United States Economic Outlook

2026–2028

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The U.S. Economic Outlook for 2026–2028

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Executive Summary

Headline Growth Undersells the Economy

The U.S. economy expanded at a modest 1.5 percent annualized rate in 2026Q2, but the headline reading masked much stronger private domestic demand. With the reacceleration in consumption spending and solid pace in business fixed investment, real final sales to private domestic purchasers added 3.3 percentage points to growth—the largest contribution since 2023Q1. Inventory drawdowns and net exports offset much of that strength. Over the past few years, AI-related investment has largely been offset by net imports, although AI-related stock market gains have been supporting economic activity.

Inflation Readings Send Mixed Signals

The inflation picture has become unusually difficult to interpret. Core PCE inflation remained elevated at 3.3 percent year over year in June, while core CPI inflation declined to 2.5 percent in July. Core goods inflation, which typically lags core, has instead boosted core inflation since early 2025, because of tariff pass-through and AI-related price increases for computer equipment. Shelter inflation is returning to a more normal pace, and recent computer memory and storage prices suggest that some AI-related price pressure may soon dissipate. The oil shock has so far passed mainly into transportation services, but broader energy-price pass-through remains a material risk.

A Stable-Ish Labor Market

The labor market has stabilized relative to the second half of 2025, but it shows little evidence of renewed tightening. The unemployment rate declined to 4.1 percent in July, largely because labor force participation fell rather than because employment strengthened. Payroll gains have been volatile and weak recently, with government employment accounting for much of the softness. Private employment has held up better. Initial unemployment insurance claims remain low, but long-term unemployment remains elevated. The labor market therefore appears broadly balanced, with enough slack to absorb stronger activity but without clear signs of renewed deterioration.

Consumers Sour, Businesses Upbeat

Consumer sentiment remains downbeat, while business surveys point to continued, if modest, expansion. The University of Michigan's Index of Consumer Sentiment has remained depressed since reaching a record low in May. This gloominess is widespread across demographic groups and political affiliations. By contrast, the Purchasing Managers' Index for the manufacturing sector has continued to signal expansion since the beginning of this year after indicating contraction in all but two months from November 2022 through December 2025. Meanwhile, services activity expanded for a 25th consecutive month. Taken together, business surveys suggest cautious optimism despite persistent cost pressures and policy uncertainty.

Housing Stalls, Autos Cruise

The housing market remains soft under the weight of elevated mortgage rates and strained affordability. The 30-year mortgage rate rose to just under 6.7 percent in early August, while sales of both new and existing homes remained anemic. New-home inventories stayed high relative to sales, and builder sentiment languished. Single-family starts fell sharply to an annual rate of 808,000 in July, although permits were more resilient.

Light vehicle sales have weathered measurably higher gasoline prices fairly well so far, averaging roughly 16.4 million units at an annual rate from March through July, generally above their range in 2024 and 2025. Improved affordability likely provided some support, as wage growth outpaced new vehicle price inflation and auto loan interest rates remained relatively stable. Domestic

assemblies also increased.

A Rate Hold with Hawkish Dissents

The Federal Open Market Committee has kept the federal funds rate in the 3.5 percent to 3.75 percent range throughout this year, with three dissents favoring a hike in July. Elevated core inflation and the possibility of further energy-price pass-through leave little reason to cut rates. The labor market appears more stable compared with a year ago, although softer recent data may have increased the risk of further slowing. Our baseline forecast holds the policy rate unchanged through 2028.

Tariffs Stabilize, Fiscal Pressure Builds

The tariff environment is calmer than in 2025, although trade policy remains unsettled. We expect the average effective tariff rate to stabilize around 8 percent. The USMCA remains in force, but annual reviews will prolong uncertainty, particularly for trade with Canada. Fiscal policy provides little prospect of restraint. Continued growth in defense spending, higher interest costs, and modest nondefense spending growth push the federal deficit from 5.6 percent of GDP in fiscal year 2026 back to 6.0 percent by fiscal year 2028.

The 2026–2028 Outlook

We project real GDP growth to rebound to a 2.5 percent annualized pace in 2026Q3 as inventories rebuild, while the momentum in consumption and private fixed investment moderates slightly. Quarterly growth then remains between 1.9 percent and 2.2 percent through 2028, supported by respectable productivity gains and consumer spending, as well as continued investment in AI-related equipment, software, and research and development. On a calendar year basis, real GDP grows by 2.1 percent in 2026, followed by 2.2 percent in 2027 and 2.0 percent in 2028.

The labor market remains broadly balanced over the forecast. We expect the July drop in local government employment to drag on job gains in 2026Q3. Job growth then recovers and settles into a monthly pace of 74,000 to 81,000, consistent with slow population growth and lower net immigration. Continued declines in labor force participation limit upward pressure on unemployment despite modest household employment growth. The unemployment rate hovers near 4.2 percent through mid-2027 before edging down to 4.1 percent by the end of 2027.

We expect year-over-year headline CPI inflation to ease gradually from 3.8 percent in 2026Q2 to 3.2 percent in 2027Q1, consistent with our oil price path assumption. As tariff pass-through wanes and AI-related price pressures dissipate, quarter-on-quarter core PCE inflation is projected to slow to 2.7 percent in 2026Q3. PCE inflation continues to decline, eventually reaching 2.0 percent year over year in 2027Q3.

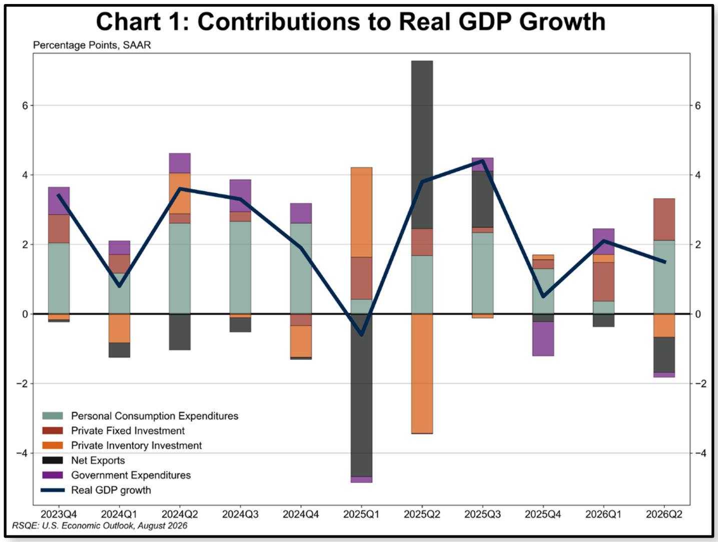
The housing market remains subdued over the forecast, although gradually declining mortgage rates eventually provide some support. We expect single-family starts to average about 900,000 units in 2026Q3 and rise gradually to 940,000 in 2028. Multi-family starts edge down from 444,700 units in 2026Q2 to roughly 420,000 by late 2027 and 2028 as improved new home buying conditions slows rental demand growth.

We expect annual light vehicle sales to remain near 16.3 million units through 2028. Muted job and wage growth limit further gains, while the prospect of annual reviews of the USMCA adds policy uncertainty. The rising durability of vehicles constrains vehicle sales.

	Actual	**RSQE Forecast**		
	2025	2026	2027	2028
GDP (billions of current $)	30762.1	32597.4	34073.7	35523.3
Real GDP (billions of 2017 $)	23850.4	24355.7	24882.1	25376.4
% change: year-over-year	2.1	2.1	2.2	2.0
% change: 4th-qtr-to-4th-qtr	2.0	2.1	2.1	1.9
Nonfarm payroll employment (millions)	158.4	158.9	159.7	160.7
Civilian unemployment rate (%)	4.3	4.2	4.2	4.1
Capacity utilization, total industry (%)	75.9	76.0	76.1	76.2
Inflation (private nonfarm GDP deflator, % change)	2.8	3.8	2.3	2.2
Inflation (CPI-U, % change)	2.7	3.4	2.4	2.3
Inflation (core CPI, % change)	2.9	2.7	2.9	2.7
Light vehicle sales (millions)	16.2	16.1	16.3	16.3
Private housing starts (thousands)	1355.8	1359.4	1337.1	1355.0
3-month Treasury bill rate (%)	4.1	3.7	3.7	3.7
10-year Treasury note rate (%)	4.3	4.4	4.3	4.2
Conventional mortgage rate (%)	6.6	6.4	6.2	6.1
Real disposable income (billions of chained 2017 $)	18017.3	18067.8	18410.4	18769.7
% change	1.7	0.3	1.9	2.0
Corporate profits after tax (billions of current $)	3518.8	4022.0	4153.7	4342.7
Value of U.S. $ (FRB broad index), % appreciation	-0.1	-2.5	0.5	0.0
Current account balance (NIPA basis, billions of current $)	-1134.7	-1239.9	-1477.2	-1596.5
Federal surplus (FY, NIPA basis, billions of current $)	-1883.6	-1812.6	-1996.7	-2106.2

The Current State of the Economy

Headline real GDP expanded at a tepid annualized rate of 1.5 percent in the second quarter of 2026. However, this single figure masks a much more upbeat underlying composition. Real final sales to



private domestic purchasers—the sum of private consumption, business fixed investment, and residential investment—contributed 3.3 percentage points, its strongest print since 2023Q1. The surge in private domestic final demand was driven primarily by two elements. First, personal consumption spending ramped up significantly (perhaps aided by larger refund checks due to the recent tax cuts) following a lull in the first quarter of the year, contributing more than 2.0 percentage points to overall growth. Second, business fixed investment growth remained solid, adding another 1.2 percentage points, while residential construction investment added slightly to the total. This robust domestic demand, however, came at the expense of a drawdown in inventories, which subtracted 0.7 percentage points from GDP growth. Net exports acted as an additional drag, subtracting approximately 1.0 percentage points. Breaking the pattern of the prior several quarters, net imports of AI-related capital goods (including computers, computer parts, telecommunications equipment, and semiconductor chips) did not surge higher. Hence, the drag came from acceleration in the growth of net imports of other goods and services, possibly responding to a more stable tariff outlook.

