June 10, 2025

Dutta’s Monetary Thoughts

Surface level analysis means deep-rooted problems

Neil Dutta

Look under the hood

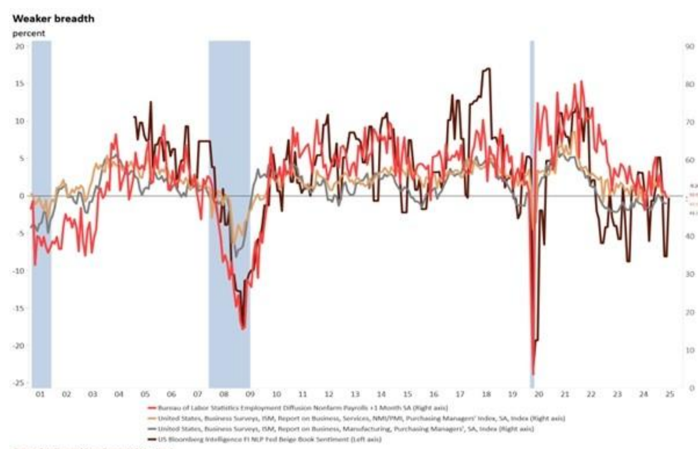
Economic analysis feels very surface level these days. “Employment growth is fine, and the unemployment rate is low” or “despite all the uncertainty around policy, the economy is still growing” or “demand is slowing, but so is supply.” Talk about watered down expectations! The Fed might be enamored with these arguments, but it just means they’re tempting fate for a deeper slowdown as they stay on hold through the summer.

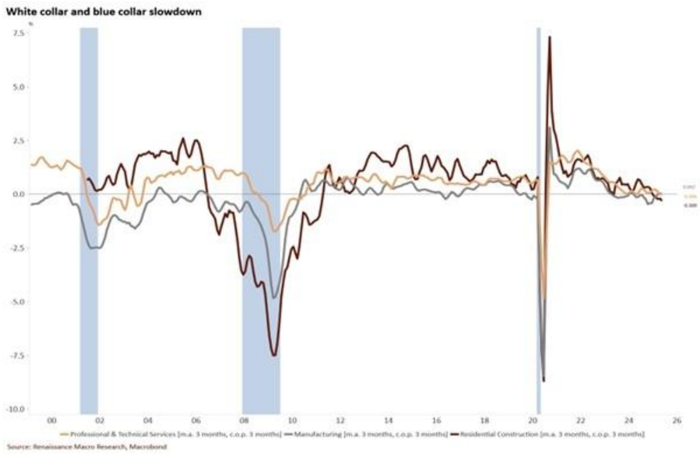
Slowdowns don’t always stop on their own and in this case, it feels like a policy response will eventually be needed. Between now and then, the pressure on the economy will continue to build even if tariff noise subsides. The longer the Fed waits, the more they will end up having to cut later.

However, complacency about the balance of risks implies a more abrupt shift in policy later.

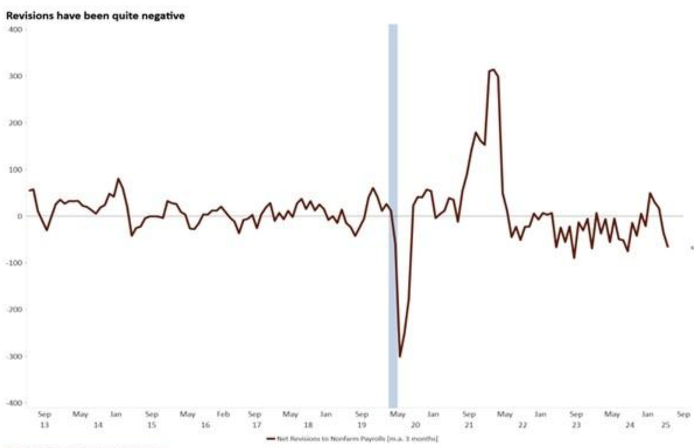
Let’s start with the labor market. Three things stand out.

- The distribution of employment growth is narrowing. In May, the payroll diffusion index stood at 50.0, the lowest since July 2024. The breadth of jobs growth is as weak as it was right before the Fed cut 50bps in September.

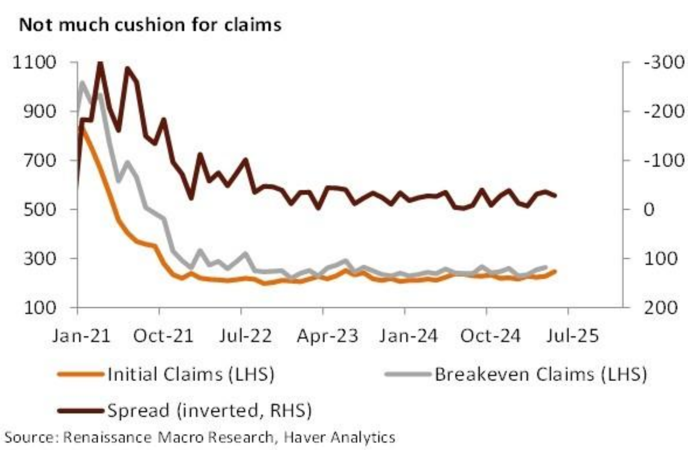




• **<u>Cyclical industries like manufacturing, construction, and temporary-help services are contracting. This is atypical if the economy is expanding.</u>**



