Urban Land Institute
Chicago

2020 Real Estate Forecast

Below is a summary of the ULI Chicago 2020 Real Estate Forecast that took place November 2019. Dr. Mark Eppli was the keynote speaker sharing a national outlook for 2020, who was then followed up by a local response panel that discussed the region's outlook. Each attendee also receive a copy of the newly released *2020 Emerging Trends in Real Estate®* report, published by PwC and ULI.

Mark Eppli, *Director & Faculty Associate,* James A. Graaskamp Center, University of Wisconsin-Madison, is widely published in commercial real estate finance, development and valuation, serves as a board member for the Federal Home Loan Bank of Chicago, and his research has been published in dozens of top-respected real estate journals.

The panel moderator was Jacqueline Barlow, *Managing Director, Regional Manager,* CIBC. In addition to Mark Eppli, panelists included Michael Brennan, *Chairman & Managing Principal,* Brennan Investment Group, LLC and Dan Lyne, *Senior Vice President*, CBRE.

To kick off the first half of the session, Dr. Mark Eppli delivered a fast-paced presentation in which he covered vast statistical ground. Along the way, he peeled back multiple layers of nuance and context to offer expert insight.

An overarching recommendation that he made was for attendees to tap into the Federal Reserve Economic Data (FRED) website, which helps provide long-term perspective in the face of the ongoing news cycle that contains so many ups and downs.

The first topic that he explored was Gross Domestic Product (GDP), which has grown this year at a 2-percent rate. He pointed out that about one-third of that growth is due to government spending, which according to Eppli, "shows a little more weakness than I otherwise would like."

Business investment, which has been on the rise in recent years, has trended downward in 2019, Eppli noted, and that does not bode for a strong GDP in the near term. He predicted GDP growth would be 1 percent in 2020.

"Business investment oftentimes leads personal consumption," Eppli said. "That's where the dig comes in, that's where the rub comes in for the Fed (Federal Reserve Bank)."

On the plus side, corporate profits have grown 18-fold since 1974. Although profits have been about the same the past five years, in the $2 trillion neighborhood, "they have stabilized at a very high level," said Eppli. For a frame of reference, during the same span, the CPI has grown six-fold.

Related to that data point is the repatriation of business profits from abroad by American companies, which soared to $777 billion in 2018, up from $155 billion the year before, after tax code changes were implemented.

"That's a lot of money to put in corporate chieftain and CFOs' pockets. That's a lot—so they have the money. What did they do with the money? Did they use that money to invest it in new businesses? No, not so much," Eppli said. "They ended up buying back their own shares, they started taking down some debt. That's not a great use of that money. So, their actions indicate that they're not all that confident about investing in business."

That decline in the CEO Sentiment Index, he added, is "something worth keeping an eye on."

Corporate sentiment may be prompted in part by individual investors shying away from investing in "old line businesses," preferring instead to invest more in disruptive companies like Facebook, Apple, Google and Netflix, he said. On the plus side, household total debt, relative to GDP, is at an all-time low: "In short, it looks like consumers still have good dry powder," said Eppli, with consumer sentiment remaining strong, at least for the time being.

As for the U.S. political landscape, Eppli said it is "not an issue at all" that would create a dip in consumer confidence. More likely triggers are a stock market downturn or a significant hike in gasoline prices.

He devoted several minutes to explaining the Phillips Curve, an economic concept whose central point is that inflation and unemployment have a stable and inverse relationship, and differing views of the concept. One perspective is that it is an "artifact" that is no longer applicable to understanding economic dynamics; another view is that it can be managed through adjusted expectations.

A third view is that the "curve still exists and could suddenly and quickly accelerate if wages fall below a threshold." Of that specter, Eppli said, "This scares the Federal Reserve officials. They can't let go of this one." Amplifying those concerns, he said, is the resemblance of the U.S. economy the past few years to what played out in the late 1960s, when inflation shot up from around 2.5 percent to 6 percent.

Meanwhile, labor force participation has been strong, he said, with the gig economy and the opioid crisis two key elements that have had some impact on the unemployment rate. Emphasizing that his remarks are strictly economic-focused, and not political, Eppli noted the difficulty of growing the economy with a labor pool diminished by the country's policy that is "unfriendly to immigration to this country."

"We need workers to grow the economy," he continued, "and we're tight."

Another subject he addressed was the Fed's expanding influence, beyond its longstanding focus on inflation and unemployment, into international financial matters. Doing so is appropriate, Eppli said, citing the fact that 43 percent of S & P 500 companies' revenue stream comes from other countries.

