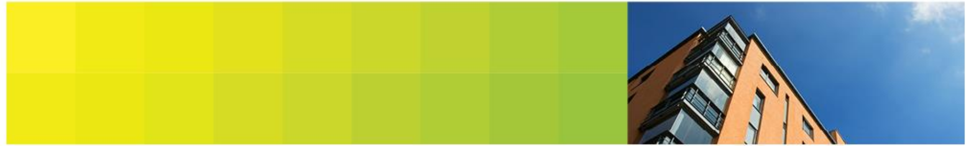
2019 Outlook

Multifamily Research Center

Freddie Mac MULTIFAMILY



Multifamily 2019 Outlook

Performance in the multifamily market remained healthy during 2018 and is expected to continue into 2019, but with more modest growth in comparison to recent years.

- The multifamily market is expected to finish 2018 with solid rent growth and only modest increases in vacancy rates despite an elevated level of new supply. Some weakness in individual markets and submarkets is evident, but the overall multifamily market remains healthy.
- New supply will remain elevated through 2019 and into 2020 given the healthy construction market based on permits and starts that are already in the system. Demand will remain robust due to demographic and lifestyle preferences, along with the rising cost of homeownership, which may hold the market in equilibrium. As a result, rents and vacancies will continue to outperform historical averages through 2019.
- Cap rates remain low and have been falling slightly over the past few quarters despite rising interest rates. While higher interest rates have caused cap rate spreads to compress, the spread remains near the long-run average. Property prices continue to grow due to solid multifamily fundamentals and strong investor demand for multifamily properties. As a result, multifamily origination volume is expected to come in at $305 billion in 2018 and grow to $317 billion in 2019 – an increase of 3.9 percent.

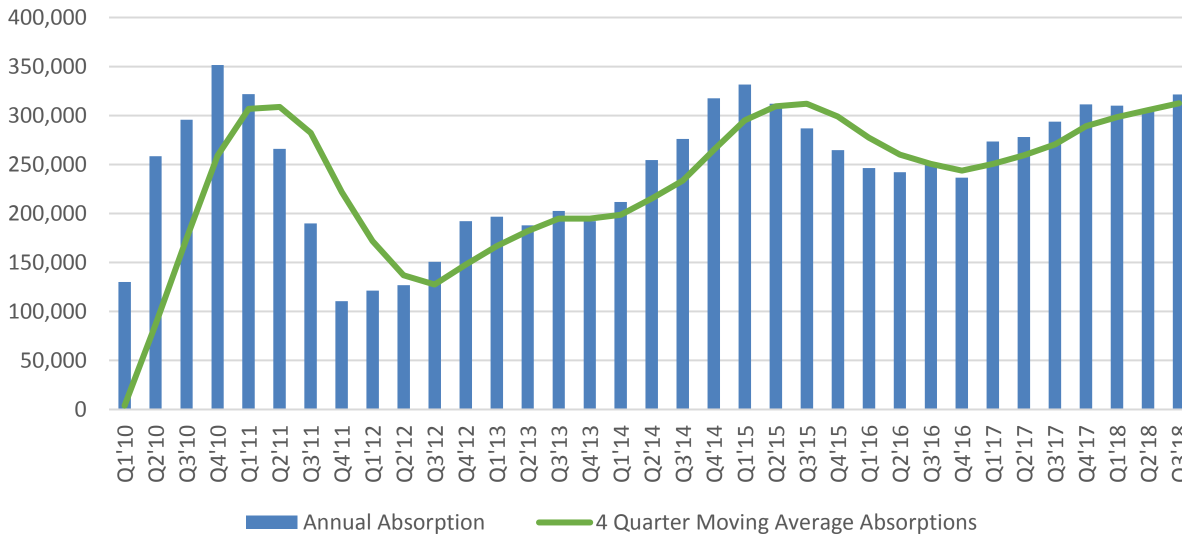
2018 in Review: Strength Continues

Performance in the multifamily market remained strong into the third quarter of 2018, despite high levels of new supply entering the market. Vacancy rates at the national level increased minimally over the year, easing fears of a sharp decrease in occupancy given the high levels of new supply. Rent growth remains healthy at the national level and in most major metropolitan areas. These dynamics vary across individual markets, which may experience more volatility in multifamily performance, but any local market softness is expected to be temporary during the lease up of new units.

The economy added an estimated 2.6 million jobs in 2018 – above 2016 and 2017 totals of 2.3 million and 2.2 million, respectively. The unemployment rate continued to tighten over the year, down 20 basis points (bps) to 3.9 percent, but crept up from the prior month by 20 bps mainly due to more people entering the labor force. The tight labor market will support higher wages, which is reflected by the 2.8 percent annual growth in the Employment Cost Index as of the third quarter 2018. Compared with the past nine years, these are healthy gains, but are lower than anticipated for a labor market with an unemployment rate below 4 percent. Near the end of 2018, the for-sale housing market showed signs of slowing when compared with the prior few years, and the financial markets have moved into correction territory. However, it's worth noting that *Witten Advisors* reported in their fourth quarter market forecasts that typical warning signs, such as the positive 2-year and 10-year Treasury spread, continued expected hikes in the federal funds rate, and only modest household leverage, do not suggest a recession in the short term.

