

OCTOBER 1, 2025 – SEMI-ANNUAL STATE OF THE ECONOMY CALL

Jean McGowan, CFA: Welcome, and thank you all for joining our State of the Economy call. For anyone who doesn't know me, I'm Jean McGowan, the Chief Investment Officer at Godsey & Gibb. Over the next 45 minutes, I will walk through our views on the state of the economy and the outlook as we head into 2026.

It wouldn't be a State of the Economy Call without something unusual happening in the days leading up to it. Before I dive into the agenda, I want to address the government shutdown that began at midnight. Shutdowns are never a good thing, and I can't imagine that in any of our jobs we could simply not do our work and still get paid, but government is different.

That said, I would like to highlight a few points. In general, government shutdowns have little impact on either financial markets or the broader economy. That's not to say there are no regional effects. In Northern Virginia, the D.C. area, and Maryland, where furloughs are more common, there can certainly be short-run impacts on local economies. But overall, the broader economy tends to do fine during a government shutdown.

Since 1974, the average shutdown has lasted eight days. The last one, in 2019, lasted 34 days, but it was somewhat different because it was only a partial shutdown since some appropriations bills had already been passed. Certain parts of the government were funded, and only a few still needed funding, which probably contributed to its length.

Notably, GDP was positive in 11 of the last 12 shutdowns, and the S&P 500 was higher in each of the last five. We also tend to see a rally in the first three months after the government reopens as uncertainty recedes. So, while this is not a great development, it tends not to have a broad impact.

In the near term, our focus is on delayed releases of important economic data. In particular, on Friday we were expecting an update on the labor market, including the unemployment rate, payroll data, and labor force participation. Those will be delayed, and the longer the shutdown continues, the more data releases could be delayed. That can add uncertainty to an environment that is already facing some uncertainty. Hopefully, this is resolved sooner rather than later so we can focus back on other important topics.

With that, I'm going to bring up the presentation and move right to our agenda for today, which covers economic growth, inflation, and the financial markets. Under the growth category, when we last held our State of the Economy call on April 16, uncertainty was at a peak. We had the announcement of

Liberation Day tariffs, a tax bill in progress but not yet approved, elevated geopolitical risk (which remains today), and we were also in the process of working on government funding, and a debt ceiling bill.

Some of those uncertainties have begun to ease. While trade negotiations continue, tariff policy has become a bit clearer, and several larger agreements have been finalized. Passage of the One Big Beautiful Bill Act has taken the threat of tax increases off the table and is providing some stimulus. The housing and manufacturing sectors are two areas of the economy which have been weak, but we are seeing signs of stabilization. In September, we also saw the first rate cut from the Fed in over a year, restarting the normalization of monetary policy.

On inflation, we expect it to rise a little bit in the near term and then moderate. We'll discuss the impact of tariffs on prices as well as other areas where we are seeing some deflationary pressures. Finally, in the financial markets, while the overall equity market is not cheap, we are seeing solid earnings growth, much more broad-based participation across the market, and still plenty of room for market appreciation.

We will cover each of these topics in more depth as we move through the slides. You'll notice some familiar slides which I think are important, along with a few new ones. If you have any questions, please use the Zoom chat to submit them and include your first and last name in case we don't get to your question during the call.

Turning to page 4, we're looking at overall economic growth. The dark green bars show annualized GDP growth by quarter, and the light green dashed line reflects the long-term trend, just over 2% on a quarterly basis. The gray bars at the end are estimates for economic growth through the end of 2026. I would like to point out that for the third quarter, which we just completed yesterday, estimates for growth are actually higher than what is presented on this slide. Economists' estimates for third quarter GDP growth range between 2.5% and 3%, which is much higher than what's contemplated on the slide.

I'd also note that in the first half of the year, because of trade policy, we had significant volatility in GDP. In the first quarter, we had a modest 0.5% contraction, followed by a strong recovery in the second quarter. On the next page, I'll discuss the factors that contributed to those differences. In general, we're seeing decent growth, with the potential for faster growth as we move into 2026, which I'll cover as we go through the slides.

