

War in Middle East weighs on growth, raises inflation

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May 2026



Hallmarks of the US forecast

- US economy has remained resilient and grew at a near-potential rate in 2025.
 - US GDP grew 2.0% over the four quarters of 2025.
 - This is down from 2.4% over the four quarters of 2024.
- In the forecast, growth remains close to potential, despite near-term drag from war in the Middle East.
 - Surging energy prices slow growth of real income and wealth in early 2026 and weigh on consumer spending.
 - US GDP growth eases to 1.6% over the four quarters of 2026.
 - Beyond 2026, growth picks up; the growth profile reflects countervailing effects of various headwinds and tailwinds.
- Unemployment rate rises to a peak of 4.8% by the first quarter of 2027.
- On inflation, tariffs, and now elevated oil prices, push through to finished goods prices.
 - Core PCE inflation rises from 2.9% in the fourth quarter of 2025 to 3.6% by the fourth quarter of 2026.
- Federal Reserve is now on pause. Easing resumes in June 2027.
 - Neutral range (3.00% - 3.25%) reached in December 2027.

Key assumptions in the May outlook

- War in the Middle East
 - The May baseline forecast assumes supply conditions remain tight for months, even if ceasefire holds.
 - Peak restriction in oil supplies occurs in May: “Dated Brent” averages \$145/bbl in May; still \$110/bbl in December 2026.
 - S&P 500 resilient: 7,098 by end of June (does imply downward adjustment from current levels).
- Tariffs
 - IEEPA tariffs, struck down by US Supreme Court, temporarily replaced with Sec. 122 tariffs (going through courts now).
 - Sec. 122 tariffs expire in July, replaced by tariffs authorized under different authority (e.g., Sec. 301).
 - Average effective tariff rate assumed to converge to and remain at 10% indefinitely (below 13% peak, above latest monthly rate of 8%)
- Immigration
 - Vintage 2025 population estimates show that population growth has slowed markedly, primarily reflecting slower immigration.
 - We assume net international migration remains 500,000 below Census (2023) projections annually during Trump presidency.
- Artificial intelligence
 - We assume negligible near-term labor market disruptions, favorable long-term impact (0.4 ppt annual boost to productivity growth).

May baseline forecast

Key summary variables and differences from previous forecast (annual)

	% ch from prior year, or annual average						% ch from Q4 of prior year, or Q4 level					
	2025	2026	2027	2028	2029	2030	2025.4	2026.4	2027.4	2028.4	2029.4	2030.4
Real Gross Domestic Product*	2.1	2.0	1.8	2.3	2.0	1.9	2.0	1.6	2.1	2.3	1.9	1.9
		-0.1	-0.2	0.2				-0.2	-0.1	0.2		0.1
Dom. Final Sales Contribution	2.4	2.1	1.8	2.0	2.1	2.2	1.8	2.1	1.8	2.0	2.2	2.2
			-0.2			0.1		-0.1	-0.2		0.1	0.1
Net Exports Contribution	-0.2	-0.1	-0.3	0.1	-0.1	-0.2	0.4	-0.7	-0.1	0.1	-0.2	-0.2
		-0.1	-0.1	0.1				-0.1		0.1	-0.1	
Inventory Invest. Contribution	-0.1	-0.1	0.3	0.2	0.0	-0.1	-0.2	0.1	0.4	0.1	-0.1	-0.1
		-0.1		0.1		-0.1	-0.1	-0.1	0.1	0.1	-0.1	
Real PCE*	2.6	1.9	1.7	2.4	2.7	2.7	2.1	1.6	1.9	2.6	2.8	2.6
		-0.3	-0.4		0.1	0.2		-0.4	-0.3	0.1	0.2	0.2
Unemployment Rate**	4.3	4.5	4.8	4.6	4.4	4.3	4.5	4.7	4.8	4.5	4.3	4.3
		-0.1								-0.1	-0.1	
Core PCE Inflation*	2.8	3.3	2.9	2.1	2.0	2.0	2.9	3.6	2.5	2.0	2.0	2.0
		0.1	0.3					0.3	0.2	-0.1		
Federal Funds Rate**	4.21	3.63	3.47	3.13	3.13	3.12	3.90	3.62	3.31	3.13	3.13	3.12
		0.01	0.06								0.01	
10-year T-Note Yield**	4.29	4.22	3.95	3.87	3.91	3.95	4.10	4.11	3.89	3.88	3.94	3.95
		0.09	0.02	-0.01	-0.01			0.05	0.01	-0.02		0.01
S&P 500 (period end)***	13.4	9.1	0.3	-0.8	4.1	2.7	16.4	2.0	-1.2	0.9	4.2	2.6
		4.4	1.6	1.0	2.5	2.3		4.4	2.1	0.7	3.0	2.1

Notes: Positive differences from previous forecast shown in teal font, negative differences shown in red font.

* % ch; ** annual average level or level at Q4; ***level at Q4 is last trading day of the year.

Source: S&P Global Market Intelligence

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May baseline forecast

Key summary variables and differences from previous forecast (quarterly)

	25-Q4	26-Q1	26-Q2	26-Q3	26-Q4	27-Q1	27-Q2	27-Q3	27-Q4	28-Q1	28-Q2	28-Q3
Real Gross Domestic Product*	0.5	2.0	1.9	1.3	1.3	1.9	2.0	2.2	2.5	2.4	2.4	2.2
	-0.2	-0.2	0.2	-0.2	-0.5	-0.2	-0.1		0.3	0.3	0.2	0.1
Dom. Final Sales Contribution	0.6	2.9	2.4	1.7	1.6	1.7	1.8	1.8	2.0	2.0	2.1	2.0
			0.4	-0.1	-0.4	-0.2	-0.2	-0.2	0.1			
Net Exports Contribution	-0.2	-1.3	-0.5	-0.4	-0.6	-0.2	-0.2	0.0	0.2	0.1	0.1	0.1
		-0.3		-0.1	-0.2	-0.1			0.1	0.1		
Inventory Invest. Contribution	0.1	0.4	0.0	0.0	0.3	0.4	0.4	0.4	0.3	0.3	0.2	0.1
	-0.2	0.1	-0.2			0.1	0.1	0.1	0.1	0.2	0.2	0.1
Real PCE*	1.9	1.6	1.6	1.6	1.5	1.6	1.9	1.9	2.4	2.5	2.7	2.6
	-0.1	-0.3	-0.3	-0.4	-0.6	-0.4	-0.3	-0.3	0.1	0.1	0.1	0.1
Unemployment Rate**	4.5	4.3	4.4	4.6	4.7	4.8	4.8	4.8	4.8	4.7	4.7	4.6
		-0.1	-0.1									
Core PCE Inflation*	2.7	4.3	3.4	3.5	3.2	2.9	2.5	2.3	2.2	2.1	2.0	2.0
		0.3		0.6	0.4	0.4	0.1				-0.1	-0.1
Federal Funds Rate**	3.90	3.64	3.62	3.62	3.62	3.62	3.57	3.37	3.31	3.13	3.13	3.13
		0.03				0.03	0.19	-0.01				
10-year T-Note Yield**	4.10	4.20	4.33	4.25	4.11	4.04	3.96	3.91	3.89	3.87	3.86	3.87
			0.16	0.14	0.05	0.04	0.03	0.01	0.01		-0.01	-0.01
S&P 500 (period end)***	2.3	-4.6	8.7	-0.8	-0.8	-0.7	0.3	-0.1	-0.7	-0.4	-0.7	0.6
		0.4	6.3	-1.4	-0.5	0.1	0.5	1.4	0.1		-0.2	0.1

Notes: Positive differences from previous forecast shown in teal font, negative differences shown in red font.

