

# **Uncertainties in Economics and Politics: What matters? And how will the real estate sector be impacted?**

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# Unprecedented uncertainties

- Geo-political
  - Rules based global economic order created over three quarters of a century is now under attack
  - Attack coming from direction least expected—US
    - US was instrumental in creating the rules based system
    - Trump has thrown a hand grenade—and the dust has yet to settle
- European Project is being questioned
  - Brexit
  - Difficulties in cooperation on migration
  - Challenge to democratic values by Poland and Hungary
- North Korea

# Globalization and European integration have brought significant benefits

- Three quarters of a century of peace in Europe
- Huge increases in trade on the basis of a global rules based system—extending the rule of law to an international context
- Huge increases in standards of living over that period
- Hundreds of millions moved out of poverty—800 million in China alone
- Seemingly successful transition of Eastern and Central Europe from Communism to a market economy

# Understanding the attack against globalization

- Over-promised: sold on the notion that everyone would be better off
  - In fact, in US, things are not going well, even though GDP growth has begun to recover
  - Still well below levels before crisis
  - Trump's hope to return growth to 4%, or even 3%, just bluster
  - Won't happen: fundamental changes to productivity and demography
- Anti-migration, anti-globalization and anti-science policies will make matters worse
  - Deglobalization may be even more disruptive than globalization
  - US position in global economy will be in decline

# The suffering in America

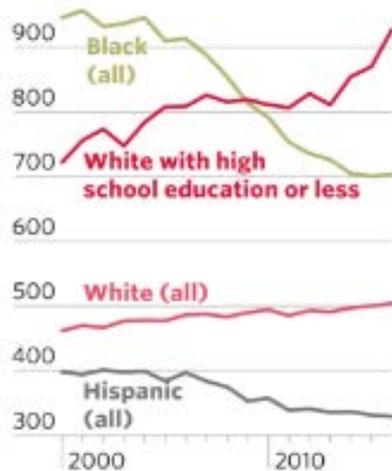
- Life expectancy is decreasing
  - Deaths of despair—suicide, drugs, alcoholism—are rising, especially among white males
- Reflects economics
- Income of a full time male worker lower than four decades ago
  - Real wages at the bottom at the level they were six decades ago
  - The American dream is now seen as a myth—US has among the lowest levels of economic opportunity of any of the advanced countries
  - All of this sits uncomfortably beside huge gains in wealth at the top and success in innovation in Silicon Valley
- The ugly turn that politics has taken is not a surprise: an important lesson for others

# Decline in life expectancies and an increase in deaths of despair

New research shows the increasing mortality rate among white Americans spans age groups and is most acute among the less-educated.

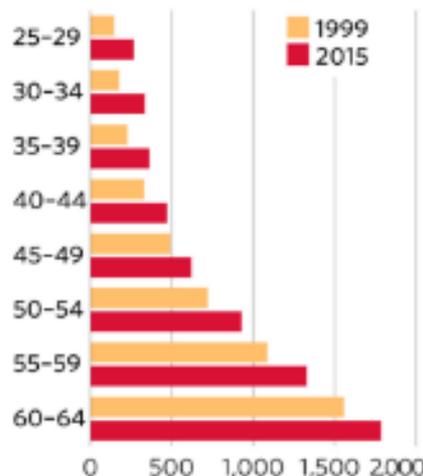
White deaths are rising...

Mortality rate by race, ages 50-54



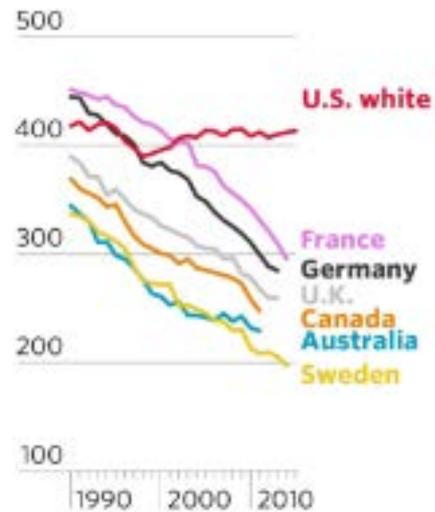
...among all age groups of less-educated whites...

