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Economic Data Round-Up: Inflation progress and a balanced labor market

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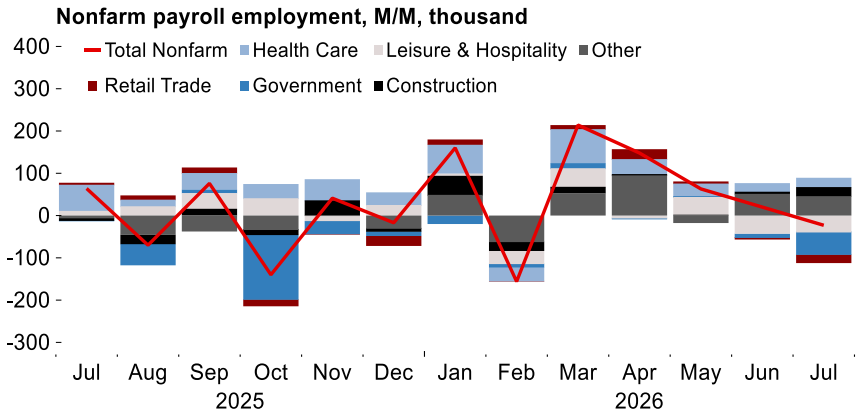
- **The labor market appears weaker on the surface, but underlying conditions may be closer to balance than headline payrolls suggest.** Payroll employment declined in July and prior months were revised lower. However, unemployment remains low as slower labor force growth has reduced the pace of job creation needed to maintain labor market stability.
- **Inflation continues to moderate as both consumer and producer price pressures ease**. While recently lower headline inflation was largely supported by lower energy prices, there may be early signs of easing underlying inflation pressures even as near-term risks from geopolitics remain.
- **Recent labor market and inflation data support a patient Fed.** Easing inflationary pressures and a labor market that still appears balanced provide policymakers with room to remain on hold in the short term. While risks from energy prices, tariffs, and AI-related investment demand warrant caution, recent data do not point to a need for additional tightening. We continue to expect policy rates to remain unchanged through the remainder of 2026, followed by gradual rate cuts as inflation moderates further.

Weak payrolls potentially signaling softer labor market conditions

In July, nonfarm payroll employment decreased by 23k, reflecting declines in local government, leisure and hospitality, and retail trade jobs (Chart 1). Meanwhile, job growth in healthcare and construction increased again, both by 22k. Moreover, this jobs report is the second consecutive negative revision to the preliminary report for the previous month, with the June payroll gain revised down to 20k, from 57k. At first sight, the weak headline payrolls and sizable downward revisions suggest a labor market that is losing momentum. However, other indicators suggest labor market conditions may be closer to balance than payroll growth implies.

Chart 1: Job growth continued to soften



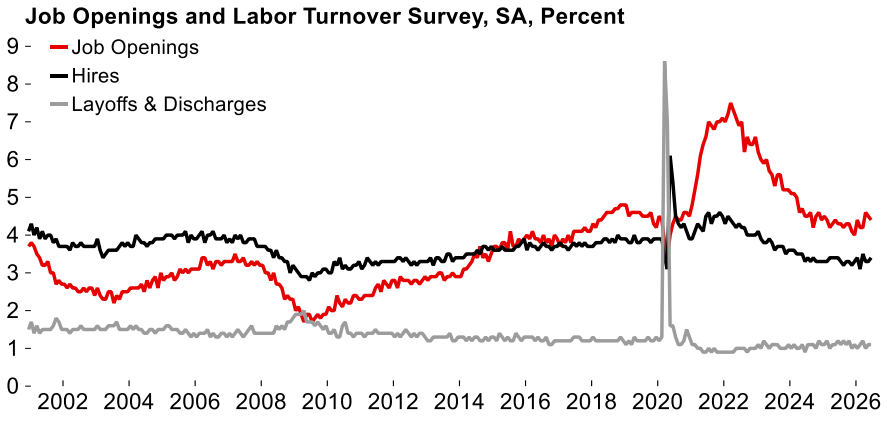
Source: BLS, MUFG Bank Economic Research Office

Meanwhile, lower unemployment indicates a labor market close to full employment

The July unemployment rate continued to edge down to 4.1%. While this may seem inconsistent with July's negative payrolls, the decline in unemployment likely reflects factors beyond hiring alone. Indeed, JOLTS data continue to suggest we are in a "low hire, low fire" environment, with job openings and hires remaining relatively subdued while layoffs remain low and stable (Chart 2).

