CAPITAL SQUARE

A SUMMARY OF 2024 MARKET OUTLOOKS:

INVESTORS ON A CHALLENGING ROAD MUST REMAIN FOCUSED ON THEIR DESTINATION

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TAKEAWAYS

- Industry experts' 2024 market outlooks do not agree on the trajectory of the economy or the timing of the return of functioning capital markets; however, there is consensus that fundamentals must support value in the multifamily market over the long-term.
- Recent declines in the inflation rate may continue, allowing for rate cuts and an ideal soft landing. Or the effects of the Fed's rate raising campaign may be still working their way through the economy and will trigger a recession in 2024. The experts are divided.
- Buyers anxious to invest capital may sense strong bargains and excellent fundamentals in multifamily assets, bringing back transactions volume. Or declining property-level income combined with sellers' inability to adjust pricing expectations may leave the market frozen. It will be a slow start to the year, but the experts are divided thereafter.
- Patient multifamily investors who focus on fundamentals may experience bumps in the road in 2024 but will be set up for future success.

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BUCKLE UP OR UNBUCKLE? FORECASTERS ONLY AGREE WE WILL GET THERE EVENTUALLY

Researchers and economists from many real estate services and investment firms have published their forecasts for economic activity in 2024 and its effect on the commercial real estate industry. As expected, this year's outlook reports focus on the biggest headline issues, including potential interest rate cuts, the return (or not) of real estate transactions activity, and whether the economy will continue its upswing or head back toward recession. We have reviewed these forecasts and condensed the information into what is hopefully a helpful overview and analysis of the various predictions for the year ahead.

Forecasts for the year 2024 generally acknowledge that we are headed for more bumps as we get back on track following the Fed's rate raising campaign. The opening quotation from the popular Urban Land Institute (ULI) Emerging Trends Report captures the situation with a great metaphor: "Unbuckle your seatbelts because it's probably going to be a slow, careful ride."[1] Along this road, there are many differing views of how 2024 plays out for better or worse. Ultimately, however, the forecasters agree that the macro factors driving housing supply and demand will win out in the longer term. A lot of noise will be generated over the coming months, but multifamily and build-for-rent (BFR) investors should expect that remaining strapped in and committed will reliably set them up for success as 2024 transitions into future years.

FORECASTERS' OPINIONS VARY WIDELY WHEN LOOKING AT THE OVERALL ECONOMY IN 2024

The industry's experts have a wide range of opinions on the economic backdrop that the real estate industry will experience in 2024. Even in scenarios where predictions for multifamily housing performance look similar, it is interesting to note the diverging viewpoints on the economy. Forecasting overall economic strength in the short to midterm entails many more variables and must be taken with a grain of salt. Accordingly, the experts find much less consensus on this point.

CBRE sounds the most bullish tone on the overall economy for 2024. Their 2024 US Real Estate Market Outlook forecast includes an ideal continuation of the current deceleration in inflation, allowing for solid rate cuts. They expect inflation to decline to 2.7% by year end, allowing the Fed to reduce rates gradually, while monitoring to keep inflation in check.[2] Overall rate cuts in 2024 are forecast to total 100 basis points, reducing the Fed funds rate to 4.25%-4.50%.[3] Although CBRE expects their upbeat economic forecast will not lead to increased capital markets activity until mid-2024, they add that the recent decline in rates may hasten the return of transactions.

Echoing this sentiment, JLL notes in their 2024 Market Outlook that greater stability should emerge as a result of rate cuts and lower inflation, providing greater confidence as market participants navigate the bumps in the economy.[4]

Cushman & Wakefield (C&W) is much more bearish on the economy for 2024 and inserted a heavy dose of reality into their 2024 Macro Outlook.[5] In a strong contrast to the "green shoots" scenario described by CBRE, C&W reminds us that the following risk factors still stand to upset the economy's current momentum:

- Monetary policy works in "long and variable lags." We are starting to see a rise in delinquency rates on many forms of consumer credit, signaling that the consumer is now starting to feel the effects of the rise in rates.
- Overall wage growth is still at 5.8% YOY (as of October 2023). Inflation levels for goods are down substantially; shelter (housing) is high but receding rapidly. However, high services inflation (driven by wages) indicates that the labor market may be too tight to cut rates. The tight labor market may force the Fed to extend the timeline before they can begin their planned rate cuts.
- It would take an "immaculate disinflation of wages" to allow the Fed to achieve a soft landing. Even in this scenario, rate cuts may have limited influence on below-trend economic growth and will not be likely to work their way through to the commercial real estate industry in 2024.

