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Economy Watch: Is There Still Runway?

Is there runway left for a continuing recovery that is now officially 31 quarters long (through March 2017)? The average post-WWII economic recovery spanned 19 quarters, with the longest reaching 40 quarters, from March 1991 to March 2001. Recoveries do not end of old age. There are always other reasons, with the most typical being either that boom period excesses come to an end, or that in its munificence, the Fed artificially moves interest rates too far above market rates.

The good news about the current recovery is that there are no systemic excesses in single-family housing, autos, or commercial construction — the sectors that have historically been prone to cyclical excess. In addition, the Fed has forced interest rates so far below market-driven pricing that inevitable rate increases will spur the overall economy (though not in every sector) as market signals take effect. This is in marked contrast to comparable points in previous recoveries in which single-family housing, auto production, and commercial development were all well above historical norms, while interest rates were above market due to Fed action. Further, only since the November election have consumer and business confidence moved notably above their historic norms. And absent a prolonged period of excessive consumer and business optimism, broad-based excesses are unlikely to occur. As a result, we believe that there is still considerable room for continued growth, and that the current recovery will stretch into 2019.

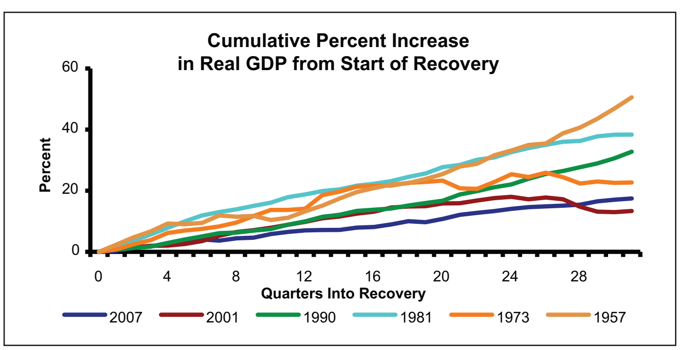

figure 1

By the way, the notion that artificially low short-term interest rates notably stimulate business investment, or that high rates harm it, is absurd on its face to anyone who has ever participated in such decisions. Does the Fed really believe that a business will decide to build a factory because the short-term rate, which represents at most 20% of their capital stack, is reduced by a couple of hundred basis points? It simply does not happen that way, as decisions about long-term capital projects focus on the long-term

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capital cost of the project. The reduction of short-term rates for a year or two has no meaningful impact on such decisions. And it is noteworthy that even the Fed's eight-year rate madness has had no such impact, as investors have worried throughout the entire period that low short-term rates were about to end. In addition, the Fed's non-transparent stress tests (a de facto regulation) have restricted the bank lending that is necessary to facilitate robust investment activity.

After bottoming at 25.3 in 2009, the Conference Board Consumer Confidence Index rebounded over the last eight years, standing at 117.9 in May 2017. The current level is about 2,600 bps above the historical average (1977-present), 2,550 bps higher than one year earlier, and 690 bps above the 2007 pre-recession level of 111.

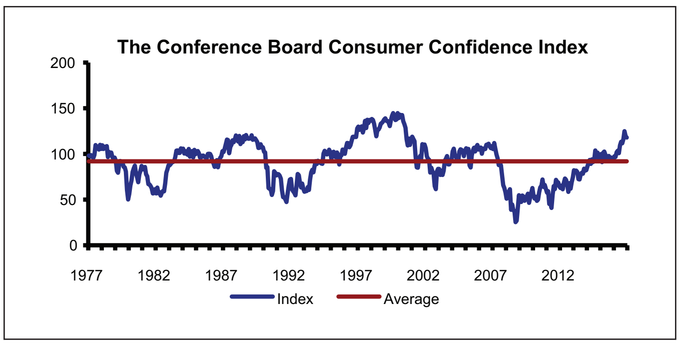

figure 2

Consumer confidence rose sharply immediately after the Presidential election, spiking by 14.2% between November 2016 and March 2017. The Index then dropped by 5.6% through May, resulting in a net 7.8% increase since November. This compares to the 22.7% increase over the comparable period when President Obama was first elected in 2008. Meanwhile, small business confidence rose 76% in the first three months post-Trump election, versus a comparable decline of 6% when President Obama was elected.

Despite rising confidence levels, the post-election pop has yet to translate into notably increased consumer spending. In fact, auto sales have retrenched a bit, as heightened political uncertainty discourages aggressive buying behavior. During the first three months of both administrations (based on December 2008/2016 through March 2009/2017, respectively), real personal consumption expenditures declined slightly (-0.03%). Only after consumer confidence has been well above average for several years will excesses creep in.

