US Economic Viewpoint

K, so what? Implications of a K-shaped economy

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Economics
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Shruti Mishra
US Economist
BofAS
+1 646 855 1040
smishra44@bofa.com

Aditya Bhave
US Economist
BofAS
aditya.bhave@bofa.com

US Economics
BofAS

See Team Page for List of Analysts

Quantifying the K

The top 10% of households account for roughly 23% of consumption, versus only 4% for the bottom 10%. K-shaped dynamics, i.e. divergence in spending growth between higher and lower-income households, emerged in late-'24/early-'25 (for drivers of K-shaped spending, see: K, but why? Five drivers of K-shaped spending). More recently, BAC card data suggest the K may be narrowing, though it is too early to know if this will persist.

The K carried the consumer

K-shaped spending makes aggregate demand disproportionately dependent on higher-income balance sheets, wealth effects and spending behavior. Hence, consumer spending has remained resilient since last year even as lower-income households faced rising rents, higher debt, elevated energy costs and weaker labor market outcomes.

The K solves the labor-consumer conundrum

K-shaped spending helped support broad economic activity even as job growth and consumer sentiment deteriorated last summer. Why? Because the latter indicators weight all consumers equally, unlike spending. Also, part of the labor slowdown was due to immigration restrictions that had only a limited impact on consumption. We argued last year that as long as higher-income spending, which is more service-oriented, is resilient, labor demand would ultimately stabilize. This is because more than five out of six jobs are in services. The recent pickup in the labor data is consistent with that view.

Lessons from the pandemic recovery

Pandemic-era fiscal support and excess savings helped fuel a stronger US recovery than the "sluggish" one in Europe. This extended beyond household balance sheets: foreign demand for US assets helped finance large deficits, while strong corporate profitability supported investment and jobs. Over time, large macro shocks interacted with unequal financial buffers and asset gains that, despite broader retail participation in equities, benefited higher-income households, contributing to today's K-shaped consumer.

Stagflation or reflation? The Fed's K-shaped dilemma

Fed tightening likely reinforced the K through higher credit costs and a widening gap between rising rents and largely fixed mortgage payments. But that doesn't mean Fed policy can fix the problem. The K manifests as reflation, i.e. a demand boom, for higher-income households, and mild stagflation for lower-income households. Each has a different policy prescription. We think the most prudent approach is gradualism, consistent with the Fed's recent reaction function.

Can fiscal policy close the gap?

Targeted fiscal support for lower-income households could help offset shocks such as higher energy prices and sustain demand when economic pressures are uneven. But deficits near 6%, competing fiscal priorities and the risk of demand-driven inflation limit the scope of fiscal policy. Also, if deficit concerns and fiscal expansion push long-term rates higher, tighter financial conditions could hurt the very households policymakers are trying to support. The effectiveness of fiscal policy in addressing rising inequality is therefore constrained by fiscal space, inflation risk and market tolerance.

U-rate: Unemployment Rate

LFPR: Labor Force Participation Rate

AHE: Average Hourly Earnings

PCE: Personal Consumption Expenditure

NFP: Nonfarm Payrolls

QCEW: Quarterly Census of Employment and Wages

HH: Household

NIPA: National Income and Product Accounts

SA: Seasonally Adjusted

NSA: Non-Seasonally Adjusted

BLS Bureau of Labor Statistics

CES: Current Employment Statistics

BED: Business Employment Dynamics

Timestamp: 29 June 2026 04:30AM EDT

Executive Summary

In a previous report (K, but why? Five drivers of K-shaped spending), we showed how consumer spending since late-'24/early-'25 became increasingly K-shaped, with higher-income households driving activity amid widening divergence across income cohorts (Exhibit 1). We documented five factors responsible for the K-shaped spending dynamics – balance sheets, housing costs, the labor market, fiscal stimulus and the affordability shock from higher gas prices.

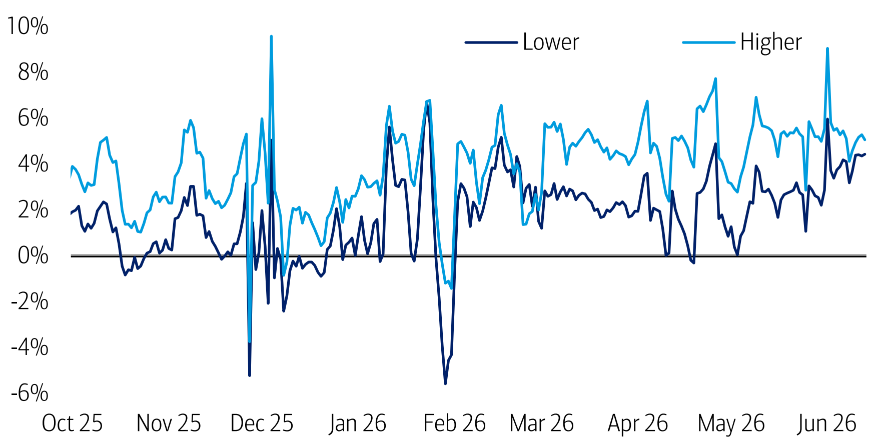
Together, these left higher-income households supported by equity wealth, stable housing costs and steadier labor outcomes, while lower-income households faced rising rents, weaker job growth and higher debt burdens. Then in 2026, this divergence widened further: higher-income spending received a larger boost from OBBBA-related tax relief, while higher energy prices from the Iran shock, acting as a regressive tax weighed more heavily on lower-income households, leaving the former better positioned to absorb the hit.

