Economic Compass

The donut economy

Growth holds, but the center hollows out

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"Things fall apart; the centre cannot hold."

- William Butler Yeats, *The Second Coming*

Irish poet William Butler Yeats wrote *The Second Coming* in 1919 when war, pandemic and political upheaval had weakened the old order before a new one had formed. The comparison is imperfect, but the sense of a rough transition resonates. The center is not collapsing. It is hollowing out.

Wars are redrawing alliances, tariffs are rerouting trade and countries are reducing their dependence on the US. The trade war with Canada could prove a tipping point, spurring additional retaliation or a larger break in the most highly integrated supply chain for the vehicle market in the world.

Those shifts are costly, constant and cumulating. Defense spending is adding to government spending and debt. Supply chains built for efficiency are being restructured for resilience.

AI has become another arms race, largely between the US and China. The data center buildout is lifting investment but straining local infrastructure and boosting costs and fomenting voter backlash.

The economy remains resilient, but gains are not widely felt. Inflation has been persistent and has compounded over time, pushing the level of prices too high for too many. The result is further eroding of trust in institutions, our political leaders and stoking political polarization at home and abroad.

Governments must finance those demands just as AI and other capital-intensive investments compete for savings. Those shifts and higher inflation are pushing long-term interest rates higher and crowding out investment elsewhere. Bond investors need compensation for lending long-term.

Growth continues its sawtooth pattern

Real GDP is poised to grow at a 3.1% pace in the third quarter, more than double the pace of the second quarter. Consumer spending remains solid, with vehicle sales hitting their strongest pace in over a year in August. Some of that reflects a desire to buy ahead of additional tariffs, the exact behavior the Fed is tasked to avert. Home buying and building remain in the doldrums, while investment in data centers continues to dominate business investment.

Inventories are rebuilding after shrinking in the second quarter. The drawdown in oil inventories was particularly dramatic. Government spending is getting a lift from defense outlays. The largest drag on growth is the trade deficit. Imports are outpacing exports, buoyed by the insatiable demand for inputs into data centers - chips, computers and equipment, many of which have tariff waivers.

Prospects for the fourth quarter are not as good. Real GDP is expected to slip to a 1.4% pace, on the heels of more moderate consumer spending gains in response to higher long-term interest rates. Home buying and building take another hit, while business investment takes a breather. Inventories are a plus, as they need further replenishing, while government should get an extra lift from defense outlays. The trade deficit continues to widen, as growth abroad suffers more from tariffs and the ongoing conflict in the Middle East.

NOTE: The AI buildout is unusually hard to track. Firms guard their plans, imported equipment counts against GDP and official data do not separate AI investment. The statistical agencies are aware. Methodology and revisions show up with a lag and will boost productivity growth and could alter what the Fed considers the neutral or noninflationary short-term rate. Hence, concerns within the Fed that current rates may be too low to contain inflation.

The Fed weighs rate hikes. The Federal Reserve is expected to raise short-term interest rates before year-end, despite intensifying political pressure to cut. Persistent service sector inflation amidst historically low unemployment will provide the rationale. Internal debate in the Fed suggests dissents are likely no matter which way it decides to move at upcoming meetings.

This edition of *Economic Compass* traces the chain from geopolitical fragmentation and recurring supply shocks to persistent inflation and higher interest rates. Bond markets are imposing discipline. We still expect the next move by the Fed to be up; the question is not whether to hike, but when and how much?

