U.S. Macro Forecast

Measured Optimism Still on the Menu

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- Near-term growth in U.S. GDP expected to increase, but not to 3.0%
- Despite economy nearing full employment, labor markets still have juice
- Fiscal policy clouds the outlook, but odds are still good that some stimulus (e.g., tax cuts) will be enacted
- Growing supply and slowing demand to cross paths this year for most asset classes
- Capital markets will shake off weak start to 2017

Overview

Despite an intense domestic political environment, the U.S. economy and the property markets continue to perform well. Real GDP growth, while weak in Q1 2017 (as is usual for a first quarter in this expansion), is already tracking much stronger for Q2 2017, currently in the 3-4% range. Other data confirm a similarly stronger trajectory. Most notably, consumer and business confidence remains high, job growth remains steadfast and healthy, and wage growth is finally accelerating to the point where the virtuous cycle is within reach. Global growth is also improving. U.S. exports recently jumped to their strongest level in five years. On many fronts, the U.S. economy looks as solid as it has been at any other point in this 7.5—year-long expansion.

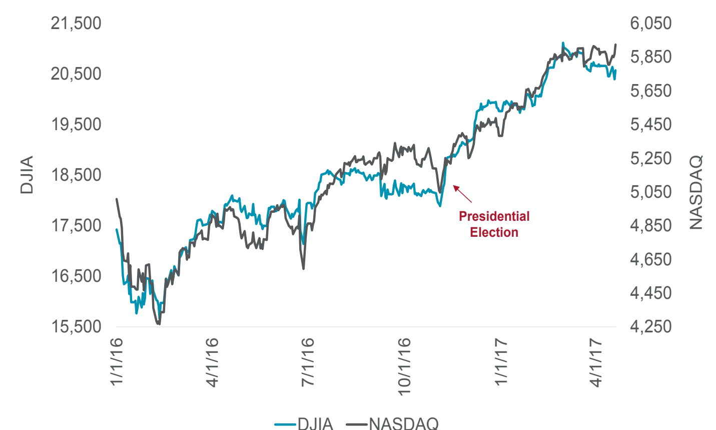
The property markets have downshifted most recently. While still positive, absorption levels have trended much lower in Q1 2017 compared to a year-ago. Retail and office markets have seen the fastest deceleration, off some 30-40%, while industrial and multifamily markets are holding up better but still slowing. This most likely reflects the lagged relationship between commercial real estate (CRE) and the economy. Businesses pumped the brakes in the fourth quarter of 2016, slowing hiring, as they digested the election results along with the sharp rise in treasury yields. Since then, interest rates have settled back down, businesses have generally continued to post profits, and confidence has soared. The demand metrics for CRE space will soon pull out of their latest slump. Investment sales also cooled off in Q1 2017. But with capital at record levels and volatility trending towards fearless levels, investment sales, too, are poised for a rebound.

Fiscal policy is the biggest wild card. The first 100 days of the Trump Administration were not exactly confidence-inspiring on the policy front. Still, financial markets continue to price in expectations that the Administration will make good on at least some of its pro-business growth agenda. Stakes are high, but our current assumption looks for policymakers to deliver just enough fiscal stimulus to keep the markets satisfied and the economy growing. Downside risks remain, but macroeconomic conditions remain highly favorable for the CRE sector. The U.S. economic expansion is poised to continue, and likely to accelerate.

Powerful Tailwinds

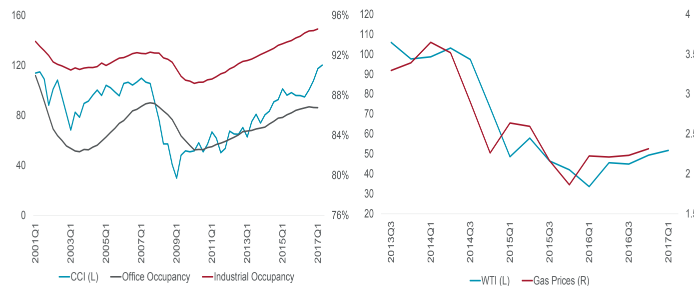
The U.S. economy has a couple of very important tailwinds at its back, and a surging stock market is one of them. Global equity markets have been on fire since Trump was elected president. Major indices—Dow Jones, the

