KPMG

Economic Compass

Prince or prisoner?

Warsh gets the crown, markets get the gavel

Diane C. Swonk, Chief Economist
KPMG US
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"Uneasy lies the head that wears a crown."

—William Shakespeare, *Henry IV, Part II*

Kevin Warsh finally has the job he wanted as chair of the Federal Reserve. He also has a harder task than the one he auditioned for.

Inflation remains elevated. AI investment is powering investment and wealth effects, while stressing the power grid, boosting the costs of chips, equipment and skilled labor before productivity can scale enough to offset those costs.

The labor market is losing momentum, with a shortfall in employment in July and downward revisions to the previous two months. Firms are doing more with less in a highly uncertain and cost-laden world, which is boosting productivity growth but not offsetting inflation.

Stronger productivity can increase the economy's speed limit and, with it, the neutral or non-inflationary fed funds rate. The Fed's current target of 3.5% to 3.75% may not be restraining overall demand enough to contain inflation. Consumer spending accelerated at its fastest pace since the summer of 2025 in the second quarter.

That leaves the Fed with a credibility problem, which has hit home. Nearly half of the participants at Chairman Warsh's first meeting in June penciled in rate hikes for 2026. Three presidents dissented in favor of hikes at his second meeting in July. That level of dissent is unusual in normal times; it's extraordinary so early in a new chair's tenure.

Politics are adding to the Fed's credibility problems. The renewed effort to remove Governor Lisa Cook and reports that Warsh remains in close contact with the president distort the way every rate decision is judged. A hike can look like proof the Fed can still say no. A cut can look like proof that it cannot.

Soft headline masks underlying strength

Real GDP rose at a 1.5% annualized pace in the second quarter, a step down from the 2.1% pace of the first quarter. Do not be fooled by the headline. The economy's core was stronger than the top-line number suggested. Imports widened as government spending fell, both of which weighed on measured GDP. Inventories swung from a support to a drag, as oil inventories were depleted to blunt the upward pressure on oil prices. Those are noisy pieces of the GDP puzzle, not the best gauge of demand.

Domestic demand alone surged at a 3.9% annualized pace in the second quarter, after rising only 1.7% in the first quarter. Consumer spending picked up, helped by wealth effects and a labor market that has cooled but not cracked. Business investment remained a bright spot, powered by equipment, software and the relentless buildout of AI-related data centers.

The third quarter should look better. We expect real GDP growth to rebound to a 2.2% pace. Lower prices at the gas pump are freeing up cash for households after the spring energy squeeze. Equity gains are still supporting spending at the top of the income ladder, even if those wealth effects are less frothy than earlier in the cycle. Data center construction remains one of the few areas of investment with real momentum, lifting demand for power generation, grid capacity, cooling systems and equipment. Recent manufacturing surveys reveal a tailwind from inventory restocking.

The catch is that the economy is becoming more uneven. Lower- and middle-income households are still stretched, housing remains trapped by high rates and affordability constraints, and tariff-related costs are working their way through supply chains. The economy is not off to the races.

Fed hikes, but labor market clouds timing. Stronger underlying demand and persistent inflation keep the Fed on track to raise rates before year-end, but labor market weakness could delay the move beyond December. Inflation persistence is becoming the larger risk. History shows that easing for short-term political gain can further stoke inflation, which hurts employers and consumers. Full employment cannot be sustained without price stability.

That is why his speech at the Jackson Hole Symposium later this month matters so much. It is an opportunity for Warsh to demonstrate his and the Fed's independence from political interference. He does not need a long speech. He needs a clear one: defend independence, commit harder to price stability and explain what would make the Fed hike, hold or cut.

The shocks keep coming. The administration is moving to replace the revenues lost to the Supreme Court ruling on tariffs; the new measures go further than those enacted last year. The situation in the Middle East remains unsettled. Economic gains are uneven and concentrated, while the inflation those shifts stoke is felt broadly and hits hardest those least able to afford it.

That leaves Warsh with the central question of this forecast: will the crown make him a prince, or a prisoner to financial markets as the Fed's inflation-fighting credibility erodes?

This edition of *Economic Compass* looks at the outlook, the tension in the Fed's dual mandate to promote full employment and price stability, and the dilemma it poses for Warsh. He has to shore up the institution's credibility, while unifying a splintered Fed.

