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Economic Update

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The US economy has entered the final months of 2026 with more momentum than many forecasters expected earlier in the year. GDP growth has exceeded the economy's underlying long-run trend despite an unusually broad array of headwinds including elevated inflation, higher interest rates, rising US Treasury yields, tariffs and trade uncertainty, geopolitical conflict, a slowing labor market, and weakness in several of the sectors most sensitive to borrowing costs. What is particularly notable is the composition of the expansion. The principal sources of strength have been **consumer spending and business investment**, two components that together account for a major portion of private domestic economic activity. At the same time, interest-rate-sensitive sectors of the economy, particularly housing, autos and certain areas of commercial activity, have been an important offset to that strength. The latest national accounts reinforce this interpretation. The Bureau of Economic Analysis (BEA) now estimates that real GDP increased at an above-trend 2.5% annual rate in the first quarter and a 2.2% annual rate after revisions in the second quarter.

More revealing is that real final sales to private domestic purchasers, the combination of consumer spending and private fixed investment, rose at a 4.6% annual rate in the second quarter. These figures suggest an economy whose private domestic demand has remained considerably firmer than the headline GDP number alone might imply.

Consumer Spending

Consumer spending, which accounts for over two thirds of GDP, continues to be the largest and most persistent source of support for the economy. What is particularly noteworthy, however, is that the recent strength in household outlays appears to be broader across income groups than had been evident earlier in the expansion. The August retail sales report provided an important piece of evidence. Retail and food-service sales increased 1.2% from July and 5.8% from a year earlier, substantially exceeding the consensus expectation for the month. More important for assessing the underlying pace of consumption, the Census

Bureau's control group, which excludes several volatile categories and feeds directly into the calculation of GDP, rose 1.4% in August. Non-store retail sales increased 2.6%, while electronics and appliance stores rose 1.6%. The rebound followed a 0.5% decline in retail sales in July. This data suggests to us that the consumer entered the third quarter with considerable momentum. They also call into question one of the standard interpretations of the post-pandemic economy: That aggregate consumption has been sustained principally by affluent households while lower-income consumers have increasingly retrenched.

There was good reason for that interpretation. Research published by the Federal Reserve Bank of New York earlier this year found that, since 2023, real retail spending had been disproportionately driven by households earning more than \$125,000. Lower-income households experienced periods in which real retail spending declined, producing what has commonly been described as a K-shaped consumer economy where different groups of consumers are moving sharply in different directions rather than experiencing the same economic cycle. More recent evidence from Bank of America, however, points toward a meaningful change in that pattern. Bank of America's proprietary credit- and debit-card data show that total card spending per household increased 0.9% in August from July and 4.5% from a year earlier. Particularly noteworthy is the bank's observation that spending and wage growth have been converging across income groups. Bank of America concluded that the consumer, after displaying distinctly K-shaped spending characteristics for more than a year, was increasingly exhibiting what it called a "great convergence." The principal exception was the highest-income segment, the top 5%, where strong balance sheets and rising asset prices continue to support unusually strong spending. This does not mean that the differences between households have disappeared. They have not. Higher-income households continue to account for a disproportionate amount of aggregate consumption and retain substantially greater financial resources. But the more recent data suggests that the lower and middle portions of the income distribution are contributing more to the current spending expansion than previously thought.

There is an important distinction here between financial capacity and spending behavior. Lower-income households remain under greater pressure from the cost of necessities than higher income earners, and they have become considerably more price-conscious. Bank of America reports that lower-income consumers have increasingly shifted toward discount apparel, value-oriented grocery stores and general merchandise retailers. Indeed, lower-income households have accounted for a growing share of spending at discount retailers even while trading down in the products they purchase. That behavior is economically significant. A consumer does not have to be unconstrained to be an active consumer. Households can respond to inflation by changing where they shop, what they buy and how much they spend without necessarily reducing aggregate consumption materially. The recent retail-sales data suggest that this process of substitution and trading down may be helping sustain overall spending.

Bank of America's August findings provide additional evidence of financial resilience. The firm reports that lower- and middle-income households continue to hold elevated deposit balances relative to pre-pandemic levels across age groups, while credit-card utilization has declined across most income and age cohorts. These observations are consistent with a consumer sector that remains capable of spending even though households are becoming more deliberate about obtaining value from their purchases.

