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Weekly Relative Value

WEEK OF SEPTEMBER 28, 2026

The Fed's Cure Is a Recession

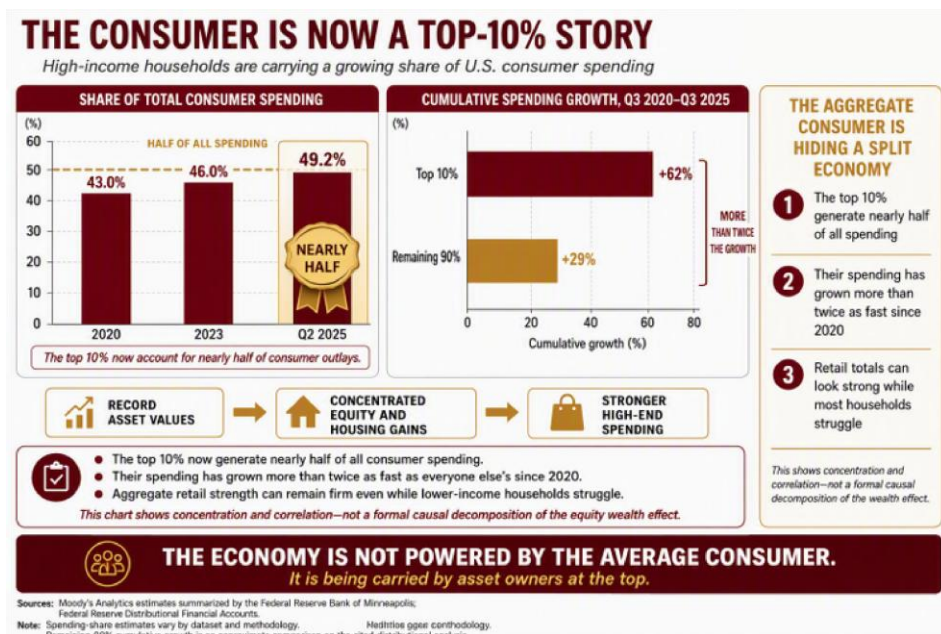
Executive Summary: The economy is standing on two shaky legs: AI spending and wealthy consumers. The Fed is tightening into weakness to fight an energy shock it cannot fix. Meanwhile, real rates are surging, the yield curve is flirting with inversion, markets are dangerously concentrated, and \$365 trillion of global debt must be refinanced at much higher rates. Simply put, this is not broad economic strength. It is a fragile setup with very little room for error.

The Wall Street Journal recently offered a reassuring interpretation of soaring interest rates:

"The Economy Can Handle Them."

The evidence suggests otherwise.

Here is the truth: Half of the growth in the U.S. economy over the past year has come from the AI spending boom. Much of the remaining strength appears tied to consumer spending at the top, where stock-market gains, high home values and large cash cushions have kept spending alive. The top 10% now account for nearly half of all consumer spending.



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SUBORDINATED DEBT: (SIMPLIFIED)

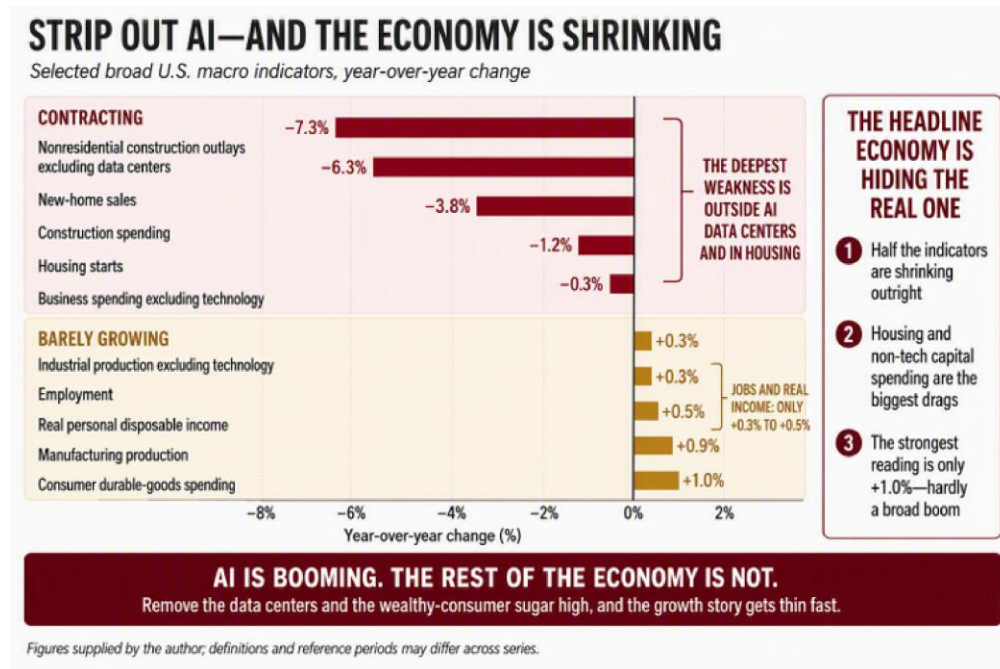
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So, two props are holding up the economy: AI capital spending and wealthy consumers. Neither is guaranteed to last. Now strip out AI and the wealthy-consumer sugar high. Here is what the rest of the economy looks like year over year.



Bottom line: These are facts, not opinions. The economy's apparent strength is narrowly concentrated in two areas: AI-driven investment and spending by wealthy households buoyed by rising asset values. Remove those two supports, and the broader economy looks far weaker, making claims that it can easily withstand higher interest rates dangerously optimistic.

THE JOBS MARKET

"Labor markets are consistent with full employment." — Kevin Warsh, Chair, Federal Reserve

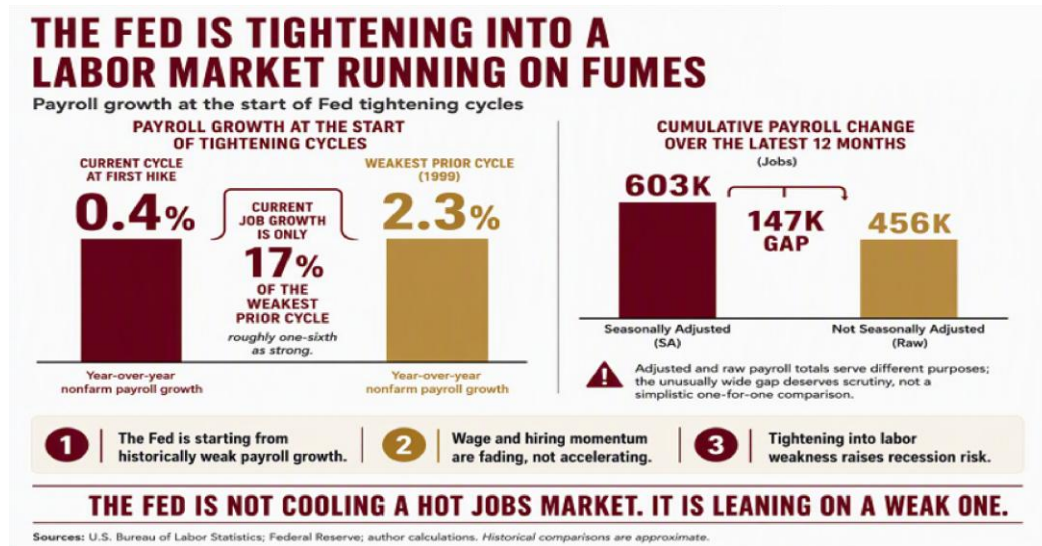
Now look at the jobs market. Seasonally adjusted payrolls rose 603,000 over the past year, while the unadjusted data show a gain of 456,000 — a 147,000 gap that is unusually wide. Seasonal adjustment is necessary because hiring follows predictable annual patterns, but a gap this large deserves scrutiny, particularly when other labor indicators are weakening.

