U.S. Macro Outlook, Q4 2016

Economic assumptions for baseline and alternative scenario forecasts

- The U.S. economy is the strongest it has been since 2007, and a recession this year is extremely unlikely.
- The details of President Donald Trump's policy agenda remain unclear, but his proposals suggest mixed effects on the economy and commercial real estate.
- CBRE EA has not materially revised its baseline outlook for employment and GDP growth, which will gradually slow before contracting in 2019.
- The Fed will likely raise its target rate three times in 2017, and the 10-year bond yield will drift toward 3%.
- We have revised inflation and interest rate projections upward to reflect new data and the expectations of financial markets.
- Our upside and downside forecast scenarios have been updated to reflect a wider range of outcomes.
- The U.S. real estate investment environment remains attractive, with strong fundamentals and limited risk.

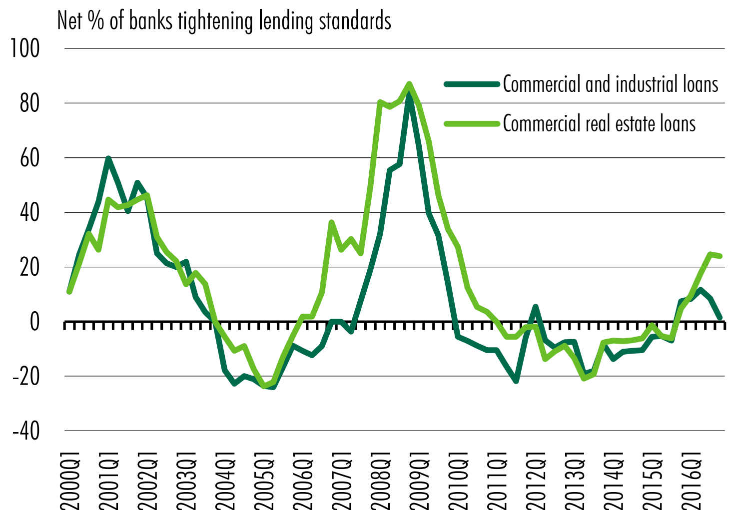
ANNUAL CHECK-UP: U.S. ECONOMY IN GOOD HEALTH

Heading into its eighth year of recovery from the Great Recession, the U.S. economy is nearly back to full health. The unemployment rate is at its lowest since 2007, thanks to a record 75 consecutive months of job gains. Wage growth, long in coming, is firming as employers compete for skilled labor; the additional disposable income this has afforded consumers is allowing them to spend freely, which will continue to be the primary driver of economic growth over the next several years. Consumer and business confidence are near their highest levels in a decade.

Although we saw similar assessments of the economy in 2007, the fact that things ended badly then doesn't mean they're shaping up to now. The biggest fundamental difference is that in 2017, there is little leverage across most sectors, and thus little chance of asset bubbles bringing down the economy. Domestic private-sector debt is well below the inflated levels of the early 2000s, as credit markets, under the scrutiny of regulators, remain pretty tight. This is particularly true in the housing sector, where tight lending remains a prime constraint on construction and mortgage origination. Bank profits are being squeezed by Dodd-Frank regulation, but the upside is that potential losses in a downturn would not lead to a complete financial crisis, as before.

Figure 1: Banks Beginning to Tighten the Screws

Source: Federal Reserve Board of Governors, CBRE Econometric Advisors.



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NEW PRESIDENT, SIMILAR OUTLOOK

The U.S. has a new president with bold policy proposals. Donald Trump's presidency will surely have economic impacts, but it is too soon to quantify what they may be. Many economists have been quick to beef up their forecasts on the assumption that President Trump will follow through on his campaign objectives to increase federal spending on infrastructure, lower personal and corporate tax rates, and reduce regulatory constraints on businesses. If done properly, each of these would likely stimulate growth, but they could cause more harm than good if implemented poorly. Other policy promises—notably those regarding immigration and trade—could have a negative economic impact. It is difficult to judge the net impact of these policies until we hear more concrete policy proposals from the administration and Congress.

Moreover, the impact will not be felt right away, since the most of these policies require that legislation move through Congress. That may not be quick to happen, given some infighting between the President and Congress on key issues. New government spending will go into effect in fiscal year 2018, which actually begins in October 2017. Other agenda items, such as the repeal of Obamacare and the restructuring of trade agreements, have the potential to make a more immediate mark on the economy.

