

Economic Compass

Navigating an erosion in trust

Lessons from the water's edge

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I recently visited the beaches of my youth along the eastern shore of Lake Michigan. A sea of ice stretched to the horizon. Families ventured farther from the shoreline, gaining confidence with each step.

The ice looked thick—solid enough to trust. The danger lies not in what we can see, but in what we cannot. Currents weaken ice from below. Fault lines form with each step.

That image stayed with me as I reflected on a series of off-the-record meetings over the past several weeks. That spanned the country and included economists from every major industry, our largest trading partners and allies.

Those conversations left me feeling much like the vista before me. The resilience of the economy, both at home and abroad, feels more illusory than real. An undercurrent has left consumers feeling more anxious about the economy than it appears on paper. That is despite signs that the labor market may be healing.

Trust has eroded both domestically and globally, extending a multi-decade decline. The deterioration has been more pronounced than developing economies and intensified over the past year.

Workers have lost faith in national governments, the media and large firms. The pandemic and the isolation it caused acted as an accelerator. People the world over have retreated into their own bubbles of friends, family and neighbors.

Economic anxieties surged alongside the loss of trust. Job insecurity flared in the wake of tariffs and rapid advances in AI. CEOs are citing AI as a reason for hiring freezes and layoffs, before the productivity associated with AI is realized.

That could prove penny wise and pound foolish; it stokes public backlash to AI, which is intensifying.

Growth decoupled from employment in 2025

Preliminary data suggest that real GDP growth rose at a 3.6% annualized pace in the fourth quarter, a slight slowdown from the blistering 4.4% pace of the third quarter. Consumer spending slowed, especially late in the quarter. Credit card data suggest stronger gains and that the data may be revised higher. Housing remained in a deep freeze. Business investment picked up on the heels of the boom in AI. Infrastructure and inventories accelerated after draining in the third quarter. Government spending slowed in response to the record-long shutdown while the trade deficit narrowed slightly on weaker imports.

The persistence of solid growth came despite a drop in employment in the fourth quarter. We shed nearly 70,000 jobs over the period, mostly in the public sector. More than 150,000 federal workers who took earlier buyouts rolled off the government's payrolls on October 1. The only sector that really added jobs in a meaningful way was healthcare and social assistance. An end to subsidies for the Affordable Care Act, tariffs and freezes to R&D funding are headwinds to those gains. Aging demographics are tailwinds.

Real GDP is forecast to rise at a 3.1% pace in the first quarter. Consumer spending is expected to accelerate in response to tax cuts retroactive to 2025. Those will show up as a surge in tax refunds, which consumers treat like windfall gains. Housing is expected to move sideways. Business investment should pick up on an acceleration in data center construction. Inventories in the retail sector are tighter than across manufacturers and wholesalers. Government spending should increase as the effects of the shutdown are reversed.

The trade deficit is poised to widen. Foreign consumers have begun to boycott US-made products to protest the recent shift in trade policies and escalating geopolitical tensions. Imports are expected to be buoyed by inputs into data centers. The tech firms received tariff waivers from the administration to support construction of data centers; there are few to no domestic substitutes for those inputs.

Fed moves to the sidelines. The Federal Reserve is in "wait and see" mode on inflation. It needs to see more cooling before it cuts rates again. We still expect three rate cuts by year-end.

Consumer confidence hit a 12-year low in January, according to the Conference Board. Consumer sentiment as measured by the University of Michigan improved modestly, but remains near record lows.

The Federal Reserve cut short-term interest rates to bolster the labor market before pausing in January. It is too soon to feel the effects of those cuts. The drop in the unemployment rate in January reflected some catch-up following the government shutdown—those on temporary layoff fell along with those forced to accept part- instead of full-time jobs.

The next shoe to drop is the surge in layoff announcements in 2025 and early 2026. Layoff notices hit their highest level in nearly a decade in 2025. Some of those cuts have been made, but more hit at the start of the year. Some will be accomplished via attrition; the rest will need to be absorbed.

This edition of *Economic Compass* provides the highlights of what I learned by sector. We entered 2026 with a tailwind from the AI buildout and extensions of tax cuts. Tariffs are still filtering through to prices, which will alleviate margin compression and the blow to employment. The level of prices, which matters most to consumers, will remain elevated.