One important takeaway from this data: If consumption is being supported almost exclusively by the wealthiest households, its durability would be particularly vulnerable to negative developments in financial markets and asset prices. A broader distribution of spending would provide a somewhat more stable foundation for aggregate demand because employment and wage income, rather than financial wealth alone, would be supporting a larger share of consumption.

Nevertheless, there is still considerable reason for caution. Real disposable income has not been accelerating rapidly, inflation remains above the Federal Reserve's 2% objective, and the labor market has cooled from its earlier strength. Moreover, the Bank of America data is proprietary and based solely on its own vast customer population; their data should therefore be viewed as an important high-frequency indicator rather than a substitute for the government's official national accounts. Still, the convergence evident in these data represents a meaningful development. The appropriate conclusion is not that the K-shaped economy has disappeared, but rather that the sharp divergence in consumer spending that characterized the earlier part of this expansion appears to have narrowed. For purposes of assessing economic growth, that distinction matters.

The August retail-sales report and Bank of America's card-spending data both point toward a consumer sector that is not only resilient but potentially broader than previously understood. Combined with continued strength in business investment, this broader consumption base helps explain why aggregate demand has continued to expand.

Business Investment

If consumer spending is the economy's traditional engine for growth, business investment has become an increasingly important second engine, perhaps the more consequential one from a longer-term perspective. The second quarter data are striking. Real nonresidential fixed investment increased at a strong pace, with spending on equipment, software and other intellectual property providing substantial support to economic growth. The composition of business investment is particularly noteworthy. Spending on information-processing equipment, software and other intellectual property has been expanding rapidly as companies invest in computing power, data infrastructure and the software required to deploy artificial intelligence. The scale of the investment associated with AI is difficult to overstate. The major technology companies alone have been committing hundreds of billions of dollars

to capital expenditures, much of it directed toward data centers, advanced computing equipment and the electricity infrastructure needed to operate them. These expenditures are beginning to extend beyond the technology sector itself, as utilities, manufacturers, construction companies and semiconductor suppliers respond to the requirements of the new computing economy. These outlays reflect more than a conventional cyclical recovery in capital spending. A significant portion of today's investment represents an effort by American companies to expand productive capacity. Data centers, semiconductor fabrication facilities, power generation and transmission, advanced networking equipment and industrial automation are all forms of capital that can remain productive for many years. The investment is therefore both a source of current demand and a potential source of future supply.

The distinction is important. Capital expenditures ordinarily rise when businesses anticipate stronger demand, but the current investment cycle has an additional motivation: the expectation that technology itself will increase productivity and profitability. Companies are spending heavily today because they expect artificial intelligence and related technologies to permit them to produce more output with fewer resources tomorrow. If those expectations are realized, the resulting productivity gains could allow the economy to grow faster without generating a corresponding increase in inflationary pressure. There is already some evidence that the investment cycle is broadening. Lending credence to our **manufacturing renaissance** theses, as discussed below, the September ISM manufacturing survey showed the manufacturing sector remaining in expansion territory, with the headline index rising to 54.5, its ninth consecutive month above the 50 level that separates expansion from contraction.

Corporate financial conditions have also provided an important foundation for the investment cycle. Corporate profits remained substantial, accelerating as the year has progressed. Many of the companies undertaking the largest capital programs are generating sufficient internal cash flow to finance a considerable portion of their investment without relying heavily on external borrowing. This is especially relevant in an environment of elevated interest rates. Investment decisions are certainly affected by the cost of capital, but companies with strong balance sheets and substantial cash generation have greater latitude to pursue projects with attractive long-term returns.

The role of data centers deserves particular attention. The rapid expansion of artificial intelligence applications has created demand not merely for computer chips but for an entire physical ecosystem: data-center construction, servers, networking equipment, cooling systems, transformers, electricity generation and transmission, and the land and construction services required to accommodate them. The investment multiplier therefore extends well beyond the companies that developed chips.

