National Economic Outlook

July 2026

Headlines

- **Inflation has reaccelerated in 2026, but there are reasons to be cautiously optimistic that inflation will improve in the second half of the year** as the peak impact of tariffs, AI-driven memory price inflation, and higher energy costs move into the rearview mirror. We expect core PCE inflation to average roughly 2.4% in 26H2, bringing the year-over-year rate down to 3.1% by December 2026. However, shelter disinflation has likely run its course, and further progress will need to come from sticky services inflation, which is by no means a given.

- **Core growth remained resilient in the first half of 2026**, even as inventories and trade weighed on headline GDP growth. While we expect consumer spending growth to moderate modestly in the second half of the year, overall real GDP growth should remain near 2%, supported in part by continued strength in AI-driven business investment.

- **Our base case remains that the Fed holds the fed funds rate unchanged through year-end.** In our view, there is still a silent majority of FOMC participants who would prefer not to hike, expect inflation to improve in the second half of the year, and see little evidence of mounting labor market-driven inflation pressures. Still, risks remain heavily tilted toward further tightening if inflation fails to improve or if the Fed becomes concerned about its inflation-fighting credibility.

- **The productivity payoff from the AI buildout has yet to materialize.** We expect productivity growth to slow through the remainder of 2026 as a larger share of output growth comes from additional hours worked. Although an acceleration in unit labor costs is not our base case, slower productivity growth would increase the risk that labor costs put renewed pressure on services inflation.

Gus Faucher
augustine.faucher@pnc.com

Jay Hawkins
jay.hawkins@pnc.com

Ershang Liang
ershang.liang@pnc.com

Brian LeBlanc
brian.leblanc@pnc.com

Rayhan Momin
rayhan.momin@pnc.com

Isfar Munir
isfar.munir@pnc.com

Kurt Rankin
kurt.rankin@pnc.com

Resilient growth, improved inflation in June

Data over the past month have been mixed but as discussed below, generally remain consistent with our view that the Fed will keep the fed funds rate on hold through the remainder of 2026, even as risks to that outlook remain tilted toward additional policy tightening. The core CPI index declined on a monthly basis for the first time since the pandemic, reflecting both a drop in core goods prices as well as the slowest growth in core services prices since early 2021. In addition, the June employment report showed a cooler pace of job growth than earlier in the spring, including downward revisions to prior months, while second-quarter GDP growth highlighted continued resilience in consumer spending and investment.

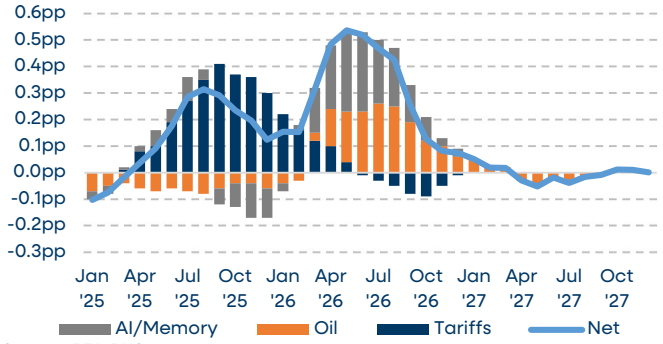
Inflation should improve in the second half of 2026, still too high

Progress on slowing core inflation stalled in 2024 before reversing in 2025 as higher tariffs pushed up core goods prices. Inflation accelerated further in 2026 as strong AI-related demand lifted computer memory prices and higher energy costs from the conflict with Iran passed through to a wider range of consumer goods and services.

These three factors – the ongoing effects of tariffs, the AI buildout's impact on memory prices, and the indirect passthrough of higher energy costs – explain much of this year's reacceleration in core inflation.

