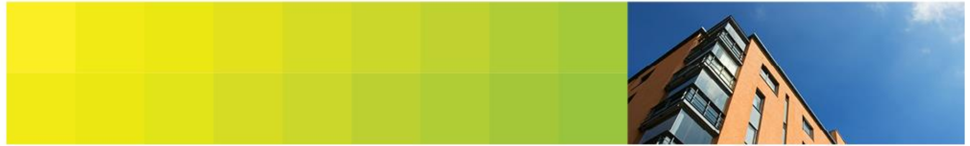
2020 Outlook

Multifamily Research Center

Freddie Mac
MULTIFAMILY



Multifamily 2020 Outlook

Performance in the multifamily market remained strong during 2019 and is expected to continue into 2020, but with more modest growth in comparison with recent years.

- The multifamily market is expected to finish 2019 with solid rent growth and only modest increases in vacancy rates despite an elevated level of new supply. Some slowing in individual markets is evident, but the overall multifamily market remains healthy.
- Multifamily construction continues to surpass the pre-recession average and based on permits and starts that are already underway new supply will remain elevated through 2020 and into 2021. Demand is expected to remain robust due to demographic and lifestyle preferences, but with the continued level of elevated supply, rent growth could moderate and vacancy rates may increase slightly in 2020.
- Cap rates remained relatively flat throughout 2019, and property prices continued 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 $369 billion in 2019, up 8.8% from 2018, and is projected to grow to $390 billion in 2020, an increase of 5.7%.

2019 in Review: Strong but Moderated Growth

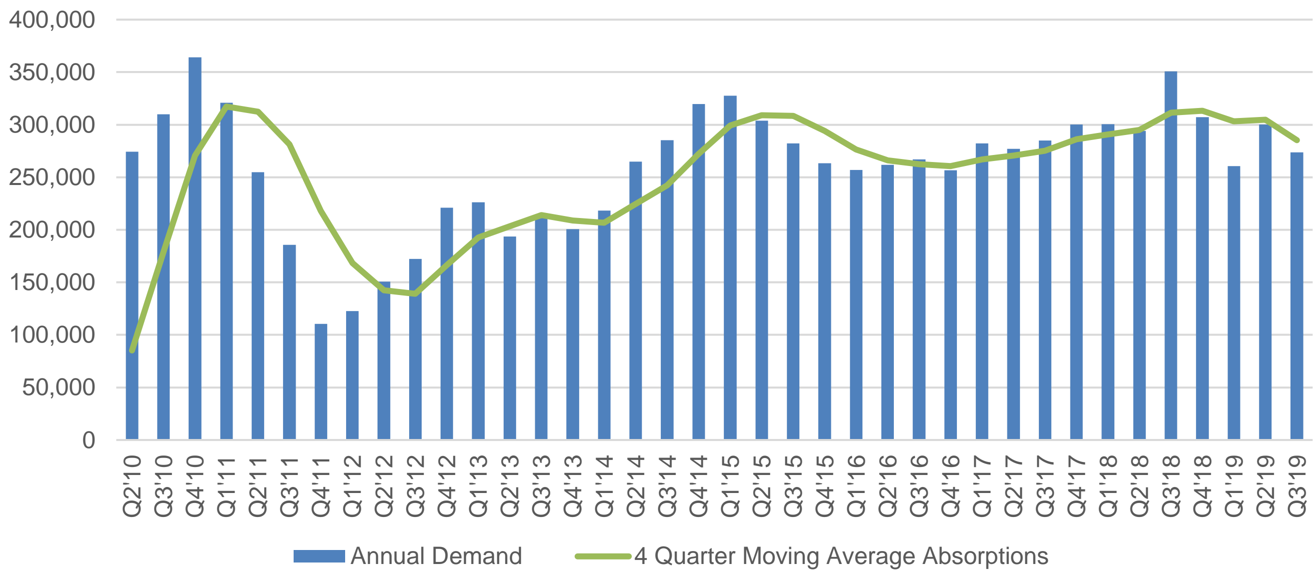
Performance in the multifamily market remained strong through 2019, despite elevated levels of new supply entering the market. Vacancy rates at the national level have held steady over the year, easing worries of a significant fall in occupancy given the high number of units delivered. Rent growth remains healthy at the national level and in most major metropolitan areas. However, rent growth is more moderate than 2018, in line with 2016 and 2017 levels, but remains above the historic average (1990-2018) of 3.4%, according to Reis. These dynamics vary across individual markets, but any local market softness is expected to be short lived as new supply is absorbed.

