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Eye on the Economy – August 2015

At mid-year 2015, the underlying economic support for the commercial property sector is as strong as it has been since the peak of the last economic cycle in 2007-2008. Unlike that peak, there is little of the frothiness of the housing bubble boom and room for even more upside in this business cycle. Looking forward into 2016, what clouds loom for commercial real estate are in the potential for tighter fiscal policy to disrupt the good times.

The principle source of optimism and strong real estate performance has been the labor market. Employment grew by some 3.1 million jobs in 2014, reaching a new historical high for the number employed in the U.S. Coupled with construction volumes that are still some 30 percent below the pre-recession peak, the demand for office and industrial space outstripped supply by a considerable amount. That created good news for occupancy and rental rates.

The July 2 jobs report showed that 1.3 million jobs had been created during the first six months of 2015, dropping unemployment to 5.3 percent. The decline in unemployment was attributed to a further decline in the workforce rather than the rise in employment. While the trend of lower workforce participation is troubling – the 62.6 percent labor participation rate was the lowest since October 1977 – the decline thus far in 2015 has been primarily from people who were fully employed leaving the workforce, rather than unemployed workers giving up.

The job gains occur as consumers grow more confident about the outlook for the economy and their own finances. Consumer spending rose 2.9 percent in the second quarter following an increase of 1.8 percent from January through March., reflecting pent-up response to lower gas prices since mid-late 2014. Consumer confidence showed strength in how people viewed the current situation with less confidence about the future. The Conference Board said June 30 that its consumer confidence index rose to 101.4 in June, up from a May reading of 94.6, but declined again in July to 90.9. The survey of current conditions found consumers registering an index of 107.4.

Consumers are in a better position to contribute to the economy that at any time since the housing bubble in the mid-2000s. Today, however, the consumer balance sheet is much improved. Debt-to-income ratios are lower than have existed for 30 years or more. Home values are improving at a higher pace, beginning to recover the ground lost after the mortgage crisis. Home inventories are low – with little more than a five-month supply available – and new construction has only topped the million-unit mark within the past year. There are fewer obstacles to healthy consumer spending, a driver of 70 percent of the economy.

The economy in Western Pennsylvania picked up steam in May and June as more people entered the labor market and employers added 15,700 and 6,700 jobs respectively. The year-over-year increase through six months has been 23,500 non-farm jobs. The seasonally adjusted unemployment rate is generated from a separate survey of households, which showed the labor force grew by 6,400 people to 1.22 million people.

“There are a lot of positive things going on that are more solid than we’re used to seeing in the past 15 years,” notes Jack Shelley, senior vice president for real estate lending and services for Dollar Bank. “When things heat up, developers tend to fall in love with every opportunity and that’s how things get overbuilt. Right now that’s not happening, even though we’re seeing more development than in many years. We’re starting to catch up with ourselves with pent-up demand.”

The improvements to the consumer side of the economy offset softness in business investment and government spending to drive a 2.3 percent increase in gross domestic product (GDP) during the second quarter. Growth was muted by a slight decline in equipment expenditures and a 68.2 percent decline in mining and drilling by oil and gas companies. The measure of private domestic demand – which strips out trade, inventories and government spending – rose 2.5 percent. The rise in GDP was somewhat below economists’ expectations, but that was in part due to revisions that the Bureau of Economic Analysis (BEA) made to the first quarter GDP – which now shows a 0.6 percent increase – and its methodology.

A trend that the BEA is investigating – and is expected to provide explanation and guidance about later this year – is the disparity in growth between the first quarter and subsequent quarters. Real GDP growth typically declines ten percent in the first quarter of the year, without seasonal adjustments, and the second quarter then rebounds by roughly 20 percent. Since 2000, however, the seasonally-adjusted growth rates have been much lower during the first quarters and have fallen precipitously after 2010. Because most analysts forecasted a solid first quarter 2015 based on other economic data, the decline seemed to really spark questions this year.

The methodology for seasonal adjustments relies on adjustments to the individual categories within GDP that are then aggregated to reach a total. This top line GDP may be affected by “seasonal interactions between the components themselves that get skewed once aggregated,” offers Kurt Rankin, vice president and economist for the PNC Financial Services Group. Rankin is quick to point out that this is his best guess of the reason, but notes that seasonal adjustments are arbitrary and seem to need some revisions to make the adjusted comparisons valid.

This may seem like a lot of economic nit-picking but when you consider the key role that consumer and business confidence played in prolonging the recovery after 2011 and the role that GDP growth is playing in the Federal Reserve Bank’s decision-making on interest rates, getting the rate of real growth right isn’t a trivial matter. In fact the Federal Reserve Bank of San Francisco (FRBSF) studied this “residual seasonality” and in its May 18 Economic Letter concluded that the BEA is not adjusting out calendar impacts. After doing its own round of adjustments, the FRBSF estimates that GDP grew at a much faster rate from January through March.