* annualized % ch; ** average level; ***simple % change.

Source: S&P Global Market Intelligence

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Comparison of the current episode to the August 1990 experience

Iraq invaded Kuwait on Aug. 2, 1990, setting in motion the First Gulf War

Spot oil prices have not risen as much

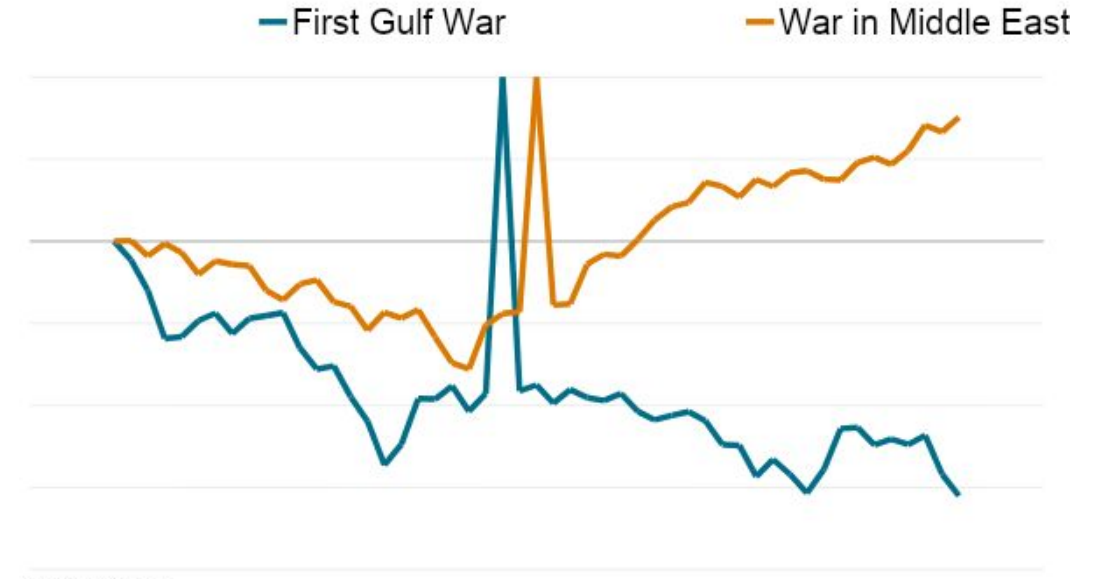
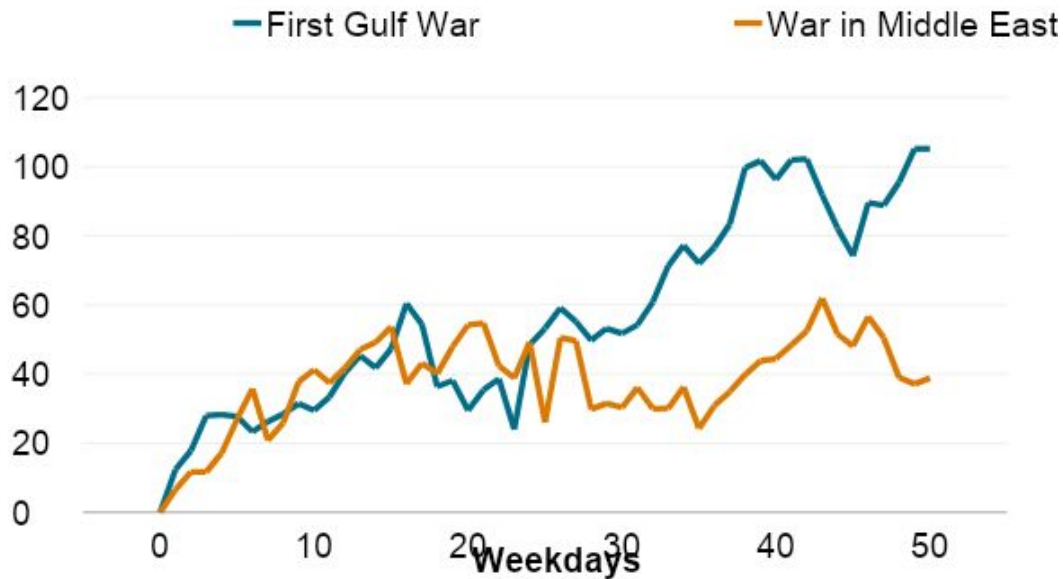
Equities initially sank, have resumed rising path

Brent spot price

Percent difference from weekday 0

S&P 500

Percent difference from weekday 0



As of May 8, 2026.
 Note: Iraqi campaign began Aug. 2, 1990. US-Israeli campaign began Feb. 28, 2026. Shown are percent differences, by weekday, from the weekday prior to the beginning of the respective campaigns.
 Source: S&P Global Market Intelligence; Commodity Research Bureau.

As of May 8, 2026.
 Note: Iraqi campaign began Aug. 2, 1990. US-Israeli campaign began Feb. 28, 2026. Shown are percent differences, by weekday, from the weekday prior to the beginning of the respective campaigns.
 Source: S&P Global Market Intelligence; S&P Global Dow Jones Indices.

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Key factors affecting aggregate demand in the forecast

- Personal consumption expenditures
 - Key drivers are **income** and **wealth**.
 - **Elevated energy prices** and a **flattening of equity values** weighing on real household income and wealth.
 - **Personal tax cut** boosting disposable personal income in 2026.
 - **Elevated productivity growth** supporting real wage growth.
 - **Slowdown in population growth** limiting job and labor-income growth.
- Business fixed investment
 - Investment in **data centers** is surging, but this is still a relatively small sector.
 - Investment in **intellectual property products** (AI) rising rapidly; growth to remain solid in forecast.
 - Investment in **computers** is elevated. Expected to reach a peak soon, begin declining.
 - Investment in **manufacturing structures** (EV batteries, semiconductors) declining; tax credits from IRA rescinded.
 - **Credit spreads** low by historical standards, expected to **widen** in the forecast, reinforce already **elevated real borrowing costs**.
- Inventory investment
 - **Below-optimal stocks** give rise to a rising pace of inventory investment into 2028.

Key factors affecting aggregate demand in the forecast

- Residential investment
 - It's mainly about **demographics**.
 - Slowing population growth translating into **slowing household formation**.
 - Slowing household formation is **weighing on housing starts**.
 - Starts and home sales (residential brokers' commissions) benefiting from **declining mortgage rates**.
- Net exports
 - Trade value of the **dollar is weakening** in the forecast; supporting net exports.
 - Weakening dollar mainly reflects **narrowing interest-rate differential** between US and foreign sovereign yields.
 - **Tariffs** raising the cost of imports, reducing imports and further boosting net exports.
- Government consumption expenditures and gross investment
 - Level of federal spending boosted in near-term from monies allocated in **2025 budget bill (OBBBA)**.
 - New defense outlays to **replenish depleted stocks** of munitions and equipment.
 - In the forecast more broadly, government spending resumes **downward trend as a share of nominal GDP**.

