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A UNIQUE ENVIRONMENT FOR THE FED AND INVESTORS

Executive Summary

- On September 17, following another set of weak labor market data, the Fed resumed the monetary easing cycle by cutting the policy rate by 25 basis points.
- However, the forecasting environment has not gotten any clearer, and the Fed anticipates two more rate cuts this year even as it projects inflation to rise further, the unemployment rate to remain relatively low, and Gross Domestic Product growth to improve. Investors must grapple with this unusual confluence of factors and its impacts on financial markets.
- Our view is that, given the multitude of dynamics at play keeping inflation structurally higher, an implicit acceptance of above-target inflation could be settling in among policymakers. We believe the longer inflation deviates from 2%, the higher the risk that 3% might be viewed as a more realistic (albeit unofficial) inflation target by market participants.
- More labor market weakness would likely result in faster and deeper rate cuts by the Fed, but it would also engender renewed bouts of volatility across equity and credit markets. On the other hand, should the Fed ease monetary policy conditions just as labor market and economic activity stabilize and credit growth accelerates, inflation could broaden out and intensify.
- Given elevated equity and credit valuation, as well as strong earnings expectations already being baked into market prices, these scenarios could cause a return of volatility over the next few months. Therefore, we recommend remaining diversified across asset classes, a strategy that has proven to dampen the impact of volatility year-to-date.

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Over the past few years, the Federal Reserve's (Fed) effort to balance the two sides of their dual mandate—stable prices and full employment—has been complicated by several factors on both the employment and inflation fronts.

- Inflation has been boosted periodically by supply-side dynamics like Covid-related bottlenecks and, more recently, tariffs. As opposed to demand-driven inflation, which is more directly controllable by adjusting interest rates, the Fed has limited tools to deal with supply-driven price pressures.

- The labor market has faced significant supply-side disruptions as well. Covid caused the labor force to shrink by ~4 million people, and more recently, stricter immigration controls have caused the pace of growth of the labor force to slow down materially—the foreign-born labor force is ~1.5 million people smaller today than it was in March of this year.

It is against this backdrop that the Fed cautiously cut the Fed Funds rate by 100 basis points (bps) between September and December 2024, but then paused in response to heightened inflation concerns due to looming tariffs. On September 17, following another set of weak labor market data, the Fed resumed the monetary easing cycle by cutting the policy rate by 25 bps.

But the forecasting environment has not gotten any clearer, and the Fed anticipates two more rate cuts this year even as it projects inflation to rise further, the unemployment rate to remain relatively low, and Gross Domestic Product (GDP) growth to improve. Investors must grapple with this unusual confluence of factors and its impacts on financial markets.

Below, we delve into several dynamics that make the current economic and market environment unique, and what we think it means from an investment strategy standpoint.

Labor market – the Good, the Bad and the Ugly

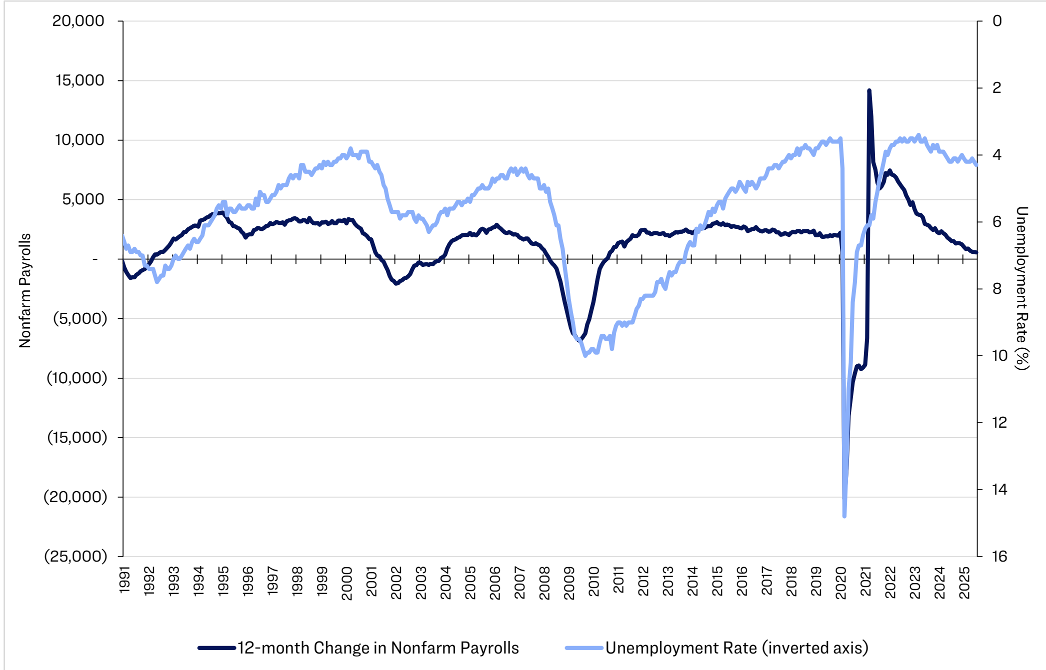
- **The Bad**: U.S. employment growth has slowed down significantly over the past few months, with a declining share of industries contributing to positive job creation, and a rising share shedding jobs. And, while layoffs and the unemployment rate have so far remained relatively contained, there is evidence that corporate demand for new workers has faded, including falling job vacancies. Given historical evidence that employment growth leads the unemployment rate by a few months, our view is that risks facing the labor market have increased (Figure 1).

