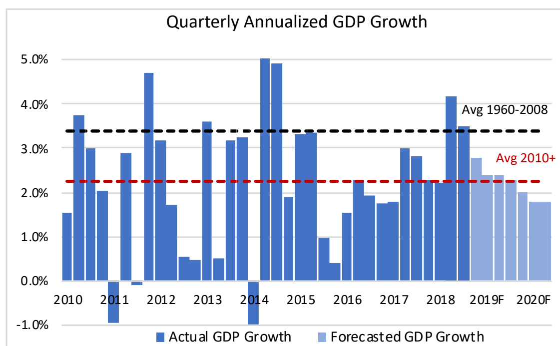
Fall Newsletter | October 29, 2018 | Andrew J. Nelson, Chief U.S. Economist

THE HOME STRETCH: The Economic Expansions Continues into Extra Innings

- ***The U.S. economy continues to fire on most cylinders, though trade and the faltering housing market are holding back growth and headwinds are picking up.***
- ***Economic growth for the year will be the strongest in years, although the recent pace will not be sustained much longer.***
- ***Job growth remains robust but continues to moderate as we near full employment.***
- ***Inflation and wage growth are now at, or above, Fed targets. The Fed will continue its pace of incremental hikes through next year, in its quest for a soft landing in 2020 or 2021.***
- ***Despite the apparently successful renegotiation of NAFTA, trade tensions remain the greatest near-term risk, but the rising dollar and interest rates and slowing global growth also threaten U.S. trade and business investment.***
- ***Property market fundamentals continue to improve, along with faster economic growth, but further gains will continue to soften in most sectors.***



Sources: Bureau of Economic Analysis, Concensus Economics, and Colliers International

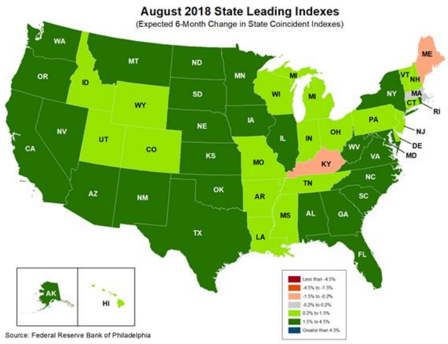
Second quarter GDP growth roared in at 4.2%, its fastest rate since late 2014, so it was almost inevitable that the pace would slow from there. But economic conditions are still quite robust, with third quarter GDP registering a still-solid 3.5% according to the initial government estimate. That's on par with its long-term average (black dashed line in the chart at right) and well ahead of its 2.2% pace during this cycle (red dashed line).

Almost everything seems to be going well right now: households are consuming, businesses are investing, manufacturers are producing and government is spending. As we reported in our last economic outlook, surveys of both consumers and business leaders remain near 20-year highs, which translates into stronger consumer spending and business investment. A pickup in government spending is also helping, fueled by the Bipartisan Budget Act enacted in January; government contributions to GDP growth this quarter were the strongest since early 2016.

Looking more broadly, the leading economic indicators tracked by the Philadelphia Fed are moderately to strongly positive for all but three states, even if strength of the index for the U.S. as a whole has been weakening since it peaked in late 2014. In the map on below, green represents positive forecasted growth, and dark green indicates even faster growth.

Chinks in the Armor

Still, growth in the third quarter was not as broad-based as earlier in the year, and signs are emerging that suggest a further slowdown is coming. Notably, deteriorating trade and housing market trends are starting to detract from growth, while rising interest rates seem to be weighing on business investment.



First, **trade is increasingly a drag** on economic growth. Despite efforts by the Administration to reverse the tide, imports continue to increasingly far outpace exports. Net exports of goods fell again in September for a fourth consecutive month, to a record -$76 billion. Three factors are at play: slowing global growth, the rising dollar (up almost 10% since January) and tensions with our trading partners.

