

STONEBRIDGE ECONOMIC OUTLOOK

April 23, 2026



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Overview

The U.S. economy continues to be challenged by policy shocks that make forecasting the outlook unusually difficult. To compensate for the extremely elevated level of uncertainty, I briefly considered providing three alternative economic forecasts, each with different assumptions about macroeconomic policies. However, providing three alternative forecasts may not be sufficient given the low probability of any three I pick being right. As a result, I selected the scenario with the highest probability of being right, with the caveat that it too is more likely to be wrong than right.

The current policy assumptions focus on war, tariffs, and government spending, and in turn their impact on inflation, interest rates, employment, wealth, and the foreign exchange value of the dollar, all of which have important implications for real disposable personal income, real personal consumption expenditures (PCE), and real gross domestic product (GDP) growth. The war with Iran is the most pressing issue, given its obvious impact on crude oil prices and consumer inflation. The situation remains very volatile, given a fragile ceasefire and the talk of negotiations. However, Iran is still preventing commercial ships from traversing the Strait of Hormuz, and the U.S. Navy is blocking Iranian vessels in the region, resulting in neither party trusting the other to negotiate in good faith. Given the fluid situation, crude oil prices respond to every announcement. At this moment, crude oil prices have spiked again on concerns that a diplomatic solution to the conflict may not be forthcoming as hoped earlier.

In the absence of a solution to the Iran conflict, diplomatic or otherwise, the price of crude oil (West Texas Intermediate) is likely to remain in the \$75-\$100 per barrel range for several months. As a result, headline consumer price inflation, which, according to the Bureau of Labor Statistics, edged up to 3.2 percent in the first quarter, is expected to spike in the second quarter and remain elevated through the third quarter as higher petroleum prices filter through to the prices of other goods and services, such as transportation, manufacturing, utilities, and food industries. Relief from high inflation is unlikely until economic growth slows to a pace well below the economy's potential, resulting in more unemployment. Not until then will the Federal Reserve be inclined to cut interest rates, regardless of whether chaired by Jerome Powell or Kevin Warsh.

In addition, the tariffs are still working their way through the economy, despite the Supreme Court ruling that denied President Trump the authority to impose broad tariffs under the International Emergency Economic Powers Act (IEEPA). President Trump responded by relying on other trade legislation, such as Section 122 of the Trade Act of 1974, to restore some of the tariffs. However, his authority under Section 122 is being challenged in the U.S. Court of International Trade as well, questioning whether Trump had properly invoked the 1974 provision to justify the new tariffs. Interestingly, the Justice Department argued in a court filing last year that the president had needed to invoke IEEPA because Section 122 of the Trade Act of 1974 did not have any obvious application in fighting trade deficits. The tariffs recently imposed under this statute are scheduled to expire July 24, which means they probably will expire before the federal trade court rules on Trump's authority to impose them. Nevertheless, once the current tariffs expire, President Trump is expected to rely on Section 301 of the Trade Act of 1974 to impose another round of tariffs. Tariffs imposed under Section 301 apparently will be harder to dispose of through a legal challenge than the prior two, suggesting that trade retaliation with tariffs and the uncertainty it creates should remain an important feature of the forecast.

A further complication to forecasting the economy is a widely anticipated boost in productivity from the application of artificial intelligence (AI). The complication comes in two parts. First, it is still unclear whether the bulk of any boost to productivity from AI will be used to ease inflationary pressures or to boost corporate profits. Without weaker demand, the temptation will be to use the potential boost in productivity to increase profit margins rather than ease prices, especially given that price competition from imported alternatives has been encumbered by the tariffs. Second, the benefit to productivity may be disruptive to the labor market, at least in the near term, as jobs are either eliminated or redefined. If jobs decline, lower inflation does not matter if a larger share of the workforce has no income. Eventually, new jobs will be created, but the transition will be slow and painful as businesses figure out how to apply AI to their production process. So far, AI has had very little effect on overall job growth, although it may have influenced the mix of jobs gained.

