ECONOMIC AND FINANCIAL DIGEST

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Navigating An Economy Held Hostage By The War

The truce that calmed oil markets in June has collapsed, and the reescalation of US-Iran hostilities has put energy back at the center of the outlook. Gas prices have already jumped back above $4 a gallon, putting renewed pressure on inflation, the consumer, and the Federal Reserve. It appears the combatants have moved into a risk management mode, stepping in just before catastrophe hits but not ready to abandon hostilities until a deal is reached that both sides can live with. When that happens and what compromises are in store remain to be seen. In the meantime, the economic landscape remains as fluid as ever.

That said, a few observations about underlying conditions can be made. For one, despite the noise from volatile oil prices, the economy is holding up reasonably well and the oil crisis has not upended inflation prospects– at least not yet. For another, the worst-case scenarios for the economy linked to tariffs and immigration policies have not played out. The tariff impact has been relatively muted, and the squeeze on labor supply from reduced immigration has not impaired the job market. Job growth has been stronger than expected, and there has been no shortage of workers to fill positions. Finally, the financial markets are responding more calmly to the disruptive shocks than would be expected. Stock prices continue to hover near record levels, and the climb in market interest rates has been modest, although meaningful.

Is there smooth sailing ahead? That would be a stretch. Perhaps the biggest risk to the outlook is that policymakers draw wrong conclusions from the swirl of events and make decisions that could do more harm than good. The new Fed Chair, Kevin Warsh, has his hands full, dealing with old problems in a new bottle. Despite the welcome inflation relief seen in the June consumer price report, inflation is still running too high, and Warsh has set low inflation as his top priority. But raising interest rates to bring that about runs the risk of slowing the economy without stifling the very catalysts stoking inflation – high energy prices linked to the Mideast war. The fog of war continues to cloud the outlook, but barring policy missteps and assuming an acceptable truce is struck in the foreseeable future, the economy should muddle through the rest of the year and regain momentum for a peacetime recovery in 2027.

Mission Accomplished?

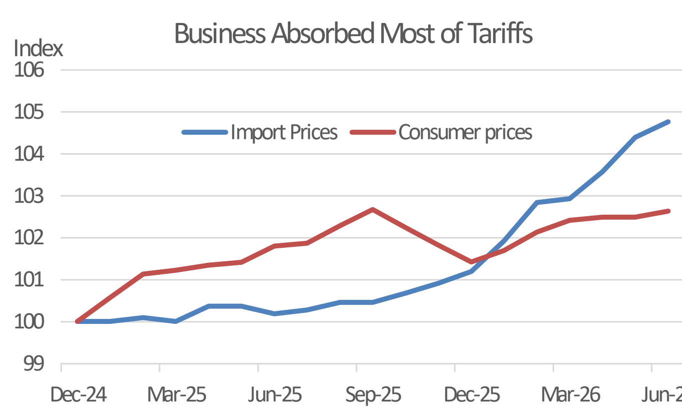
Just as it seemed inflation was getting out of control and forcing the Fed to raise interest rates, a very benign and welcome consumer price report for June hit the headlines, prompting a lot of rethinking among traders and economists. What the latest report makes abundantly clear is that the inflation scare in recent months is primarily an energy shock. The war-induced surge in oil – and gasoline – prices was the primary culprit sending inflation up, and its sudden plunge following the temporary truce in June brought inflation down. As this is written, oil prices are heading up again, so the June reprieve will be followed by a July relapse. This ebb and flow will continue as long as hostilities wax and wane and roil the energy markets.

What is also becoming apparent is that the hoopla over tariffs was more noise than substance. Of course, nothing is forever and it would be a mistake to say that tariffs won't at some point become more of an inflationary influence. If nothing else, the financial markets are agitated whenever new tariffs are announced as they create uncertainty, complicate business planning decisions and cause supply chain problems. But since the U.S. launched its Liberty Day tariffs in the spring of 2025, the impact on consumer prices has been much less than feared.

The reason: Businesses have been willing to absorb most of the increased costs imposed by tariffs. A simple exercise illustrates this point. Since March 2025, just a month before the liberty day tariff blitz took hold, import prices for goods excluding food and fuel, most of which are destined to reach consumer shelves, increased by 4.8 percent. But consumer prices for those same goods increased by less than a third as much, rising by just 1.4 percent over the period. Simply put, businesses have passed through only about 30 percent of the tariff increase. However, any thoughts that corporations absorbed the cost increase for charitable reasons would be misguided.

