

September 25, 2026 05:00 AM GMT

US Economics Weekly | North America

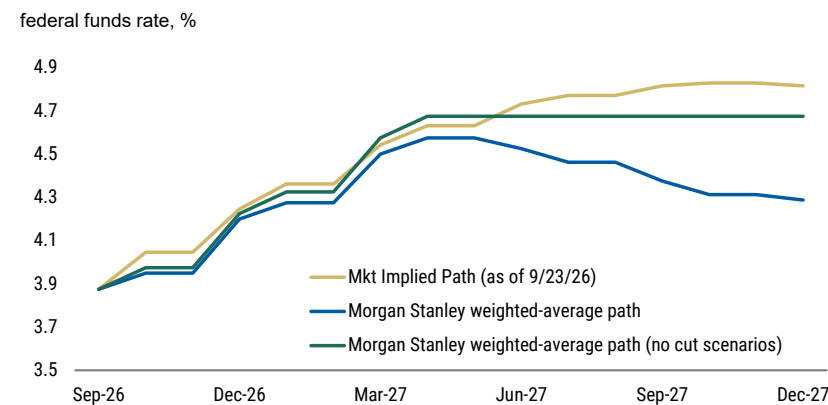
Fundamentals offer little relief from tightening expectations

Markets may be overpricing Fed tightening, but fundamentals offer little reason to believe that yet.

Key Takeaways

- The rates market has been hit by a perfect storm in the direction of tighter fed policy and higher yields.
- The market-implied path for Fed policy now brings the federal funds rate near the peak of the prior tightening cycle following the pandemic.
- Our weighted-average policy path is more benign, and we expect fewer hikes than the market-implied path.
- However, our expected policy path does not diverge from the market until after 1Q 27.
- We are hard-pressed to see fundamental catalysts for more dovish Fed expectations any time soon. If so, hawkish sentiment may remain in place.

Exhibit 1: Morgan Stanley US Economics weighted-average paths versus market-implied Fed pricing: There is little meaningful divergence between our expected policy path and the market-implied path until after 1Q 27



Source: Haver Analytics, Morgan Stanley Research

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For important disclosures, refer to the Disclosure Section, located at the end of this report.

Fundamentals offer little relief from tightening expectations

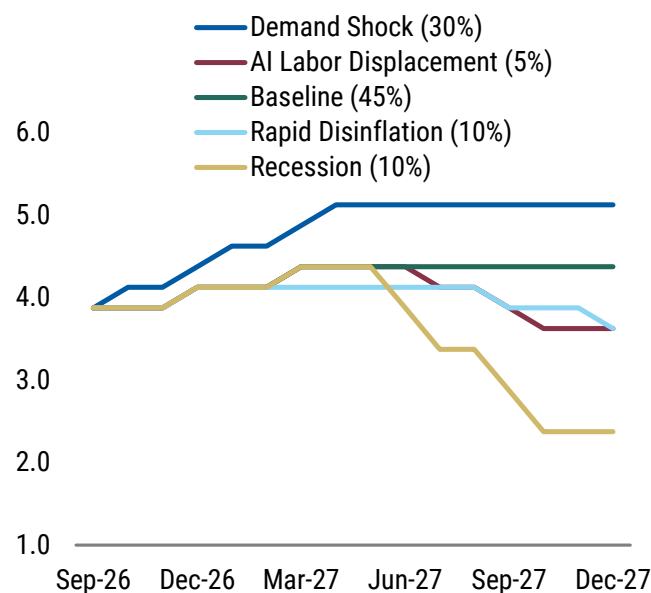
A perfect storm in the rates market

The rates market is caught in a perfect storm. Resilient growth, sticky inflation, concerns over government restrictions in energy markets, a newly hawkish Fed, corporate issuance, persistent fiscal deficits, and questions surrounding a Treasury that has become less regular and predictable have all combined to push Treasury yields significantly higher. Since March, the yield on the 2y, 5y, and 10y US Treasury note has risen between 120-150bp. Much of this rise has come from expectations for monetary tightening. Following the Fed's 25bp rate hike in September, markets are pricing in almost 100bp more in additional policy rate increases. We do not see the Fed delivering this much policy rate tightening in our baseline, but we are hard pressed to see any fundamental drivers that will make this clear to markets for some time.

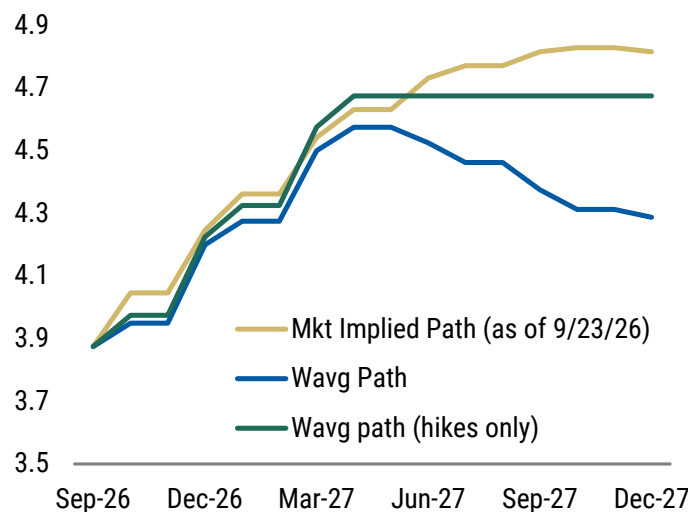
The Fed path certainly contains hikes, but how many is uncertain

With the understanding that financial markets price a continuum of outcomes, our conversations with clients in recent weeks have centered on three outcomes. The first looks like the median forecast from the September FOMC meeting: a Fed that recalibrates policy by raising its policy rate 50-75bp to lean against second round effects from supply shocks on inflation. Since monetary policy is not well-equipped to deal with supply shocks, this scenario assumes the committee accepts relatively slow convergence to the 2% target.

A second scenario is a more hawkish Fed that desires a much quicker return to 2%. Instead of leaning against second round effects from higher energy prices, the Fed reacts to the direct effects of higher energy prices on inflation. Advocates of this view point to Chair Warsh's comments in the press conference which strongly linked geopolitics, inflation, and a need for restriction. Since the Fed cannot control oil prices, it would need to constrain domestic demand more forcefully to achieve faster convergence. In our view, the most likely transmission mechanism for monetary policy in this scenario would come through lower asset prices and softer consumption. This would likely require the Fed to take the target range for the federal funds rate back toward 2023 highs as the thinking goes, or about 150bp in total rate hikes.

Exhibit 2: Morgan Stanley US Economics: Baseline and alternative paths for the federal funds rate (%)

Source: Bloomberg, Morgan Stanley Research

Exhibit 3: Morgan Stanley US Economics weighted-average paths versus market-implied Fed pricing

Source: Bloomberg, Morgan Stanley

A third possibility is an upshift to an "animal spirits" demand-driven economy. In this outcome, the AI investment boom generates feedback effects that broadens the expansion, improves economic growth, lifts employment, and keeps inflation firm. In response, the Fed takes the target range for the funds rate up 150bp and back toward 2023 highs, similar to the scenario above, but for different reasons. Inflation converges more slowly to the target, at a similar pace as in the first scenario.

Our revised outlook for the US economy is based on a permanent oil risk premium and sticky inflation. In our baseline outlook the Fed hikes two more times (75bp in total) and maintains that rate through the end of 2027. Our four alternative scenarios for the US economy (see [Exhibit 29](#)) include "animal spirits", faster disinflation, AI-driven labor market displacement, and a recession driven by much higher oil prices ([Exhibit 2](#)). Applying our subjective probabilities to those scenarios yields a weighted average policy rate path below the market path ([Exhibit 3](#)).

In addition to our weighted average across all of our scenarios, we add a weighted average for our two scenarios that contain rate hikes. This may be a more relevant comparison against the current market-implied path for policy since it re-weights our subjective probabilities around our baseline with 75bp of total hikes and our animal spirits upside scenario with 150bp of total rate hikes. Doing so results in the "hikes only" line in [Exhibit 3](#).