The economy added 2.1 million jobs in the 12 months ending December 2019 – in line with 2017 but short of the 2018 total of 2.7 million. The unemployment rate continued to tighten over the year, down 50 basis points (bps) from the start of the year to 3.5% as of December 2019, matching the lowest level in 50 years. The tight labor market will support higher wages, which is reflected by the 2.8% annual growth in the Employment Cost Index as of the third quarter 2019. These gains are above the average for the past nine years but are lower than anticipated for a labor market with an unemployment rate of 3.5%. Earlier in the year there was concern of an imminent recession, indicators included an inverted two- and 10-year yield curves, an unexpected 10 bps uptick in the June unemployment rate, and a volatile and declining stock market. Job growth also slowed, averaging 138,500 additional jobs per month from February through July, well off the 2018 average of 223,000 monthly job gains. However, the economy improved over the second half of the year with job growth bouncing back, the unemployment rate resumed its decline, and the stock market is up significantly since that time. Starting in July the Federal Reserve cut rates 25 bps three times, down to a target rate of 1.5% - 1.75%. While these rate cuts came too late in the year to significantly boost the economy in 2019, they could provide a lift in 2020.

A possible result of the economic volatility is the trend of robust household formations moderated through the third quarter of 2019, with 1.4 million new households formed over the previous 12 months, as reported by the U.S. Census Bureau. Owner-occupied households outpaced renter-occupied household formations, causing the homeownership rate to increase to 64.8%, up 40 bps from a year earlier. Data indicates renter-occupied households decreased 18,000 annually as of the third quarter 2019. However, this data does not distinguish

between multifamily and single-family rental-occupied units. *RealPage* data captures the multifamily rental segment of the market and reported healthy apartment absorptions averaging about 285,000 units over the past year. Absorption figures over the past year have been volatile, as seen in Exhibit 1. The sharp drop in the first quarter of this year may have been a combination of seasonality and falling interest rates enticing households to purchase a home. Since that time absorptions have rebounded despite continued mortgage rate declines but are trending below 2018 levels.

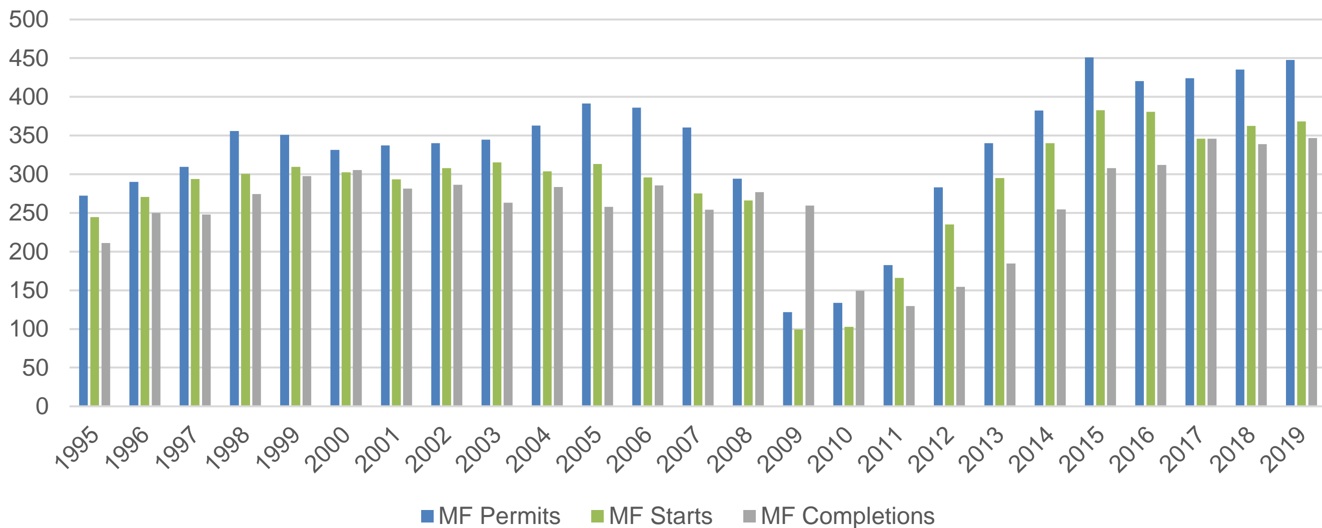
Exhibit 1: Annual Multifamily Absorptions



Sources: RealPage, Freddie Mac

According to the U.S. Census Bureau, as of the third quarter 2019, multifamily completions in five-plus unit dwellings increased slightly in 2019 compared with 2018, up only 2%. The U.S. Census Bureau reported permit growth is up about 3%, while starts are up 2%, as shown in Exhibit 2. Though data for 2019 is not yet complete, the increased permits and starts indicate that the supply will remain elevated for at least the next few years.