"If overseas (finances) aren't doing well, S & P 500 companies aren't doing well, it's likely to trickle on down to other companies in your neck of the woods," he observed.

On other international fronts, he noted that "Europe is looking weak" and if the U.S. does step up with tariffs on December 15th, that could spur on inflation and "spook the Fed. We could begin to see the house of cards there."

Real estate, when compared with other asset classes, has been faring well for investors, with 8- to 9-percent returns a typical level of performance.

The National Council of Real Estate Investment Fiduciaries (NCREIF) shows returns of 6.5 percent over the past year, an annual 8.8 percent ROI over five years, 9.3 percent for 10 years, and 8.9 percent for 20 years, while the S & P Index has had percentage results of 10.4, 10.7, 14,7, and 5.9, respectively, according to data that Eppli provided.

Within real estate, industrial has experienced the top annual returns for those one-year, five-year, 10-year and 20-year spans: 13.9, 13.7, 11.4, and 10.0 percent, stronger than office (6.8, 8.2., 8.4, and 8.2) and retail (1.8, 7.7, 9.2, 9.9).

"Overall those are good returns," said Eppli.

He also noted an important relative measure to keep tabs on are cap rates over 10-year treasuries. Applying that formula, unlike the conditions of 2007, "we're not looking overly priced, or that we're outpricing our real estate," said Eppli.

Generally, consumer debt is not rising to concerning levels—with private debt as a proportion of GDP falling from an all-time high of 171 percent in 2009 to 148 percent today, which Eppli called "a reasonable number."

"Why is this big picture important?" he added. "We're not overly levered."

Home ownership has dropped about five percentage points from the peak of 69 percent in 2006. While there has been sturdy growth of multi-family building supply, “I don’t find this real troubling,” Eppli said.

On the property markets front, the industrial sector is still the strongest segment, with volume up 63 percent, year over year, though the broader context is that figure includes the purchase of full platforms, he noted. On the other end of the spectrum, the transactions volume in the retail sector, year over year, has plummeted 55 percent.

Meantime, high-income apartments are seen as overpriced, although they are still leasing up, Eppli observed: “We still seem to be able to lease up most of that in most of our cities nationwide.”

In the panel discussion that followed, Michael Brennan’s opening remarks included his view that the economy overall is in good shape. However, there are pockets of concern, such as in the industrial sector, where “we’re starting to see the effects of a prolonged trade war, especially on the capital goods side, where people are ordering a little bit less,” he said.

“It takes a little while for that to flow through the system. Ultimately that’s going to have some impact on absorption,” Brennan added. “The fundamentals of real estate and the fundamentals of the economy don’t always walk hand in hand…so while I think the economy will slow, I think the question to ask yourselves is, `Yes, but what will that do to me? What will that do to the real estate market?’”

Key benefits coming out of the recession are the de-leveraging of corporations and individuals, with a relative few in delinquency. “A very important thing for real estate is that our banking system stay healthy,” Brennan said. “That’s 60 to 75 percent of our capital stack and by almost any measure, the banking system is in very good shape.”

Lyne brings a bullish perspective on the real estate climate.

“We’re servicing clients who, for the most part, are continuing to rapidly grow in various sectors. I would say that is really driven by the talent war.,” said Lyne. “The economy is wildly impacted by the ability to fill that need of end users.”

As the recession hit a decade ago, Lyne was a co-founder of 1871, Chicago’s Center for Technology and Entrepreneurship. “Even in an economic crisis, this was the rise of entrepreneurship in Chicago,” said Lyne. “There was a tremendous need for something like that. It gave opportunities to start businesses.”

From the standpoint of seeking yield on investment, real estate has emerged even more strongly in recent years as a good alternative to fixed-income securities, said Eppli.

Prompted by Jacqueline Barlow's question about the impact of labor force's changing composition, Eppli pointed out that, already, about five million people leave their jobs on a monthly basis (with about 5.2 million securing new posts, for a net gain of about 200,000.)

Eppli said he is "not concerned as many are" about jobs being displaced by the much-touted trends of artificial intelligence, machine learning, and autonomous vehicles. "A lot of those jobs are pretty monotonous and not great for the brain or for the person doing those jobs," Eppli observed. "As those (jobs) go away, we will re-deploy our folks."

A shift that has already been under way, favoring real estate investment, has been in the works for years. Brennan noted that when he began in the industry 30 years ago, about 5 percent of the allocation of CalSTRS (California State Teachers' Retirement System) and CalPERS (the California Public Employees' Retirement System) went toward real estate. That figure has risen closer to 15 percent today, with much of it focused on the industrial and apartment sectors.

