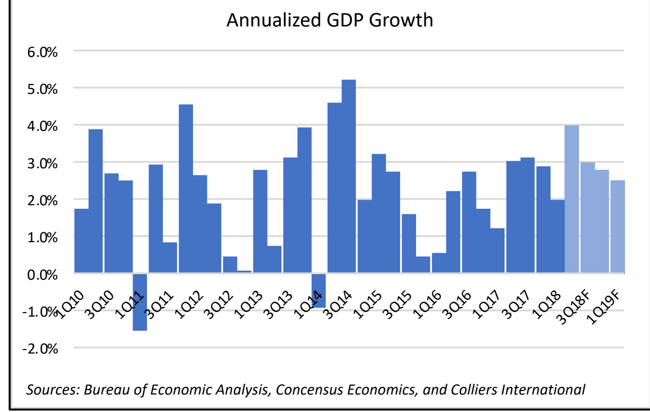
Summer Newsletter | July 19, 2018 | Andrew J. Nelson, Chief U.S. Economist

THE ECONOMY AT MID-YEAR: As Good as it Gets?

- ***Recent economic data suggests growth picked up appreciably this spring after another moderate winter. Economic growth for all of 2018 should be the strongest in years.***
- ***Meanwhile, job growth continues to be healthy but well off its pace from earlier in the cycle as we near full employment.***
- ***With inflation and wage growth now within their target ranges, the Fed will continue its planned pace of moderate hikes this year and next year, providing the seeds for slower growth by 2020.***
- ***Growing trade tensions presents the greatest risk to continued economic growth, but the rising dollar provides another headwind to U.S. trade and prosperity.***
- ***Property market fundamentals remain near peak levels for this cycle, but further gains will continue to moderate in most sectors.***

Almost everyone, it seems, is happy with the state of the U.S. economy. Surveys of both consumers and business leaders remain near 20-year highs. OK, not everyone. As in many aspects of our national experience, there is a decided split in perceptions of what's going right or wrong in the country that is at least partly explained by party affiliation. But overall, most Americans are pretty positive about the current economic conditions.

As well they should. Despite yet another slow start to the year – GDP growth in the first quarter was adjusted down to just 2.0% – early indicators suggest that growth in the second quarter will be among the strongest in many years. The Atlanta Fed's GDPNow model is predicting a very robust 4.5% growth this spring, at the high end of the range of forecasts by leading economists. (The first official estimate of second quarter GDP will be released on July 27).



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

Growth for all of 2018 is expected to reach 3% by the panel of economists surveyed by the Wall Street Journal, which would be the highest rate since 2004. Meanwhile, the economy continues to create new jobs at a healthy rate – averaging just under 200,000 nonfarm payroll jobs per month over the past year, about the same as in 2016.

Several factors are contributing to this stronger economic growth. As noted in our last quarterly newsletter, the U.S. economy has benefited from synchronized growth aboard fueling export demand for our products. Business investment has been strong ever since the election of Donald Trump, partly based on expectations of favorable regulatory and tax policies. And the federal tax cuts and reform passed last year and the expansion of federal spending authorized this year are providing a jolt to the economy, with consumer spending peaking sharply.

Gathering Headwinds

Still, there is a growing sense of unease about the economic outlook, much of it apparently related to rising trade tensions. The University of Michigan consumer confidence survey fell in July to its lowest level in six months, although it remained near its average over the past year. More than a third of people surveyed cited concerns about the rising import tariffs, more than double the share in May.

Economists and investors seem to share the concern. Two-thirds of economists surveyed in the WSJ poll believe that risks are now weighted to the downside, compared to only one in four economists at the beginning of the year. Many Wall Street analysts blame fear of escalating trade tensions for the recent slide in share prices, though the Fed downplayed the threat in its generally optimistic report to Congress last week.

Regardless, economists overwhelmingly expect growth to cool over the next couple of years. Already, the International Monetary Fund (IMF) has concluded that global economic growth appears to have peaked, with growth slowing notably in Europe and China, thereby reducing demand for U.S. products.

Moreover, the impacts of the fiscal stimulus are expected to be short-lived, with benefits fading starting in the next year. The rising dollar is another headwind for U.S. exports, potentially offsetting the benefits to U.S. producers of tariffs on imports. Though down from its recent peak at the end of 2016, the trade-weighted dollar index is now up about 7% since President Trump announced in Davos that America would be adopting tougher enforcement of trade rules.

