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North Forty Two & Co. 2026 Mid-Year Update

Navigating the Paradoxical Nature of the US Economy

Six months ago, we opined on an unstable and chaotic geopolitical landscape and a polarized, hyperpolitical scene domestically. Crippling tensions abounded both abroad and at home. Since the onset of 2026, things have not particularly improved, and many uncertainties remain for capital markets to navigate.

The central theme for markets in the first half of the year was supply-side disruption from the war with Iran and the knock-on effects on the global economy. Those increased costs of oil and fertilizer and industrial input shortages have fueled higher levels of consumer inflation for goods and services in the US. Between the uncertainty of tariffs and conflict overseas, the trend of sequentially lower inflation prints since 2022 has reversed — and the cumulative effect of higher prices over the past six years has average Americans exhausted.

Yet our economy, the envy of the globe, remains remarkably resilient due to the ability of the wealthy to continue to spend, and investment returns have been strong thus far in 2026. But growth has moderated, inflation is elevated, and stock market valuations are stretched by many measures. Unemployment is trending slightly higher among jobseekers while labor force participation is falling, as both young and old choose not to enter or remain in the workforce. And price instability is limiting the ability of the Federal Reserve to stimulate that moderating growth; after a period of highly anticipated interest rate cuts, we are now projected to have higher rates and more restrictive monetary policy by the end of the year to tame rising costs.

The study of economics is particularly tricky, which is why it is known as the “dismal science”. Because there are so many interconnected variables for macroeconomic policy and financial forecasting, it is difficult to give an unconditional assessment of economic issues. President Harry S. Truman famously said, “Give me a one-handed economist….[because] all my economists say, ‘on the one hand’ and then ‘on the other.’” While political leaders on both sides of the aisle are laser-focused on the one side of the argument that favors their persuasion, our responsibility is to be more even-handed.

At this juncture, the future can seem clear and straightforward, or rather ambiguous and discomforting, depending on one’s perspective. It reminds us of the images that evoke two different interpretations — think of the cartoon that looks like both a duck and a rabbit or the image of a woman that is either young or old depending on one’s perception. Things are both unsettling and tolerable at the same time. It is a paradoxical time for our economy.

We would like to continue to use this space to separate the signal from the noise and provide a sober and balanced analysis of the state of capital markets, highlighting important issues of the day through a deeper dive into seemingly contradictory economic indicators. Conditions which may support one perspective but upon closer scrutiny reveal another underlying issue. These paradoxes are what make markets — and both understanding them and weighing their probabilities and potential impacts on the prices of financial assets allows us to make responsible capital decisions.

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First, let us tackle the kitchen table issue of the day — the cumulative effect of higher prices on quality of living, felt most acutely through the price of gasoline. For decades, globalization functioned as a structural governor on inflation with free markets and comparative advantage, where countries could specialize in producing the goods and services with the lowest opportunity cost. During COVID, supply shocks and excess liquidity drove prices higher. Post-COVID, prices began to fall once supply chains normalized but resumed their upward trajectory in the wake of a heavy-handed, deglobalizing tariff regime and the natural passthrough of higher taxes and levies to the consumer. Add continued federal deficit spending, which occurs when tax receipts fail to cover the cost of entitlement programs, over $1 trillion of interest on the national debt, and discretionary spending appropriated by Congress, and our country has an enormous foundation of obligations that put persistent upward pressure on inflation and interest rates.

Now layer on conflict in the Middle East — specifically over the Strait of Hormuz, a geographic chokepoint for energy markets. Oil prices have been unstable due to the on-again, off-again nature of diplomatic talks, and those price spikes immediately bleed into inflation figures because of higher transportation, manufacturing, and logistics costs. US retail gasoline prices currently average $4.13 per gallon, up 27% in the last twelve months. As a result, annual headline inflation, which includes volatile inputs like food and energy, reached a three-year high in May — nearly double the Federal Reserve's longstanding target of 2%.

