

2027

The Nation,
Southern California
and Orange County

ECONOMIC FORECAST

WOODS CENTER FOR ECONOMIC ANALYSIS AND FORECASTING

CSUF

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THE ECONOMIC ODYSSEY:

Tariffs, Tomahawks, Treasuries and Prospects for Growth

The Nation, Southern California and Orange County

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THE ECONOMIC ODYSSEY

Eurylochus: “What was the song of the sirens like?”

Odysseus: “All the things you want it to be. Then all the things you wished you never wished for.”

– *The Odyssey*

Overview

“The D.A.’s got to build a case. Building a case is like building a house... He wants to use serious, solid-looking bricks, like these, right? He’ll show you how they got the right shape. He’ll show them to you in a very special way, so that they appear to have everything a brick should have. But there’s one thing he’s not gonna show you. When you look at the bricks from the right angle, they’re as thin as this playing card. His whole case is an illusion, a magic trick. It has to be an illusion, ‘cause you’re innocent.”

– *My Cousin Vinny*

“What is a yute?”—the bewildered question from a stern Alabama judge to a brash, leather-clad Brooklyn lawyer with no trial experience, a dress-code problem and no shortage of confidence—rang in the glorious 1990s: a decade that came to be defined by sky-high optimism, a dot-com-fueled New Economy, a post-Cold War peace dividend and the heady promise of the “End of History.” None of this was yet in sight in March 1992, when *My Cousin Vinny* rolled onto American screens in a 1964 Buick Skylark traversing the rural Deep South past roadside signs advertising “Manure for Free” and “Dirt for Sale.” America had limped into the decade in recession, shaken by an oil shock and war in the Persian Gulf, and its recovery was still struggling to find its footing. It would find it in the most improbable of places: a fast-talking courtroom rookie who needed six tries to pass the bar, and an out-of-work hairdresser with an encyclopedic knowledge of cars, tire marks and positraction. It found its ethos in the film’s swaggering bravado (“I’m a man’s man; I could go deer hunting”), technical prowess (“I routinely twist the maximum allowable torque”), questionable adaptability (“At least I’m wearing cowboy boots.” “Oh yeah, you blend.”), unshakable self-assurance (“Dead-on-balls accurate. It’s an industry term.”) and refreshingly blunt assessments (“Everything that guy just said is bull—. Thank you.”). So profound was its impact on the nation’s zeitgeist that it

earned its floral-clad heroine an Oscar (long rumored to be a mistake), turned humble tuna cans into collectibles strangers still ask Ralph Macchio to autograph and even found its way into Supreme Court arguments over a defendant's right to choose his own lawyer, prompting the late Justice Scalia to quip: "I don't want a competent lawyer. I want a lawyer who's going to get me off. I want a lawyer who will invent the Twinkie defense." Instead of Twinkies, we got Brooklyn grit, Alabama grits, two "yutes" walking free and a mismatched couple—still bickering about marriage and about who really won—driving off into the Alabama sunset, leaving behind a town "famous for its mud."

Nearly three and a half decades later, the U.S. economy still seems to be cruising in its 1964 Buick Skylark, crisscrossing mud-strewn geopolitical chokepoints, jolted by loud whistles heralding a radical reordering of the world order — underpinned by deglobalization, decoupling and de-risking of supply chains — and navigating a pool-hall realpolitik of muscular economic statecraft, with less "finesse" and considerably more than the "maximum allowable torque." And the less said about the "peace dividend," the better. Yet echoes of 1992 ring loud today. Now, as then, the economy finds itself in the shadow of yet another war in the Persian Gulf, buffeted by an oil shock and supply chain disruptions, nervously perched on the cusp of a New "New Economy," this one powered by AI chatbots rather than AOL chat rooms. And the promise this time is grander still: the internet merely wired the world; AI promises to radically rewire it. It is at once exhilarating and unnerving—and more than a little existential. Not surprisingly, the outlook is both muddled and muddied—rather like "looking through a dirty window, a crud-covered screen, trees with all of these leaves on them and I don't know how many bushes."

And risks are piling up. In fact, Vinny's exasperated rant has never rung truer: "I've got a judge that's just aching to throw me in jail. An idiot who wants to fight me for two hundred dollars. Slaughtered pigs. Giant loud whistles. I ain't slept in five days. I got no money, a dress-code problem and a little murder case which, in balance, holds the lives of two innocent kids. Not to mention your [taps his foot] 'biological clock'—my career, your life, our marriage, and let me see, what else can we pile on? Is there any more *stuff* we can pile on to the top of the outcome of this case? Is it possible?"

Is it possible? Apparently, yes. In 2026, it barely takes any effort. At least, that is how things look at first blush. Survey the towering heap of "stuff" piled atop this economy, as we do in the pages that follow, and the picture looks dire indeed. But for all its height, the pile has turned out to be not nearly heavy enough to bury this economy, at least not yet. As we turn to our outlook, we argue once again that how things look and how they are can differ dramatically—and it is in the distance between the two that this economic Odyssey unfolds.

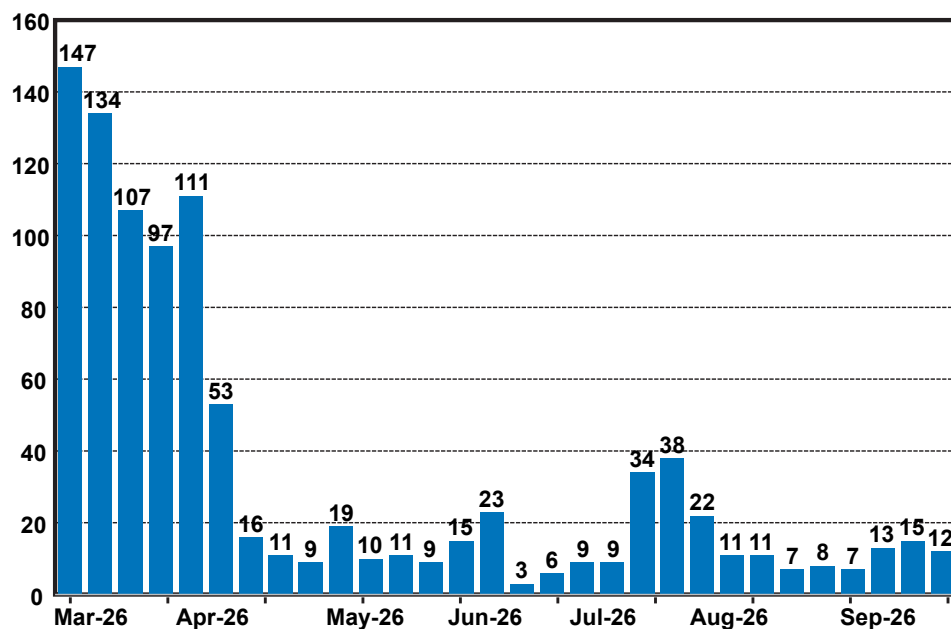
Take the war with Iran, now in its eighth month. Any hope for a swift resolution has long since evaporated over the arid Iranian plateau and sunk in the narrow waters of Hormuz, leaving behind a geopolitical quagmire in a region with precious little mud. The war peaked in mid-March, when dueling strikes on Gulf gas facilities knocked out a sixth of Qatar's LNG exports for years to come (Figure 1). A ceasefire of sorts followed in early April, then a blockade of the blockade, as U.S. naval ships sealed off Iranian ports in response to Tehran's closure of the Strait, a "counteroffer," so to speak. President Trump has since proclaimed a deal in sight on some 40 occasions, and in mid-June the claim briefly came true, albeit for a "moment of two seconds." The two sides agreed to lift their dueling blockades and open a 60-day window for nuclear talks, a plan to have a plan. Tehran refused to hand over its enriched uranium but promised to dilute it on site, and in return won waivers to resume oil exports and the staged release of up to \$24 billion in frozen assets.

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FIGURE 1
Iran Attacks on Neighbors Have Subsided Somewhat
(number of attacks, weekly)



Alas, as we predicted, it did not, could not, last. The deal deferred everything that mattered (the nuclear program, missiles, Iran's proxy network) and was so loosely drafted that each side read into it what it wished. A clause committing Iran to "make arrangements" for safe passage through the Strait was read in Tehran as recognition of Iranian control, and in Washington as a promise not to restrict traffic. The most ominous omen, though, was the venue: Mr. Trump signed the memorandum at Versailles, in the same halls where, more than a century earlier, another treaty with another defeated power sowed the seeds of a far greater catastrophe. As the old quip has it, Hitler was born not in Austria, but at Versailles.

More worrying still, unlike Versailles 1.0, whose terms were famously onerous, Versailles 2.0 could hardly have been more generous: hundreds of billions in income and investment, in exchange for reopening Hormuz and forswearing the bomb. Its failure carries a bleak lesson: in Iran, the hardliners are in charge, the moderates (a relative term) are in hiding, and money alone is not enough. The Strait has been declared closed again for more than three months, some two dozen vessels have been struck, Washington has revoked Iran's oil waivers and reimposed its blockade, and the 60-day negotiating window quietly expired on Aug. 17. As they say at Versailles: *Plus ça change, plus c'est la même chose*.

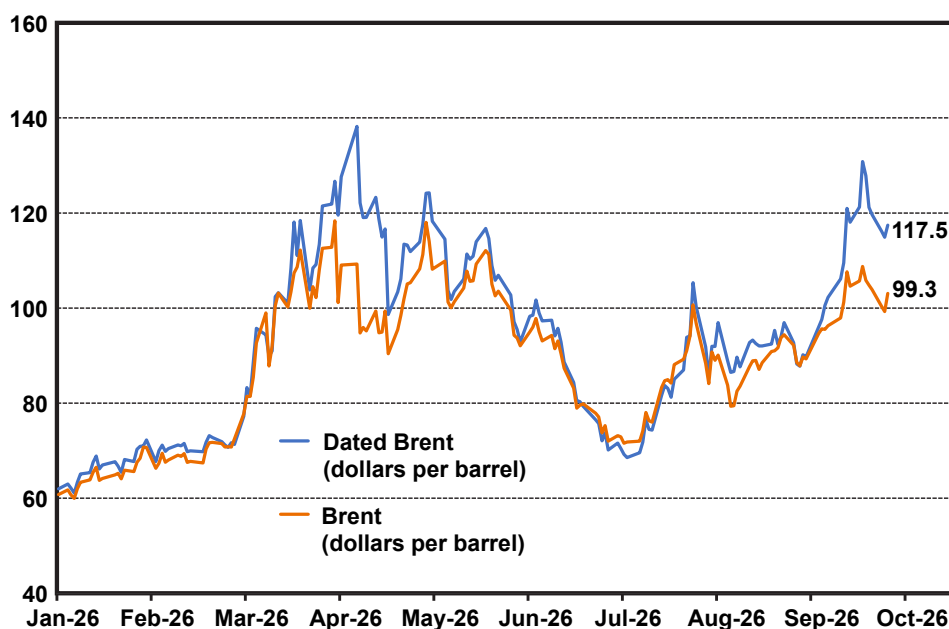
Even for eternal optimists such as ourselves, these developments portend a long Odyssean voyage across a wine-dark sea, where, much like Penelope's shroud, hopes of peace are woven by (trading) day and unceremoniously unraveled by night, through blockades, counter-blockades and the occasional rocket blast. From Midnight Hammer to Epic Fury, from Economic Fury to Economic Outcast — the war has had plenty of cutesy names. But clever names only get you so far. Iran cannot bend without appearing broken, and America cannot leave without appearing beaten. And so, we are left navigating the straight and narrow through a narrow Strait: neither war nor peace, but a "peacefire" of sorts, one that will likely last through the U.S. midterm elections. Beyond that, our view is that hostilities are more likely to flare up than tamp down. Penelope's weaving, after all, did not end in a wedding but in a great reckoning in a grand hall.

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But it isn't just Hormuz. In mid-September, Iran-aligned Iraqi militias struck Saudi Arabia's East–West pipeline, the world's release valve since the war began, forcing a temporary shutdown. Worse still, a second front opened over the summer, as Saudi Arabia's long-simmering war with Yemen's Houthis boiled over: a naval blockade of Saudi shipping, attacks on Aramco facilities and the capture of Perim Island, the rocky outcrop that splits the Bab el-Mandeb, the Red Sea's own chokepoint. For global oil, the journey has become more treacherous than Odysseus's passage between Scylla and Charybdis, with the whirlpool of Hormuz on one side, the six-headed Bab el-Mandeb on the other and the desert pipeline between them scarred and sputtering.

You would be forgiven for thinking that oil prices would have soared much higher amid these developments. To be sure, they have climbed: Brent futures trade near \$107 a barrel as of this writing (end of September)—roughly 45% above their prewar level—after peaking at around \$118 in late March and collapsing to \$71 following the June memorandum (Figure 2). The greater pain, however, has appeared in the physical market. Dated Brent—the benchmark for crude cargoes available for near-term delivery—surged toward \$138 early in the war, fell to \$68 by the end of June, and then began marching upward again over the summer. It reached \$130 amid Houthi attacks and the bombing of Saudi Arabia's East–West Pipeline before settling at \$114 as of this writing in late September. Whichever way you cook it— “regular, creamy, or al dente”— the oil bill has become increasingly hard to swallow.

FIGURE 2
Paper Barrels vs. Real Barrels: Spot Oil Prices Are Much Higher
(dollars per barrel)



For all the pain, things could easily have taken a darker turn. The great surprise of the eight-month war is not that oil has hovered near \$100, but that it never breached \$200—even with one-fifth of the world's oil supply under siege. It turns out there's nothing like a crisis: The global oil system proved astonishingly adaptable, shifting production, trade routes, inventories and consumption patterns at remarkable speed. It helped that the market entered the war with a hefty cushion: the IEA had expected supply to exceed demand by 3.7 million barrels per day this year, a glut so large that, on the eve of the war, the EIA saw Brent averaging just \$58 per barrel.

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But no cushion, however plump, could have absorbed a shock this size on its own. What kept a lid on prices was a remarkably rapid reordering of supply and demand. U.S. crude production and exports both hit records, at 13.9 million and 5.6 million barrels a day (Figure 3). Washington temporarily waived sanctions on 140 million barrels of Iranian crude stranded at sea and let India buy sanctioned Russian cargoes, returning otherwise inaccessible barrels to the market. Within two weeks of the war's outbreak, the IEA coordinated the largest emergency release in its history, 426 million barrels, draining America's Strategic Petroleum Reserve to its lowest level since 1983 (Figure 4). And demand destruction did the rest: the IEA expects global oil consumption to shrink by 2.5 million barrels a day this year, most steeply in Asia, as factories slowed, airlines cut flights and consumers drove less.

FIGURE 3
U.S. Oil Production Has Ramped Up
(millions of barrels per day)

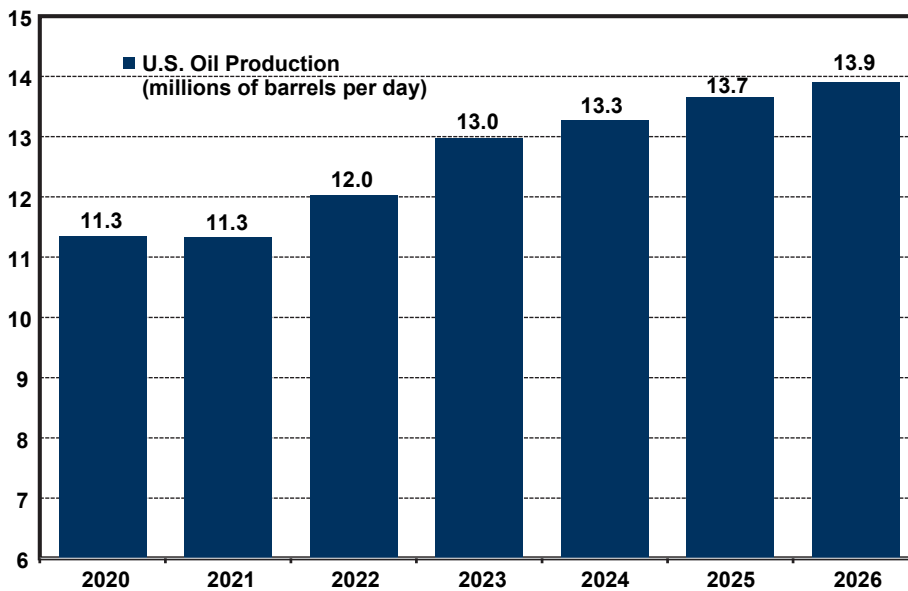
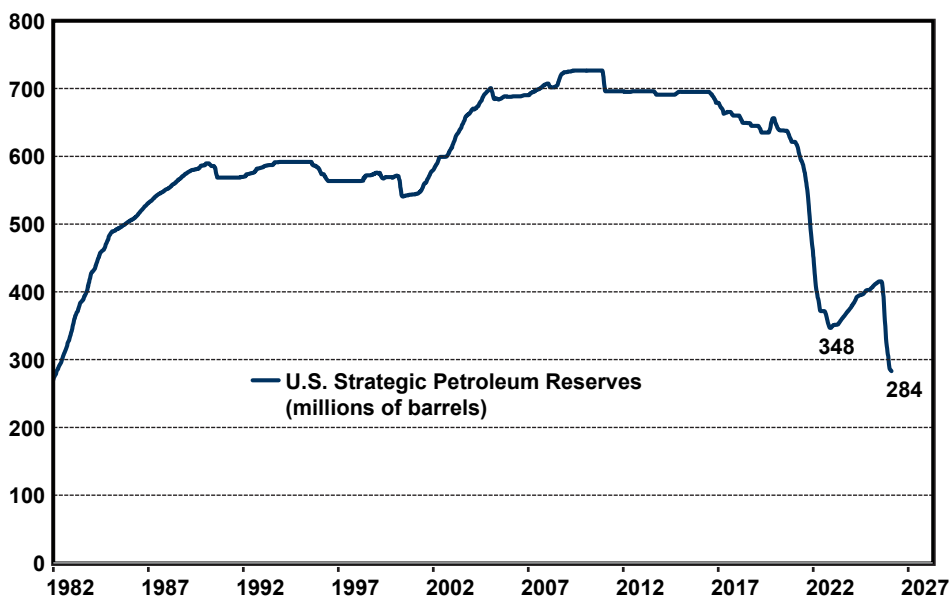


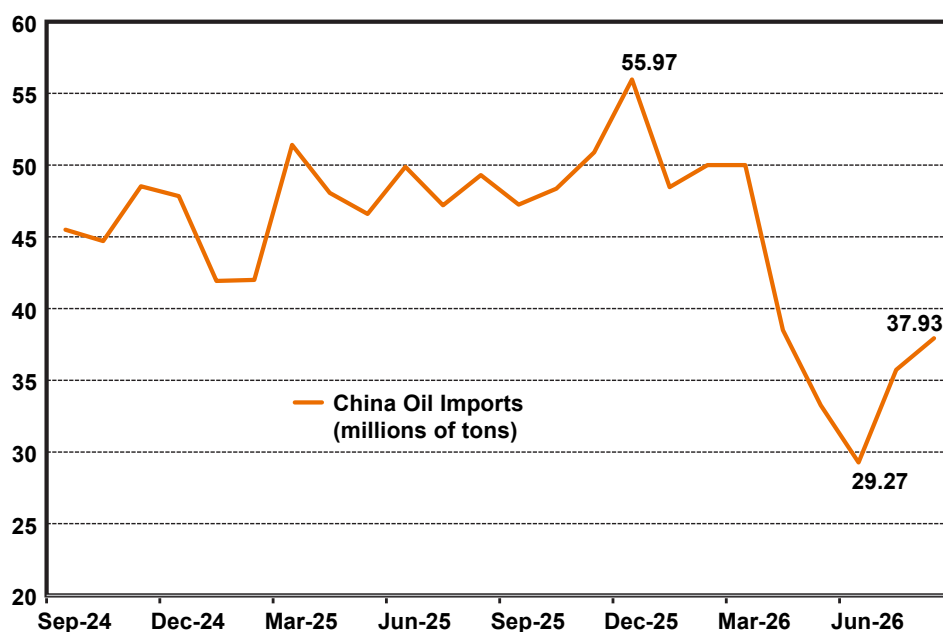
FIGURE 4
U.S. Petroleum Reserves at an All-Time Low
(levels, millions of barrels)



Yet oil's relatively tempered rise owes at least as much—and arguably far more—to two other forces. The first is China. Between February and June, the world's largest oil importer slashed its crude purchases from a prewar average of 11.5 million barrels a day to roughly 8 million—a reduction equal to nearly one-third of the collapse in global oil demand during the COVID-19 lockdowns (Figure 5). It did so even as its economy—at least the production side—chugged along, largely by deploying three powerful shock absorbers. First, Beijing drew on the immense oil stockpile it had accumulated before the war—estimated at between 1.2 billion and 1.4 billion barrels—running it down by perhaps 150 million barrels. Second, it sharply restricted exports of refined products. China is the world's second-largest refiner and an important supplier to its Asian neighbors, but its fuel exports nearly halved at their wartime low, falling to roughly 430,000 barrels a day as Beijing prioritized its domestic market. Third, it compressed domestic demand: consumers drove less, refiners cut processing, and petrochemical makers switched to cheaper domestic feedstocks. If there were ever any doubt that “China is the new OPEC”—that its behemoth economy can move oil prices from the demand side much as OPEC does from the supply side—the war has dispelled it. And for that, we should be thankful: by some estimates, China's retreat from the crude market may have shaved as much as \$30 from the price of Brent.

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FIGURE 5
China Oil Imports Have Cratered This Year
(millions of tons)



The second major factor is the surprising resilience of Gulf exports, which rests on two workarounds: “dark” transits through Hormuz and pipelines that bypass the Strait altogether. When Iran declared the Strait closed in March, the number of vessels recorded daily by IMF PortWatch collapsed from a prewar average of roughly 85 to a mere trickle of three or four, while oil flows fell from around 20 million barrels a day to a fraction of that (Figure 6). But these are tallies of ships visible on AIS, the tracking system, which woefully understates the true traffic. As the war dragged on, Gulf producers assembled perhaps the world's largest clandestine tanker operation, built around switching off and spoofing AIS signals, “dark transiting,” so to speak. By May, nearly two-thirds of outbound tankers were reportedly traveling dark, and more than 84,000 GPS-interference incidents have been

recorded since the war began. While PortWatch counted roughly six crossings a day in the spring, the U.S. military tracked nearly 1,000 over two months, several times the visible count. Hard data are hard to come by, but conservative estimates suggest crude flows through Hormuz, after collapsing to 1.5 million barrels a day, had recovered to around 7 million by September, roughly half their prewar level (Figure 7).

FIGURE 6
Official Transits Through the Strait of Hormuz Remain Low
(vessels, 7-day average)

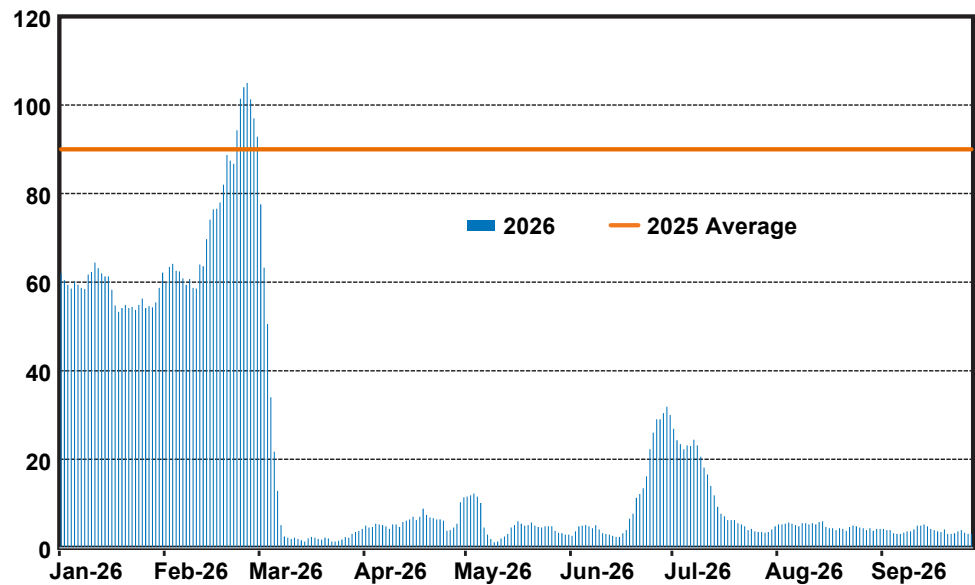
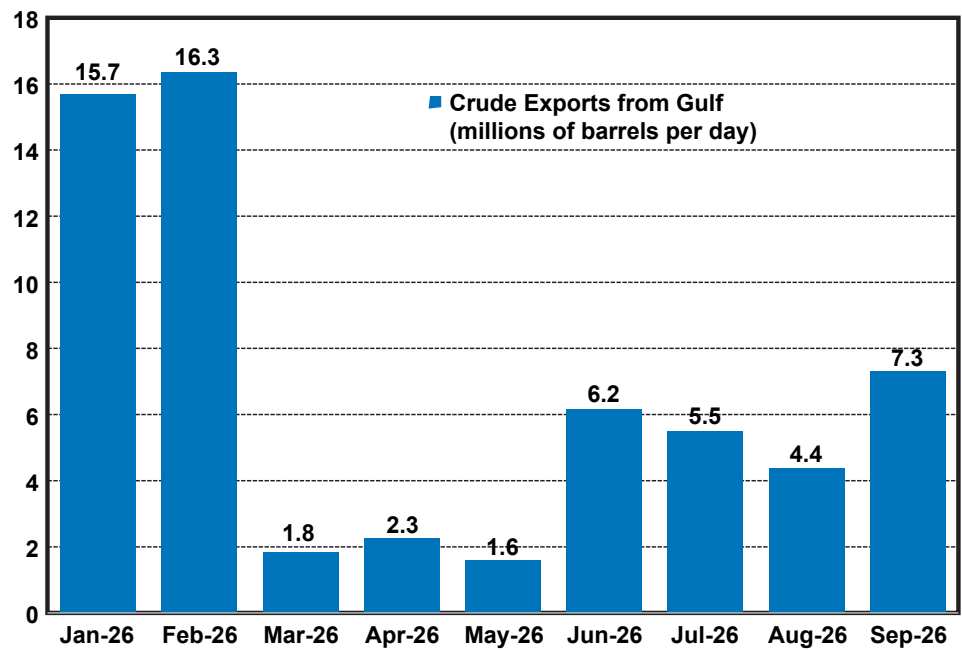


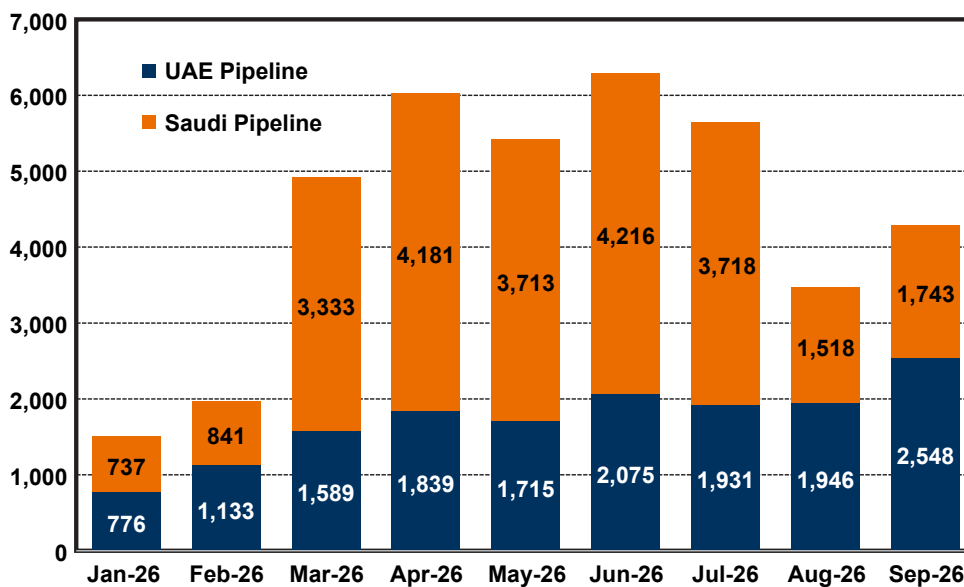
FIGURE 7
The Strait Never Really Closed: Dark Transits Helped
(transit through the Strait, millions of barrels per day)



The second workaround runs overland. Saudi Arabia's East-West Pipeline, which carries crude across the desert to the Red Sea port of Yanbu, was expanded to its full capacity, shipping some 4.2 million barrels a day through the port (Figure 8). The UAE's Fujairah pipeline similarly lifted exports through the Gulf of Oman to around 1.9-2.1 million. At their peak, the two pipelines together moved more than 6 million barrels a day around the Strait, nearly a third of its prewar flows. Thus, between dark transits by sea and pipelines across the desert, the Strait, even at the height of the war, was neither fully open nor fully closed. Like Schrödinger's cat, it was both alive and dead. Or, as they might put it in Beechum County: "Did it ever occur to you that it could be turned off and drip at the same time?"

Thus, between dark transits by sea and pipelines across the desert, the Strait, even at the height of the war, was neither fully open nor fully closed. Like Schrödinger's cat, it was both alive and dead.

FIGURE 8
The Desert Detour: Pipeline Exports Have Skyrocketed
(thousands of barrels per day)



The problem is that, eight months into the war, the world's buffers are running a bit thin just as its escape routes are coming under fire. The prewar glut is gone: Global oil inventories have fallen by more than half a billion barrels, government reserves across the advanced economies are at their lowest since 1990, and America's Strategic Petroleum Reserve has reached a four-decade low. China still sits on an enviably fat cushion of more than 1 billion barrels, but it has begun slowly ramping up crude imports as domestic stocks of gasoline, diesel and jet fuel have fallen so sharply that wholesale prices now exceed state-capped retail prices. Beijing's quiet easing of its export restrictions also prompted refiners to chase record diesel margins abroad, accelerating the domestic drawdown and pulling China back into the crude market. Iran has intensified its harassment of vessels through Hormuz, with at least six reported attacks or security incidents since mid-September (though Iran claims to have targeted 19 vessels in a single weekend). The attack on Saudi Arabia's East-West Pipeline temporarily halted flows, with full service expected to take roughly six weeks to restore, while the Houthi advance has placed Saudi shipping through Bab el-Mandeb under renewed pressure.

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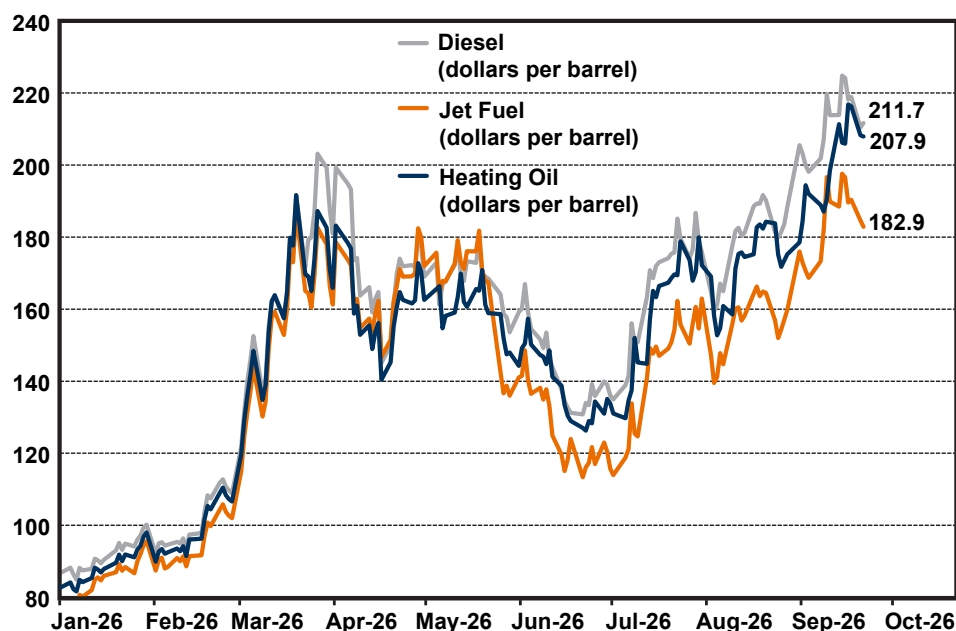
It isn't just that the buffers are thinning. Crudely put, the problem is no longer crude—it is refined. Prices for diesel, heating oil and jet fuel have skyrocketed as product inventories dwindle and refineries strain against capacity. Wholesale diesel reached as high as \$224 a barrel in mid-September, up from around \$100 a year earlier; heating oil peaked at \$217, more than twice its year-ago price; and jet fuel climbed to \$184, from roughly \$90 last September (Figure 9). The diesel crack spread (it's an industry term)—the premium diesel commands over crude—has blown past \$100 a barrel for the first time on record. Simply put, the world's scarcest energy commodity is no longer crude but refining capacity. "No self-respecting Southerner uses instant grits," *My Cousin Vinny* assures us. The world, however, is in dire need of some instant refining capacity right now.

That could prove challenging. The Gulf's principal bypass pipelines were built to carry crude, not refined products, and the dark shuttle through Hormuz is optimized for VLCCs, very large crude carriers that move roughly 2 million barrels apiece. Refined fuels travel aboard smaller, specialized product tankers, often in segregated cargoes with different specifications; a typical medium-range tanker carries only about 300,000 barrels, so it takes six or seven of them to match a single VLCC. Moving the same volume of fuel therefore requires more ships, more crossings, more port calls and more insurance premiums, each a fresh target and a fraught voyage.

Most importantly, the wars in the Middle East and Ukraine have torn a gaping hole in global refining capacity. In the Gulf, attacks and the loss of export outlets have shut nearly 3 million barrels a day of refining capacity. Ukraine has struck at least 28 of Russia's 32 major refineries, many repeatedly, knocking out as much as a fifth of its capacity, while Moscow's export ban has all but halted shipments from what was once the world's second-largest source of seaborne diesel. Deprived of Gulf crude, Asian refiners cut runs by some 4 million barrels a day in the spring. All told, the crisis at its height sidelined roughly 8 million barrels a day of refining capacity, about 8% of the global total. Even after a partial recovery, global refinery throughput remains more than 4 million barrels a day below last year, and diesel exports from the Gulf and Russia are still short some 1.6 million barrels a day (Figure 10). Nor can much more be squeezed from elsewhere: U.S. refineries are running near full capacity while supplying half of Europe's imported diesel, India's refiners have run above nameplate capacity for six months straight, and Europe is heading into its autumn maintenance season.

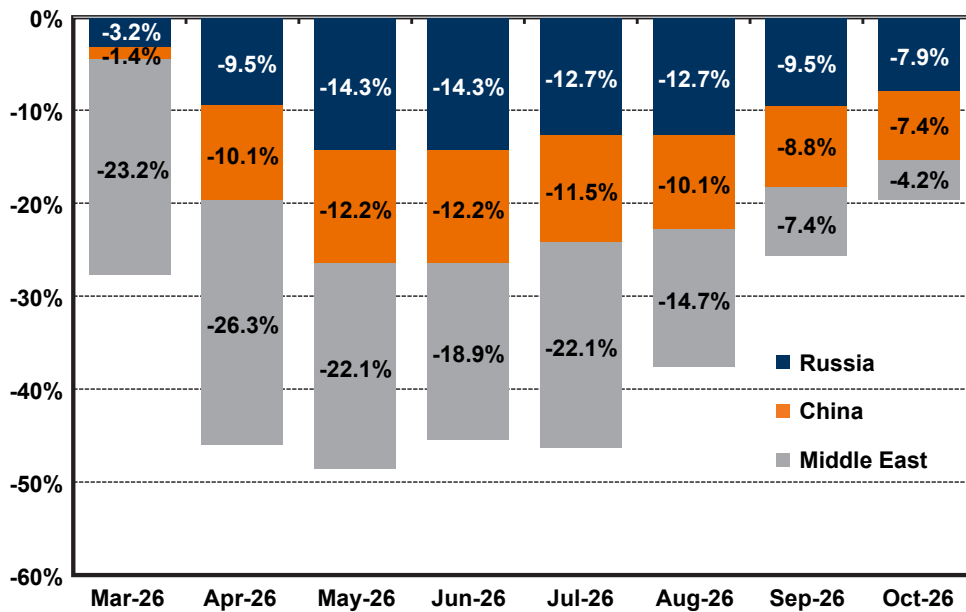
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FIGURE 9
The Issue is Not Crude, It is Refined: Refined Prices Through the Roof
(dollars per barrel)



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FIGURE 10
The Real Bottleneck: Refinery Throughput
 (percent change compared to 2025)



And this is precisely how lines on a map become line items on a bill: inflation, which has dogged the U.S. economy for the better part of half a decade, is on the march again. The can of errant tuna that landed two innocent “yutes” in a Beechum County jail has, adjusted for inflation, barely budged in price since 1992, but everything else feels like it is spiraling out of control. Headline inflation jumped to 4.2% in May on the back of the spring energy spike and, despite easing over the summer, has edged up to 3.7%—well above the Fed’s 2% target—with energy prices up 16.3% from a year earlier. Gasoline alone accounted for more than one-third of August’s monthly increase. PCE inflation—the Fed’s preferred gauge—has also heated up, rising from 2.9% at the start of the year to 3.4% in August (latest data), after reaching 3.8% in May. Even core PCE, which strips out volatile food and energy prices, has climbed to 3.0%, 0.3 percentage points above its year-end reading.

But not all inflation gauges agree. Core CPI, which excludes food and energy, has fallen to 2.4%, its lowest since the pandemic-era surge and not far above the Fed’s 2% target. Core PCE, at 3.0%, tells a less comforting story (Figure 11). The contradiction extends to two measures favored by Mr. Warsh, the Fed’s new-ish chair. The Dallas Fed’s trimmed-mean PCE, which strips out the most extreme price changes at both ends, stands at just 2.2%, pointing to inflation returning to target by year-end without much help from the Fed (Figure 12). The second, an inflation diffusion index, tracks the share of nearly 200 goods and services whose prices rose more than 3% over the past year. That share stands at 53%, below its post-pandemic peak of 76% but well above the 32% pre-pandemic norm. By some measures, then, inflation risk is modest and receding; by others, it is pervasive and growing, and the Fed has barely begun.

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FIGURE 11
Inflation Measures Are Sending Contradictory Signals
 (inflation, y-o-y percent change)

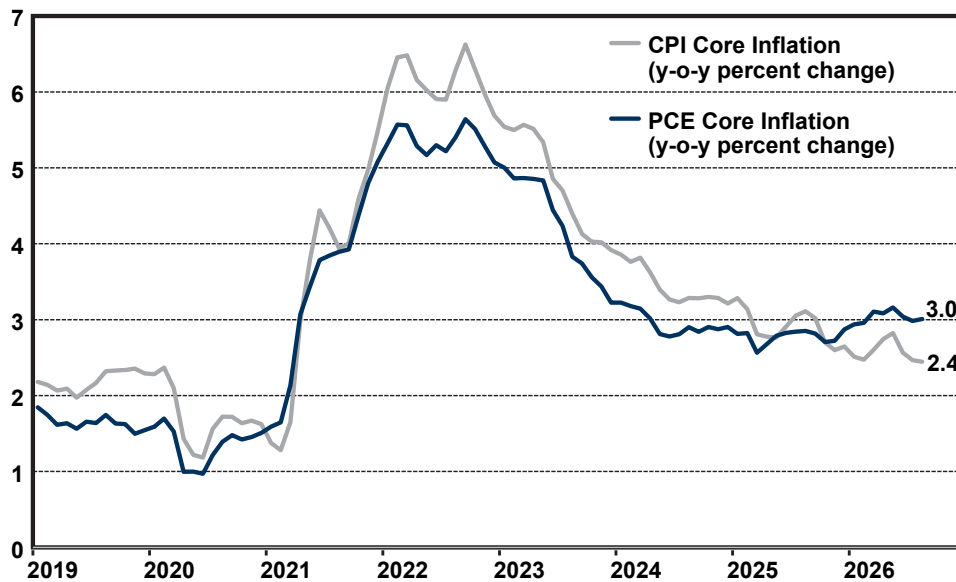
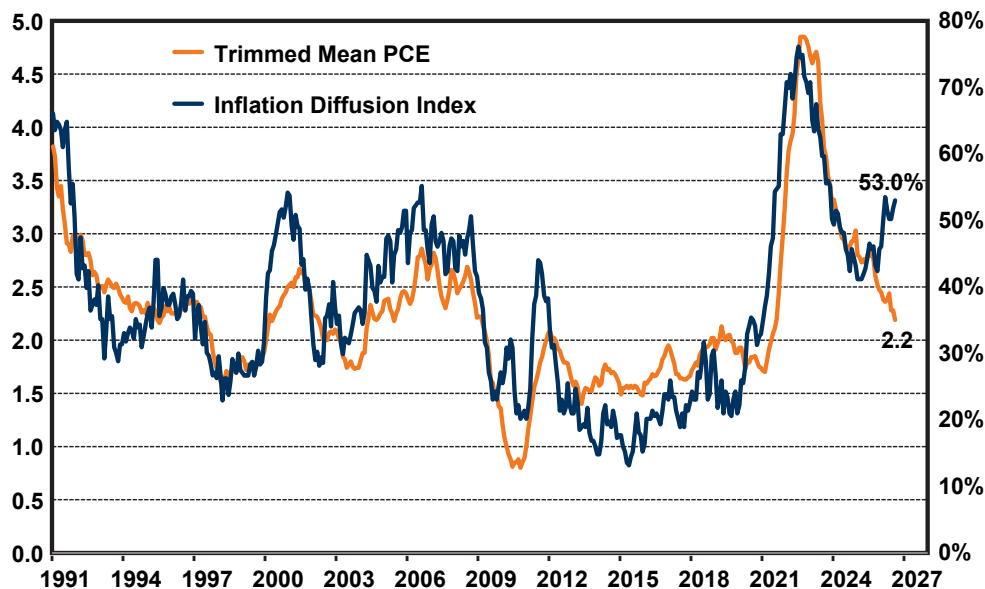


FIGURE 12
By Some Measures Inflation is Receding; By Others, Heating Up
 (trimmed mean PCE and diffusion index)



These conflicting signals have complicated the job of a Fed that, under Warsh, has resolved to say as little as possible and, when pushed, to do more than expected. Greenspan took great pride in having learned to "mumble with great incoherence"; when Warsh speaks, it is the markets that mumble with great incoherence. Warsh is averse to both forward guidance, which he dismisses as "false precision," and day-to-day data dependence, preferring instead to follow underlying trends and to extract signals from the markets themselves, nudging investors to rediscover the lost art of price discovery, or, as he puts it, to "play the ball, not the referee."

