CBRE

ECONOMETRIC ADVISORS

Q3 2023
Multifamily Outlook

EA REPORT

November 2023

Executive Summary

- The U.S. multifamily sector, still stabilizing from the post-pandemic demand surge in mid-2022, was buffeted by record completions in Q3 of 114,628 units, up 22% year-over-year (Y-o-Y). That record supply is putting stress on net effective rent growth, which was a meager 0.7% Y-o-Y in Q3 2023. We expect continued slow, but positive Y-o-Y growth in the next three quarters as those record units are absorbed, and as the macroeconomic situation becomes more of a headwind, especially in the first half of 2024.

- However, toward the end of 2024 and moving into 2025 and beyond, we project that the stabilization in supply and demand dynamics will become more apparent, with vacancy and rent growth returning toward longer-term averages. We project vacancy and Y-o-Y rent growth to return to 5% and 2.7%, respectively, by the end of 2025.

- The Northeast and Midwest lead the way in rent growth, while the West and South are expected to have negative Y-o-Y rent growth through 2024. Sun Belt markets, facing an especially large amount of supply, are forecast to have the most rent declines in the next year, but to return to fundamental-based growth in 2025.

- The national picture is more optimistic starting in 2025. Downside risks from interest rates and a possible early 2024 recession, as well as upside opportunity if employment and consumer spending remain strong, fill out the possible macroeconomic scenarios.

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Macroeconomy

2023 CBRE Econometric Advisors' Economic Forecast Brief

- The U.S. economy has defied expectations for a slowdown and even exhibited some signs of acceleration despite sharp tightening of credit conditions and ongoing write-downs in the banking sector. This resilience is due to several factors such as the Chips and IRA Acts, which stimulated the construction sector. Also, the Federal Reserve and FDIC have provided significant support to the banking sector. Perhaps the most important component is the consumer and strong household balance sheets. This was evidenced in the latest Q3 2023 GDP print, wherein consumption accounted for 270 basis points of the 4.9% GDP print for Q3 2023.

- However, headwinds such as higher oil prices, resumption of student loan payments, and a weakening global economy are intensifying. These headwinds, though not serious individually, are hitting home at a time when interest rates are beginning to squeeze important sectors of the economy. Business credit costs are up significantly, and this appears to be weighing on profits. This will cause the labor market to soften and consumers to be more prudent in coming quarters. With consumers losing their firepower we believe the economy will moderately contract in H1 2024.

- The upshot for real estate is that the Fed is likely finished with its tightening cycle, allowing a clearer path for real estate capital markets to unfold. Although we expect economic growth to deteriorate it is likely that valuations will begin to stabilize during 2024.

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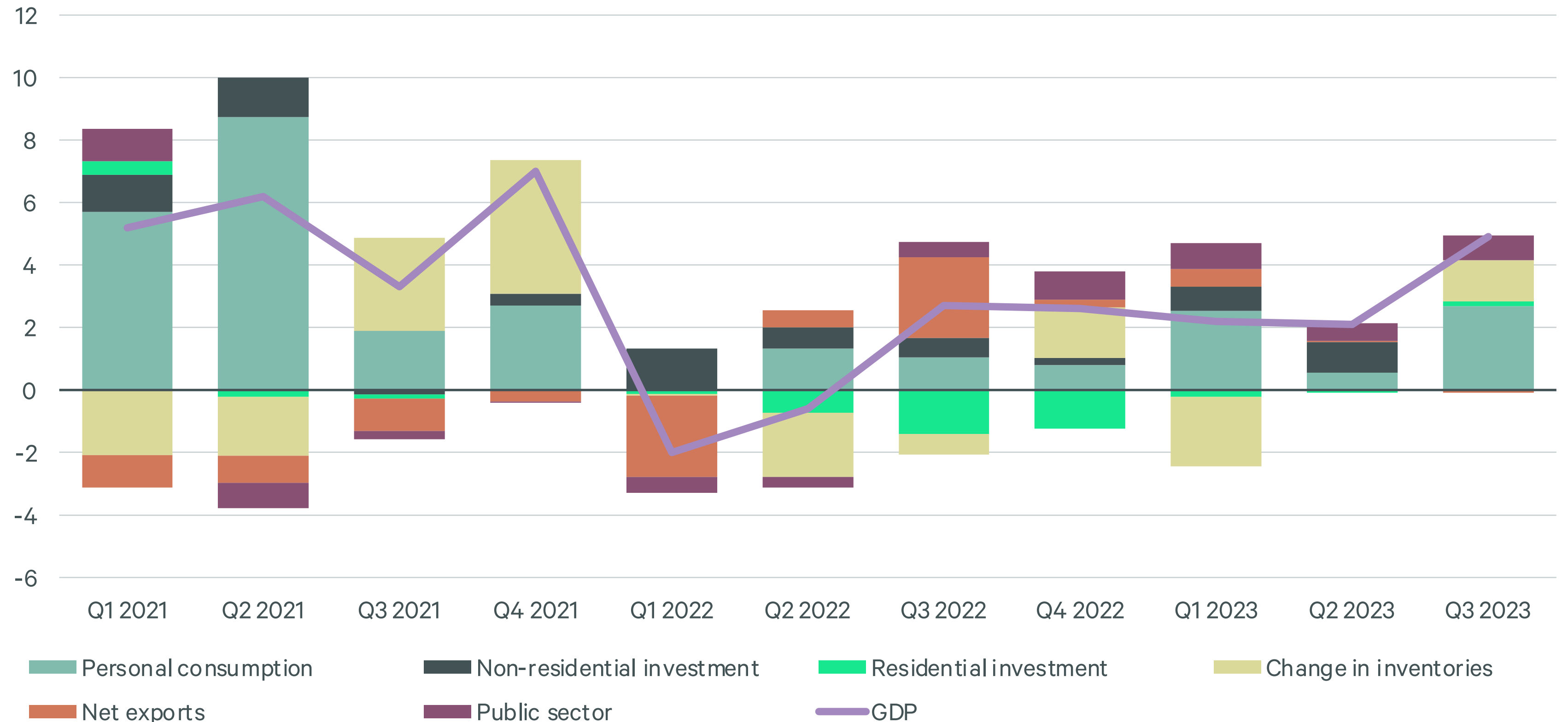
Consumption drove the economy during the summer

- Personal consumption has played an outsized role in the economy's expansion in the wake of COVID-19 lockdowns. This theme continued during the summer as households treated themselves to discretionary services, such as travel, dining out, and entertainment. We believe this current pace of consumption is unsustainable and will not make outsized contributions to GDP into 2024.

- Government stimulus continues to circulate throughout the economy and has contributed to growth during the past five quarters. Looking forward, spiraling government deficits will likely inhibit generous Federal stimulus.

