

WINTER  
2021

# POLITICAL CHANGE IN WASHINGTON:

Will It Change the Outlook for Real Assets?



The President Joseph Biden administration comes into office under unprecedented circumstances—nearly half a million Americans have died in the COVID-19 pandemic that started sweeping through the world a year ago. Fortunately, vaccines to conquer the pandemic have been developed at an astonishing speed, but the slow rollout and emergence of variants will continue to hamper a full return to schools, offices, stadiums, art centers, and other spaces. Consequently, the US economy is struggling to pull out of its pandemic-induced recession with 9 million fewer jobs than a year ago and with business restrictions in place. However, as markets have been signaling for some time, all is not doom and gloom. Equity markets continue to hit record highs, and new jobs are being created. For long-term investors in real assets, RockCreek sees opportunities.

The pandemic has impacted the valuation of real assets. Offices remain empty, and companies are rethinking their future needs as they consider adopting some form of work-from-home arrangements in the post-pandemic era. The need to shop online during the lockdown has boosted e-commerce logistics space requirements and hastened the demise of many traditional bricks-and-mortar retail stores. As some opportunities close, however, others open. Online shopping means more space is needed for logistics. Greater reliance on technology calls for increased digital infrastructure. And unlike in typical recessions, consumer balance sheets remain strong, housing demand is up, with existing home sales hitting their highest level since 2006,<sup>1</sup> and the promise that interest rates will stay “low for long” is a boon for real assets. For the economy overall, a combination

of record fiscal stimulus and extraordinary monetary easing has supported spending and incomes in 2020, despite record unemployment, and has kept interest rates low.

Looking ahead, the new administration would like to keep this combination in place. President Biden has laid out ambitious spending plans for immediate pandemic relief and, more importantly, for longer-term spending on infrastructure and related capital investments as part of his “build back better” plan. There is bipartisan support for many of the goals of the new administration. But as is always the case, legislative compromise and negotiation will determine what gets done.

Equity markets continue to hit record highs, and new jobs are being created.

With a finely balanced Congress, the Biden administration is unlikely to get everything it seeks. The president has made clear that he puts a high priority on swift action to provide COVID-19 relief to spur recovery—proposing a \$1.9 trillion fiscal stimulus package. Congressional Democrats have decided to fast-track this legislation without bipartisan support if that is not forthcoming. Some fear that if the bill for short-term relief is too high,



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1. “Existing Home Sales Rise 0.7% in December, Annual Sales See Highest Level Since 2006,” news release, National Association of Realtors, Jan. 21, 2021.





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and Congress moves forward without bipartisan support, Biden's plans for future policy changes might be in jeopardy. Much will depend on the skill and diplomacy of the new administration and the willingness of legislators of both parties to come together in support of upgrading and modernizing the country's aging infrastructure, addressing climate change, and providing broad access to today's key infrastructure: digital technology.

### Interest Rates: Low for Longer

The Federal Reserve's latest economic forecasts project that interest rates will remain near zero at least through 2023. Fed officials, led by Chair Jerome Powell, have made clear over the past year that they are willing to countenance inflation above their 2% target for a period to offset the below-target inflation experience of recent years and that they put weight on the importance of reducing unemployment even as they fulfill the other part

of the Fed's dual mandate: price stability. Investors have reacted by pushing up inflation expectations, with break-even rates now leading to projections of an annual increase in the Consumer Price Index of 2.1% over the next five years. Prices of commodities, including gold and bitcoin (typically viewed as liquid options for hedging against inflation), have also risen. Investors are now turning their attention toward increasing their exposure to other less-liquid options, such as real asset investments.

Low interest rates and the risk of an uptick in inflation increase the attractiveness of real asset investments. But we believe there are a significant number of attractive real asset opportunities independent of an inflationary environment.

### A Surgical Approach to Investing in Real Assets

As investors continue to increase their exposure to real assets, they must take a surgical approach to finding opportunities. Unlike the period after the 2008 global financial crisis, when there was a synchronized decline across all real assets, performance dispersion is now high—and is expected to remain high.