On page 5, we break out key components of GDP and their contribution to growth in any given quarter. The dark green part of each bar is consumer spending. Over the long term, consumer spending is the largest driver of GDP growth and accounts for about two-thirds of economic activity. The other factors,

business investment, trade, government consumption, and inventory changes, tend to be swing factors around the consumer over time. I will focus on the first and second quarters of 2025 to explain what's been happening of late.

In the first quarter, many businesses imported extra goods to get ahead of the potential tariff announcements that came in early April. As imports rose dramatically, exports stayed roughly the same, making net exports (the gray bar) significantly negative, subtracting about 4.5 percentage points from GDP. Because a lot of the goods brought in during the first quarter went into inventory, rather than being immediately sold, inventories (the light blue bar) grew. This growth in inventory helped offset part of the drag from net exports, adding about 2.5 percentage points to GDP.

Consumer spending (the dark green bar) was positive but moderate as consumers reacted to uncertainty in the first quarter and reduced spending relative to typical levels. Consumer spending added about 0.3 percentage points to GDP.

Fixed investment (the lighter green bar) reflects two categories of business spending. The first category is non-residential investment, which reflects typical business investments. The second category is residential investment, which reflects housing. We saw very strong fixed investment in the first quarter, stronger than we've seen in most other quarters, driven by the ongoing investments in AI and AI-related infrastructure such as databases, chip manufacturing, and other productivity-enhancing business investments.

Moving to the second quarter, as tariffs were announced and put in place, several factors reversed. Net exports (the gray bar) became additive to GDP in the second quarter as exports remained near typical levels while imports declined dramatically, since businesses imported early in the first quarter. Net exports added about 4.5 percentage points to GDP.

Fixed investment (the light green bar) remained strong, although not as strong as in Q1. If we break this down, non-residential business investment was up about 7% year-over-year, while residential investment (housing) was down about 5%. So, it was the housing component that reduced the overall contribution from fixed investment, but it was still a positive contribution.

The bigger surprise in the second quarter was consumer spending, which added about 1.7 percentage points to GDP. We expected a rebound, but it was stronger than anticipated, reflecting the consumer's continued willingness to spend on goods and services, with leisure and service activity still strong. Finally, inventories, which were built up in Q1, were drawn down as consumers spent and modestly subtracted from GDP. Altogether, we had a minor 0.5% contraction in the first quarter and a 3.8% rebound in the second quarter, producing a solid first half despite a lot of volatility in getting there.

I'll now discuss business investment drivers and our outlook for business spending going forward. Starting on page 6, we have the Small Business Optimism Index. We like to look at small businesses because they are the largest employer in the country and have a larger share of the economy than very large businesses.

This optimism index tends to correlate very well with small business investment activity. When tariffs were announced, optimism declined with businesses noting that uncertainty was so high that they couldn't make decisions about their business, including whether to expand their business or add employees. As trade deals began to be put in place and, more importantly for business spending, the tax bill passed, businesses gained better visibility for the next 6, 12, and 18 months. This drove an improvement in Small Business Optimism.

In fact, in the latest reading, 68% of businesses rated their overall health as either excellent or good, which is a significant increase from several months earlier. Behind this improvement, businesses are citing declining uncertainty, a better selling environment, improved profit trends, greater clarity on trade, the benefits of the tax bill, and the expected impact that deregulation could have moving forward.

One of the items I mentioned is the tax bill and on page 7 we look at the tax savings companies of all sizes are seeing from the passage of the One Big Beautiful Bill Act. The bill included many business tax incentives including expensing for research and development, incentives for capital investment, changes to interest deductions, and provisions focusing on certain property types, including manufacturing incentives. The chart on the left breaks these incentives broadly into capital goods, research and development, debt, and property acquisition.

For fiscal 2025, which just ended, these incentives produced about \$98 billion in tax savings for businesses, all of which was realized at the end of the year. In fiscal 2026 (the gray bars), we have another roughly \$135 billion in tax savings. This is cash that flows directly to a company's bottom line. It can be used for further investments in productivity, technology, plants and equipment, employees, M&A, or shareholder returns. This is important as it can help support the business spending that we've seen and perhaps push greater business investment as we move into 2026.