Annualized Quarterly GDP Growth (%)



Source: Bureau of Economic Analysis, CBRE Econometric Advisors

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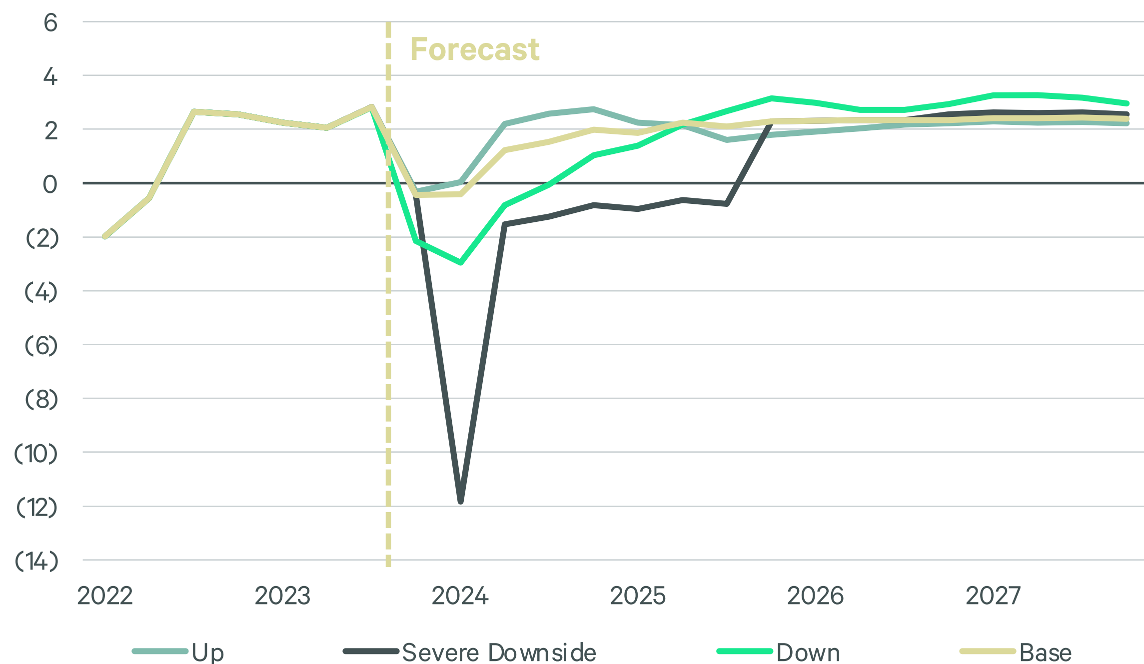
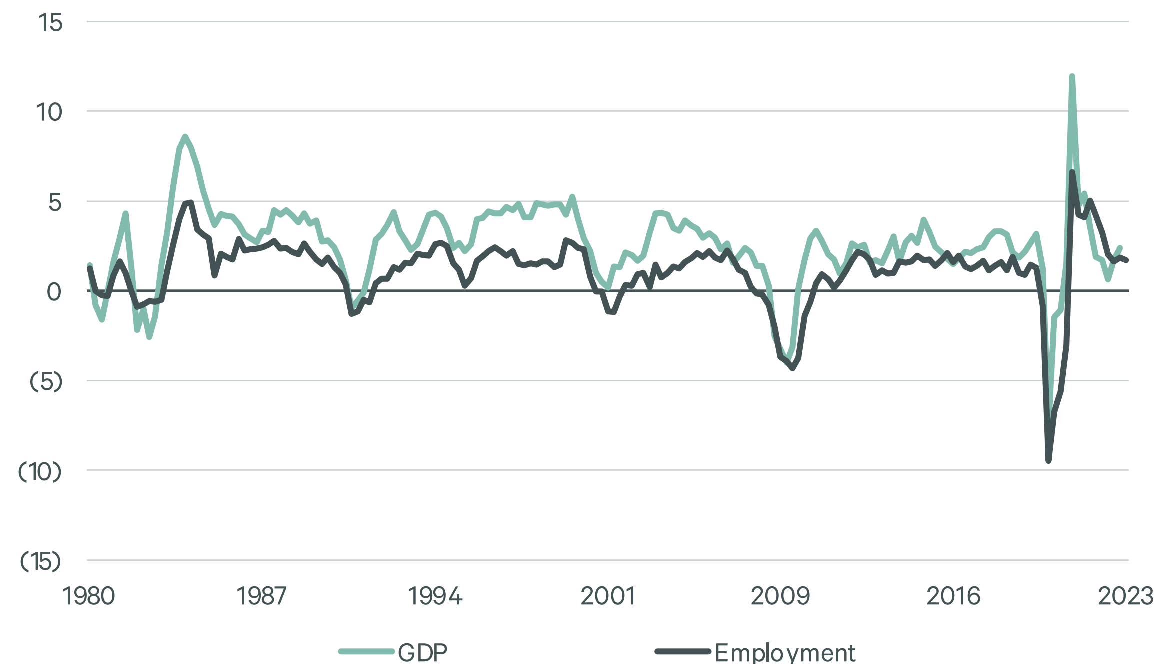
However, we still expect the economy to contract in H1 2024

GDP Scenarios, Quarterly Growth at Annualized Rate (%)



Source: Bureau of Economic Analysis, CBRE Econometric Advisors

'Soft Landings' Are Rare, Employment and GDP, Y-o-Y (%)



Source: Bureau of Labor Statistics, Bureau of Economic Analysis, CBRE Econometric Advisors

- We believe that many of the trends driving outsized growth are unlikely to continue. Foremost, higher borrowing costs will begin to strain the important machinery of the economy, such as capital markets and business balance sheets. The upshot is that GDP is poised to moderately decline in H1 2024.
- Another reason to be cautious about future growth prospects is that 'soft landings', or continued growth amid monetary tightening, does not have a rich precedent. It is typically the case that an upward shift in interest rates results in a contracting economy.

