VIEWPOINT

COVID-19: Economic Fallout and CRE Impact

In the last few weeks, it has become increasingly apparent the novel coronavirus (COVID-19) pandemic will not lead to a run-of-the-mill economic downturn, but rather a disruption perhaps unlike any other we've experienced in the post-World War II period. Beyond the human tragedy, economies and society are sure to be much changed in the coming weeks, months and possibly years. Our best estimates about how the COVID-19 crisis will play out are no more than a guess at this stage, as no true roadmap exists. The following is a summary of some of the economic and real estate issues we see playing out in the near term. As a service to our clients, and as the crisis unfolds, we will be posting additional communiques as events dictate.

If not already, commercial real estate markets are about to be whipsawed by COVID-19, perhaps on an unprecedented scale, and at least on par with the 2008/09 Global Financial Crisis (GFC). The breakdown in supply chains; the extreme disruption in capital markets, the cancellation of public events, the near shutdown of travel and all recreational activities, and the already dramatic change in consumer spending patterns, all mean economic activity will be materially impacted for the foreseeable future.

Decisions

With the depth and duration of the downturn still very uncertain, decisionmakers of all types are almost certain to be in varying stages of delaying all decisions, as a way to buy time and gain better visibility of their respective businesses. This will undoubtedly have a significant impact on real estate markets. Leasing decisions (not dissimilar to investment and development) will be in a near state of paralysis for an undetermined period. Many companies will be prone to adopting a "capital preservation" mentality meaning expansions will be put on hold, upgrading of facilities cancelled, supply-chains re-evaluated, and marginal operations shut down. In just the past few weeks, leasing mindsets, on both the landlord side and the occupier-tenant side, have changed substantially and will assuredly change more in the coming weeks and months.

Capital Preservation

In essence, every economic, political and health crisis is now a credit crisis. And we have learned when there's a shortage of credit, businesses preserve capital. With the know-how of going through multiple downturns, including the global recession in the early 1990's, the dotcom meltdown in the early 2000's [combined with "9/11"], and the GFC in 2008/09, we know credit spreads widen, capital generally becomes more expensive and business fixed investment (BFI) falls. We have seen this already in the past few weeks. [Note BBB corporate spreads (over Treasuries) have gone from 168 basis points (bps) at the beginning of March to 448 bps as of March 25.] Every business, both large and small and everything in-between, will be implementing capital preservation programs to varying degrees. Of note, with a near 220% increase in global debt loads in the past 20 years, it is reasonable to expect the impact of this credit crisis to be significantly greater than what has been experienced in past downtowns.

Government Measures

In the coming weeks and months, governments around the world, at every level, will be pursuing extraordinary lengths to mitigate the economic damage that is being done as citizens self-isolate, are unable to work and stop all forms of discretionary spending. This has already been evidenced by the $2.0T stimulus package approved by the US Congress, and trillions of dollars in monetary measures, not just in the United States, but around the world. With almost no clarity of the depth and duration of the pandemic, consumers are expected to abstain from any large purchases and investors will shy away from making any long-term investments. While critical to any form of recovery, it is important to keep in mind the limitations that fiscal and monetary efforts typically have on the overall economy. The intent of these measures is to stem the downturn and be the catalyst for recovery, and not a recovery in itself. That will come later.

Commercial Real Estate

It is through this lens that we look at the coming changes to commercial real estate markets, both here in North America and across the world. The quickly-growing paralysis in leasing, investment, and development will be a feature of almost every real estate market in the world, at least for the immediate term. The stabilization, and subsequent recovery, will be made up of multiple phases, and in some cases mini-phases. Much like in medicine, the first priority is to stabilize the patient, and only once the patient has been stabilized, the road to recovery can begin. For real estate markets, and the economy in general, this is the playbook we can expect to follow. Real estate markets first need to stabilize through a process of price discovery which may take the better part of this year. Unlike stock markets which can re-value in a matter of days, if not hours, real estate markets take much longer. It is almost certain to be a long and onerous period where "no bid" markets are the norm, and past experiences are the only guide.

As a factor of production, real estate markets have long been at the whim of the economy, the job market and capital investment. This will be no less the case as we go forward in the coming months. So, for the time being, and until we have a better idea how these three will fare, we can only hope that the COVID-19 pandemic begins to abate and a degree of normalcy returns.

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This is the first in a series of Cresa Viewpoints covering the COVID-19 crisis.