The Illinois and Chicago Economic Outlook and Implications for Real Estate, 2017

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January 12, 2017
Illinois outlook

• State has both underperformed US and region during the last recession and during the recovery.
• Unemployment rate has been higher than US and growth slower.
• Big question is the impact of poor fiscal conditions on future growth
• Employment recovery (or lack of) tells the story....
## Illinois Job Recovery vs the US
### November 2016

<table>
<thead>
<tr>
<th>Industry</th>
<th>Illinois</th>
<th>Losses during recession (in 000s)</th>
<th>Performance during the recovery (in 000s)</th>
<th>Recovery rate</th>
<th>Losses during recession (in 000s)</th>
<th>Performance during the recovery (in 000s)</th>
<th>Recovery rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>All industries</td>
<td></td>
<td>-344.0</td>
<td>401.9</td>
<td><strong>116.8%</strong></td>
<td>-7,393</td>
<td>14,437</td>
<td><strong>195.3%</strong></td>
</tr>
<tr>
<td>Construction</td>
<td></td>
<td>-52.4</td>
<td>-2.9</td>
<td><strong>-5.5</strong></td>
<td>-1,534</td>
<td>776</td>
<td><strong>50.6</strong></td>
</tr>
<tr>
<td>Education, Health</td>
<td></td>
<td>27.8</td>
<td>99.4</td>
<td>n/a</td>
<td>689</td>
<td>3,267</td>
<td>n/a</td>
</tr>
<tr>
<td>FIRE</td>
<td></td>
<td>-25.5</td>
<td>-3.2</td>
<td><strong>-12.5</strong></td>
<td>-461</td>
<td>528</td>
<td><strong>114.5</strong></td>
</tr>
<tr>
<td>Government</td>
<td></td>
<td>7.7</td>
<td>-22.2</td>
<td>n/a</td>
<td>200</td>
<td>-276</td>
<td>n/a</td>
</tr>
<tr>
<td>Information</td>
<td></td>
<td>-9.9</td>
<td>-9.3</td>
<td><strong>-93.9</strong></td>
<td>-228</td>
<td>-12</td>
<td><strong>-5.3</strong></td>
</tr>
<tr>
<td>Leisure</td>
<td></td>
<td>-17.5</td>
<td>86.1</td>
<td><strong>492.0</strong></td>
<td>-474</td>
<td>2,522</td>
<td><strong>532.1</strong></td>
</tr>
<tr>
<td>Manufacturing</td>
<td></td>
<td>-100.1</td>
<td>4.2</td>
<td><strong>4.2</strong></td>
<td>-2,020</td>
<td>592</td>
<td><strong>29.3</strong></td>
</tr>
<tr>
<td>Other services</td>
<td></td>
<td>-2.7</td>
<td>-1.2</td>
<td><strong>-44.4</strong></td>
<td>-144</td>
<td>354</td>
<td><strong>245.8</strong></td>
</tr>
<tr>
<td>Prof. and Business Svs.</td>
<td></td>
<td>-91.7</td>
<td>183.0</td>
<td><strong>199.6</strong></td>
<td>-1,615</td>
<td>4,079</td>
<td><strong>252.6</strong></td>
</tr>
<tr>
<td>Trade, Transport and Utilities</td>
<td></td>
<td>-79.7</td>
<td>68.0</td>
<td><strong>85.3</strong></td>
<td>-1,806</td>
<td>2,607</td>
<td><strong>144.4</strong></td>
</tr>
</tbody>
</table>
Dimensions of the Fiscal Problem

• State has not had a full year budget for 2 years
• Credit rating is worst in the nation leading to higher borrowing costs (160+ bp above triple A)
• Debt is more than just underfunded pensions. It also is a structural budget deficit (since 2001) where expenditures are exceeding revenues
• IGPA Fiscal Futures Project shows the complexity of the solutions
How do all of our district states stack up?  
*(actuarial reported, 2014)*

<table>
<thead>
<tr>
<th>State</th>
<th>Pension debt (S&amp;L combined, thousands)</th>
<th>Funded ratio</th>
<th>Debt/households</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illinois</td>
<td>$140,261,234</td>
<td>44.5%</td>
<td>$29,390</td>
</tr>
<tr>
<td>Indiana</td>
<td>$13,589,278</td>
<td>72.1%</td>
<td>$5,430</td>
</tr>
<tr>
<td>Iowa</td>
<td>$4,124,909</td>
<td>87.4%</td>
<td>$3,323</td>
</tr>
<tr>
<td>Michigan</td>
<td>$36,342,281</td>
<td>66.8%</td>
<td>$9,478</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>$795,885</td>
<td>99.2%</td>
<td>$345</td>
</tr>
</tbody>
</table>
Pensions are the most visible problem, but even this may be understated...actuarial reported versus market

