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February 2014

U.S. Macro Forecast: Look Through the Snow at the Fundamentals

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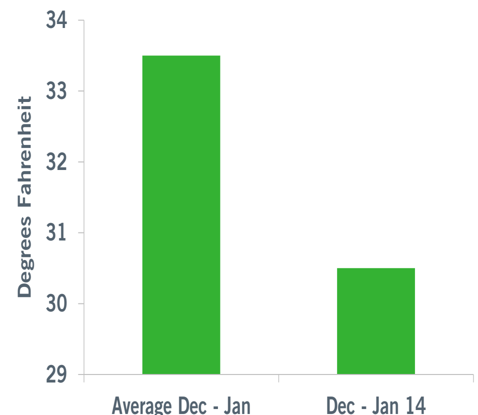
U.S. economic fundamentals remain solid. The latest string of lousy economic data can be explained almost entirely by lousy winter weather. The polar vortex, ice and snow storms in the South, colder than usual conditions in the Midwest, and a major drought in parts of California all contributed in skewing a variety of indicators from job growth to home sales to retail sales – and pushed them artificially downwards. But we need to take into account the seasonal distortions and not lose sight of the economic trajectory that began taking shape in the second half of 2013. Real GDP grew by 3.7% in the last six months of last year, the strongest rate of growth in almost two years. Barring any exogenous shocks, we should see GDP return to that rate of growth once the odd weather cycle subsides. The Federal Reserve seems to generally agree with that view: it continues to taper its bond-buying program, despite two months of weak economic data. Consequently, and given no apparent fundamental shift in the economy, our outlook for the commercial real estate sector remains upbeat. There will be widespread disparities from market to market and building to building, but in general, demand for U.S. commercial space will continue to accelerate in 2014.

Seasonal Adjustments – They Don't Always Work

Most economic indicators –such as GDP, employment and home sales –are reported in seasonally adjusted terms. Seasonal adjustment factors (SAFs) are designed to take weather out of the equation so one can get a clean read on monthly trends. SAFs are derived from past weather patterns. For instance, if the current weather conditions are in a normal range (e.g., if this January resembled an average January in terms of temperature and precipitation), then the seasonal factors would work. The SAFs would strip away any impact from weather so one could compare economic conditions during a cold month like January to those in a warm month like June. However, when Mother Nature delivers something abnormal – like a polar vortex – such SAFs don't necessarily work. They do not adjust for any abnormal weather pattern, and thus economic data can be skewed artificially downwards. Likewise, when winters are abnormally warm or less snowy compared to the average, the seasonal factors will overstate the economic data. For example, if the seasonal adjustment factors for January 2013 had been applied to January 2014 data, total nonfarm private payrolls would have increased by 265,000 rather than 142,000.

Abnormal Winter Weather



Source: National Climatic Data Center (NCDS) and NOAA

Skewing the Data - Ignore It

Source: BLS, NAR, BEA, ISM

The weather over the past three months (Dec 2013- Feb 2014) has been anything but normal. In January the average temperature for the country as a whole was 30.3° F making this the coldest December-January in 13 years. The area east of the Rockies, the Midwest, the Mid-Atlantic and the Southeast experienced below-average cold temperatures and several regions posted record levels of snow accumulation. This cold weather has had a pronounced effect on the economic data, particularly in sectors that are directly impacted by inclement weather, such as manufacturing, construction and retail. It was likely due to weather issues that the construction sector cut 22,000 jobs in December of 2013 (after adding 16,000 jobs on average in each of other 11 months of the year) and the retail sector cut 12,900 jobs in January of 2014 (after having created an average of 30,000 jobs per

month in 2013). One study that examined data over the past 10 years reveals that every 1.8º drop below December's historical temperature norm has lowered average monthly non-farm payroll gains to 38,000 below forecasts.

Fundamentals Still Solid

Despite climate vagaries, the U.S. economy remains on solid footing. Both consumer and business balance sheets are at near-record health. The household debt-to-service ratio (includes consumer debt and mortgage loans) is at its lowest level in nearly 35 years. The amount of debt that was suppressing consumer spending in the first three years of the economic recovery has been mostly refinanced or paid down. Except for the last two winter months, retail sales have been growing at an average annual rate of 5.7% since 2011. It is also worth noting that consumer credit surged in December – up 7.5% on an annualized basis, the largest increase since February 2013. Thus, consumer debt totals are rising again – adding to the evidence that consumers have regained their optimism. Likewise, corporate balance sheets are generally in great shape. Growth in corporate profit accelerated after a downturn in early 2013, posting an annualized growth rate of 10.8% in the third quarter of 2013 (the latest quarter for which data are available).

