The U.S. Economy and Real Estate: A Conversation with Dr. Joseph Gyourko

ABR Capital Partners (ABR) recently spoke with Dr. Joseph Gyourko (JG) of the Wharton School of the University of Pennsylvania to discuss the economy's performance in 2023, key economic themes for 2024, and economic scenarios that could generate opportunities for real estate investors this year, or lead to additional risks.

Dr. Gyourko is the Martin Bucksbaum Professor of Real Estate, Finance, and Business & Public Policy at the Wharton School. He also serves as the Nancy Nasher and David Haemisegger Director of the Zell/Lurie Real Estate Center at Wharton. He is a research associate of the National Bureau of Economic Research (NBER) and served as co-director of the special NBER project on housing markets and the financial crisis. Dr. Gyourko is a past trustee of the Urban Land Institute (ULI) and director of the Pension Real Estate Association (PREA).

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ABR: In 2023, real GDP grew by 2.5%, outpacing many of the forecasts that were made at the start of the year. The economy also added 2.7 million new jobs, contributing to a consistently low unemployment rate that ended the year at 3.7% in December. What are some of the main factors that allowed the economy to grow and unemployment to remain low in 2023, despite the elevated interest rate environment and several major bank failures?

JG: I think ending supply chain snafus, plus a very different labor market than we're used to seeing after a recession, created an environment in 2023 that allowed the economy to be stronger than most of us thought, including me.

Regarding the labor market, during the pandemic, a number of particularly older workers left the labor force permanently, or at least for a lengthy period of time. That labor shortage helped drive up wage rates and kept people spending. This is a huge difference from previous downturns and is one reason the economy was strong last year. Another reason is that we eliminated the supply chain snafus. Supply chain problems got worked out as the effects of the pandemic receded and companies adjusted to current conditions.

What will 2024 bring? Unfortunately, I think the economy will be weaker. I'm not forecasting a recession, but it's going to be weaker for a number of reasons. Most prominently, I see very little chance that the 10-year bond yield will fall below 4%. I think there's enough productivity growth and expected inflation out there to keep that long bond at least that high. The bad news from that is there are a decent number of assets, business models, and capital stacks that will not work with long rates at 4% plus a spread that gets you to the borrowing rate. This becomes a problem in real estate and other industries if you have to refinance and need to decide if you are going to write an equity check and put more capital into the venture, or walk away from it since you can't refinance the full amount of your outstanding loan. We're seeing this happen with startups that cannot get refinanced once their initial round of funding is over.

The other thing that is going to matter in 2024 is Fed policy. How weak 2024 is will depend a lot on whether the Fed can effectively stop any crisis in the banking sector. We are likely to see more business failures because of higher-for-longer interest rates, but will those failures affect bank lending in a major way? If they do, then we could see a real downturn. So, I am not as optimistic for 2024, but the labor market is still pretty strong, there is no obvious evidence we're going into a recession anytime soon, and hopefully the Fed can prevent any serious bank crisis from happening.

ABR: According to Bank of America, roughly 80% of outstanding U.S. mortgages are below 5%, and according to Redfin, roughly 25% of mortgages are below 3%. Many homeowners with low mortgage rates obtained them by refinancing their old mortgages, essentially locking in long-term stimulus because of the lower monthly payments on their new loans. What impact do you think refinanced mortgages with low rates had on consumer spending and economic growth in 2023 and do you expect this impact to continue for the foreseeable future?

JG: I don't have precise estimates for the impact on spending, but it's absolutely true in the United States that if you have a 30-year fixed rate mortgage at a lower rate, you are not affected by the Fed raising interest rates and this is dampening the effect of rising interest rates on consumption. So, there is this big swath of the homeowning population that really is not affected by rising rates per se. I think the biggest impact of this will be on mobility. One of my colleagues at Wharton has done some really interesting research that estimates the mobility of homeowners is going to drop by about one-third because of higher mortgage rates, and there was a bit of evidence of this in a recent report on home sales. They fell to their lowest level in 28 years. There are a number of reasons why this happened, including higher interest rates and an affordability problem, but a huge reason is that there is a large slice of the homeowning population, which has this really valuable asset called a below market interest rate loan and as long as they don't move, they get to keep this asset, which allows them to spend more because they don't have to send much money to the bank.

ABR: By all accounts, the U.S. has a significant housing shortage problem. In response, some states and municipalities have passed legislation making it easier for developers to build new homes. Do you think development-friendly legislation will have a significant impact on the nation's housing shortage over the next few years, or will other factors, such as mortgage rates and the cost of materials and construction labor have a greater impact on the supply of housing?

