BofA SECURITIES

US Economic Viewpoint

How to talk to your family about the economy over the holidays

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PCE: Personal Consumption Expenditures

MA: moving average

Year-end comes with tough conversations

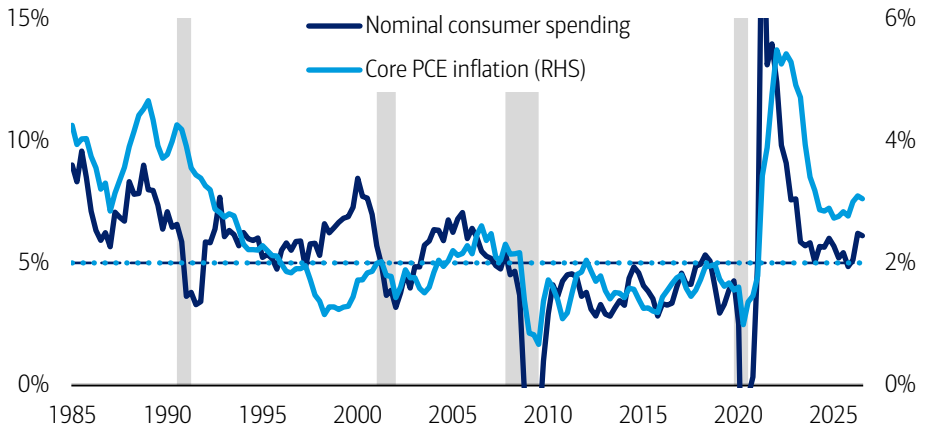
If you're reading this, you almost certainly work in finance. Bad news: your friends and family will probably unload their anxiety about affordability, AI, Iran, government debt, interest rates and the stock market onto you over the holidays. Good news: reading this report might save you some heartburn. We list 10 questions you might get asked. For each, we suggest both a short response – in case dessert is served – and a more detailed one if the turkey just went into the oven.

Great to see you again! Do you still work on Wall Street? I need to know when prices will finally come down.

Short answer: Prices might decrease for select items, but they will almost certainly keep rising on average.

Long answer: Gas has fallen over 15% from its late-September peak. Since last Thanksgiving, eggs are down more than 10% and used cars prices have decreased nearly 3%. However, you shouldn't expect broad-based price decreases. That's called deflation and it's almost never happened in the US. It isn't desirable either: most likely, the only way we'd get deflation is if we had a severe recession with millions of job losses. What we can hope for is a slower pace of price increases (i.e., inflation) next year. Again, lower energy prices should help on this front, assuming the Iran war doesn't get much worse.

Exhibit 1: Nominal spending is likely too strong for inflation to return to 2% on a sustained basis
Nominal consumer spending vs. core PCE inflation (% y/y)



Source: Bureau of Economic Analysis

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But we're likely to see more inflation in categories that aren't energy related. That's just the *price we pay* (see what I did there?) for having such a strong economy (Exhibit 1). Producers are facing many shocks: energy, fertilizers, tariffs (which are part of a broader deglobalization trend), and shortages of AI-related inputs and labor in some sectors. They're making the judgement that spending is resilient enough for them to pass those cost increases through. They've been right so far, and that's unlikely to change next year.

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Did you say the economy is strong? For whom? Billionaires?!

Short answer: Believe it or not, the US economy has done very well this year, even adjusted for inflation. Spending gains are even broadening to lower-income consumers.

