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2026 US Economics Outlook: Emerging From Policy Uncertainty

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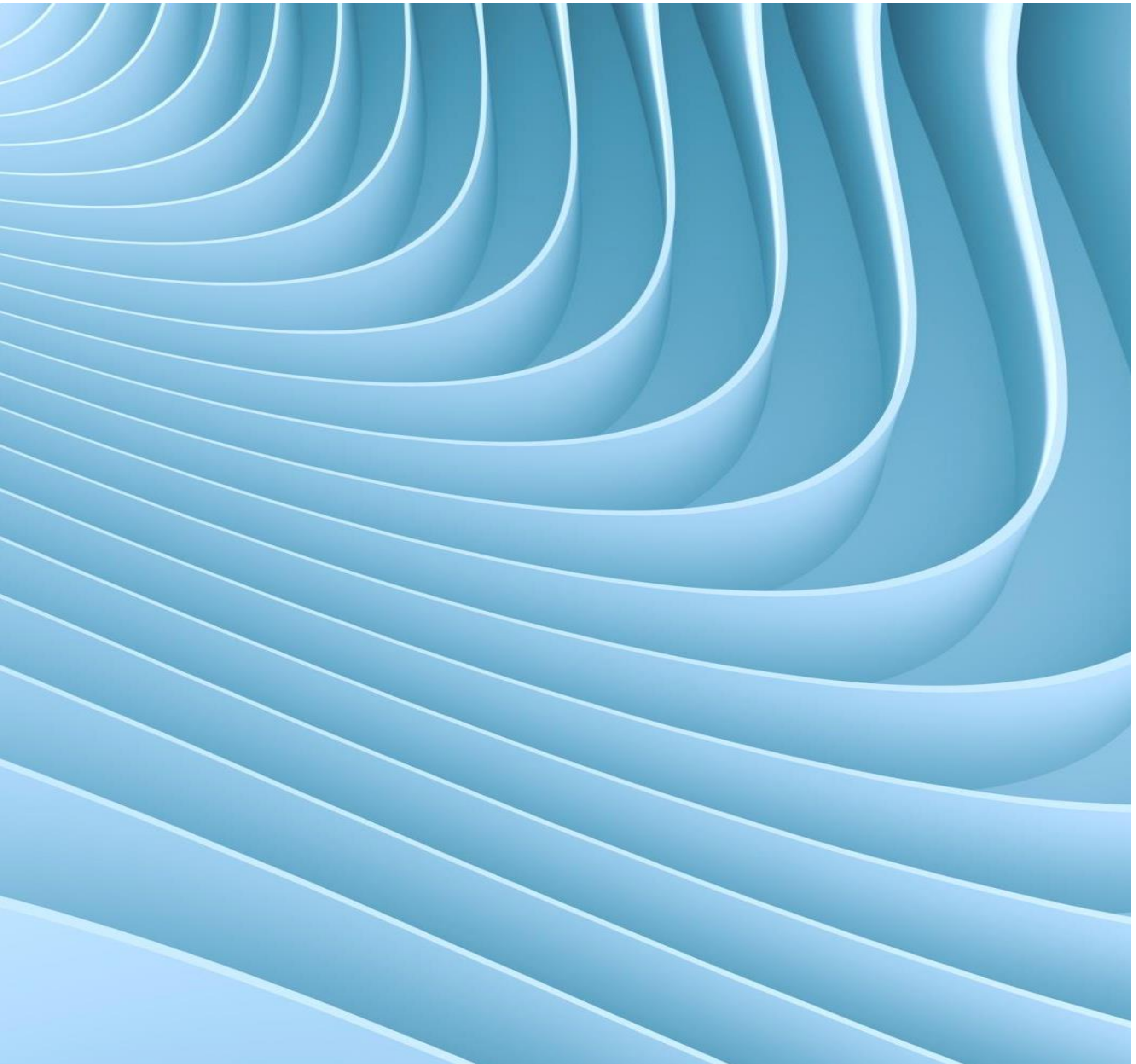


Outlook in a Nutshell

We expect weaker growth and more labor market slack near term, but the effects of policy shocks subside in 2026. Inflation starts moderating from 2Q26 as the tariff push fades. After peaking in 2Q26, the unemployment rate starts normalizing in 2H26 while GDP growth picks up. We expect 25bp rate cuts in December, January, and April as the Fed takes its policy stance close to neutral.

Key Forecasts

Growth: Real US GDP growth of 1.6% in 2025, 1.8% in 2026, and 2.0% in 2027 (all 4Q/4Q). The economy should be at its weakest in Q4 25 and Q1 26. Near-term downside risks give way to medium-term upside risks.

Inflation: Tariff-induced rises in goods prices cause headline and core PCE to rise to 2.9% and 3.1% in early 2026, before decelerating thereafter. We assume the effects of tariffs on inflation will prove transitory, though the past several years of above-target inflation could make inflation expectations more upwardly malleable than we expect.

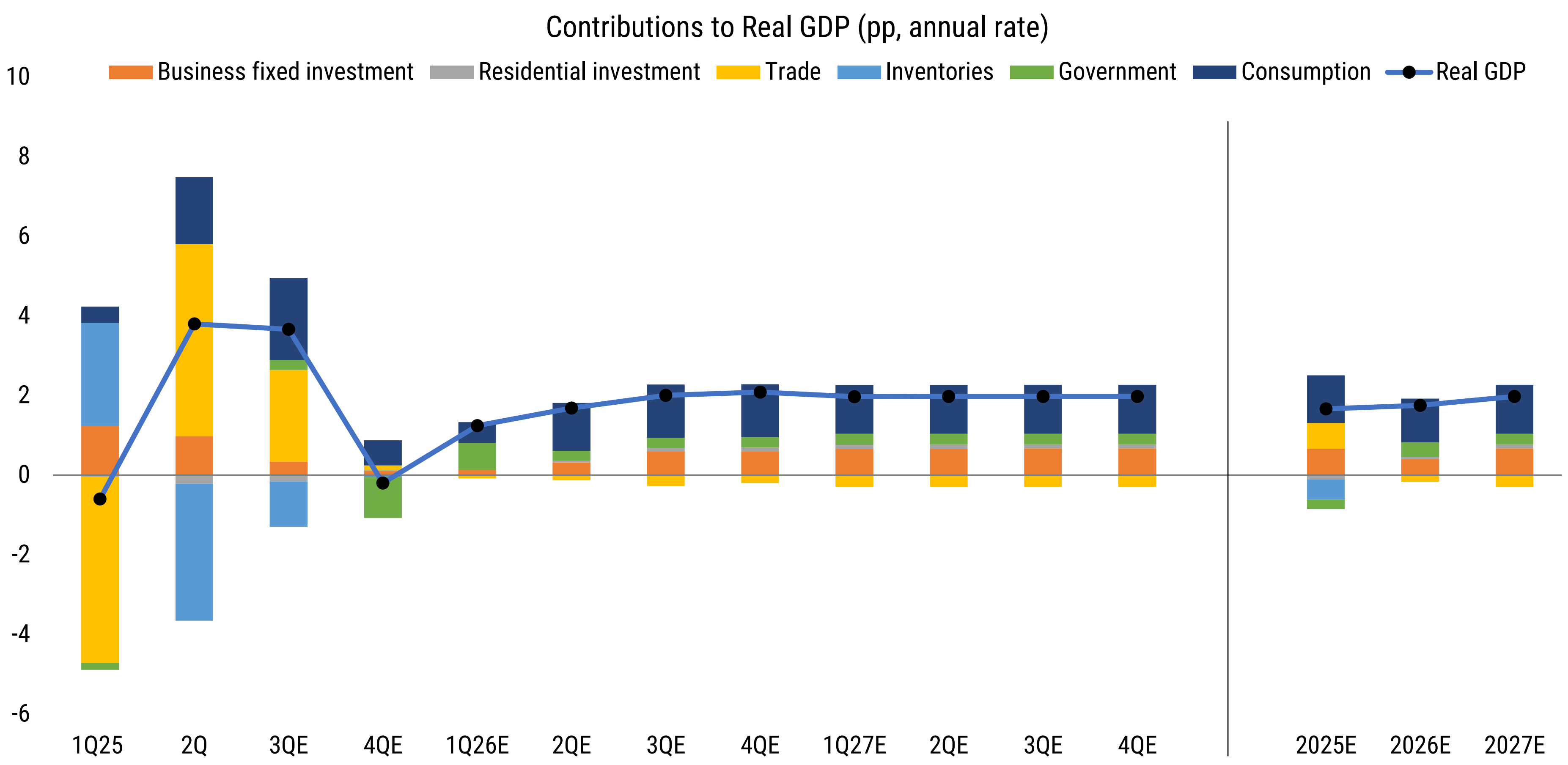
Labor markets: A slower-growing economy demands less labor while immigration controls mean a sharp reduction in available labor supply. We forecast employment growth to average 55-60k per month in 2026 and 2027. With a much lower breakeven rate, the unemployment rate rises only slowly, from its current 4.3% reading to 4.7% in Q2 26, then falls to 4.4% by the end of 2027.

Monetary policy: We expect 25bp rate cuts in December, January, and April to a terminal target range of 3.0-3.25%. A softer labor market should increase Fed confidence in transitory inflation. However, like the economy, the Fed is divided. The hawks see moderate activity, strong AI spending, and elevated asset markets and think monetary policy should lean against the wind. The dovish side sees weak labor demand and a softer consumer and believes policy should be at neutral sooner-than-later. We think the latter argument wins out.

Q4/Q4 % change, unless noted	2024A	2025E	2026E	2027E
Real GDP	2.4	1.6	1.8	2.0
Final Sales	2.6	2.1	1.8	2.0
Final Domestic Demand	3.0	1.5	1.9	2.2
Final Private Domestic Demand	2.9	2.1	1.8	2.3
Personal Consumption Expenditures	3.4	1.8	1.6	1.8
Business Fixed Investment	0.9	5.0	3.0	5.0
– Structures	-4.8	-3.0	0.3	3.0
– Equipment	3.2	8.7	3.5	5.5
– IPP	2.3	6.0	4.0	5.5
Residential Investment	1.3	-2.5	1.4	2.5
Exports	3.3	0.6	2.0	1.6
Imports	6.2	-4.4	3.0	3.6
Government	3.6	-1.4	2.1	1.6
Trade contribution to growth (pp)	-0.5	0.6	-0.1	-0.2
Inventory contribution to growth (pp)	-0.2	-0.5	0.0	0.0
Labor market				
Civilian Unemployment Rate (EOP, %)	4.1	4.5	4.5	4.4
Inflation				
Consumer Price Index	2.7	2.9	2.6	2.5
CPI ex Food & Energy	3.3	3.1	2.8	2.6
PCE Price Index	2.6	2.8	2.5	2.2
PCE ex Food & Energy	3.0	3.0	2.6	2.3
Monetary Policy				
Fed Funds Target (%, midpoint of target range, eop)	4.375	3.625	3.125	3.125

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve, Census Bureau, Treasury Dep't, Morgan Stanley Research forecasts

Contributions to GDP



Note: The annual measures are a 4Q to 4Q % change or contribution. Source: Bureau of Economic Analysis, Morgan Stanley Research forecasts

Policy backdrop is largely set

Immigration: A curious balance in the labor market. Immigration policy is clear and unlikely to change, at least not before the 2026 midterm elections. Labor supply and labor demand have fallen mostly in tandem, creating a "low hire-low fire" equilibrium. The labor market has lost some of its dynamism and a sharp slowdown in labor force growth could be a drag on potential growth by up to 50bp.

Deregulation: More micro than macro. The deregulatory agenda is proceeding, but, as we have long argued, it is a process that takes time and may have more industry-level effects than macroeconomic ones. Energy and finance should be the greatest beneficiaries.

Fiscal: Large deficits ahead. With the passage of the One Big Beautiful Bill Act (OBBBA), large deficits are likely to remain a feature of the US economy. Since the OBBBA front-loads deficits and back-loads spending cuts, fiscal policy should support growth in 2026 and, to a lesser degree, in 2027. After that, fiscal policy could turn into a drag on the outlook if entitlement spending cuts go into effect and tax cuts are allowed to expire.

Trade: Still a mixed bag, but low risk of a return to embargo-level tariffs. On trade, the picture is more mixed. The Supreme Court is reviewing the legality of the IEEPA tariffs, negotiations between the US and China remain complex and ongoing, and 2026 will bring a review of the USMCA. There are plenty of potholes that could derail the outlook. That said, a tenuous détente between the US and China remains likely and a return to "Liberation Day" tariff levels appears low. If so, the risk of a collapse in trade flows seems less likely.

Source: Morgan Stanley Research

Alternate Scenarios

Optimistic scenario 1: Demand upside (12.5%) – The economy accelerates sharply beginning in 2Q26, after a modest deceleration in 4Q25 and 1Q26. Growth receives a larger-than-expected boost from the One Big Beautiful Bill (OBBBA) in 2026–27, while strong “animal spirits” keep business investment elevated. Inflation remains well above target. The Fed pauses its easing cycle after December 2025 and holds rates steady until 4Q26, when it begins tightening.

Optimistic scenario 2: Productivity-driven upside (12.5%) – AI-driven productivity gains exceed expectations. In the near term, stronger productivity growth is mildly disinflationary. Robust growth prompts the Fed to halt its cutting cycle in 1H26, as the source of the acceleration—supply or demand—remains uncertain. As tariff effects fade and disinflation resumes in 2H26, the supply-driven nature of the shock becomes clearer, and the Fed resumes gradual rate cuts by year-end. We see a terminal rate of 2.75–3% in this scenario.

Pessimistic scenario: Mild recession (15%) – The lagged effects of tariffs, immigration constraints, and still-restrictive monetary policy prove larger than expected. Real GDP growth turns sequentially negative in 1H26, driven by a sharper decline in consumption. The Federal Reserve responds with aggressive easing in the first three quarters of 2026, cutting rates to 1.00–1.25% by 3Q26, but refrains from asset purchases.

	Baseline			Demand upside			Productivity upside			Mild recession		
	2025E	2026E	2027E	2025E	2026E	2027E	2025E	2026E	2027E	2025E	2026E	2027E
Real GDP	1.6	1.8	2.0	1.8	3.1	2.1	1.7	2.4	2.4	1.2	0.6	2.5
Unemployment rate	4.5	4.5	4.4	4.5	3.8	3.8	4.4	4.4	4.5	4.8	5.3	4.9
Core PCE prices	3.0	2.6	2.3	3.0	3.1	2.3	3.0	2.5	2.0	3.0	2.2	2.0
Fed funds rate	3.625	3.125	3.125	3.625	4.125	4.375	3.625	3.375	2.875	3.625	1.125	2.375

Source: Bureau of Economic Analysis, Federal Reserve, Bureau of Labor Statistics, Morgan Stanley Research forecasts

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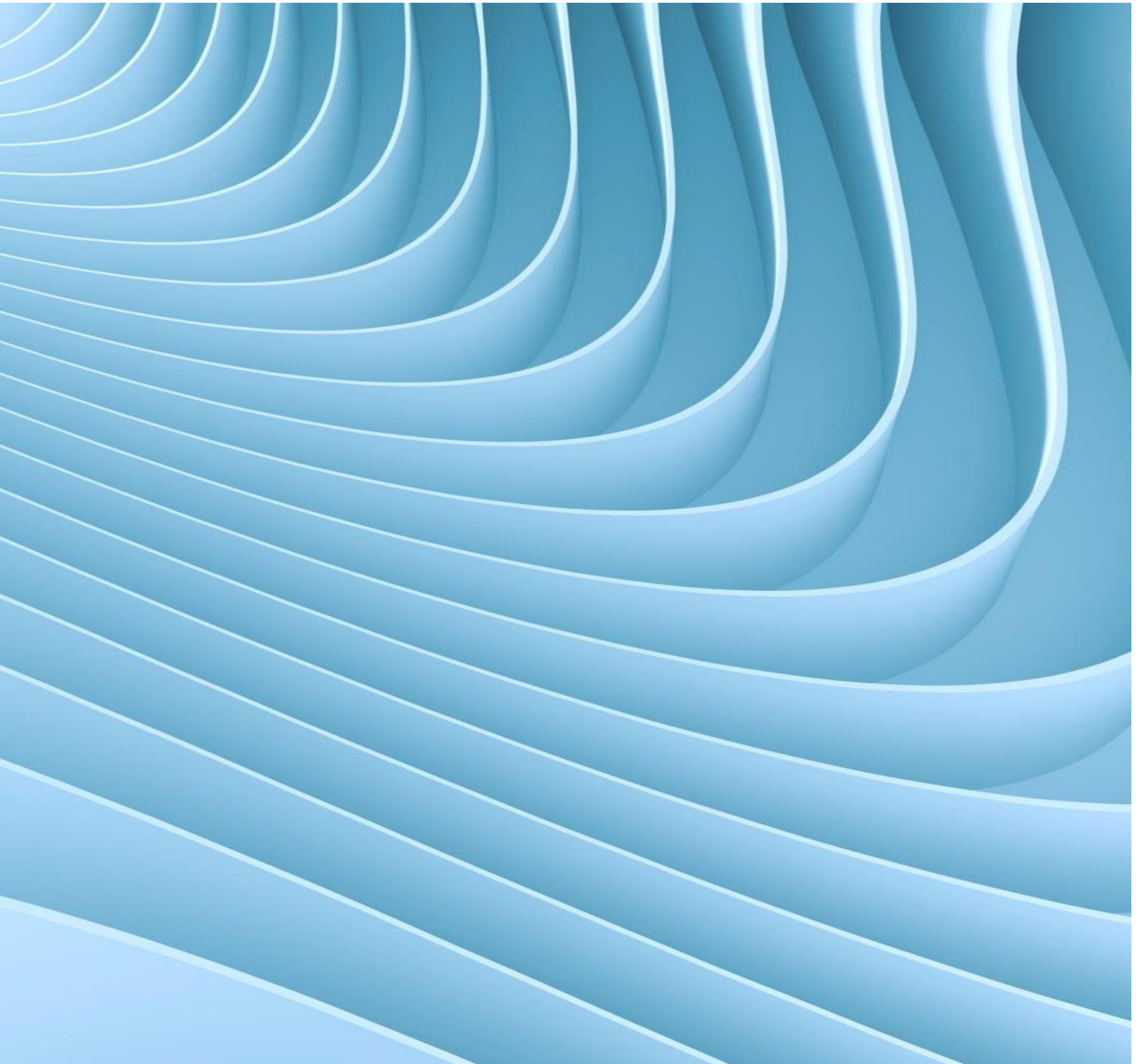


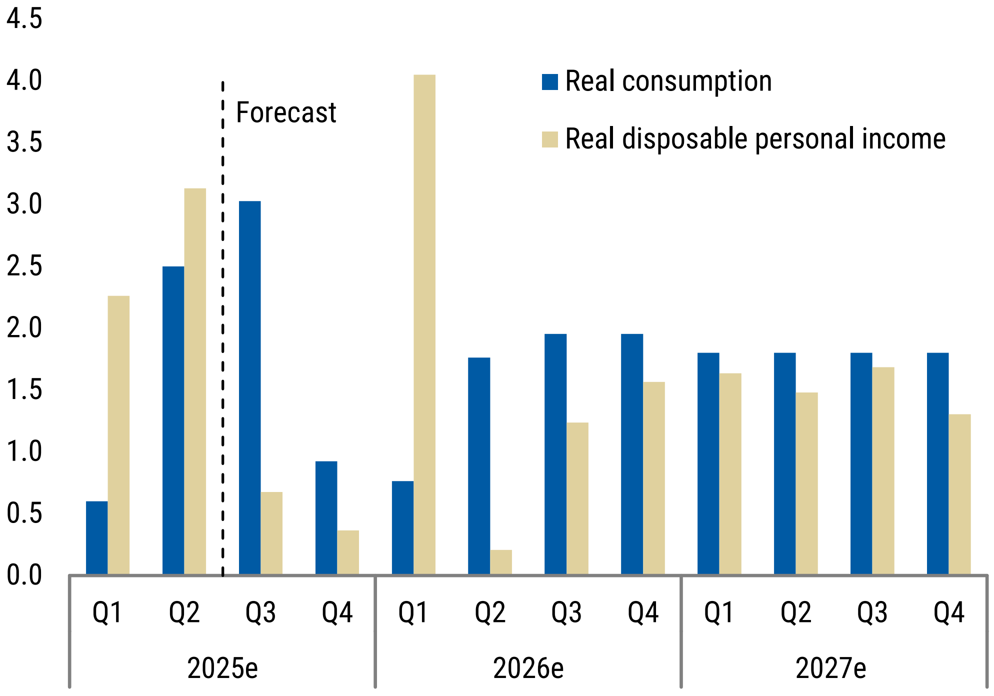
Consumption

We expect slow real income growth in 2H25 to weigh on spending growth in the near term, resulting in a somewhat weaker end to 2025 and start to 2026. As we progress throughout 2026, spending growth sees a sequential improvement: real labor income starts to recover and the fiscal bill provides some support. We expect real personal consumption up 1.8% (4Q/4Q) in 2025, 1.6% in 2026, and 1.8% in 2027.