Surging energy prices will pass through to consumer prices

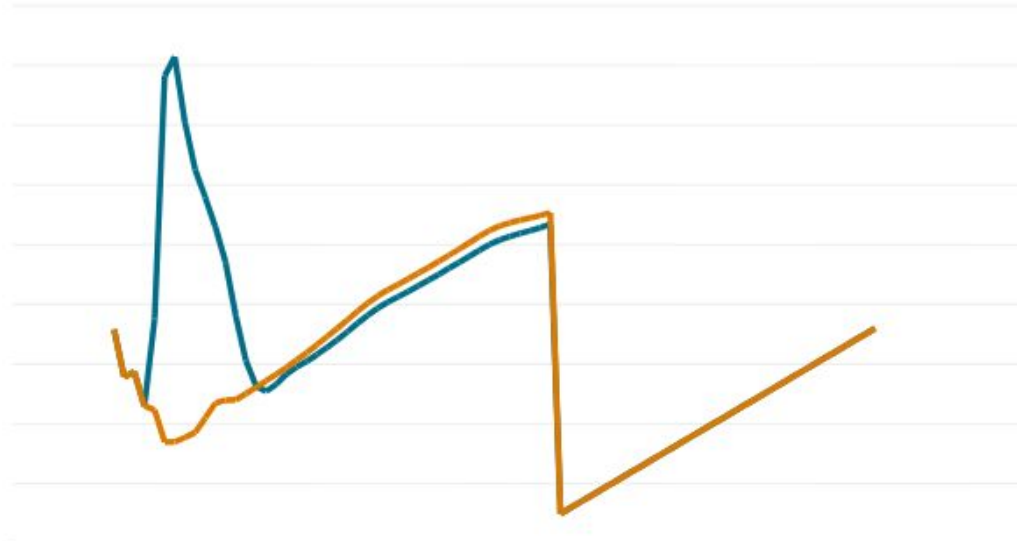
Higher inflation weighs on measures of real income and wealth

Spot Brent peaks at \$121 per barrel in Q3

Brent crude oil

Spot price, dollars per barrel

— May baseline — February (pre-war) baseline



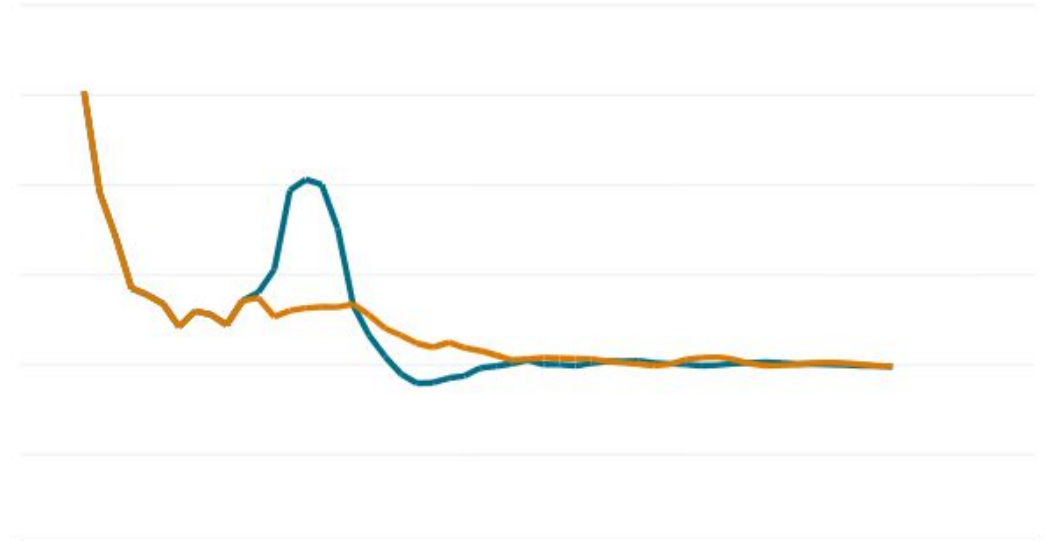
Data compiled May 6, 2026.
Source: S&P Global Market Intelligence, Commodity Research Bureau.
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Inflation reaches 4.1%

PCE inflation

4-quarter percent change

— May baseline — February (pre-war) baseline



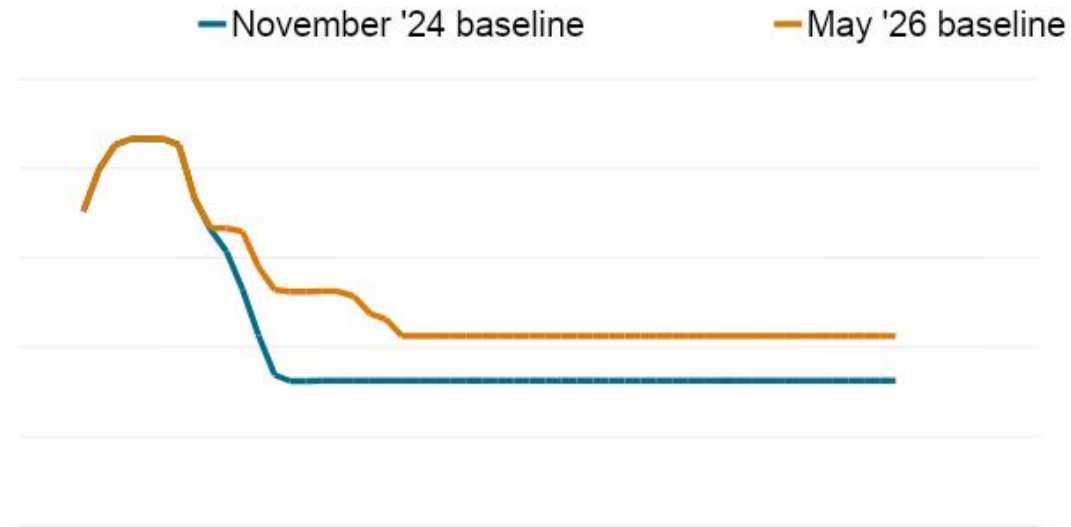
Data compiled May 6, 2026.
Source: S&P Global Market Intelligence, Bureau of Economic Analysis.
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Elevated inflation is keeping the Fed on hold and interest rates broadly higher

Fed slows easing cycle, terminal rate is higher

Federal funds rate

Percent



Data compiled May 6, 2026.

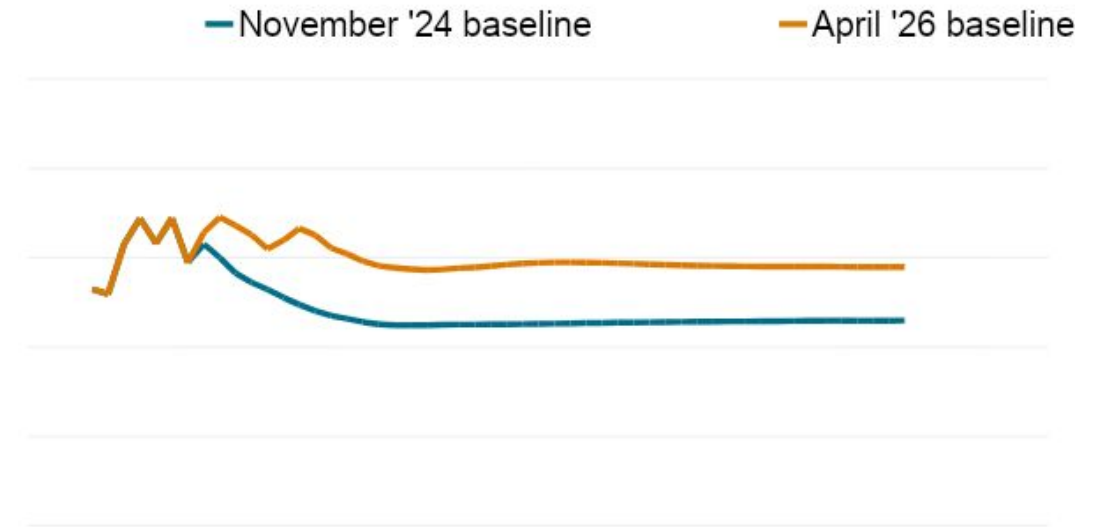
Source: S&P Global Market Intelligence, Federal Reserve Board

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Treasury yield raised by 50 bps

10-year Treasury note yield

Percent



Data compiled Apr. 1, 2026.

