



A Curious Balance

Despite the drama leading up to the latest Federal Reserve policy meeting, monetary officials did the expected - cutting interest rates for the first time this year. While unsurprising, the move was shrouded in a good deal of controversy; and future actions are hardly cast in stone. The drama concerned who would actually participate in the meeting, as one newly appointed governor was confirmed by the Senate just a day before the meeting took place and another appeared only by the good grace of the court, which temporarily disallowed the administration's legal action to remove her for cause. Still, the drama was not expected to upend the expected rate cut that ultimately took place, which came in at the widely predicted quarter of a percent.

That said, the outcome of the meeting raised more questions than answers. Why, for example, did the Fed decide to lower interest rates while inflation was still running well above its 2 percent target (and going up) and the economy continues to grow at a solid pace. Indeed, recent data on consumer spending came in much stronger than expected and AI is powering muscular capital spending by businesses. Historically, those underlying conditions would strengthen the case for more vigilance by the Fed, keeping rates higher than otherwise to stave off inflation. But not only did the central bank go ahead with the rate cut, the median forecast of the 19 members of the rate-setting committee expect to lower rates twice more this year and continue on that path throughout 2026.

The Fed's answer is straight forward, but subject to change if the facts change. Like decision makers in the private sector (and casinos) Fed officials are taking a risk management approach to policy decisions. The cards being dealt may not have changed much from the previous meeting when the decision to keep rates steady was made; but the perceived risks concerning future jobs and inflation have changed. Keep in mind that the Fed is looking through the windshield, not the rear-view mirror when making policy decisions. What it sees now is the greater risk of a jobs meltdown than an inflation flareup and it decided to take out an insurance rate cut to mitigate the greater risk.

Low Unemployment, Just Not For Everyone

On the surface, it would seem the Fed is making a mountain out of a molehill. After all, the unemployment rate, at 4.3 percent in August, is near historic lows, suggesting a healthy job market. But as they say, the devil is in the details. The unemployment rate provides a valuable snapshot of labor market conditions, but it's a summary measure that masks underlying fissures that may be poised to deepen.

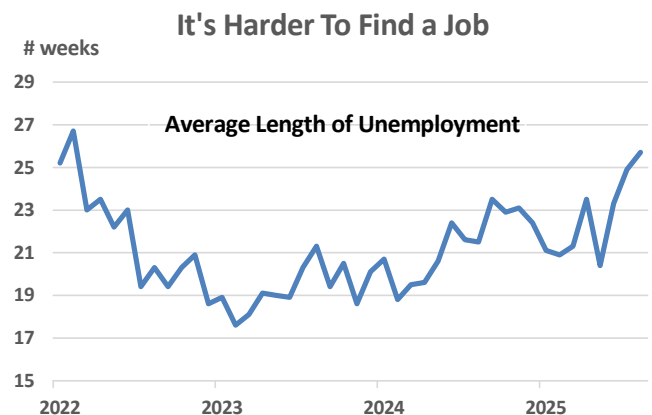
Fed Chair Powell astutely pointed out that the low unemployment rate reflects a "curious balance" between the demand for and

supply of labor. This Sherlockian notion reflects the fact that both sides of the ledger are falling at about the same pace, keeping the unemployment rate steady. But rather than seeing that balance as an equilibrium, Powell fears that it is unsustainable. The supply side, i.e., the labor force, is being restrained mainly by reduced immigration, which is shrinking the number of foreign-born workers available to hire. But that shortage has not increased the demand for native-born Americans, as businesses are in a hiring freeze, worried primarily about the impact of tariffs on sales. The good news is that they are not laying off workers as they are just as worried about rehiring difficulties if sales hold up better than expected.

The bad news about this "no hiring/no firing" mentality is that many people searching for a job are out of luck. The percent of jobless workers on the unemployment lines for more than six months is the highest since December 2021, stretching the average duration of unemployment to the highest level in more than three years. Most workers know someone experiencing a long bout of unemployment and are staying put out of growing insecurity over retaining their own paychecks. This is reducing the voluntary quit rate and dampening worker bargaining power, pointing to slower wage growth. Fears of job losses over the next six months have surged in recent surveys.

But Sales are Booming

That raises the question of why spending is still so strong. As noted, retail sales staged a much bigger increase in August than expected, and sales for the previous months were revised



higher. Hence, the slog in spending seen earlier in the year, which many thought was a recession signal, was more of a head-fake than a portent. Consumers reopened their wallets in the second quarter and spending is tracking even stronger growth in the third quarter.