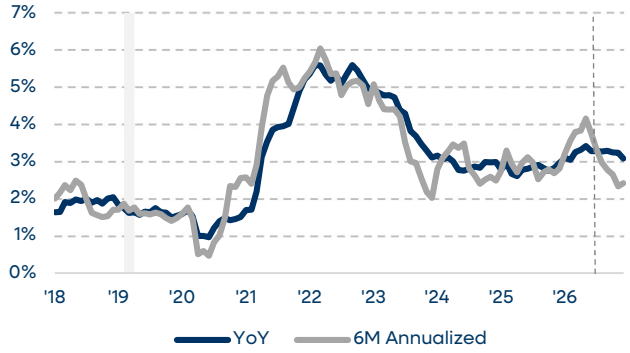
Fortunately, we estimate that the peak impact of all three factors is now behind us. As a result, we are cautiously optimistic that inflation readings in the second half of 2026 will be more consistent with a level the FOMC views as compatible with the current fed funds rate. We received an early indication of that in June, when the Fed's preferred inflation measure, the core PCE price index, increased at just a 1.6% annualized rate over the month. **We expect core PCE inflation to average out to 2.4% annualized in the second half of 2026, bringing the y/y growth rate down to 3.1% by December.**

Figure 1: Contributions to core PCE inflation over prior six months



Sources: BEA, PNC

Figure 2: Core PCE (% chg., y/y vs. 6M ann.)



Sources: BEA, PNC

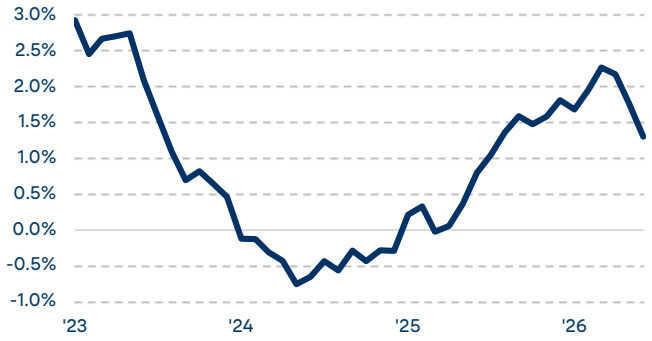
In addition, the Bureau of Economic Analysis (BEA) plans to implement methodological changes in September 2026 that we estimate will reduce year-over-year core inflation by roughly 0.2 percentage points. While these changes will not affect underlying price pressures, they should reinforce the perception that inflation is moving back toward the Federal Reserve's target.

Peak tariff impact on goods inflation is likely behind us

By now it is clear that starting in 2025, tariffs played an important role in halting the decline in core inflation that ran from 2022 to 2024. Core goods inflation reaccelerated shortly after Liberation Day, offsetting more than all of the continued slowing in services inflation since then. Although uncertainty

remains around the degree of tariff passthrough, both our estimates and Federal Reserve research suggest that consumer prices have already absorbed most of the direct impact.

Figure 3: Core goods inflation ex. memory prices (% chg., y/y)



Sources: BEA, PNC

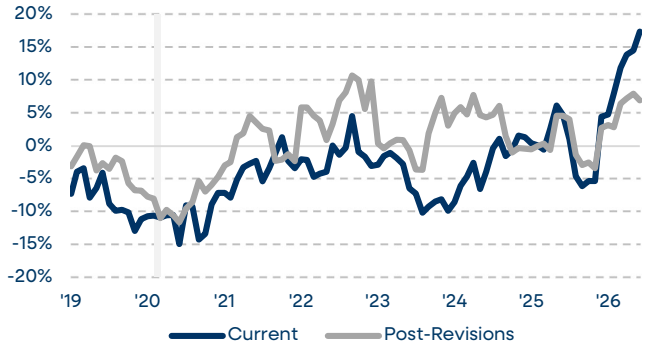
Recent data support that view. Core goods inflation outside of memory prices contracted at a 0.4% annualized rate over the past three months after increasing 1.3% over the prior year. While indirect passthrough from higher energy and transportation costs may continue to exert some upward pressure in the near term, the outlook for goods inflation has improved materially.

