Transcript

Code 53

Economic Insights for Uncertain Market Conditions

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Alison Johnson:
Welcome back to Code 53 - The Apartment Podcast. I'm your host Alison Johnson with NMHC. On this show, we bring you into conversation with apartment industry executives, leading experts in the multifamily sector and a diverse group of practitioners, all to help you learn everything it takes to create communities from business strategy to design to finance and leadership. And today on Code 53, we're going to focus on the current investment market and the challenges posed by the Fed as they continue to fight inflation and determine where to set interest rates. Coming up, a conversation with Brad Case, PhD, Chief Economist and Director of Research for Middleburg Communities about the current economic and financial uncertainty due to the recent bankruptcies of Silicon Valley Bank, Signature Bank and Credit Suisse, and what all this means to CRE capital markets.

announcer:
The Code 53 podcast is brought to you by NMHC, the National Multi-Family Housing Council, the place where the leaders of the apartment industry come together to guide their future success. From owners to managers and developers, NMHC's members create thriving communities by providing apartment homes for 40 million people contributing $3.4 trillion annually to our nation's economy.

Alison Johnson:
For many real estate investment managers right now, headwinds are strong. If the Fed's Federal Open Market Committee or the FOMC continues to raise interest rates, that will increase the difficulty that borrowers already face in finding debt and equity capital at good terms. But if the FOMC stops raising rates, that will mean economic growth is softening and maybe the banking system is under a bit more stress than anticipated, which again will increase difficulty in finding capital. Joining us now to help us put all of this in context and to provide a multi-family focused analysis is Dr. Brad Case, Chief Economist and Director of Research for Middleburg Communities. Brad Case, welcome to Code 53 - The Apartment Podcast.

Brad Case:
Well, Alison, I'm very happy to be with you today. Thank you for inviting me.

Alison Johnson:
Very delighted to have you on today to help us sift through the discourse around capital markets and the economy. You've studied both public policy and economics and you have a tenured career in real estate market research, having worked at Nareit and Fannie Mae before taking up your current role, leading analysis and research efforts at a fully integrated rental housing developer. How much of a contribution to overall inflation is housing right now?

Brad Case:
Right now the contribution of housing to overall inflation is actually negative except that the way inflation is measured makes it positive and that's a little bit confusing. So let me explain what I mean. The Consumer Price Index, the CPI and other indexes of inflation measure how much is being paid in total for rent or among homeowners, it's how much they would be paying if they were renting. And a lot of rental housing leases were signed last year. Rent growth was very strong last year. And as a result of that, what we're seeing now is the combined amount that renters are paying regardless of when they signed their new leases. That is still growing because of the growth in rents over the past few years. But the most current data is actually showing very soft rent increases or rent declines in many cities. And if you took into account the actual sort of current market rent changes on new leases that are being signed, then the overall contribution of housing to the inflation rate would be very low and the entire inflation rate would be right down below 2% where the Fed wants it to be. So it's a little bit of a transitional period between a period over the past year or two when rent has been a strong contributor to inflation and the current situation where rent is no longer a stronger contributor to inflation except that it's still being measured that way.

Alison Johnson:
Taking all of this into account, can you tell us a little bit more about how the actions that the Fed has taken in the past year to fight present day inflation and how they've affected real estate and multi-family investment today?

Brad Case:
Yeah, they've affected the multi-family market in several ways. I mean, in essence what the Fed is trying to do is two things. Number one, make sure that overall inflation does not exceed their 2% target, at least not by very much. And that's important because if inflation gets up to where it was in the late 70s and early 80s, it's very difficult and very painful to bring it back down to an amount that's really sustainable with good growth in the economy.

But on top of that, the Fed also has to pay attention to what consumers expect is going to be happening in inflation. And that is probably the primary concern right now. If you think about current new lease rents, the inflation rate is already back down where it needs to be. So that part of the Fed's job has been accomplished, but surveys of consumers suggest that they expect inflation to continue to be strong going forward. That's what endangers the economy through what could end up being a difficult wage price spiral, which is what we saw back in the 70s. And that's what the Fed is really trying to avoid. In terms of how it affects multi-family, it does make it more difficult for some people in the market to get funding for their projects, whether their projects are new development of housing, or purchasing an existing multi-family property, or even investing in sort of improved management of existing multi-family properties. But the biggest effect is the effect that inflation has had on the rents that households are paying. And as I said, that part of the battle has really been won.

Alison Johnson:
Picking up on the topic that you raised with trouble of getting capital for a deal, I mean there is a lot of concern about whether the CRE market is exposed to financial contagion risks due to last month's bank failures, the ones that I mentioned in the intro, the two regional domestic banks, Signature Bank and Silicon Valley Bank, and then the Swiss based investment bank, Credit Suisse. How do you assess these issues, these failures with respect to the real estate market and how are they affecting real estate deals or construction loans now and going forward?

