

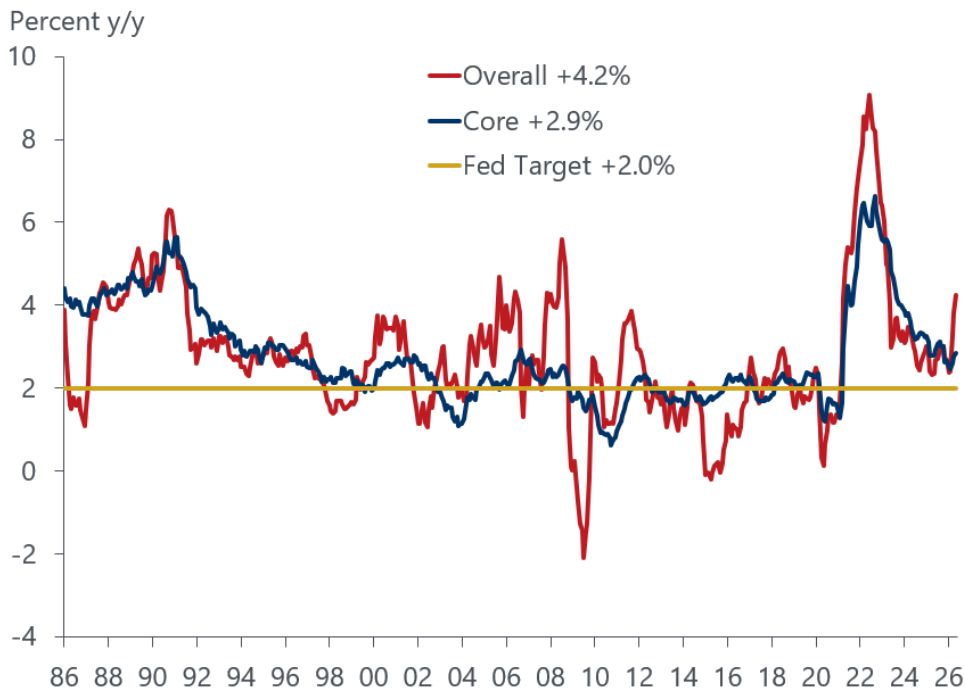
The back-and-forth negotiations between the U.S. and Iran regarding the conflict is still up in the air, although a positive note was sounded late in the week as President Trump announced that a peace deal is close and could be wrapped up by Sunday.

That prospect, unsurprisingly stoked a major stock market rally on Thursday and Friday, closing the week on a bullish note. That said, traders understandably remain wary of such announcements, which have hit the headlines multiple times over the past few weeks and were never brought to fruition. Worse, breakdowns have usually led to a reescalation of hostilities that sent the market into a nosedive, as happened earlier this week before the latest upbeat announcement was made. It's probably best to fasten your seatbelts and prepare for either outcome over the weekend. The U.S./Israel war with Iran will continue to be the singular event in the financial markets, at least for a few more days.

Assuming negotiations lead to a durable peace, don't expect the economic landscape to return to normal right away. Like any disruptive shock, it takes time for wounds to heal. In the current instance, the biggest blow landed on the inflation front, as the spike in energy prices from the conflict has stoked an inflationary surge that will linger well beyond the end of war. That war-induced surge was fully revealed in this week's consumer price report which, because it was highly anticipated, had little impact on the markets. Still, the 0.5 percent jump in the headline CPI adds to household angst over affordability, since the most visible component – gasoline – that is also one of the most frequently purchased items, was again the main culprit driving the increase.

Overall, consumer prices rose by a torrid 4.2 percent in May from a year ago on the back of a sharp 0.5 increase over the previous month. The annual gain was the steepest in more than three years and marked the third consecutive month of accelerating year-over-year inflation. Again, fuel prices were the main driver as energy costs accounted for 60 percent of the monthly increase in the CPI, according to the Bureau of Labor Statistics. The good news is that the energy-driven cost increases are not bleeding into other goods and services. The core CPI, which excludes energy as well as food prices, rose by a much tamer 0.2 percent over the previous month and 2.9 percent over the past year.

US: Consumer Prices



From a policy perspective, it is the core index that matters more, since it is more reflective of trend inflation. Both energy and food prices are considered noisy components, rising and falling due to forces that are not related to the economy's performance. They are more sensitive to what are considered transitory forces, such as wars and drought, that the Federal Reserve tends to look through before making rate changes that could have unwanted effects on the broader economy.

But there is a risk to that exclusion, especially if transitory shocks keep on coming, have delayed knock-on effects on other prices and, more importantly, infiltrate inflationary expectations. So far, the secondary impact has been muted, and inflationary expectations are still relatively anchored, lowering the risk that consumer behavior would change in such a way as to cause inflation to feed on itself. That risk would be further downgraded if the oil spigot reopens and lowers energy prices. Just the prospect of a deal being consummated over the weekend has already taken some steam out of oil prices. After recently topping \$100/barrel, crude prices ended this week around \$84, with \$10 of that decline occurring in the two days since the promising announcement of a deal was made public. There is a ways to go, however, before oil prices return to the prewar level of around \$60/barrel.

