1. INFRASTRUCTURE

In our May 2019 survey, more than 50% of the responding Counselors ranked Infrastructure as one of the top three issues affecting the real estate industry. Respondents urged that this not be put on “the back burner” even though it is a chronic issue that gets displaced from public attention as more “hot button” and controversial matters capture headlines. Ironically, given supposedly bipartisan agreement on the need for infrastructure investment, political stresses (discussed as a key issue in its own right) have again “tabled” discussion as of late May, even after a White House/Congressional leadership meeting raised hopes of an ambitious commitment of up to $2 trillion for this much needed national priority.

The CRE Top Ten has underscored the importance of infrastructure repair and modernization over the years. Yet roads, bridges, tunnels, railways, airports, the power grid, water and stormwater systems, and the levees that protect cities and farmland from flooding appear to be giving way with greater frequency. As one Counselor noted in our May survey, “Crumbling infrastructure thwarts economic growth, and is a daily aggravation to many.” Another CRE said that inadequate infrastructure “creates a hard ceiling to economic growth as we are unable to distribute goods and services efficiently.”

Counselors have first-hand experience with international commerce and the investments that have been made in infrastructure around the world. We are seen to be lagging when compared to other nations around the globe, and this is creating a drag on our economic competitiveness not only in goods flow, but in telecommunications and data management capacity. One CRE commented, “Without substantial infrastructure improvements, several large US cities (including New York and Washington DC) will become untenable for corporate expansions and top talent.” “The USA needs to invest in new infrastructure to compete in the global market,” said another Counselor.

We may have already wasted a great opportunity in the recovery from the Global Financial Crisis, as America was able to borrow long-term at very favorable rates—the very definition of the kind of financing needed for major capital projects. Yet there is still a window available, with the 20-year Treasury bond at about 2.6%. The world is hungry for long-Treasury instruments, and would readily fund an ambitious infrastructure effort, without the need for the expensive equity capital sought by most public-private partnership concepts.

Much of America’s future economic growth depends upon improved productivity, as demography is no longer as favorable as it has been since World War II. Productivity, in turn, will be a function of efficiencies across the core systems in the economy. Better infrastructure is required to support growth, and real estate values (both residential and commercial) are tied to more sustainable growth.
2. HOUSING IN AMERICA

The Counselors have expanded discussion of housing as a Top Ten issue beyond the dimension of “affordable housing” this year. While affordability is central to the discussion, we wish to stress that our concerns are not simply with lower-income, or even lower-middle-income housing. The range of population facing difficulties in securing an appropriate place to live extends from those who are homeless—in big cities, small towns, and rural areas across the country—to Millennials and Gen Z members entering the workforce in thriving cities where apartment rents have soared beyond their capacity to pay in neighborhoods reasonably proximate to their workplaces. Moreover, the liquidity of the housing market has been compromised by the difficulty of Baby Boomers in finding buyers for the homes which represent a major portion of their net worth.

The underlying causes can be found both on the supply side and the demand side of the housing equation. The mortgage crisis of a decade ago disrupted a housing production industry which had sustained solid volumes of new units, both ownership and rental. When the bubble of spurious financing mechanisms burst, one casualty was the residential construction industry. Besides a lower volume of residential building, the mix of units shifted toward more affluent buyers and renters, where it was more feasible to produce houses and apartments profitably. Increasing costs entered into the development equation, including labor costs as the number of construction workers fell after 2008, and the price of land, lumber and other building materials pushed upward, especially in those higher density cities which emerged as the most prosperous over the past decade.

From the demand side, the ability to manage housing expenses has become a juggling act for many younger households burdened with student loan debt—a negligible factor a generation ago but now a top-of-mind concern for twenty-and thirty-somethings—and healthcare costs that continue to run ahead of general inflation and which are increasingly tilted toward higher deductibles and co-pays in an insurance market enduring its own disruptions. While job creation has been strong and unemployment is at a fifty-year low, income growth has been almost exclusively seen in the upper quintile of earners, meaning that increasing housing costs for the remaining 80 percent of the population must be funded by real incomes that have diminished over the past two decades. This widens the gap between an increasingly expensive supply of housing and a decreasing level of effective ability to pay.

As with Infrastructure, Housing ranked first, second, or third in the tiered choices of more than fifty percent of CREs surveyed in May 2019. As one Counselor put it, “Housing is a 24/7/365 matter, with ramifications in job creation, the tax base, the structure of family and society.” Another Counselor commented, “Housing is at the core of social order. Challenges in adequately meeting housing demand will permeate all areas of real estate.” A third CRE elaborated that housing issues “make it difficult for people to move in pursuit of employment opportunity, and lead to political strife that is undermining the basic social compact and faith in the market-based (but regulated) economy.” A fourth CRE said,
“This is an irresponsible condition in a land of plenty, a symptom of inequality” and a fifth Counselor maintained, “Both public and private sectors have to come up with solutions. This important issue is not just affecting America but cities and communities across the industrialized world.” Still another observed that housing stress “is threatening the stability of the middle class, potentially affecting many other important parts of the economy.”