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



Sources: Freddie Mac, Census Bureau, Moody's Analytics. Note: 2019 annualized 3rd quarter data.

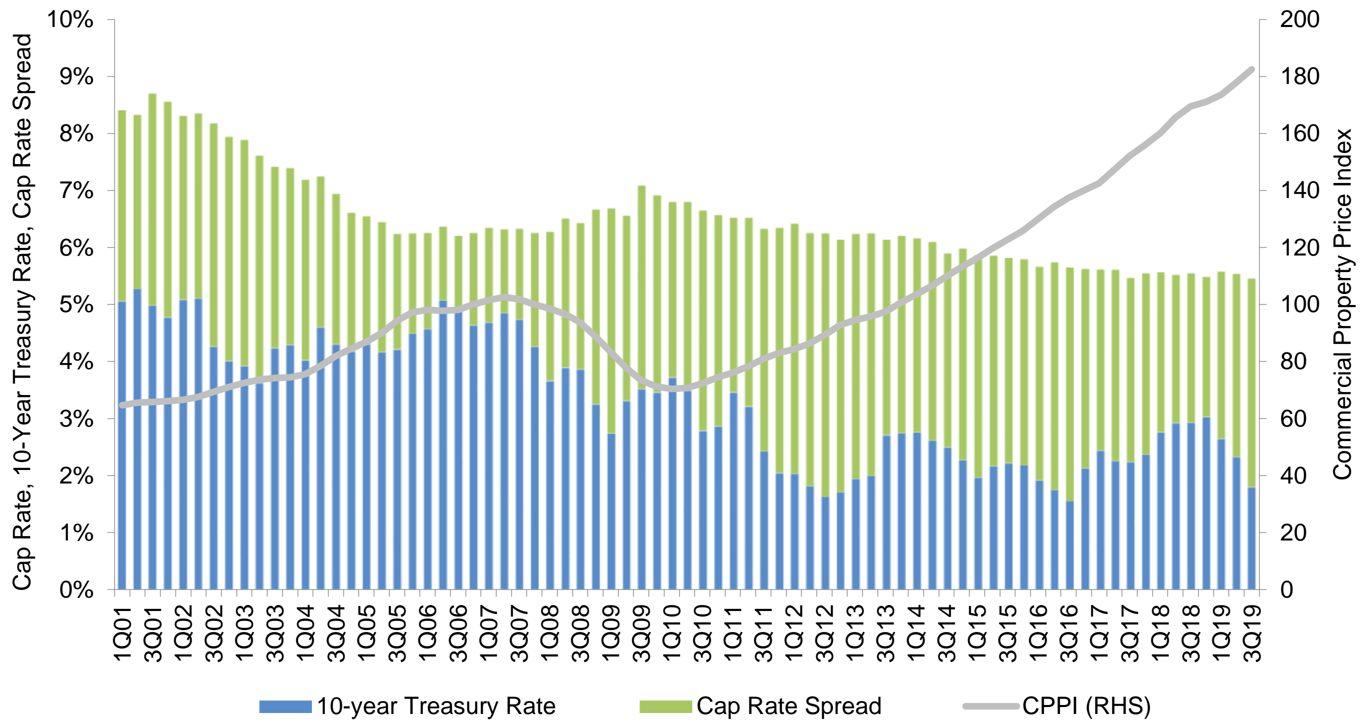
Vacancy rates, while generally increasing from the very low levels of a few years ago, have increased at a modest pace. Vacancy rate data differs across vendors, as of the third quarter 2019, but generally follow the same trend. *Reis* reported a national vacancy rate of 4.7%, which is unchanged from a year ago, *Yardi* reports the vacancy flat at 5.6%, and *RealPage* reports vacancies contracted 40 bps to 3.7%. All three of our data sources show stable or contracting vacancy rates with most below 5% indicating a healthy market. *REIS* forecasts 2019 vacancy rates will end the year at 4.9%, up just 10 bps over the year.

Rent growth continues to come down from cyclical highs but remains strong. *REIS* reported effective rent growth of 4.1% annually as of the third quarter 2019, down 110 bps from 2018 reported growth. *RealPage* reported weaker rent increases of 3% over the same period but these declined only 30 bps from 2018 growth. Rent growth has been resilient over the past few years and remains above the historical average, and well above the annual inflation rate of 2.1% reported by the Bureau of Labor Statistics.

