ECONOMIC AND FINANCIAL DIGEST

UNITED BANKERS' BANK
Suite 600 • 2 Meridian Crossings • Richfield, MN 55423

Volume 31 January 2026

A Bifurcated Expansion Rolls Into 2026

As the curtain rises on 2026, the forecasting floodgates are opening. As usual, there is no shortage of viewpoints as to where the economy is heading. There are the usual outliers, including pessimists convinced a recession – or something worse – is just around the corner. Alternatively, some see a runaway boom on the horizon, fueled by torrid AI spending and a profligate consumer. These two extremes likely spring from political allegiances rather than grounded in facts. Indeed, facts have been hard to come by in recent months, thanks to the months-long data blackout caused by the government shutdown.

But the data spigot has now reopened, and forecasters are getting some hard data to process, something that should make their lives easier. Still, the year ahead promises to be as unpredictable as the last, when a new administration entered the White House with an array of unconventional policy proposals that stoked uncertainty, upended planning and altered the behavior of businesses and consumers from what they would have done in a more tranquil environment. Policy uncertainty, particularly regarding trade, is fading; but questions about how the policies put into effect last year will play out this year remain unsettled. Will the delayed impact from tariffs continue to drive up inflation? Will that prompt the central bank to keep interest rates higher than otherwise, stifling growth and risking a recession? Regarding the Fed, the president will be choosing a new chairman to take over the realm in May. Will he or she strive to push through policies that are aligned with economic needs or bend more to the wishes of the president?

We don't pretend to know the answers to these and myriad other unknowns that linger heading into the new year. But a $30 trillion economic juggernaut is not easily knocked off the rails and we suspect that it will survive whatever is thrown at it this year. Barring a potent external shock – a war involving the U.S., oil crisis or a serious miscalculation by policymakers – it could perform pretty much the same as 2025, although without the gyrations that peppered the landscape last year. The bad news is that the fissures seen during the year, most notably the bifurcated nature of the growth engine, is likely to continue, leaving a swath of the population behind.

Consumers Will Drive Growth Again

The economy waxes and wanes mostly in response to consumer spending, which accounts for about 70 percent of total activity. Last year was no exception, although the spending spigot opened most widely for wealthier households. This cohort's purchasing power benefited mightily from a booming stock market which, along with rising home values, added significant muscle to their net worth. The so-called wealth effect, in turn, provided more oomph to consumer spending, particularly for discretionary goods and services, than it normally does.

The less wealthy members of the population also kept their wallets opened. These households depend more on income to finance purchases, and the job market provided enough paychecks for them to afford buying essential goods and services. But inflation steadily ate into incomes as the year progressed, forcing them to draw on savings and credit cards to sustain living standards. The slowdown in job growth over the second half of the year also reduced wage growth, heightening the financial struggles of lower and middle-income households.

The fragmentation of the household sector should continue in 2026, but collectively consumer spending is expected to grow at a decent pace. The first half of the year should see the biggest bump in spending, thanks in good part to the large tax refunds resulting from the One Big Beautiful Bill Act. Lower income households will receive refunds from the overpayment they sent to the IRS last year as most withheld taxes were not adjusted to align with the retroactive tax cuts implemented for all of 2025. Meanwhile, upper-income households will benefit from the Federal increase in the State and Local tax deductions.

Another Year of Strong Investment Spending

The enormous appetite for AI-related investment spending played a significant role in the economy's performance in 2025. Indeed, investment outlays contributed more to economic growth over the first half of the year than consumer spending, even though they are less than half the size. The huge appetite to jump on the AI bandwagon will continue as more firms strive

for the revenue potential and cost savings from replacing labor that the emerging technology promises to bring about. However, the outsized contribution AI-spending made in 2025 is likely to wane this year as the massive expenditures have yet to generate comparable profits. Many companies will now wait to see if this transformative technology is as financially rewarding as expected.

But what AI spending leaves on the table, other sources of investment outlays should pick up. Non-AI spending lagged in 2025 due to a surge in policy uncertainty related to the chaotic unfolding of tariff announcements. Many businesses froze budgets for capital equipment not knowing if or how significantly higher tariffs would impact their operations over the longer run. But most of the tariffs are now on the books and policy uncertainty should fade, unleashing the investments that were postponed in 2025.

