



Winter Newsletter | February 14, 2019 | Andrew J. Nelson, Chief U.S. Economist

## **PILOTING A SOFT LANDING: Odds Rise for Avoiding/Postponing a Recession**

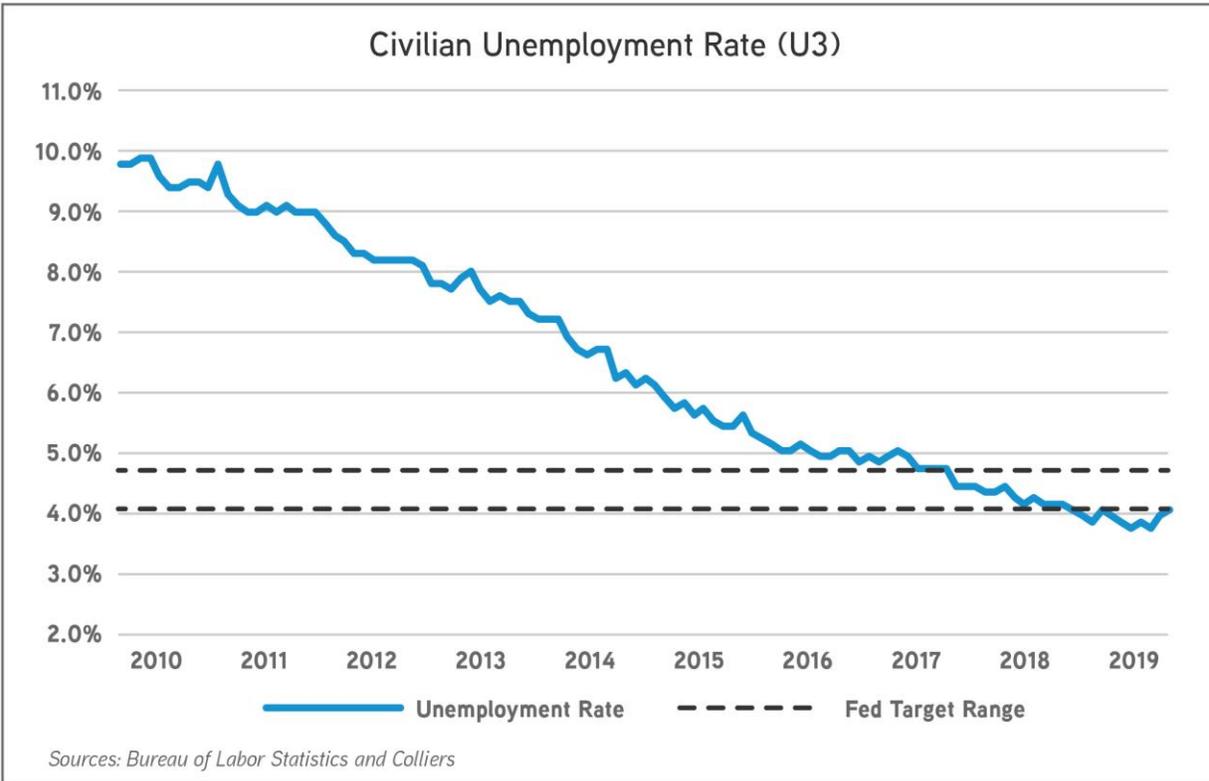
- ***U.S. economic growth last year almost certainly was the strongest, at least since 2015, if not of the entire cycle (final figures are delayed due to the partial government shutdown), job growth remains robust, even as wage gains and labor shortages escalate.***
- ***However, GDP growth is decelerating in the face of fading fiscal stimulus, slowing global growth and trade, and tighter financial conditions, while downside risks are mounting.***
- ***Nonetheless, prospects are rising for a “soft landing” that avoids an actual downturn as the Fed reversed course in January, pausing additional rate hikes, perhaps indefinitely.***
- ***The Fed’s abrupt reversal was likely motivated by heightened financial market volatility and weakening economic indicators and was enabled by fading inflation pressures.***
- ***Interest rates are likely to remain at relatively moderate levels, enabling greater business investment and consumer spending to continue.***
- ***Escalating trade tensions still present the greatest significant downside risk to U.S. economic prosperity, potentially compounding slowing global growth, and threatening U.S. exports, manufacturing and business investment.***
- ***In addition, robust and escalating wage gains, while positive for consumers and the economy overall, could force yet another Fed course reversal if wages start to fuel inflation.***
- ***Property market fundamentals continue to improve, but we expect further gains to soften in most sectors as the economic slowdown bites; tenants and investors alike should adopt more defensive strategies reflecting late cycle market trends.***