AI buildout is artificially pushing up inflation

The rapid AI buildout has also had a measurable impact on consumer price inflation. Prices for computer software and accessories have risen 17.4% over the past year, contributing nearly 0.2 percentage points to year-over-year core inflation despite representing only about 1% of the overall consumer basket.

Much of this appears to reflect measurement issues that the BEA intends to address in its September annual update. Inflation in this category has tracked memory prices almost one-for-one, and memory prices surged as AI-related investment accelerated. More recently, however, memory prices have leveled off. Even absent the planned methodological changes, we do not expect memory prices to increase materially in the second half of the year, providing an additional source of relief for core inflation.

Figure 4: Software and accessories inflation, pre- and post-revisions (% chg., y/y)



Sources: BEA, PNC

Oil prices wildcard, but impact on inflation should fade in 26H2

The ongoing conflict with Iran and its implications for global energy markets remain one of the largest uncertainties in our inflation outlook. That said, the U.S. economy is far less sensitive to energy price shocks than in previous decades, limiting both the direct and indirect passthrough to consumer prices.

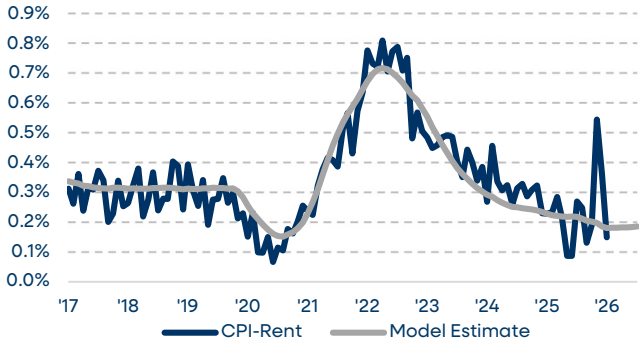
Although crude oil prices have risen sharply over the past month, the increase in retail gasoline prices has been more modest. Gasoline prices declined only partially following the initial ceasefire agreement, leaving less room for subsequent increases as oil prices moved higher. As a result, much of the impact from higher energy prices is likely already reflected in inflation data.

Barring a further material increase in crude oil prices, we believe the peak contribution from energy-related inflation is now either at or close at hand. While some indirect passthrough from higher transportation and production costs may continue in the near term, energy prices are likely to be a smaller driver of core inflation in the second half of 2026 than they were over the previous three months.

We can't rely on further deceleration in shelter inflation to save us

For much of the past three years, decelerating shelter inflation has been the primary driver of disinflation in both core PCE and core CPI. Shelter inflation is designed to measure housing costs that households face and tends to follow movements in market rents with a lag of roughly 12 to 18 months.

Figure 5: CPI rent vs. model estimate



Sources: BEA, PNC

Given that rents on newly signed leases have been below their pre-pandemic trend for some time, it is not surprising that official measures of shelter inflation have steadily moderated. However, we believe that the disinflationary impulse from shelter is now largely exhausted. While we do not expect shelter inflation to meaningfully reaccelerate through the remainder of 2026 or into 2027, we also see limited scope for further deceleration from current levels.

This has important implications for the broader inflation outlook. Shelter accounts for roughly 45% of core CPI and about 20% of core PCE, making it one of the largest components of both measures. As a result, future progress on inflation will need to come increasingly from other categories, particularly core goods and "supercore" services inflation (core services excluding housing). The latter remains closely tied to labor market conditions and wage growth, suggesting that further disinflation will depend more heavily on a continued cooling in labor demand than in recent years.

No rate hikes in 2026, but a low conviction call

Our base case remains that the Fed holds the fed funds rate unchanged in its current range of 3.50% to 3.75% through year-end, even as markets continue to price in roughly 1.5 25-basis point rate hikes over the remainder of 2026. The rationale is straightforward: we believe a solid majority of FOMC participants would prefer to remain on hold as long as inflation improves in the second half of the year, and we suspect many policymakers see that as a realistic possibility.

