VIEWPOINT

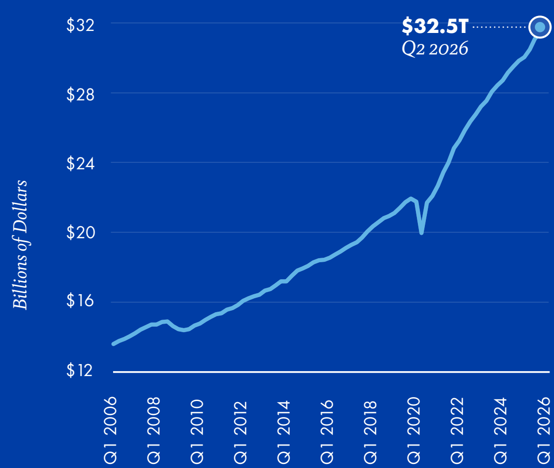
SPECIAL MID-QUARTER EDITION

Economic Commentary:

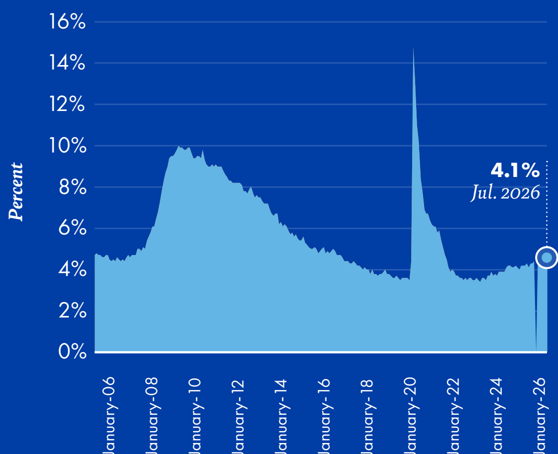
Mixed Signals Keep the Fed on Hold

August 2026

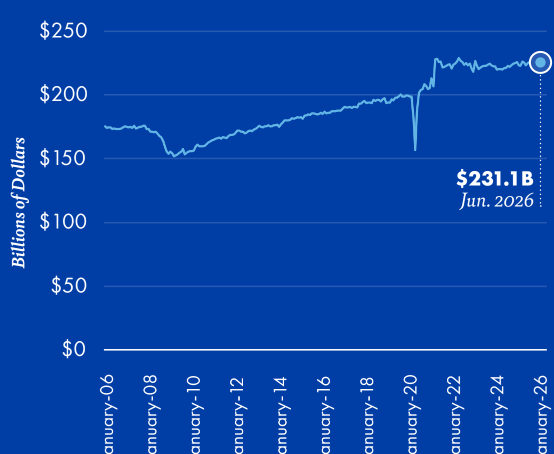
GROSS DOMESTIC PRODUCT (GDP)



UNEMPLOYMENT RATE



RETAIL / FOOD SERVICE SALES



Source: Northmarq, U.S. Bureau of Economic Analysis,
U.S. Bureau of Labor Statistics, U.S. Bureau of the Census; Oct 2025 data not available

VIEWPOINT

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Economic reports received in July confirmed an easing of inflation pressures, driven primarily by declining energy prices in June. However, the on-again, off-again conflict in the Middle East continues to create uncertainty around the path of inflation. That uncertainty is evident in the differing views among Federal Reserve policymakers regarding the appropriate course of monetary policy. Inflation also remains a concern for consumers, as purchasing power continues to erode as long as inflation remains elevated. Until a sustainable downward trend in inflation is established, meaningful interest-rate relief for businesses and consumers is unlikely.

Energy-led inflation relief

Headline CPI inflation fell 0.4% in June, below expectations, helped by a sharp decline in gasoline prices. As a result, year-over-year CPI inflation fell from 4.2% in May to 3.5% in June. Core CPI was unchanged in June, indicating no monthly inflation outside of food and energy. Year-over-year Core CPI declined from 2.9% in May to 2.6% in June. The June details provided little evidence of the broadening inflationary pressures the Fed has been concerned about.

The Fed's preferred inflation measure, Core PCE, also came in below expectations, rising just 0.1% in June, its weakest monthly reading since March 2025. Year-over-year Core PCE declined to 3.3% from 3.4%. For the second quarter as a whole, Core PCE increased at a 3.4% annualized rate, down from 4.4% in the first quarter. A renewed oil shock remains the primary risk to the developing global disinflationary trend. While the peak impact of the energy price shock on inflation is likely behind us, the pass-through to core inflation could take six to nine months to fully materialize. As a result, inflation's return to the Fed's 2% target is likely to be gradual.

Inflation remains the primary determinant of long-term interest rates. Until a sustained downward trend in inflation becomes evident, long-term rates — and particularly mortgage rates — are likely to remain elevated.