Financial markets are the other judge. The bond and equity market rout following Warsh's second press conference was a warning shot. Long yields can tighten financial conditions for the economy, but on harsher terms. That is why we still expect two rate hikes, though the timing is tricky given the softer labor market.

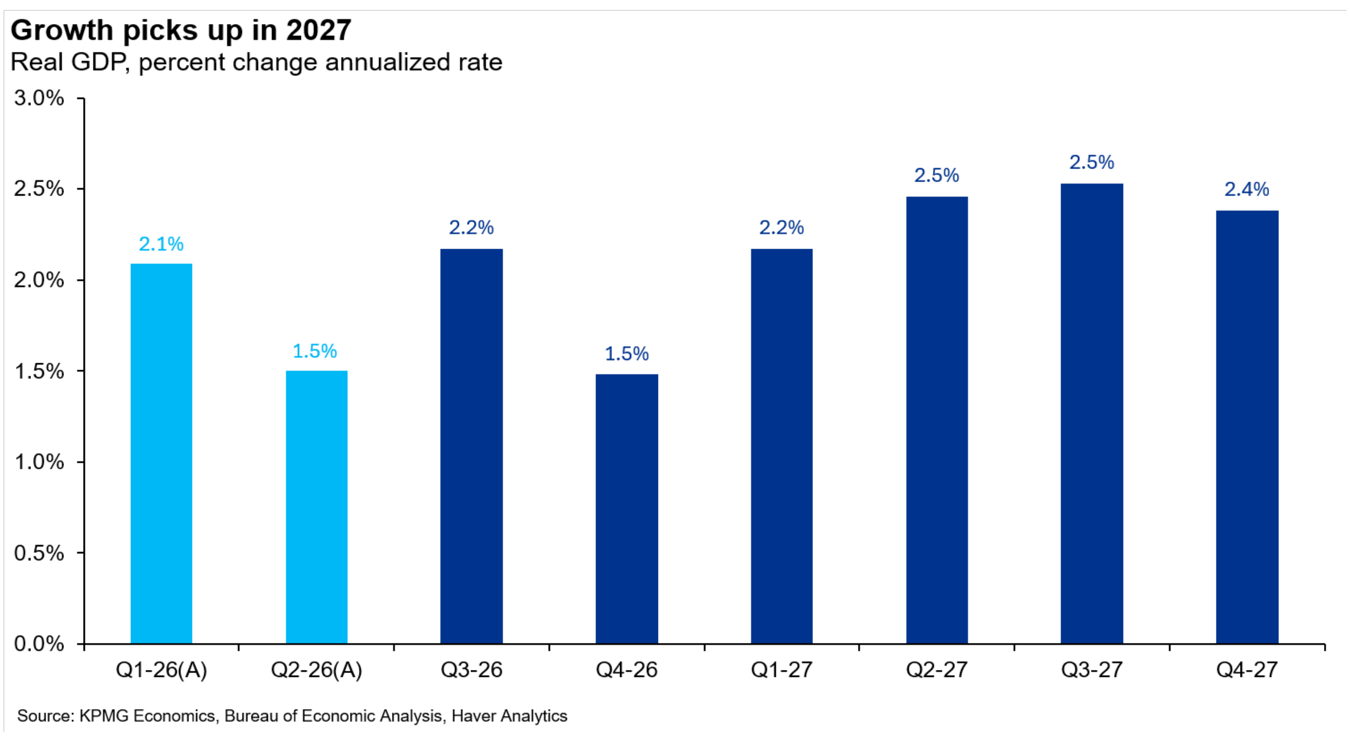
The outlook

Solid but uneven growth

Chart 1 shows the forecast for the remainder of 2026 and 2027. Growth is expected to remain resilient, at least on paper:

- **Consumer spending remains buoyed by affluent households** and some easing of energy prices. That is despite some weakness in payroll employment, much like we saw last year.
- **Housing is caught in a state of suspended animation** until mortgage rates ease in late 2027. That will unleash pent-up demand among first-time buyers. In the interim, more households are absorbing vacant apartments, which is likely to reignite rent inflation.

