

February 2026 Monthly Market Commentary

The Ascent of AI and its Implications for the Economy

If you thought winter storms were the only headwinds the nation is coping with, think again. In a swift series of shocks, the U.S. finds itself directly or indirectly linked to heightened geopolitical tensions in Iran, Venezuela and Cuba even as the four-year Russian/Ukrainian conflict remains a stubborn unresolved thorn in its side. On the domestic front, the landscape remains just as combustible. The tariff uncertainty that wreaked havoc on Wall Street and Main Street last year has taken on new life this year, as the Supreme Court ruled that tariffs imposed under IEEPA were illegal on February 20. The ruling leaves the future with even more uncertainty as to what will happen with the \$150 billion collected under false pretenses and how they will be replaced. Meanwhile, a new chairman, whose views regarding how monetary policy should be set differs markedly from the current chair, is poised to take over the Federal Reserve in two months.

So far, the financial markets have been remarkably calm in the face of these swirling events. Traders and investors usually loathe uncertainty, transmitting their unsettled feelings into heightened volatility in stock and bond prices. Whether this is the calm before the storm remains to be seen. But uncertainty often causes inertia for a while, until a consensus forms around what the consequences of the unsettling events will be. With trade policies in the process of being reset, that will take time. Keep in mind too that the mid-term elections are drawing closer, and that in itself is a time-honored source of uncertainty. There is a big difference between what policies can be adopted under a unified versus a divided government.

If there is one constant, it is that the economy keeps on chugging along much as it has over the past year. Growth slowed in the final months of 2025, but that was entirely due to the record long government shutdown that temporarily eliminated the working hours, output and paychecks of federal workers. Those losses are now being recaptured as Washington is almost back to full strength, pointing to a corresponding bounce back in the first quarter. Barring a harsh adverse reaction should any of the above-noted shocks gain traction, the economy should weather the storms this year; indeed, its resilience has been tested time and again against formidable onslaughts. But the economy is undergoing some major structural changes, thanks to the growing influence of AI, the effects of tighter immigration policies and a bifurcated consumer that has altered the drivers of growth. How traditional policy tools handle these changes will be a daunting challenge for the Federal Reserve, something that is already spurring controversy as a new leader is about to take over.

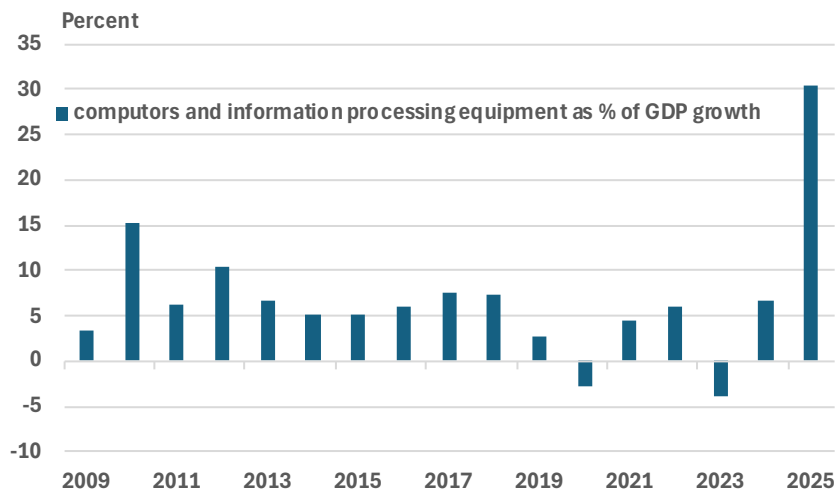
The AI impact is Growing

Despite the abrupt slowdown in the closing quarter of 2025, the economy logged a respectable growth rate of 2.2 percent for the year, only a tad below the solid 2.4 percent in 2024. Yet it surmounted more hurdles, including a chaotic trade policy that included on-again, off-again tariffs, the longest government shutdown in history and a draconian immigration policy. Consumers, as usual, did most of the heavy lifting last year, as they account for about 70 percent of GDP and are its major growth driver. Any year that consumers pulled back, the economy fell into a recession. However, not all households were behind the wheel. Low and middle income people struggled with high prices, high debt loads and low confidence; this cohort did not share in the economy's financial gains as much as wealthier households whose portfolios were burnished by another bull year in the stock market.

But the growth engine also received an outsized thrust from a much smaller cylinder, one that is receiving power from a surge in investment outlays on AI-related technology. Business spending on computers and information processing equipment contributed 30 percent to the growth in GDP last year. This spending accounts for less than four percent of GDP, so to say that it is punching way above its weight would be an understatement. Except for the Great Recession in 2008, when consumers retrenched and GDP fell, that's the biggest contribution from this sliver of the economy going back at least 30 years.

