INSIGHTS MAGAZINE

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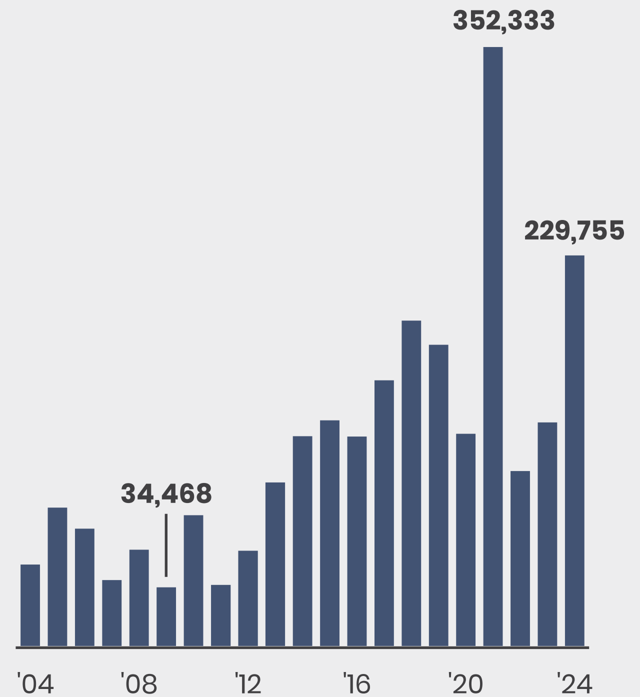
2024 Mid-Year Outlook

SAM TENENBAUM
Head of Multifamily Insights, Cushman & Wakefield



Source: CoStar, Cushman & Wakefield Research

DEMAND METRICS FOR MULTIFAMILY GENERATE BETTER THAN EXPECTED PERFORMANCE

While all eyes have focused on the strength of the supply pipeline in the multifamily sector, the demand side of the equation delivered a strong first half of the year, according to Sam Tenenbaum, head of multifamily insights for Cushman & Wakefield. Approximately 230,000 units were absorbed during the first half of 2024, which was 75% more than the first half of 2023. The second quarter saw the fourth most demand of any quarter since at least 2000.

"The multifamily sector is more resilient than people thought," Tenenbaum says. "There were more units delivered than absorbed in the first half, but robust demand has certainly surprised many. The vacancy rates anticipated last year haven't materialized thanks to that strong demand. In fact, vacancy rates fell 10 basis points during the first quarter of the year for the first time since 2021."

"We still need time to see whether we've reached the peak of vacancy rates," Tenenbaum says. "But even flat vacancy rates are a good sign given the amount of supply we're seeing."

In addition, rent growth has remained in positive territory for the first half of 2024 on a national basis.

"To get back to pre-pandemic sector performance, we need to see vacancy rates decline, rather than just flatten," Tenenbaums says. "Absorption rates have improved, but this is an early sign that we may have turned the corner."

Source: CoStar, Cushman & Wakefield Research

REGIONAL PATTERNS

The Midwest is clearly the outperformer so far in 2024.

"Investor attention shifted, especially during the pandemic (and before that as well), to the Sunbelt to follow population growth and Covid migration waves," Tenenbaum says. "Investors bypassed the Midwest, which really set that market up for outperformance for the next few years. They just don't have the supply that you see in other markets."

However, while the South has the most supply under construction, it also has the most demand.

"Last year, major markets in the Southern part of the U.S. added 811,000 people," Tenenbaum says. "The next fastest growing region in the country was the West, which added a little under 100,000 people. So, the South saw eight times more population growth in the cycle than any other region."

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Texas continues to see outsized population growth, with 34% of all population growth in major markets represented by Dallas and Houston alone.

DEVELOPMENT DYNAMICS

In any location, the decision to start new multifamily developments depends on a variety of factors, particularly interest rates and rent growth, Tenenbaum says.

"Rents need to be high enough to justify the construction costs," he says. "Construction costs haven't come down meaningfully and interest rates are still elevated, so construction is still challenging."

