Manulife Investment Management

U.S. commercial real estate outlook:

U.S. labor market hits historic highs, drives continued economic expansion

Real Estate Team
Manulife Investment Management
Q2 2019

U.S. labor market hits historic highs, drives continued economic expansion

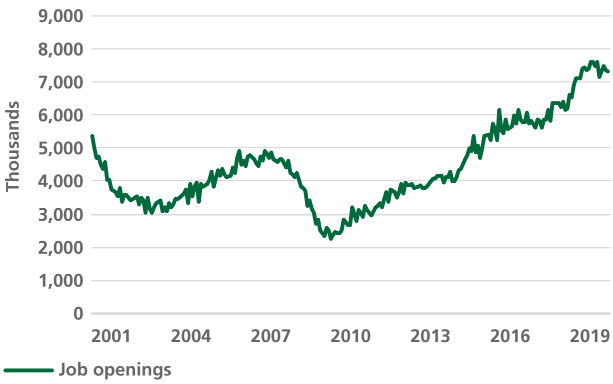
The U.S. economy experienced a robust first quarter, though it appears to have leveled off, with second-quarter GDP growth coming in at 2.1%.[1] This second-quarter deceleration wasn't unexpected, as it was widely recognized that the first-quarter 3.1% GDP growth drivers were largely transitory. Record job availability, low unemployment, and wage growth, all underpin strong consumer spending—still the engine of the U.S. economy. The U.S. Federal Reserve's (Fed's) rate cut in July provides additional support for continued economic expansion. At the same time, policy uncertainties and a somewhat tepid global growth outlook are acting as a drag on business investment.

Labor markets as strong as ever: The U.S. economy generated a monthly average of 172,000 jobs over the first half of 2019, though this was down from an average of 211,000 during the previous six months. The addition of fewer jobs was primarily connected to a shrinking available workforce, as evident from the tight unemployment rate hitting a 50-year low of 3.6% in April.[2] With over 7 million positions still unfilled, employers have to compete even harder for workers, mainly by offering higher wages. This accelerating wage growth reached 3.4% in February,[3] the highest level seen in the current expansion cycle. The economic alchemy of job gains and higher wages is the key to consumer confidence and the continued increase in consumer spending.

Soft business investment outlook: Policy uncertainties and weak global demand continue to put a dent in business confidence, with investments in business equipment falling to 3.3% for the 12 months through March—the lowest level of the past two years. Investment fundamentals are particularly weak for manufacturing, which has been set back by lackluster global demand and excess production capacity; the manufacturing capacity utilization rate was 75.7% in April, nearly 2.5% below the long-term average.[3] On the upside, tax cuts and the overall financial environment remain positives for business investment, and on the whole, we think investment should continue to grow in 2019, albeit more modestly than last year.

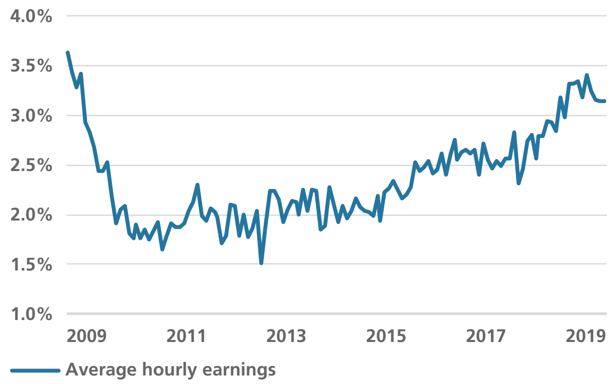
U.S. Federal Reserve changing course: Following four rate hikes in 2018, the Fed shifted its monetary policy this year with its July announcement of the first rate cut in ten years. Although most economic indicators point to sustaining the current expansion without additional monetary stimulus, the Fed's direction will be partially dictated by ongoing low-key inflation and weak global growth.

Job openings



Source: Bureau of Labor Statistics, as of May 2019.

Wages and employment cost growth, YoY



Source: Bureau of Labor Statistics, as of June 2019.

1 Bureau of Economic Analysis, as of July 2019. 2 Bureau of Labor Statistics; based on preliminary job statistics for May and June, as of June 2019. 3 Federal Reserve Bank of New York, Bureau of Economic Analysis, as of June 2019.

