CUSHMAN & WAKEFIELD RESEARCH

U.S. Macro Forecast

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May 2016

U.S. Macro Forecast: Better Days Lie Ahead

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- Volatility has receded, U.S. GDP growth will accelerate from here
- Low oil prices, rising wages, job security – confident consumers will power growth
- Job growth will continue but at a decelerating pace as the cycle matures
- Vacancy will continue to tighten across most product types as construction still lags
- Capital markets sales activity will surge, but returns will decelerate
- Most significant risks are still linked to China and spillover effects

U.S. Economy

The U.S. economy and property markets are starting to fire up again now that the early-year financial market volatility has diminished. The volatility was a contributing factor to the slowdown in U.S. investment sales in the first quarter of 2016 (down 20 percent from a year ago) as well as leasing activity for most product types. However, through this entire period of heightened uncertainty, U.S. job growth continued to boom—a consistent reminder that the core drivers of the U.S. economy remain healthy. The primary concerns in the first eight weeks of the year—a slowdown in China and declining oil and commodity prices, which stoked fears that the expansion was coming to an end—have subsided. The latest economic data on China's retail sales, confidence, and industrial production have all taken on a brighter hue, and year-over-year GDP growth clocked in at a solid 6.7 percent in the first quarter. Oil and commodity prices—though still jumpy at times—have mostly firmed and generally trended upwards since February. The global debt and equity markets have come storming back, especially in the U.S. As of the end of April (April 25, 2016), the S&P 500 had reached nearly 14.2 percent above its mid-February levels, while the Dow Jones is once again nearing record-high territory. Likewise, since late February, CMBS spreads came in, venture capital funding accelerated, and leasing activity picked up. The U.S. economy and the property markets are busting out of their slumps.

The strength of the U.S. economy is most clearly evident in the labor markets. Despite all the volatility, the U.S. economy continued to crank out new jobs. In the first quarter of 2016, nonfarm payroll growth averaged 209,000 per month, on par with the robust pace observed over the past four years. The unemployment rate fell below 5 percent, and the U-6 underemployment rate neared 9 percent. Labor markets are on track to achieve full employment by the 2016 presidential election. Consumer confidence turned around in March due in large part to a combination of sustained and accelerating hourly wage growth and steady job creation, which helped the domestic demand side of the economy remain resilient in the face of softening global demand. Although nominal retail sales have been lackluster so far this year, credit outstanding was up nearly 6% year-over-year in February, and household balance sheets and financial ratios held steady at healthy levels.

The GDP figures tell a much weaker story; however, the data appears to be wrought with odd movements (i.e. significant seasonal swings, and other unusual behavior). The Bureau of Economic Analysis, which tracks the GDP estimates, has admitted to having measurement issues, and revisions are likely to occur down the road. Real GDP growth has been weak or negative in the first quarter in each of the last three years. But the bulk of economic data on vehicle sales, traffic at airports and on roads, port activity, personal consumption

expenditures, the labor market, and other CRE demand metrics all line up and send a consistent message of solid economic growth. Our forecast calls for GDP to grow 2.3 percent in 2016 and 2.7 percent in 2017.

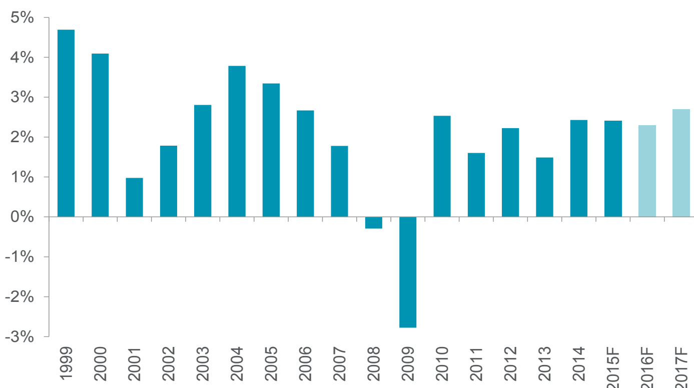
U.S. investment was weak in the first quarter, but we anticipate a reversal moving forward. The decline in investment has been concentrated mostly in the beleaguered energy sector, but this may be ending as there are signs that oil prices are nearing bottom. The WTI price per barrel has increased from $26 in mid-February to around $42 at the end of April. Although the Doha meetings in April mostly fizzled, Iran's production has been slow to ramp up, and disruptions in Iraq and Nigeria and a strike in Kuwait removed some pressure on the global oil supply glut. Most importantly, production in the U.S.—the globe's third largest producer of crude oil—is falling. The Baker Hughes oil rig count fell to 431 in the week ending April 22, 2016, down 78 percent from a peak of 1,929 at the end of October 2014. Monthly production has topped out and trended lower for the past nine months. Even if OPEC cannot reach an accord on production caps, the decline in U.S. supply will keep oil prices on a bumpy, gradual upward trend from this point forward. Our forecast calls for WTI oil spot prices to average $42 per barrel in 2016 and rise to $50 per barrel in 2017.