In this report, we turn to the implications of this divergence. We first assess why K-shaped dynamics matter for aggregate consumption outcomes, highlighting the outsized share of higher-income households in overall spending. We then show how these K-shaped dynamics help reconcile the disconnect between a cooling labor market and resilient consumer spending we got last year. Also, we use the pandemic recovery to learn about the current K-shaped cycle.

Finally, we consider what a more bifurcated economy means for policy. The K complicates monetary calibration by making aggregate demand appear firmer than underlying breadth would suggest, even as stress builds unevenly across households. While monetary policy has likely contributed to this divergence at the margin, it is not well suited to address it directly. Fiscal policy could be used to lean against the K, but it is subject to the amount of available fiscal space in an economy amid other factors.

Exhibit 1: Higher-income households continue to show stronger growth than lower-income households even in total ex gas spending

Daily total card ex gas spending per household by income group (y/y % change of the 7-day moving average of daily spending levels)



Source: BAC internal data. See the report BofA on USA: Weekly spending update through Jun 20 for methodology, limitations, and disclaimers related to BAC aggregated credit and debit card data.

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Is the K starting to close?

More recently, BAC aggregated debit and credit card data for the first half of June show the gap in total card spending ex-gas between higher- and lower-income households narrowing (Exhibit 1). Alongside this, a recent Bank of America Institute report showed a rise in after-tax wage growth for lower- and middle-income households. It is still too early to confirm a sustained shift, as the recent improvement could partly reflect tax relief, but the data bear watching.

However, if this narrowing of the K is sustained, one explanation could be job growth broadening into more blue-collar sectors such as leisure & hospitality, construction and manufacturing. Recent data provide some tentative evidence of this, alongside an improvement in professional & business services hiring after job losses throughout '25, which disproportionately affected younger, lower-income workers. Potential drivers could be reduced tariff uncertainty, ongoing equity market strength, and consequently robust higher-income spending.

This would be consistent with the pre-K environment. Before the K-shaped consumer emerged in late-'24/early-'25, lower-income households saw faster spending and wage growth than higher-income households, reflecting a labor market led by blue-collar industries such as leisure & hospitality. A sustained broadening in hiring could begin to recreate those conditions.

Implications of a K-shaped consumer

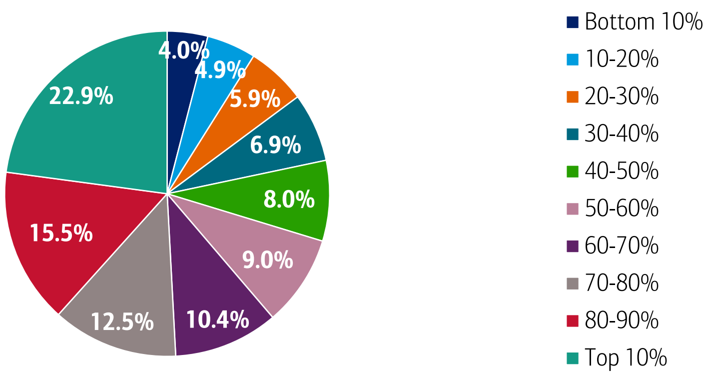
Why the K Matters for Aggregate Consumption

Spending is concentrated at the top of the income cohort...

High-income households account for a disproportionate share of total consumer spending, which has important implications for how aggregate demand behaves in periods of rising divergence across income groups, especially when other sectors of the economy (e.g., the labor and housing market) are weakening due to policy shocks or structural changes.

Exhibit 2: Top 10% earners contribute to about 23% of the consumption in the economy while the bottom 10% only have a 4% share

Share of average annual expenditure by pre-tax income decile (%)



Source: BLS (CEX Survey), Haver Analytics

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...which has the highest share in aggregate consumption

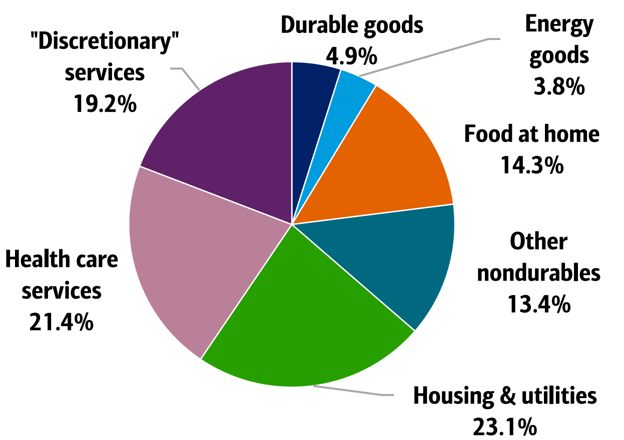
The top 10% of households by pre-tax income account for roughly 23% of total consumption, compared with only about 4% for the bottom 10% (Exhibit 2). This concentration means that aggregate consumption outcomes are increasingly dictated by higher-income financial health, balance sheet dynamics and cost pressures.

