

COVID-19 IMPACT: TIME TO STRATIFY THE RECOVERY

As of August 17, 2020

Kevin Thorpe shares his latest take on COVID-19 and its impact.

Virus Update:

POINT #1: *The spread of the virus appears to be re-intensifying around the world.* In the U.S., data reported in the first two weeks in August show that the number of newly reported cases remains elevated at around 55,000 per day, but is beginning to trend downwards. Hot spots have shifted from the Coasts to the Sunbelt, and now to the Midwest. Elsewhere in the Americas region, new infections appear to be trending up again in Canada and are surging in Latin America. As of this publication, Brazil is second in the world only to the U.S. in terms of total reported cases.

The virus has also reemerged across most of Europe. New daily infections are trending up in the U.K., Germany, France, Spain, Luxembourg and Romania as well as other locations. It appears increasingly likely that European officials will introduce greater travel restrictions and order members of the population at higher risk to stay at home.

Most parts of Asia Pacific are also trending in the wrong direction. In Australia, Japan, and India, virus cases are spiking into August. And we know that wherever the virus is raging, it has a devastating effect on those local economies.

POINT #2: *Reporting on vaccines and therapeutics continues to look very promising.* According to most public health officials, the data does look favorable on phase two vaccine trials. There are eight or so promising vaccines, and the probability that at least one of those offers efficacy and safety seems higher than not. Moreover, manufacturing is running alongside the human trials. Again, the probability that there will be a widespread vaccine or effective treatment available to a significant percentage of the world's population seems more likely than not. To inform our economic and property market assumptions, we rely on the medical communities' assumptions. According to most health officials, a medical solution to the pandemic is still on track for mid-2021, so that is the current working assumption as we model the impact on property.

Economic Update:

POINT #1: *This is the most severe global recession in the Post WWII era.* Second quarter GDP estimates are starting to roll in. In the U.S., real GDP collapsed by an annualized rate of 33% in Q2—the largest one quarter drop on record. In terms of lost economic output, the COVID-19 recession has already more than doubled what we observed during the Great Financial Crisis. Employers in the U.S. cut 22 million jobs in the months of March and April. As of July, they had only brought nine million of those jobs back.

The recession appears to have hit Europe equally hard, but employment is holding up better. Eurozone real GDP is expected to have dropped by an estimated 40% in Q2. Job losses have been less severe across Europe, at least so far, due largely to various furlough schemes and wage subsidy programs.

Asia Pacific is more of a mixed bag. Where the virus was largely contained in Q2, those economies began to rebound as is the case with Mainland China. Or those economies were at least more resilient—South Korea and Vietnam are good examples. But the bulk of the rest of Asia Pacific region fell into a deep recession in Q2 on par with what we observed across the U.S. and Europe. For example, in Australia, Singapore, Japan, and India, real GDP is expected to decline by an estimated 30-40%.

POINT #2: Q2 is expected to be the trough. For most of the world, the economic downturn lasted about two months (March and April). Since then, the global economy has started growing again. As businesses reopened, we have observed a flurry green shoots in the economic data. Pick your economic data series and you will likely find an upturn that started in May—retail sales, road traffic, restaurant bookings, mortgage applications, oil consumption—have all shown at least a partial rebound from the low levels we observed earlier in the year. That said, it is also clear that as economies have opened, the virus has spread. Nevertheless, given that the bulk of the economic data is quite clearly improving, and given that national lockdowns are unlikely (at least to the degree that we observed earlier in the year), most economists assume the worst of the recession is behind us.

POINT #3: Economic growth is expected to be subpar until the coronavirus situation resolves. Most economists now assume that U.S. real GDP will not return to pre-crisis levels until mid-2022. For Europe, not until the end of 2022. And for Asia Pacific, most assume 2021—although, that is now looking increasingly optimistic given the resurgence of the virus in various parts of the region. Bottom line: the global economy is unlikely to fully lift off until the coronavirus has faded in the rearview mirror.