• Payroll growth is not as strong as first advertised. From the initial release to the third release March was revised down by 108,000. April has so far been revised down by 30,000. At any rate, revisions tend to be correlated. Thus, I'd assume May likely gets revised down too. **<u>Perhaps this is why unemployment keeps climbing despite jobs growth running above "breakeven."</u>**



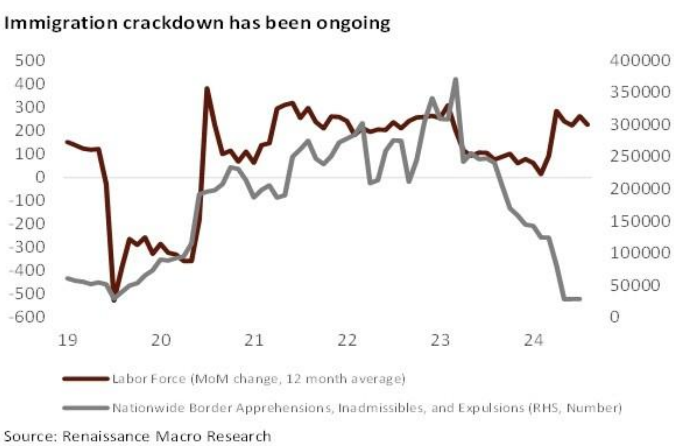
• **<u>Initial jobless claims are running quite close to breakeven, a line between payroll growth and contraction</u>**.

- Continuing claims have been rising for a couple of years now while initial claims have been stable. Recently, initial claims have perked up a little bit, which suggests the upward pressure on extended unemployment claims persists.

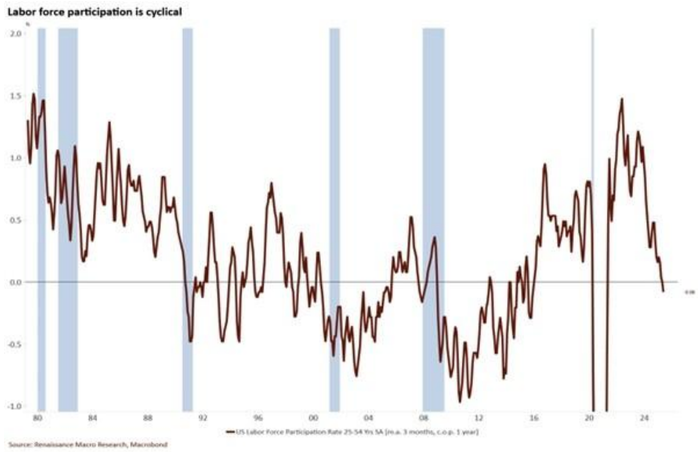
In short, the labor market continues to cool. The slowdown appears to be, thus far, relatively linear in nature; there is no sudden stop due to policy uncertainty or tariffs. That's welcome but ignores the primary source of the problem. Even if we assume a scenario where tariffs go away, I'm not so sure how optimistic we should get since the slowdown is primarily about monetary policy being too restrictive.

Supply side excuse

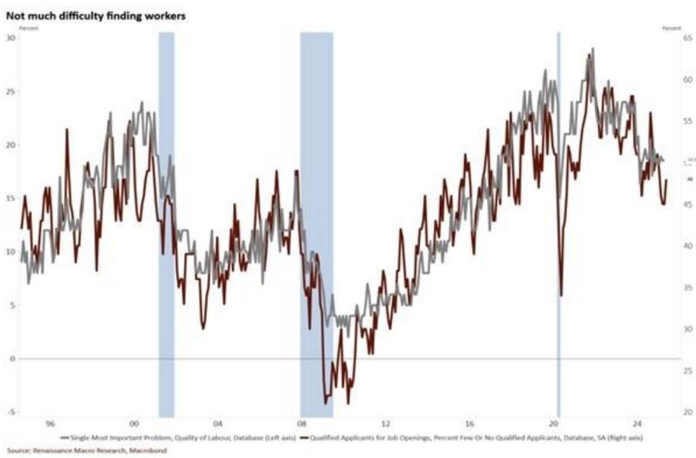
A popular retort to our views argues that the supplyside of the labor market is cooling; therefore, slowing employment growth is no big deal. Put differently, because the labor force is cooling (immigration), the breakeven pace on jobs growth does not need to be as strong to keep the unemployment rate from rising. I think there are a few problems with this.