Progress toward normalizing inflation has been rather disappointing, and the Federal Reserve's preferred inflation measure moved in the wrong direction through May. Looking beyond the oil-driven increase in headline inflation, the light green line in Chart 2 shows that year-over-year core PCE inflation rose from a recent low of 2.6 percent in April 2025 to 3.3 percent in June 2026, on par with the level in late 2023. That renewed acceleration helps explain why three members of the Federal Open Market

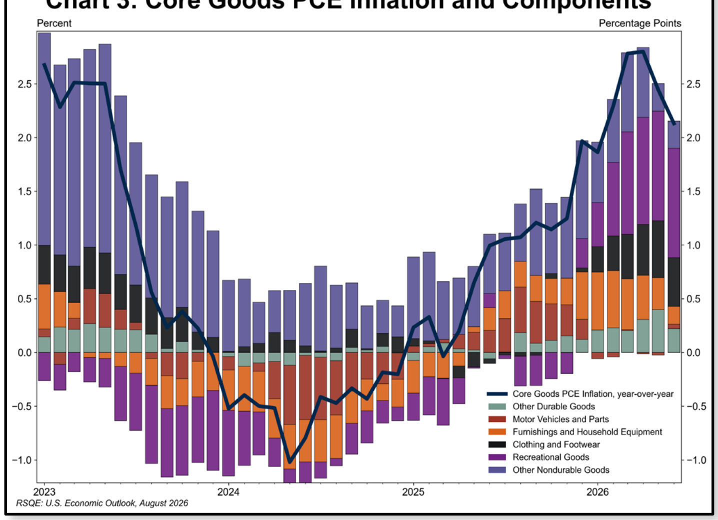
Committee (FOMC) voted to raise the federal funds rate at the Committee's July meeting. Core CPI inflation, shown in blue, has offered some relief, though. With the shutdown-related disruption to the CPI largely in the rearview mirror, core CPI inflation has continued to decelerate, reaching 2.5 percent year over year in July.

Chart 2: Core CPI and PCE Price Index Inflation

Year-over-year core CPI inflation has run below core PCE inflation since November 2025, an unusually long departure from the measures' historical relationship. This gap largely reflects differences in category weights and, within some categories, the scope of coverage, with formula effects also playing a role. For example, shelter accounts for a larger share of the CPI than of the PCE price index. Following the pandemic, persistent acceleration in shelter inflation propped up core CPI inflation more than core PCE inflation, generally keeping the former above the latter. That said, the reversal of the core PCE–CPI inflation gap in year-over-year inflation through March of this year likely reflected, in part, the undercounting of shelter inflation in the October CPI.

To a large degree, the recent movement in this gap reflects upward pressure from core goods inflation, which is likely driven by lingering tariff pass-through and the price impact of AI-related chip supply shortages. As Chart 3 shows, core goods inflation has boosted core PCE inflation since April 2025, reaching its highest year-over-year rate since the early 1990s. It is a marked departure from its typical deflationary contribution from the mid-1990s through 2020. As shown in Chart 3, the primary source of goods price inflation has shifted from furnishings and household equipment toward recreational goods in 2026. Within that category, PCE

Chart 3: Core Goods PCE Inflation and Components

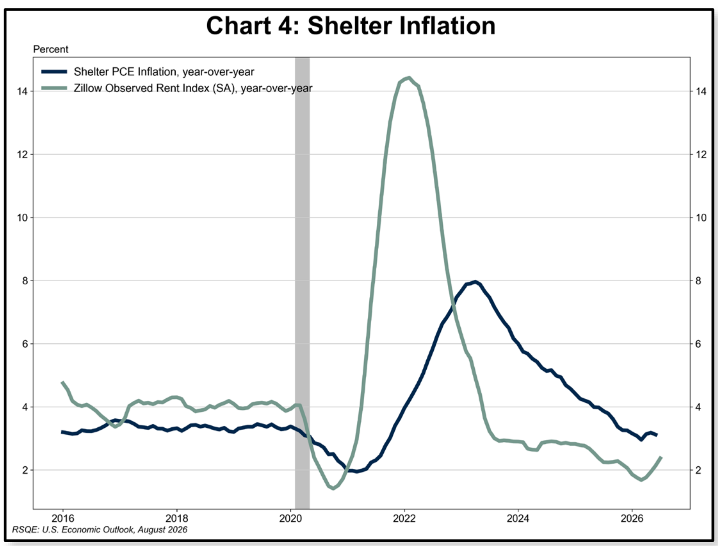


inflation for information processing equipment, the prices of which are likely affected by the surge in AI-related demand, rose to 11.4 percent year over year in June, the fastest pace in the last 60 years.

Information processing equipment accounts for more than 7.0 percent of the PCE core goods index, compared with less than 4.0 percent in the corresponding CPI core goods component. Coupled with a wide divergence in PCE and CPI inflation rates (over 10 percent versus deflation), this subcategory lifted PCE core goods inflation relative to CPI inflation. In addition, clothing and footwear prices have also continued to push inflation higher, suggesting that some tariff pass-through is still ongoing.

Taken together, these developments may have led some Federal Reserve officials to view the resulting price pressures as more persistent than temporary, which could suggest that the current monetary policy stance is not restrictive enough. Still, available real-time data on computer memory and storage prices suggest that the AI-related upward pressure on PCE inflation is likely to dissipate soon.

Chart 4 shows that shelter inflation could still be trending down. Year-over-year shelter PCE inflation averaged 3.2 percent during the first half of the year. That rate is broadly in line with its pre-pandemic pace, while CPI shelter inflation continued to cool in July. Growth in the Zillow Observed Rent Index, plotted in light green, has stabilized at a slower pace than before the pandemic. This trend suggests that shelter inflation, which typically lags rent growth, may have room to ease further.



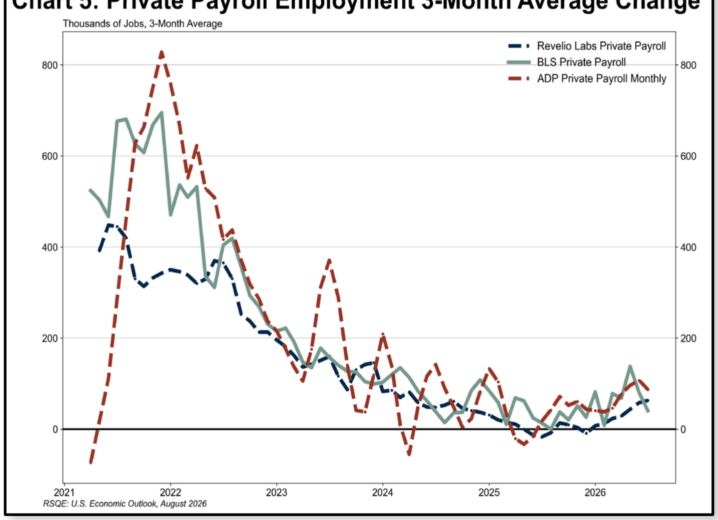
Energy prices remain a key source of uncertainty for our inflation outlook. So far, the pass-through of the oil price shock has been largely confined to transportation services, but broader inflation effects are likely to depend on how long the closure of the Strait of Hormuz persists and when a durable ceasefire is expected. One encouraging sign is that supply chain disruptions appear to remain relatively contained:

the Federal Reserve Bank of New York's Global Supply Chain Pressure Index has trended down from its April–May high, which was still less than half of its late-2021 peak.[1]

Although recent progress in reining in inflation appears somewhat limited, we remain cautiously optimistic that the current stance of monetary policy is sufficiently restrictive to return inflation to the Fed's 2 percent goal. The slowdown in price increases for tariff-sensitive goods, such as furniture, clothing, and footwear, is consistent with our view that the 2025–26 tariffs have caused a one-time upward shift in the price level. AI-related price pressures on technology accessories are also likely to ease because storage and chip prices have begun to stabilize, while the upcoming revision of how the BEA measures the PCE price index for computer software and accessories may revise past inflation lower. However, shifts in geopolitical tensions could complicate our interpretation of these trends.

The U.S. labor market has stabilized so far in 2026 compared to the second half of 2025. There are no persistent signs of labor market tightening, however. Recent establishment survey data have exhibited substantial volatility. Monthly payroll job gains posted large initial gains, exceeding 115,000, from March through May. As of the latest data, the May reading has been revised down to only 63,000 jobs, and in June–July the payroll job count held essentially flat. Downward revisions in government employment have been large, concentrated in local public sector education employment. Private sector job gains held up better, with 3-month averages of private job gains from the BLS, ADP, and Revelio Labs, shown on Chart 5, suggesting continued modest employment growth in the private sector.

Chart 5: Private Payroll Employment 3-Month Average Change

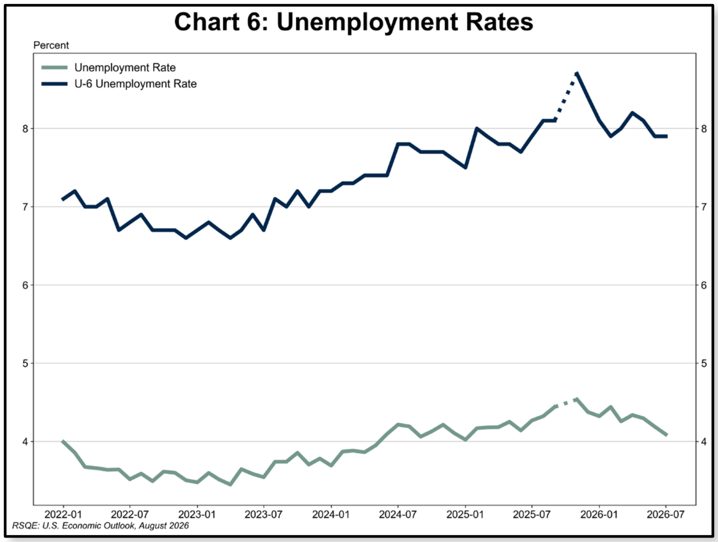


The headline unemployment rate and the broader U-6 unemployment rate have generally been sliding in recent months.[2] However, a deeper inspection of the data reveals that the bulk of the

[1] https://www.newyorkfed.org/research/policy/gscpi#/interactive

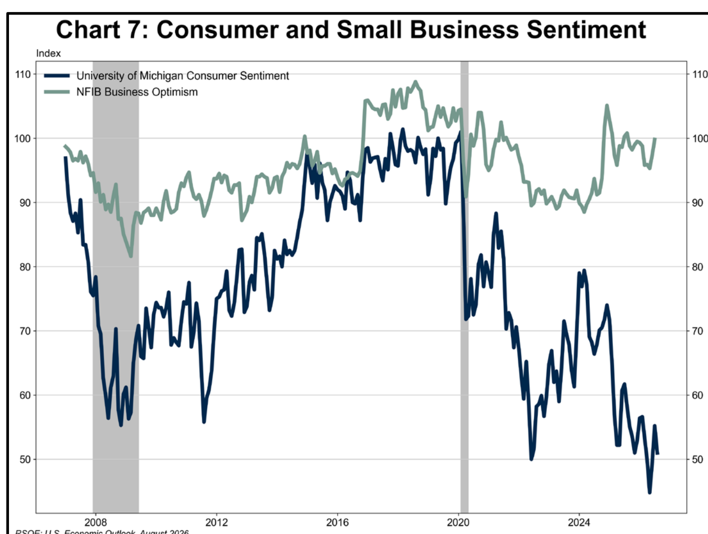
[2] The U-6 unemployment rate is a broad measure of labor market underutilization that includes those employed part-time who are unable to find full-time employment due to economic conditions, in addition to the traditionally unemployed and marginally attached workers.

improvement in the unemployment rate was driven by declining labor force participation rather than robust hiring. Since January 2026, the employment-to-population ratio has fallen by 0.5 percentage points, while the labor force participation rate has come down by 0.7 percentage points. Some drag from ongoing retirements was anticipated, but we have also seen meaningful declines in labor force participation among prime-age (25–54) and younger (16–24) workers. These declines would be a significant cause for concern if they persisted.



