BY ANDREW J. NELSON

2018 U.S. ECONOMIC and MARKET OUTLOOK

Still Some Life Left in This Aging Expansion

Property markets in the United States are robust by just about every key metric. Volumes of both sales and leasing still rank among the strongest rates ever recorded, while pricing in major markets remains well into record territory.

But, investors can be forgiven for being less than enthusiastic. Spoiled by years of double-digit returns and ever-rising prices, many lament that the best years of this aging economic cycle are behind us. Similarly, brokers and others whose compensation depends on deal flow are feeling the sting of double-digit declines in sales transactions and falling absorption rates *(see Graph 1)*.

Indeed, U.S. property markets have been exhibiting tell-tale signs typically associated with the end of market cycles: record asset pricing; falling returns; flat capitalization rates; fewer leasing and sales transactions; and investors chasing yields into new markets and riskier assets, among other trends. This conclusion is not brand new, as Colliers International's research team made this call last May, and those indications have only intensified since then.

But, reaching market peaks does not imply that a market crash is imminent. For one thing, markets and economies are dynamic systems that evolve and pivot, so even emphatic trends can reverse course as underlying conditions shift. Property returns fell steadily from mid-2011 before stabilizing in 2013 and recovering in 2014, so we can only truly call the inflection with hindsight. Even if conditions in this cycle continue to trend downward, however, there is little indication that we are about to see a dramatic fall-off or outright downturn with falling rents and rising occupancy.

Contrary to the expectations of most economists, U.S. economic trends in 2018 are actually looking up again for the first time since mid-2014.

New Life for the Aging Economy?

One key reason is synchronized global growth. All major regions of the world are growing simultaneously for the first time in more than a decade, increasing demand for U.S. products and services. But, the biggest factor is a significant pickup in business investment, reversing the decline in 2016. Business confidence is sky-high, based on anticipations of tax relief and regulatory reform, as well as growing foreign demand.

Meanwhile, job growth continues to be robust, even if not as strong as earlier in the cycle *(see Graph 2)*. Job growth peaked at more than 250,000 monthly in 2014 and 2015 and has been trending down ever since. Lately, employers have been adding an average of 170,000 jobs per month. With the unemployment rate at just 4.1 percent, firms find it increasingly difficult to hire qualified workers when needed.

The major disappointment is wage growth, which continues to be anemic despite the tight labor market conditions. This reduces consumer spending, which accounts for more than two-thirds of our economy. Households are managing by reducing their savings, but the nation's savings rate is near its all-time low, so spending will slow further unless wages finally start to rise.

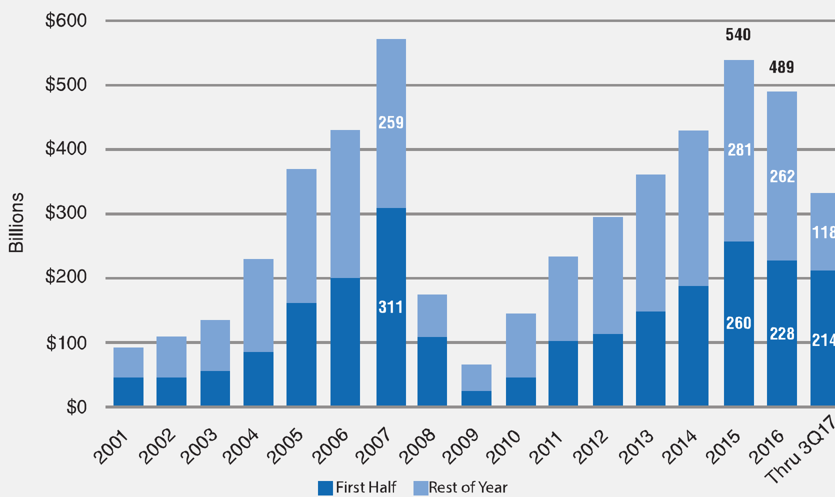
The Economy in 2018

Moderation has been the theme of the U.S. economy for the entirety of this current cycle, with gross domestic product (GDP) growth averaging just 2.2 percent annually in this cycle versus 3.1 percent since 1960. But, we seem to be moving onto higher trajectory, driven by three factors:

Synchronized pickup in economic growth globally. The global economy is experiencing its fastest growth since 2010 and, as noted, all major regions around the world are growing at the same time. Manufacturing and trade both have picked up last year. Meanwhile, inflation remains tame, allowing central banks to retain their pro-growth policies. Stronger global growth will fuel more demand for U.S. goods and services.

