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The Economy Beyond the Tipping Point: Crisis and Opportunity for Renewal

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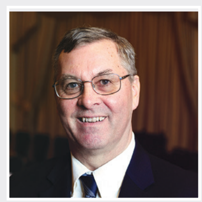
Economic Renewal was listed as the #2 issue in the 2020-21 Top Ten Issues Affecting Real Estate® by The Counselors of Real Estate®.

As we reach the half-way point in calendar year 2020, real estate is facing a triple threat across the United States. We are in a public health emergency, an economic contraction of historic proportions, and a suddenly explosive condition of civil unrest. The third of these issues erupted as an immediate consequence of the killing of George Floyd by Minneapolis police, but underlying stress from America's "original sin" of racism, the disproportionate concentration of COVID-19 illnesses and deaths in minority and low-income communities, and the greater exposure of those communities to job loss were significant contributing factors.

It would be tempting to ascribe the confluence of the three elements – each of which would be independently critical for the real estate economy – to monumental bad luck. But, to cite the wise words of Shakespeare, "the fault is not in our stars, but in ourselves." Despite proclamations of a robust, "best-ever" economy at the turn of the year, **we were heading toward an economic tipping point prior to COVID-19 and the lockdown of the economy in March**, and beyond that tipping point we find deep and persistent challenges facing the economy and the real estate industry.

ABOUT THE AUTHOR



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There were a number of statistical signals of deceleration for those willing to see them. Annual job growth in the U.S. had dropped from roughly 3 million in early 2015 to about 2 million in 2019. Industrial production expansion peaked in mid-2018 and had decelerated into negative territory by late 2019. Even more fundamentally, labor force growth had declined from the double-digit pace of the final three decades of the 20th century to less than 8 percent from 2000 to 2019, driven in part by the reduction in the U.S. birth rate to below the Zero Population Growth threshold and in part by the constriction of the immigration valve by national policy.

The fragility of the economy, even as headline statistics encouraged complacency, was evident in the impact of the partial government shutdown of late 2018-early

2019, when the loss of a couple of paychecks to federal employees and related workers drove hundreds of thousands to food banks and scrambling to friends and relatives to meet monthly bills, including rent and mortgage payments. This was stark confirmation of the findings of a 2018 Federal Reserve study showing that 40 percent of U.S. households did not have the resources to cope with an unexpected $400 expense.

So we were at risk, and the novel coronavirus SARS-CoV-2 triggered the disruption that pushed the economy over the edge. It may be worth noting that The Counselors' Top Ten Issues a year ago included these observations:

> *"It may seem peculiar to cite "complacency" as a particular risk as of mid-2019… Extrapolating recent trends indefinitely into the future while ignoring signs of the limits to growth sets us up for harsh surprises."*
>
> *"There is also the potential for a truly disruptive surprise… To the extent that both equities and real estate values are anticipating a "normal" upturn after a recession, the readjustment of prices … will make this "end of cycle" event even more painful, puncturing the complacency still widely felt in early 2019."*

Hindsight is 20/20, as many will surely remark. But a year ago the experience and the objectivity of members of The Counselors of Real Estate were ahead of the curve in identifying latent risk and urging attention to serious risk management. Those who acted on this perspective had defensive strategies already in play prior to COVID-19's arrival on our shores.

A TWO-PART FRAMEWORK

What then might be the relevant interactions between a disruptive public health crisis that is metastasizing into an economic downturn that, by some measures, falls between the Global Financial Crisis of a decade ago and the Great Depression of the 1930s as a challenge to society and to the economy?

Public Health

The curve of the pandemic in the United States seems, in the short run, to have passed its peak in some, but not all, of the most hard-hit areas. But in other parts of the country, especially in a broad swath of Southern and Western states, the metrics for COVID-19 cases, hospitalizations, and deaths were seeing a disturbing pattern of increase in the late spring. Epidemiologists see the so-called "first wave" as extending through the summer months, while still warning of a "second wave" in late 2020 and early 2021. The pandemic, then, will be presenting a headwind against which economic growth will be contending for the foreseeable future.

As of June, all 50 states were in some phase of economic "re-opening." Many, if not most, states and localities are planning for a period of "semi-normal" beginning in the summer and continuing for the balance of the year. Semi-normal indicates a relaxation of some but not all social distancing restrictions, with the effect of controlling the pace of community spread of the virus. A minority of states and localities were, by mid-June, re-evaluating the pace of re-opening in the face of a rising infection rate. Although there have been encouraging scientific developments in the areas of vaccines and medical therapies, epidemiologists are not expecting a population-wide inoculation program during 2020.

