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Either Way, Underlying Inflation Pressures Still An Issue

It came as little surprise that the total Consumer Price Index (CPI) rose by 0.9 percent in March, the largest monthly increase since June 2022 when snarled global supply chains were contributing to the fastest rate of core goods price inflation since 1975. The obvious culprit behind the jump in the CPI in March was the spike in retail gasoline prices triggered by the conflict in the Middle East, which led to crude oil prices rising by over forty percent in March. As measured in the CPI, retail gasoline prices rose by 21.2 percent in March, but this understates the case given that the CPI measure relies on a monthly average, and we know that prices ended March over nine percent higher than the monthly average. Even if retail gasoline prices back off over the remainder of April, on a monthly average basis they are very likely to still be higher than was the case in March, meaning that gasoline prices will help push the total CPI higher in the April data, even if to a lesser degree than was the case in the March data.

The jump in the headline CPI was consistent with other indicators showing the impacts of the conflict in the Middle East on prices and global supply chains. For instance, the monthly surveys of the manufacturing and services sectors conducted by the Institute for Supply Management (ISM) showed jumps in the measures of input prices. The prices paid index in the manufacturing survey rose to 78.3 percent, the highest reading since June 2022, which was the last time the percentage of firms reporting paying higher input costs was as high as it was in March. The prices paid index in the ISM's survey of the services sector shot up to 70.7 percent in March from 63.0 percent in February, the largest monthly increase in over thirteen years.

Some may be tempted to conclude that, as it was largely driven by the spike in retail gasoline prices, the jump in headline inflation will not persist but will instead reverse once the conflict in the Middle East is resolved. That the core CPI rose by only 0.2 percent in March, a milder increase than we and the consensus anticipated, might seem to support that assessment. We'd caution against such an assessment on several grounds. We can point to a number of, let's say, quirks in the CPI data that we think are biasing the core CPI lower. One such quirk is the continued decline in the CPI measure of prices for used motor vehicles despite what has been a run of increases in used vehicle prices on the wholesale level. While it may seem unlikely that this would hardly move the needle on core inflation, the data tell a different story, as can be seen by focusing on the CPI measures of prices for core (non-food, non-energy) consumer goods. In each of the past two months, the year-on-year increase in the measure of core goods prices which includes used motor vehicles has been seventy basis points lower than the year-on-year increase in the measure of core goods prices which excludes used motor vehicles, after having been fifty basis

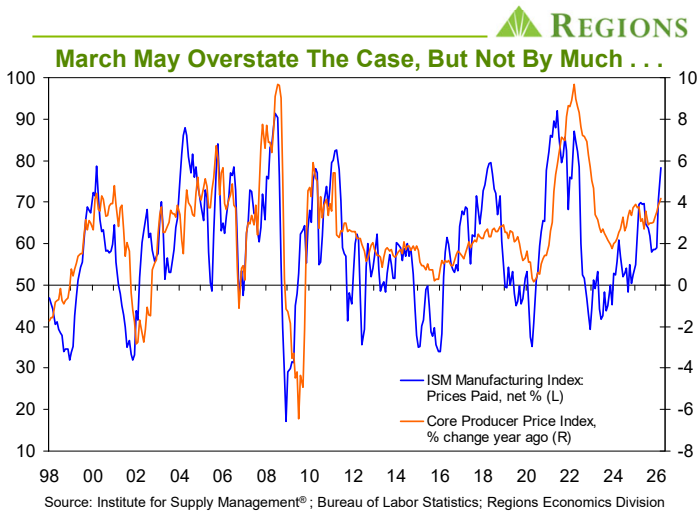
points lower in the January data. Granted, the spread in the two measures has been considerably wider since the onset of the pandemic in 2020 than was historically the case (the average gap over the life of the two series prior to the pandemic was roughly ten basis points), largely reflecting how volatile the CPI measure of used vehicle prices has been over recent years. Either way, the disparity has gotten larger of late, and the continued declines in used vehicle prices as measured in the CPI, at odds with other measures, have acted as a drag on core CPI inflation.