Finally, all indications – including the Fed's own words – suggest that the Fed will continue its policy of gradual rate hikes, reflecting its view that the economy is growing at a "solid pace" and the job market is "strong." The cumulative impact of rising interest rates will eventually cool economic growth as businesses pull back on investing and consumers reduce spending, particularly on big-ticket items like autos and homes that require financing.

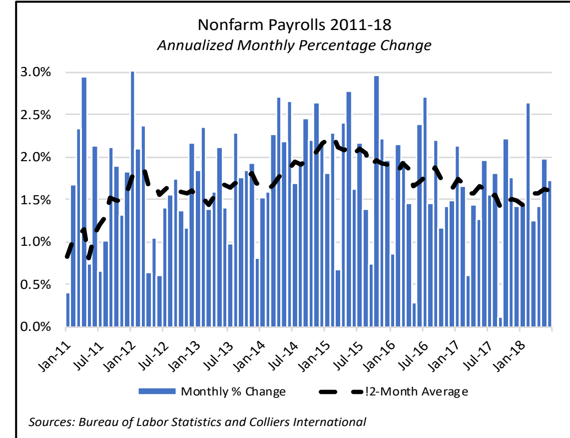
In summary, we expect robust economic growth to continue this summer and through early next year. But the economy is likely to start slowing by mid-2019 and certainly 2020. Significantly, that does not necessarily mean a recession is in the offing – and certainly not a recession as deep, long, or widespread as the last one – though signs are gathering for a least a moderate downturn in the next couple of years (see next section on the yield curve). Nonetheless, in this time of plenty, the seeds for slower growth are already being planted.

Slowing Job Growth

But even more important for property markets is that fact that U.S. job growth is slowing, as jobs are the single greatest driver of space absorption. Though the relationship is not inviolate, firms tend to lease more space when they are adding headcount. But both job growth and space leasing peaked some three years ago.

To be sure, the economy continues to create new jobs at a healthy rate, as noted above. But the pace of job growth is easing. Measured on a percentage basis, as we do for GDP, job gains peaked in early 2015 and fell steadily through the end of 2017, though increasing modestly in recent months (black dotted line in the graph).

The reason for the slowdown is clear: the U.S. economy is now close to "full employment" – when everyone who wants to work has a job. The unemployment rate is now at 4%, near its lowest point in almost 50 years and well below its long-term average.



This means there are fewer workers available for the positions firms are trying to fill, as many industries report growing labor shortages. As a result, positions are going unfilled and hiring inevitably slows, as explained in more detail in my recent blog on slowing job growth.

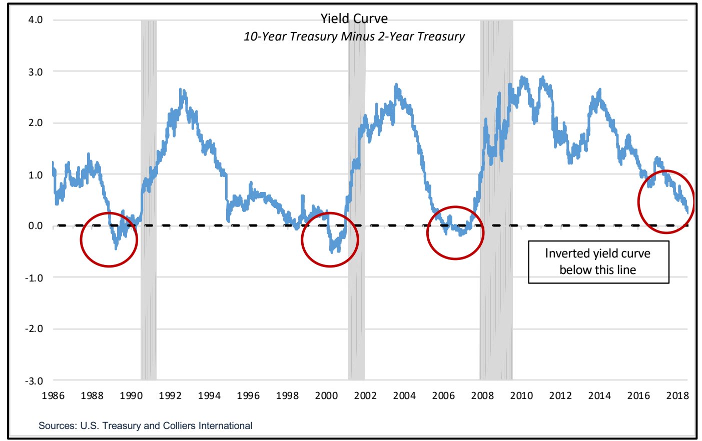
So, while job growth remains healthy and property occupancy remains strong, job growth will continue to moderate, leading to continued slowdown in property leasing. The notable exception is industrial real estate, which has thrived with the shift to online shopping prompting a dramatic expansion and overhaul in how goods move from manufacturer to consumer. Unless we see a significant rise in job growth – which seems unlikely at this late stage in the economic cycle – don't expect the temporary pickup in economic growth to translate into meaningful CRE space absorption.