This copious infusion of funds for AI technology shows no sign of slowing down and should contribute significantly to growth again in 2026. Importantly, this spending is having knock-on effects, as the enthusiasm over AI technology has spilled over into the stock market. The so-called mega stocks paced the market to new highs last year, buffing the wealth of richer and older households and, in turn, their spending. While this wealth effect is expected to continue this year, the rest of the population relies primarily on income to support spending. As was the case last year, their contribution will be restrained by a weakening job market that is curbing the growth in wages. Once again, a bifurcated consumer will underpin spending, with wealthier households carrying most of the load.

AI Spending Driving Growth



AI Spurs Concerns

Throughout history, every major technological breakthrough has done two things simultaneously: created enormous value while destroying old business models. Artificial intelligence is no exception. For nearly three years, the stock market has been fixated on the value creation side of AI, as profit growth among AI-related firms has been running roughly five times faster than the corporate average. Unsurprisingly, since 2023, the Mag 7 stocks have soared, massively outperforming the broader indices.

But markets are never one-sided for long. Since November, sentiment has shifted, as investors are increasingly focusing on the destruction side of the AI revolution. The initial anxiety centered on overinvestment, stoking fears that future earnings would not justify the massive sums companies are spending on the technology. It's still in the early days, but the shift in sentiment has had an impact, as these stocks have underperformed in the overall market so far this year. Other sectors, however, have taken up the slack, so – at least through late February – the broader indices have held up and actually hit new highs before the latest tariff brouhaha hit the headlines.

More recently, AI concerns migrated to the broader economy. At its core, artificial intelligence is a labor displacement technology, and the contours of disruption in the job market are coming into focus. Tasks that are repetitive, diagnostic or rules-based are increasingly being automated or augmented by machines. Entire workflows in law, accounting, coding, customer service, design and even medicine, can be redesigned from the ground up with AI. Not surprisingly, concern over job security is permeating the labor force, and it extends beyond fears of a recession, the usual culprit.

Labor Angst is Real

So far, the much-feared worker displacement has not occurred, at least on an economy-wide scale. Widespread layoffs are not happening; unemployment rates are historically low and robust demand for healthcare workers is offsetting the reduced demand for workers in other sectors. But the broader picture of job market health masks pockets of weakness among groups that are vulnerable to the rapidly-evolving new technology.

Many of the tasks noted above that AI can readily take over are usually found in entry level positions for recent college graduates. But this group is struggling to find jobs, as shown in the steady climb in unemployment rates among 20 to 24-year-olds with college degrees. Young workers and recent college grads who thought coding was the way up the income ladder are now on the unemployment lines. Needless to say, a growing swath of white-collar workers are cognizant of this displacement and are wondering if AI is coming for their jobs in the near future.

Importantly, the threat of AI displacement, just like fears of a recession, clearly limits the bargaining power of labor. Both have the same result, lowering the demand for workers. There is a big push underway for the government, businesses and schools to offer retraining programs for those vulnerable to AI displacement. One positive offset is that the AI boom is spurring a surge in construction – and construction workers – as companies rush to build out data centers and businesses invest in power-generating capacity. However, while it takes many workers to build a data center, it takes very few to run it. So, the winners in the AI boom may have a short shelf life.

The Fed's Conundrum

It's unclear how much of the strength in productivity in recent years came from the AI boom, which is the ultimate goal for employers embracing the technology. The more productive a company is, the less labor is needed to generate output, which lowers labor costs and encourages companies to keep prices lower than otherwise. In the 1990s, the internet revolution dramatically boosted labor productivity, which drove inflation down rapidly, even as it spurred rapid output growth. That episode enabled the then-Fed chair, Alan Greenspan, to successfully resist pressure to raise interest rates. That pressure came from traditional policymakers who viewed strong growth as a catalyst for higher inflation.

The incoming Fed chair, Kevin Warsh, is drawing from that playbook but taking it a step further. He believes the prospect for sustained productivity growth should lead the Fed to cut rates now to prevent a wave of job losses in the future. But this is a highly controversial view, as the current slowdown in job growth and rising pockets of unemployment are less of a demand problem than a structural one. The biggest sources of job market woes are linked to AI's labor displacement and the shrinking supply of workers due to the immigration crackdown that is removing a huge chunk of foreign-born labor. This is not a problem that is cured by lower interest rates.

Meanwhile, inflation is still running well above the Fed's two percent target, and it is questionable whether productivity will improve sufficiently to offset the possible inflationary impact of lower rates. Over the near term, the vast spending on AI seems to be having the opposite effect, as the construction of data centers is pushing up electricity costs. The Fed has successfully navigated the headwinds over the past two years, lowering inflation while keeping the economy on an even keel; but the ascendance of AI as a major economic influence will surely test its policymaking skills in 2026.

Unemployment rate: college graduates - 20-24 yrs old
12-month moving average

