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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF AUGUST 17, 2026

Bring Back the Tea Party

"I ran for office originally as part of this Tea Party Movement because we were upset with Republicans who've doubled the debt. We were upset with Republicans that bailed out the banks." — Rand Paul

I haven't talked about U.S. debt in a while, but the problem has clearly gotten worse**.** Per the Congressional Budget Office (CBO) we've borrowed an astounding $1.8 trillion this fiscal year, with $431 billion in the month of July alone — equating to nearly $6 billion per day. We're on track to surpassing $2 trillion in borrowing this fiscal year despite not being in a recession. That is not normal.

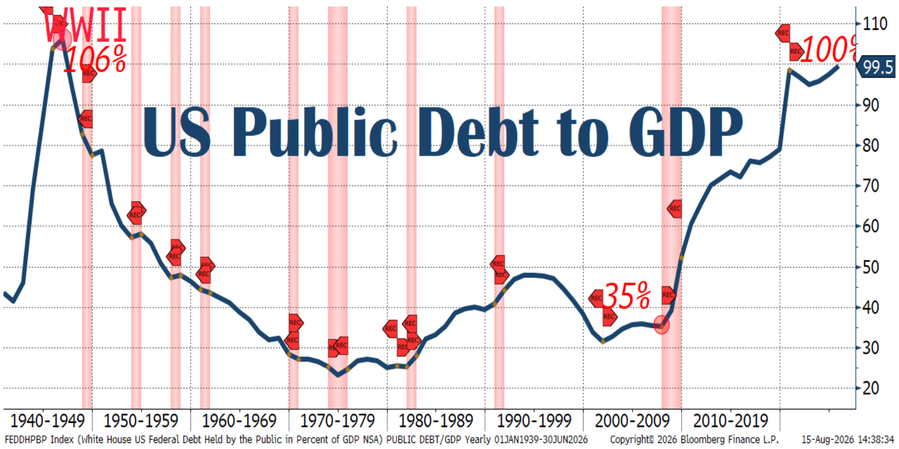
Undoubtedly, both parties are responsible for the fiscal mess we are making; however, the current administration and Congress have made things much worse.

When Trump first entered office the U.S. deficit as percentage of gross domestic product (GDP) was less than 5%. Fast-forward to today: The fiscal year 2025 deficit came in at $1.8 trillion — 5.9% of GDP, about 55% above the 50-year historical average of 3.8% of GDP. And it's headed the wrong way. Sadly, whoever is in the White House, the deficit keeps landing in roughly the same trap.

THIS WEEK

Incredibly, such an enormous level of borrowing barely scratches the surface of our fiscal deterioration. We are about to hit the sobering milestone of $40 trillion in gross national debt, and things are only likely to get worse. By 2031, the deficit will be over $50 trillion. That's assuming no recession.

Deficits are rising fast, the population is aging, healthcare and pension promises are underfunded, interest costs will soon exceed $1 trillion a year, long-term bond yields are moving higher, and public debt is already around 100% of GDP. So, the obvious question is: What should a responsible country do?



Congress's answer appears to be simple: Cut taxes and spend more. Republican leaders are now considering another party-line spending bill with at least $95 billion in new spending and no new revenue to pay for it. Before moving ahead, they might want to take a hard look at the fiscal hole they have spent the past two years digging.

Their signature achievement, the One Big Beautiful Bill Act, is expected to add at least $4.1 trillion to deficits between 2025 and 2034. Because "temporary" tax cuts in Washington usually become permanent, that could add another $1 trillion. If that happens, annual deficits could approach $3 trillion, while debt climbs to levels not seen since World War II.

Congress also claims it found savings. Not really. Lawmakers cut IRS funding by roughly $32 billion, which means fewer workers and less capacity to audit complicated returns, especially from wealthy individuals and corporations. The CBO estimates that each dollar cut from tax enforcement can cost about $3.27 in lost revenue, meaning the IRS cuts could add roughly $73 billion to deficits instead of reducing them.

Put simply, cutting IRS enforcement is like firing the bill collectors to save money on salaries, then acting surprised when fewer bills get paid. It may sound like spending restraint, but if it reduces tax collections, it makes the deficit worse. Then there are the promised spending cuts. Supporters claimed $900 billion in Medicaid savings, mostly by reducing coverage, but those savings are small relative to the tax cuts. Another bill cut foreign aid and public broadcasting but saved only about $9 billion through 2035 — small potatoes against the overall deficit problem.

Meanwhile, spending keeps rising. The Secure America Act added about $70 billion for immigration enforcement and border security, including personnel, detention facilities, deportation operations, legal processing, border activity and administrative costs. Unless Congress cuts elsewhere or raises new revenue, those are real expenses that push the deficit higher.

There is also a bigger economic issue: A smaller immigrant workforce can mean fewer workers, less tax revenue, slower growth and higher costs for industries that rely on immigrant labor. Fewer people working and paying taxes means less revenue, which makes the fiscal math worse.

Simply put, the crackdown costs a lot to run, may reduce tax revenue and comes with no offsetting savings. That is why it could add roughly $500 billion to deficits over 10 years instead of reducing them.

The latest House bill would add still more: $73 billion for the war in Iran, $12 billion to help farmers hurt by trade policies and $10 billion for "election security." Because this is new spending, it does not reduce the deficit unless offset by cuts or new revenue.

The Department of Government Efficiency was supposed to cut spending, but the savings look questionable, while the disruption may have cost taxpayers about $135 billion last year.

And then there are tariffs. Tariffs are taxes on imported goods, and companies usually pass those costs on to consumers through higher prices. So while tariffs raise revenue for the government, households effectively pay the bill — roughly $900 per household per year.

Tariffs are a lousy way to raise money. They discourage trade, reduce business investment, hurt productivity and slow growth — all of which make the debt problem harder to manage. Even under generous assumptions, tariffs might raise $2.1 trillion over 10 years, covering less than 9% of projected deficits. In other words, tariffs are like charging consumers more at checkout and calling it deficit reduction: They raise some money, but not nearly enough, and they may damage the economy in the process.

