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The Consequences of Public and Private Debt on Real Estate

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By K.C. Conway, CRE, MAI, CCIM, and Thomas Curtin, CRE

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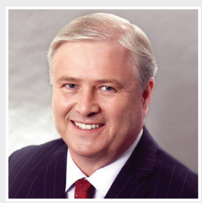
Public & Private Indebtedness was listed as the #4 issue in the 2020-21 Top Ten Issues Affecting Real Estate® by The Counselors of Real Estate®.

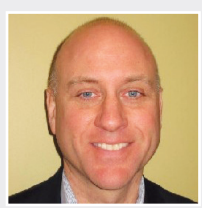
Prior to the COVID-19 pandemic, the United States was on track for its first $1.0 trillion fiscal year deficit since 2009 and the onset of the Financial Crisis. The aggregate incurred deficit at the end of fiscal year 2019 was approximately $23 trillion. However, the Federal Reserve was on a different path and was shrinking its balance sheet back below the $4.5 trillion expansion during the 2009-2015 period due to the liquidity intervention required to combat the Great Recession.

A lot has changed in a short period of time. Up through the May Federal Open Market Committee meeting, the U.S. Congress had passed four Coronavirus stimulus and rescue bills (the largest being the $2.3 trillion CARES legislation), and the Federal Reserve had ballooned its balance sheet to a new record of $7.2 trillion dollars with announced new facilities, such as the Main Street Lending Program to support lending to small and medium-sized businesses that were in sound financial condition before the onset of the COVID-19 pandemic. In aggregate, the Federal Reserve announced facilities that will increase its balance sheet to a record $10-$12 trillion by the end of 2020. Let's put these figures in perspective. The Federal Reserve's balance

ABOUT THE AUTHORS



K.C. Conway, CRE, MAI, CCIM has a history of accurately forecasting real estate trends and changing market conditions across the United States. He is a nationally recognized Subject Matter Expert on commercial real estate matters with specialized expertise in Valuation, Ports & Logistics, housing economics, AG Land, Aging-Services Housing, Bank Regulation and Real Estate Finance. Conway has extensive experience with risk management, valuation, and market intelligence experience, with progressive roles within the Federal Reserve (Commercial Real Estate Risk Specialty Officer), national brokerage & large bank organizations. Conway is a real estate industry recognized speaker with presentations to approximately 750 conferences. He has published content in media and journals.



Thomas Curtin, CRE is a Managing Director within the Alternatives - Real Estate investment team at State Street Global Advisors. Tom is based in Stamford, CT and his primary focus is on external manager sourcing and monitoring on behalf of US and UK clients. Previously, Tom served as SVP of Risk for GE Asset Management and spent 25 years at GE Capital Real Estate, overseeing global new business underwriting and closing. Tom held positions in valuation and urban planning in Connecticut and New York City. Tom holds a BS and MBA from the University of Connecticut.

sheet 90 days into the COVID-19 outbreak was nearly 50% higher than its peak level during the Great Recession and is anticipated to reach the equivalent of one-half year of U.S. GDP by spring 2021. This level of public indebtedness is unprecedented and will have consequences post COVID-19. One of those consequences that have tentacles to commercial real estate is interest rates.

While the U.S. can borrow at rates below 1% today (the 10-Year Treasury for example has fluctuated between 60 and 80 basis points in recent months), it is the result of the perceived strength of the U.S. Dollar and the United States' credit rating. That may not be the case a year from now. Interest rates and the cost of this unprecedented monetary intervention are now in focus as the Treasury Department prints currency to fund asset and loan purchases by the Federal Reserve. Keep in mind that the Federal Reserve does not produce or sell anything to generate the cash to buy assets. Essentially printing currency and expanding the money supply by the Treasury Department provide that funding. And the assets backing that new money supply is no longer high quality with a high likelihood of full repayment.