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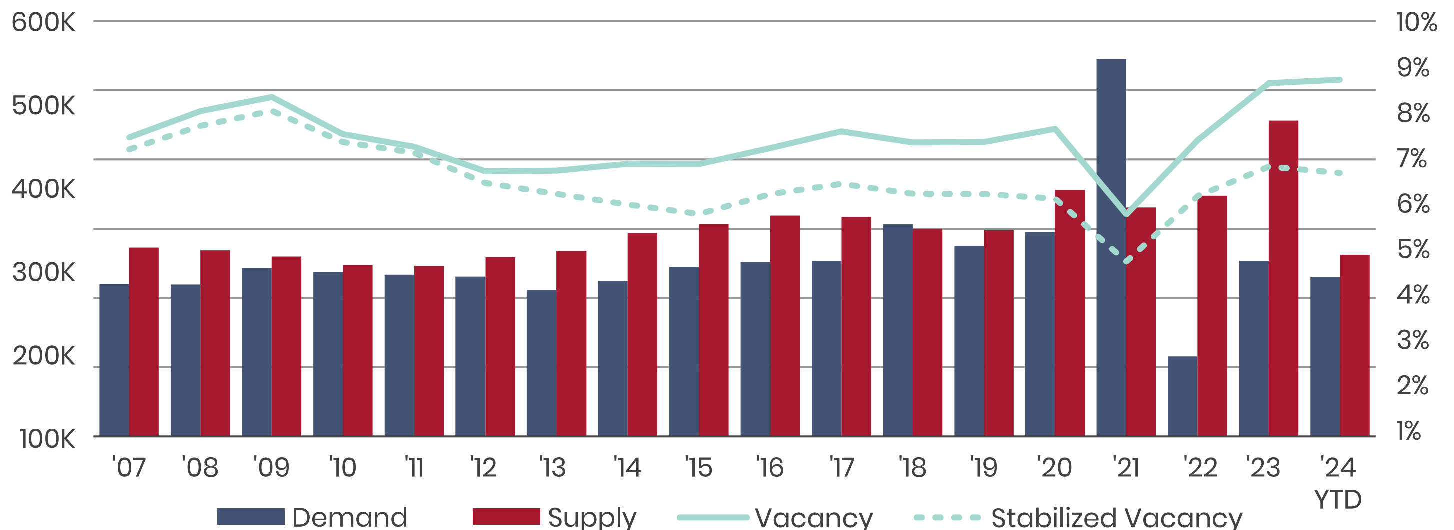
Multifamily starts declined 6.6% in May 2024 compared to May 2023 to an annualized pace of 295,000 units, the lowest pace for apartment construction since April 2020, according to the Census Bureau.

In 2023 construction starts were down about 35% compared to 2022.

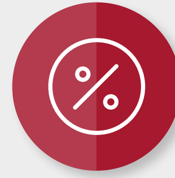
"We were building between 300,000 and 400,000 units annually from 2015 to 2020, so multifamily starts just under 300,000 units don't represent falling off a cliff," Tenenbaum says. "There are still units coming to market, but the influx to the pipeline is declining."

CONSTRUCTION LEVELS CONTINUE TO OUTPACE DEMAND



Source: CoStar, Cushman & Wakefield Research

KEY FACTORS TO WATCH



For the multifamily sector, labor markets and household formation are always important indicators for demand. In the current environment, interest rates are a prime factor to watch with implications for the supply side and the economy, Tenenbaum says.

"We've had solid job growth all year, including 1.3 million jobs added in the first half of the year, which is one of the reasons why we see really strong demand," Tenenbaum says. "Employers are still adding jobs and therefore people feel pretty good about their financial situation, enough that they feel good about creating new households to rent."

Consumer sentiment about the economy impacts demand.

"At the end of 2022, when every publication was predicting a recession, we saw demand really pull back in a meaningful way," Tenenbaum says. "The macroeconomic backdrop does matter. If people think there's a recession or think there's going to be a bad recession, they won't make big financial decisions which can delay household formations."

Given the amount of new supply coming online, the U.S. needs as much new household formation as it can get, he says.

OTHER FACTORS TO PAY ATTENTION TO INCLUDE:

- **Rent control measures.** As of 2022, 200 local governments have rent control measures in place, according to the National Apartment Association. More jurisdictions are considering rent control measures, although 33 states ban rent control on the local level. Regulatory changes can have a major impact on the ability of investors to finance, build, own and operate multifamily buildings.
- **Rising insurance costs.** Insurance costs for multifamily owners were up 30% in the first quarter of 2024 compared to the first quarter of 2023, Tenenbaum says. Insurance rates are highly localized, with bigger increases in places like South Florida compared to markets in the Midwest, for example. "Predictability of rates is important for modeling cash flow and for business plans," Tenenbaum. "The increase in insurance rates is related to natural disasters, but it's also a reflection of the increase in values that a lot of buildings saw over the course of the pandemic. Buildings that were valued substantially higher were theoretically underinsured relative to the cost to replace them."
- **Administration action on ancillary fees.** The Biden administration announced policies aimed at lowering fees for consumers or providing more transparency around costs for a variety of services, including airlines, hotels, credit cards and apartments. Depending on the outcome of legislation and election results, this may have an impact on owners' ability to offset rising expenses, Tenenbaum says.

