Slower Growth, But a Patient Fed Will be Supportive of Commercial Real Estate in 2019

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Highlights

- Similar to the outlook for economic growth, the U.S. commercial real estate (CRE) market is bound for some moderation this year. Price growth, which has been slowing across all four CRE segments, is expected to continue to decelerate. Rents, while charting a similar course, should fare somewhat better, providing some support to cap rates.
- Performances will vary across CRE segments, with signs of moderation likely more pronounced in the multifamily segment, where vacancy rates are expected to edge higher. In contrast, more conservative construction trends in office and retail will likely help vacancy rates remain near current lows.
- Performances will vary across major markets along the East Coast. Metros located in the south, which boast relatively wider cap rate spreads over Treasury yields, faster population growth, and cheaper prices than their northern counterparts, should continue to outperform on rent and price growth. The one exception to this is Miami, where the recent construction boom across market segments, augurs for vacancy rates to edge higher over the next year.
- In the northern half of the region, soft spots include the office and retail sectors of D.C. and New York City, where stretched valuations and relatively expensive rents point to little-to-no rent and price growth this year. Philly's industrial segment also appears bound for a softening in conditions, as the supply of logistics space looks to come in ahead of demand.

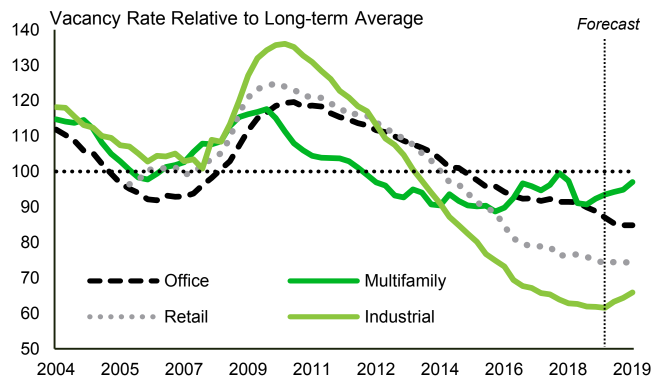
The U.S. economic expansion is maturing. Assuming it continues to the third quarter of this year, it will be the longest period of sustained growth on record. Given its highly cyclical nature, concerns about the durability of the expansion are particularly important to the outlook for commercial real estate (CRE). While downside risks to the economic outlook have risen, there is good reason to believe growth will continue. Despite geopolitical and trade risks, economic data have remained relatively resilient. The labor market has continued to pump out jobs at a healthy rate and, with the unemployment rate at a cyclical low, wage growth is accelerating. With the Fed turning toward a more "patient" stance, the case for growth to continue has been bolstered.

Still, with fiscal stimulus fading and past interest rate increases raising borrowing costs, economic growth is likely to be slower over the next year than it has been over the past one. The same can be said for the CRE market. Price growth, which has already slowed across CRE segments, is likely to continue to decelerate. Rent growth too is likely to slow along with demand, but with vacancy rates remaining close to historical lows, it should outperform prices, giving support to cap rates. With a slower pace of Fed hikes, rising interest rates appear less of a risk to the sector, a reprieve from the last several years.

With this macro backdrop, the old truism of location, location, location rings especially true. In this issue of the CRE report, we devote

Sections

Chart 1: Vacancy Rates Pushed Lower Last Year, Remain Below Long-Term Average



Source: CoStar, TD Economics

special attention to commercial real estate markets in eight major metro areas on the East Coast. While performances will vary across markets and segments, the southern metros of Charlotte, Orlando and Tampa, which are the most vibrant in terms of population and employment growth, and tend to be cheaper than their northern counterparts, should generally continue to outperform on rent and price growth. The Miami metro, where the pace of construction has been the fastest, will be somewhat of an outlier in the south, with vacancy rates in this market expected to edge higher across all sectors.

A few of the northern markets also bear close watching. Expensive rents and stretched valuations in D.C. and New York City will limit future gains, with little-to-no rent and price growth in the cards for their office and retail sectors this year. Philly's industrial market, which has had a pretty successful run over the last few years, also appears headed for some cooling, with the supply of logistics space expected to come in ahead of demand this year.

Cap rate spread compression may be coming to an end

A strong economy has provided a solid base for growth in CRE demand over the past several quarters. Total occupied commercial space grew by a relatively healthy 1.5% last year. This performance hides divergence among the different segments, with demand picking up steam in the multifamily space and waning for retail and industrial space.

With absorptions outpacing completions, vacancy rates continued to trek lower across all four segments. The improvement has been especially pronounced in the apartment segment, with improved occupancy in the sector buoying rent growth (Chart 1). In the remaining three segments, more modest improvements in vacancy rates have been accompanied by a slowdown in rent growth. Price growth has also decelerated across most segments, with subdued, but steady gains in office properties marking the only exception (Chart 2).

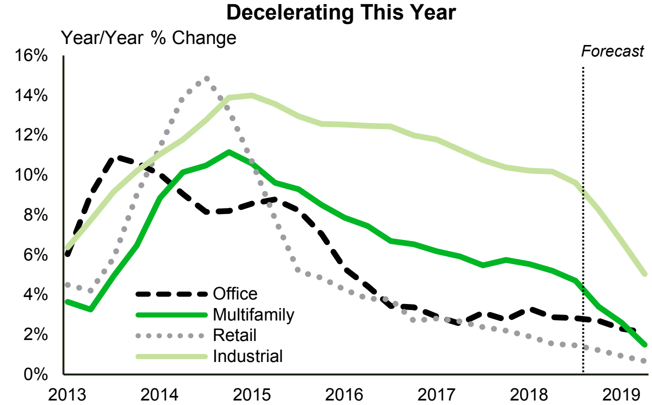
Given this mix of mostly decelerating rent and price growth, and continued moderate improvements in occupancy, the return on commercial assets (as measured by cap rates) has remained fairly steady. In the meantime, the 10-year Treasury yield rose nearly 70 basis points through the year and the spread between cap rates and risk-free assets continued to narrow.

