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SIOR Commercial Markets Ride Economic Pick-up in Q3.2017

Economic activity accelerated in the third quarter of the year, building on momentum gained throughout the year. Real gross domestic product advanced at an annual rate of 3.3 percent, based on the second estimate from the Bureau of Economic Analysis. The growth rate was revised upward from an initial estimate of 3.0 percent.

The economic advance was driven by solid gains across all GDP components, with the exception of state and local governments' spending. Consumer spending—the main component of GDP—increased at a 2.3 percent rate. Consumers increased their spending on vehicles by 12.6 percent, while also opening their wallets wider for furniture and household appliances (up 7.9 percent). Spending in grocery stores was also higher in the third quarter, rising at a 3.0 percent annual rate. Spending on services increased a more modest 1.5 percent on an annual basis. However, within services, several components posted solid gains, including health care (up 4.2%), transportation (up 2.5%), recreation (up 4.1%), as well as lodging and restaurants (up 2.1%).

Business investments kept an upward trend during the past three quarters, as companies posted higher profits amid rising optimism about the prospects of tax reform. Nonresidential fixed investment increased at a 4.7 percent annual rate in the third quarter. Corporate investments in equipment advanced by double digits—10.4 percent—boosted by spending on information processing and transportation equipment, which rose 10.4 percent and 14.2 percent, respectively. Investment in industrial equipment also increased at a 7.5 percent annual rate.

Spending on intellectual property products—software, research and development—advanced by 5.8 percent in the third quarter. Investments in commercial real estate declined at a 6.8 percent annual rate, while investments in residential real estate declined at a 5.1 percent rate.

International trade also maintained momentum in the third quarter, even as the renegotiations of the North American Free Trade Agreement approached a standstill. Exports rose at a 2.2 percent annual rate in the third quarter of 2017. Imports—a negative factor in GDP calculations—declined at a 1.1 percent annual rate, leading to a positive balance of trade for the quarter.

Government spending rose by 0.4 percent on an annual basis, led by spending on federal defense. Nondefense spending was cut 0.4 percent. State and local governments' spending slid by 0.1 percent.

As economic winds gained strength, payroll employment also gained ground in the third quarter of 2017, with a net advance of 364,000 new jobs, according to the Bureau of Labor Statistics (BLS). Private service-providing industries continued as the growth engine during the quarter, with 261,000 net new jobs. Within the service industries, education and health posted the highest number of net new employees—119,000. Professional and business services accounted for the second highest number of new positions—112,000. Financial services added 34,000 new positions, supporting increased demand for office space. With the winding down of the summer vacation season, the leisure and hospitality sector lost 61,000 net positions. The retail trade sector continued retrenching in the wake of announced department store closures, with a decline of 6,500 jobs, marking the fourth consecutive quarter of job losses. The wholesale trade sector added 18,500 new jobs during the quarter, while the transportation and warehousing sector contributed 39,500 new positions to payrolls. These gains kept demand for industrial properties on an upward trend.

The unemployment rate declined from 4.7 percent in the first quarter to 4.3 percent by the end of September, based on data from the BLS. The rate declined further in October, to 4.1 percent. The number of workers employed on a part-time basis for economic reasons declined from 5.7 million in the first quarter to 5.2 million in the third quarter, the lowest figure since the first quarter of 2008. The labor force participation rate has been unchanged—despite monthly volatility—over the first three quarters, at 63.0 percent.

Consumer confidence mirrored the upswing in economic conditions and employment. The Conference Board's Consumer Confidence index advanced in the third quarter by 19.5 percent year-over-year, to 120.3, the highest quarterly value since the fourth quarter of 2000. The value for November 2017 was even higher, at 129.5, indicating continued optimism about the current economic environment. Separately, the Consumer sentiment index compiled by the University of Michigan notched an increase in the third quarter of the year to 95.1, compared with the 90.3 value from the third quarter of 2016. Similarly, the index continued rising in the first months of the fourth quarter, reaching 98.5 by November.

SIOR Index Results

Based on the SIOR Commercial Real Estate Index, commercial fundamentals displayed improving conditions, in keeping with the broad economic activity. The SIOR CRE Index, representing third quarter 2017 data, increased 0.3 points from the second quarter of 2017. Compared with the prior year, the index rose by 7.0 percent. The national index, based on 10 variables pertinent to the performance of U.S. industrial and office markets, closed at 127.3. An index value of 100 shows a balanced market, meaning that the current value of the national index is pointing to growing conditions, having surpassed its historical average. The figure represents the highest value since the index's inception in 2005, and the fourteenth quarter with a value above the 100-point threshold since the Great Recession.

