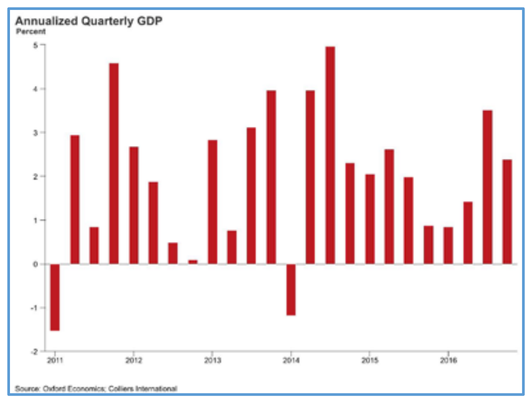
February 16, 2017 | Andrew J. Nelson, Chief U.S. Economist

WHERE WE ARE: Starting the Year on a (Relative) High Note

In short: The economy is starting the year on solid footing, broadly (if not fully) recovered from the financial recession and continuing its uneven pace of moderate growth. After more than seven years of gains, already 40% longer than the average expansion, Washington faces the challenge of both extending and boosting growth before the next downturn.

After 92 consecutive months of expansion, the economy is still chugging along. Though GDP growth dipped in Q4 2016 to just 1.9%, shy of consensus expectations and well below the revised annualized rate of 3.5% in the third quarter, much of the volatility is explained by a one-off trade issue that inflated the third-quarter figure and suppressed the fourth quarter. The larger story is that GDP growth surged from only 1.1% in the first half of 2016 to a relatively strong 2.7% in the second half, on par with the 2.6% growth in 2015. Still, growth for all of 2016 was only 1.6%, the weakest annual performance since 2011 and barely half its long-term average of 3.1%. GDP has not reached 3% since 2005.



Consumers continue to be the main driver of growth, supported by job gains and rising wealth. Home values and equity prices are both at record levels, though wage growth continues to be slow. Overall, consumers are feeling good, with consumer confidence near a 15-year high. Home prices rose further into record territory in November, after finally reaching a new peak in September. In sum, consumer spending rose at a respectable annualized rate of 2.5% in Q4, following a 3% growth rate in Q3.

Other bright spots in the GDP report included business investment (+2.5% annualized) and especially residential investment (+10.2%). The most notable weak spot in the economy was net exports — the first net trade drag in a year — as exports fell 4.5% while imports surged 8.3%.

But overall, the economy ended 2016 on a relative high note. The widely-cited surveys of purchasing managers — fairly reliable gauges of future economic activity — have been rising strongly. The services index is at its highest level in 15 months, while the manufacturing index is at a two-year high. Similarly, factory activity accelerated to more than a two-year high in January on the strength of gains in new orders, pointing to a recovery in manufacturing.

Meanwhile, the economy continues to add jobs, the single most important metric for property markets and the strongest indicator in this cycle. Gains rose to 227,000 jobs last month, the largest gain in four months after averaging only 165,000 per month in the fourth quarter. This is all the more impressive for an economy near full employment. The economy has now added jobs for a record 75 consecutive months. In all, private-sector employment has grown by 15.8 million jobs in this expansion after shedding 8.7 million jobs during the recession. Nonetheless, wage growth remains weak though the trend is generally firming. To be sure, the U.S. is not alone in this predicament: wage growth has been weak throughout the developed world. Wages did see their fastest annual gain in seven years in 2016, but overall wage gains through this cycle have been weak and have often not kept up with inflation, especially for lower-skilled workers.

Putting it all together, the economy has essentially healed from its worst downturn in more than half a century. Indeed, I wrote a blog post last May on the theme that the "recovery" phase of the cycle is over, and our economy has only grown since then. However, as I explained in that post: "That's not to say that our economy now is fully 'healed' in the sense that it exceeds pre-recession conditions on every last metric. It does not. Our country is much different now than in 2008 — in some ways better, some worse, some just different." Some parts of the country and our economy have not shared fully in the recovery.

