Rental Housing Market Exhibits Cyclical Stability, Contains Structural Questions

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SPECIAL REPORT

By Ivan Kaufman and Sam Chandan

ARBOR

About The Authors

Ivan Kaufman is the Founder, Chairman and CEO of Arbor Realty Trust, Inc. (NYSE:ABR), a leading multifamily and commercial real estate lender and real estate investment trust. Arbor manages and services a $30 billion real estate loan portfolio and originates more than $7 billion in loans annually. Arbor is recognized as a top lender by Fannie Mae and Freddie Mac. Ivan is also the cofounder of Arbor Multifamily Acquisition Company (AMAC), an investment firm created in 2012, which owns and operates over 8,000 units and has acquired more than $1.75 billion of multifamily properties across the country. In addition, Ivan is the CEO of ArborCrowd, an online real estate crowdfunding business he launched in 2016. Through his successful development and evolution of many companies that span nearly four decades through all cycles, Ivan Kaufman is a trusted thought leader and pioneer in all aspects of commercial real estate finance.

Sam Chandan is a professor of finance at the NYU Stern School of Business and head of the Stern Center for Real Estate Finance. He joined the Stern faculty in late January 2022. From 2016 through early January 2022, he was the Larry & Klara Silverstein Chair and academic dean of the Schack Institute of Real Estate at the NYU School of Professional Studies, one of the world's largest centers of real estate education. He is also the founder of Chandan Economics, an economic advisory and data science firm serving the institutional real estate industry, a contributor to Forbes, and host of the Urban Lab on Apple Podcasts. Dr. Chandan is chair of the Real Estate Pride Council, a global association of lesbian, gay, bisexual, and transgender leaders in the professions of the built environment. Dr. Chandan is a Fellow of the Royal Institution of Chartered Surveyors (FRICS), the Royal Society for Public Health (FRSPH), and the Real Estate Research Institute (RERI), and an Associate Member of the American Society for Microbiology (ASM). His multifaceted research interests address real estate as well as urban epidemiology and the preparedness of global cities and other systemically important urban areas in managing novel public health threats.

Key Findings

- The Federal Reserve continues to engage in aggressive monetary tightening.
- The rental housing sector is well-positioned to withstand growing economic headwinds because the cyclical forces that lower homeownership rates also historically have increased rental housing demand.
- Superstar cities must undertake strategies to address affordability and livability concerns to compete in a remote-work economy.

The Outlook

As we turn past 2022's halfway mark, optimism surrounding the U.S. economy's expansion has dimmed. An erosion of household spending power, spiking financial volatility, declining consumer sentiment, and now consecutive quarters of negative growth are all combining to depress the near-term outlook. When high levels of inflation started to emerge as a primary concern last year, the big question was whether the Federal Reserve could pull off a soft landing by calming price pressures without derailing the recovery. Now, the debate has shifted from if some economic pain will be on the horizon to *how much* and for *how long*.

