2023 Multifamily Outlook

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Corey Aber [00:00:00] So this year has been a really interesting year from a market perspective. A lot of change. A lot of change has been going on relative to interest rates, stock market, the economy more generally. But we're coming to the end of the year and it's time to look ahead a little bit. So, Steve, what are you seeing for 2023?

Steve Guggenmos [00:00:18] Yeah. You know, this makes me think of an analogy that we use in the industry to talk about where we're at and we talk about a baseball analogy as to what inning we're in, and that kind of relates to our economic cycle and business model.

Corey Aber [00:00:34] All right. So what inning are we in right now then?

Steve Guggenmos [00:00:36] Oh, yeah. I haven't even answered the question yet. You know, I like to expand on the analogy and consider what's happening inside each inning. Starting in the latter half of 2020 and throughout 2021 and into 2022, we were in a big inning. I think the multifamily market hit around and a bunch of extra base hits, probably even a grand slam. Vacancies were at an all-time low, rents were growing at a record pace and property prices way up, too. That was a really good inning.

Corey Aber [00:01:06] All right. So what happens in the next inning?

Steve Guggenmos [00:01:09] Yeah, you're right. With rates up and expectations for a recession, the other team definitely brought in a relief pitcher. But, you know, given our lineup or relative position of multifamily in the market overall, I think we're still in a position to knock out some singles and doubles and score some runs. I think the game is still going.

Corey Aber [00:01:33] Hello and welcome to this episode of the Freddie Mac Multifamily Podcast. I'm Corey Aber.

Steve Guggenmos [00:01:38] And I'm Steve Guggenmos. Today we're going to talk about multifamily market conditions, and we are fortunate to be joined by my colleague in Multifamily Research, Sara Hoffmann. Sara leads the research team that produces a wide range of research covering multifamily markets, including the yearly outlook that comes out at the beginning of each year. Today, she's going to share with us key findings that we have for 2023. Thanks for joining us, Sara.

Sara Hoffmann [00:02:03] Thanks for having me.

Steve Guggenmos [00:02:04] Absolutely. So, you know, we talked about this, you know, about six months ago and talked about some of these changes in the market. But, you know, given what we've learned since then, you know, what's changed and what are you seeing now?

Sara Hoffmann [00:02:18] And it's a very interesting time and a lot to consider as we kind of put our thoughts together for this next year in 2023. But yeah, maybe let's start with kind of where we came from six months ago. You know, back in June of 2022, we were cautiously optimistic. We knew that the robust growth seen in the multifamily market wasn't sustainable for the long haul and actually welcomed some sign of moderation. The idea that the higher up you go, the further you have to fall. So if things just kind of kept going at that trajectory, that would be much worse in the sustainability factor. So seeing things kind of come back down to a more sustainable level was actually a relief, I think, for many of us. But with the increased concerns of a recession later this year or into next, that kind of kept us a little bit on our toes, just kind of keep an eye on some of those signs. And as of right now, the recession is still a high potential, but our current trajectory kind of sees us going into 2023 with slowing growth, but not quite hitting the recession level. It is possible, but not kind of in our baseline expectations. So the moderation in the multifamily market has started to take shape. We're kind of saying that we're at an inflection point now at the end of 2022 as we head into 2023. Demand is slowing, although that is across all housing types, including single family. So this is related more to uncertainty in the economy. People are less likely to form new households, giving all the economic volatility we're seeing among high inflation rollercoaster, the stock market, lower consumer confidence, it's all kind of just halting demand right now for household formation. So that inflection point for multifamily we're seeing in terms of rent growth slowing and vacancy rates starting to go up. Now, this does line up with the typical seasonality patterns that we see in the market. But given where the overall economy is, we do expect that the typical seasonality with slowing rent growth into the winter months may be a little more enhanced this go around, given where the economy is and how the Fed is trying to continue to kind of halt and put the brakes on on the growing economy.

