MILLER TABAK + CO., LLC

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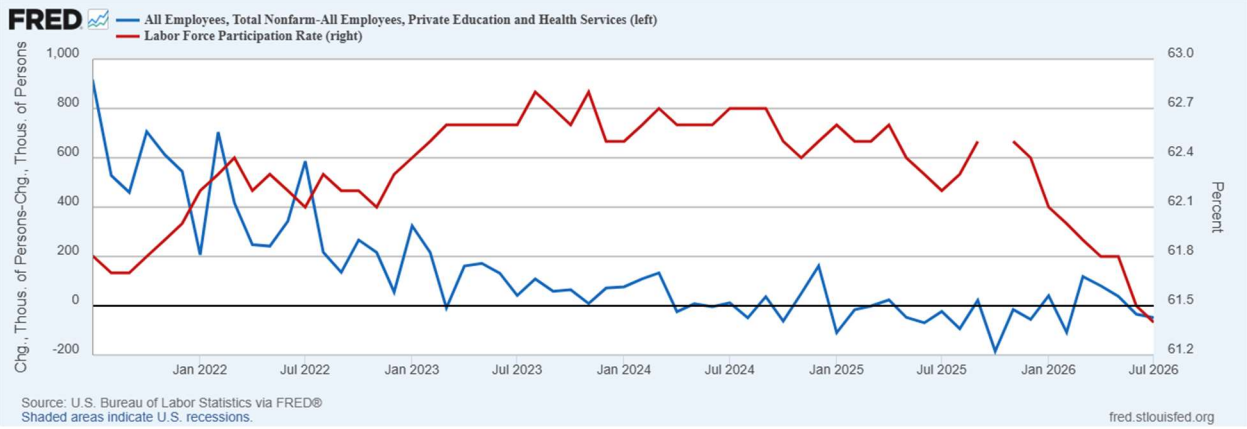
Blame the Fed for the Awful Jobs Report

The July employment report is even worse than suggested by the 23,000 decline in jobs, and major downward revisions to recent months. The labor market showed tentative but genuine signs of recovery from March through May, which helped drive a good 2Q2026 GDP report (more on this later). Higher yields, however, have now crushed this recovery. **Two clear trends should worry markets and the Fed far more than inflation: falling labor force participation from the household survey, and stagnant hiring from the separate firm survey.**

On the firm side, we always focus on jobs outside of education and healthcare (blue in Figure 1). Those sectors are famously recession proof and accounted for all job growth between January 2025 and February 2026. Apart from those sectors, the rest of the economy lost 34,000 and 48,000 jobs in June and July, respectively. The Fed is not to blame for the initial spike in yields following the outbreak of war in Iran. They have, however, failed to look through an energy price spike, and instead chose to talk yields up, especially since the June FOMC meeting. The awful July employment report is a consequence that could have been avoided. We reiterate that a further decline in employment is a far bigger risk than persistent inflation. **Unfortunately, we expect it will take until 2027 for the FOMC to be convinced.**

