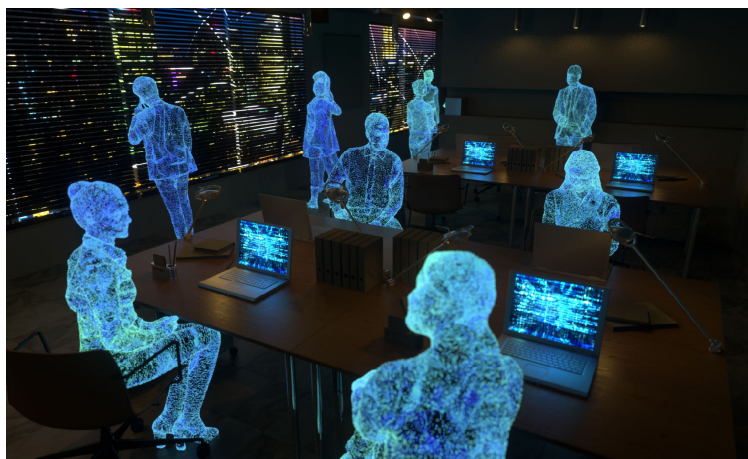


AI Boom, Hiring Bust: Is 2026 The Next Jobless Expansion?

The data fog is finally lifting now that the longest government shutdown on record has ended. But it will be a while before policymakers, economists and investors get full clarity on the economy's performance. That's because the data for October and November will be very sideways, as data collection for those periods was not fully up and running. They will also be distorted by the spillover effects from the shutdown. Furloughed government workers, for example, did not get paid for all of October and most of November, which depressed spending for those people without a savings buffer. Likewise, for lower-income households who were deprived of SNAP benefits. We suspect that the direct economic damage caused by the shutdown will be mostly repaired over the final month of the year and early 2026 as paychecks are restored and spending returns to normal.



That means the data releases in coming months will be highly volatile, revealing a temporary weak fourth quarter followed by a brief surge in the first quarter. Such volatility stoked by artificially imposed forces is never a good backdrop for economists striving to understand the health of the economy's fundamental underpinnings. If you take a look at household sentiment, expressed in myriad surveys, conditions appear to be going down the drain. Look at the stock market and various reports of consumer and capital spending (driven by an enormous demand from AI-related companies) and conditions appear to be doing just fine. For the Federal Reserve, which must decide on December 10 whether to lower interest rates for the third consecutive time since September, the task of navigating these crosscurrents is particularly vexing.

The economic ramifications of whether it does or doesn't is not very significant. A quarter point rate reduction is not likely to stoke an overheated economy that would send inflation into overdrive. Rates are still hovering near the highs of the past thirty-five years, and such a modest reduction would still leave them in restrictive territory. Nor would keeping them where they are be the last straw that sends the economy into a recession. While there isn't hard data to back that claim, there is little evidence that the glue holding the economy together – the job market – is poised for a nosedive, a necessary condition for a recession. That said, the Fed may have more to worry about than the near-term implications of its upcoming rate decision. It may be faced with an economy that continues to grow, but without a corresponding growth in jobs. Some believe the seeds for such a jobless expansion are being sown, reminiscent of the episode surrounding the bursting of the dot-com bubble in the early 2000s.

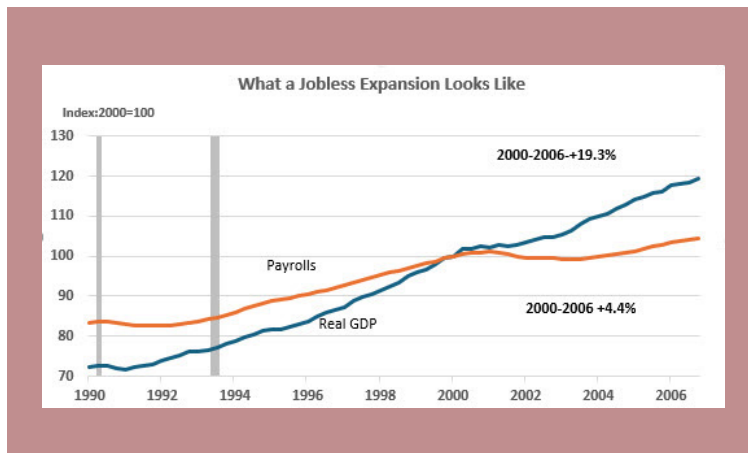
Y2K Redux?