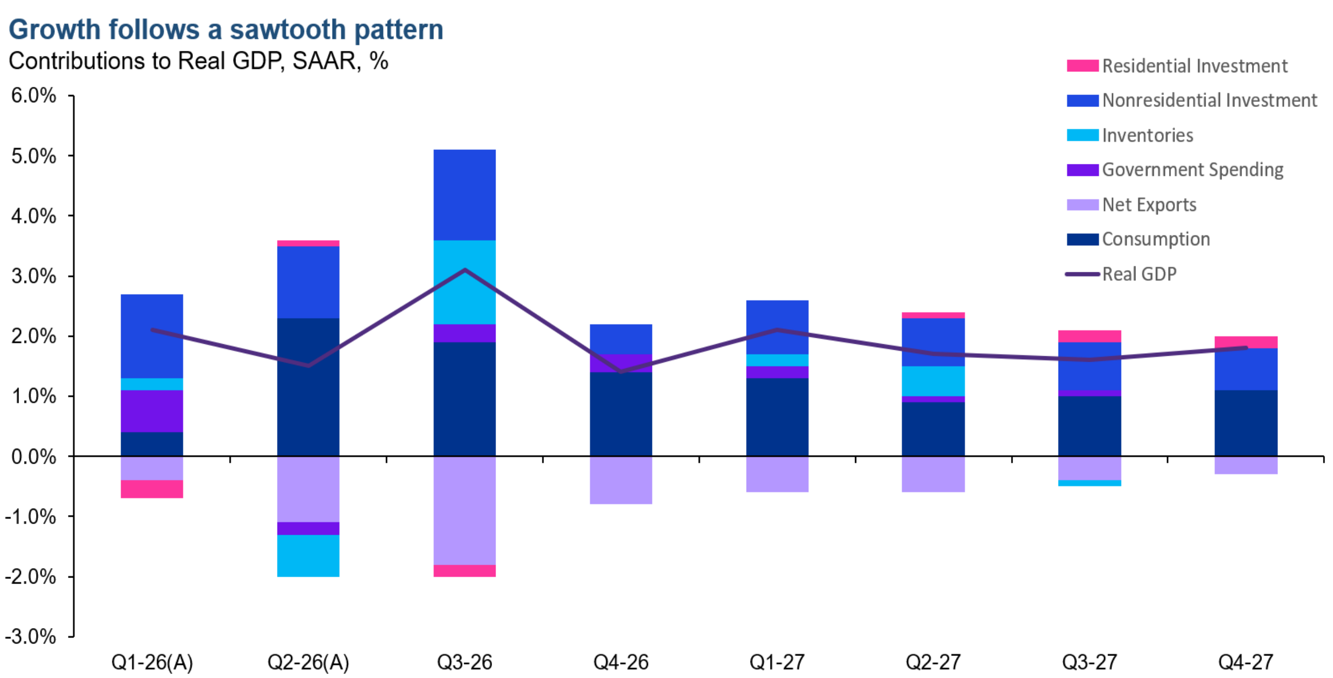
The outlook

Stronger but uneven gains

Chart 1 shows how each sector contributes to growth. Real GDP is forecast to match last year's 2% pace in 2026 and cool only slightly in 2027. The topline numbers look solid, but are not widely dispersed:

- **Consumer spending is accelerating,** helped by state and local tax cuts, stronger hiring and spending gains by affluent households. Low- and middle-income households have become more judicious in their spending. Lower gasoline prices should help in 2027, but momentum is expected to slow.
- **Housing has been in recession for roughly two years.** High financing and construction costs are deepening the downturn, while more sellers and builders cut prices. Substantial homeowner equity should limit the collateral damage seen during the subprime crisis.
- **Business investment remains dominated by AI.** The data center pipeline extends years, not quarters; official data undercount the buildout. Investment growth should moderate but remain robust. We are not at peak data center construction.
- **Inventories are poised to rebuild** after a boom-bust cycle driven by front-running of tariffs and fuel shocks. Oil stocks fell sharply with the conflict in the Middle East; those buffers need replenishing.
- **Government spending rebounds in the second half, then slows in 2027.** Defense outlays are expected to get a lift from the Middle East conflict. The fiscal 2027 budget is still up in the air - midterm elections could shift the composition, not the level of spending. State and local governments are struggling; data center tax revenues are helping but unevenly.
- **The trade deficit widens.** Higher energy prices and tariffs hamper growth abroad and are weakening export demand, while the AI boom has kept afloat imports. The trade war with Canada adds another threat by delaying investment and raising risks for highly integrated supply chains. The escalation comes as other countries weigh their responses to new tariffs and other barriers by the US.

Chart 1



Source: KPMG Economics, Bureau of Economic Analysis

Risks skew to the downside. Equity market gains have been buffeted by a surge in foreign demand betting on the AI boom. A correction would undermine spending among affluent households, who are carrying more of the spending than in the past.

Deficits are poised to widen, which could stimulate the economy but at a price: higher long-term interest rates. The debt crossing $40 trillion was as much a physical as psychological barrier, testing bond investors' tolerance for debt.

The conflict in the Middle East and war in Ukraine remain unresolved. That ups the risk of higher energy costs. Refining capacity is particularly constrained.

Gains are not resonating

Public frustration with this economy is increasingly visceral. Aggregate data continue to show solid gains, but many households see little resemblance between that data and their lives. Inequality is not new but has compounded in recent years. Most households are feeling left behind and shortchanged.

