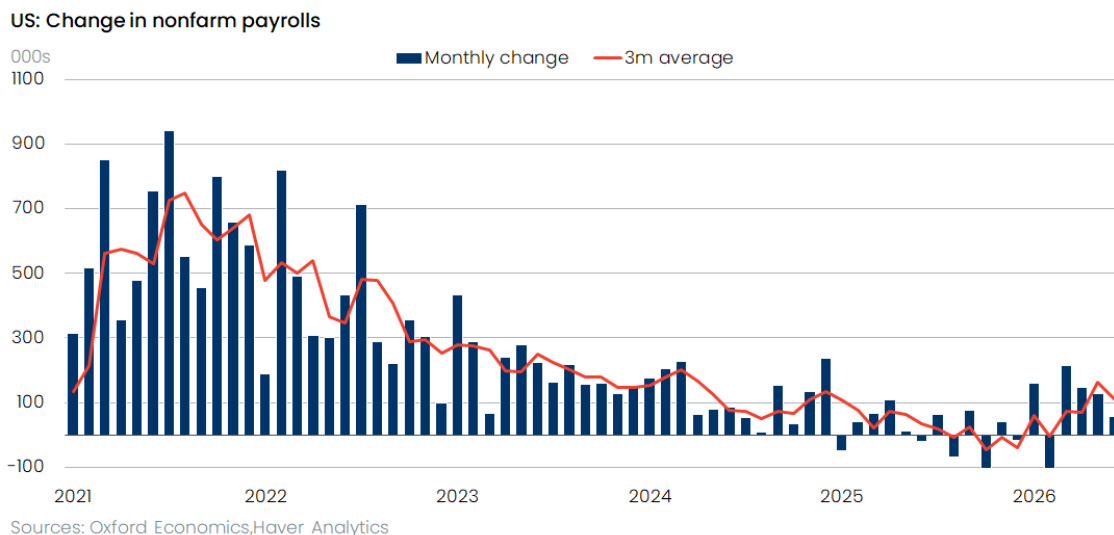


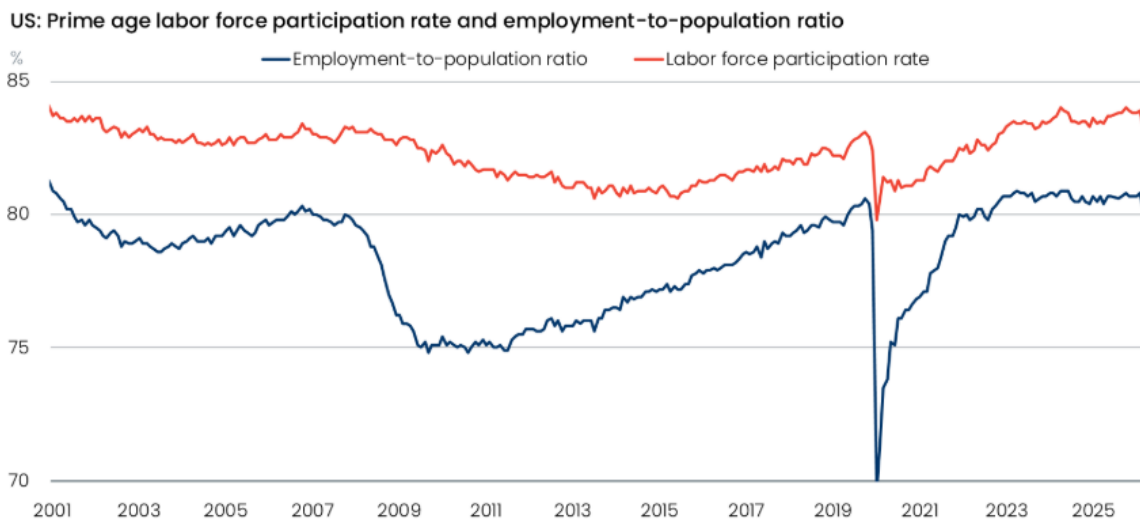
Kevin Warsh just served his first full month as Chair of the Fed and is probably more pleased than not with the first significant economic report for the period – the June jobs report. The 57 thousand increase in nonfarm payrolls last month was far less than the expected 115 thousand. What's more, the downside surprise was amplified by revised estimates for April and May, which now show 74 thousand fewer jobs than earlier reported. The main gift to Warsh is that it relieves pressure on him to join the rate-hiking advocates among the policy-setting committee where sentiment to tighten the monetary screws would have intensified if the spurt in job growth over previous months continued. Indeed, the futures market immediately dialed back expectations of a rate increase this year.

We did not believe that the job market was overheated before and are more comfortable with that view now. Likewise, we didn't believe that labor costs would be a source of inflation pressure before and still don't despite a slight uptick in wage growth in June and a move down in the unemployment rate to 4.2 percent from 4.3 percent in May. If anything, the latest jobs report further muddies perceptions of what the correct breakeven rate for job growth is, one that is consistent with a stable unemployment rate and a balanced labor market. Average job growth over the last three months fell to 111 thousand, down from 164 thousand over the three months ending in May.



