Cassidy Turley Commercial Real Estate Services

U.S. Macro Update

June 2012

It's the Euro-(not the U.S.)-crisis, Stupid

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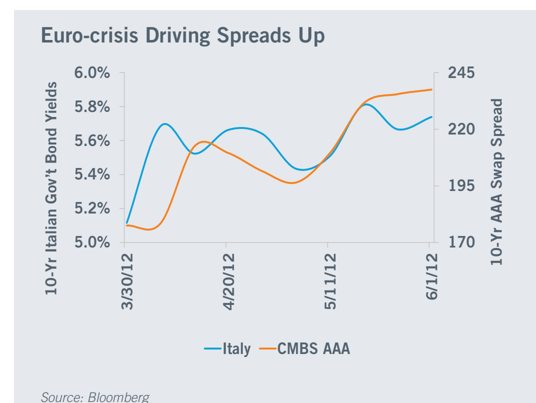
- European sovereign debt yields back in dangerous territory
- U.S. 10-Year Treasuries hit record lows and will likely go lower
- The U.S. is insulated from global external shocks, but it is not immune
- Oil prices down to $83 per barrel – an important tailwind
- CRE recovery hangs in the balance of Europe's policy decisions

The threat of disorder in – or even an outright breakup of – the euro-zone is once again dragging down global economic growth. Greek 10-year debt yields have blown out, over 30%; both Italy and Spain are trending closer to the point of financial insolvency. Growth in China's economy, the world's second largest, is slowing; in May, China's manufacturing index fell to its lowest level since November of 2011 -- a clear indication that global demand is weakening. The U.S. economy, while proving to be insulated from the external shocks, is not immune. As of June 1, 2012, U.S. equity markets had given back nearly all of their gains of the year so far. U.S. real GDP growth in the first quarter of the year was revised downward to 1.9% – well below potential, and job creation is decelerating as we enter into the summer months. Likewise, commercial real estate has experienced a similar soft patch. CMBS spreads widened across the board in May, though mostly driven by falling Treasuries rather than rising cap rates. Still, cap rates are no longer moving down. A preliminary look at second quarter data reveals that demand for both office and industrial space is slowing.

The U.S. recovery is wobbling, but the economy is still expanding. Through May, real GDP was on track to grow by 2% in the second quarter of 2012. According to Moody's, the latest odds of a recession occurring in the U.S. in the near term are just slightly higher than 1 in 4 -- still a long way from the near 50% probability back in September of 2011. More signs point to growth than to contraction. Most encouraging, the housing market is continuing to make steady improvement, the U.S. manufacturing sector, although slowing, remains in expansion, oil and gas prices are dropping back, and consumers continue to spend. However, the path ahead for the economic recovery and by extension the health of the U.S. property markets will depend largely on policy decisions made in Europe.

Euro-crisis Not Going Away

We are down to a coin toss to determine whether or not Greece will exit the euro-zone. A Greek departure, viewed in isolation, would be manageable. Greece has roughly $500 billion in debt, which accounts for less than 3% of EU GDP, and most of the financial world has already written down the bulk of their expected losses. Indeed, many argue that a return to a new devalued drachma in Greece is the best option available from a large list of terrible ones. However, the fallout that may ensue is unpredictable, with one scenario ending in a massive run on European banks and ultimately a break-up of the euro-zone. Some estimate that a full break-up would cost a core country in Europe (e.g., Germany or France) 20-25% of its GDP in the first year[1]. Just the fear of this scenario is already driving up sovereign debt yields in most of Europe's peripheral countries, making the cost of servicing their existing debt too high to maintain fiscal sustainability.



