U.S. Macro Outlook, Q2 2018

Economic assumptions for baseline and alternative scenario forecasts

- Despite trade uncertainties and a continually flattening yield curve, the U.S. economy posted strong growth in Q2 2018, due to tax cuts and the lagged effects of a buoyant global economy in 2017.
- Growth in H2 2018 will likely moderate as financial conditions become tighter and the one-time effects of the export surge likely begin to fade.
- Weaker-than-expected hiring over the past few months has little to do with trade uncertainties and more to do with a shortage of workers. However, wages have grown just marginally faster than inflation.
- The FOMC will increase the Fed Funds Rate twice more this year. The 10-Year Treasury will likely hover around 3% for the rest of the year, with the possibility of it rising higher.
- From an absolute yield perspective, despite worsening fiscal health, investor appetite for U.S. debt will remain strong so long as the U.S. experiences solid growth and higher bond yields than its peers.
- We expect the trade deficit to widen as a fiscal stimulus-led boost to demand leads to higher imports. Trade dispute has yet to materially affect CRE.
- EA's baseline scenario remains unchanged from last quarter: 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, also remain unchanged from last quarter.

ECONOMIC GROWTH: OUTLOOK FOR 2018 REMAINS STRONG, EVEN AS GROWTH MODERATES IN SECOND HALF

The U.S. economy posted strong growth in Q2 2018 as real GDP grew at an annualized rate of 4.1%—its strongest pace since Q3 2014. This was due to the lagged effects of a buoyant global economy in 2017, and to the tax cuts and the stimulus still being provided by the only-moderate rise in interest rates. Underlying domestic fundamentals also remain strong; GDP less inventories and net exports rose by an impressive 3.9% even as the yield curve continues to flatten. On an annual basis, the economy expanded by 2.8%—its strongest rate since Q1 2015.

Consumer spending was the biggest contributor to GDP growth in Q2, as households bought more motor vehicles and spent more on healthcare, utilities, food and accommodation. Consumption was also buoyed by a robust labor market, which averaged 215,000 new jobs per month during H1 2018. Government spending was also supportive of overall growth, as spending on defense increased. While export of goods was the second-largest contributor to real GDP growth, this had more to do with a rush to export inventories before the trade tariffs took effect, than with an increase in production. In effect, the contribution from exports netted out the drag from private inventories, as firms didn't ramp up new production in anticipation of the tariffs, they just drew down existing inventories.

Business spending on equipment grew more slowly than in Q1 and versus the first half of 2017. Many companies chose to pay dividends and buy back shares instead of reinvesting their tax savings. The 2017 tax overhaul—designed to encourage business spending on equipment by lowering the corporate tax rate and increasing flexibility on business expensing—has yet to have meaningful impact.

We expect growth to moderate in H2 as one-off factors like the Q2 export growth surge—likely a temporary response to the looming trade tariffs—start to fade. Moreover, import duties could end up raising consumer prices while also hampering business investment and hiring. The stress from trade uncertainty has already begun to weigh on manufacturing, as supplier delivery times have risen to a 14-year high. Longer delivery times disrupt production all along the supply chain. We also expect financial conditions to become tighter as monetary policy continues to normalize.

LABOR MARKET: LABOR SHORTAGES GROW; WAGES BARELY KEEP PACE WITH INFLATION

Although the ongoing trade tensions could potentially dampen hiring activity in the coming quarters, the past few months' weaker-than-expected hiring has little to do with trade uncertainty and more to do with a shortage of workers. Small businesses have struggled to fill unskilled positions. The Federal Reserve's Beige Book report also highlights a scarcity of labor in a wide range of sectors—such as manufacturing, construction, information technology and trucking.

Despite an ever-shrinking talent pool, wages have been growing just marginally faster than inflation, and are not historically commensurate with the current level of unemployment. One reason may be the likelihood that the falling unemployment rate has created sectoral labor shortages, and not necessarily an economy-wide shortage. Secondly, the labor participation rate (62.9%) has remained flat over the past few years as discouraged workers have returned to find work as baby boomers have retired. On a positive note, the underemployment rate declined in July to 7.5%—the lowest rate since 2001—from June's 7.8%. The still-high underemployment rate is often viewed as a sign that the labor market has yet to reach capacity and as a reason that wages haven't increased significantly.

MONETARY POLICY & INFLATION: EXPECT TWO ADDITIONAL RATE HIKES FOR 2018; INFLATION & WAGES ARE KEY

Although the Federal Reserve has already increased rates twice this year, strong GDP growth in Q2, a continuously tightening labor market and solid upticks in overall and core consumer prices in Q2—to 2.8% and 2.2%, respectively, on a year-over-year basis—should keep the Fed on track for at least two more rate hikes this year. Wage gains, however, remain modest, while the Core PCE—the Fed's preferred gauge of inflation—remains just below the 2% target. The Fed's outlook will likely evolve as any increase in concern over the government's fiscal stimulus—i.e., the Tax Cuts and Jobs Act and its effect on inflation—will likely be reflected in the Fed's projections going forward.