Fortunately, we seem to have averted an all-out war within our own hemisphere when the Trump Administration successfully renegotiated the terms of the North American Free Trade Agreement (NAFTA) with Mexico and then Canada (though each country still must ratify the deal, which is by no means assured). But the disputes with Europe and especially China are active and threaten to slow U.S. economic growth. Trade overall was the greatest drag on GDP growth last quarter, with net exports declining at an annualized rate of 3.5%.

And it seems that the **housing market has plateaued**. Among other metrics: year-over-year sales of existing homes have fallen for six straight months and nine of the past 12; housing construction and permits peaked three years ago and have dropped sharply recently; and home price appreciation continues to fall (though prices are still rising modestly). Among other reasons: soaring construction costs, unaffordable housing prices and rising mortgage rates. Importantly, the housing market is frequently the first sector to weaken in a business cycle, and residential investment has among the weakest components of GDP recently, and has now declined for three consecutive quarters.

Finally, rising interest rates are also likely to blame for the **plunge in business investment**, despite strong business confidence and a positive near-term business outlook. Business investment has been the strongest component of GDP over the past two years, surging after the 2016 election as firms (correctly) anticipated tax relief and more favorable regulatory treatment began under the new Republican Administration and Congress. After averaging just 1.8% in 2016, quarterly annualized business investment jumped to 6.3% last year and 10.1% in the first half of this year but dove to just 0.8% in the third quarter. A slump in business investment, if sustained, would ultimately hit both worker productivity and job growth, further slowing economic growth.

Nonetheless, **the Federal Reserve Bank seems determined to cool the economy**. In September, the Fed hiked the federal funds rate by 0.25 points for the third time this year, bringing the total number of such hikes to eight since they began in late 2015. The Fed has also started to reduce the massive balance sheet it accumulated through its policy of quantitative easing. **Interest rates are rising** on everything from car loans and mortgages to business loans, causing declines in consumer and business borrowing. Moreover, the Fed is giving clear guidance that it intends to stay the course as both inflation and wage growth exceed their targets. Expect another hike in December and up to three more next year.

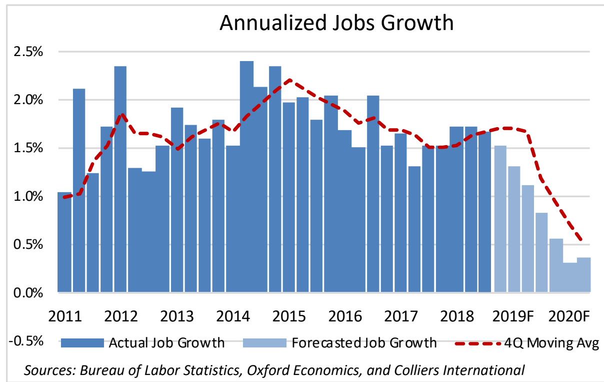
Equity markets are also taking note, as slowing global growth (and rising interest rates) seems to be behind the recent surge in volatility after an unusually long period of sustained calm. Increasing stock market volatility, and the possibility of a market correction, must be considered as another risk to continued expansion.

In summary, the strength of the recent headline GDP figures is deceiving, as they have been driven partly by one-time factors that will either reverse or fade in the coming quarters. For the first time in several years, the risks seem weighted much more to the downside.

The panel of economists surveyed by the Wall Street Journal forecasts GDP growth will be 3.1% for all of 2018. Looking forward, GDP is forecasted to trend down to be more in line with its average for this economic cycle and then taper further in late 2019 and 2020 as economic headwinds rise and the impacts of the temporary stimulus dwindle.

Slowing Job Growth

Job growth is still remarkably robust for this point in the cycle — averaging more than 200,000 nonfarm payroll jobs per month over the past year, modestly higher than in the prior 12 months. Nonetheless, job growth has slowed significantly since last peaking in 2015 and is now forecast to slow more sharply in 2019 and beyond. This trend is critical for the property sector, as jobs are the single greatest driver of space absorption.



