



United States Economic Outlook

2026–2027

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The U.S. Economic Outlook for 2026–2027

Alexander Boca, Jacob T. Burton, Gabriel M. Ehrlich, Daniil Manaenkov, Niaoniao You, and YINUO Zhang

University of Michigan

Executive Summary

Middle East: The Near-Term Wildcard

This forecast was completed just prior to the U.S.-Israeli attack on Iran. The forecast is now effectively predicated on a prompt de-escalation, with limited damage to energy infrastructure and shipping routes through the Persian Gulf. In that scenario, the spike in oil prices should prove largely transitory, with WTI prices trending back toward 60 dollars per barrel by mid-2026. The path of the hostilities represents the most significant near-term wildcard facing the forecast. A more prolonged conflict that disrupts oil flows through the Strait of Hormuz—which handles roughly 30 percent of global seaborne oil trade—could weigh on the global economy.

Resilience Through Shutdown Noise

The headline pace of economic growth appears to have hit a speed bump, with real GDP slowing sharply to an annualized 1.4 percent in the final quarter of 2025. However, this figure was heavily distorted by the record-breaking federal government shutdown, which alone shaved a full percentage point off the growth rate. Looking past these temporary disruptions, real final sales to private domestic purchasers—a cleaner gauge of underlying momentum—grew at a healthy 2.0 percent pace. While this reflects a modest cooling from previous quarters, it highlights the underlying resilience as the economy braces for heightened uncertainty stemming from geopolitical tensions.

Labor Market Stabilization? Too Close to Call

While noisy, incoming labor market data hint that the softening trend of 2024–25 may be abating. Post-revision private payroll job gains appear to have bottomed in August 2025 and have been gradually improving, while the public sector continues bleeding jobs. Unemployment rates have pulled back from their late-2025 peaks. Wage growth, however, is slowing rapidly, and new job opening rates have retreated to a new low. It will likely take several months of consistent

readings to see whether early signs of stabilization translate into more robust labor market trends.

Inflation: Noisy, and Not Yet Tamed

Recent progress toward inflation normalization has been uneven. Year-over-year core CPI inflation eased into early 2026, but the monthly pace picked up in January. Year-over-year core PCE goods inflation has climbed from deflationary territory early in 2025 to near 2.0 percent in December. Even without accounting for shutdown-related data distortions, the underlying trend shows that inflation remains a concern for the Fed. Inflation expectations, however, have retreated considerably from their peaks, and businesses and consumers alike anticipate further moderation—but an enduring energy price spike linked to hostilities in the Middle East poses a significant near-term upside risk.

Business as Usual Under a Different Statute

The Supreme Court's ruling against the use of IEEPA to impose broad tariffs and the looming review of the USMCA have compounded the trade policy uncertainty faced by businesses. The Administration has responded to the Supreme Court's ruling by invoking Section 122 authority to institute a temporary 10 percent global tariff. Concurrently, several Section 301 investigations are underway that could eventually push tariff rates higher in a durable manner. As a result, we do not expect a drastic decline in the effective tariff rate through 2027. Although the USMCA is likely to stay in place, the possible transition to annual reviews will make planning long-term investments more challenging.

No Cuts until Next Fed Chair

The FOMC cut rates by 25 basis points in December before holding steady in January, and we expect it to leave rates unchanged until at least mid-2026. The combination of persistent above-target inflation, a still-resilient labor market, and the approaching Fed

leadership transition calls for patience. We project two additional 25 basis point cuts over the course of 2026, bringing the federal funds rate to the terminal range we project for this cycle. However, ongoing hostilities with Iran may lead to higher prices and renewed inflation pressures, potentially delaying inflation normalization and further rate cuts.

Fiscal Gridlock before the Midterms

With the record-breaking shutdown over, the immediate fiscal path is likely to remain relatively calm. The appetite for significant new legislative initiatives has largely evaporated with the 2026 midterm elections approaching. Although prolonged Middle East conflicts may increase the likelihood of emergency military funding, our baseline assumes fiscal policy remains essentially on autopilot. With nearly all fiscal 2026 appropriations now enacted, federal spending holds roughly flat relative to the previous fiscal year.

Cautious Recovery in the Housing Market

The housing market is navigating a slow and uneven recovery. Mortgage rates declined meaningfully from their 2025 peak of over 7.0 percent to roughly 6.0 percent by early 2026, giving buyers some renewed breathing room. New and existing home sales showed encouraging improvement late in 2025, but builder sentiment has softened again in early 2026 amid affordability concerns, elevated construction costs, and an ongoing inventory overhang of new homes.

The 2026–2027 Outlook

We expect the rebound from the federal shutdown to help boost the annualized pace of real GDP growth to 2.7 percent in 2026Q1. Growth of private domestic final demand edges down through mid-2026 as higher tariff

costs and slowing wage growth weigh on consumption, before firming in the second half of the year as monetary easing and tax relief filter through. Calendar year real GDP growth registers 2.6 percent in 2026 and 2.1 percent in 2027.

The unemployment rate edges up from 4.3 percent in early 2026 to 4.4 percent by mid-year amid tepid private sector momentum, before flatlining through 2027. Monthly private payroll gains dip to roughly 69,000 in 2026Q2 before recovering to around 90,000 per month by the end of 2027. Government employment contributes little to growth over the forecast, as modest gains at the state and local level largely offset the continued decline in federal civilian employment.

Despite an anticipated mid-2026 blip due to previous collection gaps, inflation continues its trajectory to normalization. Headline CPI inflation drifts down toward 2.7 percent by year-end 2027, with PCE inflation following a similar path toward 2.3 percent.

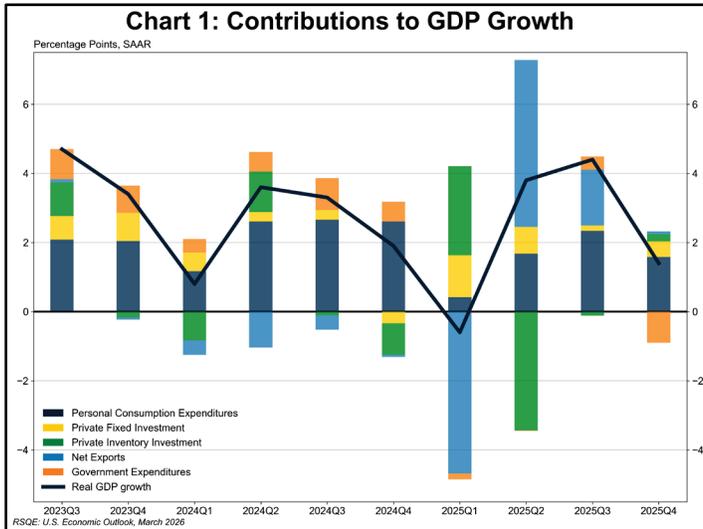
The housing market recovery remains gradual and uneven. We expect new single-family starts to recover slowly to around 967,000 units by 2027Q4 as mortgage rates decline and the inventory overhang clears. Multi-family starts hover near 400,000 units over the forecast as slowing population growth tempers rental demand.

Light vehicle sales, which averaged a 15.7-million-unit pace in 2025Q4 following the expiration of the EV tax credit, fell to 14.8 million in January 2026 before rebounding to 15.8 million in February. We expect the underlying baseline pace to stabilize near 15.7–15.9 million units through 2027, as renewed trade uncertainty following the Supreme Court ruling and the looming USMCA renegotiation are likely to keep automakers cautious about managing their production.

	Actual		RSQE Forecast	
	2024	2025	2026	2027
GDP (billions of current \$)	29298.0	30779.0	32481.0	34000.2
Real GDP (billions of 2017 \$)	23358.4	23864.5	24475.8	24984.6
% change: year-over-year	2.8	2.2	2.6	2.1
% change: 4th-qtr-to-4th-qtr	2.4	2.2	2.3	2.0
Nonfarm payroll employment (millions)	157.7	158.4	159.0	160.1
Civilian unemployment rate (%)	4.0	4.3	4.4	4.4
Capacity utilization, total industry (%)	76.1	76.0	76.0	76.0
Inflation (private nonfarm GDP deflator, % change)	2.5	2.8	2.9	2.5
Inflation (CPI-U, % change)	3.0	2.7	2.9	2.8
Inflation (core CPI, % change)	3.4	2.9	3.1	2.9
Light vehicle sales (millions)	15.9	16.2	15.7	15.8
Private housing starts (thousands)	1370.6	1358.5	1317.2	1345.2
3-month Treasury bill rate (%)	5.0	4.1	3.3	3.1
10-year Treasury note rate (%)	4.2	4.3	4.0	3.9
Conventional mortgage rate (%)	6.7	6.6	5.9	5.7
Real disposable income (billions of chained 2017 \$)	17723.9	18005.3	18226.3	18582.4
% change	2.9	1.6	1.2	2.0
Corporate profits after tax (billions of current \$)	3498.8	3479.3	3834.4	4045.2
Value of U.S. \$ (FRB broad index), % appreciation	2.2	-0.1	-4.3	0.0
Current account balance (NIPA basis, billions of current \$)	-1179.9	-1157.8	-1004.9	-987.4
Federal surplus (FY, NIPA basis, billions of current \$)	-1826.2	-1889.6	-1831.9	-1929.9

The Current State of the Economy

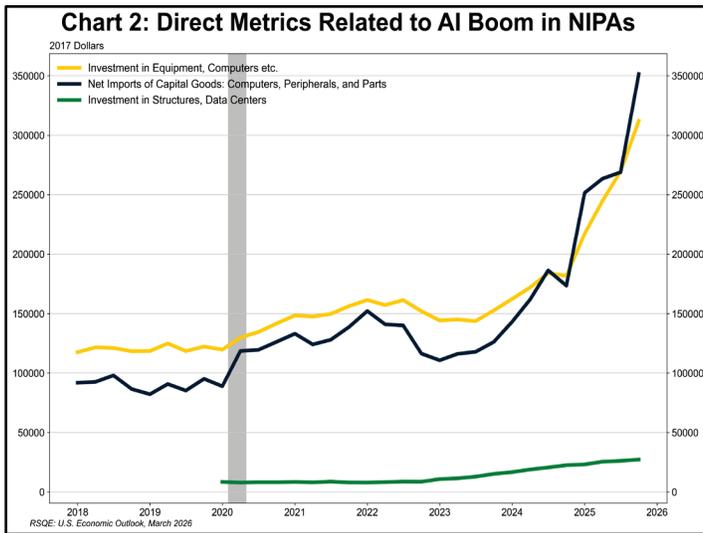
The quarterly annualized pace of real GDP growth slowed sharply to 1.4 percent in the final quarter of 2025, 3.0 percentage points slower than in 2025Q3. Chart 1 shows the pace of headline growth along with its sources. The growth contributions of net exports and private inventory investment registered a very tame 0.1 and 0.2 percentage points, respectively, after fueling the wild swings in



headline economic growth previously in the year. Last fall's federal government shutdown, which was the longest to date, crushed the value added of hundreds of thousands of federal employees in the National Income and Product Accounts (NIPAs) during 2025Q4, resulting in a 1.0 percentage point drag on growth for the quarter. The contribution of real final sales to private domestic purchasers, the

sum of the maize and blue bars on Chart 1, contributed about 2.0 percentage points to growth. It also slowed relative to 2025Q2–Q3, but only modestly, falling from 2.5 percentage points to 2.0 percentage points—still a healthy contribution. We believe this metric is a better measure of economic momentum than the growth rate of the whole GDP.

