



VIEWPOINT

Economic Commentary:

Ceasefire Eases Energy Prices as
Consumer Spending Continues to Slow

July 2026

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At the year's midpoint, there is little evidence that the economic trends established earlier this year have materially changed. The recent ceasefire in the Iran conflict has provided welcome relief to energy prices and may mark the peak in inflation pressures. But inflation's return to the Federal Reserve's 2.0% target is likely to be gradual. Economic activity remains positive, supported primarily by business investment in artificial intelligence (AI), while consumer spending — the traditional engine of economic growth — continues to slow. Against this backdrop, the Federal Reserve has kept monetary policy on hold, with future policy decisions dependent on whether inflation continues to move toward their target.

Inflation near peak as energy prices ease

Headline CPI increased 0.5% in May, in line with expectations, reflecting the surge in fuel prices and the resulting increases in transportation-related costs such as airfares and delivery services. On a year-over-year basis, headline CPI rose 4.2%. Core CPI increased a more modest 0.2%, slightly below expectations, and has now posted 0.2% monthly gains in three of the past four months. Year over year, core CPI rose 2.9%.

Importantly, higher prices have not spilled over into wage inflation. Real average weekly earnings declined 0.2% in May and have now fallen for three consecutive months — the first such streak in three years. On a year-over-year basis, real average weekly earnings are down 0.4%, underscoring the erosion in purchasing power that is beginning to weigh on consumer spending.

The Fed's preferred inflation measure, the Core Personal Consumption Expenditures (PCE) Index, increased 0.3% in May, lifting the year-over-year rate to 3.4%, its highest level since October 2023. While higher service prices continue to contribute to inflation, the larger source of pressure has shifted to the pricing of goods, reflecting both the AI investment boom and the pass-through from higher energy costs. With oil prices retreating following the ceasefire, the energy-related component should begin to moderate. The Fed's focus will increasingly shift toward determining whether underlying inflation proves more persistent than anticipated.

Consumer spending slows amid income squeeze

The May Personal Income and Spending report, together with the third estimate of first quarter GDP, provided mixed signals on the economy and consumers. Real GDP growth was revised upward to a 2.1% annualized pace from 1.6%, although the revision was driven primarily by weaker-than-estimated imports, which boosts GDP. More concerning was the significant downward revision to consumer spending, which was reduced to just a 0.5% annualized gain from the previously reported 1.4%, reflecting weaker services consumption.

The more important story continues to be the squeeze on household purchasing power. Real disposable personal income increased 0.3% in May, recovering only part of the cumulative 1.1% decline recorded over the previous three months. On a year-over-year basis, real disposable income growth is flat. Real consumer spending also rose 0.3% in May, but over the past year, spending has continued to outpace income growth, increasing 2.1% year over year. Consumers have financed this gap by drawing down savings and increasing credit card debt, while higher-income households have supplemented spending through gains in financial wealth. The personal saving rate has fallen to 3.0%, well below the 2025 average of 4.6%.

Lower energy prices should provide some relief to household budgets, particularly for low- and middle-income consumers, who devote a larger share of income to gasoline. The ceasefire also removes a supply shock that monetary policy was largely powerless to address.

Manufacturing and services remain in expansion

The ISM Manufacturing Index declined 0.7 points to 53.3 in June. Despite the modest decline, the report continues to point toward expansion. New orders and production eased but remained comfortably above the 50 threshold, while inventories moved back into expansion territory for the first time since April 2025. Customer inventories remain unusually lean, suggesting inventory rebuilding has further room to run. Encouragingly, the prices-paid index fell 9.3 points, indicating that producer price inflation may have peaked as energy prices recede.

The ISM Services Index edged down 0.5 points to 54.0 in June, although every major component remained in expansion territory. Supply-chain disruptions continue to ease, and pricing pressures have moderated, although several industries still anticipate higher input costs over the coming months. The employment component returned to expansion for the first time in four months, suggesting that the labor market is stabilizing rather than reaccelerating. That dynamic supports the Federal Reserve's current pause as policymakers remain focused primarily on inflation.

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.

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Labor market softens with full-time losses

The June employment report also suggested a stabilizing labor market, albeit one with notable underlying weakness. Nonfarm payrolls increased by just 57,000, roughly half the consensus forecast of 113,000, while revisions subtracted a combined 74,000 jobs from the previous two months.

The labor force participation rate declined to 61.5%, its lowest level in five years, reflecting the growing effects of tighter immigration policies and demographic trends. The unemployment rate edged down to 4.2% from 4.3%, but only because the labor force contracted more rapidly than employment.

The Household Survey paints a considerably weaker picture than the payroll survey. Employment fell by 507,000 in June and has declined by 833,000 since February. The deterioration would have been even greater without a 126,000 increase in multiple-job holders. The decline was concentrated almost entirely in full-time employment, which fell 514,000 in June and has declined by more than one million over the past three months. Over the same period, part-time employment has increased by 336,000, suggesting employers are becoming increasingly cautious about expanding permanent payrolls.

Average hourly earnings increased 0.3% in May and were up 3.5% from a year earlier — a pace broadly consistent with the Fed's inflation objective and further evidence that wages are not driving inflation. Because headline inflation accelerated following the Iran conflict, real wages declined over the three months ending in May. However, easing energy prices should allow real earnings to return to modest positive growth beginning in June.





The Fed holds policy as outlook remains divided

The Federal Reserve held its first meeting under Chair Kevin Warsh on June 16–17. Warsh appears to have successfully established his “less is more” communication strategy, with Federal Open Market Committee members remaining notably restrained in their public comments following the meeting.

Within the FOMC, policymakers remain divided over the appropriate path for monetary policy. While recent attention has focused on inflation stemming from higher energy prices, the more significant issue may be the slowing 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. Should that occur alongside moderating inflation, the case for additional rate hikes would diminish considerably. Markets are still pricing in one interest rate increase by the end of the year, but conviction in that expected increase has diminished as the wartime surge in oil prices has almost been completely reversed.



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