"Is it Time to Worry about the Flattening Yield Curve"?

That was the question posed last week by Capital Economics, a leading economic research forecasting company, and a concern increasingly raised by Wall Street analysts and even the Fed.

The "yield curve" is the difference in interest rates on short- and longer-term bonds. Interest rates normally increase with the term of the bond reflecting the greater uncertainty and opportunity cost to investors associated with longer bond maturities. But this relationship is inverted during a downturn as investors have greater faith in the long-term economic prospects than in the immediate term. Indeed, the yield curve has been the most reliable predictor of recessions, which typically start within 12 to 18 months after the spread inverts.

Accordingly, investors become concerned when the yield curve begins to flatten – that is, when the rates on short-term bonds approach those on longer-term bonds, typically measured by the yields on two-year versus ten-year Treasury bonds, respectively. That spread has been falling fairly consistently since 2013, and for the last few days has hovered at about 25 basis points – its lowest point since before the last recession, and a clear warning sign to many economists.



But others are more sanguine arguing that the recent flattening of the yield curve reflects not concerns with the near-term economic outlook but rather global demand for longer-term U.S. bonds, which is driving down interest rates. From this perspective, the spread reflects a decline in the term premium for ten-year bonds, making the yield curve a less reliable indicator.

A variation on this view is that the Fed's policy of bond purchasing to keep rates lower than normally would be the case (known as quantitative easing), is also keeping the yield curve flatter than it normally would be, again making it a weaker signal.

It should be noted that this is hardly the first time that economists have debated the predictive value of the yield curve. There was a furious debate about what the inverted yield curve in the last economic cycle was really signaling – and then on cue, the recession emerged about two years later.

So back to Capital Economics and whether it's time to worry about the yield curve: Maybe it's not time to panic, but attention should be paid. Capital Economics expects the yield curve to finally invert by mid-2019. "And although [they] aren't explicitly forecasting a recession, [they] do expect GDP growth to slow sharply in 2020, as the fiscal boost fades and tighter monetary policy takes its toll."

IMPLICATIONS FOR PROPERTY MARKETS

The near-term economic forecast is about as strong as it has been in this economic cycle, but commercial real estate professionals should not be deluded into believing this pickup portends a new leg in the cycle. First, the 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 importantly, across most property sectors, tenant demand for space is more closely associated with job growth than with economic growth, and this outlook looks much more moderate, largely because the ranks of unemployed workers available to be hired is largely exhausted. Accordingly, we do not anticipate significant growth in property leasing this year outside of the surging industrial sector, which is benefiting from the shift from in-store to online shopping.

ANALYSIS OF RECENT ECONOMIC NEWS

Americans' Sentiment Falls as Worries Multiply Over Tariffs (Bloomberg) "U.S. consumer sentiment dipped to a six-month low in July as Americans became increasingly concerned about the fallout from an expanding trade war, a University of Michigan survey showed . . . While sentiment remained relatively elevated as a tight labor market and tax cuts continue to buoy incomes in the world's largest economy, Americans' worries over tariffs 'greatly accelerated in early July,' according to the report."

China's Cooling Economy Spells Trouble Ahead for Global Growth (Bloomberg) "Confirmation that China's economy is slowing amid an escalating trade war is a worrying omen for global growth . . . [A]n ongoing campaign to curtail credit is putting the brakes on the world's second-largest economy. Given that China generates as much as a third of global growth, that's adding to signs that the best world expansion in years is plateauing."

IMF says the global economic expansion has 'plateaued' (Bloomberg) "The sunny outlook for the global economy seen this spring has gotten a lot darker, the International Monetary Fund said Monday. Growth is slowing in the euro area, Japan and the United Kingdom, the IMF said, in an update of its world economic outlook. The IMF continued to project global growth rates of 3.9% for this year and 2019, but said this strong growth is 'less even, more fragile [and] under threat.'"

Strong retail sales report suggests robust economic growth in the second quarter (CNBC) "U.S. retail sales rose solidly in June, boosted by increases in purchases of motor vehicles and a range of other goods, cementing expectations for robust economic growth in the second quarter. The Commerce Department said on Monday retail sales increased 0.5% last month. Data for May was revised higher to show sales rising 1.3% instead of the previously reported 0.8% gain. May's rise in retail sales was the largest since September 2017."