### **A Near Goldilocks Moment**

Despite a cascade of unfavorable economic news in recent weeks, the underlying story remains quite positive. Indeed, from the narrow perspective of the Fed’s twin mandates, namely promoting maximum employment and stable prices, conditions are positively rosy. The [latest jobs report](#) was especially positive, as the U.S. economy registered its 100<sup>th</sup> month of consecutive positive job growth in January—the longest such streak since government recordkeeping began. Though it ticked up one-tenth of a percentage point to 4%, the unemployment rate remains at the low end of the Fed’s target range (left chart).

Firms continue to hire workers at a very healthy clip, averaging 240,000 new jobs per month over the past three months, astonishingly strong at this late stage in the economic cycle, despite [rising wages](#), [growing labor shortages](#), and the unemployment rate being well below the “natural” unemployment rate (the

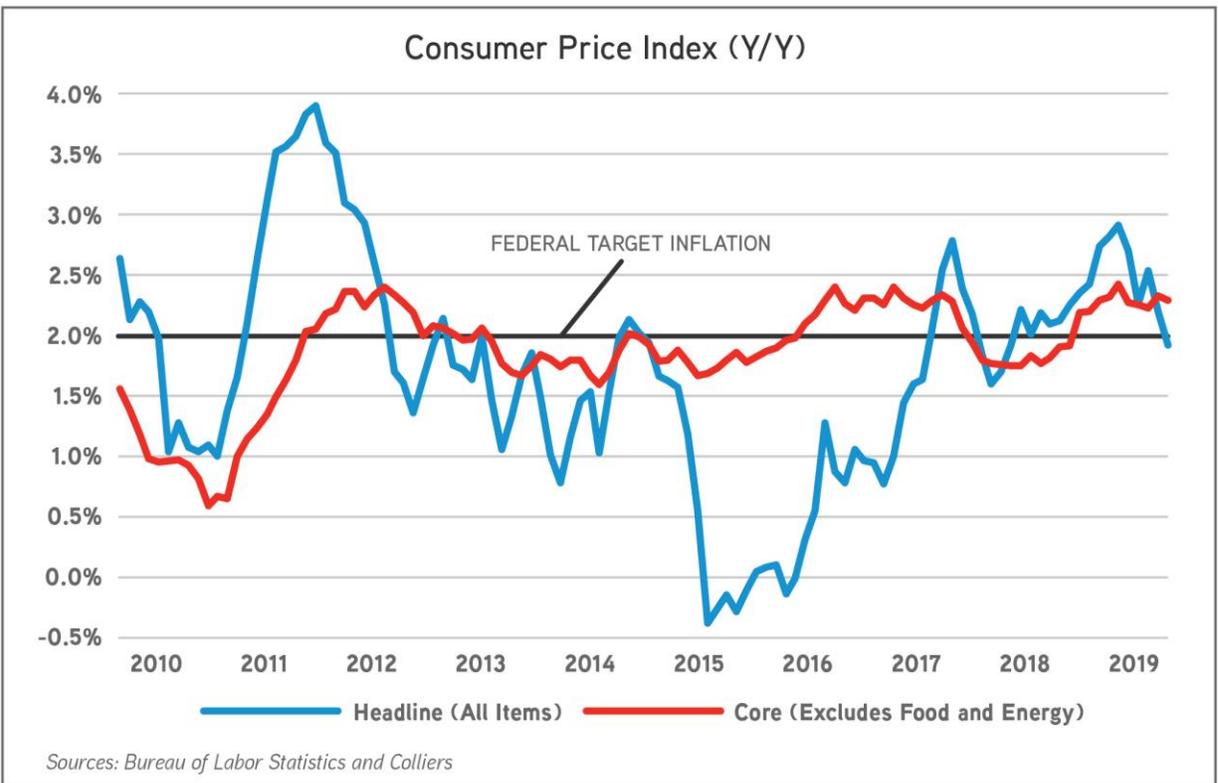
theoretical rate at which labor supply and demand are in equilibrium).



As I've emphasized in past outlook reports, this trend is especially positive for property markets, as job growth is the single most important factor driving tenant demand across most property sectors.

But perhaps the best recent economic news registered barely a blip amidst all the noise about the federal government shutdown, stock market volatility and trade tensions with China: Inflation seems to be moderating and very much under control. Year-over-year "headline" inflation, as indicated by the [Consumer Price Index](#), declined to just 1.9% in December, continuing a gradual decline since peaking at 2.9% in July (blue line right chart), in part thanks to a steep drop in gas prices. Meanwhile, "core" inflation (excluding the volatile food and energy components), remains benign at just 2.2%.

