

# FRONT BARNETT

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## Economic Update

Underpinned by a solid jobs market, favorable financial conditions and robust profits, the US economic expansion rolls on. First quarter profits grew at an astonishing 28.6% year-over-year rate, near double the 14.8% consensus estimate. Initial jobless claims for state unemployment benefits have fallen to levels last seen in the 1960s. And despite the huge US federal budget deficit there are no indications yet that government borrowing will crowd out economic activity in the private sector.

Nevertheless, despite the fundamental momentum evident in the economic data, the possibility of accelerating inflation stemming from an energy shock remains a key downside risk. The disruption in energy supplies has lasted almost three months, but inventory drawdowns and the redirection of trade have thus far muted its macroeconomic impact. However, should oil prices rise significantly from current levels, or the supply disruption continue for another quarter, the outlook will shift decidedly. So far, resilient growth has enabled financial markets to take higher oil prices in stride. But higher energy prices could pressure the Fed and other central banks to shift policies toward less accommodation, raising the risk of a possible recession.

***At this point, though, our base case, which sees continued expansion over the next year, is built upon three pillars: AI-driven capital spending, wealth-driven consumption and a solid labor market. It also assumes the near-term resumption of energy flows through the Strait of Hormuz that allows WTI oil prices to drop back toward \$80 per barrel by year-end and to fall further in 2027. We see the odds of a recession somewhat elevated, but at only 30%.***

### Three Pillars

Consensus forecasts project *AI-driven capital spending*, the lynchpin to our forecast, to reach \$1 trillion annually this year, nearly doubling from 2023 levels, growing at an exceptional 37% rate, and outpacing overall capital spending growth which is projected at roughly 5-7% annually. This investment wave is a transformational force. It will accelerate productivity, sustaining economic expansion over the balance of this year and beyond.

The drivers behind this surge include:

- **Generative AI and machine learning platforms** where investment in AI models and platforms is expanding rapidly, requiring substantial compute power and specialized hardware;
- **AI-enabled automation**, where manufacturing and logistics sectors are increasing capital outlays to integrate AI-driven robotics and process automation, improving efficiency and reducing labor costs;
- **Cloud and edge computing infrastructure** as the shift toward decentralized data processing requires new data centers and edge devices, a capital intensive endeavor; and
- **AI chip demand** where semiconductor firms are ramping up production of AI-optimized chips, with capital spending in facilities rising sharply.

Capital goods orders, a proxy for investment activity, have increased by over 20% year-over-year in the technology equipment segment, corroborating these spending trends. Corporate investment surveys also reflect heightened confidence, with over 60% of firms planning to increase technology capital expenditure this year.

***The productivity impact of this capital deepening is expected to grow accordingly. McKinsey estimates that AI adoption could add up to 1.5 percentage points annually to labor productivity growth by 2030 compared to the historical average of about 1.0%. This productivity acceleration supports higher potential GDP growth, estimated to increase from roughly 2% currently to 2.5-3.0% in the medium term.***

The capital spending surge complements our other pillars, wealth-driven consumer spending and a solid labor market, creating a reinforcing cycle where enhanced productivity and innovation from AI investments supports wage growth and corporate profitability, reinforcing wealth accumulation and consumption capacity. The solid labor market, characterized by tight job openings and rising real wages, provides human capital necessary to deploy and benefit from these technologies creating foundations for sustainable growth.

### **Forward-looking Economic Indicators**

Recent leading indicators suggest that the US economy continues to expand at a moderate pace, though the composition of that growth remains uneven and increasingly dependent on productivity gains and resilient household balance sheets. The latest readings from the Institute for Supply Management indicate that manufacturing activity has stabilized after an extended period of weakness. The ISM Manufacturing Index held at 52.7 in April, marking its strongest sustained reading since mid-2022 and remaining modestly in expansion territory. New orders improved further, though employment within the sector continued to contract, underscoring the persistent divergence between output growth and labor demand.

At the same time, non-manufacturing activity continues to signal ongoing expansion in the larger services economy, albeit at a slower and more uneven pace. Service-sector firms continue to report healthy demand in technology, health care, and professional services, while transportation, housing-related industries, and certain consumer discretionary categories remain under pressure from elevated financing costs and higher input prices.

Labor market indicators remain broadly constructive. Initial jobless claims have continued to fluctuate near historically low levels, recently registering approximately 209,000, while continuing claims have remained contained near 1.78 million. These figures suggest that employers remain reluctant to shed workers despite evidence of slower hiring activity and softer business sentiment.

Consumer sentiment, however, continues to reflect caution. Surveys indicate that households remain concerned about inflation, affordability pressures, and the cumulative effects of elevated interest rates. The divergence between relatively firm hard economic data and softer survey-based measures of confidence remains one of the defining characteristics of the current cycle. Businesses continue to invest and consumers continue to spend, but sentiment has yet to fully recover.

Elsewhere, our firm's proprietary [Economic Model](#), using publicly available economic data and 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 signaling expansion ahead.

***Taken together, these indicators point to an economy that remains resilient but increasingly constrained by elevated price pressures, and slower employment growth. The expansion continues, though with narrower margins for policy error and greater sensitivity to external shocks.***

## **Fed Monetary Policy**

The recent upward drift in inflation measures, driven in part by tariffs as well as higher oil and industrial commodity prices, presents the Federal Reserve with more complicated policy decisions than markets anticipated earlier this year. While core disinflation trends remain intact in several interest-sensitive sectors, including housing and autos, the renewed rise in energy prices over the last couple of months risks slowing the pace of overall inflation improvement and complicating inflation expectations among households and businesses. The Fed is likely to distinguish between temporary commodity-driven price increases and broader evidence of sustained underlying inflation pressure. Historically, policymakers have been reluctant to respond aggressively to isolated energy shocks, particularly when those shocks originate from geopolitical disruptions or supply constraints rather than excessive domestic demand. However, the persistence of above-target inflation over the past several years has heightened the sensitivity of policymakers to any evidence that inflation expectations may become less anchored.

