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What Would a Recession Mean to the Multifamily Market?

Before COVID, the U.S. economy had experienced its longest expansionary period in recorded history[1]. Recovering from the Great Recession was painful, but both single-family and multifamily housing markets emerged from their hole and grew at an accelerating pace throughout the decade. The pandemic then struck, sending shockwaves through the respective markets. Prices and rental rates shot through the roof, exacerbating persistent affordability issues. But now, with the economic tide shifting towards a slowdown, is the market headed for a crash? What can we learn from past downturns that can be applied toward determining how the housing market may fare in the next recession?

Every recession has been different, although they were all inevitably associated with negative GDP growth, value depreciation across multiple asset classes, volatilities in the stock market and distress over the labor market. According to the third estimate released by the Bureau of Economic Analysis, the U.S. real gross domestic product (GDP) decreased 1.6% annually in the first quarter of 2022. That was a steep drop from 6.9% annualized GDP growth just a few months earlier. In Moody's forecast released on July 11, the Q2's GDP growth will likely also be negative. And with an annualized inflation rate jumping from 8.6% in May to 9.1% in June, the highest level since 1981, the Fed will be forced to raise interest rates further, placing greater downward pressure on consumer and business demand. So, are we there yet? Are we in a recession? Likely not yet. The labor market continues to hold up well, a situation that may prevent the National Bureau of Economic Research (NBER) from officially declaring this to be a formal recession. But with rates going higher, a softening of the labor market is likely and some form of a recession has become more probable within the next 6 to 18 months. So if we do end up in a recession, would the housing markets experience déjà vu to the Great Recession?

To determine where the multifamily market is heading, we decided to look further back from the Great Recession and compare and contrast the current economic cycle to various recessions of the past. While our study focuses on the multifamily market, given the substitutability between the single-family housing and multifamily housing, a discussion of the single-family market is also warranted. Further, particularly attention was given to the late 1970s and early 1980s period when a lot of today's buzzwords sounded quite familiar.

[1] For a full timeline of US business cycles as defined by the National Bureau of Economic Research, see https://www.nber.org/research/data/us-business-cycle-expansions-and-contractions

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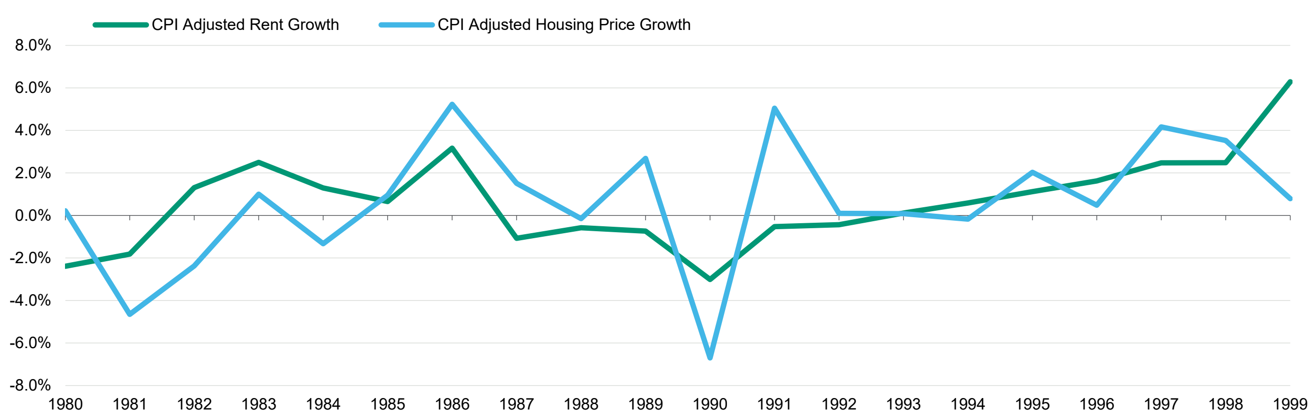
The Volcker Shock

The early 1980s was turbulent. Inflation rose to staggering high of 14% between the late 1970s to 1980. Unemployment was 7.2% entering the '80s, peaking at 9.7% in 1982. The stock market was in deep retreat. Oil prices spiked over 10 times in the '70s. To turn things around, the newly appointed Federal Reserve Chairman, Paul Volcker aggressively jacked up short-term interest rates to as high as 19%, which was even higher than the peak inflation rate at the time. Consumer demand froze and excess savings dried up in just three years. The Fed finally got inflation back in control. However, reinstating price stability came with a cost: two back-to-back economic recessions. The economic pain was so severe that this period was nicknamed 'The Volcker Shock'.