An early (published April 24, 2020) study in *Science* ("Projecting the transmission dynamics of SARS-CoV-2 through the post pandemic period") indicates that containment of the virus is highly dependent upon the duration and rigor of social distancing, even given a hypothetical pharmaceutical (vaccine or treatment) intervention that would become available during 2021. The models investigated in this study suggest a need for preparedness and response throughout 2021. An independent report issued by the Center for Infectious Disease Research and Policy at the University of Minnesota largely echoes that study in *Science*.

Economic Consequences

The immediate impact on the U.S. economy has been dire and, if anything, the worldwide economic consequences are at least as bad, if not worse.

One sign of the degree of distress is the shift in relevant comparison from any of the post-World War II recessions to the epitome of economic dislocation that was the Great Depression of the 1930s. The more-than-40 million unemployment insurance claims filed between mid-March and the end of May pushed the jobless rate beyond any seen in post-war cycles. In 1982, unemployment hit 10.8 percent at peak and in the Great Recession it touched 10.0 percent briefly.

Even with the recall of some workers tallied in the early re-opening phase this spring and summer, significant segments of the economy remain debilitated. Leisure and hospitality, retail, air travel, and construction can expect slow and partial rebounds into 2022. Ironically, the healthcare industry – especially workers in lower-income jobs – is facing an intense financial squeeze in the wake of the Coronavirus. The impact of the economic lockdown on state and local tax revenues could shrink non-federal government employment levels, as occurred in the Global Financial Crisis, and shelve important infrastructure projects. Such risks suggest an unusual "W-shaped" recession – a second contraction following the initial improvement of a partial economic re-opening.

The consensus forecast of the Blue Chip Economic Indicators panel, issued June 10, 2020, suggests a GDP contraction in 2020 of 6.1 percent, and a 4.0 percent expansion in 2021, not fully making up the 2020 losses. By year-end 2021, real GDP will still be lower than at year-end 2019.

Final demand for goods and services will depend upon rebuilding the effective buying power of the American workforce, playing out in the context of the public health situation and civic unrest. Needless to say, this is not a sunny outlook for the real estate sector.

Between June and December, it is true, we will see a substantial increase in the short-run measures of change (month-over-month, quarter-over-quarter), the mathematical consequence of the huge loss of income as the economy locked down. Those short-term gains, however, are a kind of "dead cat bounce", and unsustainable on a percentage basis. A more reliable measure of changes in spending power will be the year-over-year change, both in absolute dollars and in percentage change. That story is going to be less dramatic, as 70 percent of GDP reflects personal consumption. So, in terms of timing, expect recovery in final demand to be attenuated.

A key reason for expecting a long wait for final demand recovery is in the structure of job losses in the first wave of COVID-19 contraction, and the prospects for bringing millions of those lost jobs back into the economy. A Brookings Institute report identifies 27.4 million workers in the most vulnerable jobs, plus another 9.8 million across the rest of the economy as at high risk in the near- and mid-term. Besides hotels and restaurants, retailers, casinos, building materials, and personal and child-care services are on Brookings' list.

If the extended timing of recovery proves an accurate prediction, many of these workers will still be displaced a year from now. Most of them are ill-equipped for long-range joblessness. Brookings indicates that vulnerable workers already toil in low-paying occupations, earning on average just $32,700 (compared with $57,700 for other workers). As such, they are already subject to housing stress and food insecurity. For most Americans, health insurance is connected to employment, and so job loss creates exposure to medical expenses – onerously so, as anyone who has had to purchase COBRA coverage can attest.

The concentration of job losses in lower-paid occupations has a powerful multiplier effect, too. Households at the lower end of the income spectrum recycle virtually all of their paycheck into the consumer economy (called the 'propensity to spend') while more affluent households have a higher propensity to save. So a dollar lost at the lower end of the income distribution translates directly into lower consumption – and lower GDP – whereas income loss in higher brackets has a lesser marginal effect on the economy.

That describes a troubling economy in the year ahead, with the "W-Shaped" recovery requiring a long duration. Discretionary spending is likely to plummet during the second down leg. Even 'essential' spending – including rent and mortgage payments – is at risk, given the need of households to triage their budgets for food, shelter, medicine, and daily necessities. Even those households with some safety margin in their budgets are going to be inclined to frugality.

