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HOW A RISING MORTGAGE RATE ENVIRONMENT AFFECTS MULTIFAMILY DEMAND

White Oak Partners Research Team | August 2022

- *Homeownership is unattainable for many households due to rising mortgage rates and inflated home prices.*
- *Mortgage rates reached 5.7% in the first half 2022.*
- *90% of existing mortgages have interest rates less than 5%.*
- *Residents are paying nearly the same percentage of their income towards rent now as they were before the pandemic due to wage growth.*
- *Multifamily communities offer an attractive alternative to homeownership due to the desirable suburban locations and access to luxury amenities.*

Inflation has turned out to be far stickier than many initially thought and soared to a 40-year high in June 2022. To combat inflation, the Federal Reserve raised interest rates, including a 75-basis point rate hike in June—the highest increase since 1994. As a result, mortgage rates have jumped from 3.2% to 5.7% in the first half of 2022. The combination of rising rates, declining purchasing power, and low inventory of for-sale housing is pricing many would-be homebuyers out of the housing market. As a result, families will remain renters for longer, which will drive multifamily performance for the foreseeable future. Multifamily is often viewed as an inflationary hedge due to staggered lease expirations that allow apartment owners/operators to increase rents to offset rising operational costs. In this edition of WOP Insights, we'll explore the impact that rising rates have on mortgages, the for-sale housing market, and multifamily demand.

CURRENT ENVIRONMENT

The U.S. economy appears to be hitting an inflection point where the Federal Reserve seems willing to do whatever it takes to cool down the headline risk being widely discussed today—inflation. A number of factors have contributed to the inflationary environment today. The labor market has experienced a seismic shift as the shutdown of much of the economy at the beginning of the pandemic created a 14.7% unemployment rate. However, the U.S. quickly shifted into an extremely tight labor market as the economy started to open back up and remote work allowed employees in select industries to have access to jobs nationwide. Employees suddenly had options they had never had before, and pent-up demand and consumer spending left many employers fighting over employees. The reopening of the economy spurred employee demand and inflationary pressures that resulted in higher wages. Now, the fear of a wage-price spiral is prompting the Fed to aggressively raise rates to keep the labor market under control. Additionally, the war in Ukraine and resulting sanctions on Russia have put enormous pressure on the price of commodities such as oil and natural gas. At the same time, global markets are still sorting out the pandemic related supply chain weaknesses and lockdowns in China.

The Fed's primary tools to combat inflation are raising its federal funds rate and reducing its balance sheet. The impact of these efforts will ripple through the U.S. economy—especially the housing market, which is extremely sensitive to rates.[1]

MACRO (MARKET LEVEL)

The median home value in the US reached $428,700 in the first quarter of 2021—a record high.[2] Historically low rates and housing inventory, along with pandemic-induced migration patterns, have been the driving forces of record high single-family home prices. Today's increasing borrowing costs are growing the typical monthly mortgage payment and limiting affordability for many individuals. Mortgage rates have risen from 3.2% to 5.7% in just the first half of 2022.[3] Roughly 90% of existing mortgages have an interest rate below 5%, primarily due to a surge in refinancing over the past two years.[4] Homeowners who previously locked in attractive rates may choose to stay in their starter-homes longer than expected instead of trading-up for something more expensive. This will further reduce the inventory of for-sale housing.

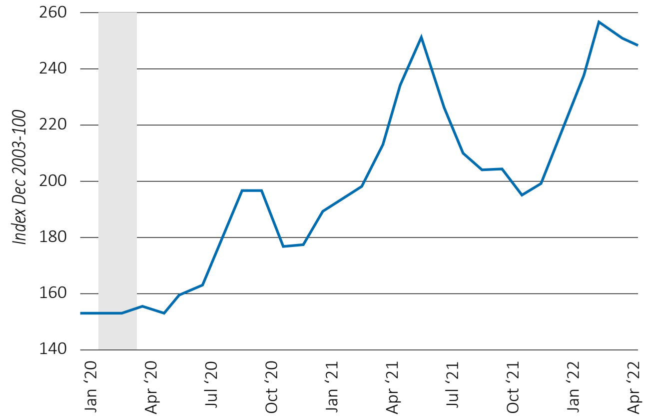
Home builders have been hit hard by inflation, limiting the available housing stock. The rise in the cost of materials and labor have caused a slowdown in new home starts. The cost of building materials was up more than 19% year-over-year as of April 2022, and more than 35% since the beginning of the pandemic.[5] The increase in lumber prices alone has caused the average price of a new single-family home to increase by more than $18,600.[6] According to the National Association of Home Builders (NAHB), 55% of single-family builders reported a shortage of labor.[7] Onsite labor typically costs 20-25% of the total selling price. (Figure 1)

The sharp increase in the cost of construction materials, labor, and capital will likely result in developers building fewer homes

Figure 1

PRODUCER PRICE INDEX BY INDUSTRY: BUILDING MATERIAL AND SUPPLIES DEALERS

January 2020 - April 2022

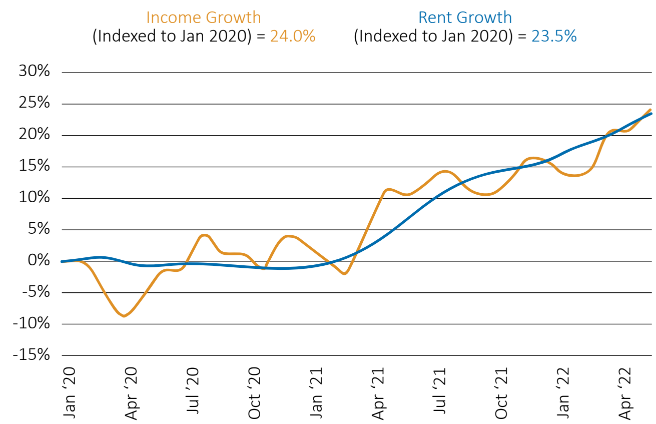


Source: St. Louis Fed

Figure 2

U.S. AVERAGE ANNUAL INCOME V.S. AVERAGE RENT - INDEXED TO JAN 2020

(Reported Resident Income, Source from Signed New Lease Agreements)

