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WHITE PAPER

U.S. Economic Outlook 2026:

Navigating the Divergence Between Growth and Employment in an Era of Accelerating Productivity

AI was used to generate this paper based on the transcript and slides from the expert-led webinar, U.S. Macroeconomic Drivers in 2026.

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The U.S. economy enters 2026 locked in a tug-of-war. On one side, artificial intelligence investment, expansionary fiscal policy, and accommodative monetary conditions are pulling growth forward. On the other hand, trade restrictions, immigration constraints, and a softening labor market are pulling it back. For the moment, the tailwinds are winning, but the margin is narrow, and the risks are real.

Our baseline forecast projects real GDP growth of 2.6% in 2026, an acceleration from 2.2% in 2025, and about in line with the economy's potential growth rate. Inflation, as measured by the Consumer Price Index, will hover around 3%, stubbornly above the Federal Reserve's 2% target. And the unemployment rate will drift higher, reaching 4.6% by year's end. The combination of faster GDP growth and a weaker job market is unusual and reflects a fundamental shift in how the economy produces output: through productivity gains rather than expanded hiring.

This divergence between growth and employment will define the economic landscape in 2026. It creates a challenging environment for policymakers, businesses, and households alike. And it raises a deeper question about who benefits from an economy that is expanding without creating many new jobs.

MONETARY POLICY AND INFLATION

The Federal Reserve held the federal funds rate steady at its most recent meeting, citing a labor market that, while cooling, remains broadly intact and inflation that has been slow to recede. The Fed has been lowering rates since late 2024, but long-term interest rates have not followed. The 10-year Treasury yield remains near 4%, and the 30-year fixed mortgage rate is stuck above 6% (see Chart 1). This disconnect reflects investor expectations of persistent inflation, ballooning federal deficits, and uncertainty around the trajectory of fiscal and trade policy.

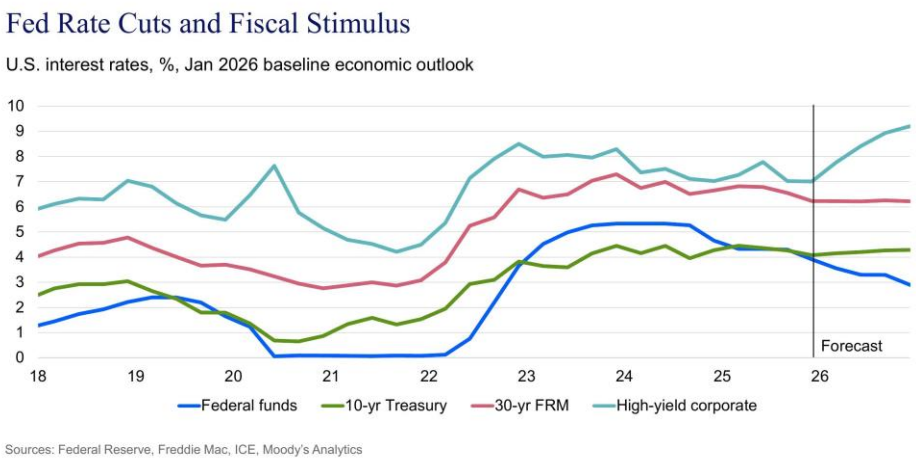

Chart 1: Fed Rate Cuts and Fiscal Stimulus

Our baseline calls for three quarter-point rate cuts by the Fed this year, bringing the federal funds rate to about 3.5% by year's end. Markets broadly agree, though the timing remains uncertain. Much hinges on the transition in Fed leadership. Chair Jerome Powell's term ends in June, and market expectations for rate cuts increase sharply around that date (see Chart 2). The expectation is that a new chair will be more tolerant of higher inflation and quicker to ease monetary policy.

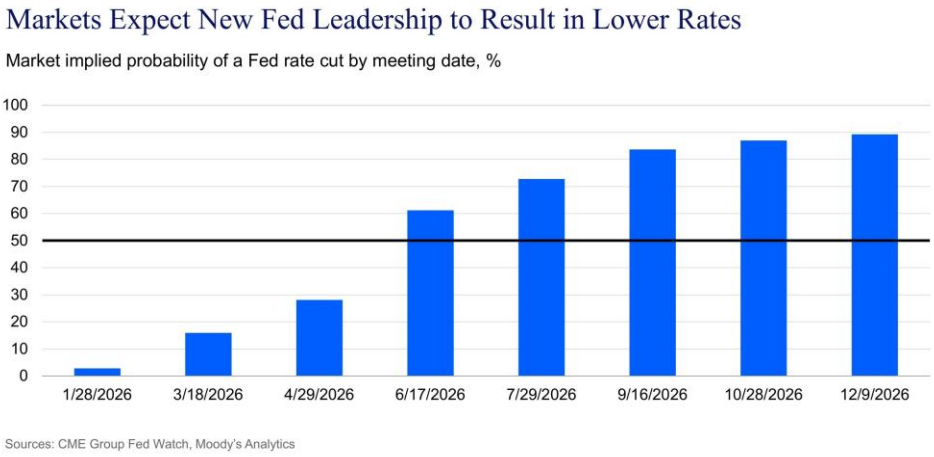

Chart 2: Markets Expect New Fed Leadership to Result in Lower Rates

On inflation, the picture is stubborn but not alarming. Headline CPI is running near 3%, with services inflation—particularly in housing—finally beginning to slow. But goods prices exposed to tariffs are accelerating, and they now constitute a growing share of the inflation picture (see Chart 3). For much of 2025, companies absorbed the cost of tariffs rather than passing them along to consumers, but that buffer is wearing thin. We expect more companies to pass through tariff expenses in 2026, particularly among firms with slim margins.

