The national economy remains in slow growth mode as the uncertainty created by the seemingly endless series of budget confrontations inhibits both businesses and consumers, whose balance sheets are healthy but confidence is low.

• While it is not a “grand bargain” resolving the long term fiscal challenges faced by the U.S. government, the budget agreement arrived at in mid-December sets the stage for a more stable political environment than we have seen over the past two years.
• Once the immediate issues are resolved, the underlying health of the U.S. private sector is expected to assert itself leading to stronger growth in 2014 and 2015.
• Although New York City has been one of the better performing metropolitan areas in the U.S. during the current recovery, growth has moderated over the past two years.

The key reason for the slowdown has been weakness in the financial services sector.
• Over the next several years we expect the New York City economy will at least match the U.S. economy’s performance and has good potential to exceed national growth.
• This “better than average” performance will lead to rising occupancy over the next several years. However, it will be countered by an important long-term headwind as companies seek to become more efficient in their utilization of real estate. In addition, the inventory of office space in Manhattan is expected to increase for the first time in 20 years as major new projects on the West Side and at the World Trade Center are completed.
• The result will be declining vacancy over time, but until there is significant growth in financial services, the vacancy rate will not decline enough to drive rents upward at the double-digit-per-year pace typical of a market spike.
U.S. ECONOMIC OUTLOOK

The U.S. economy began to recover from the recession of 2007-2009 in the third quarter of 2009. In the seventeen quarters since, U.S. GDP has increased by an average of 2.3% per year. This is roughly half the average growth rate of the previous four economic recoveries. Almost all measures of economic activity, from consumer spending to employment to production have grown more slowly in the current recovery than in previous upturns and continue to do so to this day.

HEALTHY FUNDAMENTALS

This sluggish performance has occurred in spite of a set of economic conditions that have historically led to stronger economic expansion:

• Improving Labor Markets: layoffs have fallen dramatically during the recovery as indicated by the weekly unemployment claims statistics. Historically, when the number of people filing for unemployment insurance each week falls below 400,000 the number of jobs created in the economy accelerates. The number of new unemployment filings has now been below 400,000 per week for two years with the exception of two weeks after Hurricane Sandy, yet job growth has remained modest.

• Better Balance Sheets: Household debt service ratios have fallen dramatically over the past several years and are now at the lowest level ever recorded. U.S. corporations are recording at or near record profits and have plenty of cash on hand to expand. These trends mean that both households and businesses are in a position to increase spending. They are just waiting for the right environment.

• Housing revival: After seven years of decline the housing sector has finally turned decisively higher with sales, prices and new construction all rising. As the economy continues to steadily improve, housing will also continue to rise, stimulating growth in many of the industries that go into homes including construction, appliances, furniture, all the materials that go into a house and many other sectors. In addition, the increasing value of homes will boost consumer confidence and create a wealth effect which will support stronger consumer spending growth.

• Pent up Demand: As their durable goods are wearing out, consumers are increasing their purchases. This can be seen most dramatically in the auto sector where sales are up strongly from a year ago and are likely to top 15 million units in 2013, the strongest year for auto sales since 2007. With higher confidence levels, consumers would be expected to act on this pent up demand and increase purchases of durable goods.

• Strong sectors. While the overall economy has remained sluggish, two important sectors of the economy are growing rapidly and are likely to continue: technology and energy. The technology sector continues to evolve and grow in new areas including cloud computing, numerous new retail platforms, social media and many other products and services. To meet growing demand for all kinds of technology services, businesses in this sector are growing rapidly across the U.S. In the energy sector, the development of hydraulic fracturing and horizontal drilling techniques have led to a revolution in oil and natural gas production from shale reserves and started the biggest boom in the energy industry since the early decades of the 20th century. Not surprisingly, cities and regions that have strong businesses in these two sectors are among the best performing in the nation.
CAUTIOUS BUSINESSES AND CONSUMERS

The persistence of slow growth in the face of these healthy economic developments can be traced to the U.S. budget debate that began in mid-2011 and has continued up to today. The uncertainty that the continuing political battles over the budget have created in the business and consumer sector has been a major constraint on the U.S. economy. It has made businesses much more risk averse. Instead of boosting employment in anticipation of a rising economy, businesses have held back, taking a wait and see attitude as the budget confrontations in the U.S. went on and on. The budget brinksmanship that went on for more than two years finally hit a peak in October 2013 with the partial shutdown of the Federal Government. The resolution of that confrontation created a new set of budget deadlines in December/January/February. These deadlines are now leading to serious discussions on a budget for the current fiscal year. An agreement appears close to achievement as of Mid-December. Once this agreement is passed, the budget will, for a time, fade from public view.

No one in Washington wants to go through that again. Instead, the most likely scenario is that Congress will continue current policy and wait for the next election before considering whether to address long term budget issues. In the meantime, the deficit will decline because of the policies already put in place and the budget will, for a time, fade from public view.