The Volcker Shock had varying degrees of pain for the housing market. Even though single-family housing prices continued to inch up during the early '80s, growth slowed and lagged behind inflation as the cost of credit skyrocketed. Adjusting for inflation, single-family housing prices collectively declined 6.7% by the end of 1982. In contrast, the multifamily retreat was much smaller: the average multifamily rent only dropped 2.4% in 1980 and another 1.8% in 1981.

As illustrated in Figure 1, while the single-family housing market sluggishly rebounded a few years after the recessions, multifamily bounced back with positive rent growth as early as 1982, and remained so until the single-family housing market caught up in the second half of 1980s. As a substitute for single-family housing, multifamily proved to be a more resilient and affordable residency option during this time of economic distress; a trend that would continue during future recessionary environments.

Figure 1 Real Housing Price Growth and Real Rent Growth Prior to the 2000s



Source: U.S. Bureau of Labor Statistics (BLS), National Association of Realtors (NAR), Moody's Analytics

The Great Recession

Volcker set the stage for a long and very good period for the development of the US economy. Some even call the time between the mid-1980s up to 2007 the Great Moderation; as while there were two recessions during this period, they were relatively short-lived and shallow. But with the emergence of Great Recession in the winter of 2007, the period of relatively steady economic performance came to an abrupt end, and the most significant economic downturn since the Great Depression would follow. Not only was its duration the longest in modern history, it also carried the most severe and profound economic and real estate impacts in recent times.

Table 1 Comparison of How Bad Each Recession Has Gone

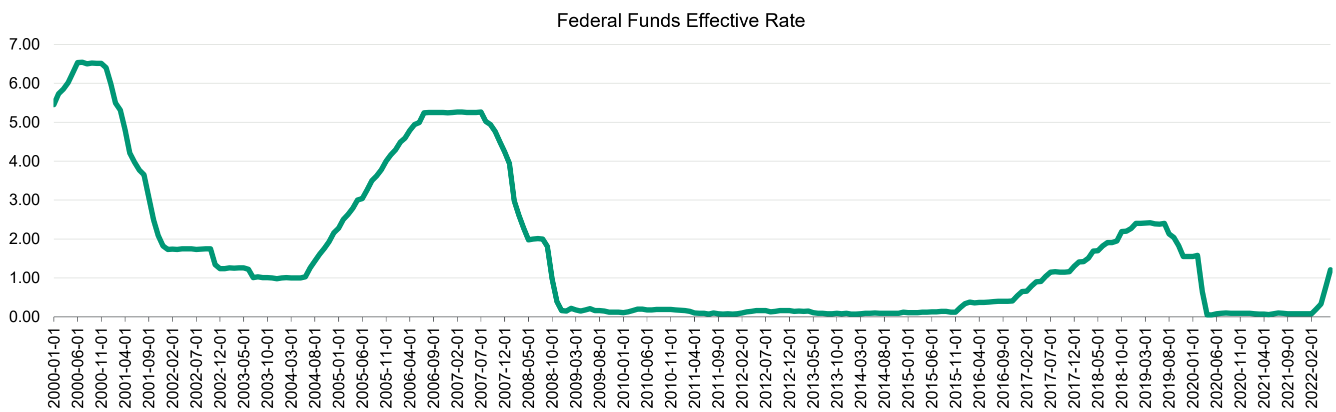
Recession	Duration (months)	Lowest Real GPD Growth	Highest Unemployment Rate	Maximum Annual CPI Growth	Lowest Single-Family Housing Price Growth (CPI Adjusted)	Lowest MF Rent Growth (CPI Adjusted)
Great Inflation (1980.1-1980.7)	7	-8.0%	7.8%	14.6%	-3.4%	-2.4%
Great Inflation (1981.8-1982.11)	16	-6.1%	10.8%	11.0%	-5.3%	-1.8%
Early 1990's Recession (1990.7-1991.3)	9	-3.6%	6.8%	6.4%	-6.7%	-3.0%
Dot Com Bubble (2001.1-2001.11)	11	-1.6%	5.5%	3.6%	1.0%	1.5%
Great Recession (2007.12-2009.6)	19	-8.5%	9.5%	5.5%	-14.9%	-1.6%
Pandemic Recession (2020.2-2020.4)	3	-31.2%	14.7%	2.3%	3.9%	1.1%