More importantly, the Personal Consumption Expenditure deflator—the Fed's preferred inflation measure—[fell to 1.8%](#) in its latest reading, and is now running below the Fed's target rate. This "Goldilocks" moment—the economy growing strongly with few signs of overheating—provides the Fed with license to ease off its efforts to slow the economy by implementing further interest rate hikes.



That's good news for financial markets and the economy alike. Indeed, [financial markets rallied](#) on the news that the Fed was reversing course, pausing planned rate hikes and easing its pace of balance sheet “normalization” (selling off its swollen portfolio of assets it accumulated through “quantitative easing” in the early days of the last recession).

Interest rates are likely to remain at their relatively moderate levels, enabling business investment and consumer spending to continue at higher rates than if interest rates had kept rising. Thus, with the Fed no longer actively braking the economy, at least temporarily, the odds are increasing that the Fed will successfully engineer a “soft landing” that allows the economy to decelerate enough to let off excesses that are building in the system, but not slow to a stall that would herald an actual downturn. In other words, recession averted, at least for now.

### The Fading Outlook

Of course, that begs the question as to why the Fed would be looking to reverse course, just six weeks after it raised rates in December based on economic activity that is [rising at a strong rate](#) and provided guidance for at least two more hikes in 2019. Have economic conditions soured so quickly?

Not quite, but it seems the Fed was spooked by a combination of tighter financial conditions, growing evidence that the economy is already slowing in the U.S. and abroad, faltering business and consumer confidence, and, relatedly, the surge in stock market volatility; all factored into the [Fed's decision, to at least pause](#), additional rate hikes and issue more “dovish” guidance.

It was probably the stock market sell off in December and rising volatility that most got the Fed's attention (though the Fed disavows seeking to support or stabilize equity markets per se, the so-called “Powell put”). In turn, Wall Street was likely focused on [slowing global economic growth](#) as well as [tightening financial conditions](#). After growing by 4.2% in the second quarter of 2018 and 3.4% in the third, economists in the latest [Wall Street Journal poll](#) expected GDP to grow just 2.6% in the final quarter of 2018 and project 2.2% growth for all of 2019. And the partial government shutdown didn't help.

The International Monetary Fund (IMF) has [downgraded its 2019 forecast](#) for the second time in just the last three months, as the U.S., China and Europe are all expected to grow more slowly this year than last. Already [Italy entered into a recession](#) in the second half of last year, [Germany is teetering near a technical recession](#), and the Eurozone overall grew by just 0.2% in both the third and fourth quarters—its slowest pace since 2014. Meanwhile, [China is expected to grow](#) at its slowest rate since 1990 (albeit at 6.6%, almost twice the global growth rate and around three times as fast as the U.S.).

Meanwhile, the [Leading Economic Index](#) published by the Conference Board, declined in December for the second time in three months, and “suggests that the [U.S.] economy could decelerate towards 2% growth by the end of 2019.” Similarly, Oxford Economics’ Economic Momentum Indicator shows a sharp contraction in both their hard data index (actual economic activity like auto sales and housing starts) and “soft data” index (based on business and consumers surveys and financial indicators).

### What’s Driving the Downshift?

What accounts for the downgrade in the U.S. growth outlook? First, **slowing global trade**, largely due to **growing trade tensions**, particularly between the U.S. and China, but also related to the potential failure of Britain to negotiate a deal to exit the European Union. Indeed, the IMF report cites these [trade tensions](#) as a major factor underlying its forecast for slower growth.

Also key: Chinese trade with the rest of the world [fell precipitously in December](#), as both imports and exports dropped sharply, suggesting a more rapid **weakening of the Chinese economy**. This slowdown is having [impacts around the globe](#), including in the U.S., hitting domestic manufacturers and other exporters.

The decline in Chinese imports is only exacerbating tensions with China. Despite the Trump Administration’s concerted efforts to reverse long-standing trade imbalances with China, their [trade surplus with the U.S.](#) grew 17% in 2018 to another record, raising the risk of an all-out trade war. Still, [negotiations between our countries continue](#), with the goal of making enough progress to avoid the next tranche of tariffs due to take effect on March 1, 2019 that would raise U.S. tariffs on Chinese goods from 10% to 25%.

