Wilmington Trust's Capital Considerations with Tony Roth

Episode 36: America's on the Move: The Reshaping of Our Urban and Suburban Populations
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ERIC WILLET: Overwhelmingly our research on the past year and the COVID-19 pandemic has suggested for commercial and residential real estate the patterns that we saw pre-pandemic and those supply-demand dynamics that we saw pre-pandemic, they're largely holding true. And so, our confidence in the market, residential and commercial, is really sustained.

TONY ROTH: That was Eric Willett, Director of Research and Thought Leadership for the Pacific Southwest Division of CBRE, the largest commercial real estate company in the world. Eric's joining me today to discuss recent demographic shifts and their impact on the commercial real estate landscape.

TONY ROTH: Welcome to Capital Considerations, the market and economic podcast that's fully invested in your success. I'm your host, Tony Roth, Chief Investment Officer of Wilmington Trust.

COVID certainly touched every aspect of our society. Not only did it result in remote work becoming ubiquitous, it intensified the need for more living space in homes that now often double as offices. We saw a greater desire for separateness that stemmed from social distancing, on top of existing generational trends that were already leading for many different reasons, Millennials and Baby Boomers to what we might think of as second-tier cities and the sunbelt. All of this has contributed to massive population movements away from traditional urban centers. These changes all make it a good time for us to take a fresh look at the real estate sector and break down what's behind the migration and what might this mean for portfolios.

We're fortunate to have Eric Willett with us today to talk demographics and real estate. Eric is the director of Research and Thought Leadership for the Pacific Southwest Division of Commercial Real Estate at global leader Coldwell Banker Richard Ellis, often known as CBRE. He leads the development of forward-looking insights across property sectors that help to explain the region's evolving commercial real estate landscape and inform CBRE's client investment solutions. He's also a regular contributor to regional and national media outlets, such as the *Los Angeles Times*, the *New York Times*, and FOX Business. Eric was previously a vice president at RCLCO Real Estate Advisors, where he led research and strategic consulting engagements for high-net-worth investors and families. Eric, thank you so much for being here today.

ERIC WILLETT: Thank you for having me. I'm looking forward to the discussion.

TONY ROTH: Eric, we've seen these big population shifts over the last year and we've all experienced the work from home or the remote work or the hybrid work and there just does seem to be this feeling that people want to get away from wherever they used to live. There are some distinct trends. People moving to warmer places, more comfortable places, less expensive places, prettier places.

When you look at it from your perspective, how do you see the forces that are really driving these shifts? How permanent do you think they are?
ERIC WILLETT: So, as you know, I mean the last year has really been a shockwave to the global economy, the national economy, and then also just to people's lives. And so, as a result of that we've seen some

pretty dramatic and interesting changes in migration patterns. Now, the tricky part, of course, is that demographic patterns are inherently really sticky. Where people move tends to, you know, move in these long waves. And so, even pre-pandemic we saw, you know, a lot of the dynamics that you mentioned, people leaving urban areas, people moving to the sunbelt, people leaving high-cost areas in particular to lower cost metros. And across all three of those categories, we saw those same patterns continue in the pandemic and even accelerate, right, this unique impact and the spread of the disease and the social distancing restrictions in place in various metros meant that people were reconsidering where they wanted to live and how they wanted to live their life.

TONY ROTH: So, what do you think the biggest winners and losers are from a geographic standpoint? I mean we all hear about Austin, Texas. It's not just Elon Musk. He's only one family. But and then on the other hand, San Francisco, I mean my gosh, when I was growing up, when I came out of college, everyone wanted to live in San Francisco and then the next generation, of course, it was Seattle. But these West Coast cities are really taking it on the chin as well. So, when you put it together, where do you think the biggest winners and losers are going to be from the migration pattern?

ERIC WILLETT: Well, let's start with the obvious ones and you hit on a lot of those key stories, right, in that the high-cost coastal metros saw—over the last year saw—the greatest outflow. And I should, you know, going backwards, a lot of our data is from U.S. Postal Service address changes, which is a really frequently updated data, very granular. And so, it allows us to get some visibility into where people are moving in this unique period of time.

And what it shows is that in places like San Francisco, Los Angeles where I'm based, and New York people left in much larger numbers last year than they were in previous years. In, say, 2019 or 2018 there was already a net outflow. We know this and this has been going on for a long time. But what was different about 2020 is the magnitude of that outflow.