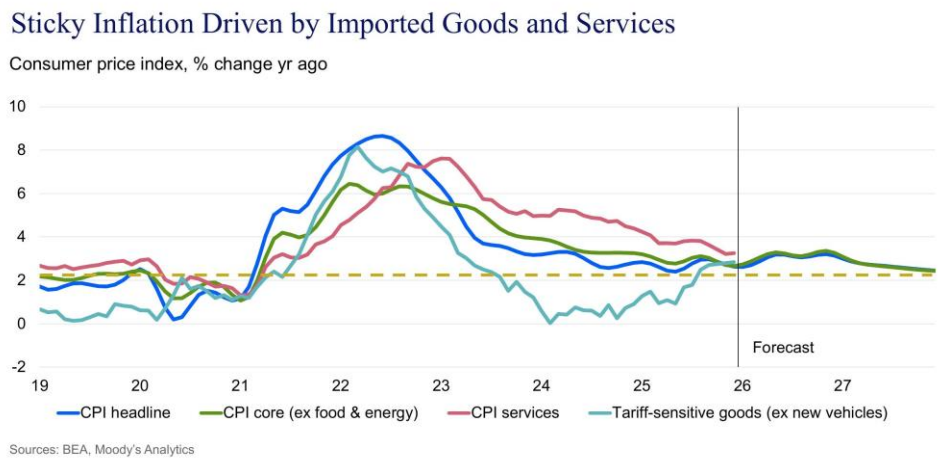

Chart 3: Sticky Inflation Driven by Imported Goods and Services

The effective tariff rate is now about 10%, up substantially from about 2.5% before the current trade policy regime began. The Supreme Court is expected to rule on the legality of the reciprocal tariffs imposed under the emergency declaration, but regardless of the outcome, we expect tariffs to remain in place in some form. The administration has signaled it will reimpose tariffs through alternative mechanisms if necessary.

A STRUGGLING LABOR MARKET

If GDP growth tells one story, the labor market tells another. Job growth has slowed to a near standstill. Since the second quarter of 2025, average monthly payroll gains have been about 50,000—well within the statistical margin of error for the Bureau of Labor Statistics estimates. Almost all net job creation in the past year has come from a single industry: healthcare. Goods-producing sectors—manufacturing, mining, construction—are shedding jobs. Government employment has been cut sharply, with the Department of Government Efficiency eliminating about 300,000 federal positions. The employment diffusion index, which tracks the share of industries adding jobs, has fallen below 50% on a six-month moving average—a threshold that has historically never been breached without a recession following (see Chart 4).

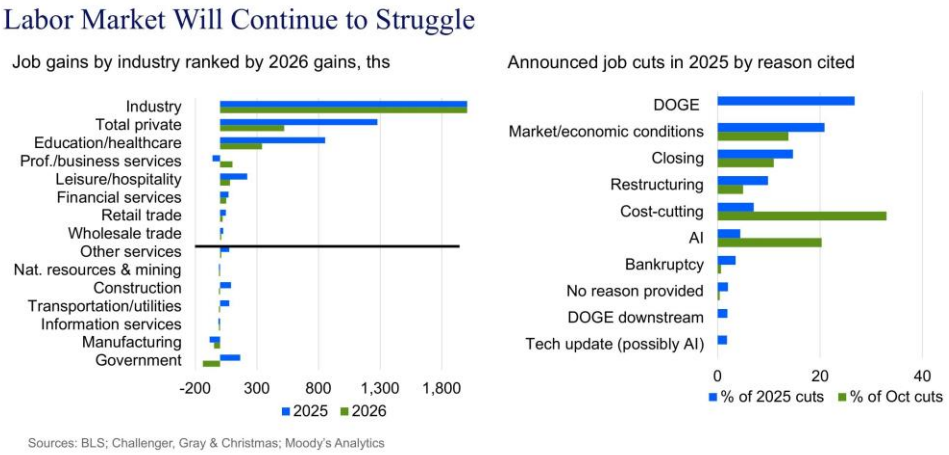

Chart 4: Labor Market Will Continue to Struggle

What makes this labor market particularly noteworthy is the role AI is beginning to play. Through most of 2025, AI accounted for only about 5% of announced job cuts. In recent months, that share has increased meaningfully as companies cite AI adoption as a factor in workforce decisions. The question of whether AI is displacing workers or simply causing firms to pause hiring while they evaluate the technology remains open, but the labor market impact is becoming visible.

PRODUCTIVITY: MIRACLE OR MIRAGE?

The flip side of weak employment growth amid solid GDP growth is, by definition, higher productivity. Nonfarm business productivity grew nearly 5% at an annualized rate in the third quarter of 2025. On a five-year moving average basis, productivity growth is approaching 2%, about in line with the long-run historical average and a marked improvement compared with the 1% growth that characterized the decade following the Global Financial Crisis (see Chart 5).

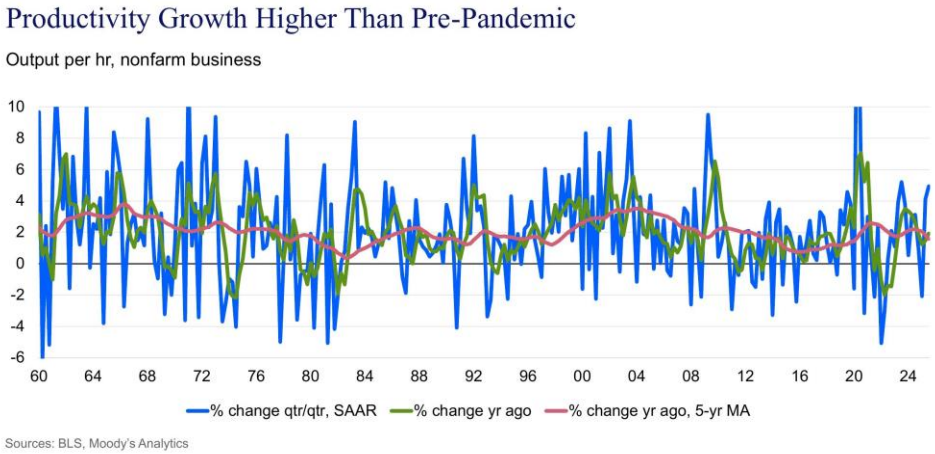

Chart 5: Productivity Growth Higher Than Pre-Pandemic

Is this AI's doing? Not entirely. Much of the productivity improvement likely traces to structural changes wrought by the pandemic—the shift to remote work, better labor-market matching across a national rather than regional market, and accelerated adoption of cloud computing and digital tools. That said, AI is already contributing and will likely contribute more over time. Businesses typically take five to 15 years to fully integrate transformative technology, a pattern observed with both personal computers in the 1980s and the internet in the 1990s.