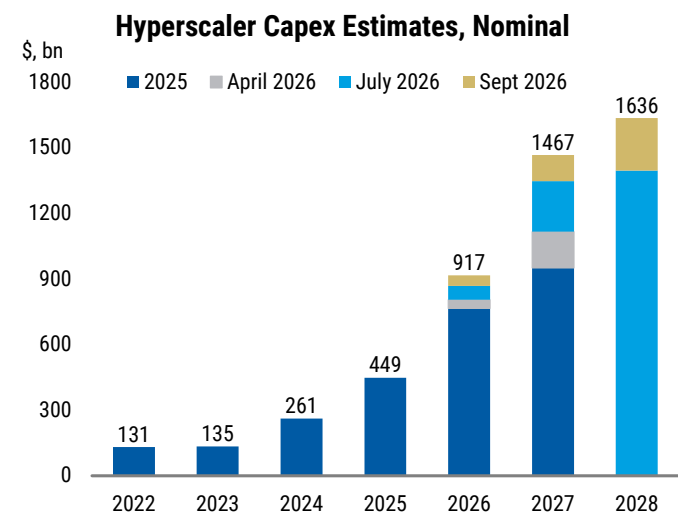
Too many hikes, but no near-term catalyst

So what can we say from this? In our baseline, we still see growth as resilient but with limited evidence that AI-related spending is leading to an overheating economy. As we have noted, AI-related spending has a heavy import content and may be fueling positive output gaps abroad more than at home. Some further monetary restriction should help

keep inflation heading in the right direction, and our equity analysts project the growth rate of hyperscaler capex spending will slow in 2027. The second derivative of this spending is what matters for GDP growth and any slowdown should reduce overheating concerns. If all this proves correct, then we think the market is pricing in too many Fed hikes. That said, the gap between our expected policy rate path and the market's does not diverge until after 1Q 27.

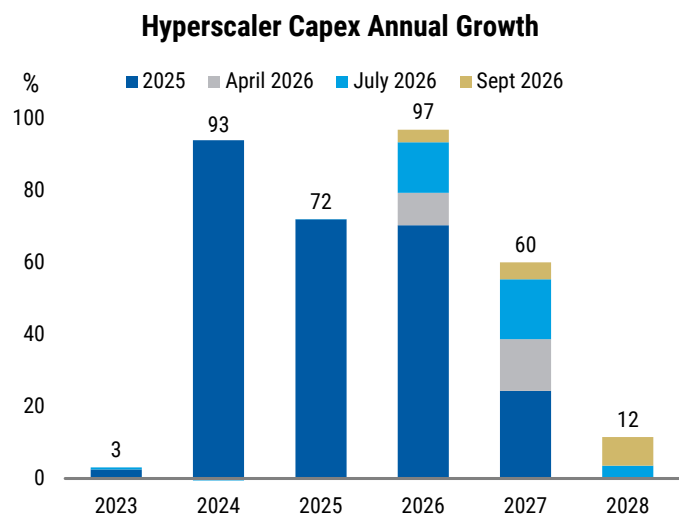
Our main takeaway is that fundamental catalysts that could tilt market expectations in favor of fewer expected rate hikes from the Fed – whether it's successive inflation prints that show progress toward the target, a resolution to the ongoing conflict in the Middle East that brings relief to energy markets, decelerating AI-related spending that would temper upside growth risks – do not appear right around the corner. We are hard-pressed to see a near-term fundamental catalyst that can change the current narrative. If so, then the adverse winds buffeting the rates market and federal funds futures are likely to remain in place.

Exhibit 4: Our equity analysts project around \$1.5 trillion in hyperscaler spending in 2027



Note: see [The Morgan Stanley AI Guidebook](#)
Source: Morgan Stanley Research

Exhibit 5: Level versus growth rate: The growth rate of hyperscaler capex is expected to slow beginning in 2027



Source: Morgan Stanley Research

Oil Tracker: Running Out of Buffers

Our baseline outlook for the US economy assumes a permanent oil risk premium. The renewed pressure on energy prices has dragged the world into the seventh month of this prolonged energy price shock. Historically, episodes of acute geopolitical or physical supply disruption have mostly lasted 3–6 months, with the notable exception of the 1978–79 oil shock and its aftermath. As buffers such as higher U.S. exports, weaker Chinese imports, and ample inventories begin to fade, we update our oil tracker to highlight developments and trends that matter for U.S. economic growth.

The latest data suggest that crude oil inventories in the Strategic Petroleum Reserve (SPR) have fallen further, while both U.S. crude oil imports and exports have remained on an upward trend. Crude oil prices have continued to rise, while diesel margins have widened further.

Prices: higher crude spot prices, wider diesel margins

The latest spot prices, as of September 22, were \$96.41 per barrel for WTI in Cushing, Oklahoma, and \$114.89 per barrel for Brent in Europe. We convert diesel and gasoline prices to a per-barrel basis for a better comparison: diesel was at \$216.47 per barrel, while gasoline was at \$178.95 per barrel. The gap between gasoline and crude oil prices has remained broadly unchanged, whereas the gap between diesel and crude oil prices has continued to widen since early July.

We think this divergence is partially driven by refineries around the Strait of Hormuz reducing their demand for crude oil as disruptions constrain their ability to ship refined products out of the region. At the same time, these disruptions have reduced the effective supply of diesel to the global market, putting upward pressure on diesel prices relative to crude oil.

Quantities: Falling SPR stocks, stable net imports, rising production

As of September 22, U.S. commercial crude oil stocks, which represent the EIA's estimate of how many barrels of crude oil are physically held in U.S. storage at period-end, remained broadly unchanged from a week earlier. Meanwhile, crude oil stocks in the Strategic Petroleum Reserve (SPR) continued to fall to around 284.6 million barrels, the lowest level since April 1984.

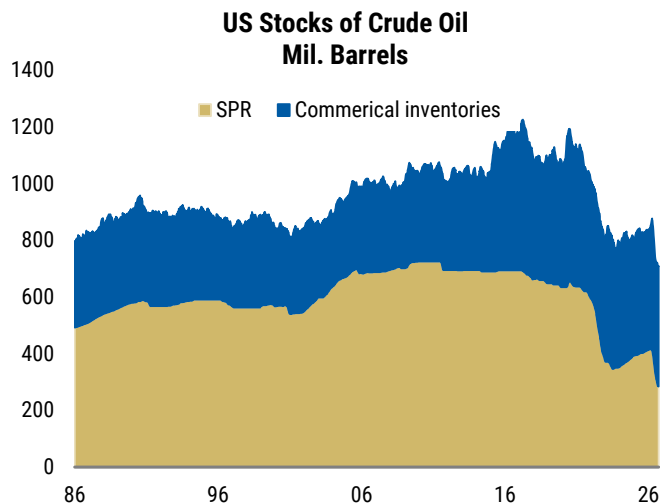
The Energy Department said the SPR's minimum inventory is determined by "cavern mechanics," which, when applied across the full system, translates to a conservative operational minimum of about 70 million barrels. If the SPR continues to decline at a pace of roughly 30 million barrels every four weeks, inventories would approach this operational minimum by March 2027. Using data on U.S. domestic crude oil production, net imports, and SPR drawdowns, we estimate monthly U.S. crude oil use at around 520 million barrels. A monthly SPR drawdown of 30 million barrels therefore accounts for only about 6% of U.S. crude oil use.

Both U.S. crude oil imports and exports have been on an upward trend since July, though they have risen at a similar pace, keeping net imports broadly unchanged. Canada remains the largest source of U.S. crude oil imports. Imports from Venezuela have risen at an

average monthly rate of 14%, although the overall volume remains too small to have a meaningful impact so far. Imports from Saudi Arabia were minimal from May through August, reflecting constraints around the Strait of Hormuz, but appear to have improved moderately in September.

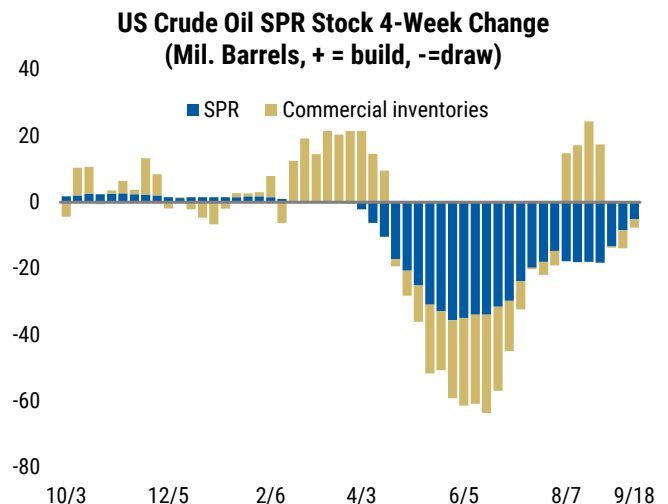
U.S. domestic crude oil production has also continued to rise, while U.S. refineries have increased their utilization, helping to support domestic supply amid ongoing disruptions.

Exhibit 6: SPR reached its lowest level since April 1984.