We can point to other components of the March data for which reported declines in prices seem to be one-offs or implausible, if not both, which held down the increase in the core CPI. More broadly, we continue to argue that the BLS's methodology for dealing with missing data for October 2025, which is to assume prices did not change during the month, is causing measured CPI inflation to be understated by around twenty basis points. Perhaps more importantly, we think March was too soon for many of the effects of the increases in energy prices and disruptions in global supply chains seen since the start of the conflict in the Middle East to have spilled over into other categories, including food and various components of core prices. In other words, even if taken at face value, we do not think the mild March print on the core CPI is necessarily a useful guide to what lies ahead.

Time will tell whether we're correct on this point but, either way, our sense is that the focus on the spikes in crude oil and retail gasoline prices since the start of the conflict in the Middle East has deflected attention away from what we think to be an important point. Specifically, while some were arguing prior to the start of the conflict that inflation pressures were fading into the background, we had been taking the opposite side of any such arguments. This conjures up unpleasant memories of 2021, when from day one we countered the premise of "transitory" inflation by arguing that inflation pressures would be more intense, more broadly based, and more persistent than was being assumed by those in the transitory camp. While no one is expecting, at least at this point, a return to the rates of inflation seen in 2021-22, we nonetheless thought that many analysts and market participants had become somewhat complacent on the outlook for inflation prior to the start of the conflict in the Middle East.

One factor in our thinking was the behavior of the prices paid indexes in the ISM's monthly surveys. It isn't as though those indexes suddenly sprung to life in the March surveys. Instead, the ISM's prices paid indexes have for some time now been signaling persistent and broadly based upward pressures on input prices. This goes back much further in the services sector survey than in the manufacturing survey, but in each case input price pressures have become more broadly based over recent months. Though many are quick to dismiss the ISM surveys on the grounds that survey based, or, "soft," data series are less informative than are "hard" data series as survey responses can be swayed by biases

and/or perceptions of respondents, we’ve always thought that to be a curious criticism of surveys of purchasing managers such as those conducted by ISM or S&P Global. And, please, don’t even get us started on the reliability issues that plague so many of the “hard” data series, though our longer-term readers are no doubt familiar with the issues we routinely raise in this realm.

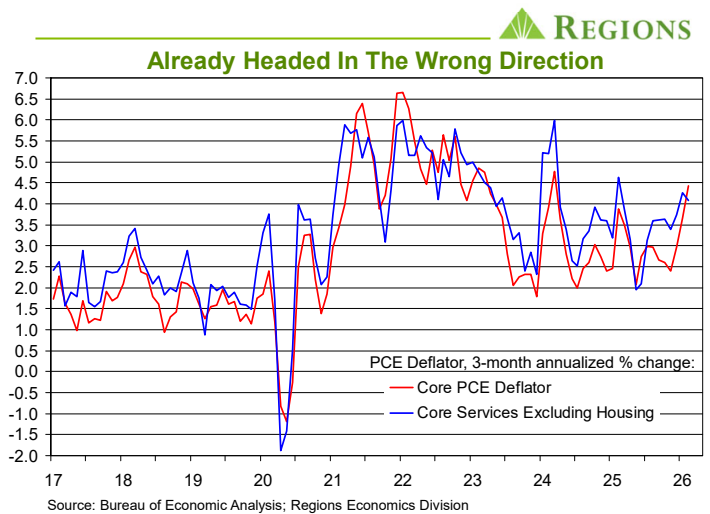


Either way, we’ve found that over time the prices paid index in the ISM’s monthly survey of the manufacturing sector has been a good guide to movements in the core Producer Price Index (PPI), as we summarize in the above chart. Note that with the diffusion indexes in the monthly ISM surveys, any reading above 50.0 percent is consistent with growth (increases) and any reading below 50.0 percent is consistent with contraction (declines), with movements away from (closer to) 50.0 percent indicating more (less) intensity. While the jump in crude oil prices played a strong hand in the March increase in the prices paid index, the reality is that upward pressures on input prices were firmly entrenched prior to March, which seems clear from movements in the core PPI. Part of this, at least since 2025, reflects the impacts of higher U.S. tariffs on imported goods, and ISM has noted that higher tariffs on steel and aluminum have reverberated strongly through supply chains. It helps to recall that raw materials/capital goods used in factories to produce intermediate and finished goods account for over one-half of all goods imported into the U.S.

