FRONT BARNETT
A Mesirow Company

Marshall B. Front
Senior Managing Director
Portfolio Manager

353 North Clark Street
Chicago, IL 60654
t: 312.641.9001
e: marshall.front@mesirow.com

front-barnett.mesirow.com

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Economic Update

While there is evidence the US economy has lost some momentum this summer, data we have seen point more to a recent deceleration in consumer outlays rather than a downturn in overall business activity. In that regard, three reports released recently marking the slowdown are worth noting. First, in the labor market, July payrolls fell by 23,000, the first monthly decline since February. More importantly, May and June payroll gains were revised down by a combined 103,000. The unemployment rate remained at 4.1%, but that stability was largely attributable to a decline in labor force participation rather than stronger employment. Second, *real* purchasing power has declined modestly as wage growth has slowed to about 3.2% year-over-year, while CPI inflation is running at 3.4%, above wage growth. So, wages have now failed to keep pace with prices for several consecutive months, presenting a meaningful headwind for discretionary consumption. Third, government data shows retail sales stumbled entering the second half of the year, falling 0.6% in July, the largest decline since May 2025, versus expectations for a 0.1% increase. “Control group” sales, which include categories of everyday products that economists track closely, more relevant for GDP calculations, declined 0.4%, the first such decline this year. Under the surface, though, the retail sales report shows the year-over-year shortfall was mainly due to Amazon Prime Day moving from July last year to June this year driving a 2.2% decline in non-store retail sales, compared with a 7.7% increase in June. Contributing to the decline in sales was a 0.8% decline in gasoline receipts in July, after a larger 5.8% decline in June, reflecting a fall in crude oil prices, and a 1.8% decline in auto sales which reversed unusually strong June spending.

Taking into account the Prime Day timing and other one-off factors that do not reflect economic weakness such as hot weather and the end of the World Cup, the pace of shopping was probably close to flat last month. Should this slowdown continue, third quarter GDP may well print below private sector economists’ current 2.0%-2.2% consensus expectation. That said, while the July Department of Commerce retail sales data presents a bit of a wake-up call, we find no anecdotal evidence pointing to a

sustained downturn in overall consumer outlays which account for nearly 80% of GDP growth.

Outlook

Beyond the July shopping slowdown, second quarter household spending grew at a strong 3.2% annualized rate, well above the longer-term 2.0%-2.5% trend. Balance sheets, particularly those of higher-income households, remain strong, supportive of continued growth. The two major sentiment surveys (i.e. University of Michigan and Conference Board) have bounced from their very depressed May-July levels, though consumers remain unusually pessimistic due to persistent price increases and fallout from the Iran war which have dimmed their view of the economy.

Meanwhile, business surveys are considerably more encouraging than those of consumers. Manufacturing has become a genuine source of optimism, services remain firmly in expansion territory, and small-business sentiment, at an eleven-month high, has improved materially. Polls cite strong order books and expanding backlogs, resilient consumer demand, improving hiring intentions which run counter to the recent disappointing payroll data, favorable trends in capital investment and technology and less concern about inflation among small businesses as only 14% of NFIB respondents identify inflation as their most pressing problem.

More broadly, corporate profit growth has accelerated and profit margins are expanding providing momentum to the expansion. The US banking system is well reserved, with ample liquidity available to support the economy's expansion, and importantly, there is no recession signal from Initial Jobless Claims reports which ordinarily spike before a downturn.

So, while uncertainty remains elevated amid heightened geopolitical risks, erratic trade policies and high energy prices, we conclude from the information we have that there are no signs at this point of a significant business downturn. The economy remains sound, likely to continue its expansion in the months ahead, albeit at a somewhat slower pace.

Fed Tug-of-War

The Federal Reserve's interest rate dilemma has become more difficult in recent weeks as those officials who favor a rate increase, and those who would stand pat, are able to point to data supporting their cases. The inflation hawks can point to inflation that for five years has remained materially above its 2% target; the doves can cite weakening employment figures, declining real wages and softer consumer spending last month.

Leading up to the September 16 rate decision, FOMC members will focus on a handful of key economic releases. Most important of these will be the August employment report due on September 4, and the Personal Consumption Expenditures (PCE) Index which will be published August 26. Should employment deteriorate further while inflation continues to moderate, the doves will win the argument and rates will remain unchanged. Doves are hoping inflation will fade, moving toward the Fed's 2% target, as the pressures of tariffs and higher oil prices from the Iran war ease. Should employment deteriorate but inflation remain around 3% or above, the hawks will gain the upper hand, and the Fed may have to tighten credit conditions, accepting slower growth to preserve its inflation credibility.