The critical question is not just whether productivity growth will persist, but who captures the gains. The share of non-farm payroll employment in the Technology industry has been declining since ChatGPT's release in late 2022 (see Chart 6). While some of this reflects post-pandemic normalization in tech hiring, it also suggests that AI's labor-market effects are already at work—not through mass layoffs, but through a quiet reduction in new hiring.

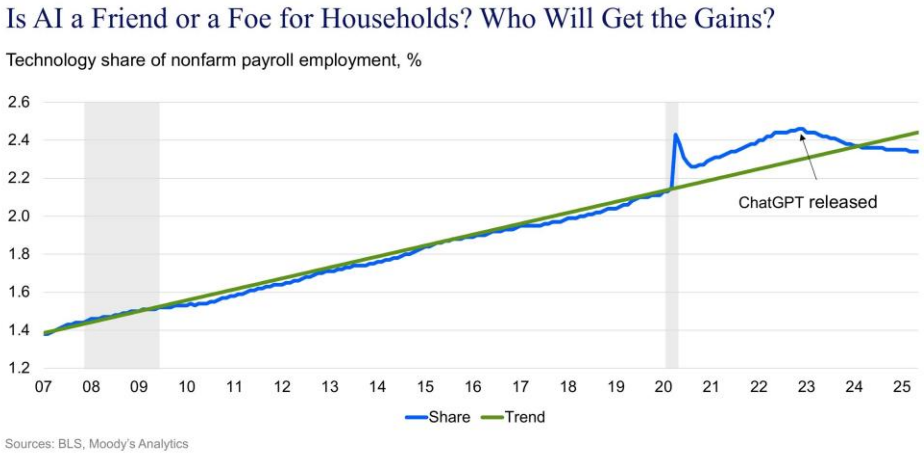

Chart 6: Is AI a Friend or a Foe for Households? Who Will Get the Gains?

To frame the range of possibilities, we have developed three AI scenarios beyond the baseline (see Chart 7). In the first, the AI equity bubble bursts, stock valuations fall, and a short, shallow recession ensues. In the second, productivity gains arrive rapidly and are accompanied by large-scale job losses, producing a more severe downturn. In the third—the optimistic case—AI delivers broad-based productivity gains that more than offset job losses, and the economy

achieves a virtuous cycle of rising output, higher wages, and low unemployment. We assign probabilities of about 50% to the baseline, 30% to the bubble-burst scenario, and 10% each to the job-loss and productivity-miracle scenarios.

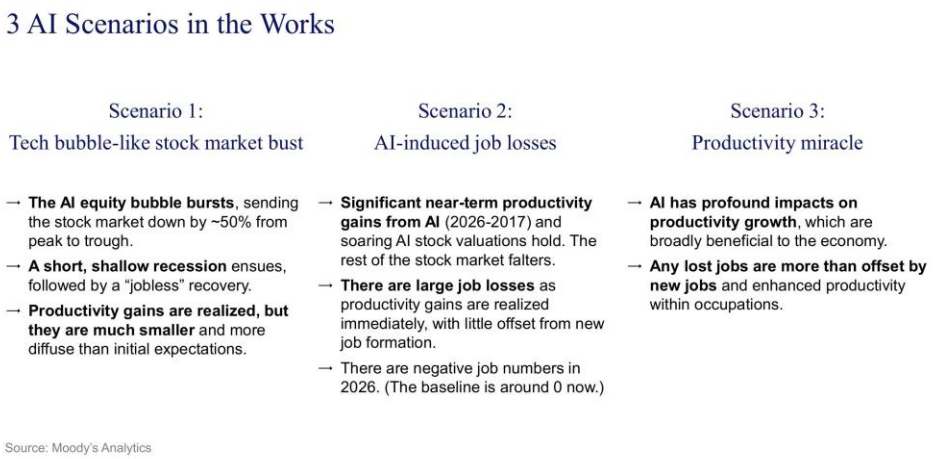

Chart 7: 3 AI Scenarios in the Works

STRAINED AFFORDABILITY

If the macroeconomic data paints a picture of resilience, the consumer confidence surveys tell a different story entirely. Both the Conference Board's Consumer Confidence Index and the University of Michigan's Consumer Sentiment Index remain at levels typically associated with recession, not with 2.6% GDP growth (see Chart 8). The disconnect is striking, and points to something real.

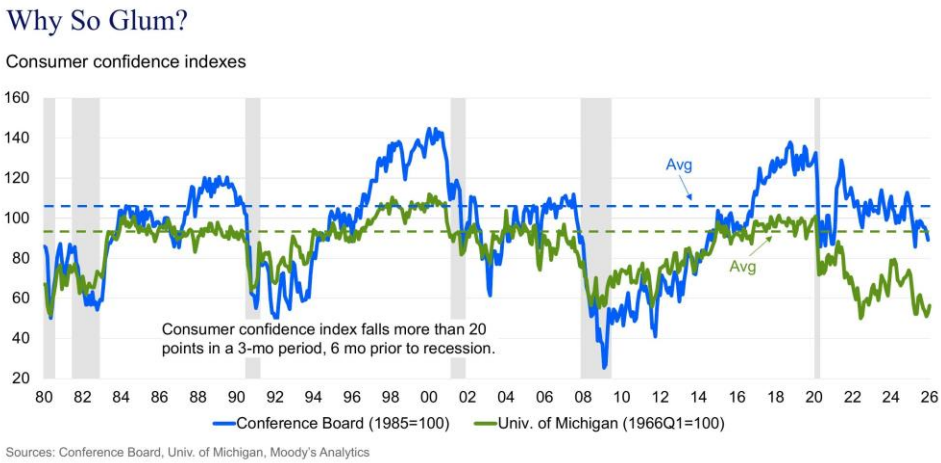

Chart 8: Why So Glum?