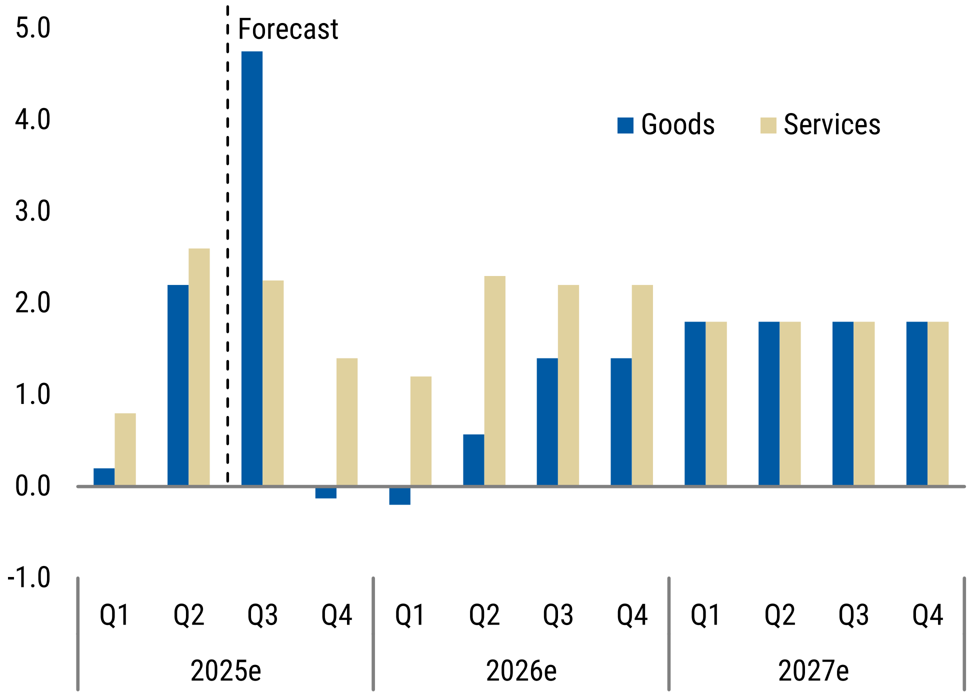
Consumption growth slows near term then improves sequentially

We expect that real personal consumption expenditure (PCE) growth will step up sequentially starting in 2Q26, after a weak start in 1Q26. The slower growth at the start of the year is largely concentrated in weaker goods spending, which is related both to the effects of tariffs on goods prices, as well as the pull forward to durable goods purchases ahead of tariffs in 2025. Real services spending remains close to its 2013-19 trend, albeit slower than in 2023-24.

Personal consumption and income (% q/q saar)



Goods v services spending (% q/q saar)

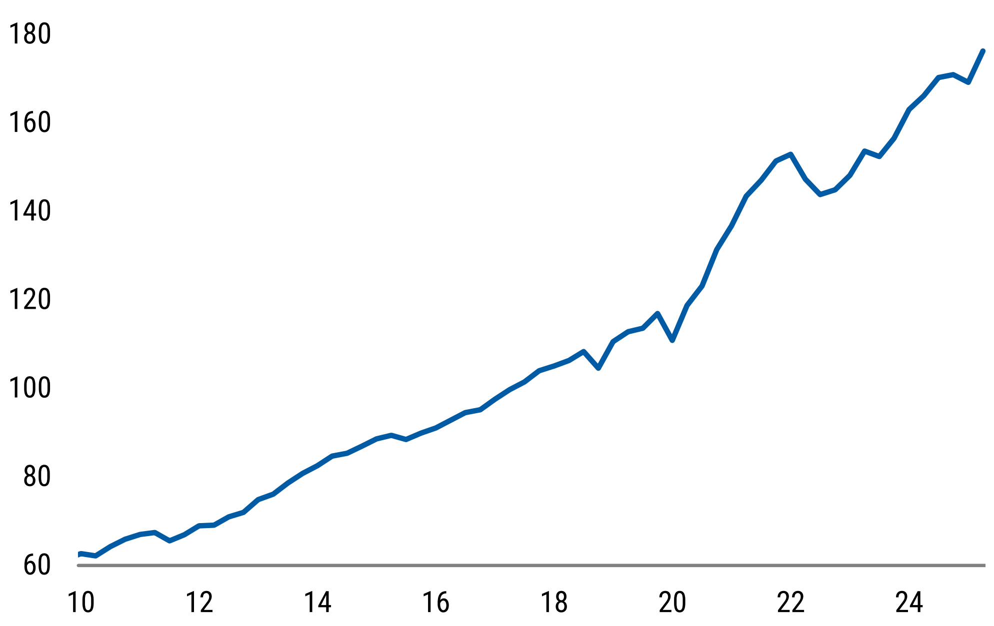


Source: Bureau of Economic Analysis, Morgan Stanley Research forecasts

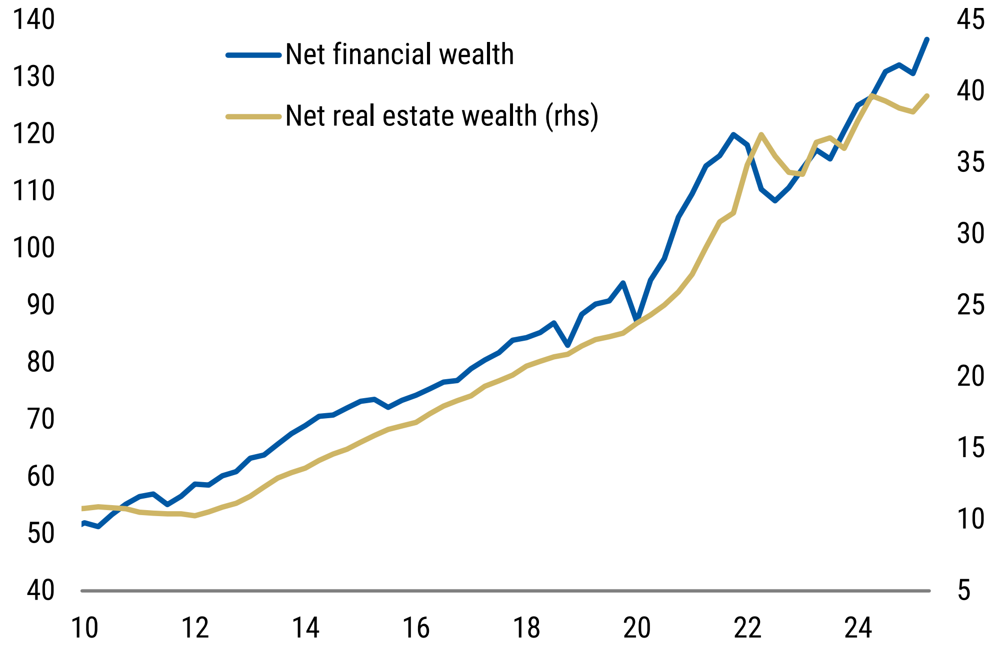
Wealth has continued to support spending this year

Household net wealth is up $59tn, or 50%, since 2019 and currently stands at $176.3tn. One in every three dollars of net wealth on household balance sheets was created in the last five years. Real estate and financial wealth have both contributed, but financial wealth plays a more prominent role, accounting for about 70% of the increase.

Household net worth ($tn)



Household net worth breakdown ($tn)

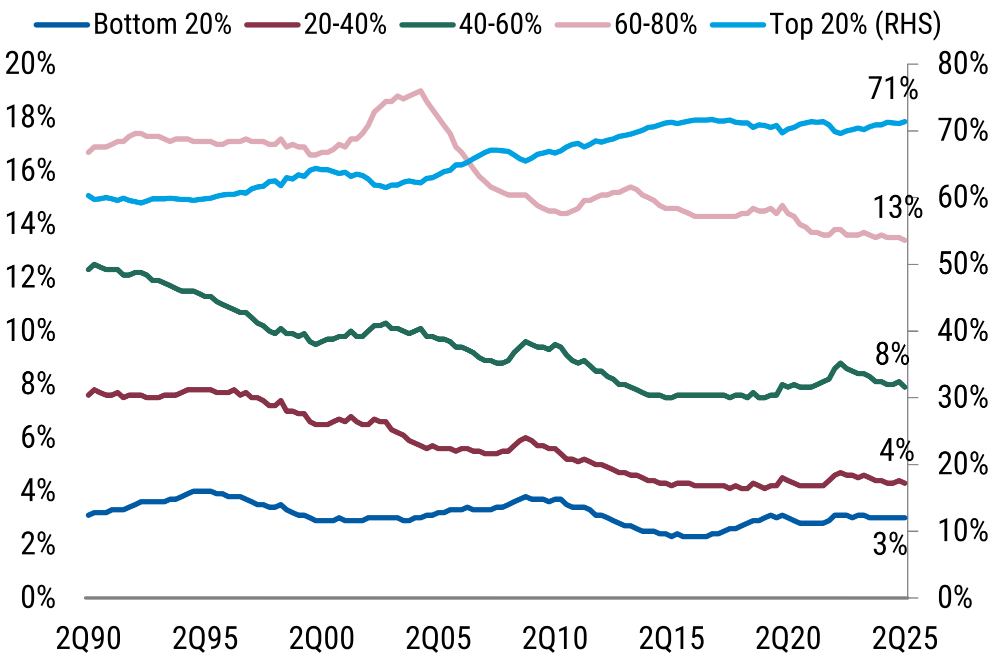


Source: Bureau of Economic Analysis, Morgan Stanley Research forecasts. The lagged response of spending growth to the FFR decline is estimated based on a VAR model for 1980-2019.

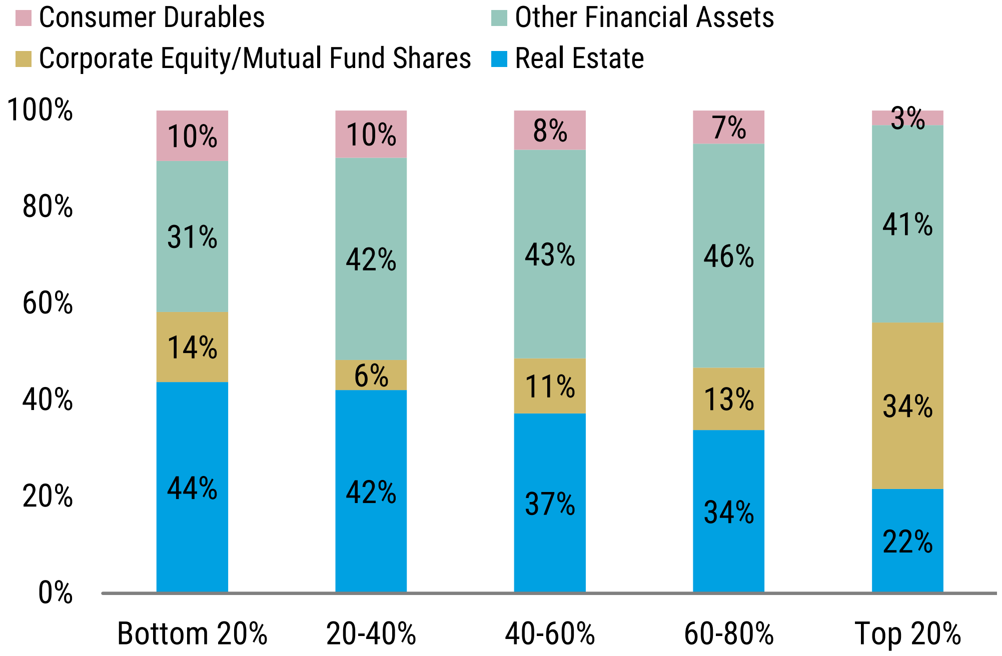
A K-Shaped Economy

High-income consumers benefit disproportionately from this increase in wealth. The top 20% income cohort holds 71% of household net wealth and 87% of corporate equities and mutual fund shares. As a result, these consumers have more resources to absorb price increases.

Shares of net worth by income quintile



Composition of household assets by income quintile

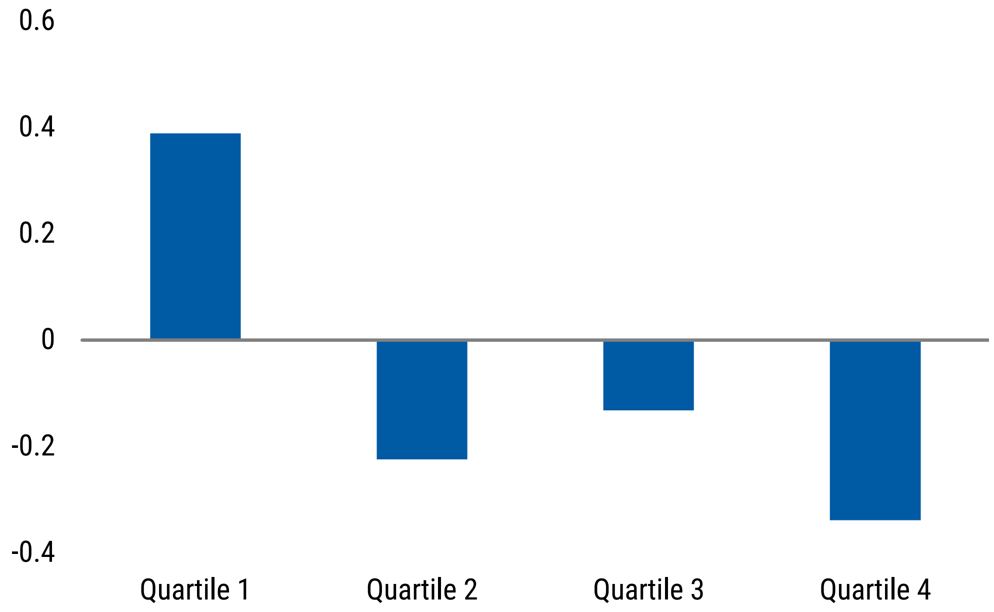


Source: Federal Reserve Board, Morgan Stanley Research

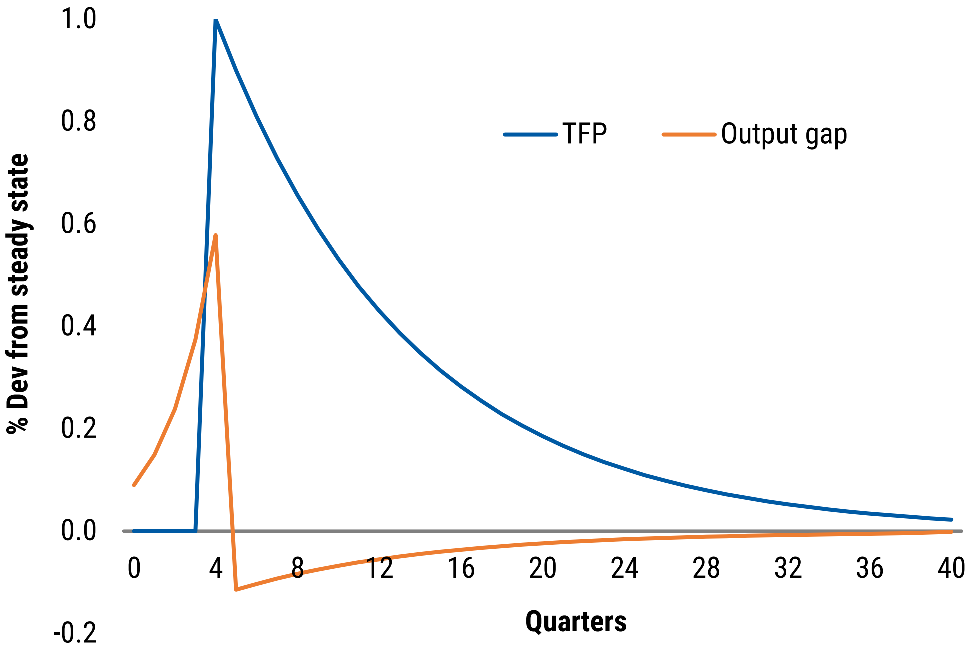
Consumption Dynamics of Income Cohorts

The narrative around the K-shaped consumer remains in place in the near-term. Through 2026, the expected economic improvement is likely to also accrue to middle- and some lower-income cohorts, broadening the base of consumption growth. That said, we do not expect these cohorts to experience outsized nominal wage growth. In our productivity-upside scenario, with disinflation, gains could accrue disproportionately to lower cohorts.

