October 2018

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Tick, Tock: Timing of the Next Downturn and What it Means For Commercial Real Estate

Economic downturns in recent decades have generally started with a bang—bubbles bursting in the housing or technology markets or oil price shocks come to mind—but the next one is more likely to arrive as a whimper.

As the U.S. economy approaches a decade without a recession—closing in on the longest such period post-World War II—guessing what will cause the next downturn and when it will commence has turned into a parlor game for business.

Analysts looking for an overheated sector that could bring the entire economy down are searching in vain. Problems that caused previous recessions seem relatively under control. For example, commercial mortgage lending has grown through the cycle, but leverage levels seem under control. Consumer debt is at an all-time high, but consumer debt-to-income ratios and household balance sheets are healthy. The stock market dropped 10 percent in October as investors worry about rising interest rates, the impact of trade policy and an economic slowdown, but it's hard to predict a bear market when corporate profits are at record levels. Oil price shocks have been a major factor in virtually every recession of the last half-century, and while oil prices have risen lately, they remain nowhere near all-time highs, while oil's impact on the economy is diminishing.

It's true that the next bubble is rarely obvious until after it pops. And there are many potential trouble spots—just none identified to date that have the capacity to create major waves by themselves. Consequently, the next downturn might be caused not so much by the pop of a major bubble but by the cumulative effect of a series of economic events.

As to when economic growth might turn negative, it's unlikely to happen soon. U.S. and global GDP is likely to hit a multi-year high at about 3% this year, and the consensus view is that growth will slow only slightly in 2019. The U.S. employment market continues to be robust. Absent an unforeseen event, 2020 is the earliest a recession could commence, and even that might be a stretch.

Potential Headwinds: A Series Of Unfortunate Events?

Factors that could serve to reduce economic growth include:

- **Corporate debt bubble.** Corporations have taken advantage of low Treasury rates by issuing huge volumes of debt. Total corporate debt tops $9 trillion, nearly 50% above the peak during the last bubble. However, debt-service levels and corporate debt as a share of GDP are not as high as in past cycles.

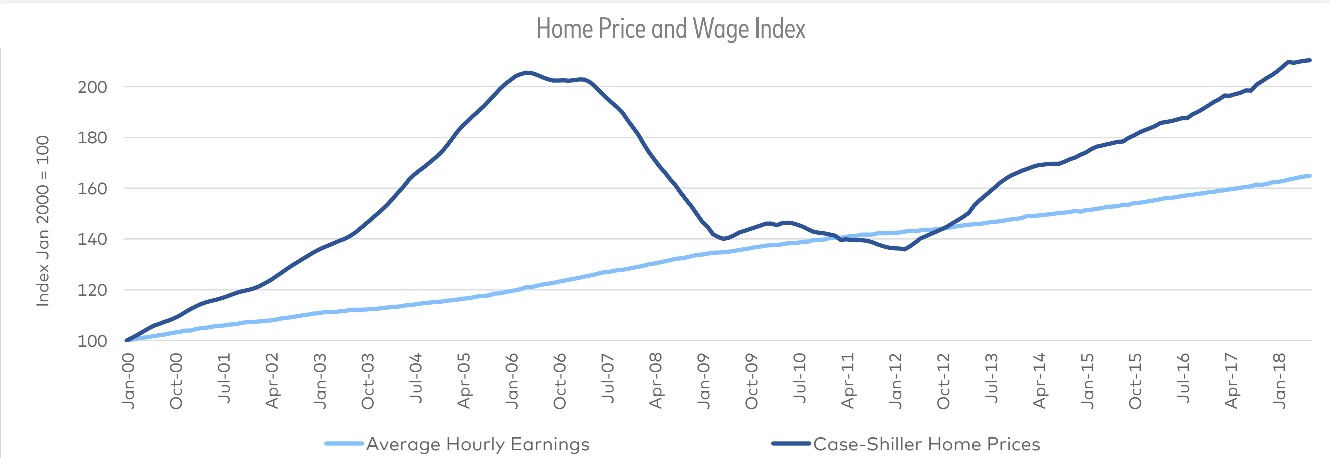
- **Weaker global growth.** Economies in most of the world have picked up in recent years, but trouble spots are on the horizon. Examples: Japan's population continues to shrink, GDP growth in China is slowing as the government attempts to control rising debt levels, and Europe is struggling to deal with the fallout of Brexit and anti-immigration movements. Emerging markets such as Argentina and Turkey are showing signs of stress, which could grow worse.

