RESEARCH REPORT - WEEKLY ECONOMIC UPDATE

The U.S. Economy is Much Healthier than the Headlines Suggest

November 13, 2015

CUSHMAN & WAKEFIELD

- The U.S. economy remains fundamentally sound and is growing at a solid pace.
- Healthy economic growth should support continuing improvement in demand for commercial real estate over the coming year, leading to significant absorption and declining vacancy rates.
- Financial market volatility and uncertainty about economic conditions in China led to a brief third quarter slowdown as businesses became more cautious.
- However, consumers continue to spend at a strong pace, driving demand for goods and services throughout the economy. A rebound in growth is expected to occur in the final three months of the year and into 2016.
- Strong economic conditions will lead to rising demand for all categories of commercial real estate in the fourth quarter and well into 2016.

Headlines from third quarter government statistics suggested that economic growth is faltering as both the business and consumer sectors paused.

- The U.S. economy only added 137,000 jobs in September after 153,000 jobs in August.
- Retail sales rose a meager 0.1% in September after remaining unchanged in August.
- U.S. Gross Domestic Product (GDP) grew at a 1.5% annual rate in the third quarter, a sharp slowdown from the 3.9% annual growth rate recorded in the second quarter.

A deeper look at these and other statistics tell a much more positive story on the state of the U.S. economy. In fact, the economy's performance in the third quarter was stronger than the headlines suggested and indicators suggest that we will see a bounce back to a much stronger growth rate in the fourth quarter, putting the economy in position to enter 2016 with healthy momentum. The first evidence of a rebound in growth came last Friday when the Labor Department announced a surge in employment in October as the economy added 271,000 jobs, the largest monthly increase of 2015.

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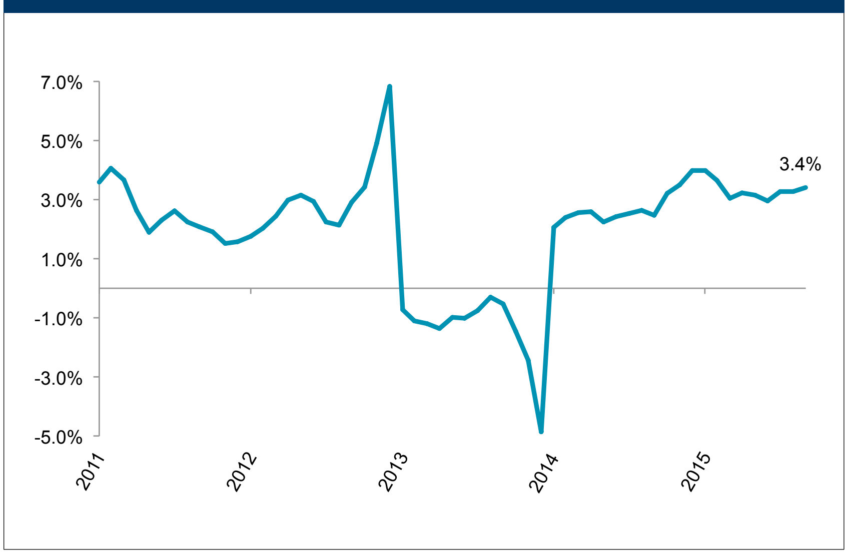
A Slowdown in Name Only. Although U.S. GDP grew at a weak 1.5% in the third quarter, the slowdown was mostly a result of an excessive buildup of inventories earlier in the year. When businesses experience rising demand, they usually respond by building up inventories in anticipation that demand will continue to increase. If demand does not rise, businesses are left with surplus inventories that they need to reduce. The result is an inventory correction as businesses cut back orders to reduce the stocks on their shelves. Since the change in inventory is a component of GDP, when inventory accumulation slows, it has a negative impact on GDP—exactly what happened in the third quarter. Inventory accumulation was running at a $113 billion annual rate in the first half of the year, but that pace was cut in half to $56.8 billion in the third quarter. If we remove the impact of the change in inventories, the economy grew at a much more respectable 2.9% annual rate. Now that the inventory correction has run its course, we expect GDP growth to bounce back in the fourth quarter.

