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associates
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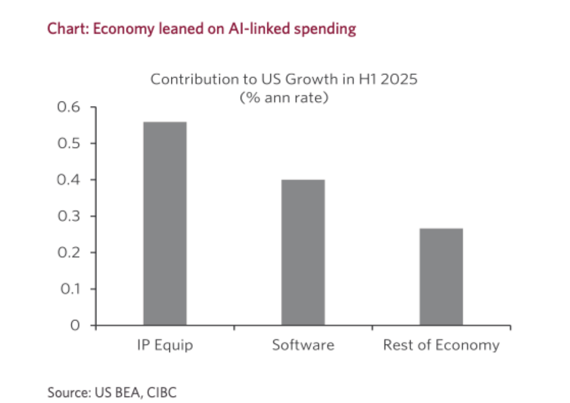
Recent Economic Events

The economy appeared to bounce back strongly from its first quarter swoon, but facts suggest that trade distortions had much to do with the process. Just when it seemed that we were getting clarity on tariffs, many of the levies were declared illegal under the law cited by the President when they were imposed. So far, contrary to the goal of incenting manufacturing employment through tariffs, the levies have contributed to factory job losses. The overall job market has also weakened, but inflation appears to be moving farther away from the Federal Reserve's 2% target. This toxic combination is known as stagflation and creates a "damned if they do, damned if they don't" dilemma for the FOMC.



Second-quarter GDP increased by 3.3%, up sharply from the (0.5%) contraction in the first quarter. Much of the quarter-to-quarter volatility was due to a subsequently-reversed import surge to avoid tariffs. If we average the two quarters, the American economy grew by 1.4% annualized in the first half of the year. This was a substantial slowdown from 2024. If not for buoyant spending on artificial intelligence, growth would have been close to stalling altogether.

After a rather chaotic rollout of tariffs near the end of the summer, businesses were starting to understand the implications and the costs involved. Then a federal appeals court struck down the broad country tariffs, ruling that the law the President used to impose them did not apply. The action was stayed until mid-October to give the administration time to appeal, and an appeal to the Supreme Court is exactly what Mr. Trump demanded. The tariffs not covered by the ruling are perhaps more problematic, however. These cover intermediate goods that companies need in their production process, like steel and aluminum. Because of the increased costs of these inputs and the overall uncertainty generated by the trade war, domestic manufacturing jobs are down, not up, this year. It is not surprising, as far more factory workers are employed in industries that use the metals than in those that produce them. Noted economic pundit Susan Church-Jamesson opined, "Who'da thunk it."

Turning to the overall job market, there are clear signs of softening. In fact, the July employment report which was released in early August not only came in below expectations, it included revisions of previous job figures (lower by over 250,000). The release prompted the President to fire the head of the Bureau of Labor Statistics, contending that the report was "rigged". It wasn't, and the August report proves it. Job growth was a paltry 22,000, and once again, previous months were revised down. The three-month average job gain is now only 29,000, a figure too low to keep the employment market stable. And in fact, the

Recent Economic Events-continued

unemployment rate moved up to 4.3% — the highest level in almost four years.

Core PCE inflation posted an annual gain of 2.9% in July. This was the highest level in six months, suggesting tariffs are starting to impact the figures. Unfortunately for consumers, Goldman Sachs published a study that indicated that as of the end of June, only 22% of tariff costs had been passed along to them. They estimated that this would jump to 67% by the end of October. Studies covering the tariffs assessed during President Trump's first term suggest that well over 90% of the costs were eventually passed along. There was bad news in the Producer Price Index as well. It jumped by 0.9% in July, the biggest increase in three years. Recall that three years ago, the country was battling the highest level of inflation in decades.

Stagflation was a term coined in the 1970s when both unemployment and inflation were rising. A way to measure its severity was the Misery Index which summed the two measures. Back then, it typically totaled in the mid-teens. Today, adding the unemployment rate and core inflation results in an Index in the low 7% range. I wouldn't worry too much if we stay under 8% but would be concerned if we top 9%. Consequently, the Federal Reserve has some room to cut later this month and over the rest of this year. After that, the fundamentals might suggest a pause while the politics argue for more ease. Observers can be excused if they bet on politics. Stay tuned.