Mortality rate for whites with high school education or less, by age



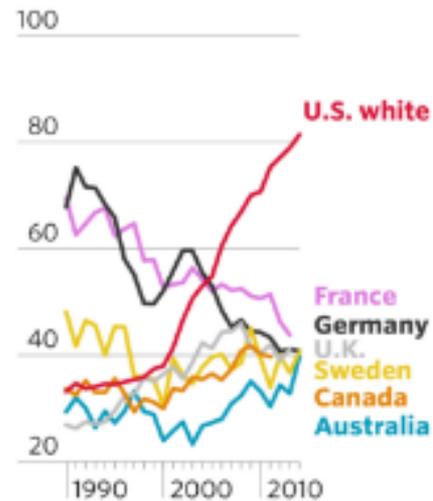
...in contrast to elsewhere...

Mortality rate for all causes, ages 45-54



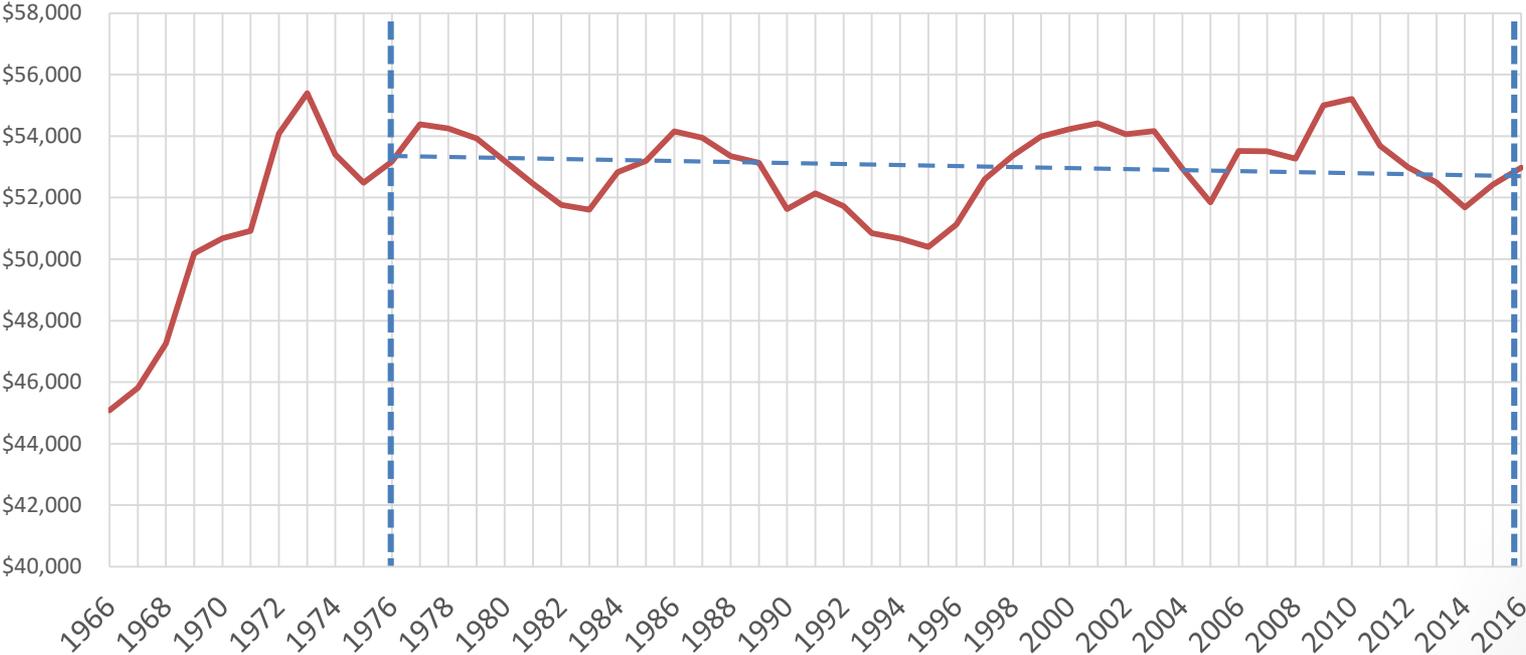
...due in part to increases in 'deaths of despair'.