The investment cycle has therefore acquired an unusual degree of self-reinforcement. Businesses are spending today because they expect technology to raise productive capacity tomorrow; the companies supplying that technology are investing in their

own capacity to meet the demand; and the infrastructure required to support the technology is generating additional investment across the broader economy. At the same time, strong corporate profits and cash flows provide an important source of financing.

Taken together, the evidence suggests that businesses continue to invest despite considerable uncertainty surrounding tariffs, interest rates, geopolitics and the outlook for demand. That resilience is important because business investment does more than contribute to current GDP. It expands the economy's capital stock. If the productivity gains anticipated from today's technology investment materialize, the payoff could extend well beyond the current economic cycle, raising potential output and providing an important counterweight to some of the demographic and labor-force constraints facing the economy.

The Labor Market and Inflation

The labor market has been gradually losing momentum for some time, but the September employment report provides the clearest evidence yet that the adjustment may be entering a new phase. For much of the past year, the labor market could reasonably be described as a “low-hire, low-fire” environment: employers were becoming more cautious about adding workers, but layoffs remained limited. That distinction helped explain how the economy could continue to expand at a solid pace even as monthly payroll gains slowed. The September jobs report suggests that this equilibrium is becoming less favorable. The economy added only **29,000** nonfarm jobs in September, far below the consensus expectation of roughly 90,000 and well below the already modest average monthly gain of 45,000 during the preceding twelve months. More importantly, the weakness was not confined to September. The Bureau of Labor Statistics revised July payrolls from a gain of 21,000 to a decline of 10,000, while August was revised from 162,000 to 133,000. Taken together, July and August employment was 60,000 weaker than previously reported. This pattern matters because revisions can tell us more about the underlying trend than any single monthly observation. A weak September number could ordinarily be dismissed as noise, particularly in a series as volatile as monthly payroll employment. But when a weak current reading is accompanied by downward revisions to the preceding two months, the evidence for a genuine slowing in labor demand becomes more persuasive. The unemployment rate provides a second indication of this change, increasing from 4.1% to 4.2%, with the number of unemployed Americans reaching approximately 7.1 million. The uptick is hardly dramatic as the unemployment rate has remained within a narrow 4.1% to 4.3% range since March, but the direction is noteworthy because it occurred alongside very weak payroll growth.

There is also a more constructive interpretation of the increase in unemployment. The labor-force participation rate rose to 61.8%, while the employment-population ratio remained at 59.2%. Some of the increase in unemployment reflected people entering or re-entering the

labor force and looking for work rather than a sudden wave of layoffs. The number of people not in the labor force who wanted a job remained essentially unchanged at 5.8 million. This is an important distinction. A rise in unemployment caused primarily by layoffs would provide considerably more evidence of deteriorating economic conditions than an increase resulting from people becoming more willing to look for work. The September report contains elements of both, but the available data continue to suggest that hiring has weakened more substantially than firing. The industry detail reinforces that interpretation. Health care continued to add jobs, although its September gain of 17,000 was only about half its 12 month average. Construction added 11,000 jobs and manufacturing 9,000, while financial activities lost 7,000 and information employment declined by 10,000. The breadth of employment gains therefore narrowed considerably.

Perhaps the most consequential development for the inflation outlook is occurring on the wage side of the labor market. Average hourly earnings increased only 0.1% in September and were up 3.0% over the preceding twelve months. The average private-sector work week was unchanged at 34.4 hours. The combination of slower employment growth, little change in hours worked and moderating wage growth suggests that labor compensation is becoming a less significant source of upward pressure on prices. That development could prove important for monetary policy. The Federal Reserve faces an unusually difficult balancing act because inflation remains above its 2% objective even as labor-market conditions are deteriorating. Until recently, the combination of persistent inflation and relatively solid economic activity had left the possibility of a series of additional rate increases firmly on the table. The September employment report changes that calculus. Markets responded accordingly. Following the report, Treasury yields declined and expectations for another near-term Federal Reserve rate increase retreated sharply. The immediate market interpretation was that the risk of excessive labor-market strength, and therefore additional inflationary pressure, has diminished.