On the right side, we show those business recovery programs' dollars as a percentage of GDP over the full 10-year tax window. In fiscal year 2025, the business incentives are about 0.3% of GDP. In fiscal year 2026, they will be about 0.5% of GDP. Following that, they start to tail off as the business tax cuts were very front-end loaded and they expire after five years. In the final five years, the effect turns negative relative to GDP as the tax incentives go away. However, at least for the next five years, we do have these incentives for businesses to invest and grow.

Moving to the consumer on page 8. As we've previously talked about, the key for the consumer is the labor market. We have seen some slowing in the labor market, and we expect some further weakness through the rest of this year, but we don't expect a significant weakening. The left side of the page shows the unemployment rate, which is currently at 4.3%, up from 4.0% coming into this year. So, it has moved up and we expect it will continue to move a little higher, but not significantly. Historically, this remains a relatively low level of unemployment.

On the right side, we look at another measure of the health of the labor market. The labor force participation rate is the percentage of the population, over the age of 16, that is either employed or actively looking for work. The dark green line is the overall participation rate (left axis), currently around 62.3%. The gray line is important as it reflects the prime-age participation rate, which is the percentage of the population between the ages of 25 and 54 that are either employed or actively looking for work. The bulk of the labor force falls into this range and those are the people who are going to be working for a long time. That line has been improving, showing the health of the market and indicating that we are not seeing a decline in people attempting to work.

The decline in the overall participation rate is more structural than cyclical as aging baby boomers are retiring and we saw an increase in early retirements during the COVID pandemic. So, the overall labor force is shrinking because of that aging demographic (which was expected). More importantly is that the prime age labor force is not shrinking but rather growing.

On page 9, we have additional labor market data. On the left is the non-farm payroll series, which shows how many new jobs are added to the economy in any given month. We've been on a trend of lower gains over the past several years. The last few months, in particular, have been weak. We have seen almost no job growth and while it's not good for the labor market to show no growth, we are not seeing massive layoffs or significant job losses. I would note that, to maintain the unemployment rate near current levels, we need roughly 60,000 to 100,000 new jobs per month. We are not achieving that currently, but it is important to recognize that we don't need significant job growth to keep the overall unemployment rate relatively stable.

Another indicator we monitor is applications for unemployment insurance claims, shown on the right side of the page. This series is more volatile, but it has been in a range of 215,000 to 260,000 new claims per week. I would note that the recent uptick to 260,000 a few weeks ago was largely due to fraudulent claims in Texas, which have since reversed. Overall, new unemployment insurance applications are averaging about 237,000 per week and this is a typical level seen in a positive economic environment. We value this data because it is weekly and reflects actual applications rather than survey responses.

While the labor market does appear slightly weaker right now, it is not concerning yet. I would like to highlight other labor market metrics we are watching to ensure we do not see further weakening. For unemployment insurance, we monitor continuing claims, which is the number of people receiving unemployment benefits. It is about 1.9 million right now, and has been relatively stable, which is a good sign. We are also closely watching the duration of unemployment, which tracks how long it takes for someone who is unemployed to find a new job. If duration begins to rise, it signals that the labor market may be weaker than we currently believe. We look at multiple jobholders, currently about 5.4% of the labor force, which is generally a sign of consumer stress, with individuals taking multiple jobs to make ends meet. Another measure we follow is the underemployment rate, which measures people working part-time who want full-time roles, or who are employed below their desired skill level.

Thus far, none of these indicators show major signs of a significant weakening. Having said that, we are seeing a slowdown in the labor market. Before leaving the labor market, I would note that while job growth is slowing, wages continue to grow at a reasonable rate. Over the last 12 months, depending on the data series, wages are up approximately 3.5% to 4%. This provides some cushion to those employed, since it is running ahead of the inflation rate, and it's allowing consumers to continue spending.