SENIOR HOUSING FORECASTING

While estimates vary depending on the source, a recent study by Zillow found that the U.S. housing shortage grew to 4.5 million homes in 2022. The number of U.S. families increased by 1.8 million, while only 1.4 million housing units were built in 2022.

4.5M

2022 U.S. Housing Shortage

"We have a housing shortage in this country, so all housing is good housing," Tenenbaum says. "But the graying of America is not a secret. The oldest baby boomers are turning 78 this year and will soon be in their 80s and 90s when they may need more services and care. Their consumption patterns are going to shift fairly dramatically as well, which will change things for the housing market."

Demand for senior housing is anticipated to increase in the coming decade.

"Getting in front of this wave of need for various niches in the senior housing space such as independent living, memory care, assisted living and skilled nursing care is an important endeavor for investors today," Tenenbaum says. "The late 2020s will be the front of a wave of 80-plus renters. Even if you're a regular multifamily operator, you probably can't just walk into the senior housing space and deliver exactly what they need. There are different regulatory requirements in different states for it."

Growth in the senior housing sector is a longer-term trend that multifamily investors may want to follow. ■

HUD Launches Manufactured Housing Program

The U.S. Department of Housing and Urban Development (HUD) has launched a new Manufactured Home Community loan product, which will provide an FHA-insured financing option for the purchase, refinance, and revitalization of manufactured home communities. A vital source of affordable housing, manufactured housing communities may now garner more attention for preservation, stabilization and revitalization as housing costs rise to crisis levels.

"Manufactured home communities offer a stable and affordable housing option for many families. Today, HUD is providing new resources for preserving and revitalizing these communities by providing FHA-insured financing to mission-focused groups to buy or refinance and revitalize manufactured homes," said HUD Acting Secretary Adrianne Todman. "This is just one of many ways HUD is empowering residents, industry leaders, and governments to expand access to innovative, affordable housing solutions, particularly in rural communities."

Noting that this effort is intended to help avoid institutional investors from acquiring manufactured home communities, HUD is encouraging certain mission-focused entities such as resident-owned manufactured home communities, cooperatives, non-profit entities and consortia, state and local governments, community development financing institutions, and Indian Tribes, that are eligible to use this new program to finance the acquisition or improvement of existing communities, including making updates to common area resources and helping to maintain rent affordability.

"As manufactured housing owners want to exit from ownership, HUD acquisition financing could become very interesting for residents seeking to own the community cooperatively," said David Young, Managing Director at Greystone.

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DAVID YOUNG
Managind Director, Greystone

"Generally, resident-owned communities (ROC) financing has been done through smaller Community Development Financial Institutions Funds. Given that the program also allows for repairs to be financed, it could become as popular as when HUD allowed for refinancing and rehabilitation of the older Section 202 Supportive Housing for the Elderly."

HUD's Manufactured Home Communities program leverages FHA's Multifamily 223(f) program, providing permanent mortgage financing for these types of communities that may have previously been ineligible, and for previously ineligible manufactured home cooperative borrowers to be eligible to acquire and obtain financing for existing communities. ■

Learn more about the new Manufactured Home Communities program.

LEARN MORE

Q&A: Interest Rate Outlook

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Managing Director, Head of Agency CMBS Trading
Greystone

Q In early July, Citi Research analysts predicted interest rates will drop 200 basis points over the next 8 Fed meetings to 3.25-3.50%. How likely is this?

Citi's Research forecast for the Federal Reserve Bank (the Fed) to cut 2% off the overnight Fed Funds rate (that's eight quarter point cuts starting in September 2024 through to July 2025) seems not plausible unless the economy moves into a full-blown recession. First, the Fed's own Dot Plot from mid-June indicated rate cuts of only 1.25% drop by year-end 2025 - one quarter point cut by year-end 2024 and four cuts (1% lower) by year-end 2025. To be fair, the Fed's Dot Plot is just a straw poll of the 19 Fed officials at the time of the June FOMC meeting and typically changes over time with additional data on inflation and the economy. However, to buy into Citi's forecast of a 2% cut, pretty much everything has to go right with inflation and go wrong with the economy and the labor market.

The Fed has a dual mandate – (1) to keep prices stable (i.e., fight inflation) and (2) to keep employment high and the economy growing. For the past year, the Fed has maintained a 5.25% - 5.50% Fed Funds rate with the intent to reduce pressure on inflation by restricting economic activity. During this time, the unemployment rate was below 4% for most of the year (and at one point approached 3.5%, a near record low); the Fed had a clear path to focus on fighting inflation. Now with the unemployment rate at 4.1% (moving higher by 0.4% since January 2024; inflation versus a weaker labor market, the risks are more balanced. We are at a point where either further improvement on inflation or a weaking of the labor market could give the Fed sufficient reason to start to cut interest rates. However, for the Fed to move rates down by 2% over the next year would require inflation moving to 2% or below and/or for the unemployment rate and the economy to weaken further.

