Change on the Horizon:

An overview of the economy and its impact on commercial real estate

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Commercial real estate is intrinsically linked to the economy at national, regional and local levels. That's a good thing today and for the immediate term ahead, as economic strength continues to benefit almost all major asset classes.

Looking longer term, however, a combination of evolving economic, geo-political, and industry-driven factors, along with rising interest rates, an expanding trade war, and potential overheating in key markets and segments, indicate a slowdown is on the horizon within the next few years.

Today, things look good

Contributing to the current hawkish view at the national level is real GDP growth, which forecasters put at a healthy 3% for 2018. At the Fed's June 13th meeting, Chairman Jerome Powell proclaimed the U.S. economy was in "great shape," raising the institution's projections for economic growth and lowering its projections for unemployment.

Citing solid economic growth, a strong labor market, and inflation close to its 2% target, the Federal Reserve raised its benchmark federal funds rate by 25 basis points to the 1.75% to 2% range, with two more increases expected before year-end.

What does all that mean for our corner of the world…commercial real estate in California?

First, it has translated into commercial construction that is at near pre-recession territory. For example, according to Colliers International, new construction totaling 5.2 million square feet is underway in the Los Angeles Basin office market alone, three quarters of which will deliver in 2018.

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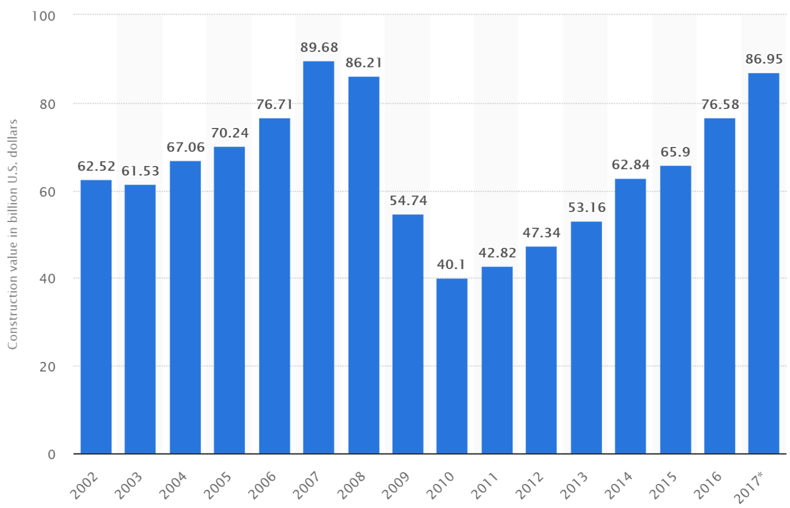
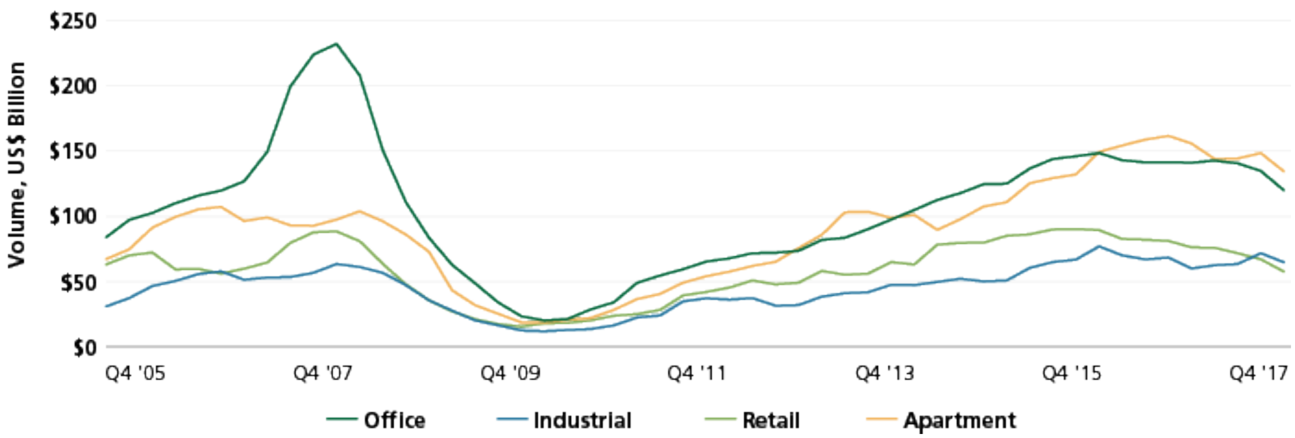
Value of U.S. commercial construction put in place from 2002 to 2017 (in billion U.S. dollars)



Source: Statista 2018

However, for a second year in a row, commercial real estate transaction volumes declined in 2017, with the total value of Office, Industrial, Retail and Apartment transactions decreasing by 13% year-over-year. All asset types experienced slower market activity, except for Industrial which increased by 8%.