- **Slowing housing market.** Housing prices have rebounded well, with home equity growing by $9.2 trillion since the Great Recession. But affordability and rising interest rates are making it difficult for first-time buyers to afford homes, and construction will get more expensive due to tariffs on housing construction materials.

- **Rising oil prices.** Crude oil prices rose to the mid-$70 range before dropping. The added cost to consumers of gasoline and other products has mitigated the positive impact of tax cuts. Prices could go up further for several reasons, including political tensions and sanctions on Iran that cut into global production.

- **Auto production.** The U.S. auto industry has rebounded well since 2009. Sales are topping 17 million per year, led by light trucks and SUVs, and auto debt is increasing accordingly. An increase in gasoline prices could eat into sales of popular vehicles, while higher interest rates could reduce credit available for loans to purchase vehicles.

- **Immigration.** Economists largely agree on the benefit of skilled immigrant workers to the economy, and policies that make it harder to bring workers to the U.S. are a headwind to growth. Example: Commercial real estate development companies report critical shortages of skilled construction workers, in part due to restrictions on immigration.



Sources: U.S. Bureau of Labor Statistics; S&P Dow Jones Indices LLC; CoreLogic, Inc.; S&P CoreLogic Case-Shiller Home Price Indices; Moody's Analytics

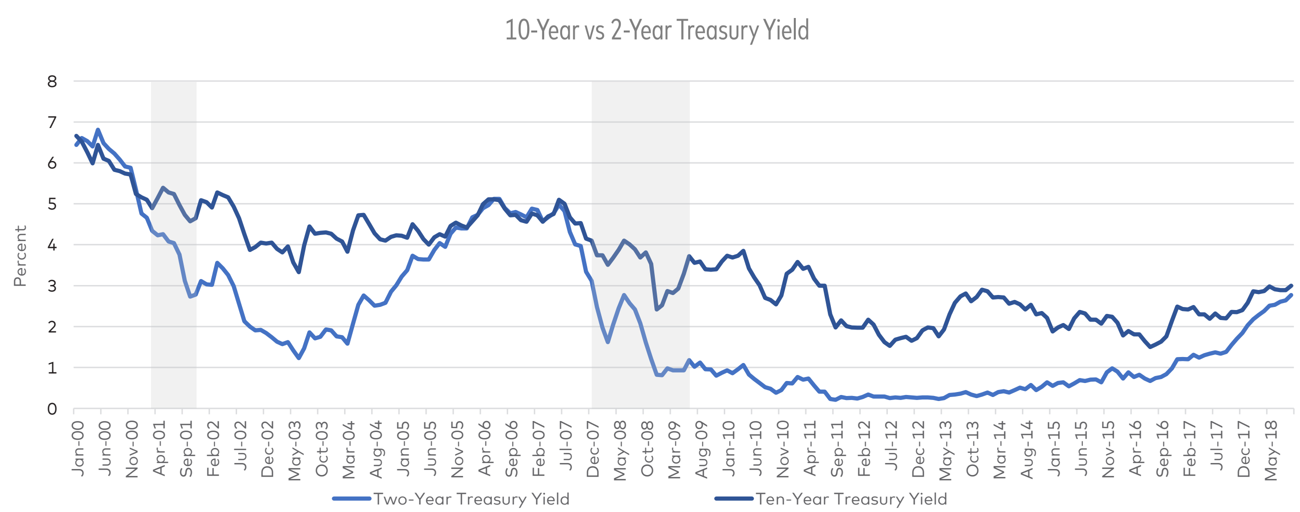
- **Fiscal policy reversal.** Corporate and personal income tax cuts have injected a fair amount of stimulus into the economy, although the impact diminishes in 2019 and turns into a negative drag on growth in 2020. Greg Daco, chief U.S. economist at Oxford Economics, said policies signed into law in 2017 and 2018 will boost U.S. GDP by 65 basis points in 2018 and 50 basis points in 2019 but will reduce GDP by 30 basis points in 2020.