The behavior of the prices paid index from ISM’s manufacturing survey has also been consistent with movements in commodity prices, which further weakens “soft” data criticisms in this case. The broader point here is that if you think about the chain of production starting with costs of commodities and other inputs used to produce intermediate/finished goods, higher costs will, to varying degrees, be passed along through the chain of production and ultimately be reflected in prices for final goods. This helps account for why market participants are so focused on the prices paid index in the monthly ISM and S&P Global surveys, and though the links may not be as direct, the same argument holds for the prices paid indexes in the surveys of the broad services sector.

We have long seen the prices paid indexes in the various surveys of purchasing managers as useful early gauges of price pressures further down the line. The signals being sent by these indexes help account for our view that the path back to the FOMC’s 2.0 percent

target for inflation as measured by the PCE Deflator would be longer and less direct than some have assumed, and that was our view well before the start of the conflict in the Middle East. To that point, as of February (the most recent data point) the core PCE Deflator was up 3.0 percent year-on-year, the third straight month at or above 3.0 percent, leaving the core PCE Deflator up 4.4 percent on a three-month annualized basis, the fastest such pace in a year, meaning core PCE inflation is drifting further from, not closer to, the increasingly elusive 2.0 percent marker.



The chart above shows the annualized three-month change in the core PCE Deflator which, again, was already headed in the wrong direction even prior to the start of the conflict in the Middle East. We were not ever big fans of the annualized three-month change, but this became a widely used metric in 2021-22; while the year-on-year percentage change, how inflation is usually measured, was running at the fastest pace in over four decades, many argued that the three-month annualized change was a better gauge of underlying price pressures and this remains a commonly cited metric. The chart also shows the PCE measure of “supercore” services price inflation, i.e., prices of core services excluding housing, which many see as a more reliable indicator of underlying services price pressures. Note that decelerating rent growth is acting as a drag on core inflation, though not nearly to the extent in the PCE Deflator as in the CPI due to differences in weighting, with rents accounting for over forty-two percent of the core CPI and less than half that weight in the core PCE Deflator.

Core PCE inflation was not only moving in the wrong direction prior to the start of the conflict in the Middle East but was also becoming more broadly based, as could be seen by breaking down the 178 categories that comprise the core PCE measure. As of February, over one-half of these categories showed year-on-year price increases above three percent, well higher than the share a year prior, and over one-third showed year-on-year price increases in excess of four percent. In addition to underlying price pressures in supercore services, core goods prices as measured in the PCE Deflator were up 2.3 percent year-on-year. Granted, that may not sound like much, but keep in mind that over the decade prior to the onset of the pandemic mild core goods price deflation was the rule, not the exception. Moreover, by the end of 2023 the spike in core goods prices triggered by the pandemic and the policy response to it had run its course, to the extent that core goods

prices declined in 2024 before higher U.S. tariff rates helped revive core goods price inflation in 2025. So, while the rate of core goods price inflation may not seem like much, the more relevant point here is that it is accelerating, and if we are correct in thinking there is more tariff pass-through to come that would have helped sustain core goods price inflation even absent any spillover effects into core inflation stemming from the conflict in the Middle East.