Corey Aber [00:04:37] Sara, it certainly feels like, you know, from the numbers, other things we're hearing in the market, it feels like it's not just seasonality and with a lot of things going on here. So let's look at that a little bit more deeply with some of the trends that you're seeing in the market.

Sara Hoffmann [00:04:53] Yeah, exactly. So maybe a good step back is kind of what growth we saw over the past 18 months with rent growth in 2021 up about 12% to even 15%. That carried through into 2022 with really strong, un-seasonality strong, rent growth in the first quarter brought on by really strong demand. But that demand did start to turn kind of starting in the second quarter and third quarter. And as a result, that would bring occupancy rates down quite a bit and then rent growth expected to follow. So if you're not going to really see strong demand, then you kind of have to give some pricing break a little bit more there. And as we go into the winter months, the labor market still remains relatively strong. And that's kind of one of our shining lights for the multifamily performance. As long as jobs keep forming, then household formation will come. But with the Fed really trying to slow down inflation by raising the fed funds rate, we are seeing the trend of employment start to slow over the past few months — still positive and still above the pre-recession monthly growth rates — but if that does kind of start to falter, that's where we would really kind of be more concerned of a greater hit to the multifamily industry.

Corey Aber [00:06:20] Now, are there parts of the country or some markets in the country that are experiencing this shift a little bit differently?

Sara Hoffmann [00:06:28] With the slowdown, we're definitely seeing those that had the greater increase throughout 2021 and into 2022 kind of cool faster. Now, that doesn't mean they're dropping from a cliff and, you know, losing all of the gain they had in the past 18 months. But the Phoenix, the Las Vegas — those kind of Southwestern markets that during the pandemic maybe saw a big inflow of migration from people from the more expensive coastal gateway cities moving into lesser, expensive, warmer areas — those areas saw really strong growth during the past 18 months and now we're seeing them cool faster. I think what's interesting, though, is, you know, for those areas, specifically kind of mentioned Phoenix and Las Vegas, they come off of our when we say our top 10 list for next year, when we look at gross income growth for 2023, but they're not in the bottom 10 list. So they're kind of more towards that middle of the pack. So, you know, that's where they're cooling and they, you know, when you kind of see that rate of change over the year, that looks like a bigger Delta, knowing that they had some of the top performance in the past couple of quarters and now they're kind of cooling back down. But expectations are that they're going to be kind of more in line with kind of national average, not stand out, but not fall way behind.

Steve Guggenmos [00:07:52] Yeah. And I think that that can be consistent with the story of we kinda continue to plug along through these difficulties and/or in changing economic conditions. One of the big pieces of change I know that we've talked about is, is how much interest rates have moved. And I know that affects, you know, us and the broader market. But as you look at that kind of circling back to the overall market, how have you seen kind of the interest rates affect the housing market?

Sara Hoffmann [00:08:26] So the interest rates really come into play, I think, let's talk about single-family market. So the higher interest rates on, up until recently, higher median home prices have priced the single-family market up almost 90% since the start of the pandemic. So that kind of takes into a measurement of the monthly P&I (Principal & Interest) on a median home price with the going mortgage rate increased almost doubled since the start of the pandemic. So interest rates really play through in those higher mortgage rates. The demand that we saw coming out of the pandemic that increased home prices also played into that. And what we think about that in terms of multifamily is not that that's a creator of demand for multifamily because you know, kind of people think you're either in single family or multifamily, but we kind of see it more as a prolongation of multifamily demand. So people are less likely to be able to afford the single-family home so they'll stay renters longer. Now, that can have that kind of snowball effect that if they're not moving out of units, then new people can't move into those units and form the households. We're not really seeing that. That would be, you know, really evident with really if vacancy rates remain tight. But we are starting to see those loosen up a bit. They're still tight relative to historical standards, but the expectation, they will kind of loosen up. So that's where I go back to household formation has been stalling, you know, slowing down quite a bit and higher interest rates are really kind of seen through the higher cost of ownership, which has outpaced even the really strong rent growth gains that we've seen in the past 18 months.