Regardless of whether or not there is as dramatic a rebound in the second and third quarters of 2015 as in 2014, there are few domestic head winds to slow the U.S. economy. June and July brought reminders that some of the world's largest economies aren't on as firm a footing as the American economy, but thus far the ripples from the Greek debt default and the slowdown in China have barely been felt in the U.S.

As had been predicted, the small size of the Greek economy and the certainty of the ultimate outcome of negotiations to restructure its debt rendered that "crisis" insignificant to the U.S. Few options existed for Greece except to agree to austerity measures and social changes that the European Union – and mainly Germany – made as provisions for extending a lifeline. While there was media discussion of Greece's problems imploding the EU, there was little likelihood of that happening. U.S. investors and businesses behaved as though there was little chance of a Greek default triggering a global financial event, and indeed, when a deal was struck the reaction to the agreement was muted.

Of more potential danger is a recession in China. Concerns over a real estate bubble persist and the level of consumption and investment by Chinese companies has declined compared to the decade-long trend; however, Chinese GDP growth remained at seven percent in the second quarter, slightly higher than the 6.9 percent that was forecasted.

Chinese stock exchanges have gotten headlines for the recent volatility but the Shanghai Index has risen more than 20 percent since January 1 and Hong Kong's Hang Seng Index is up roughly six percent. Investors in Chinese stocks seem to have an increasing level of anxiety over the role the Chinese government will play in supporting the markets. China has purchased blue-chip stocks through a portfolio called the China Securities Financial Corp. and has dialed back inflows into the market, either to test whether stocks can be supported without intervention or because its own liquidity is constrained. Few observers believe it is the latter and government response to significant weekly or daily selloffs seems to reinforce that opinion.

These two highlights of the global economy reflect the environment in which American companies must do business. Weaker demand and weak economies in Europe – coupled with the fear that the Eurozone may yet dissolve – continue to create pressure to maintain loose monetary policy. Likewise, a softer Chinese economy will be an incentive for the central bank there to stimulate growth. Either of these scenarios, let alone the relative strength of U.S. businesses, makes investing in U.S. assets more inviting. For at least the balance of 2015, U.S commercial real estate assets will be among the favorite of those foreign investments.

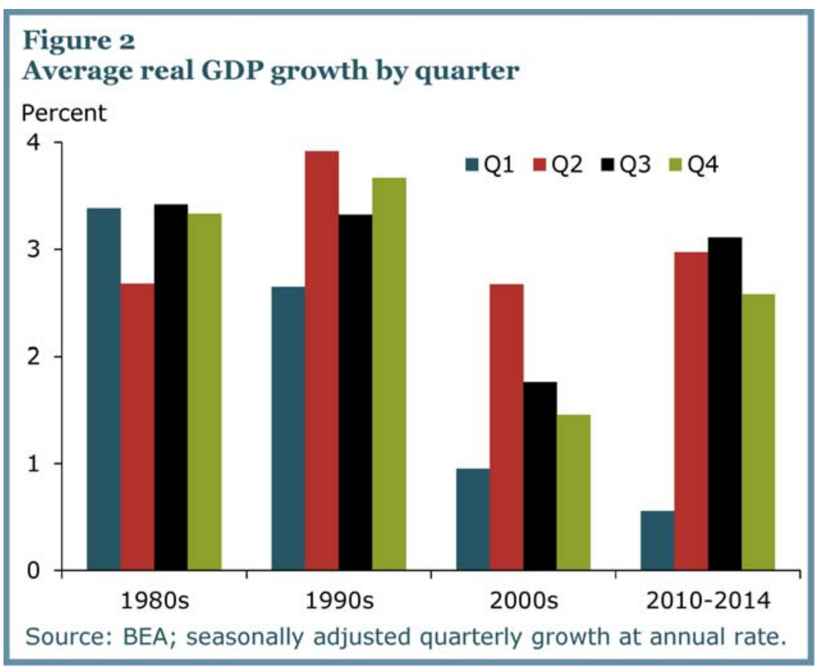
It is the favored position of U.S. real estate that might give some observers pause, as the market conditions begin to more closely resemble those in 2007. Certainly there are similarities to that period from the perspective of capital chasing assets but there are a number of metrics that indicate a difference in markets.