The Fed is poised to undergo a leadership transition. The Senate refuses to confirm a replacement for Chairman Jay Powell until the investigation against him is dropped. The Supreme Court looks like it will restrict firings.

We still expect three rate cuts in the back half of the year. Financial markets will likely test the new Fed Chairman and are showing signs of becoming more fragile and susceptible to shocks.

2026 Outlook

Confident on growth, not employment

Chart 1 shows the forecast for 2026, with each bar illustrating the contribution to growth by sector. Preliminary data suggest we ended 2025 with robust growth but without generating jobs.

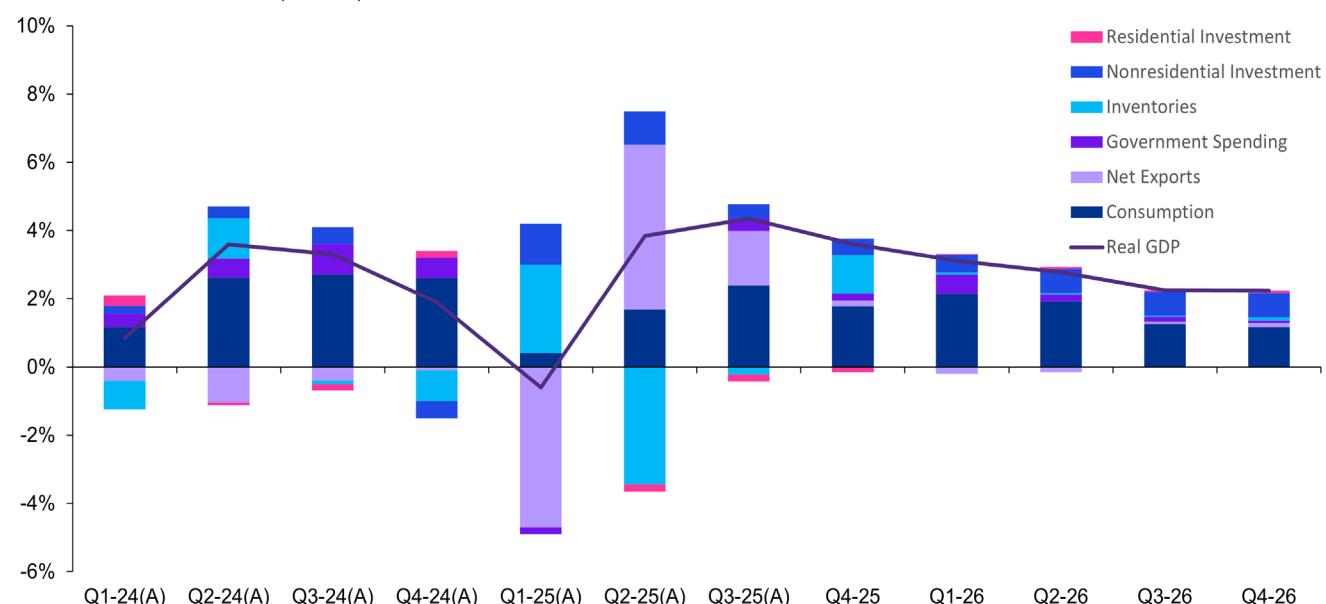
Productivity picked up as firms scrambled to do more with less. Those gains were not enough to offset the margin compression due to tariffs or to lift wages.

Employment appears to be picking up. We do not need to generate many jobs to hold the unemployment rate steady. We expect the unemployment rate to edge back down to 4.2% by year end. However, much remains in flux, notably regarding the initial displacement due to AI.

