2023 Midyear Outlook

Duration	00:25:24
Speakers	Corey Aber, Vice President of Mission, Policy & Strategy, Freddie Mac Multifamily Sara Hoffmann, Director of Multifamily Research, Freddie Mac Multifamily

Sara Hoffmann [00:00:00] Hey Corey, I got a bunch of numbers for you today, but I'm not going to tell you.

Corey Aber [00:00:03] So I guess today's episode is going to be 45 minutes of me just asking you a bunch of questions trying to figure out what numbers you're thinking of?

Sara Hoffmann [00:00:10] You got it.

Corey Aber [00:00:11] Sounds like it's time for the midyear outlook.

Sara Hoffmann [00:00:12] Let's get started. Hello and welcome to this episode of the Freddie Mac Multifamily podcast. I'm Sara Hoffmann.

Corey Aber [00:00:23] And I'm Corey Aber and today on the show we are going to dig into the midyear outlook. And look, a lot has changed in the market over the past couple of years. And Sara, I think you alluded to some of this in the outlook that we we talked about a few months ago at the beginning of this year, but now six months into the year, there's a lot more to cover with this and maybe some things confirmed, maybe some things still up in the air. So glad to have you here to talk about this today. But let's start with start with maybe just lay the groundwork and maybe a little bit of a reminder sort of what's been the the long-term trend that we've seen? And then we'll get into a little bit what what's changed recently and what we're looking at now.

Sara Hoffmann [00:01:03] I think this sounds great, Corey, and it's a really important time to kind of come back and think about where we've been in the past six months, but then also how we can think about how that relates to a longer time period. Six months ago, when we put out our year outlook, that was the point where we anticipated the inflection point in the market — in the rental market. And we have seen that come through to fruition with rent growths slowing, property prices declining and occupancy slowing down. And then our anticipation was that midyear through 2023, we would see some of that growth start to come back. And what I want to kind of touch through today is where we've seen that growth come back, where we're still kind of waiting a little bit, where things have maybe not quite met our expectations on it.

But kind of taking a step back when we think long term, looking at the past two years when we saw tremendous growth in many instances, record-setting growth and rent growth and demand in occupancy levels, property price appreciation, pretty much anything we're going to see now is going to look pretty muted toward that. But when we look a little bit further back, say coming out of the great financial crisis, that's where we saw a long stable period of multifamily growth, typically above the long-run average, going back to either 2000 or even the 1990s. So now what we're seeing is at this inflection point with things slowing down, when we compare to the prior few years, things look much slower, but we, you know, the post-pandemic ramp up of everything really kind of skewed numbers out of line there. But looking kind of past the past 12 years, that's where we see that rent growth, demand, property prices are not quite meeting those averages. Going back to 2000 or even 1990 we're starting to see things more in line with that time period. So it might look and feel like a slowdown, especially coming out of the really

strong 12 or so years of multifamily growth, but in general, things still seem to have a stable footing going forward.

Corey Aber [00:03:00] Sara, I'm glad you mentioned sort of going back 10-plus years here and even thinking back to around the time of the financial crisis, Great Recession and and period after. And you know, you mentioned sort of seeing a few things going on there: increase in rents, increase in property values, increase in demand for rental housing. So you had a couple of things you sort of see in those topline numbers. But can you tell me a little bit what was going on behind those numbers during that period? And then because that also leads up to it, we had this long-term trend of rent increases outpacing income, and then we had this spike during the pandemic, too, where you saw a shock to income. You also saw a shock from a rent perspective as well. So we would like to dig in to some of the underlying things during that period, so maybe we can start with that, you know, 10-plus year run up before the pandemic, what was going on there?

Sara Hoffmann [00:03:54] So coming out of the great financial crisis, that's when you had obviously driven by housing with the single-family market crashing in ‘07, ‘08, ‘09. But that also corresponded with the time when the millennials, the first millennials, were kind of coming of age and creating their new household formation. So that's where you start to see demand for housing pick up. Now, the great financial crisis muted some of that given just the state of the economy and the job market at the time. But then kind of as we started coming out of it, you know, 2011, 2012, that's when you start to see some of that demand really pick up. And it was a product of the great financial crisis when credit wasn't as easily available, not, you know, while there was a surplus of single-family homes given working through all that inventory, the credit constraints pushed a lot of people into rental housing. But at the same time, that's when the older millennials today, but at that time in their early to mid-20s were coming of age and moving into the rental housing. So we had a lot of demand push up rental housing and multifamily and that created then higher rents during that time. At the same time, vacancy rates were coming down and got to some of their really tight, stable levels of 5% or slightly below, which is a typical equilibrium of an overall stable multifamily market. And during that time, you also saw multifamily property price appreciation near double digits on an annual year-over-year basis, and that went up much faster than all the other commercial real estate property types. So the different assets of hotels, retail.

