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Wide Range Of Potential Impacts

It is obviously too soon to know how events in the Middle East will play out and the timeline on which they will do so. It is also too soon to know how lasting of an impact there will be on energy prices and on the broader economy. All we can say for certain at this point is that the longer this persists, the higher the toll on the U.S. economy and on the global economy. Were the conflict with Iran to conclude fairly quickly, the effects on energy prices seen thus far would likely reverse quickly as would the effects seen thus far in the financial markets. The risk, however, is that this turns into a protracted conflict triggering a large and persistent energy price shock that filters throughout the economy, adversely impacting household income and spending, employment, business investment, asset prices, and credit performance.

Again, there is simply no way of knowing at this point, and while we could easily construct an array of economic forecasts covering a wide range of outcomes, we don't see a lot of value in doing so, at least at this point, particularly given that attaching probabilities to the various scenarios, as some are doing, is a completely subjective exercise. That said, as we write this at the start of the second week of the conflict, there are already meaningful effects in the economy and the financial markets. In conjunction with what to this point has been a better than thirty dollars per barrel increase in crude oil price, retail gasoline prices have risen sharply, up by more than sixty cents per gallon at this point in some parts of the U.S. This will add to the financial stress already being experienced by many lower-to-middle income households.

One offset for many households, however, will come in the form of income tax refunds, larger than a year ago due to changes in the tax code enacted into law last summer, making their way into household deposit accounts. To be sure, we and others have for some time been pointing to a substantial boost, on the order of \$150 billion on an annualized basis by our estimates, in after-tax household income in Q1 2026 that would act as a support for growth in consumer spending. While the size of that boost is not impacted, the disposition of it is, and to the extent these funds are diverted to spending on gasoline and other energy goods and services to simply keep pace with rising prices, that means either less growth in other forms of spending, less saving, or less debt paydown than would otherwise have been the case. One risk is that a sharp and persistent energy price spike filters through to prices of food and finished goods – via production and shipping costs – and thus takes an even greater toll on spending.

Another impact already observed is that, in contrast to the "safe haven" effects that in times of geopolitical tensions/conflicts typically push down yields on U.S. Treasury securities, yields rose meaningfully over the first week of the conflict with Iran. It seems that, at least thus far, market participants have been more focused

on the potential inflationary impacts as opposed on the potential growth impacts. This could, of course, change and do so quickly, but it was striking that the shockingly weak headline print on the February employment did not elicit more of a reaction, i.e., a move downward, in yields on longer-term U.S. treasury securities. One implication is that the bump in yields has arrested the decline in mortgage interest rates seen in the weeks prior to the start of the conflict with Iran, throwing yet another hurdle in the path of an already challenged housing market just as the spring sales season is set to kick off. Even if yields reverse course, and take mortgage interest rates down with them, that may not provide much of a boost to the housing market until the conflict has concluded.

While at this point there may not be much of a basis for businesses to make decisions on employment and capital expenditures, the higher energy prices go and the longer they stay elevated, the greater the chances that firms do begin to make cuts, particularly should they come to expect a protracted period of weak demand. The absence of widespread layoffs has been the saving grace of a labor market already characterized by tepid hiring. There is, after all, a difference between firms not wanting more labor and firms wanting less labor, and a shift from the former to the latter would have significant adverse impacts for the broader economy. At the same time, we've been pointing to the strong positive momentum in business capital spending over the past several months and have expected this to be a meaningful support for real GDP growth in 2026. Should business confidence waver and/or higher costs make firms reconsider planned capital outlays, what at this point looks like the early phases of a promising run of growth in capital spending could be, if not stopped in its tracks, at least deferred. Additionally, though the U.S. is somewhat insulated by virtue of being a net exporter of oil, weakness in foreign economies brought on by higher energy prices, physical shortages of energy, and commodity costs pushed higher by a stronger U.S. dollar would result in weaker foreign demand for U.S. goods and services.

Another risk from a protracted conflict that would trigger a large and persistent energy shock would be the possibility of a steep decline in equity prices. Dimmer growth prospects and higher costs would obviously pressure corporate earnings which, in turn, would push equity prices lower. To the extent that impressive equity returns over the past few years have sparked wealth effects that have supported spending amongst higher-income households, particularly discretionary services spending, a sharp reversal in equity prices could trigger the opposite reaction, opening another channel through which aggregate spending weakens.

