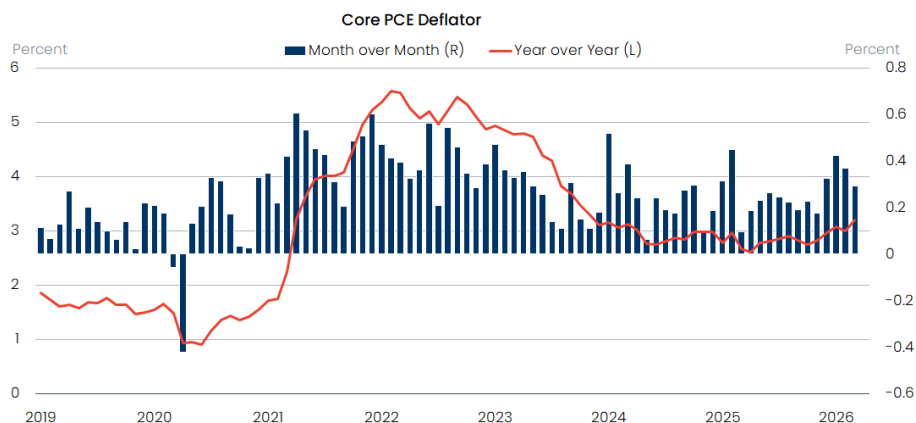


“Hello, I must be going”

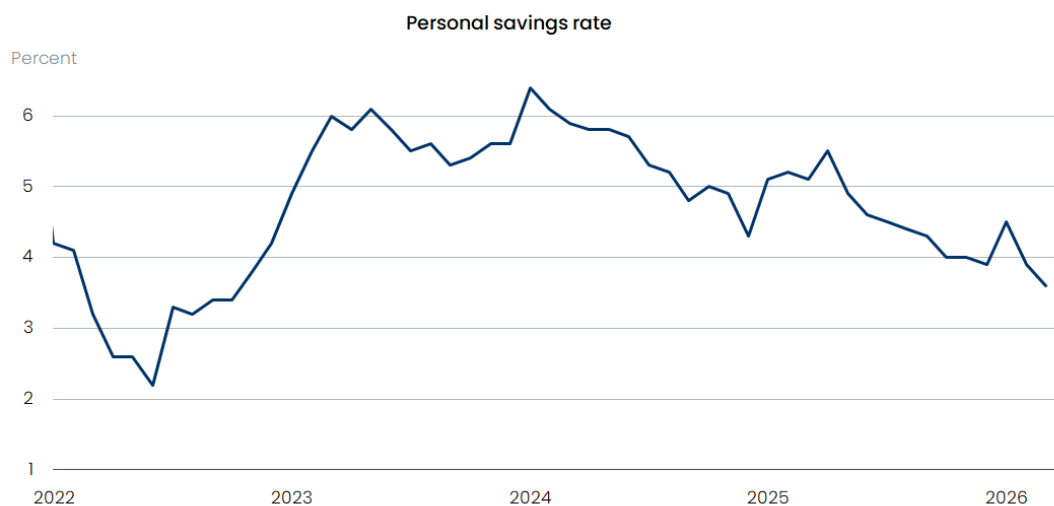
In a more serious vein than Groucho’s semi exits in “Animal Crackers”. Fed Chair Powell bid adieu to an adoring audience – but only after he stays around for a while in a less exalted role than his leadership position. That was one of several surprises at this week’s FOMC meeting, which featured more dissenters of the decision to keep rates unchanged than at any time since 1992. Three officials wanted to signal that rate hikes are not off the table, and one wanted rate cuts immediately. Mr. Marx would have had a ball with this rambunctious crowd, but Chair Powell is graciously leaving the task of forging a consensus to the incoming Chair, Kevin Warsh, when he’s expected to take over the helm on May 15.