Brad Case:
Yeah, I think there are two real reasons that there's heightened concern about commercial real estate as a result of these events in the banking system. The first reason is the concern that it might spread to other banks, and that is a possibility, but I don't think a very big one. Signature Bank had a very specialized business base, both in terms of the deposits that they took and in terms of the loans that they made. Same thing with Silicon Valley Bank. Those are two very specialized banks, and the fact that they're so specialized means that it will be relatively difficult for the problems in those banks to spread to other banks. And you have to keep in mind those banks really did have fairly poor risk management systems and most banks are much better in terms of the risk management.

The second reason for concern is the role of the regional banks as opposed to the very largest banks in the real estate market. For various regions of the country, one or several dominant regional banks are very important sources of capital for construction loans especially, and also for mortgages. However, they're not the only sources of capital. And in fact, there is a live debate as to whether the role of regional banks is more important or less important than the role of the largest banks. And the reason I say that is if you're going to argue that regional banks are especially important, then the argument you're making is effectively the regional banks know the local real estate markets better than anybody else. And so they're able to make good loans and they're able to avoid making poor loans. And the argument is that the largest banks don't have that local knowledge.

However, there's another way of looking at it, which is that the regional banks don't have the same capability as the largest banks to evaluate the risk that they're taking, and they certainly don't have the same capability to diversify their risks across investments in lots of different parts of the country. And as we all know, real estate is a location specific investment market. And so if as a regional bank, you know the local market very well, but you're not able to diversify by also holding things in other regional markets, then that may put the regional banks at a disadvantage. I don't want to take a position as to whether regional banks are more or less important than the largest banks, but I do want to note that it's not clear.

Alison Johnson:
This debate has to be affecting how companies are approaching their deals in capital stack composition. What are you seeing in terms of any differences or changes to how development and investment for multi-family construction and portfolio management, how that's going forward? What changes are you seeing?

Brad Case:
The first thing that I think is very important to note is that when we look at averages like the average difficulty of getting a real estate loan, it's enticing to think that applies to everybody and it absolutely does not. If you think about vacancy rates, for example, years ago there was a lot of concern about increased vacancy rates in retail properties. And it's not that every regional mall saw their vacancy rates go up by 10 or 15%. It's that some regional malls were doing just fine and others were empty. And it's the same thing in the financial markets. One of the most important things that a company can do if that company is investing in real estate is to diversify its sources of capital so that if conditions become more challenging in one part of the capital market, you'll still be able to get financing from other parts of the capital market.

So for example, if regional banks are all you had to fund your construction activities or your acquisition activities, then you might be stuck in the water even if you have strong projects. But if you have strong projects and good relations with different parts of the real estate market, you're going to be able to find funding. Warren Buffet is quoted as saying, "You don't know who's swimming without their shorts on until the tide goes out." In capital markets, when lending conditions become a little bit more difficult, you find out who has been doing a good job of tending their capital sources and who has just been operating on a wing and a prayer hoping that the capital would continue to be available. And so if I think about what we're seeing in the market, some of the sources of capital are saying, "Listen, our management has asked us to pause our lending activities for a certain amount of time so that we can evaluate whether our risk management processes are keeping up with our risk exposures."

And when that happens, that's fine. It doesn't mean that they're pausing for a long time. Maybe they're pausing till the end of the month. And if that's the situation, then maybe all that you're doing is giving them a few weeks to make sure everything is in good shape and continuing from there. Or maybe they're talking about a longer term pause or maybe they're talking about applying more stringent criteria. And in those cases, if that's because of something specific to that capital source, then you're likely talking to the other capital sources that you have been cultivating over the years for exactly that kind of a situation. So I would say that in general, the commercial real estate market is feeling the effects of a heightened concern about risk management in real estate, but it is absolutely not evenly distributed through the industry. It has to do with the range of capital sources that you have been in contact with over the past several years and how confident those capital sources are that doing business with you will not expose them to any additional risks.

Alison Johnson:
That context is very helpful Brad. I want to bring in one more question here, kind of looking to the future. Recent reports of notes from the FOMC's last meeting indicate that the market may need to hold on for at least one more rate hike. And you've described a situation of being in a rock and a hard place as it is. So how do you see these rate hikes having lasting effects on the industry, particularly the multi-family industry? Will there be more stress on private sector's ability to keep up production of multi-family and affordable housing?