Meanwhile, much is riding on the outcome of [trade talks with Europe](#) concerning autos, agriculture, energy and other goods, but the prospects are uncertain and could lead to further rounds of retaliation. Finally, the election of a Democratic majority in the House of Representatives has made prospects for passage of the new North American Free Trade Agreement (NAFTA) deal [much less certain](#), potentially disrupting trade with Mexico and Canada.

U.S. growth is also threatened by **fading business and consumer confidence**. To be sure, both business and consumer confidence remain at relatively elevated levels, near 20-year highs. But both measures have dropped sharply in recent weeks. [Consumer confidence](#) fell in January 2019 to its lowest level since President Trump was elected, suggesting a potential pullback in consumer spending. Meanwhile, business sentiment has also generally softened since the summer, though the [manufacturing index](#) posted a modest recovery in January. Lower business confidence can be a harbinger of slower business investment.

Finally, the positive impacts from the **fiscal stimulus** via recent tax cuts and stepped-up federal spending are now starting to fade. Oxford Economics estimates that these policies added a full percentage point to GDP growth last year, but the stimulus will add just 0.3 percentage points this year and nothing in 2020.

However, the direct impact of the recent **partial federal government shutdown** was likely minimal. The [Congressional Budget Office \(CBO\) estimates](#) a net loss of just \$3 billion, which is trivial in a \$20 trillion economy—just 0.02%! However, the indirect impact could be materially greater. With another shutdown a

distinct possibility, anecdotal evidence suggests that federal government workers and contractors are [holding back on spending](#), which would have collateral impacts on businesses and the economy.

### And Wither the Housing Market?

A variety of indicators increasingly suggest that the housing market is stalling, though not necessarily headed for a correction. [Existing home sales](#) fell sharply again in December and are well off their pace from 2017. [New homes sales](#) jumped in November (latest figures available), but this was an aberration, as this metric, too, is well off the rate from a year ago. Similarly, [housing starts and completions](#) are down from a year ago, though permits are about flat. And while home prices continue to rise, the rate of appreciation continues to decline, according to the [Case-Shiller Index](#), falling to their lowest rates in four years. A key reason is declining affordability. According to the National Association of Realtors, [housing affordability](#) peaked in 2016 and has been declining steadily since as both home prices and mortgage rates rose. Mortgage rates have declined marginally in December, but probably not enough to move the dial on affordability. Housing market trends bear watching closely as the housing sector is often a leading indicator for changes in the direction of the broader economy.



#### A SIDEBAR ON [GAS PRICES AND INFLATION](#)

The falling inflation rates are generally welcome news for the economic outlook, but the inflation news is not all positive. A primary reason for the decline in inflation is falling gas prices, due to the [slowdown in global economic growth](#). Not so long ago, a drop in prices at the pump would generally bode well for the U.S. economy overall—putting more dollars back in consumer pockets, reducing input costs for manufacturers that rely on petroleum products, and shrinking the flow of dollars to hostile nations who sell us oil.

[But that dynamic is changing](#), as the U.S. recently became a [net oil exporter for the first time in 75 years](#). Falling gas prices obviously hit economic output, employment and property markets in oil-producing metros like Houston, Oklahoma City and Denver. But there is a broader impact. Investment in oil-related equipment like drilling and refining are now [major drivers of business investment](#). And now with gas prices down to their lowest level in over a year, business investment is slipping, slowing GDP growth.

Economists at Oxford Economics conclude that falling gas prices are still a net positive for the country. But the overall benefits are not nearly as positive as they once were.

