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ECONOMIC TALKING POINTS

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The Fed's Inflation Conundrum:
Higher Rates May Be Needed, But Who Really Pays the Price?

Retail sales held up again in October, after a strong increase September. The data only reinforces expectations the Fed will raise interest rates again in December. More than half the voting members on the Fed's Open market Committee have come around to the view that a more restrictive monetary policy is needed. Whether they raise rates by 25 or 50 basis points remains to be seen.

What is clear is that inflation is moving in the wrong direction.

We estimate that consumer prices rose approximately 4% over the 12 months ending in October, with core CPI climbing 2.8%. These are estimates because the government shutdown during October 2025 prevented the Bureau of Labor Statistics from collecting price data needed to calculate annual comparisons. But other forecasting firms, including Moody's Analytics and Oxford Economics, have arrived at a similar conclusion. So, inflation remains stubbornly elevated, with the latest increase likely the highest in nearly two decades, if you set aside spike during the Covid pandemic.

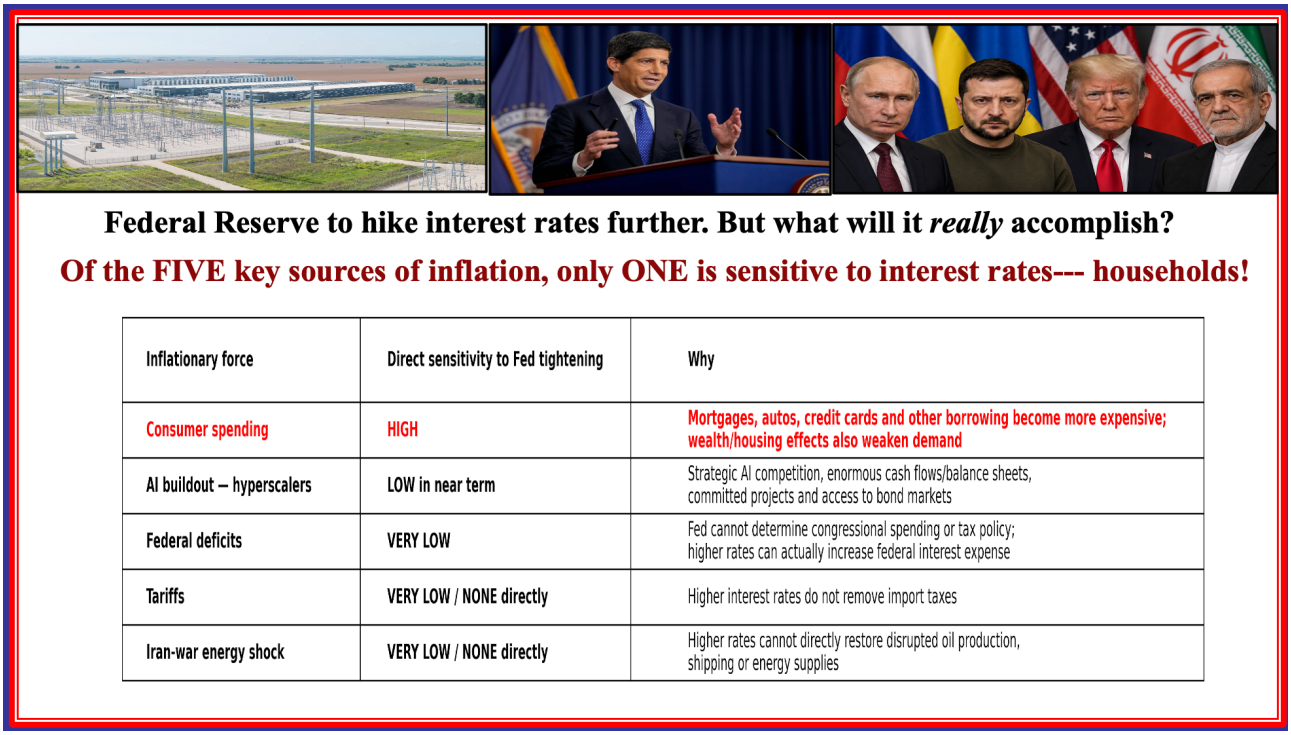
But the Federal Reserve now faces a real conundrum. What will a hike in rates this time really achieve?