Tax Law May Stimulate Economy Less Than Expected, or Maybe Not at All (WSJ) "The tax cuts Republicans enacted in late 2017 will likely provide less of a boost to economic growth than many

forecasters predict — and possibly none at all — economists at the Federal Reserve Bank of San Francisco. That's because the changes took effect at a time when the economy was already firing on all cylinders. As a result, there are fewer unemployed workers, spare resources and idled factories ready to kick into action than there would have been during a downturn."

Goodbye inverted yield curve? Fed looks for alternative signals to guide policy (Reuters) "Federal Reserve officials are scouring new niches of the financial markets to find signals accurate enough to warn the central bank when it is time to stop hiking interest rates before they risk tipping the economy into a recession. In the run up to previous downturns, the Fed has jacked interest rates to restrictive levels as it sought to temper inflation. This time, the central bank hopes for a softer landing with rates moving just high enough to avoid overheating without ending a nearly decade long expansion."

What's the Yield Curve? 'A Powerful Signal of Recessions' Has Wall Street's Attention (NY Times) ". . . if you're in the business of making economic predictions, it has become very difficult to disregard an important signal from the bond market. The so-called yield curve is perilously close to predicting a recession — something it has done before with surprising accuracy — and it's become a big topic on Wall Street."

OTHER WORTHWHILE READS

ECONOMIC NEWS AND VIEWS

Without Better Training, U.S. Will Fall Short on Workers, Economists Say (WSJ) "White House economists have identified a potential stumbling block to maintaining the U.S. economy's momentum: a lack of well-trained workers. The economy appears poised to expand this year at the fastest clip since the recession ended in 2009. That has allowed employers to extend their streak of consistent hiring, which began in 2010, and push the unemployment rate to nearly its lowest level in 50 years. But there also is a growing gap between the rising number of job openings and the number of workers equipped to fill them, and this could limit growth in the long run, according to a paper from President Donald Trump's Council of Economic Advisers released Tuesday."

The Immediate Economic Impact of the Tax Cuts and Jobs Act Could be Even Less Than Expected (ITEP) "Before the recent tax law passed, multiple economists across the political spectrum warned it was an ill-timed fiscal stimulus that could leave policymakers in a quandary should the country face another economic recession in the near future. Now, new research from the Federal Reserve Bank of San Francisco finds that the Tax Cuts and Jobs Act may not be so much of a stimulus after all. In other words, lawmakers have left themselves with few options should the country face an economic recession, *and* the country may not receive a substantive economic benefit in the short term."

Bernanke, Geithner, Paulson Voice Some Concern About Next Crisis (Bloomberg) "Federal Reserve policy makers appear confident that they have the weapons they'll need to fight the next financial crisis. Some of their predecessors on the front lines are not so sure. Ben Bernanke, Timothy Geithner and Henry Paulson all voiced varying degrees of concern about America's ability to combat another financial meltdown 10 years after they played prominent roles battling the last one. While agreeing that the banking system is a lot stronger than it was back then, they saw some weak spots in the country's crisis-fighting arsenal that didn't exist a decade ago."

Wages aren't growing when adjusted for inflation, new data finds (MarketWatch) "Wages aren't growing when adjusted for inflation, a new report released Tuesday showed. According to the Labor Department, median weekly earnings fell 0.6% in inflation-adjusted dollars in the second quarter, compared to the same time period of 2017. That's now the third straight quarter where inflation has outpaced wage growth."

Growth in Trade Is Already Starting to Slow (WSJ) "Even before a round of U.S. tariffs levied on China comes into force Friday, there are signs that global trade is already cooling. Business surveys published this week show that global export growth, strong in 2017, has slowed to a relative crawl—helping to drive sharp stock-market falls in big exporting nations like South Korea and Japan. The data suggest that the synchronized world-wide growth that sustained global markets and company earnings for much of last year is already starting to run on empty. And that slowdown is likely to have a greater impact on trade than the developing conflict among the U.S., China and other major economies."