The U.S. economy and the property markets are busting out of the slump.

The Federal Reserve, consistent with its past communication, did not vote to raise the federal funds rate in January, March or April, signaling its willingness to wait for the effects of the global headwinds to dissipate before further normalization. With several major central banks imposing aggressive monetary easing, including the implementation of negative interest rates and downgraded global growth and inflation forecasts, a slightly more gradual trajectory for the federal funds target rate is expected. Core inflation is firming within the U.S. As a result, our current assumption is that the Fed will announce its next 25 basis points (bps) rate hike in June. However, whether the next rate hike is in June or September will likely depend on how the global financial markets behave in the weeks leading up to the referendum on the U.K.'s membership in the European Union (EU) on June 23 (commonly referred to as "Brexit"). Our forecast assumption includes a period of heightened volatility in the equity markets in the second quarter, but no exit from the EU.

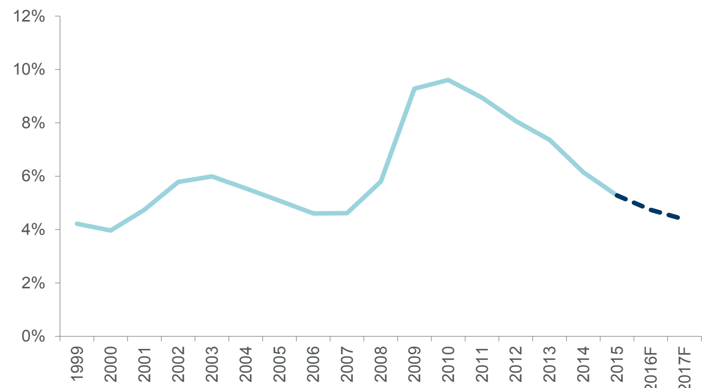
Real GDP Growth

AR, %



Source: U.S. Bureau of Economic Analysis, Cushman & Wakefield Forecast

U.S. Unemployment Rate



Source: U.S. Bureau of Labor Statistics, Cushman & Wakefield Forecast

Macroeconomic Outlook

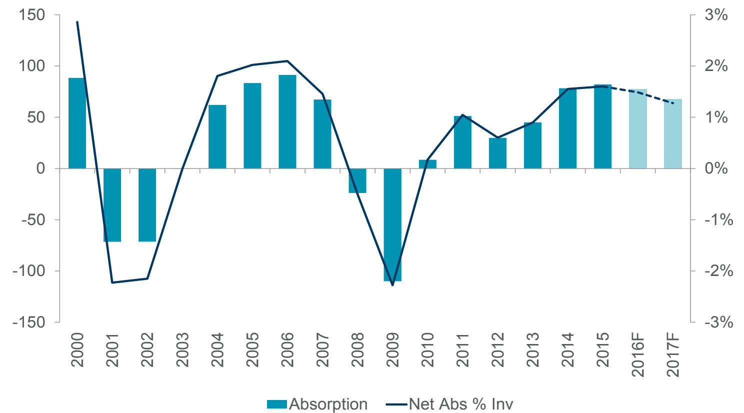
GDP: Our forecast continues to reflect a moderate growth path for the U.S. economy (2.3 percent in 2016 and 2.7 percent in 2017). For reasons mentioned earlier, real GDP growth (after all revisions) will likely be anemic in the first quarter of this year; our current estimate is for 1% growth. In the subsequent two quarters, GDP growth will accelerate to average 3.7%. Consumer spending will continue to fuel economic growth, averaging 3.3% in 2016 and 3.8% in 2017. Business investment should accelerate through 2016 and peak in the second half of 2017. Net exports will remain the most significant drag on GDP growth as the trade deficit widens due to weakening global demand for U.S.-manufactured products and the appreciation of the U.S. dollar.

