



Economic Compass

Running on Empty?

War, supply chain shocks & the outlook

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History does not repeat, but it often rhymes. Right now, the US economy sounds like a refrain from Jackson Browne's 1977 hit "Running on Empty." We could soon be driving the economy on fumes instead of a full tank.

The war with Iran is not a replay of the 1970s. Energy shocks are smaller compared to income, labor markets are more flexible and inflation expectations are better anchored for now. Still, the rhyme is unmistakable.

Geopolitical tensions in the Middle East have turned energy into a weapon. We have already endured a long period of inflation and the Federal Reserve's credibility in achieving price stability has frayed. That ups the ante that inflation expectations will become unmoored.

Nothing affects consumer psychology more than a surge in prices at the gas pump. Gas stations act as billboards advertising the rise in prices.

The shock is more than an oil shock. It is roiling supply chains the world over. Shipping is still constrained and controlled by Iran - it is their key leverage. Mines need to be cleared from the thoroughfare, which is why ships must hug the coast. The disruptions are similar but not as severe as the pandemic.

Rationing has begun in emerging markets that can no longer afford scarce fuel supplies. Work-from-home mandates are taking hold. Schools, businesses and public services are shutting down. Factories and offshore services (including call centers) could be next.

Rising diesel, jet and bunker fuel prices have boosted shipping costs. Those increases are colliding with tariff-induced price hikes and elevated service sector inflation.

Disruptions to the flow of oil and refined products will take weeks or even months to normalize. Damage to some energy infrastructure will take years to repair.

War in Iran weighs on growth

Real GDP growth is expected to rise by 1.9% in the first quarter, more than double the previous quarter's rate. Consumer spending increased in March, driven by higher tax refunds and strong vehicle sales. Home building picked up, but overall sales stayed muted. Investment expanded beyond AI infrastructure while inventories declined slightly.

Government spending recovered most losses from the six-week shutdown. The outlier is the Department of Homeland Security (DHS). The Senate passed a continuing resolution covering most of the DHS budget, but the House of Representatives rejected it before a two-week recess. An executive order may be needed to guarantee TSA agent pay.

The trade deficit worsened as imports rose faster than exports. Lower, temporary tariffs introduced to replace those invalidated by the Supreme Court, have reduced the cost of imports from emerging Asia. Those tariffs will be replaced with higher ones in August. Higher shipping costs and rationing across many economies could be a problem going forward.

Real GDP is forecast to rise at a more tepid 1.3% pace in the second quarter. It takes time for Middle East production to come back on line and supply chains to unfurl. Tax refunds blunt the blow of higher energy prices, but not in full, Housing remains lackluster due to escalating costs. Investment softens a bit in response to elevated transportation fees. Government spending slows; the trade deficit widens. The blow to growth from the war in Iran hits our trading partners harder than it hits us.

Fed signals optionality. The Fed is expected to signal that the next move in rates could either be up or down when it meets later in April. New Fed Chairman Kevin Warsh is expected to push for rate cuts to blunt the blow of the war - his colleagues will want more progress on inflation. We have tentatively penciled in two rate cuts by year-end, but the risk of repeating the mistakes of the 1970s will hang heavy over a decision to cut. Stimulus mixed with repeated supply shocks contributed to the nightmare of stagflation.

This *Economic Compass* revisits war scenarios. The economy entered the year with a tailwind of fiscal and monetary stimulus, but headwinds are mounting. The costs of the war compound with time. The effects will linger after the strait more fully opens. Market euphoria following the cease fire is understandable but premature.

The Federal Reserve is left in a tough position. The threshold to cut again was high ahead of the war. Debate will be intense to avoid a repeat of policy mistakes of the 1970s - excess stimulus in the wake of an oil shock. The base case offers a narrow path to additional rate cuts, but inflation needs to cool before that can occur.

Current energy dynamics

The closure of the Strait of Hormuz disrupted more than 20 million barrels per day, or one-fifth of global supply. That compares to roughly 4.5 million barrels per day, or 7% of global supply, during the 1973 shock.