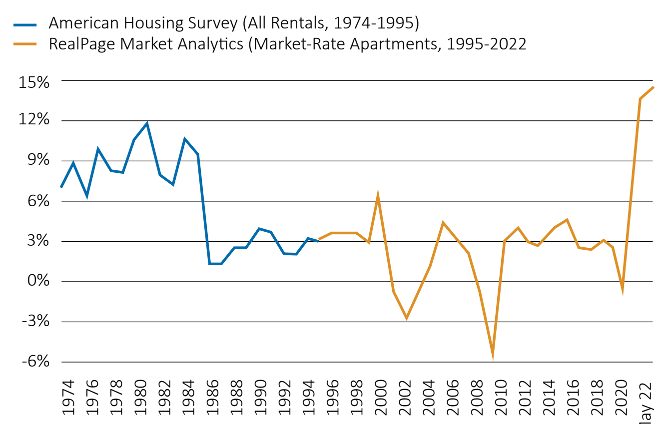


Source: RealPage

Figure 3

HOW DO RENTS MOVE IN A HIGH-INFLATION ENVIRONMENT? LOOK TO THE 1970S

US Residental Rent Growth



Source: RealPage

or increasing prices to offset rising construction costs. There is already some evidence of single-family developers reducing their pipeline; single-family housing starts declined 1.7% in March 2022 and building permits fell 4.8%.[8] Homebuilders in the U.S. were already facing a backlog of unsatisfied demand due to pandemic-related supply chain issues.

The reduced housing inventory, inflated home prices, and declining purchasing power due to inflation is causing renters to stay in place longer. As such, rental vacancy rates have plummeted over the past decade, hovering at 5.8% in the first quarter of 2022, a trend that accelerated during the pandemic.[9]

The Fed is expected to continue to raise rates with recent guidance suggesting that the federal funds rate will settle in the mid-3%'s over the next 12 months.[10] The downstream effect of an increase in the federal funds rate will continue to affect mortgages in the near future.

MICRO (INDIVIDUAL LEVEL)

These current market conditions are putting extreme pressure on households' ability to afford single-family homes. The monthly payment on the median home in the U.S. is up to $2,345.[11] According to Census data, families with the median household income will have to pay 43% of their income to afford the mortgage payment on the median home, assuming a 20% down payment and a 30-year fixed mortgage.[11] First-time buyers are even more disadvantaged as outsized rent growth nationwide has eaten away at their ability to save for a down payment. Additionally, first-time buyers do not have equity from a previous home sale to use for a down payment. First-time homebuyers who have been house hunting in the past year are watching their purchasing power decline each month as mortgage rates rise. Many would-be homebuyers may delay purchasing a single-family home in the short term so as not to settle for a home lower on the quality spectrum for their budget.

Although it may appear that outsized rent growth is eating away at the ability to continue to increase rents, residents are paying nearly the same percentage of their income towards rent now as they were before the pandemic due to wage growth (RealPage).

Current renters have demonstrated resilience during this period of outsized rent growth thanks to increases in wages and migration away from expensive gateway cities (Figure 2). While many of these renters seek homeownership, the current economic environment makes saving for a down payment difficult, and the higher monthly mortgage payments are becoming unattractive to many households. Potential homebuyers also have to weigh the trade-off of moving to a lower quality location to afford the house that they once could in a low-rate environment. The amenities of the luxury multifamily lifestyle can offset delaying the "American Dream" of homeownership by providing desirable suburban locations with great schools and convenient access to employment and nightlife options.

MULTIFAMILY FUNDAMENTALS IN INFLATIONARY ENVIRONMENTS

Multifamily is often viewed as an inflationary hedge due to the short-term leases that provide opportunities for price adjustments to offset rising operational costs. The resilient nature of multifamily compared to other asset classes can be seen by looking back to previous inflationary environments. The last inflationary period in which the Consumer Price Index (CPI) increased greater than 8% year-over-year was back in the 1970s. During the period from 1974 to 1985, rent increased between 7% and 12% each year.[12] (Figure 3)

RISKS

Despite the outsized rent growth in many markets, there are several key risks to consider in multifamily. The Fed's unpredictability and potential for aggressive rate hikes remains a concern. While the Fed has expressed expectations on future rate increases, it's unclear what the exact increase will be at each Fed meeting. The 75-basis point rate hike in June came as a surprise to many and felt reactionary towards recent consumer sentiment data. These rate hikes have increased volatility in the debt markets. However, multifamily has a unique advantage over other commercial real estate asset classes due to the liquidity Fannie and Freddie provide to the market. Additionally, persistent inflation on typical household commodities like food, gas, and energy will disproportionately affect many lower-income households, stifling their ability to absorb rent increases.

PAYOFF

Today's inflationary environment and the increase in interest rates has made buying a home more difficult for many households. Potential homebuyers will have to weigh the possibility of seeking a lower quality home as the cost of capital continues to increase. Class A multifamily communities offer a unique mix of resort-style amenities and desirable locations that makes them an attractive alternative to homeownership given the current market conditions.

Sources:

1. Fortune
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