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Investment Strategy Quarterly

Real Estate and Reflation

HOW RISING DEFICITS AND PARTISAN GRIDLOCK MAY WORK IN REAL ESTATE'S FAVOR

MetLife Investment Management

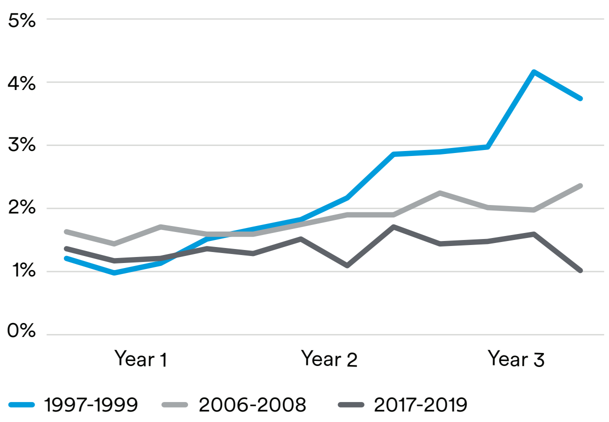
Accelerating economic growth and a small supply pipeline relative to history have left real estate fundamentals in a solid position, especially when compared to similar periods in past cycles. As a new congress takes office next month, however, the risk of government gridlock also rises, similar to the split congress that took office in 2011. For several years following 2011, legislation was slow to move, a government shutdown slowed economic growth, and U.S. Treasury debt was either put on negative watch or downgraded by the major rating agencies. Today, rising deficits and the threat of government dysfunction may leave the Federal Reserve in the unfortunate position of balancing its low inflation mandate with the economic repercussions of potential further rating downgrades. This dynamic, as well as tariffs and a tight labor market, point toward potentially higher inflation in 2019 and beyond. Portfolio managers who increase their allocation to inflation protected sectors, such as real estate, may therefore be better positioned to outperform.

Positive Fundamentals

As the end of 2018 approaches, we believe the fundamentals supporting commercial real estate are well positioned to produce several more years of solid investment performance. As we outlined in our last issue, *Tariffs Add to the Tally*, supply growth is dropping due to sharply rising construction costs. Over the last several months this trend has continued, with labor costs further accelerating and materials costs showing few signs of an impending decline. Though we have typically discussed these factors in regards to future supply growth, it is worth acknowledging that their near term impact has been significant as well. CBRE-EA's full year 2018 office completion forecast, for instance, was 65 million square feet as of the second quarter, but was revised down to 55 million by the close of the third. Although we suspect these projects will finish eventually, it highlights the magnitude to which rising costs are already taking a toll on new development.

Moving from the supply to demand side, the economy continues to grow at a robust pace. GDP growth accelerated from around 2.3% in 2017 to a forecasted 3.0% in 2018.[1] Employment growth has also accelerated, with 204,000 new jobs per month so far in 2018, up from 182,000 per month in 2017.[2] Consumer confidence has also been steadily rising, and in November reached its highest point in 18 years. As a result, net office absorption is on pace to total 55 million square feet in 2018, up from 49 million in 2017 and 39 million in 2016. Apartment net absorption has also improved, from 215,000 units in 2016 to 269,000 in 2017, and an expected 336,000 in 2018.[3]

Exhibit 1 | Late-Cycle Office Construction (% of stock)



Source: CBRE Econometric Advisors

Decelerating supply and accelerating demand is not typical during late cycle periods. As figure-1 depicts, historically the supply pipeline has accelerated into recessions. We therefore believe the fundamentals supporting commercial real estate are better positioned for a downturn today than they were at prior late-cycle periods.

All Eyes on Washington

We believe the acceleration in economic growth over the last year can largely be attributed to government spending and tax reform. According to an analysis by the Wall Street Journal, approximately half of the acceleration in growth over the last two years can be attributed to the rise in military spending alone,[4] and we believe the reduction in corporate and individual taxes has also played a role. Federal stimulus is budgeted to continue growing in 2019 and we therefore expect demand for real estate to remain strong. One risk, however, may come from the government's ability to function with a split congress.