The difference today is the lack of buffers. Strategic reserves coordinated by the International Energy Agency are insufficient to offset a shock of this scale. They only cover about 20 days of supply and are released slowly to refineries, where capacity is limited. Spare refining capacity trapped in the strait, will take time to restart.

Sanctioned oil already on the water does not add to supply. It is simply rerouted to buyers who can afford much higher prices. Sanctions on oil have always been loose, to limit the collateral damage to consumers.

Those constraints have translated quickly into reduced flows. Traffic through the strait has fallen to about 10% of normal. Bypass pipelines cannot run at peak capacity due to other infrastructure snags. That leaves us with seven to eight million barrels per day, or about a third of normal flows.

Ukraine's strikes on Russia's oil infrastructure is further limiting global supply. Troop deployments in the strait could temporarily halt traffic entirely.

Hormuz is functioning less as a physical chokepoint than as a risk-pricing mechanism. Iran still controls the traffic flows, along with insurers. Mines have yet to be cleared. Spot prices are up more in response to scarcities.

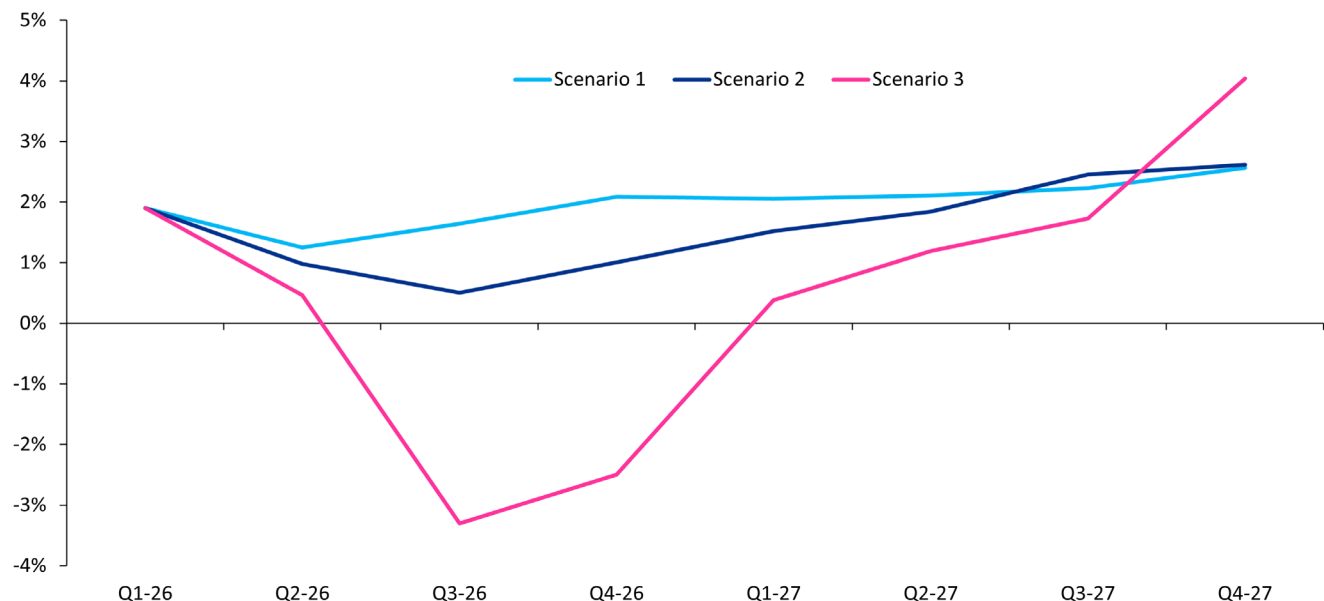
Physical crude sold for more than \$140 per barrel in early April and continues to rise in price. Helium, which is used in high-tech manufacturing, is scarce. Shortages have prompted chip producers to prioritize those used for AI, which will seed shortages elsewhere.

The result is a domino effect, which snarls supply chains beyond oil alone. That is similar but not as large as when we emerged from the pandemic. However, our economic reserves are more depleted than they were then.

