

# Going to America

Dove and Hawk revisit the USA



# The New World in Middle Age

Life is never dull in the land of opportunity. In the five years since Lehman Brothers declared the largest bankruptcy in history, Americans have elected a black president, made a 28 year old a billionaire, seen their stock market triple in value, named a rapper and former drug dealer the most influential man in America and even let Simon Cowell on their TVs. These individuals found opportunity within the economic malaise but an environment of slow growth, unprecedented monetary policy and a ballooning national debt might be cause enough for international investors to hold on to their cash. We disagree.

Dolly and Harry flew over the pond to give us their bird's eye view.

Dove: Why are you standing like that?

Hawk: I'm twerping.

Dove: It's twerking – and no, you're not. You look like you've pulled a hamstring.

Hawk: Don't be such a kill-joy, I'm engaging with the cultural emancipation of a disaffected generation blighted by an inherited debt burden.

Dove: You're not, you're shaking your backside around like Miley Cyrus and you don't even have a record to sell. And when did you start talking like Russell Brand?

Hawk: Don't be so dismissive – mark my words, there's a generation of millennials fighting for jobs with wages outrun by inflation so they can fill black holes in pension funds they will never benefit from. They are not happy about it.

Dove: Nothing new there – I think I've still got my copy of Rage Against the Machine somewhere... Anyway, the under-funded pensions will be a thing of the past once the last defined benefit schemes run-off in 10 years time. Look, I agree there are some structural problems for the US at the moment but look around you; this is still the land of opportunity.

Hawk: I love the optimism Dove but it's hard to focus on opportunity when the government can't even operate properly.

Dove: I admit the shutdown was a little embarrassing but let's focus on the macro picture before we look at some more immediate concerns like what caused the shutdown in October. I think the US is in a good position to grow strongly over the coming decades.

Hawk: You don't think the 20th century was America's time in the sun and they'll lag the emerging Asian economies now?



Dove: Growth may be a little slower sure, but think about some advantages that will be pretty hard for the emerging markets to replicate –

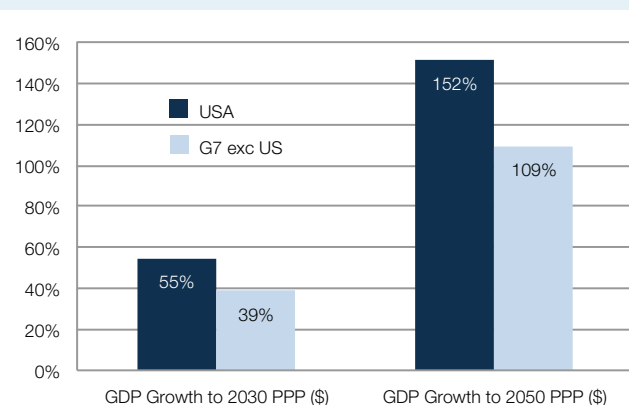
- control of the world's reserve currency;
- an established legal, regulatory, business and logistical infrastructure;

- an ingrained culture of education and innovation;
- a stable democratic platform and constitution; and
- an endowment of natural resources (particularly energy).

Hawk: All very impressive but what's new? These are all static risk mitigators – I'm more interested in whether we're going to see any growth.

Dove: Well there's plenty of potential – by 2030 there'll be another 40 million people in the US, generating an extra \$8 trillion of GDP – a 55% increase. That's like adding the GDP of Germany and Japan to the US economy.

## US is forecast to grow faster than other developed nations



Source: PriceWaterhouseCoopers

Hawk: That's interesting, I didn't realise the USA's population was growing so much, particularly after listening to Hans Rosling's recent lectures suggesting global population will peak much quicker than people think – he's an interesting guy, I'll send you his latest TED talk. A lot of the US growth must be immigration led though. What about productivity gains and internal growth?