Tailwinds: Soaring Stock Market



Source: Dow Jones, NASDAQ

Tailwinds: Confidence is High **Tailwinds: Still Low Oil Prices**



Source: The Conference Board, Cushman & Wakefield *Source: West Texas Intermediate*

NASDAQ, the DAX, the Nikkei—are all up by double digits since last November. A good portion of these gains are based on the assumption that the Trump Administration will deliver greater fiscal stimulus in the U.S. (i.e., tax cuts, deregulation, infrastructure spending) which will subsequently boost corporate earnings (improve the "E" in the "P/E" ratio) and ultimately result in a more business-friendly environment that will stoke economic growth. Across the board, increases in stock prices have led to a $2 trillion surge in wealth, and estimates show that for every $1.00 increase in stock wealth, consumer spending increases by $0.03. This implies that the wealth effect could boost consumer spending by an additional $59.9 billion, which will filter through as a positive multiplier in real estate markets when and if spent. Of course, the opposite could also occur. If policymakers don't deliver a fiscal stimulus package, then we will likely see a significant market correction, one that could lead to a negative wealth effect that may impede domestic economic growth. Again, stakes are high.

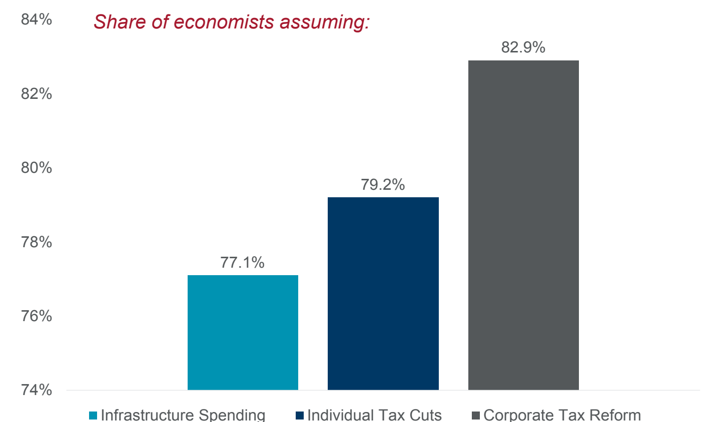
Another tailwind is the surge in the sentiment-based indicators, often referred to as "soft data." The Conference Board's Consumer Confidence Index has jumped 20% since October of last year. Most of that increase can be attributed to rising expectations of economic prospects. Businesses also seem to have regained their swagger. The National Federation of Independent Businesses' Small Business Optimism Index increased from 104.0 in October of 2016 to 114.6 in March of 2017. In addition to the prospect of fiscal stimulus, oil prices sitting at a sub-$50 per barrel price hasn't hurt confidence either. Interestingly, although the main takeaway from such data is robust sanguinity, in the three months preceding and in the four months since the election (for which there are data), the share of businesses reporting that they are uncertain about or don't know what to expect in the next six months is at an all-time high.

Fiscal Policy Wildcard

The Trump Administration has spotlighted several priorities that affect economic/CRE forecasts directly: tax reform and/or tax cuts (for both corporations and individuals), a repeal or replacement of the Affordable Care Act (ACA), renegotiation of major trade agreements, increases in specific discretionary spending categories (defense and infrastructure) and the unwinding of or revisions to certain regulations (i.e., Dodd-Frank).

Given the current political environment, any change in policy is far from certain. Still, over 80% of economists surveyed by the National Association of Business Economics believe that some policy changes will be enacted, although likely watered-down to gain bipartisan support (particularly in the Senate). In addition, the results of any policy changes will need to maintain or come close to deficit neutrality—a requirement for most legislation if it is expected to become permanent. In our baseline scenario, we assume government spending and investment—actual outlays— will increase by an additional $70 billion over the next two years, with nearly

Economist's Fiscal Stimulus Assumptions for 2017-18
NABE's March 2017 Outlook Survey



Source: NABE

40% of that increase going to defense. The fastest growth is expected to occur in 2018 when overall government spending will grow at a 2.5% annual rate.

