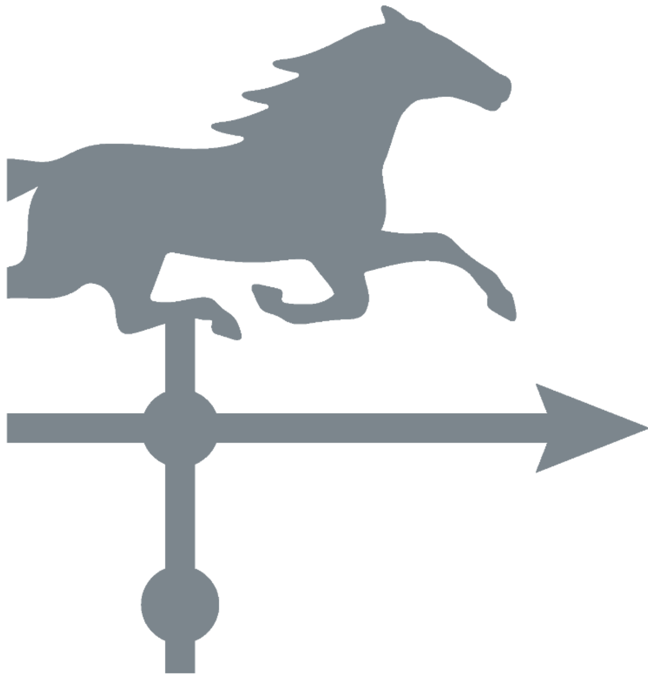

Current Demand and Supply Drivers Affecting Rental Housing Investment

WAR, PRICES & JOBS: LOOKING FOR CLARITY IN FOGGY CONDITIONS

March 9, 2022

Current Market Conditions are Confusing and Nerve-Racking—But, Ultimately, Not Threatening for Rental Housing Investors

Inflation at its highest rate in 40 years, even before war in Europe sent energy prices soaring. Treasury yields rising by 50 basis points in 40 days before sinking by 30 basis points in 20 days. Strong corporate earnings and productivity growth unable to stop major stock market indices from plummeting. A continuing pandemic that has now claimed six million people.

Written by Brad Case, Chief Economist and Director of Research

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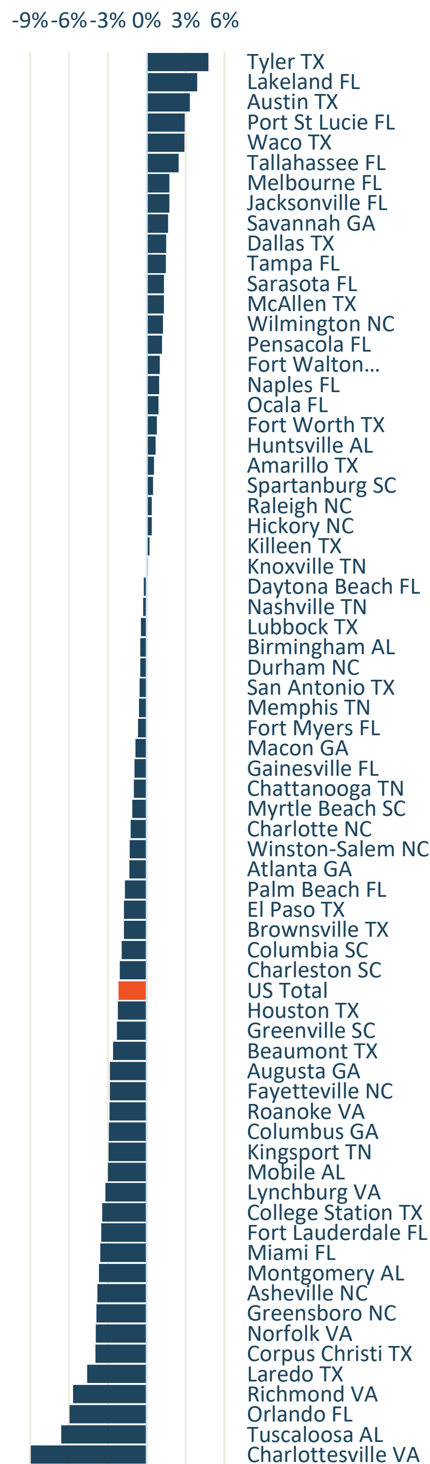
There's certainly no shortage of news demanding an investor's attention right now. Sorting through all of these confused and confounding developments is made more difficult by the fact that each of us will have to evaluate them differently from simultaneous but often competing perspectives: that is, our responses to these developments will differ depending on whether we are facing them just as a participant in political decision-making, just as an investor, or just as a concerned human being. In this commentary we'll focus on the recent developments that are especially important for real estate investors, and we'll focus on what they mean specifically for investment actions—not because that's the only perspective that matters, but because achieving clarity in such foggy conditions requires taking only one perspective at a time.

