Recession Signals Rising: Inflation, Weak Labor Market & Oil Shock

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For the past year, I've been warning that the economy is weaker than most people realize. While headline data has at times suggested resilience, the underlying details indicate an economy that has been narrowly supported by high-income consumers, AI investment, surging asset prices, and leverage.

The spillover effects from the Iran war will test the strength of that foundation and further expose existing fragilities in the economy.

Even before the war in Iran and the ensuing shock to energy and materials markets, the U.S. labor market was the weakest it had been in decades, consumer spending was bifurcated, and inflation was persistently above target. Now, as oil prices have jumped more than 50% in the past month, higher gas and diesel prices threaten to drive inflation higher and crowd out consumer spending on other goods and services, potentially leading to a vicious cycle of low growth and high inflation—**stagflation**.

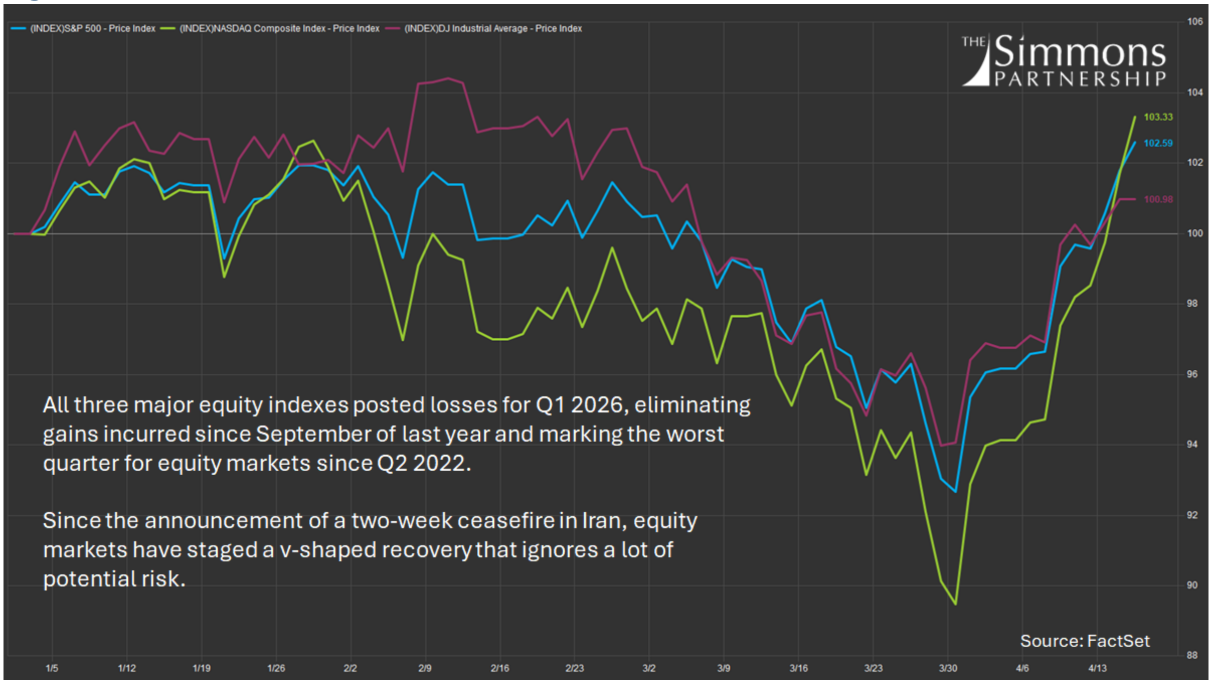
For now, the Fed is stuck on the sidelines, waiting to see how long the shock to energy markets lasts and how consumers and businesses respond.

Nevertheless, equity markets have shrugged off these concerns and rebounded back to all-time highs—investors are pricing markets as if the war is behind us and there will be no lingering effects. Even if the war does come to an immediate end, this assumes a lot and ignores a tremendous amount of potential risk.

V-Shaped Recovery from March Lows Ignores Potential Risks

After declining 5% in the first quarter, eliminating all the gains since September of last year, and marking the worst quarter for the major indexes since Q2 2022, equity markets have staged a V-shaped recovery from the March lows, setting new all-time highs for the S&P 500 and Nasdaq Composite.

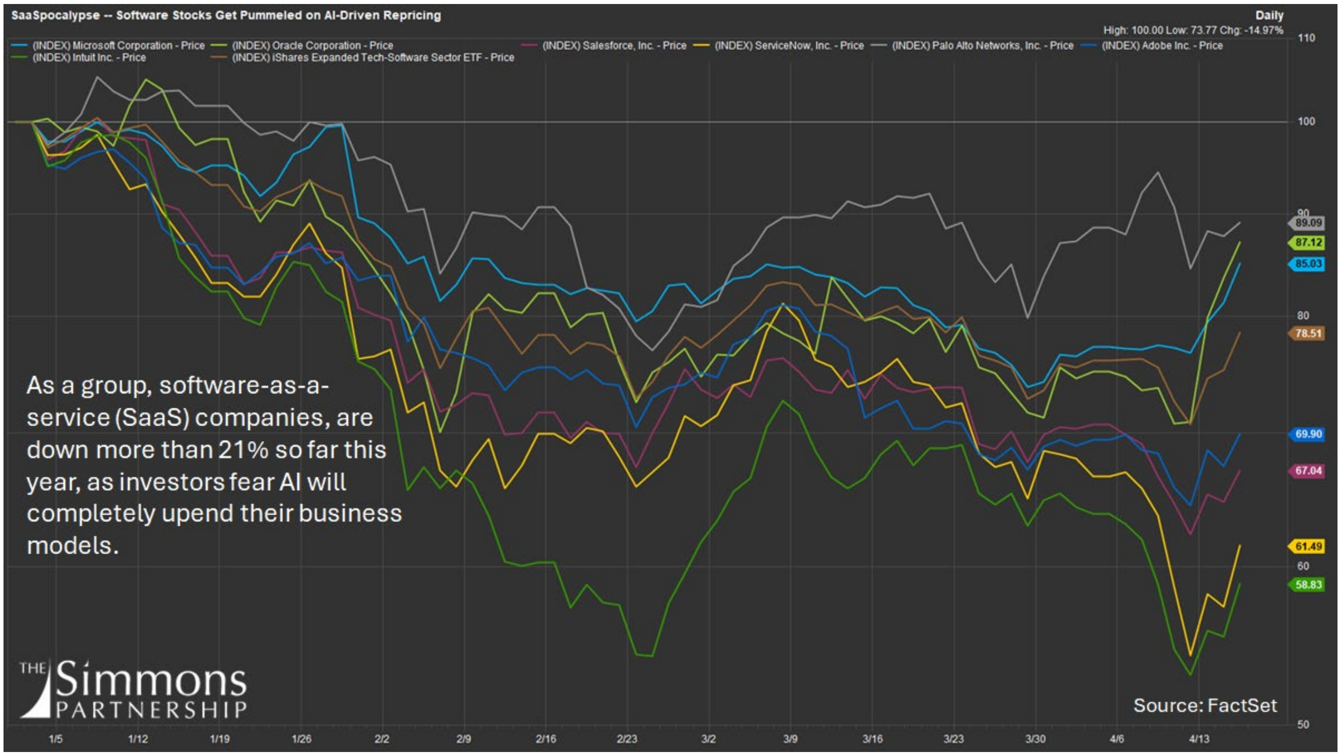
Figure 1



However, the recent movements in the indexes do not reflect the dramatic underlying volatility in individual stocks and particular sectors that has manifested itself in equity markets since the end of last year.