Chart 1



- **Business investment remains buoyed by the AI boom** and its spillover effects. The pace of gains is expected to be constrained by heavy backlogs, rising prices and growing resistance to data centers. That resistance is one of the few issues that cuts across party and income lines.
- **Inventories are being restocked** after being drained sharply last year and at the start of this year. The process is slow but showing up as a rebound in manufacturing activity and rising input costs.
- **Government spending is poised to pick up** in response to aging demographics and a bump in defense outlays due to the conflict in the Middle East. Those shifts will amplify the cost pressures associated with AI, given the role AI is now playing on the battlefield.
- **The trade deficit is expected to widen further,** despite the higher costs of imports associated with tariffs. The conflict in the Middle East has hurt growth abroad more than it has hurt growth at home. That is suppressing exports, while imports are being kept afloat by the AI boom. Many inputs to data centers are imported and escape tariffs via waivers, although that is shifting with new tariff announcements.

Risks skew downward. A setback in the US-led AI boom is the largest downside risk. A sharp repricing would hit wealth, capital spending, data center buildouts and demand for imported equipment. The factors that boosted growth could take the economy down. That could flip the Fed's rate hike calculus.

Full employment?

The unemployment rate dipped to 4.1% in July, its lowest level in a year and a half, but for the wrong reason. Participation in the labor market dropped to a five-year low and is hovering at levels we have not seen since the mid-1970s. (See Chart 2.)

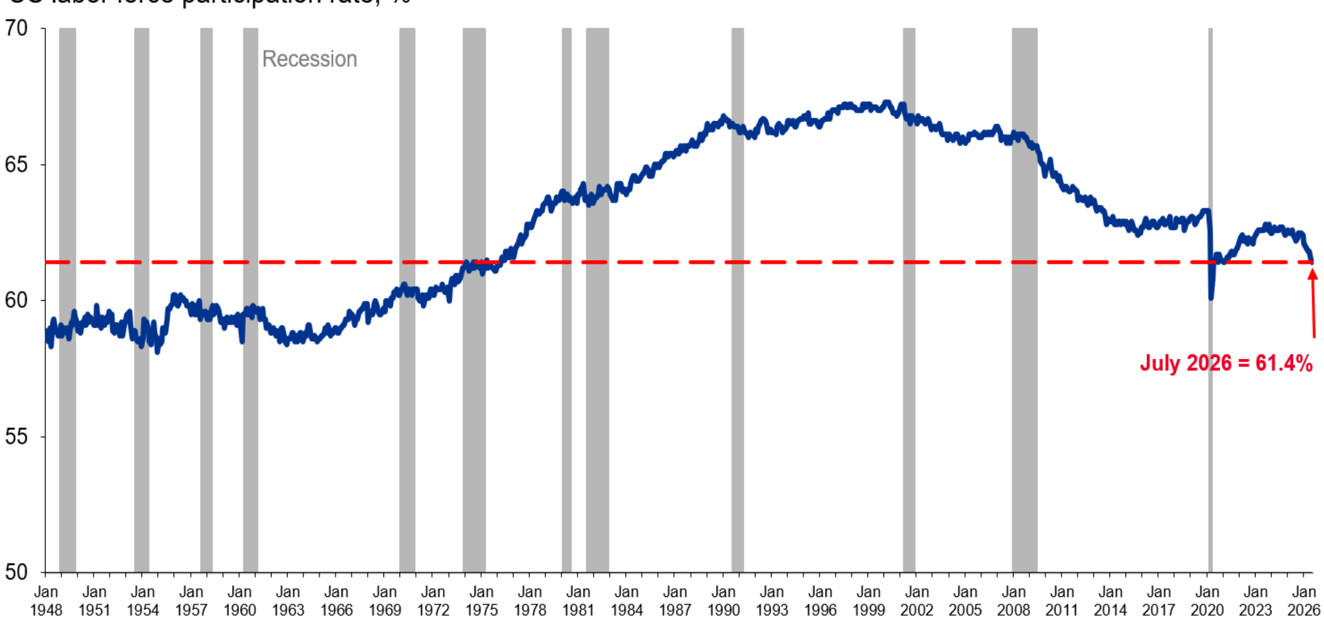
Why is participation falling?

- **Statistical adjustments.** St. Louis Fed research shows that much of the recent drop reflects population-control adjustments and changing participation within age groups.
- **Aging demographics.** Baby boomers are moving through retirement ages, while equity gains make retirement easier for households with assets.

Chart 2

Labor force participation plummets

US labor force participation rate, %



Source: KPMG Economics, Bureau of Labor Statistics

- **Curbs on immigration.** Foreign-born workers participate at higher rates than the native-born population. They often complement native-born workers, not replace them, especially in the service sector. Fewer immigrant arrivals and efforts to remove legal avenues for existing immigrant workers hit labor supply.
- **Fewer entry-level opportunities.** A low-hiring, low-firing environment leaves fewer options for those attempting to get a foot in the door. The unemployment rate among new college graduates has moved higher this year, even as the overall unemployment rate fell. Many of those workers have become discouraged and given up looking.