Now, the tricky part for those same metros is that most of that movement was actually close by. So, San Francisco suffered the most from the COVID pandemic in terms of the outflow of talent and the outflow of individuals. But at the same time, the market that actually had the highest positive impact of the pandemic was Sacramento, right, you know, just a couple, you know, hundred or so miles down the road.

And I think that really highlights this relationship between these core coastal metros and their surrounding areas in that many people during the pandemic were reconsidering whether they wanted to live in their one-bedroom apartment with their, you know, with their dog and their work-from-home setup and wanted someplace with more space or more affordable and moved out of the metro. But they wanted to stay within what we call the economic watershed or the larger macro metro areas.

TONY ROTH: Well, that's, you know, that's fascinating because that's—I had not appreciated that. I had thought that everybody wanted to get out of dodge if you lived in the Northeast city and you wanted to move to Texas or Florida or Arizona. And so, in a way that's somewhat reassuring for those local communities or states that not everyone is fleeing quite as far.

TONY ROTH: And so, what's driving that again, Eric, is that staying in—I love that term, the economic watershed, if you will—what's driving that is the desire to live in a place that's maybe a little bit softer, kinder, gentler perhaps than that core urban center but still being close enough to a work environment where maybe you could commute once in a while or you're still near some of your family and friends.

ERIC WILLETT: Absolutely. That's exactly right. And San Francisco and Sacramento, the relationship, the duality between those two is the most dramatic. But we see it across the U.S., Los Angeles to the inland empire Riverside and San Bernardino Counties, Washington, DC to Baltimore. Really similar dynamics where, you know, Washington, DC, significant loser of people, Baltimore, significant gainer; inland empire significant gainer, L.A. significant loser.

And it reflects the fact that for the overwhelming majority of people to begin with, they like moving nearby, right. Eighty-plus percent of moves in any given year are within destinations within 500 miles of the original location. And so, that reflects the link to families, the link to the economic opportunities, all of those components.

TONY ROTH: Right. And generally speaking, that hasn't radically changed then over the last year.

ERIC WILLETT: No.

TONY ROTH: People are still moving, but they're moving closer by.

ERIC WILLETT: Well, we did see an increase in people leaving their county and moving to nearby counties, right. That number increased. But it's still, you know, that reflects this dynamic that we're describing now.

So that, that's the big loser side but I want to get back to who the big winners are, because you highlight the belle of the ball, Austin, Texas, for instance.

TONY ROTH: Right. Yes.

ERIC WILLETT: And certainly, without a doubt Austin was a beneficiary of the pandemic. Many people, you know, relocated to Austin. And you can pick other up-and-coming cities, whether it's Nashville, you know, Boise, Idaho, take your pick. But many of those cities were winning pre-pandemic. They saw an even greater influx of talent and individuals during the pandemic.

TONY ROTH: Well, one of the theses that I had coming into the conversation was that a lot of this migration was driven by taxes. With the repeal of the SALT deduction, effective repeal of the SALT deduction, a lot of folks just couldn't bear the burden of paying taxes at 13%, 15%, 16% total rates and decided that, hey, if I can go and live somewhere and pay zero percent state tax, yeah, my federal rate will actually—effective rate goes up a little bit, but my total amount that I'm paying is clearly lower. It's just simple math, right.

Is there a term for folks that are tax migrants? I would think that while it's a pretty clear and interesting story, probably aren't that many people that make enough money and are that motivated by taxes to really relocate.

ERIC WILLETT: Right. That's exactly right. And the reality is the tax sensitive bucket of migrants is relatively small. And it's important to probably understand and highlight the dichotomy between cost of living and taxes, particularly in a state like California where I'm based and do most of my research, in that for the overwhelming majority of the population in California the tax code is actually quite favorable. So, taxes for middle income earners in California are more favorable. The tax burden is lower in California than it is in Texas, for instance, which is not, you know, most people would assume that is not the case.

TONY ROTH: But how could that be if Texas has no state income tax whatsoever and California does?

ERIC WILLETT: It's the combination of taxes on retail, sales tax, other levies. It's the whole—

TONY ROTH: Oh, all tax, real estate taxes.

ERIC WILLETT: It's—exactly.

TONY ROTH: The whole picture, got it.

ERIC WILLETT: The whole tax burden on income earners, right. And so that it's this really kind of surprising element and it reflects the progressive nature of California politics, right, that are geared towards taxing higher-income individuals and oriented away from taxing lower-income individuals. But all of that is to say taxes are low in California. Cost of living is obscenely high, right. And so, there is a dynamic and the cost dynamic for decades and continuing during the pandemic has been pushing more low-income and middle-income individuals out of the state because, simply put, the cost of housing in particular is exorbitantly expensive.

