Transcript
Fed Talk: 2026 Economic Outlook
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Presentation

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Julianne Dunn:

Good afternoon. Thank you for joining us, and welcome to today's *Fed Talk*. I am Julianne Dunn. I'm regional executive at the Federal Reserve Bank of Cleveland's Cincinnati branch, and it's my pleasure to kick off today's *Fed Talk* on the 2026 economic outlook. *Fed Talk* is the Cleveland Fed speaker series, in which we share research that is relevant to our community. Past events have covered such subjects as the economy, access to the labor market, and financial literacy. Our events can be found on our website, clevelandfed.org.

A few housekeeping items before we begin. During this event, your microphone and camera are disabled. Please type and submit your questions in the Q&A box so that they can make their way to me. In the case the Zoom meeting drops, please use the dial-in info provided in the invitation to join the call. I would like to state that the views shared today by myself and our presenter are our own, and not necessarily those of the Federal Reserve Bank of Cleveland or the Federal Reserve System.

So as we enter a new year, it's a good time to look at a variety of key economic indicators to offer some preliminary analysis for the economic year ahead. Joining us today is Ed Knotek, Senior Vice President and Director of Research at the Cleveland Fed. At this time, I will turn it over to Ed to get us started.

Ed Knotek:

Thank you, Julianne, and thanks to all of you for joining us today. As Julianne said, my name's Ed Knotek. I'm the research director here at the Cleveland Fed, and I'll be presenting the 2026 Economic Outlook. As Julianne mentioned, as is always the case, the views that I'll express today are my own, and not necessarily those of the Cleveland Fed or the Federal Reserve system.

My presentation today will focus on four main points. First, the US economy was relatively resilient in 2025, as changes in government policies contributed to large swings in economic growth. Nevertheless, the economy looks to have expanded at a solid pace overall. Second, the labor market softened over the course of 2025, as job growth slowed and the unemployment rate rose. This is an unusual pattern in an expansion, but in line with the resilience of the overall economy, there are no signs of rapid deterioration.

Third, inflation remained elevated relative to the FOMC's 2% objective, and it showed little further progress last year. And fourth, projections released by the FMC at its December meeting suggests that most monetary policymakers expected small reductions in inflation, the unemployment rate, and the federal funds rate in 2026.

Let me first turn to gross domestic product, or GDP. GDP is the broadest measure of economic activity, capturing spending on all goods and services in the economy across consumers, businesses, and government, and international trade. In the first quarter, GDP decreased at a 0.6% annualized rate. It then grew around 4% at an annualized rate over the next two quarters, very strong growth. Spending growth on consumption, business fixed investment, and residential investment last year was positive overall, and relatively steady. The big swings in spending largely reflect swings in international trade and inventory behavior as businesses primarily responded to incoming information about changes in tariff policies.

There are a wide range of estimates for growth in the fourth quarter of last year. Professional forecasters in the Blue Chip survey see growth somewhere between 0% and 2%, with many clustered around positive 1%. Part of the step-down comes from the federal government shutdown in October and part of November. That held down spending directly in the fourth quarter. It's also delayed the release of many data series that provide us information about the economy's trajectory. Even with that likely slower fourth quarter, GDP looks to have grown at better than a 2% rate for all of 2025. This is a pretty solid reading, compared with most estimates of longer-run trend growth for the economy.

Let me dig into the data a little further, starting with spending by consumers, all of us. A major support for consumer spending is solid income growth. Aggregate disposable personal income in blue shows household incomes, which includes wage growth and expanding employment, plus income from assets, plus government transfers to households, minus taxes. In orange, we have outlays, which is spending. In general, outlays rise alongside incomes over time. Spending rose at a solid pace last year, continuing its recent trend.

In addition to income from assets, rising asset prices boost household's wealth and provide a wealth effect that supports spending. Here, we have household net worth as a percentage of disposable personal income. Last year was a strong year for households' balance sheets overall. Households' non-financial assets increased 2% year over year through the third quarter. Households' financial assets increased 9% year over year through the third quarter. This means that net worth rose even faster than incomes, pushing this ratio to its fourth-highest reading on record.

