Freddie Mac MULTIFAMILY

2024 Midyear Multifamily Outlook

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Corey Aber [00:00:00] Sara, are we there yet? Sara? Are we there yet? Are we there yet?

Sara Hoffmann [00:00:04] Oh, are we going on a road trip this summer? Where are we heading?

Corey Aber [00:00:07] No, I just want to know: Have we turned the corner yet on the market?

Sara Hoffmann [00:00:11] Ah, I see what you're asking now. And it sounds like it's a great time to present our midyear outlook.

Corey Aber [00:00:16] That's right. Hello, and welcome to this episode of the Freddie Mac Multifamily podcast. I'm Corey Aber

Sara Hoffmann [00:00:27] And I'm Sara Hoffmann. Today on the show, we're going to talk about our 2024 midyear multifamily outlook. And joining us today is Mike Donnelly, part of the Multifamily Research team and author of the 2024 Midyear Outlook report. Mike, I hope you can help us understand a little bit more about what's happening in the market in the multifamily industry today, and hopefully you can help answer Corey's question so he can stop asking, are we there yet?

Corey Aber [00:00:53] Mike, thanks for being here today. I'm really excited to talk about the Outlook with you, but I do want to hear an answer to my question, though it might not be a quick one. Are we there yet?

Mike Donnelly [00:01:03] We're not quite there yet, Corey, but we're getting there soon.

Corey Aber [00:01:05] I guess that's encouraging. So, so so let's dig in a little bit. So, tell us about what you see going on in the economy overall. Let's start there.

Mike Donnelly [00:01:14] Sure. And thanks for having me on today. So, in 2023, economic growth was above long-term averages and above expectations. GDP [Gross Domestic Product] growth was nearly 3% and that is slowing in 2024 but still above the long-term average. Inflation has proven to be sticky in the 3 to 3.5% range, which is obviously higher than we'd all like. The federal funds rate has been stable at the 5% range for well over a year now. And interest rate cuts are a hot topic and there's a lack of consensus, and every time we get a new data point, the calculus changes.

Sara Hoffmann [00:01:50] All right. So, it sounds like we're not quite there yet on inflation. So, how's the labor market responding to this higher-for-longer environment?

Mike Donnelly [00:01:58] The labor market, which was red hot over the past 12 to 24 months, has started to cool. Job growth is moderating but is still strong by nearly any historic measure. So is wage growth, which is a key factor in taming inflation. We seem to be on track for that coveted soft landing though. We expect that the economy will moderate over the next year but continue to be positive. That said, the risk of a recession is still elevated.

Sara Hoffmann [00:02:21] So that's great to hear that we're still on track for that soft landing. But say, compared to six months ago when we last had this discussion, do you feel that we're still on that same exact track or has anything shifted?

Mike Donnelly [00:02:31] Things have shifted a little bit. Over the past six months, as I said, the overall economy has slowed. In 2023, we saw GDP growth of about 3% — that's really unsustainable in the long run. And as I said, the labor market especially is coming down, and that's probably the most impactful change that we've seen. Inflation continues to moderate: It's down to just above 3%, which is on track of the Fed's stated goal of 2%. But we're not quite there yet. We're certainly on a lower course, but I don't think it's something that we didn't anticipate happening six months ago. I think we're on the same trajectory — or I guess, the same flight path if you want to speak in aeronautical terms — for that soft landing.

Corey Aber [00:03:07] Right. So, Mike, that gives us some good overall context about the economy. But so now let's dig into the multifamily market itself. What are we seeing there?

Mike Donnelly [00:03:14] The multifamily market, despite the strong labor market — which is one of the key driving factors — is pretty flat over the past year. Rent growth is essentially zero; add up 20 basis points over the past year. Vacancies have crept up over the past year overall, but it flattened out recently. The main driver behind that is new supply. There are, in round numbers, 650,000 new units coming to the market this year. Some of those units may slip into 2025, but regardless, we're going to see the highest new supply probably since the mid-1980s this year. But that supply is not evenly distributed across the country. A majority of those new units are located in the Sun Belt and Mountain West regions.

Sara Hoffmann [00:03:52] Well, that supply number can definitely turn some heads there. That's kind of the highest we've seen in a couple of decades. What do we see on the demand side? Has it been keeping up or falling short?

Mike Donnelly [00:04:01] Demand has been on a roller coaster, but over the last four quarters it has been above average. There's some seasonality to demand, and typically the first and fourth quarters are the lowest. Yet over the past year, demand has been highest in the first and the fourth quarters. We're running about three times higher than typical demand during those periods. I should also say that demand is also highest in the Sun Belt and Mountain West regions, so the areas that are seeing a lot of supply are also seeing the most demand.

Corey Aber [00:04:25] So Mike, this is an interesting thing that we're seeing going on over time, right. Because you talked about wage growth, you talked about that has been kind of up recently, right. And we talked about rent growth being relatively flat now. So, one of the long-term stories we've talked about over the last decade or so is rent growth outpacing wage growth. But it sounds like things may be flipping a little bit.