Source: Federal Reserve Bank of St. Louis, Moody's Analytics

Specific to the real estate market, the issues came from both sides of the supply and demand equation. Beginning in the early '90s, a wave of single-family housing construction emerged. This wave continued and grew well into the early 2000s. This additional supply was eagerly gobbled up by subprime home buyers and short-term single-family housing investors aiming to "buy low and sell high". An easy credit environment, brewed by the Great Moderation, buoyed these demand pressures. By the time Federal Reserve increased the short-term borrowing rate to control the rising inflation (Figure 2) in 2004, the housing bubble was inevitable.

All these problems came to a head in 2007. Declining home equity and ballooning adjustable mortgage payments forced homeowners out of their houses. The mounting credit risk and foreclosure losses caused cascading failures on investment banks, who bundled bad mortgage loans and sold them as MBS/CDO products, and an economic catastrophe was born.

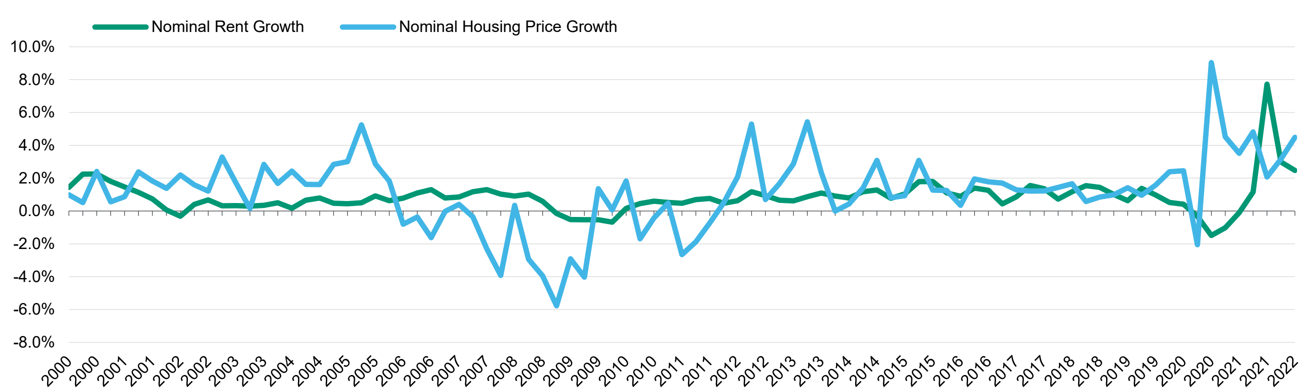
Figure 2 Federal Funds Effective Rate



Source: Federal Reserve Bank of St. Louis

Like the Volcker Shock before it, the unique Great Recession period provides useful insights into future recessionary impacts, especially because of its nearly 30% drop in average home prices from their mid-2006 peak to mid-2009[2] trough. **One lesson from this experience, is that while housing is generally considered a necessity, or inelastically demanded, subcategories within housing can have vastly different sensitivities to economic conditions.** As single-family housing prices slid due to slower demand and a rise in foreclosures, "panic selling" or selling due to a fear of prices falling further, created a spiraling effect in the market. While demand from investors and households evaporated for single family homes, as illustrated in Figure 3, multifamily properties served as a housing substitute, helping to keep rents steady until nearly the end of the recession.

