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## *The "Nobody Knows Anything: Part Deux" Annual Outlook . . .*

It has been said that history does not repeat itself, but it does often rhyme. While that may indeed be the case for history, when it comes to annual economic outlooks, or at least the overriding themes of annual economic outlooks, sometimes repeating is the best you can do. And not just because you don't have anything new to offer. Case in point, the further we got into producing our 2026 outlook, the more it seemed like a case of *déjà vu* all over again. Or for those preferring words without upside down commas over the vowels, the more it seemed like of a case of the more things don't change, the more they stay the same.

As our longer-term readers are aware, our annual outlooks don't tend to revolve around us laying out an array of specific forecasts for specific metrics. While we may lay out some markers for some of the main metrics such as real GDP growth, the unemployment rate, and the rate of inflation, these are simply pulled from our January baseline forecast for the year in question. As our January baseline forecasts are no more or less magical than those of any other month, we don't think that to be a very interesting basis on which to discuss the year ahead. Instead, our approach has been to identify some of the main themes that we think will help shape the path of the economy over the coming year.

When it comes to our annual outlooks, we think that part of looking forward is looking backward, which is why once we've selected some of the main themes for the year ahead, we always look back at what we had laid out for the year just ended. That applies to what we picked as the main themes as well as to any specific forecasts we offered. We've always seen this as more than simple scorekeeping. Our view is that if we put a forecast out there, we'll own that forecast, for better or worse, right or wrong, and when we're wrong, we will, as best we can, identify where our forecast went off track and provide an accounting to our readers.

While working on our 2026 outlook, it was somewhere between the looking forward and looking backward that we began to feel an overwhelming sense of *déjà vu* all over again. The overriding theme of our 2025 outlook was "nobody knows anything," which also doubled as the title of last year's piece. While that may have been a bit much, not necessarily because we know anything but instead because surely someone out there knows something, when it came to 2025 the alacrity with which we typically approach producing our annual outlook pieces gave way to a sense of bewildered resignation. There were two main reasons for that.

First, with the new administration and control of Congress aligned as they were, we anticipated meaningful changes across the policy landscape. While the broad contours of those changes seemed

fairly obvious at the time we produced our 2025 outlook – more fiscal stimulus, looser regulatory policy, higher tariff rates, and a more restrictive immigration policy – the details had yet to emerge. Moreover, we saw such a wide range of possible outcomes across the entire array of policy that we thought it futile to make assumptions about what those details might look like and blend those assumptions into our baseline forecast. Instead, we opted to just live with the policy uncertainty and adjust our forecast as specific policy details emerged. We realized, of course, that either approach added significant uncertainty around any forecast made in the early days of 2025, ours included. We did not, however, realize exactly what we'd be in for over the course of 2025.

The second source of our bewildered resignation was that the degree of confidence we had in much of the economic data had sunk to what for us was an all-time low. As we put it a year ago, "we've been doing this a long time and have never had so little confidence in so much of the economic data as is the case at present." Between steadily declining response rates across much of the survey-based (i.e., "soft") data, seasonal adjustment still reeling from the significant distortions in patterns of economic activity triggered by the pandemic, and what in many cases were maddeningly large revisions to initial estimates of key data points, we noted that it had, at least for us, become easier and easier to both be surprised by and to make mistakes in interpreting much of the economic data. As we like to put it, it's hard to know where you're going when you're not sure where you are.

A year later, we find ourselves asking whether, or to what extent, either of those things have changed. To be sure, there is greater clarity around the path of fiscal policy given last summer's tax and spending bill, but while we think that will be a meaningful support for real GDP growth in 2026 some of that support could easily be negated if longer-term interest rates increasingly reflect concerns over the ability of the U.S. to fund what seems likely to be another decade of gaping budget deficits. There does, however, remain uncertainty around the paths of trade policy and immigration policy, such that both could continue to impact the U.S. economy, even if not to the same degree as in 2025, as we'll discuss below.

As for the economic data, hard as it would have been to imagine a year ago, we have even less confidence in much of the economic data now than we did then. On top of the by now usual but no less frustrating culprits (i.e., response rates, seasonal adjustment, maddening revisions) we can layer on what remain significant gaps in the data stemming from last year's government shutdown. As of this writing, we are still missing September, October, and November observations of some of the top-tier data series. On top of that, there have been some, let's say, curious movements in many of the data series put on hold during the shutdown, making them hard to interpret. This goes straight to our point that it's hard to know where you're going when you're not sure where you are.

As such, it should come as little surprise that the overriding theme of our 2026 outlook is “nobody still knows anything,” which of course comes with the caveat that, sure, probably someone out there at least knows something. It isn’t just the overriding theme of our 2026 outlook, however, that hasn’t really changed from our 2025 outlook, as we saw when we made a list of what we thought to be some of the questions that would help shape the path of the U.S. economy this year and compared that to last year’s list. For those not having our 2025 outlook committed to memory (and, really, if you don’t, then shame on you for two weeks), this is last year’s list:

Would changes in immigration policy lead to an adverse labor supply shock? Would rising layoffs amid a slowing trend rate of hiring sink the labor market? How would consumer spending fare amid growing divisions across income cohorts in the household sector? Would changes in U.S. trade policy trigger isolated skirmishes or a battle royale? Would the housing market ever catch a break? Is productivity growth up to the task of filling in the gap left by markedly slower labor supply growth?