Based on the belief that the Fed's actions may take a long period to work through the economy, C&W predicts that the U.S. enters a mild recession in 2024, with different sectors affected at different times and in different magnitudes.[6]

MULTIFAMILY HOUSING MARKET TO BE SLOW IN 2024, BUT WITH SILVER LININGS APPEARING

Forecasters across the board pile on the list of woes to impact the multifamily market for the early months of 2024 but leave open the prospect of many positives that could bolster the market by later in the year. Commercial Observer sets the tone by calling 2024 "the end of an era," wherein the easy money of owning real estate and profiting from cap rate compression is over, and owners now must profit by creating value.[7]

Creating and capturing value looks extremely difficult in the near term, as ULI notes that the slower economic growth caused by higher rates means slower job growth and less need for real estate space. Adding to this challenge, JLL points out that higher rates hurt fundraising efforts due to rising hurdle rates and more conservative underwriting on the part of capital providers. To top it off, real estate may be a victim of former success, as real estate asset values have risen so much that the denominator effect causes capital allocators to limit additional real estate investment activity until values come back in line with target allocations.[8]

At the property level, many experts comment on the impact that macro factors will have on occupancy levels and net operating income (NOI). C&W forecasts that the need to soften rents and offer concessions, due to new supply, leads them to predict a 2.3% rent decrease in 2024, with rent growth projected to resume in 2025.[9] CBRE points out similar risks but still sees the opportunity to eke out 1.2% rent growth in 2024. Commercial Observer finds operating expenses to be a bigger risk to NOI than the revenue side of the equation. While they see rent growth as minimal or flat, they expect expenses to continue growing. Some expenses, particularly insurance and payroll, have been more impacted recently and may continue growing at much greater rates than rental rates, leading to NOI that could potentially decline in the near term. Difficulties with property level income, combined with sellers' hesitancy to reset their pricing expectations (or to hold off selling at all), means that transactions may continue at a painfully slow pace.

In contrast to the above, some experts see the perceived challenges to multifamily asset values being just what is needed to jumpstart transactions. CBRE foresees the effect of economic slowdown and higher interest rates as providing bargain asset prices that will entice many investors.[10] Multifamily will remain a favored option for these transactions due to the backdrop of strong long-term fundamentals. CBRE believes that after cap rates broadly expanded 150bps from early 2022 to late 2023, another 25-50bp expansion will follow in 2024. This implies another 5-15% decline in values. Survey respondents to ULI's Emerging Trends report agreed with this interest on the part of investors to find bargains and resuscitate the market. Investors gave the highest "Buy" rating since 2010 in ULI's buy/hold/sell barometer for 2024.[11]

Finally, multifamily housing values cannot be discussed or predicted for 2024 without considering the current supply pipeline. While this appears to be the biggest challenge to the market, many risks may already be baked into forecast values, and there are actually several potential upside scenarios to consider. The timing of delivery of the supply wave is the first element to keep in mind. Forecast softening to rental rates due to new supply (as discussed above) should already be accounted for in 2024 budgets and valuations; however, C&W points out that new supply is expected to crest in early 2024.[12] After this peak, supply slows abruptly, with new deliveries for 2025-2027 being 25% less than the pre-pandemic average in 2015-2019, and new construction starts being down 60% from peak levels in 2022. Looking at single-family housing, Deloitte states in their 2024 Commercial Real Estate Outlook that housing construction is not expected to bounce back until 2025.[13] The lack of new housing supply, combined with extremely limited housing inventory due to owners locked in to low rates, should provide a strong tailwind for multifamily demand. BFR will serve as another great temporary solution for these potential buyers as they wait for the interest rate market to settle before they commit to homeownership.[14]

INVESTORS WILL ABSORB ANY BUMPS IN 2024 IF FOCUS REMAINS ON LONG-TERM FUNDAMENTALS

Despite issuing 2024 market forecasts rife with risk factors, industry experts reach a general consensus that multifamily investors should not lose track of the forest for the trees this year. Multifamily will continue to be supported by the basic long-term need for shelter, which is accentuated by the fact that we are not creating enough new housing supply. ULI's Emerging Trends report cites a figure that the currently supply shortage in in the United States is 3.9 million units.[15] Adding to this shortage, CBRE expects the imbalance of renting versus owning to remain elevated at a 35% premium to home ownership in 2024 (compared with a 52% premium in 2023). Just at the point when homeownership is the least affordable that it has ever been compared to renting, 45% of the Gen Z demographic is now entering their prime rental years.[16] ULI argues that the current supply wave will soon look like a blip compared against longer term trends, and that seems to be an apt statement for the status of the broader industry heading into 2024.

Across the landscape of 2024 industry outlooks, there are a few headline grabbing claims to the positive or negative, but after peeling back the layers on the expert's market calls, we find that the consensus is that investors need to cut through the noise and focus on market fundamentals. 2024 may not end up being the flashiest or most profitable year, and there is no way to foresee the week-to-week bumps in the road. Overall, though, the collective wisdom of the industry is that this is the year we will put ourselves back on the road forward with patience and a focus on fundamentals.

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