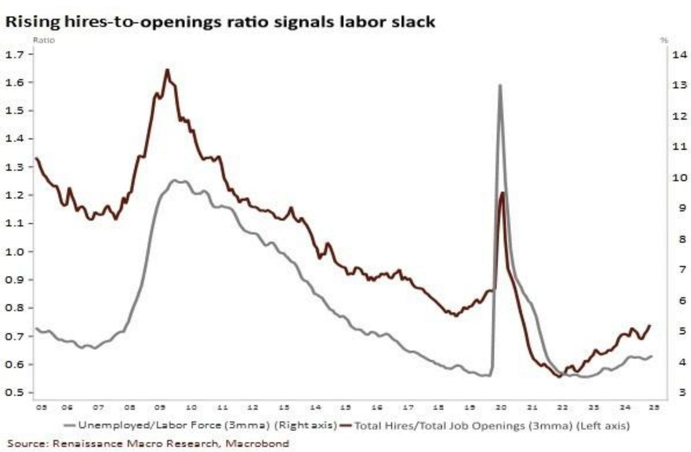
For one, the immigration pressure to the civilian labor force has been waning for a while now. Nationwide border apprehensions peaked well over a year ago and began falling while Biden was still in office.



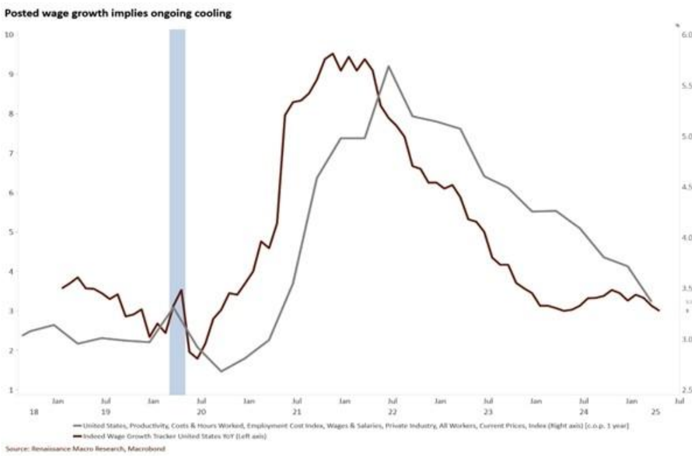
Second, this argument ignores that there is a cyclical element to labor force participation (LFPR). Prime-age LFPR tends to rise in an expansion and fall during economic slumps. Over the last year, the prime-age LFPR has declined 0.2ppt.



Next, it's been getting somewhat easier to find workers at the margin. Complaints about labor quality or firms reporting few applicants for posted jobs have been waning.



The ratio of hires to job openings has been rising. That would not be happening if the labor market was tightening because of supply-side considerations.



Finally, if this supply-side story was dominant, I'd expect to see unemployment fall and wage growth rise. Instead, unemployment has been rising while wage growth has been slowing. Over the last six months, average hourly earnings are up 3.6% SAAR and posted wage growth is barely at 3.0%.

Thus, pinning the slowdown in the labor market on supply side considerations might be misdiagnosing the issue or at a minimum, absolving policymakers from recognizing that demand is cooling rapidly too!

Economy is still slowing

Ultimately, the labor market reflects the economy, and the economy is still slowing. I'm watching a few things.

- Housing is an industry that's tied to rates and conditions are getting worse: inventories are rising week after week, climbing to levels not seen since before the pandemic, prices are cooling, and construction activity is coming under pressure

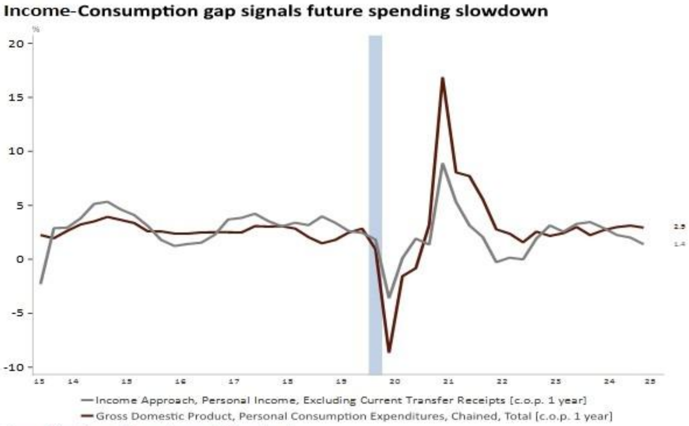
- Nonresidential construction is coming under pressure too. According to AIA, the Architectural Billings Index has been in contraction territory since November. This implies a drop in commercial real estate construction is ahead of us

These are two areas where tariffs likely play a small role in the weakness; but ultimately, rates are probably too high to get these industries moving.

Business investment is one area that is clearly impacted by tariffs.

Policy uncertainty and higher prices for inputs will keep companies from investing, particularly outside of AI related tech. Across a range regional PMIs, six-month capital spending plans remain well below normal even if they have improved somewhat since April. For the S&P500, forward capex expectations are essentially flat over the last two months

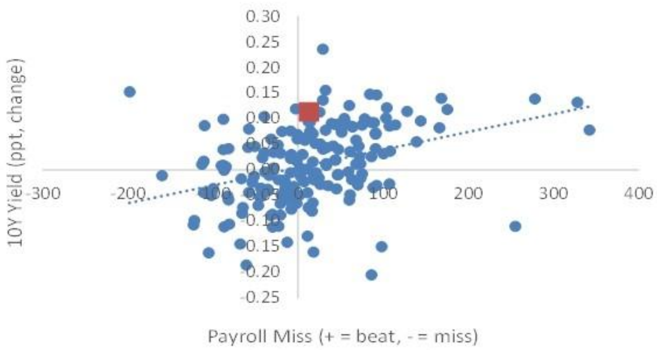
Income-Consumption gap signals future spending slowdown



Source: Renaissance Macro Research, Macrobond

Consumers will crack when the labor market does. So long as people are employed, they will keep spending. However, I have a tough time seeing why consumption speeds up with the labor markets still slowing down. Real income growth remains under pressure and there is a limit to how much consumers can draw down their savings. Indeed, despite a tailwind from tariff-related front loading, real consumption rose just 1.2% SAAR in Q1, the weakest since Q2 2023.

