U.S. Macro Outlook, Q4 2017

Economic assumptions for our baseline and alternative scenario forecasts

- The beginning of February saw a sharp sell-off in U.S. equities as January's job gains and uptick in wage growth—to the strongest rate in nearly nine years—were viewed as precursors to higher inflation, tighter money and, in effect, lower corporate profits.
- The "real" economy, however, is on firm footing and will remain so in 2018, with strong consumption spending, higher private investment and the government's new tax plan expected to drive growth.
- Job growth will moderate in 2018, as employers have difficulty filling skilled positions from an ever-shrinking labor pool. Wage growth will accelerate further if the unemployment rate—already at a low of 4.1%—continues to drop.
- Federal tax reform will stimulate the economy in the medium term, while also straining the government's already weak fiscal position.
- The FOMC will increase the Fed Funds Rate three times in 2018. The impact of the fiscal stimulus and an increasingly tight labor market may make the FOMC more hawkish. The 10-Year Treasury will likely hover around the 3% mark by the end of 2018.
- The investment environment for U.S. real estate remains attractive due to strong fundamentals and limited risk. Tax reform will likely be a net positive, as new rules on expensing could lead to more construction.
- EA has revised its baseline forecast for 2018 GDP growth upward 20 basis points, to 2.6%. Fiscal stimulus will provide a modest boost to growth. We expect a mild cyclical downturn starting in mid-2019, followed by a quick return to growth. Our upside and downside forecast scenarios, while reflecting a wider range of outcomes, remain unchanged from last quarter.

ECONOMIC GROWTH: THE "REAL" ECONOMY TO REMAIN ON FIRM FOOTING IN 2018

Despite below-consensus GDP growth in Q4 2017—2.6% versus an expected 3.0%—the U.S. economy ended 2017 on a relatively strong note, having grown 2.3% over the year—up from 1.5% in 2016. January's impressive jobs report and an uptick in wage growth—the strongest in nearly nine years—further demonstrated the domestic economy's strength. The U.S. equity markets, however, view wage gains as a precursor to higher inflation, tighter money and, in effect, lower corporate profits, as companies must pay workers more. The result was a 6.5% drop in the Dow Jones Industrial Average. As investors try to rebalance their portfolios away from risky assets to safer ones, the 10-year Treasury will find favor with investors in the immediate term. However, expectations for higher inflation and higher government borrowing—especially when fiscal health and tighter money are a concern—will exert upward pressure on 10-year yields. We expect more volatility as asset prices get used to tighter money, but this should not derail the global or domestic economies.

Although net imports and inventory subtracted from overall growth, core GDP—which includes business investments, consumer spending and housing—in a sign of underlying strength, grew at a solid 4.6% in Q4 2017 and 3.3% in 2017 (both adjusted for inflation)—its fastest growth since 2014. And although lower

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inventory levels weighed down growth in Q4, we expect a stronger build-up in inventory—owing to strong domestic demand—to contribute to stronger GDP growth in early 2018. In January, forward-looking indicators like the Purchasing Managers' Index (PMI) showed growth in inventories of manufacturing inputs to be at a 12-month high, with the largest increase in finished goods inventories in six months. The PMI survey also showed a strong uptick in new orders for durable goods—to their highest level in five months.

Moreover, a sharp reduction in the corporate income tax rate—from 35% to 21%, part of the recently enacted $1.5 trillion tax-cut package—is expected to encourage companies to invest more in their factories and workers, thus likely driving the unemployment rate even lower and wage growth and productivity higher. Overall, strong consumption spending, higher private investment and fiscal expansion will ensure solid growth for 2018.

LABOR MARKET: JOB GAINS TO MODERATE AS MARKET TIGHTENS; WAGES ON THE CUSP OF RISING FASTER

Although the labor market continues to add jobs at a solid clip, we expect the rate of gains to moderate as employers have difficulty filling skilled positions from an ever-shrinking labor pool. Job gains are expected to drop from 2017's roughly 160,000 per month, to around 125,000 in 2018. The January jobs report also showed that labor market tightness may finally be translating into better pay increases for workers, with wages registering their strongest year-over-year increase (2.9%) since the Great Recession ended. We wouldn't call one data point a trend, but we would expect wage growth to accelerate further if the unemployment rate—already at a low of 4.1%—were to continue to decline.

MONETARY POLICY & INFLATION: EXPECT THREE RATE HIKES FOR 2018; INFLATION IS KEY

The FOMC is expected to raise the Fed Funds Rate three times this year. The impact of the fiscal stimulus and an increasingly tight labor market may make the FOMC more hawkish. Although the recent sell-off in equity markets has forced traders to dial back their expectations for Fed rates hikes in 2018—from 3-4 hikes to 2-3 hikes (according to interest rate futures and the CME Fed Watch survey)—the underlying macroeconomic fundamentals remain intact.

