July 10, 2017 | Andrew J. Nelson, Chief U.S. Economist

THE ECONOMY AT MID-YEAR: Faster GDP Growth vs. Slowing Job Growth

- ***Recent economic figures point to stronger growth this spring than in this past winter.***
- ***Economic growth for all of 2017 should outpace that in 2016. However, job growth continues to slow as we near full employment, notwithstanding the strong June jobs report.***
- ***Below-target inflation and wage growth will likely limit Fed hikes this year and possibly next year as well.***
- ***Overall, the key property markets drivers are still positive, but we should expect future gains in market fundamentals to moderate.***

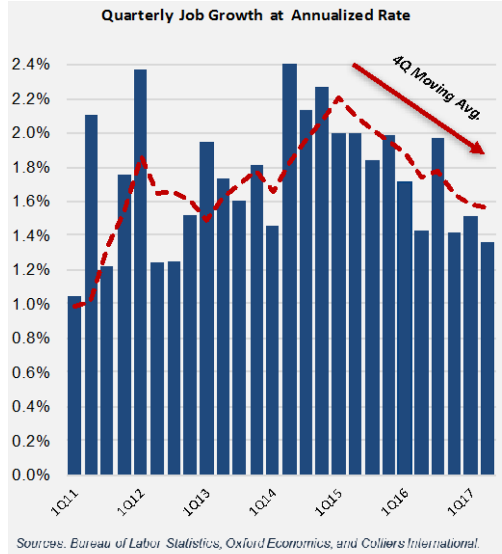
As we begin the second half of the year and await the preliminary GDP estimate for the second quarter (to be released on July 28), economists generally believe that growth has accelerated this spring after (yet) another slow winter. Actually, first quarter growth wasn't as slow as first believed, as the government again upgraded its GDP estimate to 1.4%, fully double its initial figure of 0.7%.

Still, the most recent data has been below expectations: retail sales, consumer confidence, housing starts, durable goods orders and inflation all dropped in the latest reports. However, both new and existing home sales rose in May — the rare exceptions to the downward trends. Little wonder then that the Q2 2017 forecasts from the Atlanta Fed's GDPNow model have been dropping. The GDPNow model still calls for a relatively robust 2.7% annualized growth during the second quarter, but the figure was 4% as recently as a month ago. Other sources suggest rates between 2.5% and 3%.

Looking further out, the average forecast from Consensus Economics calls for 2.2% growth for the year as a whole. This is better than the 1.6% growth in 2016 but still modest by historical standards, which has been the hallmark of this economic cycle. Business investment is now the strongest economic driver of GDP and is expected to grow 4.4% this year versus a decline of 0.5% last year. Meanwhile, the much larger consumer sector is anticipated to slow slightly, from 2.7% growth in 2016 down to 2.5% this year. With dwindling expectations of a stimulus package coming out of Washington this year, the consensus economic forecast is now about the same as it was prior to the November election.

On a more positive note, global GDP continues to strengthen. As reported in my last newsletter, growth in developing and advanced nations alike has been sluggish in recent years. But the International Monetary Fund (IMF) has been raising its global GDP forecast due to improving international trade, investment and manufacturing — all of which should eventually be positive for the U.S. economy. Now the Organization for Economic Cooperation and Development (OECD) has similarly upgraded its forecast for the rest of this year and 2018, as economic indicators continue to strengthen. These trends are somewhat at odds with the concerns over rising protectionism, which could derail or at least constrain economic growth.

Regardless, U.S. job growth appears to have peaked and is slowing as we near full employment, notwithstanding the strong June jobs report. This trend carries significant implications for property markets as jobs are the single greatest driver of space absorption. Firms tend to lease more space when they are adding headcount, although to a lesser degree today than in prior cycles as firms are being more efficient in space usage and more employees are working remotely.



Job growth has been among the strongest economic indicators in this expansion, helping to fill space vacated during the recession and new space constructed since. But as shown in the chart here, quarterly job growth peaked in mid-2014, and the four-quarter moving average has now declined for eight of the past nine quarters through Q2 2017. Accordingly, net absorption of both office and industrial space has been slowing in recent quarters.