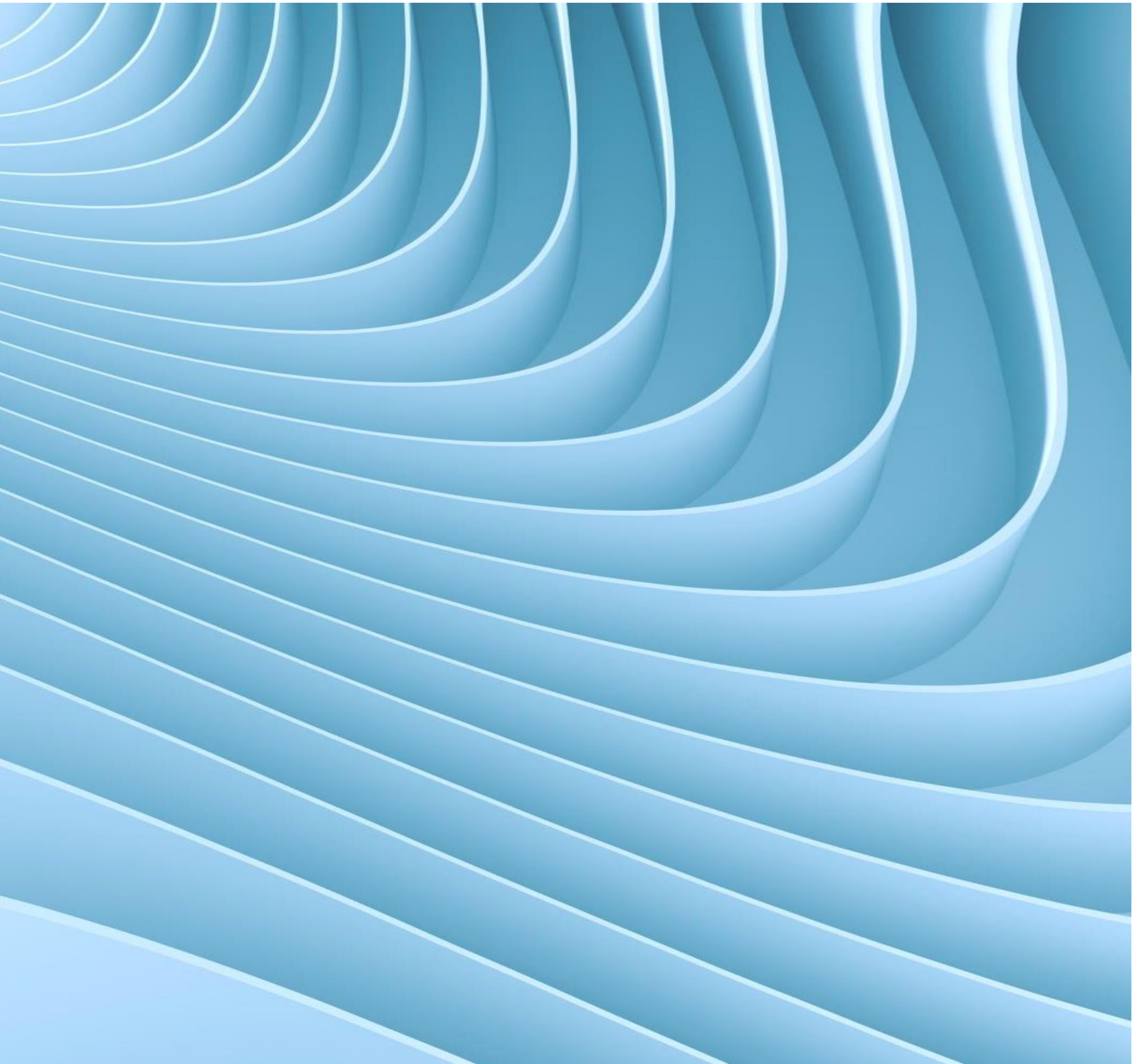
Response of nominal wage growth to an increase in labor market tightness



Response of output gap to an anticipated technology shock



Note: Left chart shows the response of the y/y growth in nominal wages of different quartiles to a 1 s.d. increase in the vacancy/unemployment ratio for the 2002-2019 period. Right chart illustrates the effect of a 1pp increase in technology which is anticipated 4 quarters in advance. This is based on the simulated impulse responses from a small New-Keynesian model. The effects are modelled purely as a demand shock, with no offsets for potential disinflationary effects of a positive technology shock. Source: BLS, BEA, Census, Morgan Stanley Research.



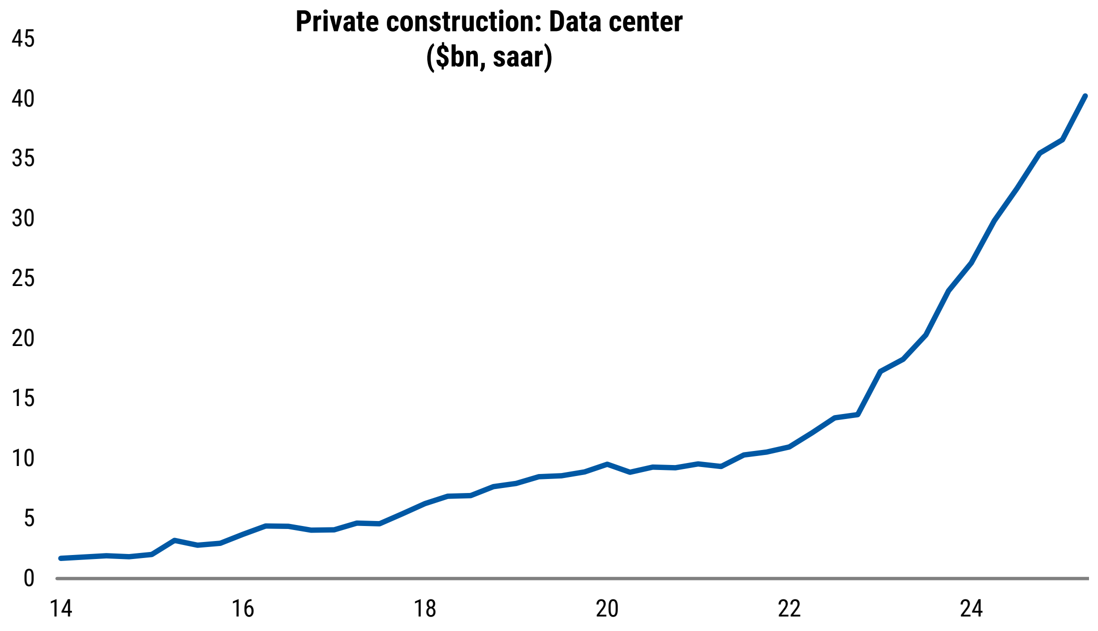
Nonresidential Investment

Business investment is being propelled by strength in AI-related spending while non-AI-related areas remain less consistent. Firms' AI spending plans are large and rising, and we expect that strength will continue. However, for other business spending, we think that the tariff-driven slowdown in growth at the turn of the year slows activity for several quarters. We project nonresidential fixed investment growth to slow from 5.1% in 2025 to 3.1% in 2026 before reaccelerating to 5.1% in 2027. The 2026 gain is nearly all AI-related.

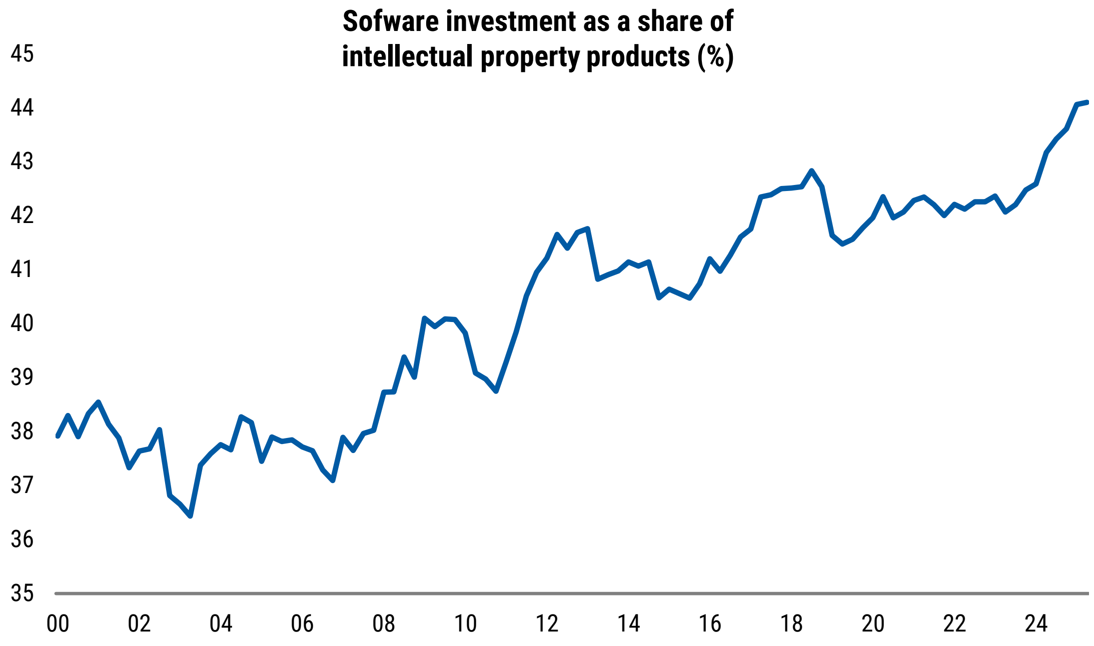
AI Spending Continues to Surge

AI-related spending, already committed, continues to rise fairly rapidly and limits the amount of cyclical softness in overall business spending. We expect AI-related spending to contribute about 3pp to growth in total nonresidential fixed investment across our forecast horizon. Non-AI spending stalls in 2026, but we expect it to accelerate in 2027, with growth rapid enough to contribute about the same 2pp to growth in business spending as we saw in 2025.

Data center investment rose rapidly



Share of Software Spending in IP trends higher



Source: Bureau of Economic Analysis, Morgan Stanley Research

AI Powers Growth, Non-AI Recovers Slowly

We forecast equipment investment to follow cyclical trends, while structures remain soft outside of AI-related projects. Intellectual property spending should continue rising and is increasingly cycle-resistant, with nearly half tied to software—boosted by the surge in AI-driven capex. Importantly, robust company capex announcements do not always translate into stronger reported GDP growth.

AI and non-AI business investment contributions to GDP growth

	2024	2025	2026	2027
Nonresidential fixed investment contrib to GDP growth, pct pt	**0.14**	**0.67**	**0.41**	**0.67**
AI	0.41	0.36	0.39	0.41
Non AI	-0.28	0.31	0.02	0.26
Imports contribution	**-0.16**	**-0.16**	**-0.17**	**-0.19**
Direct effects	**0.25**	**0.20**	**0.22**	**0.23**
Productivity	**0.00**	**0.09**	**0.19**	**0.21**
Total	**0.25**	**0.29**	**0.41**	**0.43**

Note: 2025, 2026, and 2027 numbers are Morgan Stanley Research estimates. Source: Census Bureau, Morgan Stanley Research estimates

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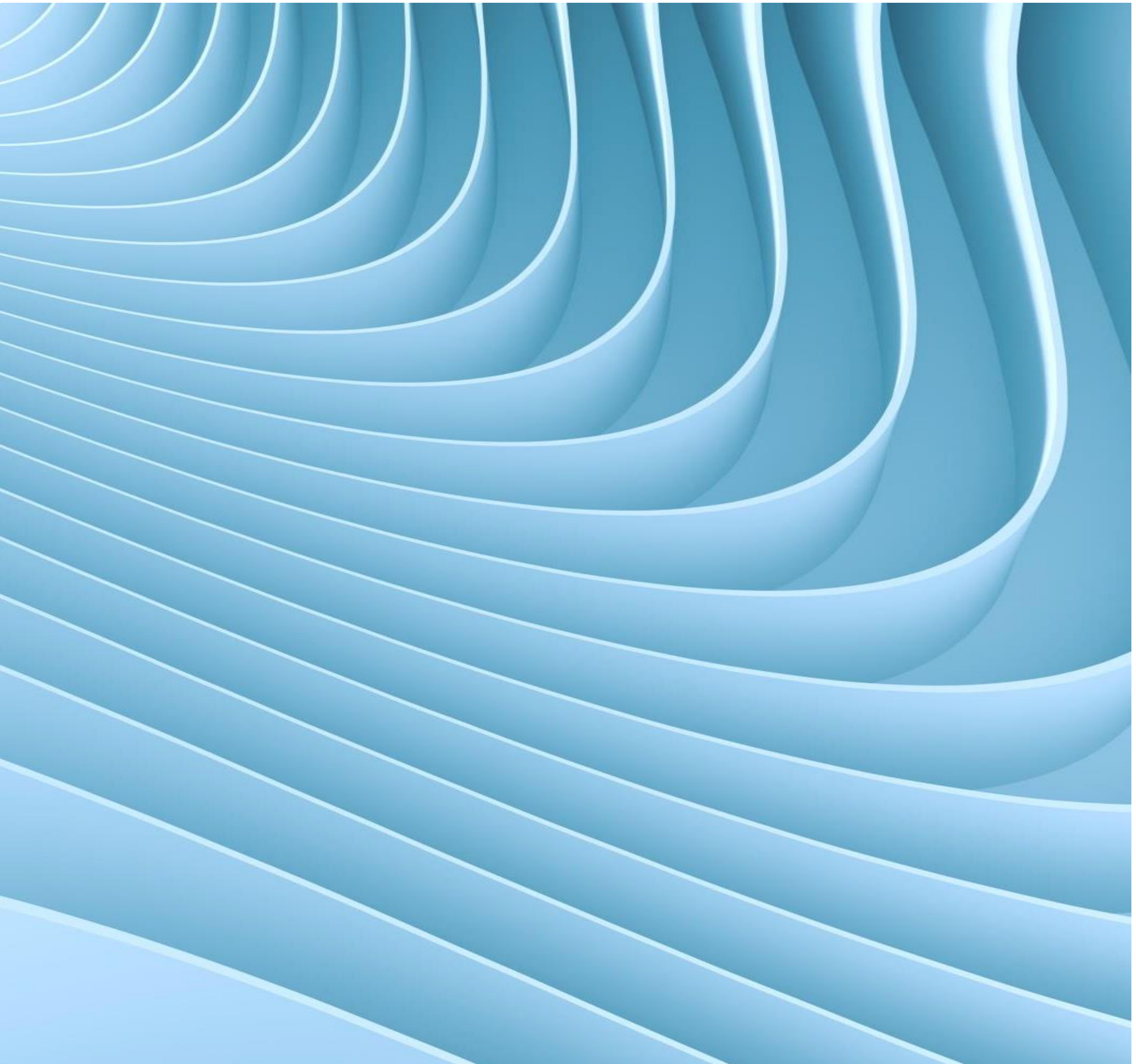


Residential Investment

Challenged affordability and the locked-in state of the housing market have continued to weigh on housing activity. Lower mortgage rates over the next few quarters should help activity accelerate somewhat in 2026, with more improvement in 2027. Real residential investment declines 2.4% (4Q/4Q) in 2025 before rising 1.4% in 2026 and 2.5% in 2027.

Housing begins to thaw

Our rates strategists expect the 10y to rally to 3.75% by mid-2026, contingent on our economic forecast and outlook for monetary policy, which would bring mortgage rates from the current 6.3% to around 5.5-5.75%. They then expect rates to begin to pick up again in 2H 26 and 2027.

Lower mortgage rates should help affordability and supply begin to improve. We think new home inventory needs to be worked through before starts pick up more significantly, and sales usually pick up more in the 12m after the affordability improvement. Housing activity and residential investment accelerates somewhat in 2026 but more so in 2027.

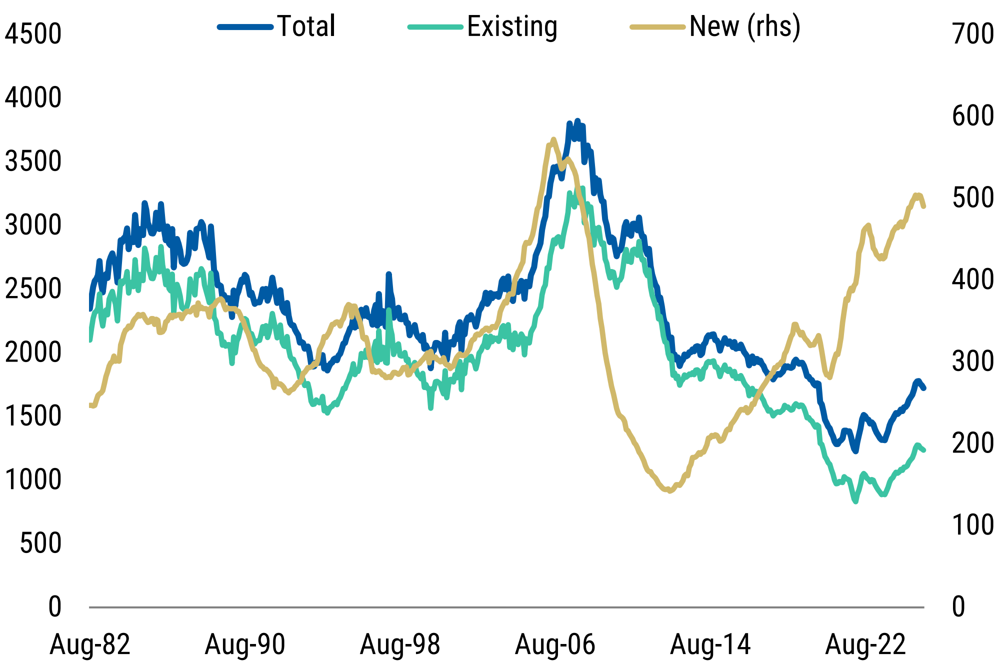
	Percent Change				Actual Values			
	2024a	2025e	2026e	2027e	2024a	2025e	2026e	2027e
HPA	4%	2%	2%	3%				
Existing Home Sales	-1%	1%	3%	7%	4.06mm	4.10mm	4.23mm	4.50mm
New Home Sales	3%	-2%	4%	6%	686k	675k	700k	745k
1-Unit Housing Starts	7%	-5%	2%	8%	1013k	960k	975k	1050k

Source: Census Bureau, NAR, Morgan Stanley Research Forecasts

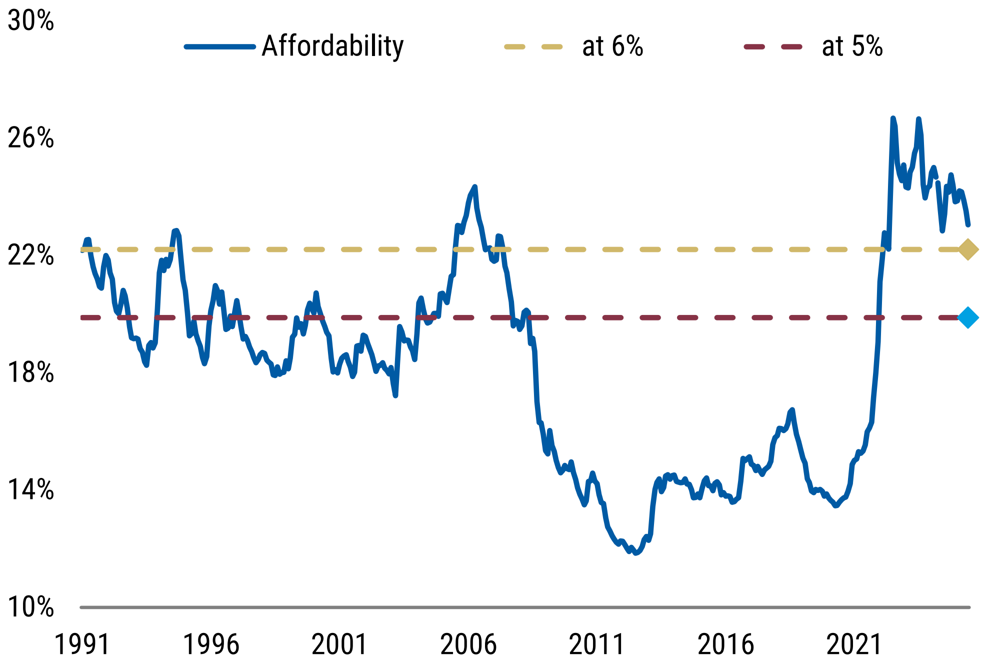
Lower rates should help affordability and supply

77% of outstanding mortgages are at rates below 5.5%. Still, inventories have continued to climb. Lower mortgage rates should lead to continued growth in supply, but demand has been the bigger constraint on sales. Lower mortgage rates will help affordability, though somewhat limited near-term by slower income growth.

