



Charts and Smarts®

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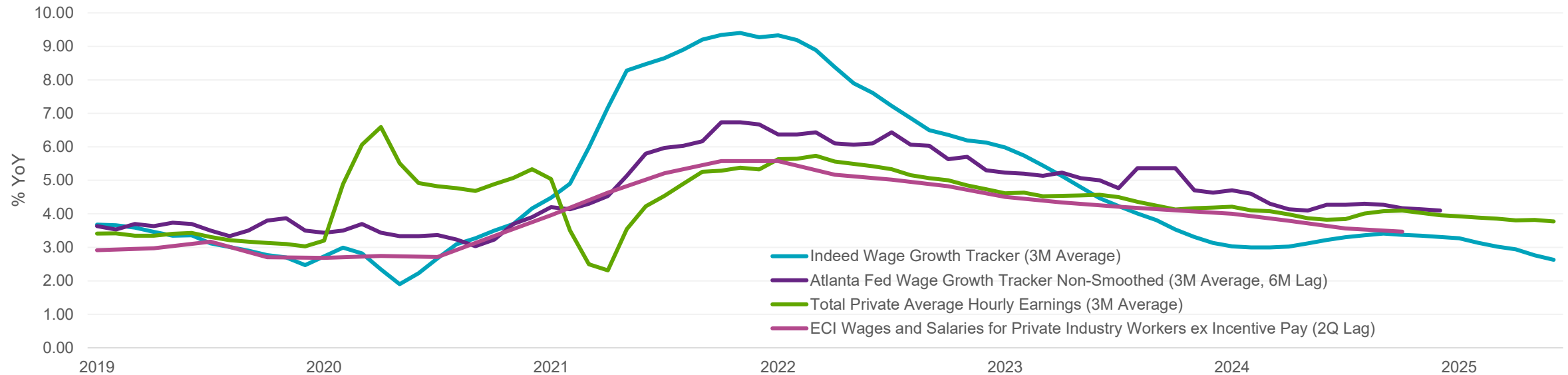
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Who Knows What Tomorrow May Bring

Measures of Wage Growth (3/31/19–8/31/25)

