



2026 US outlook: shifting into higher gear

From Macroeconomics

We believe the US economy will regain momentum in 2026, supported by fiscal easing and fading of the trade policy shock. The lagged effects of this year's monetary easing and accommodative financial conditions contribute to our constructive outlook.

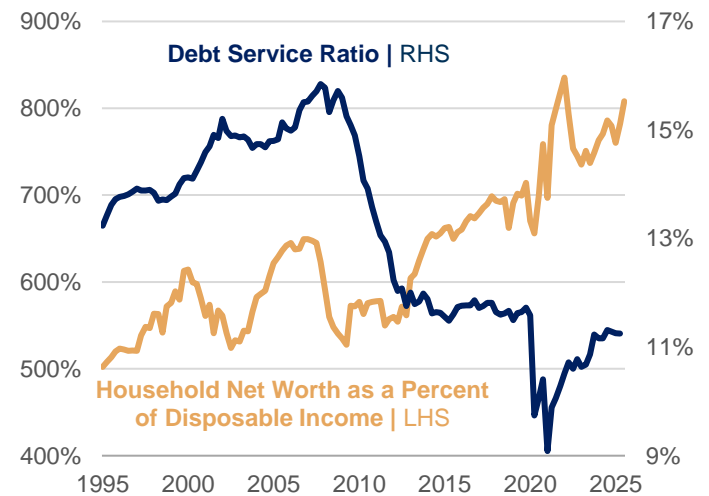
With growth set to pick up, a transition from tariff-driven goods inflation to sticky services inflation will forestall any meaningful disinflation progress for another year. This suggests limited scope for Fed easing in 2026.

Risks to our base case center on any unanticipated tightening in financial conditions, including if optimism around the AI investment cycle reverses. We are also attuned to the risk that turnover at the Federal Reserve opens the door to a dovish shift in monetary policy

While 2025 has been a subpar year for US economic performance, the economy nonetheless displayed remarkable resilience in the face of substantial changes to trade and immigration policy. At time of writing, we estimate the US economy is tracking roughly a 1.8 percent growth rate for the year, only modestly below potential. The economy's resilience has to a large extent stemmed

from the investment boom related to the artificial intelligence (AI) build-out, which has also underpinned strong equity gains that have supported household spending despite a cooling labor market. Healthy household and corporate balance sheets, in the aggregate, have also helped to insulate the economy from shocks.

Figure 1: Aggregate household sector balance sheet remains healthy



Source: Board of Governors of the Federal Reserve System, MacKay Shields. Debt Service Ratio is total household interest payments as a percentage of disposable income, through Q2 2025. Household Net Worth through Q3 2025 with third quarter estimate based on quarterly change in S&P500 and home prices.

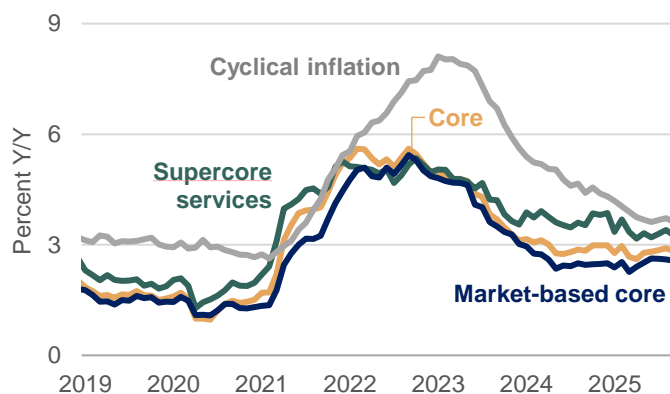
As the calendar turns to 2026, we believe the economy is poised to regain momentum as growth drivers broaden out, resulting in growth a shade under 2.5 percent. Most importantly, fiscal policy is likely to ease as a result of the administration's signature fiscal package passed this summer. In addition to substantial increases in military and border spending, new household provisions may lead to a strong refund season that increases disposable income, while business investment incentives will support capital expenditures.

