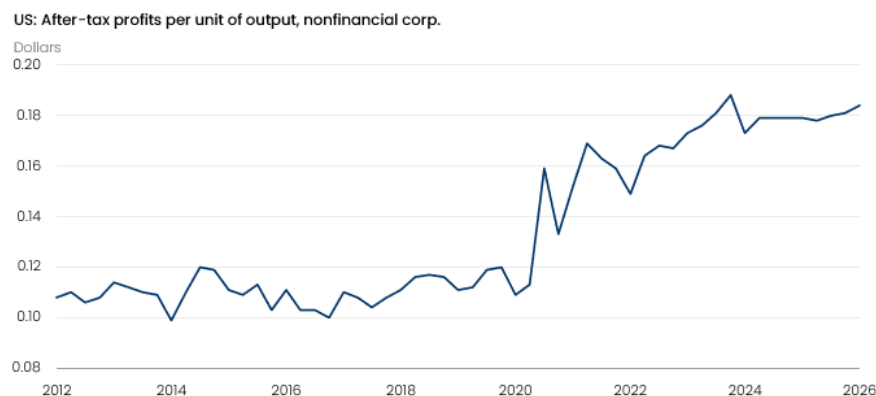


The stock market continues to rejoice, setting one record after another, as investors opt to look through the myriad headwinds battering the economy. The biggest battering ram, of course, is the ongoing Mideast conflict that has spurred a gas-induced surge in inflation, higher interest rates, a squeeze on budgets for all but wealthy households, sinking confidence and a shift in expectations regarding monetary policy – from cutting rates to possibly raising them first. Negotiations to end the conflict ebb and flow and the end game is still unclear. Yet, the U.S. economy has held up better than expected, and market participants are optimistic that it will muddle through. Underpinning that optimism is the assumption that rational minds will ultimately prevail, and hostilities will not escalate to the point of no return.

That mindset would be on shakier ground if the conflict had severely damaged corporate earnings, the lifeblood of the stock market. Despite widespread fears that supply disruptions and rising costs related to surging oil prices would damage profitability, that has not been the case so far. With demand holding up reasonably well, businesses have been able to pass on cost increases as profit margins widened in the first quarter, although they settled a bit below the record set in 2023. The first estimate of corporate profits was released with the revised GDP print for the first quarter, which revealed a slower growth rate than the preliminary estimate. The period only encompassed the early stages of the Mideast conflict, which erupted in late February, so the ripple effects may be causing more of a margin squeeze in the current quarter.

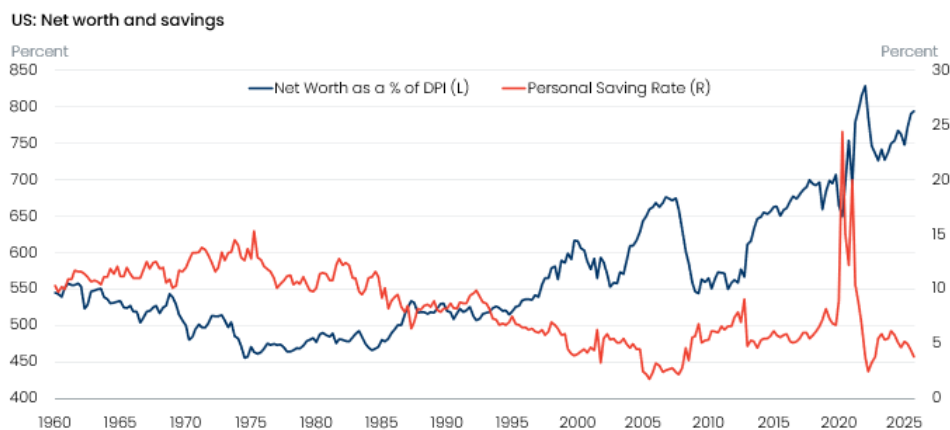


Growing signs that the inflationary impact of the war is taking a toll on demand support that notion. While margins widened in the first quarter, profit growth slowed, reflecting the revenue sapping impact of weakening demand. That trend continued as the second quarter got

underway. Following the downward revision in the first quarter, inflation-adjusted consumer spending edged up by a slim 0.1 percent in April, less than a third of the March advance. What's more, the April gain once again outpaced the increase in household income, driving the savings rate down to 2.6 percent, the lowest since June 2022. Back then, however, the low savings rate conveyed a less ominous message. The economy was amid a powerful post Covid rebound, the demand for labor surged, wages were rising at a 7-8 percent annual pace, and households were far more upbeat about job and income prospects.

Importantly, the economy's strength was pervasive, with broad swaths of the population participating in the improving performance. Not only was wage growth accelerating, but lower-wage workers were enjoying stronger pay increases than higher wage earners. Given that favorable environment and brighter prospects, households were more willing to live with a slimmer savings cushion. Put simply, the low savings rate in 2022 was a sign of confidence, not stress. That's not the case now. Wage growth is slowing, worker anxiety is increasing, and lower wage earners are receiving slower pay raises than those higher up the wage ladder. Meanwhile, inflation is taking a bigger bite out of low- and middle-income household budgets.