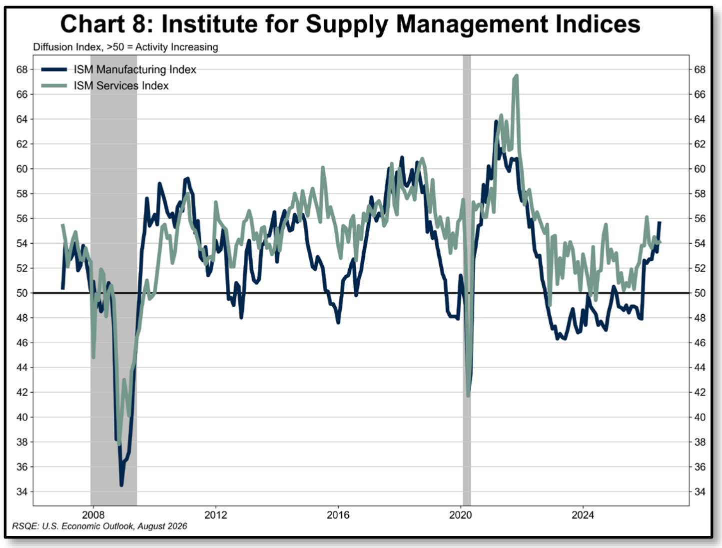
Initial unemployment insurance claims remain very low, however. The claim exhaustion rate, the smoothed ratio of individuals collecting their final unemployment payments to the number of new initial claims six months ago, peaked in November 2025, and has been declining slowly in recent months. However, the share of the unemployed who have been without a job for longer than 27 weeks has improved only modestly and remains substantially elevated, showing that the labor market remains tough for many. Overall, the labor market appears to be in a stable place, but with meaningful slack to be absorbed should broader economic activity pick up.

Consumer sentiment remains downbeat, whereas business surveys generally signal modest optimism. The University of Michigan's Index of Consumer Sentiment has stayed depressed since reaching a record low of 44.8 in May, the same month in which the CPI gasoline price index peaked following the war with Iran. The weakness in consumer sentiment extends beyond demographic groups to all political affiliations. In the preliminary August release, the reading for Republicans fell by 10 index points, its largest drop since November 2025, whereas the



readings for independents and Democrats remained subdued. Similarly, the Conference Board's latest release showed soft consumer confidence. By contrast, the National Federation of Independent Business' measure of optimism has risen from its local trough in May. On balance, most regional Federal Reserve Bank surveys pointed to expanding business activity in June and July despite persistent input price pressures.

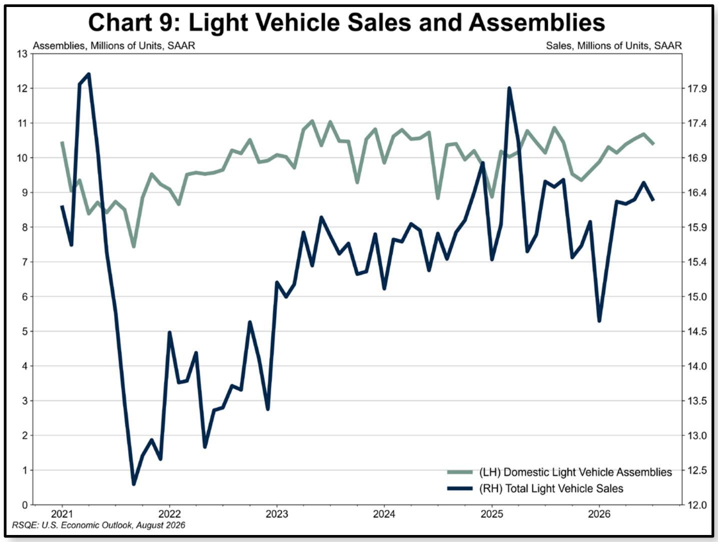
The latest readings from the Institute for Supply Management's Purchasing Managers' Index (PMI) underscore sustained healthy growth in both the manufacturing and services sectors despite geopolitical tensions and supply chain disruptions. The Manufacturing PMI has remained in expansion territory since the beginning of this year. Its employment subindex rose above 50 in July for the first time in 33 months, and its production and new orders subindexes remain in growth territory. The Services PMI indicated expansion for the 25th consecutive month, highlighting the underlying resilience of the U.S. economy despite elevated inflation, high borrowing costs, policy uncertainty, and U.S. involvement in new foreign conflicts.



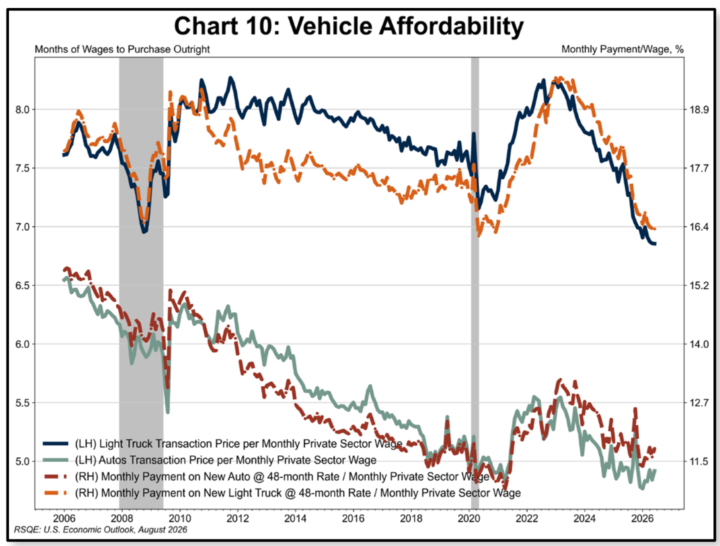
The annualized pace of light vehicle sales has improved measurably so far in 2026. Since mid-2023, light vehicle sales have generally fluctuated within a range of 15.5 to 15.9 million units on an annualized basis, with a few notable event-driven spikes in late-2024 and 2025.[3] In early 2026, however, the pace of light vehicle sales ramped up and then averaged roughly 16.4 million units from March through July, despite sharply higher gasoline prices.[4]

[3] The threat of future vehicle tariffs in the aftermath of the 2024 Presidential election, the imminent introduction of new tariffs in the spring of 2025, and the prospect of expedited expiration of the EV tax credit in September 2025 temporarily boosted sales above that trend.
[4] The combined share of electric and hybrid vehicles rose by just over 1.0 percentage points in May and June of 2026 compared to the same period in 2025, which represents sales that had not yet been affected by the termination of the EV tax credit. So, we judge that the resilience of sales cannot be explained by a run-up of sales of energy-efficient vehicles.

A more stable labor market likely helped, but another potential explanation is improved vehicle affordability. As of July 2026, average transaction prices for both cars and light trucks were at or close to



their lowest readings in relation to private sector average wages since the pandemic, as shown on Chart 9. Taking vehicle financing costs into account, we show monthly vehicle payments as a share of average private sector wages in the two dashed lines. Light trucks look as affordable as ever, while financing a new vehicle consumes about the same percentage of a worker's wages as it did in 2019. These improvements in average affordability were likely due to lower sales of high-priced electric trucks, relatively flat vehicle finance interest rates, and wage growth that far outpaced new vehicle price inflation.[5] While it was originally feared that early-2025 tariff levels would result in considerable increases in vehicle MSRPs, subsequent policy actions later in 2025—such as removing penalties for Corporate Average Fuel Economy standard violations, or a new set of manufacturer credits to offset tariffs—have reduced the urgency to raise prices.[6]



The annualized pace of domestic light vehicle assemblies has also ramped up during 2026, rising from 9.4 million in November 2025 to 10.7 million in June, placing it closer to the higher end of its 2023–25 range. However, many trade tensions remain unsettled, especially with Europe and Canada. As a result, there is considerable uncertainty over the future course of the vehicle market. While the higher

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[5] Although a changing sales mix complicates the interpretation of average transaction prices as a measure of affordability, conducting a similar analysis using CPIs for autos and light trucks divided by hourly wages does not change this basic conclusion.
[6] The refund of IEEPA tariff in the aftermath of the Supreme Court ruling in the first half of 2026 likely padded vehicle manufacturer profits further.

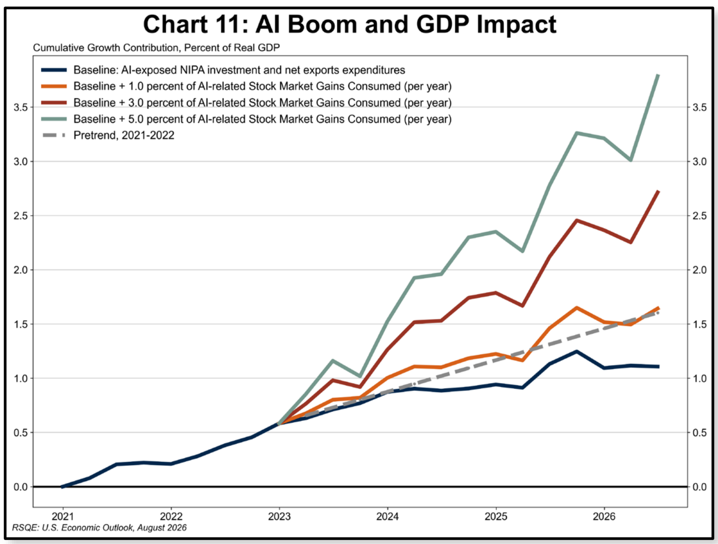
pace of sales is a welcome development, it is unclear whether market fundamentals are in place to sustain further increases in sales and production.

Overall, the economy appears resilient enough to continue expanding at a respectable pace unless large new shocks disrupt its momentum.

Next, we detail several key policy and economic assumptions underlying the forecast.