PROPERTY MARKET VIEWS AND NEWS

U.S. Commercial Property Values Surge in Niche Sectors (WSJ) "Student housing, manufactured homes and industrial property were the top performing commercial real-estate sectors in the past 12 months, according to new data from Green Street Advisors. These three sectors outperformed the broader commercial property market, which saw values remain flat between June 2017 and the end of the first half of this year. Meanwhile, values fell 10% in the hard-hit retail sector during the 12-month period, according to Green Street, which tracks the market with its Commercial Property Price Index."

Final Verdict: Workers Hate Open Offices And They Reduce Productivity (Bisnow) "It has been one of the pillars of modern office design and workplace theory: open offices, with fewer walls, doors and spatial boundaries, encourage interaction and collaboration between workers. . . But a new study from two Harvard academics, published by the Royal Society of Great Britain, suggest that this idea has no basis in reality, and that office design should be more nuanced. That is because their research shows that open office spaces actually cause workers to interact with each other less frequently and the office layouts kill productivity.

Young Americans buying fewer houses (IREI) "Homeownership rates among young adults today are even lower than in 1988, because of pressures created by elevated housing construction costs, weak income growth among low- and moderate-income households, and expensive land prices, according to The State of the Nation's Housing 2018, a comprehensive annual report produced by the Joint Center for Housing Studies of Harvard University.?

Brick-And-Mortar Retailers Rush to Open More Fulfillment Centers As They Strive to Keep Pace in a Changing Landscape (Co-Star) "Sam's Club plans to spend the coming months converting closed stores into distribution centers to fill online shopping orders, joining other national retailers in scrambling to grab up warehouse, industrial or even former big box store properties in response to the boom in e-commerce. In another sign of a rapidly changing retail landscape, the rush to seize these properties is prompting developers to revitalize industrial areas across the country. Retailers are seeking to cut delivery times and transportation costs, raise their e-commerce capabilities and compete with a changing landscape driven by Amazon, which operates more than 300 distribution and delivery centers that process shipments from other parts of the country to get individual packages to the homes of shoppers."

Development Pipeline Creates Near-Term Risks for Multifamily (MultiHousing News) "A study by Yardi Matrix of demand and supply trends in the top 30 U.S. metros by population over the next five years found that multifamily deliveries may outpace demand in some of the top 30 U.S. metros over the next two years. That should create volatility as some markets and submarkets with outsized development activity experience rising vacancy rates and stagnating rent growth."

Sorry, Power-Lunchers. These Tables Are Reserved for Drop-In Workers (NY Times) "Everything is now a co-working space, one of those shared offices that are popular among freelancers, small companies and other workers who want a change of scenery. Coffee shops are co-working spaces. Gyms are co-working spaces. Social clubs are co-working spaces. And now restaurants — but only before dinnertime."

US-focused fundraising hits lowest level in six years (PERE) "Private real estate fundraising during Q1 2018 showed noticeable shifts in terms of the geographies and sectors where investors are putting

their capital, according to newly released *PERE* data. The amount of capital raised during the first half of 2018 held steady at $60.56 billion, just slightly above the $60.23 billion amassed during Q1 2017. Last year marked the lowest private real estate fundraising volume in the past six years, with an aggregate $114.49 billion collected, down from the 2015 peak of $152.52 billion, the data showed."

RECENT COLLIERS REPORTS AND BLOGS

It's *not* the economy. It's the jobs (at least for CRE) "With the economic growth heating up, property owners may be expecting this to translate into comparable rates of greater space absorption. But these expectations should be tempered. No doubt there will be some pick-up in leasing associated with the spike in GDP growth. But owners should focus more on job growth as better gauges for leasing prospects, and this outlook looks much more moderate, mainly because the ranks of unemployed workers available is largely exhausted."

The Supreme Court's Online Sales Tax Decision: A Welcome Boost of Fairness for Physical Retailers – But No Panacea for the Ailing Sector "In a decision long sought by the nation's shopping centers and local governments, the U.S. Supreme Court ruled last week that states and municipalities can require online retailers to collect sales taxes on e-commerce transactions in their jurisdictions . . . While physical retailers surely will benefit from this decision, it's not clear that this ruling alone will do much to boost the beleaguered conditions of shopping centers today."