With the economy having operated marginally above its potential GDP for a fourth consecutive quarter, the Fed will be keenly watching how the tax cuts percolate through to business investment and consumer spending. As we've argued before: when the economy is said to be operating at capacity, a fiscal stimulus can prove to be inflationary. The fear of runaway inflation, however, seems distant at present, given that the 5-year and 10-year break-even inflation rates—measures of medium- and longer-term inflation expectations—have only just climbed a bit over 2%.

We continue to expect the 10-year Treasury rate to rise above 3% by year's end. The rising issuance of debt to fund higher budget deficits, rising national debt, faster inflation from the fiscal stimulus, and the Fed's gradual balance sheet reduction—which will gather steam in late 2018 and 2019—will likely keep the yield hovering around the 3% level for the rest of the year, if not slightly higher.

FISCAL POLICY: TAX PLAN, WHILE STIMULATIVE IN THE MEDIUM TERM, IS LEADING TO RECORD DEBT ISSUANCE

With GDP growth having surpassed 4% in Q2 and the unemployment rate having fallen to 3.9% in July, there's little denying that the economy is feeling the immediate benefits of President Trump's fiscal stimulus. However, the budget deficit widened to $607 billion during the first nine months of the current fiscal year—a 16% increase from a year earlier—as total spending rose by 4% while revenues increased a modest 1%. Higher debt servicing costs and spending on Social Security, Medicare and Medicaid drove up spending. Meanwhile, during the first six months of 2018, corporate tax payments fell by 33% from the same period a year earlier. As a result, corporate tax receipts as a share of GDP dropped to a near 75-year low.

According to the Congressional Budget Office (CBO), the budget deficit is expected to end the current fiscal year at $804 billion, up from $665 billion in fiscal 2017, and then surpass the $1 trillion mark by 2020. The White House's own forecasts acknowledge that the deficit will exceed 5% of GDP in 2019—a level last breached only after deep recessions when employment topped 10%. Today, the economy is in its tenth year of expansion with the labor market nearing full employment, while, worryingly, the debt-to-GDP ratio has risen from around 60% in 2008 to a little over 105% in 2017.

Rising budget deficits are also boosting the U.S. Treasury's debt issuances, which are expected to top $1 trillion by the end of the current fiscal year, which ends on September 30. The Treasury expects to raise another $440 billion in the October-December quarter, bringing the second-half borrowing estimate to $769 billion, the highest since H2 2008's $1.1 trillion. Markets are wary of all this additional borrowing just as the Fed is starting to pare its balance sheet. Their concern has been all too visible as yields on the 10-year have climbed from 2.4% at the start of 2018 to 2.95%-3.0%.

However, it appears that the government's rising debt load seems to be less of a pressing concern for investors than are the threat of an all-out trade war and the pace of the Fed's interest rate increases. Moreover, the U.S. 10-year yield is running 2.50 and 2.85 percentage points above its German and Japanese counterparts, respectively. From an absolute yield perspective, investor appetite for U.S. debt will remain strong so long as the U.S. experiences solid growth and higher bond yields than its peers.

CRE IMPLICATIONS: TRADE DISPUTE YET TO MATERIALLY AFFECT CRE

The tariffs imposed thus far are modest and have a relatively low impact on total U.S. trade. Likewise, provided that a full-blown trade war does not occur, there is not much potential impact for commercial real estate. The greatest impact likely would be on the industrial & logistics (I&L) sector and its supply chain dynamics. If the U.S. moves away from open trade, corporations would be forced to abandon their existing supply chains for greatly shortened ones that focus on domestic sources of materials and parts, and domestic markets.

Two recent CBRE EA research studies have shed light on the likely real estate impacts of such disruptions. In the first—What trade barriers might mean for U.S. warehouse demand—we demonstrate that imports generate most of the demand for warehouses. This is because imported goods must be landed, stored, transshipped and distributed, while exports generally go directly from domestic factory to port.

In the second study—Industrial automation may reduce net demand for industrial space—we conclude that automation leads to less overall industrial and warehouse space demand. Any resurgence in U.S. manufacturing to replace imported goods would likely involve greater automation, which could well reduce the absorption of factory space and warehouses.

Lastly, with normalization of monetary policy underway and the Treasury set to increase the supply of bonds to finance rising budget deficits, longer-term rates will continue to rise in the medium term. Given that longer-term Treasurys are the primary driver of both commercial and residential mortgages, along with other longer-term securities, the increase in rates will likely slow purchases and refinances on the commercial and residential side.

