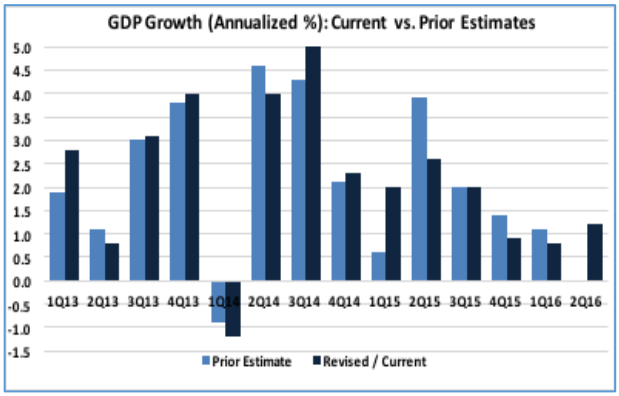
August 1, 2016 | Andrew J. Nelson, Chief U.S. Economist

WHERE WE ARE: GDP Disappoints

The ink was still damp on my mid-year outlook in my last newsletter when the government reported this past Friday its first estimate of 2Q real GDP at only 1.2%, about half of the consensus forecast (and my own expectations). With a host of positive economic news in the past few weeks, most economists were expecting a decisive pick-up in economic growth. Well, we got it, but for the wrong reason: The Bureau of Economic Analysis ("BEA"), which compiles the GDP figures, on the same day also issued their annual benchmark update that retroactively revised its GDP estimates for the past three years, and they adjusted 1Q GDP back down to only 0.8% (from its prior "final" estimate of 1.1%). So, GDP did indeed accelerate this past quarter, but only relative to the downgraded 1Q figure, and well below expectations.

Don't be surprised if this first estimate is ultimately adjusted upward in subsequent versions, which seems to be the pattern in recent quarters. Our economy is complex and increasingly hard for the BEA to measure, as services account for a rising share of the total. Still, these revisions tend to be relatively modest. [The average revision per quarter for the last three years was only ±50 bps and the *net* change only 20 bps as the adjustments were essentially offsetting in aggregate.] Moreover, the GDP data seems inconsistent with other indicators, including job growth, business and consumer surveys, and property markets.



And there was a silver lining in the GDP report. The lower growth this year is partly due to technical issues. Stripping out items like inventory adjustments and net exports, the core domestic economy ("Real Final Sales to Private Domestic Purchasers") grew at 2.75% in 2Q and has been averaging a respectable 2.25% over the past year. A key reason is the strength of consumers, as spending grew by 4.2% annualized last quarter. Though unlikely to be sustained in future quarters, this was the strongest growth since 2014. Moreover, the latest consumer confidence survey shows consumers remain resilient, notwithstanding global economic weakness and election year uncertainty. Still, the drop in business spending is worrying and cannot be easily dismissed. Business investment fell 2.2% in 2Q, hurt by continued commodity weakness and the global economic slowdown.

But the end is *not* nigh. Other economic trends and indicators remain at least modestly positive. Job growth continues, if less robust than previously, as we flirt with "full employment." And just today the Institute of Supply Management reported that its manufacturing index remained strong in July at 52.6%, down slightly from 53.2% in June, but well above the 50% figure that represents expansion. These and other indicators suggest growth will continue through 2016 and into 2017.

Nonetheless, the disappointing 2Q GDP coming on top of the lowered 1Q figure, indicates that economic growth this year looks to be the lowest since the recovery started in 2010 – likely less than 2%. This is not unexpected in of itself. My 2016 outlook had called for slower growth this year. But the extent of the decline is both surprising and discouraging. Growth over the last four quarters is averaging just 1.2%. And the election could be a wildcard, as businesses turn conservative in light of the uncertainty.

With real GDP barely growing above stall speed, and 3Q GDP figures not due until late October, the Fed will not raise rates in September (i.e., until after the election). As always, future hikes will depend on reported job gains and economic growth, as well as inflation. Regardless, I'll maintain my basic position that the magnitude and pace of near-term hikes will not be material to the real estate sector.

Property Markets

One reason to question the integrity of the latest GDP figure as reported is the continued improvements in property-market fundamentals in 2Q, as Colliers will be reporting in the next few days. Along with job growth, economic growth is the most important driver of demand for tenant space in the property markets. Leasing in the office, apartment, industrial, and retail sectors all depend on GDP growth, particularly consumer spending. The continued growth in absorption suggests stronger underlying economic growth than is being reported. The slowdown in business spending certainly bears watching. But while the risks of recession continue to rise, the threats espoused in the business press seem overstated, particularly within the next year.