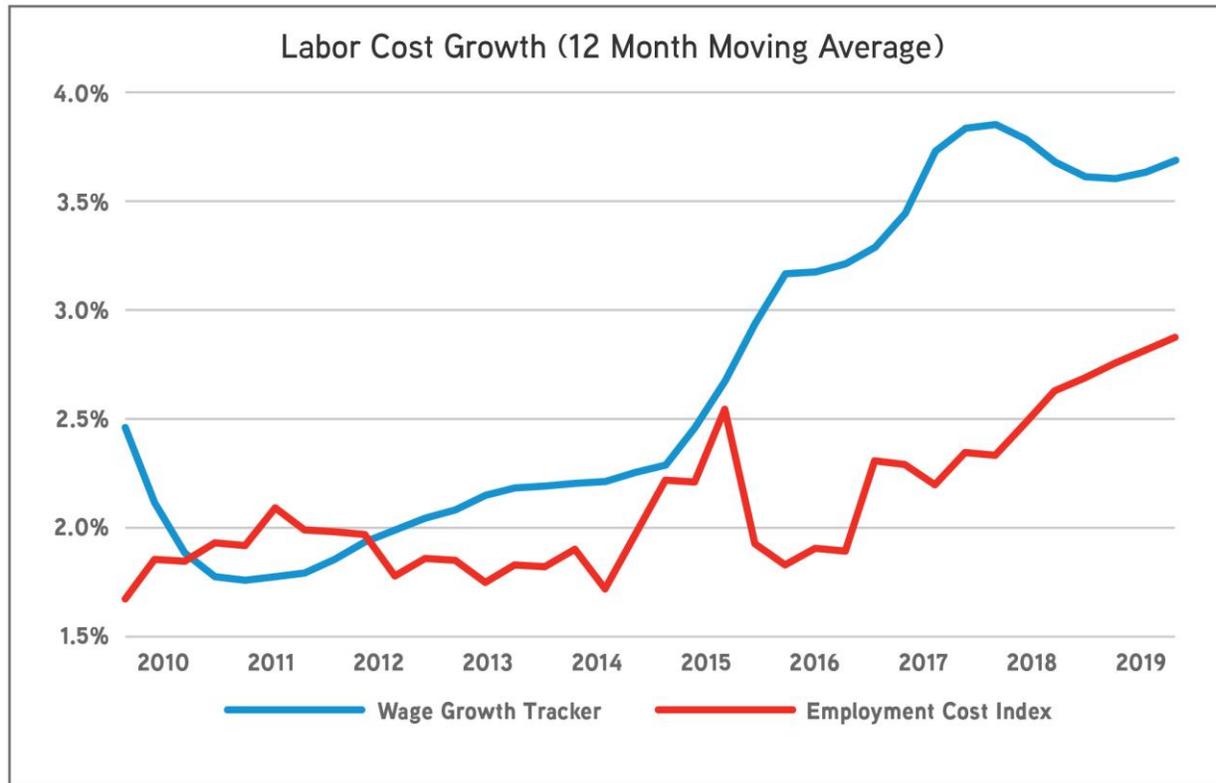


#### A SIDEBAR ON [WAGES AND INFLATION](#)

Inflation is highly (though not perfectly) correlated with wage growth. Wages are a key cost for employers, so when wages rise (as due to labor shortages), firms will try to pass along their greater costs to consumers in the form of higher prices. Plus, when wages are higher, consumers start to bid up the prices of goods. Both of these force fuel inflation.

For this reason, the Fed keeps a close eye on wage growth, and in particular the Employment Cost Index (ECI) —a measure of the full compensation cost of workers including benefits—as an important gauge of whether inflationary pressures are building up in the economy. As noted above, inflation has been moderated of late by falling gas prices as well as the strong dollar (making imports prices less expensive),

among other factors.



But wage growth has been rising, as measured by both the ECI and the “wage growth tracker” estimated by the Atlanta Fed. Thus, while inflation seems to be under control and provides cover for the Fed to suspend its efforts to cool the economy, wage growth bears close watching for signs that the economy is overheating—and indications that the Fed might reverse course again and renew its rate hikes.

## » CONCLUSIONS AND IMPLICATIONS FOR PROPERTY MARKETS

The near-term economic forecast continues to be quite strong in terms of both economic, and especially, employment growth. This solid performance has fueled continued, if moderate, improvement in property markets in the second half of 2018. With no credible signs of an immediate downturn or correction, we believe the good times for property markets will continue into early 2019.