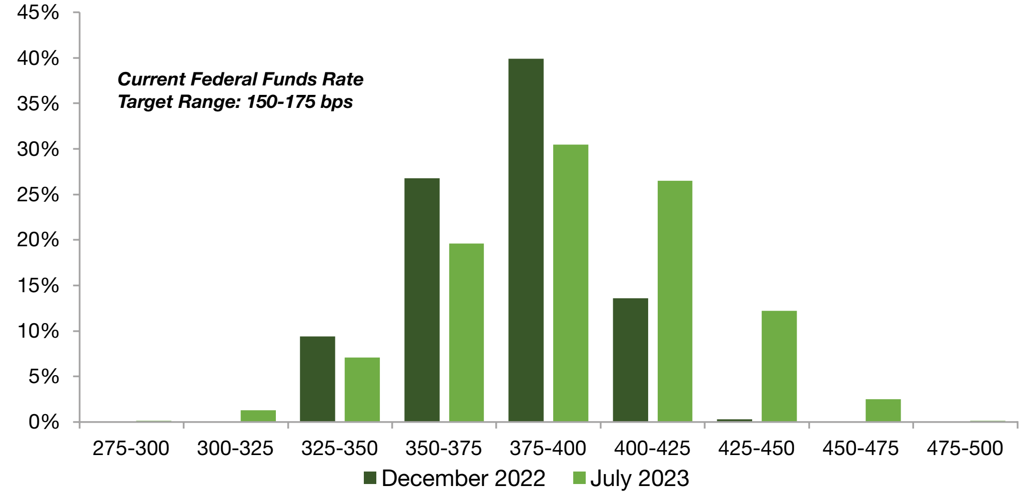
As reported by the U.S. Bureau of Labor Statistics, consumer prices were up 9.1% during the 12 months ending in May, keeping today's inflationary environment at its highest sustained level in over 40 years. At its June and July policy meetings, the Federal Reserve moved its Federal Funds Rate (FFR) up by 75 basis points (bps), its largest single-meeting rate hikes since 1994. Markets are currently betting that the Federal Reserve will need to increase its policy rate by another 100 bps by the end of this year, bringing the FFR up to a target range between 325 and 350 bps *(Chart 1)*. Thereafter, markets are split on whether more

CHART 1

Implied Probabilities of Effective Federal Funds Rate Target Range by Date

Measured as of June 15, 2022

Source: Chicago Mercantile Exchange Group

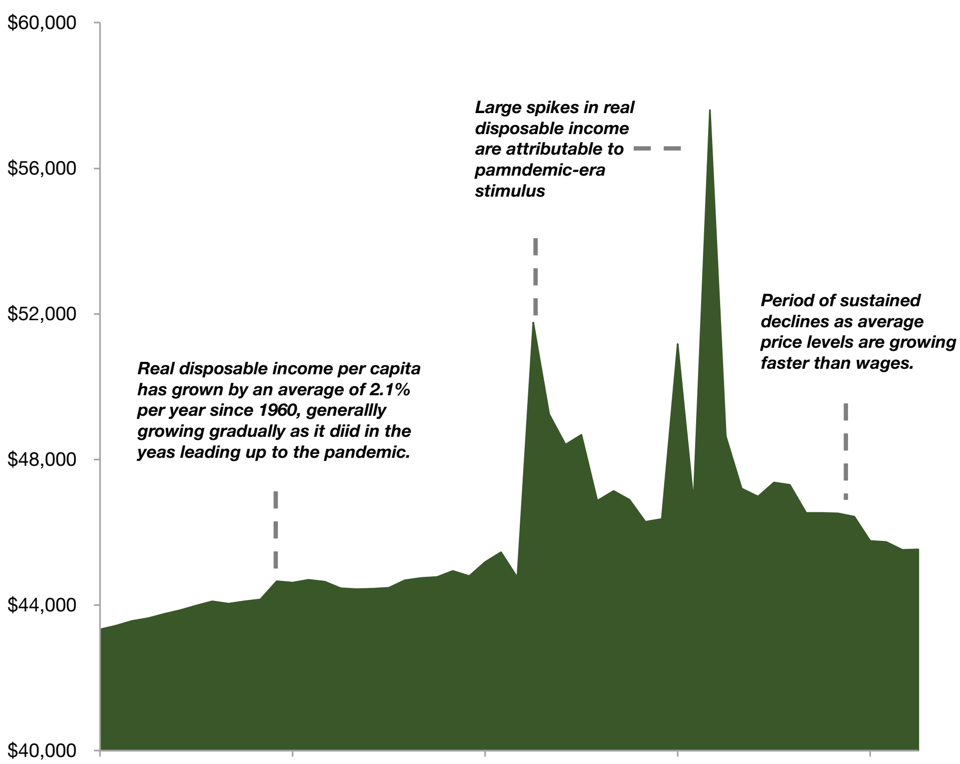


monetary tightening will be necessary, or if the FOMC may have to start cutting interest rates and reintroducing accommodation.

