ECONOMIC AND FINANCIAL DIGEST

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This Isn't Your Boring Bond Market

With the dog days of summer over the economy has entered a new season that, hopefully, will be more tranquil than the last. Sadly, that prospect is looking less likely with each passing day. The Iran war is still raging, energy prices are still elevated, trade tensions are still ramping up and households are still downbeat, particularly among the budget-constrained lower-income cohort. In addition to these lingering stressors, the U.S. is bracing for the mid-term elections, with the onslaught of usual negative campaign ads, and the beginning of what is likely an interest-rate hiking cycle by the Federal Reserve. The first took place on September 18 and all indications are that more will come.

What can we make of all of this? Well first, there is no need to jump off a cliff. Despite the turmoil over the summer, the economy has weathered the storm quite admirably. With two months of critical data on the books, it looks like it will expand by a healthy pace of around 4 percent in the third quarter, which would double the growth rate over the first half of the year and is solidly faster than the long-term trend. The job market is holding up as unemployment continues to hug a near-historic low of 4.1 percent. Consumers, the economy's main growth driver, are still spending, fueled by wealth gains in the stock market accruing to affluent households. An equally powerful contribution is coming from the AI buildout, generating billions of dollars for construction spending on data centers, semiconductors and other tech-related projects.

But there is a downside to all this that could soon become troublesome for the economy. The top-line growth rate – GDP – is, as noted above, supported mainly by wealth gains in the stock market and by AI-related investment spending. It's questionable whether these are sustainable influences. The AI boom is juicing the stock market, so if one falters the other will most likely too. Meanwhile, elevated inflation is prompting the Fed to raise interest rates, which until now the economy has been strong enough to accommodate. But what happens if tariffs and war keep inflation high, but the economy weakens and job losses mount? That toxic mix would put policymakers in an untenable position of having to choose between the least-worst option. From our lens, that's not the most likely outcome, but in an unsettled economic landscape buffeted by ongoing shocks, it could be a stormy ride heading into the winter.

Bond Market Takes Center Stage

When it comes to headline-grabbing news in the financial press, the stock marketends to get most attention as wide swings can have life-changing effects for millions of investors – from billionaires down to common folk trying to build a nest egg for retirement. At times, as is currently the case, it can also have a meaningful impact on economic activity, fostering more spending or less. But the less sexy bond market has a broader and deeper influence on the economy, and it captures the most attention from policy makers. President Trump recently changed a tariff policy because he thought the bond market was acting a little too "yippy".

Importantly, it is the bond market, broadly defined to include short and long-term securities, through which the nation's vast sums of money are borrowed that forms the lifeblood of the economy. When interest rates and borrowing costs go up, it becomes more expensive for the government to service its debt and for corporations to finance investment spending and pay workers' salaries. Households don't borrow directly in the bond market, but the rate they pay on credit cards, auto loans and mortgages are linked to the yields in the bond market as well as to the rate-setting policy of the Federal Reserve.

That's why so much attention was paid when the bellwether 10-year Treasury yield pierced 5 percent in recent weeks, a threshold briefly hit three years ago but not seen more lastingly since before the 2008 financial crisis. To some, passing this psychological level could be the tipping point for a U.S. economy that has become accustomed to twenty years of low interest rates. Before jumping to that conclusion, however, it's important to recognize that while 5 percent seems high to the current generation, it is below where it was for almost all of forty years prior to 2007. True, times and conditions are different, but we caution that there is no magic number that determines whether the economy expands or sinks

Direction and Speed Matter

Instead of the level, the more important influence is the direction and speed with which bond yields rise or fall. What



caught the attention more than reaching 5 percent was how quickly it got there and whether the direction continues to move higher. Earlier this year, when it was thought the Fed might cut rates the 10-year yield hovered around 4 percent and seemed likely to fall through that level, raising hopes that mortgage rates would follow and make homes affordable for millions of potential buyers who were shut out of the housing market. An additional positive side effect is that refinancing of older mortgages into ones with lower rates puts fresh cash into the hands of homeowners that could be used for other spending purposes.

But before that prospect could gain traction, the direction of rates changed again, snuffing out any housing revival and refinancing dividend for owners. Outside of the housing sector, however, the economy continued to flourish. Higher interest rates did not deter consumer spending, which actually grew stronger during the spring and summer. One reason: households of all stripes — low as well as middle-income Americans – benefited from fiscal policy, including outsize tax refunds and tax cuts from last year's One Big Beautiful Bill Act. That took the sting out of higher borrowing costs that households incurred due to the backup in market yields.