EMPLOYMENT

For the success of Middleburg's primary focus—middle-market Class A rental housing communities—there is not a single condition more important than the health of the labor market. March 4's employment report from the Bureau of Labor Statistics (BLS) was much stronger than expected: total employment grew by 678 thousand (about 70 percent more than the consensus forecast) and other indicators of a healthy labor market such as the unemployment rate (3.8 percent), the labor force participation rate (62.3 percent), and average weekly earnings ($1,096) also improved. Total employment is still 2.1 million shy of its pre-pandemic record, but four more months like the last four will bring us back to that level.

Moreover, the health of the current labor market is quite widespread: for example, the median unemployment duration has dropped to just 9.6 weeks, and one of the most vulnerable populations—women who maintain families without a spouse present—has seen its unemployment rate drop by two-thirds to just 5.3 percent.

The fact that strength in the labor market has extended to even some of the most vulnerable populations is unquestionably a positive for owners and developers of middle-market rental housing. On top of that, though, employment conditions are even stronger in the areas where Middleburg Communities operates: for example, 70 percent of the metro areas in Middleburg's part of the country have seen stronger employment recovery than the nation as a whole, and 42 percent of them—including large markets such as Jacksonville, Tampa and Raleigh—already have more jobs than they did before the pandemic began.



WAR

Though the invasion of Ukraine is dominating news, it is not the only country where people are dying in battle: already this year lives have been lost to active civil wars or terrorist insurgencies in places like Yemen, Ethiopia, Nigeria, and the Democratic Republic of the Congo, while our close neighbor Mexico continues to be torn by a fierce drug war. Russia is the world's third-largest oil exporter, but the top sources of petroleum products also include Nigeria and Mexico, along with countries such as Saudi Arabia and Iraq that are at least in uncomfortable proximity to active armed conflicts. And oil is not the only commodity important to investors: for example, the DR Congo is among the world's largest exporters of copper, important in construction and many other industries.

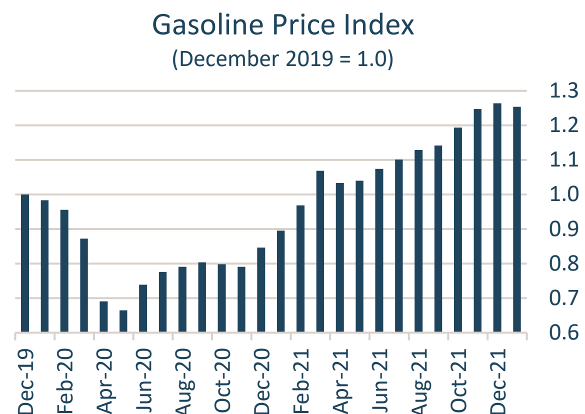
Solely from the viewpoint of an investor, what make the conflict in Ukraine of such high importance are its very

prominent effects on global energy markets and its additional effects on influential European economies such as Germany and the United Kingdom. Oxford Economics has estimated that the war in Ukraine—including sanctions in response—is likely to reduce global GDP by less than 0.2 percent in 2022 and slightly more than 0.2 percent in each of 2023 and 2024. Most of the economic cost is expected to fall upon European countries, reducing Eurozone GDP by 0.3 percent in 2022 and around 0.5 percent in each of 2023 and 2024. In contrast, the likely effects on the U.S. are much smaller, with an estimated cost to GDP of less than 0.2 percent in each of the three years.

