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Early Thoughts on Risks Across Markets

The longest business cycle in United States history ended abruptly in March 2020 as the public health crisis caused by COVID-19 spread around the world. Most global economies are now amid severe recessions and there is a lot of uncertainty with regards to how deep and prolonged their downturns will be. According to the International Monetary Fund, the "Great Lockdown" recession would be the steepest (but not the longest) in almost a century, with the global contraction and subsequent recovery likely to be worse if virus infection levels persist or reoccur.

The current baseline scenario for the U.S. calls for production growth to resume later this year, but it also assumes that there is no second wave of COVID-19 infections or some other major shock. In this scenario, the national employment level returns to its recent peak by the end of 2022. While it is expected that the labor market recovery will be about twice as fast as the one that followed Great Recession of 2008-2009, there is a lot of uncertainty around this outlook. What is already clear; however, is that the crisis, its human and financial toll, as well as policy measures for dealing with it will also have major long-term implications for the economy, capital markets, real estate, and society in general.

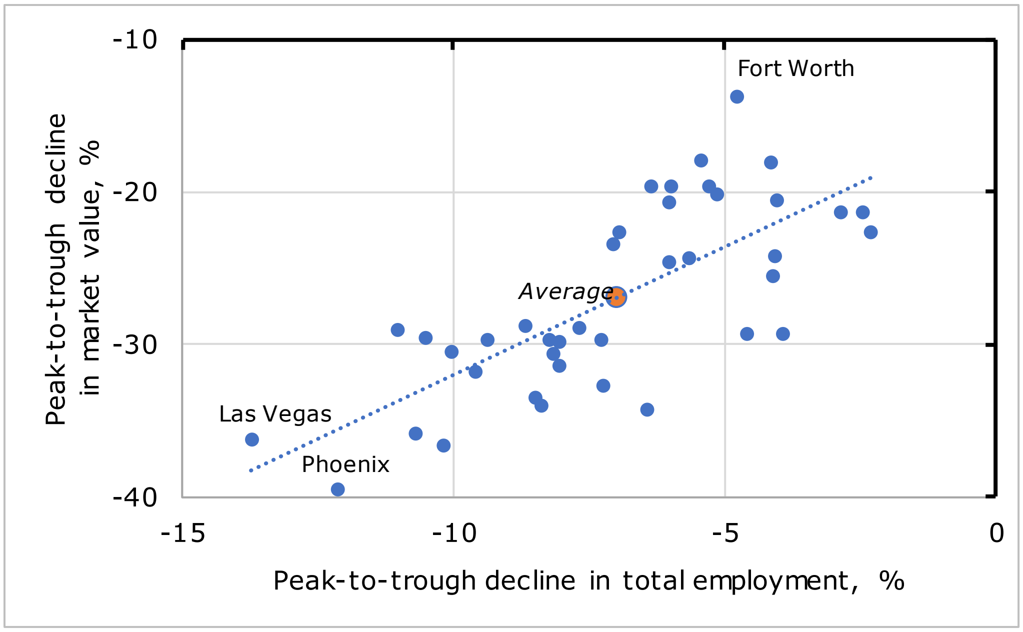
It is still too early to estimate how this recession will impact different real estate segments, markets, and types of assets from both fundamentals and investor sentiment perspectives over the next few years. While hotels and retail have taken the first hit, and their demand has already contracted, other sectors are not immune and will be affected to varying degrees.

What we can do at this point; however, is look at the past cycles, recognizing that each is unique and especially this downturn with its non-economic cause. History can offer some useful clues on how one might start evaluating relative risks and opportunities with regards to future investment performance across property types and markets.

As an example, we can look at apartment values following the last downturn as the Great Recession was one of the most severe in terms of its impact on both real estate fundamentals and capital liquidity. At that time, NCREIF's market value index (MVI) for apartments posted its first decline in Q3 2008, or about six months after the official business cycle peak. MVI then continued dropping through Q4 2009, posting a cumulative peak-to-trough decline of 24.6%. After that, it took another three years for MVI to fully recover nationally. While the apartment sector was the first major property sector to see values return to the pre-recession peak, there was still a rather wide variation across markets–both in terms of severities and durations of their corrections. One of the key reasons for this was the relative exposure of markets to housing-related employment.