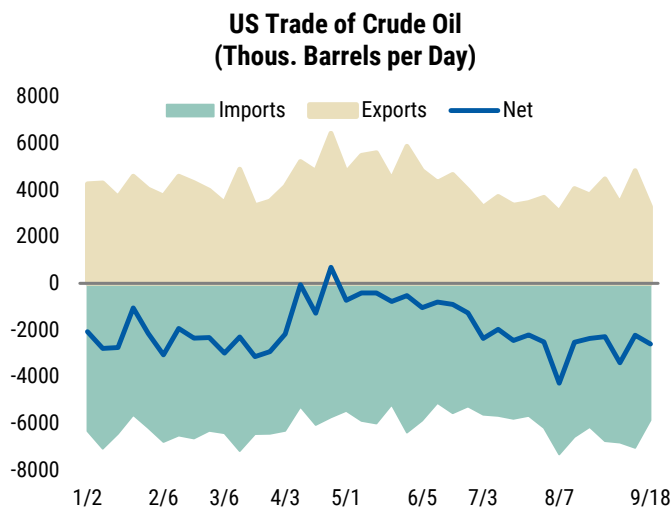
Source: Energy Information Administration, Haver Analytics, Morgan Stanley Research

Exhibit 7: SPR drawdowns have slowed since June.



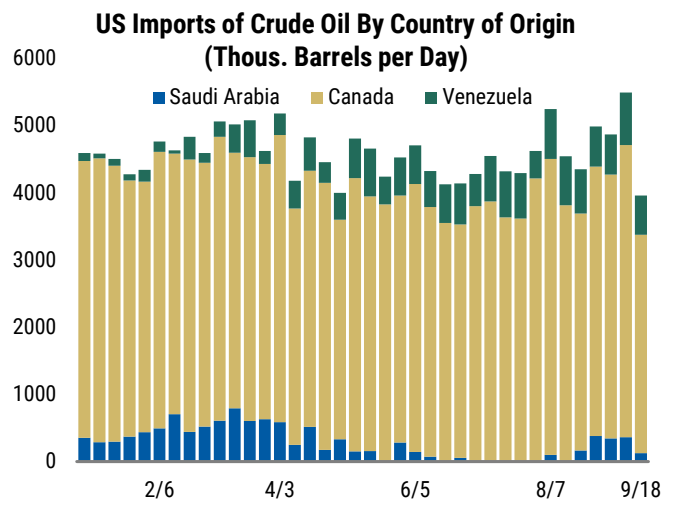
Source: Energy Information Administration, Haver Analytics, Morgan Stanley Research

Exhibit 8: U.S. crude oil imports and exports have been on an upward trend since July



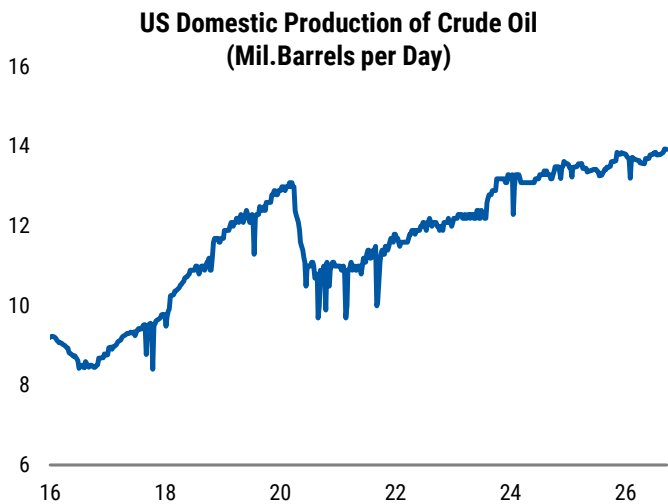
Source: Energy Information Administration, Haver Analytics, Morgan Stanley Research

Exhibit 9: Canada remains the largest source of U.S. crude oil imports



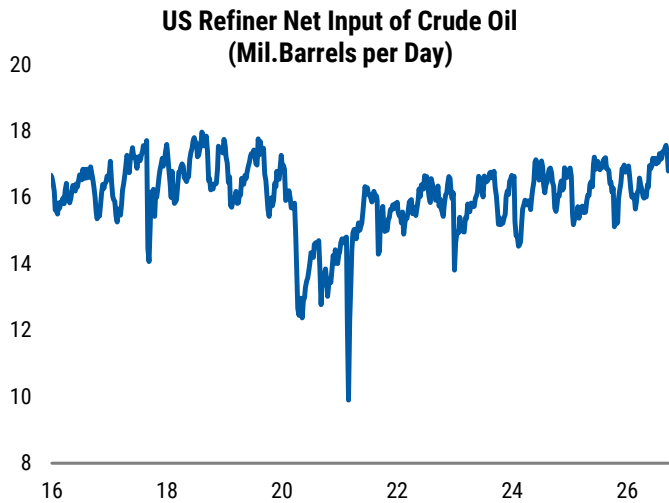
Source: Energy Information Administration, Haver Analytics, Morgan Stanley Research

Exhibit 10: U.S. domestic crude oil production has also continued to rise



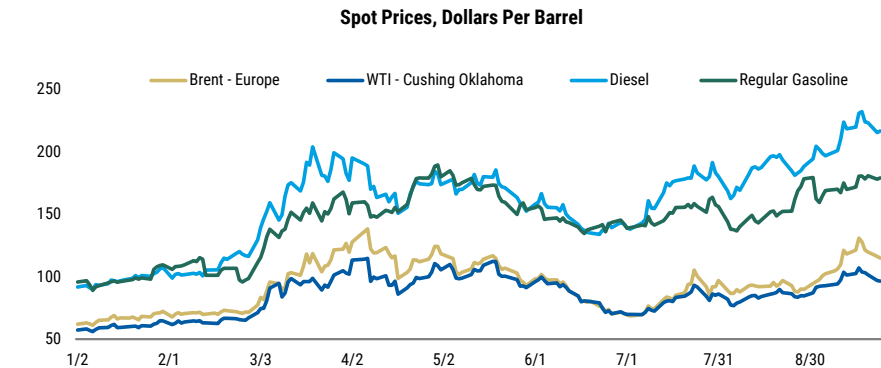
Source: Energy Information Administration, Haver Analytics, Morgan Stanley Research

Exhibit 11: U.S. refineries have increased their utilization



Source: Energy Information Administration, Haver Analytics, Morgan Stanley Research

Exhibit 12: The gap between diesel and crude oil prices has continued to widen since early July.



Source: Energy Information Administration, Haver Analytics, Morgan Stanley Research

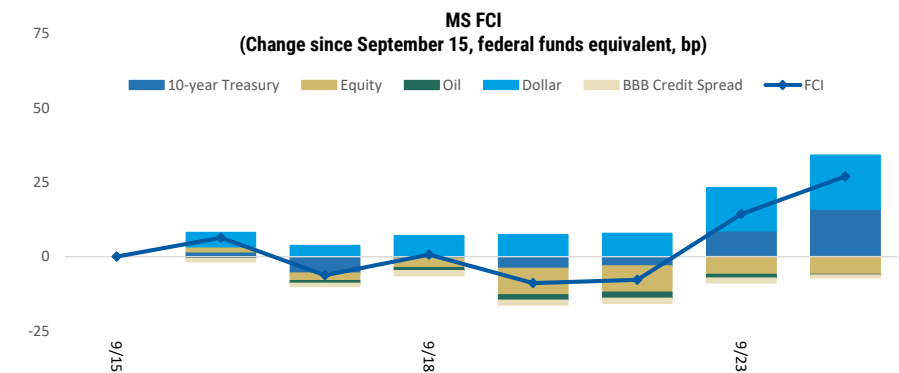
Financial conditions: The Fed Awakens

Following the 25bp rate hike in September and the shift into an "oil risk premium" baseline, we reset our financial conditions index to September 15 2026, the day prior to the September FOMC meeting, to track our FRB/US-based measure of financial conditions in this new hiking cycle. **As of the September 24 market close, financial conditions were about one hike tighter than they were before the September FOMC meeting.**

The index aims to capture how changes in asset prices weigh on future economic activity. It includes five daily variables: the 10-year Treasury yield, S&P 500 returns, the corporate BBB credit spread, the valuation of the U.S. dollar, and the price of oil. These are aggregated based on their estimated growth elasticities relative to the federal funds rate using the Federal Reserve's FRB/US model. As a result, the index can be interpreted as the equivalent change in the federal funds rate, expressed in basis points, required to generate a similar effect on economic activity.

Since the day before the September FOMC meeting, the easing in financial conditions has been equivalent to about a 27bp hike in the federal funds rate, driven primarily by a higher 10-year Treasury yield and USD appreciation. Equity returns and BBB credit spreads have offset some of the tightening.

