

Monday Monetary Thoughts

What will versus what should?

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U3 unemployment key for the Fed

Labor cost pressures continue to ease. In Q2, unit labor costs in the non-farm business sector rose just 1.3 percent SAAR, up a similar amount over the last year. In July, average hourly earnings rose just 0.1 percent, pulling the 12-month rate down to just 3.2 percent. As our nearby figure shows, several industries have seen wage growth cool over the last year.

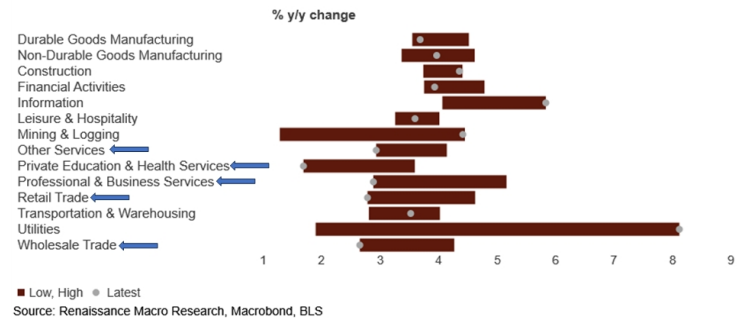
That said, I don't view the FOMC as being persuaded for several reasons. Thus, I continue to anticipate a rate hike in September.

- **Most policymakers accept that the labor market is not a meaningful source of inflationary pressures as it is.** Despite the cooling in labor market conditions, core services ex-housing has strengthened. One explanation could be that inflation expectations have increased. That is a tough pill for the Fed to swallow. So, there is an asymmetry at work. Evidence of cooling labor market conditions doesn't matter as much when inflation is running above target.

- The unemployment rate has declined well below estimates for 2026. This matters and that's why the unemployment rate – not payroll growth – is what goes into the Summary of Economic Projections and traditional monetary policy rules. **As Janet Yellen once stated, the headline unemployment rate is “probably the best single indicator” of labor market conditions.**

Several industries at low end of 12 month range

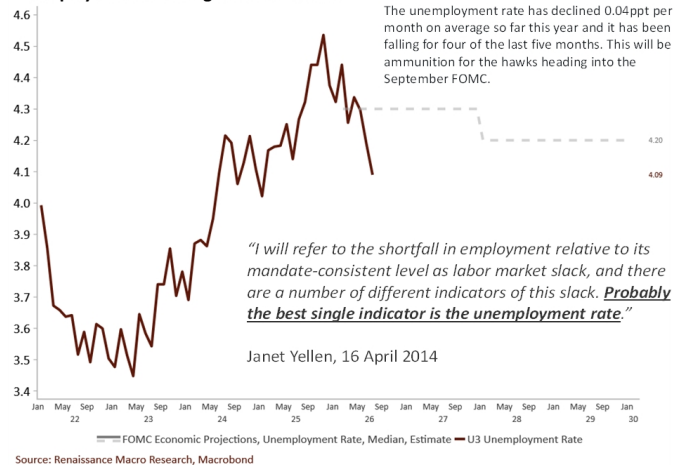
Changes in Average Hourly Earnings Relative to Range of % Y/Y Changes Last Year (as of July 2026)



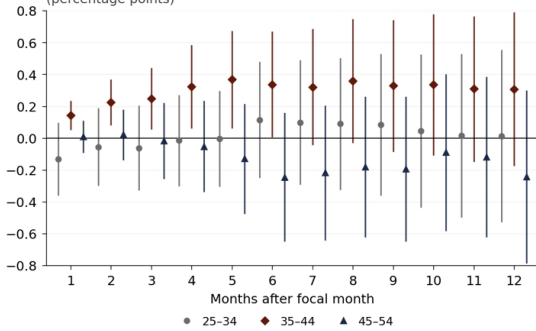
Non-housing core services firming even as wage growth cools



Unemployment is running below estimates



Unemployment among workers 35 to 44 still leads the overall rate (percentage points)



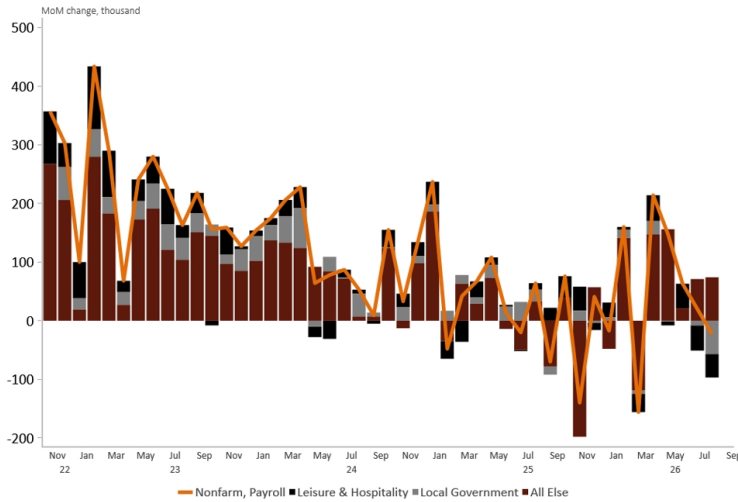
Data through July 2026; each series' maximal history, HC1 standard errors.

Each point is the coefficient on the contemporaneous change in the group unemployment rate, from a separate regression at each horizon that also includes two lags of that change plus the contemporaneous change and two lags of the overall unemployment rate. Bars are 95 percent confidence intervals.

Source: Renaissance Macro Research, Haver Analytics, Current Population Survey

- **There is some risk that the unemployment rate continues to slide.** For one, the most recent data simply reinforces the notion that the breakeven level to hold the jobless rate flat has declined. Next, [looking at key demographic groups](#) – ages 35 to 44, less than high school education, and blacks – implies overall unemployment declines. The framework's (Rinz) near-term read is roughly -0.06pp on the headline UR within a month or two, building to about -0.2pp over the next four to six months.

