Experts See Construction Costs, Loan Market At Risk For Recession

March 25, 2019 | Jarred Schenke, Bisnow Atlanta

The economy is vulnerable to a variety of shocks that could lead to the next recession. But which will it be? Labor, the cousin of the CMBS market and global warming are among the candidates, panelists at a *Bisnow* event said last week.

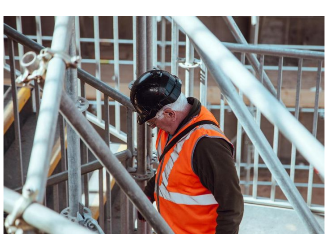
“There's a sense of yes, it's coming, but it seems like a gradual slowdown rather than a crashing halt, like past cycles,” Noble Investment Executive Vice President Adi Bhoopathy said.

Bhoopathy was part of a panel lineup of capital market experts during *Bisnow's* Atlanta Capital Markets and Opportunity Zones event March 19, where discussions ranged from signs of the next recession to current appetites of investors to possible changes in future opportunity zone borders.

Few expect the next downturn to be anything as dramatic as the Great Recession, when a subprime mortgage market crash caused banks to fail, the national gross domestic product to drop 4.3% and unemployment to spike to 10%. But, outside of "black swans" and other ignitions that are impossible to predict, there are current risks to the overall economy that could lead to economic contraction.

Preferred Apartment Communities Chief Financial Officer John Isakson is concerned that a shortage of labor will derail the economy.

“What that landing is going to look like and when it's going to come, in our opinion, is a lot more dependent on the labor picture,” Isakson said.



During the past two years, the U.S. economy has added more than 200,000 jobs a month, plunging the jobless rate to its lowest in five decades. Job growth is finally leading to at least modest wage growth. Last year, wages increased 1.5% globally. This year, they are projected to increase by another 1%.

Isakson said he would like to see another up to 60 months of wage growth. But if wage and labor participation stall, so could economic growth, he said.

Money360 President Gary Bechtel raised alarms about the growing collateralized loan obligation market. Similar to CMBS, CLOs are a single security often made up of hundreds of corporate loans that generally have low credit ratings. A CLO investor assumes the risk of default on the loans while generally taking higher-than-average returns.

Bechtel said the CLO market is largely unregulated, and has grown fast in recent years, raising his fears that any blip in the economy could spur on a correction in the sector that cause disastrous ripple effects. Bechtel said he is concerned about some of the loan assumptions being made in some CLO loans, particularly lending to real estate projects.

More than $120B in CLOs were raised last year, setting a pace for one of the highest years on record, according to Bloomberg. Most of the loans underlying CLOs have floating rates.

“We have absolutely seen … hundreds of new lenders coming into this market,” Bechtel said.

Patterson Real Estate Advisory Group founder Lance Patterson said when it comes to office buildings, rising construction costs are forcing developers to raise rent expectations on their buildings, which in reality may not be possible in Atlanta. Today, a developer needs to underwrite $50/SF in rents to justify an office building, Patterson said.

While many developers maintain confidence in achieving that number, only a small handful in Metro Atlanta actually have.

“I hope they get $60 rents, I'm rooting for everyone right now,” Patterson said. "But to me, that's a huge issue."

Construction costs are also going to be affected by climate change, especially when it comes to rebuilding after natural disasters precipitated by a warming planet, TriStar founder Margaret Stagmeier said.

Last year, the U.S. government released an alarming report — based on the assessment of more than 100 scientists from a host of U.S. agencies, including NASA, the State Department, and the departments of commerce, defense, agriculture and energy — that concluded that global warming is real and already impacting communities across the country.

Between $66B and $106B worth of real estate will be below sea level by 2050, the report found, and $238B to $507B will be below the rising level by 2100. Within an eighth of a mile of a U.S. coastline lies $1.4 trillion worth of businesses and homes.

“I would say global warming is having an impact that people aren't noticing,” Stagmeier said. “The commodity prices for materials is really having an impact.”

Despite the concerns — made even more apparent by recent signs that the U.S. could be heading into a recession — Patterson said lenders continue to be much more disciplined, and there is plenty of equity seeking projects in which to invest.

“Nobody's doing stupid deals, and that's great,” he said. “If you have a good deal, good sponsor, it works. You get a lot of interest in it.”