"Unlike the stomach, the brain doesn't alert you when it's empty."
- Arab proverb

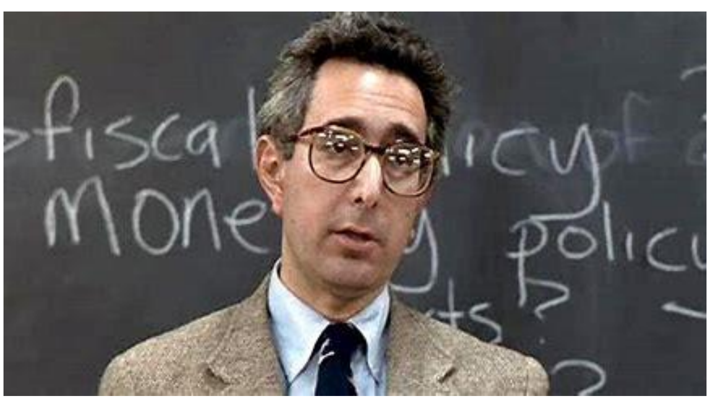
"Now is the accepted time to make your regular annual resolutions. Next week you can begin paving hell with them as usual."
- Mark Twain

"The work of a mature human being is to carry grief in one hand and gratitude in the other, and to be stretched large by these two things."
- Francis Weller

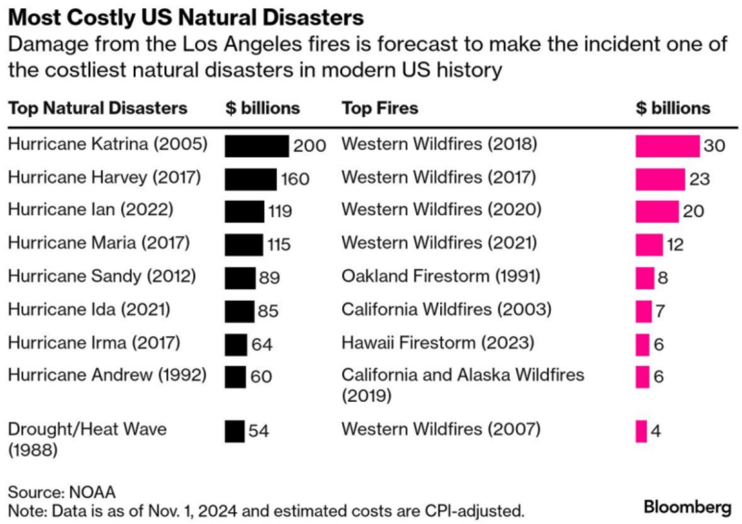
When I started writing this memo a few weeks ago, I planned on beginning it with references to three seminal '80's movies, all of which were on repeatedly during the holidays: "Back to the Future," "Fast Times at Ridgemont High," and "Ferris Bueller's Day Off." The plan was simple. I would weave some of their storylines into a narrative to describe some of what we are witnessing in today's economy, financial markets, and/or policies proposed by the Trump Administration, Part Deux, to inform and to perhaps compel you to keep reading.

After all, how could we possibly forget Ferris Bueller's history teacher, played by Ben Stein, asking a classroom full of zoned-out high school students about the tariffs established by the Smoot-Hawley Act of 1930 and whether they were able to alleviate the impact of the Great Depression. Not wanting to keep you hanging, Mr. Stein provides a predictably monotonic response: "they did not." Well, with tariffs potentially making a comeback, perhaps Mr. Stein might give this enthralling lecture to those contemplating such a decision.

Meantime, as "Back to the Future" and its sequels seemed to play daily on TNT over the holidays, I found myself thinking about Doc's time-traveling DeLorean and how well the film captures human ingenuity and the nature of innovation, and how that relates to everything from the driverless Waymos I see daily around Southern California, to generative AI, to CRISP gene editing, to 5G technology. The only other thing I had to ponder was whether I would rather have a DeLorean or a Hot Tub (as found in the more recent cinematic gemstone, "Hot Tub Time Machine") to accompany me on my time travels. Tough call.



Then came Tuesday, January 7th, and my Pacific Palisades neighborhood began to burn…and burn, and, unlike Bob Uecker (rest in peace), I got to witness it all from a front row seat. Pacific Palisades has been my family's neighborhood and community for nearly 30 years. Where my kids went to school, where we shopped, dined, and worshipped. And while our home miraculously survived, a mere two and a half blocks from where the eastern flank of where the Palisades fire stalled, our neighborhood and community are decimated. We know dozens and dozens that lost everything in what will likely prove to be the single most costly natural disaster in our nation's history, surpassing Hurricane Katrina. To feel heartbreak and gratitude at the same time is strange.



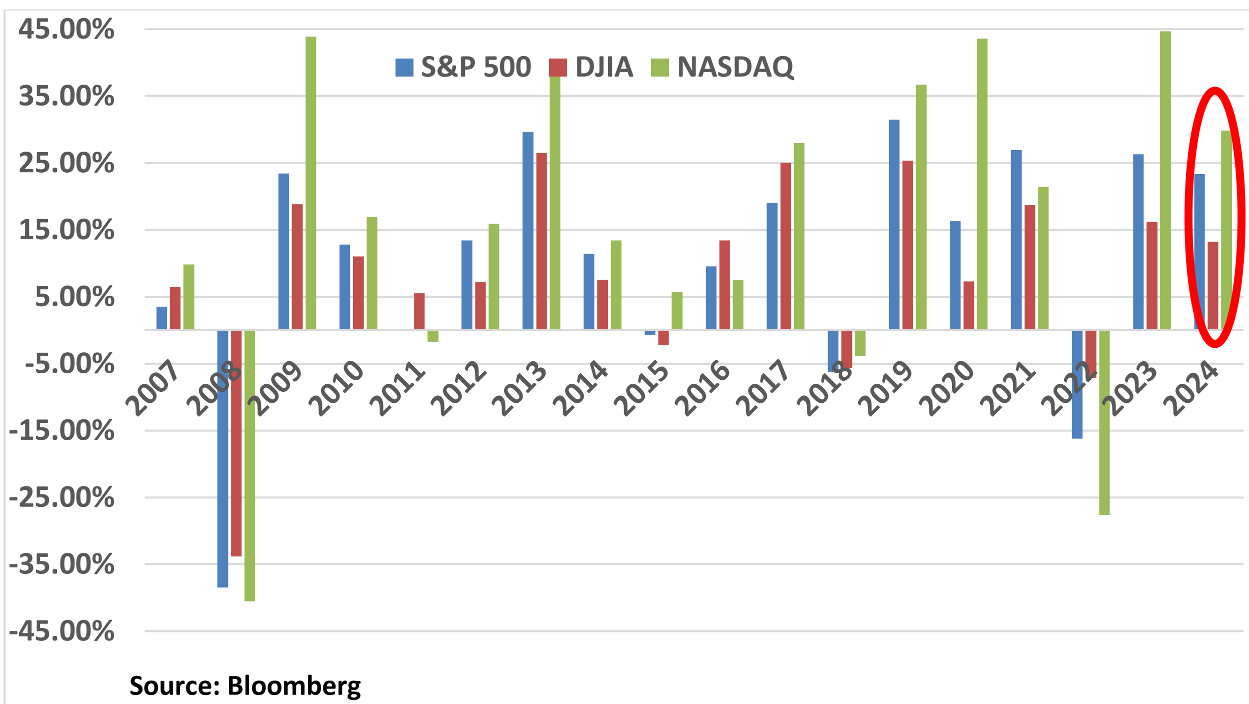
What's so disturbing is that much of the damage would likely have been prevented were it not for bureaucratic incompetence. There are probably 20 or so significant canyons from northwest Los Angeles county to the south and southeast. Competent Fire Department management, if not common sense, would have led to a fire truck or two being stationed at the entrance and/or end of each canyon, knowing that we would experience record winds, have experienced record drought, and a brush fire had literally broken out in the hills of Malibu near Pepperdine University a mere week earlier. Besides, this is precisely the sort of preventative action that had been taken in anticipation of previous "wind events," which are not uncommon around these parts.

But no, that would apparently be asking too much of our local government. And don't even get me started on the issues regarding empty reservoirs or malfunctioning fire hydrants. It's simply wonderful to receive less government than we have the displeasure of paying for here in California, the state with the highest taxes. If anything, the wildfires demonstrate how poorly our politicians, bureaucrats, and government leaders plan and coordinate. Maybe it's the fundamental disconnect between short-term election cycles and the long-term strategic planning necessary to address water needs, prepare for inevitable natural disasters, while balancing both with reasonable regulation, tax policy, and spending. Maybe it's just human nature. After all, when do they sell the most earthquake preparedness kits? Why do many choose Ozempic over diet and exercise?

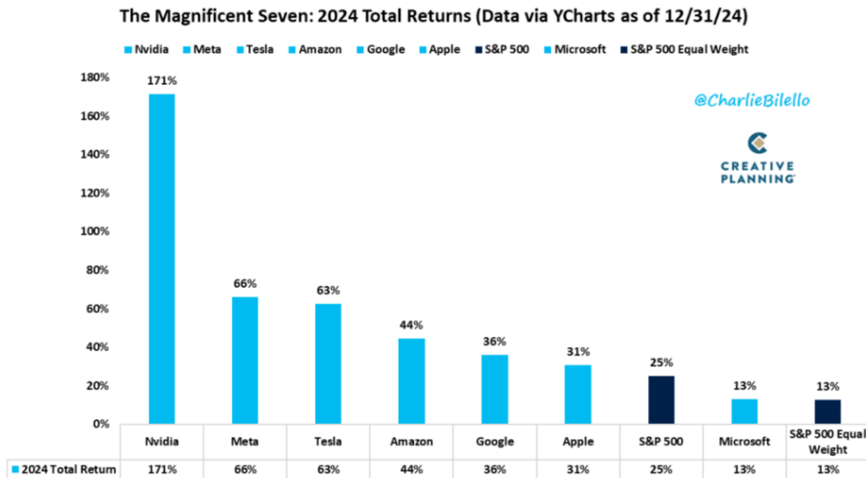
Which brings me to today's "risk-on" market, where speculation in cryptocurrencies, worthless meme coins, a select group of "growth stocks," and whatever Cramer might be "booyahing" about on a particular Tuesday evening would make 17th century Dutch tulip growers smile. I used to joke in class (and I was only half-joking) that investors should short the stock of any company who pays to have a stadium named after them. So, when the "Staples Center" became the "Crypto.com arena" in late 2021, I was fairly sure we had reached peak cryptocurrency fervor. Wrong.

When that name change took place, Bitcoin was trading for about half of where it trades today. And the absurd "Trump coin" a meme coin released the Friday before his inauguration (purely coincidental, of course), was but a twinkle in the President's eye, let alone a completely speculative (read: valueless) instrument with a market cap of $15 billion. Even if I buy into the narrative that Bitcoin and its brethren are merely the equivalent of "digital gold," supported by trust and faith in their inherent values, the volatility and the speculative fervor surrounding them contradict that storyline. And don't even get me started on "Hawk Tuah" or "Fart" coins (I kid you not). Just differently colored tulips, I suppose.

Meanwhile, the "risk-on" sentiment can be seen elsewhere, certainly in the equity markets, which remain "pricy" and concentrated. The equity markets turned in another terrific year in 2024, with the S&P 500 up approximately 23.3% and the tech-heavy NASDAQ, up over 29.8%.

