Flash Fixed Income

July 2025

Forget tariffs, watch the US labour market

- **The US labour market looks to be at a pivotal juncture, with weaker job growth in certain industries potentially showing the shift in immigration policy starting to take effect.**
- **A falling participation rate and anticipated lower labour force growth are another headache for the Federal Reserve as it weighs the timing of rate cuts.**
- **The evolving labour market scenario calls for selective positioning in our view, and our focus is on corporate issuers' pricing power and their exposure to potential wage cost pressures.**

It is often said that markets are only capable of focusing on one thing at a time, and at present that one thing appears to be US tariff policy.

As we approach President Trump's new August 1 deadline, when the paused 'Liberation Day' tariffs are set to activate, the US is reported to be aggressively pressing nations to sign trade deals. Sector-specific tariffs such as the 50% placed on copper, or the floated 200% on imported pharmaceuticals, are a threat layered on top of the so-called reciprocal tariffs. While global markets have held steady so far, analysts are warning that consumer prices and economic growth could soon feel the strain if these policies persist or expand.

But away from tariffs, there are other inputs to macroeconomic conditions undergoing important shifts that could be of vital importance in determining what investment conditions will look like for fixed income investors over the coming years. One of the most important right now in our view is the US labour market, and here we will look at how its dynamics are shifting.

Pivotal time for US labour market

As we move into the second half of 2025, the US labour market looks to be at a pivotal juncture. Strong employment conditions persist, but shifting policy frameworks, particularly regarding immigration under the Trump administration, suggest substantial impacts on labour supply and wage growth ahead. Understanding these dynamics will be critical for fixed income investors navigating the intertwined paths of inflation, economic growth, and Federal Reserve (Fed) policy.

Data on the US labour market remains noisy. After weaker reports, the June jobs numbers came in hot with non-farm payrolls showing job creation above expectations and the unemployment rate falling. But the jump in payrolls was driven by an increase in state and government jobs. The private sector appears to be struggling even as average hourly earnings increased to 3.9%. This weakness looks set to continue through 2025 based on surveys of hiring managers which show a low pace of job additions.

For us, a key data point was the continued fall in the Labor Force Participation Rate, which dropped to 62.3%, its lowest level since 2022 (see Exhibit 1). A shrinking labour force helps explain some of the disconnect between private sector hiring hesitancy and rising wages. With a replacement ratio of 1.6x, the US has (along with the rest of the developed world) been experiencing an aging of its population. This drives a decline in participation in the labour market. However, in recent years this trend has been offset by an increase in prime age workers entering the US economy via immigration.

Credit market performance

	Total return YTD (%)	Total return last 30 days (%)	Yield (%)	Duration (yrs)
EUR IG	1.93	0.17	3.1	4.5
GBP IG	3.03	0.39	5.3	5.7
US IG	3.44	0.63	5.1	6.4
EUR HY	3.29	0.44	5.2	2.8
GBP HY	5.11	1.20	8.1	2.8
US HY	4.45	1.14	7.2	3.1
EM HY	4.81	1.13	7.7	3.8
Euro Senior Banks	2.34	0.20	2.9	3.6
CoCo	5.31	1.21	6.1	3.4

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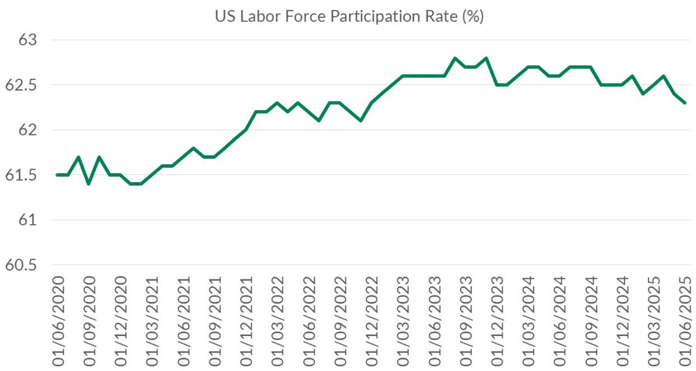
Exhibit 1: The US participation rate is sliding



Source: U.S. Bureau of Labor Statistics, Bloomberg, 10 July 2025

Falling participation is why Fed Chair Jerome Powell has referred to the labour market as being "at or near maximum employment" even as other Fed governors such as Michelle Bowman and Christopher Waller highlight labour market fragility. Even while headline employment is low at 4.1%, out-of-work employees are taking longer to find new jobs, a sign the labour market "appears to be less dynamic" according to Bowman.[1]

All else equal, this combination of low unemployment and reduced labour force growth implies a tighter labour market ahead, exerting upward pressure on wages – a significant driver of inflation. Historically, a constrained labour market environment has consistently translated into heightened wage inflation and subsequent upward revisions in inflation expectations.

Immigration curbs could tighten US labour market

The Trump administration's immigration stance represents one of the most impactful levers influencing US labour supply today, in our view.

The administration has a three-pronged strategy aimed at reducing the number of unauthorised immigrants in the country. The first prong is slowing new inflows by tightening border security, including reinstating the "Remain in Mexico" policy and rolling back several humanitarian parole programs. The second is targeting existing legal protections for certain immigrants already living in the US, a move that could see some lose their work permits. The third is stepping up deportations, with President Trump targeting 4m deportations over the next four years in comparison to an annual average of around 330k over the last decade (see Exhibit 2).