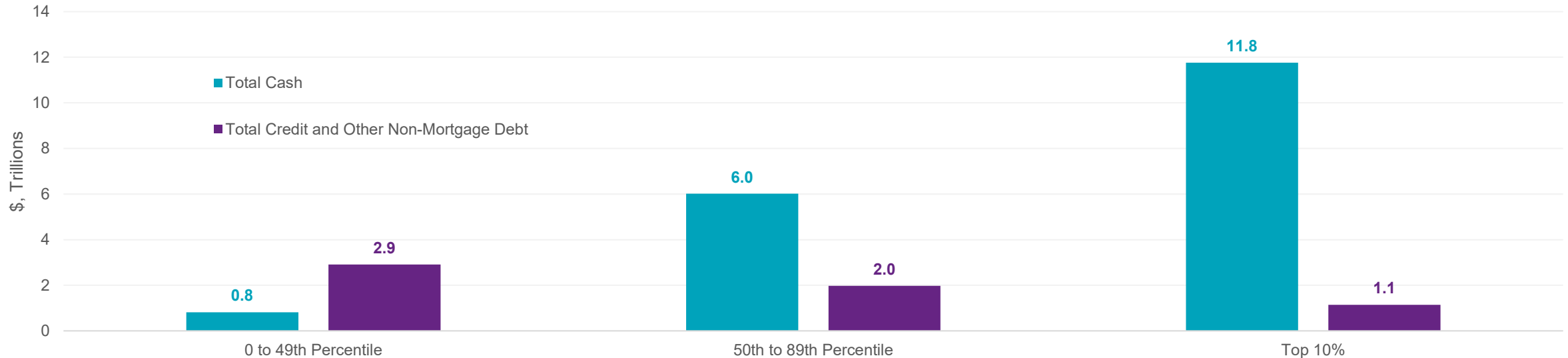


While market participants may be flying blind as a result of the government shutdown-induced data vacuum, the debate around the state of the labor market continues to rage. The Fed may have finally thrown in the towel with respect to its characterization that labor markets remain solid, citing downside risks to the labor side of the mandate as the factor behind its risk management cut in September. But the market largely continues to be of the mind that the softening in labor market conditions are primarily a function of decreasing labor supply. To be sure, labor force growth has collapsed from a robust run rate of 1.5%-2.0% from 2023 through mid-2024 to a stagnation thus far through 2025, which does indeed push down the breakeven rate of payrolls growth required to keep the unemployment rate stable. The simple fact that the unemployment rate has been grinding higher all year, despite the lack of labor-force growth, suggests that the labor market is not in a “curious balance” as Chair Powell has claimed. Slack is building, and that slack is a function of weak labor demand, not declining labor supply. Perhaps the strongest evidence countering the claim that labor supply is the key driver is the fact that wage growth continues to slow. Whether it’s average hourly earnings, the Atlanta Fed Wage Growth Tracker, Indeed-posted wage growth, or the Fed’s preferred measure, the Employment Cost Index (ECI) wage growth has largely normalized to, or below, pre-pandemic levels and continues to soften. That’s not something one would see when labor markets are in any sort of state of balance. It’s a sign of outright slack as labor demand has weakened more than supply. For now, labor markets remain in their trend of linear cooling, a fact confirmed by the latest batch of private sector employment data that investors have been forced to scour in the absence of official labor market data. And while risks remain clearly skewed to the downside, the left tail has been compressed as the Fed has once again embraced the labor side of the mandate. The Powell put is firmly in play and that’s good for the economy and markets alike.

Source: Portfolio Analysis & Consulting, Bloomberg.

Feelin' Alright

Total Cash vs Non-Mortgage Debt By Income Cohort (As of 2Q25)