Output Effects of the AI Boom

With the AI boom in full swing, estimates regarding its actual contribution to U.S. economic growth vary widely. Below, we construct our own back-of-the-envelope estimate.[7] On Chart 11, we start by constructing the blue line, which aggregates cumulative quarterly real GDP growth contributions of AI-exposed components of private investment, exports and imports in the national income and product accounts (NIPAs) since 2021Q1.[8]



The combined cumulative contribution of these AI-exposed NIPA expenditures had been trending up prior to 2022Q4, when OpenAI publicly released its ChatGPT tool, reflecting the pre-existing momentum in the technology-related growth contribution. In what follows, we will visually evaluate where our four pictured lines fall relative to the extension of this pre-trend. The blue line has flattened slightly after 2024Q1, reflecting a massive surge in the raw imports of capital goods like

[7] Our simple analysis below comes with a long list of caveats. We will explicitly mention only a few. This exercise is not a proper counterfactual, and it does not consider general equilibrium effects. One can argue that, without the help of the AI boom, monetary policy would have been looser and long-term interest rates could have been lower, with ambiguous effects on the labor market. The analysis is a heuristic accounting exercise along the realized path.

[8] The blue line sums cumulative approximate quarterly real GDP growth contributions of NIPA expenditures on: nonresidential fixed investment in structures: data centers and power; intellectual property products: software; equipment: computers and peripherals, communications, engines and turbines; net exports of capital goods: computers, peripherals, parts, semiconductors, and telecommunications equipment; net exports of services: telecommunications, computer, and information services.

computers, parts, semiconductor chips, and telecommunications equipment. The cumulative growth contribution shortfall relative to pre-trend is around 0.5 percent of GDP.[9]

Simultaneously, the AI boom has generated a significant stock market wealth effect that has helped sustain consumption expenditure growth despite multiple economic headwinds. To get a sense of the quantitative significance of this wealth effect, we look at the stock market run-up since 2022Q4,. Estimates suggest that between 50 and 75 percent of the stock market run-up since then was driven by AI-related equities, depending on how broadly such stocks are defined.[10] For this rough analysis, we assume that approximately two-thirds of the cumulative increase in stock wealth since 2022Q4 is AI-related. We define that portion as AI-related wealth gain and deflate it by the PCE price index and use that as a base for the wealth effect calculation.[11]

The ultimate impact on real activity depends on the assumed aggregate marginal propensity to consume (MPC) out of equity wealth, which academic literature generally places within a range of 1 to 5 percent.[12] For our middle-case scenario shown in dark red on Chart 2, we use an MPC of 3 percent, calculate the time-series of real wealth-induced consumption expenditures, and divide by real GDP. For the total AI impact through 2026Q2, we combine the cumulative growth contribution of AI-exposed NIPA components and, starting in 2023Q1, add the wealth-driven consumption effect.[13] By 2026Q2, the total effect is about 1.1 percent of real GDP above the pre-trend line, amounting to an average boost to growth of 0.3 percentage points between 2023Q1 and 2026Q2. The assumed strength of the wealth effect matters substantially, as illustrated by the higher- and lower-end estimates shown on the chart with green and red lines, respectively. If we adopt a lower-end stock wealth MPC of around 1.0 percent, the

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[9] The fact that the growth contribution of investment and exports has lagged behind that of imports of components measured at the dock (before accounting for tariffs, freight, and installation costs) potentially suggests that domestic AI-related investment spending may be somewhat undercounted in current statistics.

[10] Estimates from J.P. Morgan and Barclays suggest that broadly-defined AI-related equities accounted for roughly 75–80% of the S&P 500's gains since late 2022. While a December 2025 report by S&P Dow Jones Indices indicates that Google, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla contributed 55% of the S&P 500's total return during 2023–25.

[11] We measure total stock market wealth as household holdings of corporate equities and mutual fund shares from the Financial Accounts of the United States, extended through 2026Q2 using the S&P 500 total market capitalization growth.

[12] For a recent paper that supports our middle-case estimate, see Chodorow-Reich, Gabriel, Plamen T. Nenov, and Alp Simsek. 2021. "Stock Market Wealth and the Real Economy: A Local Labor Market Approach." American Economic Review 111 (5): 1613–57.

[13] In principle, this calculation is improper given the chain-weighting procedure underlying the calculation of real GDP. Given the fairly heroic assumptions we make in calculating the consumption effect, however, we think that adding actual real GDP growth contributions of NIPA components and a ratio of the real consumption expenditure effect to real GDP can nonetheless produce an illustrative estimate, especially over a relatively short time horizon.

combined AI contribution suggests virtually no overall impact on real GDP relative to the prior trend, as illustrated by the close tracking of the dark red and dashed gray lines.[14] Conversely, if we assume a higher-end MPC of 5.0 percent, the cumulative AI effect rises substantially, reaching about 2.2 percent of real GDP by 2026Q2, or an average boost to growth of 0.6 percentage points between 2023Q1 and 2026Q2. In summary, our analysis indicates that the AI boom has likely provided meaningful support to economic activity in recent years, but attributing a dominant role to it requires quite optimistic assumptions.

Monetary Policy

Under new leadership, the Federal Open Market Committee (FOMC) is continuing its cautious approach to monetary policy as inflation remains above its 2.0 percent objective and amid noisy labor market data. The Committee kept the target range for the federal funds rate unchanged at 3.5–3.75 percent at its July meeting, the latest in a series of no-change decisions in 2026. The 9-3 vote, however, revealed a hawkish minority favoring an increase of 25 basis points (bps) strongly enough to log a dissent. Taken together, still-elevated June PCE inflation, softer July CPI data, and unexpectedly negative July payroll job gains despite a low unemployment rate support our expectation that rates will remain unchanged in the near term. Chair Kevin Warsh described the current posture as one of “watchful thinking” rather than watchful waiting.

Market pricing had moved toward some probability of rate hikes in 2026 and 2027 before the July FOMC meeting. Chair Warsh used the July press conference to reaffirm the Fed’s commitment to its 2.0 percent PCE inflation target, rejecting the notion of a soft or implicit higher target. He also framed the Fed’s reduced forward guidance as a way to let market prices send a cleaner signal about financial conditions, while a set of new task forces evaluates data and monetary strategy. We interpret this

[14] The use of this lower-end estimate is likely justified if one thinks that most of the AI-driven stock market gains accrued to the wealthy. In an August 2025 FEDS notes article, Federal Reserve researchers estimate that MPC from equity wealth for the top quintile of households by income is under 1.0 percent. See Beach, Samara, William Gamber, and Patrick Moran (2025). “Wealth Heterogeneity and Consumer Spending,” FEDS Notes. Washington: Board of Governors of the Federal Reserve System, August 05, 2025.

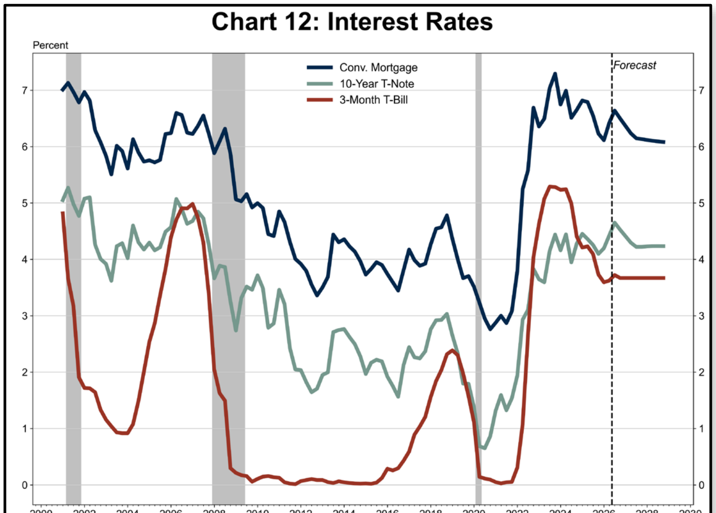
communication as reducing the likelihood of near-term cuts while preserving the Committee's flexibility to tighten if above-target inflation persists.

While the most recent readings of trend inflation have improved a bit, the current level of core PCE inflation remains substantially above target. The July FOMC minutes showed that most participants expected inflation to ease as tariff effects and earlier energy-price increases waned, but many still saw upside risks from persistent underlying inflation, elevated input costs, and AI-related demand pressures. We currently expect the recent boost to some measures of trend inflation due to these factors to dissipate without the need for tighter monetary policy.

The labor market also supports a cautious monetary stance. The broad picture appeared relatively stable during the first half of 2026, with modest job gains and a slowly declining unemployment rate. However, recent data have softened somewhat, raising the risk of further labor market cooling. In our view, this recent weakening provides sufficient reason for the Fed to hold off on raising rates this fall. On balance, low unemployment reduces the urgency to cut rates, while recent softer-than-expected payroll gains weaken the case for immediate tightening.

Our forecast is consistent with a Fed navigating heightened uncertainty around lingering inflation pressures, a gradually softening labor market, and the ongoing transmission of financial conditions. While our base case is that the Fed holds rates flat throughout our forecast horizon, both tighter and looser monetary policy paths are quite plausible. One alternative path would involve rate cuts next year if energy pressures ease quickly, while tariff pass-through and AI-related price pressures dissipate more quickly than we expect, putting inflation on a clearer path toward the 2.0 percent target while the labor market still looks vulnerable. By contrast, persistent energy-price pressures or renewed and durable AI-related inflation could lead to rate hikes if the Committee judges that elevated inflation is becoming entrenched.

Chart 12: Interest Rates



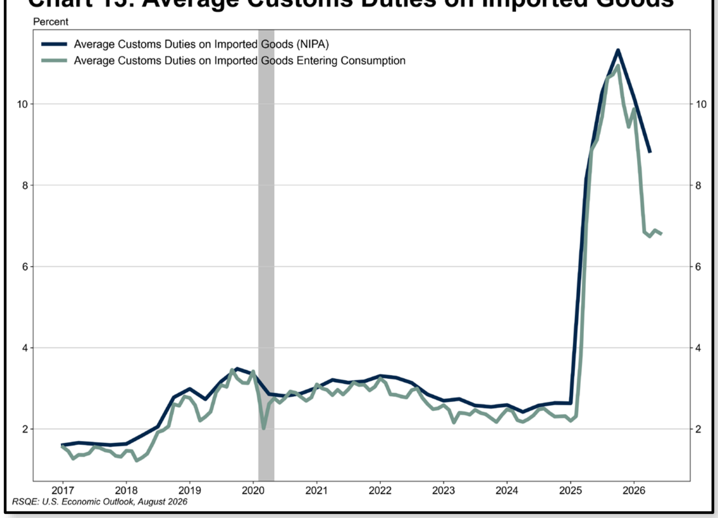
RSQE: U.S. Economic Outlook, August 2026

Chart 12 shows our projections for selected key interest rates. The 3-month Treasury bill rate hovers around 3.7 percent through our forecast horizon, consistent with our forecast of a flat federal funds rate. The 10-year Treasury rate is expected to trend higher to 4.7 percent in 2026Q3 and then decline before stabilizing at 4.2 percent by 2027Q3. The 30-year conventional fixed-rate mortgage rate similarly edges up to 6.6 percent in 2026Q3 and then resumes its decline, reaching 6.1 percent by the second half of 2027 and 6.0 percent in 2028Q4. The ongoing conversion of maturing and prepaid mortgage-backed securities on the Federal Reserve's balance sheet into Treasury bills will likely slow the narrowing of the spread between the 30-year fixed mortgage rate and the 10-year Treasury yield.