Property Update:

POINT #1: GDP matters. Historically, GDP has been a solid predictor for gauging the health and performance of commercial property markets. The pattern we've seen goes as follows: as GDP recovers, the economy begins producing jobs again, which translates into more absorption, leasing, rent growth, inventory growth, properties to manage, and capital markets activity. In many ways, we expect that the property market recovery will track very similarly to the path of the recovery in the economy, although this varies by market and by asset type.

POINT #2: There are bright spots in property. The coronavirus impact has clearly accelerated a few trends that were already in the making. For example, eCommerce was clearly gaining market share over traditional bricks and mortar retail going into the crisis, and we know that this trend was accelerated by the lockdown and stay-at-home orders. Online sales accounted for 16% of total U.S. retail sales in 2019, a figure that jumped to over 20% during the COVID-19 lockdown period and that has remained elevated. We also know that this acceleration in online sales is boosting demand for industrial logistics space, which has already nearly returned to pre-crisis levels of absorption. And occupancy rates for these kinds of facilities hovered at approximately 95% in the U.S. in Q2.

Other types of real estate that are either already benefiting or likely to benefit from secular shifts and accelerating trends include data centers, internet-related real estate, life sciences and real estate in the suburbs.

Although the apartment sector faces significant near-term headwinds (e.g., job losses will undoubtedly impact the fundamentals), this sector also has long-term strength. In the U.S., for example, nearly half of the millennial generation are still in their 20s—prime renting ages—and Generation Z is coming up right behind them. By some estimates, Gen Z is even larger than the millennial cohort. Empty nesters will also be an important source of demand.

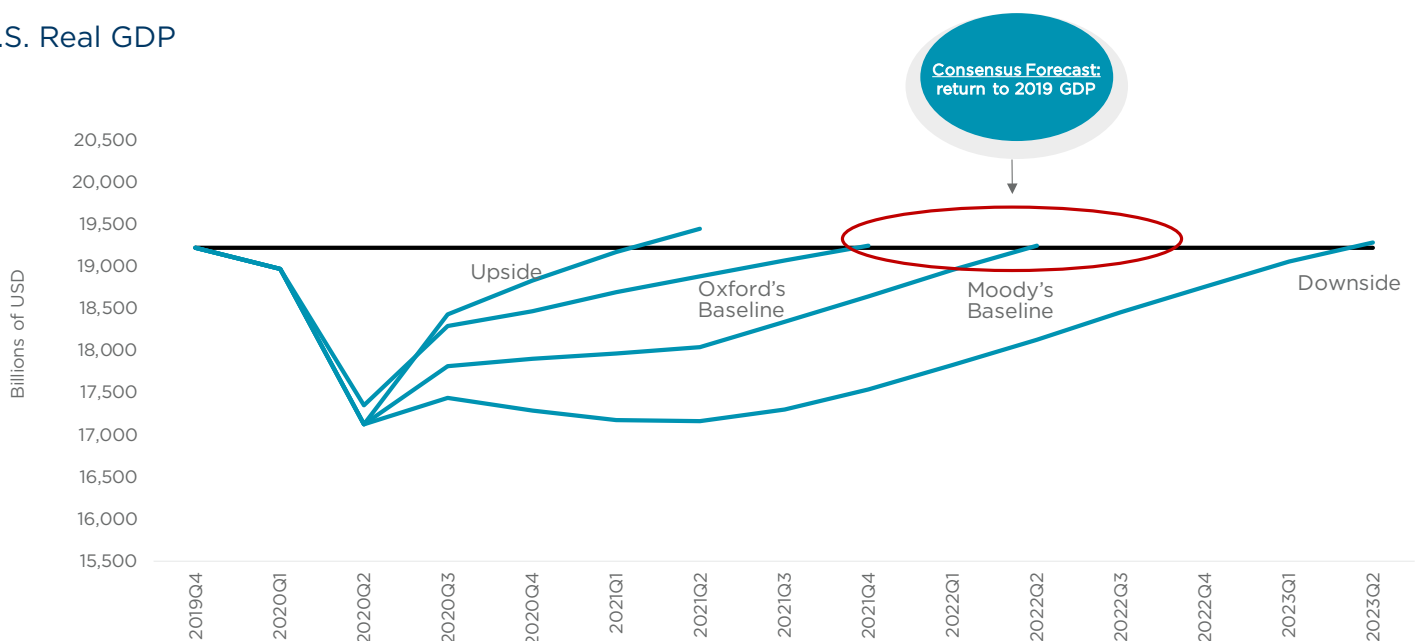
POINT #3: Office will also fully recover, it's just going to take longer. The office sector faces more challenges. First, we know that the office sector, like most other sectors, faces a cyclical impact. That's the normal demand decline caused by a sharp recession coupled with an expectation that a return to full employment will take several years. If the economy follows this script, the impact of office-using job losses will invariably translate into increased vacancy and place downward pressure on rents. None of this is unique. The office sector has faced cyclical impacts before and it has always recovered to pre-recession levels of performance and beyond. But in this recovery, office also faces structural impacts that are being accelerated by COVID-19. Most surveys indicate a larger share of office workers will permanently work from home. Similarly, we'll see a larger agile worker population—people who work remotely at least some of the time. For some businesses, those new dynamics are likely to change the mix of space they lease in the central business district versus the suburbs.