For example, key sectors of the U.S. economy—namely, technology and financials—were in correction territory just two weeks ago. Technology stocks—particularly software-as-a-service (SaaS) companies, which had been the beneficiaries of AI speculation—declined significantly to start the year, as the market suddenly awoke to the idea that AI could render some of their business models functionally obsolete. As a group, SaaS companies are down more than 21% year to date. Microsoft (MSFT), an AI powerhouse, lost almost a quarter of its value in Q1, making it the worst quarter for the company since the 2008 Global Financial Crisis.

Figure 2



Don't get me wrong, some of those fears are probably warranted. AI will undoubtedly upend some of these business models and the companies could eventually go out of business. Many of these firms will probably struggle through periods of lower sales and margin compression as AI erodes core product lines. But I'm just as sure that there is opportunity here—many of these companies will survive and evolve in ways that are not yet apparent. We are selectively buying companies in this space that have been caught in the downdraft and that our research indicates are undervalued.

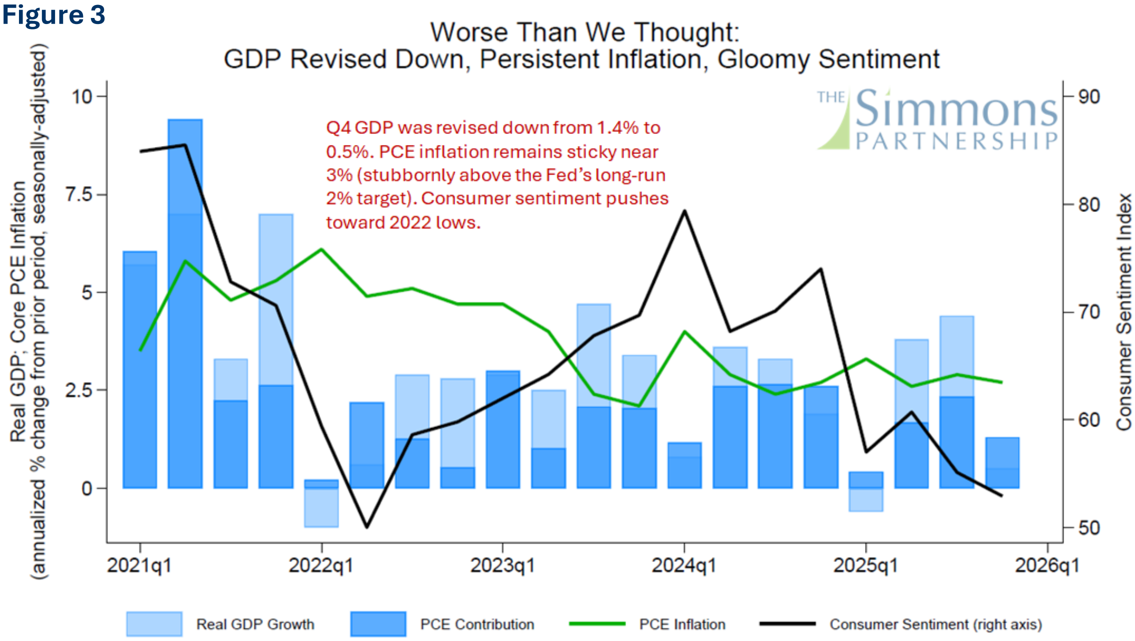
While this volatility is consistent with investors beginning to reprice risk, the market as a whole continues to be driven by narratives and emotion, rather than fundamentals. The broad indexes rebounded back to all-time highs on the announcement of a two-week ceasefire in Iran, suggesting investors are pricing markets as if the war is behind us and there will be no lingering effects. Even if the war does come to an immediate end, this assumes a lot and ignores a tremendous amount of potential risks.

Worse Than We Thought: Growth was Slowing Even Before the Iran War

Because final GDP statistics from the Bureau of Economic Analysis (BEA) are released with a severe lag, we're only now getting a sense of the true pace of economic growth for last year. On the surface, 2025 wasn't bad—real GDP grew 2.1% over the prior year. However, growth was uneven and appears to have slowed significantly in the fourth quarter.

After posting higher than expected real GDP growth of 4.4% in Q3 (annualized) on surprisingly strong consumer spending data, the advance estimate for Q4 came in at a more modest 1.4% annualized rate—not great. But the final estimate was revised even lower to an anemic 0.5% annualized rate. For comparison, that's half the growth rate of France during the same quarter and it puts us midway between Belgium and Switzerland. **The difference between Q3 and Q4 of last year is so large it's shocking.**

Figure 3



Data courtesy of the U.S. Bureau of Economic Analysis and University of Michigan (retrieved from Federal Reserve Bank of St. Louis FRED Database)

As I've discussed many times, the uneven pace of growth throughout 2025 was primarily driven by unpredictable trade and tariff policies. To be fair, some of the slowdown in Q4 could be attributed to pull forward demand in Q3 coupled with an unusually cold winter dampening demand in Q4. Whatever the reason, **economic growth was below potential even before the onset of the war in Iran.**

