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Economic Update

As we enter the second half of 2026, the US economy remains surprisingly resilient despite major geopolitical uncertainties and inflation risks. Incoming data we track point to an economy that has not only weathered a period of extreme stress but has continued to generate growth, employment, and investment at levels consistent with ongoing expansion. Evidence we have supports a constructive outlook, as forward-looking economic indicators point to continued growth. Employment remains strong. Wealth-driven household spending overall continues to expand. Corporate balance sheets are generally healthy, supporting rapidly expanding investments in AI. The banking system is well capitalized. Financial conditions, while no longer exceptionally accommodative, remain supportive of continued expansion. Most importantly, liquidity within the financial system appears sufficient to sustain expansion without the need for additional monetary easing. And corporate profits, a key longer-term determinant of stock valuations, have broadly exceeded expectations and are forecast to continue to surprise to the upside in coming quarters.

In short, today's economy bears little resemblance to the conditions that have preceded past recessions and significant stock market drawdowns. Excesses are limited, credit quality remains sound, and key leading indicators are generally improving rather than deteriorating. While significant risks exist, they are occurring against a backdrop of substantial underlying economic strength.

Labor Market

The Labor market, one of the Three Pillars we believe underpins the current expansion, remains a principal source of strength. Recent employment reports indicate accelerating job creation in the past three months, following a period of relative stagnation last year. Payrolls surged past consensus forecasts in May, delivering 172,000 jobs versus expectations of 88,000. Two-month revisions added an incremental 93,000 jobs. That brings the three-month average of job gains to 188,000 for non-farm payrolls, certainly a hot print, particularly against a backdrop in which many economists believe the so-called breakeven rate of employment growth to maintain a stable unemployment rate remains close to 25,000 jobs.

Importantly, recent job growth has yet to add to already elevated inflation as the work week held steady in May at 34.3 hours and wage growth came in at 0.3%, bringing the year-on-year rate down to a relatively mild 3.4%. While payroll growth has moderated from the exceptionally rapid pace seen earlier in the cycle, the unemployment rate held steady last month at 4.3%, for a third consecutive month, it remains more than sufficient to absorb labor force growth and support household incomes.

The overall picture, then, is one of a labor market that has cooled gradually rather than deteriorated. Such an outcome is consistent with a mature expansion rather than one approaching recession.

Consumer Spending

Overall consumer spending, the second Pillar supporting the expansion, which accounts for roughly two-thirds of economic activity, has also remained surprisingly resilient. *Retail sales* in May rose a strong 0.9%, significantly exceeding expectations and following an upwardly revised April report. Despite higher energy prices and continued concerns regarding inflation, consumers have continued to spend, their outlays supported by solid employment conditions, rising incomes, and substantial household wealth. That said, there is a growing body of evidence supporting the view that consumer spending, the highest on record, has become increasingly bifurcated, with affluent households accounting for a disproportionate share of aggregate demand. The top 10% of US households now account for roughly 49% of all consumer spending, the highest share on record, up from 36% in 1995, according to Federal Reserve data. A recent Fed study found middle- and high-income households have fueled retail spending growth, while low-income households have reduced real spending during much of the post-pandemic period. As of 2024, real spending by high-income households was up 17.7% from 2018 levels versus 7.9% for low-income households.

Virtually all recent Fed and private sector research points in the same direction: higher-income families are contributing a growing share of spending growth and are largely responsible for the resilience of aggregate consumption. A bifurcated consumer sector where high-income households continue to spend freely while middle- and lower-income households become more constrained, can sustain an expansion for a time. However, it introduces vulnerabilities that differ from those seen in a more broadly based economy. For example, if affluent households are driving a disproportionate share of spending, a 15%-20% decline in equity markets could have a larger effect on aggregate demand than in prior cycles. Fed research shows that each dollar of stock market wealth generates roughly 2 to 4 cents of annual consumption. With US household wealth exceeding \$50 trillion, a 20% market decline, if sustained, could ultimately reduce spending by \$200-\$400 billion annually, or approximately 0.7%-1.4% of GDP. Also, expansions tend to be more durable when wage growth and consumption are broadly distributed. If spending becomes concentrated among a relatively small group of households, aggregate demand becomes dependent on the confidence and wealth of fewer households. And, keep in mind, delinquencies on credit cards and auto loans have risen from exceptionally low level seen during the pandemic. While not signaling systemic risk, continued deterioration could restrain spending among lower income households, those with the highest propensity to consume.