The investment opportunity set this time around can be divided into two broad—and to some extent overlapping—groups. The first group consists of opportunities that are attractive because of long-term secular changes related to demographics, environmental sustainability, and consumer behavior. Because of the demographic trend impelling aging millennials to seek out larger spaces to start families, single-family rental and suburban multifamily assets should benefit, especially in fiscally attractive secondary markets, such as the Southeast and Texas, with strong migratory trends. The rise in climate concerns has provided an impetus to sustainability, and there is now a growing interest in "environmental commodity markets" for carbon credits, forest conservation, mitigation banking, and water rights subsectors that are attractive because they are highly fragmented with nascent institutional capital. Secular changes to consumer behavior have also become apparent as shopping

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## DOES POLITICAL PARTY MATTER FOR REAL ESTATE PERFORMANCE?

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Historical performance data suggest there is no meaningful difference in the performance of real assets whether the country is led by a Republican or a Democratic administration. On average, annualized total returns for real estate over the past 40 years under Democratic and Republican leadership have returned 9.0% and 8.2%,\* respectively. Further study suggests that periods of unified government—when the party in the White House also controls Congress—generally lead to stronger real estate returns.†

\*NCREIF Property Index (NPI)

† RockCreek analysis of NPI data and US government party control

preferences shift online, increasing the demand for last-mile distribution and cold storage assets.

The second group of investment opportunities includes those that are likely to become attractive as a result of the priorities of Biden administration policies. The president's campaign pledge to "build back better" laid out spending initiatives of \$11.1 trillion over the next ten years, of which \$3 trillion is for infrastructure and climate change, and \$640 billion is for expanding affordable housing.<sup>2</sup> As noted, winning congressional passage for complicated legislation will require compromise and negotiation.

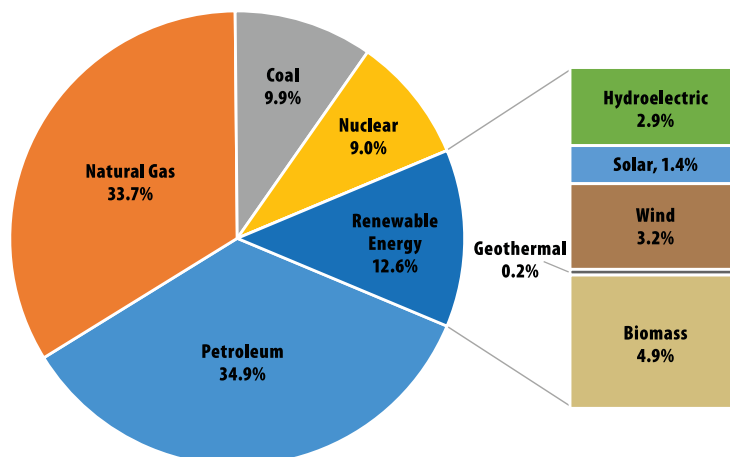
## Riding Tailwinds

### Renewable Assets Including Solar, Wind, and Hydroelectric Assets

President Biden has called climate change "the number one issue facing humanity" and pledged to move the country to net zero emissions by 2050.<sup>3</sup> RockCreek has been active in sustainable investing for the past 17 years and has witnessed the growing attention by investors to this sector. One measure of investor enthusiasm for clean energy is reflected by the appreciation of a select basket of renewable stocks that is up by more than 200% in a year.<sup>4</sup> Notwithstanding likely congressional challenges, the Biden administration is expected to catalyze this momentum for renewables, thereby accelerating a theme already in place—more than 110 countries have already pledged carbon neutrality by 2050.<sup>5</sup> With the US government reengaged in the global fight against climate change, investors would be well advised to increase the weighting of sustainable real assets in their portfolios.

Significant investments aimed at transforming the power sector and electrifying transportation would be needed to enable the country to meet its clean energy commitment. As of October 2020, only 12.6% of US primary energy consumption came from renewable energy (Exhibit 1). Approximately \$4.5 trillion would be needed to fully decarbonize the US power grid over the next decade.<sup>6</sup> This is an investment opportunity that should generate

**Exhibit 1: US Primary Energy Consumption by Source**



Source: US Energy Information Administration, Monthly Energy Review, January 2021

attractive returns through the repurposing and development of new renewable assets.

