Recalibrating Amid Uncertainty

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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 $42 billion real estate loan portfolio and has originated more than $20 billion in loans since 2021. Arbor is recognized as a top lender by Fannie Mae and Freddie Mac. Ivan is also the co-founder of Arbor Multifamily Acquisition Company (AMAC), an investment firm created in 2012, which owns and operates over 12,000 units and has acquired more than $2.5 billion of multifamily properties across the country. 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 and Director of the Chen Institute for Global Real Estate Finance at the NYU Stern School of Business. 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

- Despite a slowdown in new investment, the macro economy has outperformed expectations in 2023, indicating a soft landing is more likely.

- A yield curve normalization could place additional upward pressure on long-term interest rates and cap rates into 2024.

- While local challenges in select rental markets are meaningful, the multifamily sector remains structurally sound and well-positioned to limit distress on a national level.

The Outlook

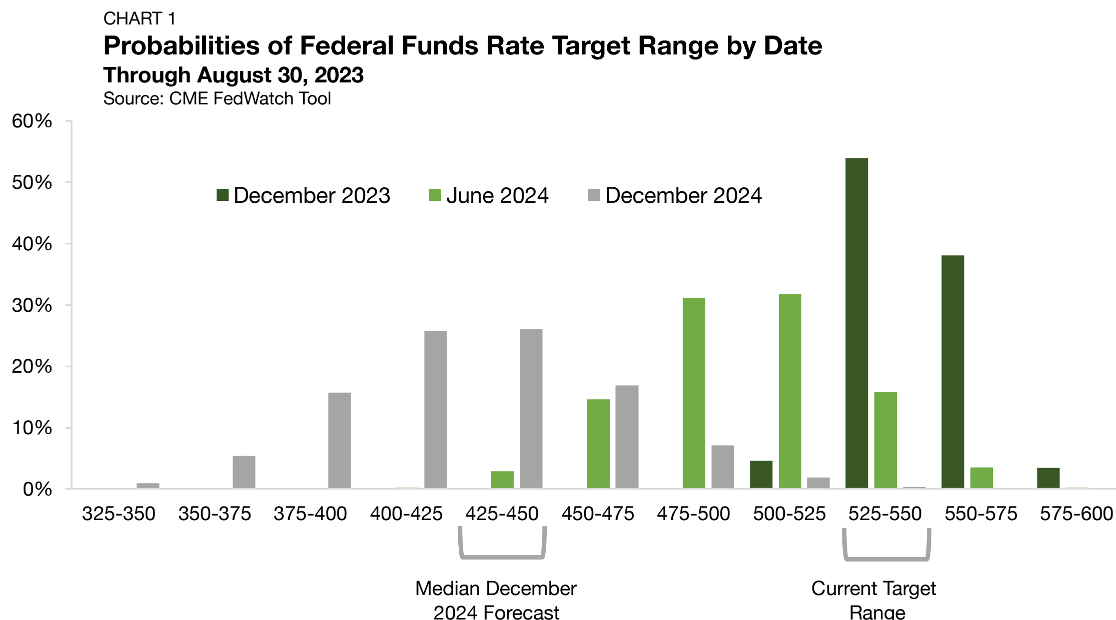
In early 2023, as the Federal Reserve began its monetary tightening cycle, the central bank insisted that an economic downturn was not a foregone conclusion, although history indicated otherwise. Over the next few quarters, turbulence is foreseeable as multifamily investors navigate the bottom of this cycle and recalibrate their expectations.

The nation's economic environment remains challenged. The failures of two large regional banks and high interest rates have added fuel to pre-existing economic anxiety. In the thick of this dislocation, the financial markets continue to see significant volatility, and expectations are that the next two to three quarters will be the most challenging part of the cycle. Nevertheless, national economic growth has proven resilient as the labor market has displayed strength and shed excess momentum, moving the economy closer to a soft landing.

Seatbelts Fastened

Deservedly, there is more optimism in the U.S. economic outlook now than there was six months ago, but we are far from being out of the woods. Generally, periods of economic instability will last 18 to 24 months. Given that the market is about 15 months into the current cycle, there could be six to nine months left. However, it does appear the market has reached the bottom.

