Insights: Will the Office Sector Fall Off of the Fiscal Cliff?

It seemed like a reasonable deal at the time. In August of 2011 a select committee, dubbed the "Super-committee," was created with the sole purpose of recommending a series of fiscal policies to reduce the deficit and achieve fiscal sustainability. If the committee failed, the federal budget would be automatically reduced by $984 billion over the next 10 years (a law procedure called sequestration), with 50% of the cuts going to defense and 50% going to non-defense programs. On November 21, 2011, the committee issued a statement saying that they had failed to reach a bipartisan agreement. The sequestration cuts are now scheduled to kick in on January 2, 2013. On top of that, there is a debate over the Bush-era tax cuts and other tax policies that will expire on the same day. So here comes the "fiscal cliff," possibly.

The phrase "fiscal cliff" was coined by Ben Bernanke, Chairmen of the Federal Reserve, in describing the impact of budget sequestration and tax increases on the U.S. economy, effectively causing a new recession to occur. The Congressional Budget Office (CBO) agrees. They estimate that the new policies will cause real GDP to contract by 0.3% in 2013. However, the CBO acknowledges the possibility of avoiding the cliff if policymakers adopt alternative solutions. In this paper, we review the various scenarios and evaluate the impact each scenario would likely have on the commercial real estate (CRE) markets.

CBO proposes two scenarios.

Scenario 1: Fiscal Cliff (30% probability)

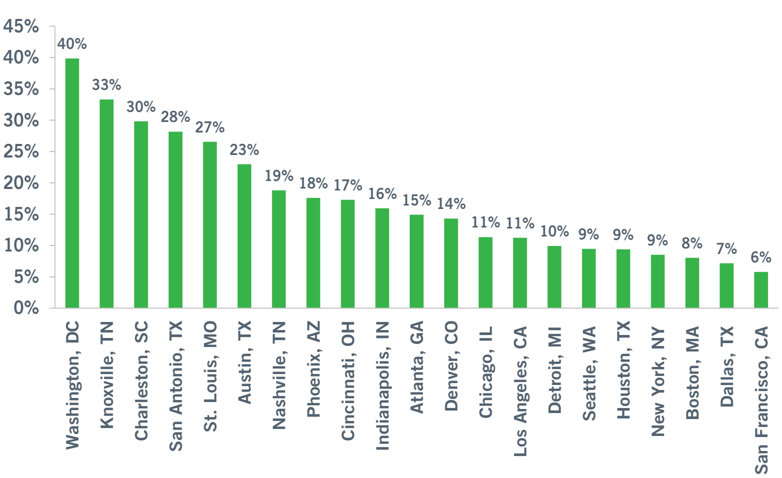
This scenario assumes that the U.S. continues with the policies that were signed into law as part of the Budget Control Act of 2011, along with the expiration of the Bush-era tax cuts. On the upside, the fiscal cliff scenario would reduce the deficit by $641 billion in 2013. On the downside, raising taxes and cutting spending would create a substantial drag on growth in the short-run. Real GDP would shrink a sobering 3.9% in the first quarter of 2013. Under this scenario, the unemployment rate would rise to over 9% by the end of 2013. Capital Economics, a research group based out of Toronto, put the odds of the fiscal cliff occurring at 30%.

We tend to agree that the odds are low. Given that neither party wants a new recession pinned on them, there is a clear incentive to work out a deal that would effectively take the fiscal cliff off of the table. However, given the heightened animosity in Washington, DC, right now, there is no guarantee that a deal will be worked out before or right after the election.

Figure 1 depicts the markets with the strongest links to federal spending. Assuming the sequestration cuts are done evenly across the board, Washington, DC, will likely take the hardest hit should the policies remain in place. On the contrary, San Francisco is the least dependent on federal funding of the major metros.

Figure 1: Markets with Greatest Exposure to Sequestration

Federal Spending as % of local GDP



Source: BEA, CFFR

Table 1: Fiscal Cliff Scenario

	2011	2012	2013
US Economy			
Real GDP (a)	1.7	1.9	-0.3*
Nonfarm Employment (b)	1,503	1,772	-796*
Unemployment Rate	9.0	8.1	8.8*
U.S. Office Sector			
Net Absorption (c)	52.0	49.4	-2.6
Vacancy Rate	16.4%	15.6%	15.8%
Asking Rents	$21.41	$21.69	$21.25

**Moody's Analytics, Inc. forecast. All other forecasts are from Cassidy Turley.*
(a) - Annualized growth rate
(b) - Thousands, SA Yr/Yr Chg.
(c) - Millions sf

Scenario 1: Impact on CRE

If the fiscal cliff is allowed to occur, we estimate demand for U.S. office space will register at negative 2.6 million square feet (msf) of net absorption in 2013. Office vacancy rates would rise by 20 bps (lack of new supply would prevent a spike), and rents would move sideways at near-bottom levels. Again, the probability of the fiscal cliff occurring is low (70% chance of it *not* occurring). In forming real estate strategies, some will play the odds, seeing this is as more of a "fictional scenario," and using that to their advantage in identifying opportunities while the buyer pool has been reduced.

Scenario 2: No Cliff, No Fiscal Restraint (20% probability[1])

A second scenario assumes the extension of all current policies. This scenario has the opposite effect compared to the fiscal cliff scenario: the economic outlook will improve in the short-run, but fiscal sustainability problems will worsen. The "no cliff" scenario does not address the federal deficit issue what-so-ever. The federal government cannot spend beyond its means indefinitely. The CBO estimates that the extension of the current budget would cause the federal debt held by the public, which is currently at 73% of GDP, to grow to 90% by 2022 *(Figure 2)*. This is the highest level since 1947. Under this scenario, the credit rating agencies would downgrade the U.S. credit rating from AAA to AA, in all probability. Nevertheless, in the short-run, avoiding the cliff would result in a relatively healthy economic trajectory. Moody's Analytics projects an increase in aggregate demand with real GDP growing at an annualized rate of 3.8% in calendar year 2013, which is similar to the projection made by CBO[2] *(Table 2)*. Unemployment would fall to 8.0% but could go as low as 7.3% by the end of 2013, according to CBO.

