Economic Report
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The US Economy: The Year in Review

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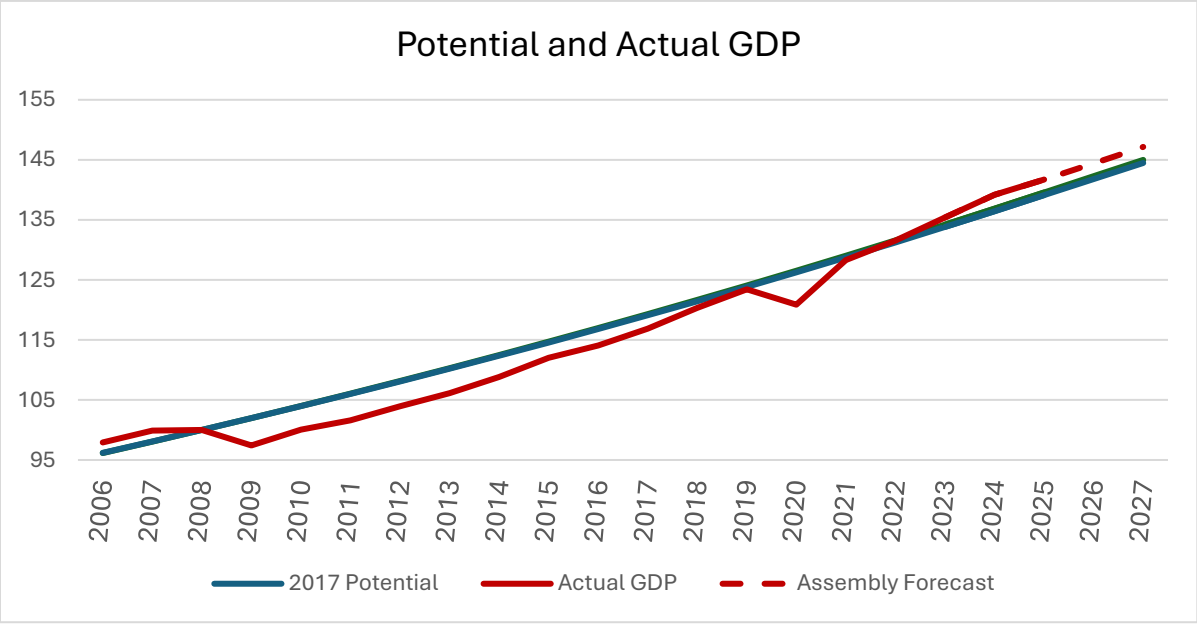
I. The Real Economy

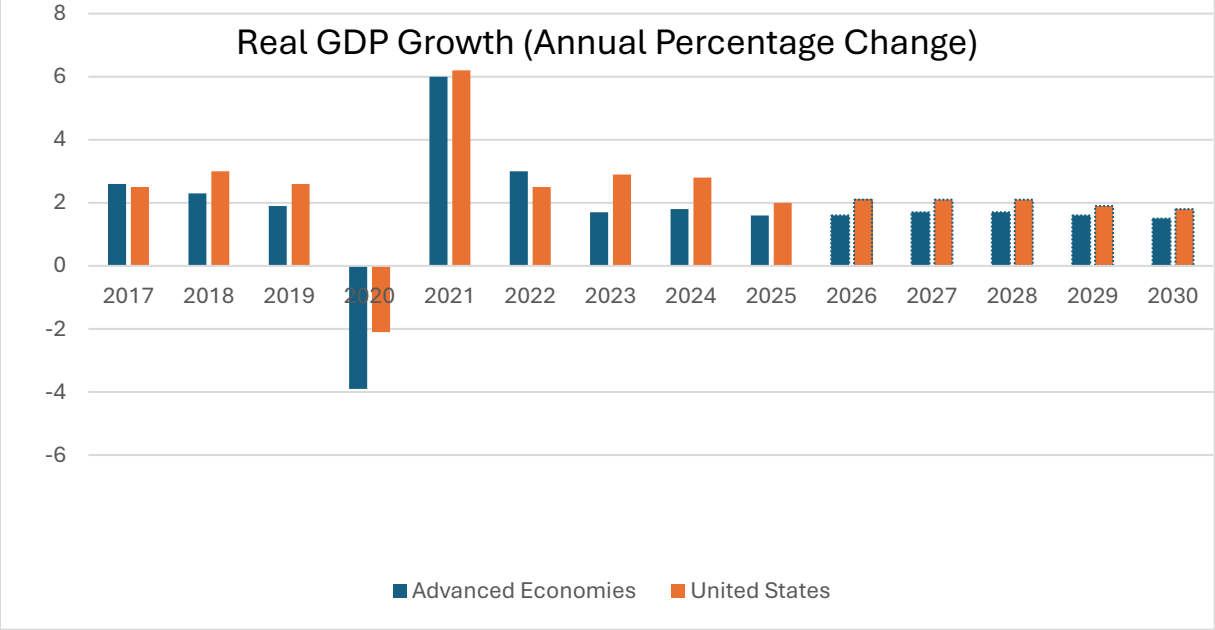
Figure 1a: The US economic activity is growing steadily

Current GDP is growing above the potential GDP that would have prevailed had the last two crises not occurred



Source: FRED

Figure 1b: US is expected to grow slightly faster than other advanced economies



Source: IMF

Figure 2a: A strong post-pandemic recovery is tapering off

Compared to previous business cycles, the economy emerged from the last recession vigorously, but its momentum is decelerating relative to the earlier recoveries (black line)

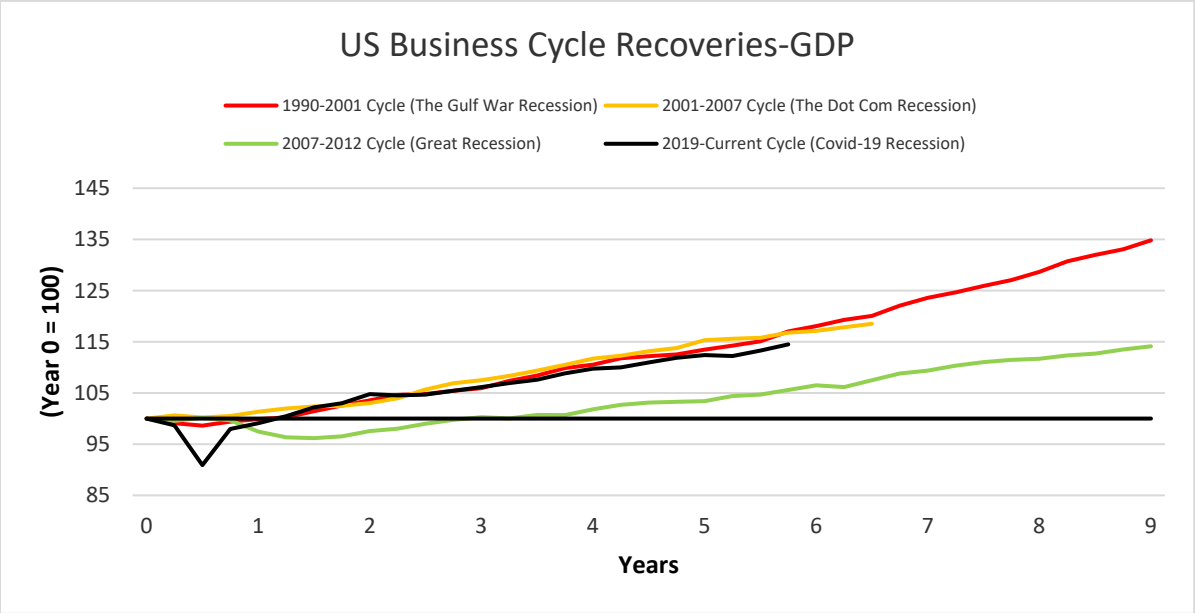
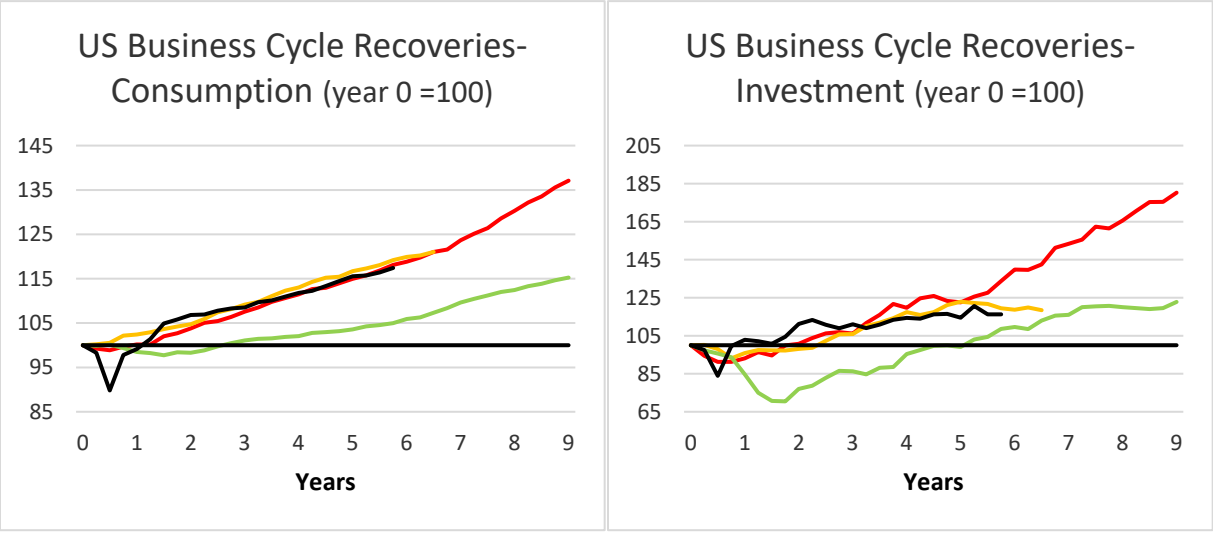