This is not intended as a complete rundown of the channels through which a persistent energy price shock could impact the economy, nor is this to say that any, let alone all, of these effects will come to pass. Our aim is to lay out some of the main risks in what would amount to a worst-case scenario even if at this point

how this will play out remains highly uncertain. As for where this might leave the FOMC, we think for now it leaves them on the sideline, even if more uncomfortably. The effects seen to date are far more on the inflation front than on the growth front. To the extent that remains the case, with inflation already stubbornly above the FOMC's two percent target rate and, as evidenced by the minutes of the January FOMC meeting, a sharply divided Committee, it's difficult to envision further cuts in the Fed funds rate at this point, especially at this month's meeting. That said, should the conflict with Iran persist and pose an increasing threat to growth, that could make the Committee more willing to set aside concerns over inflation and cut the funds rate. While we do not think the economy, or the FOMC, is at that point yet, this is a fluid situation, and things can change quickly and in ways we may not be able to perceive at this point.

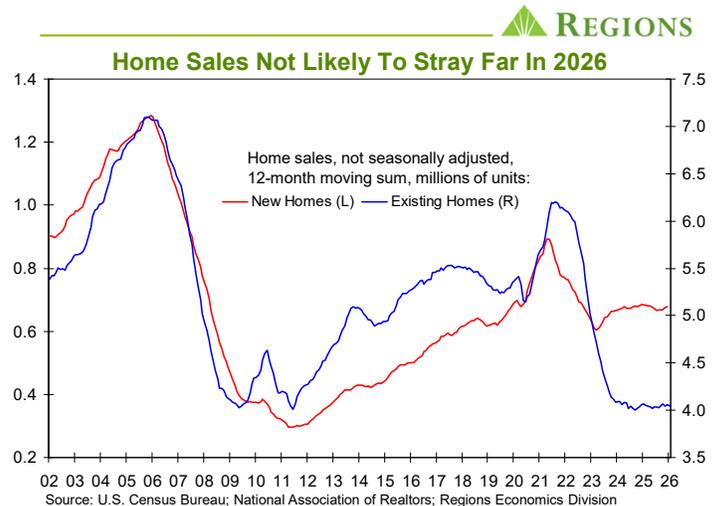
“Frozen In Time” Housing Market Set For A Thaw?

One of the ongoing challenges in our job is trying to make sense of the frequent twists and turns in the various economic data series we rely on to assess the state of the U.S. economy. To be sure, in any given data series a certain degree of volatility is to be expected from one observation to the next, and we often find it necessary to remind people that the economic data do not move in straight lines. Over the past few years, however, it seems more and more the case that whatever inherent volatility there is in the economic data is being compounded by sampling, data collection, and seasonal adjustment issues, sometimes all in the same data release, making it even harder to segregate the signal from the noise in the data. As our regular readers know, this has been an ongoing frustration of ours in the years since the pandemic.

One way to think about it, in the spirit of the recently concluded Winter Olympics, is that after for decades having more closely resembled the more orderly rhythms of cross country skiing, much of the economic data now seems to more closely resemble short track speed skating, in which chaos (i.e., noise) can, and often does, win out over skill (i.e., signal). Okay, maybe it's not quite that extreme but, either way, that so much of the data have become so volatile makes any exceptions to the general rule that much more noteworthy. We have on several occasions pointed to two such exceptions – manufacturing output and sales of new and existing homes – for which the underlying trends had been eerily stable for two-plus years. “Stable” is not, at least in this context, necessarily desirable, given that activity in these segments had stabilized around such low levels. By year-end 2025, however, we had begun to point to building momentum in manufacturing activity, and that has carried into 2026 as evidenced by strong and broadly based growth in orders for core capital goods as well as the improvement in the ISM Manufacturing Index.

That, for better or worse, leaves home sales as a, for lack of a better term, beacon of stability in the economic data. As beacons go, however, this one is about as dimly lit as they come given that, again, home sales have stabilized around notably low levels. That can best be seen in the following chart, in which we show the running twelve-month totals of new and existing home sales which, as our regular readers know, is what we think to be the

most reliable gauge of underlying sales trends, at least to the extent that what are basically flat lines count as trends.



One virtue of the above chart is that it helps illustrate a point which almost always goes overlooked, which is that home sales, both new and existing, hit their cycle peaks in 2021, with the initial declines in sales reflecting supply constraints. To be sure, what began as a supply-side story eventually became a demand-side story as mortgage interest rates rose sharply and house prices continued to climb, a combination that has yielded increasingly binding affordability constraints that have left sales so tightly rangebound for more than two years now.