So you saw a lot of strength in multifamily coming out of the great financial crisis, and that's when you think of kind of the average rent growth of the average vacancy rate or average property price during that time. If you even exclude the blip of the pandemic, then today when you kind of compare those numbers to then you're definitely seeing more of a slowdown, albeit still positive rents, property prices are still coming down given just the financial interest rate markets currently. So it's kind of when you put it in perspective of that time. Now when you think of those underlying drivers, is the demand still there? You know, millennials are, you know, 10-plus years older than coming out of the great financial crisis. So you're going to see some of them, you know, transition into homeownership. But then that kind of sets us up for the next question of just the tight single-family market currently given higher interest rates today, higher property prices, even though they did slow down slightly at the end of 2022, by no means enough to race the high interest rates or the run up due to the pandemic. So you're definitely seeing a much tighter single-family market that is even harder for those first-time homebuyers to enter. Not saying they're not there, but it's just going to be much harder for them to price into that market.

Corey Aber [00:06:46] So obviously that then affects sort of rental demand still even post-pandemic.

Sara Hoffmann [00:06:51] Correct, yeah. I mean, we usually say that the single-family market doesn't create demand necessarily when people are being priced out for it, but it prolonged the demand. So if you can't find that single-family home, if that's your next move, then you're going to stay in your rental unit a little bit longer, which will keep occupancy a little bit more stable.

Corey Aber [00:07:09] So we had this period during the pandemic where you saw significant, and in many ways unprecedented, sort of rent increases. You saw a lot going on during that period, but now we're seeing — and we sort of talked about this in the outlook discussion we had a few months ago — but you're seeing a little bit of a shift or return to how things were before slower growth. What's driving that now?

Sara Hoffmann [00:07:33] So I think the overall economic uncertainty in the market right now we've been hearing almost nonstop like, 'when's the recession' or 'what's the chance of a recession?' And we definitely see much lower consumer confidence levels, especially at the end of 2022. So pretty much when the consumer's not confident in the economy that they're less likely to form a new household or to form an additional household. So they're more likely to hold on to their current situation, whether that's living in a parent's basement, living with roommates. So if they have a little bit more concern of the future state of the economy, of whether they're based on employment status, they're less likely to form a household. So that's really what we saw kind of at the end of 2022 even the beginning of 2023 was a slowdown in demand. And that impacted rent growth where we saw rents slow down. Now, typical seasonal patterns actually have rent slowing in the fourth quarter. You know, looking back the past 12 years or so, even prior to that, the fourth and the first quarter, always slower months. Typical turns come in the second and third quarter when people graduate school, go find their new household, move during the summer months. So it wasn't abnormal to see that slowdown. When you think about how that compares to the past several years, depending again on that time frame you want to look at, it might look like it was higher severity in the slowdown versus kind of the past 12 years. But again, if you go back to 2000, that slowdown is a little bit more in line with that longer-term outlook.

Corey Aber [00:09:10] Sara, you mentioned seasonality and some of what what people experienced throughout the year. Did we see that seasonality in the market like during that shock of the pandemic?

Sara Hoffmann [00:09:21] Now the pandemic pretty much threw a wrench in everything. So with the pandemic hitting in pretty much the second quarter of 2020, when the multifamily markets start seeing its pickup for the summer months, that pretty much squashed all moves during that time. So we did not see a lot of demand for rental housing during that time. But that being said, it then kind of pushed it toward the end of the year when people then started realizing kind of how the pandemic work-from-home situation was going, playing out, people then started forming more households near the end of the year. So typically when fourth-quarter demand slows down, rents slow down, was when they actually started to pick up at the end of 2020. And that's what we then saw through most of 2021. And then again in 2022, we actually saw demand start to slow down in the second quarter of the year. So the pandemic did shift things around. We do believe we're kind of back to this seasonal pattern. Given the state of the overall economy, it is a bit slower than what we saw in the prior 12 years.