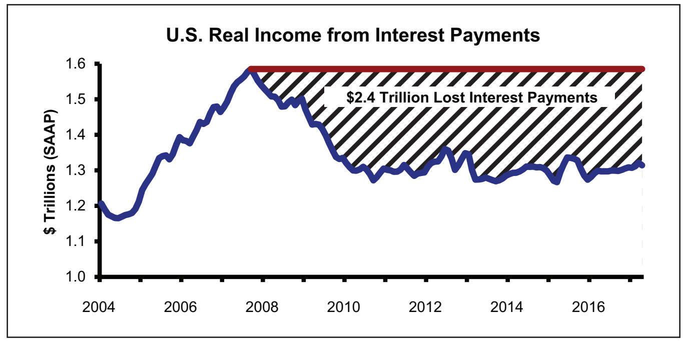

figure 3

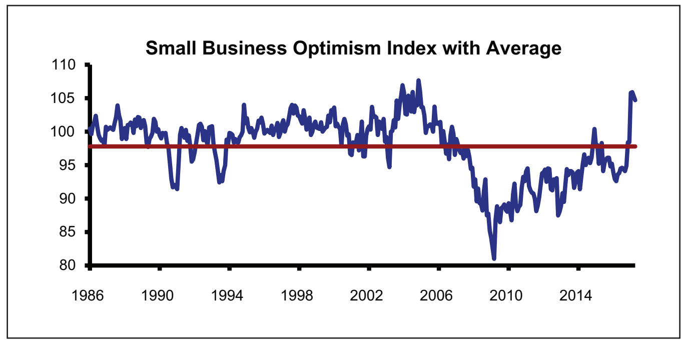

figure 4

The sharp increase in small business optimism post-election is also unmatched by more aggressive investment activity — further evidence of several years of expansion runway. Look to single-family housing as it continues its slow recovery, remaining a staggering 2.7 million units below its historic norm. We cannot say often enough that this is because artificially low interest rates hindered potential buyers accumulating down payments. Only as short rates rise will this down payment dilemma disappear, in turn spurring homebuilders to aggressively increase supply to make up for the cumulative shortfall.

The Economic Policy Uncertainty Index (EPUI) has a long-term average of 108 and stood at 108.5 as of May 2017. The EPUI is comprised of three major components:

- A search of key words and phrases (e.g. uncertainty, economy, Congress, legislation, etc.) in ten major U.S. newspapers;
- The number of temporary federal tax provisions as reported by the Congressional Budget Office; and
- Examination of the Federal Reserve Bank of Philadelphia's Survey of Professional Forecasters, and specifically the level of disagreement among forecasters.

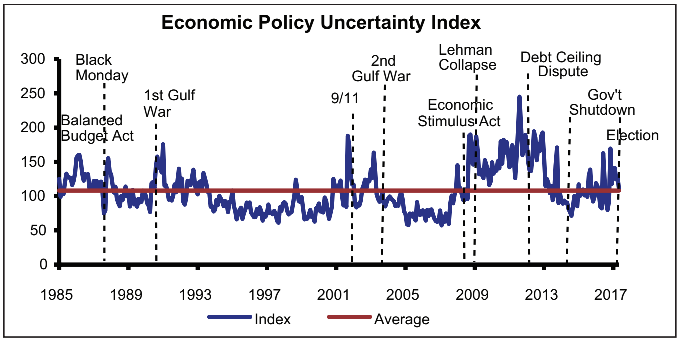

figure 5

We expect the Uncertainty Index to retreat a bit, as the policy landscape (for better or worse) becomes more clearly defined.

We expect 2.3% (annualized) real GDP growth in the second quarter of 2017. In the first quarter, although employment grew by 527,000 jobs (0.4%), real annualized GDP growth was reported as just 1.2%. All we can say is, "get real." This is an artificially low GDP growth rate, as there is no way such labor market strength could occur while GDP only grew by