That shows up in consumer attitudes, which weakened further in August. Hopes for a better labor market were more than offset by worries about the future; inflation, gas prices and job security ranked high on the list of concerns.

Overall spending is holding up. Confidence is not. It has become less predictive of consumer spending over time.

Historically, households resist cuts in living standards for as long as they can. Affluent households draw support from market gains; others save less, borrow more or trade down to keep spending. That resilience can mask mounting strain. The headline holds up. The household experience does not.

The divide is measurable. CEOs at the largest US firms earned about 281 times the pay of a typical worker in 2024, up from 21 times in 1965.

The top 1% of earners now owns more than half of equities and mutual funds: a record. In comparison, the bottom half holds close to 1%. Growth may be holding, but its rewards are pooling at the top. The cushion for low- and middle-income households is eroding.

Comparisons with the Gilded Age are hard to dismiss. Wealth concentration is moving toward levels last seen at the turn of the twentieth century. Billionaire wealth is rising faster than the broader market. The widening gap is eroding trust in institutions and political leaders.

The revolutionary gap

Chart 2 tracks the widening split between profits and pay. Profits climb while labor loses ground. It becomes a "revolutionary gap" when workers conclude that the rules are written for someone else. Frustration then shifts from the economy to the institutions that govern it. The electorate rewards candidates who promise to break the system rather than repair it.

Inflation widens that gap. Affluent households can absorb higher prices; lower- and middle-income households have far less room to adjust.

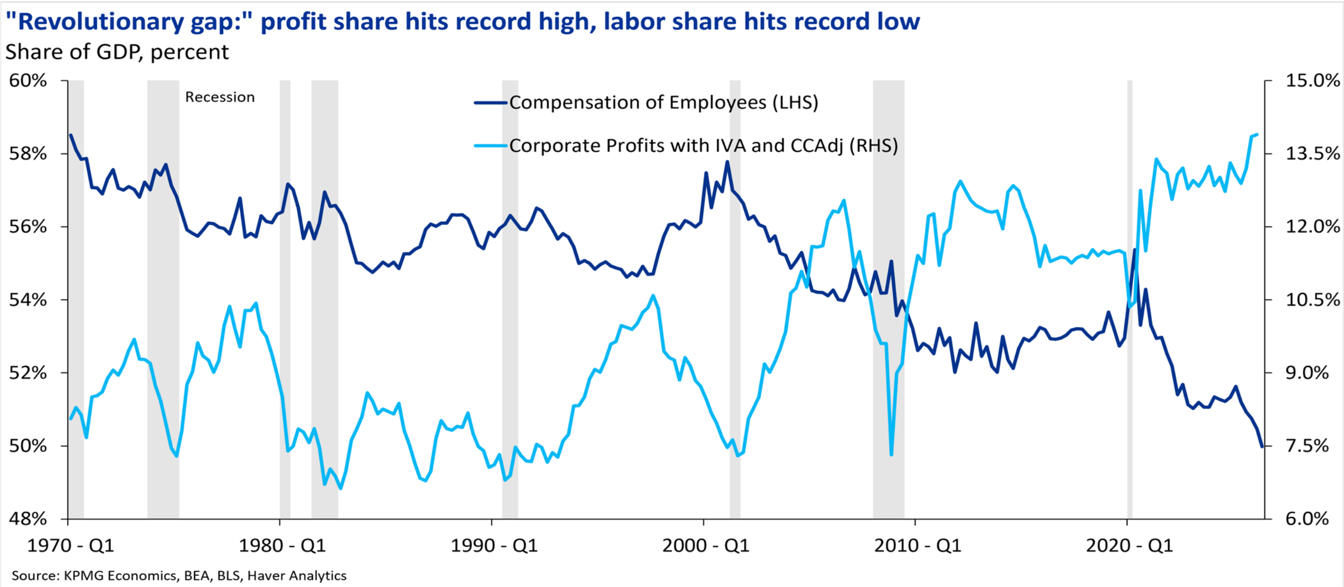
AI is arriving in an economy already divided. Workers doubt they will share in the gains. The backlash is crossing party lines and will show up on ballots in November.