Over the short-term, with the Fed embracing hawkish monetary policy, fears are rising that a recession may lie around the corner if we are not in one already. By increasing the cost of capital, a decrease in investment activity is the intended mechanism for pulling the reins back on the economy and cooling runaway prices. An echoing chorus of notable voices, including former Treasury Secretary, Lawrence Summers, has forecasted a near-term recession in recent months. Similarly, as captured by the Wall Street Journal Economic Forecasting Survey, which reflects the sentiments of a broad cross-section of leading economists, respondents pegged the probability of near-term recession at 49% when polled in July — up from 28% in April and 18% in January. As reported by Morning Consult, the technical declarations by the National Bureau of Economic Research mean little to the average American, with two-in-three adults thinking we are already in a recession.

Beyond just a recession, the specter of a stagflationary environment — where inflation remains untamed as the economy contracts — is the most significant macroeconomic risk on the table today. Disposable income per capita declined in 12 of the last 15 months through June — making recent history one of the most entrenched periods of consumer spending power loss on record *(Chart 2)*. According to

CHART 2
Real Disposable Income per Capita
Seasonally Adjusted Annual Rate, Measured in 2012 Dollars, Through April 2022
Source: U.S. Bureau of Economic Analysis



the U.S. Census Bureau's Household Pulse Survey, declining spending power is having a tangible effect on the ability of consumers to afford daily expenses. In July, the share of households reporting at least some difficulty in meeting their expenses in the past week reached 65.5%.

In an economy where consumption accounts for the dominant share of gross domestic product, there is no plausible scenario where households can fall behind for an extended period without a commensurate deterioration in both spending and growth. While the probability of returning to a 1970/80s-style stagflationary environment remains low, its presence in the national conversation alone necessitates caution and vigilance from policymakers on both sides of the monetary and fiscal divide.

Multifamily Resiliency

Within the market for rental housing in the U.S., the multifamily sector is uniquely positioned to withstand growing economic headwinds. An extraordinary run-up in single-family home prices and rising borrowing costs are pushing ownership out of reach for many first-time homebuyers. Mortgage interest rates are up above 5.3% in the second quarter of 2022, making the debt servicing costs for new homebuyers roughly twice as high as they were just one year ago. According to John Burns Real Estate Consulting, potential homeowners could expect to pay $839 more per month if they were to buy instead of rent, the highest such premium on record. Subsequently, the Mortgage Bankers Association notes that mortgage credit availability declined for the fourth consecutive month in June, and credit standards are significantly tighter today than before the pandemic.