IMPLICATIONS FOR PROPERTY MARKETS

Overall, economic fundamentals should keep property markets strong in 2017 and going into 2018. As we have seen through almost the entire cycle, despite subpar growth, the economy has expanded enough to fill our empty real estate, helped by the below-average rates of new construction. Fueled in part by historically low interest rates and strong offshore interest, property prices have surged to new highs. In turn, this has supported exceptionally strong investment returns for some six years now. Even before taking into account anticipated policy directions from Washington, the property markets are riding enough momentum to keep the party going at least a bit longer.

Apartments remain the strongest sector, with vacancies well below their historic averages and rents well beyond prior peak levels. Much needed construction is finally starting to raise vacancies and slow (or even reverse) rent growth, which is probably healthy for the sector overall as demand continues to be strong due to job growth and firming income gains. Meanwhile, the industrial sector continues to demonstrate the strongest improvement, as the expanding economy and especially consumer shifts to e-commerce fuel demand — at the expense of bricks-and-mortal retail. And office demand remains strong, though perhaps showing signs of aging in the tech segment.

Finally, despite modest rises in interest rates (and more in the offing), rates remain low. Meanwhile, despite policy uncertainties that may keep some capital on the sidelines, many institutional investors are sitting on record levels of capital targeted to the property sector — all of which should maintain demand for the near term.

WHAT'S NEXT?

The next few years promise the biggest economic policy changes in a generation across a broad range of areas. Clearly, Wall Street seems to be anticipating good tidings. Equity prices are riding the so-called "Trump bump," repeatedly surging to new highs with the S&P500 back at its all-time high and up more than 7% since Election Day. However, traders may have gotten a bit ahead of themselves, as so much about the policy direction is still unknown. No economic programs have even been formally proposed yet in the form of legislation, much less adopted. Moreover, as with most any economic policy changes, there are some clear downside risks along with the upside Wall Street is expecting.

As I outlined in my first post-election newsletter and then in our 2017 Outlook, we are expecting two broad sets of economic policy initiatives. First, a stimulus package of tax cuts and infrastructure spending is planned for 2017 that should boost jobs and GDP growth. But given the realities of the legislative process and federal contracting, we should not expect much stimulus impact before late in the year. Moreover, we should expect gains from the stimulus to be at least somewhat moderated by greater inflation and higher interest rates, as suggested by the post-election surge in rates.

We also expect to see a series of business-friendly measures — such as lowering and restructuring business taxes and reducing regulation — that would likely boost investment, hiring and economic growth. However, businesses are also awaiting the exact contours of the new trade policies that could counteract the foregoing tax and regulatory benefits for some sectors.

On balance, most economists have raised their growth forecasts for 2017 and 2018 slightly — as well as their risk expectations. The consensus forecast calls for real GDP growth of about 2.3% in each of the next two years (up from 1.6% in 2016), along with modest increases in inflation and interest rates.

All property sectors would gain from the stimulus package of lower taxes and infrastructure spending. But office and industrial would likely benefit most of all, as they tend to be the most pro-cyclical sectors — rising and falling with economic and job growth. The expected regulatory rollbacks in the financial and pharmaceutical sectors — both major office-space users — could boost office leasing as well, while relaxed environmental regulation, new infrastructure programs and additional military spending could all boost demand for industrial space. However, uncertainty over the direction and impact of trade policies could ultimately prove to be a headwind for the sector.

ANALYSIS OF RECENT ECONOMIC NEWS

Higher Jobless Rate Suggests Economy Has Room to Run (WSJ) **“**Despite brisk hiring, the U.S. unemployment rate rose in January and wages grew modestly, evidence for the Trump administration and the Federal Reserve that the economy has room to run before it overheats. The backdrop of a steady but unspectacular labor market is likely to keep the Fed cautious about raising interest rates and could prevent it from colliding with President Donald Trump as he aims for faster economic growth.”

Presidents Have Less Power Over the Economy Than You Might Think (NY Times) “Presidential reputations rise or fall with gross domestic product. The state of the economy can determine if presidents are re-elected, and it shapes historical memory of their success or failure. But the reality is that presidents have far less control over the economy than you might imagine. Presidential economic records are highly dependent on the dumb luck of where the nation is in the economic cycle. And the White House has no control over the demographic and technological forces that influence the economy.”