Payrolls shed more than 20,000 jobs in July, even as unemployment edged lower. The losses were concentrated in local education, which may be a statistical fluke, but blows to payrolls are inbound.

Temporary Protected Status (TPS) lapsed for roughly 330,000 Haitians in late July, about 200,000 of whom were working. Another 350,000 Venezuelans are expected to lose their TPS in early October. Firms face penalties if they keep those workers on payrolls, though some may try to move work off the books.

The threat of deportation has its own chilling effect. The losses will show up as a blow to payrolls, not unemployment, because immigrants who lose their ability to work do not count as unemployed.

Those shifts keep the jobs side of the Fed's mandate alive, but not the dominant factor determining the course of policy. Hawks remain more concerned about the persistence of inflation.

Risks: The labor market may look smooth as ice but is chilling below the surface. TPS cliffs, lower participation and weak entry-level hiring can depress payrolls without boosting unemployment.

Inflation lingers longer

Chart 3 shows the forecast for the core personal consumption expenditures index, or core PCE. It strips out food and energy – the part monetary policy is designed to cool. Core PCE remains more than one percentage point above the Fed's 2% target and will stay there into 2027.

Duration is the problem. Inflation has not been too high for a month or two; it has been too high for more than five years. That erodes the Fed's benefit of the doubt. Each new shock is harder to dismiss as temporary when households and firms have already lived through years of price increases.

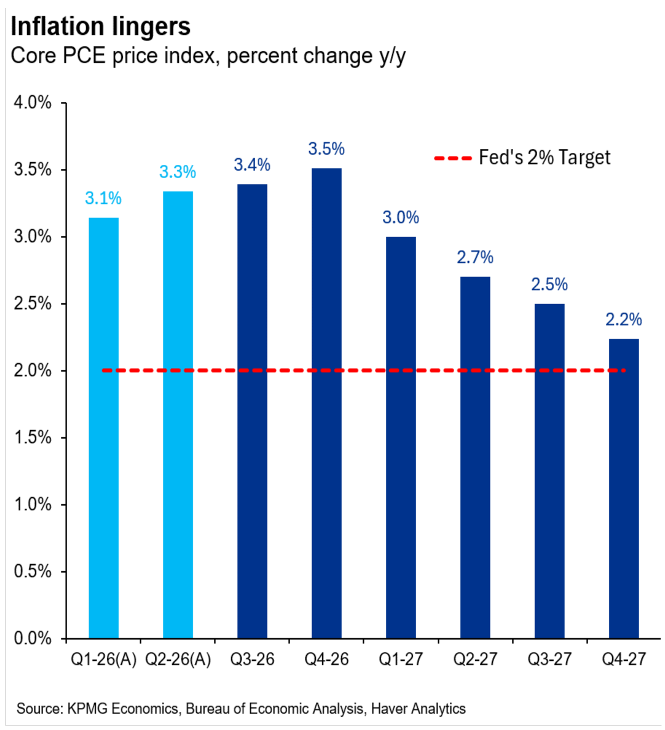
Inequality keeps demand more resilient than sentiment suggests as long as wealth keeps rising. Spending gains from wealth effects, AI and defense are supporting overall demand, though prices remain too high for too many.

That resilience matters because the pressure points are broad. Tariffs, energy risk, shipping frictions and AI and defense demand all keep pressure on costs.

More tariffs are coming. Inputs into semiconductors are being tariffed for national security reasons, which will lift the costs associated with data center construction and in the manufacturing sector more broadly.

Separately, the bill in Congress to further sanction Russia includes up to 100% tariffs on countries that import Russian oil and natural gas. Those will be at the discretion of the president.

Chart 3



The United States Mexico and Canada Trade Agreement is up for review. The administration would like to tighten content rules, which allow about 90% of trade to traverse the borders tariff free. The stakes are high as they are looking for 50% of the 75% North American content to be US content.

That would be costly. The auto sector is exposed. Parts traverse the borders multiple times before a finished vehicle rolls off the assembly line. That makes content tracing a logistical nightmare.