Nothing terribly weighty in that list, right? More importantly, one can make a most plausible argument that, one year later, these are still amongst the main questions facing the U.S. economy. Believing this to be the case, we suppose we could just stop right here and refer you back to our 2025 outlook, but, really, what fun would that be, not to mention that leaving a bunch of blank pages after this one would just be kind of weird. Besides, this is not necessarily an exhaustive list, which leaves more for us to discuss.

**2025 Review: What A Long, Strange Trip It Still Is.** Before getting to those questions and laying out a broad contour of how we expect the U.S. economy to perform in 2026, we’ll check in on how our 2025 forecast fared, though with the remaining gaps in the economic data any such assessment is still a work in progress. Being somewhat, let’s say, navigationally challenged, we often find that while we ultimately end up getting to where we’re going, how we get there is often not as we planned (and, no, there is not yet a GPS system that can overcome our particular talents). We could say the same for our forecast of the U.S. economy in 2025.

Our January 2025 baseline forecast called for real GDP growth of 2.2 percent, and with the data now at hand and our forecast of Q4 growth, 2025 real GDP growth is tracking at 2.2 percent. Note that this is on an annual average basis, not a Q4/Q4 basis which, while commonly cited, is at odds with the definition of GDP. We’ll note that our forecast of 1.3 percent real GDP growth (annualized rate) in Q4 2025, which reflects the impacts of the government shutdown, will change as remaining gaps in the data are filled in, which could impact full-year 2025 real GDP growth.

Either way, while the economy basically got to where we thought it would get, how the economy got there was nothing like we imagined at the start of 2025. That can perhaps best be seen by looking at the quarterly changes in real GDP over the course of the year. After contracting at a 0.6 percent rate in Q1 2025, real GDP grew at a 3.8 percent rate in Q2 and at a 4.3 percent rate (pending revision) in Q3, and at present we are expecting growth at just a 1.3 percent rate in Q4. Suffice it to say that our 2025 outlook envisioned a somewhat more sedate quarterly growth profile,

though we will say that as the sharp swings in inventories and net exports that largely drove the quarterly real GDP growth patterns over the first three quarters of the year began to turn up in the higher frequency data our forecasts followed suit. Those swings reflected households and firms first anticipating and then reacting to changes in U.S. trade policy, which proved to be sharper and more sudden than had been anticipated at the start of 2025.

In last year’s outlook we noted that “despite having more than worn out its welcome, inflation is showing few signs of going away.” Our forecast had both headline and core PCE inflation at 2.4 percent on an annual average basis in 2025, with the risks to that forecast weighted to the upside. As of this writing we only have data through September, and on a year-to-date basis PCE inflation was running at 2.6 percent and core PCE inflation was running at 2.8 percent. We noted continued upward pressure on input prices in both the manufacturing and services sectors, as seen in the prices paid component of ISM’s monthly surveys, would be one source of sustained inflation pressures, and also noted that even before factoring higher tariffs into the equation we expected core goods prices to transition from being a drag on core inflation to being a support for core inflation.

To our earlier point, at the time we produced our 2025 outlook we opted to make no assumptions about how high tariff rates might go. Which worked out as whatever assumptions we would have made at the start of 2025 would have been dreadfully wrong between April 2 and April 9 and still wrong but less so after April 9. For those who don’t recall, April 2 was the day on which tariff rates significantly higher than even the worst case scenario would have anticipated were announced, while on April 9 those increases were pushed back to allow room for trade deals to be negotiated between the U.S. and its trading partners. As it turned out, the April 2 announcement came just two days prior to our April update of our baseline forecast which, as such, showed a significantly higher inflation rate than we had previously anticipated. We revised our April baseline forecast after the April 9 announcement, and that forecast had a more moderate increase in inflation.

As for the impact of tariffs on inflation, we’d argue the jury is still out. We were consistent in arguing that any impacts of higher tariff rates on goods prices would come gradually rather than all at once. Given the lingering uncertainty around where tariff rates would ultimately settle, it figured that firms would await more clarity before adjusting prices, while the significant accumulation of inventories, largely driven by imported goods, over the early months of 2025 meant that for much of the year firms were selling goods not subject to higher tariffs. As these factors reversed, we expected firms to begin testing their pricing power more aggressively, which we’ve expected to see in early-2026. This would mean that the acceleration in core goods prices seen over the latter months of 2025 would pick up pace in 2026. Whether, or to what extent, this will be the case remains to be seen.

We’ll also note that the October data for the Consumer Price Index (CPI) not having been collected due to the government shutdown will have a lasting impact on both the CPI and, given that it relies on certain components of the CPI, the PCE Deflator. The manner in which BLS opted to make up for the missing October data will bias the year-on-year percentage changes in the CPI and the PCE Deflator lower over the next several months.

We began pointing to the impacts of sharply curtailed foreign immigration on the labor market in late-2024, and our 2025 outlook flagged this as a downside risk to the labor market and, in turn, the broader economy. The household survey data in the BLS's monthly employment reports show declines in the levels of the foreign born labor force and foreign born employment that got progressively steeper until late in the year, which we've argued was a key factor behind the marked slowdown in the pace of nonfarm employment growth. We also noted that the slowing trend rate of nonfarm employment growth had thus far been a function of a diminished rate of hiring rather than a rising pace of layoffs. While we expected that tenuous balance to hold through 2025, we flagged rising layoffs as a downside risk. A year later, we can make the exact same point. It does, however, seem that our forecast for the unemployment rate to average 4.1 percent in 2025 was too low. The unemployment rate averaged 4.3 percent in 2025, though here too gaps in the data stemming from the government shutdown are having an impact on the data.