Keep in mind, however, one structural positive for U.S. office remains intact—a structural transformation towards a professional-services oriented economy. That trend started well before the pandemic and it partly explains why the office sector has been growing at an accelerating rate, generally speaking, for the past 50 plus years. In other words, sectors that traditionally occupy office space have been increasing as a share of the overall labor market for decades. For reference, in 1950, U.S. office-using employment was just 14% of nonfarm employment. By 1990, it was up to 18%, and by 2019, up to 22%. Over the next 10 years, one-quarter of all jobs are expected to be office-using, implying that these industries will continue to account for a disproportionate share of future job gains. That means office has a very strong structural engine powering demand for space. Further, this definition of office employment does not include government or medical occupiers, which are also sources of office demand.

Cushman & Wakefield Research recently produced an internal study to measure the net impact COVID-19 will have on the U.S. office sector. In this analysis, in addition to the cyclical impacts, we made assumptions about the possible values key structural parameters may take, driven by external academic research and surveys. The study produced two key findings. First, in the baseline scenario, U.S. office vacancy will rise from 13% in 2019, and will top out at 18% in mid-2022. The higher vacancy will put downward pressure on rents. We estimate that asking rents will decline by 10 to 15% peak-to-trough. The second key finding is that office will in fact recover. The structural shift referenced above—more permanent work-from-home employees and more agile employees—delays the recovery in office by 12-18 months versus other typical recessionary recoveries. But demand for office space does turn positive in the back half of 2022 and vacancy begins to trend downward.

Some of the factors that point to a full recovery include the likelihood the economy continues to grow, that the population continues to grow, that office employment continues to penetrate broader nonfarm employment, and that businesses will need to put some percentage of their workers somewhere other than their own homes. These trends, in addition to the agglomeration benefits of a traditional office environment—opportunities for knowledge spillover, innovation and creativity, employee bonding, culture and brand, mentoring and training, productivity and more—suggest that office real estate will continue to play a vital role in the way organizations work and grow.