By the end of February, mortgage interest rates had, as reported by *Mortgage News Daily*, slipped below six percent, lower than they had been in more than three years. That sparked hopes of home sales shifting into higher gear, particularly with some relief on the supply side of the market. Between builders motivated to pare down unwanted inventories of spec homes for sale and rising inventories of existing homes for sale, supply-side conditions were becoming more supportive of sales. We did not, however, expect much of a pop in sales, in part because even with mortgage interest rates dipping below six percent and some improvement on the supply side of the market, we just didn't see much relief from the affordability constraints that have been weighing on sales. While at some point the market will answer that question for us, that point has been pushed further out into the future. By the end of the first week of the conflict with Iran mortgage rates had risen back to 6.15, keeping step with rising yields on 10-year U.S. Treasury notes, and even should yields, and in turn mortgage rates, ultimately be dragged down by a dimming growth outlook, such a scenario would not be conducive to rising home sales.

Even with mortgage interest rates having dipped below six percent, our view was that affordability constraints were binding to the point that it would take some combination of larger declines in mortgage interest rates and/or prices than seen to date to fuel a significant boost in home sales. While existing home prices have been declining in many markets across the U.S., those declines have for the most part been fairly modest, and the markets in which prices are falling more sharply tend to be the same markets in which house price appreciation had been the most robust over the prior few years, meaning that on net there was less relief from

affordability constraints than would be implied by simply looking at the magnitude of the price declines.

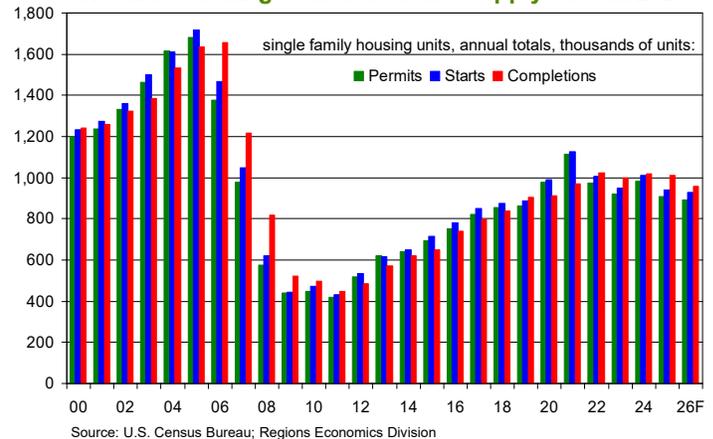
There are other factors that we think are weighing on demand for home purchases. While the link between measures of consumer confidence/sentiment and growth in overall consumer spending is, at best, somewhat spotty, the link could be stronger when it comes to specific types of expenditures, particularly “big ticket” purchases that would clearly include home purchases. That would especially be the case when consumers are less upbeat on labor market conditions, which has for some time now been the case. Being less confident about their own job and income prospects would make people less willing to take on major expenditures, and that could be one factor weighing on demand for home purchases.

More broadly, we’d argue that a less dynamic labor market was a primary factor behind diminished geographic mobility in 2025, particularly with more firms implementing return to office policies. Diminished geographic mobility translates into diminished housing turnover, and it isn’t clear to us that this set of conditions will change much in 2026 even though we do expect to see some firming in the trend rate of job growth as the year progresses. Still, even in a more dynamic labor market, the number of households with current mortgage rates of less than three percent acts as somewhat of a constraint on mobility to the extent those owners are unwilling to “trade up” into a higher mortgage rate.

aimed at improving housing affordability that we’ve seen thus far would work to increase demand rather than supply which, rather than improving affordability, would likely push house prices higher, thus putting a further dent in affordability.