While some observers project the Federal Reserve will begin cutting rates by mid-2024, the speed at which the central bank rolls back its rate hikes is unlikely to match its historically rapid pace of tightening. Investors anticipate that the federal funds rate will fall by only 100 bps from its current rate of 5.3% between now and the end of 2024 *(Chart 1)*, which is consistent with the Fed's internal projections.



Even if the Federal Reserve begins cutting short-term interest rates, there remains a high likelihood that long-term interest rates will experience upward pressure over the next year. Generally, investors require a premium to hold long-term investments instead of short-term investments, resulting in a positive yield curve, which is the norm. Inverted yield curves are abnormal red flags that have historically signaled recessions. If we see a return to an upward-sloping yield curve, it is likely to result in higher rates on 10-year Treasurys and all other long-dated market securities.

Nevertheless, the forecast has improved even as clouds remain on the radar. In the span of 12 months, inflation has fallen from 9% to 3% and is likely to fall more in the coming months. A major contributing factor to inflation staying above target is shelter costs, which, according to research presented by the Federal Reserve Bank of San Francisco, should ease substantially in the months ahead.

The ongoing strength of the labor market is also fueling optimism among the investment community. Job openings have dropped by more than 20% from their 2022 highs, and monthly job gains have repeatedly beat economists' expectations. At the same time, unemployment remains near historic lows, and the share of prime-age workers in the labor force is higher than at any point since the 2008 financial crisis. As we look ahead to 2024, the resilient economy appears to be on the path to a soft landing.

Commercial Reality

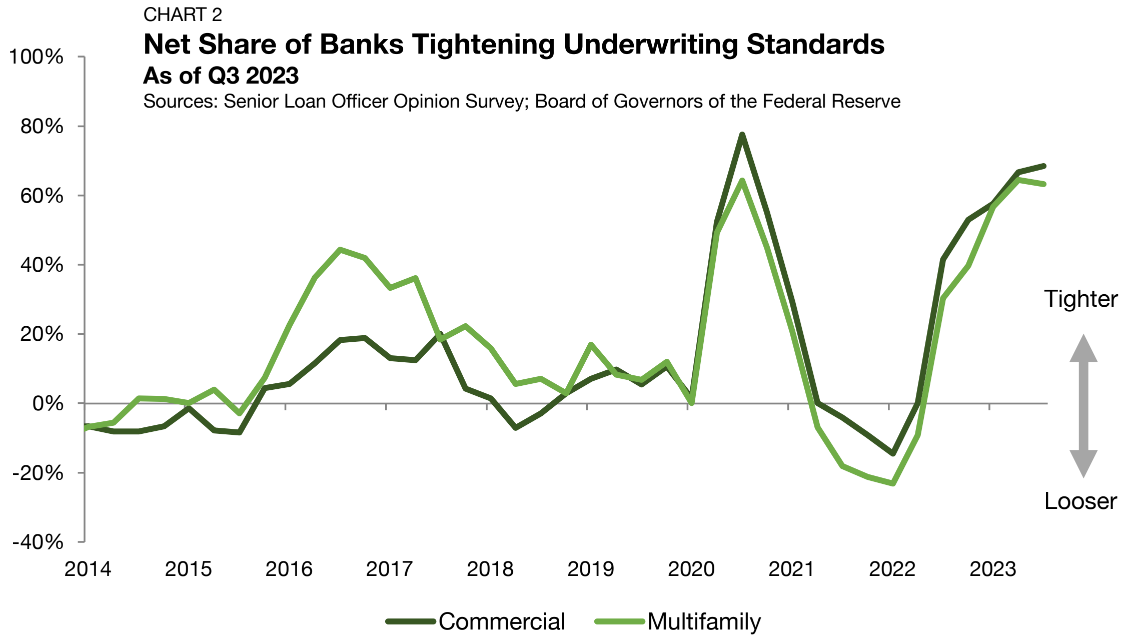
With macroeconomic conditions at a potential cyclical bottom, the rental housing sector finds itself balanced between an unforgiving interest rate climate and operational stability.

