ECONOMIC AND FINANCIAL DIGEST

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A Teflon Economy?

The figures are not in yet, but if current trends continue it looks like the economy will stage another impressive growth rate in the second quarter, following the sturdy 2 percent increase in the first. Not only is the headline impressive, but the main growth engine is also chugging along. Consumers are keeping their wallets open, and unemployment remains near historically low levels of just over 4 percent. Considering the powerful headwinds buffeting the U.S. that's a remarkable performance, one that is poised to outpace other advanced economies. What gives? Is the U.S. totally impervious to the inflation and confidence shattering shocks stemming from the Mid-east conflict? If indeed the economy is shrouded in Teflon, we might as well go on with our business and stop fretting over external events.

But the data says one thing, and most people are saying another. The vibes according to household surveys, are in the dumpster, with consumer sentiment at all-time lows and expectations of job and income prospects no better. This so-called "vibecession" is not new; it has been around for some time even as the economy is putting up impressively good numbers. The situation evokes the notable line in the film *Cool Hand Luke*, where the protagonist claims, "what we have here, is a failure to communicate". Where the disconnect appears now, is between the wealthy and the less fortunate – a wedge often describing a K-shaped economy. The main growth drivers are sitting on the top K line, and everyone else on the bottom line.

Why is this so? Doesn't a rising tide – the broad GDP measure — lift all ships? To a certain extent, it does. After all, the labor market, as noted, is relatively healthy and 60 percent of the population have jobs. As long as most people are receiving paychecks and unemployment is low, depression-era footage of long lines at food banks will remain a distant memory. But an economic engine that runs on few cylinders – wealthy households and AI-fueled investment spending – is vulnerable should either or both fall on hard times. That's not likely to happen in our view, but the wounds from the Mideast conflict, whenever it ends, are biting deeper and the scars will linger after it is over. Hopefully, the healing process will be quick and policy makers will come up with the correct remedy to keep the economy chugging along, bringing more ships along with the rising tide.

The Big Picture Has a Dark Side

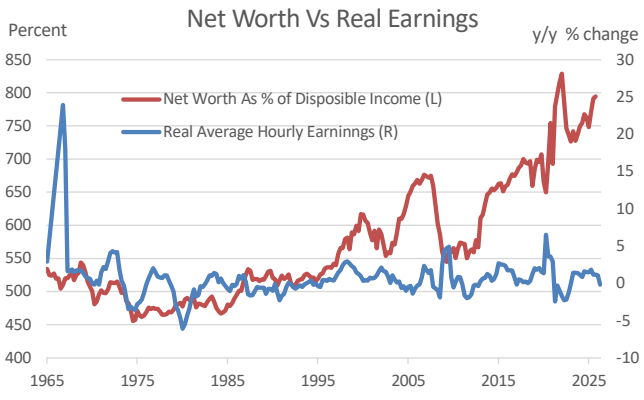
Once again, if you look at the big picture, the headlines portray a bright image of the economy. Top-line growth, as measured by GDP, is forging ahead at an above-trend pace, practically anyone in the labor force looking for a job can find one, as reflected in a historically low unemployment rate, and businesses are enjoying healthy profits, fueling a stock market rally that has lifted equity prices to one record after another. An economist from Mars looking down would clearly view the U.S. as the global shining star.

But as they say, the devil is in the details. The economic engine appears to be running in high gear, but a look under the hood reveals that not all cylinders are operating smoothly. What you see is historically low real income growth and historically high net worth relative to incomes. The former reflects the struggles of rank-and-file workers, whose wage increases have been steadily slowing and are no longer keeping up with inflation. Conversely the small fraction of the population who hold most outstanding stocks are sitting on enormous asset gains in recent years, driving up net worth.

What's more, the Mideast conflict has made things worse for the average worker, as surging gas prices are taking an ever-bigger toll on budgets. In April, service stations accounted for over 8 percent of retail sales, the largest share in three years. Many households are having to cut back on other purchases to fill up at the pump, or dip into already depleted savings to sustain living standards. The good news is that high net worth individuals are taking up the slack, as roughly 3 percent of their asset gains enter the spending stream. That's no small injection; the 8.5 percent increase in stock prices this year (through May 25) translates into $5--$6 trillion of additional wealth. Carving out 3 percent of that increase puts $165 billion of spendable funds into the economy.

The Other Growth Driver

While consumer spending accounts for two-thirds of GDP, and is organically its main growth driver, a smaller sector has



lately been an even more powerful force for growth. The astonishing rapid adoption of AI technology throughout businesses as well as households has led to an equally astonishing surge in investment spending by the purveyors of the new technology. The so-called hyperscalers are pouring funds into data centers, computer chips and software at an unprecedented rate, and their spending has contributed more to GDP growth in recent quarters than has consumer spending.