That does not mean that inflation is no longer a problem. The September employment report is only one month's observation, and wage growth at 3.1% remains above what would be consistent with the Federal Reserve's 2% inflation objective if productivity growth were modest. Moreover, other sources of inflation, including tariffs and energy costs, are largely independent of domestic labor-market conditions. A weaker employment report therefore does not guarantee a return to 2% inflation. But it does change the balance of risks. Until recently, the principal concern was that the economy was growing sufficiently to keep labor demand firm while inflation remained stubbornly elevated. The September report introduces the opposite possibility: economic growth may be slowing sufficiently to reduce inflationary pressure, even as employment conditions deteriorate. That is a very different policy environment.

For now, employment data points to only a cooling of the economy. There are no signs of widespread layoffs. Initial unemployment claims remain historically low, and the unemployment rate, at 4.2%, remains low by longer-term standards. The September report is therefore better understood as more of a notable change in direction of the economy than as evidence of a recessionary labor market. The broader implication, though, is that the economy's risk profile has shifted. Earlier in the year, the combination of resilient spending, strong business investment and persistent inflation created concern that economic growth might remain sufficiently strong to keep the Federal Reserve tightening policy. The latest employment data point in the other direction. In short, growth appears to be losing some of its labor-market support, while wage pressures are moderating. That shift in the balance of risks may ultimately prove more important than the headline payroll number itself.

Corporate Profits

One of the most consequential developments in the US economy this year has been the extraordinary acceleration in corporate profitability. After S&P500 earnings increased roughly 28% in the first quarter, the second quarter produced another unusually strong performance, with reported earnings growth well above 30% after adjusting for unusually large, unrealized gains at Alphabet and Amazon. The momentum has carried into the second half of the year: Analysts now estimate that S&P500 earnings increased approximately 29% in the third quarter, which would make three consecutive quarters of earnings growth above 25%. The earnings acceleration is being supported by particularly strong revenue growth, about 15% in the second quarter. The S&P500's net profit margin, including unrealized gains, reached approximately 15.7% in the second quarter, the highest level dating back to 2009.

The significance of this development extends well beyond the reported earnings of publicly traded companies. Corporate profits are ultimately a source of the funds that finance investment, research and development, hiring, dividends and share repurchases. The current cycle is especially important because a substantial portion of those profits is being recycled into an extraordinary wave of capital investment in artificial intelligence, data centers, semiconductors, electrical equipment and related infrastructure. That investment is itself becoming an increasingly important source of economic growth. Indeed, the most recent revision to second-quarter GDP showed the economy expanding at a 2.2% annual rate, with consumer spending rising 3.8% and business investment in equipment continuing to grow at a double-digit pace.

There is a reinforcing relationship between profits and the broader economy: strong demand produces higher revenues; higher revenues, combined with productivity gains and operating leverage, produce stronger profits; and those profits provide businesses with the resources to invest in additional productive capacity. The result is

a potentially virtuous cycle in which corporate profitability is not merely a consequence of economic growth but an important contributor to it.

For investors, the importance of the earnings surge is clear: over time, the value of common stocks is anchored by the cash flows and earnings that the underlying businesses can generate. Exceptionally strong earnings growth therefore provides an important fundamental counterweight to the headwind created by higher interest rates and elevated equity valuations. It also helps explain why the market's valuation has not risen as dramatically as the level of the major indexes might suggest: earnings estimates have been rising rapidly alongside share prices. The more important question as we move into 2027 is whether the current rate of profit growth can be sustained. Some moderation is likely after three consecutive quarters of growth above 25%, particularly as the extraordinary contribution from AI-related investment becomes harder to accelerate at the same rate. Yet moderation from an exceptional growth rate is very different from a deterioration in profits. If revenue growth remains healthy, productivity continues to improve, and businesses are able to convert their substantial investment in technology and AI into higher output and margins, corporate America enters the next phase of the economic cycle with a considerably stronger earnings foundation. For investors, that distinction is critical: the durability of the earnings expansion, not simply its extraordinary magnitude in 2026, will be one of the most important determinants of equity performance in the years ahead.

Forward-Looking Economic Indicators

The leading economic indicators we monitor present a mixed but still generally constructive picture of the US economy.