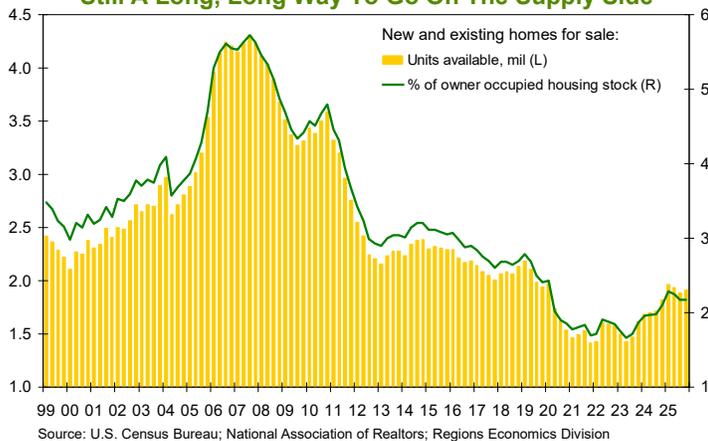
Not Much Change On New Home Supply Side In 2026



We’ve consistently argued that the root cause of most of the housing market’s current ills is what has been a prolonged period of under-construction of new single family homes. As seen in the above chart, we’re actually looking for modestly lower annual totals of single family permits and starts in 2026, primarily because spec inventories of new homes for sale remain significantly higher than most builders are comfortable with. Moreover, shortages of labor and stiff cost increases have thrown a wrench into the works for builders, acting as further drags on new construction. For point of reference, in the chart above don’t look to the levels of new single family construction over the 2004-06 period as where single family construction “should” be, for what we think are painfully obvious reasons. Instead, we frequently say that 2000 through 2003 are the last “normal” years we’ve seen in the housing market, so think of the cumulative gap between levels of construction seen over that period with actual levels seen this side of the mid-2000s housing market bust as a proxy for the shortfall of single family construction. To the extent we’re correct on this point, the reality is that there is no quick remedy to the lack of supply that we think is the root of the affordability problem, and an effective remedy won’t be found on the demand side of the market.



Still A Long, Long Way To Go On The Supply Side



We’d also argue that, while there has been some improvement in supply-side conditions, the housing market nonetheless remains chronically undersupplied. We often use the above chart to make this point (we don’t have longer history of the current series on inventories of existing homes for sale, thus limiting how far back in time our chart can go). The gold bars reflect combined new and existing homes for sale, while the green line is a proxy for the rate of turnover of the owner occupied housing stock. While both measures have come off the lows hit in the post-pandemic years (to our earlier point, the low in units available for sale coincides with the peak in home sales in 2021), neither is anywhere near where it would be in a more balanced market.

This is by no means a new issue, as we first began pointing to limited inventories as a drag on existing home sales more than a decade ago. We’ll also note that almost all of the various proposals

A “New Normal” For Nonfarm Employment?

It is highly unlikely that anyone would refer to the monthly data on nonfarm employment as a “beacon of stability,” and one need only look at the past two months to understand why. After having risen by 146,000 jobs in January (originally reported as an increase of 172,000 jobs), private sector payrolls fell by 86,000 jobs in February. Accounting for the loss of 6,000 public sector jobs, total nonfarm payrolls fell by 92,000 jobs in February. The shockingly weak headline print on the February employment report led to renewed worries about the state of the labor market, with some quick to call on the FOMC to overlook inflation stubbornly sticking above their 2.0 percent target and resume cutting the Fed funds

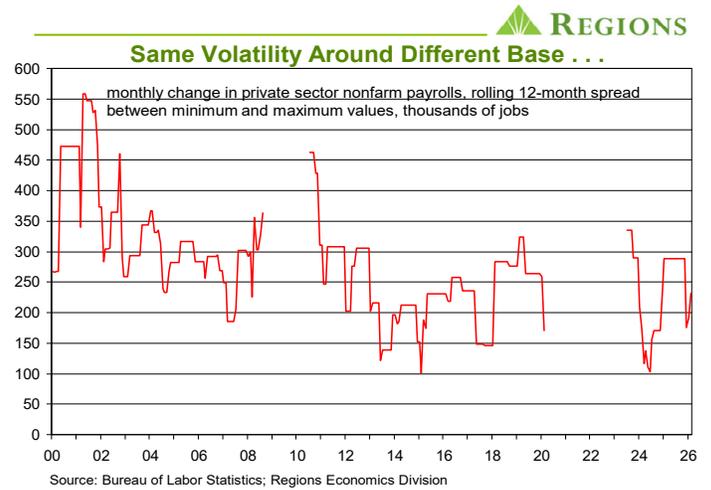
rate. Missing in those calls, however, was any explanation of how exactly another twenty-five basis point in the funds rate would “support” the labor market. As for us, we noted upon its release that the January employment report likely overstated job growth, and by the same token we think it highly unlikely that the labor market suddenly disintegrated in February.