Abstracting from the range of possible policy changes, the economy is poised to slow. There are a number of factors which we are confident will contribute to softer growth this year and next:

- **Labor shortage.** The economy is very close to being at "full employment": essentially, everyone who wants a job can find one. Of course there are still people out of work and plenty of unfilled jobs, but a mismatch between the skills and jobs available prevents more hiring from taking place. With job openings currently at a record high, it is not a matter of demand; rather, there's a scarcity of appropriately-skilled labor.
- **The strong U.S. dollar.** The trade-weighted dollar has appreciated nearly 30% in the last 18 months and is approaching record highs. This rally accelerated immediately after Trump's victory, although the President's public appeal for a weaker dollar has caused some volatility. In the long term, the strength of the dollar is, for the most part, outside of the President's control. Potential fiscal stimulus and tax cuts would likely result in an even stronger currency, so further dollar appreciation is likely. A strong dollar weighs on the trade deficit—which directly subtracts from GDP—putting domestic manufacturers at a competitive disadvantage to foreign competitors.
- **Higher interest rates.** The Federal Reserve has been extremely cautious about not raising interest rates too quickly and short-circuiting the economic recovery. The Fed expected 2016 to be the year it ramped up its interest rate normalization, but it only ended up raising the fed funds target by a single 25-bps increment. There is good reason to believe 2017 will be the true breakout year. The Fed's employment objectives have been met, and inflation is inching closer to target. Fed will also see more reason to be aggressive if the Trump administration rolls out inflationary fiscal policy.
- **Fewer car sales.** U.S. auto manufacturers will not produce as many cars and trucks in the next few years, as vehicle sales are likely to slow from their breakneck pace. Autos have been a major driver on both the production and consumption sides of the economy during this expansion, but much of the pent-up demand for autos has been fulfilled. Additionally, a glut of used vehicles is hitting the market and 2017 will be a record year for lease returns. Auto companies will have to slow production.

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- **Sluggish housing market.** The overbuilt housing market that contributed to the Great Recession is a now having the opposite problem: being underbuilt. Single-family homes and apartments both remain unaffordable for a large swath of Americans; the lack of affordable housing is preventing more economic growth from taking place. Housing construction, particularly for single-family homes, has a tremendous spillover impact on the economy. While the supply side has its problems, demand for housing is likely to be restrained as mortgage rates rise with interest rates.

EA BASELINE FORECAST

Our baseline forecast is slightly changed from Q3 2016. The job market slowdown that EA has been anticipating is underway and should continue due to labor supply constraints. That said, we still expect the economy to add a healthy 1.7 million jobs this year, down from 2.2 million in 2016. Wage growth should accelerate more vigorously with the job market this tight, providing a nice lift to consumer spending.

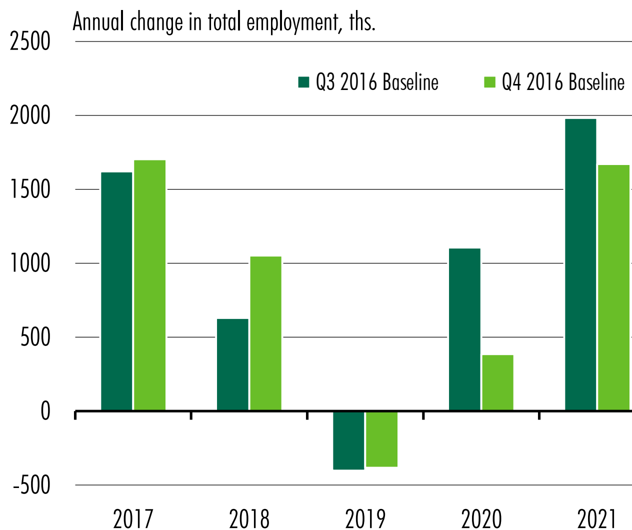
Figure 3: We Expect Economic Growth to Moderate

CBRE EA BASELINE FORECAST	2017	2018	2019	2020	2021
GDP, %	1.5	1.2	0.0	1.5	2.1
Employment, mil.	1.7	1.1	-0.4	0.4	1.7
CPI, %	2.9	2.5	1.2	1.8	2.2
10-yr Treasury, %	3.4	3.4	1.6	2.35	3.1

Note: Figures are Q4/Q4 change—except the 10-year, which is Q4 % yield.