TONY ROTH: Right. And that's a supply/demand phenomenon because people want to live in California because it's a nice place to live all else being equal.

ERIC WILLETT: That's right. The state has … housing for decades and is slowly building its way out. And it also reflects the attraction, the economic attraction of—in productivity growth in California and places like New York and Seattle and other really high-cost coastal metros. These are the centers of the next generation of the US economy, particularly tech, media and entertainment, legal services, and these centers are in high demand by well-compensated workers, and it is driving the cost of housing and the cost of living more generally up for the full swath of residents.

TONY ROTH: So, Eric, let's get to your specialty, not—I mean your demographics, yes, but let's get to the actual housing. So, we all know that there's been a, something of a bubble, in housing prices. Whether it's vacation homes, whether it's primary residences for folks that are moving to Austin or Florida or other areas, whether it's the ex-burbs so called or the suburbs, it seems like everywhere you look housing prices are at record highs pretty much everywhere.

How much of that is driven by the desire for people that didn't own homes to now own homes versus just the housing stock, if you will? A lot of folks don't want to move. They don't want to give up their homes. There's not a lot of supply. If you have that many more people looking for homes and you don't have the normal stock coming on the market, even a small change in the margin sometimes can really radically affect a market. So, what's really going on when you look at the dynamics that are driving those prices so high?

ERIC WILLETT: Absolutely. And it's a unique confluence of all of these factors that you mentioned and some more that are—that is driving this really accelerated increase in housing prices. Before going there though, let's say what we're not seeing, because I think the—it's important particularly to benchmark against the last time that we saw the B word used, you know, pre-great recession, the B word being bubble of course.

TONY ROTH: In my world, not yours. I know you don't like to use the bubble word, right.

ERIC WILLETT: Right. But what we haven't seen is reckless over-building and we haven't seen reckless lending, right. Those were two main factors leading up to, you know, '05-'06'-'07.

TONY ROTH: Great financial crisis.

ERIC WILLETT: Leading up to the great financial crisis and the great recession. And we haven't seen that play out over the last ten years and we certainly haven't seen it play out over the last year. And so, I think that's an important grounding in that the dynamics that are underpinning this growth in the housing market are—in housing prices and increased demand are different, right. We're seeing a different set of factors.

And what we are seeing is, one, unprecedented interest rates, right. There is an unprecedented amount of money, of federal support, monetary policy support for the economy as a result of the pandemic that is creating, you know, amplifying demand for residential properties. And secondly, we had the pandemic, right, which changed for many people the way they relate to their living space because of this need to remote work or just the need to not be able, you know, to cook, right. You can't go out to restaurants. Whatever the case may be, the relationship to the house really changed. And so, we saw for many people across the U.S. a change and a desire to change their living status, and that included a shift towards for-sale properties.

Now, one additional element that really ties into the demographic conversation we were having is that we're also on the cusp of a very significant demographic shift in the US irrespective of the pandemic in that the Millennial cohort, which is an abnormally large cohort—we talk a lot about Baby Boomers. The Millennial cohort is only slightly smaller. That cohort is now entering what has traditionally been family formation age and entering into the traditional age where they would buy first homes, right, you know, aging into their 30s to put a number on it.

And leading out of the great recession, the Millennials were not entering that, you know, home ownership in great numbers. But we think the pandemic, what we saw during the pandemic is this really sizeable shift for this demographic in terms of the way they are living and a big chunk of that is them deciding to actually purchase homes. And so, that is enough of a shift that it changes the supply/demand dynamics in a very real way.

TONY ROTH: I also, I think the pandemic has had a very visceral impact on people emotionally where there's a feeling that home is equivalent to safety and if they didn't have a home, they didn't have a place to be sheltered and to be protected from those forces in the world that have become really quite extraordinarily unpredictable and scary.

ERIC WILLETT: Absolutely.

TONY ROTH: And I think that a home represents safety and that in and of itself probably for the Millennials as well as others has brought them into that market.

ERIC WILLETT: I think that's absolutely right. And on the flip side, that same sense of safety has had impacts on new supply listings, right, people willing to list their homes, right. If you are comfortable with your living arrangement and you have a nice home, why would you, you know, put it on the market, prices aside, in the midst of this global pandemic and concerns about, you know, safety and security and health. And so, I think there has been both this increased desire on the one hand and this reticence to list new supply. And so, you're seeing that mismatch play out in the markets today.