One frequently cited narrative explaining resilient growth despite the sharply higher tariffs is the ongoing AI boom. The direct evidence in the NIPAs is inconclusive, however. Business fixed investment contributed 0.5 percentage points to overall growth in 2025Q4, with the strongest boost worth 0.7 percentage points coming from investment in information processing equipment. However, as shown on Chart 2, the AI-related surge in domestic equipment investment over 2025 was fueled by an explosion of imports of computers and parts, which subtract from real GDP. The build-out of data centers has

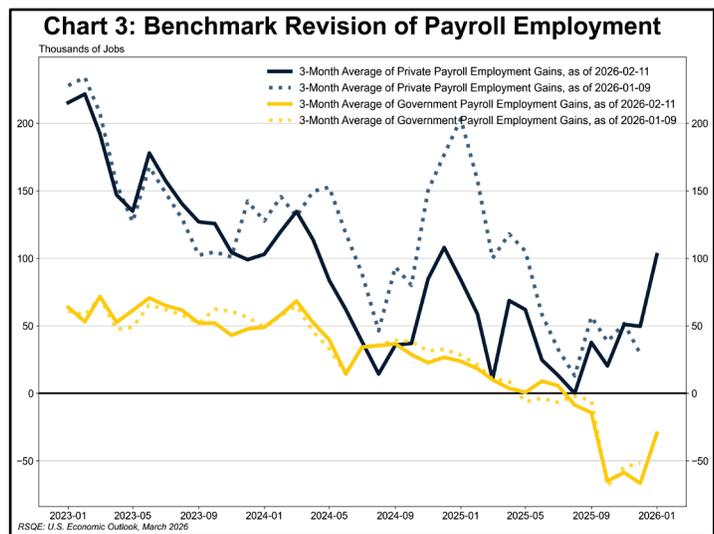


accelerated in recent years but added little to real GDP.¹ On balance, the NIPA series most likely to capture the AI boom have so far delivered little net growth over 2025.² We certainly do not suggest that the impact of AI on growth has been trivial. In fact, the AI boom has boosted stock values and helped sustain consumption and the flow of business investment in other sectors of the economy

(e.g., energy). On the other hand, without the AI boom, monetary policy probably would have been looser, boosting other interest rate-sensitive sectors relative to where they ended up in 2025.

The labor market is showing some signs of stabilization. The jobs report released in early February incorporated the annual establishment survey benchmark, matching the series closely to administrative data between April 2024 and March 2025.³ Furthermore, the introduction of several methodological changes and the re-estimation

of seasonal factors resulted in revisions to both historical and post-benchmark data. Chart 3 shows the results of that revision for private and government job counts. While the public sector appears just as likely to continue bleeding jobs in the revised data, the private sector outlook may be stabilizing. In the post-revision data as currently published, the 3-



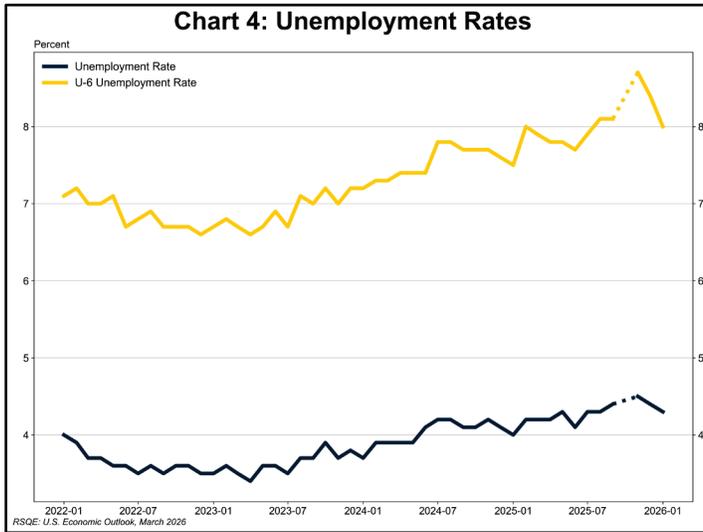
month average of private payroll job gains dropped to zero in August 2025 and has been gradually picking

¹ Unlike traditional factories, where permanently installed equipment intrinsic to factory output shows up in nonresidential investment in structure, equipment powering data centers is not considered to be permanently attached to the factory floor and thus shows up in business equipment investment.

² There are a few other NIPA series such as investment in software where the impact of AI is potentially visible, but growth rates are not yet outsized by historical standards.

³ The usual introduction of new population controls for the household survey has been delayed until the March 6th report.

up since.⁴ Nonetheless, it will take more months of data to confirm this change in the trend, as payroll job

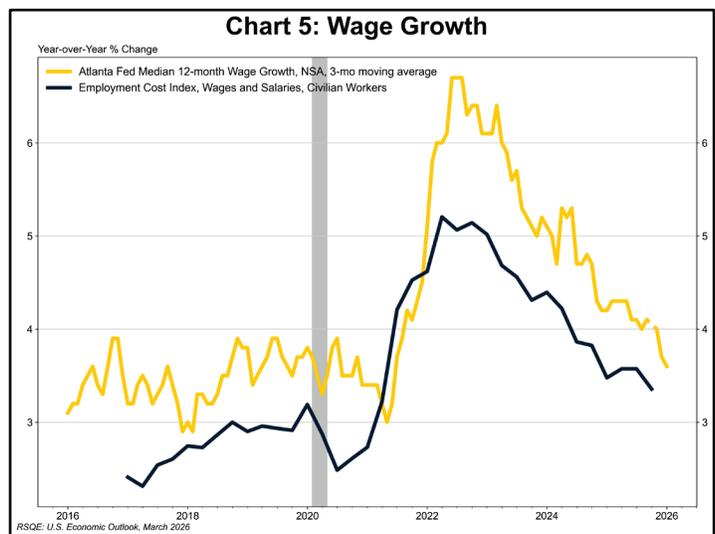


gains have been subject to large month-on-month revisions over the past few years. Additionally, the underlying patterns of net immigration that drive labor supply growth remain volatile and hard to estimate, making the interpretation of payroll job gains even more challenging.

Chart 4 shows recent data on unemployment that are consistent with the

trend toward stabilization. New unemployment insurance claims continue to remain exceptionally low. Both the headline and the broader U-6 unemployment rates for January 2026 came in below their respective September 2025 readings.⁵ However, the household survey's sampling error has likely risen substantially over the prior decade, as response rates have trended down from nearly 90 percent a decade ago to below two-thirds in January 2026. Hence, it will take several months of stable unemployment rate readings to validate the recent declines.

Wage growth is still slowing, however. Chart 5 shows the employment cost index and data from the Atlanta Fed wage growth tracker. Both metrics are cooling rapidly, approaching their pre-pandemic readings. Policymakers will



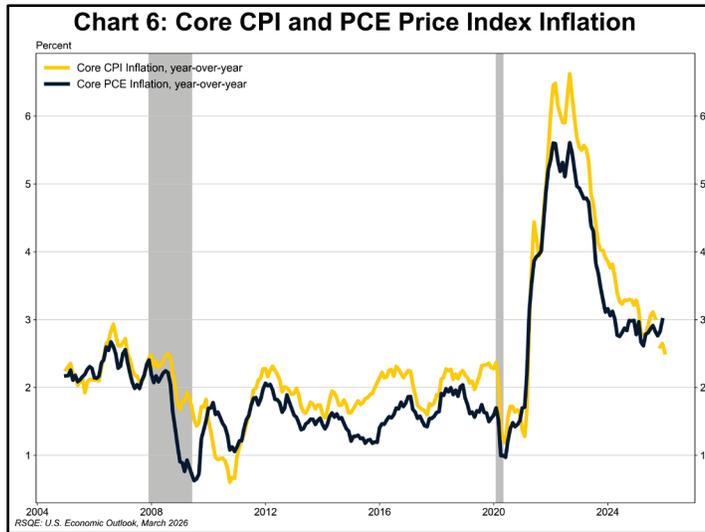
be watching wage growth dynamics intently over the next few months to see if the recent firming up of private employment growth and the stabilization of unemployment rates translate into wage growth

⁴ This forecast was completed prior to the release of the February 2026 jobs report on March 6th.

⁵ The U-6 rate includes people working part-time but unable to find fulltime work for economic reasons, and those who want a job, are available to work, have searched for a job over the prior 12 months, but did not search over the four weeks preceding the survey.

trends. Additionally, the rate of new job openings in the Bureau of Labor Statistics' (BLS's) Job Openings and Labor Turnover Survey has dipped substantially in November–December 2025, declining to its lowest level since May 2017, excluding the early portion of the COVID-19 pandemic in the first half of 2020.