Source: S&P Global Market Intelligence, Federal Reserve Board

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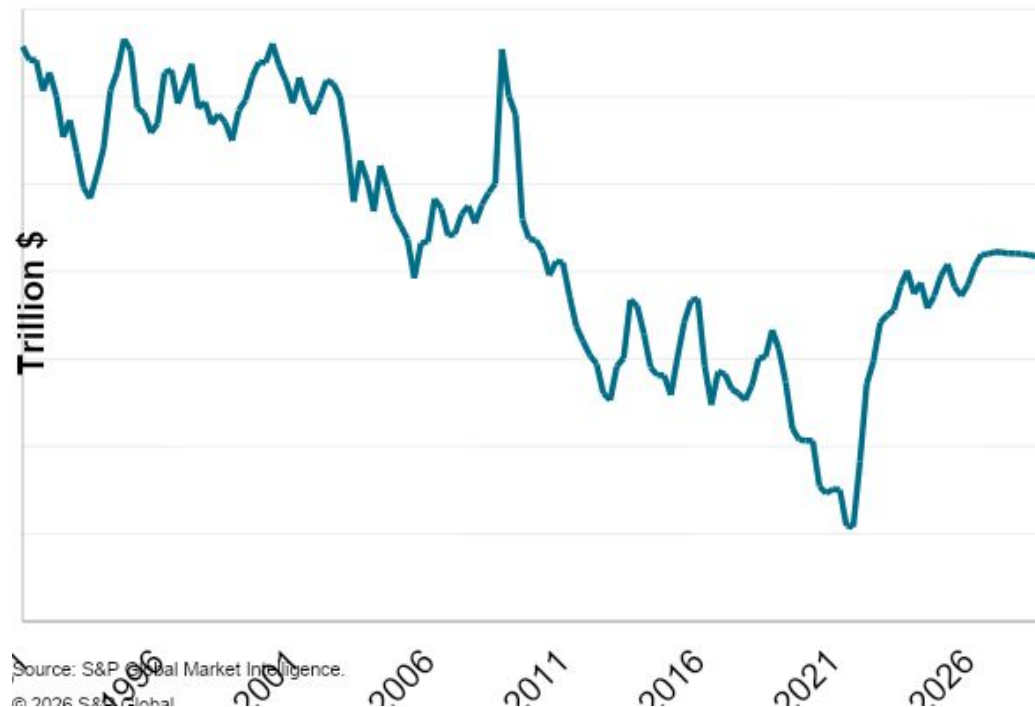
Real corporate borrowing costs are elevated, to weigh on BFI after AI surge

Robust investment in computers and intellectual property products boosting near term investment spending

Highest real borrowing cost in 15 years

Real corporate borrowing cost

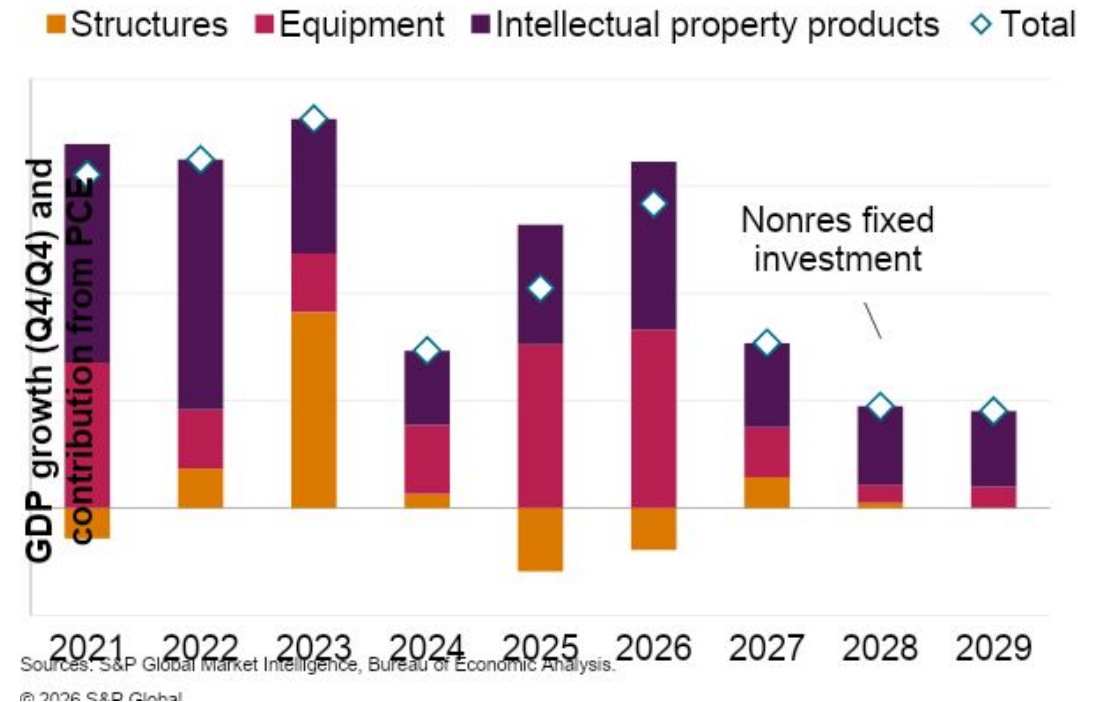
Baa yield less expected inflation, percent



BFI firms through 2026, then slows

Growth of nonresidential fixed investment

Contributions to percent change



Fiscal tailwinds that had been boosting growth have reversed or diminished

Spending on **manufacturing structures** has peaked and **state & local gross investment** to plateau