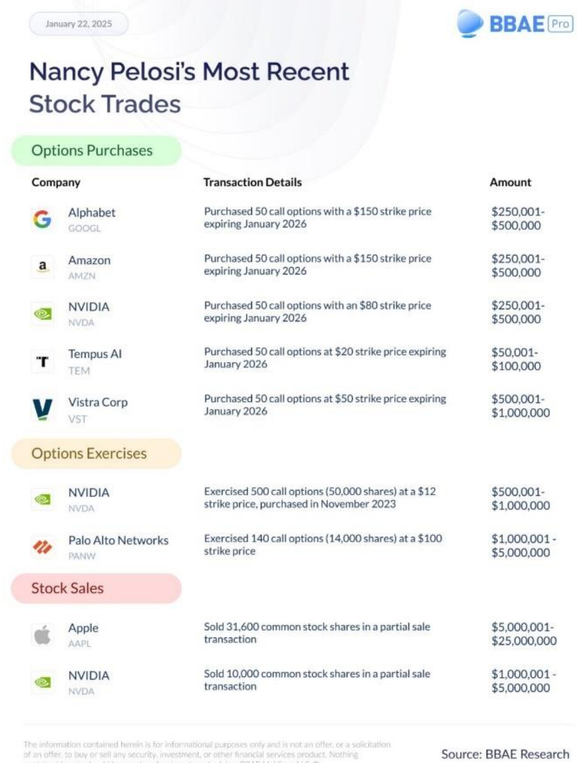


However, if you peek under the equity market hood, it becomes apparent that investors have piled into a very select group of companies. Just think that the "top 10" stocks represent roughly 40% of the entire value of the S&P 500. Passive index funds and ETFs are so yesterday.



	Nvidia	Meta	Tesla	Amazon	Google	Apple	S&P 500	Microsoft	S&P 500 Equal Weight
2024 Total Return	171%	66%	63%	44%	36%	31%	25%	13%	13%

Meanwhile, corporate executives are taking advantage of the market's largesse, selling more stock than ever, with the ratio of sellers to buyers also reaching a record high. Granted Nancy Pelosi continues to buy stocks and purchase call options, so maybe those corporate insiders are not quite as "in the know" as our former Speaker. After all, they don't have an ETF inspired by their trades like Speaker Pelosi does, the "Unusual Whales Democratic ETF" (symbol "NANC"). Unreal.


January 22, 2025

BBAE Pro

Nancy Pelosi's Most Recent Stock Trades

Options Purchases

Company	Transaction Details	Amount
Alphabet GOOGL	Purchased 50 call options with a $150 strike price expiring January 2026	$250,001-$500,000
Amazon AMZN	Purchased 50 call options with a $150 strike price expiring January 2026	$250,001-$500,000
NVIDIA NVDA	Purchased 50 call options with an $80 strike price expiring January 2026	$250,001-$500,000
Tempus AI TEM	Purchased 50 call options at $20 strike price expiring January 2026	$50,001-$100,000
Vistra Corp VST	Purchased 50 call options at $50 strike price expiring January 2026	$500,001-$1,000,000

Options Exercises

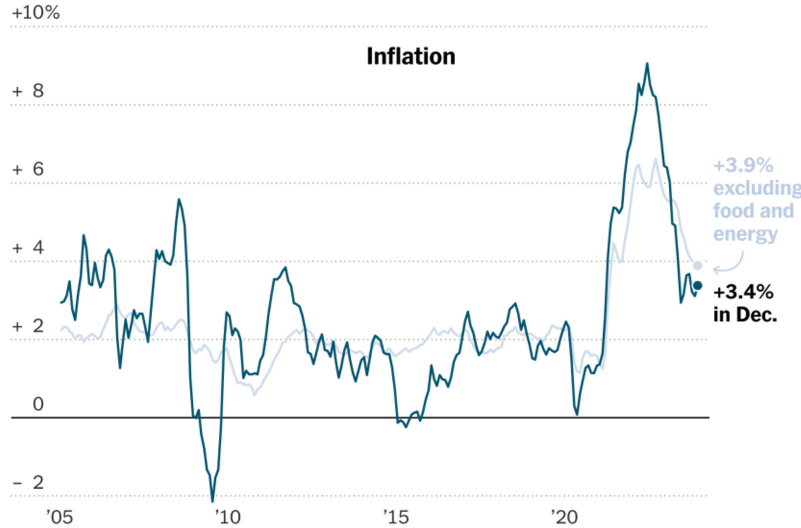
Company	Transaction Details	Amount
NVIDIA NVDA	Exercised 500 call options (50,000 shares) at a $12 strike price, purchased in November 2023	$500,001-$1,000,000
Palo Alto Networks PANW	Exercised 140 call options (14,000 shares) at a $100 strike price	$1,000,001 - $5,000,000

Stock Sales

Company	Transaction Details	Amount
Apple AAPL	Sold 31,600 common stock shares in a partial sale transaction	$5,000,001-$25,000,000
NVIDIA NVDA	Sold 10,000 common stock shares in a partial sale transaction	$1,000,001 - $5,000,000

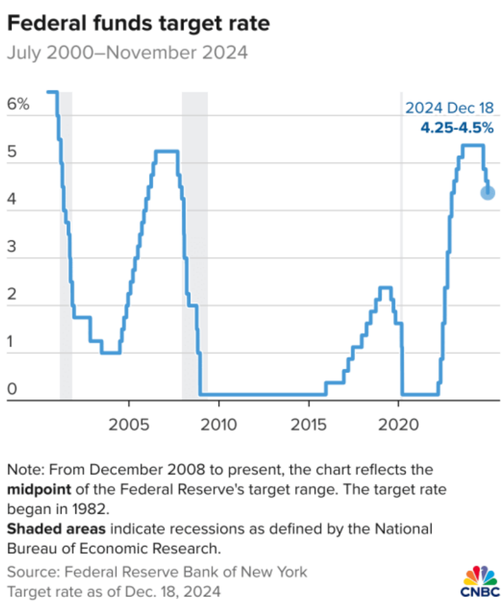
Source: BBAE Research

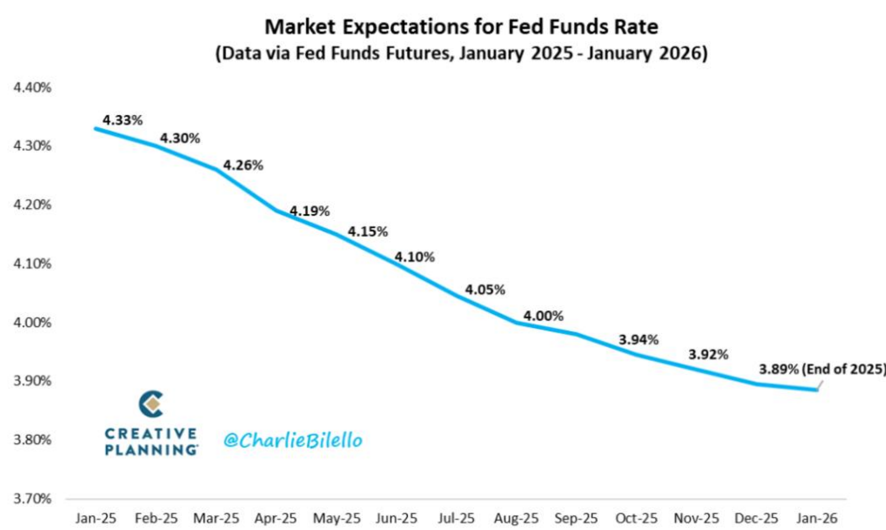
Keep in mind that this risk-on mindset is happening while inflation remains sticky and interest rates, elevated. While inflation is moving in the right direction overall, prices climbed more quickly in December, at least when compared to November. Overall year-over-year inflation increased 3.4% in December, versus 3.1% the previous month, more than forecasts. However, after stripping out food and energy prices, which tend to be more volatile, "core inflation" declined 0.1%, to 3.9%. marking the first time the core index has dropped below 4.0 % since May of 2021.



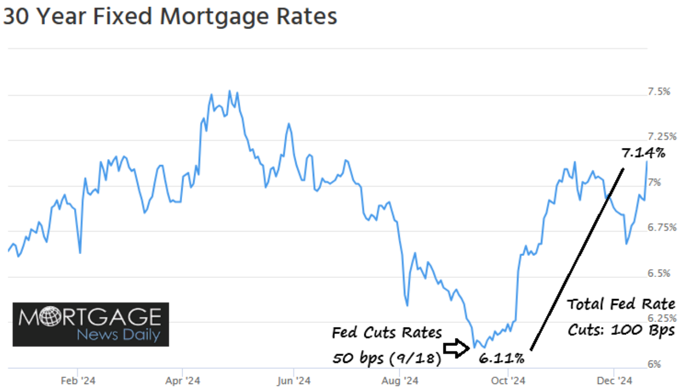
The mortgage market has not been impressed, with one headline from late December capturing it well: "The Fed Cut Rates. Mortgage Costs Went Up." In late December, the Fed cut rates for the third time, reducing the Fed Funds target rate to the 4.25%-4.5% range, while signaling just planned two rate cuts in 2025 (totaling 0.50%). At last glance, the market anticipates that the discount rate will be 3.89% by the end of the year, reflecting those two additional cuts.

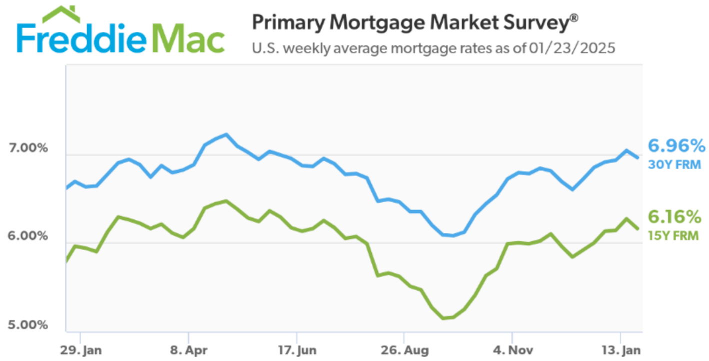
How can the Fed reduce rates and mortgage rates not follow suit? The discount rate, the rate controlled by the Fed, directly impacts most variable-rate auto, credit card and real estate loans, while fixed-rate mortgages are another story, as they track longer-term Treasury yields. So, it is kind of a mixed bag. We (and others) benefit from reduced rates on floating-rate debt, but, to the extent we strive to replace these loans with longer-term fixed rate financing, that becomes more challenging.



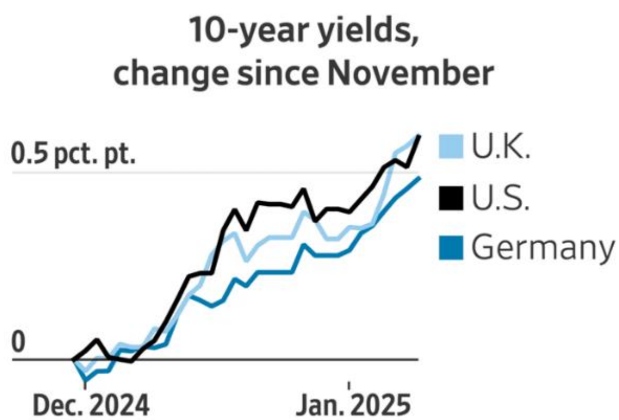


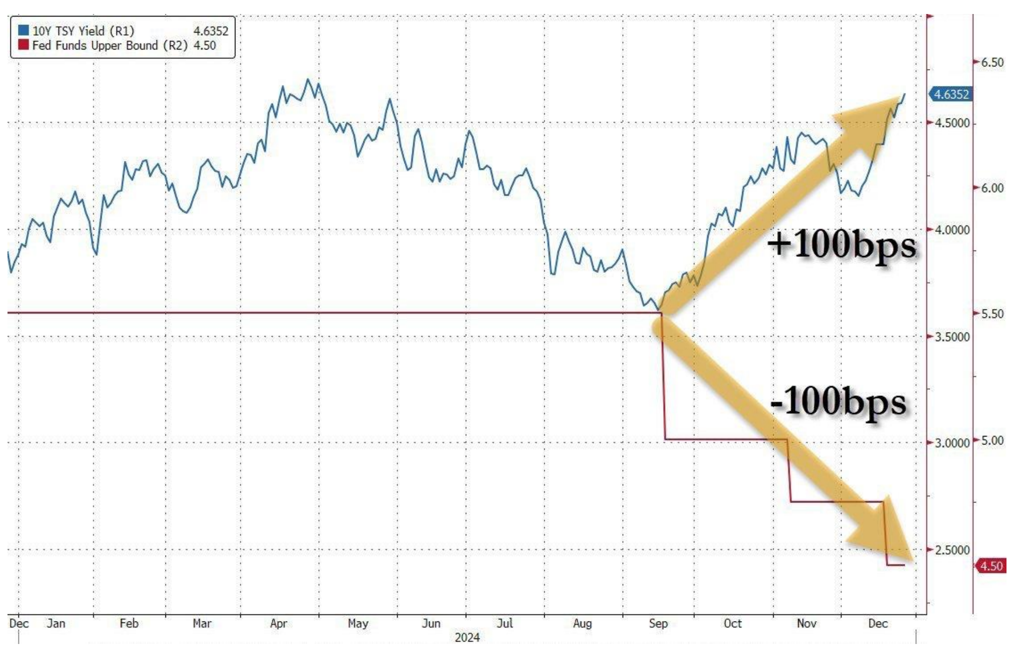
In fact, since the Fed cut rates in December, 30-year fixed rate mortgages jumped to 6.72% during the week ending December 19th and peaked at 7.14% that month. At last glance, the 30-year fixed rate stood at 6.96%. So much for lower fixed rate mortgage rates.





