SMITH AFFILIATED CAPITAL

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A New Fed Leader Facing Some Old Problems

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The new Fed Chair, Kevin Warsh, handled his first FOMC meeting and press conference last month capably but gave few clues regarding the direction of policy. That was deliberate, as Warsh wants to make a clear break in the communication style from his predecessor, believing that less is better. However, the central policy dilemma he faces is almost the same as that faced by Jerome Powell. Simply put, his Fed colleagues are almost equally divided over the economic and rate outlook, and there's no clear path forward to break the policy deadlock other than letting incoming data swing the argument one way or the other.

Despite leaving rates unchanged, the mid-June meeting signaled a modest tilt to a more hawkish sentiment as the median forecast conveyed by the dot plots called for a rate hike this year. We caution, however, that the median encompassed 18 of the 19 members of the FOMC committee whereas only 12 are voting members, and they include more dovish officials than the broader group. That said, the futures market is pricing in 100 percent odds of at least one hike this year. Clearly, those bets are heavily influenced by incoming data as much as by the dot plots.

However, we are living in a very fluid economic landscape, disrupted by myriad external events that may or may not fade abruptly. The Mideast conflict has been the proximate catalyst behind the surge in inflation, the AI boom is fueling overzealous investment spending -- and, until recently, a powerful tech-led stock market rally -- and enlarged tax refunds imparted muscle into consumer spending during the spring. But the MOU announced in mid-June suggests that the war could end soon, oil prices have since plummeted, and those tax refunds have dried up. Meanwhile, the AI buildout is facing hurdles, as voters are increasingly denying applications to build data centers in many districts. In short, Incoming data may look very different a few months from now as the ebb and flow of external shocks disrupts the economic landscape

Transitory Growth-Boosting forces are Fading

Incoming data are tracking a 2 percent growth rate for the just-completed second quarter, almost spot-on with the 2.1 percent in the first quarter. Both the labor market and consumer spending were more resilient than expected and, importantly, inflation turned hotter thanks mainly to the war-induced surge in energy prices. That confluence of events gave the new Fed Chair cover to leave rates unchanged and caused perceptions on Wall Street to pivot from expecting a rate cut earlier in the year to a rate increase now.

From our lens, expectations of a rate hike are premature, as they are anchored in stale data that were heavily influenced by transitory forces. The surprising resilience of consumer spending has stemmed from two main forces – elevated tax refunds and a strong stock market, including a 15 percent increase in the S&P 500, that amplified the wealth effect from high-net-worth households. As noted, the tax refunds are mostly spent, and low- and lower-middle-income households drew down savings to support spending that will need to be rebuilt in coming months. While the second quarter delivered the strongest gain in stock prices in six years, signs of fatigue are emerging as the S&P 500 lost ground in June. Critically, the MAGA stocks are no longer providing momentum and could readily ignite a market correction if growing sentiment regarding overpriced tech shares turns more broadly negative.

While energy prices have reversed course, they have taken a significant toll on household purchasing power that will have a delayed restraining effect on consumption. In both April and May inflation outpaced wage growth, resulting in a decline in real earnings for the first time in three years. We suspect that the decline in gasoline prices in June will drag headline inflation down significantly and restore real earnings growth. But the expected precautionary buildup of depleted savings will limit spending growth. What's more, the MOU is on shaky grounds, with periodic flareups of hostilities threatening to undercut the ceasefire and spur a rebound in oil prices.

AI spending Will Cushion the Blow

Whatever void is left by slower consumer spending should be filled by AI-related investment spending, which shows no signs of slowing. Overall, the near-term outlook for investment outlays remains bright. Business sentiment weathered higher oil prices and geopolitical uncertainty throughout the war in Iran, and with the end to the conflict in sight that headwind is likely to be removed. The continued buildout in AI will support computer and electronic orders, while the provisions of the One Big Beautiful Bill Act, which provides for full upfront expensing of equipment investment, should provide more broad-based support. The potential for higher interest rates due to a more hawkish Federal Reserve policy may introduce a small drag at the margins if it occurs. But we continue to expect business equipment investment to be one of the fastest growing components of GDP this year.

However, it may not be smooth sailing. While major technology giants historically relied almost entirely on their massive cash reserves to fund growth, the unprecedented scale of the AI infrastructure buildout has forced a dramatic turn to global debt markets. In the first five months alone, the five top tech firms issued $159 billion in bonds, which exceeded their combined debt issuance from the entire five-year period between 2020 and 2024 and is $51 billion higher than all of 2025.

While the credit spigot remains open, with funds from unregulated private credit sources exceeding the amounts raised in the public markets, the willingness to keep the flow going depends on whether the near-term earnings growth on AI justifies the outsize spending planned. We note that the share of tech-related spending on capital equipment and software rose to 11.3 percent of nominal GDP in the first quarter and is tracking higher in the second quarter. The last time it was this high was in the second quarter of 2000, when the share peaked at 11.5 percent. At that point, the capacity overbuild became obvious, ushering in the dot.com bust and a blowout of credit spreads that stifled access to the credit market.

Risks to the AI Boom

We do not envision a repeat of that episode, as the tech firms in the spotlight are mostly well-established profitable companies, unlike the sock puppet at the turn of the century. While we expect them to remain a key force driving growth going forward, some tapering off in spending should occur. The aforementioned public backlash as well as potential financing hurdles are already posing problems and seeping into market sentiment. Private credit funds are facing huge withdrawal demands from investors who are growing more skeptical over whether the potential rewards of enormous AI spending justifies the risk. What's more, the unprecedented growth in the AI build-out is having knock on effects on the broader economy that could offset the growth-inducing impact of its spending.