All in all, the labor market is sending mixed and likely noisy signals, tilted slightly toward the conclusion of the softening trend observed over much of 2024–25.



Last year's shutdown has also injected some persistent "noise" into recent inflation metrics. The funding lapse prevented October data collection and compressed the BLS's November survey window. Therefore, the headline CPI time series is permanently missing in October, and the November reading is likely noisier than usual.⁶ Moreover, because shelter inflation is derived from a six-

month rotating panel, the bias introduced through missing data and the subsequent imputation procedure will be largely resolved with the release of April 2026 CPI report, for which the October households are due to be surveyed again. All in all, we believe there is likely a downward bias in recent CPI levels that will persist through the March report.^{7,8}

Noise aside, progress towards inflation normalization has been mixed. Despite the deceleration in year-over-year core CPI inflation to 2.5 percent in January 2026, the annualized monthly rate poked up from 2.8 percent in December to 3.6 percent in January 2026. Meanwhile, twelve-month core PCE inflation rose to 3.0 percent in December. From March to December 2025, year-over-year core PCE

⁶ In fact, the CPI-U motor vehicle insurance series were missing for November, as well, because BLS deemed the data was inadequate for publication.

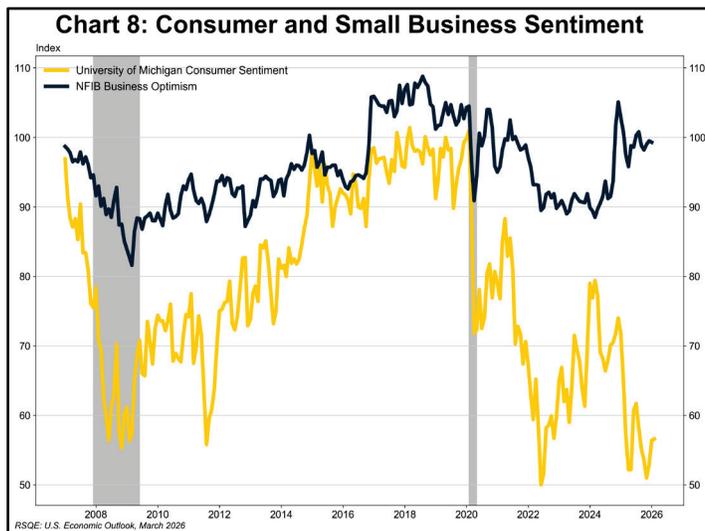
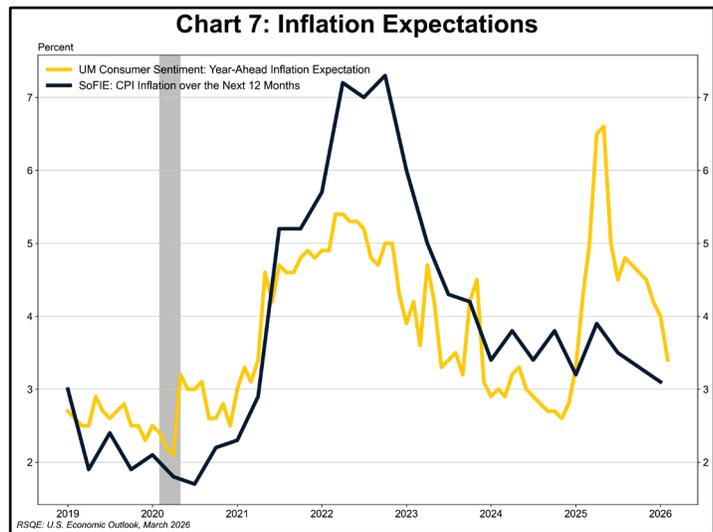
⁷ For further details regarding the impact of the shutdown on the CPI, see <https://www.bls.gov/cpi/additional-resources/2025-federal-government-shutdown-impact-cpi.htm>.

⁸ The October PCE price index is inferred based on geometric means of the September and November CPIs for relevant components; hence, it also shares the downward bias from shelter. For further details regarding the impact of the shutdown on the PCE, see <https://www.bea.gov/news/2026/personal-income-and-outlays-october-and-november-2025>.

goods inflation ramped up from a sub-zero rate to near 2.0 percent, while “supercore” inflation remained entrenched above 3.1 percent.⁹

Despite lingering inflationary pressure, short-term inflation expectations have normalized closer to pre-tariff levels. Consumers’ year-ahead inflation expectations from the University of Michigan’s Survey of Consumers have been easing for six consecutive months since August 2025. However, this encouraging trend may be

susceptible to gasoline price spikes resulting from prolonged hostilities in the Middle East. The latest data from the Federal Reserve Bank of Cleveland’s Survey of Firms’ Inflation Expectations (SoFIE) indicates that firms anticipate further moderation in CPI inflation as well. Notably, the share of respondents expecting year-ahead CPI inflation to exceed 5 percent dropped below 15 percent for the first time since the onset of the pandemic.



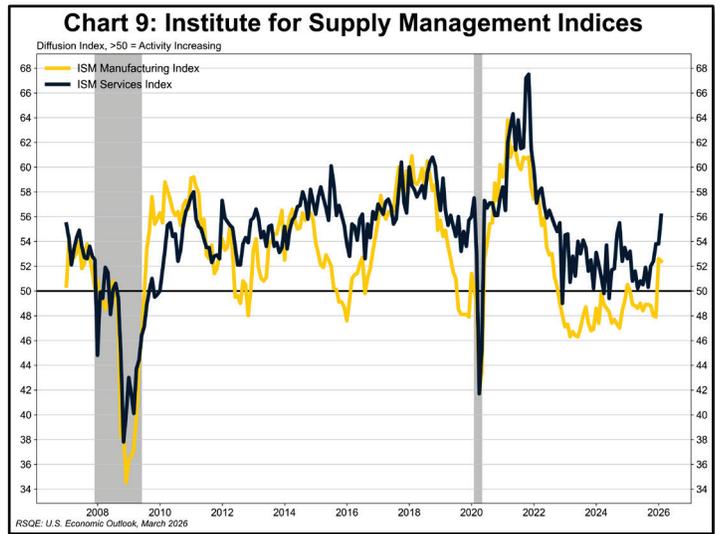
Prior to the start of the recent turmoil in the Persian Gulf late in February, the prevailing mood among consumers and small businesses suggested stability, with no immediate flashpoints or significant upside risks. The University of Michigan’s index of consumer sentiment bottomed in November 2025 and has since turned around. This improvement is more pronounced among

families with incomes over \$100,000. Nevertheless, consumer sentiment remains well below its pre-

⁹ Supercore inflation measures the growth rate in the services price index excluding energy and housing.

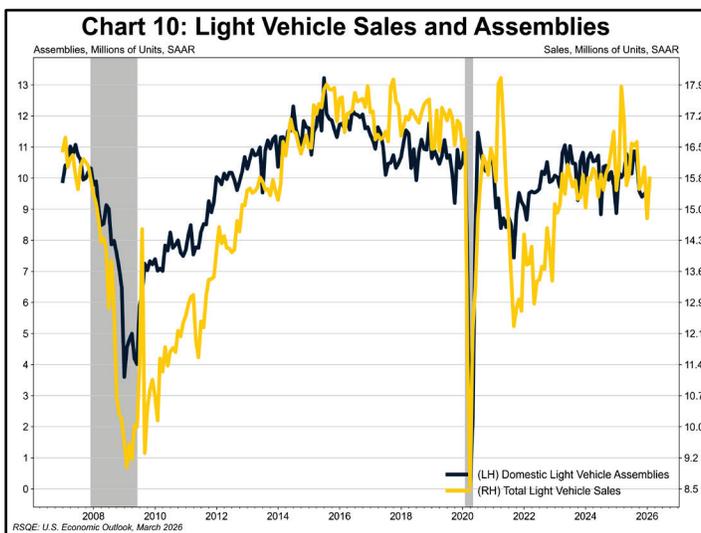
pandemic average. Meanwhile, optimism among small businesses is holding up, partially supported by improving expectations of future sales, which dipped considerably in March–April 2025.

The beginning of 2026 saw a synchronized uptick in both the manufacturing and service sectors. The Institute for Supply Management's Purchasing Manager Indices (PMIs) for the manufacturing sector saw its largest increase in five years this January, jumping 4.7 index points to cross the 50-point expansionary threshold. This momentum extended through February, hinting at a



renewed expansion within the sector. This recovery was partially bolstered by increased activity in new orders and production. A softer overall tariff stance in the near term may help to sustain this strength, while surges in energy prices could threaten this outlook. The service sector continues to demonstrate resilience. Following six months of contraction through November 2025, the employment activity subindex has since remained in expansionary territory through February 2026.

The annualized monthly pace of light vehicle sales declined considerably late in 2025, averaging 15.7 million units in October–December after averaging 16.4 million over the first nine months of the year.



The expiration of the electric vehicle (EV) tax credit in September contributed significantly to the slowdown. The sales pace again dropped sharply to 14.8 million units in January 2026, likely reflecting harsh winter conditions late in the month. The February sales pace rebounded to 15.8 million, which we deem to be a sustainable near-term pace. The annualized rate of domestic light vehicle

production has retreated by roughly 1.0 million units relative to the April–September 2025 pace, averaging 9.5 million since October 2025, perhaps due to declines in production of some EVs and the outright discontinuation of others. These losses were concentrated among General Motors, Honda, and Ford, with the latter likely suffering from the aftermath of the September 2025 Novelis aluminum sheet plant fire. Despite significant tariffs, CPI inflation for new vehicles remains tame.

The new round of trade uncertainty associated with the recent Supreme Court tariff decision as well as the looming joint review of the United States–Mexico–Canada Agreement (USMCA), may be contributing to vehicle manufacturers’ cautious approach to managing production.