Figure 3 Real Housing Price Growth and Real Rent Growth After the 2000s



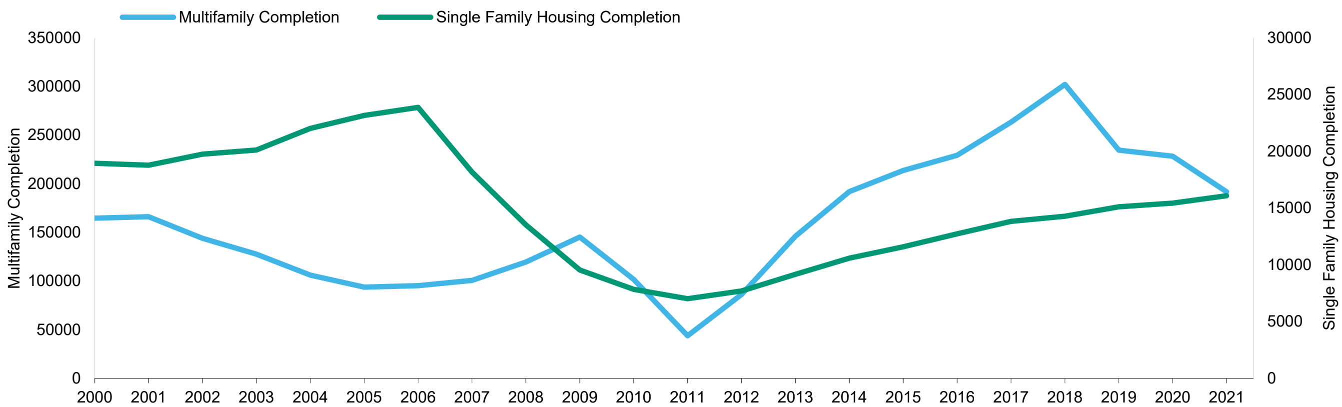
Source: U.S. Bureau of Labor Statistics (BLS), National Association of Realtors (NAR), Moody's Analytics

[2] https://www.federalreservehistory.org/essays/great-recession-of-200709#:~:text=Lasting%20from%20December%202007%20to,longest%20since%20World%20War%20II.&text=The%20Great%20Recession%20began%20in,notably%20severe%20in%20several%20respects.

What can we expect in the next recession?

The investment landscape fundamentally changed following the Great Recession for both single-family housing and multifamily markets. New single-family home construction fell off a cliff during the Great Recession even as demand for it recovered. The annual single-family home completion level dropped and stayed near historical lows throughout the expansionary period. Traditionally lagging behind single-family home construction, multifamily emerged as a growing investment opportunity between 2011 and 2018, as shown in Figure 4. Despite an overwhelming amount of construction, average multifamily vacancies hovered around 4% as renters scooped up the growing inventory.

Figure 4 Single-family and Multifamily Completion



Source: Federal Reserve Bank of St. Louis, Moody's Analytics

The balance between multifamily supply and demand was suddenly distorted by the COVID-19 pandemic. Although the 2020 economic contraction precipitated by COVID lockdowns was short lived, its impacts were felt far and wide, including on the housing and multifamily markets. Upended by the public health crisis, homeowners and renters alike suddenly reflected on where and how they wanted to live.

As storefronts, gyms, and pools shuttered, and public transit felt unsafe, the draws to dense multifamily living disappeared overnight. Single-family homes – private dwellings with better air circulation and more breathing room – stepped in to fill the demand void.

The single-family construction lull after the Great Recession still had not rallied when demand surged. Housing prices skyrocketed as a result: 9% increases in the third quarter of 2020 alone. While all housing has become more expensive over the last two years, entry-level homes at bottom third of the price range rose the fastest[3], worsening housing affordability and putting pressure on potential first-time buyers. At the same time, multifamily boomed in the second half of 2021. Renters who were incentivized by discounted rents, the economy reopening, and hybrid work returned to the multifamily market.

