KPMG Economics

The two faces of the economy
Can we break out of jobless growth?

Diane C. Swonk, Chief Economist
KPMG US
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The Roman god Janus, for whom the month of January is named, has two faces: one looks forward to the future while the other looks back toward the past. Janus was the most important of Roman deities, symbolizing both beginnings and endings.

The imagery of two faces, looking in opposite directions, resonated as I gathered my thoughts on the economic outlook. Tariffs, curbs on immigration and the recent escalation in geopolitical tensions harken to the past, while AI and how it might upend current business models could determine the future.

The AI boom and the wealth it has generated have powered the overall economy forward but failed to deliver on other investments and job gains. Firms held back on hiring and shed jobs as uncertainty spiked, amidst shifts to trade and immigration policy.

Inequality intensified with the fate of the economy concentrated in fewer firms and households. Recent work by the Dallas Federal Reserve Bank suggests that the top 20% of earners accounted for a record-breaking 57% of consumer spending through the first half of 2025. The bottom 80% struggled to make ends meet.

Employment slowed to the weakest pace since 2020. It was the second worst year for job gains since the global financial crisis in 2009; we expect it to be revised lower.

Consumers are not pleased. Consumer confidence dropped to recession levels again in December. Concern about both inflation and the labor market moved up in tandem for the first time since the 1970s. Inflation is a regressive tax; it hits low- and middle-income households the hardest.

Even the Federal Reserve was flummoxed. It cut interest rates for the third time in as many meetings in December. The vote was contentious.

A jobless boom

Real GDP rose at a 4.3% annualized pace in the third quarter of 2025, making it the strongest single quarter in two years. Consumer spending accelerated, buoyed by a surge in spending on healthcare, which rose at the fastest pace since the height of the Omicron wave in 2022. Housing activity has continued to contract, business investment has moderated and inventories have been drained. Government spending rebounded when appropriations for fiscal 2025 were finally passed in July; that compressed much of the spending for the fiscal year into the third quarter.

The trade deficit narrowed sharply. Additional tariffs in August and September took a toll on imports, while exports picked up. Global trade has remained remarkably resilient through the ups and downs of tariffs. Most countries have resisted the temptation to retaliate. Supply chains rapidly adapted with producers shifting to lower tariff countries in Asia as opposed to reshoring. Mexico benefitted as well. Manufacturing continued to shed jobs during the year, which points to little reshoring.

Preliminary data suggest that growth remained resilient in the fourth quarter despite losses due to the government shutdown. Real GDP is forecast to rise at a 3.4% annualized pace. Those gains occurred des pite a sharp slowdown in employment during the second half of the year. We generated only 79,000 jobs in the fourth quarter, less than one-fifth the pace of a year earlier. Part-time jobs expanded as a share of the total, along with multiple job holders.

Fed pauses. The Federal Reserve has made clear that it will pause rate cuts, at least in January. Officials are waiting to get a better read on the economy due to lapses in the data during the government shutdown; they are still struggling. Inflation is rising in response to shifts in trade and immigration policy, while those same shifts are boosting unemployment.

The Fed needs to see the dust settle on data disruptions due to the government shutdown before cutting again. We now expect only three rate cuts in 2026, starting in June.

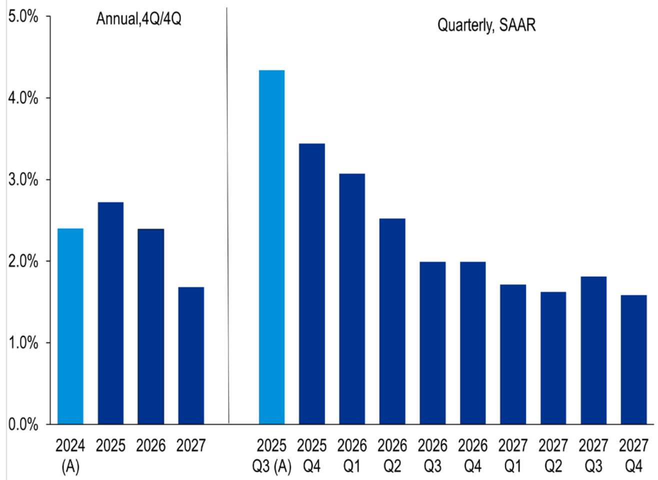
This edition of *Economic Compass* takes a closer look at the outlook for 2026, paying special attention to the weakness in the labor market, what is causing it and the outlook for inflation. The economy enters the year with a tailwind, but those gains will not ease the tension between inflation and unemployment.

