Top RE Macro-Trends for 2016
The Real Economy

David Snow, Privcap:
Today we’re joined by Lee Menifee of Prudential Real Estate Investors, and Joe Brusuelas, Chief Economist of RSM. Gentlemen, welcome to Privcap today; thanks for being here.

Lee Menifee, Prudential Real Estate Investors:
Thank you.

Joe Brusuelas, RSM:
Thank you.

Snow: Today we’re going to talk about the real estate market and the affects that several important macro disruptions are having on the real estate market. So we’ve identified a few trends, and I’d like to kind of go through them with you. Let’s start first with the trend for young people – millennials primarily – moving to major cities, seeking work and having different expectations about what their workplace should be like. What kind of affect is that having on the office market, in particular, and perhaps some other affects that it’s having on real estate more generally?

Brusuelas: Well as the tip of the spear, those 25-34 year olds have entered the market, at least since the recovery's began. It’s been on the margin, very positive for commercial real estate. Just simply the sheer numbers of the millennials showing up in the workplace, and they're forming households. What you’re seeing is a little bit of a renaissance in many of these buildings as demand for the integration of advanced technology in the workplace accelerates.

Menifee: Twenty, thirty years ago office properties, the best ones were in the suburbs cause that's where the employees wanted to work. And now they're in cities cause that's where the employees want to work. It's just a different set of employees.

Snow: Joe, we can touch maybe briefly on housing. You mentioned family formation. What is the trend among, I guess, millennials and family formation, and how is that affecting perhaps multifamily assets?
Brusuelas: What we’ve seen is a real shift away from single family residences in the suburbs. We saw, at least with the last two generations, towards more of a demand for multifamily dwelling, condos and coops. And that’s altered the composition of housing starts around the country. And as I travel and speak on the economy, you can really see it in many of the metro areas. Boston’s the one, I think, where it’s most telling, where they’ve got a very low unemployment rate. There’s an intense competition for workers, and the millennials who are arriving have real different forms of demands that they want. So you see lots of multifamily units being built, adjacent to highly clustered, dense workplaces where of course, many of these young people to ride their bikes or take public transportation to work rather than own a car.

Menifee: We were looking at the household formations data with trepidation for many years. It was incredibly low, and really put off by what was a really severe recession for everybody but particularly for young people who had an extremely hard time getting a job and coming into the workforce. But now that’s the fastest, hiring that’s going on in that age cohort – the 25-34. They’re the fastest pace of hiring, and that’s why we’re seeing this huge increase in household formations which is good because we’re building a lot of multifamily too. And our view is that building the multifamily really is meeting up nicely with demand. We’re not particularly concerned about that supply getting ahead of that demand, although in a few markets maybe it is a little bit ahead.

Snow: Let’s talk about another real estate tight area that is undergoing tremendous disruption, and that’s retail. Maybe starting with a question for Lee, what part of the bricks and mortar retail market is not dying, and how can an investor find a place to invest in real estate where retail actually takes place?

Menifee: Yeah. For us, retail is a far more defensive investment than I think a lot of people would view it. So you look at the disruption that’s going on in bricks and mortar retail. You see a whole sector is like office supply that are in trouble, consolidating; electronics, which is almost going away, even the grocery segment, which is a sort of an ongoing consolidation trend. And then you get to that with the threat from ecommerce, and there’s a lot of reasons to be very, very negative about retail. But for us, that doesn’t really really jibe with what we view as good trade areas and good retail centers in those trade areas.
Our basic view is that we don’t know, in ten years, whether or not the tenants in any particular center are going to be there in ten years. We don’t know what the next disruption is going to be. But we do know what the trade area looks like, and we know that somebody will want to be in those centers.

Snow: Joe, from an investor’s point of view, what do they need to understand about some macro trends that are affecting retail that might influence the way that they invest?