Mike Donnelly [00:04:48] A little bit, and there's some nuance to it too. So, since early 2020, when COVID[-19] hit, rent growth spiked in 2021 and into 2022, but has moderated in 2023 and has been essentially flat. As we talk about over that four-year period, rent growth is just under 20% at 19.6[%]. The other half of the affordability equation is wage growth, which totaled just over 22% over that same four-year period. And so, for a while, in the middle of 2021 and into 2022, wage growth was lacking, or not keeping up with market-rate rent growth. However, given the flatness in rents over the past 12 months and the continued wage growth, which ended the first quarter of the year at almost 5%, wage growth has outpaced rent by a little bit since the outbreak of the pandemic.

Corey Aber [00:05:34] Yeah, so just looking at the numbers over that period, right, as you said right now, maybe, maybe things look like wage growth is a little bit over rent growth. One might draw the conclusion that like we've turned a corner there, and maybe just looking at the top-level numbers, things look maybe

kind of good. But this feels like it's one of those cases of my favorite paradox of all time, Simpson's paradox — which I've said so much, we just need to rename it Corey's paradox or Aber's paradox, which ever one sticks — is this a case of that?

Mike Donnelly [00:06:00] I think we should just go with the full Corey Aber's paradox. I believe this is probably another case of Corey Aber's paradox. Well, the numbers look promising with headline rent growth of 20 basis points. When we break down those headline numbers, you see some different trends emerge. Rent growth of just 20 basis points over the past year's low. But there is a renewal rate that's more relevant to most renters because more than half of renters typically renew their leases, and those rates are much higher than the new unit rates. Those are typically in the 3 to 4% range, and coming off of Covid, they're still probably elevated compared to historic levels.

Sara Hoffmann [00:06:33] So it's really interesting point, Mike, about the new lease rate and the renewal rate, because that's where we do see some of those affordability challenges that you might not see on the headline numbers really impact the renters there that typically stay, but they're still seeing decent rent growth increases. Meanwhile, you've seen these headline numbers of pretty low rent growth nationwide. I think it's also interesting if you kind of then also splice it out on the income distribution side. Inflation definitely hits income distribution very differently. The wage growth is very different across. So, while again we're seeing all these headline numbers, back to the Corey Aber's paradox, once you break it out into these different segments of the population and the incomes and just where you're renting and what type of building you're renting, in the story is going to feel very different.

Corey Aber [00:07:19] Now thanks, and thanks for continuing to use Corey Aber's paradox. I wonder if this will ever make it into a textbook. I'm going to guess no. But there, there is another part of the equation because we talk about the rental housing market a lot, but that is also affected by the for-sale housing market. So, what are we seeing there?

Mike Donnelly [00:07:33] Yeah, Corey, that's a good point. And that's a good way to think about it. The other half of the housing equation is the for-sale housing market. And while rents have gone up significantly over the past four years like we said, about 20%, the for-sale housing market has seen monthly costs skyrocket over that same period. Over the prior four years, the monthly principal & interest payments have essentially doubled. They've gone from roughly $1,000 a month to over $2,000 a month, and that doesn't even include the increase in down payment, the increase in cost of insurance, the increase in costs of maintenance, and all the other things that inflation has influenced over the past four years as well. And the other thing to think about when we talk about the for-sale housing market is wage growth, which is only at 22% compared with the doubling of monthly home costs. So, affordability for the for-sale housing market is much more strained than the rental market, although both are a problem.

Sara Hoffmann [00:08:23] So it's really interesting because when we look back to 2020 at those numbers, the monthly PMI [Private Mortgage Insurance] for ownership was less than the monthly rent on the multifamily side, at least on average the nationwide. But obviously it's going to be very different in different markets. But now that the for-sale cost is more than doubled and that has actually put renting is more affordable compared to ownership, especially in some of these secondary, tertiary cities that typically were more known to be affordable housing options. So, I think that's really interesting, not to quote back to the paradox, but that now we're even seeing it across different household types, where you're really seeing the impact of affordability, where people are priced out of ownership and then into rentals, which typically weren't as expensive four years ago.

But that kind of leads me to my next question. We're thinking about different markets, and especially those that were historically a little bit more affordable compared to the gateway, primary markets. What are we seeing? Any impacts on the multifamily side or overall housing affordability in some of those less expensive secondary, tertiary markets?

Mike Donnelly [00:09:31] So as we've been discussing for a while, supply is one of the main drivers for rent growth and occupancy, for that matter. Supply is concentrated in the Sun Belt. We're seeing it particularly in the southeast, Nashville, [Tennessee]; Texas; Florida; to a little bit of a lesser extent out west in Phoenix, Colorado and Utah. But these trends are pretty consistent, and they've been maintained for a couple of years now. Well, it's not universal — markets that are seeing high supply are generally seeing rent growth below average rates or even negative. Think of areas like Austin; Orlando; Jacksonville, Florida; and Nashville.

Corey Aber [00:10:00] So what about, what are we seeing in the lower supply areas or the markets that are not seeing that influx of supply?