TONY ROTH: So, as supply chains start to loosen everywhere, you know, lumber prices have come down. They've probably peaked, other commodities, etcetera. And hopefully the labor market will heal itself such that people are not incented to sit on the sidelines or are not scared to work because they're going to become sick or ill or exposed to the virus. There'll be some type of equilibrium that we'll reach in the housing market.

Do you think that we'll be sitting in a year or two and we'll see a collapse in the housing market? And what about the areas that have been in high demand? Do you see any potential issues for people who just recently bought homes? Or do you think that this is more sustainable this time? It's more organic and housing prices are going to remain high for quite some time.

ERIC WILLETT: We think in the long term this is sustainable. We see this growth long term, and we don't foresee any sort of collapse. Now, there may be some pullback in the next year. But we're in this really tricky reset period as we search for that equilibrium. And so, you know, it is not unreasonable to expect some choppiness as we move towards equilibrium and get out of this really artificial economic and, you know, health environment that we were in for the past year-and-a-half. But we don't think that there is a fundamental mismatch in supply and demand that is going to lead to any sort of broad reset over the next several years.

TONY ROTH: One of the most frequent questions that we're asked by our clients is, is it a good time to buy a residence? I'm not happy with my current residence. I want a larger residence. I want a second residence. I'm afraid to do it right now because the prices seem so lofty. And certainly, if you're financing the residence and you're able to take advantage of those low interest rates, your advice would be to move forward and feel comfortable doing so all else being equal, obviously.

ERIC WILLETT: I would say overwhelmingly, and this is a bit of a bigger answer to that specific question, but overwhelmingly our research on the past year and the COVID-19 pandemic has suggested for commercial and residential real estate the patterns that we saw pre-pandemic and those supply-demand dynamics that we saw pre-pandemic, while they've shifted a little bit during the pandemic, they're largely holding true, right. We haven't seen U-turns. We haven't seen about-faces.

And so, our confidence in the market, residential and commercial, is really sustained and similar to where we were pre-pandemic. In some ways, it's better, right. Like we think the economy is poised for really remarkable growth this year. That gives us a lot of optimism for sure. And in some ways, it's worse as the—as we work through the labor challenges of the last year. But overall, I think we—we're looking at the real estate market broadly with a real sense of optimism and see really strong supply/demand dynamics for investors going forward.

TONY ROTH: Let's just focus for a moment on that. So, we did spend a fair amount of time focusing on the single-family home, if you will. But thinking more from an investment standpoint, whether it's multifamily or whether it's warehouses or malls or office buildings, where do you see the greatest opportunity?

ERIC WILLETT: So, first on the single-family residential side, we've actually seen intense investor demand usually on an institutional level but also from a high-net-worth level in single family rental, in particular the growth of the build-to-rent single-family rental market. It's somewhat of a new investment concept, only was institutionalized in the past decade since the great recession. But it's a really exciting space and we think the supply and demand dynamics for that sector in particular are really strong, similar to the single family for buy market, right, and for individuals buying their own homes. But for investors looking to invest, the single-family rental market is really exciting right now. We've seen a lot of institutional capital come into the space over the last two years and a lot of exciting movement there as well. So there, there's a lot to look forward to there.

On the more traditional institutional asset classes, we continue to be intensely bullish on residential and industrial. For—on the industrial side the rise in e-commerce, the rise in consumerism, and increased spending, particularly on goods and products as opposed to services over the last year has been a real boon for that sector. Industrial pricing is at all-time highs and the market is intensely tight. And so, that is something that we foresee continuing going forward.

On the residential side, it's really a remarkable story because if we had chatted six months ago, we would be looking at the numbers in major metro areas and saying it looks somewhat scary and that we've seen an intense drop. But just over the past few months and I think this reflects that migration rebound as restaurants and bars reopen and offices reopen. People have been moving back to urban centers in large numbers. And the rent growth we are seeing in places like Los Angeles where I am or in places like New York are really remarkable over the last several months, in many cases creating records.

And so, the long-term outlook for multifamily residential is very strong and the economic pull of these major urban areas is consistent, right. So, the investment prospects there are very positive.

You mentioned office and I think that's a really tricky place because there is this ongoing discovery period of figuring out how do large office occupiers want to use their space. What we increasingly see, though, is people are heading back to the office. I'm in the office today with a number of my colleagues and we see this shift and I think we'll see a lot more over the next several months as people move back to kind of a more, a new normal, I guess.