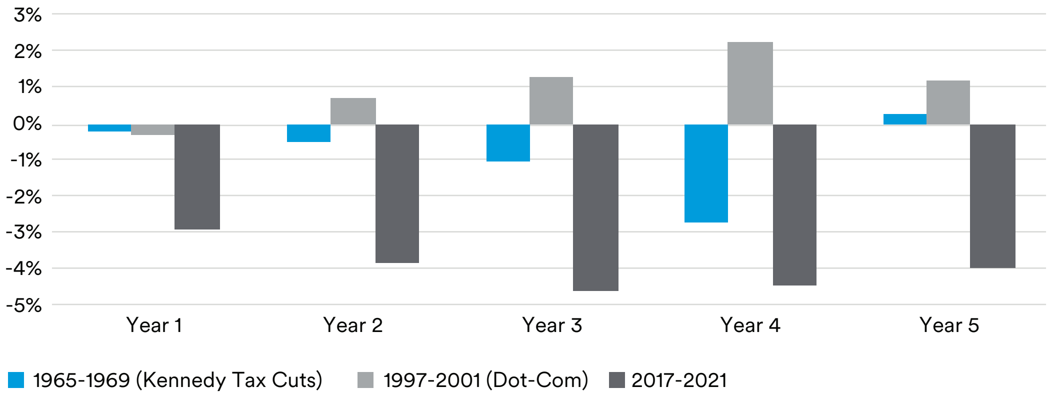
Although markets have sometimes reacted positively to a split congress, gridlock has led to a number of problems as well. In 2013, for instance, a two week government shutdown was estimated to have slowed that quarter's GDP growth by about half a percentage point.[5] Debt ceiling fights during this era also took a toll in 2011, with Moody's and Fitch placing U.S. Treasury debt on ratings watch negative. Standard & Poors went one step further and downgraded U.S. Treasuries from AAA to AA+, where they remain today. Despite these risks, a split congress modestly improves the likelihood of a major infrastructure spending package since infrastructure has historically been a priority of the Democrats. We believe a carefully crafted infrastructure spending package would be positive for the economy, and for commercial real estate, although it would likely also further increase fiscal deficits if passed without corresponding tax increases.

Although there is also some risk that part of the government stimulus enacted in 2017 and 2018 will be reversed, we think it's more likely that the law will remain unchanged. Even if there are a few rollbacks, it's important to understand how large the current stimulus is, especially in the context of where we are in the economic cycle.

Before stimulus efforts began in 2017, the unemployment rate was 4.6% and GDP was growing at approximately its estimated potential level of 2.0%.[6] A significant late-cycle stimulus has only been enacted at one other point in U.S. history and the results were decidedly mixed.

The Revenue Act of 1965, also known as The Kennedy Tax Cuts, was also enacted when the economy was growing at its potential rate and labor markets were at full employment. The tax cuts helped boost and extend economic growth in subsequent years, but also contributed to sharply rising inflation in the late 1960s and 1970s. As figure 2 depicts, however, The Kennedy Tax Cuts were not as large of a stimulus as today. We believe the current government stimulus is the largest ever enacted during a period of full employment.

Exhibit 2 | Late-Cycle Deficit as a Percent of GDP



Source: Congressional Budget Office, Bureau of Economic Analysis, Moody's Analytics

In addition to an unprecedented deficit, U.S. federal debt is now near the highest level in history, which was last reached as a result of World War II. Going forward, there are five ways to manage this: default on the debt, accelerate economic growth, raise taxes, cut spending, or allow inflation to rise. The U.S. used all but the first option to reduce World War II debt, with the 1950s-70s marked by population growth driving economic growth, an average top marginal income tax rate of around 75%[7] (compared to 37% today), slowing government spending after the war ended, and inflation rising to an average 7% per year by the 1970s (compared to about 2% today).

Considering these options, slightly higher inflation may be one possible outcome amongst a field of unlikely outcomes. Economic growth would be the best option but without a significant change in immigration policy, or an unexpected boost in productivity, today's economy is unlikely to match growth rates of the 1950s-70s. Meaningful tax increases or spending cuts also seem unlikely in the current political environment. In the long run, The Federal Reserve may therefore find themselves in a position of balancing an interest-payment-stressed budget deficit (and potential additional U.S. Treasury rating downgrades) with allowing for higher inflation.