I raise this issue because Fed policymakers are confronting a business cycle that is anything but normal?

Getting inflation anywhere near its 2% target requires more than simply raising interest rates. The reason? Four of the five sources behind today's climbing prices are largely unresponsive to higher borrowing costs! They involve energy, tariffs, AI spending and the government's prodigious deficits.

The only sector of the five that's destined to experience proportionally more hardship when the cost of borrowing increases will be American consumers.(Table 1)

Table 1



Let's examine why.

1. Energy: The Fed Can't Raise Its Way Out of A Supply Crisis

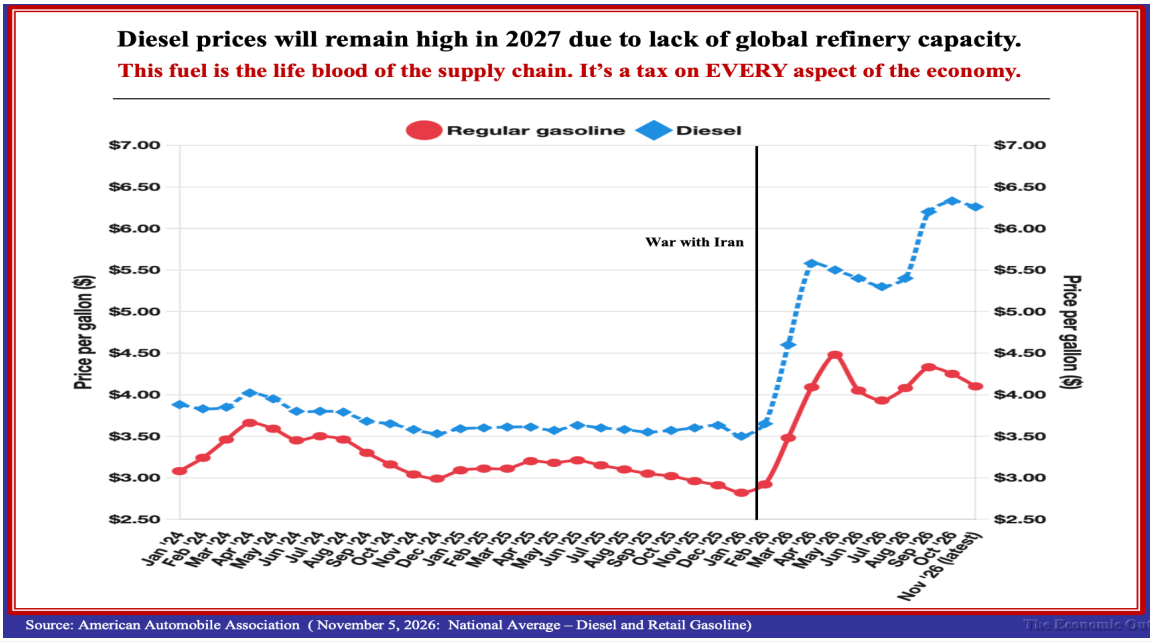
The soaring costs of gasoline, diesel, aviation fuel and heating oil are a direct consequence of the U.S. war against Iran and the continuing conflict between Russia and Ukraine.

Both conflicts inflicted substantial damage to the world's energy infrastructure. They have substantially reduced global refining capacity and severely depressed inventories of these critical fuels.

Consider diesel fuel, for a moment (Table 2). It's the lifeblood of the entire supply chain network. Trucks, railroads, merchant ships, farm machinery, construction equipment and manufacturers all depend on diesel. Its price

has surged 65% in the U.S. since the outbreak of the war against Iran last February.