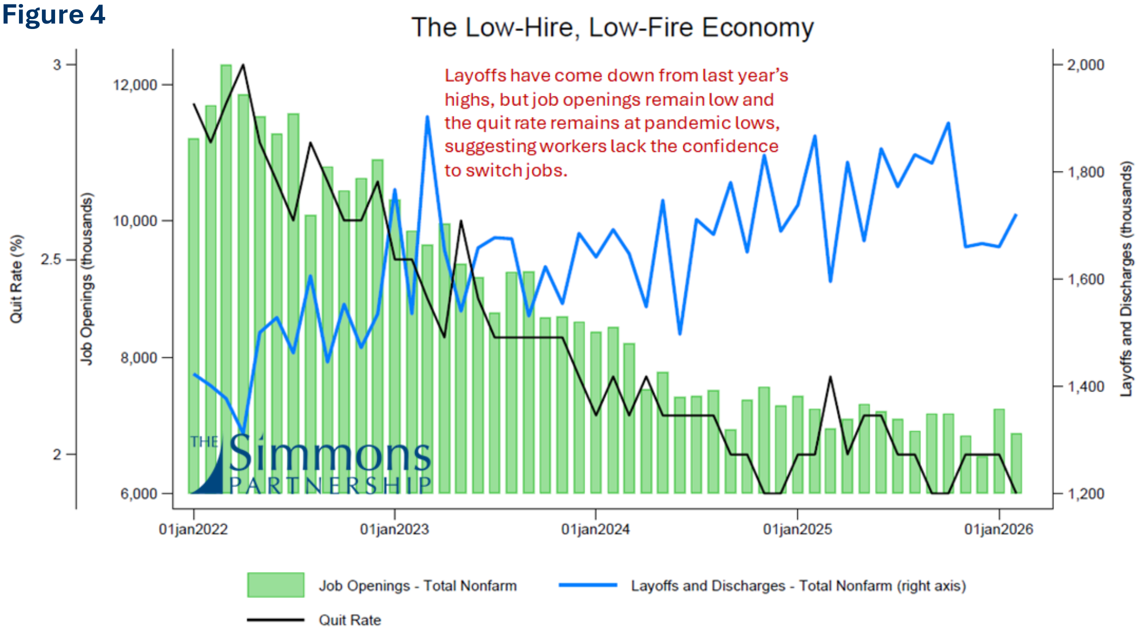
It will be several months before we begin to get a sense of the net impact of the war on economic growth. But the longer the conflict drags on, the more severe the effects will be. As higher oil and fuel prices begin to seep through the economy, the resulting demand destruction could further erode already fragile macro foundations.

Job Creation has Ground to a Halt, Popular Recession Indicator Flashing Red

As discussed in my 2026 outlook, this is one of the weakest labor markets in decades. Though headline statistics sometimes look hopeful, the underlying data are increasingly concerning.

The financial press has dubbed this the "Low-Hire, Low-Fire" job market and the data support that moniker. New graduates are having a hard time breaking into the labor force, as the promise of AI threatens entry-level jobs. Layoffs have declined from last year's highs but the total number of job openings in the economy remain stuck at roughly half the post-pandemic peak reached in 2022. Perhaps an even more telling statistic is the quit rate—the share of employed workers who voluntarily quit their jobs—which is stuck at pandemic lows, suggesting employed workers are hunkered down and lack the confidence to switch jobs in the current environment.

Figure 4

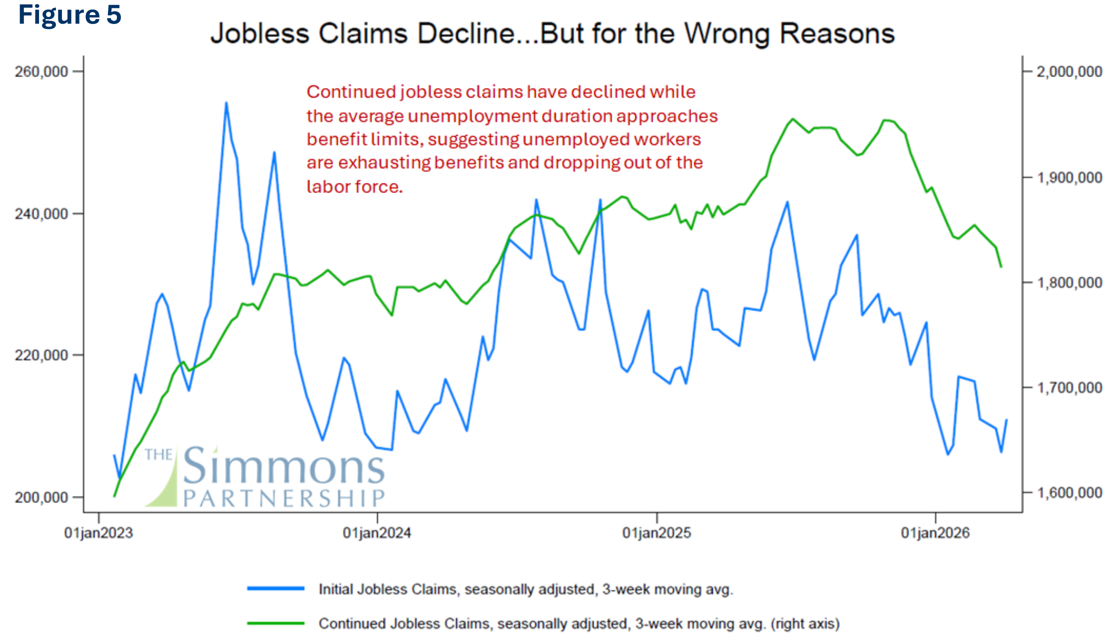


Data courtesy of the U.S. Bureau of Labor Statistics (retrieved from Federal Reserve Bank of St. Louis FRED Database).

Currently the headline (U-3) unemployment rate is at 4.3%, down slightly from 4.4% in December, and initial jobless claims—the number of people filing new claims for unemployment benefits—have fallen from last year's highs.[1] In isolation, these statistics are encouraging. Fewer layoffs have helped reduce the number of initial jobless claims leading to fewer unemployed workers. Continued claims—the number of people filing for ongoing unemployment benefits—have also declined from last year's highs, but perhaps for the wrong reasons.

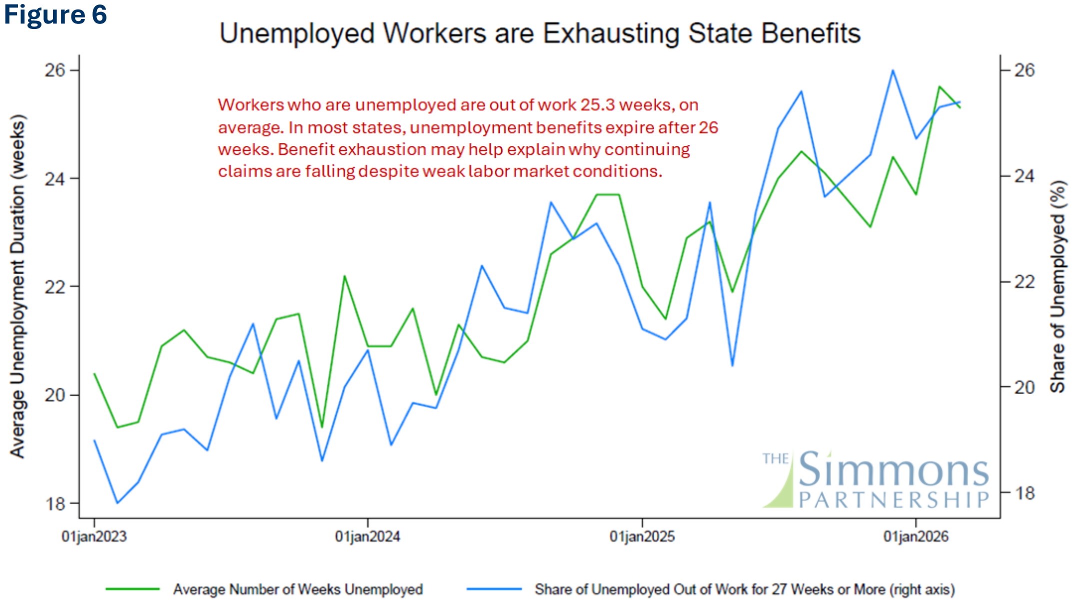
The average duration of unemployment is now 25.3 weeks and more than a quarter of unemployed workers have been out of work for 27 weeks or more. Importantly, most states' unemployment insurance benefits are exhausted after 26 weeks, meaning that **the average unemployed worker is approaching a cliff where they will no longer qualify to receive unemployment benefits.** At that point, people typically must resort to other (often more permanent) forms of government assistance such as SNAP, Medicaid, housing assistance, or other social welfare programs. **This is how people fall off the roles and slip through the cracks, but ironically it can give the false appearance of improvement in the labor market.**

Figure 5



Data courtesy of the U.S. Department of Labor, U.S. Employment and Training Administration (retrieved from Federal Reserve Bank of St. Louis FRED Database).