At the end of 2018, the 10-year Treasury Rate was relatively high, which caused cap rate spreads to compress to their lowest level since 2007, down to 250 bps. The compression came from cap rates remaining relatively unchanged during the Treasury Rate swings. As of the third quarter 2019, with interest rates declining during the year and cap rates remaining flat at 5.4%, the cap rate spread has widened out 110 bps to 360 bps; above the long-run average of 320 bps going back to 2001, according to Real Capital Analytics (RCA) shown in Exhibit 3. However, this period captures largely the post-recession period where cap rates widened out considerably after the Great Recession as interest rates declined quickly. Using ACLI data back to 1965, the cap rate spread average is much lower at 220 bps. Given that the current cap rate spread of 360 bps is well above the longer term average, we could see cap rates continue to decline if interest rates remain low.

With consistently low cap rates and solid market fundamentals, apartment price appreciation remained healthy in the past few quarters, albeit, moderating somewhat as compared with the prior few years. As of the third quarter of 2019, prices grew 7.7% over the past 12 months, according to Real Capital Analytics.

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



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

Last year saw more legislation around new or reformed rent regulation laws as a remedy to the problem of high rental housing costs. Rent regulation legislation introduces additional risks to the multifamily market in the form of decreased supply – further impacting the housing shortage which is a major underlying cause of the rent increases, deterioration of units (since owners will be less likely to keep up units subject to these regulations) and reduced investor demand for rental properties in those areas. As more localities consider such legislative actions, these risks could impact their local multifamily markets going forward.

2020 and Beyond: A Healthy Market with Some Economic Questions

The current trajectory of the economy does not indicate any looming headwinds in 2020 that would cause major disruption to the multifamily market. However, there are some economic uncertainties that may play a significant role in the national economy. The largest and most publicized of these unknowns is the ongoing trade conflict with China, which is estimated to have reduced gross domestic product (GDP) by an estimated 0.4%, according to Moody's Analytics, through third quarter 2019. [1] Furthermore, the past 12 months has seen a decline in both consumer confidence and business investment. The Consumer Confidence Index is down 7% for the year ending November 2019, and business investment has declined over 14% annually, as of September. The baseline economic scenarios we use to forecast multifamily performance do not incorporate these potential issues but if they do occur, they will impact the broader economy and likely create different outcomes for the multifamily market than anticipated.

While there are several economic uncertainties that could impact the broader economy, we believe the most likely scenario for 2020 is one of economic stability and continued growth in the multifamily market. Demand for housing is expected to remain robust, specifically for apartment rentals, which will continue to spur the

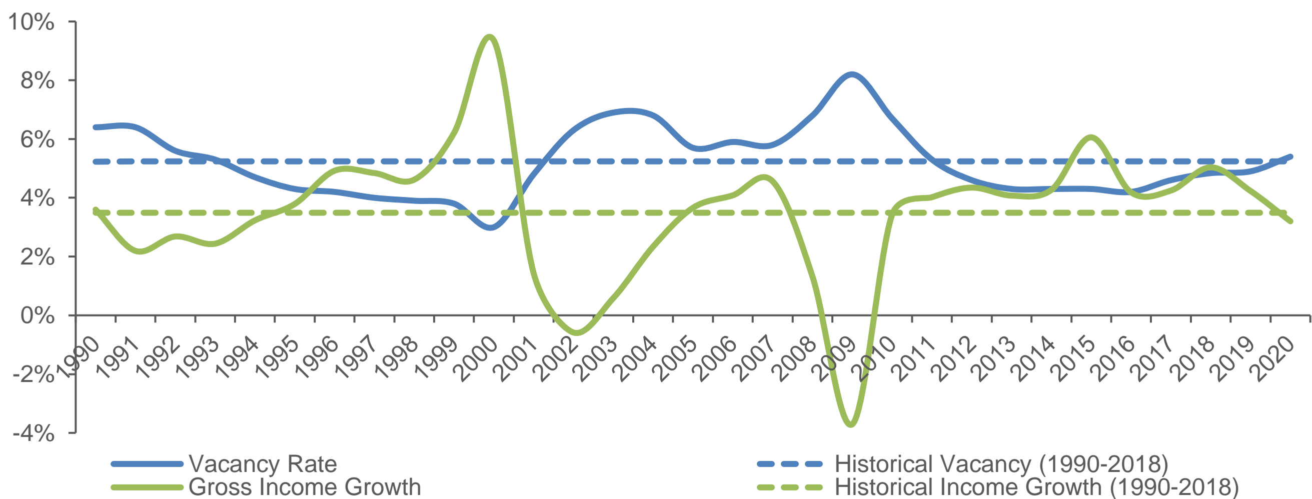
[1] https://www.economy.com/dismal/analysis/commentary/377455/US-Macro-Outlook-Two-Economies/