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q4 2016.

Figure 4: Change in the Employment Forecast



Source: CBRE Econometric Advisors, Q4 2016.

The Fed has given weak signals that it may take a more hawkish stance following the election, but the degree of uncertainty regarding monetary policy has increased. The FOMC will want to see clear signs of inflation before adopting a more aggressive stance, regardless of what happens in the political realm. The outlook for long-term bond yields is also more uncertain now, as the competing forces of a potentially aggressive Fed and steadfast capital inflows to the U.S. balance each other. We think the odds favor a quicker rise in interest rates across the yield curve, with the Fed raising its target range three times this year and the 10-year yield just breaching 3%.

Higher interest rates will raise borrowing costs for everyone, leading to lower consumer spending and business investment. After a few years, this will weigh on growth expectations and lead to an inversion of the yield curve—a telltale sign of recession within the subsequent year. Thus, our baseline scenario envisions a short technical recession beginning in 2019, yielding a net employment loss of about 500,000 that year. The decline is similar in magnitude to our Q3 baseline, but it should be noted that the recession

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date has been pushed back several quarters on the prospect of fiscal stimulus, which could buoy the economy as the private sector begins to contract.

Commercial real estate's cycle will closely mirror that of the U.S. economy. Over the next several years we are likely to see fundamentals and pricing moderate, with negative nominal rent growth in most property types by 2019 or 2020. Multifamily should be the first to falter; several large markets have already reached an inflection point.

Since we do not anticipate any distinct external shocks to the economy, markets and property types should behave similarly to their performance in past business-cycle recessions. We do not anticipate idiosyncratic patterns like those associated with tech-bubble or housing-market crashes. Rather, markets with the largest supply/demand imbalances will falter first. Office markets in the Bay Area and Houston stand out as examples, as do a handful of multifamily markets burdened with flush supply pipelines.

EA UPSIDE SCENARIO

Our upside scenario reflects a more optimistic view of the U.S. economic outlook. The upside is even more sanguine than previous versions on the possibility that President Trump's fiscal policies will be highly stimulative to economic growth. The scenario also assumes that the tariff and immigration policies he has floated do not materialize or are scaled back. Under this scenario, the economy takes off in 2017 and 2018 as President Trump's policy proposals invigorate afresh optimism about U.S. growth, inciting robust construction, capital expenditure and hiring. This optimism would be partially underpinned by favorable business reaction to the reduced regulatory burdens pledged by Trump.

Figure 5: Upside Scenario: Economic Growth to Increase Slightly

CBRE EA UPSIDE FORECAST	2017	2018	2019	2020	2021
GDP, %	2.5	2.8	2.1	1.7	2.2
Employment, mil.	2.7	3.0	2.2	1.2	1.7
CPI, %	2.9	2.3	2.3	2.3	2.3
10-yr Treasury, %	3.8	3.5	3.5	3.5	3.5

Note: Figures are Q4/Q4 change—except the 10-year, which is Q4 % yield.

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q4 2016.

Under such a best-case scenario, job growth would accelerate over the next two years, generating 2.7 million and nearly 3.0 million jobs in 2017 and 2018, respectively. Employers would have trouble finding these workers in the existing labor pool, so some portion of the jobs would go to legal immigrants, new graduates, and previously disenfranchised workers. Inflation and interest rates would both rise at quicker rates as well. The Fed would likely tolerate above-trend inflation initially, but would soon begin to raise interest rates on a steeper curve than it does under our baseline scenario, resulting in higher long-term bond yields as well. Another staple of our upside is that we do not anticipate a recession within the 10-year forecast period. While history says we are unlikely to go this long without a recession, there are no time limits on expansions, so the economy has the potential to grow indefinitely in the absence of any setbacks. This scenario represents a fundamentally better economy in the near term, and pro-growth structural reforms.