Outsized reaction in the bond market
Data from 2008 (excluding 2020-2021, on NFP days)



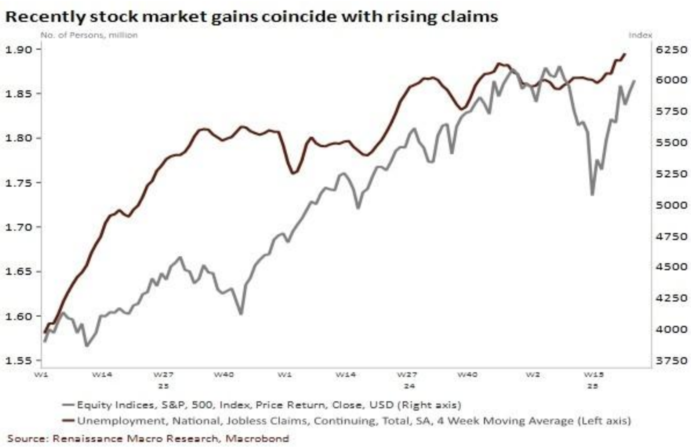
Source: Renaissance Macro Research, Bloomberg, Haver Analytics

Evidence needs to be overwhelming

For market participants, it's likely going to take a lot of information to materially change views and be convinced the economy has cracked. After all, investors have been growing wary of betting on a recession that never seems to arrive.

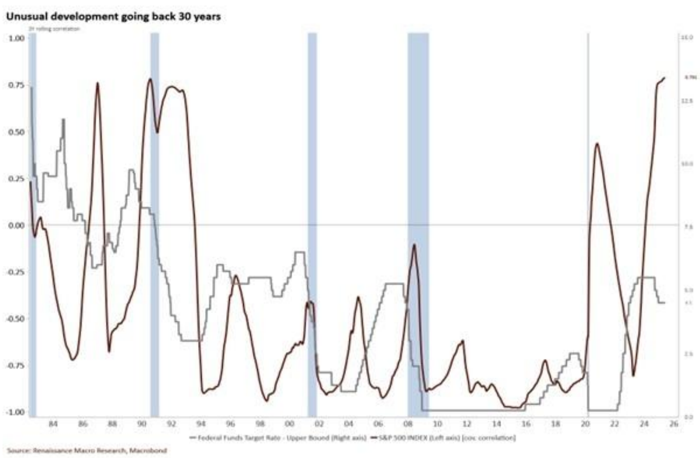
Consider our nearby figure. I plot the beat or miss on nonfarm payrolls and the change in 10-year yields the day of the employment release. As you'd expect, there is an upward sloping line. The bigger the beat, the more yields rise. Look at last month, however, the beat was small and yet, there was an outsized market reaction. The chart shows all data-points excluding the COVID era (2020-2021). Normally, you'd expect yields to rise 1bp on a beat of this magnitude; instead, ten-year rates rose 12bps

Thus, I think it is fair to conclude that the evidence needs to be overwhelming. Jobs growth may well be negative by the time the Fed decides to adjust rates. Thus, the risk for the economy and investors is that by the time it becomes obvious, it will be too late



Question: Claims and stocks

Here is question I have for everyone. How long does the contemporaneous correlation between these two lines stay positive? It's been three years so far. The chart shows the S&P500 rising alongside continuing unemployment claims.

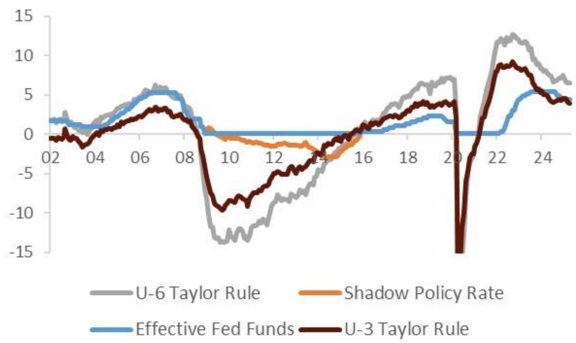


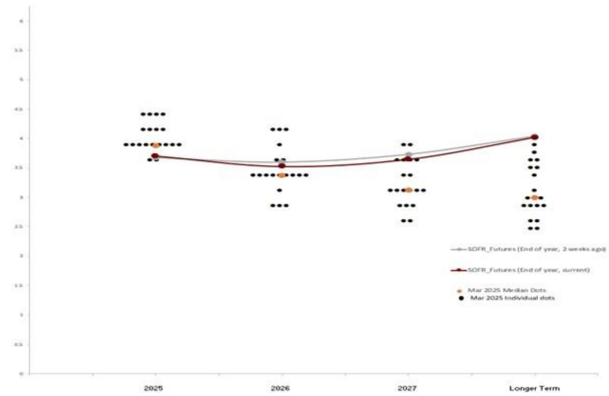
I ran a simple 3Y rolling correlation chart dating back to the early 90 to illustrate this. It's pretty unusual to see a positive relationship between to two series. Normally, the relationship is negative: stocks rise as claims fall. Makes sense: expansions are good for the labor market and stock prices.