Trade and Fiscal Policy

Trade policy remains fluid, but recent developments do not materially alter our view that the tariff landscape is relatively calmer than it was a year ago. The temporary 10 percent import surcharge imposed under Section 122 expired on July 24 after reaching its 150-day statutory limit. The Trump Administration replaced it with tariffs of either 10 or 12.5 percent under Section 301 on imports from 60 economies, subject to product exemptions and special treatment for several major trading partners.

Chart 13: Average Customs Duties on Imported Goods



Despite the change in legal authority, the broad tariff burden remains similar. Monthly trade data in Chart 13 suggest that the effective tariff rate has moderated and stabilized since March. Going forward, we expect the average effective rate to remain around 8 percent.

A notable challenge to that broad stability is the announced 50 percent tariff under Section 338 of the Tariff Act of 1930 on roughly $20 billion of Canadian imports, including goods eligible for the United States-Mexico-Canada Agreement (USMCA) exemption. The tariff was set to take effect on August 19, but the Administration has since delayed its implementation without cancelling it. Although the affected trade volume is relatively small, the action signals that trade tensions with Canada are not over.

The United States declined to renew the USMCA in its current form for a full 16-year term. The agreement remains in force but is now subject to annual reviews, which will likely sustain uncertainty over North American trade policy. Mexico has engaged more actively with the United States than Canada has, recently updating its regulation of dual-use exports to align its controls more closely with U.S. restrictions, including those covering semiconductors, aerospace products, and navigation equipment. There has been limited progress with Canada, which will likely weigh on near-term trade policy uncertainty.

Refunds of the invalidated tariffs imposed under the International Emergency Economic Powers Act are expected to continue through 2026Q3, although a small subset of older entries remain subject to litigation. As of July 13, U.S. Customs and Border Protection had accepted approximately $122 billion in refund declarations out of an estimated level of $166 billion. The agency had transferred about $86 billion, including interest, to the Treasury for disbursement. These payments go to importers of record rather than directly to consumers. In the NIPAs, these refunds are recorded as a capital transfer from the federal government in 2026Q1, regardless of when the cash is disbursed.[15] They therefore do not increase NIPA corporate profits, although their receipt has certainly boosted reported earnings for some companies.

Congress has been managing to remain active despite the midterm elections looming only a few months away. So-called “Reconciliation 2.0” ended the partial shutdown of the Department of Homeland Security in June and provided $69.5 billion for immigration enforcement activities. That funding will boost nondefense spending through fiscal year 2029.

The House passed the fiscal 2027 budget resolution to start “Reconciliation 3.0” in July. The current instructions would result in an additional $95 billion of budget authority over fiscal years 2027 through 2036, including $60 billion for the war with Iran, and would reserve funding to implement the Safeguard American Voter Eligibility (SAVE) Act. The Senate has yet to take up this measure as of this writing, nor do we think it will before the midterm elections. We judge that some additional support for the war with Iran could materialize, but the timing and size remains uncertain.

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[15] https://www.bea.gov/help/faq/1488

Looking ahead, we expect the fiscal year 2027 budget process to proceed with less disruption than in recent years. Both the House and Senate have passed versions of a continuing resolution that would fund federal activities through December, and the Senate version has attracted more bipartisan support. With the midterm elections approaching, a shutdown would be politically costly and would keep Members of Congress in Washington rather than campaigning in their districts. We therefore expect the federal government to stay open until at least December, with the stopgap measure remaining broadly in line with fiscal year 2026 funding rates. Our forecast also assumes that divided government will return after the midterm elections.

Defense spending is likely to rise substantially in fiscal year 2027. In July, the House passed its version of the National Defense Authorization Act, which includes the SAVE Act. The Senate's version, which does not include the SAVE Act, received bipartisan approval from the Senate Armed Services Committee but has yet to reach the Senate floor. Despite the disagreement over the SAVE Act, both versions would authorize roughly $1.1 trillion for defense, more than $200 billion above the fiscal year 2026 level. We believe that these proposals point to continued strength in defense spending over the forecast horizon.

Table 1
Federal Budget, NIPA Basis
(Billions of Dollars)

		FY Forecast		
	2025	2026	2027	2028
Current receipts	5525.8	5901.7	6091.9	6358.9
% change	8.7	6.8	3.2	4.4
Current expenditures	7409.5	7714.3	8088.6	8465.1
% change	7.3	4.1	4.9	4.7
Consumption	1493.0	1511.4	1594.5	1668.7
% change	5.6	1.2	5.5	4.7
Transfer payments	4640.6	4846.5	5061.1	5276.4
% change	7.6	4.4	4.4	4.3
Federal subsidies	110.9	114.7	102.5	104.6
% change	17.3	3.4	-10.6	2.0
Interest payments	1165.0	1241.8	1330.5	1415.5
% change	7.1	6.6	7.1	6.4
Surplus (+) or deficit (-)	-1883.6	-1812.6	-1996.7	-2106.2
Percent of GDP	-6.2	-5.6	-5.9	-6.0

RSQE: U.S. Economic Outlook, August 2026

Table 1 shows the data and our projections for federal receipts and expenditures by major category on a NIPA basis for fiscal years 2025 through 2028. Nominal revenue receipts grew by a brisk 8.7 percent in fiscal 2025, owing to a sharp increase in tariff revenue. Receipt growth then edges down modestly to 6.8 percent in fiscal 2026 as effective tariff rates moderate marginally. Thereafter, revenue growth averages 3.8 percent through fiscal 2028, broadly in line with its historical average.

Federal expenditure growth is projected to slow from 7.3 percent in fiscal 2025 to 4.1 percent in fiscal 2026, when sizable retroactive payments under the Social Security Fairness Act boosted outlays.

Ongoing sales from the Strategic Petroleum Reserve (SPR) are likely to temporarily offset discretionary nondefense spending through 2026Q4. Elevated interest costs and continued strength in defense spending are expected to support expenditure growth of 4.9 percent in fiscal 2027 and 4.7 percent in fiscal 2028, while transfer payments increase by roughly 4.4 percent per year.

The federal deficit improves to 5.6 percent of GDP in fiscal 2026, but it widens to 6.0 percent by fiscal 2028. We do not anticipate a sizable reduction in the Federal Reserve's balance sheet through 2028. Therefore, federal debt held by private investors is projected to continue to rise, from 83.7 percent of GDP in 2026Q2 to 88.4 percent in 2028Q4.

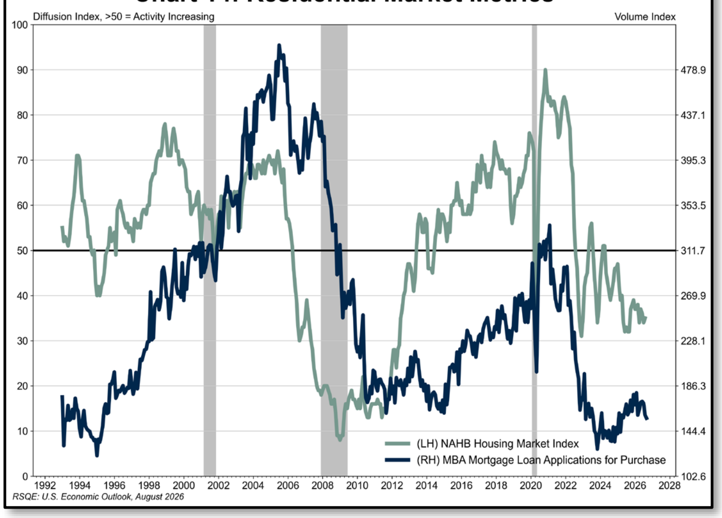
The Housing Market

The housing market remained soft through July 2026 as financing costs moved higher again. Elevated mortgage rates and strained affordability continued to weigh on demand for both new and existing single-family homes, while builders faced weak buyer traffic, elevated inventories, and uncertainty about construction costs. These conditions have restrained construction and cooled recent home price appreciation. Looking ahead, we project mortgage rates will resume their gradual descent and home price growth will rebound starting in 2026Q3.

After declining from 6.8 percent in June 2025 to 6.0 percent in February 2026, the 30-year conventional fixed-rate mortgage rate rose to just under 6.7 percent in early August, slightly above its August 2025 level. Existing single-family home sales averaged a 3.8-million-unit annualized pace in 2026Q2 and stood at 3.7 million units in July, close to their 2025 average. New single-family home sales rose through 2025 as mortgage rates declined, but that momentum faded in early 2026. Sales averaged 631,000 annualized units in 2026Q2, little changed from 622,000 in 2026Q1 and below the pace of 711,000 reached in 2025Q4.

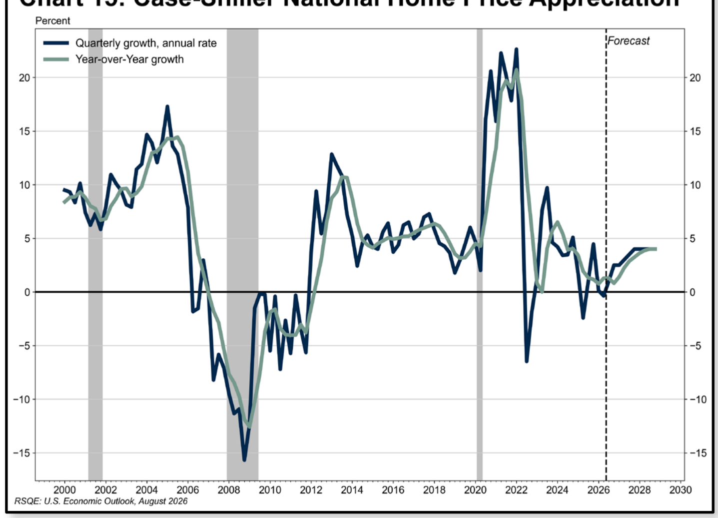
Chart 14 reflects soft buyer activity and builder caution amid the rebound in financing costs, illustrating the Mortgage Bankers Association's (MBA's) purchase application volume index and the National Association of Home Builders (NAHB)/Wells Fargo Housing Market Index (HMI). Housing-related sentiment remained weak alongside the recent rise in mortgage rates and elevated costs uncertainty. The HMI slipped to 35 in August after averaging 36 in 2026Q2, remaining well below both its 2025Q4 average of 38 and the neutral level of 50. The six-month ahead sales expectations component also softened, hovering around 44 from April through August this year after averaging 52 in 2025Q4. The MBA's purchase application index slipped to 158 in early August, below its 2026Q2 average of 170 and slightly below its 2025 average of 163.