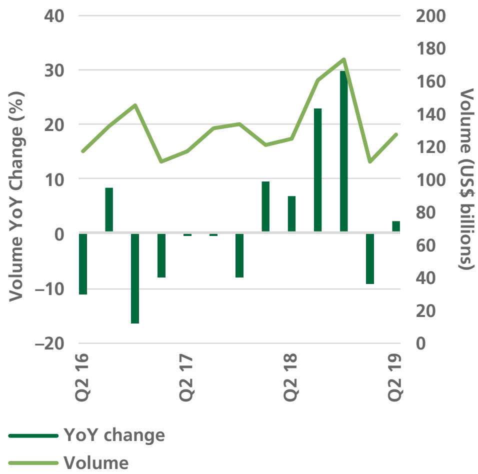
Investment markets[4]

Commercial real estate investment activities increased in the second quarter of 2019, with total volumes increasing 2.3% year over year. This Q2 growth is in stark contrast to the prior quarter, when economic uncertainties and rising interest rates were the main factors in investment volumes falling by 9.3% year over year. Current conditions should help sustain growth: Most economic indicators have improved, the 10-year U.S. Treasury yield has contracted from more than 3.0% late last year to almost 2.0% as of end of Q2, and the Fed's recent rate cut should fuel further economic expansion. Considering all of these factors, investment activity in the second half of 2019 is likely to remain strong.

Total second-quarter transaction volume growth was primarily driven by the office market, where volumes were up by 30.0% year over year. Multi-residential was the second highest-growing property type, showing 19.0% growth, while both the industrial and retail sectors experienced negative year-over-year growth.

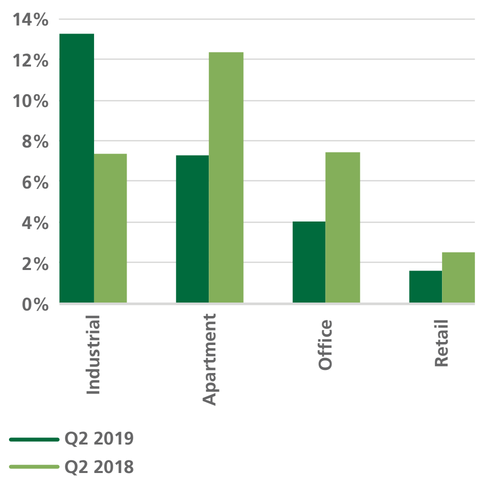
Although cap rates remain relatively stable, income growth should support ongoing price appreciation. While prices for all property types continue to rise, the gap between the highest growing and lowest growing has widened. As per Real Capital Analytics (RCA), the Commercial Property Price Index (CPPI)—a quality-adjusted measure of price appreciation—the industrial sector saw the greatest price appreciation over the past 12 months—13%, followed by apartment at 7%, office at 4%, and retail at 2%.

Quarterly transaction volume



Source: Real Capital Analytics, as of June 2019.

Commercial Property Price Index (CPPI), year over year Growth



Source: Real Capital Analytics, as of June 2019.

4 All market fundamental statistics, including vacancy, absorption, completion, under construction, and rent growth sourced from CoStar, as of Q2 2019. All capital market statistics, including transaction volume, cap rates, and price index sourced from Real Capital Analytics, as of Q2 2019.

Office markets[4]

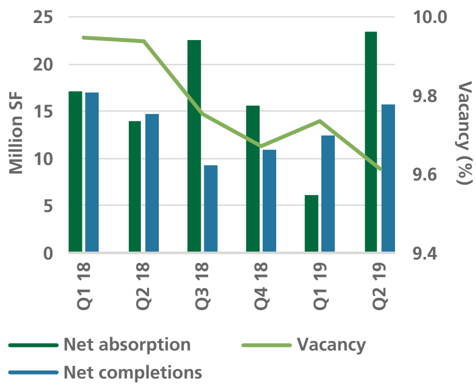
Demand for office space in the second quarter rebounded to its highest level in the past three years, with total net absorption of 23 million square feet (SF). The quarter-over-quarter increase was in large part due to the year getting a slow start, when heightened economic uncertainty took a toll on leasing activities. Even though supply of new space has trended upward over the last four quarters, it remains below demand. Net completions of 16 million SF fell 8 million SF short of demand, with vacancies dropping by 10 basis points to a record low of 9.6%.