The trend of robust household formations continued through the third quarter of 2018, with 2.3 million new households formed annually, as reported by the U.S. Census Bureau. Owner-occupied households outpaced renter-occupied household formations, causing the homeownership rate to increase to 64.4 percent, up 50 bps from a year earlier. Data indicates renter-occupied households increased 320,000 annually as of the third quarter 2018; a reversal in trend compared with the prior few quarters, which reported annual declines in renter-occupied households. However, this data does not distinguish between multifamily and single-family rental-occupied units. *RealPage* data shows consistently healthy apartment absorptions at the national level in the past several years, averaging about 310,000 units annually in the past year, as seen in Exhibit 1. This strong growth in renter formed households is consistent with the solid performance that we are seeing in rents and vacancies nationally.

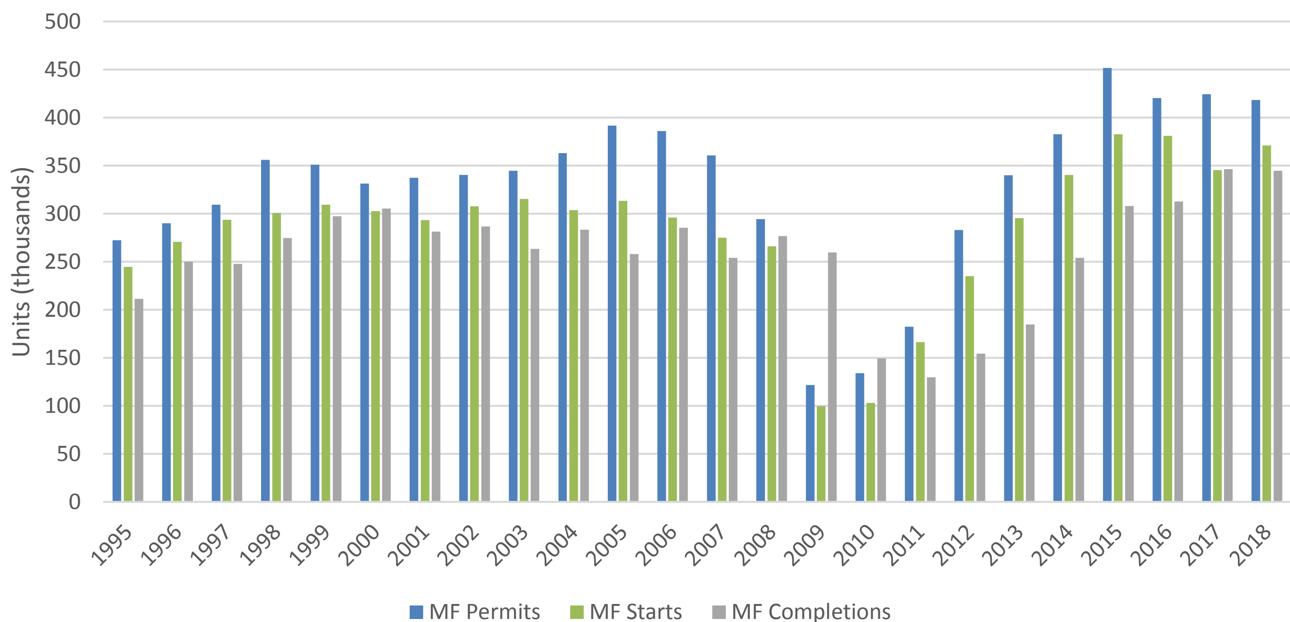
Exhibit 1: Annual Multifamily Absorptions



Sources: RealPage, Freddie Mac

According to the U.S. Census Bureau, multifamily completions in five-plus unit dwellings remained flat in 2018 compared with 2017 (as of November released data). Completions could increase slightly but are expected to remain near current levels for the short term. The U.S. Census Bureau reported permit growth is relatively flat, while starts are up 7 percent, as shown in Exhibit 2. Though data for the year is not complete, it appears that increased construction starts indicate that the elevated level of deliveries will be with us for several more years. This is a reversal of the trend seen over the past two years of construction moderating.

Exhibit 2: Multifamily Permits, Starts and Completions (5+ Units)



Sources: Freddie Mac, Census Bureau, Moody's Analytics. Note: 2018 annualized as of November data.