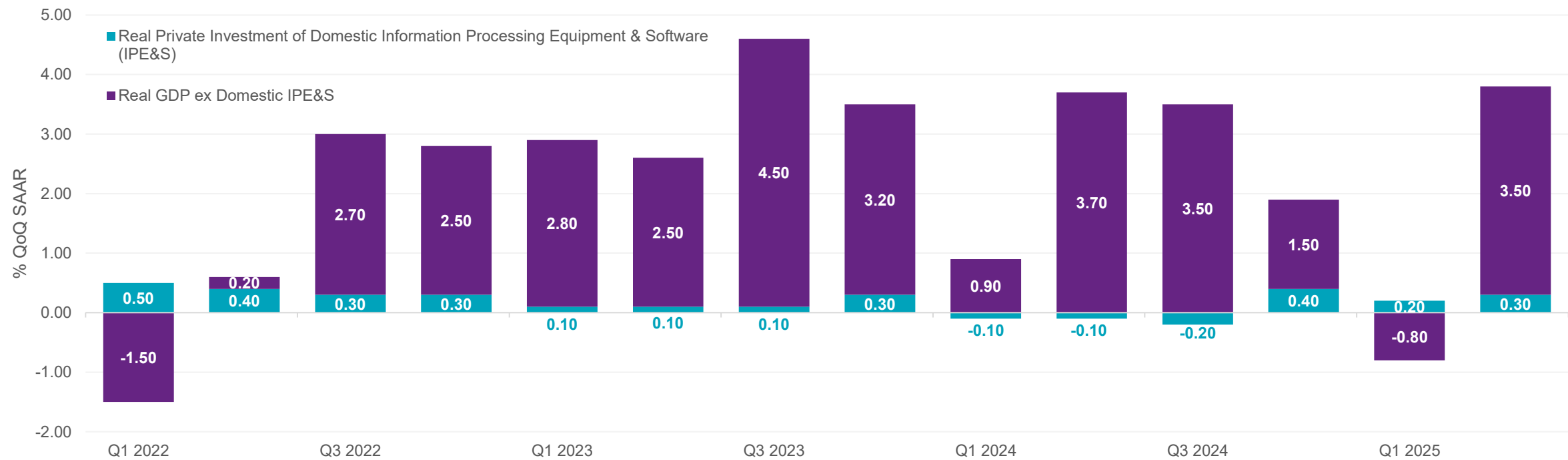


While the Powell Put is helping to compress the left tail of economic outcomes, another force appears to be increasingly critical in preventing that linear cooling in labor markets from morphing into a more pernicious, nonlinear deterioration: upper income consumers. The days of alphabet soup are back with the “K-shaped” economy having been revived from its pandemic era fame. While many imply that the K-shape is an anomaly unique to this cycle, it’s really more of the norm for the US economy. Wealth and income inequality has been a feature of the US economy for decades now and it has important implications for the cycle. Income tends to be the fuel behind consumption, and that relationship was remarkably tight through the pandemic recovery. But, over the past year, that link has been somewhat looser as consumption has remained remarkably resilient despite the deceleration in income growth, and the key to that deviation appears to be the resilience in spending from upper-income consumers. For all the focus on the growing strains on the lower-income consumer from cumulative inflation, spending cuts, and tariffs, the lowest quintile of consumers by income drive less than 9% of aggregate consumption, while the bottom 40% of consumers drive just over 21% of spending. Put differently, while lower-income consumers drive the marginal rate of change in consumption, wealthier consumers provide a very strong floor beneath consumption. The current environment is certainly lending some support to the idea that wealth effects are fueling more robust consumption than labor market and income trends would suggest. Upper-income consumers are benefiting from both healthy cash yields as well as net worth surging higher on the back of AI momentum in equity markets. While labor market trends are indeed concerning, these wealth effects suggest that consumption has become somewhat less sensitive to income growth. In other words, while downside risks to labor markets continue to mount, it will require more than a linear softening in labor markets to derail spending patterns and morph that linear cooling into a more concerning, nonlinear deterioration.

Source: Portfolio Analysis & Consulting, Bloomberg.

Gimme Some Lovin'

Tech Capex Contribution to Real GDP Growth (3/31/22–6/30/25)



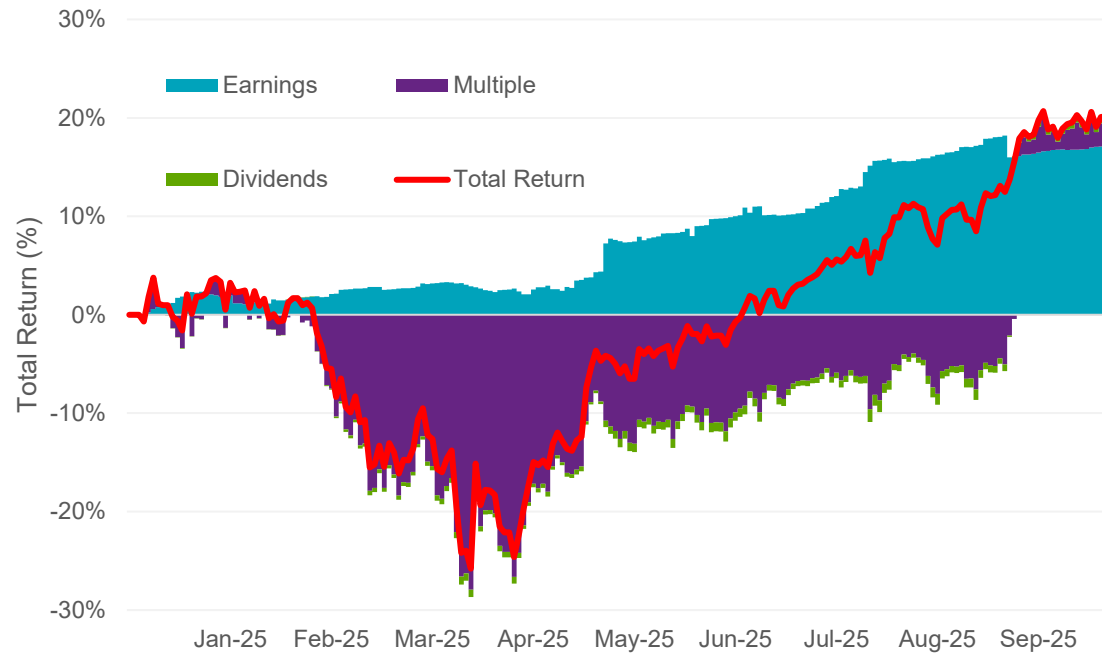
Speaking of AI, a popular narrative that emerged in the wake of the release of second-quarter GDP estimates was that as consumption faltered, the AI investment boom was increasingly the lone driver of growth in the economy. Subsequent estimates have seen second-quarter consumption revised materially higher, with both consumption- and tech-related fixed investment contributing equal shares to GDP growth over the first half of 2025. While it is certainly still noteworthy that tech-related investment, which represents just 6% of GDP, is contributing as much to growth as consumption, which is nearly 70% of the economy, the investment spending is only one part of the equation when it comes to growth contributions. Given that nearly all the chips and semiconductors being purchased for the AI buildout are produced abroad, imports of those chips mechanically drag on GDP growth. Netting those imports out against fixed investment in information-processing equipment and software tells a very different story. The AI capex boom is certainly contributing positively to both markets and the economy but, net of imports, the impact on real GDP growth is, in fact, fairly modest, adding just 25 basis points, on average, through the first half of 2025. Of course, given the indirect effects of AI spend on economic activity, it's impossible to perfectly portray the counterfactual of what the economy would look like in the absence of the AI boom. But, in simple terms, AI capex is not the sole driver of economic growth as surface level analysis suggests.

