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GLOBAL RESEARCH

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*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team.*

Over a decade ago, a mentor shared a joke about return attribution. Great deals feature astute asset selection, meticulous value-creation plans, and top-flight management teams. Bad deals face "macroeconomic headwinds."

For hedge funds, gains result from penetrating genius; losses from a Fed "behind the curve." Keep children's eyes from the invective directed at Powell & Co. in the next round of investor communications.

In a different market environment, last week's labor market data might have been complaisantly received as the last step in the path to rate cuts. One could even imagine these data comporting with some observers' definition of a "soft landing." But because those rate cuts (and more) had already been fully priced in—alongside aggressive earnings forecasts—markets had only one way to go. This is what we meant last Thursday morning when we described major stock indexes as "priced to perfection."

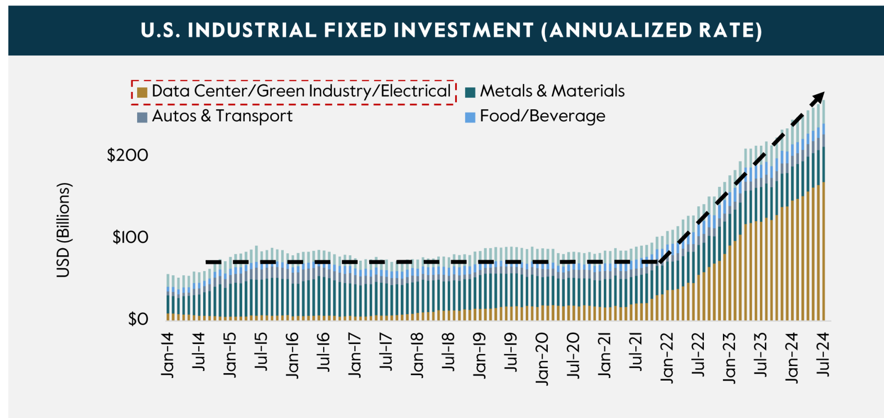
Over the past several months, people spoke of the "triggers" for rate cuts with the serenity of a schoolteacher explaining what to expect from a water displacement experiment. But, as we'd noted, "one would only expect rate cuts to arrive in the context of a growth scare" (Compass, June II) and were not likely to prove the "happy event" expected by some to "celebrate the economy's resilience in the face of inflation's vanquishment" (Compass, July 9). The state of the world that yields rate cuts tends to be filled with negative emotional energy, recriminations, and gnashing of teeth.

Now that we're here, let's not catastrophize. The U.S. economy continues to grow, fueled by a concentrated capex boom in data centers, green industry, renewable energy, and infrastructure unlike any observed in more than 20 years (Figure I). Base rates will finish 2024 at least 50 basis points below where they sit today and the sharp decline in longer-term interest rates of the past few weeks should foment recovery in interest-sensitive sectors like housing and durable goods. Companies' financial buffers have widened due to the massive wave of refinancings completed in the first half of the year. And thanks to the Fed's patience,

they've retained massive amounts of firepower to respond aggressively if data disappoint from here.

Depending on one's investment horizon, it may not be risk that has increased so much as the market's collective sensitivity to it. And that tends to portend very attractive capital deployment opportunities as investors get compensated to bear the downside surprises frothier markets ignore.