These comments and others from our survey underscore the depth and breadth of the problem. Some noted that public policy responses have tended to be blunt instruments, ranging from the spread of rent control around the country to the provisions enacted in the current Tax Code that limit the deductibility of state and local property taxes in the Federal Income Tax, squeezing urban and suburban homeowners with a double penalty—the property tax liability itself, and then the loss in disposable personal income on an after-income-tax basis. In neither case is the fundamental supply/demand problem outlined above even remotely addressed.

Although the CRE Top Ten Issues list has identified housing as a perennial topic, at the present time Counselors are seeking to target it with an urgency that has intensified. Concerns about housing affect several other topics on our Top Ten list this year, including Population Migration, Political Division, and Volatility and Confidence. It is apparent that our professional real estate membership regards housing in America with a higher level of concern—both in the short and long run—than is expressed in more broadly-based opinion polls.
3. WEATHER AND CLIMATE-RELATED RISKS

For many investors, they can no longer rely on historic performance to predict future returns. Climate risk has emerged as a new—and likely permanent—aspect of fiduciary duty and what it means to assess, disclose, and manage these risks for real estate investments. Increasingly, investors are demanding that climate risk be assessed and factored into future return projections and day-to-day decisions. One Counselor notes, “whether it is coming or not, it is affecting investment decisions.”

Weather and climate related events present physical and operational risks for real assets. Both in terms of acute risk from hurricanes, flooding, wildfires, landslides, and extreme snowfall, but also chronic risks from sea level rise, drought, heat waves, water scarcity, and food security. For the real estate industry these risks provide new opportunities and additional challenges. Many real estate owners and developers are adapting by hardening assets, strengthening emergency preparedness plans and strategies, moving mechanical systems to higher floors, installing backup generators, sea walls and berms, and calculating the ROI of on-site renewables and battery storage.

Even if a property isn’t exploring or implementing adaption and resiliency strategies, they are surely relying on insurance as a strategic response to climate risks. The National Center for Environmental Information (NCEI) is the Nation’s scorekeeper of the economic impact of weather and climate data. According to NCEI, the average insured loss per year for 1980 – 2018 is $19.3 billion. The frequency and intensity of weather events is increasing. The year 2017 was the most expensive year in recorded history for weather and climate-related insurance losses, costing the U.S. more than $300 billion. As one Counselor astutely says, “Our cities will survive Trump, Brexit, and even another downturn, but we cannot continue to have Houston-like events and pretend this won’t impact our industry.”

Since 2008, the volume of property and causality premiums written increased over 33%. The 2018 insurance losses for California topped $12 billion following the deadliest and most destructive wildfires in a century. More than 13,000 insured homes and businesses were destroyed out of more than 46,000 claims reported by insurers. Midwest flooding is preventing farmers from planting crops and there is much discussion about how weather is likely going to affect farmer yields this year. Following climate related events, property valuations are taking a big hit. An analysis by NCREIF and National Hurricane Center data found that for all property types, on average a hurricane decreases values by almost 6 percent one year after the storm hits. The negative effect is even greater two years out with a 10.5 percent valuation decrease.

As a Counselor warns, “Insurance will be unable to deal with the risk, and costs will rise sharply. Insurance will no longer be available for certain types of risk. Costs to remediate effects of rising sea levels will be astronomical.” Further, insurance has its limitations as a response strategy. While properties can be insured against the actual damage from a climate event such as hurricane, it can’t address the loss in value due to changes in the supply and demand for space in that market.
Additionally, there is also transitional risks associated with climate, especially that of policy and legal risk, technology risk, market risk, and reputation risk. One Counselor expresses concern regarding “our general unpreparedness” as an industry by saying, “the associated risks of climate change will be a game changer for our industry and we are not prepared to integrate these new risks into our standard business processes for due diligence, operations, valuation, and sale.”

The Counselors correctly observe that climate change is driving a host of new building laws and ordinances that owners and operators need to understand. Twenty-nine cities and two states now require building laws that range from mandatory energy and water benchmarking to ambitious climate goals. Public and private buildings must be made dramatically more energy efficient. For example, in Washington D.C. the Clean Energy DC Omnibus Act focuses on energy reductions with performance targets that must be met, whereas New York City’s Local Law 97 focuses on carbon reductions, setting annual carbon intensity limits on building emissions, including emissions from electricity consumed by buildings 25,000 square feet and larger. In Washington, the rulemaking process will define the details of compliance, whereas in New York City Local Law 97 already spells out carbon intensity limits that will effectively require improvements by the bottom 20% of worst performing buildings in the initial 2024-2029 compliance period. Property owners and investors have a new set of rules to understand and strategic responses to be developed in order to comply with these laws and maintain projected returns.

Responding to greater market awareness of these risks, investors and stakeholders are increasingly pushing for more actionable information and greater transparency. In particular, the Financial Stability Board (FSB) Task Force on Climate-Related Financial Disclosures (TCFD) seeks to stimulate market dialogue and increased transparency on climate-related risks by providing information to investors, lenders, insurers, and other stakeholders, and encouraging investment managers to align their disclosures with investors’ needs. As of February 2019, over 580 companies, responsible for over $100 trillion of assets, have expressed support for the TCFD recommendations and are working to assess and integrate climate-related risk in company disclosures.

