

## A Bifurcated Expansion Rolls Into 2026

As the curtain rises on 2026, the forecasting floodgates are opening. As usual, there is no shortage of viewpoints as to where the economy is heading. Markets enter the new year following a period of relative strength, particularly across income-oriented assets, even as uncertainty around policy and late-cycle dynamics persists. Indeed, the year ahead promises to be as unpredictable as the last, when a new administration entered the White House with an array of unconventional policy proposals that stoked uncertainty, upended planning, and altered the behavior of businesses and consumers from what they would have done in a more tranquil environment. Policy uncertainty, particularly regarding trade, is fading; but questions about how the policies put into effect last year will play out this year remain unsettled. Will the delayed impact from tariffs continue to drive up inflation? Will that prompt the central bank to keep interest rates higher than otherwise, restraining growth and risking a recession? Regarding the Federal Reserve (the Fed), the president will be choosing a new chairman to take over the realm in May. Will he or she strive to push through policies that are aligned with economic needs or bend more to the wishes of the president?

These and myriad other unknowns linger heading into the new year. But a \$30 trillion economic juggernaut is not easily knocked off the rails and we suspect that it will survive whatever is thrown at it this year. Barring a potent external shock – a war involving the U.S., oil crisis, or a serious miscalculation by policymakers – it could perform pretty much the same as 2025, albeit with a slower and more uneven growth profile. The bad news is that the fissures seen during the year, most notably the bifurcated nature of the growth engine, will continue, leaving a swath of the population behind. Importantly, the economy derived its strength from three main pillars in 2025 – spending by affluent households, an AI investment boom, and another record-setting year for stocks that amplified the wealth gains of the upper income cohort. While this concentration has supported aggregate growth, it also underscores the importance of selective positioning should any one of these drivers weaken. That narrow base of support renders the economy more vulnerable to a setback if any one or all of them falters.

From our lens, both sides of the Fed’s dual mandate remain under pressure. Inflation seems to have stopped accelerating for now, but it remains sticky and poised to respond to the final leg of the tariff pass-through early in the new year. We view this risk as a potential source of near-term inflation noise rather than a renewed inflationary regime. As inflation continues to ease unevenly, our base case for 2026 is that the Fed retains flexibility, ultimately enabling two more rate cuts in 2026. Meanwhile, job growth is slowing, but a corresponding slowdown in the labor force is curbing the rise in the unemployment rate. That should keep the Fed on the sidelines for a while. But the labor market remains increasingly fragile, with a freeze on hiring alongside a lengthier time that jobless workers are staying on the unemployment lines. The glue holding things together is the lack of broad-based accelerating layoffs, which would heighten the risk of a recession. Odds are, the Fed will focus more on preventing this prospect from becoming a reality later in the year if, as we expect, inflation starts to recede.

### Consumers Will Drive Growth Again

The economy waxes and wanes mostly in response to consumer spending, which accounts for about 70 percent of total activity. Last year was no exception, although the spending spigot opened most widely for wealthier households. This cohort’s purchasing power benefited mightily from a booming stock market which, along with rising home values, added significant muscle to their net worth. The so-called wealth effect, in turn, provided more oomph to consumer spending, particularly for discretionary goods and services, than it normally does. This dynamic was also reflected in market outcomes, reinforcing asset prices and supporting confidence among higher-income consumers.

The less wealthy members of the population also kept their wallets opened. These households depend more on income to finance purchases, and the job market provided enough paychecks for them to afford buying essential goods and services. Even so, they had to draw down savings and add to credit card debt to finance purchases, even as inflation steadily ate into incomes as the year progressed. The slowdown in job growth over the second half of the year also reduced wage growth, heightening the financial struggles of lower- and middle-income households. This divergence underscores why growth has moderated without collapsing and why consumption remains uneven across income cohorts.

The fragmentation of the household sector should continue in 2026, but collectively consumer spending is expected to grow at a decent pace. The first half of the year should see the biggest bump in spending, thanks in good part to the large tax refunds resulting from the One Big Beautiful Bill Act. Lower-income households will receive refunds from the overpayment they sent to the IRS last year as most withheld taxes were not adjusted to align with the retroactive tax cuts implemented for all of 2025. Meanwhile, upper-income households will benefit from the Federal increase in the State and Local tax deductions. While these fiscal tailwinds support near-term consumption, their impact is likely to be front-loaded rather than sustained.

