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Working backwards: Dealing with unprecedented policy uncertainty

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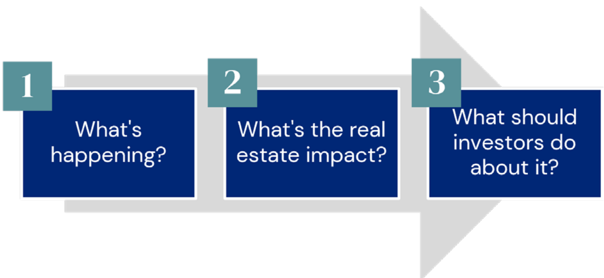
A reader waking up from a quarter-long slumber on April 1, 2025 would be forgiven for confusing the headlines for an April Fools' Day prank. They would scan the news and see stories about:

- large tariffs alternately announced, rescinded, delayed and reintroduced at a breakneck pace (see LaSalle Macro Quarterly, or *LMQ*, p. 4);
- US equities in correction territory as ex-US markets, including even China's, outperform (*LMQ* p. 25);
- increasing calls that the risk of a US recession is rising (*LMQ* p. 20); and
- substantial *upward* revisions in forecasts of long-term European GDP growth (*LMQ* p. 21).

Each of these is at least partly (and in some cases completely) contrary to expectations from the beginning of this year. But the quick reversal in the economic narrative is no April 1st joke. The post-election consensus of a supercharged US economy pulling ahead of the rest of the world has clearly been challenged, if not upended.

In this period of elevated policy uncertainty, real estate investors should focus on what they can and should do amidst all the noise. At the risk of stating the obvious, we think it helps to take a step back and break down the analysis into three basic steps of incorporating news flow into investment strategy — the what, the so what, and action steps. But as we will discuss, the first two are characterized by so much uncertainty that it is also helpful to start from the end and **work backwards**, asking: What can investors do to improve their chances of successfully navigating this environment regardless of what happens?



1. What's happening?

Normally, the "what" of political developments and other events is the easy part. But since the US presidential inauguration, the Trump administration has made policy announcements — especially regarding trade and federal employment — at a rapid pace. Some of these seem to have taken even insiders by surprise. Widespread post-election expectations that actual policy would be more measured than campaign-trail rhetoric have proven incorrect.[1] Reversals and postponements have also been a regular occurrence.

Adding to the news flow are announcements by other countries. These include the tit-for-tat of retaliatory tariff measures. But there have also been substantial structural shifts, most notably the German coalition agreement to spend more on infrastructure and defense. This news is arguably linked to a realization by European leaders that, given less collaboration with the US, Europe will have to forge its own path to generate economic growth and provide for its security.[2] Aside from the break that this represents from the post-World War II order, this change is significant because it is a key driver of higher economic growth expectations for Europe.

The result of all this is a "layering" of announcements that is difficult to digest at once (see our attempt at a timeline at *LMQ* p. 4). It is even more of a challenge to roll-forward the news into reasonable predictions for subsequent weeks, let alone months. As a result, measures of economic policy uncertainty have risen to levels close to historic highs (*LMQ* p. 5). Indeed, the implications of the many recent developments on the growth and inflation outlook include first-order effects such as the direct impacts of lower government spending on GDP and higher prices on tariffed goods (*LMQ* p. 7), but also the second-order effects of broadly elevated uncertainty.

Uncertainty is the enemy of investment decision-making. This applies both to financial investment as well as spending by businesses in plant, property, equipment and digital tools. Empirical research has shown a clear negative relationship between uncertainty and investment.[3] If businesses are unsure (as they are today) about the rules of the road — for example, around the basic terms of trade governing imports and exports — they may be hesitant to commit capital to long-horizon projects. At the same time, expectations of lower taxes and less regulation may push them back toward optimism.

Our analysis of recent events comes with a dose of humility. While LaSalle dedicates significant resources to tracking and analyzing the constant flow of indicators and news — as highlighted by the *LaSalle Macro Quarterly (LMQ)* — we do not purport to have a unique competitive advantage doing so. We would expect that our readers follow a range of news outlets, forecasters and other observers in staying abreast of the news flow and making sense of it.

[1] We made this mistake as well, saying that "legislative obstacles exist to enacting full campaign-trail rhetoric" in our November 11, 2024 ISA Briefing, "The 'Red Sweep' and real estate: has the outlook changed?".
[2] Source: Signum Global Advisors, Piper Sandler, Oxford Economics
[3] According to analysis by Piper Sandler, there is an inverse correlation of -42% between a sustained upward shift in policy uncertainty (as measured by the US Economic Policy Uncertainty Index) and GDP growth; a doubling of uncertainty over a quarter is consistent with -1.5% real GDP growth over the following year. For academic work on this relationship, see Baker, Bloom and Davis, 2016.

2. What's the real estate impact?

We do feel, by contrast, that our experience managing property and data from our portfolio puts us in a strong position to assess the likely impacts of policy developments on real estate. Even in the context of elevated overall uncertainty, we can make several observations with relative confidence.

First, we suspect that a key real estate impact of recent policy trends could be **higher replacement costs.** Tariffs on construction materials, such as steel, are likely to drive up their price. In addition, a lower level of migration into the US may reduce the supply of construction labor there. Increased European spending on infrastructure and defense could also contribute to higher global and regional materials costs. Higher replacement costs would mean that rents would have to rise more to justify new development, ultimately leading to higher net operating income (NOI) growth. This could counterbalance the impact of macro factors such as a potentially slower economy, as well as property type-specific impacts such as softer demand for housing in the context of muted household formation by immigrants. A simpler way to state this is that real estate can act as an inflation hedge.[4]

Second, we see value in undertaking **granular research to identify potential winners and losers** from the current policy environment. This approach can help investors identify real estate that is likely less exposed (or may even benefit from) current trends, while flagging potentially more-impacted market segments. Although the exact mix of government policies remains uncertain, the direction of travel is clear enough in some areas to make a few relative calls. For example, a move away from global free trade could weaken real estate demand related to import-export activities, for example in proximity to ports, while bolstering it in emerging near-shoring hubs.