So, while the tendency may be to focus on the jumps in energy prices since the start of the conflict and assume those will simply reverse, with little or no impact in the broader economy, once the conflict is resolved, that is unlikely to be the case. While energy prices will almost surely give back some of the increases seen since the start of the conflict, it is unlikely they will give back all of those increases, at least any time soon. Not only has there been damage to the energy infrastructure in the Middle East that will support prices being higher than they were prior to the start of the conflict, but there is also likely to be a risk premium priced into energy markets as well as for consumer and capital goods shipped through the Strait of Hormuz. Moreover, there have already been significant increases in prices for fertilizer, chemicals, plastics, and other materials, while goods sellers and airlines have already factored higher fuel costs into their pricing structure.

While these costs were not highly visible in the March CPI data (and won't be in the March PCE Deflator data when released), that seems likely to change as soon as the April data. In other words, the April data will likely show higher headline and core inflation than did the March data, and the longer the conflict endures, the more pronounced will be the push to inflation. While the data on prices for raw, intermediate, and finished goods will ultimately show smaller year-on-year increases once the conflict ends, that will likely still leave the level of these prices above pre-conflict levels. Any such effects, however, will come on top of what we think remain meaningful inflation pressures that seemed to be gathering pace, rather than abating, prior to the start of the conflict. If we are correct in this assessment, it could be that many will be surprised by the persistence of inflation pressures after the resolution of the conflict.

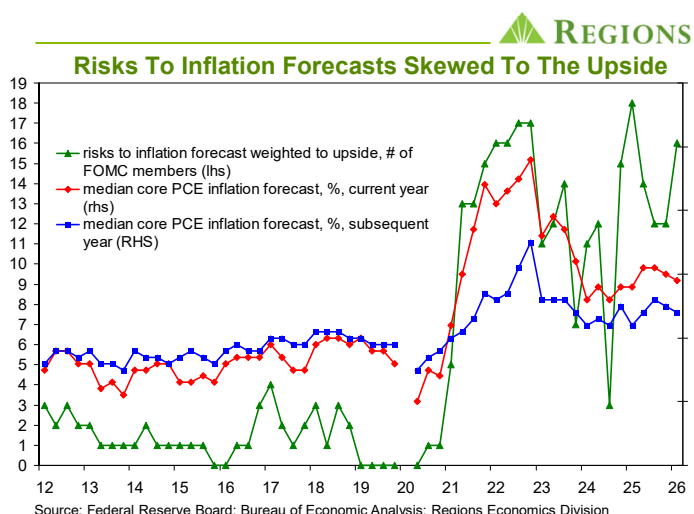
Inflation Worries Were Already Mounting Amongst FOMC

It isn't only market participants and private sector analysts who are trying to assess the economic effects of the conflict in the Middle East, as this topic dominated the March FOMC meeting. Indeed, the minutes of the March FOMC meeting strike a decidedly hawkish tone, with some Committee members noting that should the conflict persist and energy prices continue to rise, Fed funds rate hikes may be in order, particularly should there be signs that inflation expectations are becoming unanchored.

Recall that the March FOMC meeting brought an updated edition of the Summary of Economic Projections (SEP), a compilation of members' forecasts for growth, inflation, and unemployment along with their assessments of the path of the Fed funds rate consistent with their economic outlooks. It came as no surprise that the median forecasts for headline and core PCE inflation were marked up from the prior (December 2025) edition of the SEP, which at least in part reflected the jumps in energy prices seen in the early

stages of the conflict in the Middle East. It also came as no surprise that members' assessments of the risks to their inflation forecasts were heavily skewed to the upside, i.e., if they miss their inflation forecasts, the vast majority of FOMC members think that will be because inflation is higher than their forecasts.

To that point, in the March SEP sixteen of the nineteen FOMC members assessed the risks to their forecast of PCE inflation as being weighted to the upside and seventeen members assessed the risks to their forecast of core PCE inflation as weighted to the upside. The last, and in the history of the SEP the only other, time the assessments of risks to the inflation forecasts were skewed so heavily to the upside was 2021-22 when inflation was running at a more than four decade high. While the March assessments may seem unremarkable given the jumps in energy prices seen by the time of the meeting, what may have gone overlooked by those who don't regularly look at members' assessments of the risks to their forecasts is that the assessments of risks to the inflation forecasts had already become skewed to the upside prior to the March FOMC meeting. This is consistent with perceptions of a sharp divide amongst FOMC members, with some members more focused on perceived downside risks to the labor market and some members more focused on perceived upside risks to inflation.