The good news is that with Fed rate hikes likely to be limited to just one this year, Treasury yields are not likely to see much increase either. Relative to its level at the end of 2018, we expect the 10-year yield to rise just 30 basis points to 3%. This is below the yield reached in November of 2018 of about 3.25%. All factors considered, the squeeze on cap rate spreads should abate and likely begin to reverse course slowly this year (Chart 3). From a macro vantage point, this is likely to further mitigate the chance of a negative price adjustment.

Tight labor market presents positives and negatives for office sector

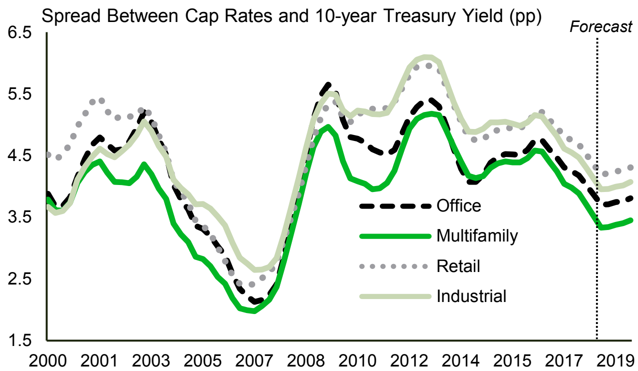
Office vacancy rates have tended to be higher than other CRE segments, but the sector has seen improvement over the last year, with the rate falling 0.3 percentage points.

Chart 2: CRE Price Growth Expected to Continue Decelerating This Year



Source: CoStar, TD Economics

Chart 3: Cap Rate Spread Compression Likely Coming to an End



Source: CoStar, TD Economics

This trend has been supported by two key ingredients. First, a strong economic backdrop buoyed office-using employment at a steady 2% pace – an outperformance of nearly half a percentage point relative to overall job growth. Second, a relatively muted pace of new construction has allowed demand growth to absorb unoccupied space.

The ongoing outperformance of office-using payrolls vis-à-vis the rest of the job market is impressive, and likely has more room to run. Still, as workers become harder to come by, office-using job growth is likely to slow. A focus toward a more efficient use of space – particularly among some industries such as finance, which have continued to move toward automation, coupled with a rising trend of working from home, will add to the pressure.

Fortunately, the outlook is paired with bearable levels of construction. Nationwide, the ratio of office space under construction to the existing stock is 1.7%, close to the long-term average of 1.6% (Chart 4). Absent of major economic shocks, demand for office space is likely to run marginally ahead of oncoming supply, implying some modest improvement in vacancy rates over the next year.

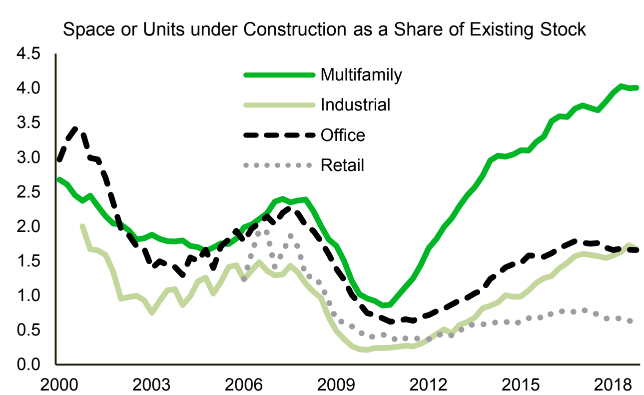
Office outlook by major metro

The story is more varied regionally. At present, nearly all of the markets in our footprint mimic the national trend of shrinking vacancies – some primarily due to a sluggish or receding flow of new inventory (i.e. Orlando and Tampa), and others due to an acceleration in office-using employment (i.e. Boston and Philly).

Miami, which has seen both a notable upswing in new completions and slower net absorptions, marks the only exception. The amount of new office space that came to market in the metro last year more than doubled to 1.4 million square feet. Meanwhile, office-using payrolls ground to a halt toward the end of the summer. As a result, Miami's office vacancy rate rose by nearly a full percentage point on the year to around 9%. Payroll growth has resumed a more stable path in recent months, but construction has also trekked higher. While construction is not far off historical norms, a large portion of it appears to be speculative in nature. Some 40% of space under construction is in fact, not paired with a lease. Given reduced support from pre-leasing, the notion of "if you build it, they will come" will be challenged this year, with the vacancy rate expected to continue edge higher. Rent and price gains are likely to continue to slow as a result.

The **Washington D.C.** metro, while carrying a relatively high vacancy rate has a number of things going for it, which will help buoy demand for office space in the year ahead. Office-using employment has improved over the past 12 months and is growing at 2.0% (year-on-year), with professional and tech services a primary driver. The metro's growing tech tilt, which includes high-growth clusters such cybersecurity, will continue to provide some counterbalance to a fading federal government sector. Amazon's HQ2 expansion in the area will be an added boon. The tech giant plans to occupy some four million square feet of office space, with the potential to increase its footprint to eight million square feet. The initial phases of the expansion will help soak up idle space this year. Amazon's move may spur additional tech relocations to area, and is ex-

Chart 4: Construction Pipeline Beginning to Moderate



Source: CoStar, TD Economics

pected to have other positive side-effects. Still, the benefits generated from Amazon's move will be spread out through time. Of the 25k jobs that are slated to be created in National Landing, only about 400 employees are expected to be hired this year.

New York City's office segment is charting a similar course to D.C.'s. The amount of new office space coming to the Big Apple continues to grind higher. In 2018, completions nearly tripled from the year prior. Remarkably, the market managed to absorb the added space and vacancy rates were little changed. But this appears to have come at the expense of rents, with NYC the only major metro on the East Coast to see office rents trek lower over the last several quarters.

The amount of new space coming to market will continue to be an important factor in determining the fortunes of NYC's office market. At over 25 million square feet, office space under construction in NYC amounts to about a fifth of all office construction taking place in the country, far exceeding that of any other top market. The number of completions slated to take place in the quarters ahead is reason for caution, especially in a slowing growth environment. Fortunately, the majority of space under construction – about three quarters – is already pre-leased and ongoing demand from tech firms like Google, Facebook and Spotify will continue to support demand.