Exhibit 13: Financial conditions have eased slightly following the September rate hike



Source: Bloomberg, Morgan Stanley Research

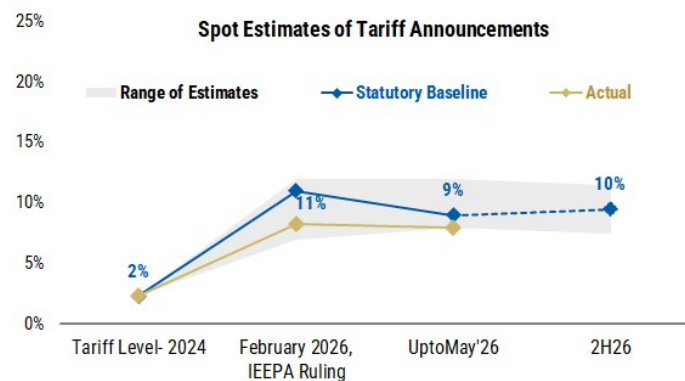
The effective tariff rate, tariff receipts, and refunds

Tariffs averaged 6.7% over May-July, and we expect that it will rise to near 10%

USTR's final forced-labor Section 301 action was broadly in line with our expectations.

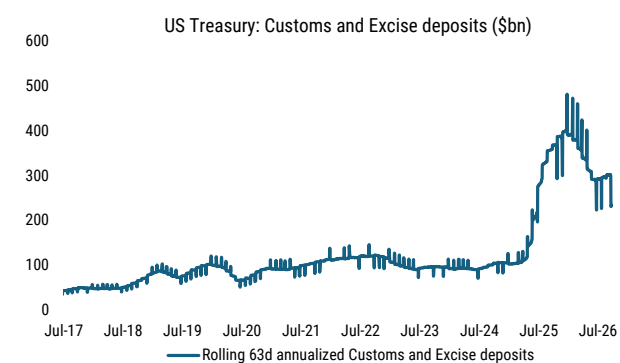
Effective July 24, the agency imposed additional tariffs on imports from 60 economies, setting a 10% duty on economies that have adopted, partially adopted, or committed to adopt a forced-labor import prohibition and a 12.5% duty on most others. The final action also preserves several key carve-outs, including goods already subject to Section 232 tariffs, USMCA-compliant imports, and a range of general and country-specific product exemptions. Overall, both the tariff structure and the principal exemptions closely resemble the proposal, reinforcing our expectation that Section 301 would serve as the broad country-level tariff floor. We continue to expect that the statutory effective tariff rate will converge toward ~10% by year-end. In the July 2026 data, the effective tariff rate is estimated at ~6.5%. Over the past three months of detailed trade data (May, June and July), the tariff rate has averaged 6.7%. There has been a recent escalation of trade disputes with Canada, and [section 338 tariffs have been applied on approximately \\$20bn of Canadian imports](#). However, for now, we do not expect this to meaningfully affect our year-end tariff estimates.

Exhibit 14: US effective tariff rate



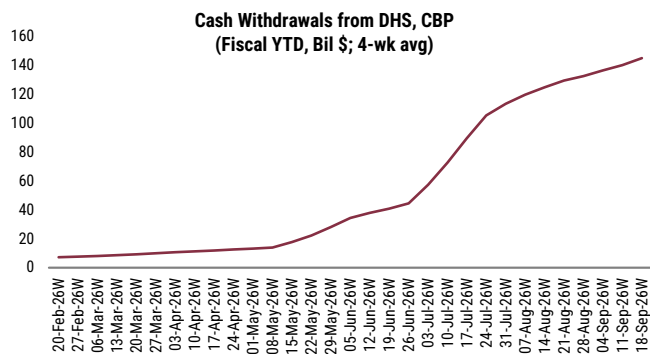
Source: US Census, US HTS, USITC, Morgan Stanley Research. The "Up to May '26" estimate is the average tariff rate on all imports over Jan - May 2026.

Exhibit 15: US Treasury: Customs and excise deposits from tariffs



Source: US Treasury, Bloomberg, Morgan Stanley Research

Exhibit 16: Cash withdrawals from the DHS - CBP, as a proxy for tariff refunds



Source: US Treasury, Haver Analytics, Morgan Stanley Research

Tariff refunds represent cash returned to importers when customs duties were previously overpaid or later determined to be refundable, for different reasons, including a tariff exclusion or court-ordered refund or a drawback claim tied to goods that are exported or destroyed. The process generally runs through CBP, where importers or brokers submit the relevant claim and supporting documentation; CBP then reviews eligibility, confirms the entry and status, and certifies approved refunds for payment. In Treasury cash-flow data, we monitor these payments at high frequency through CBP-related withdrawals in the Daily Treasury Statement. We interpret this as a tariff-refund proxy.

3Q GDP tracking remains at 2.5%

This week's housing data left our 3Q GDP tracking unchanged at 2.5%. For a second quarter in a row, it appears that demand is running faster than output. While we estimate 3Q GDP rises at a 2.5% q/q annual rate, we estimate private final domestic final purchases (PDFP) rises at a 3.7% pace, with booming business investment and consumption growth of nearly 3%. In 2Q, similarly, GDP rose 1.5% but PDFP rose 4.2%.

The Atlanta Fed's estimate was unaltered at 5.1%. Its faster pace mostly reflects two categories. Services consumption, at 4.6% growth, is a point and a half higher than ours, contributing an extra 0.7 pct pt to GDP growth. And the Atlanta Fed also is estimating that inventories add 2.0 pct pts to growth in 3Q, 1.7 pct pt more than we estimate. The New York Fed nowcast was unaltered at 2.3%.

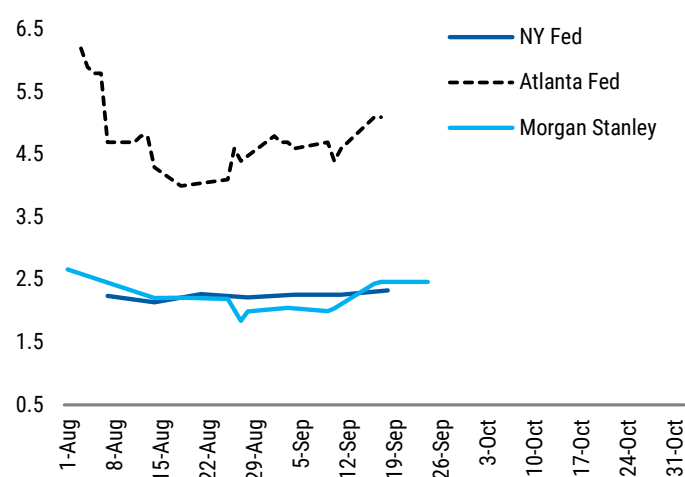
Exhibit 17: The effect of incoming data on our US GDP tracking estimate

Details of Q3 2026 US GDP tracking (% q/q saar unless indicated)													
Date	Data release	GDP	Final sales	PCE	Res	Equip	Struct	IPP	Gov	X	M	NX (level)	CPI (level)
Aug 7	Baseline	2.7	2.6	2.4	1.0	8.0	-3.0	8.0	1.4	1.0	2.0	-1086	-47
Aug 14	Retail sales and CPI	2.2	2.1	1.8	1.0	8.0	-3.0	8.0	1.4	1.0	2.0	-1086	-47
Aug 18	Housing starts and permits	2.2	2.1	1.9	-1.5	8.0	-3.0	8.0	1.4	1.0	2.0	-1086	-47
Aug 25	New home sales	2.2	2.1	1.9	-2.0	8.0	-3.0	8.0	1.4	1.0	2.0	-1086	-47
Aug 26-27	Trade and durables	1.8	1.6	1.9	-2.0	8.0	-3.0	8.0	1.5	-3.3	2.4	-1130	-38
Aug 28	2Q consumption	2.0	1.7	2.1	-2.0	8.0	-3.0	8.0	1.5	-3.3	2.4	-1130	-37
Sep 3	Trade detail	2.1	1.6	2.1	-2.0	15.0	-3.0	8.0	1.5	-6.0	4.0	-1165	-26
Sep 10	Existing home sales	2.0	1.6	2.1	-2.3	15.0	-3.0	8.0	1.5	-6.0	4.0	-1165	-26
Sep 16	Retail sales	2.4	2.1	2.9	-2.3	15.0	-3.0	8.0	1.5	-6.0	4.0	-1165	-34
Sep 17	Housing starts and permits	2.5	2.1	2.9	-1.6	15.0	-3.0	8.0	1.5	-6.0	4.0	-1165	-34
GDP tracking		2.5	2.1	2.9	-1.6	15.0	-3.0	8.0	1.5	-6.0	4.0	-1165	-34
<i>Contribution to GDP growth (pp)</i>		<i>2.2</i>	<i>2.0</i>	<i>-0.1</i>	<i>0.9</i>	<i>-0.1</i>	<i>0.5</i>	<i>0.2</i>	<i>-0.7</i>	<i>-0.6</i>	<i>-1.3</i>	<i>0.3</i>	
Morgan Stanley official forecast		2.7	2.6	2.4	1.0	8.0	-3.0	8.0	1.4	1.0	2.0	-1086	-47

Note: Our GDP tracking estimate is distinct from our official published GDP forecast. It reflects the mechanical aggregation of monthly activity data that feed directly into the BEA's calculation. Where data releases have implications for the tracking components, cells have been bolded. Final sales is GDP less inventories. Source: Morgan Stanley Research

Exhibit 18: GDP nowcasts

Real GDP tracking, Q/Q % change, a.r.



