ECONOMIC AND FINANCIAL DIGEST

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The Times, They Are A-Changin'

That 1960s song by Bob Dylan resonates today, as the economy is undergoing structural changes that will impact its performance for years to come. The population is aging, labor supply growth is slowing, artificial intelligence is transforming the workplace, and capital is driving growth more than labor. It's unclear what all this means for the long-term functioning of the economy, much less for society's well-being in general. We are economists not philosophers.

That said, the changes have been underway for a while, and the economy is still standing. We are living in a $30 trillion economic juggernaut that does not shift gears on the dime. The structural shifts have been well-telegraphed and will not transform the economy overnight, providing time to adjust to their impact. The headline-grabbing AI revolution may turn out to be transformative in the long run. But like past earth-shattering catalysts, it too faces hurdles. Local resistance to energy-hogging data centers is impeding the AI buildout and the enormous amount of borrowing needed to finance their construction is starting to worry investors.

One thing is clear, the Federal Reserve, the agency in charge of regulating the ebb and flow of economic conditions, can do little to alter the trajectory of these changes; nor would any attempt to do so be advisable. But there is an old adage in baseball that states a manager of a team can do little to win a game, but a lot to lose one by making bad decisions. The Fed is in the catbird seat, grappling with the decision over what to do with interest rates amid widely differing opinions among its members. Whatever it decides will not alter the structural shifts underway; but it could well alter the economic environment in which these shifts take place. Change is more acceptable if it occurs amid a strong economy that can adapt to its ramifications. But it can be highly disruptive – economically, socially and politically – amid a weaker environment when people are struggling and looking for villains.

A Changing Labor Market

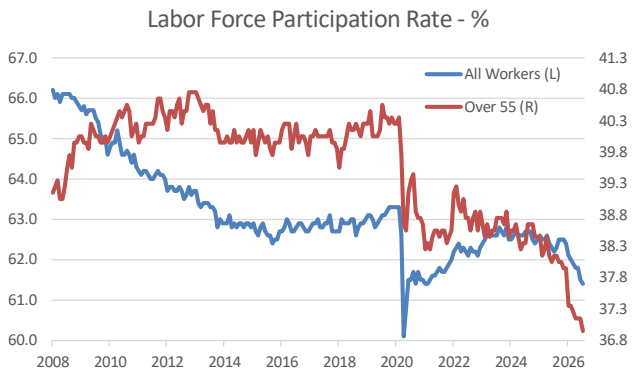
One of the more dramatic structural changes is occurring in the workplace. Historically, labor has played a key role driving economic growth, as workers generate output each hour they are on the job. More output, in turn, underpins an expanding economy that has grown at a 2 -2.5 percent annual rate since the turn of the century. But the labor force is no longer increasing and its contribution to growth is downshifting.

The downshift has been especially dramatic this year. In July the share of the working age population holding a job or looking for one fell to 61.4 percent. Aside from the pandemic, when business shut down and forced workers to stay at home, that's the lowest rate since 1976. As a result, the civilian labor force shrunk by 1.3 million workers since January. Tougher immigration policies and a wave of retirements are the two main reasons for the decline. But the explanation goes deeper than that.

For sure, the loss of foreign-born workers and aging boomers taking retirement are important reasons behind the decline in the labor force. But a look under the hood is more revealing because it shows that all age groups and other demographic categories have seen a decline in labor force participation. Importantly, the decline in the older cohort, people over 55, does not mean that seniors are dropping out of the labor force at an accelerating rate. It is just that the population is aging, pushing people into an older age group that is less likely to participate in the workforce. For example, the labor force participation rate for 60–65-year-olds is 60 percent, but it falls to under 20 percent for those over 65. So as more people age into the next rung, it drags down the overall participation rate.

Searching for Answers

But, as noted, all age groups are withdrawing from the labor force, including young workers in their late teens and early 20s who are enrolling in school instead of taking a job, as well as those in their prime – the 25-54 year olds – which form the life blood of the labor force, as well as older workers. That middle group, the prime age workers, is the most perplexing as the reasons for their lower participation are not entirely clear; hence, it's impossible to know if the trend is sustainable or just noise that will correct over time. Some surveys cite an increase in family responsibilities or illness as the primary causes of dropping out of the labor force, but more research is needed to confirm that or identify other causes.



Outside of less immigration, the younger and older segments of the population have accounted for most of the decline in the workforce. Both groups have understandable reasons for the move – increased school enrollment for the youngsters, and the inevitable aging process for the elderly. But the over 55 cohort is a much broader category than the 19-24 year old demographic, and there's distinctive causes for the decline in participation among segments of that group. Most important, the increase in labor force dropouts among the younger elements – the 60-65 segment – reflects early retirements due to burgeoning nest eggs stemming from appreciating stock portfolios and housing equity over the years.