Add it all up and the picture is not fiscal discipline. The tax cuts are large, the offsets are too small, and some of the supposed savings may actually increase deficits. Washington is borrowing more, weakening tax enforcement, adding new spending and pretending the arithmetic still works.

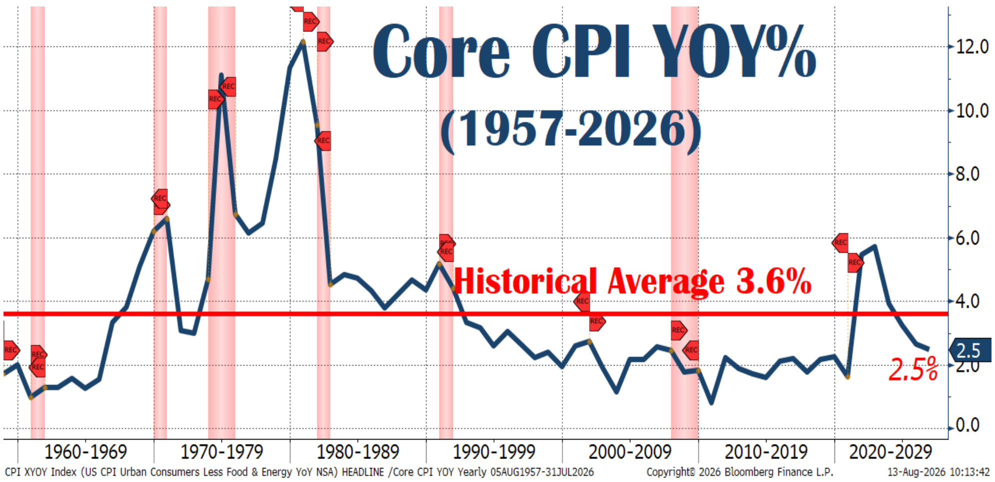
Bottom line: If Congress actually wanted to fix this, it could. There is already a bipartisan House plan that would make spending easier to track, clean up the budget process, and target annual deficits of 3% of GDP within 10 years. Hardly revolutionary stuff — just basic arithmetic, which apparently now qualifies as fiscal courage in Washington. Instead, Republicans have added massive new costs, chipped away at America's fiscal credibility, and produced little beyond larger deficits dressed up as policy. If voters eventually decide they have had enough, Congress can spare us the shocked faces.

DEFLATIONARY THUMBPRINTS

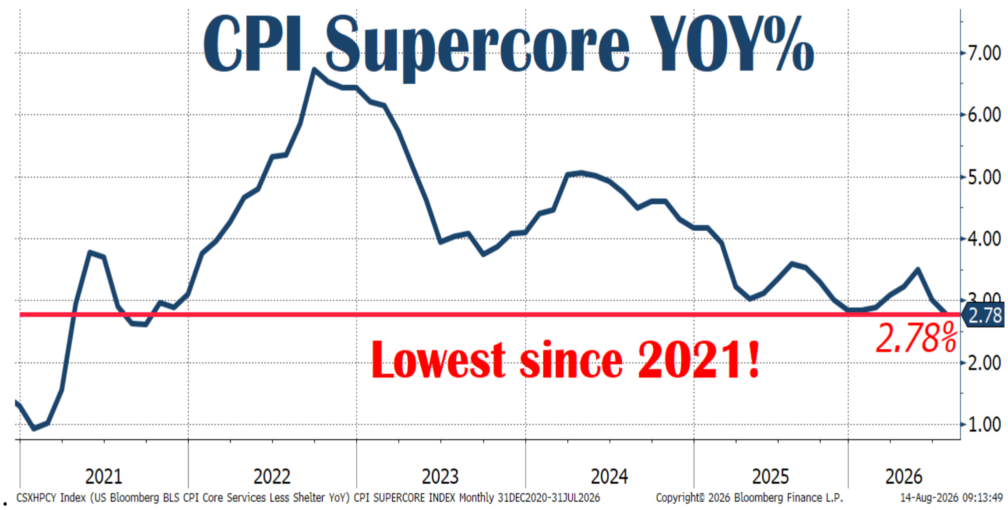
"Under our baseline economic forecasts, the inflation news is more likely to improve further than to deteriorate anew as the year progresses…We still think market pricing for the funds rate is too hawkish."
— Jon Hatzius, Chief Economist at Goldman Sachs

The decline in oil prices (before the late July/early August rebound) supported lower prices in July's Consumer Price Index (CPI) print, but expectations were for an uneventful 0.1% month-over-month rise in the headline print. And the print was perfectly in line, rising 0.,1% month over month and 3.4% year over year (down from +3.5% in June), the lowest since March.

Core CPI rose 0.2% month over month (as expected) with annual growth slowing to 2.48% **— its lowest since February.**

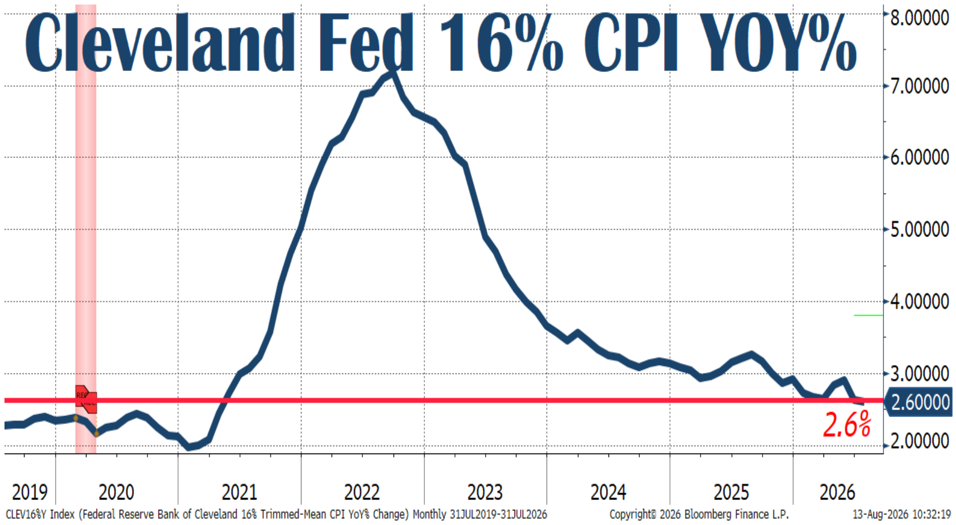


The much-watched supercore CPI (core services excluding shelter) fell to +2.78% year over year — **the lowest since Sept 2021.**



