Apex Realty Advisory - Real Estate Trends Newsletter

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Economic Update

The U.S. economy is going on seven years of economic expansion continuing into the second half of 2016, or it's fourth-longest since the end of WWII. Meanwhile the global economy has slowed. Second quarter U.S. GDP was 1.4 percent, lower than the 2.6 percent expected by economists. Business investment in Q2 fell 2.2 percent, its third consecutive quarterly decline. GDP investment fell 9.7 percent, and residential investment, which had been on the rise, declined 6.1 percent, the first decrease since early 2014. GDP for the first half of 2016 eked out an anemic growth of just 1.2 percent. Trading Economics forecasts GDP to increase to 1.8 percent in the 3rd quarter. Growth is expected from strong private consumption, steady job creation, decent real wage growth and higher consumer borrowing. A strong U.S. dollar and cutbacks in business investment will prevent faster growth. Employment growth continues an impressive 70-month stretch of gains averaging about 192,000 per month over the past three months, plus consumer confidence is its highest since August 2007. Meanwhile, unemployment edged higher to 5 percent as more people came into the labor force. Note too simply to keep up with population growth the economy needs to add more than 100,000 jobs every month. US private-sector businesses have now added 15 million jobs since early 2010, the longest streak of total job growth on record. The GDP results counterweighted by the declining jobless rate indicate that there's little moving economic growth forward other than consumer spending. Over the year, worker wages have gone up by 2.6 percent, the highest since the start of the recovery, but not enough to make up for the wage stagnation experienced by US workers over the past decade.

The Federal Government

We are in the middle of a presidential election race. Amidst all the rhetoric and verbal sparring from the candidates, we have to remember that the president really controls a very small sphere of political control. The checks & balances of Congress, the Federal Reserve plus state and local governments can all overturn president enacted policies. The accommodative Fed raised its benchmark federal-funds interest rate up 25 bps from near zero in December 2015, with the expectation to nudge rates up four more times in quarter-percentage-point increments throughout 2016. The move hasn't occurred due primarily global problems. In its most recent September meeting the Fed decided to hold interest rates unchanged and won't commit to moving until a stronger consensus can be reached about the outlook for growth, hiring and inflation. According to the Fed Chairwoman economic growth, the improving labor market and the outlook for inflation are strengthening the case for an interest rate increase.

Commercial Real Estate Investment

Commercial real estate sales volume in the first half of 2016 was strong at $169 billion, but is down 22 percent compared to the same period of 2015. However 2015 was also flush with portfolio and M&A entity-level deals that are not easily replicable year-over-year. Nonetheless volume is at its second highest year-to-date level of this most recent real estate cycle. The FTSE NAREIT PureProperty Index Series indicates that the year-to-date thru September REIT returns have averaged 12.91 percent. The Fed indicates commercial lending grew at an annualized rate of 10.1 percent year-to-date through May 2016, driven by an increase of 14.9 percent in multifamily loan volume. Changes in demographics & technology, exemplified by companies like Airbnb Inc. and WeWork Cos., are undermining operations traditional holdings such as hotels, office buildings and residential properties. Strong job growth has assisted property fundamentals to remain solid, providing for NOI growth and positive cash flow. However if a combination of rising interest rates and softening tenant demand occurs, then any additional gains in rent growth will be muted and investor yields will be compressed. At mid-year 2016 investor market sentiment remains cautious, but underlying fundamentals favor a healthy U.S. real estate investment market. The Brexit vote caused a disruption in the U.K. and European investment sales markets, but it may actually prove to be a boon for U.S. property markets, as more foreign investors are now more likely to re-direct capital to the U.S. The reclassification of real estate as a separate sector within the Standard & Poor's 500 index on September 1, 2016 will help raise the profile of real estate as a distinct asset class. This will likely also attract more analysts & capital into real estate. The disruption of the CMBS markets at yearend 2015 and underwriting the new 2016 risk retention rules has made it tougher for some maturing CMBS loans to pay off. Thanks to competitive and liquid debt markets, lenders appear able available to refinance maturing loans. New banking regulations have limited some developers' ability to leverage up to historical levels. This is due in part to high volatility rules which require banks to put 15 percent of the future value of a property into deals. This is making it difficult for lenders to do construction loans, thus forcing borrowers to work with private lenders.