Affordability concerns are not overblown. They reflect a convergence of factors that are hitting lower- and middle-income households especially hard. Wage growth has been slowing across the board, but it has slowed most sharply for workers in the bottom quartile of the income distribution—a reversal of the typical pattern in which lower-wage workers see faster percentage gains (see Chart 9). For many households in this segment, wage growth is barely keeping pace with inflation, and for a meaningful share, real wages are declining.

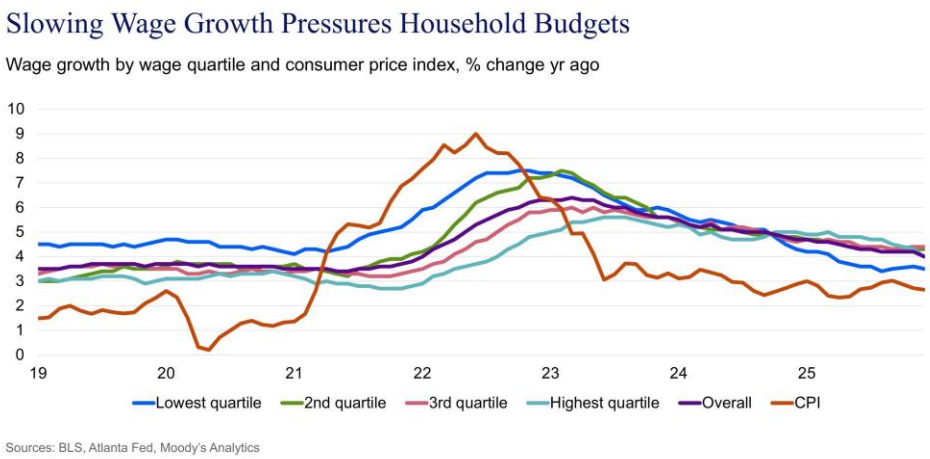

Chart 9: Slowing Wage Growth Pressures Household Budgets

Aggregate consumer spending has been solid, running about in line with historical averages when measured in real terms (see Chart 10). But that aggregate conceals a sharply bifurcated picture. Since the end of 2019, real spending by the top 10% of households by income has surged nearly 70%. For households in the middle of the distribution, spending has barely kept pace with inflation. And for the bottom 20%, real spending has been essentially flat (see Chart 11).

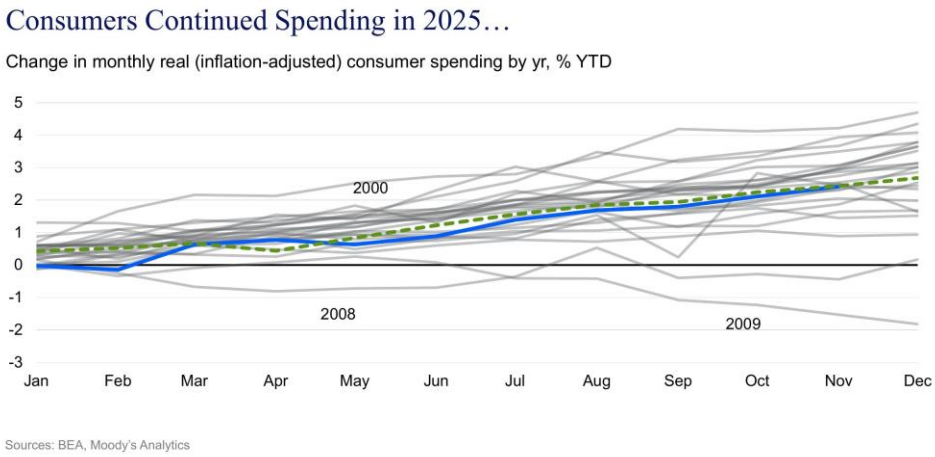

Chart 10: Consumers Continued Spending in 2025…

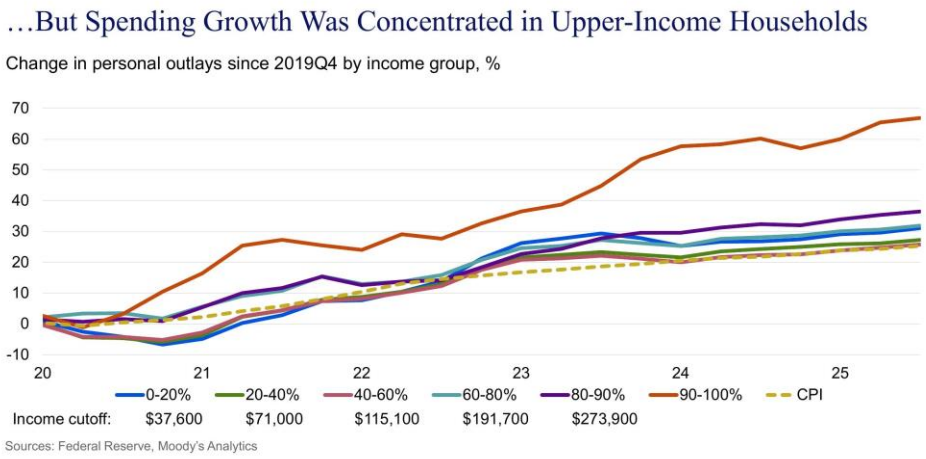

Chart 11: …But Spending Growth Was Concentrated in Upper-Income Households

This concentration matters for two reasons. It means the consumer spending that is powering GDP growth is narrowly based and therefore more vulnerable to a negative shock, particularly a stock market decline that would erode the wealth supporting upper-income spending. And it means the broad middle of the economy is under genuine financial stress.

That stress is compounded by the fact that lower-income households face systematically higher inflation. Estimates from the New York Federal Reserve show that the bottom 40% of households by income experienced inflation about a quarter percentage point higher than the top 20% over the past year (see Chart 12). This differential reflects spending patterns: Lower-income households devote larger shares of their budgets to food, energy, housing, and goods—precisely the categories most affected by tariffs and commodity price swings.

