



KPMG Economics

Here comes the sun: Bring the sunscreen Annual economic outlook

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December 11, 2025

The Beatles iconic hit “*Here Comes the Sun*” is still one of the most streamed songs on music platforms, which underscores its endurance. The feelings of despair, relief and hope that George Harrison’s lyrics evoke spoke to me. We are beginning to emerge from the economic equivalent of “a long, cold, lonely winter.”

This year has been hard. Measures of economic uncertainty eclipsed those of the pandemic. The aftermath of the April 2 tariff announcement was particularly unsettling. Financial markets imploded and prompted a course correction. Tariffs were paused and scaled back but not eliminated.

The AI boom, or arms race as most in Washington see it, continued unabated. The investment and wealth generated by AI concentrated economic gains into the hands of fewer firms and households. That inequality left us with an economy that looks better on paper than it feels to most Americans. Inflation and unemployment edged up in tandem, while consumer attitudes tanked.

Congress passed the One Big Beautiful Bill (OB BB) in July and a spending resolution for fiscal year 2025. However, it failed to agree upon a fiscal 2026 spending plan, which led to the largest government shutdown on record.

We are beginning to catch up on the disruptions due to the shutdown, but they were substantial. Federal workers were paid in arrears but contractors were not.

Food lines swelled as subsidies were suspended. Nearly one in four children relies on federal funds to keep their bellies full, which is its own commentary on the inequality we are enduring. Hungry children can’t learn.

That begs the question, where is the sun in this economic metaphor? It will emerge as the clock strikes midnight on January 1, and we step into the dawn of a new year.

Shutdown clouds outlook

Preliminary data suggest that real GDP rose at a 3.5% annualized pace in the third quarter, close to the rebound of 3.8% we saw in the second quarter. Consumers held on, housing contracted, business investment drove gains and inventories were liquidated after soaring in anticipation of tariffs earlier in the year. Government spending picked up as spending for fiscal 2025 was approved. The trade deficit narrowed but only modestly - some imports got a bump ahead of additional tariffs slated to jump in August.

The government shutdown delayed the release of data for the third quarter. The initial cut of third quarter GDP will not come out until December 23, nearly two months late. Some data for October was lost entirely and will have to be interpolated to estimate real GDP for the fourth quarter.

The government shutdown shaved about 1.5 percentage points from growth at the start of the fourth quarter, but from what base? The available data suggest that the economy cooled to a 1.6% annualized pace in the fourth quarter but the uncertainty regarding that forecast is extremely high. Employment looks like it shed jobs on net in October and November.

A late Thanksgiving shifted the start of the holiday shopping season to December. That likely delayed hires and spending from November into December, much like we saw a year ago. December 2024 was the strongest month of the entire year for job gains.

The Fed is expected to pause. Debate within the Fed is expected to remain elevated about the trajectory of rate cuts. One additional cut could occur in March. The bulk of rate cuts is expected in the back half of the year, after Powell is replaced as chair.

Earlier rate cuts by the Federal Reserve will kick in, while expansions to tax cuts voted into law in 2025 are realized. Many will see their take-home pay rise on January 1, while refunds surge to their highest level on record during tax season. Consumers treat those as windfall gains; much will be spent.

The Fed's actions provide us with little protection against the burn of inflation. The Fed is deeply divided over whether price hikes will cool on their own or morph into a more persistent bout of inflation.

Consumers care more about the level of prices, which is expected to remain elevated even as the pace of price hikes cools. The inflation of 2025 added to the erosion in purchasing power triggered by the pandemic. Too many are struggling to make ends meet.

This edition of *Economic Compass* takes a closer look at the economic outlook by sector in 2026. Trade and immigration policies are still evolving but uncertainty about the future has abated. That should add to the momentum due to the ongoing boom in AI and a new round of monetary and fiscal stimulus. Economic gains are expected to become more evenly distributed, at least early in the year.

Special attention is paid to the fallout for inflation and how the Fed is likely to react. The bond market has grown skittish. Concerns that the Fed might overstimulate have already lifted bond yields from the lows hit in October. The widening federal deficit and debt could add to the cross currents buoying long-term interest rates.

New prospects, old challenges

2026 outlook

Real GDP growth is expected to rise at a 2.8% annual pace in 2026, more than one-half percent faster than the 2.1% estimate for 2025. The statistical agencies were closed during the government shutdown, which has delayed data releases. Some data was lost entirely, which means statisticians will have to interpolate data for October to get an estimate for fourth quarter GDP.