The issue is not that adjusted data are inherently misleading; it is whether the current model is accurately capturing an economy reshaped by the pandemic and subsequent disruptions. Firing the commissioner in 2025 probably did not help the credibility problem.

Warsh's message on the jobs market is essentially that **labor conditions are still strong enough for the Fed to keep tightening**. He appears to view softer wage growth as a **lagging indicator**, not convincing evidence that inflation pressure is fading.

I say hogwash:

- Payroll growth is unusually weak for the start of a tightening cycle.
- Wage growth is softening rather than accelerating.
- The Fed has **never begun tightening with payroll growth this weak.**



Bottom line: Warsh is treating the labor market as resilient enough to absorb higher rates, while the underlying data suggest he may be tightening directly into employment weakness.

MOVING THE GOAL POSTS

"The measures I prefer are looking at things that are called trimmed averages. We take out all of the tail risks, all of the one-off items, and we ask ourselves whether the generalized change in prices is having second-order effects on the economy." — Kevin Warsh

Kevin Warsh keeps changing the inflation rules — and the bond market keeps guessing. In April, July, August and September, he gave four different answers.

Warsh once praised alternatives to core personal consumption expenditures (PCE), especially the Dallas Fed's trimmed-mean measure. At Jackson Hole, he shifted to headline PCE and the share of components running above 3%. By September, he would not even say which measure mattered most. That is a strange way to run a central bank.

Here's the reality regarding the inflation story.

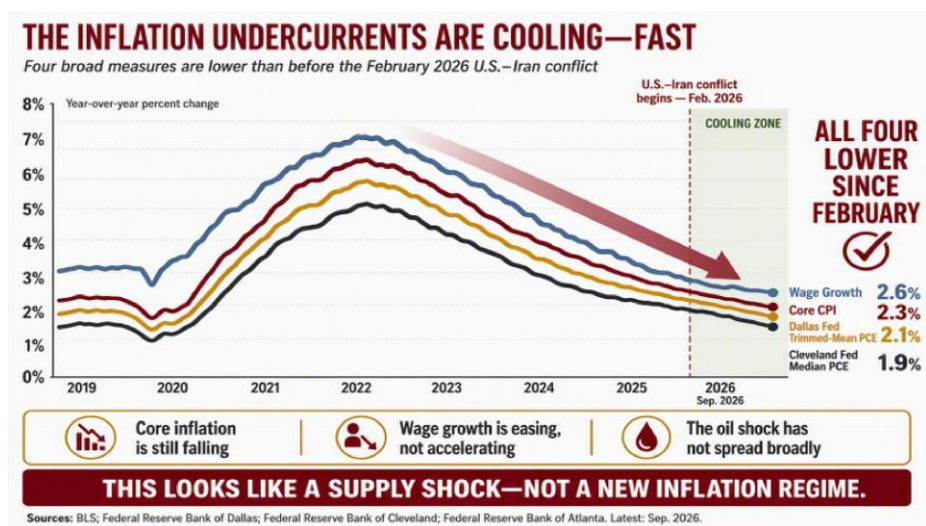
Over the past six years, the pandemic, the Russia-Ukraine war and the Iran conflict caused most of the price surge. Without those shocks, headline and core inflation would be near 2%.

That means much of the recent inflation pressure came from supply shocks the Fed could not directly repair with higher rates.

Energy may be the primary source of the latest inflation impulse, but the key question is whether it is spreading into wages, expectations and broader prices.

Here is the simple question: How persistent can inflation be when the core Consumer Price Index (CPI), Dallas Fed trimmed-mean PCE, Cleveland Fed median PCE and wage growth are all lower than before the U.S.-Iran conflict began in February?

The broader data says this is a temporary shock, not a new inflation regime.

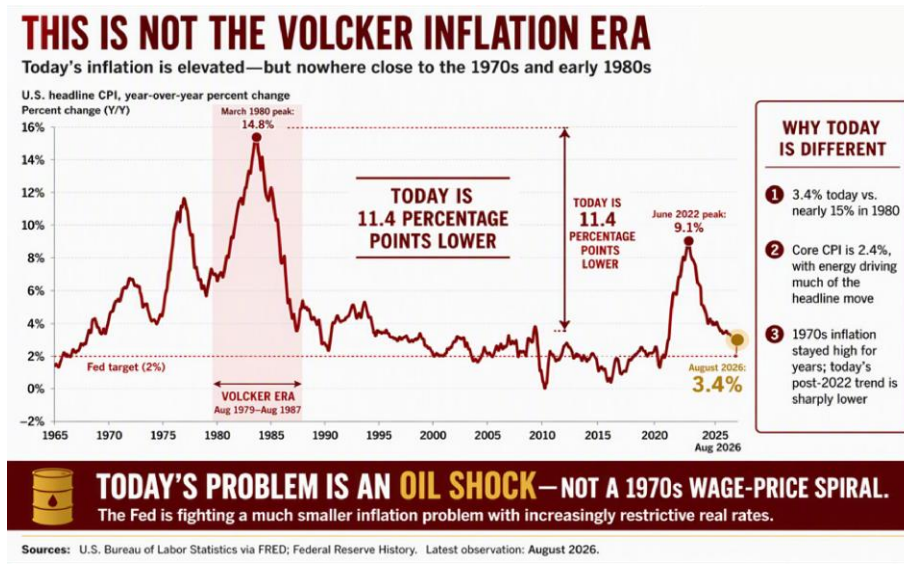


Raising rates to fight an oil shock is one hell of a gamble. The Fed cannot drill for oil or produce a single barrel of energy. To drag inflation back to 2%, it has to crush prices everywhere else — airfares, delivery services, goods and wages. Translation: The Fed must weaken the rest of the economy to offset an energy problem it cannot fix.

This can get ugly fast. The Fed stopped after one hike only once, in 1997. The next three moves were cuts after the Asian crisis, Russia's default and the Long-Term Capital Management blowup. Today the 2s/10s curve is only 26 basis points from flat, and there is no giant fiscal package waiting to save the day.