In our 2025 outlook, we also pointed to faster growth in labor productivity as being critical in offsetting the adverse impacts of meaningfully slower labor supply growth on real GDP growth, inflation, and corporate profits. Through the third quarter of 2025 the volatile quarterly profile of real GDP growth had been mirrored in the quarterly profile of labor productivity growth. Still, the eight-quarter moving average of labor productivity growth, which we see as the best proxy of the trend rate of productivity growth, was 2.3 percent as of Q3 2025, easily above where it stood prior to the onset of the pandemic.

In what was the easiest call we made in our 2025 outlook, we noted that "it's hard to see things getting much better for the housing market in 2025." We saw builders making only limited progress in paring down spec inventories of new homes for sale, in part because we expected little relief in the form of lower mortgage interest rates or lower house prices, absent of course the aggressive incentives many builders had resorted to in order to clear their spec inventories. That said, though there are still gaps in the data stemming from the shutdown, the decline in new single family housing starts in 2025 was on course to be even more severe than we anticipated. At the same time, while we expected the CoreLogic HPI to show house prices up 2.2 percent in 2025, through November the increase was tracking at 1.6 percent.

Finally, we noted that while we saw further room for Fed funds rate cuts in 2025, inflation remaining easily above the FOMC's 2.0 percent target rate would limit that room. As such, we expected two twenty-five basis point cuts in the funds rate in 2025, whereas a deeply divided FOMC delivered three such cuts while signaling in December that they could be on hold for some time.

**2026 Outlook: Another Long, Strange Trip To Where We Think We'll Get?** All in all, the economy ended 2025 pretty much where we thought at the beginning of the year it would. That said, many of the steps on that journey were vastly different than we anticipated. Aside from the question of whether you're still right if you were right for the wrong reasons, the more relevant question in this context is whether 2026 will prove to be another long, strange trip for the U.S. economy. Obviously, at this juncture we cannot forecast how the specific steps of this trip will play out, so we'll instead concentrate on what we expect the final destination

to look like. In keeping with our overriding theme here, i.e., a sense of *déjà vu* all over again, our 2026 forecast does not look all that different than our 2025 forecast looked, at least based on our January baseline forecast in each year.

We look for real GDP growth of 2.5 percent in 2026, again on an annual average basis. Part of that growth, however, will come at the expense of 2025 growth given that we look for the government shutdown to have taken up to 1.50 percentage points off Q4 2025 real GDP growth, with much of that drag being made up for in Q1 2026 real GDP growth. We expect last summer's tax and spending bill to provide support for both the household and business sectors in 2026. Reflecting the retroactive nature of reductions in income tax withholding rates that were not adjusted in 2025 along with expanded deductions (childcare, SALT, senior citizens, amongst others), and other changes, we anticipate a significant boost in after-tax personal income in Q1 2026, with much of that gain going to households now feeling the highest degree of financial stress. This will act as a support for consumer spending.

At the same time, changes in the corporate tax code should support growth in business spending on equipment and machinery and outlays on intellectual property products (the main component of which is R&D outlays). By year-end 2025, we had already seen not only faster but also more broadly based growth in orders for core capital goods, a leading indicator of business investment in equipment and machinery in the GDP data. This, in turn, leads us to expect that the acceleration in labor productivity growth seen over the past several quarters has much further to run. We think this will be a critical support for real GDP growth given that we expect labor supply growth to remain listless.

If we are correct in assuming continued listless labor supply growth and further acceleration in labor productivity growth, that would mean another year of what on the surface will look like uninspired growth in nonfarm employment. Keep in mind, though, that slower labor supply growth pushes the "breakeven" rate of job growth, i.e., the pace of job growth necessary to keep the unemployment rate more or less stable, lower. At present, we think the breakeven rate of job growth could be as low as 40,000-50,000 jobs per month, though with the noise in the household survey data it's hard to be too precise about the true rate of labor force growth and, in turn, the breakeven rate of job growth. Our forecast anticipates the unemployment rate averaging 4.4 percent in 2026, but if we're underestimating the pace of labor supply growth our forecast of the unemployment rate could be a bit low.

As an offset to what we expect to be a fairly tepid pace of job growth, we expect productivity growth to accelerate further in 2026. This is in part predicated on continued growth in business investment in business investment in equipment and machinery and in intellectual property products. We will note that while on an annual average basis, our baseline forecast anticipates full-year 2026 growth in both components being slower than full-year 2025 growth. That, however, is more a reflection of how strong growth in both components was over the first two quarters of 2025, a pace which was clearly unsustainable. Our 2026 forecast is more in line with the pace of growth seen over 2H 2025. We do not, however, hold out much hope for business investment in structures, with our forecast anticipating a third straight annual decline in this component of business fixed investment in 2026.

Neither do we hold out much hope for meaningful improvement in the housing market in 2026. Our baseline forecast anticipates a second straight decline in single family housing starts. While we do look for modest sequential improvement over the back half of 2026, that will still leave starts lower on a full-year basis. We see a similar pattern in new home sales in 2026. While builders have made some progress in paring down spec inventories of new homes for sale, for many builders those inventories nonetheless remain uncomfortably high. While our baseline forecast does anticipate some relief in the form of lower mortgage interest rates, absent meaningful relief in the form of lower prices affordability constraints will continue to weigh on demand for home purchases. Our baseline forecast anticipates house prices, as measured by the CoreLogic House Price Index, being basically flat in 2026, with declines over the first half of the year giving way to modest increases over the back half of the year.