Mortality rate due to alcohol, drugs and suicide, ages 50-54



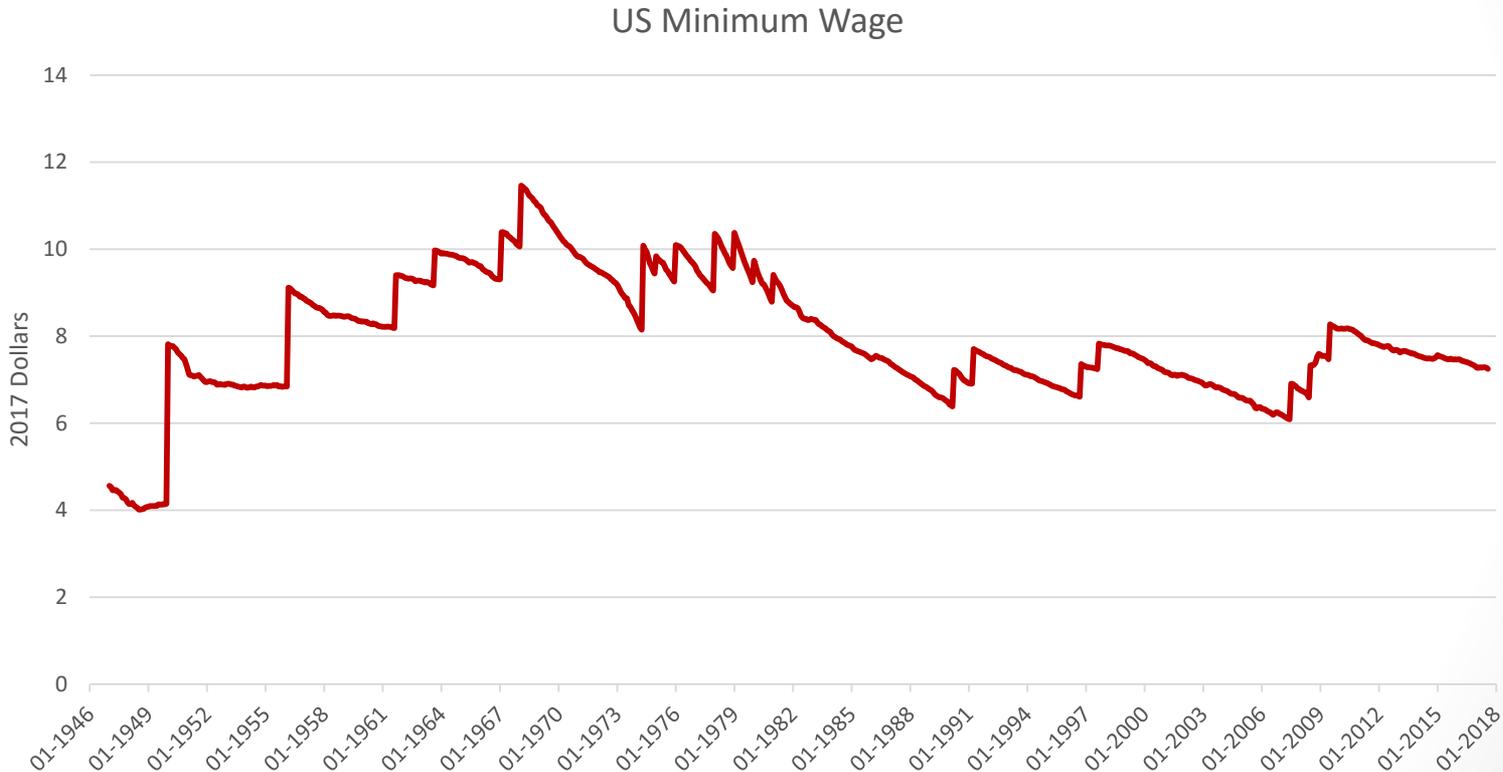
# US: Median income of a full time male worker is at the level that it was more than 4 decades ago

(constant 2016 \$)



