
**Spring Newsletter | April 17, 2018 | Andrew J. Nelson, Chief U.S. Economist**

## LAST DANCE? The economy gathers steam but is the end of the expansion nigh?

- ***Despite recent financial market volatility and growing concerns over trade wars, economic momentum is mounting this year, likely yielding the strongest growth since 2015.***
- ***However, job growth continues to slow as we near full employment and work shortages rise.***
- ***With inflation and wage growth now nearing Fed targets, the Fed will hike its target rate three to four times in 2018, and more next year, slowing economic growth as the cumulative impact of higher interest rates starts to cool business investment and consumer spending.***
- ***Property markets remain vibrant, but signs suggest that conditions peaked three years ago and will continue to trend down, particularly as the economy slows in late 2019 into 2020.***

### A Long but Moderate Recovery

With our economic recovery — nay expansion — now at 105 months and counting, we're entering new territory. Assuming the economy keeps growing this month and next, this expansion will become the second-longest in U.S. history, moving past the go-go 1960s. And should the growth continue for another 15 months through next August — not an unreasonable expectation — we'd really be making history with our nation's longest expansion ever. (*Trivia quiz: Which expansion currently ranks as the all-time longest? See answer below.)*

Alas, another much less laudable hallmark of this cycle is its moderation. Real GDP has grown less than 20% so far in this cycle and jobs by just 13%. For perspective, in the 1960s expansion, GDP grew 53% and jobs by 33%. Perhaps it was all the dynamic energy from the nascent rock 'n' roll movement.

And we expect 2018 will conform to another unfortunate feature of this cycle: the tendency for first quarter GDP to be the weakest of the year (as happened in five of the last eight years). In fact, GDP growth has averaged just 1.2% in the first quarter of each year in this cycle compared to 2.5% during the rest of the year. "Seasonality adjustments" to the raw data are supposed to adjust for the fact that economic activity does indeed slow after the December holidays. So either these seasonality adjustments are missing the mark or the economy really is slowing up more than usual in this cycle for reasons unknown.

Regardless, Q1 2018 growth looks to be the weakest of any quarter since last year at this time and expected to be the weakest of 2018 overall. GDP in the first quarter is predicted to grow by 1.9% according to the Federal Reserve Bank of Atlanta's, GDPNow forecasting model, and by 2.1% says the economists polled by the *Wall Street Journal (WSJ)*. This is well shy of the 3.1% average for the last three quarters of 2017.

**Growth Will Accelerate in 2018 . . .**

But perhaps the bigger story is not only that this cycle still soldiers on, but that it even shows sign of accelerating modestly. Economists polled by the WSJ predict GDP will grow by 2.8% for all of 2018, which would rank as the strongest annual growth since 2015. Several factors are contributing:

- Synchronized global growth: For the first time since 2010, the global economy has been growing at potential, with all major regions participating. Though the U.S. economy is not fundamentally export driven, there's no doubt that our nation grows faster when we have strong trading partners.
- Strong business investment: Business investment, which had been lagging earlier in this cycle, picked up significantly last year, likely in anticipation of tax reform and regulatory relief.
- Government stimulus: Oxford Economics estimates that last year's tax cuts will add 0.4 percentage points to GDP this year, while the increase in federal government spending from the new budget will add another 0.2 percentage points.

**. . . But Begin to Slow in 2019**

However, all three factors — global growth, increasing business investment and government stimulus — will be short-lived. Already, growth is slowing in key major developed countries — including the U.K., Germany and Japan — as well as China, the second largest economy in the world. Meanwhile, various business surveys suggest that the boom in business investment will be tapering. Finally, the government stimulus will largely run its course by the end of 2019.

On top of this, trade deficits are growing which reduce GDP, while consumer spending has been flat for two years now. Taken together, the pickup in GDP this year will be relatively modest. Even the forecasted 2.8% growth would be less than the average since 1960, so not much to crow about.

