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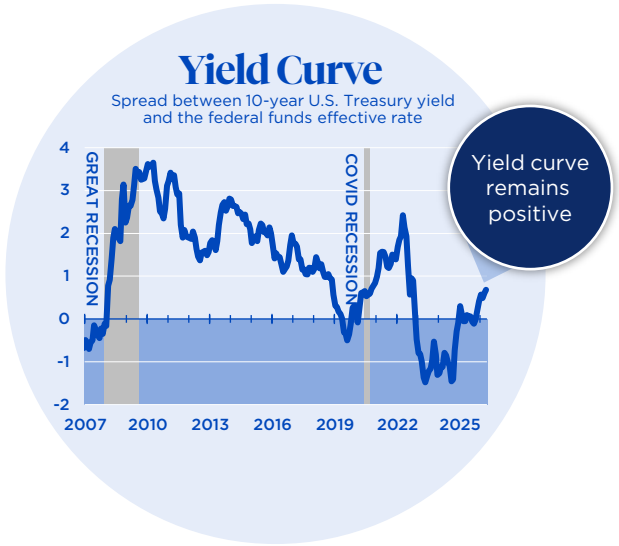
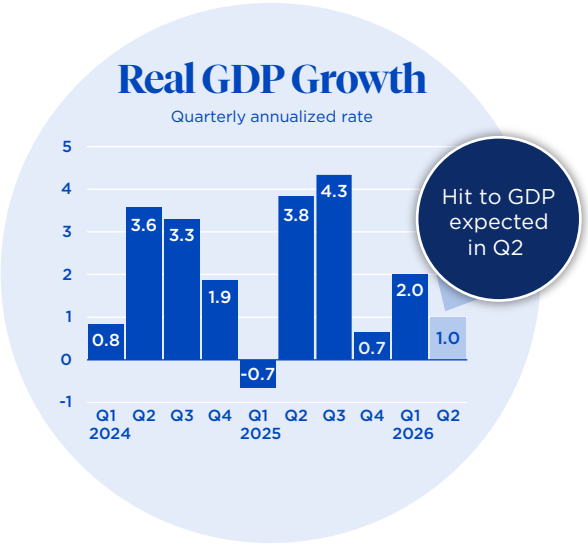
Economic & Financial Markets Monthly Review | May 2026

Economy weathers another spike in inflation

Where is the economy now?

Consumer spending and hiring activity have remained solid despite the building financial pressure for households and businesses from higher energy costs. That said, near-term GDP growth is likely to slow in response to the oil supply shock and the hit to confidence from the extended conflict in the Middle East. Despite a change in leadership, faster inflation should keep the Fed on hold until late in the year at least — with elevated interest rates an added headwind for growth.





Energy price spike shaves growth

Headwinds from higher energy costs are expected to slow GDP growth in the coming months as consumers pare spending while businesses cut investment plans. Interest rates remain elevated and the Fed could be on pause until late in the year — adding further drag on expected purchases of auto and homes over 2026.

Treasury yields climb higher

Interest rates have climbed higher as financial markets reset inflation expectations and reprice for reduced Fed easing over the remainder of 2026. After dropping briefly below 4.0 percent in February, the 10-year Treasury rate climbed to 4.6 percent in May. The spread between the 2- and 10-year yields has held steady with rates across the curve shifting higher.

Solid growth in the first quarter

Continued AI buildout, resilience in consumer spending, and a bounce back from the government shutdown supported GDP growth at the start of 2026. Final sales to private domestic producers (or core GDP) rose at a solid 2.5 percent annualized pace as business investment on IT processing equipment and software surged over the first quarter.

What does this mean for the economic outlook?

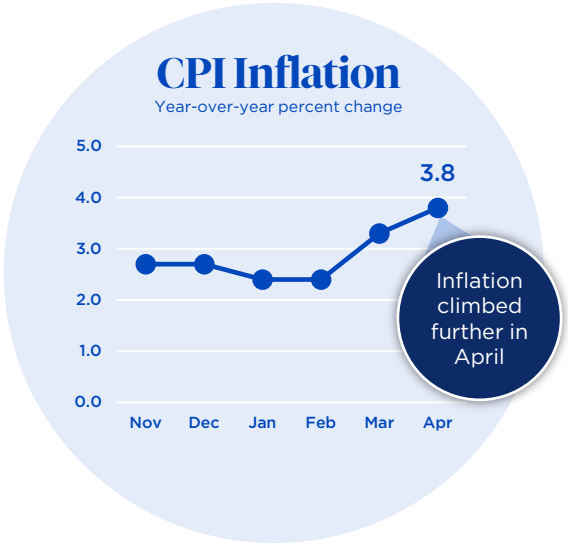
We expect that sluggish near-term growth will give way to an upswing in activity in the second half of 2026 if energy markets start to normalize over the summer. However, for now, higher energy costs, elevated uncertainty, and the hit to confidence is offsetting some of the fiscal stimulus from the OBBBA.