- **The Ugly**: Routinely, the Bureau of Labor Statistics revises the initial estimates for nonfarm payrolls to expand the original sample (~120,000 businesses) into a population that includes ~95% of all U.S. businesses (more than 12 million). Based on data published two weeks ago and covering the April 2024 to March 2025 period, the initial estimate for nonfarm payrolls was revised lower by 911,000 jobs, suggesting that employment growth started softening well before what initial estimates implied. The revisions also showed that the private sector's nonfarm payrolls, when the healthcare industry is excluded, contracted by almost 300,000 jobs between April 2024 and March 2025.

- **The Good:** Despite the notable step down in the pace of employment growth, income growth has remained remarkably resilient. The annualized pace of disposable income growth, a key determinant of consumer spending, year-to-date is in line with 2024 levels, even after accounting for inflation adjustments. While this resilience could be undermined should labor market conditions continue to weaken, it may be explained by shifting demand and supply dynamics in the labor market, whereby employment growth is slowing, but so is the pool of available workers available to be hired, given the drop in immigration flows.

FIGURE 1

Employment growth historically leads the unemployment rate.



Source: Bureau of Labor Statistics, TIAA Wealth Chief Investment Office

Inflation – Is 3% the new 2%?

Since January and following the implementation of several rounds of country- and product- specific tariffs, the U.S. effective tariff rate has risen from less than 3% to ~16%. We continue to expect this shift to result in a gradual increase in the pace of goods price inflation over the next few quarters, keeping overall consumer price inflation well above the Fed's 2% target and closer to 3% year-over-year (YoY).

This is not an out-of-consensus view: the Fed itself, in its updated Summary of Economic Projections, anticipates core inflation to reach 3% by the end of the year. This complicates the Fed's rationale for resuming interest rate cuts, and both the post-meeting statement and Chair Powell's press conference belied some lingering concerns within the FOMC about price stability. But these concerns were trumped by two narratives that have taken hold within the Fed:

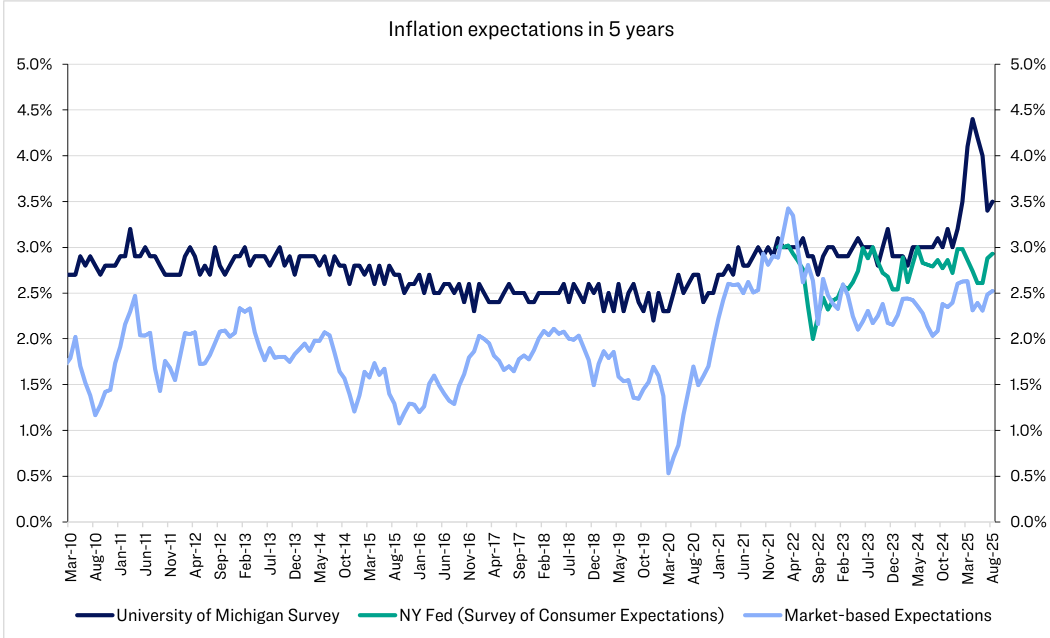
1. **Tariff-driven inflation will be transitory and limited to goods.** However, the past couple of CPI reports pointed to a reacceleration in the pace of service inflation, and the diffusion of price increases within the CPI basket has been broadening.
2. **Inflation expectations remain within historical ranges, therefore reducing the risk of an inflationary spiral.** Evidence is mixed on this front (Figure 2).

Our view is that, given the multitude of dynamics at play keeping inflation structurally higher, an implicit acceptance of above-target inflation could be settling in among policymakers. We believe the longer inflation deviates from 2%, the higher the risk that 3% might be viewed as a more realistic (albeit unofficial) inflation target by market participants, resulting in further increases in the term premium.[1]

1 The excess compensation demanded by investors for owning long-term bonds rather than continuously rolling over short-term bond holdings.

FIGURE 2

Different sources, different inflation expectations.



Source: University of Michigan, Federal Reserve, Bloomberg, TIAA Wealth Chief Investment Office

Economic activity – A mixed bag

There are three growth dynamics we are closely monitoring:

1. After adjusting for inflation, household consumption ran at one of the slowest paces of the past 20 years through July. However, retail sales bounced back over the summer (after slightly contracting between January and May), with an annualized 9% growth rate since May. Importantly, retail sales are not adjusted for inflation, and therefore part of this reacceleration could be due to rising goods prices rather than larger sales volumes.
2. Consumer spending is increasingly supported by a narrow cohort of households. According to Moody's, almost 50% of consumer spending in the U.S. in the second quarter came from households in the top 10% of the income distribution.
3. On a YoY basis, bank lending to businesses has recently picked up pace. On one hand, steeper yield curves increase net interest margins for banks, in turn boosting their appetite for growing their loan books. On the other hand, there are a few dynamics that might be supporting business demand for new loans: lower yields and tight credit spreads; AI-related investments; the One Big Beautiful Bill Act provisions allowing businesses to deduct 100% of qualifying capital expenditures in the year in which they are incurred; and evidence that businesses might be borrowing more to offset tariff-related input price increases.

This backdrop represents a mixed bag for the Fed, as interest rate cuts are resuming when credit growth is potentially accelerating, household consumption has slightly improved from a subdued first half of the year, and yet the divergence between high-income and low-income consumers keeps widening.

Artificial intelligence – A game changer

Artificial intelligence has been a game changer and crucial support for the U.S. economy over the past couple of years:

- As household consumption softened substantially and trade uncertainty clouded the business outlook in the first half of the year, AI-related fixed investments provided a key source of ballast for the U.S. economy.

- Corporate earnings have been boosted by the "Magnificent 7" basket of stocks—companies with immediate exposure to the AI theme—thanks to their role in building the AI infrastructure. We expect the adoption of AI by U.S. businesses to continue to gain speed, in turn leading to faster productivity growth and boosting corporate profit margins.

- The incessant thirst for computing power behind AI has driven a parabolic rise in the construction of data centers, which has offset weakness in more traditional real estate sectors such as offices, warehouses, multifamily housing and commercial buildings (Figure 3).

However, AI also comes with significant adjustments for the U.S. economy. Data centers have been driving a huge surge in electricity demand, and globally they are projected to consume more electricity than Japan by 2030. Since the end of 2020, electricity prices have risen by 35%, compared to a 23% increase in the entire CPI basket. This is one key example of how the historic wave of investments behind the AI revolution might be having a "crowding out"[2] effect on other sectors of the economy, including consumers.