Figure 1: Job Growth Excluding Education and Healthcare, and LFP



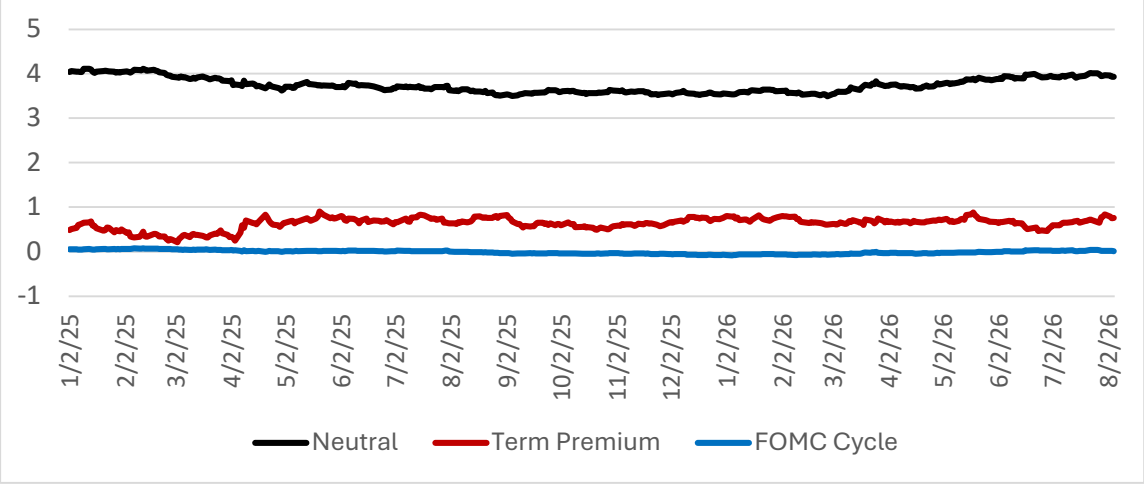
The decline in the unemployment rate to 4.1% is irrelevant. The bigger story from the household survey is that workers have responded to reduced hiring by leaving the labor force altogether instead of being classified as unemployed. After a major decline in June labor force participation (LFP, read in Figure 1), we expected some recovery in July. Instead, overall labor force participation fell to 61.4%, it's lowest since February 2021. **These workers will re-enter the labor force in coming months, which will then quickly pass through to higher unemployment.**

The only silver lining is that this report should kill any chance of a September rate hike. It will not, however, push the Fed back into a more dovish posture. Upcoming labor reports will continue to be weak. **We are also raising the risk of a U.S. recession within the next year from 35% to 45%.**

Other Developments in Macroeconomics:

1. While elevated yields are to blame for renewed weakness in the labor market, the story behind why yields are higher is not what we expected. Figure 2 decomposes the 10-year Treasury yield into different parts. Since March, bond markets' implied neutral rate (calculated using 5-10 year yields) have drifted sharply upwards. This is a reversal of the decline that began in 2022. **The estimated neutral rate has risen from 350 bps in March to 392 bps today.** We reiterate that the best evidence suggests that neutral is between 290-300 bps. The initial rise was caused by higher energy prices, although the Fed has done everything in its power to amplify it. Also, since Chairman Warsh's first press conference in June, term premiums have risen by 22 bps. This likely reflects greater uncertainty about how Warsh's Fed will set rates.

Figure 1: Breakdown of the 10-Year Term Premium



2. As he mentioned last week, despite not raising rates, the Fed's communications have helped keep yields much higher than they otherwise would be. Although we disagree with Warsh's hawkish posture, he has put himself in a good position politically**. Inflation is going to come down regardless of what the Fed does over the next year.** Underlying core measures that either ignore shelter or fix the BLS's poor measure are already close to the Fed's 2% target. Like Paul Volker in the 1980s, Warsh will be in a good position to take the credit even if it does entail weaker than needed growth, or even a mild recession. Once he declares victory, the Fed will then be able to lower rates to around neutral. **We expect this to happen in 2Q2027 when the Fed will next cut rates.** We expect gradual rate cuts until the Federal Funds rate reaches 275-300 bps in mid-2028. **At the same time, we expect the 10-year Treasury yield to fall to its long-term average of 350 bps.**

3. The labor market report makes 2Q2026 GDP growth partly old news. Nevertheless, despite overall growth of just 1.5%, the more important data point is that consumption grew at an excellent 3.2% rate, which comes on the heels of two weak quarters. This shows hints that the good labor market data from March through May was real. **The good GDP report will not be inflationary for a few reasons.** First, much of it was fueled by imports. Second, it was accompanied by better than expected labor productivity growth (1.4% vs just 0.5% expected). Non-residential investment was again strong at 8.4%, and it is good news that this growth was much broader than just AI investment. Finally, it is interesting that housing grew at 1.5%, its first positive quarter since 4Q2024. This, however, is mostly a curiosity as high mortgage rates rule out a genuine recovery.

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