The most encouraging signal comes from the business surveys. The September S&P Global composite PMI rose sharply to 58.4, from 56.0 in August, its highest reading since July 2021. Both manufacturing and services contributed to the acceleration, indicating that the improvement was relatively broad rather than concentrated in a single sector. The September ISM manufacturing PMI likewise remained firmly in expansion territory at 54.5, its ninth consecutive month above the 50-level separating expansion from contraction. Within the index, new orders rose to 55.3, employment to 52.7 and backlogs to 56.4. These are important forward-looking components because they suggest that manufacturers continue to see sufficient demand to maintain production and, increasingly, employment. The principal concern is the prices-paid index, which rose to 77.9, providing additional evidence that inflationary pressures remain embedded in the supply chain.

Meanwhile, labor-market indicators are sending a more cautious signal. Initial unemployment claims fell to 197,000 in the latest week, while the four-week moving average stood near 200,000. Those numbers remain exceptionally low by historical standards providing little

evidence of widespread layoffs. At the same time, however, the September employment report showed that employers are becoming considerably less willing to add workers. The recent JOLTS report for August showed a decline in job openings to their lowest level since March, reinforcing the message of the weak September jobs report. The unemployment rate rose to 4.2%, and wage growth moderated to 3.0% over the past year. The combination of very low layoffs and much slower hiring is characteristic of a labor market that is cooling rather than collapsing.

Our firm's proprietary [Economic Model](#), which is designed to identify changes in the direction of the US economy approximately six to nine months before an inflection point, remains above trend and continues to signal expansion ahead. Taken together, these indicators suggest that the economy is entering the final months of 2026 with positive underlying momentum, although the composition of that momentum is changing. Business activity and private demand remain firm, while employment is becoming a progressively less powerful source of support. The principal question for monetary policy is whether this moderation in labor demand will eventually translate into lower inflation without producing a more substantial slowing in economic growth.

The Outlook

On balance the economic data we've reviewed present a combination of strength and restraint. Consumer spending remains solid. Business investment, particularly investment associated with technology, artificial intelligence and productive capacity, is exceptionally strong. Manufacturing and services surveys remain in expansion territory. Employment is still growing, although at a slower pace than previously. And corporate profits are growing at an exceptional rate, exceeding Wall Street expectations. Against this strength stand elevated inflation, restrictive financial conditions, higher long-term interest rates, tariff uncertainty, geopolitical risks and weakness in interest-sensitive sectors. The net result is not an economy without vulnerabilities. Nor is it an economy exhibiting the broad-based weakness that would normally precede a significant economic downturn. Rather, the current expansion appears to be supported by two unusually resilient pillars: consumer and business investment, while other portions of the economy are absorbing the effects of higher interest rates and other constraints. That distinction will matter in the months ahead. The sustainability of the expansion will depend increasingly on whether productivity gains and business investment can continue to offset the restraint coming from monetary policy and whether household income remains sufficient to sustain consumption.

For investors, the important point is that the economy has thus far demonstrated considerable capacity to absorb shocks. The latest data show that private domestic demand is running substantially faster than headline GDP, with real final sales to private domestic

purchasers increasing 4.6% in the second quarter. The challenge now is to determine whether that resilience can persist as inflation remains elevated and financial conditions tighten further.

At this juncture, the evidence we have suggests an economy that is slowing in some important areas but continuing to grow because the trends of its two principal private-sector engines, consumer spending and business investment, are quite positive.

Equity Investment Policy

Equity investment policy remains unchanged. Portfolios under our firm's supervision remain fully invested within agreed guidelines reflecting our view that the US economy remains fundamentally sound and corporate earnings continue to provide a favorable backdrop for equity investment. Our large cap core portfolios remain well diversified and balanced between *growth* and *value* shares, providing exposure to different sources of earnings growth and market leadership over an economic cycle. That view is reinforced by our firm's proprietary [Economic Model](#), updated last week, which remained above-trend, signaling expansion ahead. Though inflation remains elevated and interest rates have moved higher, economic activity continues to expand at a solid pace, supported by resilient domestic spending, strong productivity growth and robust capital investment. Importantly, corporate fundamentals have remained solid. Recent sell-side industry conferences across financials, technology, industrials and healthcare have generally reinforced a favorable earnings outlook, with analysts raising estimates for a number of companies following management updates. Despite persistent concerns over the health of the economy, higher interest rates and the durability of AI-related investment, business conditions remain generally sound, demand has held up well and corporate profitability remains strong. Merger and acquisition activity remains healthy, while the IPO pipeline still includes a number of high-profile technology offerings, though recent postponements suggest investor appetite has become more selective as market conditions have grown less certain. Even so, there are few signs thus far of the broad deterioration in business fundamentals investors have periodically feared.

