

STONEBRIDGE ECONOMIC OUTLOOK

August 25, 2026



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Overview

The outlook for the U.S. economy in the second half of 2026, for the most part, is a repeat of the first half of the year and slightly better than the forecast shown in the previous *Economic Outlook* published in April.¹ The exception might be overall inflation, which is expected to slow somewhat due to lower energy prices. Nevertheless, better is still not great.

Real gross domestic product (GDP) is now projected to increase 1.9 percent over the four quarters of 2026, which is up from the previous estimate of 1.4 percent. Interestingly, this pace is better than the economy's potential growth rate, which I estimate to be about 1.5 percent, reflecting sluggish growth in hours worked due to a declining labor force and only moderate productivity gains in the nonfarm business sector. Artificial intelligence (AI) is expected to boost productivity, but not immediately and probably not as much as currently being advertised.

One reason for the moderate upward revision to real GDP growth for all of 2026 was the surprising gain in real personal consumption expenditures (PCE) in the second quarter. The surprise was not that real PCE increased but that it increased so sharply despite real disposable personal income (DPI) registering a substantial decline in the second quarter, as well as very sluggish income growth in the previous several quarters. This dichotomy may help explain the bifurcation between the haves and the have-nots—the so-called “K-shaped” economy.

The decline in the unemployment rate to 4.1 percent in July from 4.2 percent in June, which normally would signal a stronger economy, did nothing to boost my assessment of the economy in the second half. Indeed, the underlying factors contributing to the lower unemployment rate may have increased the risk to the downside rather than to the upside. In particular, the number of people employed in July declined 87 thousand from a month earlier and about 1.0 million from a year earlier, while the civilian labor force declined a whopping 264 thousand in July from a month earlier and 1.4 million from a year earlier. In other words, the unemployment rate fell because the labor force shrunk more than employment.

Of course, there are several reasons for people dropping out of the labor force, but I contend that the drop in labor force participation by people 65 and older accounted for the bulk of the decline. The details are at the margin. After all, the number of people aged 65 and older differs every year, as more people turn 65. The final wave of boomers are approaching retirement age, if they have not already retired. The labor force participation rate for people aged 55-64 years is 65.9 percent, while the participation rate for people aged 65 and older is 18.5 percent, suggesting that when people move from the first age group to the second, there is likely to be a sharp drop in participation. In 2026, there are 4.2 million people turning 65 this year, many of whom likely have or will retire and no longer participate in the labor force.

Also in July, total payroll jobs fell by 23 thousand, following a collective downward revision of 103 thousand in prior months. A sharp drop in the government sector jobs, especially education jobs for local governments, accounted for all of the decline. Excluding the government sector, payroll jobs increased 30 thousand. Although still disappointingly weak compared to the consensus estimate of 80 thousand, there is

¹ Daniel E. Laufenberg, Chief Economist, *Stonebridge Economic Outlook*, April 23, 2026.

every reason to expect that the drop in government jobs was a one-off event and unlikely to be repeated—possibly somewhat reversed—in August. Indeed, I would expect payroll jobs to rebound somewhat in August but still average about 40 thousand new jobs a month over the final six months of the year.

Headline price inflation, as measured by the consumer price index (CPI), increased in line with expectations in the first quarter but surged to a shocking 6.1 percent at an annual rate in the second quarter. The war with Iran and the jump in crude oil prices most likely accounted for most of the second-quarter upturn in inflation. Core CPI inflation was less volatile but remained elevated in the first half of 2026.

Forecast

According to the final estimate from the Bureau of Economic Analysis (BEA), real gross domestic product (GDP) grew at an upward revised 2.1 percent annual rate in the first quarter, which was slightly more than my forecast of 1.7 percent in the previous issue of the *Economic Outlook*.² As expected, business fixed investment and nondefense federal government spending accounted for the bulk of the gain in real GDP in the first quarter. Of course, even the so-called final estimate is not final. The annual benchmark revisions to the National Income and Product Accounts over the next three years could alter this estimate. I mention this because the two earlier estimates of first-quarter real GDP growth were 2.0 percent and 1.6 percent before the final estimate of 2.1 percent.

Business spending on information processing equipment and intellectual property products contributed 1.5 percentage points to first-quarter real GDP growth, reflecting primarily the investments in the data centers needed to support artificial intelligence (AI). The surge in federal nondefense spending, which added another 0.5 of a percentage point to real GDP growth in the first quarter, reflected a rebound in federal payroll and benefits from the decline in the fourth quarter of 2025 due to the government shutdown. Although both were expected, their contributions to real GDP in the first quarter were stronger than anticipated.

On the other hand, real PCE grew a mere 0.5 percent at an annual rate in the first quarter, which contributed less than 0.4 of a percentage point to first-quarter real GDP growth. A sluggish gain in real consumer spending was expected in the first quarter, given the sluggishness of real DPI growth, but the sluggishness exceeded my expectations. According to the BEA, real DPI increased 0.9 percent at an annual rate in the first quarter, following a gain of 1.1 percent over the four quarters of 2025. Clearly, real consumer spending faced strong headwinds going into the first quarter.

In the second quarter, real GDP increased at a 1.5 percent annual rate according to the BEA, which was stronger than the 0.9 percent rate I expected.³ The primary reason for the better-than-expected second quarter was a strong 3.2 percent gain at an annual rate in real PCE, following a 0.5 percent gain in the first quarter. The surge in spending was a surprise given that real DPI declined 1.5 percent at an annual rate in the second quarter following a gain of only 0.9 percent in the first quarter. Clearly, it was not personal income as measured by the BEA that drove the surge in PCE in the second quarter.