That economic boost is not about to vanish anytime soon. The tech sector has been racking up enormous profits and has ample cash flow to fund investment spending. Nor are the ones that have a funding shortfall being stifled in their efforts. Investors have a keen interest in the future profitability of AI and are more than willing to buy a stake in the companies involved, providing capital either through purchases of new stock offerings or through loans. Stock investors have been richly rewarded for their investments, as tech companies are among the leaders in the market rally. At the same time, rapidly growing private credit funds are funneling a massive volume of loans to the sector.

However, just as trees don't grow to the sky, there are limits to the tech sector's outperformance. Another bust, like the dot-com fiasco, is unlikely as the vast majority of tech companies are delivering products that have value and are generating actual earnings, unlike the sock puppet that was emblematic of the bust at the turn of the century. But their stock prices have raced far ahead of earnings, and many analysts worry that they are overpriced, heightening the risk of a setback. While some would welcome a correction, the risk is that it could feed on itself if market sentiment turns against the industry. As it is, there is a growing public backlash towards AI, reflecting concerns over worker displacement, cultural anxieties, civil liberties and fake information. Pocketbook issues are poised to become more of a factor, as the huge demand for energy-hogging infrastructure is driving up electricity costs. A growing number of localities are banning proposed data centers for that very reason. If this backlash bleeds into the financial markets and leads to a severe correction that dents the net worth of wealthy households, a major source of consumer spending would weaken.

AI Driving Growth but Disrupting the Workforce

Perhaps the most headline-grabbing concern regarding AI is its potential to replace workers and the killing of job prospects for recent graduates. It's well known that the current job market is one of the worst in recent memory for young people just receiving college degrees. Many entry level positions have been automated by AI, particularly in the information field where layoffs have risen significantly and openings for newly minted software engineers and coders have virtually disappeared. Overall, recent graduate unemployment rates have risen markedly since 2022, hitting 5.6% in March, which is far higher than the national unemployment rate of 4.3%.

So far, the plight of these workers has not shown up in the broad unemployment data, as the headline jobless rate has hardly budged in two years. But that's not because these displaced workers are finding jobs in other industries. Simply put, fewer jobs need to be created than before to keep the unemployment rate from rising, as the closing of the immigration spigot has stifled the growth in the labor supply. Meanwhile, the void left by foreign-born workers is not being filled by the native population, as ageing baby boomers are leaving the labor force in droves.

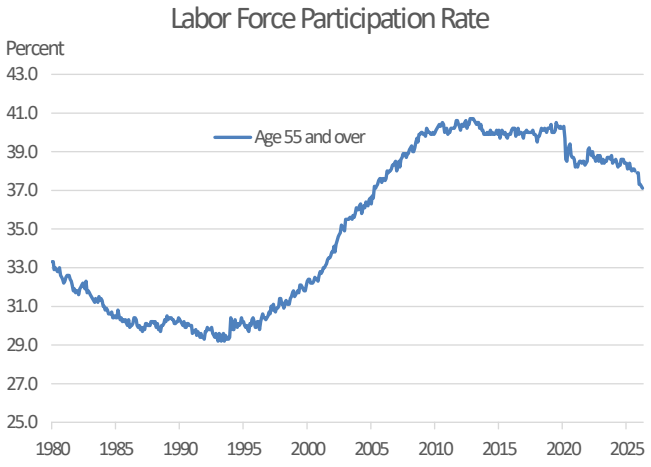
After rising for decades and then hovering around 40% in the 2010s, the share of Americans over age 55 and in the workforce has slipped to 37.1%, the lowest level in more than 20 years. The financial cushion of rising home equity and stock-market returns is driving some of the decline, but many older professionals say they don't want to spend the last years of their career going through the tumult of AI adoption, which has brought new tools, new expectations and a lot of uncertainty.

When the Facts Change, So Does Policy

The rapid growth of AI technology along with the Iran conflict have been two of the most consequential influences on the economy this year—and the endgame for both is still unclear. What is clear is that they have changed how the Federal Reserve perceives the risks facing the economy and upended its rate-setting plans. The oft-quoted sentiment expressed by the notable economist, John Maynard Keynes, "When the facts change, I change my mind. What do you do sir?" clearly applies here. Indeed, the economic landscape has clearly evolved in a much different way than thought a few months ago.