Figure 2b: The slowdown is reflected in both consumption and investment

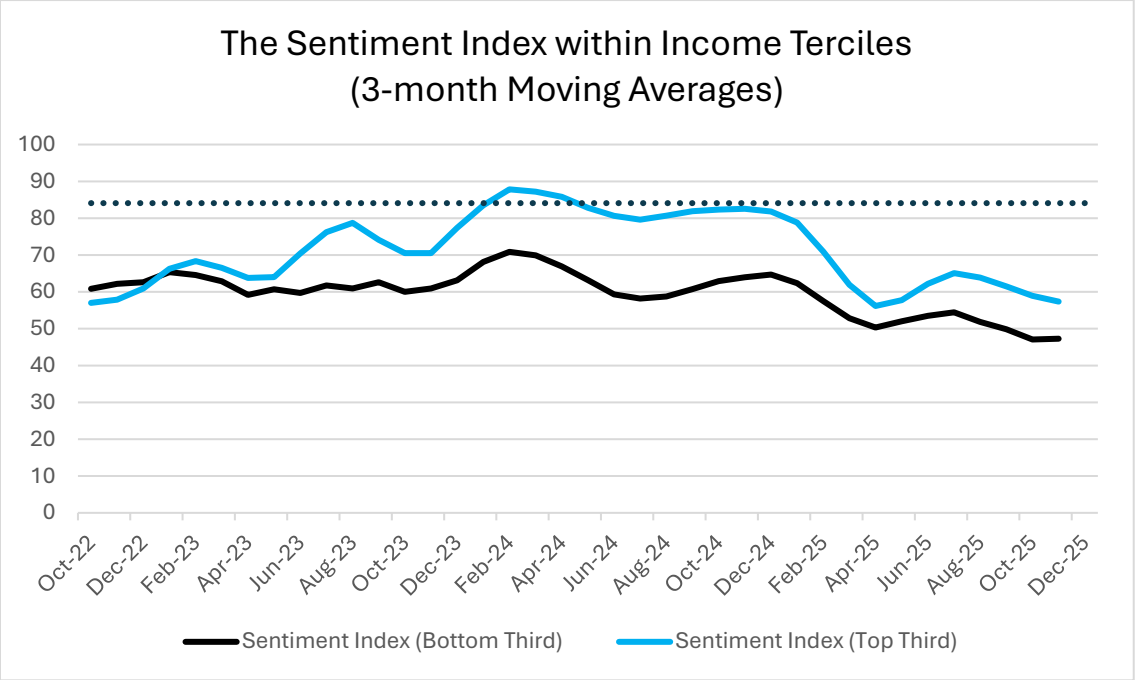


Source: FRED and authors' calculations

We observe a K-shaped growth pattern, which describes an economy where different groups recover and grow at markedly different rates after a downturn. As in the letter "K", the upper arm rises sharply (wealthy individuals, tech/asset-heavy sectors booming) while the lower arm declines or stagnates (lower-income earners, struggling industries). This divergence allows the wealthy to accumulate further gains through investments, such as stocks and real estate, while many others face stagnant wages, inflation, and financial strain, leading to increased inequality:

Figure 3a: Consumption--historically low consumer sentiment: a K-shaped recovery in sentiment

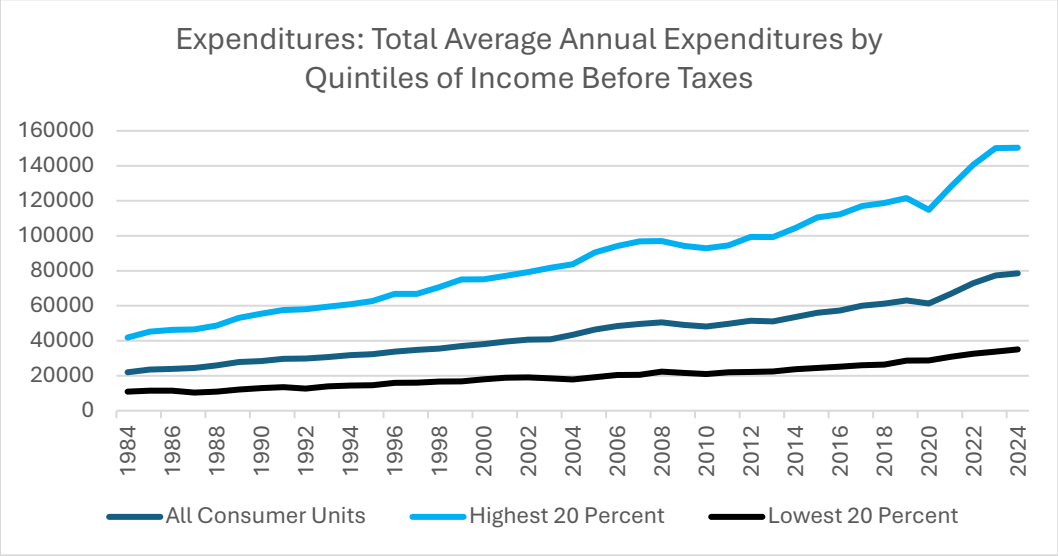
Even though total consumption is holding steady (Figure 2b, left panel). consumer sentiment reached historic lows in all income categories:



Source: University of Michigan

Figure 3b: Consumption – K-shaped growth in consumption expenditures

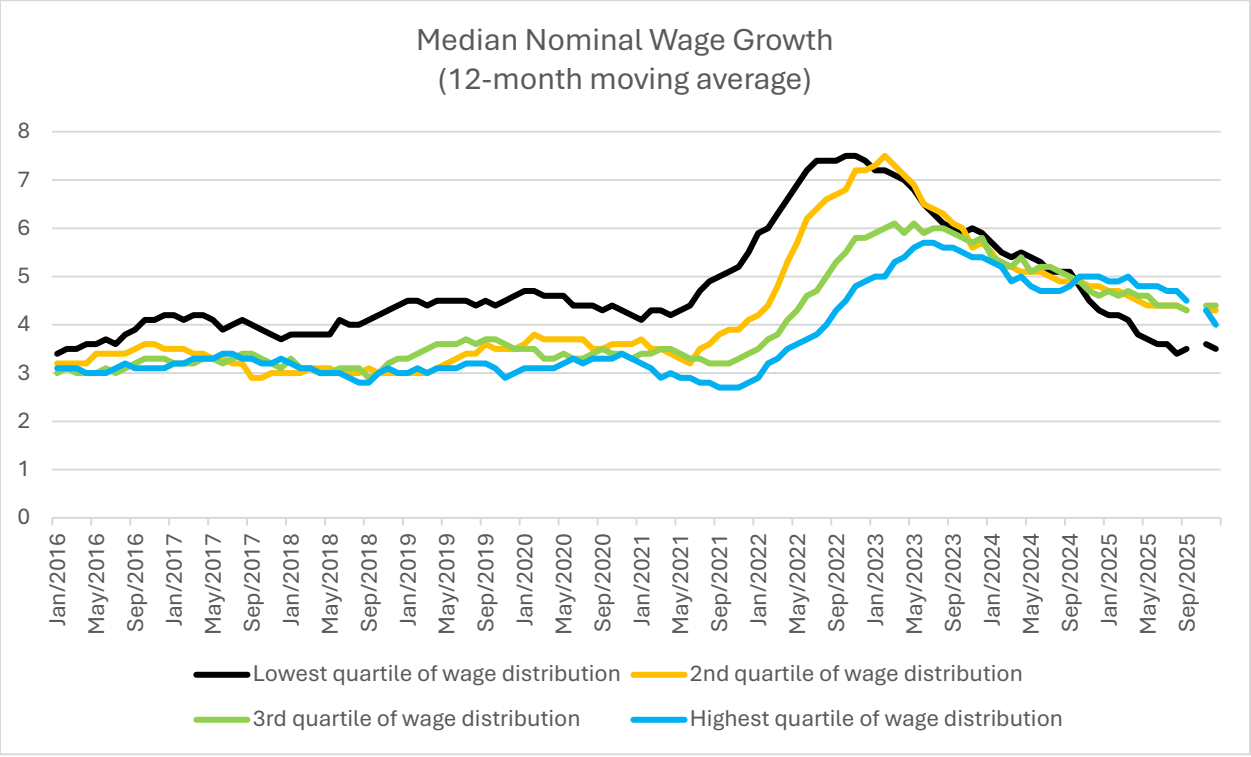
Most consumption comes from highest income earners