Source: Portfolio Analysis & Consulting, Ernie Tedeschi. QoQ SAAR represents quarter-over-quarter seasonally adjusted annualized rate.

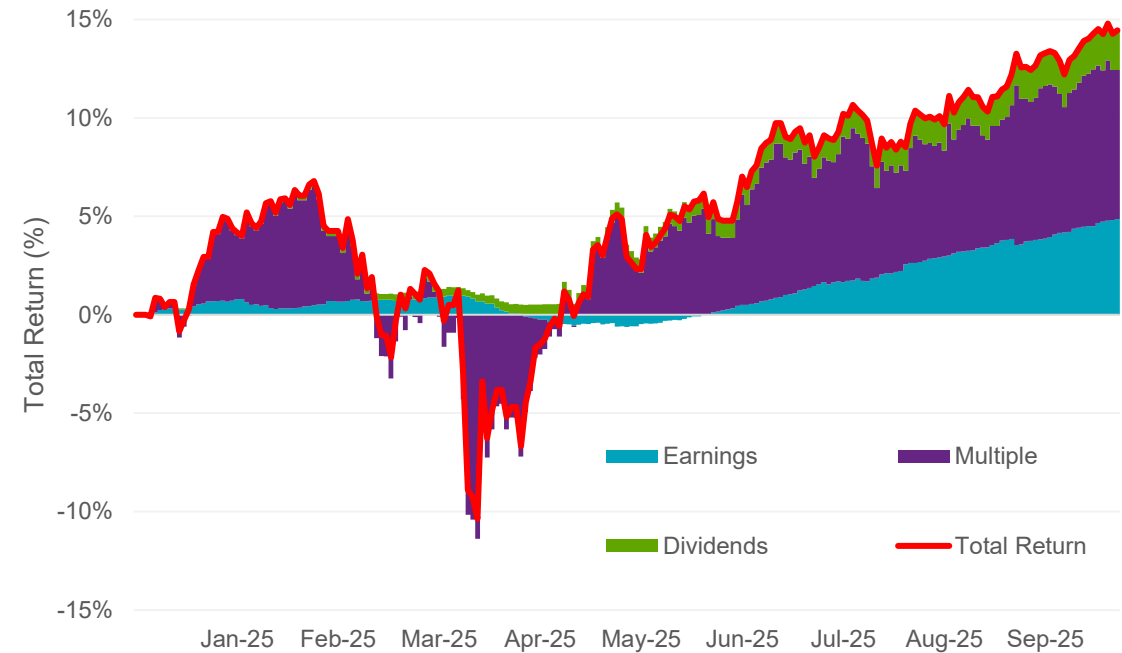
The Low Spark of High Heeled Boys

Total Return Decomposition (12/31/24–10/9/25)