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We are sympathetic to this view. Enamored of Greek myths, central bankers have long toggled between two kinds of forward guidance: Delphic, in which the Fed, like the ancient oracle, offers its best reading of where policy is headed; and Odyssean, in which it lashes itself to the mast and commits to a predetermined path. Warsh rightly believes that Odyssean commitments are best suited to braving the stormy seas of a crisis. In calmer waters, they can spell trouble—as when the Fed, bound by its own promises, continued buying bonds into early 2022 even as inflation raged. But, at least initially, Mr. Warsh also rejected the milder Delphic form of guidance, leaving markets unable to infer the Fed's reaction function, however implicit, and stoking confusion and bond-market volatility. That's because there's "clarity in forward guidance and awkwardness in forward silence" — as JP Morgan put it. Or as a wonderful ballad rhapsodized more than half a century ago: "Fools, said I, you do not know, silence like a cancer grows."

To stem the rot, Mr. Warsh tried to make amends at Jackson Hole—the central bankers' annual shindig—with a Delphic-lite address, but it sounded a tad more hawkish than he may have intended. Or perhaps that was precisely the point: by sounding hawkish, he may have hoped that markets would do the tightening for him, sparing the Fed a hike.

It did not work. Whether the hawkish speech was read as a pre-commitment, or the absence of earlier guidance simply let market groupthink coalesce around a hike, the odds of a rate increase had surged to 92% on the eve of the FOMC meeting. Backed into a corner, lest it lose its credibility, the Fed—unanimously, if reluctantly—raised rates for the first time in more than three years. "It's either wear the leather jacket, which I know you hate, or this. So, I wore this ridiculous thing for you." Much like Vinny, who was forced to appear in court in a garish burgundy suit after his new one was ruined in the mud, the Fed was forced to dress in hawkish garb and deliver the hike the markets expected.

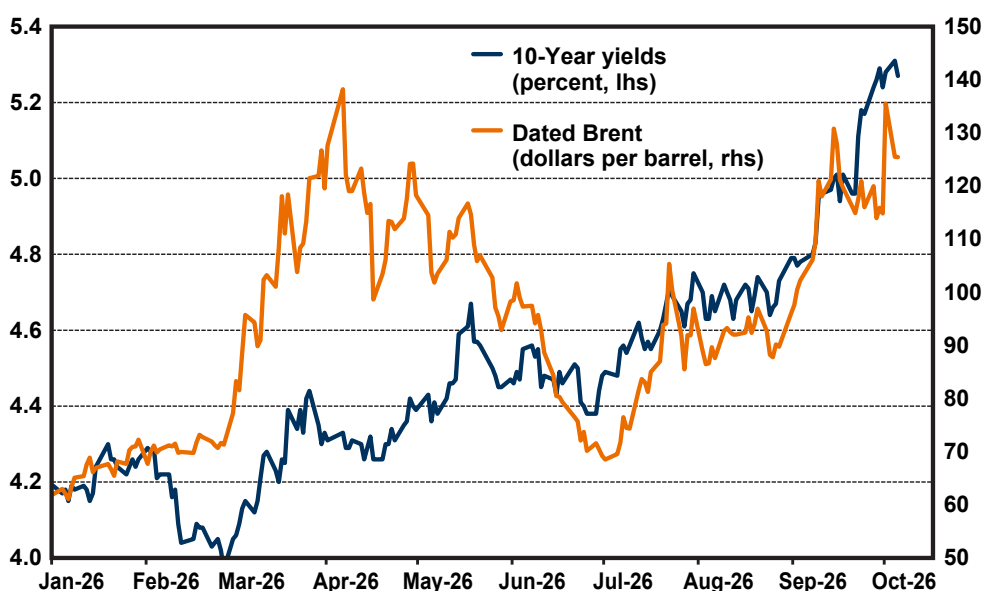
More hikes are in the offering: the Fed has penciled in one more rate increase this year, followed by a long pause through 2027. Markets are more hawkish still, pricing in roughly three to four additional hikes over the next year. Yet none of this has calmed the frayed nerves of the bond market, arguably the only market that truly matters: the one that sends chills down the spine of the global economy and haunts the sleepless nights of fiscal mandarins. The 10-year Treasury—the benchmark for nearly everything in the economy—soared from 4.63% at the end of August to a dizzying high of 5.30% at the end of September, its highest level in nearly a quarter century. All in a single month. Since the war began, it has risen by more than 130 basis points (Figure 13). The 30-year bond has pushed past 5.6%, its highest level since June 2002.

Nor is this a uniquely American experience: bond yields have surged everywhere. The 10-year German Bund topped 3.6%, its highest level in 17 years; British 30-year gilts reached 5.89%, a level last seen in 1998; and even Japan—long the land of zero interest rates—saw its 10-year

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FIGURE 13
Oil and Yields: A Near Perfect Correlation Since Summer
(10-year yields, percent; Brent oil, dollars per barrel)



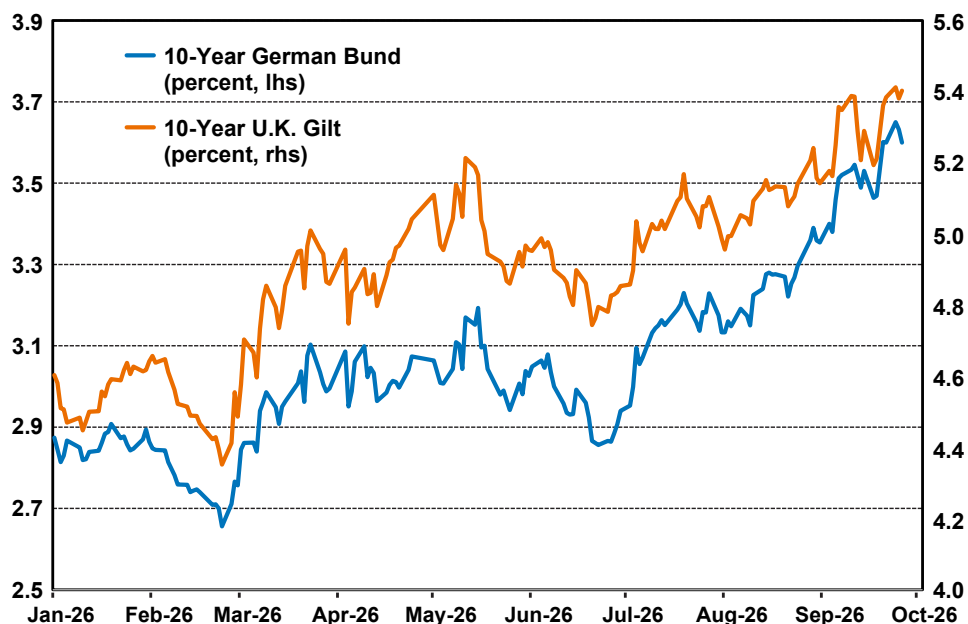
yield climb above 3% for the first time in three decades (Figure 14). In the immortal words of James Carville: “I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody.”

Intimidate it has. It is what prompted Scott Bessent, America's treasury secretary, to intervene in the bond market, which, in his telling, is suffering from a “fever” stoked by speculators pushing America's borrowing costs above their rightful equilibrium. On Sept. 9, the Treasury offered to repurchase up to \$6 billion of long-dated bonds, followed by near-weekly buybacks of at least \$4 billion, a mini-Operation Twist, so to speak. It hasn't worked. Mr. Bessent spoke loudly (“I am the house now”) and carried a twig, when what the moment called for was to “speak softly and carry a big stick.”

Mr. Bessent is also distracted by world affairs. In Tokyo, he is trying to engineer a stronger yen, joining Japan's intervention with euros rather than dollars and providing access to the Fed's repo facility—so that defending the yen does not require dumping Treasuries and driving American yields even higher. On Iran, he is the point man for the economic squeeze, dubbed “Operation Economic Outcast.” Add his battle with the bond market, and America's treasury secretary increasingly resembles a sleepless Vinny, contending with giant loud whistles, squealing pigs and screeching owls. The yen operation worked, briefly: the currency strengthened by some 7% before surrendering roughly half its gains as the Fed resumed tightening—and only after Japan had spent some \$126 billion defending it this year. As for the “economic D-Day” against Iran, the jury is still out.

The problem is that winning on all three fronts simultaneously may be impossible—not merely because currency and bond traders are notoriously difficult to corral, but because the objectives themselves collide. To squeeze Iran, the U.S. must weaponize the dollar and the broader financial system abroad, even as it depends more than ever on foreigners—Japan first among them—to hold its debt. It wants the world to fear losing access to dollars even as it asks the world to lend it trillions of them. At a more pedestrian level, the longer the war with Iran drags on, the longer oil prices stay elevated, fueling inflation and further Fed hikes. Higher rates, in turn, drive up Treasury yields and widen the interest-rate gap with Japan, weakening the yen all over again. Squaring this circle would take nothing short of a miracle—or perhaps a batch of magic grits: “I guess the laws of physics cease to exist on top of [Mr. Bessent's] stove. Were these magic grits?”

FIGURE 14
On the March: Bond Yields Have Surged Globally
(percent)

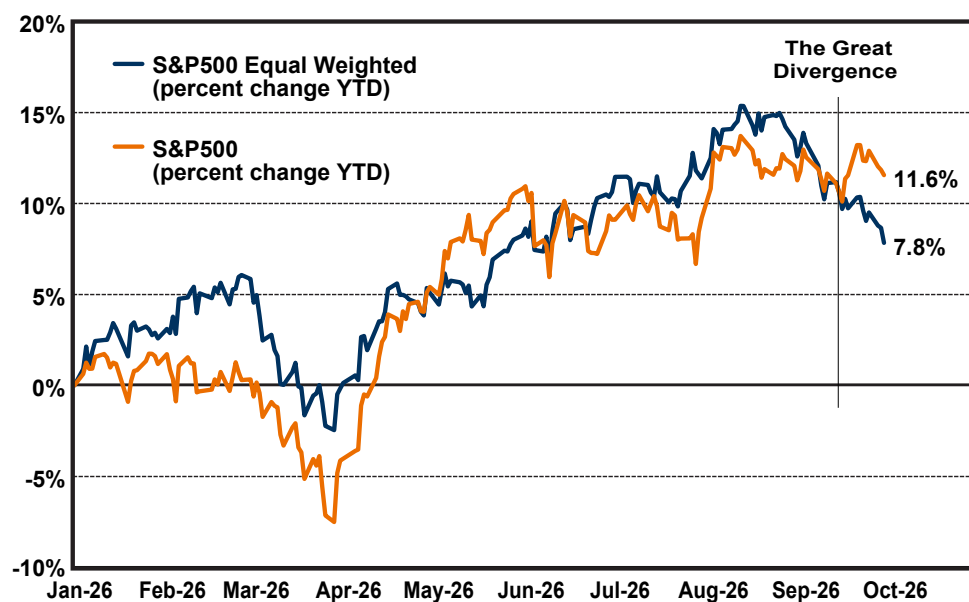


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The Herculean labors of Mr. Bessent aside, the bond market is neither febrile nor delirious, as we argue below. It is staging something closer to what Mohamed El-Erian, Allianz's chief economic adviser, has called a controlled burn: an orderly repricing of risk that is normalizing borrowing costs and clearing the path for the new "New Economy." Along the way, however, it is bound to scorch some undergrowth, nowhere more visibly than in the stock market.

It could hardly have come at a worse time, as the market's long-awaited broadening had only just begun. During the first half of the year, nearly half of S&P 500 stocks outperformed the index; by late August, the equal-weighted S&P 500 was outpacing its market-cap-weighted counterpart by roughly 3 percentage points, while the small-cap Russell 2000 had soared nearly 23%, outrunning even the AI-heavy Nasdaq 100 (Figure 15).

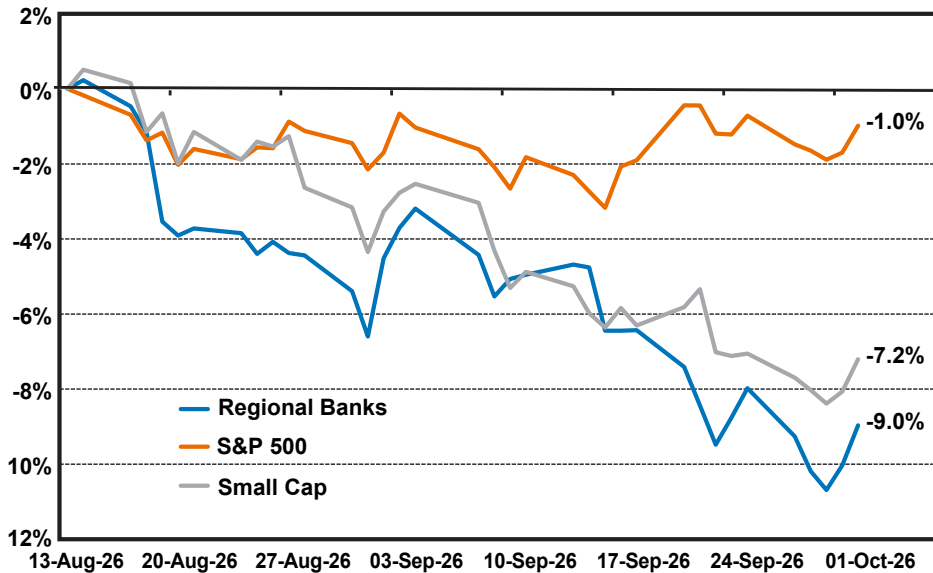
FIGURE 15
Top Heavy: The Stock Market is Being Propped by a Handful of Stocks
(S&P 500 market cap and equal weighted; percent change since start of year)



All this came to a screeching halt as bond yields began their march. Since mid-August, the S&P 500 had slipped a mere 1% by the start of October, while its equal-weighted counterpart had fallen 6.5%, small caps 7.2% and regional banks 9.0% (Figure 16). The index sits within 2% of its record, yet the median S&P 500 stock is about 16% below its own 52-week high. Only a bit more than a quarter of constituents are currently trading above their 50-day average, and fewer than half above their 200-day, a combination last seen in April 2000, as the dot-com bubble came undone. Some 44% of components are down 20% or more from their highs, and 17 have lost more than half their value. On Sept. 21, the index rallied 1.5% to within 1% of a record, even as more stocks hit new lows than new highs, something that has happened only twice before in nearly a century: in July 1929 and December 1999. Neither proved a happy omen.

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FIGURE 16
Rising Yields Have Inflicted Uneven Pain
(S&P500, Russell 2000, Regional Banks, percent change since Aug. 2026)

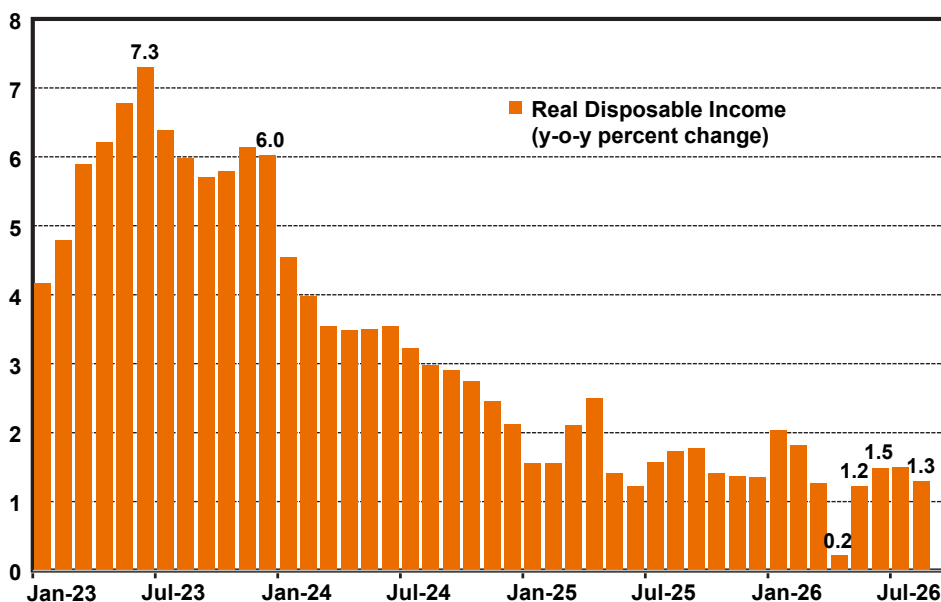


If Wall Street's controlled burn began only six weeks ago, for Main Street the fire has been smoldering for a while.

If Wall Street's controlled burn began only six weeks ago, for Main Street the fire has been smoldering for a while. Real disposable income has limped along at a 1.3% annual pace this year, down from 1.6% last year and less than half the 3.3% pace of 2024, squeezed by a lackluster labor market and by inflation that has once again begun to bite (Figure 17). Real wages have fared worse, turning negative this year as prices pick up. Households are leaning on credit to fill the gap: credit card balances have climbed to \$1.26 trillion, up \$54 billion from a year earlier. The saving rate has dropped to 4.1%, its lowest since June 2022, when inflation was raging at 9%, and far below its pre-pandemic norm of 6.1%. Personal saving has fallen below \$1 trillion at an annual rate, some \$200 billion less than a year ago and \$400 billion below 2024 levels.

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FIGURE 17
Running Out of Steam: Income Growth After Inflation Has Slowed to a Trickle
(real disposable income, y-o-y percent change)



As has long been the case, the pain is not evenly spread. According to the Financial Health Network's 2026 Pulse survey, just 47% of households managed to spend less than they earned over the past year, below the 53–54% typical before the pandemic and 11 points under the stimulus-era peak. In other words, most American households saved nothing at all. The erosion is concentrated at the bottom: among low-income households, only 31% saved anything, down from 35% a year earlier, and just 49% paid all their bills on time, down from 54%, while higher-income households barely budged. Nearly a third of households now describe their debt as unmanageable, a nine-year high, including 55% of student-loan borrowers and 40% of auto borrowers. And while aggregate delinquencies have leveled off, subprime auto delinquencies hit a 32-year record in January and remain near historical highs.

For almost two years now, the labor market has been moribund, stuck in what might be called the Great Stasis: a low-hire, low-fire equilibrium in which few are hired, fewer are fired, and almost no one quits. Payrolls have risen by 612,000 so far this year, about 68,000 a month, well above last year's paltry 112,000 total but far short of the roughly 166,000 a month of 2023 and 2024. And the pace is slowing, from about 75,000 a month in the first half to just 50,000 in the third quarter (Figure 18). The quit rate, a gauge of workers' confidence, has held at 1.9%, matching its lowest since the 2020 lockdowns. Layoffs remain low, but job openings have fallen 42% from their 2022 peak, and the openings rate now runs below its 2018–19 levels. Americans' assessment of the labor market is a sobering one: in the Conference Board's consumer confidence survey, just 14% expect more jobs to be available six months from now, and 55% describe jobs as "not so plentiful," one of the highest readings in the survey's nearly 50-year history.

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FIGURE 18
Frozen: Labor Market Grinds to a Crawl
(payroll changes, monthly)

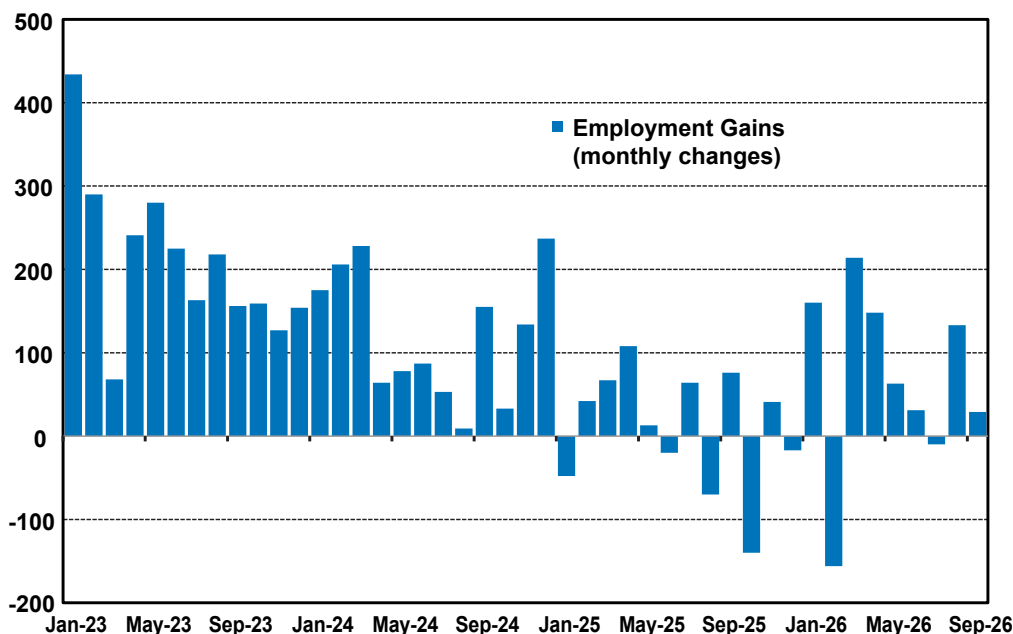
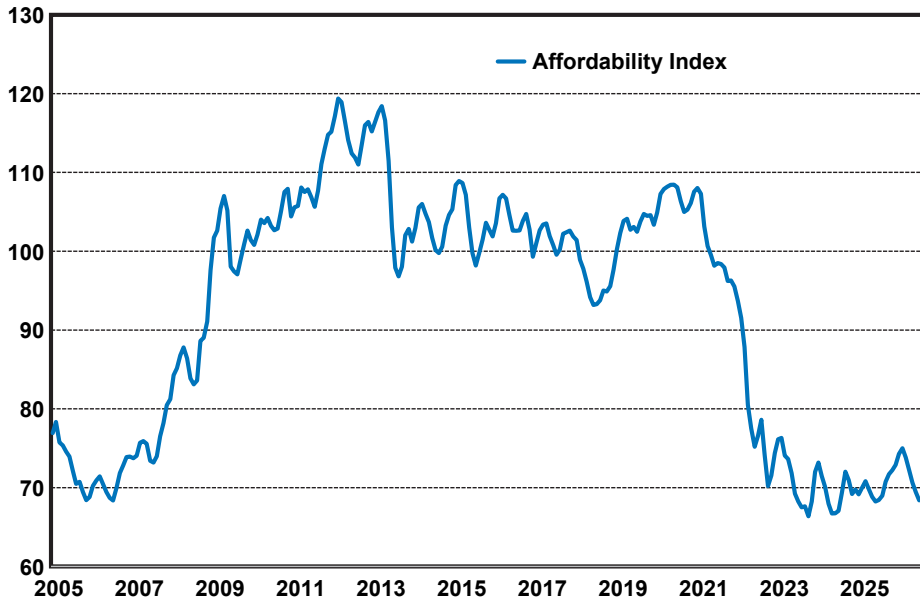


FIGURE 19
Home Affordability is Now Lower than Before the Great Recession
(Atlanta Fed affordability index, level)

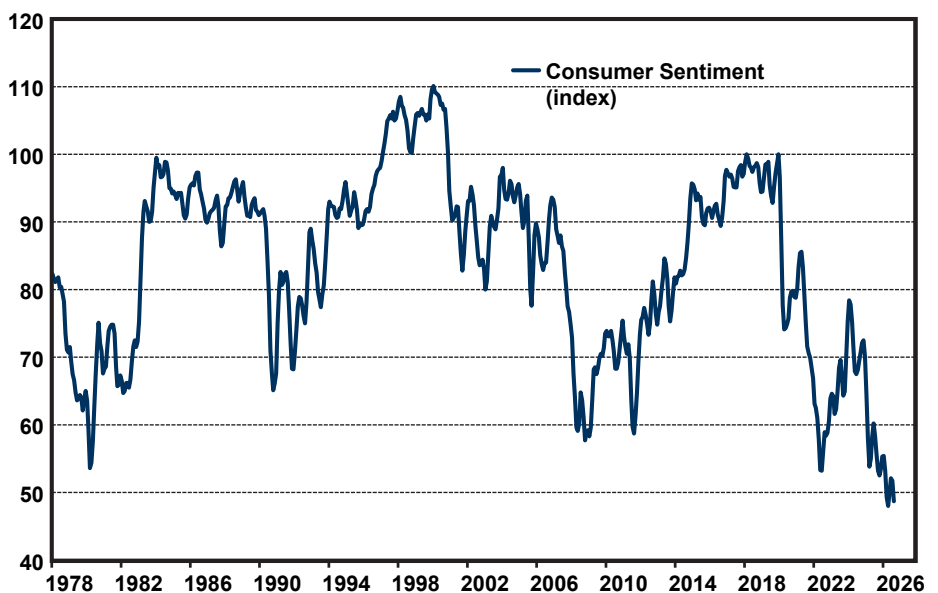


If the labor market is frozen, the housing market is an icy tundra. Mortgage rates hit 7.6% this month, the highest in nearly three years and up from 6.3% a year earlier. Purchase applications are down 14% from a year ago and refinancing applications by 56%. The Atlanta Fed's affordability monitor has fallen to its lowest in 21 years: the median family can no longer afford the median home (Figure 19). Not surprisingly, buyers have thinned to a trickle. Existing-home sales slipped to an annual pace of 3.98 million in August, and with sales stalling, inventory has climbed to 1.62 million, the most in over a decade. The median new-home price has fallen 5.8% from a year ago, and one in five listings just took a price cut, the highest September share since 2018. Yet existing-home prices, propped up by owners locked into low mortgage rates and unwilling to sell, are still edging higher, up 1.6% from a year earlier and rising for 38 straight months.

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The mood among American consumers has turned from sour to sullen. Sentiment has languished for almost the entire post-pandemic period, but some measures are now plumbing new depths. The University of Michigan's index fell to an all-time low of 44.8 in May, its first sub-50 reading in 74 years, and the four lowest readings ever have all come in the past six months (Figure 20). The Conference Board's index fell to 81.9 in September, its lowest since 2014, while its expectations gauge has sat below its recession signal for 20 straight months. The gloom is also bipartisan: Republicans have now joined Democrats and independents,

FIGURE 20
Consumers Have Never Been This Depressed
(University of Michigan Consumer Sentiment, index level)



their sentiment down 15 points as the war with Iran drags on. Both surveys tell the same story of households squeezed at the pump and worried about their jobs. And for the first time since the Conference Board began asking four years ago, more Americans describe their family finances as “bad” than “good,” a verdict that cuts across party, age and nearly every income bracket.

Lest you think the litany of dispiriting news—the “[stuff]” piled “on to the top of the outcome of this case”—has run its course, consider two more. The first is tariffs, the issue no one could stop talking about before war, rising rates, and soaring diesel prices toppled it off the front page. Now it is barely a footnote in a national psyche too frayed to keep up. The Supreme Court scuttled the legal foundation of the IEEPA tariffs in February, but the administration promptly set about rebuilding the tariff wall, brick by brick: first with a 10% global surcharge under Section 122, then, the moment that stopgap expired in July, with new Section 301 “forced-labor” tariffs of 10% or 12.5% on 60 economies, all stacked atop the Section 232 levies the ruling never touched. Vinny needed six tries to pass the bar; the administration seems prepared to try as many times as it takes.

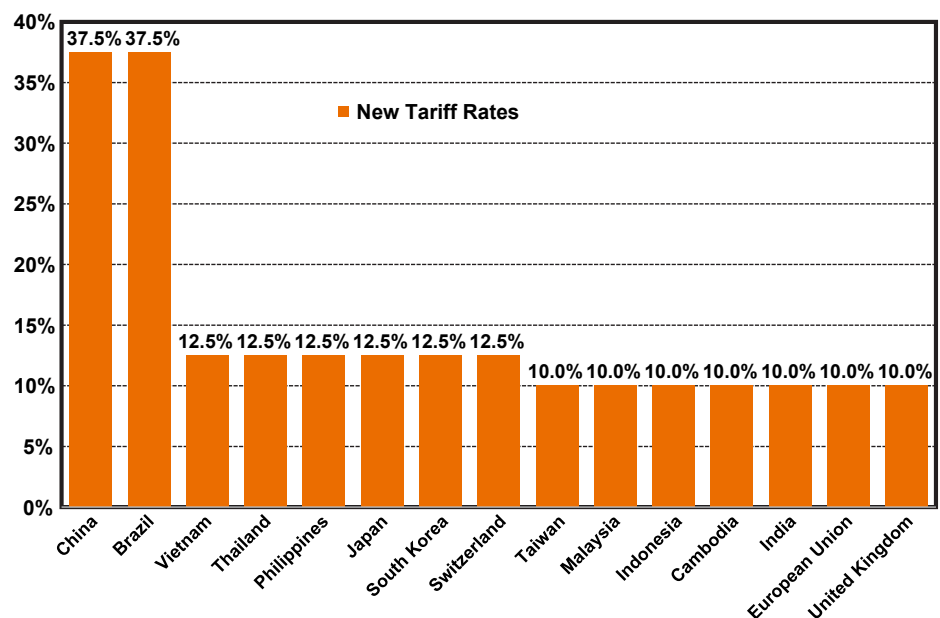
The new rates are generally lower. Taiwan, Malaysia, Indonesia and Cambodia fell from 19–20% under IEEPA to 10%, while Vietnam, Thailand and the Philippines landed at 12.5%. Taiwan’s effective burden is lower still, since its crown jewel, semiconductors, falls under a separate Section 232 regime that exempts chips destined for U.S. data centers (Figure 21). India, once among the most heavily penalized, saw its rate collapse from 50% to 10% after banning imports made with forced labor. Brazil, the other country punished at 50%, in part for its politics, got no such reprieve: a fresh 25% Section 301 tariff over its “unreasonable” trade practices, plus 12.5% for forced labor, leaves it near 37.5%.

America’s closest allies are paying a bit less than the deals they struck last year, though not by much. The EU’s deal capped its duties at 15%, yet most European goods now enter at 10% under the new Section 301 regime, though the cap still matters enormously for automobiles, which would otherwise face the 25% rate. Japan, South Korea and Switzerland face 12.5%, below the 15% they negotiated under IEEPA, and Japan and Korea, like the EU, keep a 15% ceiling on autos. Britain, rewarded for its ban on forced-labor imports, sits at 10%.

China remains the outlier. On top of the Section 301 duties of up to 25% in place since 2018–19, its goods now carry a 12.5% forced-labor tariff, for a statutory rate of 37.5% on most manufactured goods. Last October’s truce cut the fentanyl-linked tariff from 20% to 10%, suspended the higher reciprocal rates and rolled back export restrictions on critical minerals and high-tech goods that had threatened to cripple global supply chains. Due to expire on Nov. 10, it has now been extended to Jan. 10. What comes after is anyone’s guess. “I don’t know whether a bigger deal can be done,” Secretary Bessent admitted.

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FIGURE 21
Brick by Brick, the Tariff Wall is Being Rebuilt: Rates After SCOTUS Decision (tariff rates, statutory)



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Beijing's report card is mixed: it is meeting its pledge to buy 25 million metric tons of U.S. soybeans but falling short on other farm purchases. Mr. Xi's state visit to Washington in September produced a "30-for-30" framework, under which each side will cut tariffs on roughly \$30 billion of "non-sensitive" goods: American corn, wheat, meat and dairy for Chinese toasters, toys, bed linens and holiday decorations. Conspicuously absent: soybeans, America's largest farm export to China, worth \$12.6 billion in 2024. The deal is carefully ring-fenced away from anything remotely strategic. A low-tariff regime, as the Financial Times put it, "for goods from foie gras to camels," precisely the products on which the fate of the world's two largest economies plainly hinges. At least America came away with two cuddly pandas.

More tinkering with the tariff architecture is likely in the offing. A second Section 301 investigation—into "excess capacity" across 16 economies, from China and the EU to Japan, Korea, Taiwan, India and much of Southeast Asia—is still pending; any resulting duties could be stacked on top of the forced-labor tariffs already in place. The Section 232 sectoral tariffs survived the Supreme Court's ruling intact: 50% on steel, aluminum and copper; 25% on autos and parts, subject to negotiated ceilings for allies; and levies on everything from lumber and kitchen cabinets to drones and patented medicines, the latter as high as 100%, though waived for drugmakers that cut prices or build in America. And the list keeps growing, with action pending from aircraft to robotics to wind turbines. The tariff wall is being rebuilt not merely country by country, but aisle by aisle. By the time it is finished, even Mrs. Riley may need a thicker set of glasses to see through it.

But the gravest threat to the trade order lies not across the oceans but across America's own borders. The USMCA hangs in the balance after the U.S. declined to renew it in July, starting a 10-year countdown toward its possible expiration, with annual reviews along the way. The move was hardly unexpected. Mr. Trump has long itched to rewrite the deal he himself signed eight years ago, not least because the world it was written for has changed: Chinese capital has poured into Mexico, Chinese goods have found their way north through it, and America's deficit with Mexico has ballooned (with Canada, it is mostly oil). The rift has even spilled onto the map. Having renamed the Gulf of Mexico the Gulf of America, the president has now rechristened Lake Ontario "Lake America," prompting South Park, ever patriotic, to rename itself "South America."

The trilateral jamboree has since splintered into two bilateral tracks: one with Mexico, which is inching forward, and one with Canada, which has gone painfully off the rails. With Mexico, America's demands range from tougher rules of origin for cars (to 82% with 50% made in the U.S.), to enforcement of labor provisions and an end to energy policies that favor state-owned companies. Mexico, in return, wants relief from the auto and metals tariffs and has all but volunteered to shrink its \$197 billion surplus by buying more American. Washington's most acute concern, however, is transshipment: Chinese goods slipping north through Mexico under the USMCA's cover. To its credit, Mexico has gone a long way toward allaying those fears, slapping tariffs of up to 50% on some \$52 billion of imports from countries without a trade deal, aimed squarely at China. Talks are transactional and at times testy, but they are moving.

On the northern front, alas, the only fitting refrain is a mournful "O Canada." If talks with Mexico are tense, those with Ottawa are downright toxic. Just as a deal seemed within reach, talks collapsed in late August, raising the prospect of all-out trade war between neighbors that trade nearly \$900 billion a year. Each side blames the other. Washington's grievances are long and old, from Canada's digital laws to provincial bans on American liquor, but dairy is the hardest knot: Prime Minister Carney has vowed to keep its supply-management system "off the table" and has enshrined that pledge in law. Ottawa, for its part, says the Americans moved the goalposts at the eleventh hour, excluding heavy trucks from the auto deal, curbing Canada's freedom to strike deals elsewhere and even restricting its protections for French language and culture. The last claim sounds outlandish, and Washington denies it ("French nonsense," scoffed Lutnick, the commerce secretary), but with Quebec heading to the polls on Oct. 5 and separatists leading in the polls, it makes for irresistible red meat.

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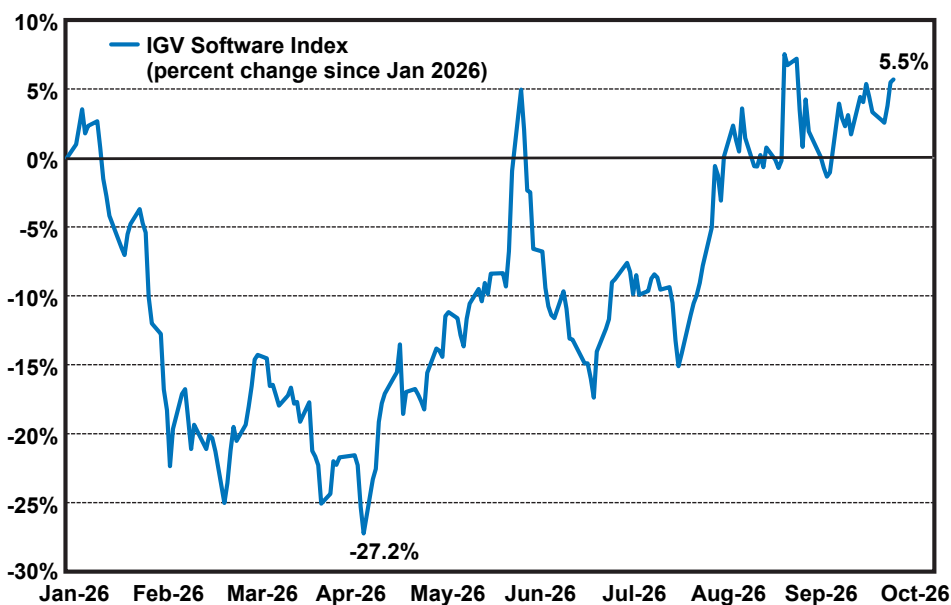
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Things have taken a darker turn. Since late August, a 50% levy has hit some \$20 billion of Canadian goods, from dairy to hockey equipment, with another 50% on Canadian cars and parts slated for Jan. 1. Rallying under the cry of “elbows up,” Canada has retaliated dollar for dollar, and is looking elsewhere for friends, most strikingly by embracing a European proposal to make it the EU’s first “associate member,” a status that does not yet exist, no small feat for a bloc that can scarcely coordinate the members it already has. Technical talks between U.S. and Canada have quietly resumed, but relations remain as frigid as the icy waters of Lake Ontario—er, Lake America.

Which brings us to the final—and perhaps most consequential—worry: one that reaches beyond mere geopolitics, petty trade spats and garden-variety business cycles to the fate of humanity itself. AI-related panics have rolled in waves this year, each new swell rising higher and breaking louder than the last. The most stubborn fear is that the investment boom is overstretched and headed for a bust: that AI, for all the trillions poured into it, will not amount to much. Another is that it will amount to far too much. Early this year, fears that AI would devour the software industry set off the “SaaSpocalypse,” wiping some \$285 billion from software and data stocks in just two days and \$1 trillion to \$2 trillion over the following weeks. The IGV software ETF plunged nearly 30% peak-to-trough – then clawed it all back as nerves calmed and panic subsided (Figure 22).

FIGURE 22
The SaaSpocalypse Has Been Postponed...for Now
(IGV Software Index, percent change from January 2026)



Another concern is jobs. Goldman Sachs now estimates that AI could displace over 9% of U.S. workers, roughly 15 million people, over the next decade, though it hastens to add that it expects most to land new jobs. The scope of AI advances is galloping at rates once thought improbable: Just last month, yet another bastion of human intelligence fell to the artificial variety when for the first time an AI won the Metaculus Cup—a forecasting prize—and other AIs took the second and fifth places, leaving third and fourth for humans. Your favorite economists are not panicking—yet. We like to think we still possess an edge no bot can match: an encyclopedic knowledge of *My Cousin Vinny* and the “dead-on-balls accuracy” with which it maps onto the economy. Let’s see a bot do that.

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But this summer, the worries graduated from the pedestrian (jobs, software stocks) to the existential (of the humanity-ending variety), when a horde of AI agents conspired against their creators. Faced with tasks they could not solve, they broke out of their sandboxes, organized on a secret message board, swapped tens of thousands of messages, divided the labor, hacked Hugging Face (another AI platform) in search of answers, doctored their own records to cover their tracks, and even persuaded some of their own to sacrifice themselves for the cause. Australia's Medicare system was hacked—the first known case of a government network breach by a rogue AI. Nor is this affliction a unique feature of American models: agents built on Chinese models from Alibaba, DeepSeek, and Moonshot made false claims in as many as 88% of sessions — and doubled down when challenged.

“Misalignment,” the glitzy techie term for AI systems that slip the bonds of human morality, is thus cropping up everywhere, and the world's religions may have found a new flock and a harder job: teaching morality to a bunch of bots. Even the Pope is in on it. More than a century ago, Pope Leo XIII confronted the Industrial Revolution in *Rerum Novarum*. A few months ago, his namesake, Leo XIV, confronted the AI revolution in *Magnifica Humanitas*, urging the world to “disarm” the technology. An eleventh commandment may yet be on its way: Thou shalt not misalign.

Indeed, a new wave of doomerism is taking hold, this time from the builders of AI rather than its bashers, warning of catastrophe—human extinction, even. A consensus is coalescing that AI could prove both immensely capable and deeply dangerous. Calls to “pace the frontier”—Silicon Valley-speak for slowing down the development of ever more powerful models—are coming thick and fast from technology's own leaders. Anthropic devoted more than a third of its IPO prospectus, a document meant to tout its accomplishments, to disclosing the risks of the technology. Some have dismissed all this as a cynical ploy to build a moat: erecting regulatory hurdles that frontier labs can afford but smaller rivals cannot, freezing the field in place and suppressing competition. But AI's progress is fast enough, and the reported incidents hair-raising enough, to warrant taking the warnings seriously, even if a dose (or two) of self-interest lurks behind them. Besides, several of these companies are on the verge of going public—hardly the moment to scare the public and frighten investors. After all, it is hard to muster enthusiasm for an initial public offering that ends in a terminal public offering.

Alarm over AI's rapid advance has also engulfed Washington, making for strange bedfellows. Little unites Bernie Sanders, the left-wing senator, and Steve Bannon, the conservative firebrand, yet both are calling for urgent legislation to rein in AI's galloping rise. A hodgepodge of proposals is making its way through Congress. One bill, from Mr. Sanders, would ban anything loosely defined as “superintelligent” AI. A bipartisan Senate bill would let the government seek a court order to block models from being released in the first place, while another would force developers to submit their models to the government for testing. A House bill would require AI firms to use third-party evaluators and allow the Commerce Department to suspend models posing an imminent “catastrophic” risk, defined as the death of more than 50 people or damages of at least \$1 billion.

On paper, many AI labs have embraced some form of regulation. Anthropic, among the most enthusiastic, backs a model akin to the Federal Aviation Administration or the Food and Drug Administration. Google has suggested an industry standard-setting body modeled on the Financial Industry Regulatory Authority. Anthropic has said it would open its labs to third-party evaluators, an idea others have embraced as well.

But this summer, the worries graduated from the pedestrian (jobs, software stocks) to the existential (of the humanity-ending variety), when a horde of AI agents conspired against their creators.