As with labor market conditions, the economic damage in Middleburg's part of the country is likely to be less than in other parts of the country. Of course Texas is well known as the country's largest producer of both crude oil and natural gas, so its economy is likely to benefit from increases in global energy prices. Other states in Middleburg's territory are likely to benefit in ways that are similar but less well known: for example, it is not widely known that North Carolina and Florida trail only California and Texas in production of solar power, that Alabama and South Carolina are among the largest producers of nuclear power, that Virginia is a major producer of natural gas, or that Alabama and Georgia lead the nation in production of energy from wood. The most serious consequence in our territory is likely to be that higher gasoline prices will reduce car travel to vacation destinations.

CONSUMER INFLATION

For U.S. investors as well as U.S. consumers, the most significant impact of Russia's invasion of Ukraine is likely to be its effect on inflation. Inflation was already high before the war began—as has been widely reported, January's 7.5 percent year-over-year consumer price inflation was the highest rate in 40 years—and Oxford Economics estimates that the Ukraine invasion will add 0.6 percentage points to US inflation during 2022. The main culprit, of course, is energy prices, especially gasoline: gasoline accounts for 3.9 percent of the spending tracked by the Consumer Price Index (energy is 7.5 percent), and the year-over-year inflation in gasoline prices was 40 percent in January (for energy it was 27 percent).



Inflation in gasoline prices and overall prices is serious, but the figures highlighted in headlines are misleading. Year-over-year inflation has actually *declined* for both gasoline and energy over the past two months. Is that because prices have eased? No: a year-over-year comparison is an inherently misleading way to present the data in

current conditions, because a year ago energy prices were still abnormally low owing to the covid pandemic. It's certainly true that inflation is high by recent historical standards: for example, "core" inflation over the past two years has averaged 3.7 percent per year, the highest rate recorded since 1993, while two-year inflation in gasoline and energy prices is the highest it's been since—well, 2018.

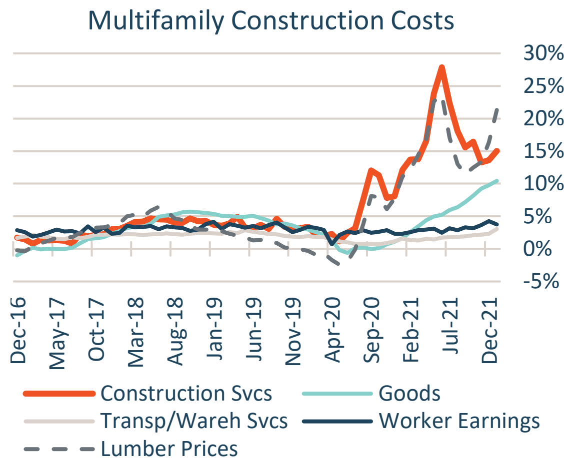
Still, high inflation was real even before the U.S. imposed a boycott on Russian energy imports. Core inflation as of January was already higher than it has been 57 percent of the time going back to the beginning of 1967, and headline inflation was higher than it's been 71 percent of the time. From the perspective of an investor, that raises two principal questions: how it is going to affect asset returns, and how bad it's going to get. Last month I published an analysis of rental housing as an inflation-protecting asset, noting that apartments have been among the most dependable investments for protecting against high inflation—better than gold, commodities, TIPS, or stocks—both because apartment rents tend to increase when inflation increases and because apartment property values also tend to increase, driven by higher expected future net cash flows.

The goods that have been driving high inflation—not just gasoline, but also used vehicles, which account for almost as much of consumer spending (3.9 percent) as gasoline does, and which have seen even more dire price increases (24 percent per year over the past two years)—are among the most volatile components of the Consumer Price Index, because both markets can see sharp changes in available market supply: gasoline as the level of petroleum production, refining, and distribution activities fluctuates, and used vehicles as owners replace them with new vehicles.

We believe it is likely that inflation will come back down before it does substantial damage to the economy: probably not this year, perhaps not next year, but not long after that. The Federal Reserve Bank of Cleveland, for example, estimates inflation over the next year at 2.6 percent, but average inflation over the next five years at just 1.9 percent per year. That's important, because the Cleveland Fed's inflation model has been systematically more accurate than other predictions including the five-year inflation expectation implied by TIPS yields as well as the widely quoted University of Michigan survey of consumer inflation expectations.

