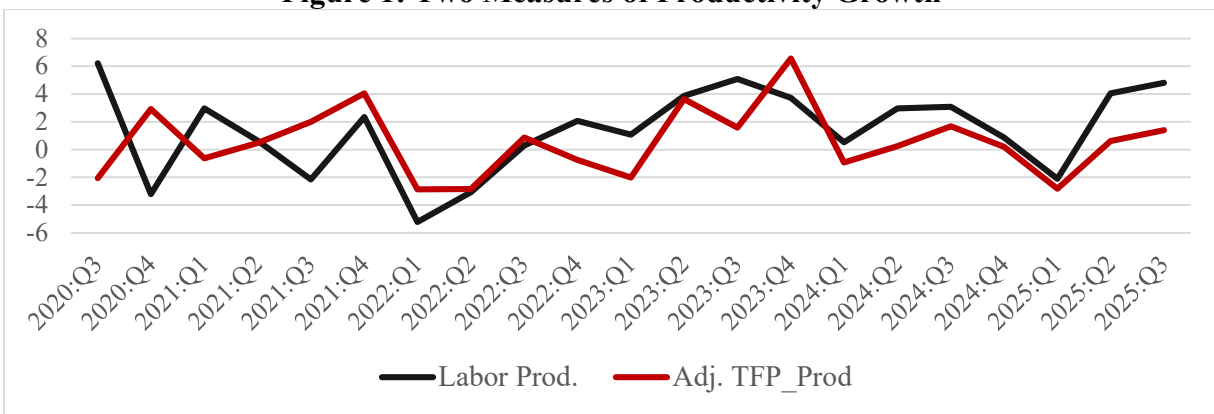


The Productivity Surge is an Illusion

The most important economic question of the new year is what explains the exceptional gap between strong GDP growth and a stagnant labor market. The Atlanta Fed now expects 4Q2025 GDP growth to hit 5.1%. Although almost 3% of this is due to temporary factors including exports and inventories, underlying growth remains very good. How this gap resolves will largely determine the path of the U.S. economy in 2026. We remain pessimistic.

This week, we looked closer at productivity’s role. After the pandemic, we wrote often about productivity because, at that time, it was mostly driven by supply factors such as the recovery of supply chains. Figure 1 (black) shows labor productivity, the most widely used productivity measure. It is simply GDP divided by hours worked. For GDP growth to be much higher than employment growth, it must be the case that labor productivity is growing rapidly. In 3Q2025, it came in at 4.8%

Figure 1: Two Measures of Productivity Growth



The problem is that labor productivity can be driven by either supply or demand side factors. One hopeful interpretation is that AI is driving the current surge. If so, solid GDP growth could persist even if unemployment continues to rise. Furthermore, higher unemployment would be structural rather than cyclical, still a problem for policymakers, but not a sign of an unhealthy economy. Our view, however, is that much of strong labor productivity growth, unlike 2022, has come from firms streamlining their payrolls. As the most recent Fed Beige Book summarized, firms are “limiting headcounts using hiring freezes, replacement-only hiring, and attrition rather than through layoffs.” **If this is the case, and we think it is, then strong GDP growth cannot continue for much longer absent a major uptick in hiring.**

Figure 1 also reports a measure of productivity from the San Francisco Fed known as Adjusted Total Factor Productivity (TFP). This is designed to isolate the role of supply-side

factors such as technology, including AI. TFP is hard to measure, and the series is admittedly noisy. It shows that while labor productivity averaged 4.4% in 2Q and 3Q2025, the San Francisco Fed's TFP measure averaged just 1.0%, slightly below its 1.2% historical average. **In other words, supply factors, including AI, are probably not the main driver of higher labor productivity.** This is bad news and we continue to estimate that there is a 60% chance that GDP stagnates in 2026 to match the labor market.

Other Developments in Macroeconomics:

1. We have been relatively calm about President Trump's prior efforts to manipulate the Fed into lowering rates. This is partly because we have been confident, and correct so far, that the data would eventually induce the Fed to continue rate cuts regardless of Trump's pressure. This week's initiation of a vexatious criminal probe into Chairman Powell is, however, a much more serious threat. Were it to succeed, it would have a major sustained impact on yields. For now, we are encouraged by its bipartisan condemnation and Senator Tillis's decision to block any of President Trump's Fed appointments until the probe is resolved. **Nevertheless, it will cause term premiums to stay higher for longer and we are raising our 2026 target for the ten-year yield from 340 bps. to 350 bps.** We reiterate, however, that bond market's implied neutral rate is still around 350 bps, 60 bps too high. As the Fed continues to cut, this will pass on to lower yields.
2. We are surprised that markets are treating the December CPI report as a non-story. Overall core-CPI (all figures m/m annualized) was 2.9%, which was roughly as expected. This was, however, entirely due to shelter which came in at 4.8%. Core, ex-shelter, is our preferred measure and it was just 1.2% in December and is 2.0% y/y. The y/y figure includes roughly a 0.5% impact from tariffs, which is about half of what we expected. We reiterate our view that after an initial spike, tariffs will eventually be disinflationary. **In December, core-goods inflation was 0.0%, a sign that the tariffs may be moving into their disinflationary phase.** It is past time to stop worrying about inflation remaining above 2%. The bigger risk is that by holding rates above neutral despite a weaker labor market, the Fed could push inflation well below 2%. **We still, however, expect the Fed to restart rate cuts in March with 100 bps of cuts this year to lower the Fed Funds rate target to 250-275 bps.**
3. Recent employment data have not changed our view that it is more likely that GDP slows this year to match the stagnant labor market than vice-versa. The November jobs report showed an alarming rise in underemployment which caused the U-6 rate (an alternate measure that includes unemployed workers) to rise from 8.0% (since revised to 8.1%) to 8.7%, the biggest jump in its history outside a formal recession. The December figure was a little better with U-6 coming in at 8.4%. **The series does, however, show a steeper upward trend and our main concern remains that we see nothing that will prevent further labor market weakening this year.**

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