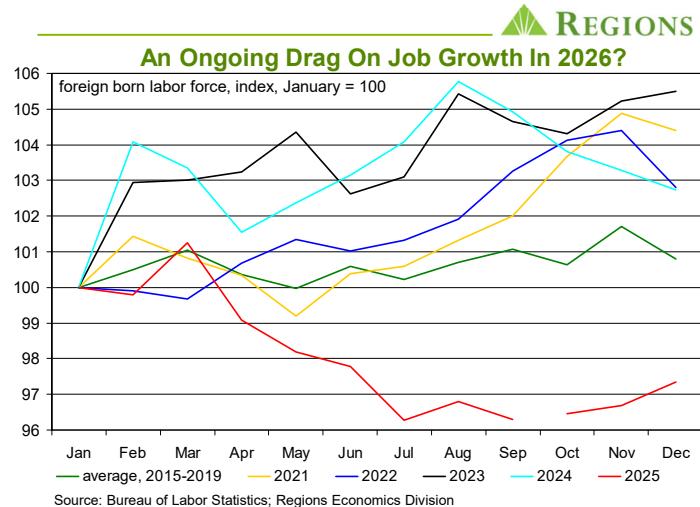
We expect some moderation in inflation in 2026 but nonetheless anticipate both headline and core PCE inflation averaging 2.5 percent in 2026. With the Fed funds rate getting closer to what most FOMC members would perceive to be “neutral,” inflation remaining above the FOMC’s 2.0 percent target limits the amount of downside room for further cuts in the funds rate in 2026 absent more pronounced deterioration in either the labor market or the broader economy than we are anticipating in 2026.

With the bookkeeping out of the way, we’ll move on to what we see as some of the main questions facing the economy in 2026. As noted earlier, however, they are mostly the same questions we had a year ago. Given that we discussed these questions in great detail in our 2025 outlook and how often we discussed them over the course of last year, we won’t repeat that discussion here. Instead, we’ll offer a few observations on what might be different in 2026 and the potential impacts on the economy.

**Has The Outflow Of Foreign Born Labor Run Its Course?**  
 As noted above, we began voicing concerns over the implications of diminished inflows, if not outflows, of foreign born labor in late-2024. Our concerns stemmed from understanding how significant net international in-migration had been as a source of total growth in the U.S. population. To that point, as of the current Census series on components of population growth (to be updated later this month), international in-migration accounted for roughly eighty-five percent of total population growth over the 2022-2024 period. We argued this was a significant source of the rapid growth in the supply of labor that helped facilitate robust job growth and, in turn, real GDP growth over that same period. Given the sharp slowdown in southern border crossings that began in the summer of 2024, we expected to see slower labor supply growth.

The series on foreign born population in the BLS’s household survey (which, by the way, does not ask about immigration status, only origin) was quick to pick up on this in 2025. Given that the series comes only on a not seasonally adjusted basis and that the levels reported in the household survey are not strictly comparable across years due to changes in the population controls used to construct the survey, we began to compare intra-year patterns in this series as a check on our premise. As shown in the following chart, there was indeed a pronounced drop-off in the size of the foreign born labor force in 2025, and the same pattern unfolds if one looks at a similar chart of the level of foreign born household

employment. But, as can also be seen in the chart, by year-end 2025 that outflow seems to have run its course.

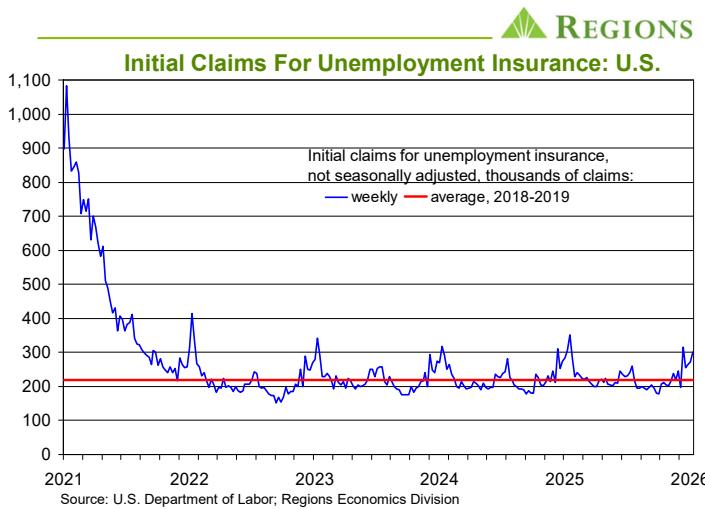


In the early phases of this outflow, we noted that it made sense to think that at some point it would level off, we just didn’t know when that would happen. As it is, at year-end 2025 the level of the foreign born labor force was 2.7 percent below where it started the year, with roughly nine hundred thousand fewer foreign born labor force participants. While some dismiss this series out of hand as little more than noise, we think that when looked at in this context it is a useful indicator. Moreover, it is consistent with anecdotal evidence and direct feedback we’ve heard from business owners across an array of industry groups for whom foreign born workers have been an important source of labor supply.

That the intra-year patterns in this series were weaker in 2025 than in any year we have looked at largely reflects changes in U.S. immigration policy. The question at the start of 2026 is whether this outflow has run its course, which in part will be determined by whether there are further changes in immigration policy and/or enforcement policies that would make foreign born labor more/less inclined to participate in the U.S. labor market. It could also be that if labor market conditions are perceived as being much weaker, thus limiting prospects for employment, that would lead to either fewer foreign born workers coming to or remaining in the U.S. Either way, with foreign born workers accounting for roughly nineteen percent of household employment, flows of foreign born labor, in either direction, will help shape the contours of the labor market in 2026.

