Not Waiting for Normal

Opportunities Abound for Well-Positioned Investors

FALL 2024

SPECIAL REPORT

ARBOR

Key Findings

- The interest rate outlook has brightened considerably, while the election and a labor market slowdown have generated increased volatility in financial markets.
- As the market enters a cycle of normalization, unique opportunities have emerged for well-positioned investors in a dislocated market
- The workforce housing investment outlook remains strong as increased support for dedicated lending products and tax credit incentive programs converge to address an affordable housing shortage.

The Outlook

As would-be homeowners face a tight housing market, the resilient rental housing sector navigates two sets of conflicting crosswinds. On the one hand, cyclical factors such as elevated interest rates and a [cresting wave of new apartment deliveries] have weighed down rent growth and other measures of topline performance. Nevertheless, multifamily permit filings have dropped off dramatically, and the multifamily demand profile has displayed consistent strength.

Going into the next cycle, investors should look no further than the housing shortages in their communities for a sign of what to do next. Recent policy changes have strengthened investment incentive programs to jumpstart affordable housing development in the U.S., enhancing opportunities in a sector known for its stability.

While the normalization of monetary policy will likely proceed gradually, opportunities will continue to emerge for investors who are ready to deploy capital. The best deals are often made during or coming out of down-cycles and become even more attractive after normalization returns.

Traffic on the Landing Strip

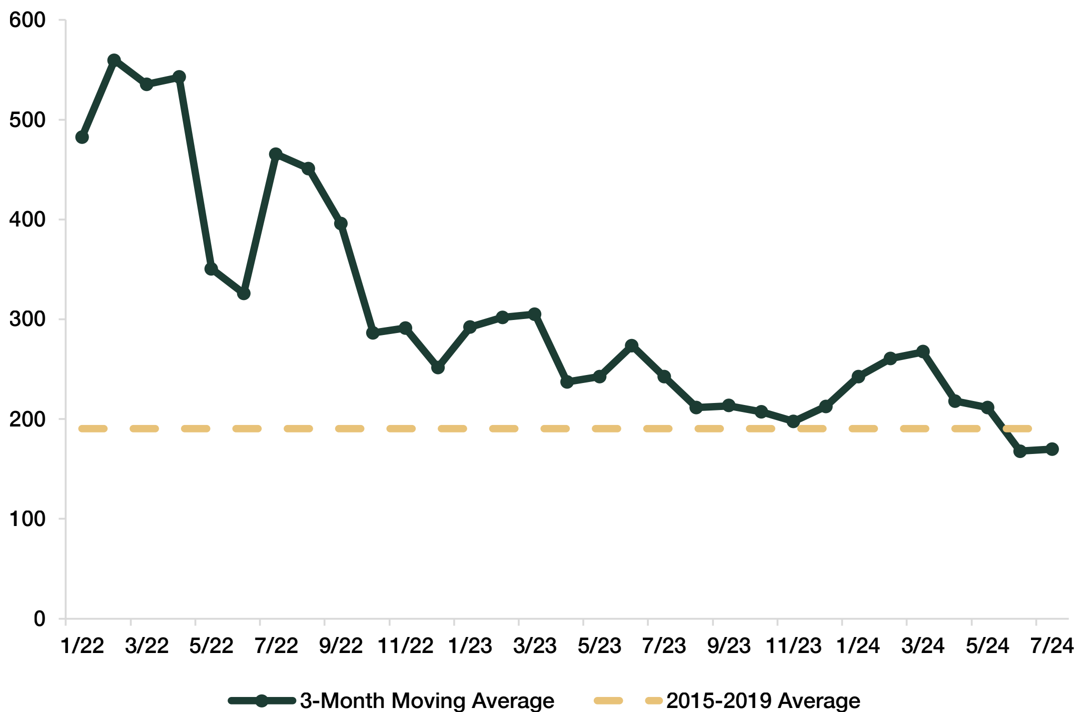
Early in the Federal Reserve's current monetary tightening cycle, the labor market's momentum appeared impervious to the effects of the engineered slowdown caused by rising interest rates. However, excess hiring demand has proven to be a persistent challenge in the central bank's fight to rein in inflation. Now that inflation has begun stabilizing, attention has shifted as job growth has slowed considerably. Net payroll additions have fallen by more than 60% in the past two years and currently sit below the hiring pace set in the five years before the pandemic *(Chart 1)*. Wage growth has also eased, and the number of jobs available per unemployed worker has returned to pre-pandemic norms.