One-way investors can rank and compare real estate fund performance is through the proliferation of more than a dozen voluntary reporting frameworks. These frameworks have emerged to evaluate, validate, score and provide business intelligence on Environmental, Social and Governance (ESG) aspects of sustainability. Among these frameworks, the Global Real Estate Sustainability Benchmark (GRESB) is uniquely designed as an ESG benchmark for listed property companies, private property funds, developers, and investors that invest directly in real estate. In 2018, more than 900 organizations surveyed over 79,000 assets across 64 countries that represent more than $3.6 trillion in gross value. And, more than 90 institutional investors, collectively representing over $22 trillion in institutional capital used GRESB data and rankings in investment decisions.

This is just the tip of the proverbial iceberg, with many additional implications for real estate. From building certifications and rating systems, to new underwriting and lending products, to more stringent building codes and standards, to an already strained and antiquated infrastructure, investors and policy maker’s response is having a dramatic and indelible mark on the real estate industry. Climate related risks are deeply interconnected to other top issues on this year’s list, including political divisions, infrastructure, affordability of housing, and investor confidence.
4. THE TECHNOLOGY EFFECT

“Tech is going to drive the capital markets, use of space, leasing, brokerage, valuation, and building operations,” said one Counselor in our May 2019 survey. “Technology may be making the actual location of a business less important,” said another.

It’s no surprise that technology is a Top Ten issue since it affects nearly every area of our lives and the business of real estate is no exception. Real estate has had somewhat of a different technology adoption path compared to other industries because of the bifurcation between the back-office technology and the “front of house” technology in our buildings. In other words, back-office solutions and systems were generally in-step with tech advances in other industries, whereas the buildings and the technology that run them have been at least a decade behind in employing what was otherwise current-day tech.

While leveraging many IT attributes, the buildings themselves used a different type of tech called operational technology (OT) which was somewhat left behind. The OT building control systems such as HVAC, elevator, lighting, and parking work on and depend on computer servers, operating systems, protocols, local area networking (LAN) and remote Internet access. Those responsible for designing, installing and maintaining them for the past 40 years have neither IT nor cybersecurity skills. Thus, in addition to the bifurcation issue, there is a systemic risk that the entire building-control-systems value chain does not have IT skill sets, which has operational risk implications.

Notwithstanding those risks, all the back-office and building technologies are now beset by new technology leveraging the Internet of Things (IoT), big data, analytics, digital twin, artificial intelligence (AI) and blockchain. These are all moving faster than the industry can assimilate them and as a result we see a wide variety of solution types, adoption rates, vendors and results.

If this makes your head hurt, it’s just getting started. The industry is moving into overdrive with increased intensity on occupant experience where all of this comes together in near real time by having to track people and react with environmental conditions, amenities and responsive services, and dynamic billing or allocation—all requiring integration and automation like never before.

The answer is simpler than it sounds. Like we saw with smart phones and tablets, the more technology advances the simpler it can be to have experiences and get results. Since no one expects real estate executives to be MIT technologists, don’t approach it that way. Take a step back and count on the fact that there is ample technology to support even your most inventive desires for efficiency, experience, and risk management. The real estate industry can start creating next-generation use-cases in real estate terms and not tech terms. Some large organizations have even disseminated RFPs with only use cases as the criteria and let the industry figure out how to respond, partner and fulfill the requirements.
In more general terms, organizations need to staff and organize around the realities of technology including the speed of change, which is equally bringing risk and opportunity. It’s important to measure twice and cut once. Underlying all of this is a need for new levels of cybersecurity not only addressing the data and hacking, but also the fragmented OT systems and contractors. The greatest risk is not adapting and changing quickly, which will be a competitive miscalculation or an impending operational risk or more likely both.

Technology enables shifts in consumer behavior (ecommerce), which has impacted industrial real estate positively and retail somewhat negatively. Tech companies are the dynamic drivers of economic growth, leading to highly selective criteria for office locations. Emerging technologies could cause future impact on supply chains (automated vehicles), warehouse space demand (robotics), delivery of medical services (seniors housing and medical office), data proliferation (data centers), and property security and marketing (all sectors).

Technological advancements have a nexus to many of the selected issues in the 2019-20 Top Ten. It’s at the core of international trade issues, is a central driver in demand for the four primary real estate asset categories, and is central to continued productivity gains.
5. END-OF-CYCLE ECONOMICS

It may seem peculiar to cite “complacency” as a particular risk as of mid-2019. Most macroeconomic indicators seem to point to economic conditions that can be fairly described as “robust,” if not “the best we have ever seen.” The unemployment rate has descended below four percent. We continue to see strong employment expansion, and some improvement in incomes. The Bureau of Labor Statistics “JOLTS” indicator (Jobs Openings and Labor Turnover Survey) is measuring a greater number of available jobs than there are prospective workers to fill them. Yet, under such strong conditions, inflation and interest rates remain low and consumer confidence levels are relatively elevated.

This all looks like a “Goldilocks” condition, as the U.S. is ready to set a record for the duration of a rising business cycle. Nevertheless, the very ebullience of the economic psychology may be causing us to ignore the very nature of cycles – that they peak just as a downturn is nigh. There is a tendency to forget in good times, as well as a false expectation that the shape of a previous downturn will help predict the conditions of the next recession. Extrapolating recent trends indefinitely into the future while ignoring signs of the limits to growth sets us up for harsh surprises. Or, as Alan Greenspan wrote about the crisis of a decade ago, economists (including himself) “never saw it coming.”