Early in the year, the biggest risk was perceived to be a slowing economy, as job growth stagnated, tariff-induced price hikes eroded income and a long government shutdown snuffed out GDP growth in the fourth quarter. With the tariff effect fading, the Fed thought inflation would too, providing cover for the planned two additional interest rate cuts it had penciled in for this year. But as the boxer Mike Tyson opined before a fight, everyone has a plan until they get punched in the face. That punch was delivered with a wallop when the war on Iran erupted, sending gas prices sky high and stoking both inflation and inflation expectations, as well as a surge in market interest rates. With the economy still chugging along, thanks to spending on AI and by high net-worth households, the Fed is now viewed as likely to raise rates as to cut them this year.

But as we have seen in recent years, facts are not immutable; we are living in a fast-changing world that makes the outlook highly unpredictable. Tariffs, new technology and geopolitical turmoil are just the latest external shocks that complicate planning decisions. The economy may be shrouded in Teflon now, but the Fed needs to be just as nimble to respond to these changes before deep



KEY ECONOMIC AND FINANCIAL INDICATORS

Financial Indicators *

	April	March	February	January	December	November	October	12-Month Range High	12-Month Range Low
Prime Rate	6.75	6.75	6.75	6.75	6.83	7.00	7.23	7.50	6.75
3-Month Treasury Bill Rate	3.61	3.61	3.57	3.57	3.59	3.78	3.82	4.25	3.57
5-Year Treasury Note Rate	3.94	3.85	3.78	3.78	3.70	3.67	3.65	4.02	3.65
10-Year Treasury Note Rate	4.32	4.25	4.21	4.21	4.14	4.09	4.06	4.42	4.06
30-Year Treasury Bond Rate	4.91	4.85	4.84	4.84	4.80	4.70	4.64	4.92	4.64
Tax-Exempt Bond Yield	4.74	4.84	4.77	4.79	4.80	4.77	4.77	5.27	4.74
Corporate Bond Yield (AAA)	5.42	5.48	5.34	5.34	5.31	5.26	5.13	5.54	5.13
Conventional 30-Year Mortgage Rate	6.33	6.18	6.10	6.10	6.19	6.24	6.25	6.82	6.10
Dow Jones Industrial average	48430	46860	49138	49138	48119	47016	46710	49138	41864
S&P 500 Index	6957	6654	6929	6929	6853	6741	6736	6957	5811
Dividend Yield (S&P)	1.16	1.21	1.16	1.15	1.15	1.16	1.16	1.32	1.15
P/E Ratio (S&P)	28.2	25.6	26.9	27.7	27.3	27.2	28.4	28.4	25.1
Dollar Exchange Rate (vs. Major Currencies)	119.0	119.9	119.2	119.2	120.6	121.8	121.2	122.7	119.0

* Monthly Averages

Economic Indicators

	April	March	February	January	December	November	October	12-Month Range High	12-Month Range Low
Housing Starts (Thousands of Units)	1465	1507	1346	1385	1378	1319	1273	1507	1273
New Home Sales (Thousands of Units)		682	635	583	728	748	650	748	583
New Home Prices (Thousands of Dollars)		387	409	413	429	403	404	720	387
Retail Sales (% Change Year Ago)	4.9	4.2	4.2	3.3	2.4	3.2	3.2	5.00	2.4
Industrial Production (% Change Year Ago)	1.4	0.8	1.0	1.4	1.2	1.8	1.8	1.9	0.1
Operating Rate (% of Capacity)	76.1	75.6	76.0	75.6	75.7	75.4	75.6	76.4	75.4
Inventory Sales Ratio (Months)		1.32	1.33	1.35	1.36	1.37	1.38	1.39	1.32
Real Gross Domestic Product (Annual % Change)		2.0			0.5			3.8	-0.6
Unemployment Rate (Percent)	4.3	4.3	4.4	4.3	4.4	4.5	4.5	4.5	4.1
Payroll Employment (Change in Thousands)	115	185	-156	-41	-17	41	-140	185	-156
Hourly Earnings (% Change Year Ago)	3.6	3.8	3.8	3.8	3.7	3.9	3.9	4.0	3.6
Personal Income (% Change Year Ago)		4.5	4.2	4.5	4.2	4.3	4.4	5.6	4.2
Savings Rate (Percent of Disposable Income)		3.6	4	4.5	3.6	4.5	4.4	5.5	3.6
Consumer Credit (Change in Blns. Of Dollars)			9.5	7.7	15.8	3.2	7.9	17.9	-4.3
Consumer Prices (% Change Year Ago)	3.8	3.3	2.4	2.4	2.7	2.7	2.7	3.8	2.4
CPI Less Food & Energy (% Change Year Ago)	2.8	2.6	2.5	2.5	2.6	2.6	2.6	3.1	2.5
Wholesale Prices (% Change Year Ago)	6.0	4.3	3.4	3.0	3.1	3.1	2.8	6.0	2.4

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