



Strong Jobs Data Raises Fed Pressure

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The August employment report was much stronger than expected and reinforces my view that the U.S. economy remains remarkably resilient. Payrolls increased by 162,000, above every estimate, while revisions added another 55,000 jobs to the previous two months. The workweek increased by one-tenth of an hour, the household survey was extremely strong, and the participation rate finally moved higher. Wage growth remains contained at just 3.1% year over year. This is about as favorable a labor mix as one could ask for.

The strength of employment does temper productivity statistics. Estimates for third-quarter GDP growth remain very strong, perhaps around 3.5% averaging forecasts that I watch closely. I hoped that such strong output accompanied by very modest hiring would produce another dramatic productivity gain and provide clear evidence that artificial intelligence is already lifting economy-wide productivity. Instead, employment and hours worked are rising. Productivity should still be respectable, but this quarter may not provide the strong productivity uptick I anticipated.

That does not mean AI is failing. Goldman Sachs estimates that businesses adopting AI are experiencing productivity improvements of roughly 30%, consistent with academic studies showing gains in the 20%-30% range. Yet these gains have not yet translated into higher profit margins. Competition appears to be forcing firms to pass much of the benefit through lower costs and prices. Over time, that is exactly how productivity should benefit the broader economy: lower inflationary pressure and higher real wages. Importantly, there remains virtually no evidence of an AI-driven employment apocalypse. Jobless claims remain in the low 200,000s, layoffs attributable to AI remain limited, and displaced workers generally appear able to find new employment quickly.

The stronger economy does, however, complicate the Federal Reserve's decision. Expectations for a September rate increase rose meaningfully following the employment report, and I believe the economic case for a 25-basis-point hike is strong. Money growth reinforces that conclusion. Since the beginning of the Iran war, M2 money supply has been expanding at roughly a 10% annualized rate, compared with approximately 4% for several years beforehand. This is nothing resembling the extraordinary monetary expansion during the pandemic, but it is difficult to characterize current monetary conditions as restrictive when credit and money are expanding this rapidly. If the federal funds rate were truly restrictive, borrowing should be slowing much more significantly.

The complication for Chair Warsh is political. With the midterm elections only two months away, raising rates would inevitably attract administration criticism, particularly because higher short-term rates feed directly into credit cards and auto loans. Ironically, a rate increase could ultimately lower longer-term yields if investors become convinced that the Fed is serious about controlling inflation. But the political optics are already difficult, as Trump has avowed to hike tariffs if rates are not decreased! This week's producer and consumer price reports will be extremely important in determining whether the Fed follows the economic case for another hike.

For equities, the employment report is fundamentally good news, but there could be a limit to how much higher interest rate stocks can absorb. Stronger growth supports earnings, but higher bond yields increase the discount rate applied to those earnings. The 10-year Treasury yield has moved toward 4.8%, approaching the 5% level reached during the battle against the post-pandemic inflation surge. A sustained move above 5% could become a meaningful problem for equities, and it would certainly be a problem for bonds. There could be one silver lining: sufficiently high long-term rates may finally force Washington to confront the federal deficit.

Oil and geopolitics remain the major wild cards. Despite higher WTI prices, crack spreads have declined and gasoline futures suggest relatively contained pressure on retail prices. But the Iran conflict and the Strait of Hormuz could quickly change that calculation. The principal risk to equities is no longer recession. It is that continued economic strength, rapid money growth and geopolitical pressure that keep inflation and bond yields high enough to force the Fed, and ultimately the market, to recalibrate.

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