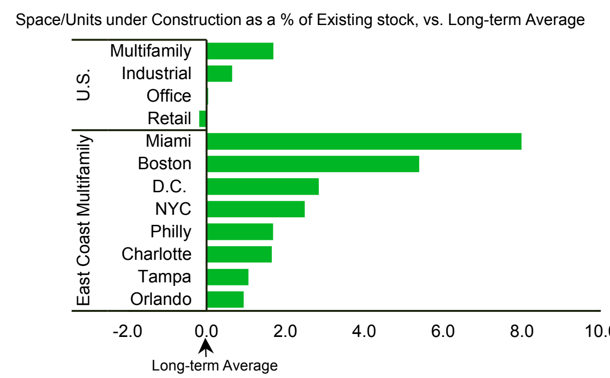
Charlotte, another market with considerable supply in the pipeline, has an even brighter outlook. The office market is on the small side when compared to others on the East Coast. Yet, with prices growing at 13% (year-on-year) and rents growing at 7%, it is the hottest office market in the region. Robust demand has also spurred construction, with some 4.7 million square feet currently in the pipeline. Fortunately, Charlotte's economic expansion is underpinned by strong fundamentals, including population growth that is three times the national average. Financial firms, which have played a key role in absorbing new space, should continue to do the heavy lifting. Tech firms will also lend a helping hand. After a slow start to 2018, hiring in professional and tech services accelerated to 13% y/y toward the end of the year. All in all, the robust fundamentals suggest that the incoming supply shouldn't struggle to find tenants.

New supply, softer demand to push up apartment vacancy rate

The U.S. housing market was plagued by poor headlines for much of last year, but the rental apartment market continued to surprise on the upside. Improved job growth and an increase in household formation, coupled with lean for-sale inventories and rising interest rates – factors that weighed on the home sales – provided a boost to the rental market. After hitting a speedbump 2016, absorptions of rental stock continued to improve, rising to 330k units and surpassing new deliveries by some 40k last year. As a result, the U.S. multifamily vacancy rate fell by roughly 60 basis points to just under 6% in the first three quarters of 2018 – the sharpest improvement among all four CRE segments.

Many of the elements supporting rental demand are likely to remain in place, but to a lesser degree over the next year. This includes slower employment gains as the labor market tightens further. Expected modest gains in the homeownership rate pose additional downside risk for apartments, particularly as related to more affluent renters that have grown in presence in recent years and have better means of purchasing a home.[1] Unlike last year, pressure from borrowing cost hikes should be more muted this year. Mortgage rates have pulled back by some 60 basis points in recent months and the Fed is likely to hike only once in 2019. Coupled with expectations for a continued slowdown in residential home price growth, this should help pause the erosion of homeownership affordability this year. Prospective homeowners should also have a bit more choice when it comes to buying homes, as for-sale inventory continues to perk up.

Chart 5: Mutifamily Sector has The Most Supply in the Pipeline; East Coast Metros above Long-term Average



Source: CoStar, TD Economics

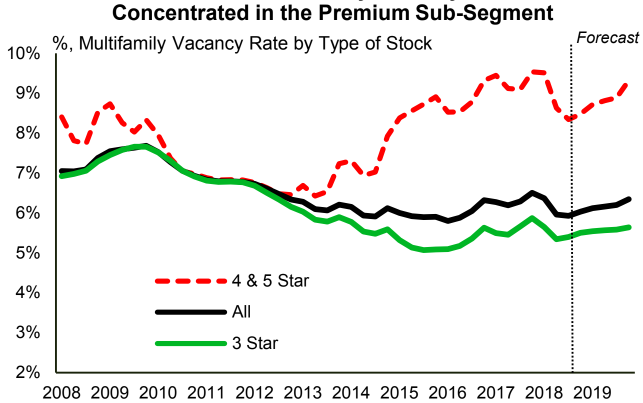
On the supply front, the multifamily sector boasts the largest pipeline of stock under construction among the four CRE segments (Chart 5). The number of units under development hit a new cyclical peak recently. At some 655k units, it is nearly double that seen during prior peaks in 2000 and 2007. A little less than half of what's currently under construction is slated to be completed this year. As the new supply continues to roll in, rent and price growth are poised to decelerate, with the latter expected to slow to just below 3% this year.

Within the apartment market, there is a divergence between higher-end and other more-affordable stock. Over the last several years, developers have focused heavily on the premium sub-segment, sometimes at the expense of lower-end properties which have been demolished or reconditioned into luxury units. With more of the premium supply coming to market over the years, the vacancy rate in this subsector has increased and decoupled from the rest of the market (Chart 6). Roughly 9 out of the 10 units that are slated for completion this year, are also of a higher classification, which points to increased pressure for the premium sub-segment. In contrast, with affordability being the name of the game at this point in the cycle, strong demand for more reasonably-priced workforce rental properties will keep vacancies relatively low for this part of the market.

Multifamily outlook by metro

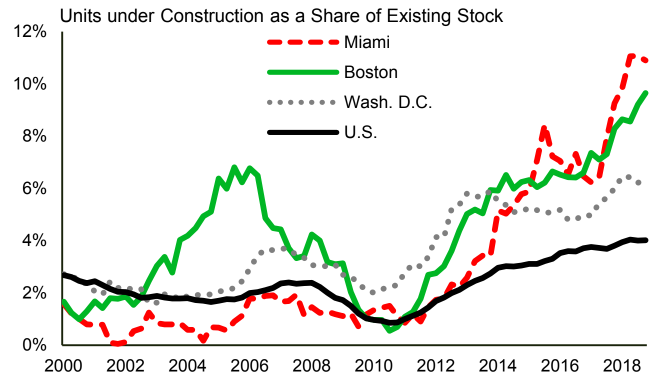
Multifamily markets across major East Coast metros exhibited trends similar to the nation last year. Aside from a few exceptions, vacancy rates and rent growth generally improved in yearly terms, while price growth decelerated across most markets. The Orlando apartment market, which recorded both lower occupancy and faster price growth, was the main aberration from this narrative, with Philly the only other market to go against the grain on price growth.

Chart 6: Rise in Multifamily Vacancy Rate to be Concentrated in the Premium Sub-Segment



Source: CoStar, TD Economics

Chart 7: Miami Has the Most Bloated Apartment Construction Pipeline among Top U.S. Metros



Source: CoStar, TD Economics

The outlook across metro areas this year is also broadly similar, though there are pockets of risk within some larger metros. The **Miami** market is perhaps the most obvious one. The metro has some 16k units under construction, which amount to roughly 11% of existing stock – the highest among any of the top fifty metro areas nationwide, and one that deviates the most from its historical pattern (Charts 5 and 7). The majority of the oncoming supply is focused on premium/luxury units. This means that even as overall demand for apartments remains strong, there may be a mismatch between the type of units sought and those available for lease.

