Kidder Mathews

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COVID-19'S ECONOMIC IMPACTS ON CRE

The order to shelter at home and closing of non-essential businesses has created a significant impact on the national and local economies. The unemployment claims over the last seven weeks are near 33.5 million[1] exceeding prior records by many times. The current unemployment rate is estimated at 14.7%[2] based on a survey by Reuters, with some economists projecting a rate as high as 20%.

To combat the dire economic trends, the Federal Reserve ("Fed") has been extremely active in maintaining support for the economy and financial markets. On March 3, 2020, the Fed made an unscheduled cut to the fed funds rate. It slashed rates by 0.5%, double the amount of its recent moves, and the largest cut since the 2008 financial crisis[3]. In addition, the Fed implemented a number of other actions including:

MARCH 12 the Fed expanded reverse repo operations, adding $1.5 trillion of liquidity to the banking system.[4]

MARCH 15 the Federal Reserve set out several pieces of monetary stimulus[5]:

- It cut interest rates by a full percentage point, down to a range of 0.00% to 0.25%.
- The Federal Reserve restarted quantitative easing with the purchase of $500 billion in treasuries and $200 billion in mortgage-backed securities.
- The Fed lowered the interest rate on the discount window by 1.5% to 0.25%.

MARCH 16 the Federal Reserve increased reverse repo operations by another $500 billion.[6]

MARCH 17 the Fed introduced two new programs to help preserve market liquidity, including the Commercial Paper Funding Facility (CPFF) and the Primary Dealer Credit Facility (PDCF).[7]

MARCH 18 the Federal Reserve announced the Money Market Mutual Fund Liquidity Facility (MMLF).[8]

MARCH 23 the Federal Reserve released another raft of monetary stimulus including:

- Expanding the scope of what mortgage-backed securities it will purchase, now including agency commercial mortgage-backed securities.
- Expanding its asset purchases of both treasuries and mortgage backed securities by an additional $625 billion, and committed to continue purchasing; however, many assets are needed to "support the smooth functioning of markets."
- Establishing the Primary Market Corporate Credit Facility (PMCCF) to buy bonds and loans banks give to large businesses.
- Establishing the Secondary Market Corporate Credit Facility (SMCCF) to purchase bonds and bond ETFs to provide liquidity for the corporate bond market.

- Re-establishing the Term Asset-Backed Securities Loan Facility (TALF) to purchase asset-backed securities backed by things such as auto loans, student loans, or small business loans.
- Each of these special purpose vehicles will run until September 30, 2020 unless extended, and the Treasury department will cover up to $10 billion in loan losses each from the ESF. In total, they will provide up to $300 billion in new financing.
- Expanding the MMLF to include more different types of money market funds.
- Expanding the CPFF to include a wider variety of commercial paper assets, and a reduction in the interest rates for loans from the CPFF.
- It announced that it will soon be rolling out the "Main Street Business lending Program'" to support small and medium businesses.[9]"
- In addition to Fed activities, the Congress and the president have worked to pass significant legislative measures along with executive orders. These have included:

MARCH 6 President Trump signed an $8.3 billion spending bill, currently called "Phase One" of stimulus efforts, to fund efforts to fight the pandemic. Among other things it:

- Funded research on a vaccine.[10]
- Gave money to state and local governments to fight the spread of the virus.
- Allocated money to help with efforts to stop the virus's spread overseas.