Aggregate demand becomes less sensitive to lower-income stress

This asymmetry helps explain why aggregate consumption can remain resilient even as lower-income households face pressures from higher rents, elevated debt-servicing costs, weaker labor market outcomes, and greater exposure to energy price shocks. As long as higher-income consumers who are more insulated from these pressures and more exposed to equity wealth, tax relief, and higher-income continue to spend, headline consumption growth can mask underlying stress elsewhere in the economy. A BEA-BLS study reinforces this point.

Today, when many of the post-pandemic dynamics and policy shocks operate asymmetrically, the rising concentration of spending at the top makes aggregate consumption less sensitive to conditions facing lower-income households. As a result, traditional signals of consumer weakening, such as rising delinquencies or softer hiring among lower-wage workers may coexist with steady overall spending, complicating real time assessments of consumer health from the perspective of the broader economy.

Exhibit 3: 63% of spending by the bottom 10% is on energy goods (including gas), groceries, housing and healthcare
Consumption basket of the bottom 10% (2023)



Source: BEA, Haver Analytics

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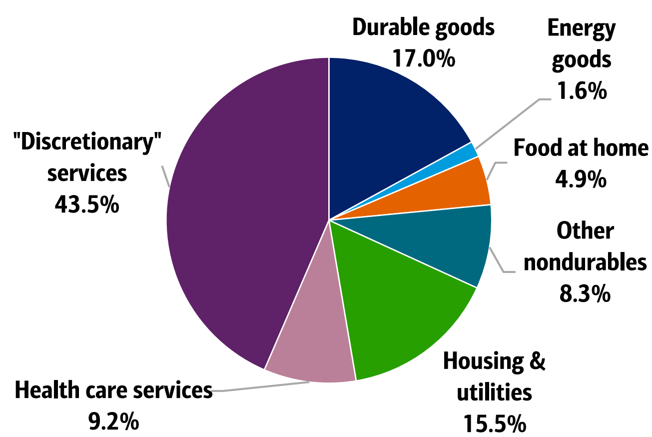
Exhibit 4: Only 31% of spending by the top 10% is on energy goods (including gas), groceries, housing and healthcare
Consumption basket of the top 10% (2023)



Source: BEA, Haver Analytics

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What lies beneath the K: spending pattern differences

To better understand the K-shaped dynamic, we drill down into how spending patterns differ across income cohorts (Exhibit 3 and Exhibit 4 show spending patterns across the bottom and top consumption decile). The divergence is most evident in housing & utilities, other essentials and discretionary services.

Higher exposure to necessities of lower-income households...

Lower-income households allocate a much larger share toward necessities. 63% of spending by the bottom 10% is on energy goods (including gas), groceries, housing & utilities and healthcare vs the top 10% only do 31% of their spending on these necessities. A number of factors are responsible for this divergence.

...in the form of housing and healthcare pressures...

Lower-income households are more likely to rent and are hence more exposed to rising rents. Meanwhile, higher-income households are more likely to be locked into low pre-pandemic fixed-rate mortgages, keeping housing costs relatively stable, especially in the era of "higher for longer" rates. Also, lower access to better insurance leads to a higher share allocated towards healthcare spending by lower-income households.

...and greater vulnerability to energy and food inflation

Energy exposure reinforces this gap. Lower-income households devote a larger share to energy goods, including gas (4.9% vs. 1.6%), making them more sensitive to the Iran shock. Similarly, the higher share of spending on groceries suggests greater vulnerability to cost pressures. With fertilizer supply risks linked to Middle East tensions, food inflation could remain elevated in '27, prolonging this divergence. Though risk of this might reduce now given some progress on the peace deal.

Stronger discretionary spending of higher-income households

By contrast, higher-income households spend a far greater share on discretionary services (43.5% vs. 19.2%), highlighting their stronger capacity buffer. Indeed, our recent BAC card data show that lower-income households, already spending less on discretionary services, have seen a larger rise in necessary spending (Exhibit 5), further compressing discretionary outlays and widening the K on that front (Exhibit 6). The higher share of energy goods (including gas) consumption among lower-income households has effectively acted as a tax on discretionary spending at the lower end.