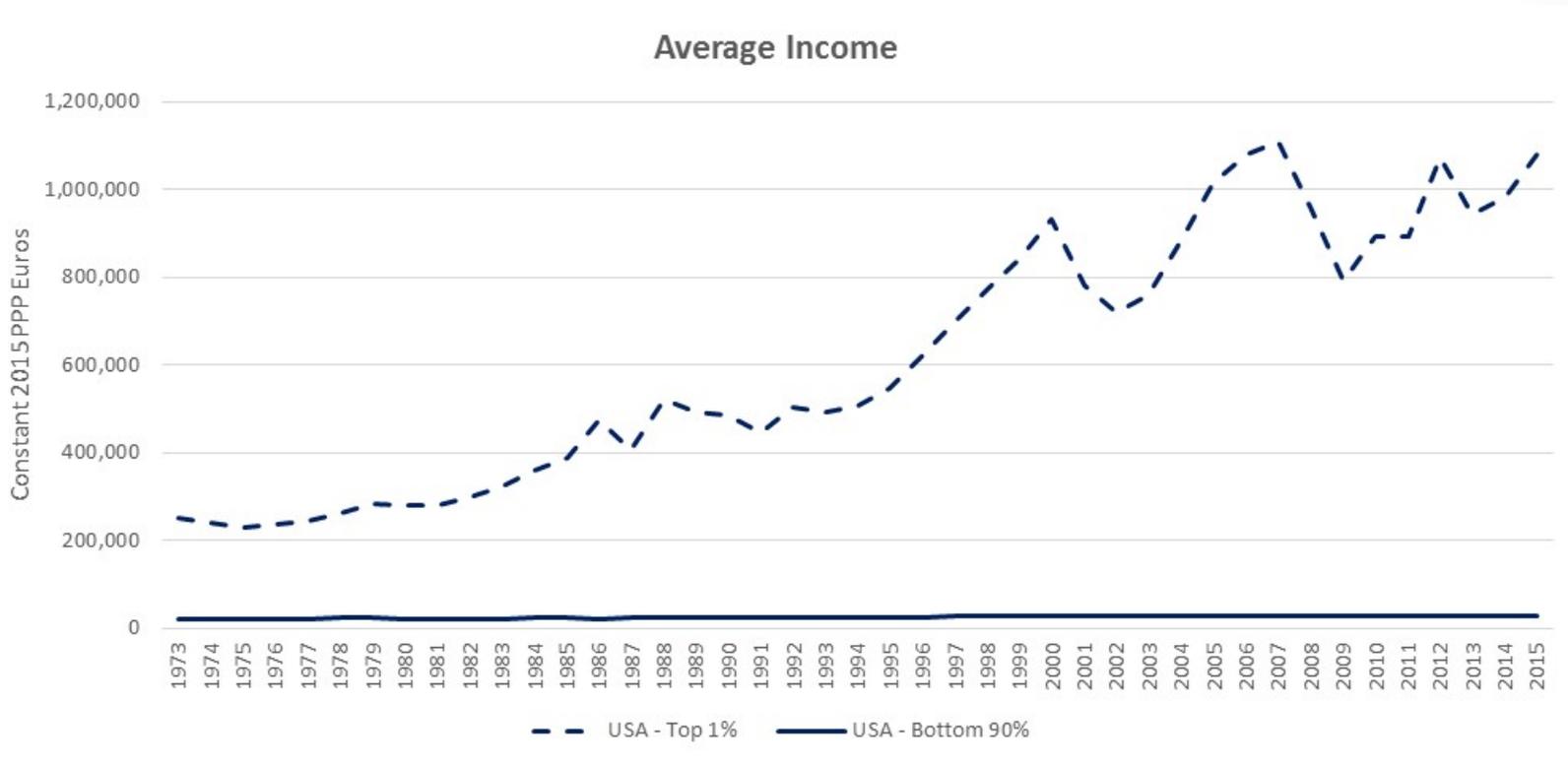
Note: Data is adjusted for the methodological change of 2013.  
Source: U.S. Census Bureau.