Consumer resilience combines with slower growth

The June personal income and spending data, along with the first estimate of second quarter GDP, underscored the resilience of the consumer. Although annualized real GDP growth slowed to 1.5% from 2.1% in the first quarter, real consumer spending accelerated to a 3.2% annualized pace from just 0.5% in the first quarter, helped by above-average tax refunds during the filing season. Personal outlays were also revised higher in prior months, indicating that the underlying trend in real consumption was stronger than previously reported. However, the end of the favorable tax refund season and the need for lower-income households to rebuild savings are likely to temper consumer spending in the months ahead.

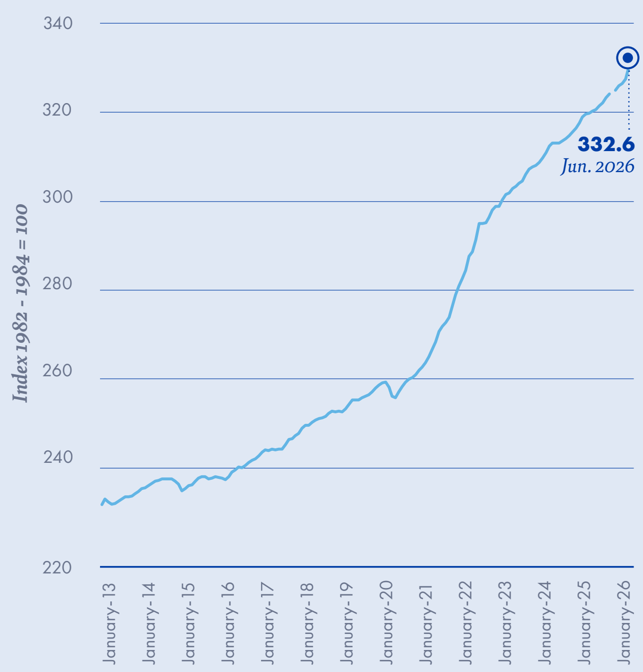
The squeeze on household purchasing power continued in June. Real disposable personal income increased 0.3%, while real consumer spending rose 0.4%. On a year-over-year basis, however, real disposable income increased just 0.5%, compared with 2.5% growth in real consumer spending. The resulting gap has continued to be financed through savings, with the personal saving rate falling to 2.7% in June from 2.8% in May, and 4.6% a year ago. With gasoline prices rising again, weakening real income growth is likely to put renewed pressure on consumer spending during the second half of the year.

The second-quarter GDP details provide additional insight into the economy's composition. The slowdown in real GDP growth reflected declines in government spending and slower growth in investment and exports, which were only partially offset by stronger consumer spending.

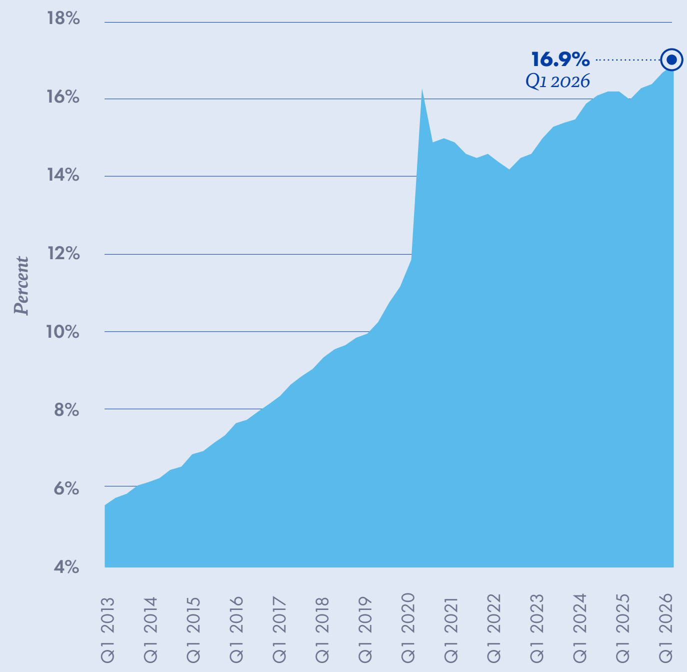
Importantly, real final sales to private domestic purchasers — a useful measure of underlying domestic demand — increased 3.9% in the second quarter, up from 1.7% in the first quarter and the strongest quarterly reading since the first quarter of 2023.

Another encouraging development is that investment outside of AI is beginning to show signs of life. Non-AI investment posted its largest quarterly gain in three years and could gain further momentum in coming years, supported by tax incentives and the need to rebuild lean inventories.

CONSUMER PRICE INDEX (CPI)



E-COMMERCE RETAIL SALES (% TOTAL SALES)



Source: Northmarq, U.S. Bureau of Labor Statistics, U.S. Bureau of the Census; Oct 2025 data not available for CPI

Manufacturing strength, steady services

Business surveys also showed continued strength. The ISM Manufacturing Index rose 2.3 points to 55.6 in July, exceeding expectations and reaching its highest level since May 2022. The details were also encouraging. The New Orders Index increased 0.7 points to 56.7, while the Backlog of Orders Index jumped 4.5 points to 55.0. Stronger orders and backlogs helped push the Production Index 6.3 points higher to 58.5, its highest level in five years.