It is apparent, however, from the survey results of the Counselors’ view of top issues affecting real estate, that CREs are very attentive to the risks that macroeconomic conditions pose for commercial and residential property. Perhaps Counselors’ long-term and short-term memories are especially attuned to the industry’s cyclicality. Most CREs have weathered four or more recessions over the course of their careers and have seen (especially in the collapse of values 1989-1994 and again 2008-2011) how economic exuberance can deflate unexpectedly. Or how, more recently, signs of fragility emerged during the December 2018-January 2019 government shutdown. Even the solid numbers generated by GDP last year and in 2019’s First Quarter failed to protect the 800,000 Federal employees from needing to resort to food banks once a couple of paychecks were missed. And for many, the specter of further income disruption put their ability to meet the rent or mortgage payments on their housing haunted the family future – even though a U. S. government job might appear the essence of secure employment. The lesson: while the edifice of the economy still seems impressive, its foundations may be shakier than generally presumed.

Comments by the Counselors reveal their sensitivity to past patterns, and to the unusual conditions on the economic and industry horizon for 2019/2020. “Nothing,” one CRE said, “will affect real estate more than the end of the cycle, which is fast approaching.” Another concurred, “Real estate demand is derived from the economy, and there are many signs the expansion is coming to an end, probably by 2020.”
Watching the property markets specifically, a third Counselor observed, “The extended upcycle has encouraged increased speculative development in non-traditional product and even in multifamily in some markets. It may prove painful for late-stage projects.” Another warned, “Lessons never seem to be learned. Market participants are once again lacking discipline.” Interest rates are signaling trouble with the inversion of the yield curve, and with an overhang of public and private debt, the “end of cycle event” could impact liquidity if a shift in the cost of funds seeps into real estate valuations.

There is also the potential for a truly disruptive surprise for those who believe that real estate “knows how to deal with cycles and can count on a return to growth after a short downturn.” Neither the capital markets generally nor the real estate markets in particular seem prepared for a US economy that is likely to grow in the 2020s at a rate of only 40% to 50% of its 2012-2019 pace in terms of GDP and jobs increase. To the extent that both equities and real estate values are anticipating a “normal” upturn after a recession, the readjustment of prices to expectations of much slower growth will make this “end of cycle” event even more painful, puncturing the complacency still widely felt in early 2019.
6. POLITICAL DIVISION

The Counselors of Real Estate is not an advocacy group, and our membership spans almost the full range of the political spectrum. We therefore tend to refrain from political commentary that would not reflect the views broadly held by CREs. However, as we polled our membership in May 2019, the adversarial conditions prevailing in the current political arena were frequently cited as a major issue affecting real estate directly, and indirectly through their economic impacts. As several of the Counselors observed, political gridlock and/or infighting is either creating problems or frustrating solutions in many of the issues considered elsewhere on our Top Ten list. These include Climate Change, Population Migration, Infrastructure, and Housing.

The state of America’s political dysfunction, which some Counselors note has eroded our international standing, has intensified over the past several years, even during the period when a single party controlled both the Executive and the Legislative branches of government. And the faceoff between a Democratic-controlled House of Representatives and a Senate aligned almost unanimously with a Republican-controlled White House has brought governance to a screeching halt.

Specific policies which might otherwise elicit bipartisan action have been blocked by the political chasm. A primary example might the brief glimmer of hope for an infrastructure bill raised by a White House meeting between the President and the Democratic leadership, when a suggested $2 trillion initiative was discussed publicly. A bare three weeks later, that comity collapsed when the President took the topic off the table, subject to the condition that the House desist in its varied investigations, including some that appeared to aim at establishing predicates for impeachment proceedings. Thus, the vital state of the nation’s physical systems became a bargaining chip in our divisive politics.

Lost in the headline news about tariffs and trade is the underlying disagreement about executive power versus congressional power in the realm of international agreements. The White House has invoked its broad national security discretion in the selection and implementation of tariffs, even in the case of long-standing allies and trading partners in our own hemisphere and in Europe. Given the interests of constituents adversely affected by the tariffs, including farmers suffering loss of markets and American consumers facing rising prices for imported goods, elected representatives would normally be expected to push back effectively. But the shift of executive attention from multilateral trade agreements to attempts to reframe policy bilaterally, coupled with the extensive discretion granted the White House especially after 9/11, has limited congressional leverage. Thus, trade policy has become a tool to favor selected U. S. industries or to influence other countries toward preferred policies on issues including migration and NATO financing. Improved political dialogue domestically would likely result in better prospects for real estate conditions including farmland values, the level of demand for industrial properties, and levels of risk affecting investment flows into commercial property as an asset class.
While both ends of the opinion spectrum, left to right, could be found in the comments submitted by Counselors, it was the effect of the partisan division itself that prompted concern in a practical sense. One CRE described it this way, “Political differences make our options more limited, increase the cost of solutions, and cost us more and more of our competitive advantage around the world.” “There is so much vitriol,” remarked a second Counselor, “it has gotten ugly and volatile, and political stalemate is off the charts.” Other CREs chimed in:

- “It is hard to get people focused on long-term goals.”
- “If we cannot work together, we cannot get anything done – including other items on the Top Ten list.”
- “This is a time of crisis and will impact all aspects of real estate and commerce.”
- “Uncertainty in government leads to uncertainty in real estate demand.”

