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Something Has To Give, Just Don't Ask Us What That Is . . .

On February 27, yields on 10-year U.S. Treasury Notes settled at 3.97 percent. At the time, many were writing obituaries for the labor market and the broader economy and speculating over how many times the FOMC would cut the Fed funds rate as they rode to the rescue of the U.S. economy. On June 5, yields on 10-year U.S. Treasury Notes settled at 4.53 percent amid signs of a reinvigorated labor market and many wondering how many times the FOMC would raise the Fed funds to quell frustratingly stubborn inflation pressures. To that point, yields on two-year U.S. Treasury notes were almost eighty basis points higher on June 5 than they were on February 27.

The seemingly obviously explanation is that the conflict with Iran has pushed energy prices meaningfully higher and led to supply chain disruptions. Headline inflation has already accelerated, and it seems only a matter of time until higher costs for energy and other inputs to production along with higher shipping costs spill over into measures of core inflation. Even to the extent that is the case, that seems unlikely to fully account for the move higher in yields. After all, assuming there is at some point a resolution to the conflict with Iran, energy prices will recede, even if with a delay as production comes back online and inventories are replenished, thus pushing inflation and, in turn, yields down. That premise, however, seems at odds with current market pricing of the path of the Fed funds rate.

That leaves the question of what other factors may be behind the sharp increase in yields on U.S. Treasuries even if, at least for us, a 4.50 percent yield on 10-year Treasuries is easier to understand than was the 3.97 percent yield on February 27. After all, our February baseline forecast anticipated real GDP growth of 2.7 percent for 2026 with inflation remaining easily ahead of the FOMC's 2.0 percent target rate through 2027. Moreover, in our 2026 annual outlook, we discussed a few factors which we thought would put gentle but persistent upward pressure on longer-term interest rates over the course of 2026. In other words, there was no point at which we were writing obituaries for either the labor market or the broader economy and, in that context, we struggled to explain 10-year Treasuries yielding less than four percent.

As it turns out, we didn't have to struggle with that for very long. Still, to our point about the outlook for growth and inflation helping shape the path of longer-term interest rates, the economy has, at least thus far, proven to be somewhat resilient despite the jumps in energy prices and interest rates seen since early March. That is not to say the economy has been immune, as higher prices have weighed on real growth. For instance, since our February forecast of 2.7 percent real GDP growth, our forecast of full-year 2026 real

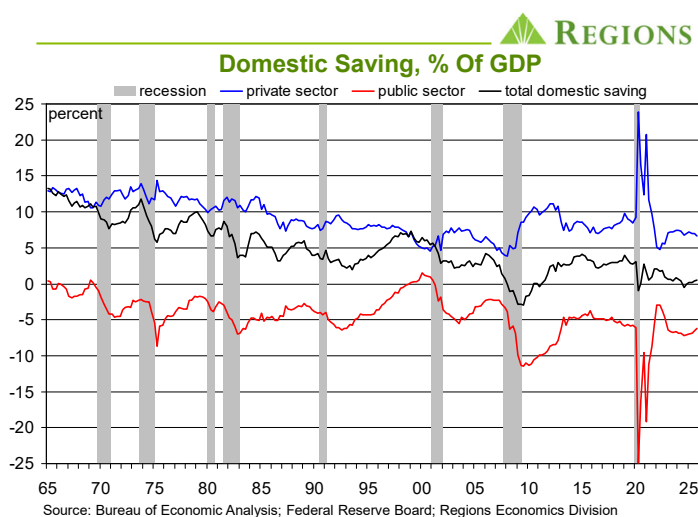
GDP growth has come down in each successive month and as of our June forecast is at 2.0 percent. Still, that would be much better than what many expected as they watched crude oil and retail gasoline prices spike following the start of the conflict with Iran, particularly those who back in February were already feeling antsy about the outlook for the U.S. economy. With surging business investment and labor market conditions having at least stabilized if not firmed over the past few months, that economic growth is proving to be resilient has likely contributed to the move higher in longer-term interest rates. To be sure, the growth picture would dim sharply and suddenly were the conflict with Iran drag on to the point that physical shortages of crude oil/diesel fuel and other inputs lead to disruptions in economic activity, but that is not the scenario being priced into financial markets at present.

