Commercial Real Estate Outlook Update

Lower Rates Help, but Slowing Growth Will Challenge Commercial Real Estate Over the Next Year

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Highlights

- The U.S. expansion is now the longest on record. The labor market is healthy with the unemployment rate near a 50-year low. Economic growth is expected to continue over the next year, but at a more muted pace, reflecting cautious business investment and an aging workforce.
- Slower economic growth will mean softer demand for commercial real estate space, but relatively muted supply pipelines should help keep a lid on vacancy rates. At the same time, interest rates are likely to remain low, putting a floor under investor appetite and supporting modest price growth.
- Demand for office space is likely to slow alongside employment, putting modest upward pressure on vacancy rates. Demand will be strongest in tech markets in southern cities that continue to experience robust population growth.
- The shift in consumer spending toward e-commerce will remain a challenge for traditional bricks and mortar retail space. A limited supply pipeline and demand growth from service and experience-based users of retail should limit the damage over the next year.
- What e-commerce takes from retail it gives to industrial. With same-day delivery an increasing phenomenon, demand for industrial space should remain solid. Still, trade tensions and a burgeoning supply pipeline suggests more moderate price growth going forward.
- A gradual rise in the homeownership rate over the next several years suggests slower demand for rental apartments and modest upward pressure on vacancy rates, which are low relative to history.

At over a decade long, the U.S expansion is now the longest on record. Notwithstanding pockets of weakness in trade-exposed sectors like manufacturing and agriculture, the economy is performing well. The nation's unemployment rate sits at 3.6% in October, just a hair above the 50-year low of 3.5% hit in September. The strength in the labor market is reflected in solid growth in consumer spending, which accounts for almost 70% of economic activity, and in stock markets, which, after a scare late last year, have pushed to all-time highs.

Still, trade disputes have raised uncertainty and slowed investment. Progress toward a preliminary trade deal between China and the U.S. is an unambiguous positive for the outlook on this front. Even so, with low unemployment and an aging population, finding skilled workers will remain a headwind to business expansion. As a result, economic growth is likely to slow over the next several years relative to the past.

In our latest economic forecast, we expect real GDP growth to moderate to 2.3% in 2019 and further to 1.7% in 2020, down from 2.9% in 2018. Consumer spending is likely to remain a lynchpin of growth, but at a more subdued rate than the past several years. Investment, meanwhile, is likely to be muted, reflecting heightened global uncertainty and the broader moderation in demand growth.

For commercial real estate, softer economic growth means slower demand for space. Vacancy rates, which are low relative to history across segments, are likely to drift higher over the next year. Still, a relatively muted supply pipeline should put a ceiling on this upward drift and leave rent growth relatively stable.

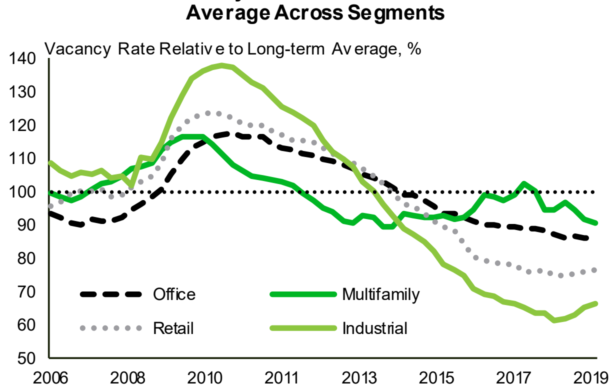
The saving grace for commercial real estate (CRE) is that interest rates are likely to remain low. Since late July, the Federal Reserve has cut rates 75 basis points to insure against downside risks to the outlook. Yields at the longer-end of the curve have been more volatile, ebbing and flowing with news on global growth, trade deals and fears of recession, but are still down noticeably from levels at the start of the year. With little inflation and modest economic growth, we expect interest rates to remain subdued over the next year. This is likely to put a floor under investor appetite for CRE and support modest price growth across segments.

