



Charts and Smarts®

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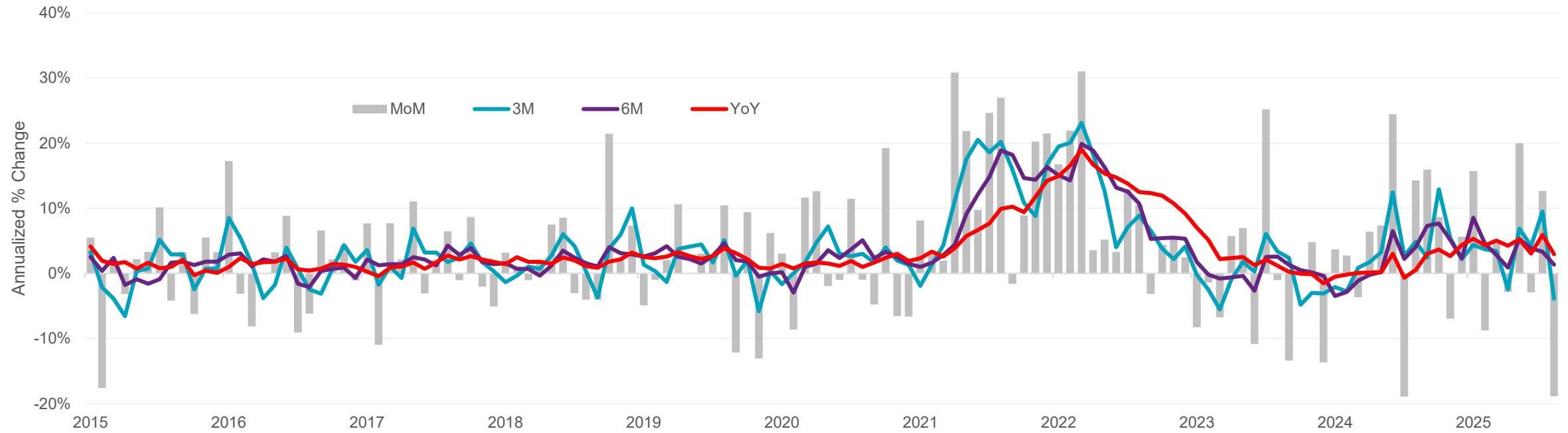
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Strange Brew

PPI Final Demand Trade Services (1/31/15–8/31/25)