The chart above shows, for each edition of the SEP going back to their inception in 2012, the number of FOMC members assessing the risks to their forecast of core PCE inflation as being weighted to the upside. As we often note, however, any assessment of the balance of risks to a forecast is relative to what the forecast is; for instance, if one's forecast for core inflation over the coming year is 140 percent, they would likely see the risks to that forecast as being weighted to the downside, unless of course they were forecasting the inflation rate for Venezuela, where inflation of 140 percent would be a welcome relief.

In any event, we thought it would be useful to show members' assessments of the risks to their inflation forecasts in the context of the median SEP forecast of core PCE inflation for both the current year (red line) and the coming year (blue line). One thing that jumps out is that in the interval between the inception of the SEP and the onset of the pandemic, core inflation consistently undershot the 2.0 percent threshold, and not only did the median SEP forecasts expect this to remain the case, but very few FOMC

members ever feared inflation overshooting 2.0 percent, as the most members seeing the forecast risks weighted to the upside in any single edition of the SEP was four (March 2017).

Regardless of what one may think about the FOMC's forecasts, this raises an important point, which is that in what was a prolonged period of low and stable inflation, inflation expectations amongst market participants, firms, and consumers, came to be anchored around the FOMC's 2.0 percent target rate. This, in turn, helped guide market interest rates and economic decisions amongst firms and households. All of which went to pot post-pandemic, what with that whole inflation at a four decade high thing.

Over time, however, inflation expectations drifted back down to the point they were more or less consistent with inflation ultimately realigning with the FOMC's 2.0 percent target. But, with signs of persistent inflation pressures even prior to the start of the conflict in the Middle East, the FOMC is increasingly concerned over the prospect of inflation expectations becoming unanchored. To that point, Chair Powell and other FOMC members have suggested that they may be inclined to look past what, at least for now, they perceive will be a temporary bump in inflation as long as inflation expectations do not begin to drift higher. While surveys of consumers show consumers' expectations of inflation over the coming year have risen, market based measures have yet to show a meaningful increase in inflation expectations.

Returning to the March Summary of Economic Projections (SEP), it could be that the extent to which FOMC members' assessments of the risks to their inflation forecasts are so heavily skewed to the upside leads market participants to put a wider band of uncertainty around their expected paths of inflation, which could push market interest rates higher. If so, the FOMC's reaction function to the conflict in the Middle East could vary from what it otherwise would have been. Moreover, that so many FOMC members had perceived the risks to their inflation forecasts as being weighted to the upside even prior to the start of the conflict in the Middle East, with very good reason in our view, should have tempered expectations as to the scope of any further cuts in the Fed funds rate, particularly with inflation already running above the FOMC's target. In other words, the obvious conclusion may seem that once the conflict is resolved, the door will be open for further Fed funds rate cuts but, while that door may indeed be open, it just may not be open as widely as many market participants seem to think will be the case.