construction of multifamily units. New unit deliveries are expected to remain elevated for the next few years due to construction already in place. The high level of permits and starts in the last few years indicates that developer confidence is high in the multifamily market. *RealPage*, which reports on larger, institutional investor-owned buildings, forecasts annual completions of apartment units to increase, totaling 340,000 units over the next 12 months, above the 300,000 annual average seen going back to 2016.

Supply is expected to moderately outpace absorptions throughout 2020, causing vacancy rates to increase 50 bps up to 5.4%, as seen in Exhibit 4. Expectations are for demand to cool slightly compared with the elevated levels seen over the past few quarters due to lower forecasted employment growth. As a result, we could see vacancy rates move above the long-run average by 2020. However, for the past few years we have seen absorptions consistently outperform expectations due to acute changes in lifestyle and demographic preferences. At the same time, new supply is consistently delayed or taking longer to be constructed. Both of these factors have contributed to stronger performance than anticipated in the past and has the potential to continue in 2020.

Rent growth is expected to remain healthy in 2020, growing 3.6% just above the historical average. *RealPage* and *Yardi* project annual rent growth for 2020 to come in around 2.5% – while lower, this still portrays a healthy market and growth above the target inflation rate of 2%[2] and forecasted inflation rate of 2.2%[3]. The increasing vacancy rate is projected to cause income growth to moderate as landlords and managers balance rent growth and occupancy. As a result, we forecast gross income growth of 3.2% in 2020, falling just below the historical average.

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



Sources: Reis, Freddie Mac projections for 2019 and 2020

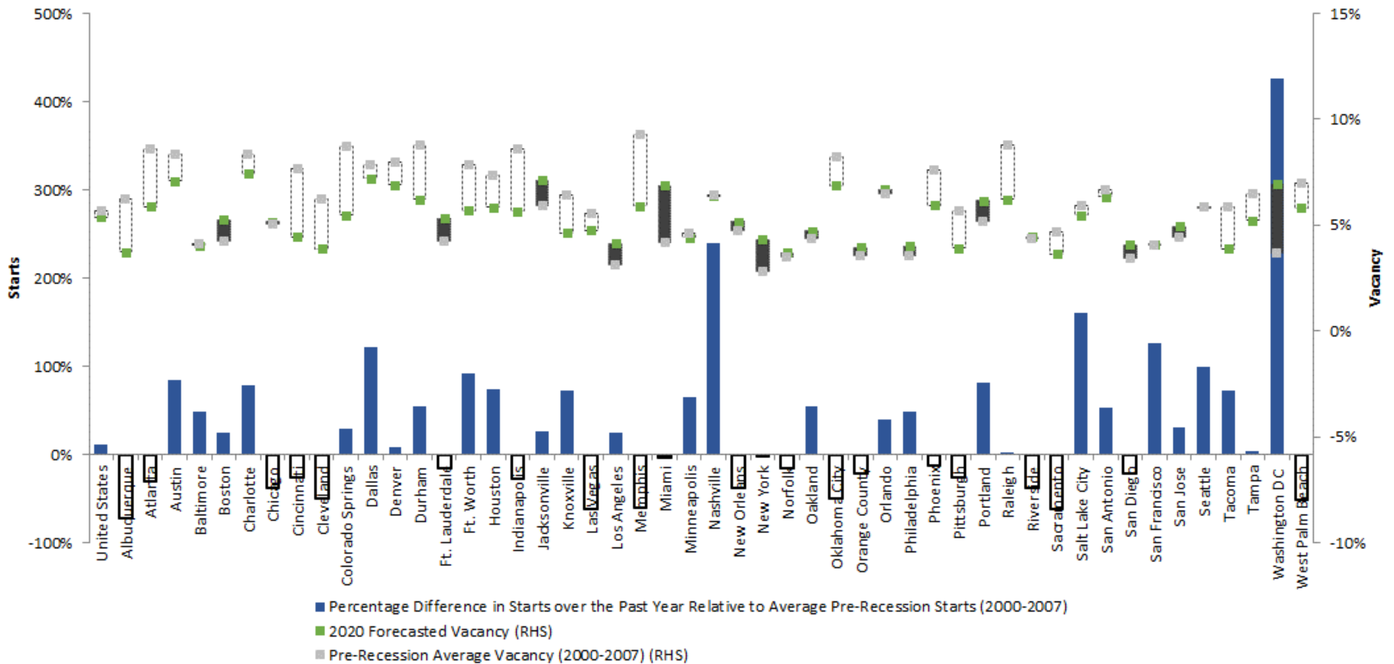
At the metro level, construction remains above pre-recession levels, but in the majority of cities vacancy rates are forecasted to remain below the long-run average; a similar dynamic to the prior few years. There is no change among the top two metros with the highest level of construction starts compared with historical averages; Washington, D.C., representing only the District of Columbia, remains the highest followed by Nashville. By this measure Salt Lake City has the third highest level in the country. Overall, the cities that saw the largest increase in the number starts include Houston, Orlando and Tampa. On the flip side, Los Angeles, Oakland and San Diego have seen the largest decreases in construction starts over the past year.