Bond markets have grown skittish; investors are not buying what the Fed is selling. Bond yields have moved up since the Fed resumed its cutting cycle. That is worrisome on many levels, including the backdrop of escalating geopolitical tensions. Gold has regained its luster as a safe haven at the expense of US Treasuries.

NOTE: The forecast assumes that the Fed retains its relative independence and does not overstimulate. Historically, such moves have added to inflation, pushed up bond yields and undermined the credit-worthiness of the countries that pursued such policies.

Chart 1

Growth is front-loaded
Real GDP growth, %



Source: KPMG Economics, Bureau of Economic Analysis

Front-loaded gains

Chart 1 shows the outlook for 2026. Annual gains are measured on a fourth-quarter-to-fourth-quarter basis instead of annual averages, a better measure of economic momentum. Real GDP growth is expected to accelerate in the Spring. Gains will briefly be more evenly distributed across income strata:

- The bulk of the catch-up after the government shutdown is still ahead of us. Federal workers were paid in arrears but contractors and the communities they rely upon were not. Temporary layoffs associated with the shutdown are abating.
- Expansions to tax cuts in 2025 will show up as lower withholdings and larger tax refunds in early 2026. Consumers treat refunds like windfall gains; much will be spent.
- A bump in the minimum wage across 19 states will provide a boost to an estimated 8.3 million low-wage workers at the start of the year.

Those gains could borrow from growth later in the year; then we will be back to relying on AI investments and the wealth they generate to carry the economy forward. The backlog of investments in data centers is large, but less than we saw at the start of 2025.

The wildcard is speculators, who are using debt to finance data center construction. That poses the risk of turbocharging those investments, but hurdles are emerging. The chips needed to run AI models are in limited supply, while the energy grid is stressed.

Risks: Reliance on AI has left us more vulnerable to stock market corrections. Geopolitical tensions have flared, which could boost defense spending.The president has asked for a 50% increase in the defense budget. Congress would need to sign off.

Broader based, but still tepid employment

A perfect storm took a toll on employment in 2025:

- Uncertainty soared as tariff announcements accelerated, which caused firms to delay major investment decisions. That included hiring decisions.
- The premium for job hoppers evaporated as quit rates plummeted. That forced firms to enact hiring freezes, even as overall layoffs remained subdued.
- Tariffs compressed profit margins, especially in the most tariff-exposed sectors. Manufacturing alone shed 72,000 jobs between May and December.
- A drop in foreign-born workers limited hiring in immigrant-dependent sectors: the care economy, construction, leisure and hospitality and agriculture.

Those losses had spillover effects. The economic research shows that foreign- and native-born workers function more as compliments instead of substitutes for each other. The loss of immigrant workers takes a toll on entire ecosystems – native-born unemployment rose in areas where deportations were the largest in the 2010s.

Evidence exists that AI added to that weakness, although it gets more credit than it deserves. Research on AI and its toll on employment used the introduction of the first large language model in 2022 as its anchor. That year the market cap of the major tech firms dropped, which prompted layoffs.