Solid performance across CRE segments

Commercial real estate has performed well over the course of this year. Net absorption has largely kept pace with supply and vacancy rates are either falling or close to historical lows across segments (Chart 1).

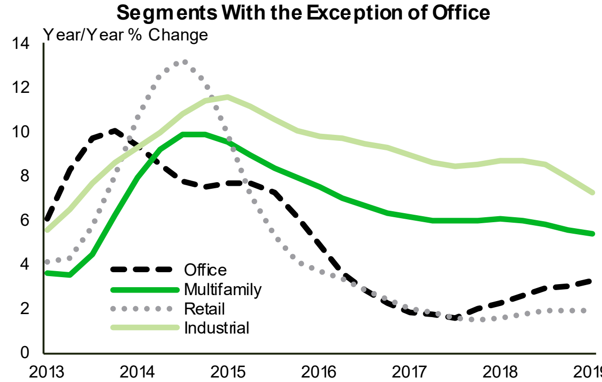
After several years of falling vacancy rates, a stronger supply pipeline has pushed up vacancies in the industrial segment. For office space, demand has been soft, but still more than sufficient to absorb limited new supply. Within retail, vacancy rates remained low relative to history, but edged higher over the course of 2019. The apartment sector, meanwhile, has seen strong growth in both supply and demand, with demand retaking the upper hand and pulling vacancy rates down through the year to date.

Chart 1: Vacancy Rates Remain Below Historical Average Across Segments



Source: CoStar, TD Economics. last data point 2019Q3.

Chart 2: CRE Price Growth Moderates Across Segments With the Exception of Office



Source: CoStar, TD Economics. Last Data point 2019Q3.

On the price side, after several years of robust gains, price growth for the hottest segments – multifamily and industrial – has moderated. Prices for office buildings on the other hand, have stabilized and even shown some positive momentum recently, with the CoStar price measure up over the 3% year-on-year to the third quarter (Chart 2). Retail prices, which have seen the slowest growth among segments, remains soft, but edged slightly higher to around 2.0% year-over-year in the third quarter of 2019.

We expect price growth to continue to slow for industrial and multifamily properties, and remain relatively staid at subdued levels for office and apartment segments.

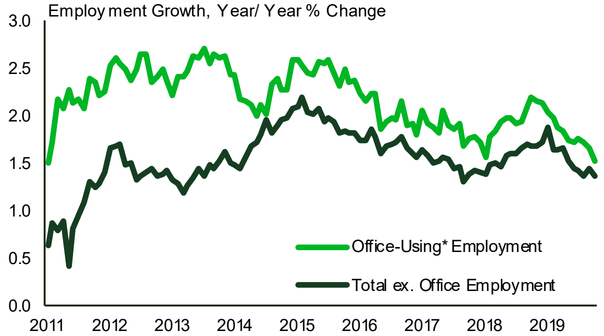
The remainder of this piece considers the outlook by major CRE segment, updating the piece we published earlier this year.

Office – slowing demand growth and uncertainty around "coworking" are key headwinds

Slower economic growth will be a headwind to future office demand. The good news is that office-using employment has outpaced overall job growth over the course of 2019 and looks to continue to do so over the foreseeable future (Chart 3). Still, with the economy coming up on full employment and baby boomers continuing to exit the workforce, a more subdued pace of growth appears likely.

The other challenge for office demand is the move to more flexible workspaces and the rise of "coworking." Coworking is not exactly new, but the growth of WeWork has promoted its advance, and has allowed for more efficient use of existing space. More recently, the struggles of the company have created fears that its potential exit from the market

Chart 3: Office-Using Employment Slowing, But Still Outpacing Other Sectors



*Includes professional & business services, financial activities, and information.
Source: BLS,TD Economics

Chart 4: E-Commerce Continues to Rise in Share

Source: Census Bureau, TD Economics. Last data point June 2019.

may leave a hole that is difficult for landlords to fill. While WeWork is big in the area of flexible office space, overall it represents just 2% of national office inventory. Still, its struggles could create some near-term volatility in markets like Manhattan, San Francisco and Seattle where it has made up a high proportion of new leases.