The hot topic in financial markets these days is whether the stock market is in a bubble, fostered by enthusiasm over a handful of AI-linked companies and their ability to transform the economy into a productivity workhorse, generating huge profits in the process. On a broader scale, the new factories and capital equipment needed to deliver the promises of AI are expected to promote a burst of hiring while the productivity enhancements from the new technology helps wring inflation out of the system.

The enthusiasm for the so-called megacap stocks today is reminiscent of the optimism that prevailed during the internet revolution in the 1990s, which also held out great promise of huge profits, productivity-enhanced growth, and low inflation. As we now know, irrational exuberance that invited many poorly run companies to join the stock market party eventually burst when earnings did not meet expectations; the subsequent dot-com bust and market downturn ushered in a recession at the start of the 2000s. Time will tell if the stock market meets a similar fate this time. More importantly, however, is that the forces that led to the jobless recovery following the dot-com bust are very much in play now.

Recall that the 1990s were halcyon years. Job growth was strong as capital spending surged and productivity gains helped lower inflation, allowing the Federal Reserve to keep interest rates low for longer than otherwise. But after the recession removed excess from the system, the recovery that followed was hardly the script that job seekers hoped for. The economy enjoyed a sustained period of growth, but the hiring

binge of the 1990s faded and job growth lagged seriously behind the growth in output. Most of the 2002-2007 period was dubbed the “jobless recovery”.



What Is A Jobless Recovery?

In a literal sense, there is really no such thing as a jobless recovery, as it is almost impossible for the economy to sustain growth without some employment gain. Paychecks and incomes would stagnate, depriving consumer spending of any fuel to grow. Since personal consumption accounts for about 70 percent of GDP, the economic engine would simply falter and stop moving forward. Recognizing this, economists refer to a jobless recovery as one in which GDP increases but employment gains are modest at best.

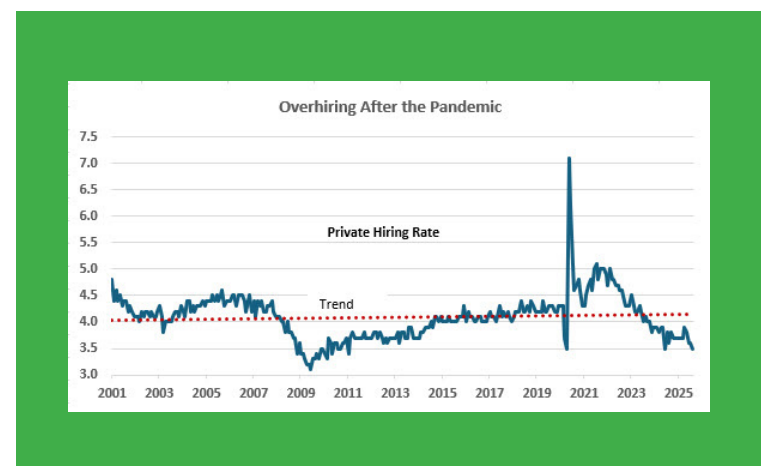
That was starkly evident during the 2002-2007 expansion when real GDP expanded more than four times faster than employment. Indeed, it took four years before the job losses during the 2001 recession were recovered, longer than any previous recovery even though that recession was one of the mildest on record. What are the portents from that episode that are appearing now? For one, the late 1990s saw a good deal of overhiring, thanks mainly to the capital spending boom fueled by surging demand from high-tech companies. When the dot-com bubble burst and left a mountain of overcapacity, so too did the need for labor. As noted, it took years for firms to right-size its workforce, bringing it back to levels more aligned with the economy's reduced demand for goods and services. The manufacturing workforce was also dinged by the ongoing advance in globalization, which sent many jobs overseas.