New York Fed President John Williams has been among the most explicit on this point, noting that the inflationary effects of tariffs should fade over time and that the Fed could justify holding rates steady if core PCE inflation averages roughly 0.2% m/m going forward.

Another reason the case for additional tightening may become less compelling later this year is that much of the labor market strength seen in the first half of 2026 has already been revised lower. The unemployment rate has been stable, while wage growth continues to moderate. The Employment Cost Index shows wages and salaries rising just under 3.2% y/y through June, only modestly above the pace in 2018-2019 and well below recent peaks. Without a meaningfully tighter labor market, it is difficult to make the case for sustained acceleration in "supercore" inflation. Combined with easing goods inflation and continued low shelter inflation, the backdrop increasingly supports patience.

That said, risks remain tilted toward further tightening. Services inflation could prove more persistent than expected, or a renewed increase in energy prices could reverse some of the recent easing in inflation.

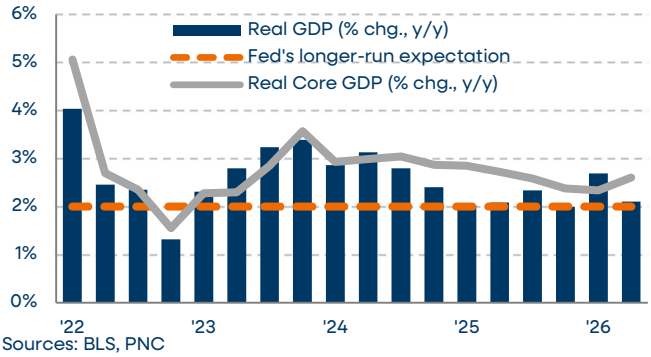
An additional risk emerged following the July FOMC meeting. Market pricing moved lower but inflation expectations moved higher after Chair Warsh's press conference was perceived as dovish, raising the possibility that some policymakers become

more sensitive to maintaining the Fed's inflation-fighting credibility. As a result, there is an outside risk of a rate hike even if the incoming data remain broadly consistent with the Fed staying on hold. We continue to view this as a tail risk and look to future Fed communication for additional clarity.

AI capex supports growth but raises downside risks

The AI buildout has become an important driver of economic growth through both capital spending and the wealth effects associated with equity-market gains. Robust investment demand has helped keep growth in real core GDP above headline real GDP growth; core GDP excludes volatile components such as inventories, net trade, and government spending, making it a better gauge of the economy's underlying momentum. The gap between core and headline growth has remained positive on a four-quarter average basis since late 2024, when hyperscaler capex began to accelerate more sharply.

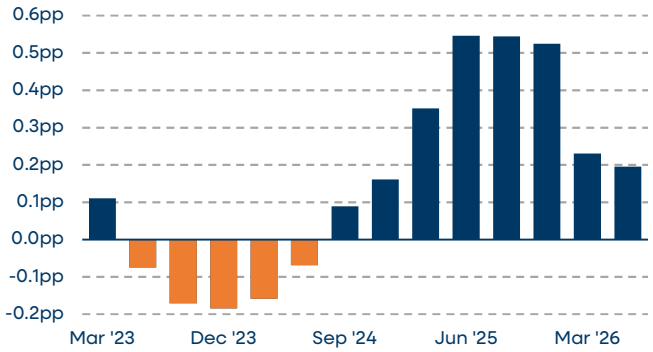
Figure 6: Real growth is running at or above potential



Sources: BLS, PNC
Note: Real Core GDP is the sum of consumption, business fixed investment, and residential fixed investment.