<table>
<thead>
<tr>
<th>Illinois 2014</th>
<th>All State and Local Systems</th>
<th>All State Systems</th>
<th>Local Systems</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension debt (thousands)</td>
<td>$140,261,234</td>
<td>$99,978,217</td>
<td>$40,283,017</td>
</tr>
<tr>
<td>Funded ratio</td>
<td>44.5%</td>
<td>44.5%</td>
<td>44.5%</td>
</tr>
<tr>
<td>Assumed rate of return</td>
<td>7.89%</td>
<td>7.89%</td>
<td>7.89%</td>
</tr>
<tr>
<td>Debt per household</td>
<td>$29,390</td>
<td>$20,949</td>
<td>$8,441</td>
</tr>
<tr>
<td>Debt as a share of total (S +L) general fund revenues</td>
<td>3.81%</td>
<td>2.72%</td>
<td>1.10%</td>
</tr>
</tbody>
</table>
But if you change a few assumptions, things look much much worse

<table>
<thead>
<tr>
<th>Illinois 2014 Market</th>
<th>All State and Local Systems</th>
<th>All State Systems</th>
<th>Local Systems</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pension debt--market (thousands)</td>
<td>$371,398,779</td>
<td>$264,733,075</td>
<td>$106,665,704</td>
</tr>
<tr>
<td>Funded ratio</td>
<td>23.3%</td>
<td>23.3%</td>
<td>23.3%</td>
</tr>
<tr>
<td>Assumed rate of return</td>
<td>3.0%</td>
<td>3.0%</td>
<td>3.0%</td>
</tr>
<tr>
<td>Debt per household</td>
<td>$77,822</td>
<td>$55,471</td>
<td>$22,350</td>
</tr>
<tr>
<td>Debt as a share of total (S + L) general fund revenues</td>
<td>10.10%</td>
<td>9.33%</td>
<td>3.76%</td>
</tr>
</tbody>
</table>
Making up the pension gap...how do you get a 7.5% return?

**Rolling the Dice**
Investors grappling with lower interest rates have to take bigger risks if they want to equal returns of two decades ago.

**Estimates of what investors needed to earn 7.5%**

<table>
<thead>
<tr>
<th></th>
<th>1995</th>
<th>2005</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>100%</td>
<td>52%</td>
<td>12%</td>
</tr>
<tr>
<td>U.S. Large Cap</td>
<td>20%</td>
<td>8%</td>
<td>8%</td>
</tr>
<tr>
<td>U.S. Small Cap</td>
<td>5%</td>
<td>14%</td>
<td>22%</td>
</tr>
<tr>
<td>Non-U.S. Equity</td>
<td>5%</td>
<td>13%</td>
<td>13%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>5%</td>
<td>12%</td>
<td>12%</td>
</tr>
<tr>
<td>Private Equity</td>
<td>4%</td>
<td>13%</td>
<td>17.2%</td>
</tr>
</tbody>
</table>

*Likely amount by which returns could vary
Source: Callan Associates

THE WALL STREET JOURNAL.
University of Illinois Fiscal Futures
Project Analysis

• “If you find yourself in a hole, stop digging” (Will Rogers)
• All funds budget
• Structural deficit emerged in FY2001
• Estimates that FY17 deficit is $13 billion
• Projected gap of $14 billion per year for next five years
• Legacy liabilities (mostly pensions) are $174 billion
• Unpaid bills of roughly $10 billion
Can the gap be solved in 10 years?

• IGPA options
  – Spending cut of 2% for all discretionary spending (32% reduction in gap)
  – Income tax rate hike (4.75% for personal, 6.65% for corporate), (40% reduction in gap)
  – Expand income tax base by 10%, (12% reduction)
  – Increase sales tax base by 15% (tax more services), $2 billion revenue gain
  – Supply-side—get ½ of 1% faster personal income growth, (only produces $100 million in tax income)
What if you do everything?

• Most of the budget gap would be gone in 10 years (2027). Gap would decline to $9.4 billion in FY17 to $2 billion by FY21 and near 0 by 2027.

• Caveats—
  – Doesn’t address current bill backlog
  – Need to fund the annual deficits by either decreasing assets or increasing liabilities
  – Assumes pension contributions are based on current actuarial projections to have pensions funded to 90% by 2045.

• What is needed is a “Grand Plan”.
Turning to Chicago

- Economic growth has recently picked up as business and professional services have roared back.
- Real estate has been a positive but that may be slowing into 2017.
- Big issue is the fiscal headwind...underfunding of pensions is as bad as it is at the state level.
Chicago’s Recent GDP growth

Source: Thomson Reuters Datastream
As Apartment Construction Slows...