**Trade Skirmish or War?**

And then there's the recent trade skirmishes, which threaten the synchronized global growth. To be sure, at current levels, the announced tarrifs and related measures are relatively trivial in the context of our economy. According to estimates by Oxford Economics, if the threatened U.S. tariffs on China are implemented, and China retaliates fully, the reducuction in the GDP over 2018-2019 would only be 0.3% — and it's quite possible that even these relatively modest measures will be reduced.

But it's also possible that these skirmishes spread and escalate into full-scale trade wars, with significant downside risks to both the U.S. and global economy. Meanwhile, the U.S. Administration is seeking to renegotiate the North American Free Trade Agreement (NAFTA). While most observers agree that there is good reason to update the terms of the 24-year-old treaty, indications suggest that the parties are still far apart and the Administration has threatened to pull out if a deal is not reached, which would have serious implications for trade in the region.

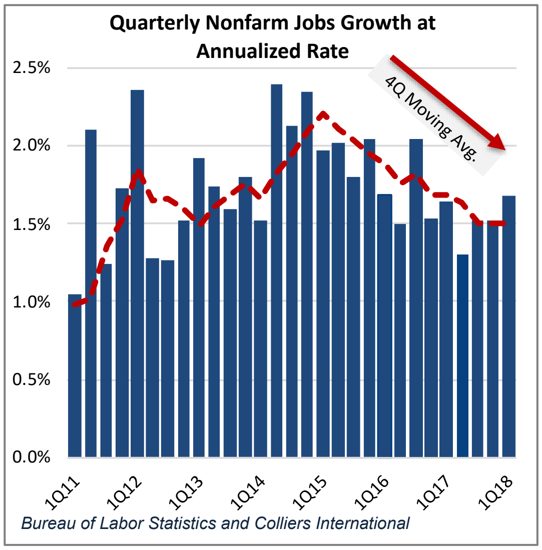
Moody's Analytics predicts that in the event of an all-out trade war with China, in which the U.S. withdraws from NAFTA, GDP would be reduced by about two percentage points, sending the economy into a brief recession. Fortunately, Moody's pegs that risk at only 10%, though they see the risk of more limited trade battles at 25%. In the end, the likelihood of a full trade war is highly speculative but remains a significant downside risk to the forecast.

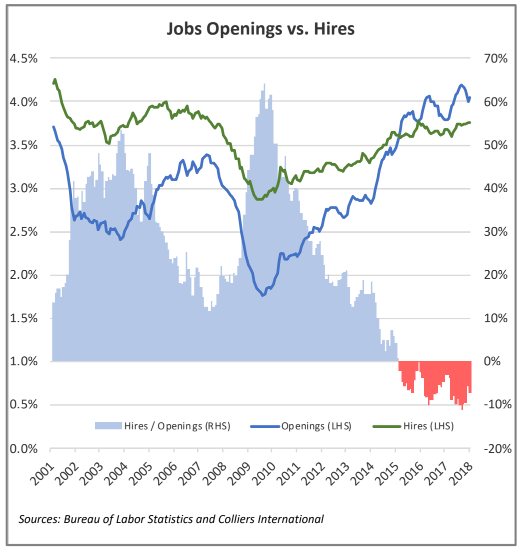
**Here Comes the Fed**

Finally, with inflation and wage growth both now nearing target ranges, the Fed is moving more aggressively this year and next to cool the economy with rate hikes — likely three to four hikes (of 0.25% each) this year followed by several next year. The Fed's initial hikes in late 2015 and 2016 had little impact on longer-term interest rates. But rates are now moving up more significantly and by next year may approach the point at which they start to choke off both business investment and consumer spending on capital items like automobiles and houses. (See the "Deep Dive" section below for more insights.) All of which means, we should expect GDP to start slowing in 2019 and 2020 especially.

**Job Growth Continues to Slow**

The other major economic factor impacting property markets is that job growth — in my view the most important driver of property demand — has been slowing. Actually, job growth in this cycle peaked in early 2015 and has been on the decline ever since, as shown by the red line in the left graph below.