Chart 1

War takes a toll on the growth outlook

Real GDP, percent change annualized rate



Source: KPMG Economics

Chart 2

Uncertainty spikes

US Economic Policy Uncertainty, 1985-2019 = 101



Source: KPMG Economics, PolicyUncertainty.com, Haver Analytics

Three scenarios

Chart 1 compares three scenarios and their implications for real GDP growth. The key factors that determine how the economy reacts include: the length of the disruption, damage to energy infrastructure and the uncertainty the war fuels.

Chart 2 shows the economic policy uncertainty index. It eclipsed that of the pandemic in the wake of Liberation Day; it spiked again at the start of the war. The cease fire is fragile and we have yet to re-negotiate the USMCA. That could trigger another jump in trade-related uncertainty, We are betting the agreement survives, but there are some in the administration who would prefer it replaced with bilateral agreements.

The economic [research](#) is clear how uncertainty acts as a tax on the economy, prompting firms and households to pause major investments. Hiring is on that list. Extreme periods of uncertainty alone can cause a [recession](#).

Scenario 1

Slow-flation

The first scenario is our base case. It assumes the strait opens as agreed upon with no additional damage to energy infrastructure. Ramping up and normalization take two to three months.

The price of Brent comes down in fits and starts. Financial markets are getting ahead of damage assessments. It averages close to \$100 per barrel in the second quarter and ends the year at \$70. The spread between West Texas Intermediate (WTI) and Brent returns to \$5.

Real GDP growth slows to 1.7% on a fourth-quarter-to-fourth-quarter basis in 2026. That is slightly below the economy's potential to grow and 0.3% below the subdued 2% pace of 2025:

- Consumer spending slows but does not collapse. Affluent households moderate their spending but stay in the game. A surge in tax refunds blunts the blow of high energy prices for most households. Low-income households take it on the chin.
- Home buying and building remain subdued in 2026 but recover in 2027.
- Investment slows but does not collapse due to the ongoing boom in AI infrastructure. Another plus is expansions to tax cuts last year, which enable companies to write off new plant and equipment expenses. That offsets some of the surge in costs.
- Inventories gradually rebuild.

- Government spending slows after a burst at the start of the year due to the catch-up from last year's government shutdown. Congress has not passed a full fiscal year 2026 budget but has approved most appropriations. The exception is the Department of Homeland Security.
- The trade deficit deteriorates, as our trading partners suffer larger losses than we do from the war. Asia and Europe are hit hard; emerging markets that do not produce oil suffer the most. Those shifts will amplify the widening of the trade deficit due to another front-running cycle on tariffs and soft boycott of exports. The temporary tariffs levied to bridge those ruled illegal by the courts make imports cheaper until August.

A period of "slow-flation" sets in. Inflation and unemployment edge higher, but overall growth does not collapse. Earlier rate cuts and expansions to tax cuts last year keep the economy moving forward, although at a slower pace than we entered the year.

Scenario 2

Mild bout of stagflation

The second scenario is less benign. It assumes a partial normalization of oil flows over the next two months, followed by another two to three months of global rebalancing. No additional damage to oil infrastructure. The price of Brent averages \$110 per barrel in the second quarter and falls to \$80 by year-end.

Real GDP comes in at a tepid 1.1% on a fourth-quarter-to-fourth-quarter basis, close to half the pace of 2025. Growth essentially flatlines in the second half of the year before rebounding in 2027:

- Consumer spending suffers a larger blow due to unemployment, higher inflation and financial market volatility. Spending shifts toward necessities.
- Housing contracts in 2026 and rebounds in 2027.
- AI investment continues but faces cost headwinds. Speculative data center construction is sidelined. Higher oil prices for longer enable some uptick in mining activity. A shale boom would require a larger disruption to justify new investments.
- Inventories drain more aggressively in the second half of 2026 due to weaker growth and persistent uncertainty. That saps manufacturing activity but sets the stage for a rebound in early 2027.
- Government spending is already on a preset trajectory, although added defense spending and fiscal stimulus are possible.

- The trade deficit widens as growth abroad is weaker than growth at home.

