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Tariffs and Trade Could Stall Economy

While this extended recovery will break the 120-month expansion record in July, the “vroom” economy is being forced to make a pit stop.

By K.C. Conway, MAI, CRE | July.Aug.19

Through the first five months of 2019, the U.S. economy shook off Federal Reserve rate hikes and a government shutdown, defying prognostications for recession. In fact, it behaved more like an economy in the early stages of a recovery, posting first quarter growth of 3.1 percent gross domestic product, averaging 200,000 in monthly job increases, and posting healthy corporate earnings across various industries.

Small business optimism, according to the National Federation of Independent Business, also rebounded to 105 in May from a brief lull of 101.2 in January, following the government shutdown and a fourth Fed rate hike in December 2018. I originally characterized the U.S. economy heading into summer 2019 as having “vroom” - but then came the tariff boomerang. It resurfaced as a top risk - one that wasn't just 10 percent tariffs on China, but now 25 percent on China and potential penalties on Mexico. Combined, the two tariff issues are tough to shake off. Additionally, the timing is terrible because it complicates the crucial ratification of the United States-Mexico-Canada Agreement (USMCA), which is scheduled for Congressional vote before the August recess.

Unfortunately, the tariff issue is all the market needed to lose confidence. An early warning sign that the vroom is dropping out of the economy was the May ADP jobs data, which revealed that just 27,000 jobs were produced in that month, and small business employment contracted by 52,000 jobs. ADP explained that these May numbers were “the worst since the recovery began 118 months ago” and were largely attributable to two factors: 1) labor shortages impeding hiring and 2) layoffs at brick-and-mortar retailers becoming more pronounced with store closings on pace for a record high in 2019.

So what now? Well, we wait. The damage from tariffs and trade wars won't show up in the data for months. New GDP numbers for the second quarter won't come out until August, with the 3Q2019 released at the end of October. In addition, the Fed meetings in June could set the stage for a rate cut in July in response to the inverted yield curve. Unfortunately, what ails the economy now can't be mediated by Fed rate cuts. Companies are not going to add employment, expand facilities, and grow because the Fed reduces rates once, twice, or even three times by the end of the year at a time when trade, sales activity, and cost of inputs are uncertain.

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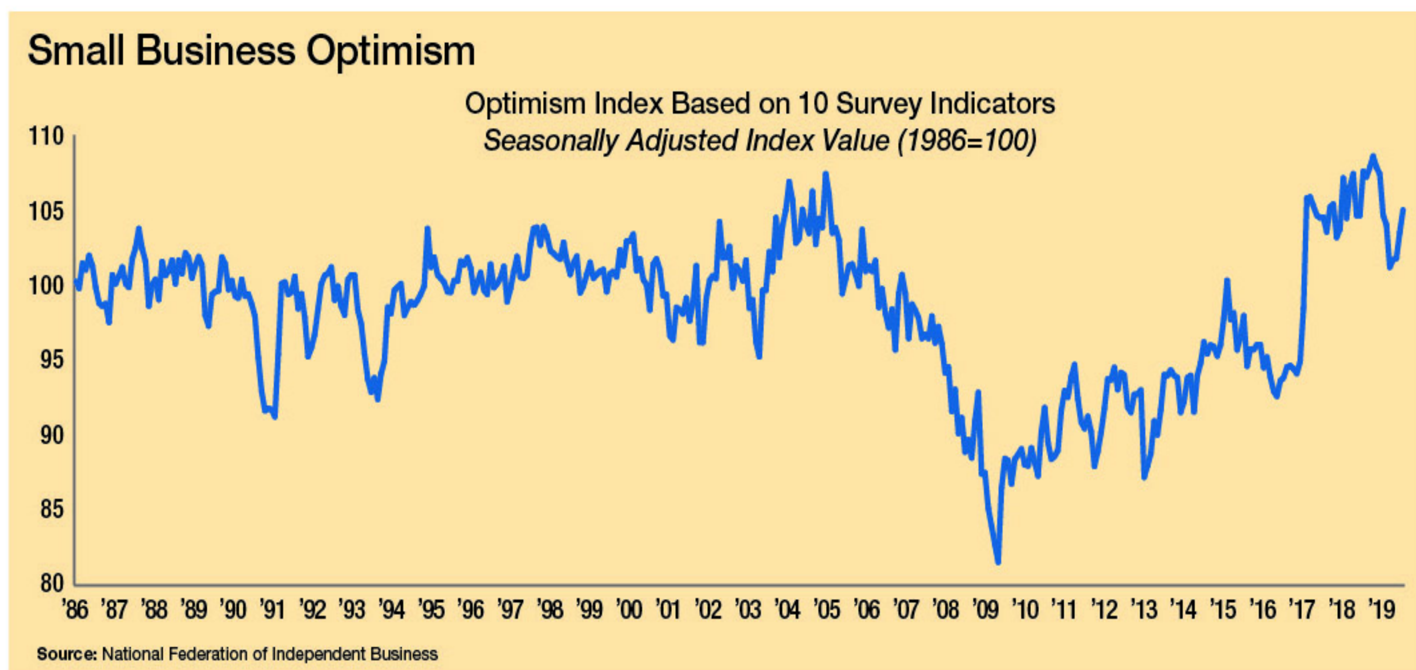
Companies want certainty, and they don't know how these trade issues will impact business activity and profitability. No number of rate cuts can mitigate that. All the Fed will accomplish with rate cuts is affirm the market's fears - that a recession is ahead. Economies rise and fall on psychology and confidence. Until this trade uncertainty is resolved, expect economic momentum to stall.