Goods prices have escape valves: inventories, sourcing shifts, discounts and substitution. Some big-box discounters have even announced price cuts over the summer, especially on food to lure low-income buyers back. It is unclear how long they can absorb higher costs.

Margin compression can delay price hikes, but it cannot erase them. Once margins are squeezed far enough, firms either pass costs through, reduce investment or cut workers.

Services have fewer buffers. A care visit, a restaurant meal, a hotel stay or a construction project still need workers in the moment. That is why services inflation is slower to break. Changes in immigration policy will cause pockets of labor shortages, notably in food prep, elder care and construction.

Wages cooled in July, but largely because benefits costs are rising. Those costs are buoying service sector inflation.

Immigration cuts both ways for inflation. Fewer workers can lift wage pressure in some sectors. Fewer consumers can weaken spending in others. One shock pushes the inflation dial in two directions.

Energy is the swing risk. The Strait of Hormuz will likely reopen, but that does not preclude price spikes. China has absorbed some of the shock by drawing down inventories, but that safety valve is finite. If stockpiles fall too far, restocking could push oil prices higher.

This is not the 1970s, but it rhymes: inflation is lingering even as the labor market weakens.

The current inflation is not a one-time shock the Fed can look through; it is tariff pass-through, energy risk, immigration frictions and AI and defense demand layered on top of five years of above-target inflation.

That is the muscle memory the Fed fears. Repeated shocks can train firms to pass costs through faster and consumers to expect higher prices. Inflation becomes easier to restart and harder to stop.

That shifts the question for the Fed. If growth is cushioned at the top while inflation lingers underneath, the question is less whether to hike rates than when financial markets force the Fed's hand.

The takeaway is simple: the burden of proof lands on those arguing for patience.

Warsh's dilemma

Warsh's problem is not just where rates go next. It is who appears to be driving the decision. Concern about the labor market argues for patience. Inflation argues for vigilance. Politics make both look suspect.

If he holds, he must explain why inflation credibility is safe. If he hikes, he must show the move comes from his framework, not from politics or panic.

That is the prince-or-prisoner dilemma. A prince shapes the debate and owns the decision. A prisoner waits for hawks, markets or politics to force his hand.

Warsh wants a quieter Fed: less forward guidance, fewer market handholds and a smaller communications footprint. That may sound disciplined, but it raises the stakes. A quieter Fed needs a clearer reaction function, not a blurrier one.

He has floated the idea of reducing the number of meetings. The last time that occured was in 1981 when former Chairman Paul Volcker formalized an eight meeting per year schedule. The downside is such a move would leave a void for markets to second guess the Fed, which would add to an already volatile policy environment.

Risks: If productivity has moved the neutral point higher, monetary policy is less restrictive than it looks. Those shifts coupled with the persistence of inflation raise the risk that the Fed repeats the mistakes of the 1970s and the financial markets start to override the chairman with higher long-term rates.

Fed hikes with caution

The Fed is not on a simple path. The labor market is cooling, but not enough to make the hawks stand down. Inflation is easing, but not enough to give Warsh cover.

A hold is possible if inflation softens and labor market weakens again. A hike is more likely if prices stay hot, survey inflation remains elevated or long yields keep signaling doubts about Fed credibility. The question is less whether the Fed can justify a hike than whether Warsh can justify waiting.

If AI is lifting productivity, policy may be less restrictive than it looks. That is not an automatic case for cuts. It is another reason rates may be too low.

Our base case remains two hikes before year-end. Financial markets are pricing in a coin flip on the next meeting.

Risks: If the Fed waits to long it risks validating above target inflation and a higher term premium in long-term bond yields. Hike too sharply, and it turns a cooling labor market into a weaker one and undermines equity market gains.

A Jackson Hole reset?

Reporting on the new chairman reveals he is looking to reset expectations at the Jackson Hole Symposium. The stakes have gone up amid intense political pressure to cut.

He need not say a lot. Former Fed Chairman Jay Powell faced a similar situation at the event in 2022, when the Fed found itself behind the curve on post-pandemic inflation. His speech was barely eight minutes, but it landed with force. Warsh needs his own version: less philosophy, more resolve:

- **Defend Fed independence, calmly and clearly.** No fight. No drama. Just a clear defense of the institution and its process.
- **Reaffirm the 2% target.** The inflation target still has to bind. Markets need to hear that the Fed is not redefining success because the last mile is hard.
- **Do not move the goalposts.** Changing the inflation yardstick now would look like declaring victory early.
- **Name the reaction function.** Markets need to know what would make the Fed hike, hold or cut, even if Warsh rejects month-to-month data dependence. If inflation stays elevated, the next move stays live.