Meanwhile, the Fed has become the most hawkish central bank on earth. A few months ago, the dot plot showed a cut. Now 16 of 18 officials expect another hike by year-end, and October is a coin flip. So much for forward guidance.

If Warsh tries to force inflation back to 2% during an energy shock, prices elsewhere may have to fall. Volcker needed two brutal recessions, and inflation was still near 4% when he left. Today it is 3.4%, yet Washington is acting as if the 1970s are back.

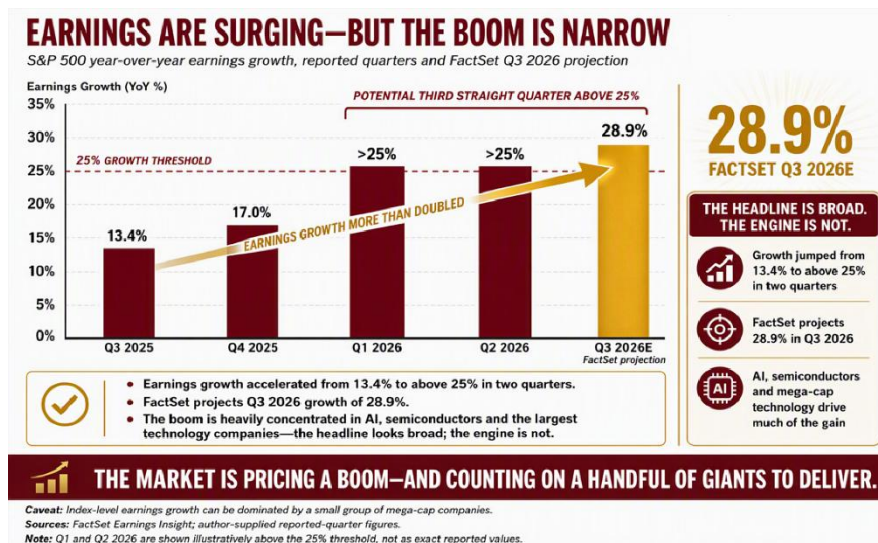


Bottom line: Warsh keeps moving the inflation goal posts because the data does not support his hawkish case. You cannot cure supply-driven inflation with rate hikes. You can only crush enough demand to offset the lost supply. That is a recession by design. Warsh will not say it that way — Trump might notice — so we get a sales pitch about an economy strong enough to survive the experiment.

CORPORATE EARNINGS SOAR

“Profits are the mother’s milk of stocks and the lifeblood of the economy.” — Larry Kudlow

It’s true that corporate earnings have boomed. Indeed, as displayed below, we have witnessed four straight quarters of strong double-digit growth, with the past two quarters exceeding 25%. FactSet projects Q3 2026 at +28.9%, which would make it the third consecutive quarter above 25%.

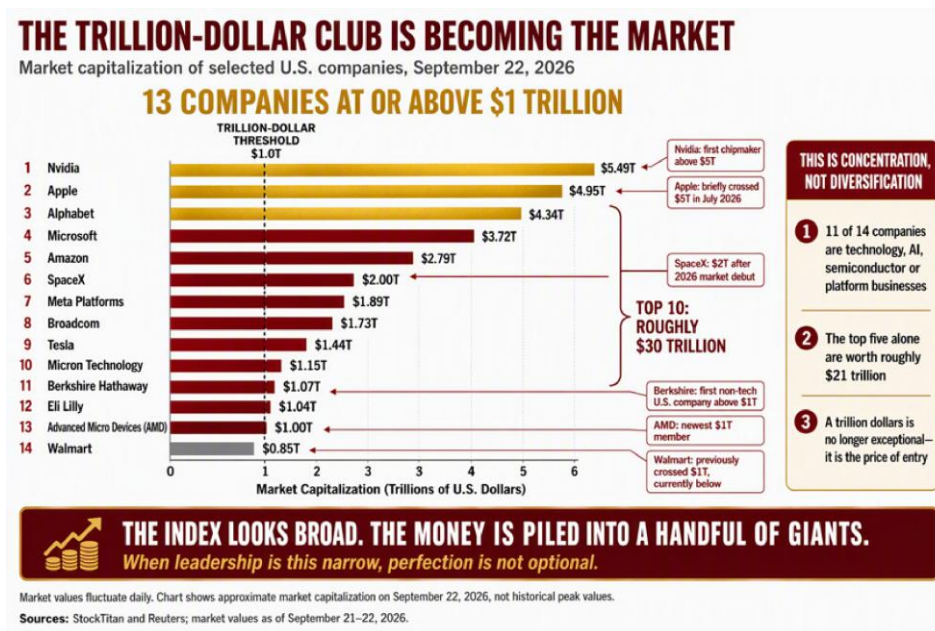


There are a couple of asterisks:

Larry Kudlow likes to say, “Profits are the mother’s milk of stocks.” On that score, the market is well nourished — but most of the milk comes from the same handful of AI and mega-cap cows. Roughly half of S&P 500 earnings growth is coming from AI infrastructure and mega-cap technology. Strip out the chips, cloud companies and data-center boom, and the earnings picture is still positive — but far less spectacular. The headline says corporate America is booming. The footnotes say Nvidia and friends are doing most of the lifting.

The earnings boom comes with another asterisk. The One Big Beautiful Bill handed companies a major tax boost through immediate depreciation. At the same time, roughly \$300 billion of off-balance-sheet exposure is making corporate credit look healthier than it is. The rating agencies have apparently decided curiosity is overrated.

Meanwhile, on the back of strong earnings there are incredibly now fourteen U.S. companies to have made it to the \$1 trillion club, and eleven of these reside in the tech space, broadly speaking.



At the 2000 tech bubble, the highest value for any company was barely more than \$500 billion — Microsoft was the leader back then, at a \$560 billion market cap, and there were only two others (Cisco and G.E.) with a market capitalization north of \$500 billion. Today, not one of the top ten is valued below \$1 trillion.