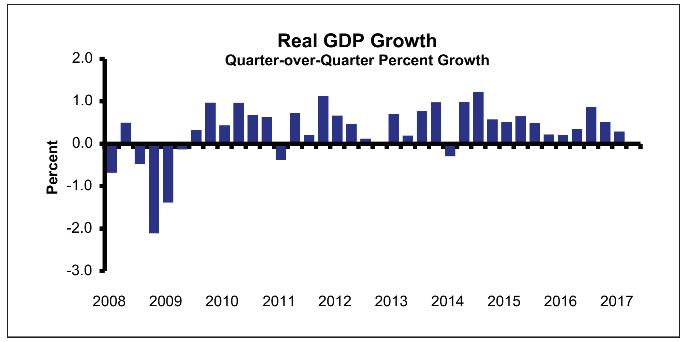

figure 7

On the Road to Recovery: Then vs. Now

	2009	2017	% Change
Real GDP ($ billions)	$15,855.8	$18,623.7	17.5
Real Per Capita GDP	$51,710.9	$57,398.6	11.0
Real Retail Sales ($ millions)	$330,019.9	$405,946.3	23.0
Real Median Home Price Index (FHFA)	191.9	241.2	25.7
Durable Industrial Output Index	77.9	105.4	35.3
Non-Durable Industrial Output Index	97.0	102.8	6.0
Real Per Capita HH Net Worth	$201,895.9	$284,192.4	40.8
Payroll Employment (000s)	131,451.3	146,135.0	11.2
Unemployment Rate (%)	9.3	4.3	-53.8
Conference Board Consumer Confidence Index	48.3	117.9	144.0
Median Weeks Unemployed	14.8	10.4	-29.9
Capacity Utilization Index	67.1	76.7	14.2
SA Auto & Light Truck Sales - Thousands	809.7	1,381.9	70.7
Median Home Price-to-Per Capita DPI	6.0	6.8	12.5
Profits After-Tax ($ billions)	$1,177.2	$1,525.3	29.6
Percent of Industries Adding Workers (LTM Avg)	29.4	60.0	103.8
Multifamily Starts (SAAR 000s)	99.0	284.0	186.9
Single-Family Starts (SAAR 000s)	425.7	794.0	86.5
Real Home Prices ($) (Census)	$240,019.3	$297,204.2	23.8
Real REIT Value Index	98.1	227.1	131.4
Real Private Real Estate Value Index	96.9	154.7	59.6
Real Average Office Rent PSF	$29.46	$29.06	-1.3
Office Vacancy (%)	13.7	11.2	-18.2
Real Median Multifamily Rent (Census)	$782.7	$848.2	8.4
Apartment Vacancy (%)	8.3	6.5	-21.2
Hotel Occupancy (%)	57.6	65.5	13.8
Real RevPAR	$59.43	$81.89	37.8
Real Average Industrial Rent PSF	$6.40	$6.41	0.2
Industrial Vacancy (%)	10.1	4.2	-58.1

**Quarterly data through 1Q17; latest monthly varies, Mar-May 2017.*
SAAR indicates seasonally-adjusted annual rates.
All dollars in real 2015 dollars.

figure 6

just 1.2%. Job creation and low new unemployment claims continue to indicate growth for the rest of the year.

New weekly unemployment claims remained very strong in the first quarter, averaging 247,000 per week. In mid-June, they were 245,000, well below the 300,000 threshold for labor market strength, and basically at the lowest level in more than 40 years. The strength of the labor market is seen in the fact that claims as a percent of the labor force are 0.15% today versus 0.25% at the 1973 low. This is in spite of the fact that the labor force is 76% larger than in 1973, when claims hit a low of 214,000 for one week in January and averaged 240,000 that year. And remember that real unemployment benefits are notably more generous today. Averaging 244,000 year-to-date through mid June 2017, weekly initial unemployment claims continue to prove the enduring strength of the labor market. However, if claims sharply increase for 2-3 months, it will be a sign that the economy is weakening notably.

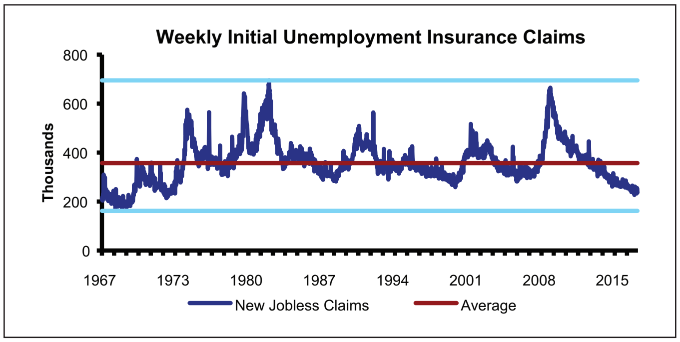

figure 8

About Dr. Peter Linneman

Dr. Linneman, who holds both Masters and Doctorate degrees in economics from the University of Chicago, is the Principal of Linneman Associates. For over 30 years he has provided strategic and financial advice to leading corporations. Through Linneman Associates, he provides strategic and M&A analysis, market studies, and feasibility analysis to a number of leading U.S. and international companies. In addition, he serves as an advisor to and a board member of several public and private firms.

Dr. Linneman is the author of the leading real estate finance textbook, *Real Estate Finance and Investments: Risks and Opportunities*, now in its fourth edition. His teaching and research focuses on real estate and investment strategies, mergers and acquisitions, and international markets. He has published over 100 articles during his career. He is widely recognized as one of the leading strategic thinkers in the real estate industry, and was named among the top 30 "Most Influential People in Real Estate" by Commercial Property Executive in 2013.

He also served as the Albert Sussman Professor of Real Estate, Finance, and Business and Public Policy at the Wharton School of Business at the University of Pennsylvania until his retirement in 2011. A member of Wharton's faculty since 1979, he served as the founding chairman of Wharton's Real Estate Department and the Director of Wharton's Zell-Lurie Real Estate Center for 13 years. He is the founding co-editor of *The Wharton Real Estate Review*.

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