Consumers Are Just Fine Thank You. Another way to look at the performance of the economy is to look at consumer spending. Consumer spending accounts for roughly 70% of U.S. GDP and it remains strong. In the third quarter, consumer spending increased at a 3.2% annual rate, the second quarter in a row and the fifth time in the past six quarters that consumer spending has increased

REAL AFTER-TAX INCOME
Percent Change from a Year Ago



Source: US Bureau of Economic Analysis

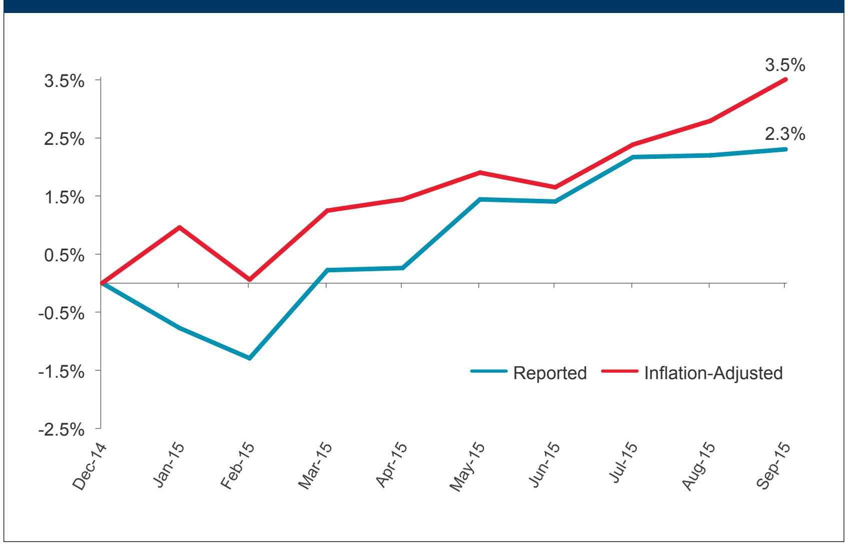
at faster than a 3.0% annual rate. For some perspective, in the previous 18 quarters (4.5 years) consumer spending only exceeded a 3.0% annual rate three times.

Clearly, consumers have ratcheted up the pace of spending in the past year and a half. This spending acceleration appears to be a result of several factors: rising income, declining energy prices and steady improvement in the housing sector.

In September 2015, income after taxes and inflation stood 3.4% above the level of a year ago, continuing the strong income growth that has characterized the economy throughout the year. This growth has been caused by two factors: moderate wage growth and strong job growth. This combination of more people working and steady wage growth is enabling consumers to increase their spending at a strong pace.

In addition, the oil price decline has had a positive impact on consumer spending. For quite a while there has been a concern that the 50% decline in oil prices was not leading to stronger growth in consumer spending. Retail sales tell a different story. According to the Commerce Department, from December 2014 to September 2015 retail sales rose 2.3%, or at a 3.1% annual rate. Good, but not very strong. However, a big reason for the slow growth has been declining prices, particularly for gasoline. Retail sales fell in January and February and were flat in August and September largely because of declines in gasoline prices. If we adjust for inflation, sales have increased 3.5% so far this year, a solid 4.7% annual rate and the strongest first nine months of a year since 2010.

RETAIL SALES GROWTH SINCE DECEMBER 2014
Reported vs. Inflation-Adjusted



Source: US Department of Commerce

Finally, the housing sector continues to gradually, if somewhat erratically improve. In September, sales of existing homes rose to the second highest level of the past eight and a half years. A strong housing sector tends to have a multiplier effect on consumer spending, especially for durable goods from furniture to appliances.

The consumer has been spending at a strong rate for the past year and a half and appears poised to continue raising outlays in the coming year. This will have a positive impact on both the retail and industrial segments of the commercial real estate market as the consumer dollar is directed through multiple channels from stores to online spending.

Early data for October suggest consumers continued to boost spending at a strong pace. Sales of motor vehicles reached an estimated annual rate of 18.2 million units. That's a high point for the current cycle and only the third time in the past 15 years that motor vehicle sales have been at or above the 18.2 million annual pace.