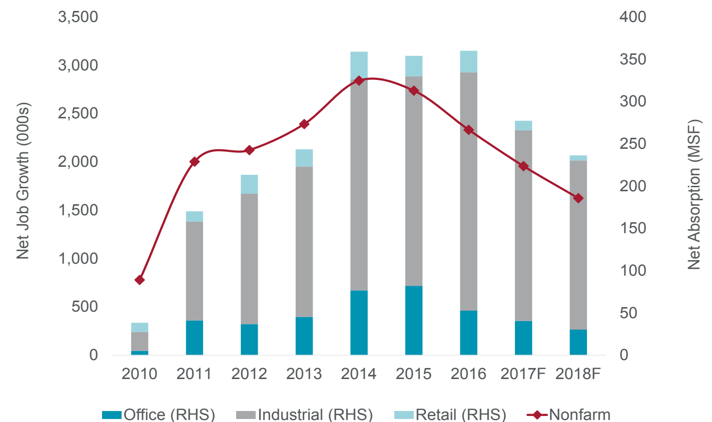
The likelihood of any changes being made to tax rates or tax policy is even less certain. Our forecast anticipates the effective corporate tax rate—that is, the tax rate actually experienced by firms—to decline from 20.2% in 2016 to 16.9% over the 10 years. That is the equivalent of about a $500 billion tax cut. It also assumes that personal income tax reform will not occur until 2018.

Labor Markets Still Have Juice

Although the U.S. economy is nearing full employment, there is still plenty left in the tank for job creation to continue to fuel healthy demand for real estate. The current U.S. unemployment rate is low—at 4.4%—but it can certainly go lower. There have been a number of times in the post WWII era—the 1950s, 1960s and the late 1990s—when unemployment dipped below 4%. The lowest on record was in 1953, when the unemployment rate dropped to 2.9%. In the late 1990s, when the unemployment rate was lower than it is currently, the U.S. economy created over 3 million net new nonfarm payroll jobs per year. In other words, the labor market has not tightened to the extent where job growth shouldn't remain at least solid. Certain markets are more susceptible to having their growth potential curbed by labor shortages (e.g., Denver, Boston, San Jose—all with unemployment below 4%), but most cities still have plenty of room left for unemployment to decline.

Most of the indicators that correlate with future job creation remain healthy. Job openings currently total over 5.7 million, near record highs. Wage growth is accelerating, and it is broadening. In our baseline scenario, the U.S. will create 2.0 million net new nonfarm payroll jobs in 2017 and 1.6 million in 2018, down slightly from the 2.4 million annual average during this expansion, but still healthy.

Nonfarm Job Creation and Demand



Source: BLS, Cushman & Wakefield

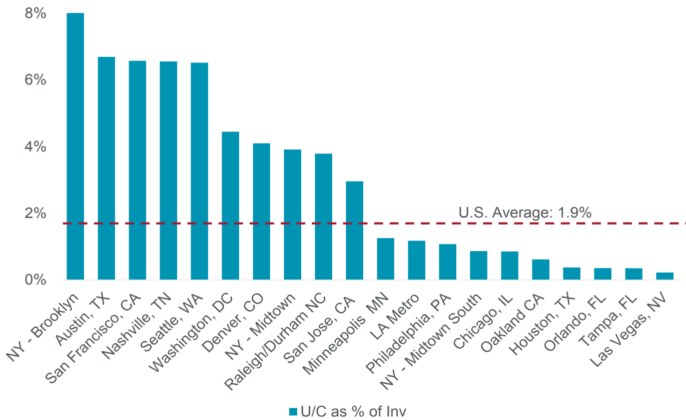
Implications for Commercial Real Estate

Office: New Development Is Highly Concentrated

Developers of office product have remained quite disciplined throughout this cycle. Whether because of memories of the pain endured during the previous recession or because of a tighter lending environment, construction volumes have been much lower than in previous cycles. Completions are roughly 25% lower than in the run-up leading to the Great Financial Crisis and 50% lower than after the Dotcom Crash. The office supply cycle will peak in 2017, and most of these new buildings are delivering in markets that need the space. Even factoring in the latest density trends, the U.S. is generally not overbuilding office product.