Existing and new single-family home inventories (thous, SA)



Monthly payment as a % of income

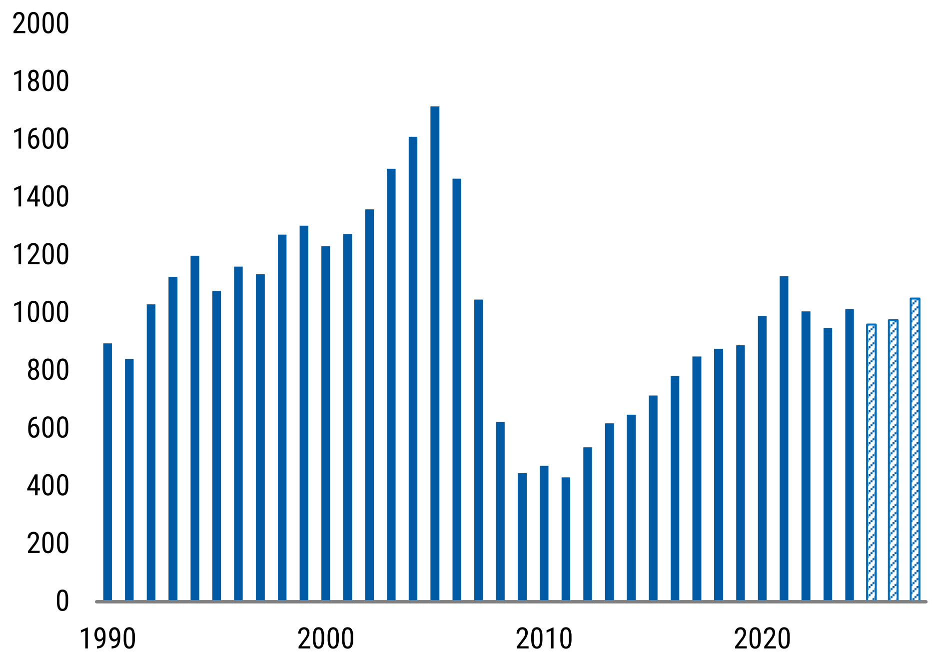


Note: In the right chart, "Affordability" is measured as average monthly payment as a percent of average monthly income using current mortgage rates. The dashed lines indicate the payment as a percent of income at the indicated mortgage rate. Source: NAR, Freddie Mac, Census Bureau, eMBS, BLS, Morgan Stanley Research

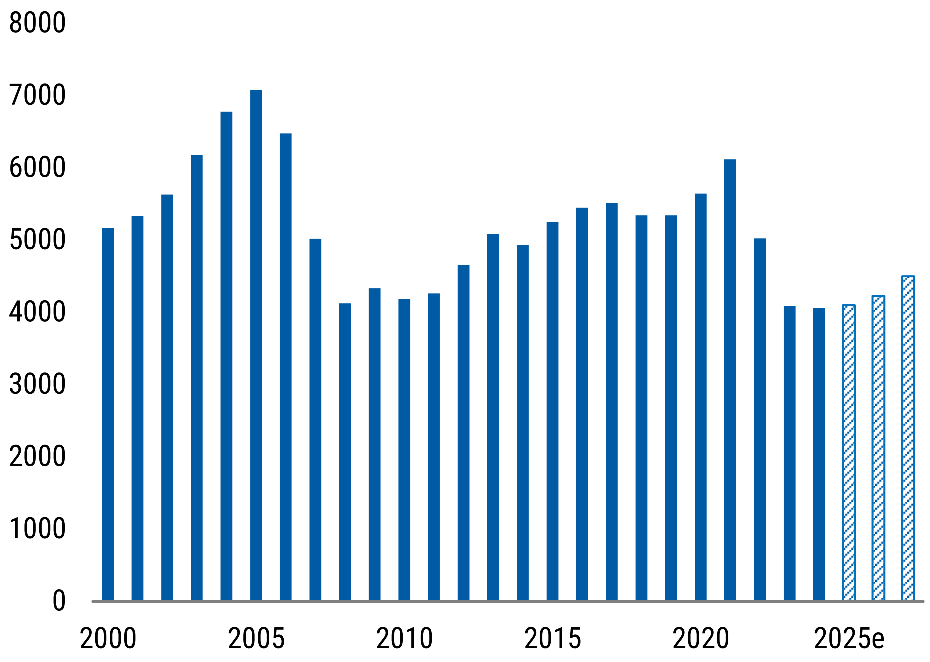
More incentives are needed for the housing market to really “take off”

In our base case, residential investment still provides a relatively small boost to real GDP growth over our forecast horizon: 0.05pp in 2026 and 0.10pp in 2027. Whether activity picks up more than these forecasts will largely be a matter of incentives. Policy changes that help affordability could help spur demand and lead to stronger home sales. Higher ARM issuance could also lead to more sales, even without a significant rally in longer-term rates. In these scenarios, we could see more of a “take off” than is factored into our base case.

Housing starts: 1 unit (NSA, thous)



NAR total existing home sales (NSA, thous)



Source: Census Bureau, Morgan Stanley Research

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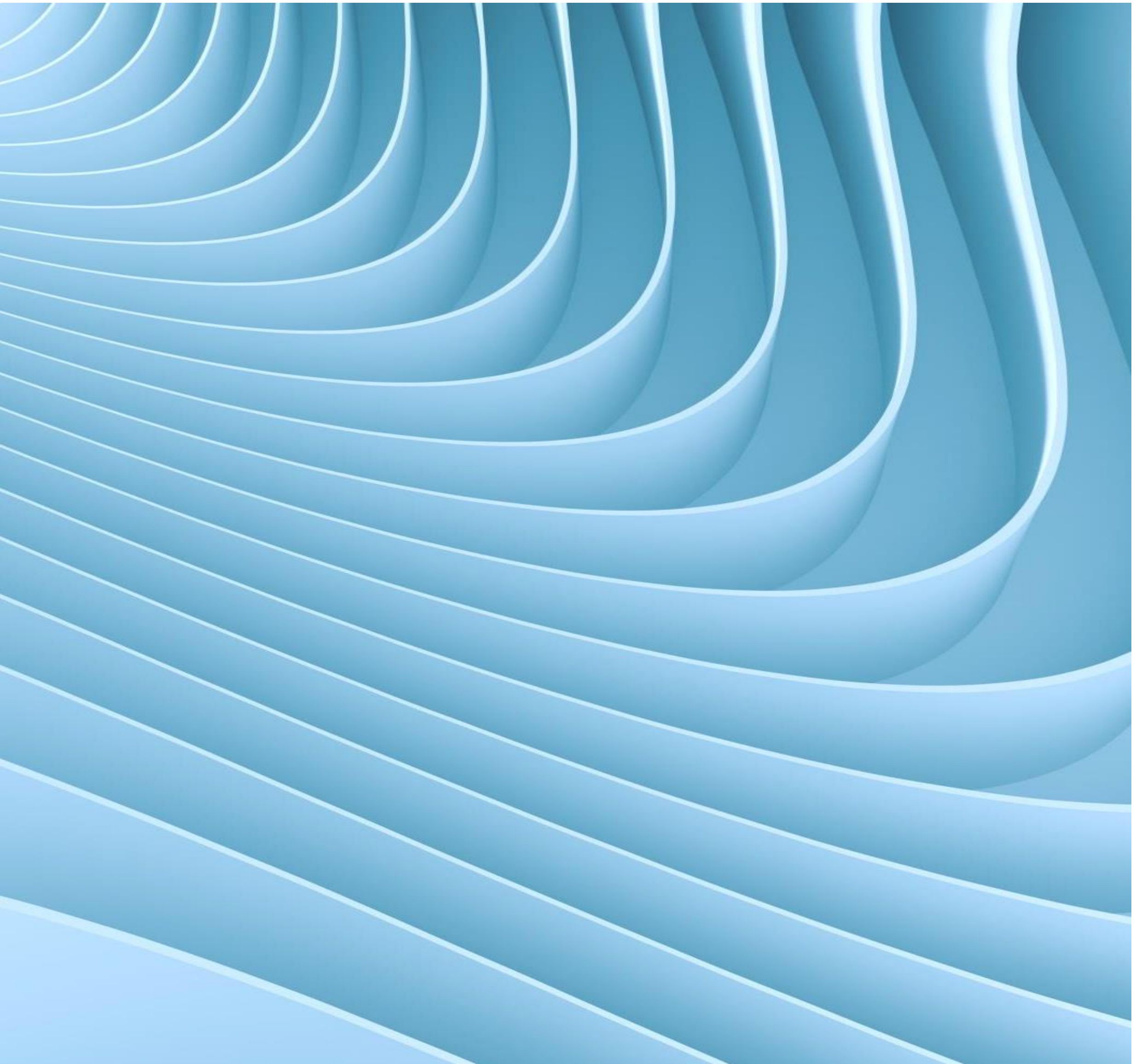


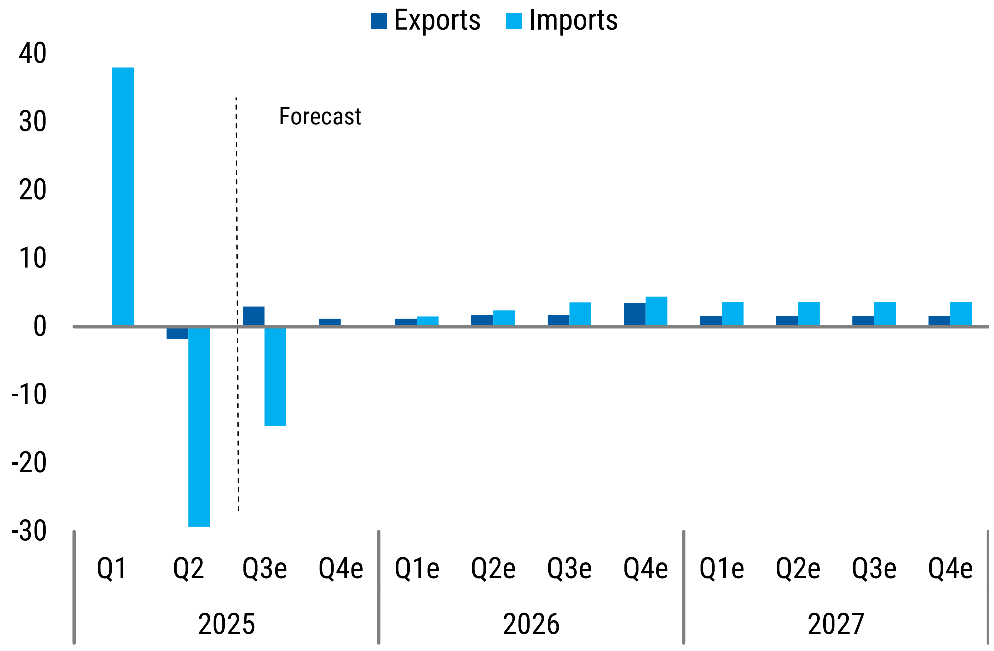
Trade and Inventories

Most imports surged in the first quarter of 2025 ahead of tariffs. Many items subsequently reversed, causing a reduction in imports in the second and (likely) third quarters. Next year's recovery in imports is slow as domestic demand for goods remains weak until the second quarter. Our export forecasts reflect weak foreign growth and the general slowdown in trade volumes. All in all, we expect a small drag from trade in 2026 and 2027: 0.1 to 0.2pp per year. Beyond this year, we expect flat contribution from inventories on growth in 2026 and 2027.

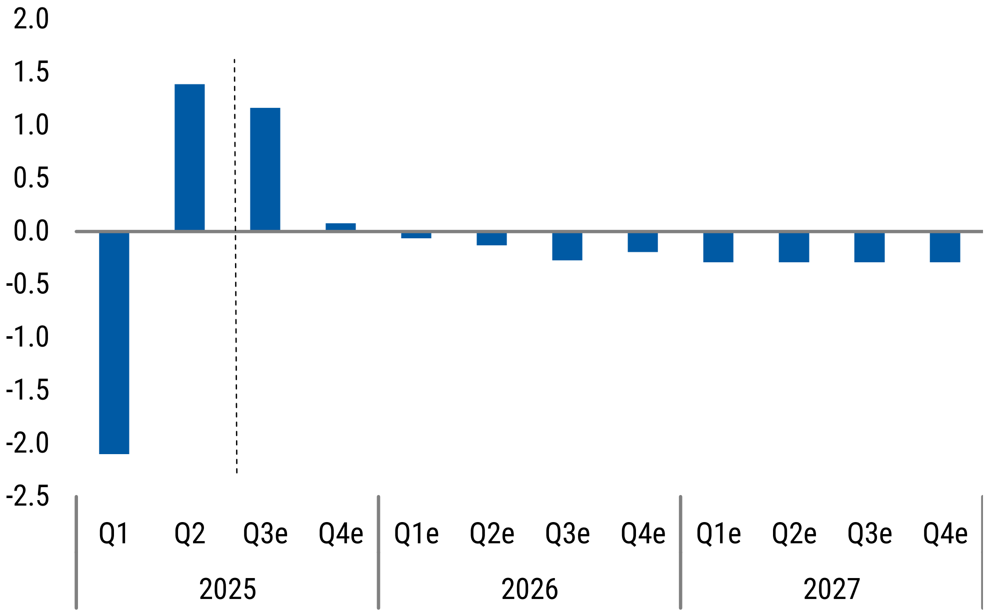
Trade is a small drag on growth

We expect next year's recovery in imports to be slow, as domestic demand for goods remains weak until the second quarter. We see imports rising 3.0% in 2026. With a fuller recovery in domestic demand, imports rise 3.6% in 2027. Our export forecasts reflect weak foreign growth and the general slowdown in trade volumes. We expect growth of ½% in 2025, 2% in 2026, and 1 ½% in 2027. In 2026 and 2027, we expect a small drag from trade: 0.1 to 0.2pp per year. Beyond this year, we expect flat contribution from inventories on growth in 2026 and 2027.

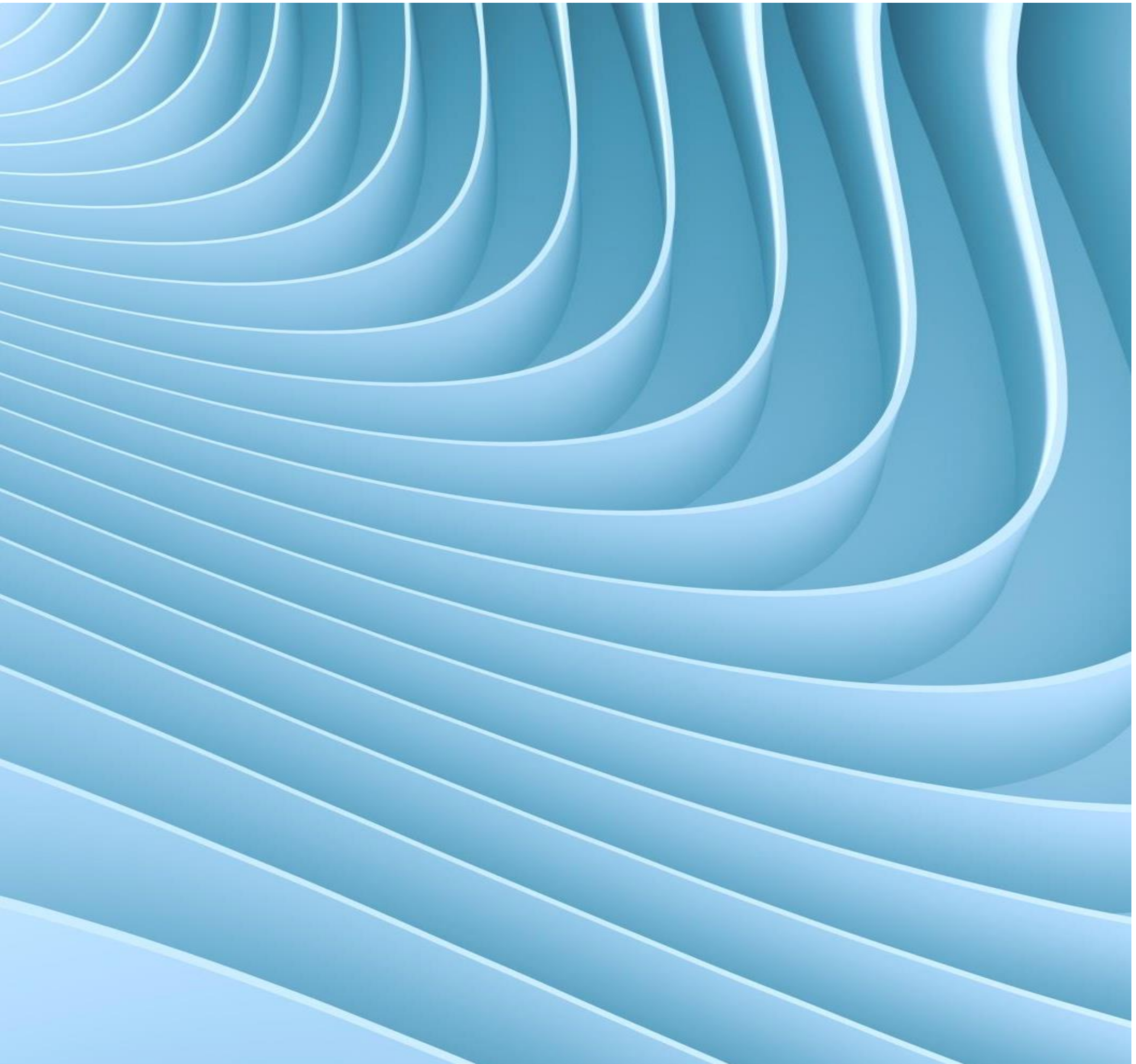
Exports and imports (% q/q saar)



Net trade and inventories (pp contribution to growth)



Source: Bureau of Economic Analysis, Haver Analytics, Morgan Stanley Research forecasts



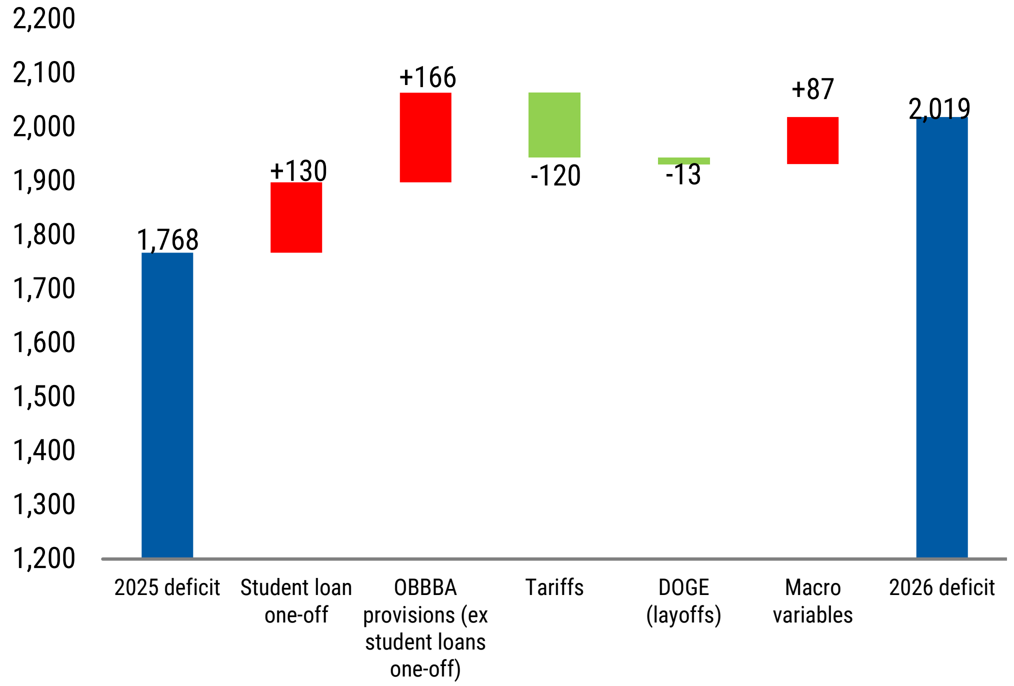
Fiscal Policy

We expect fiscal deficits to remain around 6% of GDP in our forecast horizon. Relatively high deficits imply a moderate fiscal impulse in 2026 and 2027, with acceleration in federal government spending and a higher contribution to GDP growth. The shutdown will be a drag to growth in 4Q25, but we expect payback in 1Q26.