While consumers continue to spend at a good clip in general, consumer attitudes are subdued. The blue line here shows the University of Michigan's Consumer Sentiment measure. While the orange line has the Conference Board's Consumer Confidence measure. These measures capture slightly different concepts, but ultimately they're asking people for their views on the economy. Both are well below where they were in 2018 to 2019, and they both trended down over the course of last year. The disconnect between spending and sentiment likely reflects, in part, a trend that many business contacts report: higher-income consumers have been spending strongly, helping to push up the aggregate numbers, while lower-income consumers have been more cautious in their spending.

Turning to the housing market, after a rapid burst of activity following the pandemic recession, activity in the housing market pulled back and has remained subdued. This is especially the case for existing single family home sales in the blue line. These have been trending largely sideways

for about the last three years, at a sales pace similar to what was seen in the depths of the Great Recession. There have been some recent upticks in both existing and new home sales, in orange, but we'll need to see if they persist.

There are a number of factors at play here. In new construction, costs have risen sharply, and building capacity is not what it had been 20 years ago. Another important factor in housing finance is mortgage rates. Mortgage rates drifted down over the course of last year, back to levels from the mid-2000s. Mortgage rates are largely determined by longer-term treasury yields, which are also well above their pre-pandemic levels.

Many households have low mortgage rates from when they bought or refinanced over much of the last decade. This channel creates what's been called house lock, where some households prefer to keep their old, low-rate mortgage, rather than move and require a new mortgage. This has probably weighed on the supply of existing homes that are available for sale.

Another factor limiting some activity is the level of home prices. Home prices grew very slightly last year, but they're up about 50% versus pre-pandemic levels. As with many things, this has pros and cons for the economy and for individual households. High home prices boost wealth for homeowners, helping to support the wealth effect that I mentioned earlier. But they pose a challenge for new home buyers to enter the market, who have raised concerns about housing affordability.

Let me turn next to business activity. This chart shows business surveys from the Institute for Supply Management, for the manufacturing sector in blue and the services sector in orange. Readings above 50 indicate that more businesses are reporting expansionary conditions. And here we see that firms in the services sector have turned more optimistic in recent months. Meanwhile, conditions are more subdued in the manufacturing sector, where businesses on net are reporting somewhat soft activity.

There are three important trends in the business sector that they're watching. First among these is the tariff picture. There are many developments last year related to changes in tariff rates and changes continue into this year as well. This series from the Yale Budget Lab shows the average effective tariff rate, which jumped from roughly 2% in 2024 to about 14% in 2025. This was the highest level for the effective tariff rate since 1939, and a historically big one-year change in rates.

Business contacts frequently cite tariffs as having played an important role in raising costs in 2025. In many cases, tariffs directly raised the prices of imported intermediate inputs, or tariffs raised costs indirectly by causing firms to switch to alternative suppliers and processes. In other cases, contacts reported that uncertainty around tariffs had also raised their costs. For example, by using additional staff time to research alternative supply chains and negotiate prices, or for scenario planning. The Cleveland Fed's regional team regularly surveys business contacts to produce our SORCE indices that report on activity, prices, costs, and employment in the fourth district. Prior to each FOMC meeting, our website updates those series to provide you with a snapshot of conditions.

As a result of changing tariff rates and inventory dynamics, trade flows experienced very large swings in 2025. Early last year, businesses pulled forward imports to get ahead of impending tariffs, stockpiling inventories as a result. This caused a sharp deterioration in the trade deficit, which was a major factor weighing on first quarter growth last year. It then led to a rebound that

boosted second quarter growth. It'll take some time to work through all the inventories, to see how tariff rates will impact the trade balance both this year and beyond.

A second trend to be watching in the business sector comes from information technology. Artificial intelligence or AI, cloud computing, and other developments have generated tremendous interest and investment. This includes financial investments, as seen in rapid stock price gains of major IT firms, as well as physical investments in capital. The left chart here shows the very rapid growth in construction spending on data centers over the last three years, admittedly from an extremely low base. In fact, the series only starts in 2014.

The right chart shows business investments in computers and peripheral equipment, that is, the machines that sit at desks and also populate those data centers. Such spending has more than doubled since before the pandemic. In my mind, it's still early days to know with certainty how AI will fully impact the economy. Nevertheless, a number of economists see it as contributing importantly to productivity gains over time.