- **Rising interest rates.** The federal funds rate is up to 2.0% and the Federal Reserve is expected to raise policy rates by 0.25% per quarter. The 10-year Treasury rate climbed to 3.2% in early October, the highest level since May 2011. The Fed is trying to prevent inflation from rising above the 2% target level, but there is concern it could wind up choking off growth. Interest rates are a particular concern to commercial real estate because growth in the 10-year Treasury will increase the cost of permanent debt financing and reduce the premium between debt costs and acquisition yields. Cap rates have remained near all-time lows even as the 10-year Treasury has risen over the past 18 months, but something will have to give as the premium narrows even more.

- **Yield curve.** A related concern is that the short-term interest rate will increase above the 10-year Treasury rate, which is called an inverted yield curve, a phenomenon that frequently has presaged recessions. The yield curve has steadily declined since January 2014 and was about 25 basis points before the latest jump in 10-year rates. If the Federal Reserve continues to raise short-term rates and growth falters, the yield curve could invert.

- **Tariffs.** Economists almost universally hate a trade war, and the Trump Administration's use of tariffs as a policy tool is a stress on the economy, increasing the cost of consumer goods, housing, autos and more. So far, the impact has been minor, but that could worsen if other countries such as China and Canada retaliate, and the number of tariffs escalates. Nouriel Roubini, a professor at NYU's Stern School of Business and CEO of Roubini Macro Associates, lists tariffs and unpredictable policy responses among the likely causes of the next recession.

Although it's late in the cycle, there are possibilities with upside, as well. One would be that corporate tax and regulatory reform produces a wave of investment and higher productivity. Another is



Sources: U.S. Board of Governors of the Federal Reserve System; Moody's Analytics that wage growth could accelerate and produce a wave of consumer spending. Still, the most likely positive economic scenario is for growth to maintain its current level, producing steady job growth and low volatility in the capital markets.

With growth solidly near 3% , and the unemployment rate at 3.7%, the lowest since 1969, it must be said that none of the potential headwinds on the radar could produce enough of a downside to turn into a recession on their own. That means a likely recession scenario encompasses several areas of the economy softening at once or a combination of variables such as higher interest rates or tariffs or an exogenous global political event snowballing into a loss of consumer/business confidence. Whenever it comes, those recession scenarios are unlikely to occur before 2020 or 2021, and the resulting downturn will probably be shallow.

