The Pinkard Fund

Investor Update — January 2017

Market Update — For Q4 2016

This quarter's update is the political update, and why not? After all, this is the new Washington and it is fashionable to make bold statements about what will happen next. "The swamp is going to be drained," or maybe it's not. "The Affordable Care Act is going to be repealed and replaced immediately," or it may take some time to figure out the replace part of it. There are other policy uncertainties; our relationship with Russia, building and paying for the Wall, immigration policy, deportations and on and on. With all of this uncertainty, we thought it made the most sense to make our predictions on something that we actually know about, the potential impact of political change on the Washington real estate market. Below are some of our thoughts on changes ahead.

Law firms should be big winners in the District of Columbia with the Congress and the Executive Branch in Republican hands. Look for a flow of new legislation to be passed, and while one can debate how good each piece of legislation is for the country, there is no doubt that the legal community in DC will be busy. JLL did a study on the absorption of office space in DC and found that it is highly correlated with the passage of legislation. That correlation was reflected in the stagnant office market during the legislative stalemate of the last few years when an historically low volume of legislation was passed, but the prospects look good for more legislation and robust office absorption going forward. Added to the expected growth of the law firms is the predicted expansion of the advocates on both sides of the aisle. There is a lot at stake and the amount of money supporting those who lobby is growing. The greatest impact will be in the Downtown office markets, but there will be some spillover effect to the close-in suburbs.

However, the dynamic of the suburban market fundamentals is largely independent from Downtown DC. In its simplest form think of Suburban Maryland real estate being affected by the health sciences (NIH, FDA, biotech) and Northern Virginia being impacted by defense and cybersecurity. During a Democratic administration, Suburban Maryland typically benefits more from government spending in the region and during a Republican administration Northern Virginia is a larger beneficiary.

Ending the sequester and expanding the defense budget could have an enormous impact on the Northern Virginia market. John McCain is proposing a $430 billion increase in defense spending over the next five years.

"For too long, we have allowed budget constraints to drive strategy," the Arizona Republican's proposal argues. "It is time to turn this around and return to the first order question: What do we need our military to do for the nation?"

McCain goes on to point out that spending on our country's military has declined by 21% over the last eight years. The President has also been clear about his desire to increase defense spending. The future looks bright for the defense industry with Republican control of the government in place. The question we ask is where are the tea party and the smaller government folks in all of this? It is hard to see how we get to a smaller government while spending more money on the Wall, infrastructure, defense and other Trump priorities. Like much of what is currently happening in Washington, this conundrum poses an uncertain view of the future, but our bet is that those forces behind an expanded defense presence will prevail.

Finally, 2016 was a very good year for the Washington Region with net job growth the highest since 2004. You might remember 2004 was a year of significant growth in federal spending in the region in the aftermath of 9/11. The growth in professional and business services jobs, which in 2004 was mostly in the government contractor space, is now in private sector jobs outside the government contracting arena. This is significant because it means that the region is growing robustly outside of the federal sphere, reducing its dependence on Uncle Sam. At the end of 2016 the region had an unemployment rate below 4% and a reported 30,000 unfilled technology jobs. Our next challenge could very well be a labor shortage for these higher paying jobs.

While the action appears to be fast and furious at the White House, any changes to government priorities will take some time to have a broad effect on the local real estate market. In 1981 Ronald Reagan swept into office with a promise to rebuild our military. Legislation was quickly enacted, yet it took 18 months for the market to experience increased contractor demand for office space. In the meantime, we will be patient and try to determine the real estate winners and losers as this administration's policies and priorities continue to unfold.