Employment: Job growth peaked in 2014, with more than 3 million nonfarm payroll jobs created (the strongest year since 1999). In 2015, 2.8 million jobs were added to payrolls, the second highest total. In general, job creation is strong by historical standards, but it is decelerating as the economic cycle matures. Our forecast is for 2.7 million and 2.6 million nonfarm jobs to be created in 2016 and 2017, respectively, making 2014-2017 the strongest four years of job growth since the end of the 1990s. We then expect job gains to moderate substantially in 2018 (1.7 million). After averaging 5.3% in 2015, the unemployment rate will decline to 4.7% in 2016 and 4.4% in 2017. As the unemployment rate approaches a range traditionally associated with a very tight labor market, upward pressure on wages will intensify. Hourly wage growth exceeded core PCE inflation by 1% in the second half of last year, a trend still gaining momentum. While we expect inflation to pick up, we also forecast a sustained rise in wages. This should drive healthy churning in the labor market over the next two years.

Implications for Commercial Real Estate

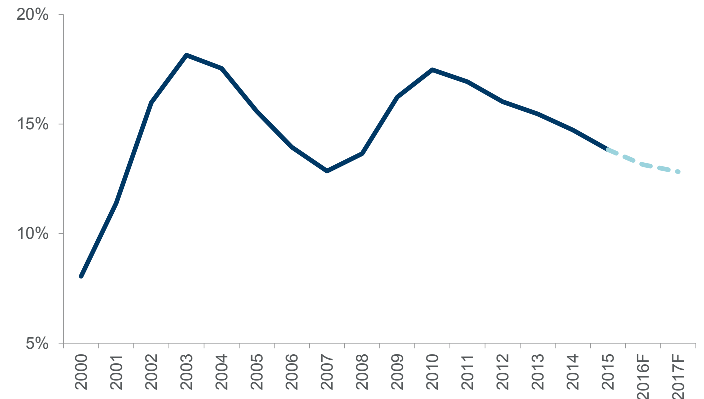
Office: Like total nonfarm employment, office-using employment is expected to grow, but at a decelerating rate. After increasing by 800,000

U.S. Office Net Absorption
MSF



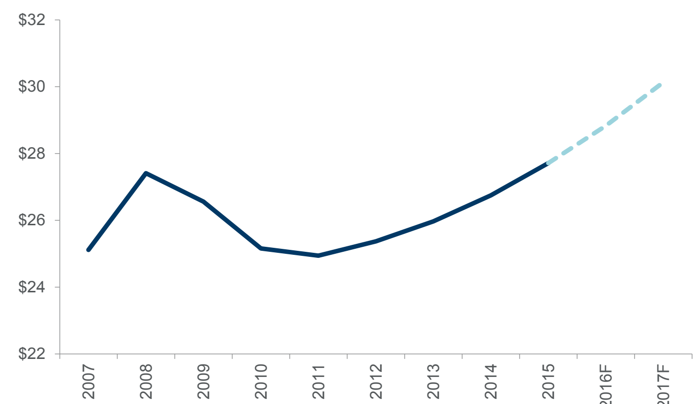
Source: Cushman & Wakefield

U.S. Office Vacancy Rate



Source: Cushman & Wakefield

U.S. Office Rents
Weighted Average Asking Rent ($/SF)

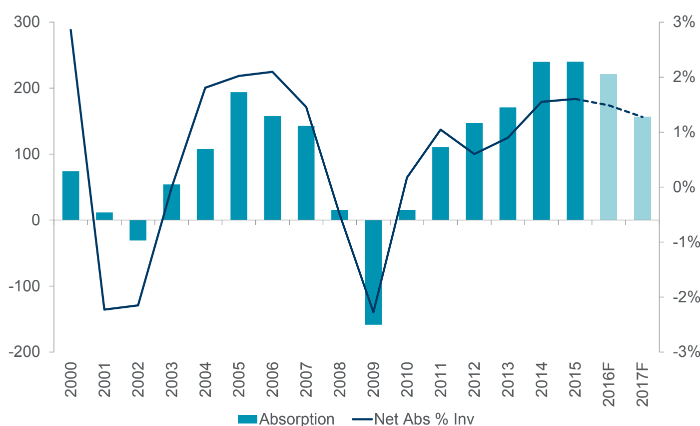


Source: Cushman & Wakefield

jobs in 2015, office-using employment is forecast to rise by 786,000 payrolls in 2016 and 724,000 in 2017. Due to the anticipated slowdown in hiring (which is a function of a tightening labor market, not a function of a slowdown in growth), aggregate demand for office space will also slow. We forecast U.S. net absorption to decrease from 82.0 million square feet (msf) in 2015 (a cyclical peak) to 77.6 msf in 2016 and 67.8 msf in 2017. Deliveries will not keep pace with net absorption for another two years, though completions will continue to increase as a share of inventory. Thus, we forecast vacancy to decline to 13.2% in 2016 and 12.8% in 2017 from 13.8% in 2015. With conditions tightening, U.S. office rent growth will continue, rising 3.9% in 2016 and 4.3% in 2017. In 2018, new development should finally catch up with decelerating demand growth. This is expected to be the inflection point when aggregate vacancy begins to flatten/rise and rent growth slows.