So, since September, when the Fed began to reduce rates, the 10-year Treasury yield is <u>up</u> over 1.0% (from 3.6% to 4.65%), a trend seen not just here, but globally. These sort of opposing interest rates movements have never occurred before, another one of those “unprecedented,” moments in the markets we have witnessed in recent years.



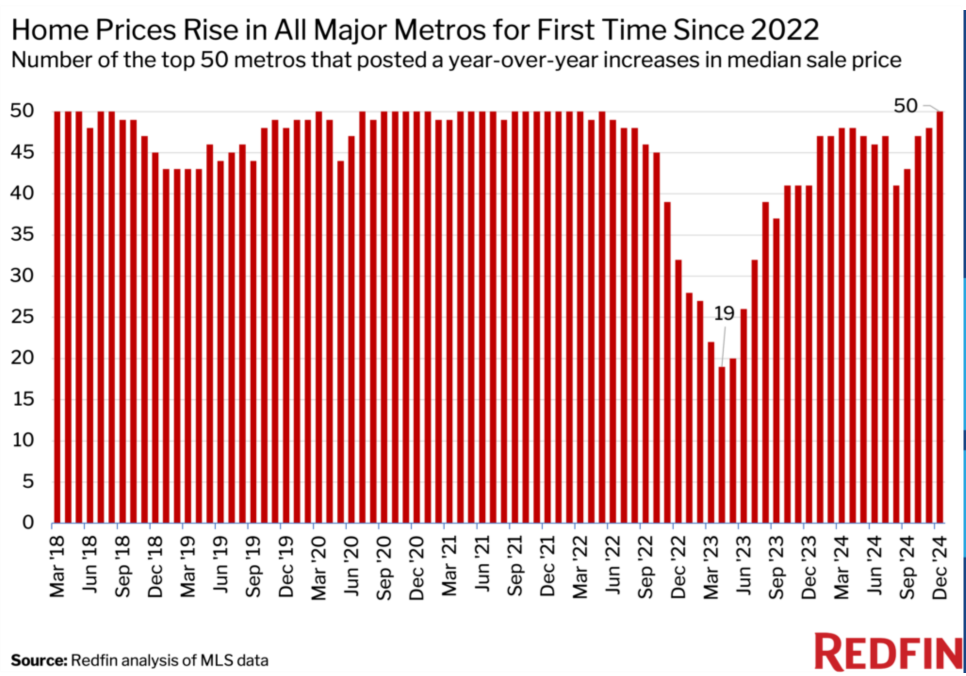


At some point, it becomes frustrating trying to make sense of it all, to plan, and to assess the impact of everything from inflation, the appetite of the Chinese, Japanese, and Saudis for our debt, our expanding deficit and increasing need to borrow, threats of tariffs and mass deportations, and potentially lower corporate tax rates on interest rates. In fact, just last week, President Trump said that he will "demand that the Fed lower interest rates" and in response, 10-year Treasury yields went up about five bps (0.05%), so there you have it. Maybe we can just pay off all the debt with a Trump coin, a Melania coin…or what, the heck, the Clearcoin.

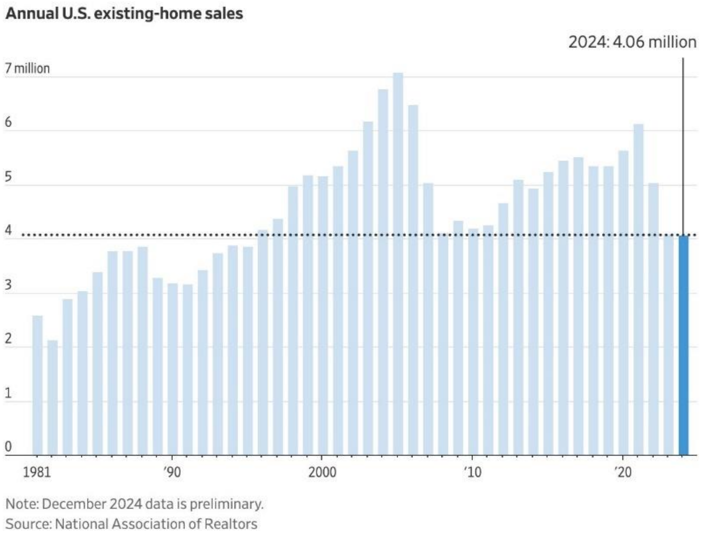
And what about residential real estate? How is it faring in the face of higher rates and the broader "risk-on" environment?

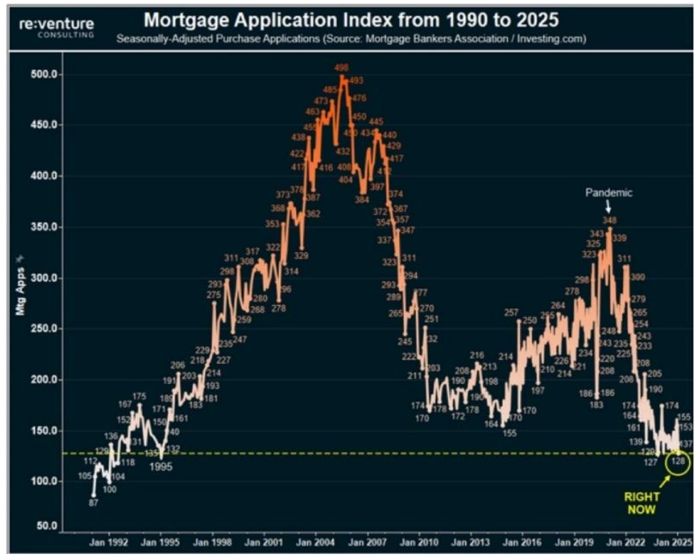
Well, the themes of the past several quarters persist. Single-family home prices? Higher in every single market this past December, despite those higher mortgage rates. Single-family transaction volume? Up, year-over-year. Mortgage applications? Down sharply. Housing affordability? Never been worse. Apartment fundamentals? Rents were down virtually everywhere, while vacancy rates increased, namely as a result of increased supply, rent concessions, and perhaps a post-COVID hangover. Insurance and other operating costs are substantially higher. It is a tale of different markets.

Let's start at the top. In December, U.S. home prices rose in all 50 of the most populous "Metropolitan Statistical Areas" for the first time since May 2022. Median home sales prices have increased for 19 consecutive months, year-over-year, higher interest rates be damned.
Overall, home prices nationally increased 6.3% last year, with the largest increases occurring in…. wait for it…Cleveland, Milwaukee, and Philadelphia, up 15.0%, 14.5%, and 14.0%, respectively. Even in the face of higher rates, home prices continue to rise due to significant undersupply. Housing affordability is somehow still getting worse.

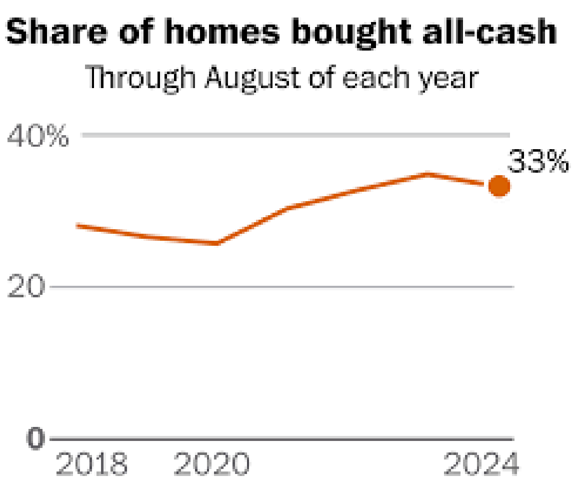


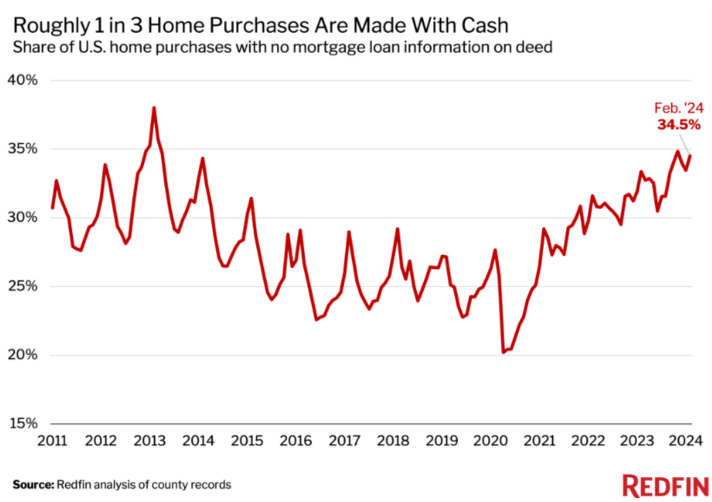
Meanwhile, total existing home sales in the U.S. fell to their lowest level since 1995, while total mortgage application volume for the two weeks ended Dec. 27, 2024, dropped 21.9 % compared with the week before that period, according to the Mortgage Bankers Association's seasonally adjusted index. Applications to refinance a home loan, which are most sensitive to interest rate volatility, fell 36% from two weeks earlier, but remained 10 % higher than in the prior year period.



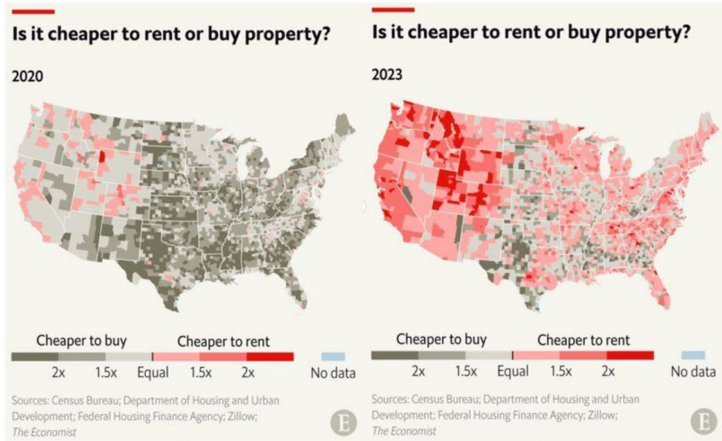


In a related story, "all-cash" buyers are still snapping up homes. Through August, roughly a third of homebuyers purchased homes without a mortgage, according to Redfin, consistent with data throughout 2024. Now, many of these buyers are likely institutions (the build- or buy-to-rent crowd) or foreign purchasers, but nevertheless, the data confirms that prospective homebuyers are not using mortgage financing in the face of higher borrowing costs. How many traditional homebuyers have $400K or more in liquid assets just sitting around?