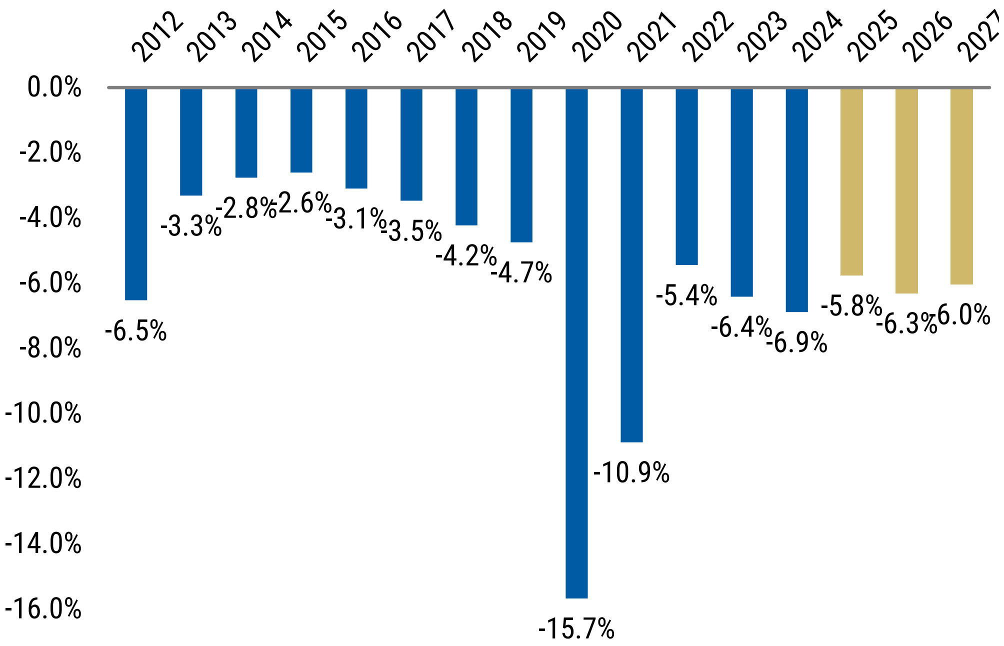
We expect a wider deficit in 2026

We project a wider fiscal deficit in 2026, reaching $2.02tn (6.3% of GDP). OBBBA provisions will add to the deficit while softer nominal growth and more modest employment gains in 2025 are expected to slow tax receipts in 2026. An increase in tariff revenues and additional savings from federal layoffs in 2026 partially offset this. Our models suggest a similar deficit level in 2027—$2.01tn or 6.0% of GDP. We expect the debt-to-GDP ratio to rise from 124% in 2025 to 126% by 2027.

Deficit 2025 v 2026 (CY, $bn): Components explaining the change



Federal fiscal balance (% GDP)

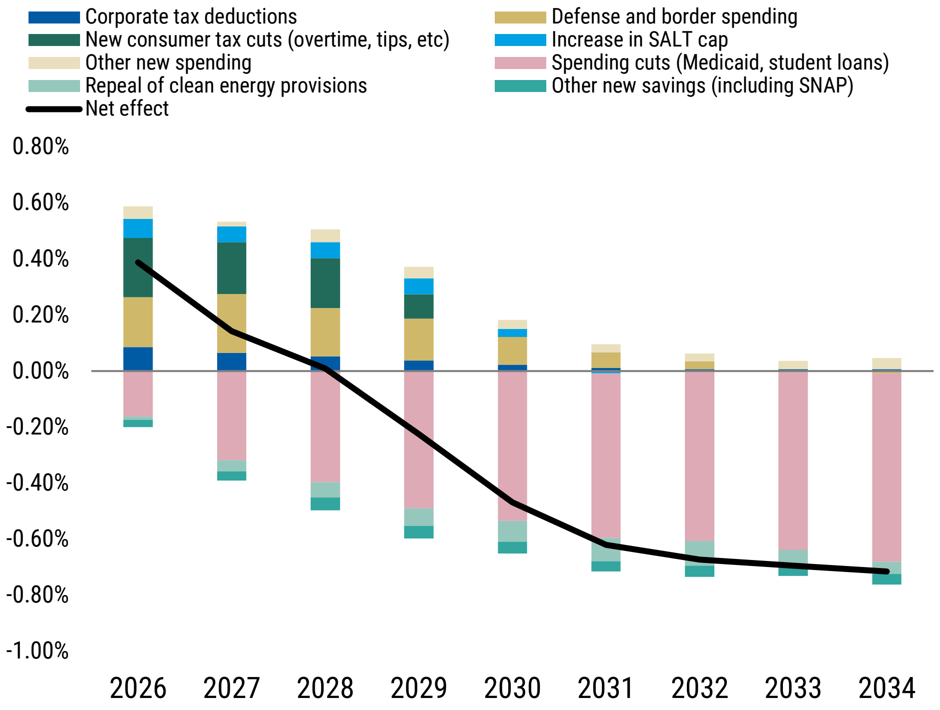


Note: In left chart, "Macro variables" includes the net effect of changes in GDP growth, inflation, employment, interest rates on deficit forecasts. Source: US Treasury, Morgan Stanley Research

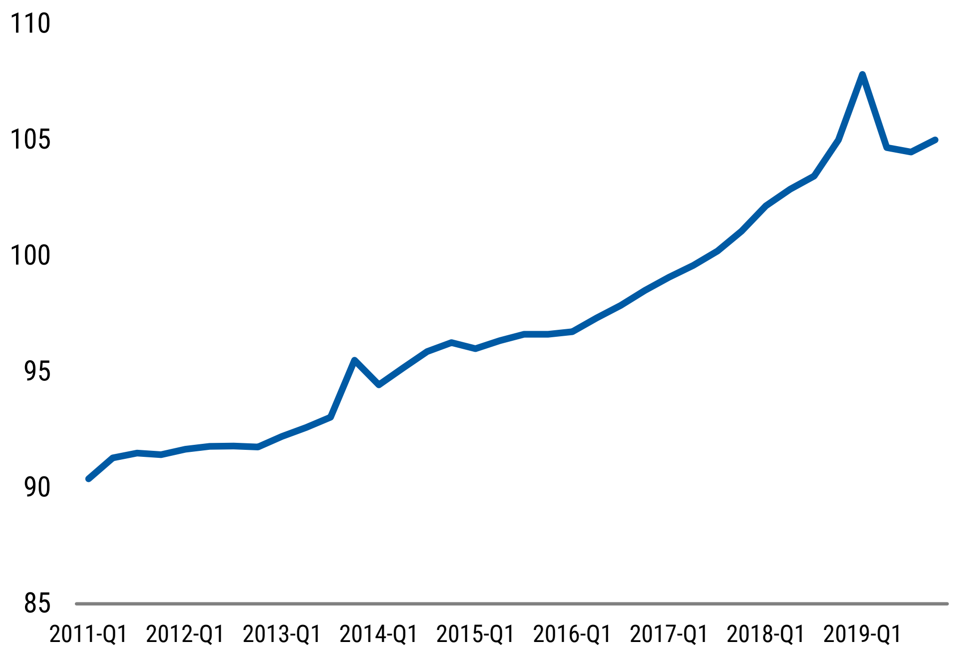
OBBBA should boost growth in 2026 and 2027

We estimate that the One Big Beautiful Bill Act will boost GDP by approximately 0.4 percentage points in 2026 and 0.14 percentage points in 2027. The primary drivers of this impulse include new consumer tax cuts (e.g., on overtime pay and tips), the increase in the SALT deduction cap, expanded corporate tax deductions, and higher spending on defense and border security. The government shutdown will distort the quarterly profile of real government spending, subtracting from GDP growth in Q425 and boosting it in Q126.

OBBBA fiscal effects on GDP



Federal government nondefense consumption deflator



Source: CBO, BEA, Morgan Stanley Research

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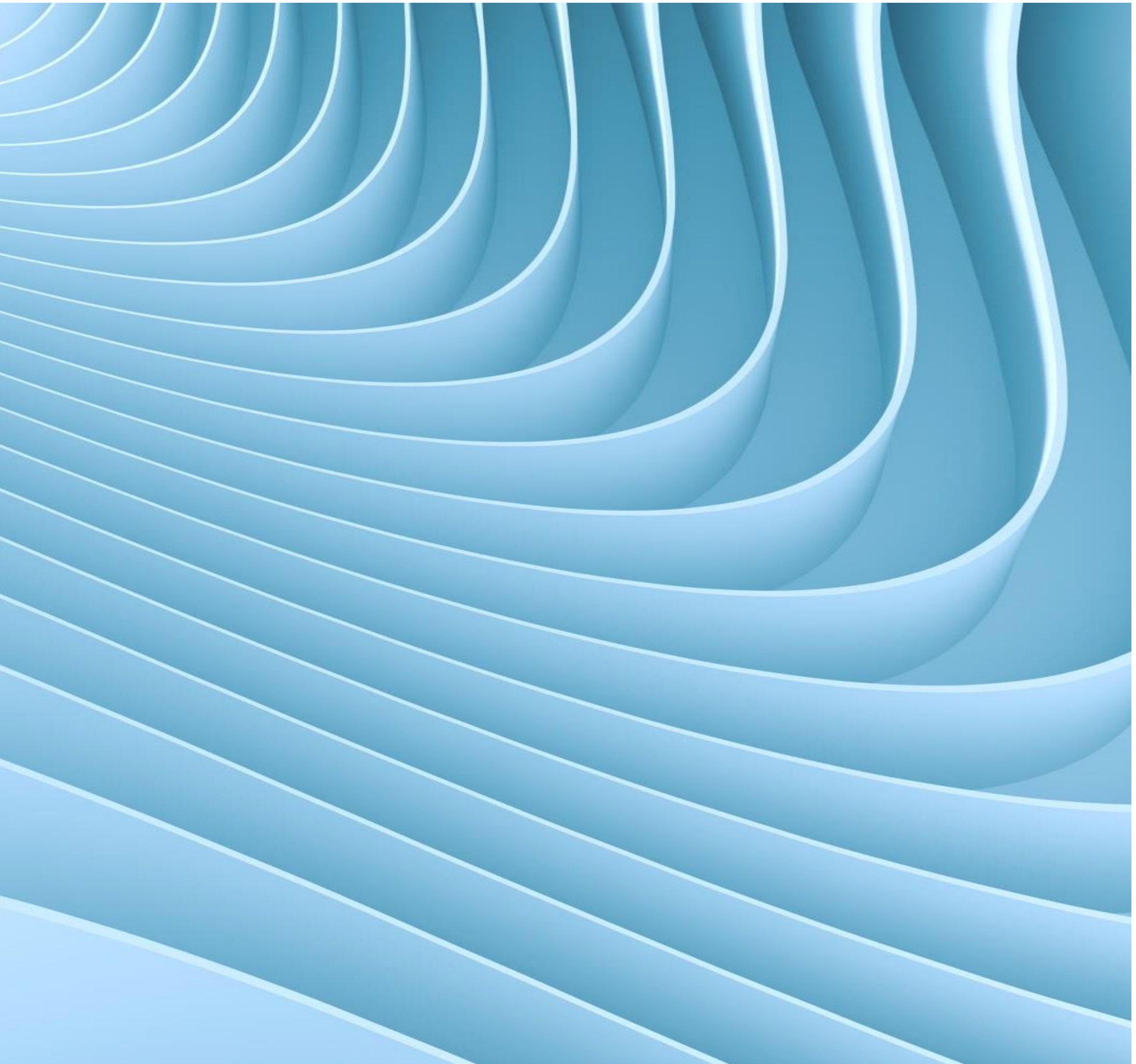


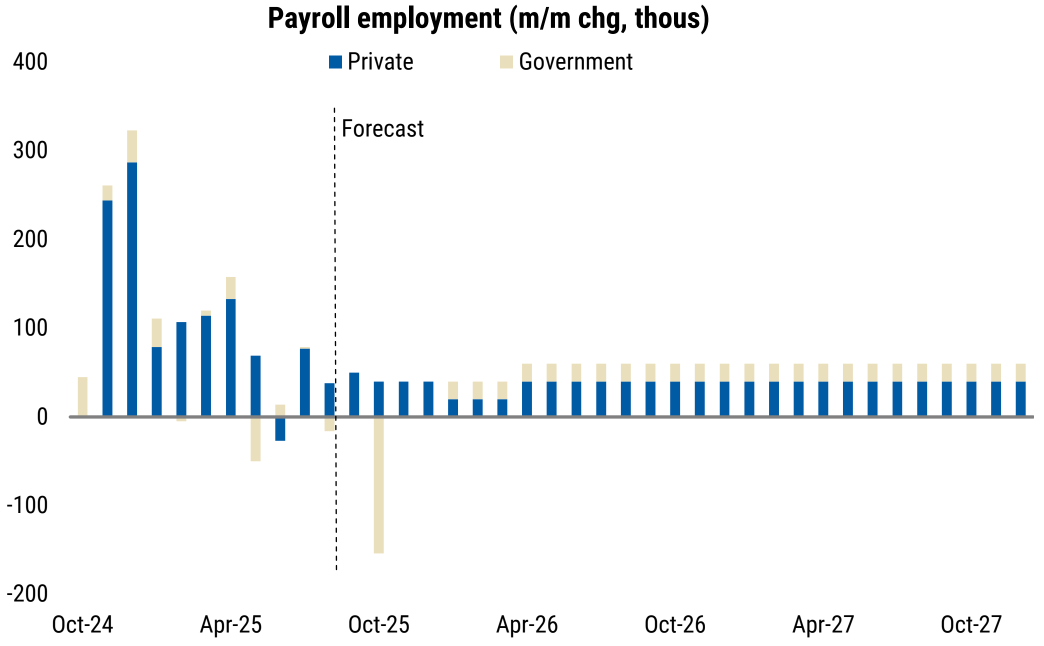
Labor

The sharp slowdown in labor force growth remains a key feature of the US labor market in our forecast. We expect employment growth to remain muted in 2026-27, at 55k and 60k per month respectively. As the corporate sector adjusts to higher tariffs, reduced labor demand should lead to increased slack and a higher unemployment rate. We forecast the unemployment rate to rise to 4.7% in 2Q26, supporting our outlook for further Federal Reserve rate cuts. We project the unemployment rate to fall back to 4.4% by end-2027.

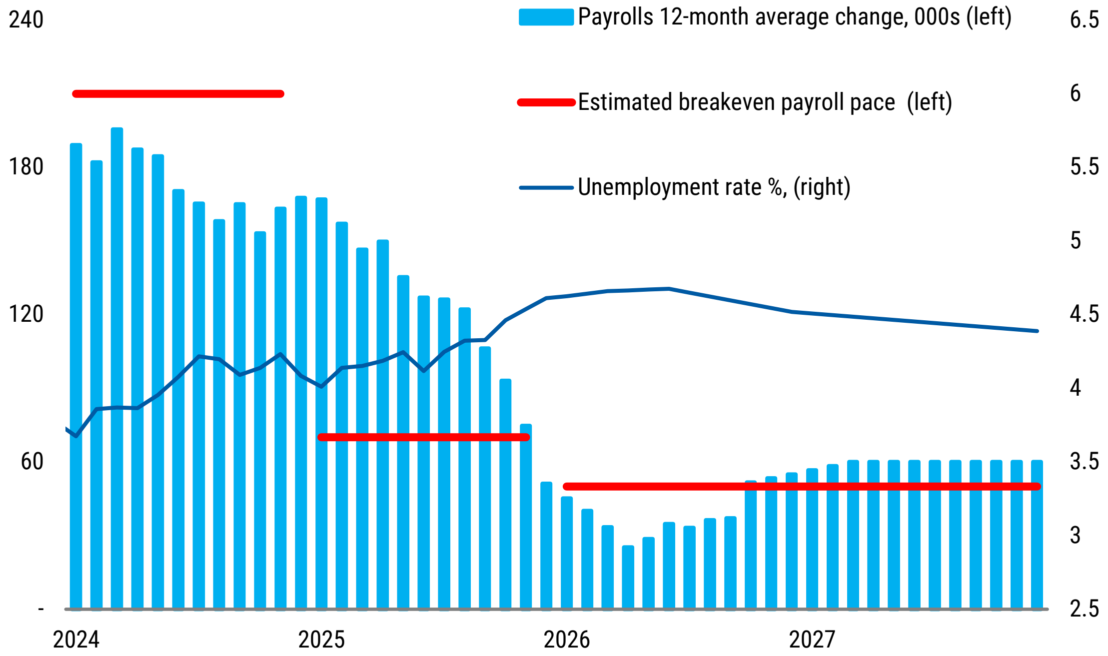
Slow Immigration, Aging Population, Cautious Hiring

We project unemployment to rise to 4.7% by mid-2026 before falling to 4.4% by end-2027. Slowing immigration is curbing labor supply growth, adding pressure to an already tight job market. Demographic shifts, including an aging population, are reducing participation rates and further limiting workforce availability. At the same time, non-labor cost pressures such as tariffs and corporate cost pass-through are weighing on hiring decisions and amplifying these constraints.