Corey Aber [00:10:28] And thinking of the state of the overall economy. And one of the indicators that I think people latch on to a lot, if you're homebuyer, you see mortgage rates are tremendously different from like two years ago. If you're an owner of multifamily properties, you're seeing the same thing. You're seeing Treasurys go up a lot. We talked about inflation a little bit. Can you spend a little bit more time on how that factors in?

Sara Hoffmann [00:10:54] So some of this change in the economic environment where we see this increased uncertainty and potential for a recession was intentional. So with the higher inflation that we saw coming out of the pandemic, the Fed needs to increase the federal funds rate to help combat, bring down some of that inflation. And we've all been hoping for that soft landing. And what we're seeing right now is the, definitely an elevated risk of a recession. But we're not there. But what we keep seeing is revisions for economic growth lower and lower. So each month that we're looking at it, the overall economy's growth for this year is expected to be lower than the prior month. And that's where Moody's Analytics has coined this ‘slowcession’. So we're not expected to go to recession necessarily this year, but it will be slower growth. And that's kind of, you know, as we talked about consumer confidence and

there are concerns of the economy, that's where we see that impact into rental housing demand, where they might slow down in their decision-making for forming new households.

Corey Aber [00:11:54] And do you see that same sort of slowdown or — maybe caution is a, is a word that that factors in here when you look at just transaction volume in the market and thoughts about that from different people studying this — how does that factor in there?

Sara Hoffmann [00:12:07] So the transaction side is definitely a little bit of a different story, but it's in the same direction and that takes a little bit slower to get realized. And this is one of those areas that we really haven't seen pick up at the halfway point in the year. Transaction volume is still really slow as many investors remain on the sidelines waiting out this period of uncertainty due to the higher interest rates — the prolonged higher interest rate environment — which is all leading buyers and sellers to stay in this price discovery mode. And when the interest rates, when the 10-year Treasury goes up, then your risk premium kind of needs to go up to match that because you have a certain a spread, we call the cap rate spread there. And when interest rates went up very quickly, very volatile over the past several quarters, the cap rate spread is slow to react and you saw that risk premium shrink down. So that cap rate spread shrunk to very low levels that we've not seen for 10-plus years. That is influenced then on the transaction side, when properties are transacted, they need to then reassess what that cap rate is. Now that you have higher interest rates, that cap rates are going to be higher. So when that cap rate goes up, what that has affect is lower property values, so then property values would start to come down. We started seeing that again at the end of 2022, but we're still seeing that take place in the market just given how slow things are to react on that side.

One thing that you can also think of is compared to the great financial crisis, there is not a big surplus of people trying to free up liquidity. The multifamily properties are still performing decently well on average, so no one's trying to sell something if they're still performing and it's rent growth. So you're going to have people kind of sit more on the sidelines waiting to see a more favorable interest rate environment to be able to make these transactions. Now that being said, cap rates have increased over the past several quarters. So while they're sticky and they're not increasing as fast as interest rates, we have seen them up almost 50 to 60 basis points over the past three quarters. And even going back to the great financial crisis, we did not see in a three-quarter span, cap rates increasing that fast. We saw in one quarter in 2009 a 50-bp increase, but then it pretty much came back down over the next two quarters. So the fact that everyone's talking about cap rates are taking long to react to this. If you kind of look at how the past three quarters have, we don't really see that in the past 20, 23 years of this quick increase on them. So this is kind of the fastest cap rates have moved in the recent history.

Corey Aber [00:14:43] Yeah, that's interesting. Sort of again, continuing with what we've seen for the last couple of years, we're sort of in in some ways in unprecedented territory, or at least not recently precedented if that's, if that's a phrase that exists. What about geographic differences? We've talked a lot about that in the past. And are we seeing the same kind of performance, the same sort of corrections happen universally across the market as we've sort of seen with like rent growth and rent increases in the past couple of years, we saw a lot of that sort of almost universal. What are we seeing right now?

