

COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION

CHICAGO CHAPTER

Real Estate Forecast Breakfast 2019

Mark J. Eppli. Ph.D.

Director, Graaskamp Center for Real Estate, University of Wisconsin -- Madison

January 17, 2019



TOGETHER FORWARD®

So, how did I do last year?

Assets fully priced, but not over-priced based on relative risk spreads

- Cap rates remained narrowly unchanged Got it right!
- Equity capital markets are in check, and stepped back in 2017T
 - Transaction volumes were up 5.8% YOY 2018Q3 Got it right!
- Debt capital markets are at a sustainable level
 - Debt started to grow at unsustainable rates Got it directionally right.
- Space markets are not overbuilt, with the exception of fairly narrow pockets of apartments
 - Apartments are being overbuilt Got it directionally right.
- GDP growth looks sustainable through 2018, probably 2019 growing 2.25-2.75%
 - GDP grew at 2.90% YOY, underestimated Got it directionally right.

Wage inflation will push interest rates higher

• 10-year UST up 14 bps from 2.57% to 2.71% -- Got it directionally right.



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History shows us that the worst transactions are done at the best of times . . . now is the perfect time to be cautious.



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Dirty capital: the City of London The fate of Jamal Khashoggi Medicare for all

The next recession How bad will it be?



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Source: Economist, October 13-19, 2018

The next recession will not be wicked, it will likely be politically initiated

.... maybe China restarts its debt-fueled growth (from 175% of GDP in 2009 to 300% today)

.... what could possibly go wrong with Brexit and Italy's weak economy and the EU???

.... the U.S. consumer get spooked, SALT limits, import prices/tariffs, market volatility, etc

.... financial markets tighten (wage inflation, quantitative tightening, Fed rate increases)

Tools to address a downturn are limited:

Federal Reserve – Fed typically cuts rates five points in a recession – has only 2.5 points today -- Fed has a \$4.06 trillion on balance sheet from Quantitative Easing

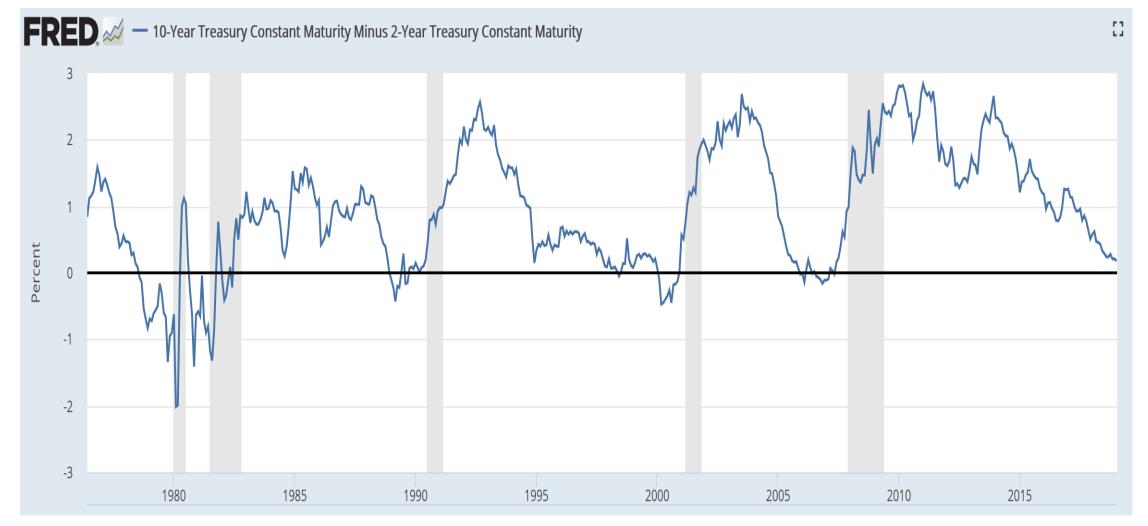
Fiscal Stimulus -- Federal deficit was 3.9% of GDP in 2018 and is expected to be 4.6% in 2019



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JAMES A. GRAASKAMP CENTER *for* real estate Source: Economist, October 13-19, 2018

The inverted yield curve (10 yr. v. 2 yr.), a solid a recession predictor . . .





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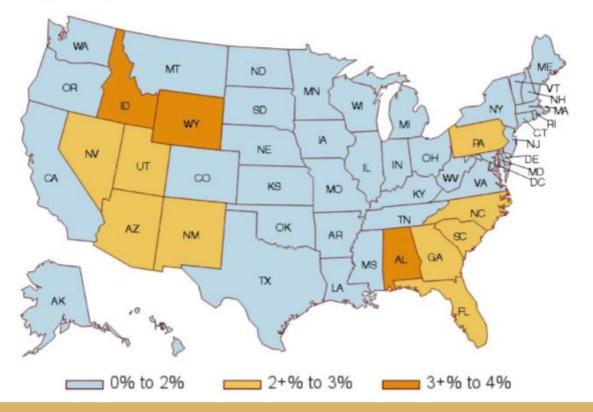
Source: Federal Reserve Economic Data.

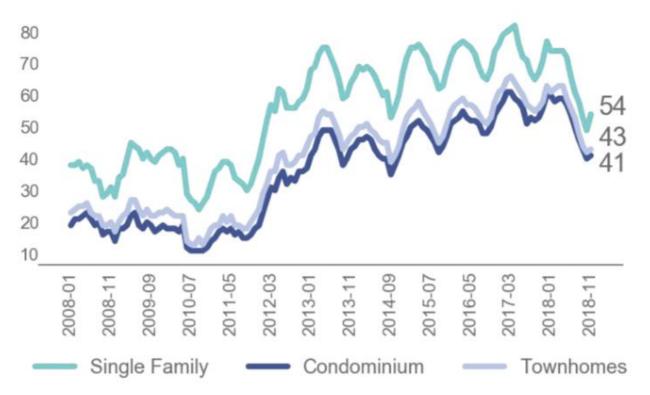
.... consumer expectations are dimming, this despite an average 6.1% price appreciation over previous six years

