Freddie Mac
MULTIFAMILY

Multifamily Mid-Year Outlook 2016

Executive Summary

Multifamily fundamentals moderated in the first half of 2016, consistent with trends that were expected for this phase of the economic cycle. The market will not decelerate enough to derail the multifamily industry this year as demand remains strong and growth continues, but it will grow at more sustainable levels.

Stable Market Growth

Steady economic growth and key drivers will keep the multifamily market moving forward through the rest of 2016 and 2017.

- Multifamily fundamentals began to moderate at the end of 2015 and continued into the first half of 2016.
  - The moderation results from high levels of new supply entering the market along with slowing job growth. However, favorable demographic trends remain strong, which will keep demand high.
  - Vacancy rates began to slowly increase for the first time since 2013. Meanwhile, rent growth has slowed but remains above the long-run average.
- Construction permits slowed in the first six months of 2016. The number of completions in the first half of 2016 was equal to 2015 levels, but new supply will pick up a bit in the second half of 2016 and into 2017.
- Growth in the labor market also decelerated in the first half of 2016 and is expected to continue to pull back from the rates seen in the prior two years.
  - Moderation in the labor market is expected at this phase in the economic cycle, and growth going forward is expected to converge to the population growth rate.
  - The unemployment rate remains around 5 percent, despite the temporary drop in May brought about by a decline in the labor force.
  - Wage growth has started to produce encouraging numbers: up 2.6 percent annually in June. Wage growth has been stronger than in 2015 but still below pre-recession growth rates.
- Multifamily property prices increased again in first quarter 2016 but at a slower rate than in the prior few years. As rental income slows, it will impact property price appreciation.
- Multifamily origination volume will have another record year in 2016 because of increasing property prices, new completions, and maturities, all of which present favorable investment opportunities.

Vacancy and Rent Growth at the Geographic Market Level

For the majority of markets, vacancy rates will remain below and rent growth above their historical averages through 2016 and 2017. New supply will affect some markets more than others, but most will see rent growth increase in 2017 from 2016 levels, as new deliveries are absorbed.

- Our top 10 list of metropolitan areas based on 2017 gross income growth is dominated by West Coast markets – albeit at lower levels than the double-digit growth seen in 2015 – along with West Palm Beach and Chicago.
- Nashville, Washington, D.C., and Dallas lead the industry in the amount of new supply compared to historical levels. Low vacancy rates will support new supply in Nashville and Dallas, but will exceed the historical average in Washington, D.C.

- Several markets saw lower rates of construction, including several high-rent-growth areas such as San Jose and Seattle.
- Rent growth in most markets will decelerate in 2016 but remain above the historical average. Rents are expected to moderate most in 2016 as new supply is delivered. In 2017, rent growth is expected to increase from 2016 levels as supply and demand converge.
- Markets with rent growth that moderated most in the first six months of 2016, compared to the same period in 2015, were those impacted by low oil prices, high supply, and moderating labor markets.

Multifamily Mid-Year Outlook 2016

- The multifamily rental market continued its strong growth in the first half of 2016 but at more moderate and sustainable levels than last year. Amid the strong growth, multifamily originations will hit another record high.
- New supply continues to enter the market, affecting some metropolitan areas more than others; at the national level, construction is starting to pull back.
- With new supply and a slowing labor market, multifamily performance at the national level will moderate but remain above average in 2016. However, the underlying fundamentals creating strong demand will remain steady and performance in 2017 will rebound.
- As of June 2016, the metros with the most moderation decelerated because of new supply, low oil prices, and lower job formations.

The multifamily market continued to perform above average in the first half of 2016 despite slowing down from the record-high growth in 2015. The moderation does not signal that the ball game is coming to an end, but that a healthy market is moving toward equilibrium. The deceleration was anticipated and is in line with expectations at the national level. Strong economic and demographic fundamentals will continue to support growth in the multifamily industry, but at more sustainable levels.

Moderation is expected to continue through the second half of 2016 and into 2017 as a result of the high level of new supply entering the market. The slowdown is not from shifts in the underlying demand drivers, which are anticipated to remain strong for several years to come. Vacancy rates have started to slowly increase but not at alarming rates and will remain below the historical average through 2017. With vacancy rates remaining relatively tight, landlords will be able to increase rents, but at a slower pace than the last few years. While these trends will be more prevalent in some metros than others, the overall multifamily market will continue to benefit from favorable factors that will allow the industry to perform above average for several years to come.

Section 1 – Multifamily Market Drivers

The U.S. economy continues to grow steadily despite headwinds that threaten to derail it. The year had a rocky start with disappointing first and second quarter gross domestic product (GDP) – although the first quarter was later revised upwards – along with sliding oil prices, global uncertainties, and slowing job growth. GDP came in at 1.1 percent and 1.2 percent for the first and second quarter, respectively, constrained by the strong dollar and global uncertainties. Overall growth in 2016 is expected to be similar to 2015, around 2 percent as strong consumer spending and residential investment boost the economy.

A theme in 2016 is moderation, especially in job growth and the multifamily industry. The remarkable job growth and multifamily performance achieved in 2014 and 2015 are not sustainable in the long-run; if continued, they could lead to a more severe correction. Instead, many factors indicate the market remains healthy and a slight deceleration is natural at this point in the cycle. However, as the economy enters the next phase, impacts on local markets will vary and we expect dispersion to widen across metro areas.