On the positive side, there may be a floor to consumer demand growth given that a large share of the adult population receives a check from the federal government, typically through Social Security. Two interesting statistics: One is that as of April 2025, 73.9 million people—or more than a fifth of the entire U.S. population—received benefits from one of Social Security’s programs; and the other is that government transfer receipts account for about 19 percent of all personal income as reported by the Bureau of Economic Analysis (BEA) in the National Income and Product Accounts. In most cases, the government transfer receipts are adjusted for inflation, suggesting that real benefits are perceived by recipients as permanent. Of course, the government’s inflation adjustment is delayed, suggesting that an uptick in consumer inflation early in any fiscal year could be a burden until the adjustment is made at the start of the following calendar year.¹ Moreover, according to the life-cycle theory of spending, most of the recipients of these benefits (such as retirees on Social Security) generally are not savers.

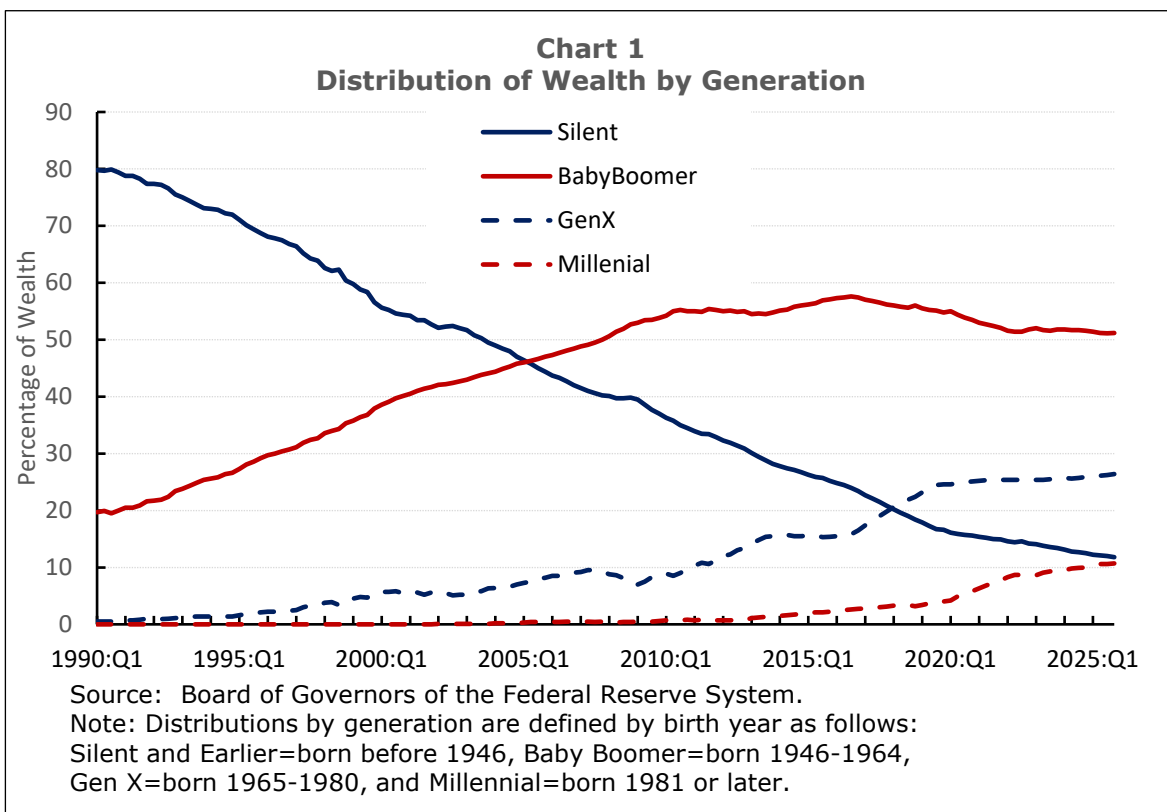
The S&P 500 Stock Price Index at the end of last year was at a level 78.3 percent higher than it was at the end of 2022, with substantial gains in the stock market in each of the last three years. Over the same period, homeowner equity increased 16.5 percent, suggesting that both financial and non-financial assets added markedly to consumer net worth and to the so-called wealth effect on consumer spending. With the S&P 500 index at record highs as of Wednesday, April 22, the stock market continues to contribute to the wealth effect and consumer spending. However, we need to understand how the wealth effect works. It does not require that consumers realize a gain to spend it, but rather that consumers who feel wealthier will spend more of their income than they might otherwise. Also, it takes time for the wealth effect to be triggered. That is, the increase in wealth operates with a lag of at least six months before it alters consumer spending decisions. Of course, the wealth effect works only if consumers have wealth and income to spend. For older households that already spend all their income, the wealth effect may show up as a reduction in their net worth—typically through realizing capital gains on financial assets or tapping home equity.