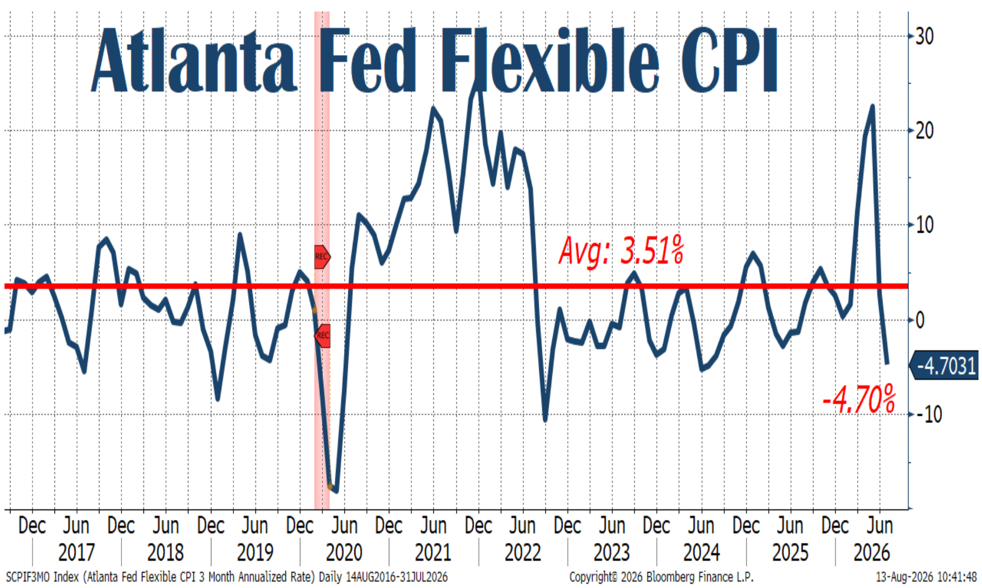
In addition to the tame CPI and core readings in July, there was added good news in that the Cleveland Fed's trimmed mean measure also came in light at +0.2% month over month in July. Year over year, this index is at 2.6%.

The Cleveland Fed trimmed mean matters because it confirms that inflation is not just being helped by falling oil prices or a few temporary declines. It suggests the broader inflation trend is cooling, which weakens the case for more tightening.



It will undoubtedly raise some eyebrows to suggest that there are some deflationary thumbprints in this report, because the Atlanta Fed's "flexible" CPI (purely cyclical) fell -0.5% after a -1.7% slide in June. The three-month year-over-year rate has declined to -4.70%. The "flexible core" index dropped -0.2% last month, and that too followed a deflationary reading of -0.4% in June. Year over year, the Fed core CPI is running at 1.08%.

The flexible CPI tells you where inflation may be headed before the slower-moving categories catch up. If flexible prices are already falling, it strengthens the case that inflation is cooling and that the Fed may not need to keep tightening.



I must also highlight the editorial in *The Wall Street Journal* titled **"Disinflation Returns, Kevin Warsh's Critics Hardest Hit"** was music to my ears. The inflationists point to oil, electricity, memory chips and computers but don't seem to realize that there are 700 goods and services inside the index. They concentrate on four components — including the dissenters over at the Fed!

Not sure everyone is aware, but the six-month pace CPI is now running at +2.4% annualized. The year-over-year trend is +2.5%. Here's the thing. If substituted the lagged rental measures from the Bureau of Labor Statistics with real-time shelter data, the core is really running at +1.5%. At the same time, the labor markets are clearly weakening as the nonfarm payrolls are running +0.3% over the at a mere +0.15% annualized pace and are at past six months. Yet all I hear is the job market is "stable" and "solid." Go figure.

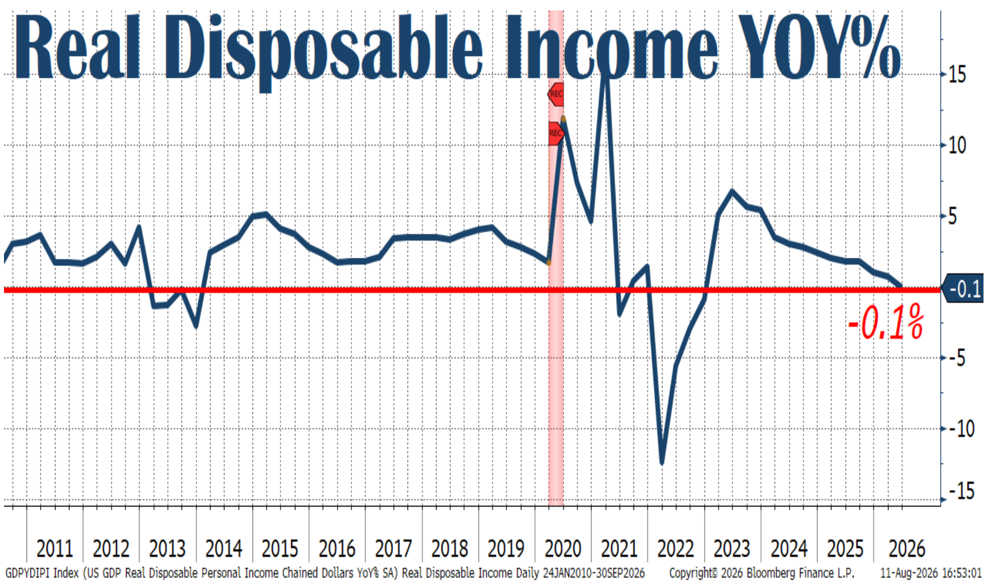
Bottom line: Inflation fears are overdone. There is no meaningful wage pressure, and the economy is growing below its potential — a setup that naturally cools inflation. Oil prices and memory chips may grab headlines, but they are not large enough to overpower a widening disinflationary output gap. When actual growth falls short of what the economy could produce at full strength, weaker demand.