Corporate Earnings Provide a Big Cushion

Despite absorbing a roughly tripling of the effective tariff rate since early last year, corporate earnings continued to stage remarkable gains through the first half of the year. To be sure, a



few giant tech firms (the Maga 7) are leading the way with a projected 31 percent increase this year; but the gains among the remaining 493 firms are nothing to sneeze at, as their combined bottom lines are expected to increase by more than 20 percent. Small wonder that amidst the formidable headwinds hitting the economic landscape, the stock market continued to forge ahead through mid-summer.

Economists have no clearcut explanation as to how companies continue to generate powerful earnings in an economy that is growing below its long term trend. One theory is that the bloat built up during the pandemic – i.e. over hiring to meet torrid demand juiced by stimulus-fueled consumers – is still being worked off to drive current output. Hence, revenues are being generated from the labor costs set five years ago. Another popular notion is that AI technology is boosting labor productivity, as early adopters have rapidly moved up the learning curve and are applying the transformative technology in ways that cut costs and expand output. From our lens, however, most of the cost efficiencies and productivity gains from AI are yet to come.

Whatever the catalyst, one thing is clear: the sturdy earnings increase has come at the expense of labor. Make no mistake. The tide is lifting all ships, as gross domestic income has grown by 63 percent since the pandemic in 2020. But the slices of the enlarged pie have changed, with corporate profits rising from 9.3 percent of GDI to 11.5 percent in 2024, the last year available . Meanwhile, labor has gotten an ever smaller slice of the income pie, as its share has shrunk from 54.6 percent to 51.9 percent.

Weaker Bargaining Power

Simply put, labor's competitive standing in the income distribution chain has weakened considerably over the years. There are many reasons why that has occurred, but few stand out. Most notably, a swath of workers have lost their biggest bargaining weapon – unions – which have historically negotiated through strength in numbers to assure workers share equally in the growing economy, as well as retain job security. But those numbers have shrunk dramatically over the years. Today, union membership has declined to under 6 percent of private sector employment from 12 percent in 1990, when globalization gained traction.

In the absence of union muscle, workers have less power at the bargaining table. Making matters worse is that globalization has eviscerated the manufacturing sector, sending millions of jobs overseas that were previously filled in the U.S. Not surprisingly, there is a connection between offshoring and the declining power of unions because the bulk of those lost jobs were typically held by union members. Meanwhile, even as union jobs were replaced by cheaper labor overseas, company profits benefited from importing supplies and materials made by foreign workers that are less costly than if they were made domestically.

Finally, U.S companies have made great strides in boosting productivity, thanks mainly to technological advances in the workplace, such as the growing use of robotics, and other cost-savings measures, including improved inventory management and exploiting tax-incentives that encourage investments in capital equipment over hiring workers. Importantly, workers have not shared equally in the productivity gains, most of which embellished profits at the expense of labor income.

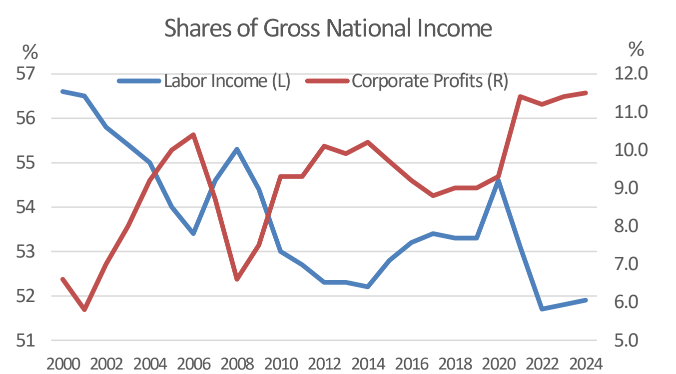
Fed Can't Fix Structural Problems

The shifting shares of national income is a structural problem that policy makers cannot easily fix. A drastic change in tax policies might level the playing field. But that is not widely supported, nor tested as it could have unintended consequences by hurting workers more than profitability. A more relevant and timely discussion linked to the increased share of corporate earnings is the growing income and wealth disparity among households.

Profits and the capital gains stemming from those profits have greatly boosted the wealth of a small fraction of the population. Meanwhile the livelihood of most households depends on the very labor-generated income that is losing ground to corporate earnings. This too is not easily fixable. One popular remedy gaining steam is a wealth tax on the rich, which proponents claim would not only level the playing field, but help finance the government's burgeoning deficit. But this also has many flaws that could do more harm than good. The economy derives most of its strength from consumer spending, and the so-called wealth effect – spending by affluent households – has done much of the heavy lifting in recent years. Policies that would dampen the wealth effect would also cut off a major source of spending, which would translate into fewer jobs and lower wages than otherwise

As we move further into the second half of the year, the economy continues to derive much of its strength from the two influences that underscore the widening gap between profits and labor income and between the wealthy and other households – strong spending on productivity-enhancing investments and the wealth effect on consumption from affluent households. Layered on top of this is the war-induced inflation shock.