CHART 1

Monthly Change in U.S. Payrolls

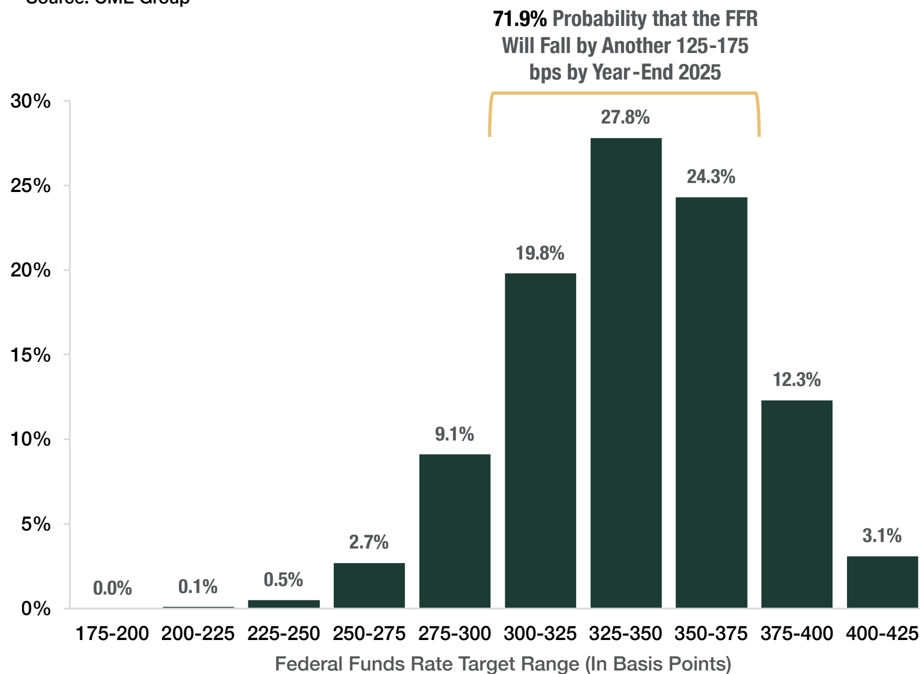
Measured in Thousands, 3-Month Moving Average, Through July 2024

Source: U.S. Bureau of Labor Statistics



While the labor market has recently raised concerns, the interest rate outlook has shifted in a more favorable direction. Debate slowed about when an interest rate cut would come, turning instead to how much it would be. Following the first

rate cut in four years in September 2024, markets are now betting the federal funds rate will drop another 150 bps by year-end *(Chart 2)*.



