OTHER SIDE
ASSET MANAGEMENT

Feelings often lag Reality!

Always darkest before the dawn

There's an old saying that it's *always darkest before the dawn*. Not because the night suddenly gets worse, but because human perception is at its weakest just before conditions begin to change.

Markets behave the same way. They tend to stabilize and recover before confidence returns. Prices respond to improving conditions long before people *feel* them. By the time things feel better, markets have often already moved.

That disconnect — between perception and process — is where we find ourselves today.

There's a strange tension in the economy right now, and it's one we see confuse investors more than almost any other phase of the cycle … we'd by lying if we said it hasn't challenged us at times over the years.

By the math, things are improving. Not dramatically. Not explosively. But measurably. Growth has stabilized and is beginning to reaccelerate at the margin. Inflation pressures are easing on a forward basis. Interest rates have started to respond. Financial conditions, while still restrictive by historical standards, are no longer tightening.

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Yet if you ask most people how the economy feels, the response is almost universally negative. It feels bad.

Not just uncomfortable, but fragile. As if something is wrong beneath the surface. As if the improvement being pointed to in the data can't possibly be real. For many, it feels like we're being told things are getting better while lived experience suggests otherwise.

That reaction isn't irrational. It's not ignorance. And it's not a failure to understand the headlines. It's the natural result of how economic change actually works … versus how we experience it in real time.

Markets don't move based on how the economy feels. They move based on rate of change. Direction matters more than level. Less bad growth can be good. Slowing inflation can matter more than low inflation.

This is where the disconnect forms.

People experience the economy through prices, housing costs, job opportunity, and affordability. Markets experience it through growth trajectories, inflation trends, volatility, and liquidity.

Right now, growth and inflation…the two variables that define the investing regime…are both moving in directions that historically matter for markets. Growth is improving at the margin. Inflation is decelerating on a forward basis. That combination doesn't guarantee smooth sailing, but it does change the environment in which capital flows, policy expectations, and market behavior operate.

And when the regime shifts, flows follow.

Passive investing, systematic strategies, and momentum don't wait for confidence, comfort, or consensus. They respond mechanically to changes in trend, volatility, and rate of change. That's why markets can begin to move well before sentiment improves … and why periods like this often feel the most confusing.

The goal of this month's letter is not to argue that everything is "fine," or that the challenges people feel aren't real. They are. Housing remains expensive. Hiring has slowed. Affordability is still strained. Those realities matter.

But they are not the same thing as regime drivers.

Understanding the difference between how the economy feels and how it is changing … between levels and direction…is critical. Especially in environments where markets begin to respond to improvement long before confidence catches up.

That's the lens we'll use this month as we walk through the data, the rate of change in growth and inflation, and why those forces continue to drive flows…even when it doesn't feel like they should.

Before diving into the data, it's worth slowing down on one point that underpins everything that follows.

Markets don't react to snapshots. They react to movement. They don't respond to whether growth or inflation are "good" or "bad" in isolation. They respond to whether conditions are getting better or worse relative to where they were. That distinction explains why economic discussions often feel disconnected from market behavior, especially in periods like this one.

To understand why markets are responding the way they are today, we need to start with growth. Not as a headline number, but as a rate of change. Because growth does not need to be strong to matter. It needs to stop deteriorating.

Growth … improving at the margin

When investors talk about growth, the mistake most often made is focusing on whether growth is "strong" or "weak," rather than whether it is **accelerating or decelerating**. Markets don't require booming growth to function. They require growth that is no longer getting worse.

That distinction matters enormously right now.

From a GDP standpoint, the data continues to show stabilization and modest reacceleration at the margin. Atlanta Fed GDPNow is tracking roughly 3% growth for Q4. That number on its own is not remarkable. What matters is the direction relative to prior quarters, when growth expectations were rolling over.

Income tax withholdings are running approximately +4% YoY, a critical but often overlooked data point. Withholdings provide a real-time proxy for aggregate income growth, and they suggest that while hiring has slowed, income across the system remains intact. That supports consumption, which still represents roughly 70% of economic activity.

Retail Sales reinforce this point. While headline retail data can be noisy, the Control Group improved MoM and continues to feed directly into GDP calculations. This tells us consumers have not pulled

back in a way consistent with an economy sliding into contraction. Spending patterns are changing, but spending itself remains present.