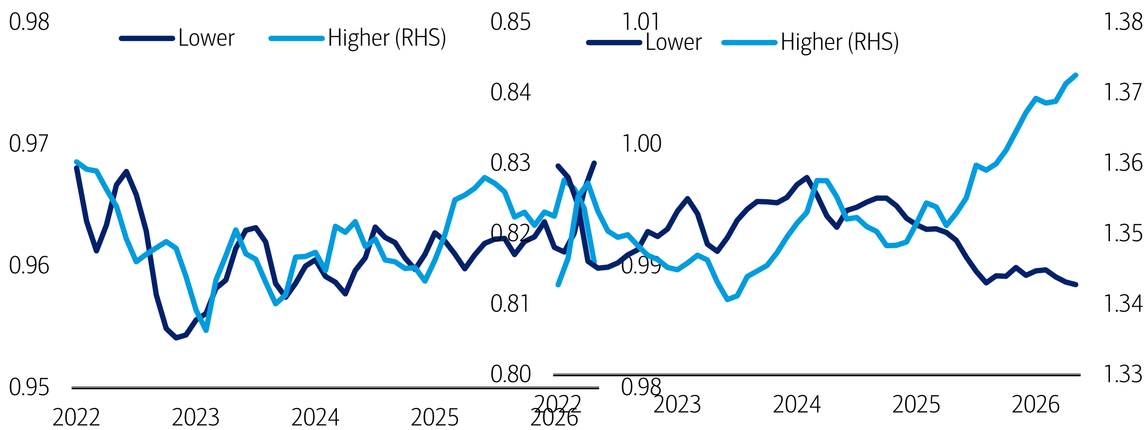
Overall, the data show that the K is not just about differences in spending growth rates, but also about differences in spending basket, with lower-income households increasingly constrained by necessities, while higher-income households retain the capacity to drive discretionary demand.

Exhibit 5: Non-discretionary spending by lower-income households was likely impacted by higher gas prices

Ratio of lower- and higher-income spending to middle-income discretionary spending (3m average of monthly levels, SA)

Exhibit 6: K-shaped spending dynamics remain pronounced in discretionary categories

Ratio of lower- and higher-income spending to middle-income discretionary spending (3m average of monthly levels, SA)



Source: BAC internal data. Non-discretionary spending is spending on gas, groceries and utilities. See the report BofA on USA: Weekly spending update through Jun 20 for methodology, limitations, and disclaimers related to BAC aggregated credit and debit card data.

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Source: BAC internal data. Discretionary spending is total spending excluding gas, groceries and utilities. See the report BofA on USA: Weekly spending update through Jun 20 for methodology, limitations, and disclaimers related to BAC aggregated credit and debit card data.

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The K helps reconcile the labor-consumer conundrum

Strong consumption but a weak labor market

Last year, there was a lot of talk about the disconnect between a cooling labor market and resilient consumer spending. Usually, these two sectors have a chicken and egg relationship (Exhibit 7). This disconnect can in part be explained by the K-shaped nature of the US economy that emerged in late-'24/early-'25.

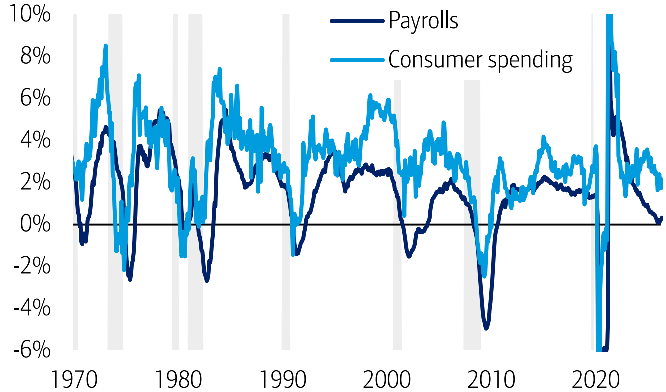
Demand supported by higher-income households

Aggregate consumption was and continues to be supported by higher-income households, buoyed by wealth effects, stronger balance sheets and favorable fiscal dynamics, even as lower-income households face more labor market stress.

The labor supply shock from tighter immigration policies

Additionally, part of the labor market slowdown, especially in sectors like leisure & hospitality, construction and manufacturing was also supply driven, linked to tighter immigration restrictions. Via this channel, job slowdown is more impacted than consumption given the likely lower share immigrants who are more likely to be lower-income have in aggregate consumption. This further complicated the labor-consumer signal.

Exhibit 7: Consumer spending has historically led jobs
Nonfarm payrolls and consumer spending and (% y/y)



Source: BLS, BEA, Haver Analytics

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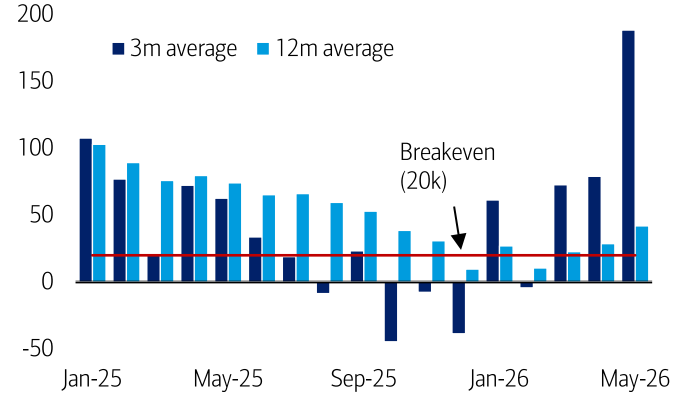
Exhibit 8: In recent data, payrolls are comfortably above breakeven
Change in nonfarm and private payrolls (3m moving average, m/m thous SA)