MARCH 13 the House of Representatives passed a stimulus bill (subsequently passed by the Senate on March 18), called "Phase Two" of the stimulus that included, among other things:

- Free virus testing.
- Expanded unemployment benefits.
- Additional funds for Medicaid.
- A provision requiring paid sick leave for some workers affected by COVID-19.[11]

MARCH 13 President Trump announced a state of emergency, allowing the Federal Government to distribute up to $50 billion in aid to states, cities, and territories.[12]

MARCH 17 Treasury Secretary Steven Mnuchin announced that individuals and businesses would have an extra 90 days past April 15 to pay their tax bills. He estimates this will free up $300 billion in extra liquidity over this period.[13]

MARCH 20 the U.S. Secretary of Education, Betsy Devos, announced that, "All borrowers with federally held student loans will automatically have their interest rates set to 0% for a period of at least 60 days.[14]

MARCH 25 the Senate unanimously passed a $2 trillion Phase Three stimulus bill. Included in the bill are:

- $301 billion in direct cash payments, totaling $1,200 for those earning up to $75,000 and $500 per child.
- $500 billion government lending program to companies impacted by the crisis, with a possibility that the government can take equity stakes in companies receiving the loans.
- $367 billion in federally guaranteed small business loans, with whatever is spent on rent, utilities, or payrolls, not needing to be paid back.
- $250 billion to expand unemployment insurance to include gig and freelance workers, increase the length to 39 weeks, and add $600 dollars a week for four months.
- $221 billion in business tax cuts including allowing businesses to defer payroll taxes for the rest of the years, and would temporarily allow businesses to claim deductions for current losses against past profits to claim refunds.
- $150 billion in money for state governments.
- $130 billion for hospitals and other healthcare providers.
- $25 billion for public transit to make up for lost revenue.
- $32 billion in cash grants to cover wages at airlines, airlines that receive the money cannot issue dividends or make stock buybacks. In addition, they cannot make furloughs or pay cuts through September.
- $48 billion for agriculture and nutrition programs
- $27 billion to fund drugs and vaccines for the coronavirus.
- $10 billion for the postal service to help cope with problems caused by the pandemic.
- Student loan payments will be suspended without interest accruing until September 30.
- Waives early withdrawal penalties for 401(k) of up to $100,000.[15]

MARCH 27 the Phase Three stimulus bill passed known as the Coronavirus Aid, Relief, and Economic Security (CARES) Act. It was passed by Congress with overwhelming, bipartisan support and signed into law by President Trump the same day.[16]

MARCH 31 President Trump said he would approve a 90-day suspension of tariffs. [17]

March was a very busy month. However, the Fed continued in April with additional liquidity and support, including Emergency Lending Facilities, to implement the CARES Act. Samples of some of these facilities included:

PAYCHECK PROTECTION PROGRAM LIQUIDITY FACILITY (PPPFL) will purchase Payment Protection Program (PPP) loans from lenders, freeing those banks to continue lending under the PPP, and most crucially, removing these non-performing loans from the balance sheets of private industry.[18]

MAIN STREET BUSINESS LENDING PROGRAM will purchase $600 billion of debt from companies employing up to 10,000 workers or with revenues of less than $2.5 billion, with any required payments on these loans deferred a year.

MUNICIPAL LIQUIDITY FACILITY will purchase $500 billion of debt from states and cities with populations over 1 million[19]; and

EXPANDED THE SCOPE of three existing facilities, the PMCCF, CMCCF, and TALF. These programs will now support up to $850 billion in credit. In addition, the Fed has expanded the list of eligible assets for participation in the TALF program.[20]

SUMMARY

The key takeaway from this summary is that the federal government understands the severity of the economic impacts and is ready and willing to provide proper stimulus to help businesses weather the crisis. This addition of stimulus was created from lessons learned in the 2008 – 2009 recession. Several trillion dollars have been pumped into the economy with likely additions in the next few weeks.

The most recent comparison in a downturn was the Great Recession that started in late 2007 and ended 18 months later in mid-2009. However, job losses continued into 2010, and employment (8.7 million jobs lost[21]) did not recover to pre-recession levels until 2014. Assuming average job losses over 6 years were 4.35 million (8.7 million jobs lost in year one and zero jobs in year 6), the jobs lost equated to lost spending power of losing 26 million jobs. Assuming an average income of $40,000, the total loss in spending power was $1.05 trillion. This created a shortfall in stimulus as less than $831 billion[22] was pumped into the economy through the Troubled Asset Relief Program (TARP) and related legislation.