Given historic low unemployment levels and the demographic challenges created by baby boomers reaching retirement age, availability of educated labor will be the key differentiator in office markets for employment and office demand growth going forward.

Rents are continuing to rise, though growth rates have taken a step back of late: Average annual rent growth in the second quarter was just 2.3% compared with 6.0% in 2015. Technology markets take the top positions in rent growth, with Austin, San Jose, and San Francisco showing 6.4%, 6.1%, and 5.9% annual rent growth, respectively.

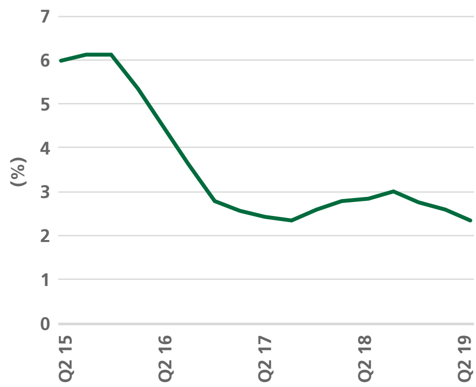
Historic low vacancies haven't translated into greater construction activities, which remain measured. With total space under construction at 1.8% of available space, it’s at the highest level for the current cycle, but is still substantially below the peak activity of past cycles.

Office supply/demand fundamentals



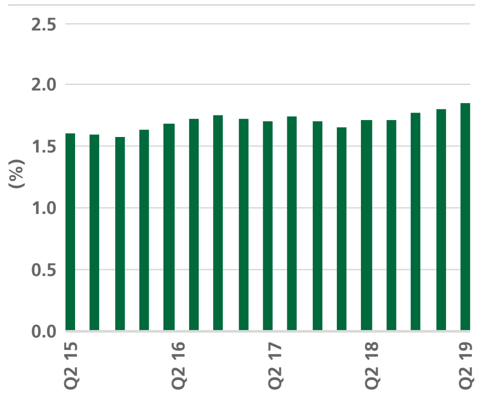
Source: CoStar, as of June 2019.

Office rent growth



Source: CoStar, as of June 2019.

Office under construction as % of stock



Source: CoStar, as of June 2019.

Industrial markets[4]

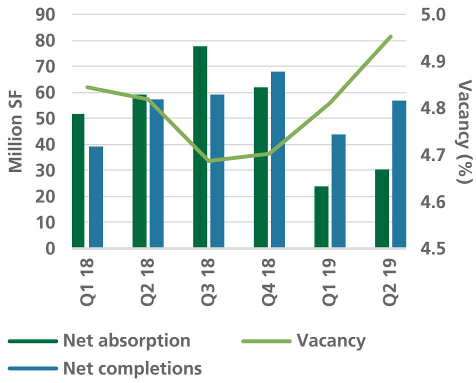
Evolving e-commerce logistics continues to define the industrial market, with demand having outpaced supply over the past nine years and vacancies falling precipitously across the board. The availability of modern logistics space is particularly tight in most major markets, which in part explains the slower leasing activity over the past two quarters. Net absorption of 30 million SF was 27 million SF short of completions, resulting in an average vacancy rate increase by 20 basis points to 5% in Q2 2019.

To meet tightening delivery timelines, e-commerce retailers are storing products closer to consumers. As a result, e-commerce is reconfiguring industrial market demand, increasing the need for space near urban centers that can function as last-mile delivery storage.

As supply increasingly comes to the market, rent growth has begun to stabilize. At 5.5% year-over-year growth, however, industrial continues to outperform other property types by a wide margin. Industrial rent growth is also more pervasive, with even the worst-performing markets experiencing above 3.0% rent growth year over year.

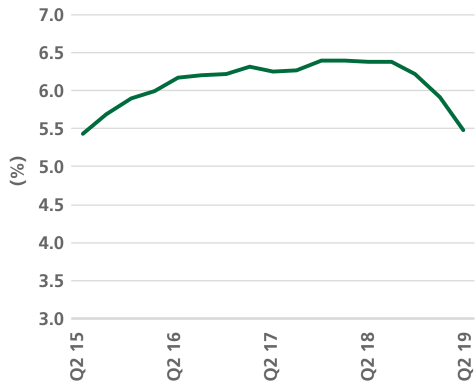
Robust market demand has also had an energizing effect on construction activities, which reached a record high of 295 million SF—equivalent to 1.8% of the total market as of the second quarter. Although greater supply is likely to put pressure on vacancies, given our positive outlook for consumer spending and still-evolving e-commerce logistics, we expect the impact in fact to be minimal.