# US: Real wages at the bottom are at the level that they were roughly sixty years ago



Source: Federal Reserve

# US: bottom 90% have seen little increase in income over last third of a century



Source: World Wealth and Income Database

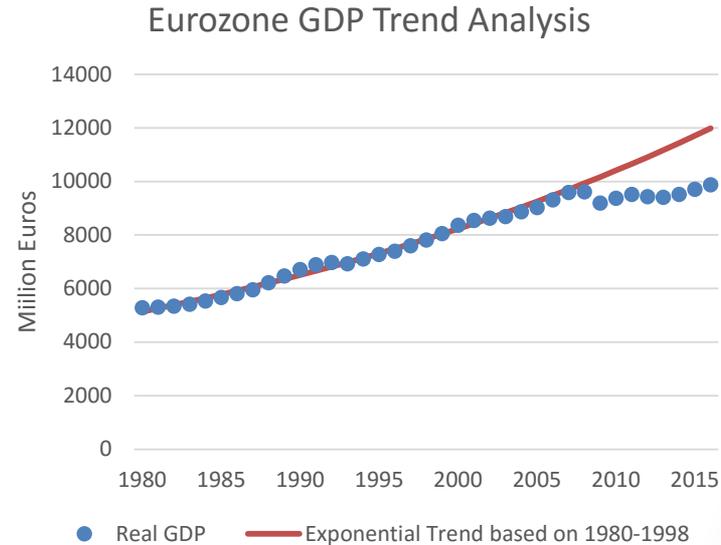
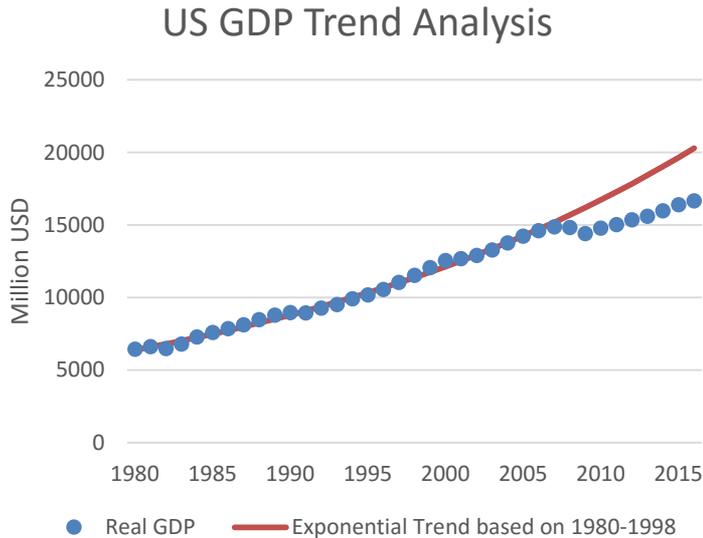
# Understanding the growth of inequality over the last third of a century

- Large role play by increase in market power throughout the economy
  - And decrease in bargaining power of workers
  - Share of corporate profits has tripled in US since 1985
- Rules of the economic game have been rewritten in last third of a century
  - And globalization has played *some* role
    - Especially as a result of weakening of bargaining power of workers
    - But even without globalization, less skilled workers would have faced difficulties
  - If globalization had been better managed, some of gains of the winners would have been shared with those who lost
    - Economics had predicted that there would be winners and losers
      - Trickle down economics doesn't work
    - But the winners were unwilling to share their gains with the losers
    - Consequences particularly severe in the US, with an inadequate system of social protection

# Europe

- While Europe is finally recovering, as in the US, growth is anemic
  - Less than before the crisis
  - With many countries still below pre-crisis level—a lost decade
  - For Europe as a whole growth over the past decade has been a mere 0.9%
  - Huge gap between where the economy would have been and where it is
- Dissatisfaction in many quarters is palpable
  - Weakening of traditional center parties, increase in parties of the extreme
  - Brexit—opposition to EU in UK based on many of the same underlying forces contributing to anti-globalization in US
    - Won't solve the problem of those that have been left behind
      - Likely will have adverse economics effects on both EU and UK
      - Though likely less than widely anticipated
      - US and Canada have prospered together with a trade agreement, but without other aspects of integration
      - And most on both sides of the border believe that that is a good thing

