2024 Multifamily Outlook

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Speakers	Corey Aber, Vice President of Mission, Policy & Strategy, Freddie Mac Multifamily Sara Hoffmann, Director, Multifamily Research, Freddie Mac Multifamily Michael Donnelly, Manager, Multifamily Research, Freddie Mac Multifamily

Sara Hoffmann [00:00:00] All right, Corey, I've got two numbers for you today: 120 and 3,000.

Corey Aber [00:00:04] All right. Well, this sounds good. Should I guess what they are? Or do you want me to do, like, the average? My math skills are kind of weak, so I might get that one wrong.

Sara Hoffmann [00:00:14] Why don't you give each one a go.

Corey Aber [00:00:15] All right. The first one is the air pressure of a volleyball and the second one … second one is somehow associated with gravity on the moon.

Sara Hoffmann [00:00:29] Okay so your guesses are not related at all, but the second one is at least in the right ballpark. So 120 is roughly the number of miles out that an aircraft usually starts its descent for landing, whereas 3,000 is the numbers of miles out [where] the space shuttle enters the earth's atmosphere as it comes in for landing.

Corey Aber [00:00:48] Interesting. Well, I think I know where this is going because when when I hear soft landings, I tend to think about the housing market, especially right now. So it sounds like it's time for us to talk about the Outlook. Hello and welcome to this episode of the Freddie Mac Multifamily podcast. I'm Corey Aber.

Sara Hoffmann [00:01:15] And I'm Sara Hoffmann. Today on the show, we're going to talk about our 2024 Multifamily Outlook. And joining us today is Mike Donnelly from the Research Team, who's going to help us dive in and understand a little bit more about what's shaping up the economy and the multifamily market.

Mike Donnelly [00:01:29] Thanks, Sara. I look forward to the discussion.

Corey Aber [00:01:31] All right. Well, Mike, I'm glad you're here and welcome to the podcast for the first time. Look, there's a lot to dig into with the Outlook for next year with what's going on in in the market today and what the implications of that are. Let's start big picture. What's going on in the economy? How should we think about the economy right now?

Mike Donnelly [00:01:54] The economy is performing relatively well. However, the labor market is beginning to show signs of weakness.

Corey Aber [00:01:59] Sounds like we've got some mixed signals going on with with the economy. I know we talk about inflation a lot, we talk about recession risk; like how do you see that playing in? And then I want to turn to like, what does that mean for housing?

Mike Donnelly [00:02:12] The Federal Reserve has been raising interest rates for most of the year and appears to have reached its terminal rate. However, those interest rate increases take a while to flow through the economy and now we are starting to see the effects of those rates, which is slowing the economy.

Sara Hoffmann [00:02:38] So Mike before we get into how this is shaping up our outlook for next year, maybe we can take a step back and think about how our views have changed throughout this year? We've done a lot of work looking at 2023, so I think it will be good to kind of set the stage for how this past year has changed and wrapped up before we start kind of thinking about 2024.

Mike Donnelly [00:02:49] So to start the year, we believed that the recession risks were elevated, and it was quite possible that we were going to see a recession this year. As the year has gone on, those risks have lowered. However, supply has been elevated in the multifamily market for the past couple of years, and that has begun to slow things down considerably. When we started the year, we expected 2023 to be a relatively strong year for the multifamily market, just below the average for rent growth and vacancy rates. As the year has gone on, it's kind of trended down a little bit below those and we're probably end the year just above zero rent growth with vacancy up about 40 basis points.

Corey Aber [00:03:28] So that's interesting. And we covered this a little bit in the midyear discussion. But it's interesting, right, because we've had this period of growth for a long time. We've got different things going on in the economy. We've got slower or, as you said, like close to zero rent growth. What do you see driving that?

Mike Donnelly [00:03:45] The main thing that's slowing the multifamily market is probably the slowing in the labor market and even more so the new supply. There's right about a million units under construction right now. And we're near probably 40-year highs for the number of units that are going to deliver in 2023 and into 2024.

Corey Aber [00:04:04] So, Mike, thanks for laying out some of the different things going on in the economy and some things we need to think about as we talk today. Let's kind of go through these in in some order. And you talked about interest rates and inflation. Let's dig into that a little bit and think about some of the implications of that, first.

Mike Donnelly [00:04:22] Well, interest rates have a profound effect on the single-family housing market, and since the first quarter of 2020, the monthly principal and interest payments have more than doubled. So the for-sale housing market is much more expensive than it was three years ago, and that’s both in terms of monthly cost, as well as the sales price. While rents have increased significantly since then — they’re up about 20% over the past three year — renting is still a much cheaper option across many parts of the country.