Chart 1

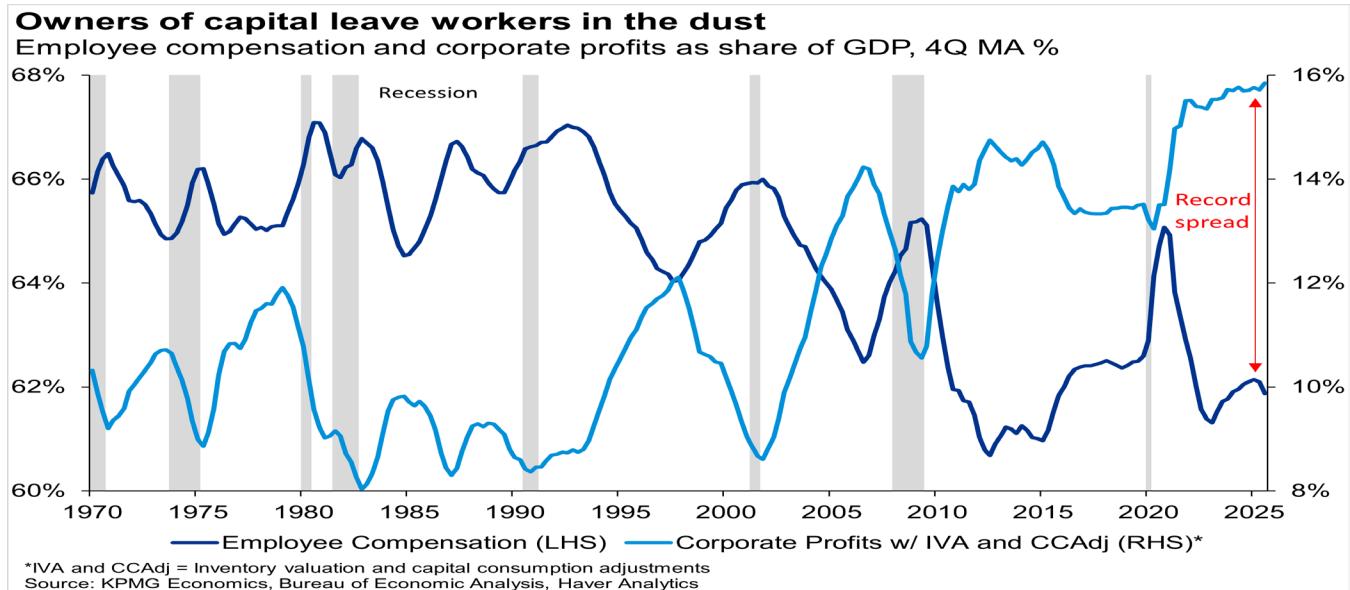
AI boom and stimulus fuel GDP growth

Contributions to Real GDP, SAAR, %



Source: KPMG Economics, Bureau of Economic Analysis

Chart 2



Tax refunds, World Cup buoy spending

Chart 2 highlights the causes of the anxiety that many consumers are feeling. The share of the economy going to profits rather than wages has reached a post-WWII high. The result is a widening split in spending patterns, with affluent consumers driving most of the gains.

A friend refers to the gap in fortunes between the owners of capital and workers as the “revolution chart.” It is a measure of inequality, which creates social and economic instability. The French revolution is an extreme example.

The gap in trust between high- and low-income households hit a new record in late 2025; the data go back to 2000. The US led that shift, followed by Indonesia, Nigeria, France and Saudi Arabia. That makes for odd bedfellows.

Tax refunds early in the year will temporarily narrow that gap. Vehicles, appliances, consumer electronics, vacations and jewelry tend to get the largest boost from refunds—timely with Valentine’s Day approaching.

Some of those refunds will be used to pay down debt. Credit delinquencies hit the highest level since 2017 in late 2025. That is not yet alarming but worrisome. Subprime borrowers and Gen X with student loans are struggling the most.

Luxury hotel stays and first class travel have increased, while bookings for economy rooms and seats have weakened. International travel to the U.S. cratered last year. The World Cup will provide a brief reprieve but not enough to erase the travel trade deficit.

Used vehicle sales are expected to benefit more from tax refunds than new. Few consumers can afford new models. Tariffs dealt a blow to domestic vehicle margins in 2025. Depreciation in the yen and won are expected to offset tariffs on Japanese and South Korean imports.

Areas hit hardest by immigration raids are struggling. Studies on deportations in the 2010s show that foreign and native born workers tend to be compliments rather than substitutes. Entire ecosystems were hit by the loss in immigrant workers.

Housing remains in the doldrums

Home buying and construction are expected to post modest gains in 2026. Many in the industry worry that focusing on mortgage rates and tapping 401(k)s for down payments will do more to reignite home values than improve affordability.

There are now more mortgage holders with rates at 6% or higher than those with rates at 3% or lower. This shift supports refinancing but not many home sales – unless mortgage rates drop dramatically.