Inflation lingers longer

Chart 3 shows the inflation forecast. The personal consumption expenditures (PCE) price index, the Fed's preferred inflation measure, does not return to the 2% target until late 2028. The forces keeping inflation elevated are:

- **Inflation creates muscle memory.** After more than five years above target, firms pass through costs faster, workers seek larger wage gains and households anticipate further increases. Inflation becomes self-reinforcing.
- **Services remain sticky.** Aging demographics are lifting demand for healthcare and other labor-intensive services, while affluent households sustain discretionary spending. The pressure is expected to intensify in 2027, with healthcare premiums poised to rise at a double-digit rate.
- **Price hikes are widespread.** The share of goods and services with inflation above 3% remains well above pre-pandemic norms. Broad increases are more difficult for the Fed to reverse than spikes in a few volatile categories.
- **Pipeline pressures are building.** The Institute for Supply Management's manufacturing and services price indices signaled broad and accelerating input costs. The services price index showed prices have been rising for nearly a decade; the manufacturing index clocked 23 consecutive months of increases.

Chart 2



- **Trade pressures persist.** [Minneapolis Fed research] finds that tariffs are still feeding into prices more than a year after they were first imposed. New duties on Canada could compound costs across integrated supply chains. Increased enforcement at the border is adding bureaucratic red tape. Sanctions on Iran are another potential pinch point.
- **Weather shocks have a long tail.** Drought, heat and floods damage harvests and disrupt shipping. Higher energy and fertilizer costs and El Niño-related crop losses can take months to pass. Don't forget we are entering peak hurricane season.
- **Diesel remains a pressure point.** Refining constraints and low inventories keep freight, farming and construction costs elevated. Record diesel prices and fuel surcharges are boosting shipping costs, while consolidation in the trucking market has reduced competition.

The offsets are real but limited. Oil prices are expected to ease once the Middle East shock fades, although a geopolitical risk premium should keep energy costs above prewar levels.

Some retailers are leveraging tariff refunds to offer targeted discounts. New tariffs could eat into those price cuts over time.

Some prices on homes are falling, but high homeowners association fees and escalating real estate taxes are offsetting those declines. Apartment rents are starting to firm again.

Risks skew higher. Geopolitical threats, additional tariffs and sticky services prices keep the balance tilted upward. The greater risk is the persistence of inflation.

The Fed is divided

One camp expects tariff and energy shocks to resolve themselves and worries about raising rates in a low-hire economy. The other sees inflation spreading and warns that any further delay could force a more aggressive rate hiking cycle.

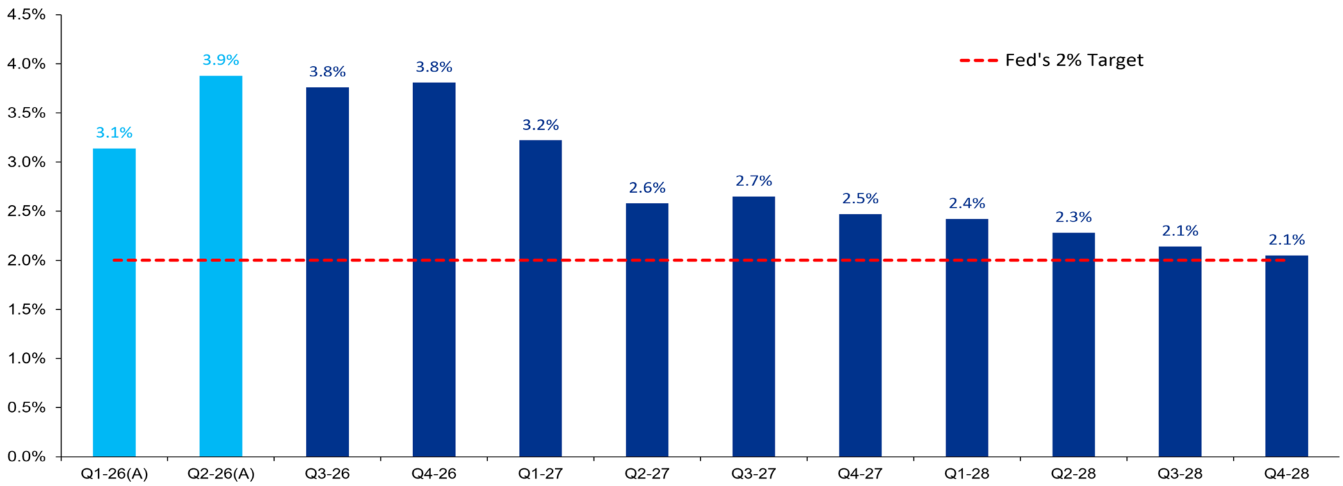
Fed Chairman Kevin Warsh used the Jackson Hole meeting to reset after a difficult July press conference. "Inflation must be moving clearly and quickly toward 2%," he said, or the Fed has more work to do.