Importantly, as is the case for households, the incentive to spend on capital equipment will be getting a boost from the One Big Beautiful Bill. Among the investment incentives, the legislation allows for full expensing for new equipment and immediate expensing for domestic R&D outlays. The financial backdrop for capital spending should also be quite friendly, Companies ended the year with healthy profit margins, borrowing rates are coming down and banks are eager to lend. Agriculture equipment spending is also expected to rise, supported by a recently negotiated reduction of reciprocal tariffs aimed at opening markets for U.S. poultry, beef, nuts, and wheat, and a farm bailout embraced by the $12 billion Farmer Bridge Assistance Program in December.

Weaker Hiring Aligns With Reduced Labor Supply

A vital cog in the economy's growth engine is the job market. If that cylinder sputters, the road ahead will be bumpy. In 2025, GDP outpaced job growth by a wider margin than usual. It's unclear why that occurred, but various influences were at play. They include improved productivity that enabled companies to generate more output with less labor; overhiring during the early post-pandemic years that left employers with ample workers to generate output; and, perhaps most important, the smaller pool of workers available to hire due to the immigration crackdown.

The last influence is important because it offset the weaker hiring during the year and kept the unemployment rate mostly steady, at least until the uptick in November. Simply put, it made it difficult to detect how much slack there is in the labor force. The low hiring trend suggested that there was more slack than indicated by the low unemployment rate. But the reduced supply of labor suggested that the labor market was tighter, as less hiring was needed to accommodate the fewer number of workers seeking jobs. Hence, while job growth slowed over the second half of the year, unemployment barely budged until the very end.

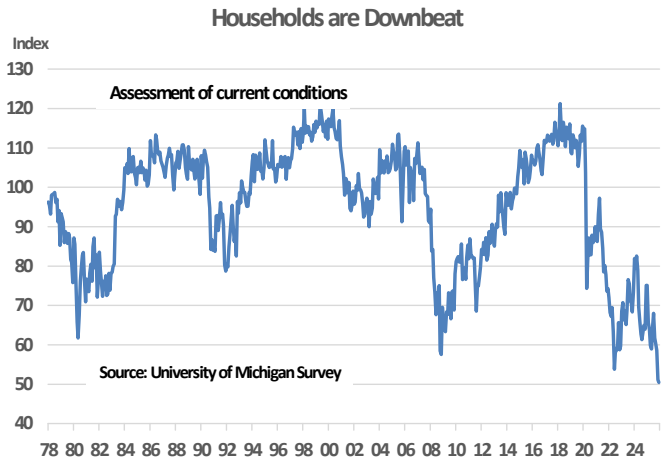
It's unlikely that the borders will reopen and allow a resurgence of immigrants to bolster the labor supply in 2026. Meanwhile, our aging population assures that the ever-increasing wave of retirements will continue to be a drag on labor supply. Hence, the breakeven rate, i.e., the number of new jobs needed to keep unemployment from rising, will be considerably less than in the past. Most estimates are that a monthly increase of around 50 thousand would be sufficient, a far cry from the 168 thousand average in 2024. The question is: Will that lower threshold be met?

Vibes Versus Reality

The short answer is yes. But that doesn't mean 2026 will measure up to a healthy or balanced performance. Slower employment growth, even if accompanied by a low unemployment rate, suggests that the fissures that opened up in 2025 will get wider. One of the most unusual features of the economy last year is the wide gap that opened up between reality and perception. The economy, as noted, did just fine, punctuated by an eye-opening 4.3 percent annual growth rate in the third quarter. But ask people on the street how they feel, and the answer you will get is that the economy is in a recession. According to the University of Michigan's latest survey, household assessment of present economic conditions fell to an all-time low in December.

This vibe recession is generally downplayed by policymakers who put more emphasis on hard data for guidance, regardless of what their underlying drivers are. As Fed Chair Powell has noted, the rate-setting lever under its control is a blunt instrument that shapes macro trends -- inflation and employment -- not the micro influences that lie under the hood. Lowering or raising interest rates is aimed at stoking or restraining growth and inflation but does little to narrow the income gap between affluent and poorer households. True, the expectation is that growth-inducing policies generate a tide that lifts all ships, rich as well as poor. But wealthy consumers and AI investments are driving the headline growth rate, and these two influences are self-reinforcing. Wealthier households are deriving their purchasing power from a surging stock market which, in turn, is deriving strength from a handful of the very AI-linked companies whose spending is spurring economic growth. Assuming these companies reap the expected rewards, they should continue to catalyze stock prices and bolster the wealth of shareholders.