The Winners and Losers from a Stronger US Dollar (Fung Global Retail & Technology) “A strong US dollar negatively affects US exporters and businesses with a high percentage of foreign revenues, which includes technology companies such as Alphabet, consumer staples brands such as Coca-Cola, international retailers such as Walmart and Costco, e-commerce leader Amazon and automobile manufacturers. Retailers that rely on tourism shopping will also be indirectly impacted."

OTHER WORTHWHILE READS

ECONOMIC NEWS AND VIEWS

US employment up in January but wage growth cools (Financial Times) “The US economy added far more jobs than expected last month, but wage growth cooled, offering a muddied picture on the labor market in the first jobs report released during Donald Trump’s presidency. . . 227,000 jobs were created in January, exceeding Wall Street expectations of 180,000. However, average hourly earnings rose at a rate of 2.5 per cent, a slowdown from 2.8 per cent in December and missing estimates of 2.7 per cent.”

U.S. Consumer Spending Rose in December by Most in Three Months (Bloomberg) “U.S. consumer purchases climbed in December by the most in three months as incomes picked up, signaling a strong hand-off into 2017. The 0.5 percent advance in consumption, which accounts for about 70 percent of the economy, followed a 0.2 percent advance in the prior month, a Commerce Department report showed Monday. The December increase matched the Bloomberg median forecast.”

U.S. Consumer Confidence Eases Off 15-Year High; Wage Growth Modest (NY Times) "U.S. consumer confidence retreated from a 15-year high in January likely as some of the election euphoria fizzled, but households remained upbeat about the labor market, suggesting that the economy would continue to grow this year."

GDP Shows Economy Slows to 1.9% Growth (Marketwatch.com) "The U.S. economy's expansion slowed in the fourth quarter, and annual growth failed to reach 3% for an 11th straight year, reflecting the huge hurdles the Trump administration faces in trying to speed up a 7½-year-old expansion. Gross domestic product, the official score card for the economy, expanded at a 1.9% annual clip from October to December, the Commerce Department said. That's a marked drop from a 3.5% growth rate in the third quarter and below the 2.2% MarketWatch-compiled consensus."

Donald Trump Withdraws U.S. From Trans-Pacific Partnership (WSJ) "President Donald Trump's formal withdrawal from the 12-nation Pacific trade agreement, announced Monday, creates an American policy vacuum in a fast-growing region that includes China and longtime U.S. allies. Mr. Trump's move fulfilled a promise to end U.S. participation in the proposed TPP deal, which was intended in part to show Japan, Australia, New Zealand, Vietnam and other Pacific countries that the U.S. was doubling down on a region strained by China's increasing economic and military assertiveness."

PROPERTY MARKET VIEWS AND NEWS

Home Price Growth Showed No Signs of Slowing in November, Case-Shiller Says (WSJ) "Home prices climbed strongly in November, as price growth showed no signs of slowing even after mortgage rates began to tick up during the month. The S&P CoreLogic Case-Shiller Indices, covering the entire nation rose 5.6% in the 12 months ended in November, up slightly from the revised 5.5% year-over-year increase reported in October."

Suburban Offices Woo Millennials With Food, Fitness and Fun (WSJ) "Suburban landlords trying to compete with sleek urban office settings are finding new ways to step up their game. Property owners in New York's suburbs are investing heavily to remake bucolic corporate campuses built during the 1980s and 1990s, adding glass facades for natural light-filled offices and retail space for restaurants, cafes and, in at least one case, a supermarket with specialty services. They also are rolling out features such as modern fitness centers, bike-share programs, walking trails and spacious lobbies as spaces to socialize."

2016 Marked a Decline in Investment Sales Volumes (nreionline.com) "Investment sales volume in the commercial real estate sector for 2016 fell about 11 percent year-over-year, but sources say the decline in transactions was skewed by a gangbuster 2015 marked by significant platform and portfolio sales. Figures from real estate research firm Real Capital Analytics (RCA) show approximately $488.6 billion in 2016 transactions, with $366 billion of that figure flowing from single asset sales."