Commentary

Artificial Intelligence investment has become a defining ingredient in today's economy. Without the huge capital expenditures being made to build data centers to support the calculations of the numerous AI agents, GDP might have stagnated in the face of the President's tariffs, immigration crackdown, and evisceration of scientific research. The hope is that AI can continue to support growth long enough for the benefits of large fiscal deficits and lower short-term interest rates to take the baton going forward. We will see, but there is another aspect of the AI buildout to investigate.

> ...The history of investment in disruptive technology is both fascinating and instructive...

The history of investment in disruptive technology is both fascinating and instructive, speaking to the consistency of human nature. In the 19th century, railroads offered the prospect of dramatically faster travel than animal power for people and freight. Understandably, everyone wanted to build and operate a railroad, and many did. Overexpansion ensued, resulting in a cascade of bankruptcies.

The pattern repeated in the early 20th century with automobiles. There were hundreds of car companies that eventually contributed to the Roaring Twenties boom. We all know how that ended: with the Great Depression, followed by World War II.

The transistor, which allowed production of the personal computer and its ultimate connection to the internet, fostered the dotcom boom in the 1990s, followed by the crash in the early 21st century.

Reviewing these events convinces me that the AI buildout will similarly end in tears. The problem is that we don't know when. Are we early in the game or have we entered extra innings?

Commentary -continued

While the boom-and-bust pattern caused plenty of distress, there was a silver lining. The various investment manias that created railroads, car factories, and the internet did crash and wipe out paper wealth, but the physical assets produced during the boom lived on. When the dust settled, other players were able to acquire the assets at rock-bottom prices, allowing them to rationalize and productively use them.

If the Podunk & Timbuctoo RR hadn't been replaced by a stronger player, the bankrupt ABC Car Company hadn't failed, and underground fiber hadn't been available for use after its overleveraged installer went belly up, the advances implied by the disruptive technology might have taken years longer to become part of the surviving economy.

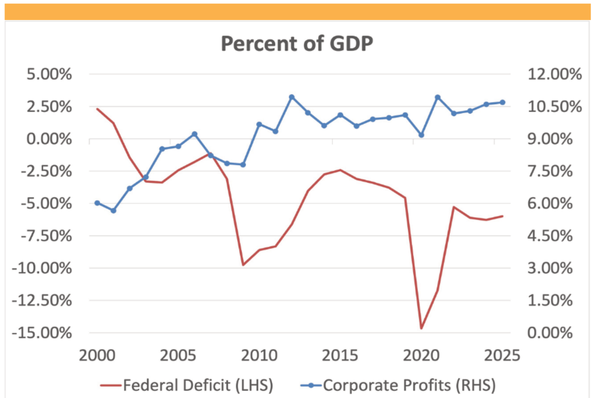
I come not to denounce investment bubbles but to praise them. Without irrational valuations that encourage entrepreneurs to pursue new ideas, economic progress would be far slower. This is the true genius of capitalism even though it can end in lost savings for many.

> *…I come not to denounce investment bubbles but to praise them.*

The trick is to ride the wave as close to the top as possible, but to get out before the inevitable decline. How to do that? When you figure it out my email is: Mjamesson@aol.com.

Market View

The stock market is at or near all-time highs because investors are looking forward to a combination of lower interest rates courtesy of the Federal Reserve and ongoing earnings growth due to fiscal stimulus and AI spending. While shorter-term rates are destined to decline, those further out on the yield curve are likely to be much stickier. In the commodity space, precious metals have been star performers this year. The dollar and bitcoin are about where they were in June. The $64,000, or should I say $64 million, billion, trillion, question is where we go from here.



I wish I knew, but my investment crystal ball is quite cloudy. Fortunately, I am a two-handed forecaster. On the one hand, stock markets don't tumble into bear markets when the economy stays out of recession and the Fed is in easing mode. Government stimulus is a major support for corporate earnings as you can see from the nearby chart which shows the significant upswing in those profits as federal deficits metastasized during the 21st century. While equity valuations are stretched, there is no hard and fast rule against further increases.