**Dove:** Well no one spends money like the US consumer so another 40 million of them will generate plenty of economic activity. But consider also some of the 'Game Changers' McKinsey came up with in their recent report on the US:

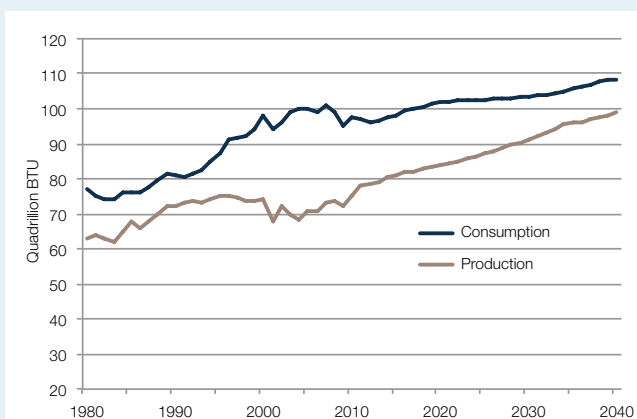
- Potential for shale gas and oil production expansion;
- World leaders in knowledge intensive trade;
- A head start in big data analysis;
- Increasing infrastructure investment; and
- Building on the educational establishment advantage.

Check out the report - if the US can capitalise on these they will really be flying.

**Hawk:** That's interesting; I'd heard the US will soon be a net exporter of shale gas thanks to the advances in the extraction process.

**Dove:** Great for energy hungry US businesses and I guess less dependence on energy imports could make America less interested in its diplomatic progress in the Middle East...

### Total US energy production catching consumption



Source: Energy Information Administration

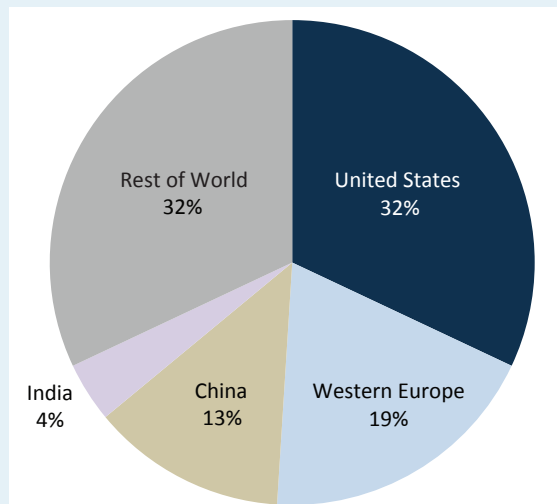
**Hawk:** That production trend is impressive – a nice shot in the arm for the economy while prices stay keen. I can see it makes sense for the US to focus on activity higher up the value chain like innovation industries and venture capital, data analysis and high skilled information jobs.

**Dove:** What does this mean for the property sector though?

**Hawk:** The technology sector has really kept things vibrant in the last few years and it has been the biggest driver of occupancy demand in hot property markets like San Francisco and Seattle, even New York come to that.

We are just starting to scratch the surface of some of the productivity gains that can be made from analysing Big Data. The US is really leading the way.

### Data Universe in 2012 (100% = 2.8 exabytes)



Source: IDC, McKinsey Global Institute

**Dove:** We've got a lot to learn from the Americans about how they successfully turn geeky hypothetical ideas and university-led research into viable businesses.

**Hawk:** The Twitter IPO was pretty spectacular. Maybe we should set up a @doveandhawk account!

**Dove:** Hmm – I think I'd have to be in control of that one.

**Hawk:** So the US is well placed to remain the world's leading nation and, more than just a safe place to diversify a property portfolio, it could also throw up huge opportunities in a generally rising economic tide.



**Dove:** I agree with that, but there are some more immediate issues facing the US – let's wing it down to D.C. and see how things look from Capitol Hill.

# US Snapshot - Still improving, still fragile

It's been an up and down year for the US - steady economic growth, recovering real estate markets and all-time highs for the stock market have been offset by reminders of the fragility of the government and market systems. The government shut down in October shows how hamstrung the country has become by its politicians. Reluctance to intervene in Syria shows a waning of appetite for global policing and the capital markets' nervous reactions to the threat of tapering shows an acknowledgement that four years of easy credit have not wholly addressed the structural flaws that led to such a dramatic collapse in 2008-09.

