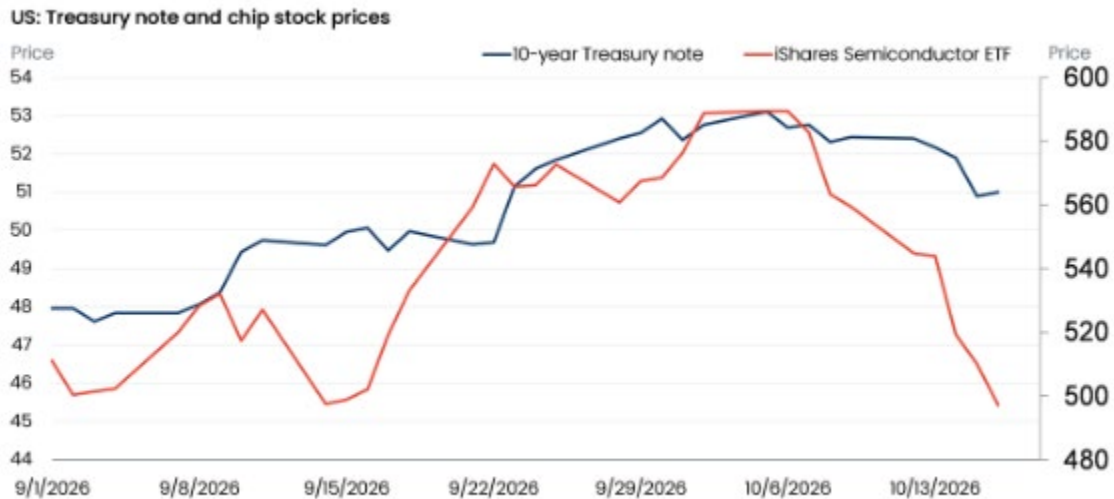


While most macro data, including employment, growth and spending, are disconnected from household sentiment surveys, the one notable exception is inflation. That singular downbeat catalyst reared its ugly head again this week and may nudge the Fed to pull the rate-hiking trigger at its upcoming policy meeting on October 29. No doubt, that would exacerbate the downbeat mood of the public, reinforcing affordability concerns of consumers who are already struggling with high prices. But to the extent that upper-income households keep their wallets open, thanks to the wealth effect linked to a booming stock market, that disconnect should remain intact. Consumer spending would continue to drive growth even as inflation and high interest rates take an increasing toll on the purchasing power of lower and middle-income households.

But the mirror image of the disconnect noted above is the strong connection between the wealth generating stock market and its most powerful engine, the outsized gains in AI-related companies. These firms are not only juicing the broader stock market, but they are also working hand in hand with upper income households to stoke the economy's growth through their enormous spending on data centers, chips and other equipment needed to feed the AI buildout. In the process, they are also borrowing tons of money in the capital markets, which investors have eagerly snapped up, believing that future profits will be more than sufficient to service the burgeoning outstanding debt. Their enormous borrowing, in turn, is competing with the even larger financing needs of the U.S. Treasury for a finite pool of investable funds, a time-honored combination that leads to higher market yields. Unsurprisingly, both Treasury and corporate yields have risen this year; surprisingly, though, Treasury yields have increased faster, resulting in a sharp narrowing of credit spreads.

Recently, however, growing investor anxiety over the huge borrowing needs of AI firms, except for the hyperscalers, has hit the headlines, sending tremors through the financial markets. Tech stocks have taken a hit, and the seeds of a risk-averse mindset may be sprouting, spurring a flight to the safety of Treasury bonds. By itself, the recent climb in Treasury bond prices is not that significant, as a one-week move may be more noise than substance. But what gives the move more meaning is that it continued despite hotter-than-expected inflation reports this week. That would normally have the opposite effect, raising the odds of a more imminent Fed rate hike and sending market yields higher. However, Fed Chair Warsh avoided any suggestion of a looming rate hike at a speech in Thailand on Thursday, helping to stabilize the Treasury market.



It remains to be seen how traders sort out the risk/reward uncertainty linked to the AI trade, and whether the tumble in chip stocks drags down the rest of the stock market, imperiling the wealth boost driving consumer spending. So far, the broader market has held up and the recent dip in market yields, if sustained, may give the Fed more reason to stiffen its inflation fight by hiking rates sooner rather than later. Despite the consensus view that the Fed will stay on the sidelines until December, the case for an earlier move is hard to dismiss in light of the latest batch of data. Most notable is the September inflation reports released this week, as both consumer and producer prices staged outsized increases for the month and signal another hot reading in the Fed's preferred inflation gauge, the personal consumption deflator, due out on October 29, a day after the conclusion of the Fed's next policy meeting.

