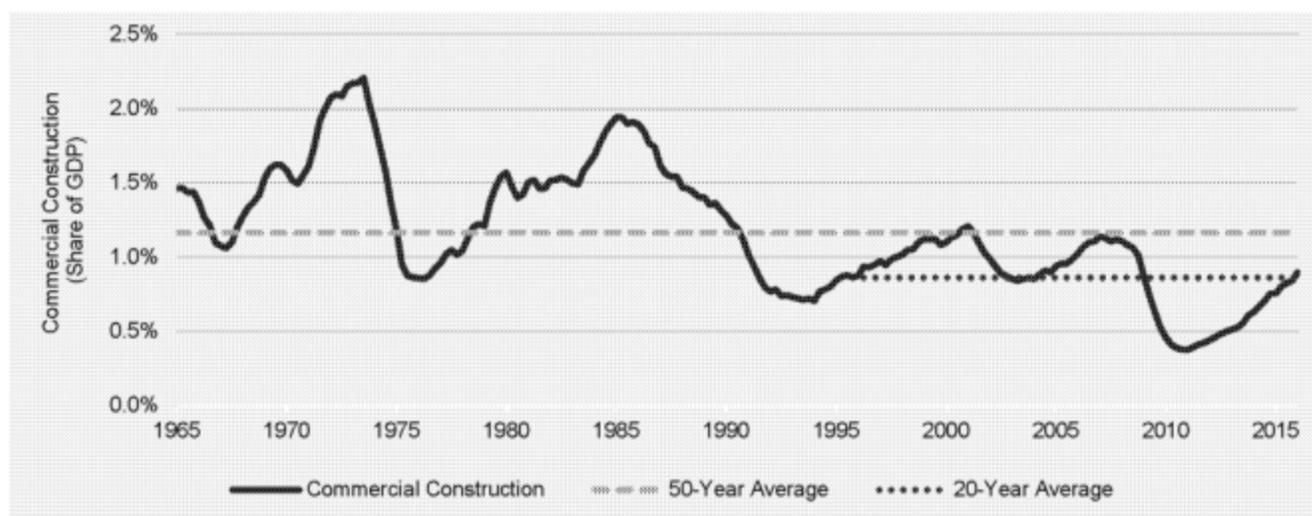


Economic and structural forces are expected to support CRE demand, with some modest shifts around the margins: With the unemployment rate below 5%, job creation will likely ease from its heady pace of the past two years, even though population growth and low participation rates leave room for further gains. Slower job growth could temper office absorption, although intensifying competition for talent should underpin demand for quality space. A stabilizing homeownership rate (as Millennials in their mid-30s contemplate home-buying) may dampen apartment absorption. At the same time, a tighter labor market will likely put further upward pressure on wages, fueling consumer spending. Some brick-and-mortar retail will struggle to benefit as sales of goods move online, but necessity and service-oriented centers should fare well. And strong consumer spending, cheaper imports (thanks to the strong dollar), an expanding housing and home renovation market, and e-commerce distribution should support warehouse absorption.

2.2 Real Estate Supply

Real estate development is gathering momentum, but it remains generally under control both relative to demand and historical levels (see Exhibit 3). On a national basis, construction of multifamily and commercial space totaled 0.9% of GDP in the first quarter 2016, in line with its 20-year average (0.8%) and close to the lows set in 1994 (0.7%) and 2001 (0.9%).⁹ To be sure, aggregate national numbers overlook pockets of potential oversupply: multifamily starts have reached their highest levels since the 1970s and a handful of office markets are at risk.¹⁰ But in general, real estate conditions are balanced and appear poised to remain so.

Exhibit 3: Commercial Construction



Source: Bureau of Economic Analysis. Data as of March 2016

In our view the benign supply picture in part reflects the heterogeneous nature of the recovery. In many markets, prices have not increased enough to justify new construction (i.e., it is still less expensive to buy a building than to build one). In markets where prices have rebounded sufficiently, including several coastal metros, land constraints, rigid planning regimes, and labor shortages have delayed the supply response. Lenders have also been cautious about financing development: in its second quarter 2016 survey, the Federal Reserve reported that a net 25% of banks were tightening lending standards on commercial development loans, likely in response to stringent regulatory oversight.¹¹ These hurdles will lift over time: San Francisco, Austin, and Charlotte are expected to see a significant increase in office supply over the next two years. However, on a national basis the pickup is expected to be gradual.

⁹ Bureau of Economic Analysis. Data as of March 2016.

¹⁰ Census Bureau. Data as of May 2016.

¹¹ Federal Reserve Senior Loan Officers Survey. Data as of June 2016.