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Multifamily Outlook Second Half 2015

Executive Summary

As a large wave of multifamily supply enters the market in 2015, the multifamily sector remains robust but with growing dispersion across geographic markets.

Favorable Market Conditions

Key drivers are expected to keep the multifamily market moving forward in 2016.

- Multifamily rental demand in 2015 has been stronger than anticipated and will remain strong into the foreseeable future.
    - Favorable demographic trends, strength in the job market, and reduced affordability of owning a home will continue to fuel the strong demand for multifamily rental units.
    - Because of the improving economy, pent-up demand has started to release into the market, largely benefiting the rental sector. We expect the strong demand for multifamily units to continue in the years to come.
    - As more supply enters the market, fundamentals will moderate but are not expected to significantly deteriorate. Vacancy rates will increase but remain below 5 percent and gross income growth will decrease to around 2.5 percent by year-end 2016.
- Multifamily completions saw a spike in the first half 2015, mostly in the second quarter; 285,000 units, annualized, entered the market, the highest level post-recession. The wave of new multifamily supply is expected to remain elevated over the next few years, considering construction permits rose again in 2015.
- The labor market continues to grow but, despite a low unemployment rate of 5.1 percent, some softness still exists based on low wage growth and elevated underemployment.
- Strong multifamily property price growth has been driven by investor confidence in the multifamily market, strong fundamentals and availability of capital.

- Favorable multifamily investment opportunities along with a high volume of loans reaching maturity in the near term will continue to push origination volume up into 2016.

Supply, Oil Price, and Net Migration at the Geographic Market Level

For the majority of markets, vacancy rates trended upward but kept increases smaller than originally predicted in 2015. Rent growth is more mixed across markets and will further disperse as new supply enters the markets.

- Our top 10 list of metros based on 2016 gross income growth is dominated by West Coast markets, the only exceptions being San Antonio and New York.
- Only three markets have vacancy rates forecast to be meaningfully above the long-run average in 2016: Washington, D.C., Austin, and Norfolk.
    - Washington, D.C. and Austin will experience declining rent growth and rising vacancy because of the large amount of new supply expected in the short term. If these areas can continue to provide strong job growth, the impact will be minimal and short-lived.
- The Houston multifamily market is among those at the greatest risk of economic impact from low oil prices.
    - The Houston economy has slowed down and job growth has dipped below the national average. With oil prices remaining low longer than anticipated at the beginning of the year, we anticipate further slowdown in this market as a result of additional job cuts and decline in investments.
    - Because Houston now has a more diversified local economy, we anticipate the impact to be moderate but less severe than the 1980s oil bust or the Great Recession.
- Net migration patterns in the past year have suggested stronger foreign migration into larger cities, while domestic movers prefer warmer, more affordable areas with healthy economies.

Special Analysis: Multifamily Investment Index

The Freddie Mac Multifamily Investment Index measures the relative value of investing in multifamily properties and can be used by potential buyers to understand current conditions. The Index is reported at the national level and for 13 metros.

- Over the past few quarters, the Multifamily Investment Index has declined because of higher growth in property prices compared to net operating income (NOI); the current Index is near the historical average as of second quarter 2015.
- Investment opportunities vary at the metro level; metros that have had high property price appreciation, such as New York City and San Francisco, typically have Index values below their historical average. Meanwhile, metros with less property price appreciation, such as Philadelphia and Phoenix, have Index values above their historical averages.

Multifamily Outlook Second Half 2015

- The multifamily rental housing market started 2015 strong, despite a wave of new supply.
- Multifamily supply will continue to enter the market at elevated levels, reaching the highest level of completions since the 1980s.
- Performance at the national level will remain strong, but for some individual markets increasing supply and low oil prices will impact multifamily fundamentals.
- Net migration patterns among the major markets indicate more domestic movers are attracted to warmer areas with more affordable housing and strong economies, whereas foreign migrants prefer the larger cities.
- The Freddie Mac Multifamily Investment Index has steadily declined over the past few quarters as the growth in multifamily property prices outpaces net operating income (NOI) growth.

The multifamily rental market is in its sixth straight year of robust growth. Demand has kept pace with new supply hitting the market, calming concerns that growth might start to decelerate. It is now clear that the nature of demand is more than a temporary correction stemming from the Great Recession. Favorable demographic trends will support strong multifamily growth into the foreseeable future for the nation as a whole. However, some individual metros are starting to see the impacts of an imbalance between supply and demand.