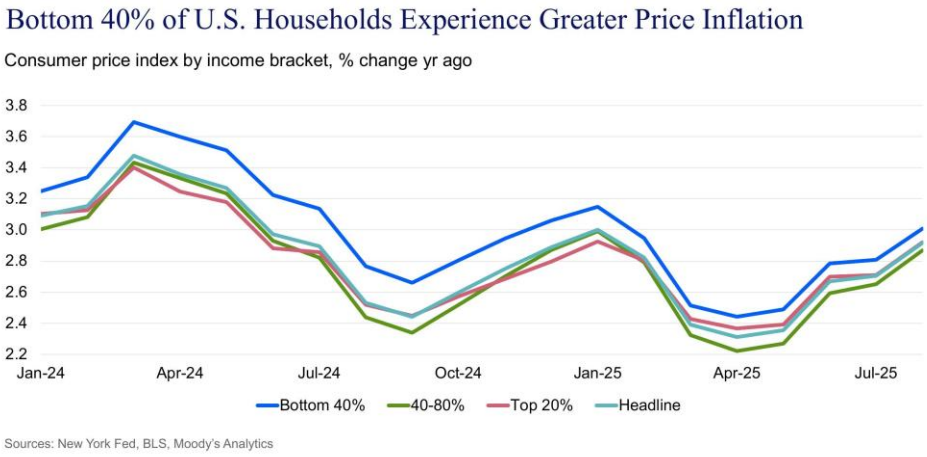

Chart 12: Bottom 40% of U.S. Households Experience Greater Price Inflation

THE HOUSING LOCK-IN EFFECT

Housing affordability is particularly troubling for young households, having declined to levels not observed since the early 1980s. The average monthly mortgage payment for a median-priced home now stands at approximately $2,100 per month. more than double what it was just a few years ago. The National Association of Realtors' affordability index—which measures median family income relative to the income needed to qualify for a mortgage—is near historic lows (see Chart 13).

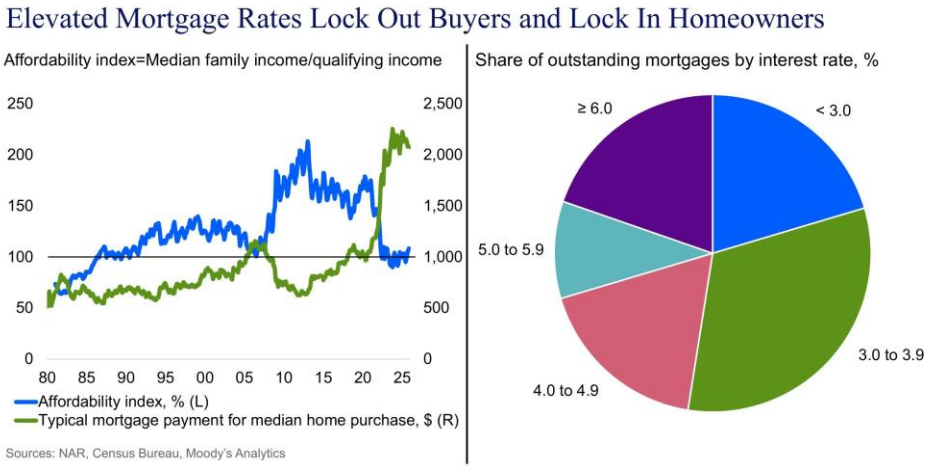

Chart 13: Elevated Mortgage Rates Lock Out Buyers and Lock In Homeowners

For existing homeowners, the story is different but equally constraining. About half of all outstanding mortgages carry interest rates below 4%, and about two-thirds are below 5%. With current market rates above 6%, selling and buying a new home means a massive payment shock. This lock-in effect suppresses housing supply, limits geographic mobility, and further inflates house prices for the would-be buyers who are already priced out.

The affordability crisis extends beyond housing. Consumer delinquency rates across auto loans, credit cards, and personal loans have risen from pandemic lows and are now stabilizing at levels well above 2019 norms. Student loan delinquencies have jumped sharply since payments resumed in early 2025 (see Chart 14). Consumers are making their payments, but with little margin for error.

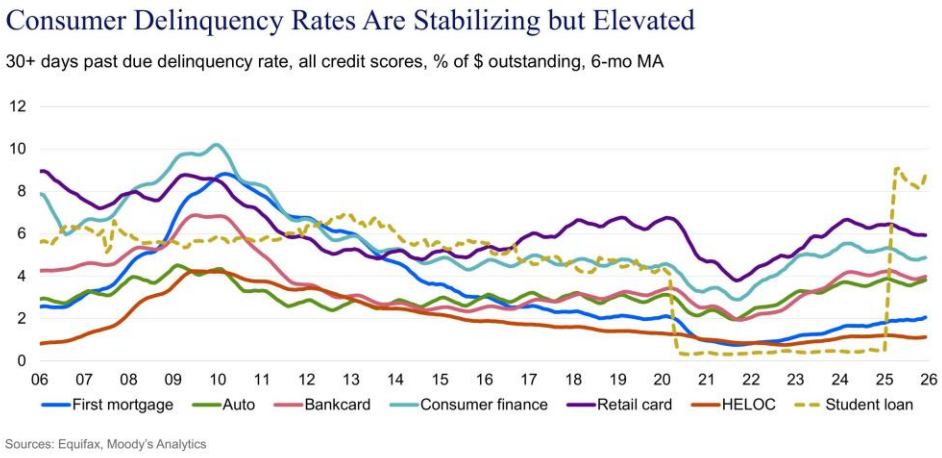

Chart 14: Consumer Delinquency Rates Are Stabilizing but Elevated

BIG WEALTH EFFECTS

If affordability is the story for the bottom two-thirds of the income distribution, wealth effects are the story for the top third. And it is the top third that is driving the economy right now.

The relationship between household wealth and consumer spending is powerful and well-documented. When wealth increases relative to income, households save less and spend more. When wealth declines, savings rise. The correlation between the wealth-to-income ratio and the personal saving rate is striking at -0.51, and the pattern is visible across decades of data (see Chart 15). The wealth-to-income ratio is near record highs, and correspondingly, the personal saving rate has fallen to about 4.5%, well below the long-run average.