In fact, the latest data from the CBO shows that the U.S. economy's output gap has closed. A fiscal stimulus at this juncture will likely be inflationary, as it is expected to spur business investment and already-strong consumer spending, thus ensuring that the Fed stays on its current rate-hike path for 2018. Overall, inflation remains the key metric to watch. In January 2018, core personal consumption expenditures (PCE) was 1.5%—below the Fed's stated target of 2% inflation. Although the 10-year break-even inflation rate—a measure of inflation expectations—has climbed steadily since November 2017 (from around 1.8% then, to 2.1% in February), it remains to be seen whether inflation expectations will be sustained at this level.

The 10-year Treasury will likely hover around the 3% mark by the end of 2018. A worsening fiscal deficit position, rising national debt, faster inflation from the fiscal stimulus and the Fed's balance sheet reduction—which will gather steam in late 2018 and 2019—will likely drive yields closer to 3%, if not slightly higher. While investors may favor U.S. Treasurys over U.S. equities in the immediate term due to the recent sell-off in the latter, concerns over longer-term fiscal health and faster inflation will likely put upward pressure on yields.

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FISCAL POLICY: TAX PLAN TO BE STIMULATIVE IN THE MEDIUM TERM; GAINS WILL BE MODEST

While there's little denying that the government's new tax plan will drive private investment, jobs and consumer spending in 2018—and possibly until mid-2019—the tax cuts will also increase the budget deficit by $1.5 trillion over the next ten years. This is a major cause for concern, given the rising trajectory of U.S. public debt. Moreover, much of the economic gain will likely be on the margins, as the stimulus coincides with the economy operating nearly at capacity.

In 2017, the government ran a budget deficit of $666 billion—the largest since 2013. The Congressional Budget Office (CBO) anticipates that tax receipts under the new plan will be lower by $10-15 billion per month. Despite these lower revenue projections, a rising fiscal deficit and growing public debt, the government is on track to borrow $955 billion this fiscal year—an 84% jump over last year and the most in six years—and to borrow more than $1 trillion in 2019 and more than $1.1 trillion in 2020.

Markets are especially wary of all this additional borrowing just as the Fed is starting to pare down its balance sheet and plans to raise rates at least three times this year. Wage growth is also on the brink of picking up, which brings with it the threat of higher inflation. A confluence of these factors is expected to drive up long-term borrowing costs for the private sector, while also raising existing debt-servicing costs. In fact, investors' discomfort was all too visible on February 2, as concerns about higher borrowing and faster inflation led to the highest spike in the 10-year Treasury since 2014, which in turn, partly drove the worst weekly stock market sell-off in two years.

IMPLICATIONS FOR CRE: NEW TAX PLAN A NET POSITIVE

Demand for apartments remains strong, and solid economic growth this year should help renters' pocketbooks and their ability to pay more. Moreover, the new tax law should further tilt the "buy vs. rent" incentive toward "rent" with increased standard deductions that boost the lower end and decreased ability to deduct mortgage interest which will boost the higher end.

Additionally, Bill Wheaton argues that the tax reform's provision for a new and novel way to depreciate new capital investment—"expensing"—will provide huge incentive, especially for the real estate sector, to build new structures like shopping centers, industrial parks and offices. That said, there is no shortage of new investment in these property markets at present. Demand for retail space is on the wane as consumers shift to internet shopping. While demand for industrial space is healthy, a building boom is already underway in the sector. In the office sector, the rise of co-working spaces is causing some amount of unease. Therefore, while the new form of expensing might encourage new building construction, property fundamentals might not warrant it.

TRADE & THE DOLLAR: TRADE DEFICIT TO WIDEN; STRONG ECONOMIC FUNDAMENTALS TO SUPPORT THE DOLLAR

In 2017, the U.S. trade deficit widened to a nine-year high of $566 billion, with the deficit in goods with China hitting a record $375 billion. Imports from Mexico also climbed to a new peak. The larger deficit was driven by higher global petroleum prices and strong domestic demand, which in turn encouraged consumers to buy more imported goods. Given that the U.S. cannot control the international price of oil nor discourage its consumers from buying imported cars or electronics, a strengthening economy in 2018 will likely widen the trade deficit further. While the government has taken a hard line with key trading partners such as China, Mexico and Canada, there's been little progress on renegotiating trade rules.

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The U.S. dollar index has gained around 1.2% since February 2—after January's impressive jobs report and the FOMC's cautiously hawkish policy announcement—having depreciated nearly 7% between November and end-January. The depreciation pressure prior to February was likely fueled by speculation that a pickup in global growth would result in other major central banks following the Fed's lead in tightening monetary policy, thus eroding United States' yield advantage. However, the European Central Bank and the Bank of Japan have pushed back against this narrative. Going forward, stronger economic activity, along with tighter monetary policy for 2018, will likely give the dollar a boost.