*Support from IRA is **fading**, tax credits rescinded*

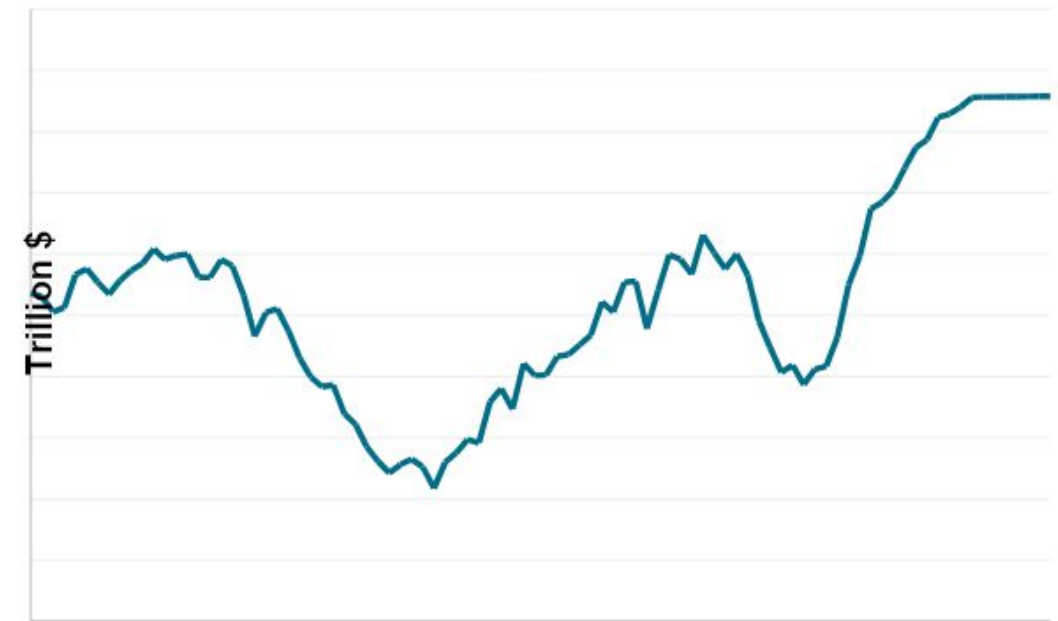
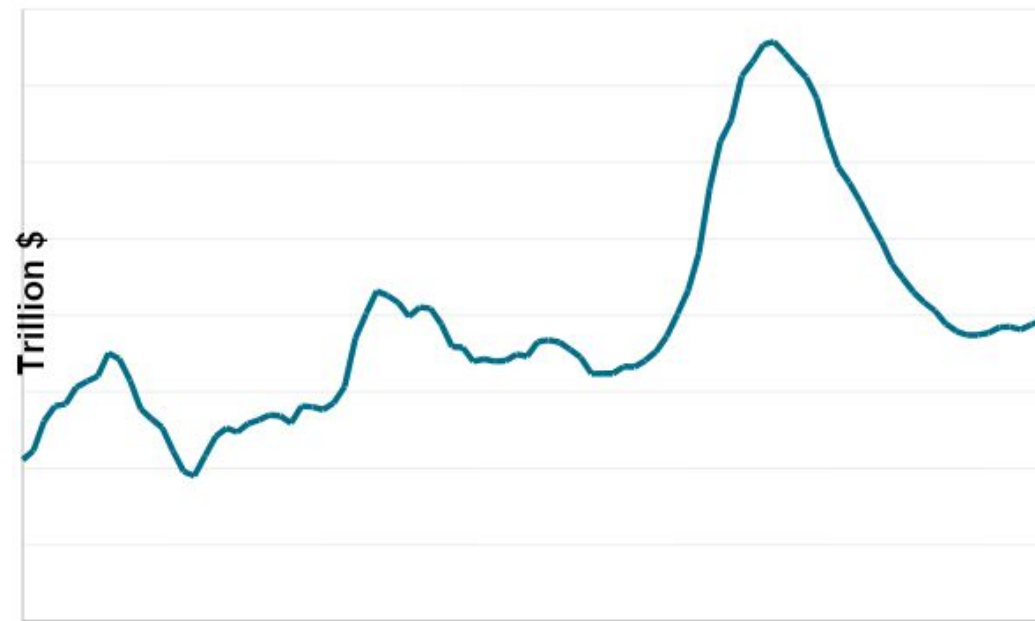
*IIJA no longer supports **growth***

Real fixed investment in manufacturing structures

State & local government gross investment

Billions of chained (2017) dollars, SAAR

Billions of 2017 dollars, seasonally adjusted annual rate



Source: S&P Global Market Intelligence; BEA.
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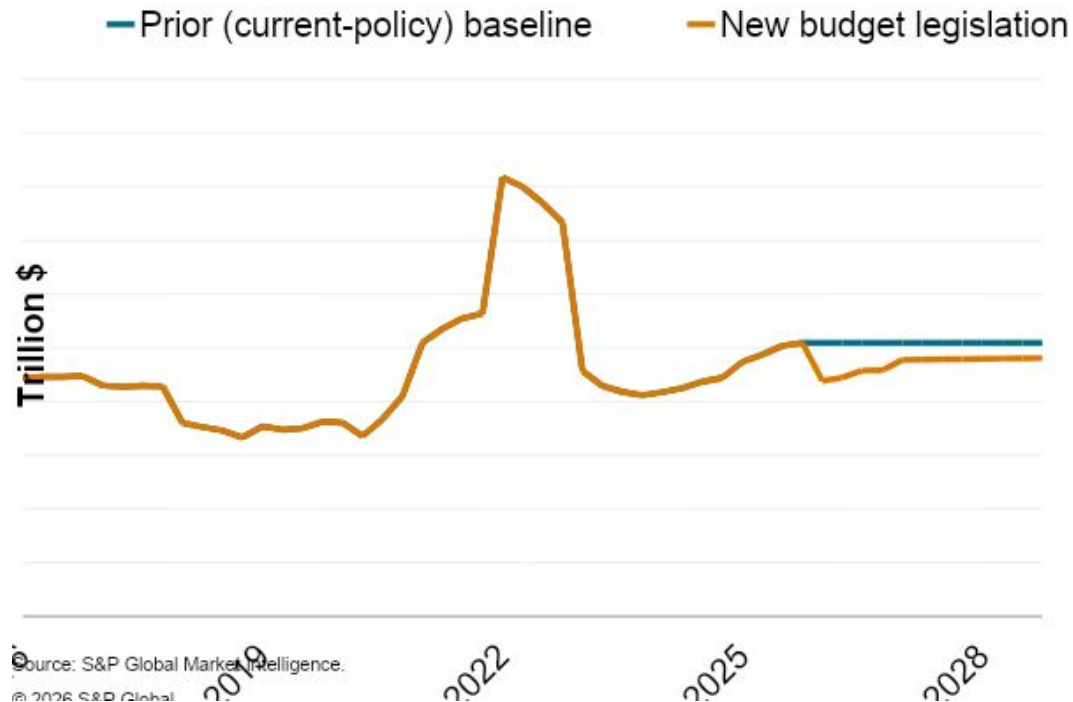
Sources: S&P Global Market Intelligence; BEA.
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New fiscal tailwinds are supporting growth

Summer 2025 budget legislation includes personal tax cuts and increases in federal spending