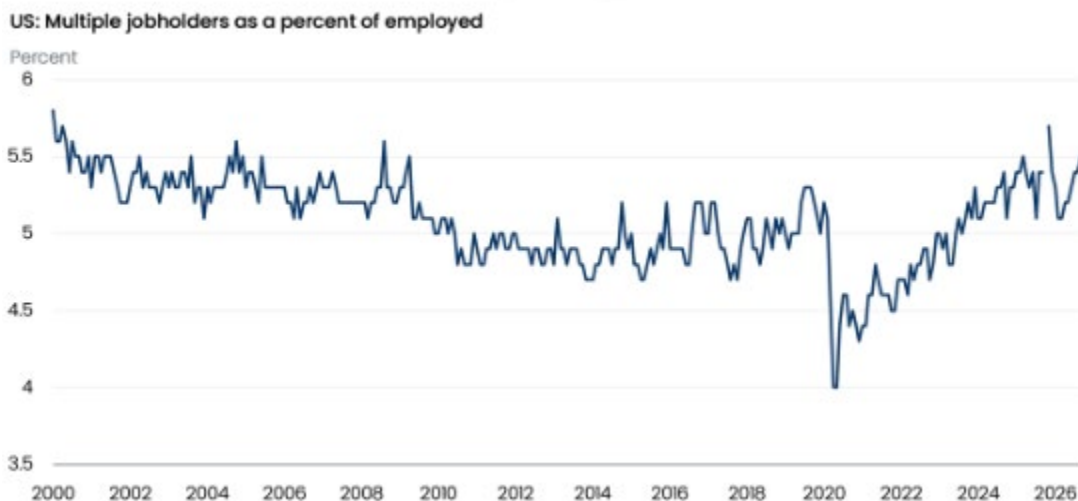
To be sure, much of the heat in the inflation reports derived from soaring energy prices, including a 9.1 percent surge in gasoline prices that accounted for about half of the 0.6 percent increase in the headline consumer price index last month. But spiking fuel prices are no longer a one-off external shock to inflation that the Fed can patiently wait to subside. Not only is there no end in sight for the Mideast conflict that is sustaining the rise, but higher oil prices are also bleeding into other goods and services, such as airfares, fertilizers and shipping costs that will eventually translate into higher grocery prices. The core CPI, that excludes volatile oil and food prices, also rose by an uncomfortable 0.3 percent for the second consecutive month, lifting the year-over-year increase from 2.4 to 2.6 percent. The 12-month increase in the headline CPI jumped from 3.4 to 3.7 percent; both measures continue to run stubbornly above the Fed's 2 percent target.

So far, the hot inflation readings have not meaningfully boosted long-run inflation expectations, something that the Fed closely monitors and would likely respond more forcefully to if that were the case. However, the link between high inflation and low household sentiment has become even more apparent last month. Not only do goods and services cost more and

exacerbate the affordability crisis for lower- and middle-income families, the paychecks needed to keep up with rising costs are falling steadily behind. The 3.7 percent annual increase in consumer prices last month easily outpaced the 3.0 percent increase in average hourly earnings, resulting in declining real earnings for the sixth consecutive month. Real purchasing power of worker paychecks are no higher now than they were in December 2024.



To be sure, workers could compensate for eroding hourly earnings by putting in more hours of work. But despite an uptick over the summer, the average workweek at 34.4 hours is the same as it was in the spring of 2024 and below historical levels. Indeed, real weekly earnings have been just as weak as hourly earnings. Instead, workers are compensating by taking on multiple jobs. The share of employed workers holding two or more jobs is hovering around the highest level since the 2008 financial crisis. Faced with the Hobson's choice of living with reduced purchasing power or taking on another job is a sure-fire recipe for sinking household sentiment.



The Fed faces an equally difficult Hobson's choice: raise rates and risk a wealth-destroying market correction or hold the line and risk falling behind the inflation curve. We believe the odds favor a rate hike on October 28, as the inflation embers remain overly hot and the economic underpinnings, particularly the job market, remain on a solid footing. However, high borrowing costs and slowing wage growth will be taking an increasing toll on consumer spending, prompting the Fed to move to the sidelines as the calendar turns to 2027. AI spending will still be contributing importantly to economic growth, compensating for softer consumer spending, but it should also be generating the productivity gains that will dampen inflationary pressures. Lower inflation and improved purchasing power will go a long way towards lifting household spirits and bring them more aligned with macro trends.

FINANCIAL INDICATORS

INTEREST RATES	October 16	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.17	4.16	4.08	3.93
6-month Treasury bill	4.34	4.33	4.28	3.81
2-year Treasury note	4.72	4.80	4.76	3.47
5-year Treasury note	4.88	5.03	4.87	3.60
10-year Treasury note	5.08	5.25	5.01	4.01
30-year Treasury bond	5.43	5.61	5.33	4.61
30-year fixed mortgage rate	7.40	7.40	6.95	6.27
15-year fixed mortgage rate	6.71	6.73	6.26	5.52

STOCK MARKET				
Dow Jones Industrial Index	52,002.41	51,654.95	51,682.60	46,190.61
S&P 500	7,659.44	7,811.54	7,650.50	6,664.01
NASDAQ	26,140.03	27,366.17	26,522.55	22,679.97

COMMODITIES				
Gold (\$ per troy ounce)	4,188.50	4,219.4	4,417.1	4,245.2
Oil (\$ per barrel) - Crude Futures (WTI)	101.72	91.60	99.68	57.70

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Consumer Price Index (September) - % change	0.6	0.4	0.1	0.3
Core CPI (September) - % change	0.3	0.3	0.2	0.2
Producer Price Index (September) - % change	0.5	0.3	0.5	0.5
Retail Sales (September) - % change	0.8	1.3	-0.4	0.6

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