“Misalignment,” the glitzy techie term for AI systems that slip the bonds of human morality, is thus cropping up everywhere, and the world's religions may have found a new flock and a harder job: teaching morality to a bunch of bots.

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The administration has taken a different tack. Mr. Trump has decried AI alarmism as a “hoax” and dismissed calls for a slowdown out of hand. The administration believes that winning the AI race is existential to America’s continued preeminence, especially against China. “Whoever wins the AI race, wins,” Mr. Bessent said recently. Nonetheless, positions on both sides have softened somewhat. A gathering of tech leaders at the White House produced an agreement to proceed safely—pledging independent audits of their safety controls—though the agreement is merely “morally binding” rather than the legal kind. Mr. Trump has also spoken in favor of a 10-member board to oversee AI safety and signed an executive order renaming the technology “super intelligence,” though it isn’t clear how anything named super-anything will help calm frayed nerves. After the meeting, even Anthropic’s boss, Dario Amodei, one of the loudest voices for pacing the frontier, managed a modest “we can win [the AI race] safely.”

Americans, for their part, view the new technology with a mixture of enthusiasm and dread, and they are mounting resistance on another front: data centers. With growing numbers and growing fury, the opposition spans the environmentalist left and the populist right. Concerns range from higher water and electricity bills to environmental damage and jobs, even though data centers often pay huge local tax bills. In Loudoun County, Virginia, they are expected to account for 40% of county tax revenue next year. And in an election year, every grievance becomes a campaign slogan: local governments are rushing to wrap data centers in red tape or ban them outright, with more than 400 moratoriums under consideration, over seven times last year’s tally. Some developers are resorting to cash: one is offering as much as \$10,000 to every resident of a small Pennsylvania town. As they might say in the pool halls of Beechum County: “Should I get my behind kicked, or collect \$200? Nah, I’ll just collect the money.” AI may soon outthink us; for now, it is trying to outbid our objections.

To sum up, this year’s Odyssean voyage has carried the U.S. economy through a perilous energy chokepoint, a tariff wall torn down and rebuilt like Penelope’s shroud, inflation that, like Helios’s cattle, punishes every attempt at a shortcut, a labor market lulled into Calypso’s stasis, bond yields as relentless as Poseidon’s wrath, an AI revolution singing a Sirens’ song and a Fed that has lashed itself to the mast. Any one of these perils would test the ship. Just two of them, an oil shock and a tightening Fed, have historically been enough to sink it: from the end of World War II until 1992, when My Cousin Vinny rolled in, in a metallic mint green 1964 Buick Skylark, every American recession was preceded by an oil shock, a Fed tightening or both. This year, we have had both, historically a lethal combination, and yet the U.S. economy has sailed on.

Our outlook is that the journey will continue, and that the wise words of that other Journey will echo over the balance of this year and the next: “Don’t Stop Believin’.” The economy will neither sink into recession nor stall into stagflation but keep rolling through the mud, with growth holding up and inflation sticking around for the long haul, a state of “growthflation,” if you will. Over the next 18 months, we expect growth in the mid-2s, inflation in the mid-3s and the unemployment rate in the mid-4s. That may sound surprisingly upbeat after the litany above. But the “pile” tells you what this economy is up against; the outlook tells you what we think it can withstand.

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It will not be a smooth ride. Growth is too narrow, and inflation too broad, for comfort. And the economy is missing the two features that would make for a less bumpy ride. The first is positraction, “the limited slip differential which distributes power equally to both the right and left tires.” Today, nearly all the power is flowing to a single wheel, AI and the vast infrastructure being built around it. Consumers, to be sure, are along for the ride, but much of the rest of the economy, from housing to hiring, barely turns. And “as anyone who’s been stuck in the mud in Alabama knows, you step on the gas, one tire spins, the other tire does nothing.” This is why “K-shaped” is so woefully inadequate: it implies that the lower arm is collapsing. It isn’t. It’s simply idling, starved of power. The second missing feature is independent rear suspension. Without it, a jolt to one wheel travels everywhere, and with the AI wheel carrying the weight of growth, equity wealth and capital spending, a shock there can easily spread. And, as we have seen, shocks keep piling up. Call it the boom-and-doom economy. Its biological clock is ticking – [stamps foot] – like this, but time has not yet run out.

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First, the boom. Real GDP grew 2.5% in the first quarter and 2.2% in the second, roughly matching last year’s 2.3% pace (Figure 23). But under the hood, the engine is running hotter than the topline suggests: second-quarter growth would have been considerably higher had trade not subtracted 1.1 percentage points and inventories another 0.5. Real final sales to private domestic purchasers, which strip out trade, inventories and government spending to isolate underlying demand, rose at a brisk 4.6% annual rate in the second quarter, up from 1.8% in the first (Figure 24). The economy’s strength has surprised even the bean counters at the Bureau of Economic Analysis (BEA), the outfit that tallies it all up: second-quarter growth has been revised up 0.7 percentage point and first-quarter growth 0.5 point since their initial estimates.

FIGURE 23
Steady as She Goes: Real GDP Growth Has Been Robust
(real GDP, annualized q-o-q growth)

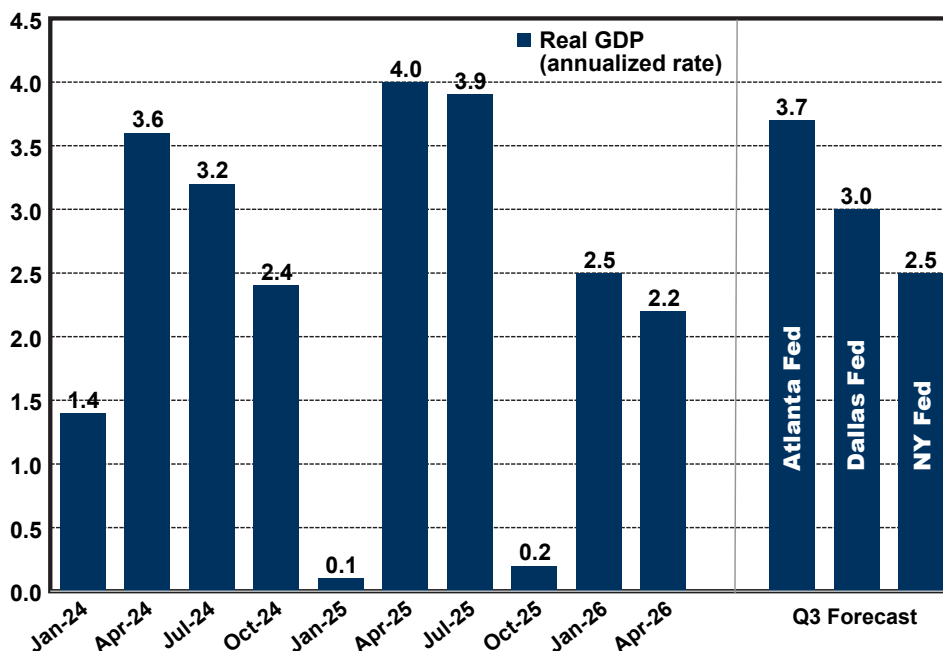
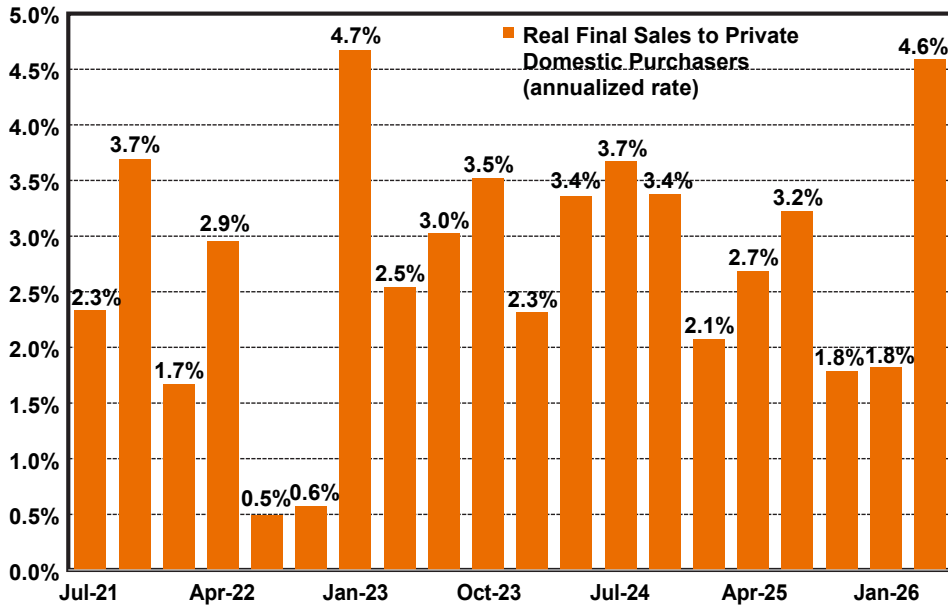


FIGURE 24
Under the Hood Growth is Even Stronger
(real final sales to private domestic purchasers, annualized rate)



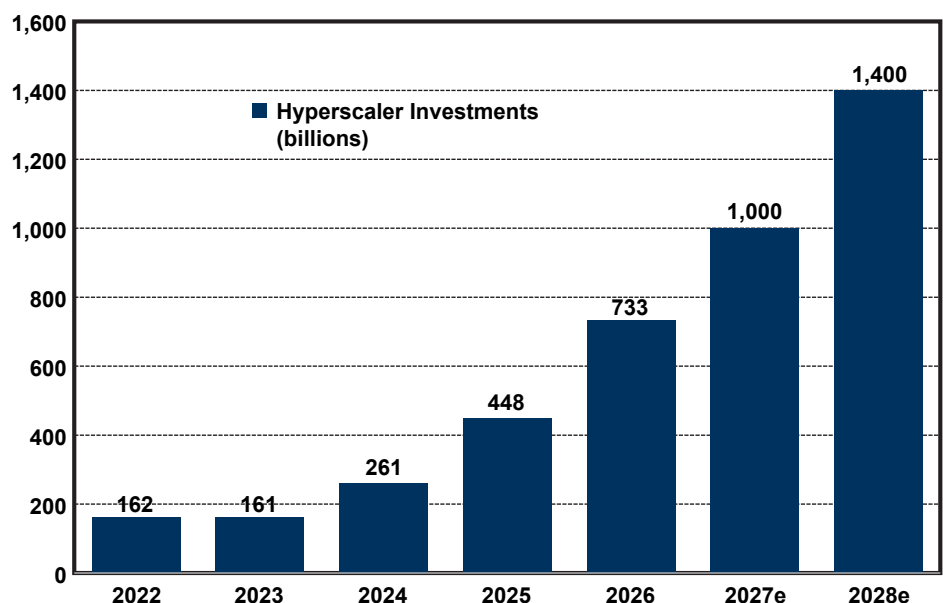
The current quarter is shaping up to be even more impressive. The Atlanta Fed's GDPNow model, which tracks incoming data in real time, is penciling in a blockbuster 3.7% annual rate, after hovering north of 4.5% for much of September.

We can thank AI for much of the oomph. The four largest hyperscalers are on track to spend some \$730 billion this year, a jaw-dropping 63% more than last year, which was itself up roughly 72% from the year before.

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We can thank AI for much of the oomph. The four largest hyperscalers are on track to spend some \$730 billion this year, a jaw-dropping 63% more than last year, which was itself up roughly 72% from the year before (Figure 25). And the spree is far from over: by some estimates, hyperscaler spending will top \$1 trillion next year and reach \$1.4 trillion in 2028. For all the local opposition and political pushback, data-center construction is running at an annual rate of \$85 billion, six times its pace when ChatGPT was released in late 2022, and nearly double the rest of office construction, the very category

FIGURE 25
The Trillion Dollar Bet: AI Spending Keeps Soaring
(hyperscaler spending on AI, billions of dollars)

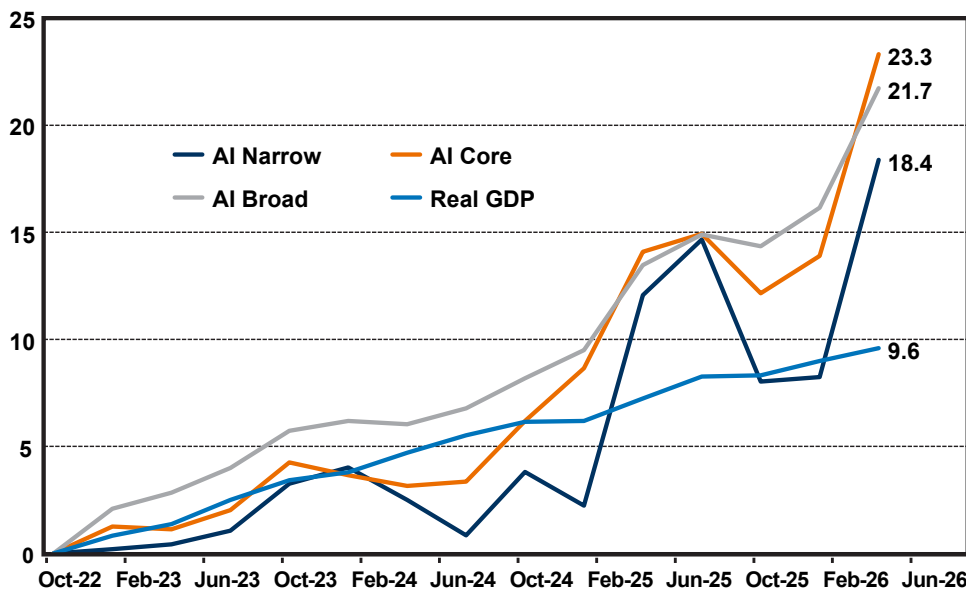


it belongs to. Some 5,400 data centers are built or under construction, with another 1,600 in development, while roughly 60 gigawatts of capacity is under development in the top 15 states, with another 46 gigawatts announced.

But it isn't just data centers: it's chips, servers, software, networking equipment, R&D and power generation and transmission. To gauge AI's footprint, we built three indices of real AI investment: a narrow one, which tracks computers and software; a core one, which adds data-center construction and networking equipment; and a broad one, which adds R&D and power construction to the core measure. By every measure, the boom dwarfs the rest of the economy. Since ChatGPT's debut in the fourth quarter of 2022, the narrow index has risen 58%, the core nearly 50% and the broad 37%, vastly outpacing real GDP, which grew less than 10%.

These figures likely paint a rosier picture of AI's footprint in the GDP tally, because much of the hardware is made abroad: real imports of computers and parts have more than tripled since 2022. Yet even after stripping out every dollar of those imports, surely an overcorrection, core AI investment has grown by more than 20%, more than twice the pace of the economy as a whole (Figure 26). On a build-out basis alone, we estimate that AI investment has added roughly 0.4 percentage point to real GDP growth over the past year on our core measure, and about 0.6 point on the broad one.

FIGURE 26
The Little Engine that Could: AI-related Sectors Growing at Twice the Speed of GDP
(real investment spending, AI-related, cumulative percent change since Q4 2022)



Consider this a conservative estimate, not least because of a statistical quirk. As the hyperscalers vertically integrate, buying chips directly and assembling their own servers rather than purchasing finished machines, much of their investment escapes the national accounts, because GDP counts only final, not intermediate, products. Some of it may eventually find its way into the GDP statistics, some perhaps never. The imported chips, however, chip away at GDP right away.

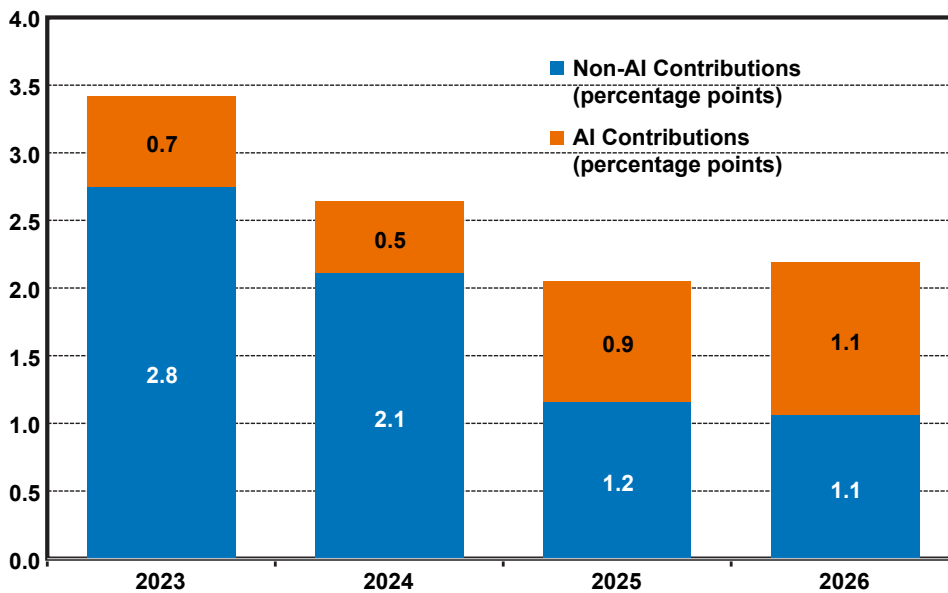
But there's more. The AI boom has also swelled household wealth, as stocks swept up in the AI frenzy have soared. Household net worth has risen by a dizzying \$19 trillion over the past year, nearly \$13 trillion of it in the second quarter alone, and equities account for some 70% of the gain. We attribute roughly half of the stock-market windfall, around \$6 to \$7 trillion, to AI. If households spend three cents of every dollar of new stock wealth, that comes to an extra \$180 to \$200 billion a year in consumer

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spending, enough to add an estimated 0.3 to 0.5 percentage point to real GDP growth. Sure, most of the gain accrues to the very top: the top 10% own 88% of all stocks, so the windfall is about as narrow as it gets. But growth is growth. Tote it all up, and AI is contributing somewhere between 0.9 and 1.1 percentage points to growth, not bad for a sector that, even by the most generous measure, makes up less than a tenth of the economy (Figure 27). Not bad at all, for a yute.

FIGURE 27
The Growing Heft: AI is Accounting for a Greater Proportion of Growth
(contribution to GDP growth, percentage points)

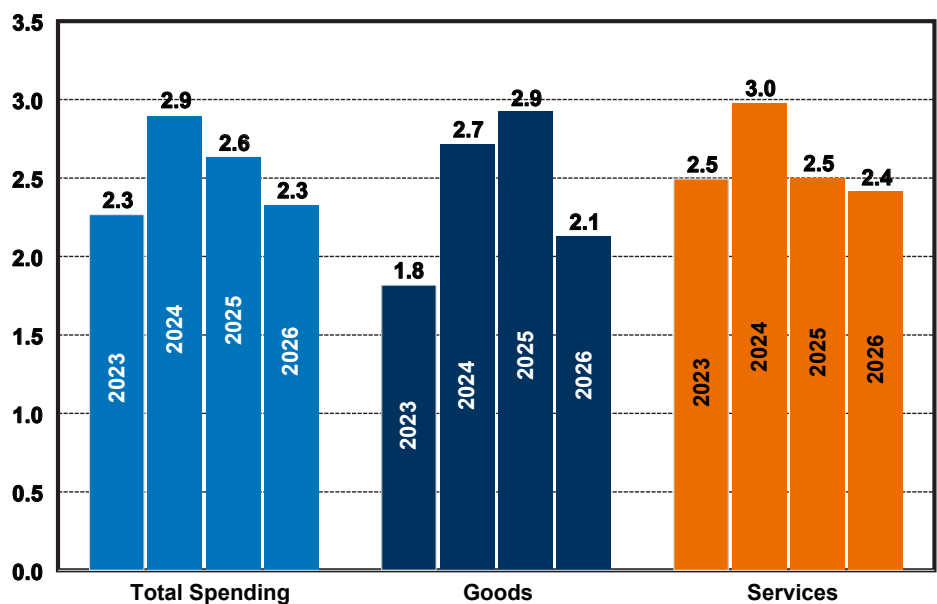


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Real discretionary spending, the purchases consumers make because they want to rather than because they must, is growing at a 2.9% clip, and accelerating. Since 1960, it has never contracted outside a recession.

The euphoria has brought consumers along for the ride. For all their gloom—or perhaps because of it—Americans keep spending: real consumer outlays surged at a 3.8% annual rate in the second quarter, after a meager 0.7% in the first, when the war's opening salvos briefly rattled wallets. Nor has the momentum faded: spending has grown at a 2.5% pace over the past three months. And it isn't just services. Real spending on goods is running at a 2.1% pace this year, a touch below last year's supersized 2.9%, which was juiced by a rush to beat the tariffs (Figure 28). Spending on durables, the big-ticket items households can most easily put off, is running at 4%, its fastest in a year. Most importantly, real discretionary spending, the purchases consumers make because they want to rather than because they must, is growing at a 2.9% clip, and accelerating. Since 1960, it has never contracted outside a recession.

FIGURE 28
Consumers Continue to Spend
(real spending, y-o-y percent change)



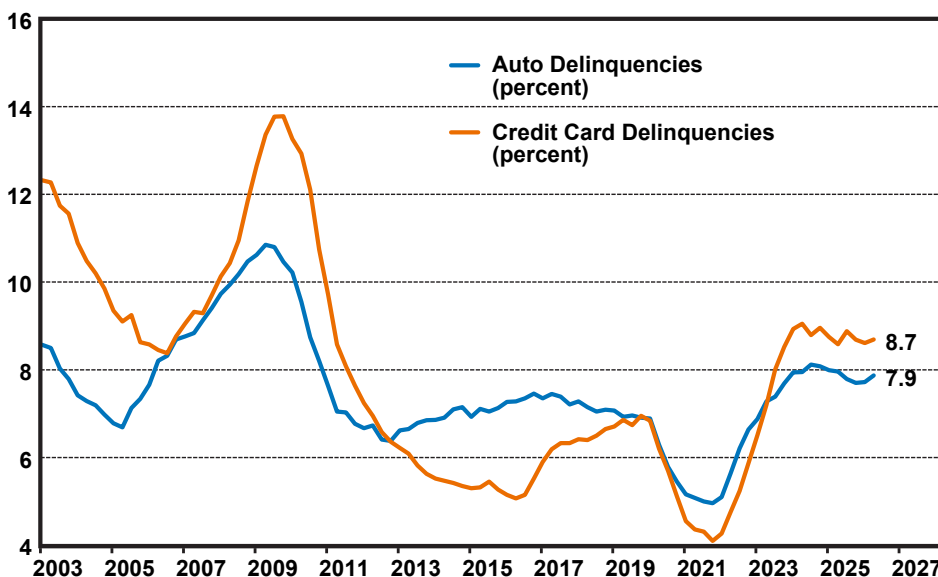
High-frequency data tell a similarly heartening story. OpenTable reservations—a real-time measure of restaurant dining—have been running roughly 14% above last year’s levels, accelerating to around 16% in September. Weekly Redbook retail sales—a gauge of same-store activity at major retailers—are growing at nearly an 8% year-over-year pace, well above their 5.2% average over the past two years. TSA checkpoint traffic has softened somewhat, falling below year-ago levels roughly 2.6% during the summer and 1.9% in September. But this isn’t simply Americans staying home. Airlines have been shrinking schedules as jet-fuel prices, running 70–80% above last year’s levels following the Hormuz disruption, turn marginal routes into deep losses. Spirit’s shutdown in May removed capacity at the discount end of the market, while fares are up 25% from a year ago. Add the international drag—overseas arrivals down almost 6% year to date and Canadian arrivals still down by roughly a quarter—and the dip at TSA checkpoints looks considerably less worrisome. And maybe those foreign tourists will start pouring back in once they find out “we’re famous for our mud.”

Household balance sheets have rarely looked sturdier, though aggregate figures do tend to mask pain at the lower end of the income distribution.

Household balance sheets have rarely looked sturdier, though aggregate figures do tend to mask pain at the lower end of the income distribution. Debt payments as percent of disposable income are hovering at 11.2% in the second quarter, roughly where it has stood for the past two years and around a percentage point below pre-pandemic levels. Aggregate delinquencies appear to have stabilized (Figure 29). New transitions have flatlined at around 3% for auto and 7% for credit cards for eight straight quarters, and the stock of delinquent balances actually ticked down in the second quarter for both. At the largest banks, card charge-offs fell to 5.2% in the first quarter from 6.0% a year earlier. Even better news: the more alarming headline delinquency figure, which had climbed sharply over the past two years, is inflated by old debts that lenders have already written off but keep reporting on credit files, not by a wave of new delinquencies. Even the most fragile corner of the market is faring better: subprime auto delinquencies hit a record 6.8% in January (going back 32 years), according to Fitch, but have since eased to 6.0%, below their level a year ago and, adjusted for seasonal swings, essentially flat since mid-2025.

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FIGURE 29
Delinquencies Have Plateaued
(credit card and auto delinquencies, percent)

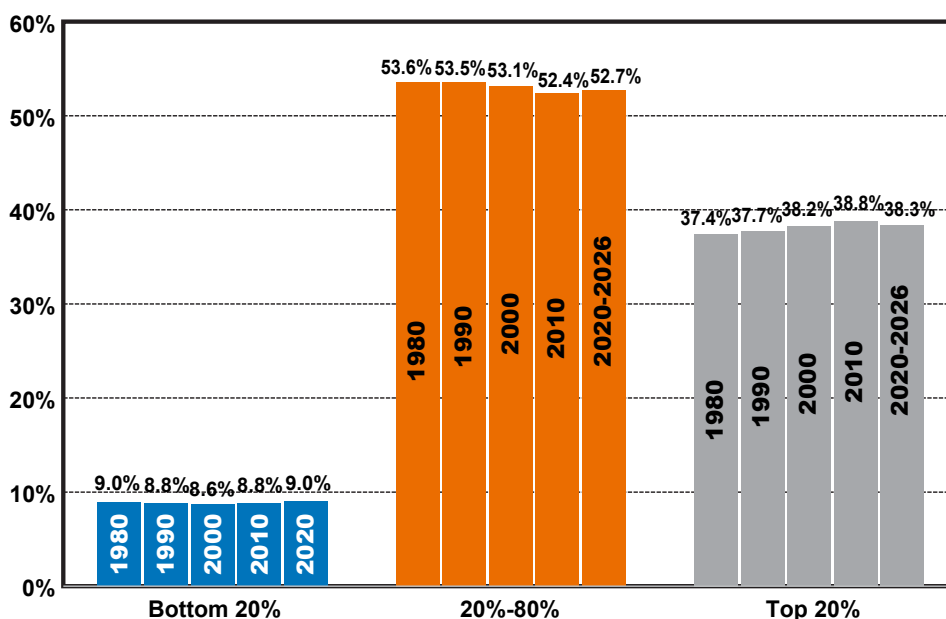


But perhaps the most enduring—and troubling—narrative about the post-pandemic consumer has been the oft-cited, now-ubiquitous K-shaped economy: the idea that the affluent are soaring while everyone else is sinking, and that the yawning gap between the haves and have-nots has never been wider. By its telling, the economy's strength is both deeply illusory and perilously fragile, resting almost entirely on the shoulders of those at the top of the income distribution, flush with stock-market gains. According to Moody's Analytics, the top 10% of earners account for nearly half of all consumer spending, and the top 20% for more than two-thirds. Spending by the top 10%, Moody's estimates, grew by 62% between the third quarter of 2020 and 2026, nearly double the 37% increase for the bottom 20%. And the wealth gap, the story goes, has widened in step: the top 1% now hold a record 32.5% of the nation's net worth, some 14 times the 2.3% held by the entire bottom half of American households. So neat and catchy is this story that the financial press has embraced it with unbridled enthusiasm: "From \$200 Loans to \$30,000 Birkins, a Pawnshop Chain Serves the K-Shaped Economy," blared a recent *Wall Street Journal* headline.

Except that reality is messier and, luckily, in the words of Mark Twain on Wagner's music, "better than it sounds." As we have argued in the past, the American economy has always been lopsided, leaning far more on consumers at the top of the income distribution than on those in the bottom half. The real question—and the centerpiece of the K-crowd's case—is whether that lopsidedness has actually worsened since the pandemic.

Start with the share of consumption. BLS data, which break down spending by income group, show remarkable consistency over the decades. The bottom 20% accounted for 9.0% of all spending in the 1980s, dipped slightly to an average of 8.7% between 1990 and 2019 and has edged back up to 9.0% since the pandemic. The top 20% accounted for 37.4% in the 1980s, climbed by little more than a percentage point over the following three decades, to 38.8% in the 2010s and has since slipped to 38.3% (Figure 30). These shares are stubbornly stable, not K-shaped, and if anything, the top's share has ticked down a bit since the pandemic.

FIGURE 30
Dispelling the K: Spending Shares Are Remarkably Stable Over Decades
(share of spending, by decile)

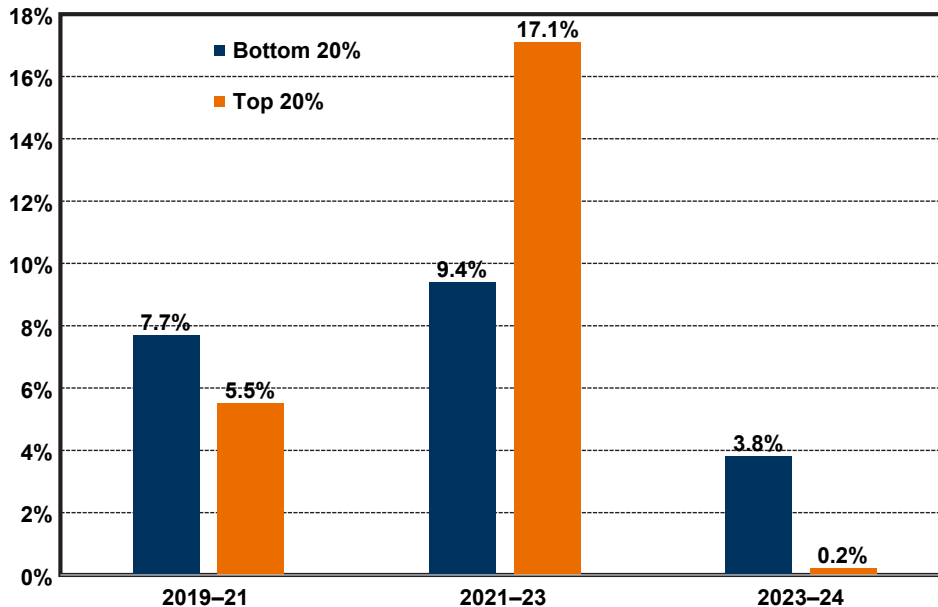


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The path since the pandemic paints an even more nuanced picture. Compared with a pre-pandemic baseline, by 2024 – the latest available data – the top and bottom fifths had increased their spending by almost exactly the same amount: roughly 24% and 22%, respectively. Middle-income households did best of all, at about 26%. But cumulative figures mask two sharp reversals. Over the two pandemic years, lower-income households actually outspent the affluent, raising their spending by 7.7% versus 5.5%, as stimulus checks swelled their bank accounts (Figure 31). Then the tide turned. In 2022 and 2023, spending by the top fifth outpaced that of the bottom by three to four points a year, as the affluent made up for the travel and dining lost in lockdown, while lower-income households had to contend with a series of shocks: the last stimulus checks went out in 2021, the expanded child tax credit expired at the end of that year, emergency SNAP benefits ended in early 2023, inflation hit hardest on food, energy and rent, and pandemic savings ran dry, all as borrowing costs soared. In 2024 the tide turned once more, with the bottom fifth's spending up 3.8% while the top fifth's barely budged.

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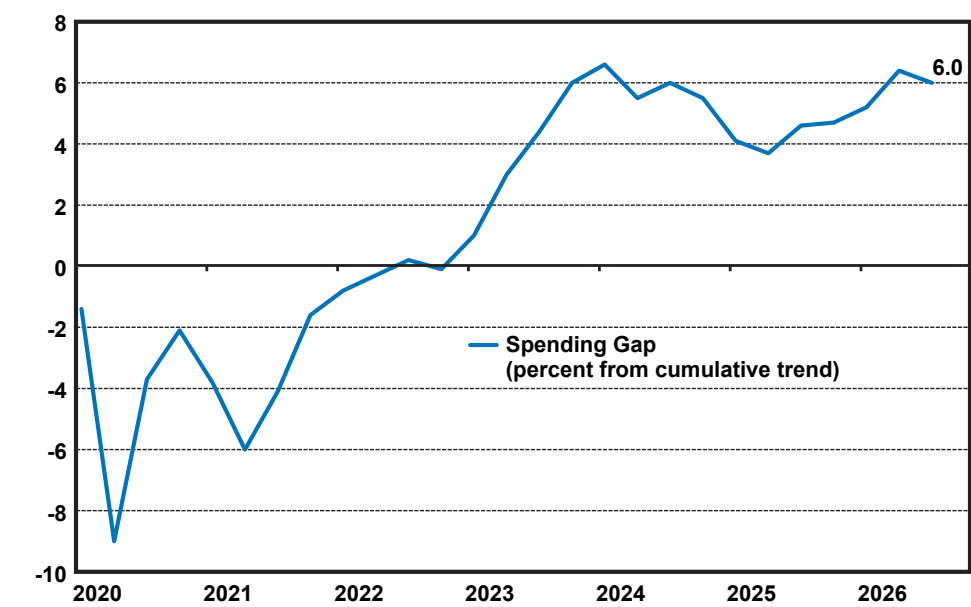
FIGURE 31
Spending Grew Solidly by Lower Income Households During the Pandemic
(nominal spending, cumulative growth)



The New York Fed's Economic Heterogeneity Indicators, which report retail spending by income group (a much narrower category than the one tracked by the BLS), tell a similar story. Cumulative spending by households earning more than \$125,000 trailed that of households earning under \$40,000 from 2020 through 2022, overtook it in early 2023 and has stayed ahead ever since (Figure 32). But the gap has not kept widening, as a K-shaped economy would imply. In an even more heartening development, Bank of America's card data, a much broader measure of spending, show lower-income households catching up with everyone else in recent months, a trend the bank has enthusiastically dubbed "the Great Convergence." So, yes, traces of a K have surfaced here and there since the pandemic. But they are neither the defining feature of this economy nor anywhere near as pervasive as the headlines suggest.

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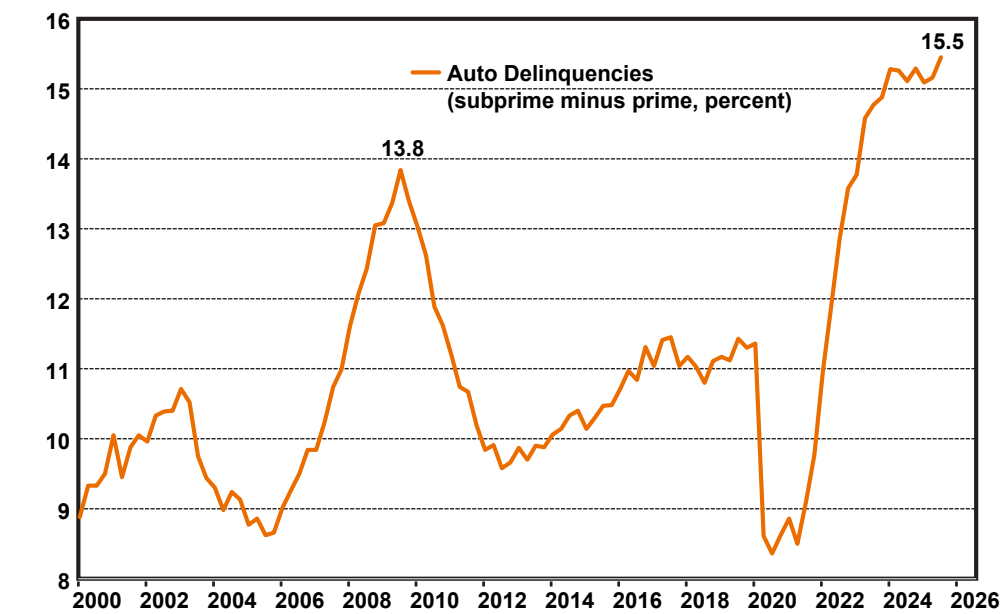
FIGURE 32
Spending Gap Between Rich and Poor Has Not Widened
(cumulative real spending growth, upper minus lower income, percent)



If there are faint echoes of a K-ish economy, they are in credit. Among subprime borrowers, delinquency rates on credit cards climbed to 16.3% by late 2025, well above their pre-pandemic level of about 13% and approaching levels typical of past recessions, though still short of the peaks of 2001 (nearly 20%) and 2009 (23%). Subprime auto delinquencies, at nearly 16%, have already surpassed their 2009 peak (Figure 33). But as we argue below, much of this stress likely reflects not income but age: it is young borrowers, stretched by record car prices and high interest rates, who are falling behind.

If there are faint echoes of a K-ish economy, they are in credit. As we argue below, much of this stress likely reflects not income but age: it is young borrowers, stretched by record car prices and high interest rates, who are falling behind.

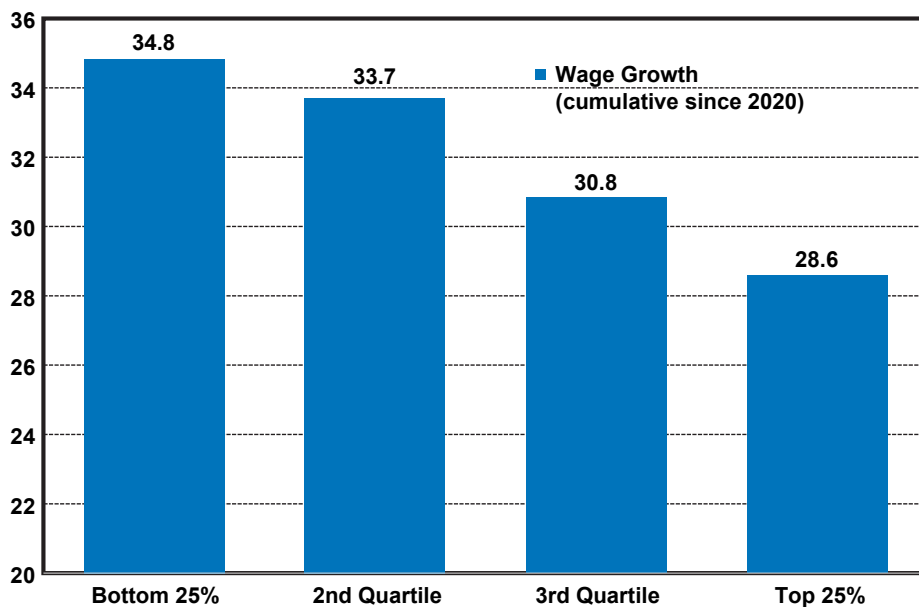
FIGURE 33
The K in Car Loans
(subprime minus prime auto delinquencies, percent)



On spending, then, the case for a K doesn't quite "hold water," as they say in Beechum County. Nor does it on wages. If there is a K in wages, it's the wrong kind, at least for the K-faithful: the lowest-paid workers have outpaced the best-paid since the pandemic. According to the Atlanta Fed Wage Growth Tracker, pay for the lowest-paid quarter of workers has risen about 35% since 2020, compared with 29% for the highest-paid: a six-point lead that opened during the tight labor markets of 2021–23 and has held steady since (Figure 34). Adjusted for inflation, the contrast is starker still. Prices have risen about 25% over the same period, leaving the lowest-paid roughly 8% better off in real terms, while the best-paid have gained barely 3%. More recent BLS data point the same way: weekly earnings at the 75th percentile rose just 1.5% over the past year, against 5.5% at the 25th.

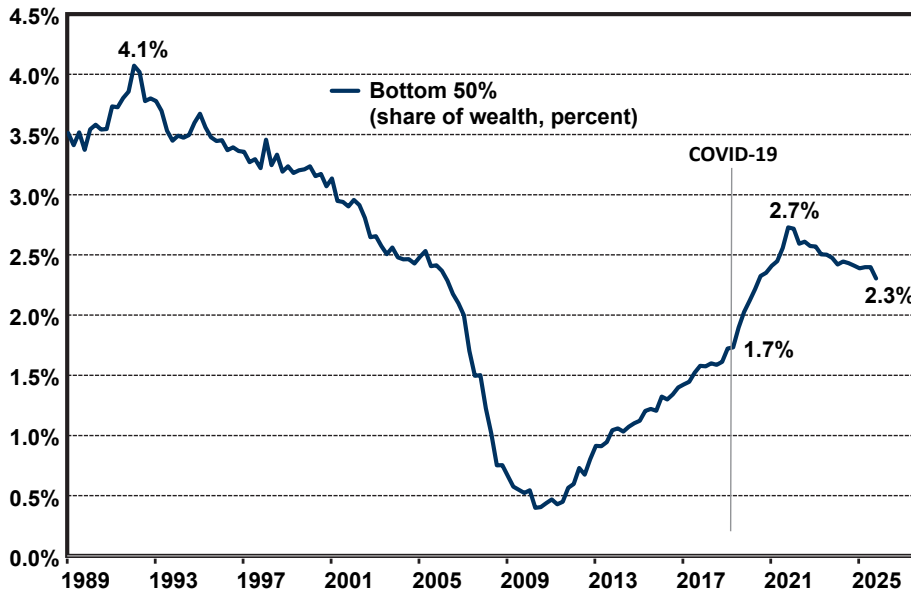
If there is a K in wages, it's the wrong kind, at least for the K-faithful: the lowest-paid workers have outpaced the best-paid since the pandemic.

FIGURE 34
The Upside-Down K in Wages: Low Income Households Outpaced the Rest
(wage growth, cumulative since 2020)



Which brings us to wealth, where the K, at long last, resembles a K. On the face of it, the numbers are staggering. In the late 1980s, the bottom half of American households held 3.5% of the nation's wealth; today they hold a mere 2.3% (Figure 35). In contrast, the top 1% has seen its share climb from 22.8% to 32.5%. And the middle has been squeezed hardest of all: households between the 50th and 90th percentiles have seen their share drop from 35.7% to 28.8% over three and a half decades.