Chart 14: Residential Market Metrics



We expect the 30-year mortgage rate to average 6.6 percent in 2026Q3 before resuming a slow decline, ultimately falling to 6.1 percent in second half of 2027 and remaining around that level in 2028. Our preferred measure of home prices, the seasonally adjusted S&P Cotality Case-Shiller Home Price Index (Chart 15), has shown a deceleration recently: quarterly annualized appreciation slowed from 4.5 percent in 2025Q4 to 0.1 percent in 2026Q1. We estimate that prices under this measure declined at a 0.4 percent annualized rate in 2026Q2, consistent with subdued demand amid higher financing costs. Starting in 2026Q3, home price inflation gradually accelerates, reaching 2.5 percent in 2026Q4 and our long-run forecast rate of 4.0 percent by 2028.

Chart 15: Case-Shiller National Home Price Appreciation



Energy Markets

The price of West Texas Intermediate (WTI) crude oil has experienced significant volatility since late February amid the war with Iran. Sentiment shifted following the signing of a memorandum of understanding (MOU) in June, which raised expectations for a ceasefire, further negotiations, and the eventual normalization of commercial shipping through the Strait of Hormuz. These developments contributed to a decline in oil prices from their spring highs. However, renewed military activity following the MOU disrupted regional energy flows once again.

More recently, WTI has traded around $80 per barrel, with prices remaining sensitive to developments in U.S.-Iran negotiations and the status of shipping through the Strait. Despite the 6-month war, prices have remained relatively contained, in part reflecting markedly lower purchases by China and significant U.S. government releases from the SPR. Given the repeated cycle of de-escalation and renewed tensions, energy price volatility is likely to remain elevated until there is greater clarity on the durability of any agreement and the sustained normalization of commercial shipping through the Strait.

Our forecast assumes that a negotiated agreement will be reached within a few months, followed by de-escalation and no lasting damage to energy extraction and shipping capacity. We also assume that shipping conditions through the Strait normalize by the second half of 2027. However, a prolonged conflict would increase the risk of lasting infrastructure damage, tighter inventories, and higher prices for longer than we currently project.

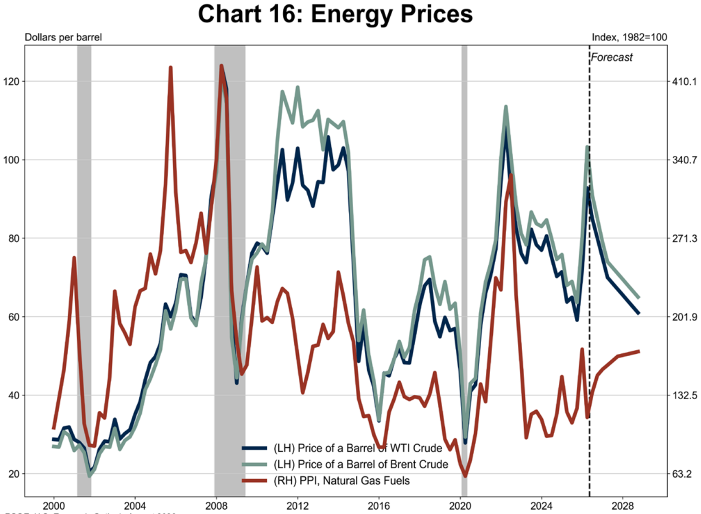
Despite the ongoing geopolitical turmoil, the global oil market is expected to gradually rebalance and become oversupplied as Middle Eastern production and shipping disruptions ease and supply growth resumes. The Energy Information Administration (EIA), in its Short-Term Energy Outlook released in August, assumes that restrictions on oil transit through the Strait of Hormuz will persist through August, with flows gradually recovering thereafter and most regional production returning toward pre-conflict levels by early 2027. U.S. crude oil production is forecast to average 13.8 million barrels per day (mbpd) in 2026 and reach a record 14.2 mbpd in 2027, adding to global supply. Meanwhile, elevated oil prices and the economic impact of the conflict are expected to weigh on near-term demand, with global liquid fuels consumption decreasing by 1.2 percent in 2026 before increasing by 2.2 percent in 2027. Overall, the market is expected to remain undersupplied in the near term, with global inventories declining through the second half of 2026 before supply recovers and inventories begin rebuilding in 2027.

Chart 16 shows our forecast for WTI and Brent crude oil prices in blue and light green, respectively, alongside the Producer Price Index (PPI) for natural gas fuels in red. As traffic through the Strait normalizes, we expect WTI prices to decline to $80 per barrel by the end of 2026. As the persistent oversupply that existed before the Iran war takes hold again, the price of WTI is expected to fall to $67 per barrel by the end of 2027 and $61 per barrel by the end of 2028. We therefore expect WTI prices to return to around their pre-conflict level in the second half of 2028. While this may seem like a rapid return to normal following the second oil shock of this decade, the EIA currently expects prices to return to pre-conflict levels around the second half of 2027.

Since the addition of WTI Midland crude to the Brent benchmark in 2023Q2, the Brent–WTI spread has averaged $4.6 per barrel from 2023Q3 through 2025Q4, exceeding $5 per barrel in only a couple of quarters. However, the war with Iran pushed the spread to an average of $8.3 per barrel in 2026Q1 and $10.5 per barrel in 2026Q2. Although the spread has since narrowed, we expect it to take some time to normalize before returning to $4 per barrel in early 2027, where it is expected to remain through the rest of the forecast.

Domestic natural gas prices, as measured by the PPI for natural gas fuels, have remained relatively stable even amid the war with Iran. This stability is due in part to the fact that natural gas primarily remains within the domestic market. We expect continued growth in oil-directed activity to support higher natural gas production over the forecast period. At the same time, robust global demand for liquefied natural gas (LNG) is expected to support further production growth but also put upward pressure on domestic prices as LNG takeaway capacity expands. We therefore expect natural gas prices to rise a cumulative 26.7 percent from 2026Q3 through the end of 2028. Even with this increase, inflation-adjusted natural gas prices would only return to their average level over the prior ten years (2016–2025) by the end of our forecast.

Chart 16: Energy Prices



RSQE: U.S. Economic Outlook, August 2026

The Forecast for 2026–2028

More than a year since the tariff and immigration policy shocks of 2025, the real economy appears largely to have weathered them, supported in part by the ongoing AI-driven stock market bull run. The economy is far from booming, however. Smoothing through the government shutdown's impact on real GDP, the pace of economic growth averaged about 1.4 percent over 2025Q4–2026Q2, although the details of the most recent report were encouraging. The labor market weakened in the second half of 2025 but improved late in the year and has stabilized so far in 2026. The inflation picture remains complex and highly consequential. The 2025 tariffs likely continued to filter into consumer prices early this year. Furthermore, the AI-driven price spikes for computer parts showed up in consumer price indices. These price pressures stalled but did not reverse the moderation of core CPI inflation, which fell in July to its lowest year-over-year reading since March 2021. By contrast, the broader 12-month core PCE inflation metric rose meaningfully this year after remaining relatively flat over 2024–25. The pass-through of fuel costs into core prices also remains a risk. A wide range of inflation scenarios remains plausible. We expect core PCE inflation to drop back promptly toward its 2024–25 range and to gradually decline from there, guiding our monetary policy path and the overall forecast. However, scenarios involving either faster disinflation or persistently high inflation also remain plausible, each entailing distinct policy assumptions and outcomes.

Chart 17: Economic Growth Forecast

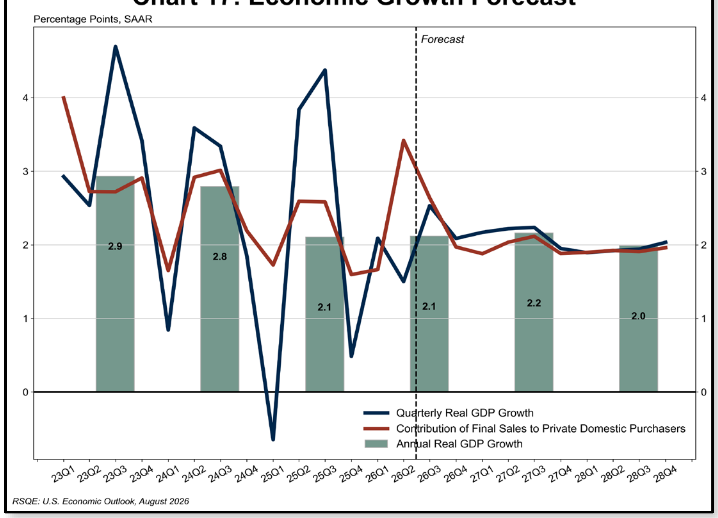


Table 2

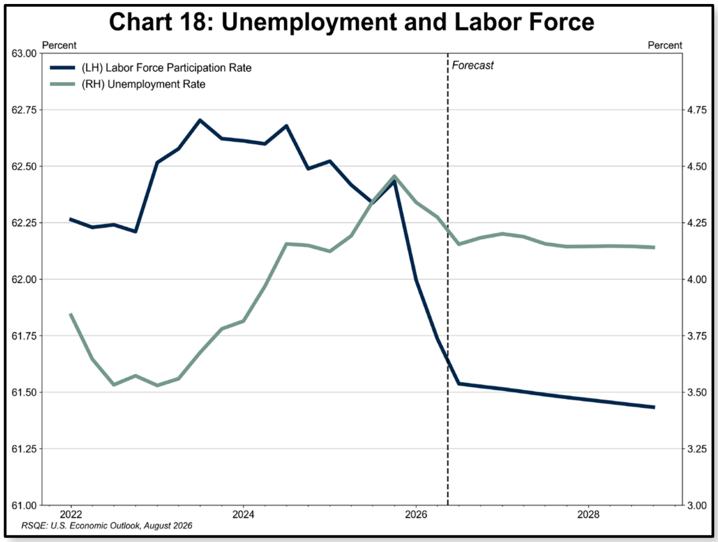
Contributions to the Growth of Real GDP

(Average quarterly contributions, percentage points at annual rate)