According to the Board of Governors of the Federal Reserve, at the end of 2025, the top 10 percent of income earners owned 24.7 percent of all wealth, and the top 20 percent

¹ Social Security benefits are adjusted for inflation at the beginning of every calendar year based on the percent change in the Consumer Price Index (CPI) over the previous federal fiscal year (October 1 to September 30).

of income earners owned 72 percent. The bottom 40 percent of income earners owned a mere 7 percent of all wealth.² Homeownership likely contributes to this dispersion, given that home equity is included as wealth, and about two-thirds of all households own their home.

If wealth is distributed by age, at the end of 2025, individuals aged 55 years and older owned 73 percent of all wealth, with individuals aged 70 and older accounting for 32 percent of all wealth. This latter group, which includes the Silent Generation and much of the Baby Boomer Generation, are likely to own their own home, have pensions or retirement accounts, and collect Social Security and Medicare benefits. Wealth distributions by generation since the first quarter of 1990 are shown in Chart 1. As a result, I contend that the wealth effect is working overtime on the older segment of the population, which in turn is helping to boost real consumer spending growth.



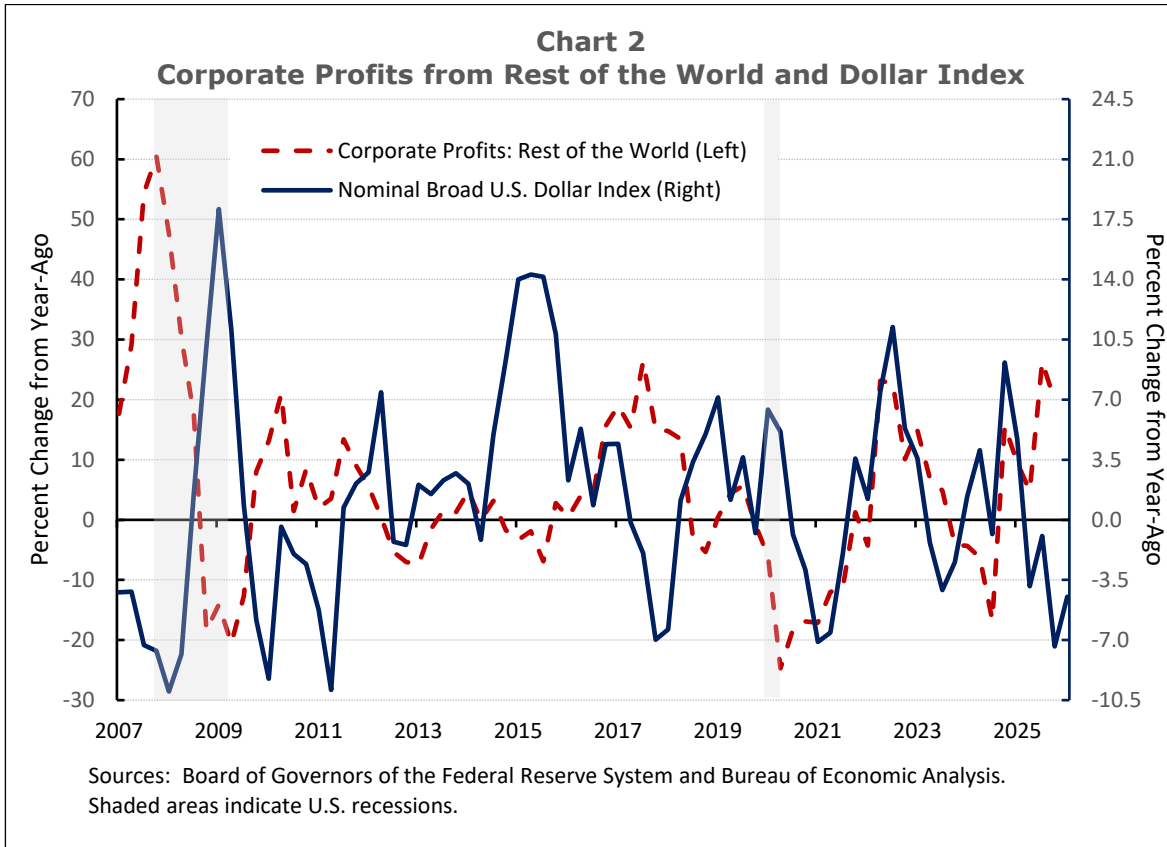
Finally, the foreign exchange value of the dollar has been credited with helping elevate corporate earnings, especially those of the S&P 500 companies, which earn 30 percent of their revenue abroad. For technology companies, it's closer to 55 percent. This means foreign demand and currency movements can impact S&P 500 earnings and the index, even when U.S. economic data feels soft.³ In particular, a weaker dollar means that it takes less foreign currency to buy a U.S. dollar, which also means that a weaker dollar

