LMC Insights

2Q 2022

A Lennar Company

Inside Look

Public Market Returns

	1Q22	1 Year	3 Year
S&P 500	-4.60%	15.65%	18.92%
Dow	-4.57%	5.14%	10.17%
Nasdaq	-9.10%	7.36%	22.53%
FTSE NAREIT[1]	-5.26%	23.58%	11.73%
Barclays Agg	-5.93%	-4.15%	1.69%
10-yr Treasury[2]	2.32%	1.73%	2.49%
CPI[3]	2.28%	7.97%	9.45%

Private Market Returns

	1Q22	1 Year	3 Year
NCREIF Property Index			
Total Return	5.33%	21.87%	9.60%
Income	0.99%	4.18%	4.28%
Appreciation	4.34%	17.16%	5.16%
Hospitality	1.76%	9.09%	-6.27%
Industrial	10.96%	51.88%	25.07%
Multifamily	5.25%	24.12%	10.19%
Office	1.60%	6.75%	4.72%
Retail	2.26%	7.06%	-0.42%

Source: NCREIF, Morningstar, Federal Reserve Bank of St. Louis (FRED)

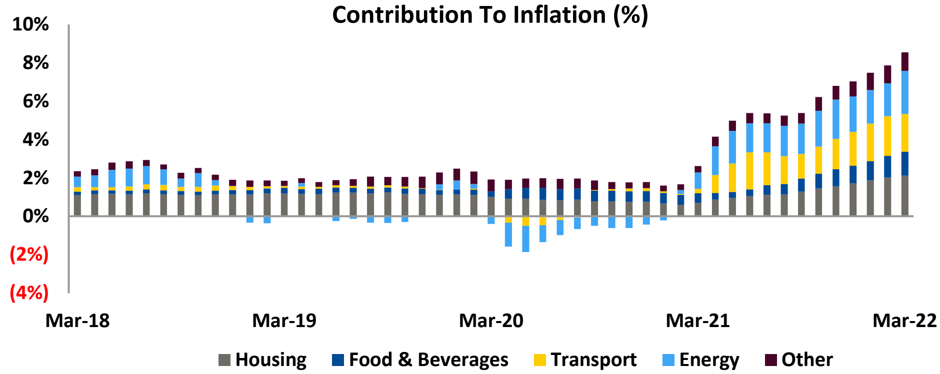
1. FTSE NAREIT All Equity REITs Index.
2. Represents current yield at the end of 1Q22, 1Q21, and 1Q19, respectively.
3. Consumer Price Index (USACPIALLMINMEI): All Items for the US, not seasonally adjusted. Represented as a percentage change at beginning of the quarter over the specified time frame.

Amid geopolitical uncertainty, global investors turn to the US and inflation-hedging asset classes for safety, as the Fed marks the end to QE and historic low interest rates; public markets respond with volatility.

State of the Economy

The U.S. economy was under pressure from both domestic and international sources in the first quarter of 2022. Consumer demand remained strong, keeping retail sales at high levels as the Omicron surge faded. That same demand, however, has stressed supply chains while new lockdowns in China tied up ships in Shanghai and Russia's invasion of Ukraine led to a spike in oil prices above $100 a barrel for the first time since 2014. Those pressures have driven higher inflation and slower economic growth, with 2022 Q1 real annualized GDP shrinking 1.4%. The decline in GDP was mainly due to increased imports, which grew at an annualized rate of 17.7%, along with declines in government spending as stimulus packages wound down. However, business investment rose as firms bought equipment to meet strong demand. Additionally, consumption accelerated in the first quarter to an annualized rate of 2.7%, 33 basis points higher than the 20-year average growth rate, providing a strong outlook to an otherwise weak GDP reading in the first quarter.