With the unemployment rate now at 3.7%, its lowest level in more than 50 years, the U.S. economy is now close to what economists consider to be full employment. For the first time since the government began collecting this data in 2001, the rate of job openings exceeds the rate of new hires. Even more astounding, there are more job openings than unemployed workers!

With fewer workers available to fill for the positions firms are trying to fill, firms across many industries report growing labor shortages. Wages are rising more quickly — and more jobs are going unfilled — slowing job growth. This slowdown will only accelerate when economic growth also starts to soften next year.

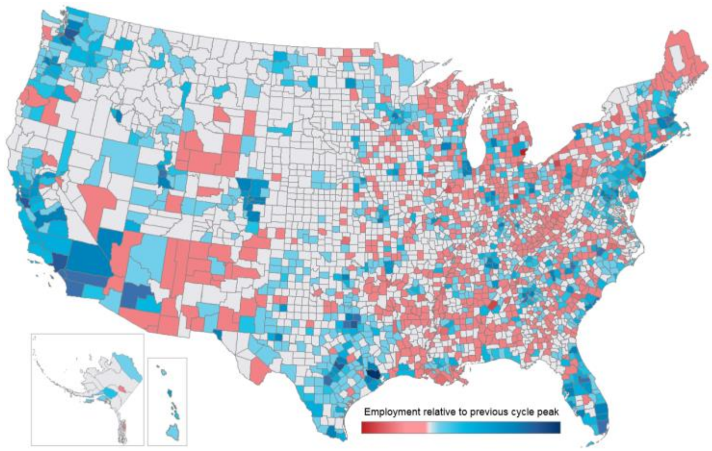
IMPLICATIONS FOR PROPERTY MARKETS

The immediate-term economic forecast continues to be stronger than it has been in several years, but signs are increasingly clear that the historically long cycle will soon by ending for both the economy as a whole and inevitably for the property sector. The current spike in GDP growth is likely to be short lived, undermined by rising interest rates, fading fiscal stimulus and downside risks from rising trade tensions.

More critically, job growth is expected to decline even more sharply than GDP — initially because there are few idle workers to hire in this full-employment economy — and then more significantly because the rate of layoffs invariably exceed the rate of decline in output during economic downturns. Accordingly, since leasing is so dependent on job growth, we believe property leasing momentum will continue to decline, with the exception of the still surging industrial sector, which looks to still have more room to run in this cycle.

CHART OF THE QUARTER: NOT EVERY METRO HAS RECOVERED

We've never had more jobs in the county. The number of jobs nationwide is now up more than 8% over the prior peak. But those gains have not be universal. Most of the gains have been concentrated on the western, southern and eastern coasts (shown in blue), while much of the central part of the country is only just back to the prior peak (gray). But recovery has been elusive for many counties, particularly in the Northeast, Midwest and non-coastal South.



Source: Oxford Economics

ANALYSIS OF RECENT ECONOMIC NEWS

U.S. GDP Grows Above-Forecast 3.5% on Consumers, Inventories (Bloomberg) "The U.S. economy expanded at a 3.5%pace in the third quarter as consumers opened their wallets, businesses restocked inventories and governments boosted spending, marking the strongest back-to-back quarters of growth since 2014."

IMF cuts its global growth forecasts, citing trade tensions between the US and its trading partners (cnbc.com) "The International Monetary Fund has cut its global growth forecasts as trade tensions between the U.S. and trading partners have started to hit economic activity worldwide. The IMF said the global economy is now expected to grow at 3.7%this year and next year — down 0.2 percentage points from an earlier forecast, according to the fund's latest World Economic Outlook report."

Fed Raises Rates and Says More Coming, Brushing Off Trump Jabs (Bloomberg) "Federal Reserve officials raised interest rates and cemented expectations for another hike this year as they reaffirmed that a strong U.S. economy will probably warrant further gradual increases well into 2019. The quarter-point hike boosted the benchmark federal funds rate to a target range of 2%to 2.25%. The move reflected an upbeat assessment of the economy that was identical to the central bank's last policy statement eight weeks ago, despite concerns over President Donald Trump's escalating trade war."