But developers are overdoing it in a handful of markets, at least temporarily. Nearly 50% of the new office buildings are being developed in the top-10 construction markets. The bulk of new space is being added in the largest cities/metros (e.g., Bay Area, NYC, Dallas) that arguably need it the most. Nevertheless, this wave of new space will challenge leasing fundamentals as it delivers at a time when broader job growth is decelerating. Certain markets, such as Manhattan, are already seeing concessions and TI's push higher to help lease the new space. But by and large, the Sunbelt markets and most other secondary/tertiary markets are seeing measured construction levels, and in many cases, are under-building relative to job creation.

Where Office Construction Is Happening



Source: Cushman & Wakefield

Although office-using job creation is expected to remain healthy, in the aggregate, demand for office space will not keep pace with supply. U.S. office vacancy bottomed out in late 2016 and is set to move up gradually in 2017 and 2018. Rent growth peaked in this cycle in 2016, at 5.4%. From this point forward, office rents will continue to rise but at a slower pace, as year-end rent growth decelerates from 3.5% this year to 1-2% in 2018. The supply pipeline buttons up quickly after 2018. If the economic expansion holds, the U.S. office sector could go from slightly overbuilding in some markets to under-building in most towards the latter part of the decade.

Industrial: GDP-agnostic

The relationship between GDP and the industrial sector, historically a reliable one, has broken down in this cycle. eCommerce is the reason. With a greater shift to online shopping has come the strongest boom that the warehouse segment has ever recorded. Since 2013, more than 1 billion square feet of industrial inventory has been absorbed, averaging more than 250 million square feet (MSF) per year. As the structural shift towards 21st century spending habits persists, so too will demand for modern warehouse and distribution product. Since 2000, eCommerce's share of the retail pie has expanded from 0.8% in 2000 to 7.2% in 2016; it is expected to gain more share over the next 5 years, hitting 8.5% by 2021. In mapping the warehouse sector to the expected growth in online sales, the industrial sector will see one-fifth of new demand each year for the next several years from eCommerce alone.

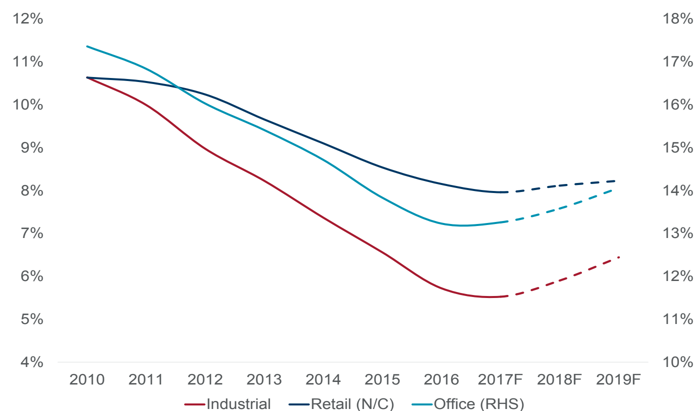
Should it spiral out of control, the political push to challenge free-trade agreements such as NAFTA does pose a significant downside risk to the industrial sector. Since NAFTA was enacted in 1994, U.S. trade with Canada and Mexico has more than tripled. And that is not just imports: U.S. exports have also more than tripled from around $150 billion in 1994 to around $500 billion in 2016. These trade flows are critical to supply chains for numerous businesses operating in the U.S. and therefore directly linked to the health of the warehouse sector. Given the economic incentives for all countries involved, our current working assumption is that any new NAFTA-negotiations will not result in a major disruption to trade flows.

The industrial construction pipeline is robust, but so is demand. Vacancy will bottom out in 2017 at a razor thin 5.3%, before inching up slightly to 5.4% in 2018. The tight market will keep upward pressure on rents, which will rise more than 4% annually over this period. Policy risks aside, the U.S. industrial sector is nearly a lock to continue to register very robust leasing fundamentals.