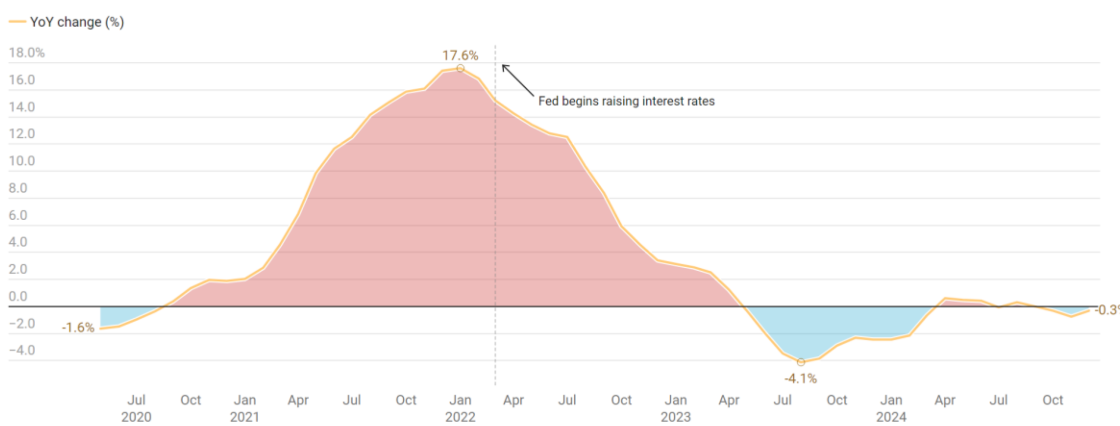
Ultimately, we have a potentially irreversible trend where it's simply going to be less expensive to rent an apartment or home, virtually anywhere, than to purchase it. Just look at the trend from just three short years, between 2020 and 2023.



In the face of higher interest rates and increased inability for prospective homebuyers to purchase homes, apartment rents and occupancy rates must be obvious beneficiaries, right?

Well, "yes" and "no." Multifamily rents nationally declined 0.6% last year, including a modest 0.3% decline in December. Rents fell most sharply in Austin, Texas (down over 16%) and Tampa, Florida (down over 10%), while rents in Providence, Rhode Island, Virginia Beach, Virginia, Louisville, Kentucky, and Baltimore, Maryland rose, experiencing double-digit rent increases.

Year-Over-Year Change in National Median Asking Rents



Rolling three-month periods; most recent period covers three months ending December 31, 2024. No YoY data prior to May 2020.

Largest Year-Over-Year Rent Changes: December 2024

Out of 44 of the 50 largest U.S. metropolitan areas.

	Metro Area	Median Asking Rent	Year-Over-Year Change ▼	Month-Over-Month Change	Metro Area	Median Asking Rent	Year-Over-Year Change	Month-Over-Month Change
1	Providence, RI	$2,145	12.6%	0.9%	Austin, TX	$1,393	−16.3%	−1.9%
2	Virginia Beach, VA	$1,578	10.9%	−1.3%	Tampa, FL	$1,737	−10.4%	−0.2%
3	Louisville, KY	$1,230	10.0%	−0.3%	Jacksonville, FL	$1,451	−6.7%	−1.4%
4	Baltimore, MD	$1,600	10.0%	0.3%	Nashville, TN	$1,495	−6.3%	−0.7%
5	Buffalo, NY	$1,315	9.4%	−0.4%	New York, NY	$2,804	−4.6%	0.3%

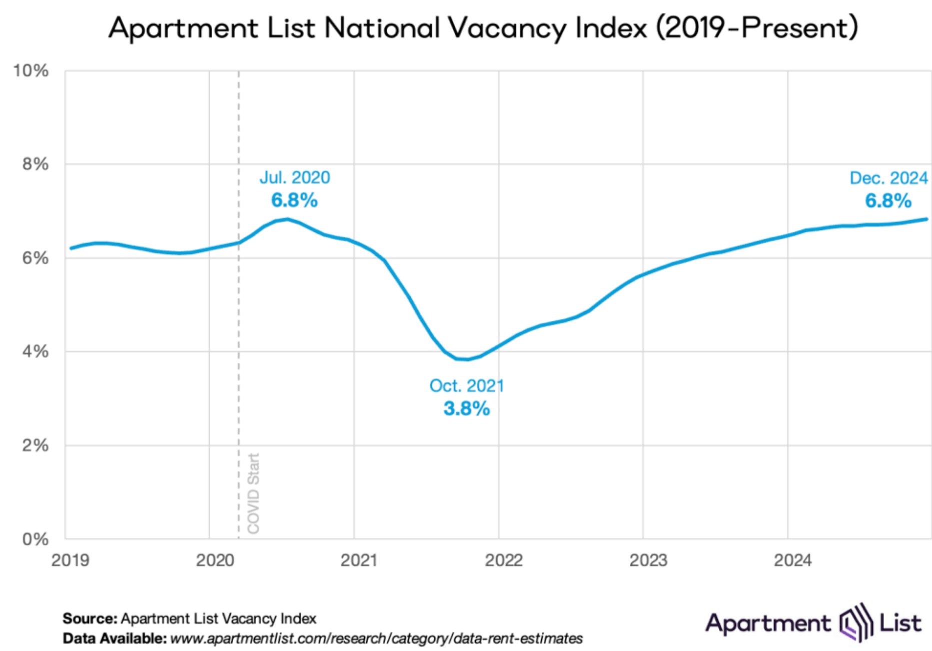
Rolling three-month period ending December 31, 2024.

Get the data • Embed • Created with Datawrapper

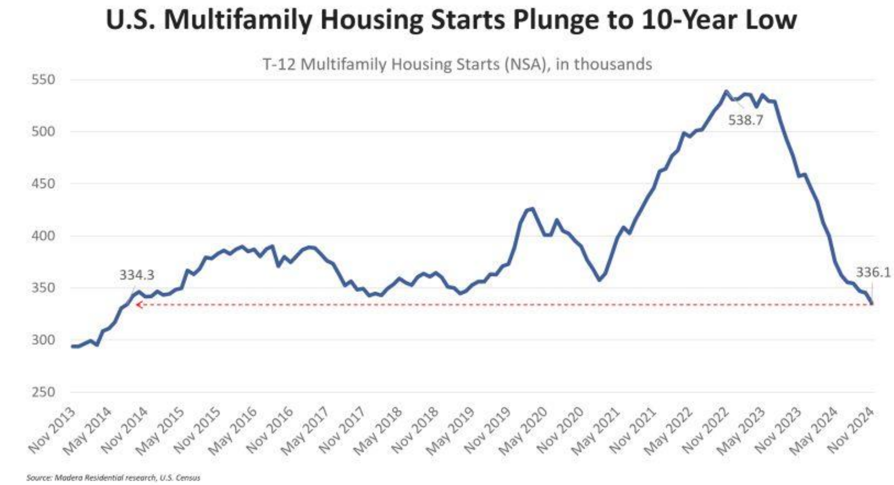
Meanwhile, the national vacancy rate hit 6.4%, equaling a rate last seen in the early days of the COVID pandemic. Rising numbers of empty apartments seem odd considering the U.S. housing market is significantly undersupplied (anywhere from 1.5 million to seven million units, depending on the source). Part of the problem is a herd mentality where real-estate developers piled into the same cities (e.g., Austin, Nashville, Dallas, Phoenix, Tampa) to build the same kinds of four-and five-star units, commanding (requiring?) average monthly rents of over $2,100.

While sound rationale may have supported this strategy, the result is a glut of Class A apartments beyond the budgets of many tenants. The national vacancy rate of these high-end units hit 11.4% according to data from CoStar, double that of more affordable properties. The vacancy rate in Austin reached 15%, for example, and landlords need to offer generous concessions to persuade new tenants to move in, perhaps two or three months of free rent on a one-year lease. These sweeteners may not show up as declines in headline rents, but they represent effective cuts of over 20%, of course. And there is a trickle-down impact on Class B units or workforce housing, the sort of units we own, if just because some of our tenants may be able to afford these lower rents (with the concessions) that Class A projects in aggressive lease-up mode are offering.

Some cities on the coasts as well as many in the Midwest, where construction was muted over the past decade or more, are proving more resilient. New York's vacancy rate is 2.8%, making it one of the tightest rental markets in the country as little new supply was built between 2021 and 2024.



The good news…and we are in need of some…is that multifamily housing starts dropped to their lowest levels in a decade, further evidence that the reduction in new apartment starts and supply will be deeper than a mere return to pre-COVID norms. Total multifamily starts for the year ending November 2024 (last available data) approximated 336,100 units, as compared to the peak of 538,700 units started in the twelve months ending November 2022. On a monthly basis, multifamily housing starts in November 2024 were the third lowest of any month since 2015. This data bodes well for 2026 and beyond, as declining single-family affordability, coupled with reduced availability of new apartment units, should translate into higher rents in the coming years.



2025 will not be an easy year for multifamily owners and operators, as the industry absorbs remaining new supply, seeks a steadier interest rate footing, and addresses rising costs (e.g., insurance, wages). When 10-year Treasury rates hit 3.6% last fall, only to increase to 4.7% in the seeming blink of an eye, hopes of replacing floating-rate mortgages with fixed-rate debt were dashed, at least temporarily. Thus, 2025 will likely be a year characterized by additional capital calls and other efforts to reduce leverage and stabilize both net operating income and overall cash flows, awaiting brighter days, which are likely to come. As I have stated before, the key is to "stay in the mix until '26" and "'27 will hopefully be heaven." As history clearly tells us, holding on is critical as time and market cycles prove helpful allies.

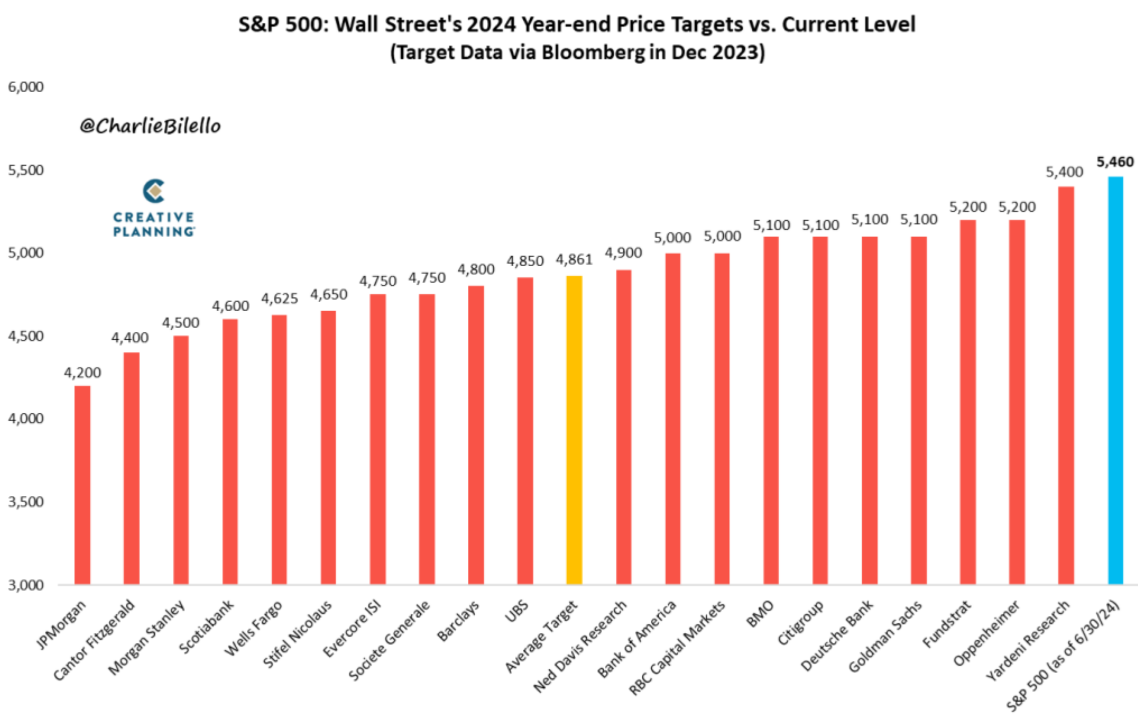
In another multifamily related tidbits, a former student asked me something recently which got me thinking. What she was wondering was whether the inability of young couples to afford a single-family home was impacting birthrates and family sizes, but in a different way. That is, once a couple comes to realize that it must rent an apartment for the foreseeable future, and that apartments, even in Class A buildings, consist principally of two-bedroom units of roughly 1,000 square feet, they would likely conclude that having more than one child is impractical, especially if a home office is needed, a likely reality these days. The conclusion? It's not just the unaffordability of single-family homes which is impacting marriage and birthrates, but the nature of available multifamily units that also has significant demographic consequences.