The great German unifier of the 19th century, Otto von Bismark, maintained that “politics is the art of the possible, the attainable, the art of the ‘next best.’” In America, Henry Clay of Kentucky served as the 7th Speaker of the House and our 9th Secretary of State and earned the nickname “The Great Compromiser” by finding solutions to major regional disagreements in the four decades prior to the Civil War, helping the United States grow despite deep ideological and party differences of the day. America today has ample opportunity to advance economically, socially, and in the development of its cities, towns, and rural area. But to do so a middle-way is required that elevates pragmatism above partisan purity. The members of the Counselors think that such pragmatism is long overdue as a bridge across the political divide.
7. CAPITAL MARKET RISK

The availability of debt and equity—and risk return expectations for this capital—is always on the Counselors’ mind. Transactions, whether debt or equity, used for acquisition or refinancing and recapitalization of existing investments rely on the liquidity provided by active capital markets participants. As risk tolerance, perception of the market’s position in the cycle, and tastes and preferences for space change, so does pricing and demand.

When you look at the other top issues on the minds of the Counselors and their clients, capital markets activity and its impact on these issues becomes more evident. Infrastructure, Housing, and Weather and Climate-Related Risk are at the top of the list, and liquid capital markets provide the “bass beat” for the soundtrack. The domestic and global infrastructure needs cannot be met without an effective leveraging of a multitude of capital options. Local municipalities require the participation of fixed-income investors to invest in project-specific bond issues. Public/private partnerships play a role in bringing the required capital to much-needed projects, requiring investment allocations from the private sector that need to be incentivized. Tax policy and infrastructure strategy need to be in alignment. On the housing front, particularly affordable and workforce housing, there are direct capital markets implications. Sources of capital for financing purchases and the availability of incentives to developers are required to provide the appropriate liquidity and new housing product. Lastly, climate change and the impact of sustainability are more prevalent in the capital markets in various forms such as green investment funds.

When looking at transaction volume as a driver for capital markets activity, we see a year-over-year decrease in volume of 4% according to Real Capital Analytics. Sales of portfolios were up 36% and single asset sales with down 12% year over year. Without the large portfolio trades, overall sales volume is down double digits. Bid-ask differences, as well as end of cycle market considerations, are becoming more visible. Private equity dry powder for real estate investing is at its highest level in over 10 years—more than $320 billion, according to Preqin.

Public REITs have shown solid returns and high-grade debt issuance is strong. In Q1 2019, 85% of the REITs met or exceeded earnings expectations. At the recent NAREIT conference in early June, the mood was upbeat with REIT shares rallying. According to Wells Fargo Securities, year-to-date issuance of unsecured REIT debt through the first six months of 2019 stands at $581 billion, down 6% year over year. REITs performed poorly vs. comparable corporates in 2008 but appear to be better positioned now after ten years of recovery—with more unencumbered assets and lower leverage—and ready to take advantage of any corrections in the market.

On the debt side of the capital markets balance sheet, the market is flush with liquidity. Debt Funds, commercial real estate CLO’s, CMBS, mortgage REITs, institutional lenders, and banks all have capital to place. Competition is strong and this has begun to show itself, affecting loan standards such as leverage, structure, and the other risks lenders are willing to take. The outstanding commercial real
estate debt stands today at a record high of almost $3.5 trillion dollars, up almost one trillion dollars from the 2011-2012 trough after the financial crisis, according to data from MBA and Morgan Stanley. Lenders are working for less spread today, with 100 basis points of yield compression just over the last 9 months, and according to market participants at a recent Morgan Stanley event, the compression isn’t going away soon. There is a lot more capital and a lot fewer deals to pursue. The emergence of debt funds and mortgage REITs and their growth over the last four years has brought the number of those lenders to more than 200. Several debt funds created over the last few years have come from the developer side of the market. Real estate developers who had traditionally stayed on the equity side of the street have now raised capital to lend because of yield compression on the equity side. Private equity firms such as Blackstone, TPG, and Starwood have created mortgage REITs, providing large scale debt packages to institutional borrowers.

Supporting this additional liquidity are CLO product as well as warehouse financing credit lines from major financial institutions. Lower cost of capital leverage has allowed Debt funds and mortgage REITs to leverage up their equity yields. Spread compression in the CLO market has supported significant growth in the market over the last 5 years, more than tripling 2015 origination levels. Another critical component of the commercial real estate/multifamily finance market has been supported by active lending from the GSE’s. In 2008 the outstanding aggregate mortgage balance for GSE’s, which include Ginnie Mae, Freddie Mac, and Fannie Mae, was under $100 billion. Today the outstanding balance for those three agencies exceeds $670 billion.