While employment fell by a record 20.5 million in April, 18 million of those lost jobs were classified as temporary layoffs, providing a small silver lining.[23] The 33.5 Million jobs lost could see a substantial change if even half of the temporary jobs are recovered in the next few months. The states are currently re-opening at various rates and by July, we should see clear direction in job recovery.

In the current crisis, job losses are 33.5 million so far through early May. Economists at Stanford and the University of Chicago, drawing on a survey of businesses and historical data, estimated that 42% of pandemic-induced layoffs will end up being permanent.[24] With more than 33 million people having filed for unemployment benefits in the last seven weeks, that's about 14 million who may have to find new work. Assuming 15 million jobs are reclaimed by year end, the average jobs lost for 9 months will result in the economy losing about $600 million in spending power or about half the loss of the Great recession. Therefore, the federal stimulus is about five times the spending power loss, which was much different from the shortfall during the Great Recession.

In our review of the economy, it appears that the federal and state governments have learned the lessons of the Great recession. The government acted very quickly in this crisis with significantly more stimulus than the 2008 recession. Further, the financial system is in much better condition. The Dodd-Frank Act insured that the systematic bad loans of the housing boom prior to 2008 are not repeated. Further, banks are required to carry much more capital than before the 2008 financial crisis.

MARKET EXPECATIONS

The next issue relates to what the market expects relating to a recovery in the commercial markets. There is some difference of opinion regarding the shape of the recovery as being either a "V," a "U," or the Nike swoosh. This will be based on public sources as well as opinions from knowledgeable market participants. We recognize that much opinion is shaped by the press to hinder or support the positions of the two parties and their elected leaders. We will give little credence to the opinions of the press and attempt to obtain data from the investment community without filters.

Early projections in the pandemic saw estimates of GDP falling from less than 10% to over 40% by a number of large firms (Fitch, UBS, Bloomberg, Citigroup, JP Morgan, Goldman Sachs, and others). However, forecasts for Q2 GDP growth are dropping as we go farther into the national shutdown. The chief economist for Deutsche Bank, Matthew Luzzetti, wrote that Deutsche Bank had previously estimated Q2 GDP at -13%, but currently expects that to fall to close to a negative 40%. The bank forecasts "GDP to rebound to 15% in the third quarter and 6.5% in the fourth quarter – an overall decline of 8% for the entire year, more than the prior forecast of a 3.2% decline.[25]"

The New York Fed is projecting an annualized downturn of 31.2%[26] in Q2 GDP. Kiplinger expects Q2 GDP to drop 30% to 40% on an annualized basis, but full year 2020 GDP will fall by 4% to 5%. The Economist projects full year GDP to drop by 2.9%.[27] The projections vary considerably, but a reasonable expectation for full year GDP decline will be near 5%. This compares to the Great recession where GDP declines were -2.01% in 2008 and -2.40% in 2009.[28]

The Congressional Budget Office ("CBO") is projecting GDP growth of 2.8%[29] in 2021. Pension & Investments is projecting 6.2% GDP growth in 2021. Northern Trust is projecting US GDP growth of 4.8%[30] in 2021. The estimates vary, but most economists are projecting a return to growth in 2021. The growth will be unusually high as the economy snaps back from the coronavirus pandemic.

After reviewing available research on the matter, we believe that the economic impacts will be quite sharp and deep initially. The economy should start to recover in the third quarter, and back to growth by the end of the year. However, the loss of many small businesses in retail and food& beverage industries will cause a net loss in GDP for the year 2020 of near 5%. A return to growth of 5% or more should occur in 2021, and returning to more normal growth trends of 2% to 3% after that. The pandemic economic picture should be seen as a Nike "swoosh" with

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a sharp drop in Q2 2020, followed by improvement through the remainder of 2020 and into 2021.