Interestingly, the personal savings rate in the US has fallen dramatically. Prior to the pandemic, Americans typically saved 6% to 8% of their disposable personal income. During the pandemic, the savings rate rose to 30% because of stimulus payments, and limited spending opportunities. The savings rate has since fallen to 2.6%, among the lowest readings since mid-2000's as lower income households who have experienced the greatest stress, have drawn down their savings to maintain their outlays. How much further this dissaving will go before aggregate spending is cut remains to be seen.

Bifurcated spending does not necessarily cause a recession. In fact, it can prolong an expansion as affluent households generally persist in their spending across cycles to maintain their lifestyles, enabled by their substantial financial resources and relatively low debt burdens. However, this behavior shifts the economy away from dependence on broad-based income growth, which is relatively stable, toward reliance upon asset values which can be volatile. In such an environment, equity prices, home values, and confidence among higher-income households can become increasingly vulnerable to shocks that affect households wealth, becoming important determinants of overall economic activity rather than employment alone.

Business Investment

Business investment, the third Pillar, has emerged as an increasingly important source of economic momentum. The rapid deployment of artificial intelligence (AI) technologies continues to drive substantial capital expenditures in data centers, semiconductors, networking equipment, software, and supporting infrastructure. The scale of investment associated with AI adoption is becoming increasingly evident in both corporate earnings reports and national economic data. What began as a technology story is now influencing industrial production, productivity, and broader economic activity. The resulting demand for equipment, construction, and high-value manufacturing has provided an important offset to interest rate sensitive areas of the economy (i.e. housing, autos and real estate) that remain weak.

US investment in data centers, cloud computing and related technologies is now running at an annual pace exceeding \$400 billion, more than double pre-pandemic levels, becoming an increasingly significant driver of aggregate demand. The result is an expansion supported not only by consumption but also by an unusually strong cycle of business investment that is forecast to persist for the next couple of years.

Forward Looking Economic Indicators

Perhaps the most encouraging development of the past few months has been the turnaround in manufacturing activity, which represents about 13% of GDP. The revival should contribute an estimated 0.3 percentage points to GDP growth this year. For several years, the factory sector struggled under the combined weight of higher interest rates, inventory corrections, and slowing global demand. Recent survey data, however, suggest that a cyclical turning point may be underway. **The forward-looking Institute for Supply Management's Manufacturing Index (ISM)** rose to 54.0 in May, its strongest reading in approximately four years. New orders, production, exports, and capital spending indicators have all moved into expansion territory. While one month does not establish a trend, the breadth of improvement suggests *manufacturing* may be transitioning from a prolonged

period of stagnation toward renewed growth. Meanwhile, the latest reading of the **ISM Non-Manufacturing Index**, where services account for 70% of GDP, continues to signal expansion. And our firm's proprietary **Economic Model**, designed to signal a change in the direction of the US economy 6 to 9 months ahead of an inflection point, remains well above trend, calling for expansion ahead.

As further investments in manufacturing facilities take place, we expect additional productivity gains and a broader, more balanced expansion, beyond AI-related technology and communication services.

And *consumer attitudes*, while still subdued by historical standards, have also shown signs of stabilization following a difficult spring. Sentiment had been heavily affected by concerns surrounding inflation, energy prices, and conflict in the Middle East. More recently, the cease-fire in the region and the gradual reopening of the Strait of Hormuz have reduced some of the most acute concerns regarding global energy supplies, lowering the odds of a recession. Markets have responded favorably, and preliminary evidence suggests that households are becoming somewhat less pessimistic regarding future economic conditions.

Risks

It would be unwise to minimize the challenges to continued growth that remain. The global environment continues to present meaningful risks as two major conflicts remain unresolved. While the recent cease-fire has reduced immediate concerns regarding energy supplies, geopolitical developments remain fluid and difficult to predict. Any renewed disruption to oil production, shipping routes, or global trade could once again place upward pressure on commodity prices and inflation.

Inflation itself remains the principal macroeconomic risk. Recent increases in energy and fertilizer prices have pushed headline inflation higher. Policymakers will be watching carefully to determine whether these pressures prove temporary or become embedded more broadly throughout the economy. The distinction is critical. Should inflation fail to moderate in coming months, central banks could find themselves compelled to maintain restrictive policies for longer than currently anticipated or potentially tighten policy. While less Fed accommodation is not our base case, it remains a possibility that deserves serious consideration in assessing the risks to further economic growth.