Dolly and Harry fly down to Washington D.C. to try and make sense of things.



**Hawk:** So I've warmed to the idea that the US has a lot going for it in the long term but can the potential really be harnessed? The politicians don't seem to have a grip on things if they can't even afford to pay the White House cleaner. What happened?

**Dove:** Well it's the same old story of the debt ceiling being hit. There are limits on the level of government borrowing and in return for their vote to raise those limits the Republicans tried to lever some concessions from the Democrats on their spending programme - particularly in relation to Obamacare.

**Hawk:** So they used the threat of a US debt default as a bargaining chip. Pretty reckless, no?

**Dove:** Absolutely! In the end the markets didn't think the threat was credible and the Democrats conceded very little at the time. But getting so close to the edge really shook people.

**Hawk:** I can see that Obamacare is contentious (and it's pretty embarrassing that they couldn't even get the website to work), but surely these guys have to see the bigger picture - it doesn't matter who's right or wrong when you're fighting so close to the edge of the cliff that everyone just wants you to stop! Who do you think is right? Can the US afford to raise the ceiling again? Isn't their debt burden already pretty huge?

**Dove:** It is but the key thing is that it's manageable. A consistently high level of debt may not be something to worry about and the cost of borrowing is still cheap.

**Hawk:** I suppose the Fed can always reduce the ratio through a combination of austerity, growth and, importantly, inflation, so the debt position can be effectively managed while the private sector finishes its deleveraging process and begins to drive demand in the economy.

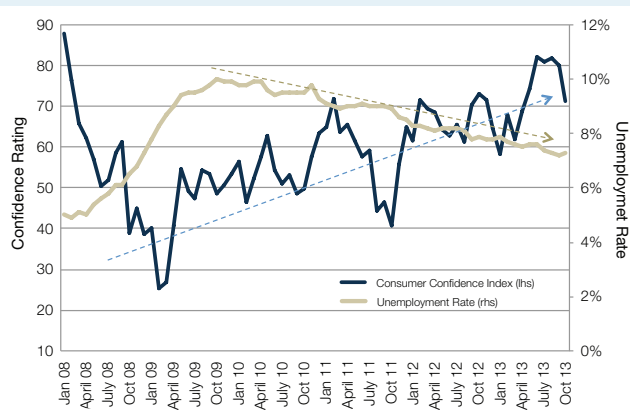
**Dove:** That's right and to be honest it has worked quite well. Unemployment has fallen, consumer confidence is trending up and there has been fairly consistent GDP growth.

**Hawk:** We keep talking about growth as the panacea but when the last set of figures from Q3 said the US was growing at a healthy 2.8% and unemployment had dropped the equity markets fell. What's going on?

**Dove:** Well, the equity market has recovered since but it does seem counter-intuitive. It is all tied in to Quantitative Easing. The Federal Reserve, having committed for the last 3 years to buying up great chunks of Treasury Debt (about \$88bn each month) now has to reduce or "taper" its purchases.

