Looking for Love (and Returns) in All the Wrong Places: Why Investors Should Focus More on Job Growth than Consensus Outlooks

Andrew J. Nelson, Nelson Economics, November 2019.

Job growth is moderating, which will slow property leasing and reduce investment returns. For investors still in the hunt for new acquisitions, market selection becomes that much more important.

In this analysis, I review the consensus market recommendations from several ULI's annual *Emerging Trends* reports over the last decade, as well as both recent and historical job growth trends for the nation's larger metropolitan areas. Among my key findings:

- ULI's *Emerging Trends* reports can provide valuable guidance for investors. ULI's top-ranked markets yield consistently higher than average returns over both the short and longer term.
- However, the herd mentality implicit in these consensus outlooks tends to draw from a relatively short list of leading markets, often relying on outdated market reputations while neglecting markets with even greater return potential, especially when market conditions are changing.
- Most of the investment outperformance among the top ULI metros is attributable to appreciation returns (based on investor expectations) rather than income returns (based on property performance). This suggests a certain self-fulfilling prophecy generated by the "mob mentality" of investors focusing on the consensus metros, thereby driving up values.
- Investors can realize even greater outperformance by focusing on markets with the strongest economic drivers – especially job growth – that bolster property fundamentals and raise income returns. Relative to the ULI markets, properties in the fastest-growing metros derive a much greater share of their returns from income.
- Accordingly, investors should always consider the economic outlook, particularly projected job growth, in addition to consensus expectations. Turning away from the herd and focusing more on economic fundamentals is especially crucial for investors more concerned with income returns than capital appreciation.

Where to Look for Returns?

So often in life we resort to the familiar and the comfortable, particularly in times of change and uncertainty, instead of challenging ourselves to consider new opportunities and seek out the best options. And so it is with real estate investment strategy: year after year investors and analysts recommend a relatively consistent set of markets.

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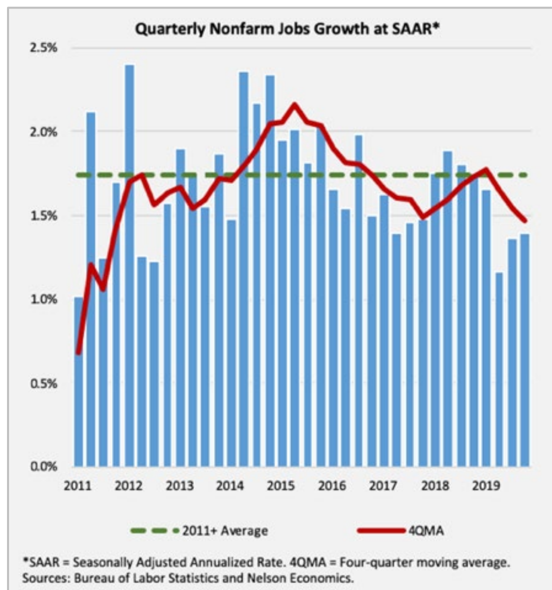
As captured by the Urban Land Institute's annual *Emerging Trends* survey released each autumn, metro rankings of "overall real estate prospects" vary modestly each year, but most of the metros near the top are drawn from a relatively short list of leading markets. Of the 20 markets ranked highest in ULI's 2009 survey, 11 were still in the top 20 both five and ten years later, while another five stayed in the top 20 in one of the two years; only four were "one and done." And fully 20 of the roughly 50 markets ranked by ULI never reached the top 20 even once.

But how well placed is the collective confidence in the markets? Given that the past decade has seen property markets cycle from deep recession to recovery to growth to peak, one may question the wisdom of sticking with the same universe of metros no matter the stage of the cycle.

Believing what worked in the past will continue to work in the future or that yesterday's market conditions and trends will prevail going forward, blinds us to evolving market conditions, to say nothing of shifting demographic or business practices. But reality is more complex and dynamic.

National Context: Slowing Job Growth

Job growth is slowing, along with economic output. Blame reasons both negative (rising trade tensions, fading fiscal stimulus, slowing global growth) as well as more benign (a shortage of workers relative to the number and types of job openings). Regardless, **that's a problem for commercial real estate markets.** Expect market conditions and investment returns to weaken.



After a moderate bump in early 2018, when federal tax cuts and spending increases fueled a modest but temporary burst in U.S. GDP, job growth is again trending downward. Job gains in this cycle peaked in 2015, which I've argued also represented the peak of this property cycle, that is, when property markets were achieving their greatest growth in this cycle.[1]

That's not a coincidence. Job growth is the single most important driver for property demand**.** More than any other single factor, new jobs are what fill commercial real estate space, push up rents, and attract investors and developers. It's what puts households in apartments and workers in office buildings, gives spending power to consumers to spend at shopping centers, and puts products on shelves in warehouses.