For another, it takes time for new technology to generate the productivity improvement that justifies its enormous spending

on research and development – and the hiring binge associated with that spending. Keep in mind that it takes a lot of workers to build a productivity-enhancing plant, but few to operate it once it is finished. Throughout most of the 1990s, productivity grew at about a 1.5 percent annual rate, close to its long-term trend. But from the end of 2001 through 2006 productivity growth surged to 2.8 percent. Simple math explains the downshift of job growth during that period. GDP is the product of labor input and productivity; the stronger the productivity, the less labor is needed to generate output.

Fast Forward

As they say, the past is not always prologue. But the seeds of the 2002-2007 jobless expansion can be seen now. The overhiring that preceded the dot-com bust is evident in the overhiring that took place in the post-COVID years. The catalysts were different. The AI boom has not stoked a surge of job growth, as the dot-com boom did then. This time, it was the torrid fiscal stimulus that emerged from the pandemic and its aftermath. Households went on a spending spree with their newfound funds, and companies that faced severe labor shortages during COVID scrambled to catch up. Understandably, they overcompensated, making sure enough workers would be available to meet demand going forward.



Following two years of binge shopping, the savings from those stimulus payments have been depleted and demand, predictably, has slowed. Employers have responded, pulling back on hiring and posting fewer job openings. For the first time in 4½ years, there are more unemployed workers than job openings. Meanwhile, productivity is picking up. After averaging just 1 percent during the 2010-2019 expansion, productivity growth has increased to a 2.4 percent annual rate over the past two years. It's still too early to tell what extent AI technology is boosting productivity and

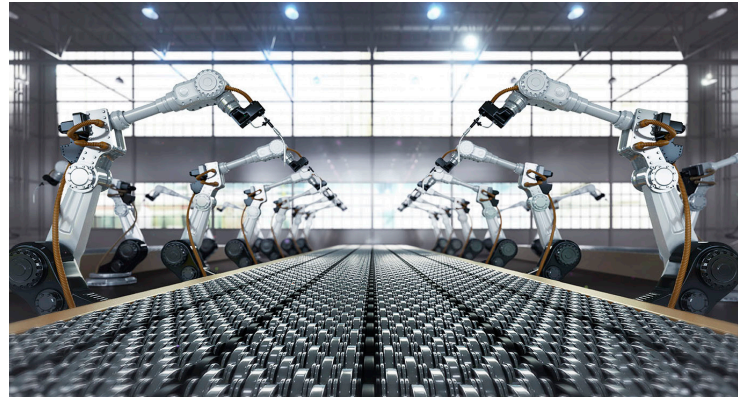
replacing workers, but a big chunk of the recent wave of layoff announcements is, ironically, by technology companies.

One job-destroying feature that existed in the earlier recovery – globalization – is not a factor now. Indeed, government policy is heavily tilted towards restricting trade, using tariffs as a cudgel to bring jobs back to the U.S. So far, that hasn't worked, as manufacturing jobs have continued to decline. That may reflect early signs of the growing influence AI-related technology is having on the factory floor, with robots replacing many of the repetitive tasks previously assigned to workers.

Fewer Jobs Needed

A new wrinkle contributing to weak job growth this time is that it is as much due to reduced labor supply as to labor demand. Thanks to the government's immigration crackdown, foreign-born workers have been leaving the labor force in droves. That, along with the ongoing increase in retirements linked to an aging population, has sharply reduced the growth in the labor force. It is estimated that the economy needs to generate only about 50 thousand jobs a month to meet that growth and prevent the unemployment rate from rising. That's a far cry from the 168 thousand monthly increase in 2024. Even during the 2001-2006 jobless recovery, job growth averaged 112 thousand a month.

Simply put, it looks very much like we are heading for a jobless expansion in 2026, with productivity gains sustaining GDP growth even amid sluggish employment increases. However, there is a big difference with the jobless recovery of the early



2000s. Back then inflation was dormant, running at 2 to 2.5 percent or lower for more than a decade, allowing the Federal Reserve to keep interest rates low. Ben Bernanke, the Federal Reserve at that time, argued that robust productivity growth could allow the central bank to keep monetary policy easy.