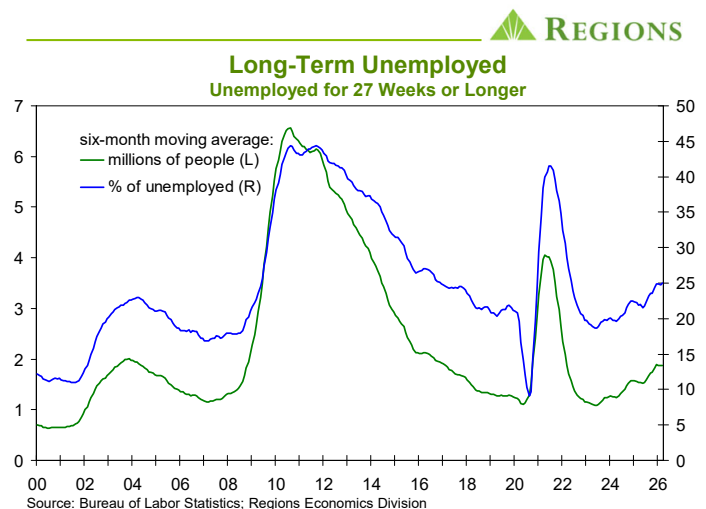
March Employment Report

Total nonfarm employment rose by 178,000 jobs in March, above our forecast of 109,000 jobs and even further above the consensus forecast of 55,000 jobs, with private sector payrolls up by 186,000 jobs and private sector payrolls down by 8,000 jobs. While March's job gain was better than anticipated, that was tempered by revised data showing nonfarm payrolls declined by 133,000 jobs in February, larger than the originally reported decline of 92,000 jobs. March marked the tenth consecutive month in which the change in nonfarm payrolls alternated signs, which would seem the very definition of a labor market lacking direction.

We'll make the same point here we made in last month's edition. While the trend rate of job growth has clearly slowed, the variability in the estimates of the monthly change in total nonfarm employment is pretty much the same as it has always been. With

that variability now coming around a lower mean (i.e., the lower trend rate of job growth), it should come as no surprise that we've seen more frequent negative headline prints over the past several months than has historically been the case outside of recessions. Our assessment is at odds with the assessments of those who take each month's headline print as an authoritative pronouncement of the state of the labor market, and in turn the broader economy, which has to have been somewhat dizzying over the past several months, and it seems odd to base sweeping conclusions on monthly changes that typically amount to less than one-tenth of one percent of the level of total nonfarm employment.

Either way, we see the "low hire-low fire" labor market narrative as still holding, even if this is a somewhat tenuous equilibrium for the labor market. While the rate at which firms are hiring labor has slowed sharply, the rate at which workers are being laid off has yet to fall back to the pre-pandemic rate. We also continue to argue that there are supply side factors behind the marked slowdown in the hiring rate, including a significant outflow of foreign born labor. To our point about this being somewhat of a tenuous equilibrium for the labor market, it is worth noting that such a low trend rate of hiring leaves the labor market vulnerable to adverse shocks and/or sudden shifts in business sentiment, which is something to keep in mind in the context of the conflict in the Middle East. In other words, whether due to spikes in energy and shipping costs, shipments of materials being delayed/canceled due to supply chain disruptions, or a loss of business confidence, the labor market and the broader economy are vulnerable to the effects of the conflict in the Middle East.



Independent of that, one often overlooked implication of the "low hire" part of the labor market narrative is that while the overall rate of layoffs remains low, those who are laid off are having a harder time finding new jobs. The duration of unemployment, both average and median, has risen as has the share of unemployment accounted for by long-term unemployment. The downward drift in continuing claims for unemployment is being at least in part driven by people exhausting benefits as opposed to finding new jobs. This is a reminder that the "low hire-low fire" labor market narrative is not as benign as it may seem. One reason this issue merits attention is the body of empirical evidence showing that the longer one is unemployed, the lower the odds of their finding a new job.