The labor shortage continued unabated in the U.S. during the first quarter of 2022, with roughly 1.8 job openings per unemployed worker. Despite companies struggling to find labor, hiring maintained a strong pace, with nearly 1.7 million jobs added in the quarter. While U.S. employment is still 1.58 million jobs short of recovering to pre-pandemic levels, a full employment recovery is expected by the end of 2022, as higher wages and inflation pressure continue to entice workers off the sidelines. The labor force participation rate increased 70 basis points in the first quarter, as 25-54-year-old labor participation rates have nearly recovered. Older workers, those above 55, have also begun to finally return to the workforce after their participation rate remained stubbornly low throughout 2021, but remains one percentage point below pre-pandemic levels in the face of many choosing early retirement.



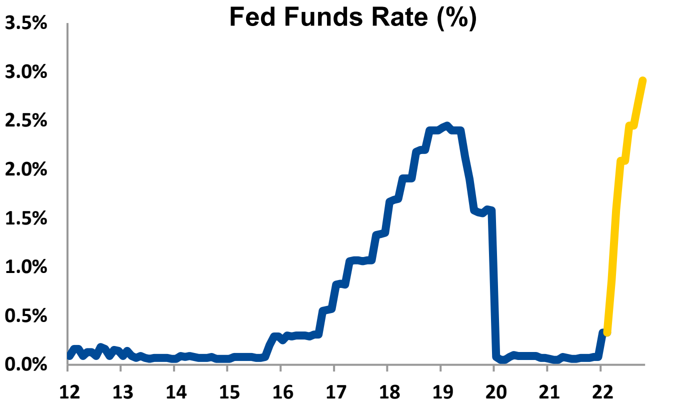
Source: Macrobond: BLS: CoStar Advisory Services

As of March 2022

LMC Investments

A tight labor market, along with a worsening supply chain, has led to an accelerating inflation environment. CPI reached 8.5% in March 2022, the highest level the index has achieved since 1981. Housing and car prices have been major contributors to the price increase, but fuel prices for housing and motor vehicles contributed 2.24 percentage points to the 8.5% inflation reading in March.

The March 2022 Federal Reserve meeting kicked off a long-anticipated rate tightening cycle with a 25-basis point rate hike. Raising interest rates likely will not fix U.S. supply chain woes, but they will help tamp down demand for goods. The Fed has signaled it is likely to raise rates 50 basis points in its next meeting, and the market believes the Fed will continue to pursue aggressive rate hikes in the June and July 2022 meetings as well. Fed Fund futures project that the Fed will raise rates by 250 basis points by the end of 2022, the fastest one-year interest rate hike pace since 1989.



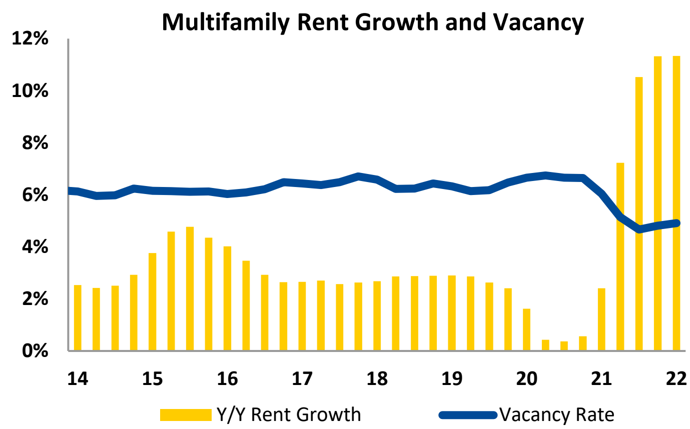
Sources: Macrobond; CME Group; CoStar Advisory Services As of April 25, 2022

Despite high inflation and a slow reaction by the Fed, inflation expectations for three and five years ahead remain well anchored, hovering just above 20-year averages. The market has maintained confidence that the Fed raising interest rates, along with pandemic era stimulus wearing off, will bring inflation under control. The concern going forward is whether the Fed will be able to guide the U.S. economy to a soft landing. Historically, the Fed has struggled to bring inflation under control without sending the economy into a recession and pushing up unemployment rates. However, the Fed has some cushion, as high job openings rates allow for some demand reduction without higher unemployment and consumer finances are still on solid footing.