The most visible effect is the inflationary impact that the massive spending on energy -hungry infrastructure, notably data centers, is having on electric grids and water supplies. That's already driving up utility bills and is a main catalyst behind growing public resistance to expansionary spending plans. Meanwhile, the capital equipment and software needed to fill these structures and feed the appetite of AI's transformative technology is straining the supply of semiconductors and memory chips, driving up prices of consumer electronics as well as on industrial inputs.

The big debate is whether productivity gains promised by the AI buildout will more than offset the inflationary boost it is currently imposing on the economy. This prospect is embraced by none other than Kevin Warsh, who is dipping into the then-Chair Alan Greenspan's playbook of the late 1990s. At that time Greenspan resisted calls to raise rates amid a

red-hot economy and low unemployment arguing that stronger productivity growth would keep inflation in check. That stance proved to be correct for several years – until it overstayed its welcome and forced a recession-inducing response in policy.

Less Forward Guidance but More Volatility Expected

With the benefit of hindsight and more information, we think the Fed will adopt a more flexible approach to the complex set of forces now playing out. Time will tell how the debate between AI's productivity promise and inflation is resolved. The debate is also connected to growing fears that AI will replace labor and amplify the wealth disparity that has opened more widely in recent years. Aside from software technicians and entry level positions typically filled by recent college grads in white-collar jobs, there has been little displacement of note so far. Indeed, the investment spending boom appears to be having more of a positive than negative effect on job growth for both white- and blue-collar workers. But it is still early days, and we note that it takes a lot of workers to build a data center, but only few to run it.

In our view, the drivers of the surprisingly strong rebound in job growth in recent months are losing power. The June increase in nonfarm payrolls fell short of expectations and previous estimates for April and May were revised down sharply. That said, the trend rate over the past three months was respectable, averaging 110 thousand a month. If anything, it further muddies varying estimates of what the breakeven rate of job growth is, one that aligns with growth in the labor force and keeps the unemployment rate steady. Some thought it could be as low as zero, given the wave of retirements amid an aging population and constraints on immigration. Despite exceeding that threshold by a healthy margin, however, it's apparent that the job market is not overly tight nor a source of inflationary pressures; wage growth is slowing, and productivity is strengthening.

Given the fluidity of the economic landscape, the Fed is poised to let the flow of data determine what the next rate move will be. We expect to see an extended pause as the disinflation process, interrupted by tariffs and the Mideast war, has stalled, pointing to elevated inflation until the effects of those shocks wear off. That may not fully play out until well into next year. Meanwhile, slower, but sustainable, growth should continue to be propelled by stronger productivity and investment spending, overcoming the drag from a stagnating labor force and vulnerable consumers striving to rebuild savings and confidence without the aid of supportive fiscal policy. Absent forward guidance from the Fed, the financial markets are susceptible to heightened volatility as unpredictable data stokes wild shifts in traders' perceptions. In this environment, an investment strategy that emphasizes flexibility within a portfolio of quality income-producing assets is the most opportune path to take.

Rates and Total Returns Quarterly And Annual Comparison

U.S. Treasury Market	Yield %			Total Return (%)	
	12/31/2024	12/31/2025	6/30/2026	2nd Qtr.	12 M 2026
3 Mo Bill	4.32	3.63	3.82	0.90	3.89
2 Year Note	4.24	3.48	4.15	0.29	2.70
5 Year Note	4.38	3.73	4.20	-0.14	1.99
10 Year Note	4.57	4.17	4.44	0.18	2.83
30 Year Note	4.78	4.85	4.93	0.88	2.34

Municipal Bonds	Yield (%)			Total Return (%)	
	12/31/2024	12/31/2025	6/30/2026	2nd Qtr.	12 M 2026
BB General Obligation Index	3.53	3.34	3.36	2.35	6.72
BB New York Bond Index	3.74	3.66	3.60	2.77	7.34
BB California Bond Index	3.50	3.36	3.40	2.26	6.77
BB Revenue Index	3.84	3.70	3.67	2.57	7.20

Equities	Levels			Total Return (%)	
	12/31/2024	12/31/2025	6/30/2026	2nd Qtr.	12 M 2026
S&P 500	5,882	6,846	7,499	15.20	22.29
Dow Jones	42,544	48,063	52,319	13.38	20.65
Nasdaq 100	21,012	25,250	30,276	27.73	34.38

Commodities	US $			Total Return (%)	
	12/31/2024	12/31/2025	6/30/2026	2nd Qtr.	12 M 2026
Comex Gold Future ($ per oz)	2,641	4,341	4,039	-14.59	15.71
Commodity Futures (CRB) Index	297	299	354	-5.05	18.95
W. Tx Int. Crude Future ($ per bbl.)	72	57	70	-17.56	36.35

Currencies	Levels			Percent Change (%)	
	12/31/2024	12/31/2025	6/30/2026	2nd Qtr.	12 M 2026
DXY	108.49	98.32	101.19	1.23	4.45
Yen	157.20	156.71	162.55	2.41	12.86
Sterling	1.25	1.35	1.33	0.26	-3.42
Euro	1.04	1.17	1.14	-1.13	-3.10

Global Bond Markets	Levels			Total Returns USD (%)	
	12/31/2024	12/31/2025	6/30/2026	2nd Qtr.	12 M 2026
German 10 year	2.36	2.85	2.86	0.76	-2.04
Japanese 10 Year	1.09	2.06	2.67	-3.70	-17.23
UK 10 Year	4.56	4.48	4.76	2.62	-0.48

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