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Monthly condensed analyses of crucial real estate and economic issues offered by UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. In this July 2024 Letter, UCLA Anderson School Visiting Scholar David Shulman summarizes dramatic shifts and trends in the housing market.

Summer 2024 Housing Update: 7 Hot Trends and Surprises

By David Shulman

The UCLA Anderson Summer 2024 Outlook (June 6) included a residential real estate report: “Forecast for the Nation & California.” Here, I summarize my contribution. Looking beneath the numbers, I find unexpected, or even contradictory trends. They include ongoing higher interest rates; the sudden decline in multifamily construction, despite strong demand; the consumer price index remaining high, despite rents weakening in many markets; and the long-running affordability crisis (possibly alleviated by “upzoning”).

GET USED TO IT: THE ERA OF SUPER-LOW INTEREST RATES IS OVER

From their deep lows of below 3%, mortgage interest rates are now around 7%. It is very unlikely that the average 30-year fixed rate will dip much below 6% over the remaining decade. Why? Globalization is in retreat, onshoring (moving production within U. S. borders) is here, and the U.S. has a 4% unemployment rate. Such low unemployment would have been unthinkable 10 or 20 years ago. Further, the federal deficit is now at 6% of Gross Domestic Product (GDP), and pressure remains strong for more federal spending rather than less. All this adds up to mortgage rates hanging at current highs for the next decade, with a resulting brake on home sales continuing.

“Though market rents are weakening, the rent component of the Consumer Price Index will continue to lag the spot market and remain high, sometimes surprisingly so.”
HOME PRICES ARE RESURGING, DESPITE RECENT DIP

Despite elevated mortgage interest rates, house prices continue to rise. The 20-city Case-Shiller average index (measuring year-over-year changes) rose to approximately 20% in 2022, and that was even higher than in the mid-2000s. From this record-high appreciation, prices turned negative briefly in 2023, but they are rising again. The shortage of housing has spread nationwide, and prices may continue to rise between 2-4% a year. I do not expect a home price crash unless there is a nationwide economic crash. Therefore, look for increases nationwide, and not just in California. The fastest growing market on the Case-Shiller index is San Diego, with more than 10% rise year-over-year.

HOUSING STARTS ARE STALLED

If you look at previous upcycles from the early 70s, the number of new homes starting construction was over 2 million per year. This includes from late 2005 to 2006, so it’s clear the country’s homebuilders have the capacity to produce. But this time around, we will not get close to 2 million overall starts. Instead, expect starts to stay stuck at about 1.3 million nationwide, which, again, is not good for improved housing supply and affordability.

![Multi-Family Starts Reverse Course](chart)

EVEN WITH HIGH DEMAND, THE MULTIFAMILY BOOM IS OVER. WHY?

A major part of the housing-start slump comes from multi-family construction. Over the next two years, multi-family starts could drop from approximately 600,000 to 300,000, essentially cut in half. There is no lack of housing demand, so what explains this wild reversal?

Cap-Rate Increase: For one thing, the rise in interest rates triggered a collapse in multi-family values. A typical apartment building today, compared to one financed in 2020 or 2021, has lost 25-30% in value. When interest rates were exceptionally low (January 2021), the capitalization (cap) rate on multi-family housing in many areas was 4% or less, or approximately 25 times net operating income. But with the cap rate suddenly at 6%, that rate drops to 16 times net operating income. A fall from 25 times income to just 16 times income creates a huge compression in value. The collapse in volatile Southern California was dramatic: We had a 25-30% compression in value because the cap rates had been well below 4%, so there was a much bigger swing.

Fantasy Projections: There is a second factor in this shift. Many starts were based on wishful thinking by multi-family developers. When they bought at a 3.5% cap rate while rents were rising 10% for the next 3 or 4 years (and then maybe settling to 5%), they could justify paying practically any price for a building. But this market is sensitive to swift changes: If supply pops, rents drop. Austin, Texas is a prominent example. The thinking was: “Austin is one of the hottest cities, with
high-tech headquarters, state capital, a major university, a desirable culture, and new apartment rents are down 9% year over year. Let’s build a 200-unit luxury building. We will exit financing at 4% cap rate, rents will rise 10% annually, and we’ll get rich!” But when they face a 6% cap rate and rents begin falling rather than rising, they are suddenly under water and the bank ends up owning the building.

A similar phenomenon is in Nashville, Tennessee. There it’s not unusual for newer, high-end projects to offer one- or two-months free rent on a one-year lease. With increased supply, and with interest rates rising, values drop. Add the costs for construction, land and labor, and a new building no longer pencils out. All this is going to severely limit nationwide apartment construction over the next two years. We see this in pockets of Los Angeles, certainly DTLA, where there’s a lot of supply.

THE STUBBORNLY HIGH CPI

Though market rents are weakening, the Consumer Price Index (CPI) will continue to lag them and remain high, sometimes surprisingly so. Here are three reasons.

See-Saw Rents: The CPI measures the “in-place” rents the consumer actually pays. But those ultimately roll into the higher rent increases we saw previously. Indeed, in-place apartment rents as reported by the apartment Real Estate Investment Trusts (REITs) are still rising. Analysts at Core Logic show single-family rents hit a peak of 14% in 2022. Many of the “bulls” predicted inflation remaining flat and rents remaining flat. But these rents have stopped moving down, year-over-year. They are now rising a little bit. In some cities, the worst of the rent-drops are behind us. Those contractions have gone through the system, and we’ll probably see market rents begin to go gently higher rather than gently lower. This, too, will keep more pressure on the CPI compared to some predictions.

Hidden Mom and Pops: Anecdotal evidence suggests that many mom-and-pop landlords keep rents at what they think is market-rate but is really below-market. When they realize they can get $1,800 a month for an apartment they had leased for $1,400, they respond accordingly. But many of these small landlords are not queried by the big rental surveys, which look at large, national multi-family landlords – the big private equity holders, and professionally managed apartments. Now the smaller owners are catching up. That means increased rents.

Rent Control: Jurisdictions with restrictive rent-control ordinances tend to be over-weighted in the CPI. These rents may rise two or three percent per year. But upon moveout – given the super increases around them – you see gigantic spikes: Sometimes up to a 40% increase in rent. This figure then goes right into the CPI, making the CPI higher than it would be otherwise.

HOME SALES ARE AT DEPRESSION LEVELS

We had become very used to selling 6-7 million housing units per year, nationally. Now we are at approximately 4 million units, and it will stay low. Here’s why. Approximately 60% of all mortgages are set at 4% or below. Unless they are responding to pressures such as the need to relocate, homeowners are not going move from their primary residence with a 3% mortgage. Even if they seek to downsize, their payment will rise with new higher interest rate and housing price. People are locked in to their nice, low rate. They are not going to sell. Here’s a simple example: On a national average, in 2021 a $400,000 house with an 80% loan value at 3% interest results in $1,350 a month mortgage payment. Today, the price of that home is $500,000, with a 7% interest rate and a resulting mortgage payment of $2,660. In Southern California you can double those numbers.

THE AFFORDABILITY CRUNCH

Even if someone really wants to purchase a house, their income has statistically lagged behind home prices and interest rates. Half of today’s renters are paying more than 30% of their income on housing and utilities. There’s also a jobs/housing mismatch, which lessens demand among renters wishing to buy. Their income just doesn’t support it. One positive sign is the loosening of zoning codes: Cities have long instituted restrictions on new housing in certain areas, but this is beginning to change as they allow more “upzoning” in existing neighborhoods. Anti-NIMBY legislation is beginning to increase supply, but it will take some time to see results.