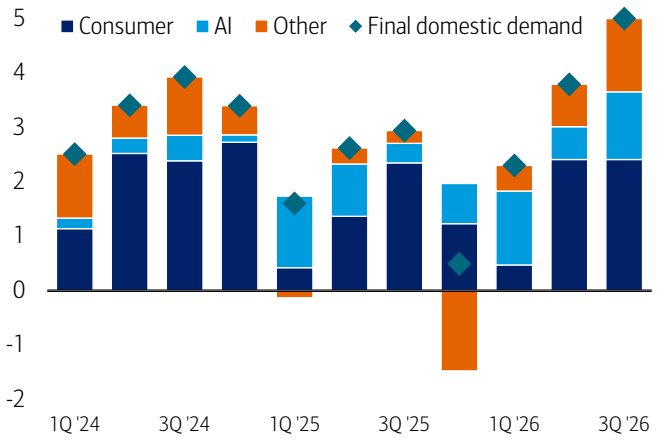
Long answer: Inflation-adjusted GDP growth will probably be around 2.5% this year and 2.2% in 2027. That's good by historical standards. Growth is being driven by two sectors: AI-related investment (think data centers) and consumer spending (Exhibit 2). You're right that the benefits of business investment are skewed toward higher-income folks.

Regarding spending though, it's a different story. There's still a lot of talk about the "K-shaped" consumer, i.e. a dynamic in which higher-income households are doing great but lower-income consumers are struggling. But BAC aggregated credit and debit card data point to broadening spending growth. The gap between income cohorts in spending growth closed over the summer. And since late Sep, lower-income households have seen faster y/y spending growth than higher-income households, even ex of gas (Exhibit 3).

I know this is counter to what you've been hearing so let's try to make sense of it. Probably the biggest reason for this reversal is the pickup in job growth this year after a very weak 2025. Even if the jobs that are being added aren't skewed toward lower-income workers, the key point is that these workers typically don't have a saving buffer. So, finding a job has a bigger effect on their spending.

To be clear, this doesn't mean that all is well. Some of the growth that we're seeing in y/y lower-income spending could just be a product of the fact that late 2025 was particularly challenging for these households. And delinquency rates are still elevated by historical standards for credit cards and auto loans. So, it's likely that a subset of lower-income households is facing significant hardship, even if that isn't moving the needle on broader trends in the BAC card data.

Exhibit 2: Consumer spending and AI capex have been the pillars of domestic demand since 1Q '25
Contributions to q/q saar growth in final domestic demand (pp)



Source: Bureau of Economic Analysis

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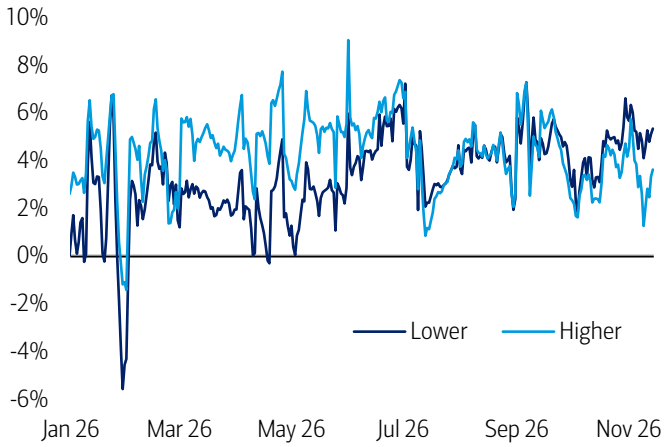
Exhibit 3: Lower-income spending growth has consistently outpaced higher-income spending growth since late September
Total card ex-gas spending per HH by income group, based on BAC aggregated card data (y/y % change of the 7-day MA of daily spending levels)



Source: BAC internal data. See the report: BofA on USA: Weekly spending update through Nov 14 for methodology, limitations, and disclaimers related to BAC aggregated credit and debit card data.

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Let's get back to data centers though. What's the deal with them?

Short answer: AI capex – physical investment and software development – is booming. It's been a big driver of the economy, but we could be in trouble if/when it slows down.