EA DOWNSIDE SCENARIO

Our downside scenario describes what could realistically go wrong for the U.S. economy during the next few years. Plenty of risks exist for investors to be concerned about; this scenario assumes that some combination of shocks sinks the economy into a recession in the next year. Some amount of financial market turbulence is our downside scenario's single prerequisite—the source of such volatility could

include uncertainty about monetary and fiscal policy, geopolitical events, a trade war, or the popping of an unexpected asset bubble. Recessions are always accompanied by a stock market correction, even if the reverse is not always true.

Figure 6: Downside Scenario: Recession in 2017

CBRE EA DOWNSIDE FORECAST	2017	2018	2019	2020	2021
GDP, %	0.5	-1.2	0.0	2.4	2.0
Employment, mil.	0.7	-1.8	-2.1	1.4	1.7
CPI, %	1.2	1.2	1.3	1.8	2.2
10-yr Treasury, %	1.4	1.4	1.6	2.3	3.1

*Figures are Q4/Q4 change—except the 10-year, which is Q4 % yield.

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q4 2016.

A domestic policy misstep is a greater risk than it was a few months ago. Regardless of the merit behind President Trump's agenda items, it is clear that he is less willing to adhere to political norms, which could mean a greater surprise factor. Bouts of uncertainty can cause financial markets to whipsaw in an instant, and it is conceivable that a few tweets could mark the beginning of a downside scenario. Once business and consumer confidence are undermined, it could be difficult for the economy to right itself before slipping into recession.

In addition to the confidence factor, actual policies matter. While our baseline assumes that stimulative fiscal policies are put in place, our downside scenario assumes that these do not come to fruition, are poorly enacted, or are watered down. This may seem unlikely given Republican control of Congress, but semantics could prove tricky. Many Republican leaders are not eager to increase government spending and lower taxes without offsetting reductions elsewhere. President Trump has vowed to protect Social Security and Medicare, leaving less room to make stimulus deficit-neutral. Additionally, economic research shows that fiscal multipliers—the bang for the buck of government spending and tax cuts—are much lower when the economy is running near full capacity, as it is today. This implies that the stimulus may not be that stimulative at all—meaning the economy would get higher inflation and interest rates without the benefit of stronger growth. The downside scenario is the extreme version of this, accompanied by other downside policies such as a trade war, large-scale deportations, and otherwise anti-growth legislation.

A realistic downside scenario more closely resembles the dot-com bust than the Great Recession, in terms of overall damage to the economy. Our model predicts about 3 million net job losses at its worst, before a cyclical recovery takes hold. The Fed's aggressive response—along with foreign capital flows into the U.S.—would likely keep the 10-year yield well below 2% until 2020.

EA SEVERE DOWNSIDE SCENARIO

Figure 7: Severe Downside Scenario: Stress Test

CBRE EA SEVERE DOWNSIDE FORECAST	2017	2018	2019	2020	2021
GDP	-3.6	-0.5	2.7	2.1	2.2
Employment	-4.6	-3.2	1.9	1.9	1.7
CPI	0.4	1.2	1.3	2.2	2.4
10-yr Treasury	0.3	1.4	1.9	3.3	3.5

Note: Figures are Q4/Q4 change—except the 10-year, which is Q4 % yield.

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q4 2016.

Our severe downside scenario is meant as a proxy for the Federal Reserve's "Severely Adverse" supervisory scenario under its Comprehensive Capital Analysis and Review (CCAR) program. CCAR is meant to evaluate the capital planning processes and capital adequacy of U.S. banks under stressful macroeconomic scenarios. This scenario is certainly stressful; the Fed assumes the unemployment rate to hit 10%—equal to its 2009 peak. The peak-to-trough GDP decline in this scenario is also on par with that recorded during the Great Recession.

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Since the Fed does not provide guidance on payroll employment growth, EA uses the change in the unemployment rate path to approximate the impact. The scenario's supposed recession occurs immediately and wipes out 6.5 million jobs by the end of 2017. Although the Fed is quiet on what might cause such a severe recession, we can safely assume that financial markets would suffer some sort of systemic failure, likely leading to government intervention. The Federal Reserve does not discuss a hypothetical reaction in terms of monetary policy either, but history tells us it would use everything in its toolbox to stop the bleeding. This could mean negative interest rates, quantitative easing, and even helicopter money. The severe downside scenario has an extremely low probability, but it offers a useful guide to capital planning under the direst macroeconomic situations.

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