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ECONOMIC PULSE

A BI-MONTHLY REPORT ON THE U.S. ECONOMY AND ITS IMPACT ON COMMERCIAL REAL ESTATE

WEATHERING THE STORM

THESE ARE NOT THE BEST OR WORST OF TIMES FOR ECONOMY AND REAL ESTATE INDUSTRY

BY KEN McCARTHY

As we all know, the U.S. economy faltered substantially in 2007 under the weight of a slumping housing sector, rising energy prices and the emergence of the credit crisis. Gross domestic product (GDP) expanded at an annual rate of only 0.6% in the fourth quarter, as weaker housing was partially offset by higher exports. Consumer spending, the bedrock of growth, slowed to an annual rate of 2% in the fourth quarter from 2.8% in the third quarter.

For the real estate industry, the most important driver is employment. In January 2008, U.S. employment turned down with the economy losing 17,000 jobs, although that preliminary number will be revised. In the fourth quarter of 2007, employment growth had slowed to about 94,000 jobs per month, roughly half the rate of 2006. Employment in office-using industries (finance, professional services and information) slowed from an average of 53,000 jobs per month in 2006 to 23,000 in the second half of 2007, as job losses in financial services dragged down growth.

2008: Tough year ahead

The outlook for 2008 is clouded by uncertainty surrounding the credit markets. A year ago, there was general optimism about the outlook for the U.S. economy; today, several leading economists and Wall Street firms are forecasting a recession for 2008 with employment and overall economic activity declining. Overall, real GDP growth is projected to average about 2% in 2008, the slowest since 2002, with much of the growth occurring in the second half of the year.

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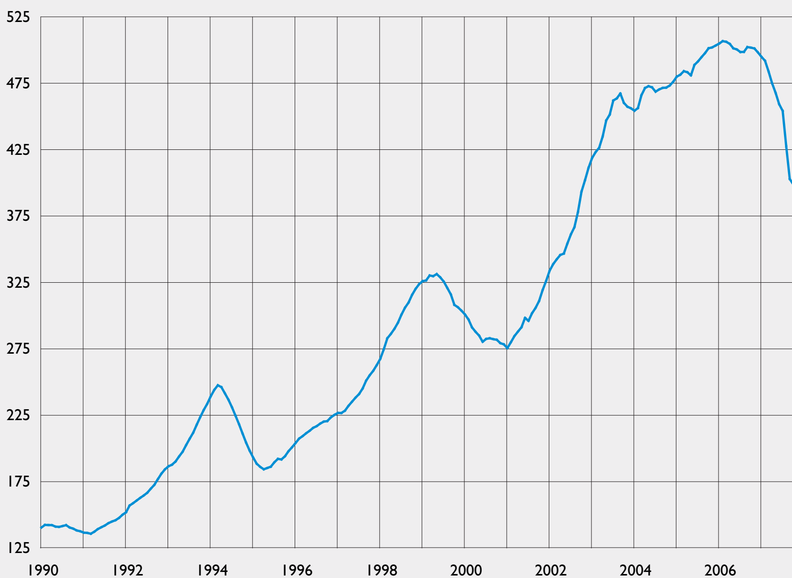
The biggest change was brought on by volatility in the credit markets, with the securitization model supporting much of the liquidity in the economy coming under pressure. In mid-2007, confidence in this model suddenly plunged as holders of debt securities found that the value of the subprime mortgages in some of these securities was falling much more rapidly than anyone anticipated because of the housing decline. As a result, they could not accurately calculate the value of the securities and were reluctant to buy more. As the demand for debt securities dried up, the major financial services firms were left with these instruments on their books. This has had two important effects on economic activity:

- First, it has reduced amount of capital available in the economy. The ability of non-bank lenders such as mortgage companies to provide loans depends on their ability to sell securities backed by those loans. Since they cannot easily sell those securities today, these lenders are not providing the credit to the economy that they were earlier in the year.

Chart 1 | MORTGAGE INDUSTRY EMPLOYMENT (thousands of persons)



Source: US Bureau of Labor Statistics, Moody's Economy.com

- Second, the financial firms that are unable to sell the securities are holding them on their books. Since these securities must be marked to market every quarter, and their value is declining, firms are writing off huge amounts of asset values, which has come directly off their income statements. We estimate that the financial company losses in the third and fourth quarters of 2007 topped $115 billion. Those losses have already led to layoffs in financial services. Since the middle of 2007, employment in the mortgage industry has plunged by 69,000 jobs or 16%. Since July, employment in financial services as a whole has decreased by 74,000 or .9%, and, in light of the continuing writedowns in asset values, more job losses in financial services are probably coming.

Thus, the availability of credit, the lifeblood of the economy, has been constrained and this is likely to cause more job losses, particularly in financial services. These pressures, along with other constraints, will weigh on the economy in the first half of the year.