Finally, I read that Greystar, the largest owner of apartments in the U.S. (approximately 110,000 units, at last glance), is "taking a leap" into modular homes, finishing up its first such project in Coraopolis, PA, outside of Pittsburgh, consisting of 312 units. Modular construction has been touted as a means of building more cheaply and quickly for as long as I can recall, but has never seemed to go mainstream, sort of reminiscent of an old joke that applies to many situations: "modular construction is the future of development…and always will be." Obviously with housing in short supply and a need to build more cheaply and quickly, especially in Southern California following the wildfires, let's see if the bullish predictions surrounding modular development come to pass.

So, between the elections, a new Trump Administration, a market characterized by significant speculation, sticky inflation, and broad geopolitical and economic uncertainty, what's in store for 2025 and beyond?

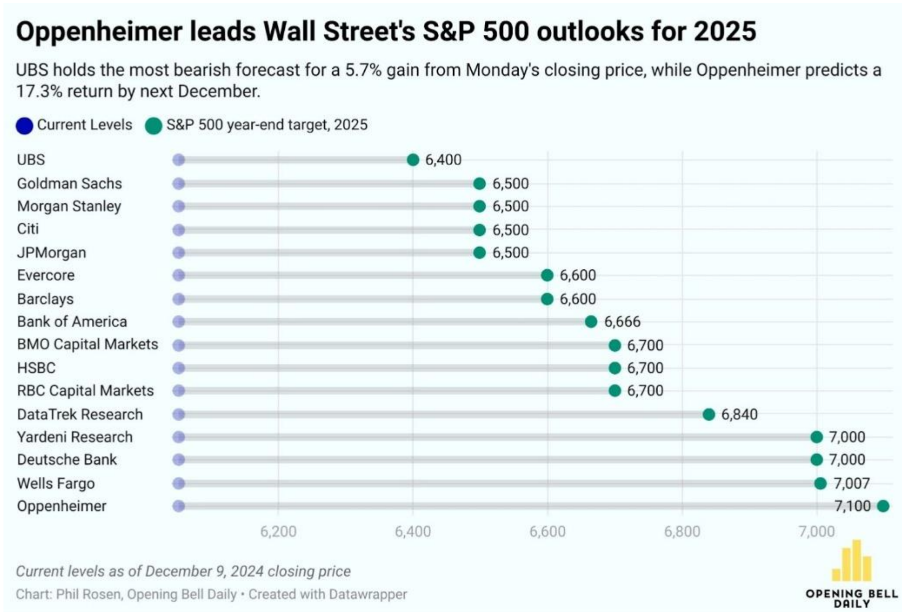
If predictions are like opinions, which, in turn, are like a certain body part that everybody possesses, I am not sure how much stock we should put in them, or whether it even makes sense that I try and make them myself (for the record, I am talking about predictions, not the body part). A couple of graphs highlight the point. The first simply plots the December 2023 predictions made by Wall Street's top investment firms as to where they thought the value of the S&P 500 would be at the <u>end</u> of 2024 versus where it stood a mere six months later, at the end of June 2024.

The results speak for themselves. The most bearish firm was JP Morgan, which predicted that the S&P 500 would be 4,200 at the end of 2024. The most bullish? Yardeni Research, whom I had never heard of, with a far more bullish target of 5,400. So, how did their predictions fare? In a word, "poorly." They were all wrong…and mostly way off.

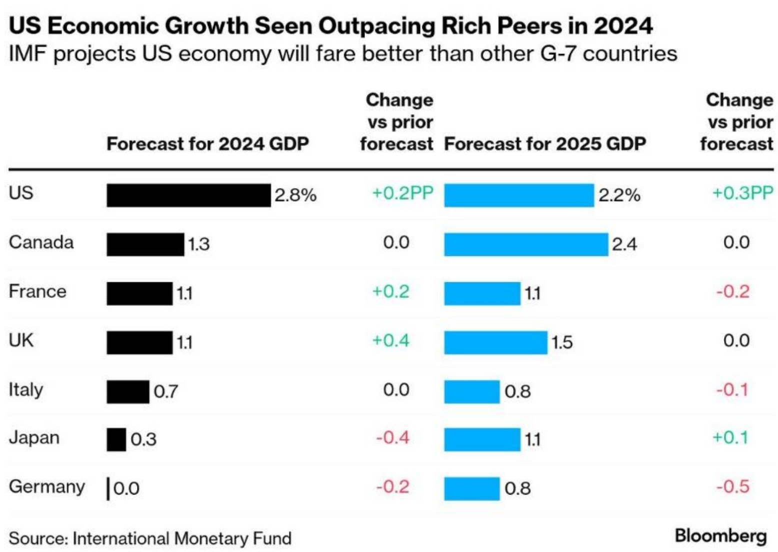


By the end of June of last year, the S&P 500 stood at 5,460, above even the most bullish forecast…for the entire year. And JP Morgan? They were so, so close, only off by about 30%. And where did the S&P 500 actually end 2024? 5,883 and change, almost 8% higher than where it stood on June 30th, and up over 23% for the year, so there you go. I can almost hear Maxwell Smart, aka Agent 86 from that corny TV series, "Get Smart," sarcastically intoning, "Missed it by thaaaat much."

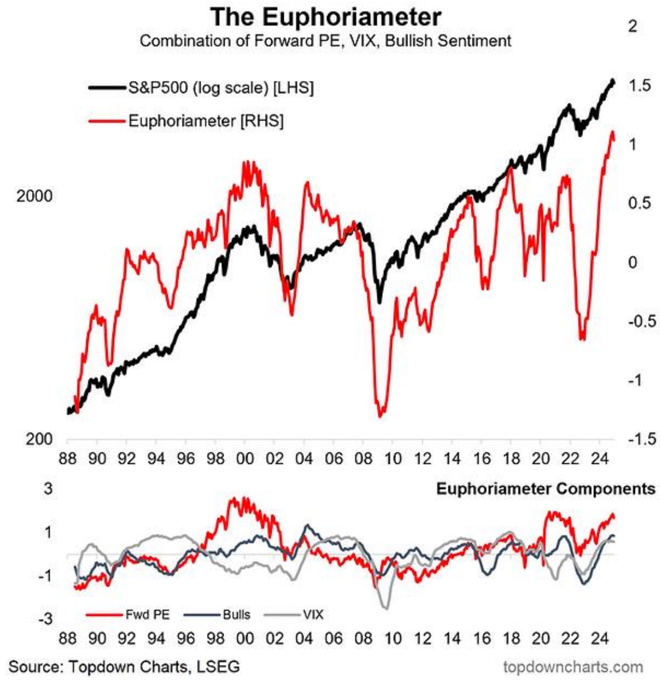
And what are these crackerjack analysts predicting for 2025? Well, buckle up, as every single firm predicts higher equity markets this year. UBS is the most bearish, predicting "only" an 8.8% total return for the S&P 500, while Oppenheimer, which was fairly bullish 2024, maintains their optimistic vibe, predicting a nearly 21% return for the Index, to 7,100. When there is this kind of consensus, I get nervous, believing something else is more likely to occur.



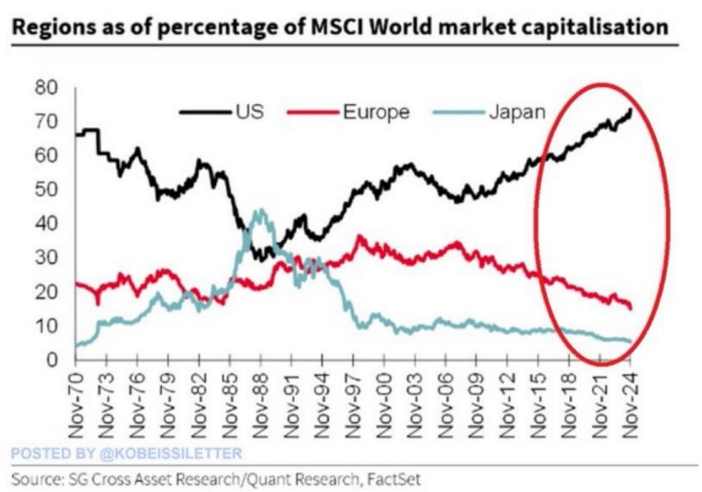
Further to the point of how difficult forecasting can be, the U.S. economy defied expectations last year, outperforming every one of its G-7 peers, despite the divisive election rhetoric, elevated interest rates, and predictions of an economic slowdown and lower interest rates.



And it's not just the analysts who are feeling optimistic, if not a bit euphoric. According to the "Euphoriameter," which combines three key gauges of broad investor sentiment - "Surveyed Sentiment," based on investor surveys (how optimistic investors say they are), the Forward Price-Earnings Ratio, the price of stocks versus the next 12 months of consensus earnings, and the VIX, a measure of implied market volatility - investors have only been more positive twice in history, during the post-pandemic SPAC/cannabis/green bubble and in the dot-com bubble of 1999-2000.

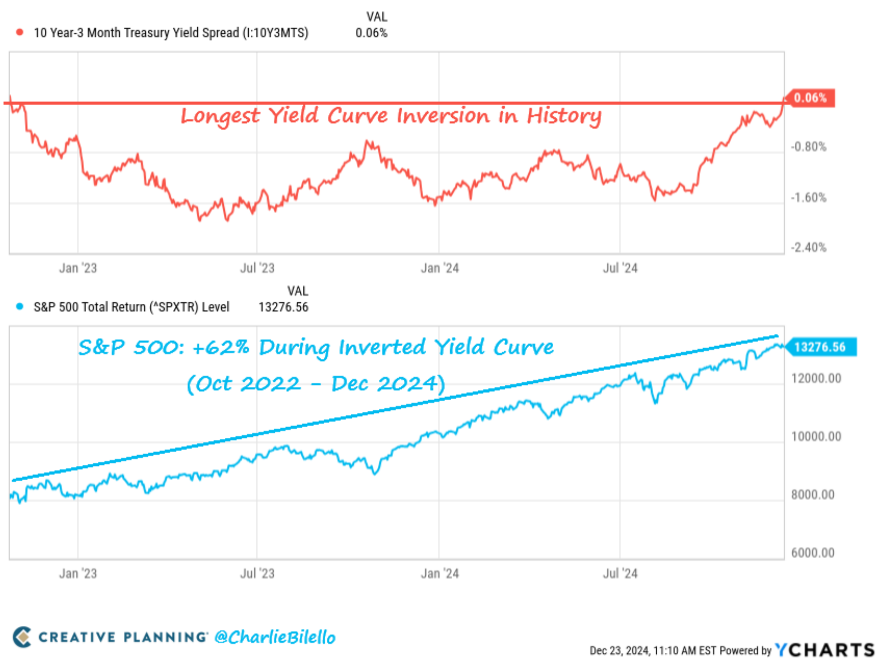


Analysts and investors alike are especially bullish on the U.S., at least when comparing our equity markets to those across the Pond and in Asia. Relative to European stocks, U.S. stocks have never been this "expensive," while our overall market capitalization as a %age of the broader MSCI World Index has never been higher. Following the election, fund managers are more "overweight" U.S. stocks than any time since 2013, according to a recent Bank of America survey. Meanwhile, money is pouring into funds at an exceptionally high rate as well, close to new highs. These realities are hard to square with the widespread belief that we somehow need to "make America great again." The equity markets seem to be telling us that we are not doing too badly.



In any event, when investors are collectively this optimistic, there is far greater risk to the downside, if just because they are already so heavily invested in the markets, consistent with their bullishness. Adding to the collective "euphoria," investment newsletter writers have rarely been more bullish or less bearish, according to the weekly survey by Investors Intelligence. And not to be left out, households have never been so confident that stocks will rise over the next year, according to the Conference Board's monthly survey. I don't know what the trigger or catalyst for a market downturn might be, but it doesn't need to be much at this level of "euphoria."