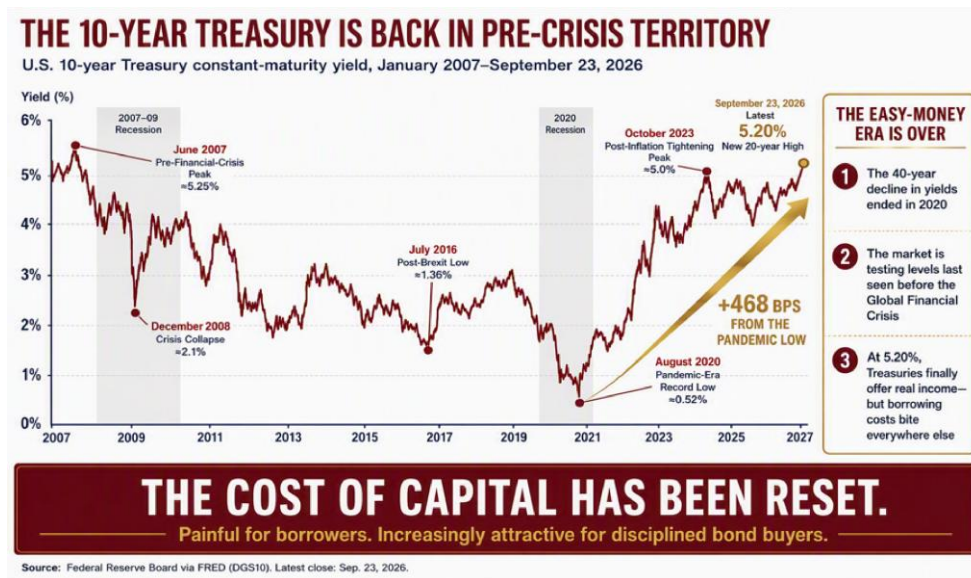
The top ten stocks today command north of a 40% share of the S&P 500 market cap, and that compares to less than 30% back at the 2000 bubble peak, when all we did back then was lament about acute concentration risk.

Bottom line: Earnings are strong, but the market is increasingly dependent on a small group of AI and technology giants delivering near-perfect results. Leadership is more concentrated than it was at the peak of the 2000 tech bubble, and the economy can withstand high rates only if AI investment and wealthy consumers keep carrying the load. That is impressive — until it isn’t.

MR. BOND — SHAKEN AND STIRRED

“Investors aren’t rejecting Treasuries because inflation credibility is collapsing, but because the real policy and term premium outlook demands a larger concession.” — Alyce Andres, Bloomberg

Bonds got crushed. The 10-year Treasury hit 5.20%, its highest level in 20 years, while the 30-year approached 5.50%. Nearly the entire curve traded above 5%. The level hurts. The speed of the move hurts more.



Bloomberg News ran with [“Global Bonds Near Average 4% Yield as Inflation Concerns Mount.”](#)

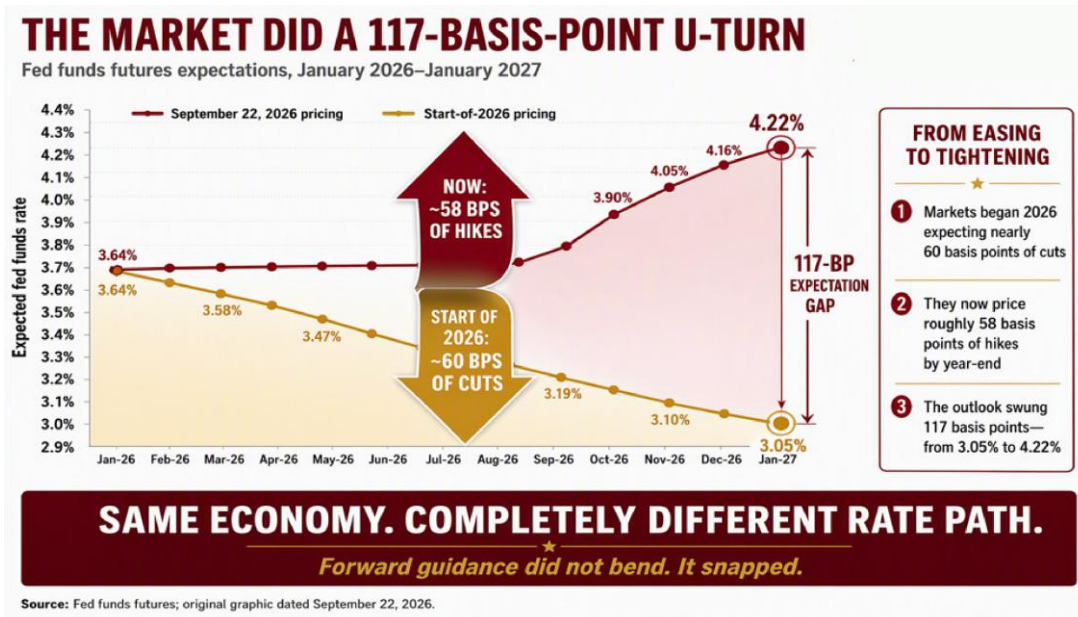
Sorry, but the bond market’s latest move is less about inflation expectations and more about Washington’s policy circus — big deficits, trade confusion, foreign-policy risk and a Warsh Fed trying to become the most hawkish central bank on earth.

Yet, inflation expectations remain anchored. The 10-year breakeven is just **2.35%**, so the entire 100-basis-point yield surge has come from higher real rates and term premium — not inflation.

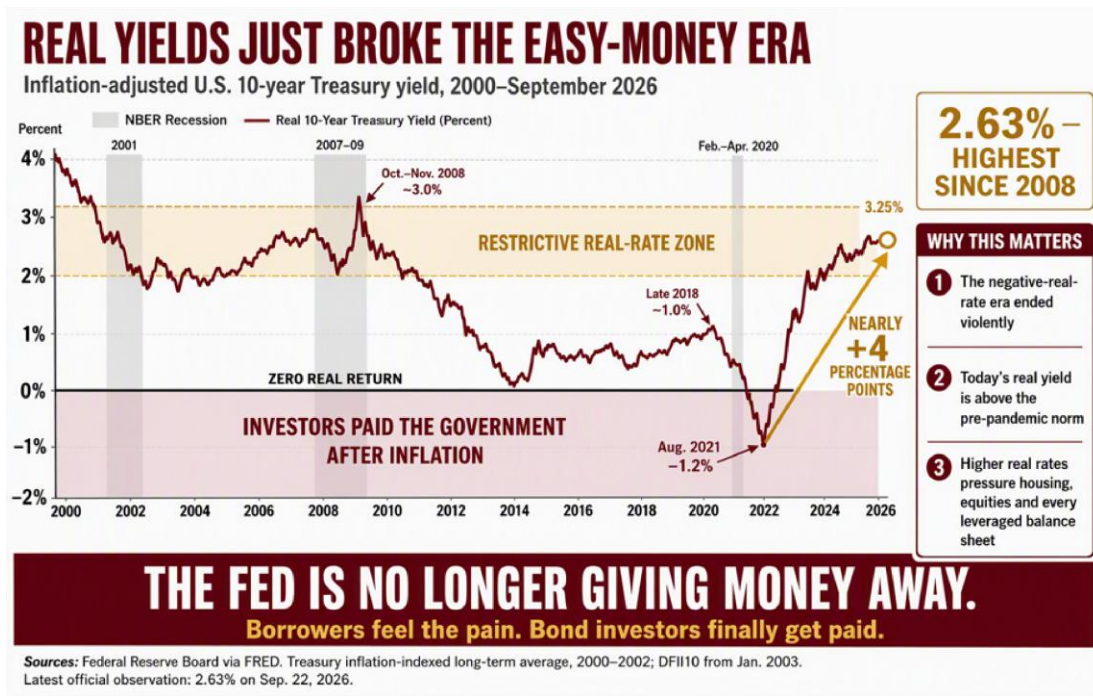


Investors realize that this is partly about the intensifying demand for capital coming out of AI that has bumped against structurally high government deficits and a thumbs down to government policy.