The main areas hit by the current lockdown and percent of GDP include travel and hospitality, food & beverage businesses, and a portion of retail sales. Research from Morningstar shows that exempted businesses are 70% of the GDP. While there is an obvious temporary impact, it should not be as drastic as some forecasts. The impact on real estate markets will vary considerably. Based on experience from past deep recessions, and considering the social distancing impacts of the current situation, we see the following on various real estate sectors:

INDUSTRIAL – The industrial market will likely see very little impact through the end of the year. We see a slowdown in leasing activity due to social distancing, but there are still demands from users for space that is being met in the market. Vacancy may increase slightly from record lows, and rent increases will moderate. Prices may dip due to loan pricing, but this will likely change in 2021.

The areas of industrial demand that we see profiting from the recession is distribution, technology, life sciences. The demand for space to develop vaccines and other medicines will likely sharply increase starting in the second quarter of this year. Further, demand for new technologies will continue to grow as will on-line shopping.

OFFICE – Office will likely see a drop in demand in the future. Technology is changing the face of the office workplace with remote working increasing sharply in the future. This will partly be offset by workplace social distancing and the density of work stations. Workplace collaboration is important, so office space demand will still occur.

We see the demand for office space stabilizing. While many employees will be allowed or requested to work remotely, many others will be working in offices at least part of the workweek. In addition, newer and greener buildings will be favored due to worker health concerns. Suburban low-rise buildings may return to favor with less crowding in elevators and creating more outside open space.

RETAIL – Retail uses will see a sharp drop off in demand. This trend started many years ago with online shopping, and the trend will accelerate. There will still be a need for retail outlets for clothing and durable goods, but the brick and mortar space demand will decline. The exception will be retail centers offering some type of experience. Notable examples are Caruso projects in Southern California, such as the Grove in Los Angeles or the Americana on Brand in Glendale. These are retail outlets offering a mix of shops, food, entertainment, and even residential.

LODGING & HOSPITALITY – The lodging market has been hard hit. Business travel will likely increase to pre-recession levels. However, video conferencing may start to eat into travel demand. We expect hotels to perform below long term trends well into 2021.

Virtually all restaurants are closed except for take-out orders. While the fast-food segment will likely recover fairly well, smaller independent restaurants will see a large number of closures, and may not return readily.

RESIDENTIAL – While new development in urban areas has been moving to higher densities, we see some push back on these properties from renters. The areas hardest hit by the Coronavirus seemed to be in major urban areas (New York, Chicago, Detroit). Apartment renters may start looking for lower density alternatives. While demand may shift, occupancy should not change dramatically. The risk is that if the slowdown lingers, it may force people to move into communal living, resulting in an overall decrease in demand.

RECREATION – Recreation, including sports, movies, theaters, and outdoor activities have been tremendously impacted. With social distancing remaining for perhaps into 2021, sports venues and theaters will be most heavily impacted. The reduced seating density will have a direct impact on financial performance. However, outdoor activities such as golf and tennis will likely see little impact except for the need in locker rooms to upgrade sanitation. Most likely, impacts on outdoor activity recreation will be rather short term in nature.

IN CONCLUSION

As of early May 2020, the economy is starting to reopen in many areas of the country. We are seeing that many small businesses are coming back and operating in the "new normal" which includes social distancing, wearing face masks, and other precautions. Traffic is increasing on highways in areas that are opening, and even airline flights are seeing recovery.

While the economic picture is bleak currently, it should be remembered that the country entered this crisis with a record strong economy. Compared to the Great Recession of 2008-2009 or the Great Depression, banks are in great shape. Further, the government has pumped a huge amount of money into the economy. The government responded much more quickly and aggressively that during any other downturn in the county's history. While the future remains uncertain, we believe that the U.S. economy will show resilience in the coming year. The American spirit should not be discounted.

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