Table 2



These increases ripple throughout the economy. Higher transportation costs raise production costs. And given that companies have shown a reluctance to reduce payrolls, they have little choice but to pass these additional input costs on to customers to protect profit margins.

And the outlook for 2027 could be more troubling.

U.S. refineries have been running at exceptionally high utilization rates. They have also delayed much needed maintenance because refining profit margins look too attractive. But there's a danger to such prolonged operations. Energy companies cannot postpone scheduled maintenance indefinitely. Pushing refiners past their operational limits worsens equipment wear and increases the risk that future maintenance shutdowns would last longer than usual.

If so, the result would be even less supplies of diesel and other distillates in 2027, which means continued high fuel prices and more inflation. Since the Federal Reserve cannot produce a single additional barrel of diesel, its only recourse to combat inflation is by raising interest rates.

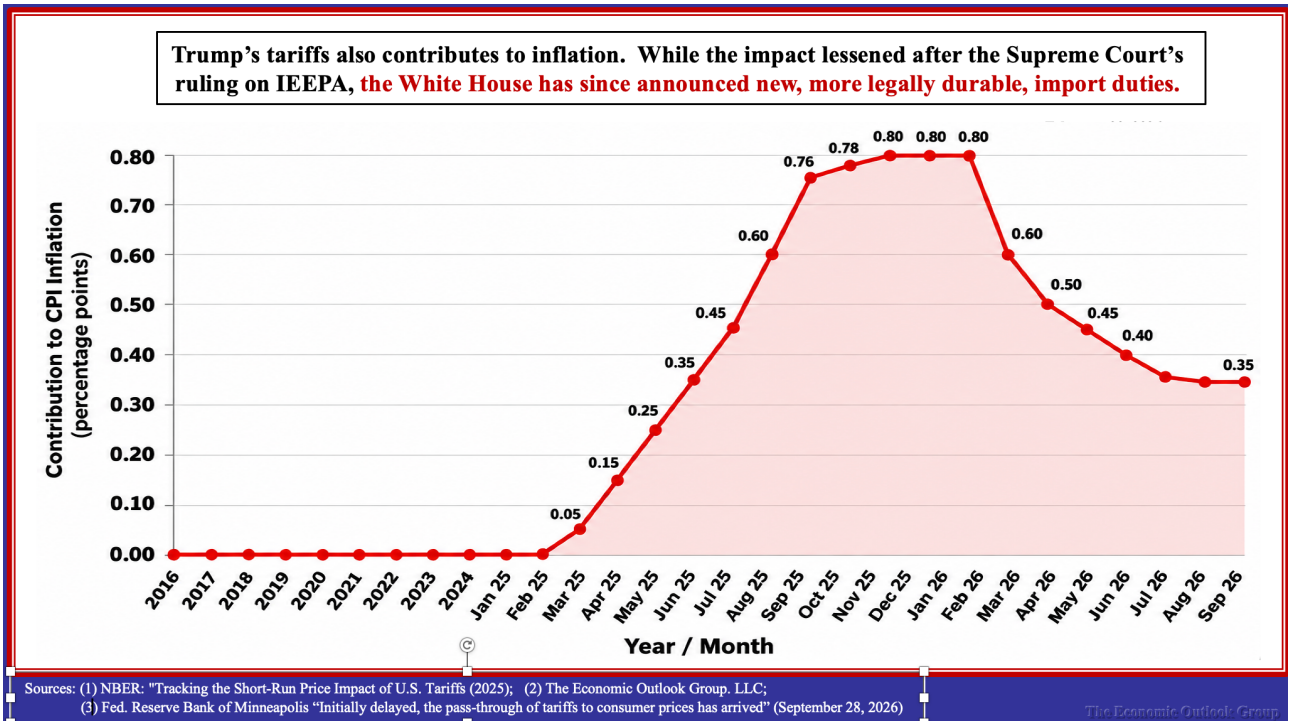
Higher rates may reduce some demand for fuel --- but the hard reality is this: There is no chance the Fed can bring inflation anywhere near 2% so long as the war against Iran continues.