Data released earlier this month have strengthened the case for Fed patience. July CPI and PPI figures were both softer than feared at the same time as retail sales have weakened. That combination has caused futures markets to sharply reduce the probability of a September rate hike, putting downward pressure on short-term interest rates, which are most affected by changes in Fed policy. Longer-term rates, driven by inflation fears and expectations for rapidly increasing sovereign and corporate debt issuance, have made new highs for the year, steepening the yield curve.

The Fed is no longer debating simply whether policy is restrictive enough; it is debating which risk is greater: allowing inflation to remain above target for longer, risking that higher-than-desired inflation expectations will become engrained, or keeping policy too restrictive just as the labor market and the consumer begin to soften, risking a more severe slowdown*. *That is the essence of the hawk vs dove tug-of war over which new Fed Chair Kevin Warsh is presiding.

Manufacturing Renaissance

One of the more consequential, but still underappreciated, developments in the US economy is, in our view, the renaissance of domestic manufacturing we are seeing. This is not simply a cyclical rebound in factory output. It increasingly appears to reflect a structural reorientation of corporate investment, supply chains, and productive capacity toward the United States. The implications for economic growth, productivity, capital formation, and importantly for investors, could be substantial, even in a scenario where artificial intelligence (AI) enthusiasm moderates or stumbles in the near term.

Importantly, it is useful to put manufacturing in proper macroeconomic context. The sector accounts for roughly 10% of US GDP, meaning that even meaningful cyclical or structural improvements in manufacturing will not, by themselves, dominate aggregate growth. The US economy remains primarily driven by services. That said, manufacturing's influence on productivity, capital intensity, innovation diffusion, and high-value supply chains is disproportionately large relative to its share of output. It is therefore best understood not as a dominant sector in size, but as a strategically important one in terms of investment intensity and economic spillovers.

The evidence for manufacturing improvement is becoming increasingly difficult to dismiss. The Institute for Supply Management's Manufacturing PMI moved above the 50 breakeven level in January 2026 and remained in expansion territory through July. More importantly, new orders have surged along with production which has now expanded for nine consecutive months, following years of contraction. Five of the six largest manufacturing industries, including computers and electronics, machinery, transportation equipment, and chemicals, reported growth last month. ISM also reported that just 5% of manufacturing GDP was contracting in June, and only 3% was in "strong contraction."

The improvement in underlying demand is particularly encouraging. New orders have expanded for seven consecutive months after four months of contraction, while order backlogs have remained above breakeven. The employment index, now well above 50, improved materially last month as manufacturers reporting increased hiring outnumbered those reducing employment by 1.8 to 1. These developments suggest that the manufacturing recovery is broadening beyond a narrow group of industries.

This trend is now also beginning to show up in hard labor-market data. The July employment report showed that while the US economy unexpectedly lost 23,000 jobs, manufacturing employment continued to grow, increasing by 5,000. Within that, transportation equipment manufacturing added nearly 12,000 jobs, more than offsetting weakness in other subsectors. In July, a month of broad labor-market softness, manufacturing stood out as one of the few areas of net job creation according to the Bureau of Labor Statistics (BLS).

Perhaps the strongest evidence of structural change is the extraordinary scale of investment in American production facilities. Manufacturing construction spending reached an annualized $174.8 billion in May 2026, according to Census Bureau data compiled by the Federal Reserve Bank of St. Louis. Manufacturing capacity is projected by the Federal Reserve to increase 1.0% in 2026, following a 1.1% increase in 2025. The magnitude of this investment reflects more than normal replacement spending; it represents the creation of new productive capacity.

Foreign capital is reinforcing this trend. The Bureau of Economic Analysis (BEA) reports that the foreign direct investment position in the United States increased by $266 billion during 2025, to $5.86 trillion. Manufacturing accounted for the largest industry increase, led particularly by electrical equipment and components. This is an important signal: multinational corporations are not merely selling into the American market; they are increasingly locating production here.

Importantly, this shift is not occurring in a vacuum. Several powerful structural forces are driving it simultaneously.

- The acceleration of artificial intelligence and advanced automation is fundamentally changing the economics of production. AI-enabled manufacturing, robotics, and machine vision systems are reducing the labor-cost advantage of offshore production. Even if AI adoption proves uneven or experiences near-term setbacks, the broader direction of travel toward automation and capital intensity still favors reshoring. As capital becomes a larger share of total cost, proximity to end markets, engineering talent, and innovation ecosystems become more valuable.