Corey Aber [00:10:11] Sara, a lot of what you just talked about is pretty interesting because at first, you know, you were mentioning a little bit on the multifamily side, right? Vacancy rates going up a little bit, maybe a little bit of moderation on the multifamily side, but then also we have this pressure on the single-family side, which sounds like it would in some ways, in quotes, help a little bit on the multifamily side keep demand in place there. So as you look at vacancy rates may have gone up a little bit, do you see that as a trend going forward or is that sort of offset a little bit by what's going on in the single-family market with the rising rates and rising cost?

Sara Hoffmann [00:10:57] So the trend for next year with vacancy rates are to continue to go up. And that speaks more to the slowdown in formation of households versus single family, kind of the spillover effect of, say, single-family would be owners not kind of making that move because it also, it really does impact different segments of the rental market. We usually kind of peg those would-be owners on the higher side of the income distribution. And to go a little bit more into detail on those, those are the ones that, you know, wouldn't be as impacted by inflation, possibly seeing higher wage growth, you know, all those things aren't evenly distributed across the income spectrum. We expect those at the higher end to probably benefit a bit more, just in the sense that inflation wouldn't be as drastic to them and potential for higher-wage growth that we're all seeing across the economy. Those renters are typically then in the higher-cost rentals based on incomes. And that's where we're seeing a lot of that income growth is in those new lease signings, newly signings coming, rent growth up much higher than the renewals. So it's not quite an evenly distributed across the whole spectrum, so we do kind of see that there and that's going to be than typically what you would think would be the potential that they could afford to own but choose to rent instead. And so there could be a little bit of a skew that if they're kind of driving up that segment of the rental market compared to kind of what we say is the more affordable or the lower income. You know, all rent rates over the past 18 months have really kind of seen that increase and it's a little bit more pronounced in some of those, you know, we call it kind of discretionary or top-end property classes, but it is kind of felt across everywhere. So kind of, as you said, the single-family market, if people are not able to enter that, we think that will kind of impact that one side of the rental market. But, you know, across the spectrum, with wages going up and rent growth going up, we would hope that kind of helps affordability rise, you know, rise in tandem. But that's not always the case, so we do see that, you know, affordability continues to be squished at that lower end. To bring that back to your question, Corey, which was a long-winded way of trying to describe the demand side of the equation, there's another big key component, and that's the supply side, and that's what we'll be seeing over the next couple of years is just the high level of new supply, a lot of new units under construction, and they're going to be delivered throughout 2023 and 2024, which is definitely gonna also have an impact when we kind of think of those long term vacancy trends.

Steve Guggenmos [00:13:52] So I think what you just discussed reminds me of some of the work that you've recently done on cost of ownership versus cost of rental. And I know that the interest rates have hit both of us, but certainly you've talked about the increase of payments. And so I think that for people that have previously been sitting on the fence and hoping to buy, it's probably a little bit more distant. But can you tell us a little bit about that analysis?

Sara Hoffmann [00:14:18] Correct. Yeah. So we actually brought up this analysis from an outlook we had done three-ish years ago that looked at how the cost to own versus the cost to rent has changed over time. This is a little different than kind of that calculation of the monthly P&I. We tried to include more ownership costs, such as real estate taxes or insurance, so it follows kind of that overall monthly P&I growth, but a little bit more nuanced. And what we saw in 2021 and 2022 is just that the cost to own outpaced the cost to rent nearly three and a half times. So even with the really strong growth and rent growth, the cost to own just shot up so much more. Year to date in 2022, cost to own is up over 40%, whereas the cost to rent year to date is just above 7%. Now, it is interesting that that, all that growth was in the first two quarters, the third quarter for the cost to own has actually been flat. So that's where we see, we’re actually starting to see some of that break in the home prices, they've come down slightly in the third quarter. But that being said, interest rates are still up given the rising fed funds rate. Now, kind of thinking historically, then we look back in this analysis and we do see kind of the time period of 2014 to 2017, a little bit more of an equilibrium between those two costs. So that's when rent growth and the cost to own, not every year but on average kind of grew in tandem, so they kind of kept the same rate of growth, you know they might have different starting points, but kind of that same rate of growth was kind of seen during those 3 to 4 years, just given kind of where the economy was. And so that's kind of what we think of a little bit of like, you know, if you have to kind of point back to a time of equilibrium when things are kind of moving together, we kind of see that and that growth, you know, kind of averaged around, you know, the 3% to 5% a few years, a little lower. But we kind of saw that that was a time period where both growth rates grew at the same time.