Some research from the Cleveland Fed suggests that productivity alternates between low-growth and high-growth regimes, shown here in the orange dotted line. Productivity growth over the past three years has been fairly strong, even before the gains from AI have likely been realized. A key question is whether it will be sustained. Strong productivity growth is generally a positive for the economy, because it allows for rising living standards over time, but there's debate over how AI will impact the labor market in particular, so let me turn there next.

2025 saw a notable slowing in job growth. Job gains had averaged above 150,000 per month in 2024 before declining to about 50,000 per month last year, based on current estimates. Reduced demand for labor is part of the picture. The federal government reduced its payrolls in 2025. In some cases, businesses have indicated reduced staffing levels to offset higher non-labor costs, or holding off on hiring because of elevated uncertainty. At the same time, labor supply growth has come down due to changes in immigration policy and declining participation rates. Slower growth in the labor force means a lower trend rate of payroll growth over time.

In line with the slowing in job gains, the unemployment rate rose in 2025, ending the year at 4.4%. Consistent with some cyclical slowing in the labor market, we have seen increases in the unemployment rates for certain groups, such as younger workers, and for Black or African American workers. Last year's the third calendar year in a row with a rising unemployment rate. At this point, the unemployment rate is one percentage point higher than its low point of 3.4% from April 2023, which itself was a multi-decade low reading, indicating how unusually tight the labor market was.

Zooming out, this chart shows the unemployment rate back to the 1940s. Let me focus on two points here. First, while the unemployment rate moved up recently, it's still fairly low by historical standards. It's equal to its best reading from the mid-2000s expansion, and it's only a little above its reading from the late 1990s expansion.

So while the labor market has softened, the unemployment rate is not far from many estimates of its longer run value. Second, this long, gradual, rising unemployment rate is unique among US expansions. Usually, the unemployment rate rises quickly during a recession, declines quickly immediately after a recession, and then declines gradually or flattens out as the expansion matures. So the current pattern is unique compared with past patterns that we've seen here in the US.

Behind the upward drifting unemployment rate, turnover in the labor market has declined. The job openings rate, in the blue line, which had surged amid the reopening of the economy, has come down to a level more consistent with its pre-pandemic rate. As shown in the orange line, the pace of hiring has slowed, and is similar to the tepid pace immediately following the Great Recession. Job separations have also declined. The quits rate in the green line has been subdued. The same is true for the layoff rate, not shown here, which remains very low.

Layoffs are noteworthy, because they tend to jump as the economy enters a downturn. This chart shows the long evolution of initial claims for unemployment insurance. Recessions, in the gray bars, coincide with a big jump in initial claims. To this point, initial UI claims have been relatively steady at historically low levels, suggesting that there is not a rapid deterioration in the labor market.

Economists at the Cleveland Fed collect and monitor notices related to upcoming large scale layoffs, so called WARN notices, for the Worker Adjustment and Retraining Notification Act. The factor that they extract from those data tends to be a leading signal of future job loss. In the November 2025 reading, that factor was right around its historical average level. So while the labor market data have softened compared with the very tight readings we saw earlier in this expansion, the picture does not really suggest a very soft labor market overall.

So with that, let me turn to examining prices and inflation in some detail. As you may know, the FOMC has a longer-term inflation objective of 2% inflation, as measured by changes in the price index for personal consumption expenditures, or PCE. I'll focus on PCE-based measures today. Importantly, inflation looks at the rate of change in broad price measures, not at price levels per se.

Here are three measures of inflation. Headline PCE in blue, which captures all prices relevant for consumers. In orange, we have core PC inflation, which excludes food and energy, and which is one measure of the trend in inflation. And in green, we have median PCE inflation, which is the change in prices in the middle of the distribution, another measure of the trend in which we calculate here at the Cleveland Fed.

All of these inflation measures are well below their peak readings, a sign that inflationary pressures have subsided from where they had been. However, they're all running above the FMC's 2% objective. In addition, all three measures have leveled out over the past year and a half or so.

Let me break down PCE inflation into five major components: energy, food, core goods, housing, and core services excluding housing. Food and energy are quite small components based on spending shares, but they can be very volatile, which means that they frequently move overall inflation. Core inflation excludes these series, and consists of the other three major components. Core goods, such as autos, apparel, and recreational items, are about one quarter of spending. Core services excluding housing in red are about half of consumer spending. Food and energy prices played an important role in the earlier run-up of inflation, hence why headline inflation was above core inflation.