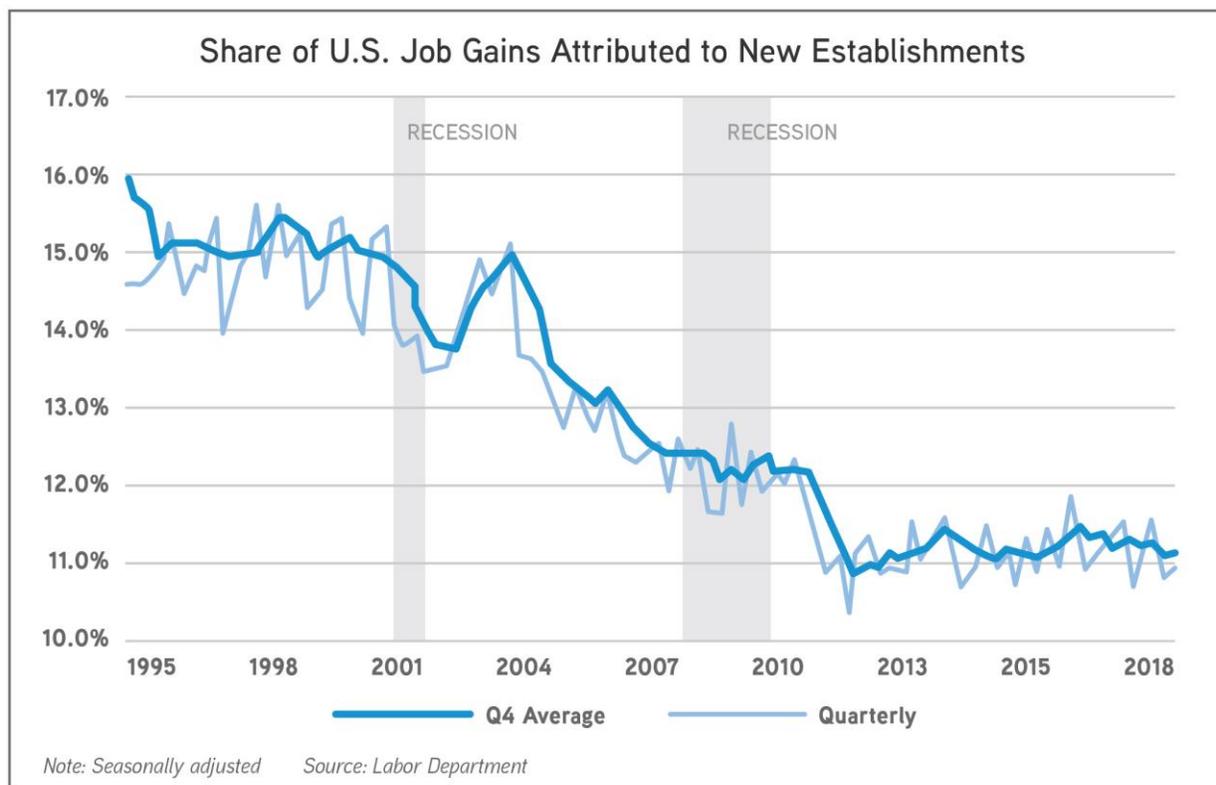
Nonetheless, indications are mounting that a slowdown is already in the making. Business and consumer confidence, industrial output and business investment all remain at healthy levels but are fading across the board. Expect growth this year to be in the mid 2% range, down from almost 3% in 2018. Only job growth continues to post outsized gains, exceeding expectations, though not nearly to levels experienced earlier in the cycle. Rising wage growth thus far has not seemed to restrain demand for labor.

But we continue to believe that job growth will indeed cool in the near future. Job openings are outpacing new hires, providing concrete data that confirms more anecdotal evidence of growing labor shortages. Despite recent marginal gains in the labor force participation rate, the ranks of unemployed workers is small and shrinking, which will drive up wages further and eventually temper new hiring. Thus, expect fewer leasing and sales transactions this year, along with slower price appreciation.

But absent a surge in inflation, the Fed is likely to stay on the sidelines for now, and the economic slowdown just may avoid metastasizing into a full-fledged recession. Just keep an eye on wage growth. And tariffs.

## » CHART OF THE QUARTER: NEW FIRMS CREATING FEWER JOBS

Though the tech sector gets lots of attention, there are worrying signs that rates of entrepreneurship are on a long-term slide, and never recovered from the recession—though the decline goes back much further. Not only are [fewer firms being created](#), but new firms also create far fewer jobs than they used to, as shown in this chart produced by Steven Davis and John Haltiwanger in a [National Bureau of Economic Research working paper](#), via a blog in [The Wall Street Journal](#). The impacts of a less dynamic corporate sector with greater economic concentration in the top firms are serious and include, in addition to fewer jobs, [slower wage growth](#), [rising inequality](#) and [lower productivity](#).



## » ANALYSIS OF RECENT ECONOMIC NEWS

### [IMF says the global economic expansion is losing momentum as it cuts growth forecasts \(CNBC\)](#)

“The International Monetary Fund (IMF) revised down its estimates for global growth on Monday, warning that the expansion seen in recent years is losing momentum. The Fund now projects a 3.5% growth rate worldwide for 2019 and 3.6% for 2020. These are 0.2 and 0.1 percentage points below its last forecasts in October—making it the second downturn revision in three months.”