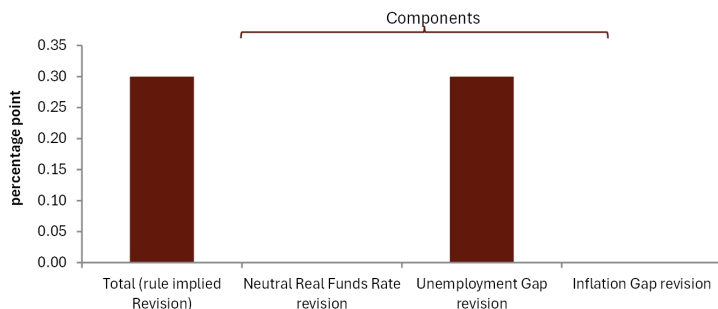
Two sectors pushed the headline down



Source: Renaissance Macro Research, Macrobond

- Lastly, **there is reason to assume that nonfarm payrolls growth rebounds in August. After all, the decline was led by two sectors: local governments and leisure & hospitality.** That's likely due to seasonal adjustment factors. What seasonals taketh, they giveth later. So, I'd expect a positive print heading into the September FOMC meeting.

Rule-implied (Taylor 1999) 2026 funds rate revision



Note: Funds rate revision = neutral_real_rate_revision + $0.5 \times \text{Core_inflation_revision}$ + $2 \times \text{Unemployment_gap_revision}$

In short, the slowing in wage growth is notable but is not as important as the decline in the unemployment rate. **Assume a scenario where the unemployment rate estimate for 2026 comes down by 0.1ppt to 4.2 percent. That by itself implies roughly a quarter-point upward revision to the implied policy path in a standard Taylor Rule type function.**

MoM Changes in 2026

	NFP	U3
January	160	-0.05
February	-156	0.12
March	214	-0.19
April	148	0.08
May	63	-0.04
June	20	-0.11
July	-23	-0.10
Average	61	-0.04

At the end of the day, the unemployment rate has declined 0.04ppt per month on average so far this year and it has been falling for four of the last five months. This will be ammunition for the hawks heading into the September FOMC.

Two risks to the outlook: Fiscal and consumption

The point of hiking is to slow growth down and I do think a hike or two will increase the downside risks to the economic outlook. That's a risk the consensus on the FOMC seems willing to tolerate. There are two things to consider, in my view.

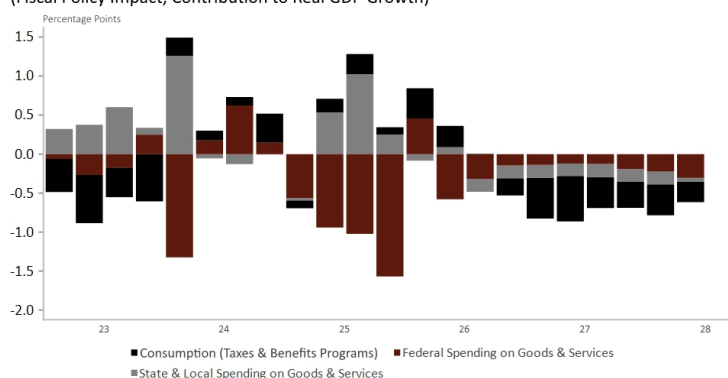
First, fiscal policy is becoming increasingly restrictive as we head into 2027. The Brookings Institute says this of their Fiscal Impact Measure (FIM):

*"We expect fiscal policy to be moderately restrictive over the remainder of 2026, as continuing weakness in government purchases and the effects of tariffs are partially offset by the stimulative effects of the tax cuts in the OBBBA. In 2027, we project the FIM will become more restrictive as **purchases continue to be weak and supply side effects—notably the equipment purchases we assume had been spurred by the CHIPS and Inflation Reduction Acts—turn negative.**"*

Over the next four quarters, federal spending on goods and services will cut US GDP growth by an average of 0.2ppt per quarter.

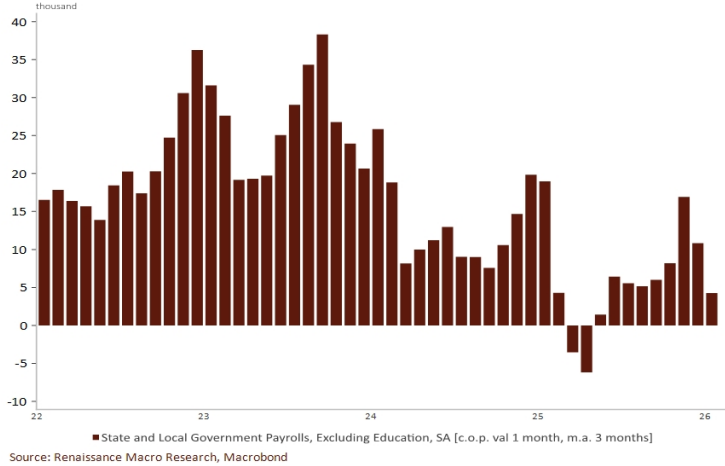
Fiscal policy turns more restrictive through 2027

(Fiscal Policy Impact, Contribution to Real GDP Growth)



Source: Brookings Institution, Renaissance Macro Research, Macrobond

State and local government hiring has stalled



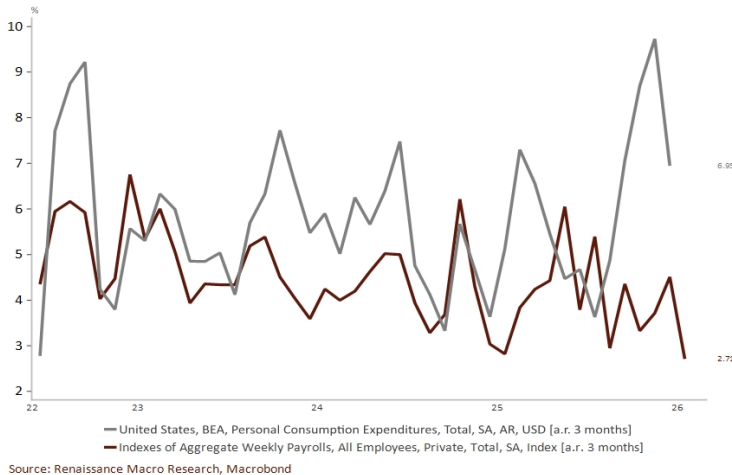
State and local governments are expected to be a modest headwind too, but the fact that state and local government employment has stalled over the last year is by itself a reason to anticipate less contribution to GDP from state and local government.