Brad Case:
Yes, I think that's right, but not in any way there particularly concerns me. And what I mean by that is this. First of all, in terms of whether rates will continue to go up, yes, I do believe that the next meeting, there will be another 25 basis points increase. I pay attention to the doves among the FOMC members because when they start talking about maybe we need to stop raising rates, then it'll be worth thinking about. But they haven't been saying that. And so I think that rates will continue for at least one more meeting and very possibly more after that.

On the other hand, they are paying close attention to the overall state of the macro economy. Last week we saw some unexpected weakness in retail spending. That's the kind of thing that they'll pay attention to. And because they're looking to balance something and that balancing act is not an easy thing to accomplish. The main thing that gives me concern about the state of the macro economy is the single family housing market, which you know might think, well, I work for a company in the multi-family, in the rental housing market, and so maybe trouble in the single family market is a good thing. No, it's not. Trouble in the single family market is something that threatens trouble for the rest of the macro economy. And so I do expect it to recover, but I am looking closely to see that.

In terms of lasting effects, I'm not among those people who want rates to be low because when rates are low, lots of people are able to get sloppy with both the financing that they're using and the projects that they're undertaking. When rates are higher, you have to make better decisions. And so for the economy as a whole and for the rental housing in particular, it's better when sort of everybody involved in the industry is being really careful to make good decisions. And that is to say people aren't going out for financing for projects that aren't actually pretty good projects. In sloppy times, there are plenty of developers who will say, "Well, listen, this isn't a particularly good project, but look how cheap capital is. Let's just go for it." That's not what you want as an industry.

On the financing side, you don't want people saying, "Well, it's so easy to make loans and everybody's trying to make loans. We want to keep up our market share, so let's cut our underwriting criteria." You want a reason for everybody, developers, buyers, sellers, and especially sources of finance to be careful about what they're doing. I think that the fact that interest rates will continue to go up at least a little bit and that they may well stay up there is a good thing for the entire industry. But looking more longer term, you have to keep in mind that our country is still under housed, under-supplied with housing, especially rental housing. And so it'll take a long time for development of rental housing to catch up with the underlying demand for it. And we need to make sure that the projects that are going to increase the supply of rental housing are good projects so that we don't bring volatility to our industry that shouldn't be there.

Alison Johnson:
Brad, can you dig a little bit deeper into how the FOMC evaluates economic measures versus how they use them such as the CPI?

Brad Case:
Yeah. Absolutely. When you look at inflation, generally speaking, what the government, what the Bureau of Labor Statistics in this case is doing is going out to stores and saying, "All right, how much does it cost to buy a gallon of milk?" They're getting information on how prices have changed for all sorts of products. The thing is, most of those products you use up pretty quickly, and so there isn't any lag between when they collect the data and when they report the data for people like the FOMC to use. With housing, it's very different because when I sign a lease, it's a lease for a year of renting an apartment. And so they don't just look at new leases, they want to know how much are people paying, and they ask everybody, "How much are you paying and how much has that changed since the last time we asked, which was several months previously?"

So they end up with a very lagged measure of what's happening right now in housing markets. And it's not just rents that they're measuring this way, they're using rental data to estimate what's happening with implied cost of owning a house. And the reason that's important is that in our forecasts, we don't believe that the shelter component of the CPI will come down to 2% until about a year from now. Maybe even next summer. However, the FOMC is trying to say, "All right, what's happening right now with prices?" And so they're looking at something a little bit different than what the CPI is measuring. So they need to be aware of that lag in the way shelter costs are measured by the CPI, and they're very much aware of it. When they look at the data on new lease rents, they know that inflation in new lease rents has gone away. That's no longer a concern. But they need to pay attention to the overall CPI in part because they also have to make sure consumers don't get fooled by it into thinking that inflation will continue to be very high.

So in terms of the fight against inflation, they've completed that fight, they have solved that problem. But in terms of the fight against expected inflation, that one isn't over, and that's why they have to continue raising interest rates. The big problem, of course, is that if the economy softens, then they have to be ready to help the economy avoid a recession. And in the notes from the last Federal Reserve meeting, they noted the possibility that the economy may go into a recession late this year precisely because of the problems in the banking system. And we'll have to see whether that happens, but certainly the risk is there enough so that the Fed knows that they can't go too gung-ho against inflation, especially since they have beaten the inflation part of it.

Alison Johnson:
Brad Case, Chief Economist at Middleburg Communities, thank you so much for your clear-eyed analysis and being our guest on Code 53 - The Apartment Podcast.

Brad Case:
Very much my pleasure, Alison.

Alison Johnson:
And thanks to everyone downloading and sharing the show. Make sure you subscribe and meet us right back here for another new episode of Code 53.