Employment is expected to move back into the black after slipping into the red in the fall, but remain subdued. The unemployment rate is expected to rise in early 2026 before receding a bit later in the year. Unemployment is a lagging indicator.

Limits on the supply of workers lowered the breakeven for monthly payroll employment to between 30,000 and 60,000 new payrolls a month. We slipped below that lower threshold over the summer and the unemployment rate edged up. That slump in payroll gains will get worse before it gets better.

The supply of workers is expected to be even more constrained as we move into 2026. Baby boomers are aging into their peak retirement years, while curbs on immigration have intensified. Even workers who have been here for decades are seeing their status challenged, which is acting as a deterrent along with more stringent policies on new immigration.

That has created pockets of labor shortages even as the overall labor market weakened. Food preparation, construction and the care economy are showing the largest strains. Costs of child and eldercare, which were already rising, have soared.

Women with children under five are paying the largest price. Escalating childcare costs are prompting those with children under five to drop out, reversing the surge in participation post-pandemic. Those with a bachelor's degree or higher are leaving at the fastest pace.

Unpaid eldercare is another hurdle. Both men and women are spending more time doing unpaid eldercare for their families; young men (ages 15-34) now dominate the younger cohort of workers doing that. That may be a reason why young men are still missing from the labor market.

Tariffs stick

Chart 1 shows the trajectory for the effective tariff rate. We expect to hit a peak of a little above 13% in the first quarter. That is nearly half of the tariffs announced on April 2, but still more than four times the level at the start of the year.

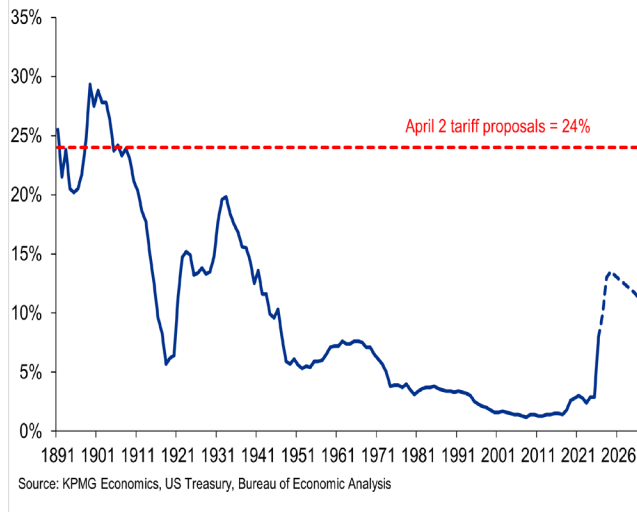
The Supreme Court is poised to rule on whether the tariffs levied via emergency powers are legal. Refunds are not guaranteed; the process would be a logistical nightmare. Firms must apply ahead of time to qualify, and even then, not all would receive refunds.

The administration has made clear it will use other levers to keep tariffs in place. Section 122 and 338 tariffs could be implemented immediately by the executive branch to prevent tariffs from lapsing. That could buy time for any additional tariff investigations needed to keep the levies elevated.

Chart 1

Effective tariff rate peaks lower

Federal effective customs duties rate, %



Tax cuts front-load consumer spending

Consumer spending is poised to pick up in the first half of 2026. Employment is expected to firm, as disruptions due to the government shutdown recede. Earlier stimulus will add to those gains.

Average tax refunds could jump from about \$3,050 in 2025 to more than \$3,600 in 2026. The ranks of those receiving refunds will rise. The amount is less than pandemic-era stimulus but still significant.

The boost from fiscal stimulus alone could add one-half percent or more to first quarter GDP growth. The fact that refunds will straddle the first and second quarters suggests the boost to growth will be greatest between March and May.

Refunds will be issued on everything from taxes on tips to overtime pay, interest on new vehicle loans, expansions to charitable deductions, and larger tax credits for children and seniors. The deduction for state and local real estate taxes has been lifted for households earning up to \$500,000 a year.

That will provide a much-needed lift for discretionary purchases. Spending on vehicles, appliances, consumer electronics, jewelry and vacations tend to benefit the most from a surge in tax refunds.

