Insights: Euro-Crisis Restrains Optimism for Commercial Real Estate

by Kevin Thorpe & Keith Zeff

The economic data from around the world is turning increasingly more upbeat. From rallying global equity markets to rebounding manufacturing indices to easing credit markets to revved up U.S. employment reports – things seem to be clicking, with most signs pointing towards an accelerating recovery. Property markets, too, have seen a similar streak of better data. Since October of 2011, demand for space has been generally rising, vacancy has been generally trending downward, and the 10-yr AAA swap spread has tightened by nearly 150 bps.

Still, no matter how strong the recent data appear, the euro-crisis continues to restrain optimism. On January 24, 2012, the IMF revised its global GDP forecast for 2012 downward by nearly ¾ of a percentage point – to 3.25% -- citing "downside risks are intensifying" with an emphasis on dim prospects for growth in the euro-zone. Likewise, even as economists slowly revise their forecasts upward for 2012, most continue to cite the euro-crisis as one of the principal threats to the U.S. economic recovery.

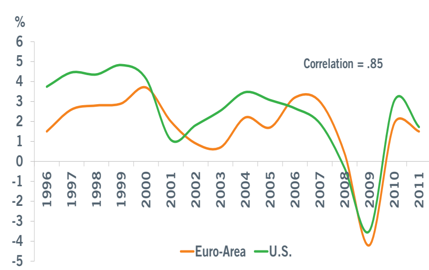
In this paper, we examine the economic ties between the U.S. and the European Union (EU). We also discuss the potential impact different European scenarios will have on the property market recovery and which U.S. local markets have the most exposure to developments in the euro-zone.

Economic Relationship between the U.S. & the EU

The euro-crisis represents a significant downside risk to the U.S. economic recovery. There is a .85 correlation between Europe's GDP and U.S GDP. Thus, the historical relationship suggests that if Europe sinks into recession, so too will the U.S. Another indication of the strong ties between the EU and the U.S. can be observed through mutual investment stocks. [1]Total U.S. investments in the EU are three times

U.S. & Europe Often Move in Tandem

U.S. Real GDP vs. 17 Country Euro-area GDP



Source; IMF, U.S. Census Bureau

higher than in all of Asia, and the EU investment in the U.S. is around eight times the EU investment in India and China combined. Although trade links represent a potential drag on the U.S. economy, they are not the principal threat. The bigger concern is with the banking sector. [2]U.S. banks have an estimated 16.9% of their existing capital exposed to the peripheral countries in the euro-area and 77% of their capital exposed to the entire euro-zone. Thus, if defaults in a few peripheral countries (Italy, Portugal, and Greece) result in a cascading effect that sinks banks elsewhere in Europe, then that will reverberate in the U.S. and potentially sink the entire global financial system.

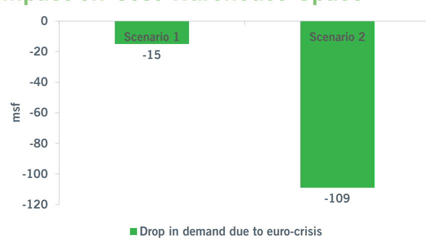
Despite such a gloom and doom scenario, there have indeed been some positive developments in Europe. The European Central Bank's (ECB's) long-term refinancing operation (LTRO) – which provided unlimited funds to European banks for 36 months at an interest rate of 1% - has been effective at lowering long-term bond yields in some countries. For example, Italy's 10-year government debt yield has dropped from an alarming 7.3% in November of 2011 to under 5.5% by the end of February of 2012. Most encouraging, at the recent Brussels Summit, leaders of the European Union governments agreed on important measures that move the region closer to a stronger fiscal union. Among other provisions, member states' annual budget structural deficits must not exceed 0.5% of GDP; those exceeding a 3% deficit ceiling may be subject to sanctions; and the euro-zone's permanent bailout fund is scheduled to take effect in July 2012. In addition, European leaders pushed through a second emergency aid package for debt-stricken Greece.

Impact on the Industrial Sector

To assess the potential impact on the industrial sector, let's look at this from a trade perspective. The World Bank has defined two "downside scenarios" for the euro-zone, which we use in the analysis. In the first, the euro-crisis is assumed to be "contained," impacting only one or two small euro economies equal to about 4% of euro-zone GDP. In the second scenario, the freezing of credit is assumed to spread to two larger euro-zone economies equal to around 30% of euro-zone GDP. Trade between the U.S. and the EU in 2010 accounted for about 13.5% of U.S. exports and 16.3% of U.S. imports. Under the first scenario above, U.S. export volume would decline by $11.3 billion; under the second scenario the decline would be $84.7 billion.

If we assume that the industrial warehouse market mirrors the GDP equation (the ratio of goods exports to total GDP goods is a fair proxy for the percentage of warehouse space that is utilized for international trade), then we estimate that 29% of all U.S. warehouse space is utilized for international trade. Delineating further, there is currently 11.1billion square feet of industrial warehouse space in the U.S., 3.2 billion of which is utilized for international trade, and 364 million square feet for trade just with Europe. Thus, under scenario 1 above, where trade volume is reduced by 4% due to the euro-crisis, demand for industrial space would decline by just 15 million square feet (vacancy would rise by 20 bps). Under scenario 2, where trade volume is reduced by 30%, demand for industrial space would decline by 109 million square feet (vacancy would rise by 160 bps). It would hit certain local markets harder than others. The impact on warehousing would be concentrated primarily in New York/New Jersey, Baltimore, Savannah, Norfolk, and Charleston, which account for th great majority of East Coast containerized trade.