The congressional tax bill. Just before year-end, the House and Senate reconciled their tax bills, providing the most sweeping tax reform since the Reagan Administration and offering at least a modest economic boost in 2018. To some extent, the tax bill already is having an effect: raising business confidence, which is encouraging the pickup in business investment. But, the primary stimulus will come from the unfunded tax cuts, likely to top $1 trillion even once the effects of

Graph 1: U.S. Commercial Real Estate Transaction Volume > $2.5MM ($ Billions)



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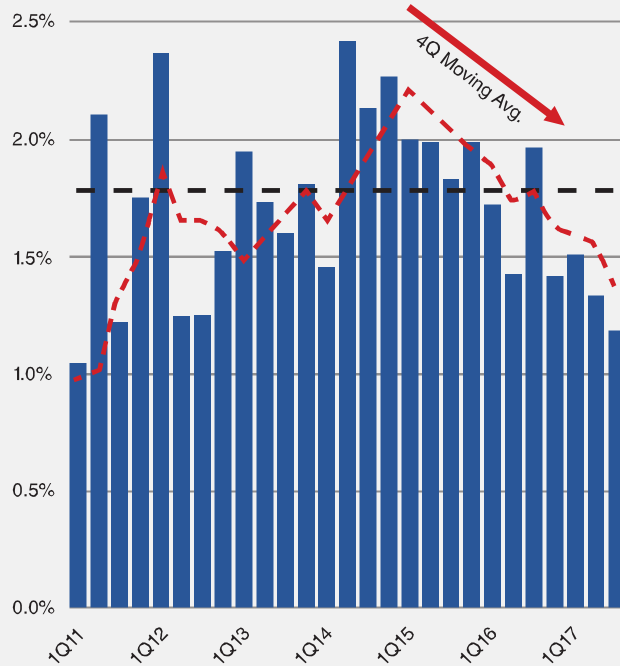

induced economic impacts of the tax bill are considered.

Longer term, the economy also will benefit from faster productivity growth from the greater business investment. The benefits to households appear to be much more limited or shorter term, however, with many taxpayers facing tax hikes.

Exuberant business confidence. Surveys show business confidence at its highest level in years. Anticipation of sweeping tax cuts and reform is one reason, along with more lenient regulatory burdens. And, large multinational firms also are benefiting from the growing global economy, supporting rising offshore demand for our products.

The result is surging business investment in capital goods and structures, estimated to have grown more than four percent in 2017 after declining in 2016. Industrial output also is rising, expected to have grown by close to two percent in 2017 after falling in both 2015 and 2016.

All of these trends portend a pickup in economic growth in 2018. But, not all is smooth sailing. The tax bill is likely to prompt the Federal Reserve to raise interest rates more rapidly in order to ward off inflation. The job market faces increasing labor shortages that are being exacerbated by curbs on immigration. And, trade wars remain a downside risk if trading partners retaliate against more protectionist U.S. trade policies.

But, overall, near-term risks seem skewed to the upside. Although preliminary fourth-quarter 2017 GDP figures will not be released until late January, it is expected that year-end growth for 2017 will be around 2.5 percent, with similar growth in 2018. However, the economy is likely to slow again in 2019—and especially in 2020—as the cumulative impact of the Fed rate hikes take full effect. For now, though, economic forces seem aligned for faster growth in the near term.

Implications for U.S. Property Markets

Property fundamentals will benefit from this faster economic growth and continued solid job growth. The weak link will continue to be wage growth, to the detriment of the multifamily and retail sectors.

Industrial real estate will continue its star run in 2018 as the top-performing property sector, with record construction and asking rental rates, as well as strong absorption and low vacancy rates. Stronger trade, rising housing construction, the shift from physical to online retailing and the improving economy all will fuel greater warehouse demand.

The multifamily sector also will continue to post strong performance, if less robust than in recent years. Affordability is becoming an issue in more markets, as record rents will limit new demand just as construction hits its peak. Rent growth and occupancy will both slide, particularly in prime urban core submarkets witnessing significant deliveries. But, rising home prices and credit challenges for millennials will limit downside risks for rental properties.

The office sector seems to have peaked for this cycle, but, with construction moderating, occupancy should remain stable for at least the near term. The uptick in GDP should increase demand for space, though occupancy gains will be limited by industry trends for space efficiency and shared space.

And, the retail sector shakeout will not let up in 2018. Another wave of post-holiday store closures and bankruptcies will be announced, with the pain focused on secondary retail centers, especially those in weaker markets. To be sure, the best centers will continue to thrive and meet the online shopping challenge. The United States still suffers from significant excess retail space, however; many retail centers must convert to other uses before occupancy and rents can regain their former levels.

The slowdown in property investment will continue this year. The Fed will continue its current pace of rate hikes, which may soon finally start to have a material impact on property acquisition costs and development financing. But, the large stockpile of "dry powder" will ensure transaction volumes remain robust. However, more deals will be done in suburban submarkets and secondary metros, as record pricing in major markets deters return-focused investors.

Finally, the new tax bill will have little direct effect on the property sector beyond improved fundamentals, owing to stronger economic and job growth. Traditional tax advantages for the real estate sector—mortgage interest deductibility, asset depreciation and tax-free 1031 exchanges—are largely unchanged. But, there are some new benefits for investors, including lower corporate taxes, more generous pass-through income provisions and lower tax rates on REIT dividends. However, rules that tighten carried-interest holding requirements to qualify for capital gains treatment could hurt some entities. And, interest rates may well rise faster as a consequence of the stimulus, hitting rate-sensitive parts of the property sector, especially REITs and development. But, overall, the impacts will be neutral to positive.

In summary, commercial real estate has many reasons to be optimistic in 2018. This current economic expansion has been very positive for the industry and, as it soon becomes the second-longest expansion in U.S. history, there's no reason to believe it won't continue to mean growth for the property sector. B

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