At the same time our forecasts of real GDP growth have come down, our forecasts of nominal GDP growth have been marked steadily higher. That divergence reflects upward revisions to our inflation forecasts, which has almost universally been the case. This is likely of more relevance to the path of interest rates than a more constructive outlook for growth. Moreover, not only have inflation forecasts been marked higher, but many are now starting to think that inflation pressures may be more persistent than they had previously anticipated. As our regular readers are aware, this has been our expectation all along, i.e., even before the start of the conflict with Iran we were arguing that inflation pressures were likely to be more persistent than generally anticipated, which is one reason we expected an upward drift in longer-term interest rates over the course of 2026. To the point such expectations are becoming more widely held, that would be one factor behind the increase in longer-term interest rates and one which would not simply reverse upon resolution of the conflict with Iran.

Many have also pointed to concerns over the fiscal path the federal government is on as a factor behind rising long-term interest rates. To accept that premise, however, one has to also accept the premise that the fiscal path ahead is suddenly more perilous in than it was in late February when, again, yields on 10-year U.S. Treasuries were below four percent. Even allowing for the costs of the conflict with Iran, this seems like more than a bit of a reach to us. We're reminded of June 2024, when the Congressional Budget Office (CBO) caused quite a stir with the release of their updated outlook for the federal government and the broader economy in which they projected annual budget deficits on the order of \$2 trillion over the next decade. At the time, yields on 10-year Treasuries were hovering around 4.20 percent, and there was considerable talk of the "bond vigilantes" saddling up again to ride herd over the federal government as they had back in the early-1990s. Of course, less than two months later, 10-year yields were below four percent, the bond vigilantes apparently having lost their way back to the O.K. Corral. It has been noted elsewhere that the recent run-up puts yields on U.S. Treasuries roughly back in line

with where they were in 2007, the difference being that the level of outstanding national debt at present is over three times higher than it was then.

This isn't to say that concerns over the U.S. fiscal path have no bearing on market interest rates, but rather that any link between the two is more nuanced than simply pointing to the level of the national debt, which seems to be the default explanation. Indeed, we discussed the CBO's updated budget projections in our July 2024 *Outlook*, in which we noted that public sector dissaving (i.e., federal government budget deficits) were effectively absorbing domestic private sector saving, leaving the U.S. reliant on inflows of foreign capital to help fund the investment spending that is the fuel for sustained economic growth. The following chart helps illustrate this point.



In the context of this discussion, the question is whether global investors are now less inclined to hold U.S. dollar denominated debt, including U.S. government debt. It could be argued that this is at least to some degree the case. After all, yields on government debt across much of the globe have risen, including within the Euro Zone with the prospect of more expansionary fiscal policy, and Japan, where yields on government debt have also risen sharply. To the extent investors in these countries harbor a "home bias" that would make them more inclined to buy domestic government debt as opposed to U.S. government debt, that would be a source of upward pressure on U.S. interest rates. Moreover, to the extent that trade flows have shifted amid elevated global trade tensions, that could also be weighing on foreign demand for U.S. Treasuries. After all, the flip side of a trade deficit is a capital inflow, and a singular focus on reducing the former leads one to overlook the potential effects on capital flows and interest rates.

We also think it worth reiterating a point we've made before, which is that many people think of global capital flows and the potential impacts on U.S. interest rates incorrectly, i.e., as a question of stocks rather than flows. In other words, many seem to be bracing for the day when foreign investors and/or foreign central banks suddenly decide to dump significant quantities of U.S. dollar denominated assets, which would lead to a sharp and sudden surge in U.S. interest rates. Not only is that unlikely, but it is also not necessary in order for there to be effects on U.S. interest rates. The point being that it isn't a question of stocks, it's a question of

flows, i.e., it would simply take foreign investors/central banks either accumulating U.S. dollar denominated assets at a slower pace or simply not reinvesting proceeds of maturing dollar denominated assets in order for there to be impacts on U.S. interest rates. Recall that prior to the start of the conflict with Iran there were signs that global investors were reallocating capital away from U.S. dollar denominated assets as yields on foreign government debt were rising. Yields have risen further since the start of the conflict, which could have led to further shifts in global capital flows, thus adding to the increase in U.S. interest rates.

