NAIOP
COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION
CHICAGO CHAPTER

2018 Real Estate Forecast

by Matt Baron, NAIOP Chicago Staff Writer

This is a summary of the January 11, 2018, meeting of the Chicago chapter of NAIOP, the Commercial Real Estate Development Association.

Its members gathered at The Estate at Gene & Georgetti 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, *Real Estate Development: Principles and Process,* and worked in commercial real estate for PM Realty Advisors and GE Capital.

Providing a forecast for the seventh consecutive year to NAIOP's Chicago chapter, Mark Eppli framed the outlook around one question: Is the current commercial real estate environment sustainable or is it on the verge of a bubble?

Overwhelmingly, the trends point to sustainability for at least the next year—with that pattern likely holding true for upwards of another year. Beyond that, though, the outlook gets murky—with "some clouds on the horizon," Eppli said.

These near-term bright prospects are particularly the case in the industrial sector, he added. One benchmark that Eppli cited for his bullish view: investment speculation is not high. Although commercial real estate prices have gone up 6.2 percent annually over the past decade, well in excess of the rate of inflation, it's partly compensating for the declines brought on by the Great Recession. In addition, the hike is barely half of the 11.2 percent annual increase during the five-year span leading up to 2007.

"It doesn't look we have had an unsustainable speculative run-up in commercial real estate, especially when you start to compare it to other metrics," Eppli said.

Capital markets also counter any bubble concerns—in fact "it looks like a little bit of a pull-back," said Eppli. That restraint does not reflect concern about an imminent bubble as much as it does heightened regulations that have served as a tempering force.

One encouraging sign, Eppli noted, is that the California Public Employees' Retirement System (**CalPERS**) has increased the commercial real estate portion of its investment allocation, from 9.3 percent in 2002 to 11 percent in recent years, to 13 percent this past year.

“That’s a big number…they will lead the industry” as an influential force, he said.

Global private equity has also been modest, with $110 billion being placed last year. In addition, there is $136 billion of “dry powder” (or money that investors are looking to invest) in this category, up from $120 billion a year earlier.

“Pension funds and private equity both look like they have a continued equity demand for commercial real estate,” Eppli concluded.

A significant trend over the last decade is the decline in home ownership, from 69 percent to 63.5 percent, which helps explain the 5.1 percent debt that has been racked up to fund apartment construction.

Commercial real estate, relative to other bank assets, is doing well, and banks are likely to deploy more money in 2018 than this past year, said Eppli. He offered an anecdote about a recent conversation with a bank executive who does business in the Chicago area: of 24 loans that were coming due, five were below pro forma (with four of them by only 1 to 5 percent), while six were performing better than 10 percent above pro forma.

“Even in this market where it looks like we are softening around some of these apartment (developments), they did fairly well across those 24 (loans),” said Eppli. “It goes to say that banks in 2018 will look to deploy as much money, or a little more money, than they did the previous year.”

In the past, banks have been “pro-cyclical,” loaning money more freely when the market is strong and then tightening the purse strings when the market sours, thus increasing volatility. This time around, banks tightened up “when they didn’t need to,” said Eppli, in part because of constraints, like the High Volatility Commercial Real Estate (**HVCRE**) regulation that took effect three years ago.

On the construction front, and comparing inflation-adjusted and population-adjusted data from across the past quarter-century, “we’re at a reasonable place…with the exception of fairly narrow pockets of apartment overbuilding,” Eppli said.

Currently, the economy has experienced 102 months of recovery since the Great Recession—the third-longest sustained recovery in the U.S. since 1854. And the country figures to break the record of 120 months in mid-2019. Though it marks the largest expansion in the nation’s history, the bounce-back has come with a modest average annual GDP growth rate of 2.1 percent, so “it’s been a slow recovery, but one with low volatility,” Eppli observed.

Personal consumption represents 68 percent of the GDP and business investment is roughly 10 percent. The favorable tax environment for businesses—coupled with corporate profits that Eppli termed “crazy strong”—should spur on more investment as well as repatriation of foreign profits.

“We could see some great GDP growth from business over the next—not just two or three years—but five years and more,” he added. “I think that’s important for you who are in the industrial market, among others. People are investing in new equipment, new facilities and so forth, because they’re going to have the money to do it.”

Boosting the wealth (in part, via reduced taxation) of the upper 10 percent of Americans will also likely “have people spending more in the future,” said Eppli.

Another distinction between the GDP growth in recent years, and the growth that occurred preceding the Great Recession: in this cycle, it has not been fueled by debt.

The U.S. is enjoying the longest period of employment growth in history, at over seven years and averaging 196,000 new jobs per month. Also, the unemployment rate of 4.1 percent is at its lowest point in 16 years, and is particularly favorable for college graduates (1.9 percent). The low rate enables continued employment at a job with the expectation of higher wages, as well freedom of movement from job to job, said Eppli.

However, one factor that will impede economic growth, he noted, is the Presidential administration’s immigration policy.

On the inflation front, Eppli said it will be driven largely by wage increases and represents “somewhat of a concern.”

Compensation rate growth is being kept in check to about 2.5 percent, in part, via Baby Boomers leaving the workforce on the high end of the salary scale and being replaced by lower-paid Millennials, said Eppli.

“That big roll-off, that we’ve never seen before, is keeping down wage inflation,” he noted. “So that younger set is going to be able to negotiate far higher wages in the future.”

Eppli emphasized two overarching, significant positives. One is continued strong confidence among consumers. The second positive is “the promise of lower corporate and personal tax rates,” which, among other things, could help bring money back into the U.S. from foreign investments that American companies have made, and further fuel consumption.

On the negative side, he cited the Federal Reserve raising the interest rate three times in the past year, as well as expectations that it will continue to rise.

During a question-and-answer period, Eppli addressed several inquiries, including one challenging his view that cap rates will rise.

Acknowledging the merits of an opposite perspective, partially in light of the stock market’s surge, Eppli concluded his remarks, “I have found pension fund managers to be really patient with their money and if they think things are overpriced, they will hold off.”

Responding to a question about the reduction in the labor force participation rate, Eppli said, “Opioids are a problem and it’s affecting how employable some of those folks are over the age of 25.”

Another individual questioned, in light of process and technology advances, why labor inflation is projected to continue playing a role in the increased cost of goods. In his reply, Eppli touched on two factors: the cost of safety regulations and the dollar’s diminished power overseas by about 5 to 7 percent over the last half of 2017. Because of that latter factor, American companies need to bump up prices when importing products.

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

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