Sara Hoffmann [00:15:16] So it's not universal. And we're definitely seeing some of this rent contraction localized. And a lot of these markets — some of these markets actually had really strong runup. So the Las Vegas, the Phoenix, really strong growth during and after the pandemic and now they're kind of seeing that correction. And then some other areas, such as Austin and Colorado Springs, are seeing year-over-year declines in rent. But that's a little bit more of a supply story since some of those areas have some of the highest supply compared to their inventory coming in this year and even into next year.

Corey Aber [00:15:50] So some of that supply is going to like offset some of the rent increases that you saw saw before?

Sara Hoffmann [00:15:55] Correct. So yeah, with a lot of supply, you're going to see — even, even if there's strong demand, Austin and Colorado Springs are areas that have decent job growth or expected to, there's a risk of an imbalance in supply and demand despite potential strong job growth there.

Corey Aber [00:16:10] So with that, that variation across markets. And so, you know, we've laid a lot of groundwork, but what are we seeing for the rest of the year?

Sara Hoffmann [00:16:17] So if we go back again six months to what we expected by midyear, our expectations were that growth would have a slow start to the year and then start picking up midyear through the end of the year. We're starting to see that a little bit in the rent growth numbers. While they slowed at the end and beginning of the year. So far, kind of starting off the second quarter, we've seen month-over-month increases. They're slower than, say, the 12 years kind of post-great financial crisis up to the pandemic. So the seasonality of kind of the first quarter being slower ramping up into the second quarter, we're seeing that trend. So that's a good sign that the market's kind of following its normal seasonality trend with growth returning in the second quarter. It's just a little bit more muted than what you might think of as the prior 12-years' average. And I think that's a good way to think about what the rest of the year is going to bring us. So we're going to kind of follow these seasonal trends with growth during the summer months, the second and third quarter and then slowing down again in the fourth quarter. But just with that expectation that it's not going to be what we saw in the post-great financial crisis leading up to the pandemic. Again, if you kind of go back and look at a broader or longer time period, we're not seeing things too far outside those averages. Vacancy rates expect to stay pretty stable at 5%, rent growth in the 2 to 3% range, which kind of might feel a little slower, especially coming out of the pandemic years and even the past 12 years. But in average, if you're kind of looking at a longer-term multifamily run rate, we're getting pretty close to that level, which we think kind of signals healthy, modest growth.

Corey Aber [00:18:01] So 2 to 3% from a broad market rent increase. Now let's just put that into context. So during those 10 to 12 years leading up to the pandemic, what did that look like year over year, is 2 or 3% kind of in line with that? Or is it a bit lower than what we've seen before?

Sara Hoffmann [00:18:17] So coming out of the great financial crisis, rent growth averaged around 4%, a little bit higher than 4%, and that's even higher than if you kind of go back 20, 30 years. So that's what we're seeing. It was a strong time for multifamily, really stable growth above the long-run average for many consecutive years.

Corey Aber [00:18:36] And then during the pandemic, I mean, that was a shock period. What did it look like then?

Sara Hoffmann [00:18:40] I mean that was, we were talking, you know, 10, 11, even 12% during the past two years, 2021 and 2022. So, yeah, there's 2 to 3% is going to feel much lower, especially compared to that and even compared to the prior 12 years. But then going back even further to 2000, you know, we're looking at an average annual growth of about 3%. So we kind of put ourselves right in line if not just slightly below that.

Corey Aber [00:19:04] There's an interesting point, too, going on right now where I mean, you mentioned it with a couple of the markets you talked about with some supply coming on, but we're starting to see more of that story come out at the national level, right. More multifamily starts than than in recent years. And and maybe there is some relief from that, some correction coming through that. But what do we see when when we look at the supply potentially coming online now?

Sara Hoffmann [00:19:28] Supply is a main concern, probably one of the biggest ones outside of just the overall state of the economy right now. There's estimated about a million units expected to be delivered in 2023 and into 2024, which equates to about 2% of inventory annually over the next two years, according to RealPage. And when you think about how high that is and the highest we've seen in decades, but as a

percent of inventory, that number remains relatively low, especially going back to the 1970s and the 1980s, when all that new supply equated to around 6 to 7% of the inventory. So to kind of put that in perspective of just how much inventory is coming into the market. But it's still a large number and we still expect that it'll have implications and it's going to be very localized in the markets that are seeing all that new supply coming in. Of all the supply, it is heavily concentrated and a couple markets make up a good size of that. But it's also kind of specific markets that maybe don't see a ton of supply are now seeing more coming in. And that's where we talked about the Colorado Springs earlier. On the other side, Austin, Nashville are ones that have seen a lot of supply working its way through for the past few years.