The good news is that overall, the supply of new space in the office sector has remained subdued. Most of the development activity is concentrated in tech markets in the southeast where employment and population growth has also outperformed.

Overall, office vacancy rates may drift up slightly over the next year, but are likely to remain low relative to history. Rent growth, which has been slow and steady despite low vacancy rates is likely to remain so. Similar to the construction outlook, rent growth will remain strongest in markets with the strongest population and job growth, favoring more affordable urban centers in the sunbelt.

Retail – e-commerce displacing bricks and mortar, but new tenants taking their place

The outlook for consumer spending forms the basis for demand for retail space. Consumers have delivered over the course of this year, with overall retail sales up 4.1% year-on-year (to September). Even excluding non-store retailers, retail sales are up 2.9%, roughly consistent with the pace a year ago.

Still, the shift to online retailing, which now makes up 11% of total retail sales (from less than 1% in 2000) has led to closing of stores among many traditional retailers (Chart 4). More than 8,200 stores including Payless Shoes, Gap, Victoria's Secret have recently announced store closures. The move to online retailing alongside labor-saving productivity improvements in retail has also showed up in the jobs data, leading to steady job losses in traditional retail categories like clothing, sporting goods, and general merchandise stores (including department stores).

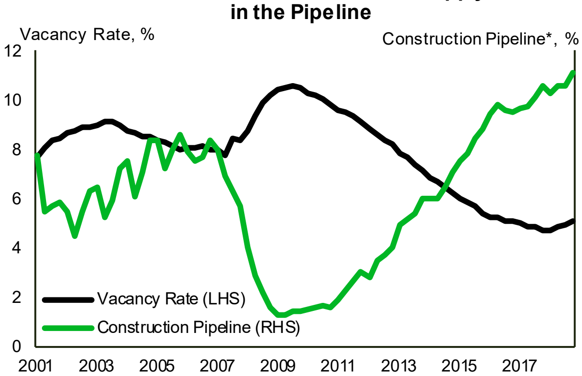
Landlords have responded to the lower demand in various ways: slicing up larger spaces to accommodate smaller stores, increasingly renting out space to less traditional tenants such as fitness centers, trampoline parks, medical offices, and pharmacies, or transforming spaces to pick up and delivery spots, supporting online retailing. This has helped maintain a relatively steady net absorption flow and with limited new supply, has kept vacancy rates subdued.

The outlook for the retail industry is neutral as developers remain cautious in supplying new space. Indeed, new construction has been limited to relatively high-income areas with strong population growth. These are likely to remain well supported and nation-leading. Overall, rent growth has held in the 1-2% range in recent quarters and is expected to remain at this subdued rate over the next year.

Industrial – solid demand, but decent supply pipeline suggests more moderate growth

As the e-commerce market continues to expand, the demand for warehouses, logistic buildings, and bulk distribution center has grown along with it. With relatively limited supply, this has pushed vacancy rates for industrial properties to near record-lows. The strong fundamentals have helped drive strong price gains, especially in well-established and densely populated markets such as New York, Los Angeles, Chicago, and Dallas.

Chart 5: Lots of New Industrial Supply in the Pipeline



*Construction pipeline is measured as units under construction as a share of existing stock. Source: Census Bureau, TD Economics. Last data point 2019Q3

The growth of e-commerce is likely to continue. On October 15th, Amazon began one-day delivery on all of its products to prime members. This is likely to increase the company's demand for warehouses and distribution centers. Moreover, the competitive landscape is likely to lead other online retailers such as Walmart, Macy's, and Target to follow suit, maintaining demand for industrial space within relatively close proximity to major population centers.

While demand remains strong, the supply pipeline has picked up considerably (Chart 5). In an environment of slowing economic growth, this is likely to put some upward pressure on vacancy rates that will slow the pace of rent and price growth in the sector.