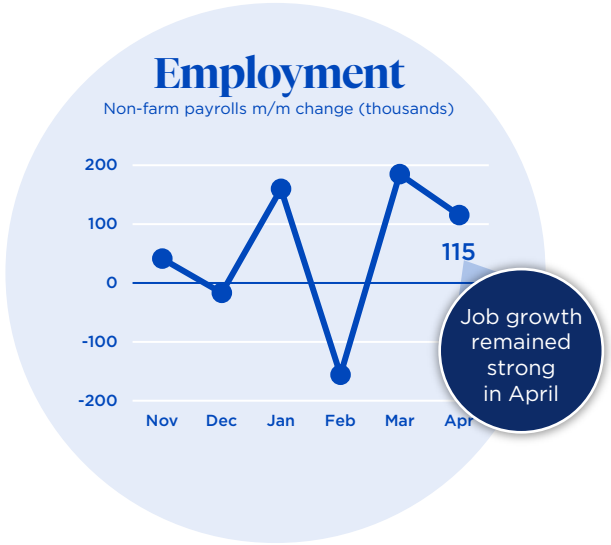
The Fed is poised to drop its easing bias and hold interest rates steady until at least late 2026. While we still see the possibility of one rate cut by year end, the bar to further easing has increased with the jump in inflation.

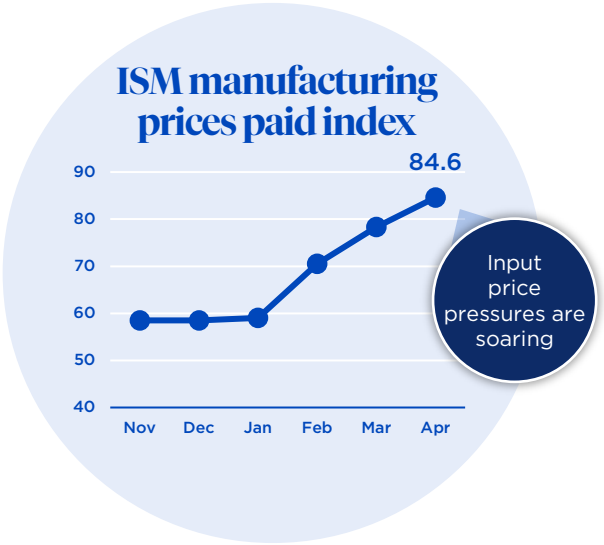
The jump in energy costs and uncertainty due to the Iran conflict is expected to weigh on growth in Q2 with just a 1.0 percent increase projected. Even though the drag from high prices for gasoline and Diesel fuel could extend later in the year, AI investment and stimulus efforts should prevent a sharp decline in growth.

Inflation accelerates as labor market remains firm

Consumer inflation heated up in April as higher energy, food, and shelter costs pushed headline CPI to its fastest pace in nearly three years, while the labor market has firmed with solid hiring and a low unemployment rate. At the same time, the surge in the ISM manufacturing prices paid index points to intensifying price pressures tied to the Strait of Hormuz supply disruptions, raising the risk that goods inflation will climb higher in the months ahead.







Price pressures heat up, led by energy

Consumer inflation heated up in April as headline and core CPI firmed on higher energy, food, and shelter prices. Headline CPI inflation rose to 3.8 percent — the fastest pace since May 2023 — while core inflation was lifted by a temporary rental inflation true-up after last year's government shutdown.

Strong hiring buffers the energy shock

April hiring was solid, with payrolls up 115,000 and gains led by private services. Healthcare and social assistance remained the main driver, but hiring broadened to retail, wholesale trade, transportation and warehousing, and leisure and hospitality. The unemployment rate held at a low 4.3 percent.

Input cost pressures intensify

The ISM manufacturing prices paid index has surged in recent months to its highest level in four years, and the three-month climb from January to April was the largest in over 20 years. The sharp rise reflects intensifying input cost pressures tied to the closing of the Strait of Hormuz.

What does this mean for the economic outlook?

We expect further acceleration ahead, with headline inflation likely surpassing 4.0 percent in May as gasoline prices keep rising. Any easing later this year depends on oil flows through the Strait of Hormuz; the current stalemate with Iran could keep pressures elevated and inflation running hotter.