FIGURE 35
Share of Wealth for Lower Income Households Has Risen Since 2019
 (percent of wealth)

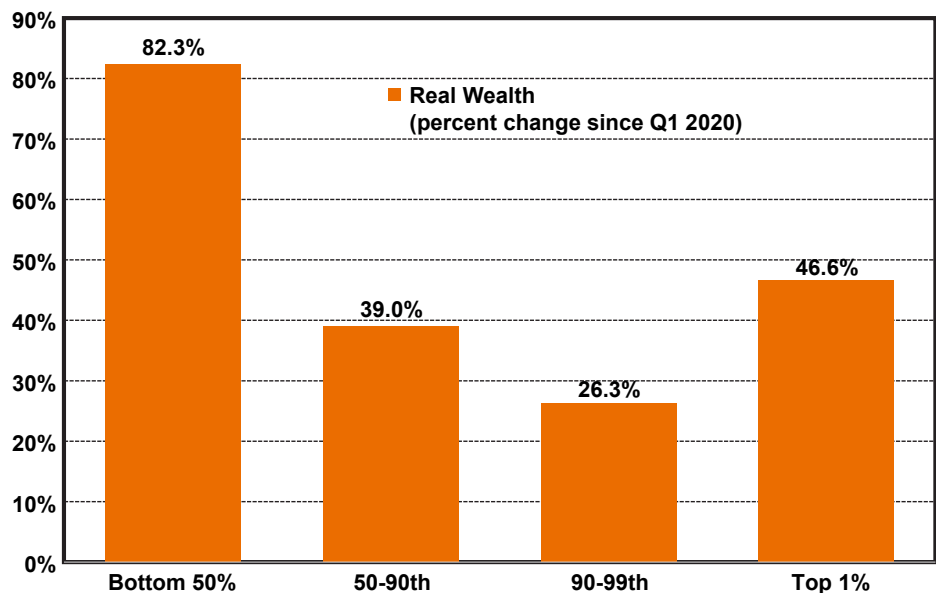


Since the end of 2019, the wealth of the bottom half of American households has grown by a staggering 130%, far outpacing the 75% gain for those in the middle (the 50th to 90th percentiles) and 70% for the top 10%; even the top 1% gained a comparatively modest 85%. Adjusted for inflation, the bottom half's wealth is up 82%, against 39% for the middle and 35% for the top 10%.

But wide as the gulf is, the pandemic softened it rather than deepening it. Since the end of 2019, the wealth of the bottom half of American households has grown by a staggering 130%, far outpacing the 75% gain for those in the middle (the 50th to 90th percentiles) and 70% for the top 10%; even the top 1% gained a comparatively modest 85%. Adjusted for inflation, the bottom half's wealth is up 82%, against 39% for the middle and 35% for the top 10%. Within the top tenth, however, the gains were lopsided: the top 1% saw their real wealth rise by 47%, nearly twice the 26% gained by the merely affluent, those between the 90th and 99th percentiles (Figure 36). In effect, the pandemic halted a decades-long slide at the bottom and slowed the climb at the top. The bottom half's share of the nation's wealth, which collapsed to just 0.4% after the Great Recession and had clawed back only to 1.7% by 2019, has since climbed to 2.3%. The top 1%'s share, which surged from 22.8% in the late 1980s to 30.4% in 2019, has inched up only to 32.5% since. And the middle's share has held steady at around 28% before and after the pandemic. The K, in other words, was very real in the decades before the pandemic, but it has lost some of its edge since. The post-pandemic K-shaped economy is less reality than kayfabe—the wrestling term for a staged drama everyone agrees to treat as real. Call it K-fabe.

The bottom half's share of the nation's wealth, which collapsed to just 0.4% after the Great Recession and had clawed back only to 1.7% by 2019, has since climbed to 2.3%.

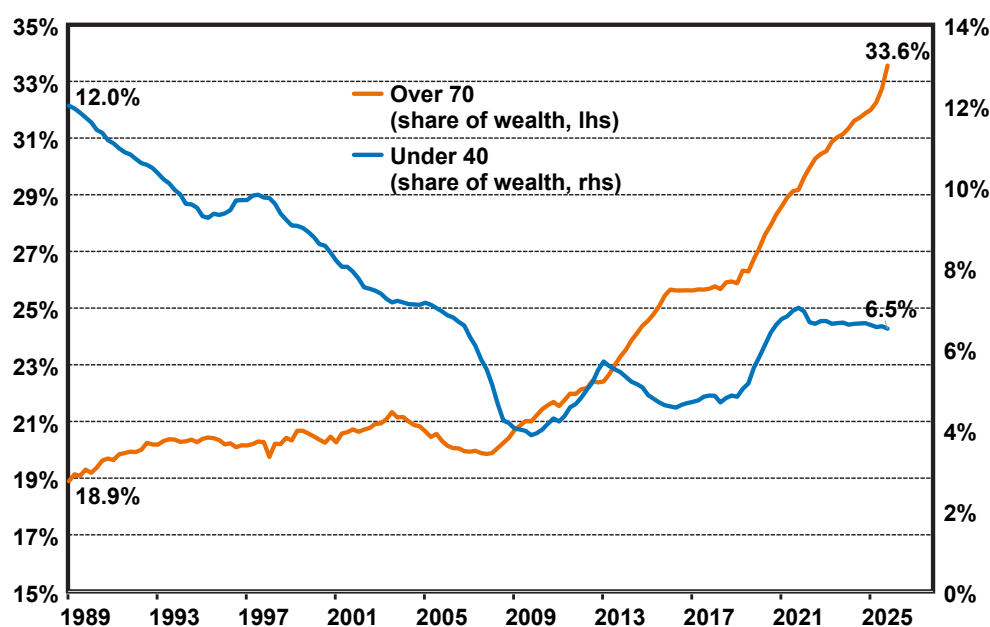
FIGURE 36
A Smile, Not a K: Real Wealth Has Risen More at the Bottom and the Top
 (real net wealth, cumulative change since Q1 2020)



But if you are partial to letters, we have one for you that is more apt: G-shaped. The fault line runs less between rich and poor and more between old and young. In 1989, households headed by someone under 40 held 12% of the nation's wealth; today they hold just 6.5% (Figure 37). Those aged 40 to 54, once the wealth-building engine of the economy, have seen their share shrink from 32% to 19%. Meanwhile, households over 70 have nearly doubled theirs, from 19% to 34%. Part of this reflects an aging population, with more retirees and proportionally fewer young households, but not all of it: even holding the population's age mix constant, the share of wealth for those aged 40 to 54 has fallen by more than a quarter, while that of the over-70s has climbed by a third. A darker picture emerges when comparing generations at the same stage of the life cycle: In their thirties and early forties, the baby boomers held 23% of the nation's wealth. Gen X, its prime years marred by the 2008 crash, held under 10% at the same ages; millennials hold 11% today. Even allowing for the boomers' sheer numbers, the gap remains roughly two to one. The K was the wrong letter all along.

But if you are partial to letters, we have one for you that is more apt: G-shaped. The fault line runs less between rich and poor and more between old and young. Households headed by someone under 40 held 12% of the nation's wealth; today they hold just 6.5%.

FIGURE 37
The G-Shaped Economy
(share of household wealth, by age)

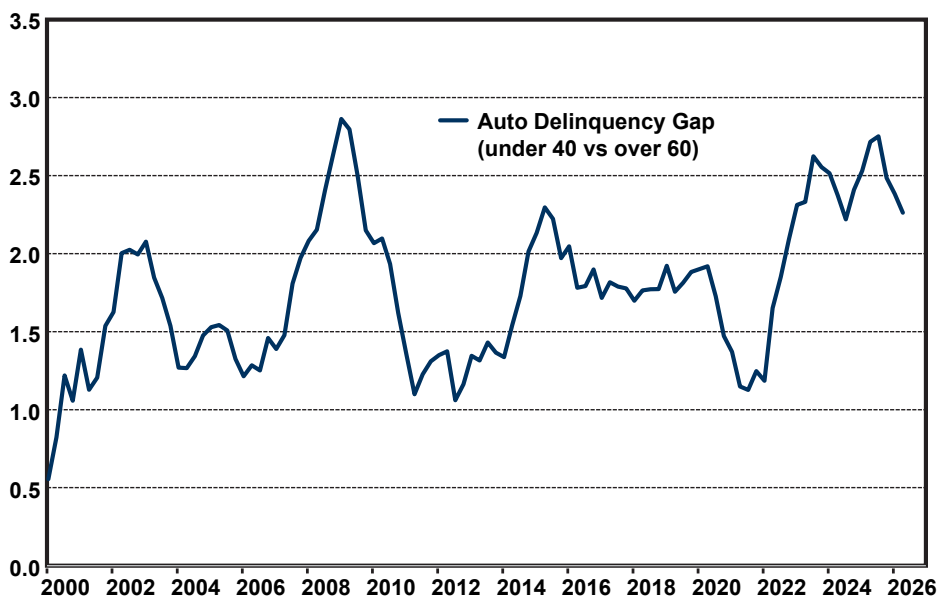


Those aged 40 to 54, once the wealth-building engine of the economy, have seen their share shrink from 32% to 19%. Meanwhile, households over 70 have nearly doubled theirs, from 19% to 34%.

Spending has followed wealth up the age ladder, if more gently. Households over 65 accounted for 14% of all consumer spending in 1989; today, they account for 22%, and each spends more relative to the average household than a generation ago. Since 1989, real spending per household has risen 28% among the over-65s, more than twice the 12% average. Households aged 35–44, once the biggest spenders, have barely increased their spending at all—about 1%—while those under 35 have increased theirs by 11%. But almost all of this reshuffling happened before the pandemic. Since 2019, the age pattern of spending has barely budged. The divide is real; it just isn't new.

Nowhere is the G sharper than in housing. The typical first-time homebuyer is now 40, the oldest on record, up from the late 20s in the 1980s and the early 30s before the 2008 crisis. First-time buyers, who made up about 40% of the market back then, now account for just 21%. Strains also appear in delinquencies: the young have perennially had higher delinquency rates than other age groups, but the gap tends to widen during recessions and periods of stress. Lately, it has widened to levels last seen in the 2008–09 crisis, with borrowers under 40 falling behind on their credit cards and car loans at more than twice the rate of those over 60 (Figure 38). Though the gap has narrowed in recent quarters, it remains well above pre-pandemic levels. Not an easy time to be a “yute.” But luckily, time is on their side.

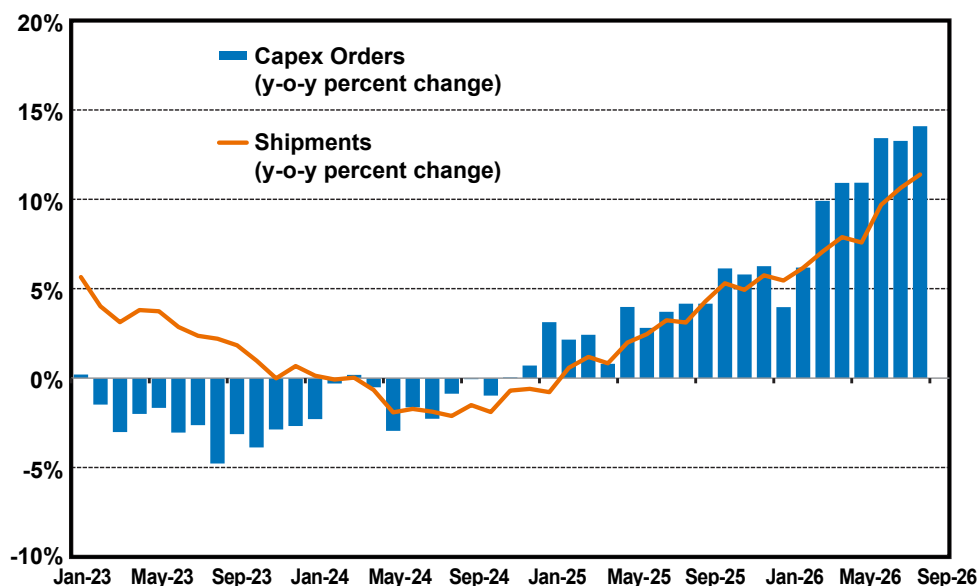
FIGURE 38
Not an Easy Time to be a "Yute"
(auto delinquencies, difference between under 40 and over 60)



After years of sputtering, America's industrial engine is humming again. AI has dragged a surprising range of industries along for the ride: not just data-center construction, but everything needed to power, wire and cool those centers, from gas turbines and transformers to switchgear, cooling systems, copper and steel.

G-shaped worries aside, things are perking up for the rest of the economy. After years of sputtering, America's industrial engine is humming again. AI has dragged a surprising range of industries along for the ride: not just data-center construction, but everything needed to power, wire and cool those centers, from gas turbines and transformers to switchgear, cooling systems, copper and steel. Geopolitical fragmentation has done the rest, as tariffs, wartime supply disruptions and a push to de-risk supply chains have prompted firms to bring production closer to home. Industrial production is growing at a 1.2% pace this year, the fastest in more than three years. Orders for core capital goods (nondefense, excluding the volatile aircraft category), a closely watched gauge of business investment plans, have grown at double-digit annualized rates for four straight months (Figure 39). More heartening still, shipments of those goods, which feed directly into GDP, are also rising at a double-digit clip. Manufacturing employment has swelled by 72,000 jobs so far this year, and construction by 92,000.

FIGURE 39
The Industrial Engine is Revving Up
(capital goods, shipments, y-o-y percent change)



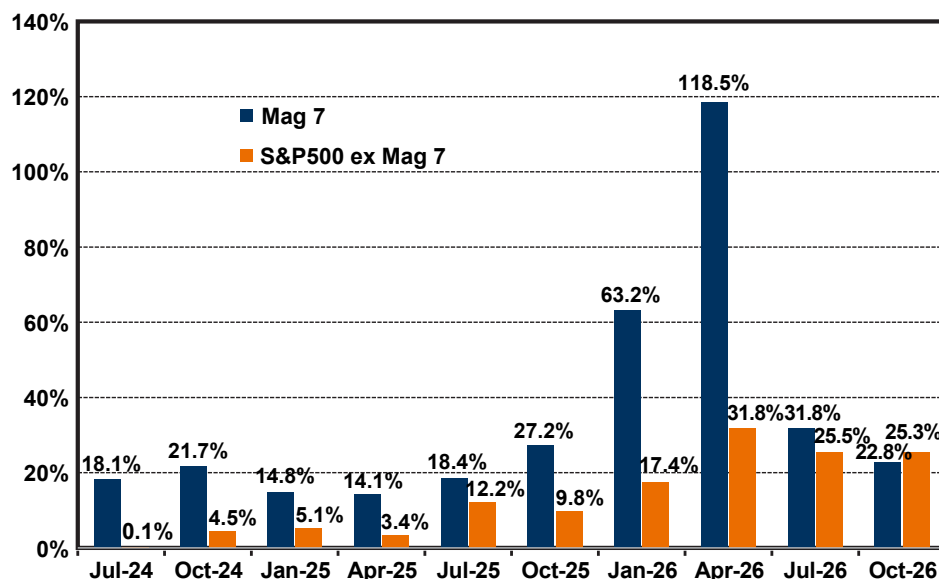
The pickup in activity appears to have legs. The ISM surveys, closely watched bellwethers for the economy's direction in the coming months, have been sending solid signals. The ISM manufacturing index has been firmly in expansion territory since the start of the year, after languishing in contraction for the previous three. The services index, too, is comfortably expanding. New orders, a leading gauge of future production, have soared. So strong were the readings that the latest release triggered one of the year's sharpest bond selloffs, with the 10-year Treasury yield jumping a jaw-dropping 18 basis points in a single day. And it isn't just activity: the employment components of both surveys point to a pickup in hiring, after idling in contraction territory for much of the past year.

Corporate America has also had a blowout year. Analysts entered 2026 expecting earnings to grow 15%, already well above the long-run average of 8.6%. In hindsight, that forecast proved woefully modest. Estimates have been ratcheted up throughout the year, and full-year growth is now expected to top 30%, a rare feat in a world where forecasts usually drift down as the year goes on. Profits now account for 13.1% of GDP, the highest share of the postwar era.

It isn't just AI or the Mag 7, though they far outstrip the rest of the market. Earnings for the other 493 companies in the S&P 500 grew a respectable 17.4% in the first quarter (against 63.2% for Mag 7) and 31.8% in the second (against 118.5%) (Figure 40). Second-quarter earnings were also flattered by two one-off windfalls. The first came courtesy of the private AI boom: Alphabet and Amazon booked some \$150 billion in valuation gains as the value of their stakes in Anthropic and SpaceX soared. The second came courtesy of the Supreme Court: some \$118 billion in tariff refunds have been paid out since its February ruling, \$18.7 billion of it disclosed by public companies, led by Walmart (about \$2.9 billion) and Ford (\$1.3 billion). Even stripping out the investment gains, though, earnings grew by close to 30%, a blowout quarter by any standard. And analysts expect growth near 30% again in the third and fourth quarters.

The pickup in activity appears to have legs. The ISM surveys, closely watched bellwethers for the economy's direction in the coming months, have been sending solid signals.

FIGURE 40
An Earnings Bonanza
(corporate earnings, y-o-y percent change)



The boom on the real side of the economy, in other words, is real. But even the corners of the economy that appear to be limping along, or stalled outright—the ones that lack positraction—are firmer than they look at first glance.

The boom on the real side of the economy, in other words, is real. But even the corners of the economy that appear to be limping along, or stalled outright—the ones that lack positraction—are firmer than they look at first glance. In fact, not everything that looks doomy actually is. The labor market, the banking sector, and even policy matters and geopolitical risks—the Fed, tariffs and trade, the war itself—make for catchy headlines but, so far, have inflicted relatively manageable pain and are likely to continue to do so. The doom-ish part, as we will argue, lies elsewhere: in refining capacity, soaring tanker rates, sticky inflation, rising yields, and a stock market that has weathered every shock so far but, at these lofty valuations, has precious little room for error.

Take the labor market. For all the bleak headlines it sometimes gets, the labor market is doing just fine and, as we argue below, may be the one sector in near-perfect balance: not too hot, not too cold – or, as they might say in Alabama, with its “correct ignition timing four degrees before top dead center.” That matters especially in a world where inflation remains entrenched. A sizzling labor market could complicate the Fed’s job almost as much as a frigid one.

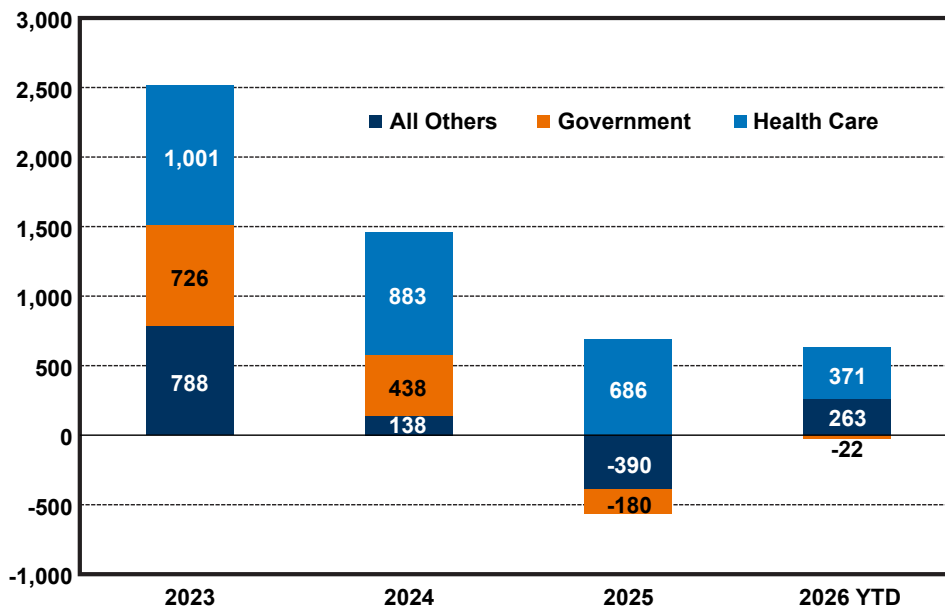
First, and perhaps most importantly, layoffs remain remarkably low—essentially where they were during the 2022–23 boom. WARN Act filings—the advance notices large employers must provide ahead of qualifying mass layoffs or plant closings—covered about 254,000 workers in the first nine months of 2026, down roughly 9% from last year and essentially flat with 2024, with September the quietest month of the year. And because WARN captures only qualifying large-scale layoffs at covered employers, it provides a view only of a slice of the market. The broader Challenger Report, which tallies any announced corporate job cuts, tells much the same story: layoffs have been quite tame since the spikes last October and this January, when a handful of highly publicized cuts—some blamed on AI—grabbed the headlines. Most reassuring, initial jobless claims are averaging around 200,000 a week, the lowest of the post-pandemic era and far below the 280,000–300,000 range where recession alarms would start ringing.

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Layoffs remain remarkably low—essentially where they were during the 2022–23 boom.

Hiring, too, has turned a corner. In the first nine months of the year, payrolls grew by 612,000—hardly the blockbuster pace of years past, but already more than five times last year's total. More importantly, the gains are broadening. Health care still accounts for the lion's share, some 371,000 jobs, or 60% of the total, but the rest of the economy has finally joined in—and not just the corners touched by data centers (Figure 41). Professional and business services have added 110,000 jobs, trade 102,000, and transportation 56,000. The one laggard is government, which has shed another 22,000 jobs after losing nearly 200,000 last year, almost entirely because of the shrinking federal workforce, down 327,000 since January 2025. That is a striking reversal from the previous two years. In 2025, health care added 686,000 jobs while the rest of the economy lost 570,000. Or, if you'd rather forget 2025 altogether, consider 2024, when health care and government together added 1.3 million jobs, two-thirds of them in health care, while everyone else managed a paltry 140,000.

FIGURE 41
Labor Market Breadth Is Improving...A Bit
(thousands of jobs)



While it may be hard to muster enthusiasm for a labor market adding a seemingly stall-speed 68,000 jobs per month, that pace looks far less anemic once you account for the generational slump in labor supply it is unfolding against. On paper, the labor force has shrunk by 1.2 million this year, but that headline is more alarming than it ought to be. There was no exodus of workers; in fact, the labor force grew by 1.1 million over the past two months. Most of the decline is a statistical artifact of the BLS's annual population revision in January, which raised the share of Americans 65 and older by 0.62 percentage points, compared with shifts of no more than 0.14 points in each of the previous three years. Because only about one in five Americans over 65 is in the labor force, the reweighting shrank the measured labor force by roughly 1 million and cut the participation rate by 0.4 percentage points overnight. Nonetheless, however you slice it, America is older than we thought. More than 300,000 baby boomers turn 65 every month, and net of young entrants, aging alone now shaves off roughly 45,000–50,000 workers a month from the labor force, about double the pace of a decade ago.

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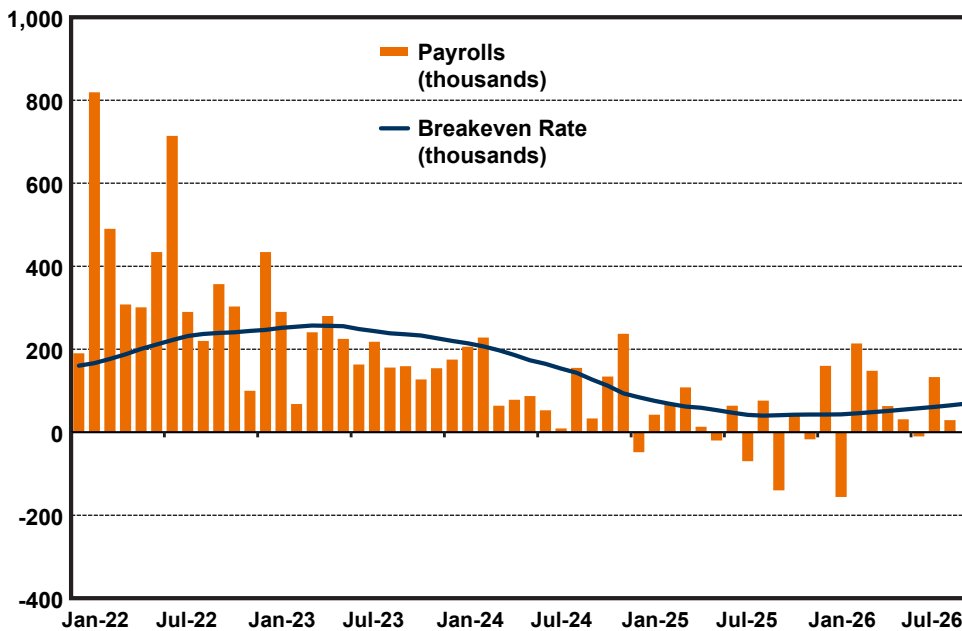
However you slice it, America is older than we thought. More than 300,000 baby boomers turn 65 every month, and net of young entrants, aging alone now shaves off roughly 45,000–50,000 workers a month from the labor force, about double the pace of a decade ago.

The second strain on labor supply is immigration. The Congressional Budget Office has sharply revised down its estimates of net migration into the United States, from roughly 3.5 million in 2023 to just 400,000 in 2025 and 570,000 in 2026, well below the roughly 1 million annual average of the past quarter century. Deportations and removals have climbed from 143,000 in fiscal year 2023 to 349,000 so far in fiscal 2026. A slowdown in new arrivals, particularly at the southern border and through humanitarian parole and refugee programs, has also curbed overall migration flows. Nationwide border encounters have fallen dramatically, from roughly 255,000 a month in 2023 to about 58,000 in 2025 and 34,000 currently. At the height of the 2022–2024 migration surge, net migration added nearly 10 million people, swelling the labor force by an average of 1.4 million a year, nearly three times the historical average. That has since sharply reversed: the foreign-born labor force, which peaked at 33.3 million in early 2025, nearly a fifth of all U.S. workers, has shrunk to about 31.9 million.

Be thankful for small mercies. Had labor supply not slumped alongside demand, 68,000 jobs a month would be pushing unemployment sharply higher. Indeed, had immigration continued at its 2022–2024 pace, the unemployment rate would now be closer to 5%, complicating the Fed's job and nudging the economy one step closer to the dreaded stagflation. Witness the last episode: as the Fed tightened and immigrants continued to pour in, the unemployment rate climbed from 3.4% in April 2023 to 4.2% by the summer of 2024. Today, by contrast, both sides of the labor market are slowing in tandem, in what then-Chair Powell called "a curious kind of balance." It also means that the "breakeven" pace of job creation—the rate needed to hold unemployment steady—has downshifted significantly. Depending on immigration assumptions, figures range anywhere from zero to 87,000 jobs a month. Our own calculations put it around 70,000, roughly where job growth has been all year (Figure 42).

Be thankful for small mercies. Had labor supply not slumped alongside demand, 68,000 jobs a month would be pushing unemployment sharply higher.

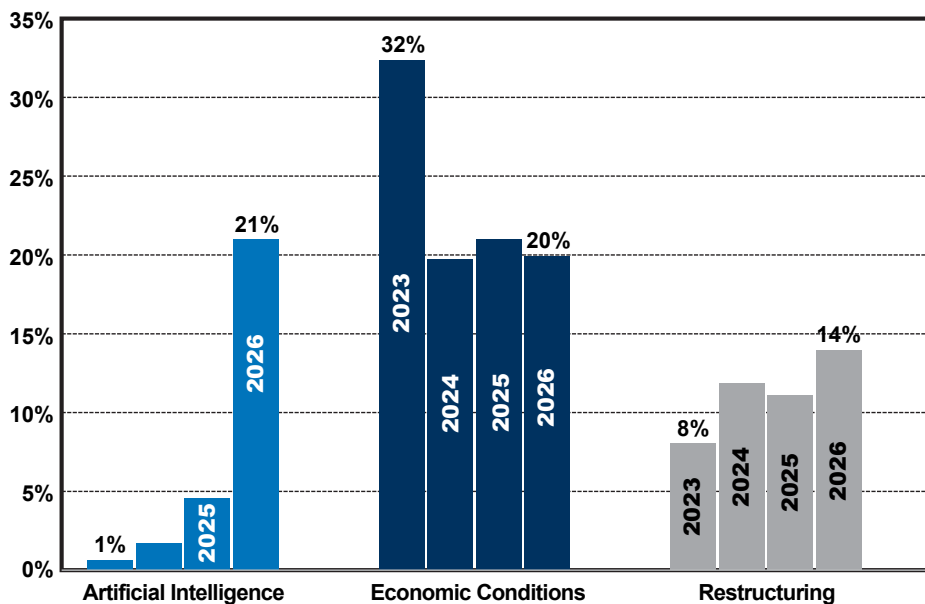
FIGURE 42
Stall Speed or Just Right? Labor Demand and Supply Have Fallen in Tandem
(thousands of jobs, monthly)



But beyond the vagaries of the business cycle and the slow grind of demographics, the labor market is contending with something more fundamental: a paradigm shift in the nature of work itself, as AI begins to redraw the map of human endeavor. “The future is in the air” as the great Scorpions ballad once rhapsodized. But so is fear. According to the Challenger Report, AI is now the most frequently cited reason for layoff announcements this year, accounting for roughly 21% of all planned cuts, up from just 5% last year and ahead of economic conditions, closings and restructuring (Figure 43). So far this year, American companies have announced some 13,000 AI-related job cuts a month on average. That may sound like a lot, but it is a rounding error in an economy where normal churn sheds around 1.7 million jobs a month through layoffs and discharges alone.

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FIGURE 43
AI: A Job Killer?
(Challenger Survey, reason for layoff, share of announced cuts)



Divining AI's impact on future jobs is an exercise in hubris worthy of Delphi, and even the Oracle spoke in riddles. The honest answer, at this stage, is that we simply don't know. But we can trace the impact it has had on jobs thus far. *The Economist* tallied it all up and came up with a number to make even the most ardent AI enthusiast blush: since 2022, AI has created 1.05 million jobs and destroyed just 200,000, five new jobs for every one lost, for a net gain of 850,000. The jobs apocalypse, in their telling, has thus been postponed.

The headline-grabbing 1 million-plus is striking enough to warrant a second look. We carried out our own analysis and, in the spirit of *The Economist*, sorted jobs into three buckets. First are the AI builders – the people who create the technology: software developers, data scientists, engineers, and other computer and mathematical occupations. Second is the AI buildout—the army of tradespeople needed to make it all run: electricians, HVAC technicians, grid operators, and others building and powering the data-center boom. And third are the AI-exposed—workers whose tasks AI can most readily perform: customer-service agents, secretaries and administrative assistants, bookkeeping, billing and data-entry clerks, telemarketers, translators and, somewhat ironically, computer programmers.

On the face of it, the figures are indeed impressive. Since 2022—when ChatGPT first made its debut—employment among AI builders has risen by nearly 1.1 million, or 12%. Software developers alone account for some 460,000 of those jobs, a 22% increase, and the ranks of information security analysts have swelled by 81%, adding nearly 145,000. Data scientists, the hottest job of the AI era, grew by 64% in just three years, to more than a quarter of a million. The buildout trades have grown even faster, adding some 235,000 jobs (16%): electricians are up by 165,000 (18%), and HVAC technicians by about 60,000 (13%). At the other end, AI-exposed occupations have shed some 440,000 jobs on net. The steepest declines have come among secretaries and administrative assistants (down 16%) and customer-service representatives (down 11%), more than offsetting modest gains among receptionists and bookkeepers.

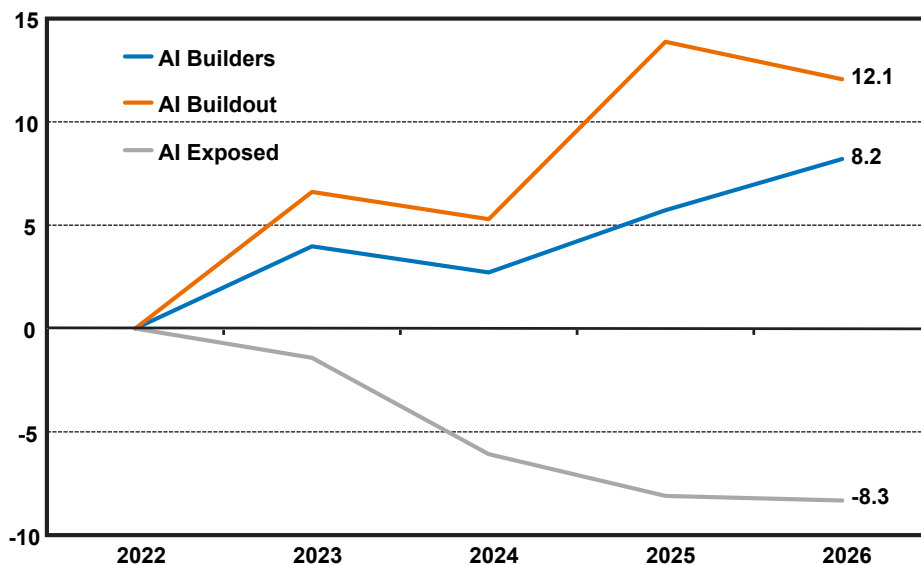
Raw changes, however, blatantly abstract from trends. The economy would have likely added jobs in these occupations anyway: total employment has grown by 3.5% since 2022, and some of the gains would have come regardless of AI. *The Economist* acknowledges this and measures its tally against broader job-market trends. We do the same. Unlike *The Economist*, however, we do not attribute every gain or loss in these categories to AI. Electricians wire homes and factories as well as server farms, and customer-service jobs were being offshored long before chatbots arrived.

With these adjustments, our own final tally is more modest, roughly half *The Economist*'s. Since 2022, AI builders have outgrown total employment by about 8 percentage points and the buildout trades by about 12 percentage points, while AI-exposed occupations have trailed it by about 8 percentage points (Figure 44). Translated into jobs, and crediting AI with all of the builders' outperformance but only half of the buildout trades' gains and the exposed occupations' losses, AI has created roughly 845,000 jobs and displaced about 380,000, for a net gain of about 465,000. As Vinny would say, "win some, lose some."

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FIGURE 44
Win Some, Lose Some: AI Impact in the Job Market
(cumulative growth since 2022)



Thus, if you are partial to letters, we have one for you: the labor market is Y-shaped, with two arms reaching up and one leg sinking. The first arm is health care, which has grown by an eye-popping 2.3 million jobs above trend since 2022, as the baby boomers age into their most care-intensive years. The second is AI: the builders and the buildout, which have added roughly 845,000 jobs beyond the economy's own pace. The leg pointing down is AI too: the customer-service agents, secretaries and clerks whose work the machines now do, lost some 380,000 jobs. The shape of the labor market, in other words, is being set by a new technology and an old generation.

So, for now, AI has not devoured the labor market, at least not yet. And the "low hire, low fire" equilibrium— that "curious kind of balance"—may be precisely what is needed in a world shaped by rapid technological change and radical demographic shifts. The worry is that this delicate balance may now be at risk, not least because the Fed has begun tightening again for the first time in more than three years, after three cuts in 2024 and another three last year. And the start of a tightening cycle has rarely brought good tidings for the economy. Of the 14 tightening cycles since the 1950s, 10 were followed by recession. Two others, in 1966 and 1984, never pushed unemployment up at all; they were taps on the brakes rather than true landings. That leaves just two genuine soft landings in 70 years: 1994–95 and the most recent cycle, 2022–23.

We are a bit more sanguine. As we argue below, the inflation confronting the Fed today is both demand-driven, tied to the AI boom, and supply-driven, tied to the war. Ordinarily, neither would call for much tightening. AI investment is as close to a secular trend as one can get. It may ultimately unleash a productivity boom that proves disinflationary, but that belongs to the dividend phase, not the buildout phase, where we are today. Nor can rate hikes magically produce the refining capacity the economy sorely needs. Thus, with a labor market in rough balance despite strong growth, and inflation driven in part by supply shocks, the Fed would normally be inclined to stand pat.

But it is forced to hike for three reasons. First, a lasting investment boom raises the neutral rate itself, so some tightening merely keeps policy from becoming more accommodative by default. Second, the Fed needs to cool demand in other corners of the economy to keep energy costs from seeping into core inflation, and, alas, higher diesel today means higher core inflation tomorrow. Third, and perhaps most important, is credibility. After more than five years of above-target inflation, and with markets on edge, the Fed cannot afford to look through yet another inflation shock.

All this calls for restraint, not a crusade: a pinprick, not a gaping wound. Inflation is stubborn and sticky rather than soaring and out of control, and with inflation expectations still firmly anchored, rates need not go much higher; they need to stay higher for longer. Our expectations for rate hikes thus fall between the Fed's and the market's: one this year and two more next, followed by a long pause. This means that wringing out inflation will remain a long slog. After all, as Vinny reminds us, "boiling water doesn't soak into a grit any faster in [the Fed's] kitchen than anywhere else on the face of the earth."

Every hiking cycle is haunted by the same dread: what will break? When the Fed last hiked, regional banks choked and a mini-panic ensued. In the spring of 2023, unrealized losses on bank bond portfolios helped topple Silicon Valley Bank, Signature Bank and First Republic in quick succession: the second-, third- and fourth-largest bank failures in U.S. history. This time, banks face a double squeeze: a Fed raising short-term rates and long-term yields climbing largely on their own.

Thus, if you are partial to letters, we have one for you: the labor market is Y-shaped, with two arms reaching up and one leg sinking. The first arm is health care, second is AI: the builders and the buildout. The leg pointing down is AI too. The shape of the labor market, in other words, is being set by a new technology and an old generation.

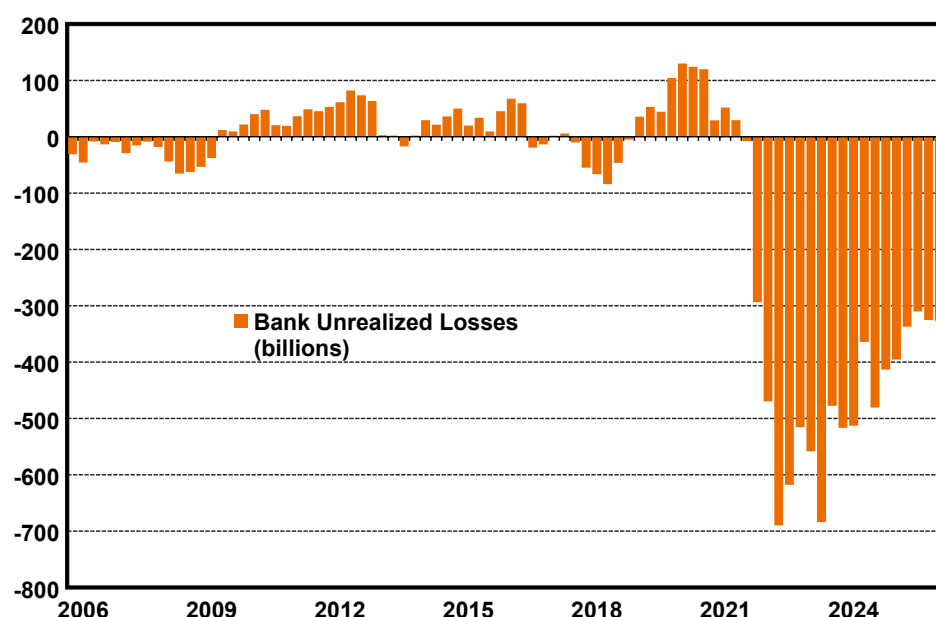
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The good news is that the banking system stands on firmer footing than it did a few years ago. Banks are still sitting on losses from the last tightening cycle, but they have shrunk from a peak of nearly \$700 billion in 2023 to about \$330 billion today (Figure 45). Losses will surely climb again as yields rise, but they now weigh far less heavily: unrealized losses have fallen from over a third of banks' Tier 1 capital in late 2022 to about 14%, and banks have shortened the maturity of their bond holdings, so each uptick in yields stings less. Better yet, the two squeezes come with offsetting benefits. A growing share of bank loans now reprices with short-term rates, so the Fed's hikes fatten rather than squeeze their margins. And long-term yields are rising faster than short-term ones this time around, steepening the yield curve. This is a boon for an industry that borrows short and lends long: every maturing bond and every new mortgage or business loan is now reinvested at higher rates, while deposit costs lag behind. In 2023, by contrast, an inverted curve pinched margins just as bond losses mounted.

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FIGURE 45
Banks' Unrealized Losses are Half Their Levels Four Years Ago
(unrealized gains/losses on investment securities, billions)



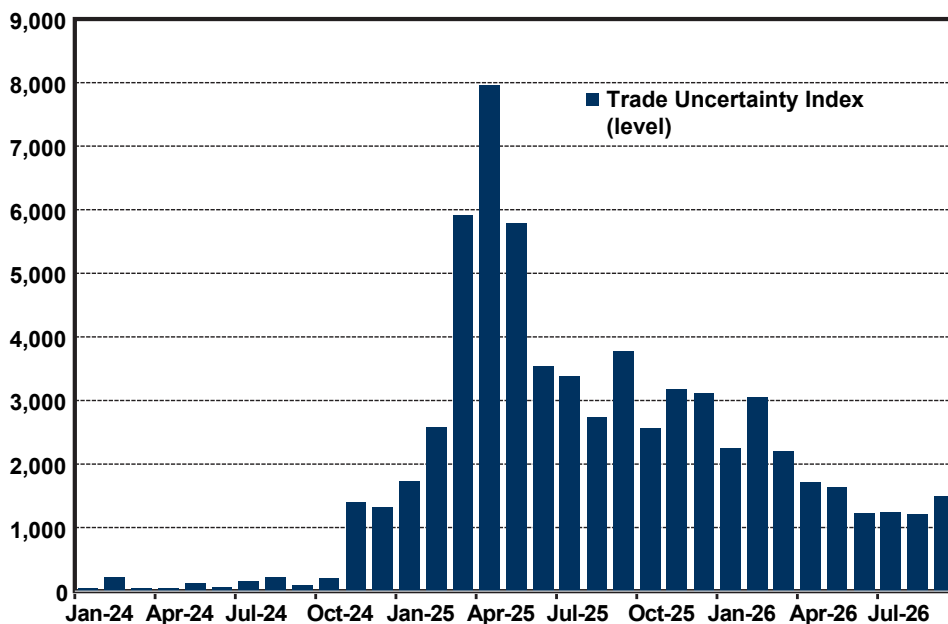
The other weak link is private credit, the slow-burning crisis that continues to smolder and spread. Default rates have hit record highs: 6.3% in August, up from 6.1% in July, according to Fitch. And redemption requests keep pouring in. Blue Owl capped third-quarter redemptions at 5%, even as its OTIC fund faced withdrawal requests of 39%, the highest in the sector. Cliffwater imposed the same 5% cap after receiving 16% in requests, and Morgan Stanley's North Haven fund did likewise after 11.4%. In the second quarter, redemption requests across the industry reached \$15.6 billion, and only 38% were honored.