Trade conflicts and slowing global growth is another downside risk for the industrial sector. So far, the impact appears limited, but the uncertainty is reflected in the ISM manufacturing purchasing managers index, which has dipped into contractionary territory and remained there for the past three months. A fall in business confidence and uncertainty about tariffs could put a stall on new industrial leasing. By the same token, trade deals that remove existing tariffs and take off the threat of new ones could go a long way to reducing this source of uncertainty and supporting industrial leasing demand.

Apartment – rising homeownership could slow apartment demand, but not stem it entirely

The apartment market has been well supported in the years since the recession by falling homeownership and a general move to renting among younger households. After falling steadily from its peak in 2004, the homeownership rate finally troughed in 2016 and rose over the next two years. Alas, its upward trajectory is not guaranteed. The homeownership rate fell in both the first and second quarters of 2019, perhaps reflecting increased sensitivity to rising interest rates. As a result, the number of renter households grew by a robust 600k, enough to keep pace with supply and leave vacancy rates low.

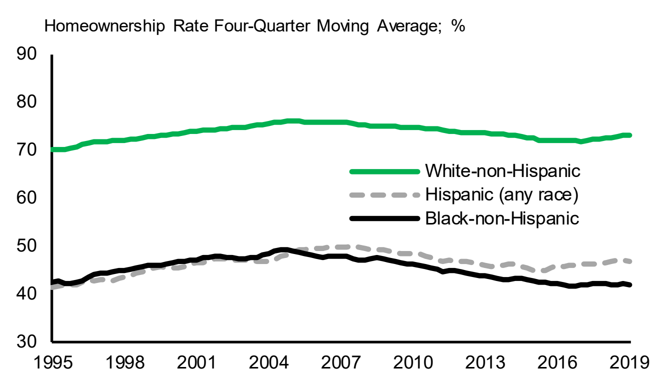
Nationally, the homeownership rate should be expected to move higher over the next several years. Homeownership rates tend to rise linearly with age, with big jumps once people turn 30 – precisely where much of the population growth is likely to be over the next several years.

Still, there are several reasons to expect its rise to be muted. Most of the population growth over the next decade will be among visible minorities that have lower rates of homeownership relative to the majority population. The homeownership rate of Hispanics is just 47%, while that of black households is just 42% (Chart 6). This compares to a homeownership rate of 72% for white (non-Hispanic) households.

In part, lower homeownership rates among minority population reflect the fact that they are much younger. As they age, the homeownership rates should be expected to rise. Still, the low starting point for homeownership for groups experiencing the fastest household growth will be a headwind to the aggregate homeownership rate.

On the supply side, the increase in apartment starts over the last several years is likely to result in a high level of completions. Alongside slowing rental demand, this is likely to put upward pressure on apartment vacancy rates. Still, as with other segments, outcomes will vary significantly by location. In many sunbelt markets with strong

Chart 6: Homeownership Rates Differ Significantly by Race and Ethnic Group



*Native Hawaiian and Pacific Islander. Source: U.S. Census Bureau population growth, overall housing construction is below the pace of household formation, and even with some upward drift in homeownership, net absorption should keep pace with apartment supply. The one exception to this is Miami, where a surge of new construction suggests more scope for upward drift in vacancy rates and more possible price concessions for major rental properties.

The Bottom Line

The economic cycle is maturing and concerns have been raised about its sustainability. Still, warnings about an imminent downturn are not supported by the data. Consumer fundamentals remain sound and there is little evidence of excesses in household leverage that would hasten a downturn. The key risk lies on the business side of the economy, where global trade and policy uncertainty is weighing on investment and has contributed to the economic slowdown.

Even with slower economic growth, a low interest rate environment means that commercial real estate will remain an attractive investment class. While challenges are well known within the retail and office sectors, a limited supply pipeline and more muted price growth over the last several years, should keep these segments well bid. The industrial sector, meanwhile faces downside risk from trade wars, but is likely to see ongoing healthy demand for space from growth in e-commerce. In the apartment space where cap rate spreads are the thinnest, vacancy rates are likely to drift higher. This may require more vigilance among investors in picking their spots. Still, there are plenty of high growth regions of the country and with a solid cohort of millennials supporting overall household formation and putting a floor under demand in the market.