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Employment, corporate resilience and rate cuts

January economic data are notoriously volatile due to very large seasonal adjustments. For instance, the consensus payroll forecast for January was +189,000 (this is the seasonally adjusted figure). It came in at 517,000, a beat of 328,000.

This sounds like a lot and it certainly drove press headlines. However, the US economy loses a lot of jobs in January as people hired for the Holiday rush get laid off in the New Year. In January 2023, US employment actually fell by 2.5 million month-on-month. There was a seasonal adjustment of +3 million to get to the +517,000 seasonally adjusted figure.

The 328,000 beat was only 10% of the seasonal adjustment. It is highly likely this is just statistical noise that will reverse in coming months. However, the data surprise was enough to trigger a sprint higher in bond yields. With company margins under pressure from rising wages, we think it is very likely that companies will start to cut back aggressively on hiring.

Talking of contrary indicators, it really looks like corporates nailed the top of the market with their booming equity issuance in 2021. When the queue of companies trying to get new issues away is backed up right round the block, that's generally not a good sign for forward equity returns. On the flip side, the recent drought of new issuance may well be a positive for forward equity returns.

A major irritant for the bear case on equities is that corporate profits, particularly in Europe, are pretty solid. Bernstein highlighted that 12-month forward EPS (earnings per share) forecasts for MSCI Europe are only 6% from their peak. This is very different to the Armageddon that investors were expecting and a major reason why the European equity market has been resilient. Bernstein noted this was smaller than the usual -12% cut in EPS during a downgrade cycle in Europe, which you can interpret either way.

We prefer the positive spin, which is that after a decade of austerity driven pain in Europe, companies in the region have generally restructured and are much better businesses than they were heading into the 2009 credit crunch and this is coming through in a more resilient profit profile. Having had to endure the credit crunch and then two spasms of crisis in the Eurozone, companies in Europe know a thing or two about managing their businesses in a tough environment. In addition, European companies have obviously benefited from the strong dollar, which boosts their international revenues reported in euros.

There are three things that are a cause for concern and need to be watched.

- 1) Subprime auto delinquencies are rising in the US. This indicates that poorer consumers are really starting to feel the heat from high inflation and interest rates.
- 2) US banks are tightening lending standards, particularly on credit cards and small company loans. On balance, this will put downward pressure on consumption and investment.
- 3) The global property market is under pressure, both residential from higher rates and commercial due to plummeting office occupancy. For instance, in Manhattan, the office occupancy rate is still only 54% and the vacancy rate has surged to 22%, nearly double the historic average. There will likely be a step up in write-offs in Commercial Real Estate over the coming years – although this is mainly a feature for investors as opposed to banks as much of the debt has been securitized.

The main mitigating factor across these three issues is low levels of unemployment.

These three points indicate the US Fed monetary policy is really starting to bite and as a result we are now likely to be very close to the peak of the rate cycle. Therefore, after a repricing of Fed Fund Futures, the Fed could end up cutting faster than the market anticipates.

For a comprehensive list of common financial words and terms, see our glossary at:

<https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms>

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