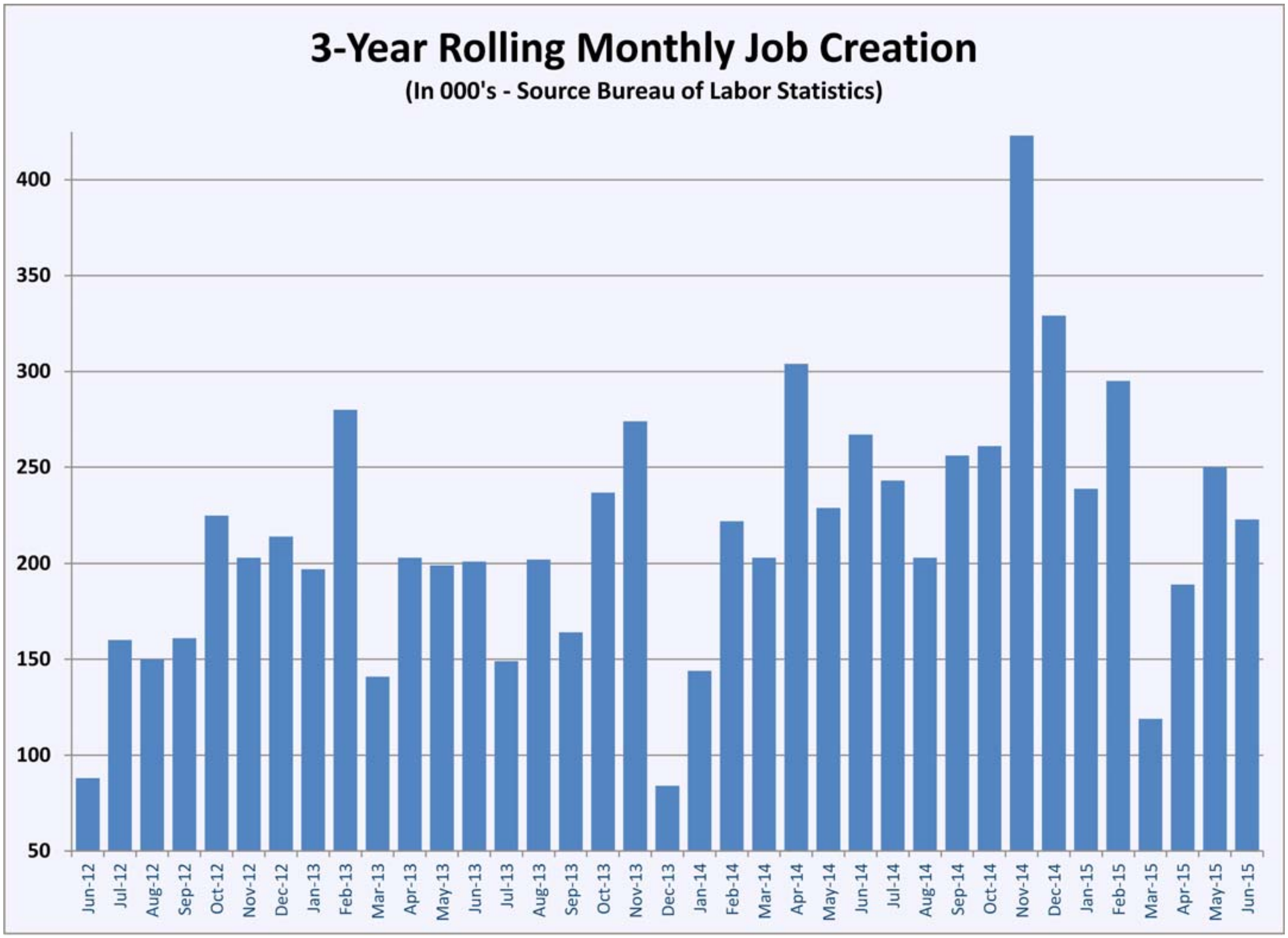
For one, there is virtually no asset class that has been overbuilt in the way the housing market was in 2007. There is an argument to make for a bubble in apartment construction but the number of new apartments in the pipeline is not near some of the historical highs of previous cycles and both occupancy levels and rents continue to climb for apartments. For the remaining commercial real estate products, regulatory constraints have kept pressure on appraisals and loan-to-value ratios that have restrained property valuations. It's difficult to make a case that any commercial asset class is artificially inflated, except to the degree that the low interest rates are factored in. Interest rates would seem to be the main risk factor looming for the real estate market.

In her most recent remarks to Congress, Federal Reserve Bank Chair Janet Yellen signaled that the Fed was finally ready to raise rates. Neither the stock markets nor the Treasury debt market mustered much of a response to Yellen's remarks, creating the impression that the first increase or two is already priced into the markets. At this point, there seems to be confidence that the Fed will manage any tightening skillfully and that the increases that occur over the next 12 to 18 months will be small.

For an industry that depends upon job growth, consumer confidence, economic stability and appetite for yield as its recipe for success, commercial real estate is in a very strong environment for the next 18 to 30 months. The primary risk appears to be higher interest rates, a risk that seems remote and limited in its impact.

Seasonally-adjusted GDP growth rates for the first quarter have declined steadily over the past four decades. Source: Federal Reserve Bank of San Francisco.




3-Year Rolling Monthly Job Creation
(In 000's - Source Bureau of Labor Statistics)
400
350
300
250
200
150
100
50
Jun-12
Jul-12
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Sep-12
Oct-12
Nov-12
Dec-12
Jan-13
Feb-13
Mar-13
Apr-13
May-13
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