COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION

CHICAGO CHAPTER

2017 Real Estate Forecast

by Matt Baron, NAIOP Chicago Staff Writer

This is a summary of the January 12, 2017, meeting of the Chicago chapter of NAIOP, the Commercial Real Estate Development Association.

Its members gathered at the Riverway Auditorium in Rosemont to hear insights from Mark J. Eppli, Robert B. Bell Sr. Chair in Real Estate and Professor of Finance at Marquette University, on predictions, trends and growth sectors for the coming year.

Among other credentials, Eppli is the co-author of the best-selling real estate development text in the nation and worked in commercial real estate for PM Realty Advisors and GE Capital.

Precisely a year to the day since his last annual forecast, Mark Eppli returned to offer his 2017 forecast before a crowd of some 250 NAIOP members and guests who packed the auditorium. His visit came on the heels of a rare 365-day span marked by events that defied expectations and history.

“All along I saw Trump being the next President of the United States,” he dead-panned, sparking heavy laughter. A few moments later, he added, “The Cubs winning the World Series? I said that last year, I do recall.”

Shifting to a more serious tone, Eppli briefly reviewed most of his predictions that came true (or at least approximated how the year turned out) and some of the ways in which they did not, including industrial and retail returns.

Then, on an especially timely note, Eppli moved to “election economics” and a staggering statistic: white, non-college graduate voters preferred U.S. President-Elect Donald Trump over Hillary Clinton by 39 points.

“Why was that group so strongly (for) Trump?” he asked, then referenced a December story in *The New York Times* that contrasted results from a recent survey of Americans with one from 40 years ago. In the recent survey, only those in the bottom 30 percentile of household income believe their children will fare better economically than they have done. In 1976, however, even the 90th percentile families—earning more than all but one out of 10 households—held that optimistic view.

“In that way, the American dream is gone,” Eppli observed, “and that’s a really interesting starting point for the Trump campaign.”

“The top 1 percent is starting to look a whole lot like the Robber Baron years of almost a century ago,” he continued. “We’re concentrating the wealth into a smaller group.”

Another metric reflecting American society’s widening economic gap: since 2000, zip codes with median house prices between $500,000 and $1 million have seen property values rise by 103

percent, while homes in zip codes with a median sale in the $100,000-to-$150,000 range have experienced a property-value uptick by only 39 percent.

“You start to see a divide, an inequity, where the lower-income aren’t doing nearly as well as the higher-income,” said Eppli.

Drawing further from Federal Reserve Economic Data (FRED), he cited another statistic that underscores the growing gap between haves and have nots: college graduates’ unemployment rate is about one-third that of those with only a high school diploma.

Eppli also touched on rising economic expectations since Trump’s election over two months ago. Ten-year U.S. Treasury bonds, for example, are up 53 basis points (as of January 6th). That, along with other indices, reflects anticipation of increased inflation.

“The market participants are not perceiving greater risk on a net basis from a Trump presidency,” Eppli said. “One of the things that has clearly happened since the election is financial stocks have really done quite well.”

Bank stocks, in the two months since the election, appreciated about three times the S & P 500, which itself is up a robust 6.8%.

On the nation’s economic horizon, Eppli noted some of the Trump administration’s potential pros (growth from reduction or clarification of taxes, growth from regulatory reduction, and growth from solid consumer confidence) as well as the new leadership’s potential cons (uncertain/unclear policy platform, unproven possibility of unexpected high inflation, overpromised growth, and unproven non-governmental cabinet appointments).

“The net effect of this has been bullish, largely around regulatory and tax benefits,” Eppli concluded. “So we’re going to have greater earnings by corporations because of lower taxes and maybe be more productive because they don’t have as big of a regulatory burden, especially in the financial services industry.”

Over the next two years, therefore, Eppli said he does not foresee “a step back” in the economy. “However,” he cautioned, “all bets are off when it comes to international policy and how that might impact things.”

Perhaps most notably, although Trump and Russian President Vladimir Putin currently have what Eppli termed a “bromance,” it won’t last forever. “At one point, I think that comes to a head,” he predicted. “I think that will create a challenge.”

China, also, poses “a pretty big challenge,” in part because President Xi Jingping, consolidating his power through his first four years in office, has turned his anti-corruption crusade into an anti-loyalty campaign. “That’s a bad call,” said Eppli.

One cause for concern about China: its debt is growing at triple the rate of its nominal GDP, which is “not sustainable” and “we have the possibility of a trade war,” said Eppli.

“Domestically we’re in good shape, from an economic perspective, but internationally these things could spur some challenges in the next two years, quite clearly,” Eppli said.

Despite the overall positive economic indicators in the U.S., “it will be next to impossible for Donald Trump to meet his (promised) 4 to 5 to 6 percent GDP growth rate.” GDP is driven largely by higher productivity and a larger workforce, but Trump has a strong anti-immigration stance that hampers expansion of the workforce.

