

## SF FedViews:

# Uncertainty Clouds the Outlook on Inflation and the Economy

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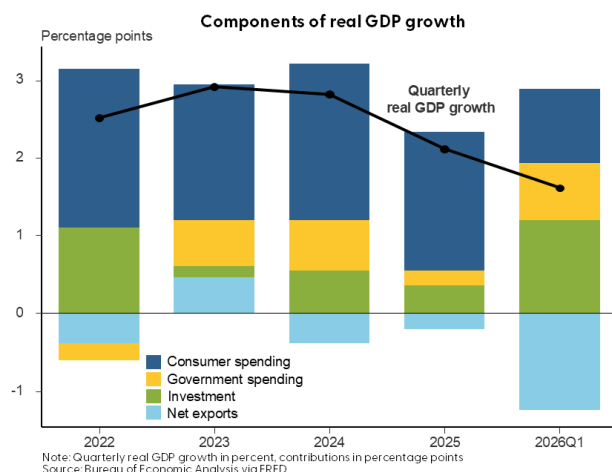
Geopolitical events have contributed to elevated inflation and have had a moderating effect on economic activity. The U.S. economy expanded at an annualized rate of 1.6% in the first quarter of 2026, below our 2.0% estimate of longer-run trend growth. Business investment, particularly in artificial intelligence (AI) infrastructure, was the largest contributor to first-quarter growth. Consumer spending has been generally solid since the beginning of the year but is somewhat below expectations. High costs for gasoline and groceries have taken up a greater share of household spending, adding pressure on budgets. The unemployment rate in April stood at 4.3% and has been stable around this figure since late 2024. Uncertainty about the resumption of maritime traffic in the Strait of Hormuz has kept prices of oil and other industrial commodities elevated, contributing to higher inflation readings in April. Households and financial market participants now expect inflationary pressures to persist somewhat, but financial market pricing still views long-term inflation expectations as well anchored. Continued geopolitical instability raises the downside risks to the economy from worsening supply bottlenecks and weaker consumer spending. Higher commodity prices could further delay the return of inflation to the Fed's longer-run goal of 2%.

## GDP growth slightly below long-term trend but with risks to the downside

Real GDP grew at an annualized rate of 1.6% in the first quarter of 2026, weaker growth than in 2025 and below our 2.0% estimate of longer-run trend growth. Business investment, particularly in AI infrastructure, was the largest contributor to first-quarter growth.

While consumers continued spending at a generally solid pace, they appear to be pulling back somewhat relative to previous quarters as high gas and grocery prices remain, inflation outpaces average hourly earnings, and

### Strong investment offsetting weaker consumer spending



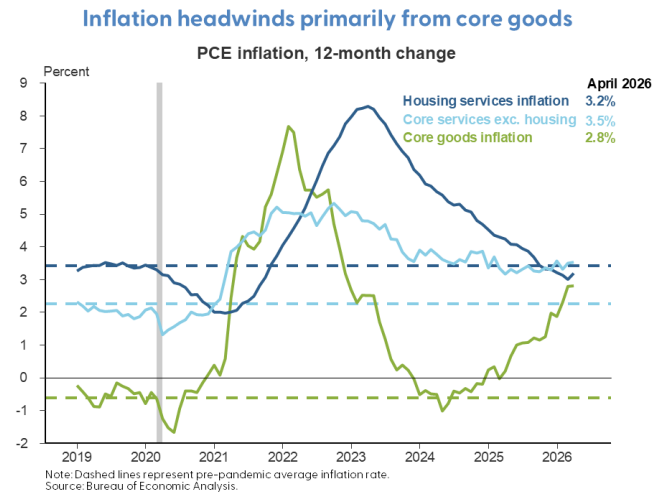
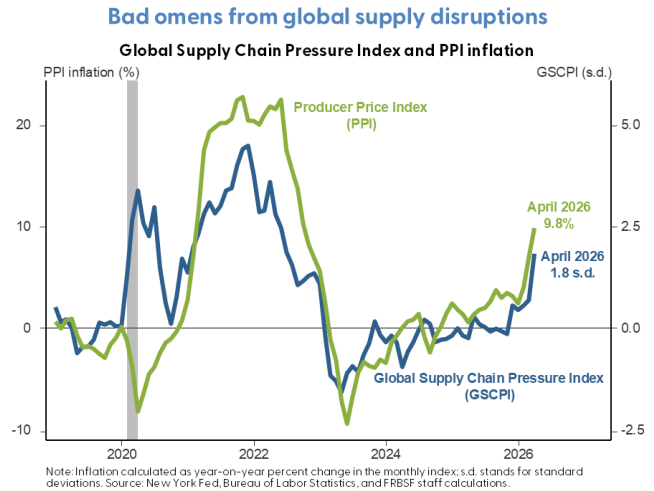
uncertainty is elevated. Our baseline projection is for real GDP to grow close to trend for the remainder of the year, but developments in the Middle East could impact this projection.

**Choke points: A bad omen for global supply flows and goods prices**

Both the New York Fed’s Global Supply Chain Pressure Index and the Producer Price Index from the Bureau of Labor Statistics jumped significantly in March and April due to ongoing hostilities in the Middle East. The resulting supply chain disruptions for energy products, agricultural and chemical commodities, and industrial and emerging technology materials are all expected to affect the prices of several goods categories. These market developments are likely to stoke the upward trend of overall goods inflation that began in early 2025.