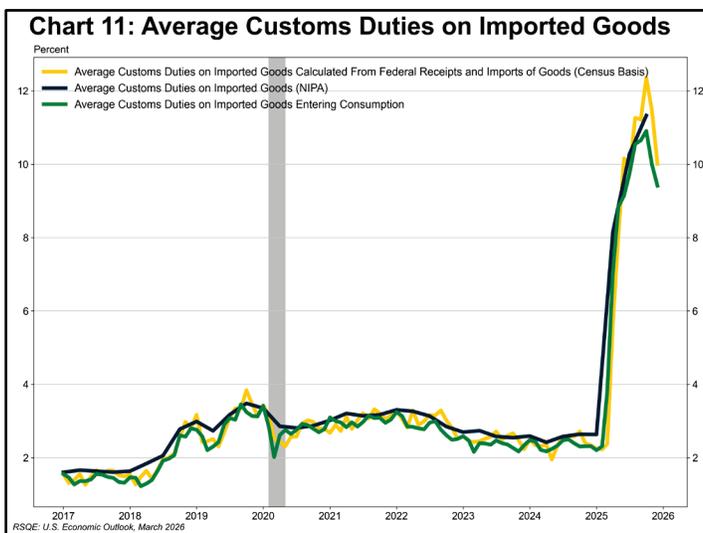
Overall, the economy appears resilient enough to continue expanding at a moderate pace and is unlikely to be derailed by adverse external shocks of modest size.

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

Trade Policy

Although the Supreme Court struck down the Trump Administration’s use of the International Emergency Economic Powers Act (IEEPA) to impose tariffs, we do not expect to see a macroeconomically significant shift in the broad forward-looking tariff landscape just yet. As the Administration engages in the USMCA joint review process with our trade partners, we expect the current status quo to hold, albeit shadowed by elevated uncertainty.

The effective tariff rate edged down marginally late last year even prior to the Supreme Court’s



decision. Chart 11 illustrates the average tariff rate across various metrics: monthly readings derived from Treasury statements and the Census Bureau trade reports (maize and green, respectively) typically lead quarterly readings from the NIPA table (blue). Our preferred measure in green, which likely better reflects actual tariff rates paid by businesses

because it includes goods previously stored in customs bonded warehouses and Foreign Trade Zones, stepped down to 9.4 percent in December from a peak of 10.9 percent in October, as the yearlong trade truce with China took effect in November.

Despite the Supreme Court's unfavorable ruling, the Administration remains committed to seeking trade policy continuity and will likely reinstate duties near pre-ruling levels through less contestable methods, such as Section 232 and 301 investigations, once temporary authorities expire.¹⁰ While the IEEPA-based fentanyl and global reciprocal tariffs are no longer active, a temporary 10 percent global tariff has gone into effect under Section 122 of the Trade Act of 1974. Designed to address fundamental international balance of payments problems, this measure expires after 150 days unless extended by Congress.¹¹ While the justification for invoking this section remains debatable, we do not expect it to be overturned through litigation prior to its expiration. The previously threatened rate of 15 percent, which is the statutory maximal rate under Section 122, has not been implemented as of this writing. While Section 122 provides only temporary authority, the initiation of several Section 301 investigations could eventually result in higher tariffs for some countries.¹² Given the current level of uncertainty, we currently assume that the average tariff rate will stabilize near 9 percent.

Although the collection of IEEPA-based tariffs has ceased, the status of refunds on previously collected revenue remains uncertain. We expect the refund process to involve prolonged legal battles. As such, our current forecast does not include large-scale tariff reimbursements.

Another outstanding item on the trade agenda is the USMCA joint review due on July 1st. The U.S. is widely anticipated to seek substantive modifications, such as stricter rules of origin and measures to restrict the flow of Chinese products via Mexico or Canada. While discussions have remained primarily bilateral, with Mexico engaging more actively than Canada, we expect the USMCA to stay largely in place for three reasons. First, if no agreement is reached by July, all parties will switch to annual joint reviews

¹⁰ Office of the United States Trade Representative, "Ambassador Greer Issues Statement on Supreme Court IEEPA Decision" (press release, February 2026), ustr.gov/about/policy-offices/press-office/press-releases/2026/february/ambassador-greer-issues-statement-supreme-court-ieepa-decision.

¹¹ Products subject to tariffs under Section 232, such as steel, aluminum, automobiles and parts are not subject to tariffs under Section 122. USMCA compliant goods remain exempted.

¹² White House, "Fact Sheet: President Donald J. Trump Imposes a Temporary Import Duty to Address Fundamental International Payment Problems" (February 2026), www.whitehouse.gov/fact-sheets/2026/02/fact-sheet-president-donald-j-trump-imposes-a-temporary-import-duty-to-address-fundamental-international-payment-problems/.

while the current terms remain in effect until 2035. Second, since the actual implementation of USMCA is a domestic statute, withdrawal requires congressional support, which may prove difficult to obtain. Finally, given the high degree of supply chain integration in the North American auto industry, withdrawal will be detrimental to the domestic manufacturing sector. Ultimately, we believe that simply exiting from the USMCA would be both procedurally challenging and politically unfavorable for the Administration. However, a transition to annual reviews would likely pose more challenges for businesses to plan their long-term investments.

Monetary Policy

The Federal Open Market Committee (FOMC) is continuing to calibrate its policy stance as the federal funds rate approaches the Committee's median longer-run target, and as it prepares for a new Chair. The FOMC reduced short-term interest rates by 25 basis points (bps) at the meeting in December before holding rates unchanged in January. As progress toward inflation normalization remains uneven and risks to full employment recede, we expect the Fed to adopt a wait-and-see approach with two additional 25 bps cuts expected in mid- and late-2026 after the leadership transition. Ongoing hostilities with Iran may lead to higher prices and renewed inflation pressures, potentially delaying inflation normalization and further rate cuts if the Fed follows a typical response to a cost-push shock.

The continued resilience of output growth and the tenacity of the labor market have given the FOMC additional time to assess whether progress toward its inflation target is continuing before committing to further adjustments in policy rates. During the FOMC's January meeting, the strength of household wealth and business investment in technology lent confidence to the majority's decision to keep rates unchanged, although two members advocated for a reduction of 25 bps in the federal funds rate. Meeting minutes showed that participants expected tariff-related inflation to diminish this year, but the pace of disinflation remained highly uncertain.¹³ Some businesses have been delaying their attempts to pass tariff-related costs onto consumers, which could extend the normalization process for inflation. Additionally, commodity price movements driven by conflicts in the Middle East are likely to affect

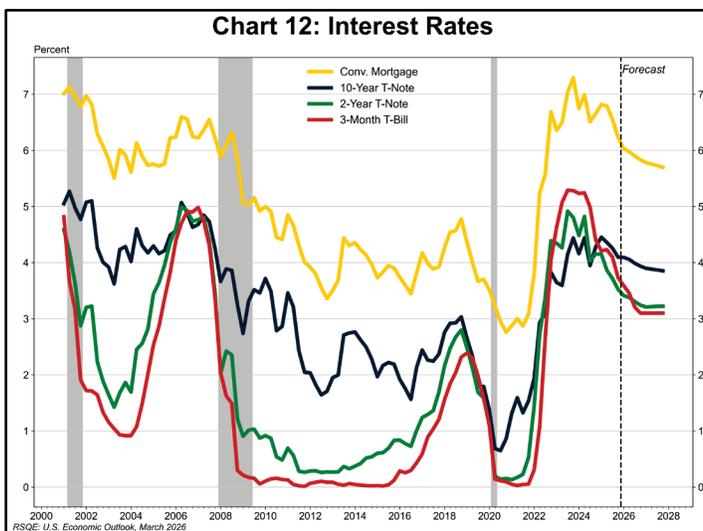
¹³ <https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20260128.pdf>

headline inflation in the near term. Although more FOMC members view the current policy rate as closer to neutral than restrictive, the persistent sluggishness in the labor market justifies the consideration of further rate cuts.

Chair Jerome Powell's term expiration in May is another reason for the FOMC to adopt a wait-and-see approach until at least mid-2026. Kevin Warsh, President Trump's nominee to succeed Powell as Fed Chair, is expected to advocate for less restrictive monetary policy. However, the timing of any further rate reductions is likely to depend on whether incoming data indicate continued disinflation and stable employment.

Our forecast is consistent with a Fed that is slowly transitioning toward a more neutral policy stance, given the low churn labor market and still-elevated inflation. As the tariff-related component of inflation subsides, we expect two 25 bps cuts by the end of 2026. This trajectory brings the fed funds rate range to 3–3.25 percent, the terminal range we project for this cycle. Our forecast assumes that the intense hostilities in Iran will prove relatively short-lived, but geopolitical uncertainties are certain to remain prominent. We believe the most likely alternative path for the FOMC's actions would involve delaying rate cuts by one or two meetings. However, such a delay would have limited impact on the rest of our forecast federal funds rate path.

Chart 12 shows our projections for selected key interest rates. The 3-month Treasury bill rate declines from 3.6 percent in 2026Q1 to 3.1 percent in 2026Q4, before stabilizing at that level through the end of 2027. The 10-year Treasury rate is expected to average 4.1 percent in 2026Q1, before edging



down to around 3.9 percent from 2026Q4 through 2027Q4. The 30-year conventional fixed-rate mortgage rate edges down from 6.0 percent in 2026Q1 to 5.8 percent in 2026Q4 and 5.7 percent in 2027Q4. The announced conversion of maturing and prepaid mortgage-backed securities on the Federal Reserve's balance sheet into medium-term Treasury

debt will likely slow the narrowing of the spread between the 30-year fixed mortgage rate and the 10-year Treasury yield. Planned mortgage-backed securities purchases by the Government-Sponsored Enterprises represent a small fraction of the purchases by the Federal Reserve under pandemic-related policies, and as such we judge that they will likely have limited impact on mortgage rates and spreads.

Fiscal Policy

Last year's federal government shutdown, the longest on record, has left a visible mark on the fourth quarter GDP report. The federal government contribution to growth, at -1.2 percentage points, was the largest drag since 1994Q1. Despite the shutdown triggered by expiring Obamacare premium tax credits, legislative momentum for healthcare reform has subsided following the December 2025 failure to pass partisan healthcare proposals in the Senate.