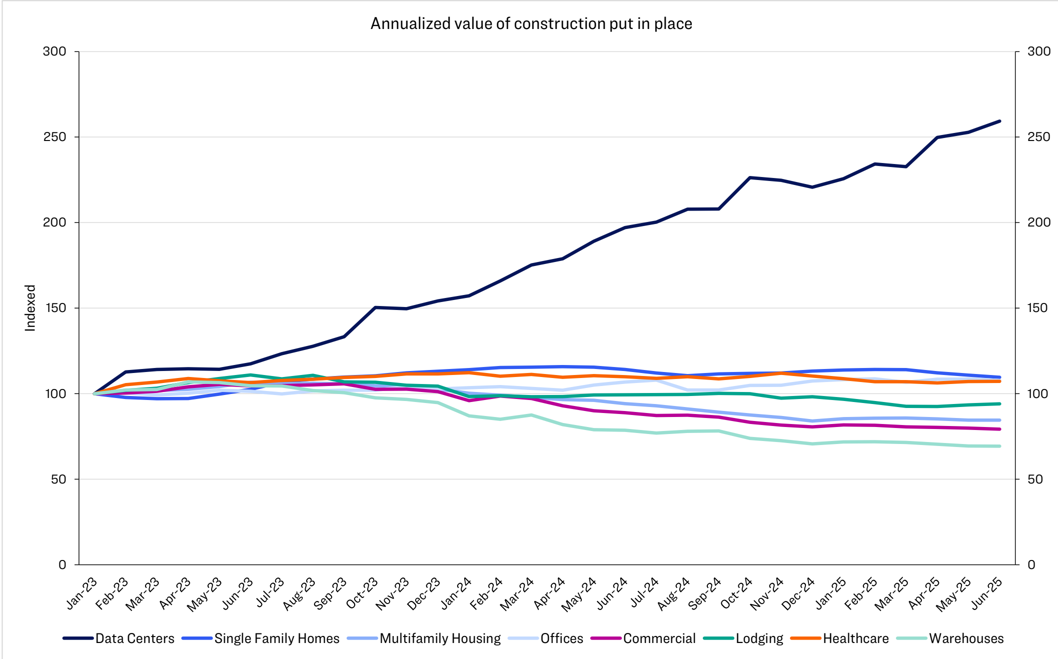
In addition, the effect of AI on the labor market represents a key risk, especially if productivity gains are achieved by reducing the availability of jobs. Over the past two years, the unemployment rate for people in the 20-to-24 age group has risen by almost three percentage points, suggesting that AI may already be impacting jobs that are easier to replace, such as many process-oriented entry-level jobs.

AI holds the promise of generational productivity growth, with positive ramifications for economic growth and corporate earnings. At the same time, AI might also be exacerbating inflationary pressures and labor market softness, therefore further complicating the Fed's dual mandate of stable prices and full employment.

2 AI-related investments and resource consumption compete, or crowd out, for limited resources with other sectors of the economy.

FIGURE 3

Data center construction has risen parabolically over the past two years.



Source: Census Bureau, TIAA Wealth Chief Investment Office

Conclusions – Stay diversified amid a possible return of volatility

The Fed's assessment of the balance of risks facing the U.S. economy is unlikely to get easier any time soon.

- More labor market weakness would likely result in faster and deeper rate cuts by the Fed, but it would also engender renewed bouts of volatility across equity and credit markets.

- On the other hand, should the Fed ease monetary policy conditions just as labor market and economic activity stabilize and credit growth accelerates, inflation could broaden out and intensify. Long-end bond yields would likely rise in response, thereby offsetting the stimulus effect of Fed rate cuts.

Given elevated equity and credit valuation, as well as strong earnings expectations already being baked into market prices, these scenarios could cause a return of volatility over the next few months. Therefore, we recommend remaining diversified across asset classes, a strategy that has proven to dampen the impact of volatility year-to-date. In addition, we think small cap stocks could continue to cover some lost ground against large cap stocks as faster rate cuts or an acceleration in the credit and capital market cycle—more M&A activity and stronger capital expenditures—are historically positive environments for small caps relative to large caps.

On the fixed income side, we favor investment grade bonds over high yield bonds, as historically tight spreads could come under pressure in a higher volatility environment.

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