NAIOP
COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION
CHICAGO CHAPTER

2019 Real Estate Forecast

by Matt Baron, NAIOP Chicago Staff Writer

This is a summary of the January 17, 2019, meeting of the Chicago chapter of NAIOP, the Commercial Real Estate Development Association.

Its members gathered at The Westin O'Hare in Rosemont to hear insights from Dr. Mark J. Eppli, *Director & Faulty Associate,* James A. Graaskamp Center, University of Wisconsin-Madison, on industry trends, growth sectors, and commercial investment trends to be watching in 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.

Addressing over 300 attendees, Mark Eppli delivered this year's real estate forecast—his eighth in a row for NAIOP's Chicago chapter—in his trademark rapid-fire style. In just 40 minutes, he covered dozens of graphs and other slides. Permeating his remarks was tempered optimism: the fundamentals bode well for continued, if muted, growth in 2019.

"Overall what we are seeing in the real estate industry is we are in a stable and a good place," he said.

As always, though, Eppli rightfully exercised the classic economist's disclaimer, both in the big picture as well as in subsets of the economy. This was best illustrated by an early visual in his presentation: "History shows us that the worst transactions are done at the best of times…Now is the perfect time to be cautious."

He agreed with the October 2018 edition of *The Economist* magazine's conclusion that what is coming will not be a "wicked recession." It may not even be a recession at all, "but it'll certainly be a slowdown from my perspective."

"You should know," he added, with another disclaimer, "that economists are notoriously bad at guessing when the next recession comes."

In fairness, though, Eppli's review of predictions from a year ago demonstrated that events since then have proven him more often right than wrong. And the scales tip more in his favor when including those instances where he has been "directionally right."

For example, a year ago he underestimated economic growth "by a little bit," he said, and he thought interest rates would go up 25 to 50 basis points, somewhat higher than their actual 14 basis-point rise.

For those who may be skeptical of the relevance of international developments with those occurring locally and domestically, Eppli shared several anecdotes to underscore the link. To wit: 43 percent of revenue, collectively among S & P 500 companies, come from outside the United States; and 65 percent of fast-food titan McDonald's revenue is from other countries.

"We cannot ignore some of this international stuff," he said.

Part of Eppli's concern about a prospective downturn is that "we will be limited as a country with what we can do, a little bit, based as a country on what position we have put ourselves in. Typically, we will see a 5-percent reduction in the Fed funds rate. Well, the Fed funds rate is 2 ½ percent right now. Clearly, we can't do that, so we don't have the stimulative effect of low interest rates."

Also, federal deficits of around 2 to 3 percent are not so much a problem, but "when we start running deficits that are closer to 4 and 5 percent, we're eating our young," he added. "We're already at that point where we're limiting what we can do in the future."

Any economist is challenged to wade through the myriad of economic data points, view those figures in relation to historical precedent, and then determine how much correlative weight to assign those past and present statistics.

For example, one of the biggest predictors of future recessions is the inverted yield curve, or the relationship between the 2-year and the 10-year interest rates, said Eppli. Before the Great Recession, it showed ominous signs for nine months; before the tech recession, there was a two-month indicator.

"We haven't inverted (currently), so to speak, but you can see the trail we're on as one indicator," said Eppli.

Consumer confidence is another pivotal sentiment to watch, with the Realtors Confidence Index one key indicator. The past six years, real estate prices nationally have risen by an average of 6 percent. Over the next year, most Realtors do not think the median price change will go higher than 3 percent, said Eppli.

"This is a signal—a signal that might not be right," he added.

Meanwhile, SALT (state and local taxes) are a rising concern, especially in high-tax states like Wisconsin and Illinois, he said. Using his own situation as an example, Eppli said he had $55,000 deductions in 2017, with $40,000 in state and local taxes. "This year, I can use $10,000 of that" from 2018 earnings, he added. "I'm losing $30,000 of deduction."

Speaking more broadly, "I think this could have an effect on consumer spending come April, May, June."

From a business perspective, another looming concern is the undersupply of workers to pull into the job market—which leads to rising wages. It's one of many factors the Fed is evaluating as it gauges what to do with interest rates.