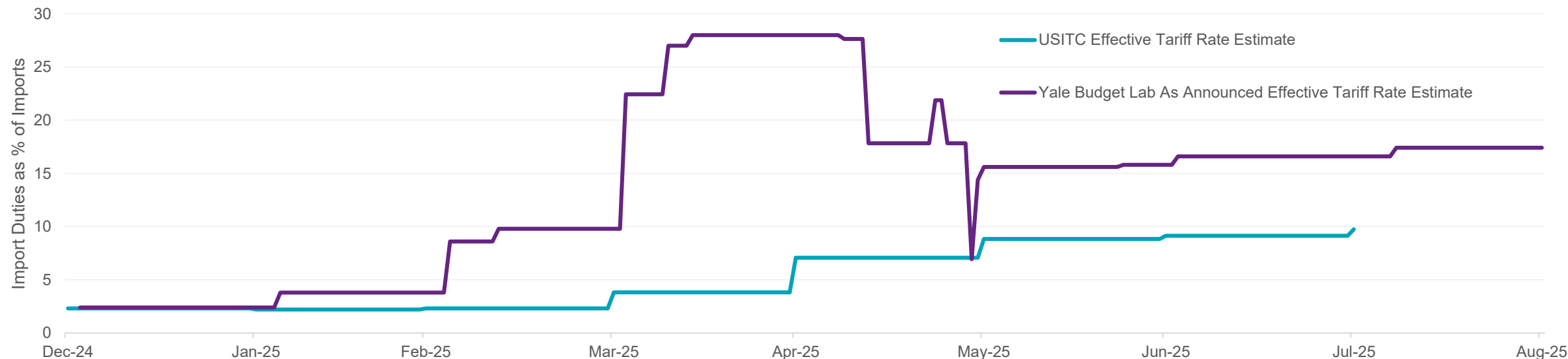


Just as fast as the inflation data returned to the spotlight, it has seemingly drifted into the background once more. The failure of the July inflation data to show meaningful follow through of the tariff effects paired with a meaningful downshift in the pace of job creation over the past few months has triggered yet another shift in the balance of risks away from price stability and back to the labor side of the Fed's dual mandate. While inflation prints have firmed in recent months, the magnitude of the firming to date has been smaller than feared. And it's not just CPI data that is confounding policy makers and investors alike, but PPI data as well. We know tariffs are indeed being paid, but, as of yet, it's hard to definitively determine how that burden is being shared. Tariff sensitive goods prices have deviated from their pre-tariff deflationary trends, but the impact on consumer prices has been relatively muted. Import prices have been flat as the dollar has weakened suggesting foreign companies aren't shouldering the burden. And corporate margin estimates continue to sit near all-time highs, suggesting corporates aren't suffering cost pressures. With little evidence that foreign suppliers are paying the tariffs via lower import prices or a stronger dollar, it's clear consumers and businesses are sharing the burden, though the extent of each remains unclear. Given the subdued move in consumer prices to date, it appears corporates are perhaps absorbing those increased costs, a point that's reinforced by the decline in trade services PPI, which measures margins for wholesalers and retailers. Corporates can only tolerate that margin compression for so long until they find some way to offset that pressure through future price increases, cost cutting, capex reductions, or cuts to employment or hours.

Source: Portfolio Analysis & Consulting. Bloomberg.

Passing the Time

US Effective Tariff Rate Evolution (1/20/25–8/31/25)