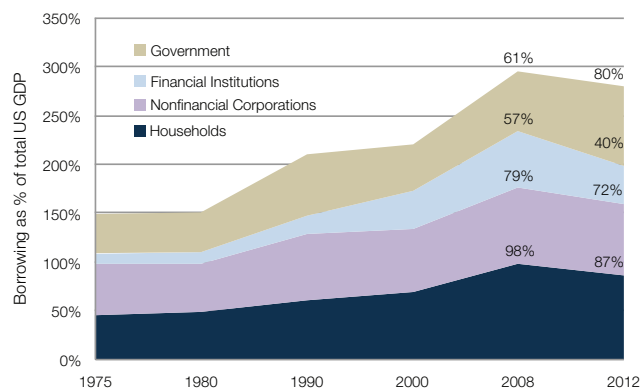


## The workforce is more productive and willing to spend



Source: The Conference Board, Bureau of Labor Statistics

## The Great (non-Government) Deleveraging



Source: McKinsey, Bureau of Economic Analysis

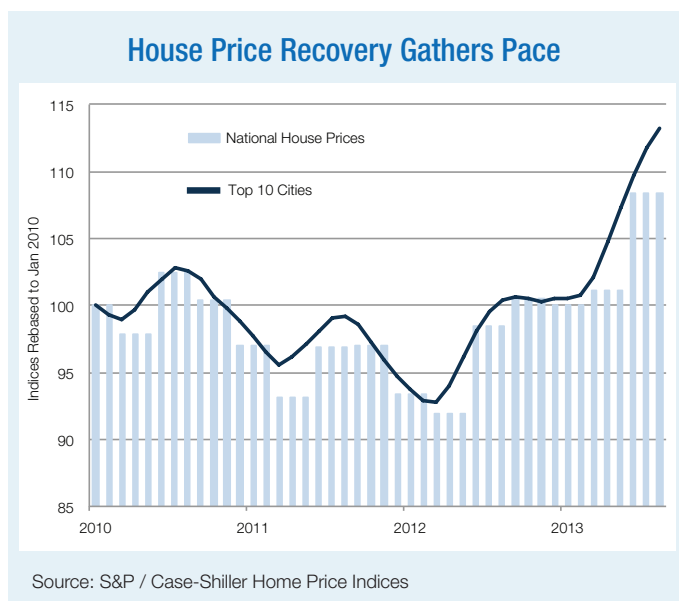


**Dove:** Understandably people are nervous that if this huge buyer of Treasuries leaves the market too quickly the price of bonds will crash and interest rates will rise. This leaves us with the strange situation where positive GDP and jobs numbers make the economy look healthy enough to withstand the start of the taper and therefore the markets see it as a negative.

**Hawk:** Sounds upside down to me. But while the Fed has been printing new cash to “buy” all this government debt have corporates and households made any progress in deleveraging?

**Dove:** Yes they have. Regardless of whether you agree with Hayek or Keynes, it is encouraging to see corporate and household balance sheets have paid down a huge amount of debt. This means they are more ready to invest into the economy again to support growth. The banks particularly (who have been told by regulators to up their capital reserves) are now in a better position to lend to small and medium sized enterprises who have been starved of cash since the crash.

**Hawk:** You’re rhyming like Jay Z – nice. The housing market has recovered well too which is normally a good bell-weather for confidence. When people’s houses are worth more they tend to feel good about spending money, setting up businesses, moving jobs and making investments.



**Dove:** Economists and journalists never seem to draw conclusions on this kind of thing, “on the one hand this – on the other hand that”. Are you saying everything will be alright next year?

**Hawk:** It can be hard getting a straight answer but it’s just as bad when they make predictions and forecasts and then when they’re wrong saying “no one could ever have predicted that”. These are complex systems we’re talking about and, by the very nature of their inputs, are unpredictable.

**Hawk:** But yes – given the long term structural advantages of the US we talked about earlier I think the US economy will be able to soak up shocks along the way better than most and we will see the steady economic growth chugging along in a bumpy but positive direction.

**Dove:** The first bump will be in February when we have the unedifying spectacle of another debt ceiling negotiation! This has to be sorted out longer term.



**Hawk:** I agree. You can’t underestimate the contribution of sentiment to the way markets move and watching the government squabble like teenagers does not imbue optimism. I’m pretty positive about the outlook for the US in 2014 but you should be very sensitive as to:

- The political process breaking down further;
- The direction taken by the new Fed chairman on tapering QE; and
- The pricing of the equity markets.

Each one of these could spark a sell-off and it could be pretty dramatic.

**Dove:** Understood. Can we get to talking about the property markets now? What’s going on in the St Bride’s World Cities at the moment? Are Boston, Chicago, Los Angeles, New York, San Francisco and Washington D.C. still driving the action?

**Hawk:** There’s a lot of action in these Gateways of course but it’s not been all plain sailing - especially for D.C.

**Dove:** It’s getting late – let’s head back to New York. The bar at the Ace is a great spot for a drink, it’s in Little Korea, they mix a great Dark and Stormy and apparently it has the fastest WIFI network in the city.