Source: Federal Reserve Banks of New York and Atlanta, Morgan Stanley Research

Exhibit 19: Our tracking vs. the Atlanta Fed tracking

	Morgan Stanley		Atlanta Fed		Difference contrib, pts
	q/q%, ar	contrib	q/q%, ar	contrib	
GDP	2.5		5.1		-2.6
Final sales	2.2	2.2	3.0	3.1	-0.9
Final sales to dom. purchasers	3.3	3.4	4.3	4.4	-1.0
Private	3.7	3.2	4.7	4.0	-0.9
Consumption	2.9	2.0	4.1	2.8	-0.8
Goods	2.8	0.6	3.2	0.7	-0.1
Services	3.0	1.4	4.6	2.1	-0.7
Residential investment	-1.4	-0.1	-4.7	-0.2	0.1
Equipment investment	15.0	0.9	17.4	1.0	-0.1
Nonres structures	-3.0	-0.1	2.2	0.1	-0.1
Intel. Property	8.0	0.5	6.4	0.4	0.1
Government	1.5	0.2	2.3	0.4	-0.2
Exports	-6.0	-0.7	-2.7	-0.3	-0.4
Imports	4.0	-0.6	7.5	-1.1	0.5
Net exports		-1.3		-1.4	0.1
Inventories		0.3		2.0	-1.7

Source: Federal Reserve Bank of New York, Morgan Stanley Research

Data review & preview

Review of past week's data

Exhibit 20:

Monday 21 Sept	Data	Period	Forecast	Consensus	Prev	Actual
6:30 AM	Fed's Goolsbee Speaks About Monetary Policy					
8:30 AM	Chicago Fed Nat Activity Index	Aug		0.0	-0.1	-0.04
Tuesday 22 Sept	Data	Period	Forecast	Consensus	Prev	Actual
8:15 AM	ADP Weekly Employment Change	5-Sep				20
8:30 AM	Philadelphia Fed Non-Manufacturing Activity	Sep		-8.7	-10.6	-22
10:00 AM	Richmond Fed Manufact. Index	Sep		2.0	4.0	-2
10:05 AM	Fed's Williams Gives Keynote Remarks				0.0	
10:20 AM	Fed's Jefferson speaks on Treasury Market functioning					
1:00 PM	Fed's Barkin speaks					
Wednesday 23 Sept	Data	Period	Forecast	Consensus	Prev	Actual
7:00 AM	MBA Mortgage Applications	18-Sep				-1.5
9:45 AM	S&P US Manufacturing PMI	Sep P		53.7	53.9	57
9:45 AM	S&P US Services PMI	Sep P		55.9	56.5	58.7
10:05 AM	Fed's Barr speaks on housing					
Thursday 24 Sept	Data	Period	Forecast	Consensus	Prev	Actual
4:10 AM	Fed's Williams Speaks During Moderated Discussion					
8:00 AM	Fed's Barkin speaks					
8:30 AM	Current Account Balance	2Q	-245.0	-258.1	-226.8	-246.0
8:30 AM	Initial Jobless Claims	19-Sep	200	200.0	196	197
8:30 AM	Continuing Claims	12-Sep	1750	1740.0	1730	1719
8:50 AM	Fed's Hammack Delivers Opening Remarks at Inflation Conference					
10:00 AM	New Home Sales	Aug	660	616	607	684
10:00 AM	New Home Sales m/m	Aug	-1.5	1.3	-10.5	6.4
10:10 AM	Fed's Paulson Speaks At Fintech Conference					
11:00 AM	Kansas City Fed Manf. Activity	Sep		8.0	10.0	14
4:30 PM	Fed balance sheet (H.4.1)					
Friday 25 Sept	Data	Period	Forecast	Consensus	Prev	Actual
5:15 AM	Fed's Williams Participates in Policy Panel					
8:30 AM	Durable Goods Orders	Aug P	0.0	-0.3	1.1	
8:30 AM	Durables Ex Transportation	Aug P	0.6	0.6	0.4	
8:30 AM	Cap Goods Orders Nondef Ex Air	Aug P	0.7	0.5	0.0	
8:30 AM	Cap Goods Ship Nondef Ex Air	Aug P	0.7	0.7	1.2	
10:00 AM	U. of Mich. Sentiment	Sep F		47.5	47.8	
10:00 AM	U. of Mich. 5-10 Yr Inflation	Sep F		3.4	3.4	
11:00 AM	Kansas City Fed Services Activity	Sep			-3.0	
2:00 PM	Fed's Hammack Participates In Policy Panel Discussion					
4:15 PM	Commercial bank balance sheets (H.8)					

Source: Bloomberg, Morgan Stanley Research forecasts

Preview of upcoming data

Exhibit 21: Monday

Monday 28 Sept	Data	Period	Forecast	Consensus	Prev
10:30 AM	Dallas Fed Manf. Activity	Sep		7.2	11.6

Source: Bloomberg, Morgan Stanley Research forecasts

Exhibit 22: Tuesday

Tuesday 29 Sept	Data	Period	Forecast	Consensus	Prev
9:00 AM	FHFA House Price Index m/m	Jul			0.0
9:00 AM	S&P Cotality CS 20-City m/m SA	Jul		0.2	0.2
10:00 AM	Conf. Board Consumer Confidence	Sep		90.0	89.4
10:00 AM	JOLTS Job Openings	Aug		7225	7271
10:00 AM	JOLTS Job Openings Rate	Aug			4.4
1:00 PM	Fed's Goolsbee Speaks in Moderated Discussion	0-Jan			
2:00 PM	Fed's Williams Speaks At Event	0-Jan			

Source: Bloomberg, Morgan Stanley Research forecasts

JOLTS. Job openings have rebounded, and the vacancy rate ratio of job openings to the number of unemployed has bounced back above 1.0. At its new, higher level, it no longer raises risks that the unemployment rate rises more sharply.

Exhibit 23: Wednesday

Wednesday 30 Sept	Data	Period	Forecast	Consensus	Prev
7:00 AM	MBA Mortgage Applications	25-Sep			
8:15 AM	ADP Employment Change	Sep		70	38
8:30 AM	Retail Inventories m/m	Aug			0.7
8:30 AM	BEA Releases Annual Revisions to GDP and Personal Income	0-Jan			
8:30 AM	Personal Income	Aug	0.4	0.5	0.4
8:30 AM	Personal Spending	Aug	0.7	0.9	0.2
8:30 AM	Real Personal Spending	Aug	0.4	0.6	0.0
8:30 AM	PCE Price Index m/m	Aug		0.4	0.2
8:30 AM	PCE Price Index y/y	Aug		3.7	3.7
8:30 AM	Core PCE Price Index m/m	Aug		0.3	0.2
8:30 AM	Core PCE Price Index y/y	Aug		3.3	3.3
8:30 AM	GDP Annualized q/q	2Q T	1.5	1.5	1.5
8:30 AM	Personal Consumption	2Q T	3.4	3.4	3.4
8:30 AM	Core PCE Price Index q/q	2Q T		3.6	3.6
8:30 AM	Advance Goods Trade Balance	Aug	-110.0	-113.9	-118.8
8:30 AM	Wholesale Inventories m/m	Aug P			1.3
9:45 AM	MNI Chicago PMI	Sep		51.2	47.1
1:30 PM	Fed's Barkin Gives Welcome Remarks at Rural America Conference				
3:25 PM	Fed's Cook Speaks at Investing in Rural America Conference				
5:15 PM	Fed's Goolsbee Gives Keynote Address				

Source: Bloomberg, Morgan Stanley Research forecasts

PCE prices. We expect core PCE to rise 0.25% m/m in August, with acceleration in both core goods and core services inflation, while headline PCE increases 0.34% m/m. Our estimates incorporate our best assessment of the upcoming PCE revisions. Including the effects of the revisions, we expect core PCE inflation to run at 3.26%, 3.18%, and 2.73% on a 12-, 6-, and 3-month annualized basis, respectively, compared with 3.19%, 3.32%, and 3.41% in July. See forecast details here: [U.S. Data Pulse: CPI: August CPI: A hawkish surprise \(11 Sep 2026\)](#)

Personal income and spending. We expect real personal spending rose 0.4% m/m in August, with goods up 1.2% and services up 0.1%. This services expectation includes a drag of about a tenth as World Cup spending from June and July is not repeated. We expect nominal personal income rose 0.4% m/m, with labor compensation up a stronger 0.5%. Real disposable personal income is flat on the month with the re-acceleration in oil prices, and the saving rate falls from 3.0% in July to 2.6% in August.