Meanwhile, markets now price nearly four hikes as the yield curve nears inversion — a nasty growth signal. At the start of 2026, markets were pricing in two Fed rate CUTS. Last week, the Fed HIKED rates 25 basis points. Today, markets are pricing at least one more rate HIKE before year-end. That is one violent reset. Trump wanted a dovish Warsh and lower interest rates. Instead, he got a hawk.



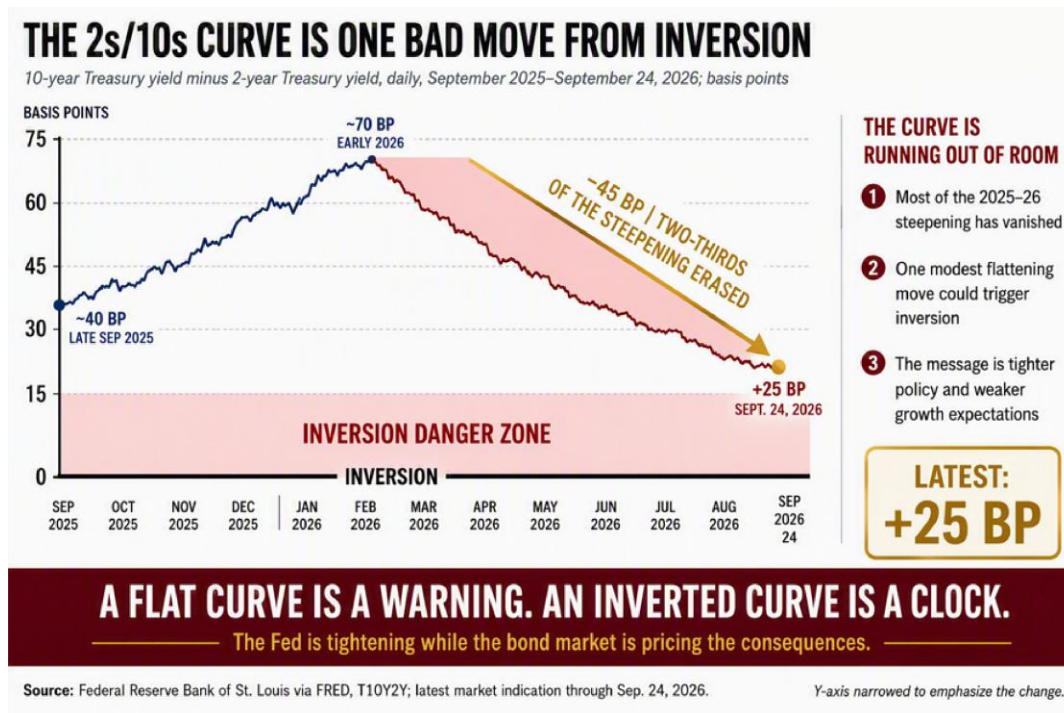
At the same time, the real 10-year yield is now at its highest level since October 2008. That should get everyone's attention. We know what came next.



Meanwhile, investors still act as if recessions have been permanently outlawed and the business cycle has retired. Maybe. But the bond market is sending a less cheerful message.

On the day of last week's Fed rate hike, the 2s/10s curve closed at just +20 basis points. Since 1983, the average and median spread when the Fed finally admits it is behind the curve has been closer to +100 basis points. From +20 basis points, it would not take much to invert the curve again.

The economy can live with a flat curve. It struggles with an inverted one. The problem is that a curve that keeps flattening is moving in the wrong direction.



Bottom line: The bond market is warning that real rates, policy uncertainty and a flattening yield curve are tightening financial conditions fast. Inflation expectations remain anchored, but the cost of capital is surging — and bond-market shocks rarely stay in the bond market.

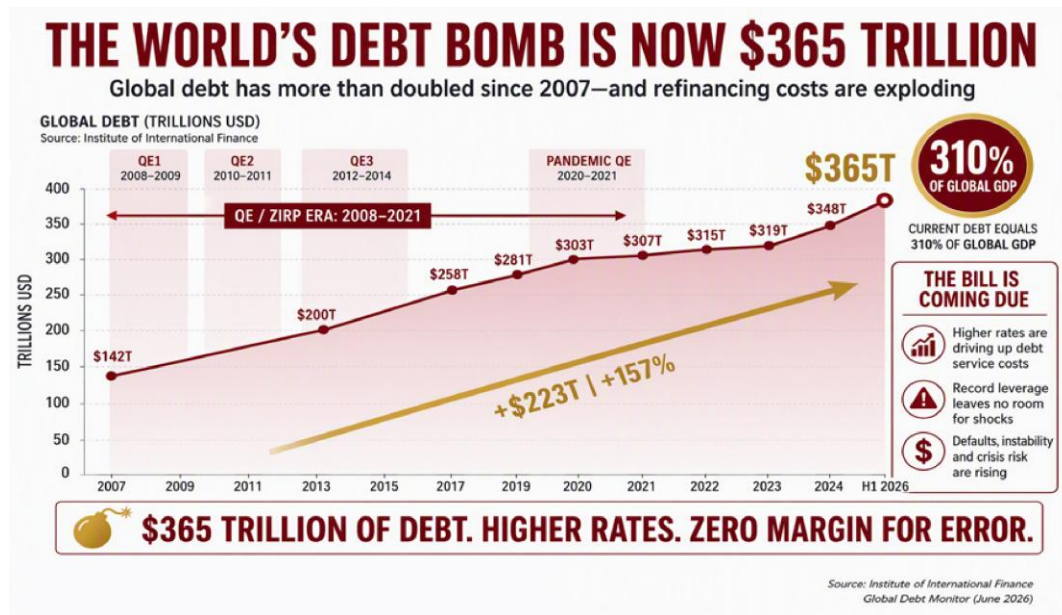
Forewarned is forearmed.

THE WORLD'S \$365 TRILLION DEBT BUBBLE

"If something cannot go on forever, it will stop." — Herbert Stein

We should all be concerned about the state of fiscal policy, not just in the United States, but globally. **World debt at all levels has soared +\$10 trillion in the first half of 2026 to a nosebleed level of \$365 trillion. That is equivalent to 310% of global gross domestic product (GDP).** You read that right — global debt is more than 3x bigger than the global economy, and financing this extreme liability at a 5% interest rate is a far different place than funding the largesse at 2%.

The last time market interest rates were at today's level, back in 2007, the level of world debt was \$142 trillion and less than a 270% share of the global economy. The risks are far more serious today from a refinancing-risk perspective.



