U.S. Macro Outlook, Q3 2018

Economic assumptions underlying EA's baseline and alternative scenario forecasts

- Strong consumer activity and a spurt in government spending pushed Q3 growth that was strong, if down a bit from Q2. Net exports were a drag, while business investment remained anemic.
- Driving growth in 2019: the remainder of the fiscal boost, the capital spending cycle, high consumer confidence and—perhaps—continuing wage growth. Growth will be more moderate than in 2018.
- The FOMC will raise the Fed Funds Rate once more in 2018. We see the possibility of three rate increases next year, if wage growth and inflation surge. The 10-Year Treasury will likely hover around 3% through the end of 2018, before rising higher in 2019.
- So long as the U.S. maintains solid growth and higher bond yields than its peers, investor appetite for U.S. debt should remain strong, even as fiscal health declines.
- A strong dollar, the recent tax cuts and other fiscal stimulus will boost demand to outstrip domestic production, keeping imports high and further widening the trade gap. Trade disputes have yet to materially affect CRE.
- EA has upwardly revised its GDP baseline outlook for 2018, 2019 and 2020. We expect a mild cyclical downturn to begin in mid-2020, lasting a full year. Our upside and downside scenarios—still tuned to reflect a wider range of possible outcomes—have been revised as well, in keeping with the shift to the baseline.

ECONOMIC GROWTH: FISCAL BOOST KEEPS OUTLOOK FOR 2019 STRONG

The U.S. economy continued to barrel ahead in Q3, with real GDP rising at 3.5%, annualized. Although this was slower than Q2's 4.2%, their combined six-month stretch was one of the best of the past decade. On an annual basis, the economy grew 3% in Q3, up from Q3 2017's 2.3% and Q3 2016's 1.5%. This latest strong GDP print came amid a turbulent month for U.S. equities, as rising rates, weaker-than-anticipated earnings results from tech and industrial companies, fears of a Chinese slowdown and rising trade tensions caused jitters among investors.

Consumer spending remains the primary driver of the current economic expansion. In Q3, growth was also partly fueled by a spurt in government spending. The latest data point also bore the negative imprint of President Trump's trade wars, however, with trade data particularly weak from a surge in imports and a sharp drop in goods exports. Moreover, the run-up in inventories—a significant contributor to Q3 growth—may reflect companies' stockpiling of goods ahead of the trade tariffs.

Non-residential fixed investment's contribution to GDP was effectively zero, with investment in intellectual property nearly offset by a decline in spending on commercial buildings. Contribution from corporate investment has waned through 2018, despite the tax reforms. While it may be too early to conclude that tax cuts have had little impact on corporate investment, a survey by NABE finds that much of the windfall from tax reform has been spent on share buybacks, rather than investment. A Fed study concludes that U.S. companies' repatriation of cash held overseas had not led to an obvious spike in investment. However, benefits from such reforms do take years to fully manifest. Moreover, President Trump's reordering of U.S. trade relations and the consequent uncertainty have likely weighed on investment.

Overall, our GDP outlook for 2018, 2019 and 2020 has been revised upward. The remaining impact of the fiscal boost, the capital spending cycle, high consumer confidence and—perhaps—continuing wage growth will drive growth in 2019—a more moderate growth than 2018's. Rising interest rates (long and short) will weigh on business and consumer activity by late-2019, leading to further volatility in equity markets. By the second half of 2020, we expect the economy to slow in reaction to higher interest rates, equity market corrections, credit market problems and international geo-political/economic risk factors. The slowdown will be relatively mild and quick, however—more like 1991 and 2001 in severity than 2008-9. We anticipate some loss of jobs in 2021 as the economy slows.

LABOR MARKET: SOLID JOB GAINS ACROSS ALL SECTORS, WHILE WAGES GAINS BREACH THE 3% THRESHOLD

Despite the recent stock market volatility and potential employment impact of Hurricane Florence, the most recent jobs report (October) showed solid gains across all sectors of the economy. 2018's average monthly job gain stood at a solid 213,000. Unemployment is at its lowest rate in nearly two generations, and year-over-year wage growth reached 3.1% in October—its fastest increase since April 2009. A significant improvement over earlier wage growth during this expansion, that rate is still not historically commensurate with current unemployment, nor is it enough to keep pace with recent quarters' consumer spending. Adjusted for inflation, wages are advancing at just a creep. Nevertheless, the consensus among economists is that wage growth should accelerate as the labor market continues to tighten. A recent survey by the National Federation of Independent Business (NFIB) shows that the proportion of small businesses looking to raise pay is at its the highest since the survey began.