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

Underpinned by a strong dollar and solid economic growth, the U.S. trade deficit rose by 7% ($3 billion) on the month, to $46.3 billion—the first monthly increase in four months and the fastest pace of increase since November 2016. For the first half of 2018, the deficit stood at $291 billion, up from the 272 billion posted in first half of 2017. President Trump had imposed import tariffs on solar panels, washing machines and certain steel and aluminum product in June. In July, President Trump followed up on a series of threats by imposing a 25% tariff on $34 billion worth of Chinese goods, prompting Beijing to respond with retaliatory levies on high-value U.S. exports, such as soybeans. At the time of writing, the Trump Administration unveiled the next round of Chinese imports—worth roughly $16 billion—to face 25% tariffs starting August 23. Beijing has responded in equal measure. A recent CBRE EA research study—Trade disputes so far having little impact on CRE—sheds light on the potential collateral damage from the escalating trade tensions.

The announcement of tariffs generally prompt companies to ratchet up imports of targeted goods before the tariffs take effect, after which they tend to look for alternative sources. This was evident in June's trade data, where imports of steel and iron fell 19% on the month; imports of bauxite and aluminum were also down 10%. Imports of both groups of metals had been increasing earlier in the year. Likewise, the looming trade uncertainty with China likely contributed to the surge in soybean exports in Q2 (especially in June), which in turn had an outsized effect on GDP growth. The trade dispute with the U.S. could see China shifting its purchases to Brazil and other countries. Going forward, we expect the trade deficit to continue to widen as a fiscal stimulus-led boost to demand leads to higher imports. Meanwhile export growth will likely slow as global growth cools.

Moreover, the solid economic outlook and rising interest rates have led to the U.S. dollar index gaining nearly 7% since March, thus making American goods less competitive in the international market. Looking ahead, tighter monetary policy and stronger economic activity driven by the fiscal stimulus are expected to drive the dollar higher.

EA BASELINE FORECAST

Our baseline forecasts remain unchanged from last quarter. While growth in the first half of 2018 was particularly strong, growth in the second half will likely moderate as financial conditions become tighter and the one-time effects of the export surge seen in Q2 will likely start to fade. We expect inflation to be stronger in 2018 relative to the 2.1% in 2017. The 10-year Treasury will likely hover around 3% for the rest of 2018, with the possibility of rising higher—partly due to the Fed's balance reduction and

Figure 3: Baseline Forecasts Unchanged Since Last Quarter

CBRE EA BASELINE FORECAST	2018	2019	2020	2021	2022
GDP, %	2.5	0.8	0.8	2.9	2.3
Emp, mil.	2.2	0.8	-0.7	1.0	1.8
CPI, %	2.5	1.8	1.2	1.7	2.0
10-yr Treasury, %	3.0	2.2	1.9	2.2	2.5

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

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q2 2018.

increasing government debt issuance. We expect a slowdown to hit in late 2019 and to last a full year, though it will be relatively mild—5 quarters of slightly negative to 0.8% GDP growth. The slowdown causes the Fed to lower interest rates and the 10-year drops from 3.0% in 2018 to 2.2% in 2019. Inflation also declines with the slowing economy. The recession will be mild, and we will see a quick rebound only toward the beginning of 2021, as the economy recovers.

EA UPSIDE SCENARIO

The upside scenario is also the same as last quarter. 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, and the Fed is not forced to raise interest rates to curtail inflation.

Figure 4: Upside Scenario: Unchanged Since Last Quarter

CBRE EA UPSIDE FORECAST	2018	2019	2020	2021	2022
GDP, %	3.6	2.5	1.7	2.8	3.2
Emp, mil.	3.3	4.3	2.0	1.7	1.9
CPI, %	3.5	2.8	2.5	2.4	2.6
10-yr Treasury, %	4.0	3.3	3.1	2.9	3.0

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

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q2 2018.

EA DOWNSIDE SCENARIO

Figure 5: Downside Scenario: Outright Recession in 2018 and 2019

CBRE EA DOWNSIDE FORECAST	2018	2019	2020	2021	2022
GDP, %	-0.3	-1.3	2.1	2.9	2.5
Emp, mil.	1.4	-0.7	-1.1	1.1	1.8
CPI, %	0.5	-0.4	0.0	0.5	1.0
10-yr Treasury, %	1.4	1.3	1.7	2.1	2.3

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

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q2 2018.

Our downside scenario is also unchanged from last quarter. We expect GDP growth to turn negative in 2018 and 2019. 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 suggests 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. We expect a total of 1.8 million net job losses over 2019 and 2020, 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 late 2020.

EA SEVERE DOWNSIDE SCENARIO

Figure 6: Severe Downside Scenario: Stress Test

CBRE EA SEVERE DOWNSIDE FORECAST	2018	2019	2020	2021	2022
GDP, %	-5.4	1.7	1.9	2.8	2.4
Emp, mil.	-1.8	0.1	0.7	0.4	1.7
CPI, %	0.2	0.4	1.2	1.8	1.5
10-yr Treasury, %	1.1	1.3	1.7	2.1	2.2

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

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q2 2018.

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 nearly 2 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 everything in its toolbox 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 direct macroeconomic situations.

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