We have already discussed the impact on businesses from the tax bill. Now, we'll cover the impact on consumers from the bill on page 10. Unlike the business tax incentives, many of the consumer-related changes will not appear until 2026, and they will be reflected in tax refunds. On the left side, we have the total tax refunds by fiscal year and the expected refunds for fiscal 2026, with a notable increase from \$359 billion to \$517 billion.

On the right side of the page are several key provisions, and their estimated stimulus amounts, including changes to the SALT deduction, no tax on overtime, no tax on tips, changes to the child tax credit, and others. In total, these provisions amount to roughly \$170 billion of consumer stimulus that will have an impact in 2026. Many of these provisions are targeted, so not everyone will benefit from each change. Nonetheless, adding approximately \$170 billion of new stimulus on the consumer side should continue to support, and potentially increase, consumer spending.

On page 11, we look at two areas of the economy that have underperformed over the past 12 months, housing and manufacturing. We are seeing some signs of stabilization for these two sectors, and they have the potential to improve as we enter next year, supported by lower rates from monetary policy and fiscal stimulus.

Existing home sales, on the left, remain low at around 4 million on an annualized basis. While not as low as it was during the housing crisis, this level is relatively subdued compared with subsequent

years. The two primary drivers, as you're probably well-aware, are elevated mortgage rates and substantial home price increases, particularly over the last five years. Together, these factors have materially constrained affordability in the housing market.

Looking ahead, we are beginning to see modest relief on mortgage rates. If the Federal Reserve continues to reduce rates into next year, that relief should grow. Lower mortgage rates would help, and while home prices are not falling, the pace of appreciation has moderated notably over the past six months. The latest Case-Shiller data shows home prices nationally are up about 1.7% year-over-year through August. Some regions are experiencing modest declines while others are stabilizing. Overall, we are no longer seeing the 4% to 6% gains that we saw during the pandemic.

If home prices stabilize and mortgage rates decline, activity could pick up. Housing activity has extensive linkages to the broader economy. Home turnover (people buying, selling, and moving) leads to purchases of items like appliances and furniture. When people feel confident about the housing market, they are more likely to undertake projects in their current homes whether it be renovations, new kitchens and bathrooms, or making improvements in preparation for a sale. These effects propagate through the broader economy. With a stable to modestly improving housing market, new home construction, which has been weak, could also increase and drive hiring in construction and related sectors. So, a slight improvement in housing over the next 12 months would be meaningful as it could provide a modest boost to the economy.

On the right side is the ISM Manufacturing Index. Although manufacturing represents a smaller share of the economy, it is still important. A reading above 50 for the index indicates an expansion in manufacturing while a reading below 50 indicates a contraction. The sector has been contracting, with one brief uptick a few months ago, but the overall trend has shown a modest contraction. However, underlying data is showing an improved tone with new orders beginning to pick up. In addition, several tax provisions we discussed are targeted towards the manufacturing sector, so we see potential for a return to modest expansion. These are two sectors which have been underperforming, and we see potential for them to improve as we move into next year.

On page 12, moving away from growth to inflation, which has been a major talking point of late and is certainly very important to the Fed and to all of us. On the left side of the page, we have the core Personal Consumption Expenditures (PCE) price index which is one of the measures of consumer inflation. We're using it here because it's the Fed's preferred measure, though if we looked at the Consumer Price Index (CPI) we would see similar data.

Inflation has been trending slightly higher partially due to goods inflation, which I will discuss in a moment, and partially due to services inflation, which includes categories like insurance. We are still

seeing strong demand in leisure, hospitality, and food away from home, and that demand is also leading to somewhat higher pricing, but we are not expecting it to move significantly higher from here. Right now, core PCE is at 2.9% and CPI is at 2.8%. So, inflation is up modestly over the course of the year, it will likely move a little higher, and then we expect it to moderate. I will go through the reasons for that expected moderation shortly.