2. Tariffs: Another Inflationary Force Beyond the Fed's Reach=

Tariffs are another source of inflation that is impervious to higher interest rates.

While its contribution to rising prices eased after the Supreme Court rejected Trump's use of the International Emergency Economic Powers Act (IEEPA) to impose sweeping tariffs, the White House has since worked to rebuild a tariff regime designed to be more legally durable (given the President's statutory authority under Sections 232, 301 and 338). Currently, our calculations suggest that the latest tariffs still add 30–40 basis points to annual inflation. (Table 3)

Table 3



Nor do we see any relief ahead. The President has signaled an interest in expanding the tariff regime in 2027. It's fair to point out that Trump's belief in tariffs borders on the theological. You could drop a banker's box filled with academic research papers and think-tank studies, all documenting the economic harm of tariffs on his desk. Yet that will not dissuade him from using his favorite tool as leverage in economic and foreign policy.

And so once again, higher interest rates by the Fed could suppress some demand for imported goods but it cannot eliminate the additional costs these taxes impose on imports. A new round of tariffs in the months ahead can still add to inflationary pressures.

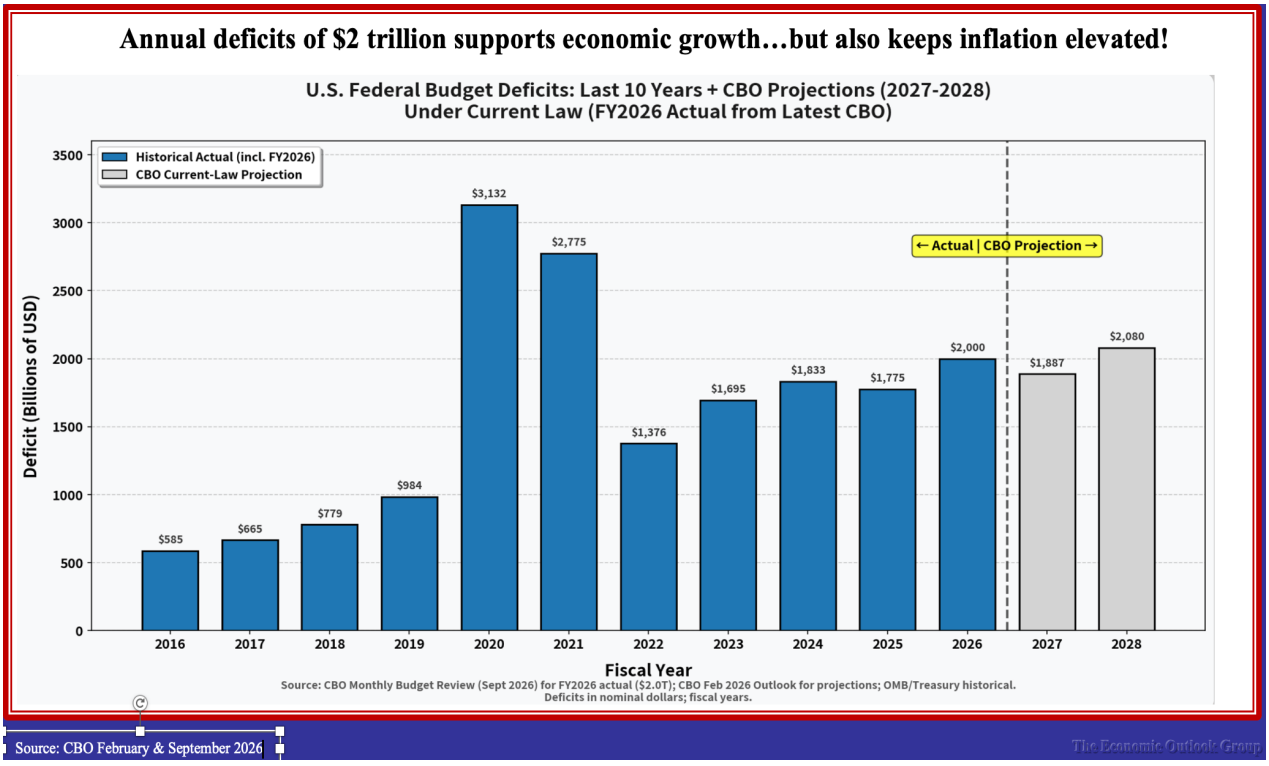
3. Federal Borrowing: The Treasury Cannot Simply Walk Away

