SummerStreetAdvisors

Foggy Economic Outlook in the Trump Era

April 2017

Please enjoy the latest insights into commercial real estate finance, investment, advisory and valuation from Summer Street Advisors. This article, a version of which appeared on Globest.com, discusses the potential opportunities and challenges facing real estate professionals in the first year of the Trump Administration.

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As we approach the milestone first 100 days of Donald Trump's presidency, his impact on the U.S. economy and the commercial real estate market is still a question mark. Some analysts worry that disruptive policies could trigger a recession in light of the fragile global economy. Others look forward to an economic boom brought on by lower corporate taxes and a rollback of energy and financial regulations.

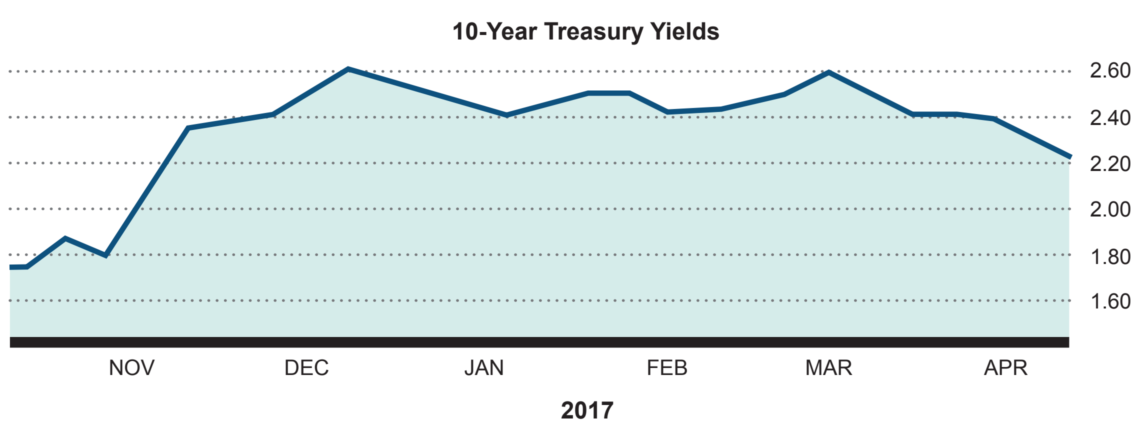
Capital markets have sent mixed signals. Interest rates rose immediately after the election in what's been described as the "Trump bump." At the same time, the stock market has seen a "Trump rally." Between November and March, the Dow Jones Industrial Average has jumped from 18,000 to as high as 21,000 and the S&P 500 Index has increased from about 2100 to nearly 2400.

Business leaders see reasons to applaud Trump's presidency and reasons to be concerned about it. A Duke University survey of 350 CFOs released in March showed that C-suite executives overwhelmingly believe tax relief will spur the economy, but 85 percent oppose Trump's plan to curtail H1-B visas for skilled workers and 68 percent don't want Janet Yellen replaced as head of the Federal Reserve. Moreover, two-thirds of CFOs expressed concern over market "fluctuations and uncertainty" stemming from Trump's tweets criticizing companies, industry sectors and foreign governments.

Even the financial services industry is conflicted. At the Mortgage Bankers Association Commercial Real Estate Finance (MBA CREF) conference in February, a panelist related how some people in the banking business view President Trump's impact on the banking business by using the letters of his name: 'T' for tax reform, 'R' for regulatory relief, 'U' for upbeat earnings, 'M' for M&A opportunities, and 'P' for relative positioning. But others on the panel were less exuberant. Although Trump and the Republican-controlled Congress will most likely seek to make major changes to Dodd-Frank, real estate lenders don't have a lot of confidence that risk retention rules on mortgage debt will be eased.