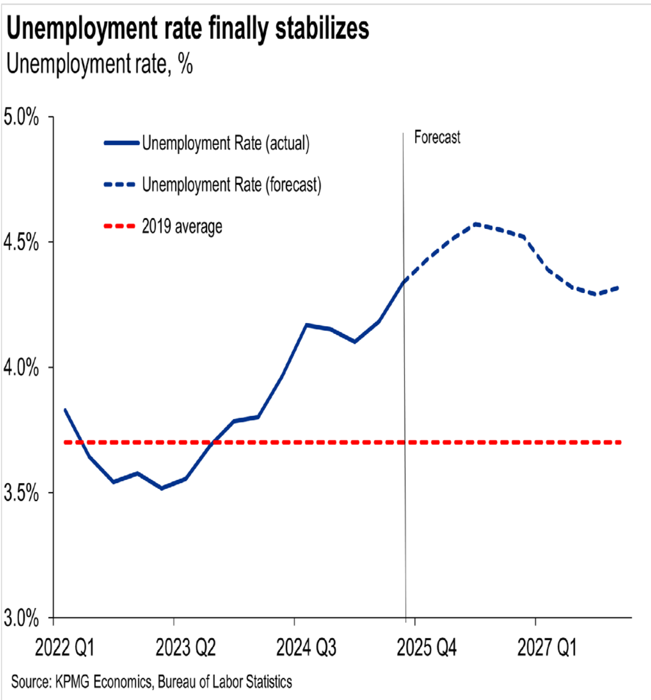
Younger workers were more affected than experienced workers as employment faltered. They are the most vulnerable as getting a job is easier if you have one. Newly minted computer programmers and accountants were hit hardest. Experienced workers benefitted.

That begs the question, who are we training to eventually replace them? What skills will be needed as business models shift and new industries emerge?

Many firms cited AI as a reason to implement hiring freezes, cautious about how AI might alter their hiring strategies. AI was a less politically charged excuse than the margin compression due to tariffs or offshoring.

Separately, employment gains became more concentrated and dependent upon one sector. What little we saw in employment gains since May were concentrated in one sector- healthcare and social assistance.

Chart 2



Preliminary census data suggest that revisions to employment in 2025 will be to the downside. The Bureau of Labor Statistics (BLS) has difficulty catching inflection points, especially among small businesses. The data on firm births and deaths is lagged, which means the impact on hiring shows up in revisions.

Measures of uncertainty have come off their peaks but remain elevated. That should alleviate the hesitation to hire, along with clarity on where tariffs will be. Waivers have picked up. The tech firms were awarded the most waivers to fuel what has become an arms race with China in AI and quantum computing.

Add a little fiscal stimulus and the catch-up following the government shutdown, and employment should firm a bit in 2026. Those gains should be enough to stabilize the unemployment rate in the 4.5% range, before its tapers in 2027. (See Chart 2.)

The break-even level of jobs needed to hold the unemployment rate steady has dropped over the last year. Curbs on immigration and rising retirements have diminished the supply of workers who need to find jobs. That is little solace for new grads.

Risks: A surge in layoffs could cause a more consequential rise in unemployment, while a freezing of federal childcare funding poses new risks. Many childcare facilities rely on those funds and will close if the funds are allowed to lapse.

The collateral damage to working parents will be greatest. Our own research reveals that childcare disruptions have risen over 20% since before the pandemic.

Inflation lingers

Chart 3 shows our forecast for the core personal consumption expenditures (PCE) index, which the Fed favors. The core measure strips out food and energy prices: the Fed has less influence over those prices. PCE now peaks at 2.7%, 0.4% lower than a month ago. It will linger close to that level for much of the year.

Part of that slowdown is due to data lost to the government shutdown. The BLS zeroed out much of the inflation for October, including shelter costs. That was consequential and not likely to be corrected fully until April. The data for November were compressed into the last two weeks of the year, which were dominated by Black Friday promotions.

Tariffs are expected to peak in the first quarter. The administration will quickly reinstate any tariffs ruled illegal by the Supreme Court; it has many levels to pull.

Many firms held off raising prices until the dust on tariffs settled. That is why more of the initial effects of tariffs showed up as a blow to employment. We have hit a tipping point: January is a time of year when firms tend to reset their prices.