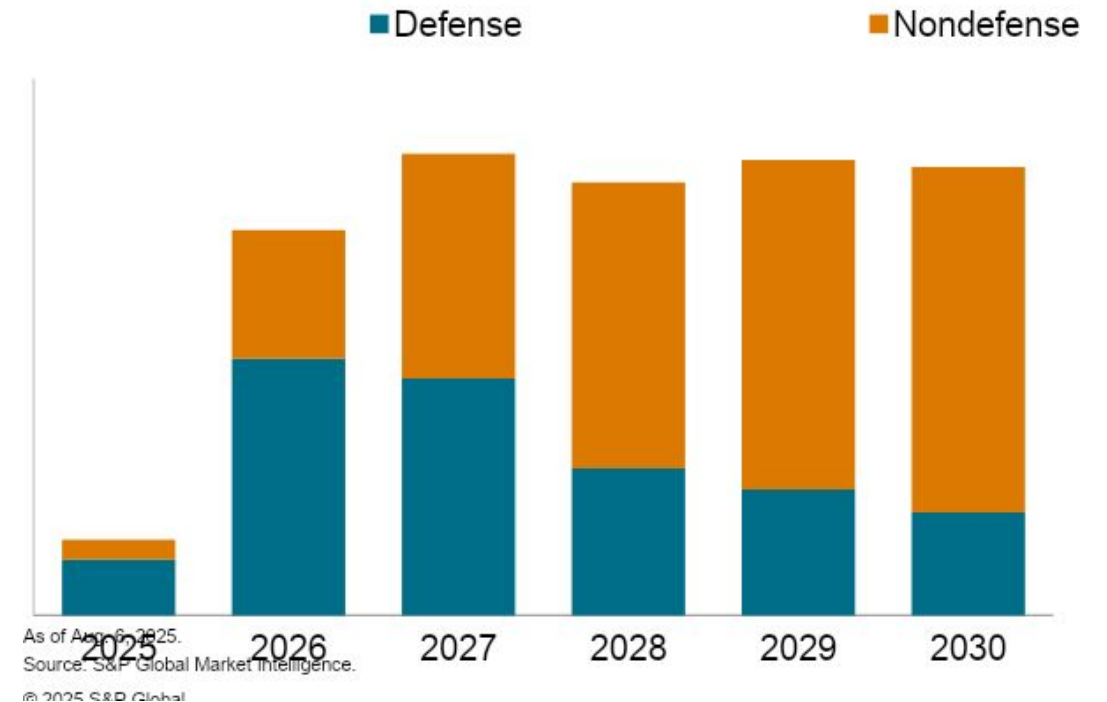
Average federal personal tax rate

Percent of taxable income



Real federal consumption and gross investment

Difference from July baseline, billions of (chained) 2017 dollars



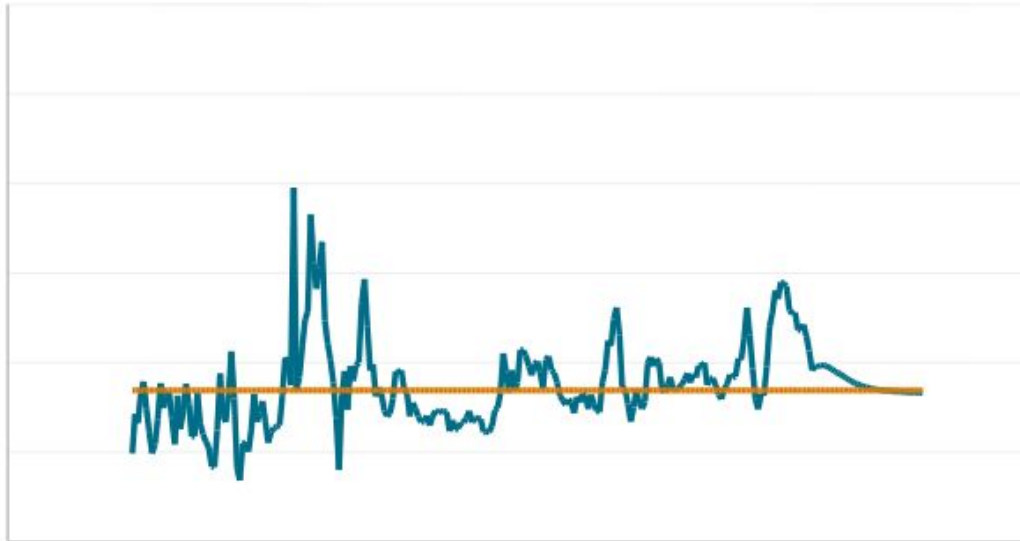
Narrowing mortgage spread, rising inventory investment boosting growth

Narrowing mortgage spread supports housing

Mortgage spread

Conventional 30-year mortgage rate less 10-year Treasury

— Spread — Historical ('66-'25) during expansions



As of May 6, 2026.

Source: S&P Global Market Intelligence; Freddie Mac; Federal Reserve

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Inventory investment boosts near-term growth

Nonfarm I/S ratio & inventory investment

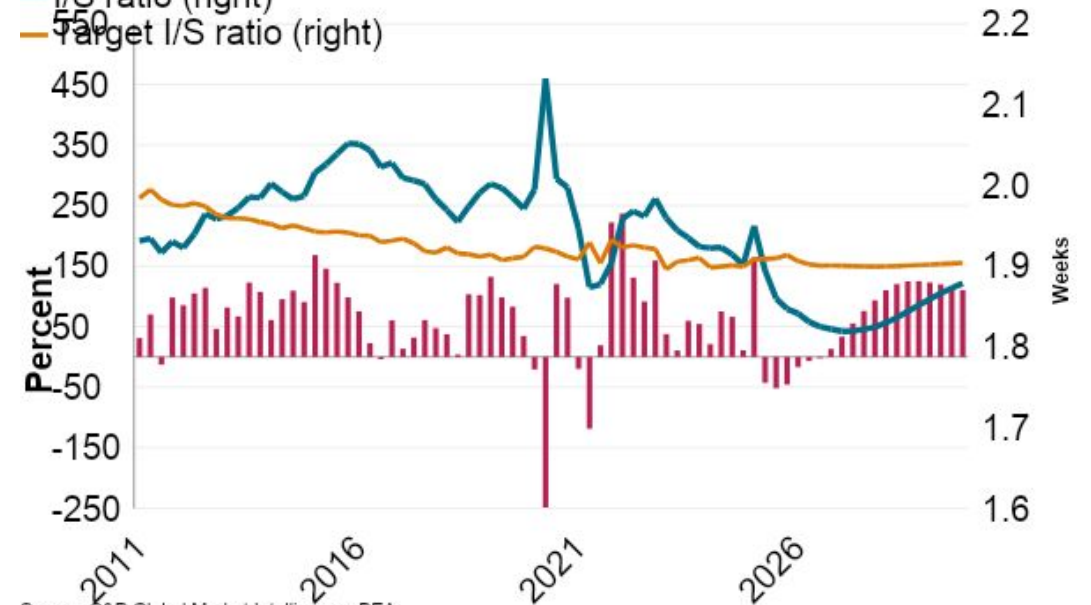
Billions of chained (2017) \$

Months supply

■ Nonfarm inventory inv. (left)

— I/S ratio (right)

— Target I/S ratio (right)