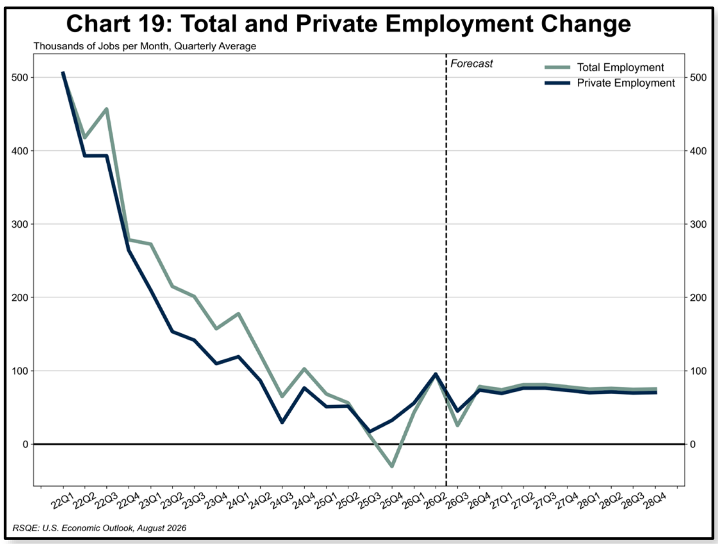
	'26Q2	'26Q3	'26Q4	'27	'28
Real GDP (% change, AR)	1.5	2.5	2.1	2.1	1.9
Contributions to real GDP growth					
Final sales to private domestic purchasers	3.3	2.6	1.9	2.0	1.9
Consumption	2.1	2.0	1.2	1.2	1.2
Nonresidential fixed investment	1.2	0.7	0.7	0.6	0.6
Residential investment	0.1	-0.1	-0.0	0.1	0.1
Government purchases	-0.1	0.3	0.3	0.3	0.2
Net exports	-1.0	-0.9	-0.3	-0.3	-0.2
Inventory investment	-0.7	0.6	0.2	0.2	0.0

RSQE: U.S. Economic Outlook, August 2026

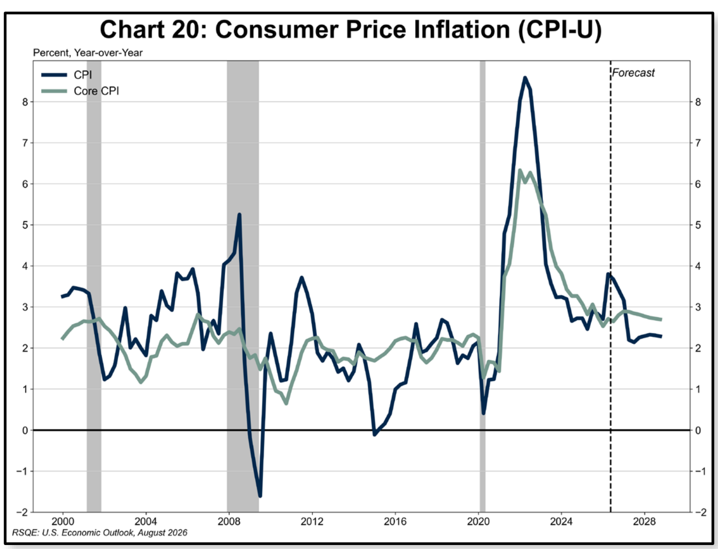
- Final sales to private domestic purchasers contributed an outsized 3.3 percentage points to growth in 2026Q2, but the combined drag from net exports and inventories undid 1.7 percentage points. As a result, real GDP growth slipped compared to 2026Q1.
- We project the annualized pace of growth to rebound from 1.5 percent in 2026Q2 to 2.5 percent in 2026Q3, as an inventory rebuild follows a large drawdown, while the momentum in private fixed investment and consumption spending moderates slightly.
- Beyond the current quarter, we expect real GDP growth to stay in the narrow range of 1.9–2.2 percent That pace would be near its historic trend, helped by respectable labor productivity gains.
- In 2026, calendar year real GDP growth registers 2.1 percent, on par with 2025. Growth then edges up to 2.2 percent in 2027 before slipping marginally to 2.0 percent in 2028.
- The growth contribution of consumption jumped from an anemic 0.4 percentage points in 2026Q1 to 2.1 percentage points in 2026Q2, perhaps boosted slightly by personal tax cuts raising refund checks. We expect the strong consumption momentum to persist in 2026Q3 but then to moderate, contributing about 1.2 percentage points to growth through 2028.
- The growth contribution of nonresidential fixed investment remains strong over the forecast, supported by robust investment in AI-related structures, equipment, and software.
- Residential investment drags on growth until 2027, as housing affordability remains a challenge, with the 30-year mortgage rate holding over 6.0 percent through 2028.
- The resumption of oil sales from the SPR due to the war with Iran subtracted 0.4 percentage points from the government's growth contribution in 2026Q2.
- The combined quarterly growth contribution of net exports and inventory investment averages around 0.1 percentage points in 2026Q4–28.



- The unemployment rate fell for a second consecutive month, reaching 4.1 percent in July after hovering near 4.3 percent earlier in 2026. However, the decline does not signal broad labor market tightening, as it has been accompanied by a sharp pullback in the labor force participation rate, which fell to 61.4 percent in July after a retreat from its January 2026 reading of 62.1 percent.
- We expect the participation rate to edge down over the forecast, as ongoing retirements outweigh support from steady labor demand and slow population growth.
- The labor market is projected to remain largely balanced. A sliding participation rate helps limit upward pressure on unemployment from weak growth in the household employment count, which adds less than 70,000 jobs per month on average over 2027–28. The unemployment rate hovers around 4.2 percent through mid-2027, then edges down to 4.1 percent in 2027Q4 and 2028.

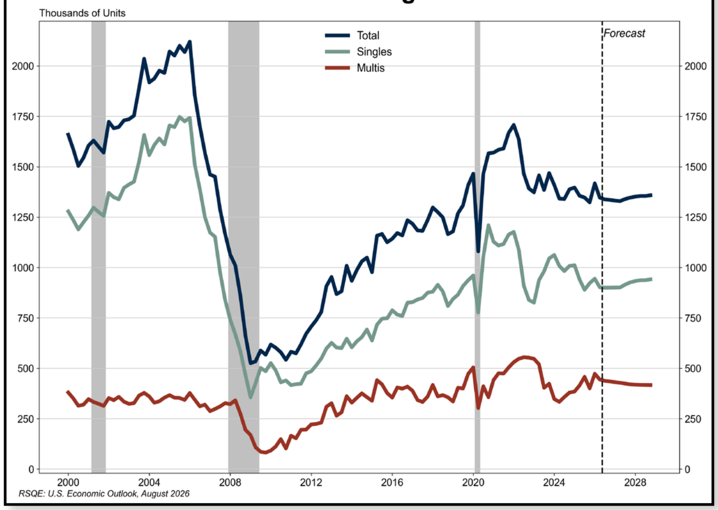


- Private payroll job gains have been volatile but modestly positive on average so far in 2026. However, a sharp drop in local government employment resulted in a net loss of 23,000 total payroll jobs in July. We expect monthly job gains to average only 25,000 for 2026Q3. Job gains ramp up by 2026Q4 and stay in the 74,000–81,000 range through 2028Q4.
- The recent pace of job gains has been underwhelming relative to historical standards. Still, it is broadly compatible with weak population growth and current net immigration projections. Our forecast is at the higher end of recent estimates of the breakeven pace of job creation, the pace of payroll job gains consistent with a stable unemployment rate.
- Due to the sharp drop in local government education employment in July, monthly government payroll job gains are projected to average a loss of 20,000 in 2026Q3. The interaction of the timing of the summer break and seasonal factor calculations likely accounts for part of the drop. Slow growth of government employment resumes starting from 2026Q4.



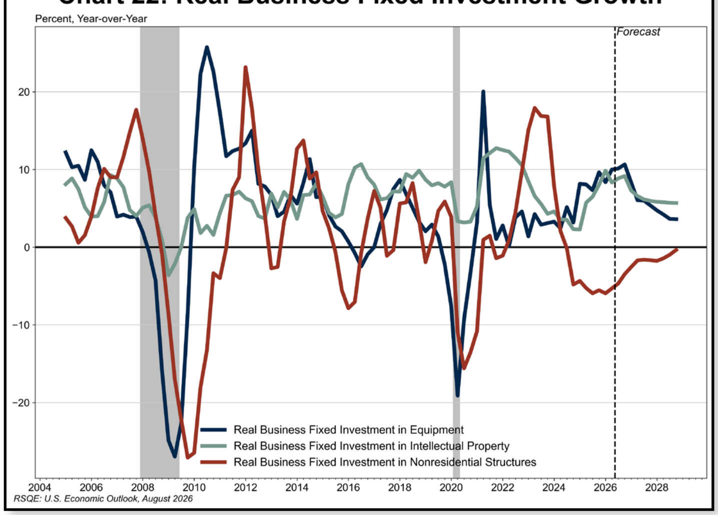
- We expect quarter-on-quarter core CPI inflation to moderate gradually. Base effects due to shutdown-related distortions that lowered the core CPI level in 2025Q4 and 2026Q1 push year-over-year readings higher in 2026Q4 and 2027Q1. Between 2027Q2 and 2028Q4, core CPI inflation declines from 2.9 percent to 2.7 percent.
- The oil price spike pushed year-over-year headline CPI inflation higher in 2026Q2, although the increase partially reversed in June and July. Our projected oil price path implies that year-over-year headline CPI inflation stays elevated through 2027Q1 and runs below core thereafter.
- Core PCE inflation, a key measure of the trend, remains elevated at 3.3 percent year over year in through the end of 2026. Inflationary pressures tied to AI-related investments and health care services keep the deceleration in PCE core gradual.

Chart 21: Housing Starts



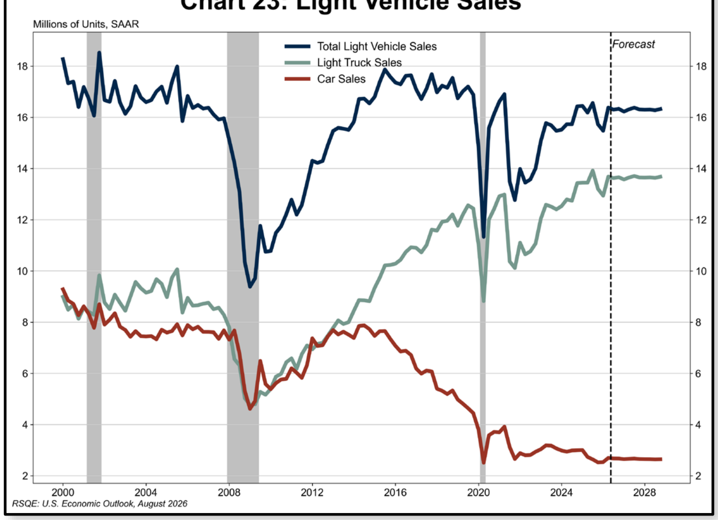
- While single-family housing starts dropped to 808,000 annualized units in July, permits remained stable. We expect starts to rebound and hover around 900,000 units in 2026Q3 amid low builder sentiment and higher construction costs, then recover gradually to roughly 940,000 units by 2028 as lower mortgage rates provide support.
- Multi-family starts posted a solid pace of 444,700 units in 2026Q2 but were quite volatile over the past 1.5 years. As financing conditions gradually improve and support new home sales while job growth remains tame, rental demand growth slows and multi-family starts edge down to around 420,000 units in 2027H2 and 2028.
- Total starts slow to 1,330,000 units by 2027Q2, before recovering to a 1,358,000-unit pace by the end of 2028.