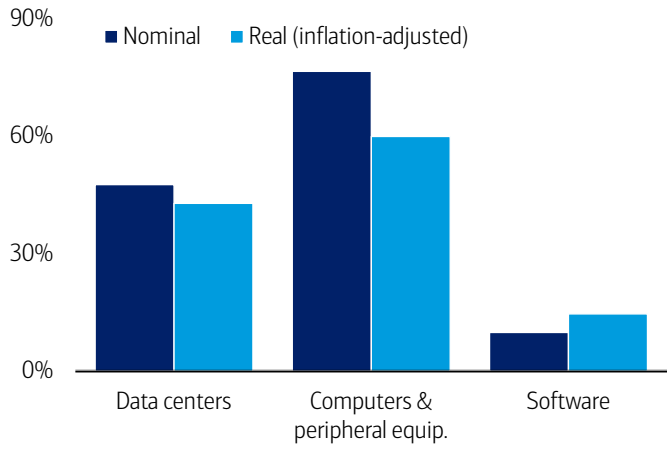
Long answer: There are three components of the AI build-out. First, as you noted there's data centers, i.e. the physical structures. They're still small relative to the size of the economy, but they're growing at over 40% annualized since the start of 2025 (after adjusting for inflation, Exhibit 4). Second, there's computers & equipment, i.e. what's needed to tool up data centers. This category has been growing even faster (60%) since the beginning of last year. Though a lot of this equipment is imported, and the imported components don't add to GDP.

Third is a category that doesn't get talked about as much because it's intangible. But it's much bigger in terms of dollar outlays. Software development. It's been growing at a 15% pace. These three categories account for about a fifth of this year's GDP growth so far. The indirect effects – job creation and the increase in spending power due to the stock market rally earlier this year (we call this "equity wealth effects") – might account for another fifth of the growth we've seen.

But the AI buildout is a double-edged sword. As helpful as it's been for the economy, the potential for a big slowdown in investment is probably the biggest downside risk to the economy in 2027-28. This could happen for two reasons. A major correction in the stock market or credit markets might lead some firms to delay or cancel their planned investment. Or it might turn out that there are only a couple of winners in the space, which take all the market share. In that case everyone else would have over-invested. It's hard to have conviction on the timing of any slowdown, and it's very plausible that the boom continues for substantially longer before the potential bust.

By the way, this is a fantastic meal. All boom, no bust.

Exhibit 4: AI capex has been absolutely booming
Annualized growth in AI capex components since the start of 2025



Source: Bureau of Economic Analysis

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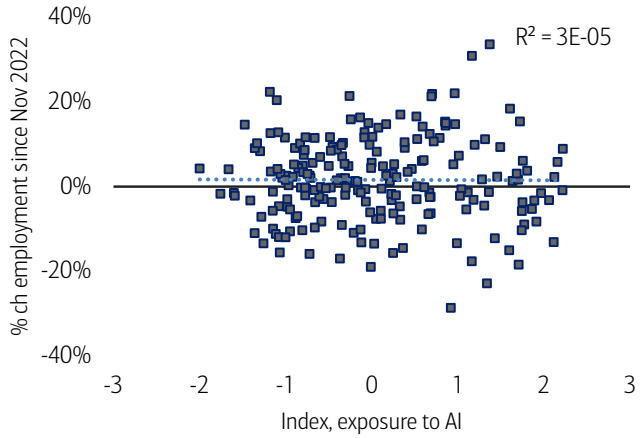
Exhibit 5: There is little correlation between employment growth and an industry's AI exposure. AI matters but only to a degree.
Employment growth vs. AI exposure



Source: Federal Reserve Bank of Dallas, Bureau of Labor Statistics and "Occupational, industry, and geographic exposure to artificial intelligence: A novel dataset and its potential uses," by Edward W. Felten, Manav Raj and Robert Seamans, Strategic Management Journal, 2021 Note: Scatterplot is across 206 industries.

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Okay but you didn't talk about all the jobs that AI could take. Will Zach be able to find work when he graduates from college next year?

Short answer: Tell Zach not to panic. AI may make the first rung of the career ladder a little harder to reach, but it isn't about to pull the whole ladder away.

Long answer: There is a real reason for concern. Recent college graduates have had a tough time finding work, and entry-level workers could be particularly exposed to AI, given that many junior roles involve routine tasks that AI can increasingly perform. But AI

exposure matters only to a degree. Over the last four years, there has been little relationship between AI exposure and employment growth (Exhibit 5).