The assets being layered onto the Federal Reserve's balance sheet today are not just investment-grade government bonds or high-grade corporate paper; rather, they are all kinds of paper down the credit curve to small business and even student loan debt. These assets have a risk of default and nonpayment, increasing the risk that the Federal Reserve could see losses in these assets unlike those that backed the $4.3 trillion in assets during the Great Recession. And more monetary intervention is expected to support state and municipal governments for unemployment insurance, with municipal bonds supporting airports and vital infrastructure such as the NY Municipal Transit Authority (MTA) and ports that enable our supply-chain and logistics to function. We need to be asking now: What are the unintended consequences and cost of future borrowing (interest rates) if this level of debt and monetary intervention continues?

TRANSLATING U.S. PUBLIC DEBT AND LOCAL DEBT

From a U.S. perspective, public and private indebtedness can be impactful on real estate values and returns in five areas:

1. The U.S. Federal budget impacts private industry which benefits from public funding, including: General Services Administration leases; backing of Government Sponsored Enterprises; funding of state and local government programs (including infrastructure); funding for public institutions and parks etc.—all having downstream impacts due to increased federal taxation on companies and individuals.

2. State and local government indebtedness affects budgets, credit ratings (cost of raising infrastructure and capital improvement debt), taxes and fees, funding of pensions, paying employees, real estate ownership, and the cost of leasing and utilizing real estate space.

3. Corporate indebtedness affects balance sheets and credit ratings, impacting the ability of corporate tenants to hire and grow and pay rent. The cost of occupancy is also impacted by state and local taxes flowing through to tenants. Prior to COVID-19 this was already a growing issue in a number of states such as California, Illinois, New York, and Connecticut.

4. Individual and personal indebtedness such as student loans, car loans, and credit cards is a drain on disposable income, which directly impacts an individual's ability to pay rent, buy a home, and spend at local businesses.

5. The cost of real estate capital can rise as high federal debt levels impact the federal balance sheet and U.S. credit rating. Monetary policy impacts interest rates as Government Sponsored Enterprises such as Fannie Mae and Freddie Mac establish lending rates in the housing market.

While mortgage rates have been favorable for residential real estate buyers and investors, the impact of rising non-mortgage consumer debt is a red flag. The steep ascent as a percentage of GDP from 2010 to 2019 is similar to the rise in consumer mortgage debt as a percentage of GDP leading up to 2008-09.

As we know, all real estate is local and the value of commercial real estate can be influenced by local indebtedness that gets funded by local taxes, primarily property and state income taxes. Many larger states in the Northeast and on the west coast became reacquainted with just how impactful local taxes could be on real estate demand and values post the 2017 Tax Act and its limitations on the deductibility of SALT (State and Local Taxes). It put states like New York, New Jersey, Connecticut, and California at a disadvantage to no-income-tax states like Florida, Texas, and Tennessee.

A quickly escalating issue for the November 2020 elections and the debate over future fiscal intervention by Congress to address the tentacles of the COVID-19 outbreak is fiscal aid that states will need to fund essential operations and essential infrastructure that support an array of commercial real estate—from urban housing and office buildings that depend on public infrastructure, to industrial warehouses that rely on ports, rail, and road infrastructure that enable the flow of goods and functioning of our supply chain. All of these essential services and infrastructure are funded via local bonds issuances that are now at risk when one in five working Americans, or 40+ million people are unemployed, GDP contracts 5% for the first time in more than a decade, and now 90% of air travel is idled. According to the Transportation Security Administration, by April airline passenger traffic had fallen from 2.3 million passengers per day to a low of <90,000 – and that has only recovered to a daily average of 250,000 passengers in May as states reopened.[1]

The PEW Charitable Trusts examined the disparity in fiscal health among states in a report published April 2020 with the results revealing the bifurcation in states' fiscal health.[2]