Source: Bloomberg

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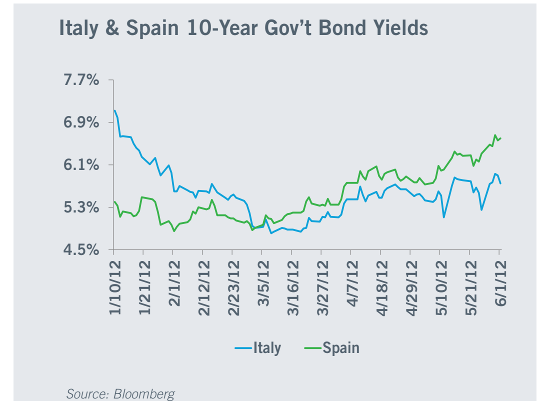


Source: Bloomberg

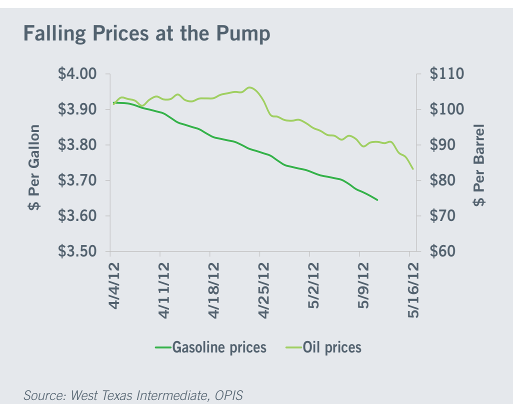
Spanish 10-year debt yields have increased 150 basis points (bps) since March to 6.5% in June. Italian 10-year debt yields are up 100 bps to 5.7% during the same time period. Both Italy and Spain, which have the third and fourth largest economies in the euro-zone, are walking a very fine line between solvency and default, or some other extreme economic reform.

The U.S. economy is somewhat insulated from the euro-crisis and is healthy enough to survive a mild European recession. Only 14% of all U.S. exports are to the euro-zone, and the bulk of them go to countries with the healthier economies (Germany and France). The financial links are more troublesome, but are also murkier. Total direct exposure of U.S. banks to the euro-zone periphery is only 12% of tier 1 capital[2]. Again, most U.S. financial institutions have already written down most of their debt exposure to the weakest economies. However, if a Greek departure from the euro-zone leads to a cascading set of defaults and a run on most European banks, then U.S. banks stand to get crushed. U.S. banks' direct exposure to the entire euro-zone is $729 billion, closer to 60% of tier 1 capital[3].

Our current assumption is that European policymakers along with the European Central Bank (ECB) and International Monetary Fund (IMF) will do enough to avoid a deep, protracted recession in the euro-zone and the U.S. economic recovery will continue. Conversely, if the euro-crisis morphs into a severe recession, the recovery in the U.S. ends, and a new recession begins. The next Greek parliamentary election is scheduled for June 17th – when Greece will once again attempt to form a coalition government and negotiate its future status in the euro-zone. That will be the next moment of clarity, one way or another.

More Tailwinds than Headwinds

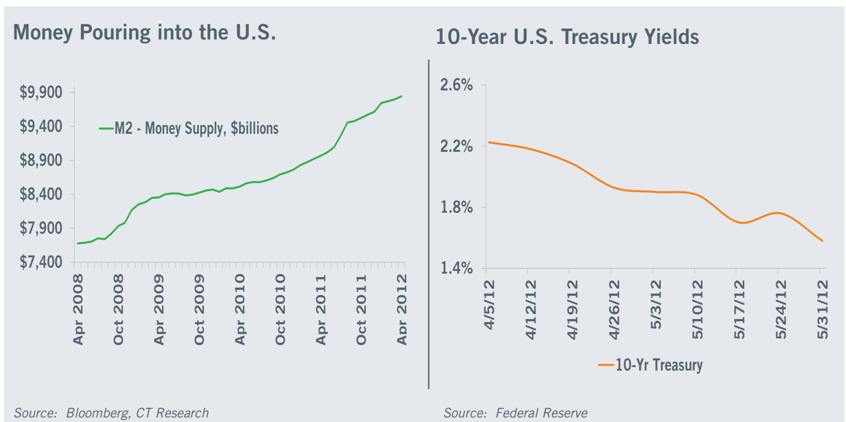
Even as risks mount, the U.S. economic recovery has made significant progress, and the wind is at its back in a number of areas. One reason for the recent slowdown in economic growth is related to spiking gas prices, which were pushing close to $4.00 per gallon in April. Nationally, gas prices are averaging $3.67 per gallon in early June. It's encouraging to note that every 1 cent *decrease* in the price of a gallon of gasoline is followed by a $1.3 billion increase in consumer spending -- and every $1.3 billion increase in spending typically results in the creation of 31,000 net new jobs.