To our prior point about the U.S. being reliant on inflows of foreign capital to help fund investment spending, there is a demand side component that could be contributing to higher U.S. interest rates. The surge in investment related to AI, and for that matter the pickup in overall business investment spending, means increased demand for credit. To some extent, this is mitigated by the ability of firms, particularly the largest technology firms, to self-fund investment spending, a point that also applies more broadly. Note that Q4 2025 (the most recent observation) was the third straight quarter in which the corporate "financing gap" – the difference between capital expenditures and internal cash flows – for the nonfarm nonfinancial corporate sector had been negative, meaning that firms could, in the aggregate, internally fund capital spending even with the pace of capital spending having picked up over 2H 2025. There are, of course, distributional issues here and it is certainly not the case that all firms are able to internally fund capital spending, nor does being able make firms willing to do so. To the extent firms are tapping credit markets, this means more competition for funds. Given that some of the largest technology firms are able to issue long-term debt at very narrow spreads to U.S. government debt, it could be that investors are opting for private sector debt, or, as a colleague puts it, investors may be more willing to bet on, say, Apple's balance sheet than on the federal government's balance sheet. The bottom line, however, is that this could make it more costly for the government to borrow.

It is simply not possible to quantify the extent to which the factors we've mentioned here might be contributing to higher longer-term interest rates. Okay, sure, it is possible, but it is not possible to do so with any degree of precision, as the results would obviously be sensitive to all of the assumptions one would have to make in order to do such an attribution. And, as noted above, it is more than reasonable to think that some, but we do not think all, of the increases seen since the start of the conflict with Iran will be reversed upon the resolution of the conflict.

We will, presumably, know that in due time. But, to the extent higher interest rates persist, another common question is whether, or to what extent, higher interest rates are impacting the U.S. economy. One can make the case that, outside of the housing market, the effects have been limited. To the extent mortgage interest rates move with yields on 10-year U.S. Treasury Notes, the upward move in yields is another hurdle in the path of an already stumbling housing market. Recall that in last month's edition we showed how the trend rates of new and existing home sales have basically been flat lines for more than two years, and higher mortgage interest rates only serve to intensify affordability constraints that have pushed some prospective buyers out of the for-sale segment of the housing market. Additionally, to the extent that interest rates on auto loans and other fixed-rate consumer

loans are tied to yields on U.S. Treasury securities, borrowing costs for various forms of household credit have risen as well. That said, there is little evidence that motor vehicle sales have been dinged, as the annualized rate of unit sales of new vehicles has topped the sixteen million unit mark in each of the past three months. It could be that higher financing costs have led consumers to put off at least some borrowing, but higher prices seem a bigger threat to spending than do higher financing costs.

There are few signs of activity in the nonfinancial corporate sector being meaningfully impaired by higher interest rates, as can be seen in the data on capital spending and improving conditions in the manufacturing sector. Note that key benchmark interest rates, such as the prime rate and SOFR, have not changed with the FOMC having been on hold. Moreover, largely overlooked in discussions of the causes and consequences of higher interest rates is that overall financial conditions, of which interest rates are but one component, remain accommodative. This reflects other components of overall financial conditions, such as narrow credit spreads, strong corporate earnings that are pushing equity prices higher, and more recently a rebounding exchange value of the U.S. dollar, acting to counter higher interest rates, particularly given what remains ample liquidity in the corporate sector (and to a lesser extent in the household sector).

For instance, the last time the Goldman Sachs index of financial conditions consistently showed financial conditions to be as accommodative as they are at present was early-2022. At the same time, the *Financial Stress Index* produced by the Federal Reserve Bank of St. Louis based on eighteen financial market indicators continues to show a below-average degree of financial market stress, less now than the last observation prior to the start of the conflict in the Middle East. While not arguing that higher interest rates do not matter, it does seem that overall financial conditions having remained notably accommodative is acting as a strong counter to higher interest rates, which is helping sustain economic activity. That could of course change, and do so quickly, but thus far we'd argue it has been a powerful support.