In other words, it is tempting to blame every white-collar job loss on AI, but other forces have been at work too. Some highly AI-exposed sectors, including tech, have been unwinding substantial post-pandemic over-hiring. Tariff uncertainty has also contributed to broad weakness in hiring. AI may be slowing hiring at the margin, particularly for junior positions, but it isn't single-handedly causing mass layoffs. At least not yet.

Also, there is some good news for Zach. Unemployment among college-educated workers aged 20-24 has eased from its recent highs, and hiring has broadened, including in professional and business services.

But the bigger lesson from history is that new technologies tend to reshape jobs rather than simply eliminate them. There will almost certainly be some job reshuffling, just as there was with computers and the internet. But based on the evidence so far, the extreme doom-and-gloom scenario probably isn't arriving by Zach's graduation next year. He should still polish his CV though!

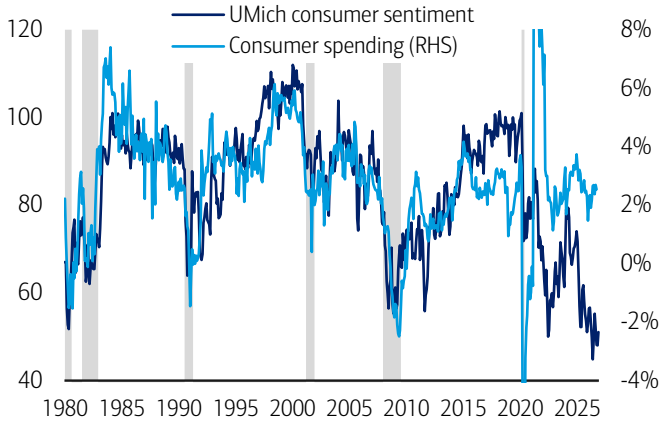
You seem optimistic about the economy. Why is everyone I talk to so upset?

Short answer: People are upset about inflation, even if they're still spending. AI-related angst, the Iran war and political polarization are also affecting consumer sentiment.

Long answer: Consumer sentiment cratered five years ago, when inflation took off. It's never really recovered: for the most part, it's been below the April 2020 trough. That's something, isn't it?

During this time, it's gotten totally detached from consumer spending (Exhibit 6). Inflation-adjusted spending has been growing at a 2.6% annualized pace since mid-2021. Again, that's solid by historical standards. Sentiment is probably so weak because people find inflation uncomfortable even if they are able to find ways to keep spending. It forces them to think about prices and be on the lookout for deals much more than they had to in the past. Most people simply don't enjoy this.

Exhibit 6: Consumer sentiment has gotten completely detached from spending in the last five years
UMich Index of Consumer Sentiment vs. consumer spending (% y/y)



Source: University of Michigan, Bureau of Economic Analysis, Haver Analytics

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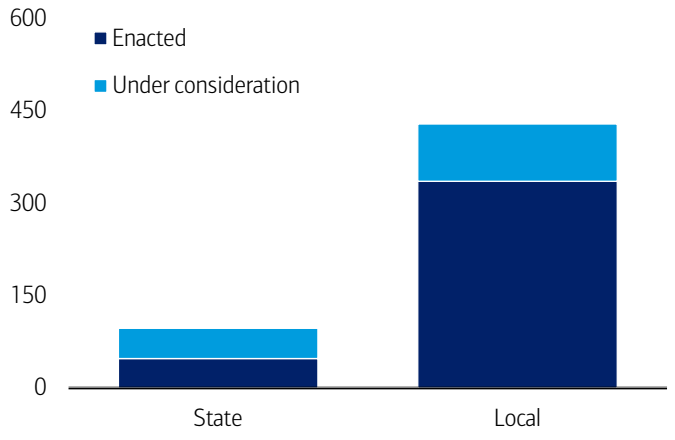
Exhibit 7: State and local governments have and should continue to pass regulations aimed at data center development
Actions aimed at regulating data center development by type of government since 2024 (count)