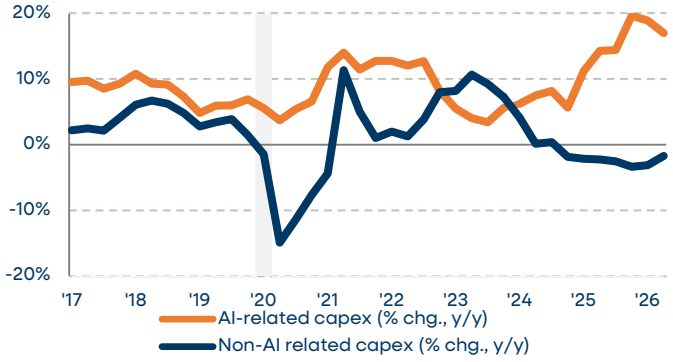
Growth in real AI-related capex has edged down slightly as higher prices have weighed on the pace of the buildout, but it continues to offset weakness in other areas of business investment. Despite the already immense scale of spending, hyperscalers continue to revise their capex plans higher. Following recent earnings announcements, aggregate guidance for the five largest hyperscalers is 40% higher for 2026 and 63% higher for 2027 than it was at the start of the year.

Figure 7: Real core GDP growth continues to outpace headline growth (% chg., y/y)



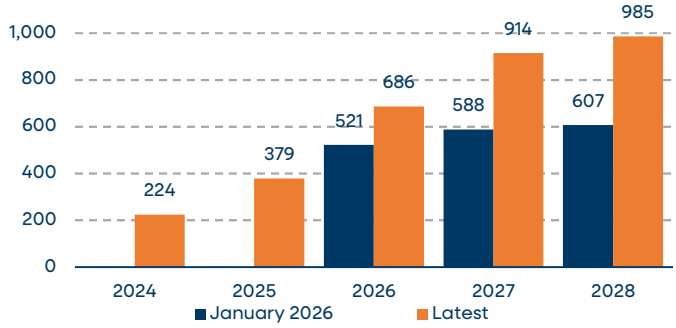
Sources: BLS, PNC

Figure 8: AI buildout continues to support growth



Sources: BLS, PNC

Figure 9: Hyperscaler capex guidance (billions of dollars)



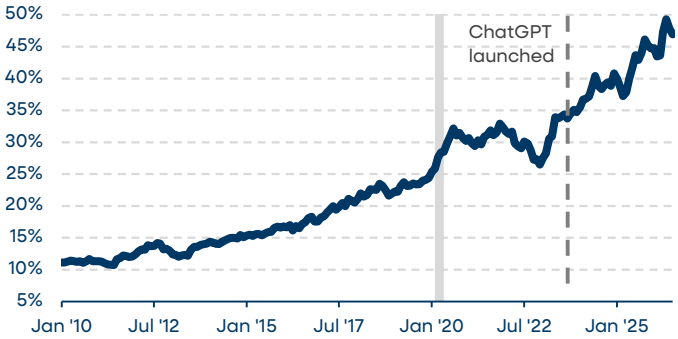
Sources: Bloomberg, PNC
Note: Sum of capex guidance from Amazon, Google, Microsoft, Meta, and Oracle.

Because much of the AI buildout relies on imported equipment, the boost to headline GDP is smaller than the increase in capex would otherwise

suggest. Even so, with consumer spending growth expected to moderate modestly in the second half of the year, continued strength in AI-related business investment should help keep overall economic growth near 2%.

The growing dependence of both consumer spending and business investment on the AI boom also leaves the outlook more exposed to a shift in market sentiment. AI-linked firms account for nearly half of the S&P 500's market capitalization, despite some recent volatility. At the same time investors appear to be becoming more discerning about upward revisions to AI capex. A sustained downturn in sentiment could weigh on equity prices, weaken the associated wealth effects supporting consumer spending, and prompt AI firms to slow investment. Together, those forces pose a meaningful downside risk to growth.