² Ibid.

³ Ibid.

Table 1
U.S. Economic Forecast

	Annual	2026 Quarterly				Annual	
	2025	Q1	Q2	Q3f	Q4f	2026f	2027f
Real Gross Domestic Product	2.0	2.1	1.5	2.6	1.3	1.9	1.3
Real Disposable Income	1.1	0.9	-1.5	2.7	1.5	0.9	1.5
Civilian Unemployment Rate	4.5	4.3	4.3	4.2	4.4	4.4	4.9
GDP Chain-Type Price Index	3.3	3.6	4.6	3.3	3.5	3.8	2.7
Consumer Price Index, All	2.7	3.2	6.1	2.4	3.2	3.7	2.7
Consumer Price Index, Core	2.7	2.5	2.9	2.6	2.7	2.7	2.7
Price of WTI crude oil (\$/bbl)	59.6	72.0	95.2	85.0	72.0	72.0	60.0
Trade-Weighted Dollar	120.8	119.1	119.1	119.1	119.4	119.4	119.0
S&P 500 Operating Earnings	274.5	81.0	98.9	80.0	81.0	340.9	322.6
Percent vs. Year Ago	12.3	27.2	47.6	12.7	8.9	14.9	-5.4
91-Day Treasury Bill Rate ⁿ	3.9	3.7	3.7	3.8	3.8	3.8	3.0
10-Year Treasury Note Yield ⁿ	4.1	4.2	4.4	4.6	4.7	4.7	3.8
30-Year Mortgage Rate	6.2	6.1	6.4	6.6	6.7	6.7	5.8
Bank Prime Rate	7.0	6.8	6.8	6.8	6.8	6.8	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), real disposable personal income (DPI), 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, real DPI, 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.

I continue to believe that real DPI growth is necessary to sustain real PCE growth. Gains in DPI depend primarily on job growth and wage gains, while interest income, rental income, dividend income, government transfer receipts, and personal income taxes also matter. However, what seems to be more important in the current environment is not what is included in the BEA measure of DPI, but what is not. In particular, the BEA's measure of disposable income does not include capital gains or losses from financial or real assets. Given the aging of the baby boomers, who are in the spending phase of their life cycle and heavily exposed to financial and real assets, any gain or loss on such assets could have considerable influence on their spending. This is referred to in the economic literature as the wealth effect, where capital gains make consumers feel wealthier, causing them to save less. As defined by the BEA, this would include spending a larger share of their income, which could be facilitated by tapping into their accumulated wealth (including capital gains) or increasing their reliance on debt to spend. On the other hand, capital losses make consumers feel less wealthy, causing them to save more and spend less of their income.

Most of the other major categories of real GDP in the second quarter were more in line with expectations. Nonresidential fixed investments contributed 1.2 percentage points to real GDP growth, but information processing equipment and intellectual property products accounted for only about half. Industrial and Transportation equipment accounted for the other half. Also, as expected, real government spending detracted about 0.1 of a percentage point from real GDP growth, net exports detracted a more substantial 1.0 percentage point, and the change in business inventories detracted another 0.7 of a percentage point.

S&P 500 operating earnings per share were very strong in the second quarter, currently estimated at \$98.90, a gain of 22.1 percent from the first quarter and a whopping 47.6 percent from a year earlier. Much of the surge in earnings in the second quarter was in the energy and communications sectors, reflecting higher prices rather than productivity gains from AI as suggested by some analysts. Over the first two quarters of 2026, nonfarm business sector labor productivity increased an average of 1.1 percent at an annual rate, while total hours worked increased an average of 0.5 percent.

Headline consumer price inflation is expected to slow to a quarterly average annual rate of 2.8 percent in the second half of the year from a quarterly average of 4.6 percent in the first half. The expectation is that energy prices will decline following the end of the war with Iran, whenever that might be. I assume that President Trump will be pressured politically to end the war before the mid-term elections. How that happens is unclear. On the other hand, core inflation is expected to remain sticky upward. The primary reasons for the stickiness of core prices are the ongoing macroeconomic policies being pursued by the Trump administration to deglobalize the U.S. economy, including the latest round of tariffs on imports.

Also, although not necessarily a factor in the near term, higher prices are likely to be among the unintended consequences of the federal government acquiring ownership of private companies, which number 30 at the latest count. Government ownership, even partial ownership, could lead to policies and directives that benefit those companies at the expense of overall efficiency and competitiveness, resulting in protection for individual companies rather than markets.

Given the labor market remaining tight and core inflation remaining elevated, the Federal Reserve will remain between “a rock and a hard place” regarding its stance on monetary policy. For now, the expectation is that the Fed keeps its federal funds rate target at the current level through the end of the year. However, if Chair Kevin Warsh initiates sweeping reforms at the Fed as he suggested, my outlook for monetary policy may change even without the economic data to support it. One change that has already occurred at the Fed is the end of forward guidance on policy. Chair Warsh has been criticized by some market participants for removing forward guidance. I favor the Chair’s decision on this point. After all, guidance may be counterproductive given that the Fed just as uncertain about the future of the U.S. economy as the rest of else. Why should they pretend that they have unique insights by offering guidance. Currently, the outlook is as murky as ever, adding more credence to removing guidance. The Fed continues to tell us what they did, which is as much transparency from the Fed that market participants should expect.