To be sure, job growth is still robust, which will continue to fuel tenant demand for more space. But absent a significant economic turnaround beyond that expected by most economists, it seems the strongest job growth — and space absorption — of this cycle is likely behind us.

WHO YA GONNA BELIEVE: STOCKS OR BONDS?

Beyond econometric models of key economic indicators, analysts often look to the financial markets for indications of future economic activity. But lately we have been witnessing an interesting divergence in signs from the equity and bond markets.

Stock prices in the equity markets theoretically are based on investor expectations of future profits, so rising share prices should bode well for future economic conditions. Stocks are trading near record prices — indeed, the Dow Jones Industrial Average hit a record intra-day high on July 3 — suggesting investors are very confident about the economy. True, tech stocks have taken a hit over the past month, but they still closed the first half of the year up more than 16%, while the S&P 500 registered its strongest first-half performance since 2013, suggesting good times are ahead.

But there is ample reason to question the stock market's verdict on the economy. As I explained in a blog post last year, the equity markets "are not reliable indicators of the state of the economy — there are just too many disconnects between what floats stock prices and what drives our economy." For example, the major bourses are populated with global firms whose fortunes depend much more on foreign revenues than does the U.S. economy as a whole. Hence, the recent strong stock performance may say more about the improving global GDP outlook (mentioned above) than about our domestic economy.

Meanwhile, bond markets have their own forecasting rule of thumb, though it's rather more obtuse. This looks at the difference in interest rates on short- versus longer-term bonds, known as the "yield curve." Normally investors require higher interest rates on longer-term bonds to induce them to lend the government money for longer periods, so rates tend to increase with the term of the bond. But this relationship is inverted during a downturn as investors have greater faith in the long-term prospects than in the immediate term. Indeed, the yield curve has been the most reliable predictor of recessions.

Some analysts are concerned because the yield curve is flashing a signal of caution. Rate spreads have been falling in recent months and are now near their lowest point since this expansion began in 2010 — though still not inverted. Thus, the bond market may be signaling that it is pessimistic about future growth.

But here again there is reason to believe that "this time is different" — that the flattening yield curve is not, in fact, signaling slower growth ahead. First, the Fed has started pushing up interest rates but has much greater influence over short-term rates than long-term rates. Second, the rates on longer-term government bonds are being held down by strong demand from foreign investors, as even the historically low rates on our bonds still provide healthy yield premiums over rates in Europe and Japan. With the Fed pushing up short-term rates and foreign investors pushing down long-term rates, the flattening yield curve may be clouding its implied outlook for the economy.

Let this serve as a cautionary note against blindly following simple market rules. Sometimes they can provide a useful warning of impending economic change, but rarely do the signs agree early enough or with enough clarity to be meaningful. With the financial markets providing diverging guideposts, don't be surprised if this issue is debated until we're firmly in a recession!

IMPLICATIONS FOR PROPERTY MARKETS

Colliers International is now compiling the market data for our mid-year reports, but one key takeaway is already clear: Property fundamentals remain at their strongest of this cycle and generally on par with conditions at the peak of the prior cycle. Most sectors in most metros continue to experience positive net absorption, falling vacancies and rising rents — many to record highs. But gains are moderating as economic and job growth have slowed since 2015. The expected acceleration in GDP growth in Q2 2017 and beyond is unlikely to translate into significantly faster space absorption, absent a strong pickup in job growth, which seems even less probable.

Similarly, sales transaction activity remains robust, though well off levels reached earlier in this cycle. Sales have fallen in 12 of the past 16 months through May, mostly by double-digit declines. Together with other factors, this continued slide suggests property markets have peaked, as I explained in my last blog post. But perspective is in order here: As aptly summarized in a recent headline from Real Capital Analytics, "deal volume is falling but the sky is not." Property capital markets are still very healthy.

Indeed, anecdotal evidence suggests that demand for property remains strong but that capital is being more patient than in the previous cycle. As pricing in top markets reaches further into record territory, investors are seeking compelling risk-adjusted returns in secondary markets. These deals tend to be smaller and require more due diligence as the markets are less familiar, making it tougher for investors to place money quickly and further slowing transaction volumes.