SUPPLY ADJUSTMENTS

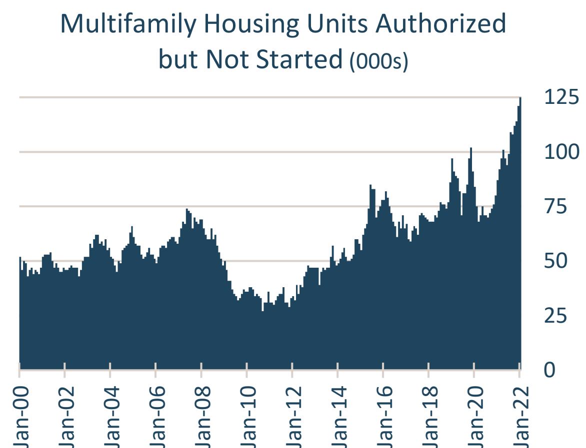
Gasoline and vehicle prices are likely to normalize in response to supply adjustments, but it's far less clear that real estate supply can adjust enough to bring down price inflation in property markets. Aside from "the usual suspect" of local regulatory constraints, in the current market situation there are added constraints from the availability and cost of crucial construction resources, especially lumber.



The Bureau of Labor Statistics calculates a set of Producer Price Indices specifically applying to construction of multifamily housing, with three main components: construction trade services (meaning payments to subcontractors), goods purchased directly by general contractors, and transportation or warehousing services purchased directly by general contractors. The overall cost of constructing multifamily housing has soared by 28 percent since the start of the covid pandemic (at a rate averaging 13.7 percent per year) and almost the entire increase can be attributed just to the spike in lumber prices over that period, which reflects almost perfectly the spike in payments to subcontractors.

The National Association of Home Builders gives four reasons for the sharp increase in lumber prices, which they estimate has increased new multifamily home prices by $7,300 on average. The first is that sawmills curtailed production at the start of the covid pandemic—in expectation of a sharp decline in demand—and were slow to react when demand instead increased. Two other reasons were unusually severe wildfires in western states of both countries, and a large increase in tariffs on lumber imported from Canada (partially reversed earlier this year). The fourth reason is the same set of covid-related supply chain disruptions that have caused prices to surge for consumer goods such as new and used vehicles. In fact, lumber is not the only input affected by supply-chain disruptions: builders have reported serious shortages of appliances, windows and doors, plumbing fixtures, copper wiring, and other materials.

Finally, although average weekly earnings of construction workers have not yet increased substantially, both general contractors and subcontractors have reported shortages of workers in multiple elements of housing constructions, especially carpentry trades. It is this tightness in labor markets that is likely to continue to suppress new supply in the rental housing market even after the covid-related supply chain disruptions have been resolved. In fact, as of January the number of new multifamily housing units already permitted but not yet started had climbed to 125 thousand nationwide, more than double the long-term median of 56 thousand. And with almost half (61 thousand) of those delayed starts just in the



South region, housing undersupply in Middleburg's part of the country is likely to last considerably longer than merely the supply-chain disruptions.

FOG FROM OTHER QUARTERS

Investors certainly have other questions to wrestle with at the same time. Will the Federal Open Market Committee push ahead with interest rate hikes to combat inflation, or will they back off in the face of severe trade disruptions and a new refugee crisis in Europe? Will strength in consumer spending support, and a continued waning of the covid pandemic, support renewed strength in stock markets, or will elevated market valuations have to go through a painful reset first? Is it possible that the cumulative hits—war, refugees, sanctions, trade disruptions, energy prices—will damage consumer confidence and perhaps even tip the economy into recession? The questions that investors face now are too many and too complex to address in a single report, but we hope that the information presented here will help to clarify at least part of the picture.

The data presented in this report are gathered from multiple sources that have been cited. Note that even historical data may change in subsequent reports. Although every effort is made to ensure the accuracy, timeliness, and completeness of the information provided in this publication, the information is provided "AS IS" and Middleburg Communities does not guarantee, warrant, represent, or undertake that the information provided is correct, accurate, current, or complete. This paper makes a number of predictions. These predictions of the future environment for the multifamily industry address matters that are uncertain and may turn out to be materially different than as expressed in this paper. The information provided in this paper is not a substitute for legal and other professional advice. If any reader requires legal advice or other professional assistance, each such reader should consult his or her own legal or other professional advisor and discuss the specific facts and circumstances that apply to the reader. Middleburg Communities is not liable for any loss, claim, or demand arising directly or indirectly from any use or reliance upon the information contained herein.