And if inflation is losing momentum, the consumer may be losing something even more important: income.

A RECESSION IN PERSONAL INCOME?

Real personal disposable income has dipped by -0.1% over the past year. So much for the solid labor market narrative. Yet, real consumer expenditures have risen by +2.5% as the personal savings rate was drawn down in epic fashion to 2.7% from 4.6% a year ago (and 5.7% two years ago). Had spending matched incomes, consumer spending growth would have practically flattened in the past year.

The spending growth was propped up by the equity wealth effect at the high end and stepped-up credit card usage at the low end. I fail to see how that fits the description of "resilience." The annual trends in housing, commercial construction, government (yes, it's true), and non-artificial intelligence (AI) capital expenditures are all running negative over the past four quarters.



That brings us to retail sales, where the same consumer strain is starting to show up at the register.

RETAIL SALES LOWEST IN A YEAR

"I'll Never Apologize, You're Just Paying a Tiny Bit More." — President Donald Trump

The American consumer has cooled but has not collapsed. That is striking given flat employment, no real disposable income growth over the past year, and gasoline prices that have jumped roughly 35% since the start of the U.S.-Iran war. The answer is simple: Consumers are borrowing and tapping home equity to keep spending alive.

1. Credit-card borrowing rose at nearly a 7% annual rate in Q2, according to the New York Fed's quarterly household debt report.
2. Home-equity withdrawals provided $47 billion of cash flow through the first three months of the year.
3. Second mortgages added another $25 billion, while cash-out refinancing contributed $22 billion, up 18% from a year ago.
4. Home-equity revolving lines of credit increased at more than a 12% annual rate in Q2, adding another $25 billion buffer so far this year.

That borrowing cushion helped keep spending afloat for a while, but the latest retail-sales data suggest the consumer is starting to run out of room.

We received a fresh update on the U.S. consumer to end the week with the release of July retail sales.

U.S. retail sales fell 0.6% in July, the biggest drop in over a year and well below the small gain economists expected. The Big Momma, aka control group, which strips out volatile categories and feeds into GDP calculations, fell 0.4% when forecasters had it rising 0.3%. June was also revised down a tick to +0.4% from +0.5%. This is the kind of weakness last seen in October-November 2024 and January 2025, when the Fed was cutting rates, not hiking them. Notably, online sales dropped 2.2% after Amazon pulled Prime Day into June. Consumer sentiment fell again this month. Gas is at $4.08 a gallon, up 92 cents from a year ago. Credit card debt has passed a trillion dollars, up 60% in five years.

The softness was broad enough to matter:

- Auto sales fell 1.8%, the worst decline since May 2025.
- Appliance sales dropped 0.5% and have been flat or lower for three straight months.
- Grocery chains, department stores and sporting-goods stores were essentially flat.
- The main gainers were building materials, restaurants, pharmacies and clothing, but those categories were not large enough to offset weakness elsewhere.

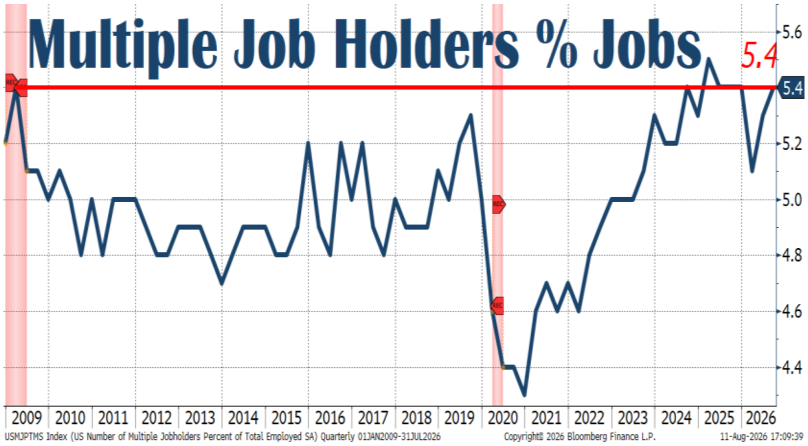
Adjusted for inflation, real retail sales sank by -0.7% month over month and completely wiped out June's pop. This is very important because it suggests that there is now 0% momentum so far for Q3. This means that we are very likely to see four quarters of real GDP growth average less than a +1.5% annual rate, which is extremely rare, quite often the harbinger of a recession, but more to the point, it is well below the Fed's estimate of the +2% supply-side growth potential for the economy. This emergence of a disinflationary output gap as growth in aggregate demand now slips below that of aggregate supply should be rather bullish for the fixed-income market and should remove any threat of a Fed rate hike, now and in the near future.

Bottom line: The two legs holding this economy up are a housing market losing steam and an AI buildout funded with debt. The consumer, which is about 70% of GDP, just showed up limping. The tax refunds that propped up spring spending are gone, gas costs a dollar more than last year, and credit card balances are at records with delinquencies climbing. People are tapped, and this data confirms it.

I don't think one bad month is a recession call, and some of the drop is just Prime Day shifting into June. But stack this next to last week's weak jobs numbers, the housing freeze and consumer sentiment falling again, and the picture gets harder to wave off. The economy has been running on the willingness of American households to keep spending through inflation and rising debt. At some point, that willingness hits a wall, and I think we're closer to it than the stock market is pricing in.