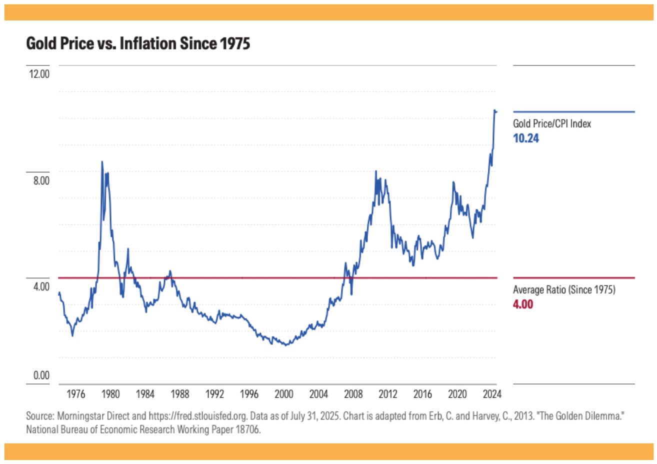
On the other hand, excessive stimulus boosts inflation, which should weigh on bonds and the dollar while enhancing the appeal of commodities in general.

Adding up the pluses and minuses, I am cautiously optimistic on equities. Domestically, any company that can benefit from the AI buildout makes sense. This would include utilities, industrials, and natural resource suppliers. Think electricity, HVAC

Market View -continued

equipment, and copper. I continue to believe that foreign markets, especially Europe and Latin America, will extend their outperformance.

The risk that the Federal Reserve cuts rates by far more than is justified by the economic fundamentals separates the fixed-income world into different buckets. The most promising one is high-quality bonds in the three-year range (Treasuries or corporates) which will benefit as cash returns offer less competition. Since I believe we will avoid a recession, a portion of your allocation could include junk bonds. The risk of inflation keeps me negative on long-term bonds where I expect the extra interest demanded by investors (term premium) to grow. Furthermore, the appetite by overseas investors for long-term Treasuries is likely to be lukewarm as long as the dollar is falling in value. If you must buy longer duration bonds, TIPS let you hedge the risk.



Source: Morningstar Direct and https://fred.stlouisfed.org. Data as of July 31, 2025. Chart is adapted from Erb, C. and Harvey, C., 2013. "The Golden Dilemma." National Bureau of Economic Research Working Paper 18706.

Gold has hit an all-time high, and adjusted for inflation (see chart), is clearly in extended territory. Silver and alternative precious metals are starting to move and have room to catch up further. A weak dollar, along with years of underinvestment, should help more mundane commodities as well.

Bitcoin and its crypto-currency brethren are maturing, but I continue to classify them as speculative and highly correlated with equities. If you accept that risk, you might as well buy equities.

Editor's Note

Susan planned a 43rd Anniversary trip to Scotland and England, scheduling it almost two weeks before the official date. This was a test to see if we could make it. We did, but not before Susan broke her wrist and I became traumatized by the British road system. Positioning to take a picture of an architectural gem in Glasgow, Susan stumbled and came down hard on her wrist. Kind Scottish bystanders bundled us into an Uber which took us to the emergency department at the main hospital. Nurses and doctors there reset the bones, applied a splint, and had us on our way in less than four hours. With no department to charge us, we had no indecipherable bill to puzzle out and our cost was zero. I am an enthusiastic supporter of the United Kingdom's National Health System but not their highways. Not only were they based on Roman roads, but they hadn't been widened since Richard the Lionheart's time. Picture a lane just wide enough for two small cars with a tank truck bearing down on you. The only good news was the eight-foot hedges lining both sides of the road so you couldn't see oncoming traffic to scare you until the last moment. I still get flashbacks. My advice if you are considering driving in the British Isles is: don't. There is a reason that trains, buses, and short-haul planes are ubiquitous.

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