Moderating Employment Growth

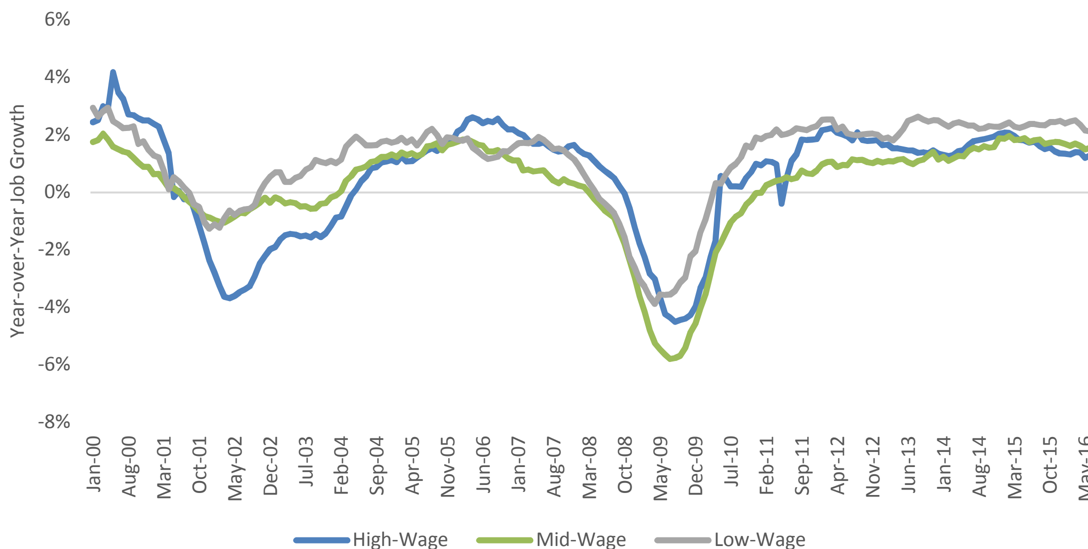
Job growth in 2016 remains healthy – despite only 11,000 new jobs added in May – but is starting to slow from the pace seen in the past few years. Year to date at the end of June, the economy had added 1 million new jobs, slightly less than the 1.3 million and 1.4 million added in the first six months in 2015 and 2014, respectively. On average, 170,000 jobs have been added each month in 2016, less than the 230,000 and 250,000 in the past two years but a healthy addition to the economy. The easing in job growth is not an ominous sign of an economic downturn, but instead the start of the transition into long-run, sustainable growth.

The unemployment rate at the end of June was 4.9 percent, in line with the average of 5 percent since August 2015. The unemployment rate took a temporary dip in May, to 4.7%, driven by a reduction in the labor force. In April and May, the labor forced declined by 820,000 as more people left the labor force. The labor force increased by 414,000 people in June, a sign that people looking for work see opportunities in the market, pushing the unemployment rate back to 4.9 percent. The unemployment rate is expected to remain unchanged, on average, through the end of 2017.

With the job market tightening, wage growth has started to grow, albeit at modest levels. Average hourly earnings grew by 2.6 percent year-over-year in June – averaging 2.5 percent annual growth over six months – and an increase from 2015 average growth of 2.3 percent. While the slightly stronger wage growth is a good sign of the labor market tightening, the growth remains lackluster compared to 3.2 percent and 3.1 percent seen in 2007 and 2008, respectively. Wage gains are expected to beat inflation through the rest of 2016, but remain modest.

Another reason for the slow wage growth is because growth continues to be dominated in the low-wage sectors, as shown in Exhibit 1. Growth in mid- and high-wage sectors has been slower during the recovery compared to low-wage sectors. High-wage sector growth fell below mid-wage growth in the past few months, partially because of the slowdown in hiring in the energy industry, which typically offers higher-paying jobs.

Exhibit 1 - Job Growth by High-, Mid-, and Low-wage Tiers



Sources: U.S. Bureau of Labor Statistics (BLS): Current Employment Statistics (CES), Quarterly Census of Employment and Wages (QCEW); Moody's Analytics Estimates, Freddie Mac

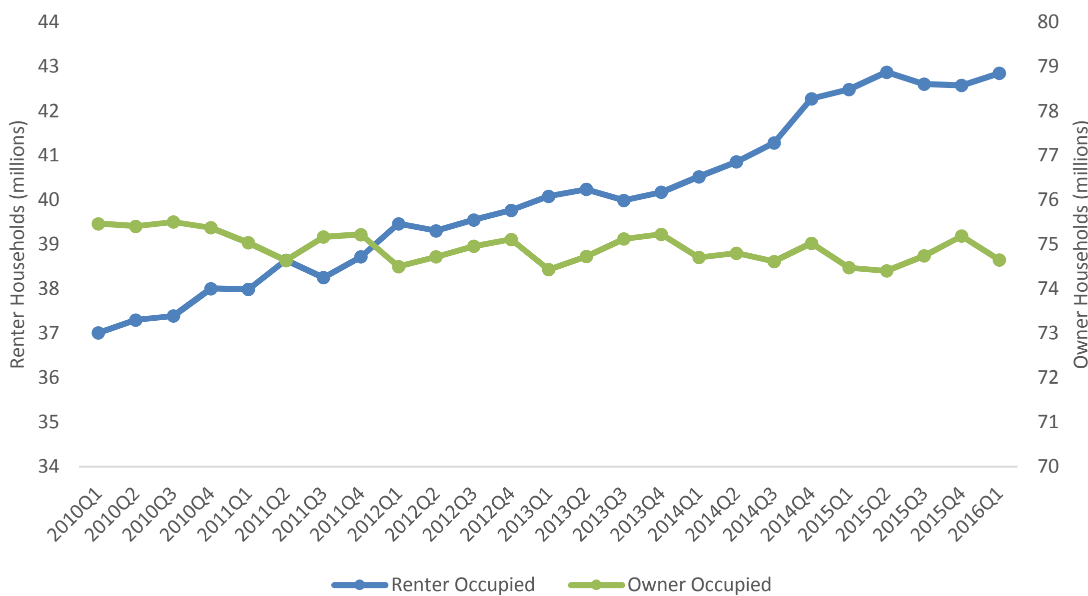
Strong Rental Household Formations

The number of households increased by 1.9 million in 2015. This was comprised of 1.6 million new renter households and 300,000 new owner households. Overall, the homeownership rate continued to decline -- to 63.1 percent at the end of the second quarter 2016. Further declines are expected based on age demographics,