Leasing activity in major tech markets has slowed over the last two quarters. Additionally, in certain tech markets, sublease space availability has risen. Although some are concerned about a worst-case scenario in which the tech engine is shutting down, those concerns seem premature and overwrought. Other economic data sends a clear signal that the tech sector will continue on a healthier path. The

U.S. Industrial Net Absorption
MSF



Source: Cushman & Wakefield

Federal Reserve Bank of San Francisco's Tech Pulse Index—a coincident barometer of the industry's health which also reflects the consumer tech demand—continued to trend upwards through March of 2016. Moreover, as of this writing (April 25, 2016) the NASDAQ has rebounded 7% from mid-February and venture capital funding also ticked up in the latest quarterly reading. However, the share of nonfarm job growth in the high tech sector is forecast to shrink after peaking at 12.4% in 2015. We expect high tech industries to account for 11.4% of new jobs in 2016, and 9.7% in 2017. High tech employment is not synonymous with office-using employment but we generally expect robust job creation across office-using sectors to buoy office markets around the country, even if some footprint rightsizing takes place in the near term.

Industrial: Warehouse/distribution space will benefit from both a more confident, higher-spending consumer and the positive outlook for the U.S. labor market (via spending, e-commerce, and an expected increase in single-family activity).[1] These factors have been major drivers behind several years of robust absorption, including a record-setting 240 msf in both 2014 and 2015. In 2016, we forecast a continuation of this trend, resulting in 220 msf of net absorption. Manufacturing space, which represents about one-fifth of national industrial inventory, will face headwinds and tailwinds, the former arising from declines in manufacturing activity (due mainly to slowing exports). Additionally, as interest rates slowly inch up over the course of the year, the recent boom in the auto sector will eventually subside. Auto sales are currently a tailwind for the manufacturing sector, but this will shift over the next several years. Despite these undercurrents, overall vacancy will tighten further, declining from 6.6% in 2015 to 5.9% in 2016. This is on par with the tightest conditions ever observed in the sector. However,

[1]Single-family residential real estate will continue to expand, with permits and starts peaking in the second half of 2018. Building and construction materials make up more than 8 percent of inventories.

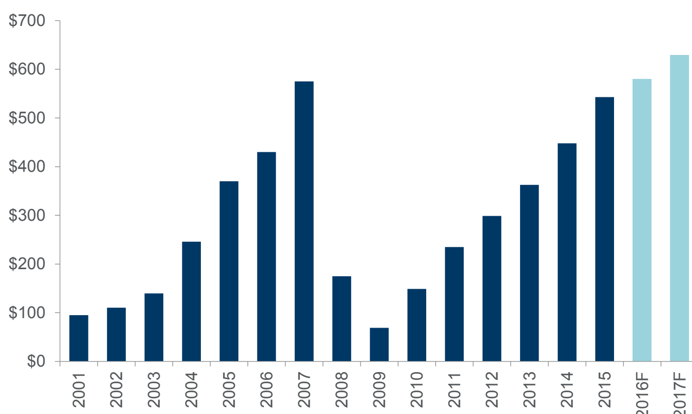
we expect an uptick in construction activity in 2017, which will help to alleviate some of the space shortages, causing vacancy to tick upward to 6.1%. Strong tenant activity and supply constraints will fuel rent growth. The rent growth forecast of 4.7% for 2016 will not only exceed the 3.8% registered in 2015, but will continue to accelerate through 2017, hitting 5.5%.

Retail: Demand will largely remain focused on Class A product and/or new space. Over the next two years, a combined 80 msf in net absorption will put downward pressure on vacancy, resulting in a decline to 7.7% in 2016 and 7.5% in 2017 from 8.1% in 2015. Rent growth will remain bifurcated and a stronger-than-anticipated closure season has dampened the rent outlook. Rents will grow 3.8% in 2016, although most of that growth will occur in the first half of the year. In other words, if we look at the percent change in rents from the second half of 2015 to the second half of 2016, we would find that rents are forecast to increase by only 1.4%. Deceleration in some retail asset classes will push headline rent growth down to 1.2% in 2017. However, positive consumer spending trends will fuel retail fundamentals, especially as low gas prices and further wage gains support stronger growth.