Looking ahead, the near-term points of contention are likely to center on immigration enforcement measures and geopolitical tensions in the Middle East, with fiscal 2027 appropriations sliding into view later this fiscal year. While developments on both domestic and foreign policy fronts remain fluid, we view the current Congressional debate surrounding them primarily as political discourse. Therefore, our forecast does not assume any immediate fiscal adjustments tied to these issues. Should the conflict in the Middle East escalate or persist, an emergency defense funding package would be on the table.

All appropriation bills for fiscal 2026 have been enacted, with the exception of the bill for the Department of Homeland Security (DHS). Current estimates suggest that the topline spending total remains near \$1.6 trillion for fiscal 2026, roughly in line with fiscal 2025. Within this figure, a roughly \$10 billion reduction in non-defense spending is essentially offset by an equivalent increase in defense outlays.¹⁴ The economic impact of the DHS shutdown, which started mid-February, should be small in the near term, because most DHS employees are classified as essential.¹⁵ We believe the ongoing partial shutdown should be resolved before significant disruptions emerge.

¹⁴ This estimate is based on Congressional Budget Office (CBO) cost estimates for H.R. 6938, H.R. 7006, H.R. 7148, and S.A. 3937 to H.R. 5371. See also Committee for a Responsible Federal Budget, "Assessing FY 2026 Appropriations" (January 15, 2026), available at www.crfb.org/blogs/assessing-fy-2026-appropriations.

¹⁵ "How a DHS Shutdown Affects Different Components and Employees," *Federal News Network* (February 16, 2026), federalnewsnetwork.com/government-shutdown/2026/02/how-a-dhs-shutdown-affects-different-components-and-employees/.

While military action against Iran had long been a possibility, the length and the scope of hostilities remain far from clear even after the current operation began on Feb 28th. Funding for the campaign is likely covered by the defense appropriation of \$150 billion within the One Big Beautiful Bill Act (OBBBA). A prolonged and broad operation, however, will likely exhaust existing budgets and require the Pentagon to seek further supplementary funding from Congress. Meanwhile, we believe the chance of Congress enacting war powers resolutions with a supermajority that would promptly and meaningfully restrain executive authority to continue the strikes remains virtually zero.

Table 1 shows the data and our projections for the federal budget on a NIPA basis for fiscal years 2024 to 2027 by receipts and expenditures categories. Nominal revenue expanded at a brisk 8.6 percent in fiscal 2025 owing to rising tariff revenue. As tax cuts work their way through the economy and inflation slows, revenue growth decelerates to 7.0 percent in fiscal 2026 and to 3.4 percent in fiscal 2027. We do not anticipate tariff revenue refunds, if any, to materialize until after 2027.

We project that federal expenditures growth will moderate as Medicaid enrollment slides, transfer payments decelerate, and federal hiring remains weak. Federal consumption spending growth slows to 2.4 percent in fiscal 2026 before recovering in fiscal 2027 amid a pullback in non-defense spending and continued strength in defense spending. Transfer payment growth eases to 4.3 percent in fiscal 2026 and

	2024	2025	FY Forecast	
			2026	2027
Current receipts	5082.2	5519.8	5908.4	6109.0
% change	4.5	8.6	7.0	3.4
Current expenditures	6908.5	7409.5	7740.3	8038.9
% change	7.1	7.3	4.5	3.9
Consumption	1414.4	1493.0	1529.2	1595.7
% change	7.7	5.6	2.4	4.3
Transfer payments	4311.5	4640.6	4841.6	5019.6
% change	4.0	7.6	4.3	3.7
Federal subsidies	94.5	110.9	110.2	100.2
% change	-9.7	17.3	-0.7	-9.0
Interest payments	1088.1	1165.0	1259.4	1323.3
% change	22.8	7.1	8.1	5.1
Surplus (+) or deficit (-)	-1826.2	-1889.6	-1831.9	-1929.9
Percent of GDP	-6.3	-6.2	-5.7	-5.7

RSQE: U.S. Economic Outlook, March 2026

to 3.7 percent in fiscal 2027 as cuts to safety net programs outlined in the OBBBA take effect. Federal subsidies slide in fiscal 2027 as the agricultural subsidies wane. Finally, interest expense growth slows from 22.8 percent in fiscal 2024 to 5.1 percent in fiscal 2027 as interest rates decline. However, the overall debt service spending level stays

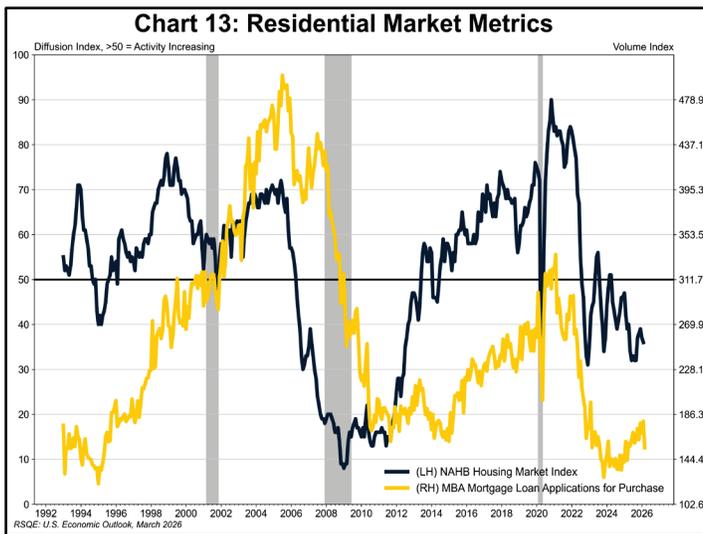
elevated, and maturing long-term debt continues to be refinanced at higher rates.

Revenue growth is projected to modestly outpace expenditure over fiscal 2025–27, narrowing the federal deficit to below 6.0 percent of GDP. As the Federal Reserve redirects its reinvestment of maturing

agency securities towards Treasury bills, we expect federal debt held by private investors to rise slowly, from 84.5 percent of GDP in 2025Q4 to 85.8 percent in 2027Q4.

The Housing Market

The housing market faces a mixed outlook in early 2026. While lower mortgage rates provided a slight boost to demand and modestly improved affordability at the end of 2025, they also contributed to a rebound in home price appreciation. Recent sales data show encouraging but uneven improvement,



yet overall activity remains muted by historical standards. Furthermore, persistent builder caution and an ongoing inventory overhang of new homes continue to weigh on suppliers' sentiment. Looking ahead, we project a stabilization in home appreciation as broader financing conditions gradually ease.

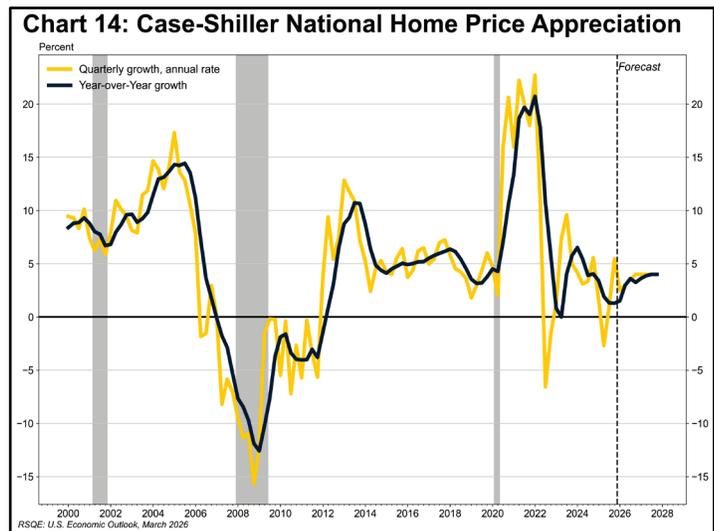
After hovering near 6.8 percent in mid-2025, the 30-year conventional fixed-rate mortgage gradually declined to below 6.0 percent by late-February 2026. This improvement in financing costs gave the market some respite late in 2025. Existing single-family home sales increased to 3.8 million units in 2025Q4, the fastest pace since 2023Q1, though still weak relative to longer historical averages. The annualized pace then fell back to 3.5 million units in January 2026. The new single-family home market demonstrated more robust activity, with sales jumping to 720,000 annualized units in 2025Q4, resulting in the fastest quarterly growth pace since 2022Q1. Overall, recent home sales trends appear bumpy but encouraging, and resilient buyer demand should support the market as financing costs are expected to improve further.

Chart 13 captures both soft buyer activity and builder caution. The chart illustrates the Mortgage Bankers Association's (MBA) purchase application volume index and the National Association of Home Builders (NAHB)/Wells Fargo Housing Market Index (HMI). After recording gains throughout 2025, the

MBA index fell sharply at the start of 2026, returning to levels recorded at the beginning of the previous year. Meanwhile, builder momentum remains constrained by an ongoing supply overhang and persistent concerns about elevated land and construction costs. Reflecting these headwinds, the NAHB HMI registered a reading of 36 in February, marking a deterioration from 2025Q4. This decline was heavily influenced by a sharp drop in the sub-index for sales expectations over the next six months, which fell from above 50 in 2025Q4 to 46 in February, indicating that the optimism seen in late 2025 has dissipated.

The new home market continues to work through an elevated inventory overhang, keeping construction activity restrained. Months' supply of new homes for sale declined during the second half of 2025 but remained elevated at 7.6 months in December, well above the 6-month mark that historically characterized the upper bound of a balanced market. By the end of December, there were 472,000 new single-family houses for sale. While that level was down from the peak of 504,000 in May 2025, it remains at a high level by historical standards. Consequently, single-family housing starts averaged a subdued annualized rate of 939,000 units in 2025Q4. Single-family permits have largely stabilized at a modest sub-900,000 level since May 2025, while multi-family permits remained quite volatile.

Following a period of slowing appreciation in the first half of 2025, which included outright price declines in 2025Q2, home price growth rebounded late in 2025 according to our preferred measure, the seasonally adjusted S&P Case-Shiller Home Price Index shown in Chart 14. The index's annualized quarterly growth rate rose to 5.5 percent in 2025Q4. Despite the return of home price appreciation, overall affordability has modestly improved thanks to the continued decline in mortgage



rates. We project the 30-year mortgage rate to continue declining to 5.7 percent by the end of 2027. Concurrently, we forecast a near-term cooldown in home price appreciation to 2.5 percent in 2026Q1, before recovering to our long-run projection of 4.0 percent by 2026Q4.