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U.S. CRE Forecast Strong for Year Ahead

The U.S. property market landscape in 2017 will be characterized by continued strong fundamentals, increased investor flows and high transaction volume.

As for the economic landscape, the U.S. continues to grow moderately and add jobs. The U.S. employment gains continue to be strong, with unemployment dropping below 5.0 percent earlier this year, and adding to demand for housing in a variety of forms, for office space, for the retail sector and for industrial/distribution facilities. While many fear the end of the current economic cycle, the fact that the recovery was so protracted leads me to believe that we may have another two years left in the current growth cycle.

The U.S. Federal Reserve made it clear last December that the central bank sees U.S. growth as relatively stable, notching the federal funds rate higher by a quarter point. Nevertheless, underlying inflation is extremely tame in the U.S. and in major emerging markets (with worries of deflation in some sectors and countries), providing no impetus for significantly higher rates. Lending rates and fixed-income rates of return will still be very low by historical standards, inducing continued levered purchases of real estate assets.

Global economic and political uncertainties: The Brexit vote in the U.K. has added new uncertainties that will not be fully understood, much less resolved, in the near term. The IMF has downgraded global growth twice since January as uncertainties blur the outlook. For U.S. markets—real estate in particular—the impact is likely to be largely positive as U.S. assets become more attractive and valuable to global investors. We can probably expect enhanced inbound foreign investment in U.S. real estate as the U.S. becomes even more of a safe haven. The IMF predicts higher economic growth in the world as emerging markets find their footing and commodities continue their recovery. Stronger global growth is likely to provide more real estate inflows into the U.S. market as the U.S. remains one of the most attractive commercial real estate markets.

The U.S. economy-as indicated by GDP-grew at an annual rate of 1.2% in the second quarter of 2016. This rate was about half of economists' expectations, as GDP was dragged down as businesses reduced their inventories and held off on major business investments. The decline in inventories was the most since the third quarter of 2011. Excluding inventories, GDP rose at a 2.4% rate in the second quarter. Private fixed investment, which includes residential and business spending, dropped 3.2% in the second quarter, the largest decline in seven years.

Total government spending declined in the second quarter, with federal nondefense spending being the only subcategory that rose. Consumers were resilient in the second quarter, with consumer spending growing at its fastest pace in the past six quarters, driving the second-quarter GDP into positive territory. The trade deficit narrowed and contributed somewhat to the second-quarter growth in GDP.

Data analyzed by the Conference Board continue to indicate moderating economic growth through the end of 2016. Further, the weaknesses among the leading indicators have become somewhat more widespread than the strengths in recent months. However, the report noted that the economy still appears resilient enough to weather volatility in the financial markets and a moderating outlook in the labor markets.

After weak growth in May, job creation surged in June, rising by 287,000 new jobs. This marked the strongest month for jobs since October 2015 and was far greater than economists' forecast. Job growth so far this year has average 172,000 jobs per month, which is well above the pace the White House Council of Economic Advisers has stated is necessary to maintain a low and stable unemployment rate. The unemployment rate crept up 0.2 percentage point in June, though some of the rise was attributed to more workers entering the workforce, as the labor-force participation rate also edged up.

While job growth rose significantly in June, wage growth only improved modestly. Average hourly earnings for all private-sector employees increased only two cents in June. Regardless, the White House Council of Economic Advisers drew attention to the fact that nominal hourly earnings for all private-sector workers have increased 2.6% over the past 12 months while consumer prices have risen just 1.0%. It found that nominal hourly wages have generally been rising faster than inflation since mid-2012, translating into real wage gains for American workers.

