

The Job Numbers and Commercial Real Estate

Why the government's good news isn't all that good for the industry; and a warning about these springtime stats

Last Friday's jobs report from the Labor Department initiated a wave of articles and blog entries depicting a robust economy and blue skies ahead. Democrats have taken the position that the administration's policies are starting to work, and Republicans are directing most of the credit toward the extension of the Bush-era tax rates. For a number of reasons, however, it is important to not get too excited about last Friday's announcement.

To a very significant degree, the health of the building sales market in New York has been strengthened by two factors; first, an acute supply-demand imbalance where there are significantly more people looking to purchase investment properties than there are properties for sale; and, second, an extremely accommodative interest-rate environment. Many believe that the low-interest-rate environment is an overriding factor creating the positive conditions in the sales market today.

If you are a frequent reader of Concrete Thoughts, you know that I consistently point to the fact that there is no metric that has a



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more profound impact on the underlying fundamentals of commercial and residential real estate than employment. While this remains a fact, job growth, or shall I say the *appearance* of job growth, is a potentially double-edged sword.

An increase in the number of jobs is certainly good for the economy. As American consumers become employed, they increase consumption. This is a vital part of our economy, which is 70 percent consumer-driven. As jobs increase, demand for residential and commercial space increases. Additionally, upward pressure should be exerted on wages, adding to the disposable income of U.S. consumers.

The other edge of the sword is that the appearance of job creation could lead the Fed to begin to tighten interest rates. If interest rates rise, mortgage lending rates will rise. As lending rates rise, capitalization rates will rise, exerting downward pressure on real estate values.

Tangible job increases will have a very positive impact on the economy and enable the marketplace to absorb modest increases in interest rates. If, however, the job increases appear to be there but are overestimated, this could lead to a tightening of rates without real underlying fundamental enhancements.

Let's take a look at what the current data is telling us.

Last Friday's report showed a very positive net gain of 216,000 jobs. There were 230,000 jobs created in the private sector, which were offset by 14,000 jobs lost in the government sector. The unemployment rate dropped from 8.9 percent in February to 8.8 percent in March. This drop represented the fourth consecutive monthly decline; the unemployment rate has dropped 1 percent since November 2010.

Some of the articles that I have read recently indicate that "discouraged workers are now returning to the job market." However, of the 1 percent decrease in the unemployment rate, it has been projected that 0.8 percent is due to actual employment hiring and 0.2 percent is due to a contraction in the labor force. This indicates that discouraged workers are not coming back looking for work in the numbers that some people have indicated.

To the extent that the Fed interprets this job data overly optimistically, it is likely that it will allow its \$600 billion program to purchase assets to expire on schedule in June. It is thought that the Fed would adopt a neutral policy moving forward, under which it wouldn't begin tightening until further positive jobs data is collected.

The latest jobs gain comes on the heels of February's 192,000 gain and appears to be very positive. But let's take a closer look.

The jobs recovery that we have had thus far has remained one of the weakest on record coming out of a postwar recession, as the U.S. employment level is still about seven million jobs below pre-recession levels. Even if the job market was to see consistent gains, similar to those achieved in March, it would take eight years to get back to pre-recession employment levels.

Additionally, due to the significant slack in the jobs market, wages remained flat at \$22.87 an hour. Uncharacteristically, wages have been essentially flat for the past six months, despite consistent month-over-month job gains. If, however, we take into consideration that, on a year-over-year basis, wages have increased by 1.7 percent and inflation has increased by approximately 2 percent, real wages have actually declined by more than 1 percent on an inflation-adjusted basis. This dynamic has created consumer discomfort and increased the expectation of future inflation.

These conditions are emblematic of a recovery that has been fueled, to a significant degree, by an exceptionally forgiving monetary policy. For about 28 months now, the Federal Reserve has kept interest rates at or near zero levels and has accompanied this with unprecedented asset purchases to keep bond rates low. This has been an extraordinarily positive dynamic for our commercial real estate capital markets, as lending rates have remained at or near historic lows. However, the implications for the broader economy may not be so positive.

Looking further into the jobs market, the number of Americans who have been out of work for 27 weeks or longer remains extremely elevated, at more than 6.1 million people. Long-term unemployment is only a 10th of 1 percent below its peak level. Long-term unemployed, as a percentage of all unemployed workers, has risen to 45.5 percent from 43.9

percent.