At the same time, labor supply has also weakened. In July, the labor force participation rate (the share of adults working or looking for work) fell to 61.4%, its lowest point in over 5 years.

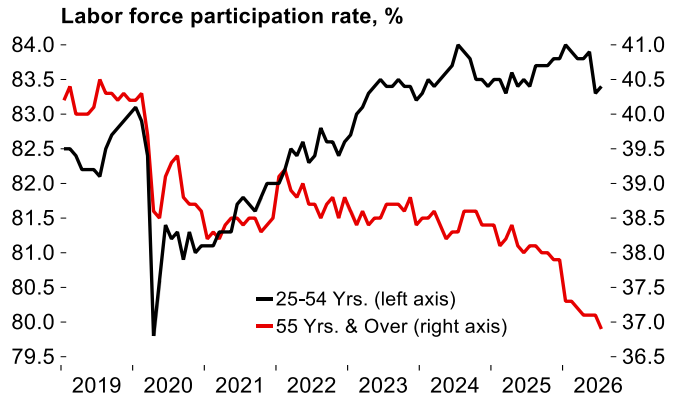
Chart 2: Weak JOLTS continue to point to relatively cautious hiring and little involuntary terminations



Source: U.S. Bureau of Labor Statistics (BLS), MUFG Bank Economic Research Office

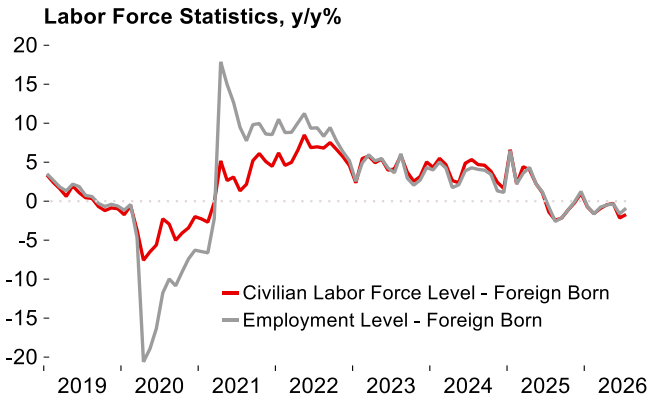
The decline in labor force participation likely reflects broader demographic shifts and changes in labor supply behavior. Participation among workers aged 55 and older is declining, while prime age (24-54) participation is holding up (Chart 3). In the past, immigration helped offset the labor supply constraints by supplementing growth in the available workforce. However, that offset appears to be diminishing as the foreign-born labor force continued to contract (Chart 4). Foreign-born labor force and employment growth remain in negative territory, indicating fewer immigrants are entering the workforce and/or more are leaving. Upcoming immigration policy changes, including Temporary Protected Status expirations and potential restrictions on work authorization, could further reduce labor supply growth by limiting the availability of foreign-born workers.

Chart 3: The older population remains the main cohort to exit the labor force



Source: BLS, MUFG Bank Economic Research Office

Chart 4: Labor force and employment growth rate for immigrants continue to be negative