Outlook. In our view, the very fact that there will be little or no debate over the budget will be a positive for the economy, leading to higher levels of confidence. As businesses and households look at their own situation instead of focusing on Washington, confidence should improve. As confidence rises the healthy fundamental factors outlined above will begin to emerge leading to faster economic growth, stronger job growth and generating higher incomes. As income rises, demand will begin to increase leading to stronger output growth-faster employment growth and more income. The result will be a healthy, self-sustaining recovery which we expect to emerge during the first few months of 2014. This will boost U.S. GDP growth from the average 2.3% per year of the past four years to 3.1% in 2014 and 4.1% in 2015.

This national environment will have an important impact on New York City in the coming year.
NEW YORK CITY ECONOMIC OUTLOOK

Since the U.S. recovery began in 2009, the New York City economy has been one of the best performing metropolitan areas in the nation. Overall the City has seen employment increase by 313,000 jobs or 8.6% since reaching a bottom in November 2009. Over the same time frame, U.S. employment has increased 5.4%. But there are two important points about this stellar performance:

1. While employment in the economy as a whole has grown rapidly, employment in the three key office-using sectors (financial, professional & business services and information) has grown more slowly. Since November 2009, employment in these three sectors is up 8.2%, a solid growth rate, but actually, slightly slower than the national average of 8.4%. So the office-using sectors have kept pace, but are not outperforming.

2. The rate of growth has slowed over the past two years. In 2011 employment in New York City increased 2.4% (from December 2010 to December 2011) about 50% faster than the pace in the U.S. as a whole. In 2012 the pace slowed to 2.0% and through the first ten months of 2013, employment in the City increased 1.9%. In each of the past two years the rate of employment growth in New York City has continued to outpace that of the U.S. as a whole, but the margin is much smaller than earlier in the recovery.

The New York City economy is continuing to expand because of growth in two major sectors: tourism and technology. But financial services, a third, very important local industry has lagged since the middle of 2011. That’s critical because financial services is far more important in New York City than in the nation as a whole. In the U.S. financial services employment accounts for 5.8% of all jobs, but in the City it accounts for almost double that share-11.1%.
The three key office using sectors: professional and business services, information and financial services account for approximately 32% of all the jobs in New York City. This office-using employment has recovered all the jobs lost in the recession. All three sectors experienced a decline in employment during the recession and subsequent recovery beginning in late 2009. However, starting in mid-2011 the performance of employment in the three sectors began to diverge, as employment in financial services began to decline while in both the professional and business services and information sectors continued to increase. Mid 2011 saw a number of events impact the financial sector from the re-emergence of the eurozone fiscal debt crisis to the signing of the Dodd-Frank law to the beginning of the U.S. budget deficit/debt ceiling confrontation that continues to this day. All of these developments have caused the financial services industry to hold back on hiring until the environment becomes clearer.

We do anticipate that employment in the financial services sector in New York City will pick up again in the future for a number of reasons. First the debt debates in the U.S. and eurozone are winding down reducing uncertainty. Second, as growth accelerates in the U.S. the need for all kinds of financial services is likely to increase. And third the regulatory environment will become clearer as the rules associated with the Dodd Frank law are promulgated. As the fog lifts and the economy picks up, financial services employment will recover, but it is likely to be late in 2014 before we start to see any meaningful growth.

Fortunately the New York City economy has become more diversified over the past two decades and is not as reliant on financial services as it was in the early 1990s. In 1990 financial services accounted for 14.6% of total employment vs. 11.1% today. One set of industries that has increased its share of total employment is the Technology, Advertising, Media and Information group known by the acronym TAMI. Employment in these technology-driven, creative industries have grown twice as fast as the economy as a whole and are continuing to add jobs at a much faster rate. Today, employment in the TAMI sectors accounts for approximately 10% of total payroll employment in New York City, making it almost as large as financial services. And it is projected to continue adding jobs at a faster pace over the next several years. Since the end of 2009 employment in the TAMI sectors has increased by approximately 50,000 jobs while employment in financial services has not changed.
MANHATTAN OFFICE MARKET

CURRENT CONDITIONS

The slowdown in financial services and the rise of the TAMI sectors has important implications for the current market and future growth. It means that the epicenter of the real estate market in Manhattan has shifted from Midtown to Midtown South. Most of the occupants of the TAMI sectors are located in Midtown South or want to be there while most of the companies in the financial services sector are either in Midtown or Downtown. So it’s no surprise that, with the growth in TAMI employment, Midtown South has become the tightest market in the U.S. In the third quarter of 2013 the vacancy rate in Midtown South was 7.6%, compared with a national average of 13.4% and an 8.7% vacancy rate in the next closest market-San Francisco.

By comparison, the Midtown vacancy rate in the third quarter was 11.4% up from 10.5% a year earlier. In fact, the vacancy rate in Midtown was 9.6% at the end of 2011, so the vacancy rate is up almost 2.0 percentage points in less than two years. The difference between Midtown and Midtown South can also be seen in the behavior of rents. Asking rents in Midtown at the end of the third quarter were 3.0% above year-earlier levels while in Midtown South they were up 22.8% over the same period. Net effective rents-actual transaction rents adjusted for landlord concessions-show the dramatic changes in Midtown South since the recovery began. In the second half of 2009, the average net effective rent (NER) in Midtown South was $31.54. In the latest six-months those rents are up 55.3% to $49.00. Over the same period, the NER increase in Midtown was 21.5%. The growth of the TAMI sectors has caused the Midtown South market to tighten and is pushing up rents rapidly. As Midtown South has gotten tighter and more expensive, firms have started to look elsewhere, particularly to the Downtown market. Downtown has enjoyed healthy leasing in 2013, more than 30% above its 10-year average while leasing in the Midtown market this year is -1.5% below the long-term average.