In addition to higher potential inflation from an accommodative Federal Reserve, a tight labor market and increasing trade frictions may also exert shorter term inflationary pressures. U.S. unemployment is at the lowest level since the 1960s and this has resulted in average hourly earnings growth of 3.1% from a year ago[8], the fastest rate of growth so far this cycle. Tariffs with China, the bulk of which were enacted in September of this year, are also likely to begin exerting modest upward pressure on consumer prices in the early months of 2019. Trade with Europe has also been more restrictive. All of these factors hold the potential to produce a rise in inflation. But how does inflation affect real estate?

Inflation and Commercial Real Estate

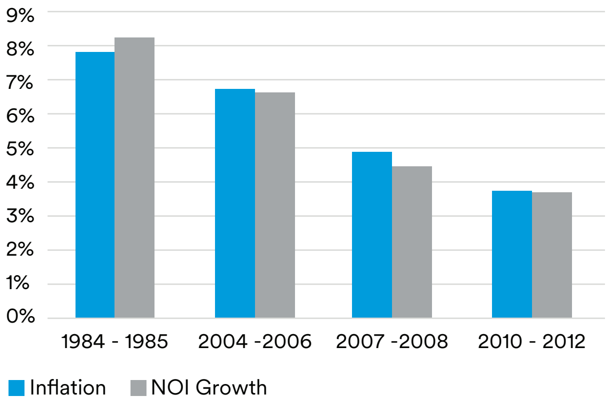
Over the long run, commercial real estate prices appreciate at slightly above the rate of inflation. The longest and most reliable index of commercial real estate prices is the NCREIF Market Value Index. This index, dating back to 1978, is based on a combination of repeat-sales and repeat-appraisals over time, and indicates inflation-adjusted real estate prices are 8% higher today than they were in 1978. In other words, over the past 40 years commercial real estate prices have appreciated at the rate of inflation plus 0.20% per year.

Although prices have generally followed inflation over the last 40 years, the relationship has been far from perfect. The most significant deviation between price growth and inflation growth occurred as a result of tax policy changes in the 1980s. The 1981

Economic Recovery Tax Act included methods to harvest losses from real estate, which contributed to significant overbuilding until parts of the law were reversed in 1986. When the early 1990s recession occurred, the commercial real estate sector experienced its worst downturn on record, far worse than what occurred as a result of the 2001 dot-com crash or the 2008 Global Financial Crisis. As a result, real estate prices significantly underperformed inflation from 1989-1995, then outperformed as the size of the economy caught up with the size of the real estate stock in the late 1990s and 2000s.

In addition to real estate prices, real estate income has generally grown at the rate of inflation. Figure 3 shows the tight correlation that exists during periods of balanced fundamentals. Rising inflation risks, and a slowing supply pipeline, are therefore both positive for the commercial real estate sector. We believe this leaves the real estate sector as an increasingly critical part of a well-diversified institutional portfolio today since, outside of TIPS, there are very few alternative inflation hedged investment options.

Exhibit 3 | Inflation Spikes During Balanced CRE Conditions



Source: NCREIF, Bureau of Labor Statistics

Conclusion

A slowing construction pipeline and sustained government stimulus have left real estate fundamentals in a far more favorable position than is typical late in the cycle. The stimulus efforts, however, are also likely to lead to a pickup in inflation when combined with a tight labor market and growing trade restrictions. In the long term, commercial real estate offers investors an effective hedge against the inflation these factors may produce, increasing its relative attractiveness to investors when compared against other hybrid fixed-income sectors. We therefore feel that commercial real estate is well positioned for many of the risks we face today, and indeed, may benefit from some as well.

Endnotes

1 Bureau of Economic Analysis
2 Bureau of Labor Statistics, December 7, 2018
3 CBRE-EA
4 "A Big Reason U.S. Economy Is Accelerating: Government Spending", Wall Street Journal, Oct. 25, 2018
5 "Gridlock Has Cost U.S. Billions, and the Meter Is Still Running", New York Times, Oct. 16, 2013
6 "An Update to the Economic Outlook: 2018 to 2028", Congressional Budget Office, August 13, 2018. Potential GDP growth is based largely on demographics.
7 Statistics of Income Tax Stats – Historical Table 23, Internal Revenue Service
8 Bureau of Labor Statistics, November 2, 2018

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