The reason for the slowdown is clear: With the unemployment rate at 4.1%, the economy is near what economists believe to be full employment. As shown by the blue line in the right graph above, the rate of job openings are at their highest rate since the Department of Labor starting tracking this figure in 2001. Indeed, firms are facing increasing labor shortages in many sectors, limiting the rate of job hires (shown by the green line). Thus, for the first time ever, job openings exceed job hires (as indictated by the red bars). No surprise then that wage growth is rising as firms must increase pay in order to attract workers.

**In summary . . .**

2018 looks to be a better year than the last two, with relatively strong drivers for property demand. But property markets will face increasing headwinds in 2019, and beyond, as job growth continues to slow while interest rates rise, slowing economic growth and making real estate more expensive to acquire.

*(Quiz answer: The longest expansion in the nation's history was 120 months, which began in 1991 and ended with a bang exactly ten years later with the dot.com implosion in early 2001. Ironically, this growth came courtesy of productivity gains fueled by the same tech revolution — widespread adoption of personal computers and introduction of the internet — that ultimately spelled its demise. GDP grew by 43% and jobs by 22% — less than the 1960s expansion, but double that of our current cycle.)*

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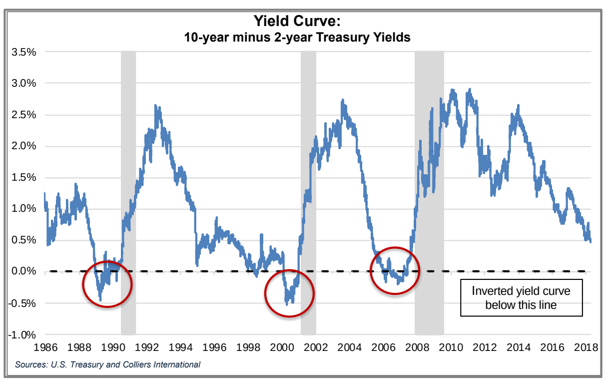
## THE DEEP DIVE: What's the evidence for a downturn?

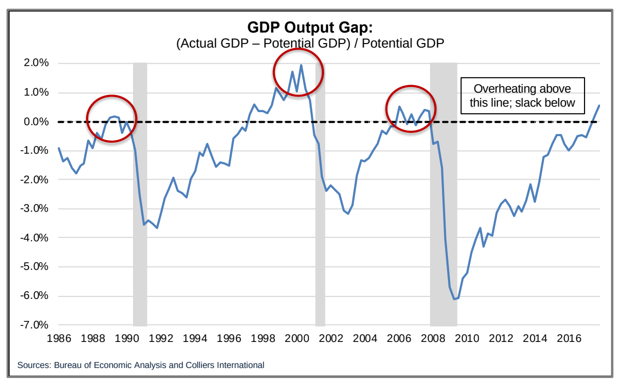
Some leading indictors are flashing that the expansion is nearing its end. Should we be concerned? After all, economists as a group are notoriously bad at predicting precise turning points or market peaks. Perhaps that's to be expected (without sounding defensive). Forecasting a recession is not like predicting the next return of Halley's Comet (my prediction is July 28, 2061 by the way, but that's only a guess). Any number of factors can alter the trajectory of economic growth, both positively and especially negatively, many of which are "black swan" events inherently impossible to predict, while others are more foreseeable events that are nonetheless difficult to quantify in a model.

But if this expansion has been disappointing in its vigor, at least it has been relative predictable. For example, the mean GDP forecast of economists surveyed by [Consensus Economics](#) (subscription required) in October 2016 — a month before the fateful presidential election — called for 2.2% growth in 2017; this average was just 10 basis points from the eventual actual figure of 2.3%. Indeed, despite monthly volatility in key economic metrics, and the unending surprises out of Washington, overall economists have been pretty spot-on in forecasting at least the headline economic figures. The path of long-term interest rates has been a conspicuous and embarrassing exception. Despite widespread and longstanding predictions of rising rates, in fact interest rates remained low until very recently.