OUTLOOK

The divergent trends in key office-using industries will also have important implications for future market conditions. Employment in the office-using industries, which increased by roughly 30,000 jobs in each of the past two years is projected to slow to 10,000 jobs in 2013. Even as the national economy picks up in 2014, office-using employment in New York will grow a moderate 20,000 jobs as the financial services sector recovers only slowly. We expect even stronger national growth in 2015 to push employment in financial services up more strongly in that year, leading to a jump in office-using jobs in the city by approximately 38,000 jobs. However, just as the slower growth of the past year led to an increase in the vacancy rate in Midtown, stronger growth will not have the same impact as in the past. The reason is two important market headwinds, a rising volume of new construction and increasing efficiency in the use of office space.
MARKET HEADWINDS

New Construction and Tenant Efficiency. Historically, strong growth in office-using employment has led to significant declines in vacancy rates and placed upward pressure on rents. Yet, thus far in the current recovery we have not seen the same impact from employment growth as in the past. Employment in office using industries as of September 2013 was slightly above where it was at the peak in August 2008. Yet the Manhattan vacancy rate in the third quarter of 2013 was 10.6% while in Q3 2008 it was 7.4%. There are two important trends driving this difference: new construction and tenant efficiency.

One of the characteristics of the Manhattan office market over the past two decades has been the lack of inventory growth. In 1990 Cushman & Wakefield estimated there were 392 million square feet (msf) of office inventory in Manhattan and at the end of 2012 the inventory was 393 msf. To be sure, new office buildings have been completed over the past 22 years, but a large volume of office has also been converted to residential space offsetting the impact of new construction. However, 2013 has seen the completion of approximately 3.6 msf of office space in both Midtown and Downtown, and an additional 3.0 msf of space will come on line in the first quarter of 2014 with the completion of One World Trade Center. Thus, for the first time in decades, there will be a material increase in the Manhattan inventory. By the end of the first quarter of 2014 there will be roughly 6.6 msf more space in Manhattan than there was a year earlier, the largest 12-month increase since 1990.

Of course, more inventory tends to push up the vacancy rate until it gets absorbed by more jobs. The challenge today is that jobs are not creating the same volume of demand they did in the past. Employment in office using industries as of September 2013 was slightly above where it was at the peak in August 2008. Yet the Manhattan vacancy rate in the third quarter of 2013 was 10.6% while in Q3 2008 it was 7.4%. There are two important trends driving this difference: new construction and tenant efficiency. Employment in office using industries as of September 2013 was slightly above where it was at the peak in August 2008. Yet the Manhattan vacancy rate in the third quarter of 2013 was 10.6% while in Q3 2008 it was 7.4%. There are two important trends driving this difference: new construction and tenant efficiency.

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Forecast

The Manhattan office market is facing a near-term challenge caused by a slowdown in the financial services sector, which is leading to slow demand for space, particularly in Midtown; a rising inventory of new space and increasing efficiency in the use of space by tenants. These supply and demand forces have led to an increase in the vacancy rate and stable rents, except in Midtown South.

Over the next two years, as economic growth accelerates, the Manhattan office market is expected to experience a modest decline in vacancy and steady rent growth. The focal point for the rent growth will be Midtown South with Midtown and Downtown growing, but much more slowly. Thus, even with the expected headwinds, the Manhattan market is expected to continue to experience declining vacancy and rising rents, just much more slowly than what we have seen in the past.
CONCLUSIONS

The Manhattan office market is in sound fundamental shape. With a vacancy rate of 10.6% at the end of the third quarter, Manhattan had the third lowest vacancy rate in the nation. And average asking rents were the highest in the nation. But the market has not performed as expected, or as it has in the past, particularly in Midtown where the large corporate and financial services tenants are more cautious. However, this Midtown sluggishness has been countered by strong demand and activity in the TAMI sectors which are largely focused on Midtown South. Downtown, which is benefitting from the growth in Midtown South and from proximity to the TAMI hot spots, is also experiencing high vacancy as a result of the rebuilding of the World Trade Center. In the long run Downtown will benefit from the billions of dollars of infrastructure investment that has been made there as well as the growth in the TAMI sector and the attractive new office space being built there. But the near term challenge will be an excess of space.

The outlook for Manhattan is positive. We forecast declining vacancy and rising rents. As is always the case in real estate, everything depends on your location. But no matter where you are, the next few years will see steady improvement driven by an accelerating national economy, a growing TAMI sector and eventually, a rebound in financial services.

That’s why we remain fundamentally optimistic on the Manhattan office market.

End Note:
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