That's not the case now, as inflation has been running at 3 percent or higher for more than four years – hence, why the Fed may nudge rates a quarter point lower on December 10 as insurance against a weakening job market. With little runway to go much further lest it ignite an inflation flareup. In a sense, therefore, a jobless recovery like the low hiring/low firing one now underway may be just what the doctor ordered, as it would keep inflation in check while keeping the economy out of a recession. But if AI does not live up to its promise, resulting in disappointing growth and rising layoffs, all bets are off, as the prospective jobless recovery would morph into a time-honored recession.

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KEY FINANCIAL AND ECONOMIC INDICATORS

FINANCIAL INDICATORS*

	<u>October</u>	<u>September</u>	<u>August</u>	<u>July</u>	<u>June</u>	<u>May</u>	<u>April</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
Prime Rate	7.23	7.38	7.50	7.50	7.50	7.50	7.50	7.81	7.23
3-Month Treasury Bill Rate	3.82	3.92	4.12	4.25	4.23	4.25	4.21	4.42	3.82
5-Year Treasury Note Rate	3.65	3.66	3.79	3.95	3.96	4.02	3.91	4.43	3.65
10-Year Treasury Note Rate	4.06	4.12	4.26	4.39	4.38	4.42	4.28	4.63	4.06
30-Year Treasury Bond Rate	4.64	4.74	4.87	4.92	4.89	4.90	4.71	4.92	4.54
Tax-Exempt Bond Yield	4.77	4.96	5.22	5.27	5.24	5.22	5.18	5.27	4.04
Corporate Bond Yield (AAA)	5.13	5.21	5.35	5.45	5.46	5.54	5.45	5.54	5.13
Conventional 30-Year Mortgage Rate	6.25	6.35	6.59	6.72	6.82	6.82	6.73	6.96	6.25
Dow Jones Industrial average	46710	45908	44765	44500	42753	41864	39876	46710	39876
S&P 500 Index	6736	6584	6409	6297	6080	5811	5370	6736	5370
Dividend Yield (S&P)	1.16	1.19	1.21	1.23	1.28	1.32	1.43	1.43	1.16
P/E Ratio (S&P)	28.4	27.8	26.8	26.9	26.3	25.1	23.8	28.4	23.8
Dollar Exchange Rate (vs. Major Currencies)	121.2	120.5	121.0	120.5	121.0	122.7	124.5	129.0	120.5

* Monthly Averages

ECONOMIC INDICATORS

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								<u>High</u>	<u>Low</u>
Housing Starts (Thousands of Units)	NA	NA	1307	1429	1382	1282	1398	1514	1282
New Home Sales (Thousands of Units)	NA	NA	800	664	676	627	706	800	623
New Home Prices (Thousands of Dollars)	NA	NA	414	395	404	425	414	431	395
Retail Sales (% Change Year Ago)	NA	4.3	5.0	4.1	4.4	3.4	5.0	5.10	3.4
Industrial Production (% Change Year Ago)	NA	NA	0.9	1.3	0.9	0.7	1.2	1.4	-0.9
Operating Rate (% of Capacity)	NA	NA	77.4	77.4	77.7	77.5	77.6	77.7	76.8
Inventory Sales Ratio (Months)	NA	NA		1.37	1.38	1.39	1.38	1.41	1.37
Real Gross Domestic Product (Annual % Change)	NA	NA			3.8			3.8	-0.6
Unemployment Rate (Percent)	NA	4.4	4.3	4.2	4.1	4.2	4.2	4.4	4.0
Payroll Employment (Change in Thousands)	NA	119	-4	72	-13	19	158	323	-13
Hourly Earnings (% Change Year Ago)	NA	3.7	3.7	3.9	3.7	3.8	3.8	4.2	3.7
Personal Income (% Change Year Ago)	NA	NA	5.4	4.9	4.7	4.9	5.8	5.8	4.7
Savings Rate (Percent of Disposable Income)	NA	NA	4.6	4.8	5.0	5.2	5.7	5.7	4.3
Consumer Credit (Change in Blns. Of Dollars)	NA	NA	0.4	18.1	-4.7	7.9	16.8	18.1	-109.6
Consumer Prices (% Change Year Ago)	NA	3.0	2.9	2.7	2.7	2.4	2.3	3.0	2.3
CPI Less Food & Energy (% Change Year Ago)	NA	3.0	3.1	3.1	2.9	2.8	2.8	3.3	2.8