Chart 15: More Wealth, Less Saving

Econometric analysis confirms the relationship. Our consumption function, estimated on a state-level quarterly panel stretching back to 1997, finds that a 1% increase in household equity wealth raises consumer spending by about 5 basis points. The housing wealth effect is somewhat larger, at about 7 basis points per 1% increase (see Chart 16). These are modest-sounding elasticities, but they translate to large effects given the scale of recent wealth accumulation.

Explaining Consumer Spending

The dependent variable is consumer spending per household

Log linear specification
Estimation method is pooled least squares with fixed effects
Sample period is 1997Q1 to 2023Q4
Time period observations: 108
State cross-sections included: 51
Total pool observations: 5508

Independent Variables:	Coefficient	Std. Error	t-Statistic
Constant	0.324	0.189	1.7
Equity wealth per household	**0.054**	0.051	3.1
Housing wealth per household	**0.068**	0.018	3.8
Personal income per household	**0.797**	0.086	9.2
Share of the population in their 20s	**0.118**	0.071	1.7
Fixed effects not shown			
R-squared	0.98		
Adjusted R-squared	0.98		
S.E. of regression	0.04		
Sum squared resid	7.61		
Log likelihood	10318.80		
F-statistic	6025.39		
Durbin-Watson statistic	0.42		

Sources: BEA, Federal Reserve, Census Bureau, Moody's Analytics

Chart 16: Explaining Consumer Spending

And the scale has been enormous. Over the past year alone, total shareholder wealth in the United States has increased by more than $10 trillion, driven overwhelmingly by AI-related stocks. Our estimates suggest that this wealth appreciation contributed about half a percentage point to GDP growth in the fourth quarter of 2025 (see Chart 17)—a magnitude comparable to the peak contribution during the late-1990s internet bubble.

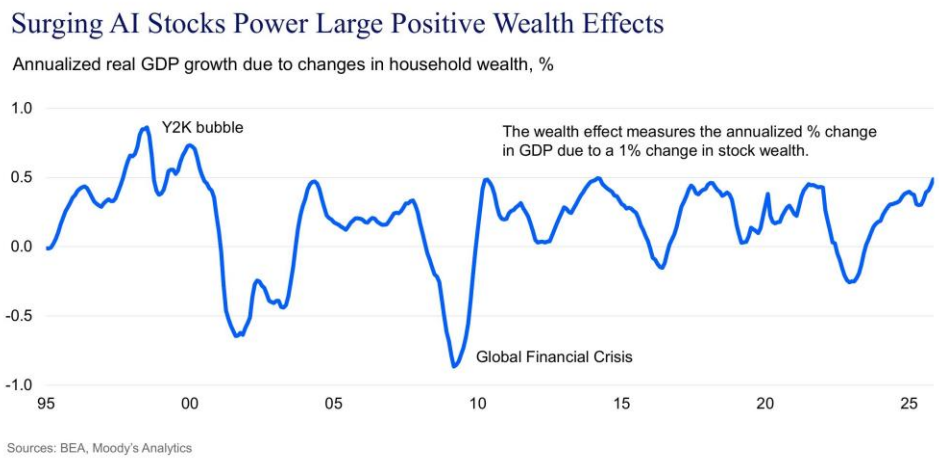

Chart 17: Surging AI Stocks Power Large Positive Wealth Effects

This is both a tailwind and a vulnerability. The wealth channel supports consumption even as income growth moderates and affordability pressures intensify. But it is concentrated among the top 10% of the wealth distribution, which holds about 85% of all stocks. If equity markets stumble, the wealth effect swings from positive to negative, and with it goes a critical support for the economy.

FINANCIAL SYSTEM VULNERABILITIES

The financial system is not in crisis, but it is vulnerable. Valuations are stretched, leverage is rising, and the cushion against negative shocks is thin.

Start with the stock market. Our preferred measure of equity valuation—the ratio of the Wilshire 5000 to after-tax economy-wide corporate earnings—currently exceeds 20, well above the historical average of about 12 and more than two standard deviations from the norm (see Chart 18). The only time the multiple was higher was during the Y2K bubble, which burst.

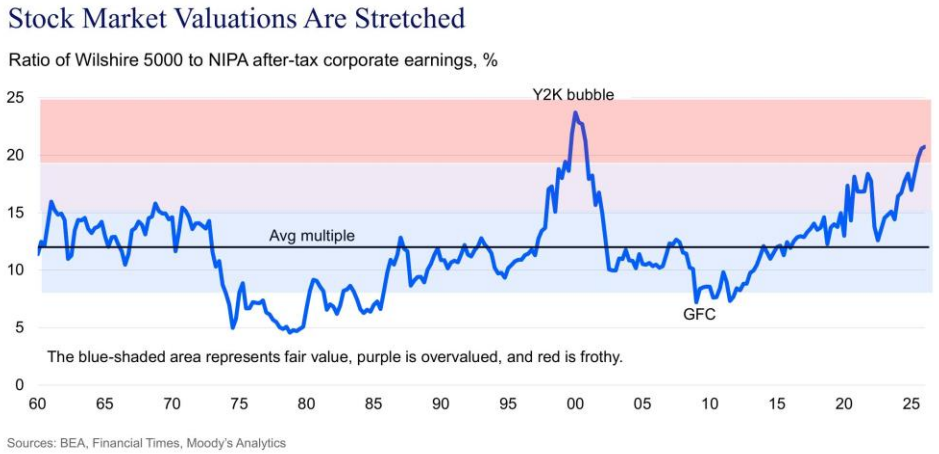

Chart 18: Stock Market Valuations Are Stretched

Corporate bond spreads tell a similar story of compressed risk pricing. High-yield spreads—the premiums investors demand over Treasuries for holding speculative-grade corporate debt—are near historical lows, about 1.5 standard deviations below the long-run average (see Chart 19). This is not consistent with an environment that carries meaningful downside risks.