A reset only works if markets know what would make the Fed act. Rejecting data dependence does not mean markets stop reacting to data. If markets do not know the Fed's rule, they will write their own with the level of bond yields as a guide.

Risks: If Warsh fails to demonstrate the Fed's commitment to containing inflation and defending its independence, the bond market could punish him by pushing yields higher.

Treasury market plays judge

Chart 4 shows pressure building at the long end; yields are already above where they were when the Fed started cutting in late 2024. The upward pressure on yields is expected to worsen before it eases in late 2027. The 10-year is expected to top 5% for the first time in more than twenty-five years over the next six months. It does not come down until well into 2027.

The warning is already visible. After the July Federal Open Markets Committee (FOMC) meeting, short rates fell while long yields rose. Markets were not cheering easier policy. They were charging more for inflation risk, escalating federal deficits and debt, and doubts about Fed credibility.

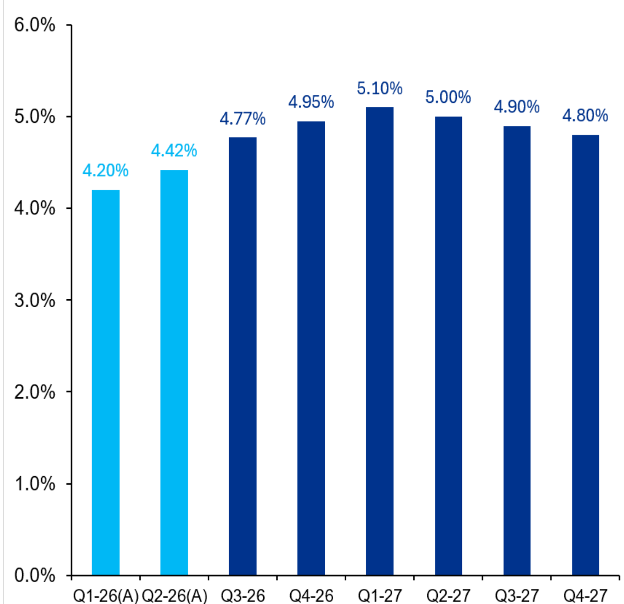
That raises the stakes for Warsh. He has to prove the Fed is fighting inflation, not financing the deficit. If investors see fiscal dominance, long yields rise.

The fiscal backdrop gives him little room to maneuver. Defense spending, aging-related outlays and rising interest costs drive increased federal borrowing.

Chart 4

Long-term bond yields cross 5%

10-year Treasury note yield, quarter average



Source: KPMG Economics, Federal Reserve Board

The Treasury Secretary has leaned more on short-term issuance to take pressure off the long end of the market, but that only shifts the risk. Rates will reset faster and at a higher level.

Risks: A rate hike may not pull long yields lower. Heavy issuance tied to widening federal deficits, inflation uncertainty and doubts about Fed independence can keep the term premium elevated. The Fed may still achieve tighter financial conditions, but with less control over where the pain lands.

Bottom Line

I have never seen anything like we are currently enduring; neither has the Fed. Jobs are being shed, while unemployment is falling and inflation is still too high. Productivity growth has accelerated but most of the boost due to AI is still ahead of us. That may mean the current fed funds rate may be too low to contain the current bout of inflation.

The duration of inflation alone has dented the Fed's credibility. The political environment threatens Warsh's as well.

Jackson Hole is his chance to reset the narrative before the bond market does it for him. He has to show that the Fed can still say no, that policy is being made for the long-term stability of the economy. If he leads with clarity, he can steady the institution, anchor the long end of the yield curve and preserve the expansion.

The crown comes with a choice: prince or prisoner. The risks are real, but so is the opportunity. A credible Fed can still contain inflation without surrendering the expansion; that would give households their best chance to regain the ground lost to inflation.

Be kind; pay it forward.