ethnic diversification, and affordability constraints. Just how steep a decline is debatable and the subject of a series of U.S. Department of Housing and Urban Development's (HUD's) Office of Policy Development and Research articles.[1] In the short term, homeownership is predicted to drop 1-3 percentage points by 2020. But in the long term, expectations are mixed; one forecast predicts the ownership rate will increase to 66-68 percent by 2050 but most expect the rate will continue to fall to the mid-to-high 50s. The most pessimistic scenario, which models less affordability, predicts an ownership rate of 54.9 percent by 2020 and 47.7 percent by 2050.

Exhibit 2 shows the strength in renter household formations by quarter. While quarterly data reflects seasonality, in general, renter household formations from third quarter 2013 to second quarter 2015 were exceptionally strong. Vacancy rates fell and rents grew as a result. Renter household formations slowed slightly at the end of 2015 but increased in first quarter 2016 and are expected to remain strong but at more moderate levels.

Exhibit 2 - Owner- and Renter-occupied Households by Quarter



Sources: U.S. Census Bureau: Current Population Survey/Housing Vacancy Survey, Freddie Mac

Solid Multifamily Performance

The multifamily market continued its above-average performance in the first half of 2016, albeit at lower levels than in the prior few years. At the end of second quarter, vacancy rates remained below 5 percent, while rents increased on average by 3.7 percent, as reported by Axiometrics. Vacancy rates increased slightly over the year, up 10 basis points (bps) to 4.8 percent from second quarter 2015, but are down 40 bps from first quarter 2016. Likewise, rent growth slid 140 bps year-over-year, but remains on pace to be above average in 2016.

Moderation in multifamily performance began at the end of 2015. While the start of any moderation can give the impression of a more rapid decline to follow, this is not expected to be the case here. Performance at 2015 levels is not sustainable for the long term.

Much of this year's moderation is due to supply outpacing demand in some markets. Multifamily completions are expected to outpace last year and demand will fall short of absorbing all of the new supply. Vacancy rates will increase, causing landlords to ease rent growth. As a result, gross income growth (which accounts for rent growth and vacancies) in 2016 will moderate but remain in line with the long-run historical average of around 3.4

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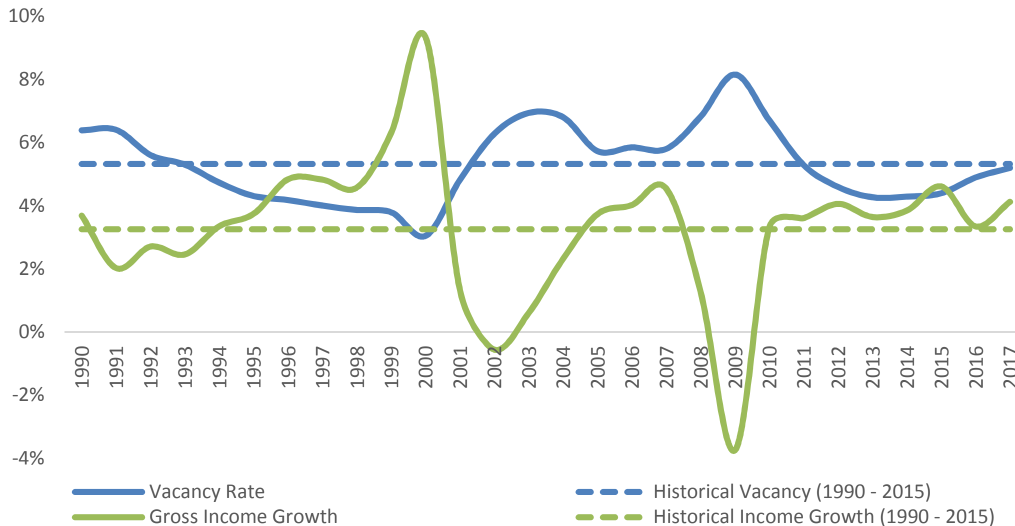
[1] *Cityscape.* Point of Contention: Declining Homeownership. https://www.huduser.gov/portal/periodicals/cityscpe/vol18num1/index.html

percent. However, the influx of new supply is expected to stabilize into 2017 and, because demand for multifamily units will remain favorable, income growth will be stronger in 2017, as shown in Exhibit 3.