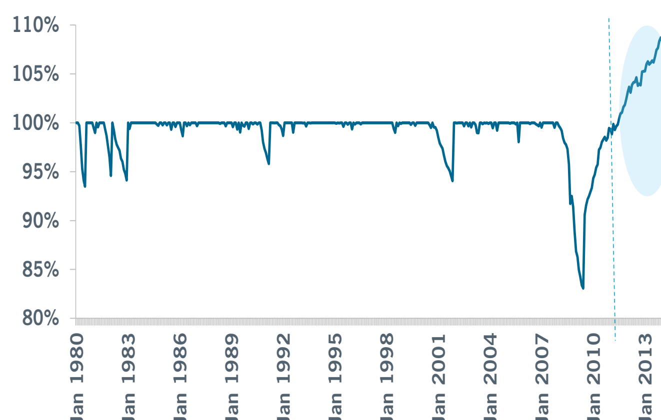
Real Economic Engines

Unlike during the first few years of the recovery when economists (including us) were all but guessing what might drive economic growth, we see clear evidence of real economic engines forming and maturing. It's a growing list:

Technology – PricewaterhouseCooper's *MoneyTree Report* for the fourth quarter of 2013 showed that venture capitalists invested $11 billion in software during 2013 – more than any period since 2000. Software venture capital also had a record year: the $7.1 billion raised is the largest amount since 2001. Overall, venture capital investments grew by 7% in dollar terms to $29.4 billion in full year 2013, with the number of deals growing by 4%.

Energy – Almost across the board, energy prices are expected to continue declining throughout 2014 and even into 2015, according to the Energy Information Administration *2014 Short Term Outlook*. Although some parts of the country saw heating oil prices more than double within one month (due to the unusual weather), heating oil, diesel and gasoline prices are expected to continue their 2013 downward trend.

Industrial Production: % of Previous Peak



Source: Federal Reserve

Advanced Manufacturing – This industry is poised to increase productivity in the U.S. (and have spillover effects in other industries). Although advanced manufacturing comprised only 11% of GDP in 2013, it accounted for over 80% of private investment in R&D and for over 33% of all U.S. exports. In the next decade, half of global consumption will be in emerging markets. A Brookings Institution study shows that spending by advanced manufacturing workers, who earn twice the national average in annual wages, generated an additional 3.8 million jobs in the communities where they reside.

Housing – In 2013, the year-over-year declines in mortgage balances that have persisted since the recession finally stopped. For the first time in four years, mortgage balances increased by $16 billion, ending the year at $8.05 trillion, $152 billion higher than in the third quarter of 2013. Non-housing debt balances grew at an even stronger rate, at 3.3% in the fourth quarter -- the strongest pace since the third quarter of 2007. Delinquency rates on mortgage loans continued to improve through 2013 and foreclosures are decelerating and the number of foreclosures is now approaching pre-recession 2005 levels.

Fiscal & Monetary Policy

The U.S. economy even had a dose of good news on the policy side of things. First, there was the Bipartisan Budget Act of 2013 passed (and signed) in December. Then the Congress voted to raise the debt ceiling limit, which in fact set no statutory limit on the federal debt through March of 2015. Those two developments are some indication that politicians have finally provided a positive, more certain landscape for businesses. Given the sensitivity of consumer confidence to political stalemate, these actions by the Congress could allow some economic momentum to finally stay with us. Even though underlying fiscal policy (i.e., higher taxes and spending cuts, which knocked 1.5 percentage points off of real GDP growth in 2013) will restrain growth in 2014 by an estimated 0.3%, it will be far less of a drag than was otherwise anticipated.