Additionally, the relatively low employment rate of 8.8 percent is due in large part to the fact that the labor force has been shrinking steadily. At present, 64.2 percent of Americans are working or are looking for work. This so-called "participation rate" is the lowest in 25 years and well below the peak of 66.4 percent before the recession. In March, this participation rate was unchanged, indicating that discouraged workers were not encouraged to get back into the job market.

Our 8.8 percent unemployment rate compares favorably with the 10.1 percent rate in late 2009. Local government positions have shrunk significantly; there have been 416,000 jobs lost in local government since peak employment levels in September 2008. In March, this sector shed another 15,000 jobs, and it is expected that over the next year or two, local government employment will continue to shrink as municipalities have to bridge budget deficits.

So why aren't companies hiring more? Profitability and productivity have both increased substantially, and today a record \$1.8 trillion sit on corporate balance sheets. Clearly, employers have the ability to hire; however, they are choosing not to based upon strategic decision making. The reasons for this caution are numerous and exist on the domestic as well as international fronts.

On the domestic front, it is yet to be seen whether federal, state and local governments can actually control spending. To the extent they cannot, taxes will need to increase to meet budget deficits.

The real impact of the Dodd-Frank Financial Reform Bill is yet to be seen, and corporations need to determine how to maneuver around all of the new requirements in that regulation. Add to this the fact that no one in the country can accurately tell what the real cost of health care expenses will be moving forward. However, it is clear that they will continue to rise. As we see more and more "favored groups" of the Obama administration obtain exemptions from the new health care bill, the burden of paying for the 35 million newly covered citizens shifts disproportionately to those without the benefit of exemptions.

Lastly, our tax policy has been set, but only for another year and a half before we are likely to have another political battle over the magnitude of our tax obligations.

On the international front, there are several factors that could impact the health and pace of our economic recovery. The European debt crisis still looms very large, and recent uprisings in the oil-rich Middle East render elusive any comfort about predicting energy costs moving forward. Japan's crises could significantly impact the broader economy, and the fact that several trade agreements seem to be going nowhere will have a negative impact on the U.S.'s ability to increase exports.

Lastly and more importantly for the U.S. job market is the answer to the following question: How reliable are these Department of Labor statistics? The way the government measures job growth is heavily biased toward reporting employment booms in the spring. This happens nearly every year, so why should we believe that 2011 is any different?

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The complete guesswork surrounding what is called the Birth/Death Model is included in almost every month's employment figures. This is essentially an educated guess as to how many new companies might have been formed in a particular month and the resulting jobs that might have been created from these new companies.

In 2009 and 2010, this guesswork caused the Labor Department's figures to be highly inaccurate. In 2009, for example, more than 900,000 jobs had to be removed from its count, given inaccuracies of Birth/Death Model projections. In 2010, the jobs statistics were inflated by nearly 400,000 positions. Springtime optimism is the main reason these projections have been overstated.

It is likely that in April, May and June, we will continue to see this impact inflate the job-creation numbers beyond what they actually are. To the extent that the Fed

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acts on these numbers and begins to tighten monetary policy prematurely, it could slow the economic recovery and would have a significantly negative impact on the commercial real estate sector.

To the extent that job gains are real, however, the industry would gladly accept stronger employment numbers and modest increases in interest rates.

Compared with the sluggishness of the national employment market, in New York we have fared relatively well. As of February, the last month of available data, New York State's unemployment rate was 8.2 percent, down from 8.8 percent year-over-year. In New York City, the unemployment rate is 8.9 percent. Remarkably, during this past recession, the city lost only about 160,000 jobs, compared with 320,000 jobs lost in the recession of the early 1990s. Since January 2010, 53,000 of these jobs have been recovered. All things considered, New York City is doing much better than the nation as a whole.

A notable exception to the city's strength appears in the Bronx, where the unemployment rate continues to climb. In January 2010, the borough's rate stood at 12.5 percent, and has since increased, currently sitting at 12.7 percent. Why policy makers fought against the Kingsbridge Armory development, which could have produced

2,000 full-time jobs for the borough, remains perplexing given these higher unemployment rates. But in a borough where elected officials pre-

fer "no jobs" to jobs they feel aren't "good enough," perhaps they like leading the city in one category, even if it is unemployment.

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