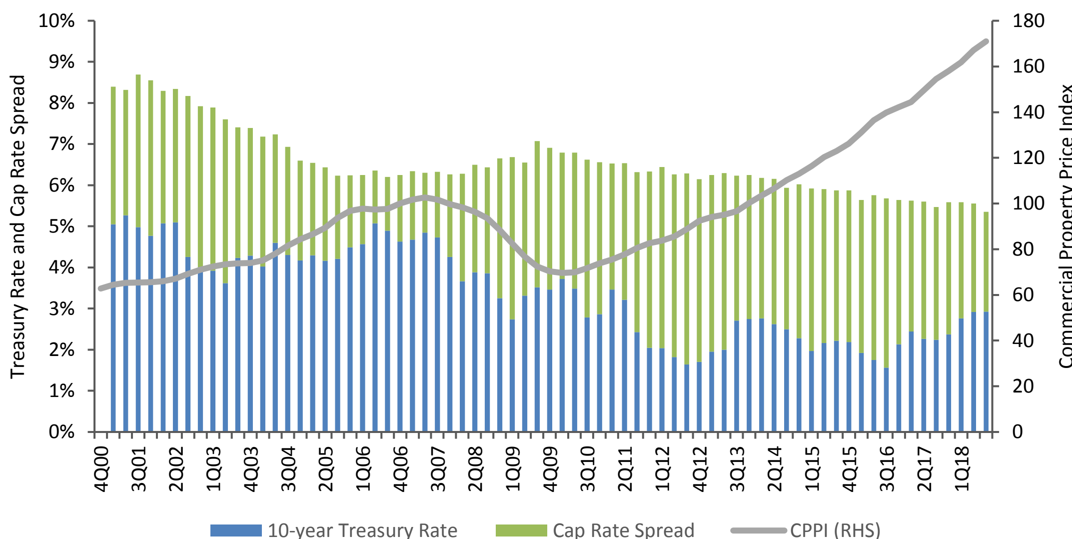
The high level of new supply had some market participants worried that vacancy rates would increase drastically. However, most markets have been absorbing the supply well and occupancy has remained relatively stable, alleviating concerns about markets being out of balance. Vacancy rates have consistently performed better than forecasted, which put the market in a good position to absorb the high levels of new supply. Vacancy rate movement over the past year, as of the third quarter of 2018, differs across vendor data: *Yardi* reports flat vacancy growth at 4.6 percent, *RealPage* reports vacancies contracted down to 4.2 percent and *REIS* showed modest gains of 40 bps up to 4.8 percent. All three of our data sources report a vacancy rate of less than 5 percent, which generally indicates a healthy market. Using *REIS* data to forecast 2018 year-end results, we expect vacancy rates will end the year around 4.9 percent, up a modest 20 bps over the full year.

Despite lower than anticipated increases in vacancy rates, rent growth continues to moderate from cyclical highs but performance remains above expectations. *REIS* shows effective rent growth of 4.2 percent annually as of the third quarter 2018, down 50 bps from 2017 reported growth. *RealPage* reported slightly lower rent increases of 3 percent over the same period but saw growth improve from 2017 by 30 bps. Our forecast has rent growth of 4.1 percent for all of 2018. While growth measures differ among forecasters, rent growth has been resilient over the past few years and remains well above the annual inflation rate.

The 10-year Treasury rate continued its march upward for most of 2018, reaching 3.2 percent in November before declining back to 2.7 percent by the end of the year. Meanwhile, cap rates decreased slightly over the past year, averaging 5.4 percent, as of the third quarter of 2018. The cap rate spread continued to compress, decreasing 80 bps over the year to 240 bps as of the third quarter of 2018, shown in Exhibit 3.

While cap rates and Treasury rates are correlated and we expect cap rates to increase as Treasury rates increase, cap rates are stickier and have taken longer to react. As such, while cap rate spreads remain below the long-run average of 280 bps going back to 1990, we expect they will start responding to higher interest rates and slowly increase. Meanwhile, properties continue to experience strong price appreciation. Multifamily property prices increased 10.7 percent annually as of the third quarter of 2018. Despite moderating fundamentals, apartment investments continue to provide stable and safe returns for investors compared with other investments, both of which contribute to continued property price increases.

Exhibit 3: Multifamily Price Index, Cap Rate Spread and Treasury Rate



Sources: Freddie Mac, Moody's/RCA CPPI, Federal Reserve Board, Moody's Analytics

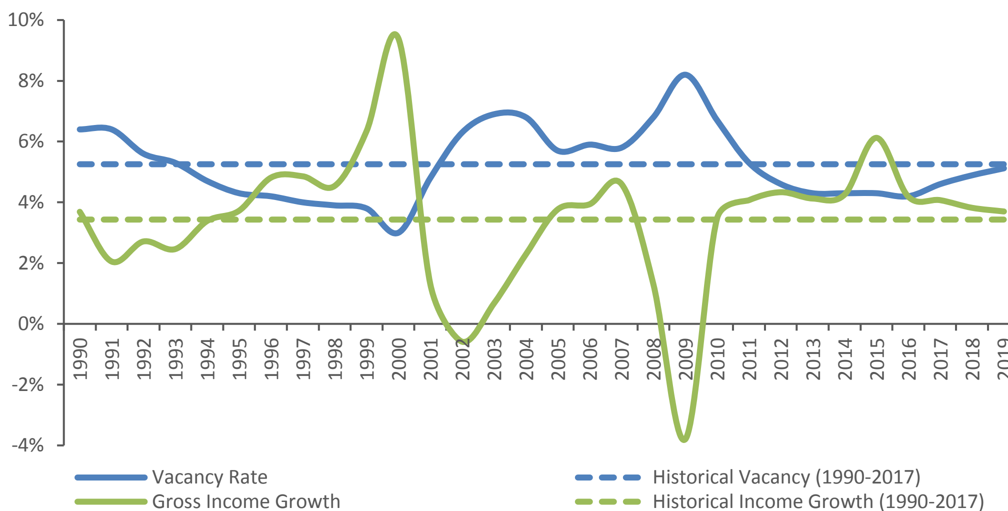
2019 and Beyond: Healthy Growth Continues