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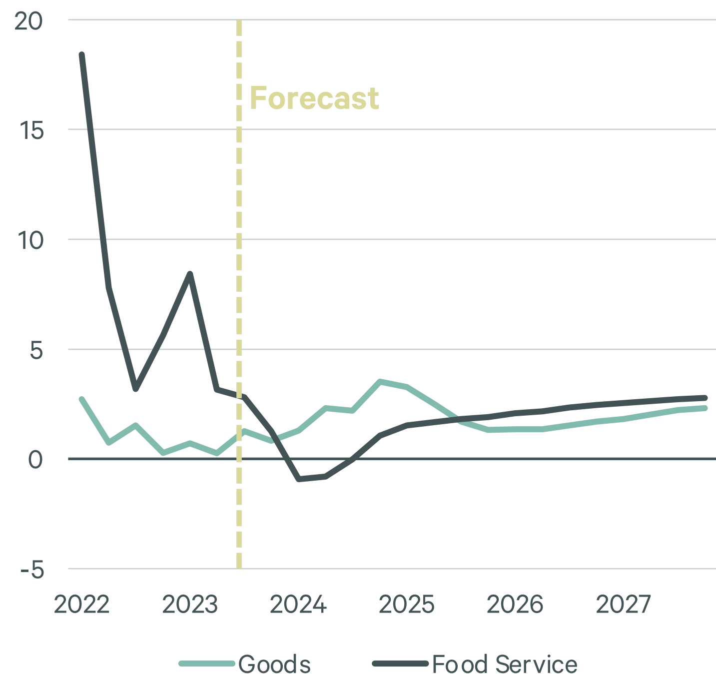
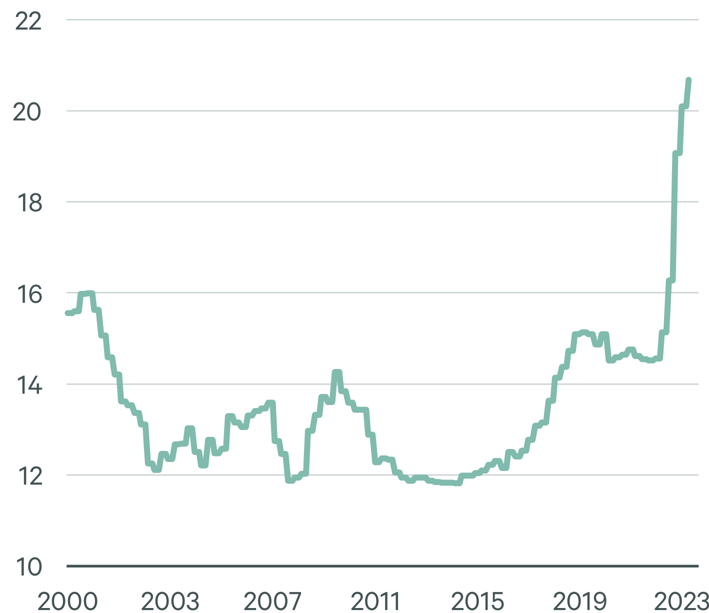
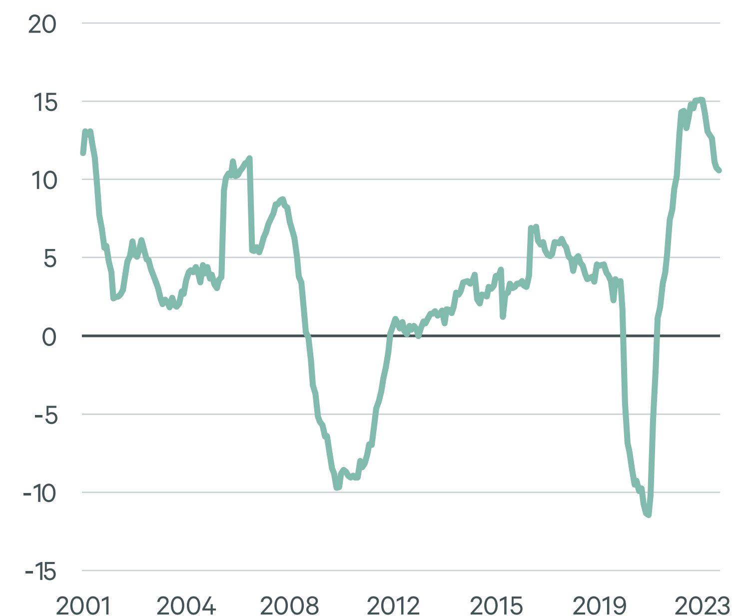
The U.S. consumer will struggle to drive greater growth



Source: U.S. Census, CBRE Econometric Advisors



Source: Federal Reserve, CBRE Econometric Advisors



Source: Federal Reserve, CBRE Econometric Advisors

- Consumer services (e.g., dining out, travel, recreation) is driving the boom in consumption. As the pace of economic growth slows, we believe spending on discretionary services will slightly contract in 2024.
- It is unlikely that U.S. consumers can maintain spending via borrowing as credit costs are prohibitive. The ability of households to service existing debts is sturdy but recent data shows the pace of credit growth is slowing.

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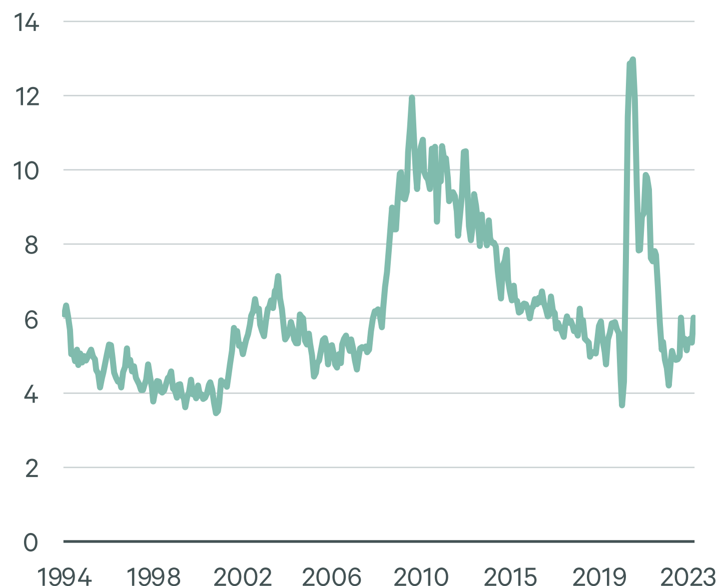
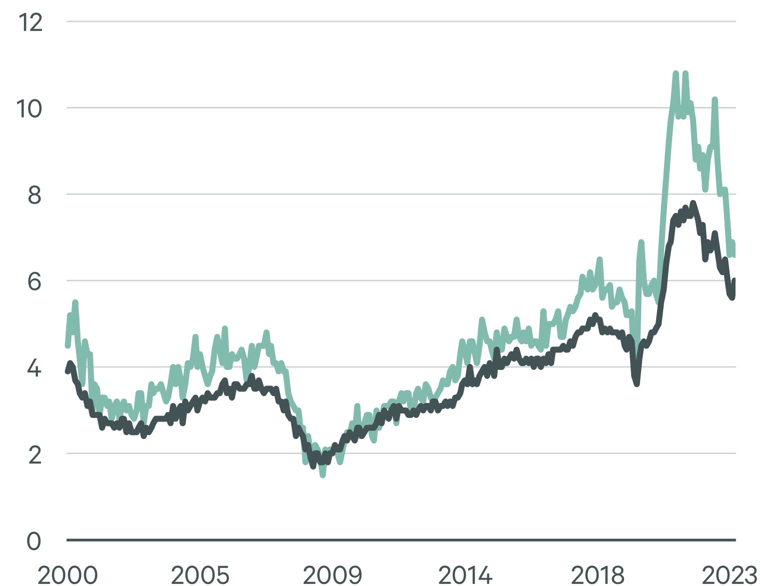
Despite strong payroll growth the labor market is softening

Duration of Unemployment Is Ticking Up



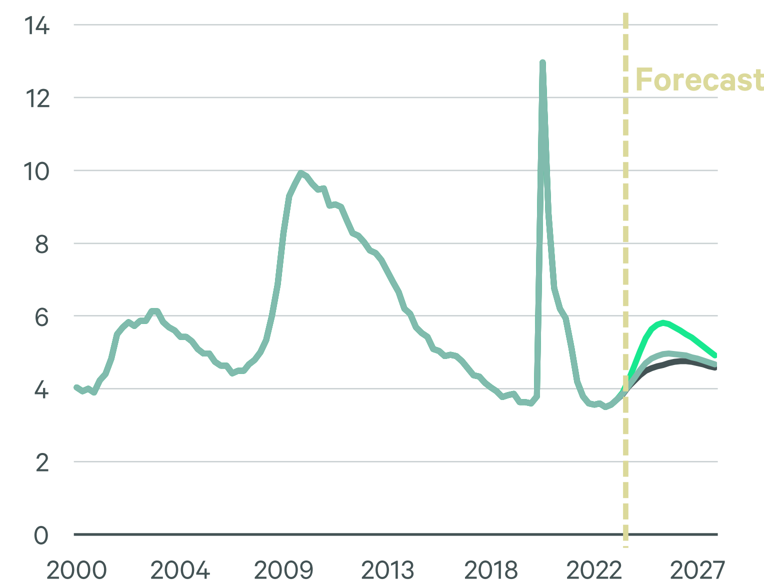
Source: Federal Reserve, NBER, CBRE Econometric Advisors