Households and non-AI linked companies can choose to postpone purchases or delay borrowing when interest rates become prohibitive. The U.S. Treasury, however, has no such apprehension. The government must finance its operations to meet its legal obligations and will pay whatever the market rate happens to be.

That difficult lesson will be apparent again shortly. Nearly $10 trillion in publicly held marketable Treasury securities is scheduled to mature over the next 12 months. Virtually all of that debt will now have to be refinanced at yields higher than when those securities were originally issued.

Add to that annual federal deficits of $2 trillion each year through the end of the decade and you can see how Washington's excess spending will continue to fuel inflationary pressures. (Table 4)

Table 4



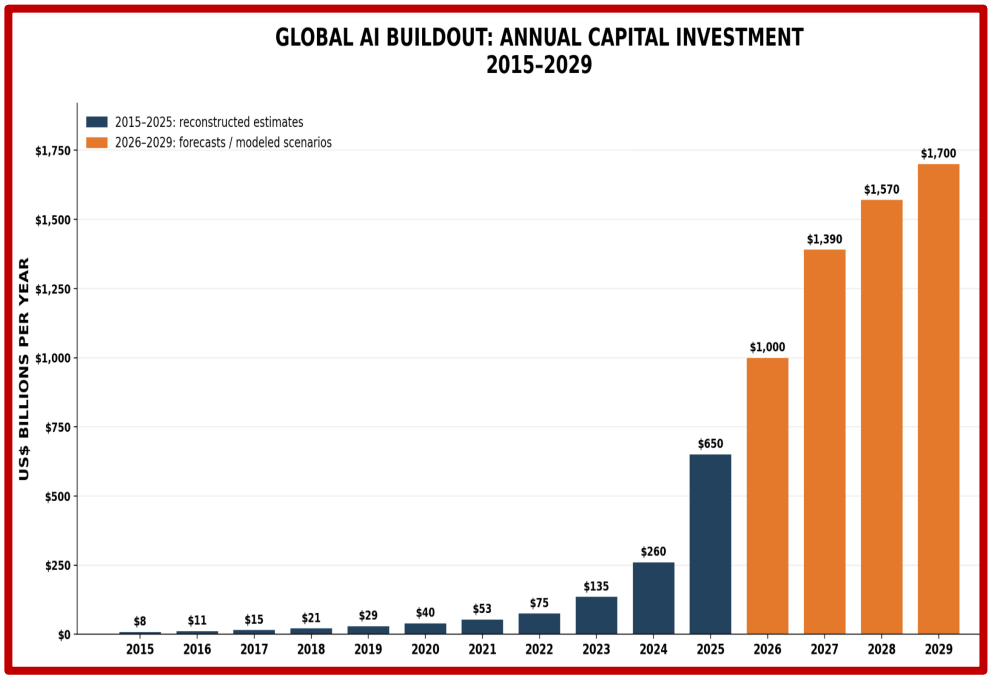
While economists may disagree about how much of that deficit spending drives inflation, at the very least it undercuts the Fed's efforts to return inflation to its 2% target.

4. AI Buildout: A Capital Spending Boom That Defies Traditional Interest-Rate Restraints

Then there is the colossal investment boom in artificial intelligence.