Figure 6



Data courtesy of the U.S. Bureau of Labor Statistics (retrieved from Federal Reserve Bank of St. Louis FRED Database).

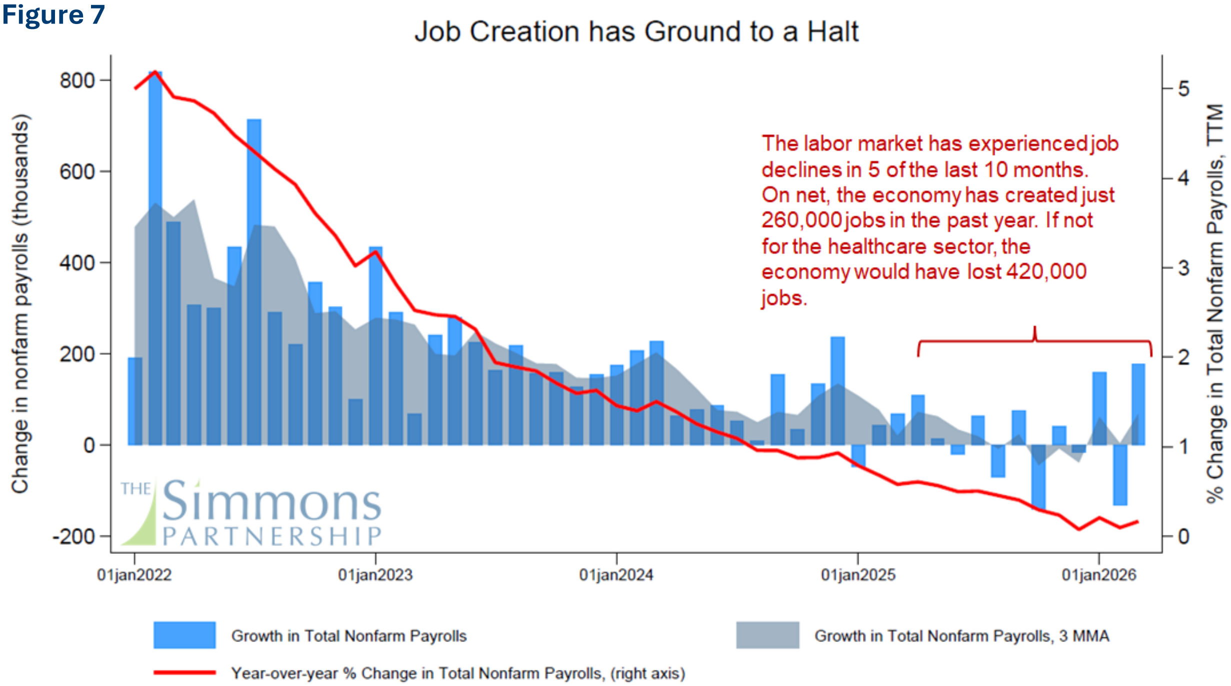
[1] There are several alternative measures of unemployment published by the U.S. Bureau of Labor Statistics (BLS), ranging from the narrowest definition (U-1) to the broadest definition (U-6). The official measure, which is most commonly cited in the press, is the U-3 unemployment rate. The different statistics are incremental, with each measure adding another category of unemployed worker. Interested readers can learn more about how BLS measures unemployment here.

Discouraged job seekers who stop actively looking for work are not considered to be unemployed and are no longer counted as part of the labor force. This "**discouraged worker effect**" can distort headline statistics and paint a rosier picture of the labor market by reducing the number of continued jobless claims and lowering the headline unemployment rate.

Moreover, in an era where gig work has become ubiquitous, some people choose short-term, task-based work (think Uber, Instacart, DoorDash, etc.) as an alternative to unemployment. This also makes the labor market look healthier than it is. But quite often this is not the kind of steady work on which you can support yourself or a family for very long.

A more comprehensive unemployment statistic would add back discouraged job seekers, workers who are marginally attached to the labor force, and those working part-time because they can't find full-time employment. **Taking these individuals into account, the (U-6) unemployment rate is currently 8.0%—nearly double the official rate.**

Figure 7



Data courtesy of the U.S. Bureau of Labor Statistics (retrieved from Federal Reserve Bank of St. Louis FRED Database).

One thing is painfully clear—**job creation has ground to a halt.** While the March nonfarm payrolls number looked promising—an increase of 178,000 jobs—it was effectively a wash when netted against the decline from February.

The economy has experienced job declines in five of the last ten months and, on net over the past year, has created just 260,000 new jobs—a growth rate of just 0.16%. As shown in Table 1, **what gains we've seen have been concentrated in just a handful of industries.**

Of the 17 industries listed, 11 have experienced job declines in the past year. Of the six industries that have posted increases, only three had increases of more than 1%. If not for those three industries, the economy would have lost 597,000 jobs over the past year. Moreover, given that the nonfarm payroll numbers have been subsequently revised down for the past 14 months in a row, we will have to wait and see whether last month's uptick holds up.

