MILLER TABAK + CO., LLC

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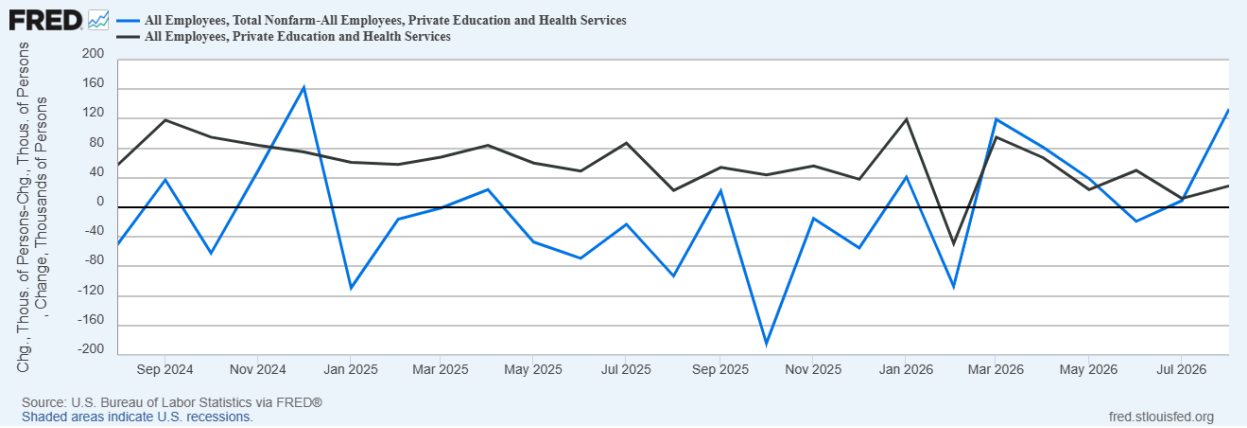
The Stage is Set for a Fed Blunder

The August employment report, which showed job growth jumping from 21,000 (revised upwards from -23,000) to 162,000 in August is great news, but not because it shows hiring taking off in August. That is at odds with other recent sources, including ADP's report showing August job growth at 38,000 and the Fed's August Beige Book showing employment growing "very slightly." **Rather, it is excellent news because it shows that the July data, which hinted at imminent recession, were not as bad as they initially seemed.**

We have focused on job growth outside of private education and healthcare, two famously recession proof sectors which have accounted for all job growth since January 2025. These sectors grew by 29,000 in August with 133,000 new jobs coming from elsewhere, a very good figure. All the jump in hiring came from reversals in two areas. Government employment growth switched from -50,000 in July to 35,000 in August, while leisure and hospitality switched from -21,000 to 69,000. We are not claiming that growth in these areas is unimportant. Rather, we suspect that much of their jumps reflect data problems, including undercounting in July and a seasonal adjustment formula that does not fully reflect changes in seasonality post-pandemic.

Figure 1: Job Growth in Education and Healthcare (black) and Everywhere Else (blue)



A three-month window now shows that job growth has averaged 71,000, with 30,000 coming from sectors besides education and healthcare. While no longer showing the steep decline through July, the labor market is still weaker than between March through May, before yields rose so high.

There are a pair of caveats. First, high yields and poor consumer sentiment leave the labor market at risk of a significant weakening. **We expect a significant increase in unemployment, to over 4.5%, by mid-2027**. Second, this report could be fodder for an FOMC that appears to be looking for a reason to raise rates. We reiterate that the downside risk to the labor market remains far greater than that of inflation. Until now, there were no data to justify any of the nine FOMC members who voted to hold rates steady in July switching to a rate hike in September. This report should not be nearly enough, especially given recent inflation data. Nevertheless, Governor Chris Waller, who voted to stay put in July had already said that the August CPI report, which comes out on September 11, could swing his decision.

The problem is that upcoming headline readings will be bad. The Cleveland Fed's forecasting model predicts about 4.5% annualized headline readings in August and September, along with core readings around 2.4%. The former mostly reflect higher energy prices since early July, which were yet to show up in the July data. The latter would indicate some pass-through to core. **These higher inflation figures will be temporary and will again reverse after crude oil prices eventually come back down.** In addition to there being no source for persistent inflation (more on this later), we reiterate that using Zillow's housing price index in place of the BLS' mismeasured shelter measure results in y/y readings of 1.5% and 2.9% for core-CPI and core-PCE, respectively.