Source: BofA Global Research, datacentertracker.org

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There are probably also other factors weighing on sentiment that don't have a direct effect on spending or the economy. These include worries about the potential for job losses and inequality due to AI, dissatisfaction among some people with the Iran war

(beyond its effects on prices), and political polarization. That said, we need to be empathetic about the fact that some households are really struggling, as we discussed earlier. But those are mainly households that don't spend a lot, so they don't move the needle as much on total consumer spending or GDP.

Could you pass the stuffing please?

You're right about all the things that are making people unhappy. How could the midterms results affect the economy?

Short answer: The results probably won't have much of an impact on the economy over the next two years, since there's likely to be gridlock on Capitol Hill.

Long answer: The midterms, like the 2024 elections, were confirmation that voters are still concerned about affordability and inflation. Democrats outperformed across the board, winning most competitive races. However, major policy changes face two roadblocks: 1) they lack a filibuster-proof majority (60 votes) in the Senate, and 2) the President should be able to veto any bill he disagrees with.

That means any legislation by Congress over the next two years will likely be more of an appetizer than a main course. Republicans and Democrats could trade some priorities to get to an agreement on funding the government. Think about increased defense funding for more healthcare spending. On that note, don't be surprised to see a shutdown at some point. So, keep any plans for a national park visit flexible.

Congress might not do anything to end the war in Iran either. The truth is, they don't have much power to do so, which means oil prices will probably remain rangebound at least in the near term. My recommendation: if you haven't booked your December holiday travel yet, start looking now. Or if you can drive, that might be the most affordable option, because airfares are up about 20% over the last year.

One thing I'm watching closely is data center regulation, given AI's role in powering growth. Congress probably won't pass anything that slows down investment in the US. State and local governments, meanwhile, will likely continue to throw sand in the gears when it comes to investment, given voters' strong opposition to data centers (Exhibit 7) But that's not true for all states and there's plenty of construction activity underway that should support growth next year. Is it too late for Zach to think about trade school?

Well, I hope they find a way to do something about the debt. I heard the government has over $40 trillion in debt. Why can't they get it under control?

Short answer: Don't get your hopes up. Congress is unlikely to do something about the debt situation until they're forced to by investors demanding higher interest rates on Treasuries.

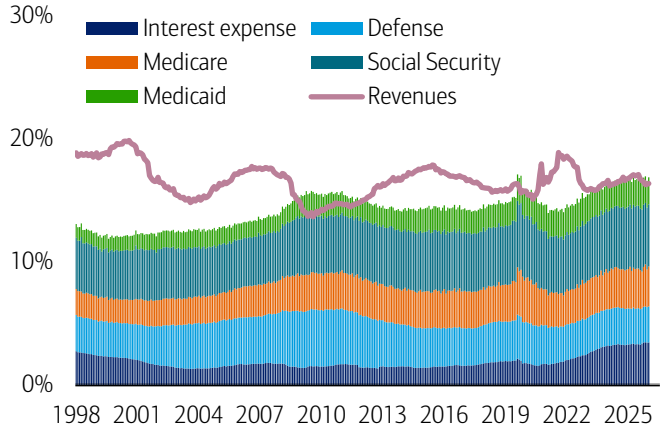
Long answer: Deficits are around $2 trillion and interest expenses account for more than half of that. In fact, Defense, Medicare, Medicaid, Social Security and interest expenses together exceed the federal government's revenues (Exhibit 8). Deficits should remain near 6% of GDP over the next two years. That means the debt-to-GDP ratio will likely keep rising even in a relatively strong growth environment, which should put some upward pressure on interest rates too.

The size of the deficit also means that fixing or improving our fiscal house requires hard choices: cuts to entitlement spending, higher taxes, or both. That's likely not a good way for members of Congress to keep their jobs. So, the incentives for Congress to address the debt problem don't exist right now.