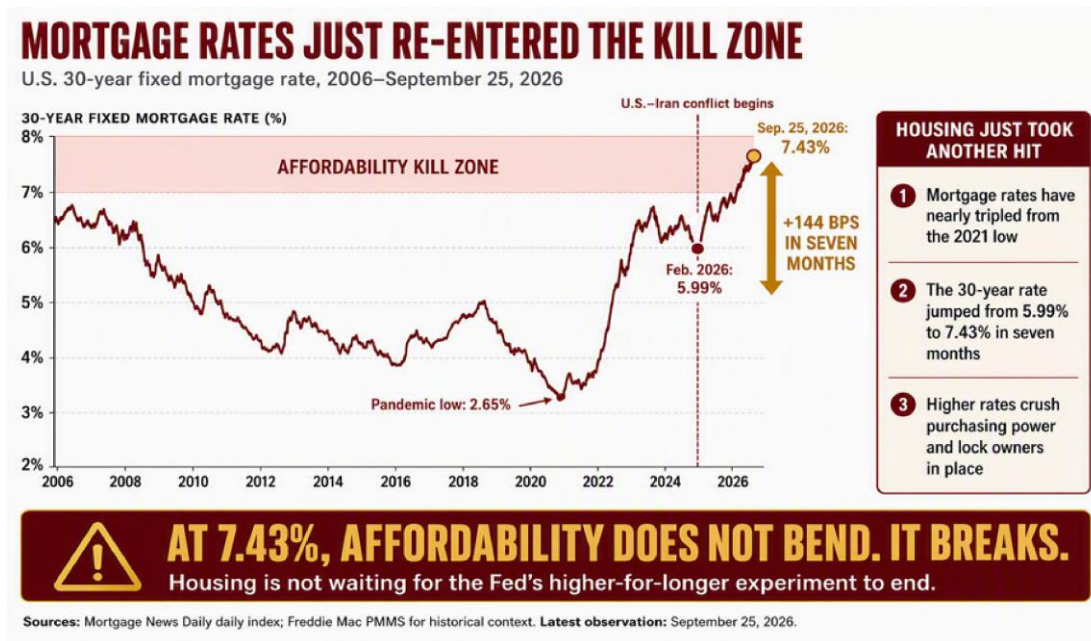
Bottom line: The world borrowed like money was free. \$365 trillion of debt was built for a 2% world; refinancing it in a 5% world is where the bubble meets the pin.

The only question is whether it will deflate gradually or all at once.

BUILDERS BLINK FIRST

"We are adapting to market conditions as they are and not waiting for the market to bounce back."
— Stuart Miller, Chief Executive Officer, Lennar

While everyone celebrates the alleged economic boom, higher real yields are pushing mortgage rates up and housing prices down. New homes are already cracking.



Big builders have accepted reality. They need to sell homes, so they are cutting prices, offering incentives, buying down mortgage rates and lowering construction costs. Margins suffer. Inventory moves.

Margins, profits and share prices have all taken a hit. Builders adjusted anyway — and kept building. New-home inventory is now at its highest level since the 2005-2007 housing bubble, even though sales remain far below that era.

The result is a new home price below pre-pandemic levels.

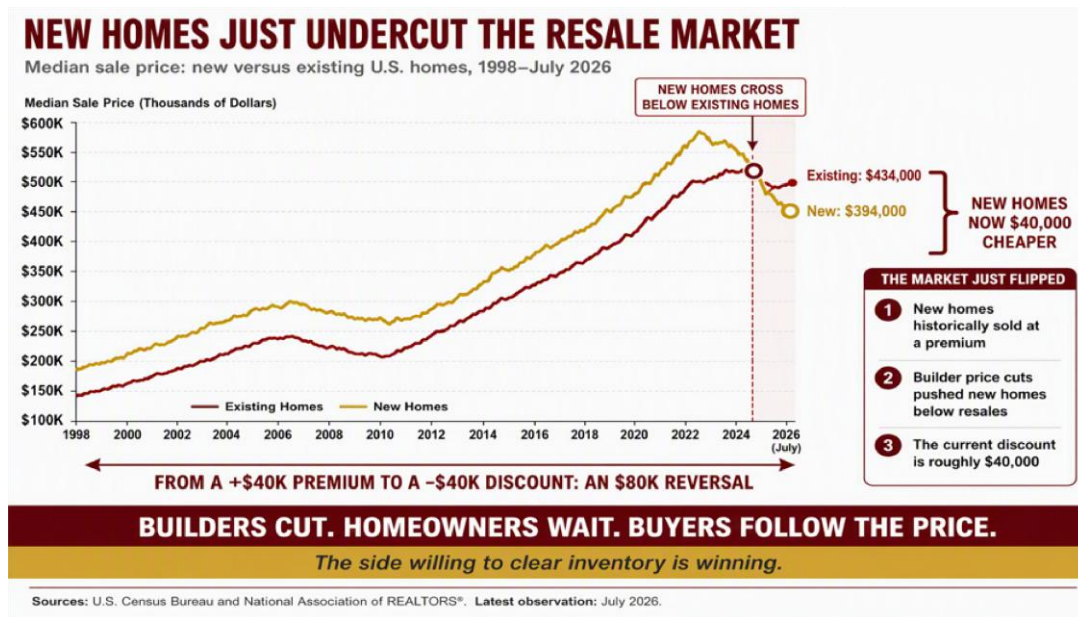
That inventory is exactly what the market needs. In August, builders held 8.5 months of supply. Build it and buyers may come — but only if the price is low enough and the incentives are rich enough.

Lennar, America's second-largest homebuilder, has cut its net selling price roughly 30% from the pandemic peak — from \$511,000 in 2022 to \$359,000 in the third quarter of 2026. That is not a rounding error. That is price discovery.

Existing home sellers have been making the opposite choice.

Builders are cutting prices to create a sale. Many homeowners are refusing to cut at all. They list too high, wait, then delist rather than admit the market moved. One side is clearing inventory. The other is defending a Zestimate.

That split has created something extraordinary. In July 2026, the median new home sold for \$394,000 versus \$434,000 for an existing home — a \$40,000 discount. Historically, new homes carried roughly a \$40,000 premium. The relationship has flipped by about \$80,000.



Builders are showing us the real market: weaker demand, rising supply, expensive mortgages and prices low enough to restart transactions.