Source: S&P Global Market Intelligence, BEA

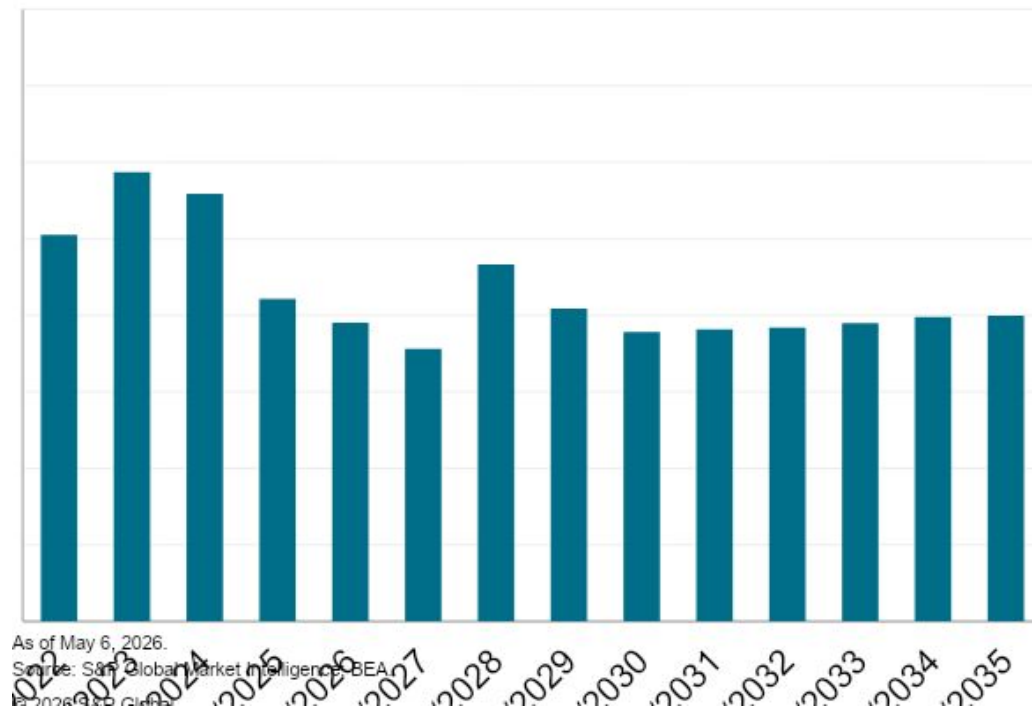
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GDP growth slows from recent rates as headwinds broadly dominate tailwinds

GDP growth settles near long-run potential

Real GDP growth

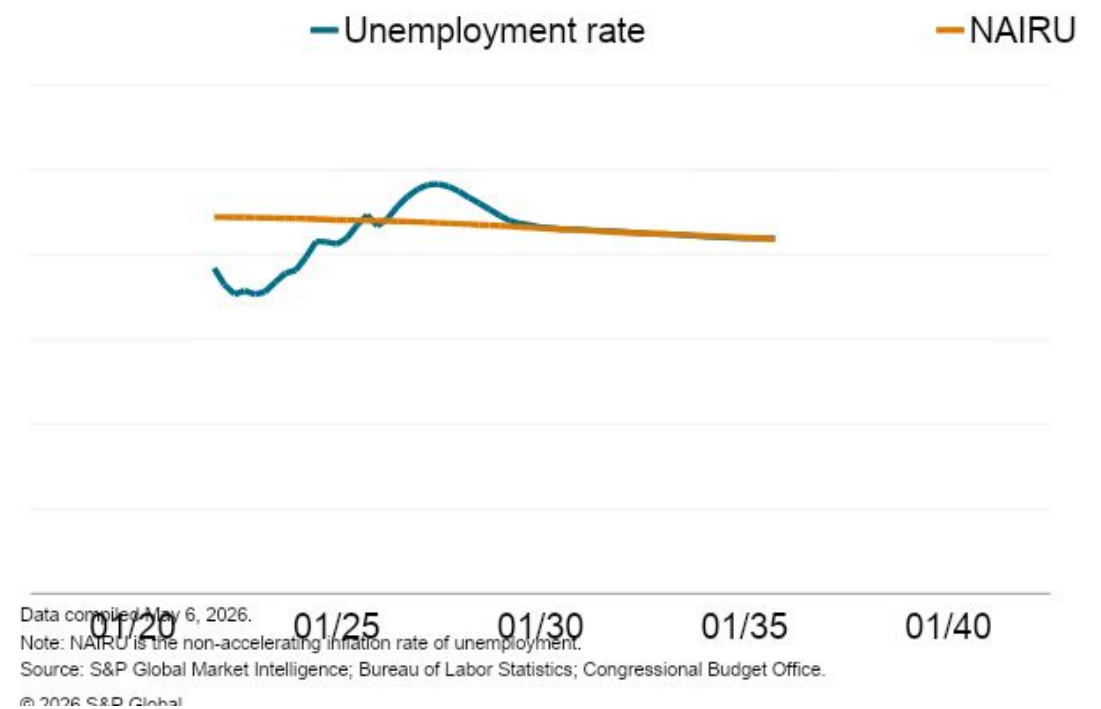
Percent change



Unemployment rate peaks above the NAIRU

Unemployment rate and NAIRU

Percent of labor force

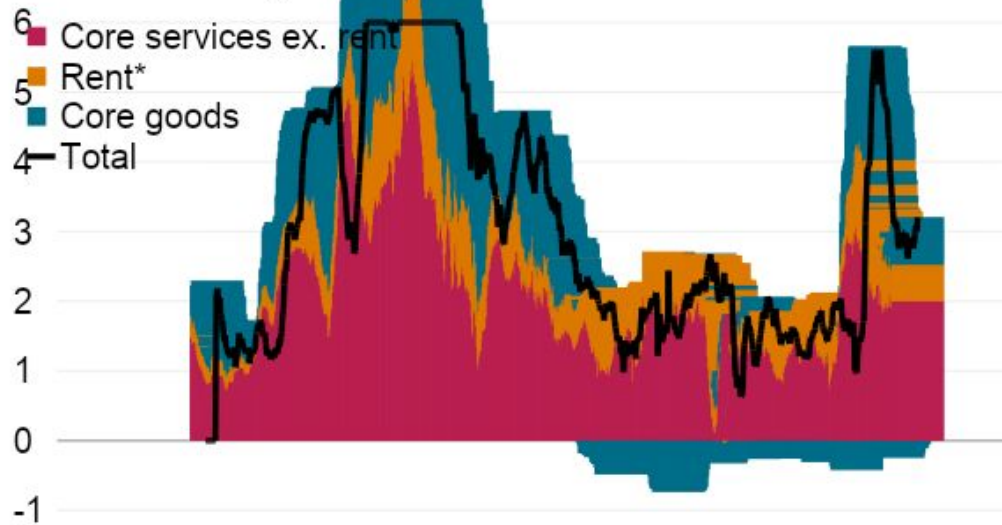


Inflation will eventually be driven by market rents and conditions in labor markets

Core inflation was on a path to 2% prior to tariffs

Contributions to core PCE inflation on

12-month % change



PCE = personal consumption expenditures.

*Rent is imputed rent of tenant-occupied nonfarm housing.

Source: Bureau of Economic Analysis.

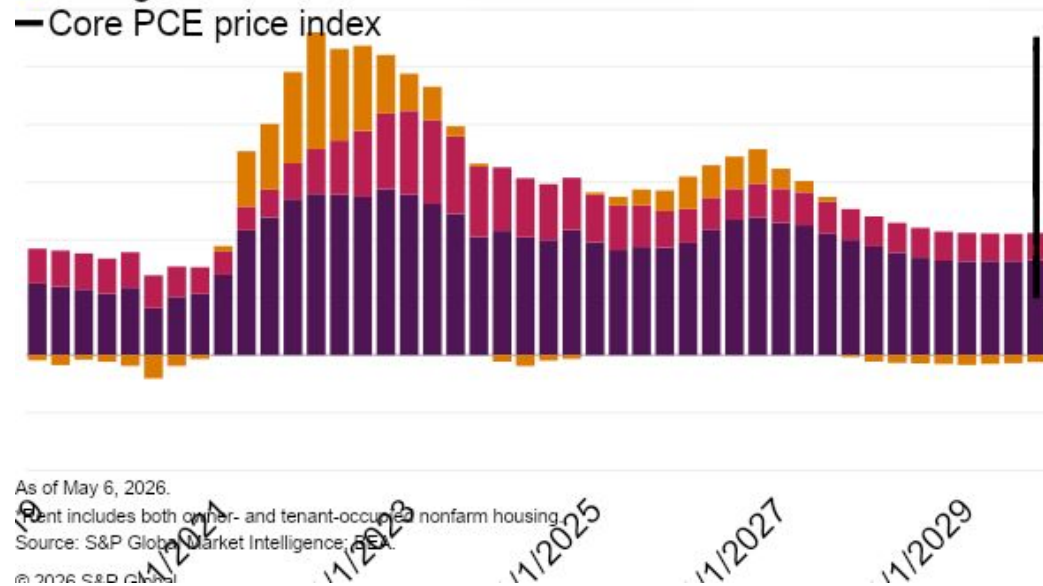
- Pre-pandemic: core PCE inflation below 2%.
 - Housing rents about one-third.
 - Services ex. housing rents about two-thirds.
 - Core goods inflation was roughly zero.
- During the recovery, inflation surged.
 - Core goods inflation surged as supply chains became strained.
 - Core services ex. rent inflation rose as labor markets tightened.
 - Rent inflation firmed in response to rapidly rising house prices and market rents.
- More recently, inflation has eased, remains elevated.
 - Core goods inflation slightly positive and firming (tariffs).
 - Core services inflation (rents and other services) still elevated.

