

## SF FedViews:

# Volatile Oil Markets Cloud the Economic Outlook

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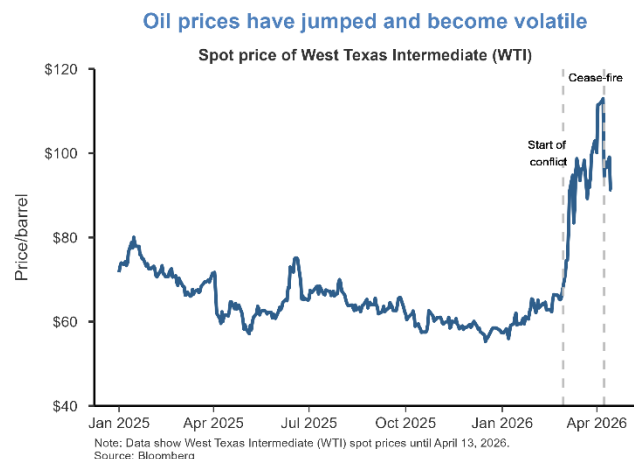
**Vice President, Federal Reserve Bank of San Francisco**

Oil markets have experienced considerable volatility, significantly clouding the economic outlook. While long-term inflation expectations remain anchored, new price pressures pose the risk of pushing the economy further away from the Fed's 2% inflation goal in the near term. With the labor market and consumer spending already slowing in recent months, the disruptions in energy markets also increase downside risks to economic activity. The ultimate economic impact will depend critically on how long these disruptions persist.

### Oil prices are high and volatile

Oil prices have surged and remained volatile in response to the ongoing conflict in the Middle East, significantly clouding the economic outlook. The increase in oil prices has been accompanied by rising costs for critical production inputs, including fertilizers, aluminum, helium, and plastics. While the latest information from oil futures markets suggests a partial price recovery by the third quarter of 2026, the duration of energy market disruptions remains highly uncertain. The ultimate economic impact will depend critically on how long these disruptions persist; if sustained, high energy prices risk spilling over into a broader set of goods and services while weighing on real incomes, employment, and output growth.

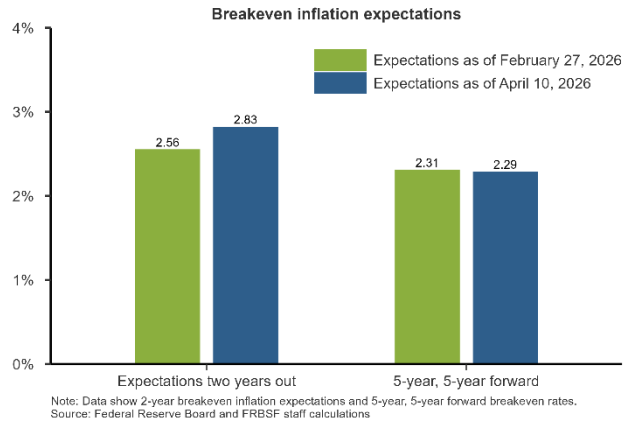
Higher energy costs caused inflation, measured by the 12-month change in the consumer price index (CPI), to jump to 3.3% in March—a



significant increase from February’s 2.4% reading. This is the first inflation reading to be received after the start of the Middle East conflict. Core inflation, which strips out volatile food and energy costs, remained stable near its February level at 2.6%.

Market-based measures of inflation expectations over the next two years have climbed since the conflict began. These indicators are particularly informative, as investors’ financial positions provide a credible gauge of anticipated inflation trends. While near- and medium-term expectations have risen in response to the disruptions in energy markets, longer-term projections for the five- to-10-year horizon remain largely unchanged. This relative stability suggests that market participants continue to view long-run inflation as well anchored around 2%.

**Markets expect near-term inflation pressure**

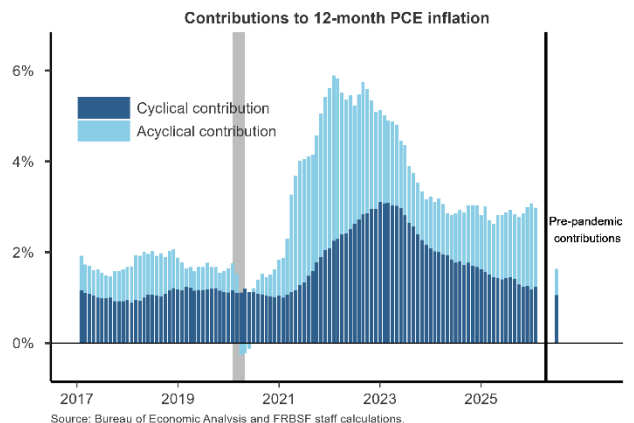


**Inflation remains high from acyclical factors but expected to reach 2% by 2028**

The personal consumption expenditures (PCE) price index, the Federal Reserve’s preferred inflation gauge, shows the 12-month change in headline inflation was 2.8% in February and core inflation was 3.0%. While both measures have retreated from their 2022 peaks, they have remained persistently above the Federal Reserve’s 2% longer-term goal since March 2021.