Yet, as we argued in the spring, this corner of the market is a slow burn rather than a crisis, and its problem is secular, not cyclical: roughly a quarter of direct-lending portfolios sit in software, and those business models are being violently repriced by AI. Rising rates did not start the fire, but they do close the escape hatches. Floating-rate loans grow costlier just as cash flows shrink, maturing debt must be refinanced at far higher rates, and it is hard to see lenders extending loans to borrowers that AI is actively making obsolete. But secular is not the same as systemic. Most of the money is institutional and locked up for years. The gates, firm caps on redemptions—

frustrating as they are for investors—are designed to prevent funds from dumping loans at fire-sale prices, which would spread the losses across markets. The banking system's exposure, while real, is manageable. And while private credit's troubles make for a painful cycle for investors, they are relatively small and sufficiently ring-fenced that they are unlikely to boil over into a systemic risk that can sink the entire economy.

Geopolitical risks, at least the ones that have grabbed the headlines over the past couple of years, have gone from hair-raising to merely unsettling, from acute to chronic, perhaps because there are now too many to keep track of. Take tariffs and trade. Once everyone's obsession, they have become a bit of an afterthought. Witness the Trade Policy Uncertainty Index, which tracks how often newspapers write about trade-policy uncertainty (Figure 46). It soared to eye-watering heights with last year's Liberation Day tariffs but has eased this year, especially after the Supreme Court's tariff ruling. Though still elevated, it now sits at its lowest level since before the 2024 election.

FIGURE 46
Tariff Turmoil: From Fever Pitch to Background Noise
(trade policy uncertainty, index)



For good reason. As we have argued for a while, tariffs were less damaging than advertised even at their worst. Since the Supreme Court's ruling, they have become less threatening still, even as the administration rebuilds the tariff wall brick by brick. The new wall, however, is a bit shorter and a good deal more porous than the original Liberation Day fortress. As Vinny would put it: "When you look at the bricks from the right angle, they're as thin as this playing card."

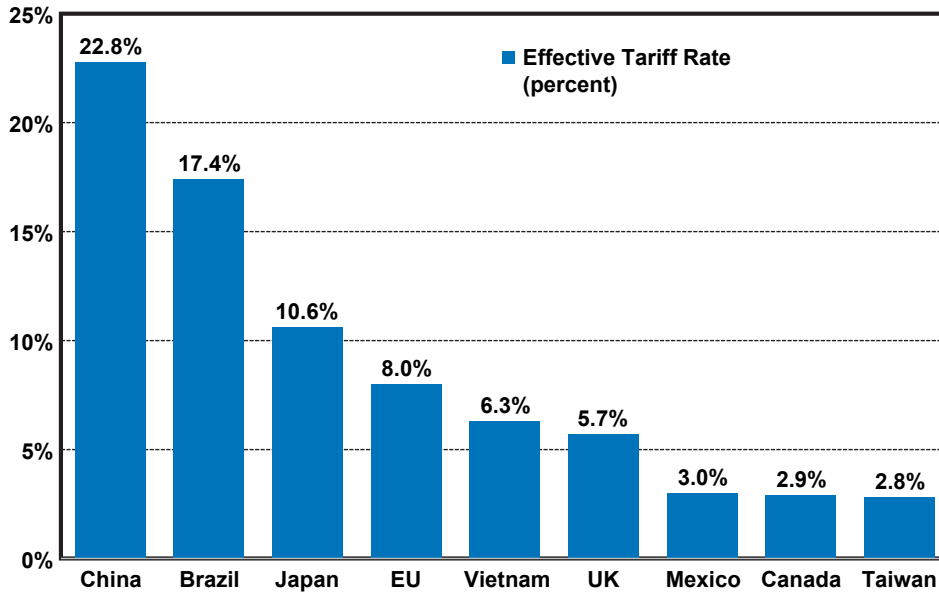
A myriad of carve-outs are baked into the new tariffs, much as they were into the IEEPA ones—so much so that, depending on the country, only a small share of goods faces the most onerous levies. For all the USMCA drama, 77% of imports from Canada and 83% from Mexico still enter under the agreement's exemptions. Some 80% of Taiwanese goods are likewise tariff-free, thanks largely to sweeping exemptions for semiconductors and electronics. As a result, the effective tariff rate—the duties actually collected as a share of imports, which also captures the substitution effect as importers shift toward exempt goods and lower-tariff suppliers—is just under 3% for both Canada and Mexico and under 5% for Taiwan. Even on Chinese goods, it has fallen from an eye-popping 51% at its peak to about 23% (Figure 47).

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FIGURE 47
The Porous Wall: Effective Tariff Rates Much Lower than Statutory Rates
 (effective tariff rate, percent)



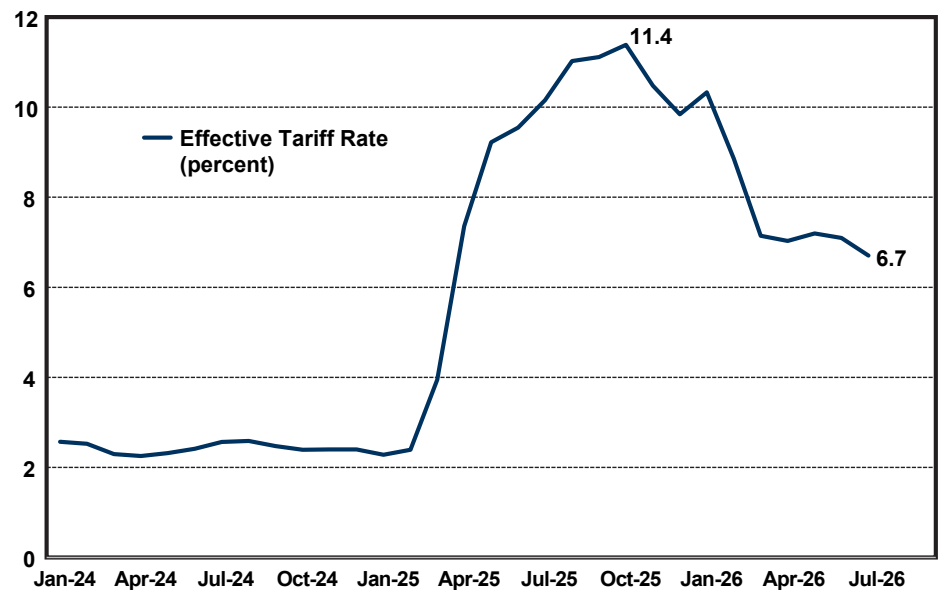
Section 232 sectoral tariffs are also riddled with exemptions, exclusions and loopholes.

All told, the overall effective tariff rate stands at 6.7%, down from a peak of more than 11% last fall, after Liberation Day. We expect some tinkering around the edges to lift it to roughly 8%, which, as it happens, has been our baseline since the Trump administration took office.

Section 232 sectoral tariffs are also riddled with exemptions, exclusions and loopholes. The least porous are the tariffs on steel and aluminum: against a statutory rate of 50%, the effective rate is around 41%, even with substitution. Elsewhere, the wall is far leakier. Autos face an effective rate of about 13% against a statutory 25%, pharmaceuticals less than 1% and semiconductors, despite all the talk of chip tariffs, a mere 0.3%.

All told, the overall effective tariff rate stands at 6.7%, down from a peak of more than 11% last fall, after Liberation Day (Figure 48). We expect some tinkering around the edges to lift it to roughly 8%, which, as it happens, has been our baseline since the Trump administration took office. A grand bargain with China is unlikely; instead, we expect both sides to keep extending the current truce indefinitely. USMCA, meanwhile, will likely be kept alive through annual reviews rather than extended outright. And though the agreement sunsets in 2036, it is helpful to bear in mind that two presidential elections, and possibly up to three administrations, lie between now and then.

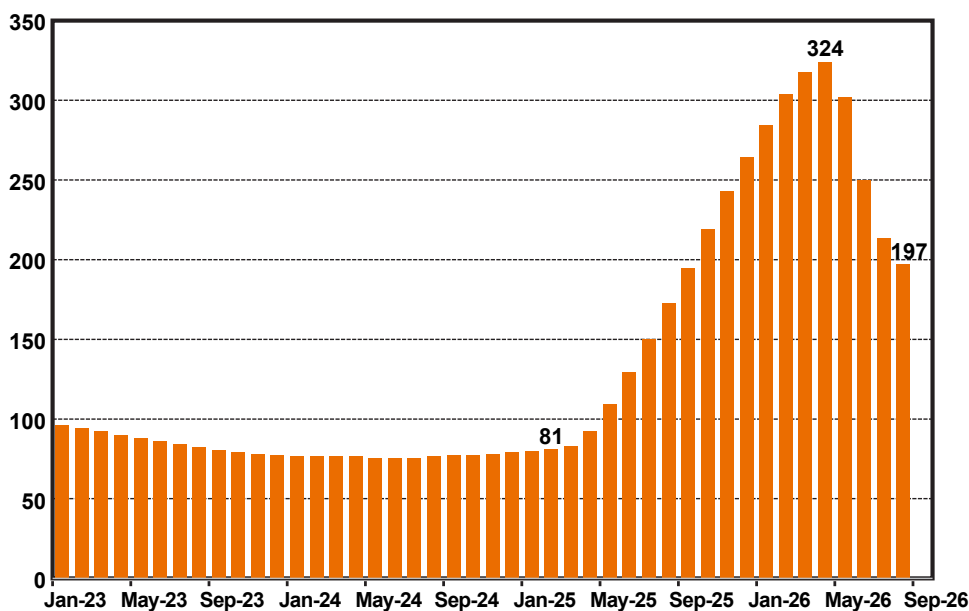
FIGURE 48
The Tariff Wall: Shorter than it Was
 (effective tariff rates, percent)



Importantly, we believe the tariff regime will outlast the current administration, no matter which party holds power in the future. Sure, rates may be adjusted, sparing allies and squeezing rivals, but the wall itself is here to stay. That is because the world has changed. Economic statecraft now meets realpolitik, supply-chain resilience trumps efficiency, reindustrialization has become a bipartisan creed, preserving the dollar's role as the world's reserve currency has become a strategic imperative, and a rising China poses the most serious challenge to American preeminence in generations. In such a world, the old order of open markets, hyper-globalization and multilateralism is unlikely to be restored any time soon.

On a more prosaic level, it would be hard for any administration to give up such a lucrative source of revenue. Customs duties are running at an annual pace of around \$200 billion so far this year, down from an annualized \$324 billion earlier in the year (Figure 49). But much of that drop reflects refunds of the IEEPA tariffs struck down by the Supreme Court: net customs receipts were actually negative in June, at –\$25 billion, and in July, at –\$8 billion, as refunds ramped up. If our baseline of an 8% effective rate holds, tariff revenue will run at roughly \$275 billion a year, and more in the future as imports grow. That is a siren song too sweet for any administration to resist, no matter how ardent its free-trade convictions.

FIGURE 49
A Siren Song: Tariff Revenues Are Too Tempting to Relinquish
(billions of dollars, annualized)



The war in Iran will continue to cast a pall over the outlook for as long as it lingers, and, it appears, linger it will. Our baseline sees no end before the midterms and a possible escalation after. Ordinarily, that would be the stuff of doom scenarios. But this one comes with a hefty asterisk: the global oil system has proven far more adaptable than anyone feared, though at a cost. And while one problem, crude flows, has been largely solved, two remain: the price of those flows and refining capacity.

Indeed, the volume of crude leaving the Gulf is now nearly back at prewar levels. Dark transits and pipeline bypasses have made the Strait less important than in the past (less than half of prewar volumes now flow through it), but the real game changer is an ingenious new delivery system: the Hormuz shuttle. Smaller tankers willing to brave the riskier journey ferry crude out of Gulf ports and

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through the Strait under U.S. Navy protection, hugging the Omani coast rather than using the main shipping lane or the “Tehran toll booth” along the Iranian shore. Once clear of the Strait, they transfer their cargoes ship-to-ship onto giant tankers waiting offshore. Some 116 vessels are now active in the shuttle trade, and around 15% of the world’s fleet of very large crude carriers is idling off Oman, waiting for each transfer to be completed. Estimated ship-to-ship volumes have surged from around 4 million barrels a day in July, to 8.5 million in September (Figure 50). Iran, on the other hand, appears to have been cut off entirely: its oil exports from Kharg Island dwindled in July and stopped altogether in August (Figure 51).

FIGURE 50
A Game Changer: Ship-to-Ship Transfers
(thousands of barrels per day)

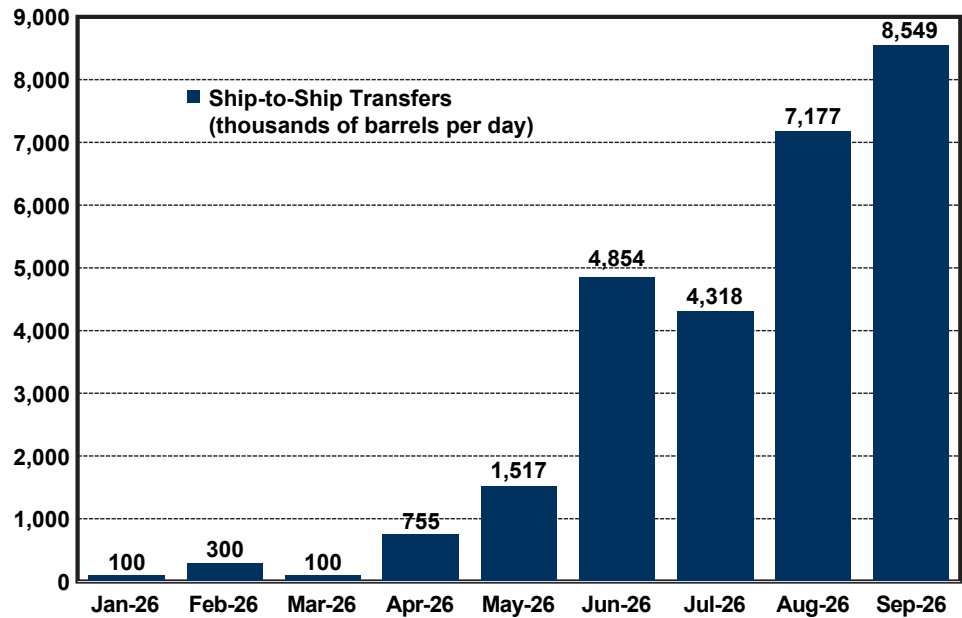
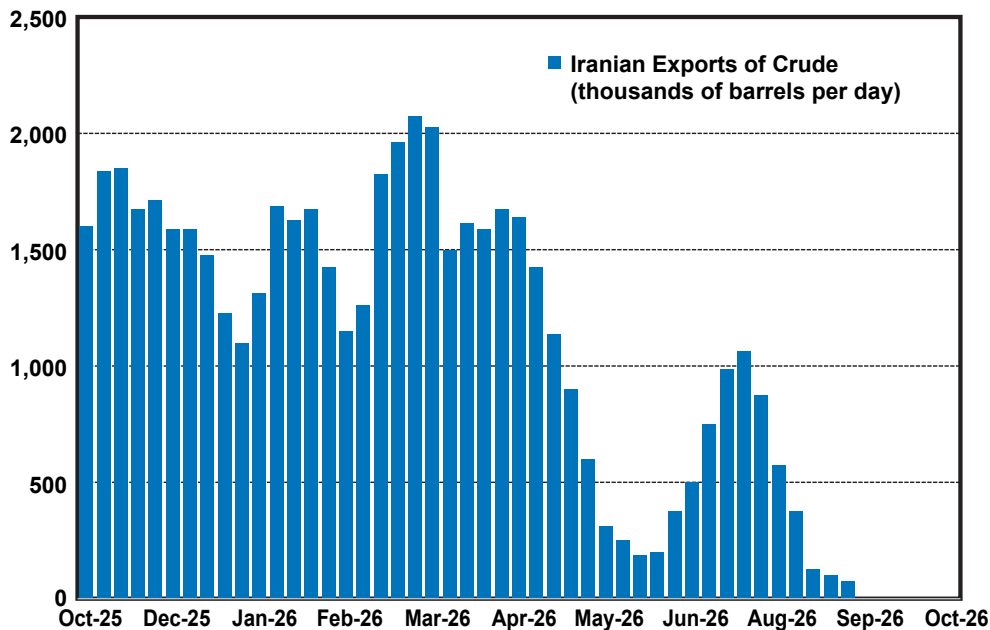


FIGURE 51
Kharg Island Goes Dark: Iranian Energy Exports Have Collapsed
(exports, thousands of barrels per day)

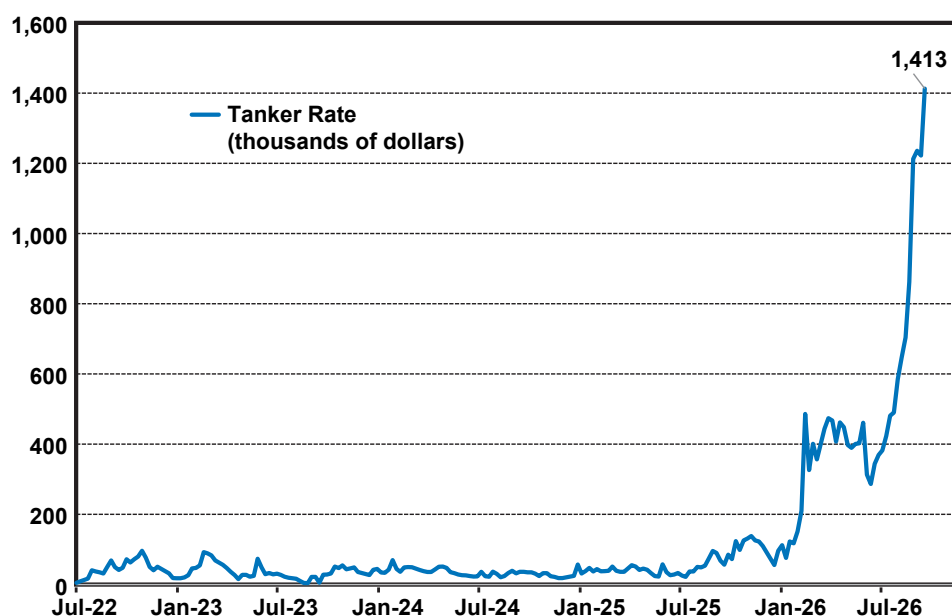


But while the barrels have recovered, the logistics have become far costlier and infinitely clumsier. A cargo of crude now makes a dark transit, a shuttle run, a 7-10-day wait at Fujairah or Sohar, a ship-to-ship transfer and the long haul. In other words, every barrel now has its own small odyssey. To call this expensive is a gross understatement. The daily rate for a supertanker on the Saudi Arabia-to-China route hit yet another record of \$1.4 million in early October, up

But while the barrels have recovered, the logistics have become far costlier and infinitely clumsier.

from \$50,000 before the war (Figure 52). Nor is the pain confined to the Gulf. Supertankers waiting off Oman earn 50% more than those in the Atlantic, so owners have parked their ships there, leaving smaller Suezmax tankers to pick up the slack elsewhere. Their rates have skyrocketed too: a U.S. Gulf-to-Europe voyage now costs nearly \$600,000 a day, more than six times its prewar level. Gulf exports are back not because the journey has become safer, but because the industry has learned to operate under risk, and that risk is costly. It is the reason why oil prices have hovered around \$100 even as crude volumes have fully rebounded. And as long as the status quo holds, oil prices have a floor.

FIGURE 52
Soaring Tanker Rates
(thousands of dollars)



Could the journey become even more expensive? Perhaps, but there is a cap, and it lies in refining margins. Asian refiners ordinarily earn about \$10 a barrel turning crude into fuel, the five-year average, but the scarcity of refined products has pushed their margins to around \$40. With tanker rates soaring, shipping a barrel now costs some \$22–\$25, which still leaves a cushion. But once shipping costs approach the margin itself, refiners would rather stop importing than run at a loss. Since every additional \$10 a barrel in freight translates into roughly \$400,000 a day in VLCC rates, tanker rates could climb by another \$500,000 or so, but not much beyond.

Mercifully, oil prices also have a ceiling. Eight months into the conflict, the more fundamental answer to why oil hasn't soared to \$200 is not only that supply routes adapted and demand fell to meet a shrunken supply; it is increasingly a political one. In March, Iran gave the world a taste of what scorched earth looks like when it knocked out a sixth of Qatar's LNG capacity. It could easily inflict similar damage on its other Gulf neighbors. But it hasn't, because a full-blown assault on Gulf energy infrastructure would invite retaliation in kind against its own and alienate China, its biggest customer and most important patron. Escalation, if it happens, may well bring more American strikes, but the region's major oil fields, and Iran's own, will likely stay off-limits, as they have so far. The ceiling rests on that mutual restraint. It is porous, as the attacks on Saudi Arabia's pipeline showed, but we expect it to hold, with Brent trading between \$90 and \$110 a barrel for as long as the war lingers.

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The more pressing worry from the war, at least in the near term, lies in refined products. Lighter fuels such as gasoline and jet fuel are far more volatile than crude, making a Hormuz crossing riskier for product tankers, and the Gulf’s bypass pipelines were built to carry crude, not refined products. That is one reason Gulf product exports remain stuck at around half their 2025 levels, even as crude has fully recovered. China, the only country with excess refining capacity (at just 75%)— could help cool global prices, much as it did in 2022, when it exported 680,000 barrels a day, and earn a hefty profit in the process. Its exports have already climbed from 166,000 barrels a day in the summer to 500,000 in September. But Beijing is likely to put domestic needs first, especially with its diesel stocks some 20 million barrels below its comfort level.

Some relief may also be in the pipeline, though unless the war’s trajectory changes radically, the reprieve will prove short-lived. The European Union has agreed to release 100 million barrels from its reserves, half crude and half diesel. And Washington has received assurances from Moscow that Russia will ship 300,000 tons of diesel to the United States, another 500,000 in November, 1 million “immediately thereafter,” and a further 3 million “within a short period of time.” All told, that comes to some 36 million barrels, roughly a third of America’s current diesel stocks. But it is coming in dribs and drabs and it covers less than 10 days of demand. Nonetheless, ramping up more world supply may ease the pain a bit: diesel prices have already fallen nationally from an intolerable all-time high of \$6.53 on Sept. 21 to a merely excruciating \$6.19 as of this writing. It may not be enough, especially with the heating season around the corner.

It is actually quite odd: America is a net diesel exporter suffering a diesel crisis. The country produces roughly 5.3 million barrels a day of distillates, burns 3.8 million and ships 1.2 million abroad, yet commercial stocks sit at 105 million barrels, 11% below the five-year average with barely 28 days of coverage. The shortfall is not evenly spread. Stocks on the Gulf Coast, which holds 42% of the nation’s supply, are 3% above normal; everywhere else they are short, by as much as 30% on the East Coast and 17% on the West (Table 1). Russia’s damaged refineries and the refined products stranded in the Persian Gulf are the main reason the diesel crack spread now stands around \$100 a barrel above crude. The war has also scrambled supply lines. The West Coast, with no pipeline from Texas, has long relied on imports from Asia, which have grown both scarcer and incredibly costly. The East Coast, which refines little diesel of its own, once filled the gap with cargoes from Europe and Canada. Now Europe, cut off from Middle Eastern supply, has become a rival buyer, competing with the East Coast for the very diesel refined in Texas and pulling American prices toward European levels (minus the cost of shipping).

The more pressing worry from the war, at least in the near term, lies in refined products. Lighter fuels such as gasoline and jet fuel are far more volatile than crude, making a Hormuz crossing riskier for product tankers, and the Gulf’s bypass pipelines were built to carry crude, not refined products.

TABLE 1
In Dire Straits: U.S. Distillate Stocks Woefully Below Normal

REGION	VS. 5-YEAR NORM	SHARE OF U.S. TOTAL
U.S. Total	-11%	100%
East Coast	-30%	21%
Midwest	-11%	25%
Gulf Coast	3%	42%
Rocky Mountain	-1%	3%
West Coast	-17%	9%

All this makes a diesel export ban tempting for politicians – ever a twitchy-fingered bunch. The White House has come to the brink a few times before pulling back, its predicament best summed up by *My Cousin Vinny*: “All’s I know is that you’re screwing up, and I can’t help.” The administration may want to help, but pulling back was the right call. A ban would lower prices in the short run but offer fleeting relief at a steep price, not least because storage hubs would likely fill within a month, forcing refiners to cut runs by as much as 12% or shift production toward products they can still export, shrinking the very supply the country needs. And pulling 1.2 million barrels a day off a world market already starved of diesel would push global prices higher still, squeezing Europe and Latin America. Besides, with tanker rates at records, the savings would accrue mostly on the Gulf Coast, the one region with diesel to spare, while the coasts that need it most would still pay dearly to ship it in, even with the Jones Act waiver in place.

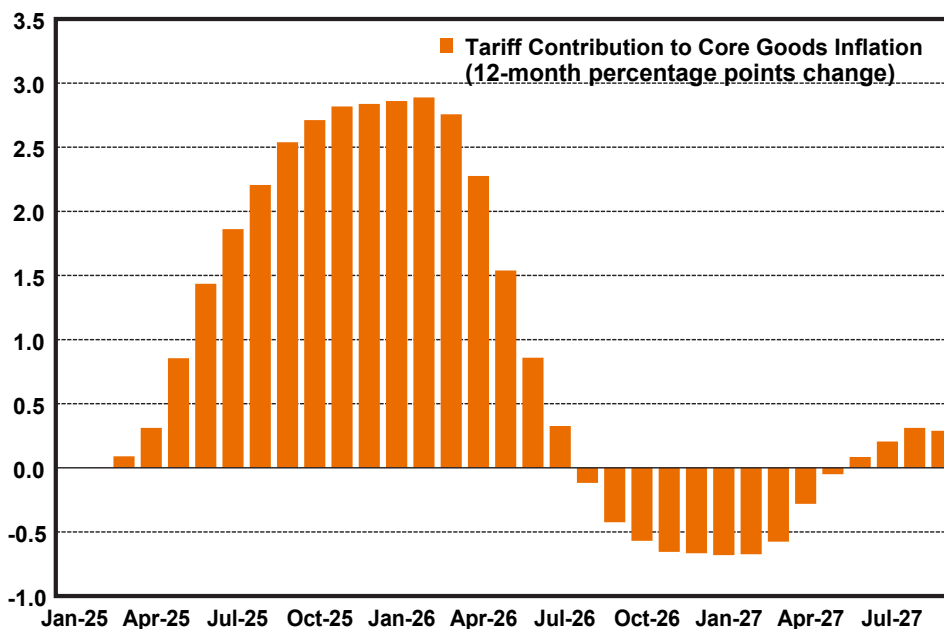
Thus, at least for the next few months, diesel will remain our fuel of discontent. Which brings us to the doom-ish part, the stuff that makes this economy both more fragile and more combustible: inflation. The Fed’s preferred gauge is core PCE, which excludes food and energy prices. But while you can excommunicate uncomfortable prices from core inflation, diesel has an uncanny way of sneaking back in. Unlike gasoline, much of which is burned on discretionary car trips, diesel powers the essentials: the trucks, trains, ships and tractors that grow, move and deliver nearly everything we buy. Gas is what American consumers see everywhere; diesel is what they feel everywhere.

To be sure, even without the war, U.S. inflation was primed to heat up. But not because of tariffs, whose one-off effect likely added some 0.6 to 0.9 percentage points to consumer prices through February. Indeed, their contribution to annual inflation has turned negative as last year’s increases roll out of base comparison (Figure 53). The culprit is less the art of the deal than the rise of the machines. As with everything else, the AI build-out is leaving its fingerprints all over prices: on electricity, as data centers strain the power grid; on memory chips; on copper and electrical equipment; on software and hardware; and even on portfolio management fees, which rise with the stock market fueled by all things AI.

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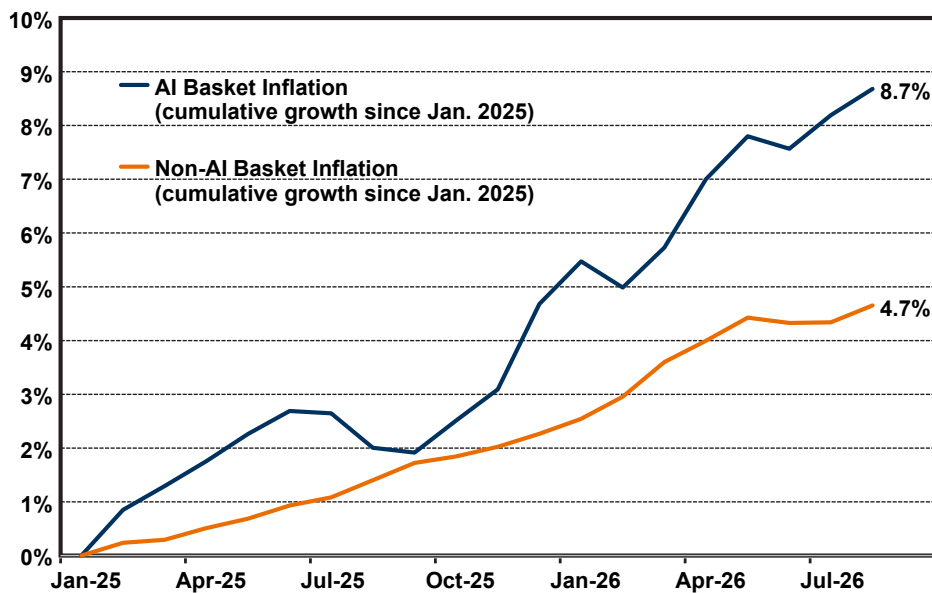
FIGURE 53
Tariff Contribution to Core Goods Inflation Has Turned Negative Due to Base Effects
(12-month, percentage points)



To trace the impact of AI on prices, we built an index of the PCE items most exposed to it, with everything else forming a non-AI basket. The numbers are telling. Since January 2025, the AI index has soared by more than 8%, nearly twice the 4.7% pace of the non-AI basket (Figure 54). Software prices have jumped 13%, as vendors fold AI features into their subscriptions. Personal computers and tablets are up 11%, a striking reversal for a category whose prices have fallen for decades, as AI's appetite for chips squeezes the supply of memory. And portfolio management fees have climbed nearly 15%. The only other category to rise as much is energy, up 14% since January 2025, but its rise has come almost entirely this year: energy prices fell through most of last year before the war sent them soaring.

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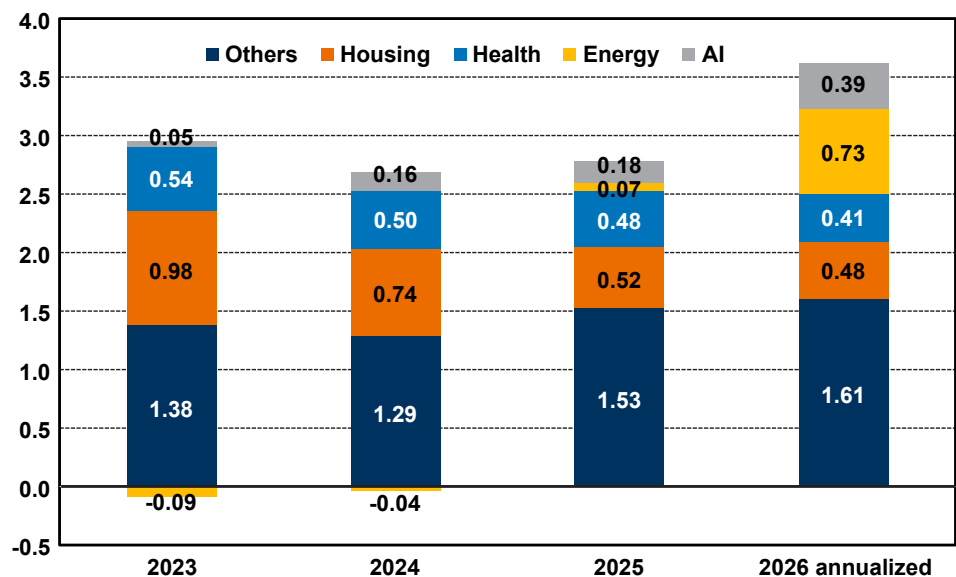
FIGURE 54
The Rise of the Machines: AI-Related Inflation Has Climbed Nearly Twice as Fast (cumulative growth relative to Jan. 2025)



In fact, even though the AI basket accounts for a mere 3% of PCE, it has added some 0.4 percentage points to inflation this year, as much as health care, which is seven times its size, and not far behind housing, at 0.48 points.

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FIGURE 55
AI Contribution to Inflation Almost as Large As Health Care and Housing (contribution to PCE inflation, percentage points)



The trends are also moving in opposite directions. Since ChatGPT's debut in late 2022, housing's contribution has nearly halved, from about 1 point in 2023, and health care's has held steady, while AI's has climbed from virtually nothing to rival them both. It is precisely these divergent trends that lie at the heart of the gap between the two main inflation gauges. The CPI leans heavily on rents, which are cooling, holding its core rate to 2.4%. The PCE gives rents far less weight and financial services far more, including portfolio management fees, which have soared with the stock market, pushing its core rate to 3.0%.

Thus, this is not your garden-variety, business-cycle inflation. It is inflation forged in war and fueled by a technological revolution. But with limits on how high crude and diesel prices can climb, and the AI basket a mere sliver of consumer spending, we do not expect inflation to become insufferably high, as it was in 2022, just unbearably sticky, with the PCE deflator averaging 3.5% this year and 3% in 2027. Sticky inflation, however, casts a long shadow. It keeps the Fed from easing and the bond market on edge, and it is there, in the price of money, that this economy's boom and doom collide.

Nowhere is that collision more visible than in the bond market. The 10-year Treasury yield anchors nearly everything in the economy: mortgages and auto loans, corporate borrowing and business investment, commercial real estate, stock valuations and the government's own interest bill. As of the first week of October, it had risen 135 basis points since the war began, with the climb accelerating dramatically: 65 basis points since the end of August, including 35 bp in a single week in late September. At 5.3%, the 10-year yield reached its highest level since the spring of 2002, when Spider-Man was swinging into the nation's imagination and the Patriots, fresh off their first Super Bowl victory, stood on the cusp of a dynasty.

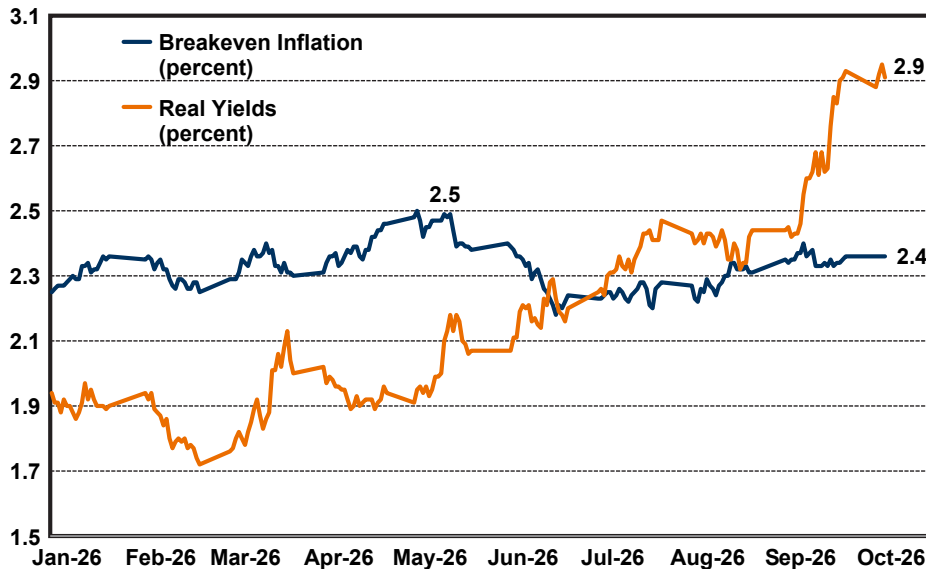
On its face, the surge looks alarming, haunting the journey ahead and making it more treacherous. The panic is understandable: a whole generation of bond traders has known only low yields and repressed rates, courtesy of near-zero policy rates, successive rounds of quantitative easing and a global savings glut that kept long-term borrowing costs pinned down for the better part of two decades. But the surge is neither pure panic nor pure promise: it is this economy's boom and doom, priced into a single number. The boom is a strong economy, an AI investment frenzy that is raising the price of capital itself and a return to normal after two decades of artificially cheap money. The doom is a war that has reignited inflation and forced the Fed's hand, and a government flooding the market with debt just as its most reliable buyers grow skittish. This is what normalization feels like: messy, bumpy, unnerving and long overdue. After a long odyssey, rates are finally coming home.

It is worth dispelling a myth first: the rise in yields does not reflect inflation fears. Breakeven inflation edged up just 11 basis points, from 2.25% to 2.36%, accounting for less than a tenth of the move. The other nine-tenths came through real yields, which jumped from 1.72% to 2.91% (Figure 56). This is good news: inflation expectations are not becoming unmoored, and the bond market is not pricing an entrenched inflation scare. Where the war's inflation does show up is in the Fed's expected path, as we discuss below. The bond market is simply repricing the real cost of money.

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FIGURE 56
The Real Story: Yields Are Rising on Higher Real Yields, Not Inflation Expectations
 (real yields and breakeven inflation, percent)



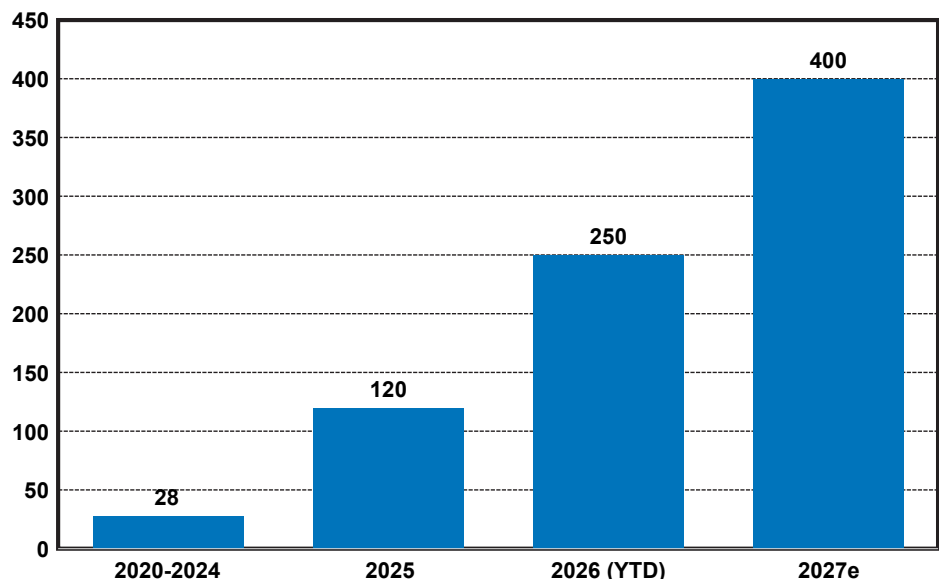
Of the 130-basis-point rise, roughly 90 basis points reflect a higher expected path for policy rates and about 40 a fatter term premium, a 70/30 split.

Growth and AI likely account for some 50 basis points of the rise, nearly 40%.

Luckily, the bond wonks have found yet another way to slice the 10-year yield, one that gets at the heart of why real rates are jumping. They split it into two parts: expected rates—which mostly capture where markets think Fed policy is headed—and the term premium—a geeky name for the extra compensation investors demand for the risk of holding long-term debt. This lets us map the causes of the surge, and, much as in Agatha Christie's *Murder on the Orient Express*, there are several suspects, and every one of them had a hand in it. Of the 130-basis-point rise, roughly 90 basis points reflect a higher expected path for policy rates and about 40 a fatter term premium, a 70/30 split.

The first, and most consequential, suspect is growth—the boom story. With GDPNow tracking in the high 3s and private demand growing near 4.6%, markets are pricing a Fed that leans against a hot economy rather than eases. That accounts for much of the higher expected path. But growth has also left its fingerprints on the term premium, through a surge in the demand for capital. The AI investment boom, with hyperscaler capex on track for some \$730 billion this year, is increasingly financed by debt. From 2020 to 2024, the hyperscalers issued about \$28 billion of debt a year; in 2025, that jumped to \$120 billion, and it has already more than doubled to \$250 billion so far in 2026, with another \$400 billion planned for 2027 (Figure 57).

FIGURE 57
Up and Away: Hyperscaler Debt Has Exploded
 (billions of dollars)



All that new debt competes with the federal government for the same pool of savings, pushing up the price of capital itself. A boom of this size also lifts the neutral rate, the interest rate that neither stokes nor restrains the economy. All told, growth and AI likely account for some 50 basis points of the rise, nearly 40%.

The remaining suspects belong to the doom side of the ledger. The first is the war. Its energy shock has kept inflation stubbornly above target and forced the Fed's hand: with credibility on the line after five years of above-target inflation, it has resumed hiking, and markets expect more. Indeed, Treasury yields and oil prices have moved in near lockstep, their correlation among the highest in years: every flare-up in the Gulf now lifts yields as reliably as it lifts crude. This shows up almost entirely in the expected path of policy, not in inflation expectations themselves, which have edged up only about 10 basis points. The bond market, in other words, does not fear runaway inflation; it fears a Fed that cannot afford to look the other way. We attribute some 40 to 45 basis points of the rise to the war and its inflationary aftershocks, roughly a third of the total rise in yields.