As it turned out, the earlier weakness was caused more by heightened uncertainty over tariffs and fiscal policy than deteriorating fundamentals. Nothing causes inertia among consumers more than uncertainty, particularly when it comes to influences that affect household budgets. Since the Liberation Day tariff announcements, however, the fog of uncertainty has lifted, albeit full clarity on the tariff front still awaits. Meanwhile, the One Big Beautiful Bill Act was passed by Congress in July, removing a source of uncertainty over tax and spending prospects that loom in 2026.

But a look under the hood of the spending rebound reveals that there is more afoot than meets the eye. Yes, aggregate sales staged a healthy increase, but not all consumers went on a spending binge. As has been the case for some time, upper income individuals have been driving the gains. Keep in mind that the top 20 percent of income earners account for about 45 percent of total spending in the economy. This cohort has been thriving, nurtured by surging stock portfolios and home values. Recent studies show that every one dollar increase in household wealth generates about 14 cents in additional spending. That wealth boost has contributed mightily to consumer spending this year. Meanwhile, lower income households have struggled under the weight of higher prices and slower income gains. . Simply put, the robust gain in personal spending is masking a bifurcated consumer that could run into a wall if a market setback dings the wealth effect.

Spending Not Boosting Jobs

Importantly, the resilience seen in consumer spending is not helping people find jobs. To say that the job-creation engine is petering out would be an understatement. Over the past three months, the growth in nonfarm payrolls has downshifted to an average of 27 thousand a month, including an outright 13 thousand decline in June. Unless it is revised higher, that marks the first negative reading on jobs since December 2020. In 2024, job growth averaged 168 thousand a month.

Clearly, the immigration crackdown played a big role in the job slowdown, as the labor force barely increased this year, offsetting the softer demand for workers. But the slowdown in job growth has been much greater than the modest slowdown in economic growth this year. After contracting by 0.5 percent in the first quarter, GDP rebounded to a 3.8 percent growth rate in the second quarter and, underpinned by a resilient consumer, is on track for another sturdy increase in the third quarter. Unsurprisingly, recession fears so evident earlier in the year are now absent, despite growing concerns by the central bank about a weakening job market.

The divergence between robust growth in the economy and the slowdown in job growth means that fewer workers are generating more output. Simply put, improved labor productivity has filled the gap. But it's unclear if the productivity boost reflects technology advances or efforts by companies to get rid of bloat on payrolls, operating more efficiently with a leaner staff. We suspect that the latter is more likely, as businesses went on a yearslong hiring spree to overcompensate for the labor shortages they faced during the pandemic. It is too early to see much productivity benefit from AI or stronger investment spending coming from the CHIPS and Inflation

Reduction Acts passed under the previous administration.

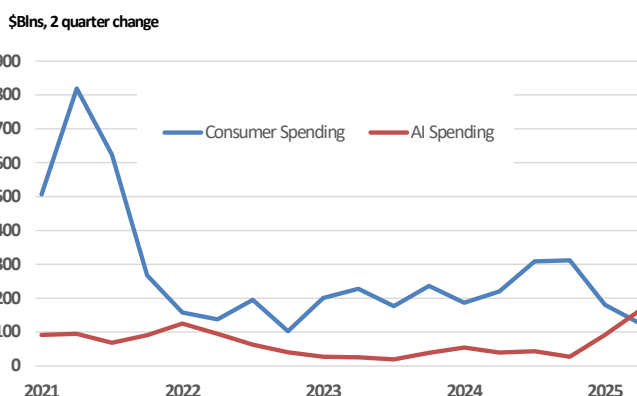
AI Adding Gas to Growth Engine

While companies are not adding many jobs to their payrolls, they are investing heavily in productivity-enhancing equipment and software. Indeed, AI-fueled investment spending has surpassed consumer spending as the main growth driver of GDP over the first half of this year. Outside of recessions, when consumer spending hits the skids, this has never been the case over a two-quarter period. What makes this even more astonishing is that consumer spending is four times the size of tech-related investment spending by private businesses. Clearly, AI-related spending is punching far above its weight.

No doubt, it is still early days in the surging trend for AI spending, which should continue to be a major growth driver for years to come. But will that goose hiring and open up positions for job searchers who are spending an ever-longer time on the unemployment line? One thing is clear, the promise of stellar profits from AI spending is turbocharging stock prices, paced by the so-called mega-caps, the giant companies in the tech sector, which is further enriching shareholders. No one knows if this is a bubble in the making that could end in a veil of tears, as was the case with the dot-com bubble twenty-five years ago. But the longer the rally persists, the longer will the wealth effect, along with tech spending, keep the economy's engine running.