Actions speak louder than words, but the committee is not singing from the same song book. Cleveland Fed President Beth Hammack says "...it's time to act." Governor Chris Waller would vote to hold if disinflation continues but would consider a hike if August inflation runs hot. New York Fed President John Williams remains in wait-and-see mode.

Chart 3

Inflation lingers

Headline PCE price index, percent change y/y



Source: KPMG Economics, Bureau of Economic Analysis, Haver Analytics

Data frames the debate, but may not settle it

The producer price index (PPI) arrives one day before the consumer price index and could run hotter as pipeline pressures build. Cooler PPI services and softer core inflation would support a decision to hold; broader acceleration would strengthen the case for a rate hike.

Either decision could draw dissent. Those favoring a hike fear inflation is becoming entrenched; those favoring a hold believe current rates are restrictive enough. Warsh is challenged to build consensus without letting disagreement undermine the Fed's credibility with markets.

We still expect 50 basis points in rate hikes before year-end. The longer the Fed waits, the more it may have to do later.

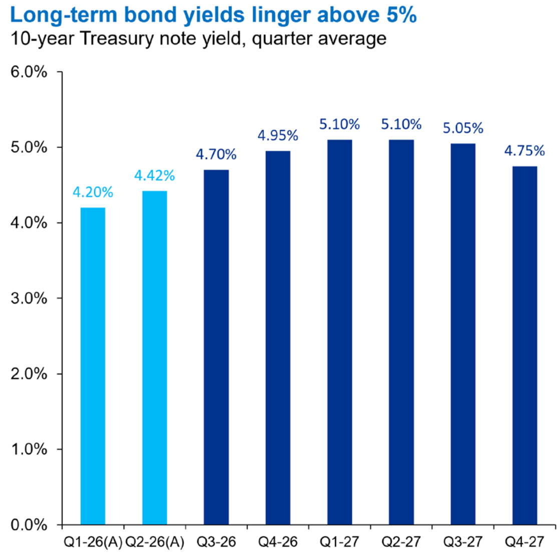
Risks lean toward more hikes. AI investment, defense spending, larger deficits and recurring supply shocks suggest the neutral rate for the fed funds rate is higher than currently believed; current policy may be less restrictive than it appears. If the AI buildout is undercounted, which the statistical agencies are now investigating, that risk grows.

10-year yields higher for longer

Chart 4 shows the forecast for the 10-year Treasury yield, a key benchmark for mortgage, business and consumer loans. We expect it to cross 5% and remain there for its longest sustained stretch since 2007. The forces keeping yields higher for longer include:

- **Inflation and Fed policy.** Persistent inflation, a potentially higher neutral rate and additional rate hikes keep upward pressure on bond yields.
- **A flood of new debt.** Growing deficits mean the Treasury must sell more bonds. Investors may require higher yields to buy them.
- **More competition for capital.** AI-related corporate debt and initial public offerings are arriving alongside heavier government borrowing abroad. More borrowers are competing for the same funds, crowding out other investments.
- **Foreign demand is waning.** Foreign holdings remain large, but US debt is growing faster. Many investors are diversifying away from Treasuries, including central banks and major sovereign wealth funds. Norway's Pension Fund, the largest in the world, announced a reduction in its holdings last week. That leaves domestic demand to pick up the slack.

Chart 4



Source: KPMG Economics, Federal Reserve Board

Can't we grow ourselves out of debt? AI could boost growth and revenues, but Brookings finds that job displacement, aging, interest costs and defense spending would absorb much of the gain. Even optimistic scenarios only slow the rise in debt. Hard choices on spending and taxes remain unavoidable.

The Fed can set the overnight interest rate. It cannot dictate that investors hold long-term debt. The Fed controls the short end. The bond vigilantes patrol the long end.

Risks skew toward higher rates. Markets may further tighten financial conditions before the Fed acts. Higher long-term yields raise mortgage payments, curb business investment and weigh on stocks. Treasury interventions to lower rates risk backfiring if they stoke concerns about fiscal dominance, which is when rising debt costs constrain the Fed's inflation fight.