Consumer price index inflation rose to 3.8% in April. The personal consumption expenditures (PCE) price index, the Federal Reserve’s preferred inflation gauge, also showed headline inflation at 3.8% in April on a 12-month basis. After stripping out the volatile food and energy categories, 12-month core PCE inflation was 3.3%. Thus far, services inflation in the housing sector has continued slightly below its pre-pandemic trend. Inflation in nonhousing core services categories, sometimes referred to as supercore inflation, has been sticky over the past two years and remains elevated. In contrast, core goods inflation continues to run well above its pre-pandemic trend and is a major factor contributing to elevated inflation.

This ramp-up in core goods inflation began around late 2024 and early 2025, coinciding with the introduction of tariffs and, more



recently, supply disruptions of oil and other raw materials coming from the Middle East.

We expect 12-month headline PCE inflation to rise a bit further this year before gradually returning to 2% by the end of 2028. Spillovers of higher energy and commodity prices to the broader economy and the disruptions to the flow of maritime traffic through the Strait of Hormuz could delay the return of inflation to 2%. If these developments continue, consumer spending and business investment could slow in response to higher energy prices and elevated uncertainty, reducing real GDP and raising unemployment. While market-based measures of inflation expectations over the 5- to 10-year horizon have remained well anchored, consumer expectations for future inflation have grown since the start of the Middle East conflict.

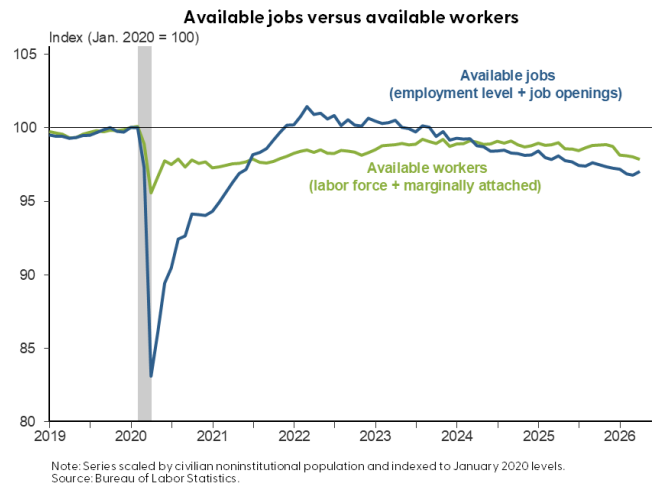
**Consumers less sanguine than markets on inflation**



**Muted signs of stress in labor markets so far**

New job growth has moderated over the past year toward the pace needed to keep up with normal labor force growth. Declining labor force participation, partly due to the aging of the population and to the more recent slowdown in immigration, has contributed to reducing the number of jobs needed to keep available workers employed. Viewing labor market dynamics from the perspective of available jobs versus available workers—with analysis showing that the two are slowing in tandem—helps to explain the relative stability over the past two years of the unemployment rate, which is currently at 4.3%.

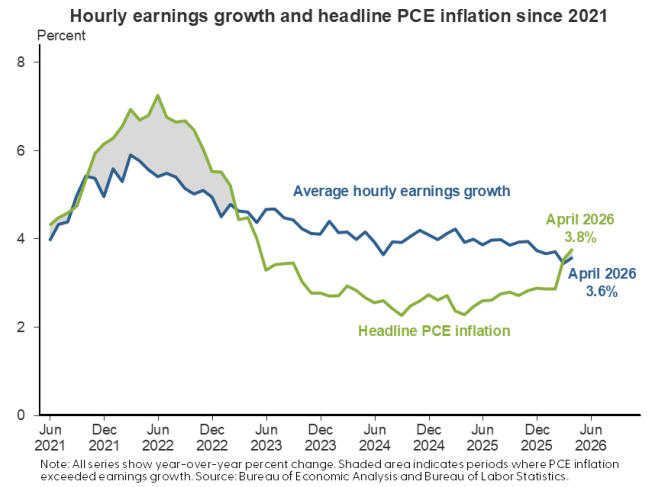
**Labor market is broadly balanced**



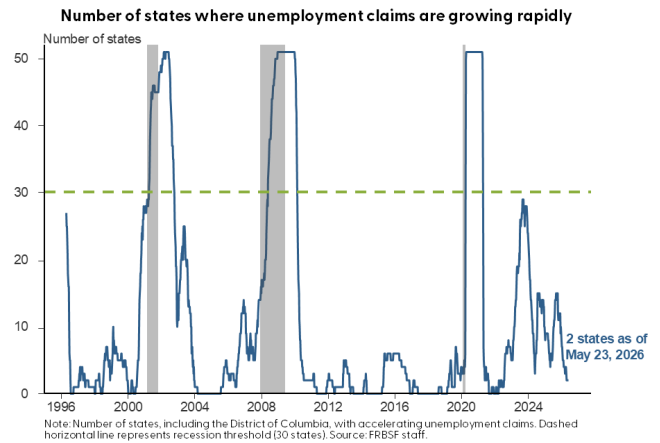
Average nominal hourly earnings of private-sector employees grew slower than the headline PCE price index during March and April, indicating that average real hourly earnings have declined in recent months.

State-level data on weekly unemployment claims show no evidence of any acceleration in claims that would indicate stress in state-level labor markets. Overall, we expect a slight increase in the unemployment rate over the latter part of 2026, with gradual moderation in 2027 and 2028.

### Wages starting to lose ground to inflation



### Little sign of stress in state-level labor markets



## Markets expect tighter monetary policy going forward

The market-implied path for the federal funds rate indicates that market participants have adjusted their views on the likely action of policymakers. Financial markets no longer expect a reduction in the policy rate this year or next; instead, they place some probability on a rate increase by December or early 2027. This outlook likely reflects the view that returning inflation to the 2% target will require sustained tighter financial conditions.

### Markets expect somewhat tighter policy going forward

