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Economics
US Economic Perspectives

Date
4 February 2026

Growth-labor disconnect likely to drive Fed and sentiment in '26

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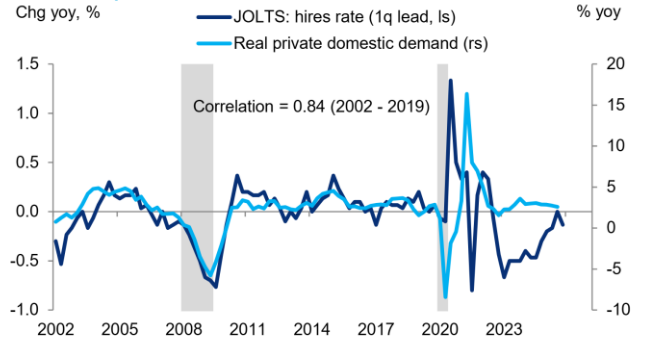
Over the past year, the economy has been characterized by a breakdown in a typically strong economic relationship. During the pre-Covid period, changes in the hiring rate were significantly positively correlated with growth in economic activity (here proxied with real final sales to private domestic purchasers). From 2002 to 2019 this correlation was 84%.

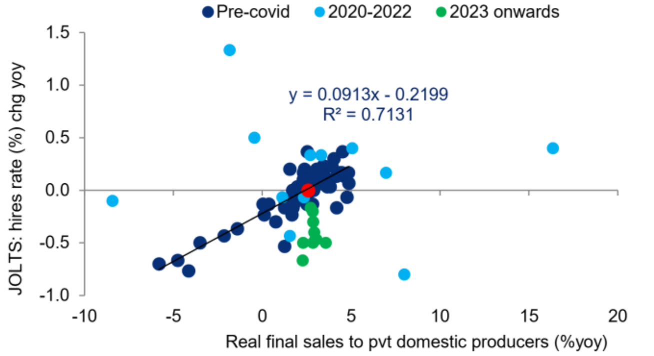
However, the pandemic broke this typically strong relationship. While the breakdown between hiring and economic growth was understandable in the aftermath of the pandemic shock, the persistence of this divergence over the past two years is notable. Even as economic growth has strengthened and remained generally solid, hiring trends have stayed weak.

Figure 1: Hiring rate has been substantially weaker than economic growth trend



Source: BEA, BLS, Haver Analytics, Deutsche Bank Research

Figure 2: Since 2023, hiring rate and domestic demand are uncorrelated



Source: BEA, BLS, Haver Analytics, Deutsche Bank Research

This divergence has had at least two significant implications for the economy. First, weaker hiring, which manifested in soft payrolls and a modest rise in labor market slack, was the primary reason the Fed cut rates by 175bps over the past two years despite solid growth and continued (well) above-target inflation. Second, as we argued recently, weak hiring trends are at the core of why household perceptions of the labor market -- and broader economy -- are historically downbeat despite strong growth (see [“Downbeat labor sentiment reflects less dynamism”]).

We, therefore, see the potential resolution of this divergence as a critical determinant of the Fed outlook and possibly the midterm election outcome. If hiring trends converge towards growth, the labor market will strengthen, and the Fed will be unlikely to cut until inflation has demonstrated clearer evidence of moving back towards 2%. Moreover, consumer sentiment / perceptions of the economy will improve, in turn likely providing a more positive backdrop for the majority party (Republicans).

Conversely, if growth converges towards hiring — or even if the gap stays wide — the labor market is likely to remain weak. In this environment, the Fed could cut again to support the labor market, and household sentiment about the economy is likely to remain depressed. That outcome could prove more supportive for Democratic chances in the midterm elections.

Appendix 1

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