Second, **consumer spending is likely to moderate and that's important for GDP bean counting**. If the annualized rate of consumers' spending slows from 3.0 percent, the pace in Q2, to 2.0 percent, the contribution from consumption to GDP declines by 0.7ppt. To put this into context, nonresidential business fixed investment would need to accelerate another 5ppt to offset that.

Why do we see consumption slowing? Two reasons.

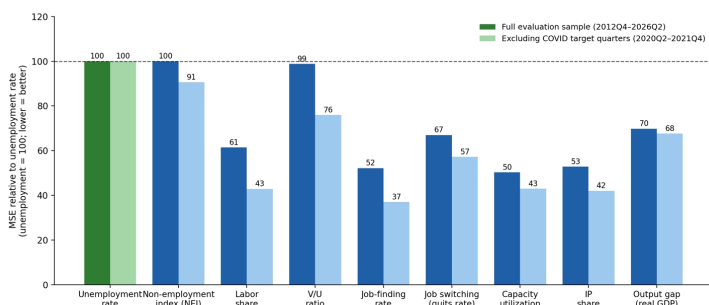
First, **income growth is weak**. Over the last three months, the index of aggregate weekly payrolls, a rough proxy for labor income, has advanced just 2.7 percent SAAR in nominal terms. That's no great shakes. I'd be careful assuming that the pace of nominal spending growth can persist when it's already running 4ppt ahead of incomes. There is a limit to how far the savings rate can decline

Spending is running well ahead of labor income



Performance of slack measure forecasts: Wage inflation

Figure 3 of Barnichon & Shapiro (2022), reproduced with data through mid-2026 — one-year-ahead AFE (prod. & nonsup.) inflation, rolling 10-year Phillips-curve windows, 55 out-of-sample forecasts



Note: Forecast errors relative to the unemployment-rate benchmark. Slack measures HP-detrended ($\lambda=1600$), 2003Q1-2026Q2. Job switching proxied by JOLTS quits rate. JOLTS-era sample means the evaluation window begins 2012Q4 rather than the original letter's 2003. Source: BLS, BEA, Federal Reserve Board, Richmond Fed, University of Michigan via FRED; calculations follow Barnichon & Shapiro, FRBSF Economic Letter 2022-04.

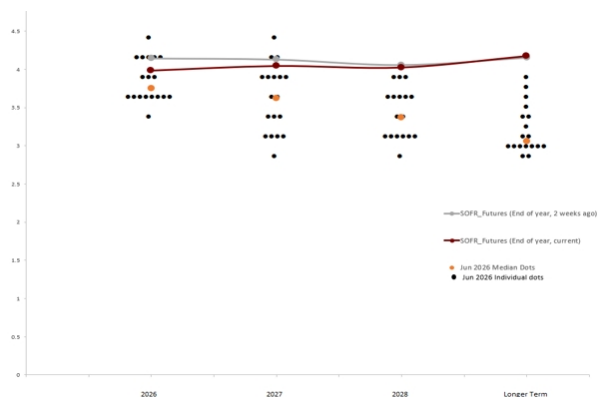
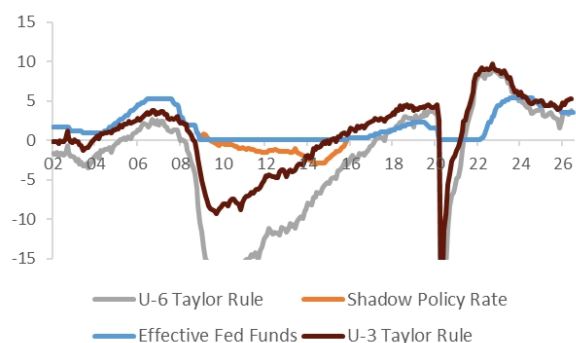
Moreover, **I would not assume that the decline in the unemployment rate by itself implies stronger wage growth is on the horizon.** Indeed, rates of job finding and switching, both of which are quite low, tend to be more useful in forecasting future wage pressures than the unemployment rate.

Second, **tax policy will become less favorable to households in the coming quarters.** Wild guess, but we will not be talking about “record-breaking tax refunds” in 2027. The tax relief tailwind lifted activity in H1 and that bump will not extend into the current half of the year. The Brookings Institute’s FIM shows taxes and benefits cutting US GDP by Q4 2026 with the headwind building for the next two quarters.

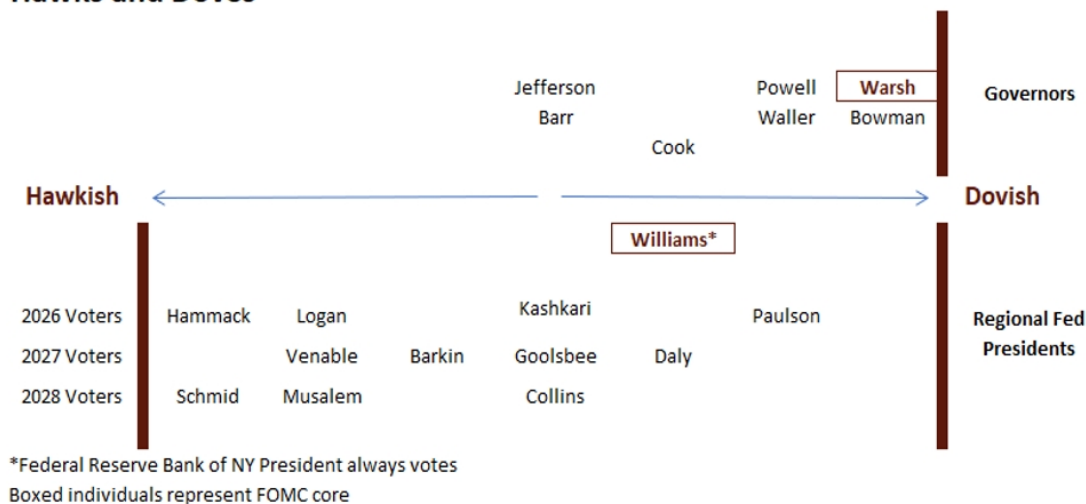
Fed hiking into downside risks

In short, the unemployment rate is coming down, but that does not necessarily mean that downside risks to the economic outlook are going away. Indeed, at the margin, the lower unemployment rate will push the Fed towards tightening policy even as the odds rise that fiscal policy tightens and consumption cools.