Source: BLS, Haver Analytics

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Our base case: spending resilience supports labor demand

Now, we had two ways in which we thought about how this dichotomy would resolve. More than five out of six private sector jobs are in services. Therefore, services spending, even if it is narrowly based (driven by higher-income households), is arguably the most important driver of labor demand. As long as services spending holds up in aggregate, that should limit the extent of labor market slack (along with declining tariff uncertainty, fiscal stimulus and now a more contained oil price shock). We leaned towards this glass half full view. Also, it was consistent with the idea that supply factors had played a big role in the labor slowdown.

Downside risk 1: Higher-income spending weakens

That said, the lack of breadth in spending introduced a clear downside risk. A glass half empty view could be that reliance on higher-income consumers leaves aggregate demand more vulnerable to a sharp correction in equity markets, especially given the volatility from the Iran war or any AI-driven correction like the recent sell-off. Also, a tightening in financial conditions by the Fed in response to higher inflation could also erode higher-income demand. A meaningful erosion of wealth effects could quickly translate into weaker aggregate consumption and labor demand.

However, recent experiences tempered this concern. Higher-income spending in BAC data held up during the post Liberation Day equity selloff, suggesting that the cumulative gains in equity markets over recent years have created a sizable buffer. In our view, it typically takes a sustained equity drawdown of 20% or more to generate a material negative wealth effect on spending. Indeed, since the start of the Iran war, higher-income ex gas consumer spending in the BAC data has held up, in large part due to the equity market holding up. And this has sustained as recently as late-June, even after the tax refund buffer is behind us.

Downside risk 2: Labor market weakness broadens

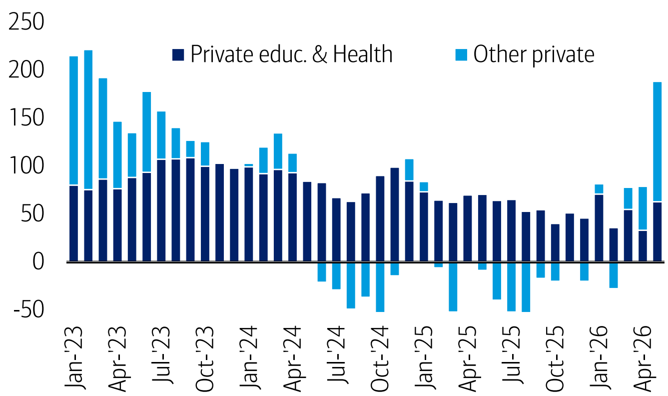
A second downside risk was that labor income losses among lower-and middle-income households could eventually deepen enough to overwhelm the offset from higher-income consumption. If employment conditions continued to weaken at the lower end of the income distribution, the consumption buffer provided by wealthier households may no longer be sufficient to sustain overall economic momentum.

But if the conflict resolves soon given the recent positive developments around the peace deal being agreed upon and consequently oil prices don't go materially above $90 amid receding tariff uncertainty, we will stick to our base case of a labor market recovery.

Recent evidence points to labor demand stabilization

Indeed, the recent labor market data show that job growth is comfortably coming in above breakeven and it has broadened to other sectors beyond education & health. Even though some of the recent rise is clouded by temporary factors like early World Cup hiring and seasonals, the labor market is showing clear signs that it has bottomed out. It is starting to look closer to the solid consumer spending numbers in the economy, in line with our glass half full view (Exhibit 8 and Exhibit 9).

Exhibit 9: Job growth has broadened recently beyond education & health
Payroll growth (m/m change, thous, SA)



Source: BLS, Haver Analytics

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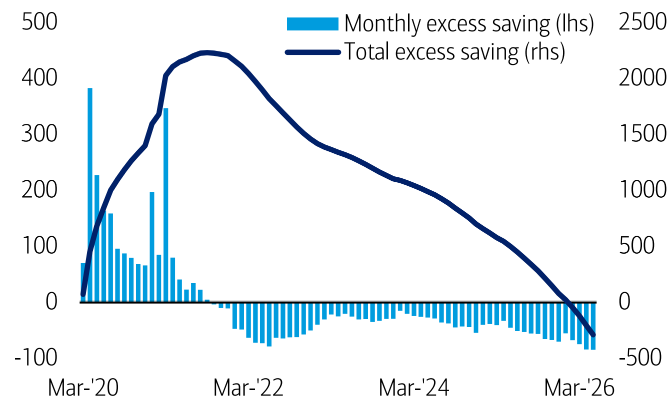
Exhibit 10: While excess savings have now largely been depleted, they peaked at close to $2.2tr
Excess savings ($, bn)



Source: BEA, Haver Analytics, BofA Global Research

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Lessons from the pandemic recovery

Fiscal support and excess savings by US households

As the US economy navigates a K-shaped landscape today while recovering from the uncertainty shock of 2025 and absorbing a new oil-price shock, it could be instructive to look back at a recent episode where a similar divergence emerged.