Table 1

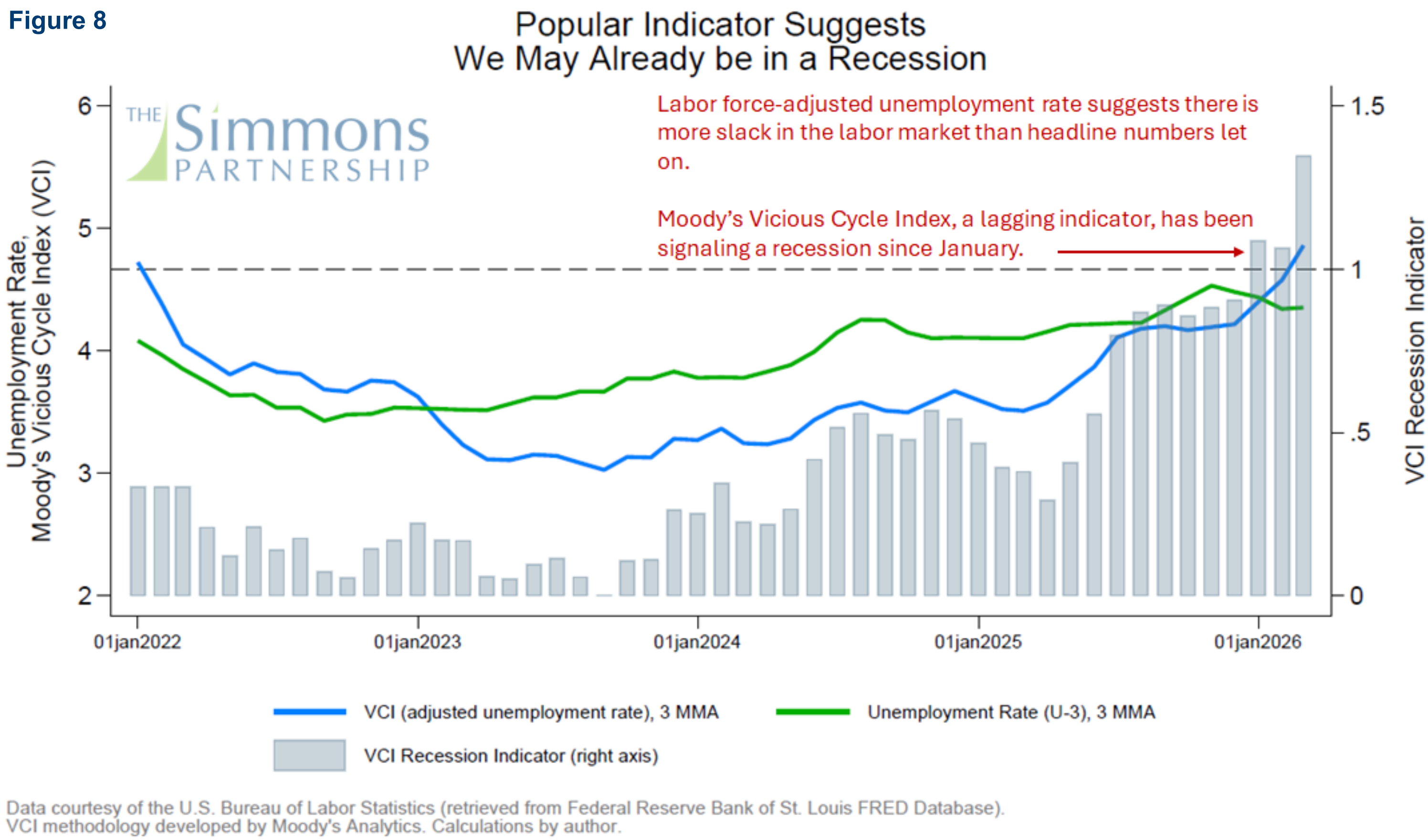
	Seasonally adjusted			
Industry	**Mar. 2025**	**Mar. 2026**	**Growth (ths.)**	**Growth (%)**
Total nonfarm	158,377	158,637	260	0.16%
Mining and logging	620	603	-17	-2.74%
Construction	8,273	8,330	57	0.69%
Manufacturing	12,666	12,591	-75	-0.59%
Wholesale trade	6,062	6,055	-7	-0.12%
Retail trade	15,458	15,428	-30	-0.19%
Transportation and warehousing	6,672	6,551	-121	-1.82%
Utilities	600	605	5	0.77%
Information	2,867	2,791	-76	-2.65%
Finance and insurance	6,743	6,690	-53	-0.79%
Real estate and rental and leasing	2,458	2,444	-14	-0.57%
Professional and business services	22,457	22,417	-40	-0.18%
Private educational services	4,056	4,039	-17	-0.41%
Healthcare	18,028	18,408	380	2.11%
Social assistance	5,048	5,349	301	5.96%
Leisure and hospitality	16,823	16,999	176	1.05%
Other services	5,987	6,022	35	0.58%
Government	23,559	23,317	-242	-1.03%

Source: U.S. Bureau of Labor Statistics Employment Situation, *Table B-1. Employees on nonfarm payrolls by industry sector and selected industry detail*
https://www.bls.gov/news.release/empsit.t17.htm

An overarching theme that has plagued the labor market and clouded unemployment statistics has been the shrinking U.S. labor force and declining labor force participation rate. The pool of potential workers has been shrinking for years, primarily due to demographic factors: older workers aging out of the workforce, record low fertility rates, and stricter U.S. immigration policies.[2] The labor force participation rate—the share of the working age population that is either working or looking for work—never fully recovered after the COVID-19 pandemic and recently declined to 61.9%. Outside of lows reached in 2020, that's the lowest level since 1977—almost half a century.

On balance, labor market conditions raise red flags and renew recession concerns independent of recent geopolitical developments. Economists at Moody's Analytics have developed a recession indicator—the Vicious Cycle Index (VCI)—which adjusts the official unemployment rate to account for declining labor force participation and flags a recession if the three-month average of the index rises more than one percentage point over the past year. According to Mark Zandi, Chief Economist at Moody's, the indicator has correctly identified every recession since World War II, without the false positives of other popular indicators, like the Sahm Rule.
As shown in Figure 8, the labor force-adjusted unemployment rate is higher than the official unemployment rate. This reinforces my belief that there is more slack in the labor market than indicated by official statistics. **The VCI, a lagging indicator, has been greater than one since January, suggesting the U.S. economy may already be in a recession.**