Energy Markets

We completed this forecast prior to the February 28th attack on Iran by Israel and the U.S. Global oil and a few regional LNG price benchmarks, already elevated on tensions that preceded the attack, jumped higher following the joint strikes and Iran's retaliation. Our forecast is now effectively predicated on a prompt de-escalation of hostilities without serious lasting damage to energy production facilities and shipping capacity around the Persian Gulf. Substantive resumption of the *status quo ante* would also require the quick retreat of the insurance premiums that insurers charge ships passing through the Straits of Hormuz. We discuss the potential implications of more prolonged hostilities in the ["Risks to the Forecast"](#) section.

In early 2026, as uncertainty about Venezuela's oil production and exports spiked and then the U.S. pressure on Iran escalated, the price of West Texas Intermediate (WTI) increased from the mid-to-upper \$50s around the turn of the year to about \$65 per barrel late in February. Looking through the current geopolitical tensions, however, the global oil market is expected to remain oversupplied in the longer term, as the Organization of the Petroleum Exporting Countries and its allies (OPEC+) remain committed to unwinding their COVID-era production cuts and U.S. crude oil output declines only marginally from its record highs. As a result, we expect the price of WTI to trend just below \$60 per barrel after a spike in the current quarter, as global demand lags supply.

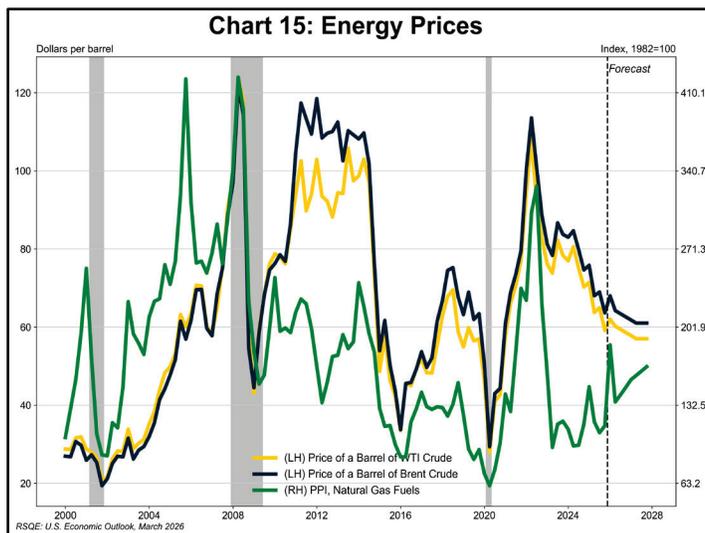
In 2023, global liquid fuels consumption of 101.2 million barrels per day (mbpd) surpassed its 2019 annual level of 100.7 mbpd and has since increased by a cumulative 2.4 mbpd over 2024–25, according to most recent estimates by the U.S. Energy Information Administration (EIA). The agency also projects global liquid fuels consumption to rise by 2.5 mbpd over 2026–27 in their February Short-Term Energy Outlook (STEO). About 1.6 mbpd of this growth will occur in Asia. In the United States, consumption of liquid fuels inches up by 0.1 mbpd over the same period, compared to the 0.3 mbpd increase between 2023 and 2025.

Global liquid fuels production growth has been strong in recent years. In 2025, it exceeded its 2019 level by 5.7 mbpd. The EIA expects global production to rise in sync with consumption in 2025 and 2026, adding 2.5 mbpd through 2027. Planned output increases by OPEC+ and strong supply growth in

in Brazil, Argentina, and Guyana are the primary drivers of this expansion. The volume of oil supplied by Russia, channeled through various third parties to refineries in India and China, remains a large wildcard for the medium-term supply outlook. Domestic production of oil is set to flatline in 2026 and to edge down in 2027, as lower onshore output and subdued prices weigh on total volume. Domestic production of other liquid products will increase marginally.

Chart 15 shows our forecast for WTI and Brent crude oil prices in maize and blue, alongside the Producer Price Index (PPI) for natural gas fuels in green. The price of WTI averaged \$59.1 per barrel in the fourth quarter of 2025, and we had penciled in an average of \$62 per barrel this quarter due to the prevailing geopolitical risk at the time of forecast. As persistent oversupply continues to weigh on the market, however, prices are projected to edge down over the rest of 2026 and stabilize around \$57 per barrel by mid-2027. With the recent change in the Brent benchmark composition, the Brent–WTI spread ought to become less sensitive to disruptions in oil flows from the Persian Gulf. Still, we expect this spread to widen temporarily to \$6 per barrel in the current quarter, but to hold steady at roughly \$4 per barrel through the rest of the forecast.

Natural gas prices, as measured by the PPI for natural gas fuels, rose late in 2025 on prospects of a colder winter and surged in late January 2026 as severe weather disrupted natural gas production. In daily data for February and early March from the Henry Hub, domestic natural gas prices have come down sharply, and they have barely nudged up after the Iran strikes. However, we expect prices to



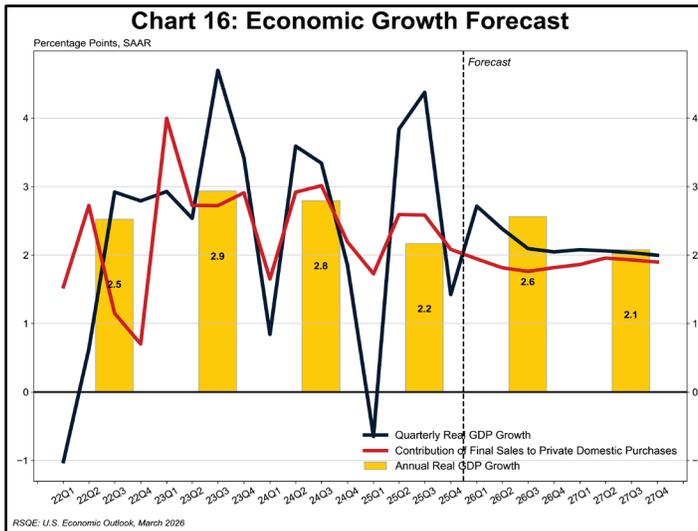
resume their upward march over the next two years as global LNG demand remains strong and domestic prices increasingly gravitate toward the higher prices in other large international markets. We anticipate that strong global LNG demand will continue to support U.S. exports, even as LNG takeaway capacity expands significantly over the

forecast. Additionally, the rising energy demand from data centers will exert upward pressure on domestic

energy prices across all major sources of power unless generating capacity expands rapidly. As a result, we project that natural gas prices will rise by 23.1 percent from the second quarter of 2026 through the end of 2027, far outpacing overall inflation over the same period.

The Forecast for 2026–2027

Over 2025, the economy expanded at a solid clip, despite a barrage of internal and external shocks. Volatile and sharply higher tariffs raised business costs and uncertainty, disrupted supply chains, pushed consumer goods prices higher, and caused wild swings in net exports. Aggressive immigration and border enforcement led to an abrupt slowdown in population growth for 2025–27, with cascading effects on the supply of labor. The passage of the OBBBA brought back very generous business investment incentives, sunset the EV tax credit, and effectively eliminated corporate average fuel economy standards. With further advances in various AI tools, the tech boom continued to boost stock valuations. While the directly measurable impact of AI on real GDP has been small so far, the secondary effects on AI-adjacent sectors were likely non-trivial. An avalanche of new data center and energy project announcements, as well as higher consumer wealth, likely added to growth last year. As a result, private final sales to domestic purchasers contributed 2.3 percentage points to annual 2025 growth, just under the 2022–24 average. Two months into 2026, the tariff uncertainty has spiked again in the aftermath of the Supreme Court ruling, and the joint U.S.-Israeli attack on Iran lifted the price of oil. On the near-term positive side, larger tax refunds due to the OBBBA are flowing to consumers. Overall, while we do not expect the list of shocks hitting the U.S. economy during 2026–27 to become shorter, we expect their impacts to be somewhat offsetting, with the broader economy remaining resilient enough to sustain a respectable pace of growth.



- The federal government shutdown subtracts and then adds about 1.0 percentage points to growth in 2025Q4 and 2026Q1, respectively. As a result, the quarterly annualized pace of real GDP growth is projected to rebound to 2.7 percent in 2026Q1.
- The growth contribution of final sales to private domestic purchasers slowed from about 2.5 percentage points in 2025Q2–Q3 to 2.0 in 2025Q4. We expect that contribution to edge down through 2026Q2, as consumers deal with a rising share of tariff costs and slowing wage growth. By 2026H2, the effects of modest tax cuts, less restrictive monetary policy, and a steadier labor market will nudge the contribution of private domestic final demand upward.
- The jagged pattern of quarterly growth rates in 2025 matters for calendar year 2026 real GDP growth, which will read 2.6 percent despite quarterly growth rates exceeding that pace only in 2026Q1. Annual growth then settles to 2.1 percent in 2027.
- Over 2025H2, a declining saving rate helped consumption contribute 2.0 percentage points to growth even while real disposable income flatlined. We expect the growth contribution of consumption to slide into a more sustainable 1.0–1.3 percentage-point range over the forecast as the saving rate stabilizes.
- The growth contribution of nonresidential fixed investment remains solid in the forecast. The build-out of AI-related infrastructure, equipment, and software is helped by robust investment in industrial equipment and solid growth of truck sales to businesses.
- Residential investment is not projected to start adding to growth until 2026Q3, as home affordability remains a challenge despite declining mortgage rates. Slow projected population growth zeros out the growth contribution of multi-family housing construction over the forecast period.
- After a very volatile 2025, the quarterly growth contributions of net exports and inventory investment settle down by 2026H2.