ECONOMIC OUTLOOK



April 2026

Q3 '25 (a)	Q4 '25 (a)	Q1 '26 (f)	Q2 '26 (f)	Q3 '26 (f)	Q4 '26 (f)	Q1 '27 (f)	Q2 '27 (f)		2023 (a)	2024 (a)	2025 (a)	2026 (f)	2027 (f)
4.4	0.5	2.2	1.8	2.4	2.6	2.5	2.4	Real GDP ¹	2.9	2.8	2.1	2.2	2.4
3.5	1.9	0.9	2.0	2.7	2.6	2.8	2.8	Real Personal Consumption ¹	2.6	2.9	2.6	2.0	2.6
3.2	2.4	3.7	3.9	4.6	4.1	4.1	4.4	Real Business Fixed Investment ¹	7.3	2.9	4.1	3.8	4.2
5.3	4.3	7.7	7.5	7.8	5.6	4.8	5.1	Equipment ¹	2.9	3.5	8.3	6.6	5.5
5.6	5.4	3.6	4.1	4.8	4.9	4.9	5.0	Intellectual Property and Software ¹	6.2	3.5	5.6	5.2	4.9
-5.0	-6.5	-4.9	-4.8	-3.4	-1.4	0.1	0.8	Structures ¹	16.7	1.1	-5.3	-5.0	-0.7
-7.1	-1.7	-6.6	-1.0	-0.2	0.2	0.9	0.2	Real Residential Fixed Investment ¹	-7.8	3.2	-2.2	-3.4	0.5
2.2	-5.6	5.8	0.1	0.3	1.0	0.5	0.2	Real Government Expenditures ¹	3.5	3.8	1.1	0.7	0.4
-955.5	-968.7	-1,032.5	-1,015.7	-1,041.2	-1,052.2	-1,067.4	-1,083.7	Real Net Exports ²	-925.2	-1,032.6	-1,090.7	-1,035.4	-1,090.0
885	929	919	903	911	920	922	929	Single Family Housing Starts, ths. of units ³	947	1,016	943	913	932
461	399	465	434	438	439	430	432	Multi-Family Housing Starts, ths. of units ³	473	355	415	444	433
1.3	0.9	0.3	-0.3	-0.6	-0.6	0.0	1.1	CoreLogic House Price Index ⁵	4.0	4.3	1.7	-0.3	1.4
16.6	15.7	15.6	15.7	15.8	15.8	16.0	16.0	Vehicle Sales, millions of units ³	15.5	15.9	16.2	15.7	16.0
4.3	4.5	4.3	4.4	4.4	4.3	4.2	4.2	Unemployment Rate, % ⁴	3.6	4.0	4.3	4.3	4.2
0.5	0.2	0.2	0.2	0.2	0.4	0.5	0.5	Non-Farm Employment ⁵	2.2	1.2	0.5	0.2	0.5
1.0	0.0	0.8	-1.2	2.5	2.3	4.3	2.5	Real Disposable Personal Income ¹	5.7	2.9	1.7	0.7	2.6
3.0	3.3	3.3	3.7	3.3	2.8	2.5	2.0	GDP Price Deflator ⁵	3.7	2.5	2.8	3.3	2.1
2.7	2.8	3.0	3.6	3.3	3.0	2.4	1.8	PCE Deflator ⁵	3.8	2.6	2.6	3.2	2.0
2.9	2.8	3.0	4.0	3.5	3.3	2.7	1.9	Consumer Price Index ⁵	4.1	3.0	2.7	3.5	2.2
2.9	2.9	3.0	3.2	3.1	3.0	2.5	2.3	Core PCE Deflator ⁵	4.2	2.9	2.8	3.1	2.3
3.1	2.8	2.9	3.2	3.1	3.2	2.9	2.7	Core Consumer Price Index ⁵	4.8	3.4	2.9	3.1	2.6
4.34	3.90	3.63	3.59	3.38	3.38	3.38	3.38	Fed Funds Target Rate Range Mid-Point, % ⁴	5.07	5.19	4.25	3.49	3.38
4.26	4.10	4.20	4.31	4.36	4.39	4.43	4.46	10-Year Treasury Note Yield, % ⁴	3.96	4.21	4.29	4.31	4.48
6.57	6.23	6.11	6.39	6.37	6.37	6.39	6.40	30-Year Fixed Mortgage, % ⁴	6.81	6.72	6.60	6.31	6.43
-3.1	-2.4	-2.5	-2.7	-2.8	-2.8	-2.9	-3.0	Current Account, % of GDP	-3.3	-4.0	-3.7	-2.8	-3.0

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2017 \$ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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