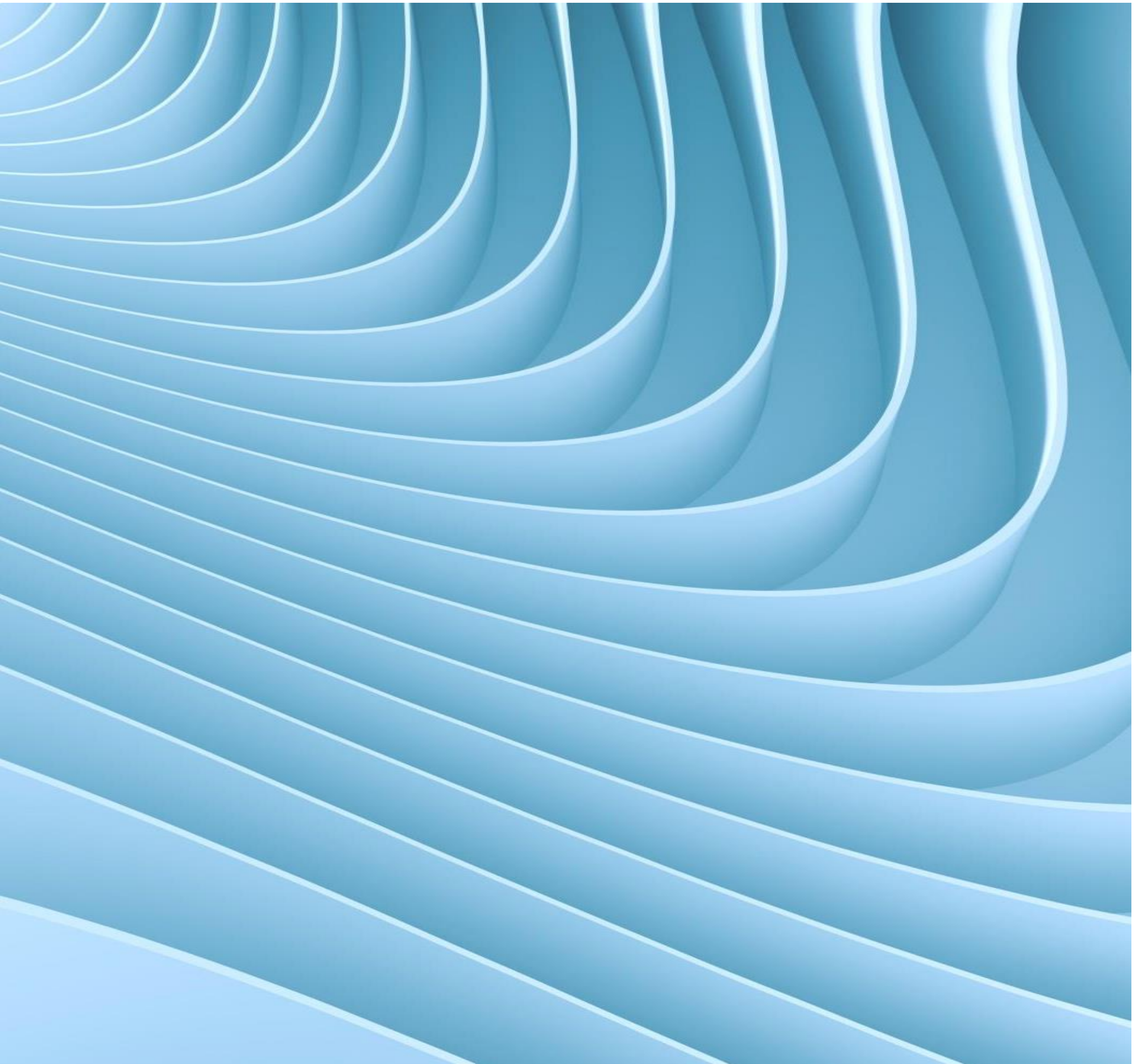
Still slow payroll growth



Unemployment rate rises through 2Q and slips again



Source: Bureau of Economic Analysis, Morgan Stanley Research



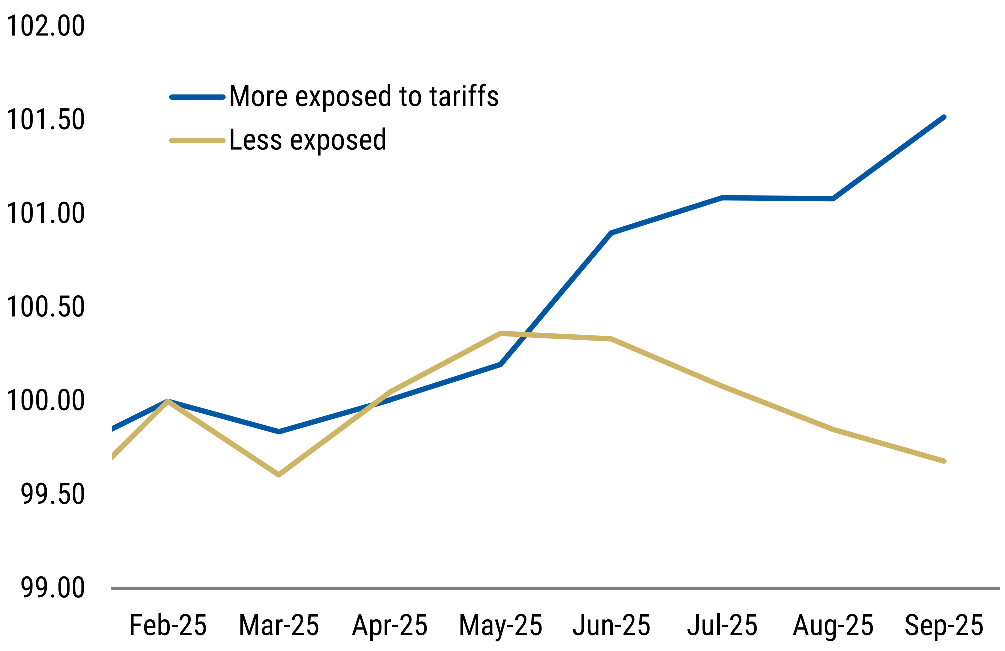
Inflation

The tariff-related push continues until Q126 keeping inflation elevated for longer. Services continue their downward trend as labor markets cool in 1H26 and lagged components like rents and car insurance keep slowing down. We see core PCE at 3.0% in 2025 (q4/q4), 2.6% in 2026, and 2.3% in 2027.

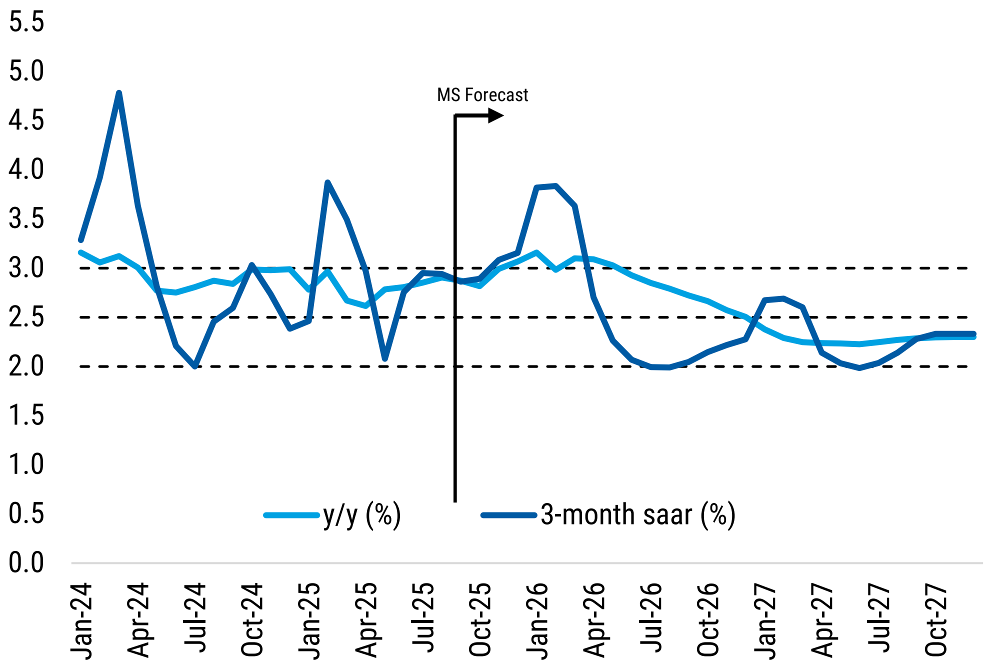
A More Prolonged Tariff Pass Through

We maintain our assumption of a 60–70bp total tariff effect on PCE prices (based on a 60% passthrough to consumers), but have adjusted the profile to reflect a more gradual impact. We now expect tariffs to continue pushing inflation through Q1 2026, with core PCE inflation at 3.0% 4Q/4Q in 2025 (vs. 3.3% previously) and 2.6% in 2026 (vs. 2.3%). By 2027, under a slightly restrictive monetary policy stance, we project inflation to decelerate to 2.3%.

PCE: Core goods prices (Feb-25=100, SA)



Core PCE (%)



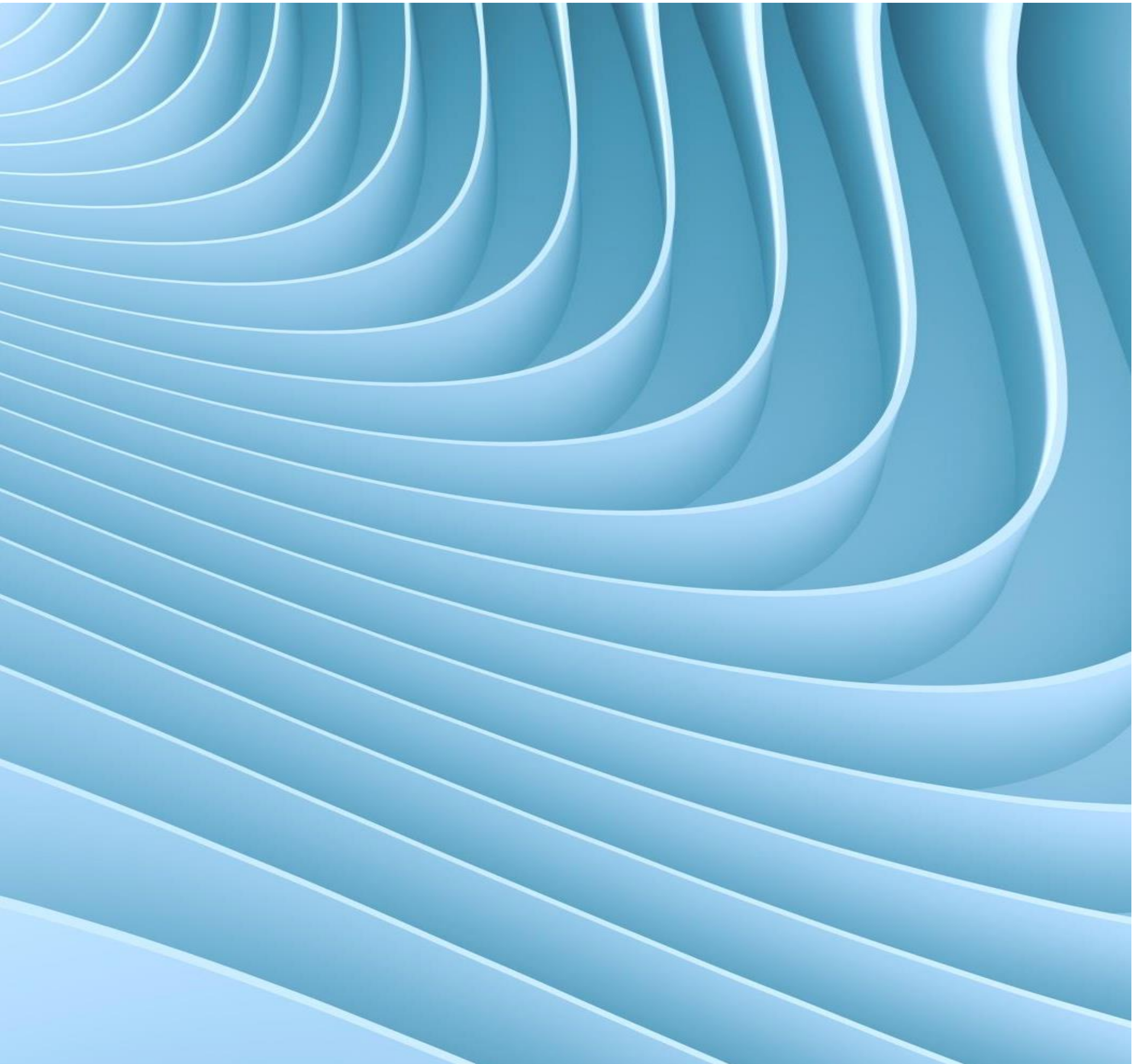
Source: BEA, BLS, Morgan Stanley Research forecasts

Monthly Inflation Forecasts

	% Change - Year-over-Year					% Change - Month-over-Month				Headline CPI NSA Index
	Headline PCE	Core PCE	Headline CPI	Core CPI		Headline PCE	Core PCE	Headline CPI	Core CPI	
Jan-25	2.6	2.8	3.0	3.3	Jan-25	0.37	0.31	0.47	0.45	317.671
Feb-25	2.7	3.0	2.8	3.1	Feb-25	0.40	0.45	0.22	0.23	319.082
Mar-25	2.4	2.7	2.4	2.8	Mar-25	0.02	0.10	-0.05	0.06	319.799
Apr-25	2.3	2.6	2.3	2.8	Apr-25	0.17	0.19	0.22	0.24	320.795
May-25	2.5	2.8	2.4	2.8	May-25	0.18	0.23	0.08	0.13	321.465
Jun-25	2.6	2.8	2.7	2.9	Jun-25	0.29	0.26	0.29	0.23	322.561
Jul-25	2.6	2.9	2.7	3.1	Jul-25	0.16	0.24	0.20	0.32	323.048
Aug-25	2.7	2.9	2.9	3.1	Aug-25	0.26	0.23	0.38	0.35	323.976
Sep-25	**2.8**	**2.9**	3.0	3.0	**Sep-25**	**0.30**	**0.24**	0.31	0.23	324.800
Oct-25	**2.8**	**2.8**	**3.0**	**3.0**	**Oct-25**	**0.20**	**0.24**	**0.20**	**0.28**	**325.079**
Nov-25	**2.9**	**3.0**	**3.0**	**3.1**	**Nov-25**	**0.24**	**0.27**	**0.24**	**0.30**	**324.782**
Dec-25	**2.9**	**3.1**	**2.9**	**3.1**	**Dec-25**	**0.28**	**0.26**	**0.31**	**0.29**	**324.724**
Jan-26	**2.9**	**3.2**	**2.7**	**3.1**	**Jan-26**	**0.34**	**0.40**	**0.29**	**0.39**	**326.277**
Feb-26	**2.7**	**3.0**	**2.7**	**3.2**	**Feb-26**	**0.24**	**0.28**	**0.24**	**0.31**	**327.816**
Mar-26	**2.9**	**3.1**	**3.0**	**3.3**	**Mar-26**	**0.20**	**0.21**	**0.19**	**0.19**	**329.335**
Apr-26	**3.0**	**3.1**	**3.1**	**3.2**	**Apr-26**	**0.23**	**0.18**	**0.28**	**0.18**	**330.564**
May-26	**3.0**	**3.0**	**3.1**	**3.3**	**May-26**	**0.16**	**0.17**	**0.16**	**0.17**	**331.513**
Jun-26	**2.9**	**2.9**	**3.1**	**3.2**	**Jun-26**	**0.19**	**0.16**	**0.21**	**0.15**	**332.386**
Jul-26	**2.8**	**2.8**	**2.9**	**3.1**	**Jul-26**	**0.10**	**0.16**	**0.09**	**0.18**	**332.534**
Aug-26	**2.7**	**2.8**	**2.8**	**2.9**	**Aug-26**	**0.19**	**0.17**	**0.23**	**0.21**	**332.993**
Sep-26	**2.6**	**2.7**	**2.8**	**2.9**	**Sep-26**	**0.21**	**0.18**	**0.27**	**0.21**	**333.701**
Oct-26	**2.5**	**2.7**	**2.6**	**2.8**	**Oct-26**	**0.10**	**0.18**	**0.07**	**0.23**	**333.579**
Nov-26	**2.5**	**2.6**	**2.6**	**2.8**	**Nov-26**	**0.18**	**0.19**	**0.21**	**0.23**	**333.175**
Dec-26	**2.4**	**2.5**	**2.6**	**2.7**	**Dec-26**	**0.24**	**0.19**	**0.30**	**0.23**	**333.094**
Jan-27	**2.3**	**2.4**	**2.6**	**2.6**	**Jan-27**	**0.24**	**0.28**	**0.26**	**0.33**	**334.570**
Feb-27	**2.2**	**2.3**	**2.5**	**2.6**	**Feb-27**	**0.15**	**0.19**	**0.17**	**0.24**	**335.899**
Mar-27	**2.2**	**2.2**	**2.5**	**2.6**	**Mar-27**	**0.16**	**0.17**	**0.17**	**0.18**	**337.389**
Apr-27	**2.1**	**2.2**	**2.4**	**2.6**	**Apr-27**	**0.21**	**0.17**	**0.25**	**0.18**	**338.552**
May-27	**2.1**	**2.2**	**2.4**	**2.6**	**May-27**	**0.14**	**0.17**	**0.13**	**0.17**	**339.436**
Jun-27	**2.1**	**2.2**	**2.4**	**2.6**	**Jun-27**	**0.17**	**0.16**	**0.18**	**0.15**	**340.227**
Jul-27	**2.1**	**2.2**	**2.4**	**2.6**	**Jul-27**	**0.12**	**0.18**	**0.10**	**0.20**	**340.419**
Aug-27	**2.1**	**2.3**	**2.4**	**2.6**	**Aug-27**	**0.21**	**0.19**	**0.26**	**0.23**	**340.969**
Sep-27	**2.1**	**2.3**	**2.4**	**2.6**	**Sep-27**	**0.22**	**0.19**	**0.29**	**0.23**	**341.752**
Oct-27	**2.2**	**2.3**	**2.5**	**2.6**	**Oct-27**	**0.12**	**0.19**	**0.12**	**0.24**	**341.787**
Nov-27	**2.2**	**2.3**	**2.5**	**2.6**	**Nov-27**	**0.19**	**0.19**	**0.22**	**0.23**	**341.387**
Dec-27	**2.2**	**2.3**	**2.5**	**2.6**	**Dec-27**	**0.23**	**0.19**	**0.28**	**0.23**	**341.234**

Source: Bureau of Labor Statistics, Bureau of Economic Analysis, Morgan Stanley Research forecasts

Morgan Stanley



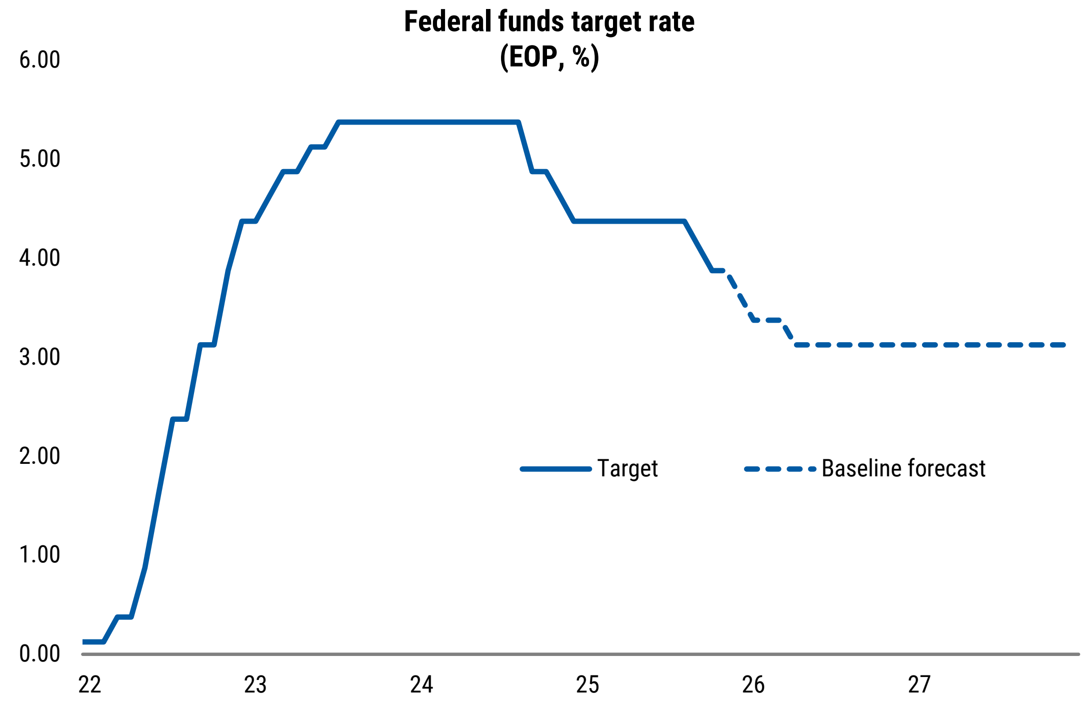
Monetary Policy

With the unemployment rate drifting higher to a peak of 4.7% in 2Q26 and tariffs having temporary effects on inflation, we anticipate further cuts from the Fed. We forecast additional 25bp rate cuts in December and January, and a last rate cut in April that brings the terminal target range to 3.0-3.25%.