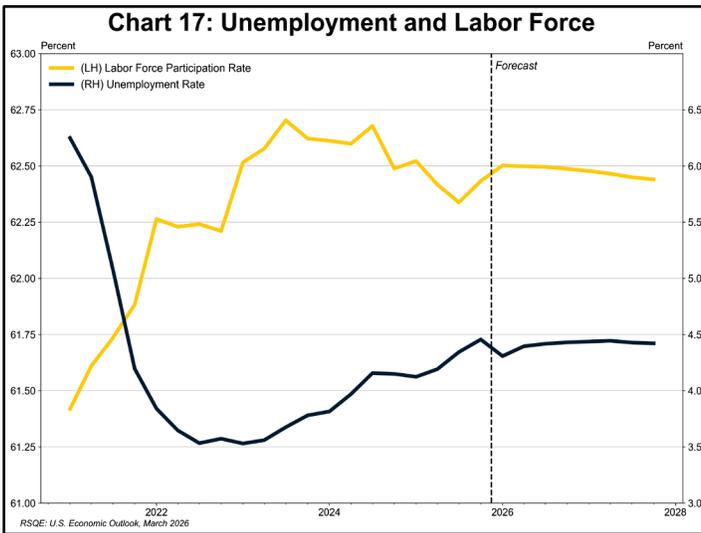
Table 2

Contributions to the Growth of Real GDP

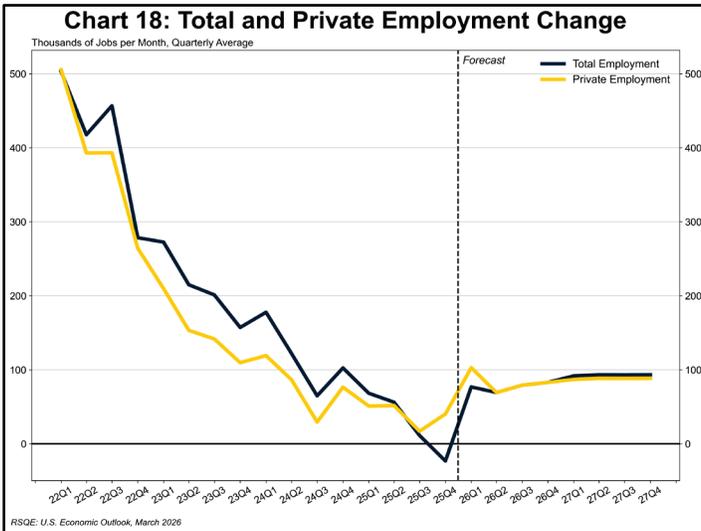
(Average quarterly contributions, percentage points at annual rate)

	'25Q4	'26Q1	'26Q2	'26H2	'27
Real GDP (% change, AR)	1.4	2.7	2.4	2.1	2.0
Contributions to real GDP growth					
Final sales to private domestic purchasers	2.0	1.9	1.7	1.8	1.9
Consumption	1.6	1.2	1.0	1.2	1.3
Nonresidential fixed investment	0.5	0.7	0.8	0.5	0.5
Residential investment	-0.1	-0.0	-0.0	0.1	0.1
Government purchases	-0.9	1.1	0.1	0.1	0.2
Net exports	0.1	-1.0	0.2	0.1	-0.1
Inventory investment	0.2	0.7	0.3	0.1	0.0

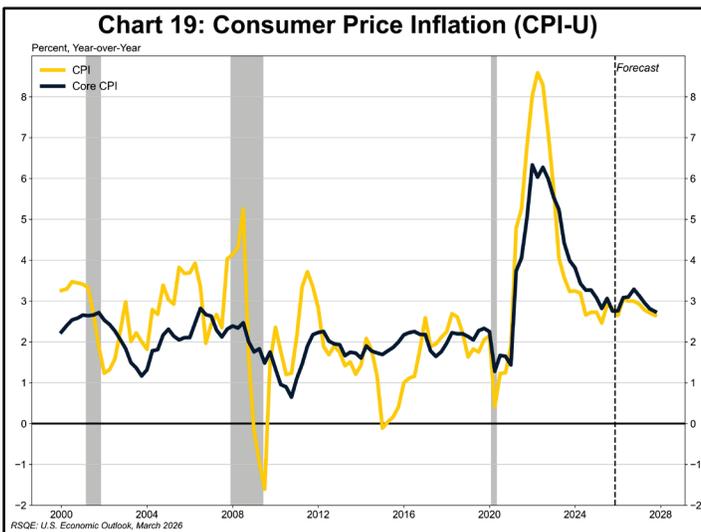
RSQE: U.S. Economic Outlook, March 2026



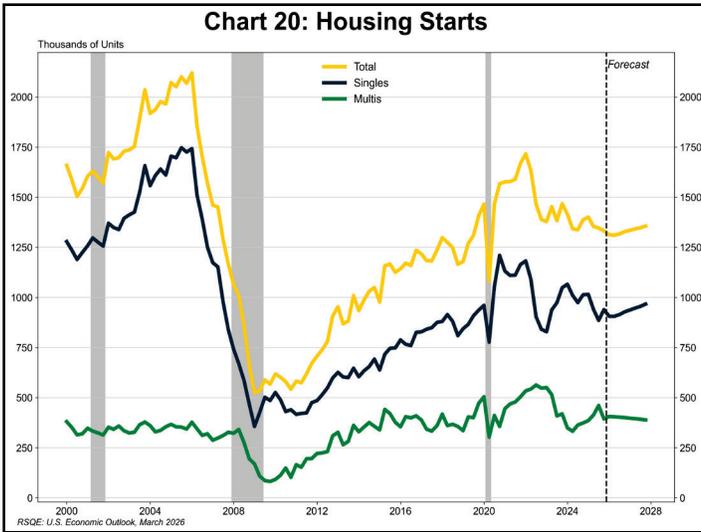
- Signs of labor market stabilization are emerging, although the incoming data have been both noisy and mixed. The headline unemployment rate fell to 4.3 percent in January from the four-year high of 4.5 percent in November. The labor force participation rate has hovered in the 62.4–62.5 percent range since September.
- We expect the labor market to remain largely balanced over our forecast. The unemployment rate inches up from 4.3 percent in 2026Q1 to 4.4 percent in 2026Q2 amid tepid private sector momentum. Easier monetary policy helps stabilize the unemployment rate from then through the end of 2027.
- We expect the participation rate to stay relatively flat over our forecast, as resilient labor demand amid slow population growth draws higher share of working-age people into the labor market, offsetting the drag from ongoing retirements.



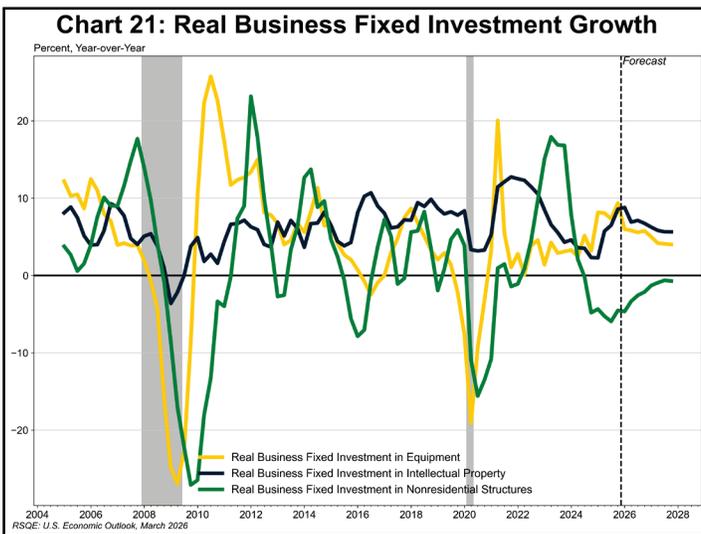
- Payroll employment growth was slow in the second half of 2025 before picking up in January. The January report estimated that 130,000 jobs were added, marking the strongest monthly increase since December 2024. While this pace is encouraging, it is probably not sustainable in the current labor market.
- We expect monthly private sector job gains to dip from roughly 100,000 in 2026Q1 to 69,000 in 2026Q2, as the jump in Q1 retreats and the economy adjusts to higher tariffs. The average pace then improves slowly to 90,000 per month by the end of 2027.
- The pace of government job gains will slow to a crawl over the forecast horizon as local government employment edges up, offsetting declines in federal civilian employment. Federal workers who took separation incentives have now been removed from the payrolls.



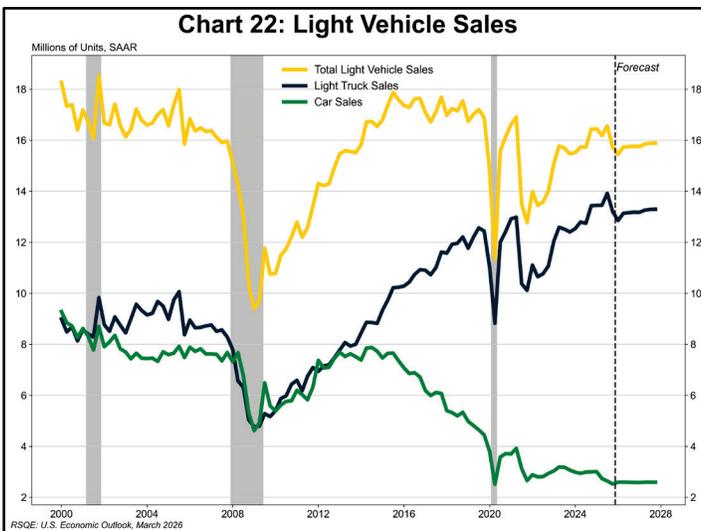
- Year-over-year CPI inflation decelerated from 3.0 percent in September 2025 to 2.4 percent in January 2026. This slowdown was driven by weak energy inflation in December followed by a decrease in prices in January. Twelve-month core CPI inflation registered 2.5 percent in January.
- The government shutdown creates a noisy year-over-year CPI inflation trajectory. The understatement of shelter inflation in 2025Q4 and 2026Q1 should end in April, pushing 2026Q2 headline inflation to 3.0 percent. The resulting “low base effect” elevates measured inflation to 2.9 percent in 2027Q1. These distortions finally wane by 2027Q2, allowing headline CPI inflation to ease to 2.7 percent by 2027Q4, slightly trailing the core.
- PCE inflation, also slightly skewed by the aforementioned shelter effects, remains elevated amid trade policy uncertainty. Year-over-year PCE inflation stays in the 2.7–2.9 percent range through 2026Q3, before decelerating to 2.3 percent by 2027Q4.