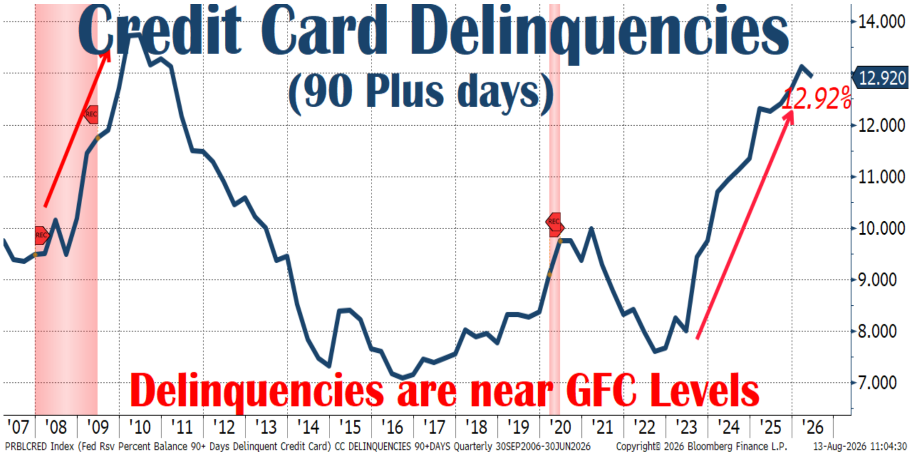
THE PAYMENT IS DUE

In another sign of emerging consumer strain, credit card usage picked up at a +6% annual rate in June — a similar trend since February, which is just about the fastest clip in two years. This stress is also reflected in the rising share of workers who are taking on more than one job to make ends meet, given that over the past year, the only positions available have been part-time.

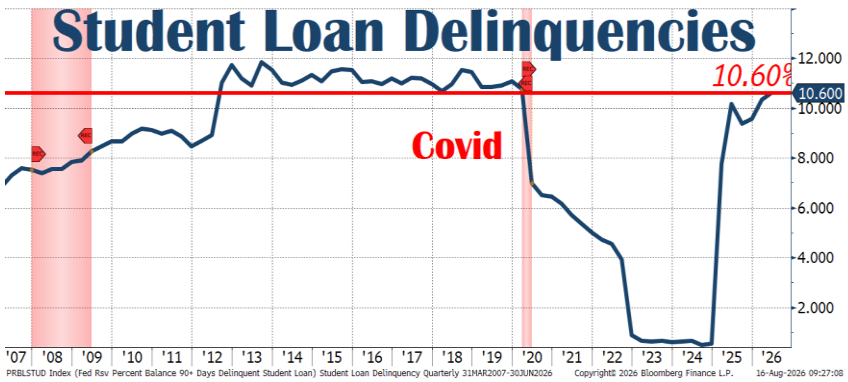


The consumer stress can be easily seen in the rising delinquency rates:

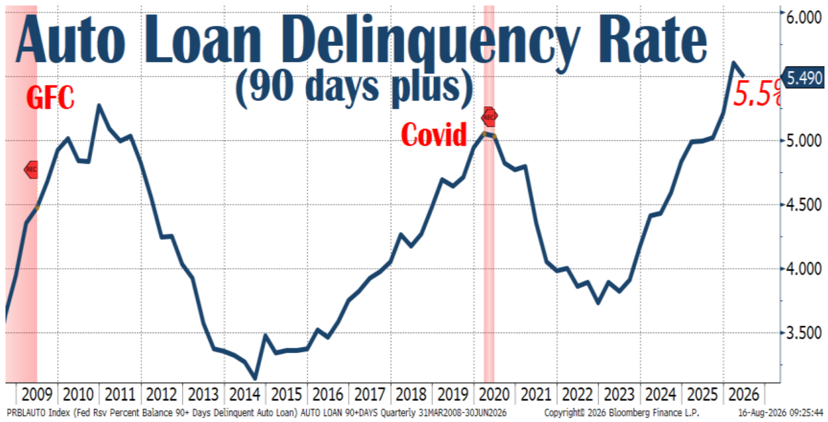
- 12.9% of credit card balances in the U.S. are 90+ days delinquent, near the highest since 2011.



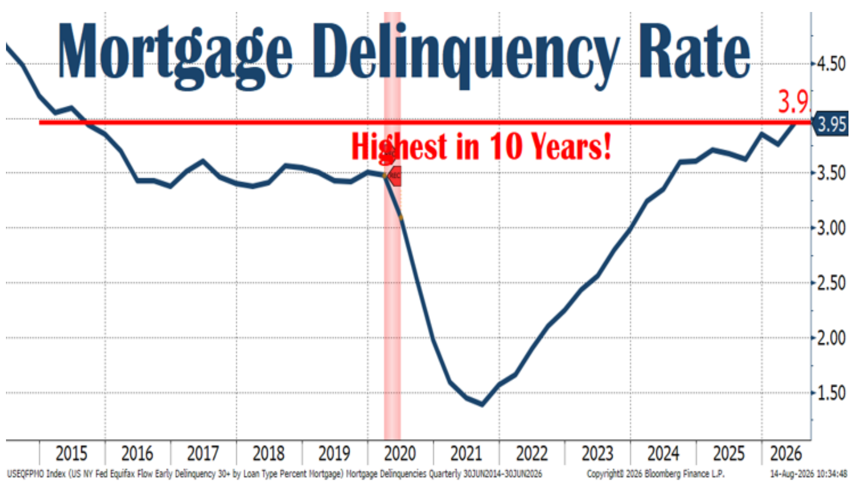
- 10.6% of student loan balances are now 90+ days delinquent, the highest since 2020.



- 5.5% of auto loan balances are 90+ days delinquent, just off the highest level on record.



Don't look now, but the residential mortgage delinquency rate just touched 4% for the first time in more than a decade.

