The Kiplinger Letter

FORECASTS FOR EXECUTIVES AND INVESTORS

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Amid the hype over AI, a practical question: When will the technology boost the economy the way its developers and promoters are promising? Is artificial intelligence going to unleash a surge in worker productivity, as epochal new tech has done in the past? Or is investor enthusiasm for it overdone?

AI

In one sense, AI is already adding to GDP. Spending on AI hardware is astronomical, both for the costly, specialized chips that power AI, and the related infrastructure to deliver the electricity that those chips devour. This spending raised GDP by 0.3% in the second quarter of this year. Even that doesn't fully capture the size of this investment surge, since some capital outlays that tech firms are making don't show up in the official GDP accounting method.

Just look at the top five firms by AI investment: Amazon. Alphabet. Meta. Microsoft. Oracle. The increase in their AI-related capital expenditures over the past two years equals about 10% of GDP gains in the U.S. over that time period. Add the power plants, transmission lines and other infrastructure they need to run their data centers, and the outlay is even bigger.

Economic Forecasts

GDP growth
1.7% in '25,
1.6% in '26

Interest rates
Pickup in inflation later will keep 10-year in mid-4's a while

Inflation
3.4% at end '25,
3.0% at end '26

Unemployment
4.3% at end '25,
4.5% at end '26

Crude oil
Trading in the mid- $60s per barrel for now

Federal tariff revenue
$300 billion in '25; $500 billion in '26 if policy is held constant

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There are also signs that businesses are gearing up for AI to make an impact on their operations. Company mentions of AI use for research tripled since Nov. 2022, when ChatGPT launched and turbocharged generative AI. 25% of job listings posted for IT professionals since the start of last year have asked for AI-related skills. The number of mobile AI app downloads hit 60 million this March. Internet searches related to AI have grown tenfold since OpenAI unveiled ChatGPT to the public.

When it comes to whether AI will make workers more productive… The picture gets murkier. There are some early signs that it's happening. Inflation-adjusted revenue per worker among S&P 500 companies has been rising since late 2022, following a 15-year period when it stayed flat. It's not clear why, but the overlap with advanced AI applications going mainstream is hard to ignore.

But with so much money pouring into AI, there are reasons for skepticism. Much of the investment being made today could end up wasted. Many companies that are in vogue now figure to fail. *(See p. 4 for more on the spike in AI start-ups.)* It's possible that AI computing power being rushed online could ultimately prove to be unneeded, akin to how fiber-optic cable networks got overbuilt in the 1990s. That capacity eventually got used as data consumption rose, but not before builders who spent too much on it went bankrupt. If the current AI data center boom fizzles, the pullback in spending could spark a mild recession, as the tech bust in 2001 did.

Most major technological leaps take time to filter through the economy. AI does seem genuinely transformative. But the transformation may take many years.

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THE ECONOMY The case for an interest rate cut on Sept. 17 comes down to the jobs report on Sept. 5, the last one before the Federal Reserve's next policy meeting. Chair Jerome Powell recently made clear that signs of labor market weakening in July have strengthened the case for a Sept. rate cut. But it's not a guarantee yet.

We think odds currently favor both a weak jobs report and a rate cut.

A bigger unknown is long-term Fed policy and whether a president can sway it. President Trump's effort to oust a Fed governor will set a major precedent, depending on whether the courts back him. If he can fire a Fed governor for cause, Trump will have named a majority of the Fed board of governors and could get eventual control of monetary policy. That would give him and future presidents leverage on interest rates in a way that most economists fear may be abused. Presidents tend to want low rates.

Inflation-adjusted consumer spending will grow by 1% in the second half of this year, as pretariff purchasing eases and price increases of certain imports cause purchases to dip. Consumers in general remain in good financial health, with the capacity to borrow and a reasonably high level of deposits. The share of consumers carrying credit card balances is slightly lower than last year's level and still below 2019's prepandemic level. There are also signs that consumers are not yet tapped out, such as the rebound in spending on services in July.

Lower-income consumers are showing signs of distress. Their wage growth has slowed the most and is now below the inflation rate. Employment growth in unskilled sectors has been revised down a lot. As a result, credit card usage by lower-income households has risen the most, and delinquencies remain elevated.