Insurance, real estate taxes and construction costs have all soared in recent years. Listings increased last year, and homeowners are being forced to offer more discounts than earlier in the recovery. However, listings remain well below pre-pandemic norms.

The share of 24–34 year olds living with their parents rose again last year and remains only slightly below the 17.8% peak reached during the pandemic. That translates into nearly eight million people, a portion of whom would like to live independently.

Construction costs continued to climb, driven higher by tariffs and curbs on immigration. The largest potential offset is deregulation at the state and local level, which could streamline permits and add to the supply of homes down the road.

The AI boom boosts business investment

AI models require massive amounts of data to run, especially the most powerful reasoning models. That has spurred the demand for data centers, which are entering the year with even larger backlogs than in 2025.

The order of magnitude is now in excess of \$1.5 trillion, almost three times the pace of last year. Aerospace has finally stabilized, with production increasing and backlogs building. Recent orders will not be finished aircraft until the 2030s.

Overall manufacturing and the freight sector remain in recession. Consolidation has pushed smaller players out of the market. There is little to support a meaningful rebound in freight volumes or truck sales. An end to the de minimis exemption for small packages added insult to injury.

Reluctant restocking

Inventory-to-sales ratios remain elevated for manufacturers and wholesalers, with much of the merchandise purchased ahead of tariffs still sitting in warehouses. Firms are reluctant to add to those inventories.

Retail is the outlier. Inventory-to-sales ratios are lower, as retailers are unwilling to absorb the cost of tariffs and storage to stockpile goods. Lean inventories give retailers more latitude to push through price increases.

A catchup to the government shutdown

Federal government spending is expected to pick up at the start of the year. That reflects a catchup in spending for the largest and longest shutdown on record. Idled agencies cost more to ramp up than keep open.

State and local governments are expected to spend at a slower pace in 2026. Limited payroll employment has constrained income tax revenues. Real estate taxes lag changes in home values, which have cooled.

Trade stabilizes

The trade deficit is expected to widen slightly after narrowing in 2025. The AI boom is heavily dependent on imported inputs, with no substitutes in domestic production. The tech sector has secured tariff waivers for those inputs; that is where we have seen some of the strongest imports.

Exports are expected to slow, despite a weaker dollar. The dollar tends to have a larger impact on export than import prices, as many imports are priced in dollars. Demand is weak, while consumers abroad have begun soft boycotts of US exports due to an erosion in trust.

Risks to the 2026 outlook: Congress is flirting with the idea of \$2,000 stimulus checks in October, ahead of midterm elections. That could boost consumer spending in the back half of the year but adds upside risks to inflation. We have seen this movie before.

Separately, the United States-Mexico-Canada Agreement (USMCA) is up for renegotiation. The baseline assumes we continue to muddle through. A breakdown in talks with a shift to bilateral agreements or no agreement cannot be ruled out. Disruptions at either border would be costly for all.

A slow deceleration in inflation

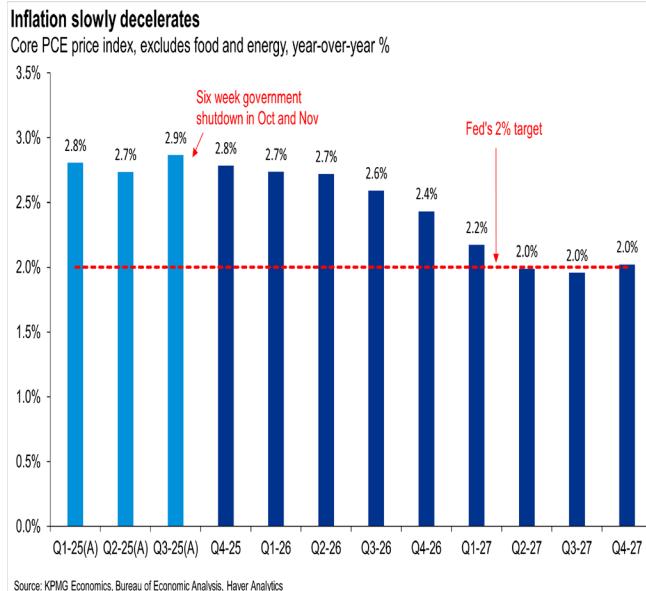
Chart 3 shows the forecast for core personal consumption expenditure (PCE) index, which excludes food and energy. The effect of tariffs is expected to peak in the first quarter and slowly fade.