This creates a difficult balancing act for policy makers. On one hand, economic activity has continued to moderate gradually, labor market conditions while solid have softened modestly, and credit conditions remain restrictive relative to the post-pandemic period. These developments would ordinarily support an eventual easing cycle. On the other hand, rising commodity prices feed directly into transportation, manufacturing, and consumer costs, potentially delaying progress toward the Federal Reserve's 2% inflation objective.

***Current monetary policy is, therefore, likely to remain characterized by caution and patience. Some policymakers may increasingly emphasize that the current policy rate is already restrictive and that additional tightening is not their base case. At the same time, others will cite recent inflation data, that in their view, precludes any near-term rate cuts and increases the likelihood the Fed will need to begin discussing a shift in policy toward less accommodation, should the upward tilt in inflation persist.***

Interestingly, financial markets continue to anticipate eventual policy easing, but the timing of that transition has become more uncertain. Much will depend on whether commodity inflation remains contained to energy and raw materials or begins to broaden into wages, services, and long-term inflation expectations.

## **Fed Leadership Transition**

The transition in Federal Reserve leadership introduces an additional layer of complexity to monetary policy at an already delicate point in the economic cycle. Markets generally prefer continuity and predictability from central banks, particularly when inflation remains above target and financial conditions are sensitive to changes in policy expectations. The arrival of a new Federal Reserve Chair inevitably raises questions about the future reaction function of the institution — not simply where rates are today, but how aggressively policymakers may respond to future inflation or growth surprises.

Historically, leadership transitions at the Federal Reserve have often occurred during periods of relative economic stability. The current environment is materially different. Inflation has moderated from peak levels but remains vulnerable to renewed pressure from energy, commodities, wages, and geopolitical developments. At the same time, economic growth has slowed unevenly, labor markets are cooling gradually rather than abruptly, and asset prices remain elevated across several sectors. In such an environment, even subtle changes in communication can materially alter market expectations.

Incoming Fed Chair, Kevin Warsh, also inherits the challenge of institutional credibility. Over the past several years, the Federal Reserve has faced criticism both for reacting too slowly to the initial inflation surge and for maintaining restrictive policy long after inflation began to decelerate. Chair Warsh will, therefore, need to establish credibility simultaneously with financial markets, Congress, and the public. That process often encourages caution in the early stages of a tenure.

The transition may also complicate internal policymaking dynamics within the Federal Open Market Committee (FOMC). While the Chair is only one vote, the position carries significant influence over

consensus formation, communication strategy, and the interpretation of incoming data. Market participants may begin reassessing which regional Fed presidents gain influence under new leadership and whether the institution's center of gravity shifts toward greater emphasis on inflation control or labor market stabilization.

***Transitions alone can tighten financial conditions. Investors may demand greater risk premiums until the policy framework of the incoming Chair becomes clearer. As a result, the Federal Reserve may find itself constrained not only by inflation and growth data, but also by the need to preserve institutional continuity during a period of heightened economic and geopolitical uncertainty.***

## **Equity Investment Policy**

Investment policy remains unchanged. Portfolios under our supervision remain fully invested within portfolio policy 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 key building blocks of employment, financial conditions and corporate profits all point toward a continuation of the current bull market. The AI trade is a reality and the capital spending boom driving it will persist. Provisions of the One Big Beautiful Bill Act (OBBBA) provide incentives for the hyperscalers to continue spending.

Nevertheless, financial markets and household sentiment are conveying sharply different messages. Consumers confront elevated food and energy costs, persistent geopolitical uncertainty, and diminished confidence in public institutions. Yet equity markets continue to reflect the resilience of corporate earnings, the extraordinary profitability of large technology firms, and expectations that productivity gains from artificial intelligence may sustain growth over time. Investors also recognize that nominal revenues and asset values often rise during periods of inflation. Meanwhile, with the Federal Reserve maintaining a measured policy stance and recession risks still contained, capital continues to flow toward risk assets despite heightened uncertainty.

As for stock market valuation, strong earnings reported this year have led to multiple compression, though when measured by forward P/E, the heavily tech-weighted S&P500, now at an all-time high, is richly valued at close to 22X earnings. But keep in mind that the market is bifurcated, and the S&P500 equal weighted index at 18X earnings is more reasonably valued, nearer to its historical average, leaving most stocks away from the mega caps and other AI related shares more attractively priced.

Equity markets routinely experience fluctuations as sentiment inevitably shifts, with double-digit drawdowns occurring before eventual recoveries. While volatility can be uncomfortable in the moment, the long-term record has favored investors who remained invested through periods of market stress. Corrections are healthy as they help reset valuations and investor expectations. They are often followed by shifts in market leadership. These dynamics reinforce the importance of

diversification and disciplined portfolio construction, as narrow, risk-driven advances may not persist, and performance leadership can rotate across market environments.

## Fixed Income Investment Policy

Laddered high-quality corporate bond portfolios under our supervision continue to target a 2.75-year duration. With bond yields having edged higher this spring as inflation worries spiked, we have been investing new cash and the proceeds of maturities in bonds due toward the upper end of their four-year plus maturity range.

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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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