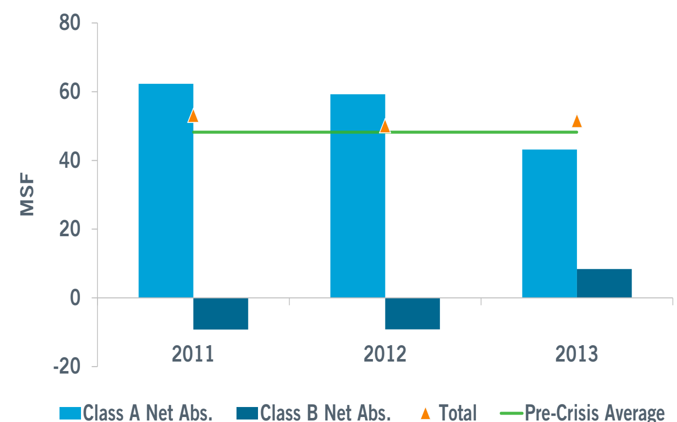
With the good news that budgetary issues for the upcoming year are in order, the Federal Reserve will not likely be put in a position to "bail out" fiscal policy in 2014, as has been the case over the last several years. The Fed has announced it will keep short-term interest rates near zero over the next two years. Rates on the 10-year Treasury note rose to 2.7% in 2013 and are expected to continue on a gradual upward trajectory back to historic levels (4.5%). Although some worry about the pressures rising rates can put on capital and credit markets, the Federal Reserve's confidence in the economic recovery was confirmed by two separate decisions that indicate demand will outpace the rising rates and economic growth will continue. The first decision, made last December, was to begin tapering the Fed's asset purchase program by $10 billion per month. The Fed then decided to continue that tapering through the end of February, despite two months of weaker data. The fact that there is equal tapering of both the mortgage-backed securities (MBS) and the long-term Treasury notes programs is a signal that the Fed has confidence in both the trends in the mortgage market and the overall economy.

Add it all up, and real GDP will accelerate from a disappointing 2% growth rate averaged throughout this recovery to 3% during 2014, and the risks remain to the upside that economic growth will exceed our forecast. Assuming the recovery follows this script it will be enough growth to generate 220,000 net new jobs per month, up from the 194,000 monthly average during 2013. U.S. employment will return to its pre-recession peak by this summer.

CRE Fundamentals – It's still a mixed bag

Even with stronger economic growth in the second half of 2013, the commercial real estate recovery is still best characterized as highly uneven. On one side of the coin, demand for apartment units and industrial space is soaring. On the other side, office and retail demand continue to lag. Indeed, demand for office space is down 22% compared to pre-recession levels, and retail is down 60%. But due to the nature of this recovery, which is sluggish and uneven itself, there are clear winners and losers in commercial real estate. New buildings are outperforming old ones, e-commerce is driving distribution center space, tech-heavy markets are experiencing faster rebounds, and geographic variation in performance is apparent across the globe, the country, and within each state and metro.

U.S. Office Net Absorption

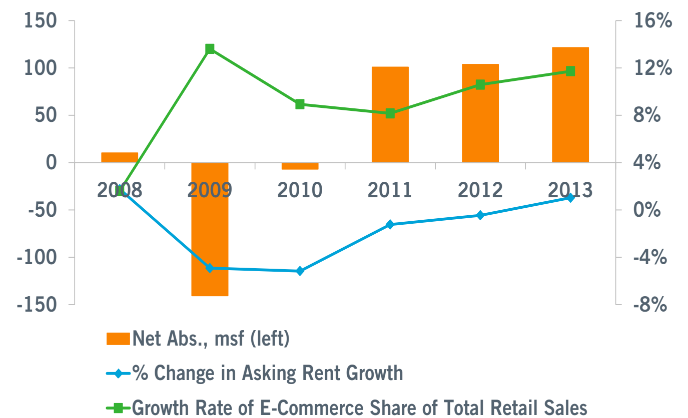


Source: Cassidy Turley Research, CoStar

Office – The office sector is a great example of a sector that is experiencing an uneven recovery. Overall, 2013 was a positive one for office space. On average, U.S. office vacancy tightened by 50 basis points (bps) from the previous year to 15.3%. Regionally, the South and the West led the way, accounting for 62% of the total office space absorbed in the U.S. Office properties under construction grew by 36% year-over-year in the fourth quarter of 2013, the first real sign that the shadow supply of leased but unoccupied space is reaching normalcy.

Exactly a decade ago, Class B and C space accounted for 52.6% of the office inventory while Class A made up 47.4%. Currently, those positions have switched: Class A accounts for 52% while Classes B and C make up 48%. In other words, the office sector is evolving. What is appearing more rapidly are office buildings suited for the next working generation that places more emphasis on mobility and remote access, collaboration and openness, as well as on energy and efficiency. This type of space, which is typically Class A, is in high demand. In fact, in 2013 net absorption of Class A space was more than five times greater than net absorption of Class B and C space. In addition to divergences in building demand, office tenants are also downsizing. According to Commercial Real Estate Development Association's NAIOP Report, the average square foot per office worker was 225 in 2010; by 2012 it was 176 square feet, and is projected to shrink to just above 150 square feet per worker in the next five years—making progress unfold at a slower pace than has typically been experienced in prior recoveries.

