Northern Trust

WEEKLY ECONOMIC COMMENTARY

May 20, 2016

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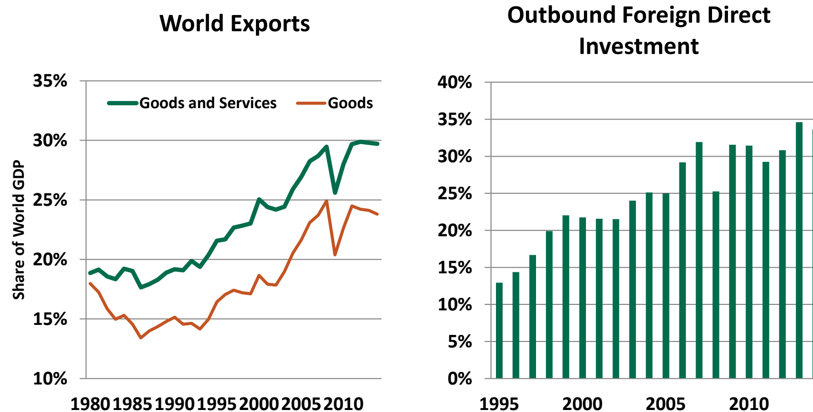
- **"Trade" Has Become a Four-Letter Word**
- **The U.S. Treasury Starts a Currency Hit List**
- **The Flat Market Flattens**

For most of the past generation, trade was in the ascendance. The mantra, "Do what you do best and trade for the rest," drove policy in most countries. The volume of goods and capital that cross borders increased exponentially; blocs of economic cooperation broadened and deepened, and a multitude of free-trade agreements were signed.

Recently, though, contrarians who see globalization as an avenue of exploitation that harms people and our planet have been in the ascendance. Responding to this, political sentiment in some key areas is drifting toward narrowing international channels of exchange.

Opening an economy to trade brings benefits and costs. There are certainly opportunities to ameliorate the downsides. But a policy of closing borders would be a very dangerous one for developed and emerging markets alike.

After 30 years of nearly continuous improvement, exports and international investment have started to taper off. Both recovered nicely after the Global Financial Crisis (GFC), but both appear to be past their peaks.



Sources: International Monetary Fund, United Nations

There are a variety of factors that have contributed to this trend, including:

- The pace of consumption growth, especially in developed markets, has slowed since the GFC. Households deleveraged, governments engaged in austerity, and maturing populations raised their saving levels. All of this means less spending, including on imports.
- China, which has been a major driver of increased global exports and a major recipient of global capital, is maturing. When developing markets reach a certain stage, they produce and consume more services, which are typically sourced domestically. Maturing economies grow

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more slowly, leading capital to look for more-fertile fields. China is experiencing both of these transitions at the moment.

- There are fewer opportunities for significant trade agreements or for the formation of significant new trading areas than there was. Regional blocks like the Association of Southeast Asian Nations, the North American Free Trade Agreement, the European Union and others have been in place for some time now. Tariffs on many items were reduced just about as far as they can go.

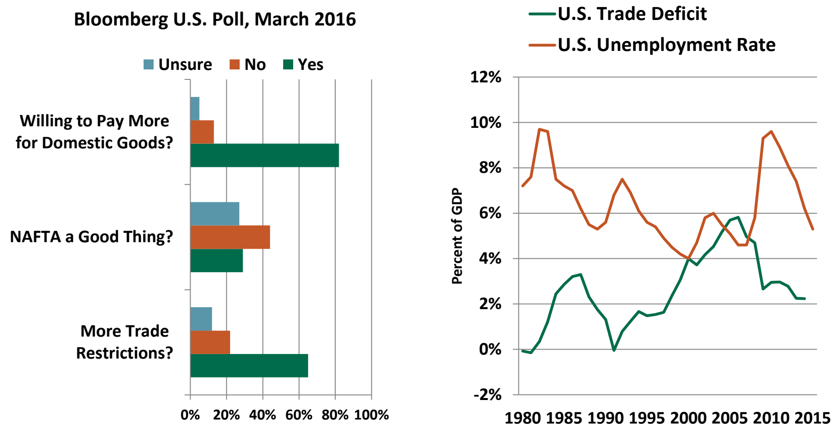
Beyond these somewhat natural causes, though, a rising level of protectionism around the world has limited global trade. As countries focused on their own recoveries from the 2008 crisis, they tended to suspend their global instincts and favor local operations. Higher tariffs, state support of companies or industries, and local content requirements all were employed to a greater degree in the past several years. And a number of the world's central banks explicitly aimed to use currency management to improve terms of trade.

