

Despite higher yields and an energy shock, Growth is holding up due to AI-related investment, equity wealth, and a modestly resilient labor market. The bond market has done much of the tightening for the Fed. Since year-end the 2-year is up roughly 140 bps and the 10-year about 110 bps, against a single 25 bps hike. Measured through financial conditions, policy entered the summer too easy. The 10-year's roughly 80 bps rise since June has effectively delivered that tightening through the market, which is why we view September's 25 bps hike as a recalibration rather than the start of a cycle.

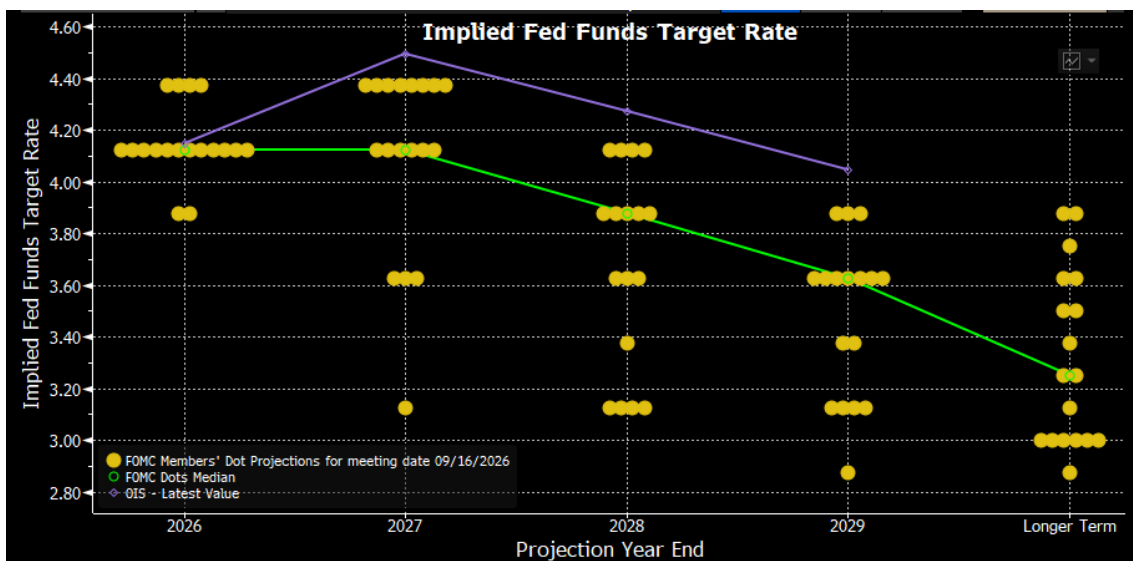
Second quarter GDP's was revised was revised higher to 2.2% in the final reading, well exceeding market expectations. The tail risk for a slowdown is fatter, though. AI spending is insensitive to rates, which keeps growth firm today but also concentrates this risk. AI-related public debt issuance this year is already more than double all of 2025, and more funding is moving into longer maturities, private credit, and off-balance sheet commitments. For now, as long as employment holds, we see no sign of the consumer slowing. Lower income wage growth is running ahead of higher earners and household balance sheets are strong, although delinquencies among younger borrowers are climbing.

On the inflation front, price pressure is broadening beyond energy. With diesel prices up roughly 80% this year we are likely to continue seeing a pass through to consumers through higher food, freight and goods costs. If sustained, it could add up to 40 bps to core, mostly in 2027. On the other side, the BEA's methodology change lowered core PCE by about 30basis points, and August core printed 3.0% against 3.3% expected. Thus puts the year-end path below the FOMC's 3.4% projection and narrows the gap to target while giving Chair Warsh (and the FOMC) room to be patient.

Oil remains the key factor for both inflation and the Fed, with Brent hovering around \$100/bbl after Houthi territorial gains around the Bab el-Mandeb caused September's spike. The G7's planned release of up to 100 million barrels of crude and diesel helps at the margin. Beyond the Gulf, France is the sovereign to watch heading into its 2027 election, particularly as rising debt levels and fiscal pressures add another potential source of instability to an already challenging geopolitical backdrop.

Friday's jobs report was soft, reporting 29k payrolls (84k consensus) and 60k of downward revisions, while the unemployment rate ticked up to 4.2% as participation rose. With immigration lower, the jobs needed to keep unemployment steady are far fewer than in the past, and monthly payrolls are noisy, so we aren't panicking on one report. However, the wage data is worth watching as it rose just 0.1% in September and 3.0% over the year, the slowest since 2021 and below headline inflation for about six months.

Overall, the data argues for holding the policy rate steady in October. Additionally, current voters Williams and Jefferson both signaled no rush. October hike odds are currently below 20% from roughly 70% a week earlier. With Chair Warsh offering no forward guidance, Fed speakers have become the guidance, and the unanimity behind September's hike has already faded. While the employment data would suggest the FOMC holds policy rate on October 28, September's inflation readings will be the dominating factor. Markets price fed funds near 4.75% by the end of 2027, above the FOMC's own projections.



Rates: Treasury yields are back to pre-GFC levels. The 10-year closed at 5.29% on September 30th, it's highest since 2007. Longer term, several scenarios could lead rates lower: 1) AI turns into a bubble and the risk off/slowdown creates a flight to quality, 2) AI succeeds and the productivity boom pulls inflation down, or 3) high energy prices destroy enough demand to slow the economy for the Fed. However, those are longer term themes and in the interim we are more cautious on adding duration only selectively until we have greater clarity.

Credit: IG credit spreads have remained resilient in recent months despite rate volatility and increased macro uncertainty. A light supply calendar coupled with strong corporate earnings continue to provide a constructive backdrop for spreads heading into year-end. One warning indicator in the broader credit markets worth watching is the widening of CCC spreads; crossing over 1000 bps for the first time since the 2023 regional banking crisis. CCC spreads are up nearly 400 bps from the beginning of the year. IG spreads widened 7 bps over the last couple of weeks and are approaching fair value in our view, mainly in higher-quality high yield and non-AI related credits.

Securitized: We still see value in securitized assets over corporates. Despite the significant backup in rates this year, this asset class has modestly outperformed credit. Floating-rate CMOs also look attractive. September's selloff forced levered holders out of low-cap floaters and new-issue floater spreads widened. Within MBS, we like 5.50% coupons for their balance of positive convexity and reduced extension risk. With mortgage rates above 7% they trade at a discount, so they will participate in price appreciation if rates fall modestly without the negative convexity, and much of the extension risk is already priced if rates keep rising.

Munis: September's selloff created value on both taxable and tax-exempt munis. The 30-year AAA muni yield crossed 5%, the highest since early 2011, 10-year muni/Treasury ratios rose to around 75% from the mid-60s in July. Tax-exempts look cheap enough to draw crossover buyers while taxable munis offer high-grade credit without the AI supply overhang weighing on corporates.

