The Economic Outlook for Real Estate Investors

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Beginning our Initial Approach for this Flight

Now
Still at high altitude at rapid speed, starting a gradual descent

Not touching down

Not a crash
Monthly Increase in Jobs
2000 to present

Source: Bureau of Labor Statistics; Federal Reserve Bank of St. Louis
Rate of Wage Growth
1960 to present

Source: Federal Reserve Bank of St. Louis
<table>
<thead>
<tr>
<th>Category</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Job Openings in November</td>
<td>6,888,000</td>
</tr>
<tr>
<td>Construction</td>
<td>278,000</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>493,000</td>
</tr>
<tr>
<td>Trade, Transportation, Utilities</td>
<td>1,275,000</td>
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<tr>
<td>Professional &amp; Business Services</td>
<td>1,176,000</td>
</tr>
<tr>
<td>Education &amp; Health Care</td>
<td>1,272,000</td>
</tr>
<tr>
<td>Leisure &amp; Hospitality</td>
<td>1,003,000</td>
</tr>
<tr>
<td>Government</td>
<td>622,000</td>
</tr>
</tbody>
</table>

Source: Bureau of Labor Statistics release on January 8, 2019
Consumer Confidence Index

18-year high in October ‘18

Source: The Conference Board
Why 2019 Will Be Slower

• Housing industry appears to have peaked
• Auto industry appears to have peaked
• Smart phone sales declined in 2017 for first time
• Low oil prices will pressure oil and gas
• Heavy duty trade negotiations with China
• Businesses not using tax benefits to expand
• Congress won’t be interested in growth
• Downdraft in stocks due to lower earnings growth
Why 2019 Will Be Slower

- Corporate earnings growth may have peaked
- Defense spending may have peaked
- Federal budget deficits can’t get too much higher
- Companies “buying ahead” inventory in front of tariffs

- 3% Interest on the 10-Year Treasury
Longest U.S. Economic Expansions
Current expansion began in June, 2009

- Mar 1991 to Mar 2001 120 months
- Feb 1961 to Dec 1969 106 months
- Nov 1982 to Jul 1990 92 months
- Jun 1938 to Feb 1945 80 months
- Nov 2001 to Dec 2007 73 months

Current expansion as of February 2019 is 116 months

HOW LONG CAN IT LAST?
Revenue Act of 1964
Enacted February 26, 1964

• Recovery from recession of 1958 was slow.
• JFK campaigned in 1960 with the slogan of "getting America moving again."
• Proposed cutting individual tax rates from 20-91% to 14-65%
• Proposed cutting the corporate tax rate from 52% to 47%.
Percentage Change in Employment After the Kennedy Tax Cuts

Source: Federal Reserve Bank of St. Louis
Tax Reform Act of 1986
Enacted October 22, 1986

Top rate for individuals cut from 50% to 38.5%.
Major reduction of depreciation for real estate
Raised tax rates on capital gains.
Corporate tax rate lowered from 50% to 35%.
Index of Leading Economic Indicators After Reagan Tax Cuts

Source: Federal Reserve Bank of St. Louis
Early Warning Detection System
Corporate Profits

Source: Federal Reserve Bank of St. Louis
Corporate Bond Spread
BB Corporate – 10 Year Treasury

Source: Federal Reserve Bank of St. Louis

2016 was looking weaker.
Small Business Confidence: “Hiring Plans in the Next Three Months”

Net Percent of Respondents

Source: National Federation of Independent Business
**Large Corporate Hiring Plans:**
Next 6 Months

<table>
<thead>
<tr>
<th></th>
<th>Q4-18</th>
<th>Q3-18</th>
<th>Q2-18</th>
<th>Q1-18</th>
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</thead>
<tbody>
<tr>
<td>More Jobs</td>
<td>56%</td>
<td>56%</td>
<td>58%</td>
<td>61%</td>
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<tr>
<td>Less Jobs</td>
<td>14%</td>
<td>13%</td>
<td>13%</td>
<td>18%</td>
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</tbody>
</table>

Source: Business Roundtable
## Population Projection: Houston Metro Area

Source: Texas State Data Center at UTSA

<table>
<thead>
<tr>
<th>Migration Rate</th>
<th>Year</th>
<th>Area Code</th>
<th>Area Name</th>
<th>Age</th>
<th>Total Pop</th>
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<tbody>
<tr>
<td>2000-2010</td>
<td>2010</td>
<td>26420</td>
<td>Houston-The Woodlands-Sugar Land</td>
<td>All (0-85+)</td>
<td>5,920,416</td>
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<tr>
<td>2000-2010</td>
<td>2015</td>
<td>26420</td>
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<td>2000-2010</td>
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<td>2000-2010</td>
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<td>Houston-The Woodlands-Sugar Land</td>
<td>All (0-85+)</td>
<td>14,221,267</td>
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</tbody>
</table>
Houston Business-Cycle Index

Source: Federal Reserve Bank of Dallas
Where Do Interest Rates Go From Here?
Here is the Logic Sequence

• Cap rates are moderately correlated with the 10-year U.S. Treasury bond rate
• The 10-year bond rate is not controlled by the Fed
• The 10-year bond rate moves up and down with the expected rate of inflation
• Conclusion: Cap rates might increase when inflation expectations increase
Inflation Rate since 1960

Source: Federal Reserve Bank of St. Louis
Inflation Rate since 1960

Source: Federal Reserve Bank of St. Louis
Inflation Rate since 2000

Source: Federal Reserve Bank of St. Louis
Finding the Elusive “Neutral Rate”

What is the neutral rate?

It’s the Fed funds rate that is not too low, but not too high.

Don’t want to overheat the economy, but don’t want to cause a recession either.
"We may go past neutral, but we're a long way from neutral at this point, probably."
- Jerome Powell, Federal Reserve Chairman
October 3, 2018

Chairman Jerome H. Powell, said the Fed’s benchmark interest rate was “just below” the neutral level.
November 28, 2018

“Where we are right now is the lower end of neutral....”
December 19, 2018
The Neutral Rate of Interest

“It is very difficult to know where that so-called neutral rate is. But we probably will know it when we are there because we will observe a certain degree of balance, which we had not perceived before, which would suggest that we are somewhere very close to where that is.”

Alan Greenspan, Financial Advisor News, June 9, 2005