Global trade is being depicted as the root of economic evil.

Behind these strategies is a hardening core of international sentiment against globalization. To skeptics, reduced barriers to exchange have allowed mistreatment of workers and natural resources. The absence of international labor and environmental rules allowed production to migrate to areas with the least-aggressive oversight.

In the developed world, trade was blamed for lingering unemployment among some communities of workers and for sluggish growth. Workers with more-modest levels of education were at highest risk of job offshoring and found it most difficult to regain their footing in the job market. The loss of market share, or even of whole industries, left regional economies in many countries in very poor condition.

The discontented found champions in the political arena. The Brexit referendum and the unexpected progress of the American presidential campaign both rest, in part, on antipathy toward the global order. The outcomes of both are very much up in the air.



Sources: Bloomberg, Haver Analytics

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Amid all the shouting that attended political discourse thus far this year, there was little opportunity for reasoned reflection. But let me attempt to offer some balance on the subject of trade.

Complaints about trade are potentially as old as trade itself. Trade does, in fact, create displacement for certain workers, companies and industries. But it also creates immense opportunity for others. As shown in the chart above, there is little correspondence between trade deficits and unemployment.

Closing borders will lock in a bad outcome.

The composition of jobs in developed countries has certainly shifted in recent decades. Some blame this on trade, but the employment transitions that many nations experienced might be more correctly attributable to technology. The level of manufacturing employment in many countries has been declining for a long time, primarily because of plant automation. And digital platforms have affected a long list of other sectors, some positively and some negatively.

Trade brings low prices to consumers, and competition to industries and firms that forces them to be sharper. The variety and cost of goods available to us would be far less attractive if international sourcing were not available. Consumers, not policymakers, are ultimately responsible for the drive to expand global trade.

Politicians in several countries proposed a re-evaluation of established trade agreements and trade zones. If one succeeds, others will certainly follow. A gradual constriction of trade channels could ensue.

We can certainly consider providing more transitional assistance for those displaced by trade and use existing treaties to steer countries toward fair play. But we must resist the temptation to turn too far inward. Countries cannot protect their way to prosperity.

Manipulation or Market Momentum?

There is a strong belief that a few countries are managing their currencies to stimulate business activity through exports instead of promoting growth through suitable domestic policies. According to this school of thought, the currency policy translated into large U.S. trade deficits with some of these countries.

To respond, Congress gave the U.S. Treasury new power to address likely situations of currency manipulation. The Trade Enforcement and Trade Facilitation Act of 2016 mandates a series of currency policy actions that the president and secretary of the Treasury must pursue if it is found a country is in violation. The law stipulates tracking three measures to identify a currency manipulator: a trade surplus in excess of $20 billion with the United States; a current account surplus that is more than 3.0% of the country's gross domestic product (GDP) during the past 12 months; and repeated foreign exchange purchases exceeding 2.0% of the country's GDP over the past 12 months.

A country is declared a currency manipulator if it meets all three benchmarks, and it is then cut off from U.S. development financing and excluded from government contracts. Initially, the Treasury did not identify any countries that had run afoul of the law, but the latest semi-annual

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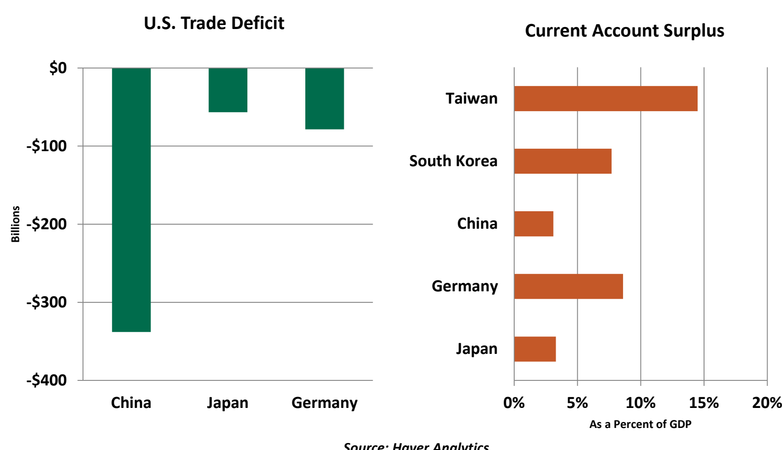
report to Congress notes that China, Germany, South Korea, Taiwan and Japan breached two of the three gauges. As a result, their foreign exchange practices warrant monitoring.



Source: Haver Analytics

Using currency trends to identify trade cheats is tricky business.