# US Gateway Real Estate

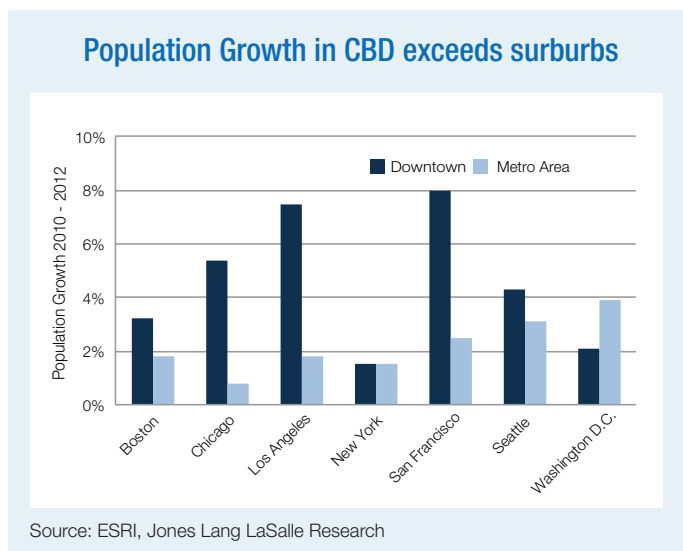
At the bar in the Ace Hotel Dolly and Harry discuss the US real estate markets surrounded by young New Yorkers plugged into laptops and a live band.

**Dove:** You mentioned Millenials earlier – what are they?

**Hawk:** That's the name given to the generational cohort between 18 and 34. They're worth thinking about because they are the life blood of the housing rebound, they are mobile and well educated and driving some different trends in retail and office structures.

**Dove:** How so?

**Hawk:** They generally prefer to walk or cycle to the gym, office and supermarket which means a big bump of population growth in CBDs and opportunities for urban retail.



**Hawk:** They are also changing the way we think of the office – not just a cubicle and a PC but a space for collaborating with the team and then heading off to process tasks on more mobile devices.

**Dove:** So we'll need offices in the future, they'll just be configured and used differently.

**Hawk:** That's right, offices now have double the amount of people per sq ft than a few years ago and by 2015 60% of workers will access content on mobile devices. Also, the network element of office life extends from the office itself to the area the office is in. Bumping into people for impromptu introductions is as important as bumping into colleagues at the water cooler or networking at more formal seminars and industry events. So location is still key.

**Dove:** All the office workers I know are like moths to the flame when they know where the best coffee is in the area!

**Hawk:** "Clustering" is not new of course, it's been going on for centuries; musicians in Vienna and Nashville, bankers on Wall Street, barristers at Lincoln's Inn, coders in Silicon Valley.

**Dove:** So how have the real estate markets in our World Cities been getting on since we were last over here? Have the millennials and anyone else been leasing, buying and building?

**Hawk:** In general, things have been improving. The positive economic picture has been feeding into the property markets in 2013. Our US World Cities have seen improving occupier demand and more deal flow, much of it from overseas investors as well as US institutions.



	Hot Sector	Investment Volume	St Bride's View
Boston	Education and biotech	\$9 bn (↑16%)	Birdie
Chicago	Hotels	\$11 bn (↓3.4%)	Par
Los Angeles	Retail and Residential	\$31 bn (↑77%)	Birdie
New York	Tech, Digital Media and Education	\$49 bn (↑39%)	Birdie
San Francisco	Tech and Pharma	\$21 bn (↑38%)	Eagle
Washington D.C.	Non-government	\$20 bn (↑42%)	Bogey

Source: Jones Lang LaSalle, Cushman Wakefield, St Bride's Managers

**Dove:** And the REITs – how are they getting on?

**Hawk:** It's a slightly mixed picture to be honest Dolly. US REITs have done really well for investors since the crash as they have been a popular source of dividend income, enjoyed NAV growth in their portfolios and seen their share prices inflate with the QE programme. But this year they've underperformed overseas REITs as they have been more susceptible than most to the tapering threats.