² Board of Governors of the Federal Reserve System, *Financial Accounts of the United States -Z.1, Distributional Financial Accounts, Distribution of Household Wealth in the U.S. since 1889*, March 27, 2026.

³ Federico Cuevas and Joe Seydl, J.P. Morgan Private Bank, Investment Strategy, *Why the U.S. economy and S&P 500 are diverging*, Published Nov. 10, 2025.

would translate into potentially more dollar profits repatriated from foreign operations of U.S. companies, all else the same.

As shown in Chart 2, the Broad U.S. Dollar Index as reported by the Federal Reserve fell 4.5 percent over the four quarters of last year, while corporate profits most likely increased over this period. In fact, over the period from 2007 to the present, there seems to be a negative correlation, albeit not perfect, between percent changes in the dollar and corporate profits from the rest of the world. Since the foreign exchange value of the dollar may be important to foreign earnings, it may be even more important to the foreign earnings of S&P 500 companies.



If the weaker dollar was a significant contributor to S&P 500 earnings last year, I doubt the foreign exchange value of the dollar will boost earnings again in 2026, especially if the Iranian conflict lingers for an extended period. In fact, real GDP growth for the rest of the world most likely will suffer from the reduced supply of crude oil more than real GDP growth in the U.S., which may encourage foreign investors to seek the U.S. dollar as a safe haven. Such a move could put upward pressure on the foreign exchange value of the dollar this year.

Forecast

According to the latest data from the Bureau of Economic Analysis, real gross domestic product (GDP) for the U.S. grew at a mere 0.5 percent annual rate in the final quarter of 2025, following stellar growth rates in both the second and third quarters. Over the four quarters of last year, real GDP grew 2.0 percent, which was better than I expected

both before and after President Trump’s “Liberation Day” tariffs announcement on April 2, 2025, but still slower than the 3.0 percent gain over the four quarters of 2024.