Multifamily Investment Outlook

Multifamily market fundamentals remained firm in the first quarter of 2022, although demand and vacancy have moderated from the record-setting levels reached in 2021. Net absorption totaled nearly 56,500 units in the first quarter of 2022, not far off of the average first-quarter totals in the five years prior to the pandemic, but well below the record-high quarterly absorption in 2021. New deliveries modestly outpaced net absorption in the first quarter, causing the national vacancy rate to tick up 10 basis points from 4.8% in the fourth quarter of 2021 to 4.9% in the first quarter of 2022.

The moderation in demand was felt across quality segments of the multifamily market, with the average vacancy rate rising from 6.8% to 7% for 4- & 5-Star properties and from 4.0% to 4.1% for 1- to 3-Star properties, from the fourth quarter of 2021 to the first quarter of 2022. Strong demographic drivers and increased net migration have kept vacancy rates near historical lows in Sun Belt markets like Charlotte, Orlando and Miami. Meanwhile, even some of the more expensive Gateway markets including San Francisco, Boston, and New York have experienced a continued decline in vacancy through the first quarter of 2022 as workers return to offices in larger numbers, further bolstering multifamily demand growth in the urban areas of these metros. Despite this slight moderation, mortgage rates, their highest since 2009, and home prices, experiencing double digit gains, have led to a home price affordability environment that is nearly the worst on record. This simple fact is likely to bolster renter demand long term. 95 of the top 100 US MSAs are reportedly less affordable than their long-term averages[1].



Source: CoStar Advisory Services As of Q1 2022
1) Source: CNBC

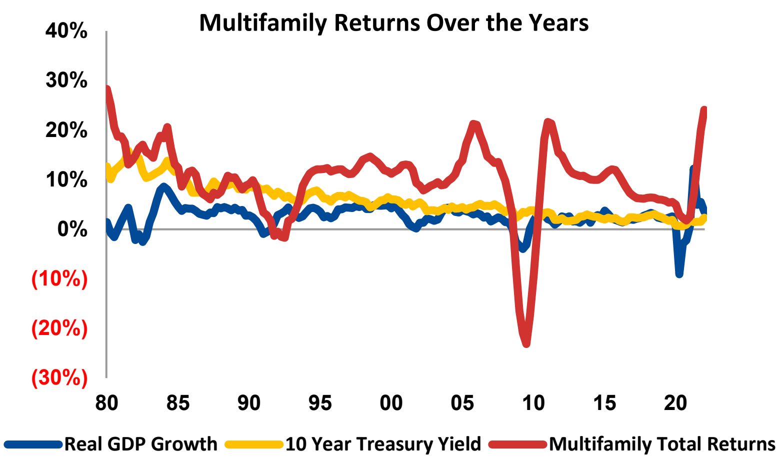
While overall multifamily fundamentals remain tight, development continues at a steady pace. Nationally, the 763,000 units under construction represents 4.3% of inventory, on a par with average rates over the last three years. The stable rate of new supply has much to do with the type of product being constructed in recent years. Roughly two-thirds of units currently underway are in mid- and high-rise buildings that have longer construction lead times relative to garden properties. As a result, the majority of the units underway will not reach completion for another two to three years. Development activity is concentrated in markets to the south and west that also boast strong demographic growth. Austin, Nashville and Miami lead the way with over 10% of inventory underway in each market. The large coastal markets of New York and Washington DC lead the nation in terms of absolute units underway at 56,000 and 28,000 respectively, but as a share of their respective market inventory, development pipelines in these markets are at or below the national average.