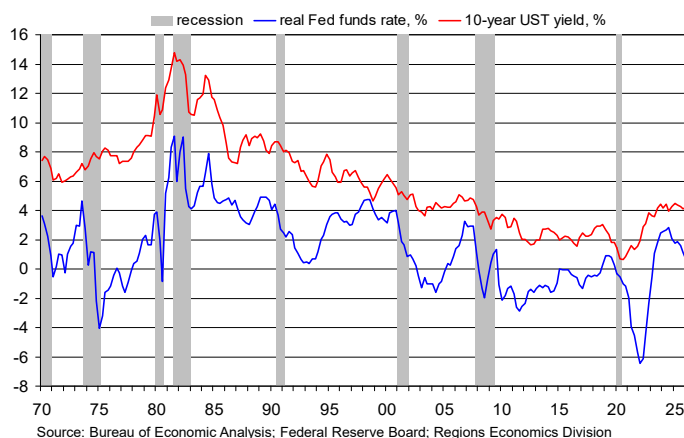
If rising interest rates seem at odds with accommodative financial conditions, we're not sure where that leaves the Fed funds rate. A colleague pointed out that the last time the Goldman Sachs index showed financial conditions as accommodative as they now are the (effective) Fed funds rate was all of thirty-three basis points; the effective funds rate now sits at 3.62 percent. While that may seem at odds with financial conditions being as accommodative as they are, note that the real (i.e., inflation adjusted) Fed funds rate is at present negative. To be sure, the real funds rate is not negative to nearly the same extent as in early-2022 when overall financial conditions were as accommodative as they now are. Still, that the real funds rate is negative at all seems to be largely overlooked, particularly given that the only "news" likely to come out of this month's FOMC meeting will be the Committee dropping the implicit easing bias from their post-meeting policy statement.

While many might be inclined to brush this off as no more than a function of a, well, transitory increase in inflation stemming from the conflict with Iran, doing so is to ignore the broader point of whether monetary policy was already needlessly accommodative given the outlook for growth and inflation prior to the start of the conflict, particularly if it was the case that inflation pressures would

prove to be more persistent than was generally expected to be the case. Those who earlier this year were clamoring for multiple Fed funds rate cuts apparently failed to notice the real funds rate was already steadily falling, let alone that overall financial conditions were accommodative. Even allowing for inflation to settle back upon resolution of the conflict with Iran, thus pushing the real funds rate back into positive territory, it will still be reasonable to ask whether the funds rate is too low, at least if our expectations for growth and inflation are close to being on the mark.



Real Effective Fed Funds Rate



The behavior of yields on 10-year U.S. Treasury Notes suggests that would be a reasonable question to ask, as yields have been notably flat while the real funds rate has fallen by almost three hundred basis points since the FOMC began cutting the nominal funds rate in September 2024. Recall that many were confounded when, while the FOMC was cutting the Fed funds rate by one hundred basis points between September 18 and year-end 2024, yields on 10-year U.S. Treasuries were rising by almost ninety basis points. While that movement is somewhat masked in the above chart showing quarterly averages, these quarterly averages also suggest that the recent run-up in yields isn't as pronounced as you'd think listening to much of the discussion of this topic, with the quarter-to-date Q2 average 10-year yield twenty basis points higher than the Q1 average. It is also noteworthy that yields on 10-year U.S. Treasuries over the past two-plus years are pretty much back in line with where they were in the time between the end of the 2001 recession and the start of the 2007-09 recession.

It could be that part of the reason many seem to fear the recent increases in interest rates is that they see the period between the 2007-09 recession and the start of the pandemic as being the normal state of affairs, when in reality that period was marked by global central banks holding policy rates artificially low and expanding their balance sheets which, in turn, helped keep yields on government debt lower than would have otherwise been the case. Others, particularly those who have been at this longer, would likely be more inclined to see current yields, if not the real Fed funds rate, as being the more normal state of affairs. This gets us back to our premise that something isn't as it should be. What specifically that is – longer-term market interest rates, overall financial conditions, the real Fed funds rate – and how, and when, that will change remain to be seen.

So, You Mean The Robots Aren't Coming For Our Jobs?

We can remember a time when the labor market was widely seen as being on its death bed, unable to withstand the assault from job-stealing robots while uncertainty over trade policy was killing off all the jobs the robots didn't claim. That time is actually not all that hard to remember, as it was, you know, February/March. Fast forward all of three months, and perceptions of the state of the labor market have changed dramatically, particularly in the wake of a May employment report being touted as a "blowout" report. As a sign of just how much perceptions have changed, recall that earlier this year many were pointing to the labor market as grounds for the FOMC to make further cuts in the Fed funds rate, whereas in the wake of the May employment report many are pointing to the labor market as giving the FOMC the latitude to raise the funds rate to combat stubborn inflation pressures.

As for our take on the May employment report, we'll just say that in a world in which over-the-top reactions to headline numbers on economic data releases are, sadly, the rule rather than the exception, seldom have we seen so much made out of so little. Sure, right now you might be wondering what report we are actually looking at. After all, total nonfarm payrolls rose by 172,000 jobs in May, more than double the consensus forecast with job gains broadly based across private sector industry groups, prior estimates of job growth in March and April were revised up by a net 93,000 jobs for the two-month period, and the unemployment rate held at 4.3 percent.