TONY ROTH: Yeah. It's interesting. Whether it be office or some of the other areas, for example multifamily residential in the urban cities, even though the outlook for these areas may not be very compelling, it doesn't mean they're not oversold and that there isn't good value to be had and opportunity.

ERIC WILLETT: That's right.

TONY ROTH: And so, as investors as we build portfolios we're always thinking in those terms, not just what's the most robust, but also where are values today relative to the opportunity.

ERIC WILLETT: Right.

TONY ROTH: And that's something that is—figures very importantly as we build portfolios. I want to ask you one more question if I could.

ERIC WILLETT: Yeah.

TONY ROTH: Which is taking a step back from the real estate space and just thinking, again, about those demographic trends when you think about the impact of how people are moving around, different areas, within more local communities or different areas of the country, what trends do you see that may be interesting for investors that are beyond real estate? In other words, do you see anything around the availability of workers in different areas of the country, different kinds of jobs, consumption habits? Anything that would be observations that we as investors should be thinking about as we think thematically what we put in our portfolios?

ERIC WILLETT: Absolutely. So, I think on the one hand the pandemic really underscored the geographic sorting, if you will, of different occupations, right, in that there are certain occupations that are very mobile and certain occupations that aren't. And overwhelmingly, high-talent occupations are sorting into many of these winner metro areas. We talked about Austin. We talked about Seattle. These are really dynamic cities that continue to attract the most productive workers, the highest compensated workers, and that has really strong benefits for those regional economies outside of commercial real estate, right. Every aspect of the economy benefits from it. So, I think that's a really interesting thread to pull on and a dynamic that we saw pre-pandemic for sure but over the last year it has become even more clear and more obvious to, you know, the investment world and to people living in that world.

On the other hand, I think, you know, one dynamic that we have been following for many years in commercial real estate, but I think this applies more broadly, is the rise of alternatives, right, and that as investors look for emerging asset classes or are looking for asset classes with more yield, they're increasingly pushed to new sectors. And I mentioned earlier single-family rental, which is one of those what we would consider an alternative asset class in the real estate space. And I think that investment shift and kind of that evolution of the investment world, and that's true at the institutional level, absolutely true at the high-net-worth level, it, you know, runs the gamut. But that shift towards alternatives is a really interesting evolution of the industry and the economy broadly that we're monitoring going forward.

TONY ROTH: Really great insights, Eric. Let me summarize what I think are three key takeaways from our conversation today.

First is that we've had an acceleration of something that was already in place, which is essentially the adoption by the Millennials of the housing market and we've had that happen in context of some really interesting demographic shifts and movements around the country where we have these Millennials really digging in, deciding where they want to live, and that they want to live in homes.

And I remember when they wanted to live in tiny homes, or they didn't want to live in any homes. Now they want to live in real grown-up homes, and that's really creating what I think is our second takeaway for today, a very healthy and sustainable housing market. People are comfortable with the idea of owning real estate. The interest rate environment, as you, Eric, I think very importantly noted, is still historically accommodative by any measure. And so, the idea that the housing market is in the kind of bubble that we had during the great financial crisis where we had rampant speculation, overbuilt situation from a supply standpoint, and a level of consumption that was just based on leverage is not what we're looking at today. I think today we're looking at a much more fundamentally healthy environment.

So, the housing market, single family housing market is very sound and very healthy. And then last is that these trends have created a lot of opportunity for investors to extend well beyond single-family housing in the real estate space. We have the industrial space, industrial warehouses. We have multifamily residential in lots of areas of the country. And probably the other area that I would talk about, is there are lots of areas of value in the real estate space, whether it be the office space or whether it be multifamily in the urban centers that—as you've talked about in Los Angeles, for example. And where we can acquire them with financing that is as cheap as it is, they can be very attractive assets over a longer period of time.

And so, real estate is very dynamic, very multifaceted and there's a lot of opportunity. And as we build portfolios, we're looking at the long-term potential of these assets. We're also looking at the entry price from a valuation standpoint and we're finding some really interesting things as we put portfolios together. So, I think those are three takeaways that I would ask people to keep in mind today from our conversation.

Eric, I want to thank you, again, for being here today.

ERIC WILLETT: Thank you, Tony. Enjoyed the conversation.

TONY ROTH: Thank you to our listeners for joining us and I encourage everyone to visit wilmingtontrust.com for a roundup of our investment and planning ideas. You can subscribe to Capital Considerations on Apple Podcast, Spotify, Stitcher, or your favorite podcast channel to ensure you get future episodes. Thank you all for listening today.

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