By the summer, however, those tax refunds were spent even as the Mid-East conflict intensified and broadened, driving up energy costs and inflation. With higher prices taking a bigger bite out of incomes, the bifurcated economy became even more transparent, as gas and utility bills account for a bigger share of low-income budgets than they do for more affluent households. For now, that drag is being offset by the tailwind from rising financial wealth, which jumped in the second quarter to 570% of households' incomes, a new record high, and well above the peak of the dot-com bubble. With most of that wealth held by the top 20% of households by income, those more affluent households are doing most of th e heavy lifting behind consumer spending.

No Help Coming

But the wealth effect can only go so far. Without reinforcement from lower income households, consumer spending will not maintain the solid pace seen so far this year. The combination of high inflation and rising interest rates is taking an increasing toll on the vast majority of consumers, now that the tailwind from fiscal stimulus is no longer buoying purchasing power. Indeed, real incomes have fallen for five consecutive months, as worker pay has not kept up with inflation. What's more, the savings cushion built up from the tax refunds and other transfer payments has been depleted, as the personal savings rate has fallen to near the lowest level in almost 20 years over the summer.

Hence, to keep the economy on a positive footing, it behooves policy makers to shore up the financial muscle of households. Lower inflation and lower interest rates would go a long way towards that effort, but the signals are not very promising. Forget additional help from Washington before the elections, or afterwards if a divided Congress is the outcome. In that event – which pollsters deem the most likely result – gridlock will set in until the early years following the next presidential election, when major legislation tends to get approved.

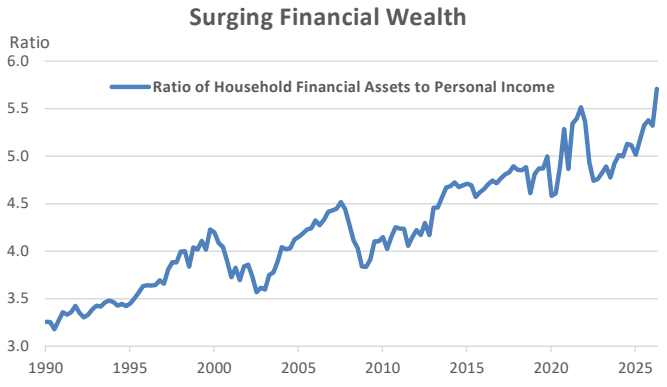
Nor is help coming from the central bank. The Federal Reserve, which seemed on the verge of cutting rates earlier this year, has done a complete about-face. The new Chairman, Kevin Warsh, firmly believes that monetary policy has been too easy this year, allowing inflation to fester amid strong growth, and is committed to tapping the brakes until inflation retreats. Following the September 18 quarter-point rate hike, he stated in the post-meeting press conference that the increase merely "removed a dose of accommodation", strongly hinting that more increases are on the way. The financial markets are pricing in at least three more increases by the middle of next year.

Higher For Longer

To be sure, the best-laid plan do not always work out. Right now it appears almost certain that more rate hikes are coming. The economy is heating up. Inflation remains stubbornly above the Fed's 2 percent target and unemployment is low. But as we have seen in recent years, Fed policy is not on a preordained course. When the facts change, so do opinions. In a world where unpredictable external shocks, most notably wars, trade tensions and spiraling energy prices, are having such a critical influence on economic and financial conditions, any forecast of what the Fed will do beyond the next few months should be viewed as tentative at best.

Even if the Fed shifts gears again in response to actual or perceived changes in underlying conditions, it does not mean the bond market would comply. Keep in mind that the central bank is not the only influence that moves interest rates. There are several instances in the past when bond market yields fell after the Fed hiked rates. One such event happened in the 1990s, which the then Fed Chair, Alan Greenspan, famously called a "conundrum". Others in the bond market call that a bullish rate hike, inferring that it will cool inflation and slow growth. This time, however, traders are driving bond yields higher, not only because of strong growth and high inflation. They also see an enormous demand for credit to finance the AI buildout that is competing with the government's massive borrowing to finance a $2 trillion deficit.