To anyone asking "what's not to like here?" our reply would be the details beneath these headline numbers. For openers, public sector payrolls rose by 52,000 jobs in May, driven by an increase of 43,500 jobs in local government excluding education. While private sector payrolls were up by 120,000 jobs, 70,000 of those jobs came in leisure and hospitality services. What these two have in common is that they were largely driven by hiring ahead of the World Cup, with local governments taking on workers to help with security and infrastructure (not seasonally adjusted payrolls in local government excluding education were up by over 100,000 jobs in May) and businesses, particularly restaurants, adding staff in anticipation of higher customer traffic. To the extent job gains in these two segments were tied to the World Cup, it follows that once the last ball has been bowled toward the last striker's wicket (or whatever it is they do in the World Cup) these jobs will go away and payrolls in these segments will get back to where they would have otherwise been.

As for job growth being broadly based, it is true that the one-month hiring diffusion index, a measure of the breadth of hiring across private sector industry groups, rose to 54.4 percent in May, the highest reading since December 2024. While we routinely cite the hiring diffusion index as an important indicator, we just as routinely point out that it measures the breadth of hiring, not the intensity of hiring. That is a useful point to recall here; with healthcare adding 47,200 jobs and leisure and hospitality services adding (at least for now) 70,000 jobs, that almost fully accounts for the increase in private sector payrolls, leaving a series of smaller gains and losses across the rest of the private sector basically amounting to a wash. For instance, construction and

manufacturing teamed up to add 24,000 jobs in May while information services and finance teamed up to shed 24,000 jobs.

Though not a commonly discussed element of any given monthly employment report, we make it a point to scour the data on total hours worked on an industry by industry basis, as this is what actually matters for output growth. Despite what have been some big headline job growth numbers over the past three months, there has been strikingly little growth in aggregate private sector hours worked. To that point, despite the gain of 120,000 jobs, aggregate private sector hours were basically flat in May. In part, this is compositional, as job growth was concentrated in leisure and hospitality services and health care, industry groups in which weekly hours are well below the private sector average. That aggregate hours were flat means that the sizable increase in private sector payrolls did little to advance output growth in May while also blunting the increase in aggregate private sector wage and salary earnings, the largest component of personal income.

The size of the labor force barely budged in May, with an increase in the "prime working age" cohort being somewhat offset by declines across other age cohorts. Moreover, May's increase in the prime working age barely offset the cumulative decline reported over the three months prior for this cohort. Gains in household employment over the past several months have lagged gains in payroll employment by a wide margin, and that the unemployment rate has been basically flat is a testament to how tepid growth in the labor force has been. To some extent, this reflects the ongoing decline in the foreign born labor force, which we've been pointing to since late-2024 as a potentially powerful drag on job growth.

Additionally, even allowing for the sizable job gains seen over the past few months, the rate at which firms are hiring labor remains lower than at any time since 2013, at least according to the data from the Job Openings and Labor Turnover Survey (JOLTS). As such, even though the layoff rate remains below pre-pandemic norms, those who do lose a job are having a harder time finding another, which is reflected in the rising duration of unemployment and what, excluding the pandemic period, is now the highest level of long-term unemployment (27 weeks or more) since 2016.

It isn't that we set out to poke holes in the May employment report, though if one were trying to do so it would take shockingly little effort, as all one would need to do would be to go through the details of the data. Instead, most of the reactions we've seen or heard seem to be based on nothing more than the headline numbers. It is dumbfounding that anyone would point to the May employment report as grounds for Fed funds rate hikes, but market pricing of the path of the funds rate shifted markedly after the release of the report. Coming days will tell whether analysts and market participants have reconsidered those initial reactions.

Our view of the labor market has not changed for quite some time. Just as earlier in the year we were pushing back on the dour takes on labor market conditions, we now find ourselves pushing back on the narrative that the labor market is again firing on all cylinders. We've consistently pointed to supply side and demand side factors holding down job growth and have argued that what will be notably slow trend job growth will nonetheless be sufficient to keep the unemployment rate stable if not slightly lower. If and when we have grounds to change our view, we will, but the May employment report doesn't come close to warranting that.