An ongoing complication for commercial real estate is competitively obsolete office space. The pandemic upended fundamental assumptions about how we work, and the built environment is just starting to catch up.

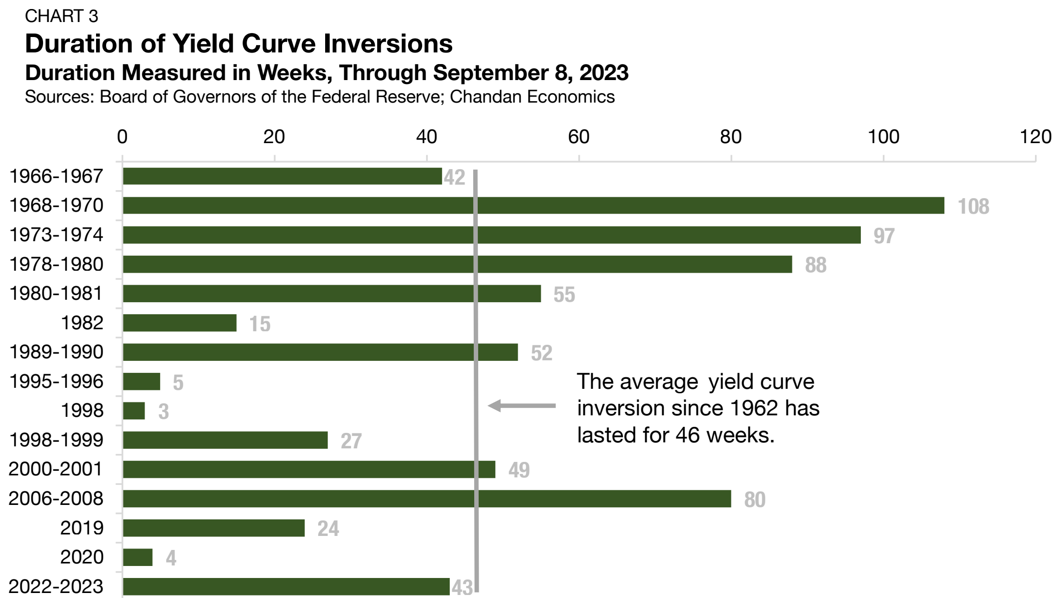
Interest in office-to-multifamily conversions reached a fever pitch in the early days of the pandemic. However, while stories of conversions have now reached front-page news, they represent the exception — not the rule. From the perspectives of structure, location, and capital markets, most impaired office assets do not lend themselves to multifamily conversion. Among the risk factors multifamily investors should keep an eye on, the prospect of a meaningful influx of converted office assets is one where the headlines outweigh the hazards.

The most notable risk presented by troubled office assets is their impact on capital markets. Even as the operational profile of the rental housing sector is in good health, traditional lenders, especially banks, have broad exposure across all commercial property types. Subsequently, even if multifamily loans are not a meaningful source of distress, bank lenders are progressing cautiously across all property types *(Chart 2)*.

Beyond spillover impacts from the office sector, the most pressing concern for investors is the short- and long-term impacts of elevated interest rates.



As discussed above, yield curve inversions are departures from normalcy. Since 1962, short-term interest rates have sat higher than long-term rates about 22% of the time, with the average sustained inversion lasting for 46 weeks *(Chart 3)*.[1]