Figure 8



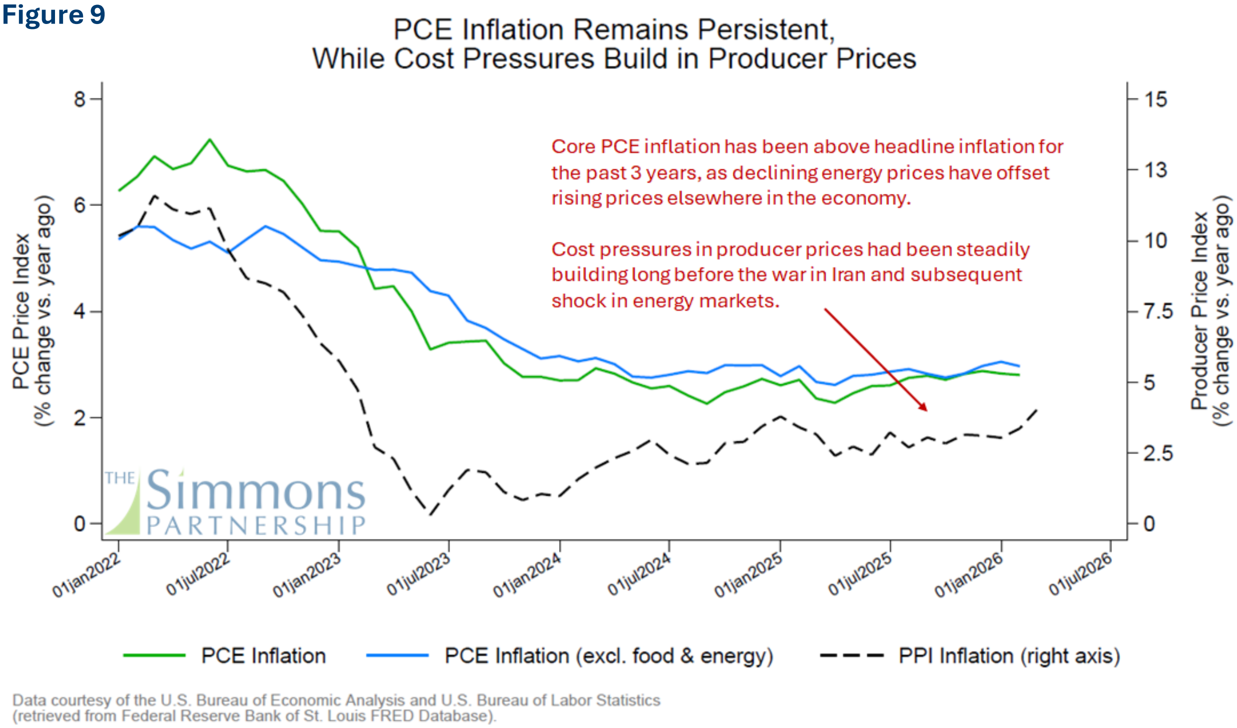
Oil Shock Risks Worsening Inflation Dynamics

Even before the Iran war, inflation was persistently above the Fed's long-run target. While down significantly from its peak in 2022, PCE inflation remains stuck near 3%. **Until recently, falling energy prices had been one of the lone bright spots in inflation reports**, with low oil and fuel prices enabling growth in consumer spending and helping to prop up profit margins outside the energy sector. Nevertheless, **since mid-2023 inflation in producer prices has been steadily rising, suggesting that there are hidden cost pressures buried in the system that have not yet been reflected in consumer prices.**

As shown in Figure 9, the inflation consumers have been feeling (the blue and green lines) has been relatively consistent for the past few years. Producer prices (the black line) have been rising *despite declining oil prices*. **As oil prices rise, producers may begin to pass their increased costs along to consumers at a faster pace.**

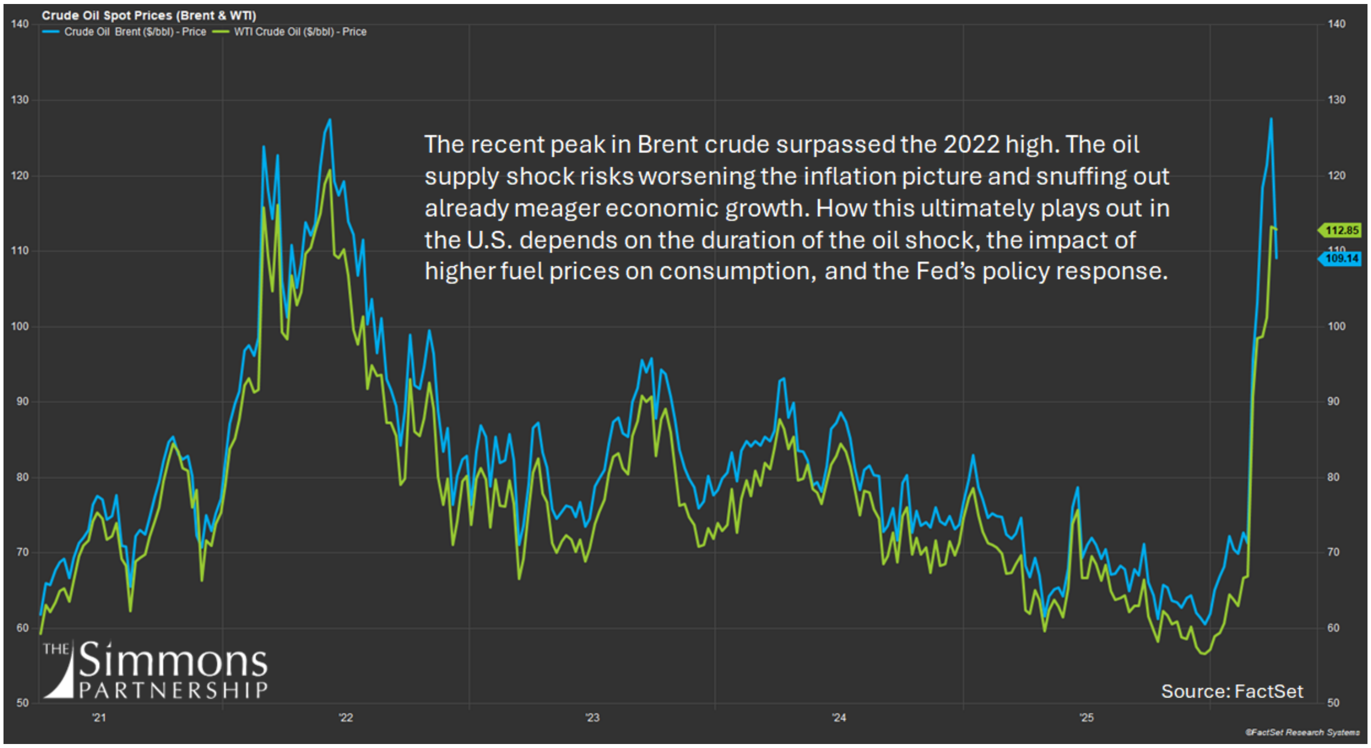
[2] For interested readers, I previously wrote about the impact of these changing demographic factors when I was an economist at the U.S. Congressional Budget Office (CBO) https://www.cbo.gov/system/files/2019-06/55331-LTBO-2.pdf (specifically, Appendix A). CBO continues to publish similar demographic analysis: https://www.cbo.gov/publication/61879.

Figure 9



Now in week seven of what was supposed to be a three-week conflict, oil prices have skyrocketed more than 50%, with Brent crude surpassing its most recent high from 2022. The national average for a gallon of regular gasoline is $4.12 (up 40% from February), jet fuel is up more than 70%, and diesel is up 48% to $5.64 per gallon. While gas prices tend to increase quickly after a shock, they also tend to be sticky on the way down. Therefore, even if the conflict were to end today, we would likely experience a hangover in gas and energy prices, as higher costs work their way through the system and sovereign nations seek to rebuild strategic reserves in the wake of recent volatility and increased geopolitical risk. The longer the war drags on, the worse the effects on inflation and consumer spending—and that doesn't take into account the damage to energy infrastructure in the Middle East, which will likely take years to repair or replace.