Monetary metrics



Hawks and Doves

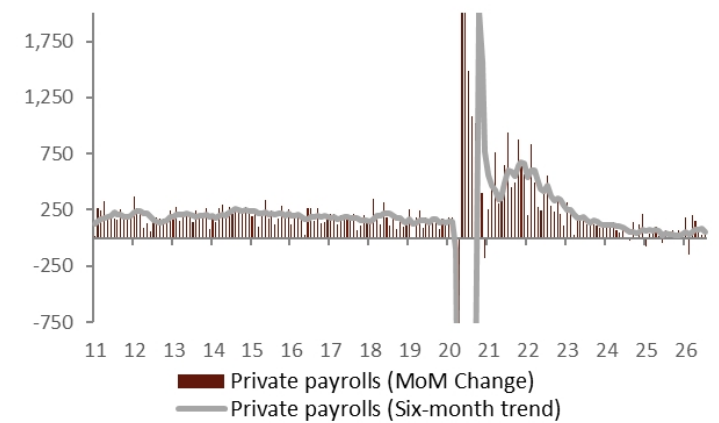
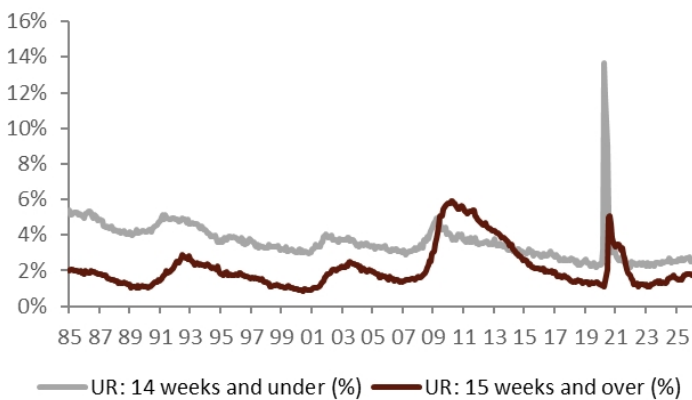
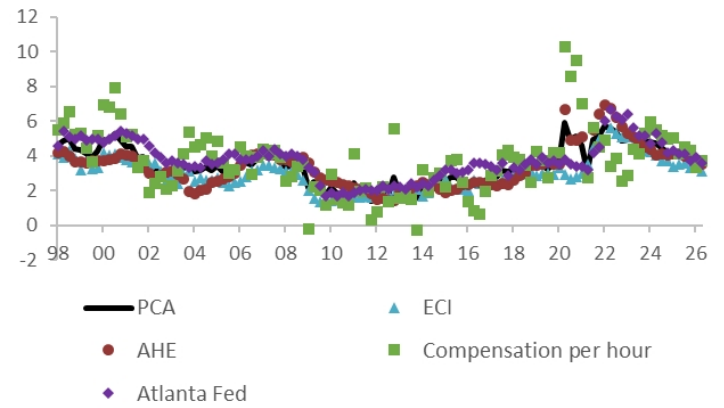
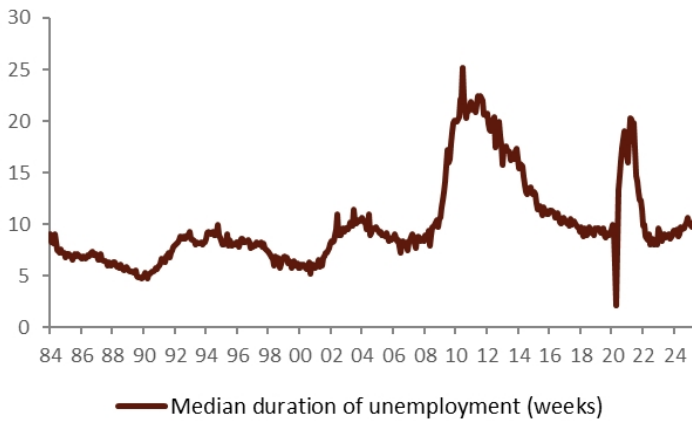
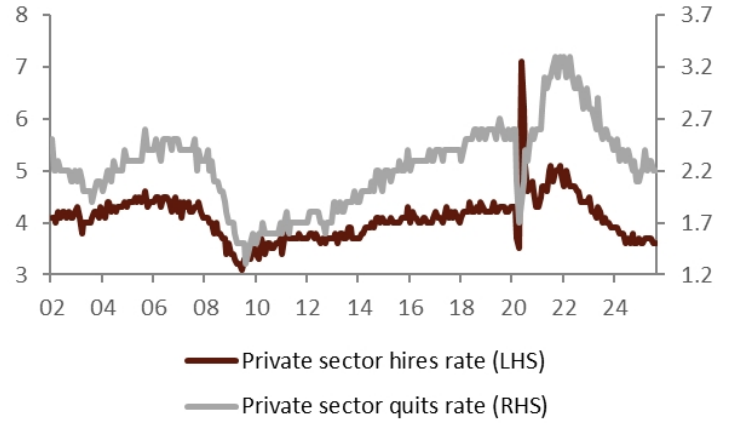
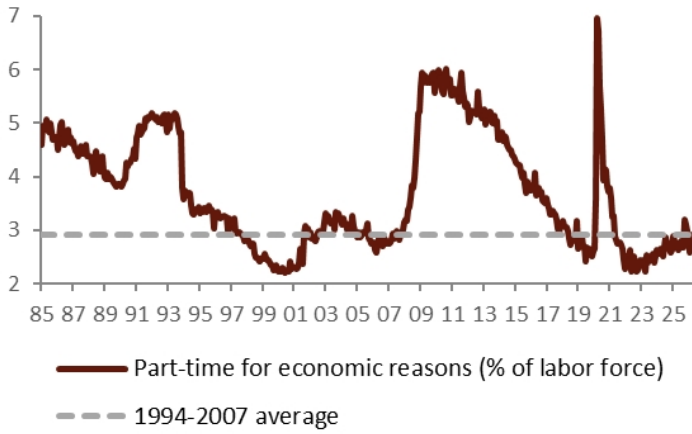