That won’t be easy, considering the complicated economic landscape he will be facing. Things on the ground might change by mid-June, when the first policy meeting led by Warsh is scheduled. But the lingering effects of the Mideast conflict – whether or not it is over by then – will still be visible as will the uncertainty they generated. For sure, inflation will still be running well above the Fed’s 2 percent target; it might even exceed the latest 3.5% reading on the PCE deflator, as higher oil prices bleed through with a lag to core prices. Meanwhile, growth is poised to accelerate in the second quarter, which should not be buffeted by the harsh weather that constrained consumer spending early in the first quarter. Households are getting a boost from the refunds and tax cuts enacted last year and AI-related investment spending, which overtook consumer spending as the main growth driver during the January-March period, is still going strong.



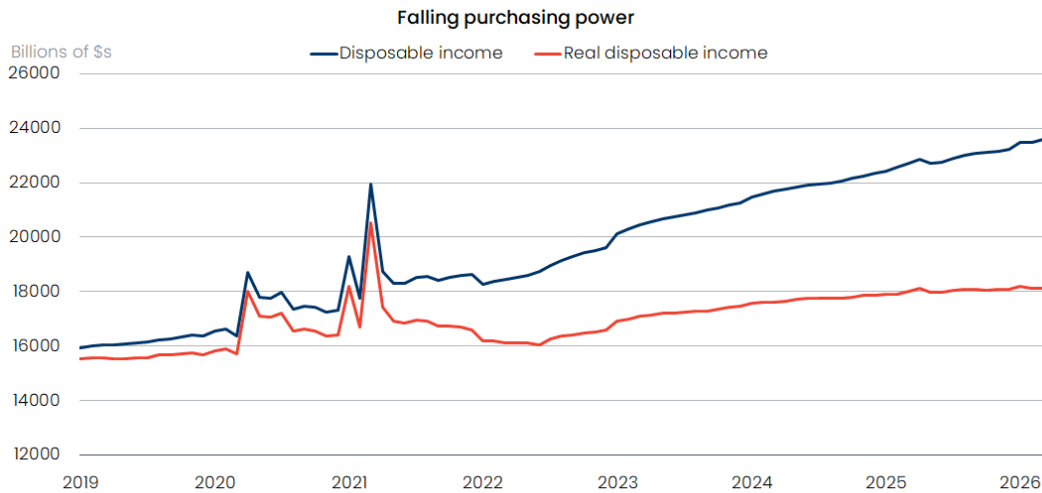
With inflation still elevated and the economy on an above-trend growth path, Warsh would have a difficult time convincing his colleagues that a rate cut is appropriate. The markets are totally onboard with a wait-and-see strategy, as the futures market is pricing in a zero chance of a cut for the rest of this year. Likewise, the two-year Treasury yield, which is highly sensitive to Fed rate expectations, moved up sharply following the hawkish Fed meeting on Wednesday, before receding late in the week. Notably, the stock market did not blink from the rate climb, as earnings announcements, particularly from tech companies, are coming in at a healthy pace. The AI-enthusiasm is not only boosting the economy's performance through its spending blitz on data centers. It is also fueling the stock market's engine, enhancing the wealth effect that is underpinning spending by upper-income households. April's 10.4% increase in the S&P 500 was the strongest monthly increase in more than 35 years.

That said, the dramatic climb in stock prices highlights the growing dependence of consumer spending on the market's performance. It also at least partially explains the sharp fall in the personal savings rate in March to a 3 ½-year low of 3.6 percent. As households accumulate more wealth from their stock portfolios, the less savings they need to support consumption. The flip side, of course, is the potential hit to spending should the stock market falter and prompt households to rebuild precautionary savings. The outsized spending on AI will continue to add muscle to the economy's growth rate. But whether it sustains an outsized influence on stock prices depends on whether future earnings justify the outlays. That remains to be seen.



Even so, the capacity of consumers to draw on savings is not unlimited, and we suspect that the current low rate is unsustainable. That means future spending will increasingly depend on income growth. On the surface, it appears that households are in good shape. Personal income increased by a solid 0.6 percent in March, which together with the savings drawdown, supported a sturdy 0.9 percent increase in spending. But under the hood, those stats look less

encouraging as inflation is taking a major bite out of both. Add taxes to the mix, and households have seen no growth in purchasing power over the past two months, as real disposable income fell in both February and March. Indeed, real DPI is no higher now than it was last April, even as current dollar income has risen significantly.