- Policy incentives embedded in recent US industrial legislation have materially altered the after-tax return on domestic investment. Subsidies, tax credits for semiconductors, clean energy manufacturing, and domestic capital expenditure have effectively lowered the hurdle rate for building new US capacity. In several strategic sectors, the United States has moved from being a relatively neutral location to a preferential one.

- Geopolitical fragmentation has become a defining feature of the global economy. Ongoing conflicts, persistent tensions between major economic blocks, and the increasing weaponization of trade, technology, and energy flows have all reinforced the strategic value of supply-chain redundancy and domestic production. Firms are no longer optimizing purely for cost; they are optimizing for resilience, security, and optionality.

- The post-pandemic reassessment of global supply chains has had lasting effects. The disruptions of 2020–2022 exposed the fragility of extended, just-in-time global networks. Since then, corporations have increasingly pursued “China-plus-one” strategies, nearshoring, and reshoring of critical inputs, particularly in semiconductors, pharmaceuticals, industrial machinery, and energy-related equipment.

- The scale of investment in semiconductors, electrical equipment, power infrastructure, and advanced manufacturing ecosystems is creating self-reinforcing industrial clusters. Once these ecosystems reach critical mass, they tend to attract additional suppliers, labor, and capital, further accelerating domestic production growth.

Investment Implications

For investors, the key question is not whether manufacturing is improving in the near term, but whether it represents a durable shift in the composition of US growth. Given that manufacturing is only about 10% of GDP, the more important issue is not its direct contribution to headline growth, but its outsized influence on capital formation, productivity, and high-multiplier investment cycles. If this trend continues, even in a world where AI-driven productivity gains are more volatile or delayed, the implications are meaningful.

- A sustained manufacturing cycle typically benefits industrials, capital goods, electrical equipment, construction machinery, and select materials subsectors. Most important, we continue to expect the composition of equity market leadership to broaden further benefiting well-diversified portfolios such as those we manage. These areas could see structurally higher earnings growth than in the post-2008, services-dominated expansion.

- Capital expenditure intensity is likely to remain elevated. This supports not only industrial equities but also suppliers into the buildout cycle: semiconductors, power infrastructure, grid equipment, automation, and industrial software. Even if AI-related capex moderates, non-AI industrial investment may provide a stabilizing offset.

- The US economy could become more investment-led and less consumption-led at the margin. That shift tends to favor companies with operating leverage to domestic fixed-asset formation rather than purely consumer-facing demand.

- Foreign direct investment flows into US manufacturing suggest a potential multi-year tailwind for the dollar-denominated asset base. Global firms building US capacity must finance, equip, and operate those facilities, creating persistent demand for US industrial assets and services.

Reasons for Caution

There are, of course, reasons for caution. Manufacturing employment remains well below its historical share of the labor force, capacity utilization remains below its long-run average, and tariffs and higher input costs could restrain margins. Moreover, if AI-driven productivity gains disappoint, some of the expected efficiency gains embedded in current investment plans may take longer to materialize.

Yet manufacturing's economic importance should not be measured solely by headcount or even its modest share of GDP. Modern factories are increasingly capital-intensive, automated, and technologically sophisticated, meaning output and productivity can rise even with modest employment gains.

For these reasons, we believe the emerging manufacturing renaissance could become an important support for US expansion and a meaningful investment theme. While it is too early to declare a new industrial golden age, rising orders, expanding production, unprecedented capital investment, renewed foreign investment, and powerful structural drivers, including AI, industrial policy, and geopolitical realignment, provide increasingly persuasive evidence that the United States is rebuilding a durable and strategically significant industrial base.

If sustained, that process could reshape sector leadership in the equity markets, support a multi-year capital expenditure cycle, and provide a more investment-led foundation for U.S. growth, even in a world where the AI narrative proves less linear than currently assumed*. *Client equity portfolios are positioned to benefit from this developing theme.

Forward-Looking Economic Indicators

Incoming economic data signal expansion ahead but reflect slowing growth at the margin.

- **The ISM Manufacturing Index** reading for July**,** which provides the clearest positive sign, rose sharply to 55.6 from 53.3 in June, its strongest score in four years. (Recall readings of the Index above 50 signal expansion while readings below 50 signal contraction). New orders expanded for a seventh consecutive month, while the employment component rose to 52.8 from 49.7, moving into expansion for the first time in 33 months. These are meaningful signals as new orders and employment tend to provide information about production in the coming months.