MEDIAN EXPECTED PRICE CHANGE WITHIN THE NEXT 12 MONTHS

REALTORS® CONFIDENCE INDEX—SIX-MONTH OUTLOOK

By State, in the Past Three Months





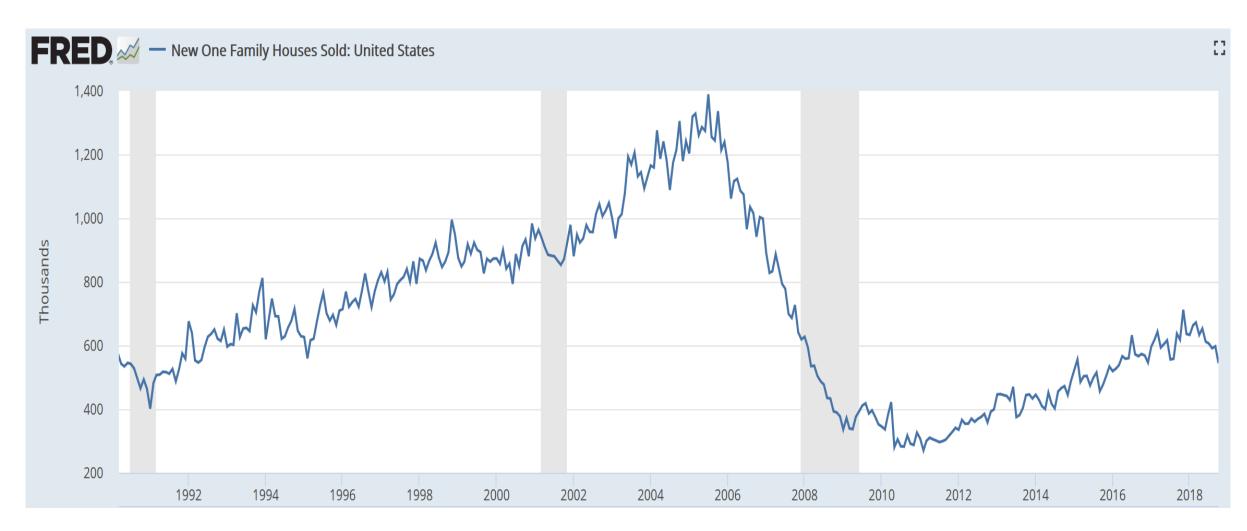


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Source: NAR, REALTORS Confidence Index Survey, November 2018.

... consumer concerns impacting new single-family home sales ...





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Source: Federal Reserve Economic Data.

... middle/upper income households may be in for tax liability

Tax Differential 2017 to 2018 for Selected Income Levels, with \$55,000 of Deductions Including \$40,000 of SALT Deductions

Income Level	Additional Taxes in 2018	
200,000	\$3,495	
300,000	\$1,663	
400,000	\$63	
500,000	\$752	
600,000	-\$3,571	
700,000	-\$8,179	



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Source: The Graaskamp Center.

.... business optimism is also dimming, with the PMI new factory orders approaching recession levels . . .

Purchasing-managers index





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JAMES A. GRAASKAMP CENTER for real estate Source: WSJ, U.S. Factory Activity Decelerates Sharply Amid Global Slowdown, Sharon Nunn and Nick Timiraos, January 3, 2019.

.... Quantitative Tightening of up to \$50 billion per month, tightening money supply





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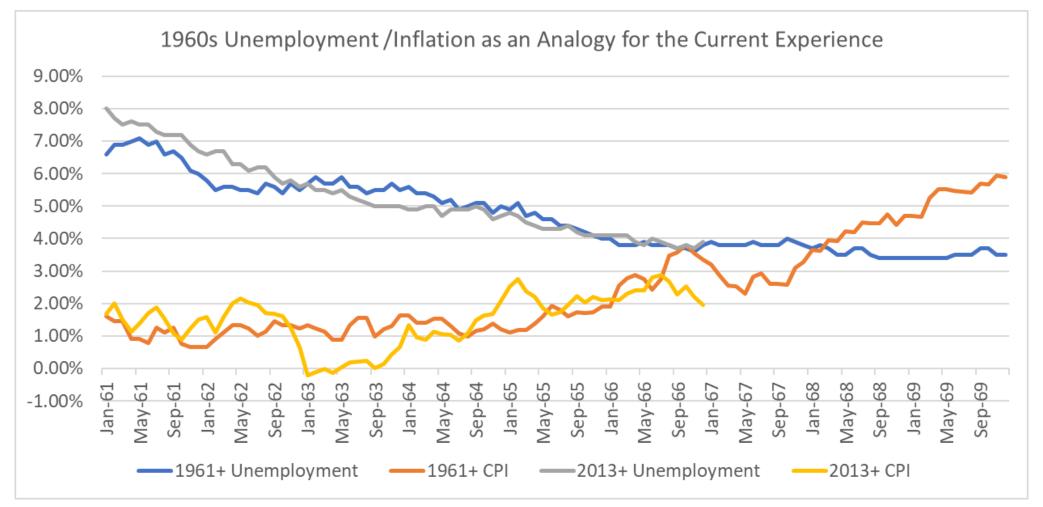
Sources: Federal Reserve Economic Data

.... trade tariffs, we have yet to feel the inflationary impacts



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.... the 1960s experience presents a challenging path for the Fed





The Rest of the Presentation

- I. The Economy
 - Economic Growth
 - Employment
- II. Capital Markets
 - Equity
 - Debt
- III. Multifamily



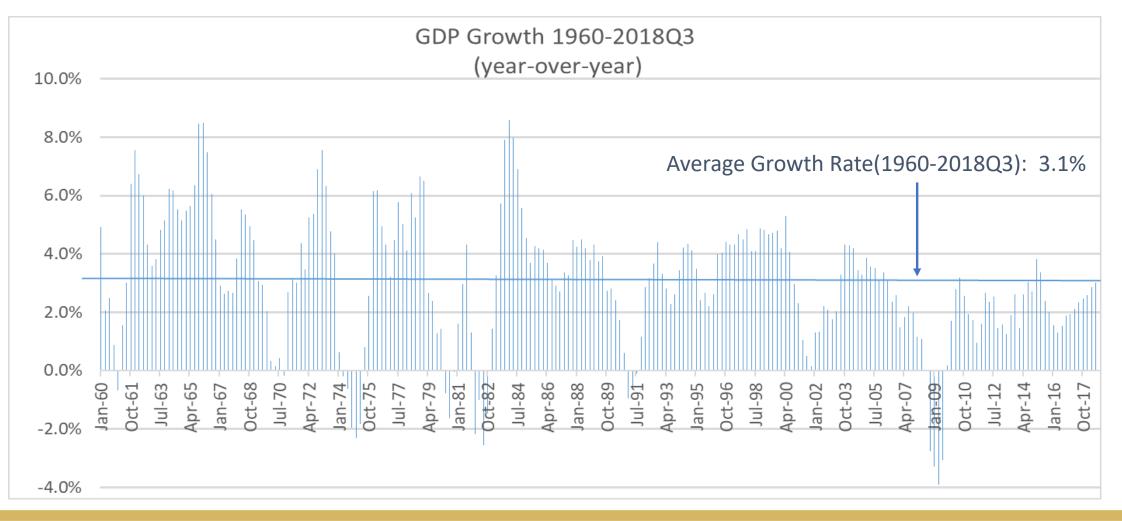
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Economic Growth



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JAMES A. GRAASKAMP CENTER for REAL ESTATE The additional 0.7% growth to a 2.9% GDP growth rate largely comes from increased defense spending (0.21%) and 0.34% in State and Local Government spending