The challenge is what the administration plans next on tariffs. Multiple threats have been made since the start of the year, which drove measures of policy uncertainty higher. (See Chart 4.)

Thus far, those threats have not resulted in additional tariff actions. Many are hoping that the Supreme Court will rule many of the tariffs that the administration levied illegal. The administration still has many levers it can pull to reinstate those tariffs, overnight.

Those levers may face additional legal challenges, but as we have already seen, the wheels of justice turn slowly. In the interim, tariffs will remain elevated with a lot of uncertainty surrounding their direction.

Chart 3



The government shutdown in October and November halted data collection across statistical agencies. The consumer price index for October was lost, while most of November's survey was compressed into the final two weeks of the month. Those shifts artificially held inflation measures down in the fourth quarter, and are expected to have a lingering effect.

The larger issues for inflation are whether inflation expectations are anchored or becoming unmoored. We tend to get the inflation we expect; consumers now anticipate more inflation than they did a year ago.

Other issues represent cross currents for inflation. Rising electricity costs, driven by surging demand from data centers, could spill into other services. Meanwhile, shelter costs are cooling. Those shifts have long lags and should alleviate the upward pressure on inflation.

Productivity growth has accelerated as firms do more with less, which showed up as layoffs in 2025. That has not alleviated the margin compression due to tariffs, which has hit a tipping point for some firms.

The largest source of price declines and deflation is China and the excess manufacturing capacity it has. Tariffs did not fully offset those effects in the US - inflation in the US would have been much higher if not for the ripple effects that excess capacity has had on global inflation.

Risks: Additional fiscal stimulus could give prices an extra lift later in the year, further normalizing higher inflation. Risks beyond that depend heavily on how the Fed manages inflation. Any signs that it is willing to stimulate for political instead of economic reasons would add to our inflation woes.

Fed further splinters

The Fed is content to stay on the sidelines for now. It wants clearer evidence that inflation is cooling before cutting rates again. That is unlikely before the second half of the year. We still expect three cuts in 2026.

Kevin Warsh, the president's nominee to replace Powell, was a known hawk. He changed his tone more recently, arguing for aggressive rate cuts. He is pinning his hopes on productivity lowering inflation.

The problem with that rationale is that higher productivity tends to raise instead of lower the neutral policy rate. [Research](#) on 150 countries over decades shows that to be the case. It is why former Chairman Alan Greenspan raised instead of cut rates as the productivity boom of the 1990s took hold.

Warsh insists he will act independently, but markets may be more jittery during the transition; it has been decades since we have seen a Fed Chair who did not represent a continuity in policy.

Initial rate cuts will need to fit into a broader narrative supported by data to be credible. Warsh's controversial views on productivity mean he may have to work harder to convince markets of his independence.