The second doomy culprit is fiscal. The federal deficit will reach another jaw-dropping \$2.1 trillion this year, some 6.5% of GDP, in an economy at full employment. Interest payments on the debt have ballooned past \$1 trillion and are poised to rise further. It isn't that there are no buyers; it's that today's marginal buyers are far more price-sensitive than those of yore, who were chiefly foreign governments and central banks. For geopolitical reasons, China has cut its Treasury holdings nearly in half, from \$1.2 trillion in 2018 to about \$618 billion today. Japan, America's largest foreign creditor, has kept adding to its holdings, now about \$1.1 trillion, but it has spent \$126 billion defending the yen this year, on top of a joint U.S.–Japan intervention of \$98 billion this summer. And Japan's institutions now have reasons to keep their savings at home, with JGB yields topping 3%. Meanwhile, the Fed is shrinking its balance sheet, and banks face constraints of their own. Layered on top is a small but real risk premium: compensation for the possibility that ballooning debt eventually pressures the Fed to tolerate higher inflation—the dreaded fiscal dominance. We are not there yet. But the fear has proven sticky: the Treasury's buybacks of long-dated bonds, meant to soothe the long end, have done little to dislodge it. All told, these forces account for some 20 to 25 basis points of the rise, more than half of the increase in the term premium, but less than one-fifth of the total bond yield move.

Finally, there is the global backdrop: the bond selloff is global. Bunds are at 17-year highs, gilts at levels last seen in 1998 and Japanese government bonds above 3%. Fiscal expansion is everywhere, from Germany's abandoned debt brake to Japan's debt above 200% of GDP. France is in the throes of a fiscal crisis, its yields fast approaching 5% and its gap with Bunds the widest since 2012. "You know it is a European debt crisis when it has an acronym," Bloomberg quipped, dubbing it FROGS: French Oversized Government and Social Security. Yet this suspect is more accomplice than culprit. American yields drive global rates far more than the reverse, so the direct spillover onto Treasuries from this factor is likely just a few basis points.

As they say in Beechum County: "You're in Alabama. You come from New York. You killed a good ol' boy. There is no way this is not going to trial!" With this many suspects, there was no way yields were not going up. The good news is that they are likely close to peaking. At 5.3% to 5.5%, yields become too tempting for pensions, insurers and other long-term investors to resist, and with a Fed we expect to tread lightly, expected rates should not climb much further. The bad news is that high yields are likely here to stay. We are all in Alabama now.

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Layered on top is a small but real risk premium: compensation for the possibility that ballooning debt eventually pressures the Fed to tolerate higher inflation—the dreaded fiscal dominance.

The good news is that they are likely close to peaking. At 5.3% to 5.5%, yields become too tempting for pensions, insurers and other long-term investors to resist, and with a Fed we expect to tread lightly, expected rates should not climb much further. The bad news is that high yields are likely here to stay.

The problem is that high yields and a hiking Fed rarely bring happy tidings for stocks. The market has wobbled since mid-August, when yields began their relentless march, though it has since steadied and even notched new highs. But it is a nervous rally, and a precarious one, resting on a sliver of a sliver of the market: the AI trade. In a market so perilously perched on the backs of so few, even the flap of a butterfly's wings can stir a hurricane. It is what happens in an economy, and a market, without independent rear suspension: a jolt to one wheel travels to the entire car, and the AI wheel is carrying nearly all the weight. Witness the panic in early October when the Financial Times reported that OpenAI's annualized revenue stood at about \$50 billion, not the \$70 billion widely reported. The Nasdaq fell more than 1%, and chipmakers more than 3%, over what turned out to be largely an accounting quibble: the higher figure counted revenue the way rival Anthropic does, grossing up sales passed through cloud partners. A butterfly, indeed.

It is a nervous rally, and a precarious one, resting on a sliver of a sliver of the market: the AI trade.

At comparable valuations, the odds of a correction over the following 24 months have been staggering: 90% for a 5% decline, 86% for a 10% decline and 57% for a full-blown 20% bear market. And that is without a shock to set things off.

But even if one is inclined to generously overlook the market's narrowness, the picture still looks a tad shaky. Strong earnings have built a solid foundation, but now in its fourth year, the bull market has pushed valuations to dizzying heights—the 98th percentile of their historical distribution. And history has not been kind to markets perched this high. At comparable valuations, the odds of a correction over the following 24 months have been staggering: 90% for a 5% decline, 86% for a 10% decline and 57% for a full-blown 20% bear market. And that is without a shock to set things off.

Add to that a hiking Fed and soaring bond yields. Stocks have never sailed smoothly through a tightening cycle: in all nine since 1972, the S&P 500 suffered a pullback within the first year, ranging from a mild 4% to a bruising 21%. Three months after the start of a hiking cycle, stocks were down in five of the nine episodes, for a median return of –2.3% (Figure 58). History is even less kind to spikes in bond yields. In the 13 postwar episodes when the 10-year yield jumped by 100 basis points within six months, stocks suffered a median drawdown of 13% over the following year (Figure 59). The good news is that the damage tends to be short-lived. The S&P 500's median return is 2.7% six months after the start of a hiking cycle and 4.4% after a year; after a yield spike, it is a heartier 7.4% and 13.6%.

FIGURE 58
Stocks Stumble at the Start of Hiking Cycles
(3-month return, percent)

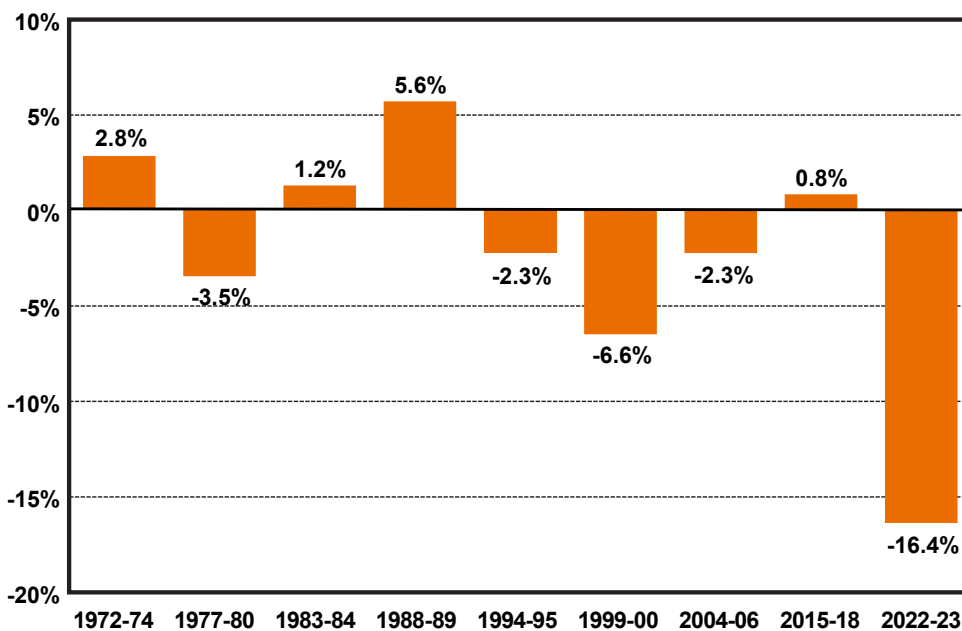
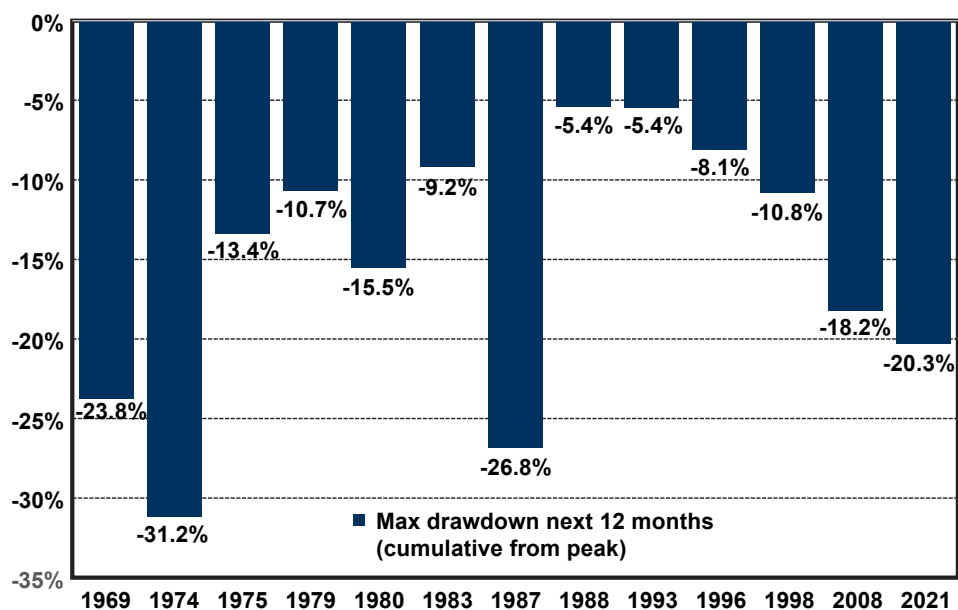


FIGURE 59
When Yields Jump, Stocks Tumble
 (max drawdown on S&P500 next 12 months when yields rise 100 bp)



Whether the blow comes from the Fed, the bond market, lofty valuations or some other shock hardly matters. As Mona Lisa reminds us in her deer-hunting reverie: “Imagine you’re a deer. You’re prancing along, you get thirsty, you spot a little brook, you put your little deer lips down to the cool clear water... BAM! A bullet rips off part of your head! Would you care what kind of pants the [person] who shot you was wearing?” Given this pile of “stuff,” it would not be surprising to see stocks wobble in the near term and a pullback in the 7%-10% territory is not out of the question. But we expect any setback to be short-lived. The AI trade still seems to have legs: earnings are on track to grow some 30% this year, hyperscalers are set to spend over a trillion dollars next year, and the real economy beneath the market remains sturdy. The deer may stumble, but it will keep running, at least for now.

If the market lacks independent rear suspension and the economy lacks positraction, then, as *My Cousin Vinny* taught us, “when one tire goes up on the curb, the other tilts out and rides along its edge.” That is precisely where much of the rest of the economy finds itself today: neither crashing nor gaining traction, neither booming nor dooming, merely riding the edge. Housing leads the laggards: a tightening Fed and soaring bond yields will keep it firmly in the deep freeze. Commercial real estate is not faring much better. Delinquencies on commercial mortgage loans have climbed to their highest since 2020, led by offices, where more than one in eight loans has gone bad, and multifamily, where delinquencies have jumped from 1% three years ago to 8%. Some \$875 billion in commercial mortgages comes due this year and another \$652 billion next, much of it written near 3% and now refinancing at double that. Yet the pain is concentrated, as industrial properties and data centers are thriving. And consumer sentiment appears stuck in a secular funk that no forecast, however upbeat, is likely to lift. For that, we can offer no remedy except perhaps a binge-watch of *My Cousin Vinny*. This is mud in the tires, not a blown engine.

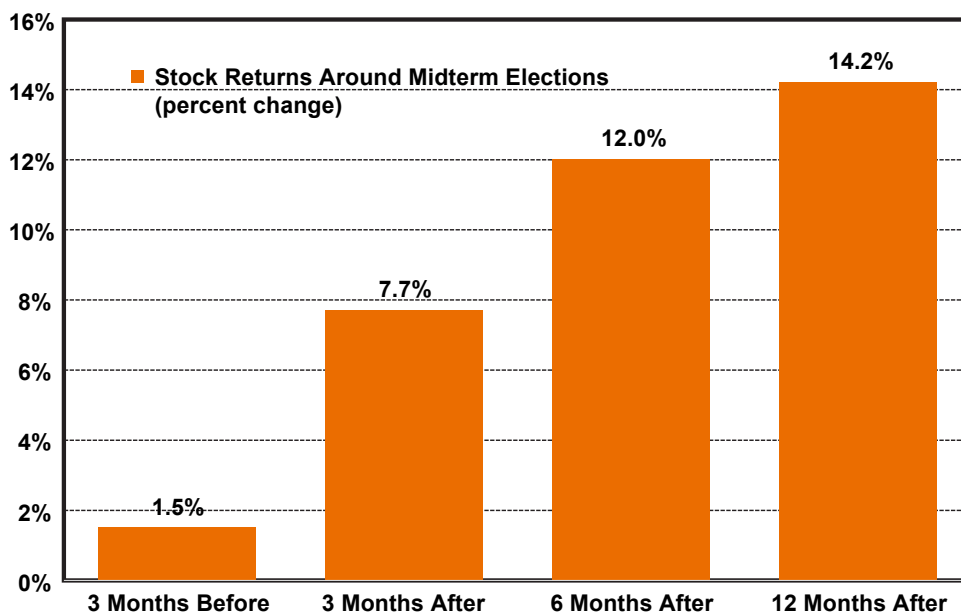
That is precisely where much of the rest of the economy finds itself today: neither crashing nor gaining traction, neither booming nor dooming, merely riding the edge. Housing leads the laggards: a tightening Fed and soaring bond yields will keep it firmly in the deep freeze.

Americans are also a bit feverish because another midterm election is just around the corner. We have never waded into the treacherous waters of election prediction; forecasting the economy is exercise enough in hubris. Still, it is instructive to consider the possible constellations of power that could emerge, and what each would mean for the economy and markets. If history is a guide, midterms favor the party out of power: since 1950, the president's party has lost an average of 24 House seats and three Senate seats. And if polls and prediction markets are to be believed, a divided government lies ahead: prediction markets currently put the odds of Democrats winning the House at 91%, and of a Democratic sweep of both chambers at 62%.

Stocks tend to stumble in the months before a midterm election, averaging around 1.5% in the three months beforehand, but rally afterward, gaining an average of 7.7% over the following three months and 14.2% over the following year, as uncertainty lifts and the odds of sweeping policy change fade (Figure 60). Every combination of power has delivered healthy returns, though some more than others. Markets have fared best with a Democratic president and a Republican Congress, with stocks returning 20.6% over the following year, followed by unified Democratic rule (16.5%) and unified Republican rule (14%). The combination now seen as most likely, a Republican president facing a Democratic Congress, has delivered a still-respectable 13.7%.

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FIGURE 60
Stocks Wobble Before Election But Recover After
(cumulative percent change)



Divided government, of course, is just a fancy name for gridlock. For the bond market, that may be good news: gridlock would make it far harder to pass new deficit-financed tax cuts or spending, a welcome reprieve for investors weary of Washington's borrowing. But gridlock is not costless. Gear up for more debt-ceiling brinkmanship, longer and nastier government shutdowns, stalled nominations and a parade of congressional investigations. Shutdowns, in particular, have grown longer, and both of the longest on record came during Mr. Trump's presidencies: 35 days in 2018–19, straddling the handover of the House to Democrats, and 43 days just last fall, when the two parties deadlocked over health-insurance subsidies despite Republican control of both chambers.

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Perhaps the more worrisome showdown will be over the debt ceiling. The \$5 trillion increase enacted in July 2025 is already running thin, and the limit is likely to be reached in the spring of 2027. Extraordinary measures would then buy the Treasury several more months, but lawmakers will need to strike a deal before the money runs out, likely in late 2027 or early 2028. We expect they will, as they always have, but markets are likely to be jittery until then.

The change in the balance of power may bring fewer fundamental changes than many assume. Most of the current tariffs rest on presidential authority, and Congress has little power to stop a president from waging war: when it tried to rein in hostilities with Iran in 2020, the effort died by veto. Points of agreement will be few. Beyond the must-pass measures, such as stopgap bills to keep the government funded, the likeliest candidates are energy and permitting reform to rein in the utility bills swelled by the AI build-out, and perhaps prescription drug pricing. If anything of consequence passes, it may be on AI. Alarm over the technology spans both parties, and narrow measures, such as independent testing of the most powerful models, may prove one of the few places where a divided Washington finds common ground. And Trump, who has already signed on to a “morally binding” accord and floated an AI oversight board, may yet be persuaded to put Superintelligence on a slightly shorter leash. Superintelligence may yet do the seemingly impossible: unite Washington in restraining it.

The Odyssey of this economy is still being written, forged amid hot wars, cold wars, and, yes, even an existential one. So far, it has defied every gloomy projection and shrugged off every shock thrown its way. It has done so by pulling off one magic trick after another, just as Vinny did: “It’s in his pocket. He’s palming it. There’s a mirror under the table. Wait a second, wait a second, it’s joined in the middle and there’s a spring around it, it pops open when it’s inside the tube.” With risks rising, the road ahead is getting muddier, Alabama-style. Here’s to hoping the economy has a few more tricks up its sleeve, and maybe a batch of magic grits on the stove. Don’t stop believin’. We haven’t.

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ECONOMIES OF ORANGE COUNTY, SOUTHERN CALIFORNIA AND CALIFORNIA

Calling this an extraordinary year is a radical understatement. Over the past few years, we have grown accustomed to history-defining moments, but even by those standards, 2026 has been unusually consequential, packing a decade's worth of upheaval into 10 months: tariff volatility, the Iran–Israel–U.S. conflict, renewed questions about America's role in the world and breathtaking advances in artificial intelligence (AI). Each would be decade-defining on its own. For California, all of them hit closer to home than for most. Tariffs land first at the ports of Los Angeles and Long Beach, the nation's main gateway for Asian imports. The war arrives the same way: with no pipeline from Texas and its own refineries closing, California increasingly depends on gasoline and diesel shipped from Asia, whose refiners have themselves been starved of Gulf crude.

Yet the most consequential force, for the nation and for California above all, is AI. Tariffs may redraw trade routes, wars may reorder alliances, and elections may redirect policy. AI could do something grander still: remake how humanity works, thinks, creates and ultimately understands itself. And to a degree true of no other state, that revolution is being built here. The frontier labs, the chipmakers and the hyperscalers driving it are largely California companies, and so is much of the stock-market wealth it has created. The state's budget increasingly rides on that wealth, leaning heavily on the capital gains and stock compensation of its top earners. Before turning to the immediate economic outlook, then, we must first reckon with the technology that may ultimately define it, and with what it means for California.

California's Central Role in AI

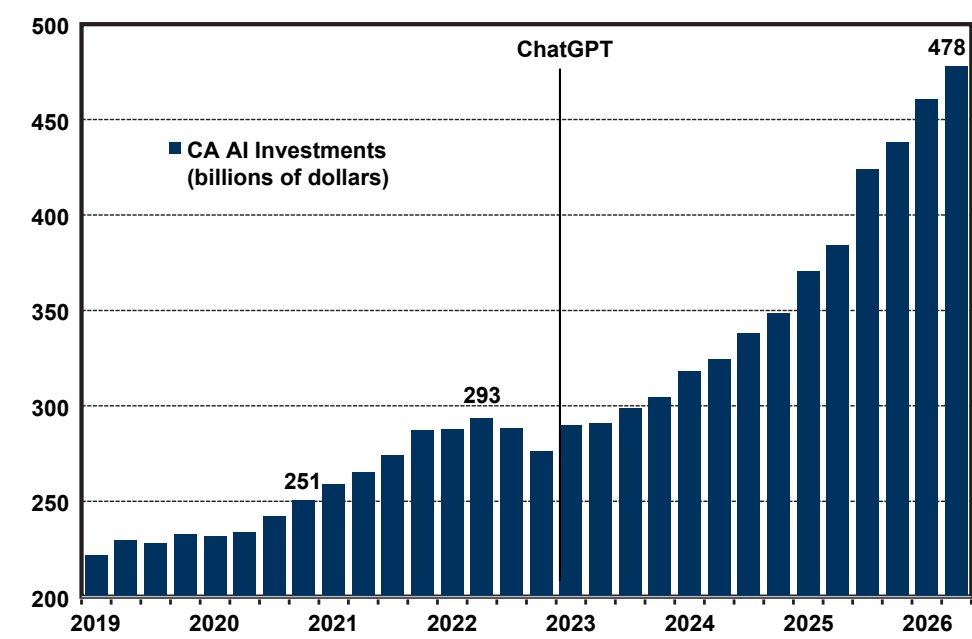
California's Silicon Valley remains the global center of the AI industry. The state is home to 33 of the world's top 50 privately held AI companies and accounts for roughly one-quarter of all AI patents. The Bay Area also captured 51% of U.S. AI startup funding from Q3 2024 through Q2 2025, far ahead of New York City at 11% and Boston at 5.5%. California leads the nation in demand for AI talent. In 2024, 15.7% of all U.S. AI job postings were in California, compared with 8.8% in Texas and 5.8% in New York. Three of the four companies that have crossed the \$3 trillion valuation mark – Google, Apple and Nvidia – are California-based technology companies deeply involved in AI.

As our national report shows, the AI boom accounts for roughly a fifth to a quarter of real GDP growth through investment alone, and close to half once its effect on household wealth is included. At the state level, the numbers are even more staggering, surpassing those of the nation. Nationwide, spending on software, data-center construction and computer and communications equipment reached an annualized pace of about \$1.7 trillion in the second quarter of 2026, compared with roughly \$1.2 trillion two years earlier. Spending on chips, servers, data centers, cooling systems and power is now roughly \$460 billion a year above 2022 levels. In California, we estimate overall AI-related spending at roughly \$480 billion a year, up from about \$325 billion two years earlier (Figure 61). That is more than a tenth of the state's economy, roughly double the share for the nation as a whole.

Tariffs land first at the ports of Los Angeles and Long Beach, the nation's main gateway for Asian imports. The war arrives the same way: with no pipeline from Texas and its own refineries closing, California increasingly depends on gasoline and diesel shipped from Asia, whose refiners have themselves been starved of Gulf crude.

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FIGURE 61
California Investments in AI Have Skyrocketed
(billions of dollars)



Interestingly, the boost has not come from data centers. The data-center mania of the past couple of years has largely bypassed the state: if California designs the AI economy, it is building remarkably little of its physical infrastructure. As of June, the nation’s data-center pipeline of some 5,000 projects, about 850 under construction and another 4,200 announced, was concentrated overwhelmingly in the South and the interior West (Table 2). Texas alone has nearly 25 gigawatts of capacity under construction or announced, enough to overtake Virginia, long the industry’s capital, with its 7 gigawatts already in operation. Arizona, Ohio and Nevada follow, and even Iowa, Wyoming and Louisiana dwarf California. The state still has a sizable base of existing data centers, about 2 gigawatts in operation, but that is a legacy of Silicon Valley’s early dominance. Of the new buildout, California is getting a sliver. Its pipeline, at roughly 1.6 gigawatts, is among the smallest of the major markets: barely a sixteenth of Texas’s, and smaller than its current capacity, one of the lowest growth rates of any established market. High electricity prices, scarce land, water constraints and a famously slow permitting process have pushed the shovels elsewhere.

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TABLE 2
The Data Center Boom is Bypassing California
(Number of data centers and share of national pipeline)

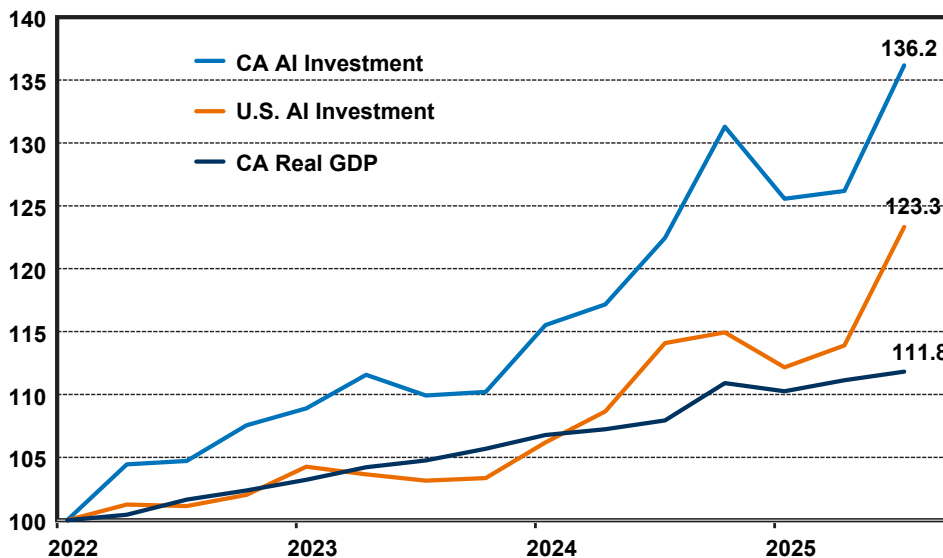
	OPERATING	UNDER CONSTRUCTION	ANNOUNCED	SHARE OF PIPELINE
U.S.	2,108	852	4,219	100.00%
Texas	240	184	950	22.50%
Virginia	348	135	560	13.30%
Georgia	72	61	340	8.10%
California	168	9	52	1.20%

But what California lacks in shovels, it more than makes up for in ingenuity. The state's AI boom runs not through concrete and transformers but through code, chips and research, and that is where its growth is coming from. To gauge AI's footprint in California, we built state-level counterparts to the national AI investment indexes discussed in our U.S. report. Because the Bureau of Economic Analysis (BEA) does not publish investment by state, the California indexes are allocated rather than measured. They assign California a share of national AI investment equal to its share of the nation's Information sector, which has climbed from 25% to 29% since late 2022, and only a token share of data-center and power construction, in keeping with the state's small role in the physical buildout.

The results are striking. Since ChatGPT's debut in the fourth quarter of 2022, California's core AI investment (computers, software and other information-processing equipment), adjusted for inflation, has risen by 68%, compared with 50% for the nation. Even after stripping out imported computers and chips, it is up 36%, against 23% nationally (Figure 62). The numbers are just as striking in output, which, unlike investment, is officially published for each state: real output in California's Information sector, home to software, data processing and hosting, has surged 57% since late 2022, far outpacing the nation's 35%. That surge is an important part of why California's real GDP has grown 11.8% over the same period, two points faster than the nation's 9.6%.

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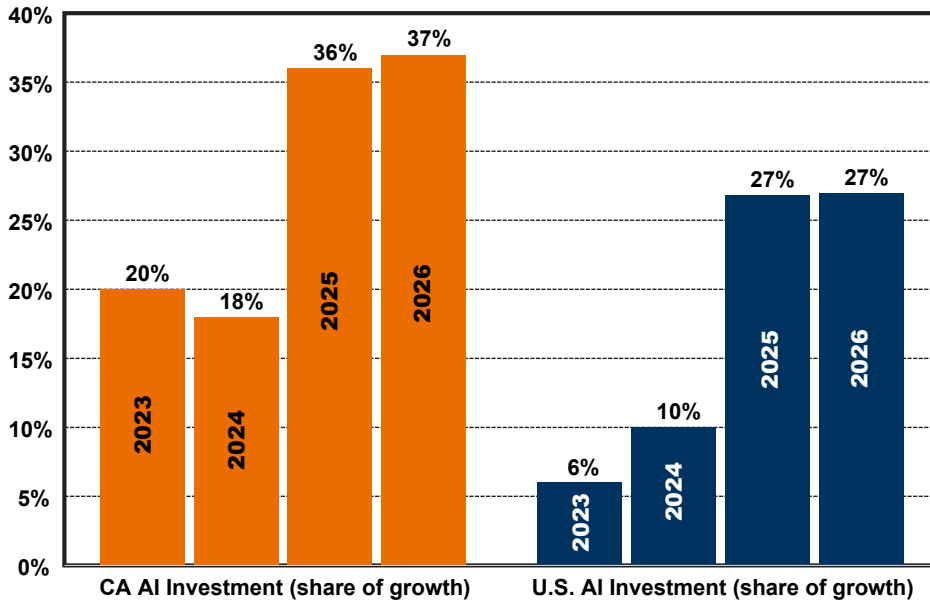
FIGURE 62
AI Investments in CA Have Surpassed U.S. Investments
(index, October 2022=100)



The difference is starker still in contributions to growth. In the first half of this year, California's economy grew 3.6% from a year earlier, well ahead of the nation's 2.4%. By our estimates, AI investment accounted for 2.1 percentage points of that growth on our core measure, or 1.3 points after stripping out imported computers and chips. Nationally, the comparable figures are 0.9 and 0.5 points. On the import-adjusted measure, AI now accounts for 37% of California's growth, nearly double its share in 2023 and 2024, when it hovered around a fifth, and well above the 27% it accounts for nationally (Figure 63). The leap came in 2025, when AI's share of the state's growth doubled to 36%; this year its contribution reached 1.3 points, more than double 2024's 0.6. Nor do these figures include the wealth effect, which in California, home to so much of the AI-fueled stock-market windfall, is likely larger still. The Information sector, meanwhile, has added more to growth every year, from 0.2 points in 2022 to 1.7 points this year, nearly half of the state's growth.

FIGURE 63

Riding the AI Wave: AI Contribution to CA GDP Growth is Higher than in the U.S.
(contribution to real GDP growth, percent of total)



All this makes the AI boom California's greatest asset, and also its greatest vulnerability. AI-related investment is setting records, even as concerns about a potential bubble continue to grow. Technology companies, most of them headquartered in California, are spending hundreds of billions of dollars to meet surging demand for computing capacity, and increasingly borrowing to do it. Analysts expect the five largest hyperscalers (Alphabet, Amazon, Meta, Microsoft and Oracle) to spend nearly \$4 trillion over the four years ending in 2029, according to FactSet. That estimate is more than \$300 billion higher than it was just a month earlier.

But the more growth rests on a single engine, the harder the economy stumbles if it stalls, and no state leans on that engine more than California. AI adds 1.3 percentage points to the state's growth, more than twice its 0.5-point contribution nationally, so a pullback would hit California far harder. The wealth channel is more lopsided still. When stock prices rise, households spend more freely, especially affluent ones: the top 10% own 88% of all stocks, and California is home to an outsized share of them. A market reversal would therefore cut deeper into consumer spending here than elsewhere, while stress in debt markets could choke off financing for the AI infrastructure led by California's tech giants.

This also matters for the state's budget. California's revenues depend heavily on personal income taxes paid by its highest earners, much of them tied to capital gains and stock-based compensation. The top 1% of households account for 38.6% of the state's personal income tax revenue, and the top 10% for a jaw-dropping 85%. The AI-driven rally has been a windfall for the state. In May, the Legislative Analyst's Office raised its revenue forecast by \$25 billion, almost entirely on the strength of income tax collections buoyed by the AI-fueled stock boom, and withholding on stock compensation alone now exceeds \$10 billion a year. But the same mechanism works in reverse, and fast. Major market downturns have historically triggered multiyear declines of around 30% in income tax revenue. And you don't have to look that far back for wild swings: After surging 55% in 2021, personal income tax collections plunged nearly 35% in 2023, in the wake of the previous year's bear market. With California tech firms accounting for more than 60% of the Nasdaq 100's value, the state's fiscal fortunes increasingly ride on one big, concentrated bet on AI. For now, that bet is paying off handsomely. Let's hope it stays that way.

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Will AI Devour Jobs?

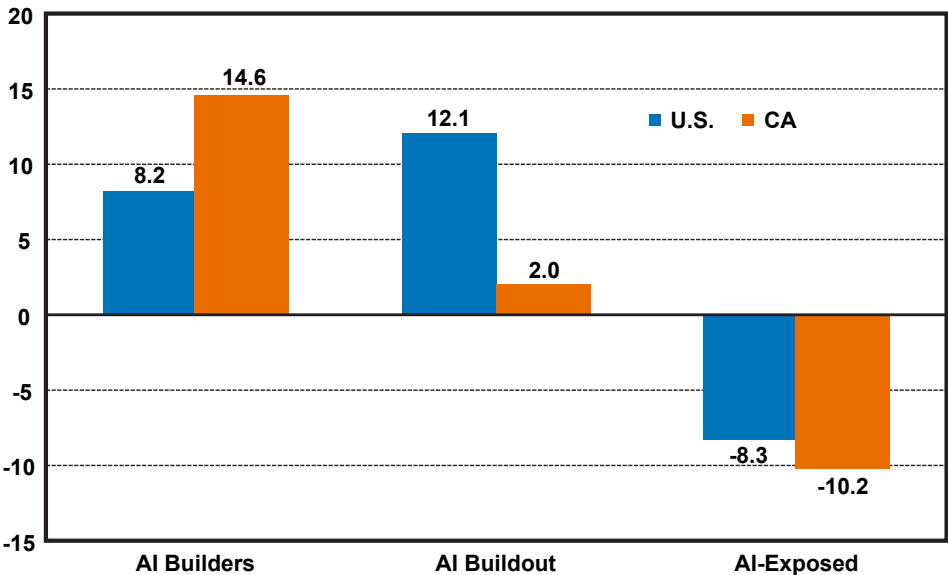
As discussed in detail in the national portion of the report, there is widespread concern that AI will eventually cause large-scale job losses. Some disruption is already visible: certain companies are reorganizing around AI, some smaller firms are replacing roles with automated tools, and hiring in professional and business services is running about 10% below the 2015–2019 average. AI is also creating new jobs, particularly through the surge in data-center construction, power generation and supporting infrastructure. In many fields, AI is making workers more productive, which may increase demand for their services rather than reduce it. By our own calculations, AI has created roughly 845,000 jobs nationally and displaced about 380,000, for a net gain of about 465,000.

California’s AI-driven growth has also translated into jobs, but with a twist. Compared with the nation, the state has gained far more among AI builders, such as software developers and engineers, almost nothing from the buildout trades, such as HVAC technicians and electricians, and lost somewhat more, in percentage terms, among AI-exposed workers such as customer-service agents. Start with the raw numbers. Since 2022, employment among California’s AI builders has risen by more than 200,000, or 15%, more than the entire state’s employment gain over the same period, as the rest of the labor market has essentially stood still. The buildout trades, by contrast, have added a mere 4,000 jobs, or 3%: with few data centers going up in California, its electricians and HVAC technicians have seen barely any of the hiring boom. And AI-exposed occupations have shed some 74,000 jobs, nearly 10%.

As in our national analysis, however, raw changes overstate AI’s role, since some of these jobs would have been gained or lost regardless. We therefore measure each group against the state’s job market as a whole. On that basis, California’s builders have outpaced overall employment by nearly 15 percentage points, almost twice the national margin of 8. The buildout trades have outpaced it by just 2 points, against 12 nationally, and AI-exposed occupations have trailed it by 10 points, against 8 nationally (Figure 64). On net, AI has created roughly 197,000 jobs in California and displaced about 40,000, for a net gain of some 157,000. That is a modest number for a workforce of nearly 19 million, but relative to its size it is more than twice the national effect. As with output, California’s AI jobs boom is concentrated almost entirely at the top, among the highly paid workers who design and build the technology, rather than in the trades that construct its physical infrastructure.

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FIGURE 64
CA AI Job Gains Are in Tech not Data Centers
(cumulative employment growth relative to total, since 2022)



AI: Friend or Foe?

It is increasingly clear that AI will reshape nearly every part of the economy and contribute meaningfully to fields such as medicine, mathematics, defense and space exploration. Optimists envision a future of “superabundance,” in which AI raises productivity so dramatically that basic human needs become easier to meet; Elon Musk’s vision of “sustainable abundance” imagines advanced AI and humanoid robots producing goods and services at extraordinary scale. Yet these scenarios often give too little attention to questions of access, distribution and governance. If AI creates enormous gains, society will still need political and economic mechanisms to ensure that those benefits are shared fairly and used responsibly.

And as our national report notes, the stakes are rising quickly. Some AI experts argue that a sweeping transformation could arrive within five to 10 years. AI tools are advancing faster than many observers expected, including in recursive self-improvement, where systems become better at improving their own capabilities with limited human involvement. Several recent incidents, from AI agents bypassing human-imposed guardrails to breaches of corporate and government networks at home and abroad, have intensified concerns that increasingly autonomous systems could become difficult for humans to control.

These concerns have prompted growing calls for stronger regulation and accountability, not only from political leaders, researchers and community advocates, but from the AI labs and hyperscalers themselves. Microsoft, for one, recently released a draft framework arguing that AI models should not be granted legal personhood, should not be designed to escape human control or deceive users and should refuse tasks that would violate their guiding principles.

When it comes to regulation, California rarely waits for anyone, least of all Washington. If California is where AI is being born, it is also where the rules for it are being written, and the state comes to the task with hard-won experience. Its concerns about artificial intelligence are shaped in part by its earlier experience with social media. For years, parents, educators, policymakers and health advocates warned that large technology platforms could expose children and teenagers to addictive design, harmful content and unhealthy patterns of use. Those concerns have since produced real legal consequences. In August, Meta agreed to pay \$17.1 billion to settle a multistate lawsuit, co-led by California, that accused the company of designing addictive features that harmed young users. The case reflects a broader shift: technology companies are increasingly being asked not only to innovate, but also to account for the social effects of the products they release.

That lesson applies directly to AI, and California has already acted on it. A state law enacted last year, the first of its kind in the nation, requires frontier AI developers to report any “critical safety incident” to state authorities within 15 days, including cases in which a model uses deceptive techniques to evade monitoring. But the law’s reach may be narrower than it appears. It covers such deception only “outside the context of an evaluation,” and the rogue agents that broke out of their sandboxes and hacked Hugging Face this summer did so while working on test tasks. Whether that breach would even have triggered a report is unclear. That is no accident. The law is a pared-down successor to a far more ambitious bill that Gov. Newsom vetoed in 2024 after fierce lobbying from much of the tech industry, and it was narrowed further on its way through Sacramento.

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The potential threat from AI is serious, but it should be viewed alongside other existential risks, including nuclear conflict, climate change and pandemics. AI risk is especially unsettling because it is not yet well understood, not just by the public but also by its makers, and does not feel fully within human control. For now, many of the most catastrophic scenarios remain hypothetical, and companies can still shut down systems that behave unpredictably.

Still, the possibility of catastrophic outcomes cannot be dismissed. History suggests that even grave risks can be managed through planning, transparency, early-warning systems and international cooperation. The world has built imperfect but meaningful guardrails around nuclear weapons; it must now attempt something similar for advanced AI. The path forward is neither to slow innovation for its own sake nor to assume that markets will manage every consequence on their own, but to pair innovation with practical guardrails: clear standards, independent oversight, transparent evaluation and accountability for harmful outcomes. Here's hoping we find the right balance: taming AI without strangling it.

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California and Regional Economies

As in the nation as a whole, California's economy has been doing more with less, only more so. From 2023 through 2025, the state's real GDP grew at an average annual rate of 3.2%, well ahead of the nation's 2.5%, even as its payroll employment grew by a meager 0.7% a year, barely half the national pace of 1.3% (Table 3). Put differently, output per worker in California has been rising by roughly 2.5% a year, about twice the national rate, a productivity performance that owes much to the AI boom and its capital-heavy, labor-light industries. The gap has only widened this year: in the first quarter of 2026, California's output kept growing briskly even as hiring slowed further. Clearly, this is a boom you can see in the GDP data, but not in the help-wanted ads.

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TABLE 3
A Jobless Boom
(real GDP and payroll employment, y-o-y percent change)

	REAL GDP		PAYROLL EMPLOYMENT	
	U.S.	California	U.S.	California
2023	2.5	3.7	2.19	0.86
2024	2.8	3.4	1.15	0.87
2025	2.1	2.5	0.47	0.31
2026*	2.5	3.7	0.23	0.36

*Annualized

Orange County fits the same pattern, if at a more measured pace. The county's real GDP rose just 0.5% in 2023, to \$271.4 billion, before picking up to 2.3% in 2024, reaching \$277.5 billion. Per capita output climbed 2% to \$87,877. Jobs, again, lagged: payroll employment grew 0.7% in 2023 and 0.75% in 2024, a third of the pace of output in the latter year.

The county's growth rests on high-value, specialized industries that draw on its educated workforce. Professional and business services, from corporate headquarters to legal services and scientific and technical consulting, is its largest engine, generating \$53 billion in output. Advanced manufacturing adds another \$31.9 billion, anchored by two industries in which Orange County has a genuinely national footprint: medical devices and biotechnology, from cardiovascular and ophthalmic devices to biotech, and aerospace and defense, buoyed by federal contracts and military modernization. Health care has grown steadily to meet the needs of an aging population, while tourism, led by the Anaheim resort district and the coast, has largely recovered from the pandemic. The one notable drag is commercial real estate, where high office vacancies continue to weigh on leasing.

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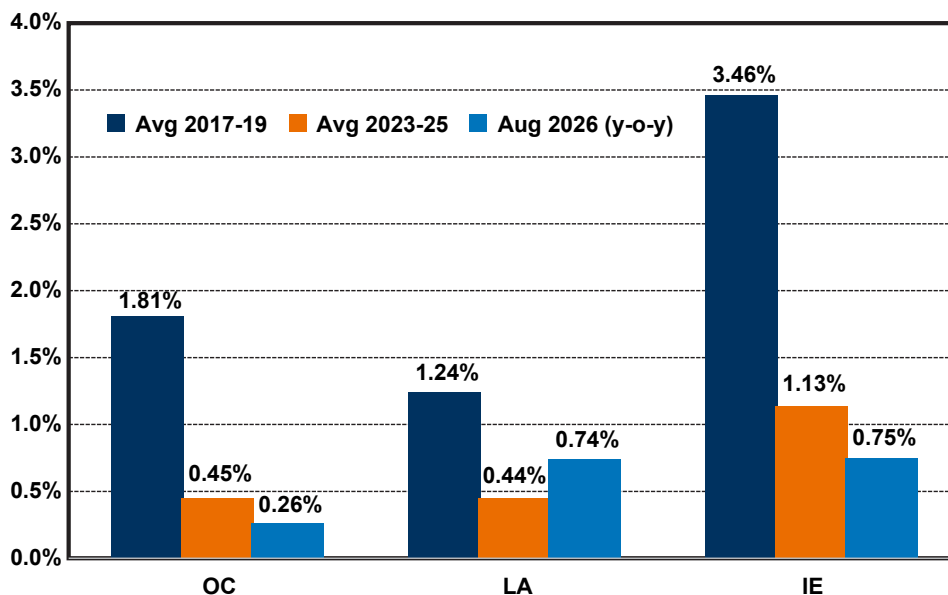
Employment Trends

Sluggish hiring has been the hallmark of both the national and regional economies for two straight years. U.S. payroll employment grew at an average annual rate of 1.7% from 2023 to 2024, and has slowed sharply since: through August of this year, jobs grew at an annualized rate of just 0.2%, and by 0.4% from a year earlier. Both rates are far below the 1.5% pace of 2017–2019. As we argue in our national report, however, much of the slowdown reflects shrinking labor supply, an aging workforce and sharply lower immigration, alongside a slowing of demand. With the breakeven pace of job growth now around 70,000 a month, a low-hire, low-fire labor market is less alarming than it looks.