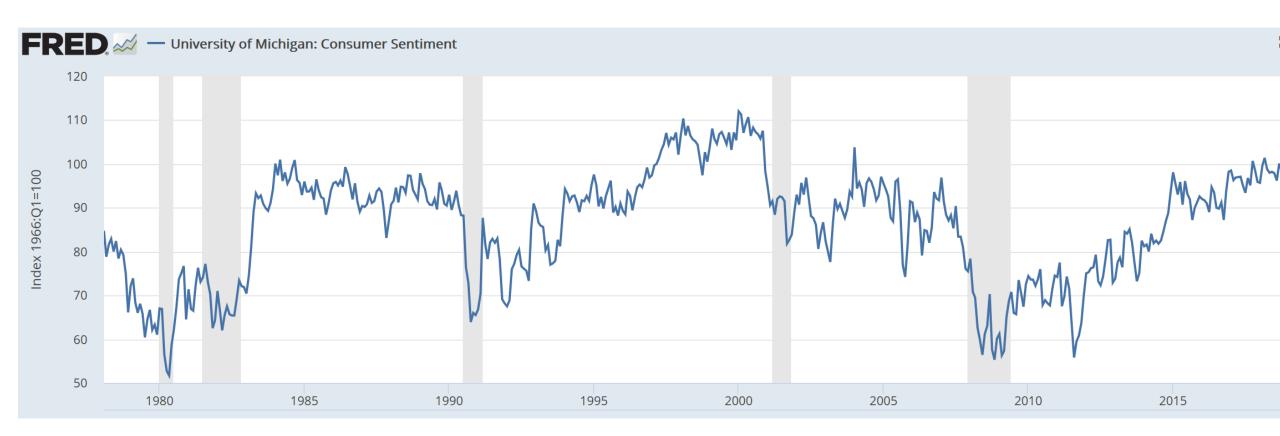


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Sources: Federal Reserve Economic Data and Graaskamp Center

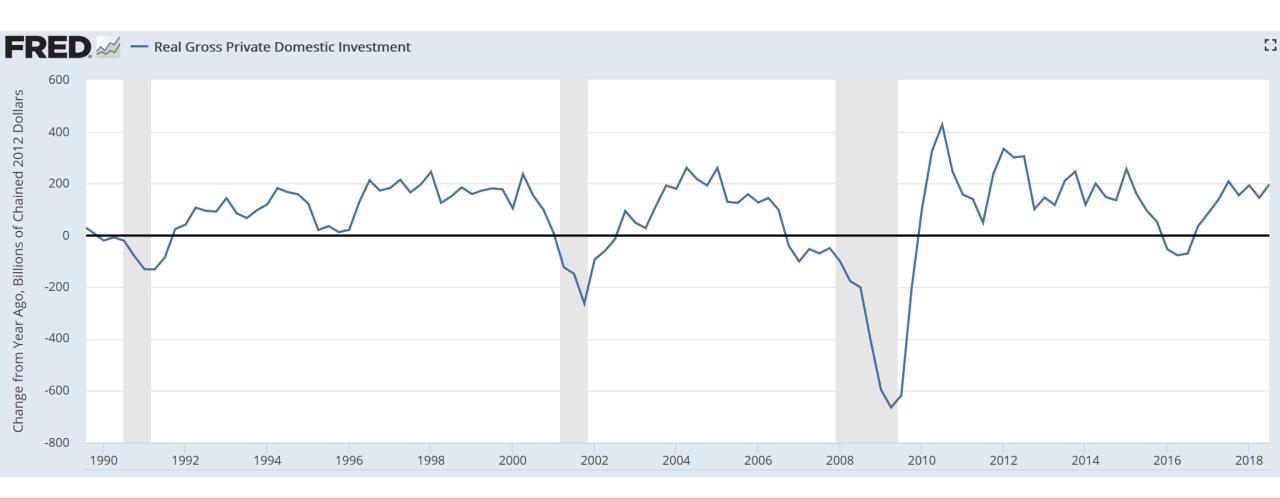
... consumer sentiment remains strong, but changes quickly ...





Source: Federal Reserve Economic Data.

.... and business investment is contributing about 1% to GDP growth





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Sources: Federal Reserve Economic Data

Wages and Employment



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The labor force has doubled since 1970, jobless claims remain near all-time lows....



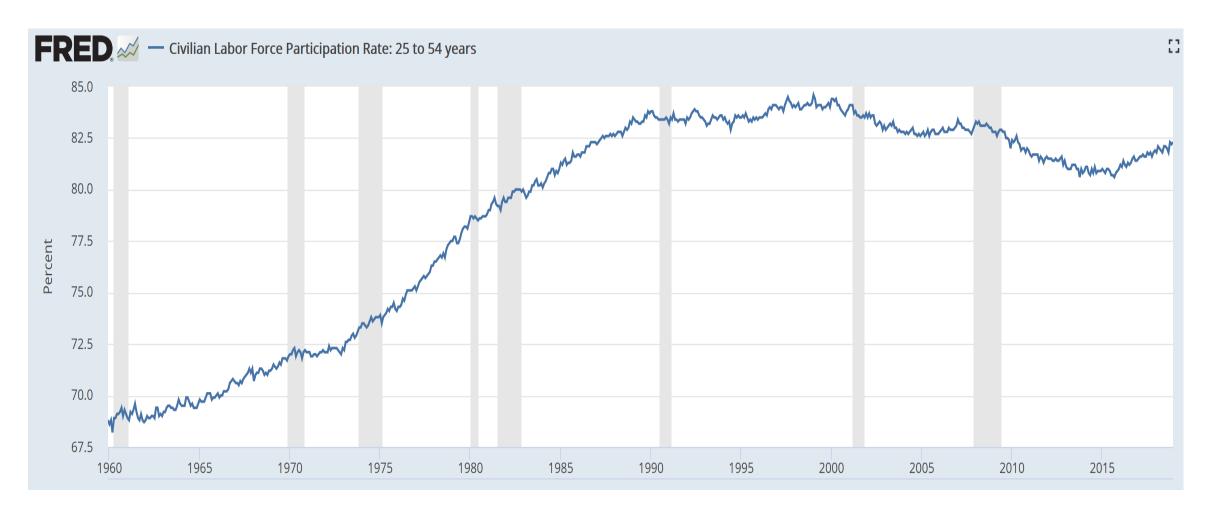


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Source: Federal Reserve Economic Data.

... labor force participation rates are edging up to mid-2000 levels



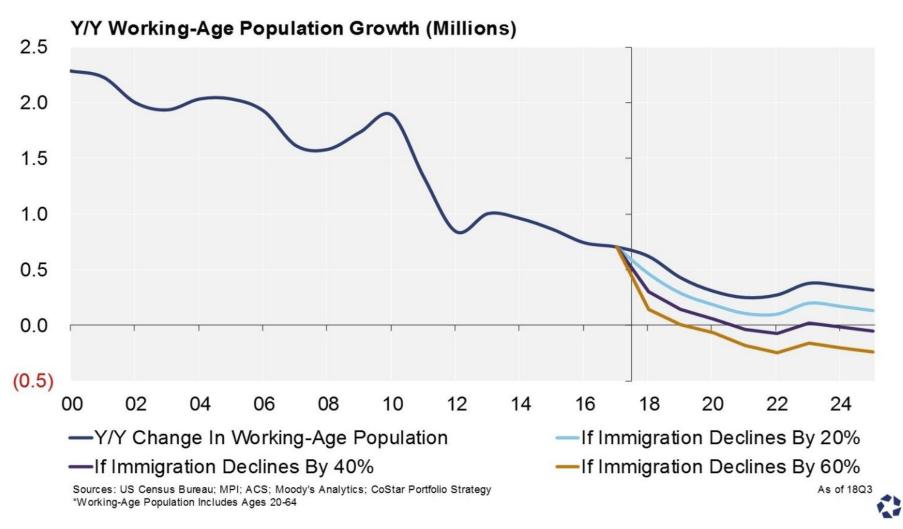


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Source: Federal Reserve Economic Data.