Sara Hoffmann [00:04:50] And that's a major theme we’ve been looking at over the past few years, is how expensive the single-family market has become compared to the multifamily market. Especially in this rising interest rate environment, which would typically depress or drive down single-family home prices, that’s not necessarily taking shape, or any declines that we did see in 2022 have been erased this year so far even though rates remain high. And that’s a disconnect in rates and prices due to the very low inventory of the for-sale market. So pretty much all the supply for for-sale housing is lower than the demand out there, which is driving up prices despite those higher interest rates. And all those higher prices and the low inventory is keeping any would-be or repeat buyers sidelined.

While that’s — while the more expensive for-sale market will prolong rental demand, it won’t necessarily create demand for multifamily or it’s not a longer-term demand trend. So, in a way, those, the higher interest rates we’ve been talking about in this regard is not directly impacting those who are choosing to rent but it’s having an impact on those looking to buy a home but remain renters now due to the low inventory and more expensive market. Now that being said, the higher interest rates do have a greater impact on the investment side of the multifamily market compared to single family. What are we seeing there?

Mike Donnelly [00:06:15] Yeah, the the transaction market for multifamily is severely impacted. The interest rates have moved up considerably over the past year, which has impacted cap rates, although at a much lower rate. That has driven down transaction volume. I think MBA (Mortgage Bankers Association) for this year projects about $285 billion, which is a decline of about 40% from last year. So, there's a lot of buyers and sellers who don't really agree on the value of assets at this point. And since the interest rates are so high, the discretionary refinances are pretty much nonexistent at this point.

Corey Aber [00:06:50] So, Mike, there was another point you mentioned. So, we have higher interest rates, we have lower transaction volume, but we also have a lot more supply coming into the market. So help me understand how that's happening at the same time that we have some downward pressure from these other forces.

Mike Donnelly [00:07:05] Sure. So, there is a time lag with new supply. So, you know, it's generally, you know, two to three years to get a project built from the time it's permitted. With all the supply chain issues and slowdown during COVID and all those issues, that that timeline is actually probably closer to three years or even more depending on the product type. High rise especially takes longer to build than than low rise. So, well, you know, demand spiked in ‘20 — late 2021 and into 2022, and developers responded with, you know, hundreds of thousands of units coming onto the market. It's taken time for those units to actually get built and occupied. So, we're kind of seeing that now. We saw the rent spike in 2021 and 2022 when supply was low. Now, all those units are being delivered when demand is a little bit weaker than it has been. And that has caused kind of the downward pressure on on rents.

Corey Aber [00:08:01] It's interesting, though, because you have that in the context of challenges in the homeownership market that that keeps some stability in the in the multifamily market or help with some stability there. When we look at the effect of the new supply, you said that there's some impact on on occupancy, but — and rent. So, you said there's some impact on rent. But you also see occupancy has been relatively stable recently. So, tie those things together for me.

Mike Donnelly [00:08:32] Yeah, Corey. There is some downward pressure on occupancy, and it’s down about 30 to 40 basis points over the past year. That large supply that's coming online, occupancy is actually relatively stable given all those new units coming as you suggested. And what owners and operators of multifamily units seem to be doing is they are trading occupancy for rent growth. So what they’ll do is they’ll maintain rents or keep them relatively flat in order to maintain occupancy within the building or lease up new buildings quickly.

Sara Hoffmann [00:09:05] And I think what's really interesting in what we saw in this report, Mike, is how that can differ across the country. You know, we’ve talked in aggregate right now about all the supply coming online and the rent growth slowing at the end of 2023. But it's really jumping into the different regions or even the metros where you can see some of those differing trends. Let’s discuss a little bit about what we're seeing at that level.

Mike Donnelly [00:09:29] Absolutely. As you said, there's huge differences across the country. The pandemic accelerated trends that were already taking place. Before the pandemic, people were already moving towards the Sun Belt, Florida, Texas, Arizona and the Mountain West. The quality of life is viewed as better. They’re also generally less expensive than the population centers in the Northeast and the West Coast. As those people moved to these areas and created additional demand, developers responded and built lots of new units in these areas, particularly in Florida, Texas, Arizona, Colorado and Salt Lake City in Utah. These areas saw a majority of the development over the past couple of years.

And to that end, we look at the supply ratio, which is the number of units being delivered over the past year into the number of existing units in the market. The higher the supply ratio means that there’s more supply in relation to the inventory, and therefore more downward pressure on occupancy and rents. The new inventory ratio has been especially high in the Sun Belt and the Mountain West, where the ratio was between 3 and 4%. And that has impacted rent growth and in those areas it’s down, negative, between a half percent and one-and-a-half percent. By contrast, the other areas of the country — the Northeast, the Mid-Atlantic, the Central and Plains, and the West Coast — they’re seeing much lower inventory ratios, generally about 1.1-1.5%. And generally have, they have seen positive rent growth. The exception to that is the West Coast, which is slightly negative, and that is due to demographics and outmigration and not an issue with oversupply.