JG: I am a pessimist on the impact of changes in regulation. It is absolutely true that states are enacting rules that limit the ability of localities to restrict development through zoning rules or other methods; however, I don't think new regulations are likely to lead to a big increase in housing supply because there are a myriad of ways that localities can stop development, ranging from the court system to causing delays in approvals and the like. So, unfortunately I do not think we're going to get a big increase in supply from regulation. Also, while the rate of inflation is weakening, and I expect it to continue to weaken throughout 2024, I do not expect the cost of construction, per se, to go down at all. This goes back to my comments on the labor shortage. There is just not an excess supply of carpenters and other people who help build homes. I think we have worked out the supply chain snafus, so lumber that's used in framing a house is no longer four times its historic average, but there is also no evidence that lumber costs are going to drop below average either. The one exception to this would be if the Chinese economy deteriorates substantially beyond what has already occurred there. China consumes a large share of building materials globally, so a material decline in demand from China could lead to lower materials prices more generally.

ABR: There has been a lot of discussion about the growing amount of federal debt held by the public. At the end of 2023, it was approaching 100% of GDP, a level it has not reached since the mid-1940s. What impact do you think the growing U.S. debt will have on the economy? For example, do you think high debt levels will cause the 10-Year Treasury to remain elevated, even if the Federal Reserve lowers interest rates this year?

JG: I think the answer to your last question is probably yes. The federal debt is historically high. You mentioned the 1940s, it was high then because of World War II, but this is peace time. It's hard for me to see deficits, which contribute to the aggregate debt, shrinking much for a variety of reasons. One, there's a bunch more elderly folks, I'm one of them, who are going to be getting Social Security, and we vote, and there's no appetite to cut our benefits. Two, I look around the world and I see higher defense spending by America, not lower defense spending. And, as you know, we're now at a level of debt where we should all start to worry about private investment being crowded out. This could weaken the economy somewhat. It won't be dramatic, but it could have an impact. Earlier, I said that I don't see the long bond falling below 4% because of productivity growth and expected inflation, and now I'll add a third reason: I think deficits remain fairly high and there's going to be competition for capital. Capital is no longer free, it's expensive, and the government is going to be competing with the private sector for it. So, I think this debt problem stays with us and it's going to slow growth a bit.

I want to add one thing. There's some worry that we've reached a debt level that is catastrophic and will lead to a default or hyperinflation. There's no reason to believe that, but the debt is a real, ongoing problem. It's costly to us now and the easiest way to see this is the share of government spending that is being used just to service the debt. It's much higher than it used to be and it's going to go up.

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ABR: Artificial intelligence is being touted as something that could revolutionize the workplace by significantly boosting worker productivity in some cases, and completely eliminating the need for human labor in other cases. What are your feelings on AI and the impact it could have on worker productivity, the demand for labor, and economic growth in the future?

JG: I am not an expert on AI, but I happen to work at a place where some of my colleagues are. At our last Members meeting at the Zell/Lurie Center, one of my colleagues who is an expert on AI, Kartik Hosanagar, talked to us about this technology and there's no doubt it is potentially very important in a couple of ways. One way is its general purpose. AI can be applied in multiple industries, in multiple settings, which gives it a large reach. Another way is the pace of innovation in AI. New AI models are coming out all the time. That being said, I do not expect AI to wipe out certain workforces anytime soon because it will take time to deploy new AI platforms and AI is

also very hard to use intelligently. I'm using AI for a research project that couldn't be done without the ability of platforms like ChatGPT to read thousands of long documents very quickly. The problem is, it's hard to use this AI intelligently. It gives you answers to questions that are sometimes flat wrong. These wrong answers are called hallucinations by AI experts and they're a real problem that AI developers are going to have to work through.

I do believe that AI is going to be very important in my lifetime and it's also going to be potentially harmful to white-collar employees. I'll give you an example. I teach a housing markets class where the last few weeks of the course are on the Chinese housing market. I asked an AI platform to prepare slide decks on the nature of this market, gave it some guidance, and it did a really good job. This demonstrates the risk AI poses to entry level people working in management consulting who provide slide decks and the like, certain researchers, and other white-collar employees. So, unlike the last big wave from automation, I think AI is more likely to impact white-collar employment than blue-collar employment.

ABR: If 2022 was the year of interest rate hikes and 2023 was the year the economy demonstrated resilience in the face of higher interest rates, bank failures, and geopolitical clashes like the ongoing Russia/Ukraine war and the Israel/Hamas war in the Middle East, what do you think the central economic themes of 2024 will be?