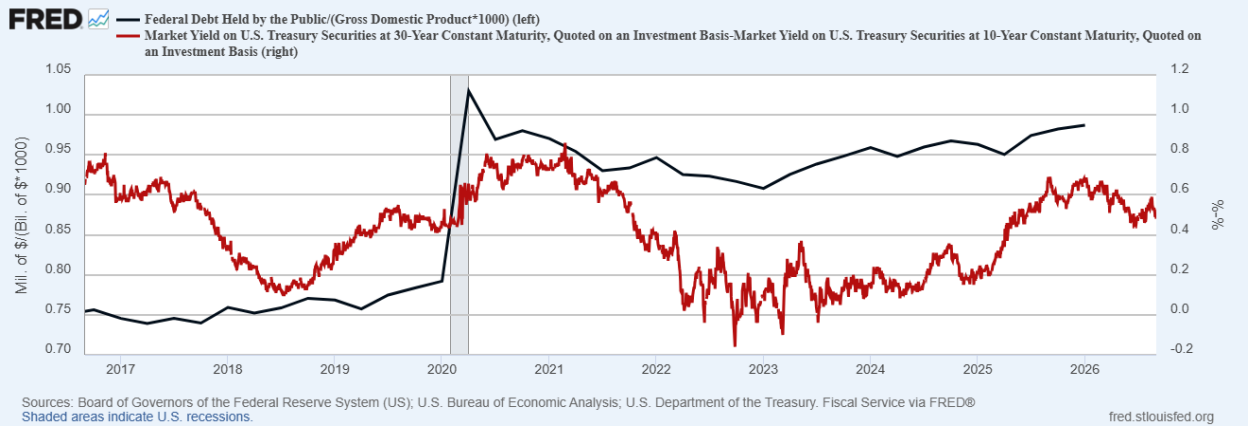
Other Developments in Macroeconomics:

1. We remind readers that employment reports are two separate surveys: the firm survey which provides the job growth figure, and the household survey, which provides the unemployment rate. For many months, the household survey has been weaker than the firm survey. The household survey is smaller and noisier than the firm survey, but the August household survey was also good. Most importantly, labor force participation, which had been low at 61.4% edged up to 61.6% This helped move unemployment up from 4.09% to 4.14%, but, by itself, that is not a concern. **Until the household survey shows a more sustained recovery in labor force participation, however, the labor market will remain fragile.**

2. The ongoing rise in yields is mostly the result of both markets and the FOMC overstating inflation concerns. Despite not having raised the Federal Funds rate, **Warsh's Fed has pushed long-term rates up by interpreting inflation data in the most pessimistic light possible, while looking at recent labor market reports through rose colored glasses**. Two other factors have been mistakenly connected to recent movements in the 10-year yield. The first is Treasury Secretary Bessent's bond buyback program. It works like the Fed's prior QE purchases except that an additional $2 billion per month is too small to

matter and, unlike the Fed, Treasury must pay for its long-term buybacks by issuing more short-term debt. Second, the admittedly awful fiscal outlook is not to blame. The risk of default or fiscal-driven inflation remains more than ten years out. Fiscal factors are, however, important for the 30-year yield. Figure 2 shows the U.S. sovereign debt (excluding intragovernmental debt) to GDP ratio, which started to deteriorate in early 2025. At the same time, the spread between the thirty and ten year Treasury yields spiked.

Figure 2: Debt/GDP versus 30-10 Year Treasury Spread



3. Another problem with recent FOMC communications is that they have not provided a rationale for why inflation will persist unless interest rates go even higher. Given current yields, policy is undeniably restrictive. Neither demand nor the labor market are overheated. The most plausible channel for inflation to remain high would be for inflationary expectations to become unanchored. Here the news is encouraging. Despite higher yields, 5-year breakeven inflation is only up to 2.37%, well below its May peak of 2.70%. The best survey of inflation expectations, the Atlanta Fed's one-year ahead survey of businesses, is at just 2.2%. **Persistent inflation does not happen at random.** In 2022, it happened because of loose fiscal and monetary policies as well as supply chain disruptions. **No such source exists today.**

-Paul Shea

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