A mild bout of stagflation materializes which we have not seen since the 1970s. That is a toxic mix of rising inflation, escalating unemployment and no growth. The cushion due to earlier fiscal and monetary stimulus is depleted and the economic engine stalls.

Scenario 3

Global recession

The third scenario is the worst. It assumes that talks break down, the war escalates, with more destruction of energy infrastructure. The price of Brent nears \$200 per barrel; the glide path down takes longer. Mine clearing requires weeks to months and help from Iran. Brent ends the year just below \$100 but remains elevated in 2027.

Conservation intensifies, oil production ramps up and global investment in renewable energy grows. Next-generation nuclear plants gain traction.

Real GDP contracts 0.6% on a fourth-quarter-to-fourth-quarter basis in 2026. Losses extend to early 2027:

- Consumer spending hits a wall.
- Housing slides deeper into recession.
- Investment contracts, except for energy.
- Inventories drain the entire year, which further saps manufacturing activity.
- Government stimulus is constrained by ballooning debt.
- The trade deficit moves sideways with the risk that exports could drop more rapidly than imports.

A deep recession ensues. The spike in inflation deals a blow to profit margins, which causes mass layoffs. Monetary policy is leaned on more than fiscal stimulus, due to already elevated federal deficits and debt.

Risks to the outlook

Disruptions of the magnitude we are seeing are extremely hard to model and could understate the ripple effects for the broader economy. Scarcities can buoy prices even as demand is destroyed. We are not out of the woods on a peace deal.

Cyber and terrorist attacks are more likely today than before the war; they are low probability/high impact events.

Chart 3

Inflation peak dependent on oil

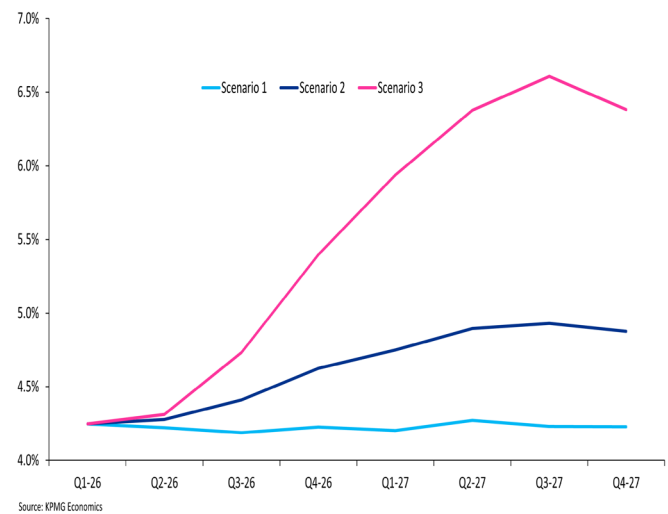
Core PCE price index, year-over-year percent change



Chart 4

Unemployment rises, with a lag

Unemployment rate, percent



Inflation & unemployment rise

Charts 3 and 4 show the scenarios for inflation and unemployment. The bump in energy prices collides with tariff-induced increases and persistent service inflation.

- Scenario 1: The spike in energy prices is short-lived, and takes only a marginal toll on demand. Layoffs pick up with a lag and show up as a modest uptick in unemployment by year-end.
- Scenario 2: Inflation expectations become unmoored, which seeds a more persistent rise in price levels - we tend to get the inflation we expect. The New York Fed survey of consumers expectations revealed a sharp jump in inflation expectations in March.
- Scenario 3: Soaring oil prices for longer sap demand, which triggers mass layoffs and a surge in unemployment. That derails broader inflationary pressures - some price levels even fall.

Risks: Recent [research](#) on repeated supply shocks amidst a high level of uncertainty results in more persistent inflation. [Work](#) done by the Fed underscores that point, suggesting that inflation dynamics have shifted post-pandemic. The dispersion and size of price hikes top what we saw pre-pandemic.

A quandary for the Fed

All three scenarios challenge the Fed's dual mandate to foster price stability and full employment. The trajectory of rates under each scenario will depend upon which side of its mandate is a greater threat.