The character of the stock market advance has also continued to evolve. Market performance became particularly narrow during September, with gains driven disproportionately by a relatively small number of mega-cap technology and semiconductor companies benefiting from the surge in spending on artificial intelligence. Nearly 80% of S&P500 stocks declined during the month, the average stock fell about 5%, and only two of the eleven market sectors advanced, led by technology. Smaller stocks also came under pressure, further highlighting the unusually concentrated nature of recent market leadership. Those AI-related investments remain important contributors to economic growth and corporate profitability, but the concentration of recent market leadership stands in contrast to the broader economic and

earnings expansion we continue to expect. In our view, this does not signal that technology leadership is nearing an end. Rather, as the economic cycle continues, we believe earnings growth and investor interest should broaden to include industrials, financials, healthcare and other areas of the economy as well.

We view broader market participation as constructive. A market advance supported by a larger group of companies would be less dependent on the continued leadership of a handful of unusually large technology companies and would better reflect the breadth of opportunity represented in diversified portfolios such as those we manage. Our approach, which includes both *growth* and *value* investments, should allow portfolios to participate as leadership shifts across industries and investment styles. Many of the large and mega-cap companies we own also operate globally, allowing portfolios to participate in economic growth across developed and emerging markets while maintaining our primary focus on high-quality US-listed firms. These companies benefit from diversified end markets, broad customer bases and multiple sources of long-term growth, reinforcing the value of diversification not only by industry and investment style, but also by geography. As market leadership continues to evolve, we believe this combination of broad sector exposure and global reach remains an important advantage of a well-diversified large cap portfolio.

Looking toward year-end, the investment environment presents competing forces rather than a uniformly bullish or bearish picture. On balance, we believe the positives continue to outweigh the negatives. Economic growth remains solid, employment conditions are stable and earnings expectations continue to rise. We do not believe corporate earnings are peaking, though the rate of earnings growth may be approaching a cyclical high. Productivity-enhancing investment in artificial intelligence and other technologies should provide additional support to economic growth over time. Against these tailwinds are persistent inflation pressures, higher interest rates and elevated energy prices, while geopolitical developments involving Iran, Ukraine and elsewhere remain potential sources of short-term volatility. The Federal Reserve's recent decision to raise its policy rate is a reminder that persistent inflation can limit the scope for monetary accommodation even as underlying economic conditions remain healthy. These crosscurrents argue for continued emphasis on companies with durable earnings growth, strong balance sheets, pricing power and the ability to generate attractive returns on capital across varying economic environments.

As for stock market valuation, equities are neither uniformly cheap nor expensive. The cap-weighted S&P500 remains above its longer-term average valuation, reflecting the premium attached to its largest and fastest-growing companies. By contrast, valuations across the equal-weighted S&P500, mid-cap and small-cap indices are considerably less demanding, reinforcing our view that opportunities remain attractive beneath the headline index. As of

September-end, the S&P500 traded at roughly 19X forward earnings compared with about 16X for the equal-weighted index. We, therefore, view the overall US equity market as fairly-valued, with more attractive opportunities available away from large technology and AI-themed companies that have driven recent market gains. Elevated valuations increase the likelihood of periodic corrections, but absent deterioration in economic and earnings fundamentals, they do not alter our longer-term constructive view toward equities.