Latest readings from the San Francisco Fed’s [Cyclical and Acyclical Core PCE](#) Inflation data series show that current elevated inflation levels are primarily driven by acyclical factors, which include goods and services categories that are more sensitive to industry-specific factors. While the contribution from cyclical

**Current high inflation due to acyclical factors**



categories—those most sensitive to the business cycle—has returned to pre-pandemic levels, the contribution from acyclical components has been rising. These patterns suggest that while tight monetary policy and soft aggregate demand are putting downward pressure on inflation, sector-specific factors—such as tariffs and strong demand for semiconductors—have kept overall inflation from declining on net.

We expect acyclical factors, including higher energy costs, to exert upward pressure on inflation in the coming months. However, we expect the impact from these factors to largely dissipate in the second half of the year, under our assumption that the tariff effects on prices fade and oil prices stabilize or recede towards pre-conflict levels. We now project that inflation will reach the Federal Reserve’s 2% goal by mid-2028, although there are considerable upside risks to our projected inflation path given the high uncertainty surrounding the duration of the conflict. Our current outlook is for headline PCE inflation to rise to approximately 3% by the end of 2026 before declining gradually towards 2% by the end of 2027.

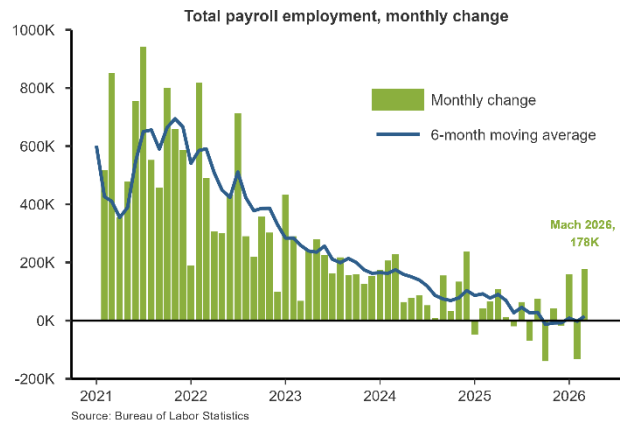


## Slow job growth despite a stable unemployment rate

The labor market has transitioned to a cooling phase, marked by a moderation in monthly job gains relative to the outsized gains observed in 2021 and 2022. While job growth has slowed considerably over the past year, the unemployment rate has remained relatively stable. The lack of any strong upward movement in unemployment, despite small job gains, suggests that the “breakeven” level of job growth, that is, the pace of job gains needed to absorb labor force growth with an unchanged unemployment rate, is currently quite low. Labor force growth has slowed due to a combination of lower labor force participation and slowing immigration.

The cooling labor market is further evidenced by a broad-based deceleration in wage growth across all skill levels. According to the Atlanta Fed’s wage growth tracker, the pace of wage increases has slowed significantly from the peaks observed in 2024. While low-skill occupations previously saw wages rising faster than high-skill occupations during the post-pandemic recovery, that trend has since ended. Wage growth measures for both groups have now converged and are trending down together towards pre-pandemic norms.

Weak job gains despite a stable unemployment rate



Wage pressures are softening across skill distribution



## Moderate GDP growth expected, but downside risks have emerged

The growth rate in inflation-adjusted consumer spending has slowed somewhat in recent months, coming in at an average of 1.2% (annualized) per month over the six months ending in February. By comparison, consumer spending was growing at an average rate of 3.6% (annualized) per month in 2023 and 2024. This slowdown in spending has occurred alongside softening wage growth, a decline in consumer sentiment, and higher goods price inflation.

Under our baseline projection, we anticipate moderate real GDP growth ahead, but the conflict has introduced significant downside risks and elevated uncertainty about near-term economic activity. Our growth projections for the first half of 2026 have been revised down, reflecting the impact of higher oil prices on real incomes and consumer spending.

The market-implied path for the federal funds rate has shifted higher in response to the Middle East conflict. While markets had been pricing in two interest rate cuts for 2026, expectations have now pivoted to a hold for the remainder of the year. This shift suggests that investors view significant upside risks to inflation. Given that PCE inflation stood at 2.8% in February—prior to the start of the conflict—these new price pressures risk pushing the economy even further away from the Fed's 2% inflation goal. The extent of the overall economic impact will ultimately depend on the duration of the supply disruptions.