FOMC Forecasts	Median				Central Tendency			
	2026	2027	2028	Longer run	2026	2027	2028	Longer run
Change in real GDP	2.2	2.3	2.2	2	2.0-2.3	2.0-2.4	2.0-2.3	1.8-2.0
March projection	2.4	2.3	2.1	2	2.2-2.5	2.0-2.4	2.0-2.3	1.8-2.0
Unemployment rate	4.3	4.3	4.2	4.2	4.3-4.4	4.2-4.5	4.1-4.3	4.0-4.3
March projection	4.4	4.3	4.2	4.2	4.3-4.5	4.2-4.4	4.0-4.4	4.0-4.3
PCE inflation	3.6	2.3	2	2	3.5-3.7	2.2-2.5	2.0-2.1	2
March projection	2.7	2.2	2	2	2.6-3.1	2.0-2.3	2	2
Core PCE inflation ⁴	3.3	2.5	2.1		3.2-3.5	2.3-2.6	2.0-2.2	
March projection	2.7	2.2	2		2.5-2.8	2.0-2.4	2	
Projected policy path								
Fed funds rate	3.8	3.6	3.4	3.1	3.6-4.1	3.1-3.9	3.1-3.6	3.0-3.5
March projection	3.4	3.1	3.1	3.1	3.1-3.6	2.9-3.6	2.9-3.6	2.9-3.5

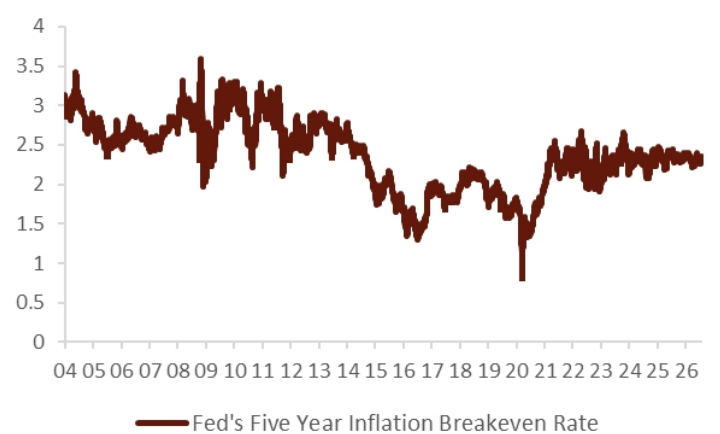
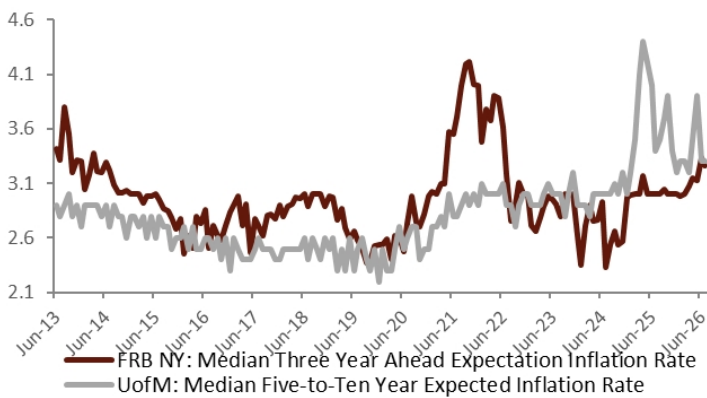
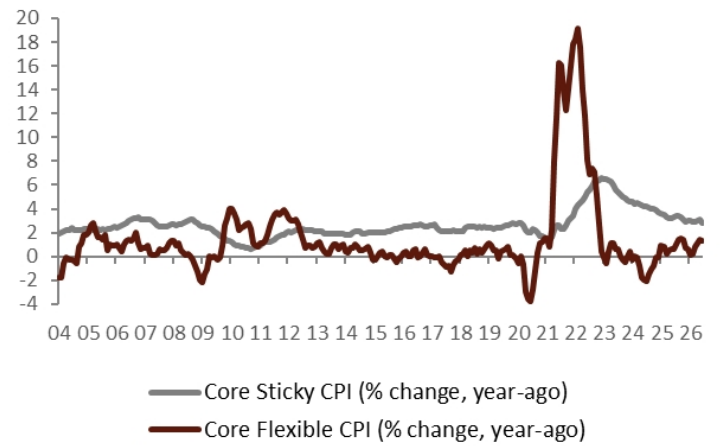
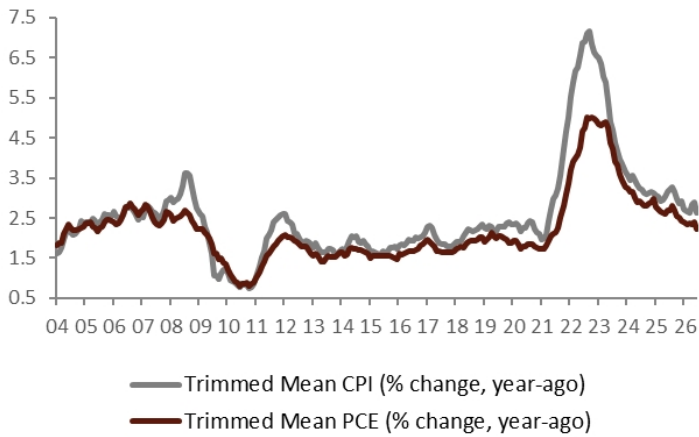
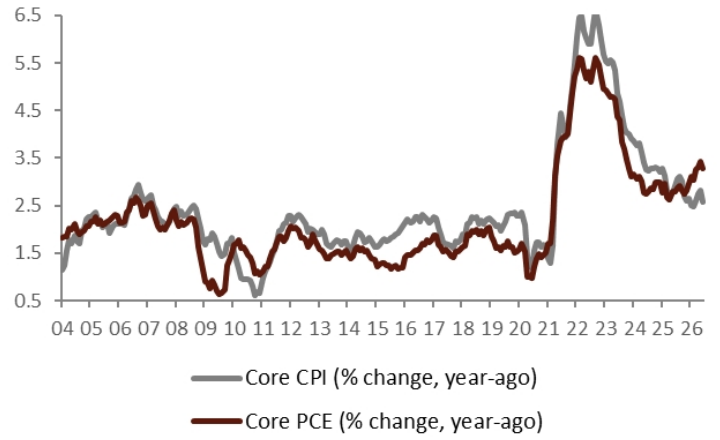
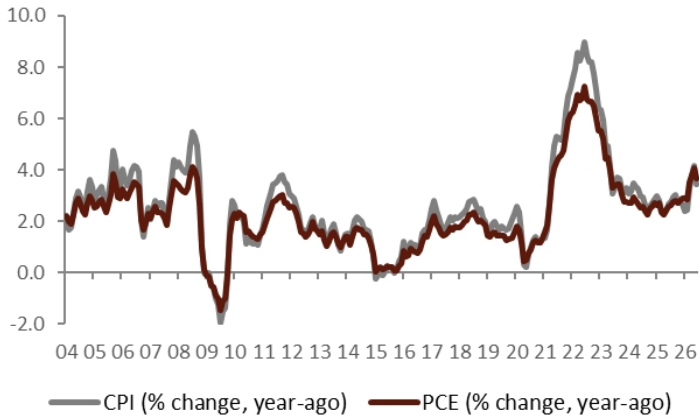
High frequency data heat-map