JG: One of 2024's themes will be how we deal with the impact of higher-for-longer interest rates. This goes back to my belief that the long bond yield will not drop below 4% and then borrowing rates will be that base rate plus some spread. This year we are going to see investment slow down and more businesses fail if rates stay higher, which I believe they will.

Something I hope is not a key theme is banking weakness, although that will require the Federal Reserve to act creatively and proactively in this area, because if I'm right about investment slowing and some borrowers not repaying their loans because their business has failed, that will affect the banking sector. The question is how big a theme will this be in 2024 and that depends on whether the Fed can stop bank runs that could lead to a contagion. I think the Fed can, but if I'm wrong, then banking weakness will be a big theme in 2024.

Another big theme that Americans don't focus on will be the impact of weak growth around the world. We already see Europe in recession, China's economy has slowed dramatically, and I think our economy will continue to be relatively weak. We like to think in America that we're immune from the rest of the world and in some sense we are. We're a big, continental sized economy. We can maintain a high GDP and a lot of employment just by buying and selling among ourselves, but the rest of the world is also important to us and the rest of the world is weaker. That's going to show up much more in 2024.

I am not as optimistic for 2024, but the labor market is still pretty strong, there is no obvious evidence we're going into a recession anytime soon, and hopefully the Fed can prevent any serious bank crisis from happening.

Geopolitical shocks would be my fourth theme. These shocks may not be an economic theme, but there is risk there. I believe geopolitical shocks are going to lead to the defense budget going up, which then feeds into the deficit and debt question you asked earlier.

Last, but not least, it's an election year in America and that will be a big theme. How it plays out is beyond my pay grade, but I can see businesses responding sharply to whatever they see, or think is going to happen in November. We generally don't think much about domestic politics impacting the broader economy, but it could this year.

ABR: What potential action or scenario do you think could provide the greatest opportunity for real estate investors this year?

JG: I think the biggest opportunity for real estate investors this year will be due to the fact that the long bond is going to stay at or above 4% and the Fed is only slowly going to lower interest rates. That's going to lead to financial distress for a number of property owners and an amazing opportunity will develop to figure out how to recapitalize over-leveraged capital stacks in real estate. This is going to require really diligent and good underwriting by firms like yours because unfortunately what happened is that rates were so low for so long, some projects got financed that shouldn't have been. These projects were not really good real estate, but because interest rates were so low, they got off the table. Your job as investors is to figure out which projects are really good real estate and just got over-levered. So, I think there's an amazing opportunity to capitalize on this dynamic that's just beginning to come into play. The other opportunity I see out there is to be operationally excellent. 2024 is an environment in which it will not pay to be a financial engineer. In other words, I don't think the Fed is going to provide conditions for really cheap leverage, so one way to make money is to figure out how to operate buildings better.

ABR: What potential action or scenario do you think presents the greatest risk for real estate investors in 2024?

JG: A serious banking crisis. Real estate is a capital-intensive business and if the Fed cannot prevent or control a banking crisis, that would be really bad for real estate. In essence, we'd be back to 2008 with a weakened banking system not willing to lend against even really good real estate.

The other risk one could conjure up is some geopolitical shock that leads to a major war that involves the U.S., but I don't know how to handicap that risk at all.

ABR: Over the past few years, there has been substantial migration to areas in the south and southwest that are generally perceived to be safe, offer a low-cost of living, good job opportunities, and attractive amenities. These areas have experienced strong population and job growth. Are there any states or cities you believe are well-positioned for growth in the future that might be under the radar right now?

JG: What one should look for are places with lots of high human capital and good weather. If you ask me what predicts population growth best since 1970, and urban economists have studied this, it's markets that have well-skilled labor forces and a lot of sun. It also happens that these places have cheaper housing because they build more homes. My one word of caution is to remember that these places tend to be in the Sunbelt and they can be overbuilt. Just because there's growing demand it doesn't mean prices will automatically rise to the sky. Markets can be overbuilt, even if they do possess strong demand trends. This makes it important to watch supply, as well as demand, in growing markets.

ABR: Is there anything you'd like to mention that we haven't discussed?

JG: My only other prediction for 2024 is that the public debt and equity markets will play a much bigger role than they have in the past. In the past few years, it's all been private real estate. Private real estate is not going away, but this year the public markets will play a bigger role in recapitalizing over-leveraged entities than they have in the past.

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