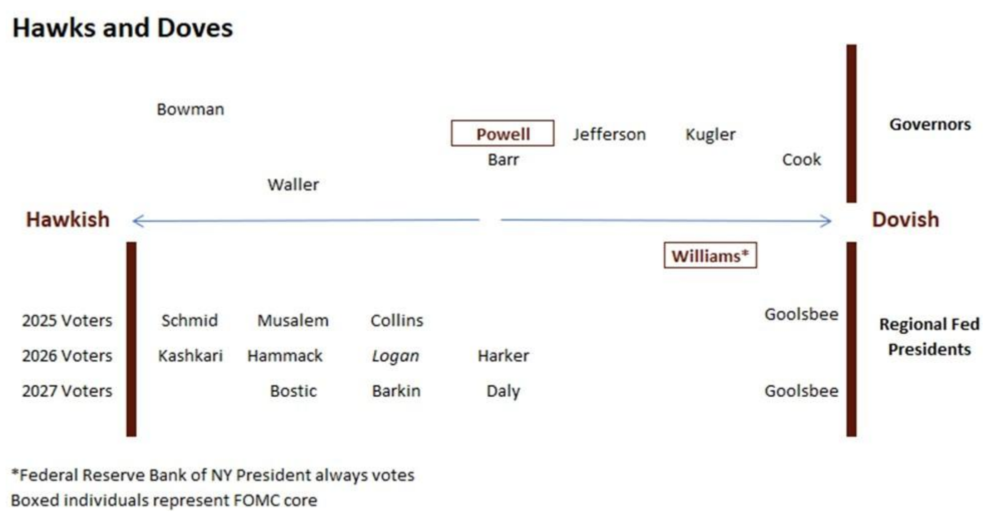
Now, I can see scenarios where both can move in the same direction like in 2022 as stocks fell and claims fell too with the Fed tightening policy to bring inflation down. Alternatively, stocks can rise alongside rising claims if the Fed is easing aggressively as was the case in the early 90s.

But, these scenarios are more the exception than the rule. Either you think claims are about to fall or the Fed is about to ease policy.