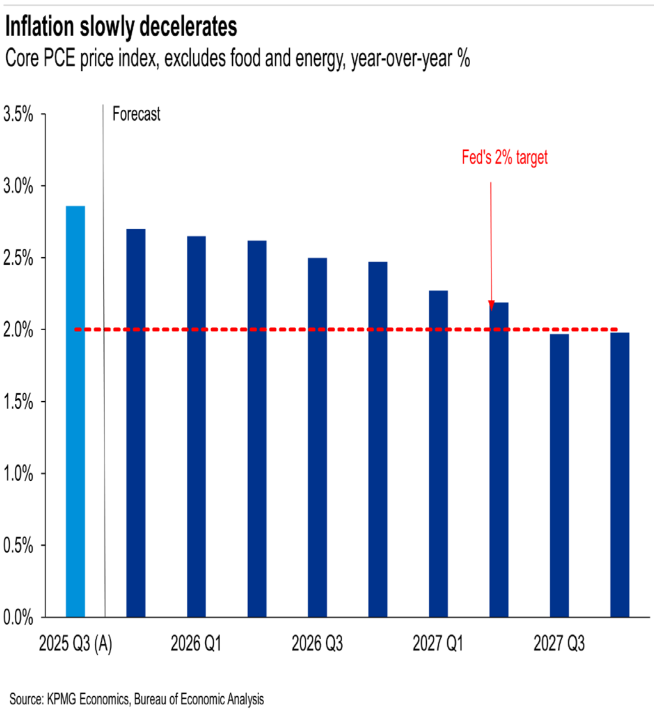
Another problem: curbs to immigration are pushing up prices in the service sector. Construction costs, childcare and in-home elder care have seen some of the largest increases. Staff at hotels have been hit as well; many have scaled back housekeeping services.

Healthcare insurance is rising at the fastest pace in 15 years. Aging demographics, the rise in costly GLP-1 drugs, tariffs, curbs on immigration and a lack of competition in the Affordable Care Act (ACA) marketplaces are all contributing to those increases.

Congress is looking for ways to extend a good portion of the subsidies for the ACA. That would still leave premiums up more than 20% from a year ago; many have doubled.

Those shifts will force many to either drop or scale back on their healthcare coverage. The result will show up in more emergency room visits, which further boosts costs.

Chart 3



Productivity gains in response to AI could alleviate pricing pressures, but much is still concentrated in a few large firms. In the interim, the AI boom is adding to inflation. Data centers are stressing the energy grid and boosting energy costs.

Fiscal stimulus at the start of the year is another factor; it could make inflation stick.

The offset is lower shelter costs, which are cooling after soaring in the aftermath of the pandemic. They play an outsize role in the calculation of both the consumer price index and the PCE. The price of gasoline has moderated and will likely fall.

Risks: Work by the St. Louis Federal Reserve revealed that consumer inflation expectations may be becoming unmoored. We tend to get the inflation we expect, and consumers are still expecting a lot more than they did a year ago. A surge in defense spending would add fuel to an already kindled fire.

The Fed splinters

Chart 4 shows the forecast for rate cuts in 2026. The Fed is expected to pause at its meeting in January. Governor Stephan Miran is expected to cast his last dissent for a one-half percent cut, before returning to the White House.

Three additional cuts are expected this year, starting in June. That would bring the Fed's target rate to a 2.75% - 3.0% range, which is considered neutral. That is the lowest rate since September 2022.

Hawks worry that inflation is becoming normalized and could become sticky. Doves counter that recent weakness in the labor market risks spiraling, while inflation due to tariffs should resolve itself.

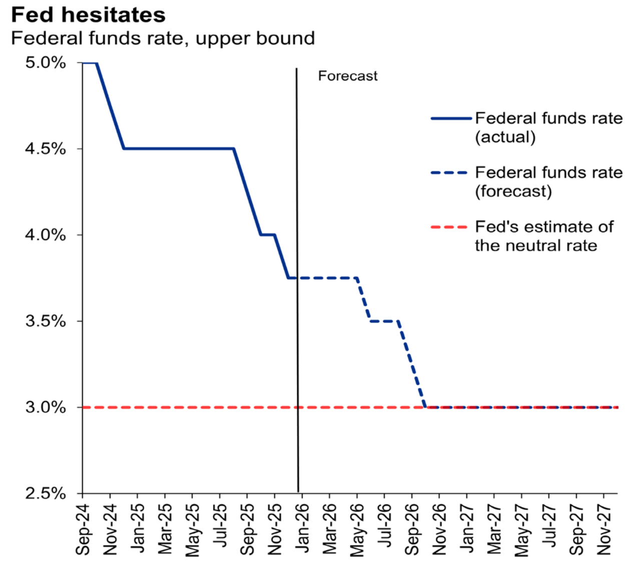
The president is expected to name Fed Chairman Jay Powell's successor soon. Powell has not said whether he intends to stay on as a governor after his role as chairman lapses.