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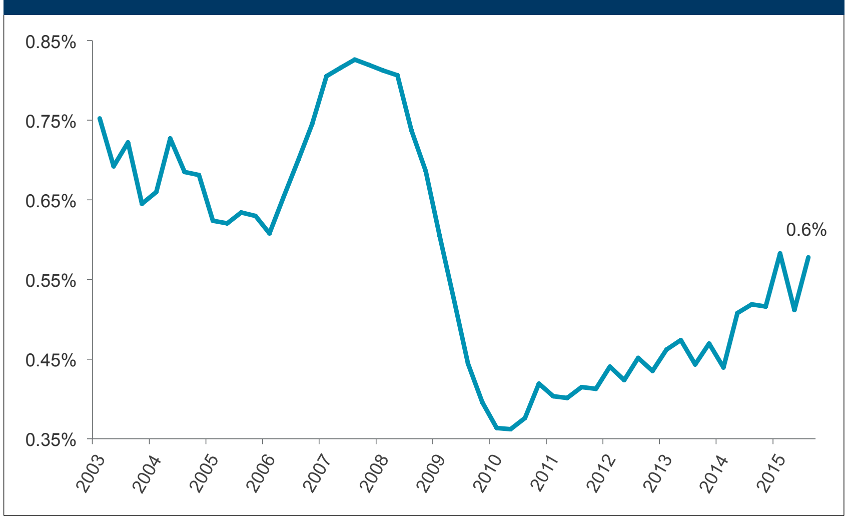
Wage growth may be accelerating. Whether consumers will be able to continue to boost spending at this rate will depend importantly on the growth of wages. Throughout this expansion wage growth has been moderate. Since the beginning of 2010, average hourly earnings as reported in the monthly employment report have increased, on average, 2.0% per year, well below the 3.1% average in 2007 through 2009. Wage growth as measured by average hourly earnings, has remained stuck at about 2.0% despite the improvement of the overall economy. But other measures of wages are a bit more positive, and measures of labor market conditions suggest that wages are starting to rise more rapidly.

One problem with the average hourly earnings statistic in the monthly employment report is that it does not take account of the mix of jobs. So if more people get hired in low wage jobs, the average would decline even if wages are rising in all jobs. In October, average hourly earnings rose 2.5% from a year ago, the strongest pace since mid-2009, as a surge in higher paying construction jobs helped boost the average. Another measure that tracks just wages, not the combination of wages and jobs, is the quarterly Employment Cost Index (ECI). In the third quarter, private sector wages in the ECI jumped 0.7%, after climbing only 0.2% in the preceding quarter. Over the last six quarters (going back to the second quarter of 2014), wages have increased an average of 0.6% per quarter. That's an annual rate of 2.4%, and tied for the strongest wage growth since 2009. In 2010, the six

QUARTERLY PRIVATE SECTOR WAGE GROWTH
Six-Quarter Moving Average



Source: US Bureau of Labor Statistics, Employment Cost Index

quarter average increase fell to roughly half the current pace.

So wage growth appears to be trending higher. In addition, labor markets are tightening.

- The unemployment rate is at its lowest level since early 2008.
- Layoffs, as measured by the weekly number of people filing for unemployment insurance, have fallen to the lowest level since the 1970s.
- Job openings are near record highs.
- More and more companies are finding it difficult to hire qualified workers. The National Federation of Independent Businesses (NFIB) has been reporting all year that between 25% and 29% of members have at least one job that is hard to fill. That's the highest sustained reading for this measure since the early 2000s.

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It all adds up to a labor market that is tightening. In this environment businesses are more likely to raise wages to either hire new employees or keep their current employees. The first evidence of this tightening may have been the October jump in average hourly earnings, although we will need to see more evidence before drawing any firm conclusions.

When faster wage growth is combined with healthy employment growth the result is likely to be strong income growth in the coming year leading to continuing strong growth in consumer spending.

This is all great news for the commercial real estate sector. In the third quarter of 2015, U.S. office and industrial markets experienced healthy positive absorption and falling vacancy rates, leading to rising asking rents. In an economy that is expected to continue to experience strong domestic demand growth, commercial real estate will perform well.

- Job growth will continue to boost demand for office space leading to positive absorption and declining vacancy.
- Strong consumer spending will support continuing growth in the retail, industrial and hotel sectors.
- Rising income will be positive for the multifamily sector where we would expect to see more household formations lead to stronger demand.

Overall, the economy is in far better shape than the headline numbers suggest. The next couple of quarters should see healthy domestic demand growth continue to power the economy ahead.

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