Figure 10: Broad AI-linked firms' share of S&P 500 market cap

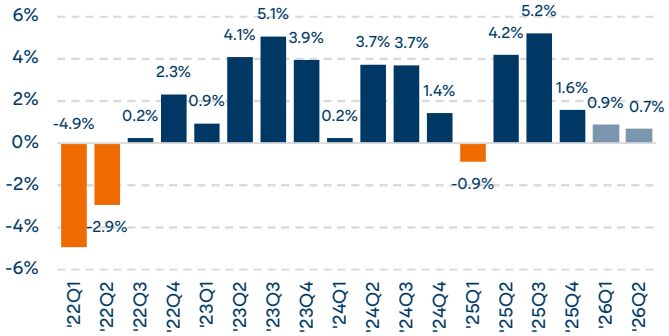


Sources: BLS, PNC

The productivity payoff from the AI buildout has yet to materialize

Although the effects of the AI buildout on growth and inflation are already apparent, it has yet to produce an acceleration in economy-wide productivity. We expect the Bureau of Labor Statistics (BLS) to revise up first-quarter nonfarm business productivity growth to 0.9% at an annual rate from the currently reported 0.3%, before a slowing to 0.7% in the second quarter. That would leave productivity growth at a still-solid 2.1% from one year earlier, although favorable base effects account for some of that strength. We expect productivity growth to average 1.2% in the second half of 2026, bringing fourth-quarter-over-fourth-quarter growth to about 1.0%, below its trailing five-year average of 1.4%.

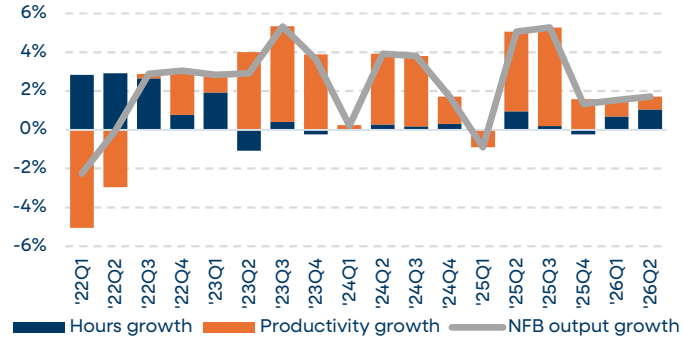
Figure 11: Productivity growth is expected to slow in 2026 (% chg., q/q)



Sources: BLS, BEA, PNC
Note: 2026Q1 is the expected revised BLS rate; the current published rate is +0.3%.

Some of last year's acceleration in productivity also reflected unusually weak growth in hours worked. Nonfarm business output growth is approximately the sum of productivity growth and growth in hours. As employment growth improves from its very weak 2025 pace, a larger share of output growth should come from additional hours worked. This should support aggregate labor income and consumer spending, allowing economic growth to remain resilient even as productivity growth slows. However, it also means that growth will depend more heavily on additional labor input than on greater output per hour.

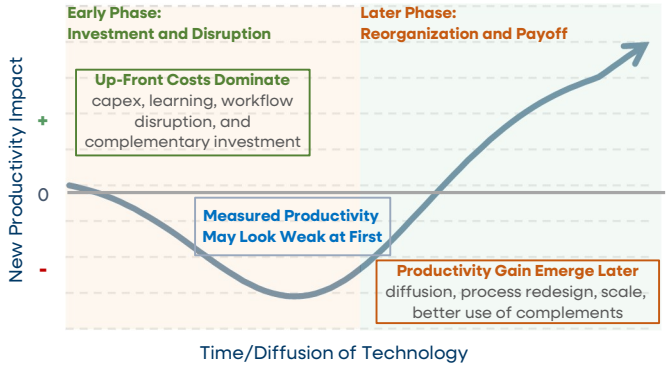
Figure 12: Stronger hours growth weighs on the Q2 productivity outlook (% chg., q/q)



Sources: BLS, BEA, PNC
Note: 2026Q1 incorporates the expected BEA-driven output revision; 2026Q2 is the release nowcast.