### Another Year of Strong Investment Spending

The enormous appetite for AI-related investment spending played a significant role in the economy's performance in 2025. Indeed, investment outlays contributed more to economic growth over the first half of the year than consumer spending, even though they are much less than half the size. The huge appetite to jump on the AI bandwagon will continue as more firms strive for the revenue potential and cost savings from replacing labor that the emerging technology promises to bring about. However, the outsized contribution AI spending made in 2025 is likely to wane this year as the massive expenditures have yet to generate comparable profits. As a result, AI investment may transition from a growth accelerant to a source of dispersion across firms and sectors. Many companies will now wait to see if this transformative technology is as financially rewarding as expected.

But what AI spending leaves on the table, other sources of investment outlays should pick up. Non-AI spending lagged in 2025 due to a surge in policy uncertainty related to the chaotic unfolding of tariff announcements. Many businesses froze budgets for capital equipment not knowing if or how significantly higher tariffs would impact their operations over the longer run. But most of the tariffs are now on the books and policy uncertainty should fade, unleashing the investments that were postponed in 2025. This shift aligns with a broader normalization in business planning rather than a renewed surge in risk-taking.

Importantly, as is the case for households, the incentive to spend on capital equipment will be getting a boost from the One Big Beautiful Bill. Among the investment incentives, the legislation allows for full expensing for new equipment and immediate expensing for domestic R&D outlays. The financial backdrop for capital spending should also be quite friendly. Companies ended the year with healthy profit margins, borrowing rates are coming down and banks are eager to lend. Agriculture equipment spending is also expected to rise, supported by a recently negotiated reduction of reciprocal tariffs aimed at opening markets for U.S. poultry, beef, nuts, and wheat, and a farm bailout embraced by the \$12 billion Farmer Bridge Assistance Program in December. Together, these factors support continued investment growth, though at a more measured pace than in 2025.

### Weaker Hiring Aligns with Reduced Labor Supply

A vital cog in the economy's growth engine is the job market. A meaningful deterioration would pose challenges, but current conditions point to moderation rather than breakdown. In 2025, GDP outpaced job growth by a wider margin than usual. It's unclear why that occurred, but various influences were at play. They include improved productivity that enabled companies to generate more output with less labor; over-hiring during the early post-pandemic years that left employers with ample workers to generate output; and, perhaps most important, the shrinking pool of workers available to hire due to immigration restrictions.

The last influence is important because it offset weaker hiring during the year and kept the unemployment rate mostly steady, at least until the uptick in November. Simply put, it made it difficult to detect how much slack there is in the labor force. The low hiring trend suggested that there was more slack than indicated by the low unemployment rate. But the reduced supply of labor suggested that the labor market was tighter, as less hiring was needed to accommodate the fewer number of workers seeking jobs. Hence, while job growth slowed over the second half of the year, unemployment barely budged until the very end. This dynamic helps explain why labor-market cooling has not yet translated into broader economic stress.

It's unlikely that the borders will reopen and allow a resurgence of immigrants to bolster the labor supply in 2026. Meanwhile, the aging population assures that the ever-increasing wave of retirements will continue to be a drag on labor supply. Hence, the breakeven rate—i.e., the number of new jobs needed to keep unemployment from rising—will be considerably lower than in the past. Most estimates suggest that a

monthly increase of around 50 thousand would be sufficient, a far cry from the 168 thousand average in 2024. This lower threshold reduces the risk that slowing job growth alone will precipitate a sharp rise in unemployment, even as hiring continues to cool. At present, trends suggest this outcome is plausible, supporting a baseline of continued labor-market normalization rather than abrupt deterioration. The question is: Will that lower threshold be met?

### Vibes Versus Reality

The short answer is yes. But that doesn't mean 2026 will measure up to a healthy or balanced performance. Slower employment growth, even if accompanied by a low unemployment rate, suggests that the fissures that opened up in 2025 will get wider. This divergence reinforces a mid to late-cycle environment rather than signaling an imminent downturn. One distinct feature of the economy last year is the wide gap that opened up between reality and perception. The economy, as noted, did just fine, punctuated by an eye-opening 4.3 percent annual growth rate in the third quarter. But ask people on the street how they feel, and the answer you will get is that the economy is in a recession. According to the University of Michigan's latest survey, household assessment of present economic conditions fell to an all-time low in December.