While price levels remain elevated, there is an interesting phenomenon occurring right now, a ***wealth paradox*** where stock markets and asset prices are at record highs, yet consumer budgets feel squeezed. Aggregate consumer spending has been surprisingly resilient due to the strength of the wealthy, but overall consumer sentiment is at its lowest measurement in the last seventy years. Consumers on both the upper and lower ends of the income spectrum are "overspending" by using more savings or revolving debt to fund their purchases. Wealthier Americans, leveraged through record investor margin debt, continue to spend on discretionary goods and experiences, while the bottom quintile wrestles with stubbornly high and rising costs for staples and bare necessities.

One key consideration is that the upper end of this K-shaped economy is asset owners who have benefitted from rising stock prices — particularly in the technology sector — and housing gains, while the lower income cohort, which failed to benefit from home ownership, has shrinking disposable income and rising aggregate debt levels. The operative question of the day is when do the top 10%-20% of wage earners change their spending ways, and how disastrous are the downstream effects for the performance of financial markets and the appreciated value of those tangible assets. In our view, it will likely take a sharp decline in real estate values, a sizeable stock market correction, or a recession to change this sociologically fragile dynamic.

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However, if the American consumer keeps spending in the aggregate, the economy can continue to perform. Corporate profits are at or near historic highs, profit margins are at a 15-year high, and in the second quarter, year-on-year earnings for the S&P 500 were up a remarkable 23.7%. Driving that growth was spending on artificial intelligence (AI), which represented 40-50% of total S&P earnings growth. AI infrastructure spending is increasing net income margins to historic levels as the workforce is continuously and incrementally downsized with the prospects of new efficiencies. But it should be noted that while technology companies are expanding margins, non-tech companies are seeing a decline in net profits. And there is some financial alchemy behind these tech-sector numbers, as existing accounting practices don't align well with the iterative, data-intensive nature of AI development — AI-related companies are often boosting quarterly earnings by capitalizing their AI investments rather than expensing them and deferring their negative impact on earnings over the long-term.

Regardless, despite high corporate profitability there is a ***labor paradox***, where unemployment is low, yet worker anxiety is high. We are in a "low-hire, low-fire" world that is particularly daunting for newer entrants to the workforce. Those gainfully employed feel stuck in their current roles with little lateral or upward mobility and real career risk for switching jobs. Wages are also struggling to keep up with inflation — in fact, wage growth has slowed to 3%, half of the long-term historical average — and increased earnings are accruing to business owners or deployed for capital expenditures rather than flowing down to the rank-and-file. All of these conditions translate to lower consumer confidence.

The artificial intelligence advances that have powered strong corporate results have a knock-on effect that may bear itself out in the short-term. In the first half of 2026, AI was cited as the primary reason for 23% of all announced US job cuts, or slightly more than 100,000 jobs. When white-collar and administrative roles are automated faster than a cyclical economy can create blue-collar jobs (despite lofty rhetoric, the manufacturing sector has shed 75,000 jobs during the current administration) or higher-paying technical alternatives, consumer spending could devolve into a structural drag that weighs down future profits and creates secular headwinds for equity markets.

Artificial intelligence currently presents a ***productivity paradox***. While at a granular level, there are tremendous gains in efficiency for coders, document discovery and drafting, and generative tasks, aggregate labor productivity gains on a macroeconomic level are muted. There are a couple of factors behind this current disconnect. First, the burden of auditing potentially hallucinogenic AI-generated work is both meaningful and was largely unforeseen. Launching native AI tools often takes assets and energies away from productive legacy endeavors. And many older companies aren't yet fully embracing the power of artificial intelligence; rather, they are using generative AI for more superficial tasks (think chatbots) rather than harnessing the next-generation agentic power of the technology, where AI systems act as autonomous workers, to optimize larger-scale business system operations.