Other considerations affecting the real estate capital markets include tariffs on various property types, the relationship between corporate yields versus CMBS and other securities, and the probability of agency reform. Since low interest rates continue to persist, investors looking for yield are moving down in credit, despite broad macro concerns of where we are in the cycle. The capital markets are complex, global, and everchanging. Technology will likely play a greater role in how capital is allocated and, in a correction, how it is efficiently traded. It’s safe to say that whatever it looks like this time, it will be very different than the last one, and the Counselors will be there alongside their clients to advise and support.
8. POPULATION MIGRATION

Real estate professionals rightly pay considerable attention to cyclical issues and short-term disruptions as critical factors affecting our business. But we should not take our eyes off some of the larger trends that slowly but powerfully change the economic landscape and the demands on property over the course of decades or even a generation. It is with this perspective that 26 percent of Counselors responding to our May 2019 survey listed population migration in their “Top Three” issues, fully justifying this topic’s place on our overall Top Ten list.

CREs noted that there are many influences on the movement of people, citing business conditions, tax policies, and technology among the factors. Climate change, too, enters the picture as natural disasters including floods, extreme weather, and wildfires motivate people to reconsider their locations. Resistance to relocation provides a wrinkle in the trends, and not just in the United States. One Counselors told of seeing agricultural villages in France largely boarded up, with only retired elderly living in them, one of the triggers for that country’s “yellow vest” unrest. As a practical matter, attention to demographics is at the heart of much real estate counseling, providing clients with fundamental facts and figures, interpreted with sophistication, on the evolution of local markets.

In the very big picture, the Census record shows that, since the first population tally of 1790, the population “centroid” (the imaginary spot on the map that represents the spot at which the American population is perfectly centered) has inexorably shifted to the West and to the South. A look at demographic change since 2010 suggests this long-range trend will continue uninterrupted when the 2020 Census is tallied.

So, is this “no news” as far as real estate is concerned? Hardly. Population is increasing in key places in all regions of the country, and yet other areas are experiencing net population loss. There could scarcely be a more fundamental demand factor for commercial and residential property.

The map of population change in the 2010-2018 period shows broad swaths of demographic gains in the major coastal cities. Big cities are prospering in California, the Pacific Northwest, Florida, the major Texas metros, and the Atlantic corridor from Boston to Washington, DC. Secondary cities are also adding population, including metro areas such as Denver, Salt Lake City, Atlanta, Nashville, Minneapolis, Charlotte, Raleigh-Durham, Kansas City, Charleston, and Greenville. In many of the latter areas, renewed suburbanization is complementing the downtown revivals that have marked urban change in the past quarter-century.

But there has been notable demographic shrinkage in the rural Midwest and South, in “Rust Belt” industrial states, and in Appalachia. Very long-term trends, largely technological, have altered opportunities for workers in agriculture, heavy industry, and mining. The population balance between metro areas and rural communities shifted a century ago, and a reversal of that trend is unlikely.
Author Nassem Taleb warns about “the narrative fallacy,” the tendency to attribute the story-of-the-day as the reason explaining change, even if short-term factors are more the “noise” in the data, than the basic signal. Presently, there is a significant amount of commentary suggesting the immigration policies and even the state and local tax provisions (SALT) of the 2017 Tax Act will basically alter the economic attractiveness of the major cities on both coasts. That’s unlikely to prove true.

For one thing, those factors are artifacts of Federal policies enacted during the one-party period of control 2017-2018 and are subject to alteration if the political balance of power shifts.

For a second and more basic reason, population moves in search of prosperity, which in turn is a function of innovation. Innovation has been led by the knowledge economy of the big cities, with secondary cities across all regions benefiting from their ability to find applications in production for the creative ideas spawned in Boston, New York, Seattle, the San Francisco Bay Area, and Southern California. Data showing the concentration of GDP by metro area, available from the Bureau of Economic Analysis validate this observation.

Nevertheless, we should not underestimate the future’s capacity to surprise. Recall that futurists predicted that, by now, the Boomer generation would have decamped wholesale from urban America—especially from the colder climes—to senior communities in Florida and Arizona. While this generational migration has to some degree taken place, its expected prominence has been eclipsed by back-to-the-city preferences, deferred retirements, and the propensity of seniors to prefer proximity to their grandkids. That shift alone affects real estate demand.

Up until a decade ago, the consensus projections had the U.S. population growing to about 440 million by 2050. That has been pushed back by as much as thirty million, a very significant deceleration. Partly the reason for slower anticipated growth is constrained immigration – and policy changes may yet cause a recalibration of that factor. But more significantly, greater attention is being paid to the lack of “natural increase” (the excess of births over deaths) from the existing population. That’s a key element behind the slower economic growth discussed in the “End of the Cycle” issue. It is a serious issue for real estate if America drifts into the net-population-decline league already having Europe and Japan in its camp.

On balance, what is most likely?