The pandemic recovery itself was K-shaped to some extent. US households as compared to Europeans ones benefited from unprecedented fiscal transfers that boosted household savings, often referred to as "excess savings". While excess savings have now largely been depleted, they peaked at close to $2.2tr (Exhibit 10).

This fiscal support helps explain some of the strength of the post-pandemic US consumer and, by extension, the outperformance of US economic growth relative to the more "sluggish recovery" in Europe where support was less "cash in hand".

Role of foreign demand and corporate savings

However, the mechanism extends beyond household balance sheets alone. Large fiscal deficits were supported in part by continued foreign demand for US assets, while strong corporate profitability also helped sustain investment and employment. Against this backdrop, differences in household balance-sheet strength, wealth accumulation and spending capacity widened across income groups, contributing to the emergence of today's K-shaped economy.

Lessons for today

The history lesson is particularly relevant because it in part shaped the current environment. Large macro shocks kept interacting with an unequal distribution of financial buffers and asset gains that, despite more retail participation in equities, benefited higher-income groups. Meanwhile, strong corporate balance sheets helped sustain investment and labor demand. Combined, this eventually led to the K-shaped consumer of today.

Why the data send mixed signals in a K-shaped economy
A K-shaped economy effectively combines a demand boom for higher-income households with stagflation like conditions for everyone else. An important implication is that macro indicators that weigh individuals equally, such as payrolls, the unemployment rate, aggregate wage growth or consumer sentiment had been signaling a more downside risk than indicators that weigh households by their spending power, such as GDP, aggregate consumption or inflation.

In an environment where higher-income households account for a disproportionate share of total spending and are also the most insulated from labor market and price shocks, measures tied to demand and output can remain firm even as labor market breadth deteriorates. We think this helps explain some of the data conundrums observed since last year, including robust GDP growth supported by solid spending alongside softer payroll growth, rising entry-level unemployment and weaker sentiment.

The good news is that a lot of these labor market indicators look like they are now on the path towards recovery.

Monetary policy implications from a K-shaped economy

Short-term policy response

Did the Fed cause the K? If yes, should it correct it?

Since March 2022, as inflation surged, the Fed has raised rates by a net 350bp. Even after cuts in 2024 and 2025, policy rates remain elevated at 3.50-3.75%, well above pre-pandemic lows.

Channel 1: Consumer credit

On the liabilities side of the balance sheet, since the onset of monetary tightening after the pandemic, transitions into serious delinquencies have been elevated and are still rising. They have disproportionately been led by younger, lower-income cohorts, particularly in credit card and auto loans. This pattern points to more balance sheet stress among households with limited financial buffers and greater reliance on short term credit.

Credit card interest rates move closely with the federal funds rate and rose sharply during this tightening cycle. A Boston Fed note showed that a 1pp rise in the credit card APR reduced aggregate card spending by almost 9% in the next month. The reduction in spending was about twice as large among account holders who carry a balance on their card & with low credit scores, likely lower-income consumers. Spending among those who pay off their balance each month, as well as those with high credit scores, likely higher-income consumers was unaffected by the higher rates.

Channel 2: Housing costs

Housing costs have been another important channel reinforcing divergence across income groups since the pandemic. Rental inflation rose far more sharply over this period than mortgage payments reflecting the fact that many homeowners are still locked into their low fixed-rate mortgages from before the pandemic given the higher post pandemic rate environment. As a result, housing related cost pressures have been borne disproportionately by lower-income households who tend to be renters.

Monetary policy contributed to the K to some extent…

So, yes, higher rates by the Fed has contributed to the K-shaped outcome to some extent by slowing activity more forcefully at the lower end of the income distribution than at the top. But it is important to remember that the Fed did this to control inflation, which also disproportionately impacts lower-income households.

...But will likely not correct it directly

Chair Warsh has alluded to wanting to close this divergence via monetary policy. His preferred way of dealing with this is via a smaller balance sheet. However, evidence is mixed on that front. Also, in our view, the Fed is unlikely to view the existence of a K-shaped economy as, on its own, a reason to drive monetary policy decision making.

Risk of policy miscalibration in a K-shaped economy

Reflation or stagflation? A policy calibration challenge

Additionally, we don't think Fed policy can fix this problem either. A K-shaped economy increases the risk that policymakers misread aggregate signals because different income groups are experiencing very different macro environments.

For higher-income households, strong balance sheets, asset gains and relatively resilient spending resemble a reflationary environment, supporting demand and keeping parts of the services sector firm.

For lower-income households, however, the combination of supply-side shocks, elevated borrowing costs and limited financial buffers feels closer to mild stagflation: growth is weaker, labor market conditions are softer, and purchasing power remains under pressure even if softer demand ultimately leads to somewhat lower inflation.