Corey Aber [00:20:44] Interesting. Sort of in recognition of greater demand in those markets, I would think, too.

Sara Hoffmann [00:20:47] Exactly, yeah. So you might see that it's a lot of new supply coming into areas like Colorado Springs, but they haven't seen typically a lot of new builds historically. But the pandemic that has shifted some demand and migration trends to some of these areas is what's driving a lot of this new supply into those areas.

Corey Aber [00:21:05] So starting to, maybe starting to catch up with the demand a little bit.

Sara Hoffmann [00:21:08] That's the hope. Yeah.

Corey Aber [00:21:10] So when you think about the type of units that are coming on online, what does that look like?

Sara Hoffmann [00:21:15] So majority of all the new supply is going to be in the Class A space. So top of the line, a lot of the new amenities and then that puts that at the higher price point as well. And that's where we would expect when we talk about, you know, rent growth moderating. You would expect it mostly in that space since that's where all the new competition is going to be coming on there. So between the Class A, B and C, we'll definitely see a little bit more pressure in that Class A space as it has a lot of new supply that's going on with the competition and driving some residents away from current into new, new buildings that might have some new concessions that drive, drive, demand that way.

Corey Aber [00:21:55] Sara, we talked about sort of the different markets and how there is some geographic variation. We talked about that sort of from a rent perspective, but what about from a property income perspective and what we might foresee over the course of this year? Where might you see the stronger or greater property income growth and versus some markets that might see less so?

Sara Hoffmann [00:22:17] So typical to what we've seen in the past few reports, we still see a concentration among Florida when we think of those markets that are expected to see the strongest gross income growth. So this is rent and the vacancy rate change taken together for 2023 and so Southern Florida, Miami, West Palm Beach, along with Tampa. But we're also seeing some return of some of the West Coast markets, specifically some of the smaller ones from Oakland, San Diego, Tacoma, and then also Seattle, and then some Midwest markets with Oklahoma and Dallas. And and really what's driving these top markets' expectations for this year is expected strong job growth there along with personal income growth such as wages, high-tech jobs moving into those areas that kind of have the higher income growth for the tenants.

On the flip side, the areas that we're expected to see below the national average at the bottom of the spectrum are a bit more mixed. Some of them are larger metros, such as New York. Other ones have a lot of new supply coming in or as we mentioned, kind of Phoenix, Nashville, those areas that saw a lot of growth during the pandemic are now kind of reverting back or are kind of in correction territory. But that growth is not expected to be negative in any of the major metros that we report on, but definitely more muted. So around the, up to the 1 to 2% gross income growth range.

Corey Aber [00:23:43] So, Sara, I feel like I've gotten all the numbers that were in your head out in this conversation except for one. And that number is what we anticipate or what people paying close attention to this are saying about how much overall volume is expected in the market.

Sara Hoffmann [00:24:02] And that's a very tricky question right now, given our conversation of cap rates and the sluggish transaction market right now. We definitely expect that given higher cap rates, lower property prices and people in general just kind of hanging out on the sidelines waiting to kind of see how things will transact, we expect volume to be down about 17% from 2022 levels to about 370 billion. Now, that being said, we have seen interest rates so far kind of stabilize this year after the very volatile year, last year of interest rates jumping quite a bit and moving up very fast. They have stabilized for the most part in the first half of this year, but still remain elevated. And we'll have to kind of wait and see the Fed's decision. We've already seen them pause in June and we'll have to see kind of how that reacts going for the rest of the year. But right now, we do expect volume to be lower this year. Given the higher interest rate environment, people are continuing to kind of wait on the sidelines while property prices continue to stabilize for where people can agree to get deals done.

Corey Aber [00:25:07] Sara, thank you so much for going through the midyear outlook. We'll see you again in six months. Everything we talked about today turned out as as we might have anticipated or what curveball there might be at the beginning of 2024.

Sara Hoffmann [00:25:20] Can't wait.

Corey Aber [00:25:23] 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. 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.