Monetary metrics

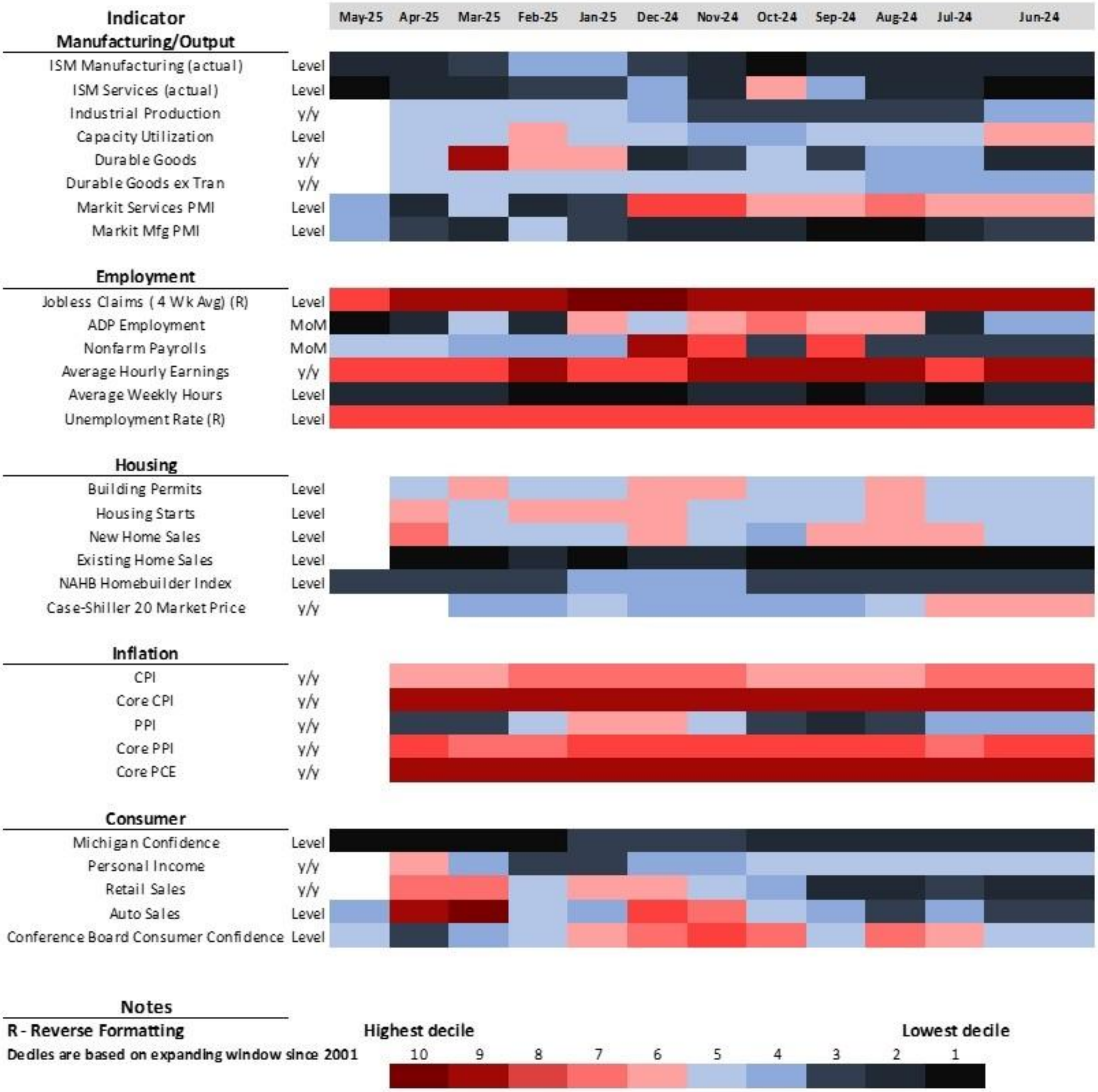




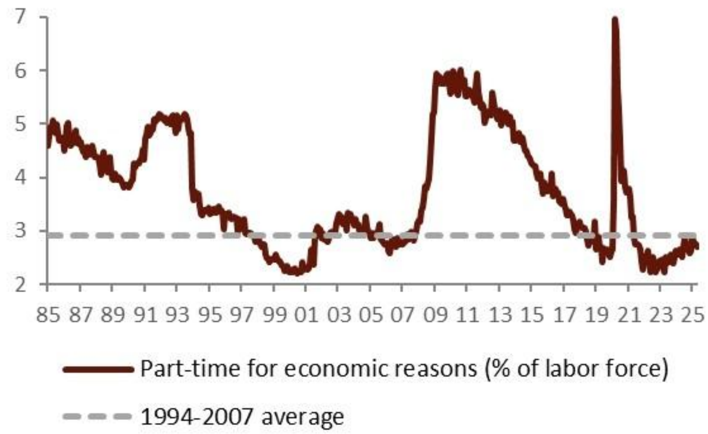


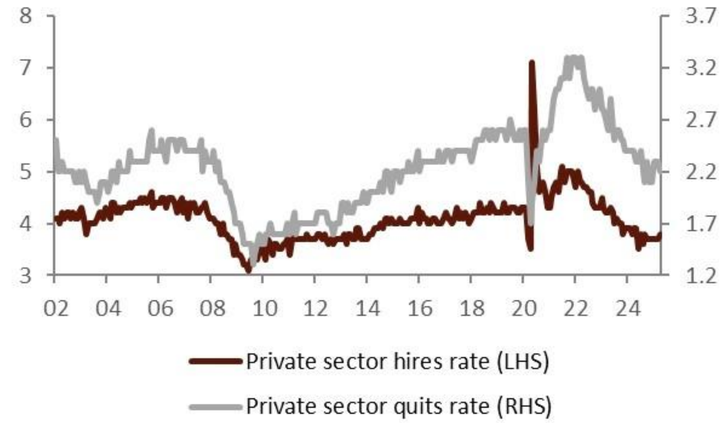
FOMC Forecasts	Median				Central Tendency			
	2025	2026	2027	Longer run	2025	2026	2027	Longer run
Change in real GDP	1.7	1.8	1.8	1.8	1.5–1.9	1.6–1.9	1.6–2.0	1.7–2.0
December projection	2.1	2	1.9	1.8	1.8–2.2	1.9–2.1	1.8–2.0	1.7–2.0
Unemployment rate	4.4	4.3	4.3	4.2	4.3–4.4	4.2–4.5	4.1–4.4	3.9–4.3
December projection	4.3	4.3	4.3	4.2	4.2–4.5	4.1–4.4	4.0–4.4	3.9–4.3
PCE inflation	2.7	2.2	2.0	2.0	2.6–2.9	2.1–2.3	2.0–2.1	2.0
December projection	2.5	2.1	2.0	2.0	2.3–2.6	2.0–2.2	2.0	2.0
Core PCE inflation	2.8	2.2	2.0		2.7–3.0	2.1–2.4	2.0–2.1	
December projection	2.5	2.2	2.0		2.5–2.7	2.0–2.3	2.0	
Projected policy path								
Fed funds rate	3.9	3.4	3.1	3.0	3.9–4.4	3.1–3.9	2.9–3.6	2.6–3.6
December projection	3.9	3.4	3.1	3.0	3.6–4.1	3.1–3.6	2.9–3.6	2.8–3.6