Separately, we are starting to see a shift in spending due to the proliferation of GLP-1 drugs. Spending on fast food and snacks is falling while spending on fruits and vegetables and smaller size clothing is increasing.

Spending is expected to slow as we get into the summer and fall, barring additional fiscal stimulus. Never say never in an election year.

Housing activity edges up

Home buying and building is expected to pick up in response to a drop in mortgage rates. Listings are still low relative to demand. However, some markets are oversupplied; many of the hottest post-pandemic markets have experienced price declines.

Affordability remains a challenge. Everything from the level of prices to the cost of homeowners' insurance and real estate taxes has increased in recent years. The National Association of Realtors reported that the average age of first-time buyers hit a new record: 40 years old in 2025.

Construction activity is expected to pick up but continues to fall short of demand. Tariffs have raised the costs of new construction along with curbs on immigration. Construction wages are already accelerating again, prior to a pick-up in home building activity.

Builder discounts are expected to wane, as mortgage rates fall and margins compress. That could limit their ability to tap the pent-up demand among first-time buyers. In 2025, the ranks of young adults living with their parents surged close to the peak we saw during the pandemic.

Investment drives economic gains

The AI boom in data centers and the electricity needed to power them has legs. Backlogs for planned data centers continued to rise at year-end. We could see a 45% increase in new data centers in 2026.

The OBBB enables firms to fully expense investments in equipment and new production plants. The bulk of those tax cuts is accruing to the tech behemoths who are driving investment gains. We could see a larger share of firms tap those tax credits, which would offset some of the costs associated with tariffs.

Lower interest rates are another plus. The tech sector has started to issue debt to fund its infrastructure projects, while deregulation is spurring mega-mergers financed by debt.

Some 89% of CEOs in KPMG's recent [survey](#) said that they were looking at acquisitions to boost growth in 2026. Some 70% - 75% of mergers and acquisitions fail to deliver on their objectives according to [analysis](#) from *Fortune* magazine.

Limits on the pool of AI talent will further boost the demand for strategic acquisitions. Startups could be valued as much for the talent that they attract as the products they develop.

Inventories stabilize

Inventories are roughly in balance after soaring in anticipation of tariffs. Companies do not want to stock up inventories given the costs of tariffs and uncertainty regarding demand. Hopes that the Supreme Court will rule many of the tariffs illegal have caused some firms to scale back orders.

Another problem is whether the government is accurately counting inventories. The data do not make sense; that could be due to an unusual amount of goods held in bonded warehouses, which are used to mitigate tariff costs.

Separately, low inventories reduce the need for discounting. That is the case this holiday season. Retailer shelves are stocked but not abundantly. That has enabled retailers to avoid heavy discounting.

Government spending slows

Government spending is expected to catch up at the start of the year from the government shutdown. It costs more to reopen government agencies than to keep them open. Another shutdown cannot be ruled out; current funding ends on January 30.

Cuts to federal spending, with the exceptions of defense and homeland security, start as we move into the year. The fate of healthcare subsidies is still being debated.

Those shifts will not be enough to stem the rise in federal budget deficits and debt. Debt as a share of GDP is expected to eclipse the size of the economy in 2026 and could soon surpass the peak during World War II. (See Chart 2.)