Chart 22: Real Business Fixed Investment Growth

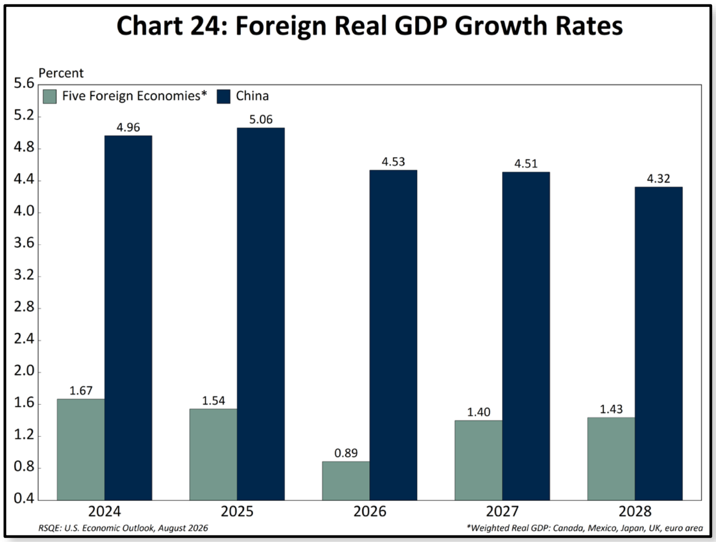


- Business fixed investment in equipment rose by 10.0 percent year over year in 2026Q2, propelled by robust growth in investment in computers and industrial equipment. We expect this rapid pace to persist through 2027Q1, while industrial equipment continues to contribute to the strength. The year-over-year growth rate holds above 10.0 percent in 2026H2, before tapering down to 3.6 percent by the end of 2028.
- Year-over-year growth in intellectual property investment reached 8.3 percent in 2026Q2, bolstered by robust growth in software and research and development (R&D) investment. We expect solid growth as businesses expand their use of AI, supporting continued strength in R&D investment through 2028.
- By contrast, investment in nonresidential structures continues to decline throughout the forecast period. The surge in construction activity tied to microchip factories has given way to a slump as projects near completion, and the build-out of data center structures has yet to offset much of that decline. Domestic drilling activity expands through 2027Q2 in response to higher oil prices.

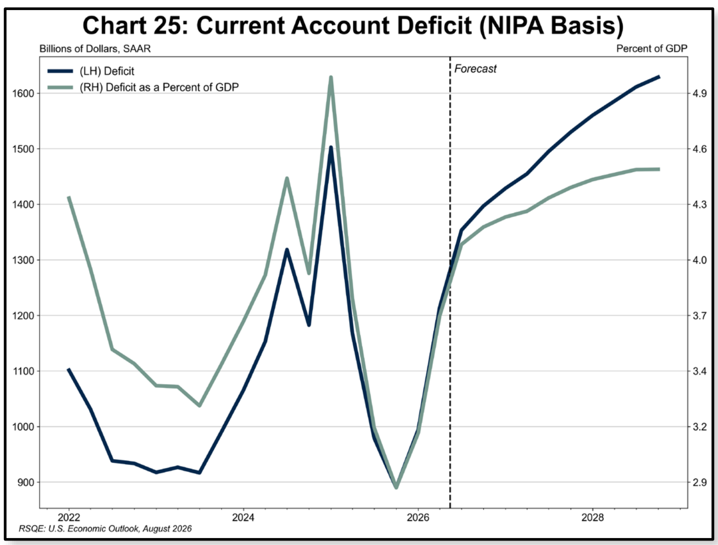
Chart 23: Light Vehicle Sales



- Light vehicle sales shifted from weather-distorted weakness early in 2026 to a healthy and seemingly sustainable pace of sales around 16.3 million this spring. The oil price spike does not appear to have resulted in a meaningful disruption in the new vehicle market.
- As muted job and wage growth limit further gains, the sales pace remains at 16.3 million units through 2028Q4.
- Policy risk is less immediate but provides little upside. Following the July USMCA joint review, current terms remain in place for now, but the prospect of annual reviews increases policy uncertainty. We project light vehicle sales to stay near 16.3 million units through the forecast horizon, a level supported by the rising average age of vehicles as drivers hold onto cars and light trucks longer.



- To forecast demand for U.S. exports, we construct a trade-weighted index of real GDP for five of our major export markets: Canada, Mexico, Japan, the United Kingdom, and the euro area. We also track China's economy, but we show it separately because it tends to grow more quickly.
- China's economic growth weakened to a 3.6 percent annualized pace in 2026Q2 due to slow growth of consumption and domestic investment. July data, however, point to sustained growth in export-oriented and high-tech industries. We expect growth to return to the mid-4 percent range through 2027, stepping down to 4.3 percent in 2028. Our projections are largely based on the Bloomberg survey of forecasters and the International Monetary Fund's longer-run outlook.
- While higher energy prices hold down growth in Japan and likely help Canadian growth; there is more area-specific heterogeneity in growth projections than a common theme. The composite growth of these five economies is projected to slip to 0.9 percent in 2026. In 2027–28, growth picks up in all five markets, and the composite growth rate averages 1.4 percent.



- The large gyrations of the current account deficit over the past six quarters were driven by different types of goods imports reacting differently to tariffs. Consumer goods imports saw some tariff front-running early in 2025 and then declined dramatically. Imports of industrial supplies, food, and automotive capital goods fell moderately, while imports of non-automotive capital goods continued to grow at a brisk pace, driven by AI-related equipment.
- The current account deficit edges up to 4.1 percent of GDP in 2026Q3, as strong net imports of computer components, telecommunications equipment, and semiconductors continue. Over the rest of the forecast, the deficit gradually widens, reaching 4.5 percent of GDP in 2028.
- Strong growth of net factor income in 2025Q4 helped push the current account deficit to its narrowest level relative to GDP since early 2020. In the forecast, however, we expect net factor income as a share of GDP to return to the trend observed during 2018–24.

Risks to the Forecast

We strive to balance major quantifiable upside and downside risks to the economy in our forecasts. Hard-to-quantify risks can also be substantial, whether or not they tilt in an identifiable direction. The most prominent risks we see involve inflation, global energy markets, policy changes under the newly confirmed Federal Reserve chair, and international trade relations. As of this forecast, quantifiable risks to the domestic outlook appear elevated but roughly balanced, although large unquantifiable risks remain.

The war in Iran has escalated and de-escalated several times in recent months but appears far from settled. Flows of energy and other key commodities through the Strait of Hormuz remain constrained, and further abrupt oil-price spikes are a real possibility. Conversely, a resolution that reopens the strait and returns Iranian oil to the market could quickly push the price of WTI below $60 per barrel, well below our projected path.

Given the recent divergence between core CPI and PCE measures, inflation's trajectory is a key economic risk. Persistently high inflation would likely prompt a higher policy rate, weakening the labor market and slowing growth. Rapid disinflation also appears plausible, especially if the war de-escalates durably, past oil-price spikes do not spread to broader inflation, and upward pressures on core inflation from tariffs and the AI boom dissipate rapidly. Monetary policy could then loosen, facilitating a decline in medium-term interest rates and supporting interest-sensitive sectors.

The new Federal Reserve chair, Kevin Warsh, has initiated a comprehensive review of the Fed's framework and communication strategy. Recent post-FOMC press conferences and FOMC members' speeches offer some signals about its new direction, but any change to the Fed's reaction function remains difficult to discern. Uncertainty about monetary policy is therefore substantial, complicating financial-market and business-investment decisions. This uncertainty will likely diminish significantly during 2027, potentially shifting markets and our future outlooks.

Global financial stability is another concern. The U.S. Treasury and Bank of Japan (BOJ) recently coordinated a large intervention to support the yen, helping Japan to avoid selling its substantial U.S. debt holdings. At 1.0 percent, the BOJ's policy rate remains well below those of other major economies, encouraging carry-trade flows that weaken the yen. The BOJ remains reluctant to raise rates despite Japan's exposure to energy-driven inflation, perhaps because its banking system relies heavily on sovereign debt as collateral. Although the intervention strengthened the yen, about one-third of that gain has since reversed, suggesting further action may follow. Markets will be watching how Japan balances banking-system resilience with fiscal sustainability, given its debt-to-GDP ratio above 200 percent.

The U.S. fiscal situation is doing little to restrain the carry trade. Long-term Treasury rates remain near one- to two-decade highs, the federal deficit is running about 6 percent of GDP, and there is little sign of future fiscal restraint. Moreover, the administration is seeking to increase defense spending by more than 50 percent. With divided government likely to return in 2027, an increase of that magnitude appears unlikely through the regular legislative process. However, escalating geopolitical tensions or hostilities could generate bipartisan support for a substantial increase. Conversely, divided government also makes fiscal consolidation and the resulting drag on real GDP growth unlikely during our forecast period.

The AI boom's economic effects remain highly uncertain, raising the possibility that we are misreading the economy's underlying strength. In 2026Q2, perhaps in response to significantly higher prices, some AI-related NIPA components showed signs of slowing, particularly computer-component imports and investment in information-processing equipment. If the AI boom stalls or reverses, the broader economic effects will be difficult to predict. AI's medium-term implications for employment, productivity, and energy demand are additional wildcard risks within the forecast horizon.

Tariff-related risks also remain prominent. The United States' decision not to extend the USMCA, triggering annual reviews until a new agreement is reached, has increased medium-term trade uncertainty. More immediately, likely passage of the Senate-approved bill authorizing secondary tariffs of up to 100 percent on countries purchasing Russian energy could threaten China, India, Japan, and several members of the European Union, exacerbating global trade and political tensions.

Finally, geopolitical risks remain two-sided. Ongoing military and economic conflicts could de-escalate or end, easing sanctions and supply constraints and lowering some commodity prices. Alternatively, they could expand and draw in additional countries, severely straining global trade, commodity markets, and financial markets.