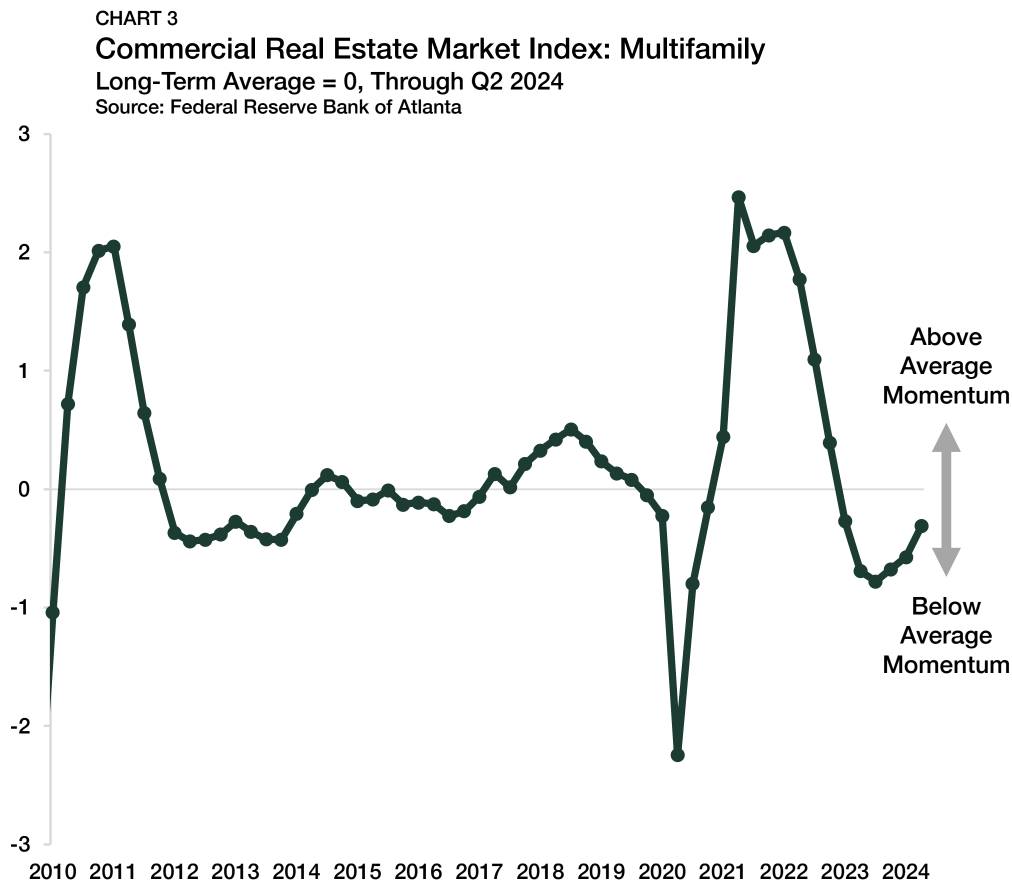
Interest rate normalization is generally welcome news, but the improving monetary outlook arrives alongside a fresh wave of anxieties. Concerns about an overheated labor market have given way to a conversation about its softening, even though job growth is positive and only slightly below historical averages. Although many historically useful recession indicators have proven less reliable lately, the repetition of warning signs has taken its toll on economic sentiment.

The upcoming presidential election has also increased jitters among some in commercial real estate. Historically, financial sector volatility spikes in the months before and after presidential elections. During these periods, markets are typically more reactionary as they digest competing policy visions. But once election day is over, the ambitious language of the campaign trail tends to give way to the measured realities of daily governance.

Over the next few months, the nervousness permeating markets will likely stick around. However, on balance, the U.S. economy has performed better than the mood suggests — and the potential for a more robust near-term expansion looks promising.

Heightened Risks and Opportunities

Over the past four years, the investment climate has swung between abnormal highs and lows. Apartment valuations rose at nearly twice the historical growth rate in 2021 and 2022 before retracting as the high capital costs took hold. Even as valuations are yet to see an inflection and the correction is not entirely behind us, stabilization is in sight. According to the Federal Reserve Bank of Atlanta's Commercial Real Estate Market Index — a comprehensive momentum gauge — the multifamily sector has seen firming conditions for the past three quarters *(Chart 3)*.