Fixed Income Investment Policy

In view of the recent spike in interest rates, we have modestly increased the target duration of bond portfolios under our supervision from 2.7 to 3.0 years, taking advantage of yields on investment grade corporate bonds maturing in five years or less, not seen in over a generation. Reflecting the recent sharp rise in interest rates, the yield on the 10-year US Treasury bond rose to about 5.34% on October 1, its highest level since 2002. Late last year, the yield on that issue was below 4.0%. Shorter-term bond yields have also risen, though less dramatically than those of longer duration instruments. The move in rates has been global: British 30-year gilt yields approached 6%, French 10-year yields approached 5%, and Japanese yields also reached multi-decade highs.

We see five forces driving US interest rates higher:

- **Inflation has not gone away.**
The combination of above-target US inflation, higher oil prices and tariff-related price pressures has caused investors to reduce expectations for a rapid return to 2% inflation. The September ISM Manufacturing Prices Index at 77.9 reinforces that concern. Globally, the Middle East conflict and elevated energy prices have added another potential source of inflation.
- **The market has repriced the future path of the Fed.**
Long-term yields incorporate expectations about future short-term interest rates. The September employment report reduced expectations of another immediate Fed increase, but the market is still contemplating a substantially higher path for interest rate policy than it had anticipated earlier in the year. The September rate increase and persistent inflation have contributed to that repricing.
- **The fiscal supply of Treasury securities is enormous.**
Large federal deficits mean that the Treasury must issue an unusually large volume of debt. Investors are increasingly demanding additional compensation to absorb that supply, particularly at the long end. This is not simply a question

of whether the government can finance its debt; it is a question of the price the market requires to finance it.

- **The term premium has risen.**

This is perhaps the most important, and least visible, part of the story. Analysts estimate that roughly 40% of the recent 90 basis point rise in the US 10-year Treasury yield was attributable to an increase in the term premium, the additional compensation for uncertainty investors demand for committing their funds to a longer-term bond rather than repeatedly investing in short-term securities. Fiscal uncertainty, uncertainty about future inflation and interest rates, and the enormous amount of government and corporate borrowing all contribute to that premium.

- **There is a global competition for capital.**

Japan and Europe are experiencing their own bond-market adjustments. Higher domestic yields make Japanese and European securities more attractive relative to Treasuries, potentially reducing the incremental demand from foreign investors that has historically helped support the US market. At the same time, the enormous investment associated with AI infrastructure is competing for global capital.

Despite the current negative sentiment, we see several potential catalysts for a reversal in rates over the intermediate term. **First, inflation could resume a convincing decline.** A sustained moderation in core inflation, particularly if accompanied by lower oil prices and evidence that tariffs are producing only a temporary price-level adjustment, would reduce the inflation premium embedded in longer-term bonds. **Second, the labor market could weaken further.** The September payroll report, 29,000 jobs and an unemployment rate of 4.2%, is an early indication that demand for labor is cooling. If that weakness broadens, the market will begin anticipating lower Fed Funds rates. That would primarily affect the two- to five-year portion of the curve initially but eventually could pull longer yields down as well. **Third, economic growth could moderate.** This is the paradox confronting the bond market. The economy has been strong enough to sustain investment and consumption, but if the cumulative effect of high interest rates, weaker employment and tighter financial conditions begins to slow private demand materially, Treasury bonds could once again benefit from their traditional safe-haven characteristics. **Fourth, fiscal policy could become more credible.** A credible reduction in the trajectory of federal deficits and Treasury borrowing would directly reduce the supply pressure on the bond market and could lower the term premium. This is potentially the most powerful structural catalyst, although it is also the least visible in the immediate future. **Finally, the global bond-market shock could simply exhaust itself.** At

sufficiently high yields, bonds become more attractive to pension funds, insurance companies, foreign investors and other long-duration buyers. A 10-year Treasury yielding more than 5% provides substantially more income than it did when yields were below 4%. Indeed, the market showed some signs of stabilization on October 2, with US and European yields retreating from their recent highs.

With yields above 5% on the 10-year US Treasury, the prospective income expectation from owning of high-quality bonds is materially different from what investors faced when long-term yields were 2–3%. The critical question is whether today's higher yields represent a **new structural equilibrium** or an overshoot that will eventually reverse as inflation and growth moderate. That is the central fixed-income question for the next several quarters. We believe the odds favor the later outcome: a substantial but incomplete reversal of the recent rate spike.

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