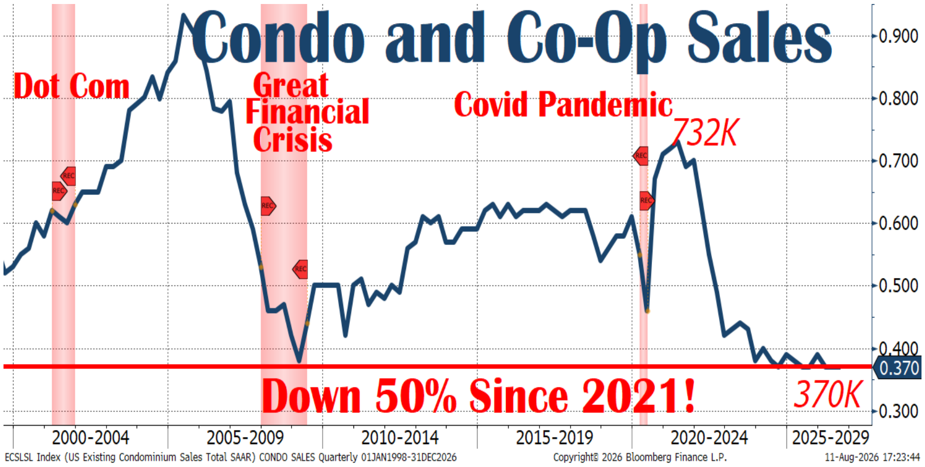


Bottom line: The consumer may still be spending, but the financial strain underneath is no longer hard to find. And if household balance sheets are starting to crack, housing is where the pressure should show up next.

HOME SALES SINK DEEPER

After years of confident forecasts calling for a rebound, the bounce in housing has simply not arrived. Sales of existing single-family homes fell by 1.9% in July from June, seasonally adjusted, the second month in a row of declines, to an annual rate of 4.06 million sales, sinking deeper into the mud at the bottom that sales have been in for four years. Today's homebuyer demand looks disturbingly similar to the 2008-09 trough. Adjust for population growth and the larger housing market, and it may actually be worse.

Sales of condos and co-ops were unchanged (seasonally adjusted and rounded to the nearest 10,000) in July, at an annual rate of 370,000, just above the record low in the data that go back only to late 2011.



Compared to the same month in 2019, sales were down: in the West (-37%), Northeast (-27%), Midwest (-24%), and South (-19%).

As sales sank deeper into the mud at the bottom, inventories rose to 1.4 million single-family homes for sale. The supply, at 4.6 months of unsold inventory, is tied for the highest since last August.

Bottom line: Housing is not frozen because buyers disappeared. It is frozen because affordability is broken, full-time job growth is weakening, and prices have not fallen enough to clear the market.

That brings the story back to the real blockage in housing: Prices still have not adjusted enough to meet buyers where their incomes and mortgage payments actually are.

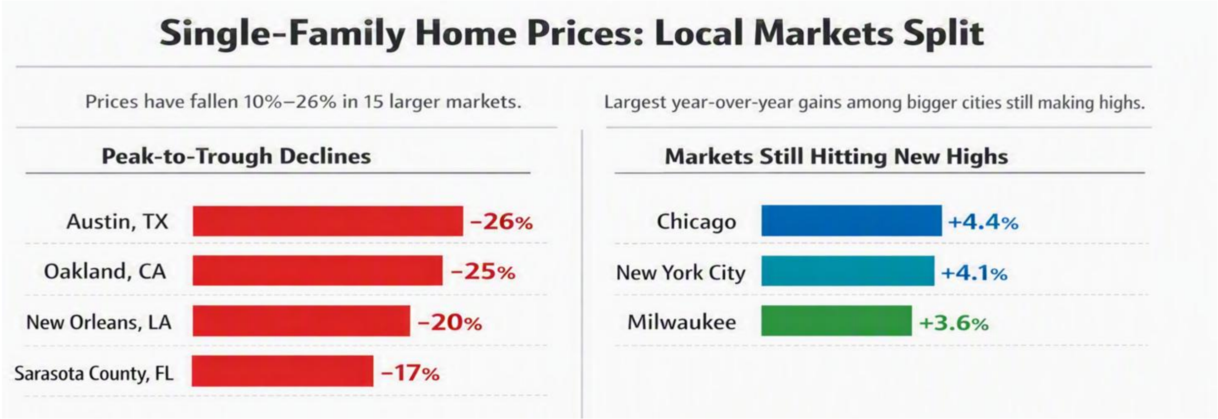
PRICES REMAIN TOO HIGH

Mega-quantitative easing during the pandemic triggered the below -3% mortgage rates while inflation was spiking in direction of 9%, resulting in mortgage rates that were deeply negative in “real” terms (adjusted for inflation). That and fear of missing out by homebuyers trying to take advantage of those mortgage rates were the main culprits in the explosion of home prices from mid-2020 to mid-2022. The Fed’s money-printing strategy ended up creating the current “affordability crisis” and lots of inflation.

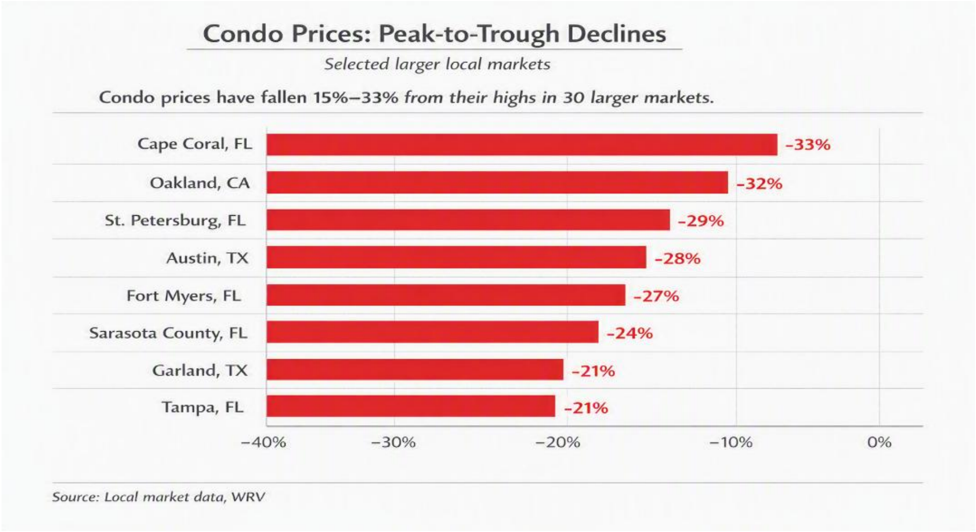
The price explosion ended in June 2022. Over the four years since then the national median price of single-family homes was +4.6% through July.