It's important to remember that business outlays on capital equipment and intellectual property products, which account for about 13 percent of GDP, does not have enough heft to be a sustainable driver of U.S. growth. The first quarter was only the seventh time out of the last 45 quarters – 15 percent of the time – that such spending contributed more to GDP growth than personal consumption. With a 68 percent share of GDP, the main cylinder continues to be consumer spending. Once the second-quarter boost from tax refunds and cuts wanes, consumers will draw more heavily on income as a spending source since, as noted, the wealth effect is not a sure thing. Over the near term, we expect some pullback in spending as the fiscal stimulus runs out. But the wealth effect should offset part of the drag on overall consumption for at least a while, as upper income households have accumulated a formidable cushion of asset gains in recent years.

Beyond the next quarter the future looks promising, assuming geopolitical tensions abate and inflationary pressures from oil prices recede. Whether or not AI spending reaps the expected earnings rewards, it will deliver improved productivity gains that will be a key growth driver next year. The time-honored contribution from labor input will be greatly diminished, thanks to an aging population and reduced net migration. But as long as economic growth keeps up with the economy's growth potential, estimated at 2 percent, the unemployment rate should stabilize. If it exceeds potential, which we expect in 2027, the unemployment rate should decline and give some measure of strength to worker bargaining power.

The good news is that stronger productivity means that each worker will be generating more revenue, allowing employers to increase wages without damaging profits. It is also a check on inflation, which we expect to eventually recede when the oil shock ends, assuming further external shocks are avoided. That's a big if, as additional tariffs on auto imports were announced by President Trump on Friday, and the administration had previously signaled it would seek other measures to replace the tariffs that were deemed illegal by the Supreme Court. No doubt, assessing the balance of risks regarding the Fed's dual mandate will still be challenging for the Warsh-led central bank in the months ahead. But in the absence of further shocks, the stage should be set for a consensus to agree on rate cuts in 2027, much to the chagrin of Groucho.

FINANCIAL INDICATORS

| INTEREST RATES | May 1 | Week Ago | Month Ago | Year Ago |
|-----------------------------|-------|----------|-----------|----------|
| 3-month Treasury bill | 3.66 | 3.68 | 3.70 | 4.31 |
| 6-month Treasury bill | 3.70 | 3.71 | 3.71 | 4.25 |
| 2-year Treasury note | 3.89 | 3.79 | 3.83 | 3.83 |
| 5-year Treasury note | 4.02 | 3.93 | 3.98 | 3.92 |
| 10-year Treasury note | 4.38 | 4.31 | 4.32 | 4.31 |
| 30-year Treasury bond | 4.96 | 4.91 | 4.92 | 4.79 |
| 30-year fixed mortgage rate | 6.30 | 6.23 | 6.46 | 6.76 |
| 15-year fixed mortgage rate | 5.64 | 5.58 | 5.77 | 5.92 |

| STOCK MARKET | | | | |
|----------------------------|-----------|-----------|-----------|-----------|
| Dow Jones Industrial Index | 49,499.27 | 49,230.71 | 46,504.67 | 41,317.43 |
| S&P 500 | 7,230.12 | 7,165.08 | 6,582.69 | 5,686.67 |
| NASDAQ | 25,114.44 | 24,836.60 | 21,879.18 | 17,977.73 |

| COMMODITIES | | | | |
|---|----------|---------|---------|---------|
| Gold (\$ per troy ounce) | 4,623.00 | 4,725.1 | 4,702.7 | 3,247.4 |
| Oil (\$ per barrel) - Crude Futures (WTI) | 102.65 | 94.88 | 112.06 | 57.41 |

| ECONOMIC INDICATOR | Latest Month/Quarter | Previous Month/Quarter | Two-Months/ Qtrs Ago | Average-Past Six Months or Quarters |
|---|----------------------|------------------------|----------------------|-------------------------------------|
| GDP (Q1) - % change, Saar | 2.0 | 0.5 | 4.4 | 2.0 |
| Personal Income (March) - % change | 0.6 | 0.0 | 0.5 | 0.3 |
| Personal Spending (March) - % change | 0.9 | 0.6 | 0.4 | 0.5 |
| Personal Savings Rate (March) - Percent | 3.6 | 3.9 | 4.5 | 4.0 |

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