Tariff wars taking some of the steam out of still strong US economic growth (cnbc.com) "The tariff wars are showing up in a wider U.S. trade deficit and have taken some of the steam out of third quarter growth that remains formidable. This week, economists trimmed third quarter growth forecasts, after reports of a wider than expected trade deficit and weaker equipment investment. The average third quarter forecast in CNBC/Moody's Analytics Rapid Update survey of economists fell by 0.2 percentage points to 3.2%."

Trump's 'Historic' Trade Deal: How Different Is It From Nafta? (Bloomberg) "The U.S., Canada and Mexico reached a deal on a successor to the 24-year-old Nafta, capping more than 13 months of negotiations and overcoming major sticking points from Canadian dairy market access to minimum wage requirements for automobile production. Here are the major differences between the old deal and the new one, called the U.S.-Mexico-Canada Agreement, or USMCA, which President Donald Trump hailed Monday as a historic achievement.

OTHER WORTHWHILE READS

ECONOMIC NEWS AND VIEWS

Global Growth Plateaus as Economic Risks Materialize (IMF Blog) "Last April, the world economy's broad-based momentum led us to project a 3.9%growth rate for both this year and next. Considering developments since then, however, that number appears over-optimistic: rather than rising, growth has plateaued at 3.7%. And there are clouds on the horizon. Growth has proven to be less balanced than hoped. Not only have some downside risks that the last WEO identified been realized, the likelihood of further negative shocks to our growth forecast has risen. In several key economies, moreover, growth is being supported by policies that seem unsustainable over the long term. These concerns raise the urgency for policymakers to act."

Caterpillar's tariff costs and 3M's slower growth in China threaten their outlooks (WSJ) "Rising costs, a stronger dollar and concerns over growth in China are posing new risks to U.S. manufacturers, sparking a selloff Tuesday affecting shares in Caterpillar Inc, 3M Co. and other industrial bellwethers."

Which US communities are most affected by Chinese, EU, and NAFTA retaliatory tariffs? (Brookings) "This short analysis reviews the exposure local communities have to these trade policy changes. It draws on the Export Monitor, a unique dataset developed as part of the Global Cities Initiative, to estimate which local and regional economies rely the most on export industries targeted by retaliatory tariffs."

Unemployment Looks Like 2000 Again. But Wage Growth Doesn't. (NY Times) "Lots of measures are telling us that the United States labor market is doing well. In some cases, very well. Most prominently, the unemployment rate has fallen steadily over the last nine years. It dipped to 3.7% in September, and it has averaged 4% over the past year, the same as it did at the economic peak just before the 2001 recession. . .In many ways, the labor market looks like the economic heyday of 2000 and 2001, but in one important way it does not: wage growth."

Interest Rates Are Rising for All the Right Reasons (NY Times) "The cost to borrow money is on the rise. That is bad news for home buyers and other prospective borrowers. It helped cause a stock market sell-off on Wednesday and Thursday, and prompted President Trump to say that the Federal Reserve has 'gone crazy.' But it amounts to good news for the long-term direction of the economy. In effect, the multi-trillion-dollar global bond market is signaling a little greater confidence than it did just a few weeks ago that the nine-year expansion in the United States may have room to keep going for years to come, and without inflation taking off.

PROPERTY MARKET VIEWS AND NEWS

Weekly mortgage applications tank 7.1% as interest rates surge to a near 8-year high (cnbc.com) "The Columbus Day holiday may have closed some lending offices, but rising interest rates are more likely the culprit for weakness in the mortgage market. Total mortgage application volume fell 7.1% for the week, according to the Mortgage Bankers Association's seasonally adjusted report. Volume was 15% lower compared with the same week one year ago. Applications to refinance a home loan, which are highly sensitive to even the smallest rate moves, fell 9% for the week and were 33.5% lower than a year ago."