Source: FRED

Figure 3c: Consumption – K-shaped growth in wages

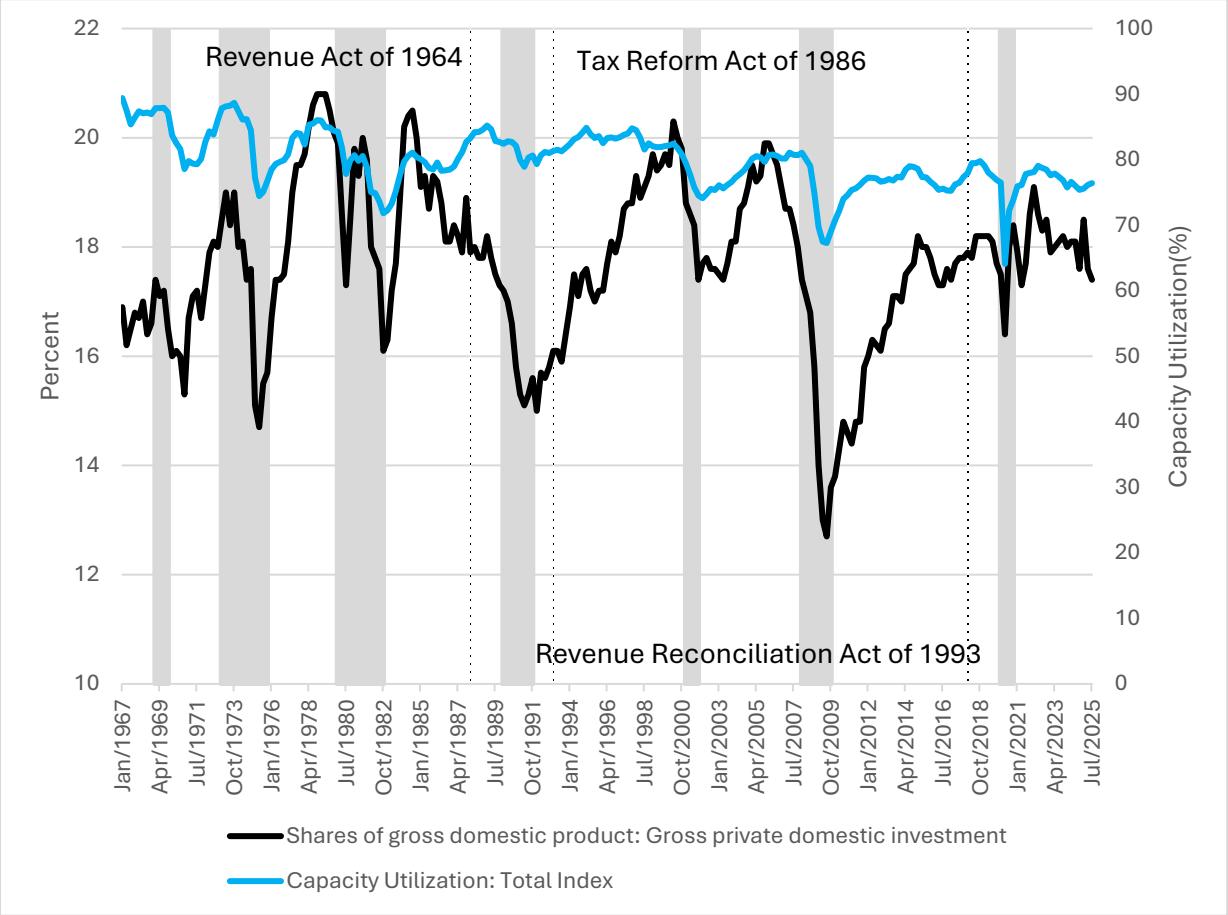
Since the pandemic, growth in the wages of lowest income groups has fallen below that of all other income categories (black line)



Source: Federal Reserve Bank of Atlanta

Figure 4a-Investment remains below its pre-2007 recession level and is not correlated with corporate tax breaks or interest rates, but with capacity utilization

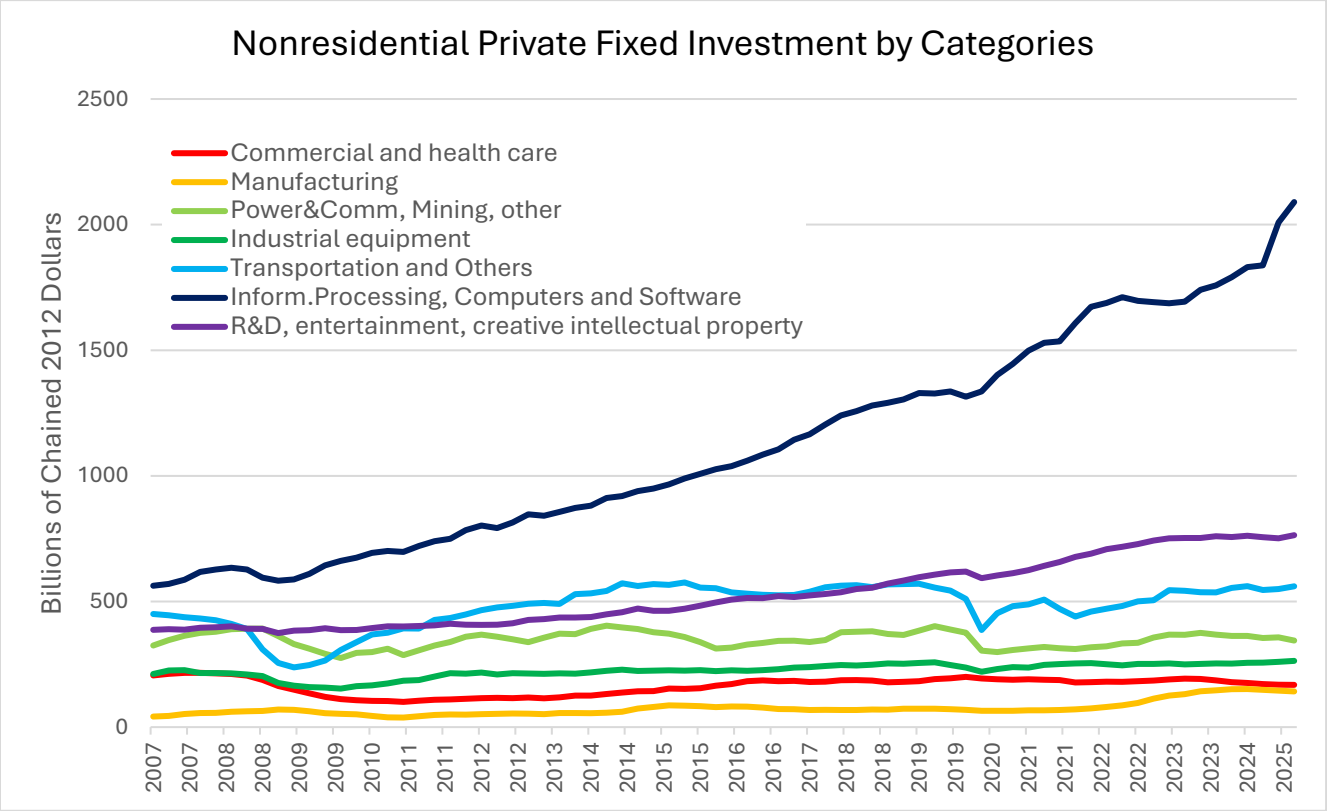
Corporate America's reluctance to reinvest reflects the fact that firms already possess more capacity (factories, machines, service capability) than they can fully use.