The one thing that could force Congress to act is if interest rates on 10-year US Treasuries press higher toward 6-7%. At that point, Congress may judge that they have

no choice given the interest burden. But until then, maybe we should get used to interest rates remaining around today's levels.

Exhibit 8: Defense, Medicare, Medicaid, Social Security and interest expenses exceed total federal government revenue
Federal revenues and major spending programs (% of GDP)



Source: US Treasury, BofA Global Research

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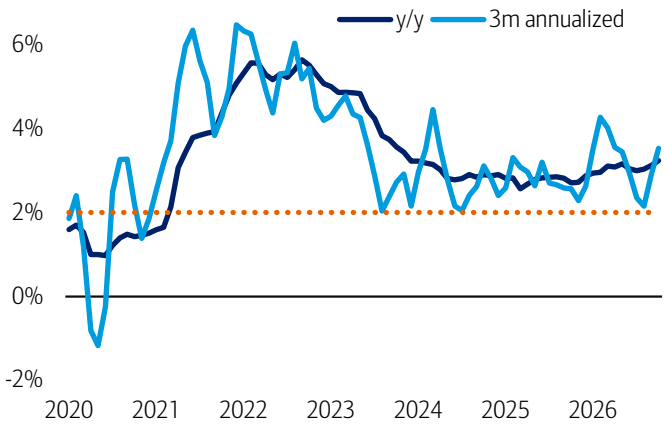
Exhibit 9: It's been nearly six years since we had even three months of 2% core inflation
Core PCE inflation



Source: BofA Global Research, Bureau of Economic Analysis. We show BofA forecasts for Oct '26.

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So, prices will stay high and the government has a debt problem. Can't the Fed do anything about this? Doesn't your cousin Kevin work there? What does he think?

Short answer: The Fed targets 2% inflation, not outright deflation. But it hasn't achieved that target either for over 5 years. It has no say in government spending.

Long answer: The Fed has a dual mandate of price stability (which it defines as 2% inflation) and full employment (think of that as a labor market in which there's a healthy balance between demand for workers and job seekers). The Fed doesn't aim to reduce broad price levels (i.e., deflation) because as we discussed earlier, that would come at a terrible economic cost.

But I'm not trying to defend the Fed too much either. It essentially has failed to hit its inflation target – even over a three-month period – for nearly six years (Exhibit 9). The Fed did hike rates aggressively in 2022-23. But with the benefit of hindsight, it probably cut them too fast in 2024-25 because i) it was worried about labor market weakness that didn't materialize, and ii) it was too confident that inflation would get back to target as "one-off factors", such as the tariffs, faded.

This year the Fed has slowly come around to the view that inflation is simply too high. Unfortunately, it's taken some really bad inflation prints in the last few months for the Fed to get there. It raised rates by 25bp in September and is likely to do three more 25bp hikes. I'm expecting those in December, January and March, but the Fed is very risk averse and it might delay or put off the last hike if the stock market keeps selling off.

The Fed has no say in the federal budget. That is the purview of Congress.

Does that mean mortgage rates are not coming down anytime soon? I don't have the energy to maintain this place for much longer. But I can't afford to downsize!

Short answer: I wouldn't hold my breath for a much better mortgage rate.

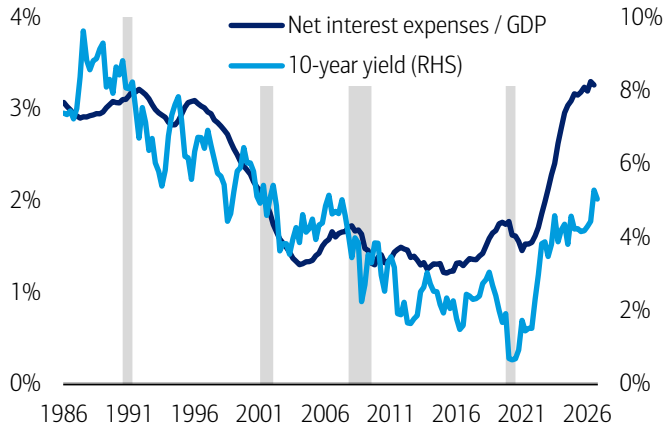
Long answer: Unfortunately, I don't have good news for you in this regard. The Fed's policy instrument, the fed funds rate, is blunt. When inflation is way above target, the