Still, even the modest drop and enhanced prospects of more to come is brightening the mood of households. On Friday, the University of Michigan released its early June reading of household sentiment. The overall index edged up a tad in the first half of the month, thanks largely to the slight relief in gas prices; the nationwide average cost of a gallon of gas has fallen from \$4.40 to \$4.10 so far in June. Before uncorking the champagne, however, keep in mind

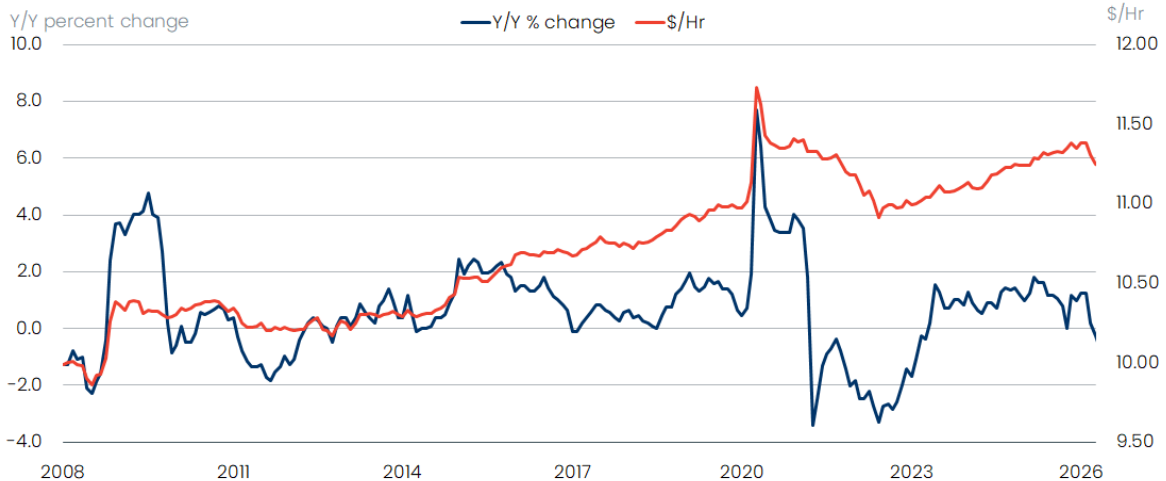
that the modest bounce is off the lowest sentiment reading on record for this series. Not only does this indicate that there is a long road ahead before households recapture the confidence level that prevailed before the war. It also highlights the toll that the higher price level – not just the change in the level – is taking on household budgets.

University of Michigan Sentiment Index



As we noted last week when the jobs report revealed another monthly slowdown in wage growth, it is not just what workers earn, but how much they can buy with those earnings. With the latest consumer price report, the squeeze on budgets has become even more apparent. The 4.2 percent annual increase in retail prices easily exceeded the 3.4 percent increase in average hourly earnings of workers in the private sector. Hence, real earnings – or actual purchasing power – took another hit and are now 0.7 percent lower than a year ago. Put another way, real earnings are no higher now than they were in February 2025.

US: Real average hourly earnings



The mixed results on inflation – fiery headline, cooler core – comes just as the Federal Reserve holds its first rate-setting meeting under its new Chair, Kevin Warsh this week. It's almost certain that no rate changes will be made, but the tone of the meeting will be somewhat more hawkish than previous ones, with the prospect of a rate cut anytime soon taken off the table. However, it is just as certain that no rate hike will be taken and, probably, not even contemplated despite inflation readings that are well above the Fed's 2 percent target. From our lens, the 4.2 percent pace in June is probably the peak of this inflationary cycle, assuming oil prices do not rebound, a big if, given the volatile geopolitics involved. And with real earnings on the skids, the threat of growing demand destruction looms large, raising recession risks that the Fed needs to guard against. The main point of interest at the meeting will be the language in the post-meeting policy statement to see how policymakers communicate their plans to balance the recession/inflation risks facing the economy in coming months.

FINANCIAL INDICATORS

INTEREST RATES	June 12	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.71	3.72	3.68	4.36
6-month Treasury bill	3.80	3.80	3.73	4.28
2-year Treasury note	4.10	4.16	4.08	3.96
5-year Treasury note	4.22	4.28	4.26	4.01
10-year Treasury note	4.49	4.53	4.60	4.41
30-year Treasury bond	4.97	5.00		4.90
30-year fixed mortgage rate	6.52	6.48	6.36	6.84
15-year fixed mortgage rate	5.84	5.79	5.71	5.97

STOCK MARKET				
Dow Jones Industrial Index	51,202.26	50,866.78	49,526.17	42,197.79
S&P 500	7,431.46	7,383.74	7,408.50	5,976.97
NASDAQ	25,888.84	25,709.43	26,225.40	19,406.86

COMMODITIES				
Gold (\$ per troy ounce)	4,233.00	4,353.80	4,543.60	3,453.00
Oil (\$ per barrel) - Crude Futures (WTI)	84.41	90.23	105.66	73.58

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (May) - % change	0.5	0.6	0.9	0.5
Core CPI (May) - % change	0.2	0.4	0.2	0.3
Producer Price Index (May) - % change	1.1	1.1	0.7	0.7
Existing Home Sales (May) - mlns	4.2	4.0	4.0	4.1

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