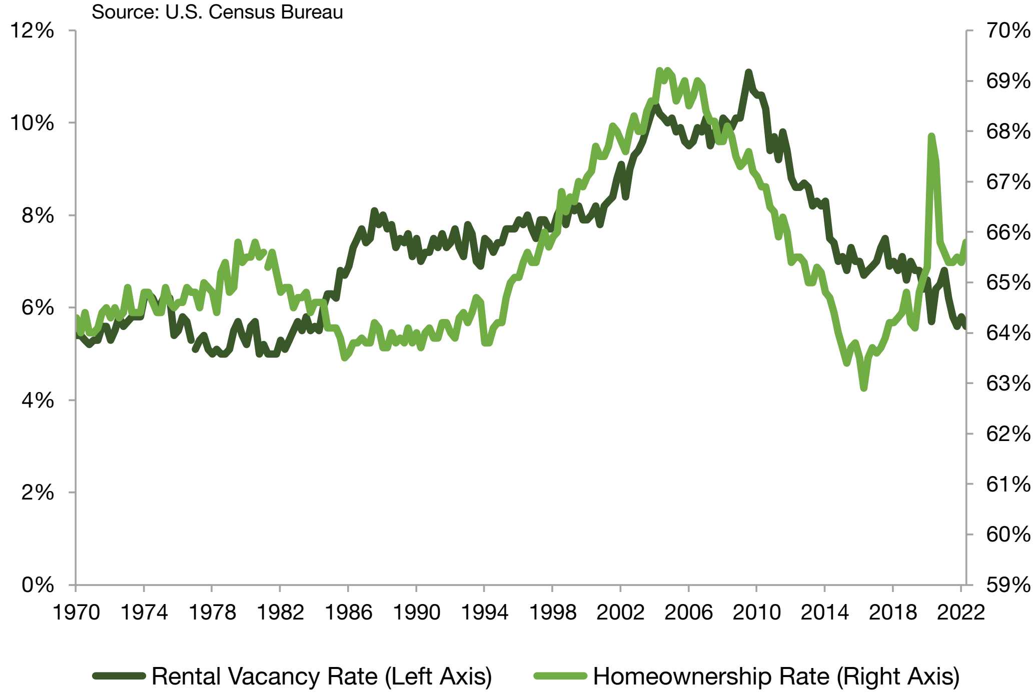
Historically, where access to homeownership has declined, the rental market has benefited. Rental vacancy rates, which are currently at their lowest levels since the early 1980s, tend to move directionally with the homeownership rate *(Chart 3)*. With barriers to homeownership mounting, the multifamily sector will likely have to make room for an influx of renters.

CHART 3

Rental Vacancy Rate vs. Homeownership Rate

Through Q2 2022

Source: U.S. Census Bureau



Beyond stable tenant demand, several other headline gauges of health continue to support confidence in the rental housing sector's ability to withstand distress. Trepp notes in its tracking of CMBS loans that the delinquency rate for multifamily has continued to improve in recent months and sat at a benign 0.9% through July 2022. Further, asset valuations continue to rise, even as public equity markets are struggling, and the cost of capital is rising. According to MSCI Real Capital Analytics, apartment prices continued to press higher, gaining 23.7% year-over-year and 1.6% month-over-month.

A Moment of Risk and Opportunity

While rental housing nationally remains on strong footing to weather growing economic headwinds, the long-term competitiveness of individual markets is justifiably under the microscope. The success of work from home (WFH) adoption is challenging the understanding of the need to co-locate in proximity to an office. In the summer of 2020, employers expected employees who were able to work remotely to WFH about 1.6 days per week.[1] As the public health crisis has lessened and corporate offices have re-opened, that number has only risen, with employers currently forecasting a post-pandemic WFH average of 2.4 days per week for these types of workers *(Chart 4)*.

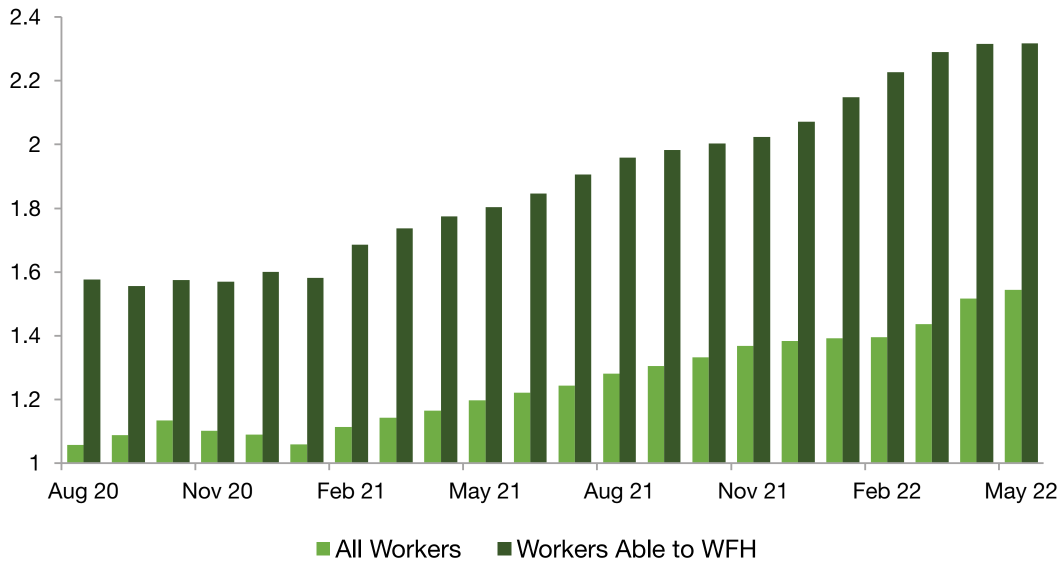
The WFH trend has changed more than workplace culture. Never have we found ourselves in a position where the workforces of our superstar cities, which comprise the lifeblood of their metropolitan economies, could completely divorce their housing decisions from their physical place of