[U.S. growth slowed toward end of 2018, but—despite government shutdown, weaker world economy—it’s hanging in there \(MarketWatch\)](#) “A trio of fresh appraisals of the economy suggest growth slowed toward the end of 2018, but the U.S. is still expanding at a moderate pace even as a month-long government shutdown drags on. The index of leading economic indicators fell in December for the second time in three months, offering more evidence the economy has downshifted from high gear, the Conference Board said Thursday.”

[The government shutdown cost the economy \\$11 billion, including a permanent \\$3 billion loss, Congressional Budget Office says \(CNBC\)](#) “The federal government shutdown cost the economy \$11 billion, according to a new analysis from the nonpartisan Congressional Budget Office, reflecting lost output from federal workers, delayed government spending and reduced demand . . . Although most of the damage to the economy will be reversed as federal workers return to their jobs, the CBO estimated \$3 billion in economic activity is permanently lost.”

[U.S.-China trade war: gloomy exports give Beijing 3 reasons to worry \(This Week in Asia\)](#) “The dramatic and sharp contraction of China’s exports and imports last month has not only confirmed the downward trend of the Chinese economy, but also further raised the risks to its growth prospects amid the uncertainty over a possible full-blown trade war. China’s export growth in dollar terms tumbled 4.4% year over year in December, from 3.9% growth in November and 14.3% the month before. Meanwhile, imports fell 7.6% from 2.9% growth in November and 20.3% in October.”

[Fed holds rates stable, pledges 'patient' approach, expects 'ample' balance sheet \(CNBC\)](#) “The Federal Reserve opted not to raise interest rates during its policy meeting this week and pledged that future moves will be done patiently and with an eye toward how economic conditions unfold. In a statement Wednesday, the central bank voted unanimously to hold its policy rate in a range between 2.25% and 2.5%.”



## OTHER WORTHWHILE READS

### *ECONOMIC NEWS AND VIEWS*

[Draghi: Eurozone faces economic downturn, more stimulus needed \(Deutsche Welle\)](#) “The head of the European Central Bank, Mario Draghi, on Thursday said the bank was ready to ‘adjust all of its instruments’ if the economy runs into serious trouble and warned that risks “have moved to the downside.’ Draghi blamed ‘the persistence of uncertainties related to geopolitical factors and the threat of protectionism, vulnerabilities in emerging markets and financial market volatility,’ hinting at continuing worries of the U.S.-China trade conflict and Brexit, among other issues.”

[The global boom, barely begun, may be over \(WSJ\)](#) “A year ago the world looked like it would finally return to the boom times it enjoyed before the global financial crisis. Now, the boom may be over before it even started. No, a recession isn’t about to hit. The International Monetary Fund still thinks the global economy will grow a respectable 3.5% this year. But that is the second downgrade from a year ago when the IMF hailed “the broadest synchronized global growth upsurge” since 2010. This latest disappointment isn’t the story; the real story is the serial disappointments that have dogged this expansion from the start.”

[U.S. trade deficit hits 10-year high \(Reuters\)](#) “The U.S. trade deficit jumped to a 10-year high in October as soybean exports dropped further and imports of consumer goods rose to a record high, suggesting the Trump administration’s tariff-related measures to shrink the trade gap likely have been ineffective.”

[Global unemployment at lowest level in almost 40 years \(Business Day\)](#) “The worldwide unemployment rate dropped from 8% in 2010 to 5.2% in September 2018, according to a report by investment bank UBS—the lowest level since the 5% unemployment rate recorded in 1980. The steep decline has been attributed to more flexible working practices, lower wages and rock-bottom interest rates. The decline is also largely due to sharp falls in unemployment in industrialized countries.”

## **PROPERTY MARKET VIEWS AND NEWS**

[Sentiment survey 2018 year-end: Downturn on the horizon \(RCLCO\)](#) “Sentiments about current national real estate conditions are noticeably more pessimistic than they were six months ago. Just under one-half (48%) of survey respondents say national real estate market conditions are moderately or significantly worse today than they were a year ago. This is 33 percentage points higher than in the mid-year 2018 survey. Conversely, the share of respondents reporting better market conditions today than one year ago decreased to 23%, down 29 percentage points from the mid-year 2018 survey.”

[Commercial real estate finance disruption: Déjà vu or something new? \(CCIM Institute\)](#) “...The question of the next commercial real estate finance (CREF) disruption is not a matter of when, but how. It will not be caused by a subprime mortgage crisis or overleveraging in commercial mortgage-backed securitization market (CMBS). The likely suspects this time around will be a combination of rising interest rates and a disruption in liquidity for commercial real estate lending as a result of accounting, regulatory and financial product shake-ups.”