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.... when participation rates stabilize, the U.S. will be need more workers

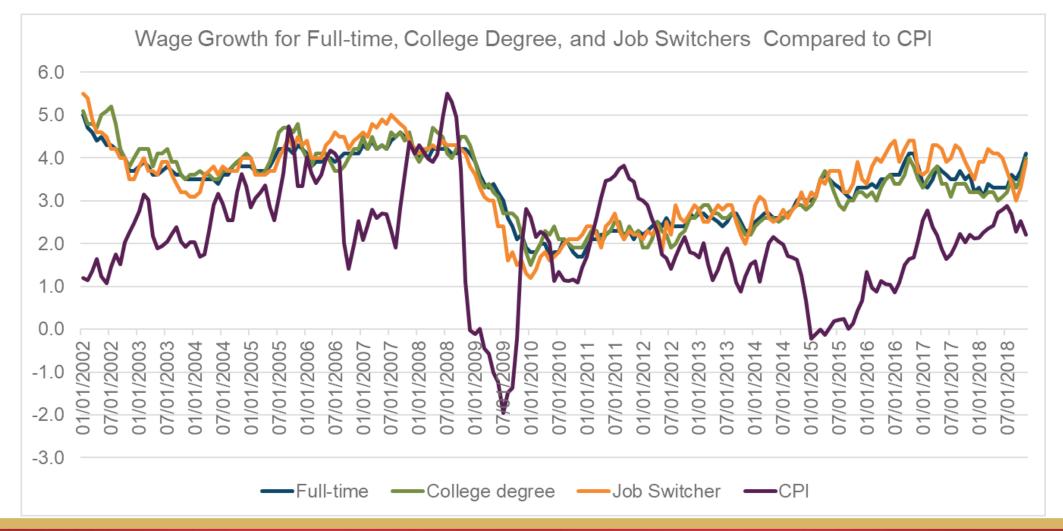




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JAMES A. GRAASKAMP CENTER for real estate Source: CoStar, As Boomers Age Into Retirement, Working-Age Population Growth Slows Sharply, November 15, 2018

... the Fed is navigating difficult economic waters.





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JAMES A. GRAASKAMP CENTER for real estate Source: Atlanta Federal Reserve Bank, Wage Tracker and The Graaskamp Center.

Equity Capital Markets

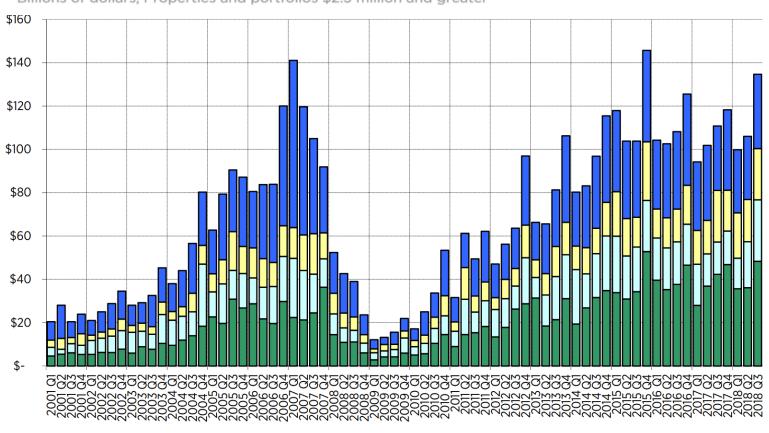


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Commercial real estate transaction volume remains stable/robust . . .



QUARTERLY SALES OF LARGER (\$2.5 MILLION+) COMMERCIAL/MULTIFAMILY PROPERTIES

Billions of dollars, Properties and portfolios \$2.5 million and greater

■ Apartment ■ Retail

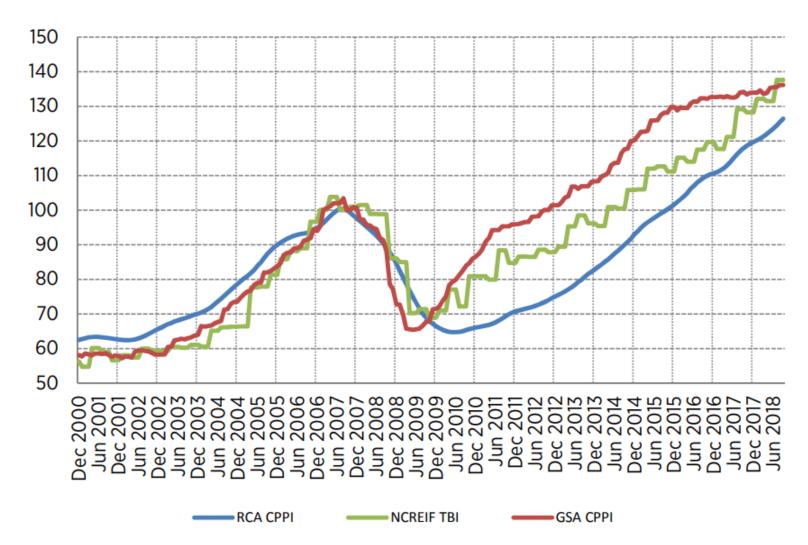
Industrial

Office



JAMES A. GRAASKAMP CENTER for real estate Source: Mortgage Bankers Association, Commercial/Multifamily Databook 2018Q3.

.... with property
values
stabilizing/growing
depending on
which index you
follow, mid-4%
CAGRs 2000-2018 .

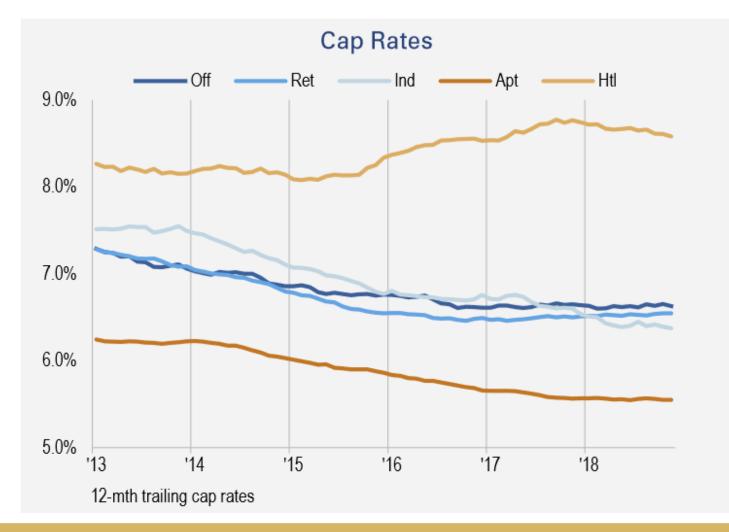


WISCONSIN SCHOOL OF BUSINESS

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JAMES A. GRAASKAMP CENTER for real estate Source: Mortgage Bankers Association, Commercial/Multifamily Databook 2018Q3.