Conditions in office and industrial markets diverged slightly. The office index increased from a value of 112.3 in the second quarter to 116.0 in the third quarter. On a yearly basis, the office index recorded a 10.0 percent advance. The industrial sector slide from the prior quarter, with the index recording a value of 134.9, but advanced 6.2 year-over-year.

On balance, SIOR members reported moderate gains in fundamentals.

- Leasing activity exceeded historical levels for 58 percent of SIORs who responded to a market survey.

- Rents showed signs of stabilization—35 percent ascertained that rents were above historical trends. Meanwhile, 61 percent indicated that rents were in line with long-term averages, and 4 percent of SIOR members considered that asking rents were below those of one year ago.

- Vacancies continued declining, with 75 percent of respondents reporting lower availability rates.

- Subleasing availability declined, with only 4 percent of SIOR respondents feeling that there was ample sublease space in their markets; 64 percent considered subleasing to have a small influence on the market.

- New construction of office and industrial spaces picked up, with 43 percent of SIOR members reporting new construction during the quarter, and 22 percent indicating new building development close to historical averages.

- Development conditions continued shifting in favor of sellers during the period, with 62 percent of SIORs rating it a seller's market. Investment prices increased slightly, with 38 percent of respondents indicating prices were above construction costs.

Local economies advanced during the quarter, with 62 percent of SIOR respondents indicating that their local economies were strong and improving. Only 5 percent of SIOR members felt that their local economy was slowing or contracting. As the national economy picked up speed, it brightened the local markets, with 60 percent of SIOR responses indicating a positive impact upon markets. In contrast, only 5 percent of SIOR respondents experienced a negative impact upon their markets from national economic conditions (the remainder was neutral).

Regionally, the survey respondents pointed to mixed conditions during the period. The West retained the highest quarterly index value—134.9. The region also posted the second highest yearly gain, at 12.2 percent. The South region came in second, with an index value of 134.3, a 2.9 percent gain over the prior year. The Northeast recorded the highest yearly advance, with a 13.0 percent gain. The Midwest posted a 2.8 percent advance from a year ago, with an index value of 126.8. Looking ahead at the last quarter of 2017, the majority of SIOR members expect the outlook to improve—69 percent of respondents indicated growth in the 1-15 percent range, while 29 percent felt the markets would maintain current levels. Only 3 percent of SIOR members expected conditions to decline.

Methodology

The SIOR Commercial Real Estate Index is constructed as a "diffusion index," a very common and familiar indexing technique for economic measures. Other examples of diffusion indexes include the Index of Leading Economic Indicators, the Consumer Confidence Index, and the Institute of Supply Management's Purchasing Managers' Index. In the SIOR Commercial Real Estate Index, a value of 100 represents a well-balanced market for industrial and office property. Values significantly lower than 100 indicate weak market conditions; values significantly higher than 100 indicate strong market conditions. The theoretical limits of this Index are a low of zero, and a high of 200, though it is unlikely that such limits would be approached as long as the property markets are operating efficiently.

The Index is based on a survey questionnaire with ten topics. The topics covered are (1) recent leasing activity; (2) trends in asking rents; (3) trends in vacancy rates; (4) subleasing conditions; (5) levels of concession packages in leases; (6) development activity; (7) site acquisition activity; (8) investment pricing levels; (9) the impact of the local economy on the property market; and, (10) the effect of the national economy on the property market. Survey respondents are given five choices. For each topic, five choices are provided, corresponding to conditions that are very weak, moderately weak, well-balanced, moderately strong, or very strong.

For each question, answers are tallied and the percentage of responses for each of the five choices is calculated. If survey panelists indicate "very weak" conditions (the "a" choices in the questionnaire), the answer is assigned 0 (zero) points; "moderately weak" ("b" answers) earn 5 points; an indication of "market balance" ("c") receives 10 points; "moderately strong" indications ("d") score 15 points; and "very strong" ("e") responses receive a maximum 20 points. Thus a score of 10 for a given question can be earned if responses are evenly distributed across all five choices, if all responses were "c", or if the answers form a "bell-shaped curve" centered around the "c" choice. The total index value is derived by summing the scores for all ten questions. Index values for each of the two property types are similarly calculated.

The survey was developed by Hugh F. Kelly, CRE, clinical professor at New York University, who worked with SIOR on research projects since 1989.

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