Exhibit 3 - Vacancy Rate and Gross Income Growth, History and Forecast



Sources: REIS, Freddie Mac projections

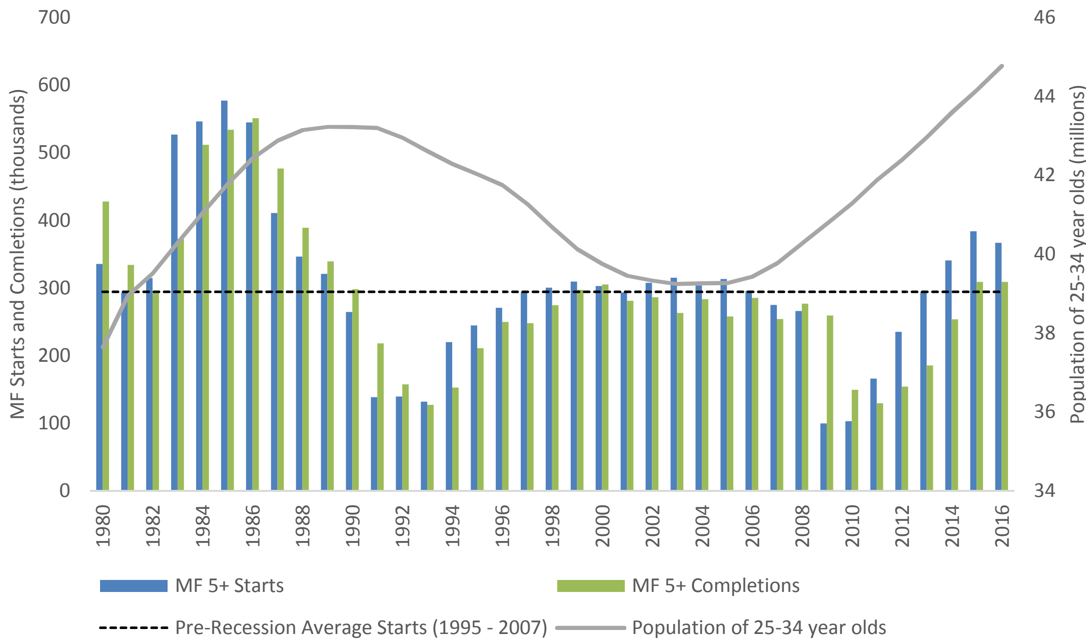
Increased Multifamily Completions, Fewer Construction Starts

Multifamily construction starts waivered slightly in the first six months of 2016 but remained elevated, with an annualized rate of 367,000 units compared to 384,000 in 2015. However, the number of construction permits has started to abate. In 2015, 450,000 multifamily permits were issued; so far in 2016, the annualized total dropped by 16 percent to 376,000 units. But considering construction time, the bulk of new completions will come onto the market at the end of this year and in 2017.

As of June, the annualized rate of completions is 309,000 – equal to the level delivered in 2015. Completions slowed in the spring of this year but as of June have started to ramp up. Expectations are for completions to continue to increase throughout the rest of the year and end the year higher than in 2015. Throughout the recovery, new supply has been opening at a moderate pace instead of flooding the market.

Barring any major disruption, we expect multifamily construction to remain slightly above the pre-recession average for our extended period. Rather than a sign of the industry overproducing, the elevated construction level is a response to the changing demand for multifamily units. As shown in Exhibit 4, the number of 25-34 year olds (millennials) continues to climb, surpassing the previous peak set by baby boomers in 1989. This cohort is one of the most important to multifamily demand because, as a whole, its members have the highest propensity to rent. This age cohort is also more likely to prefer an urban lifestyle and has tended to delay marrying and having children, driving up demand for rental housing.

Exhibit 4 - Multifamily Starts and Completions (5+ Units) and Population of 25-34 Year Olds



Sources: Freddie Mac, U.S. Census Bureau, Moody's Analytics

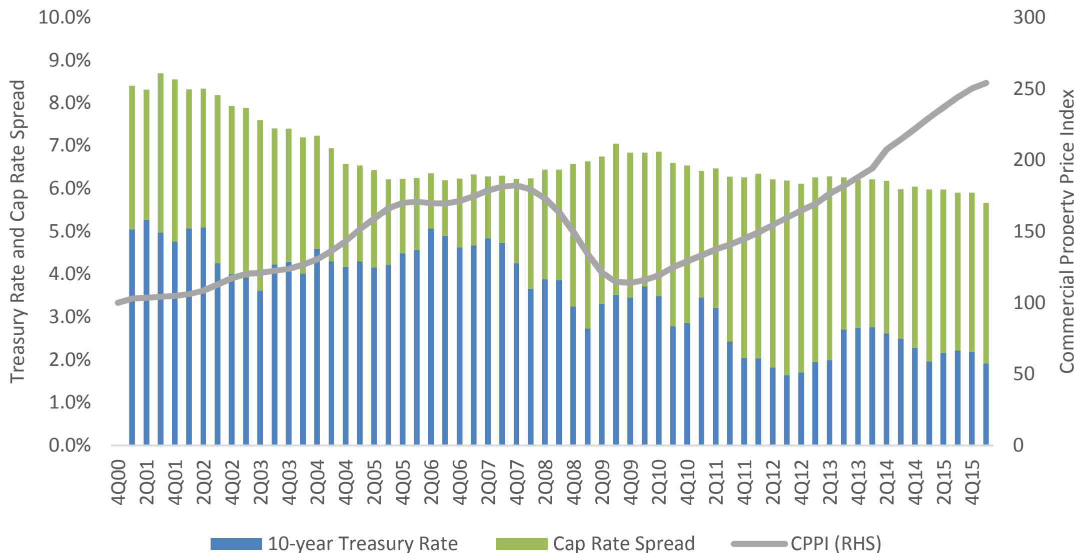
Declining Interest Rates and Cap Rates

Treasury rates have declined this year, despite the Federal Reserve increasing short-term interest rates in December 2015, which had little impact on the longer-term rates. Multifamily capitalization rates (cap rates) decreased to 5.7 percent in first quarter 2016, but cap rate spreads, or the difference in cap rates and the 10-year Treasury, held steady quarter-to-quarter at 375 bps, as shown in Exhibit 5. Because of the mixed economic news in the first half of the year along with the global disruptions, only one Federal Reserve rate hike is expected in 2016. Any movement in the 10-year Treasury will have little impact on cap rates in the short-term. The current cap rate spread is relatively wide compared to the historical average going back to 2001 of 320 bps. Therefore, cap rates can absorb some of the Treasury rate increases.