Rent growth maintained a lofty pace registering 11.3% year over year in the first quarter of 2022, on par with the record rent growth achieved in 2021, and over three times higher than the average 2.8% annual growth registered in the three years prior to the pandemic. While suburban rents continued to outperform, downtown assets made up a lot of ground as households have begun to return to city centers. The Sun Belt has experienced the largest gains with markets including Palm Beach, Orlando, Tampa, Fort Lauderdale, Las Vegas, and Raleigh all recording rent growth of 20% or higher year over year in the first quarter of 2022. Strong demographic tailwinds propelled rent growth in these markets despite a continued influx of new supply. High quality properties have recovered any weakness experienced during the pandemic and now lead the way with rent growth of 13.7% for 4- & 5-Star assets compared with 11.2% for 3 Star properties and 5.2% for 1- & 2-Star assets year over year in the first quarter.

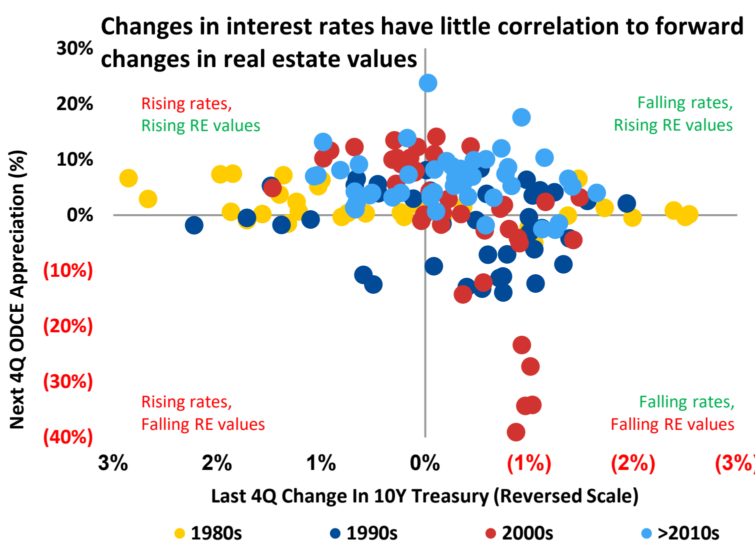
The strength of the multifamily fundamentals continues to attract significant investment capital. Sales volume totaled $50 billion in the first quarter of 2022, down from the record volume recorded in the last two quarters of 2021, but still 21% higher than the five-year historical quarterly average. New York, Los Angeles and Seattle, along with Atlanta, Phoenix, Charlotte and Denver ranked as top markets by total sales volume in the first quarter, as capital has shifted focus to a broader number of markets, particularly those in the Sun Belt, over the last few years. Average pricing per unit also experienced significant gains, increasing by 12.6% year over year as of the first quarter of 2022.

Multifamily in a Rising Interest Rate Environment

Bond yields have moved higher as the Fed has signaled its willingness to fight inflation. The rapid increase in interest rates has run up against low multifamily cap rates. Rising rates do put some upward pressure on cap rates, which in turn puts some downward pressure on returns, but yields are not the only factor in multifamily returns, and there is little correlation between changing yields and returns on multifamily investments, at least without accounting for other factors.

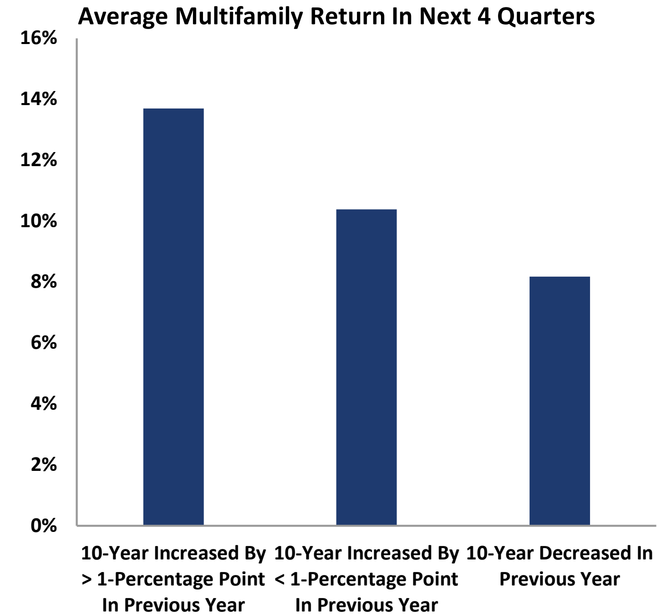


Source: Macrobond; BEA; U.S. Treasury Department; CoStar Advisory Services As of Q1 2022