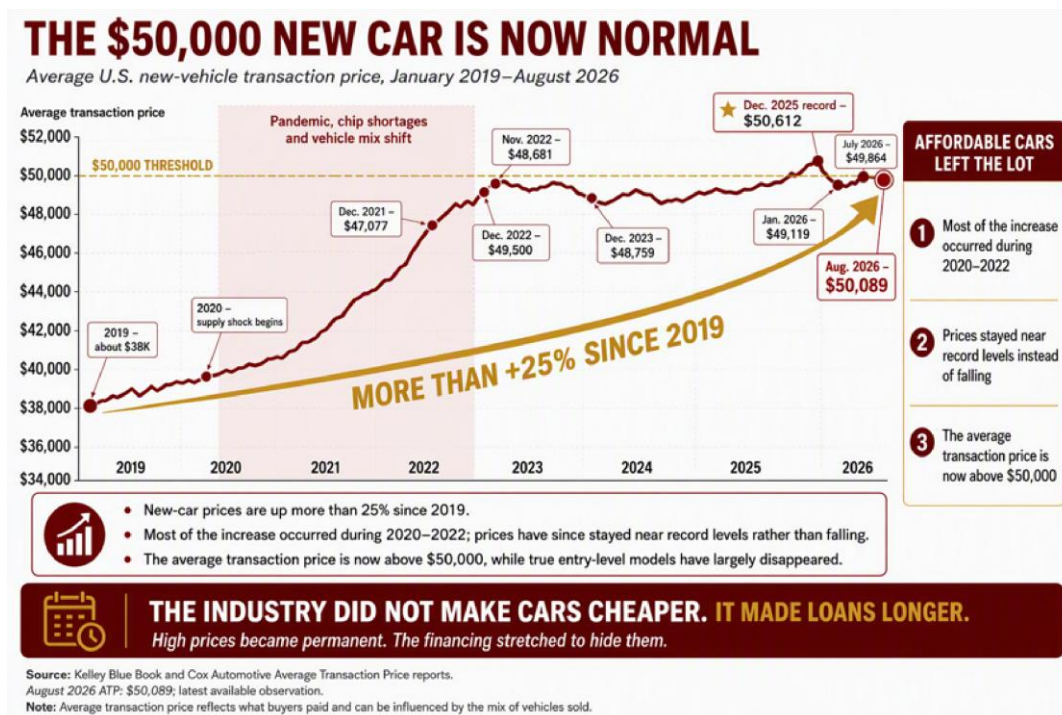
The strategy is working. New-home sales have recovered to roughly 2017-2018 levels. Existing-home sales remain stuck near 2008 lows. Builders are winning because they are willing to meet the market. Homeowners are losing because many still expect the market to meet them.

Bottom line: Housing deflation has already arrived in the new home market. Purchase applications for existing homes are near 1995 levels, inventory is rising across the South and West and builders are cutting until buyers respond. Existing-home prices may look firm only because sellers are withholding supply. Eventually, life events force listings — and market forces win.

FROM HOUSES TO CARS

We're seeing the cost of cars and the cost related to car ownership increase enormously...In the past five years, it has increased even faster." — Rikard Bandedo, Chief Economist, VantageScore

Automakers stopped building affordable cars because \$60,000 trucks and SUVs are more profitable. Great for margins. Less helpful for people who simply need transportation.



The dealer's solution is not a cheaper car. It is a longer loan. Nearly one-third of recent auto loans run 72 months or longer, and 100- and 120-month loans are now showing up. The payment looks smaller. The debt lasts eight to ten years. The warranty may be gone in five.

Meanwhile, 57.4% of recent new-auto loans carried negative equity. Buyers owed more on their trade-ins than the cars were worth, so the old debt was rolled into the new loan. You can trade in the keys. Apparently, the debt prefers to come along.

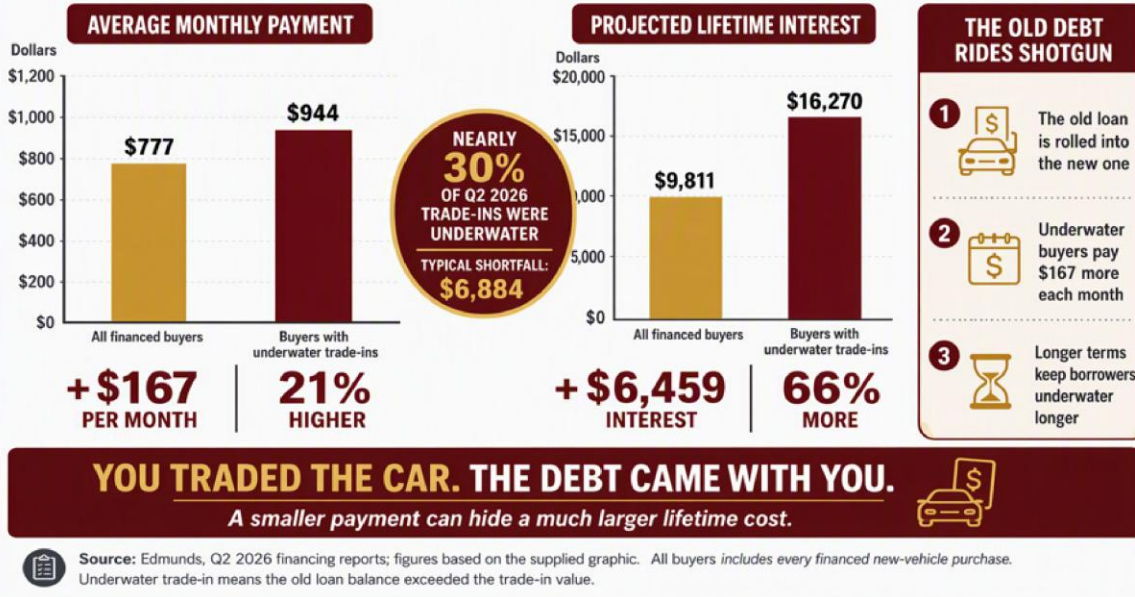
Here is how the trap works. You owe \$30,000 on a car worth \$23,000. That leaves a \$7,000 hole. Roll it into a \$40,000 replacement and you are financing \$47,000 before taxes and fees. Congratulations. You traded in one car and financed two.

To make the payment look less insane, buyers stretch the term. Nearly one in four financed new-car buyers chose seven years or longer in Q2 — a record. The monthly payment falls. The total cost does not.

Underwater buyers averaged \$944 a month and were projected to pay \$16,270 in interest, versus \$9,811 for all financed buyers. The old debt keeps charging interest while the new car starts depreciating in the parking lot.