- Scenario 1: Inflation expectations remain well-anchored, while the margin compression associated with higher energy prices undermines the labor market. The Fed resumes rate cuts over the summer and ends the year with the fed funds rate in the 3.0-3.25% range, which the Fed considers neutral.
- Scenario 2: Inflation expectations become unmoored, stagflation begins but the Fed raises rates to counter it this summer. Rates stay higher for longer; cuts resume in mid-2027.
- Scenario 3: The demand destruction due to the spike in energy prices is so large that the Fed decides to "look-through" and cut aggressively. The fed funds rates dips to a 2.0-2.25% range and stays there in 2027, barring a financial crisis. The latter would require even lower interest rates.

Risks: The Fed failed to hit its inflation target for five years. Additional price hikes would hurt its credibility, which could further untether inflation expectations.

A shift in leadership at the Fed draws even more attention to its credibility. Kevin Warsh, who has been nominated to replace Powell, will no doubt be tested by financial markets regarding his inflation-fighting resolve. The political pressure to cut rates will be intense. Rapid rate cuts risk stoking a more prolonged bout of inflation.

Treasury bond yields rise

Treasury bond yields are poised to rise in 2026 in all scenarios before they recede in 2027. High inflation is a problem, except in scenario 3. A recession precipitates a much faster drop in rates. That is a hard way to get to lower rates, and would result in scars. The ranks of the long-term unemployed have already risen.

Federal deficits and debt remain elevated, with debt poised to eclipse the economy for the first time since WWII. That ups the ante the bond market throws a tantrum if Congress approves additional stimulus.

Efforts to stimulate amidst persistent inflation and rising unemployment added to the stagflation of the 1970s. The lesson of that era was that full employment cannot be achieved and sustained without price stability. That is why all other major central banks have only one mandate - price stability.

Risks: Policy missteps, coupled with changes in leadership at the Fed, will test the patience of bond buyers. That could create a floor under Treasury bond yields and limit the drop in long-term rates should the Fed cut further.

Bottom Line

Jackson Browne's classic hit wasn't only about a gas gauge nearing empty. He wrote it while touring and recording at the same time - he was moving forward but depleted. The refrain of the song became a moniker for burnout. That is the right frame for the outlook: a shock of this scale exposes how few buffers we have.

The economy is advancing, but with less capacity to absorb another shock. Conditions will likely worsen before improving. Policy uncertainty acts like a tax; higher energy and supply-chain costs do the rest.

I remember the 1970s as a kid - an ugly decade. The Vietnam War raged as inflation surged from excessive fiscal and monetary stimulus. Profit margins collapsed and markets fell. The OPEC embargo spiked oil prices, driving both inflation and unemployment up. A deep recession ensued. The final straw was the Iranian Revolution - it was a decade lost to stagflation.

Now is the time to learn, not repeat: limit the collateral damage of the war and the risk it triggers a more vicious cycle of inflation. Otherwise, margin compression will force layoffs and the scarring of the crisis will deepen. Hope for peace. Breathe. Hug someone you love. Be kind; pay it forward.

Special thanks to my friend and colleague, Mark Finley. He is a nonresident fellow in energy and global oil at Rice University's Baker Institute for Public Policy. Without him, we could not have put these scenarios together.