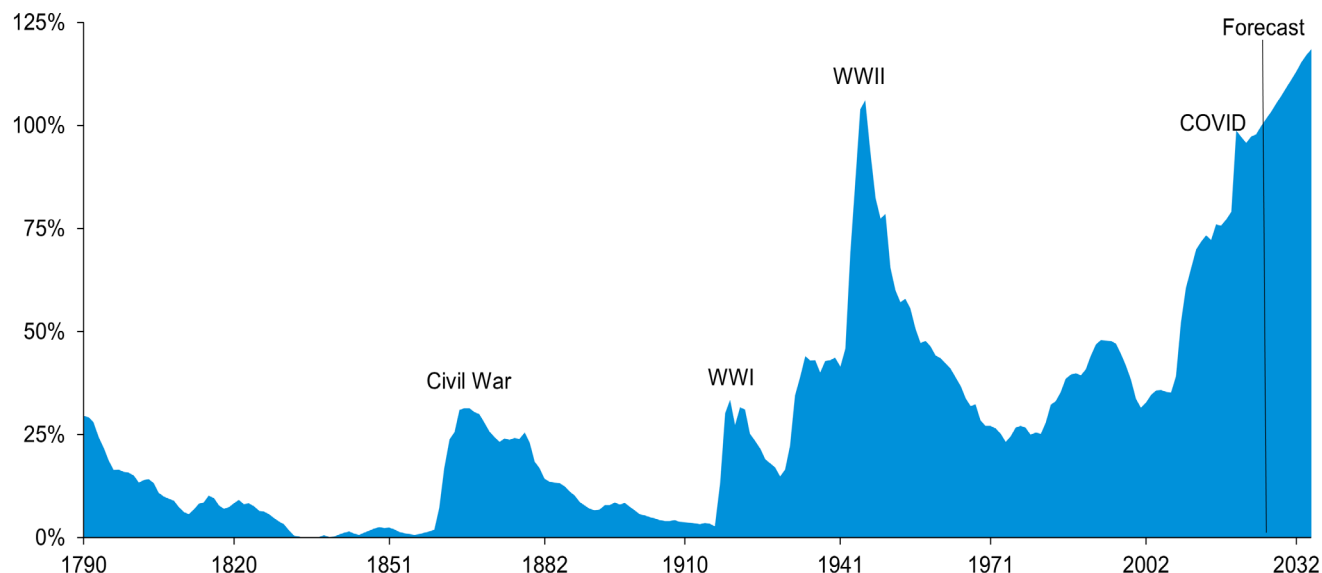
Those estimates do not include a recession or the blow from a drop in immigration. Foreign-born workers pay into Social Security and Medicare but cannot claim those benefits unless they attain permanent residency via a "green card" or citizenship.

State and local government coffers have run dry. Pandemic-era stimulus was spent or clawed back, while curbs to research and education by the federal government are further stressing public resources.

Chart 2

Federal Debt to Surpass Size of Economy Next Year

Debt Held by the Public, Pct. GDP



Note: CBO projections incorporate Fiscal Responsibility Act of 2023
Source: KPMG Economics, CBO (June 9, 2023), Haver Analytics

Cuts to Medicaid will exacerbate those pressures. The federal government provides between 60% and 90% of state outlays for Medicaid recipients. However, they cannot run deficits like the federal government. That means states will have to cut back on those services, raise taxes or some combination of both.

The trade deficit narrows

Tariffs are expected to curb imports, while exports are poised to pick up slightly. The result is a modest narrowing of the trade deficit in 2026.

The wildcard is the United States-Mexico-Canada Agreement (USMCA), which is up for renewal in 2026. If it fails to be approved, a sunset clause on the trade agreement could be triggered.

The multilateral agreement could be broken in two, with bilateral agreements for both Mexico and Canada. That could add to the effective tariff rate. About 90% of goods that cross the two borders are now USMCA compliant, which means they do not get tariffed.

Global trade flows remained remarkably resilient in 2025, despite escalating tariffs by the US. Retaliation was limited.

Instead, many countries moved to solidify trade relationships with other trading partners and move beyond the US. We are seeing that in our own backyard with efforts by the European Union and Canada to join Mercosur countries to expand free trading blocks.

Risks. Recession risks remain elevated, despite the prospects for stimulus. If the weakness in the labor market is more structural than cyclical, then stimulus will ultimately boost inflation more than employment. Full employment cannot be sustained without achieving price stability.

The AI bubble bursting is another downside risk, given the outsize role AI investments and the wealth they have generated play in buoying overall growth. If we lose affluent consumers, all bets on growth are off.

A lingering bout of inflation

Chart 3 shows the forecast for inflation in 2026. The core PCE index, which the Fed watches most closely, is expected to peak at 3.1% in the first quarter and decelerate thereafter. It reaches the Fed's target of 2% in early 2027 but does not stay there.

Factors holding up inflation include the effects of tariffs, which are still working their way through supply chains. Curbs on immigration are creating pockets of labor shortages and boosting wages and costs in some sectors. The largest effects have been in the care economy, but could soon boost the costs of food prep and show up in travel and tourism.

