

U.S. Election Results and Implications for Americas Real Estate

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Today marks a significant shift in the “status quo” with the unexpected win of Donald Trump in the U.S. Presidential election. As compared to the UK vote to leave the European Union in June, the surprise U.S. election vote is likely to be viewed as having far more significant global repercussions. As a result, most of the attention in the next few weeks will be focused on the likely volatility in financial markets.

However, as we also learned from the UK “Brexit” vote, this volatility may provide little or no usable information about what happens next, particularly with regards to commercial real estate markets. While we will be mindful of this volatility when making near-term investment decisions, we are mostly focused on the longer-term impacts of the likely policy shifts under a Trump administration.

For the United States, in addition to new policy uncertainty, the same constraints that have weighed on real estate investment decisions for at least the past year remain. These include low wage growth despite near-full employment, historically meagre business investment, concerns that Fed policy may be ineffective in a low interest rate environment, and the potential for a China hard landing to disrupt the global financial system. These economic constraints and risks are no smaller than they were at the beginning of this year. However, real estate markets have performed well so far this year despite these and other considerable headwinds, providing momentum that we expect to continue into 2017.

The outlook for Latin America, in particular Mexico, is less ambiguous, with anticipated restrictions on both trade and U.S. immigration presenting new constraints on real estate markets. Mexico has benefitted from more open trade and immigration for over 20 years. While we do not expect a wholesale reversal, the marginal impact of higher barriers to both would be negative. The Mexico economy may well slip into recession over the near term. However, we will not overreact to this short-term setback, even though financial and real estate investment markets may well do so.

Four Adjustments to the Status Quo

The main policy priorities of the Trump campaign, if they are embodied in new legislation, are likely to have a net negative impact on U.S. commercial real estate tenant and investor demand. The most notable negatives are more restrictive trade and immigration policies:

- **Trade:** There is a potential for at least partial rollbacks of existing free trade agreements, and almost no chance for approval of new large scale ones (notably including the Trans Pacific Partnership). Most credible research shows that freer trade has been a positive and significant growth driver globally in the United States and in much of Latin America, particularly Mexico, over the past two decades. Therefore, the converse would suggest that a shift away from free trade would likely have widely distributed negative economic and real estate impacts, with some concentrated (but much smaller) positive ones. On the margin, this is negative for major logistics markets in the United States, and may also compel us revisit our bullish position on long-term manufacturing growth in Mexico.
- **Immigration:** The likelihood of an initiative to reduce legal immigration, and a potential increase in deportation of illegal immigration, will weigh on consumption growth, and potentially create labor shortages in industries including construction and manufacturing. While the U.S. Census projects population growth of 0.75% from 2015 to 2030, high by comparison with most developed economies, that projection assumes net immigration accounts for more than half of that growth. Holding other factors constant, those estimates may now be too high. The U.S. apartment and retail sectors are most likely to be harmed by this shift, particularly in the Sunbelt and in other large cities. Mexico’s retail and housing sectors may be hurt even more, as remittances from Mexicans living in the United States may decline.

Partially mitigating these constraints, at least over the short term, are a potential increase in infrastructure spending, as well as stimulative effects from lower tax rates.

- **Infrastructure:** There is a likelihood of a large infrastructure package, perhaps as part of a compromise with Democrats to pass tax cuts. With a Republican Congress, this is likely to skew more towards investments in highways and bridges rather than in public transport and center cities, which may bolster real estate demand in suburban locations, particularly in non-gateway markets. However, given the long approval processes required to get these projects underway, most of the benefits are likely to be years rather than months away.
- **Taxes and Spending:** The Trump platform calls for large tax cuts, particularly for high earners, without many spending cuts to offset them. That is likely to provide some economic stimulus, at least for the short term, and the effect would be larger should the administration and Congress choose to extend the tax cuts to lower income households with the highest propensity to spend. Over the longer term however, lower taxes may curb future growth if revenues lag behind spending, since this would require future tax hikes or large spending cuts that could more than offset the initial stimulus. A sharp rise in interest rates cannot be ruled out if deficit concerns spook Treasury investors.

While some of these policy shifts may be significant, it is unclear how strong Trump's mandate is, and perhaps more importantly whether some of his policy priorities are shared with Congressional leaders in his party. This may prolong the policy uncertainty period well into next year and potentially longer, and possibly result in legislation that is mostly incremental rather than abrupt.

A Two-Pronged Approach

In this environment, we plan to take a two-pronged approach to managing our portfolios and making investment decisions:

The first prong is not making any significant changes to our long-term investment strategies in response to near-term volatility. Most likely, we will slow down our acquisitions and development activity, as well as our planned asset sales. While certain assumptions supporting our investment theses will need to be re-evaluated in light of likely policy shifts, we expect most of them to remain intact. Briefly summarized, our view on commercial real estate markets headed into 2017 is for:

- Balanced equity capital flows into U.S. real estate, with some investors moderately decreasing their real estate exposure and others (particularly non-U.S. investors) increasing it;
- Steady tenant demand, aided by limited construction activity, driving continued improvement in occupancies and rent growth in the U.S., and, albeit now with less certainty, Mexico;
- And a continued "de-risking" of U.S. commercial real estate debt markets, which will keep financing flowing to safe, stabilized assets, but constrain funding for construction and assets requiring leasing or capital expenditures.

The second prong is to seek out extraordinary opportunities that may arise due to overreactions to market volatility. These opportunities may arise in two forms:

- Real estate assets with favorable long-term fundamentals that motivated owners need to sell quickly. These may include larger assets that most investors cannot absorb, and properties with near-term capital needs. We may find these opportunities in both large and smaller U.S. markets, and particularly in Mexico.
- Sub-equity positions in capital stacks, since the returns from debt may be competitive with or even superior to equity on a risk-adjusted basis. We have already begun seeing an increase in attractively-priced debt investments, and expect more in the coming period of economic and policy uncertainty.

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