Keep in mind that we just experienced the longest period in history with an inverted yield curve (short-term rates higher than longer-term rates), roughly 26 months. Inverted yield curves are often used to predict recessions, but not only did we not experience a recession, but the S&P 500 increased 62% during the time period the curve was inverted. Shall I once again describe something as "unprecedented?"

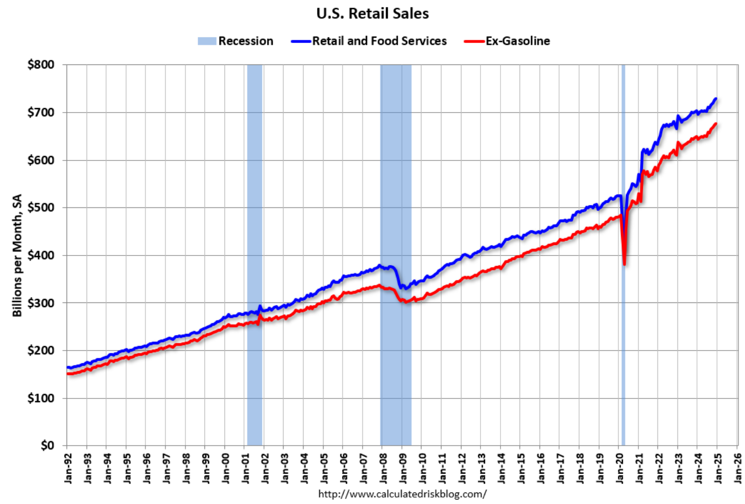


Looking forward, so much rides on i) whether the **consumer** can keep up its mojo, ii) the **job market** and whether December's strong job figures are an outlier or a harbinger of things to come, iii) whether **inflation** will continue to moderate, remain in the two to three % range, or accelerates from here, iv) the impact of **Trump's policies and/or legislation** he is able to get through Congress (including promises of additional corporate tax cuts, v) what **the Fed** does in response to economic data and/or Trump's efforts to influence their decision-making process, and vi) what happens to all the **cash and liquidity presently sitting on the sidelines**.

Let's take a closer look at each.

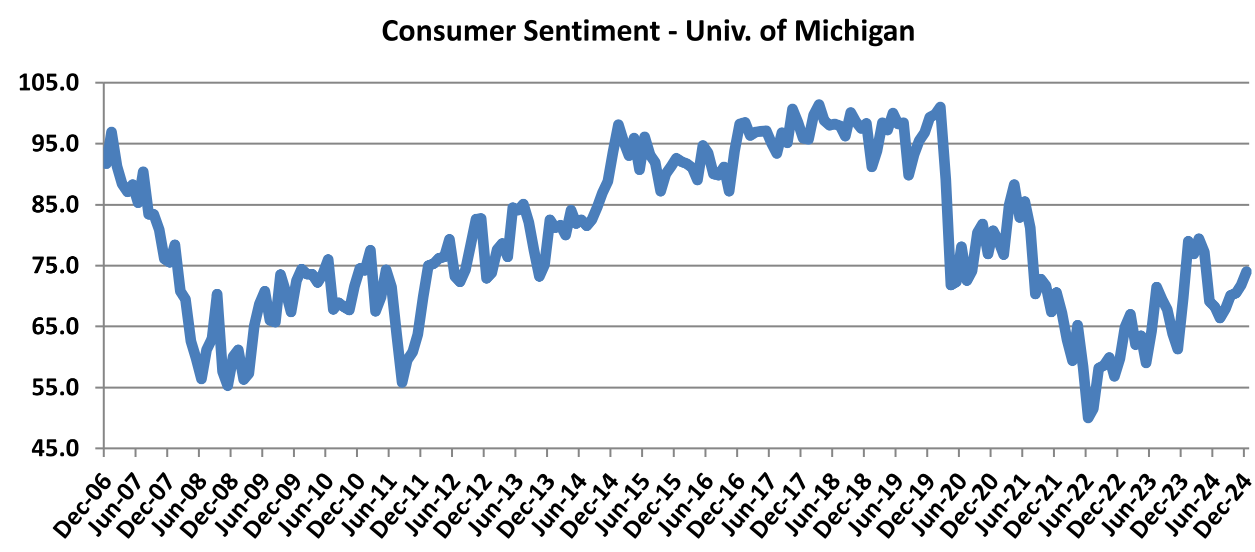
Because 70% of the U.S. economy is based on consumer spending, how they behave this year will be the most significant driver of growth…or lack thereof

Consumers continue to spend, but is it really a tale of two types of consumers, the "haves" versus the "have-nots?" While December's retail sales rose 0.4% in December, month-over-month, fairly robust results overall, the data was the weakest we have seen in the last four months. But growth is growth.



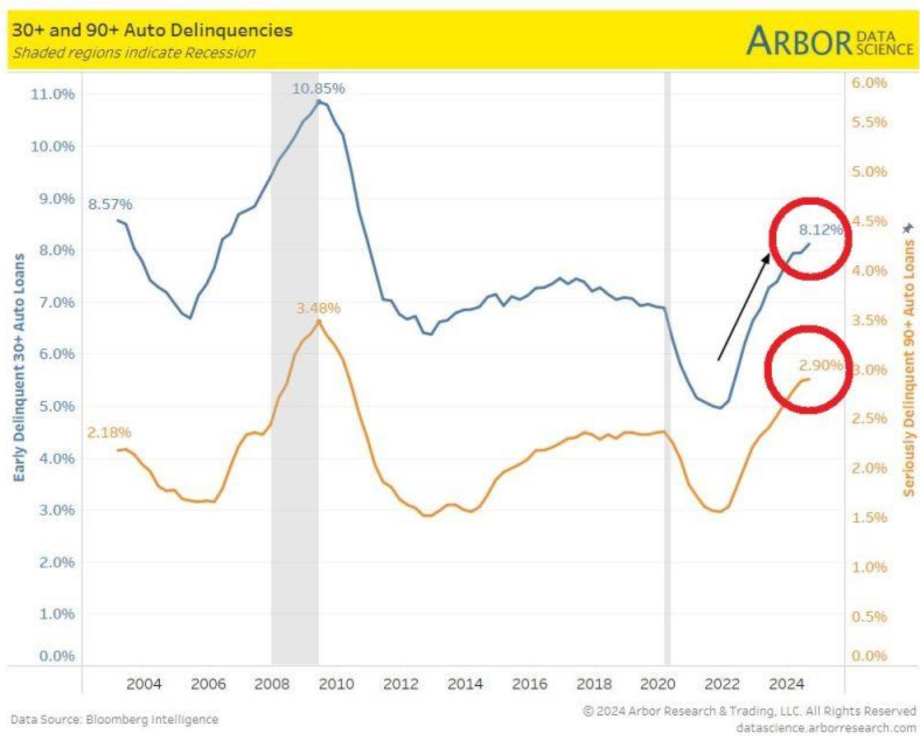
In short, it continues to be a tale of multiple markets. With a moderating Consumer Price Index, inflation-weary consumers were expected to splurge this year. However, increases in consumer spending were increasingly driven by higher-income households, those making more than $100,000 a year. Lower-income Americans were squeezed by higher prices for groceries, child care, and other monthly expenses.

Overall, consumers spent 3.8% more between the beginning of November and Christmas than they did in the same period last year, excluding auto sales, according to Mastercard. The gains were boosted by restaurant spending, which increased 6.3% in the period compared with last year. Online retail sales rose 6.7% year-over-year, while in-store sales increased 2.9%. Consumer sentiment has been climbing since July, following a sharp decline between the beginning of the year and early summer, according to the University of Michigan's monthly survey.

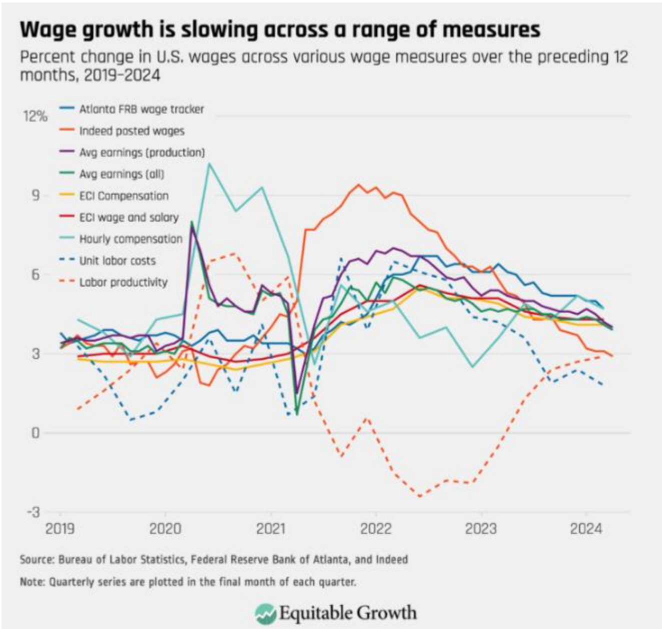


However, recent results announced by discount retailers, coupled with increasing delinquency rates on auto and consumer loans, indicate that the lower-end consumers are feeling stretched. Dollar Stores recently indicated that it began to witness "belt-tightening" last year, a trend which has continued, echoing sentiments expressed by Walmart, Casey General Stores, and even McDonalds. Dollar General indicated on its December 5th earnings call that its "value valley" aisle was its top performing category last quarter. Auto repair chain Monro said in late October that "value-oriented consumers" are trading down to "less expensive tire options." Meantime, a just-released Bankrate report that surveyed more than 1,000 U.S. adults about their ability to "handle a surprise bill" found that 59% of Americans don't have enough savings to "cover an unexpected $1,000 emergency expense."

Thus, despite strong employment data and decent overall retail sales, most consumers continue to live from paycheck-to-paycheck. They are borrowing more and falling behind more often. Credit card debt hit a record high of nearly $1.2 trillion as of the end of the third quarter, up by $24 billion from the previous three-month period. That's an 8.1 % jump year over year, a mere 15 months after the nation's total outstanding credit card balances crossed the $1 trillion threshold for the first time. Total household debt — mortgages, auto and student loans, and credit card debt, collectively — increased by $147 billion to $17.94 trillion. Meanwhile auto loan delinquencies hit their highest levels since the Great Financial Crisis. Given that the interest rates on credit cards average almost 22.0%, versus less than 15% three years ago, it's no wonder strapped consumers are falling behind on their payments.

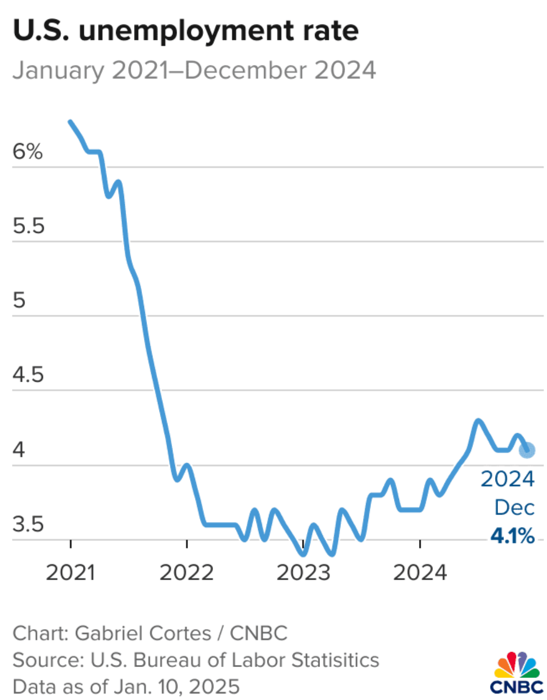


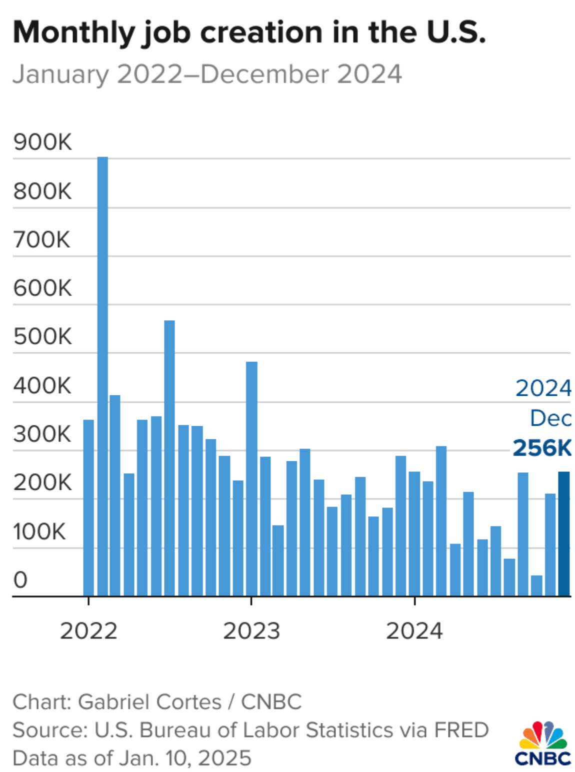
Slowing real wage growth doesn't help. According to data released less than two weeks ago by the Bureau of Labor and Statistics, real average hourly earnings increased 1.0 %, seasonally adjusted, between December 2023 and December 2024, while real average hourly earnings for all employees decreased 0.2 % from November to December. The 0.3 % increase in average hourly earnings could not keep up with the 0.4 % monthly change in the Consumer Price Index for All Urban Consumers. While the good news is that wages are no longer a significant source of inflationary pressure, they also are inadequate for consumers to meet all of their financial obligations, which might include rent.