The main trigger for the Great Recession was the sub-prime crisis that followed the burst of the housing bubbles around the country. Markets that experienced some of the biggest run-ups in home prices during the boom had seen their regional economies hit the most as the bubbles burst, particularly in Nevada, Arizona, Florida, and parts of California. These areas also saw the most foreclosures and the steepest drops in home prices and employment, especially in sectors such as residential construction. This also affected apartment fundamentals, leading to more tangible losses in demand and property incomes. The near-term impact of single-family foreclosures on apartment performance was more negative in such markets, even as millions of homeowners there became renters.

The chart below shows peak-to-trough declines in total employment versus the same for apartment values across 40 major markets. The link between the two variables is quite strong, with almost 75% correlation. On one end of the spectrum are markets such as Phoenix, which experienced one of the steepest drops in employment and where apartment value declined by about 40%. On the other end of the spectrum are markets such as Fort Worth, where values declined by less than 15%. The link between employment and market values across markets was similar when looking at the full five-year period after the peak rather than just peak-to-trough.



** peak and trough dates are specific to each market*
Sources: NCREIF, Berkshire Research.

This comparison is relevant to the current situation in two ways. First, it serves as a reminder that job growth is a key driver of real estate fundamentals and subsequently a major differentiator when it comes to investment performance across markets. Second, it shows the importance of considering factors that might contribute to variations in job growth in a downturn and subsequent recovery.

In the current environment this means taking a closer look at how various locations will be affected by the pandemic both directly, depending on how widely the virus infects their populations, as well as indirectly through their exposure to sectors facing the highest lay-offs due to lockdown and social distancing, such as hospitality services, food services, air transportation, retail trade, or energy. We should also consider markets' exposures to industries that are likely to be affected less by this crisis and may therefore cushion the impact of the recession on their local economies and lead to faster subsequent recoveries, including their real estate fundamentals. Technology, pharmaceutical research, health services, and certain types of manufacturing are the first examples of such sectors that could contribute to stronger performance in this cycle.

It is still too early to estimate direct effects as many areas are only starting to see flattening in their infection curves. The indirect effects are somewhat easier to measure by looking at exposure of local economies to industry sectors where risks of near-term job losses are particularly high. For example, the table below looks at the top five metro areas (among those with total employment of at least 500,000) based on their shares of leisure/hospitality services and retail trade. Given these exposures, near-term risks to aggregate job growth in these markets are relatively high, especially in areas where retail trade is also linked to the local tourism industry.

Share of Total Employment, %

Leisure and Hospitality Services		Retail Trade	
Las Vegas, NV	28.9	Fort Lauderdale, FL	12.9
Orlando, FL	20.6	Camden, NJ	12.5
New Olreans, LA	16.2	West Palm Beach, FL	12.1
West Palm Beach, FL	14.2	Miami, FL	12.1
Orange County, CA	13.8	Jacksonville, FL	11.8
U.S.	**11.0**	**U.S.**	**10.3**

Sources: BLS, Berkshire Research.

The next few months should give us more and better signals on how the crisis might impact employment across different industry sectors and markets. Combining this information with other key data points around trends in pricing and net operating incomes will allow for a more reliable analysis of relative risks to property values. This said, the initial analysis does suggest elevated near-term risks in markets such as Las Vegas, Orlando, South Florida, or Orange County–coincidentally, the same markets that have also experienced greater value declines in the last cycle. Investors will be well served to monitor conditions in these markets carefully now and be prepared to adjust their return expectations to account for rising risks once more information becomes available. The first step towards measuring and then managing these risks is to acknowledge that regardless of how much values might ultimately adjust nationally, there will be a wide range around that average outcome depending on a sector and product type, market, and submarket–let alone individual asset.

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