# Euro area has performed much more poorly than the US – even though the crisis originated in the US

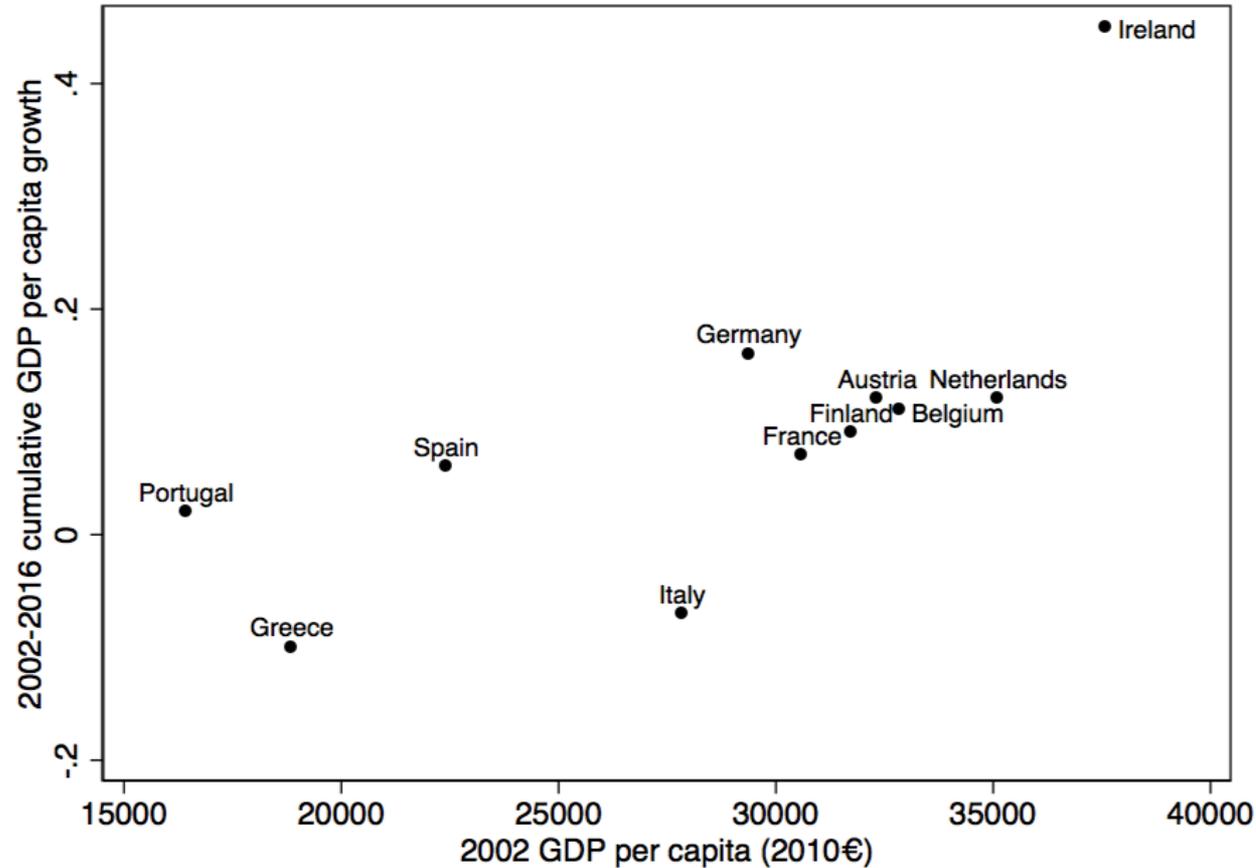


Note: Eurozone refers to the 12 countries that first joined the Euro in the early 2000s.  
Source: IMF, World Economic Outlook, April 2017.

# Weaknesses in Europe understandable: predictable and predicted

- Making a single currency system work for a diverse group of countries is difficult
  - Took away two key mechanisms of adjustment, the exchange rate and interest rate, but didn't put anything in place
- An unsustainable half-way house
  - Led to divergence, rather than convergence
- There has to be either “more” Europe or less
  - Banking union
    - Most important part of which is common deposit insurance
  - Solidarity funds for stabilization
    - Including common support for unemployment and lending funds for small businesses
  - Euro bonds or other mechanisms for common borrowing

# There has been divergence



# Other reforms needed

- Problem is in the structure and policy framework of the Eurozone itself, not with the structure of the individual countries
  - Though there have to be reforms in this area as well
- No economic justification for current strictures: deficits less than 3% of GDP; debt less than 60% of GDP; inflation less than 2% per annum
- Single minded focus on inflation misguided in an era in which deflation and unemployment are the real issues

# Changes in global and European economic landscape will have implications for the location of economic activity

- Global supply chains were created on the basis that borders didn't matter—goods and services could move easily across borders
  - Enabling production to be located at most efficient locale
  - Though tax competition sometimes (often) distorted decision making
- Financial markets were created on the basis that borders didn't matter—capital could move easily across borders
- Trump has shown that borders do matter
  - Damage will be long lasting
- Supply chains and financial flows will have to be reconstructed