Economic Forecast — August 2026

	2025(A)	2026	2027	2026:1(A)	2026:2(A)	2026:3	2026:4	2027:1	2027:2	2027:3	2027:4
National Outlook											
Chain Weight GDP1	2.1	2.0	2.1	2.1	1.5	2.2	1.5	2.2	2.5	2.5	2.4
Personal Consumption	2.6	2.0	2.1	0.5	3.2	2.1	1.5	2.1	2.1	2.2	2.3
Business Fixed Investment	4.1	6.2	3.6	10.6	8.4	3.9	3.8	3.4	3.3	2.7	2.2
Residential Investment	-2.2	-3.8	0.8	-7.8	1.5	-3.1	-2.6	0.8	2.1	5.0	6.2
Inventory Investment (bil $ '17)	29	-26	66	-17	-51	-23	-12	19	59	84	104
Net Exports (bil $ '17)	-1091	-1084	-1210	-1002	-1075	-1111	-1148	-1183	-1205	-1220	-1232
Exports	1.6	3.5	2.4	10.9	4.5	-4.6	2.9	4.1	2.5	3.4	3.6
Imports	2.7	2.3	5.0	11.8	11.5	0.4	6.0	6.7	4.0	3.9	3.7
Government Expenditures	1.1	0.5	1.1	4.4	-0.8	2.3	1.8	1.1	0.5	1.1	0.7
Federal	-1.2	-1.0	2.5	9.4	-4.1	5.2	4.7	2.7	1.0	2.4	1.3
State and Local	2.5	1.4	0.4	1.6	1.1	0.7	0.2	0.3	0.3	0.3	0.3
Final Sales	2.2	2.2	1.7	1.9	2.2	1.7	1.3	1.6	1.8	2.1	2.1
Inflation											
GDP Deflator	2.8	3.8	2.7	3.6	6.2	1.5	3.8	2.3	2.4	2.2	2.2
CPI	2.7	3.2	2.4	3.6	6.1	0.0	3.5	2.5	2.0	2.1	1.6
Core CPI	2.9	2.6	2.6	2.8	2.9	2.2	3.0	2.6	2.5	2.5	2.4
Special Indicators											
Corporate Profits2	7.3	16.3	5.7	7.0	38.9	2.4	5.4	3.9	4.5	2.8	1.7
Disposable Personal Income	1.7	0.3	3.1	0.9	-1.5	1.8	1.6	4.1	4.2	4.5	4.3
Housing Starts (mil)	1.36	1.34	1.33	1.42	1.35	1.31	1.31	1.30	1.31	1.34	1.36
Civilian Unemployment Rate	4.3	4.3	4.3	4.3	4.3	4.2	4.3	4.3	4.3	4.3	4.2
Total Nonfarm Payrolls (thous)3	745	495	469	130	344	192	86	29	87	140	234
Vehicle Sales											
Automobile Sales (mil)	2.7	2.7	3.0	2.5	2.7	2.7	2.8	2.8	3.0	3.1	3.1
Domestic	1.8	1.8	2.0	1.7	1.8	1.8	1.9	1.9	2.0	2.1	2.1
Imports	0.9	0.9	1.0	0.9	0.9	0.9	0.9	0.9	1.0	1.0	1.0
LtTrucks (mil)	13.5	13.5	13.6	12.9	13.7	13.6	13.6	13.6	13.6	13.6	13.6
Domestic	10.8	10.6	10.7	10.3	10.8	10.7	10.7	10.7	10.7	10.7	10.7
Imports	2.7	2.8	2.9	2.6	2.9	2.9	2.9	2.9	2.9	2.9	2.9
Combined Auto/Lt Truck	16.2	16.1	16.6	15.5	16.4	16.3	16.4	16.5	16.6	16.7	16.7
Heavy Truck Sales	0.4	0.4	0.5	0.4	0.4	0.5	0.5	0.5	0.5	0.5	0.5
Total Vehicles (mil)	16.6	16.6	17.1	15.9	16.8	16.8	16.9	16.9	17.0	17.2	17.2
Interest Rate/Yields											
Federal Funds	4.2	3.7	4.0	3.6	3.6	3.7	3.9	4.1	4.1	4.1	3.8
10 Year Treasury Note	4.3	4.6	5.0	4.2	4.4	4.8	5.0	5.1	5.0	4.9	4.8
Corporate Bond BAA	6.1	6.4	6.9	6.1	6.2	6.5	6.8	7.0	7.0	6.9	6.9
Exchange Rates											
Dollar/Euro	1.13	1.16	1.18	1.17	1.16	1.15	1.16	1.17	1.18	1.18	1.18
Yen/Dollar	149.6	158.3	151.3	156.8	159.4	158.0	157.0	155.0	153.0	150.0	147.0

[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.

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.