Sara Hoffmann [00:11:09] So it sounds like we're actually seeing some pretty high correlation between the rent performance through 2023 and the amount of new supply coming on. How do we foresee those playing out into 2024, into next year?

Mike Donnelly [00:11:22] I think it's going to be a lot of the same. There's there's still a whole lot of units that are in the pipeline. I think 2024 is probably actually going to be the peak year for deliveries. And again, they're still concentrated primarily in the Sun Belt, in that Mountain West region, while other areas of the country are seeing less supply. So, you know, the demand is also higher in those areas, but the supply is outpacing demand at this point, and that will probably continue into next year.

Corey Aber [00:11:46] Mike, you talked about some of the, you know, demographic shifts and outmigration on the on the West Coast. But let's let's look nationally again at just the demographics of renters and what we've been seeing in recent years and how that's playing in.

Mike Donnelly [00:12:03] Of course. So, we've talked a little bit about how high home prices are keeping renters renting. There's also the next generation of renters, Gen Z, which were born from 1997 through 2012. And they’re not quite as large as the millennials but they’re still significant, and they will be supporting growth in multifamily housing for the next couple decades. So, if we look at the 20-through-39-year-old age cohort — what can be considered prime renting age — through the middle of the next decade, it’s expected to contract by about 1.9 million people. Over that same time period, the 20-through-29-year-old age cohort only accounts for about 25% of that decline. So, while the overall numbers that we typically think of as prime renting age are expected to decrease, the next generation is significant and will likely buoy the rental market in the future.

Sara Hoffmann [00:12:54] So that really helps set up the multifamily market and to absorb all this new supply, given that we still have those tailwinds for the longer-run demographics. What about that other side of the age curve? What are we seeing on the baby boomer side?

Mike Donnelly [00:13:08] The baby boomers seem to be staying in their houses longer than they were originally anticipated. So that has created kind of a logjam in the, in the for-sale market. Typically, as seniors age, they would either move in to dedicated seniors housing or move in with family members. That seems to be happening slower than was anticipated. So that's created the logjam in the single-family market, which is also helping to boost multifamily demand.

Corey Aber [00:13:39] So Mike and Sara, we've talked about sort of broad economic environment. We've talked about some of the demographic trends and some of the, you know, market differences. What I'd like to understand is how all of this comes together when you think about just the business of owning and operating properties, the business of acquiring properties as well, like to tie it back to that. So we think about, we talk about cap rates a lot, we talk about valuations a lot. How is that playing in given the market environment we have today?

Mike Donnelly [00:14:13] Sure. So, as I mentioned, interest rates are up significantly over the past year, 18 months. Cap rates have also been increasing, but not at nearly the pace that interest rates have been. That has caused the cap rates spread — the difference between the interest rate and cap rate — to compress to just about 115 basis points, which is the second lowest rate we've seen in the past 20-plus years, basically, as far back as data goes. It's also about 200 basis points lower than the long-term average, which is about 310 basis points. As a result, property values have been coming down for about the past 15 or so months. Property prices are down significantly, but that trend is flattening. And over the past quarter, they're down about 1%.

Corey Aber [00:14:58] You know, there's sort of the math part of it with the cap rates and interest rates. But there's also the part of just if you're seeing less transaction volume, like there's just a behavioral element going on here that that seems to influence this as well. How does that tie in?

Mike Donnelly [00:15:15] For sure. No one, no one wants to catch the falling knife. And you know, the data, the data we do get, while it's the best that's available, it's still a bit lagged and it's incomplete in a lot of places. So, I think it's more good — I think it's better for general trends than actual kind of specifics.

Corey Aber [00:15:33] So when we think about some of this, right, we've seen change in valuations now change in property prices, do we see some of that continuing or do we think this is going to be relatively flat for a while?

Mike Donnelly [00:15:46] You know, the Fed has been saying higher for longer. I think kind of as interest rates have stabilized over the past couple of months, I think we're going to start to see transactions come back to the market, although it's probably going be slowly, but definitely better than 2023 or definitely at a higher level in 2023.

Sara Hoffmann [00:16:06] And I think what's really important for the market is just to see while rates might be higher, let them stabilize for a little bit. We've been jumping around quite a bit, and as you know the multifamily transaction market, it takes a while to get deals done, get them priced out. And while those interest rates have been constantly on the move on, that's definitely going to deter some or just have some of them go back, reprice, wait on the sidelines a little bit. And that's been contributing to the lower transaction volume that we've seen throughout 2023.

So, if the Fed's done raising the rates and if they stay stabilized, then we can start seeing some people return to the market, transactions being done, learning where these deals need to be priced out. The problem with the rates moving so quickly within the past year or so, it was really hard for people to be able to understand the pricing dynamics — how they would work, how you come to an agreement on them. So, it has just left a lot of people on the sidelines, which has driven down the transaction volume.