We can point to a host of factors that played into the shockingly weak headline print on the February employment report. Under the heading of “here we go again,” the initial collection rate to the BLS’s February establishment survey was just 57.7 percent, the lowest February rate since 2000 which, right off the bat, leaves the body of the February establishment survey data open to potentially sizable revision. Part of the issue is that the February survey period ended so early – prior to mid-month – in the month, which typically biases survey response rates lower. That early end to the February survey period could also have dragged weather effects into the mix, as the atypically harsh winter weather that struck much of the month, including parts of the South being blanketed in ice, carried into early February. Though lower than last February, the combined number of people either working fewer than normal hours or not working at all due to adverse weather was nonetheless meaningfully higher than is typical for the month. Construction payrolls, reported to have fallen by 11,000 jobs, are one example in which the not seasonally adjusted data show a significant divergence from typical February patterns. Payrolls in health care were knocked down by roughly 30,000 jobs due to a strike, jobs which will come back onto the books in the March data. Finally, not seasonally adjusted payrolls amongst courier and delivery services fell by over 75,000 jobs, much larger than the typical February decline for this industry group, which could reflect previously announced UPS layoffs hitting the books.

To be sure, even allowing for all of these factors, the headline print would likely still show a decline in nonfarm payrolls in February, just not as large as that reported. This, however, gets us to what we think is a plausible explanation for what we’ve been seeing in the nonfarm employment data for quite some time now, such as the level of private sector nonfarm payrolls having declined in eight of the past twenty months dating back to mid-2024. This is an extension of the discussion we started in last month’s *Outlook*, in which we pointed out that rather than the labor market suddenly hitting a wall in 2025 due to uncertainty over trade policy and/or AI, as the common narratives go, the reality is that by mid-2024 job growth had become much slower and more uneven.

We won’t repeat that discussion here but will add to it by noting something that occurred to us as we shook off the headline print on the February employment report and got to digging through the details of the data. What we think has happened is that with the trend rate of job growth having been pushed so low in a “low hire, low fire” labor market, the usual degree of month-to-month volatility in estimates of the change in nonfarm payrolls is more frequently resulting in negative headline prints. For instance, over the past six months, the average monthly increase in private sector payrolls has been 34,000 jobs, and over that span the monthly change has ranged from minus 86,000 jobs-to-plus 146,000 jobs. Extending back to mid-2024, over the past twenty months the numbers aren’t much different, with an average monthly increase of 39,000 jobs and a range of minus 86,000 jobs-to-plus 212,000 jobs. These average monthly gains, by the way, are right in line

with where we put the “breakeven” pace of job growth, i.e., the pace of job growth needed to keep the unemployment rate stable.



The chart above, with the data around the 2007-09 recession and the pandemic tossed out as they skew the scale while not at all altering the discussion, helps illustrate our point that the monthly estimates of job growth have not necessarily become more volatile. We show the running twelve-month average spread of the low-to-high estimates of the monthly change in private sector nonfarm payrolls. As it turns out, the average spread between the low-to-high estimates since 2024 has been virtually the same as was the case over the five years prior to the pandemic. In other words, it isn’t that the estimates of the monthly change in payrolls has become more volatile, instead, that same volatility is now coming around a much lower mean. Our sense is that this could be a “new normal” for nonfarm payrolls, i.e., fluctuations around a mean so low that monthly declines in private sector nonfarm payrolls are more frequent than has historically been the case.

To the extent we’re correct on this point, it won’t work out so well for those who go no further than the headline number atop any given data release, or for those who latch on to whatever the latest headline numbers are as the basis on which to spin broad narratives of the state of the economy. For the rest of us, though, it may help reconcile the seeming contradictions in the monthly estimates of nonfarm payrolls. This doesn’t by any stretch imply that all is well with the labor market. A low hire, low fire labor market is a very tenuous line on which to balance, which is one reason events in the Middle East take on such significance. It is also the case that what has become much weaker growth in labor supply is playing a role in the breakeven pace of job growth being as low as we and many others think it to be. For now, though, the economy continues to grow at a healthy clip and a curious, not to mention almost entirely overlooked, detail of the February data is that the one-month hiring diffusion index was over fifty percent despite the large decline in private sector payrolls. The ongoing acceleration in labor productivity growth is a key factor behind the economy continuing to grow, and this is where the steady and broadly based growth in business investment comes into play. As the jobs lost during the pandemic were being added back at a frenzied pace, we used to warn that at some point that rush would subside. That happened some time ago, and this is what the labor market now looks like. It just may take some getting used to.