Trade balance in goods. Price changes alone would suggest a slight widening of the trade gap in goods in August. However, we expect that real imports fall and real exports rise by about 2 1/2% m/m, and the overall trade gap narrows sharply to \$110bn. That said, capital

goods imports have repeatedly surprised with their strength.

GDP revision. The annual revision will cover from 2021 onward. As usual, the BEA will incorporate updated source data for spending and income. More important to the current macro questions will be the revisions to PCE prices. In particular, BEA is changing how it estimates prices for portfolio management services, legal services, and computer software. As well as potentially shifting the recent pace of core PCE inflation, these could alter (to the same extent, in the opposite direction) estimates of real spending.

Exhibit 24: Thursday

Thursday 01 Oct	Data	Period	Forecast	Consensus	Prev
	Total Vehicle Sales	Sep	16.2	16.6	16.8
5:30 AM	Challenger Job Cuts y/y	Sep			-38.5
8:30 AM	Initial Jobless Claims	26-Sep	200		197
8:30 AM	Continuing Claims	19-Sep	1730		1719
9:05 AM	Fed's Barkin, Collins, Schmid on Panel About Rural America				
9:45 AM	S&P Manufacturing PMI	Sep F			
10:00 AM	ISM Manufacturing	Sep	54.5	55.0	54.6
10:00 AM	Construction Spending m/m	Aug			-0.5
6:45 PM	Fed's Logan Speaks At Eleventh District Appreciation Event				
4:30 PM	Fed balance sheet (H.4.1)				

Source: Bloomberg, Morgan Stanley Research

Jobless claims likely inch up to 200k, still an extremely low level and below recent months.

Manufacturing ISM. September manufacturing surveys so far suggest resilient manufacturing activity. Demand remains strong, and labor demand continues to expand. Supplier delivery times have lengthened at a faster pace, while input prices have accelerated sharply. We expect similar patterns in the ISM. We are tracking the September ISM Manufacturing PMI at 54.5, little changed from 54.6 in August.

Construction spending. We forecast a 0.2% decline led by pullback in single-family building. However, we expect that with the upward revision to August housing starts, August construction spending will be revised from its currently reported -0.5% to about -0.3%.

Exhibit 25: Friday

Friday 02 Oct	Data	Period	Forecast	Consensus	Prev
8:30 AM	Change in Nonfarm Payrolls	Sep	65	100	162
8:30 AM	Change in Private Payrolls	Sep	75	88	127
8:30 AM	Average Hourly Earnings m/m	Sep	0.2	0.3	0.3
8:30 AM	Average Weekly Hours All Employees	Sep	34.4	34.3	34.4
8:30 AM	Unemployment Rate	Sep	4.1	4.1	4.1
8:30 AM	Labor Force Participation Rate	Sep	61.6		61.6
10:00 AM	Factory Orders	Aug			0.9
4:15 PM	Commercial bank balance sheets (H.8)				

Source: Bloomberg, Morgan Stanley Research

Employment report. Please see our [Employment Report Preview](#).

We estimate September payrolls +65k and private payrolls +75k. The unemployment rate moves sideways at 4.1%, on the verge of a 4.2%, as LFPR inches up. Average hourly earnings remain slow, rising 0.2% m/m and 3.1% y/y.

Our forecast reflects continued strong labor demand, with only limited reversal of the industry payrolls that were above trend in August. Despite resilience in payrolls, the unemployment rate moves sideways (or up) as labor force participation moves sideways (or up).

The Fed's clearly not concerned about faltering labor demand. But a drop in the unemployment rate below 4.0% would further raise the chance of an October rate hike.

Data calendar

Exhibit 26: September 28 - October 9

<i>Monday</i>	<i>TUESDAY</i>	<i>WEDNESDAY</i>	<i>THURSDAY</i>	<i>FRIDAY</i>
28 Dallas Fed Manf. Activity (Sep, 10:30 AM) Fed's Barkin Speaks (1:30 PM)	29 Home Prices (Jul, 9 AM) Conf. Board Consumer Confidence (Sep, 10 AM) JOLTS (Aug, 10 AM) Dallas Fed Services Activity (Sep, 10:30 AM) Fed's Goolsbee Speaks (1 PM) Treasury Buyback (TIPS 1Y-10Y, max \$750 mil, 1:40 PM) Fed's Williams Speaks (2 PM)	30 MBA Mortgage Applications (Wk of 9/25, 7 AM) ADP Employment Change (Sep, 8:15 AM) Personal Income and Spending, PCE Prices (Aug, 8:30 AM) GDP (2Q T, 8:30 AM) Advance Goods Trade Balance, Wholesale and Retail Inventories (Aug, 8:30 AM) MNI Chicago PMI (Sep, 9:45 AM) Fed's Barkin Speaks (1:30 PM) Fed's Cook Speaks (3:25 PM) Fed's Goolsbee Speaks (5:10 PM) Fed's Kashkari Speaks (6 PM)	1 Challenger Job Cuts (Sep, 5:30 AM) Jobless Claims (Wk of 9/26, 8:30 AM) Fed's Barkin, Speaks (9:05 AM) S&P Manufacturing PMI (Sep F, 9:45 AM) ISM Manufacturing (Sep, 10 AM) Construction Spending (Aug, 10 AM) Treasury Buyback (Nom Cpn 10Y-20Y, max >=\$4 bil, 1:40 PM) Fed's Cook Speaks (3:30 PM) Fed's Logan Speaks (6:45 PM) Omdia Total Vehicle Sales (Sep)	2 Employment Report (Sep, 8:30 AM) Factory Orders (Aug, 10 AM) Durable Orders (Aug F, 10 AM)
5 S&P Services PMI (Sep F, 9:45 AM) ISM Services (Sep, 10 AM)	6 ADP Weekly Employment Change (Wk of 9/19, 8:15 AM) Trade Balance (Aug, 8:30 AM) 3-Year Notes Auction (1 PM) Treasury Buyback (Nom Cpn 2Y-3Y, max \$4 bil, 1:40 PM) Fed's Logan Speaks (7 PM) Manheim Used Vehicle (Oct, 9 AM)	7 MBA Mortgage Applications (Wk of 10/2, 7 AM) NY Fed 1-Yr Inflation Expectations (Sep, 11 AM) 10-Year Notes Auction (1 PM) FOMC Meeting Minutes (2 PM) Consumer Credit (Aug, 3 PM)	8 Jobless Claims (Wk of 10/3, 8:30 AM) Wholesale Trade and Inventories (Aug, 10 AM) 30-Year Bond Auction (1 PM) Treasury Buyback (Nom Cpn 20Y-30Y, max >=\$4 bil, 1:40 PM)	9 U. of Mich. Consumer Sentiment (Oct P, 10 AM)

Note: For updates post-publication of the Treasury Auction Schedule, see [here](#). Source: Bloomberg, Morgan Stanley Research