**Layoffs: Just Not Happening, Or Just A Matter Of Time?** As we did at the start of last year, we’ll note that the slowing trend rate of job growth has thus far been a function of less hiring as opposed to rising layoffs. What has changed in the interim is that the slowdown in the trend rates of hiring, and in turn job growth, has become even more pronounced. What has not changed is that the rate of layoffs has yet to budge. That said, while we will flag rising layoffs as a downside risk to our baseline forecast, as we did a year ago, that the slowdown in the pace of hiring has become more pronounced leaves the economy more vulnerable to rising layoffs than was the case a year ago. Indeed, one place we are already seeing this is that, while the rate of layoffs has yet to turn

higher, those who do lose a job are having an increasingly difficult time finding another one. This is seen in rising average and median durations of unemployment.



The above chart is one we use frequently to illustrate our point about layoffs remaining well behaved. We use the not seasonally adjusted data on initial claims for unemployment insurance as a means around what can be considerable seasonal adjustment noise in the data. Another advantage of the unadjusted data is that it is easier to spot distinct breaks from the typical seasonal patterns in the data which can help identify turns in underlying labor market conditions.

Can we make it through another year without a sharp, sustained increase in layoffs? Our sense is that we can, particularly if our forecast of real GDP growth is on or near the mark. After all, that firms do not want more labor does not necessarily mean that they want less labor. Clearly, a pronounced slowdown in the broader economy could lead to an increase in layoffs, particularly if a rising degree of labor market slack leads firms to perceive it would be easier to add back labor when the demand outlook improves. Before getting to that point, however, firms would be more likely to cut back on hours worked, and thus far there are no clear signs of that happening. This is one reason we watch patterns in aggregate hours worked so closely, as we'd expect to see a clear downturn in aggregate hours before we'd see rising layoffs.

**Are The Robots Coming To Replace Us Or To Help Us?** It is virtually impossible to have a discussion of the labor market these days without saying the word "AI," which isn't actually a word, but, whatever. It is also virtually impossible to convince anyone who is sure that the robots are coming to replace us that the robots are instead coming to help us. What is often overlooked, however, is that while the use of the term "AI" may be fairly new, the discussion is not. For instance, the title of our June 2019 *Monthly Economic Outlook* was "Send In The Robots, But Only The Benevolent Ones." This was a discussion of the very same points, even if with different terminology, that are being so widely, and in many cases hotly, discussed and debated at present. That discussion was motivated by the frequency with which, during our frequent time on the road speaking to various groups about the economic outlook, we were fielding questions about automation and the impact on employment. Of course, there were times when

rather than being asked questions on this topic, we were being lectured to by those convinced that the robots were coming to take all of the jobs. As we learned, and wrote, back at the time, it's hard to not flee the room in terror when someone is painting a bleak picture of a world in which the robots are in charge and the humans are left to fend for themselves, as if acting out scenes from "*The Road*."

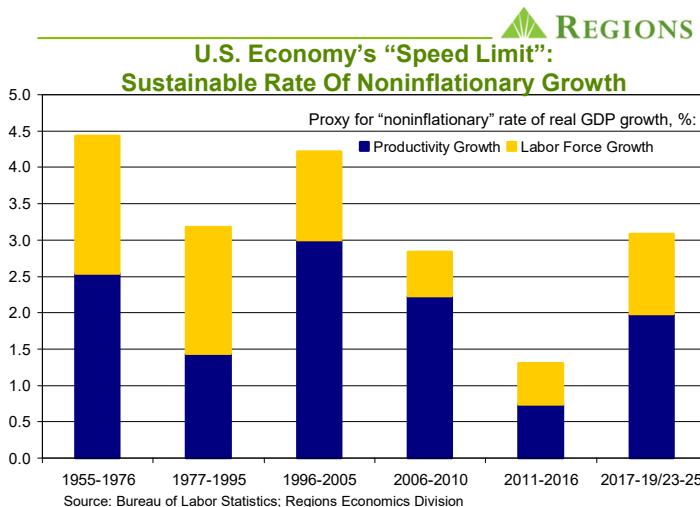
So, the question (or, in some cases, the lecture) is not a new one, and neither is our answer, which is that if we are correct in our expectations of a prolonged period of anemic labor supply growth, then automation is something to be welcomed more than feared. Years ago, our concerns about the sustainable pace of labor force growth were primarily based on demographic trends, particularly the decades-long decline in birth rates. Those concerns remain, but at present are being compounded by sharply curtailed flows of foreign born labor, as discussed above. Either way, we see automation as a way to augment labor input rather than as a means by which firms can maximize profits by simply replacing labor with automation.

Obviously, there will be instances in which firms may opt to replace labor used to perform repetitive, lower-skill tasks with automation, and it is likely the case that advances in the development of AI pose threats to higher-skill positions or, as is often contended, entry-level positions. There's a long way, however, between that and humans being totally replaced, and while increased utilization of automation and AI may contribute to the hiring rate remaining low in 2026, we don't think either is far enough along to be the primary driver. We've often made the same point about technology/automation that we've made about global trade, which is that both create, for lack of a better way to put it, winners and losers, and that there are far more of the former than the latter. We think the problem, however, is that the winners are celebrated while the losers are largely overlooked. In this context, automation/AI will in some cases help make up for a lack of labor and will in other cases change the nature of how people work. Rather than trying to stop automation/AI in its tracks, as some seemingly want to do, the better option would be to make sure that those impacted develop the skills necessary to adapt.

