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In Brief

U.S. equity markets advanced in August despite increased volatility, with the S&P-500 gaining 2.7%. Market leadership continued to rotate beneath the major indexes. Energy and Health Care were among the stronger sectors, while software stocks rebounded sharply following better-than-expected earnings. Semiconductors recovered only modestly from their July correction, highlighting increasing selectivity even within the AI-related sectors. Long-term Treasury yields remained under considerable pressure. The 10-year Treasury yield ended in August close to 4.75%, while the 30-year remained above 5.2%. Persistent inflation, substantial government financing requirements and growing private-sector demand for capital are keeping borrowing costs elevated. Increasingly, the bond market is imposing the financial tightening that investors had expected from the Federal Reserve, with the long end of the Treasury market exerting a growing influence over financial conditions independently of changes in the federal funds rate.

Economy

The U.S. economy entered the third quarter with considerable momentum. The Atlanta Fed's GDP Now model estimated third-quarter growth at 4.6% in late August, supported by consumer spending and particularly strong private investment. Artificial intelligence, data centers, power infrastructure and related equipment spending continue to provide important sources of economic growth. The consumer picture is more mixed. Personal income and spending continued to rise, but the savings rate fell to approximately 3%, leaving households with less financial cushion. Manufacturing remained in expansion territory, while elevated input prices underscored persistent inflationary pressure. The economy therefore appears stronger than expected only a few months ago. The key question is whether this investment-led expansion can continue without generating sufficient inflation to push interest rates still higher.

Labor Market

The labor market has clearly slowed, but unemployment remains low at 4.1%. Conditions vary considerably across industries. Health Care, Construction and Manufacturing remain relatively strong, supported in part by continued investment in AI infrastructure, data centers and domestic production, while weakness is more apparent in Leisure and Hospitality, Retail, Financial Services and parts of Professional and Business Services. AI is also beginning to change the composition of employment. Its impact is most visible in entry-level and routine white-collar hiring, while demand is increasing for experienced workers with AI-related skills and for the construction, electrical and technical workers needed to build AI infrastructure. So far, however, there is little evidence of broad-based AI-related layoffs. Overall, the labor market is increasingly characterized as "low-hire, low-fire;" companies are becoming more selective about adding workers, but layoffs remain historically low.

Monetary Policy

Monetary policy entered a more consequential phase in August. The Federal Reserve kept the federal funds rate unchanged at 3.50%–3.75%, but Chairman Kevin Warsh used his Jackson Hole speech to emphasize that inflation remains the Fed's primary concern. PCE inflation stands at 3.7%, well above the 2% target, while unemployment remains low at 4.1% and layoffs are limited. In Warsh's view, the labor market, therefore, provides the Fed with room to remain focused on price stability. Warsh also reinforced his preference for a "quieter Fed," with less forward guidance and greater reliance on incoming economic and financial-market data. This is particularly relevant as the bond market itself has tightened financial conditions through higher long-term yields. Following Jackson Hole, markets increased the probability of another rate increase, although the September decision remains dependent on incoming inflation and employment data.

Corporate Earnings

Corporate earnings remain an important source of support for equity markets. Second-quarter S&P-500 earnings growth was exceptionally strong, with Technology continuing to lead, while profit growth is broadening beyond the largest AI companies. Software earnings improved notably, while Health Care and selected cyclical industries also showed stronger results. AI investment remains a major earnings driver. U.S. hyperscalers are expected to spend approximately \$800 billion on capital expenditures in 2026, much of it directed toward data centers, semiconductors, networking and power infrastructure. This enormous investment is supporting earnings across the AI ecosystem, but it also raises the importance of returns on invested capital. Investors are becoming more selective in distinguishing companies generating measurable returns from AI investment from those primarily increasing spending.

Food for Thought

The U.S. continues to run a budget deficit of approximately 6% of GDP, requiring substantial Treasury issuance. Yet the size of the debt alone does not indicate a financing problem. The U.S. benefits from the world's deepest capital market and continued strong domestic and foreign demand for Treasuries. Japan alone holds more than \$1 trillion. Importantly, foreign Treasury holdings have increasingly shifted toward private investors, rather than governments and central banks. These investors are more price-sensitive and require adequate yields to absorb growing supply. A potentially important new source of demand is the rapidly growing stablecoin market: dollar-backed stablecoins are largely backed by short-term Treasury securities, potentially creating an additional structural buyer of U.S. government debt while reinforcing the dollar's international role. The Treasury also maintains a cash balance of around \$1 trillion, providing an additional liquidity buffer. The immediate issue is, therefore, not the government's ability to finance itself, but the interest rate required to attract sufficient capital. So far, higher yields have not derailed equities. Strong economic growth and corporate earnings have offset the higher cost of capital, while rising productivity is helping contain unit labor costs and wage-related inflation. Gradually rising yields that reflect stronger growth and productivity are considerably less damaging to equities than a rapid increase driven by inflation or fiscal concerns. The risk would increase if long-term yields continued to rise without a corresponding improvement in earnings and productivity.

Market Outlook

We expect market volatility to remain elevated in September, historically a difficult month for equities, but one that can also create opportunities ahead of the year-end period. The principal concern remains the rise in global bond yields, with the 10-year Treasury near 4.8%. However, current yields do not necessarily signal excessive financial tightening. U.S. nominal GDP grew 6.6% year-over-year in the second quarter, meaning nominal economic growth continues to exceed the 10-year Treasury yield. Recent data reinforce the strength of the economy. The Atlanta Fed's GDP model estimates third-quarter real GDP growth at 4.8%, up from 4.6% in late August, with consumer spending projected to grow 3.5% and private domestic investment 21.8%. Manufacturing remains firmly in an expansion mode at 54.6, while job openings stand at 7.27 million with approximately 1.05 openings for every unemployed worker. Higher yields can coexist with rising equity markets when they reflect strong economic growth and are supported by earnings and productivity gains. We, therefore, remain invested while maintaining a disciplined approach, taking partial profits where valuations have become extended and selectively adding to positions when market weakness creates attractive opportunities.