Policymakers in Washington do not want to rock the boat before the mid-term elections, which leaves only the Federal Reserve with the flexibility to effect change by raising or lowering interest rates. This is a delicate balancing act that the Fed will grapple with in coming months. Tamping down inflation is its primary concern now, but higher energy prices are a tax on households as well as an inflation catalyst. The longer the war continues, the greater the risk that inflation will bite further into income and stifle consumer spending. Raising interest rates now to combat an inflation catalyst it has no control over – the war – would only make things worse by imposing a bigger drag on the economy. There is a nontrivial chance the Fed will raise rates at the next meeting. But the best move would be no move at all until the fog of war clears, removing the major risk of a policy mistake that would derail any peacetime recovery from happening.



KEY ECONOMIC AND FINANCIAL INDICATORS

Financial Indicators *

	June	May	April	March	February	January	December	12-Month Range High	12-Month Range Low
Prime Rate	6.75	6.75	6.75	6.75	6.75	6.75	6.83	7.50	6.75
3-Month Treasury Bill Rate	3.66	3.60	3.61	3.61	3.57	3.57	3.59	4.25	3.57
5-Year Treasury Note Rate	4.21	4.15	3.94	3.85	3.78	3.78	3.70	4.21	3.65
10-Year Treasury Note Rate	4.47	4.48	4.32	4.25	4.21	4.21	4.14	4.48	4.06
30-Year Treasury Bond Rate	4.95	5.03	4.91	4.85	4.84	4.84	4.80	5.03	4.64
Tax-Exempt Bond Yield	4.68	4.78	4.74	4.84	4.77	4.79	4.80	5.27	4.68
Corporate Bond Yield (AAA)	5.52	5.56	5.42	5.48	5.34	5.34	5.31	5.56	5.13
Conventional 30-Year Mortgage Rate	6.49	6.44	6.33	6.18	6.10	6.10	6.19	6.72	6.10
								0.00	0.00
Dow Jones Industrial average	51399	49917	48430	46860	49138	49138	48119	51399	44500
S&P 500 Index	7450	7413	6957	6654	6929	6929	6853	7450	6297
Dividend Yield (S&P)		1.09	1.16	1.21	1.16	1.15	1.15	1.23	1.09
P/E Ratio (S&P)	27.6	27.9	28.2	25.6	26.9	27.7	27.3	28.4	25.6
Dollar Exchange Rate (vs. Major Currencies)	118.8	118.8	119.0	119.9	119.2	119.2	120.6	121.8	118.8

* Monthly Averages

Economic Indicators

	June	May	April	March	February	January	December	12-Month Range High	12-Month Range Low
Housing Starts (Thousands of Units)	1427	1199	1414	1522	1346	1385	1378	1522	1199
New Home Sales (Thousands of Units)	628	618	646	659	630	576	723	757	576
New Home Prices (Thousands of Dollars)	398	412	416	399	412	416	429	429	397
Retail Sales (% Change Year Ago)	6.7	7.3	5.1	4.2	4.2	3.3	2.4	7.3	2.4
Industrial Production (% Change Year Ago)	1.1	1.6	1.3	0.6	0.8	1.1	1.2	1.9	0.6
Operating Rate (% of Capacity)	76.1	76.1	76.0	75.5	76.0	75.6	75.7	76.4	75.4
Inventory Sales Ratio (Months)		1.28	1.30	1.32	1.33	1.35	1.36	1.39	1.30
Real Gross Domestic Product (Annual % Change)				2.1			0.5	4.4	0.5
Unemployment Rate (Percent)	4.2	4.3	4.3	4.3	4.4	4.3	4.4	4.5	4.2
Payroll Employment (Change in Thousands)	57	129	148	214	-156	-41	-17	214	-156
Hourly Earnings (% Change Year Ago)	3.5	3.4	3.6	3.8	3.8	3.8	3.7	4.0	3.4
Personal Income (% Change Year Ago)		3.8	2.6	3.3	3.5	4.0	4.2	5.1	2.6
Savings Rate (Percent of Disposable Income)		3.0	3	3.5	3.8	4.4	3.6	4.6	3.0
Consumer Credit (Change in Blns. Of Dollars)		-0.2	20.8	22.8	7.2	4.4	15.1	22.8	-4.3
Consumer Prices (% Change Year Ago)	3.5	4.2	3.8	3.3	2.4	2.4	2.7	4.2	2.4
CPI Less Food & Energy (% Change Year Ago)	2.6	2.9	2.8	2.6	2.5	2.5	2.6	3.1	2.5
Wholesale Prices (% Change Year Ago)	5.5	6.0	5.6	4.3	3.4	3.0	3.1	6.0	2.7