Economic Forecast — April 2026

	2025	2026	2027	2025:3(A)	2025:4(A)	2026:1	2026:2	2026:3	2026:4	2027:1	2027:2	2027:3
National Outlook												
Chain Weight GDP1	2.1	2.0	2.1	4.4	0.7	1.8	1.4	1.8	2.0	2.0	2.1	2.3
Personal Consumption	2.6	2.0	2.0	3.5	2.0	1.5	1.4	1.8	2.0	1.9	1.8	2.3
Business Fixed Investment	4.1	4.0	3.8	3.2	2.2	4.9	3.7	4.4	4.0	3.8	3.5	3.4
Residential Investment	-2.1	-1.7	3.1	-7.1	-0.5	-1.8	2.5	-3.0	0.7	3.9	5.1	6.8
Inventory Investment (bil \$ '17)	31	25	79	-24	-7	-2	27	33	41	53	80	86
Net Exports (bil \$ '17)	-1091	-1098	-1183	-955	-968	-1047	-1101	-1112	-1130	-1154	-1177	-1193
Exports	1.6	3.1	4.3	9.6	-3.3	6.9	0.5	5.3	4.4	4.7	3.8	4.5
Imports	2.7	2.4	5.3	-4.4	-1.1	14.3	6.2	5.0	4.9	5.9	5.1	4.8
Government Expenditures	1.1	0.9	0.6	2.2	-5.8	6.3	0.6	0.5	0.8	0.8	0.5	0.3
Federal	-1.2	0.6	1.1	2.7	-16.7	16.0	0.7	0.9	1.7	1.7	0.9	0.4
State and Local	2.5	1.1	0.3	2.0	1.2	1.0	0.6	0.3	0.3	0.2	0.3	0.3
Final Sales	2.2	1.5	2.0	4.5	0.4	1.6	0.9	1.7	1.9	1.8	1.7	2.2
Inflation												
GDP Deflator	2.8	3.1	2.7	3.8	3.8	2.7	3.4	2.5	3.0	2.7	2.7	2.3
CPI	2.7	3.5	2.4	3.1	2.5	3.5	6.9	2.0	1.5	2.5	2.2	2.3
Core CPI	2.9	2.9	2.9	3.2	2.0	2.8	3.3	3.4	3.1	2.8	2.7	2.6
Special Indicators												
Corporate Profits ²	5.9	8.3	1.7	9.3	4.3	9.9	10.4	7.3	5.7	3.2	2.0	1.1
Disposable Personal Income	1.7	1.5	3.3	1.0	0.2	2.8	-0.1	2.8	3.9	3.9	3.4	3.4
Housing Starts (mil)	1.36	1.34	1.37	1.35	1.33	1.43	1.31	1.31	1.31	1.33	1.36	1.38
Civilian Unemployment Rate	4.3	4.4	4.7	4.3	4.5	4.3	4.4	4.5	4.5	4.6	4.7	4.7
Total Nonfarm Payrolls (thous) ³	316	501	275	34	-91	228	143	88	41	36	30	88
Vehicle Sales												
Automobile Sales (mil)	2.7	2.8	3.0	2.6	2.5	2.7	2.7	2.8	2.8	2.9	3.0	3.0
Domestic	1.8	1.8	1.9	1.8	1.7	1.8	1.8	1.8	1.9	1.9	1.9	1.9
Imports	0.9	0.9	1.0	0.9	0.8	0.9	0.9	1.0	1.0	1.0	1.0	1.1
LtTrucks (mil)	13.5	12.9	12.9	13.9	13.2	13.0	12.9	12.8	12.8	12.9	12.9	12.9
Domestic	10.8	10.3	10.3	11.2	10.7	10.3	10.3	10.2	10.2	10.3	10.3	10.3
Imports	2.7	2.6	2.6	2.7	2.5	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Combined Auto/Lt Truck	16.2	15.6	15.9	16.6	15.7	15.6	15.6	15.6	15.6	15.8	15.9	15.9
Heavy Truck Sales	0.4	0.4	0.5	0.4	0.4	0.4	0.4	0.5	0.5	0.5	0.5	0.5
Total Vehicles (mil)	16.6	16.1	16.4	17.0	16.1	16.0	16.0	16.1	16.1	16.3	16.4	16.4
Interest Rate/Yields												
Federal Funds	4.2	3.4	3.1	4.3	3.9	3.6	3.6	3.4	3.1	3.1	3.1	3.1
10 Year Treasury Note	4.3	4.3	4.1	4.3	4.2	4.2	4.4	4.4	4.3	4.3	4.2	4.1
Corporate Bond BAA	6.1	6.3	6.4	6.0	5.9	6.0	6.3	6.4	6.4	6.4	6.4	6.4
Exchange Rates												
Dollar/Euro	1.13	1.18	1.21	1.17	1.16	1.17	1.17	1.18	1.19	1.20	1.21	1.21
Yen/Dollar	149.6	158.2	148.0	147.5	154.1	156.8	160.0	158.0	156.0	154.0	150.0	146.0

¹ In 2025, GDP was \$23.9 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.

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