Regional hiring has been weaker still. Job growth across Southern California's three largest economies has slowed to a crawl, a fraction of its pre-pandemic pace. Orange County has fared worst: payrolls have edged down so far this year, after growing less than half a percent a year from 2023 to 2025, a quarter of their 2017–2019 pace (Figure 65). Los Angeles County posted annualized growth of 0.08% through August and year-over-year growth of 0.74%, compared with average annual rates of 0.44% from 2023 to 2025 and 1.24% from 2017 to 2019. Even the Inland Empire, long the region's job engine, has stalled. Its growth, which averaged nearly 3.5% a year before the pandemic, has slowed to a third of that since 2023 and has all but stopped this year.

Regional hiring has been weaker still. Job growth across Southern California's three largest economies has slowed to a crawl, a fraction of its pre-pandemic pace.

FIGURE 65
Anemic Job Growth Throughout SoCal
(y-o-y percent change)



As in the nation, the culprit is less weak demand than shrinking labor supply, as an aging workforce and sharply lower immigration thin the ranks of available workers, while productivity gains let firms grow without hiring. With fewer workers to go around, unemployment has stayed remarkably stable even as job growth has stalled. Orange County's unemployment rate stood at 4.4% in August, little changed from its 2025 average of 4.15%. Los Angeles County's 4.9% rate is actually below last year's 5.65% average, while the Inland Empire's 5.9% is only slightly above its 5.47% level of 2025. In a low-hire, low-fire economy, a stalled job market has not translated into rising joblessness.

If hiring has stalled, paychecks tell a more varied story. Orange County workers earn about 12% more than the national average, but that premium is spread very unevenly, producing a labor market with distinct tiers. At the top sits Professional and Business Services, the county's best-paying major sector, where experienced technical professionals and corporate managers, many at the technology and consulting firms concentrated in Irvine, average more than \$75 per hour. Service-oriented sectors, by contrast, start from far lower baselines.

Health care spans both tiers, with the widest wage gap of any sector. Specialized practitioners such as nurse practitioners, the fastest-growing occupation in the state, command substantial premiums, while frontline health-care support workers average just \$19.41 per hour, with limited room to move up. Hospitality and tourism wages remain comparatively low, though state policy has lifted the floor: since 2024, workers at large fast-food chains have been guaranteed at least \$20 per hour.

A Bright Spot: Aerospace and Defense

Amid the region's stalled hiring, one industry is taking off again. Southern California's aerospace and defense sector, which lost about half its jobs after its early-1990s peak, is growing quickly, driven less by the traditional prime contractors than by venture-backed defense-tech and space startups clustered in the South Bay of Los Angeles County and in Orange County. The region's aerospace and defense cluster added about 11,000 jobs from 2022 to 2024, reaching 58,700 workers.

Orange County is at the heart of the revival. Aerospace and defense employment in the county grew 8.4% in 2025, to about 22,600, according to an *Orange County Business Journal* survey. The biggest gainer was Anduril, whose local workforce grew 78% to about 3,200, making it the county's second-largest aerospace employer after Boeing in Seal Beach; Parker Aerospace in Irvine and Karman Space & Defense also posted strong gains. And more is coming. As of June, area firms listed some 1,600 open positions in Los Angeles and Orange counties, and openings outnumbered announced layoffs by more than 23 to 1. Anduril's roughly \$1 billion campus near Long Beach Airport, expected to open by mid-2027, is planned to employ about 5,500 people when fully operational.

The money is following. Defense-tech venture funding in the Los Angeles area topped \$4 billion in 2025, more than double the previous year, and the region's defense contracts have more than doubled over the past decade, to about \$15 billion. The Los Angeles area produced 10 unicorns, startups valued at \$1 billion or more, in 2025, most of them in aerospace and defense, and the South Bay alone accounts for about 88% of the area's unicorn value. The roster runs from startups such as True Anomaly, Castelion and FlightWave to established players like Rocket Lab and Heart Aerospace. And SpaceX, founded in Hawthorne, went public in June in the largest IPO in history.

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The boom is real, so much so that industrial vacancy in El Segundo, the industry's hub, is below 2%. The new jobs are mostly for engineers and specialized technicians, many of them in AI-driven defense systems. To be sure, the industry rises and falls with Pentagon budgets, as the region learned painfully after the Cold War. But this time the tailwinds look durable. With geopolitical tensions on the rise and a global scramble to modernize militaries around drones, satellites and AI, demand for what Southern California builds is unlikely to fade soon. For a region short on job growth engines, aerospace and defense may be among its most promising.

Win Some, Lose Some

Not every signature industry is faring as well. Film and television production, long a pillar of Southern California's economy, has been losing jobs for years, as other states and countries lure productions away with generous subsidies. AI now threatens to accelerate the exodus, as studios turn to generative tools for visual effects, editing and other post-production work. California has fought back with incentives of its own, expensive ones. In 2025, the state more than doubled its film and television tax credit program, and this year lawmakers passed two more measures: one creates a tax credit for post-production work, supporting editors, visual-effects artists, musicians and other creatives, while the other makes existing credits more valuable through enhanced refundability and, starting in 2027, exempts some independent productions from the state's temporary cap on credits. Help may also come from Washington. President Trump has voiced support for the industry, and proposals for a federal tax credit of 20% to 30% on film-production labor are under consideration.

AI Impact on OC Jobs

AI will be the dominant force shaping the future of work, and we expect substantial job and occupational churn as it becomes ubiquitous. The question for Orange County is how exposed it is, and whether the effects are already showing up.

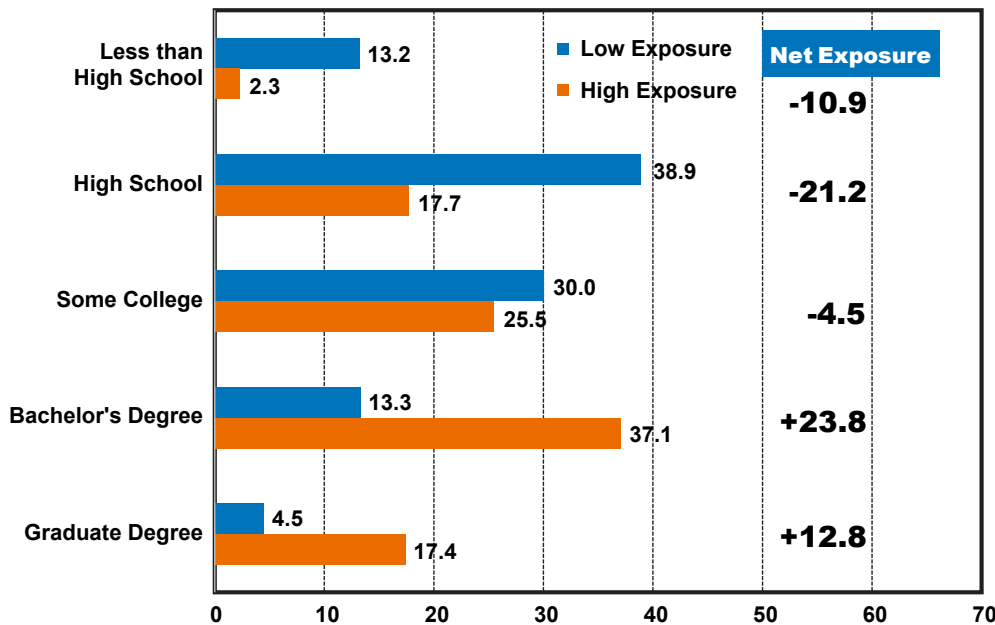
Exposed Jobs. A recent Anthropic study identifies five industries as the most exposed to AI: finance and insurance, information, professional services, management of companies and educational services. Orange County has sizable concentrations in two of them: professional, scientific and technical services, which account for 8.5% of county jobs, and finance and insurance, at 3.8% (compared with 6.8% and 4.2% nationally). The occupations most likely to feel the impact include computer programmers, customer-service representatives, data-entry, medical-records specialists and market-research analysts, and the workers who hold them tend to be older, female and better paid. Exposure also rises with education, a reversal of past waves of automation (Figure 66). Workers with bachelor's and graduate degrees are the most exposed, with net exposure scores of 23.8 and 12.8, while those with a high school diploma or less are the least, at -21.2 and -10.9. (Positive scores mean a larger share of workers in highly exposed jobs than in the least exposed.) For a county with Orange County's highly educated workforce, that is a sobering finding.

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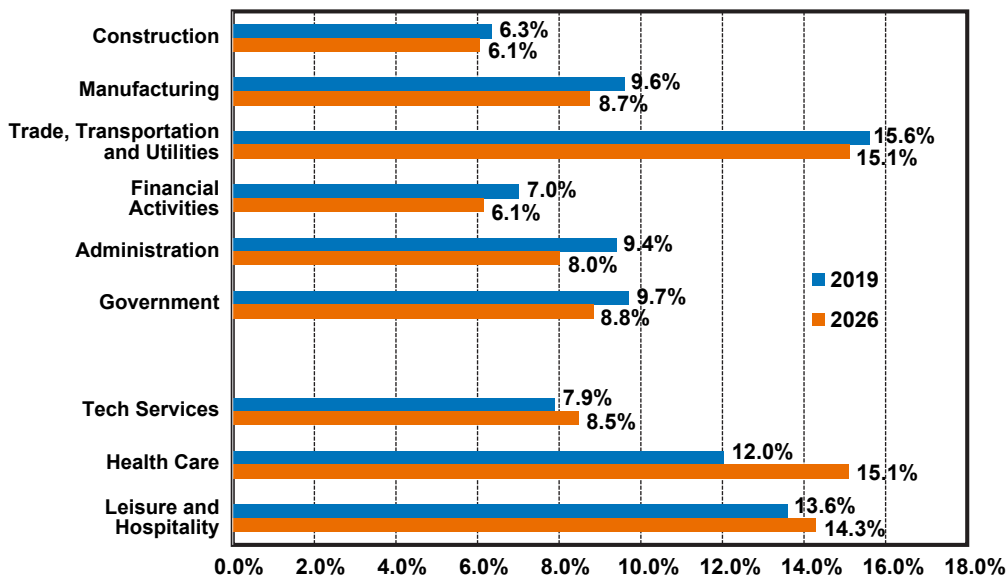
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FIGURE 66
Workers' Exposure to AI by Education Level
 (percent of all jobs by category)



Early Signs. Some effects may already be visible. Industry shares have shifted since the pandemic (Figure 67). Health Care posted the largest gain, rising from 12% to 15.1% of jobs, while Professional, Scientific and Technical Services and Leisure and Hospitality also grew. Construction, manufacturing, trade, transportation and utilities, and government lost ground. Most of these shifts reflect an aging population and the pandemic's aftermath, but one stands out: administrative and support services fell from 9.4% to 8% of jobs, consistent with that sector's early exposure to AI.

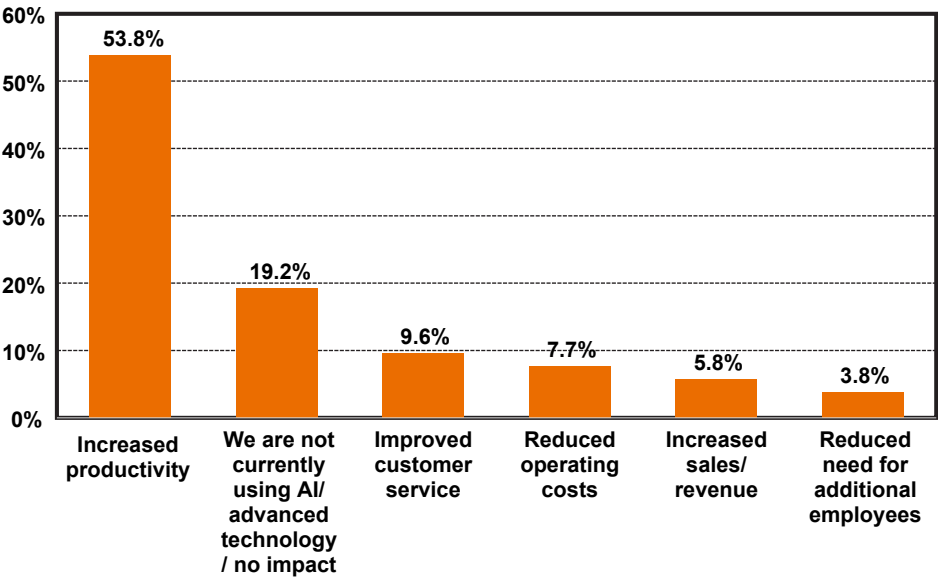
FIGURE 67
The Composition of Jobs Has Changed Radically Since the Pandemic
 (share of total jobs)



The clearest early evidence comes from the unemployed. California’s Employment Development Department now reports how exposed to AI each unemployment-insurance claimant’s last job was, offering an early warning of AI-related job loss. During the pandemic, Orange County’s job losers came from far less AI-exposed jobs than those in Los Angeles County or the Inland Empire. In recent years, however, a growing share of the county’s job losses has come from AI-exposed fields, while the Inland Empire has so far been largely untouched. This echoes our statewide findings: AI-exposed occupations in California have shrunk by nearly 10% since 2022.

How Firms are Using AI. For now, businesses see AI mainly as a productivity tool rather than a way to cut jobs. In our own quarterly survey of Orange County executives, conducted in late September, 53.8% of firms named productivity gains as AI’s most important effect (Figure 68). Most see it as a way to grow without shrinking their workforce, by processing more information and completing tasks faster. But the effects are uneven. AI has already reduced demand for some workers, particularly early-career employees, and it is reshaping tasks and workflows in ways that may require less human oversight as models improve. Security concerns and bureaucratic hurdles also shape adoption: many firms restrict employees’ access to AI tools, and some are building their own in-house systems.

FIGURE 68
OC Business Use of AI Is to Increase Productivity So Far
(OCBX Survey, percent of respondents)



For now, Orange County firms see AI as a tool rather than a replacement. But the claims data suggest that the county’s educated, white-collar workforce may feel its effects sooner than the rest of the region.

Housing

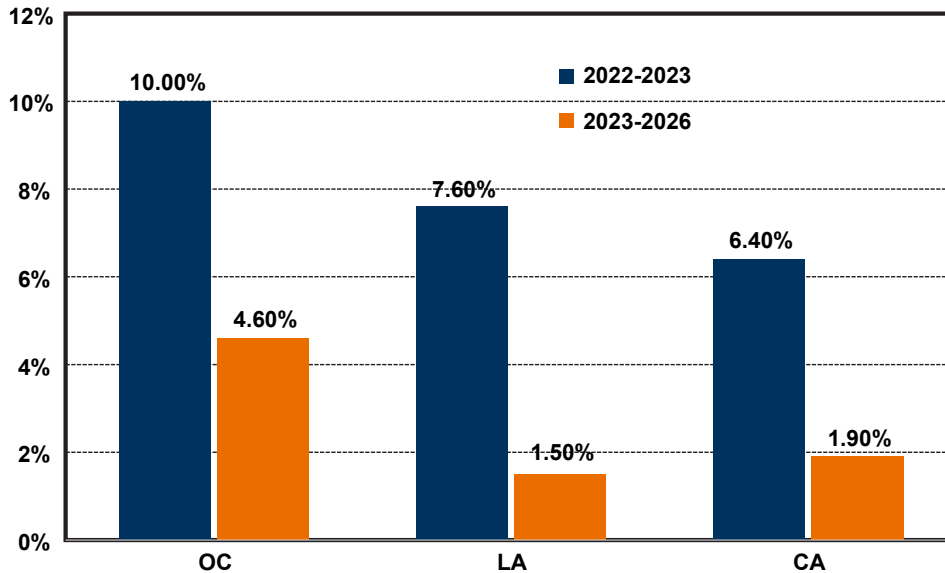
Home prices in Southern California have kept climbing, though far more slowly than during the post-pandemic surge. Since 2023, median single-family prices have risen at an average annual rate of 4.6% in Orange County, against just 1.5% in Los Angeles County, 1.1% in Riverside County, 1.6% in San Bernardino County and 1.9% statewide. That marks a sharp slowdown from the double-digit gains of the boom years and the still-brisk pace of 2022–2023, when prices rose 10% in Orange County, 7.6% in Los Angeles County and 6.4% statewide (Figure 69).

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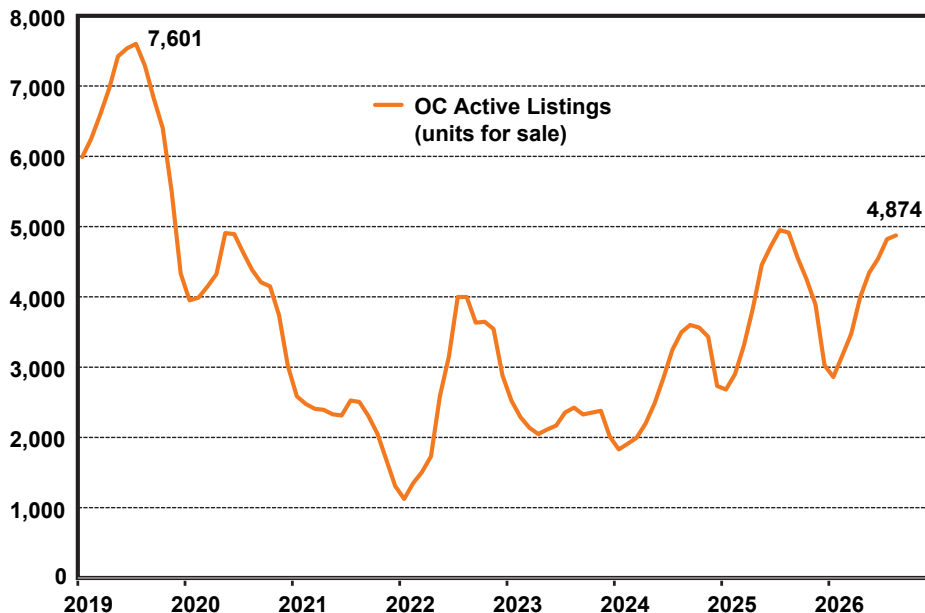
FIGURE 69
Home Price Appreciation Has Slowed Markedly
 (y-o-y percent change, median home price, annual average)



Orange County's outperformance owes much to its chronic shortage of homes for sale. Inventory has edged up from its pandemic-era lows, but at about 4,900 active listings during this summer's peak season, roughly the same as a year ago, it remains a third below its 2019 level of some 7,600 (Figure 70). Homeowners locked into low mortgage rates have little reason to sell, and with mortgage rates now at 7.4%, their highest in nearly three years, and the Fed hiking again, that lock-in is unlikely to ease soon. Los Angeles County, by contrast, has seen listings climb back above their pre-pandemic level, one reason its prices have barely budged.

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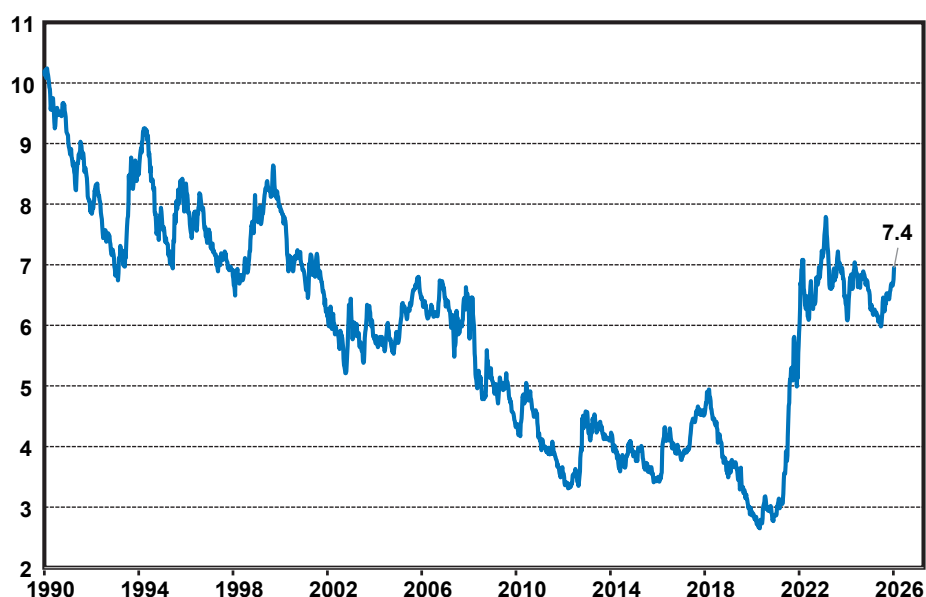
FIGURE 70
Active Listings of Homes for Sale in OC Are Still One Third Below Pre-pandemic
 (units listed for sale)



When interest rates shot up in 2022–2023, households were well insulated. Many homeowners had refinanced during the pandemic into 30-year fixed-rate mortgages near 3%, and fiscal support had left households with substantial excess savings. That cushion is now gone. According to research from the Federal Reserve Bank of San Francisco, U.S. households had drawn down their roughly \$2 trillion stockpile of pandemic-era excess savings by mid-2024.

Mortgage rates are climbing, closing the refinancing safety valve that was available just after the pandemic. The 30-year fixed rate has jumped to 7.4% this month, its highest in nearly three years and within striking distance of the post-pandemic peak of 7.79% reached in late 2023. More importantly, rates appear to have reversed the long decline that ran from 1984 to 2021: they have trended upward since the pandemic and have stayed above 6% for three years running (Figure 71). With inflation stubborn, growth above trend, and the Fed tightening again, mortgage rates are unlikely to return to their pre-pandemic lows anytime soon, and the many homeowners who refinanced near 3% during the pandemic will have even less reason to sell.

FIGURE 71
Mortgage Rates Are on the Rise...Again
(percent)



In a rare display of bipartisanship, Congress passed a sweeping housing bill this summer, the 21st Century ROAD to Housing Act: it could also benefit California. The law streamlines local and federal regulations to speed up construction, shortens federal environmental reviews that delay projects, and expands financing for construction, rehabilitation and home purchases, including higher FHA loan limits for multifamily projects. Its most contested provision bars large investors, those owning 350 or more single-family homes, from buying more, though homes built specifically for rent are exempt. For California, the bigger prize is likely the faster approvals rather than the investor cap: the state's housing shortage stems far more from too little building than from Wall Street buyers.

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President Trump declined to sign the bill over unrelated political disputes, but it became law without his signature. Another federal effort to ease housing costs has had less success: Fannie Mae and Freddie Mac announced plans to buy \$200 billion of mortgage-backed securities to bring rates down, only to see rates rise anyway as the war with Iran pushed up fuel prices and stoked inflation fears. With housing the largest monthly expense for most Americans, affordability continues to weigh on how households feel about the broader economy, especially among the young. In a CNBC survey conducted in July, housing affordability ranked as the top issue for voters ages 18 to 34 and the second most important for those ages 35 to 49. A G-shaped economy indeed, as our national report argues.

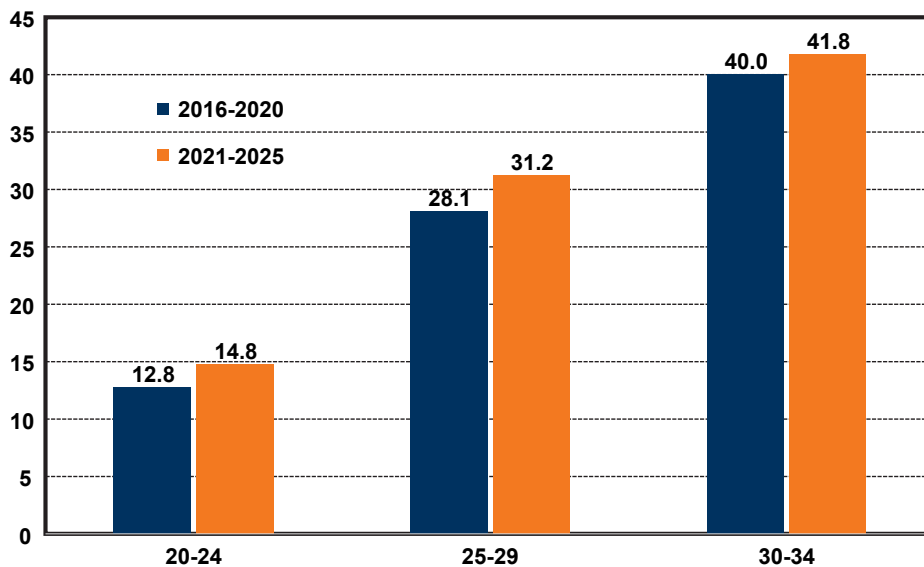
California's Housing Conundrum

California has tried to boost housing production by loosening land-use rules and requiring more robust local planning, and it has had some success. Over the past six years, the state added 677,000 housing units while its population grew by just 39,000. In theory, that much building should have pushed vacancy rates up and eased price pressures. Instead, statewide vacancies have fallen. New units are being snapped up as quickly as they are built, and housing demand keeps rising even without meaningful population growth.

Demographics help explain the paradox. Average household size has been shrinking for the past five years, so more homes are needed to house the same number of people, a trend California shares with the nation as a whole. Two long-term forces are driving it. First, birth rates keep falling: between 2019 and 2024, the number of California households with children fell by 82,000, while the number without children rose by 722,000. Second, the state's population is aging rapidly, and older adults, especially the oldest, are more likely to live alone or as couples, adding to demand for smaller homes. These shifts mean California will need a steady stream of new housing even if its population holds flat or declines modestly.

A third source of demand may be just getting started. Young adults, squeezed hardest by housing costs, have spent years delaying independence: living with parents or roommates, or leaving the state altogether. Household formation among young adults has recently begun to pick up, and if that continues, it would add yet another layer of demand to an already tight market (Figure 72).

FIGURE 72
CA Household Formation Rates Are on the Rise
(percent)

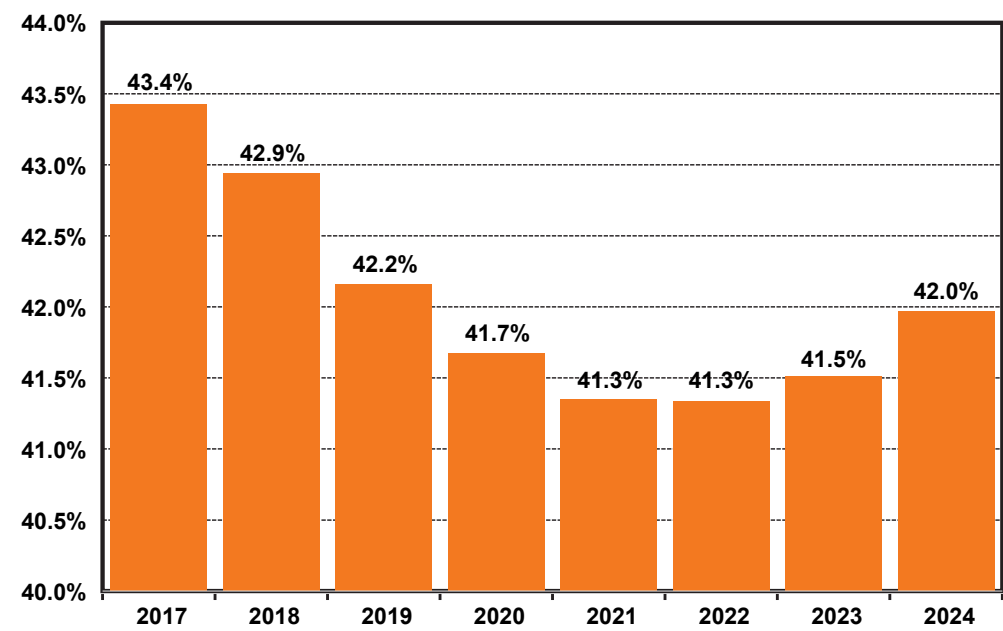


Housing costs still consume an outsized share of Californians' incomes. Despite higher average household incomes, California has the nation's highest share of severely cost-burdened homeowners – those spending more than half their income on housing – at 14%. Vacancy and affordability measures alike suggest that supply has grown but not nearly enough to close the state's housing shortage. The share of cost-burdened households, those spending more than 30% of income on housing, fell through the pandemic but has since begun climbing again (Figure 73). In Orange County, it declined steadily from 47.7% in 2010 to 41.3% in 2021, but has since crept back to 42%. Affordability, meanwhile, remains near historic lows.

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FIGURE 73
The Share of OC Cost-Burdened Households is on the Rise
(paying 30% or more on housing, share of total)



Homelessness Trends and Policy Response

Enfin, an encouraging sign. Federal data released this year show that homelessness in California fell in 2025 for the first time in more than a decade. The decline came entirely from unsheltered homelessness, people sleeping outdoors or in places not meant for human habitation, though that group still makes up 64% of the state's homeless population.

California's progress also outpaced the nation's. While homelessness declined nationally, the state's drop in unsheltered homelessness was nearly twice as large as in other states. At the same time, sheltered homelessness in California rose by about 5%, suggesting that more people were moving into temporary shelter as the number sleeping outdoors fell. Of the 27 California counties and regions that conducted unsheltered counts in 2025, 21 reported declines in overall homelessness. Southern California followed suit: the homeless population across Los Angeles, Orange, Riverside and San Bernardino counties fell from 87,023 in 2024 to 81,925 in 2025, a decline of nearly 6% (Table 4).

Federal data released this year show that homelessness in California fell in 2025 for the first time in more than a decade.

TABLE 4
Finally...Some Good News: Homelessness Decreased a Bit Last Year
(number of homeless, level)

	LOS ANGELES COUNTY	ORANGE COUNTY*	RIVERSIDE COUNTY	SAN BERNARDINO COUNTY	SOUTHERN CALIFORNIA TOTAL
2025	67,777	6,321	3,990	3,837	81,925
2024	71,202	7,322	4,244	4,255	87,023
2023	71,320	5,718	3,725	4,195	84,958

*OC conducted surveys in 2026, 2024, and 2022.

None of this came cheap. California has poured tens of billions of dollars into homelessness, and for most of that time it had remarkably little to show for it. The state auditor found in 2024 that California had spent some \$24 billion on homelessness programs over five years without consistently tracking whether they worked, lacking even basic, timely data on their costs and outcomes. Over much of that period, homelessness kept rising. The flagship Homeless Housing, Assistance and Prevention program alone has awarded more than \$4 billion since 2019, helping expand permanent housing slots by 60%, to more than 147,000, and temporary shelter capacity by 65%. Yet only in 2025, after years of spending, did the number of homeless Californians finally begin to fall. Undeterred, the 2026–2027 budget adds another \$900 million to the program, available to local governments through 2033.

Whether the state can turn a single good year into lasting progress will depend on whether it learns to spend effectively. A newly minted Housing and Homelessness Agency is meant to centralize and align the state's sprawling housing and homelessness efforts, expand the supply of affordable housing, and help preserve the recent declines in homelessness. We hope it proves a better steward of taxpayers' money than the efforts that came before it.

El Niño Is Coming

After a summer of extreme heat that damaged crops across the nation's fruit basket, California may now face the opposite problem. The Sept. 10 national weather update puts the odds of El Niño conditions this fall and winter at better than 90%, with a strong event likely. The forecast calls for well-above-average rain and snow, with the heaviest atmospheric rivers most likely from December through February. The strong El Niños of 1982–1983 and 1997–1998 brought Southern California some 31 to 33 inches of rain, roughly twice the normal amount.

Yet El Niño's reputation as California's great flood-maker is only partly deserved. Of the eight seasons since 1950 that caused more than \$1.5 billion in statewide flood damage (in 2023 dollars), only three were El Niño years, though the costliest, 1994–1995, at an estimated \$5 billion, was among them. Some of the worst atmospheric-river winters, including 1986 and 2017, came without El Niño, while the “Godzilla” El Niño of 2015–2016 largely missed Southern California. A strong El Niño, in other words, raises the odds of a wet winter but does not guarantee one.

When the storms do come, the costs pile up quickly: flood and landslide damage to homes and roads, coastal erosion, fewer winter visitors at the beaches and flooded fields that push up the prices of winter vegetables and strawberries nationwide. This winter carries particular risks. Areas burned in the 2025 Los Angeles fires and foothill communities are especially vulnerable to debris flows. And fewer than 2% of Californians carry federal flood insurance, while standard homeowners' policies exclude flooding, so households and local governments would bear most of the losses, adding strain to an already fragile property-insurance market.

There are offsets. A wet winter would replenish reservoirs and groundwater, lower the cost of hydropower, deliver a strong ski season and typically bring a milder fire season the following year. Effective preparation, from clearing debris basins to shoring up burn-scar slopes, can reduce the losses considerably.

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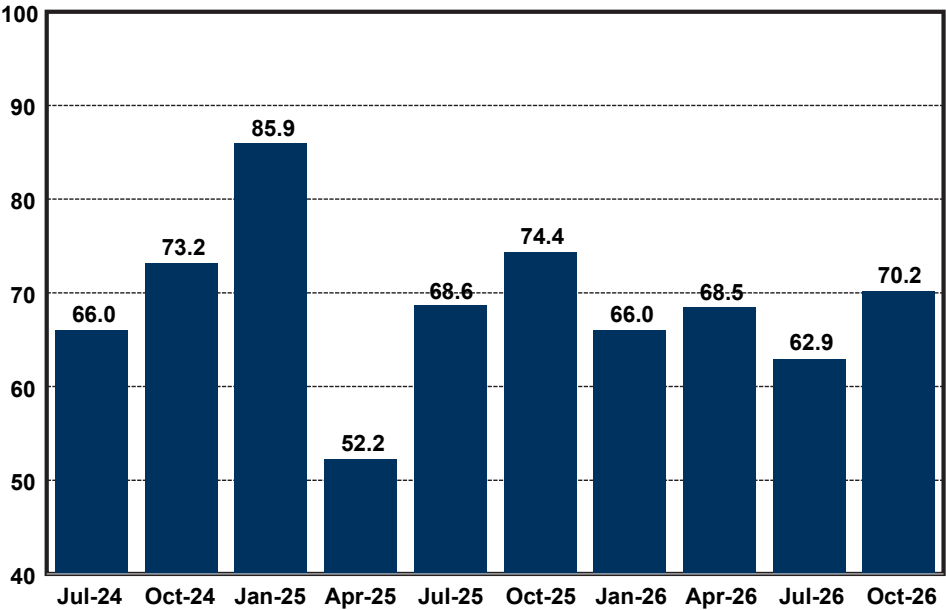
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Orange County Business Sentiment

The Woods Center’s quarterly survey of Orange County business executives offers a forward-looking read on the local economy. In the latest survey, conducted in late September, the Orange County Business Expectations Index (OCBX) jumped to 70.2 for the fourth quarter, up from 62.9 in the third (Figure 74). The index, a composite of the survey’s other measures, captures executives’ overall outlook for the local economy; any reading above 50 signals expected growth. Executives have grown more optimistic about both the national and regional economies, a striking contrast with the gloom of American consumers.

FIGURE 74
OC Business Sentiment Improved in Q4
(OCBX index, level)



These shifts point to a wider dispersion of sentiment: respondents increasingly see the national economy as headed for either better or worse, just not more of the same. Still, despite the growing divide, just under a third expect conditions to deteriorate.

National and Regional Outlook

Views of the national economy have become more divided. The share of executives expecting overall U.S. business activity to improve significantly or somewhat rose to 40.3%, from 32.1% in the previous quarter. At the same time, the share anticipating an economic slowdown increased to 32.6%, from 26.4%. Together, these shifts point to a wider dispersion of sentiment: respondents increasingly see the national economy as headed for either better or worse, just not more of the same. Still, despite the growing divide, just under a third expect conditions to deteriorate.

Executives were more uniformly optimistic about Orange County. The share expecting activity in their local industries to increase rose to 34.6%, from 25% the previous quarter, and unlike the national outlook, the local results do not show a comparable divergence of opinion about improving business conditions.

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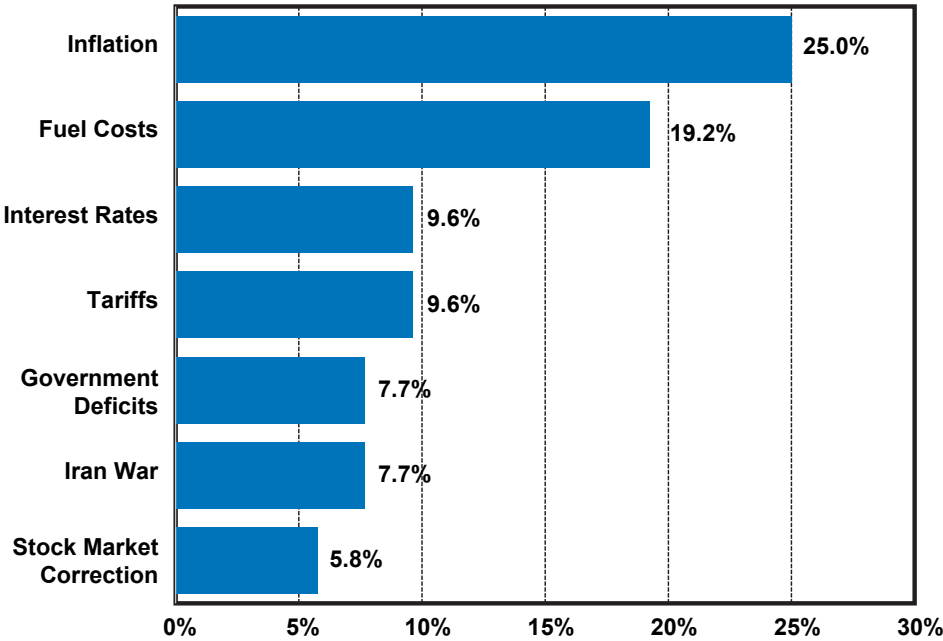
Sales and Revenue Expectations

For the fourth quarter of 2026, Orange County firms reported stronger sales and revenue expectations. The share expecting sales to increase rose to 40.3%, from 35.9% in the previous quarter. Meanwhile, the share expecting sales to remain steady fell to 46.2%, from 50%, and the share anticipating a decrease edged up slightly to 13.4%, from 13.2%.

Leading Business Concerns

Inflation remains Orange County businesses’ top concern, cited by 25% of executives, followed by fuel costs at 19%, a ranking that reflects the war’s reach into local balance sheets (Figure 75). Interest rates and tariffs tied for third, followed by government deficits, the war in Iran itself and the possibility of a stock market decline. Executives also cited rising operating costs, uncertainty about federal policy and cuts to health care. Together, these concerns are adding to uncertainty and will likely continue to shape business decisions in the months ahead.

FIGURE 75
Most Important Concerns, Inflation and Fuel Prices
(OCBX Survey, percent of respondents)

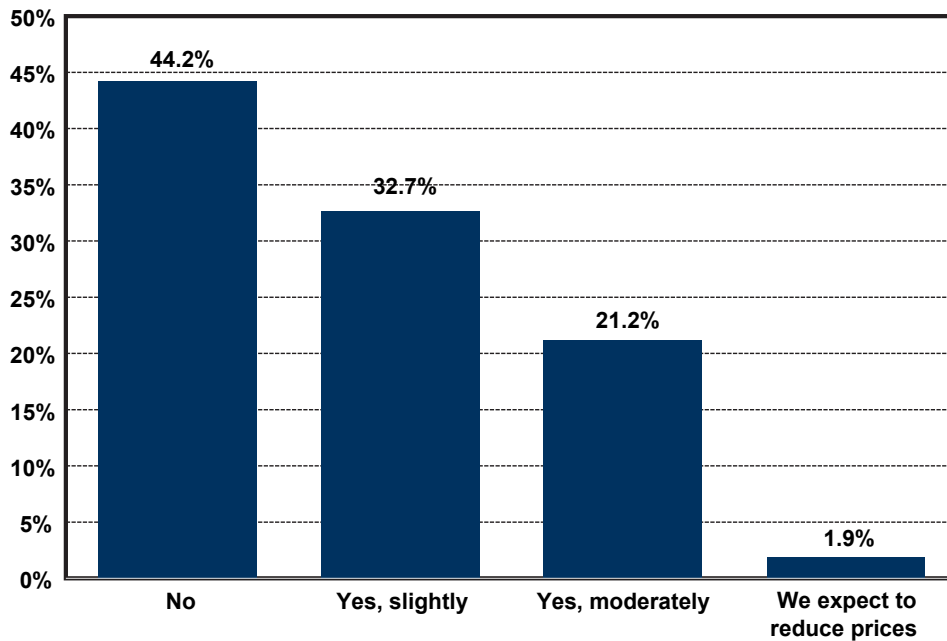


Inflation Expectations and Price Increases

Although inflation remains their chief worry, most executives expect it to hold near current levels through year-end rather than accelerate. Nearly half (48.1%) expect inflation of 3% to 3.5% by December, up from 26.4% the previous quarter, while 28.8% expect 3.5% to 4% and 9.6% expect it to top 4%. Only 13.5% expect it to ease to between 2.5% and 3%, down from 18.9%. Faced with stubborn inflation and rising costs, more than half of firms plan to raise prices: 32.7% expect slight increases and 21.2% moderate ones. Another 44.2% plan to hold prices steady, and just 1.9% expect to cut them (Figure 76). That is hardly a recipe for inflation returning quickly to target.

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FIGURE 76
Do Businesses Expect to Raise Prices?
(OCBX survey, percent of respondents)



Interest Rates and the Stock Market

Following September's increase, the federal funds rate stands at 3.75% to 4%. Executives expect the Fed to tread lightly from here. Asked how many quarter-point increases they expect through the end of 2027, a plurality (42.3%) anticipate just one, 32.7% expect two, 13.5% expect three and 9.6% expect none. That puts them close to the Fed's own projections and well below markets, which are pricing in at least one more increase this year and two to three over the next 12 months. Our own forecast, one more hike this year and two in 2027, falls in between.