Frontier technology companies, particularly hyperscalers, are committing enormous sums to construct data centers and advance computing power. The result is a staggering demand shock for resources. The competitive grab for construction workers, engineers, electricians, copper, steel, memory chips, GPUs, transformers, electrical equipment and other essential materials have pushed up the costs for all --- and that has spilled into other sectors of the economy driving prices higher. (Table 5)

Table 5



Normally, rising borrowing costs would discourage some capital investment. But, as I noted earlier, this is not a typical business cycle. The AI buildout is anything but normal.

While some of the largest tech companies have, at least initially, financed their investments through internal cash flow, most are now raising gargantuan amounts in the capital markets. And they have done so with little regard to the cost of capital. The imperative to build the most advanced AI and cloud systems is based on the faith that the trillions being spent will bear enough fruits to justify these massive investments.

Will that pace continue in 2027?

There are two headwinds the hi-tech industry faces. The first is growing skepticism among investors whether artificial intelligence will ultimately produce intelligent returns. Should those concerns deepen across the investment community, the fallout could unfold in stages, beginning with a major selloff in the stock indexes and a corresponding erosion of wealth in millions of personal investment and retirement accounts.

The second is rising political and community opposition to the unchecked construction of data centers. There are about 800 to 1,100 local and state moratoriums or bans placed on data center construction at this time in the US.

But we believe these obstacles will ultimately prove manageable. In the first instance, investors worry that selling too early could mean missing the next major surge in AI-related stocks. Unlike the dot.com era, when investors were wildly bidding up the stock price of nascent firms that in some cases had not produced even a single dollar in sales, hyperscalers are already generating significant revenues from cloud computing, digital advertising, software, and other related AI services.

Secondly, neither Democrats nor Republicans want to handicap leading hi-tech firms with burdensome regulations and risk falling behind China in computing power and technological innovation.

Finally, many communities initially opposed to data centers may become more receptive if developers offer tangible benefits, such as protecting residents from higher electrical bills, upgrading electric grids in their region, safeguarding water supplies and, of course, the promise of substantial additional local tax revenues.

Thus, we believe any set back in data center construction will prove to be temporary. The demand shock for resources due to AI-related capital investment will continue --- even if the Federal Reserve raises interest rates further.

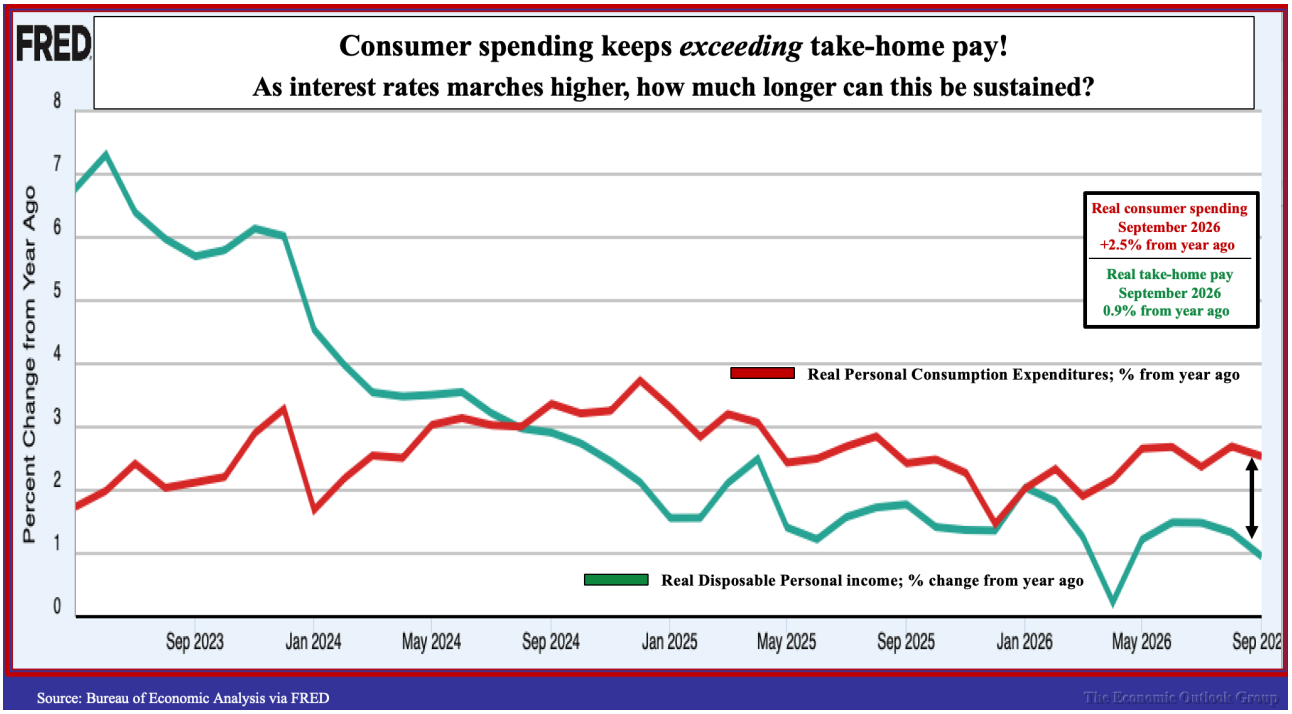
So that brings us to the fifth and only sector that is far more vulnerable to higher interest rates.