So back to the flashing leading indictors. While no indictor is foolproof, the track records of these particular metrics are solid enough to provide a high degree of confidence that they are at least directionally accurate, if not precise. The most widely-cited is the **yield curve**. Normally the yield (or interest rate) on longer-term bonds is greater than those for shorter-duration notes since risks and uncertainty generally rise with distance into the furture. Thus, investors require greater financial incentives (in the form of higher yields) to lend for longer durations. However, this relationship flips as a recession nears because investors have less confidence in short term conditions than in the longer outlook.

One simple measure of the yield curve is the difference between the interest rate on the ten-year Treasury vs. the two-year. As shown in the left graph below, the spread is usually positive, but reliably falls negative a year or two prior to the onset of recession, indicated by the vertical grey bars. This spread has been falling fairly consistently since 2013, and is now lower than at any point since the last recession. The spread is still positive — though barely, at 0.5% — and close enough to inverting to flash caution.




Another indicator is the **GDP output gap** — the difference between actual and “potential” GDP growth: the theoretical maximum rate at which the economy can grow without overheating in the form of inflation. Here, the relationship is normally negative, indicating slack in the economy. When this spread turns positive, the economy is growing faster than its potential, and inflationary pressures start intensifying.

In this situation, the Fed steps in to cool the economy before it overheats excessively and inflation runs rampant. Its primary tool is raising the interest rate it charges banks. In turn, these rate hikes ultimately cause market interest rates to rise. Credit becomes more expensive to firms, who cut back on borrowing and investing; and more costly for consumers, who reduce spending, especially for larger items like automobiles and homes, typically purchased with debt. And thus the economy begins to slow. In practice, recessions typically follow within a couple of years after the output gap turns positive.

As shown in the right chart above, the output gap fell strongly during the last recession, before bottoming in mid-2009. Though rising consistently in the last nine years, the output gap has been significantly negative and well below its long-term average. Accordingly, inflation has been relatively tame in this cycle, and below the Fed’s target rate. But the negative gap has been shrinking ever since, finally turning positive last autumn, suggesting inflationary pressures are building, which helps explains the Fed’s more aggressive moves in the last year. It also explains why market interest rates have finally jumped — coinciding almost precisely with when the output gap turned positive — and thus, we are starting the countdown to the next recession.

To be sure, the risk of a recession this year is remote. The WSJ survey of economists pegs the risk of recession starting within the next 12 months at just 15%, near its level when President Trump took office. But looking only a bit further out, a recession beginning in late 2019 or 2020 seems almost predictable based on the yield curve and the output gap — that is, unless some unforeseen event derails the expansion before then, or, less likely, boosts growth further.

That raises further questions about the next recession: How deep? How long? How widespread? That's a topic for another day. For now I'll just point out that the Great Recession was unusually deep, long and widespread by historical standards — and unusually focused on the property sector, both residential and commercial. None of these are likely to be repeated in the next recession, in part because we do not see the same excesses that fueled the intensity of the last recession. Which is to say, this next recession is likely to be milder, shorter, and narrower — and less focused on real estate.

## ANALYSIS OF RECENT ECONOMIC NEWS

**The economy looks weak in the first quarter, but better days are coming (CNBC)** "With expectations increasing that first-quarter growth will be nowhere close to earlier projections, there's good news: The rest of the year still looks fine. That point was driven home Friday when Bank of America Merrill Lynch became the latest Wall Street forecaster to knock down its growth estimates for the first three months of 2018. The firm's economists now see GDP rising at just a 1.7 percent pace, compared to the 2.3 percent as of its most recent estimate. However, BofAML economists Michelle Meyer and Anna Zhou see the weakness as temporary."

**US inflation rises to strongest level in a year (Financial Times)** "The Federal Reserve's favoured inflation measure picked up to its strongest level in almost a year in February, supporting expectations that a solid economy and tight labour market are pushing price growth towards the central bank's target. The personal consumption expenditures price index excluding food and energy rose 1.6 per cent on the year, the largest increase since April 2017, according to a report from the Bureau of Economic Analysis."

**Fed Raises Rates and Signals Faster Pace in Coming Years (WSJ)** "Federal Reserve officials signaled Wednesday they could pick up the pace of interest-rate increases to cool economic growth after next year. The Fed voted unanimously to raise its benchmark federal-funds rate by a quarter-percentage point to a range between 1.5% and 1.75%. Officials said they expected to lift it another two or three times this year, and three times next year."

