fell sharply to 8.059 million in April according to the latest JOLTS report, from 8.355 million the prior month as the jobs-to-workers gap narrowed further. The so called “quit rate” fell to 2.2% of the workforce showing workers have become less confident of landing a new job at better pay. Initial applications for US unemployment benefits jumped 13,000 to 242,000 in the week of June 8, the highest level seen in nine months. Strong job growth during the post-pandemic period has been accompanied by an increase in the number of workers, reflecting increases in the participation rate among individuals aged 25 to 54 years and a continued strong pace of immigration. **Overall, a broad range of indicators suggests that conditions in the labor market have finally returned to about where they were pre-pandemic, relatively tight but not overheated.**

Inflation

Inflation has declined sharply over the past two years but remains elevated when compared with the Fed's longer-run 2.0% target. Personal Consumption Expenditures (PCE) index prices rose 2.7% over the 12 months ended in April. Core PCE prices, which exclude volatile food and energy categories, rose 2.8% during the same period. While inflation data rose more than expected early this year, recent readings, including the CPI and PPI for May show a resumption of the moderating trend observed from mid-2022 through mid-2023.

Despite some recent easing in labor market conditions and improved inflation numbers, Fed officials, fearing a premature reduction in policy restraint could result in a reversal of the progress we have seen in inflation, voted in their June FOMC meeting to keep the policy reference rate unchanged until they gained greater confidence from incoming data that inflation was firmly on track toward their 2.0% target. **The Fed has acknowledged that the risk in reducing rates too late or too little could unduly weaken economic activity and employment, causing the bumpy landing they have sought to avoid.**

Consumer Spending

Sticky inflation and high *real* interest rates, coupled with increasing consumer debt and rising credit card delinquencies, may be sending a signal that the US consumer, whose spending accounts for about 70% of GDP, is weakening, raising renewed concerns among investors over the possibility of a less smooth-than-hoped-for landing for the economy. Disappointingly weak May retail sales and negative revisions to April's reported outlays highlight the slowing trend in consumption.

American households, particularly those at the lower end of the income spectrum, burdened by growing indebtedness, appear to be struggling. Data from the Federal Reserve Bank of St. Louis, while not alarming, show the delinquency rate on credit cards issued by all US commercial banks stood at 3.16% last quarter, up from 2.45% in the first quarter of 2023, well-above the pre-COVID

low of 2.11%. In May, the University of Michigan reported their consumer sentiment index fell by 10.5% month-over-month to a five-month low reading. That said, despite some decline in consumer sentiment, US households control more wealth than ever before. Data from the Federal Reserve shows US household's net worth totaled \$156.2 trillion at the end of 2023, up 33.5% from \$117.0 trillion at the close of 2019, before the pandemic.

Outlook

Beyond the consumer, forward-looking data and surveys we regularly review are mixed, pointing to a continuation of the current expansion, albeit at a moderating pace. For example, the *ISM Manufacturing Index*, based upon a survey which accounts for 11% of GDP, declined to 48.7 in May, signaling contraction. The major measures of manufacturing activity were mostly lower last month. Meanwhile, the *ISM Non-Manufacturing Index*, based upon a survey which accounts for 78% of GDP, rose to 53.8, last month signaling expansion, well ahead of even the most optimistic of forecasts. The major measures of services activity were all higher in May. Although the services sector has not matched the weakness in the manufacturing sector, where contraction readings have been recorded in eighteen of the last nineteen months, demand for labor in both sectors was reported as muted. Inflation remains a stubborn problem according to respondents in services industries. And finally, our firm's 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, remains above trend, pointing to expansion.

Investment Policy

Balancing the foregoing, and other factors we consider in assessing the investment outlook, we conclude the economy to be fundamentally sound and that its current momentum will underpin a slower-paced expansion over the next couple of quarters. The peak in open market interest rates is in the rear-view mirror. We expect the Fed to have entered a credit easing cycle leading to a new, broad-based economic expansion in 2025, by year-end. We concur with the current consensus view that the data the Fed will see over the next few months will provide them with sufficient confidence to begin to cut interest rates, possibly as early as September. Consequently, the widely-anticipated broadening out of US stock market leadership, until now largely relegated to a handful of high-priced mega cap tech stocks, is not likely to take hold until later this year as investors digest updated earnings data and actually see a rate cut.

From a valuation standpoint, the S&P500, a market cap weighted index driven by a 34%+ concentration in its ten largest mega cap constituents, the highest such sum in multiple decades, is fully priced, currently selling at about 21.6 times 2024 earnings and 19.8 times estimated 2025 earnings per share of \$275. (As of June 1, only 30% of the S&P500 were out-performing the cap weighted index). However, the S&P500 Equal Weighted index, which strips out the disproportionate impact of the mega cap *growth* and is more representative of the performance of the average stock, is selling at only about 16 times estimated 2025 earnings, closer to the mean multiple over the past

generation, leaving room for a higher stock market should its leadership broaden out as we expect, and rising earnings estimates are realized.

Interestingly, year-to-date, the S&P500 growth index is higher by an astounding 24.0% while the S&P500 value index has risen only 4.3% in that time. This huge disparity in performance is likely to narrow if investors regain confidence the economy is headed for a soft landing, supported by easing credit conditions and continued corporate profit growth.

Looking beyond the near-term uncertainties, equity portfolios under our supervision are fully invested within their guidelines. Stock portfolios remain well-balanced between *growth* and *value* shares, tilted toward growth which is our long-term bias. Recall that as long-term investors, Front Barnett combines high quality, large cap *growth* and *value* investments in structuring a single account, allowing portfolios under our supervision to potentially gain throughout economic cycles in which the broader market favors either the *growth* or *value* investment style, smoothing returns over time. In addition, our investment platform allows for small cap investments as well as investments in developed and emerging markets abroad.

Clients' high quality, highly marketable, laddered corporate bond portfolios have seen an increase in duration toward our target of 2.5+ years since last fall. Yields-to-maturity on the new purchases, where yields have exceeded 5.0%, replaced cash equivalents, the proceeds of maturing bonds and the sale of some shorter-dated holdings. The proceeds of bonds currently maturing are being reinvested to fill out the aforementioned 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.