Job Opening Rates Are Trending Down (%)



Source: BLS, CBRE Econometric Advisors

Unemployment Rate and Forecast Scenarios (%)



Source: Federal Reserve, NBER, CBRE Econometric Advisors

- A few signals suggest that the labor market is no longer tightening as some cracks begin to form. One interesting indicator is that the duration of unemployment is slowly increasing. Conditions are likely softer within the tech and professional services, where layoffs are measurably higher.
- The demand for labor, represented by currently employed and job openings, continues to exceed supply; however, the openings rate is trending down.
- The combination of softer labor market dynamics and falling GDP will push the unemployment rate up slightly within our Baseline scenario, peaking in the upper 4% range.

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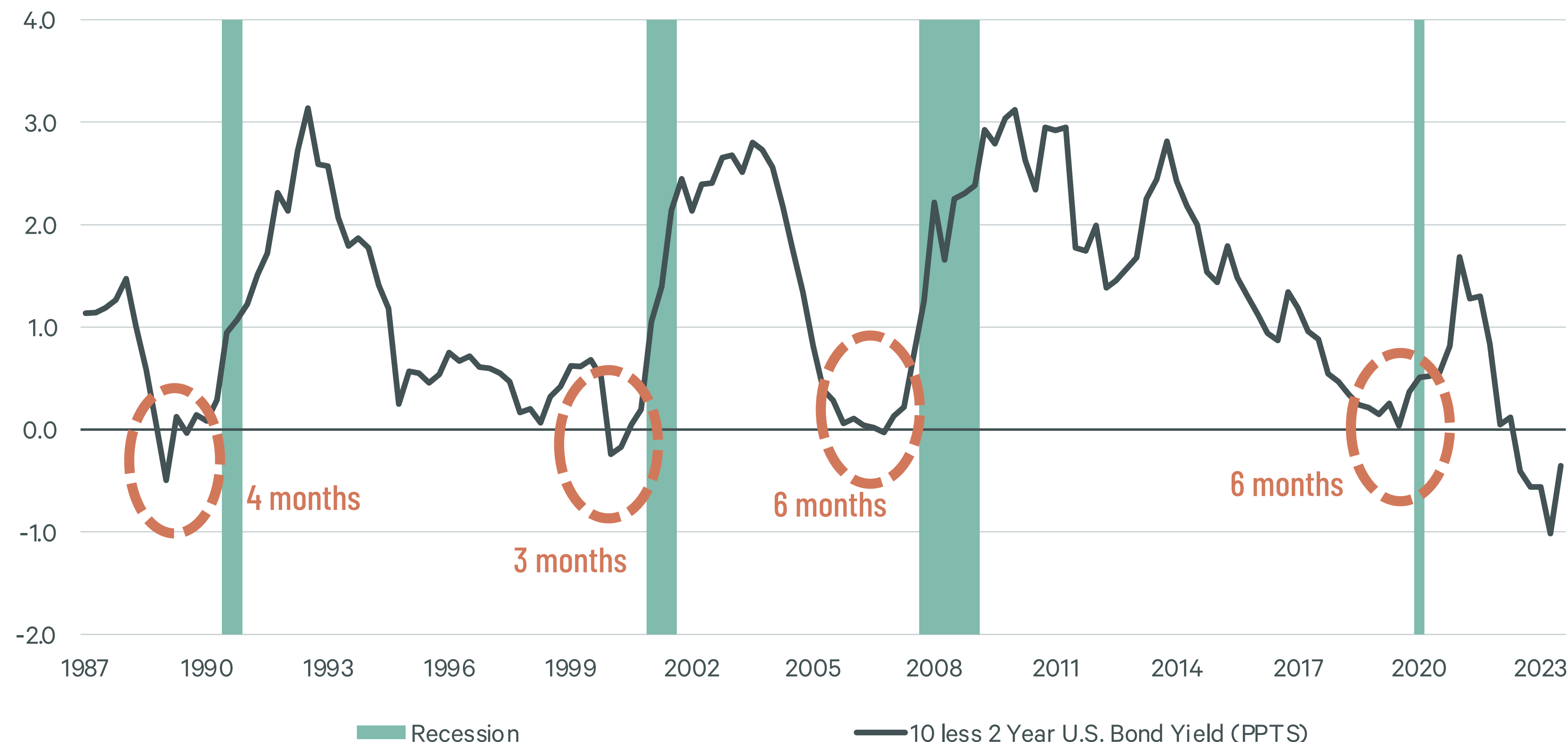
Financial market signals point to a weaker economy

- An inverted yield curve can signal that an economic cycle is overripe. A 'bear steepener', or when long-term rates quickly rise causing the yield curve to un-invert, historically suggests that an economic contraction is around the corner.

- The current uptick in long-term rates is not driven by expectations for future rate hikes but rather due to an increase in the term premium. This concept is discussed more on the next page, but the upshot is that markets are aligned that rates will likely remain higher for longer. CBRE Econometric Advisors believes this backdrop will ultimately stress the business sector, households, and even government finances.