Fed hikes to date seem to have had little direct impact on sales volumes as interest rates on mortgages have not moved nearly as much as short-term rates. But the impact on construction could prove to be more material, as construction debt tends to be based on LIBOR or other short-term instruments where the Fed's moves are having more impact. But with both inflation and wage growth muted and below Fed targets, analysts now expect the Fed to slow the pace of future rate hikes, with at most one more rate hike this year. Thus, the "lower for longer" approach seems likely to continue into next year at least, providing further support for property markets.

ANALYSIS OF RECENT ECONOMIC NEWS

U.S. retail sales in May are weakest in 16 months (MarketWatch) "U.S. retailers in May reported the biggest decline in sales in 16 months, largely owing to lower gasoline prices and fewer Americans buying new cars and trucks. Sales at retailers nationwide sank 0.3% last month, the biggest drop since January 2016, the government reported Wednesday. The May sales report was generally weak across the board. Economists polled by MarketWatch had forecast flat sales in May."

New-home sales roar back in May after April showers (MarketWatch) "Sales of newly-constructed homes rebounded in May, and government data was revised to show a stronger spring selling season than had been previously reported, another sign that the housing market remains on firm footing. New-home sales ran at a seasonally adjusted annual rate of 610,000, the Commerce Department said Friday. That was 2.9% higher than in April and 8.9% higher than a year ago."

U.S. existing home sales unexpectedly rise in May (CNBC) "U.S. home resales unexpectedly rose in May to the third highest monthly level in a decade and a chronic inventory shortage pushed the median home price to an all-time high. The National Association of Realtors said on Wednesday existing home sales increased 1.1% to a seasonally adjusted rate of 5.62 million units last month."

Consumer confidence drops to 7-month low (HousingWire) "Americans grew less optimistic in the economy in June, dropping to the lowest level in seven months, according to the Survey of Consumers conducted by the University of Michigan. The Index of Consumer Sentiment dropped to 94.5 at the beginning of June, down 2.7% from last month's 97.1 but still up 1.1% from 93.5 last year."

Inflation falls again in May as CPI recedes from recent high-water mark (MarketWatch) "The cost of goods and services for American consumers fell in May for the second time in three months as inflation continued to recede from a recent high-water mark. The consumer price index, or cost of living, fell by a seasonally adjusted 0.1% last month, the government said Wednesday."

US housing starts total 1.092M in May vs 1.215M starts expected (CNBC) "Homebuilders slowed down the pace of construction for the third straight month in May, a possible sign that the shortage of houses for sale might worsen. The Commerce Department says housing starts fell 5.5 percent in May to a seasonally adjusted annual rate of 1.09 million units. This comes after a 2.7 percent monthly decline in April and a 7.7 percent drop in March."

US durable goods orders fall 1.1% in May vs 0.6% drop expected (CNBC) "New orders for key U.S.-made capital goods unexpectedly fell in May and shipments also declined, suggesting a loss of momentum in the manufacturing sector halfway through the second quarter. The Commerce Department said on Monday that non-defense capital goods orders excluding aircraft, a closely watched proxy for business spending plans, dropped 0.2 percent, the largest decline since December."

OTHER WORTHWHILE READS

ECONOMIC NEWS AND VIEWS

Why Soaring Assets and Low Unemployment Mean It's Time to Start Worrying (WSJ) **"I**f you drew up a list of preconditions for recession, it would include the following: a labor market at full strength, frothy asset prices, tightening central banks, and a pervasive sense of calm. In other words, it would look a lot like the present."

Confidence Boomed After the Election. The Economy Hasn't (NY Times) "For all of business executives' apparent enthusiasm, the nation is adding jobs more slowly in 2017 than it did in 2016, and investment spending by businesses is growing modestly; new orders for capital goods are up only 0.7 percent so far in 2017. Consumers' spending was 2.7 percent higher in the first four months this year than in the same period of 2016, adjusted for inflation — which is slower than the 3.2 percent year-over-year gain at the end of 2016."