Meanwhile, lower and low-middle-income households who own little if any stocks are struggling with an affordability issue, something that is dominating the political discourse this year. . Their purchasing power is derived mostly from job-creating income, which is increasingly squeezed by high prices pushed up by five years of above-trend inflation. The third quarter GDP report starkly captures the bifurcation behind the stunning growth. Consumer spending surged by a robust 3.5 percent, but real incomes were unchanged during the period, indicating that wealth gains drove all of the increase. The good news is that the same forces that propelled growth in 2025 should do so again this year. The bad news is that solid growth amid sticky inflation would prevent the Fed from cutting rates as much as otherwise, perpetuating the bifurcated expansion



KEY ECONOMIC AND FINANCIAL INDICATORS

Financial Indicators *

	November	October	September	August	July	June	May	12-Month Range High	12-Month Range Low
Prime Rate	7.00	7.23	7.38	7.50	7.50	7.50	7.50	7.65	7.00
3-Month Treasury Bill Rate	3.78	3.82	3.92	4.12	4.25	4.23	4.25	4.27	3.78
5-Year Treasury Note Rate	3.67	3.65	3.66	3.79	3.95	3.96	4.02	4.43	3.65
10-Year Treasury Note Rate	4.09	4.06	4.12	4.26	4.39	4.38	4.42	4.63	4.06
30-Year Treasury Bond Rate	4.70	4.64	4.74	4.87	4.92	4.89	4.90	4.92	4.58
Tax-Exempt Bond Yield	4.77	4.77	4.96	5.22	5.27	5.24	5.22	5.27	4.04
Corporate Bond Yield (AAA)	5.26	5.13	5.21	5.35	5.45	5.46	5.54	5.54	5.13
Conventional 30-Year Mortgage Rate	6.24	6.25	6.35	6.59	6.72	6.82	6.82	6.96	6.24
Dow Jones Industrial average	47016	46710	45908	44765	44500	42753	41864	47016	39876
S&P 500 Index	6741	6736	6584	6409	6297	6030	5811	6741	5370
Dividend Yield (S&P)	1.16	1.16	1.19	1.21	1.23	1.28	1.32	1.43	1.16
P/E Ratio (S&P)	27.2	28.4	27.8	26.8	26.9	26.3	25.1	28.4	23.8
Dollar Exchange Rate (vs. Major Currencies)	121.8	121.2	120.5	121.0	120.5	121.0	122.7	129.0	120.5

* Monthly Averages

Economic Indicators

	November	October	September	August	July	June	May	12-Month Range High	12-Month Range Low
Housing Starts (Thousands of Units)		NA	NA	1307	1429	1382	1282	1514	1282
New Home Sales (Thousands of Units)		NA	NA	800	664	676	627	800	623
New Home Prices (Thousands of Dollars)		NA	NA	414	395	404	425	431	395
Retail Sales (% Change Year Ago)		3.5	4.2	5.0	4.1	4.4	3.4	5.10	3.4
Industrial Production (% Change Year Ago)	2.5	2.2	1.9	1.2	1.9	0.6	0.1	1.9	-1.6
Operating Rate (% of Capacity)	76.0	75.9	76.0	76.1	76.4	76.2	75.9	76.4	75.2
Inventory Sales Ratio (Months)		NA	1.37	1.37	1.37	1.38	1.39	1.41	1.37
Real Gross Domestic Product (Annual % Change)			4.3			3.8		3.8	-0.6
Unemployment Rate (Percent)	4.6	4.5	4.4	4.3	4.2	4.1	4.2	4.6	4.0
Payroll Employment (Change in Thousands)	64	-105	108	-26	72	-13	19	323	-105
Hourly Earnings (% Change Year Ago)	3.5	3.7	3.7	3.8	3.9	3.7	3.8	4.0	3.5
Personal Income (% Change Year Ago)		NA	5.0	5.4	5.2	5.2	5.0	6.4	5.0
Savings Rate (Percent of Disposable Income)		NA	4.7	4.7	4.9	5.0	5.2	5.2	4.3
Consumer Credit (Change in Blns. Of Dollars)		9.2	11.0	4.3	16.9	-4.0	8.5	16.9	-111.6
Consumer Prices (% Change Year Ago)		2.7	3.0	2.9	2.7	2.7	2.4	3.0	2.3
CPI Less Food & Energy (% Change Year Ago)		2.6	3.0	3.1	3.1	2.9	2.8	3.3	2.6
Wholesale Prices (% Change Year Ago)		NA	2.7	2.7	3.2	2.4	2.8	3.7	2.4

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