These sorts of analyses can operate both at the national level, for example by identifying more and less trade-exposed countries (e.g., LMQ p. 9), and at the metro-area level, by examining city-level economic exposures (LMQ p. 10 and 11). One specific economic concentration worth mentioning is that of government employment in Washington, DC. Clearly, job cuts by the newly formed Department of Government Efficiency (DOGE)[5] are a risk, but there are mitigating factors such as mandated in-person work; we predict a net negative effect for DC real estate demand, but we have not yet seen much impact on the ground or in the data.

Finally, we note that **economic softness comes with mixed effects for real estate.** As a long-duration, interest rate-sensitive asset class, it is quite possible that a mild or moderate economic slowdown that leads to lower long interest rates could, in fact, be a positive for real estate values in the aggregate. That said, there are likely to be winners

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[4] For more discussion of real estate's role as an inflation hedge, see LaSalle's *ISA Portfolio View*.

[5] DOGE is seeking to quickly remodel the US government to be more effective at a lower cost. If successful, the project could contribute to the US economy's productive capacity by reducing the crowding-out effect of government spending on private sector activity. Inconveniently, the prospects for reducing government spending face many constraints, not least the fact that a very large proportion of US government spending is committed to entitlement programs like Social Security, Medicare and Medicaid, which most politicians have pledged not to touch. Moreover, in the short term, reduced government employment and lower outlays would directly reduce GDP. Sources: Piper Sandler, Signum Global Advisors

and losers, depending on the relative sensitivity of an asset's performance to interest rates versus sensitivity to economic growth.[6]

A bigger risk than a slowdown alone is that of stagflation: weak growth at the same time that sticky inflation keeps rates high. However, most economic research suggests that tariffs represent a one-time upward adjustment to the price level, rather than a driver of a sustained, self-reinforcing cycle of higher inflation;[7] as such, central bankers may be more willing to "look through" the impact of tariffs. So far, a recent softening in 10-year Treasury yields suggests that bond markets agree with that assessment (*LMQ* p. 26).

3. What should investors do about it?

All this points to avoiding excessive pessimism on the direction of values, while remaining cautious and selective. But being discriminating is not the only thing investors can do. We also advocate for turning the process of incorporating news flow into strategy on its head. Because we know so little about where the dust will settle on many of the policy shifts, let alone the impacts of those shifts, it is also prudent to "work backwards" from the implementation step. Some of the most prudent actions an investor can take do not depend on the specific geopolitical or policy debate of the week.

A key recommendation in this regard is to **build a globally diversified portfolio.** That the market narrative has shifted quickly from one of US dominance of global growth, to a more balanced view with Europe gathering pace, reinforces that countries' trajectories may exhibit lower correlations in a more fractured global economy. Rapid reversals of market narratives can generate significant market volatility, particularly when they are "priced to perfection" as the post-election optimism now appears to have been. Diversification should help to absorb that volatility, while avoiding being "left out" of unexpected positive shifts. A microcosm of this occurred recently in the public REIT market, where post-election euphoria led to what appeared to us a significant underpricing of European listed real estate.

Investors are also likely to benefit from diversification across the capital stack, which is why we recommend **a permanent allocation to real estate debt.** As we discussed in our *ISA Focus report*, "Investing in real estate debt," debt investment provides low-correlation returns that are by definition not sensitive to volatility contained entirely within the first-loss equity position. While the risk of a recession in the next year is debatable but possibly rising, the risk of an eventual recession is always 100% in the long

[6] In LaSalle's *ISA Outlook 2025*, we highlighted our Portfolio Balance framework, which describes real estate market segments according to their historical sensitivities to economic growth and interest rates. The framework segments markets and sectors into four categories: growth-led, rate-led, stable, and reactive. We found that while short-leased, economically sensitive sectors like hotels may see values soften in a recession, other sectors may actually see values benefit if interest rates soften enough.

[7] Source: Economic Policy Institute, Federal Reserve Bank of Boston, Piper Sandler

run. A debt allocation can help add stability and predictability to a portfolio's return regardless of the exact path the economy takes.

LOOKING AHEAD

- Investors should not get lost in the noise. Our view, expressed in the *ISA Outlook 2025*, is that we are at the "dawn of a new real estate cycle." This call is not dependent on a highly certain or favorable macro context, but rests on observations specific to real estate. These include pricing that has caught up with bond yields, valuations that have caught up with pricing, solid property fundamentals and substantially approved debt availability, among other factors. Neither a booming economy nor falling rates are necessary conditions for a revival in investment activity or the existence of attractive investment opportunities.

- There will likely be both winners and losers among specific real estate strategies. Granular analysis of risks and mitigants should inform revised assessments of relative value. To get these shifts right, investors must continue to ask: *What is priced in?* Overreactions are possible, which can create opportunities for investors to take advantage of volatility.

- Near-term uncertainty can distract from a longer-term picture that is arguably clearer. Over a horizon of years and decades, trends toward higher trade barriers and a more fragmented world seem likely to continue. Moving from a global economy where countries with a comparative advantage in producing a particular good do so and sell it to other countries, to one in which trade barriers create more siloed supply chains, would likely have complex effects. Classic economic theory suggests that transition could hinder productivity. But it could also spur real estate demand as productive capacity and inventories are un-pooled and duplicated. Correlations between real estate markets could also decrease. Investors should be ready to build portfolios with these dynamics in mind.

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