At the same time, multifamily property prices continue to grow in 2016, but at a slower pace than in the previous few years. In the first quarter, property prices grew by 11 percent, down from the 14 percent average in 2011 through 2014. Growth slowed most notably in the six major markets to 7 percent over the year, while the non-major metros experienced more consistent growth of around 13 percent.[2] The slowdown in property prices is another sign that fundamentals are moderating after strong growth in the prior few years. As rent growth moderates, the pace of growth in property prices is expected to slow as well.

[2]The major metros are Boston, Chicago, Los Angeles, New York, San Francisco, and Washington, D.C.

Exhibit 5 - Multifamily Value Index, Cap Rate Spread and Treasury Rate

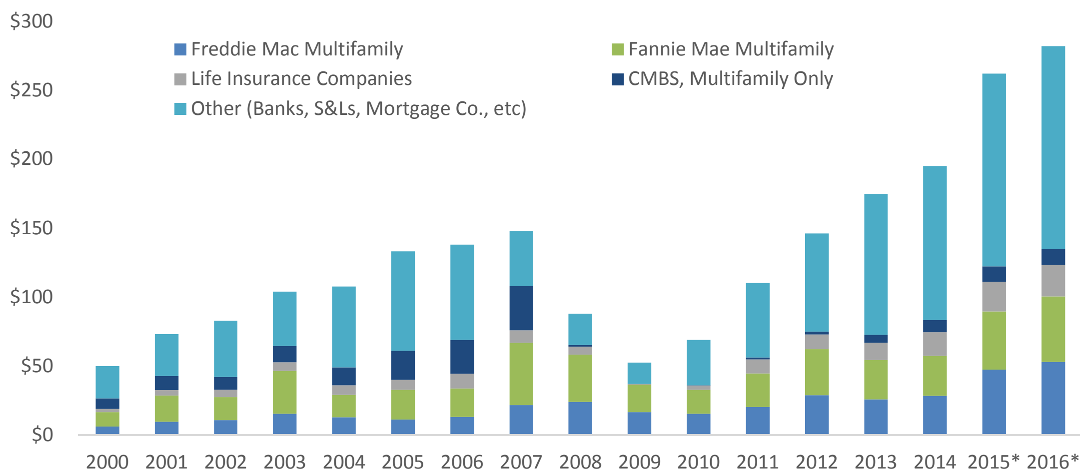


Sources: Freddie Mac, RCA CPPI™, U.S. Census Bureau, Moody's Analytics

Record Origination Volume

Following 2015's higher-than-anticipated multifamily origination volume – up 34 percent year-over-year to $262 billion, as shown in Exhibit 6 – expectations are for volume growth to continue in 2016 but at a slower pace, ending the year up 7.5 percent to around $282 billion. Many of the same factors from 2015 are still in play: increasing property prices, elevated construction pipeline, high number of maturities, and low interest rates. Growth in subsequent years is expected to increase by 3 to 7 percent as new construction and property price growth moderate. Growth expectations in origination volume could be impacted negatively by regulatory changes, or positively by global uncertainties as foreign investors turn towards multifamily real estate as a stable investment.

Exhibit 6 - Multifamily New Purchase and Guarantee Volume ($ Billions)



Sources: Mortgage Bankers Association, Freddie Mac
Notes: 2015 and 2016 numbers are projections as of July 2016

Section 2 – Multifamily Market-level Outlook

Most metro areas will continue to perform well in 2016 and into 2017, but grow slower than in recent years. Gross income growth in most metros, like at the national level, started to slow at the end of 2015 and into the first few months of 2016. Gross income grew 4.9 percent in 2015, as reported by REIS. Current year-end estimates for 2016 are at 3.4 percent – in line with the long-run average going back to 1990 of 3.3 percent. Likewise, vacancy rates will increase but at manageable increments; a 50 bps increase is expected for the year to end at 4.9 percent.

The moderation of growth in 2016 is mostly due to the expectation of a large wave of new supply hitting the market this year. Our expectations are for the increase in supply to be heaviest this year and then level out in subsequent years. As such, growth in 2017 is expected to be stronger than 2016. As shown in Exhibit 7, gross income growth in 2016 will slow in most of the top 10 markets compared to 2015, but will pick up in 2017. The slowdown will be more pronounced in markets that had considerably higher-than-average growth in 2015, such as San Francisco, Portland, Oakland, and Seattle. These markets will continue to be top performers through 2017, albeit at more moderate rates. The strength of the multifamily market is evident in the rebound expected in 2017 and evidence that we are in a period of moderation, not a downturn.