CREDIT The share of consumer credit in delinquency is back to prepandemic levels, rising to 4.4% in the second quarter. Leading the way: Credit card balances, 12.3% of which were 90 days or more overdue, the highest share since early 2011. Meanwhile, 5% of auto loans were 90 days or more overdue. The share of mortgages in serious delinquency bucked the overall trend, falling to 0.8% in the second quarter.

Many new borrowers continue to fall behind on their payments. Transitions into early delinquency held steady for all debt types, except student loans. The share of balances that moved into serious delinquency…90 days or more late on payments… fell slightly for both credit cards (to 6.9%) and auto loans (to 2.9%) in the last quarter. A high share of borrowers ages 18-29 (10%) transitioned into serious delinquency.

Expect delinquencies to remain at current levels for the rest of this year. Auto delinquency rates have risen above prepandemic levels because of a combination of higher car prices, more relaxed credit standards in the aftermath of the pandemic and the subsequent shift to higher interest rates. Car prices and lending standards are both now closer to normal levels, which should help keep a lid on delinquencies. Credit card delinquencies, too, will plateau amid falling rates and lower credit growth.

HOUSING Lower mortgage rates and slower price growth are improving home sales. Existing-home sales rose 2% in July, bouncing back from June's decline. The main driver behind the increase was likely a modest drop in mortgage rates. Meanwhile, price growth this year has cooled to its slowest pace since July 2023. Sales have essentially moved sideways in 2025, as buyers face affordability issues.

Inventories of existing homes are rising, despite the poor selling conditions. They increased 0.6% in July from the previous month. The supply of existing homes on the market is now 15.7% higher than a year ago. The amount of unsold inventory has risen to 4.6 months…creeping closer to levels last seen before the pandemic.

Expect buying activity to pick up modestly in the second half of this year, as home-price growth continues to cool and mortgage rates stay in the mid-6% range. Demand for mortgages has improved this year, despite the 30-year fixed mortgage rate hovering close to 7% for most of 2025. That said, sales are unlikely to break out of the annual pace of 4 million, where they have been stuck for the past two years.

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TRADE Tariffs will start affecting consumer prices more later this year. In June, consumers bore only 22% of tariff costs from higher prices. U.S. firms absorbed roughly two-thirds of the cost, and foreign companies, the remainder.

Expect the share borne by U.S. consumers to rise to two-thirds by the end of 2025, as business inventories of pretariff goods decline. Meanwhile, firms will become more certain which tariffs are likely to stick and at what levels.

The Federal Reserve will be watching closely. Fed Chair Jerome Powell is increasingly open to the possibility that tariffs are having a temporary effect on inflation, meaning that the Fed could still justify lowering interest rates. But the central bank will watch for any shift in long-term inflation expectations, not wanting to repeat its mistakes of 2021-22, when it ignored supply chain issues and failed to raise rates in time to head off a series of persistent price increases.

MORE TRADE The U.S. has expanded the list of goods subject to Section 232 tariffs on steel and aluminum, according to Customs and Border Protection. The hundreds of items that will now incur 50% tariffs upon entry into the U.S. include locomotives, motorcycles, truck trailers, certain car parts and numerous household appliances. Among them: Refrigerators. Ovens. Microwaves. Dishwashers. Washers. Dryers.

The steel and aluminum duties now affect at least $320 billion in imports, per one estimate, with President Trump expanding product types by executive order.

Expect the Trump administration to issue a similar list for its copper tariffs.

CONGRESS The trend of offshoring call centers has gotten the attention of Congress. A bipartisan bill would entice companies to locate call centers in the U.S. as well as discourage the use of automated phone systems in lieu of human agents. The Keep Call Centers in America Act, sponsored by Sens. Ruben Gallego (D-AZ) and Jim Justice (R-WV), would impose fines and other penalties for noncompliance.

U.S. companies increasingly have set up call centers in foreign countries where labor costs are less than in the U.S. The Bureau of Labor Statistics projects that 150,000 U.S. call center jobs will be lost and relocated overseas by 2033.

