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REVIEW OF THE WEEK
5 FEBRUARY 2024

US JOBS STRENGTH PUSHES BACK INTEREST RATE CUT FORECASTS YET FURTHER. MEANWHILE, HIGHER RATES AND CHANGING BUSINESS NEEDS KEEPS SQUEEZING COMMERCIAL PROPERTY.

The US economic juggernaut has pulverised hopes of a March interest rate cut, knocking back forecasts for the eagerly awaited downward shift to the middle of the year.

Strong labour data drove the bulldozer, yet US Federal Reserve (Fed) Chair Jay Powell was riding shotgun. The Job Openings and Labor Turnover Summary (JOLTS) showed businesses were still clamouring for employees, with professional and business services workers in particular demand. That was followed up by Nonfarm Payrolls posting 353,000 more new jobs than lost ones in January. Almost double the number expected and 20,000 higher than the previous month (which was itself a surprise) completely reset popular forecasts for US interest rates. Again, professional and business services led the charge. Meanwhile, the report showed that wage growth was picking up again – the monthly change in average hourly wages was the fastest since March last year.

There were conflicting messages in these data releases, however. The rate at which firms were hiring people is lower than it has been in almost eight years – if job openings are strong but hiring rates are low, this may signal skill mismatches. The hiring rate has a better track record of forecasting wage growth than the job openings rate. While average hourly earnings increased, the average weekly hours worked decreased at the sharpest rate in two years. That means the rate of real personal income growth is a little below the long-run trend. Meanwhile, some analysts warn of statistical discrepancies relating to changing seasonal patterns in the jobs market. In short, there's lots to suggest the US economy remains strong, but it's easy to misinterpret at present.

In the midst of these job announcements, the Fed held its January monetary policy meeting. At the post-meeting press conference on Wednesday, Powell explicitly warned that a rate cut in March was unlikely based on the data so far. He suggested the Fed wants to ensure it gets the timing of rate cuts right, and wouldn't hesitate to wait a little to do so. The Fed's official meeting statement also reiterated that the committee wasn't yet fully confident that inflation was moving sustainably towards 2%.

Many investors had hoped for a 25-basis-point rate cut in March, and had all but locked one in for May. Now a March cut is "unthinkable" and the chance of a May move is a coin toss, according to the market for fixing interest rates in the future. The US 10-year government bond price slumped in response to the week's news, sending its yield breaking through 4.0% once again after a brief plunge in previous weeks to 3.9%. Since the autumn, we have viewed 10-year bonds in a much more favourable light, and believe that the 10-year US yield is likely to be lower in a year's time than it is today. But there may be some volatility in the near term, given somewhat over-enthusiastic positioning for an early start to the rate cutting cycle.

It's interesting that this strong labour data was accompanied by rolling announcements of American companies shedding workers. Last week US-based delivery company UPS announced it was cutting 12,000 jobs worldwide (roughly 3% of its workforce), mainly from middle management. That was alongside a new American pay deal with the Teamsters union that offers 3.5% wage growth each year for the next five. The Teamsters represents about 300,000 UPS staff in the US. Its deal means the average full-time driver would earn about $170,000 (£135,000) by 2029. Digital payments business PayPal said it would cut nearly a tenth of its workforce (2,500 people), while fellow payments provider Block announced a cull of 1,000.

The tech industry has been particularly badly hit with job losses. According to Layoffs.fyi, an aggregator that tracks job losses in the sector, about 32,000 people have been let go from roughly 120 companies so far this year. Last year, more than 260,000 workers were made redundant from almost 1,200 businesses. Fully 90,000 people lost their jobs in January 2023 alone.

One way to look at this paradox is to realise that it doesn't really have to be a paradox at all. Layoffs and redundancies are stressful and upending for most people, which is why we typically see them as universally bad. Yet that denies that they also create opportunities. On one side of the equation is the newly jobless themselves: they may decide to try something new, or start a business of their own, which could make them better off than they would otherwise have been. But another, more macroeconomic opportunity is that these workers are suddenly freed up and available for businesses that might be able to use their skills more effectively.

For years, the US tech industry sucked in the brightest and most ambitious of people. That trained up a huge cohort of smart cookies in digital tools, tactics and expertise. Now, many of those skills appear to be flowing outward into the wider economy. While many tech companies are highly profitable, many, many more actually lost money hand over fist in the years of zero-percent interest rates. There's a good chance that an infusion of skilled techies could boost the performance of these less-flashy businesses.

Commuting a property death sentence

Another area of flux and change is US commercial property. In the aftermath of the pandemic, with flexible working rife, questions continue to circle office blocks like vultures.

Vacancy rates for American offices are roughly 20%, depending on who you ask. Regardless of the exact percentage of space left unoccupied, it's at a level not seen for 30 years and appears still to be rising. Property owners are getting squeezed from two sides: higher interest rates mean borrowing costs are multiples more than they were even a few years ago, while the ability to work remotely has dramatically reduced the demand for space.

We've said ad nauseam that it takes a good couple of years for higher interest rates to start hitting the real economy, and property is a likely contender for a first victim. Large buildings tend to have a lot of debt locked up for several years or more, as well as long-term leases with tenants. Four years on from the pandemic and two years on from the uplift in rates, buildings are starting to roll off these agreements. For many, that could mean much higher expenses and having to cut rents to entice people to rent the space.

This phenomenon led another US regional bank, New York Community Bancorp (NYCB), to report big losses on two of its commercial properties last week. NYCB, which bought parts of the failed Manhattan lender Signature Bank from NY regulators during the **height of concerns about American regional lenders a year ago**, lost $185 million on loans to two properties: a resident-owned 'co-op' apartment block and an office building. In a sign of things to come, the lender also set aside $500m of expected losses from its existing loan book. NYCB's stock price plummeted dramatically, though it has now stabilised and the bank is still well capitalised.

Other investors in US commercial real estate revealed losses, real or expected, as well. Mid-sized Japanese lender Azora forecast a full-year loss on its US property portfolio and roughly two years before improvement. Multinational investment bank Deutsche increased the amount it sets aside for bad loans to US commercial properties by about €100m, taking the total to €123m.

The US isn't alone with this problem. Commercial property owners in the UK and the rest of the world are battling similar pressures. **An interesting report on US office property from CBRE last year** made an important point: the picture is extremely nuanced. Not all properties are created equal. The location matters, as do the amenities, the quality of the building and its footfall or ease of transport links or carparking.

Many building owners will be struggling with higher costs, yet the fall in tenant demand could be heavily concentrated. CBRE reports that almost 80% of US smaller office buildings (below 50,000 square feet) had occupancy of 90% or higher. That's little changed from when the pandemic broke out. Meanwhile, only half of large buildings are more than 90% leased. Broad brush, larger sites in less-enticing areas of big cities like New York and San Francisco are emptying out, while smaller offices in growing regional centres and cities are doing well. Also, the crème de la crème properties in the heart of the big metropolises are also attracting strong demand. CBRE notes that 10% of all US office buildings account for 80% of the lost occupancy since the first quarter of 2020. These were described as older buildings in downtowns with relatively high levels of crime and few surrounding amenities.

Last year, when Silicon Valley Bank and other were failing, we dug into regional lenders' balance sheets and the possibility of further failures. We concluded that a few small banks on the West Coast, in particular, were at risk, but these were not 'systemically significant', by which we mean having the capacity to set off a chain reaction that could bring about a nationwide banking crisis. A year later, that's still our conclusion.

If you have any questions or comments, or if there's anything you would like to see covered here, please get in touch by emailing **review@rathbones.com**. We'd love to hear from you.