These series can experience big swings in general, because they're driven by international swings in commodity prices. Recently, however, they've fluctuated only slightly. Food and energy prices were up about 2.5% late last year.

Turning to the components of core inflation, housing inflation, in the yellowish orange, has continued to moderate, and is not far from where it was before the pandemic. Easing inflation in

new tenant rents will likely result in further easing in this series, based on research from the Cleveland Fed. Inflation and core services excluding housing in red is still a little elevated, and has been declining only slowly.

Given the strong labor component to costs for such services, the softening in the labor market is likely exerting some downward pressure on this inflation rate. That should continue going forward. This leaves core goods inflation in green, which actually picked up over the last year. Because most goods are tradable across countries, this series captures the effects of higher tariff rates on domestic prices.

Looking back over a longer horizon, positive inflation in core goods has been relatively rare in recent memory. In fact, the prices of goods for consumers have generally been falling for most of the last 25 years, due to productivity gains, quality improvements, and international trade. The major exception came following the pandemic, when the combination of shifts in demand toward goods met with breakdowns in goods supply chain.

The more recent pickup in goods inflation has been moderate so far, but an open question for this year is how much additional tariff pass-through may take place. A final piece in assessing the inflation picture is the state of inflation expectations. Economists focus on inflation expectations because of the view that beliefs about the future can affect actions today. If I think inflation will be high tomorrow, it may affect my decisions around spending, saving, working, and the wages and prices that I set today.

Here, I'm plotting three measures of consumer's inflation expectations, from the University of Michigan, the New York Fed, and a measure created by Cleveland Fed economists called Indirect Consumer Inflation Expectations.

All three measures have been elevated of late, suggesting that consumers are still relatively more concerned about inflation than had been the case earlier. Here at the Cleveland Fed, we also produce the quarterly survey of firms' inflation expectations. This captures survey responses from CEOs and other executives about their inflation beliefs. These inflation expectations rose in 2021 and 2022 as inflation moved up, both for inflation over the next one year and over the next five years.

More recently, however, business executives' inflation expectations have come down, and they're now back to where they were in 2018. Putting these pieces together, the economy enters 2026 with solid growth readings, some softening in the labor market, and still elevated inflation. In light of the shifting risks in the labor market over the last year, the FOMC reduced the target range for the federal funds rate by three-quarter percentage point between September and December.

The lingering effects of those rate reductions are one factor that will support growth in the labor market in 2026. Changes in tariffs are a second key factor to watch this year. Measures of trade uncertainty jumped in 2025 as tariffs were originally announced and implemented. General uncertainty around tariffs is likely to be lower in 2026, even if tariff levels experience additional changes, because the direction of travel is clearer now than it had been. The ongoing pass-through of past and future tariffs to costs and prices will bear watching.

Changes in tax and other government policies are another key factor. On net, changes to tax policies that were implemented in 2025 are expected to be a tailwind to growth in 2026. Reduced immigration, meanwhile, is expected to limit growth in the labor force. And a fourth key factor to watch is advances in AI and associated financial and business investments. Given the

optimism about future prospects for the sector, will we continue to see strong investment, and how will these tools impact the labor market this year and beyond?

Given those factors, let me turn briefly to the forecast. To do so, I'll show the forecasts that FOMC participants made for their December meeting. Of course, different forecasters have different views on these and other fundamentals. The red dots are the median across the individual projections, or the middle forecast, and I'll focus on those. The blue bands provide the central tendency across the projections, and the whiskers provide the range of views.

After seeing growth a little below 2% in 2025, the median FOMC participant expected that GDP growth would move higher this year, to about two and a quarter percent, a pace that is a little higher than the longer-run estimate of one and three-quarters percent. Growth over the following two years was projected to edge down a little from this year's two and a quarter percent pace.

Turning next to the unemployment rate, after averaging 4.5% to end 2025, most FOMC members expected to see some gradual improvement in labor market condition. The median FOMC participant saw the unemployment rate edging down, to end this year at 4.4%. With above trend growth, further improvement was expected in 2027 and 2028 when the unemployment rate averaged 4.2%, equal to its longer-run estimate. PCE inflation was expected to end last year a little above its 2024 reading, reflecting the combination of forces I mentioned earlier. The median FOMC participant projected that PCE inflation will gradually fall over time, reaching 2.4% by the end of this year. In 2027, inflation was expected to step down further, to just above 2%, before falling back to 2% in 2028. In the longer run, all FOMC participants believed that inflation would be equal to the FOMC's inflation objective of 2%.