Another possible reason wages have been slow to respond to the tight labor market is that falling unemployment has likely created sectoral labor shortages—and not necessarily an economy-wide shortage. On a positive note, the underemployment rate declined from 7.5% in September to 7.4% in October—its lowest point since April 2001. The still-high underemployment rate is often viewed as a sign that the labor market isn't yet at full capacity and the reason wages haven't seen a more rapid rise. Tax reform will continue to stimulate the economy, further extending the current cycle. However, additional job growth will likely be tempered, given that the economy is operating near capacity, an aging population is shrinking the available labor pool and productivity growth is low by historical standards.

MONETARY POLICY & INFLATION: EXPECT ONE ADDITIONAL RATE HIKES FOR 2018; THREE IN 2019

Although the Federal Reserve has already raised rates thrice this year, strong GDP growth in Q3, a continuously tightening labor market and solid year-over-year upticks in overall and core consumer prices in Q3 (to 2.6% and 2.2%) should keep the Fed on track for one more hike this year. If wage growth and inflation surge, we see the possibility of three rate increases in 2019. Wage gains breached the 3% mark in October, but whether they can sustain the pace remains to be seen. Meanwhile, core PCE has continued to hover around the Fed's 2% target. The Fed's outlook will likely evolve, with any increase in concern over the government's fiscal stimulus—i.e., the Tax Cuts and Jobs Act—vis-à-vis inflation likely reflected in its future projections.

As we've stated before, when an economy is operating at capacity, fiscal stimulus can prove to be inflationary. The fear of runaway inflation seems distant at present, however: the 10-year and the 5-year break-even inflation rates—measures of medium- and longer-term inflation expectations—came off their peaks (2.17% and 2.05%, respectively) in early October, though they remain anchored around 2%—the Federal Reserve's stated goal for inflation.

Along with rising inflation from the fiscal stimulus, the rising issuance of debt to fund higher budget deficits, the rising national debt and the Fed's gradual balance sheet reduction—which will continue to gather steam in 2019—will likely keep the 10-year Treasury yield hovering just above 3% level for the rest of the year, before rising to around 3.3% in 2019.

FISCAL POLICY: TAX PLAN, WHILE STIMULATIVE, IS ADDING TO THE NATIONAL DEBT LOAD AT A RECORD PACE

The U.S. federal budget deficit widened to $779 billion, or 3.9% of GDP, for the fiscal year 2018—a 17% increase over the previous fiscal period—as total spending and revenues rose by 3.2% and a meager 0.4%, respectively. Rising deficits were expected for several reasons. Firstly, tax cuts that took effect at the start of 2018 reduced taxpayers' quarterly tax payments to the Treasury over the first nine months of the year. The big revenue drop came on the business side, with corporate tax revenues falling by 31% versus the previous fiscal year—a direct consequence of the tax law signed last year. Meanwhile, rising interest rates forced the federal government to pay more in interest on the national debt, which currently stands at more than $21 trillion. Finally, an increase in inflation contributed to higher government spending for several key programs, such as Medicaid.

According to the Congressional Budget Office (CBO), the budget deficit is expected to grow further—to just under $1 trillion during 2019, and then to surpass the $1 trillion-mark by 2020—the first deficit of that size since the financial crisis. The White House's own forecasts acknowledge that the deficit will exceed 5% of GDP in 2019—a level previously surpassed only after deep recessions when employment has topped 10%. Today, the economy is in its 10th year of expansion and the labor market is 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. It expects to raise another $425 billion in the October-December quarter—the most it will have borrowed in a fourth quarter since 2009. Moreover, if the Q4 borrowing estimate does come to fruition, the government will have borrowed more than $1.38 trillion this calendar year. 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% to around 3.2% over the course of 2018.

However, for investors, it appears that the government's rising debt load seems to be a less pressing concern 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 relative to its peers.

CRE IMPLICATIONS: TRADE DISPUTE YET TO MATERIALLY AFFECT CRE

The tariffs imposed thus far are modest and have a relatively small impact on total U.S. trade. Likewise, there is not much potential impact for commercial real estate—provided that a full-blown trade war does not occur. The greatest impact likely would be on the industrial & logistics (I&L) sector and its supply chain dynamics. If the U.S. were to move 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 on 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 commercial and residential mortgages and other longer-term securities. The increase in rates will likely slow both commercial and residential purchases and refinances.

TRADE & THE DOLLAR: THE DOLLAR AND STRONG CONSUMER DEMAND WILL CONTINUE TO WIDEN THE TRADE GAP

Powered by the rising dollar, a strong U.S. economy drew a record number of imports in September, driving the goods and services deficit to $54 billion—its second-highest level since President Trump took office. Meanwhile, the goods deficit reached its highest level since July 2008—$77.2 billion. The year-to-date (Jan-Sep) goods deficit, at $651 billion, was up 9.4% over the same period last year. With rising wages and low unemployment, American consumers and companies bought more foreign-made computers, cellphones, telecommunications equipment, aircraft engines and clothing.