.... RCA cap rates are stable across the four main property types

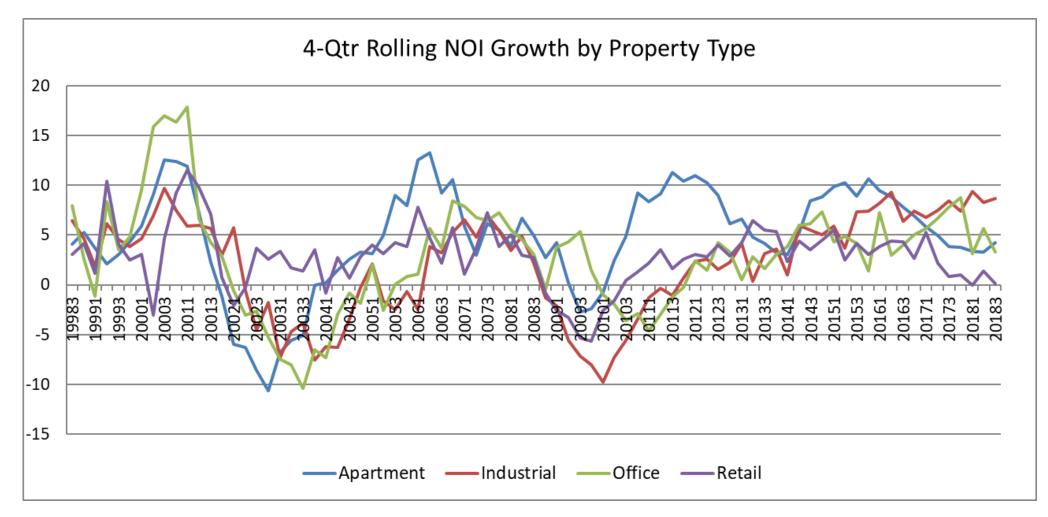




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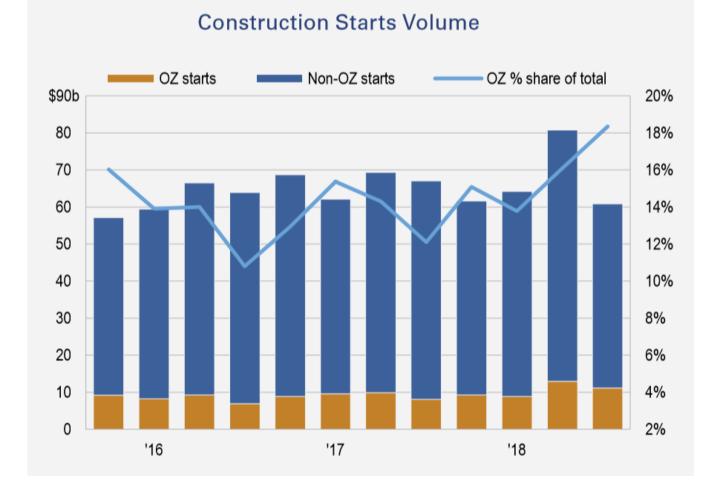
Source: RCA, U.S. Capital Trends, The Big Picture, November 2018

... NCREIF property income growth remains robust, sans retail





... and construction volumes are stable





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Source: RCA, U.S. Capital Trends, The Big Picture, November 2018.

With significant levels of equity on the sidelines



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Debt Capital Markets

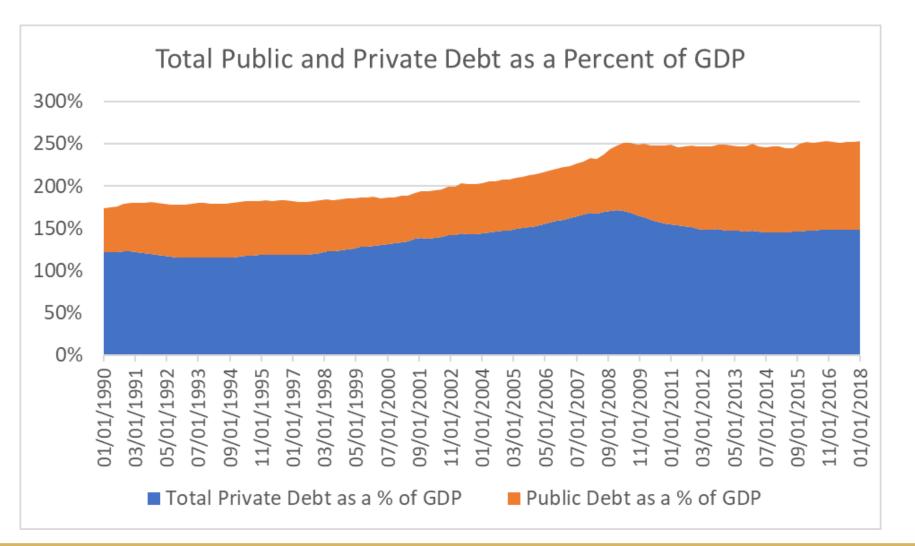


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Private debt as a percent of GDP has fallen from 171% in 2009 to 148% today . . .



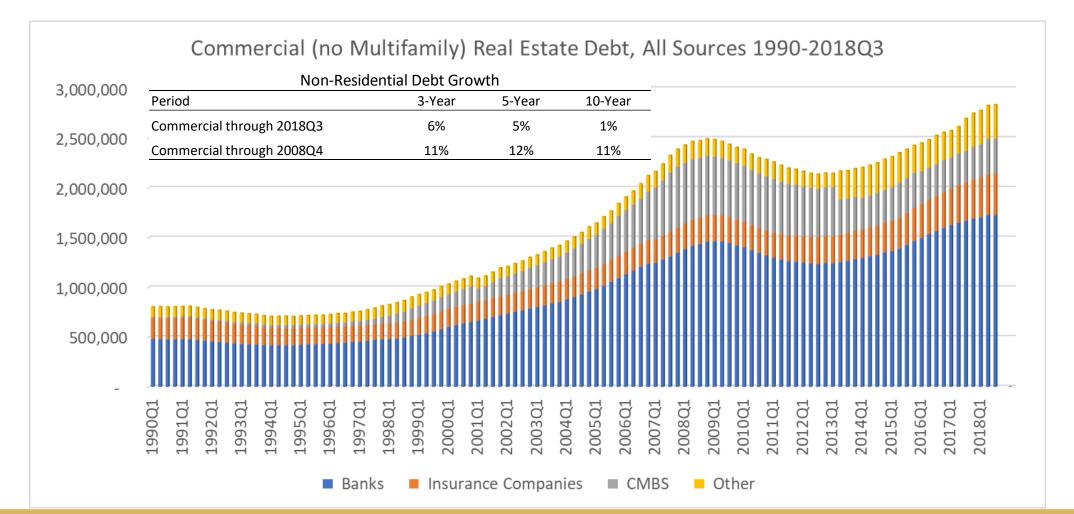


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Source: Federal Reserve Economic Data and the Graaskamp Center.