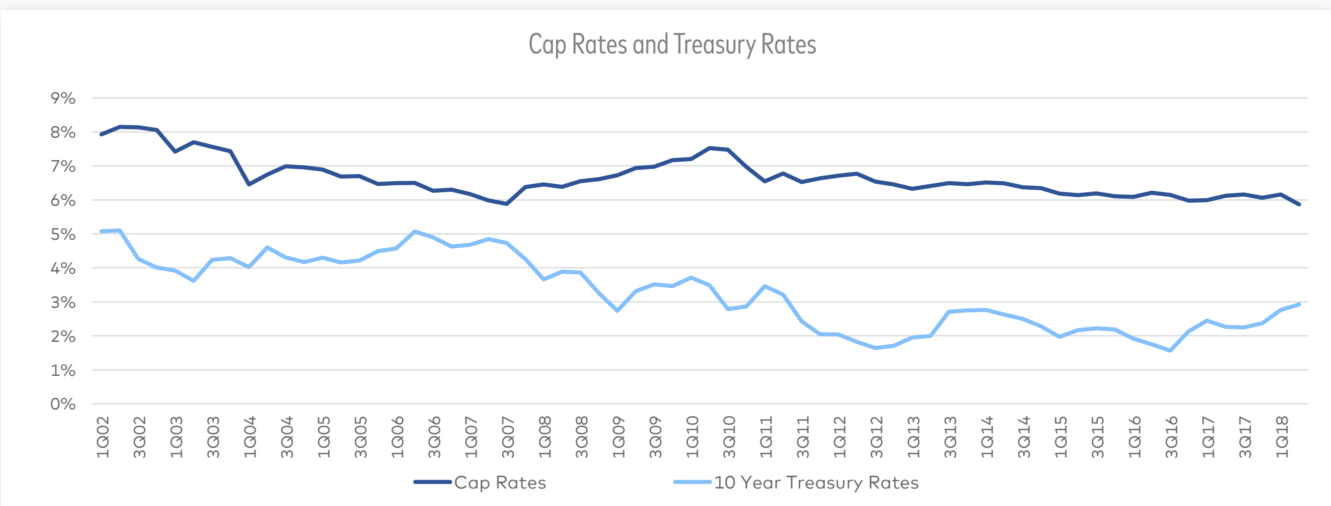
Lessons for Commercial Real Estate

We see several implications for commercial real estate:

The cycle is not at the end. For all the worrying, the near-term outlook is positive. The median GDP forecast of economists surveyed by the National Association of Business Economists (NABE) is 2.9% in 2018 and 2.7% in 2019. The biggest concern expressed by economists is on the issue of trade, as tariffs could lead to an increase in inflation and decrease economic growth by one-quarter to one-half of a percentage point. The other risks cited most often by economists in the NABE survey were higher interest rates and a declining or volatile stock market. The biggest upside risks cited in the survey were growth from corporate tax reform and higher wage growth.

Construction is constrained by economic factors. Strong economic growth cycles have in the past led to commercial real estate overdevelopment. However, new supply was limited early in the cycle by the lack of development capital by banks that had been burned by bad loans. As the cycle progressed, new regulations such as increased capital for high volatility commercial real estate (HVCRE) loans placed hurdles on bank construction lending. Increasingly, debt funds are replacing banks as development lenders. While there are pockets of overdevelopment in some specific segments, it has been far less of a problem than in past cycles.

Development is being held back by other issues. Soaring land and materials costs have made it difficult to pencil all but high-end new projects in many metros. The price producer index for multifamily construction materials rose 6.3% year-over-



Sources: Moody's Investors Service, Real Capital Analytics, Yardi Matrix year as of September, according to the Association of General Contractors, and that was before tariffs increased in October. And the shortage of construction workers is serving to put a limit on deliveries and delay some projects. More than half (54%) of respondents to the National Multifamily Housing Council's third quarter survey said that labor was not as available as a year ago, even at a higher price, while only 18 percent said labor was as available as a year ago. To hedge against these issues, developers are implementing strategies such as budgeting for delays with larger interest reserves and paying close attention to guarantor liquidity and contingent liabilities.

Demand likely to remain strong for industrial, apartments. Commercial property types are not acting in concert in this cycle. Demand is likely to remain strong in some segments even if the economy weakens. For example, the growth in e-commerce means continued demand for industrial and logistics properties near population centers. Likewise, there should be little let-up in demand for apartments. Housing construction has fallen short of household formations for several years, while the number of young adults reaching their 20s is forecast to increase through the mid-2020s. Demand is less strong for office—where companies are using less space per worker and increasing use of coworking and remote offices—and retail, as more shopping is conducted online.

Easy profits are long gone. Investors have long since worked their way through primary markets and property types, leading the acquisition premium for secondary/tertiary markets and niche property types to be reduced significantly. That doesn't necessarily spell disaster, but investors must resign themselves to the idea of hitting singles and doubles rather than home runs.

Make sure investments can withstand a downturn. Investors are advised to make sure they understand their markets and investment types. With acquisition yields near all-time lows and interest rates about to rise, returns going forward are likely to come from income growth instead of appreciation. With rent growth moderating in all property types, owners should focus on operational efficiency to increase net income. What's more, investors must realize that property purchased today with the idea of a long-term hold is likely to have to endure a downturn.

—**Paul Fiorilla,** *Director of Research*