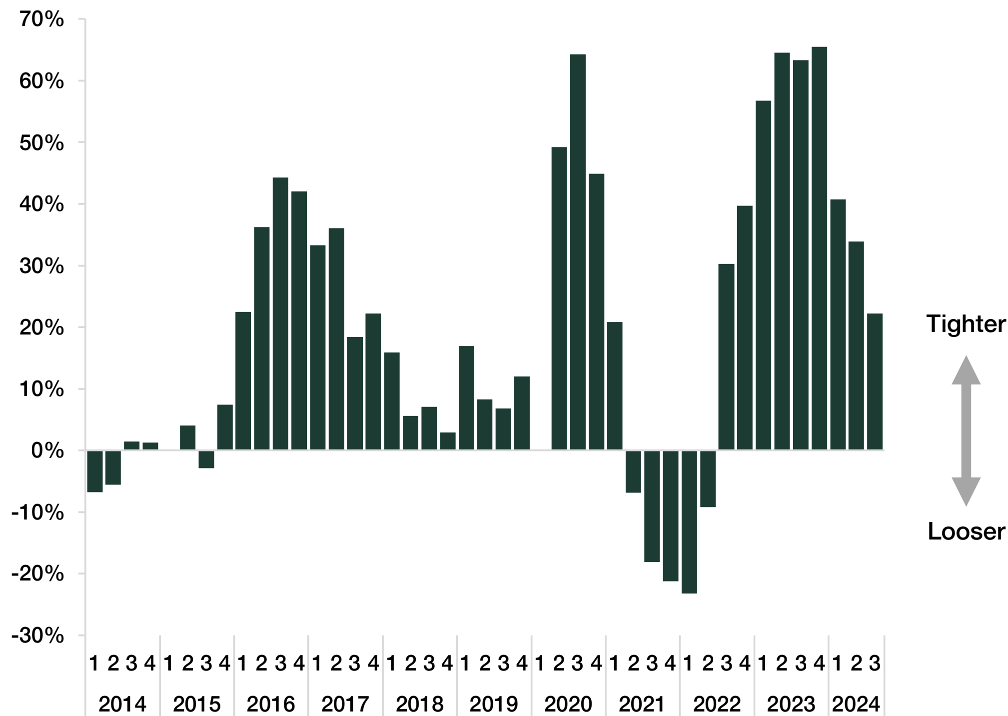


With property values still sitting at discounts, the risk-adjusted return profiles of deals made today are even more appealing — especially when considering the structural strength of the apartment sector. Rental vacancy rates, which increased only marginally in 2022 and early 2023, have held stable for four consecutive quarters.

Historic levels of new supply in many growth markets are taking the pressure off rent pricing over the short term, offering a reprieve for tenants. At the same time, operating expenses and insurance premiums have continued ascending, creating headaches for landlords. However, according to Zillow, even as generationally sky-high rent growth overall has subsided, 97 of the 100 largest U.S. metro areas have seen continued positive annual gains through July 2024.

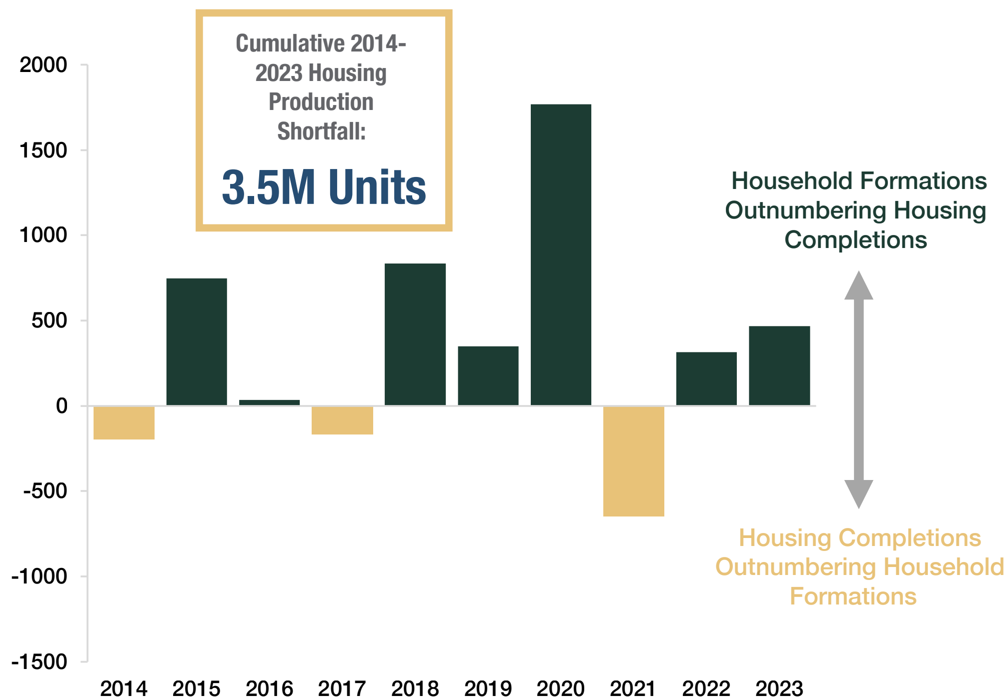
Until interest rates meaningfully shift and asset valuations return to consistent growth, risk assessment will remain critically important. Proactive lenders and borrowers have increasingly worked together to reshape and recapitalize deals to manage the moment. However, equally crucial to addressing risks is the need to remain open to opportunities. Today's economic climate provides fertile ground for investment growth. The Federal Reserve's Senior Loan Officer Opinion Survey on Bank Lending Practices illustrates just how much traditional lenders have pulled back.