As we face a potential new recession, here are 5 factors to guide us through how the multifamily market may fare compared to the previous recessions:

1. A Slower rate of new construction will keep multifamily supply and demand balanced for some time.

   Globalized manufacturing and distribution changes disrupted the supply chain for the long haul. Resources and labor – needed for building and maintaining single-family housing and multifamily properties – are hard to find, and longer lead times for lumber, building materials, appliances, and furniture lengthened project timelines. The economic shutdown also drastically slowed the permit review process, adding months of delays for each project. As a result, there has been notable slowdown in multifamily construction deliveries. Even if multifamily demand cools, limited multifamily construction will help sustain the sector.

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[3] Entering the Danger Zone-The Outlook for CRE and Housing, Victor Calanog, et al, 2022: https://cre.moodysanalytics.com/insights/cre-news/the-outlook-for-cre-and-housing/

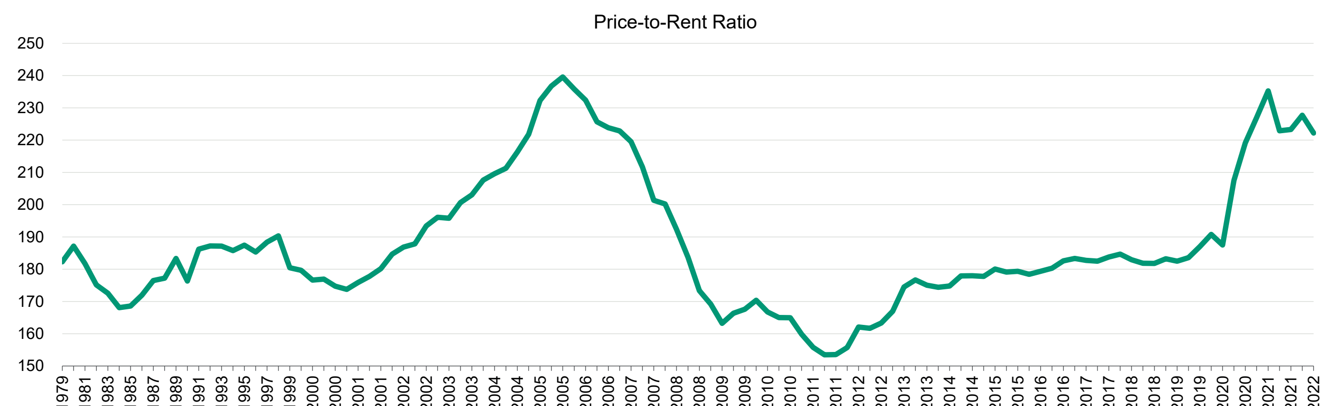
2. Housing substitutability can transfer demand to the multifamily market but watch for possible aftershocks.

   Single-family home prices skyrocketed during the COVID pandemic: **the average single-family home is now 43.7% more expensive than it was in 2019**, and the ratio of existing single-family home prices to multifamily rents is coming precariously close to its pre-Great Recession level (Figure 5). As a result, would-be single-family homeowners instead opt to rent after being priced out of owning. This, in turn, drives up demand for multifamily units.

   At the same time, with the Fed raising the short-term rate 225 bps so far this year, single-family housing demand should continue to dwindle based on the historic trend in the previous recessions. There are already signs of the market cooling in places where the prices grew the most over the past two years. These markets are experiencing rising inventories, fewer competing offers, longer listing times, or even buyers backing out of the deals. Although this may not lead to a widespread slashing of housing prices everywhere, housing price declines are a real possibility in the next few quarters or years depending on how severe and how long the next recession will be if there is one.

   Multifamily rents, on the other hand, are generally slower to respond to rising interest rates and remain more stable. If the substitutability within housing matches the Great Recession's strength, then multifamily rents may remain elevated for some time until single-family housing stabilizes. Based on the past few recessions, the effect on multifamily performance may not begin until near or after a recession ends.