[1] https://www.bis.org/review/r250623m.htm

Exhibit 2: New policy driving rise in deportations

Source: Department of Homeland Security, Economic Policy Institute, 10 July 2025

Net immigration rose sharply above its pre-pandemic trend of 1m per year over the last three years, with the monthly annualised rate peaking at 3.5-4m in late 2023. The pace had already declined by more than half to roughly 1.7m by December 2024, driven by a decline in unauthorised immigration from an annualised pace of around 2.8m at the peak to about 0.8m as of December. Since the sharp 1m slowdown in February, US net immigration has slowed only moderately by 0.1m to an annualised pace of 0.6m in April. This current pace is substantially lower than the peak of late 2023, but is only modestly below the pre-pandemic trend of 1m per year.

Immigration and inflation

The jump in deportations, added to restrictions on inflows, is expected to significantly impact sectors that have traditionally been heavily reliant on immigrant labour, such as construction, agriculture, hospitality, food processing, and household services, which are not insignificant components of the inflation basket. As well as staffing shortages, production bottlenecks and rising costs could drive inflation higher, bucking the broader disinflationary trend that has prevailed in the US in recent months (see Exhibit 3). Wages could spike in industries scrambling to replace lost workers, and supply chain disruptions could trigger temporary shortages. As we learned during the pandemic, such supply shocks can cause sharp, sudden price increases even if demand remains unchanged.

Rates dashboard

			Change (bp)		
		Current (%)	1w	1m	YTD
US Treasury	2yr	3.89	1	-2	-36
	10yr	4.41	6	5	-12
	30yr	4.95	9	11	20
UK Gilt	2yr	3.86	1	-1	-60
	10yr	4.62	8	15	1
	30yr	5.43	9	24	26
German Bund	2yr	1.90	7	8	-18
	10yr	2.73	11	25	36
	30yr	3.23	15	30	63

			Change (bp)		
	Market projection	Current (%)	1w	1m	YTD
Base rate 4.50%	end-2025	3.87	4	3	-7
	end-2026	3.24	5	-8	-72
Base rate 4.25%	end-2025	3.66	2	-3	-47
	end-2026	3.44	5	-8	-55
Base rate 2.00%	end-2025	1.86	6	8	-5
	end-2026	1.97	8	8	-10

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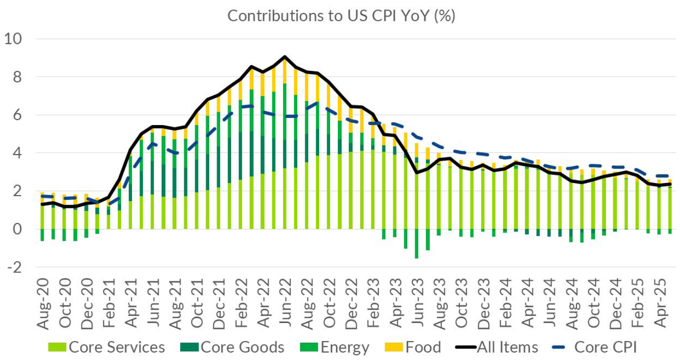
Exhibit 3: Will the US disinflation trend persist?



Source: U.S. Bureau of Labor Statistics, Bloomberg, 10 July 2025

Historical precedents such as the restrictive immigration policies of the early 20th century may offer some insight. For instance, the introduction of immigration quotas in the 1920s reduced US labour supply substantially, ultimately pressuring wages upward and exacerbating inflationary conditions during periods of economic expansion. Similarly, state-level immigration restrictions have historically created conditions of labour market tightness, leading to wage inflation and broader economic disruptions.

The limited data we have so far (the latest month for which we have detailed industry level data available is June) shows the beginning of the trends suggested above – job growth in the industries considered most exposed to immigration policy changes declined to 7k on a three-month average basis through May, down from 12k in April and 27k on average in 2024.

In a labour market already experiencing near-full employment, a stringent immigration stance could exacerbate wage pressures. Immigration has historically provided an essential relief valve in labour markets, filling gaps across skill levels, from low-skilled seasonal roles to high-skilled tech positions. Removing or significantly limiting this valve can naturally tighten labour supply, pushing employers into wage competition to secure talent.

A restrictive immigration policy not only influences inflation via wages, but it can also weigh on economic growth by constraining the labour force's expansion and productivity improvements. Industries reliant on immigrant labour may face operational disruptions, reduced productivity, and higher operating costs. At the risk of being drawn back to the overcovered headline topic, we would be remiss not to mention that these headwinds may well be exacerbated by tariff policy.

Will shrinking labour force slow rate cuts?

How will the Fed respond to these labour market dynamics? The Fed has explicitly acknowledged the relationship between labour market tightness and inflation pressures, particularly wage inflation. Recent meeting minutes highlight that policymakers are monitoring wage data closely. Fixed income markets have thus far been pricing in a relatively dovish Fed trajectory, anticipating rate cuts predicated on broader disinflation trends. However, persistent labour market tightness, driven partly by immigration restrictions, suggests a scenario where the Fed may need to reconsider the pace and/or magnitude of these cuts.

A shrinking labour force makes the data-dependent Fed's job harder. Which does it prioritise, battling inflation or growth? Despite current market expectations of ongoing rate cuts, sustained wage-driven inflationary pressures could force the Fed into a more hawkish stance. Historically, tight labour markets are associated with rate hikes.

Focus on wage costs and pricing power

For fixed income investors, the potential implications of an evolving labour market scenario – higher inflation, lower growth and a less accommodative Fed – in our view call for selective positioning. A slower rate cut cycle typically makes shorter duration bonds more attractive, while a focus on higher-quality credit may help mitigate a growth slowdown. Ultimately, however, we think there is no substitute for an industry-by-industry, company-by-company reassessment of potential wage cost pressures, as well as seeking corporate issuers with strong pricing power.

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