Transaction Volume, Trailing 4Qtr



Source: Real Capital Analytics, Manulife Asset Management, as of December 31, 2017.

Despite the slowdown in volumes, prices continue to increase. The Manulife Asset Management U.S. Commercial Real Estate Outlook for 2018 indicated that Apartment, Industrial, Office and Retail average prices were up year-over-year by 10.2%, 9.8%, 4.1%, and 3.7% respectively.

The view from the Golden State has been quite auspicious as well. California has benefitted from national growth, as well as from domestic expansion within the state itself, to recently become the world's fifth-largest economy, surpassing the United Kingdom.

Irena Asmundson, the California Department of Finance Chief Economist, said recently that all economic sectors except agriculture contributed to California's higher GDP, with financial services and real estate leading the pack.

Property Type Snapshots:

- Office: According to Marcus & Millichap, almost all major metropolitan areas in California are experiencing office vacancy levels below the national rate of 13.7%, with the sole exception of Los Angeles at 14.1%. Colliers reported that for 2018Q1, office vacancy in Los Angeles County rose to 15.6%, and in greater Los Angeles, rose to 14.9%.

- Industrial: Over the past four quarters, construction in California has been completed on more than 37 million square feet of industrial product. While the Inland Empire and Los Angeles typically garner the most attention, the industrial boom is also moving south, with lending sources showing increasing interest in multi-tenant properties in the San Diego submarkets.

- Multi-Family: The multi-family segment also is experiencing a high-level of demand. California's average effective rent on multifamily properties rose 4.9% over the past year, slightly outpacing the national rate of increase, which is around 4.6%, per Marcus & Millichap.

- Retail: Recent headlines of big box closures, in part, promulgated by online shopping, have contributed to a slightly more pessimistic outlook in the retail sector. But despite the negative headlines, many developers and owners are using the empty boxes as an opportunity to make adjustments, try new concepts and provide what the market is demanding. As a result, some regions are prospering. One of the most famous big box reuse stories making national headlines has been the McAllen Public Library in McAllen, Texas, which turned an abandoned 124,500 square-foot Walmart store into a single-story library with plentiful community and educational spaces. We'll see what happens to this segment in California, but in an era of fewer available sites for development, re-using empty big box stores provides an opportunity for developers and investors in all markets.

Why things may change

Nothing stays the same forever. Perhaps with a realistic risk of throwing a wrench into the current rosy scenario, there are multiple challenging forces in play, including the combination of a tightening labor market, higher interest rates and inflation, and the emerging global trade war. Gary Pollack, head of fixed-income trading at Deutsche Bank Private Wealth Management, said in a recent Wall Street Journal article, "The economy doesn't need two more rate hikes (this year), especially with geopolitical risks." Such risks include tariffs, which could slow growth in the U.S. and around the world.

UCLA Anderson's forecast, issued in June, proposed that the markets are signaling higher inflation and interest rates, a shift from slow growth and low interest rates. All things remaining the same, the forecast projects a 3-2-1 scenario, with expected growth in 2018 of 3%; 2% in 2019; and 1% in 2020, moving toward a potential recession.

USC's Lusk Center for Real Estate looks toward a potential trade war and concluded it could have a significant negative impact on the value of industrial real estate, depending on the economic impact of tariffs, along with a slowing of construction due to increased prices of material, which is the first place it could be expected to show up.

From the commercial real estate point of view, the combination of higher interest rates, potentially overheating property markets, including oversupply and overvaluation, and evolving demand requirements--coupled with tariffs on exports and imports on a broad variety of raw and manufactured goods—will no doubt impact both the supply and demand side of the equation and affect a spectrum of property types.

Higher interest rates will impact the cost of capital and borrowing costs for everyone, from developers to consumers, affecting both lending and new investments. In part, and in turn, higher rates usually go hand-in-hand with declining stock market valuations and offer new opportunities for investors to re-allocate funds.

As interest rates take a more central role, overvaluation is starting to be sensed in various segments of the industry, especially in those locations that are overbuilt. Each property type varies, and market data lags, not usually showing up until the following month or quarter. Nevertheless, there is evidence of upcoming change.

Today, the economy and most property segments are still in positive territory, with available market evidence indicating stability for most property classes and opportunities still emerging, or even robust, in others, such as industrial.

While 2018 is projected to remain solidly in growth territory for the economy at the national and regional levels and in California, change is on the horizon. The opportunity now is for investors, lenders and other industry players to make strategic adjustments and plans as the year progresses, to well-position themselves for what's next.