**Can Faster Productivity Growth Be Sustained?** We think it can and will be, we and we think that is an unambiguously good thing, though some would disagree, as we've learned. This is a topic we return to often, most recently in our October 2025 *Outlook*, and for good reason. As we routinely note, the rate at which any economy can grow on a sustained basis over time without sparking inflation pressures, what we refer to as an economy's "speed limit," is a function of two things – the rate of growth of total labor input and the rate of labor productivity growth. Productivity growth allows for wages to grow over time without impinging on profit margins or igniting inflation pressures.

That this basic point is so often overlooked is apparent in the frequency with which we hear people say "consumer spending is seventy percent of the economy." It's not, it's (just under) seventy percent of GDP as measured by the expenditures approach, which isn't at all the same thing, which is why we also routinely note that the economy doesn't grow over time because consumption grows, rather, consumption grows over time because the economy grows. Put differently, workers are able to consume only because they produce. In the context of the above discussion of labor force

growth and the use of automation/AI, we see productivity growth as being an ally of firms faced with labor supply constraints, which helps account for why we return to this topic so often.



Perhaps because of the focus on AI, there has been considerable discussion of the accelerating trend rate of productivity growth. What is often overlooked is that we began to see a break in productivity growth patterns back in 2017 (the chart above is broken down by productivity cycles, not by fixed time periods), though it could be that the disruptions in the economy and much of the economic data triggered by the pandemic made it easy to lose sight of this. Omitting the data for the 2020-2022 period, the above chart shows this acceleration in productivity growth. That the average rate of labor force growth over this latter period is also faster may seem to refute our concerns over labor supply growth, but keep in mind a critical component of this faster labor force growth was a significant and steady inflow of foreign born workers over the past few years. That is clearly no longer the case, putting the emphasis back on productivity growth.

We noted earlier that our proxy for the trend rate of productivity growth was at 2.3 percent as of Q3 2025, above the average for the final period shown in the above chart. That the acceleration in trend productivity growth took hold well before AI became so prominent reflects, at least in our view, firms reacting to what prior to the pandemic had become increasingly tight labor market conditions – the unemployment rate was below four percent for almost two years prior to the pandemic. While on the whole labor market conditions have loosened, skilled labor remains at a premium and firms continue to push for greater operating efficiency, in part as a means of contending with higher operating costs. As such, rather than being the catalyst for stronger labor productivity growth, we see the development of AI as adding fuel for even faster growth, something we think to still be in the very early stages. We are anticipating productivity growth of just over three percent for 2026, and while that may prove a bit ambitious, the more relevant point is that we think we're in the early phases of a prolonged period of faster productivity growth.

**Less Friction From Trade Policy In 2026?** Uncertainty over the course of trade policy and the costs of higher tariffs are widely cited as factors behind the pronounced slowdown in the trend rate

of job, and many analysts have a more stable trade environment as a key element of their 2026 outlook. To which we'd say maybe, or maybe not. How's that for a bold call?

In terms of effective tariff rates, we don't think the pending (at the time of this writing) Supreme Court decision will change much, as there are other avenues through which higher tariff rates can be implemented. But, should the Supreme Court rule against the Administration, it could be that growing concerns over affordability in a mid-term election year lead to a pause, say, until 2027, before these avenues would be traveled down.

But, the United States-Mexico-Canada Agreement (USMCA) comes up for formal review beginning in July, which is one potential source of trade friction in 2026, particularly given these are the two biggest trading partners of the U.S. Moreover, while trade tensions between the U.S. and China may be only simmering at present, they could quickly begin boiling over again seemingly at any time. These are two, but by no means the only, examples of potential trade policy frictions in 2026, so we're not so sure how safe of an assumption a more stable and predictable path of trade policy is. One lesson from 2025, however, is that what is spoken and what ultimately becomes policy are not always the same thing.

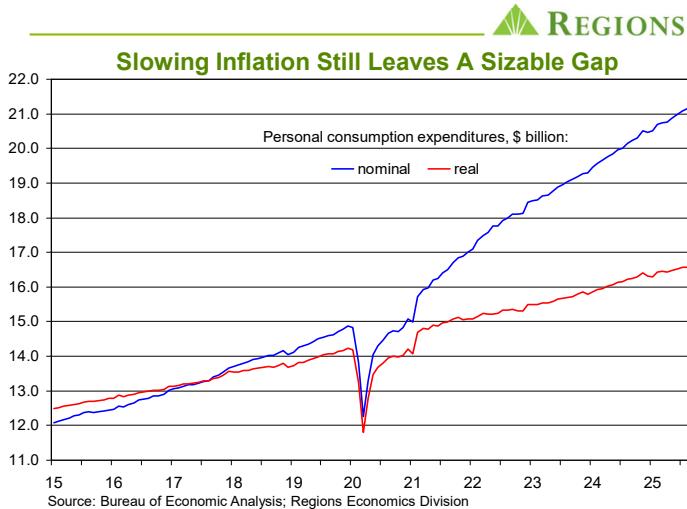
This is clearly something to watch in 2026, particularly given our view that there is further tariff pass-through to come from the higher rates imposed in 2025. While core goods inflation may still seem low, the reality is that, at 1.4 percent as of November, it is higher than at any point since mid-2023 and we think the acceleration that took hold midway through 2025 has further to run. Higher tariffs or disruptions in global supply chains would add more fuel which would in turn sustain overall inflation pressures.