Were the strong December job figures a blip or a predictor of what's to come in 2025?

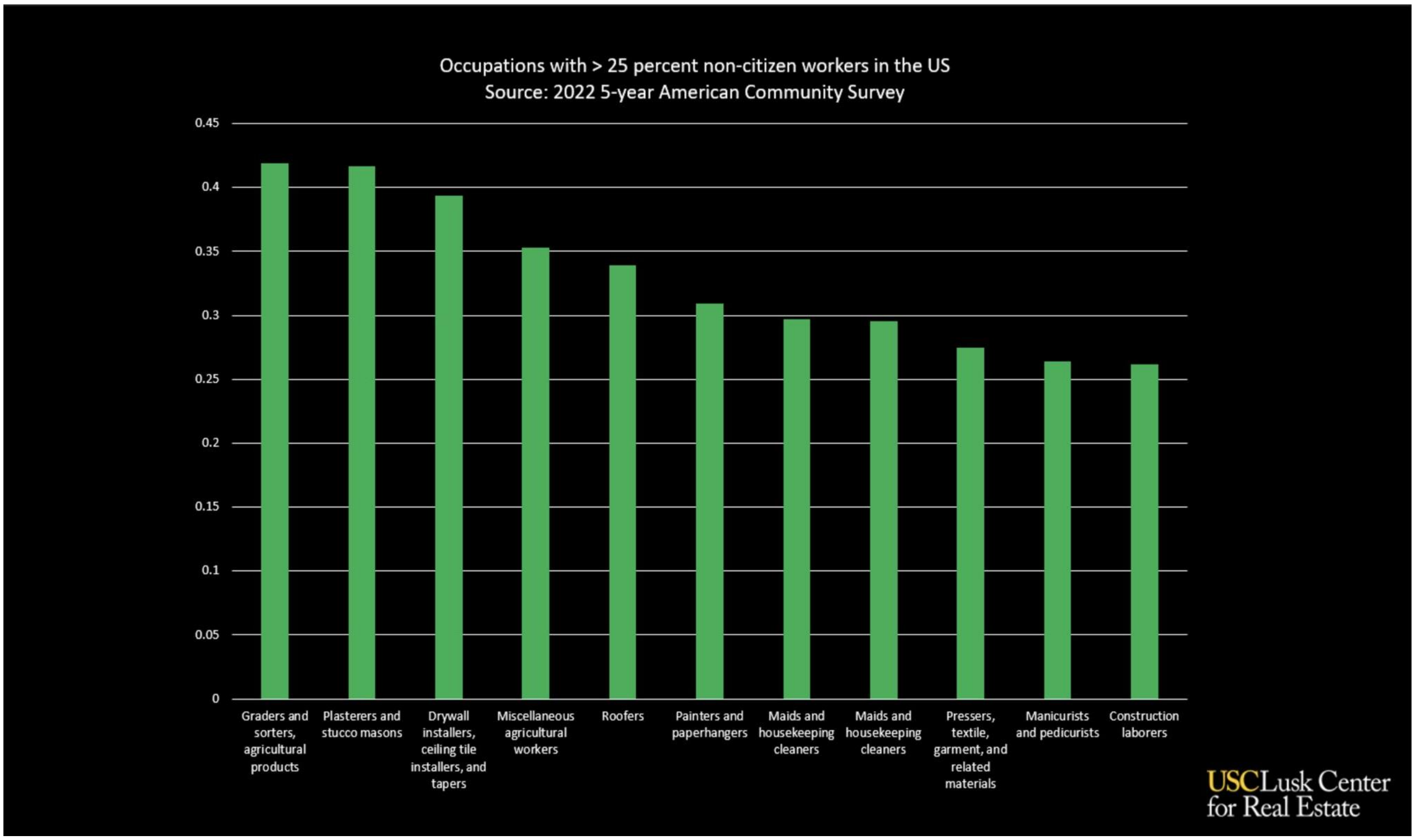
U.S. payrolls grew by 256,000 in December, surpassing all estimates, the 48th consecutive month witnessing job growth, matching the second longest streak in history. The unemployment rate fell to 4.1%. While certainly good news, the data caused interest rates to spike, equity markets to drop (albeit temporarily), and forecasts regarding future interest rate declines to temper, as discussed above, so perhaps we can file this positive data under the "mixed emotions" category.





Most of the job gains in the fourth quarter were made in health care (69,500), retail/trade (43,400), leisure/hospitality (43,000), and government (33,000). Of course, based on some recent executive orders I read about, several relieving different federal workers of their employment, the latter category may not be positive much longer.

Finally, in light of threatened mass deportations and crackdowns on immigration, it probably isn't shocking that more than 25% of the employees working in agriculture, construction and the construction trades (e.g., painters, roofers, plasterers), and housekeeping are not U.S. citizens. Campaign promises to reduce food prices and accelerate the construction of housing would seem incompatible with threatened mass deportations.



Finally, one interesting working paper I read this past quarter, "A Theory of How Workers Keep Up with Inflation," tries to explain odd observations from the labor markets between April 2021 and May 2023, characterized by high inflation (cumulative prices rose by over 14%), low unemployment, high job vacancies, and yet a decline in real wages. A traditional explanation would posit that the "hot" labor market following COVID created or added to inflation via higher labor costs.

The authors hypothesize that the relationship worked in reverse here, that inflation, not labor market strength, drove these dynamics, simultaneously increasing vacancies while pushing down real wages. That is, higher prices and inflation increased the need for workers to seek or solicit higher wages, which led to significant job changes as workers chased higher compensation to afford basic necessities. At the margin, this hypothesis may have some probative value, but without delving into their data, I have my doubts as to whether their theory provides durable or long-term explanatory power.

There is plenty of dry powder on the sidelines

While equity markets and that Magnificent Seven, Bitcoin, and gold hover near their all-time highs, money market assets have also soared to a record, nearing $6.7 trillion in total. Presumably, these assets will find their way into riskier assets in time, whether equities, real estate, or some new meme coin rising from the ashes.

Meanwhile, Warren Buffett and Berkshire Hathaway have also been stockpiling cash. According to the company's third quarter Form 10-Q, released in early November, the company is holding a record $325.2 billion in cash. What he (Berkshire, technically) ultimately does with all this moolah will be interesting to see. If only he had bought the Trump coin when first issued, he could have turned that 325.2 billion in cash into $300 trillion…plus or minus a few hundred trillion. And here I thought that Warren Buffett was a value investor.

With Trump back in office, it will be interesting to see what policies he promotes that might aid commercial real estate investors. Meantime, local and state politicians continue to do all they can to pass laws or regulations that decelerate residential development or increase the cost of housing

While President Trump was ceremoniously signing one executive order after another last week, I was wondering if any might provide needed tailwinds to the commercial estate market. After all, that's President's Trump's world, just as it is for several members in his new administration. While he has already tried his bully pulpit to influence the Fed and interest rate policy, I sense that so long as Jerome Powell remains Fed Chair, President Trump will essentially be shouting into the wind, at least when it comes to the Fed's independence and decision making. Meanwhile, his immigration policies concern me because we need more tradespeople and construction workers, many of whom are non-citizens, as indicated above. Whether he actually raises tariffs on everyone from Canada to Denmark remains to be seen, though such policies would be inflationary, at least initially. I'm not a fan.

What about Section 8 and other federal housing programs? Nearly all residential landlords of size have Section 8 tenants, whose rent is significantly subsidized by the federal government (70%) and administered through local housing departments. On the one hand, I don't think President Trump cares a whit about Section 8 tenants themselves or the spending that accompanies the Program. However, I suspect that many of his "friends," donors, and business associates would be negatively impacted should Section 8 funding and HUD largesse be curtailed. In any event, I don't believe President Trump has said anything on the issue, perhaps for good reason. Similarly, while I can't imagine President Trump is any fan of rent control, he has not said anything about trying to eliminate it. Instead, President Trump has indicated that he plans on expanding Opportunity Zones, first introduced as part of the Tax Cuts and Jobs Act in 2017. He also plans on opening up portions of federal land for large-scale home development. We shall see.

Speaking of the goings on in or near Washington, D.C., two Maryland counties passed strict rental control laws this past July that limit rent annual increases on certain units (those built after 2000) to six %, or three % plus inflation, whichever is lower, with restrictions applying not just on occupied units, but vacant ones as well. Such a policy contrasts with those here in California, where landlords can increase rents to market once a unit is vacated. The consequences of the new law remain to be seen, though I will go out on that proverbial limb that rents in those submarkets aren't going any lower as a result of these new policies. Of course, if Trump and his new BFF, Elon Musk, gut federal government and employment levels, the D.C. and adjacent multifamily markets are going to be subject to a triple whammy: rent control, lower unit demand, and increased vacancy.

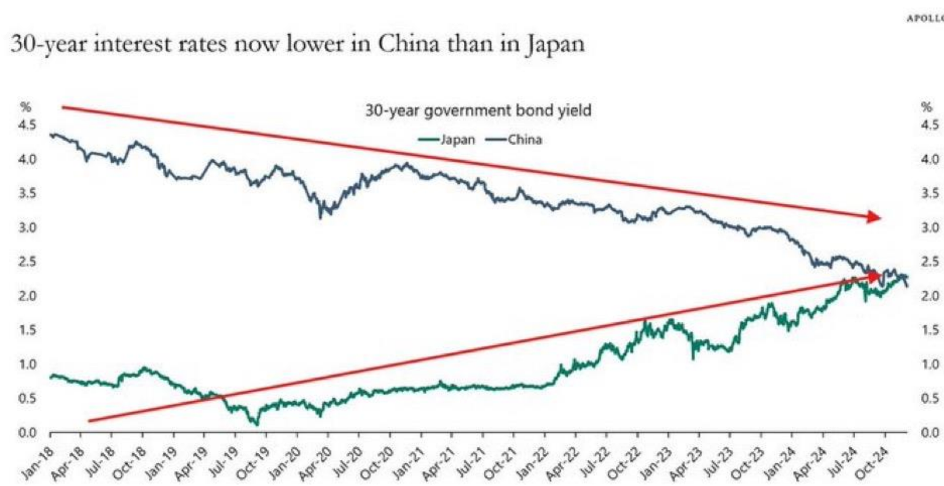
Meanwhile, closer to home, California voters, in a ballot trifecta, i) defeated Proposition 33, which would likely have resulted in significant expansion of rent control throughout the State, ii) passed Proposition 34, aimed squarely at AIDS Healthcare and repeat sponsor of rent control initiatives like Proposition 33, and, iii) defeated Proposition 5, which would have made passage of bonds, including those tied to housing, easier.