Annualized growth in nonfarm payroll jobs peaked at 2.2% in late 2014 and early 2015, gradually declining to just 1.5% in 2017. With the federal stimulus in early 2018, job growth rose again to 1.8%, but has since fallen back to an annualized rate of just 1.4% in the past half year, well below the average rate of more than 1.7% for this cycle. Property leasing has followed suit across most property sectors in most markets. (Warehouse demand is the conspicuous exception, primarily due to secular shifts in how our economy moves goods from producers to consumers.)

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[1] To be clear, the "market peak" is not the same as the "end of the cycle." Most market indicators have continued to rise after the market peak was reached: occupancy, rents, and prices are also rising. But the rates of growth have been slowing and property returns have been falling. Thus, the "market peak" represents the period of greatest growth, not the beginning of the downturn.

Thinking Fast vs. Slow

But not all markets are slowing, and some are registering breakout performances. In the 51 U.S. metropolitan areas with a population exceeding one million people, the average job growth rate over the past year (though August 2019) was 1.6%, but the metros range from a high of 4.0% (Orlando) to -0.3% (Detroit). Other fast growers include Dallas/Fort Worth, Seattle, Houston and Phoenix, all with job gains at least 70% greater than the mean. Little surprise that these markets attract a lot of investor interest. Seven of the 15 fastest-growing metros are also among ULI's top 15 investment markets for 2020 (Orlando, Dallas/Ft. Worth, Seattle, San Jose, San Francisco, Charlotte, and Austin) and another three rank among ULI's top 25 (Jacksonville, Portland, and San Antonio).[2]

On the other hand, slow-growing metros – which also include Minneapolis-St. Paul, Virginia Beach, Hartford, Rochester, and Pittsburgh – don't get a lot of love: Only one of the 15 slowest-growing metros are also among ULI's top 15 investment markets (Washington, DC).

ULI Surveys Love Fast-Growing Metros (but not Newcomers)

Number of Metros in . . .	ULI Top 15	ULI Top 25
15 Fastest Growing Metros 2009-19 (10-Year)	9	12
15 Fastest Growing Metros 2014-19 (5-Year)	9	11
15 Fastest Growing Metros 2018-19 (1-Year)	7	10
15 Fastest Growing Metros 2018-19 Relative to 10-Yr Avg	3	4
15 Slowest Growing Metros 2018-19 Relative to 10-Yr Avg	6	9

Sources: Urban Land Institute (ULI) 2020 Emerging Trends Report, National Council of Real Estate Investment Fiduciaries (NCREIF), and Nelson Economics

But **investors and analysts surveyed by ULI show even more loyalty to metros that consistently grow strongly**. Nine of the 15 fastest-growing metros over the last five and ten years rank among ULI's top 15 investment markets this year. Similarly, 12 of the 15 fastest-growing metros over the last ten years are included in ULI's 2020 top 25 investment markets.

Recent vs. Longer-Term Growth

An important finding of my analysis is that **investors seem stuck on longer-term trends and ignore recent shifts**. Of the 15 metros with the greatest job growth last year relative to their ten-year growth rate, only three rank among ULI's top 15 investment markets this year (Dallas-Fort Worth, Orlando, and Seattle), and only one other ranks among ULI's top 25 investment markets (Philadelphia). [See charts on next page.]

By contrast, six metros registering the sharpest job growth *deceleration* last year nonetheless rank among ULI's top 15 investment markets this year – including the top three: Austin, Raleigh/Durham, and Nashville – while another three rank among ULI's top 25 investment markets.

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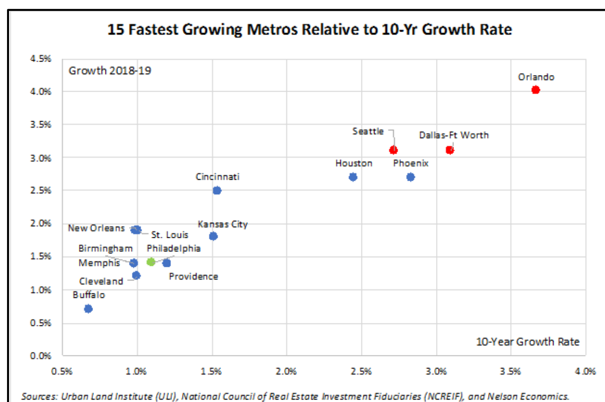
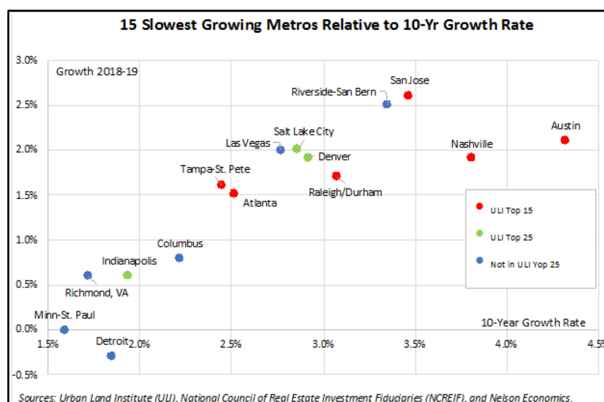
[2] Urban Land Institute, *Emerging Trends in Real Estate – United States and Canada 2020.*

To be sure, the top ULI markets – whether job growth is accelerating or decelerating – do tend to be among the faster-growing job markets in the county, both recently and longer term. Still, **investors may well be overlooking some promising markets where job gains are relatively strong and growing, while focusing on other markets where recent performance has not matched their reputation**. The average job growth rate in the accelerating metros was almost 50% greater during the past year than in the decelerating metros (2.1% vs. 1.4%).