The labor market has stayed firm despite Iran-war uncertainty. Higher gasoline prices will weigh on spending, but solid hiring should support income and confidence. With job growth still well above the estimated break-even pace and inflation rising on energy costs, the Fed is likely to be on hold for longer.

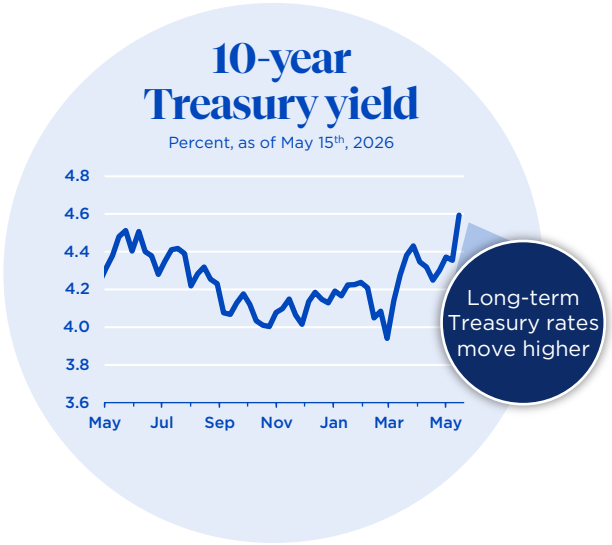
The jump in manufacturing input costs raises the risk that consumer goods inflation moves higher later this year as producers pass through at least part of those added costs. The ISM services prices paid index has also risen, although manufacturing is flashing the stronger warning signal.

Equity investors generally upbeat, but wary of jump in yields

Equity investors have been upbeat although the recent jump in global bond yields provides some concern. Bond yields have jumped on rising inflation concerns and the expectation that the Fed will keep rates on hold for longer than previously forecast. Risks are elevated, but positive economic momentum, solid corporate earnings, robust AI spending, and fiscal stimulus should dampen current headwinds to support stock prices.

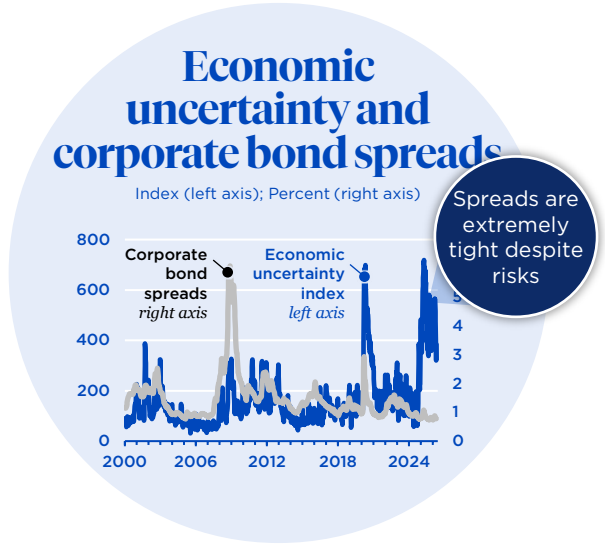
Equities hit new highs, but concerns rise

The Iran conflict is far from resolved and oil prices are trading above $100-per-barrel. Until the last few days, equity investors had seemingly discounted economic risks from the war as the S&P 500 index hit all-time highs in early May. Very positive first quarter 2026 earnings results had offset investors' geopolitical anxieties.



Inflation worries push up interest rates

Long-term Treasury yields are on the rise as investors see a greater possibility of higher and longer-lasting inflation. Short-end yields have also climbed, and investors now expect the Fed to remain on hold into 2027. The spread between the 2- and 10-year has re-widened over the last few days to a moderate level.



Investors are very optimistic

In a sign of investors' bullishness, corporate bond spreads remain extremely tight and are not placing much weight on prevailing uncertainties and risks. Notably, narrow corporate bond spreads are helping to keep financial conditions loose and mitigating the drag to economic growth from higher bond yields.

What does this mean for the economic outlook?

Robust earnings per share growth for the S&P 500 in Q1, up around 20 percent year-over-year, is easing concerns about the conflict's impacts. Corporate forward guidance remains positive, though some sectors face risks. Domestic tailwinds, namely very robust AI investment, should offset the conflict's economic ripple effects.

Developments on the Iran conflict and oil price fronts will likely remain the driving force behind Treasury yields. Our latest Fed forecast now anticipates only one 25 basis point rate cut in Q4 given the upside for near-term inflation. There is a possibility the fed funds rate remains on hold through year end.