Source: FRED

Research suggests that the disconnect between rising market valuations (high Tobin's Q) and weak business investment is accounted for by ***excess capacity*** *(Ikenberry and Grullon, The Journal of Finance, 2025). This helps explain why periodic corporate tax cuts enacted by the administration have generally failed to revive private investment across most industries:*

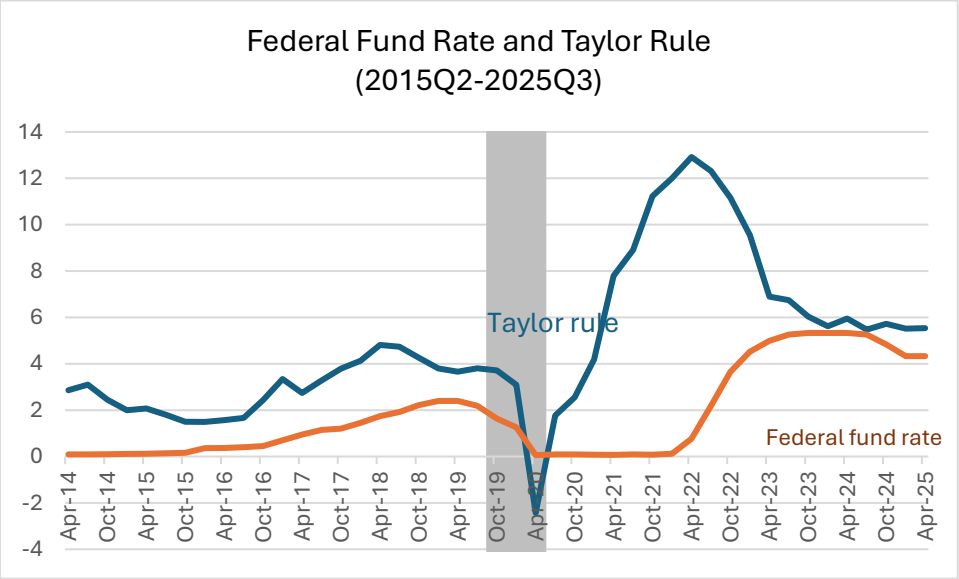
Figure 4b: A K-shaped recovery across firms: strong growth in the tech sector (in black) but weakness in most other industries



Source: FRED

II. Monetary policy: inflation-unemployment trade-off

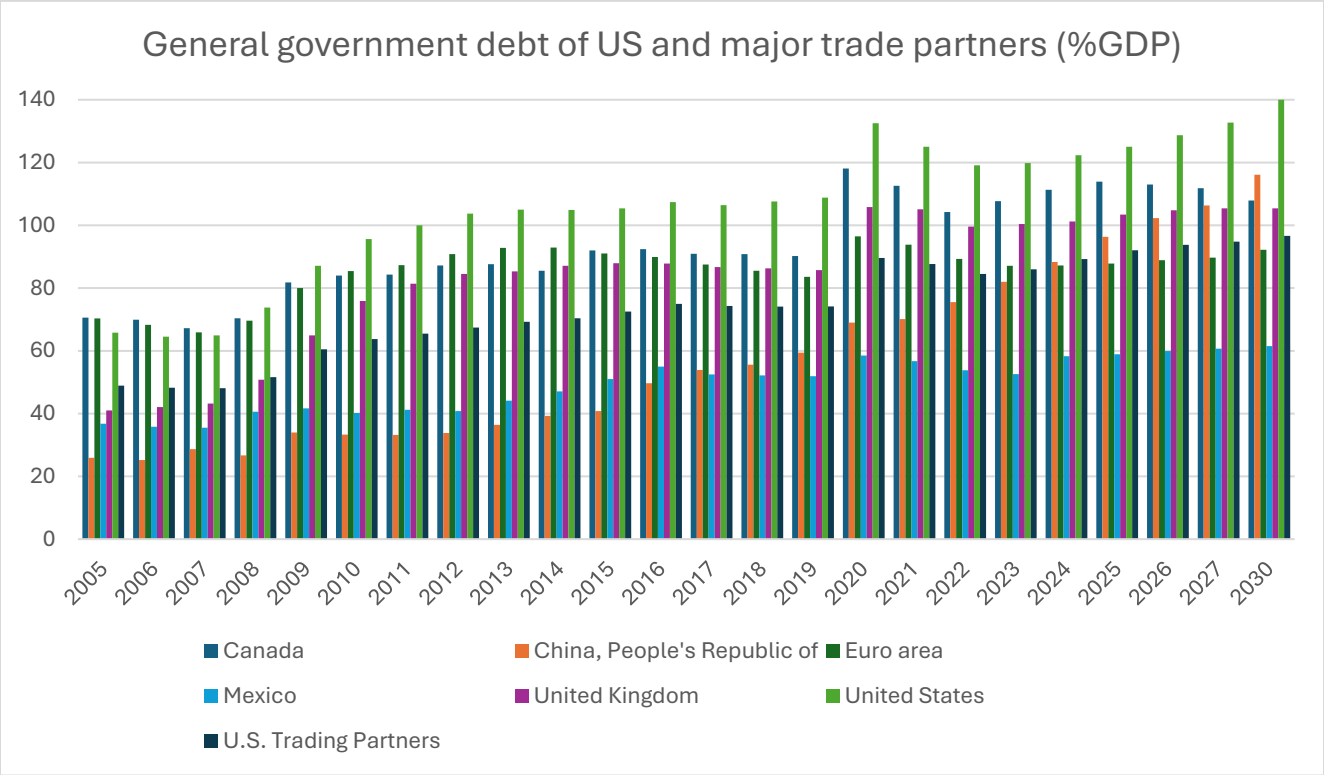
Figure 5: Are interest rates too high? Taylor rule suggests monetary policy is broadly appropriate. *The Taylor rule provides a guideline for the federal funds rate based on current inflation and economic growth. After the pandemic, it indicated that monetary policy was too accommodative, prompting the Federal Reserve to raise interest rates. Given current inflation and economic growth, the rule suggests there is little justification for rates cuts at this time (due to relatively low unemployment but sticky inflation).*



Source: FRED and authors' calculations

III. Fiscal policy and Government Debt

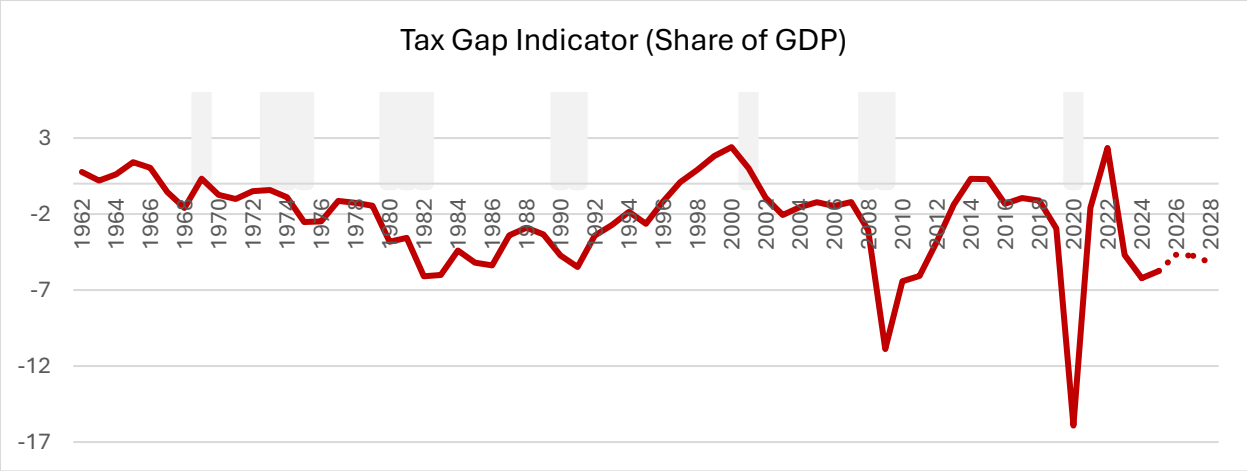
Figure 6: US Government debt (green bar) was already high before the pandemic, rose sharply thereafter, and is expected to remain elevated relative to peer economies.