PREA: Global Allocations to Real Estate Likely to Rise in 2017 (Mortgage Bankers Association)
"Global institutional investors expect their commercial real estate investment allocations to rise, reported the Pension Real Estate Association. Institutional investors currently allocate 10 percent of their funds to real estate on average; PREA said investors plan to increase their real estate allocations to 11.5 percent on average, leaving considerable room for capital to flow into the asset class going forward."

Apartment Market Rent Growth Falls Below Long-Term Average (Axiometrics.com) "The one bright spot of the decline in national annual effective rent growth recorded in over the past five quarters has been that the rate has remained above the long-term average of 2.2%. But that streak ended in December 2016, when national rent growth was 2.1%, the lowest since July 2010."

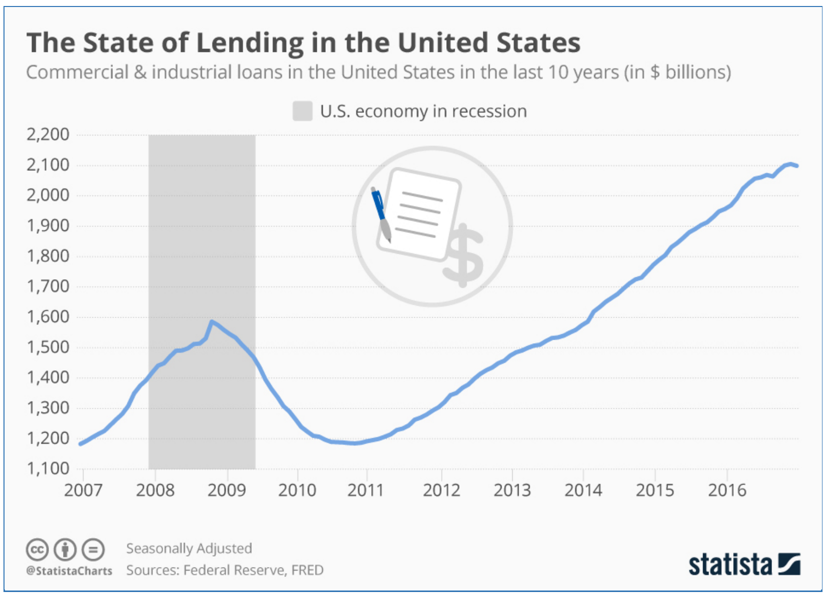
Mall Owners Rush to Get Out of the Mall Business (WSJ) "More mall landlords are choosing to walk away from struggling properties, leaving creditors in the lurch and posing a threat to the values of nearby real estate. As competition from online shopping batters retailers, some of the largest U.S. landlords are calculating it is more advantageous to hand over ownership to lenders than to attempt to restructure debts on properties with darkening outlooks."

CHART OF THE WEEK: Outstanding Commercial Debt

A key measure of the health of the financial sector and the economy overall is the availability of credit for businesses. The economy grows faster, all else being equal, when firms can borrow to fund expanding or improving their businesses. For example, the Fed tracks the net share of banks that are tightening lending standards (versus relaxing). Banks begin to raise their lending standards as overall business conditions worsen, starving firms' access to credit and thereby hastening the economy's plunge into a recession.

The Fed's figure is now at a very healthy 0.0%, meaning an equal number of banks are tightening (versus relaxing) their lending standards — not the lowest level of this cycle, but far, far below recessionary levels. One could also look at delinquency or default rates on loans (also very low now).

But in my view, the best measure of credit availability is the most direct: the amount of commercial debt outstanding for all types of businesses, including property loans. That figure now stands at $2.1 trillion, virtually a third higher than its prior peak in early 2009.



Of course, debt levels alone cannot tell the whole story. Corporate debt levels relative to earnings are now [higher than they were at the last peak] according to Moody's, worrying Fed officials about a potential bubble encouraged by very low interest rates — and the ability of firms to repay their debts when earnings fall or interest rates start rising in earnest. This concern is real and bears watching.

But for now, the more benign interpretation of this data is that America's corporations have ready access to the debt they need to build their businesses. A good omen for economic growth — and property markets.