Housing related activity also supports the idea that growth is responding to marginally improved conditions. New Home Sales are up +18.7% YoY, even as prices decline. Mortgage Applications are up +60.8% YoY, driven largely by refinancing activity surging +133.6% YoY as rates have moved lower. That response matters. It shows demand exists when affordability improves even modestly and that financial conditions still influence behavior.

Trade data adds another layer of confirmation. The U.S. trade deficit has narrowed to its best level in 16 years. Exports are up +12.1% YoY, while imports are down -3.6% YoY. The petroleum trade balance has now been positive for the 41st consecutive month, reflecting a structural improvement that did not exist in prior cycles. Trade is no longer acting as the drag it once did.

None of this suggests an economy firing on all cylinders. Manufacturing remains under pressure.

Hiring has slowed. Capital investment is cautious. But growth is no longer deteriorating, and in several areas, it is improving at the margin.

That is the point markets care about.

When growth stops getting worse and begins to stabilize, the investing regime shifts. Risk assets don't need confirmation that growth is "good." They need evidence that the downside is no longer accelerating. That is exactly what the current growth data continues to show, even if it doesn't feel that way in day-to-day experience.

Improving growth alone, however, is not enough to change an investing regime.

History is clear on this point. Growth can stabilize, or even reaccelerate, and markets can still struggle if inflation remains volatile or continues to accelerate. Growth tells us whether demand exists. Inflation tells us whether that demand can be discounted with confidence.

That's why inflation matters just as much as GDP in determining how capital behaves. To understand why markets have become more constructive even as confidence remains weak, we have to look at what inflation is doing beneath the surface…and more importantly, where it is headed.

Inflation … Decelerating

If growth sets the stage for the investing regime, inflation determines whether that stage is usable.

The most common mistake investors make is focusing on the level of inflation rather than the rate of change. Markets don't need inflation to be anemic ... they need inflation to stop accelerating.

When inflation pressure begins to ease on a forward basis, uncertainty around rates, margins, and policy begins to fall with it.

That is exactly what the data continues to show.

Headline CPI rose +0.31% MoM and +2.68% YoY, marking the slowest YoY pace since June. Core CPI increased +0.24% MoM and +2.64% YoY. More importantly, Super Core CPI slowed further to +2.84% YoY from +3.0% previously. These are not backward-looking prints that signal a sudden collapse in prices. They are incremental improvements that indicate inflation pressure is no longer accelerating.

Alternative measures reinforce the same message. Truflation suggests CPI is closer to +2.05% YoY, suggesting real time inflation pressures are already lower than what traditional CPI captures.

This gap exists because CPI contains components that respond slowly to underlying changes, especially shelter.

Energy continues to be a deflationary force. Energy prices are down on both a MoM and YoY basis, and energy feeds into the inflation data on a relatively short lag. That deflationary impulse works its way through transportation costs, goods prices, and margins over time.

Core Goods inflation is also easing. Used Auto prices fell -1.11% MoM and have decelerated sharply on a YoY basis. Shipping rates peaked in rate of change terms in mid 2024 and are now positioned to be disinflationary into 1H26. Shipping costs are a leading indicator for goods inflation, and the direction here matters far more than the absolute price level.

Services inflation, which has been the most stubborn component, is also beginning to show signs of relief. Transportation Services inflation has slowed to +1.51% YoY. Wage growth, which drives services inflation with a lag, has decelerated to roughly +3.76% YoY. Slower wage growth today translates into slower services inflation tomorrow.

This is where perception diverges from process.

Inflation still feels high because prices remain elevated relative to where they were several years ago. Markets don't reset prices. They discount change. When inflation stops accelerating, volatility around rates declines. When volatility declines, discount rate uncertainty falls. When uncertainty falls, capital becomes easier to deploy.

Inflation does not need to collapse for markets to respond. It simply needs to move in the right direction … which the data continues to support.

That shift in inflation's rate of change, combined with stabilizing growth, is what defines the current investing regime and underpins the flow dynamics driving markets … even when it doesn't feel that way yet.

When growth and inflation shift together, the conversation changes.

Improving growth combined with decelerating inflation does more than influence economic forecasts or policy debates. It alters the mechanical inputs that drive modern markets. Volatility, discount rates, and liquidity begin to respond long before sentiment catches up.

This is where understanding the structure of today's markets becomes critical. Because once the regime shifts, the transmission mechanism that matters most is not confidence or conviction. It's flow.