The administration's plans to boost advanced research on batteries, HVAC, efficient buildings, carbon-free hydrogen, the decarbonization of the food and agriculture sector, and carbon dioxide capture<sup>7</sup> should create tailwinds for electric vehicle infrastructure as well as renewable infrastructure assets such as solar, wind, and hydroelectric. An alternative way to capitalize on this increased spending by the government is through venture investments in early- and late-stage property technology companies that are developing solutions to build more cost-effective, eco-friendly real assets.

### Physical and Digital Infrastructure Assets

An acceleration in urbanization should provide a significant tailwind for real assets—in fact, 75%

2. "The Cost of the Trump and Biden Campaign Plans," Committee for a Responsible Federal Budget, Oct. 7, 2020.

3. Emma Newburger, "Joe Biden Calls Climate Change the 'Number One Issue Facing Humanity,'" CNBC, Oct. 24, 2020.

4. iShares Global Clean Energy ETF

5. Maxime Pontoire, "The Race to Zero Emissions, and Why the World Depends on It," UN News, Dec. 2, 2020.

6. Dan Shreve, "Energy Transition: Deep Decarbonisation: The Multi-Trillion-Dollar Question," Wood Mackenzie, June 27, 2019.

7. "The Biden Plan to Build a Modern, Sustainable Infrastructure and an Equitable Clean Energy Future," Joe Biden Campaign.





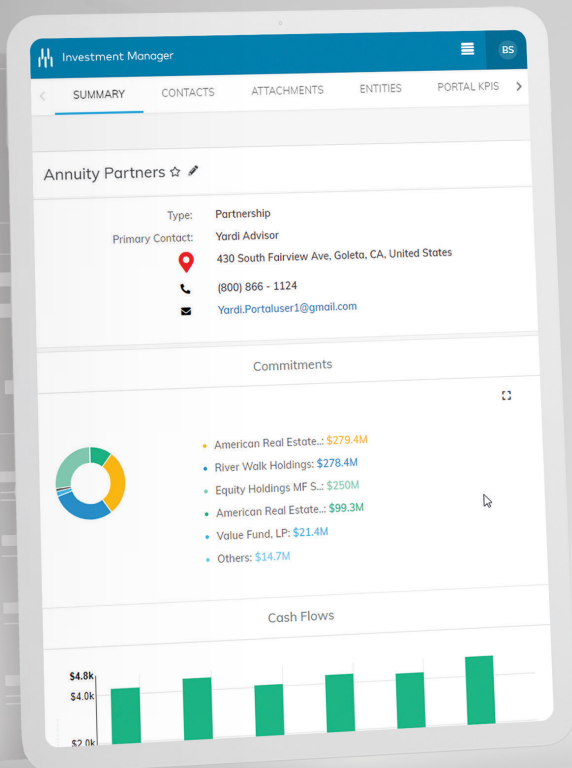
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of the urban infrastructure that will exist in 2050 has not yet been built.<sup>8</sup> To ensure resource-efficient cities in the US, the Biden infrastructure proposal includes \$1.6 trillion aimed at creating and modernizing infrastructure assets, including highways, railways, airports, transit, water treatment plants, and internet connectivity.

Biden has laid out plans to invest \$640 billion over ten years to ensure that every American has access to affordable, quality housing.

Although the spending on public infrastructure promised during the campaign may not be achieved, it is an area that is likely to attract bipartisan support. The funding needed to upgrade public infrastructure is so high that amounts allocated would certainly prove inadequate. Between 2016 and 2025, the US will underinvest in infrastructure by \$2 trillion, according to the American Society of Civil Engineers.<sup>9</sup> The demand for funds in this area should create a vast number of opportunities for public-private partnerships.

Alongside improving physical infrastructure assets, the administration has also called for improving digital infrastructure, including bringing broadband, via 5G, to every US household. With more than 12 million K-12 students without access to broadband or an internet-enabled device,<sup>10</sup> the FCC will likely focus on adoption and utilization by increasing resources to the Universal Service Fund.<sup>11</sup> There may be a more granular focus on specific programs, such as E-Rate,<sup>12</sup> which brings high-speed broadband access to schools and libraries, as well as the Lifeline<sup>13</sup> program, which provides access to communications services for low-income populations. These programs allow investors in

telecommunications assets to generate attractive returns even as they help the administration meet policy objectives.