The bill would deny companies federal grants and guaranteed loans if they move call centers overseas. Those employers would be placed on a public list for five years unless they return an equal or greater number of call center jobs to the U.S. Employers with existing federal awards that use overseas call centers would be required to pay a monthly penalty and any federal award would be nixed if the employer remains on the list at least one year after the first penalty is paid.

Call center workers would also be required to disclose their physical location at the start of communication with customers. If the center is located outside the U.S., or if artificial intelligence or any nonhuman source is generating the communication, customers could request an immediate transfer to a customer service agent in the U.S.

It's too early to predict whether the bill has enough support to become law. But because of its bipartisan nature, it should garner a close look from lawmakers.

LABOR Employers receiving federal funds may no longer require diversity in hiring or conduct race-based training, according to new Dept. of Justice guidance. The federal agency says that such practices may constitute unlawful discrimination.

Forbidden policies can range from quotas to proxies for characteristics, including geographical targeting and hiring based on factors like "lived experience."

Legal experts say that all employers should take note of the guidance and assess their vulnerability to lawsuits, either from Uncle Sam or job candidates.

The DOJ's move will pave the way for more expansive efforts by the EEOC… Equal Employment Opportunity Comm. The agency tasked with enforcing the law on workplace discrimination will soon see its quorum restored and start taking action.

TECH Investors keep plowing money into AI start-ups at sky-high valuations. Even as sales grow swiftly, losses are piling up for AI firms. Investors…venture capital firms, corporations, private equity, etc…doled out a record $70 billion to generative AI firms in the first half of 2025, says S&P Global Market Intelligence. OpenAI's $40 billion funding round and Meta's $14.8 billion minority stake in Scale AI led the way. The U.S. saw $40 billion invested over 728 deals in the second quarter, making up 84% of the global dollars, according to VC research firm CB Insights.

Look for more small players to get scooped up by leading tech giants and other large companies. Many start-ups will fail to gain traction or will go under.

Among the recent biggest deals: Scale, xAI, Anduril, Thinking Machines Lab, Anysphere and Anthropic. Other firms scoring funding: Decagon, Chainguard, Glean, Harvey, Cyera, Cohere, Abridge, Ramp, Snorkel AI, NexGen Cloud and Cyberhaven.

CYBER-SECURITY Artificial intelligence is helping defend against data breaches of all types. But AI is also increasing threats in a growing AI arms race. AI security tools can defend against phishing, deepfakes and other attacks. But a growing problem is AI tools having weak security settings, leaving the systems vulnerable to a breach. And "shadow AI"…tools used by workers that are unsanctioned by the company…is a security risk. Many firms don't have adequate policies to stop the practice.

The cost of a data breach has surged to more than $10 million in the U.S., on average, according to a recent IBM report. 20% of organizations studied by IBM were hit with a breach related to shadow AI. On the bright side, investing in AI for security led to organizations detecting breaches much faster and saving money.

New policies can help mitigate the risk, such as oversight of shadow AI, having a solid data breach response plan and regular security training for workers. Other factors that help: Encrypting data and using advanced threat monitoring tools.

DRUGS As President Trump hints that he may ease restrictions on marijuana… Note that reclassification would be a huge boost for the legal weed industry. It wouldn't make weed legal at the federal level, but it would lessen criminal penalties, making it much easier to do interstate business. Only about one in 10 Americans say the drug should be illegal, according to a 2025 Pew Research Center poll.

At issue is whether to reclassify marijuana as a Schedule III drug…a category that includes Tylenol with codeine, ketamine and anabolic steroids. Marijuana is currently a Schedule I drug, along with heroin, LSD and ecstasy.

The final decision remains uncertain, but it could come in a few weeks.

FOOD Spurred by the rise of delivery apps, food influencers and Gen Z culture… Food brands are experimenting with new global flavors more than ever. Fast-growing emerging flavors include complex spicy ones, umami, citrus, floral and earthy. Popular spices include Mexican guajillo chili, North African harissa and Korean gochujang, all gaining popularity in snacks such as hot honey popcorn. The pleasant savory flavor of umami, found in seaweed, mushrooms and soy sauce, can be found in high-end chips. An example is black garlic, mellower than raw garlic.

Quirky snack flavors are serious business. McDonald's new sodas…Strawberry Watermelon, Popping Tropic, etc…are an example of the emerging trend.

Yours very truly,



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