Corey Aber [00:16:39] It's interesting looking at that and thinking about affordability and you mentioned wage growth earlier. And that that brings in also, I think, questions of inflation and I was just, you know, shopping, grocery shopping for the family the other day and noticed the price of the rotisserie chicken, which never goes up, was up dramatically at the grocery store I go to. So that surprised me. But like tying all those things together here, like what are we, what are we seeing? Is there sufficient wage growth to offset some of the rent growth, cost of ownership, that things may become, if not more relatively affordable over time, maybe a little bit better?

Sara Hoffmann [00:17:22] So there's definitely going to be a squeeze on affordability. But going forward, this moderation slowdown in rent growth should kind of help that and it's you know when you say inflation, wage growth, rent growth, when you try to line them all up, it comes down to kind of a timing issue because they do play into one another but have separate lag factors. Rent growth is a big component of the inflation, it's part of the overall shelter costs or housing cost. So it's a pretty large driver of inflation, but it's also known to be lagged. So that means it will take longer for this moderation in rent growth to show up there. And along with wage growth, you know, there is no concern right now necessarily a wage inflation rent growth spiral given that one, rents are starting to moderate, so we see that coming down. Wages typically follow inflation, so you'll see inflation going up, then wages kind of catch up. We start to get a little bit of good news at the end of 2022 with inflation still elevated but not going up higher and actually starting to tick down a little bit, and then you expect wages to kind of follow that. So as of right now, we're still kind of in that pattern, but kind of thinking of it all in one snapshot at one point, they definitely do kind of seem like they might not exactly line up and be off a little bit. And it all comes down to, like you said, what the consumer's feeling. And I think that's really evident in kind of a consumer confidence indexes there. I think back in June, they were at the lowest levels that the some of the surveys had had seen. They're still low, but we haven't hit a new low so that they're kind of still bouncing around kind of that low level. So I think that does kind of come into play when you kind of think of like how the consumer seeing it, what they're feeling, while all these numbers might end up being delayed and lagged, how they come in, it really does show that the consumers are feeling it and those and that kind of feeds into then those concerns that, you know, we're moving to a recessionary period. You know, consumers have less confident, less spending in the economy.

Corey Aber [00:20:52] Thank you, Sara. That's such a fantastic explanation. I wonder, can we just, as an aside, can you explain the price of rotisserie chicken to me?

Sara Hoffmann [00:21:01] You know, I'll have to go in and get that. We'll include that in our chart of breakout of inflationary. We got food, we've got housing, we've got energy. We'll put rotisserie chicken in there now.

Corey Aber [00:21:11] It deserves its own category, the loss leaders. Thank you so much again for that. You know, we've covered a lot of ground on some of these background, some of these contributing factors. And maybe it's time to look at some of the markets where we see some slowing, but also some of those markets that still look like they're going pretty strong.