That raises the question of whether the drag on labor supply from these two ends of the age spectrum is a detrimental trend that will harm the economy over the longer run. Indeed, there's a longer-term upside for the labor market associated with an increase in school enrollment, since those with more education participate in the labor force at higher rates in their prime working years. And the more comfortable financial cushion that enables older workers to retire early can hardly be viewed as harmful, as wealthier retirees can spend just as readily as older workers who remain in the labor force.

Fewer Workers, Less Tax Revenues

Keep in mind too that a shrinking labor force is occurring at time when the demand for workers is also softer. Hence, fewer new jobs are needed to keep the unemployment rate from rising. And with companies having a smaller pool of available workers from which to hire, they are more likely to hold on to their existing workers during slack economic conditions. This low hiring/low firing narrative has been a feature of the economy for the past several years, suggesting that the labor market is essentially in balance and not something to fret over.

But there is a downside to a shrinking labor supply. The government has lots of expenses. It needs to fund a huge safety net for Americans, pay the military to keep us safe, cover interest on $40 trillion in debt that it owes to financial institutions, foreigners and individuals to avoid disastrous default, and satisfy other expenses to keep the government running. Where does it get those funds? Mostly from taxes, and a big chunk of those revenues comes from workers who pay income and payroll taxes out of their paychecks. About 85 percent of all Federal revenues comes from that source.

Needless to say, a shrinking labor force means that less tax revenues are flowing into Treasury coffers than would otherwise be the case. Meanwhile, the fiscal responsibilities of the government do not change. It still has to foot the bill for all the expense noted above, and those outlays are not stagnant. With little appetite in Congress to enact spending cuts, or increase taxes on a smaller base of payers, the result is more red ink. The budget deficit is poised to reach $2 trillion in the current fiscal year, and the estimates keep going up. The roughly 6 percent share of GDP that this amounts to is usually a threshold seen during recessions.

Productivity Will Drive Growth

As noted at the outset, labor is a critical input that drives economic growth. If everything remains the same, less labor implies less growth – and less income, tax revenues, spending and lower living standards. But despite the declining labor supply, the economy's growth engine has not sputtered. Over the first half of 2026, the annual increase in real GDP has averaged 2.4 percent, which is spot-on with the average growth rate over the past 25 years.

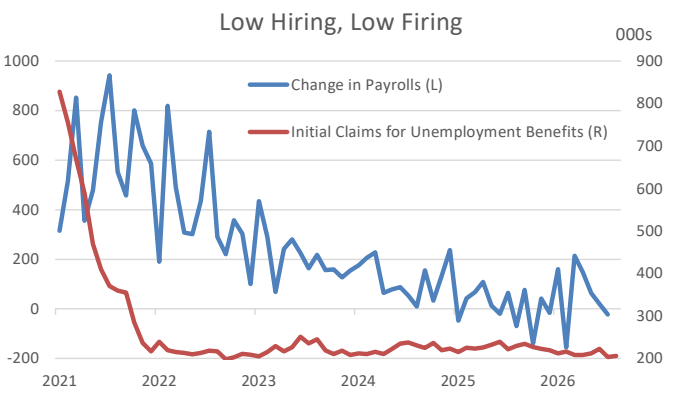
Clearly then, not everything has remained the same. Keep in mind that real GDP is the product of labor hours worked plus productivity, or the amount of output generated from each hour of work. Since GDP has remained on trend even as the labor force has shrunk, the big change in the economy has been the greater contribution that productivity has made to growth. Over the past three years, productivity growth has accelerated to 2.7 percent from a negative 0.4 percent in 2022 and 2023. That speed-up has filled the void left by the slowing labor force.

The jury is still out as to what is causing the productivity spurt, or whether it is sustainable. No doubt, AI is playing a role, and we suspect that its contribution will only increase in coming years as it is still in the early adoption stage. That said, hiring trends since the pandemic played a big role as well. Recall that companies faced a labor shortage during Covid when demand for goods surged. Eager to replenish staff when workers became more available, they over hired in 2022 and 2023 and wound up with bloated payrolls. Since then, the focus has been on regaining a leaner workforce capable of generating the output needed to satisfy demand. Fewer workers producing more goods is a formula for stronger productivity.

Managing Change Will Not Be Easy

So, the times are indeed "a-changing". Barring an unexpected loosening of immigration policy, the labor force is poised to grow more slowly than in the past. The population is continuing to age, portending more retirements, and birth rates have been declining since the 2008 financial crisis, so fewer people will be entering the working-age cohort. This means that for the economy to sustain historical growth rates, the recent productivity improvement needs to continue. Some of that improvement will fade once all the bloat in payrolls is removed; but the productivity gains from AI should continue and offset the drag from a smaller workforce.