High levels of construction do not translate into declining performance if there is enough demand to meet the elevated supply levels. In Exhibit 5 we use the average pre-recession vacancy rate compared with the forecasted

[2] Set by the Federal Open Market Committee (FOMC)
[3] Forecasted CPI: All Items from Moody's Analytics

rate as a proxy for how well the metros could absorb the new supply. We forecast that 57% of metros are expected to see vacancy rates remain below average, indicating they are in a good position to absorb most of the new supply. Our forecasts suggest that vacancy rates will move above their pre-recession average throughout the year in several metros, such as Jacksonville and Oakland. Whereas in a few metros, such as Baltimore, vacancy rates may contract as supply slows and absorptions catch up, pushing the vacancy rate to slightly below the pre-recession average.

Exhibit 5: Multifamily Starts and 2020 Forecasted Vacancies Relative to History

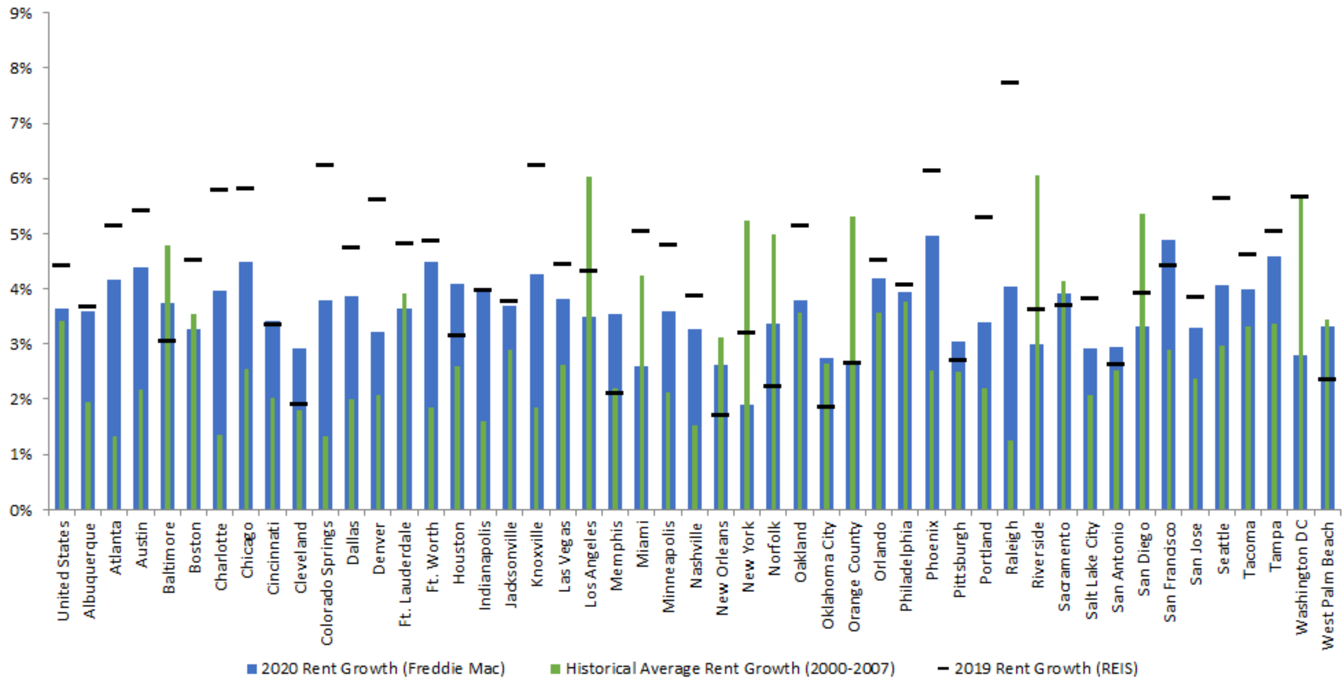


Sources: Reis, Moody's Analytics, Freddie Mac projections

Rent growth is expected to moderate in 2020 but remain above pre-recession averages in the majority of the markets, shown in Exhibit 6. Areas such as Atlanta, Raleigh, Fort Worth, Charlotte and Colorado Springs are expected to see rent growth well above their long-run average next year due in part to low vacancy rates combined with strong demand, even though in each area rent growth is projected to be lower in 2020 than 2019. Additionally, Memphis, Norfolk, Cleveland and West Palm Beach are expected to experience a meaningful increase in rents in 2020 as compared with 2019.

Meanwhile, markets with rent growth expected to come in well below their pre-recession average and lower than 2019 include New York City (5 Boroughs), Riverside, the District of Columbia, Orange County, Los Angeles and San Diego. Some of these areas are experiencing high levels of new supply entering the market causing vacancy rates to increase above their pre-recession average. As a result, rent growth has slowed and is expected to remain below their pre-recession average into 2020. We expect some moderation and pockets of slowness to continue into 2020 within metros that have the greatest amount of new supply, causing vacancy rates to increase and rent growth to slow.

Exhibit 6: Rent Growth in 2020 and 2019 Relative to History



Sources: Reis, Freddie Mac projections

In 2020, we forecast San Francisco to have the highest gross income growth followed by Chicago. The sunbelt region continues to perform well with five cities among the Top 10. The remainder of the Top 10 is populated by Seattle, Philadelphia and Knoxville. Overall the growth rates for the Top 10 metros are generally lower than in the previous few years.

Exhibit 7: Top 10 Metros by Gross Income Growth for 2020

Metropolitan Area	2020 Annualized Growth in Gross Income	2020 Vacancy Rate
San Francisco	4.6%	4.1%