All Eyes on US Cap Rates Amid Interest Rate Hikes (Real Capital Analytics) "Preliminary data shows U.S. cap rates were flat-to-down in the third quarter of 2018 despite eight Federal Reserve interest rate increases since the end of 2015. Investors have been anticipating cap rate increases for some time now – almost hoping for increases in some cases. It hasn't happened yet."

Frothy, Very Aggressive, Too Hot: Bank Warnings Are Piling Up On Commercial Real Estate (Bisnow) "Experts have been estimating the likelihood of a commercial real estate bubble for years now. As recently as a year ago, experts in sectors like multifamily denied that bubble-like conditions existed, or at least downplayed the likelihood. Now analysts are changing their tune. Warnings about a commercial real estate price bubble have been increasingly common this year. Former Federal Reserve Chair Janet Yellen said so before leaving office, her successor has hinted at it, and Goldman Sachs and Wells Fargo, among others, have broached the subject as well.

Which Properties Investors Expect To Benefit Most From Opportunity Zone Investments (Bisnow) "Investment firms have begun to set up funds to deploy money into opportunity zones, a host of areas designated by local governments that offer tax breaks under a new federal program, but not all properties within a qualified zone will experience the same benefit."

RECENT COLLIERS ARTICLES, REPORTS AND BLOGS

Occupier Activity Remains Strong Thanks to 3PL Activity: Occupier activity across the Unites States continues to be robust, particularly in bulk industrial space 100,000 square feet and larger. Over the past 12 months (October 1, 2017 through Sep 30, 2018) 1,877 industrial (warehouse, manufacturing, flex) transactions (new lease, user sales, renewals) have signed in spaces 100,000 square feet and larger, totaling 483 million square feet. Slightly higher than the 1,750 transactions total of 405 million square feet in the 12 months prior."

Click and Collect: Retailers Expanding Store Pick-Up Options, Says Colliers Report (rebusinessonline) "As e-commerce continues to grow, the number of consumers picking up online purchases in stores is increasing, according to a report by Colliers International. The share of consumers who say they regularly use "click and collect" purchasing has almost doubled over the past five years. According to the report, the percentage of consumers who say they regularly collect online orders from a physical store jumped from 17.2% in 2013 to 38.5% in 2018"

U.S. Office Market: Is Over-Supply Looming? "Construction activity in the U.S. office market remains elevated while absorption levels are muted. Is this pattern set to continue leading to rising vacancy and downward pressure on rents and pricing?"

External Industrial Indicators Remain Strong in the Face of Altering Trade Policies "As the third quarter of 2018 comes to a close, all signs point to another strong quarter for industrial real estate. Essential indicators for industrial demand remain high, including distribution industry job growth. In September 2018, the three industries directly related to industrial real estate hit all-time highs for total employed in the U.S., including truck transportation (1.48 million), couriers and messengers (756,600) and warehousing and storage (1.05 million)."

Sector Outlook Remains Solid (NMHC) "During the 2018 NMHC Student Housing Conference & Exposition, industry leaders discussed broad national macroeconomic trends and how they are likely to affect the student housing industry in 2019 and beyond. Participating in the panel discussion were **Shawn Sweeney**, senior vice president of TSB Capital Advisors; **Jim Costello**, senior vice president of Real Capital Analytics; **Taylor Gunn**, director of student housing for Axiometrics; and **Andrew Nelson**, chief economist at Colliers International."

‘We’re Close To The Top Of The Market’: 6 Commercial Real Estate Capital Markets Trends (Bisnow) “Strong investor interest in U.S. commercial property markets has led to a surprising rebound in transaction volume in the first half of the year, though Colliers International U.S. Chief Economist Andrew Nelson does not foresee this rebound carrying over into the new year.