That, of course, also keeps the curious juxtaposition in place, one that features sturdy top-line growth fueled by robust AI and wealth-induced spending against a weakening job market. It also explains why people on Main Street feel so miserable even as the economy seems to be running on all cylinders amid elevated stock prices. Complicating the Federal Reserve's effort to prevent a job market meltdown is that the full pass through of tariffs to prices is still to come, pointing to higher inflation in coming months. From our lens, this suggests that the Fed may be more cautious about cutting rates than the markets expect. The glue that is holding the labor market together - and coaxing some Fed officials to keep rates higher than otherwise - is the lack of layoffs. If companies widely decide to downsize staff because of a darkening outlook, look for a more aggressive rate cutting campaign next year. At this juncture, however, the "curious balance" in the job market will keep the Fed searching for clues, which could lead it in any direction.

AI Investment Tops Consumer Spending



KEY ECONOMIC AND FINANCIAL INDICATORS

Financial Indicators *

	<u>August</u>	<u>July</u>	<u>June</u>	<u>May</u>	<u>April</u>	<u>March</u>	<u>February</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
Prime Rate	7.50	7.50	7.50	7.50	7.50	7.50	7.50	8.30	7.50
3-Month Treasury Bill Rate	4.12	4.25	4.23	4.25	4.21	4.20	4.22	4.72	4.12
5-Year Treasury Note Rate	3.79	3.95	3.96	4.02	3.91	4.04	4.28	4.43	3.50
10-Year Treasury Note Rate	4.26	4.39	4.38	4.42	4.28	4.28	4.45	4.63	3.72
30-Year Treasury Bond Rate	4.87	4.92	4.89	4.90	4.71	4.60	4.68	4.92	4.04
Tax-Exempt Bond Yield	5.22	5.27	5.24	5.22	5.18	4.30	4.20	5.27	3.83
Corporate Bond Yield (AAA)	5.35	5.45	5.46	5.54	5.45	5.29	5.32	5.54	4.68
Conventional 30-Year Mortgage Rate	6.59	6.72	6.82	6.82	6.73	6.65	6.84	6.96	6.18
Dow Jones Industrial average	44765	44500	42753	41864	39876	42092	44209	44765	39876
S&P 500 Index	6409	6297	6030	5811	5370	5684	6039	6409	5370
Dividend Yield (S&P)	1.21	1.23	1.28	1.32	1.43	1.34	1.24	1.43	1.21
P/E Ratio (S&P)	26.8	26.9	26.3	25.1	23.8	24.0	25.5	27.2	23.8
Dollar Exchange Rate (vs. Major Currencies)	121.0	120.5	121.0	122.7	124.5	126.5	128.1	129.0	120.5

* Monthly Averages

Economic Indicators

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								<u>High</u>	<u>Low</u>
Housing Starts (Thousands of Units)	1307	1429	1382	1282	1398	1355	1490	1514	1282
New Home Sales (Thousands of Units)		652	656	630	706	660	642	726	623
New Home Prices (Thousands of Dollars)		404	407	423	413	413	415	431	398
Retail Sales (% Change Year Ago)	5.0	4.1	4.4	3.4	5.0	5.1	3.9	5.10	2
Industrial Production (% Change Year Ago)	0.9	1.3	0.9	0.7	1.2	1.0	1.1	1.4	-0.9
Operating Rate (% of Capacity)	77.4	77.4	77.7	77.5	77.6	77.7	78.2	78.2	76.8
Inventory Sales Ratio (Months)		1.37	1.38	1.39	1.38	1.38	1.39	1.41	1.37
Real Gross Domestic Product (Annual % Change)			3.8			-0.5		3.8	-0.5
Unemployment Rate (Percent)	4.3	4.2	4.1	4.2	4.2	4.2	4.1	4.3	4.1
Payroll Employment (Change in Thousands)	22	79	-13	19	158	120	102	323	-13
Hourly Earnings (% Change Year Ago)	3.7	3.9	3.7	3.8	3.8	3.9	4.0	4.2	3.7
Personal Income (% Change Year Ago)		5.0	4.7	4.6	5.4	4.7	4.6	5.4	4.3
Savings Rate (Percent of Disposable Income)		4.4	4.4	4.5	5.0	4.4	4.4	5	3.5
Consumer Credit (Change in Blns. Of Dollars)		16.0	-4.2	7.9	17.5	65.6	-1.5	65.6	-110.3
Consumer Prices (% Change Year Ago)	2.9	2.7	2.7	2.4	2.3	2.4	2.8	3.0	2.3
CPI Less Food & Energy (% Change Year Ago)	3.1	3.1	2.9	2.8	2.8	2.8	3.1	3.3	2.8
Wholesale Prices (% Change Year Ago)	2.6	3.1	2.4	2.8	2.4	3.2	3.4	3.7	2.1