As for trade with China, the Trump administration has so far imposed a 10% charge—due to rise to 25% in January—on $200 billion of Chinese goods. Another $50 billion of Chinese goods already is subject to 25% duties. While Beijing has responded with tariff hikes on $110 billion of American goods, President Trump has threatened to expand U.S. penalties to all goods from China. Despite several rounds of U.S. duties on Chinese goods, the U.S.' trade deficit with China hit a record high of $40.2 billion in September. In fact, a weaker renminbi and a strong U.S. economy meant that China's exports to the U.S. continued to grow strongly even in October, defying expectations that American tariffs would knock down demand for Chinese goods and force Beijing to the negotiating table. The resilience of U.S. imports of Chinese goods is partly a reflection of traders rushing to beat the U.S. tariff hike that is planned for January 2019. Chinese exports to the U.S. should remain strong through the end of the year as Chinese businesses continue to front-load their exports.

The U.S.' solid economic outlook and rising interest rates have led to the U.S. dollar index gaining nearly 7% since April, making American goods less competitive in the international market. Looking ahead, tighter monetary policy and stronger economic activity are expected to drive the dollar higher. The higher dollar, the recent tax cuts and the fiscal stimulus should support demand that outstrips domestic production, keeping imports high and allowing the trade gap to widen further.

EA BASELINE FORECAST

We've revised our GDP outlook for 2018, 2019 and 2020 upward. The fiscal boost, capital spending, consumer confidence and improved wage growth will drive growth in 2019. Rising interest rates (long and short) will weigh on business and consumer activity by late-2019, leading to further volatility in equity markets. By H2 2020, we expect the economy to slow in reaction to higher interest rates, equity market corrections, credit market problems and international geo-political/economic risk factors. The slowdown will be relatively mild and quick, however.

Figure 1: Outlook For GDP Revised Upward

CBRE EA BASELINE FORECAST	2018	2019	2020	2021	2022
GDP, %	3.0	2.6	0.9	0.8	2.5
Emp, mil.	2.4	1.7	0.3	-2.1	0.1
CPI, %	2.3	2.2	2.2	1.6	1.6
10-yr Treasury, %	3.1	3.3	2.7	2.1	2.5

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

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q3 2018.

We anticipate some shrinkage in employment in 2021 (a little over 2 million jobs) as the economy slows. The slowdown causes the Fed to lower interest rates and the 10-year drops from 3.3% in 2019 to 2.1% by the end of 2021. Inflation also declines with the slowing economy.

EA UPSIDE SCENARIO

This scenario assumes that President Trump's tax plan has a strong multiplier effect on growth, an infrastructure program boosts productivity, capital repatriation leads to business investment and a growing economy raises the labor force participation rate. As a result, our 2019 GDP growth forecast has been revised to 3.4%, from 2.5% previously. While these factors lead to a long expansionary cycle, the economy will see stronger inflation and might tighten more than under the baseline scenario. Tighter financial and credit conditions will cause a mild cyclical downturn starting in mid-2020, followed by a quick recovery. The downturn will not be nearly as severe as that shown in the baseline scenario.

Figure 2: Upside Scenario: Strong Multipliers From The Fiscal Stimulus

CBRE EA UPSIDE FORECAST	2018	2019	2020	2021	2022
GDP, %	3.3	3.4	1.8	1.9	2.5
Emp, mil.	2.8	2.9	1.7	-0.5	0.1
CPI, %	2.6	2.9	3.1	2.6	1.6
10-yr Treasury, %	4.0	4.3	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, Q3 2018.

EA DOWNSIDE SCENARIO

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. As a result, the economy starts to see a slowdown in mid-2019 as the effects of fiscal stimulus fade. Year-over-year growth eventually turns negative between Q4 2020 and Q3 2021, while inflation also falls well below the Fed's target.

Figure 3: Downside Scenario: Fiscal Stimulus Not Stimulative At All

CBRE EA DOWNSIDE FORECAST	2018	2019	2020	2021	2022
GDP, %	2.9	1.9	-0.3	0.3	2.3
Emp, mil.	2.2	0.8	-1.5	-2.8	-0.1
CPI, %	2.2	1.5	1.0	1.0	1.4
10-yr Treasury, %	2.8	2.2	0.9	1.2	2.0

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

Source: BEA, BLS, Federal Reserve, CBRE Econometric Advisors, Q3 2018.

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 its overall damage to the economy. We expect a total of 4.3 million net job losses over 2020 and 2021, 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 early 2022.

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