Average Time(s) Between Yield Curve Un-Inverting and Beginning of a Recession



Source: The Federal Reserve, CBRE Econometric Advisors

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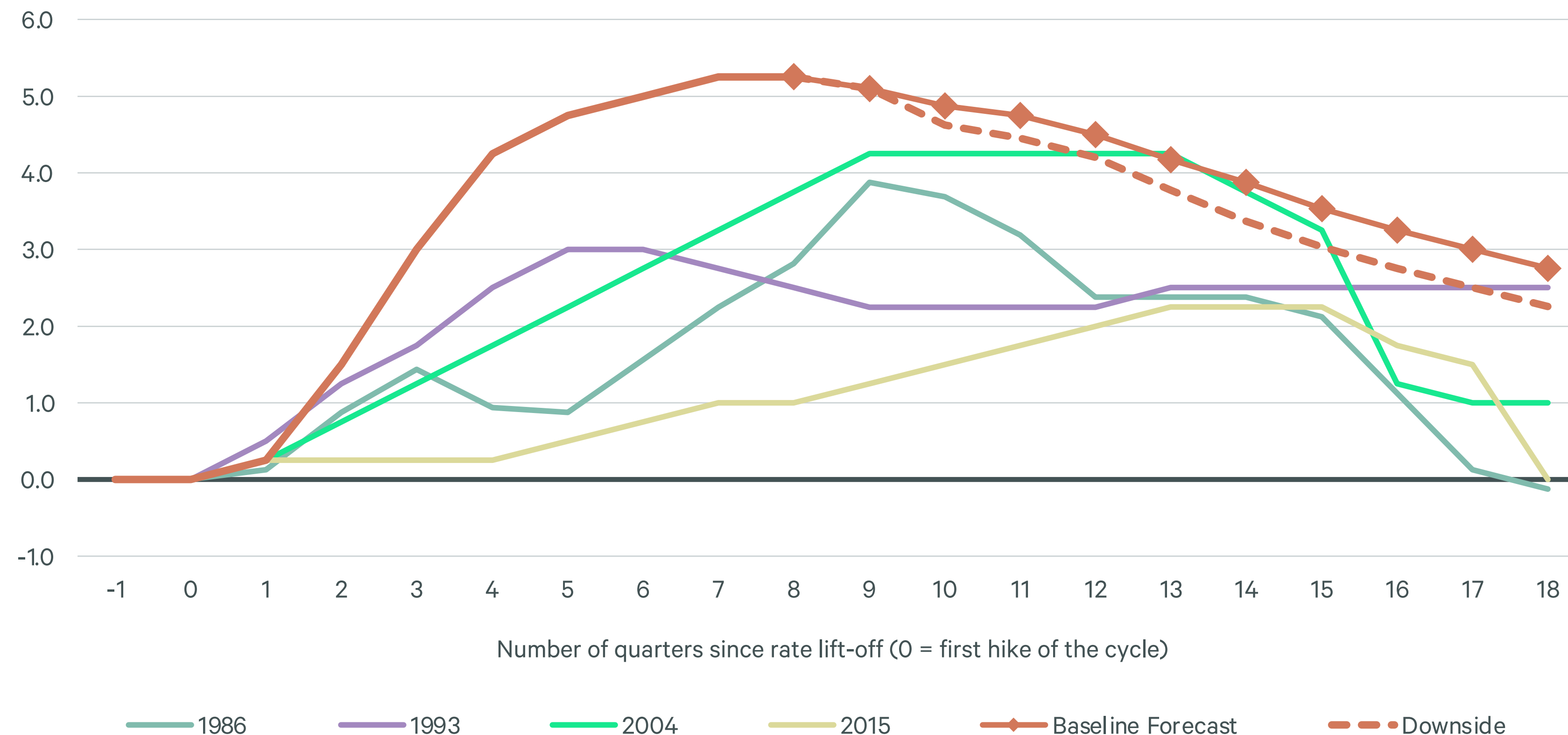
Policy rates are likely to stay higher than past cycles

- Easing Y-o-Y inflation suggests the Federal Reserve will take a pause on future hikes. But they are also unlikely to make significant cuts in the near-term, despite our outlook for a moderate recession in early 2024. Rather, the Committee will wait until inflation shows clear signs of progressing towards its 2% target.
- CBRE EA expects that the Fed Funds Rate will remain relatively heightened compared with previous tightening cycles. This 'higher-for-longer' outlook will have implications for CBRE EA's cap rate and value growth forecast.
- Should higher interest rates trigger more financial distress analogous to our Downside scenario, then policy rates will likely taper off at a faster pace.

Change In Fed Funds Rate From Beginning of Each Tightening Cycle (Percentage Points)



Source: The Federal Reserve, CBRE Econometric Advisors

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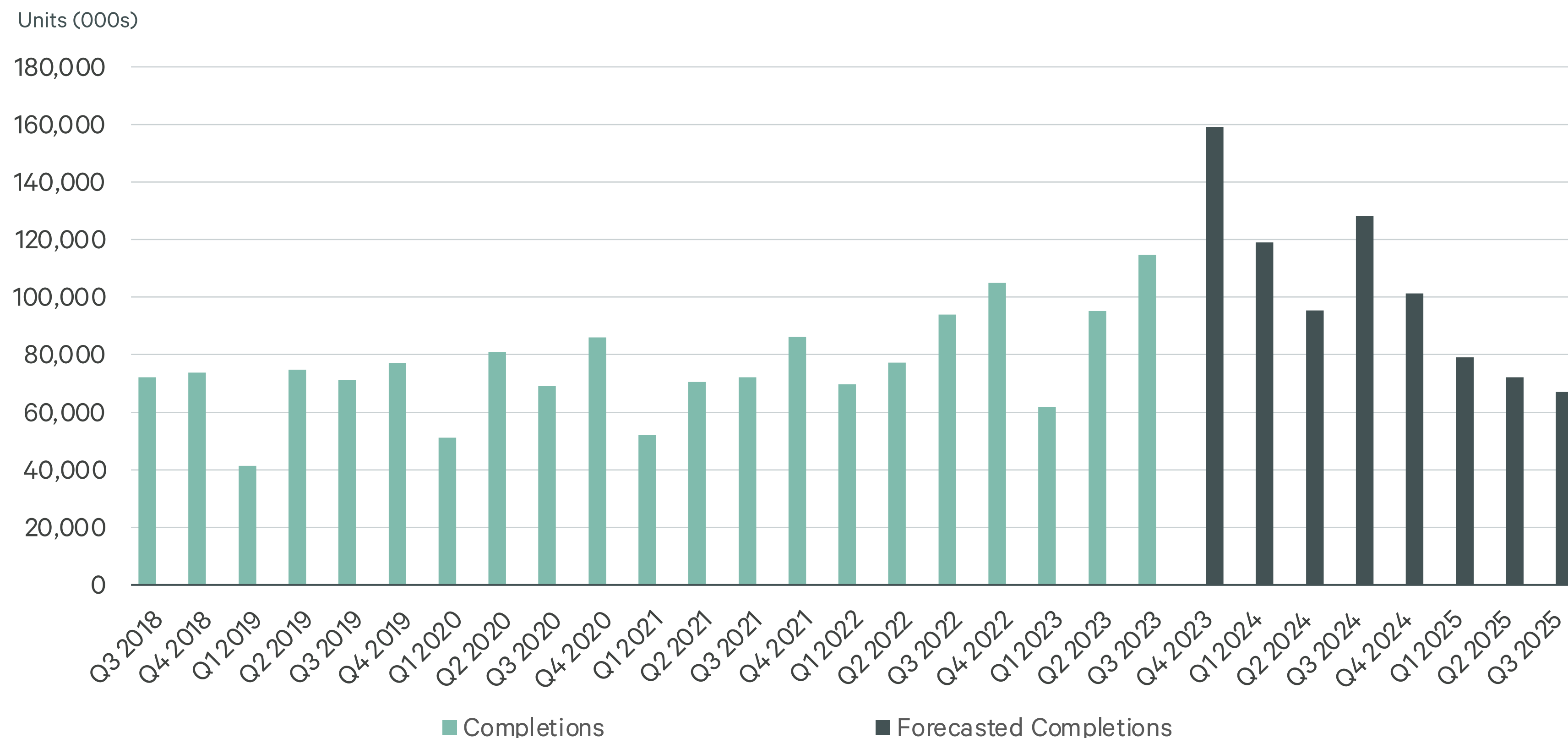
Multifamily Outlook

The wave of supply is expected to continue in the near term

- The multifamily sector witnessed a record 114,628 units of completions in Q3, up 22% year-over-year. We anticipate even more completions to flood the market next quarter, with 159,000 units expected by the end of the year. By 2025, we forecast the wave of the supply to ebb, and return to longer-term trends.
- Meeting the unprecedented supply in Q3 was a relatively strong net absorption of 82,138 units, so that vacancy moved up only slightly from 5.0% in Q2 to 5.1% in Q3.
- Completions were highest in Sun Belt markets. The bulk of peak supply in these markets is expected in the next two quarters.