Exhibit 7 – Top 10 Metros by Gross Income Growth for 2017

	Annualized Growth in Gross Income		Change in Gross Income Growth	Vacancy Rate	
Metropolitan Market	2017	2016	2016 to 2015	2017	2016
San Francisco, CA	6.2%	5.3%	-4.7%	4.2%	4.3%
Oakland, CA	6.1%	6.0%	-2.7%	3.1%	3.0%
Los Angeles, CA	5.8%	5.2%	-0.6%	3.4%	3.3%
Sacramento, CA	5.5%	5.9%	-2.0%	3.1%	2.7%
Tacoma, WA	5.1%	4.1%	0.1%	3.6%	3.4%
West Palm Beach, FL	5.0%	3.6%	-1.5%	5.2%	5.3%
Chicago, IL	5.0%	4.4%	0.8%	3.8%	3.8%
Portland, OR	4.9%	5.9%	-3.4%	5.3%	5.0%
Seattle, WA	4.9%	5.0%	-2.3%	5.8%	5.6%
San Diego, CA	4.9%	4.6%	-1.5%	3.3%	3.2%
United States (top 70 metros)	4.1%	3.4%	-1.5%	5.2%	4.9%

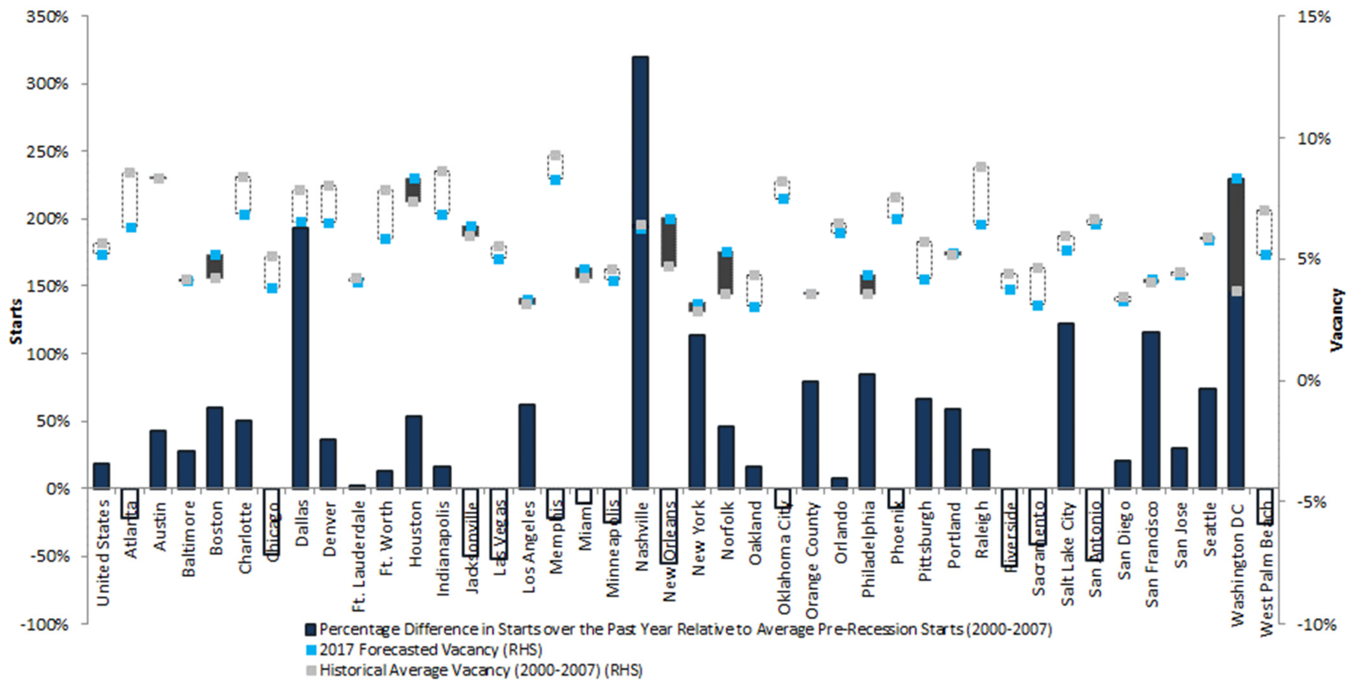
Source: REIS, Freddie Mac projections

Breaking down supply by metro, as shown in Exhibit 8, Dallas, Nashville, and Washington, D.C saw supply well above their historical averages. Meanwhile, other areas, such as San Jose and Seattle, began to pull back in construction starts. Other markets with noticeable slowdowns in construction were Houston and Oklahoma City, as their local economies responded to low oil prices.

Washington, D.C. will continue to see an elevated amount of new supply despite higher forecasted vacancy rates in 2017 relative to the historical average. However, this measure of Washington, D.C. represents the District of Columbia or the downtown, urban core, not the entire Metropolitan Statistical Area (MSA), which also incorporates suburban Maryland and suburban Virginia. Furthermore, the downtown area saw a revitalization in the past several years, driving up demand for housing. Therefore, while supply is much higher than in pre-recession years, demand has also risen. Nonetheless, the high vacancy rate does imply supply has outpaced demand, but just not as severely as it seems.

New Orleans and Norfolk also are projected to see vacancy rates above their historical averages by about 200 bps, highlighting economic weaknesses currently at play in those areas. Boston, Houston, and Philadelphia will also experience vacancy rates slightly higher in 2017 than long-run average, but within 100 bps. Slower job growth in these metros will contribute to the higher vacancy rate, although for different reasons; Houston's hiring slowed due to low oil prices, while Boston and Philadelphia are impacted by generally slowing economic growth.