ECONOMIC OUTLOOK



June 2026

Q4 '25 (a)	Q1 '26 (p)	Q2 '26 (f)	Q3 '26 (f)	Q4 '26 (f)	Q1 '27 (f)	Q2 '27 (f)	Q3 '27 (f)		2023 (a)	2024 (a)	2025 (a)	2026 (f)	2027 (f)
0.5	1.6	1.9	1.8	2.4	2.7	2.7	2.6	Real GDP ¹	2.9	2.8	2.1	2.0	2.4
1.9	1.4	2.0	1.6	2.3	2.7	2.7	2.7	Real Personal Consumption ¹	2.6	2.9	2.6	2.0	2.4
2.4	10.1	5.2	5.3	5.2	5.2	4.4	4.2	Real Business Fixed Investment ¹	7.3	2.9	4.1	5.8	4.9
4.3	17.2	11.0	11.2	9.6	8.3	6.2	5.1	Equipment ¹	2.9	3.5	8.3	10.3	8.0
5.4	11.6	4.1	5.1	5.0	5.1	5.1	5.1	Intellectual Property and Software ¹	6.2	3.5	5.6	7.2	5.0
-6.5	-5.4	-5.0	-7.6	-5.2	-3.0	-2.5	-0.9	Structures ¹	16.7	1.1	-5.3	-5.9	-3.6
-1.7	-6.2	1.2	1.4	0.2	0.2	-0.1	0.9	Real Residential Fixed Investment ¹	-7.8	3.2	-2.2	-2.7	0.5
-5.6	4.4	0.0	0.3	1.0	0.9	0.7	0.5	Real Government Expenditures ¹	3.5	3.8	1.1	0.4	0.7
-968.7	-1,063.8	-1,020.4	-1,113.5	-1,162.2	-1,193.8	-1,210.4	-1,223.3	Real Net Exports ²	-925.2	-1,032.6	-1,090.7	-1,090.0	-1,218.2
923	946	916	913	917	915	917	924	Single Family Housing Starts, ths. of units ³	947	1,015	941	923	921
401	466	481	447	442	442	442	443	Multi-Family Housing Starts, ths. of units ³	474	355	415	459	442
0.9	0.5	0.0	-0.4	-0.5	0.0	0.7	1.4	CoreLogic House Price Index ⁵	4.0	4.3	1.7	-0.1	1.0
15.7	15.4	16.0	15.8	15.9	16.1	16.1	16.2	Vehicle Sales, millions of units ³	15.5	15.9	16.2	15.8	16.1
4.5	4.3	4.3	4.3	4.3	4.3	4.2	4.2	Unemployment Rate, % ⁴	3.6	4.0	4.3	4.3	4.2
0.2	0.2	0.3	0.4	0.6	0.6	0.5	0.6	Non-Farm Employment ⁵	2.2	1.2	0.5	0.4	0.6
-0.9	0.8	-2.4	2.1	1.9	4.0	2.5	2.5	Real Disposable Personal Income ¹	5.7	2.9	1.7	0.2	2.4
3.3	3.3	3.9	3.6	3.2	2.9	2.3	2.2	GDP Price Deflator ⁵	3.7	2.5	2.8	3.5	2.4
2.8	3.1	3.9	3.8	3.7	3.0	2.2	2.1	PCE Deflator ⁵	3.8	2.6	2.6	3.6	2.3
2.8	2.7	3.9	3.7	3.7	3.4	2.3	2.3	Consumer Price Index ⁵	4.1	3.0	2.7	3.5	2.5
2.9	3.1	3.3	3.4	3.3	2.9	2.6	2.4	Core PCE Deflator ⁵	4.2	2.9	2.8	3.3	2.5
2.8	2.5	2.8	2.9	3.2	3.2	3.0	2.7	Core Consumer Price Index ⁵	4.8	3.4	2.9	2.9	2.9
3.90	3.63	3.63	3.63	3.56	3.38	3.38	3.38	Fed Funds Target Rate Range Mid-Point, % ⁴	5.07	5.19	4.25	3.61	3.38
4.10	4.20	4.43	4.44	4.39	4.39	4.42	4.47	10-Year Treasury Note Yield, % ⁴	3.96	4.21	4.29	4.37	4.45
6.23	6.11	6.41	6.45	6.40	6.37	6.40	6.43	30-Year Fixed Mortgage, % ⁴	6.81	6.72	6.60	6.34	6.42
-2.4	-2.6	-2.8	-3.0	-3.0	-2.9	-3.0	-3.1	Current Account, % of GDP	-3.3	-4.0	-3.6	-2.9	-3.1

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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