Finally, let's turn to monetary policy. This dot plot shows each FOMC participant's expectations for the appropriate level of the federal funds rate at the end of each calendar year. The midpoint of the target range for the federal funds rate at the end of last year was 3.63%. At the end of this year, the median participant projected that the funds rate would be 3.4%, roughly consistent with 125 basis point reduction in the funds rate, but the range of views was wide. The median projection was 3.1% in 2027 and 2028, roughly in line with the median longer-run funds rate projection of 3%.

Before turning to your questions, let me briefly put in a plug for the bank's Center for Inflation Research, whose resources were mentioned several times in this presentation. The Cleveland Fed's Center for Inflation Research is focused on improving the understanding of inflation and its dynamics. It provides inflation content for researchers, policymakers, and the public, ranging from an inflation 101 page, educational explainer videos, inflation data and indicators, survey estimates of inflation expectations, and in-depth analyses via our economic commentary and working paper series.

I should also note that the Cleveland Fed provides a number of resources focused on the 4th Federal Reserve District. Our regional analysis team combines quantitative data, qualitative surveys, and discussions and convenings to gain up-to-date insights on how the regional economy is doing. Working with our community development team, we share those insights in the beige book, our district data briefs, and the SORCE survey.

And new this year, Cleveland Fed staff also have produced a Fourth District Almanac, that provides statistics on how the metro areas and regions in our district have evolved over the last century. So I'll stop here, but thanks again for attending today. The Cleveland Fed has many

resources available to you if you're interested in learning more. And I look forward now to answering some of your questions.

Julianne Dunn:

Great. Well, thanks, Ed. Lots of really, really good information and economic indicators there. And so I want to remind everyone that there is Q&A option in the Zoom. You can add your questions, and they're coming through on my screen here. But I want to start maybe a little bit more broadly, because there's certainly a lot of attention on the Federal Reserve this week. While we can't comment on any of the specifics going on in DC, but I wondered if you might start with maybe a discussion of some of the academic research on central banks and independence from political pressure.

Ed Knotek:

Yeah, thanks, Julianne. Many debates among economists seem to go back and forth. There's a lot of give and take, but this one actually is fairly clear and one-sided. In general, if I had to sum up the consensus of the literature, more independent central banks produce lower inflation on average, and that seems to be a very, very robust finding. So why is that the case? So there's general agreement that high inflation has high costs for an economy. I think that many of us probably have felt those costs during the recent spell of high inflation. It's also the case that reducing inflation typically takes time. And so what you want then is you want a central bank that can operate with an eye towards the medium term, so they can be making decisions today that might take a while to actually affect economic outcomes and to bring inflation down.

At the same time, reducing inflation is costly. It typically requires higher interest rates and sometimes a slowing economy. And so elected officials may prefer to defer making those types of tough choices to bring inflation down, basically putting that off into the future and instead might be more likely to focus on things that might stimulate the economy in the near term, because of the electoral cycle.

This creates what we call a time inconsistency problem. So everybody would like lower inflation, but because it's costly, you might decide to put it off, if that's in your best interest. So what basically happens then is that that process allows high inflation to become entrenched in the economy, and then that makes it even more costly to bring that inflation down, requiring even higher interest rates. So there's kind of this ratcheting effect that can occur. So what you want then is that a central bank is able to consistently be able to lean against inflation with an eye toward the medium term, to be able to bring inflation down and to keep those costs low for society.

There's work in the 1980s by Ken Rogoff, focusing on the need for a somewhat conservative central banker, that's more focused and more concerned about inflation than the public at large, for example. There's pretty robust empirical evidence, too, that more independent central banks produce lower inflation outcomes on average. And this is true both across countries, but also within countries over time. And I think the US, the 1970s versus the 1990s is one example that many people cite. So in the 1970s, many economists believed that the Fed had less monetary policy independence at that time because of political pressure. And if you look at the history of inflation during that time, the 1970s, we had a long spell of high inflation. In fact, I don't think inflation was ever below 3% as measured by the PCE price index during the 1970s. You had two spikes going between 11 and 12% inflation in each of 1974 and then again in 1980.