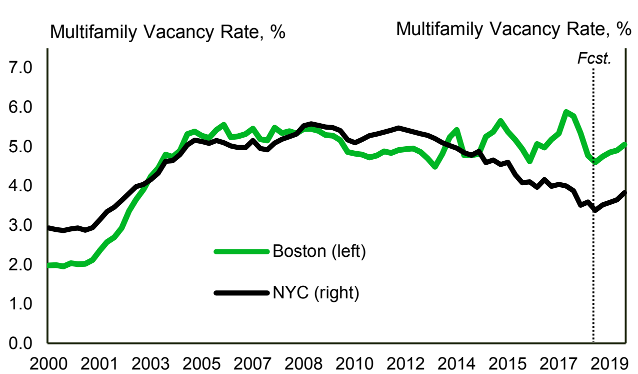
Rental demand in Miami from well-off domestic migrants, some of them from high-tax states like New York and New Jersey, will help pick up some of the slack from slowing international demand. Still, the vacancy rate for premium properties, which currently sits at 11%, is poised to rise further. As it does, Miami's overall apartment vacancy rate is likely to rise by over 1 percentage point over the next four quarters – the sharpest increase among the group. The drop in occupancy is expected to temper rent growth to below the inflation pace this year and likely cut price growth by more than half to under 3%. This base-case outlook assumes a moderate pace of completions ahead, factoring in the likelihood of construction delays – a growing trend in recent years – and the possibility for some projects to be shelved for a later date.

Boston's multifamily market, which also has a very rich construction pipeline, appears well positioned to absorb the oncoming supply wave. The Beantown metro area has some 20k units under construction, which amounts to nearly a tenth of its total stock – the second highest share among the largest U.S. metros. Apartment completions slowed toward the end of 2018, with a moratorium on natural gas work by National Grid delaying development in the area. But, with the moratorium now lifted, supply – the majority of it being premium units – should rebound and remain elevated. The vacancy rate, which fell to 4.6% last quarter – the lower bound level over the last 15 years – is expected to grind marginally higher as a result (Chart 8).

Still, with the housing shortage a prevalent theme in Beantown, the demand that has accumulated over the last several should be sufficient to absorb the oncoming supply. In this vein, occupancy is still expected to remain close to 95% by the end of the year. Boston's concentration of high-growth industries and high-paying jobs in tech, biotech, pharma and medicine, and finance will be instrumental in helping absorb premium inventory. Meanwhile, a large concentration of colleges will continue to generate demand for lower-end units. With little impact on occupancy, rent growth should remain solid.

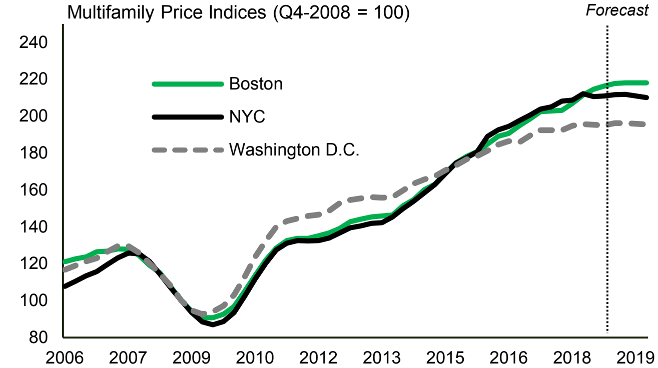
The narrative on prices in Boston is more tempered. Apartment prices are up nearly 70% from the pre-crisis peak – the largest gain among the East Coast group. From an investment perspective, the market's cap rate spread of just below 2% currently is one of the most compressed across all segments and markets examined in this report. This thin buffer will make it harder for owners to demand large premiums when unloading properties, with price growth slowing to just below 3% this year.

Chart 8: NYC and Boston Made Progress Recently, but Vacancy Rates to Edge Marginally Higher in 2019



Source: CoStar, TD Economics

Chart 9: Prices Flattening out in D.C. and NYC; to Grow by Just Under 3% in Boston This Year



Source: CoStar, TD Economics

Expensive markets mean tighter profit margins, and the same is true for the **New York** and **D.C.** metro areas, with cap rate spreads in these two apartment markets similarly low to that of Boston. Both metros saw notable improvements in occupancy last year, which allowed landlords to pass on rent increases to the tune of 2% y/y. New York's vacancy rate for instance, fell to an impressive 2.3% by the end of the year, which is its lowest level since 2002 and the lowest by far within the group (Chart 8). The improvements in both markets were the result of stronger demand and softer completions, with the delivery of new units down by about 25% y/y in each. Reduced tax deductions such as SALT and MID, which increased the cost of homeownership, likely played a role in tilting demand toward rentals.

Despite improved occupancy in both markets, price growth continued to decelerate, falling sharply to just above 1% y/y by the end of last year, from over 5% y/y in New York and 3% in D.C. at the end of 2017. Amazon's HQ2 relocation in the D.C. metro holds considerable long-term potential given the influx of new workers that will require housing. And pricing will experience some pressure from investors willing to splurge for space near the company's satellite headquarters. But, again, the impact is expected be somewhat localized and spread out through time. On the other hand, Amazon's cancellation of its investment in LIC/Queens, will scale back prospects for the local CRE market, with some projects likely to be shelved and the recent price surge reverse. While this setback will hurt LIC/ Queens, the impact will be relatively muted for the large NYC metro as a whole.