.... commercial real estate debt outstanding has grown over the last several years

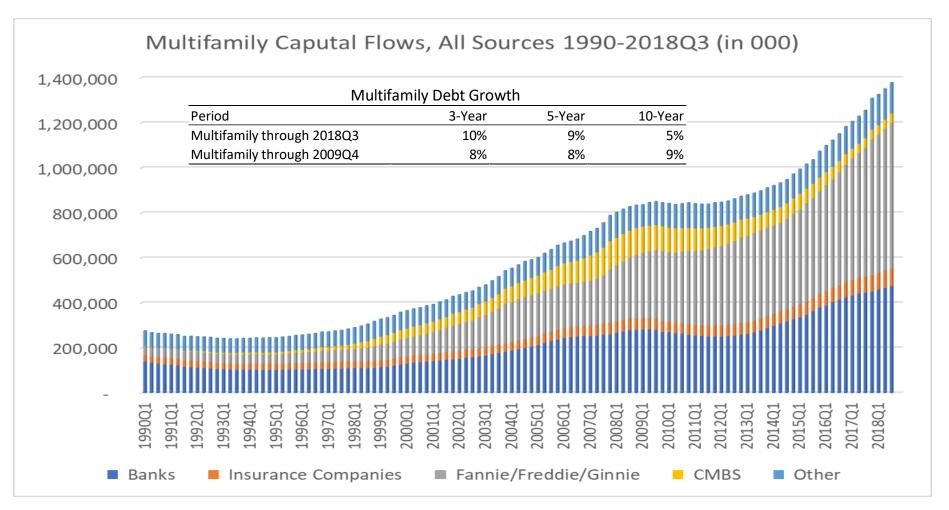




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JAMES A. GRAASKAMP CENTER *for* real estate Source: Federal Reserve Flow of Funds and the Graaskamp Center

... multifamily debt is growing at an unsustainable pace (maybe)

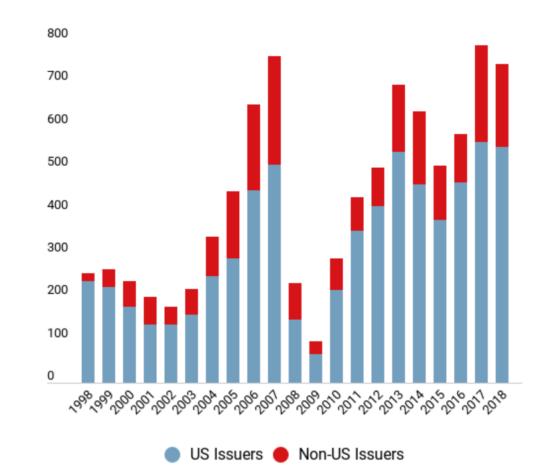




....late-cycle lending behavior, leveraged loans (for all deal types) volume is reaching 2007 levels...

Levering up Global issuance of leveraged loans has been growing since the global financial crisis.

(in billions of dollars)



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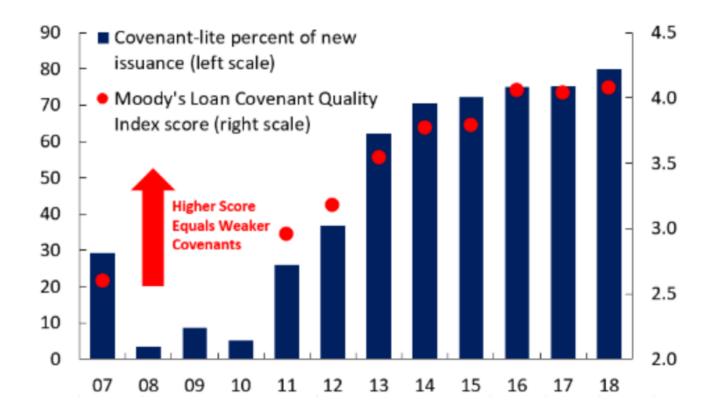
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JAMES A. GRAASKAMP CENTER for real estate Source: IMFBlog, Sounding the Alarm of Leveraged Lending Tobias Adrian, Fabio Natalucci, and Thomas Piontek, November 15, 2018 late cycle
lending
behavior is
showing up in
leveraged loan
underwriting ...

Less investor protection

The volume of loans with fewer investor protections, known as covenants, has grown in the United States, and quality has weakened.

(percent of issuance)





JAMES A. GRAASKAMP CENTER for real estate Source: IMFBlog, Sounding the Alarm of Leveraged Lending Tobias Adrian, Fabio Natalucci, and Thomas Piontek, November 15, 2018

.... what are leveraged loans

What are leveraged loans? Lending by syndicates to non-investmentgrade companies.

What is the size of the leveraged loan market? \$1.36 trillion in outstanding loans at year-end 2017, slightly bigger than the high-yield bond market.

What is the collateral underwriting? More than 80 percent of new loans are "covenant lite" loans, with no financial maintenance restrictions, that give borrowers flexibility to issue more debt, pay out shareholder dividends and even put collateral out of lenders' reach.



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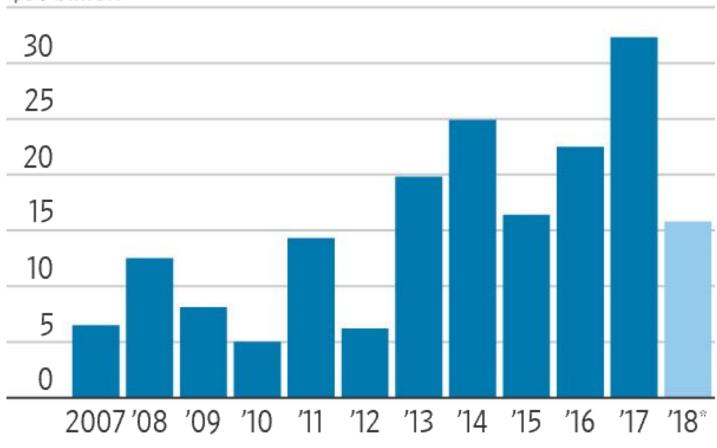
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Sources: CNBC

.... late cycle real estate behavior, leveraged loan debt is a growing part of real estate debt, with investors in these funds including CALPERS, Blackstone, Oaktree Capital, Goldman Sachs, KKR, and TPG

Real-estate debt funds

\$35billion



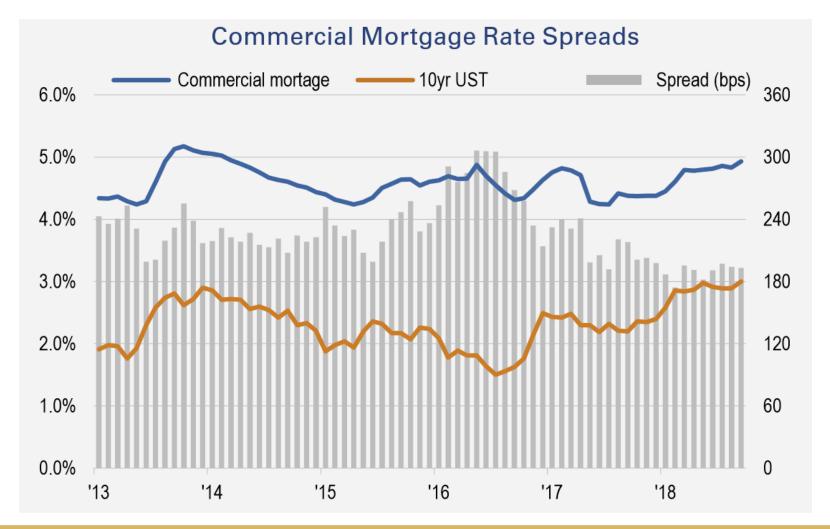
* Through August 2018



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JAMES A. GRAASKAMP CENTER for real estate Source: WSJ, As Property Investors Turn Lenders, Some Warn about Excessive Building, August 21, 2018