Brusuelas: Okay, so we’re undergoing a pervasive, disintermediating and disruption in the overall retail space. What we’re seeing is, is a profound and significant behavioral shift by the new emerging demographic majority, not only in how they shop, where they spend money, why they spend money and what they’re likely to spend money on. I think the motto of that emerging demographic majority is to own memories, not stuff. And so with a migration into preferences on spending with travel accommodation, entertainment and not just buying 12 pairs of jeans, you’re going to see a pretty thorough shake-out in the commercial real estate environment. You’re not going to see these big anchors for these malls probably exist in the numbers – at least – in which they have.

Snow: Lee, how can you even quantify the affect that something like ecommerce would have on retail real estate?

Menifee: Well we can quantify it by looking at the demand for retail real estate relative to what we would expect in an expansion, and the demand for industrial real estate and what we would expect in an expansion. And quite simply, the demand for retail real estate has been running below what we would normally see. And the demand for industrial has been far above what you would expect from typical under-volume demand drivers. So we actually see that one-to-one impact. The growing share of ecommerce is having a profound impact on retail real estate, which is on the margin, negative. But also for industrial real estate, which has been a big positive and we expect that positive to continue this year – particularly for industrial real estate that’s located somewhere where you can deliver to the consumer very, very quickly, certainly within a day sometimes within hours.

Snow: Let’s move on to another area that’s seeing quite a bit of dislocation, and that has to do with capital flows. So a big story for real estate in 2015 was the tremendous amount of capital from overseas coming into US real estate. With places like China and
elsewhere seeing significant economic turmoil, how are those capital flows being affected?

**Menifee:** Yeah, it was a remarkable year. Normally capital flows into the US, people think that they’re high but it’s usually 9% to 12% every year. And last year it was 18% of the total transaction was from outside the US. So that’s a big, big shift. We look at that and see a very diversified group, so it’s not just one group dominating that. We had increases in basically every region and every type of capital source coming into the US. And some of that is driven by good return expectations for the US. Some of that is driven by volatility elsewhere in the world, that [they’d like to safety?] capital. If we look at how that’s going to shake out this year, the return expectations for the US – while still good – are probably not going to match last year’s very, very strong pace. But the volatility elsewhere really suggests to us that that continued structural flow of capital into the US should continue.

**Brusuelas:** One of the things that I look at is what’s called the ratio of money supply using M2 as a percentage of GDP. And when you look at the different emerging market crises what we’ve over the past 20 years, what you typically see is a rate around 52% signifying an oncoming crisis. You take a look at a place like China last year that was responsible for almost three-quarters of a trillion dollars in capital outflows right. They’re sitting at over 200% in terms of that ratio. What that tells me is that one, China is really approaching its peak on its debt cycle. And it may, in fact this year or next year, begin to deleverage signifying several years of possible capital outflows out of China and the significant knock-on effect for emerging markets. And I think that’s likely to fund the next few years of global economic growth.

**Snow:** Well if a huge percentage of that capital is earmarked for real estate, where is it going to fit in in the already competitive US real estate landscape?

**Menifee:** I think there’s a view that with the larger markets becoming more competitive for buyers, that a lot of that foreign capital is going to go to smaller markets in the US. We’re not really persuaded by that view. We think that a lot of that foreign capital is very much targeting larger markets, very aware of liquidity, want to have some familiarity with where they’re investing.

**Snow:** So any big predictions for the real estate market in 2016, based on some of these trends that we’re talking about?
**Menifee:** I think the global growth story is sufficiently weak – that it’s going to be probably another kind of sluggish year. But in a lot of ways, that’s kind of how real estate’s been behaving for the past three or four years.

**Brusuelas:** We have a real supply problem here, especially in new homes and existing homes on the market. And so I’m expecting about 1.4 or 1.5 in annualized pace. That would be the strongest since prior to the crisis, but we’re still not fully utilizing our capacity to produce in that sector. And with 1.6 million, I think being the long-run equilibrium, we still have room to grow there.

**Snow:** Within housing and multifamily, where do you think the most spend will take place? Where will the most construction happen?

**Brusuelas:** Multifamily, without a doubt. Yeah.

**Snow:** Multifamily. In cities?

**Brusuelas:** Yeah, yeah. I don’t expect to see construction of single family residences reassert itself until the next business cycle.