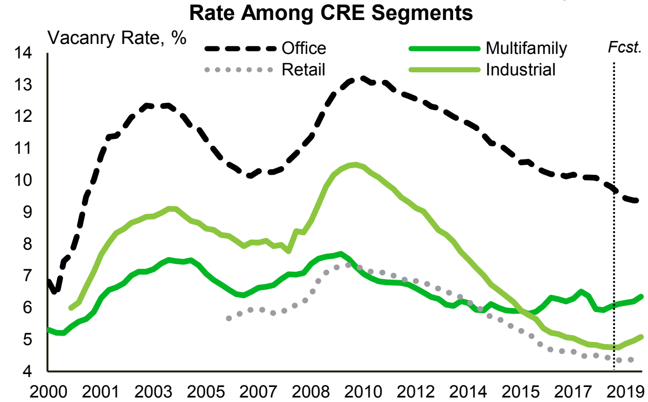
Stretched valuations and wafer-thin cap rates, coupled with some modest pressure on vacancies this year, suggest that prices for both D.C. and NYC should move sideways during 2019 – the weakest performance among the group – and even possibly dip in negative territory the following year given expectations for slower economic growth (Chart 9). The main factor behind the expected pickup in the vacancy rate in the D.C. metro area is the supply pipeline, with deliveries expected to rise to around 13k this year. In New York, on the other hand, it is a combination of a pick-up in completions and moderating demand as the impact from tax changes fades.

Some moderation is also in store for the remaining smaller metro areas, with multifamily vacancy rates in markets like Charlotte, Orlando and Tampa, expected to edge higher. But these more affordable markets, which tend to outperform on rent and price growth, should continue to offer better returns as measured by cap rates, relative to their more expensive northern counterparts. The outperformance should remain in place this year, with demand to be buoyed by generally faster population and employment growth. In addition, these markets are also expected to feel less pressure from new supply, with net deliveries expected to come in a touch softer relative to last year. Orlando, which exhibits some of the best fundamentals in the region in terms population, employment and wage growth should remain at the top of the leaderboard.

Retail sector still resilient under the surface

The retail sector continues to be surrounded by dour news, with closures and bankruptcy filings among large retail chains still making headlines. High-profile examples have included Sears and Toys-R-Us. Payless Shoes, which plans to close its vast chain of over 2,000 stores across the country, is the most recent example. Yet, despite the somber narrative, the retail CRE sector has been faring well under the hood. The sector's vacancy rate continued to improve modestly, falling to 4.4% by the end of 2018 – the lowest among the four CRE segments and its lowest level on record (Chart 10). This is the result of more conservative planning. With consumer preferences increasingly

Chart 10: Retail Sector Has the Lowest Vacancy Rate Among CRE Segments



Source: CoStar, TD Economics

shifting online over the years, the disruption in the retail sector has been a long time coming. This has instilled a more staid outlook among developers, with new completions consistently undershooting absorptions since the end of the financial crisis. From an investment perspective, the sector also continues to offer the best returns among the four main CRE segments, with the average retail cap rate holding steady above 7% recently, and all others below this threshold since late 2016.

Closures and bankruptcy filings will continue as shopping moves online, requiring investor diligence, but overall, the sector should continue to offer decent returns. (For more on the evolution of e-commerce and where it is headed, see here). Limited pressure from new supply will be an important supporting element to this outlook. After peaking in early 2017, the construction pipeline has continued to curb down, which suggests that the amount of new inventory coming to market this year will remain moderate. Efforts to improve the physical shopping experience and to diversify the tenant mix by including more service-oriented occupants will help limit the deceleration in rent growth.

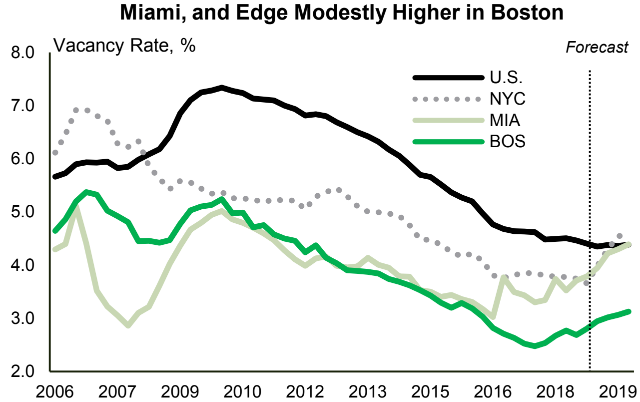
Large-scale chains closures, despite their drawbacks, also present some opportunity for landlords of prime retail locations. Long-term leases for these types of tenants, which typically occupied vast amounts of space, were often negotiated in their favor. By scrapping the older contracts and partitioning previously-occupied areas into smaller sections, landlords of prime inventory may benefit by charging much higher rents per square foot relative to the older leases.

Retail outlook by metro

At the local level, expensive markets and those deviating from the national construction narrative carry the highest risk. The **New York City** metro, which ticks both of these boxes, is likely to see continued downward pressure on rents and prices. While the metro area boasts a variety of assets classes and price points, average retail rents in the Big Apple are roughly double the national average. High rents, particularly in Manhattan, remain a barrier to entry for many prospective tenants. After expanding between 2012 and 2017, rents flat lined last year, with growth dipping into negative territory toward the end of the year. In order to secure leases, landlords have allowed more short-term contracts and provided deeper concessions. This has kept the vacancy rate at roughly 3.7% – its lowest on record, and the second-lowest in the region after Boston (Chart 11). But with over 9 million square feet of inventory under construction, the completion of a few large projects in the metro will lead to a surge in available space. This is expected to push up the vacancy rate to par with the U.S. average by the end of the year, which would mark the first such occurrence since 2008. Meanwhile, the added pressure will likely to keep rent growth in shallow negative territory over the course of 2019.

Miami is the only other large metro in the region with construction levels above the historical average, with its pipeline again the most elevated in the region (Chart 12). Its retail vacancy rate has already been ticking higher in the last two years as more supply has come online. This trend is expected to continue over 2019, as large projects, such as the Miami World Center, come to market. Similar to NYC, we expect Miami's vacancy rate to move higher over the next several quarters. Tourism dollars support significantly higher rents in both of these metro areas relative to the national average. But while NYC tenants appear to have reached a ceiling for the kinds of rent they are willing to pay, the slightly cheaper Miami market should continue to fare somewhat better, much like it did last year when rent growth surprisingly held above 3% y/y.