Labor market indicators



Inflation indicators



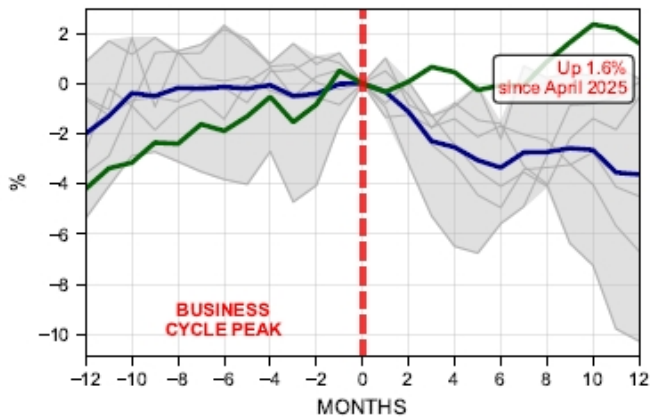
US Inflation Heatmap (6-Month Annualized)



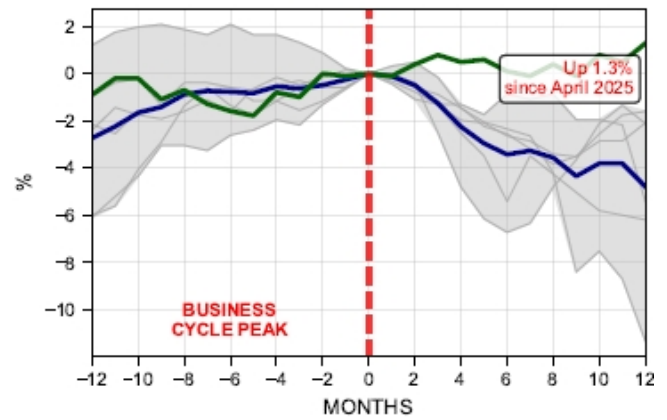
Note: The heatmap shows the distance of each US CPI component's 6-month annualized inflation rate from its historical average. The colour is white when a component's inflation rate is close to its average and is a varying shade of blue (red) when the rate is below (above) the average. Each inflation rate is standardized by subtracting its mean and dividing by its standard deviation, computed over 1996-2019. and We show full Nondurables (which includes food and energy components) alongside Durables, New vehicles, Used cars and trucks, and Apparel; the parent group itself excludes food and energy. Food away from home, Other personal services, and Tenants' & household insurance are published NSA by BLS and seasonally adjusted via X-13ARIMA-SEATS. Values in parentheses are CPI relative importance weights (parts per 100). Sources: BLS via Haver Analytics; RenMac calculations. Last observation: June 2026.

NBER RECESSION INDICATORS DASHBOARD

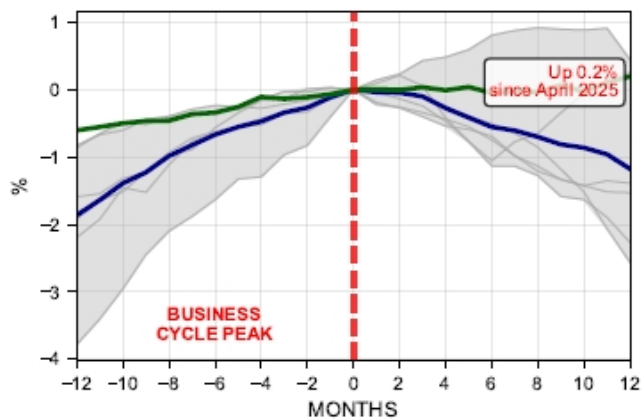
REAL SALES: MANUFACTURING AND TRADE INDUSTRIES