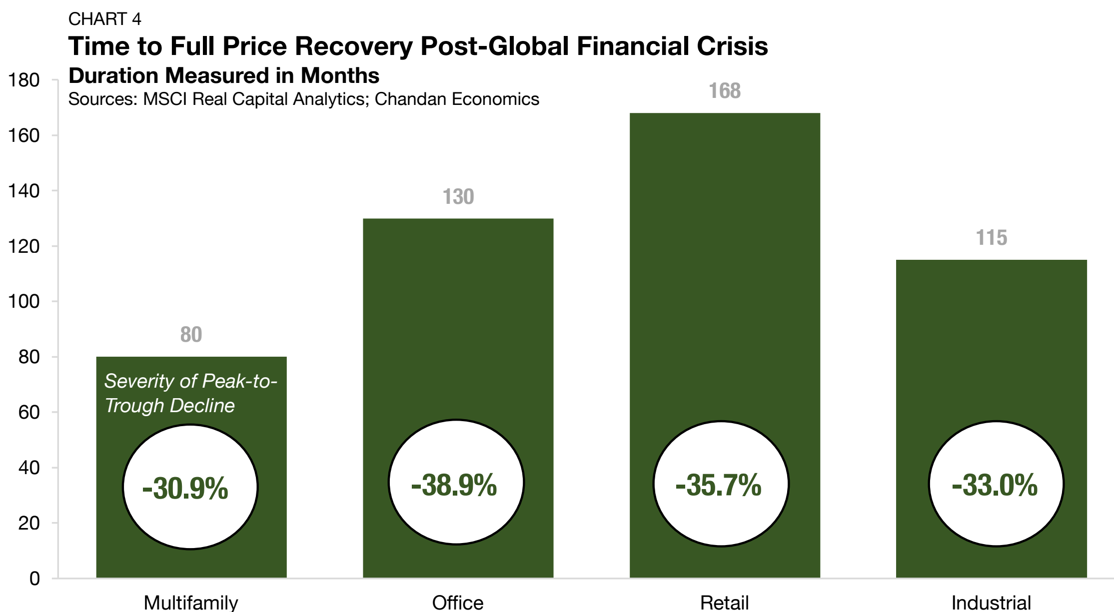


[1] Yield curve inversions described in Chart 3 are periods where the effective federal funds rate is higher than the 10-year Treasury yield. Sustained inversions are counted as the total of the number of weeks where the FFR averaged higher yields than the 10-year Treasury. Streaks interrupted by more than three (3) weeks of non-inversion are treated as separate inverted periods.

Through early September 2023, the current inversion has lasted 43 weeks. History and financial principles suggest that a yield curve normalization should be our baseline expectation. If a yield curve normalization does occur in the coming months, the consequence for multifamily would be additional upward pressure on the cost of capital and cap rates.

While rising cap rates can contribute to lower valuations, rental housing is well-positioned to absorb downside pressures and return to growth once there is a normalized interest rate environment and regular transaction volume. In the aftermath of the 2008 financial crisis, multifamily assets saw the least severe price declines and the quickest return to pre-crisis valuations compared to all other property types *(Chart 4)*.

Historically, the multifamily sector has shown stability in times of adversity. Now, with default distress remaining limited so far, rent collections holding up, and Fannie Mae and Freddie Mac backstopping liquidity, the apartment sector is seemingly in a structurally sound position. It is expected that some



properties across the country will experience an increase in delinquencies as a result of this point in the cycle. However, well-positioned operators and investors are likely to manage effectively.

While the overall long-term outlook for the rental market is decidedly positive, a wide variety of local risk factors contribute to an uneven recovery timeline across local markets.

For instance, New York, Chicago, San Francisco, and other major metropolitan cities are grappling with significant fiscal issues as impending budgetary shortfalls raise questions about financial priorities. In the Sunbelt, rising premiums or disappearing coverage for property insurance in select California and Florida markets have ignited debates over risk, resilience, and livability. Many of the growth markets that attracted large volumes of domestic migration during the pandemic and its immediate aftermath are now inundated with new construction as population flows have calmed *(Chart 5)*.