Given the objective of closing the proverbial digital divide, telecommunications assets—such as data centers, fiber, and cell towers—should benefit from increased demand for transmitting and storing data, with spillover effects for the real estate supporting these assets. The increased connectivity should also boost real assets in secondary and tertiary markets across the US.

### Affordable Housing

Biden has laid out plans to invest \$640 billion over ten years to ensure that every American has access to affordable, quality housing.<sup>14</sup> According to the National Low Income Housing Coalition, only 37 affordable homes are available for every 100 extremely low-income renter households, and 71% of the 11 million extremely low-income renter households are severely cost burdened and continue to spend more than half their incomes on rent and utilities.<sup>15</sup> Among the administration's plans to address income inequality are proposals for housing assistance to low-income renters and development incentives to spur the creation of affordable housing. Furthermore, the administration has outlined a \$100 billion affordable housing fund to construct and upgrade affordable housing.<sup>16</sup> This creates investment opportunities in regulated Section 8 housing, as

8. "Buildings," Buildings Initiative, World Resources Institute.

9. "Changing the Infrastructure Equation: Using Asset Management to Optimize Investments," American Society of Civil Engineers.

10. Sumit Chandra, et al., *Closing the K-12 Digital Divide in the Age of Distance Learning*, Common Sense Media, Boston Consulting Group, 2020.

11. "Universal Service Fund," Federal Communications Commission.

12. "Universal Service Program for Schools and Libraries (E-Rate)," Federal Communications Commission.

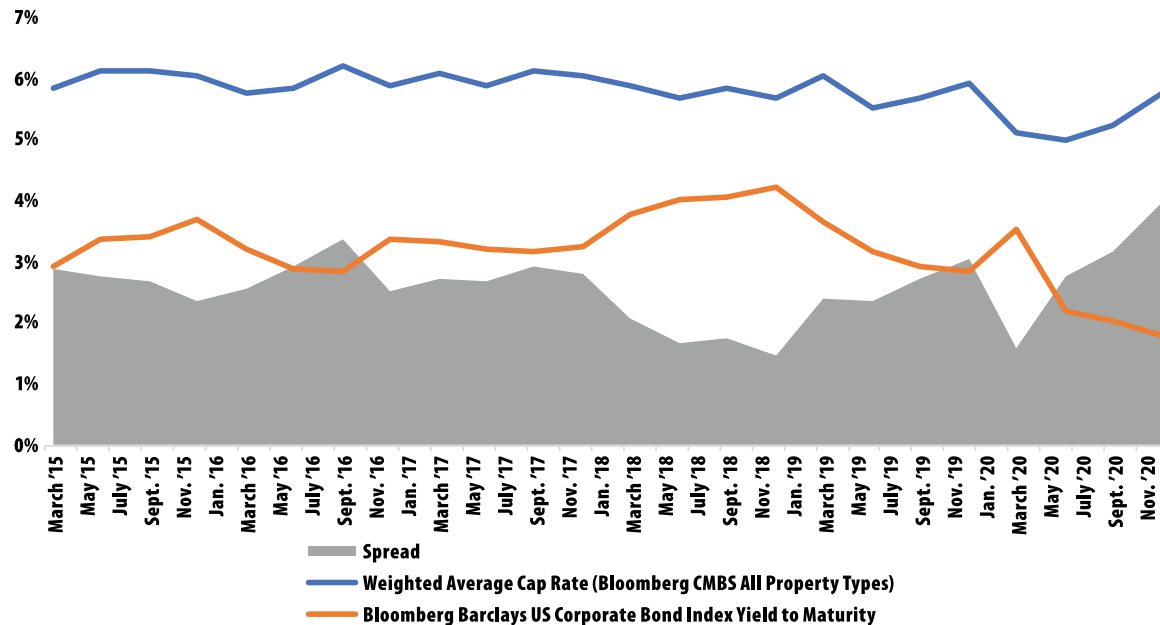
13. "Lifeline Program for Low-Income Consumers," Federal Communications Commission.

14. "The Biden Plan for Investing in Our Communities Through Housing," Joe Biden Campaign.

15. *The Gap: A Shortage of Affordable Homes*, National Low Income Housing Coalition, March 2019.

16. "The Biden Plan for Investing in Our Communities Through Housing," Joe Biden Campaign.