The Federal Open Market Committee made the decision to maintain the target range for the federal funds rate at 0.25% to 0.5%. In making its decision to leave the target for the federal funds rate unchanged, the FOMC stated that it wishes to maintain an accommodative policy in order to further support improvement in labor market conditions and a return to 2.0% inflation, which has been running low due to past declines in energy prices.

Readings for consumer confidence were mixed in June. The Consumer Confidence Index rose to an eight-month high, while the Consumer Sentiment Index retreated slightly. The Consumer Confidence report found Americans becoming more optimistic about the economy.

The Consumer Confidence report found that consumers' impression of current situations reached its second-highest reading since September 2007, and their optimism toward their short-term outlook was the highest in five months. On the other hand, the Consumer Sentiment report found that Americans had greater concerns about prospects for the economy. The survey found that consumers do not anticipate there will be a recession but have increasingly come to expect that the pace of economic growth will slow in the next year.

Business-owner optimism improved for middle-market businesses but was not significantly better for small businesses. The Small Business Optimism Index edged up slightly, but the National Federation of Independent Business called the increase "negligible." The component that improved the most was the one that measures whether business owners believe the economy will improve. Regardless, more owners believe the economic conditions will worsen rather than improve, with a net -9.0% of owners expecting improved conditions. The 2Q 2016 Wells Fargo/Gallup Small Business Index moved down, marking the fourth decline in the past five quarters. The report found that, while business owners remain cautious, small-business optimism over the past year has been higher than at any point since 2008. The RSM U.S. Middle Market Business Index increased and indicated that the U.S. middle market is expanding. The results also indicated that the middle market is outperforming large corporations, which have more broad exposure to the global economy.

Growth in the manufacturing sector, as measured by the Institute for Supply Management's manufacturing index, rose in June. The index showed that the manufacturing sector expanded for the fourth consecutive month, following five months of contraction. Industrial production also advanced in June, with the component that measures manufacturing advancing 0.4% in June and 0.4% over the past 12 months.

The services sector continued to expand in June, as measured by the Supply Management's services index, and the pace of expansion quickened. The comments from respondents were mostly positive about business conditions and the economy. The report also found that there was a strong rebound from the "cooling-off" that occurred in May.

Most of the major stock indexes recorded gains in the second quarter, though there was some volatility toward the end June as a result of Britain's vote to exit the European Union. Performance among the sectors within the S&P 500 varied. A partial rebound in oil prices helped the energy sector gain nearly 12.0%, while the information technology and consumer discretionary segments recorded losses for the period.

Amid concerns over Britain's exit from the European Union, yields on intermediate- and long-term U.S. Treasury yields retreated as investors sought out haven debt, causing prices to rise. Britain's exit also caused yields in Japan, Germany, Switzerland, the U.K., Sweden, and Denmark to all reach record lows. This drove investors into U.S. Treasuries, which were offering more attractive yields at the time, sending U.S. yields down to near record lows.

Housing starts and building permits both rose in June, though they remained below their levels from a year ago due to decreased activity in the multifamily home sector. Existing-home sales continued their upward trajectory in June, rising for the fourth consecutive month to their highest annual pace since February 2007. Home prices continued to climb in June, rising for the 52nd consecutive month to their highest prices on record.

The National Association of Realtors Confidence Index for current conditions improved but was unchanged for single-family homes and townhouses, though it improved slightly for condos. Regardless, it was up for all three housing types compared to a year ago. Builder confidence, as measured by the National Association of Home Builders/Wells Fargo Housing Market Index, improved in June and remained at a level indicating homebuilders continue to be positive about the housing market.

The National Association of Realtors' most recent Commercial Real Estate Market Survey, analyzing the first quarter of 2016, found that commercial real estate investments continued to keep a positive pace. The report found that 58.0% of Realtors closed a commercial sale and sales volumes rose 8.5% from the same period one year ago. The members surveyed were positive about the general direction of business opportunities.