**Outlook for U.S. Growth Has Improved over Last Six Months (UrbanLand)** "Real estate economists boosted their outlook for economic growth in March's ULI semi-annual survey, compared with the survey of six months ago. The passage of the Tax Cuts and Jobs Act in December 2017 may have positively affected their forecast; this same group had shown a tempering of their expectations in the previous survey. The expectation for stronger economic growth is accompanied by the potential for higher inflation and interest rates."

## OTHER WORTHWHILE READS

***ECONOMIC NEWS AND VIEWS***

**Real U.S. Wage Growth Led by Women Over Last Four Decades (Bloomberg)** "For Americans working a full week, inflation-adjusted wages have increased 4.4 percent since 1979, with pay for women accounting for the biggest percentage advance. . . Weekly pay for women working full-time has increased almost 24 percent over the last four decades, compared with a 6.1 percent decline for men. While women are making progress in percentage terms, their real median earnings are about $180 less than their counterparts."

**Opioid crisis has cost US roughly 1M workers, $702B: study (The Hill)** "The U.S. economy has lost close to 1 million workers and $702 billion due to opioid addiction, according to a study released Tuesday. The American Action Forum (AAF) analyzed the impact of the opioid epidemic on U.S. labor force participation and output between 1999 and 2015. The group applied findings from previous studies on the economic impact of opioid addiction to data tracking the size of the U.S. workforce and GDP."

**The country is shrinking its tax base just as interest expenses surge and social (WSJ)** "If you think the federal debt is bad, the bigger picture is worse. A recent report from Moody's Investors Service shows why. Moody's is to governments what Experian is to individuals: a monitor of creditworthiness. The U.S., Moody's report shows, is blessed with extraordinary advantages when it comes to borrowing. Yet it is about to experience a dramatic loss of financial freedom because it is shrinking its tax base just as interest expenses surge and social programs get harder to cut. It is like someone who borrows freely thanks to his rich parents but can't keep a steady job and won't curb his lifestyle."

**The fiscal picture is worse than it looks—and it looks bad (Brookings)** "On the surface, CBO's new projections of the federal debt and deficits over the next 10 years paint a troubling picture. But, dig deeper and the story gets … more dire. The Federal government is not only running enormous deficits, but we are doing so at a time of full-employment. When the inevitable recession comes, we will be in deep trouble."

***PROPERTY MARKET VIEWS AND NEWS***

**Q1/18 first look: fundraising totals finally move upward (Institutional Real Estate, Inc.)** "Early numbers are in for real estate investment funds closing in first quarter 2018, and they look ... interesting. At this time last year, we were looking at only $12.4 billion raised by the 18 funds that closed in the first quarter of 2017. Today, we are seeing $27.4 billion raised by 21 funds closed in first quarter of 2018.

**Mall Vacancies Reach Six-Year High as Retail Slump Batters Local Economies (WSJ)** **"** Empty space in regional shopping malls reached a six-year high in the first quarter, adding further stress to regions being hit by a retail earthquake that is shaking up the job market across the U.S. The vacancy rate in big U.S. malls increased to 8.4% in the first quarter of 2018, up from 8.3% in the fourth quarter and the highest since the fourth quarter of 2012, according to real-estate data firm Reis Inc."

**The Surprising Affordability of Some Gateway Cities (Globe St.)** **"**The Urban Institute recently developed the housing affordability for renters index (HARI), a measure that examines the 20 most-populous US metropolitan statistical areas. HARI, which the Urban Institute developed in response to what it felt was a critical flaw in housing affordability measurements, found a few surprises about some of these cities. Namely: San Francisco, Seattle and Washington, DC, are more affordable for local renters than other measures indicate. The index also shows that, nationwide, more than one in four renters have incomes that put homeownership within reach."

