

UCLA ECONOMIC LETTER

REAL ESTATE AND THE MACROECONOMY



A partnership between the UCLA Ziman Center for Real Estate and the UCLA Anderson Forecast sponsored by the Ziman Center's UCLA Rosalinde and Arthur Gilbert Program in Real Estate, Finance and Urban Economics

DECEMBER 2018

Monthly condensed analyses of crucial real estate and economic issues offered by UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. Here, David Shulman, Senior Economist for the Ziman Center and UCLA Anderson Forecast, previews some impacts on real estate of a financial slowdown. This Letter is presented as part of the UCLA Anderson December 2018 Economic Outlook: [Stock Volatility, Trade Wars and a New Congress](#).

Brace for Downshift: Real Estate in the Next Financial Fall

By [David Shulman](#)

After growing at a 3.1% pace on fourth quarter to fourth quarter basis, the growth in real GDP is downshifting to 2.1% in 2019 and 1% in 2020. This is consistent with our prior forecasts characterizing a 3-2-1 growth path for the economy. The downshift in growth is based upon our view that above-trend growth is difficult to achieve for an economy operating at full employment given the sub-1% growth rate in the labor force and productivity gains just above 1%. So unless we witness surprising gains in productivity, the speed limit for the economy is around 2%. Then you might ask, why are you forecasting a further slowdown to 1% in 2020?

“Although not as over-extended as the mortgage market was in the mid-2000s, the corporate debt market has the potential to trigger the next recession.”

Our explanation is that the benefits coming from the huge fiscal stimulus of tax cuts and spending increases will wane by the end of 2019, and the lagged effects of the Federal Reserve’s normalization of interest rates along with the negative effects of the administration’s trade policies will dampen growth further.

FINANCIAL TURBULENCE AHEAD

The recent volatility in stock prices appears to be signaling that the era of benign financial markets we have been used to for the past several years is coming to an end. Although most market pundits blame the increased volatility of Fed policy and a peak in the growth rate in corporate profits, when you look under the hood, you will notice perhaps more serious risks facing the financial markets, namely over-leveraged corporations and escalating trade tensions, especially with China. And do not forget the energy, social media, banking and pharmaceutical industries will soon find themselves in the crosshairs of the newly elected Congress.

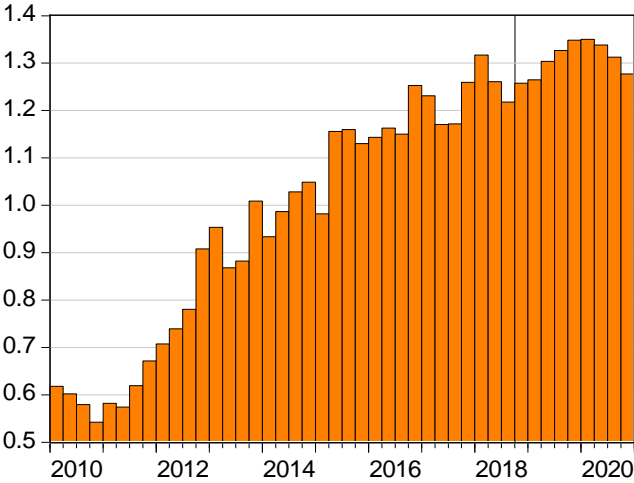
While the zero- and low-interest rate policy of the Federal Reserve helped pull the economy out of the Great Recession and later stimulated growth, it also induced corporations to leverage up. For example, AT&T borrowed \$190 billion to finance its acquisitions of Time Warner and DIRECTV. And AT&T was far from alone with such debt-financed acquisitions made by Bayer, Verizon Communications, Abbott Laboratories, Walgreens Boots Alliance, CVS and Broadcom. As a result, about half of all *investment grade* corporate bonds are now rated Baa by Moody’s, their lowest tier. That means the slightest of economic downturns can force many of these credits into “junk” territory. And this data does not take into account the huge issuance of less than investment-grade paper that has taken place over the past decade that now accounts for about half of the \$9 trillion corporate bond market.

Further exacerbating the corporate credit situation has been the “huge deterioration,” in Janet Yellen’s words, in the \$1.3 trillion leveraged loan market. Although not as over-extended as the mortgage market was in the mid-2000s, the corporate debt market has the potential to trigger the next recession. We do note that the credit risks we are discussing have only just begun to materialize in the bond market with high yield credit rising from 3.22% in early October to 4.11% in mid-November as the market responded to problems at General Electric, PG&E and oil exploration companies. **It is important to note here that the last three recessions had their origins in the financial markets.** The 2001 recession was caused by the collapse in the highflying technology/telecom shares, and the 1990 recession was caused by over-zealous lending to the commercial real estate sector.

HOUSING ACTIVITY REMAINS IN A RUT

Our main theme is that growth will gradually taper off in all of the major sectors of the economy. It looks like real consumer spending growth peaked at 4% in the second quarter and it will likely taper off to 2% by the fourth quarter of 2019 and 1.5% by the fourth quarter of 2020. Although consumer spending has been strong of late, we cannot say the same for housing activity. Put bluntly, housing activity remains in a rut. Housing starts will advance to 1.26 million units this year up from 1.21 million units in 2017. We forecast further modest gains to 1.31 million and 1.32 million units in 2019 and 2020, respectively. This level of activity lags below the 1.4-1.5 million units that we believe to be consistent with long run demand.

Housing Starts, 2010Q1 -2020Q4, In Millions of Units, SAAR



Sources: U.S. Department of Commerce and UCLA Anderson Forecast

OTHER REAL ESTATE: OFFICE ABSORPTION AND RETAIL

Although the demand for office space will remain relatively strong in 2019, the rapid slowdown in employment growth from the close to 200,000 jobs a month pace of recent years to around 50,000 jobs a month in 2020 will almost certainly weigh on office absorption. Similarly, the demand for retail space will slow with the economy, which will be exacerbated by the ongoing market-share gains coming from online shopping. We got more than a hint of that with the anecdotal evidence coming out of the Black Friday sales of this year. Moreover, the widening of credit spreads in the corporate sector will spill over to the entire commercial real estate sector thereby putting upward pressure on cap rates.