Powell's board role lasts till January 2028. The move would be unusual but not unprecedented. Much depends on whether financial markets trust his successor will not overstimulate.

History is unkind to central banks which have bent to the desire of politicians; the seminal economic research spans decades. A prolonged bout of post-pandemic inflation has dented the Fed's inflation-fighting credibility.

The regional Fed presidents are poised to push back against aggressive cuts, barring a crisis. That could leave the Fed split on how fast and how aggressively it cuts rates.

Chart 4



Source: KPMG Economics, Federal Open Market Committee

Risks: Either inflation needs to cool more rapidly or layoffs need to spike to get the Fed to move rapidly on rate cuts. Otherwise caution is warranted.

Productivity growth accelerated at the fastest pace in two years over the summer. That has many hoping that productivity growth will ameliorate inflation. However, a more sustained increase in productivity would raise instead of lower short-term interest rates; it allows the economy to grow more rapidly without stoking inflation.

Bond markets balk

We have been arguing for some time that the bond market is not likely to respond to rate cuts as much as it has in the past. That is now a reality.

We expect the spread between short- and long-term bond yields to widen even as the Fed resumes cuts mid-year. That puts our forecast for the 10-year Treasury bond yield at 3.9% at year-end.

The spread between investment grade debt and that which is riskier is narrow. That spread could widen, especially if more firms issue debt to finance data center construction.

Financial markets are beginning to question how AI will generate profits. Investors have begun to question returns in the private debt market as well, which has led to more redemptions. That is poised to accelerate in 2026, especially if rates fail to fall dramatically.

Separately, federal debt outstanding is poised to eclipse the economy in size for the first time since WWII in 2026. Expansions to tax cuts and upward pressure on spending via Social Security and Medicare will intensify.

We have entered the peak years for baby boomers turning 65 and tapping those resources. Many have claimed their Social Security benefits early this year for fear of losing benefits later.

The Congressional Budget Office just updated its population projections. They were reduced with the loss in immigration, which brings us closer to the Social Security cliff. That is when those paying into Social Security can no longer cover those collecting benefits. Previous estimates expected that to occur in fiscal 2034, now it is in 2030.

On net, the bond market will have to absorb even more debt in the year to come. Investors are now requiring more compensation to do that.

Risks: If the Fed fails to tame inflation, or its independence is viewed as compromised, then long-term rates could spike. We have been given a pass on issuing a lot more debt without compensating investors. That era may be a remnant of the past.

Bottom Line

Like Janus, we enter 2026 looking in two directions at once. One face sees the promise of AI and the stock market returns it is generating. The other sees a labor market that is frozen and a prosperity that feels increasingly out of reach.

The decisions we make today – who shares in prosperity, how we manage the technological transition, and whether we can bridge our divides – will determine whether the economy's two faces can finally look in the same direction.

The goal is to create a shared future, in which more of us can participate. I wish I could say with certitude that is the next phase for the economy. Sadly, I fear the gains we feel as refunds hit our bank accounts will be short-lived.

I will end with the words of one of my children. He penned a letter for me to open in his absence this holiday season. It said, "You taught me to love all the people of this world and make it a better place…I love you more than the universe and forever and a day."

Ring in the New Year with humility. Our kids are keeping score. Be kind; pay it forward.