Those gains, however, come with a downside, as the AI buildout is spurring inflationary pressures, driving up energy and water bills for millions of Americans that is spurring a widening backlash. The growth versus inflationary consequences of the AI buildout is probably the most vexing challenge the Fed faces over the next year. The accepted view is that AI-induced productivity gains will lower inflation over the long run but stoke inflation over the short run. Will the Fed be patient and let this structural change run its course, or intervene with rate changes that could disrupt, if not derail, the process? Like the team manager, the final score will determine whether the decision was right or wrong.



KEY ECONOMIC AND FINANCIAL INDICATORS

Financial Indicators *

	July	June	May	April	March	February	January	12-Month Range High	12-Month Range Low
Prime Rate	6.75	6.75	6.75	6.75	6.75	6.75	6.75	7.50	6.75
3-Month Treasury Bill Rate	3.73	3.66	3.60	3.61	3.61	3.57	3.57	4.12	3.57
5-Year Treasury Note Rate	4.33	4.21	4.15	3.94	3.85	3.78	3.78	4.33	3.65
10-Year Treasury Note Rate	4.60	4.47	4.48	4.32	4.25	4.21	4.21	4.60	4.06
30-Year Treasury Bond Rate	5.10	4.95	5.03	4.91	4.85	4.84	4.84	5.10	4.64
Tax-Exempt Bond Yield	4.73	4.68	4.78	4.74	4.84	4.77	4.79	5.22	4.68
Corporate Bond Yield (AAA)	5.76	5.52	5.56	5.42	5.48	5.34	5.34	5.76	5.13
Conventional 30-Year Mortgage Rate	6.54	6.49	6.44	6.33	6.18	6.10	6.10	6.59	6.10
Dow Jones Industrial average	52373	51399	49917	48430	46860	49138	49138	52373	44765
S&P 500 Index	7481	7450	7413	6957	6654	6929	6929	7481	6409
Dividend Yield (S&P)			1.09	1.16	1.21	1.16	1.15	1.21	1.09
P/E Ratio (S&P)	27.6	27.6	27.9	28.2	25.6	26.9	27.7	28.4	25.6
Dollar Exchange Rate (vs. Major Currencies)	120.6	118.8	118.8	119.0	119.9	119.2	119.2	121.8	118.8

* Monthly Averages

Economic Indicators

	July	June	May	April	March	February	January	12-Month Range High	12-Month Range Low
Housing Starts (Thousands of Units)	1239	1415	1182	1414	1522	1346	1385	1522	1182
New Home Sales (Thousands of Units)		628	618	646	659	630	576	757	576
New Home Prices (Thousands of Dollars)		398	412	416	399	412	416	418	397
Retail Sales (% Change Year Ago)	5.0	6.8	7.2	5.1	4.2	4.2	3.3	7.2	2.4
Industrial Production (% Change Year Ago)	1.1	1.3	1.5	1.4	0.7	0.8	1.1	1.9	0.7
Operating Rate (% of Capacity)	76.3	76.2	76.1	76.1	75.6	75.8	75.2	76.3	75.2
Inventory Sales Ratio (Months)		1.30	1.28	1.30	1.32	1.33	1.35	1.38	1.28
Real Gross Domestic Product (Annual % Change)		1.5			2.1			4.4	0.5
Unemployment Rate (Percent)	4.1	4.2	4.3	4.3	4.3	4.4	4.3	4.5	4.1
Payroll Employment (Change in Thousands)	-23	20	63	148	214	-156	-41	214	-156
Hourly Earnings (% Change Year Ago)	3.2	3.1	3.3	3.6	3.4	3.7	3.7	4.0	3.1
Personal Income (% Change Year Ago)		3.9	3.9	2.7	3.3	3.5	4.4	5.1	2.7
Savings Rate (Percent of Disposable Income)		2.7	2.8	3.0	3.5	3.8	4.4	4.5	2.7
Consumer Credit (Change in Blns. Of Dollars)		14.1	-1.0	19.9	22.8	7.2	4.4	22.8	-1.0
Consumer Prices (% Change Year Ago)	3.4	3.5	4.2	3.8	3.3	2.4	2.4	4.2	2.4
CPI Less Food & Energy (% Change Year Ago)	2.5	2.6	2.9	2.8	2.6	2.5	2.5	3.1	2.5
Wholesale Prices (% Change Year Ago)	4.7	5.5	5.8	5.7	4.3	3.4	3.0	5.8	2.7