Flows … why markets move

Once growth and inflation begin to move in the right direction, markets don't wait for reassurance. They respond through flows.

This is where most investors misunderstand what they're watching.

Markets today are not driven primarily by discretionary decision making. They are driven by systematic allocation, passive vehicles, and momentum-based strategies that respond mechanically to changes in trend, volatility, and rate of change. These flows do not ask whether conditions "feel good." They ask whether conditions are improving or deteriorating.

When the rate of change in growth stabilizes and the rate of change in inflation decelerates, the first variable that responds is **volatility**.

We can see this playing out across markets. Volatility has remained contained even as headlines remain unsettled … with both interest rate and equity volatility declining through this investing regime shift.

This creates an environment where systematic strategies begin to re-engage, not because they are optimistic, but because the inputs they respond to have improved.

Passive vehicles allocate capital based on market capitalization and price trends. Momentum strategies allocate based on what is working, not why it is working. Risk parity and volatility targeting strategies increase exposure when volatility falls and reduce exposure when volatility rises. None of these strategies require confidence … they require clarity in the rate of change in specific data.

That is why markets can begin to move even while surveys, sentiment indicators, and anecdotal experience remain weak.

Credit markets reinforce the same message. As rates declined, mortgage refinancing surged +133.6% YoY. Mortgage applications overall rose +60.8% YoY. Credit responds immediately to changes in financial conditions. Confidence responds later.

As we head to publish, Consumer confidence just hit a 5-month high … off of depressed levels, but that's the exact point we're trying to make here … it's the RoC IMPROVEMENT THAT MATTERS MOST!

This dynamic also explains why the next Fed cut is unlikely to be the catalyst many expect.

Fed Funds Futures are pricing roughly two cuts in 2026, with January odds near 5% and March near 22%. Markets have already adjusted to the **direction** of policy. When the Fed eventually cuts, it will not mark the beginning of a new regime. It will confirm one that has already been forming through growth and inflation dynamics.

Historically, markets do not wait for the Fed to act … they respond to the conditions that force the Fed to act.

This is why "less bad" can be good for markets. When growth stops deteriorating and inflation stops accelerating, volatility falls. When volatility falls, systematic exposure rises. When exposure rises, prices follow. The process is mechanical, not emotional.

This does not mean markets move in a straight line. It does not mean risk disappears. It means the tailwinds quietly change direction, often before people are comfortable acknowledging it.

Flows explain why markets can rise without enthusiasm, why rallies can feel undeserved, and why waiting for confidence to return often means missing the early phase of a regime shift.

Markets don't move when things feel good. They move when things stop getting worse.

If flows explain why markets can move ahead of sentiment, they also help explain why that movement often feels disconnected from lived experience.

Markets respond to aggregate conditions and marginal change. People experience the economy through housing costs, job security, and opportunity. Those two perspectives rarely align perfectly, especially during regime transitions.

At the moment, this dynamic is on full display in both … housing and labor.

Feelings vs. RoC improvements

If growth and inflation are moving in directions that support markets, the natural question becomes… why does it still feel so uncomfortable?

The answer lies largely in housing and labor. Not because they are driving the regime, but because they **lag it** and dominate day to day experience.

Housing is one of the slowest moving and most emotionally charged components of the economy. It also carries one of the longest lags in the inflation data. Real time housing conditions began to shift well over a year ago, but CPI shelter reflects those changes with an estimated 12-to-18-month delay.

That lag is critical.

Case Shiller 20 City home prices are up just +1.31% YoY, the slowest pace since July 2023. FHFA home prices are up +1.76% YoY. Apartment List rents have been negative YoY for nearly two years. Truflation housing inflation sits near +0.65% YoY. These are not subtle signals. They indicate that housing inflation pressure has already rolled over in real time.

Yet CPI shelter has not fully incorporated that shift. As a result, reported inflation remains elevated in the category people feel most acutely, even as forward pressure continues to ease.

That disconnect makes inflation feel more persistent than it actually is.

Housing activity itself reflects the same dynamic. Housing Starts are down -7.8% YoY. Building Permits are down -1.1% YoY. New Home median prices are down -8.0% YoY. These are not signs of overheating. They are signs of adjustment after an affordability shock.