Fundamentally, a 3.25% - 3.50% Fed Funds rate would indicate an inflation rate sustained at 2.25% or below. In July, we received very good inflation prints for consumer prices (June CPI). Headline CPI for June printed at 3.0% for the year (versus last month's print at 3.3%); for the month, headline CPI actually printed negative -0.1%. Core CPI (without the more volatile food and energy prices) printed at +3.3% year-over-year (versus 3.4% as of last month); for the month, Core CPI printed at +0.1% (versus +0.2% last month).

If inflation continues to stay at these low levels, Citi's forecast is possible. But inflation likely reignites when the Fed starts to cut the Fed Funds rates. A more likely scenario is for inflation to remain sticky at 0.25% +/- monthly (3% +/- annually) which would limit the Fed's willingness to declare a full victory over inflation. The Fed may also start normalizing monetary policy (and lower rates) to address a weakening labor market. Here again, the Fed would need to determine that the economy is faltering to the point where a pivot to an easy monetary policy is needed. However, the economy seems to be moving towards a soft landing with only a marginal increase in the

unemployment rate and incremental decrease in production (GDP).

Q Which categories of goods and services would keep price inflation sticky at 3% or higher?

Inflation has been broad with different categories leading with higher prices on a month-to-month basis. Fundamentally, wage inflation is the key driver for inflation as labor costs are an input category for pretty much all goods and services. Wage inflation has been moderating but is still too high, running at +3.9% as measured by Average Hourly Earnings in the last US Employment Report (July 5th). The previous month Average Hourly Wages printed at 4.1% year-over-year. Wage inflation on a monthly basis printed at 0.3% for June (versus 0.4% for May). We've also seen inflation driven by supply disruptions; the transitory inflation brought on by the COVID pandemic is a case study for supply-driven inflation. With the disruption of the supply chains globally (and the war in Ukraine), inflation had soared to 9.1% in the summer 2022. Since then, as you know, inflation has moderated (the problem is however, "transitory" supply disruptions took close to 2 years to normalize as opposed to 2-3 months). With the May and June CPI inflation numbers, we seemed to have turned the corner on sticky inflation at 3%; we obviously need to see further follow through.

Q We're in the longest stretch of an inverted yield curve – since July 2022. What does this tell us today?

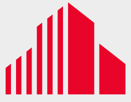
The inverted yield curve over the past two years is a result of the Federal Reserve Bank (the Fed) pursuing a restrictive monetary policy by raising the Fed Funds rates from near zero in early 2022 to a target range of 5.25% - 5.50% (as of July 2023) and keeping the rates high for about a year now. Yields on longer term bonds moved higher as well but remained lower than the short end of the yield curve, reflecting investor thinking that "expected inflation" will ultimately end up back at 3% or lower. In essence, the inverted yield curve was orchestrated by the Fed to lessen economic activity to relieve pressure on inflation.

Historically, an inverted yield curve presages an economic downturn by limiting activity in the parts of the economy that rely on financing – housing, autos, other durable goods. However, economic activity is somewhat path dependent; recall that this 2-year period of restrictive monetary policy and higher interest rates was preceded by a 2-year period of near-zero interest rates – also orchestrated by the Fed in 2020 and 2021 to support the economy during the Covid-19 pandemic. Homeowners were able to refinance at 3% or lower during the pandemic and have remained reluctant to put their properties on the market now (and pay off their 3% mortgages and only to go into a new mortgage at 7% or higher). The reduced supply of for-sale properties has pushed housing prices higher. Most all durable goods (including appliances, electronics and autos) had supply disruptions during the pandemic keeping retail prices high as well. Demand for labor hit historical highs during the pandemic and since then, the unemployment rate registered as low as 3.4% in January 2023, a near historic low. We are only now starting to see an impact of the higher rates on the economy:

- higher inventories in single family homes in many areas suggesting that housing prices are about to turn negative,
- the unemployment rate has moved up to 4.1% in June,
- inflation is moderating and the general economic activity is slowing as well.

Q Based on the current economic indicators, could the economy still be headed for a hard landing?

A hard landing, or severe recession, is unlikely based on the healthy consumer balance sheets and how resilient the economy has been. However, we will need to watch how the data unfolds; the early signs of a recession can look like a soft landing; in other words, it's a soft landing until it's not (and then it's a recession). There are a number of economic factors that could severely disrupt the economy (war, reduced crude/energy supply, global trade/politics, US government's fiscal and trade/tariff policies and/or the Fed keeping rates restrictive too long). From a Fed monetary policy perspective, expect the Fed to pivot and start to normalize interest rates if the economy starts to falter. ■



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