Fed has no choice but to penalize rates-sensitive sectors such as housing to try and get back to the 2% target. As you suggest, higher Fed policy rates tend to put upward pressure on mortgage rates through two channels: i) higher Treasury yields, including long-term yields (e.g., 10y and 30y), and ii) wider spreads between Treasury yields and mortgage rates as banks tighten lending standards.

The government's debt and deficit issues are another concern. The supply of Treasuries is likely to keep increasing. This should keep yields and therefore mortgage rates elevated. Some people argue that we shouldn't worry about the increase in long-term yields because it's just a normalization to historical levels. While there's some truth to this, the problem is that the federal government's net interest expenses are around an all-time high relative to GDP (Exhibit 10). So, there's a risk that we could get into a vicious cycle between higher yields and larger deficits (interest expenses are nearly 15% of federal outlays).

Speaking of vicious cycles, I'm spiraling between more pie and more whipped cream. This is delicious and my brain is shutting down in real time.

Exhibit 10: We are at risk of entering a vicious cycle between higher yields and higher interest costs/deficits
Net interest expenses as a share of GDP vs. 10y yield (%)



Source: US Treasury, Bureau of Economic Analysis, Federal Reserve Board, Haver Analytics
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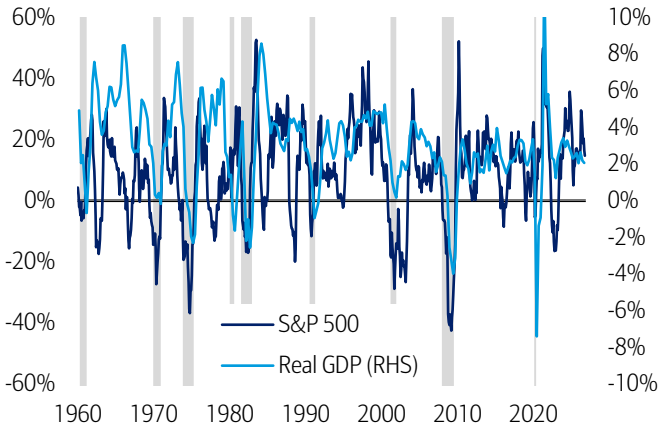
Exhibit 11: The stock market often raises "false alarms" when the economy is still healthy
S&P 500 and real GDP (% y/y)



Source: S&P, Bureau of Economic Analysis, Haver Analytics
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Let's cut to the chase then. Stocks are down. Should I buy now, or are things going to get a lot worse?

Short answer: The stock market is much more volatile than the economy. It's hard to know if this is the "right time" to buy, but the economy is still solid and stocks tend to increase over a long investment horizon.

Long answer: The stock market isn't the economy. It's much more volatile. That's why economists like to joke that it has predicted nine of the last five recessions. Okay you probably didn't find that very funny. But the point is that although the stock market always sells off significantly during recessions, it also raises many false alarms (Exhibit 11).

I can't give you investment advice, but I can give you the facts. The S&P 500 has returned 10-12% per annum over the last several decades. So, if your investment horizon is long enough, it doesn't matter much whether this is the "right time" to buy.

If you're thinking over a shorter horizon, I'd note that the S&P 500 is down more than 10% from its all-time high. The typical sell-off in recessions is 20% or more (analysts call this a "bear market"). So, if this is the start of a recession, stocks are likely to

deteriorate a lot further. But there is very little indication of a recession. The economy still looks healthy.

Does that mean this is the right time to buy, though? I'll leave that to you to decide. All I know is that it's the right time for eggnog!

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