**Continued Divide In The Household Sector?** At the start of 2025, the term "k-shaped economy" wasn't nearly as commonly used as it was at the end of the year, but in our 2025 outlook we nonetheless noted a stark divide across income lines within the household sector and offered some thoughts as for what that might mean for the path of consumer spending. We noted that we expected growth in consumer spending to be more closely aligned with growth in after-tax income in 2025 than had been the case over the prior few years, and while the gap between the two did narrow a bit, it was still wider than we anticipated. That could, at least in part, reflect the extent to which wealth effects supported spending amongst higher income/net worth households.

It was harder to get a read on consumer spending in 2025, as consumers anticipating and then reacting to higher tariff rates altered the timing of expenditures, particularly when it came to spending on consumer durable goods. Additionally, the looming expiration of tax credits for EV purchases had a meaningful impact on the timing of motor vehicle sales over the second half of 2025. Additionally, the cumulative effects of higher prices along with some slowing in wage growth, particularly amongst lower-skill industry groups, added to the degree of financial stress being felt by many lower-to-middle income households.

As with many other elements of our outlook, the questions around the state of U.S. consumers and the path of consumer spending are pretty much the same as they were a year ago. One difference is that "affordability" has become a topic of considerable attention,

though a cynic might say this is mainly a function of this being a mid-term election year. Either way, there have been a host of possible policy moves aimed at improving affordability, though at this point it remains to be seen which, if any, actually stick and, in turn, how much relief they'll actually bring.



Either way the chart above is one we've frequently used to illustrate the cumulative effects of higher prices. While the path of real (adjusted for price changes) consumer spending is back on the same trajectory it was on prior to the pandemic, that is clearly not the case for the path of nominal (not adjusted for price changes) spending, with the gap between the two reflecting the impact of price changes, or, in this case, price increases. We think this chart helps put concerns over affordability into proper context and is a useful reminder that a lower rate of inflation does not narrow the gap, it simply means the gap expands at a slower pace. It is also worth noting that the composition of spending, in terms of necessity versus discretionary spending, can be meaningfully altered by this gap continuing to expand, particularly for lower-to-middle income households.

To the extent higher income/net worth households are driving growth in overall consumer spending, and the evidence is mixed, one could argue that the economy is more vulnerable to a sharp decline in equity prices than was the case a year ago at this time. To the extent such a decline in equity prices triggered negative wealth effects, a pullback in spending, particularly spending on discretionary services, amongst this segment of households would have an outsized impact on total consumer spending. As was the case last year, we continue to flag this as a downside risk.

On the whole, however, despite a slower trend rate of job growth, aggregate wage and salary earnings continue to grow at a rate faster than inflation. Monthly debt service burdens remain near what aside from the distortions seen during the pandemic would be the lowest on record, and early-stage delinquency rates on consumer debt remain at or slightly below where they were prior to the pandemic. As noted above, changes triggered by last summer's tax and spending bill will lead to a spike in after-tax personal income in Q1 2026. And, if the economy continues to expand at or near the rate we anticipate, corporate profits should continue to grow. This would set the stage for further advances in

equity prices, even if at a slower pace than over the past three years, which in turn would alleviate concerns over negative wealth effects. As such, we look for continued moderate growth in consumer spending in 2026, with further weakening in the labor market, a tumble in equity prices, and inflation picking up pace looming as downside risks.

**Will Longer-Term Interest Rates Lay Down The Law?** Many, if not most, discussions of interest rates revolve around whether, when, and to what extent the FOMC will change the Fed funds rate which at present means cutting the funds rate further. In terms of the path of the broader economy, however, it is the longer end of the yield curve that matters more. While changes in the Fed funds rate impact the prime rate and certain business and consumer funding rates, other market interest rates, particularly mortgage interest rates, tend to be more closely aligned with movements in yields on longer-term U.S. Treasury securities. Think back to how puzzled many were over the final months of 2024 when the FOMC cut the funds rate by 100 basis points and mortgage interest rates also moved by 100 basis points, but in the opposite direction.

As we start 2026, there are a number of factors that could push yields on longer-dated U.S. Treasury securities and, in turn, longer-term market interest rates higher. Economic growth outpacing what in general are fairly low expectations, inflation picking up pace rather than easing back toward the FOMC's 2.0 percent target, renewed concerns over the U.S. fiscal path, and changes in investor appetites for U.S. dollar denominated debt could each push longer-term interest rates higher. Don't overlook that last potential catalyst, as expansionary fiscal policy across much of the Euro Zone, changes in Japanese monetary policy, and renewed global trade tensions could all impact how global investors allocate capital. This is a point that is often thought about in the wrong context, i.e., in terms of stocks rather than in terms of flows, as it should be thought about. In other words, a sudden fire-sale of U.S. dollar denominated assets by foreign holders is not likely, nor is it necessary for there to be an impact on longer-term U.S. interest rates. Instead, global investors simply deciding to purchase U.S. dollar denominated assets at a slower pace would, particularly given the financing needs of the U.S. government, be sufficient to push longer-term U.S. interest rates higher. All of this is independent of changes in the Fed funds rate.