Table 1
U.S. Economic Forecast

	Annual	2026 Quarterly (<i>f</i>)				Annual	
	2025	Q1	Q2	Q3	Q4	2026 <i>f</i>	2027 <i>f</i>
Real Gross Domestic Product	2.0	1.7	0.9	1.3	1.6	1.4	1.4
Civilian Unemployment Rate	4.5	4.3	4.4	4.4	4.6	4.6	5.0
GDP Chain-Type Price Index	3.7	3.3	4.0	3.5	3.0	3.4	2.7
Consumer Price Index, All	2.7	3.2	4.3	3.2	3.0	3.4	2.7
Consumer Price Index, Core	2.7	2.5	2.8	3.1	3.0	2.8	2.7
Price of WTI crude oil (\$/bbl)	59.6	72.0	90.0	80.0	75.0	75.0	60.0
Trade-Weighted Dollar	120.8	119.0	120.9	120.6	119.4	119.4	119.0
S&P 500 Operating Earnings	271.2	71.1	75.7	74.8	75.7	297.3	322.6
Percent vs. Year Ago	11.6	11.6	13.0	5.4	2.0	9.7	8.5
91-Day Treasury Bill Rate ⁿ	3.9	3.8	3.8	3.8	3.5	3.5	3.0
10-Year Treasury Note Yield ⁿ	4.1	4.2	4.3	4.4	4.3	4.3	3.8
30-Year Mortgage Rate	6.2	6.1	6.5	6.6	6.4	6.4	5.8
Bank Prime Rate	7.0	6.8	6.8	6.8	6.5	6.5	6.0

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, FactSet, Federal Reserve Board, Department of Energy, and Federal Home Loan Mortgage Corporation.

Annual changes in real gross domestic product (GDP) and all measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. The annual estimates of the unemployment rate, the price of crude oil, the trade-weighted dollar, and all interest rates are averages for the last quarter of the year indicated. S&P 500 operating earnings per share are for the period indicated.

Quarterly estimates for real GDP and all measures of inflation are annual rates of change from the previous quarter. The quarterly estimates for the unemployment rate, the price of crude oil, the trade-weighted dollar, and all interest rates are averages for the quarter indicated. S&P earnings are per share for the period indicated. Trade-weighted dollar is the new broad index from the Federal Reserve Board.

ⁿ—The 3-month and 10-year Treasury yields are at “constant maturities,” which are interpolated by the U.S. Treasury from the daily yield curve for Treasury securities. This curve, which relates the yield on a security to its time to maturity, is based on the closing market bid yields on actively traded Treasury securities in the over-the-counter market that are obtained by the Federal Reserve Bank of New York.

^f—forecast: data points in bold type reflect a major change from the previous forecast.

The outlook for real GDP growth over the four quarters of 2026 is 1.4 percent, with the strongest quarterly growth rate of 1.7 percent in the first quarter and the weakest quarterly growth rate of 1.2 percent in the second quarter (see Table 1). Real PCE, which accounts for about 70 percent of GDP, is expected to rise 1.2 percent over the four quarters of 2026 versus the 2.1 percent growth rate over the four quarters of 2025. Real disposable income, which tends to drive spending, increased 1.3 percent in 2025, after a gain of 2.4 percent in 2024. Interestingly, real disposable income was unchanged in the fourth quarter of last year from the previous quarter. Over the four quarters of 2026, real disposable income likely will increase in line with real PCE, or 1.2 percent, due to higher prices, less robust wage gains, and fewer jobs.

In the first quarter of 2026, retail sales adjusted for inflation (which consists mostly of goods) rose just 0.9 percent at an annual rate, while real PCE (which includes all goods and services purchased by consumers) is estimated to have increased 1.4 percent. This implies that real consumer spending on services rose 1.7 percent last quarter, a notable improvement from the 0.8 percent gain in the first quarter of 2025, but well below the 2.7 percent increase in the fourth quarter of 2025. Tax refunds may provide a modest lift to real PCE in the second quarter, but higher prices and sluggish wage growth could limit the boost. There is also talk that consumers may use refunds this year to pay down debt rather than increase spending.

In addition, I expect the unemployment rate to edge higher over the four quarters of 2026, which may influence how consumers use their refunds. The combination of slower growth and weaker employment late this year may justify further cuts in the federal funds rate target by the FOMC in 2026, regardless of who is Chair of the Federal Reserve Board.

As noted last time, considerable uncertainty rules the outlook, most of it self-inflicted. Unfortunately, I do not see it waning anytime soon. In fact, it more likely will intensify in the months ahead, especially as we get closer to the mid-term elections. I suspect that it will be volatile. Of course, this is subject to change at any time—and will.