Sara Hoffmann [00:21:38] Yeah. I know when we talked in June, we were kind of excited about Albuquerque. So kind of when we look at our top markets for 2023 — don't worry, Bugs Bunny fans. Albuquerque is still in the list — but in general, what we are seeing are Florida and kind of smaller Southwest markets. So as I previously mentioned, areas like Phoenix and Las Vegas are starting to see that slowdown. They're not completely flipping, you know, we don't see anywhere that's expected negative gross income growth in 2023. So everything, you know, right now seeing positive. Among the top metros they do have a lot of similar drivers. Vacancy rates, although expected to go up across the majority of all the metros that we track, are still relatively low compared to their historical averages and maybe not quite as much of an increase as some areas are expecting. And that's a driver because of the new supply in those areas might not be quite as high as some other areas when you put in perspective to what they're historically used to in terms of multifamily starts going on there. And that coupled with kind of the demand side and employment growth in some of these areas, you know, such as Florida markets and the smaller southwest areas of Oklahoma or Albuquerque, expected to still see decent job growth next year, slightly above the national average. On the flip side, some of those bottom 10 markets that we're keeping an eye on, their stories kind of play out, you know, kind of in the opposite of the top 10. A lot of new supply expected to come on to these areas. The Washington, D.C., especially the core area, Nashville, Austin, Philadelphia: All these areas are seeing a lot of run up in supply, expected to come through, you know, next year and into the years after. Some of those areas, like Austin especially, are still expected to see decent rent growth. But with the new supply, vacancy rates are expected to go up. And then we kind of think of that vacancy rate compared to its historical average. And the greater that that gap is, the expectation of like the less pricing power. So if you're operating at historically low vacancy rates, expect a little more pricing power. But once you're kind of well above that and there's a lot of vacant units, especially for kind of how the market has historically performed, that's where we expect to kind of lose some of that pricing power. So that will come through and lower gross income growth, giving a big rise in vacancy rates, although kind of the actual rent growth numbers for some of those popular high growth and in population or employment such as Austin or Nashville might be a little bit higher than the gross income growth.

Steve Guggenmos [00:24:38] Yeah. And I think, you know, during these times where so many things are changing, as you say, I think it's, there's some reassuring things about how the models suggest, you know, there's some at the high end, some at the low end, but they're largely hanging in there. And so, you know, as I think about it, there might be some noise as markets adjust and things might be a little bit more volatile than usual. But the great thing is whether, you know, we look at it with our approach or other people are taking a look at forecasting, I think that they're saying that the underlying drivers in the economy, where they stand now, are pointing to continued growth. So, um, so even through noise, we can kind of have some confidence in that. But speaking of areas that might have some noise, and it can also be hard to predict and understand, you know, cap rates and property prices in multifamily space, so it might be a good time to speak about that a little bit.

Sara Hoffmann [00:25:35] Yep, that one's a real tricky one, especially when you compare this back to June. We would have expected by year-end that we would have some more information on how cap rates have been adjusted to the prolonged higher interest rates, but it's still, it's still kind of up in the air. Now, with interest rates continuing to increase over the year and quite volatile, too, with jumps up and down with weekly movements, it's taken a long time for this price discovery to play out in the cap rate and the multifamily valuation space. But, so while some of the data might not actually show the cap rates, the word that we're hearing on the street with deals being done is that cap rates are up and this will put downward pressure on property valuations. And especially, you know, we kind of took a look at some of the individual markets and we can definitely see a little bit of that increase in some of those markets that we had previously mentioned, such as Phoenix, along with like Charlotte and Atlanta. We did kind of start seeing reported cap rates go up over the past quarter, over the year, kind of back to what we mentioned, things just get lagged and it does take a while. We're kind of used to this, get information right away, you know, current technology. But some of these things still take a little while to get caught up in the numbers and in the reports. But with where rates are, cap rate spreads are very compressed, which would lead to cap rates rising in the near term.

Steve Guggenmos [00:27:12] Yep. And certainly I think sometimes directionally you've got some things moving in one direction, some things moving in another direction, here are certainly upward pressure on the risk free rate has been pushed way up and the expectation that spreads would move up as well certainly kind of feeds into that. But then there's the investor demand has kind of held in there for multifamily, which is, suggests I guess a little bit about that slower move and the cap rate spread up, which also then suggests that there's some activity in the debt markets as well, which I know that we're always thinking about the, how much business that is to be done out there in the multifamily space. So how does all this flow through into expectations for originations?

