ECONOMIC

By: Tom Landstreet

2026 Economic Outlook: Inflation, Interest Rates and the Debt Dilemma

I'm thrilled to share that I've been invited to contribute regularly to the Tennessee Society of CPAs' *Journal.* I love Tennessee as a low-tax state, and accountants are among my best audience because few groups understand the influence of government policy changes better than accountants. Every time there's a change in tax policy, accountants' phones start ringing as smart people begin to adjust their affairs. We call this a tax boundary, as the response to a tax policy change is immediate. Other types of policy changes are less definitive but no less consequential.

Tariffs and Inflation: A Slow Burn

Tariffs are among them. I have dwelt on the effect of tariffs, which are taxes, in a prior article, but I'll summarize it thusly: When you tax something, you get less of it, and when there are less goods and services to purchase, prices rise. The data suggests that inflation bottomed out in July of 2024 and has been rising modestly ever since. I just spent two days at an investor conference where I sat through presentations from a number of industrial companies, all of whom cited rising input costs from tariffs. All of whom articulated their strategies for passing along these cost increases to their customers to preserve their margins. Tariffs slowly bleed into consumer prices. Beware the economists who say that tariffs are not inflationary.

Debt and Interest Rates: A Ticking Clock

Since this is meant to be a 2026 outlook edition, I'll go ahead and stick my neck out. Unless something changes on the policy front, inflation will continue to inch up throughout this year and next. This will pressure the Trump administration – who is desperate to get interest rates lower. This push likely stems more from fiscal necessity than concern for the broader economy. It's more an issue of self-preservation. With $130 trillion in unfunded obligations ($100 trillion Social Security + $30 trillion debt outstanding), the government has shortened the term structure of its massive debt, which demands that they refinance hundreds of billions of dollars in treasury bills over the coming year. The government is already spending $1.2 trillion annually just to pay the interest on the existing debt. And of course, they get the money to pay the interest by issuing more debt. It's a strategy that would be unsustainable for any household – and increasingly risky for a nation.

Recession or Stagflation?

Where does this put interest rates in 2026? One side of the argument would tell you that it depends if we go into a recession. Conventional (Keynesian) thinking dictates that recessions are disinflationary. If demand falls, producers cut prices to stimulate demand. But what if producers' costs are rising? They will seek to raise prices as much as possible while making other adjustments, such as cutting production to preserve their margins. That leads to a decline in purchasable goods – and higher prices.

History does not comply with the conventional view. From 1972-74, the U.S. experienced a long, deep 16-month recession during which unemployment reached 9%. Yet inflation soared to 12% in 1974. That's because there was a supply-side oil shock, not unlike tariffs, which diminished the supply of goods available to purchase. That supply shock came from the imposition of price control regulations by Richard Nixon. When you regulate something, you get less of it. I mentioned earlier how taxes have the same effect. Both represent a negative shock to the supply side of the economy. Therefore, if inflation persists, so might the pesky 10-year yield. Let me add that in the 1970s, the U.S. had relatively little debt. Deficits were quaint.

Markets in 2026: Liquidity vs. Reality

As for the equity markets in 2026, I feel more comfortable about my inflation and interest rate outlook than I do about the equity market outlook. Of course, AI has turned investors giddy. The momentum in the stock market remains strong, aided by record liquidity in the form of money in circulation. This is thanks to record government spending. The multiplier effect of rising equity markets has aided consumer spending. Two questions will dictate next year's equity market performance. Can the government continue to spend like this, and if not, why?

Clearly, Congress won't stop the spending. The only factor preventing more spending is investors' willingness to fund it, and that's where things might get interesting in 2026. In September, as the Federal Reserve cut the fed funds rate by 0.25%, longer dated yields abruptly rose. Interest rates might not go down despite Fed cuts because government spending is extreme.

Thus, we are watching the 10-year yield for signs of market stress. If the yield moves sharply higher, the equity market will suffer because the current stock market rally is built, among other things, on the assumption that interest rates are falling. Meanwhile, AI provides a shiny object that drives the market inexorably higher.

Without significant spending cuts, the U.S. government is going to take a beating at some point. Western governments are in trouble fiscally. Ultimately, governments are going to start monetizing the debt again to manage interest rates. That means that the Federal Reserve will print money to buy U.S. debt directly as they did in the novel quantitative easing (QE) campaigns of the last 15 years. Such an outcome would risk significant inflation, perhaps worse than that of the 1970s. 2026 promises to be a pivotal year for economic policy – and for investors navigating the turbulence.

About the Author

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