ANALYSIS OF RECENT ECONOMIC NEWS

US preliminary Q2 gross domestic product at 1.2% vs 2.6% expected (Reuters) – "The U.S. economy grew far less than expected in the second quarter as inventories fell for the first time since 2011, but a surge in consumer spending pointed to underlying strength. Gross domestic product increased at a 1.2 percent annual rate after rising by a downwardly revised 0.8 percent pace in the first quarter, the Commerce Department said on Friday . . . While the drop in inventories weighed on GDP growth last quarter, that is likely to provide a boost to output for the rest of the year. The Federal Reserve said on Wednesday that near-term risks to the economic outlook had "diminished."

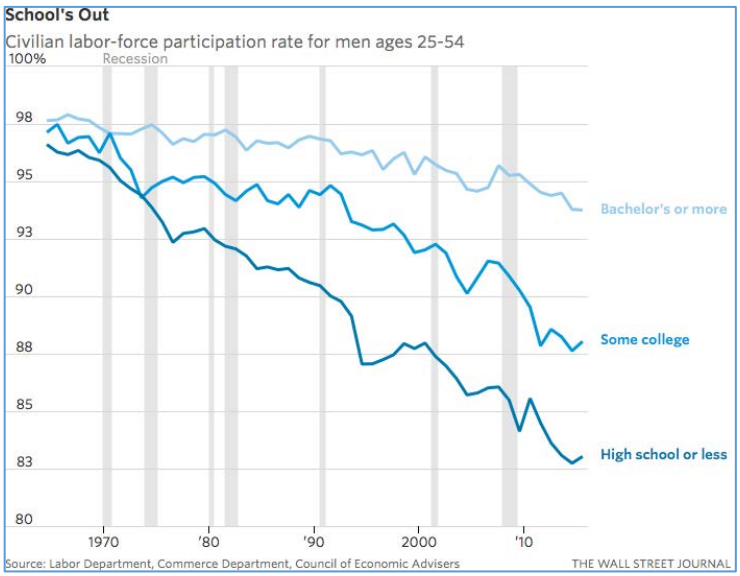
GDP Report's Silver Lining Muddied by Weak Business Spending (WSJ) – "U.S. businesses still aren't investing in their own businesses, and that's a real problem for anybody planning for better economic growth any time soon. The U.S. economy turned in its third consecutive quarter of subpar growth, with second-quarter GDP coming in at a 1.2% rate, well below consensus estimates of 2.6%. Moreover, the report came attached with benchmark revisions to prior periods; this showed that the fourth quarter of 2015 produced just a 0.9% rate (from 1.4%), and the first quarter just 0.8% (from 1.1%). Over the past year, the economy has expanded by only 1.2%."

Why U.S. GDP Figures Might Be Better than They Look (WSJ) – "U.S. growth figures for the second quarter were broadly disappointing, but a sharp fall in inventories may give some cause for hope. Gross domestic product rose at an annualized rate of 1.2% between April and June. While faster than last quarter's growth of 0.8%, the median forecast of economists polled by The Wall Street Journal was 2.6%. A closer look at the figures, though, may hint at a slightly rosier picture. This is because a decline in private inventories was a big contributor to the fall in growth. If the rate of inventory accumulation had remained unchanged, the economy would have expanded 2.4%."

U.S. manufacturers grow a touch slower in July, ISM finds (MarketWatch.com) – "U.S. manufacturers grew at a modestly slower rate in July but are still expanding at a pace that is likely to offer the broader economy more support, a survey of executives found. The Institute for Supply Management said its manufacturing index dipped to 52.6% last month from 53.2% in June, which marked a one-year high. Still, readings over 50% indicate more companies are expanding instead of shrinking. The index has been positive for five straight months following five negative readings . . ."

CHART OF THE WEEK

"Working-age males have been sitting on the sidelines in greater numbers for decades, a trend that accelerated during the latest recession and has broad implications for individual well-being as well as the overall economy. A new White House study highlights the sharpest decline among men with lower levels of educational attainment and concludes much of the cause is a loss of economic opportunity for those would-be workers. "No single factor can fully explain this decline, but analysis suggests that a reduction in the demand for less skilled labor has been a key cause of declining participation rates as well as lower wages for less skilled workers," the Council of Economic Advisers said in the report."