Growth in E-Commerce, Industrial Rent, Net Absorption

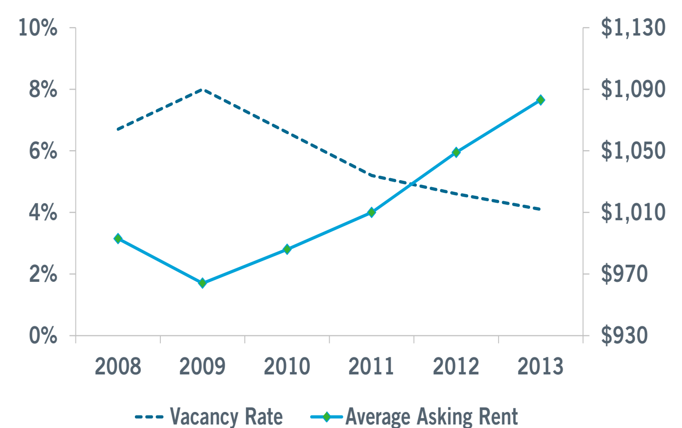


Source: U.S. Census

Industrial – Demand for industrial space continues to soar. Net absorption has been consistently 10% over the pre-crisis average for three straight years. The industrial sector has now absorbed 178 million square feet (msf) more space in this recovery than was shed during the recession. At 8.4%, industrial vacancy is down 160 bps from the peak and is just a tick above the pre-recession average of 8.2%. Nearly every major metro in the U.S. reported above average industrial absorption rates in 2013. Data centers and large big-box distribution centers that cater to e-commerce, logistics, and retail, continue to be the primary demand drivers for industrial space. With industrial vacancy approaching pre-recession levels, and demand for space still going strong, we expect the next major construction wave to begin in 2014.

Apartment – The most upbeat story among commercial properties, multifamily has performed so well that is actually beating most historical average targets. Multifamily vacancy was 4.1% at year-end 2013, about 170 bps lower than the historical average, according to Reis. Although the housing market is gaining strength, there is little evidence thus far (or historically) that demand for homes and apartment units cannot peacefully coexist. Net absorption of apartment units was 19.8% higher in the fourth quarter of 2013 than the same period a year earlier. Rents grew a healthy 3.1% in 2013, on par with their historical average. Despite very robust demand for multifamily units, weak labor income fundamentals are likely preventing rent growth from accelerating even further. The last time vacancy was this low, rent growth was over 8%.

Apartment Sector - Vacancy vs. Rent

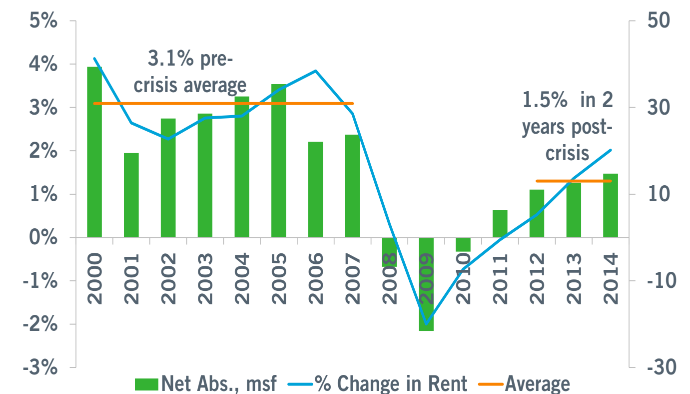


Source: Reis

The development cycle for new apartment buildings is in full swing. There are 162,000 new apartment units expected to deliver in the U.S. in 2014, and another 129,000 in 2015 – the most new product in 15 years. This has sparked concern that the multifamily sector is overbuilding. However, if one takes into account the demographics – echoboomers and babyboomers are now entering prime-rental stages – along with the fact that developers had been underbuilding homes relative to household formation norms by 40% for five straight years – the worries of overbuilding are mostly overdone. Certain markets will see vacancy jump over the next two years, but the elevated vacancy levels will be brief. In our baseline scenario, U.S. apartment vacancy will rise from 4.1% in 2013 to 4.5% by 2015.