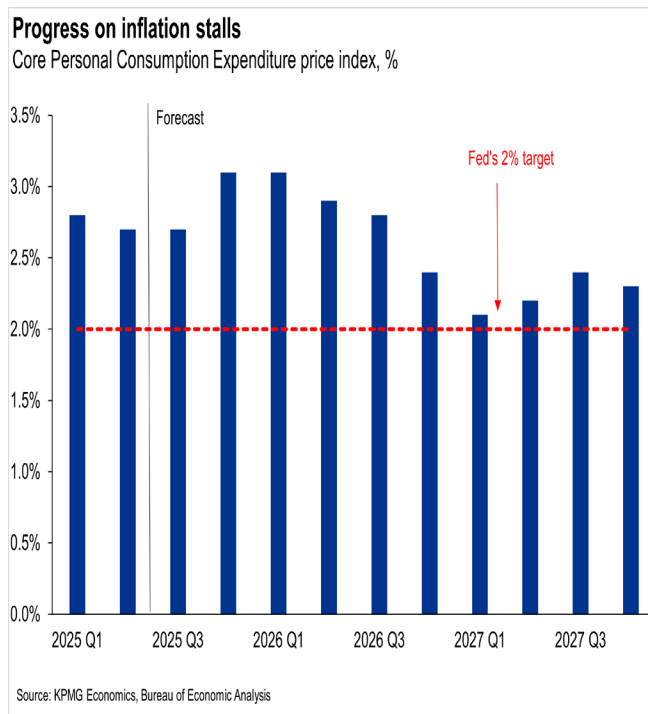
Health insurance and electricity costs are expected to continue their upward march. Aging demographics, new GLP-1 drugs and the demand being placed on our energy grid due to data centers are all culprits.

The good news is in shelter costs, which are cooling outside of hotel room rates. That and a drop in prices at the gas pump should help dampen the rise in other costs.

Another plus is the receding effect of tariffs over time. Efforts to mitigate tariffs, including waivers and shifts in supply chains to lower tariffed countries, have already reduced the effective tariff rate.

Risks. Fiscal and monetary stimulus could overshoot and stoke a more persistent bout of inflation. An AI boost to productivity growth could dampen price hikes; we are not there yet.

Chart 3



A changing of the guard at the Fed

Chart 4 shows the forecast for rate cuts by the Fed in 2026. It is expected to pause at the start of the year as it waits for data to better gauge the course of employment and inflation from here. The next rate cut will be dependent upon the degree to which the labor market firms. We have a cut penciled in for March.

The Fed remains deeply divided over the trajectory of rate cuts. Most at the Fed would prefer to avoid a recession to derail inflation that may resolve itself.

The composition of who sits around the table matters. The Supreme Court has yet to rule on whether the president can more easily fire Fed governors, and by extension, Fed presidents. The administration plans to name a new chairman who is more willing to cut interest rates. Chairman Jay Powell's term lapses in mid-May.

That would not resolve conflict within the Fed about the cadence and size of rate cuts if it is not accompanied by other changes in leadership. Governor Stephen Miran, who is on leave from his post at the White House, has the fed funds rate dropping to 2.0% -2.25% range by the end of 2026.

We have taken that forecast as the course the next Fed Chairman will pursue. That would push short-term rates well below the Fed's current estimate of neutral, which is in the 2.75%-3.0% range.

Separately, the Fed ended what is known as quantitative tightening or reductions in its massive balance sheet on December 1. It restarted purchases of short-term Treasury bonds in December. Powell underscored that the move did not represent a change in policy; it was a technical adjustment meant to keep the Treasury market from seizing.

One of the criticisms of the Fed is how much it is distorting the functioning of credit markets via its bloated balance sheet. There is no easy way for the Fed to extricate itself without risking a setback in credit availability.

Risks. The Fed could overstimulate, which would stoke a more persistent bout of inflation or worse, stagflation – a toxic mix of escalating inflation, stagnant growth and rising unemployment.