In recent weeks, inflation concerns have broadened beyond the energy markets. While higher oil and natural gas prices continue to affect transportation and production costs, a new source of pressure has emerged in the tech sector: high-bandwidth memory chips in short supply are driving up the cost of advanced artificial intelligence systems. As these chips became harder to obtain, AI infrastructure has become more expensive to build and operate. These higher costs are likely to be passed through to customers in the form of higher prices for digital services, data-intensive applications and, as is the case with Apple Inc., higher prices for their products. Persistent cost pressures across both energy and technology supply chains could complicate progress toward price stability.

Political uncertainty also tends to increase as election cycles approach. With the 2026 mid-terms drawing nearer, businesses and investors will inevitably face questions regarding fiscal policy, taxation,

regulation, trade policy, and government spending. History suggests that markets can often navigate political uncertainty successfully, but periods of heightened financial market volatility should not be surprising.

Equity Investment Policy

Given the fundamentally sound US economy and with no recession in sight, equity investment policy remains unchanged. Stock portfolios under our supervision remain fully invested within their respective guidelines, notwithstanding stretched market valuations driven by technology and telecommunications shares, and the ever-present risk of sentiment-driven 10%+ stock market correction. Large cap core equities are diversified and balanced between *growth* and *value* investments, a style unique to Front Barnett management. Domestic small cap investments, as well as equities domiciled abroad in both developed and emerging markets, complete our investment platform.

Mirroring the performance of the US economy over recent months, equity markets have demonstrated notable resilience despite the risks noted earlier, with the S&P500 making 23 new all-time highs this year. Investors have largely looked through the inflation and geopolitical risks, focusing instead on robust corporate profits which have exceeded expectations, the benefits of the ongoing surge in capital investment largely linked to AI, generally healthy business balance sheets, and more recently, the belief that Fed policy under new Fed Chair Kevin Warsh will do no harm to the economy.

The broadening out of the stock market's leadership which we have long expected and which began late last year persisted into the first quarter of 2026 as investors gained further confidence in the durability of the economic expansion and that interest rates would remain well-behaved. Cash flowed into economically sensitive investments (i.e. cyclicals, industrials and financials) which joined technology shares in leading the market higher. The start of the war with Iran at the end of February and the spikes in energy prices and interest rates, prompted another bout of risk off and yet another rotation which saw investors again favoring high priced technology shares with assured earnings prospects. Holdings of cyclicals and financials were dumped as markets reacted to renewed economic uncertainty. Most recently, with the signing of the MOU with Iran which triggered a collapse in oil prices and a retreat in bond yields, stock market leadership has again broadened out, favoring broadly diversified portfolios such as those we manage.

The market rotation we've seen in the past few quarters appears to reflect the impact of two competing forces. Higher inflation and rising interest rates tend to restrain valuation multiples and increase the cost of capital while continued economic expansion, strong corporate profitability and substantial investment in productivity-enhancing technologies support earnings growth. Taken together, these crosscurrents suggest the market's rise, supported by rising corporate profits and stable interest rates, can continue. However, structuring a portfolio that delivers competitive results will require discipline, diversification and a focus on companies with pricing power and strong financials can withstand a higher-rate, higher inflation environment we expect.

As for stock market valuation, strong earnings reported for the first quarter have led to multiple compression, though when measured by forward P/E, the heavily tech-weighted S&P500, now near an all-time high, is richly valued at about 21X earnings. But with the bifurcated market, the S&P500 equal

weighted index valued at about 19X earnings is more reasonably valued, nearer the historical average, leaving most stocks away from the mega caps and other AI related shares more attractively priced.

Recall that equity markets routinely experience significant fluctuations as sentiment inevitably ebbs and flows. Double-digit drawdowns occur routinely before eventual recoveries bring the markets to fresh new highs. While volatility can be uncomfortable in the moment, the long-term record has favored disciplined investors who remained held steady through periods of market stress. Corrections are curative as they help reset valuations, washing out speculative excesses, and rationalizing investor expectations. Periods of stress 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

Bonds encountered heightened volatility this Spring as rates rose in response to investors' growing inflation concerns. At their highest level, yields on benchmark 10-year US Treasury bonds in mid-May briefly reached 4.59% after beginning the year at 4.21%. Currently, that rate has drifted lower to 4.37% and is expected to fall further as energy-driven inflation fears subside further. We used the period of elevated rates to add to the longer end of the roughly 5-year ladder of investment grade corporate bonds we manage for clients, investing the proceeds of maturities and cash equivalents. We continue to target a 2.75-year duration.

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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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