At the same time, mortgage rates have declined to roughly 6.25%, the lowest level since September 2024. As rates moved lower, demand responded quickly. New Home Sales rose +18.7% YoY. Mortgage Applications surged +60.8% YoY. Refinance activity jumped +133.6% YoY. Housing demand exists, but it remains highly rate sensitive. That sensitivity creates volatility in sentiment even when the trend is improving.

Labor tells a similar story.

Hiring has slowed meaningfully, and opportunity feels scarcer. That alone can weigh heavily on confidence. But layoffs, which matter far more for markets, have not accelerated.

Initial Jobless Claims remain near 200k WoW, still historically low. Continuing Claims are modestly higher YoY, but not surging. ADP employment increased +41k MoM, though YoY growth has slowed to roughly +0.5%. Job openings are down -11% YoY. The quits rate sits near 2.0, signaling reduced worker bargaining power.

Wage growth has decelerated to roughly +3.76% YoY. Slower wage growth feeds directly into slower services inflation with a lag. That is a positive development for inflation dynamics, even if it feels uncomfortable for workers.

The labor market feels worse because fewer opportunities exist, not because the system is breaking. That distinction matters. Hiring slows before firing accelerates. And so far, firing has remained contained.

Housing and labor dominate lived experience. They shape how people feel about the economy far more than GDP or CPI prints. But they are lagging indicators in the regime framework. They explain why confidence remains weak even as the underlying data begins to improve.

This is why environments like this often feel the most confusing. The regime shifts first. Flows respond next. Confidence follows last.

Housing and labor explain the emotional side of the disconnect. But they do not negate the regime.

What they highlight instead is how uneven economic improvement can feel, and how long it can take for stabilization at the macro level to translate into comfort at the household level. That gap between process and perception is not unusual. In fact, it’s typical during periods when markets begin to respond before confidence returns.

Which brings us to the most important question investors face in environments like this … what to do when stability feels uncomfortable.

Final thoughts

Just because things might “FEEL” … “OFF” … it doesn’t mean that they are.

After years of volatility, instability, and inflation shocks, stability doesn’t feel reassuring.
It feels wrong.

When prices were rising rapidly, rates were spiking, and headlines were uniformly negative, uncertainty at least had a narrative. There was something concrete to react to. In contrast, periods where conditions quietly improve tend to feel unsettling. There's no crisis to explain the anxiety, and no obvious catalyst to wait for.

That discomfort is not a signal that something is broken. It's a signal that psychology is lagging reality.

Markets adapt faster than people. Always have.

When growth stops deteriorating and inflation stops accelerating, the system begins to stabilize even if it doesn't feel "good." Volatility compresses (as described above). Policy expectations become clearer. Capital becomes more willing to engage. None of that requires enthusiasm or confidence. It requires non deterioration.

This is why the early phases of regime shifts often feel the most confusing. Prices begin to move without a clear narrative. Markets respond before sentiment improves. And investors waiting for clarity are left feeling out of sync with what they're seeing on their screens.

Stability also forces a different kind of discomfort.

Volatility creates excuses. It allows investors to delay decisions, blame external forces, and stay reactive. Stability removes those excuses. It forces a harder question...what is the plan when things are no longer clearly broken, but not obviously fixed either?

That's the environment we're in now.

This regime does not demand bold predictions or aggressive positioning. It demands discipline. It demands an understanding of how growth and inflation interact, how rate of change drives volatility, and how flows respond mechanically to those shifts.

It also demands perspective.

Housing and labor still feel strained. Affordability remains a challenge. Hiring has slowed. Those realities matter, especially at the household level. But they are not the same thing as regime drivers. Confusing lived experience with investing signals is one of the most common and costly mistakes most investors make ... including the younger version of ourselves.

Markets don't move when things feel good. They move when conditions stop getting worse. By the time confidence returns, prices have often already adjusted.

The goal isn't to predict the next move or declare victory over economic challenges. The goal is to ensure that decisions are being made based on process rather than emotion, and preparation rather than reaction.

That's why we focus so heavily on understanding regimes, stress testing plans across different growth and inflation environments, and making sure both spouses understand not just what the plan is, but why it's built the way it is.

Because when conditions change quietly, the cost of being unprepared is far greater than the cost of being early.

That's the other side of the story.

CLICK HERE TO BOOK YOUR FREE CONSULTATION NOW!

As always, never hesitate to call with any questions or concerns!

Good investing!

Sincerely,

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