Figure 5 Existing Single-Family Home Prices to Multifamily Market Rent Ratio



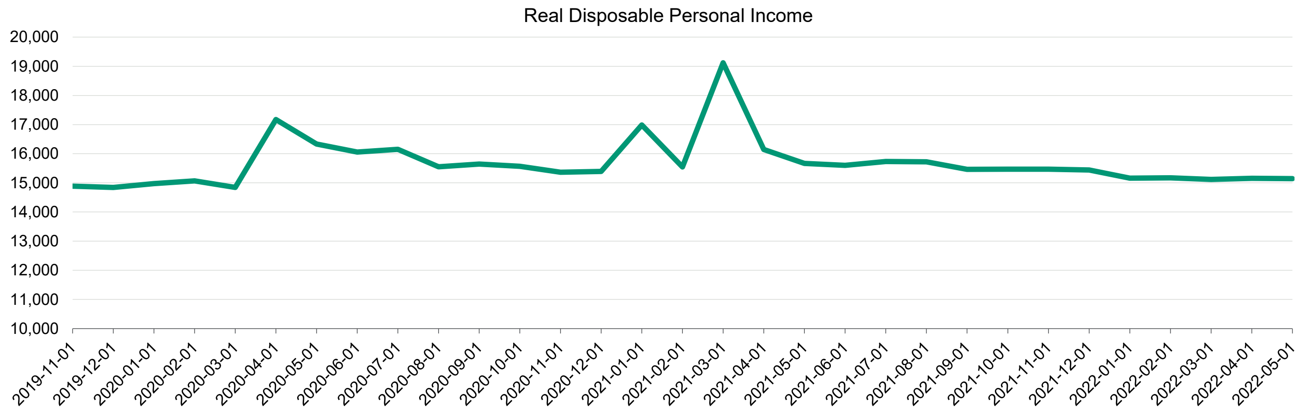
Source: Moody's Analytics

3. A change in labor market and in real disposable personal income.

   The tight labor market in today's economy is one of our best bets to sustain demand for multifamily units. Job openings outnumber the unemployed today, and even with a slowing/declining GDP, there are cushions in the labor market to weather an economic slowdown without large increases in unemployment or declines in incomes. Unlike in the 1980s during the Volcker Shock, the unemployment rate is currently at a historic low and holding strong thus far. The labor market is expected to soften, but not spike anywhere near what was seen in either of the Great Recession or Volcker Shock. Household balance sheets are generally in a better situation entering this potential downturn.

   However, disposable personal incomes are shrinking and now nearing pre-pandemic levels (Figure 6). As the multifamily and single-family home affordability crisis intensifies across more and more metros nationwide, this diminishing financial safety net is troubling, even for multifamily. Job loses or affordability issues could force some renters to find roommates or put off that move to single living.