Source: CBRE Econometric Advisors, Dodge Data & Analytics

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Operators prioritizing 'heads in beds' over rent

- The vacancy rate ticked up in Q3 to 5.2%, slightly above the long-run 2010-2019 average of 4.9%, while rent growth dropped to 0.7% Y-o-Y, well below the 3.2% Compound Annual Growth Rate (CAGR) of rent between 2010 and 2019.
- The relatively muted increase in vacancy required more generous rent offerings to fill units and absorb supply. However, rent growth did remain positive in Q3, and the recent weakness has still resulted in a strong CAGR of 3.8% from Q3 2019 to Q3 2023.

Source: CBRE Econometric Advisors, RealPage Inc.

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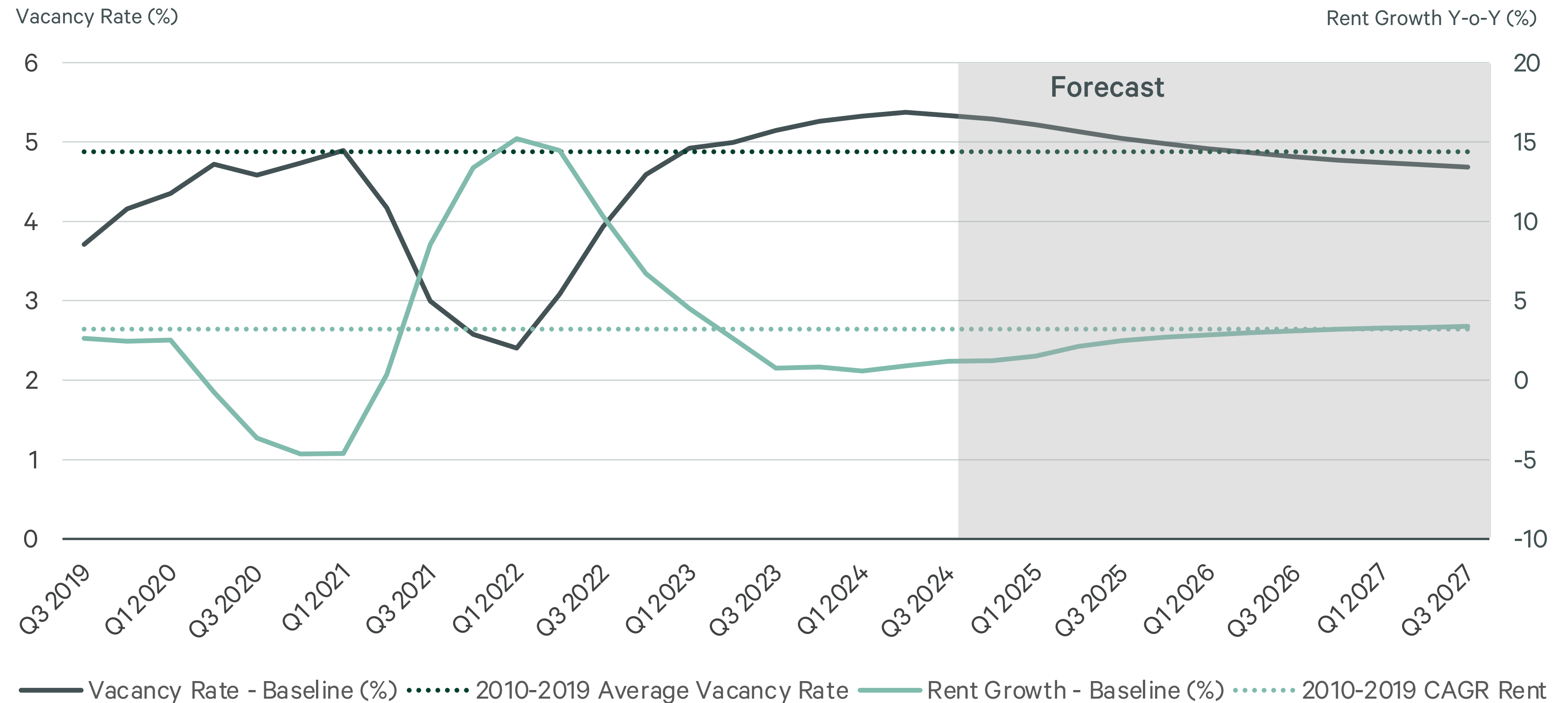
Rent and vacancy forecasted to normalize by the end of 2025

- We expect low but positive Y-o-Y growth in the next three quarters despite two headwinds:
  - Record completions of 214,000 expected in the first half of 2024.
  - A moderate recession in the Baseline Scenario in H1 2024.
- Toward the end of 2024 and moving into 2025 and beyond, we project that vacancy and rent growth move toward longer-term averages of 4.9% and 3.2%, respectively.

The Baseline Multifamily Forecast



Source: CBRE Econometric Advisors, RealPage Inc.

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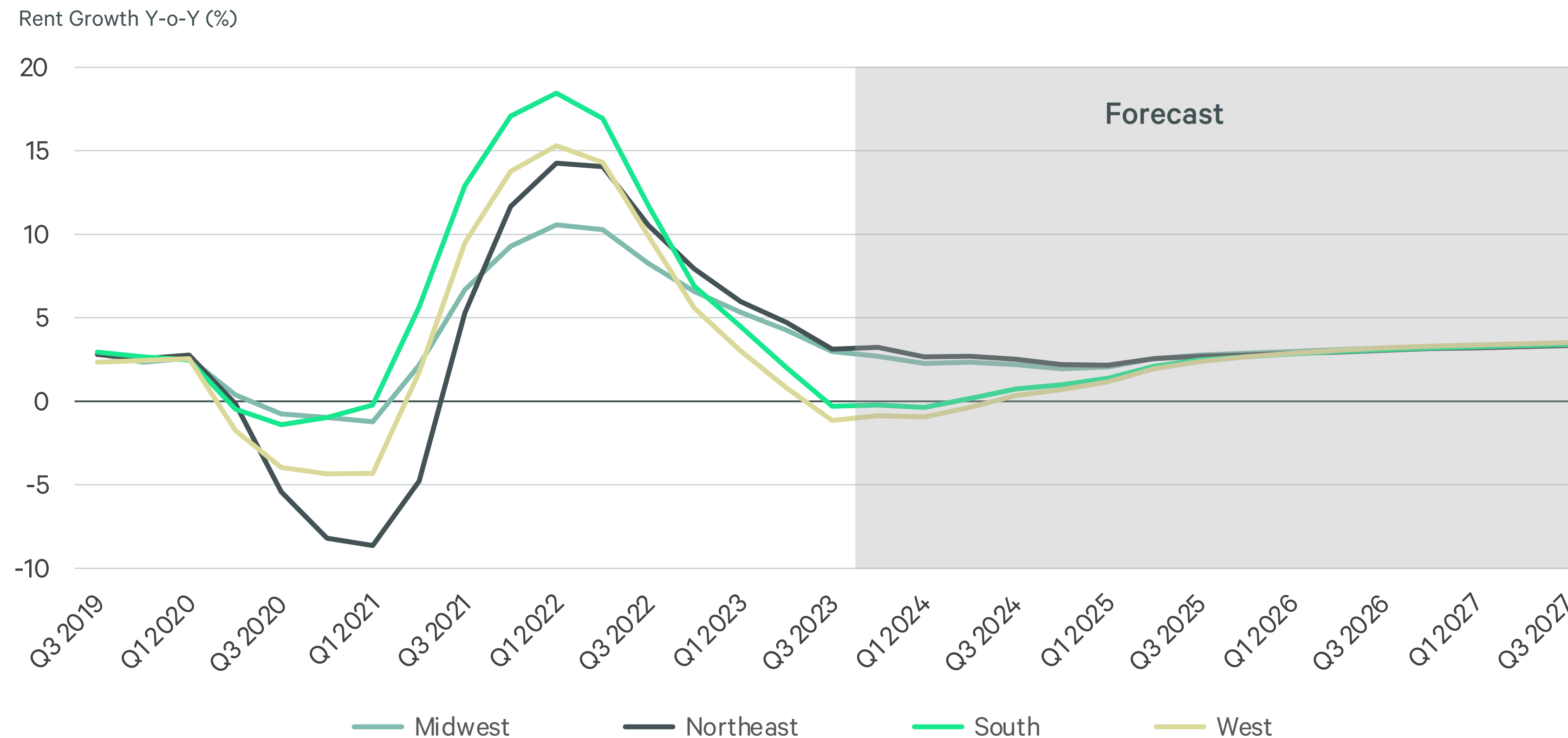
Regional rent growth strength in the Northeast and Midwest