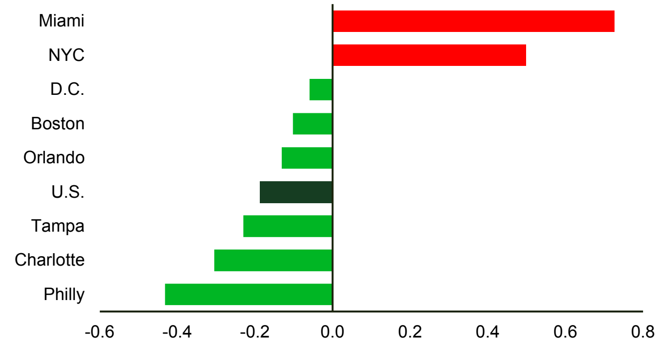
Chart 11: Retail Vacancy Rate to Rise in NYC and Miami, and Edge Modestly Higher in Boston



Source: CoStar, TD Economics

Chart 12: Retail Construction above Long-term Average in Miami and NYC

Retail Space under Construction as a % of Existing Stock vs. Long-term Average



Source: CoStar, TD Economics

With construction pipelines moderating recently and generally below historical levels, there are few signs of stress among the remaining East Coast metros. The vacancy rate has ticked higher in **Boston** – a trend which has been accompanied with slower rent growth – but, at 2.8% it remains the lowest by far in the region. The metro's strong labor market, which should continue to shore up consumption, coupled with limited development in the pipeline, suggest that any further deterioration in occupancy will continue to be moderate in nature. In addition, the type of development that's taking place – retail space has been closely aligned with office and multifamily developments, which will help drive foot traffic once completed – will also help limit potential risks for Beantown.

Vacancy rates should continue to hold near current levels in the remaining metros, particularly among the southern ones, which sport both faster employment and population growth, and relatively lean pipelines. Nonetheless, price and rent growth for some high-fliers such as Charlotte and Orlando, is still expected to see some moderation.

Industrial sector bull run to moderate

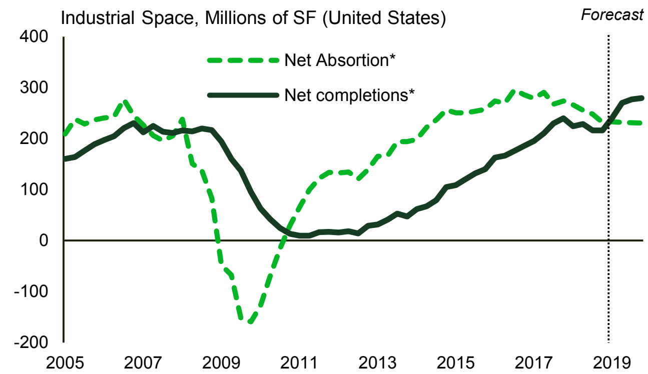
Industrial CRE encompasses a variety of building types and can be split up in smaller subcategories, such as specialized industrial space (buildings designed to house specialized equipment, i.e. manufacturing, refrigeration etc.), flex (versatile structures that allow more than one use and tend to include some office space) and logistics (warehousing and distribution facilities). The latter however, tends to make up the largest piece of the pie at the national level and is where most of the action has been recently. The same forces that have weighed on the retail sector over the last few years, have lifted the industrial sector, with the rapid rise of e-commerce driving up demand for warehouses and distribution facilities. Amazon has been a leading force in the logistics space as it bulked up its chain of fulfillment centers near dense population areas. Meanwhile, competition from rivals such as Walmart and Target, has generated even more demand.

Supply has also risen over the years, but it has generally failed to keep pace with demand in the post-recession period, leading to impressive vacancy rate compression. The sector's vacancy rate fell from a high of 10.5% soon after the recession to just 4.8% last quarter, the most aggressive post-recession improvement among all four main CRE segments. This, in turn, helped the industrial sector far outpace its CRE peers in both rent and price growth over the last several years.

The strong run during the last half-decade appears set to give way to some moderation. After running at more 6% y/y since 2016, rent growth dipped below that threshold last quarter. Meanwhile, price growth, which peaked at nearly 14% in 2015, has been decelerating by about a percentage point each year, with prices growing by roughly 10% last year. A continuation fo these trends is likely to follow in 2019 alongside a modest rise in vacancy rates.

Absorptions of industrial stock, while high relative to history, appears to have peaked in early 2017 and has been edging lower since (Chart 13). At the same time, prior buoyant conditions have brought more developers to the market, enriching the supply pipeline. As a result, an added 60 million square feet is expected to be delivered this year relative to last. This mix, suggests that vacancies should begin to grind higher, with a rise in speculative construction

Chart 13: Supply of Industrial Space Expected to Come in Ahead of Demand This Year



Source: CoStar, TD Economics. *4-quarter sum.

adding to the pressure. Last quarter, there were over 270 million square feet under construction with over two thirds of that was available for lease, compared to just over a third at the at the end of 2017.

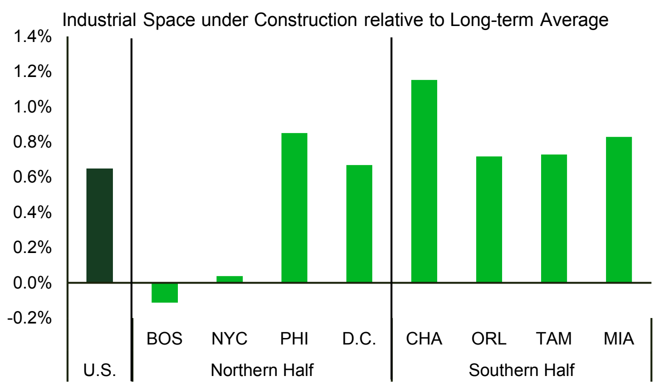
The possibility of an escalated trade conflict with China, while receding recently, poses downside risk. While the West Coast may bear the brunt of the supply chain disruptions, East Coast centers, particularly port cities that receive Chinese cargo through the Atlantic Ocean and the now-expanded Panama Canal, wouldn't escape unscathed.

Industrial outlook by metro

Industrial CRE markets across major East Coast metros have forged paths similar to that of the nation over the last few years. While the recent experience has seen some nuance, with vacancy rates ticking up in Charlotte, and to a lesser extent in Boston and Miami, vacancy rates have fallen notably since the recession and remain well below historical levels. Meaningful improvement on the vacancy front, coupled with the injection of new capital in recent years, helped prop up rents and valuations. Industrial prices across most markets, Philly and D.C. aside, have been consistently growing in the double digits for about four years, with rents across the same metros expanding at or above 5% for nearly as long.