Figure 6 Real Disposable Personal Income

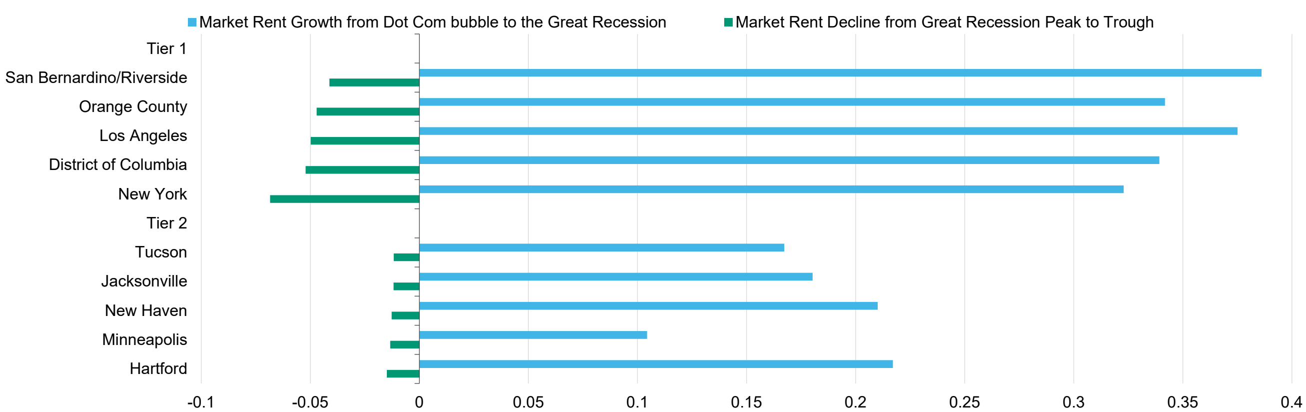


Source: Federal Reserve Bank of St. Louis

4. Monitor volatilities in tier-2 markets' multifamily performance matrix and the aftershocks.

   Historically, tier-1 markets with the most expensive single-family home prices (the top 33% of the price range) generally realize the sharpest ups and downs in their multifamily rents through a business cycle. Figure 7 illustrates how more expensive tier-1 markets had more rapid rent growth in the expansion period after the Dot Com Bubble but deeper declines due to the Great Recession as compared to some of the less expensive tier-2 markets.

Figure 7 Examples of Market Rent Growth Pre- and During Great Recession

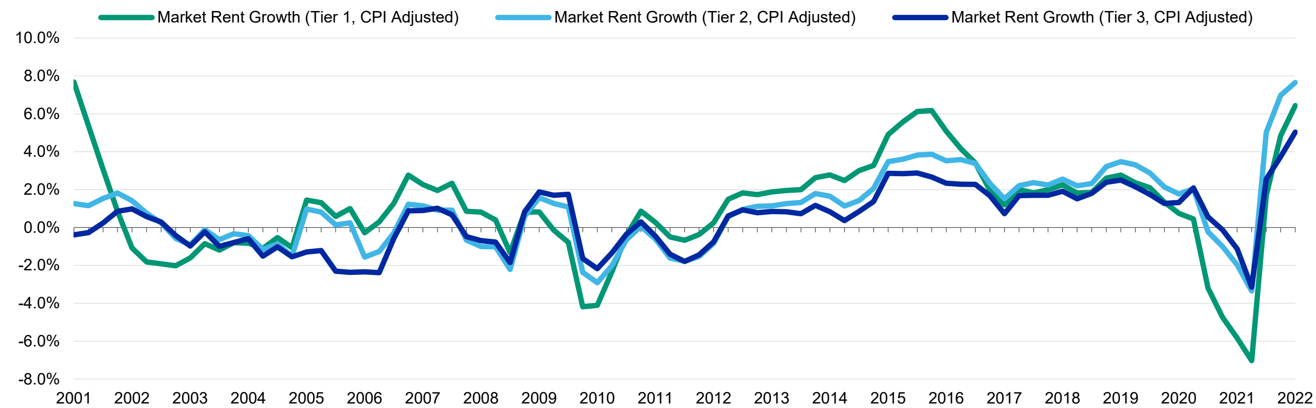


Source: Moody's Analytics

Since the second half of 2010s, the tier-2 markets whose single-family home prices are in the mid-range experienced multifamily rent growth faster than the tier-1's (Figure 8). Despite some unique COVID-induced challenges for these tier-1 markets, white hot tier-2 metros may be quicker to cool with bigger rent corrections.[4]

[4] For more details on how housing affordability is changing, please see https://cre.moodysanalytics.com/insights/cre-news/what-the-housing-affordability-crisis-looks-like-across-the-united-states/

Figure 8 Market Rent Growth for Expensive (Tier 1), Moderate (Tier 2), and Affordable (Tier 3) Markets



Source: Moody's Analytics CRE

5. A more regulated financial environment could be a blessing.

   After the Great Recession, the government passed a slew of strengthened regulations and tightened underwriting criteria designed to prevent or mitigate a disaster like the one in 2007. Even if the Federal Reserve fails to engineer a soft landing this year or next, these rules will likely prevent the real estate market from sliding into a deep and long recession or suffering large aftershocks. While many single family markets will likely see small to moderate prices decline in this situation[5], multifamily's positive performance should hold up relatively longer, as in previous downturns. Overall, in a mild recessionary environment we would expect only a moderate vacancy rate increase and rent growth to simply decelerate. A slight and short lived dip into negative territory towards the end of the recession is possible, but a free fall is highly unlikely.

[5] See this article for a list of most vulnerable markets https://www.newsweek.com/housing-market-crash-could-hit-these-20-cities-hardest-1720201