5. Consumers: The Ones Who May Pay the Highest Price

We have repeatedly heard how remarkably "resilient" Americans have been despite a succession of economic and geopolitical shocks this past year. They keep on shopping, traveling and spending. Yes, some are more conservative than others. Much depends on where households fall along the income spectrum.

But once you drill down on the data, a more somber picture emerges on what’s behind this “resilience.” To begin with, real consumer spending has exceeded the growth in real disposable personal income for more than a year. (Table 6)

Table 6



Why? One explanation is that so long as the unemployment rate remains low, shoppers are content to shop.

Another explanation points to a different psychological framework: *better buy-now-before-it-costs-more later.* Surveys show consumers expect prices to keep climbing in the coming months. According to the University of Michigan's November Consumer Sentiment report, respondents said they expect inflation to reach 4.3% over the next 12 months. While that was below their October projection of 4.7%, it remains far above the increase in nominal take home pay of just 3.1% Still, if you believe that a washing machine or refrigerator, or other major purchase will cost considerably more in the future, why wait?

But another question immediately follows. If spending consistently outpaces income growth, where is this extra money coming from?

They do so from three sources.

First, Americans are digging deeper in savings. The personal saving rate fell to 3.8% in September, the lowest monthly reading in nearly four years!

Second, people are relying on credit cards more than ever. The Federal Reserve Bank of New York just reported that credit card balances climbed to a record $1.29 trillion at the end of the 3rd quarter. This type of revolving credit leaves households especially exposed to rising interest rates.

Third, consumers eye their home equity as another viable source of funds. Borrowing from home equity lines of credit (HELOC) have expanded for 18 consecutive quarters, with balances now approaching half a trillion dollars.

The problem is you cannot draw on these funds indefinitely, since higher interest rates make credit card debt more expensive and raises the cost of variable-rate borrowings from one's home equity.

All this suggests that the "resilience" often ascribed to shoppers may in fact reveal a consumer that's actually far more fragile.

Bottom Line: The Fed's Inflation-Fighting Weapon Will Hit the Wrong Target

Inflation has accelerated so the Federal Reserve faces growing pressure to respond with a tighter monetary policy in December. The problem is this is not a conventional inflationary cycle. The primary forces driving inflation do not easily respond to higher rates.

