NAIOP
COMMERCIAL REAL ESTATE DEVELOPMENT ASSOCIATION
CHICAGO CHAPTER

"2012 Economic Forecast … the Road to Recovery!"

by Matt Baron, NAIOP Chicago Staff Writer

This is a summary of the January 11, 2012, meeting of the Chicago chapter of NAIOP, the Commercial Real Estate Development Association.

Its members gathered at the Riverway Auditorium in Rosemont to hear insights from Mark J. Eppli, Professor of Finance & Robert B. Bell Sr. Chair in Real Estate at Marquette University.

Among other credentials, Eppli is the author of the best-selling real estate development text in the nation. And over an hour-long presentation, capped by a question-and-answer session, Eppli offered insights into real estate's next chapter.

It's a mixed bag, with opportunity intermingled with obstacles. The extent to which you seize the former or grapple with the latter hinges on any variety of factors, many of which Eppli explored.

One area of concern is the impact of global events, such as the European austerity-versus-stimulus tug-of-war and the Arab Spring that has shifted the balance of power and raised questions of long-term stability in those countries.

Closer to home, the impasse among lawmakers in Washington, particularly in an election year, is fueling uncertainty for consumers and businesses. However, having a "do-nothing" Congress—while "a terrible way to legislate"—may not necessarily be an unwelcome development, Eppli noted.

He said that such a scenario would result, among other things, in markedly less long-term debt that's played a role in the nation's economic doldrums.

"U.S. government spending is on an unsustainable path… If Congress doesn't do anything over the next 10 years, it will save $350 billion a year (through) automatic spending cuts."

Since 1990, he added, government spending has risen by about 6 percent annually, or double the 3-percent inflation rate.

Among the other factors to weigh is the country's slow Gross Domestic Product (GDP) growth, which in turn limits employment growth. Payroll jobs are just now getting back to their level of 12 years ago—meaning there has been "effectively zero job growth rate" that is creating the slowest jobs recovery in the United States since World War II.

Because the productivity growth rate is 2 percent, having 2-percent GDP growth translates into no new job creation. "We need a higher growth rate than 2 percent," Eppli said.

Alas, it's hard to get the GDP going without a strong housing market. And the single-family housing market, he noted, has a problem that goes beyond the eight-month supply of 3 million homes for sale.

It’s the “shadow inventory” estimated at about 1.5 million units-homes that are delinquent, foreclosed upon, or real estate owned (REO) homes with lenders.

So as the market has worked through the subprime loans, now it is the regular loans that are starting to fail, Eppli said, “suggesting there’s a big shadow inventory that will keep the residential real estate market underperforming for another year, probably two years. That market really is not coming back quickly, folks.”

Banks, meanwhile, “are still shedding more than they are taking on” and have been generally getting out of commercial real estate. CMBS issuance in 2012 is projected to be $40 billion to $60 billion— markedly more robust than the past few years, though still a far cry from 2007’s $239 billion figure.

A problem to monitor: CMBS maturities are larger than new issuances and “that will constrain some of the markets,” Eppli said.

Life insurance companies are back in the market in full force, he said, and real estate gives them “a better risk-adjusted rate of return…than other bond, life or fixed securities companies,” he said.

“They will pick up some of the slack….They really don’t have any bad debts, or very little debts,” Eppli added.

Transaction volume is back to 2004 levels, he noted, with volume focused on low-risk properties and markets.

Real Estate Investment Trusts (REITs), said Eppli, “will lead the markets back” by providing transaction volume. One key point that Eppli emphasized: real estate, relative to other options, may well be the strongest investment play to make.

“How has your stock portfolio performed over the past decade?” Eppli asked the audience.

He shared an anecdote about the extent of fear that young adults have for the stock market: during a visit with a graduate-level entrepreneurial finance class, none of the students raised a hand in an informal poll of who was investing in stocks.

Echoing a theme that’s been trumpeted frequently of late, Eppli said apartments represent a major investment opportunity. Renter household growth is anticipated to be 350,000 units annually until 2020.

That trend is stoked on by a few demographic forces. Among them: a surge in 55- to 75-year-olds moving from single-family housing to renting; 20-somethings who are delaying marriage longer than prior generations; and a pent-up demand for apartments among college grads who have initially moved back in with their parents.

“Once jobs come back,” Eppli predicted, “the first thing they’re going to do is rent, not own.”

On the work front, the expansion of mobile Internet devices means fewer employees in office space, and that bodes for tougher times in the office market, especially in the suburbs.

One promising sign, said Eppli, is that household debt as a percentage of disposable personal income is now well below the 30-year national average. As a result, relative to our collective income, we have more flexibility to borrow if we choose to do so.

However, U.S. consumer spending is “out of balance” when compared with the rest of the world, Eppli noted, and we will likely spend a smaller share of our income in the future as a result of increased taxes and health care costs.

In response to one query from the audience, Eppli elaborated on why apartments—though they typically come with one-year leases—are less risky than industrial tenants with 5- to 15-year leases.

He noted that if you buy an 80-unit apartment building, you can afford to lose 10 percent of those tenants (and then re-lease the units), while an industrial tenant who goes away is significantly tougher to replace.

In response to a question from the audience, Eppli confirmed that his outlook was based on the premise that interest rates will remain low.

“I believe that’s very much the case,” he said, referring, among other indicators, to the Fed’s stated preference to keep interest rates low for the foreseeable future.

“There is a risk as you go beyond three or four years,” Eppli said. “(But) there is not a lot of inflation pressure in the marketplace today.”

To view the PowerPoint presentation that Eppli shared with NAIOP members, visit **www.naiopchicago.org**

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