Despite the tumultuous stock market at the end of 2018, current economic trajectory indicates there is little on the horizon that would cause a major disruption to the multifamily market in 2019. Job growth is expected to remain healthy although slower than prior years, due to the low unemployment rate which will limit the rate of new jobs added to the economy. But with a tight labor market comes higher wage growth, which will help fuel demand for household formations. Lifestyle preferences and demographics continue to support multifamily household formations and the 2017 Tax Cuts and Jobs Act may also incentivize renter formations over homeownership. Likewise, higher interest rates, together with house price appreciation, will continue to make ownership more expensive.

The high level of new supply remains a concern, but due in part to construction delays and labor shortages, we don't expect the peak in deliveries to be contained to just one year. Instead new supply will be spread out over several years. *RealPage* forecasts annual completions to average 325,000-340,000 units throughout 2019. This is only slightly higher than the previous six quarters' annual average of 320,000 units. The market has shown resilience in absorbing the new deliveries over the past several years and is a testament that, despite new supply near a 30-year high, fundamentals remain healthy.

Supply will outpace absorptions throughout 2019, but only marginally. We anticipate that vacancy rates only increase another 20 bps in 2019 up to 5.1 percent, as seen in Exhibit 4. Because of the slow increase in vacancy rates, rent growth is expected to remain healthy and above the historical average, reaching 4 percent in 2019. Our forecast uses *REIS* data, which continues to report higher rent growth when compared with other market forecasters. *RealPage* and *Yardi* project annual rent growth for 2019 to come in around 3 percent – while lower, this still portrays a healthy market and growth above the target inflation rate of 2 percent[1] and forecasted inflation rate of 2.3 percent[2]. Due to higher vacancy rates, we forecast gross income growth of 3.7 in 2019, above the long-run average.

Exhibit 4: Vacancy Rate and Gross Income Growth, History and Forecast



Sources: REIS, Freddie Mac projections for 2018 and 2019

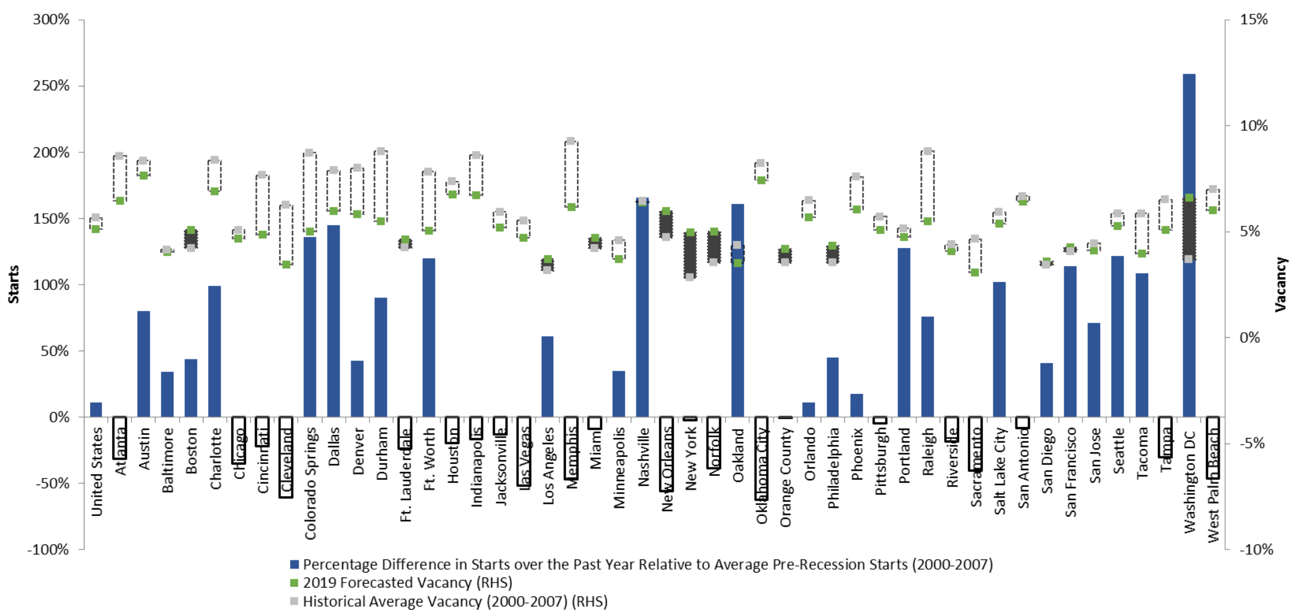
At the market level over the past year, construction starts in Charlotte, Durham, Colorado Springs and Oakland increased the most proportionally to market size. Some areas saw construction slow over the year, including Salt Lake City, Denver, Cleveland and Chicago. Areas with the highest new supply compared with their historical