The good news in the PEW report was that most states have "Total Balances" (reserves including "Rainy-Day" funds) at their highest levels post the financial crisis. The states in best shape are Wyoming, Oregon, and Texas with 397, 137, and 103 days, respectively, of balances to fund state operations. In the middle are states in the South like Alabama (68 days), Florida (40 days), North Carolina (45 days), South Carolina (76 days), Georgia (42 days), and Tennessee (42 days), and states in the West such as Arizona (59 days), California (56 days), and Oregon (137 days). In worst shape are Pennsylvania (0.3 days or less than 1 day), Illinois (4.7 days), and Kentucky (8.1 days). These reserves are being quickly depleted as the Coronavirus crisis persists and the depletion is exacerbated by the decline in the respective states' Unemployment Insurance Trusts. The bottom line is some states—and many cities—are going to require more fiscal and Federal Reserve intervention than others, but all may be asked to pay. It will potentially pit "fiscally strong" states such as Wyoming, Texas, Alabama, South Carolina, Florida, and Georgia against states in a more dire situation (Pennsylvania, Illinois, Kentucky and states in the New York region) that emanates beyond legacy issues such as underfunded pension liabilities. This disparity has potential lasting consequences for real estate and the funding for vital infrastructure that all states and commercial real estate benefit from, such as a nationwide airport system where business and leisure travel are possible among all states supporting a material U.S. tourism industry or ports that facilitate our supply chain. If a "SALT-type" divide results in COVID-19 fiscal intervention as it has from the 2017 Tax Act, the value of commercial real estate and flow of investment funds will be dislocated. That dislocation can impact business activity, site selection, and future economic development that drive job growth. It's a complex issue that impacts commercial real estate value and investment activity.

THE BIG PICTURE/CONCLUSION

Debt, be it at the federal or state and local level, influences the value and investment demand for commercial real estate in ways such as interest rates, property taxes, and real estate values. While fiscal and monetary intervention are necessary in a Great Recession like 2009, or a public health crisis such as COVID-19, understanding the tentacles of that intervention is a Top Ten real estate issue. Public debt needs to be translated locally to understand the interconnections of air travel, ports, logistics infrastructure, and public transportation that influence commercial real estate demand, value, and investment activity. A final closing reference to put all aspects of U.S. debt in perspective is the U.S. Debt Clock. Some noteworthy observations from the June 15, 2020, reading and the tentacles to commercial real estate are as follows:

- The U.S. national debt has now risen to just more than $26 trillion from $23 trillion just 6 months ago, or $210,000 per taxpayer (just shy of the median home price in the U.S.). This is a drain on savings and investment activity.
- Total state debt is approximately $1.2 trillion, or $3,500 per state taxpayer, and local debt is nearly double state indebtedness at $2.1 trillion and $6,350 per local taxpayer.
- Student loan debt is now approaching $1.7 trillion and exceeds total credit card debt of $1.0 trillion. This burden on what's now the largest demographic group in the workforce—Millennials—will inhibit housing investment and consumption behavior, adversely impacting retail, auto purchases, and leisure spending for travel.
- Total Personal Debt now exceeds $20.5 trillion and is approaching the U.S. annual GDP. That equates to more than $62,000 per citizen. Totaling personal debt, state debt, local government debt, and U.S. national debt, each U.S. citizen now owes the equivalent of the cost of a median home in the U.S. This level of debt at the onset of COVID-19—with trillions more ahead in stimulus and fiscal rescue intervention—is not sustainable. It will impact commercial real estate in many ways, from reduced demand for housing to interest rates that will eventually have to rise to attract new capital to fund our debt, to the ability to repair and upgrade our aging infrastructure and fund projects like 5G that will be essential to our future.[3]

Lastly, from a global view of public debt, the International Monetary Fund projects that global net public debt will rise from 69.4% of national income in 2019 to 85.3% in 2020. Global public deficits will climb 9.9%, topping levels seen in 2008-2009. •

ENDNOTES

1. TSA checkpoint travel numbers for 2020 and 2019, https://www.tsa.gov/coronavirus/passenger-throughput.
2. Barb Rosewicz, Justin Theal, and Joe Fleming. "States' Financial Reserves Hit Record Highs," The Pew Charitable Trusts, March 18, 2020. https://www.pewtrusts.org/en/research-and-analysis/articles/2020/03/18/states-financial-reserves-hit-record-highs.
3. U.S. Debt Clock, https://usdebtclock.org.

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