- The **ISM Non-Manufacturing Index** tells a similar story, increasing to 54.1 in July from 54.0 in June, above the 50-level separating expansion from con-traction. New orders remained strong. Yet, the employment index fell to 47.4, while prices paid index climbed to 70.3. Thus, services are expanding, but the combination of softer hiring and elevated input costs represents just the sort of tension that complicates the Federal Reserve's task. Labor market indicators are somewhat concerning. July's payroll number was a disappointment and revisions to earlier month's job figures have brought the three-month average gain down to only about 20,000 jobs, compared with 142,000 as recently as the three months through May, a substantial deceleration.

- **Initial Jobless Claims** for state unemployment benefits remain historically low suggesting employers are becoming reluctant to hire, but have not yet moved aggressively toward layoffs, the classic "low-hire, low-fire" environment.

- Our firm's proprietary **Economic Model**, designed to signal six to nine months ahead of an inflection point a change in the direction of the US economy, and which informs our investment process, remains above-trend, calling for expansion ahead.

Equity Investment Policy

Equity investment policy remains unchanged: Portfolios under our firm's supervision remain fully invested within agreed guidelines reflecting our belief that economic fundamentals are sound with no recession in sight, and that conditions for future economic growth remain favorable.

Though we have a growth stock bias, our investment platform includes well diversified high-quality large cap domestic equities balanced between *growth* and *value* shares and small caps, as well as investments domiciled abroad in both developed and emerging markets. By blending large cap *growth* and *value* investments in a single portfolio, a style unique to Front Barnett investment management, we seek to achieve competitive after-tax returns while moderating the market volatility ordinarily associated with portfolios invested exclusively in either the *growth* or *value* styles. Portfolio turnover is intentionally low. In selecting *growth* stocks, our research methodology seeks investments whose earnings are growing sustainably, more rapidly than the average, and which, in our view, are reasonably priced (GARP). The characteristics of v*alue* investments include financially strong, growing businesses with below average market P/E valuations, higher than average and often growing dividend payouts, and currently unrecognized prospects for future earnings growth acceleration, which can eventually lead to higher market valuations.

The broadening-out of US stock market leadership continues to develop along the lines we have expected, benefiting well-diversified portfolios of high-quality equities such as those we manage. Small cap stocks, former laggards, are leading the markets higher. The broader Russell 2000 is up 23% year-to-date versus about 13% for the S&P500. Equal weighted indices have modestly outperformed the S&P500 capitalization-weighted index in recent months. Moreover, about 45% of S&P500 companies have outperformed the index this year, the highest proportion since 2022. The forecast rotation is reaching beyond technology as industrials, utilities, energy, financials and other cyclical areas have been participating while the dominance of the so-called Magnificent Seven has receded. Earnings breadth has been an important driver of this change in investors' preferences. Nearly 90% of S&P500 companies reported higher than expected earnings last quarter, while eight of the eleven sectors experienced double-digit earnings growth. The broadening bull market does not represent a wholesale abandonment of technology shares as better-than-expected earnings generally from that sector have also buoyed the mega-caps.

Looking ahead, if economic growth continues to broaden, as we expect, earnings growth should come from a widening group of companies, allowing industrials, financials and consumer companies to assume a larger role in market leadership which is becoming less dependent on the handful of mega-cap technology companies dominant in 2025. This shift makes the market advance potentially more durable even though volatility is likely to remain elevated in the weeks ahead of the mid-term elections.

Stock market valuations remain rich by historical standards making equities increasingly vulnerable to periodic sentiment-driven pullbacks. We have seen two such corrections in the past couple of years despite favorable fundamentals. While volatility can be uncomfortable in the moment, the long-term record has favored disciplined investors who held steady through periods of market stress. Corrections are curative as they help reset valuations, wash out speculative excesses, and rationalize investor expectations. These dynamics reinforce the importance of diversification and disciplined portfolio construction, as narrow, risk-driven momentum-following speculative advances are unlikely to persist and performance leadership will inevitably rotate across market environments.

Fixed Income Investment Policy

Bond markets have shown increased volatility in recent weeks as shifting inflation expectations, uncertainties over Federal Reserve policy under new Fed Chair Kevin Warsh, and concerns over the growing likelihood of increased sovereign and corporate debt issuance have preoccupied investors. Yields on benchmark 10-year US Treasury bonds rose to 4.75% at the end of July after troughing at 3.9% on March 2, creating opportunities to add to bonds at the long-end of the five-year ladder we structure for clients’ high-quality corporate bond portfolios. We continue to target a conservative 2.75-year duration for bond portfolios under our supervision. Given the uncertainties, we expect bond yields to remain elevated and volatility high over the near term; it would not surprise us to see a 5.0% yield on the benchmark 10-year Treasury should the current standoff in Iran persist into the fall.

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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.