Keys to Growth

Cushman and Wakefield believes there are three factors that will act to keep the economy growing in 2008, albeit at the slowest pace in six years:

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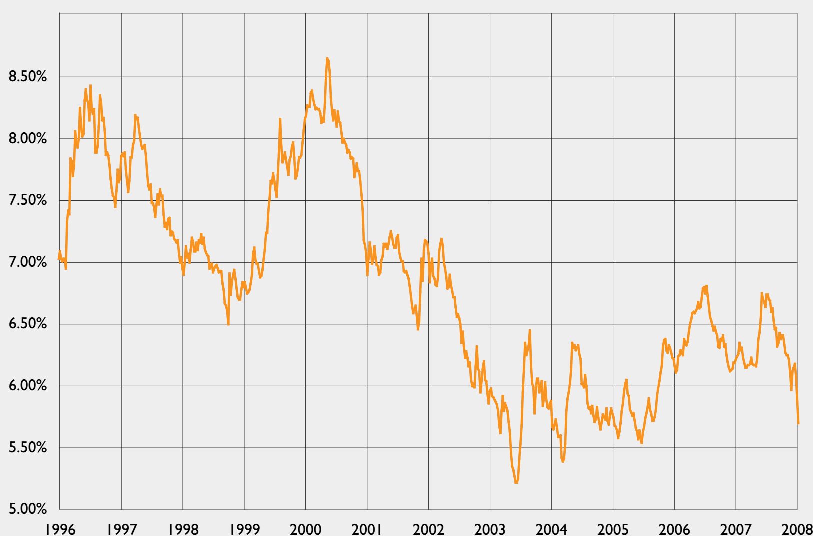
Total household net worth increased by more than $4 trillion between the third quarters of 2006 and 2007, indicating that despite the weakness in housing overall household balance sheets remain healthy.

1. Consumer Spending As always, the key to the economy's performance will be consumer spending, which accounts for 71% of total GDP. In 2007, consumers were hit with the twin pressures of declining home sales and rising energy prices. The housing decline took away an important support from consumers (the ability to take equity out of their homes) and the surge in oil prices to record territory cut into household budgets. In November 2007, consumer spending on energy was 25% above the level of a year earlier and took 6.15% of total after tax income, the third highest proportion in the past 20 years.

The key to consumer spending growth will be employment growth. In 2007, the economy added 1.1 million jobs or about 95,000 per month. But in January, the government reported the first decline in employment since 2003. Note, this preliminary estimate may be revised. As examples, employment in August was first reported as down 4,000, but is now estimated at up 74,000 and December employment, first reported as up 18,000, is now estimated as up 82,000. Nevertheless, the recent report points to a continuing downward trend that cannot be ignored. If employment falters, incomes will also deteriorate and consumer spending will soften. But if employment increases, albeit moderately, income will continue to increase. In December, income after taxes was up 5.6% from a year earlier. After adjusting for inflation, after tax income increased 2.1% from a year earlier. In addition, households continue to benefit from the overall growth in the economy. Total household net worth increased by more than $4 trillion between the third quarters of 2006 and 2007, indicating that despite the weakness in housing overall household balance sheets remain healthy. Finally, the Bush Administration and Congress seem likely to pass some sort of fiscal stimulus package including tax cuts that should put cash in the hands of consumers sometime around mid-2008, helping to boost spending later in the year.

Chart 2 | MORTGAGE RATES (conventional 30-year fixed rate mortgage)



Source: Federal Reserve Board, Moodys Economy.com

Consumer spending is thus expected to increase, but how rapidly will depend heavily on employment trends. No matter what happens, it is likely spending growth will be weaker than in recent years. From 2004 through 2006, spending growth averaged 3.3% per year. In 2008, it is more likely to be in the 2% to 2.5% range at best.

2. Interest rates The Federal Reserve acted quickly to provide monetary stimulus last fall when it became clear that the emerging credit difficulties were more severe than anticipated. From September through January, the central bank has reduced the Federal funds rate from 5.25% to 3% and it has indicated a willingness to cut more if needed. It takes time before the full effects of reductions are felt, but they are starting to take hold. For example, mortgage rates have fallen nearly 100 basis points since September

Although domestic demand has softened during the past year, one important area that has maintained its strength has been exports.

and currently stand at the lowest level since mid-2005. This drop has triggered an increase in applications for mortgage refinancing. In mid-January, refinancing applications soared 165% from the year-end 2007 level, reaching the highest level since 2004.

In the credit markets, the Fed's actions are starting to have an impact as well. The London Interbank Offered Rate (LIBOR) is the interest rate that banks charge to each other for funds. It normally trades at a slight premium above the rate on Treasury bills. Therefore, when U.S. interest rates go down, this rate also goes down. But last fall, LIBOR did not decline because of credit concerns and the so-called TED Spread (the difference between three-month LIBOR and three-month T-bills) increased substantially, which meant that the Fed's rate cuts were not making their way into the private credit markets. Now that situation has reverted to historical norms, and LIBOR is following the downward slide of Fed funds. As a result, credit is getting cheaper throughout the economy, a trend that will lead to greater borrowing in the future.

3. Exports Although domestic demand has softened during the past year, one important area that has maintained its strength has been exports. As the value of the dollar declined against many major currencies during the past five years U.S. goods have become cheaper abroad and the U.S. has become a much more attractive tourist destination. The result has been strong export growth. In the third quarter of 2007, U.S. exports were at a record high and stood 10.3% above that of a year earlier, the strongest increase since 2004 and second strongest in the past decade. In fact, the increase in exports since the third quarter of 2006 was 52% larger than the decline in housing investment. Exports are likely to continue increasing at a healthy pace in the coming year as the dollar remains low and economic growth abroad continues to boost demand for these goods and services.

Growth Outlook

When the economy slows one of three things can happen: growth can rebound, remain weak, or turn negative. Where we go from here will depend largely on sentiment, which at the moment is mixed. True, the financial services and housing sectors are weak and getting weaker, but as the profit reports of the early 2008 have shown, companies with strong overseas components are continuing to show strong growth. Our view is cautiously optimistic that the economy can get through this rough patch without descending into a full-fledged recession, but in light of the January employment data the trends are disturbing and bear careful watching. The economy is on a knife-edge and could go either way during the next several months. While we think the full effects of lower interest rates and any tax reductions that come out of Washington will be enough to support growth, the risk of recession has increased again.

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