Figure 1: Concentrated Capex Boom Continues

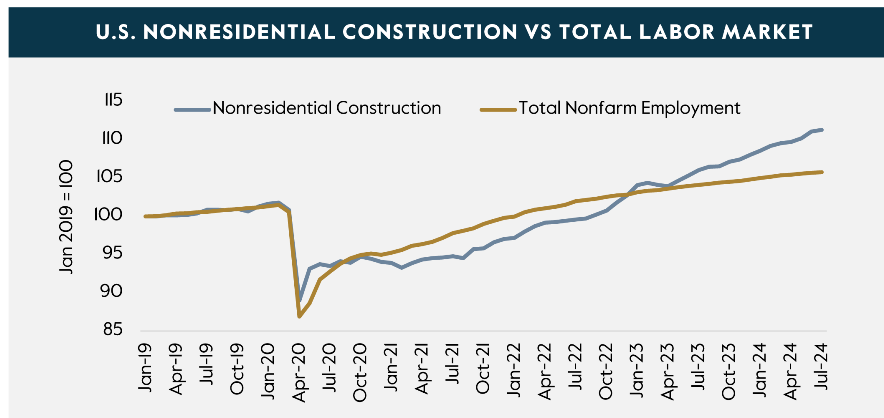


Source: Carlyle Analysis; U.S. Census Bureau, July 2024. There is no guarantee any trends will continue.

Capital Heavy, Employment-Lite

Since most of the industrial capex boom involves the construction of new facilities—data centers, semiconductor fabs, battery factories, solar power plants, etc.—it's no surprise that construction jobs have remained a bright spot in the labor market. Employment in the nonresidential construction sector has increased 5.0% over the past year and 6.3% (annualized) over the past two months, 5.5x greater than the growth in overall U.S. employment (Figure 2).

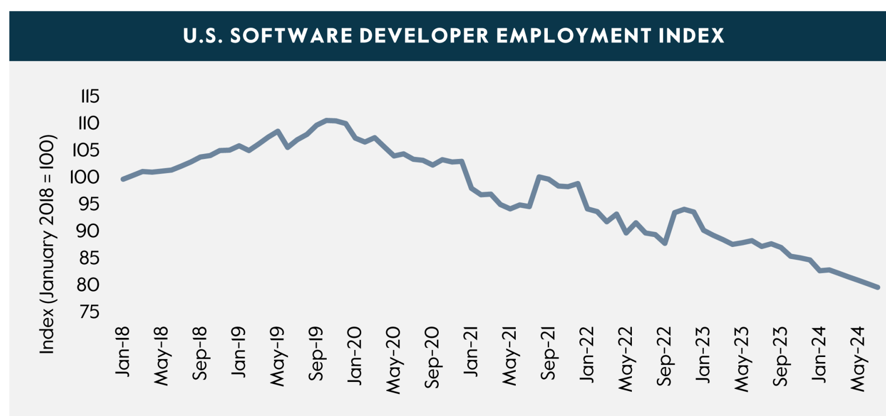
Figure 2: Office Slump No Problem for Nonresidential Construction Employment



Source: Carlyle Analysis; BLS, August 2024. There is no guarantee any trends will continue.

Even though much of this investment is being made by companies in the U.S. information technology (IT) sector, its labor market is among the weakest. Over the past year, the IT sector shed 19,000 jobs at the same time the rest of the U.S. economy added more than 2.5 million. Among IT workers, unemployment rates have risen by 320bps over the past year, 4x greater than for the labor market as a whole. The situation looks especially dire for software developers, where employment finished July down 25% from pre-pandemic levels (Figure 3).

Figure 3: IT Investment Boom No Help to IT Employment



Source: Carlyle Analysis; ADP, July 2024. There is no guarantee any trends will continue.

There are three proximate causes for the weakness. The first is AI, which techno-optimists argue is naturally displacing the need for programmers. As with the mechanization of agriculture, this technological revolution may be generating jobs, but it just happens to be in a different sector of the economy (in this case the workers constructing the data center capacity needed to train large-language models). The second is the sharp drop in Venture Capital investing since 2021, which translates to a corresponding decline in new firm formation, expansion, and labor demand. The third is the difficulties encountered by some of the software companies acquired in 2020-21 with debt loads that presupposed interest rates would remain near zero indefinitely. As base rates surged, many such businesses were forced to jettison staff to generate the cash flow necessary to meet escalating debt service costs.

Whatever the relative contribution of these factors, labor market dynamics evince an epochal shift in the sector. Companies once valued primarily for their intangible assets—and corresponding capacity to generate prodigious amounts of cash without much, if any, incremental fixed investment—are now deploying tangible capital on a scale without precedent. One wonders why valuation heuristics developed in that prior era would apply in this one.

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