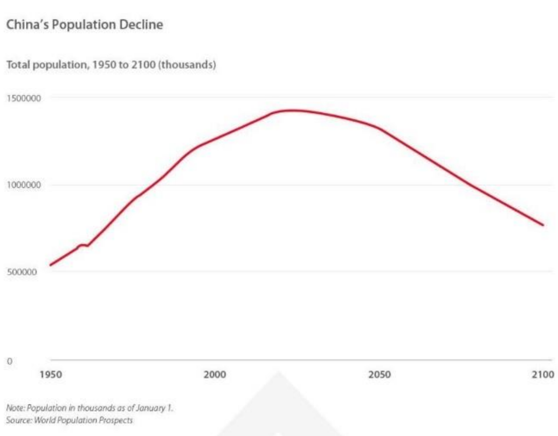
But if you think that November's election marked the end of local politician's efforts to insert their hands into the rent control cookie jar, you would be dead wrong. Shortly after the election, Los Angeles' County Board of Supervisors approved lower annual rent increases for units already under rent control to 60% of the annual change in the Consumer Price Index, with a ceiling of 3%. Meanwhile, Los Angeles housing officials released a report recommending additional changes to rent control policy. In a result shocking no one, the report recommended reducing all maximum annual allowable rent increases from 8% to 5% and suggested lowering the floor on annual rent increases from 3% to 2%.

Finally, in the wake of the devastating wildfires, Governor Newsom signed Assembly Bill 246, which will be brought to the floor of the Assembly for vote on February 15, 2025. The Bill, if passed, would act as a reduced and temporary version of Proposition 33 and be implemented throughout Los Angeles County. The most consequential language in the Bill would impose a strict 12-month vacancy control on any housing that has been rented out within the last year or has been "offered for rent." Such a policy would be more restrictive than the rent freezes during COVID by locking in the rents of previous tenants who have vacated and block apartment owners from raising rents from long-term rent-controlled levels.

No quarterly memo would be complete without a discussion of "other" topics worth mentioning not just because they are interesting, but because they will certainly impact commercial real estate markets going forward

- **China, China, China**: I debated whether to include any discussion at all about China in this quarter's newsletter because I have already done so several times before. But I can't help myself, if just because China's global impact, even in its weakened state, cannot be ignored. China continues to struggle significantly, amidst declining economic growth (if it's even growing at all), excessive debt, a slowdown in everything real estate, and a declining population. Whatever data I review, in whatever form, the picture is fairly dire. Have a look for yourselves.



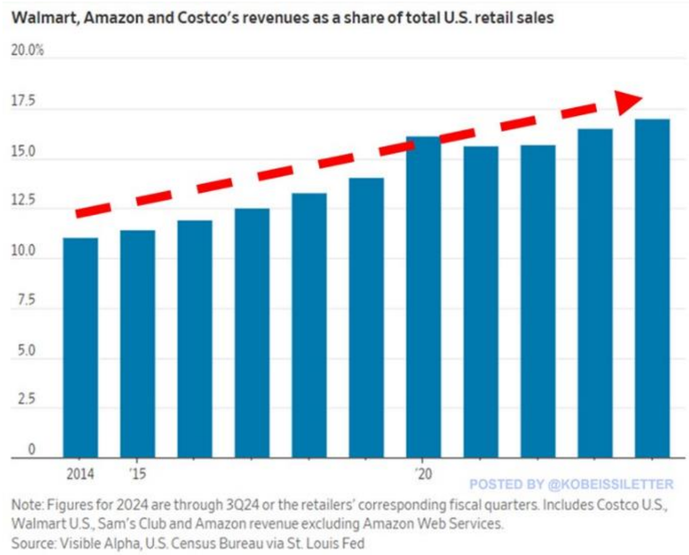


- **Other Classes of Commercial Real Estate Continue to Struggle**: For years, I wrote about the retail apocalypse, as bricks turned to clicks, "big box" retailers grabbed market share from others, and consumer buying habits changed…as they are wont to do. Then, it became the office market's turn, as it was decimated during and subsequent to COVID, and years of overbuilding came home to roost. And I have certainly written extensively about headwinds in the multifamily market and the perfect storm the industry has faced since the Fed started raising rates back in March 2022.

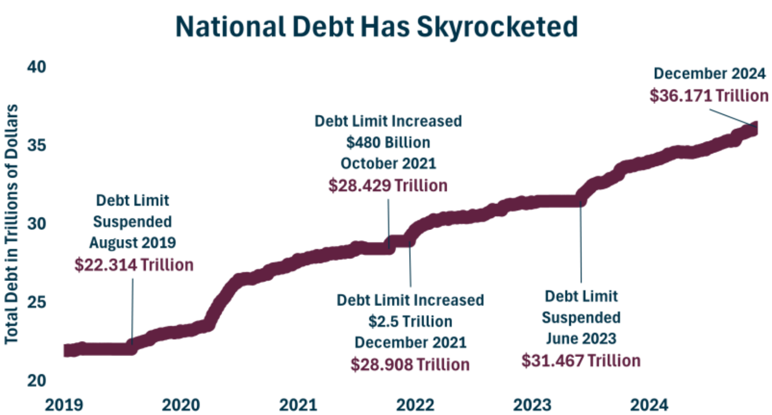
  Well, under the adage that "what comes around, goes around," I suppose, recent news surrounding retailers has not been pretty. The Container Store and Party City chains both filed for bankruptcy protection before Christmas. Meanwhile, the founding family of Nordstrom agreed to a deal to take the struggling department store private. Meanwhile, major U.S. retailers announced more than 7,300 store closings last year, up a whopping 53% from 2023. Ouch.

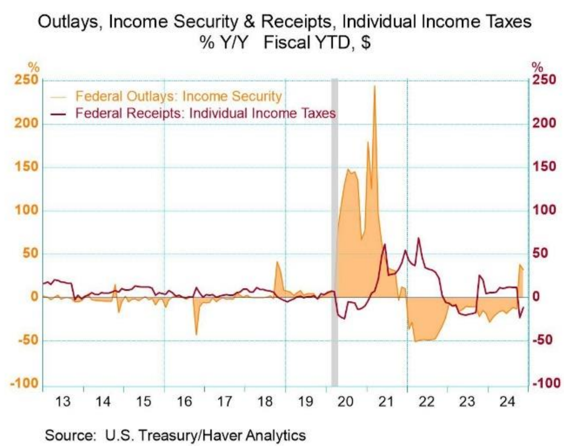
  Here is a partial list of the "closers": Family Dollar (677 stores), CVS/Walgreens/Rite Aid (nearly 1,300 combined), Big Lots (nearly 600, after also filing for Chapter 11 Bankruptcy last year), among others.

  Meanwhile, the largest retail firms are getting even bigger: Amazon, Costco, and Walmart now capture a record 17 % of total U.S. retail sales, six % higher than in 2014. Moreover, these three retailers accounted for nearly 57 % of retail sales growth over the same period, while their share prices have soared by 1025%, 332%, and 862%, respectively since that time. In 2024 alone, these stocks rallied 44%, 74%, and 40%, respectively. Big retailers continue to win.



- **DOGE and the Deficit**: Given the latest sobering data out of our nation's capital (no, not the Commanders blowout loss to the Eagles), our skyrocketing national debt and deficit, DOGE - the new "Department of Government Efficiency," led by Elon Musk (and formerly co-lead by a seemingly exiled Vivek Ramaswamy) - has its work cut out for it.





Color me a skeptic, but Trump's campaign promise to cut two billion of costs from the federal budget is a pipe dream. No way, no how, especially when he intends to reduce the corporate income tax rate to 15% (from 21%). If analyst consensus on the projected direction of the stock market makes me nervous, any government agency with the word "efficiency" in its name makes me even more uneasy. I have a feeling Mr. Musk is going to find developing the technology for complete autonomous driving and to create reusable rockets easier than cutting costs in government. My popcorn is ready in any case.

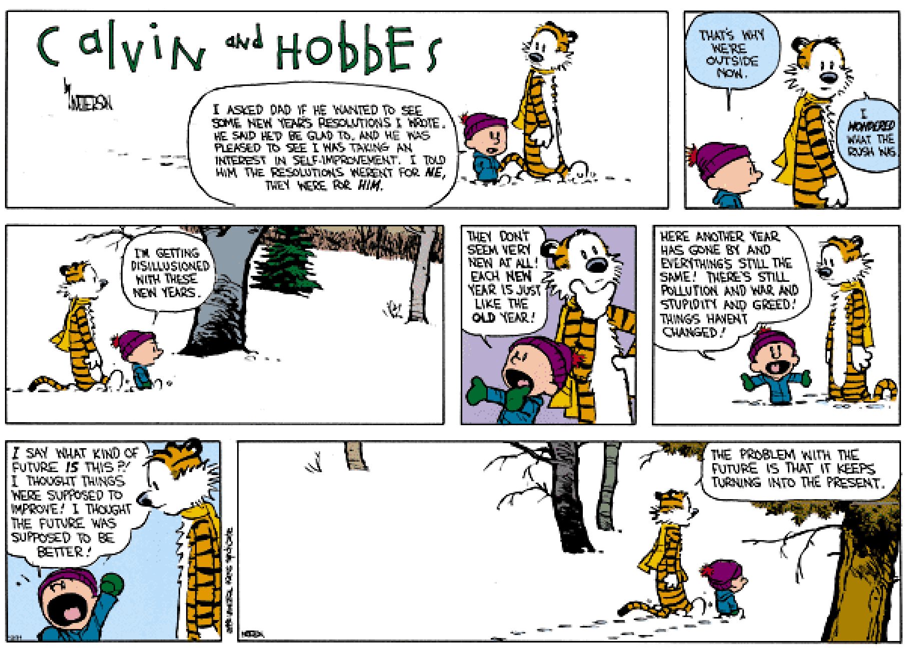
At the end of the last few memos, I have used the word "uncertainty" repeatedly to describe how I would characterize the state of the economy, markets, and political situation, here and globally…and I am not about to stop now, because "if the shoe fits…"

2024 was an eventful year, and it seems like only yesterday that Raygun was breakdancing her way to 15 minutes of fame in this past summer Olympics, an Alaska Airlines emergency door blew open at 16,000 feet, and I was wondering (not for long) if certain migrants might really be consuming household pets. Perhaps 2024 will be remembered as the year of bots, bullets, and Bitcoin, a fitting summary to describe the year.

So much remains to be determined this year and uncertainty appears everywhere I look: Bitcoin and cryptocurrencies prices and adoption, generally, including whether some "strategic Bitcoin reserve" is created (I'm dubious); the future of AI, Nvidia, and DeepSeek (China's new AI start-up); all the floating-rate debt plaguing commercial real estate and how that gets worked out…or not; immigration, tariff, tax, and Fed policy; consumers and the staying power of their wallets; inflation and rates; housing prices and rents; insurance availability and costs; China, the Middle East, and Russia; and the equity markets, given such widespread bullish expectations. Oh, and how will the rebuilding of my Pacific Palisades neighborhood proceed?

2025 will not be an easy year for multifamily owners and operators, as the industry absorbs remaining supply from the recent construction boom, seeks steadier interest rate footing and wrestles with floating-rate debt and rapidly approaching maturity dates, and addresses rising costs (e.g., insurance, wages). There are many headwinds. When 10-year Treasury rates hit 3.6% last fall, hopes of replacing floating-rate mortgages with fixed-rate debt were buoyed, and then dashed when rates spiked again, at least temporarily. Thus, 2025 will likely be a year of characterized by additional capital calls and efforts to reduce leverage, while the market awaits brighter days, which are nearly certain to come.

Finally, in an annual tradition, I bring you some closing thoughts from my favorite philosophers, Calvin and Hobbes. We can learn a lot from children, stuffed animals, and imagination, and this particular cartoon from at least 20 years ago, still seems timely. Great philosophy endures.



With that, I wish you and yours the very best for this coming year and reiterate my sincere appreciation for your continued support.

Best,

Eric Sussman
Managing Partner