Unpredictability Breeds Uncertainty

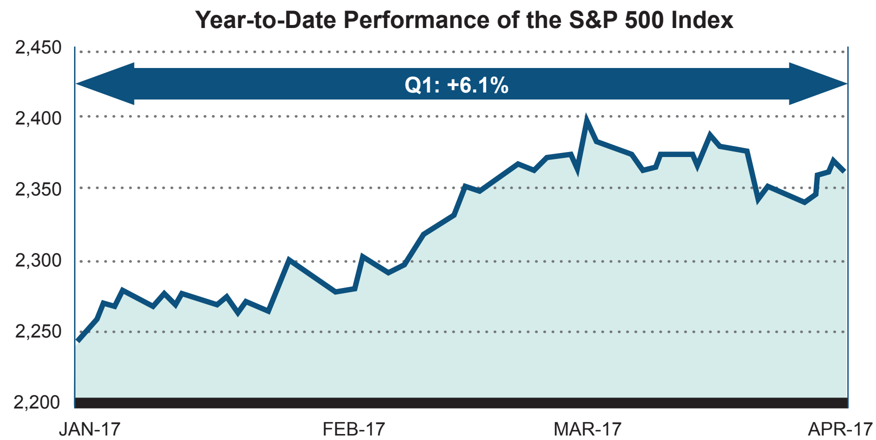
New presidential administrations often bring the prospect of change, but the changes that Trump said he would make



during the election are unprecedented. Things have not gotten much clearer since he took office. Economic policies like tax reform and job growth have not yet taken shape, and domestic priorities like reducing immigration and unwinding Obamacare are viewed as having uncertain effects on the economy. Unpredictability is also a factor, as Trump often makes dramatic statements that are difficult to turn into workable policy.

S&P 500 Index

As of March 31, 2017



How can commercial real estate investors be confident that they're following the best strategies in such an uncertain environment? Part of the answer is that the future is always unknown, and today is only marginally different from any other time. In fact, a healthy dose of uncertainty may be a good thing, if the alternative is conventional wisdom that proves false. Any investor who assumed that Great Britain would remain in the European Union may have made poor decisions as a result.

Still, investors have to make assumptions about the economy in order to develop a forward-going strategy. Some trends are fairly certain regardless of the direction of government policy. Here are some predictions that we feel confident in making:

Interest rates will rise again this year. The post-election rise in interest rates was a response to an unclear economic future, and possibly also in anticipation of the Federal Reserve's impending rate hike. Having raised rates once, the Fed has indicated that it will do so two or three more times in 2017. Any market volatility stemming from Trump or Congress will only fuel the trend toward higher rates. The question for investors is whether rising interest rates will cause cap rates to increase. We saw some re-trading of acquisitions after rates jumped, so don't be surprised if investors become less aggressive in the prices they're willing to pay for assets.

GDP growth will remain positive. If Congress reduces corporate tax rates, the short-term impact on gross domestic product (GDP) will be positive. In fact, the mere prospect of lower taxation has increased corporate valuations as measured by stock market caps. Some analysts in mid-March worried that the sharp rise in stocks isn't supported by the pace of earnings growth, and if that bubble bursts, a recession could occur. In our view, any recession in the near term would probably be mild, and nothing Trump has done or proposed would do immediate damage to the economy.

CMBS originations will be slow. Commercial mortgage-backed securities have had a tough couple of years due to volatile capital markets and the new requirement that issuers retain risk. Volume in 2016 fell short of predictions and ended up lower than any year since 2012. The market isn't going to gain steam in 2017, now that most of the expiring CMBS loan volume from the 2006-2007 period—the so-called Wall of Maturities—has mostly been refinanced or worked out in some way.

Foreign capital will continue to flow to the U.S. – Trump's foreign policy seems to be more favorable to Russia and less favorable to traditional allies in NATO. However this plays out, investors who are already nervous about the shakiness of European economies will focus even more on the U.S. as a safe haven for real estate investment.

Most of the above predictions are largely unaffected by government policy, at least in the near term. Despite the uncertainty in federal policy, investors can take heart that the U.S. commercial property market is in solid shape. Demand for multi-family and industrial product has kept pace or even exceeded supply, and national office vacancies are at their lowest point since 2009.

It's always prudent to look at public policy for clues on the economy and the real estate market. But when the signs point in many different directions, the best course may be to focus on market fundamentals , and adjust strategy to policy as it emerges.

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