[1] Set by the Federal Open market Committee (FOMC) as of the December 18-19, 2018 meeting
[2] Forecasted CPI: All Items from Moody's Analytics

average are Washington, D.C., Nashville, Oakland and Dallas. High supply does not necessarily signal a slowdown of multifamily performance for that market. When current vacancy rates are compared with the historical average, we can see which metros are better poised to absorb new supply. As shown in Exhibit 5, except for Washington, D.C., metros with the highest new supply are still experiencing vacancy rates below their historical average, indicating they have room to absorb some of the new supply.

We expect vacancy rates in most metros to remain below their respective historical average in 2019 despite the new supply entering the market. Washington, D.C. and New York City continue to experience vacancies well above their historical average due to a large number of new deliveries entering the market. Meanwhile, Fort Lauderdale, Los Angeles and Orange County are expected to see vacancy rates increase above their historical average in 2019.

Exhibit 5: Multifamily Starts and 2019 Forecasted Vacancies Relative to History

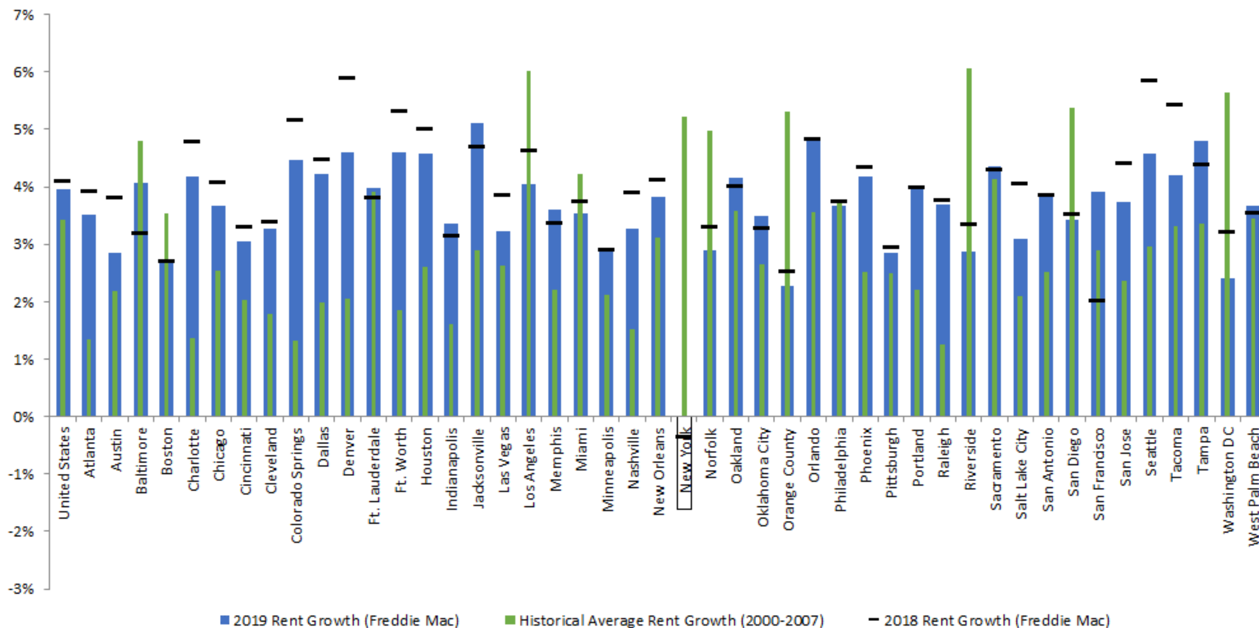


Sources: REIS, Moody's Analytics, Freddie Mac projections

Rent growth is expected to moderate in 2019 but remain above historical averages in the majority of the markets, shown in Exhibit 6. Areas such as Colorado Springs, Charlotte, Fort Worth and Denver are expected to see rent growth well above their historical average next year due in part to strong demand and relatively low vacancy rates. Meanwhile, markets with rents expected to come in well below their historical averages include New York City, Washington, D.C., Riverside, Norfolk and Orange County. On the other hand, Baltimore, Jacksonville, San Francisco and Tampa are expected to experience a meaningful increase in rents in 2019 compared with 2018.

Despite slowing rents, growth in the majority of metros is expected to be above the forecasted inflation rate of 2.3 percent. Our forecast indicates New York City will continue to experience rent declines through 2019 due to a large amount of new supply entering the market that is taking time to lease up. New York City, which comprises five boroughs in this analysis, is experiencing its highest vacancy rate going back at least 38 years (based on *REIS* data starting in 1980), suppressing rent growth and increasing competition. The average vacancy rates in the five boroughs going back to 1980 is a very tight 2.4 percent, according to *REIS*. Vacancy rates are projected to end 2018 at 5.4 percent. In comparison, vacancy rates in the height of the Great Recession did not exceed 3.7 percent. We expect rates to decline in 2019 as the new supply continues to be absorbed, but rents are forecasted to continue to decline as vacancy rates remain high by the market standard.