Retail: Not Dead, Just Uneven

We know that the consumer has been doing increasingly well over the last few years. But the translation of consumer spending into demand for retail space has been a frustratingly difficult one. Segments that have fueled organic space up-take are hitting saturation points—such as dollar stores, although the sector continues to grow—while other segments—such as restaurants and fast casual dining—are likely to hit those inflection points over the next few years. Sales at food and drinking establishments as a share of total sales reached a new peak in 2016 at 12%, where it is expected to remain over the next 5 years. Heath and personal care, as well as smaller format niche fitness studios, will also capture greater shares of retail spending, while national chains and department stores struggle to maintain market share and ultimately lose more. Overlay those trends

Vacancy to Begin Rising
Annual Average



Source: Cushman & Wakefield

with the impact of eCommerce and the recent uptick in closures among certain retailers is not so surprising. Despite some of the strong rhetoric classifying retail as dead, certain property types—and most assets with a still-viable location—are performing sufficiently well.

Neighborhood/community centers remain slightly immune to some of the downsizing—or outright closure—trends that some major retailers are experiencing. The vacancy rate for this class has fallen by 40 basis points over the last four quarters—from 8.4% in Q1 2016 to 8.0% in Q1 2017. Construction has been most robust in the Pacific, the Southeast and Texas South Central, and in the Northeast. After hitting their peak in 2016 at 15.9 MSF, deliveries will still cause vacancy pull to-and-fro around the 8% mark—slowing almost in line with demand. Over the next two years, the overall vacancy rate for neighborhood/community centers is expected to rise from 8.0% in 2017 to 8.1% in 2018, but totaling only 17.3 MSF of absorption for both years combined.

It does appear that the shake-up in retail will be felt, at aggregate levels, across most asset types. However, malls will feel the greatest effects. Power centers will be impacted by consolidation in the office-supplies and sporting-goods categories, but actually have a strong tenant pool for the kind of space that is being given back thanks to the continued strong growth of off-price apparel players. Average asking rents started to decline in 2016 but still managed to post a 2.5% growth rate thanks to rising rents in the first half of the year. The expected downward movement in rents over the near term is more moderate than in our previous forecast, but spread over a longer period. We now anticipate average neighborhood/community asking rents to decline—5.4% in 2017 to $19.26 per square foot (PSF) from $20.36 PSF in 2016, and down 3.2% in 2018 to $18.64 PSF before rebounding into positive territory in 2019.

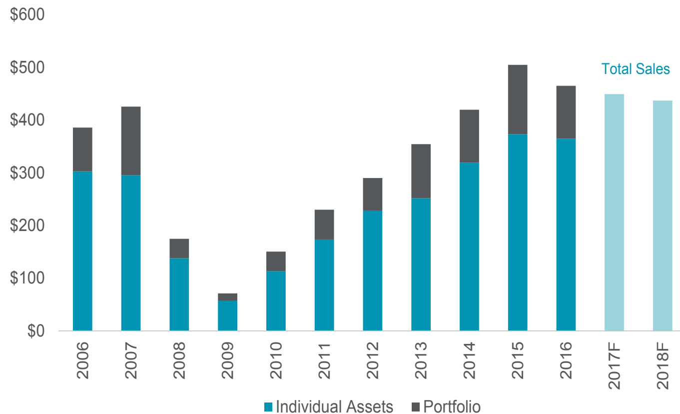
Capital Markets: Longer the Cycle, the Tougher It Gets

Investing in a maturing cycle is always difficult, but the engines suggest there is still plenty of activity ahead. Soaring equity markets, fiscal stimulus, continued monetary stimulus, and the relative attractiveness of U.S. assets will promote healthy CRE investment in the U.S. We look for sales to register more than $449.1 billion in 2017, down roughly 10% from the $494.1 billion posted in 2016. Transaction volumes will decelerate further in 2018 to $437.0 billion with substantial interest remaining from foreign investors. Coming off of a two-year streak with more than half a trillion dollars in trades in both 2015 and 2016, this deceleration is partially a function of fewer assets being positioned for sale. In 2016, investment activity was 2.7% of nominal GDP, and this is expected to moderate as the cycle continues. Reflecting continued investor demand for CRE allocations, dry powder at closed-end funds targeting CRE assets is at an all-time high supporting our outlook for continued robust deal activity.