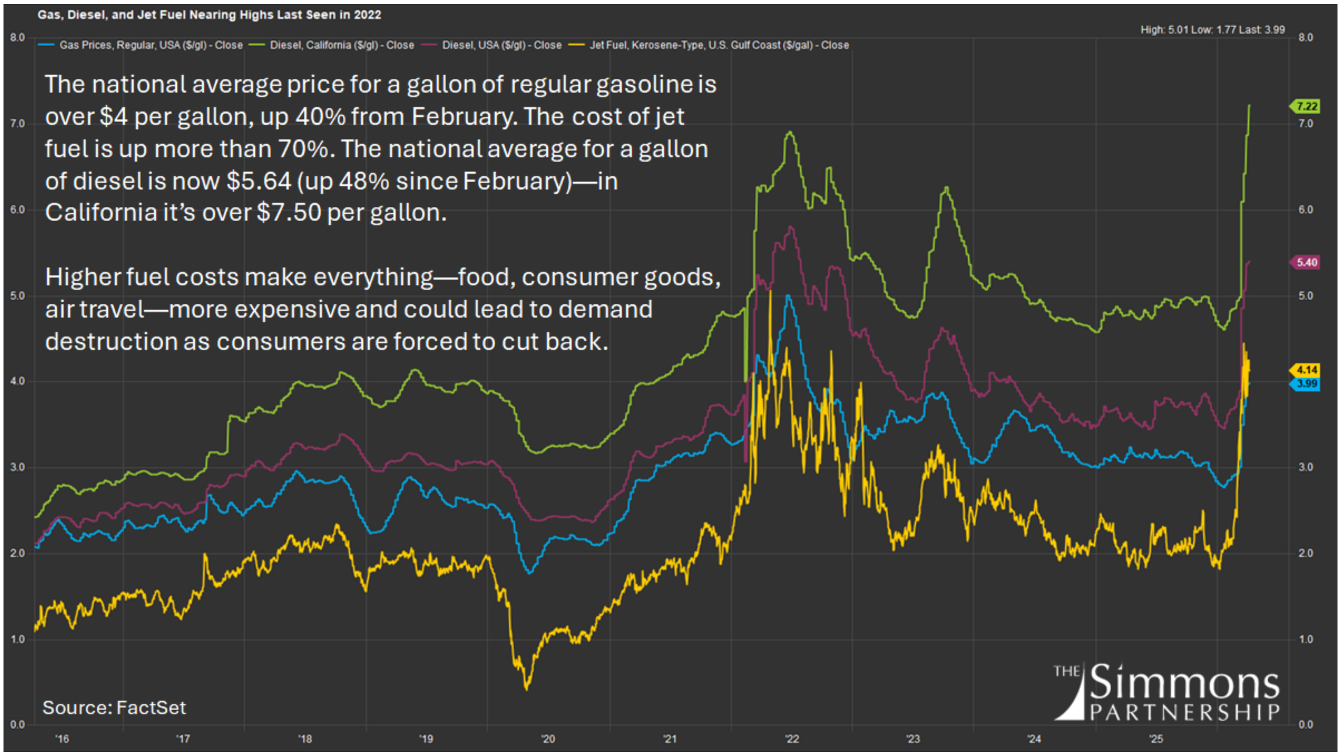
Figure 10



In short, the supply shock in energy markets risks worsening inflation dynamics and snuffing out already meager economic growth. Oil is an input to virtually everything we buy and diesel is an input cost for literally anything that is shipped via truck, rail, or ship. As the price of oil rises, so does the cost of everything else.

Perhaps more insidiously, higher prices at the pump tend to dampen sentiment (which is already near record lows) and increase inflation expectations.[3] In turn, higher gas prices tend to crowd out consumer spending in other areas as consumers cut back—a vicious cycle of low growth and high inflation **(stagflation)** that is particularly painful for policymakers to remedy with conventional tools.

Figure 11



A Tough Spot for the Fed

As I detailed in a *Market Insights* piece last month, the stagflation scenario I outlined above puts the Fed in a tough spot. **By Congressional mandate, the Federal Reserve can't choose between supporting the labor market or fighting inflation.** They are required to conduct monetary policy in a way that simultaneously promotes plentiful jobs and low inflation—two objectives that are often in conflict, particularly in times of economic stress.[4]

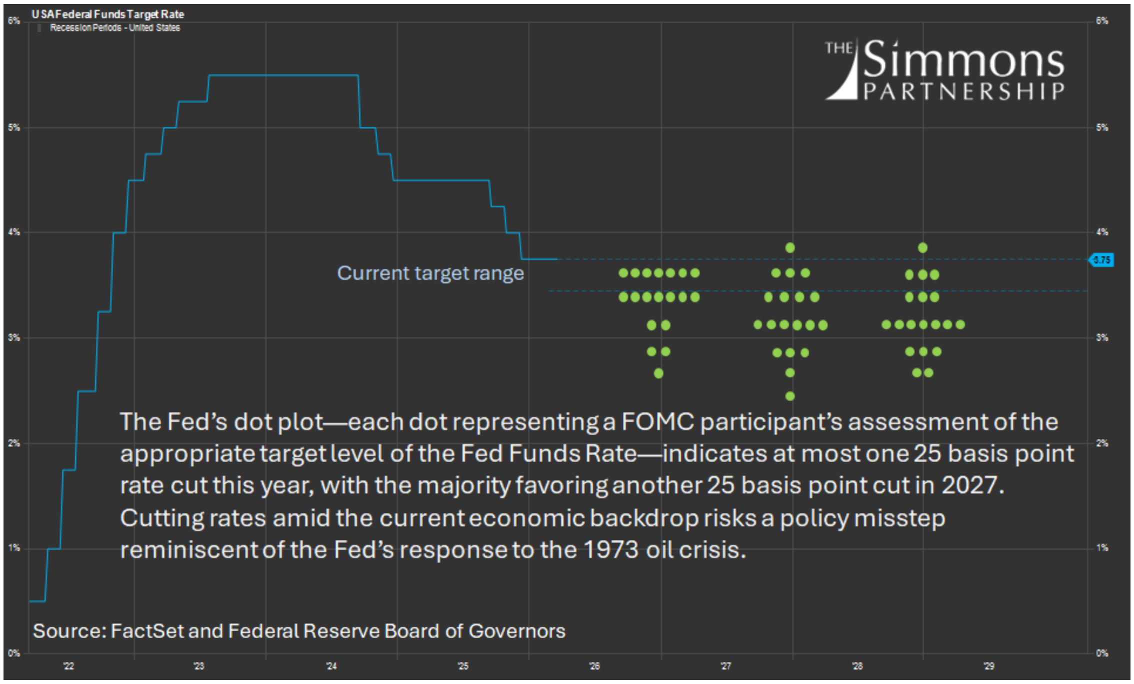
As a rule, policymakers prefer to ignore short-term shocks that result in one-time price shifts to avoid unnecessary course corrections. Looking through the current oil shock, there are some members of the Federal Open Market Committee (FOMC) who think—correctly in my opinion—the labor market is in bad enough shape to warrant cutting interest rates. As shown in Figure 12, the Fed's most recent dot plot indicates a majority of members favor at least one additional rate cut this year and one in 2027.