Importantly, on the right side of the page, inflation expectations remain anchored. The chart shows the breakeven inflation rate, which is a proxy for inflation expectations, over a 2-year and 10-year horizon. The 2-year breakeven inflation rate (the gray line) is currently around 2.6%, implying inflation is expected to average 2.6% over the next two years. The 10-year breakeven rate is 2.4%, implying inflation is expected to average 2.4% over the next 10 years. We can see that short-term expectations have been more volatile, while the 10-year measure has been range-bound.

Although both rates are above the Fed's 2% target, it is important to place them in the context of longer-term inflation. From 1948 to today, CPI averaged 3.5% across many different cycles. Over the last 25 years, from 2000 to today, CPI has averaged 2.6%. So, while above the Fed's preferred 2% level, they remain in-line with long-term historical inflation.

Moving to goods inflation on page 13. This is an interesting chart in looking at the impact of tariffs on inflation. The green bars show the effective tariff rate (left axis) for the presented categories. Appliances currently have an effective tariff rate of just under 7%. Apparel has an effective tariff rate of 26.7%. The gray dots show the actual year-over-year change in inflation in each of those category. It is not necessarily the case that a higher tariff rate is translating to higher inflation. Apparel is the clearest example of this. Despite a very high effective tariff rate, apparel prices are only up 0.3% over the last year. In the toys category, the tariff rate is almost 22% while prices are up only 0.1%. Furniture and bedding are the one outlier, where the tariff rate is at 16.7% but we've seen a significant price increase of nearly 5% over the last year.

The importance here is less about each individual category and more about the broader point that higher tariffs have not automatically produced higher prices as companies have taken multiple steps to mitigate raising prices. One we already talked about was that companies imported a lot of goods ahead of the tariffs. We are seeing supply chain shifts as companies are moving production from higher-tariff countries to lower-tariff countries. Companies are also implementing internal cost mitigation by reducing non-tariff costs to help offset increased tariff costs, without impacting profits.

As a reminder, tariffs are a one-time price increase rather than persistent inflationary pressure. So, while we have seen price increases, companies have generally rolled them out slowly and prioritized

mitigation over raising prices. They do have concerns about demand and don't want to raise prices to a point where consumers pull back.

Moving to the Federal Reserve on page 14. The green line is the Fed funds rate and the lime green line at the end shows the expectation for rates going forward. The gray line is the yield on the 2-year Treasury, which is well correlated with changes in the Fed funds rate over time. We like to view it this way because the Fed often acts later than the market in either direction. We can see that over the last year or so, the 2-year Treasury yield has been declining, while the Fed funds rate stayed relatively steady until September. So, the market was anticipating the need for the Fed to start lowering rates and normalize policy, and the Fed cut the Fed funds rate by 25 basis points in September, taking it to a range of 4.00% to 4.25%.

The current expectation is that the Fed funds rate will go to about 3.25% by this time next year through a series of cuts spread out over that period. That 3.25% level is considered to be the neutral rate, which is the level of rates that supports full employment and stable prices, which is the Fed's dual mandate. Policy is restrictive right now, but this path to 3.25% would take us to a non-restrictive, non-stimulative policy as it's implemented over time.

It is also important to note that inflation is not yet where the Fed wants it to be. However, consistent with what we discussed a few slides ago, Fed officials acknowledge that tariffs will put pressure on inflation in the short run, but they expect that pressure to moderate over time and inflation to come back down. I don't believe they expect inflation to reach 2%, which, as we discussed, would be quite low historically, but it should moderate.

I didn't mention this earlier when we talked about inflation but weakness in the housing sector and some other areas of the economy is helping to offset some of the inflationary pressures from tariffs. Goods and housing carry equal weight in the CPI, and, over the last year, we have seen rents and other housing-related prices come down, which helps offset some of that pressure. I believe what pushed the Fed to move now was the weakness in the labor market, which forced them to add a little more focus on the employment portion of their mandate.

Moving to the last section, I'm going to talk about the equity market on page 15. Price changes in the equity market are, at their core, driven by the ability of companies to generate increasing profits. The dark green bars show quarterly growth in earnings per share, and the lighter green bars show expected earnings per share growth. Going back to 2023, we had very little earnings growth and even some contraction in certain quarters. Earnings rebounded in 2024 and were positive. I would note that in 2024 much of the earnings growth came from a narrow portion of the market, mostly the

Magnificent Seven and other technology stocks, while the rest of the market saw more moderate growth and, in some cases, earnings decline.