Even if the "bond vigilantes" don't return and ride roughshod over the financial markets, there are plenty of factors that could push longer-term interest rates higher, which on net would likely act as a drag on the pace of economic activity. We'll also note that there is considerable discussion/concern over what are perceived to be threats to the independence of the Federal Reserve and what that might mean for monetary policy. Regardless of the ultimate composition of the Board of Governors and the FOMC, it is likely that market interest rates, particularly longer-term rates, will be the ultimate arbiters of looming changes to the Federal Reserve and subsequent policy decisions made by the FOMC.

We'll wrap our 2026 outlook by repeating what has become a standing call in our annual outlooks which, by the way, we've never been wrong on. We can predict, boldly or otherwise, that at the end of the year, the economy is unlikely to look as we, at the start of the year, expect it to, even if we do not now know why that will be the case.

# ECONOMIC OUTLOOK



Q2 '25 (a)	Q3 '25 (a)	Q4 '25 (f)	Q1 '26 (f)	Q2 '26 (f)	Q3 '26 (f)	Q4 '26 (f)	Q1 '27 (f)		2023 (a)	2024 (a)	2025 (f)	2026 (f)	2027 (f)
3.8	4.3	1.3	2.9	2.2	2.0	2.1	2.1	Real GDP <sup>1</sup>	2.9	2.8	2.2	2.5	2.0
2.5	3.5	1.9	2.0	2.2	2.3	2.3	2.4	Real Personal Consumption <sup>1</sup>	2.6	2.9	2.6	2.3	2.3
7.3	2.8	1.0	1.5	3.1	3.6	4.0	4.1	Real Business Fixed Investment <sup>1</sup>	7.3	2.9	4.0	2.6	4.0
8.5	5.4	1.2	1.1	4.3	4.5	4.0	4.0	Equipment <sup>1</sup>	2.9	3.5	8.1	3.3	4.1
15.0	5.4	3.5	3.7	4.0	4.5	5.2	5.3	Intellectual Property and Software <sup>1</sup>	6.2	3.5	5.5	4.8	5.1
-7.5	-6.3	-5.5	-3.3	-2.0	-0.7	0.7	1.3	Structures <sup>1</sup>	16.7	1.1	-5.4	-3.6	0.7
-5.1	-5.2	-7.0	-2.3	-0.3	0.4	1.0	1.1	Real Residential Fixed Investment <sup>1</sup>	-7.8	3.2	-2.3	-2.9	1.1
-0.1	2.2	-7.9	7.4	1.1	0.9	0.2	0.4	Real Government Expenditures <sup>1</sup>	3.5	3.8	1.0	0.8	0.3
-1,058.0	-957.2	-881.4	-919.2	-933.2	-953.1	-970.8	-993.9	Real Net Exports <sup>2</sup>	-925.2	-1,032.6	-1,069.3	-944.1	-1,017.5
941	883	891	902	910	917	924	930	Single Family Housing Starts, ths. of units <sup>3</sup>	947	1,016	932	913	940
413	456	398	417	420	423	429	433	Multi-Family Housing Starts, ths. of units <sup>3</sup>	473	355	413	422	438
1.8	1.2	0.7	0.2	-0.1	-0.1	0.0	1.0	CoreLogic House Price Index <sup>5</sup>	4.0	4.3	1.6	0.0	2.0
16.2	16.4	15.7	15.7	15.7	15.8	15.9	15.9	Vehicle Sales, millions of units <sup>3</sup>	15.5	15.9	16.2	15.8	16.0
4.2	4.3	4.5	4.4	4.4	4.4	4.3	4.3	Unemployment Rate, % <sup>4</sup>	3.6	4.0	4.3	4.4	4.2
1.0	0.9	0.5	0.3	0.3	0.3	0.5	0.5	Non-Farm Employment <sup>5</sup>	2.2	1.3	0.9	0.4	0.6
1.8	0.0	0.9	4.5	0.9	1.0	1.5	2.7	Real Disposable Personal Income <sup>1</sup>	5.7	2.9	1.6	1.8	1.9
2.5	3.0	3.1	2.7	2.7	2.3	2.1	2.1	GDP Price Deflator <sup>5</sup>	3.7	2.5	2.8	2.5	2.0
2.4	2.7	2.7	2.5	2.6	2.5	2.4	2.3	PCE Deflator <sup>5</sup>	3.8	2.6	2.6	2.5	2.2
2.5	2.9	2.9	2.6	3.0	2.9	2.8	2.7	Consumer Price Index <sup>5</sup>	4.1	3.0	2.7	2.8	2.5
2.7	2.9	2.7	2.5	2.5	2.4	2.4	2.4	Core PCE Deflator <sup>5</sup>	4.2	2.9	2.8	2.5	2.2
2.8	3.1	2.8	2.7	3.0	2.9	2.9	2.8	Core Consumer Price Index <sup>5</sup>	4.8	3.4	2.9	2.9	2.6
4.38	4.34	3.90	3.59	3.38	3.38	3.38	3.38	Fed Funds Target Rate Range Mid-Point, % <sup>4</sup>	5.07	5.19	4.25	3.43	3.38
4.36	4.26	4.10	4.16	4.19	4.22	4.26	4.29	10-Year Treasury Note Yield, % <sup>4</sup>	3.96	4.21	4.29	4.21	4.34
6.79	6.57	6.23	6.21	6.22	6.23	6.26	6.28	30-Year Fixed Mortgage, % <sup>4</sup>	6.81	6.72	6.60	6.23	6.33
-3.3	-3.2	-3.0	-3.1	-3.3	-3.3	-3.4	-3.4	Current Account, % of GDP	-3.3	-4.0	-3.8	-3.3	-3.4

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2017 \$ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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