CHART 4

Employers Expectations of WFH Days Post-Pandemic

Measured in Days per Work Week, Through May 2022

Source: Survey of Working Arrangements and Attitudes (SWAA)



[1]Survey of Working Arrangements and Attitudes (SWAA), Barrero, Jose Maria, Nicholas Bloom, and Steven J. Davis, 2021. "Why working from home will stick," National Bureau of Economic Research Working Paper 28731

work. In no uncertain terms, the threat to costly superstar cities is real. The values of agglomeration, from both a lifestyle and a productivity standpoint, are significant. However, there is a limit on how much employees and employers will pay for this agglomeration premium when there are viable, cost-effective alternatives.

To cement competitive advantages and retain labor force talent, superstar cities, now and in the decades to come, require strategic investments. Structural affordability crises and a lack of infrastructure modernization are issues that will require expensive solutions, though their price tags will be dwarfed only by continued inaction. More than ever, effective public leadership that understands these needs will be critical for the success of the nation's largest cities.

Of course, public leaders need-not go it alone. Cities are symbiotic ecosystems that require buy-in from residents and private industry, not just local governance. Through deepening public-private partnerships (PPP), local leaders can access both the expertise and capital resources needed to accomplish transformational projects. In New York, from Hudson Yards and Moynihan Train Hall to Cornell Tech and the reconstruction of the World Trade Center, where there have been alterations to the urban fabric, it has required PPPs to graduate action plans into action. Elsewhere, Challenge Seattle's efforts to bring ultra-high-speed rail and broadband internet access through the interconnected Pacific Northwest's "Cascadia Corridor" is another example of an ambitious PPP course setting.

The Road Ahead

Inflation has exceeded the Central Bank's initial expectations in both severity and duration. In the months ahead, the Fed plans to continue to engage in aggressive monetary policy, prioritizing re-asserting control of price dynamics over the longevity of the economic expansion. Still, the rental housing sector is in an idiosyncratic position of stability. The combination of risks to growth and rising rates may keep even more households in the rental market for the foreseeable future, buttressing the sector against growing macroeconomic headwinds. For cities, the time is now to leverage strengths — not rest on them. Otherwise, rental housing demand in the U.S. will begin to look more like a zero-sum game, where the superstars risk losing their shine.

About Arbor

Arbor Realty Trust, Inc. (NYSE:ABR) is a nationwide real estate investment trust and direct lender, providing loan origination and servicing for multifamily, single-family rental (SFR) portfolios and other diverse commercial real estate assets. Headquartered in Uniondale, New York, Arbor manages a multibillion- dollar servicing portfolio, specializing in government-sponsored enterprise products. Arbor is a leading Fannie Mae DUS® lender and Freddie Mac Optigo® Seller/Servicer. Rated by Standard and Poor's and Fitch Ratings, Arbor is committed to building on its reputation for service, quality and customized solutions with an unparalleled dedication to providing our clients excellence over the entire life of a loan.

Arbor Realty Trust
333 Earle Ovington Blvd.
Suite 900
Uniondale, NY 11553

arbor.com | 855.708.2090

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