Bouts of uncertainty—both abroad and domestically—have not led to a capitulation on pricing, although growth in CRE values has tempered substantially. The broadest measure of CRE asset prices is the RCA/Moody's CPPI Price Index for all property types, which grew at a 7.1% year-over-year rate in 2016, roughly half of its 2015 growth rate of 14.1%. This Index is forecast to rise by 6.6% in 2017 and by 2.3% in 2018. Of course, the outlook for prices is one reason returns are also expected to moderate over the next few years.

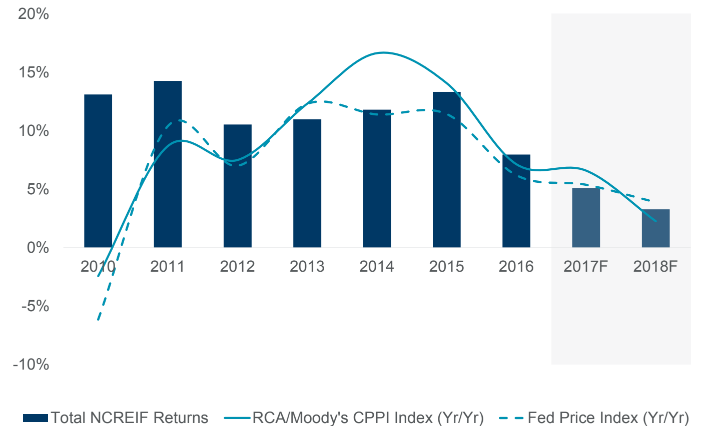
Income growth appears to have hit a cyclical low, according to data from NCREIF, whose sample is mainly core assets. Net operating income (NOI) returns were at

U.S. Investment Sales
$ Billions



Source: RCA, Cushman & Wakefield

Returns Moderate with Pricing



Source: RCA/Moody's Analytics, Federal Reserve, Cushman & Wakefield

historical lows in the last two quarters. For four of the five major asset categories, annualized growth in income for apartments was 4.4% in Q1 2017, and 4.3% in Q4 2016, followed by 4.5% for office, 4.8% annualized rate for retail and 5.1% for industrial—all in Q1 2017. Combine this with falling capital returns, and the outlook for NCREIF total returns is one of deceleration. In our baseline scenario, total NCREIF returns will slow to 5.1% this year—almost entire buoyed by income—before falling to 3.3% in 2018, although as previously noted, the wave of construction quiets beyond 2018. Thus, there is scope for a significant revival in NOI growth.

The broad deceleration in returns hides considerable variation, however. Secondary markets have recently outperformed the major metro markets on a price-return basis, closing part of the historically wide gap that has expanded during the cycle; we expect this development to continue. Similarly, suburban office returns have accelerated and are now substantially outpacing those for CBD office. Industrial and retail assets continue to be impacted by the divergent effects of eCommerce, driving total retail returns lower while sustaining industrial returns—primarily through continued strong income (albeit decelerating from the extraordinary rent growth observed recently in many markets).

Measured Optimism

Predicting the future has seldom been more difficult. Any policy promises that Congress keeps may lead to a stronger near-term outlook which would bolster demand for real estate space. However, it may also cause the trajectory for U.S. interest rates to steepen which in turn will likely affect the pace at which the Federal Reserve's Open Market Committee raises interest rates. Job growth, positive and still quite robust, will slow as the unemployment rate pushes lower. All asset categories will see tempering demand meeting deliveries, beginning a gradual upward swing in vacancy. With the exception of retail, assets will likely see rent growth remaining strong in 2017 before slowing in 2018. And capital markets volumes will buck any uptick in interest rates, with sales activity declining over the next two years but holding at a healthy pace. Real estate returns, driven largely by trends in pricing, will moderate over the near-term as well, but will remain competitive vis-à-vis alternatives.