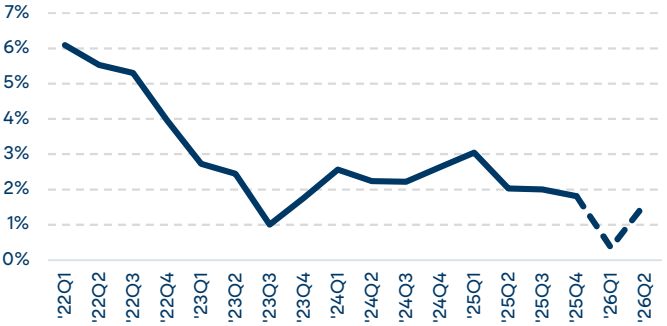
The absence of an immediate productivity payoff does not mean that AI will fail to raise productivity over time. Businesses must complement spending on computing capacity with investments in data, software, employee training, and redesigned business processes. These investments can initially consume substantial resources without producing a corresponding increase in measured output. As a result, the productivity benefits of AI may emerge only after a considerable lag.

Figure 13: The productivity J-curve



Sources: Brynjolfsson, Rock, and Syverson (2019), PNC

Figure 14: Growth in unit labor costs set to pick up (% chg., y/y)



Sources: BLS, BEA, PNC
Note: 2026Q1 incorporates an expected revision; 2026Q2 is the release nowcast.

In the near term, however, the AI buildout is doing more to support demand than to expand the economy's productive capacity. Slower productivity growth would also leave businesses more exposed to increases in labor compensation. Although an acceleration in unit labor costs is not our base case, slower productivity growth would increase the risk that businesses face renewed pressure to absorb higher labor costs through narrower margins or pass them on through higher prices. This risk is greatest in labor-intensive service industries and could make further progress on services inflation more difficult.