Simply put, the bond market is dictated by global and structural forces as well as by what the Fed does with its policy rate. That brew of influences is expected to keep rates higher for longer than expected a few weeks ago. Whether or not that sows the seeds of an economic downturn remains to be seen. We caution again that while rates are higher than they have been in some time, they are not that high by historical yardsticks. The AI buildout with its massive borrowing needs is no doubt contributing to inflation and higher interest rates, but it is also driving growth. If it also delivers the advertised productivity improvement, the economy will benefit from lower inflation and hence, lower interest rates. But if we are facing an AI bubble that could burst and extinguish a great deal of wealth, a dark cloud overhangs the future..



KEY ECONOMIC AND FINANCIAL INDICATORS

Financial Indicators *

	August	July	June	May	April	March	February	12-Month Range High	12-Month Range Low
Prime Rate	6.75	6.75	6.75	6.75	6.75	6.75	6.75	7.38	6.75
3-Month Treasury Bill Rate	3.72	3.73	3.66	3.60	3.61	3.61	3.57	3.92	3.57
5-Year Treasury Note Rate	4.38	4.33	4.21	4.15	3.94	3.85	3.78	4.38	3.65
10-Year Treasury Note Rate	4.68	4.60	4.47	4.48	4.32	4.25	4.21	4.68	4.06
30-Year Treasury Bond Rate	5.22	5.10	4.95	5.03	4.91	4.85	4.84	5.22	4.64
Tax-Exempt Bond Yield	4.73	4.71	4.70	4.78	4.74	4.84	4.77	4.96	4.70
Corporate Bond Yield (AAA)	5.88	5.76	5.52	5.56	5.42	5.48	5.34	5.88	5.13
Conventional 30-Year Mortgage Rate	6.67	6.54	6.49	6.44	6.33	6.18	6.10	6.67	6.10
Dow Jones Industrial average	53606	52373	51399	49917	48430	46860	49138	53606	45908
S&P 500 Index	7711	7481	7450	7413	6957	6654	6929	7711	6584
Dividend Yield (S&P)	1.07	1.10	1.10	1.09	1.16	1.21	1.16	1.21	1.07
P/E Ratio (S&P)	26.3	27.8	27.9	28.1	28.2	25.6	26.9	28.4	25.6
Dollar Exchange Rate (vs. Major Currencies)	118.9	120.6	118.8	118.8	119.0	119.9	119.2	121.8	118.8

* Monthly Averages

Economic Indicators

	Augusut	July	June	May	April	March	February	12-Month Range High	12-Month Range Low
Housing Starts (Thousands of Units)	1275	1309	1439	1182	1414	1522	1346	1522	1182
New Home Sales (Thousands of Units)	684	643	672	636	641	659	630	757	576
New Home Prices (Thousands of Dollars)	394	392	406	414	416	399	412	429	392
Retail Sales (% Change Year Ago)	6.0	5.0	6.8	7.2	5.1	4.2	4.2	7.2	2.4
Industrial Production (% Change Year Ago)	1.4	1.1	1.3	1.5	1.4	0.7	0.8	1.9	0.7
Operating Rate (% of Capacity)	76.3	76.3	76.2	76.1	76.1	75.6	75.8	76.3	75.2
Inventory Sales Ratio (Months)		1.30	1.30	1.28	1.30	1.32	1.33	1.38	1.28
Real Gross Domestic Product (Annual % Change)			1.5			2.1		4.4	0.5
Unemployment Rate (Percent)	4.1	4.1	4.2	4.3	4.3	4.3	4.4	4.5	4.1
Payroll Employment (Change in Thousands)	162	21	31	63	148	214	-156	214	-156
Hourly Earnings (% Change Year Ago)	3.1	3.2	3.4	3.3	3.6	3.4	3.7	3.9	3.1
Personal Income (% Change Year Ago)		3.7	3.9	3.9	2.7	3.3	3.5	5.1	2.7
Savings Rate (Percent of Disposable Income)		3.0	2.6	2.8	3.0	3.5	3.8	4.4	2.6
Consumer Credit (Change in Blns. Of Dollars)		18.1	14.6	2.0	20.2	21.0	7.2	21.0	2.0
Consumer Prices (% Change Year Ago)	3.4	3.4	3.5	4.2	3.8	3.3	2.4	4.2	2.4
CPI Less Food & Energy (% Change Year Ago)	2.4	2.5	2.6	2.9	2.8	2.6	2.5	3.0	2.4
Wholesale Prices (% Change Year Ago)	5.4	4.8	5.6	5.9	5.7	4.3	3.4	5.9	2.8

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