Identifying currency manipulation is not an easy task. The Fed's unconventional policies lowered the dollar's value, and the European Central Bank's actions resulted in the euro's depreciation. Are these central banks – or the countries underneath them – currency manipulators?

Judging who is playing by the rules and who isn't can be very challenging. We should hope that the U.S. Treasury combines its formulaic approach with some perspective and discretion.

Rental in Retreat?

Developments in the multi-family sector of the housing market do not make headline news in the financial press. However, much has occurred in the current expansion that is worth noting.

The demand for apartments, as opposed to single-family homes, expanded significantly in the last eight years. The Great Recession left many unemployed, and the tepid recovery included only modest employment gains in the early phase of the recovery. Household balance sheets were impaired, lending standards tightened and family formation slowed. In this situation, demand for rental apartments rose and lifted rents. The surge in demand for rental apartments resulted in the vacancy rate of apartment units declining consistently through the last five years, putting it at a 4.2% cycle low by the second quarter of 2015.

The potential cash flow from rental income encouraged commercial property developers to invest in multi-family units. In response, the value of existing apartment buildings increased, and investment in new multifamily units expanded. The median sales prices of apartment buildings posted substantial gains in recent years, and the capitalization (CAP) rate (net operating income/value of the property) for these properties decreased. The CAP rate spreads versus the 10-year Treasury note yield were attractive. These positive factors resulted in solid benefits from investing in apartment buildings.

But a large volume of supply becoming available changed the outlook for multifamily property. The attractive rental trends of 2014 and 2015 lured developers to expand the number of

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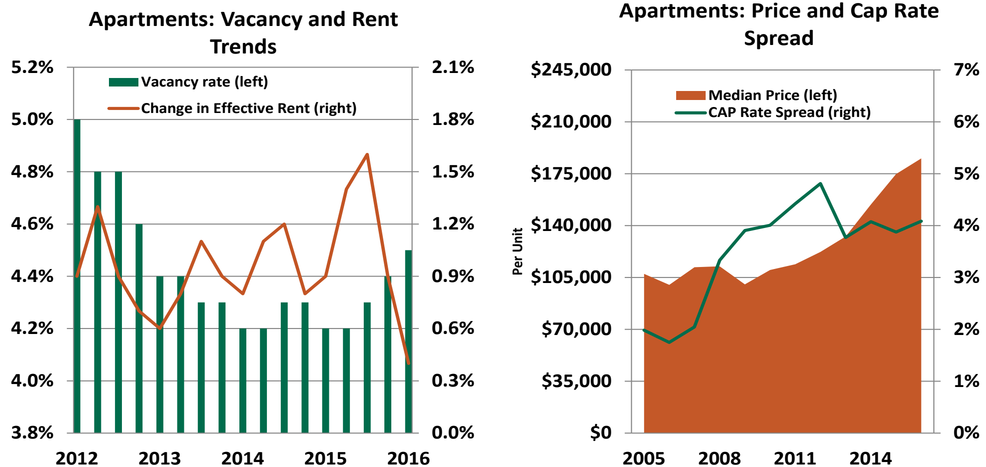
apartment units. The supply-demand balance is different, and the vacancy rate increased in the last three successive quarters.

The halcyon days for apartments as an asset class may be over.



Ries, a commercial real estate data provider, reports that developers brought 42,000 apartment units to the marketplace in 82 metropolitan areas during the first quarter of 2016, the largest addition since they began keeping records in 1999. Not surprisingly, the new supply reduced the growth of effective rent, which appears to have peaked in the third quarter of 2015.

An interesting aspect about the supply side of the story is that a large part of the increase in new multi-family housing stock built since 2009 occurred at the top end of the market. Estimates indicate that the share of high-end apartments constructed in the last six years increased four percentage points, leaving large segments of demand unsatisfied.

Second, permits extended in April for the construction of multi-family units dropped to levels seen around two years ago. The latest Federal Reserve's Senior Loan Officer Opinion Survey showed that banks tightened underwriting standards significantly for loans extended for construction of multi-family units. These factors suggest the supply of apartment buildings is unlikely to advance rapidly.

Third, the future of the multi-family sector is tied to where jobs will be created and where millennials, Generation Z and retiring baby boomers will reside. Some reports indicate that there is an increase in migration to city centers.

Fourth, the financial challenges of the young may eventually ease, leading them to consider single-family homes. The burden of student loans remains, but higher levels of employment the prospect of persistently low mortgage rates may result in a shift in dwelling demand.

The trend is turning after a stretch of declining apartment vacancy rates, and a significant plunge in activity in the multi-family sector is not on the table. But the environment in 2016 for this commercial real estate asset class should be more challenging than it was last year.

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