Source: JPMorgan

The increase in U.S. interest rates in the first few months of 2022 has been dramatic, but not record breaking. The 10-year treasury yield has increased by roughly 1.2 percentage points in the last 12 months, above the historical average, but rates also increased faster in 2009 and 2013. Multifamily returns have also typically performed well when interest rates move up. Since 1980, when the 10-year yield increased by more than 1 percentage point in the previous 4 quarters, NCREIF Multifamily returns were 13.7% on average in the following 4 quarters, 415 basis points higher than the overall average.



Source: Macrobond; BEA; U.S. Treasury Department; NCREIF; CoStar Advisory Services From 1Q80 to 1Q22

The takeaway is not "high bond yields typically generate high returns", rather that there are other factors that typically push up bond yields and returns, simultaneously. Returns are typically stronger after bond yields move up despite the pressure on cap rates because strong economic growth drives treasury yields up as inflation expectations rise. At the same time, high economic growth is a good environment for multifamily fundamentals. Growing incomes and employment drives demand, particularly for institutional quality product as consumers are willing to pay more for amenities and better locations.

Despite a negative GDP report in the first quarter of 2022, consumer and investment spending remained strong, both good indicators for multifamily demand. Historically strong demand in 2021 mixed with rising yields has narrowed cap rate spreads compared to both the 10-year Treasury and BBB corporate bond rate below their 20-year averages.

Multifamily returns have also typically performed well when interest rates move up. Since 1980, when the 10-year yield increased by more than 1 percentage point in the previous 4 quarters, NCREIF Multifamily returns were 13.7% on average in the following 4 quarters, 415 basis points higher than the overall average.

Narrowing cap rate spreads typically indicate cap rate compression will become increasingly difficult, but the current market conditions do benefit multifamily. Interest rates are being pushed up in the face of rising inflation, which hit its highest level since 1982. Multifamily, with short lease terms and strong fundamentals, is a strong asset choice for investors looking to hedge against high and uncertain inflation, as rent can adjust to changing prices while bond payments lose real value every year. The last time inflation was 8.5% was in 1982 when NCREIF appraisal cap rates were roughly six percentage points below the 10-year Treasury rate and the spread remained inverted or close to zero until 1990. While cap rates are 3.5% today, compared to 7% in the early 1980s, and cap rate compression is more difficult, the cap rate spread narrowing in the face of rising yields and high inflation historically does not equate to rising cap rates. Instead, narrowing cap rates represents the relative value of multifamily assets' ability to weather the U.S.'s current economic issues increasing compared to fixed income assets.

Let's Connect

Will Chapman
President
LMC Investments
will.chapman@livelmc.com
+1.704.661.2196

Kevin Harrell
Managing Director
kevin.harrell@livelmc.com
+1.980.296.6001

JR Plyler
Sr. Managing Director
jr.plyler@livelmc.com
+1.704.582.2683

LMC A Lennar Company

About LMC

Lennar Multifamily Communities, LLC ("LMC") is a vertically integrated multifamily real estate investment firm focused on developing, acquiring and operating Class A apartments in the United States. A wholly owned subsidiary of Lennar Corporation ("Lennar"), LMC combines the financial strength and entrepreneurial spirit of Lennar, the nation's largest homebuilder and acquirer of land, with the favorable apartment demand fundamentals nationwide. LMC currently employs over 800 professionals across 20 offices nationwide. With approximately $10.2 billion of gross assets under management[1], we offer multifamily investment strategies to a diverse set of institutional investors including pension funds, sovereign wealth funds, insurance companies, private equity companies, banks, and high net worth individuals.

1. AUM as of 12/31/2021