- The Midwest and Northeast, the two regions that missed out on the highs of blistering 2022 rent growth, are the two regions forecast to have positive rent growth in 2024.
- Markets in the West and South are expected to turn negative in 2024. However, even with that negative growth in 2024, the forecasted CAGR from 2019 through 2025 is 4.2% in the South. Forecasted rent growth weakness in the next year is not enough to reverse the gains in 2022.



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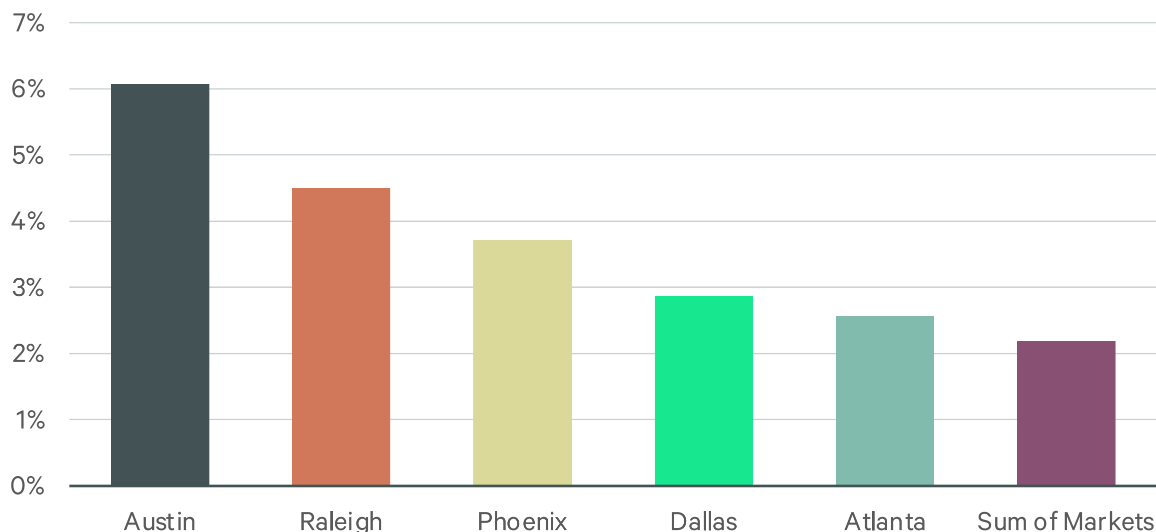
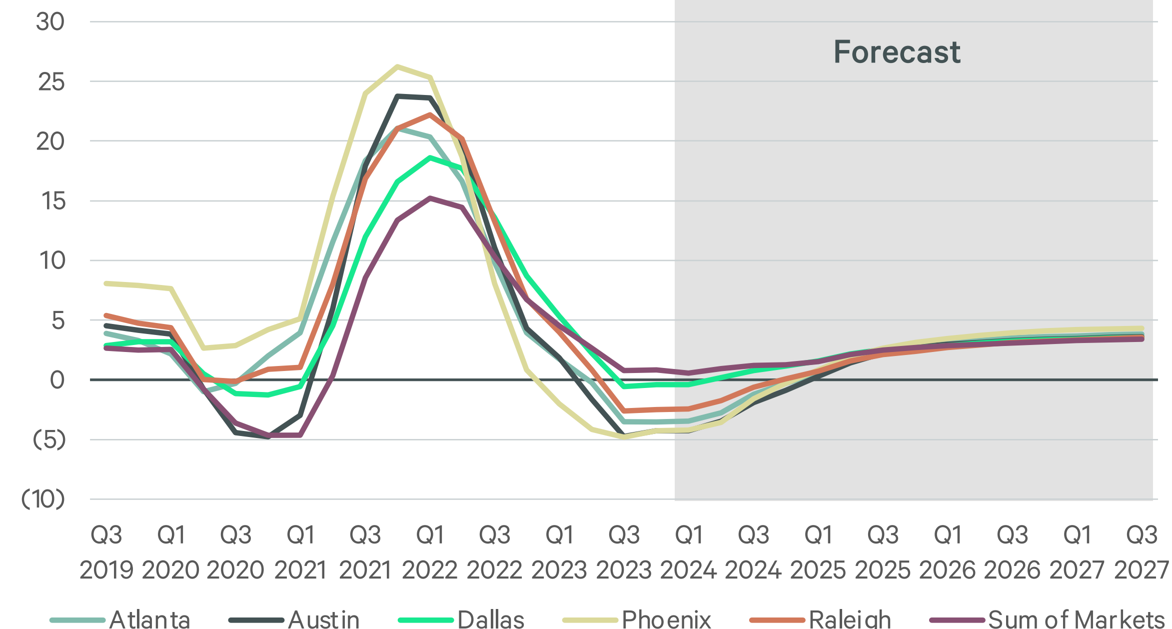
A deep dive into the Sun Belt's volatile ride

Selected Sun Belt Markets and National Completions Q3 2023



Source: CBRE Econometric Advisors, Dodge Data & Analytics

Selected Sun Belt Markets and National Rent Growth



Source: CBRE Econometric Advisors, RealPage Inc

- Sun Belt markets magnify the national trend, leading the way in terms of supply and its effect on rent growth. Perennial rent growth outperformers since 2019, these markets have lost ground relative to the national average in rent growth in 2023. We expect negative Y-o-Y rent growth for Sun Belt markets in 2024, and a longer-term moderation of their strength relative to the rest of the country.