Since the beginning of 2019, I have emphasized the importance of USMCA deal - basically, NAFTA 2.0 - being ratified. If USMCA does indeed becomes a reality, I'm optimistic the vroom economy seen earlier this year will continue toward a record recovery. This agreement is the most critical factor in altering the direction of the U.S. economy in the second half of 2019. If the deal is delayed or not ratified, the U.S. economy could contract with disruptions in supply chains to key industries like auto and equipment manufacturing.

This scenario is now more likely than previously thought. The Trump administration's emphasis on immigration over trade jeopardizes USMCA and, along with it, the U.S. economy. A North America unified on trade scares China and Europe, and it is a major factor in keeping China at the negotiating table. If the USMCA unravels over new tariffs on Mexico, the U.S. economy is headed toward recession. That is the message signaled by a volatile stock market, inverted yield curve, and difficult May ADP jobs report.

What does this mean for commercial real estate? This wait-and-see approach will likely continue until the end of the summer when 2Q2019 data starts coming out. Transaction volume could slow as businesses and investors hunker down amid uncertainty. The big risk to commercial real estate is how a shift in the economy could impact capital markets and financing. On the positive side, commercial real estate fundamentals are solid; the industry isn't overbuilding, and there aren't any phony finance mechanisms like sub-prime mortgages. Some property types are positioned to hold up better than others, and several dynamics influence performance within individual sectors.

Capital Favors Industrial

Industrial is still the star of commercial real estate - everybody loves it, and it outperforms other sectors. Vacancies remain historically low, with the national average between 5 and 6 percent. Additionally, developers are currently unable to deliver product fast enough with absorption outpacing new supply. Developers are expected to build 200 to 220 million square feet of new industrial space in 2019, with a market on track to absorb 230 million square feet.

Industrial is clearly benefiting from the shift from a shop-and-pick-up economy to one focused on online ordering and direct delivery. Whether products were typically purchased at a mall, grocery store, or automobile dealership, everything is moving to online platforms that require warehouses and fulfillment centers - and there is no end in sight.

One issue negatively affecting the sector is the rising cost of building e-commerce fulfillment centers. Construction costs now top $100 per sf, and the time to complete a project from site approval to certificate of occupancy is two years or more. In response, companies such as Amazon are experimenting with tent warehouses, which can be built faster and for less money. These tent warehouses, built with heavy-duty canvas and steel, cost roughly $40 per sf and can be constructed in three to six months. Because demand is strong, impatience from the logistics and e-commerce industry is going to continue to drive innovation.

Multifamily Maintains Steady Pace

Despite predictions that multifamily was overbuilt and going to implode, the sector is doing just fine. The national vacancy rate is hovering around 5 percent, with many markets reporting even lower levels. Rent growth is still solid at 2 to 5 percent. The new supply is still relatively tame with production generally holding at approximately 350,000 units per year.

If developers overbuild, it's likely to occur in the luxury or high-end segment of the market. In most markets, the demand for multifamily falls in the $2 to $3 per sf range for rents. Developers who try to push higher to $4 to $5 per sf are finding resistance.

The biggest challenge within multifamily is solving the workforce housing shortage - the new buzz word used to refer to a broader base of the population beyond low-income renters. In particular, the largest opportunity is for workforce housing in the rent range of $2 to $3 per sf.

Density may increase, and, like industrial, innovation may lead to new methods of achieving affordability. Developers are already increasing density with an emphasis on smaller units, including microunits, which help make rents more affordable. In areas with a burgeoning tech and STEM workforce, such as Seattle, Denver, and Northern Virginia, one-bedroom rents have gone up by as much as 50 to 100 percent in the last three to five years.

These skyrocketing prices are pushing developers to introduce new more affordable options. Some developers are testing tiny home subdivisions as a solution to the demand. For example, one developer in metro Atlanta is developing 11-foot-wide townhomes that cost between $250,000 and $300,000. In other cities, single-family homes in subdivisions are solely for rent, using modular construction techniques. Modular housing is something to monitor as a trend in communities with workforce housing shortages and price affordability limitations. Don't be afraid - it is more durable than traditional multifamily construction with lower occupancy costs due to construction efficiencies.