So in terms of inflation, you had an extended spell of high inflation. If you look at the 1990s, the consensus kind of changed. There was a lot of academic research. There was much more central bank independence, based on a number of measures. And you had lower inflation, averaging somewhere in the ballpark of two, 2.5%. So even within a country such as the US, changes in the independence of central banks have had big impacts on average inflation.

Julianne Dunn:

Gotcha. That's a great overview of the literature there. So you mentioned that sometimes elected officials have other preferences about where interest rates should be. And I know you spend a lot of time with our Cleveland Fed president, Beth Hammack, as you're getting her ready for FOMC meetings. How do those kind of comments or preferences factor into some of those discussions?

Ed Knotek:

Good question. So we have a very rigorous briefing process that we follow here in Cleveland. We are constantly looking for a lot of data. We're looking for data from our district. We're looking at reports from businesses, community contacts, hard data, soft data, any type of data you can talk about. We're also looking at all sorts of macroeconomic and financial data, data on the nation as a whole that we bring into the briefing process. We're looking at various analyses, models, forecasts. We're looking at different ways that we can think about different shocks that could enter risks that might enter the forecast, things that could affect the outlook in one way or another.

The FOMC at its core has a mandate for price stability and maximum employment. And I have every sense that Beth is focused on setting monetary policy based on data and analysis to achieve that mandate for the American people.

Julianne Dunn:

Great. I wanted to turn first to a couple of questions that came in as people registered. And I promise this isn't my question, even though it does concern the work that I do. So one of our registrants asked, "What weight do you attach to more qualitative inputs like the beige book or the SORCE versus quantitative data or forecasts?" And then, "Has that weighting changed at all since 2019?"

Ed Knotek:

It's a great question. And even if it were your question, I don't mind it. I think it's a great question. So personally, I'm always looking at a wide range of data, models, analyses, forecasts. I think about what we're trying to do here as presenting a mosaic. And so each of these little pieces of information is a tile in the mosaic. And the more pieces of information that you have, the richer the mosaic, and the bigger picture that you can see there.

So part of my job, I know part of your job as well, is talking with people in the community, talking with business leaders, community contacts, hearing what they're hearing. Sometimes they may be seeing things happen on the ground before it enters into the statistics that we see. Some statistics are released very quickly. Others might take a while to be released. There's high frequency data, that's great, but there's sometimes no substitute for what we're hearing on the ground.

So I do take those very seriously. I think that they are worth an awful lot. They're worth a lot of turning points, in particular, before the real data are able to show changes and trends. But that being said, I think that the key here is balance. You want to be taking into account the anecdotal, the soft information, the qualitative survey information. You want to be balancing that with the hard data, the numbers from the statistical agencies, you want to be looking at other high frequency data, other data sources as well, and then trying to filter those through different models, through different lenses to come up with a sense of how is the economy doing?

It's hard to put those weights on. It'd be nice to have a firm weight. I think the bottom line though is that they all matter. They're all part of the process that we approach when we're thinking about policy advising. And I'll kind of leave it at that, but I think that they're all important. They all matter a lot.

Julianne Dunn:

Great. Great. That's great to hear. So a lot of the questions that came in, I think, had to do with news of the day. And so another topic that's been in the news a lot the last couple of weeks is oil prices. Is that something that can affect our read on of inflation, and how does that factor into monetary policy decisions?

Ed Knotek:

It's a good question. And over the years, big swings in oil prices have been very important for the economy, for the outlook for inflation. In particular, as I mentioned earlier on, oil prices are driven by international movements in commodity prices. Those then have a direct impact on the price of gasoline at the pump. We drive by gasoline stations every day. That's a very salient price that we see. Many of us are buying gas on a very regular basis, so that matters a lot for consumer spending.

So a couple of points to think about here. First off is that over time, the US economy's sensitivity to oil prices has changed a little bit. So if we go back in time, we used to not produce very much oil. We were kind of short on oil, so to speak, in financial jargon. And so when the price of oil rose, that had a very big impact on consumers and businesses, and there wasn't kind of an offset in terms of producing more oil from our own economy, or if there was, it was relatively small relative to the economy.