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On to a current ***monetary paradox***. Much of our time is spent pondering monetary policy and the trajectory of interest rates because monetary policy either stimulates or restricts economic activity, which affects the cost of capital and in turn drives economic activity, corporate earnings, and asset prices. Here, we see a policy conundrum for the Federal Reserve under new Fed Chairman Kevin Warsh given persistently high levels of inflation.

Traditionally central banks could simply raise interest rates and reduce liquidity conditions during times of heighted inflation to make borrowing more expensive and prevent an economy from overheating. However, inflationary times usually result from tight labor markets where wage gains are plentiful, and job openings are abundant. That is not the case at present; wage gains are modest and the labor market is steadily cooling. Under a low-hire environment with the effects of artificial intelligence yet to fully materialize, keeping monetary policy too tight and rates too high to combat that heightened inflation carries a far greater risk of destabilizing the housing market and inducing a recession. The Federal Reserve is in a tricky position, largely because of a confusing macroeconomic landscape, and policy errors in either direction — too restrictive or not restrictive enough — are magnified, and may lead to disastrous results.

Additionally, there is a ***fiscal paradox*** where the government's refusal to adjust expenditures or raise taxes to stabilize debt levels results in a debt service loop that risks significantly higher levels of persistent inflation. This spiral scenario occurs when austere central banks raise interest rates to combat inflation, but then interest on the national debt surges (to wit, the US needs to refinance between $8-$10 trillion in low, near-zero interest debt in the next twelve months) , prompting the government to issue more debt to cover interest payments, leading to higher future inflation expectations, and structurally higher interest rates over the long-term.

Monetary policy cannot operate in a vacuum and requires some level of fiscal conservatism. Our policymakers must coordinate modestly tight monetary policy with fiscal discipline from Congress and the executive branch to alleviate our debt situation. Our national debt hit 123% of Gross Domestic Product (GDP) – twice the historic average and the highest level since World War II. The $2 trillion annual federal deficit is roughly 6% of the size of our entire economy. A bipartisan proposal to reduce the threshold to 3% — a stated goal of the administration but seemingly far out on the horizon — would put our debt on a sustainable downward path and free up government resources for more productive uses by easing our sizeable interest burden. The time to address this dilemma is now.

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Next, moving on to the implications of this paradoxical macroeconomic scene on client portfolios. Our mandate is to produce durable, risk-adjusted investment results for our clients. Financial markets are currently dislocated from the fundamentals, as they have been for some time, and the dislocation has been amplified by the exciting and largely unknown prospects of artificial intelligence. But the timing of an inevitable and meaningful risk-off environment remains in doubt. We stay guarded yet nimble in our posture.

More recent portfolio management decisions include moving chips away from certain large-cap technology names that have driven much of the performance for over a decade — in particular, some of the data center hyperscalers that face astronomical AI-related debt and future obligations totaling $3 trillion, over half of which is problematically off-balance sheet. For the same reason, we are also reducing market cap-weighted index holdings in favor of more balanced, equally weighted exposures that rely less on the concentrated performance of a handful of companies.

We continue to take on and enhance much more diversified risk exposures in all asset classes around the world, including international and emerging market stocks, real assets like gold and silver, and emerging market debt. Additionally, on the fixed income side of the ledger, after years of benefitting substantially from a shorter duration posture, we have shifted our approach slightly through more targeted and idiosyncratic positions to generate higher income and provide greater ballast in a higher interest rate environment.

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On a more personal note, we would encourage our readers to reach out to us with any concerns or to share any recent developments that are material to financial success. We intentionally built this practice with a limited number of clients so that we could concentrate our energies on engineering superior risk-adjusted investment results and delivering tailored and actionable financial planning guidance. We welcome the opportunity to hear from you and to put your mind at ease in these uncertain times.

We continue to be honored by your trust.

Best,

William L Ross

Founder & Chief Investment Officer
North Forty Two & Co.

President
North Forty Two & Co.