US economic outlook

Exhibit 27: Morgan Stanley forecasts

	4Q/4Q % change			Quarterly % change, annual rate (unless otherwise noted)							
	2025A	2026E	2027E	1Q26A	2Q26A	3Q26E	4Q26E	1Q27E	2Q27E	3Q27E	4Q27E
Real GDP	2.0	2.1	2.3	2.1	1.5	2.5	2.5	2.1	2.3	2.4	2.4
Final Sales ¹	2.2	2.2	2.1	1.9	2.2	2.1	2.4	2.0	2.1	2.2	2.2
Final Domestic Demand²	1.8	2.8	2.5	2.2	3.3	3.3	2.3	2.3	2.5	2.7	2.7
Final Private Domestic Demand ³	2.4	3.0	2.7	1.7	4.2	3.7	2.5	2.4	2.7	2.8	2.8
Personal Consumption Expenditures	2.1	2.2	1.8	0.5	3.4	2.9	1.9	1.5	1.8	2.0	2.0
– Goods	1.4	2.1	1.1	0.5	4.3	2.8	1.0	0.5	1.0	1.3	1.3
– Services	2.4	2.2	2.2	0.5	3.1	3.0	2.3	1.9	2.2	2.3	2.3
Nonresidential Fixed Investment	5.6	8.4	7.1	10.6	8.5	8.7	5.9	7.1	7.1	7.1	7.2
– Structures	-5.5	-3.1	2.0	-4.7	-1.8	-3.0	-3.0	2.0	2.0	2.0	2.0
– Equipment	9.6	13.0	9.0	15.8	13.6	15.0	8.0	9.0	9.0	9.0	9.0
– IPP	8.0	9.6	7.5	13.8	8.8	8.0	8.0	7.5	7.5	7.5	7.5
Residential Investment	-3.8	-1.9	0.0	-7.8	1.3	-1.6	1.0	0.0	0.0	0.0	0.0
Exports	1.1	3.0	1.8	10.9	4.5	-6.0	2.5	1.8	1.8	1.8	1.8
Imports	-1.9	7.6	4.5	11.8	12.5	4.0	2.0	4.1	4.5	4.7	4.7
Government	-1.2	1.6	2.0	4.4	-1.0	1.4	1.4	2.0	2.0	2.0	2.0
Inventory contribution (pct pts, a.r.)	-0.2	0.0	0.2	0.2	-0.7	0.3	0.0	0.1	0.1	0.1	0.1
Trade contribution (pct pts, a.r.)	0.4	-0.7	-0.3	-0.4	-1.1	-1.3	0.0	-0.4	-0.5	-0.5	0.0
Nominal GDP (Current \$)	5.4	6.0	4.7	5.8	8.0	5.0	5.3	4.9	4.7	4.6	4.5
Nominal Consumption	5.0	6.1	4.2	5.2	8.9	5.6	4.9	4.5	4.3	4.1	4.0
Employment & Personal Income											
Civilian Unemployment Rate (%)	4.5	4.2	4.3	4.3	4.3	4.1	4.2	4.3	4.3	4.3	4.3
Civilian Labor Force Participation Rate (%)	62.5	61.6	61.3	62.0	61.7	61.6	61.6	61.6	61.5	61.4	61.3
Employment to Population Ratio (%)	59.7	59.0	58.7	59.3	59.1	59.0	59.0	58.9	58.8	58.8	58.7
Average Monthly Change in Nonfarm Payrolls (Thous.)	10	70	50	73	81	81	45	50	50	50	50
Real DPI	1.0	0.6	1.2	0.9	-1.5	1.9	0.9	0.9	1.0	1.1	1.8
Saving rate (%)	3.8	2.3	1.8	3.9	2.8	2.5	2.3	2.2	2.0	1.8	1.8
Business Indicators											
Industrial Production	1.5	2.1	2.0	1.3	4.1	1.7	1.1	1.8	2.0	2.1	2.1
Productivity	2.5	1.3	1.8	0.8	0.6	1.7	1.9	1.5	1.8	1.9	1.9
Inflation (quarterly % change, a.r.)											
Consumer Price Index				3.6	6.1	1.5	3.4	2.0	2.1	1.9	1.8
CPI ex Food & Energy				2.8	2.9	2.2	2.7	2.9	2.3	2.3	2.2
PCE Price Index				4.2	5.1	2.6	3.0	3.0	2.4	2.1	2.0
PCE ex Food & Energy				4.0	3.3	3.0	2.5	3.6	2.6	2.4	2.2
Inflation (4-quarter % change)											
Consumer Price Index	2.7	3.6	1.9	2.7	3.8	3.4	3.6	3.2	2.2	2.3	1.9
CPI ex Food & Energy	2.7	2.6	2.4	2.5	2.7	2.5	2.6	2.7	2.5	2.6	2.4
PCE Price Index	2.8	3.7	2.4	3.0	3.7	3.7	3.7	3.4	2.7	2.6	2.4
PCE ex Food & Energy	2.8	3.2	2.7	3.0	3.2	3.2	3.2	3.1	2.9	2.8	2.7
Monetary Policy											
Fed Funds Target (% ,midpoint of target range)	3.625	4.125	4.375	3.625	3.625	3.875	4.125	4.375	4.375	4.375	4.375

1) GDP less contribution from inventory investment

2) GDP less contributions from inventory investment and trade

3) GDP less contributions from inventory investment, trade, and the government sector. (Private final consumption plus investment.)

Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve, Census Bureau, Treasury Dep't, Morgan Stanley Research forecasts

Exhibit 28: Monthly inflation forecasts

	% Change - Year-over-Year				% Change - Month-over-Month				Headline CPI NSA Index
	Headline PCE	Core PCE	Headline CPI	Core CPI	Headline PCE	Core PCE	Headline CPI	Core CPI	
Jan-25	2.6	2.7	3.0	3.3	Jan-25	0.32	0.28	0.43	317.671
Feb-25	2.6	2.9	2.8	3.1	Feb-25	0.38	0.42	0.23	319.082
Mar-25	2.3	2.6	2.4	2.8	Mar-25	0.00	0.08	0.03	319.799
Apr-25	2.2	2.5	2.3	2.8	Apr-25	0.19	0.22	0.16	320.795
May-25	2.4	2.7	2.4	2.8	May-25	0.22	0.27	0.10	321.465
Jun-25	2.6	2.9	2.7	2.9	Jun-25	0.32	0.31	0.25	322.561
Jul-25	2.7	2.9	2.7	3.1	Jul-25	0.16	0.23	0.23	323.048
Aug-25	2.7	2.9	2.9	3.1	Aug-25	0.22	0.18	0.35	323.976
Sep-25	2.8	2.8	3.0	3.0	Sep-25	0.27	0.20	0.30	324.800
Oct-25	2.7	2.8	2.9	2.8	Oct-25	0.21	0.24	0.13	#N/A
Nov-25	2.8	2.8	2.7	2.6	Nov-25	0.18	0.14	0.13	324.122
Dec-25	2.9	2.9	2.7	2.6	Dec-25	0.33	0.33	0.30	324.054
Jan-26	2.8	3.1	2.4	2.5	Jan-26	0.32	0.41	0.17	325.252
Feb-26	2.8	3.0	2.4	2.5	Feb-26	0.33	0.32	0.27	326.785
Mar-26	3.5	3.2	3.3	2.6	Mar-26	0.66	0.29	0.87	330.213
Apr-26	3.6	3.2	3.8	2.7	Apr-26	0.36	0.19	0.64	333.020
May-26	4.0	3.3	4.2	2.8	May-26	0.54	0.42	0.47	335.123
Jun-26	3.6	3.2	3.5	2.6	Jun-26	-0.07	0.17	-0.42	333.952
Jul-26	3.6	3.2	3.3	2.5	Jul-26	0.16	0.25	0.07	333.918
Aug-26	3.7	3.3	3.4	2.4	Aug-26	0.34	0.25	0.40	334.980
Sep-26	3.8	3.3	3.6	2.5	Sep-26	0.36	0.22	0.50	336.502
Oct-26	3.8	3.2	3.7	2.6	Oct-26	0.22	0.20	0.24	336.766
Nov-26	3.7	3.3	3.7	2.7	Nov-26	0.14	0.19	0.10	336.103
Dec-26	3.6	3.2	3.5	2.6	Dec-26	0.19	0.19	0.20	335.697
Jan-27	3.6	3.2	3.5	2.7	Jan-27	0.33	0.43	0.16	336.900
Feb-27	3.5	3.1	3.4	2.7	Feb-27	0.20	0.27	0.10	337.920
Mar-27	3.1	3.1	2.8	2.7	Mar-27	0.27	0.22	0.28	339.489
Apr-27	2.9	3.1	2.2	2.5	Apr-27	0.17	0.21	0.12	340.614
May-27	2.5	2.8	1.9	2.4	May-27	0.18	0.20	0.16	341.684
Jun-27	2.8	2.9	2.5	2.7	Jun-27	0.20	0.20	0.19	342.599
Jul-27	2.8	2.8	2.5	2.6	Jul-27	0.13	0.20	0.07	342.548
Aug-27	2.6	2.8	2.3	2.5	Aug-27	0.20	0.19	0.20	342.974
Sep-27	2.5	2.7	2.1	2.5	Sep-27	0.21	0.19	0.24	343.645
Oct-27	2.3	2.7	1.8	2.5	Oct-27	0.09	0.18	0.01	343.136
Nov-27	2.4	2.7	1.9	2.4	Nov-27	0.17	0.18	0.17	342.684
Dec-27	2.4	2.7	2.0	2.4	Dec-27	0.23	0.18	0.28	342.553

Source: BLS, BEA, Morgan Stanley Research forecasts. PCE numbers include the impact of PCE historical revisions.