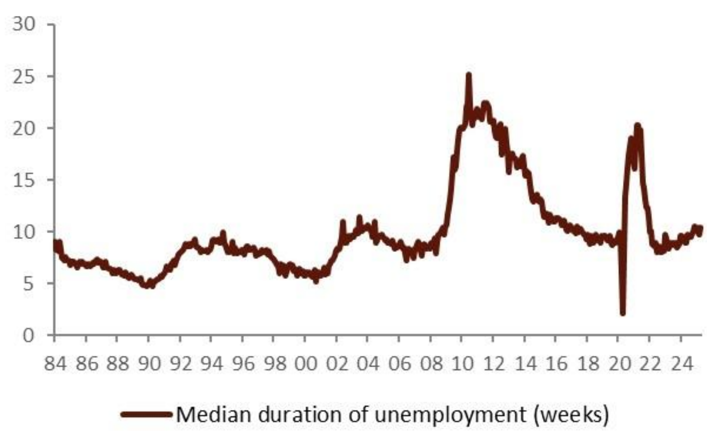
High frequency data heat-map

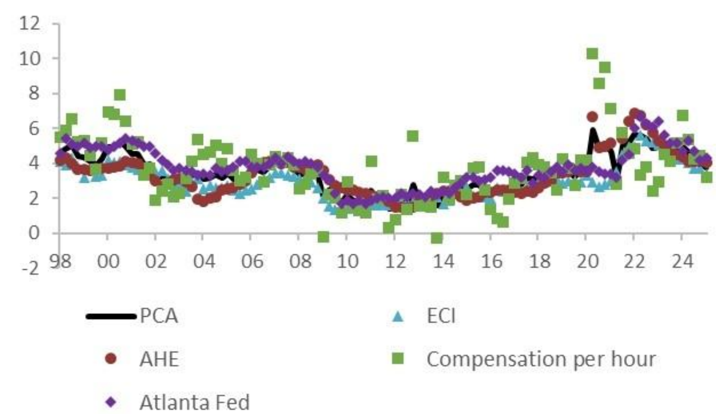


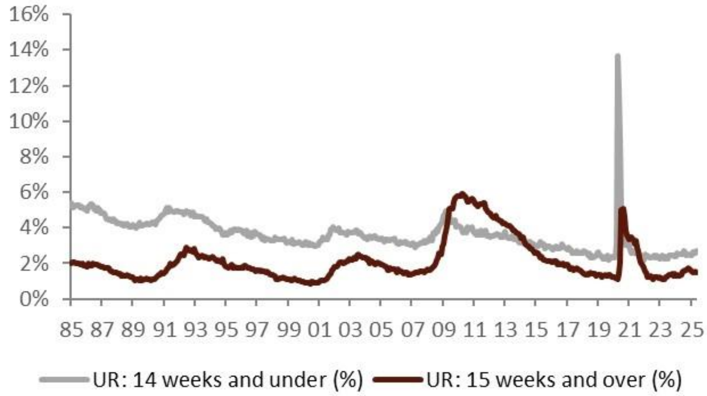
Labor market indicators

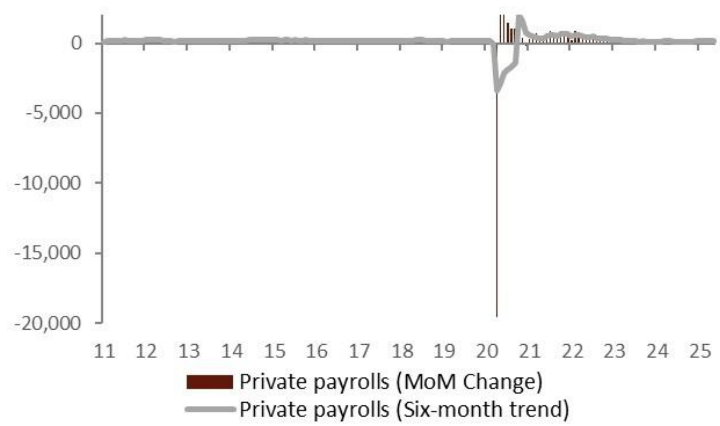




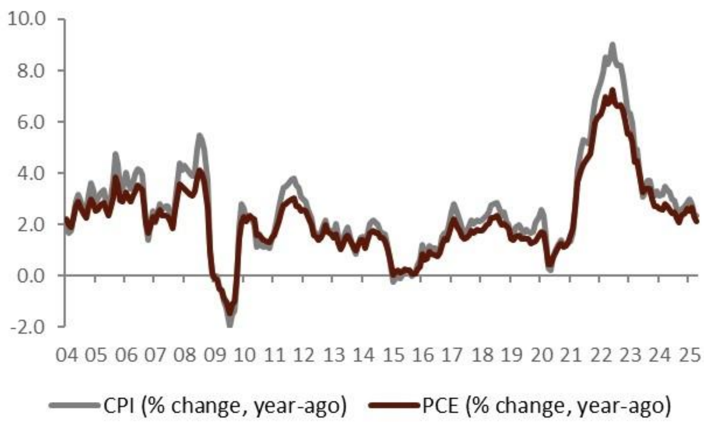


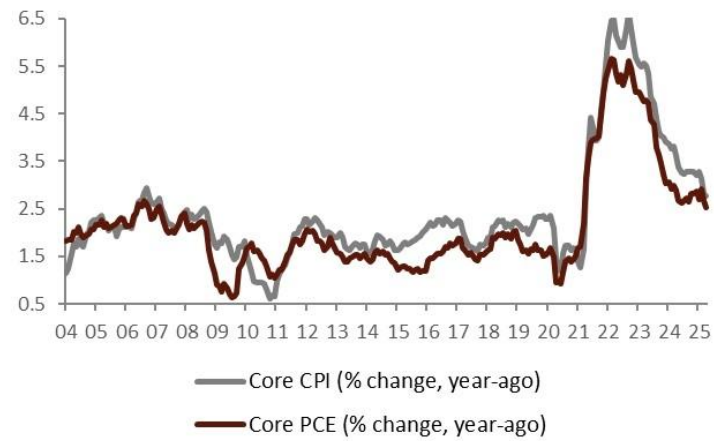


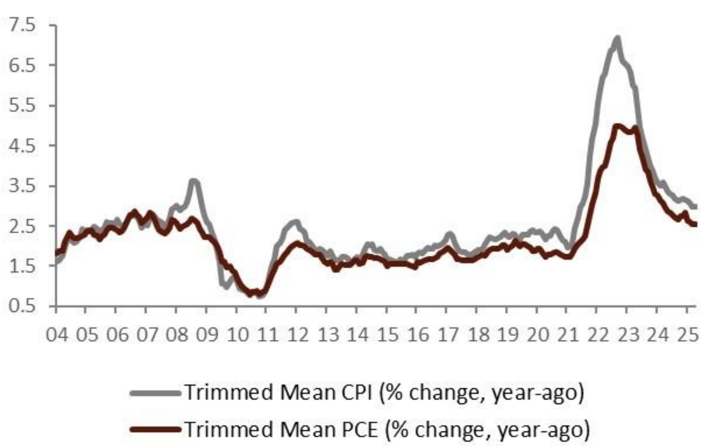


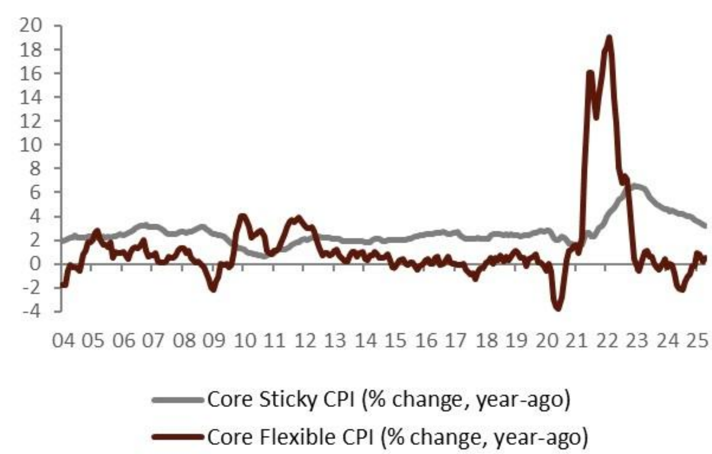