ISM vs. Markit PMI Divergence Widens Again: Believe Markit (Investing.com) "The manufacturing soft-data reports have been nearly unanimous in reporting widespread strength that has not shown up in any hard data reports. One exception has been Markit's US Manufacturing PMI report that has consistently been of a muddle-through quality."

PROPERTY MARKET VIEWS AND NEWS

Walgreens scraps Rite Aid deal, and instead will buy some stores in $5.18 billion deal (CNBC)
“Drugstore chain Walgreens Boots Alliance on Thursday called off its deal to buy Rite Aid after struggling to win antitrust approval. Instead, Walgreens will acquire nearly half of the smaller rival's U.S. stores for $5.18 billion in cash. Notably, Walgreens won't assume any debt from Rite Aid in this deal.”

What to Expect from the Logistics Sector as E-Commerce Grows Up (NREI) “Driven by new technologies and e-commerce growth, changes in the global supply chain are expected to impact industrial real estate for the foreseeable future. Since 2012, Amazon has been aggressively expanding its logistics and shipping services worldwide, disrupting traditional supply chain operators with direct competition for their business.”

What will the grocery business look like in 5 years? (Brick Meets Click) “Recent moves by Lidl, Aldi and Amazon are sending tremors through the food distribution/retailing business that will result in major changes over the next 5+ years, and the question on the minds of many is: What will the grocery business look like in 5 years? Here’s what we see happening.”

6 ways the Amazon-Whole Foods deal could impact the grocery industry (Food Dive) “For grocers weary from waging price wars, battling deflation and struggling to stay relevant amidst increasing competition for food dollars, the moves by Aldi and Lidl were two more blows in an already long and difficult battle. Amazon’s acquisition of the natural and organic foods pioneer, on the other hand, seemed to signal a tidal change in grocery retail that left many wondering what the larger impact would be on the industry.”

All of a sudden Americans are souring on the housing market (Business Insider) “Americans have been gung-ho in recent years about the housing market, bidding up prices with gusto as they went. The election helped. But since then, some dark clouds have appeared, and other dark clouds have been out there for a while — by some measures the darkest in the data series.”

Some Light Shopping With Your Drug Infusion? (WSJ) “Mall landlords across the U.S. are coming up with creative ways to fill space vacated by slumping retailers, from restaurants and gyms to trampoline parks and bowling alleys. One surprising addition? Large medical providers.”

RECENT COLLIERS REPORTS

Why Online Isn’t the End of the Physical Retail Store (Colliers Research with Colliers Retail Services and GlobalData) “Colliers International’s latest Retail Spotlight Report examines the myths, misconceptions and opportunities facing owners and retailers in the age of online shopping. This report explores the next chapter for U.S. retail, the demands based on consumer habits and the facts and figures that should make you ask: How can you find the right new opportunities?”

Industrial U.S. Seaport Outlook (Colliers Research with Colliers Industrial Services) “In this Industrial U.S. Seaport Outlook, we will explore these trends and their effect on ports throughout the country, providing insight into port capabilities and fundamentals and how they will affect the surrounding industrial real estate markets in the coming years.”

Retail Dimensions of Health Care Report - Part I (Colliers Research with Colliers Retail Services and Colliers Healthcare Services) “In this two-part report, we explore the ways health care facilities are approaching location in retail and community settings, as well as the ways retailers are leasing space in hospitals and other medical properties. In Part I, we examine the factors driving the increased presence of health care in retail properties from three perspectives: those of the consumers, providers and landlords.”

10 Emerging U.S. Industrial Markets to Watch in 2017 (Colliers Research with Colliers Industrial Services) "While core industrial markets in New Jersey/Pennsylvania, the Inland Empire, Atlanta, Chicago, Houston and Dallas will continue to thrive, we believe these 10 emerging U.S. industrial markets are positioned to experience the most robust increases in demand from both occupiers and owners. Each of these markets is unique, but they share advantages such as nearby logistics hubs, attractive rental rates, land available for development, large nearby populations, pro-business atmospheres and skilled workforces."