U.S. CRE Transaction Volume: Final 2015 investment sales figures totaled $542.8 billion, just beating our forecast of $534.0 billion. Total sales volume is creeping towards the previous cycle's peak of $573 billion in 2007. Despite a slowdown caused by financial market volatility in the first eight weeks of the year, capital markets activity is generally expected to accelerate in 2016. Continued easing in monetary policy outside the U.S., flight to quality amid global financial market volatility, and growing levels of dry powder are among the major drivers of U.S. CRE investment demand in the near term. Additional factors include the low interest rate environment, sustained downward pressure on longer-term bond rates from global headwinds, softening inflation expectations, reduced credit spreads in financial markets, and an anticipated pick-up in bank lending. Some of these factors will have more of a near-term impact, such as a likely post-volatility rally in CMBS and bank lending in the second half of 2016. While there may be some easing of CMBS issuances towards the end of the year because of new regulations (namely risk retention), insurance companies and large banks are expected to step in and bridge most financing gaps. However, prior to the implementation of these regulations (December 24, 2016), we expect a surge in CMBS activity, especially now that spreads are tightening once again—which is particularly positive for the secondary and tertiary CRE markets.

In 2016, total investment sales are expected to grow 6.9% from their 2015 level, setting a record level of sales of $580.4 billion. While some investment appetite diminished in the early months of the year, strengthening economic conditions and reduced volatility will push demand in the third and fourth quarters to record quarterly levels. Sales activity is expected to peak at $629.1 billion in 2017 with the economic cycle. In 2018, investment sales are forecast to decline 10.7% to $562.1 billion. Investor interest in "urban opportunities" that capitalize on changing demographic and economic landscape remains high. The office and multifamily sectors have led investment activity, but we are seeing increased interest in industrial and retail properties,

U.S. Transaction Volume
All Property Types (including land), $ Billions

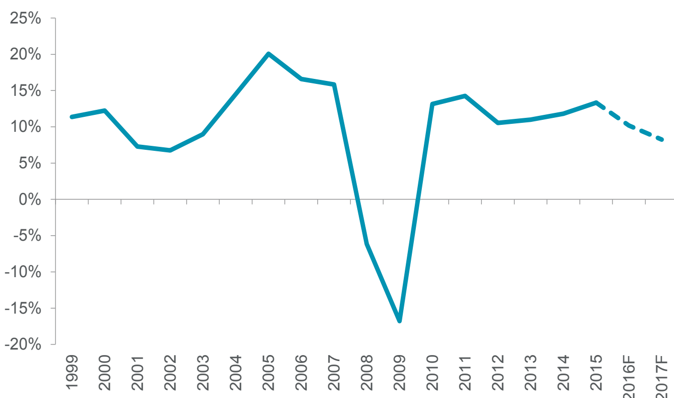


Source: Real Capital Analytics, Cushman & Wakefield Forecast

especially those in or near major population centers (industrial) and core urban retail centers.

U.S. CRE Total Returns: The outlook for total (unlevered) NCREIF returns for commercial real estate is relatively unchanged. In general, returns are expected to remain healthy but on a decelerating path for the remainder of the cycle. Last year (2015) was the fifth consecutive year of double-digit NCREIF returns.[2] Cap rates, which are expected to flatten in 2016 and then start rising in 2017, will reflect pressures on capital appreciation. We continue to expect up to a 5% deceleration in total returns over the next few years due to effects on values from rising interest rates and the maturity of the cycle. Income returns should remain sufficiently strong as leasing fundamentals support asset net operating income, which itself will increasingly support overall returns. Total returns are forecast to slow to 11.8% in 2016 and to 8.2% in 2017, from 13.3% in 2015.

U.S. NCREIF Returns
Annualized Average Quarterly Total Return



Source: NCREIF, Cushman & Wakefield Forecast

U.S. CRE Prices: Likewise, prices of commercial real estate assets are generally expected to grow at a decelerating rate over the next two years. We are forecasting moderate year-over-year growth in 2016 of 5.8% and a significant deceleration in pricing towards the second half of 2017, with most price deceleration occurring in 2018 and later.

Price appreciation in 2017 is forecast to be 4.2%. Although appreciation will temper in the near term, our forecast is above the most recent Urban Land Institute (ULI) consensus view which shows a 5% increase in all property prices in 2016 and only a 2.7% increase in 2017.