Quarterly Retail Spotlight Report | Fall 2018: What’s Driving the Click and Collect Movement?
“Consumers are excitedly embracing their 24/7 shopping superpower and it continues to become even more convenient and speedy! Click and collect is just another way to capture those seeking to have their purchases immediately — it’s a growing market and retailers are embracing how it’s done. Think of Walmart’s new TV ads and the drive-through pick up model for purchases made online. And landlords need to embrace these changes as the retail experience evolves.”

Industrial Logistics & Transportation Solutions 2018 Midyear Big-Box Review and Outlook “In this unique, interactive report, the Industrial Logistics & Transportation Solutions 2018 Midyear Big-Box Review and Outlook examines the strength of the North American big-box industrial market during the first half of 2018 which includes the seven core North American big-box markets, as well as eight emerging secondary markets.”

U.S. Industrial Market Spotlight: Salt Lake County “The Salt Lake County industrial market continues to see growth. Since 2012, developers and owner-users have added more than 15 million square feet to our industrial base, lease rates have increased in almost all product types, speculative development continues to flourish, and direct vacancy continues to drop. Utah will remain one of the fastest growing states in the nation, and it is expected to grow by an additional 8% in the next five years.

2018 Capital Flows Midyear Update: Reversal of Fortune? U.S. Property Markets Stage Partial Come Back “Let the good times roll — we aren’t done yet. Sales transactions in U.S. commercial property markets picked up in the first half of 2018 (1H 2018). Though the gains were modest, amounting to just 4% over the first half of 2017, year-over-year transaction volumes rose in two consecutive quarters for the first time since late 2015, after falling in seven of the prior eight quarters. And sales of trophy and other high-priced assets faired even better, jumping almost 9% in 1H 2018.”

Q2 2018 U.S. Office Market Outlook Report: U.S. Office Absorption Rebounds as the Market Stays Strong “The U.S. office market remains on solid ground. Absorption rebounded in Q2 2018 after a period of slow but steady decline, and rents held firm. Office occupancy has remained near its cyclical peak for 10 successive quarters.”

Q2 2018 U.S. Industrial Market Outlook Report: U.S. industrial market on a roll but headwinds starting to pick up “Our Q2 2018 U.S. Industrial Market Outlook Report highlights that led by core markets in the Inland Empire, Chicago, Atlanta and Dallas-Fort Worth, the U.S. industrial sector continues to perform exceptionally well with robust absorption and development, along with record low vacancy rates and record high asking rents.”

Solid Leasing Across Major Office Markets in Q2 2018: New Supply to Test Demand in Several Markets” The Q2 2018 U.S. Top Office Metros Snapshot reports that all but one of the top 10 U.S. office markets posted positive absorption in Q2 2018 — an encouraging shift from Q1 2018 when four markets registered negative absorption. Rents rose or held firm in nine out of 10 markets, though vacancy rose in four of the markets.

Planning the Final-Mile: The Los Angeles Basin “E-commerce has shifted the dynamics of consumer demand and, thus, occupier supply chains, perhaps more than any other force in the last half century. This shift has been a boon to industrial real estate demand as occupiers need more warehouses in more locations to get products to consumers quickly. With the exponential growth of e-commerce, which requires that warehouses stock a larger variety of products and ship directly to consumers based upon dynamic demand, larger facilities continue to be built around the suburbs of major population centers.”

U.S. Industrial Market Spotlight: Shenandoah Valley/I-81 Corridor "The Shenandoah Valley/I-81 Corridor is a cost-effective alternative to markets further north in the Lehigh Valley and central Pennsylvania. The Port of Baltimore and the Port of Virginia provide rail access through CSX and Norfolk Southern, respectively. Combined with access to labor markets in Virginia, Maryland and West Virginia, these factors make the area particularly attractive to employers."

And don't miss the **Q2 2018 Market Insights Hub** for the office and industrial sectors — your dashboard and comprehensive source for Colliers market data.