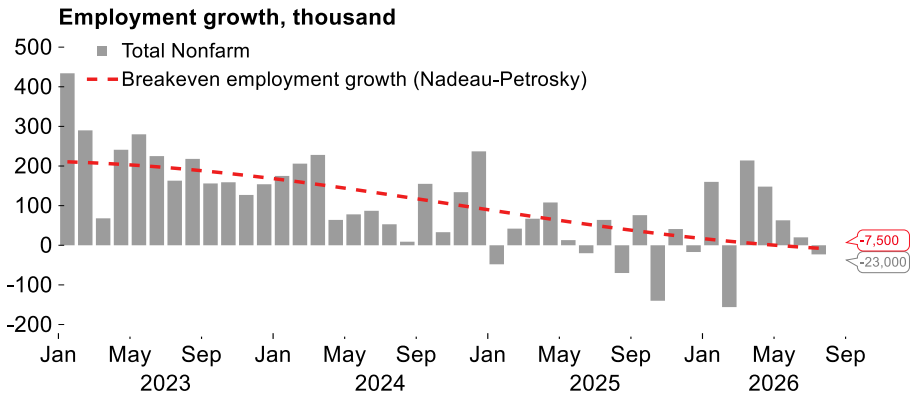
Source: U.S. Bureau of Labor Statistics (BLS), MUFG Bank Economic Research Office

The labor market may be rebalancing despite soft headline data

While recent labor market data have softened, the broader picture suggests the labor market may be rebalancing. Labor demand has moderated, with job openings and hiring rates remaining well below recent peaks. At the same time, labor supply remains constrained with a declining labor force participation rate. As a result, adjustment is occurring on both sides of the labor market.

This distinction is important because labor market conditions ultimately depend on the balance between supply and demand. Although payroll growth has slowed, the pace of job creation needed to keep the unemployment rate stable, often referred to as the "breakeven" employment growth,[1] has also declined (Chart 5). In other words, weaker labor supply means the economy now requires fewer new jobs each month to maintain labor market balance than it did when labor force growth was stronger. Going forward, the key question is whether labor demand continues to adjust broadly in line with labor supply.

Chart 5: Lower breakeven employment growth suggests moderating job growth is still consistent with labor market balance



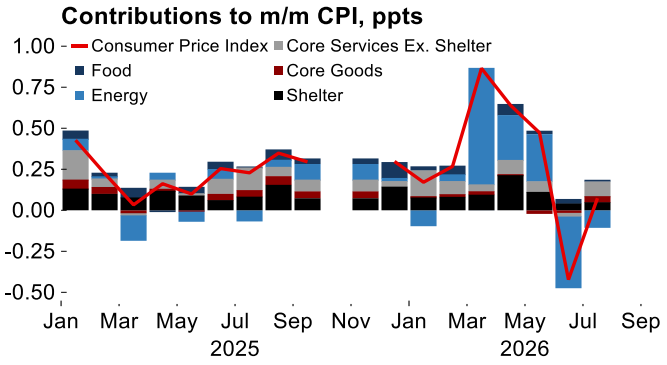
Source: U.S. Bureau of Labor Statistics (BLS), Nicolas Petrosky-Nadeau Breakeven Payrolls series, MUFG Bank Economic Research Office

Inflation peaks are behind us, but risks remain

Inflation continued to cool to 3.4% y/y in July from 3.5% in June. The recent moderation in headline inflation can mostly be attributed to lower energy prices (Chart 6). However, there may be early signs of easing underlying price pressures. Most notably, core CPI inflation reached its lowest year-over-year pace since spring 2021, at 2.5%. Indeed, core CPI is trending down with its 3m/3m annualized rate declining to 1.6% in July from 2.3% in the previous month (Chart 7). Core services and shelter prices, which posted the greatest upward pressure to inflation in July, are also on a downtrend. The trend for core goods prices did tick up in July but remained in negative territory. Additionally, with wage growth continuing to moderate and showing limited pass-through into services prices, overall inflationary pressures appear to be gradually easing.

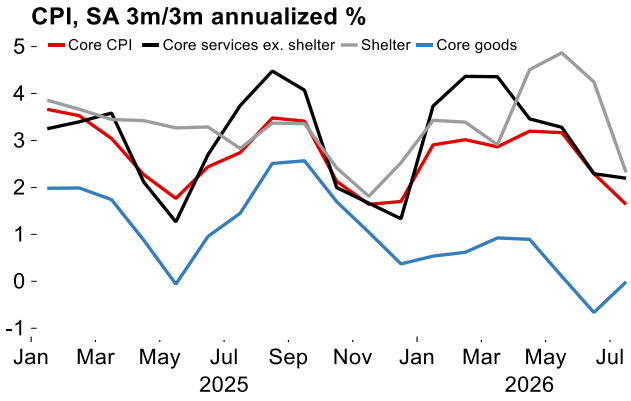
[1] Breakeven Employment Growth - San Francisco Fed