This divergence creates a policy dilemma. If the Fed focuses too heavily on aggregate consumption and GDP, driven disproportionately by higher-income households, it risks underestimating weakness among lower-income households and maintaining overly restrictive policy. But if it focuses too heavily on pockets of weakness, i.e, lower-income households, it risks easing too aggressively while higher-income demand continues to support activity and keep inflation pressures elevated. In this environment, neither the reflation nor the stagflation narrative fully captures the economy on its own. Also, each has a different policy prescription.

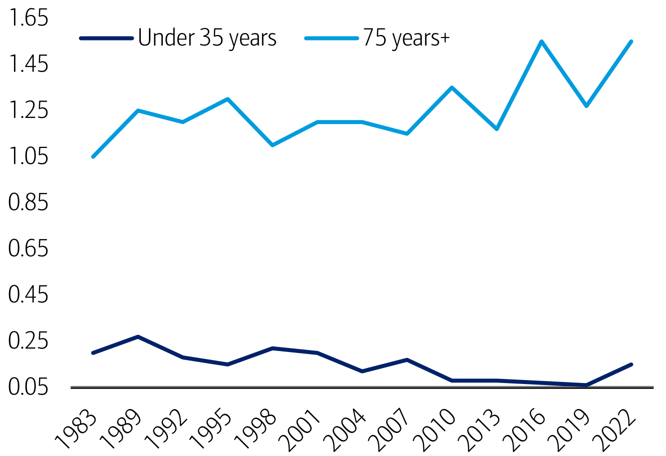
Why gradualism remains appropriate

Navigating this tension reinforces the case for gradualism rather than aggressive policy moves in either direction when faced with this conundrum. This is in line with the Fed's recent reaction function where the Fed has moved very cautiously through these data conundrums driven in part by a K-shaped consumer.

Importantly, the Fed's dual mandate is framed around maximum employment and price stability rather than GDP growth or consumer spending. As a result, policymakers typically place greater weight on labor market conditions than on measures of aggregate activity when the two diverge. This focus helps mitigate the risk that consumption and GDP strength, increasingly influenced by higher-income households, obscures underlying weakness in labor market breadth and labor demand.

Exhibit 11: Older households (75+) have become wealthier over time, while younger households (under 35) haven't seen any improvement in net worth

Ratio of mean net worth of age group to overall mean net worth



Source: Wolff, "The extraordinary rise in the wealth of older American households", NBER Aug 2025. Note: We used CoPilot to read the data from the published chart to produce this exhibit.

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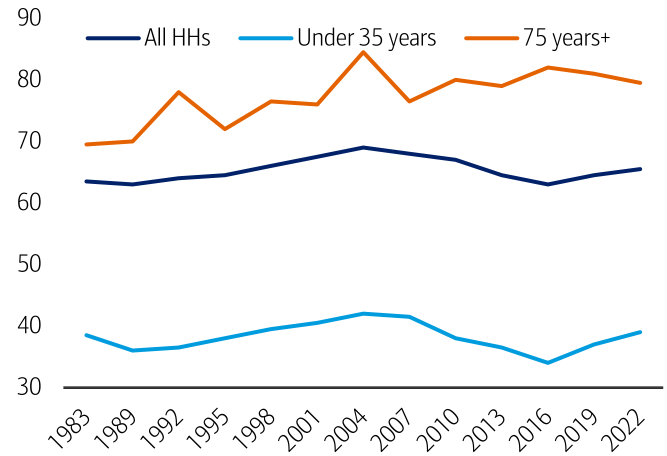
Exhibit 12: Homeownership rate for older households has risen 10pp since the 1980s, while it has remained largely flat among younger households

Homeownership rate by age (%)



Source: Wolff, "The extraordinary rise in the wealth of older American households", NBER Aug 2025. Note: We used CoPilot to read the data from the published chart to produce this exhibit.

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Medium-to-long term policy response

Structural vs cyclical causes of K

Over longer horizons, the K increasingly reflects structural rather than cyclical forces. Research points to homeownership patterns and duration exposure as key drivers of persistent wealth inequality, with falling interest rates disproportionately benefiting households with greater exposure to long-duration assets (Exhibit 11 and Exhibit 12). Historical evidence from Greenwald et al (2022) shows that top-decile wealth shares tend to rise as real yields fall and bond prices increase, underscoring how monetary regimes shape distributional outcomes over time (Exhibit 13).

Permanent wealth gains or temporary asset-price booms?

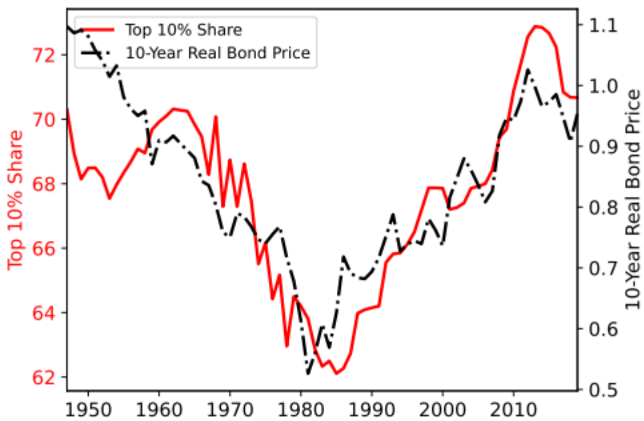
A key question, however, is whether these asset-price gains are permanent or transitory. If rising asset values largely reflect stronger fundamentals and a durable increase in wealth, the resulting divergence may persist. If instead they reflect a temporary asset-price boom, the widening of the K may ultimately reverse as valuations normalize.