[Home prices rise at a slower pace: S&P Case-Shiller \(CNBC\)](#) “Home values increased 5.2% annually in November, slowing from 5.3% in October, according to the widely watched S&P CoreLogic Case-Shiller National Home Price Index . . . The 20-city composite saw a 4.7% annual gain, down from 5% in October. Home price gains have been slowing since last spring, as higher mortgage interest rates cut sharply into affordability. The gains are slowing the most in large metropolitan markets, where home prices had overheated over the past three years.”

[What does a flattening yield curve mean for the real estate markets? \(Treppe\)](#) “The financial markets have been speaking loudly, indicating significant concerns regarding the growing risk of a recession in the near future. In particular, bond traders are now betting that the Federal Reserve will not raise rates, as the Fed itself most recently predicted, and are increasingly looking for a rate cut. These economic and yield curve dynamics are being driven by factors outside of real estate, but their impacts are already being felt closer to home.”

[Real estate's new premium gap: Urban centers versus suburbs \(CNS News\)](#) “The downtowns of most major American cities were a great investment, even for those who bought in the real estate crisis a decade ago—and the premium gap between city centers and their suburbs continues to widen, a new survey of urban real estate finds.”

## **RECENT COLLIERS ARTICLES, REPORTS AND BLOGS**

[10 emerging U.S. industrial markets to watch in 2019](#) “The U.S. industrial market is in the midst of the longest period of growth on record. As a whole, the country has posted 35 quarters of positive absorption in a row. While 2019 looks to be another strong year, a variety of factors points to a tapering off of industrial real estate activity for the country in the coming quarters.”

[U.S. flexible workspace outlook report](#) “The latest U.S. edition of the Flexible Workspace Outlook Report is now available for download. The report, part of a series to be updated subsequently with data from Canada and Latin America, will be integrated with the APAC and forthcoming EMEA editions as well. This report highlights the current state and future trends of the flexible workspace market, how it is impacting both occupiers and investors, and where opportunity exists for our clients.”

[The long economic expansion looks to slow—property markets will follow](#) “In our State of the U.S. Market and 2019 Outlook, Colliers outlines current economic and property market conditions and provides insight into what we can expect in the coming year and beyond. We take stock of key economic and market indicators, including the changing global backdrop. This analysis was prepared by Colliers’ national research team, with input from Colliers’ top professionals throughout the U.S. practice.”

[The top coworking operators \(NREI Online\)](#) “In new research, Colliers identified more than 140 different coworking operators active in 19 markets, with a total of 27.2 million square feet of flexible workspace.”

[Is this spot in the cycle as good as it gets? \(GlobeSt.com\)](#) “Everyone seems to be contemplating when the next downturn will take place. With the current cycle taking on a theme of “As Good as it Gets,” **Andrew Nelson**, chief economist | USA for **Colliers International**, says the economy is strong now but is likely to start slowing in 2019 and more intensely in 2020, as the Fed attempts a soft landing.”

[Click and collect trend shapes retailers' strategies \(Connect Media\)](#) “Click and collect is just another way to capture those seeking to have their purchases immediately—it’s a growing market, and retailers are adopting how it’s done. As consumers are excitedly embracing their 24/7 shopping superpower, it continues to become even more convenient and speedy! Think of Walmart’s new TV ads and the drive-through pick up model for purchases made online. Landlords need to embrace these changes as the retail experience evolves.”

[Colliers releases U.S. flex-workspace outlook report \(NJBIZ\)](#) “Colliers International’s U.S. Flexible Workspace Outlook Report, released on January 25, highlights the current state and future trends of the flexible workspace market, how it is impacting both occupiers and investors, and where opportunity exists for clients.”

[Occupier activity remains robust in 2018 thanks to 3PL activity](#) “Occupier activity across the United States continues to be robust, particularly in bulk industrial space 100,000 square feet and larger. In 2018, 1,406 industrial (warehouse, manufacturing, flex) new lease and sale transactions signed in spaces 100,000 square feet and larger, totaling 374 million square feet—slightly lower than the 385 million square feet signed the 12 months prior.”

[Quarterly retail spotlight report | winter 2018](#) “Fueled by innovation and inspiration from some unlikely places, brands are stepping up to capture consumers’ attention every which way. In the latest Quarterly Retail Spotlight Report, consumers are demanding a level of convenience that retailers must make work. And each year, the growing demand increases. From 2012 to 2018, an estimated 23% growth of customers who regularly order online, collect in store. With this type of growth, it is no longer a trend, but a need. Retailers must execute well to avoid losing the customer experience.”