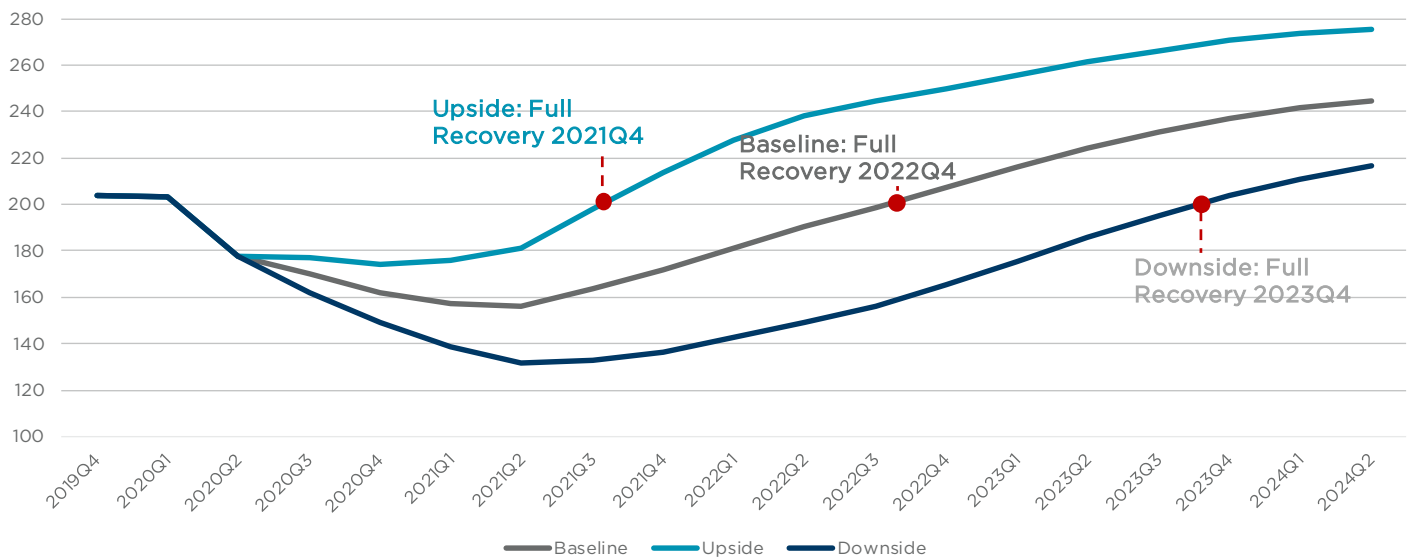
U.S. Real GDP



Source: Consensus forecast sourced to FiveThirtyEight/IMG where 22% of economists expect real GDP to return to pre-crisis levels in H2 2021 vs 44% expect H1 or H2 of 2022. Upside = Moody's Analytics SO Update Scenario, Downside = Moody's S3 Downside Scenario; Forecast as of 7-22-2020

POINT #4: Recessions create opportunity. Expect a slow, uneven economic recovery, and by extension a slow, uneven recovery for property. When the pandemic is finally in the rearview mirror, expect a lot of movement that spurs transactions. The pandemic has undoubtedly launched a flurry of new real estate strategies. Some businesses will rethink their office footprint, some will want more space in the suburbs and less downtown. Some investors will reweight their portfolios, maybe go heavier on industrial, lighter on office. Regardless, the new economy will need new things, so whether we see converted or reimagined malls, hotels, movie theaters, obsolete office buildings, fitness centers or more, real estate investors and users will find opportunity to reinvent real estate.

U.S. Office Property Price Index



Source: Upside = Moody's S0 scenarios, Baseline = Moody's baseline scenario where GDP doesn't fully recover until 2022Q2, Downside = Moody's S3 Scenario
Forecast as of 7-22-2020

Kevin Thorpe

Chief Economist
Global Head of Research
kevin.thorpe@cushwake.com

About Cushman & Wakefield

Cushman & Wakefield (NYSE: CWK) is a leading global real estate services firm that delivers exceptional value for real estate occupiers and owners. Cushman & Wakefield is among the largest real estate services firms with approximately 53,000 employees in 400 offices and 60 countries. In 2019, the firm had revenue of \$8.8 billion across core services of property, facilities and project management, leasing, capital markets, valuation and other services. To learn more, visit www.cushmanwakefield.com or follow @CushWake on Twitter.