**Exhibit 2: CRE Cap Rates Versus Corporate Bond Yields**



Source: Bloomberg

well as workforce housing aimed at tenants such as teachers, firefighters, and police. Increased support for low-income renters should improve performance of these assets, reducing delinquency and foreclosure rates. We believe that investments in these opportunities are attractive because they can help investors meet their environmental, social, and governance (ESG) objectives and generate strong investment returns.

### Valuation Uplift from Other Indirect Policies

We have discussed renewables, infrastructure, and affordable housing as opportunities with clear tailwinds from expected policy initiatives. Other real assets are also very likely to experience uplift because of the record fiscal and monetary stimulus. The spread between corporate bond yields and commercial real estate cap rates are at historically wide levels, as shown in Exhibit 2. We expect investors to take advantage of this spread differential and rotate capital from fixed income into commercial real estate, providing a valuation uplift for real assets.

### Facing Headwinds

#### Oil and Gas Investments

The Biden administration's focus on climate change will prove to be a challenge for fossil fuel industries. More stringent permit requirements for oil and gas pipelines, a rollback of regulations that supported the oil and gas industry, and the possible elimination of fossil fuel subsidies are some of the headwinds oil and gas investments face. One notable example of this adverse environment is the cancellation of the Keystone XL pipeline announced in the first days of the administration. Other policies under consideration, such as a carbon tax, could also serve as headwinds for investors in the sector; however, these measures are less likely to pass in Congress.

Recent returns in energy-related natural resource investments have been challenged as investors have migrated to opportunities that are less commodity dependent. Additionally, institutions are increasingly incorporating ESG data in their investment analyses and aligning their portfolio exposures to positive ESG characteristics, which is impacting capital flows to the traditional



energy sectors. At RockCreek, we have avoided the traditional energy sector altogether and have focused our attention on sustainable investments within real assets.

### **Real Estate Development Opportunities**

The Biden administration's \$2 trillion infrastructure plan includes goals to improve the energy efficiency of buildings. This will likely require costly retrofits and capex. Specifically, the administration has a goal to upgrade four million buildings and weatherize two million homes over the next four years.<sup>17</sup> Additionally, Biden campaigned on the promise that many of the Leadership in Energy and Environmental Design

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The Biden administration's commitment to spend on both immediate relief and longer-term investments ... should provide the tailwind that real asset investors are looking for.

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(LEED) certification requirements will be included in federal regulations. These certifications aim to promote efficient and cost-saving green buildings that will offset climate change impact during a building's lifetime. These regulations will impact the construction industry, and the additional costs will make certain development opportunities less attractive.

### **Decreased Market Liquidity from Higher Real Estate Taxes**

In his campaign, Biden suggested funding a portion of his spending plan through an increase in capital gains rates and the elimination of 1031 exchanges. Real estate has always benefited from favorable tax treatment until now. If these

tax changes pass, they could dramatically affect transaction activity in the US real estate market. Many taxable investors, including developers, REITs, and funds, rely on 1031 exchanges to transact, without worrying about capital gains taxes from sales. If the capital gains tax deferral for these exchanges is eliminated, the increased transaction cost (i.e., from deferring gains and paying a higher capital gains tax) would change the expected rate of return, and investors may look to hold on to real estate for longer periods, suppressing transaction volumes.

### **Looking Beyond COVID-19**

The most important driver of returns for real assets will be a broad-based economic and jobs recovery. That recovery, in turn, depends on the country's success in containing and overcoming COVID-19, which has upended the economy in the past year. The virus is not yet vanquished, and new variants may mean that it stays a part of life in some form. But the astonishing scientific success in developing safe and effective vaccines and the acceleration in vaccine distribution across the US bode well for a gradual return to normalcy. The Biden administration's commitment to spend on both immediate relief and longer-term investments in renewables, physical and digital infrastructure, and affordable housing should provide the tailwind that real asset investors are looking for.

We look forward to a return to health in 2021. ■

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This article reflects the opinions of the authors and not necessarily that of RockCreek. The contents herein have been prepared solely for informational purposes about general economic conditions and are not intended to be used as a general guide to investing, or as a source of any specific investment recommendations.

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17. "The Biden Plan to Build a Modern, Sustainable Infrastructure and an Equitable Clean Energy Future," Joe Biden Campaign.