Retail Shift Brings Opportunities

Store closings continues to dominate headlines in the retail sector. A recent *Wall Street Journal* article noted that 5,900 stores closed in 1Q2019 compared to 5,800 a year ago. The net number of closings versus openings is about 3,300, with many occurring in mall clothing and accessories, consumer electronics, home furnishings, and sporting goods.

Look to grocery as the next sector to be hit with closures due to the rise of online sales. Following Amazon's purchase of Whole Foods, Walmart announced that it will convert 800 stores over the next two years to serve online grocery orders. Others followed suit. Target acquired a company called Shipt to better compete with Amazon for online grocery, and Kroeger announced a partnership with Walgreens to use the drug stores as nodes for online grocery fulfillment.

The important story for retail is that brick-and-mortar locations are still viable, but more for point of procurement than point of sale. The tremendous disruption in retail also presents the industry with plenty of adaptive reuse opportunities. For example, car dealerships that are turning to online sales no longer need large lots. Instead, they are opening smaller, more flexible locations and showrooms in alternate venues such as former bank branches. Meanwhile, old auto dealerships are being repurposed as well, into uses such as multifamily.

Flexibility Is Key for Office

While office is not sizzling like industrial, it's nowhere near apocalyptic either. Office continues to be impacted by the densification trend that started a decade ago. Densification, or putting more workers into less space, has morphed into coworking. Coworking allows companies to be nimble in terms of where their workforce is located and to have greater freedom in moving people without additional leases.

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That shift, coupled with the new lease accounting standards (i.e., ASC 842) that deter companies from taking on long-term lease liabilities, is influencing demand for coworking space within the office sector. To meet coworking criteria, buildings generally need to be in cities with good accessibility to transit or ride sharing. Also, the buildings need to have been modernized with more security and energy efficient utilities, as many are increasingly running 24/7.

As an example, New York's Hudson Yards is a project that would not have been considered a Class A location 10 years ago. Hudson Yards has uncovered a pent-up appetite by companies for new, modern, high-tech office space that can operate 24/7, handle coworking, and offer more concierge services. Those factors are driving the coworking and WeWork model, and it's also leading to new office construction.

Regardless of property type, rising construction costs are on everyone's radar, especially industrial and multifamily. Rebuilding efforts are still ongoing from the five Category 3 or 4 hurricanes that hit the U.S. over the last two years, resulting in construction costs rising about 10 percent per year. Lenders must be cognizant of the loan-to-value erosion from these rising construction costs when underwriting construction loans in this environment, especially for projects with a development timeline of two or more years. Construction costs also are a limiting factor in the growth of new supply, becasue it becomes harder and harder to make the numbers work. Knowledge is power, so a couple of useful sources for monitoring these costs are provided by the Association of General Contractors and Engineering News-Record's Construction Economics published monthly.

Risks to Keep on the Radar

Clearly, there are some big risks ahead for the U.S. economy. The top three to watch are ratification of the trade agreements, Fed action on interest rates, and new lease accounting rules.

I am concerned that the likelihood of USMCA being ratified has decreased, boosting the risk of a recession in 2020. The inversion of the June yield curve in both degree and duration is going to prove correct this time around as a predictor of recession. Granted, any recession is not likely to be as severe as 2009.

If the Fed now panics and starts cutting rates, it only signals anxiety to the market, which will prove ineffective at saving the market from recession. Certainty and trade deals are what the market needs to resume growth - not rate cuts.

Lease accounting is another big issue that could really disrupt the financial side of commercial real estate. At the end of this year, all public companies in the U.S. must report leases on real estate as a liability on their balance sheets, which puts American companies in sync with international accounting standards.

There are two big implications for that surge of balance sheet liability:

1. It could trigger some downgrades in corporate ratings.
2. It could serve as a disincentive for life companies and the Wall Street securitization market to turn away from the permanent finance market for maturing construction loans and commercial real estate due to the lack of interest in financing short-term leased properties.

A Walmart or grocery store with a 5-year lease and renewal options isn't as attractive as one with a 15-year or longer lease structure. Permanent lenders have to match their capital structure (long in duration annuities or 10-year bond structures) to assets. Commercial real estate with long-term leases has always been a nice match. All that could change after 2019, though, and the commercial real estate market could see a disruption in permanent debt financing.

Permanent debt markets could potentially lock up if companies shift away from long-term leases and make it difficult to underwrite permanent loans. The U.S. already has a record $4.1 trillion in commercial real estate debt. Of that, 55 percent now is held by banks, which is more than they held before the financial crisis a decade ago. However, any ripple effects caused by lease accounting changes won't emerge until 2020, after full implementation of lease accounting rules at the end of this year.

Clearly, there are some warning signs ahead for the economy and commercial real estate. In the current climate, CCIMs can add value to clients by helping them prepare for an environment with some disruption in financing, ultimately impacting the access to and cost of capital in what has been a very liquid market.

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