That's still a respectable pace and likely exceeds the breakeven rate, given that lower net migration and higher retirements amid an ageing population are stifling growth in the labor force. In June 720 thousand workers left the labor force, reducing it to the lowest level since December 2024. The decline in labor supply exceeded the 507 thousand drop in employment as calculated by the household survey, which has consistently shown weaker job gains this year than the broader establishment survey from which the payroll changes are calculated. The payroll survey is viewed as a more reliable gauge of labor market conditions than the household survey, if only because it is broader and collects more accurate responses (households do not always tell the truth about their employment status in the survey). But the household survey does reveal emerging cracks in the labor market that may prove significant.

For one, the share of prime-age workers (age 25-54) holding jobs fell from 80.8 percent to 80.2 percent in June, which is the lowest level since December 2022. That group excludes older workers heading towards retirements, although an exodus of immigrants may have played a role. But this is a noisy series, so it would be a mistake to read too much into a one-month change. For another, the job gains continue to be concentrated in a few sectors, with health care and social services accounting for more than 80 percent of the 57 thousand payroll gain last month. This sector, which accounts for only 15 percent of total employment, continues to punch well above its weight. And since foreign born workers comprise a sizeable part of the health care workforce, it suggests the loss of immigrants may not have contributed much to the plunge in the labor force.



Interestingly, the biggest drag on employment last month came from the leisure and hospitality industry (mostly restaurants and hotels). That flies in the face of widespread expectations that the World Cup would impart a big boost to jobs in this sector. Odds are, we will see a big revision in this data point in next month's release; in any case, it is a reminder not to conclude anything firmly from a one-month report on the labor market. Alternatively, if the weak job

growth in leisure and hospitality is real, it could be a sign that wealthier households who have been the main drivers of discretionary spending this year, are running out of steam. From our lens, that's probably not the case, as the stock market just turned in another stellar performance in the second quarter, sending the S&P 500 up 15 percent, the strongest in six years. The wealth effect on consumption is probably still alive and kicking.



Simply put, the decline in the unemployment rate should not be viewed as a sign of growing strength or tightness in the labor market. The decline is more a function of fewer workers available to fill job openings. This describes the old adage that the unemployment rate is declining for the “wrong reason”. The “right reason” would be when the rate drops because the labor force is growing, but the demand for workers is growing faster. Neither the household nor the establishment (payroll) survey indicates that was the case in June. Nor does the low unemployment rate suggest that worker bargaining is getting stronger, something that would come out of a tight labor market.

True, average hourly earnings increased 0.3 percent in June and 3.5 percent over the past year, both of which are a tick faster than in May. But the trend is still down, as average hourly earnings were increasing by 4.0 percent year-over-year last summer. Worse, over that same time span, inflation has sped up considerably, from 2.7 percent to 4.2 percent. What that math shows is that workers have lost a lot of purchasing power over the past year – 1.5 percent from inflation and 0.5 percent from slower wage growth. The June inflation report will not be available for a few weeks; it's possible that the decline in gasoline prices dragged the CPI below the annual wage increase during the month. But there is still a way to go before households regain their lost purchasing power over the past year.

In short, this week's jobs report pushed back against the market narrative that the next interest rate move by the Federal Reserve would be a hike. At the European Central Bank Forum on Central Banking, newly minted Fed Chair Kevin Warsh said inflation risks have declined over the past four weeks, a view that is clearly linked to the sharp decline in oil prices. As long as Mideast hostilities do not flare up again, lower gas prices should continue to pull down inflation in coming months. Even so, the central bank is left in an uncomfortable position as inflation is still running above target and the labor market's earlier luster is starting to come off. From our lens, therefore, the Fed is poised for a prolonged pause, and the odds of the next rate move is a tossup. Barring another external shock that disrupts the economic and inflation landscape, we may not see a rate shift – up or down – before sometime next year.

FINANCIAL INDICATORS

INTEREST RATES	July 2	Week Ago	Month Ago	Year Ago
3-month Treasury bill	3.76	3.75	3.72	4.35
6-month Treasury bill	3.93	3.92	3.80	4.30
2-year Treasury note	4.18	4.09	4.16	3.89
5-year Treasury note	4.25	4.13	4.28	3.94
10-year Treasury note	4.49	4.38	4.53	4.35
30-year Treasury bond	4.98	4.87	5.00	4.87
30-year fixed mortgage rate	6.43	6.49	6.48	6.67
15-year fixed mortgage rate	5.79	5.84	5.79	5.80

STOCK MARKET				
Dow Jones Industrial Index	52,900.07	51,876.11	50,866.78	44,828.50
S&P 500	7,483.24	7,354.02	7,383.74	6,279.40
NASDAQ	25,832.67	25,297.62	25,709.43	20,601.10

COMMODITIES				
Gold (\$ per troy ounce)	4,135.50	4,083.9	4,353.8	3,338.8
Oil (\$ per barrel) - Crude Futures (WTI)	68.46	69.42	90.23	67.11

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
Nonfarm Payrolls (June) - 000s	57	129	148	92
Unemployment Rate (June) - Percent	4.2	4.3	4.3	4.3
Average Hourly Earnings (June) % change	0.3	0.2	0.2	0.3

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