.... competition for debt has kept commercial mortgage spreads tight



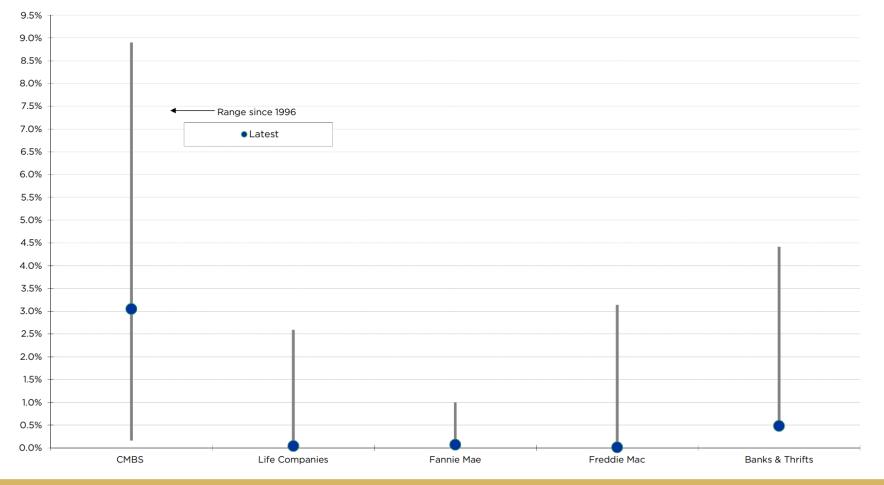


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Source: RCA, U.S. Capital Trends, The Big Picture, November 2018

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.... delinquency rates are at or near 20-year lows for all but CMBS



Delinquency Rate Range 1996-2018 for Select Real Estate Lenders



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JAMES A. GRAASKAMP CENTER for REAL ESTATE Source: Mortgage Bankers Association, Commercial/Multifamily Databook 2018Q3.

Multifamily



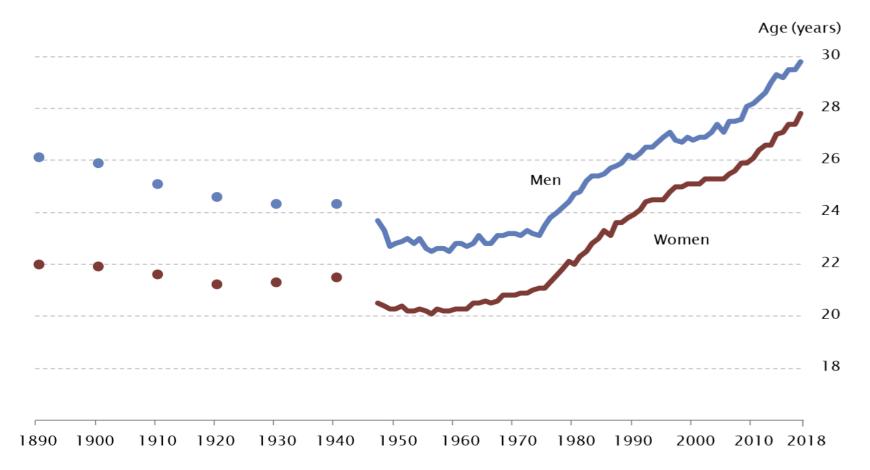
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The demographics for multifamily are very strong . . .

Median age at first marriage: 1890 to present





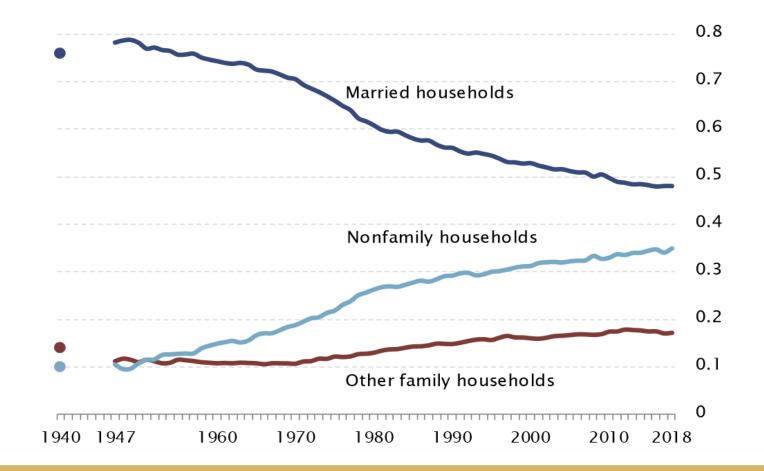
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Source: U.S. Census https://www.census.gov/content/dam/Census/library/visualizatio ns/time-series/demo/families-and-households/ms-2.pdf.

.... more strong multifamily demographics

Percent of households by type





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Source: U.S. Census,

https://www.census.gov/content/dam/Census/library/visualizatio ns/time-series/demo/families-and-households/hh-1.pdf ... between 2006 and 2016 there were

8 million new households created

with 400,000 fewer homeowners....

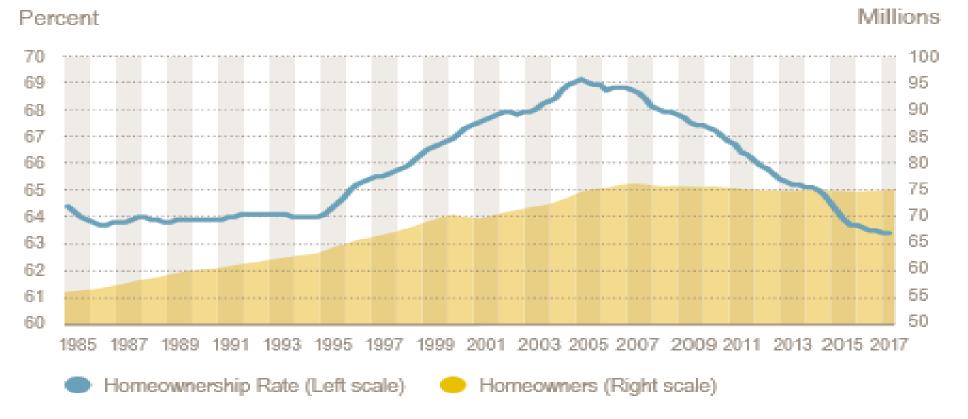


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JAMES A. GRAASKAMP CENTER for real estate Source: The Atlantic, The Never-Ending Foreclosure, December 1, 2017

.... since 2006 homeownership and homeownership rates have declined

Despite Growth in the Number of Owners, the National Homeownership Rate Fell Again in 2016





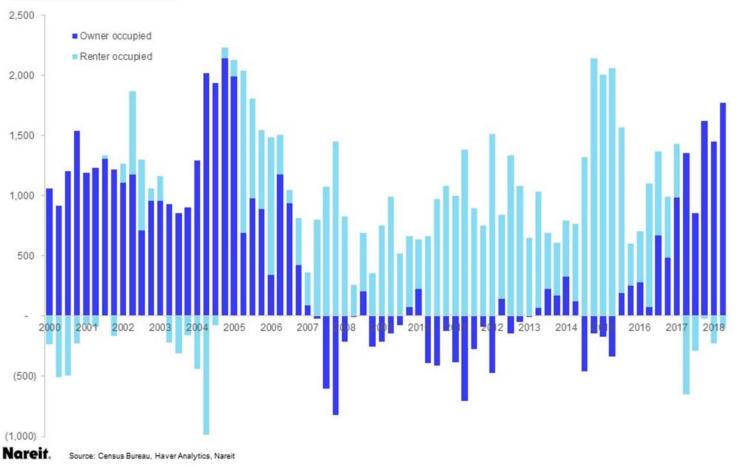
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JAMES A. GRAASKAMP CENTER *for* real estate Source: Joint Center for Housing Studies, The State of the Nation's Housing: 2017, p 20. housing
tenure
decisions
have shifted
to owneroccupied ...