Bottom Line

Growth is holding, but the center is hollowing out. Inflation lingers and the Fed is divided while bond markets impose discipline.

Yeats captured the fear of a center giving way. The challenge now is to rebuild it by spreading the gains from growth and technology instead of asking those with the least to bear the largest costs. Economic strength is not enough. More people must feel it.

That will require credible institutions, choices that outlast the next election and investment in those at risk of being left behind. The future is not predetermined. Policy matters. So do the actions we take. Be kind; pay it forward.

Economic Forecast — September 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	2.1	1.9	2.1	1.5	3.1	1.4	2.1	1.7	1.6	1.8
Personal Consumption	2.6	2.2	1.9	0.5	3.4	2.7	2.0	1.9	1.3	1.5	1.6
Business Fixed Investment	4.1	7.1	6.0	10.6	8.5	10.9	3.4	6.4	5.2	5.4	5.1
Residential Investment	-2.2	-4.0	0.9	-7.8	1.3	-5.1	-0.6	0.8	2.0	5.5	6.2
Inventory Investment (bil $ '17)	29	-2	64	-17	-53	29	32	45	73	69	71
Net Exports (bil $ '17)	-1091	-1138	-1357	-1002	-1084	-1205	-1260	-1303	-1347	-1374	-1402
Exports	1.6	3.7	2.1	10.9	4.5	-2.8	2.1	3.1	2.6	2.8	2.9
Imports	2.7	3.9	7.1	11.8	12.5	11.0	7.2	6.5	6.2	4.6	4.6
Government Expenditures	1.1	0.4	1.0	4.4	-1.0	1.9	1.9	1.1	0.5	0.4	0.0
Federal	-1.2	-1.1	2.1	9.4	-4.2	5.1	4.7	2.7	1.0	0.5	-0.5
State and Local	2.5	1.3	0.3	1.6	0.9	0.1	0.4	0.3	0.3	0.3	0.3
Final Sales	2.2	2.2	1.6	1.9	2.2	1.6	1.4	1.8	1.2	1.7	1.7
Inflation											
GDP Deflator	2.8	3.8	2.8	3.6	6.4	1.7	3.2	2.3	2.8	2.5	2.4
CPI	2.7	3.3	2.5	3.6	6.1	1.4	2.3	2.2	2.8	2.7	2.4
Core CPI	2.9	2.6	2.7	2.8	2.9	2.0	3.0	2.7	2.9	2.9	2.7
Special Indicators											
Corporate Profits2	7.3	17.6	6.0	7.0	41.5	10.0	3.1	4.4	4.5	0.7	0.5
Disposable Personal Income	1.7	0.5	2.7	0.9	-1.5	2.6	1.8	3.9	3.1	3.2	3.1
Housing Starts (mil)	1.36	1.34	1.31	1.42	1.34	1.34	1.29	1.27	1.30	1.32	1.34
Civilian Unemployment Rate	4.3	4.2	4.1	4.3	4.3	4.2	4.2	4.1	4.1	4.1	4.1
Total Nonfarm Payrolls (thous)3	745	452	640	130	287	140	184	161	142	133	104
Vehicle Sales											
Automobile Sales (mil)	2.7	2.8	3.2	2.5	2.7	2.9	3.0	3.0	3.2	3.3	3.3
Domestic	1.8	1.8	2.1	1.7	1.8	1.9	1.9	2.0	2.1	2.2	2.2
Imports	0.9	0.9	1.1	0.9	0.9	1.0	1.0	1.1	1.1	1.1	1.1
LtTrucks (mil)	13.5	13.5	13.5	12.9	13.7	13.7	13.5	13.5	13.5	13.5	13.5
Domestic	10.8	10.7	10.7	10.3	10.8	10.9	10.7	10.7	10.7	10.7	10.7
Imports	2.7	2.8	2.8	2.6	2.9	2.8	2.8	2.8	2.8	2.8	2.8
Combined Auto/Lt Truck	16.2	16.2	16.7	15.5	16.4	16.6	16.5	16.5	16.7	16.8	16.8
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	16.7	17.1	15.9	16.8	17.1	16.9	17.0	17.1	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	4.7	5.0	5.1	5.1	5.1	4.8
Corporate Bond BAA	6.1	6.4	7.0	6.1	6.2	6.5	6.8	7.0	7.1	7.1	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	159.8	155.3	156.8	159.4	161.0	160.0	158.0	156.0	154.0	153.0

[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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