Chicago	4.5%	5.2%
Tampa	4.4%	5.2%
Phoenix	4.0%	6.0%
Ft. Lauderdale	3.8%	5.3%
Seattle	3.8%	5.9%
Albuquerque	3.7%	3.7%
Philadelphia	3.7%	4.0%
Knoxville	3.6%	4.6%
Las Vegas	3.6%	4.8%
United States (Top 70 metros)	3.2%	5.4%

Source: Freddie Mac projections

San Francisco is fueled by an exceptionally strong economy leading to robust income growth. The vacancy rate is in line with the historical average with only moderate levels of new supply, which the market is poised to absorb, with rent growth above the historical average. Chicago has the second highest projected revenue due to strong income growth, along with relatively few starts compared with the historical average. The supply is being met with enough demand keeping vacancy near the historical average, all of which are leading to above-average rent growth.

Albuquerque is a story of limited supply propelling it into the Top 10 of gross income growth cities. The underlying economy does not stand out like the other sunbelt metros, with population, employment and income growth rates all trailing the national average. Starts in the metro area are limited which has led to vacancy rates well below the historical and national averages. However, rent growth has been moderate and the strength of this metro lies in its declining vacancy rate and limited new supply. We believe the market will perform well in the short term but then will revert toward its long-term average.

The other sunbelt cities Tampa, Phoenix, Ft. Lauderdale and Las Vegas all share similar characteristics:

- Strong employment growth
- High population growth – more than double the national average
- Income growth above the national average
- Rent growth equal to or higher than their pre-recession average
- Starts below their pre-recession average

These sunbelt metros typically were late to recover from the Great Recession and the multifamily construction boom seen elsewhere largely passed them over. From 2015 through third quarter 2019 across these five sunbelt cities, quarterly deliveries were 3.2% below their long-term average, measured from 1990 through third quarter 2019. Over that same period, nationwide deliveries were 16.6% higher than the long-term average. These markets tend to be heavily dependent on tourism and retail, job sectors which are closely correlated to the overall strength of the economy. With relatively strong local economies based on current economic conditions, along with limited new supply, these markets are predicted to have strong multifamily performance in 2020.

Seattle has reentered the Top 10 due to the strength of its economy. It is an example of a strong market temporarily slowed by a glut of new units hitting the market which took time to be absorbed. While Seattle continues to see elevated levels of new supply, population, employment and income growth are all well above the national average, helping drive expected income growth up in 2020.