The squeeze in supply and demand took median prices down -1.9% in July — the steepest falloff since the turn of the year. But the national median price is irrelevant for people buying or selling a home. To them, what matters are local prices.

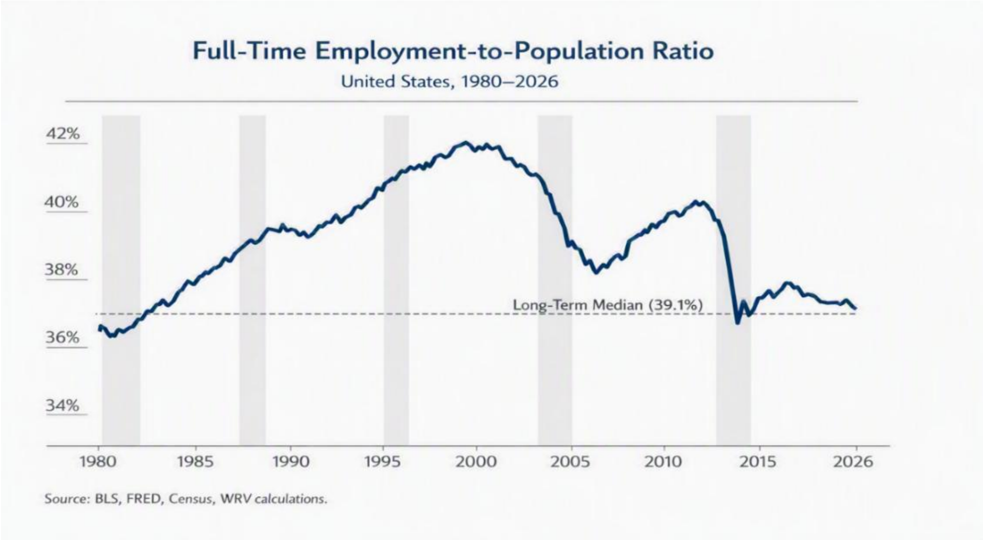
Single-family home prices have dropped by 10% to 26% in 15 bigger markets. At the same time, in some other bigger cities, prices of single-family homes have continued to rise to new highs.



The national median price of condos and co-ops rose year over year by 2.2%. On a local basis, condo prices have plunged by 15% to 33% in 30 bigger markets from their highs, with several markets dropping below their highs in 2006.



One of the better leading indicators for housing — and the economy more broadly — **is the full-time employment-to-population ratio.** Today, the U.S. has roughly 133.6 million full-time workers against a population of 342 million, leaving the ratio at just 39.1%. That is uncomfortably close to slipping below its long-term median.



Historically, peaks in the full-time employment-to-population ratio have often come just before recessions. The latest peak was in 2023, and since then the trend has been clearly lower. That does not mean a recession is guaranteed. But it does suggest the underlying health of the labor market and the economy, and the housing market is not nearly as strong as the headlines imply.

And that is the key point: The stock market is telling one story, while full-time jobs and home sales are telling another.

Affordability is already sitting near record-worst levels. But the bigger issue is that the kind of jobs needed to support homeownership simply are not improving. In other words, housing is not just fighting high mortgage rates and elevated prices — it is fighting a weakening full-time labor base.

That is why sales volumes remain pinned near 30-year lows.

Bottom line: Housing is not stuck because buyers lack interest; it is stuck because affordability is broken, full-time job growth is weakening, and prices still have not adjusted enough. Until that changes, sales are likely to remain trapped near recessionary levels.

It's funny how inflation is on everyone's brain at a time when every measure of real estate prices is now in the process of cracking. And with homeowner affordability some 20% more strained today relative to the historical norm, the only way this series mean reverts, with wage growth cooling off and mortgage rates not helping, will be via more house price deflation ahead. Do not underestimate the effect this will have on the fabled "wealth effect" on spending in the coming months and quarter — a huge offset to what the stock market is doing (assuming it continues to do what it has been doing).

With the old economy flashing more warning signs, the market is leaning harder on the newest growth story: artificial intelligence.

WILL AI PAY OFF?

Apollo chief economist Torsten Slok has put numbers around a point many have been circling: AI's economics are upside down. Chipmakers are earning rich profits, while the model builders are burning cash — and much of the money is coming from investors, not customers. Chipmakers are posting 41% profit margins, while companies like OpenAI and

Anthropic are running negative 59% operating margins. In other words, the 41% only works as long as the negative 59% can keep getting financed.

The figures, drawn from Bloomberg, reinforce the concern. Nvidia's profits are real, but they are largely funded by AI firms spending capital they raised, not cash they earned from customers. Remove the fundraising, and the foundation under those chip profits starts to look a lot thinner.

That leaves the key question: Can AI generate enough value for customers before the funding cycle runs out? Nobody knows yet. For now, the profits at the top are real, but the demand supporting them is still borrowed. I would not confuse strong chip margins with proof that the AI boom has already paid for itself.

Bottom line: AI may be the market's favorite growth story, but the economics still have to prove themselves. Chip profits are real; customer-funded demand is not yet convincing.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The U.S. economy is struggling even though bond and stock market participants are either oblivious or impervious. We will have come off a four-quarter average real GDP trend of a mere +1.0% annualized rate. The issue, however, is one of perception because a dud of a July retail sales report and three months in a row of soggy jobs data have yet to push the Fed's and Wall Street's mentality away from "resilience" and "solid" when it comes to describing the state of the U.S. economy.

However the *Financial Times* poll confirms that Main Street has a slightly different opinion (as did Friday's horrible reading on the August version of consumer sentiment from the University of Michigan).

There is 0% momentum now in economic activity being built into the third quarter. We do still have two months to go in Q3, but that is a pretty weak starting point. And it follows +1.5% real GDP growth in Q2, +2.1% in Q1 and +0.5% in the Q4 of 2025. Not once in the post-WWII period did such a move to a stall-speed economy fail to land the economy into a recession.