For real estate, the best evidence is in the pattern of investment. This reflects “voting with the wallet.” Here’s one way of looking at the bottom line: Capital is gravitating disproportionately to major markets. The ten top MSAs tallied $266 billion (46.4%) of real estate investment in 2018, though they had just 33% of US population; the next 20 largest MSAs registered $123 billion (21.4%) of investment on 19.4% of population base. All other US places saw $184.7 billion (32.2%) of invested dollars, despite having 52.4% of national population. It appears, then, that real estate investors are looking beyond mere headcount to economic vitality and are finding that vitality in a relative handful of primary and secondary cities across the nation. That’s their bet on America’s demographic and economic future.
9. VOLATILITY AND CONFIDENCE

Market psychology is mercurial, and sentiments are prone to change rapidly and sometimes quite dramatically. The measurement of sentiment factors such as confidence has become part of the toolkit of market analysis, but the use of such statistics for predictive purposes is often badly interpreted. Consumer confidence as monitored by the University of Michigan Survey and The Conference Board Index typically reach high points just prior to recessions, suggesting that the data is a rear-view mirror rather than a windshield view. Yet commentators commonly extrapolate the results of such sentiment polls as signals of what consumers intend to do over future time periods.

The University of Michigan Survey, for instance, bumped up in May and returned to the high point it had achieved in September 2018. Similarly, The Conference Board’s index bounced back in May to Fall 2018 levels, which was near an 18-year high. Both measures, however, had plummeted severely over the winter months. While the confidence polls did not follow the patterns of the overall economy, as measured by GDP (very strong through the period 2nd quarter 2018 through 1st quarter 2019, albeit with deceleration toward the end of last year), they did move in close parallel with the stock market, which plummeted from mid-September through year-end.

What the impact of May 2019’s 6.4 percent plunge on Wall Street will have remains unclear (especially with a rebound in early June). The deceleration in employment over the first five months of 2019, which averaged just 164,000 jobs added per month (versus 223,000 in 2018, and the slowest rate of job gains since 2010) may combine with financial market jitters over tariffs and the inverted yield curve to weaken confidence. End-of-cycle discussions are now becoming more prominent in the business and popular press. Taken together, high but volatile levels of confidence have captured the attention of the Counselors responding to our May 2019 survey.

Comments from CREs are focusing not so much on confidence per se, but on the impact of shaky confidence on behaviors. “Confidence is fundamental for decisions to invest, spend or not spend, increase or decrease activity. It is based – correctly or incorrectly – on all other information,” said one Counselor. Another CRE, focused on commercial real estate demand, noted, “A business leader’s confidence drives hiring decisions and capital expense commitments for the future.” The comments of other Counselors recognized the tight linkage between both consumer and business confidence on other topics on our list of Top 10 issues.

Levels of commercial property investment already appear to be reflecting such concerns about uncertainty, according to data from Real Capital Analytics. Not only has overall investment volume been down year-over-year in RCA’s tally of aggregate property transactions, but there is an underlying trend of decelerating rent gains in income-producing property, according to the company’s late May “Big Picture” report. Meanwhile, year-over-year single-family housing construction is down 9.4 percent as of April 2019, and down five percent for all residential construction in the U.S. The Census Bureau also
reports that non-residential construction volume is down 8.5 percent for commercial properties since April 2018.

Investment in existing and new property is an expression of expectations in future performance, and the data suggests that confidence in sustained demand for residential and commercial property assets is faltering. Specific to residential (single-family) sales, the NAR’s survey of members’ confidence has mirrored The Conference Board’s poll, but most states (39 of 50) expect price appreciation of less than 3 percent over the coming year, with 14 of those anticipating value growth of less than 2 percent. So, quantitatively speaking, optimism in the housing sector must be considered less than robust. In purchasing a home, or making a relocation decision, a household should be expected to have greater certainty about its prospects than is generated by the macroeconomic data of the past twelve months. The remarks of the Counselors accompany our survey, together with the tally showing 41 percent of the CREs ranking Business and Consumer Confidence as one of their three most important issues, prompts us to include this topic as one of our Top Ten this year.
10. PUBLIC & PRIVATE INDEBTEDNESS

Real estate is a business that uses debt as a tool on a regular basis. There is approximately three dollars of debt for every dollar of equity in the U.S. universe of investment property. In the wake of the Global Financial Crisis, more stringent underwriting standards have caused the current lending market to pull back to an average LTV of about 66 percent, according to 2018 data from Real Capital Analytics, but the portfolio of loans outstanding still reflects the higher leverage of earlier years. It is important to recall that the norm in real estate, well understood by Counselors, is that debt is neither to be abused nor to be shunned, but a financial tool that—used responsibly—can enhance return for equity investors. Lenders, meanwhile, are engaged in extending credit as a profit-making business with an eye to producing positive risk-adjusted returns (a spread above their cost of funds) while matching their balance sheet liabilities in duration.

It is therefore a telling sign when CREs sound an alarm about debt. As one Counselor noted, “Our industry is dependent upon the availability of abundant reasonably priced capital.” There certainly appears to be ample capital throughout the market, and although the Fed pushed up short-term rates in 2017 and 2018, interest costs are down overall. We have mentioned elsewhere the inversion in the yield curve, but this needs to be understood in the context that the entire curve has trended downward in the past year. That is, an already low interest rate environment has become even lower.

Borrowers, quite rationally, see this as a “sale” on the cost of funds and have responded enthusiastically. And even with bond yields exceptionally low, international investors have flocked to the safe harbor of US Treasuries, which at least provide positive returns. In contrast, Japan, Switzerland, Sweden, and Denmark have central bank interest rates below zero.