**Dove:** What about going forward?

**Hawk:** I'm confident in the REIT sector particularly those companies with existing portfolios in the hard-to-enter gateway markets where we will see most rental growth. They also have the ability to borrow cheaply against their balance sheets so will take opportunities to refinance or fund accretive acquisitions and developments that might not be as easy to underwrite for one-off buyers.



**Dove:** The liquidity is a double edged sword though – I suppose investing through the REIT market will mean you have to stomach some short term volatility in the share price to get access to their underlying property portfolios?

**Dove:** You sound pretty positive about the capital markets in general.

**Hawk:** I am – I'd say investment volumes will carry on going up as the banks lend more, the yield gap will persist and overseas investors will continue to purchase in the US. I think the inflation risk we talked about earlier is a key factor too – US institutional investors like real estate as an inflation hedge so steamy-looking cap rates in the prime markets might not be as off-putting as they would be otherwise.

**Dove:** I'm pretty convinced - should we still be looking at Boston, Chicago, LA, New York, San Fran and D.C?

**Hawk:** The six US Gateways St Bride's recommend on the World Cities list have led the recovery along with the likes of Seattle, Dallas and Miami. The one exception being D.C. where government occupier demand has fallen. But it's still right to focus on these markets, when rental growth comes through it will enhance total returns versus other asset classes.

**Dove:** They're also subject to different demand drivers, like finance in New York and technology in San Francisco so there's value to be derived from timing cycles amongst these markets.

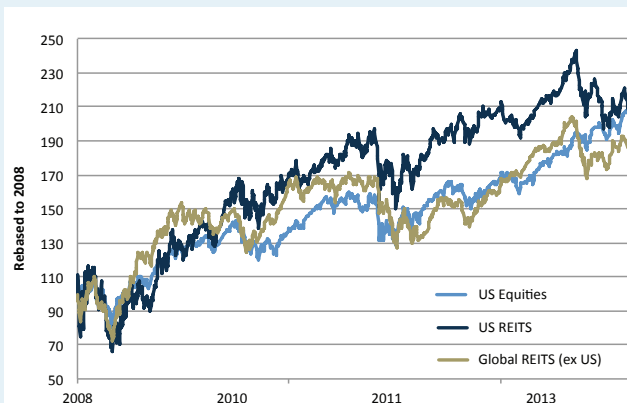
**Hawk:** I like this place and I'm feeling optimistic about next year if the new Fed chairman plays ball and party politics don't get in the way. I'm knackered Dolly – let's hit the perch.

**Dove:** No way – you bring me to New York in December and you think we're not going to go shake our tail feathers with the cool kids in Williamsburg? You're crazy.

**Hawk:** Fine but I get to watch the Giants tomorrow?

**Dove:** Deal.

## US REITS are taking a breather



Source: S&P Dow Jones Indices, St Bride's Managers analysis

**Hawk:** That's right but ultimately the real estate fundamentals drive REIT valuations – just be patient.

**Dove:** Are people still investing directly? Treasury yields have gone up and the best markets must be pretty expensive?

**Hawk:** Despite low cap rates the risk premium for real estate over 10 yr Treasuries is still in the 300-400 basis point range. You're also seeing the cost of borrowing come down so even at compressed cap rates leveraged investment makes sense.

**Dove:** I heard there's a lot of interest from international buyers?



**Hawk:** That's right – us Brits are a little behind the curve on cross border investment in the US. Money from all over the world has found a home in Manhattan, LA, San Francisco, Houston, Seattle and elsewhere.

## Total cross-border capital into the US (Q1-3 2013)

From:	Volume in \$ bn	Number of Properties
Canada	\$7.44	301
Singapore	\$1.93	9
China	\$1.73	15
Germany	\$1.72	45
South Korea	\$1.56	27
Australia	\$1.08	17
Other	\$7.82	162

Source: "Cross Sector Outlook, Fall 2013", Jones Lang LaSalle

## Conclusions:

### Taking together:

- the structural competitive advantages of the US,
- the opportunities for significant long term sustainable growth in the economy, and
- the progress made already in the task of deleveraging after a massive credit bubble.

We believe international investors should continue to look to the US as an opportunity to benefit from geographical diversification and strong risk adjusted returns in their investment portfolios.

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