That said, the low overall savings rate exaggerates the deflated cushion available to buffer the economy from a potential adverse turn of events. A good part, if not most, of the savings drawdown is by wealthier households, who have enjoyed enormous asset gains in recent years and are comfortable living with a smaller savings cushion. With rare exceptions, rising net worth has been associated with a declining savings rate, and the current experience aligns with that trend. But as the historical record clearly shows, just the opposite is also the case. With the wealthy cohort doing most of the heavy lifting under spending, the economy is increasingly vulnerable to a significant setback in stock prices.

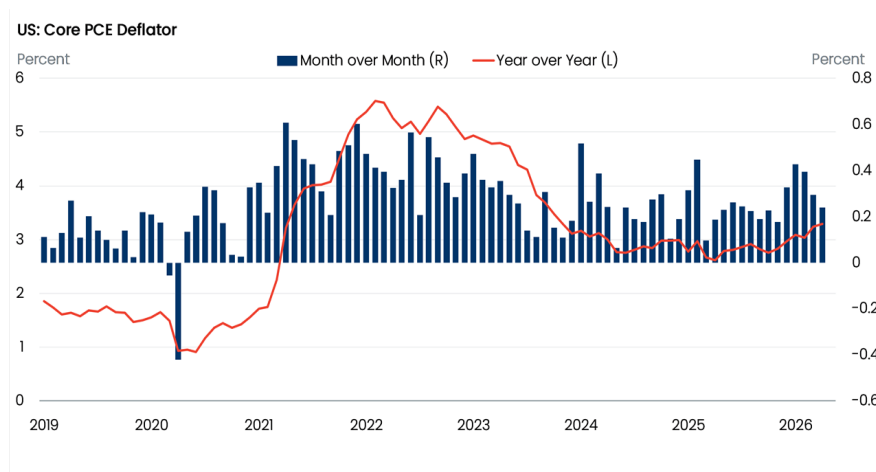


Despite the increased frequency of external shocks in recent years, the stock market has been resilient, belying any attempt to forecast an end to the rally. Indeed, any sign that the Mideast

conflict is nearing a resolution breathes new life into the market. Until that endgame appears, however, the most visible risk to the economy is that inflation will remain stubbornly high, if not accelerate, and further undercut the purchasing power and households. That, in turn, would complicate the policy decision of the Federal Reserve even more than it currently does.

As noted earlier, the inflationary consequences of the war have shifted the risk assessment of the Fed, from arresting a slowing economy to curtailing inflation. That shift received support from incoming data on labor conditions, which reveal stronger job growth than seen earlier in the year, when the Fed had penciled in two rate cuts in 2026. That plan has fallen off the table, and the markets are now pricing in greater odds that the next move will be a rate increase rather than a cut. Several Fed officials have bolstered that outlook, with two publicly commenting this week that unless inflation shows tangible signs of retreating, they would be amenable to raising rates. The new Fed Chair, Kevin Warsh, is unlikely to push for a rate cut at the upcoming policy meeting in mid-June. But if he does, there is a good chance he would be overruled by the voting committee, the first time a Fed Chair would be outvoted since Marriner Eccles was at the helm in the late 1930s.

Clearly, Warsh will be presiding at an inopportune time for a dovish move. The latest inflation reading is hardly favorable for a rate cut, as the Fed's preferred inflation gauges are flashing more red than green. The overall personal consumption deflator staged a 3.8 percent increase in April from a year earlier, up from 3.5 percent in March and almost double the distance from the Fed's 2 percent target. Nor is the trend a friend. Over the past three months, the deflator has increased at an eye-opening 6 percent annual rate, a pace not seen since the peak of the 2022 inflationary spiral coming out of the pandemic. The good news is that the energy price surge, which is primarily fueling the overall deflator, is not bleeding into core prices. The core PCE, which excludes energy as well as food prices, rose by a tame 0.2 percent in April and slowed for the third consecutive month. Still, the annual increase in the core index sits at 3.3 percent, which is uncomfortably above the 2 percent target and drifting higher.



## FINANCIAL INDICATORS

INTEREST RATES	May 29	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.68	3.68	3.66	4.34
6-month Treasury bill	3.75	3.77	3.70	4.31
2-year Treasury note	4.01	4.13	3.89	3.91
5-year Treasury note	4.14	4.26	4.02	3.97
10-year Treasury note	4.44	4.56	4.38	4.41
30-year Treasury bond	4.97	5.07	4.96	4.94
30-year fixed mortgage rate	6.53	6.51	6.30	6.89
15-year fixed mortgage rate	5.87	5.85	5.64	6.03

STOCK MARKET				
Dow Jones Industrial Index	51,032.46	50,579.70	49,499.27	42,270.07
S&P 500	7,580.06	7,473.47	7,230.12	5,911.69
NASDAQ	26,972.62	26,343.97	25,114.44	19,113.77

COMMODITIES				
Gold (\$ per troy ounce)	4,575.60	4,510.5	4,623.0	3,313.1
Oil (\$ per barrel) - Crude Futures (WTI)	88.00	97.00	102.65	60.79

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Personal Income (April) - % change	0.0	0.5	0.0	0.2
Personal Consumption (April) - % change	0.5	1.0	0.7	0.5
Personal Savings Rate (April) - Percent	2.6	3.2	3.6	3.5
New Home Sales (April) - 000s	622.0	663.0	641.0	664.0

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