All and all, upside risks more than offset the downside risks to our outlook. As we assess the future trajectory of the property markets, the positives comfortably outweigh the negatives. We may be entering into the final stage of the U.S. expansion, but that doesn't mean the final stage can't go for a lot longer.

U.S. Macro Forecast

CUSHMAN & WAKEFIELD

CELEBRATING 100 YEARS

May 2017

U.S. Macro Forecast Table

	2016		2017				2018	Annual		
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	2016	2017	2018
US Economy										
Real GDP, % (AR)	3.5	2.1	0.9	2.7	2.2	2.5	1.9	1.6	2.1	2.3
Chg. in Nonfarm Employment, ths.	704	510	553	471	476	456	476	2,332	1,956	1,625
Chg. in Office-using Employment, ths.	244	185	177	136	134	145	132	723	592	497
Unemployment Rate, %	4.9	4.7	4.7	4.6	4.5	4.5	4.5	4.9	4.6	4.5
Retail Sales & Food Services, % (SAAR)	2.5	3.9	5.0	5.0	5.6	4.8	4.0	3.0	5.3	4.0
CPI Inflation, % (AR)	1.1	1.8	2.7	2.8	3.0	2.8	2.6	1.3	2.8	2.5
Consumer Confidence Index	101	108	118	114	107	105	104	100	111	103
Federal Funds Rate, %	0.4	0.4	0.7	0.7	1.0	1.1	1.3	0.4	0.9	1.6
10-year U.S. Treasury note, %	1.6	2.1	2.4	2.6	2.7	2.7	2.6	1.8	2.6	3.0
ISM Manufacturing Index	51.1	53.3	57.0	55.1	52.9	52.6	54.0	51.5	54.4	53.0
West Texas Intermediate, $/bbl	45	49	52	52	51	50	49	43	51	50
Office Sector*										
Net Absorption, msf	16.6	6.8	6.9	6.9	15.7	8.9	4.5	52.7	40.5	30.2
Vacancy Rate	13.1%	13.2%	13.2%	13.2%	13.3%	13.3%	13.4%	13.8%	13.3%	13.6%
Asking Rent	$29.46	$29.47	$29.94	$30.37	$30.72	$30.50	$30.67	$27.67	$30.38	$30.92
Industrial Sector*										
Net Absorption, msf	78.5	63.1	53.8	56.0	52.9	62.7	54.1	281.7	225.4	200.0
Vacancy Rate	5.5%	5.5%	5.3%	5.4%	5.6%	5.7%	5.8%	5.7%	5.5%	5.9%
Asking Rent	$5.57	$5.63	$5.67	$5.77	$5.84	$5.91	$5.97	$5.54	$5.80	$6.05
Retail Sector*/**										
Net Absorption, msf	7.5	6.3	3.0	1.9	4.5	1.7	1.4	25.6	11.3	6.0
Vacancy Rate	8.1%	8.0%	8.0%	8.0%	7.9%	8.0%	8.1%	8.2%	8.0%	8.1%
Asking Rent	$20.84	$19.37	$19.52	$19.49	$19.12	$18.91	$18.77	$20.36	$19.26	$18.64
Capital Markets***										
Total Investment Sales, $ Bil.	$123.8	$166.9	$103.1	$106.8	$107.8	$139.7	$99.2	$494.1	$449.1	$437.0
NCREIF Unlevered Total Returns, Qtrly % Chg.	7.1%	6.9%	6.2%	5.3%	4.4%	4.2%	4.4%	8.0%	5.1%	3.3%
Moody's/RCA CPPI (All Property Types), Yr/Yr % Chg.	7.0%	8.5%	8.3%	6.9%	5.5%	3.6%	3.4%	7.1%	6.6%	2.3%

**Annual rents and vacancy rates are averages, not year-end*
***Historical series based on CoStar; neighborhood/community statistics only*
****RCA, NCREIF, Moody's Analytics*
****Total Investment Sales includes office, industrial, retail, multifamily, hotel, and land sales*

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