Implications for monetary policy in the long run

Since distinguishing between the two in real time is difficult, as in the case of AI driven strength in equity markets today, the Fed is unlikely to target the distributional consequences of asset-price movements directly and will instead focus on their implications for its dual mandate

Policymakers will focus on whether asset-price movements pose risks to inflation, employment or financial stability. As a result, whether the K narrows over time will depend less on attempts to directly offset disparities and more on whether easier financial conditions ultimately translate into broader labor demand, stronger wage growth and greater income gains for lower-income households.

Exhibit 13: Historical evidence shows that top-decile wealth shares tend to rise as real yields fall and bond prices increase
Top 10% wealth share vs 10 year real bond prices



Source: Greenwald et al, 2022, Financial and total wealth inequality with declining interest rates, NBER working paper 28613

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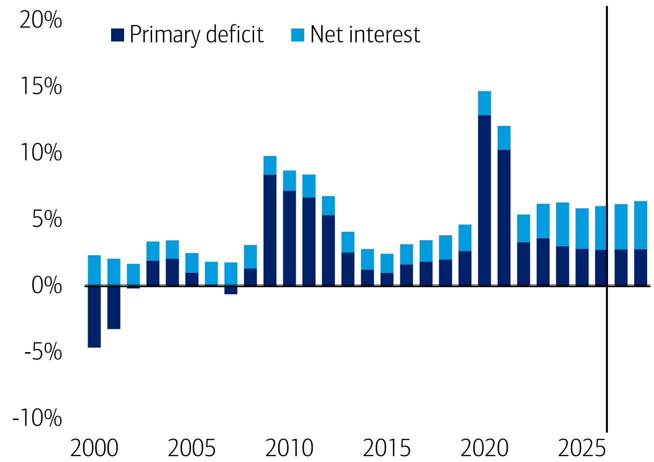
Exhibit 14: We expect deficits to remain around 6% of GDP
Deficits (% of GDP)



Source: US Treasury, Haver Analytics, BofA Global Research

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Role of fiscal policy in resolving a K-shaped economy

Since monetary policy is not well-suited to directly address distributional divergences, fiscal policy could be used as a tool, at least in the short run, particularly when the K is driven in part by policy decisions or external shocks. Recent examples include the affordability shock from higher gas prices due to the Middle East conflict and, earlier, the pandemic shock.

Targeted support as a potential stabilizer for the K

In such environments, targeted fiscal support is one potential way to help cushion lower-income households and keep aggregate demand going steady. Similar to the pandemic response, we could have seen incremental consumer support through reconciliation, potentially targeted toward lower-income households, especially ahead of the midterms, to help offset the drag from higher gas prices. Though that is less likely now given positive news on the peace deal.

Fiscal space constraints

However, the scope for such intervention is constrained by available fiscal space. US debt is already on an unsustainable long-run trajectory, even if near- to medium-term financing conditions remain supported by the dollar's reserve currency status and strong institutional credibility.

Competing demands on fiscal capacity

At the same time, deficits are set to widen further and remain above 6% (Exhibit 14) due to a combination of factors, majorly interest expenses (especially now, due to projected higher front and long end rates), along with tariff refunds (roughly ~$175bn), supplemental defense spending (potentially $100bn), and recently passed immigration-related funding bill. These competing priorities will likely absorb a meaningful share of fiscal capacity, limiting the room available for targeted redistribution.

Higher term premia

This constraint is not just accounting-based but macro-critical. If fiscal expansion materially worsens the deficit outlook or if it seems to be motivated by a populist agenda to the point that long-end rates move significantly higher, it could prove counterproductive.

Higher term premia would feed through to borrowing costs, including mortgage rates, tightening financial conditions and disproportionately affecting lower-income households. In that sense, the effectiveness of fiscal policy in addressing the K is ultimately bounded not just by political willingness, but by market tolerance for an increasingly strained fiscal trajectory.

Risk of demand driven inflation

Finally, there is also a risk that additional fiscal support fuels demand-driven inflation, echoing some aspects of the post-pandemic experience. While targeted transfers can cushion lower-income households in the short run, they may also add to aggregate demand and keep inflation elevated. Because lower-income households are typically the most exposed to rising living costs and have the least financial flexibility, sustained inflation could ultimately leave them worse off despite the initial support.

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Research Analysts

Aditya Bhave
US Economist
BofAS
aditya.bhave@bofa.com

Stephen Juneau
US Economist
BofAS
stephen.juneau@bofa.com

Shruti Mishra
US Economist
BofAS
smishra44@bofa.com