Exhibit 6: Rent Growth in 2019 and 2018 Relative to History



Sources: REIS, 2017 and 2018 are Freddie Mac projections

In 2019, we expect the highest revenue growth will be in several Florida markets, as shown in Exhibit 7. This strength is due to the strong population growth and relatively tight vacancy rates in those respective markets. These markets tend to be sensitive to the strength of the national economy and are dependent on the tourism industry which is closely correlated to the overall whims of the economy. With the direction the economy is expected to head over the next year, we don't anticipate any drastic slowdown that would hamper these markets.

Heading west, Seattle and Colorado Springs remain in our top 10 markets based on forecasted gross income growth in 2019, but we also see the return of San Francisco and Oakland to the list. San Francisco experienced a slowdown in rent growth from the end of 2016 and through 2017 due to a large amount of new supply entering the market. In 2015, units under construction as a percent of inventory reached 2.5 percent in San Francisco, or close to 6,000 units annually, as reported by *RealPage*. While construction is still up compared with historical levels going back to 2000, the volume has slowed down to a more manageable 1.7 percent. Construction in Oakland, on the other hand, has picked up in the past few quarters. *RealPage* reports the change in inventory is 3.4 percent, or close to 7,000 units. While growth remains strong as spill over housing needs from the more expensive San Francisco market keeps demand up, the Oakland market could slow if the new supply overwhelms the market.

Seattle remains a top growth market despite an abundance of new supply, but fundamentals are starting to soften as the large quantity of units enter the market and absorptions fall short. Construction in Seattle remains elevated, representing 5 percent of inventory, or 16,000 units. Nearby Tacoma is seeing a slower rate of new supply at 2 percent, representing only 1,000 units. Tacoma, however, has fallen off the top 10 list as new supply has limited pricing gains in that market.

Houston continues to experience strong rent growth from the temporary impacts of Hurricane Harvey, but is also seeing stronger growth due to limited new supply. Construction for multifamily properties halted after oil prices dropped drastically in 2015 and 2016. Construction peaked in 2015-2016 at 28,000 units, as reported by *RealPage*. It took several years for all the new construction to work its way through, but now with new supply at more manageable levels – around 8,000 units annually – rents have seen stronger growth recently.

This year some of the past top contenders fall off the list: Sacramento, Portland, San Jose and Los Angeles. However, they just barely missed the list and round out the top 15 in expected gross income growth. These areas

have recently seen strong rent growth, but due to high supply and affordability constraints, rent growth will subdue in 2019.

Exhibit 7: Top 10 Metros by Gross Income Growth for 2019

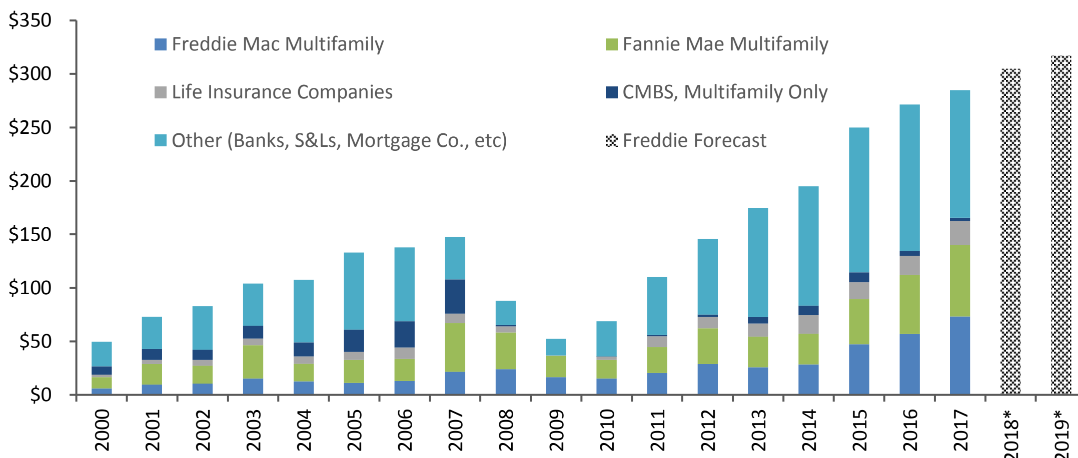
Metropolitan Area	2019 Annualized Growth in Gross Income	2019 Vacancy Rate
Tampa	4.7%	5.1%
Jacksonville	4.5%	5.2%
Orlando	4.5%	5.7%
West Palm Beach	4.3%	6.0%
Seattle	4.3%	5.3%
Houston	4.3%	6.8%
Ft. Lauderdale	4.1%	4.6%
Oakland	4.1%	3.5%
San Francisco	4.1%	4.3%
Colorado Springs	4.0%	5.0%
United States (top 70 metros)	3.7%	5.1%