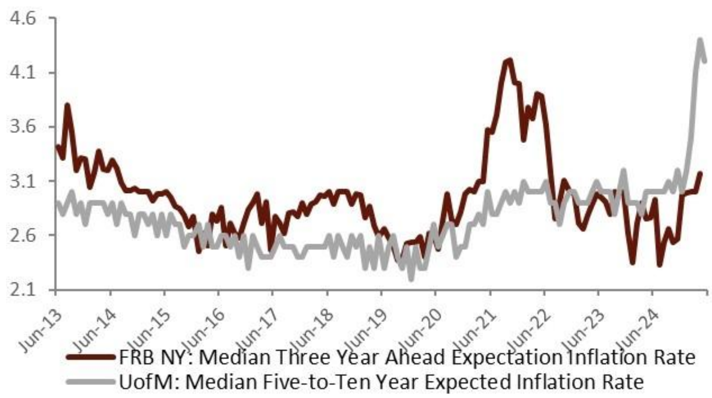
Inflation indicators







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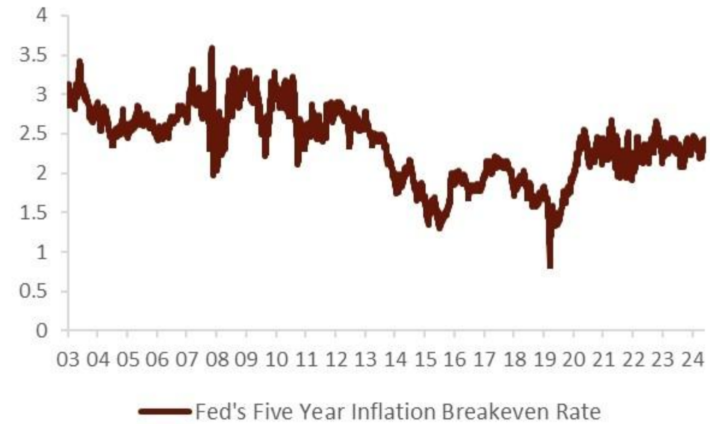
FRB NY: Median Three Year Ahead Expectation Inflation Rate
UofM: Median Five-to-Ten Year Expected Inflation Rate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Fed's Five Year Inflation Breakeven Rate