Chart 6: Lower energy prices contributed to the modest recent inflation readings



Note: October 2025 break in series due a data collection issue during a government shutdown
Source: U.S. Bureau of Labor Statistics (BLS), MUFG Bank Economic Research Office

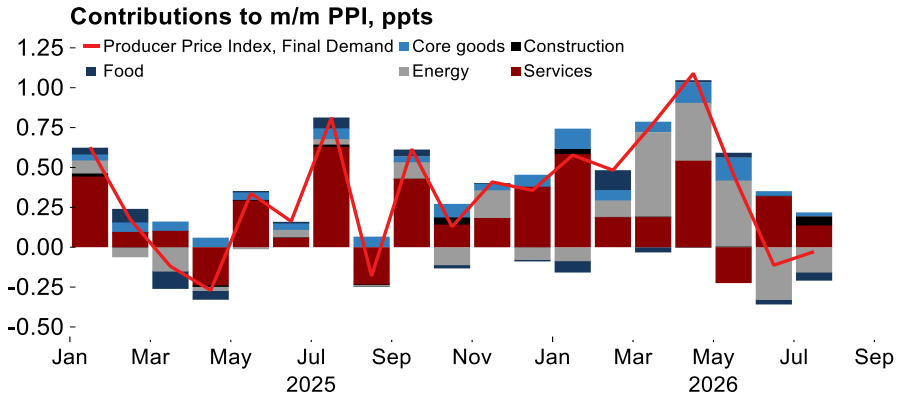
Chart 7: Core CPI components continue disinflation trend



Source: U.S. Bureau of Labor Statistics (BLS), MUFG Bank Economic Research Office

As a measure of upstream price pressures facing businesses, the PPI is often viewed as a leading indicator of future consumer price developments. Recent PPI data also points to easing inflation pressures, with goods, services and energy-related price pressures softening (Chart 8). However, business input costs remain sensitive to developments in energy and transportation markets, particularly amid uncertainty surrounding the potential re-escalation of the U.S.-Iran conflict and the implementation of additional US tariffs.

Chart 8: PPI continued to ease since April peak, tracking CPI path



Source: U.S. Bureau of Labor Statistics (BLS), MUFG Bank Economic Research Office

Looking ahead, broader geopolitical developments remain the primary near-term risks to the inflation outlook. Policymakers have also emphasized the inflationary risks associated with tariffs and energy prices, while noting that productivity-enhancing technologies such as AI could help ease inflationary pressures over the longer term. However, price increases due to AI-related demand have already shown up in the markets for products such as semiconductors, hardware, and network infrastructure. In the near term, continued investment, infrastructure expansion, and data center buildouts are likely to boost demand for more specialized hardware, electricity, water, real estate, and land, placing upward pressure on select prices and input costs. These developments warrant monitoring as a potential source of future inflationary pressure.

What this all means for the Fed's dual mandate

Recent economic data should allow the Federal Reserve to maintain a patient stance. While July's payroll report was notably weak, the broader labor market appears closer to equilibrium than headline job growth alone suggests. Slower labor force growth,

driven in part by demographic shifts, has reduced the pace of job creation needed to maintain stable unemployment, helping explain why unemployment remains near full-employment levels despite softer hiring. At the same time, inflation continues to move in a favorable direction for now, with both CPI and PPI gradually moderating.

Taken together, this reduces the urgency for either additional tightening or immediate easing. While risks from energy prices, tariffs, and AI-related investment remain sources of potential inflation pressure, recent data do not yet point to a renewed acceleration in inflation that would warrant further rate hikes. Therefore, we continue to expect the Fed to keep policy rates unchanged through the remainder of 2026. Looking further ahead, barring a material resurgence in inflation, continued progress on inflation alongside moderating growth should eventually create room for policy easing, making rate cuts more likely than hikes over the medium term.

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