Source: IMF

Figure 7: Fiscal policy is unsustainable; the tax gap indicator highlights the need to address the deficit

The tax gap indicator measures the difference between the tax ratio required to stabilize the debt-to-GDP ratio and the current tax ratio consistent with the current inflation and economic growth. A negative value indicates that current taxes are insufficient to stabilize the debt, implying unsustainable fiscal policy. The outlook suggests further deterioration (dotted line).

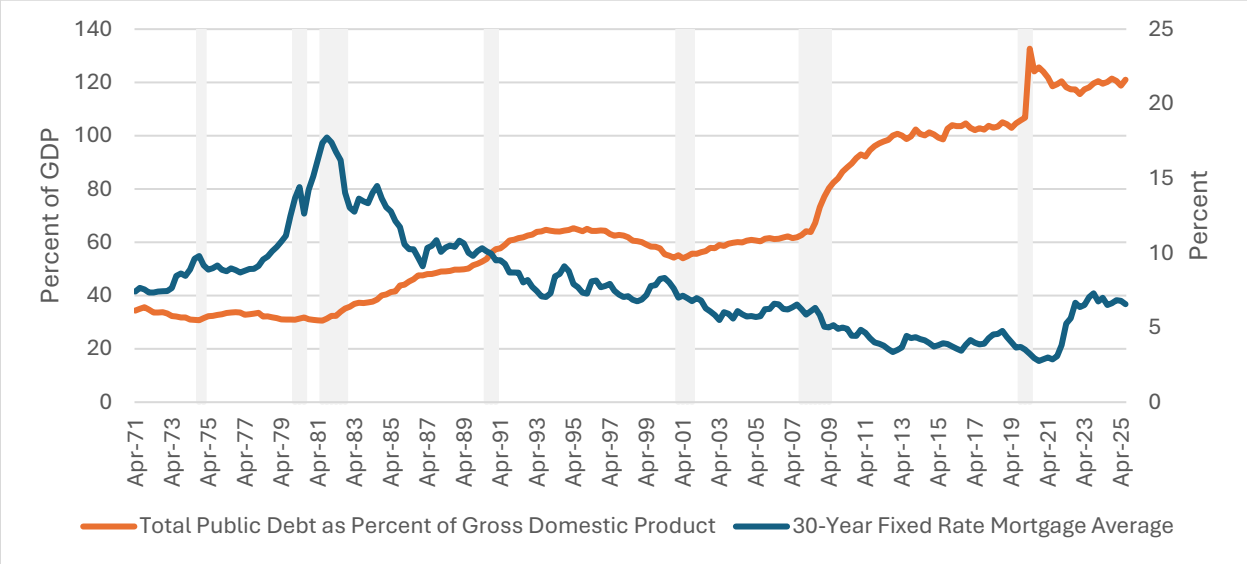


Source: OECD Economic Outlook 2025, CBO, FRED and authors' calculations

A major concern surrounding high public debt is its potential impact on the housing market through higher long-term interest rates, since mortgage rates are closely tied to the 10-year Treasury yield. Is there a positive relationship between US public debt and mortgage rate?

Figure 8: Strong global demand for US debt has decoupled US public debt from domestic interest rates, limiting the impact on mortgage rates

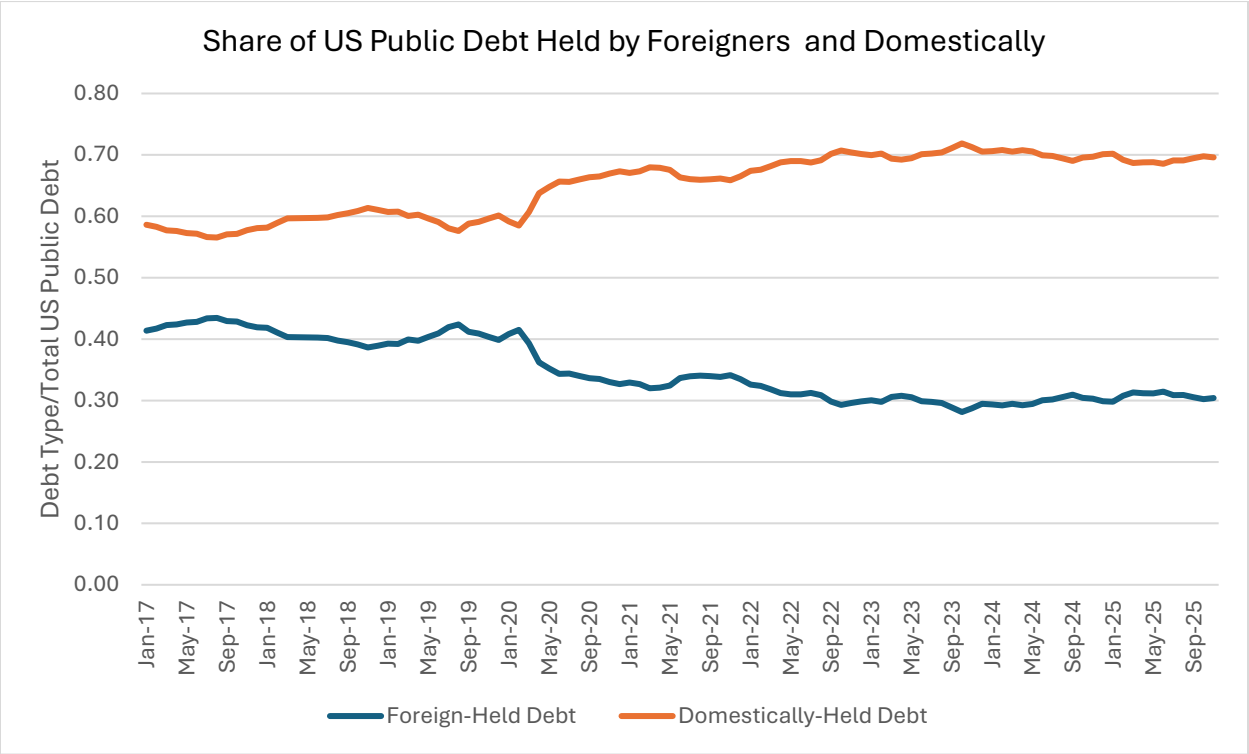
US public debt shows little correlation with mortgage rates. Empirical studies indicate that increases in public debt significantly raise long-term inflationary expectations in Emerging Market economies but not in advanced economies. In EMs, high public debt often forces central banks to combat inflation more aggressively, particularly when inflation is already elevated and central bank credibility is weak.



Source: FRED

With high deficit and debt how come the United States did not experience crowding out for the last several decades (where government borrowing competes with private borrowers for funds and pushes interest rates higher, hurting investment)? This is largely because foreign investors have financed a substantial share of US public debt:

Figure 9: Despite the geopolitical tensions, the share of US Public debt held by foreign investors has remained relatively stable.