Construction starts overall rose this year in the Chicago area, but total volume is projected to decrease in 2017.

**CONSTRUCTION CONTRACTS**

- Nonresidential
- Residential

$15.0 billion

$5.48 billion

$6.85 billion

Source: Dodge Data & Analytics

*projected
Views about Chicago Real Estate from the annual ULI/PWC survey

- 26th ranked market in the US—ranked as improving for investment, development and homebuilding
- Driving the improvement is the urban core—HQs moving downtown attract smart, affluent workers which in turn drives multi-family.
- Also, “the urban core remains attractive to tech company growth, which is driving demand for downtown office space.”
- “…the Chicago market offers a level of stability that a number of investors see as a benefit at this point in the national economic cycle. Chicago is still a core market with one of the top regional infrastructure systems in the United States”.
- Chicago real estate outlook for 2017, apartments are still top, followed by industrial, for-sale housing, retail, office and hotels.
Downside risks?

• Recovery is getting a little long in the tooth...while they don’t die of old age...

• Higher financing costs

• Some types of real estate has been heavily built over the last few years with more in the pipeline...Hotels and Office?

• Unfavorable trends for brick and mortar retail?
Market specifics--office

- Chicago Office vacancy is the lowest in a decade...hovering around 11%. Still a problem with key tenants simply moving from one class A space to another. (example Hyatt moving from 71 S. Wacker to 150 N. Riverside)
- Office development has been strong in 2016. Almost 4.5 million square feet under construction. (150 N. Riverside—1.2 million, 444 w. Lake—1.1 million and 151 N. Franklin—807 thousand)
- Not surprisingly the sublease market is growing—in Q3 of 2016, 4.1 million sq. ft, was available.
- Good news is net absorption for office has been positive since 2011 and was running at 1.6 million through Q3, 2016.
- Also good news is lease rates that continue to rise—almost $22 per sq. ft. in Q3 across all classes. Top of the class A on the market at $41 with a building under construction asking $46
Market Specifics--Housing

• Sweet spot is still multi-family and rental—projections for rent increases seem solid and demand appears to be there. Also is the product that maybe best fits the demand for young, urban professionals.

• Advantage for the market is that prices are still low relative to most major urban markets. Chicago has not seen rapid price appreciation during the recovery.
Chicago Housing Price Recovery Has Been Underwhelming
Retail

• Good and bad. Good locations are still very hot, but industry is still grappling with oversupply and e-commerce invasion. Significant overbuilding occurred before the recession (in 2006, 258 million square feet were added) and strip malls still struggle and big box vacancies are hard to fill (Bookstores, Bath Stores, Electronic Stores and Groceries).

• Good news is consumers have been restrained and may have pent-up demand. Low gas prices and possibly higher wages will increase confidence and retail activity.
Hotels

- Hotels. Convention and tourism is back, occupancy is tight but lots of construction in the pipeline
- The Chicago Central Business District has 106 hotel properties comprising 37,049 rooms. Recently opened hotels include Loews Chicago Hotel (400 rooms), Virgin Hotel Chicago (250 rooms), The Godfrey Hotel (221 rooms), and SOHO House Chicago (40 rooms).
- More than 3,200 new rooms are expected to open in the next two years, including AC by Marriott (217 rooms, June 2015), Kimpton Hotel (281 rooms, 2016), Nobu Hotel (93 rooms, 2016) and Marriott Marquis McCormick Place (1,200 rooms, 2017).
Finally--What is different about real estate this time?

- Slow recovery in business service employment and financial sector limits office demand.
  - More efficient use of space—less square feet per worker, “arbitrage” real estate costs, emphasis on anchor tenants but movement is often from one class A building to another class A building.
  - Greater stress on building infrastructure, post-9/11 security costs
- Millennials
  - Are they only city focused?
  - Will they only rent and never buy?
  - Accommodating a key part of the workforce—HQs move from suburban office parks to downtown
  - Walkable cities spillover into walkable burbs?
- Finance/new normal?
  - What if we never have meaningful inflation again?
  - When and at what pace will interest rates/borrowing costs rise?
  - Under what terms will finance be available?
The future for Chicago Real Estate

• Strengths—only world class city in the Midwest means it can attract different kinds of investment. Better able to attract physical and human capital. Plus given its stature, Chicago is cheap.

• Over the longer cycle, Chicago is still a good market but it needs to generate more internal growth. Growth that is generated by expansion and not just moving the same companies to different buildings. CBD and near adjacent areas are the hottest markets.