Source: West Texas Intermediate, OPIS

It is also encouraging to note that the monetary aggregates are growing rapidly again. The M2 money supply -- a snapshot of the total quantity of money circulating in the U.S. economy – has been growing at a rapid rate of 10% since August of 2011. The M2 growth is no longer being engineered by the Federal Reserve (QE2 ended in June of 2011), but rather from fresh capital that is pouring into the U.S. economy from overseas, and in particular, from Europe. The 10-year Treasury yield was down to a record low of 1.45% on June 1, 2012. Leading up to the Greek election, it could go as low as 1%. It is only a matter of time before this downward pressure on rates trickles down to other areas of the economy (credit cards, mortgages, etc.) which should bolster consumer spending.

Moreover, given the recent string of weak economic data, the odds of another round of monetary stimulus (QE3) are rising. Given the fear of future inflation, the next round of stimulus may come in the form of sterilized intervention (printing money to buy long-term mortgages or treasury bonds, while selling short-term loans).



The latest U.S. employment numbers were clearly disappointing, but they should not have caused the panic that ensued. The U.S. economy created a paltry 69,000 net new (non-farm payroll) jobs in May. On the day the jobs report was released, the DJIA plunged 275 points and the CBOE volatility index climbed to a new high for the year. We know that the Bureau of Labor Statistics' employment figures are often subject to huge revisions. We also know that part of the slowdown in job growth was due to seasonal factors (payback from the warmest winter season on record). Most analysts (including us) caution about reading too much into the monthly job numbers, particularly for the most recent month for which figures are released. A simple average is more informative, since it smooths out monthly volatility. On average, the U.S. economy is creating 164,000 net new jobs per month in 2012, which is consistent with GDP growth of approximately 2%. To be clear, job growth is slowing, even the recent numbers are far from a level that would indicate the recovery is falling apart. In the same week when we received the May employment figures, we also learned that construction spending is still rising, the U.S. manufacturing sector still expanding, and consumer spending is still growing modestly.

Same but Different

Given the strong start to the 2012 that was followed by a quick retreat, it is tempting to draw parallels to the recovery flop of last year. Even if that were the case -- that is, even if the U.S. economy performs only as well as it did in 2011, it is worth remembering that last year was a year of notable progress for the property markets. When all was said and done, the U.S. economy grew by 1.7% in 2011 and created 1.5 million jobs during the year. The office sector generated 52.2 msf of net demand, and vacancy declined by 60 bps. The industrial sector generated near 100 msf of net demand, and vacancy declined by 60 bps. Even if this year is just a redux of last year, it will be another year where commercial real estate continues on a path towards increasingly stronger fundamentals.

Most indications still suggest it will not be a replay. There is clear evidence that the U.S. economic recovery has matured in a number of areas, and momentum will continue to build as we create more distance from the recession. Very few analysts, if any, are calling for robust growth, but the consensus is calling for GDP growth between 2% and 3% in 2012. It's not something to jump up and down about, but the odds still point to continued progress.

[1]UBS: Euro break up - the consequences, September 6th 2011

[2]Capital Economics - How would break-up of the euro affect the rest of the world, May 23rd 2012

[3]Capital Economics - How would the US cope with a euro break-up, February 8th 2012