The southern metros, particularly the thriftier ones (**Charlotte, Orlando and Tampa**), have been at the top of the leaderboard recently, with rent growth in the 7-8% range and price growth astonishingly in the 12-14% range last

Chart 14: Industrial Sector Construction Pipelines Generally More Bloated in the South



Source: CoStar, TD Economics

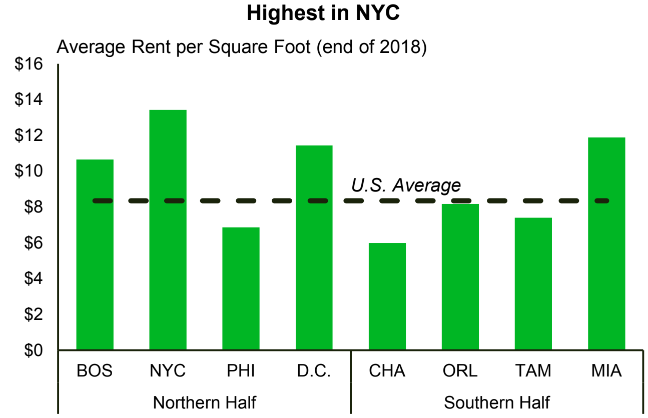
year. Numbers like these have encouraged more developers to get in the game, leading to bulging pipelines and increased spec construction (Chart 14). As the new supply rolls in, the share of occupied space will retreat, helping temper rent and price growth to more sustainable levels. Signs of moderation are already showing in Miami, where price growth recently joined rent growth in dipping below the U.S. average. But, the cooling in rent and price growth is expected to be even more pronounced in Tampa, with both of these elements having already lost considerable steam during the second half of 2018.

Industrial markets in the northern half are also in for some moderation, but they appear well positioned to manage incoming supply. Vacancy rates in the north are expected to hold near the currently low levels, with Philly being the only exception. The optimistic view on **Boston** and **NYC** is supported by softening construction trends. After surging in 2017, construction pipelines for these two expensive markets shrank over the last few quarters, with fewer new projects started. As a result, the amount of industrial expected to hit both of these markets in 2019 will be smaller than the year prior and easier to digest.

Boston is also a bit of a niche market. Its logistics space, which is generally limited to serving the local economy, makes up a smaller share of the overall industrial market, while its flex and specialized subsectors playing much larger roles than in any other major metro on the East Coast. Demand for flex and specialized space are driven by Boston's tech and life sciences sector, the prospects of which remain quite bright. The **DC** market should also manage fare well this year, with demand for industrial space to be supported by the opportunity to service its population's e-commerce needs, with its population growing at nearly double the national pace recently. The appetite of tech companies to build data warehouses will provide an added fillip, with Microsoft, Google and Amazon Web Services all racing to bulk up their presence in the area. On the other hand, D.C.'s construction pipeline shrank considerably in late-2017 and early-2018. With projects generally taking about a year to complete, the reduced flow of new deliveries in the first half of the year should be easy to digest. With the construction pipeline jumping again in late 2018, looser fundamentals will eventually follow, though this appears to be more of a 2020 trend.

Philly's industrial market appears the most likely out of the northeastern markets to experience a slackening in conditions. This market has enjoyed a solid run over the last few years, with solid demand e-tailers and other third-party logistics operators compressing the vacancy rate to its lowest in three decades. But, as the cycle matures and the area's saturation with new logistics space increases, occupancy may begin to feel the pinch. There have been a few chinks in the armor, the most meaningful being a notable moderation in absorption since mid-2017. Factoring in expectations for increased deliveries this year, the vacancy rate should move higher. Yet, Philly's strong selling points, such as its proximity to large population centers and sea ports, and significantly more competitive rents relative to other nearby markets – average rent per SF is roughly half the cost of the nearby NYC metro (Chart 15) – will limit the downside. The fact that spec construction has remained fairly moderate is another mitigating factor.

Chart 15: Industrial Rents per Square Foot Highest in NYC



Source: CoStar, TD Economics

Conclusion

The U.S. commercial real estate market is underpinned by healthy fundamentals, but is likely to slow alongside broader economic growth. Price growth, which has been slowing across all four CRE segments, is expected to decelerate further in 2019. Rents, while charting a similar course, should hold up somewhat better toward the end of the year, providing some support to cap rates. Performances will vary across CRE segments, with signs of moderation likely more pronounced in the multifamily and industrial segments, where vacancy rates are expected to grind higher. On the other hand, more conservative construction trends in office and retail, will likely help vacancy rates in these two sectors remain near current levels.

Along the East Coast, metros located in the southern half of the region should continue to outperform on rent and price growth, given support from generally faster population growth and relatively cheaper prices than their northern counterparts. The one exception to this is Miami, a market where developers are busy churning out new CRE space, especially in the multi-family segment.

In the northern half of the region, which typically exhibits thinner cap rate spreads, soft spots include the office and retail sectors of D.C. and NYC, where stretched valuations and expensive rents point to little-to-no rent and price growth this year.

Endnotes

1. **Joint Center for Housing Studies of Harvard University**, The State of the Nation's Housing 2018, page 26, "The number of renters with incomes above $100,000 rose nearly 5 percent last year, bringing the cumulative increase in 2012–2017 to about 2.6 million.", http://www.jchs.harvard.edu/sites/default/files/Harvard_JCHS_State_of_the_Nations_Housing_2018.pdf