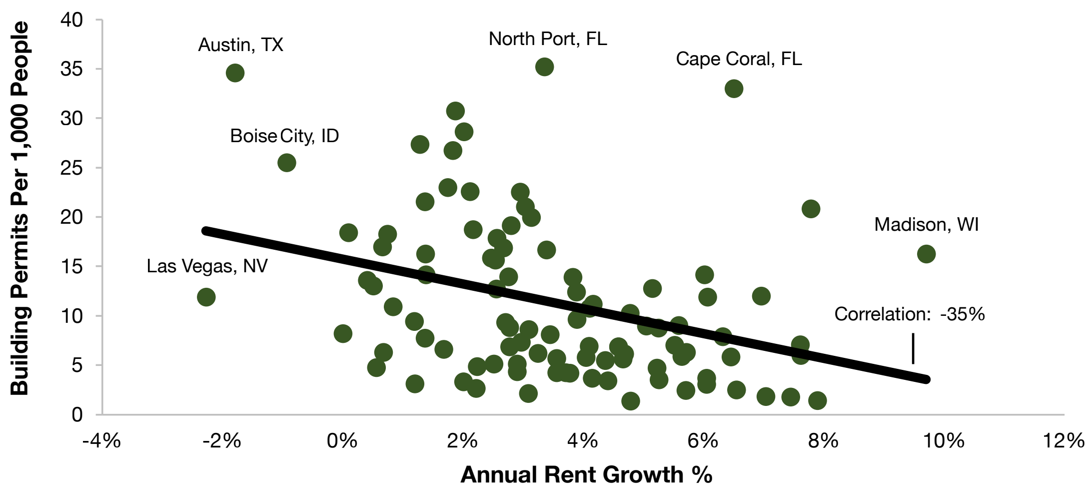
CHART 5

Annual Rent Growth vs. Building Permits Per Capita

Top 100 MSAs by Population, Through July 2023

Sources: Waller, Weeks and Johnson Rental Index; U.S. Bureau of Labor Statistics; U.S. Census; Chandan Economics

Note: Rent Data Through July 2023; Building Permits Measured as a 24-Month Sum per Capita, Through June 2023



Lastly, as rent growth has reached record highs in recent years, rent control initiatives have been introduced and implemented by some state and local legislatures. Additionally, economic vacancy (also known as rent loss, which is calculated by the difference between potential rent and collected rent) has played a role in many markets. The ability to remove non-paying tenants or collect rent from them has been an increasing issue.

Although pockets of concern are easily identifiable, rental housing remains supported by significant tailwinds that are unique compared to other commercial real estate property types. Despite mortgage rates more than doubling, we have not seen a commensurate drop in home prices. For aspirational households, homeownership appears as unaffordable today as ever, reinforcing the need for more single-family rental and multifamily construction.

Moreover, even as incoming inventory will present some near-term absorption and pricing headaches, Fannie Mae economist Tim Komosa notes that "it's possible that future demand may be able to keep pace with this new supply," citing that "there is still an ongoing shortage of housing, particularly affordable, in many places across the country." Even with these challenges taken into account, the rental market maintains a foundation of stability to withstand economic volatility.

The Road Ahead

A narrow avoidance of a recession is quickly becoming the baseline expectation and the outlook for interest rates appears to be more favorable than it was six to nine months ago. However, if 2023 has taught us anything, it's that a soft landing may not be the most apt description for what we are experiencing. Instead, this year has been more like flying through turbulence and the next two quarters are expected to be the worst of this cycle.

Even as the economy has sustained its growth, recent successes are not guaranteed to continue. Risk factors beyond our borders — whether it be a widening of the war in Ukraine, financial contagion from concerns over China's macroeconomic stability, or another black swan event — are capable of undermining domestic growth. Closer to home, debt ceiling fights in the halls of Congress have occurred with increasing regularity, eroding the U.S. government's creditworthiness.

Nevertheless, the U.S. economy deserves credit for its resilience. The U.S. has outperformed most other advanced economies in terms of reining in inflation and limiting the shortfall of potential GDP — justifying confidence in its ability to continue the course.

Growth in the face of headwinds should also breed confidence in the rental housing sector. Despite record levels of new supply, 96 of the top 100 markets continue to achieve year-over-year rent gains. Moreover, even as cap rates are forecasted to rise into 2024, so too are net operating incomes, which should limit the severity of price declines.

As portfolios are re-adjusted and economic vacancy is addressed, investors are now able to dedicate more time and attention to focusing on managing their assets. Looking forward, rental housing, across all sub-product types, is well-equipped to handle the impact of any volatility ahead, whether the landing we experience is soft, hard, or somewhere in between. ■

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, Freddie Mac Optigo® Seller/Servicer, and an approved FHA Multifamily Accelerated Processing (MAP) lender. Arbor's product platform also includes bridge, CMBS, mezzanine, and preferred equity loans. Arbor is rated by Standard and Poor's and Fitch. In June 2023, Arbor was added to the S&P SmallCap 600® index. 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.

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