Industrial supply/demand fundamentals



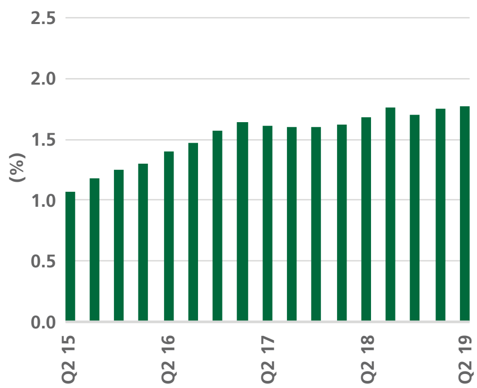
Source: CoStar, as of March 2019.

Industrial rent growth



Source: CoStar, as of March 2019.

Industrial under construction as % of stock



Source: CoStar, as of March 2019.

Multiresidential markets[4]

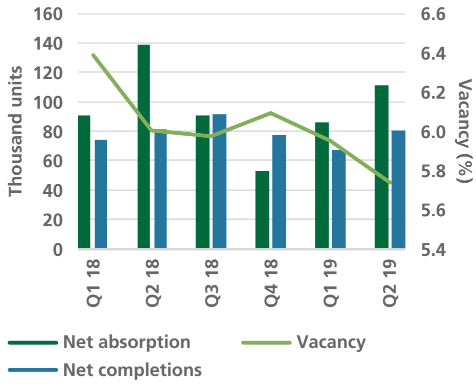
Multi-residential rental market demand over the past few years has been lifted by an overall shortage of housing options. The supply of multi-residential housing has noticeably ramped up in recent years, but it has been more than offset by weakness in single-family housing, which has allowed the overall housing market to remain undersupplied. Demographic trends—the increase in the median age of marriage and in the number of single-person households, as well as tightening homeownership affordability—are also feeding the demand for multi-residential rentals.

The multi-residential market saw a Q2 net addition of 80,000 units—far below demand of 110,000 units. The average vacancy rate contracted by 30 basis points, as a result, to 5.7%, the lowest in the current cycle.

Tightening vacancies have also enabled rent growth, which showed a Q2 2019 average national rise of 3.2%. With the higher-end products in urban markets receiving a disproportionate share of supply, rent growth in those areas continues to lag the overall market.

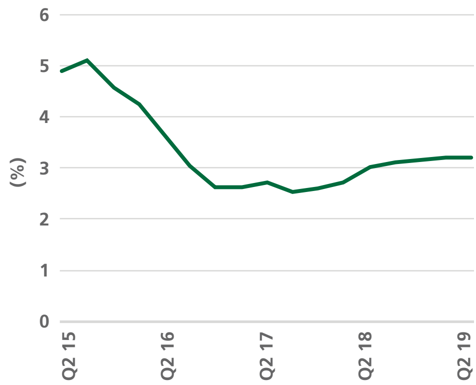
With 670,000 units under construction—equivalent to 4% of the current multi-residential market—supply is likely to stay strong over the next few years. But given the strength of demand fundamentals, we also see occupancies remaining relatively stable.

Multiresidential supply/demand fundamentals



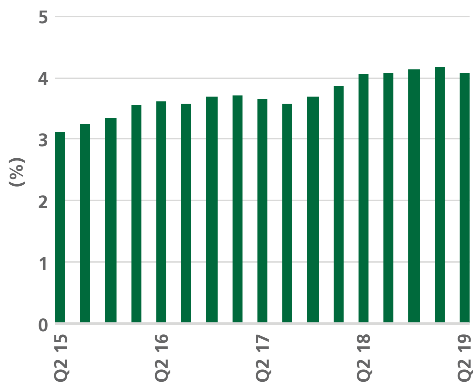
Source: CoStar, as of March 2019.

Multi-residential rent growth



Source: CoStar, as of March 2019.

Multi-residential under construction as % of stock



Source: CoStar, as of March 2019.

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Manulife Investment Management

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