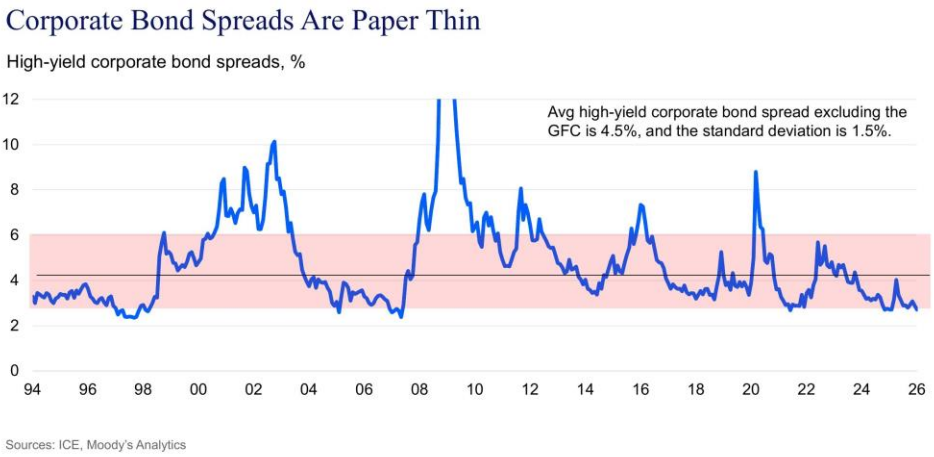

Chart 19: Corporate Bond Spreads Are Paper Thin

Meanwhile, nonbank lending—particularly private credit—is expanding rapidly (see Chart 20). Private credit funds have grown to become a substantial source of corporate financing, raising capital from insurance companies, pension funds, sovereign wealth funds, and, increasingly, retail investors. The growth has been impressive, but these markets are opaque, lightly regulated, and untested in a downturn. They tend not to mark to market, and their behavior under stress is uncertain.

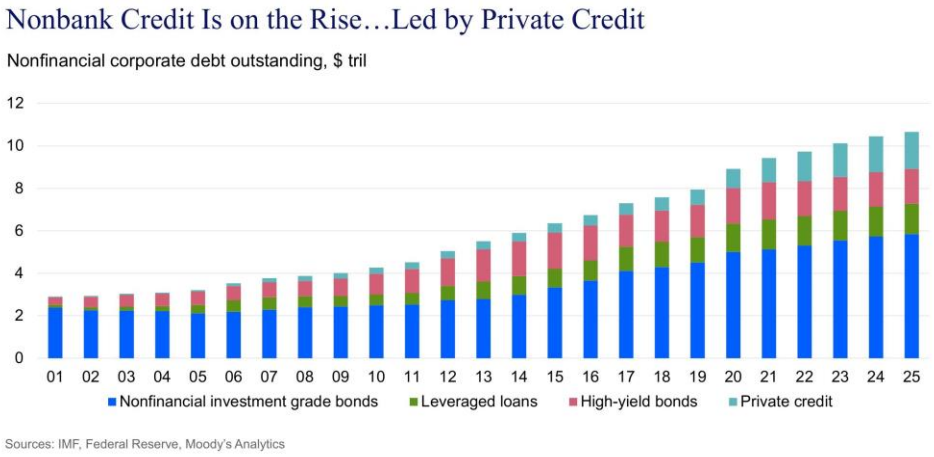

Chart 20: Nonbank Credit Is on the Rise...Led by Private Credit

AN UNSUSTAINABLE FISCAL PATH

Perhaps the most consequential vulnerability is the federal government's fiscal trajectory. The ratio of federal debt held by the public to GDP is approaching 100% and is projected by the Congressional Budget Office to rise further (see Chart 21). The federal deficit exceeds 6% of GDP. Interest payments on the debt are consuming an increasing share of the budget. Never in the past three decades have all three simultaneously been flashing red.

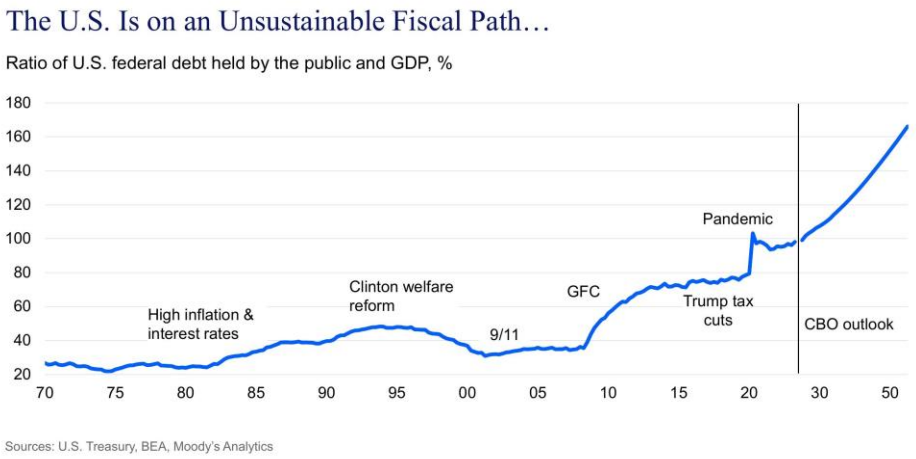

Chart 21: The U.S. Is on an Unsustainable Fiscal Path…

The deterioration is weighing on the Treasury market and on investor confidence more broadly. Credit default swap spreads on U.S. sovereign debt, while still low in absolute terms, are elevated relative to the nation's credit rating (see Chart 22). Gold prices have gone parabolic, with an ounce recently trading at $5,500—a signal that investors are increasingly nervous about the stability of fiat currencies and sovereign creditworthiness (see Chart 23).