Scenario 2: Impact on CRE

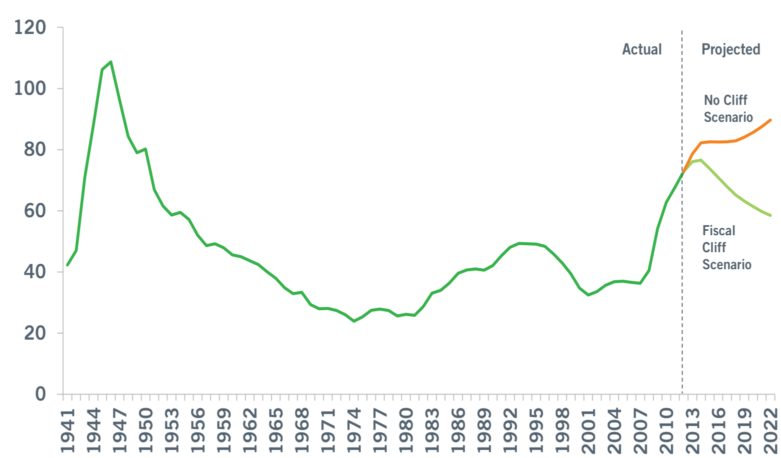
In the short-run, this scenario would likely improve market confidence and increase the pace of hiring, consumption and investment. Net demand for office space is expected to increase by 35% in 2013 relative to 2012. This level of increased demand would rival some of the strongest real estate years on record (akin to 2004 to 2007 and just slightly below the 1990s tech boom period). Vacancy rates would tighten quickly, and the rent recovery would accelerate. The downside of this scenario is, of course, that ignoring the deficit is not a sustainable option. Given the increased risks to U.S. credit, interest rates would eventually shoot up, which would have significant long-term repercussions for the U.S. economy and for the property markets.

Table 2: No Cliff, No Fiscal Restraint Scenario

	2011	2012	2013
US Economy*			
Real GDP (a)	1.7	1.9	3.8*
Unemployment Rate	9.0	8.1	8.0*
U.S. Office Sector**			
Net Absorption (b)	52.0	49.4	89.1
Vacancy Rate	16.4%	15.6%	13.9%
Asking Rents	$21.41	$21.69	$22.60

**Moody's Analytics, Inc. forecast. All other forecasts are from Cassidy Turley.*
(a) - Annualized growth rate
(b) - Millions sf

Figure 2: Federal Debt Held by the Public, % of GDP



Source: Congressional Budget Office

Scenario 3: Hybrid Scenario (50% probability[3])

A third scenario was outlined by Moody's that they describe as "Fiscal Nirvana[4]." The Nirvana scenario would significantly reduce the need for short-term austerity by putting more emphasis on entitlement reform and tax revenue. Under this scenario, real GDP growth would be 2.4% in 2013, which would be enough growth to generate 2 million net new jobs.

Scenario 3: Impact on CRE

This Fiscal Nirvana scenario is in line with our baseline scenario that assumes smaller short-term cuts coupled with entitlement and tax reform. Under this scenario, the U.S. office sector will continue to make reasonably healthy progress. Net absorption will clock in at 56 msf and vacancy will fall by 70 bps in 2013. *(Table 3)*

There is a Path to Better Days

Policymakers have a variety of options to both reduce the federal deficit and preserve the economic recovery. This is not an unsolvable problem. It is widely believed by both parties that we need to bring deficit spending inline with GDP growth (from 8% of GDP today to 2% of GDP by 2022). That is believed to be the long-term path towards fiscal sustainability. You can bring spending roughly in line with revenues in a lot of different ways: entitlement reform, taxes, spending cuts – lots of combinations solve the deficit problem over time. Our current assumption is that the sequestration and tax hikes will be scaled back significantly next year, but there will also be a plan in place that puts the budget on a sustainable long-term path. If policymakers can get this right, then the path forward for the U.S. economy and the property markets looks significantly stronger. Throughout this recovery the U.S. has shown flashes of underlying strength – surges of consumer spending, occasionally strong GDP, occasionally strong job growth, occasionally strong housing data, occasionally strong growth in the equity markets. Up until now, the strong trends haven't held, but the economic engines are still percolating beneath the surface. If business and consumers can finally get clarity on policy… it is a big "IF," but if we can get that, then there is potential for this to go from a painfully slow recovery to a robust one.

Table 3: Fiscal Nirvana

	2011	2012	2013
US Economy*			
Real GDP (a)	1.7	1.9	2.4*
Nonfarm Employment (b)	1,503	1,772	2,000
Unemployment Rate	9.0	8.1	7.9
U.S. Office Sector**			
Net Absorption (c)	52.0	49.4	55.8
Vacancy Rate	16.4%	15.6%	14.9%
Asking Rents	$21.41	$21.69	$22.20

**Moody's Analytics, Inc. forecast. All other forecasts are from Cassidy Turley.*
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[1] Cassidy Turley Estimate.
[2] CBO's highest estimate of real GDP growth which assumes the extension of most policies is 3.3%. Moody's estimate of 3.8% assumes the extension of all policies.
[3] Cassidy Turley Estimate.
[4] Navigating the U.S. Fiscal Cliff, June 2012

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