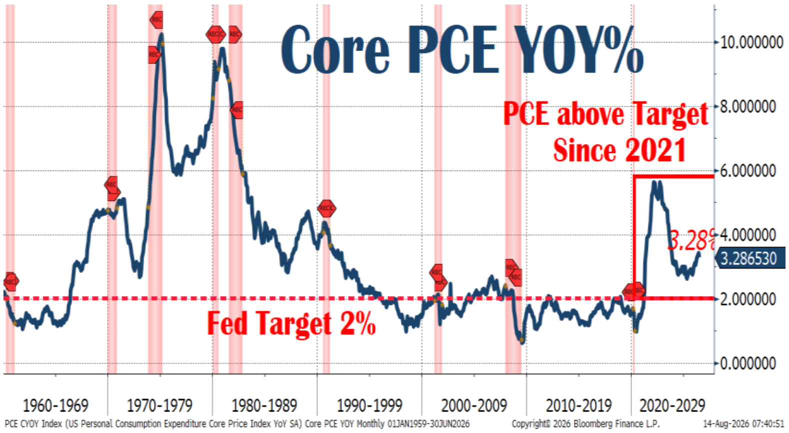
Moving on. Inflation, where is thy sting? CPI rose just 0.1% in July after a 0.4% decline in June, bringing its three-month annualized trend to only 0.5%. That's the inflation scare? The Producer Price Index (PPI) was flat in July after slipping 0.1% in June, leaving the three-month trend at a terrifyingly tame 1.3% annualized pace. Average hourly earnings barely budged, rising just 0.05% month over month, while the three-month trend slowed to a 2.3% annual rate — the weakest since December 2022. At this pace, core inflation should be back at the Fed's 2% target by April.

So, what is the case for more tightening. Some say it's because inflation has been above target for five years? Who cares? Policy should not be made through the rear-view mirror, especially when the full impact of Fed tightening tends to hit the economy about twelve months later.

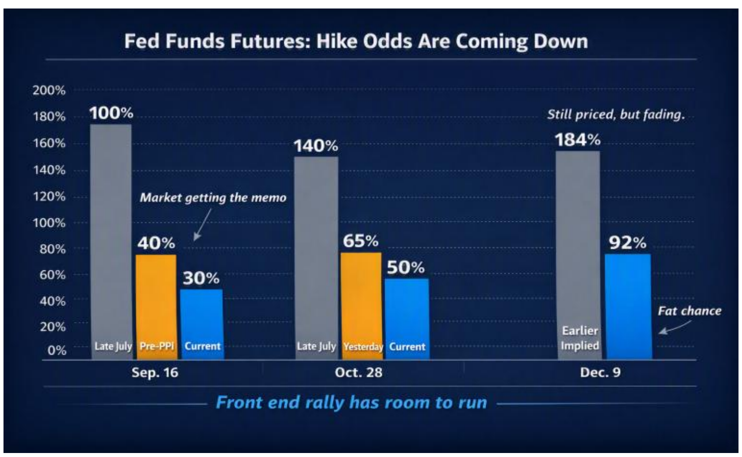
Besides, what exactly would higher rates do to fix a commodity supply problem?

Last week's report was broadly in line with expectations and supports the view that U.S. inflation peaked in May and is now easing, even if the path lower is likely to be uneven. That said, the data will ultimately guide the Fed. For now, the committee remains focused almost entirely on inflation running above target, with far less attention on the labor market. That should change as evidence builds that softer inflation and weaker job growth are not noise, but signal. This is no longer a one-month story; it is a three-month pattern.

I'm focused on where the core personal consumption expenditures (PCE) deflator is headed — still the Fed's preferred inflation gauge. The base effects coming later this year and into 2027 should do much of the heavy lifting. My view has not changed: The Fed stays put, the dissenters begin walking it back by the fall and the conversation shifts from yesterday's inflation problem to today's labor-market cracks.



The market is getting the memo. September hike odds have fallen to roughly 30%, October is close to a coin toss and even December has been cut sharply from late-July levels. Fat chance.



The next Federal Open Market Committee (FOMC) meeting is September 16, with one more CPI report and payroll print before then. I see no case for a hike now, and doubt one appears by then. October comes just before the midterms, when the Fed usually prefers quiet, and December arrives as liquidity fades and books close.

As the market lets go of a year-end hike, the front end of the Treasury curve should keep rallying. If inflation and policy risk keep fading, the long end should improve too.

Final thought: Everyone loves buying the dip in stocks. Nobody wants the dip in bonds. Strange — lower prices are supposed to be the opportunity.

But still… everybody hates bonds. The 30-year Treasury yield is now at their highest levels since 2007. Remember 2007? As late as June, the Fed said its "predominant policy concern" was that inflation wouldn't moderate sufficiently. Well, what happened next was one of the great Treasury rallies of all time. I'm not saying we're going to have another Great

Financial Crisis. I *am* saying that bonds are: hated, despised, detested and looking very tasty.

Bottom line: Despite widespread negative sentiment, bonds still offer an attractive risk/reward tradeoff at these levels. Inflation looks less durable than advertised, the economy looks weaker than markets want to admit and the Fed risks tightening into a slowdown driven more by supply shocks, oil headlines and speculative excess than by genuine demand-led inflation.

Stay patient, stay liquid and use today's unusually hated bond market to add duration selectively before the Fed and the data force the market to rethink the path of policy.

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As Alloya's Market Strategist, **Tom Slefinger** leverages nearly 40 years of investment strategy expertise to deliver insightful commentary on the economy and market events to optimize balance sheet performance at the credit union level. With thousands of subscribers, Tom's daily and weekly publications are widely read amongst credit union executives.

Prior to becoming the corporate's Market Strategist, Tom served as the Senior Vice President of Institutional Fixed Income Sales at Alloya Investment Services, a division of Alloya Solutions, LLC. In this role, Tom developed and managed operations associated with institutional fixed income sales in addition to developing investment portfolio strategies, identifying appropriate sectors and securities, and optimizing portfolio performance at the credit union level.

Tom holds a B.S. in business administration from the University of Maine. In addition, he holds a Series 7 and 63 through ISI.