Exhibit 8 - Multifamily Starts and 2016 Forecasted Vacancies Relative to History

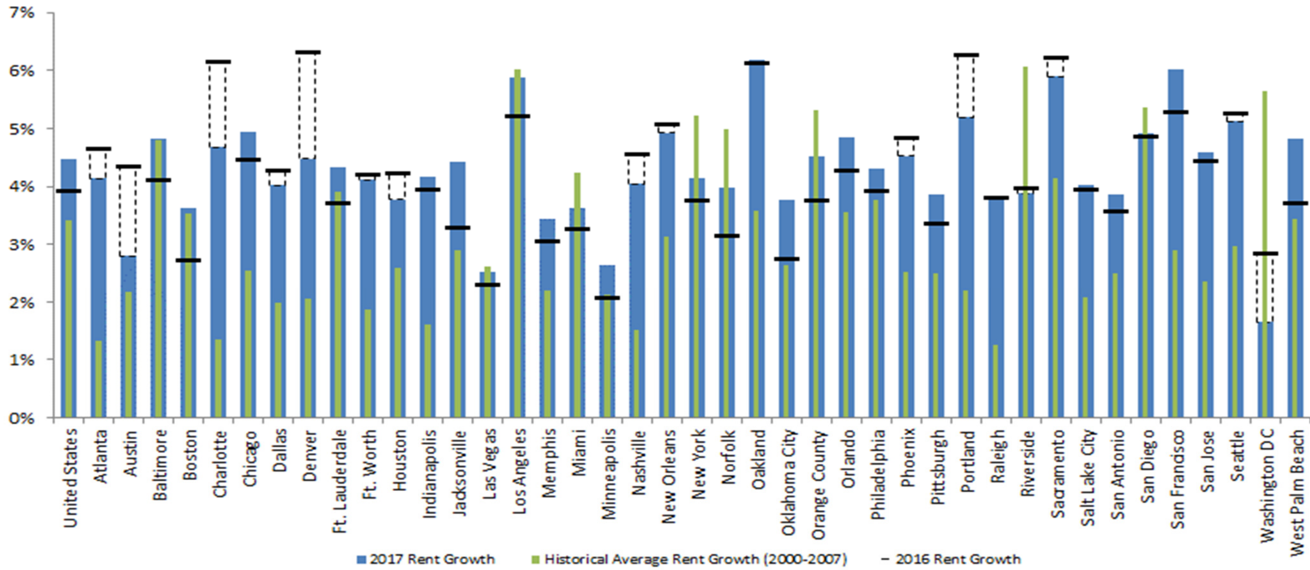


Sources: REIS, Moody's Analytics, Freddie Mac projections

Despite the moderation in rent growth, the majority of markets will remain above the historical average through 2016 and 2017, as shown in Exhibit 9. Moderation in 2016 will cause some markets to experience below-average rent growth. But in most metros, rent growth will rebound in 2017, while a few will experience rent growth continue to moderate. Even with the moderation, rent growth remains healthy across many metro areas and above the expected inflation rate of 2 percent.

In those areas that will experience slowing rent growth in 2017 -- including Austin, Charlotte, Denver, Portland, and Washington, D.C. -- a large amount of new supply will be the main driver. The forecasted slowdown is less pronounced in other areas, such as Atlanta, Dallas, and Sacramento, which will experience slight moderation in 2017.

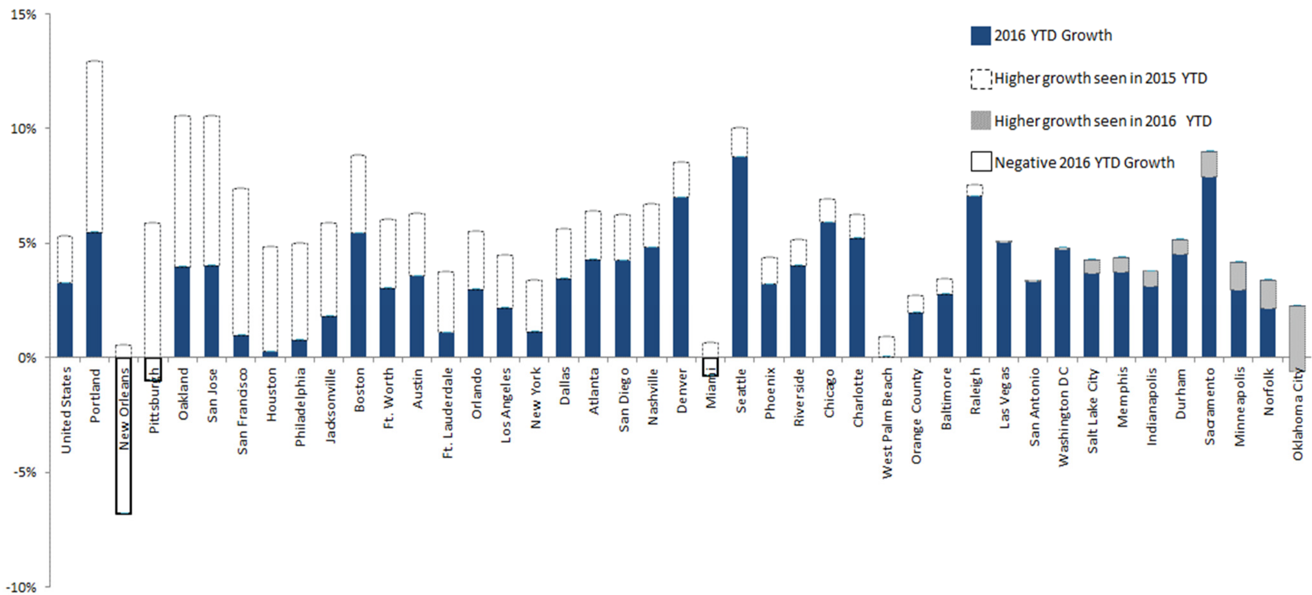
Exhibit 9 – Rent Growth for 2017 Compared to 2016 and Historical Average



Sources: REIS, Moody's Analytics, Freddie Mac projections

Taking a closer look at where rent-growth moderation will have the greatest impact, Exhibit 10 shows year-to-date (YTD) rent growth as of June 2016 compared to the same period in 2015. Those metros where there is a dotted box above the blue box indicated lower rent growth so far this year as compared to last year. The metros with the gray box overlaying the blue box are metros where YTD rent growth is higher in 2016, as compared to last year. While two quarter's worth of data may not be enough to forecast the annual trends, it provides insight into where the deceleration is occurring, allowing for a deeper look into the drivers in those metros.