Conclusion

Though the start of the year triggered fear of a slowdown, the major economic drivers that matter to growth are still chugging along. Consumer conditions will continue to improve; consumer spending will be one of the major contributors to growth for the rest of the cycle. Further, as the headwinds from the start of the year dissipate and the impact of low oil and commodity prices subsides—at least from metrics like growth in inflation and changes in corporate profits—business investment will also start to pick up. Slower than expected monetary policy normalization will help to buoy job growth in the near term, though economic conditions will likely warrant more rate hikes next year. Property markets, which responded to the year-end and early-year weakness, are also turning a corner. Already, leasing and sales activity is firming. Demand will remain strong, vacancy will tighten, and rental growth will continue this year—albeit unevenly for some asset classes. These conditions will also support stronger activity in the capital markets for the remainder of the year.

[2] This refers to the annualized average quarterly rate of return.

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U.S. Macro Forecast Table

	2015		2016	2016			2017	Annual		
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	2015	2016	2017
US Economy										
Real GDP, % (AR)	2.0	1.4	1.0	3.8	3.6	2.0	0.3	2.4	2.3	2.7
Chg. in Nonfarm Employment, ths.	670	720	620	628	686	760	717	2,775	2,694	2,569
Chg. in Office-using Employment, ths.	192	220	139	199	206	242	244	812	786	724
Unemployment Rate, %	5.2	5.0	4.9	4.9	4.7	4.5	4.5	5.3	4.7	4.4
Retail Sales & Food Services, % (SAAR)	4.5	1.0	2.7	3.9	6.4	6.0	6.3	2.2	3.7	5.8
CPI Inflation, % (AR)	1.3	0.8	-1.0	1.5	2.1	2.3	2.5	0.1	0.9	2.3
Consumer Confidence Index	98	96	96	98	101	102	103	98	99	102
Federal Funds Rate, %	0.1	0.2	0.4	0.6	0.7	1.0	1.3	0.1	0.7	1.6
10-year U.S. Treasury note, %	2.2	2.2	1.9	2.0	2.3	2.5	2.8	2.1	2.2	2.8
ISM Manufacturing Index	51.0	48.6	49.8	50.9	52.7	52.2	51.3	51.3	51.4	50.6
West Texas Intermediate, $/bbl	47	42	33	44	45	46	47	49	42	50
Office Sector										
Net Absorption, msf	21.5	20.5	10.7	24.4	22.3	20.2	12.6	82.0	77.6	67.8
Vacancy Rate	13.7%	13.5%	13.5%	13.4%	12.9%	12.8%	12.9%	13.8%	13.2%	12.8%
Asking Rent	$27.90	$28.10	$28.50	$28.60	$28.88	$29.03	$22.49	$27.67	$28.75	$29.99
Industrial Sector										
Net Absorption, msf	56.5	65.1	58.2	61.7	52.5	52.6	40.9	240.3	221.6	156.4
Vacancy Rate	6.5%	6.3%	6.1%	6.0%	5.8%	5.7%	6.0%	6.6%	5.9%	6.1%
Asking Rent	$5.28	$5.36	$5.42	$5.48	$5.53	$5.65	$5.73	$5.27	$5.52	$5.82
Retail Sector*										
Net Absorption, msf	14.2	10.1	4.8	11	14.5	9.4	8.3	39.0	44.9	36.1
Vacancy Rate	8.0%	7.9%	7.9%	7.7%	7.6%	7.5%	7.3%	8.1%	7.7%	7.5%
Asking Rent	$25.75	$25.98	$26.08	$26.14	$26.19	$26.24	$26.31	$25.21	$26.16	$26.49
Capital Markets**										
Total Investment Sales, $ Bil.	$117.1	$165.8	$110.7	$146.3	$152.3	$171.1	$154.3	$542.8	$580.4	$629.1
NCREIF Unlevered Total Returns, Qtrly % Chg.	3.1%	2.9%	2.2%	2.9%	2.6%	2.1%	1.8%	13.3%	10.2%	8.2%
Moody's/RCA CPPI (All Property Types), Yr/Yr % Chg.	14.6%	12.2%	7.7%	6.3%	4.8%	4.4%	5.4%	14.9%	5.8%	4.2%

**Historical series based on CoStar; rents are unweighted*
***RCA, NCREIF (Appraisal Index), Moody's Analytics; Total Investment Sales includes office, industrial, retail, multifamily, hotel, and land sales*
****All percentages are period averages unless noted otherwise*

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