CHURCHILL PERSPECTIVES

The Current State of the Residential Real Estate Market and What to Expect in the Year Ahead

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Given the state of interest rates, why should investors feel optimistic about the RTL space? To what can you attribute any existing momentum?

RTL products are becoming increasingly attractive, accretive relative-value products given they are short-term and carry low risk. As residential credit spreads continue to tighten, we're seeing more new loans originated and an increasing appetite from both new and existing investors, driven by favorable conditions and the emergence of rated securitization activity in the RTL space with little evidence of performance issues. We expect more deals, both unrated and rated, to come to market in the coming months. The first RTL deal was issued in 2016 and the market has since grown to approximately $10 billion outstanding. In the last few years issuance was $2-3 billion per annum, which is expected to continue growing, with $4-5 billion projected issuance for 2024.

The stable outlook for housing based on limited inventory has given rise to new and consistently growing forms of RTLs, short-term loans to contractors who repair and renovate a home. The positive backdrop for RTLs is driven by several factors including the chronic housing shortage, favorable immigration dynamics, older homeowners' tendency to age in place, low homeownership among Millennials and Gen Z, and the fact that older homes need revitalization given median home age is approximately 45 years old with roughly half of US homes built prior to 1980.

How are home prices changing across geographies? What regions in the U.S. are experiencing higher demand? What is driving these changes?

Despite the challenging level of affordability for the incremental home buyer, we continue to expect positive home appreciation as a result of persistently low inventory, limited new housing developments, anticipated higher interest rates for a longer period, and the "lock in" effect keeping average outstanding mortgage rates at 3.9%. Of course, we acknowledge that these factors driving home appreciation vary by region.

The Western U.S. witnessed turbulent price movement at the end of 2023, signaling a continued trend of decreasing affordable housing options in that region. In particular, metro areas such as San Diego, Los Angeles, and Phoenix have seen home prices rebound: The largest increases were in San Diego, which had the fastest annual home-price growth in the country, followed by Los Angeles. The weakest market was Portland, where prices rose 0.27% on an annual basis, and while Texas, Idaho, and Montana have seen yearly price increases of less than 1%, no state saw declines. The Northeast and Southeast saw larger home price increases than the national average due to workers moving back to traditional job centers and the sustained affordability of some metros in these states. The states with the highest increases year over year, per the CoreLogic HPI, were Rhode Island, New Jersey, and Connecticut.

The Sunbelt region also saw increases in housing supply at the end of 2023. While national supply has not risen overall, it's notable that a region known for having home price appreciation (HPA) rates above the national average is seeing increased supply, especially as housing permits and new home sales have increased as well as incoming immigration dynamics. Moving forward, new housing should continue to be a contributor to the region's housing market and should be well absorbed, with expected improvement in affordability as a result.

What are the trends you're seeing in the multifamily market specifically?

We expect to continue seeing an increase in multifamily units becoming available as construction backlogs are addressed and the price of certain materials, such as lumber, continues to fall from 2020/21 highs. However, while a decline in new permits will help alleviate the construction backlog, rent growth will be muted as operators are forced to keep rents low in order to fill new units hitting the market.

Despite this potential growth in vacancies, we remain bullish on the multifamily sector due to the strong labor market. Multifamily builders have responded quickly to fundamentals in the market, with permit numbers steadily declining since mid-2022 and currently sitting at pre-pandemic levels. This is a result of both slower rent growth and higher financing costs. In kind, starts declined, but completions remained elevated while builders work through the construction backlogs. Once construction backlogs are addressed, we anticipate a decline in new starts to rebalance rents.

Property operators are aware of the incoming supply pipeline and how it may impact vacancy rates. Apartment vacancy rates have increased marginally in recent years, a trend that is more consistent with the growth in supply than with credit concerns. Owners will be able to remediate vacancies by decreasing starts, rents, and offering additional new tenant incentives. Overall, the multifamily market may see slight road bumps in 2024 due to higher vacancy rates and slower rent growth, but developers are taking steps to slow incoming supply, which should improve these issues.

What trends do you believe will impact the residential real estate market in the year ahead?

We are monitoring several factors poised to influence the residential real estate market in the coming months. Despite higher financing costs, home prices remain robust, heightening the affordability challenges and driving demand towards the rental market and new construction projects. The balance between fundamental demand drivers and affordability complicates the equation for potential homebuyers, resulting in subdued transaction volumes for existing homes but healthy levels for new home sales, buoyed by seller concessions.

Additionally, tight credit spreads and the introduction of highly rated deals in the RTL space further contribute to market stability, with Churchill's managed portfolio demonstrating strong performance, internal performance metrics on whole loans demonstrating favorable results compared to that of securitized loans. While gradually lower rates may improve affordability, supply-demand imbalances are expected to keep home prices relatively flat, with certain regional disparities influencing housing supply dynamics – impacted by immigration and a backlog of deliveries.

High interest rates continue to deter renters from purchasing homes, while supply remains constrained due to the rate lock-in effect, particularly in Sunbelt markets. However, as the Fed cuts rates, we anticipate supply will increase as existing homeowners become freer to sell and meet rebounding demand. On the supply side, multifamily builders have adjusted to market fundamentals, reflected in declining permit numbers and steady completion rates despite higher financing costs, indicating their ongoing adaptation to evolving market conditions. Demand will be there, driven by strong employment, wealth accumulated in equity markets and existing homes, and immigration inflow.