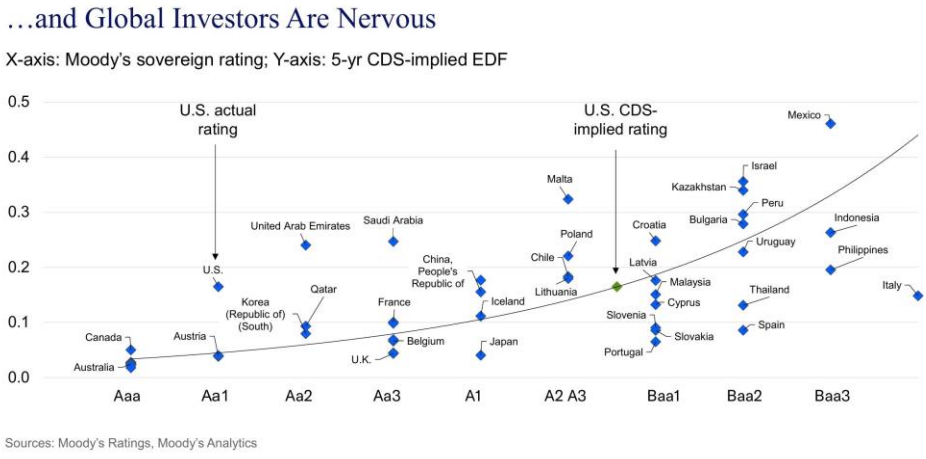

Chart 22: …and Global Investors Are Nervous

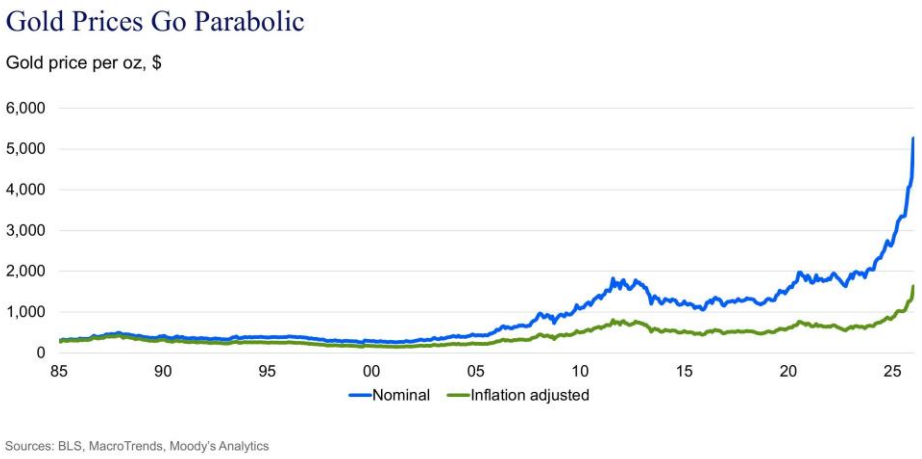

Chart 23: Gold Prices Go Parabolic

The situation evokes Ernest Hemingway's renowned observation that bankruptcy occurs initially in a gradual manner, followed by an abrupt onset. The erosion of the United States' safe-haven status and reserve currency privilege is in the slow phase. The foundations remain strong, in part because there is no viable alternative. But cracks are forming, and dismissing the possibility of a more abrupt shift would be unwise.

THE RISK LANDSCAPE

Our risk matrix tracks the severity and probability of more than two dozen potential threats to the economic outlook (see Chart 24). Several themes stand out.

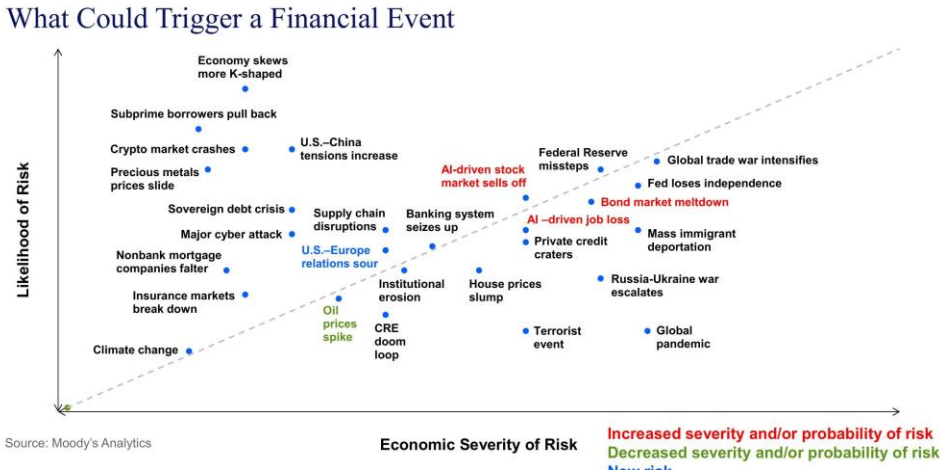

Chart 24: What Could Trigger a Financial Event

The risks that have increased in both probability and severity include an AI-driven stock market selloff, a bond market meltdown tied to fiscal sustainability concerns, and an intensification of the global trade war. The relationship between the United States and Europe, strained by the Greenland episode and broader tensions, is a new addition to the matrix. The risks that have moderated include a commodity price spike, though that assessment could shift depending on developments in Iran.

The baseline forecast assumes that financial markets adjust gracefully—that stock prices go sideways, bond spreads widen modestly, and the Treasury market muddles through. That is the most likely outcome, but the margin for error is slim. There is a lot of tinder in the financial system, and there is no shortage of potential matches.

LOOKING AHEAD

The probability of recession over the next 12 months is about 25% to 30%—elevated but not our primary scenario. Fiscal stimulus provides a cushion, and the near-term outlook for GDP growth is solid. The deficit-financed tax cuts and spending provisions enacted in early 2026 should provide a meaningful boost to consumer spending, particularly in the first half of the year. That fiscal juice may produce a head fake—a sense that the economy is performing better than the underlying fundamentals warrant.

The deeper challenge is structural. An economy that grows through productivity gains while shedding jobs or refusing to create them is an economy that is leaving a large share of its workforce behind. AI holds enormous promise, but its benefits are accruing unevenly. Wealth effects are supporting spending, but they are concentrated among households that were already prosperous. Lower- and middle-income households face stagnant real wages, elevated inflation on necessities, housing costs that are out of reach, and a labor market that offers little security or opportunity.

For businesses, this environment calls for prudent risk management—strong balance sheets, operational flexibility, and realistic expectations about the path ahead. For investors, valuations across most asset classes are stretched, and the risk-reward calculus argues for diversification and caution. For policymakers, the challenge is to navigate the crosscurrents of AI adoption, fiscal sustainability, trade disruption, and a labor market in transition—all while maintaining the confidence of increasingly skeptical financial markets and an anxious public.

The economy is resilient, but resilience can erode quickly when conditions change. The tug-of-war will continue, and the outcome remains uncertain.