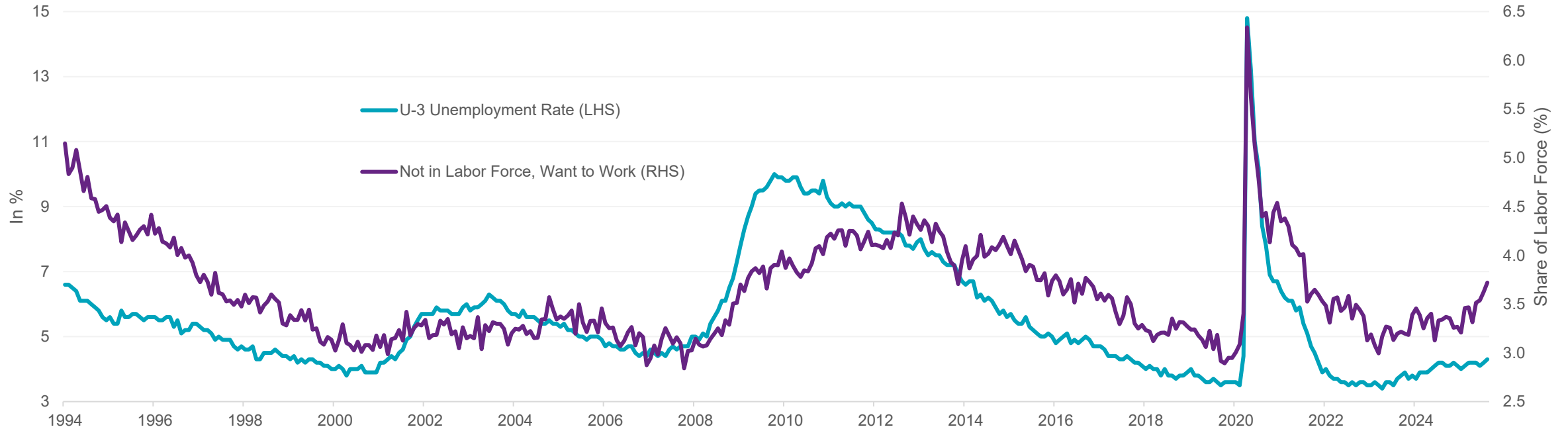


While it's hard to decipher who is shouldering the largest burden of the government's new revenue source, there are a handful of potential explanations as to why the macro impulse so far has been smaller than expected. The final, and decidedly most bullish option, is that perhaps we simply overestimated the potential impact of tariffs as firms are again proving their flexibility and dynamism in managing the incremental costs and finding ways to defend, and even expand, margins without pushing aggressive price hikes. Another potential answer is that corporates are finding it difficult to pass tariff costs onto consumers as consumer demand elasticity has risen thanks to softening nominal income growth. If that's the case, firms are likely absorbing the bulk of the tariff impact through margin compression and it's only a matter of time until they implement strategies to offset that compression which would only weigh further on real growth. The third option, is that companies are simply waiting to push price increases to protect market share as they work through low-cost inventory that was accumulated as firms scrambled to front run the tariff effective dates. The chart above lends some credence to that idea as the effective tariff rate through July sits at just 9.8% as compared to the statutory rate under currently assessed rates of almost 17.5%. In other words, it will take longer than the consensus expects to see the full effects of tariffs filter into prices as firms are waiting to raise prices until they are forced to restock inventory that is now subject to those tariffs. These are not mutually exclusive explanations, and the truth is likely a combination of these options. The price effects of tariffs can both be smaller than feared and play out over a longer period of time than originally anticipated while still presenting material downside risks to growth. Should we see more explicit passthrough of tariffs into prices in the months and quarters to come, it is likely to occur against a backdrop of continued cooling in nominal income, reducing the risk of tariff-induced inflation morphing into a more persistent inflationary process and keeping the balance of risks leaning decisively toward the labor side of the Fed's dual mandate.

Source: Portfolio Analysis & Consulting, Bloomberg, The Budget Lab at Yale.

Born Under a Bad Sign

Labor Force Attachment vs Unemployment Rate (1/31/94–8/31/25)