Exhibit 10 – Year-to-Date Rent Growth 2016 Compared to 2015



Sources: Axiometrics, Freddie Mac

This exhibit, sorted from largest to smallest gap in rent growth, shows that rents are growing less quickly in 28 markets, about the same in three markets (within 0.3 percent), and more quickly in eight markets, while declining in three markets. Several factors influence the deceleration seen in the first six months of 2016: new supply, labor markets, and, in one case, renter fatigue from sky-high prices. However, most markets are expected to see higher growth in the second half of 2016 as the leasing season picks up and job growth bounces back.

Three metros have experienced negative rent growth over the first half of the year: New Orleans, Pittsburgh, and Miami, mainly due to sluggish economic factors. New Orleans continues to deal with the impacts of low oil prices and weakening trade because of the strong U.S. dollar, causing job growth to pull back considerably. New Orleans experienced flat job growth in the past 12 months. Although jobs started to pick back up in the first five months of 2016, new supply jumped at the same time, which constrained rent growth considerably.

Pittsburgh has also been feeling the impacts of lower job growth for the past few years -- a very disappointing 0.2 percent annual average from 2012 to 2015. Losses in manufacturing and natural resources and mining -- two industries that, despite industrial diversification, remain strongly tied to the Pittsburgh economy – stunted job growth.

While Miami has also seen negative rent growth so far in 2016, the decline is not as substantial because rent growth was relatively low in the first half of 2015. Nonetheless, lower job growth has plagued Miami in the past few months compared to the prior year. Miami is closely connected to Latin and South Americas' economies, and is feeling the effects of their sluggish growth.

Several West Coast markets experiencing considerable deceleration in rent growth include Portland, Oakland, and San Jose. But this moderation is not surprising. Rent growth in these markets was in the double-digits over the prior year, an unsustainable growth rate for the long-term. Furthermore, despite the large gap over the year, rent growth in these areas is still relatively strong, ranging from 4.0 to 5.5 percent in just the first six months of the year.

San Francisco paints a slightly different picture than its West Coast counterparts. While rent growth so far this year has retreated to similar levels as in San Jose and Oakland, it has been limited to only 0.9 percent. The metro is seeing the same trend in moderation, indicating the market's response is similar to its neighbors'. But consider this: San Francisco experienced the very strong rent growth from June to August last year, when rents increased on average around 2 percent per month. Starting in September, rents declined slightly and started to flatten out, coinciding with when job growth started to slow. Another factor to consider is renter fatigue. Rent prices have hit their sustainability ceiling after years of strong rent growth and very high rental rates. According to Axiometrics, San Francisco has the highest rent among all metros covered going back to August 2014. New York had a similar situation, specifically in Manhattan. Rents in these situations have reached the height of what can be attained at the current level of income growth and are expected to grow at more moderate levels going forward.

Another market worth mentioning is Houston, which is hit by a slowing local economy and increased levels of new supply. The continuing decline in oil prices in the beginning of the year resulted in a decline in job growth. Employment grew 0.3 percent between May 2015 and May 2016, compared to 2.2 percent in the previous 12 months. However, the sharp decline in oil prices seen in the first few months of 2016 has further impacted Houston; in the first five months of 2016, job growth declined 0.3 percent. At the same time, new construction has increased, which is stressing multifamily fundamentals. As of June, vacancy rates have risen by 1.2 percent, or 120 bps, according to Axiometrics in the past 12 months as new supply has entered the market and fewer jobs has meant less demand. Likewise, rent growth so far this year is positive, although barely, at 0.3 percent, and down 1 percent year-over-year. Fundamentals are expected to remain stressed through the rest of the year and will start to normalize going into 2017.

On the other end of the spectrum, several metros have seen improved performance in the first half of 2016; specifically, Oklahoma City and Norfolk. Oklahoma City experienced virtually zero job growth in the first five months of 2015, but hiring has resumed in 2016. Norfolk's increase in rent growth is less transparent; occupancy has increased but with little job growth. Possible explanations include job growth skewed to higher-paying industries or the return of more normal rent increases where they were too low in the past few years – the opposite of renter fatigue.

Strong growth continues in several markets, such as Seattle, Sacramento, and Denver. Job growth in Seattle and Denver continues to outpace the previous few years' pace, absorbing new supply at healthy rates. Sacramento continues to benefit from low construction levels and increased demand as high-cost, northern California markets expand to more affordable areas.

Conclusion

Following a year that greatly exceeded expectations, the multifamily market overall will remain strong in 2016; however, as more supply is delivered, performance will be lower this year than last. The pace of job growth has slowed in 2016, a sign of normalizing to sustainable growth in line with population growth. Deceleration in the multifamily market is a healthy sign that markets are adjusting appropriately to this phase of the economic cycle. Growth cannot be sustained at 2015 levels given the current economic conditions. However, the underlying demand fundamentals remain strong. Fundamentals will rebound in 2017 as we move past the wave of new supply working its way into the market. Dispersion across individual markets will continue, but increased supply or economic headwinds in some markets will not derail multifamily growth at the national level.

For more insights from the Freddie Mac Multifamily Research team, visit the Research page on FreddieMac.com/Multifamily.

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