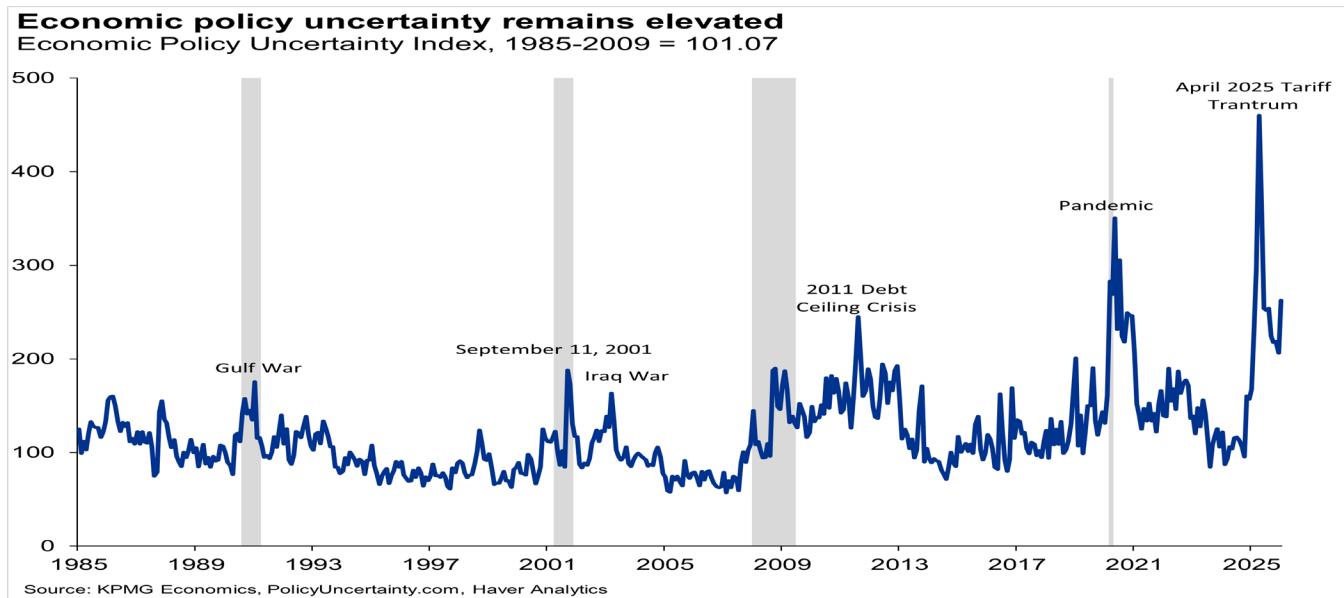
Warsh would like to shift away from data-dependence toward more forward-looking models. That is difficult, given the shifts we have seen post pandemic and the breakdown in historic relationships underway.

Monetary policy is ultimately set by committee. Deep divisions have emerged as the Fed's dual mandate – price stability and full employment – has come under strain. Those gaps will be hard to close.

Separately, Warsh would like to reduce the size of the Fed's bloated balance sheet. The problem is that quantitative easing is easier to accomplish than quantitative tightening. Rapid reductions, including asset sales, could cause rates to spike.

The Fed had to abandon a portion of its balance sheet runoff in late 2025. It restarted asset purchases to lower short-term rates, after they failed to fall without intervention.

Chart 4



Risks: Financial markets could test the Fed's commitment to independence with the change in leadership. That could limit the transmission of lower rates into the rest of the economy. We are already seeing some of that today, with long-term bond yields above where they were prior to the last round of cuts.

Tensions in Treasuries

The International Monetary Fund [estimates](#) that global debt soared to 235% of GDP in 2025 and is expected to move higher in the year ahead. That includes both private and public sector debt, although public sector debt is making up a rising share.

Federal debt outstanding in the US is poised to eclipse the overall economy in 2026 for the first time since WWII. Expect a surge in debt issuance.

That is a lot of debt for credit markets to absorb. Credit spreads between investment grade and other debt are near record lows. That leaves little room to go but up. Higher inflation is another concern which feeds into the gap between short- and long-term yields.

Finally, composition of Treasury bond buyers is shifting. Highly leveraged and more price sensitive hedge funds are replacing institutional investors—central banks, pensions and sovereign wealth funds—on the margin of those purchases.

On net, we expect the yield on the 10-year Treasury bond to edge lower in 2026, but only modestly. The yield is forecast to fall from about 4.25% to about 4% by year-end, as a floor forms underneath how low yields can go.

Risks: Additional fiscal stimulus late in the year would add to the sheer volume of Treasuries that must be absorbed. That could stem the drop on long-term yields.

Fragilities in financial markets

Financial markets run on trust, which has eroded both on a global scale and in the US specifically. Hence, the stunning surge in gold prices over the last year.

Everything from concerns about the losses in private debt markets to rapid shifts in AI are causing investors to rethink stock valuations. Even the funding for data center construction is getting greater scrutiny. The ice beneath our feet is thinning.

Stock valuations in the Wilshire 5000, which covers a lot more firms than the S&P500 or the Dow Jones stock indices, are close to the peak hit during the tech bubble. The fear of missing out and herd behavior are driving those gains, which are red flags.

Risks: A major market correction cannot be ruled out. That could derail the AI boom and the wealth effects that have carried consumer spending. The spillover affects would be global in scope.

Bottom Line

The calm on the surface of the economy masks deeper fractures. Like the frozen lake of my childhood, the footing looks solid, but currents beneath are eroding the foundation. Trust across workers, firms, governments and allies has been deteriorating for decades and slipped further last year.