Mike Donnelly [00:10:06] So we're seeing less supply in the Northeast and the Midwest. And those areas of the country are generally seeing the most rent growth. Broadly speaking, these have more modest levels of new supply and are also smaller, less expensive markets and seem to be seeing higher rent growth within those broad geographies. The upstate New York market: Syracuse, Rochester and Buffalo are all seeing high rent growth, to call out just a few. The West Coast markets are also seeing lower rent growth, but that is due to the area's overall higher costs and outmigration trends.

Corey Aber [00:10:33] So, Mike, so that's what we've seen. Do we expect those trends to continue?

Mike Donnelly [00:10:38] Generally speaking, our top 10 markets are secondary and tertiary markets located in the Midwest or South where they are less expensive alternatives to more expensive markets. Talking about markets like Oklahoma City; Tulsa, [Oklahoma]; Little Rock[, Arkansas] — they're near North Texas and are a less expensive alternative than Dallas. Other areas that we think will see above-average rent growth are West Palm Beach, [Florida]; New Orleans; and a few in the Northeast like Hartford, [Connecticut] and then out west in California, Riverside.

Sara Hoffmann [00:11:05] All right. So that's kind of similar to what we've heard before with those secondary and tertiary markets kind of making their way up in the top 10 along with being in the Midwest. But what about the other side, the bottom 10. Are we seeing any new trends emerge there?

Mike Donnelly [00:11:19] So our bottom 10 markets are generally either facing high levels of new supply or have little demand. The bottom three markets are Austin, [Texas]; Raleigh, [North Carolina]; Durham [, North Carolina] and Nashville, which are facing high new supply. Other areas are those kind of expensive markets in the Northeast that we talked about. That would be [Washington,] D.C., Philadelphia and the outer suburbs of New York City.

Corey Aber [00:11:37] So, Mike, it's interesting when when we look at the top 10 and bottom 10 and where we think there's going to be rent growth levels over time in the future. Some of these are markets that are just not accustomed to seeing much rent growth. And that feels like maybe the new story over the past couple of years. You talk about Oklahoma City, for example, Little Rock, like these are markets that historically have not seen a whole lot of rent growth in the way that people are accustomed to thinking of, like New York or some of the California cities being historically expensive. So, it makes sense that people are having a different experience on the ground in some of these markets.

Sara Hoffmann [00:12:14] So, Mike, let's turn to the debt market. Let's discuss a little bit how that's been faring over the past six months as interest rates have remained high and volatile, especially with cap rates and property valuations. It's been a really tricky one to get our heads around, especially with Corey's intro question of asking if we're there yet. I feel like sometimes we're in two different types of markets when we talk about, say, the debt market and interest rates versus the economic strength. So, while we know that we're kind of still at a standstill for higher-for-longer interest rates, and we see the economic news is softening but still remains pretty strong. How is that impacting the multifamily debt market side?

Mike Donnelly [00:12:50] So we're still waiting for those. Ten-year Treasury rates remain elevated well above 4%, and probably more crucially, they're still volatile, which is making multifamily deals hard to get done. The cap rate is up 100 basis points over the year, but it's been relatively flat recently. The cap rate spread is not at its historic low, but it's not far off it and is less than half the historic average. So, the risk premium for multifamily is extremely low right now compared to the risk-free rate of the 10-year Treasury. That's led to property prices falling overall and are now down about 20% since the peak in mid-2022 and have been down about 9% over the past year.

Corey Aber [00:13:28] And that seems to be one of the bigger stories of what's going on this year and what's been going on over the past few months. Do we expect to see that change any time soon, or does it feel like that's going to continue?

Mike Donnelly [00:13:37] Yeah, it seems like there's some indications that property values are stabilizing. There was a third-party cap rate survey recently released that showed they were stable, and there have been some transactions as well by large private equity firms that indicate property prices may have bottomed out.

Sara Hoffmann [00:13:52] So, Corey, maybe to that point, if we're kind of seeing those signals of property prices leveling off and cap rates hitting their peak, maybe that's the corner you've been asking about or looking for, and maybe we're finally getting there, but it'll be an interesting second half to the year to see how some of these things play out.

Corey Aber [00:14:08] Yeah, we'll certainly have to check in on that at the next outlook coming out in the beginning of 2025.

Sara Hoffmann [00:14:13] Maybe we'll finally reach that soft landing we've been waiting for. Or maybe we don't have to mention Simpson’s or Corey Aber's paradox as much.

Corey Aber [00:14:21] We can never not mention Corey Aber's paradox, but we can certainly drop Simpson's paradox. Mike, thanks so much for being with us today to talk about the Outlook.

Mike Donnelly [00:14:28] Happy to be here, Corey.

Corey Aber [00:14:30] The Freddie Mac Multifamily podcast is produced and supported by a team of our Freddie Mac colleagues, including our production lead, Jenny Nguyen, and our audio producer, Jackson Carmichael. To listen to more and keep up with the latest episodes, be sure to subscribe wherever you get your podcasts and check out our website mf.freddiemac.com/research for the full catalog of podcast episodes and original Freddie Mac research.