So an increase in oil prices would drive up inflation, and tend to really weigh on consumer spending. If we fast-forward to the 2010s, we've had the big increase in oil production because of shale technology and fracking. So that means that we're a little bit more neutral in terms of our exposure to oil. So now big sectors of the economy, when oil prices rise, they may actually increase investment to produce more oil. So you still get the effect that higher oil prices can weigh on consumer spending, because that's basically, it's kind of like a tax on consumers, but you have other parts of the economy where higher oil prices can actually stimulate some investment. So the sensitivity of the economy to oil prices has changed a little bit over time.

A second key factor in there is that there's an asymmetry in the way that consumers respond to changes in oil prices. So when oil prices go up, consumers cut their spending by more than when oil prices go down, and they would subsequently raise their spending. So bottom line, oil prices are a key factor that I pay a lot of attention to, that our staff pays a lot of attention to. And their effects, though, can be somewhat complicated and dynamic depending on what's going on in the economy.

Julianne Dunn:

Gotcha. So I wanted to turn to a couple of questions about the labor market and labor market data. So the first one I think you answered during your presentation, but I'll just pitch it to you again. So have the federal layoffs appeared in the data yet?

Ed Knotek:

Yes. So if you look in the last couple of employment reports in the October employment situation release, there was a large decline in federal employment, because of the federal layoffs. So those are in fact visible in the employment survey. Yes.

Julianne Dunn:

Okay, gotcha. And then a couple questions, I think particularly in this environment, where maybe we haven't gotten all of the data that we typically would, is a question from the audience, why can't the Fed provide an alternative estimate of job creation by aggregating all the major online payroll providers?

Ed Knotek:

Good question. So some Feds, a variety of Feds do produce research and update that research on a regular basis. So in particular, the Chicago Fed has some new data indicators that they put out related to jobs and how the state of the labor market is. The Kansas City Fed has labor market indicators out there as well. So the bottom line is that some Feds do produce similar types of indicators like that, but there's a key difference that these are not usually official measures like the ones that the BLS provides, where they're based off of surveys and they're looking at, very carefully controlling for the composition of firms in the economy and things like that. So there are some differences there. The statistical agencies spend lots of time and attention in developing their measures to make them the official indicators. At the Feds, oftentimes these are more research oriented, and they just don't have the same resources behind them oftentimes. So something that I think researchers are constantly looking at, though.

Julianne Dunn:

Makes sense. So I want to shift gears a little bit. We got a question about what's going on in credit markets. And so how do you see the effects in the credit market from 2025, rising delinquencies, and auto lending, and student loans, and private credit impacting the dynamics in 2026?

Ed Knotek:

A great question, and something that definitely bears watching. So financial markets, I think you might say financial markets and think about that as a single concept, but of course there are many, many, many elements to financial markets. You have equity markets that increased sharply in 2025. International equity markets increased often by even more than domestic US markets did. You have credit markets, you have interest rates, you have government credit markets with treasury yields, you have bond yields, corporate bond yields. We sometimes look at the spread between corporate bond rates and treasury rates. Those are quite low, suggesting that corporations can borrow on fairly favorable terms. And then of course you have other credit markets out there, bank lending, and then that's where you get into some of these delinquencies

as well. And then you have the whole private equity, private credit markets as well. So lots and lots of different sub-components of financial markets to look at.

At a very high level, while it is the case that we've seen some increases in delinquencies by some measures for some segments of credit markets, when I at least look across many, many different measures, financial markets as a whole seem like they're fairly accommodative, which in turn should help to support growth in 2026. There's kind of this lag of the wealth effect that takes place. So I see financial markets as being somewhat of a tailwind to growth prospects in 2026, but of course that's kind of abstracting from individual segments. So some segments of consumers, they're experiencing higher delinquencies, they're under more stress. And so that is something that we're certainly paying attention to as well.

Julianne Dunn:

Gotcha. Makes sense. So you mentioned data centers and data center investment. I think there's some concern out there that some of this investment could turn into a bubble. Do you think that's the case, and how are you thinking about the impact to the regional economy of this data center investment?

Ed Knotek:

Sure. It's a great question. And I think it's one where economists struggle with the concept of bubbles. It seems like you may only know that there's a bubble after it happens. Other people might say that it's hard to identify a bubble at any point in time, because there was some reason behind what people did at that point in time that may be perfectly legitimate.