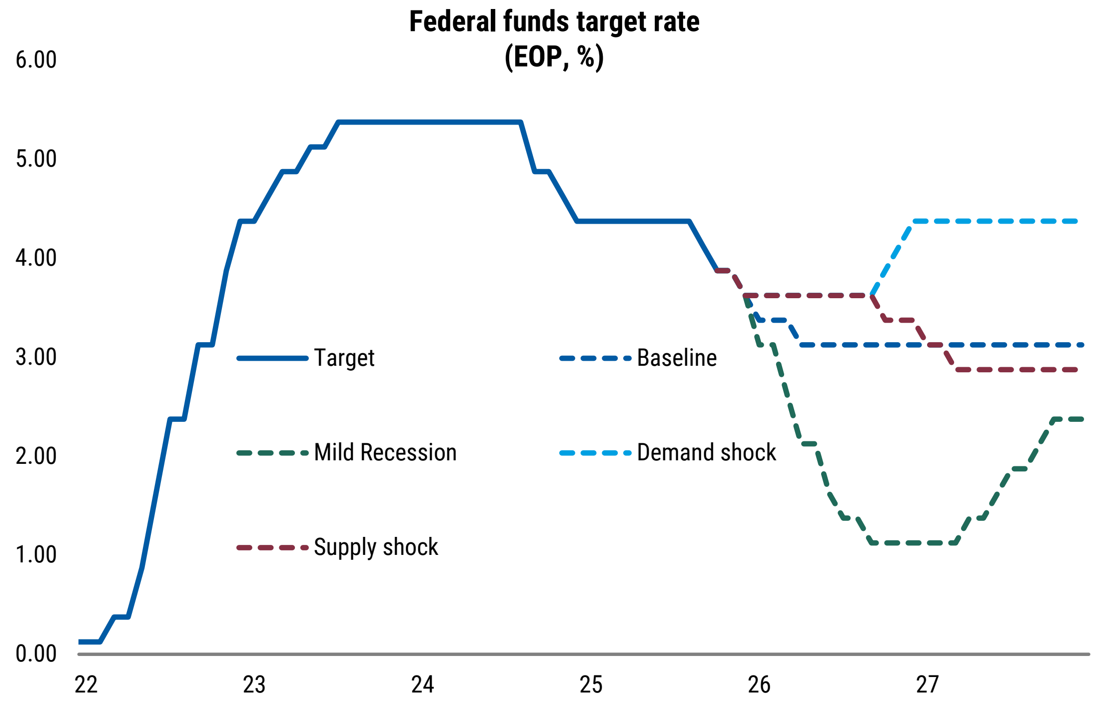
Insurance to labor markets comes at an inflation cost

We expect the Fed to cut rates further as the unemployment rate drifts higher to a peak of 4.7% in Q2 2026 and tariffs temporarily push inflation up. Our forecast includes two additional 25bp cuts in December and January, followed by a final cut in April, bringing the terminal target range to 3.00–3.25%.

We expect terminal target range of 3.0-3.25% in 2026

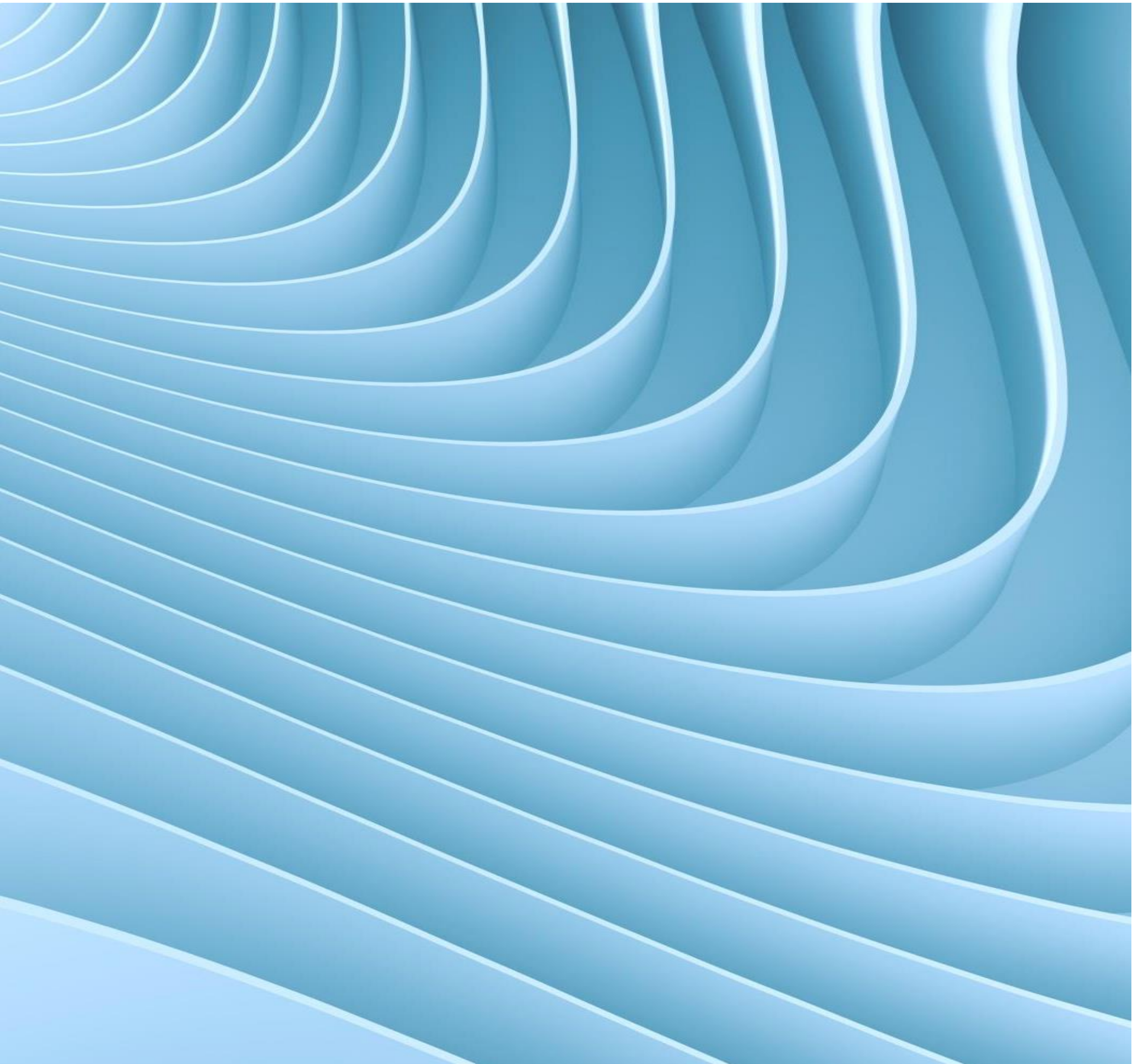


If a mild recession, demand shock, supply shock…



Source: Federal Reserve Board, Morgan Stanley Research forecasts

Morgan Stanley



Special topic: Lost In Translation

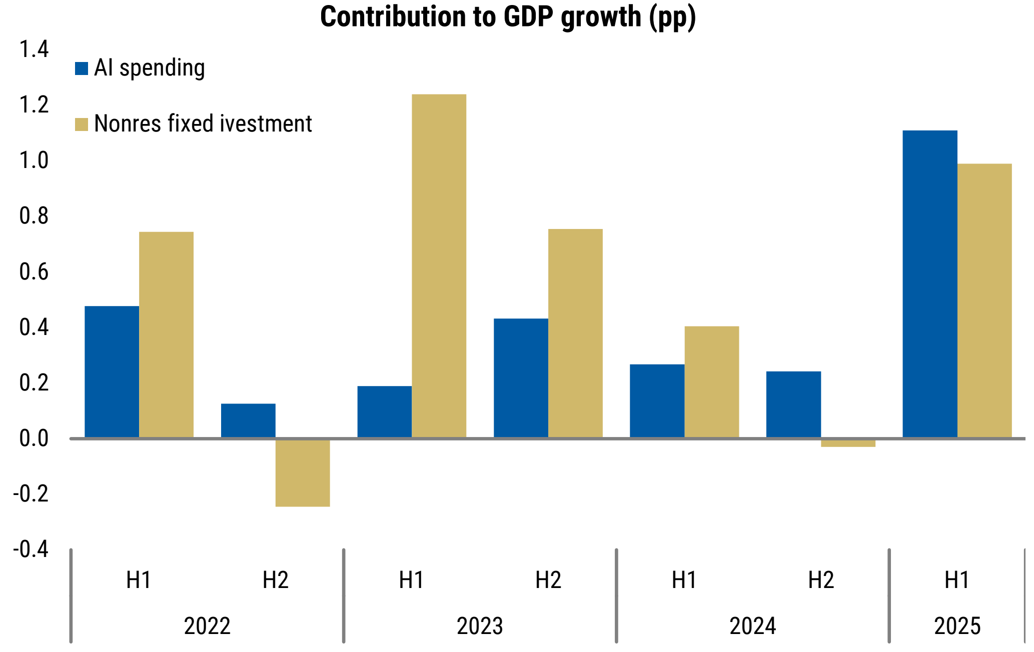
-- When robust AI spending does not translate to strong GDP growth

AI-related capital expenditures will be a major theme for the US economy through 2027, but high spending does not automatically translate into faster GDP growth. Corporate AI capex announcements often include items like software, data centers, and imports, which differ from GDP's focus on domestic final output. As a result, simple comparisons between announced spending and GDP overstate AI's contribution to economic activity.

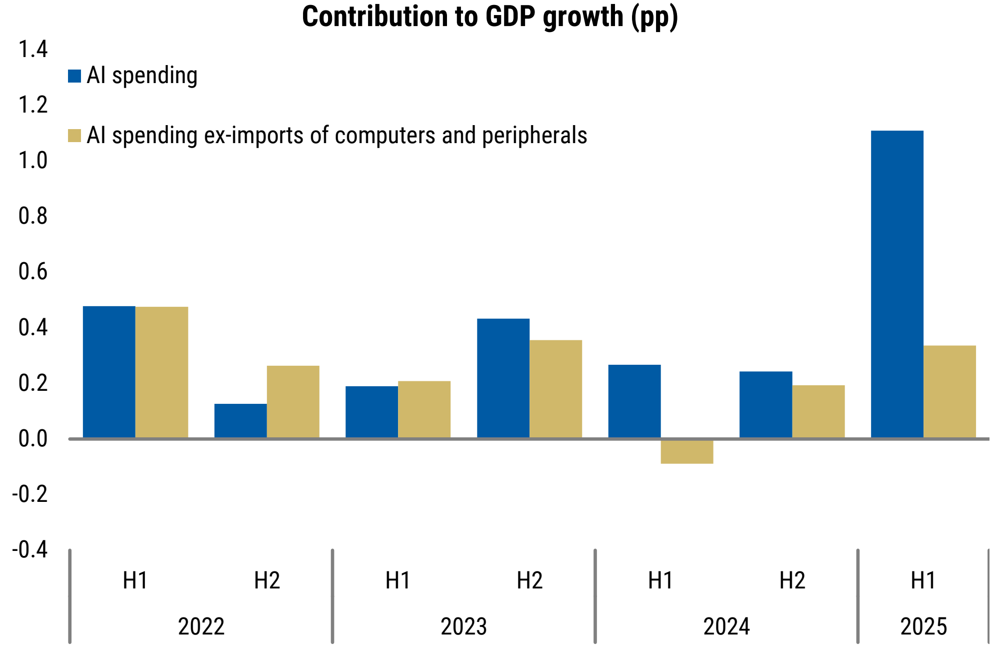
AI Spending: Mostly Intermediate Goods and Imports

AI-related spending made up a large share of nonresidential business investment and accounted for about two-thirds of GDP growth in 1H 2025, even as non-AI investment dragged on growth. After adjusting for imports, AI's net contribution to GDP growth drops sharply to roughly 0.3pp in 2023, 0.1pp in 2024, and 0.3pp in 2025.

Large direct effects on real GDP Growth



Effects subdued after accounting for imports

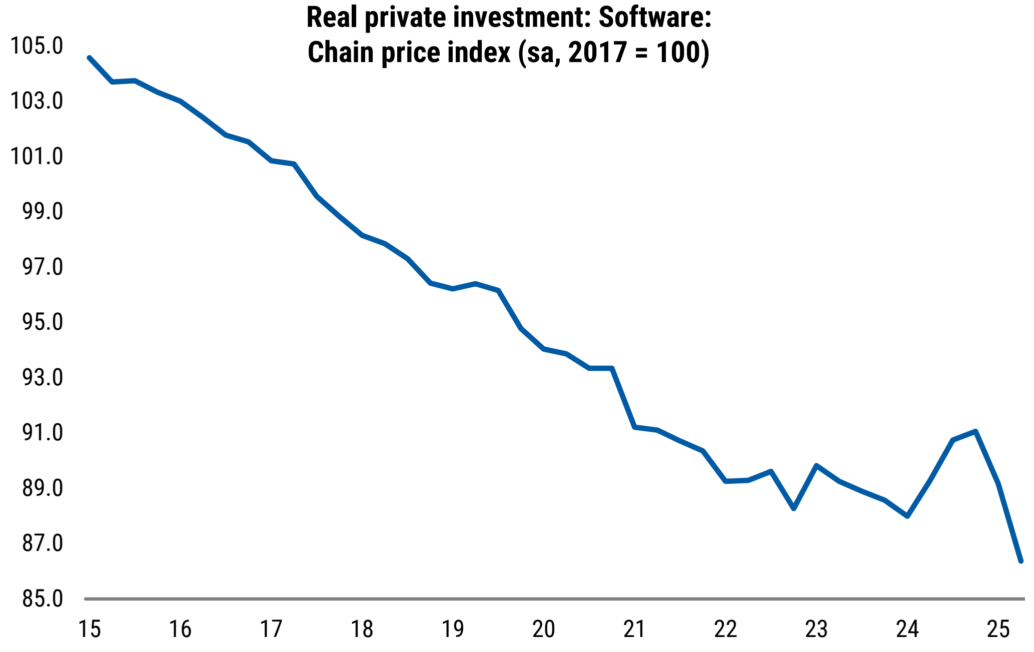


Source: Bureau of Economic Analysis, Morgan Stanley Research

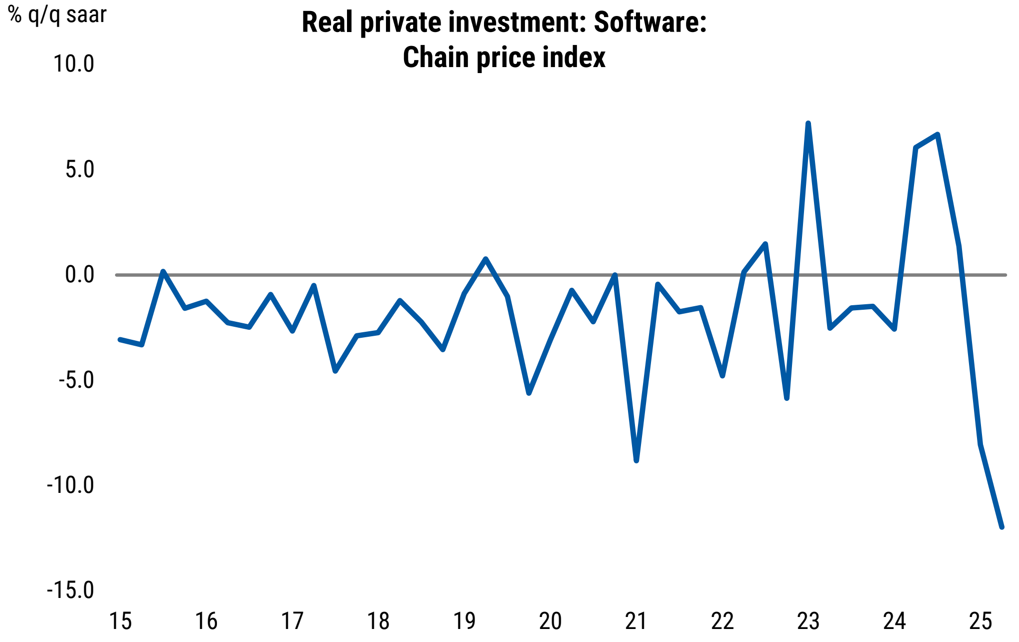
Deflators matter as well

A sharp swing in the software deflator distorted real spending figures: its unexpected rise in 2024 suppressed growth, while a 13% annualized drop in 1H 2025 inflated contributions to GDP. With the deflator now back on trend, future gains will depend on higher nominal spending rather than price-driven boosts, though growth rates are likely to slow as AI investment levels rise.