As of July 2024, a positive net share of bank lenders reported tightening their multifamily underwriting criteria for the ninth consecutive quarter *(Chart 4)*. Lenders with liquidity are well-positioned to step in and strategically leverage an unmet market need. Deals with comfortable cash flows in the current interest rate environment will only look rosier once a normalization occurs.



Housing's Structural Needs

Industry experts have been sounding the alarm over housing affordability for over a decade, but this issue has recently gained more attention in the public and private sectors. While the solutions are wide-ranging, how we got to this moment is clear. The number of U.S. households has grown more quickly than housing completions in seven of the past ten years, with the cumulative shortfall over this period amounting to nearly 3.5 million units *(Chart 5)*.



The affordable housing shortage has also contributed to an imbalance in the types of housing currently under development. New construction tends to be of higher quality than the average existing housing stock. According to Moody's Analytics CRE, between 2015 and 2023, Class A rental inventory has grown by roughly 39%. Meanwhile, Class B&C inventory has only increased by about 5%.

With new construction focusing on the top end of the market while 50% of households are considered housing cost-constrained, there is an apparent mismatch between what the rental market needs and what types of units are delivered.

However, the ground has started to shift, and the investment case for new workforce housing development is becoming brighter by the day. While change often happens slowly, the recent expansion of programs incentivizing the development of low- and middle-income housing is noteworthy. The Low-Income Housing Tax Credit (LIHTC) recently received a major shot in the arm, which is expected to finance an additional 1.2 million affordable rental units, and there is bipartisan support for a similar tax credit program for middle-income rental units. Simultaneously, lending infrastructure designed to support workforce housing deals continues to strengthen, led by targeted programs such as Fannie Mae's new Sponsor-Dedicated Workforce (SDW) Housing Product Initiative.

Between the widening housing gap, growing public-sector support, and tailored improvements in credit markets, the long-term investment outlook for workforce housing is overwhelmingly positive.

The Road Ahead

The big question of the past two years has been whether there would be a soft landing or if the Federal Reserve's monetary tightening cycle would result in a full-blown recession. To date, the U.S. economy has landed somewhere in the middle. The Gross Domestic Product (GDP) has remained in growth mode for the past eight consecutive quarters amid a concurrent investment slowdown. However, storm clouds on the horizon have started to retreat.

According to a July 2024 Bankrate survey, economists estimate a 32% recession probability over the next 12 months. In early 2023, this projection was nearly twice as high at 63%. Federal Reserve Chair Jerome Powell shares this optimism. He believes there is "good reason to think" the U.S. economy will achieve both price stability and a strong labor market in short order.

Now that monetary policy has begun to loosen, normalization will percolate through the rental sector as it adjusts to a new credit equilibrium. As we move out of dislocation, opportunities for outsized returns will be there for the investors who do not wait for normal. ■

About Arbor

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

arbor.com | 855.708.2090

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