The ISM Services Index changed little in July, edging up to 54.1 from 54.0. The details showed that continued strength was driven primarily by robust new orders and business activity, while employment remained a drag on the overall index.

Labor market loses momentum

The July employment report, however, showed a meaningful loss of momentum. Nonfarm payrolls fell by 23,000, well below expectations for an 80,000 increase. Job growth in May and June was also revised lower by 66,000 and 37,000, respectively.

The primary source of weakness in July was a 50,000 decline in state and local government employment. Private payrolls increased by just 30,000, also well below expectations for an 82,000 gain.

The unemployment rate declined to 4.1% from 4.2%, but this was not the result of stronger employment. Household employment declined, but the labor force contracted even more rapidly. The labor force participation rate fell from 61.5% to 61.4%, its lowest level in five years, reflecting the growing effects of tighter immigration policies and demographic trends. The labor force contracted by 264,000 in June and by more than 2.4 million since the beginning of the year. Without this contraction in the labor force over the past two months, the unemployment rate would be approximately 4.7%. The key message is not that unemployment has improved, but that labor supply continues to contract.

The Household Survey was similarly weak. Employment fell by 87,000 following a 507,000 decline in June. Full-time employment fell by 106,000 after declining by 514,000 in June and is now down more than 1.6 million since the beginning of the year.

Wage growth is also showing little evidence of generating inflationary pressure. Average hourly earnings increased just 0.1% in July, the weakest monthly gain of the year. Year-over-year wage growth slowed to 3.2%, its lowest level since May 2021. The absence of accelerating wage growth suggests that the labor market is not experiencing the type of tightness that would normally generate sustained inflation pressure.

Productivity trends provide additional support for the disinflationary outlook. Nonfarm business productivity increased at a 1.4% annualized rate in the second quarter and 2.2% year over year. Unit labor costs, which measure compensation adjusted for productivity, increased just 1.3% annualized in the second quarter and 1.4% year over year. Higher productivity is limiting the increase in labor costs per unit of output.

The Employment Cost Index (ECI), which measures total compensation costs, increased 0.9% in the second quarter, unchanged from the first quarter. Year-over-year growth was 3.4%, down sharply from the 5.1% peak reached in the second quarter of 2022. At 3.4%, ECI growth is consistent with the Fed's inflation objective given trend productivity growth of more than 2%.

The June JOLTS report also indicated that softer labor demand is likely to continue easing wage-related inflation pressures. Labor demand cooled during the month, partly reflecting the unwinding of temporary hiring associated with the World Cup.

VIEWPOINT

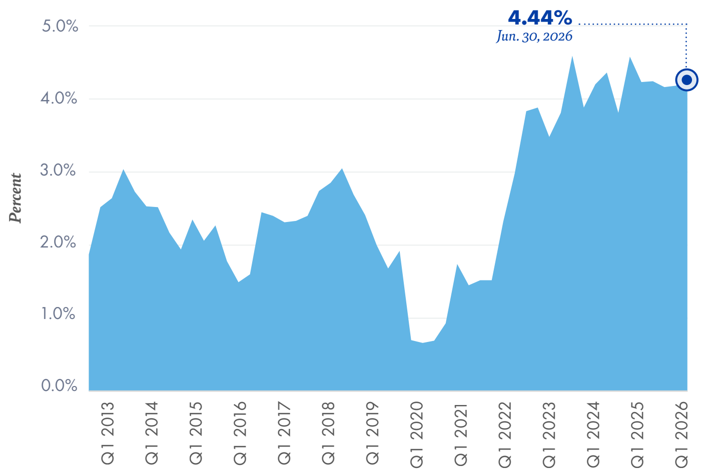
Fed holds steady on interest rates

At its July 29 meeting, the Federal Open Market Committee voted 9-3 to maintain the federal funds target range at 3.50%–3.75%. The three dissenting members favored a 0.25% rate increase. Since the Fed's June meeting, financial conditions have tightened even without a change in the policy rate, with long-term rates increasing approximately 30 basis points. Whether rates remain on hold for the rest of the year or the Fed raises rates at its September meeting will depend heavily on the next two inflation reports and the August employment report.

The Fed is currently focused on three overlapping supply shocks — the Iran conflict, the AI buildout and tariffs — as the primary risks to achieving its 2% inflation target. The labor market, by contrast, does not appear to be a significant source of inflationary pressure, as evidenced by the continued decline in year-over-year ECI growth.

While recent attention has focused on inflation resulting from higher energy prices, the more significant risk may be the consumer. As fiscal stimulus fades and the squeeze on real incomes persists, consumer spending is likely to weaken further, placing additional pressure on the labor market during the second half of the year. If that occurs alongside continued moderation in inflation, the case for rate hikes would diminish considerably. Markets continue to price in one interest rate increase by year-end, but no additional hikes are currently priced in for 2027.

10-YEAR TREASURY RATE



Source: Northmarq, U.S. Federal Reserve; graph includes quarter-end values and may not illustrate daily high or low points throughout the quarter

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