So, even if increased deregulation happens as Trump wishes, with the workforce projected to grow by a mere 0.2 percent annually through 2025, the U.S. will be hard-pressed to achieve as much as a 2 or 2.5 percent annual growth in the GDP, said Eppli.

Even with a pro-immigration policy, drawing talent to the U.S. is hindered by fertility rates in the world's 35 developed nations that are part of the Organisation for Economic Co-operation and Development (OECD). The overall OECD rate of 1.7 is lower than America's 1.9 (and 2.1 is the rate needed to maintain population), so other countries are even more motivated to retain their own residents, said Eppli.

As to whether the current economic expansion is sustainable, Eppli commented that while its length is the third-longest of the past century, its rate of growth (2.1 percent) is about half of the previous expansionary period of 1991 to 2007.

"Look at the cumulative growth—it's really small," he said.

However, "an overly frothy debt market" is something that could bring the expansion to an end. Total credit markets doubled from $13 trillion in 2000 to $26 trillion in 2008—and right into the Great Recession.

"We grew our debt far faster than our economy," Eppli said. "That creates froth."

Since then, that figure has grown by a total of about 10 percent—"pretty moderate," Eppli said. Consumers, comprising about 70 percent of the economy, "have been very well behaved" and just returned to 2008 levels of debt, added Eppli. "There's room for us to take on more debt as consumers."

In an effort to "get you to think about what (metrics) you're using to buy real estate," he provided extensive insight on the importance of determining which metrics were helpful—and which are given too much credence—to gauge where the market may be headed.

Eppli singled out the Cap Rate-to-10-Year U.S. Treasuries spread as "a misguided or an altogether wrong metric."

"Why does it matter? Ten-year treasuries are up 50 basis points since Trump (was elected). That means real estate is (supposed to be) getting priced a little more tightly," Eppli elaborated. "No. What's happened…is the risk premiums actually have compressed, making real estate look a little better from a risk perspective."

Bank credit has gotten tighter since the last quarter of 2015, and Eppli expects that will continue "because of the regulatory environment…some of the bank leadership, not necessarily the real estate (leadership), might think they are over-allocated to real estate."

Delving into a perennial theme, Eppli offered commentary on renter household growth, which flowed largely from 9.6 million foreclosures and short-sales that were part and parcel of the Great Recession. Annually for the past five or six years, there have been about one million new apartment-dwelling units—more than double the norm and "not sustainable," Eppli said.

Of those who have gone through foreclosures, only about 35 percent have purchased again—"that'll push down home ownership rates, push up rental rates," he added.

Between 2015 and 2025, the number of millennial households is projected to climb from 15 million to 38 million, or a 2.3 million increase annually that will grow that segment of the population's share of the market more than any other segment.

Turning to retail cap rates, Eppli noted that they appear to be stabilizing.

“I think the demise of the brick and mortar retailer is way overstated. I understand more of the growth in retail is going to be absorbed by the Internet, but the need for brick and mortar retail and an omni-channel delivery system exists as much as it ever has,” Eppli said. “What we have seen is pretty much a flat-lining of retail cap rates.”

Transaction volume in November, year over year, was off 10 percent nationally—and some Chicago-area brokers that Eppli has spoken to “have seen dips that are far beyond that. So it’s been a little bit tougher here in the Chicago market.”

During a question-and-answer period, Eppli fielded several wide-ranging questions. The first was about the role of technology in GDP growth.

With the on-shoring of new processes, Eppli replied, technical skills in high demand will be CAD-CAM (computer-aided design and computer-aided manufacturing). “Overall, we’ve seen some good productivity gains there,” he added, while “service productivity has been flat, if not negative, over the last decade.”

The specter of cyber-crimes has also resulted in a significant cost to the service economy. “Think about your dinner tonight. They’re not getting that much more efficient, so our service economy, while we can set up a reservation on any number of platforms, it’s not necessarily increasing the productivity of our service workers,” Eppli said.

Another query was whether China is “too big to fail” or could fall victim to a “black swan” scenario—an unexpectedly negative turn economically.

China has more than $3 trillion in reserves, down about $1 trillion from last year as the world’s most populous nation sought to protect its currency, Eppli observed.

“They’ve got a big (financial) cushion and centralized, managed government so they have a lot of strings they can pull, but at one point that combination is a bad combination, and that is your black swan,” Eppli said. “I don’t know when that happens because they can see this out for a number of years, but if they don’t rein that in, that’s a big concern.”

A key factor: China’s labor force rates “are so much higher than in Vietnam and elsewhere that they’re losing all these big jobs,” Eppli said.

As a result, “they’re trying to shift from a manufacturing economy to a consumer economy, and they will have some tremendous difficulty doing that because the Chinese are huge savers,” Eppli concluded. “They’re not quite willing to spend their money like we do here in the United States.”

To view the presentation that Eppli shared with Chicago NAIOP members, click **here**.

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