Table 1: Cap Rate Spreads Generally Below Historical Average																
	Office				Multifamily				Retail				Industrial			
	Cap rate spread (pp)			Actual Cap rate	Cap rate spread (pp)			Actual Cap rate	Cap rate spread (pp)			Actual Cap rate	Cap rate spread (pp)			Actual Cap rate
	History	Q4-18	*Diff.*	Q4-18	History	Q4-18	*Diff.*	Q4-18	History	Q4-18	*Diff.*	Q4-18	History	Q4-18	*Diff.*	Q4-18
U.S.	4.0	3.7	-0.3	6.6	3.7	3.3	-0.4	6.2	4.4	4.2	-0.2	7.1	4.0	4.0	-0.1	6.9
Boston	3.5	3.1	-0.4	6.0	2.4	1.9	-0.5	4.8	4.1	3.7	-0.4	6.6	3.6	3.5	-0.1	6.4
New York	2.8	2.2	-0.6	5.1	2.2	1.7	-0.5	4.6	4.0	3.0	-1.0	5.9	3.4	2.6	-0.8	5.5
Philadelphia	4.6	4.4	-0.2	7.3	3.7	3.6	-0.1	6.5	4.6	4.3	-0.4	7.2	4.5	4.5	0.1	7.4
Wash. D.C.	3.3	3.5	0.2	6.4	2.3	2.0	-0.3	4.9	3.4	3.4	0.0	6.3	3.6	3.5	-0.1	6.4
Charlotte	4.9	3.7	-1.2	6.6	3.6	3.5	-0.1	6.4	4.3	4.4	0.1	7.3	4.8	4.3	-0.5	7.2
Orlando	4.3	4.4	0.1	7.3	3.6	3.2	-0.4	6.1	3.8	4.0	0.2	6.9	4.1	4.1	0.0	7.1
Tampa	4.8	4.2	-0.6	7.1	3.8	3.4	-0.4	6.3	4.6	4.2	-0.4	7.1	4.4	4.5	0.1	7.5
Miami	4.2	2.9	-1.3	5.9	3.2	2.8	-0.4	5.7	3.5	2.6	-0.9	5.5	4.1	3.1	-1.0	6.0

Source: CoStar, TD Economics. *Historical 1990-2018. **Spread is Cap rate vs. 10-year U.S. Treasury yield 4Q-moving average.

Table 2: Vacancy Rates												
	Office			Multifamily			Retail			Industrial		
	History	2018	2019F	History	2018	2019F	History	2018	2019F	History	2018	2019F
U.S.	11.1	10.0	9.5	6.6	6.1	6.2	6.0	4.5	4.4	7.9	4.8	4.9
Boston	9.9	7.7	7.1	4.6	5.1	4.9	4.2	2.7	2.9	8.6	5.4	5.0
New York	8.5	8.6	8.5	3.0	2.4	2.5	5.7	3.7	4.3	6.4	4.2	3.9
Philadelphia	10.3	8.4	8.2	6.1	5.8	5.9	5.5	4.4	4.3	8.2	5.2	5.5
Wash. D.C.	11.4	13.2	12.7	6.0	6.2	6.3	4.4	3.9	3.7	9.2	6.3	5.9
Charlotte	10.6	8.3	8.0	7.2	8.2	8.3	5.7	3.9	3.9	9.9	6.6	7.1
Orlando	10.5	6.8	6.4	6.7	6.4	6.8	5.7	4.2	4.0	8.4	4.0	4.3
Tampa	11.1	7.2	7.0	7.7	6.5	6.9	6.0	4.5	4.5	6.9	4.7	5.1
Miami	10.0	8.5	9.0	5.2	5.6	6.3	4.2	3.7	4.3	5.9	4.0	4.3

Source: CoStar, TD Economics. Historical vacancy rate for office and multifamily start in 2000, industrial in 2001 and retail 2006. Table showing yearly average of quarterly values.

Table 3: Construction Pipelines *(%, Stock/units currently under construction as a share of existing stock)*												
	Office			Multifamily			Retail			Industrial		
	History	Q4-2018	*Diff.*	History	Q4-2018	*Diff.*	History*	Q4-2018	*Diff.*	History	Q4-2018	*Diff.*
U.S.	1.6	1.7	0.0	2.3	4.0	1.7	0.8	0.6	0.2	1.0	1.7	0.6
Boston	1.7	1.4	0.2	4.3	9.6	5.4	0.7	0.6	0.1	0.4	0.3	-0.1
New York	1.4	2.5	1.1	1.8	4.3	2.5	1.1	1.6	0.5	0.7	0.7	0.0
Philadelphia	1.0	0.6	0.4	1.4	3.1	1.7	0.6	0.2	0.4	0.7	1.5	0.8
Wash. D.C.	2.7	2.1	0.6	3.6	6.4	2.8	1.1	1.0	0.1	1.3	1.9	0.6
Charlotte	2.7	3.8	1.1	5.0	6.7	1.7	1.1	0.8	0.3	1.0	2.1	1.1
Orlando	2.0	2.1	0.1	4.6	5.6	0.9	1.1	1.0	0.1	1.5	2.1	0.6
Tampa	1.4	0.9	0.5	2.7	3.8	1.1	0.8	0.5	0.2	0.8	1.5	0.7
Miami	2.5	2.3	0.1	2.9	10.9	8.0	1.5	2.2	0.7	1.0	1.8	0.8

Source: CoStar, TD Economics. *Historical is 2000-2018, except for retail (2006-2018).

Table 4: CRE Price Growth												
	Office			Multifamily			Retail			Industrial		
	2017	2018	2019F	2017	2018	2019F	2017	2018	2019F	2017	2018	2019F
U.S.	3.1	3.0	2.6	6.3	5.5	2.8	3.0	2.0	1.2	11.9	10.4	7.1
Boston	4.9	3.1	3.3	6.3	5.3	2.8	4.4	3.1	1.8	10.7	10.8	8.1
New York	0.2	1.3	-0.4	5.7	3.0	0.2	2.4	0.9	1.0	12.9	10.4	7.0
Philadelphia	1.8	2.7	2.3	3.9	6.1	4.5	3.7	2.9	1.7	8.9	8.4	6.6
Wash. D.C.	-0.6	-1.5	-0.2	3.8	1.9	0.5	0.6	-0.2	0.2	7.0	5.2	3.8
Charlotte	8.6	12.2	7.5	6.4	5.2	4.8	1.9	3.7	2.3	12.5	12.5	10.8
Orlando	7.7	6.6	4.7	7.3	9.3	5.2	6.5	7.4	4.1	12.1	13.8	10.4
Tampa	8.0	4.4	4.3	7.6	7.7	4.7	5.2	6.1	5.1	10.3	12.2	5.3
Miami	3.7	5.4	4.2	6.9	6.7	2.7	3.2	2.0	1.9	11.4	10.0	6.8

Source: CoStar, TD Economics.