Additional charts and tables

Table 1: Baseline U.S. Economic Outlook, Summary Table

Indicator	25Q3	25Q4	26Q1	26Q2f	26Q3f	26Q4f	27Q1f	2025	2026f	2027f	2028f
Output											
Nominal GDP ($bn)	31,098	31,423	31,866	32,414	32,703	33,062	33,397	31,423	33,062	34,399	35,805
Percent Change Annualized	**8.3**	**4.2**	**5.8**	**7.1**	**3.6**	**4.5**	**4.1**	**5.4**	**5.2**	**4.0**	**4.1**
Real GDP ($bn, '17 SAAR)	24,027	24,056	24,180	24,271	24,385	24,506	24,621	24,056	24,506	24,973	25,474
Percent Change Annualized	**4.4**	**0.5**	**2.1**	**1.5**	**1.9**	**2.0**	**1.9**	**2.0**	**1.9**	**1.9**	**2.0**
Consumer Spending	16,586	16,665	16,688	16,818	16,901	16,976	17,045	16,665	16,976	17,259	17,570
Percent Change Annualized	**3.5**	**1.9**	**0.5**	**3.2**	**2.0**	**1.8**	**1.6**	**2.1**	**1.9**	**1.7**	**1.8**
Business Fixed Investment	3,688	3,710	3,804	3,882	3,950	4,002	4,049	3,710	4,002	4,182	4,343
Percent Change Annualized	**3.2**	**2.4**	**10.6**	**8.4**	**7.2**	**5.3**	**4.8**	**5.6**	**7.9**	**4.5**	**3.8**
Residential Investment	764	761	746	748	751	754	757	761	754	769	791
Percent Change Annualized	**-7.1**	**-1.7**	**-7.8**	**1.5**	**1.6**	**1.4**	**1.4**	**-3.8**	**-0.9**	**1.9**	**3.0**
Change in Private Inventories	-24	-16	-17	-51	-40	-23	-23	-16	-23	-19	-9
Net Exports	-955	-969	-1,002	-1,075	-1,140	-1,175	-1,191	-969	-1,175	-1,229	-1,274
Government Expenditures	4,015	3,957	4,000	3,992	4,007	4,017	4,030	3,957	4,017	4,056	4,098
Percent Change Annualized	**2.2**	**-5.6**	**4.4**	**-0.8**	**1.5**	**1.0**	**1.3**	**-1.2**	**1.5**	**1.0**	**1.0**
Industrial Production (*'12 = 100*)	102	101	102	103	103	104	104	101	104	107	109
Percent Change Annualized	**2.1**	**-1.9**	**1.3**	**3.9**	**2.9**	**2.5**	**2.3**	**1.6**	**2.6**	**2.7**	**2.5**
Capacity Utilization (*Percent*)	76.2	75.6	75.6	76.1	76.4	76.6	76.9	75.6	76.6	77.6	78.4
Prices											
CPI (% Change Ann.)	3.1	2.9	3.2	6.1	1.7	2.0	1.9	2.8	3.2	2.0	2.1
Core CPI Index (% Change Ann.)	3.2	2.2	2.5	2.9	2.7	2.4	2.2	2.8	2.6	2.2	2.2
PCE Price Index (% Change Ann.)	2.8	2.9	4.6	5.1	1.5	1.8	1.7	2.8	3.2	1.8	1.9
Core PCE Price (% Change Ann.)	2.9	2.7	4.4	3.4	2.5	2.1	2.0	2.9	3.1	2.0	2.0
GDP Price Index (% Change Ann.)	3.7	3.7	3.6	5.5	1.7	2.4	2.2	3.3	3.3	2.1	2.0
Crude Oil, WTI ($/Barrel)	65.8	59.6	72.7	94.6	79.1	77.4	76.5	59.6	77.4	75.7	75.8
Case-Shiller HPI (% Change Ann.)	-0.2	3.5	2.1	0.0	0.0	1.0	1.0	1.3	0.8	1.0	1.0
Labor Markets											
Payroll Jobs (*Millions*)	158.5	158.4	158.6	158.9	159.3	159.9	160.2	158.4	159.9	161.0	161.8
Percent Change Annualized	**0.1**	**-0.2**	**0.3**	**0.9**	**1.1**	**1.3**	**0.8**	**0.2**	**0.9**	**0.7**	**0.5**
Unemployment Rate (*Percent*)	4.3	4.5	4.3	4.3	4.2	4.2	4.2	4.5	4.2	4.2	4.2
Avg. Wkly Hours, Prod. Works.	33.7	33.7	33.8	33.8	33.8	33.8	33.8	33.7	33.8	33.8	33.8
Personal Income											
Average Hourly Earnings (*$*)	31.5	31.8	32.0	32.3	32.6	32.8	33.1	31.8	32.8	33.8	34.9
Percent Change Annualized	**3.6**	**3.8**	**3.3**	**3.5**	**3.1**	**3.1**	**3.1**	**3.9**	**3.3**	**3.1**	**3.1**
Real Disp. Income (*2017 $bn*)	18,071	18,030	18,072	18,004	18,087	18,201	18,322	18,030	18,201	18,694	19,147
Percent Change Annualized	**1.0**	**-0.9**	**0.9**	**-1.5**	**1.9**	**2.5**	**2.7**	**1.0**	**0.9**	**2.7**	**2.4**
Interest Rates (%)											
Prime Rate	7.5	7.0	6.8	6.8	6.8	6.8	6.8	7.0	6.8	6.8	6.8
Federal Funds	4.25	4.00	3.75	3.75	3.75	3.75	3.75	4.00	3.75	3.75	3.75
3-Month Treasury Bill	4.2	3.8	3.7	3.7	3.7	3.7	3.7	3.8	3.7	3.7	3.7
10-Year Treasury Note	4.3	4.1	4.2	4.4	4.4	4.3	4.2	4.1	4.3	4.2	4.2
30-Year Fixed Mortgage	6.6	6.2	6.1	6.4	6.4	6.2	6.2	6.2	6.2	6.2	6.2

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