US Outlook Scenarios

Exhibit 29: Morgan Stanley US Economics baseline and alternative outlooks for the US Economy: 2026, and 2027

	Aggregate Demand Shock: Animal Spirits (30%)	Rapid Disinflation (10%)	Baseline: Oil Risk Premium/Sticky Inflation (45%)	AI Productivity Boost with Labor Displacement (5%)	Recession (10%)
Key Forecasts					
GDP growth	Elevated wealth supports consumption and "animal spirits" keep business spending elevated. GDP grows 3.0% in 2027, 0.5-1.0pp faster than the baseline.	High oil prices act as a tax on consumption near-term, though with slightly more rebound in mid-to-late 2027. Real growth rises to 2.6% (4Q/4Q) in 2027.	Oil prices remaining near \$100/bbl in 4Q and 1Q weigh on growth near-term. Real GDP rises 2.3% in 2027 (4Q/4Q), though private final domestic demand decelerates slightly vs 2026.	GDP growth is steady, rising 2.0% in 2027. Strong business spending is offset somewhat by weaker labor markets and low consumer confidence. Despite softer inflation in 2027, consumer spending stays sluggish as labor displacement mounts.	Oil prices rise to \$140-160/bbl. Supply shortages ensue, and demand destruction occurs. The result: mild recession with two quarters of negative GDP growth in mid-2027. Real GDP rises only 0.1% in 2027 (4Q/4Q).
Labor markets	Stronger demand results in tighter labor markets. The unemployment rate falls to 3.9% in 2026 and 3.5% in 2027.	Average monthly payroll gains are slightly stronger vs the baseline, around 60k next year. Labor demand remains soft on geopolitical uncertainty. Less immigration means a lower breakeven rate of hiring. The unemployment rate finishes 2027 unchanged vs 2026, around 4.2%.	The "curious balance" continues. Average monthly payroll gains average around 50k next year. Labor demand remains soft on geopolitical uncertainty. Less immigration means a lower breakeven rate of hiring. The unemployment rate finishes 2026 at 4.2% and 2027, a tenth higher vs 2026.	The economy experiences a prolonged period of net zero job creation. The separation rate edges higher, but widespread layoffs are avoided. The unemployment rate creeps higher, rising to 4.8% in 2027, 0.5pp above our baseline outlook.	Payrolls fall an average of 30k per month beginning in 2027. The unemployment rate rises to 5.5% next year.
Inflation	Inflation pressures step-up due to demand-side pressures. Headline inflation is 3.8% in 2026 and 2.8% in 2027. Core PCE inflation firms through Q1 27, prompting Fed hikes, which subsequently slow inflation.	High inflation in 2026 dissipates in 2027. Energy prices push headline PCE inflation to 3.4% 4Q/4Q in 2026. Headline and core PCE decelerate to 2.0% and 2.3% 4Q/4Q in 2027 as the oil shock fades. Energy is a headline story with no important second-round effects on core.	Two more years of above-target inflation. Energy prices push headline PCE inflation to 3.7% 4Q/4Q in 2026, while core accelerates to 3.2% on tariff push, the AI demand push, and second round effects from the oil shock. Headline and core PCE decelerate to 2.4% and 2.7% 4Q/4Q in 2027 as the inflationary effect of the oil shock fades.	Inflation rises on account of higher energy prices, but weak labor markets and slow wage growth provide offset. Headline inflation already peaked at 3.7% y/y in 2Q 2026 and finishes the year at 3.6%. Productivity gains speed up the disinflation process. Inflation falls back to the 2.0% target in 2027.	Headline inflation surges to 5.1% y/y in 4Q 2026. On weaker demand, inflation decelerates to 1.1% in 2027.
Federal reserve policy	Hikes to counter inflation. The Fed raises rates by 150bp in total to 5.00-5.25%, more than reversing the 75bp in pre-emptive cuts to support the labor market in 2025.	The Fed hikes once more in December, but with oil pressures abating, disinflation is faster and the Fed does not need to tighten further. They cut twice in 2H27, to a terminal rate of 3.5-3.75%.	Inflation remains sticky, leading to two more 25bp hikes in Dec 2026 and Mar 2027. The Fed then pauses there at 4.25%-4.5% for the remainder of 2027.	Labor displacement leads to cuts next year. The Fed hikes in Dec and March, but the rising unemployment rate leads the Fed to cut by 75bp in 2H27, to a terminal rate of 3.5-3.75%.	The Fed hikes in December and March as oil prices rise, but then shifts to cuts as downside risks to growth mount. They cut by 200bp beginning in mid-2027 to a terminal of 2.25-2.5%. No QE.
Key Forecasts					
Consumer spending	Better than expected equity market returns and a rebound in labor markets boost consumption to around 3.0% in 2027. Upper-income consumers drive much of the spending, but nominal wage growth supports low- and middle-income spending.	Faster disinflation results in more of a rebound in real income, while policy is less of a constraint than in the base case. By mid-2027, we start to see some broadening out. Real consumption growth is similar in 2027 as 2026, around 2.1%.	Consumption has been resilient through the oil shock. Still soft real income growth and tighter policy continue to weigh on spending, especially for low- and middle-income consumers. Wealth is an offset, supporting the high-end. Consumption slows modestly to 1.8% in 2027.	Consumption slows further to 1.0-1.5% in 2027. In addition to near-term high gas prices, soft labor market conditions and fears of AI displacement make consumers turn cautious in 2027 despite improving real spending power from decelerating inflation.	Consumption falls for most of 2027, before a gradual reacceleration. Households cut back on durable goods spending. Negative wealth effects lead upper-income consumers to pull back, with spillover into broader spending.
Nonresidential fixed investment	Business spending broadens out beyond AI, due to animal spirits and fiscal support.	Similar to the baseline. AI-related spending remains robust, while AI adoption rates rise and firms realize productivity gains. Broadening out in non-AI sectors continue, perhaps at a slower pace.	AI-related spending remains robust, leading nonresidential fixed investment to moderate only modestly to 7.1% in 2027. AI adoption rates rise and firms realize productivity gains.	AI-related spending remains robust, leading nonresidential fixed investment to moderate only modestly to 7.1% 2027. AI adoption rates rise more than the baseline and firms realize higher productivity gains.	A retrenching business sector cuts employment and capex. Investment declines throughout 2H and into Q1 2027, followed by recovery.
Residential investment	Stronger growth is balanced by higher rates. Housing activity remains subdued.	Housing remains "stuck", but activity picks up slightly versus the base case on stronger real income growth and less restrictive policy. Residential investment grows modestly in 2027.	Housing remains "stuck" due to low affordability and limited inventory, which higher rates only reinforce. Residential investment is flat in 2027 after declining in 2026.	Housing activity remains sluggish in both 2026 and 2027, despite lower interest rates. Improved affordability is offset by softening labor market conditions.	Housing activity is weak on the back of slower growth and weak labor markets. Activity begins to pick up towards the end of 2027 as growth recovers and low rates spur demand.
Net trade	Imports are strong with strong demand, resulting in a larger drag on GDP and a wider trade deficit.	Imports are strong with somewhat stronger demand than the baseline, thus a larger drag on GDP. Imports rise 5.0% in 2027. Exports rise 1.8%. Net trade subtracts 0.4pp from growth in 2027.	Imports rise 4.5% in 2027 after strong 7.6% growth in 2026. Exports rise 1.8% in 2027 after 3.0% in 2026. Net trade subtracts 0.3pp from growth next year.	Relative to the baseline, imports are softer. AI-related imports are robust, but imports of consumer goods are more muted on the back of softer household spending. Net trade subtracts 0.2pp from growth next year 2027.	Imports and exports both fall over the next few quarters as demand falls and slow global growth limits export demand. Net trade contributes positively to growth in 2026.
Fiscal policy	Fiscal multipliers are higher than in the baseline, resulting in higher contribution to growth. With stronger growth, fiscal deficits decline.	The fiscal impulse in the OBBBA is neutralized by higher gasoline prices. The midterm elections bring divided government, leading to budget gridlock and large deficits at about 6.0% of GDP.	Higher gas prices more than offset the growth effects of the OBBBA. The midterm elections bring divided government, leading to budget gridlock and large deficits at about 6.3% of GDP.	Similar to the baseline. A softer labor market means slightly less revenue growth and more automatic stabilizers. The deficit is 6.3% of GDP in 2026 and 2027.	Deficits rise further as tax receipts decelerate and automatic stabilizers boost transfer payments. Defense spending picks up. The deficit as a percent of GDP is 6.9% in 2026 and 6.7% in 2027
Credit conditions	Credit conditions loosen somewhat on the heels of stronger growth and animal spirits. Bank lending accelerates.	Geopolitical uncertainty combined with consumer resilience mean conditions are steady over the forecast horizon.	Geopolitical uncertainty combined with consumer resilience mean conditions are steady over the forecast horizon.	Credit conditions bifurcate, with willingness to lend to consumers worsening amid solid growth in C&I lending.	Credit conditions tighten further as the economy contracts. By late next year, the Fed has eased policy enough to encourage some new credit supply but demand remains weak.
Productivity growth	Similar productivity growth as the baseline, even with stronger employment growth.	Productivity rises faster than in the baseline in 2027. Productivity gains are from higher output, not less employment.	Productivity rises 1.8% in 2027, with a modest boost from AI.	Higher productivity growth than the baseline, which brings greater labor displacement.	With rapid declines in output, productivity falls over the next few quarters. Productivity then begins to recover in 2027.
Consumer and business confidence	Confidence rebounds across the course of the year, and further in 2027.	Confidence of households and business remains near 2022-2023 lows on account of low labor demand, high inflation, and elevated uncertainty.	Confidence of households and business remains near 2022-2023 lows on account of low labor demand, high inflation, and elevated uncertainty.	Labor displacement pushes consumer confidence down further, testing new lows. Business optimism remains elevated.	Recession pushes confidence down further, testing new lows.

Source: Morgan Stanley Research forecasts

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