Inflation to return to 2% after tariffs, oil shock run their course; Fed resumes easing in June 2027

Contributions to core PCE inflation

4-quarter % change

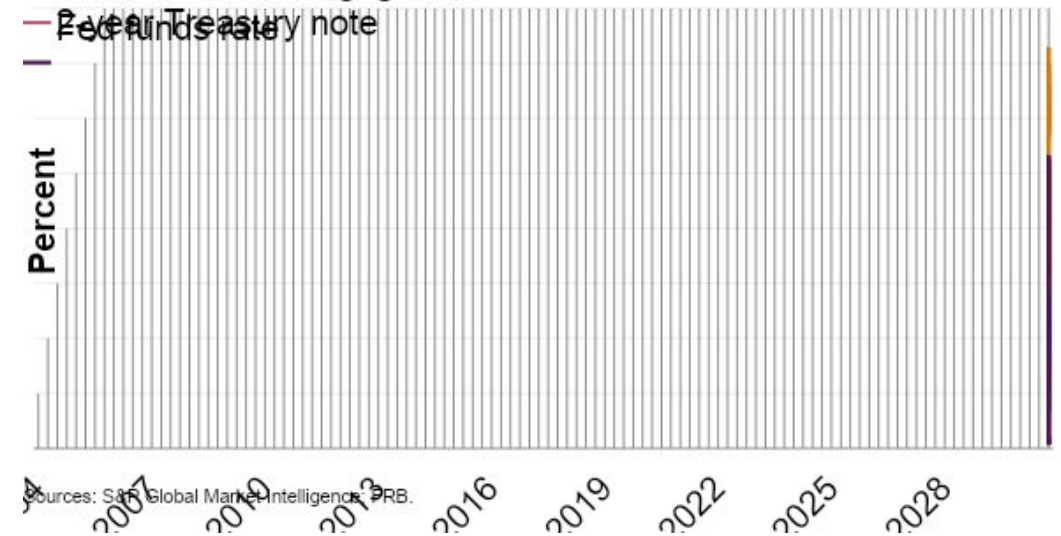
- Core services ex. rent
- Rent*
- Core goods
- Core PCE price index



After three cuts to end 2025, Fed pauses until June 2027 as inflation firms due to higher oil prices

Percent

- HF Line
- 10-year Treasury note
- Conventional mortgage rate
- 5-year Treasury note
- Fed funds rate



Contact us

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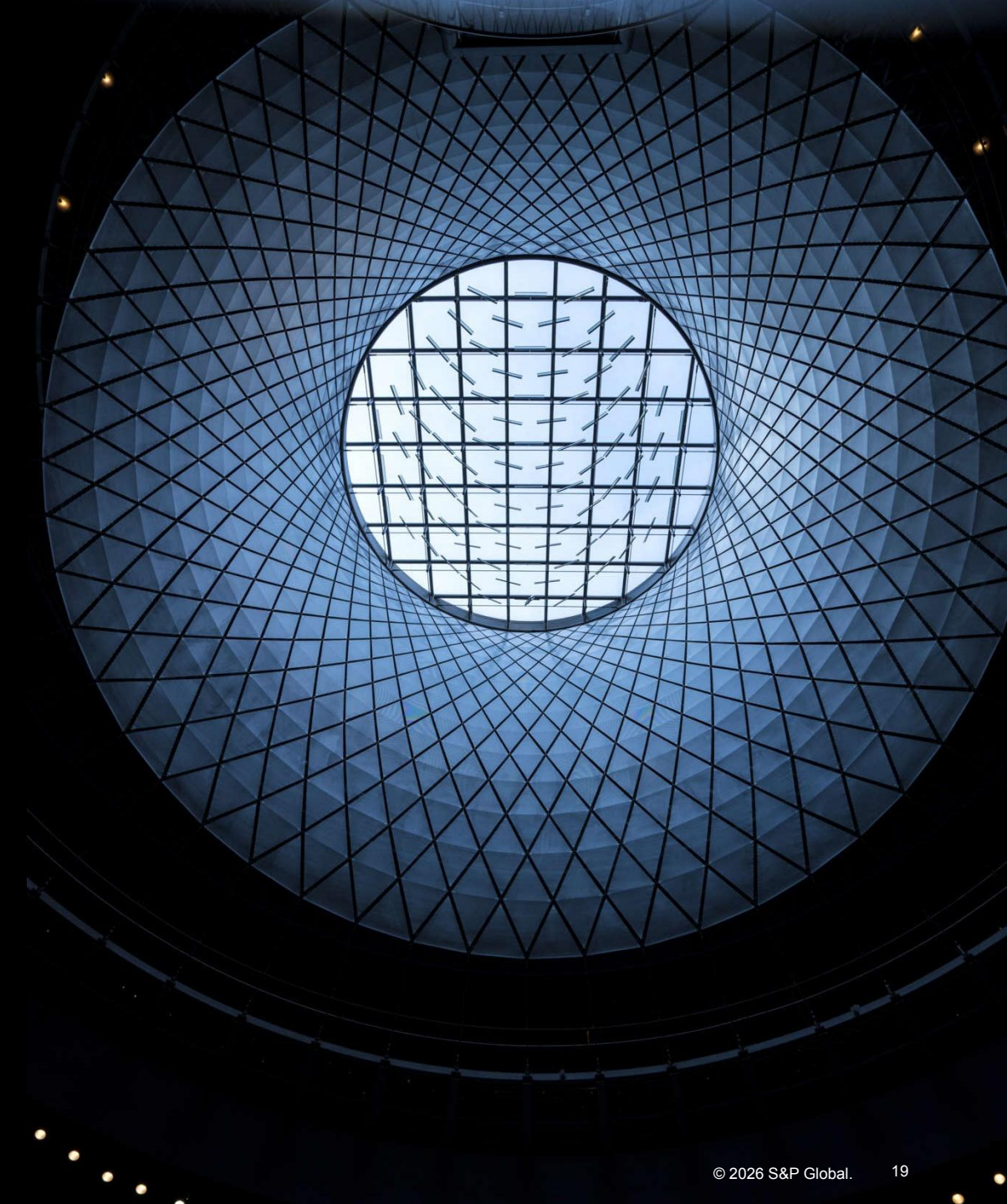
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