With the 10-year U.S. Treasury yielding 2.09% and the 20-year T-Bond at 2.36% (as of June 7), this would appear to be an ideal time for America to invest in long-term assets (like infrastructure), yet our Federal budget deficit has widened with the most recent combination of tax cuts and increased spending on military and/or border security operations that do little to leverage the low cost of funds to effect superior long-range returns.

Counselors’ concerns about indebtedness across the economy fall into a few discrete categories. The first concern is the impact on markets, including real estate markets, when today’s low rates rise. “Nothing could have a bigger negative effect on property values,” said one CRE, “than higher long-term interest rates. And given the rate at which all governments (international, federal, state and local) are borrowing, they will have to go up one day.” Counselors have vivid memories of the economic dislocation caused by the “funny money” mortgages of the last (pre-GFC) cycle, and look warily at reports that the European economy is largely buoyed by household debt subsidized by negative interest rates (see https://www.businessinsider.com/negative-interest-rates-europe-property-prices-2019-5 ). CREs have not forgotten the risk of financial contagion and know that even if U.S. rates are not negative, there is still danger for American residential and commercial property values if today’s mortgage rates turn out to be underpricing risk—as they appear to be. “The basis for the next collapse,” remarked another CRE, “will be from debt defaults.”

The second concern focuses on the debt burden on US individuals and households. In March 2019, U.S. consumer debt rose 3.1% to $4.052 trillion. That surpassed last month’s record of $4.042 trillion. Of this, $2.995 trillion was non-revolving debt, and it rose 5.0%. Most non-revolving debt is education and auto loans. In March
In 2019, school debt totaled $1.598 trillion and auto loans were $1.161 trillion. Credit card debt totaled $1.057 trillion, decreasing 2.5%. It exceeds the record of $1.02 trillion set in 2008. But credit card debt is only 26% of total debt. It was 38% of total debt in 2008. (Data can be found in the Federal Reserve’s monthly G-19 reports.) And these figures do not include the roughly $12.3 trillion in residential mortgage debt outstanding, according to the Fed’s June 2019 tally.

The rate of debt expansion must be placed in the context of the lag in income growth enjoyed by the typical U. S. household, as most real gains have gone to the highest income brackets. As debt growth outpaces income growth, stresses on household budgets increase. Default and delinquency figures, while still far from the levels of the last recession, are beginning to rise. Credit card delinquency, for instance, has hit 2.59% as of Q1 2019, its highest level since early 2013 when we were still in relatively early recovery from the financial crisis. Some 7 million Americans are 90 days or more delinquent on their auto loans, according to the Federal Reserve Bank of New York (FRBNY), a 2.4% rate that is even higher than the peak during the recession.

Erosion of the credit of such borrowers eventually feeds back into the residential mortgage market by limiting households’ eligibility to qualify for home purchases. Student debt also has been confirmed to have a serious impact on the residential market, with another FRBNY study finding that 20 percent of the decline in homeownership was among young adults from 2005 forward. That impact, in absolute numbers, amounts to 400,000 fewer homebuyers over time.

The third principal area of concern about “indebtedness” can be summarized as unfunded future liabilities in the public sector. While not borrowed money, strictly speaking, one CRE feared that “unfunded public sector retirement obligations will require a massive redistribution of wealth.” Another Counselors echoed that sentiment, “At some point, we will have to pay the piper… when the music stops, the debt structure will crumble.”

While large Federal programs such as Social Security and Medicare have been a target of debt hawks for decades, it has become apparent that at the national level there will be relatively minor and readily feasible tweaks to the system (not “socialism” as is sometimes decried). More than half the anticipated “shortfall” anticipated by 2034 could be eliminated by adjusting the FICA withholding tax from 12.4% to 13.4%, according to the Society of Actuaries. Gradually raising the cap on earnings subject to FICA from the present level of about $128,000 could further extend the point at which the actuarial deficit hits the system. We have already seen a change in the eligibility age, and this is another option as Americans’ life expectancy increases.

But most of the Counselors’ concerns emphasize state and local liabilities. This is because it is at the state and local level that government revenue turns to property and real estate transaction taxes to cover operations, and virtually every state is constitutionally obligated to maintain a balanced budget (Vermont is the sole exception). Counselors expressed concern that such “fiscal tension creates investment disincentives for taxable real estate,” a situation exacerbated by the $10,000 limitation on state and local tax (SALT) deductibility in the 2017 Tax Cut act. Even so, the exposure to this risk varies widely.

Nationwide, it is true, public pension funds hold assets worth only 66% of the liabilities due future retirees and their dependents. But that rate varies considerably. While great attention has been directed to states with the largest funding gaps (New Jersey and Kentucky have only 31% of what they will need, and Illinois isn’t much better at 36%), Wisconsin, South Dakota, Tennessee, and New York have assets amounting to 90% or more of their expected future needs, according to a study by the Pew Charitable Trusts.

In sum, there is ample reason to include “Public and Private Indebtedness” as one of the Top Ten issues of concern for real estate, although it should be conceded that only 24% of CREs responding to our May 2019 survey saw fit to rank this issue among their personal list of three most important topics.

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