U.S. economic growth came to a near-halt in the first quarter, decelerating to its slowest rate since the first quarter of last year. The weak first-quarter growth came in below economists' forecasts and resulted from a slump in business investment and exports. Reports noted that some of the headwinds restraining the economy will most likely fade and give way to "moderate" growth. While economists surveyed by Bloomberg found that the economy is likely to bounce back from the temporary restraints of the harsh winter weather and delays at the West Coast ports, the harm caused by the drop in fuel prices and stronger dollar may be longer lasting.

The Conference Board reported that the Leading Economic Index continued its upward trend in March, but its pace of growth continued to ease. The March LEI reading continued to point toward a moderate expansion in economic activity, but the slowing of the index's six-month growth rate suggested weaker economic growth ahead.

The Conference Board's Consumer Confidence Index improved in March as consumers became more optimistic in their outlook for their employment and income prospects. However, consumers' assessment of current conditions deteriorated for the second consecutive month. In contrast to the results of the Consumer Confidence Index survey, the Consumer Sentiment Index fell. Most of the decline in consumer sentiment in March came from lower income households, whose budgets are more sensitive to the rising gas prices. Households with incomes in the middle and top thirds of the income distribution recorded confidence gains in March.

The outlook for small-business owners dropped in March. The National Federation of Independent Business reported that every component in the Small Business Optimism Index fell in March, a rare occurrence. The components that suffered the worst were the ones that measure whether business owners expect the economy to improve and whether owners plan to hire.

Job growth continued in March, though job gains were at their weakest level since September 2013 as job growth slowed in a number of industries. Though March job growth was below the recent trend, the White House Council of Economic Advisers noted that the private sector has added 12.1 million jobs over 61 straight months of job growth, extending the longest streak on record.

The Institute for Supply Management's manufacturing sector index declined in March for the fifth consecutive month. Regardless, the data indicated that the manufacturing sector expanded for the 27th consecutive month and the overall economy grew for the 70th consecutive month.

The Institute for Supply Management's index for the services sector edged down in March, though most of the respondents' comments were positive toward business conditions and the overall economy. Despite the March decline, the index sat at a reading indicating that the services sector has now grown for the 62nd consecutive month.

The Federal Reserve reported that industrial production dropped in March and declined in the first quarter. This was the first quarterly drop since the second quarter of 2009.

The Federal Reserve maintained its decision to not raise interest during the first quarter and found it unlikely it would raise rates at the upcoming April meeting. While the Federal Reserve stated that it would be appropriate to raise the target for the federal funds rate once the labor market improves further and when inflation moves closer to its objective, it maintained that it has not decided on the timing of such a raise.

Total returns for stocks were positive in the first quarter, though small-cap stocks outperformed large-cap stocks, helped in part by their lower exposure to foreign markets. Analysts at T. Rowe Price found that the strong dollar took a disproportionate toll on the earnings of large-cap companies. Stock market volatility remained mostly mild, as measured by VIX. U.S. Treasuries were volatile but finished with gains in the first quarter, marking the fifth consecutive quarter of positive returns for U.S. government debt.

The Consumer Price Index rose in March, as declining food prices were offset by rising energy prices, specifically gas and fuel oil. The Producer Price Index also rose in March, after four straight monthly declines, as both the indexes for final demand services and for final demand goods moved higher. Leading the March advance in prices for final demand goods was the index for gasoline.

Housing starts rose in March as increased single-family constructions offset a decline in multifamily starts. However, housing starts remain down from one year ago. Building permits authorized fell, dragged down by the multifamily sector.

The National Association of Home Builders/Wells Fargo Housing Market Index edged down in March due to supply issues concerning lot and labor shortages, as well as tight underwriting standards. However, the index remained at a level indicating more builders view sales conditions as good, rather than poor, for the ninth consecutive month.

The National Association of Realtors reported that existing-home sales soared to their highest annual rate in 18 months. The amount that home sales increased in March was the largest monthly jump since December 2010. Sales have now been above their year-over-year levels for the sixth consecutive month. March also marked the 37th consecutive month of year-over-year home price gains. Further, the Realtors Confidence Index for current conditions improved for all property types.