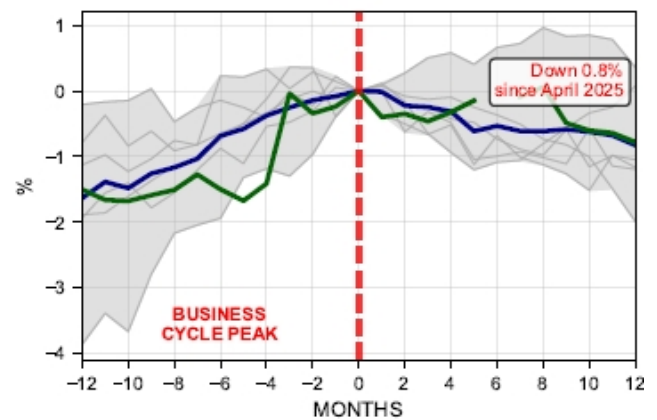
INDUSTRIAL PRODUCTION



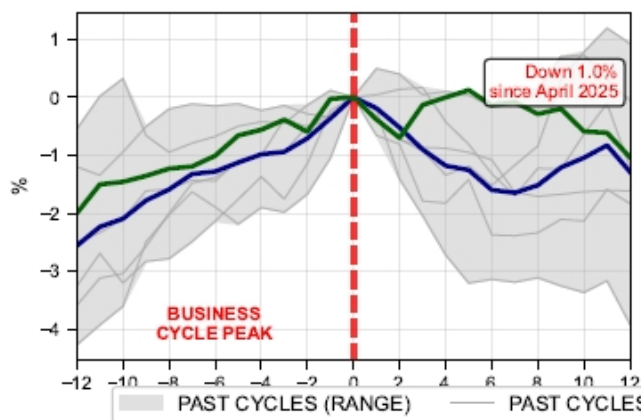
US NONFARM PAYROLLS



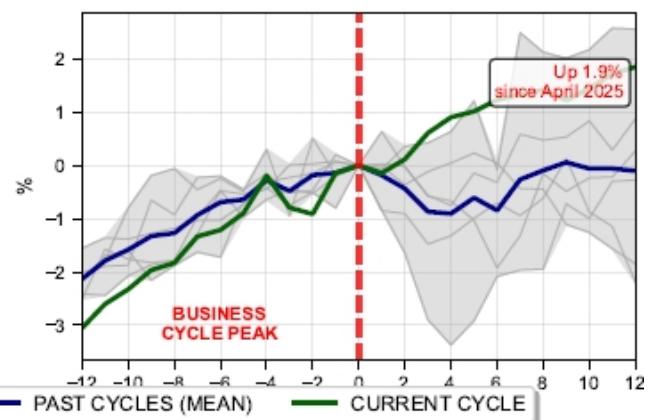
CIVILIAN EMPLOYMENT



REAL PERSONAL INCOME MINUS CURRENT TRANSFER RECEIPTS



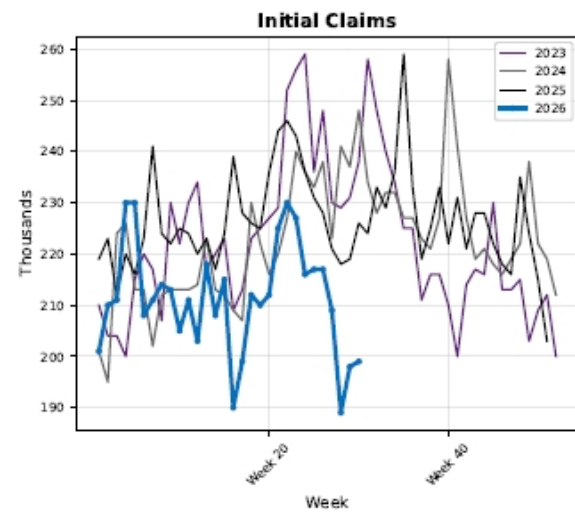
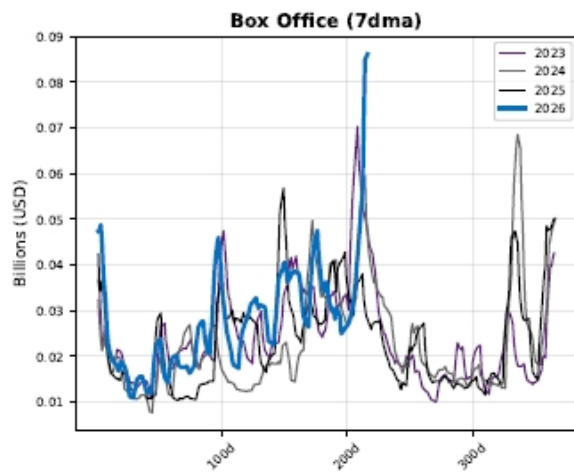
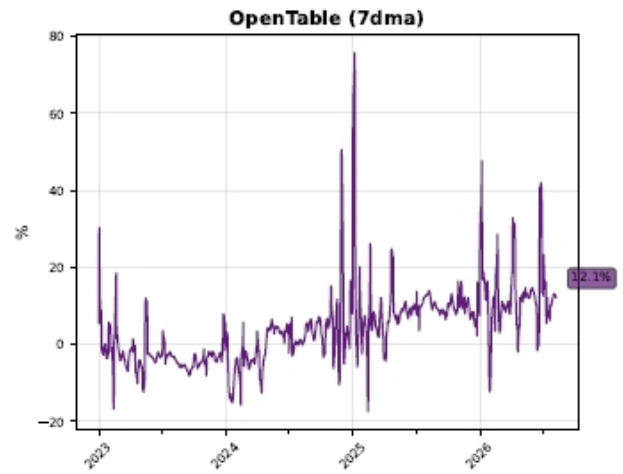
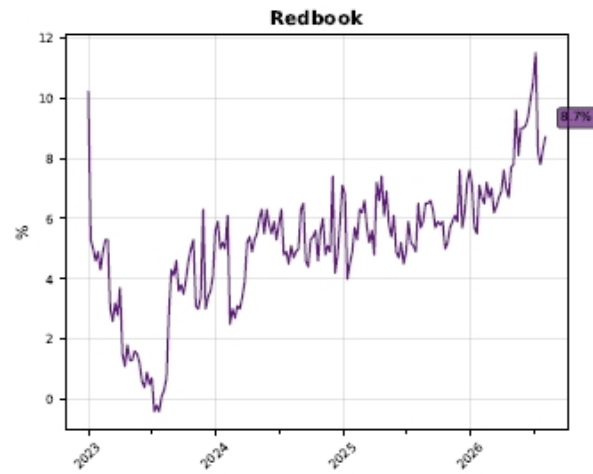
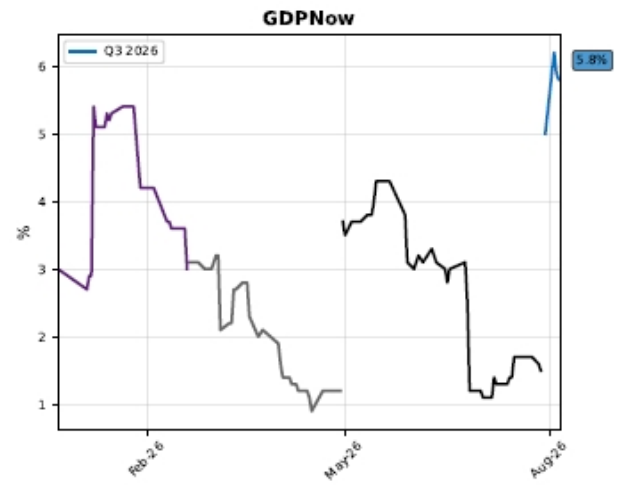
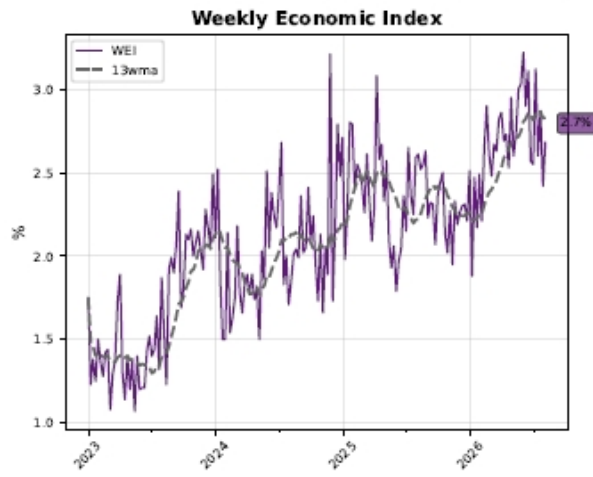
REAL PCE