Software deflator spike in 2024 reversed in 2025

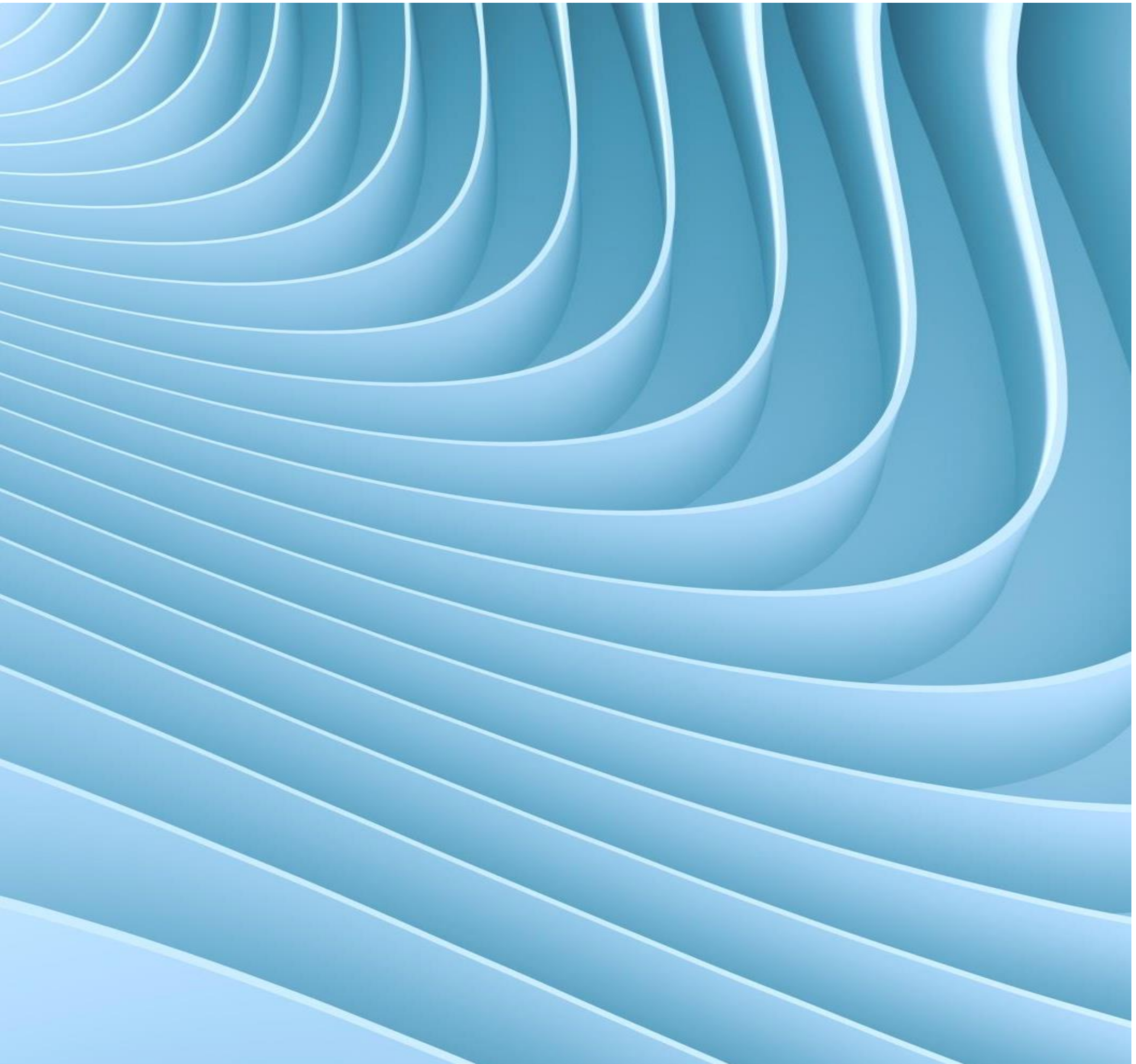


10% fall in software prices reverses prior increases



Source: Bureau of Economic Analysis, Morgan Stanley Research

Morgan Stanley



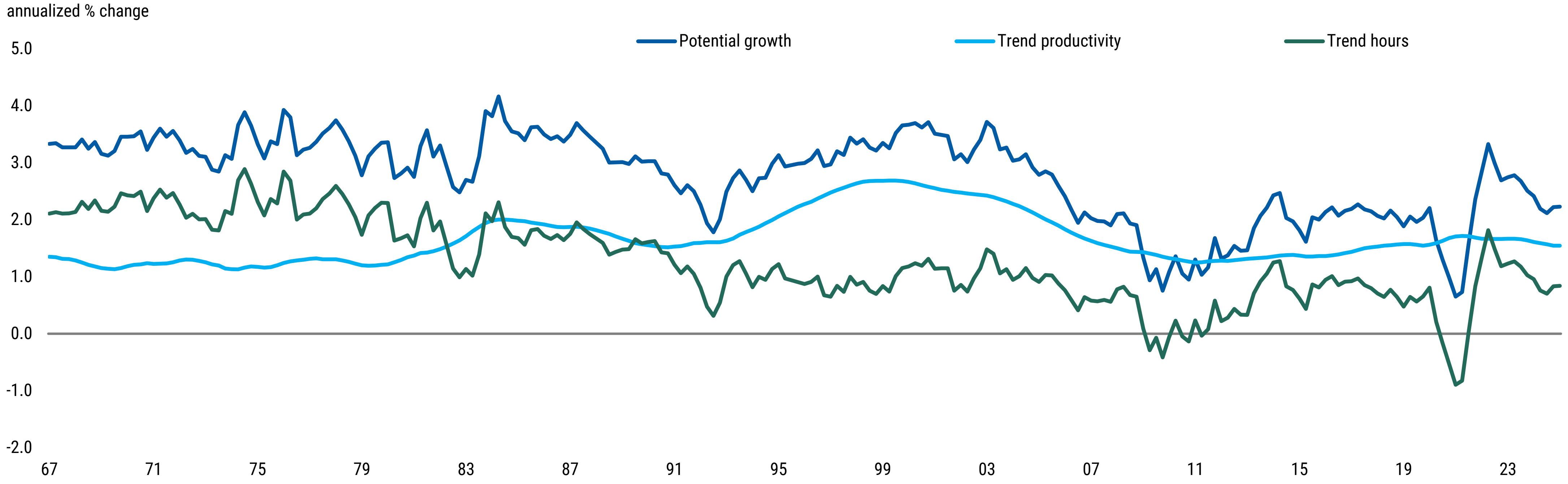
Special topic: What might an AI productivity cycle look like?

AI-driven innovation could mark the sixth major U.S. innovation cycle, with each wave historically shorter than the last. If the tech boom is any guide, modest productivity gains may appear soon, while stronger acceleration will likely take longer. Initial estimates often miss these improvements in real time, and history suggests revisions could take a year or more to fully capture the gains.

From Tech Boom to AI: How Productivity Gains Unfold

We expect modest productivity gains from AI in 2026–27, with more significant improvements likely after 2030. Drawing on the tech boom as a guide, investment in information processing equipment accelerated in 1988, while productivity gains began around 1993 and strengthened after 1995. It took roughly five years to build momentum and seven or more years for noticeable effects, with growth peaking at 2.7% in 1999.

Productivity Accelerated in Mid-1990s and Stayed Above Trend for a Decade

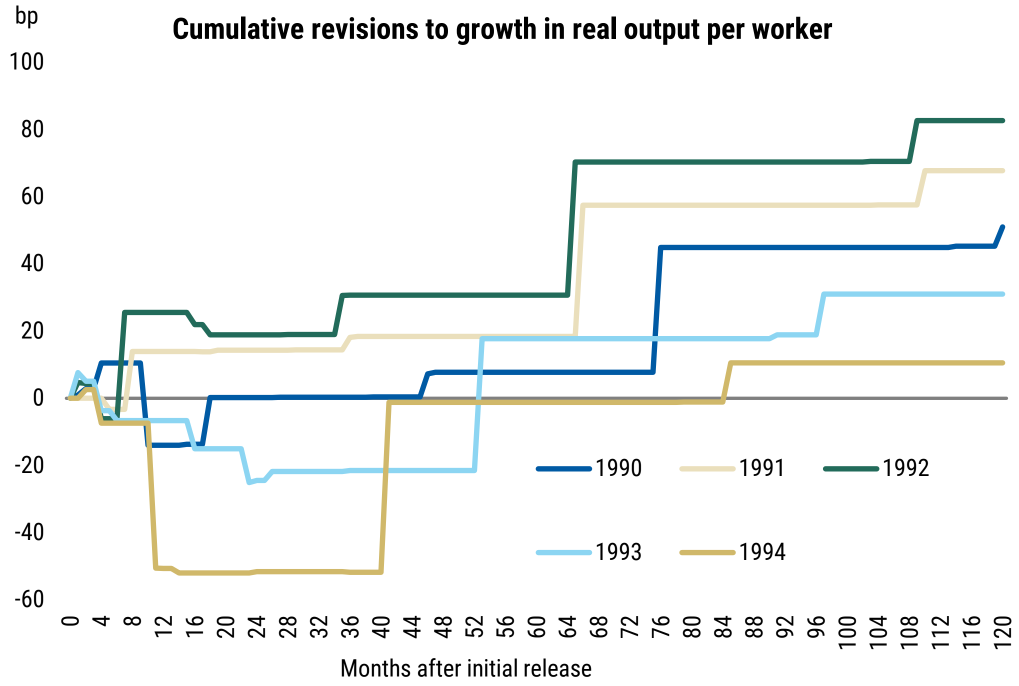


Source: Bureau of Economic Analysis, Morgan Stanley Research

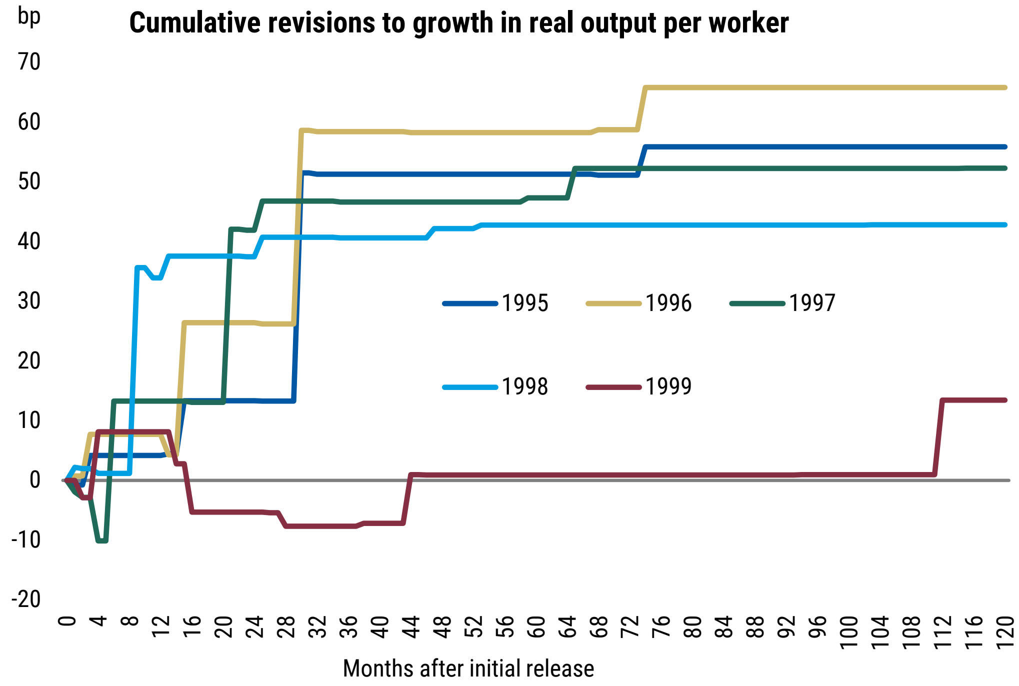
Productivity Gain Appears Late in GDP Data

Productivity gains often show up with a lag because early GDP estimates rely on incomplete data and trend assumptions. As seen in the 1990s tech boom, revisions over several years lifted productivity growth by 40–70bp, suggesting AI-driven gains may also take time to appear in official data.

Revision to productivity growth:1990 - 1994



Revision to productivity growth: 1995 - 1999



Source: Bureau of Economic Analysis, Morgan Stanley Research

Full Forecast Table

	Cal. average % ch.			4Q/4Q % change			Quarterly % change, annual rate (unless otherwise noted)									
	2025E	2026E	2027E	2025E	2026E	2027E	3Q25E	4Q25E	1Q26E	2Q26E	3Q26E	4Q26E	1Q27E	2Q27E	3Q27E	4Q27E
Real GDP	**2.0**	**1.7**	**2.0**	**1.6**	**1.8**	**2.0**	**3.7**	**-0.2**	**1.2**	**1.7**	**2.0**	**2.1**	**2.0**	**2.0**	**2.0**	**2.0**
Final Sales [1]	2.2	2.0	2.0	2.1	1.8	2.0	4.8	-0.2	1.2	1.7	2.0	2.1	2.0	2.0	2.0	2.0
Final Domestic Demand [2]	2.3	1.5	2.2	1.5	1.9	2.2	2.4	-0.3	1.3	1.8	2.2	2.2	2.2	2.2	2.2	2.2
Final Private Domestic Demand [3]	2.5	1.6	2.3	2.1	1.8	2.3	2.6	0.9	0.7	1.8	2.4	2.4	2.3	2.3	2.3	2.3
Personal Consumption Expenditures	2.5	1.6	1.8	1.8	1.6	1.8	3.0	0.9	0.8	1.8	2.0	2.0	1.8	1.8	1.8	1.8
— Goods	3.4	1.0	1.6	1.7	0.8	1.8	4.8	-0.1	-0.2	0.6	1.4	1.4	1.8	1.8	1.8	1.8
— Services	2.1	1.8	2.0	1.8	2.0	1.8	2.3	1.4	1.2	2.3	2.2	2.2	1.8	1.8	1.8	1.8
Nonresidential Fixed Investment	3.9	2.4	4.7	5.0	3.0	5.0	2.5	0.8	1.0	2.4	4.4	4.4	5.0	5.0	5.0	5.0
— Structures	-4.3	-0.8	2.2	-3.0	0.3	3.0	1.0	-2.0	-1.0	0.0	1.0	1.1	3.0	3.0	3.0	3.0
— Equipment	8.1	2.8	5.4	8.7	3.5	5.5	6.0	0.0	0.0	3.0	5.6	5.5	5.5	5.5	5.5	5.5
— IPP	4.8	3.7	5.2	6.0	4.0	5.5	0.0	3.0	3.0	3.0	5.0	5.0	5.5	5.5	5.5	5.5
Residential Investment	-1.7	-0.2	2.4	-2.5	1.4	2.5	-4.0	0.4	-0.5	1.0	2.5	2.7	2.5	2.5	2.5	2.5
Exports	1.1	1.5	2.0	0.6	2.0	1.6	3.0	1.2	1.2	1.7	1.7	3.5	1.6	1.6	1.6	1.6
Imports	1.4	-2.7	3.7	-4.4	3.0	3.6	-14.5	0.0	1.5	2.4	3.6	4.4	3.6	3.6	3.6	3.6
Government	1.0	0.6	1.6	-1.4	2.1	1.6	1.5	-6.0	4.0	1.5	1.5	1.5	1.6	1.6	1.6	1.6
Inventory contribution (pct pts, a.r.)	-0.3	-0.4	0.0	-0.5	0.0	0.0	-1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Trade contribution (pct pts, a.r.)	-0.1	0.0	0.0	0.6	-0.1	-0.2	2.3	0.0	-0.1	-0.1	-0.3	0.0	-0.3	-0.3	-0.3	0.0
Nominal GDP (Current $)	4.7	4.4	4.2	4.5	4.2	4.2	6.5	2.7	4.6	4.1	4.1	4.2	4.4	4.1	4.1	4.2
Nominal Consumption	5.2	5.2	4.4	4.7	4.1	4.0	5.9	4.0	4.2	4.3	3.9	4.0	4.3	3.9	3.8	4.0
Employment & Personal Income																
Civilian Unemployment Rate (%)	**4.3**	**4.6**	**4.4**	**4.5**	**4.5**	**4.4**	**4.3**	**4.5**	**4.6**	**4.7**	**4.6**	**4.5**	**4.5**	**4.5**	**4.4**	**4.4**
Civilian Labor Force Participation Rate (%)	62.4	62.2	62.0	62.3	62.1	62.0	62.3	62.3	62.2	62.2	62.1	62.1	62.1	62.0	62.0	62.0
Employment to Population Ratio (%)	59.7	59.3	59.3	59.5	59.3	59.3	59.6	59.5	59.4	59.3	59.3	59.3	59.3	59.3	59.3	59.3
Average Monthly Change in Nonfarm Payrolls (Thous.)				51	55	60	50	-11	40	60	60	60	60	60	60	60
Real DPI	2.1	1.8	1.5	1.6	1.8	1.2	0.7	0.4	4.1	0.2	1.2	1.6	1.7	1.5	1.7	1.3
Saving rate (%)	5.0	5.1	4.9	4.6	4.9	4.8	4.8	4.6	5.4	5.1	5.0	4.9	4.9	4.9	4.9	4.8
Business Indicators																
Industrial Production	1.0	-0.1	1.3	0.9	0.6	1.4	-1.1	-1.0	-0.7	0.3	1.2	1.6	1.4	1.4	1.4	1.4
Productivity	1.4	1.3	1.4	1.2	1.3	1.4	4.0	-0.9	0.9	1.4	1.3	1.5	1.4	1.4	1.4	1.4
Inflation (quarterly % change, a.r.)																
Consumer Price Index							3.1	3.2	3.3	2.7	2.1	2.3	2.8	2.3	2.2	2.6
CPI ex Food & Energy							3.3	3.4	3.9	2.3	2.2	2.7	3.2	2.2	2.4	2.8
PCE Price Index							2.8	3.0	3.4	2.5	1.9	2.0	2.5	2.1	2.0	2.2
PCE ex Food & Energy							2.9	3.0	3.8	2.3	2.0	2.2	2.7	2.0	2.2	2.3
Inflation (4-quarter % change)																
Consumer Price Index	2.8	2.8	2.4	2.9	2.6	2.5	2.9	2.9	2.8	3.1	2.8	2.6	2.5	2.4	2.4	2.5
CPI ex Food & Energy	3.0	3.0	2.6	3.1	2.8	2.6	3.1	3.1	3.2	3.2	2.9	2.8	2.6	2.6	2.6	2.6
PCE Price Index	2.6	2.7	2.2	2.8	2.5	2.2	2.7	2.8	2.8	2.9	2.7	2.5	2.2	2.1	2.1	2.2
PCE ex Food & Energy	**2.8**	**2.9**	**2.3**	**3.0**	**2.6**	**2.3**	**2.9**	**3.0**	**3.1**	**3.0**	**2.8**	**2.6**	**2.3**	**2.2**	**2.3**	**2.3**
Monetary Policy																
Fed Funds Target (%, midpoint of target range)				**3.625**	**3.125**	**3.125**	**4.125**	**3.625**	**3.375**	**3.125**	**3.125**	**3.125**	**3.125**	**3.125**	**3.125**	**3.125**
Balance Sheet ($ bil.)				6610	6656	6752	6659	6610	6608	6614	6635	6656	6680	6704	6728	6752
Fiscal Policy																
Federal Budget balance (% of GDP)				-5.8	-6.3	-6.0										

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve, Census Bureau, Treasury Dep't, Morgan Stanley Research forecasts

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