Economic Forecast — January 2026

	2025	2026	2027	2025:3(A)	2025:4	2026:1	2026:2	2026:3	2026:4	2027:1	2027:2	2027:3
National Outlook												
Chain Weight GDP[1]	2.3	3.0	1.8	4.3	3.4	3.1	2.5	2.0	2.0	1.7	1.6	1.8
Personal Consumption	2.7	2.8	1.8	3.5	2.8	3.1	2.9	1.8	1.7	1.6	1.6	1.8
Business Fixed Investment	4.0	2.5	2.4	2.8	1.4	1.2	2.9	3.1	3.0	2.3	1.9	1.7
Residential Investment	-2.3	-1.6	2.6	-5.1	-7.2	0.3	1.2	2.4	3.6	-1.5	2.3	9.1
Inventory Investment (bil $ '17)	34	42	77	-30	12	37	39	42	48	64	77	82
Net Exports (bil $ '17)	-1077	-938	-945	-957	-913	-930	-945	-942	-936	-936	-941	-947
Exports	2.1	4.8	4.4	8.8	6.1	3.6	4.6	5.1	4.8	4.2	4.1	4.1
Imports	2.7	-0.3	3.5	-4.7	-0.4	4.6	5.1	3.5	2.9	3.1	3.6	3.7
Government Expenditures	1.6	1.7	0.3	2.2	1.2	3.3	1.2	0.8	0.4	0.3	0.1	-0.1
Federal	0.1	2.9	0.4	2.9	1.5	7.9	2.3	1.6	0.5	0.4	0.0	-0.5
State and Local	2.5	0.9	0.3	1.8	1.0	0.6	0.5	0.3	0.3	0.2	0.2	0.2
Final Sales	2.4	3.0	1.7	4.6	2.7	2.6	2.5	1.9	1.9	1.5	1.4	1.7
Inflation												
GDP Deflator	2.8	2.5	2.2	3.8	3.2	2.1	2.0	2.4	2.2	2.3	2.4	1.4
CPI	2.7	2.3	2.4	3.1	2.1	1.8	2.1	3.0	2.3	2.5	2.7	1.9
Core CPI	2.9	2.5	2.3	3.3	1.8	2.6	2.7	2.6	2.2	2.5	2.4	1.7
Special Indicators												
Corporate Profits[2]	6.9	6.9	-0.9	9.1	8.5	10.1	10.4	6.3	1.2	0.4	-0.6	-1.7
Disposable Personal Income	1.7	4.1	3.2	0.0	2.2	8.2	4.5	3.6	3.7	2.8	3.0	3.0
Housing Starts (mil)	1.34	1.31	1.33	1.33	1.29	1.30	1.30	1.31	1.32	1.23	1.35	1.36
Civilian Unemployment Rate	4.3	4.5	4.3	4.3	4.4	4.5	4.6	4.6	4.5	4.4	4.3	4.3
Total Nonfarm Payrolls (thous)[3]	1446	487	557	88	-36	152	182	162	121	163	182	51
Vehicle Sales												
Automobile Sales (mil)	2.7	2.7	2.9	2.7	2.5	2.5	2.7	2.7	2.8	2.9	2.9	2.9
Domestic	1.8	1.8	1.9	1.8	1.7	1.7	1.8	1.8	1.9	1.9	1.9	1.9
Imports	0.9	0.9	1.0	0.9	0.8	0.8	0.9	0.9	0.9	1.0	1.0	1.0
LtTrucks (mil)	13.4	12.8	12.9	13.8	12.9	12.7	12.7	12.8	12.8	12.9	12.9	12.9
Domestic	10.7	10.2	10.3	11.2	10.4	10.2	10.2	10.2	10.2	10.3	10.3	10.3
Imports	2.7	2.6	2.6	2.6	2.5	2.5	2.5	2.6	2.6	2.6	2.6	2.6
Combined Auto/Lt Truck	16.1	15.4	15.8	16.4	15.4	15.2	15.4	15.5	15.6	15.8	15.8	15.8
Heavy Truck Sales	0.4	0.5	0.5	0.4	0.3	0.4	0.4	0.5	0.5	0.5	0.5	0.5
Total Vehicles (mil)	16.5	15.9	16.3	16.9	15.8	15.6	15.8	16.0	16.1	16.3	16.3	16.3
Interest Rate/Yields												
Federal Funds	4.2	3.4	2.9	4.3	3.9	3.6	3.6	3.3	3.0	2.9	2.9	2.9
10 Year Treasury Note	4.4	4.0	3.8	4.3	4.2	4.1	4.0	3.9	3.8	3.8	3.8	3.8
Corporate Bond BAA	6.1	6.0	6.1	6.0	6.0	6.0	6.0	6.0	6.0	6.1	6.1	6.1
Exchange Rates												
Dollar/Euro	1.13	1.18	1.19	1.17	1.16	1.17	1.18	1.18	1.19	1.19	1.19	1.19
Yen/Dollar	149.6	151.4	144.0	147.5	154.1	155.0	152.5	150.0	148.0	146.0	144.0	142.0

[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.

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