So as I mentioned in the presentation, we've seen tremendous growth in spending on construction of data centers. We've also seen tremendous growth in equipment spending, the equipment that goes into data centers. There are lots and lots of reports of major tech companies planning to increase spending on data centers this year and beyond. A lot of this is related to cloud computing. A lot of it's related to AI. Some of these very sophisticated models that require lots and lots of capacity, lots of energy, lots of computers.

They're very cutting edge. And there's so many things that we just don't know about how this will play out, around how AI will play out, how it will integrate into the economy, how it will integrate with the labor market, and what the implications of that will be for data center spending and that build out.

So at this point in time, I think it's very premature for me to speculate on, is this a bubble? Is it not a bubble? How will it end? Will it end? We'll just keep growing. It's possible that we're at the beginning of something that's going to be going on for five or 10 or 15 years in terms of this very strong growth in data centers. So I think that's just very tough to say. I think it is something, it's one of the key factors in my mind worth watching in 2026, but at this point in time, I think it's too early to call a bubble or be concerned about a bubble, per se.

Julianne Dunn:

Gotcha. So related to the technology and AI question, how do you see AI and automation impacting demand for labor?

Ed Knotek:

A great question. I think we're certainly in the early innings in terms of AI, and what it means for the economy writ large and the labor market in particular. So maybe I'll lean a little bit on some of what we're hearing from our regional contacts, because they're kind of experiencing this firsthand. And then you can fact check me, Julianne, because you talk with many of these contacts, and you can make sure that I'm representing the facts correctly.

So I think as consumers, as individuals, many people are fiddling with AI, playing with AI, using it for personal uses, that certainly is the case in the business world as well. But even there, it's the case that many, many firms are reporting that it's kind of very early days. They're just trying to figure out, okay, what is this capable of doing? What's it not capable of doing? Where is it doing things well? Where does it struggle?

So I think we're hearing that many firms are still trying to figure out how to use it and what its implications could be. I think that there are a few firms out there, IT-focused firms that have really gone all in on it. They're seeing that it's changing a lot of their businesses, they're adapting processes, and then that might be having a big impact on their labor forces or how they're thinking about labor. But many, many firms are somewhere in the middle. So we're hearing some reports of that firms are holding off a little bit on hiring in some areas, but not in others because of the possibilities of AI. We're hearing some that they're starting to use it, but making no changes to their labor force plans. And then some are actually increasing the demand for labor because you do AI with one thing, but then that creates the need for more labor somewhere else to help with their production processes.

So have I characterized things pretty accurately from your conversations with business contacts?

Julianne Dunn:

Yeah, absolutely. I certainly have been talking with my contacts a lot just recently about this very question. And I absolutely think this idea of, people are kind of in early days was a really broad theme in a lot of those conversations.

All right. So I think maybe we'll do one more before I wrap us up. Oh, this is an easy one. So I think this what came in as you were talking about FOMC Prep, but are you present at FOMC meetings? Can you talk a little bit about who's in the room for those discussions?

Ed Knotek:

Sure. Great question. So each president gets to take one advisor with him or her to the FOMC meeting. So I go to some, but some of our staff here at the Cleveland Fed also get to go as well. I think it's a great opportunity for people to see what's happening in the room, and to be able to get to know Beth a little bit more, and help to support her better. You learn an awful lot by going to the FOMC meetings, how things work out, how the conversations are held. And so I think it's a great development opportunity for our staff. So I try to go to some meetings, but I try to share that experience with others as well.

Julianne Dunn:

Very good. Very good. Well, I think I will close us there. I want to just say thank you, Ed, for a really informative discussion. For those online in the chat, you should see a link to a post-survey session. This survey will also pop up in your browser after the Zoom session is closed. We invite you to take a moment to complete this survey to share your valuable feedback.

Information about today's program will be sent in a follow-up email, and a video and audio recording of the event will also be posted on clevelandfed.org/fedtalk. You can also listen to this and previous *Fed Talk* programs by subscribing to the *Fed Talk* podcast, available wherever you listen to podcasts. So thank you for joining us. Please join us on Thursday, February 12th for our next *Fed Talk*, called Finding Workers for America's Manufacturing Future, and have a great day.