Retail – The retail sector continues to slowly tighten, but still remains a two-fold tale. Vacancy rates for the sector were at 10.4% at the end of 2013, down 30 bps from 2012. The retail sector has registered positive absorption for three straight years, but demand for space in this recovery remains subpar. Although the retail sector is showing some improvement in the aggregate, it remains highly bifurcated. Demand for Class A space in prime locations is surging in nearly every major metro in the U.S. Some higher-end Class B properties, let's call them B+, are improving, but Class B demand remains tepid for now.

Retail Net Absorption vs. Rent Growth



Source: Reis

Two trends are likely to become more pronounced—the competition of e-commerce sales with retail sales and the bifurcation in the luxury, mid-market and bargain retail sectors. E-commerce sales currently comprise just under 6% of total retail sales. But the aggressive upward growth, which has averaged 12% each year since 2001, is expected to continue throughout the next decade.

Although consumers will shop more from home in the future, they are shopping with less money today. Companies that market to affluent shoppers are performing comparatively better than mid-market retailers. That finding is echoed by research done by Neilsen Co. and in the Luxury Consumption Index published by Unity Marketing. Bargain stores, which market to the more parsimonious consumer, are also thriving. Among some of the largest bargain retailers—Dollar Tree, Family Dollar, TJX, Ross Stores—same store sales are beating internal guidance and earnings per share are growing in the double digits. High-end retailers are also benefiting disproportionately from the recover's unevenness. In 2012, 38% of domestic consumption was attributed to the top 5% of income earners, up from 28% in 1995. Inflation-adjusted spending by the top 5% has risen by 17% since 2009, compared to 1% for the rest of income earners, according to studies done at Washington University and at the Federal Reserve Bank of St. Louis. With high-income earners spending more, it is no surprise that we are observing strong growth for high-end retailers such as Tiffany & Co., Prada, and Neiman Marcus.

Still A Ways To Go, But Don't Rule Out Robust

Without a doubt, the U.S. economy has made significant strides since the depths of the Great Recession, the most damaging recessionary period in 70 years. U.S. Real GDP is currently at $15.7 trillion, about $2 trillion less than the $17.7 trillion that would have been expected had the financial crisis never occurred. That gap is something we can still see and feel. It represents the slower-than-average recovery in employment, which, for all its positive benefits, still favors low-skilled, low-wage positions. Trends underlying the labor force, such as aging workers entering retirement and discouraged workers exiting the labor force, allow the unemployment rate to appear even lower than it really is. However, it's important to note when a recession stems from a financial or banking crisis, the recoveries that follow are typically slow and bumpy. Looking at developments over last year and even considering the latest months' data, the current state of the economy signals that we are finally entering a period of stronger growth. More commercial real estate submarkets as well are moving from a recovery stage into an expansionary one.

Although downside risks still exist – rising interest rates, emerging markets rebalancing, global disinflation – there are far more reasons to be optimistic that U.S. growth will accelerate in 2014. Expect a GDP growth rate of 3%, but if all goes well, 4% is still within reason. Under this economic backdrop, demand for space will accelerate in most markets, vacancy will erode more quickly, and sales volume will continue to climb.

U.S. MACRO FORECAST

Cassidy Turley

Baseline Scenario:

	2013		2014				2015		Annual		
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	2013	2014	2015
US Economy											
Real GDP (a)	4.1	3.2	2.0	4.1	3.0	3.2	4.0	3.7	1.9	3.1	3.9
Nonfarm Employment (b)	479	581	440	686	592	575	600	580	2,263	2,293	2,360
Office-using Employment (b)	177	148	140	219	189	183	191	185	737	731	732
Unemployment Rate	7.2	7.0	6.7	6.7	6.6	6.5	6.4	6.3	7.4	6.6	6.4
Retail Sales & Food Services (a)	4.8	4.2	4.7	4.1	4.6	5.9	5.4	5.2	3.9	4.8	5.3
CPI Inflation (a)	2.6	0.9	1.4	1.9	2.4	2.8	3.1	3.2	1.2	2.1	3.5
CCI	81.0	74.0	80.4	82.5	86.6	86.3	88.6	97.8	73.0	83.9	93.2
Fed Funds Rate	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
10-year Gov't Bond	2.7	2.8	2.9	3.1	3.2	3.4	3.7	3.9	2.4	3.2	4.0
ISM Manufacturing Index	55.8	56.7	51.3	50.5	51.3	52.8	55.2	55.2	53.9	51.5	55.2
West Texas Intermediate	105	97	97	99	101	103	90	90	98	100	90
Office Sector											
Net Absorption (c)	6.1	14.9	8.8	11.1	14.7	18.8	10.1	12.8	51.6	53.4	55.6
Vacancy	15.5%	15.3%	15.2%	15.1%	15.0%	14.8%	14.7%	14.6%	15.3%	15.0%	14.6%
New Deliveries (c)	8.6	12.9	8.1	8.4	9.2	12.2	7.7	6.8	33.4	37.9	44.5
Asking Rents	$21.90	$22.00	$22.22	$22.30	$22.42	$22.53	$22.65	$22.78	$21.86	$22.40	$22.70
Investment Sales (d)	$25.3	$36.9	$22.0	$25.8	$29.7	$47.9	$28.6	$33.5	$101.5	$125.4	$130.1
Industrial Sector											
Net Absorption (c)	31.8	34.9	35.0	32.7	33.3	34.4	35.6	36.0	121.4	135.4	137.2
Vacancy	8.4%	8.2%	8.0%	7.8%	7.6%	7.4%	7.1%	7.0%	9.0%	7.7%	7.1%
New Deliveries (c)	6.5	16.4	8.4	15.5	10.4	17.3	5.6	19.4	58.3	51.7	50.0
Asking Rents	$5.14	$5.20	$5.23	$5.25	$5.30	$5.35	$5.38	$5.40	$5.11	$5.30	$5.40
Investment Sales (d)	$14.4	$14.5	$13.3	$12.8	$17.1	$21.4	$19.6	$19.0	$47.0	$64.6	$77.2
Retail Sector**											
Net Absorption (c)	2.3	4.5	3.2	4.0	4.4	4.9	6.1	3.6	12.6	16.5	19.4
Vacancy	10.5%	10.4%	10.3%	10.2%	10.1%	10.1%	10.0%	10.0%	10.5%	10.2%	10.0%
New Deliveries (c)	1.4	2.1	1.2	1.8	2.9	4.8	4.3	5.0	5.9	10.7	13.9
Asking Rents	$21.61	$22.51	$22.57	$22.63	$22.69	$22.75	$22.82	$22.83	$19.23	$22.70	$22.80
Investment Sales (d)	$19.9	$17.6	$13.1	$16.6	$18.0	$19.0	$19.3	$19.7	$60.8	$66.7	$78.0
Apartment Sector**											
Net Absorption (e)	36.2	42.4	22.8	23.8	32.7	50.6	19.3	22.6	164.8	130.0	123.3
Vacancy	4.2%	4.1%	4.2%	4.3%	4.3%	4.3%	4.4%	4.4%	4.3%	4.3%	4.5%
New Deliveries (e)	37.5	41.7	29.6	38.2	39.6	54.2	23.6	30.5	126.6	161.6	129.2
Asking Rents	$1,122	$1,131	$1,139	$1,147	$1,152	$1,157	$1,163	$1,168	$1,117	$1,149	$1,166
Investment Sales (d)	$21.5	$31.2	$26.2	$24.7	$16.7	$22.6	$34.2	$34.7	$103.5	$90.2	$101.2

(a) - Annualized Growth Rate, Quarter-over-Quarter (b) - Thousands, SA, Quarterly Chg. (c) - Millions square feet (d) - Quarterly Sum, Billions (e) -Thousands
*some cuts in spending for most of 2013 and reduces cuts by 2014, no additional tax increases.
**Reis & RCA Historical data; Reis forecasts for new deliveries

About Cassidy Turley

Cassidy Turley is a leading commercial real estate services provider with more than 4,000 professionals in more than 60 offices nationwide. With headquarters in Washington, DC, the company represents a wide range of clients—from small businesses to Fortune 500 companies, from local non-profits to major institutions. The firm completed transactions valued at $25.8 billion in 2013, manages approximately 400 million square feet on behalf of institutional, corporate and private clients and supports more than 24,000 domestic corporate services locations. Cassidy Turley serves owners, investors and tenants with a full spectrum of integrated commercial real estate services—including capital markets, tenant representation, corporate services, project leasing, property management, project and development services, and research and consulting. Cassidy Turley enhances its global service delivery outside North America through a partnership with GVA, giving clients access to commercial real estate professionals in 65 international markets.

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