Geopolitical conflicts are driving up energy prices. Waves of new tariffs by the White House have made imports from food to memory chips more expensive. Relentless federal borrowing and the staggering amount of AI-related capital investment are also important contributors to inflation. To a great extent these forces are resistant to interest rate hikes.

In the end, it will be American consumers that will feel pain the most in a rising rate environment. The Fed may feel compelled to raise rates in December and again in 2027 to preserve their inflation-fighting credibility.

But the fear is that instead of killing inflation, it will just kill consumer spending. It's an unsettling specter because it brings the whiff of stagflation.

United States

	I 2025	II 2025	III 2025	IV 2025	I 2026	II 2026	III 2026	IV 2026	I 2027	II 2027	III 2027	IV 2027	I 2028	II 2028	III 2028	IV 2028
Real Gross Domestic Product (GDP):																
%	0.1	4.0	3.9	0.2	2.5	2.2	3.4	2.6	1.8	2.0	2.2	2.3	1.8	1.9	2.3	2.5
Personal Consumption Expenditures:																
PCE %	0.6	2.1	3.7	1.9	0.7	3.8	3.8	2.3	0.9	1.4	2.0	2.1	1.3	1.9	2.0	2.2
Inflation, end of period, year-over-year:																
CPI %	2.4	2.7	3.0	2.7	3.3	3.5	3.7	3.6	3.7	3.8	3.6	3.4	3.2	2.9	2.7	2.6
Unemployment Rate (end of period):																
%	4.2	4.1	4.4	4.4	4.3	4.2	4.2	4.4	4.4	4.5	4.5	4.6	4.6	4.8	5.0	5.0
Non-farm Payrolls, monthly avg. thousand:																
	20	36	23	-35	73	81	51	60	55	65	80	85	85	80	65	60
Treasury 10-yr Note Yield % (end of period):																
	4.25	4.23	4.15	4.17	4.31	4.42	5.29	5.30	5.35	5.40	5.45	5.45	5.40	5.25	5.25	5.20
Federal funds rate % (mid-point, end of period):																
	4.38	4.38	4.13	3.63	3.63	3.63	3.88	4.13	4.63	4.88	4.88	4.88	4.38	4.13	4.13	4.13

Real GDP Growth - Global Economy - Year over Year

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
US	2.7	1.6	2.3	2.1	2.5	2.9	1.8	2.5	3.0	2.6	-2.1	6.3	2.4	2.9	3.0	2.3	2.6	2.1	2.0
Eurozone	1.7	1.4	-0.9	-0.2	1.4	2.1	1.9	2.5	1.8	1.6	-6.2	5.7	3.5	0.5	0.9	1.5	1.0	1.2	1.3
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.7	1.6	-10.4	8.7	4.3	0.1	1.1	1.3	1.2	1.2	1.4
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	0.5	1.7	0.6	-0.4	-4.3	2.3	1.0	1.5	0.1	1.1	0.8	0.8	0.9
Canada	3.1	3.1	1.8	2.3	2.9	0.7	1.0	3.2	2.8	1.9	-5.1	5.0	3.4	1.1	1.5	1.7	0.9	1.3	1.8
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.4	4.0	-5.9	9.2	7.2	7.7	6.4	7.4	7.2	6.5	6.8
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.7	6.0	2.2	8.5	3.0	5.2	5.0	5.0	4.5	4.3	4.3
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.2	1.2	1.4	-3.6	5.3	3.0	2.9	3.4	2.5	2.1	2.1	2.3
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.7	2.4	2.2	-0.3	-8.8	6.1	3.9	3.2	1.5	0.6	1.5	1.9	2.1
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.8	1.9	-2.0	5.4	4.1	2.1	1.0	2.6	2.0	2.2	2.3
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.8	2.2	-2.7	5.6	-1.2	3.6	4.3	1.0	0.5	0.9	1.1
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.7	-3.0	6.2	3.0	2.7	3.3	2.7	2.9	3.0	3.1

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