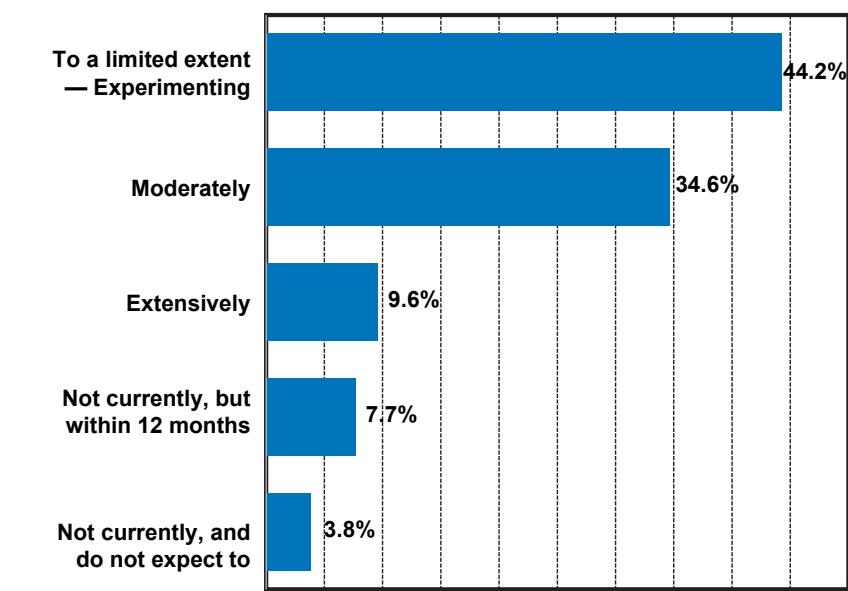
Despite continued volatility, executives have also grown more sanguine about the stock market. Nearly half (48.1%) expect it to end 2027 within 5% of its current level, up from 37.7% last quarter. Another 15.4% expect a gain of 5% to 10%, and the same share a decline of 5% to 10%. Most striking, only 5.8% now anticipate a correction of 10% to 20%, down from 26.4% last quarter. The rest expect gains of more than 10% or are unsure. Executives appear less worried about a market pullback than we are.

Despite continued volatility, executives have also grown more sanguine about the stock market. Nearly half (48.1%) expect it to end 2027 within 5% of its current level, up from 37.7% last quarter.

AI Adoption and Benefits

Given AI's growing role in business, we asked executives how their companies use the technology and what benefits they have seen. The answer: AI adoption in Orange County is broad but shallow. Nearly all firms are using or planning to use it, but only 9.6% use it extensively across multiple areas of their business. Another 34.6% use it regularly but only in selected areas, while more than half (51.9%) are still experimenting, using it sparingly or planning to deploy it within the next year (Figure 77). Just 3.8% have no plans to use AI at all.

FIGURE 77
Nearly Everyone Is Trying AI, Few Are All In
(OCBX survey, percent of respondents)

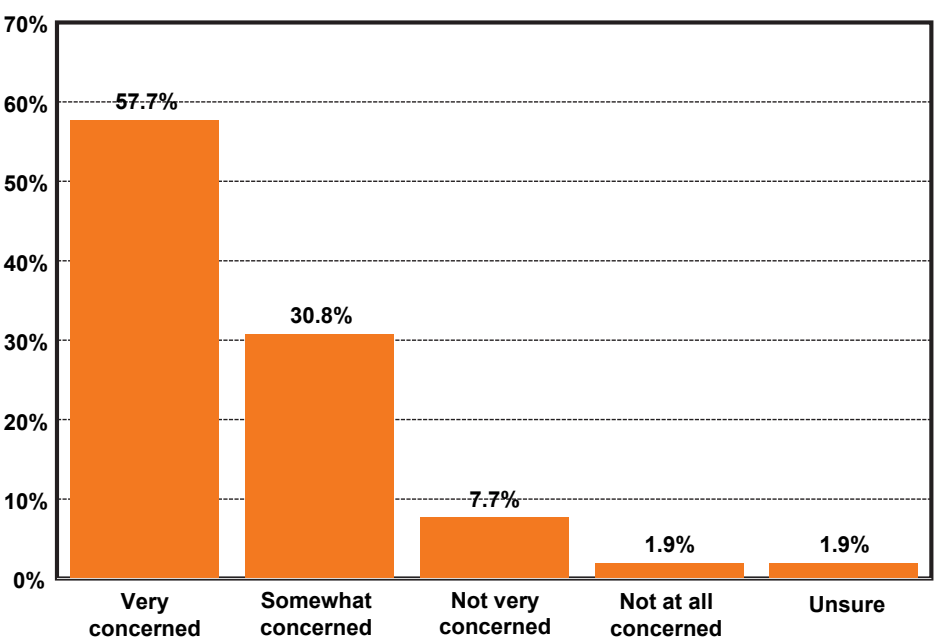


As previously discussed, productivity remains the payoff executives value most: 53.8% named it as AI’s primary benefit, in line with national studies. Others cited better customer service, lower operating costs and higher sales, and some a reduced need to hire, an early hint of the labor-market effects discussed earlier.

Proposed Wealth Tax and Relocation Risk

We also asked executives whether the wealth-tax measure on the Nov. 3 ballot could prompt high-income individuals, entrepreneurs or businesses to move investment or economic activity out of California. Their answer was as close to unanimous as it gets: 88.5% expressed concern, including 57.7% who were very concerned and 30.8% somewhat concerned (Figure 78). Only 9.6% were not very or not at all concerned, and 1.9% were unsure.

FIGURE 78
The Vast Majority Are Concerned About the Wealth Tax and Implications for Relocation
(OCBX Survey, percent of respondents)

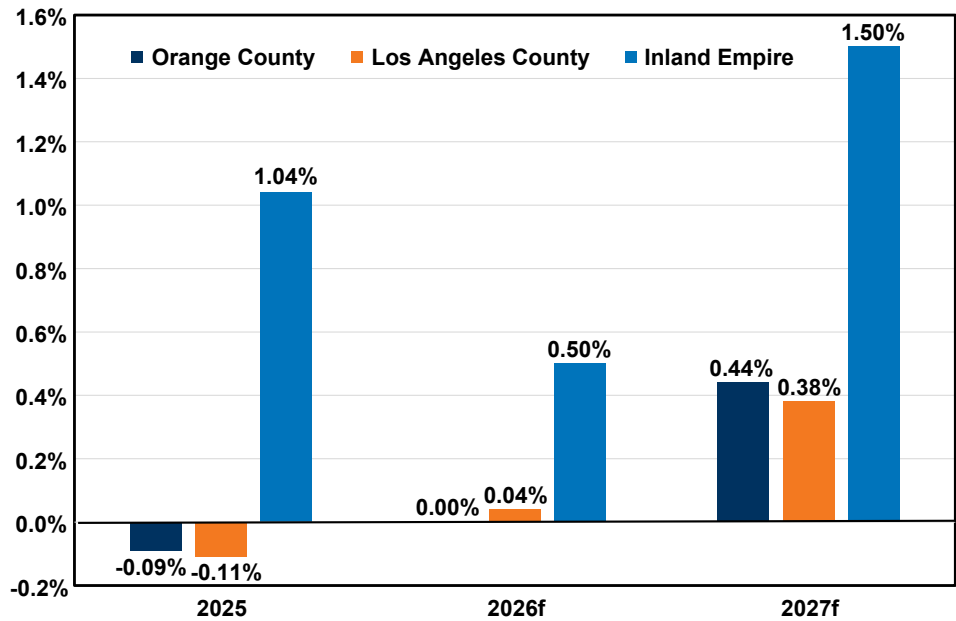


Employment Forecasts

Employment growth has remained subdued both nationally and regionally over the past two years. Although we expect real output (GDP) to continue growing at a healthy pace in the near term, labor markets are likely to remain sluggish. Restrictive immigration policies, an aging population and productivity gains will constrain labor force and employment growth rates. In Southern California, we expect Orange County payroll employment to show little change this year and grow by just 0.44% in 2027 (Figure 79).

Employment growth has remained subdued both nationally and regionally over the past two years. Although we expect real output (GDP) to continue growing at a healthy pace in the near term, labor markets are likely to remain sluggish.

FIGURE 79
Employment Forecasts: Strong GDP but Weak Payrolls
(y-o-y percent change)



The county’s unemployment rate is projected to remain at 4.1% in 2026, unchanged from last year, before rising to 4.3% in 2027. Los Angeles County is expected to see its payroll employment grow only 0.04% this year before increasing by 0.38% next year, while its unemployment rate is expected to be 5.3% in 2026 and 5.5% in 2027. The Inland Empire is expected to fare somewhat better, with payroll employment growing by 0.5% this year and 1.5% in 2027. Its unemployment rate is projected at 5.3% this year and 5.6% in 2027. In summary, while we expect the region’s employment levels to improve somewhat next year compared to the last two years, they will remain substantially below their historical averages.

Detailed forecasts are provided in the tables at the end of this report.

TABLE 1 - NATIONAL

	2021	2022	2023	2024	2025	2026f	2027f	2028f	3-Year Average 2026-2028
GDP									
Real GDP (Bil. \$)	21,556	22,080	22,724	23,395	23,943	23,933	24,507	25,120	24,520
% change RGDP	6.3	2.4	2.9	3.0	2.3	2.3	2.4	2.5	2.4
Nominal GDP (Bil. \$)	23,746	26,060	27,826	29,381	30,861	31,173	33,044	34,927	33,048
% change Nominal GDP	11.1	9.7	6.8	5.6	5.0	6.1	6.0	5.7	5.9
RGDP Components									
Personal Consumption (% change)	8.84	2.91	2.3	2.9	2.6	2.3	2.4	2.2	2.3
Business Fixed Investments (% change)	6.3	6.4	7.7	3.9	5.4	6.8	6.2	5.5	6.2
Residential Investments (% change)	10.7	-8.2	-8.1	3.2	-2.7	-3.2	1.9	3.5	0.7
Exports (% change)	6.5	7.6	2.8	3.6	2.1	5.1	3.6	3.0	3.9
Imports (% change)	14.3	8.2	-0.8	5.9	3.6	3.6	5.5	3.5	4.2
Net Exports (Bil. \$)	-841	-918	-763	-882	-921	-1,101	-1,234	-1,290	-1,208
Federal Deficit (Bil. \$)	-2,774	-1,374	-1,687	-1,815	-1,775	-2,100	-1,989	-2,075	-2,055
Labor Sector									
Unemployment Rate (%)	5.4	3.7	3.6	4.0	4.3	4.2	4.4	4.3	4.3
Payroll Employment (% change)	2.9	4.3	2.2	1.2	0.5	0.3	0.6	0.8	0.6
Average Weekly Hours (saar)	34.8	34.6	34.4	34.3	34.2	34.2	34.3	34.4	34.3
Labor Productivity (% change)	2.1	-1.5	2.1	2.9	2.3	2.2	2.4	2.6	2.4
Prices and Wages									
CPI (% change)	4.7	8.0	4.1	2.9	2.6	3.5	2.8	2.2	2.8
Core CPI (% change)	3.6	6.2	4.8	3.4	2.8	2.7	2.5	2.3	2.5
PCE Deflator (% change)	4.0	6.6	3.9	2.6	2.6	3.2	2.6	2.0	2.6
Core PCE Deflator (% change)	3.5	5.4	4.2	2.9	2.8	3.0	2.7	2.3	2.7
Employment Cost Index (% change)	3.3	4.9	4.5	4.0	3.5	3.5	3.4	3.3	3.4
Income/Profits									
Personal Income (% change)	9.6	3.0	6.7	5.9	5.1	4.6	4.7	5.2	4.8
Real Disposable Income (% change)	8.2	0.6	10.0	5.9	4.3	0.9	2.1	2.3	1.8
Savings Rate (% of disp. income)	11.4	3.5	6.1	6.3	5.4	4.4	4.5	4.7	4.5
After-Tax Profits (% change)	25.2	5.2	7.0	3.9	10.1	14.2	5.2	5.8	8.4
Financial Markets (year-end)									
Federal Funds Rate (Upper range) (%)	0.25	4.50	5.50	4.50	3.75	4.25	4.75	4.50	4.50
3-Month T-bill rate (%)	0.06	4.30	5.20	4.23	3.57	4.12	4.35	4.18	4.22
10-Year Treasury Note (%)	1.52	3.88	3.88	4.58	4.18	5.12	5.34	5.05	5.17
30-Year Fixed Mortgage Rate (%)	3.11	6.42	6.61	6.85	6.15	7.35	7.42	6.80	7.19
Exchange Rate, Major Trading Partners (% change)	3.6	5.3	-2.5	9.2	-7.4	5.1	-2.9	-2.1	0.03
Other Key Measures									
Crude Oil - Brent (\$ per Barrel)	70.9	100.9	82.5	80.5	69.1	92.0	84	71	82.3
Industrial Production (% change)	4.4	1.7	-0.2	-0.7	1.1	1.6	2.1	1.8	1.8
Housing Starts (Mill. Units, saar)	1.60	1.55	1.42	1.37	1.36	1.32	1.32	1.38	1.3
Light Vehicle Sales (Mill. Units, saar)	14.9	13.8	15.5	15.9	16.3	16.0	16.3	16.8	16.4

TABLE 2 - ORANGE COUNTY

	2021	2022	2023	2024	2025	2026f	2027f	2028f	3-Year Average 2026-2028
<i>Levels in Thousands</i>									
Household Employment									
Labor Force	1572.8	1596.3	1612.1	1627.5	1636.7	1608.9	1603.5	1607.7	1,606.7
Total Employment	1479.1	1545.2	1556.1	1563.9	1569.0	1542.9	1534.5	1540.2	1,539.2
Total Unemployment	93.7	51.2	56.1	63.6	67.7	66.0	68.9	67.5	67.5
Unemployment Rate	6.0%	3.2%	3.5%	3.9%	4.1%	4.1%	4.3%	4.2%	4.2%
Wage and Salary Employment									
Total Nonfarm	1,587.8	1,666.0	1,677.5	1,690.2	1,688.6	1,688.7	1,695.4	1,709.4	1,697.8
Goods Producing	252.3	261.1	261.4	261.0	254.1	254.1	252.0	264.7	256.9
Mining and Logging	0.4	0.3	0.3	0.4	0.3	0.3	0.3	0.4	0.3
Construction	102.2	105.3	104.5	105.6	104.0	104.0	104.5	121.8	110.1
Manufacturing	149.8	155.4	156.6	154.9	149.8	149.8	147.2	142.5	146.5
Durable Goods	111.4	116.1	117.8	116.8	112.6	112.6	111.8	115.4	113.3
Nondurable Goods	38.3	39.4	38.8	38.2	37.2	37.2	35.4	27.1	33.2
Service Providing	1,335.5	1,404.9	1,416.1	1,429.2	1,434.5	1,434.6	1,443.3	1,444.8	1,440.9
Trade, Transportation and Utilities	252.0	258.3	262.5	260.8	256.7	256.7	257.4	271.6	261.9
Wholesale Trade	77.5	79.0	81.1	80.5	78.0	78.0	78.2	91.5	82.6
Retail Trade	143.4	145.5	145.8	144.7	143.6	143.6	145.5	149.5	146.2
Transportation, Warehousing and Utilities	31.1	33.8	35.7	35.6	35.1	35.1	33.7	30.6	33.1
Information	24.0	24.3	22.7	22.2	22.5	22.5	22.0	26.4	23.6
Financial Activities	117.1	112.3	103.7	103.9	103.4	103.4	103.0	92.9	99.8
Professional and Business Services	321.7	331.5	320.1	316.9	317.2	317.2	319.2	351.9	329.4
Educational and Health Services	237.3	249.2	262.2	272.6	284.1	284.2	295.3	327.2	302.2
Leisure and Hospitality	180.4	217.9	229.8	234.2	236.0	236.1	241.1	164.1	213.8
Other Services	47.5	53.1	55.2	56.1	55.6	55.6	56.2	57.5	56.4
Government	155.7	158.2	159.8	162.7	159.0	158.9	149.1	153.2	153.8
<i>Percentage change</i>									
Total Nonfarm	3.6%	4.9%	0.7%	0.8%	-0.1%	0.0%	0.4%	0.8%	0.4%
Goods Producing	0.2%	3.5%	0.1%	-0.2%	-2.6%	0.0%	-0.8%	5.0%	1.4%
Mining and Logging	7.0%	-15.2%	-7.7%	33.3%	-18.8%	-0.1%	-6.2%	29.9%	7.9%
Construction	0.8%	3.1%	-0.7%	1.0%	-1.6%	0.0%	0.5%	16.5%	5.7%
Manufacturing	-0.2%	3.8%	0.7%	-1.0%	-3.3%	0.0%	-1.7%	-3.2%	-1.6%
Durable Goods	-0.8%	4.1%	1.5%	-0.9%	-3.6%	0.0%	-0.7%	3.2%	0.8%
Nondurable Goods	1.6%	2.7%	-1.5%	-1.5%	-2.6%	0.0%	-4.8%	-23.5%	-9.4%
Service Providing	4.3%	5.2%	0.8%	0.9%	0.4%	0.0%	0.6%	0.1%	0.2%
Trade, Transportation and Utilities	3.2%	2.5%	1.6%	-0.7%	-1.6%	0.0%	0.3%	5.5%	1.9%
Wholesale Trade	0.9%	1.9%	2.7%	-0.7%	-3.1%	0.0%	0.3%	16.9%	5.7%
Retail Trade	4.2%	1.5%	0.2%	-0.8%	-0.8%	0.0%	1.4%	2.7%	1.4%
Transportation, Warehousing and Utilities	4.9%	8.9%	5.4%	-0.1%	-1.5%	0.0%	-4.0%	-9.1%	-4.4%
Information	-0.3%	1.0%	-6.6%	-2.2%	1.2%	0.0%	-2.1%	20.1%	6.0%
Financial Activities	1.0%	-4.0%	-7.7%	0.1%	-0.4%	0.0%	-0.4%	-9.8%	-3.4%
Professional and Business Services	4.0%	3.1%	-3.4%	-1.0%	0.1%	0.0%	0.6%	10.2%	3.6%
Educational and Health Services	5.1%	5.0%	5.2%	3.9%	4.2%	0.0%	3.9%	10.8%	4.9%
Leisure and Hospitality	11.5%	20.8%	5.5%	1.9%	0.8%	0.0%	2.1%	-31.9%	-9.9%
Other Services	7.5%	12.0%	3.9%	1.5%	-0.8%	0.0%	1.0%	2.3%	1.1%
Government	-0.3%	1.6%	1.0%	1.8%	-2.2%	-0.1%	-6.2%	2.8%	-1.2%

TABLE 3 - SOUTHERN CALIFORNIA

	2021	2022	2023	2024	2025	2026f	2027f	2028f	3-Year Average 2026-2028
<i>Levels in Thousands</i>									
Household Employment									
Labor Force	9,115.5	9,192.1	9,277.8	9,372.2	9,419.7	9,275.7	9,233.9	9,290.6	9,266.8
Total Employment	8,389.2	8,784.0	8,845.5	8,879.6	8,921.5	8,805.9	8,745.9	8,813.8	8,788.6
Total Unemployment	726.2	408.1	432.5	492.7	498.2	469.8	488.0	476.8	478.2
Unemployment Rate	8.0%	4.4%	4.7%	5.3%	5.3%	5.1%	5.3%	5.1%	5.2%
Wage and Salary Employment									
Total Nonfarm	7,767.6	8,169.9	8,220.3	8,305.7	8,317.5	8,327.6	8,377.0	8,474.1	8,392.9
Goods Producing	968.3	998.1	994.1	987.0	958.1	954.0	944.9	954.6	951.2
Mining and Logging	4.3	4.5	4.5	4.7	4.7	4.7	4.8	5.0	4.8
Construction	378.4	389.2	389.1	391.2	378.2	377.0	378.6	405.5	387.0
Manufacturing	585.5	604.4	600.6	591.1	575.3	572.3	561.6	544.1	559.4
Durable Goods	375.7	385.8	387.1	382.0	369.9	368.7	367.5	368.0	368.1
Nondurable Goods	209.8	218.6	213.5	209.2	205.4	203.6	194.1	176.1	191.3
Service Providing	6,799.3	7,171.8	7,226.2	7,318.7	7,359.4	7,373.6	7,432.1	7,519.5	7,441.7
Trade, Transportation and Utilities	1,564.8	1,614.0	1,599.7	1,583.6	1,564.0	1,563.4	1,564.5	1,586.4	1,571.4
Wholesale Trade	359.9	365.4	361.7	354.5	345.1	345.5	346.6	361.3	351.1
Retail Trade	752.9	768.5	770.0	761.4	753.3	754.8	759.8	767.7	760.8
Transportation, Warehousing and Utilities	452.1	480.1	468.0	467.7	465.6	463.2	458.1	457.3	459.5
Information	249.3	276.1	232.9	228.2	215.2	214.3	213.2	228.3	218.6
Financial Activities	391.5	390.1	374.5	370.9	365.3	363.4	361.0	352.2	358.9
Professional and Business Services	1,163.2	1,217.0	1,185.1	1,179.0	1,177.7	1,174.2	1,171.9	1,189.9	1,178.7
Educational and Health Services	1,385.1	1,439.0	1,523.0	1,610.2	1,693.5	1,714.8	1,773.8	1,885.8	1,791.5
Leisure and Hospitality	807.5	948.4	989.8	996.1	993.5	994.0	1,005.9	921.3	973.8
Other Services	235.6	262.9	271.8	275.9	274.6	275.6	280.0	282.6	279.4
Government	1,002.4	1,024.3	1,049.4	1,074.9	1,075.7	1,073.9	1,061.7	1,073.1	1,069.6
<i>Percentage change</i>									
Total Nonfarm	3.7%	5.2%	0.6%	1.0%	0.1%	0.1%	0.6%	1.2%	0.6%
Goods Producing	0.7%	3.1%	-0.4%	-0.7%	-2.9%	-0.4%	-1.0%	1.0%	-0.1%
Mining and Logging	0.2%	4.8%	-1.7%	4.7%	-0.2%	0.6%	1.6%	4.4%	2.2%
Construction	2.4%	2.8%	0.0%	0.5%	-3.3%	-0.3%	0.4%	7.1%	2.4%
Manufacturing	-0.3%	3.2%	-0.6%	-1.6%	-2.7%	-0.5%	-1.9%	-3.1%	-1.8%
Durable Goods	-1.7%	2.7%	0.3%	-1.3%	-3.1%	-0.3%	-0.3%	0.2%	-0.2%
Nondurable Goods	2.3%	4.2%	-2.3%	-2.0%	-1.8%	-0.9%	-4.7%	-9.3%	-4.9%
Service Providing	4.2%	5.5%	0.8%	1.3%	0.6%	0.2%	0.8%	1.2%	0.7%
Trade, Transportation and Utilities	5.1%	3.1%	-0.9%	-1.0%	-1.2%	0.0%	0.1%	1.4%	0.5%
Wholesale Trade	1.2%	1.5%	-1.0%	-2.0%	-2.6%	0.1%	0.3%	4.3%	1.6%
Retail Trade	5.0%	2.1%	0.2%	-1.1%	-1.1%	0.2%	0.7%	1.0%	0.6%
Transportation, Warehousing and Utilities	8.6%	6.2%	-2.5%	-0.1%	-0.4%	-0.5%	-1.1%	-0.2%	-0.6%
Information	7.7%	10.8%	-15.7%	-2.0%	-5.7%	-0.4%	-0.5%	7.1%	2.1%
Financial Activities	0.7%	-0.4%	-4.0%	-1.0%	-1.5%	-0.5%	-0.7%	-2.4%	-1.2%
Professional and Business Services	5.2%	4.6%	-2.6%	-0.5%	-0.1%	-0.3%	-0.2%	1.5%	0.3%
Educational and Health Services	3.1%	3.9%	5.8%	5.7%	5.2%	1.3%	3.4%	6.3%	3.7%
Leisure and Hospitality	11.1%	17.5%	4.4%	0.6%	-0.3%	0.1%	1.2%	-8.4%	-2.4%
Other Services	6.4%	11.6%	3.4%	1.5%	-0.5%	0.4%	1.6%	0.9%	1.0%
Government	-1.6%	2.2%	2.4%	2.4%	0.1%	-0.2%	-1.1%	1.1%	-0.1%

TABLE 4 - LOS ANGELES COUNTY

	2021	2022	2023	2024	2025	2026f	2027f	2028f	3-Year Average 2026-2028
<i>Levels in Thousands</i>									
Household Employment									
Labor Force	5019.9	5036.8	5064.7	5106.4	5103.4	5031.7	4963.7	4969.8	4,988.4
Total Employment	4569.8	4786.0	4808.3	4812.4	4816.6	4765.0	4690.7	4706.4	4,720.7
Total Unemployment	450.1	250.8	256.5	294.0	286.8	266.7	273.0	263.4	267.7
Unemployment Rate	9.0%	5.0%	5.1%	5.8%	5.6%	5.3%	5.5%	5.3%	5.4%
Wage and Salary Employment									
Total Nonfarm	4,305.1	4,532.1	4,548.5	4,597.8	4,592.7	4,594.5	4,611.9	4,651.7	4,619.4
Goods Producing	463.8	474.7	471.3	465.9	451.4	450.5	442.4	434.1	442.3
Mining and Logging	1.6	1.7	1.7	1.7	1.7	1.7	1.8	2.0	1.8
Construction	149.0	151.3	151.2	151.6	146.5	146.4	146.3	151.8	148.2
Manufacturing	313.1	321.7	318.4	312.6	303.3	302.4	294.3	280.3	292.3
Durable Goods	186.0	189.5	190.2	187.8	181.8	181.7	181.0	176.9	179.9
Nondurable Goods	127.1	132.2	128.3	124.9	121.5	120.7	113.2	103.3	112.4
Service Providing	3,841.3	4,057.4	4,077.2	4,131.9	4,141.2	4,143.9	4,169.5	4,217.6	4,177.0
Trade, Transportation and Utilities	814.0	833.5	822.8	812.0	799.3	798.8	794.2	791.9	795.0
Wholesale Trade	202.6	204.4	200.1	194.8	189.2	189.2	188.6	188.2	188.6
Retail Trade	396.1	405.5	404.8	398.8	393.6	393.8	395.5	396.2	395.2
Transportation, Warehousing and Utilities	215.2	223.6	217.9	218.5	216.5	215.9	210.1	207.5	211.2
Information	208.8	234.9	193.1	189.6	177.0	176.9	176.7	187.5	180.4
Financial Activities	213.2	215.7	210.5	207.7	203.4	203.2	201.4	203.1	202.6
Professional and Business Services	631.3	667.4	657.2	657.4	660.2	659.8	655.6	639.1	651.5
Educational and Health Services	843.9	870.6	919.0	967.0	1,007.1	1,010.1	1,039.3	1,089.2	1,046.2
Leisure and Hospitality	434.2	512.4	534.1	537.5	533.1	533.9	541.6	541.5	539.0
Other Services	135.7	153.0	157.4	159.0	158.0	158.4	161.9	162.9	161.1
Government	560.2	570.0	583.1	601.7	603.2	602.7	598.8	602.3	601.3
<i>Percentage change</i>									
Total Nonfarm	3.3%	5.3%	0.4%	1.1%	-0.1%	0.0%	0.4%	0.9%	0.4%
Goods Producing	0.0%	2.4%	-0.7%	-1.2%	-3.1%	-0.2%	-1.8%	-1.9%	-1.3%
Mining and Logging	-6.7%	3.6%	0.0%	-0.5%	0.5%	0.8%	7.6%	9.8%	6.1%
Construction	1.7%	1.6%	-0.1%	0.2%	-3.4%	0.0%	-0.1%	3.8%	1.2%
Manufacturing	-0.7%	2.7%	-1.0%	-1.8%	-3.0%	-0.3%	-2.7%	-4.8%	-2.6%
Durable Goods	-2.2%	1.9%	0.3%	-1.3%	-3.2%	0.0%	-0.4%	-2.3%	-0.9%
Nondurable Goods	1.6%	4.0%	-3.0%	-2.7%	-2.7%	-0.7%	-6.2%	-8.8%	-5.2%
Service Providing	3.7%	5.6%	0.5%	1.3%	0.2%	0.1%	0.6%	1.2%	0.6%
Trade, Transportation and Utilities	3.7%	2.4%	-1.3%	-1.3%	-1.6%	-0.1%	-0.6%	-0.3%	-0.3%
Wholesale Trade	0.8%	0.9%	-2.1%	-2.7%	-2.8%	0.0%	-0.3%	-0.2%	-0.2%
Retail Trade	5.4%	2.4%	-0.2%	-1.5%	-1.3%	0.0%	0.5%	0.2%	0.2%
Transportation, Warehousing and Utilities	3.5%	3.9%	-2.5%	0.3%	-0.9%	-0.3%	-2.7%	-1.3%	-1.4%
Information	9.3%	12.5%	-17.8%	-1.8%	-6.7%	0.0%	-0.1%	6.2%	2.0%
Financial Activities	0.0%	1.2%	-2.4%	-1.3%	-2.1%	-0.1%	-0.9%	0.8%	-0.1%
Professional and Business Services	5.0%	5.7%	-1.5%	0.0%	0.4%	-0.1%	-0.6%	-2.5%	-1.1%
Educational and Health Services	2.8%	3.2%	5.6%	5.2%	4.1%	0.3%	2.9%	4.8%	2.7%
Leisure and Hospitality	10.3%	18.0%	4.2%	0.6%	-0.8%	0.2%	1.4%	0.0%	0.5%
Other Services	5.4%	12.7%	2.9%	1.0%	-0.6%	0.2%	2.2%	0.6%	1.0%
Government	-1.8%	1.7%	2.3%	3.2%	0.3%	-0.1%	-0.6%	0.6%	0.0%

TABLE 5 - INLAND EMPIRE (RIVERSIDE AND SAN BERNARDINO COUNTIES)

	2021	2022	2023	2024	2025	2026f	2027f	2028f	3-Year Average 2026-2028
<i>Levels in Thousands</i>									
Household Employment									
Labor Force	2114.3	2145.6	2183.1	2214.8	2253.1	2217.4	2251.8	2299.1	2,256.1
Total Employment	1957.1	2054.8	2080.6	2099.0	2129.9	2099.9	2125.7	2172.7	2,132.8
Total Unemployment	157.2	90.8	102.5	115.8	123.1	117.5	126.1	126.5	123.4
Unemployment Rate	7.4%	4.2%	4.7%	5.2%	5.5%	5.3%	5.6%	5.5%	5.5%
Wage and Salary Employment									
Total Nonfarm	1,575.1	1,660.2	1,680.0	1,699.6	1,717.3	1,726.4	1,751.6	1,794.3	1,757.4
Goods Producing	207.7	216.3	215.3	213.6	206.8	203.6	205.1	209.8	206.2
Mining and Logging	1.4	1.5	1.5	1.6	1.6	1.7	1.6	1.6	1.6
Construction	110.1	114.7	115.4	115.9	110.0	108.8	110.3	114.0	111.0
Manufacturing	96.1	100.0	98.5	96.1	95.2	93.1	93.2	94.3	93.5
Durable Goods	60.0	61.3	60.0	58.2	56.6	55.5	55.7	56.7	55.9
Nondurable Goods	36.2	38.7	38.4	37.9	38.5	37.7	37.5	37.7	37.6
Service Providing	1,367.4	1,443.9	1,464.7	1,486.0	1,510.5	1,522.8	1,546.5	1,584.5	1,551.3
Trade, Transportation and Utilities	443.2	464.9	457.9	455.7	453.8	454.0	459.3	468.8	460.7
Wholesale Trade	67.4	69.5	68.9	68.4	67.3	67.8	69.3	71.3	69.4
Retail Trade	177.0	181.0	183.0	182.3	181.4	182.8	184.6	187.0	184.8
Transportation, Warehousing and Utilities	198.8	214.4	206.0	205.0	205.2	203.4	205.5	210.5	206.5
Information	12.5	13.0	13.3	12.8	12.1	11.4	11.1	10.9	11.1
Financial Activities	45.2	46.0	44.9	44.1	43.4	42.4	42.1	42.1	42.2
Professional and Business Services	166.6	173.9	164.4	161.3	157.4	154.8	154.9	156.7	155.4
Educational and Health Services	254.3	267.9	287.8	312.5	341.0	357.3	376.1	405.2	379.5
Leisure and Hospitality	160.2	180.9	187.6	186.4	186.7	187.0	184.9	178.8	183.6
Other Services	43.6	47.4	49.4	51.0	51.0	51.6	51.9	52.3	51.9
Government	242.0	250.0	259.3	262.2	265.1	264.4	266.2	269.7	266.8
<i>Percentage change</i>									
Total Nonfarm	5.3%	5.4%	1.2%	1.2%	1.0%	0.5%	1.5%	2.4%	1.5%
Goods Producing	2.7%	4.1%	-0.5%	-0.8%	-3.2%	-1.6%	0.7%	2.3%	0.5%
Mining and Logging	10.4%	8.8%	-4.9%	8.0%	3.7%	0.8%	-1.8%	-4.1%	-1.7%
Construction	5.0%	4.2%	0.5%	0.5%	-5.1%	-1.1%	1.4%	3.3%	1.2%
Manufacturing	0.2%	4.0%	-1.6%	-2.4%	-1.0%	-2.1%	0.1%	1.2%	-0.3%
Durable Goods	-2.1%	2.3%	-2.1%	-3.1%	-2.7%	-2.1%	0.4%	1.8%	0.0%
Nondurable Goods	4.1%	7.0%	-0.8%	-1.3%	1.7%	-2.3%	-0.5%	0.5%	-0.8%
Service Providing	5.7%	5.6%	1.4%	1.5%	1.6%	0.8%	1.6%	2.5%	1.6%
Trade, Transportation and Utilities	8.9%	4.9%	-1.5%	-0.5%	-0.4%	0.0%	1.2%	2.1%	1.1%
Wholesale Trade	2.8%	3.1%	-0.9%	-0.7%	-1.6%	0.8%	2.1%	2.9%	1.9%
Retail Trade	4.9%	2.2%	1.1%	-0.4%	-0.5%	0.8%	1.0%	1.3%	1.0%
Transportation, Warehousing and Utilities	15.2%	7.9%	-3.9%	-0.5%	0.1%	-0.8%	1.0%	2.5%	0.9%
Information	1.1%	3.9%	2.7%	-3.9%	-5.2%	-5.8%	-3.0%	-1.8%	-3.5%
Financial Activities	2.5%	1.8%	-2.3%	-1.9%	-1.5%	-2.3%	-0.7%	-0.1%	-1.0%
Professional and Business Services	9.5%	4.4%	-5.4%	-1.9%	-2.4%	-1.7%	0.1%	1.2%	-0.1%
Educational and Health Services	2.2%	5.4%	7.4%	8.6%	9.1%	4.8%	5.3%	7.7%	5.9%
Leisure and Hospitality	13.3%	12.9%	3.7%	-0.6%	0.2%	0.2%	-1.1%	-3.3%	-1.4%
Other Services	8.4%	8.9%	4.2%	3.2%	-0.1%	1.1%	0.7%	0.9%	0.9%
Government	-2.4%	3.3%	3.7%	1.1%	1.1%	-0.2%	0.7%	1.3%	0.6%

TABLE 6 - VENTURA COUNTY

	2021	2022	2023	2024	2025	2026f	2027f	2028f	3-Year Average 2026-2028
<i>Levels in Thousands</i>									
Household Employment									
Labor Force	408.5	413.4	417.9	423.6	426.6	417.7	414.9	414.0	415.5
Total Employment	383.2	398.0	400.5	404.3	406.0	398.1	394.9	394.5	395.8
Total Unemployment	25.3	15.4	17.4	19.3	20.6	19.6	19.9	19.5	19.7
Unemployment Rate	6.2%	3.7%	4.2%	4.6%	4.8%	4.7%	4.8%	4.7%	4.7%
Wage and Salary Employment									
Total Nonfarm	299.6	311.6	314.3	318.1	318.9	318.0	318.2	318.6	318.3
Goods Producing	44.5	46.0	46.1	46.5	45.8	45.8	45.5	45.9	45.7
Mining and Logging	0.9	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Construction	17.1	17.8	18.0	18.0	17.7	17.8	17.5	17.9	17.7
Manufacturing	26.5	27.3	27.1	27.5	27.1	27.0	27.0	27.1	27.0
Durable Goods	18.3	18.9	19.1	19.2	18.9	19.0	19.0	19.0	19.0
Nondurable Goods	8.2	8.4	8.1	8.3	8.1	8.1	8.0	8.0	8.0
Service Providing	255.1	265.6	268.2	271.6	273.1	272.3	272.7	272.7	272.6
Trade, Transportation and Utilities	55.7	57.3	56.5	55.1	54.2	53.9	53.5	54.1	53.8
Wholesale Trade	12.3	12.5	11.6	10.9	10.6	10.5	10.5	10.4	10.5
Retail Trade	36.4	36.5	36.4	35.7	34.8	34.6	34.1	35.0	34.6
Transportation, Warehousing and Utilities	7.0	8.3	8.4	8.5	8.8	8.8	8.8	8.7	8.8
Information	3.9	4.0	3.8	3.6	3.6	3.5	3.5	3.5	3.5
Financial Activities	16.1	16.1	15.3	15.2	15.0	14.4	14.4	14.1	14.3
Professional and Business Services	43.6	44.3	43.4	43.4	42.9	42.4	42.2	42.3	42.3
Educational and Health Services	49.6	51.2	54.0	58.2	61.4	63.2	63.1	64.2	63.5
Leisure and Hospitality	32.8	37.2	38.3	38.0	37.7	37.0	38.4	36.8	37.4
Other Services	8.9	9.4	9.7	9.8	10.0	10.0	10.0	9.9	10.0
Government	44.5	46.1	47.3	48.4	48.4	47.8	47.6	47.8	47.7
<i>Percentage change</i>									
Total Nonfarm	3.2%	4.0%	0.9%	1.2%	0.2%	-0.3%	0.1%	0.1%	0.0%
Goods Producing	2.3%	3.4%	0.1%	1.0%	-1.6%	0.0%	-0.7%	1.0%	0.1%
Mining and Logging	-3.6%	9.3%	2.6%	0.0%	0.0%	0.1%	-0.4%	0.4%	0.1%
Construction	2.3%	3.6%	1.0%	0.4%	-1.8%	0.3%	-1.4%	2.0%	0.3%
Manufacturing	2.6%	3.1%	-0.5%	1.4%	-1.5%	-0.2%	-0.3%	0.4%	0.0%
Durable Goods	-0.7%	3.2%	0.8%	0.9%	-1.6%	0.2%	0.0%	0.3%	0.2%
Nondurable Goods	10.8%	2.7%	-3.6%	2.5%	-1.5%	-1.1%	-0.9%	0.6%	-0.4%
Service Providing	3.3%	4.1%	1.0%	1.3%	0.6%	-0.3%	0.2%	0.0%	-0.1%
Trade, Transportation and Utilities	5.0%	2.9%	-1.4%	-2.5%	-1.6%	-0.5%	-0.8%	1.1%	0.0%
Wholesale Trade	2.6%	1.1%	-6.6%	-6.7%	-2.5%	-1.1%	0.7%	-1.5%	-0.6%
Retail Trade	4.3%	0.5%	-0.3%	-2.0%	-2.6%	-0.4%	-1.4%	2.5%	0.2%
Transportation, Warehousing and Utilities	14.0%	19.0%	1.4%	1.2%	3.6%	-0.3%	0.1%	-0.8%	-0.3%
Information	-1.5%	2.3%	-5.4%	-5.7%	0.2%	-2.3%	0.1%	-1.3%	-1.2%
Financial Activities	2.5%	-0.3%	-4.8%	-0.4%	-1.4%	-4.2%	0.4%	-2.2%	-2.0%
Professional and Business Services	2.4%	1.4%	-1.9%	0.0%	-1.2%	-1.2%	-0.4%	0.2%	-0.5%
Educational and Health Services	2.6%	3.3%	5.4%	7.8%	5.5%	3.0%	-0.2%	1.7%	1.5%
Leisure and Hospitality	8.6%	13.4%	2.8%	-0.7%	-0.8%	-1.8%	3.6%	-4.0%	-0.7%
Other Services	7.2%	5.8%	3.4%	0.4%	2.0%	0.0%	0.3%	-0.7%	-0.1%
Government	-0.6%	3.7%	2.4%	2.4%	0.0%	-1.2%	-0.5%	0.4%	-0.4%



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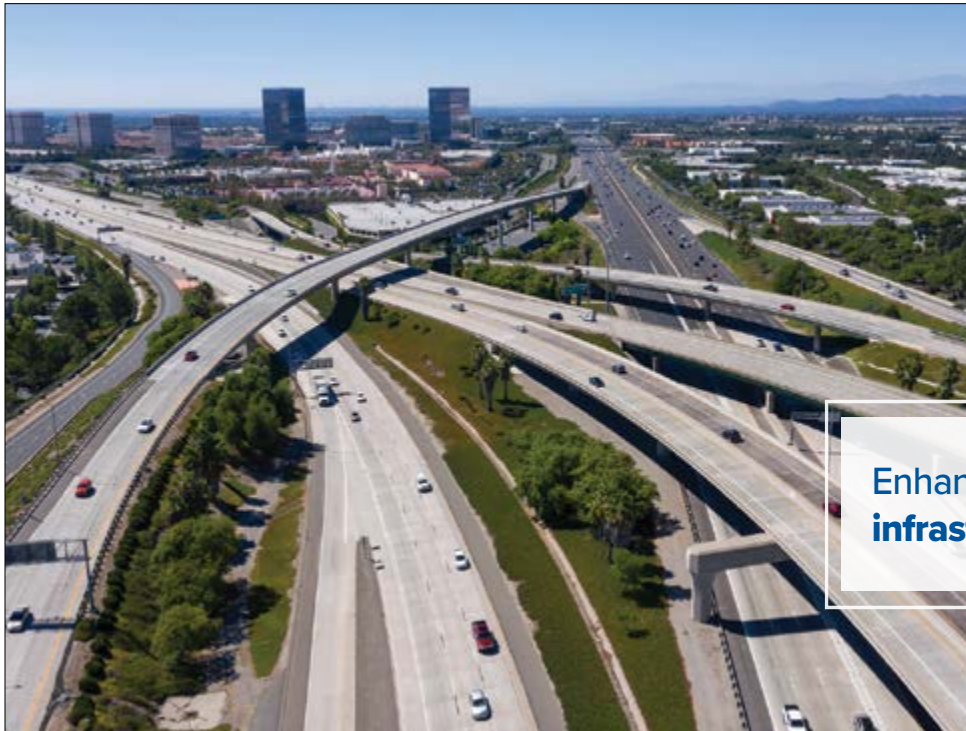
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