The result is an economy that appears resilient but feels increasingly fragile. Growth has held up, yet the connective tissue that supports labor markets, investment, and global cooperation is fraying. Workers are more anxious, investors more herdlike, and markets are more vulnerable to shocks than headlines suggests.

We enter 2026 with a tailwind of AI investment, fiscal and monetary stimulus. The challenge is to ensure that those gains narrow, not widen, the divides across our economy and society. We retreated into echo chambers, which sow the seeds of deeper divisions.

That leaves me with a final observation. I met with people whose views often differed sharply from my own. Yet we broke bread, listened and—more often than not—moved closer rather than further apart. Trust may be in deficit, but it can be rebuilt, one careful step at a time. Tread cautiously. Be kind; pay it forward.

| Economic Forecast — February 2026 | | | | | | | | | | | | |
|-----------------------------------|-------|-------|-------|-----------|--------|--------|--------|--------|--------|--------|--------|--------|
| | 2025 | 2026 | 2027 | 2025:3(A) | 2025:4 | 2026:1 | 2026:2 | 2026:3 | 2026:4 | 2027:1 | 2027:2 | 2027:3 |
| National Outlook | | | | | | | | | | | | |
| Chain Weight GDP1 | 2.3 | 3.2 | 2.1 | 4.3 | 3.6 | 3.1 | 2.8 | 2.2 | 2.2 | 2.1 | 1.9 | 1.8 |
| Personal Consumption | 2.7 | 2.8 | 1.8 | 3.5 | 2.6 | 3.2 | 2.9 | 1.9 | 1.7 | 1.6 | 1.6 | 1.8 |
| Business Fixed Investment | 4.1 | 4.4 | 4.3 | 2.8 | 3.5 | 3.8 | 5.3 | 5.2 | 5.3 | 3.8 | 3.7 | 3.5 |
| Residential Investment | -2.1 | -1.1 | 2.3 | -5.1 | -4.1 | 0.6 | 1.5 | 1.1 | 1.9 | 2.9 | 2.8 | 2.1 |
| Inventory Investment (bil \$ '17) | 40 | 42 | 84 | -30 | 35 | 38 | 40 | 42 | 48 | 67 | 83 | 90 |
| Net Exports (bil \$ '17) | -1086 | -975 | -988 | -957 | -947 | -964 | -980 | -979 | -975 | -976 | -983 | -991 |
| Exports | 1.8 | 3.9 | 4.3 | 8.8 | 1.5 | 3.6 | 4.6 | 4.9 | 4.7 | 4.1 | 4.0 | 4.0 |
| Imports | 2.7 | -0.2 | 3.5 | -4.7 | 0.0 | 4.7 | 5.1 | 3.5 | 3.0 | 3.2 | 3.7 | 3.8 |
| Government Expenditures | 1.6 | 1.7 | 0.3 | 2.2 | 1.2 | 3.3 | 1.2 | 0.8 | 0.4 | 0.3 | 0.1 | -0.1 |
| Federal | 0.1 | 2.9 | 0.4 | 2.9 | 1.5 | 7.9 | 2.3 | 1.7 | 0.5 | 0.4 | 0.0 | -0.5 |
| State and Local | 2.5 | 0.9 | 0.3 | 1.8 | 1.0 | 0.6 | 0.5 | 0.3 | 0.3 | 0.2 | 0.2 | 0.2 |
| Final Sales | 2.4 | 3.2 | 1.9 | 4.6 | 2.5 | 3.0 | 2.7 | 2.2 | 2.1 | 1.8 | 1.7 | 1.7 |
| Inflation | | | | | | | | | | | | |
| GDP Deflator | 2.8 | 2.6 | 2.1 | 3.8 | 3.5 | 2.1 | 2.0 | 2.3 | 2.0 | 2.1 | 2.0 | 2.2 |