We will also see the impact the volume origination numbers next year is in the amount of maturities coming due. So, while we have a higher share of multifamily maturities in 2024 and 2025, those loans will need to refinance and they'll have to come to the market, figure out how they can refinance in this higher interest rate environment. And that can lead to some turning in transaction volume into the next few years.

Corey Aber [00:17:24] You know, that's an interesting point because it gets to two different parts of the market, right? You have the the, you know, transactions by choice and then you have transactions where you just need to get it done. And that might, as you say, have some influence.

Sara Hoffmann [00:17:40] Yep. And that's something we're definitely keeping our eye on with the maturity volume or the maturity schedule that's coming due. For one, if you don't have the choice but your loan term is coming up — especially with the fundamentals we've seen over the past year start to weaken — that might have some concern on the property or the borrower's ability to refinance at these higher interest rates when the fundamentals have slipped a little bit in the past year or so. But we like to think of the longer-term picture. Most of the debt that's coming up in the next couple of years has had time to season, so that will allow NOIs (net operating incomes) to increase and property values to grow despite the past few quarters' softening. So, there's definitely going to be some concerns based on the type of loan originated and at what standards or underwriting standards it's been originated at. But for the most part, the multifamily debt coming due has a bit longer term, so it has some cushion with NOI and valuation growth that it's seen over the past several years.

Corey Aber [00:18:39] One of the things that we always cover when — on the Outlook episodes is what what next year will will look like. And, you know, it's a complicated environment. We just talked about transaction volume. I can imagine one of the hardest things to do right now would be to forecast what that's going to look like next year. And probably everybody really wants to know. I won't take a crack at it because I got neither of the numbers right you teed up at the beginning, Sara, But I would like to hear would like to hear from Mike and and you how you're thinking about the forecast next year and how others in the market are thinking about it.

Sara Hoffmann [00:19:16] So, yeah, it's gonna be a hard one. Forecasting volume is always a little bit difficult. But as Mike described, the mixed signals from the economy and where we see things going for next year — with a soft landing but higher interest rates — that'll definitely continue to suppress what could be transaction volume churning. And as Mike said, with a lot of the new supply coming on, that also typically turns some volume, as we see more transactions based on supply — construction loans converting into permanent loans. So that being said, we do expect some volume growth for next year up in 2024. Given the interest rates, hopefully will stabilize and bring more people to the table to get transaction done. We have it up to about $370 billion to $380 billion for the year. So, this is about a 30% increase from the low levels of MBA's forecast for 2023, but it's still a good bit below what we saw in 2022 and 2021 — closer to more of that pre-pandemic 2019 level that we saw.

Mike Donnelly [00:20:22] So the other thing that we tend to think about when we think about projections for for next year is we look at rent growth and vacancy. And for 2024, we expect rent growth to come in at about 2.5%, which is a bit below the long-term average and vacancy rates to come in at 5.7[%], which is also a bit — about 40 basis points worse than the long-term average. So, it points to a stable, although slow market. So that would also kind of tend to point to a lower origination volume compared to 2021 and 2022.

Sara Hoffmann [00:20:54] So I think that's a great point, Mike. While there's expected to be growth, given the high supply and the higher interest rates, the rent growth is expected to come in slightly below what we've seen historically for the multifamily market. And while vacancy rates are expected to be slightly above the long-run average, that will also impact the fundamentals and the NOI that drives property price when we think of the transaction volume for next year.

Corey Aber [00:21:20] Mike, thank you so much for being here today. We covered a lot. Sara, thank you so much also for for helping all of us understand how this fits together. I have one last question for both of you. Sara, you mentioned at the beginning airplane and space shuttle and the different amount of time and distance to make their landings. Would you characterize the multifamily market right now more as an airplane or as a space shuttle? Mike, I'll ask you first.

Mike Donnelly [00:21:52] I would categorize it as an airplane. It's coming down slowly. It's coming down softly. And hopefully, you know, there might be a little turbulence over the next couple of months or year, but hopefully it makes a nice soft landing in 2024.

Sara Hoffmann [00:22:09] I would tend to agree. And I would maybe even think of it as one of the larger 747s or Airbus 380s that may need a little bit more time to descend, especially as we think about the supply pipeline elongating that runway. But in general, we do see the economy going towards a soft landing, just might be drawn out a little bit. And we never talked about it being a quick or fast landing — these things take some time to to work through and get down on the ground.

Corey Aber [00:22:34] Well, thank you. Thank you very much. And not an ornithopter either, maybe. And we'll leave it at that. Thank you both for a great discussion.

Mike Donnelly [00:22:43] Thanks, Corey.

Corey Aber [00:22:44] The Freddie Mac podcast is produced and supported by a team of our Freddie Mac colleagues, including our production lead Jenny Nguyen and our audio producer Dalton Okolo. 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.