Source: Freddie Mac projections

Origination Market Forecast

Multifamily origination volume exceeded expectations in 2017, coming in at $285 billion, as reported by the Mortgage Bankers Association (MBA), representing a 5.9 percent increase over the prior year. Due to strong fundamentals and demand for multifamily investments, we expect to see continued growth. Actual volume for 2018 will not be available until later in 2019, but our expectations are for total origination volume in 2018 to rise by 7 percent to $305 billion. Increasing interest rates are expected to slow origination growth, which we expect to impact the market more in 2019. We forecast volume in 2019 to increase by 3.9 percent to $317 billion. While property price growth continues to be strong, higher interest rates may cause cap rates to increase slightly. This will put downward pressure on property price appreciation and cause volume growth to moderate.

Exhibit 8: Multifamily New Purchase and Guarantee Volume ($ Billions)



Sources: Mortgage Bankers Association, Freddie Mac projections
Note: 2018 and 2019 results are projections as of December 2018

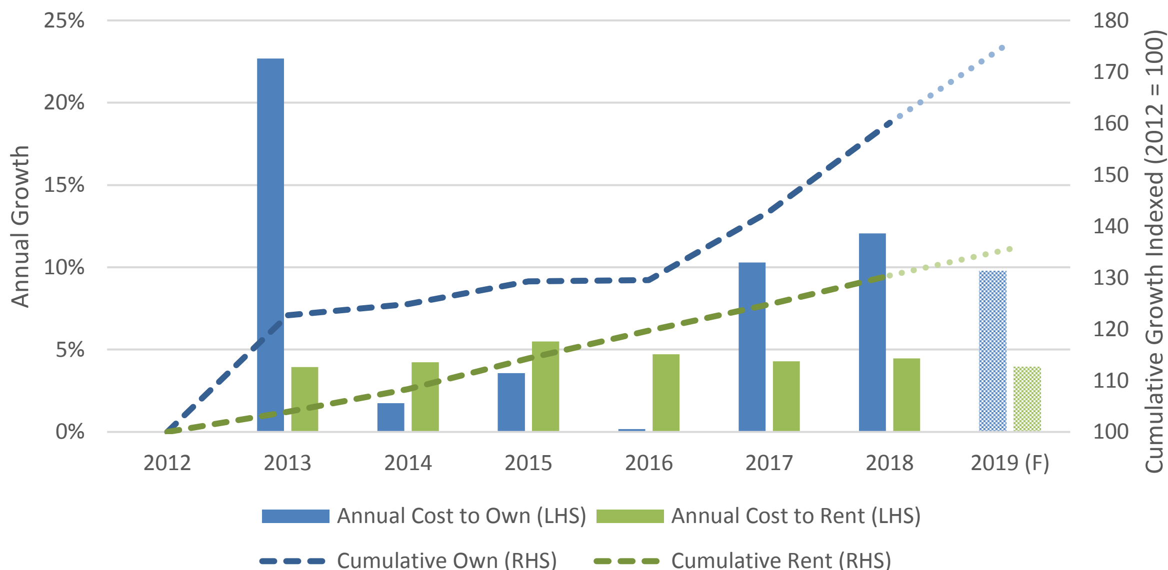
Cost to Own vs. Rent

In the past several years, apartment rents have consistently grown faster than the historical average – averaging 4.4 percent per year since 2012, according to *REIS*. Many areas that experienced robust population and employment gains saw much stronger rent growth, such as Seattle, where rents increased around 8.4 percent annually over the past six years. Demographics and lifestyle preferences continue to support apartment demand, but will the higher cost of renting push more households to ownership? Here we look at how the cost to rent and cost to own have changed over time.

While measuring the cost to rent is more straightforward, the cost of ownership is more complex and volatile, with many factors influencing the cost of ownership. Our analysis examines the cost of homeownership based on the median home price and 30-year mortgage rate, assuming a 20 percent down payment and a 1 percent property tax. The cost is computed each quarter and represents the current monthly mortgage cost.[3]

Measuring the annual change in ownership is challenging due to the timing of interest rate movements throughout the year. We see the growth in the cost of ownership ranging from above 20 percent in 2013 to 0.2 percent in 2016, as seen in Exhibit 9. Meanwhile, rent growth has remained between 3.9 and 5.5 percent each year. The cumulative line shows the cost of ownership has increased 60 percent while rents rose 30 percent from 2013 to 2018. In the past year alone, the cost to own has increased 12.1 percent due to house prices increasing 4.8 percent and mortgage rates increasing 70 bps. We expect the trend to continue into 2019, with the cost to own up nearly 10 percent compared with 4 percent rent growth. Even though home price growth is forecasted to moderate in 2019 – increasing 4.3 percent compared with 5.1 percent in 2018[4] – positive appreciation and higher mortgage rates will continue to drive up the cost of ownership.