Sara Hoffmann [00:28:02] Yeah, I think that's a really good point. Also with what I forgot to bring up before I get into our volume expectations is that right now with rents and vacancies holding in there, the lag in seeing any cap rate movement come through is because people aren't necessarily motivated to sell right now. You know, if they're making their debt cover and the property's performing, if valuations take a hit, that they're not quite as motivated to sell, which has kind of kept cap rates a little bit more stagnant longer than probably expectations given the sharp rise in Treasury rates. But that being said, how that plays through to the volume market, you know, we do see that things are slowing down given that people aren't necessarily in the motivations to do transactions, definitely saw that slowing and expected to be down this year compared to last year in total origination volumes by about five-and-a-half percent around 460 billion. Going through into next year, we really do see that with rates still not kind of settled with the Fed still targeting to raise the rates until inflation really starts coming down, we can expect higher rates prolonged. And until we really get a settled time period that price discovery can take hold, you know, we do expect that the market in terms of origination might be a bit slower in the first part of the year. Our expectations are that growth will return in 2023 after kind of a slower winter and into spring. You know, this is backed by the underlying demographics preference for multifamily. It's still a really strong asset class among investors and as we kind of mentioned, the very expensive single-family market. This will all kind of help create the demand to push multifamily kind of later in the, in 2023, based on our current trajectory of kind of skirting by any kind of deep, deep recession. So that also plays through to the origination market. And so we do expect that originations will come back once this period of price discovery has settled and interest rates kind of slow down their volatility. So that being said, next year, long-winded way of saying what we are expected for next year, is continued slight decline maybe to the 4% to 5% range in volumes down to maybe around the 440 billion mark for 2023.

Corey Aber [00:30:43] Thank you for that, Sara. It's really fascinating. You know, you guys do the outlook every six months, which sort of, you know, causes you to look frequently and in some cases in shorter time segments, but a little bit of what I'm hearing is you really look at the fundamentals like the underlying demographics, as you said. And you know, participants in the market have a way of, you know, sometimes things slow down a little bit as they adjust, but it seems to continue to return to what those fundamentals are, what the underlying demographics show, and just that fundamental need for rental housing in this country.

Steve Guggenmos [00:31:21] Like you said Corey, I think that's exactly right. We need to look at it and keep an eye on what's happening in the markets and then we also need to have that long-term view and know kind of the underlying drivers of where things are at. And certainly in a market that's as tight as it's been and continues to be tight at this point, and whether you consider the multifamily market or the overall housing market, and you consider that in general, because housing and land are limited goods in a time of inflation, we're worried about everything. But typically inflation of housing and rents is a little bit higher than overall inflation because it takes time to build and there are limited goods. So I think that does play into this overall as we move through this, is we'll probably get to the other side and things kind of revert to that and be in a pretty good place. So, Sara, I think as we kind of come to a close, are there any kind of final remarks that you would have?

Sara Hoffmann [00:32:24] So I think kind of some of my closing remarks is while I'm all for the baseball analogy — even though it makes me miss the warmer months right now that we're getting into these cold winter months — personally, I'm more of a runner, so I like to think of us in a point in the race course that we're starting along uphill. We feel good from the recent downhill that we just came off of, where we picked up our pace a bit, but we know a climb is coming where our pace may slow down, but overall we're still running and we're still in the race and when we kind of think of this long term, our average pace is still going to be very robust given where we're set up for this race.

Steve Guggenmos [00:33:04] Fantastic. Thanks a lot, Sara.

Sara Hoffmann [00:33:06] Thanks for having me.

Corey Aber [00:33:09] The Freddie Mac Multifamily Podcast is produced and supported by a team of our Freddie Mac colleagues, including our production leads, Jenny Nguyen and Raquel Sands and audio producer Dalton Okolo.

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