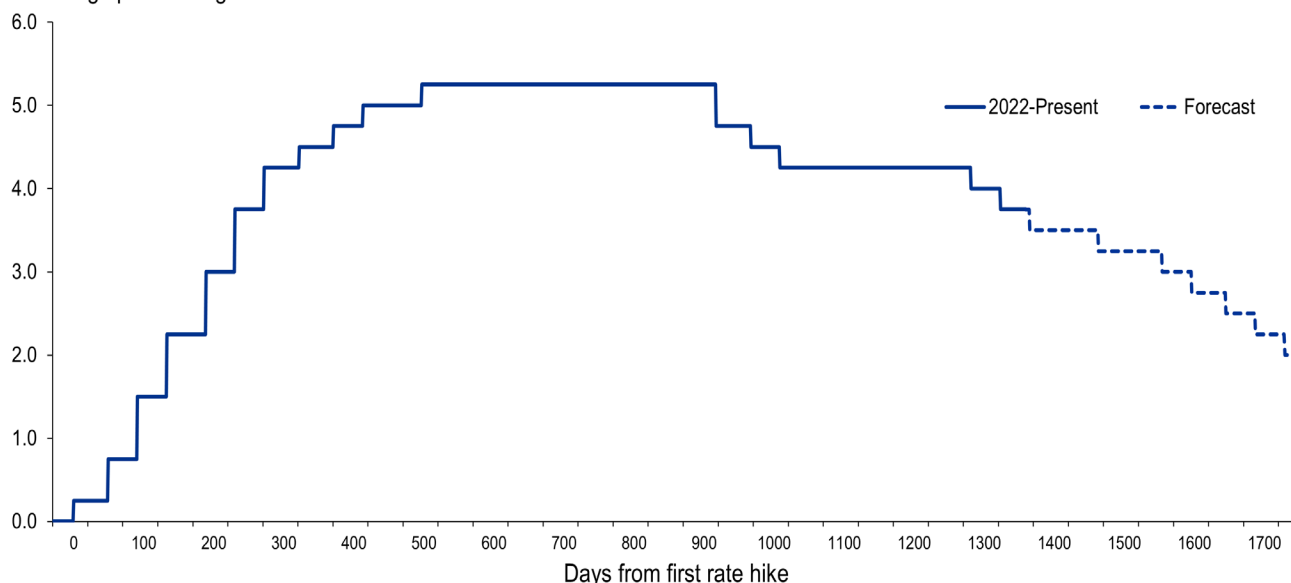
Bond market participants grow skittish

Treasury bond yields are expected to edge lower in response to cooling inflation and rate cuts by the Fed. However, bond yields are expected to remain above pre-pandemic norms. The ultralow rates we saw in the 2010s were an anomaly.

Chart 4

Easing accelerates in 2H 2026

Percentage point change in fed funds rate from first rate hike



Source: KPMG Economics, FOMC

Bond market participants have begun to grow skittish about inflation and the sheer volume of debt being issued. Efforts to inflate our way out of debt would likely be met with higher bond yields. That is in addition to concerns about the Fed's inflation-fighting credibility, which is rapidly waning. The 10-year bond yield is already higher than it was in late October, despite additional rate cuts.

Risks. A more sustained bout of inflation could trigger a return of the bond vigilantes. Bond yields could spike, which would undermine the stimulus due to lower short-term rates by the Fed.

Bottom Line

George Harrison wrote his lyrics during a dark period for the Beatles. The band was fracturing, while its record company was hemorrhaging money. He skipped a business meeting and took a walk in Eric Clapton's garden. He had his guitar in tow and the lyrics of "Here Comes the Sun" came to him as the sun of an early spring day seemed to melt his problems away.

Just as the sun broke through for Harrison to melt the ice of his discontent, the economy will feel the heat of stimulus in 2026. That along with a lifting of the clouds of uncertainty should make for a stronger economy, but at what price? Inflation could become more entrenched.

The relief that Harrison found was fleeting. The Beatles broke up less than a year later, even though their music lives on.

The same metaphor holds for the economy. The high of stronger growth could prove short-lived if it stokes inflation and further erodes purchasing power.

Until we know for sure, I have learned to celebrate the small things. That has left me focused on the horizon, awaiting the beauty of a sunrise for at least a day. "Sun, sun, sun, here it comes." Happy New Year! Be kind; pay it forward.