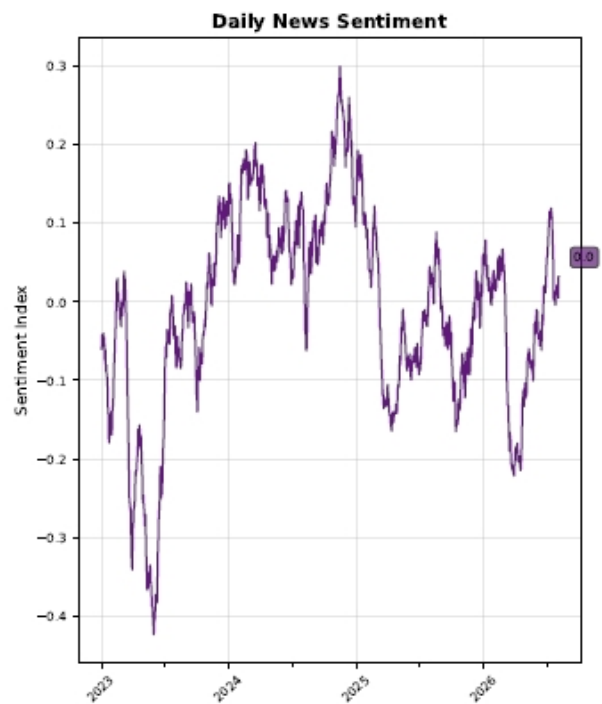
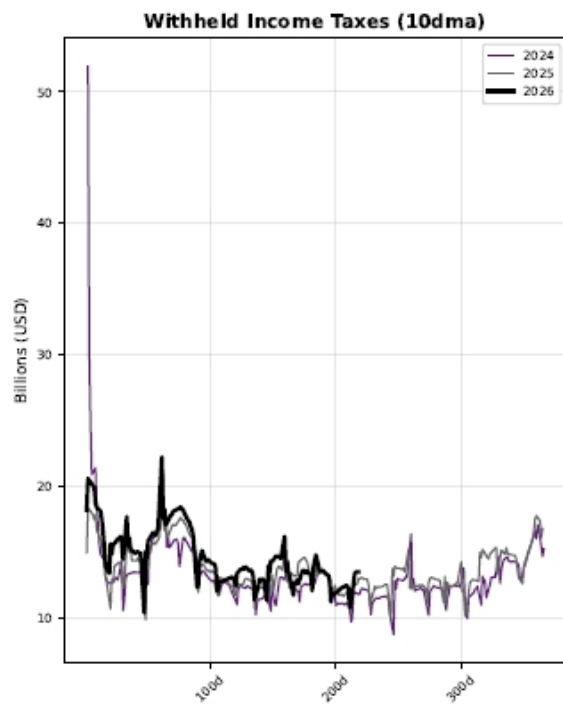
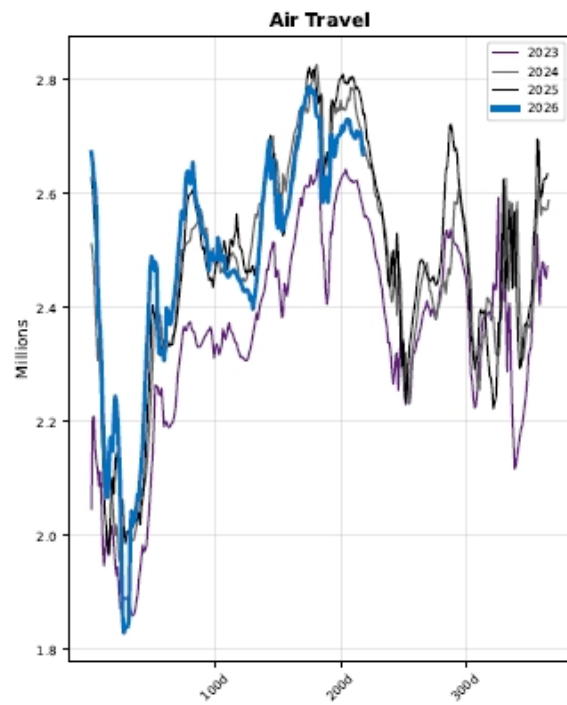
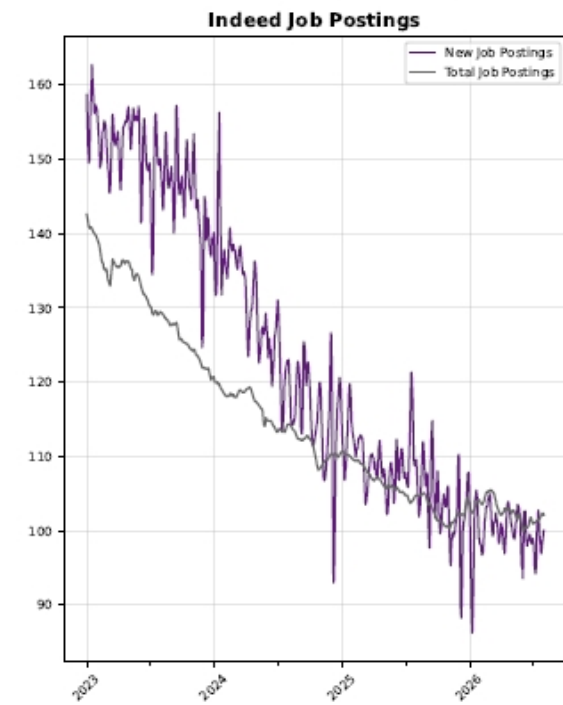
PAST CYCLES (RANGE) PAST CYCLES PAST CYCLES (MEAN) CURRENT CYCLE

Past 7 cycles excluding Covid-19 period

High Frequency Economic Dashboard



High Frequency Economic Dashboard



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