Bluntly put, the post-COVID-19 economy will not be settling into long-run GDP, spending, and employment growth rates that bear any similarity to the 2000 – 2019 period. Once the first year of recovery is accomplished – and even this will mean some jobs permanently lost – final demand for U.S. businesses, including real estate, will remain truncated. For the decade of the 2020s, the economy is constrained by long-run potential GDP growth that is a weak 1.5 – 1.6 percent. That is the 'new normal' for which we need to prepare.

BUT DO NOT TAKE THE COUNSEL OF DESPAIR: ADAPT AND INNOVATE

When the Great Depression hit, the key to recovery was a fresh approach, rather than a return to the 'good old days' of the 1920s. The reforms of the New Deal – reconstitution of banking practices, the institution of Social Security, Keynesian fiscal policy, the use of public work to tap the labor of the unemployed, massive upgrades in infrastructure such as the Tennessee Valley electrification and projects such as the Hoover Dam – left an imprint for generations.

The disruption of the Second World War tightened linkages to allies around the world, prompted tremendous investment in new technologies, and developed national coordination in production.

Following the war, both the Truman and Eisenhower administrations upgraded the workforce through the GI Bill, expanded infrastructure in the Interstate Highway system, pushed technological advances in communication and aerospace, promoted homeownership, and lay the foundations for the expansion of a prosperous Middle Class. Although there were still major flaws in society, the socio-economic change of state accomplished by wise management of the disruptive forces of the Depression and the War affords an example well worth our consideration in 2020.

Thinking Ahead

The present crisis gives us an opportunity to think and to plan for a post-COVID-19 economy – even allowing for an extended 'semi-normal' period of transition. Demographic, technological, and social changes point toward a "decelerated" level of decade-long growth, but we can still take the current disruption as a 'teachable moment'. Some elements to be thought through and planned for are:

- Redeployment of the suddenly unemployed, many of whom may face the likelihood of the permanent evaporation of their positions, in a forward-looking infrastructure development and maintenance program aimed at national growth in the 2030 – 2050 period. This will require coordination at all levels of government.
- Reconsideration of the U.S. role in the global economy; this would not seek to sever economic interdependence, but focus on mutual benefit in growing world markets while preserving key elements of U.S. autonomy.
    - This would involve a degree of "re-shoring" strategic manufacturing, accepting higher costs as an investment in the national interest.
    - Altering, though not eliminating, the just-in-time inventory control process to maintain emergency flexibility against key supply shortages.
- Re-thinking stimulus tools beyond the Keynesian model, such that counter-cyclical public spending would be more than a short-run "demand yank" and move in the direction of a steady, long-run expansion of final demand – recognizing the large public benefit of reducing income inequality.
    - Re-thinking the civilian/military relationship, emphasizing the military's capacity to develop skills that are transferable and deployable when needed across the economy (as was seen in the tremendous work accomplished by the Army Corps of Engineers this past Spring).
    - Investing in science, as was done in the NASA programs of the 1950s and 1960s, both in "pure"

research, and applied research for programs such as the "telemedicine" now being deployed in the COVID emergency.

- o Re-structuring federal, state, and local approaches to public safety and health, with a greater emphasis on training and tapping the talent and energy of young people to provide community services, especially in lower-income areas.

CONCLUSION

The philosopher Immanuel Kant said that there were three key questions for us in life:

- *What can we know?*
- *What should we do?*
- *What may we hope?*

We are still learning about the coronavirus that has plunged us into the public health crisis, and triggered the economic dislocation that will, it appears, be with us for quite some time. We need to recognize that there's a lot we do not know. But that itself is the key to question number two. What should we do? First, it is imperative to keep an open mind. We are best advised to avoid panic, but to draw on all our resources. Historical perspective helps, but this crisis has its own unique profile and so in our lives and our businesses the key is to be oriented to the future - to build the portion of the economy and of the real estate domain over which we do have some ability to make a difference. As Counselors, being thought-leaders and problem solvers is at the heart of our professional job description.

As for what we may hope, it is important to stress that hope is not just empty wishing. Hope is considered a virtue, and the word "virtue" signifies strength. For myself, I find the exhortation of Pope Francis to be "anchored in hope" to be a key principle. The times are turbulent, and it would be delusional to ignore that. But in our personal and business lives, being anchored in hope means (speaking personally) identifying those actions I can take to improve the conditions of those I am connected with.

When I was in grammar school, we used to have workbooks entitled "Think and Do." The very exercise of evaluating the economy as one of our Top Ten Issues for 2020-2021 - especially the final section urging us to avoid nostalgia and the temptation to go BACK to normal but, instead, to drive toward and work toward opportunities yet to come - that's my pragmatic answer to Kant's question, "What may I hope." •

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