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Macroeconomic scenarios and multifamily performance

- In the Downside Scenario, tight credit and a fall off in consumer spending pushes the economy into a medium-sized recession through 2024. Rent growth bottoms out at -2.5% in Q1 2024.
- In the Upside Scenario, employment and consumer spending continue to be strong, and output continues to surprise on the upside. The economy experiences the hypothesized 'soft landing' and multifamily rent growth bounces back in 2024 rather than in 2025.

Multifamily Forecasts by Macroeconomic Scenario

Source: CBRE Econometric Advisors

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EA Scenarios

‘Baseline’ Scenario

- The Baseline Scenario assumes that economic growth will contract as credit conditions remain tight and private investment and consumption weakens. Q-o-Q declines could emerge as soon as late 2023 and last through H1 2024. (NOTE: The figures to the right show Y-o-Y growth.) Our Baseline expects that the labor market will eventually roll over by 2024 and the unemployment rate will increase to the upper 4% range.
- Although recent CPI reports indicate a M-o-M uptick in inflation we believe it will generally trend downward from here. Some components of inflation, such as consumer services, could remain stubbornly high in the near-term.
- The combination of peaking inflation and weaker economic growth suggests that the Fed is done hiking this cycle, albeit one more rate hike this year is within the range of possibility.

Y-o-Y Change (%); 10-Year Treasury Displays Quarterly Yields

	GDP	Employment	CPI	US 10-Year
2021 Q1	1.6	(5.4)	1.9	1.3
2021 Q2	12.0	8.6	4.8	1.6
2021 Q3	4.7	4.7	5.3	1.3
2021 Q4	5.4	4.6	6.8	1.5
2022 Q1	3.6	5.0	8.0	1.9
2022 Q2	1.9	4.7	8.6	2.9
2022 Q3	1.7	4.2	8.3	3.1
2022 Q4	0.7	3.4	7.1	3.8
2023 Q1	1.7	2.9	5.8	3.6
2023 Q2	2.4	2.5	4.1	3.6
2023 Q3	2.4	2.1	3.6	4.1
2023 Q4	1.7	1.5	3.5	4.6
2024 Q1	1.0	0.8	3.2	4.4
2024 Q2	0.8	0.3	3.2	4.3
2024 Q3	0.5	(0.1)	2.8	4.1
2024 Q4	1.1	(0.0)	2.4	4.0
2025 Q1	1.7	0.3	2.3	3.9
2025 Q2	1.9	0.5	2.3	3.8
2025 Q3	2.1	0.7	2.3	3.7
2025 Q4	2.1	0.8	2.3	3.6

Source: Oxford Economics, CBRE Econometric Advisors

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‘Tighter Financial Conditions’ Scenario

- In this scenario, the U.S. economy is not able to withstand tighter credit conditions and output contracts more than expected. Business investment plans are shelved, and firms are not able to retain staff as they would be able to in a more moderate recession. Both employment and GDP decline for the duration of 2024. A key trigger of tighter credit conditions is interest rates drifting higher than our Baseline would suggest.
- The ‘Tighter Financial Conditions’ will have a disproportionate impact on the commercial real estate sector, which leans on regional banks as a key source of financing. With the key driver of this scenario being higher interest rates the impact on cap rates and valuations would be quite negative.

Y-o-Y Change (%); 10-Year Treasury Displays Quarterly Yields

	GDP	Employment	CPI	US 10-Year
2021 Q1	1.6	(5.4)	1.9	1.3
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2023 Q2	2.4	2.5	4.1	3.6
2023 Q3	2.4	2.1	3.6	4.1
2023 Q4	1.2	1.3	3.5	4.8
2024 Q1	(0.1)	0.1	3.2	4.6
2024 Q2	(0.8)	(0.8)	3.0	4.4
2024 Q3	(1.5)	(1.6)	2.5	4.3
2024 Q4	(0.7)	(1.6)	1.9	4.1
2025 Q1	0.4	(1.1)	1.6	4.0
2025 Q2	1.1	(0.6)	1.6	3.9
2025 Q3	1.8	0.0	1.7	3.7
2025 Q4	2.3	0.6	1.8	3.6

Source: Oxford Economics, CBRE Econometric Advisors

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‘Soft Landing’ Scenario

- The ‘Soft Landing’ is driven by consumers continuing to spend their excess savings with limited impact on inflation. Thus, the economy gets the benefit of more activity without the tax of higher interest rates. More clarity around the path of interest rates provides some relief for rate sensitive sectors, such as real estate and manufacturing. The pace of hiring will slow partly due to supply-side constraints.
- The ‘Soft Landing’ scenario has won more converts within the economic forecasting community. However, there is little historical precedent for a ‘soft landing’ following a dramatic uptick in interest rates or tightening of credit conditions.
- Indeed, a potential driver of outperformance this cycle could be an unchecked overhang of stimulus still circulating the economy.
- This scenario would create more stable real estate capital markets and support higher asset prices. Further, the stronger economic outlook would maintain occupier markets.

Y-o-Y Change (%); 10-Year Treasury Displays Quarterly Yields

	GDP	Employment	CPI	US 10-Year
2021 Q1	1.6	(5.4)	1.9	1.3
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2023 Q3	2.4	2.1	3.6	4.1
2023 Q4	1.7	1.5	3.5	4.6
2024 Q1	1.1	0.8	3.3	4.4
2024 Q2	1.2	0.5	3.3	4.2
2024 Q3	1.1	0.3	3.0	4.1
2024 Q4	1.9	0.6	2.7	4.0
2025 Q1	2.4	0.9	2.5	3.8
2025 Q2	2.4	1.1	2.4	3.7
2025 Q3	2.2	1.0	2.3	3.6
2025 Q4	1.9	0.9	2.2	3.6

Source: Oxford Economics, CBRE Econometric Advisors

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‘Severe Downside’ Scenario

- In this scenario the U.S. economy is shocked by a major exogenous event. There could potentially be an unknown financial threat triggered by the continued uptick in interest rates. This event would not take hold immediately but rather begin to bite as rates drift higher in early 2024.
- Such an event would trigger a severe recession in coming quarters analogous to the *Global Financial Crisis*. A key feature of this scenario would be lasting economic scarring as households, firms and the financial system struggles to regain its footing.

Y-o-Y Change (%); 10-Year Treasury Displays Quarterly Yields

	GDP	Employment	CPI	US 10-Year
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2023 Q2	2.4	2.5	4.1	3.6
2023 Q3	2.4	2.1	3.6	4.1
2023 Q4	1.7	1.5	3.5	4.8
2024 Q1	(2.0)	(0.8)	2.9	4.6
2024 Q2	(2.9)	(2.3)	2.7	4.4
2024 Q3	(3.9)	(3.5)	2.2	4.2
2024 Q4	(4.0)	(4.2)	1.6	4.0
2025 Q1	(1.1)	(3.1)	1.5	3.8
2025 Q2	(0.9)	(2.5)	1.4	3.7
2025 Q3	(0.8)	(2.2)	1.5	3.5
2025 Q4	(0.0)	(1.7)	1.6	3.5

Source: Oxford Economics, CBRE Econometric Advisors

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Thank you

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