**US population disperses to suburbs, exurbs, rural areas, and "middle of the country" metros (Brookings)** "Newly released census data for the first seven years of this decade signal a resumption of the population dispersal that was put "on hold" for a good part of the post-Great Recession period. The Census Bureau's annual county and metropolitan area estimates through 2017 reveal a revival of suburbanization and movement to rural areas along with Snow Belt-to-Sun Belt population shifts."

**Cranes up: West Coast dominates East in construction activity, survey says (The Real Deal)** "It's been a cold winter north of the border in Toronto, but crane activity was hot in January. The 88 construction cranes in the Canadian metropolis led Rider Levett Bucknall's biennial "Crane Index," which found North American activity hitting a new peak in the first month of the year."

***RECENT COLLIERS REPORTS***

**Warehouses Are Now Worth More Than Offices, Thanks to Amazon (Bloomberg)** "While China slams the brakes on buying trophy properties and the retail apocalypse draws nigh, something less sexy but striking is going on in real estate. Warehouses are now worth more than office buildings. Giant, high-tech warehouses, to be precise. These "big box" affairs are defined as having at least 200,000 square feet and 28-foot ceilings, in a report by Colliers International that calls out the surge in their value."

**MOB's New Attraction: Why institutional investors should consider adding medical office to their portfolios (Commercial Property Executive)** "Medical office buildings have long been considered a niche sector, but surging interest among investors and developers is rapidly bringing the asset category into the commercial real estate mainstream. The aging U.S. population—combined with the sector's long-term, stable returns and resistance to e-commerce—is providing a steady tailwind for MOB demand."
**Tech Tenants Continue to Lead US Office (Globe St.)** "The top US office markets posted generally solid performances in 2017, with average lease rates going up, and vacancy rates trending down, according to a new report from Colliers International. The company attributes much of the vibrancy to the need among tech-oriented tenants to expand. But the prognosis for 2018 is not uniformly rosy."

**US Office Market Will Stay Vigorous in 2018 (Globe St.)** "The US office market remained vigorous in 2017 with occupancy staying at peak levels and rents holding firm, according to a new report from Colliers International. The vacancy rate has been quite low for an unusually long stretch of time, and experts say the economy will most likely generate enough demand to sustain that dynamism even longer."

**Why Amazon May Be Picking Up More Retail Locations (National Real Estate Investor)** "Time to delivery is now the yardstick for e-commerce success, so "last mile" distribution space is of utmost importance to online retailers. With last-mile warehouse space in short supply and most of it in old, obsolete industrial buildings, it was only a matter of time before big-box stores began doubling as distribution space."

**Big-Box Industrial Finishes Another Historic Year (Globe St.)** "The North American big-box sector just finished another historic year, largely due to a healthy US economy that continued to expand, and the seemingly unstoppable rise of e-commerce, which now accounts for 10% of non-auto retail sales.Overall net absorption hit an all-time high of 116 million square feet in 2017, 2.4% higher than the previous year, according to Colliers International's latest Big Box Market Report, a series of studies that track the sector, comprised of distribution buildings with more than 200,000 square feet and clear heights of 28' or greater.

**Secondary Markets Set to Dominate 2018 Industrial Landscape (Commercial Property Executive)**
"The rise of e-commerce and healthy fundamentals are fueling the U.S. industrial sector. With multiple markets reaching all-time low vacancies and skyrocketing rental rates, there's no sign of slowdown in 2018. Expanding businesses need not only space, but also quality facilities and access to infrastructure and labor pools. Based on the above factors, Colliers International published a report highlighting the top 10 markets bound to reshape the industry's direction this year. As expected, activity is highest in core areas. However, secondary markets displaying demographic expansion, profitable lease rates and developable land recorded the greatest growth."

**Five Midwest cities make Colliers list of industrial markets to watch in 2018 (RE Journals)** "What do Cincinnati, Indianapolis, Kansas City, Memphis and St. Louis have in common? These are the Midwest industrial markets that Colliers International has pegged as some of the most important ones in 2018. The five cities made appearances on the Top 10 Emerging U.S. Industrial Markets to Watch in 2018 report compiled by Colliers. That's pretty impressive. Half of this year's list is made up of Midwest cities."