Throughout his presentation, Eppli provided good news juxtaposed with troubling signs.

The country is in the midst of its second-longest period of sustained economic growth in history—and, if it keeps up, that will match the record in June (at exactly 10 years).

And last year, economic growth rose from 2.2 percent to 2.9 percent. Eppli said he had expected that growth to come largely from business growth, but defense spending accounted for 21 basis points of that rise, and 34 points was from state and local government spending.

“A big piece of that, in my mind, is borrowing against all of us,” Eppli noted. “That’s tax spending. So, I don’t necessarily count that as real growth.”

Jobless claims are near an all-time low, even as the labor force has doubled since 1970, so “we’ve got an extraordinarily tight labor force.”

According to the Bureau of Labor Statistics, the anticipated growth rate of 50,000 new jobs per month is “nowhere near” the potential of 200,000 per month that could be brought into the workforce. Much depends on the future immigration rate, and “if we don’t have a labor force growth rate, I’m not sure we have much growth in GDP,” said Eppli.

“This is a concern. I’m not pro-Trump or anti-Trump. This is about economics and politics,” he continued. “The administration has been decidedly difficult toward immigration in this way...the Baby Boomers are rolling off (the employment rolls) with barely as many Millennials rolling on the work rolls.”

The economy has seen a stabilization of property values over time, and that is tied to the stabilization of cap rates, said Eppli. Coupled with the recent widening of bond rates, he added, is “solid news.”

“If you have cap rates that are the same, how can values actually grow? Guess what. NOI (Net Operating Income) is growing 4 percent a year.”

In the debt markets, there has been a dip in private debt, from 171 percent of the Gross Domestic Product (GDP) in 2009 to 148 percent currently. By contrast, the federal government “is more than making up for it” to fund the national deficit.

“Hopefully we’ll begin to elect officials, and hopefully we as citizens will say, `No, that (reducing government spending) is more important than getting a tax cut or other things for today. We have to look to the future.’”

Another significant trend is the reduction of housing tenure, from 69 percent in 2006, to about 64 percent today. In addition, leveraged loans—given to those with high levels of debt already—are coming to real estate in greater numbers, from sources of major players such as Blackstone, CalPERS (California Public Employees’ Retirement System), Oaktree Capital, Goldman Sachs, KKR and TPG. While uncertain of the motivations behind those loans, Eppli said it does not “bode well for what they feel the industry is looking at.”

Demographics for multi-family housing remain strong, driven in part by a trend that Eppli termed “astounding”: over the past 20 years, the average age for first-time marriages has risen to 27 and 25 for men and women, respectively, up by about three years.

“That shows a wicked strong potential for multifamily,” he noted. “…marriage leads to home ownership as much as anything, but what we have here is less than half of the households are married. And less than 20 percent homes are married with kids at home. It was 78 percent married in 1947.”

Further reflecting the surge in multifamily housing, between 2006 and 2016, there were eight million new households created with 400,000 fewer homeowners. Tied into that trend is the rise in home rentals—over the last decade, almost seven million single-family homes went from owner- to renter-occupied, climbing from 11 million to 18 million.

During a question-and-answer period, Eppli fielded several inquiries, including on the topics of increased allocation of pension funds in real estate and whether the United States will remain the preferred “flight to quality” destination for international investors.

He said that he believes the U.S. will remain the preferred spot, but “we have got these concerns with China. We’ve got this tariff issue.”

“China alone is solidly over $1 trillion of our debt, which isn’t huge compared to our overall debt. But they could play with us. They could say, `OK, you guys are going to play hardball?’ They could start spinning off treasuries in a quick way and disrupting the market.”

“Some of our lack of good relationship globally could change that (investment in the U.S.) a little bit, but I don’t know another good place to put that money.”

In one final hopeful note, albeit in the context of a difficult situation that has been unfolding, Eppli said the partial government shutdown will not have a lastingly negative effect on the economy.

“The American consumer has been resilient to some of the—for lack of a better term—silliness that goes on in D.C. at times… they don’t seem to be impacted largely by that,” Eppli said. “I would argue probably the same as it relates to the government shutdown.”

View Mark Eppli’s Presentation

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