1Q26 Economic Summary

The volatility roller coaster ramped up in the first quarter of 2026 as solid economic data took a backseat to rising geopolitical risk. After a steady start to the year, equities sold off sharply in March as the conflict in Iran escalated, resulting in large quarterly declines across major stock market indices. Fixed income markets also had a challenging quarter as the war's impact on energy prices sparked inflation concerns and drove yields up across the curve. Reports of a possible near-term resolution to the conflict triggered a rally across all markets on March 31, but it was not enough to offset the damage done from weeks of war-related volatility.

Despite mounting headwinds from geopolitical tensions and energy price shocks, U.S. GDP growth came in at 2.0% for the first quarter, marking a solid rebound from the weak 0.5% pace recorded at the end of last year. The acceleration was driven primarily by stronger business investment, particularly AI-related expenditures. Business outlays on equipment and structures rose sharply as demand for AI data centers and the infrastructure to support them proved insatiable. Government spending rebounded after the shutdown last quarter, with outlays on defense spending and infrastructure contributing positively to first quarter growth. Consumer spending remained strong but slowed slightly as the strain from higher prices continued to take a toll. Tax refunds and limited layoffs supported consumption, but Americans are increasingly having to dip into savings to keep up with the high cost of living. Residential investment remained a soft spot for growth, declining modestly as elevated mortgage rates kept affordability strained and dampened both home sales and new construction activity. Net exports were also a drag on growth as a sharp increase in imports more than offset a modest rise in exports. Final sales to domestic purchasers, which strips out the volatile components of trade and inventories, came in at 2.8%, pointing to an even steadier pace of demand than that suggested by headline GDP.

The U.S. labor market showed mixed signals during the quarter, with job growth proving volatile. Nonfarm payrolls added 160,000 jobs in January but strikes and severe winter weather contributed to an employment decline of 133,000 in February. Job growth rebounded in March with 178,000 jobs added. While the advance was led by the healthcare sector, gains were widespread across industries. Despite the ups and downs, the unemployment rate was relatively stable, ending the quarter where it began at 4.3%. The low-hiring/low-firing environment remained intact as job openings declined but initial jobless claims remained low, signaling that employers are holding onto the workers they have. Thus far the war in Iran has not had noticeable impact on the labor market, but if hostilities continue, companies may begin to delay hiring or to initiate layoffs in response to higher energy prices and potentially diminished demand.

US inflation accelerated sharply during the quarter, driven primarily by the war's impact on energy prices. The disruption of cargo flows through the Strait of Hormuz resulted in an oil shock that is feeding into transportation, manufacturing and food costs. Headline CPI surged to 3.3% in March, marking a significant departure from the relatively tame inflation readings at the start of the year. Core CPI, which excludes food and energy, showed more moderate movement, edging up to 2.6% in March.

The Federal Reserve left rates unchanged in the first quarter, keeping the target range for fed funds at 3.50%-3.75%. At the March meeting, policymakers emphasized a "wait-and-see" approach as inflation remained above the 2% target and progress on disinflation proved uneven. The Fed highlighted the ongoing uncertainty tied to geopolitical risks – particularly rising energy prices – and their potential to reaccelerate inflation. The dot plot showed that the median rate projection for 2026 had not changed, with one rate cut still in the forecast. However, there was a shift in the dot plot distribution toward fewer cuts, indicating that even the most dovish members of the FOMC had become more cautious about easing policy. In the minutes to the meeting, the Committee appeared less confident that rate cuts would be needed soon, with "the vast majority" of participants noting that the risk of inflation running persistently above the Fed's 2% objective had increased. In addition, some members saw a "strong case" for a two-sided description of future rate decisions, reflecting the possibility that it might even be necessary to raise rates if inflation remains above target. Markets took note of this more hawkish lean and repriced from roughly one cut in 2026 to effectively zero, with any easing pushed to December at the earliest.

The war-driven rise in inflation complicates the monetary policy decision. The energy shock puts upward pressure on prices while also threatening to dampen economic activity. Looking ahead, the path for rates will hinge on whether the conflict de-escalates and energy prices normalize, or whether sustained pressure on inflation forces tighter financial conditions and slows demand.