Economic Forecast — December 2025

	2024	2025	2026	2025:2(A)	2025:3	2025:4	2026:1	2026:2	2026:3	2026:4	2027:1	2027:2
National Outlook												
Chain Weight GDP ¹	2.8	2.1	2.8	3.8	3.5	1.6	3.3	3.2	2.2	1.7	1.9	1.5
Personal Consumption	2.9	2.6	2.4	2.5	3.2	1.2	2.8	2.9	1.8	1.5	1.7	1.6
Business Fixed Investment	2.9	4.3	3.5	7.3	4.1	3.6	2.9	3.1	3.1	3.2	2.6	2.6
Residential Investment	3.2	-2.0	1.8	-5.1	-5.2	-2.6	4.3	8.8	3.8	2.1	2.5	1.2
Inventory Investment (bil \$ '17)	43	29	-1	-18	-35	-2	-9	0	4	-1	14	18
Net Exports (bil \$ '17)	-1033	-1105	-979	-1058	-990	-992	-989	-983	-974	-969	-970	-982
Exports	3.6	1.4	3.1	-1.8	4.6	2.5	2.1	4.1	4.7	4.3	4.1	4.0
Imports	5.8	3.0	-1.2	-29.3	-4.0	2.0	1.3	2.3	2.5	2.6	3.1	4.3
Government Expenditures	3.8	1.2	1.4	-0.1	0.7	-0.9	4.9	0.9	0.7	0.3	0.3	0.1
Federal	3.8	-0.7	2.5	-5.3	-0.2	-4.2	13.0	2.1	1.5	0.3	0.3	-0.1
State and Local	3.8	2.4	0.7	3.1	1.2	1.1	0.4	0.2	0.2	0.4	0.2	0.2
Final Sales	2.8	2.2	2.9	7.5	3.7	1.1	3.4	3.0	2.1	1.7	1.7	1.4
Inflation												
GDP Deflator	2.5	2.7	2.6	2.1	2.0	4.8	2.6	1.5	1.5	3.0	2.5	2.7
CPI	3.0	2.7	2.5	1.6	2.5	3.6	3.0	1.5	2.0	2.9	2.6	2.9
Core CPI	3.4	2.9	2.8	2.1	2.7	3.8	3.5	2.0	1.7	2.8	2.6	2.6
Special Indicators												
Corporate Profits ²	5.1	6.5	5.8	3.6	10.0	6.1	8.1	8.9	4.2	2.5	1.7	0.1
Disposable Personal Income	2.9	2.0	4.0	3.1	1.1	0.3	8.2	5.1	3.7	3.2	3.0	2.8
Housing Starts (mil)	1.37	1.35	1.38	1.35	1.35	1.31	1.38	1.40	1.37	1.38	1.38	1.36
Civilian Unemployment Rate	4.0	4.3	4.5	4.2	4.3	4.5	4.5	4.5	4.5	4.4	4.4	4.3
Total Nonfarm Payrolls (thous) ³	2081	1468	470	280	146	-64	95	222	114	226	149	183
Vehicle Sales												
Automobile Sales (mil)	3.0	2.7	2.7	2.8	2.7	2.5	2.5	2.7	2.7	2.8	2.9	2.9
Domestic	2.0	1.8	1.8	1.8	1.8	1.7	1.7	1.8	1.8	1.9	1.9	1.9
Imports	0.9	0.9	0.9	1.0	0.9	0.8	0.8	0.9	0.9	0.9	1.0	1.0
LtTrucks (mil)	12.9	13.4	12.8	13.4	13.8	12.9	12.7	12.7	12.8	12.8	12.9	12.9
Domestic	10.2	10.7	10.2	10.7	11.2	10.4	10.2	10.2	10.2	10.2	10.3	10.3
Imports	2.7	2.7	2.6	2.7	2.6	2.5	2.5	2.5	2.6	2.6	2.6	2.6
Combined Auto/Lt Truck	15.9	16.1	15.4	16.2	16.4	15.4	15.2	15.4	15.5	15.6	15.8	15.8
Heavy Truck Sales	0.5	0.4	0.5	0.5	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5
Total Vehicles (mil)	16.3	16.5	15.9	16.7	16.9	15.8	15.6	15.8	16.0	16.1	16.3	16.3
Interest Rate/Yields												
Federal Funds	5.1	4.2	3.0	4.3	4.2	3.9	3.6	3.3	2.9	2.3	2.1	2.1
10 Year Treasury Note	4.2	4.3	3.8	4.4	4.3	4.2	4.1	3.8	3.7	3.6	3.7	3.7
Corporate Bond BAA	5.8	6.1	5.9	6.3	6.0	5.9	5.9	5.9	5.9	5.9	5.9	5.9
Exchange Rates												
Dollar/Euro	1.15	1.15	1.20	1.13	1.17	1.17	1.18	1.19	1.20	1.21	1.22	1.23
Yen/Dollar	146.7	148.5	144.5	144.5	147.5	152.0	149.0	146.0	143.0	140.0	138.0	138.0

¹ in 2024, GDP was \$23.3 trillion in chain-weighted 2017 dollars.

² Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

³ Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation. Total may not add up due to rounding.

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