Ordinarily, this "vibe recession" is generally downplayed by policymakers who put more emphasis on hard data for guidance. We concur that it makes more sense to respond to what people do rather than what they feel. But it would not take much for reality to catch up with vibes if the narrow slice of the economy's strength starts to crack. Importantly, this risk reflects concentration rather than broad-based economic weakness. The most headline-grabbing vulnerability is the astonishing surge in AI-related stocks that has underpinned the wealth gains of upper-income households and, in turn, their outsized contribution to consumption.

Keep in mind too that much of the AI-related investment spending last year was financed with debt. Indeed, AI debt issuance accounted for 30% of the near-record \$1.7 trillion of investment-grade debt last year, fueled by the narrowest credit spreads since the turn of the century. This dynamic heightens sensitivity to earnings delivery rather than signaling immediate financial stress. If profits don't live up to expectations, spreads will widen and increase the costs of refinancing maturing debt, hurting profits. That could be the catalyst for a sell-off in tech stocks – which many analysts believe are already overvalued – and undercut the wealth gains of affluent consumers as well as a major source of the economy's spending support.

Absent clear evidence of a breakdown in earnings or credit conditions, the economy should continue to benefit from formidable fiscal support, fading policy uncertainty and low unemployment amid a sticky inflation environment—keeping the Federal Reserve in a patient, data-dependent posture rather than on a fixed policy timetable. As inflation resumes its retreat, supported in part by favorable base effects—tariffs drove up inflation in the second half of 2025, improving year-over-year comparisons later in the cycle—the Fed would retain flexibility to resume easing should labor-market conditions warrant additional support.

U.S. Treasury Market				Total Return (%)	
	12/31/2024	9/30/2025	12/31/2025	4th Qtr	1Yr
3 Mo Bill	4.32	3.94	3.63	0.99	4.23
2 Year Note	4.24	3.609	3.48	1.12	4.95
5 Year Note	4.38	3.742	3.73	1.07	7.15
10 Year Note	4.57	4.15	4.17	1.10	8.19
30 Year Note	4.78	4.73	4.85	-0.50	3.73

Municipal Bonds	Yield (%)			Total Return (%)	
	12/31/2024	9/30/2025	12/31/2025	4th Qtr	1Yr
BB General Obligation Index	3.53	3.42	3.34	1.60	4.31
BB New York Bond Index	3.74	3.73	3.66	1.53	3.69
BB California Bond Index	3.50	3.44	3.36	1.55	4.11
BB Revenue Index	3.84	3.77	3.70	1.57	4.21

Equities	Levels			Total Return (%)	
	12/31/2024	9/30/2025	12/31/2025	4th Qtr	1Yr
S&P 500	5,882	6,688	6,846	3.41	16.84
DJIA	42,544	46,398	48,063	4.68	15.17
Nikkei (Tokyo) US \$	39,895	44,933	50,339	12.15	30.55

Commodities	US \$			Total Return (%)	
	12/31/2024	9/30/2025	12/31/2025	4th Qtr	1Yr
Comex Gold Future (\$ per oz)	2,641	3,841	4,341	11.18	57.20
Commodity Futures (CRB) Index	297	301	299	-0.61	0.69
W. Tx Int. Crude Future (\$ per bbl.)	72	62	57	-5.18	-5.38

Currencies	Levels			Percent Change (%)	
	12/31/2024	9/30/2025	12/31/2025	4th Qtr	1Yr
Yen	157.20	147.9	156.71	5.96	-0.31
Sterling	1.25	1.3446	1.3475	0.22	7.66
Euro	1.04	1.1734	1.1746	0.10	13.44

Global Bond Markets**	Levels			Total Returns USD (%)	
	12/31/2024	9/30/2025	12/31/2025	4th Qtr	1Yr
German 10 year	2.36	2.71	2.85	-0.63	12.69
Japanese 10 Year	1.09	1.64	2.06	-8.12	-5.17
UK 10 Year	4.56	4.70	4.48	2.69	13.84
BB US Emerging Market	6.71	6.01	5.71	2.40	11.11