Impact on U.S. Warehouse Space



Source; Bureau of Economic Analysis, IMF, Cassidy Turley

Impact on Office Sector

The interrelationship between European banks and U.S. banks is already having an impact on the office sector. While the U.S. economy overall has been adding jobs at an accelerating rate, the financial sector has generally seen declining employment figures since the summer, down by about 3,000 jobs since May of 2011. That equates to approximately 600,000 square feet of office space rendered empty.

Table 2 presents data on the 20 largest office markets in terms of rentable office space. The right-hand column shows estimates of square feet occupied by selected service and banking sectors in each market. The service sectors include accounting and other consulting services which might see reduced demand from European countries.

Exposure risk will vary by market. New York City, with 16.6% of total employment in the specified sectors at risk, has the highest exposure. In a worst-case scenario, 25% of the selected sectors' space in New York, or 4.2% of total occupied space, would be at risk from exposure. Interestingly, despite the ongoing challenges related to the financial sector, New York still absorbed 4.2 million square feet of office space in 2011, second only to tech-charged San Jose-Silicon Valley. Growth in New York's technology sector, health services, and professional and business services has more than offset the declines in financial services, thus far.

In addition to the direct impact on office space, the euro-crisis continues to negatively impact the debt markets. CMBS issuance has generally been slow since October of 2011 (when Greece was dominating the headlines), posting just $1 to $2 billion per month versus $4 to $5 billion in the first half of 2011. According to the January 2012 Federal Reserve Senior Loan Survey, 46.4% of

Table 1: Exports and Imports as a Share of U.S. GDP

	2011 ($Billions)	2010 % w/EU	Est. 2011 $ w/EU	% of 2011 U.S. GDP	Scenario 1: 4% Reduction	Scenario 2: 30% Reduction
U.S. GDP	15087.7					
Exports	2087.6	13.5%	282.2	1.9%	1.8%	1.3%
Goods	1474.4	11.4%	168.1	1.1%	1.1%	0.8%
Services	613.2	18.6%	114.1	0.8%	0.7%	0.5%
Imports	2665.8	16.3%	432.9	2.9%	2.8%	2.0%
Goods	2239.5	16.8%	376.2	2.5%	2.4%	1.7%
Services	426.2	13.3%	56.7	0.4%	0.4%	0.3%

Source: IMF & Cassidy Turley Research

nonfinancial companies with significant exposure to European economies indicated they have tightened lending standards.

European Policy Is the Key

As of this writing European policymakers were inching towards a comprehensive plan towards long-term fiscal sustainability. There has been significant progress. The new government in Italy is opening discussions on labor law reform that have been off-limits for decades. Spain's new government, faced with an economy registering 23% unemployment, has proposed reforms that reduce businesses' employment costs, making them more competitive exporters. Although there is no shortage of political bickering, most polls show that the majority of Europe is intent on doing what it takes to keep the euro-zone together under one currency.

For the U.S. economic recovery, things are starting to look very right. Unfortunately, it would not take many missteps from Europe to make things go very wrong.

[1] *Source: European Commission Directorate-General for Trade, BEA*

[2] *Source: Capital Economics*

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Table 2: Employment in Selected Sectors for 20 Largest U.S. Office Markets

	Location	Total Nonfarm Employment 2011	Financial Activities % of total nonfarm	Professional, scientific, technical services % of total nonfarm	Total Occupied Office SF	Occupancy for Financial, Professional, Scientific & Technical Sectors
		(000s)			Q4 11	SF
1	New York, NY	8326.4	8.8%	7.8%	400,943,269	66,556,583
2	Los Angeles, CA	5151.1	6.0%	6.9%	167,501,046	21,607,635
3	Chicago, IL	4274.9	6.7%	6.4%	199,629,693	26,151,490
4	Dallas, TX	2925.9	8.1%	6.4%	160,767,773	23,311,327
5	Philadelphia, PA	2696.6	7.4%	7.5%	97,477,268	14,524,113
6	Houston, TX	2590.8	5.2%	6.9%	184,256,618	22,295,051
7	Boston, MA	2463.0	7.0%	9.2%	128,117,292	20,755,001
8	Washington DC	2419.6	6.2%	16.3%	109,809,371	24,707,108
9	Atlanta, GA	2242.0	5.8%	7.7%	146,351,002	19,757,385
10	Seattle, WA	1666.5	5.3%	6.8%	72,357,015	8,755,199
11	San Diego, CA	1239.5	5.5%	9.8%	59,371,495	9,083,839
12	Tampa, FL	1129.1	7.9%	7.2%	61,078,809	9,222,900
13	Denver, CO	1021.2	8.6%	10.3%	145,961,989	27,586,816
14	Central New Jersey	974.0	5.9%	8.7%	86,920,353	12,690,372
15	Northern New Jersey	966.2	7.1%	8.4%	125,688,755	19,481,757
16	Oakland-East Bay, CA	946.4	4.9%	8.7%	89,532,371	12,176,402
17	San Francisco, CA	942.4	13.0%	22.3%	73,354,739	25,894,223
18	San Jose-Silicon Valley, CA	874.2	3.5%	12.4%	169,121,106	26,890,256
19	Charlotte, NC	803.8	8.7%	5.6%	83,383,455	11,923,834
20	Sacramento, CA	802.1	5.9%	6.3%	69,503,330	8,479,406

Source: U.S. Bureau of Labor Statistics