| CPI | 2.7 | 2.5 | 2.4 | 3.1 | 2.5 | 2.4 | 2.2 | 3.0 | 2.1 | 2.3 | 2.4 | 2.7 |
| Core CPI | 2.9 | 2.6 | 2.3 | 3.3 | 2.1 | 2.6 | 2.8 | 2.6 | 2.0 | 2.3 | 2.0 | 2.5 |
| Special Indicators | | | | | | | | | | | | |
| Corporate Profits2 | 7.1 | 76 | -0.9 | 9.1 | 9.4 | 11.1 | 11.5 | 7.4 | 1.2 | 0.6 | -0.6 | -1.6 |
| Disposable Personal Income | 1.7 | 4.2 | 3.4 | 0.0 | 2.2 | 8.4 | 4.7 | 3.8 | 3.9 | 3.1 | 3.3 | 2.7 |
| Housing Starts (mil) | 1.34 | 1.29 | 1.30 | 1.31 | 1.31 | 1.30 | 1.29 | 1.29 | 1.29 | 1.30 | 1.30 | 1.30 |
| Civilian Unemployment Rate | 4.3 | 4.3 | 4.1 | 4.3 | 4.5 | 4.3 | 4.3 | 4.3 | 4.2 | 4.1 | 4.1 | 4.0 |
| Total Nonfarm Payrolls (thous)3 | 750 | 509 | 554 | 34 | -69 | 210 | 145 | 175 | 169 | 140 | 163 | 55 |
| Vehicle Sales | | | | | | | | | | | | |
| Automobile Sales (mil) | 2.7 | 2.8 | 3.1 | 2.6 | 2.5 | 2.6 | 2.8 | 2.9 | 3.0 | 3.0 | 3.1 | 3.1 |
| Domestic | 1.8 | 1.8 | 1.9 | 1.8 | 1.7 | 1.6 | 1.8 | 1.8 | 1.9 | 1.9 | 1.9 | 1.9 |
| Imports | 0.9 | 1.1 | 1.2 | 0.9 | 0.8 | 1.0 | 1.0 | 1.1 | 1.1 | 1.1 | 1.2 | 1.2 |
| LtTrucks (mil) | 13.5 | 12.8 | 12.9 | 13.9 | 13.2 | 12.7 | 12.7 | 12.8 | 12.8 | 12.9 | 12.9 | 12.9 |
| Domestic | 10.8 | 10.2 | 10.3 | 11.2 | 10.7 | 10.2 | 10.2 | 10.2 | 10.2 | 10.3 | 10.3 | 10.3 |
| Imports | 2.7 | 2.6 | 2.6 | 2.7 | 2.5 | 2.5 | 2.5 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 |
| Combined Auto/LtTruck | 16.2 | 15.6 | 16.0 | 16.6 | 15.7 | 15.3 | 15.5 | 15.7 | 15.8 | 15.9 | 16.0 | 16.0 |
| Heavy Truck Sales | 0.4 | 0.5 | 0.5 | 0.4 | 0.4 | 0.5 | 0.4 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 |
| Total Vehicles (mil) | 16.6 | 16.1 | 16.5 | 17.0 | 16.1 | 15.8 | 15.9 | 16.2 | 16.3 | 16.4 | 16.5 | 16.5 |
| Interest Rate/Yields | | | | | | | | | | | | |
| Federal Funds | 4.2 | 3.4 | 2.9 | 4.3 | 3.9 | 3.6 | 3.6 | 3.3 | 3.0 | 2.9 | 2.9 | 2.9 |
| 10 Year Treasury Note | 4.4 | 4.2 | 4.0 | 4.3 | 4.2 | 4.3 | 4.3 | 4.2 | 4.2 | 4.1 | 4.1 | 4.0 |
| Corporate Bond BAA | 6.1 | 6.2 | 6.3 | 6.0 | 6.0 | 6.1 | 6.2 | 6.3 | 6.3 | 6.3 | 6.3 | 6.2 |
| Exchange Rates | | | | | | | | | | | | |
| Dollar/Euro | 1.13 | 1.20 | 1.21 | 1.17 | 1.16 | 1.19 | 1.20 | 1.20 | 1.21 | 1.21 | 1.21 | 1.21 |
| Yen/Dollar | 149.6 | 151.0 | 144.0 | 147.5 | 154.1 | 154.0 | 152.0 | 150.0 | 148.0 | 146.0 | 144.0 | 142.0 |

¹ In 2025, GDP was \$23.9 trillion in chain-weighted 2017 dollars.

² Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

³ Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation. Total may not add up due to rounding.

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