TRADING IN THE CAR DOES NOT TRADE AWAY THE DEBT

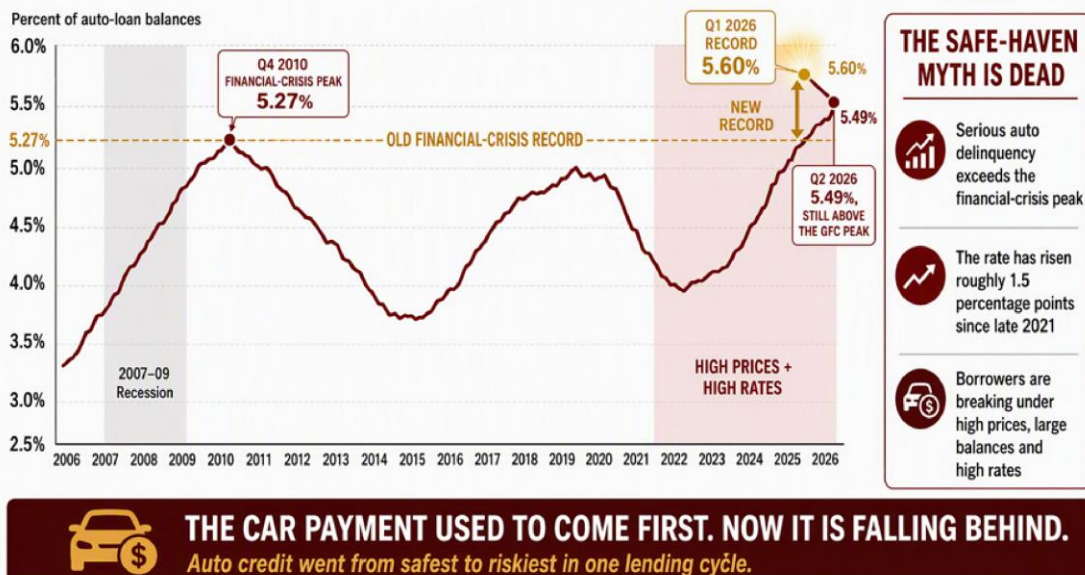
U.S. financed new-vehicle purchases, Q2 2026



Auto loans were once a safe haven, with drivers prioritizing payments on their transportation above other debts, but delinquencies on car loans have jumped since 2010. VantageScore found that, in relative terms, monthly car payments are increasing faster than mortgage payments. Car loans have gone from the safest consumer credit products to among the riskiest over the last 15 years as delinquencies rose more than 50%, driven by soaring car prices and rising interest rates.

AUTO DELINQUENCIES JUST BROKE THE FINANCIAL-CRISIS RECORD

Share of outstanding U.S. auto-loan balances 90 or more days delinquent, Q1 2006–Q2 2026



Note: 90+ delinquent means at least 90 days past due. Balance-level measure, not borrower count.

Source: Federal Reserve Bank of New York, Quarterly Report on Household Debt and Credit; Consumer Credit Panel/Equifax.

Bottom line: My advice: If you buy a new car, cap the loan at 60 months. If the payment does not work at five years, the car costs too much. Buy smaller. Buy used. **Arrange financing through a credit union before visiting the dealer.** And if the only way a car looks affordable is with an eight-year loan, it is not affordable.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

*"You would sign me up for the yield dynamic we're in any day of the week over what we experienced post-financial-crisis, with a zero-rate environment... **Investors are finding opportunities that years ago they did not.**"*

— Michael Hans, Chief Investment Officer, Citizens Wealth

AI spending will continue because too much money is already committed. But capital is not free. The AI boom is sucking money from the rest of the economy just as mortgages top 7% and diesel hits \$6.50.

"I am the house now... And you can bet against me if you want." — Scott Bessent, U.S. Treasury Secretary

Note: The direct warning targeted currency traders betting against the U.S.-Japan effort to support the yen, although markets interpreted it as a broader challenge to bond traders because Japan is the largest foreign holder of Treasuries, and Bessent was simultaneously expanding Treasury buybacks.

Yields rose afterward, prompting the obvious punch line: **Bessent said he was the house. The bond market reminded him that sometimes the house loses.**



Meanwhile, bond investors are in full panic mode. More than half of the 173 Markets Pulse respondents expect the 30-year yield to hit 6%.

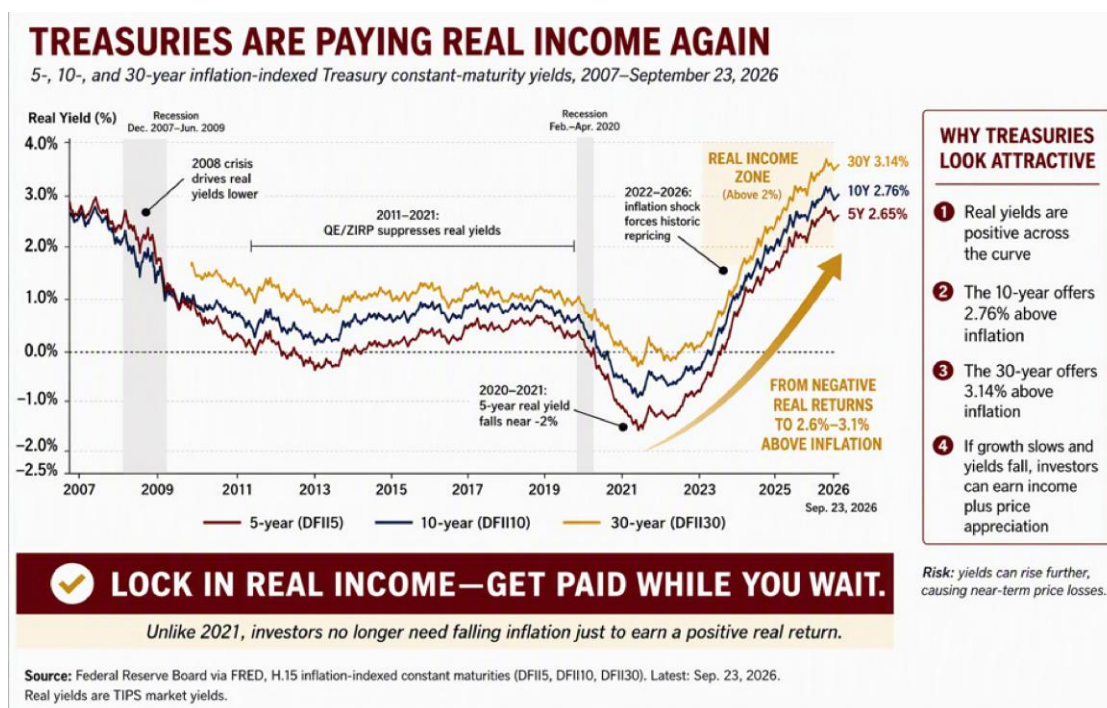
This is a serious rate shock, and the Fed has barely started. Futures price four hikes while credit cards, auto loans, mortgages and fuel all get more expensive. This time, there is no fiscal rescue.

Stocks still act as if AI repealed the business cycle. Housing says otherwise. Mortgage rates are above 7%, and prices are cracking in one of the economy's biggest assets.

Tightening into an oil shock with a flat yield curve is how policy mistakes become recessions. Warsh wants credibility and 2% inflation. The economy may pay the price.

The question this week is simple: How much pain can the economy take before the Fed blinks?

There is one silver lining: Real yields are 2.76% on the 10-year and 3.14% on the long bond. This is not 2021, when real yields were roughly -1.00% on the 10-year and -0.60% at the long end. Painful for borrowers. Better for bond buyers. Today, investors earn a healthy return above inflation.



Bottom line: Higher rates, expensive energy and tighter credit are squeezing the economy from every direction. The Fed may keep tightening until something breaks, but the bond selloff has finally created real value. Stay patient, keep liquidity and add duration gradually.

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For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at tom.slefinger@alloyacorp.org or (630) 276-2753.

As Alloya's Market Strategist, **Tom Slefinger** leverages over 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.

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