Trade policy should also serve as less of a drag going forward, as households and businesses adjust to higher import costs, in part by shifting to lower-cost suppliers. The effective tariff rate on imports should decline over 2026, as the Supreme Court has signaled that it is likely to overturn the administration's use of the International Emergency Economic Powers Act (IEEPA) to implement broad-based global tariffs. While the administration has other authorities it can use to replicate IEEPA tariffs, these will take time to implement and are likely to be less comprehensive. In addition, overturning IEEPA opens the door to tariff refunds, although the timeline for any such refunds remains highly uncertain. Elimination of IEEPA-based tariffs also deprives the administration of its preferred tool for quickly implementing onerous tariffs in response to any conflicts with foreign governments, as happened on several occasions in 2025. Finally, voter frustration over affordability issues increases the likelihood that the administration will replace the IEEPA tariffs with a new tariff regime that will be less burdensome for households, especially with midterm Congressional elections coming next fall. The midterms also increase the incentive for the administration to seek additional trade deals that lower tariff rates or preclude announced tariffs from being implemented.

In addition to fiscal and trade policy, the administration's broad efforts at deregulation, including in the financial sector, will likely support business confidence and investment. Finally, financial conditions should remain a tailwind to growth, especially with some additional monetary easing in the pipeline for next year. If the recent decline in primary mortgage rates carries over into next year, residential investment should not be the same drag on GDP growth as it was in 2025 and may even turn into a modest tailwind, especially given the anticipated improvement in overall economic momentum.

With growth picking up next year to a pace moderately above potential, inflation is likely to prove sticky, ending 2026 around 2.75 percent. Tariff-related goods inflation should moderate, but demand-driven services inflation is likely to pick back up alongside an improving economy and stabilization in labor demand. In fact, with immigration and

Figure 2: Little disinflation in 2025

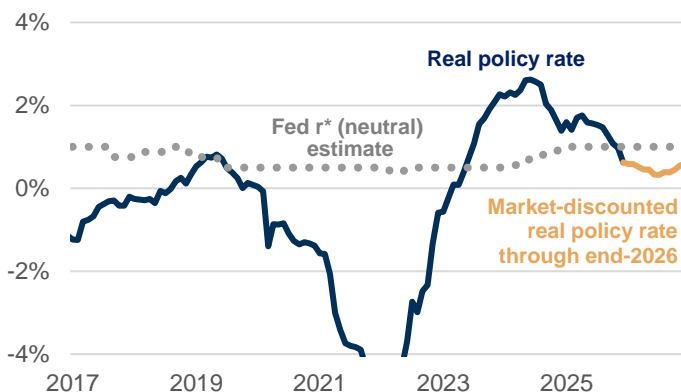


Source: Bureau of Economic Analysis, Federal Reserve Bank of San Francisco, through September 2025. All measures based on the personal consumption expenditures price index and its components. Market-Based core includes only those prices indices for items sold in competitive markets with observable transaction prices. Supercore services excludes owners' equivalent rent and primary rents from core services. Cyclical inflation is based on those PCE price indices that show sensitivity to the business cycle.

deportation policies continuing to weigh on labor force growth, the second half of 2026 is likely to see the labor market begin to tighten again.

The combination of improving economic momentum, a retightening labor market, and sticky inflation should limit the scope for further monetary easing in 2026. It may be challenging for the incoming Federal Reserve chair to build consensus for significant easing given the concerns of many policymakers about still-elevated inflation. Hence, we have penciled in just one additional 25 basis point rate cut, likely in the first half of the year as concerns over weak labor demand remain the focus of policymakers. With such a move, the policy rate would remain slightly below the FOMC's estimate of the neutral real policy rate, after adjusting for inflation expectations.

Figure 3: Monetary policy is no longer restrictive



Source: Bloomberg, Federal Reserve, MacKay Shields. Future real policy rate based on OIS futures prices as of December 11, and median expected inflation from Bloomberg Economist Survey.

While our base case for the US economy is constructive, there are several risks we are monitoring. First, financial conditions have been a meaningful tailwind to growth, but are susceptible to reversal. By way of example, most advanced economies have already finished their easing cycles, and markets are increasingly focused on the potential for higher policy rates going forward. Recent data and central bank communications in Japan, Canada, the euro-area and Australia have revealed how sensitive bond markets are to any shift away from the lower-rate narrative of 2025.

The AI boom also poses risks to financial conditions, given that it has served as the main driver of US equity gains this year. Any developments that call into question the future

profits that will accrue from AI investment could prompt a sharp reversal in equities that would weigh on household spending, business capex and hiring.

Finally, while the next Federal Reserve chair is likely to be constrained by more hawkish members of the FOMC, there is a distinct possibility that turnover among Federal Reserve Governors opens the door to a more dovish slate of policymakers and overly stimulative policy, especially in 2027. With the real policy rate already slightly below a neutral setting, such an outcome risks delaying a return of inflation to the two percent objective for even longer, and raising serious questions about the Federal Reserve's commitment to its inflation objective.

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