The Philadelphia economy has been performing well recently, as compared with its long-term averages. The apartment market is generally seen as stable, with moderate rent growth and low vacancy rates. Recently the market has picked up, and absorptions for 2019 are at record levels according to RealPage. This led to vacancy rates below the historical average increasing landlord's pricing power. We expect the market to return to its more modest norms, as the local economy trails the national averages in population, employment and income growth.

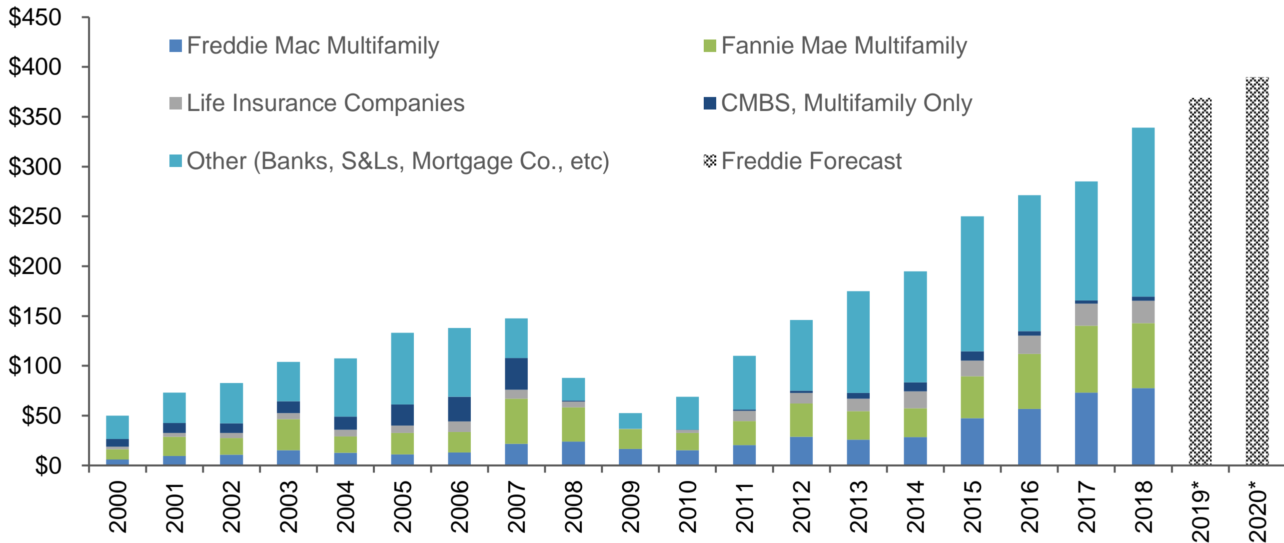
Knoxville's economy has been relatively strong over the past few years, with most measures better than the national average. The apartment market has been relatively strong as well with vacancy and rent growth better than the historical average. The relatively strong income growth in the area is projected to fuel gains in the apartment market in the near term. While the market is more volatile than others due to the high proportion of students in the area, the recent strength has propelled the market into our Top 10 for 2020.

Origination Market Forecast

The most recent data available on multifamily origination volume exceeded expectations. Volume in 2018 came in at $339 billion, as reported by the Mortgage Bankers Association (MBA). This represented an 18.9% increase over the prior year. Due to strong fundamentals and demand for multifamily investments, we expect to see continued growth. Actual volume for 2019 will not be available until later in 2020, but our expectations are for total origination volume in 2019 to rise by 8.8% to $369 billion. Low interest rates and continued strong multifamily performance are expected to help multifamily origination volume grow. We forecast volume in 2020 to increase

by 5.7% to $390 billion. The wide cap rate spread compared with the longer term historical average and strong investor demand leads us to believe that cap rates have further room to decline, which combined with strong market fundamentals will lead to increasing property values over the short term, driving up origination volume.

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



Sources: Mortgage Bankers Association, Freddie Mac projections
Note: 2019 and 2020 results are projections as of December 2019

The multifamily market performed well throughout 2019, and while there is the potential for some slowing in the market in comparison with the past few years it should remain healthy through 2020. Rent growth will moderate and vacancy rates are expected to increase modestly. The potential for lower cap rates combined with solid market fundamentals could lead to an increase in property values and higher origination volumes. While lifestyle preferences and demographics are creating strong demand for multifamily rental units, the lack of for-sale housing inventory at lower price points is also keeping potential home buyers in rental units. Given the nationwide undersupply of housing, and an economy that is projected to maintain positive growth we do not see any short-term obstacles that would cause a significant downturn in the multifamily market.

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