EA BASELINE FORECAST

We've revised our baseline GDP growth for 2018 upward by 20 bps relative to Q3 2017. The government's fiscal stimulus will boost growth, but gains will be modest given that the economy is operating at near capacity. While the unemployment rate might drop lower, the forecast for monthly employment gains—unchanged from last quarter—slows to around 125,000 from 2017's 160,000. Inflation has been revised up slightly for 2018, while our 10-year Treasury forecast remains unchanged. For 2019, we've revised the 10-year Treasury upward, partly due to the Fed's balance reduction and strained government finances. We expect a slowdown to hit in late-2019 and last for a full year, though it would be relatively mild with GDP growth between slightly negative and 0.8% for 5 quarters. Projected job losses total 500,000 for 2019 and around 1.2 million for 2020.

Figure 1: Economic Growth Revised Upward for 2018

CBRE EA BASELINE FORECAST	2017	2018	2019	2020	2021
GDP, %	2.5	2.6	0.8	0.8	2.9
Employment, mil.	2.0	1.5	(0.5)	(1.2)	2.2
CPI, %	2.1	2.5	1.8	1.2	1.7
10-yr Treasury, %	2.4	3.0	2.2	1.9	2.2

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

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q4 2017.

The slowdown causes the Fed to lower interest rates and the 10-year drops from 3.0% in 2018 down to 2.2% in 2019. Inflation also declines with the slowing economy. We see a quick rebound only toward the beginning of 2021 as the economy recovers, but like the past three recessions, job gains come more slowly than GDP.

EA UPSIDE SCENARIO

Our upside scenario is mostly unchanged from last quarter. GDP growth has been revised up slightly for 2018. This scenario assumes that President Trump's tax plan leads to a strong multiplier effect on growth, an infrastructure program that boosts productivity, capital repatriation that leads to business investment and a growing economy that adds to the labor force participation rate. These factors lead to a long expansionary cycle, where the economy steers clear of overheating. The Fed, therefore, is not forced to raise interest rates to curtail inflation.

Figure 2: Upside Scenario: Economic Growth Revised Up for 2018

CBRE EA UPSIDE FORECAST	2017	2018	2019	2020	2021
GDP, %	2.5	3.6	2.5	1.7	2.8
Employment, mil.	2.0	4.0	3.5	0.5	2.5
CPI, %	2.1	3.5	2.8	2.5	2.4
10-yr Treasury, %	2.4	4.0	3.3	3.1	2.9

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

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q4 2017.

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EA DOWNSIDE SCENARIO

Figure 3: Downside Scenario: Outright Recession in 2018 and 2019

CBRE EA DOWNSIDE FORECAST					
	2017	2018	2019	2020	2021
GDP, %	2.5	(0.3)	(1.3)	2.1	2.9
Employment, mil.	2.0	(0.3)	(2.4)	(1.3)	2.2
CPI, %	2.1	0.5	(0.4)	0.0	0.5
10-yr Treasury, %	2.4	1.4	1.3	1.7	2.1

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

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q4 2017.

Our downside scenario also remains largely unchanged from last quarter. We expect GDP growth to turn negative in 2018 and 2019. Inflation forecasts for 2019 and 2020 have been revised downward. While our baseline assumes that the government's stimulative fiscal policies will produce strong growth multipliers, our downside scenario assumes that these do not come to fruition, are watered-down or misguided. 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. The implication is that the stimulus may not be that stimulative at all; the economy would get higher inflation and interest rates without the benefit of stronger growth. Our downside scenario is the extreme version of this, accompanied by other downside policies effects such as a trade war, large-scale deportations, and otherwise anti-growth legislation.

In terms of overall damage to the economy, a realistic downside scenario currently resembles the dot-com bust more closely than it does the Great Recession. We would expect 2.4 million net job losses before a cyclical recovery took 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 late 2020.

EA SEVERE DOWNSIDE SCENARIO

Figure 4: Severe Downside Scenario: Stress Test

CBRE EA SEVERE DOWNSIDE FORECAST					
	2017	2018	2019	2020	2021
GDP	2.5	(5.4)	1.7	1.9	2.8
Employment	2.0	(5.5)	3.4	(0.7)	1.8
CPI	2.1	0.2	0.4	1.2	1.8
10-yr Treasury	2.4	1.1	1.3	1.7	2.1

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

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q4 2017.

Our severe downside scenario, unchanged from last quarter, 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.

Since the Fed does not provide guidance on payroll employment growth, EA uses the change in GDP and the unemployment rate to approximate the impact. The scenario's supposed recession occurs immediately and wipes out more than 7 million jobs by the end of 2018. 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 every tool at its disposal to stop the bleeding. This could mean the re-introduction of quantitative easing, or even the introduction of negative interest rates. 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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