The U.S. economy is more insulated from the Iran conflict than many other economies. Our base case is the conflict will not cause major, long-lasting damage to the corporate sector. However, we remain vigilant for downside risks as the Strait of Hormuz remains effectively closed and the conflict is lengthening.

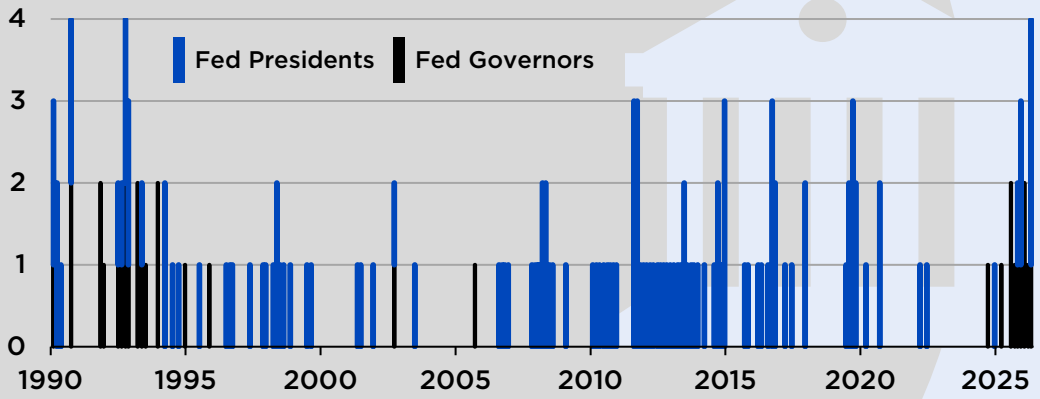
Outlook

Fed divisions could drive a longer pause in rates

While the FOMC held interest rates steady at its April meeting, there were four dissents for the first time since 1992 — highlighting the hardening divisions between Fed officials. Three of the dissents represented the hawkish wing of the committee who wanted a more neutral policy stance given inflationary pressures from the spike in energy prices, as opposed to the current bias that leans towards an eventual rate cut. Commentary from Jerome Powell, during his last press conference as Fed chair, implied that most members preferred to keep rates on hold for some time given the uncertainty in the outlook.

Incoming Fed Chair Kevin Warsh is likely to push for lower interest rates over time, but he may have difficulty convincing the other 11 voting FOMC members (which will include Powell as a Fed Governor for the time being) that such a move is warranted by current economic conditions. Given that energy prices could be elevated over the summer due to the lengthening Iranian conflict, an extended Fed pause is likely until at least late in 2026. We now expect only one rate cut in Q4 2026 with rising odds that the Fed stays on hold into 2027 — although a rate hike remains a low probability despite the hawkish shift.

Number of Fed dissents per meeting



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Forecast

Data as of May 2026

	2025 ACTUAL	2026 ESTIMATE	2027 FORECAST	2028 FORECAST	2029 FORECAST
REAL GDP [1]	2.2%	2.0%	2.3%	2.3%	2.3%
UNEMPLOYMENT RATE [3]	4.5%	4.2%	4.2%	4.2%	4.2%
INFLATION [1] (CPI)	2.8%	**3.3%**	**2.0%**	2.0%	2.0%
TOTAL HOME SALES	4.74	4.78	5.24	5.72	5.86
S&P/COTALITY HOME PRICE INDEX	1.3%	1.8%	2.7%	3.0%	3.0%
LIGHT VEHICLE SALES	16.2	15.8	16.4	16.5	16.5
FEDERAL FUNDS RATE [2]	3.50%	3.25%	3.00%	3.00%	3.00%
5-YEAR TREASURY NOTE [2]	3.73%	3.75%	3.55%	3.55%	3.55%
10-YEAR TREASURY NOTE [2]	4.18%	**4.20%**	**4.00%**	4.00%	4.00%
30-YEAR FIXED-RATE MORTGAGE [2]	6.18%	6.00%	5.60%	5.50%	5.50%
MONEY MARKET FUNDS	4.03%	3.47%	3.09%	3.03%	3.03%

Further upside for inflation in 2026

Energy prices climbed higher into May. The extended nature of the oil supply shock adds to the upside risk for inflation in the near-term and lifts our year-end estimate above 3.0 percent — up from 2.5 percent before the war.

Modestly higher long-term rates over 2026

The 10-year Treasury rate has shifted higher in recent weeks as markets reset to reduced Fed rate cut expectations and higher risk for inflation. While rates would ease if the conflict is resolved, we now expect a slightly higher path over 2026 as a result.

[1] *Percent change Q4-to-Q4*
[2] *Year end*
[3] *Q4 average*

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