As we move forward into 2025 and out to 2026, we are seeing a return to solid earnings growth. Importantly, we are seeing broad-based earnings growth across most sectors, not just the technology companies. In fact, estimates for the third quarter show seven out of eleven sectors are expected to post solid earnings growth, technology among them, but also industrials, real estate, finance, materials, and several others. This points to a healthier, broad-based potential for earnings growth going forward.

That earnings breadth is translating into broader-based returns, as shown on page 16. On the left side are quarter-to-date returns and on the right side are year-to-date returns. I'll note that the returns on the charts were updated as of Friday's close (September 26th) and did not include quarter-end. It was a very strong quarter with the S&P 500 ending the quarter up 8.1% (versus the 7.4% shown on the chart). The sectors that outperformed the market did not change but their returns did. Among the sectors that were positive but lagged the market, their order did not change but their returns were slightly different.

On the right side, the year-to-date view really highlights the breadth of returns. The S&P 500 ended the quarter up 14.8% year-to-date (versus the 10.3% shown on the chart). Sectors including utilities, materials, industrials, and finance all outperformed the 14.8% market return while the energy sector was roughly equal to the market. The one notable change from Friday's data to the actual end of the quarter is health care had a solid rally in the last two days and ended up 2.6% for the year. We ended the quarter without any negative sectors on a year-to-date basis, and only four sectors with returns below the market. This is a much healthier picture than what we saw in 2024 and late 2023.

This marks the end of my slides and now I would like to address a question I saw, which we've been receiving more often recently, about market valuations or price-to-earnings (P/E) multiples and what an elevated P/E implies. A P/E multiple is a point-in-time measure that tells you how much you are paying today for next year's earnings. So, a P/E of 20 means the price today is 20 times next year's expected earnings per share.

It is an important valuation metric but there are two important points I would like to highlight. The first one is that P/E multiples are not a good timing tool and P/Es can stay elevated for a long time. Elevated P/Es can resolve in several ways, earnings can grow faster while prices grow more slowly (bringing the multiple down), prices can decline while earnings stay the same, or some combination of those moves can bring a high P/E ratio down.

The second point relates to what's driving this multiple up. The current P/E for the S&P 500 is about 23x, meaning you're paying 23 times next year's earnings if you bought the S&P 500 today. However, the S&P 500 is a market-cap-weighted index and a handful of very high-multiple companies are pushing that figure higher than it would be if we looked more broadly. If you equally weight all 500 companies and consider their forward P/Es, the multiple falls to about 18 times earnings, which is slightly above the 10-year average for the S&P 500.

The key takeaway is that, while the overall market may appear overvalued, within those 500 companies there are many with lower P/E ratios and strong earnings growth. Given the stimulus and factors we discussed setting up better growth next year, those companies are in a good position. At current levels, as long as earnings continue to grow, we expect continued price appreciation. Perhaps not to the extent seen in 2023 and 2024, but solid positive returns and more broad-based returns like we have seen this year.

With that, I know I have gone over time. We will get back to you if you submitted a question during the call and if you have additional questions, please reach out to your wealth management advisor and we will get back to you with answers as soon as we can. I would like to thank you all for participating in our call today. I hope this provided you with an optimistic outlook and some useful data as we move forward. Thank you again for joining us.

Disclosure: This transcript and corresponding presentation is intended for the use of Godsey & Gibb Wealth Management clients and is not suitable for general retail public use. The information presented, including the use of charts, graphs, and other illustrations, is for educational purposes and should not be substituted for personalized financial, tax, or legal advice, or used to guide investment decisions. Information was obtained from sources considered reliable, but no representations or warranties are made to its accuracy, timeliness, suitability, or completeness. Forward-looking statements expressed are subject to revision due to changes in the market and economic conditions and there are no guarantees that these results will be achieved. Past performance is not indicative of future results.