Chart 2. Household formation

Homeowner households are increasing while renters are flat to down

Change over four quarters, thousands





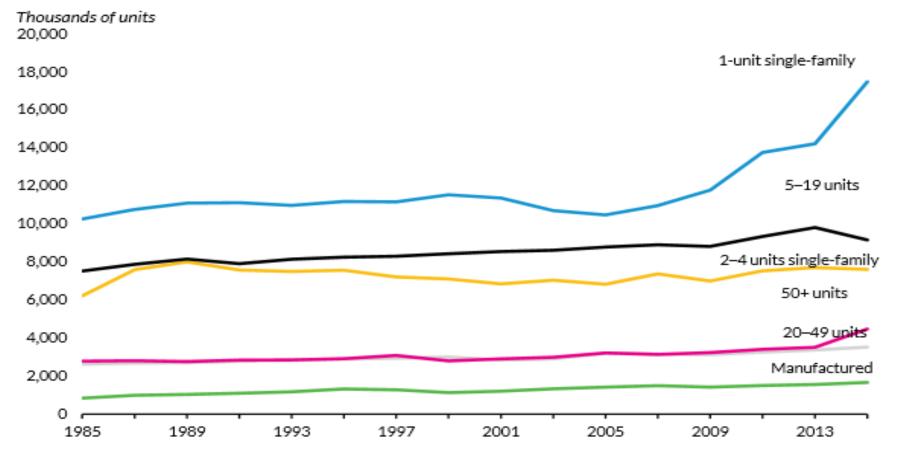
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JAMES A. GRAASKAMP CENTER for real estate Source: NAREIT, Rising Homeownership, Apartment Demand, Single Family Home Rentals and REITs 9/28/2018 | By <u>Calvin Schnure</u>.

... over the past decade, almost seven million single-family homes went from owner- to renter-occupied

Occupied Rental Housing Units, by Number of Units in Structure

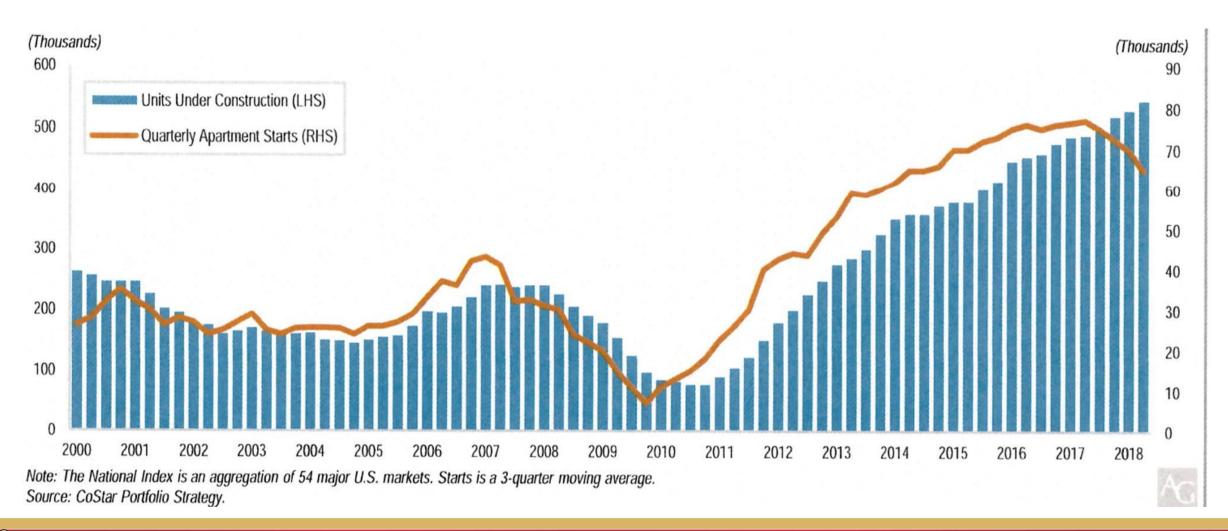




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JAMES A. GRAASKAMP CENTER *for* real estate Source: Urban Institute, L. Goodman and K. Kaul : Fannie Mae's Financing of Single-Family Rentals: Good Pilot but Plenty to think about, February 2017.

.... your next multifamily deal will not lease up like your last deal

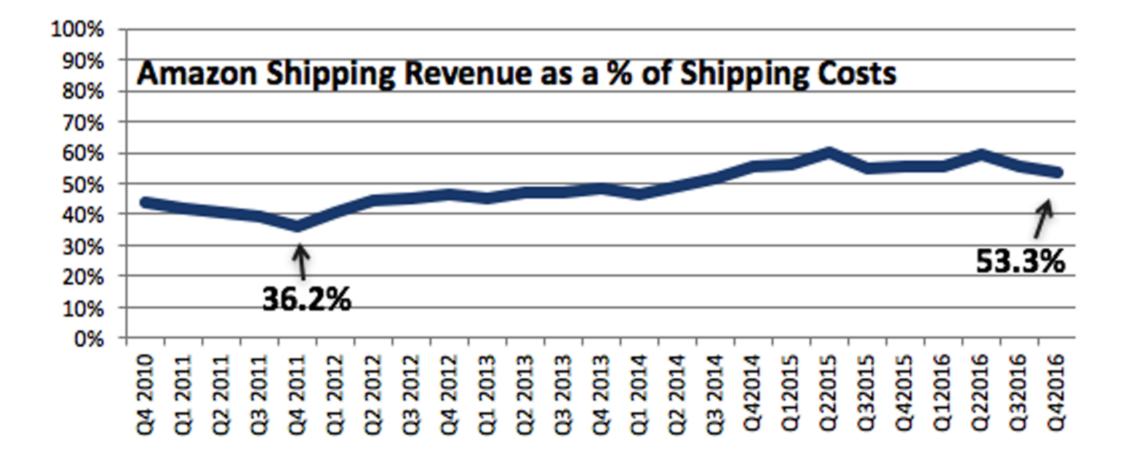




JAMES A. GRAASKAMP CENTER *for* real estate Source: WSJ, As Property Investors Turn Lenders, Some Warn about Excessive Building, August 21, 2018

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Warehouse, one slide, fix this problem for Amazon!





JAMES A. GRAASKAMP CENTER for real estate Source: GeekWire and Amazon Financials, The cost of convenience: Amazon's shipping losses top \$7B for first time, Todd Bishop, February 17, 2017.

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The Forecast

Asset prices:

• Cap rates will widen out by 25-50 bp to account for new risk premiums Equity capital:

- Transaction volumes will fall by 5-10% over economic and pricing concerns Debt capital markets:
 - Will be robust, but tighten near year end
- Space markets:
- Apartment overbuilding and weak absorption will reduce YOY NOI GDP growth:
 - 2.0% YOY and falling

Wage inflation will push interest rates higher, weak economy as an offset

• 10-year UST at 3%+/-



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