Exhibit 9: Cumulative and Annual Growth of Cost to Own and Cost to Rent



Sources: Freddie Mac, Census Bureau, Moody's Analytics, REIS
Note: Last data point as of 3Q. To provide annual growth rates, calculated from 3Q to 3Q. Forecasts for 2019 apply annual growth projections onto 2018 Q3 data and use 2019 30-year mortgage rate forecast.

[3] The analysis does not consider all potential costs, such as the opportunity cost of purchasing a home, maintenance costs, or tax implications of homeownership. Because we're simply looking at the rate of growth and not absolute cost, the omission of these factors does not materially impact the results.
[4] *Expect Modest Housing Market Growth in 2019* http://www.freddiemac.com/research/insight/20180628_rising_housing_costs.html

We'd have to go back 10 years to measure a time when the cumulative cost to own is less than cost to rent. While home prices increased around 35 percent since 2008, mortgage rates declined 180 bps. The net impact is that the cost to own only increased 10 percent since 2008. In comparison, the cost to rent over that same period increased 35 percent.

We see similar trends at both the metro and national level for three-year growth rates, as seen in Exhibit 10. During the past three years, most metros saw the cost to own increase more than the cost to rent, except for Philadelphia. Over this time period, the cost to own grew the most in Tampa, Orlando and Seattle. These areas also saw higher rent growth on average compared with their market counterparts. Areas with the lowest growth in the cost to own were Philadelphia, Virginia Beach and New York City.

Exhibit 10: Cost to Own and Rent Across Metro Areas (Cumulative over past 3 years)

Metro	3-year Cost to Own	3-year Cost to Rent	Metro	3-year Cost to Own	3-year Cost to Rent
Atlanta	33.0%	19.4%	Nashville	33.4%	21.8%
Austin	28.1%	13.6%	New Orleans	33.5%	11.7%
Baltimore	26.7%	9.0%	New York City	14.9%	5.6%
Boston	24.0%	11.7%	Orlando	40.3%	19.5%
Charlotte	31.1%	15.8%	Philadelphia	8.9%	13.5%
Chicago	22.9%	14.4%	Phoenix	32.4%	17.3%
Cincinnati	26.5%	12.4%	Portland	32.8%	18.6%
Cleveland	28.6%	11.5%	Raleigh-Durham	26.4%	15.1%
Columbus	29.1%	14.3%	Richmond	23.2%	13.6%
Dallas	32.5%	19.5%	Riverside	31.5%	13.6%
Denver	35.4%	19.6%	Sacramento	34.8%	19.4%
Houston	17.4%	13.0%	San Antonio	23.5%	11.2%
Indianapolis	27.5%	12.4%	San Diego	24.5%	15.0%
Jacksonville	34.8%	13.0%	San Francisco	32.0%	7.9%
Kansas City	25.1%	13.7%	Seattle	38.2%	27.9%
Los Angeles	30.8%	19.2%	St. Louis	16.6%	13.7%
Memphis	24.5%	10.8%	Tampa	40.8%	15.9%
Miami	30.1%	17.1%	Virginia Beach	14.7%	8.8%
Milwaukee	22.9%	13.1%	Washington, D.C.	17.0%	13.5%
Minneapolis	28.3%	13.6%	**United States**	**23.8%**	**14.1%**

Sources: Freddie Mac, Census Bureau, Moody's Analytics, REIS
Note: Last data point available is 2018Q3, growth rates are based on 3Q to 3Q

As wages increase, this will offset some of the costs, but for individuals who were contemplating ownership in the past two years have seen the cost to own grow more than double the cost of renting. A recent study highlights that the main factors keeping young adults from homeownership is high housing costs.[5] As such, renting continues to be a more affordable option despite increasing rents. Based on our recent survey, 78 percent of renters find that renting is a more affordable option for them currently; an increase from the prior few years' surveys.[6]

[5] *Locked Out? Are Rising Housing Costs Barring Young Adults from Buying their First Homes?*
http://www.freddiemac.com/research/insight/20180628_rising_housing_costs.html
[6] *New Research Shows Renters Continue to Find Affordability in Renting*
http://www.freddiemac.com/research/consumer-research/20181017_affordability_renting.html

There are many things to consider when determining if buying or renting is a better option. The actual cost to own varies based on assumptions regarding many other factors such as the down payment amount, taxes, maintenance and unrealized gains. A major hurdle for many potential homeowners is saving for a 20 percent down payment. While growth tells one story, the initial level of affordability plays a key factor in whether to rent or own. Where you might see renting fatigue is in areas or property types where rents are significantly above mortgage payments.

All in all, the multifamily market continues to perform above average through 2018 and is expected to follow similar growth trends in 2019. Strong rent growth and relatively low vacancy rates will support property price growth, which may be offset by higher cap rates. While demographic and lifestyle preferences are creating robust demand for multifamily rental units, the affordability constraint on ownership will also support rentership. Overall, we expect 2019 to be another strong year for the multifamily industry.

For more insights from the Freddie Mac Multifamily Research team, visit https://mf.freddiemac.com/research.