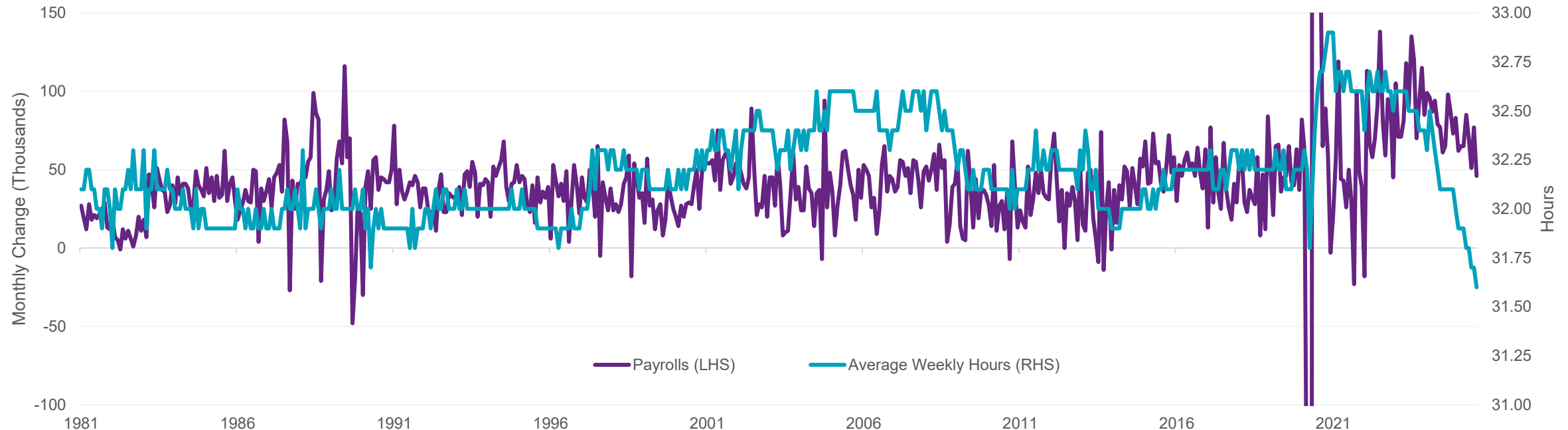


The narrative around the labor market has rapidly shifted in the wake of a spate of soft payrolls prints, large downward revisions, and cooler reads from a broad swath of other labor market indicators. But despite the clear evidence of a linear cooling that has been in place for that past year, there remains a widely held view that much of the slowing is the product of falling labor supply. While labor supply is indeed declining, in part thanks to the Trump administration's immigration policy, the focus on immigration is largely a red herring. Labor demand has been clearly slowing, as evidenced by declining vacancies and job postings. Growth bulls continue to argue that labor supply falling in line with demand means that labor markets remain in equilibrium, but this is not a stable equilibrium, and more importantly, it hasn't been enough to keep the unemployment rate from slowly but surely rising to new cycle highs. What's more, there's a long and growing list of indicators suggesting the U-3 unemployment rate may in fact be understating the degree of slack in labor markets. One notable example is the growth in those not in the labor force but want to work now sits at the highest levels since August 2021, matching levels seen in 2016 when the unemployment rate was hovering around 5%. Labor supply certainly appears to be declining, but it appears to be less a function of immigration policy and more a reflection of weakening attachment and increasingly discouraged workers as labor demand softens. For now, the trend of linear cooling continues as the labor market remains in stasis. But that stasis can only persist for so long, and risks are growing that what has so far been a relatively benign softening may morph into a more pernicious non-linear deterioration.

Source: Portfolio Analysis & Consulting, Bloomberg.

Badge

Education and Health Services Employment vs Hours Worked (1/31/81–8/31/25)



Throughout the slowing in payrolls growth over the past year we've repeatedly highlighted the critical role acyclical sectors have played in supporting headline jobs growth. In particular, education and health services have been responsible for 88% of all net job creation in 2025, with health care and social assistance driving nearly all of those job gains. In other words, excluding education and health services, the economy has added just 69,000 jobs this year, and that's without accounting for the preliminary benchmark revisions that will likely see figures for the first three months of the year revised lower. Cyclical momentum has ground to a halt in labor markets, and the stasis is translating to continued cooling in activity with payrolls growth teetering on the edge of outright contraction. In an environment defined by such low rates of hiring, it doesn't take much in the way of an increase in layoffs to push payrolls growth into negative territory and place further upside pressure on the unemployment rate. And that's particularly true as momentum slows within the all-important education and health services sector which has seen jobs growth moderated from a three-month average of 81,000 jobs in December 2024 to 58,000 through August. Firms tend to cut back on hours before reducing headcount, and with average weekly hours for the sector sliding to the lowest levels on record, employment growth looks likely to continue slowing. While July and August saw payrolls growth rebound from the contraction in June, there may be more negative prints in store over the next few months as cyclical momentum remains weak and acyclical job creation continues to slow.

Source: Portfolio Analysis & Consulting, Bloomberg.

Crossroads

SOFR Implied Terminal Rate (12/31/21–9/12/25)



While upside risks remain on the price side of the Fed's dual mandate, inflation has largely increased in line with the FOMC's median expectations as laid out in the June Summary of Economic Projections all the while the unemployment rate remains on pace to reach the median forecast of 4.5%. Put differently, the data over the past few months has largely validated the median dot indicating two cuts for the balance of the year. Indeed, there's little doubt of a 25 basis point cut at the September meeting as even the hawks have begun to fall in line behind Powell's rallying cry at Jackson Hole, but there appears to be little appetite to front load the renewed cutting cycle given the well-established camp on the committee that remains concerned that a tariff-induced price level shift could morph into a more persistent inflationary process. That leaves the pace and scope of future cuts very much a function of the incoming labor market and inflation data. While the market's assessment of the balance of risks has clearly shifted to the labor side of the mandate with rates markets pricing in nearly three full cuts, the FOMC appears to be somewhat divided in its views, setting the stage for potential disappointment should the Fed pursue a more measured pace of recalibration. For now, risk assets are still of the mind that weak data equates to more cuts which bolsters investor risk appetite. But given the still present upside risks to price stability, that feedback loop is on less stable footing as the left tail for labor market outcomes is opening up as labor slack builds for less benign reasons. Against that backdrop, less cuts now likely translates to the need for more cuts later, something increasingly reflected by the continued decline in the market implied terminal rate. The prospect of a growth startle continues to loom large should the market begin to price more cuts for the wrong reasons.

Source: Portfolio Analysis & Consulting, Bloomberg.

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