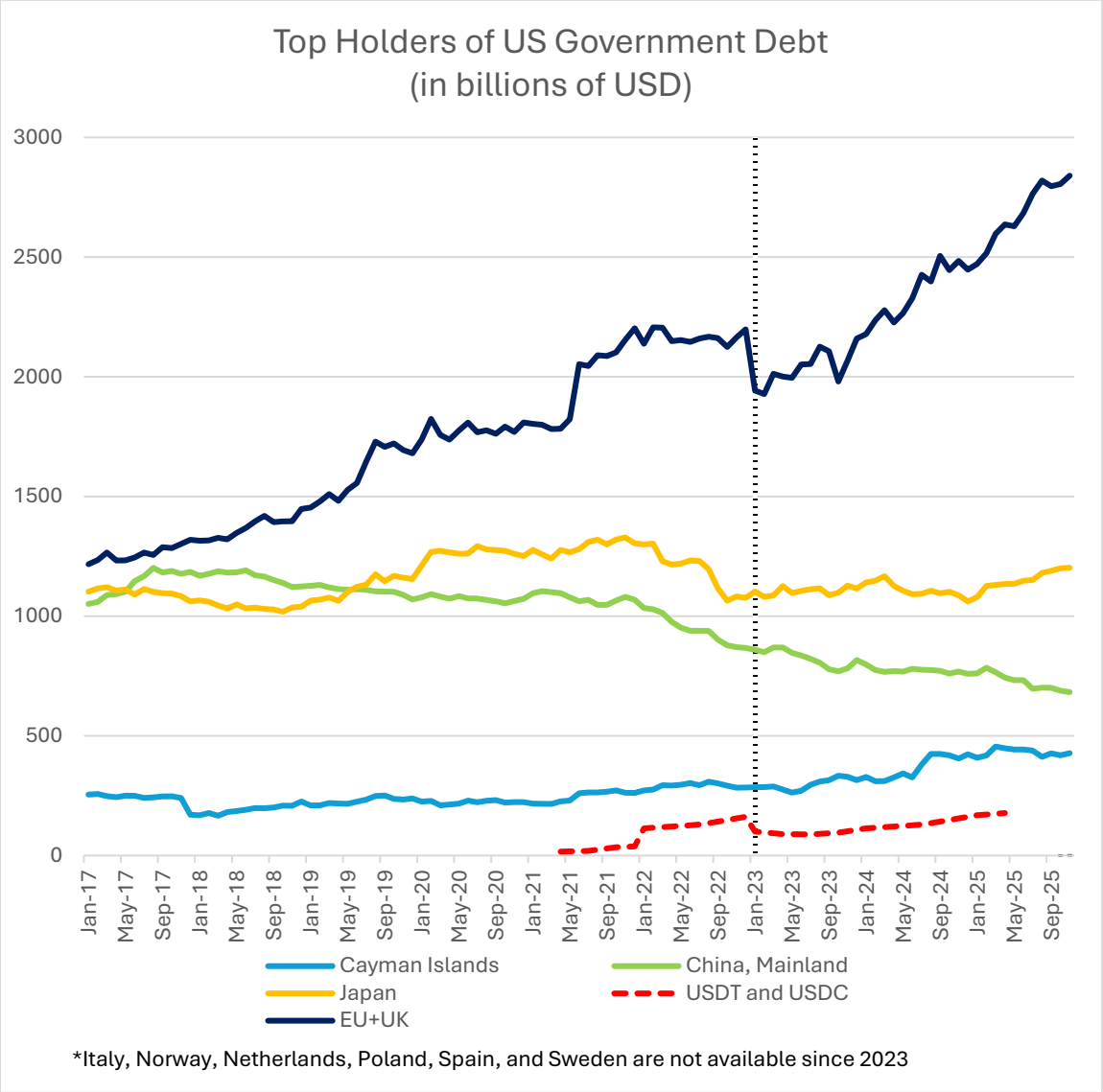


Source: Department of Treasury

Who is holding the US public debt outside the United States?

Figure 10: Flight to safety/safe asset demand (US Treasuries):

European investors have increased their purchases of US Treasuries for the last two years, while China has steadily reduced its holdings since 2018.

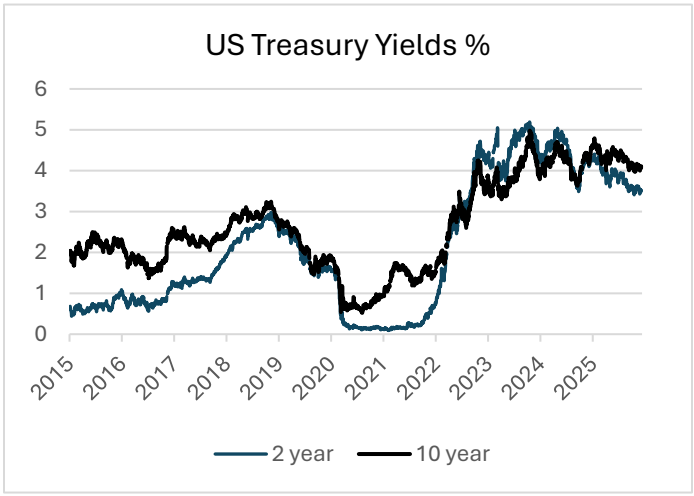


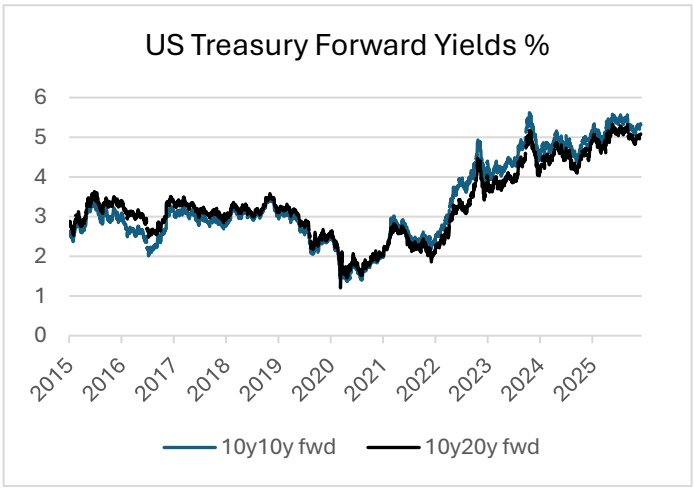
Source: Department of Treasury

Demand for U.S. Treasury bills from stablecoin issuers (such as USDT and USDC) is also growing rapidly. Stablecoin providers (Tether and Circle) invest reserves in short-term Treasuries for safety. Projections suggest that this source of demand could eventually reach trillions of dollars, particularly as markets expand and regulatory frameworks such as the GENIUS Act take effect.

IV Recession fears at home and abroad

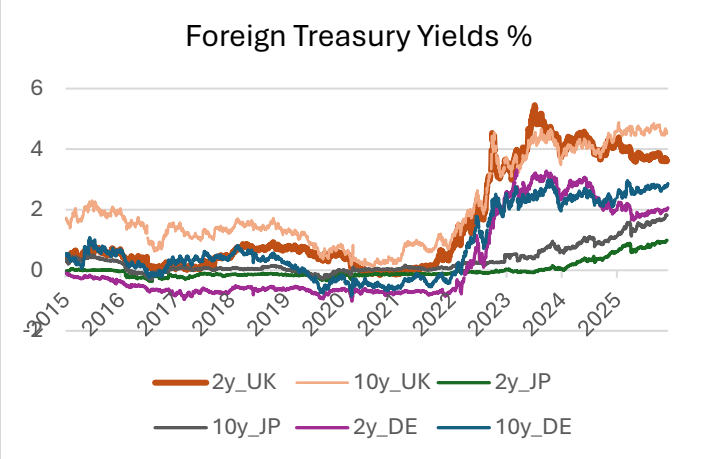
Figure 11a: Financial Markets and US Government debt: investors are pricing in more Fed cuts but concerns about a debt crisis are intensifying

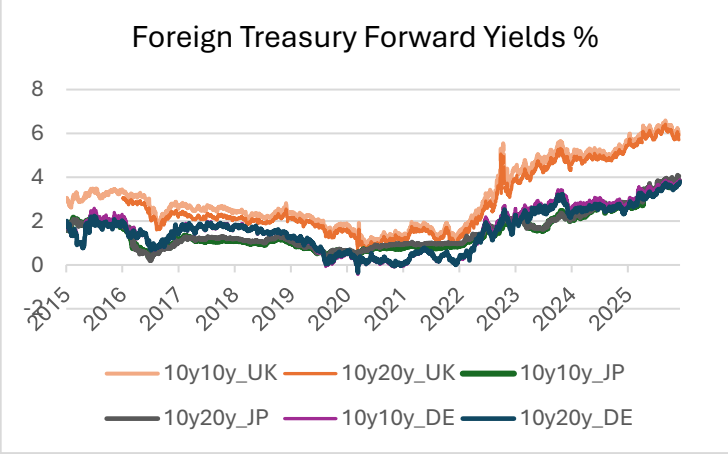




Since COVID, there has been a global oversupply of government debt in the world, leading to higher yields. Recession fears in the US have increased expectations of Fed rate cuts, pulling down short-term (2-year) yields. At the same time, concerns about fiscal sustainability keep 10-year yields elevated (left panel)
The right panel shows market-implied expectations for the 10-year yield 10 and 20 years ahead. These forward rates trend upward, largely independent of prospective reductions in the fed fund rate.