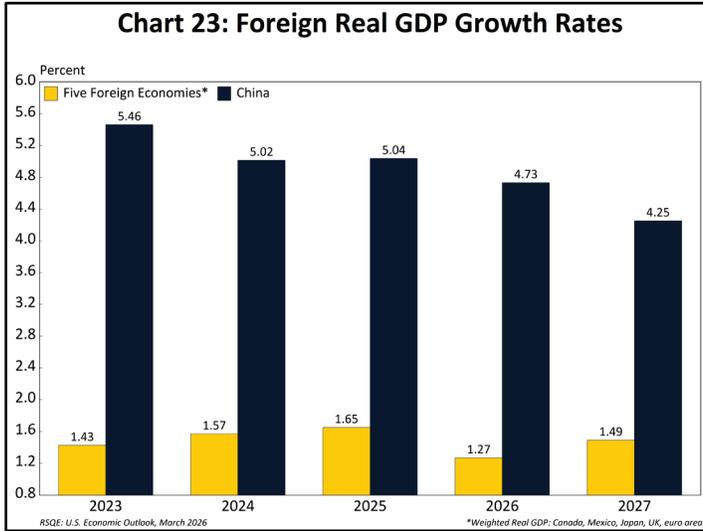
- New single-family housing starts improved to an annualized pace of 939,000 units in 2025Q4. Starts slide to 906,000 units in 2026Q1 amid low builder sentiment before recovering to 967,000 units by 2027Q4, supported by lower mortgage rates.
- Multi-family starts softened to an annualized pace of 394,000 units in 2025Q4. While steady labor market job gains support demand growth and help starts to improve to 406,000 units in 2026Q1, the combination of elevated construction costs and single-family affordability improvements pulls multifamily starts back below 400,000 units in 2027.
- Total housing starts slow to 1,312,000 units in 2026Q1, stalled by lingering uncertainty about the future sales pace. In the medium term, as the existing supply overhang clears, improvements in affordability from lower mortgage rates should help lift total starts gradually. We expect housing starts to rebound slowly to 1,356,000 units by the end of 2027.



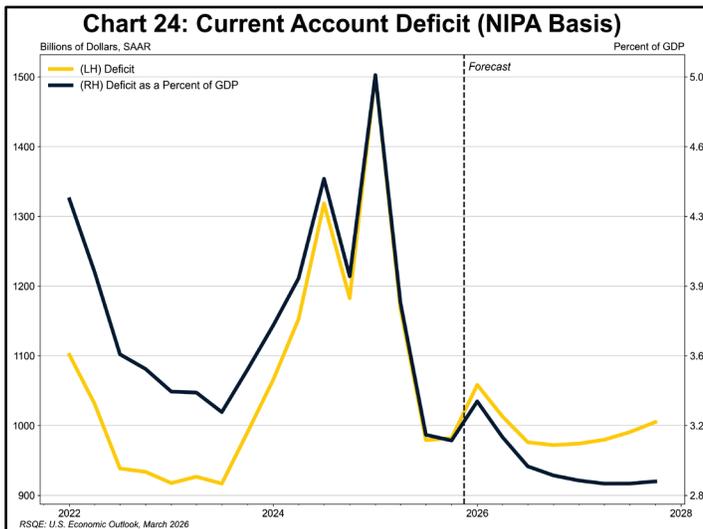
- Business fixed investment in equipment finished 2025 on a strong note, propelled by robust gains in computers and peripheral equipment investment. We anticipate the surge in data processing equipment investment to persist alongside intensifying AI development. The year-over-year growth rate is projected to hold well above 4.0 percent throughout the forecast horizon.
- In 2025, year-over-year growth in intellectual property investment rose steadily from 2.3 percent to exceed 8.0 percent, driven by accelerating investment in software. We expect growth to moderate gradually from its 2026Q1 peak of 8.8 percent year over year, while remaining robust through the end of 2027.
- By contrast, investment in nonresidential structures continues to retreat throughout the forecast period. The surge in construction activity tied to microchip factories gives way to a slump as projects near completion, and the data center build-out does not provide enough boost to compensate. Drilling activity is likely to remain moderate.



- The annualized pace of light vehicle sales fell considerably to 15.7 million units in 2025Q4, largely driven by the expiration of the EV tax credit in September. Sales dropped further to 14.8 million units in January 2026, likely reflecting severe winter weather, before rebounding to 15.8 million in February.
- We estimate the underlying baseline pace of sales has stabilized around 15.7 to 15.8 million units. However, the aforementioned January weakness pulls the overall 2026Q1 average down to a subdued 15.4 million units.
- We expect a cautious approach to vehicle production amid renewed trade uncertainty following the recent Supreme Court tariff decision, the Administration's response, and the looming USMCA renegotiation. As automakers adapt to these new conditions, light vehicle sales hover around 15.7–15.9 million units per year in 2026–27.



- 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 remains solid, meeting its 5.0 percent calendar 2025 growth target. Strong net exports supported growth in the fourth quarter. China recently set its growth target for 2026 below 5.0 percent for the first time in decades. Based on the Bloomberg survey of forecasters, we expect China's growth to cool to 4.7 percent in 2026 and to around 4.3 percent in 2027.
- The composite five-economy calendar year growth rate edged up to 1.7 percent in 2025, as tariff-driven weakness in Mexico offsets a meaningful improvement in Japan, the U.K., and the euro area. In 2026, composite growth slips to 1.3 percent as the Mexican economy accelerates, but the other four slow. In 2027, growth picks up in all five countries, and the composite growth rate picks up to 1.5 percent.



- The current account deficit collapsed to 3.1 percent of GDP over 2025Q2–Q3, after spiking to 5.0 percent in 2025Q1 due to tariff front-running. The 2025Q4 deficit relative to GDP was the lowest since 2020Q3, but it was still somewhat wider than the 2014–19 average of 2.1 percent.
- The deficit widens slightly in 2026Q1, as strong capital goods import growth continues. Over the rest of 2026, growth of imports moderates and the deficit gradually declines toward 2.9 percent of GDP, where it lingers over 2027.
- The bulk of the action is confined to net exports of non-petroleum goods, while net exports of oil, services, and net factor income stay relatively flat as a share of GDP.
- The current account deficit jumps back above the \$1.0 trillion level in 2026H1 but then dips below that level until the final quarter of our forecast.

Risks to the Forecast

We strive to strike a balance between major quantifiable upside and downside risks to the economy in our forecasts. However, hard-to-quantify risks can at times be large, but tilt in an identifiable direction. Additionally, significant developments can occur during the writing of the forecast narrative, skewing the risk balance of the already finalized forecast paths one way or another. The U.S.-Israeli attack on Iran is the most recent example of the latter. As a result, we think that as of this writing the balance of the risks is tilted noticeably to the downside.

Our current forecast effectively assumes a prompt de-escalation of the hostilities and limited lingering damage to energy-related infrastructure and shipping routes in the Persian Gulf. A more prolonged conflict risks severe disruption or an outright halt of the flow of oil and LNG along the two-mile wide shipping lane through the Straits of Hormuz, which accounts for about 30 percent of the global seaborne oil trade and about 20 percent of global LNG. A short supply disruption could be managed via drawdowns of inventories and redirecting LNG from other sources, while spare output is stored offshore within the Persian Gulf. In a longer disruption scenario, only Saudi Arabia and the UAE have significant capacity to redirect their oil exports away from Persian Gulf terminals. The last time a significant share of the Gulf's oil output was disrupted or threatened was in 1990, when oil prices quickly more than doubled before retreating over the course of about six months.

While a persistent run-up in oil prices would benefit domestic shale oil producers, the hit to consumer and business budgets will likely more than offset the positive effect. If the conflict persists or expands into a broader regional war in the Middle East, more commodity and goods markets will be disrupted, as key Asian markets (a major destination of oil shipped out of the Persian Gulf) would be hit by energy shortages, risking cascading supply chain disruption and upward pressure on inflation beyond the elevated energy costs.

Trade policy likely remains the largest source of domestic policy risk. After the Supreme Court ruling, the President has largely restored the broad level of tariffs of 10 percent using Section 122 authority to institute temporary tariffs for up to 150 days. Our forecast assumes that the average tariff will stay at that level through 2027, but it is far from given. If 150 days expire without a permanent Congressional fix, the Administration will have to rely on a patchwork of Section 232 and Section 301 tariffs (or threats thereof) to convince other countries to honor trade agreements made under the threat of reciprocal tariffs instituted under the IEEPA authority. Hence, the tariff path could diverge from our assumptions later this year. Furthermore, the USMCA is up for review and possibly renegotiation later this year, with a broad range of plausible outcomes.

The slimmest of majorities for the GOP in the House of Representatives combined with election-year politics will likely make it impossible for Congress to pass any legislation with significant fiscal

implications. One possible exception could be additional military appropriations should the conflict in Iran persist and expand. The return of a divided government starting in 2027 is our baseline expectation. Should the November 2026 election hand the control of Congress to one party, a considerable divergence of the fiscal trajectory from our forecast is plausible even for fiscal 2027.

The nomination of Kevin Warsh as the next Fed Chair also raises questions about the direction and the scope of the Fed's future policy. We deem it unlikely that the Fed will adjust the policy rate range again before the new Fed Chair takes over in May given the outcome and the minutes of the January 2026 FOMC meeting. However, should the labor market deteriorate sharply or, alternatively, if inflation were to accelerate in February–March, additional action is possible. After May, it is unclear how the views of the incoming Fed Chair will be reconciled with the balance of views of the rest of the FOMC. Should the labor market firm up while inflation remains elevated, it will be hard for the Chair to push for lower rates, despite political pressure. On the other hand, should labor market deterioration resume with few signs of additional tariff passthrough, the incoming Chair may be able to convince a majority of the FOMC to agree to a more rapid decline in policy rates than we have projected.