Market and Economic Update

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July 2026

Headline growth is holding, but the composition keeps weakening. AI infrastructure investment remains the primary engine, while tax rebates cushioned much of first half spending. The consumer story is mixed, with real cash balances for the top cohorts well above their 2019 base, while the bottom 20% have fallen to roughly three-quarters of the 2019 level. Additionally, the boost to. household spending from 2026 tax refunds has largely run its course and has been more than offset by higher energy costs, leaving households with a net negative impact to disposable income.

May personal income and spending both rose 0.7%, yet the saving rate has trended lower throughout the year and now at 3% as households run down cushions to keep up with prices. With the low-income consumer out of buffer, that is where spending on necessities is now rolling over.

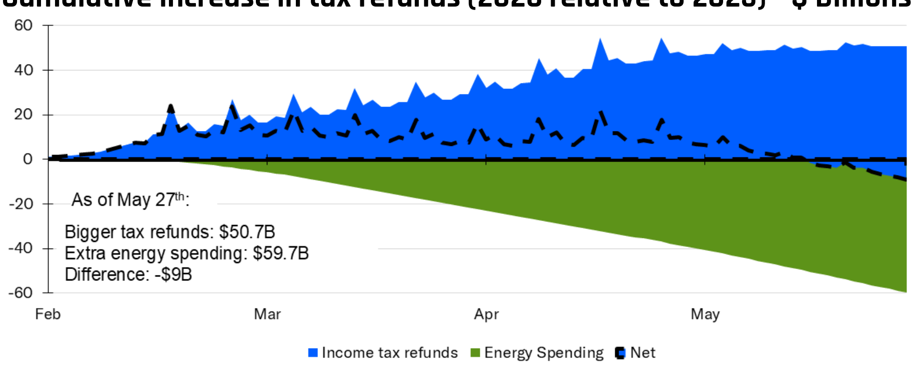
The labor market has cooled as June payrolls, rose just 57k against a ~110k consensus, and April and May were revised down a combined 74k. Unemployment ticked down to 4.2%, but for the wrong reason: participation fell to 61.5%, the lowest since 2021, and household employment dropped over 500k. Leisure and hospitality shed 61k on weak seasonal hiring, unwinding the earlier World Cup boost. Wage growth held at 3.5% year-over-year. The vacancy-to-unemployment ratio remains below 1.0 and hiring is broadly soft, reducing pressure on the Fed to hike.

The Strait of Hormuz is the single most important economic variable tied to the conflict and the reason our rate view changed materially this spring. Brent has collapsed from its ~$120 April peak to around $71, with WTI near $68, both at pre-war levels and the lowest since late February, as tanker traffic recovers. Following the June 17 memorandum of understanding and a late-June widening of the JMIC route near Oman, daily flows through the Strait have increased but still below pre-conflict levels. The situation remains fragile, with Iran still insisting on administrative control of the waterway, but the direction of travel, more oil moving and lower prices has pulled the near-term inflation scare out of the market and should ease the energy "tax" on households into the back half of the year.

Realized inflation remains elevated even as the energy impulse fades. Core PCE reached 3.4% in May, its highest since October 2023, and headline PCE hit 4.1%, though core CPI was firmer at 2.9% and softer in the details, suggesting the surge is energy-led rather than broad based. Beyond energy, we frame the medium-term path as a tug-of-war between AI-driven forces (data-center electricity demand, hyperscaler capex, chip and memory inflation) and AI-driven deflationary offsets (adoption, productivity pass-through, lower unit labor costs, model-efficiency gains). Our base case is that these roughly offset. The tail risk we watch is the "AI investment trap," where the cost of building AI outruns its productivity payoff and feeds a self-reinforcing spiral, which could setup a scenario of firm inflation alongside softening growth.

The June FOMC meeting was Kevin Warsh's first as Chair. He struck an inflation-focused tone, pledging to "deliver price stability" invoking the phrase a dozen times. The SEP removed the prior 2026 cut and penciled in a possible hike. Chair Warsh looks less like an aggressive-policy Chair than a process-focused one, leaning away from forward guidance, declining to submit his own dot, and launching task forces on communications, the dot plot, and the balance sheet. Markets had drifted toward pricing September and December hikes, but the recent jobs report markets have walked that back. We continue to think the bar to hike remains high and expect the majority of the committee to look through the conflict-driven inflation.

Cumulative increase in tax refunds (2026 relative to 2025) - $ Billions



Sources: U.S. Treasury, AAA EIA, Moody's Analytics

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Product Views

Rates: The 10-year sits above 4.45% with the 30-year recently topping 5%, and we are not buying the rate-hike narrative. With inflation expectations anchored and the energy impulse fading, we see a greater probability that the next Fed move over the coming year is a cut rather than a hike. Duration is attractive, and we are constructive on the curve but more broadly the 2 & 3 year parts of the curve, favoring a bull steepening as rate hikes are priced out.

Credit: Global credit markets have demonstrated remarkable resilience, absorbing geopolitical tensions, elevated energy prices, and record issuance without meaningful dislocation. However, the unprecedented wave of hyperscaler and AI-related financing is beginning to reshape market technicals. Investment grade spreads are drifting wider from historically compressed levels, bonds that traded at a scarcity premium only months ago are widening under the weight of supply, and the recent SpaceX issuance weakened sharply in the secondary market after fast-money demand faded. These developments suggest that the next phase of spread widening is likely to be driven by supply dynamics rather than deteriorating corporate fundamentals.

Corporate balance sheets and earnings remain supportive, but valuations continue to offer limited compensation for risk. As a result, we maintain an underweight allocation to investment grade credit, favoring selective, higher-quality exposure over broad market participation.

The more immediate risk is technical rather than fundamental. A potentially more hawkish Federal Reserve, combined with record primary issuance and reduced investor capacity to absorb new supply, creates the conditions for credit spreads to reprice wider from cycle tight levels.

Securitized: Within structured products, we continue to find attractive relative value opportunities. Data center ABS offers some of the widest A-rated spreads in the asset class, with meaningful dispersion across issuers. We favor seasoned transactions with established operating histories, strong debt service coverage ratios, and long-duration lease profiles. Agency CMBS also is attractively on a relative value basis, trading at spreads that compare favorably with similarly rated investment-grade corporates. In agency MBS, subdued housing activity continues to constrain new issuance, while lower prepayment payups have improved the relative value of prepayment-protected collateral.