Figure 11b: Global markets --The conditions are dire if not more dire in major economies

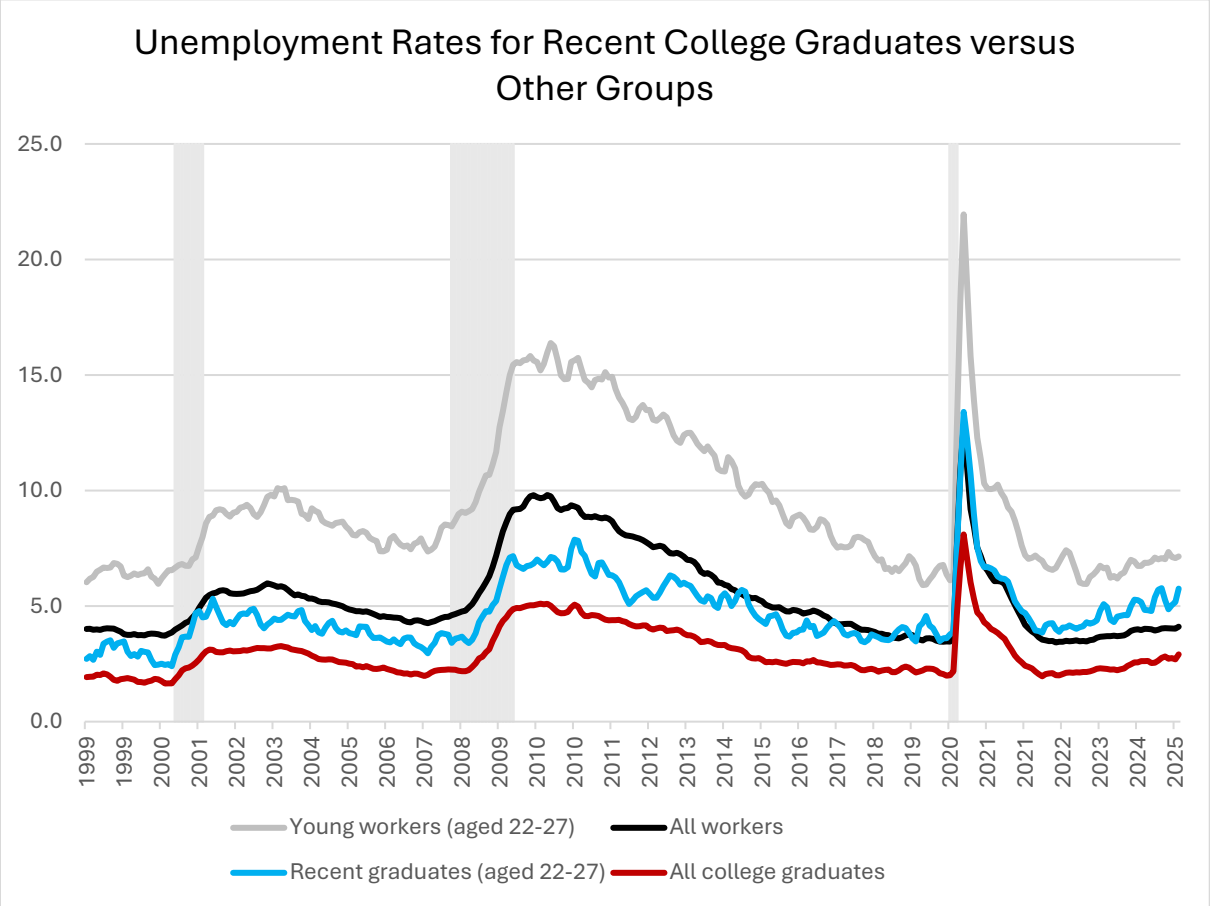




Source: FRED, Bank of England, Bank of Japan, Deutsche Bundesbank and authors' calculations.

Concerns about public debt are especially acute in the UK, Germany and particularly Japan where debt/GDP is 240%.

Figure 12: The labor market reflects a "low-hiring, low firing" environment, with AI playing an increasing role

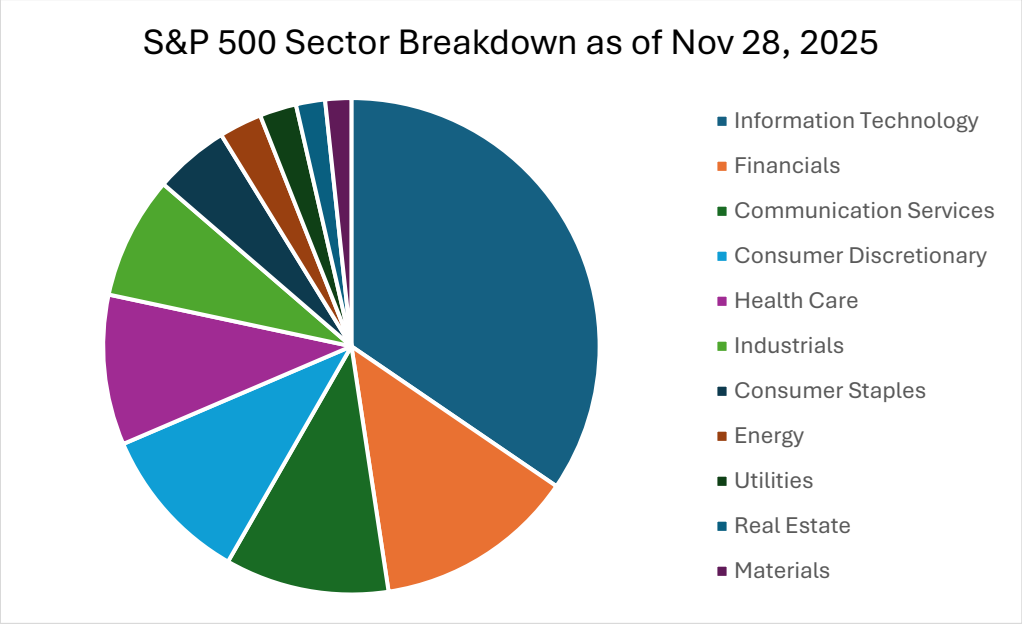


Source: FRBNY, US Census Bureau, BLS and Current Population Survey

Recent labor market evidence suggests the emergence of "Forever layoffs": recurring rounds of small job cuts, typically affecting fewer than 50 employees at a time and frequently escaping public reporting. Hiring rates have fallen to their weakest level in ten years. The unemployment rate among young college graduates (ages 20-24) in the US has climbed to levels not seen since 2014 risen to its highest levels in years, reaching 9.5% in September 2025, almost twice the rate for the overall adult population. This trend predates the Covid downturn.

A significant share of this deterioration is concentrated in specific tech-related disciplines. Unemployment stands at 7.5% among computer engineering graduates and 6.1% for those in computer science. This reflects a broader pullback in junior hiring: firms, most notably in tech industry, have dramatically reduced recruitment at entry-level. Research from Stanford reports a 67% decline in US postings for entry-level tech jobs between 2023-2024, a shift largely attributed to the spread of AI and automation that replace tasks once handled by junior employees, along with employers' increasing preference for more senior staff.