OK, So What: Job Growth and Property Returns

It turns out that **investors would do well to follow the consensus suggested by the ULI surveys**. Investing in a basket of the top 15 markets recommended by the survey yields consistent outperformance. For example, the top ranked 15 markets in the 2009 survey yielded an average return of 9.88% annually (unweighted average), 63 basis points (bps) above the 9.25% NPI average for the decade.[3]

Investment Returns (%), NCREIF Property Index (NPI)

	NPI Returns (%)			Returns Relative to National Averages		
	Total	Appreciation	Income	Total	Appreciation	Income
ULI 2019 Top 15 - One-Year	7.45	2.55	4.81	+0.94	+0.64	+0.28
ULI 2014 Top 15 - Five-Year Average	9.60	4.53	4.85	+0.77	+0.63	+0.06
ULI 2009 Top 15 - Ten-Year Average	9.88	4.23	5.48	+0.63	+0.55	+0.06
15 Fastest Growing Metros 2018-19 - One-Year	8.01	3.09	4.81	+1.50	+1.18	+0.28
15 Fastest Growing Metros 2009-19 - Ten-Year Avg.	10.27	4.25	5.85	+1.02	+0.57	+0.43
15 Fastest Accelerating Metros 2018-19 - One-Year	6.41	1.02	5.35	-0.10	-0.89	+0.82
National NPI - One-Year	6.51	1.91	4.53			
National NPI - Five-Year Average	8.83	3.90	4.79			
National NPI - Ten-Year Average	9.25	3.68	5.42			

Sources: Urban Land Institute (ULI) Emerging Trends Reports 2009, 2014, and 2019; National Council of Real Estate Investment Fiduciaries (NCREIF); and Nelson Economics.

However, investors would have done even better if they had simply stuck with just the fastest growing last metros, as returns averaged 10.27% over the last ten years – more than a full percentage point greater than the national average and besting the ULI top 15 by 39 bps. Of course, hindsight is 20/20, and we only now know what metros would grow the fastest over the past decade, though I'd submit that virtually every entry on this list would have been on most predictions from 2009: Austin, Charlotte, Dallas-Fort Worth, Denver, Las Vegas, Nashville, Orlando, Phoenix, Riverside, Salt Lake City, San Antonio, San Francisco, San Jose, and Seattle.

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[3] All returns are for institutionally-owned property as reported by the NCREIF Property Index (NPI).

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Even more interesting is the composition of those returns: Most of the outperformance among the ULI metros is attributable to appreciation returns (based on investor expectations) rather than income returns (based on property performance). For example, of the 63-bp annual return premium for the top 2009 ULI metros, appreciation accounted for 55 bps and income only 6 bps. This suggests a certain self-fulfilling prophecy generated by the herd mentality of investors focusing on the consensus metros, thereby driving up values.

By sharp contrast, the fastest-growing metros derive a much greater share of their returns from income (based on the ten-year average, appreciation accounted for 57 bps and income for 43 bps of the return premium). That only makes sense: income returns are based on property performance, which are driven primarily by the local economy, especially job gains. Thus, **strong economic growth drives income returns**.

Finally, consider the returns for the 15 metros where job growth is accelerating the most relative to their long-term trends: Here the overall return premium over the last year was actually negative overall. Income outperformance amounted to an incredible 82 bps as strong economic drivers improved operating fundamentals, yet appreciation lagged the national average by 89 bps as investors are slow to recognize markets shifts and thus continue to discount the value in these markets. **Might investors be overlooking some important opportunities? Yes, particularly those seeking to maximize their income returns**.

Conclusions

Job growth is moderating, which will slow CRE leasing and reduce property investment returns. For investors still in the hunt for new acquisitions, market selection becomes that much more important.

Surveys like ULI's annual *Emerging Trends* reports can provide valuable guidance for investors. My analysis demonstrates that top-ranked markets yield consistently higher than average returns over both the short and longer term. But by **focuing excessively on outdated reputations, even when market conditions are changing,** these **consensus outlooks can also fall victim to a herd mentality that neglects markets with even greater return potential. Investors should always consider the economic outlook, particularly projected job growth, in addition to consensus expectations.** Turning away from the herd and focusing more on economic fundamentals is especially crucial for investors more concerned with income returns than capital appreciation.

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