[3] Inflation expectations are an important consideration for monetary policy, partly because inflation expectations are sticky and partly because the Fed's ability to keep inflation in check relies on the public's belief in the central bank's commitment to stable prices. While inflation has come down from its highs in 2022, consumer inflation expectations remain high. Therefore, even as inflationary pressures eventually ease, inflation expectations may be slow to recede. This is important because consumer expectations of higher inflation can to some extent become self-fulfilling—consumers, fearing higher prices in the future, may pull forward demand, driving prices higher in the current period. Also, expecting prices to increase in the future, consumers demand higher wages to offset price increases. If productivity does not keep pace with wage gains, those cost increases flow through to consumers in the form of higher prices, setting off a cycle of higher inflation expectations begetting higher inflation.

[4] The Federal Reserve Act of 1977 explicitly states: *The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production,* ***so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates.***

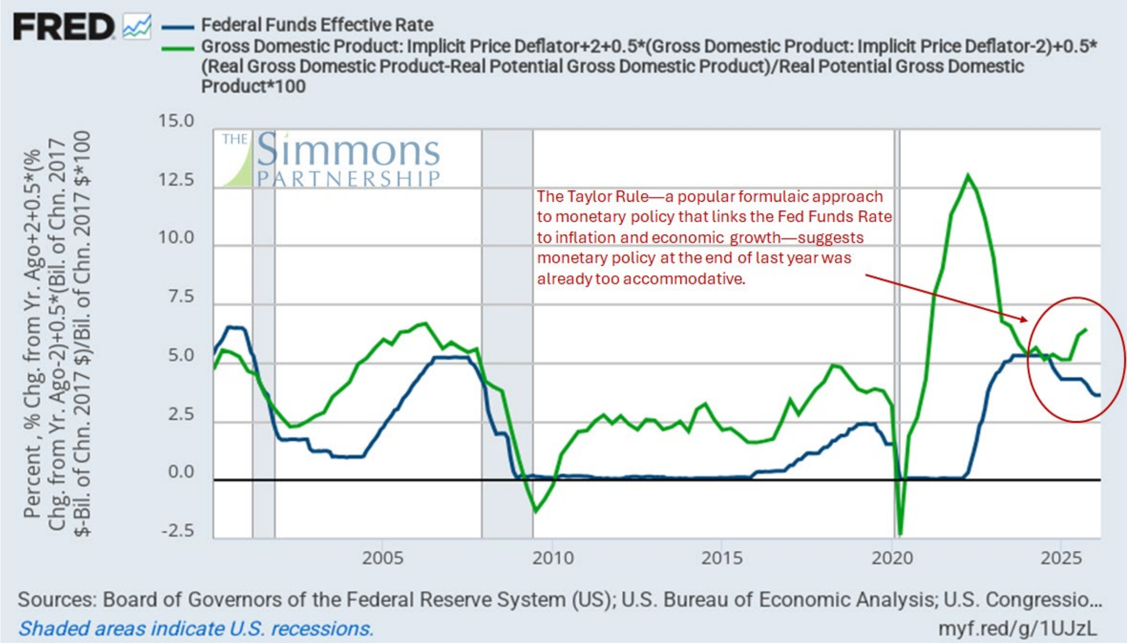
Notably, other central banks do not have this dual mandate. The European Central Bank (ECB), for example, is only required to pursue price stability. Which is why the ECB was quick to pause rate cuts in the second half of last year and is widely expected to keep rates higher for longer in response to inflation concerns stemming from the war in Iran.

Figure 12



But lowering rates in the current environment to drive growth and boost the labor market risks pushing inflation even higher. If the conflict in Iran drags on or rising oil prices prove to be more than temporary, the Fed risks losing control of inflation expectations and worsening stagflation—a policy mistake reminiscent of the early 1970s. The rub is that you don't know if a shock is temporary until after the fact. This is no doubt why the FOMC held short-term rates steady in March, ending the series of three straight rate cuts that closed out 2025.

Figure 13



Beating stagflation would require painful choices—dramatically raising short-term rates to quash inflation would likely deliver a crushing blow to the labor market, destroy economic growth, and push the economy into recession. While far from ideal, this response could eventually become necessary, as it did in the late 1970s and early 1980s when it resulted in back-to-back recessions. At least one FOMC member favors a 25 basis point rate hike next year. Moreover, the Taylor Rule—a popular formulaic approach to monetary policy that links the Fed Funds Rate to inflation and economic growth—suggests monetary policy at the end of last year was already too accommodative, with the Fed Funds Rate almost 240 basis points below the level prescribed by the rule.

For now, the Fed is stuck on the sidelines, waiting to see how long the shock to energy markets lasts and how consumers and businesses respond.

What Does This Mean for Your Money?

American households now hold 45% of their wealth in stocks—the largest share ever. At the same time, the use of leverage in the form of margin debt, derivatives, and leveraged ETFs has both fueled the current speculative boom in equities and added risk to the system.

Despite increased volatility, lackluster macroeconomic fundamentals, and heightened geopolitical risks, a notable degree of complacency remains embedded in the positioning of many investors, particularly those who remain anchored to naïve mantras engrained in their psychology since the pandemic. If investing was as easy as “buy the dip” every trader and hedge fund manager would be out of a job. Successful investing requires discipline and proactive risk management—particularly in volatile markets like this one.

Complacency is often a sign of market tops, as investors come to believe risk is irrelevant because (as the meme goes) “stonks [sic] always go up.” We think this view is myopic. The risks are clear. If history is any guide, imbalances in the system ultimately reassert themselves. And this time, broader market participation and increased leverage will likely make the eventual correction deeper and more widespread than anything we have seen in the past.

In fairness, it’s easy to dismiss these warnings as cynical and out of touch. For more than a decade, the market has rewarded those who ignore fundamentals and passively buy the dip with no regard for the risks brewing in the economy and markets. But these are not normal market dynamics. And for the record, I’m not as bearish as it may seem. I’m just selectively optimistic.

So what moves are we making in this environment? At the beginning of the year we moved tactically overweight cash, healthcare, and energy. Not because we had great foresight, but because we saw opportunity in undervalued names and stuck to our discipline. Our portfolio has benefited greatly from the recent rotation into value. After a strong run, we have taken profits in most of our energy names and are reinvesting the proceeds selectively in overlooked companies and sectors.

Currently, we see significant value in select healthcare and software names, both high growth industries that rarely go on sale. As always, we are proactively managing risk through diversification, active hedges, and keeping cash on the sidelines to cushion the portfolio during drawdowns and take advantage of good values as they arise.

Sophisticated investors require more sophisticated investment strategies.
If you ever get the feeling that the advice you’re getting is being read from a script, we’d love to talk to you.

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