Figure 13a: A stock market bubble led by the Tech sector

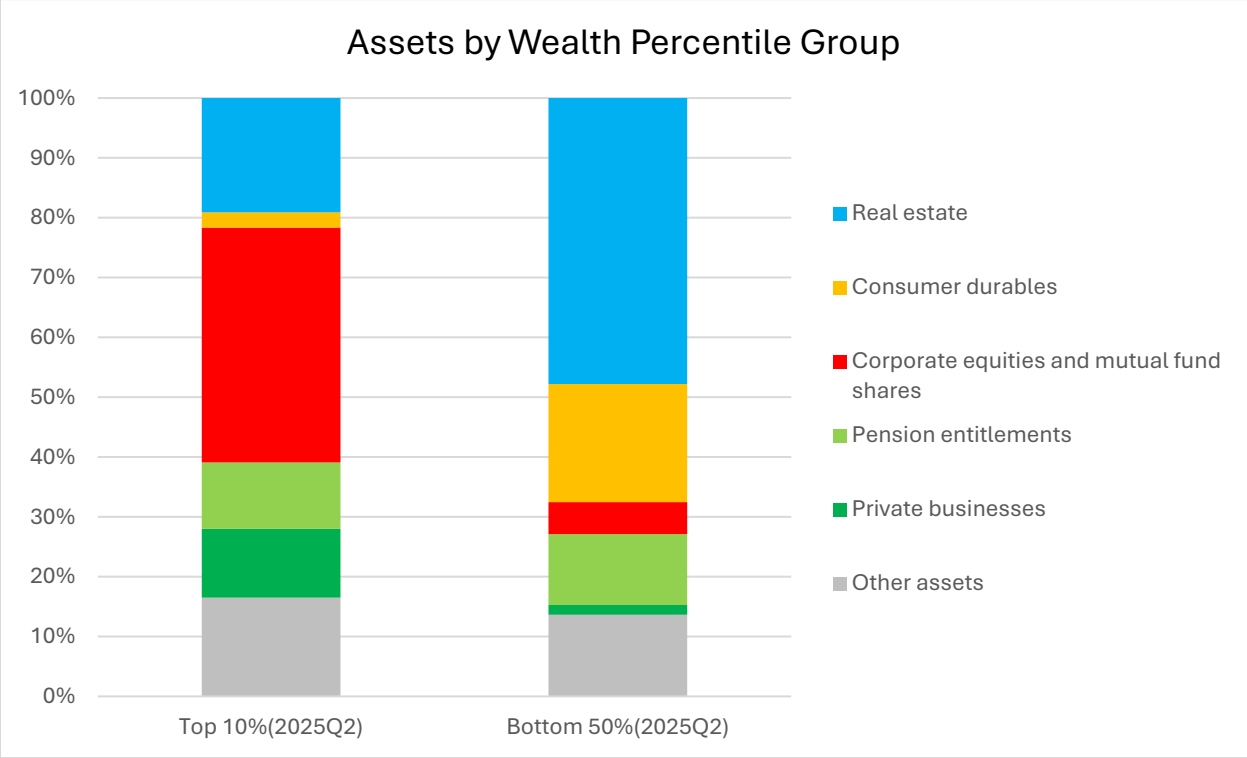


Sector	Index Weight
Information Technology	**34.60%**
Financials	**13.10%**
Communication Services	**10.70%**
Consumer Discretionary	**10.30%**
Health Care	**9.80%**
Industrials	**8.00%**
Consumer Staples	**4.90%**
Energy	**2.80%**
Utilities	**2.40%**
Real Estate	**1.90%**
Materials	**1.70%**

The share of the tech sector has risen dramatically over the past decade, up from about 12% in 2015 to 35% today. Concentration of market value in these seven companies has driven much of the S&P 500's recent performance, while also increasing overall index volatility and the risk associated with a potential bursting of the Tech bubble.

Would this matter?

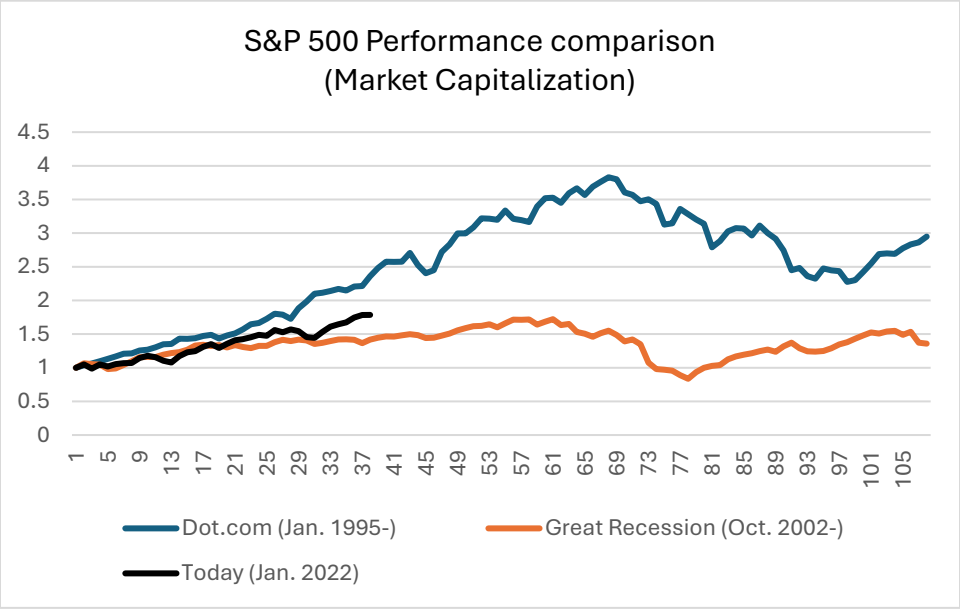
Figure 13b: a K-type bubble: 40% of equities are held by top income earners, who also sustain consumption growth (figure 3b)



Source: Board of Governors of the Federal Reserve System

Because consumption is disproportionately supported by top income earners (Figure 3b) who hold most financial assets, a market crash could significantly reduce aggregate consumption and propagate broader economic weakness.

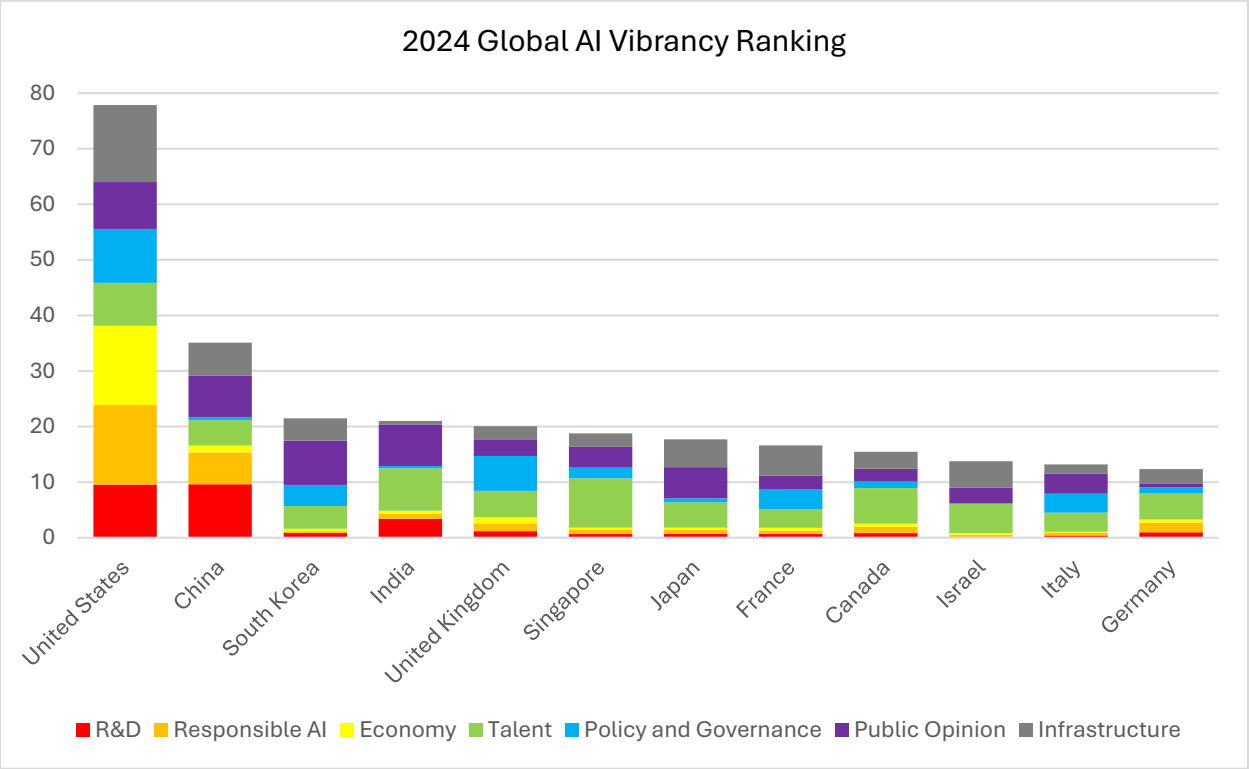
Figure 14: Perhaps not a bubble yet? Comparison with the Dot.com bubble



Source: Global Financial Data and authors' calculations

Current equity valuations remain below the levels observed at the comparable stage of the dot.com bubble.

Figure 15: Ground for optimism—The US global dominance in AI vibrancy



Source: Human-Centered Artificial Intelligence, Stanford University

AI Vibrancy is and index developed by Stanford University to enable cross-country comparison of 42 indicators, including R&D (academic publications, patent, Machine Learning models); Responsible AI (conference submissions); Economic activity (private investment in AI startups, AI mergers and acquisitions, AI hiring, job posting); Public Opinion (social media posts, discussions); Infrastructure (semiconductor exports, supercomputers, internet speed),...

The United States leads by a wide margin across nearly all categories. Strong investment in AI and the broader technology sector reflects market confidence that the US technological advantage will continue to support economic growth well into the future.