Law Firm Services Group: 2018 North America Outlook "In this report, we examine how to achieve space efficiency and control costs while attracting the best talent. The North American office market is nearing a potential inflection point while law firms continue to wrestle with implementing new real estate standards. To provide insight into the key real estate trends for law firms to consider, this report highlights the office market characteristics and law firm activity in each of the 24 North American real estate markets covered by Colliers' Law Firm Services Group."

U.S. Industrial Market Spotlight: Charlotte "Located at a strategic point on the East Coast between major ports and inland cities, the Charlotte region provides easy access to the bulk of the United States' population. Transportation assets include Charlotte Douglas International Airport; the intersection of two major interstate highways; an inland terminal operated by the North Carolina Ports Authority; Norfolk Southern's state-of-the-art intermodal facility; and CSX's recently launched direct rail service to the Port of Wilmington."

Q1 2018 U.S. Office Market Outlook Report "As highlighted in Colliers' Q1 2018 U.S. Office Market Outlook, the U.S. office market showed continued strength in Q1 2018. The office occupancy rate has remained near its cyclical peak for nine successive quarters and rents showed an uptick in the first quarter. The market remains on very solid ground although absorption and sales volume have fallen."

Occupier Activity Remains Strong Thanks to 3PL and E-commerce Transactions "Occupier activity across the United States continues to be robust, particularly in bulk industrial space defined as 100,000 square feet and larger. Over the past 12 months (June 1, 2017 to June 1, 2018) 1,184 industrial (warehouse, manufacturing, flex) transactions (new lease, user sales, renewals) have signed in spaces 100,000 square feet and larger, totaling 305 million square feet. This is only slightly lower than the 1,255 transactions signed in the 12 months prior, totaling 331 million square feet. The average size of a bulk transaction remained nearly the same, at 261,000 square feet, only slightly lower than the 264,000 square feet average the previous year."

Q1 2018 U.S. Industrial Market Outlook Report "Our Q1 2018 U.S. Industrial Market Outlook Report highlights that the U.S. industrial sector continues to perform exceptionally well, with robust net absorption, rent growth, construction and occupancy, all fueled by the continued growth of e-commerce and a solid U.S. economy."

Q1 2018 U.S. Top Office Metros Snapshot: Most Major Office Markets Hold Steady in First Quarter 2018 "The Q1 2018 U.S. Top Office Metros Snapshot report shows that most major office markets in the U.S. held firm in Q1 2018. Changes in vacancy and rental levels were mostly marginal. Tenants continue to seek the newest, high-quality space to retain and attract the best talent and provide an optimal work environment. Pre-leasing of new construction is required to meet major requirements in most markets."

Retail Market Spotlight Report | Spring/Summer 2018 "In the past year, the CRE industry's retail sector has undergone a market revolution. The most notable highlights include the tumbling demise of iconic brands like Sears and Toys R Us, while underdog niche brands like ASOS and Daniel Wellington rose in popularity, and behemoths like Amazon and Jet.com claimed their stake offline."

Southern U.S. Dominates Industrial Activity in Q1 2018 "The Southern U.S. dominated activity in Q1 2018 evidenced by nearly 23 million square feet of net absorption, 46.5% of the total net absorption in the U.S. Occupiers continue to move into the market in droves because of the region's growing population and significant logistics advantages. At the time of this report, over 111 million people lived in the southern region, the most of any region in the country, and this is expected to grow by a nation-leading 6.4% over the next five years."

U.S. Industrial Market Spotlight: Sacramento "Located just 90 miles northeast of San Francisco, the Sacramento industrial market was one of the top growing industrial markets in the country in Q1 2018. Over 17 million people live within 250 miles of the market's core, making it an ideal location for retailers, wholesalers and third-party logistics (3PLs) to locate."

2018 Industrial U.S. Seaport Outlook "U.S. seaports help deliver vital goods to consumers, ship exports overseas and support millions of jobs. In fact, seaports are a vital economic engine for the U.S., and are one of the top demand drivers for industrial real estate. The major seaports across the country all posted strong results in 2017 for both loaded inbound and outbound container volume for a variety of factors. Our latest report, the 2018 Industrial U.S. Seaport Outlook, presents an engaging, visual representation of the key facts about the major seaports."

And don't miss **"Your Q1 2018 Market Insights Hub"** for the office and industrial sectors – your dashboard and comprehensive source for Colliers market data.