"That has a huge implication for pricing," he added.

The life sciences sector, though requiring a substantial learning curve for investors, is an emerging force, according to Lyne. He noted that the uses go well beyond laboratories located near a hospital or medical campus.

"These buildings and these investments, while extremely intensive on the upfront investment side, also are a moving target with how they are being utilized," said Lyne. "You are seeing this massive merger of mathematical and biological sciences coming together, and then married up with advanced analytics and data thresholds…A lot of it is packed on the mapping of the genome, and that was a big moment in history."

At the same time, cities are in a race to learn their needs, and how these life science uses mesh with their needs, he said.

In this regard, bolstered by major research universities such as the University of Chicago and Northwestern University, Chicago has "so much potential" and "the making and the markings for growth to build this asset class," said Lyne, even though the city is "lagging" in having primary Class A lab space.

On the bright side, the life science segment is generally "very mission-driven and it is focused on patient care," he added. "….in our town, we have a tremendous amount of philanthropic and personal wealth, and family funds, who have leaned into this, because they have been impacted."

As for foreign investment, over the past two years it has moved to “super-regional,” or secondary markets, said Brennan. More cash flow has poured into those markets than the gateway markets like New York and San Francisco, where foreign investors have been so focused in the past, he added.

“It’s a sign of a couple of things,” Brennan said. “It’s hard to get enough money in these markets; it’s also a sign that actually the fundamentals (in those markets) are pretty good.”

“In a broader context,” responded Eppli, “industry clusters matter. To get an employer to come into a community, they want to make sure they can pull talent, maybe from other employers, so the idea of investing around an industry cluster, like biotech or whatever, really matters. Think about that when you deploy your funds—is this a one-off, or is this part of where this municipality or this city or this area is going?”

Panelists agreed Chicago continues to draw capital because of its sheer size—or, as Brennan put it, “the overwhelming power of the consumption zone.”

“Chicago has done incredibly well,” said Lyne. “One thing we can’t forget: we live in a global city and it is very hard to build a global city.” He cited massive investments such as the intermodal center and O’Hare Airport, along with area universities, that “have allowed us to compete on a global scale.”

Saying “you pull yourself out of a hole over time, or you dig yourself a hole over time,” Brennan issued caution. He pointed to factors like the state’s potential income-tax increase. Even if such a hike were not to prompt significant numbers of people to leave Illinois, it may dissuade others from moving in and thus hamper the area’s economic vitality, he said.

“To actually grow, you have to attract people and make them comfortable that once they land here, they’re not going to get whacked with a huge tax,” Brennan said. “…it’s not like we’re going to wake up tomorrow and find that the Sears Tower is empty, everybody left. (Instead), it’s `How come we didn’t get that kind of growth? How come we didn’t get that tenant? How come we didn’t get that investment?’ That’s actually what I am more worried about.”

Lyne emphasized the importance of a “champion chief marketing officer for a region,” a role that he said former Chicago Mayor Rahm Emanuel played as a “ferocious business developer.”

“He was out there picking up phones, trying to demystify some of these components on the tax issues, or the crime that was here,” Lyne said. “The business community, the investment community felt as though, to a degree, they had access…at least to someone at the helm that was taking it on."

"Now I am encouraged by what I am seeing from the city, and from a name recognition (perspective), our governor is a very visible person—he is a welcome silver bullet to take on that chief marketing role, as one of his higher and better uses, to try to go after some of those real issues that we are talking about," Lyne added.

On the plus side, graduates from all the Big Ten schools "want to come to Chicago. This is where talent goes," observed Eppli. "It's still vibrant." A related question: "Can you retain that talent?" Eppli added. "That's what I think the city needs to start thinking about, and not have it migrate back to Madison and Milwaukee and other places."

When Barlow asked which segments would be winners in the coming year, Brennan reeled off a list that included apartments, industrial real estate, data centers, and the food business. Lyne circled back to life science— "scientists are people too, and they should be celebrated."

"From a real estate asset perspective, we are going to see over the next decade in the city a fundamental shift in the investment infrastructure to support companies that revolve around patient care," Lyne continued. As a prime example of opportunity in this regard, he pointed to Tempus, which under the direction of CEO Eric Lefkofsky, previously Groupon's co-founder, grew from two employees to 1,000-plus in less than three years,

Lyne also addressed coworking spaces, which he dubbed "the elephant in the room" in the wake of setbacks to that niche, such as the well-publicized struggles of industry leader WeWork.

"We're going to see better curated space…I don't want what's happening in the background to impact people's notion of this. It's a very important asset class and it's helping to feed start-up and growth-stage companies."

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