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SIOR Commercial Markets Benefit from Employment Gains in Q2.2017

Sept, 2017—WASHINGTON, DC — At the midpoint of 2017, the United States economy picked up the pace. In the wake of a middling first quarter, characterized by a weak 1.2 percent annual growth rate, real gross domestic product advanced at an annual rate of 3.0 percent, based on the second estimate from the Bureau of Economic Analysis. The growth rate was revised upward from an initial estimate of 2.6 percent, due to higher consumer spending and an increase in business investments. However, the economy remains on a modest growth trajectory, even before the impact of the recent hurricane Harvey is tallied.

The economic advance received a boost from solid gains across all GDP components, with the exception of state and local governments' spending. Consumer spending—the main component of GDP—rebounded from the soft first quarter, to notch a 3.3 percent annual gain during the quarter. The start of the summer season brought increased consumer confidence, reflected in the pace of spending. Consumers increased their spending on furniture and household appliances by a 9.9 percent annual rate, while upping their purchases of recreational goods and vehicles by 14.0 percent. Spending on clothing and shoes also posted a noticeable 10.6 percent annual rate jump. Car sales rose by a 3.4 percent annual rate, a slower pace than the prior year. But, based on available third quarter data, auto sales showed signs of weakening. Spending on services rose 2.1 percent on an annual basis, with housing, health care and financial services leading the modest gains.

Business investments offered a solid contribution to GDP during the past two quarters, as companies remained cautiously optimistic about the prospects of a smaller federal regulatory footprint. Nonresidential fixed investment increased at a 6.9 percent annual rate. Companies increased their investments in equipment—with double-digit advances for information processing and industrial equipment. Spending on intellectual property products—software, research and development—advanced by 4.9 percent in the second quarter. Investments in commercial real estate rose at a 6.2 percent annual rate, while investments in residential real estate declined at a 6.5 percent rate.

With the process of renegotiating the North American Free Trade Agreement looming, international trade remained on an upward trend. Exports rose at a 3.7 percent annual rate in the second quarter of 2017. They were offset by imports—a negative factor in GDP calculations—which also increased, at a slower 1.6 percent annual rate.
Government spending slid by 0.3 percent on an annual basis, following cuts in federal nondefense as well as state and local spending. Federal government spending increased by 1.9 percent, as defense spending received a 4.7 percent boost. State and local governments' spending slid by 1.7 percent.

With economic activity on an upswing, payroll employment notched a positive second quarter of 2017, with a net gain of 562,000 new jobs, according to the Bureau of Labor Statistics (BLS). Private service-providing industries continued as the growth engine during the quarter, with 480,000 net new jobs. Within the service industries, professional and business services posted the highest number of net new employees—140,000. Financial services added 41,000 new positions, supporting increased demand for office space in the second half of the year. Ramping up for the summer travel and vacation season, the leisure and hospitality sector added the second-highest number of net new positions—131,000, followed by education and health, with 122,000 net new payroll jobs. The retail trade sector continued retrenching in the wake of announced department store closures, with a decline of 18,100 jobs. The wholesale trade sector added 17,400 new jobs during the quarter, while the transportation and warehousing sector contributed 26,400 new positions to payrolls. These gains supported a solid industrial property sector, which has been a high performer during this real estate cycle.

The unemployment rate declined from 4.7 percent in the first quarter to 4.4 percent by the end of June, based on data from the BLS. The rate was flat as of August. The number of workers employed on a part-time basis for economic reasons declined from 5.7 million in the first quarter to 5.3 million in the second quarter, the lowest figure since the first quarter of 2008. The tightening labor market, however, has yet to translate into accelerating wages.

Following advances in employment, consumer confidence continued riding an upward wave. The Conference Board's Consumer Confidence index advanced 24.6 percent year-over-year, to 118.1, the highest value since the fourth quarter of 2000. The value for August 2017 was 122.9, indicating growing optimism about the outlook. Separately, the Consumer sentiment index compiled by the University of Michigan notched an increase in the second quarter of the year to 96.4, compared with the 92.4 value from the second quarter of 2016.

SIOR Index Results

Commercial real estate investment markets returned to diverging trends during the second quarter. Deal volume declined in large cap markets by 5.0 percent, totaling $109.2 billion in transactions. In comparison, sales volume in small cap markets advanced 4.4 percent during the second quarter, fueled by continued interest in higher yielding properties in strong secondary and tertiary markets. Meanwhile, based on the SIOR Commercial Real Estate Index, commercial fundamentals offered mixed performance during the quarter. The SIOR CRE Index, representing second quarter 2017 data, increased a modest 0.9 points from the first quarter of 2017. Compared with the prior year, the index rose by 3.2 percent. The national index, based on 10 variables pertinent to the performance of U.S. industrial and office markets, closed at 127.0. 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 thirteenth quarter with a value above the 100-point threshold since the Great Recession.

Conditions in office and industrial markets diverged. The office index declined from a value of 114.1 in the first quarter to 112.3 in the second quarter. On a yearly basis, the office index recorded a 2.3 percent decline. The industrial sector picked up speed, with the index recording a value of 135.1, a gain of 6.6 year-over-year. The industrial sector recorded its highest quarterly value since the inception of the SIOR index, riding a growing wave of demand for warehouse and distribution space. On balance, SIOR members reported moderate gains in fundamentals.

- Leasing activity exceeded historical levels for 57 percent of SIORs who responded to a market survey.
- Rents rose for office and industrial properties—77 percent ascertained that rents were above historical trends. Meanwhile, 20 percent indicated that rents were in line with long-term averages, and 3 percent of SIOR members considered that asking rents were below those of one year ago.
- Vacancies continued declining, with 69 percent of respondents reporting lower availability rates.
- Subleasing availability declined, with only 8 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 18 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 45 percent of respondents indicating prices were above construction costs.

Local economies advanced during the quarter, with 65 percent of SIOR respondents indicating that their local economies were strong and improving. Only 6 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 58 percent of SIOR responses indicating a positive impact upon markets. In contrast, only 4 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 recorded the quarter's high mark and its highest value on record—135.1. The region also posted the highest comparative yearly gain, at 5.1 percent. The South region came in second, with an index value of 127.2, a scant 0.5 percent gain over the prior year. The Northeast recorded the highest yearly advance, with a 4.9 percent gain. The Midwest posted a 1.6 percent advance, with an index value of 124.2.

Looking ahead at the third quarter of 2017, the majority of SIOR members expect the outlook to improve—62 percent of respondents indicated growth in the 1-15 percent range, while 31 percent felt the markets would maintain current levels. Only 7 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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