Source: As Low-Skilled Jobs Disappear, Men Drop Out of the Workforce (WSJ)

OTHER WORTHWHILE READS

ECONOMIC NEWS AND VIEWS

The Divide Between GDP and Jobs (WSJ) – "Will the real economy please stand up? Gross domestic product grew at just a 1.2% annual rate in the second quarter, the Commerce Department reported on Friday, not much better than the first quarter's 0.8% and well below the 2.6% economists expected to see. Details of the report suggested the economy wasn't as poky as the headline figure suggested—consumer spending was strong, and there was a big drag from companies cutting inventories that ought to be reversed later. Even so, the message from the GDP report is that the economy is growing only slowly—a message greatly at odds with labor market readings. In the first six months of this year, the economy gained over one million jobs. If the historical association between GDP and employment growth from before the financial crisis held, about 400,000 fewer jobs would have been added."

Seven Years Later, Recovery Remains the Weakest of the Post-World War II Era (WSJ) – "Even seven years after the recession ended, the current stretch of economic gains has yielded less growth than much shorter business cycles. In terms of average annual growth, the pace of this expansion has been by far the weakest of any since 1949. (And for which we have quarterly data.) The economy has grown at a 2.1% annual rate since the U.S. recovery began in mid-2009, according to gross-domestic-product data the Commerce Department released Friday."

Brexit worse than 2008 for finance chiefs, study finds (FT.com) – "Revenue expectations, investment and hiring plans have fallen sharply since the vote to leave the EU, with chief financial officers more pessimistic than they were after the 2008 collapse of Lehman Brothers. Research by Deloitte found 73 per cent were "less optimistic" about their companies' financial prospects than they were three months ago . . . its highest level since the survey started in 2007."

Where Donald Trump and Hillary Clinton stand on economic issues (WSJ.com) – "In the end, elections usually come back to the economy—to jobs, wages, taxes, imports and exports, the price of goods and the cost of an education. Differences over all these issues—from tax rates and immigration to globalization and the minimum wage—are particularly sharp this year between Donald Trump and Hillary Clinton. Here's a look at where the two candidates stand on the top economic issues."

The Economy Is Again Under the Sway of Asset Prices (WSJ) – "The past two recessions were ushered in by a collapse in asset prices. The risk of a repeat is growing. . . U.S. stocks have hit fresh highs. Real estate is quietly doing the same: home prices are just 2% below the peak hit in 2007, while commercial property values have hit records. The result is that net wealth in the U.S. now tops 500% of national income. Ominously, net wealth has reached that level only twice before: from 1999 to 2000 during the Nasdaq bubble, and 2004 to 2008 during the housing boom."

White House battle set to chill US economy, says FT survey (FT.com) – Uncertainty over the direction of economic policy in a hard fought race for the White House is expected to chill US economic activity this year, as companies put projects on hold despite record-low borrowing costs. More than two-thirds of economists surveyed by the Financial Times said the contest between Donald Trump and Hillary Clinton would act as a headwind to growth in the US, blunting large scale investments until businesses have a better view of the regulatory, tax and government spending climate."

PROPERTY MARKETS

U.S. Homeownership Rate Falls to Five-Decade Low - Real Time Economics (WSJ) – "The U.S. homeownership rate fell to the lowest level in more than 50 years in the second quarter of 2016, a reflection of the lingering effects of the housing bust, financial hurdles to buying and shifting demographics across the country. But the bigger picture also suggests more Americans are gaining the confidence to strike out on their own, albeit as renters rather than buyers. The homeownership rate, the proportion of households that are owner-occupied, fell to 62.9%, half a percentage point lower than the second quarter of 2015 and 0.6 percentage point lower than the first quarter 2016, the Census Bureau said on Thursday. That was the lowest figure since 1965."

Cities Struggle to Add Upscale Housing While Maintaining Diversity (WSJ) – "As urban populations near a new apex, city planners are raising the ire of many locals with proposals to allow developers to pack more housing into existing neighborhoods . . . The push to add density without sacrificing diversity comes as an influx of professionals are driving up prices and rents in many cities, a force expected to intensify in coming years. The issue has become more severe as large numbers of millennials, pushing off marriage and children, eschew suburban living for amenity-rich urban areas."

The Mall of the Future Will Offer Dinner, Movies, and a Colonoscopy (Bloomberg) – "While urgent-care centers have been strip-mall staples for decades, the chance to catch dinner, a movie, and a surgical procedure under the same roof is new—and coming soon to a mall near you. The reason is commerce: Mall operators are looking for tenants that trade in entertainment and services to replace the brick-and-mortar retailers slowly being strangled by Amazon.com and its online competitors."

Internet Commerce Drives Strongest Surge in Demand for US Industrial Space Since 2001 (CoStar Group) – "Prologis, the world's largest developer and owner of industrial real estate, reported the first six months of 2016 were the strongest in its company's history as moderate levels of new supply paired with a strong appetite by e-commerce and other companies created the tightest market for tenants since the first internet boom of the early 2000s."