Magnificent 7



S&P 493

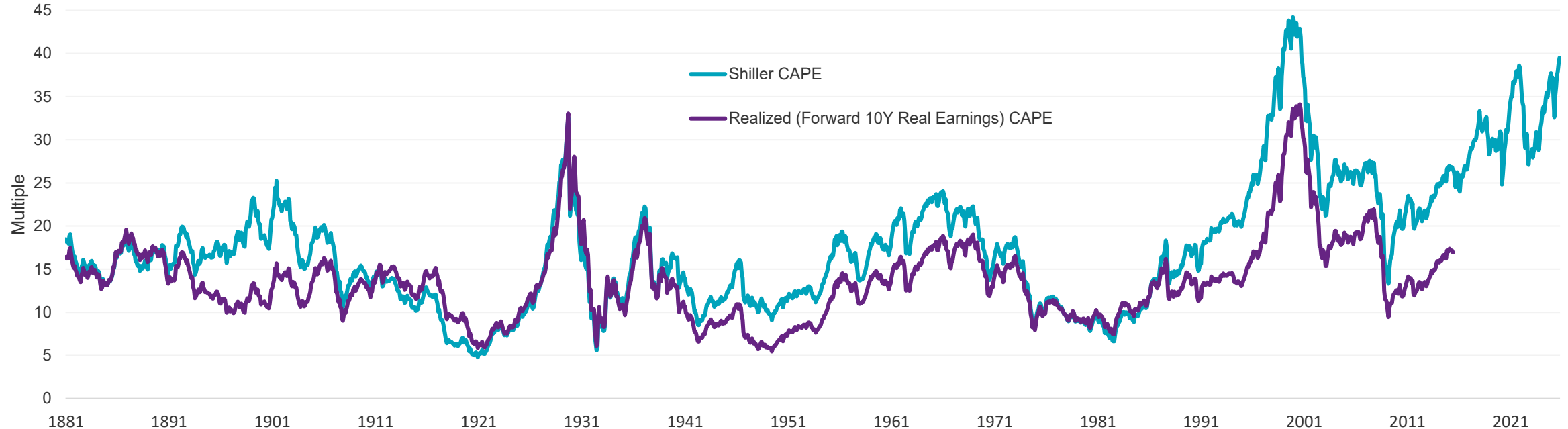


If there's one thing markets are great at, it's coming up with narratives. As we push further into the data vacuum, markets are grasping at anything to build a story around. Not only has that yielded the so-called "debasement trade," in which investors are supposedly rotating away from the US dollar into bitcoin and gold, just as the dollar makes multi-month highs, but the latest topic du jour is the revival of the AI bubble chatter. But whereas previous incarnations of AI bubble fears have been largely a binary yes or no debate, the current narrative is that AI is indisputably a bubble, but bubbles can go on for longer and further than anyone expects. Perhaps it is indeed a bubble, and certainly the recent headlines of circular financing and debt-fueled capex spend harken back to the Dot-com era, but it's ironic that despite all the fear around elevated valuations, the driver of the Magnificent 7's 20% year-to-date gain has been almost exclusively earnings growth. Forward earnings have grown over 17%, while multiple expansion has driven just 2.6% of the group's total return. If there's an excessive valuation argument to be made, it's with the rest of the 493 as multiple expansion has fueled 8% of the nearly 15% year-to-date total return, while earnings has fueled 4.6%. Don't hear anyone calling the broad market a bubble. Looks more like a bubble in bubble talk.

Source: Portfolio Analysis & Consulting, Bloomberg. Performance data shown represents past performance and is no guarantee of future results.

Dear Mr. Fantasy

Shiller CAPE vs Realized CAPE (1/31/1881–9/30/25)



It's been a while since we discussed valuations, and even longer since we discussed the infamous Shiller Cyclically Adjusted Price-to-Earnings (CAPE) ratio. And for good reason. But, with all the bubble concern that has emerged of late, the CAPE ratio has emerged from the shadows once more as the measure ticks up to 40 times, a level surpassed only during the Dot-com bubble. No wonder it's been cited of late. The ratio compares today's price for the S&P 500® Index to the index's average, trailing, 10-year, inflation-adjusted earnings in order to smooth out business cycle volatility. It's an interesting concept but falls short on many fronts. First and foremost, markets are forward-discounting mechanisms. Today's prices reflect investors' expectations of future earnings, not trailing. Constructing a forward CAPE ratio using realized real earnings demonstrates the gaping divide created by valuing firms on trailing earnings that massively understate the realized earnings growth potential of the market. Second, markets operate in the nominal world and discount nominal earnings, not real. And finally, using valuations to call rich markets implicitly assumes valuations are stationary. But valuations are dynamic and have historically exhibited distinct regimes. What may be rich in one period may be cheap in another, thanks to changes in index composition and other economic factors. Valuations can be a useful allocation tool over the long run, but their predictive power is only statistically significant over a 10-year, or longer, time horizon. Elevated valuations can make markets more prone to shocks and provide fuel for a pullback, but that doesn't make them the catalyst for that move. In the short run, valuations are little more than a barometer of risk appetite, and a fairly weak one at that.

Source: Portfolio Analysis & Consulting, Shillerdata.com.

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