# Borders matter

- This forces a rethinking of decisions about the location of economic activity
  - Which in turn will have large implications for real estate
  - Not just commercial real estate, but housing for those who work in the new establishments and who provide them services
- A move of a significant portion of the financial sector out of London to the continent would have large implications for both sides of the channel
  - Concerns may be exaggerated
  - Official location of transaction may differ from where value added actually occurs
    - Illustrated by off-shore banking centers
- And London will remain an important financial center for many outside of the EU

# These changes occur on top of ongoing changes in real estate market with profound implications for our economic landscape

- Retailers leaving inner city
  - End of shopping centers
- Retailers being displaced by internet
  - New ways of delivering goods to consumers
  - With growth of warehouses and logistic systems
- Many smaller places being devastated
- Housing preferences changing—towards urban life
  - Most important: creating green cities, to meet Paris goals
  - Will require changes in transportation systems and economic landscape
- Economic restructuring and migration are also changing patterns of demand for real estate

# Further changes

- US tightening standards for money laundering through real estate
  - Agenda began under Obama
  - Likely large role of Trump in money laundering heightened interest in subject
  - Likely will spread beyond US
- Already affecting NY real estate market
- In US, worry that insufficient amount of rental housing has contributed to low mobility
  - Re-examination of the mix between rental and owner occupied housing
  - Re-examination of the forms of mortgage
  - Still many balloon mortgages—what will happen if interest rates rise?

# Of critical importance: pace of increases in interest rates

- Led by US
  - As it reaches low levels of unemployment (4.4% as of August 2017)
  - And strives to return to a more normal monetary policy—after a long decade
- In spite of absence of inflationary pressures
  - And high unemployment rate among some marginalized groups
    - Whose employment only fell when labor markets have been very tight
- Standard relationship between unemployment and inflation has changed

# Ongoing controversy

- Advocates of an increase in interest rate increase argue
  - Inflation is around the corner, given low unemployment rate
  - Low interest rates have distorted markets—search for yield
  - Need ammunition in case of a downturn
    - Which some see as overdue
- Opponents worry:
  - Real wages have not really recovered—and only will if labor market remains tight
  - Marginalized groups will be brought in only if we keep interest rates low
  - Construction particularly important for groups that have suffered from marginalization
- What is clear is that the risks for interest sensitive sectors—like real estate—are likely to remain high

# Outcome uncertain

- Especially because Trump's fiscal agenda is in doubt, but could pass
  - Large gap between promises and campaign rhetoric and performance
  - A trillion dollar infrastructure program is unlikely
  - But a multi-trillion dollar tax cut (cost over ten years) might occur
  - Would jeopardize America's economic future for a generation
  - And would likely ensure faster increases in interest rates
- Many vacancies on the Fed, more to come
  - Vice chair has resigned
  - Chair's term of office ends soon
- Before election, Trump criticized low interest rate policy—surprising for some one from real estate sector
  - No one expects any intellectual consistency
- But there are many influential advisors from Wall Street who argue for higher interest rates

# The outcome will have important implications for Europe

- Europe already seems headed for an exit from QE easy money policies
  - But the pace of recovery in Europe has been slower than the US
  - And the mandate of the ECB is markedly different from that of the Fed
- Europe's highly indebted countries pose a special problem
  - If interest rates rise significantly, their fiscal position would deteriorate
    - Possibly precipitating a crisis
  - If Europe does not raise interest rates in tandem with US, imbalances may be a problem
    - Large cross border capital flows
    - But exchange rate devaluation would be of benefit to Europe
- Europe is caught in a predicament

# Concluding comments

- A time of unprecedented uncertainty in the global economic landscape: this is the only thing about which we can be certain
- Navigating these dangerous shoals will be difficult, for both the private and public sector
  - There will be some real opportunities, as the location of economic activity shifts
  - But real risks, especially to heavily debt financed enterprises
    - Shifts out of the country can lead to decreases in real estate prices (e.g. in London)
      - And especially so if interest rates rise, as seems likely
  - Changes in interest rate are likely to have an even more profound effect on the real estate sector
    - Both directly
    - And indirectly in Europe—if these interest rate increases precipitate another crisis
- But times of risk and uncertainty are also times for opportunity
  - Provided that decisions are guided by careful analyses of the risks and uncertainties