Demand for rental housing will remain strong for several more years because of a strengthening job market, growth of household formations, and reduced affordability of owning a home. We expect the labor market will add more than 2.5 million jobs in 2015. As a result, household formations will continue the upward trend that began at the end of 2014. While both owner and rental sectors benefit from the growth in households, the declining homeownership rate indicates that the rental sector is benefiting more from this trend. One of the contributing factors is that affording homeownership remains a challenge for many households, especially for many first-time buyers.

Section 1 – Multifamily Market Drivers

The economy continues to improve steadily, with a few speed bumps along the way. After another brutal winter, predictions for 2015 gross domestic product (GDP) have been revised downward. GDP came in at a disappointing 0.6 percent for first quarter 2015 but rebounded in the second quarter to 3.7 percent. GDP is expected to grow around 2.4 percent for the year, rather than around 3 percent as originally predicted. While below original predictions, it is still similar to the growth rate achieved in 2014. Recent global developments, from Greece to China, have increased volatility in the financial markets, which can make assets like real estate relatively attractive.

Full Employment Remains Elusive

A respectable 1.7 million jobs were added this year through August. At the same time, the unemployment rate continued to decline, ending August at 5.1 percent, the lowest since March 2008. Many market participants believe that this low of an unemployment rate meets the Federal Reserve's requirement of full employment. Several other factors also indicate a strengthening labor market. The number of people changing jobs has been trending up, which can be considered a proxy for opportunities to improve earnings, and the number of job openings is at its highest since the data started being reported in 2000. However, the labor force continues to experience some volatility and headwinds; such as temporarily elevated layoffs, underemployment, and wage stagnation.

In August, unemployment dropped to 5.1 percent; despite the strong gains throughout the year, underemployment and stagnant wages still hold back the economy from attaining full employment.

The August 2015 Challenger Report counted 434,554 announced layoffs so far this year, compared to 332,931 during the same time period in 2014. The majority of the layoffs this year have been in the energy and government sectors. Job losses in the energy sector have eased from the high levels seen at the beginning of the year but remain elevated. However, with oil prices remaining low longer than originally anticipated, the energy sector could see more cuts in the near future. Meanwhile, the government sector saw a large number of layoffs in July, largely based on a draw-down of U.S. Army troops and civilian personnel. The Army layoffs will be spread out over the next two years and large military cuts are not expected to be as frequent, so this does not represent an upward trend in military job layoffs.

While some of the recent layoffs can be considered temporary, two main factors still prevent a full recovery of the job market: underemployment and wage stagnation. Underemployment, which includes people who work part-time for economic reasons[1] and those who currently are not working but want a job, still accounts for

[1] Reasons to be forced to work part-time include slack work or unfavorable work conditions, inability to find full-time work, or seasonal declines in demand.

about 1 percent of the labor force. Moody's Analytics forecasts that the economy could take up to another year to fully absorb those underemployed.[2]

Another barrier is wage stagnation. Despite the improved employment rate, wage growth has yet to rebound to pre-recession levels. The Employment Cost Index (ECI), which measures changes in labor costs, has remained near historic lows. The ECI for total compensation -- wages, salaries, and employer costs for employee benefits -- was just under 2 percent for the trailing 12 months ending June 2015. This is a setback from the prior four quarters, when annual growth exceeded 2 percent and seemed to be on an upward trend. Even so, market consensus considers ECI growth too low to support the mid-term inflation target of 2 percent. Wage growth has been slow to rebound in the post-recession recovery, but strong job growth and low unemployment should put upward pressure on wages.

Household Formations Trending Toward Rental Housing

Demand for rental housing continues to be strong, while the homeownership rate declined to 63.4 percent, the lowest level 1967.

Along with the strengthening economy, household formations ramped up significantly at the end of 2014 and the first half of 2015. The majority of newly formed households chose rental housing, a consistent trend since 2007, as shown in Exhibit 1. Since then, the total number of renter households has grown by 8.3 million, or an average of 980,000 a year. The growth in renter households reflects new households deciding to rent along with a growing number of households leaving homeownership. From 2007 through second quarter 2015, the number of owner households decreased by 2.1 million, or an average of 251,000 a year. Consequently, the homeownership rate continued to slide and hit a new low of 63.4 percent in second quarter 2015.

The results are in line with our 2014 Mid-Year Outlook[3], in which we projected strong renter household growth. We calculated that more than 3.9 million potential households that would have formed in a stronger economy went unformed. Most of the pent-up households are young adults, with a strong propensity to rent. With improving labor market conditions, pent-up demand is beginning to release, largely benefiting the rental sector. Given demographic demand drivers, formation of renter households is expected to remain strong for the foreseeable future.

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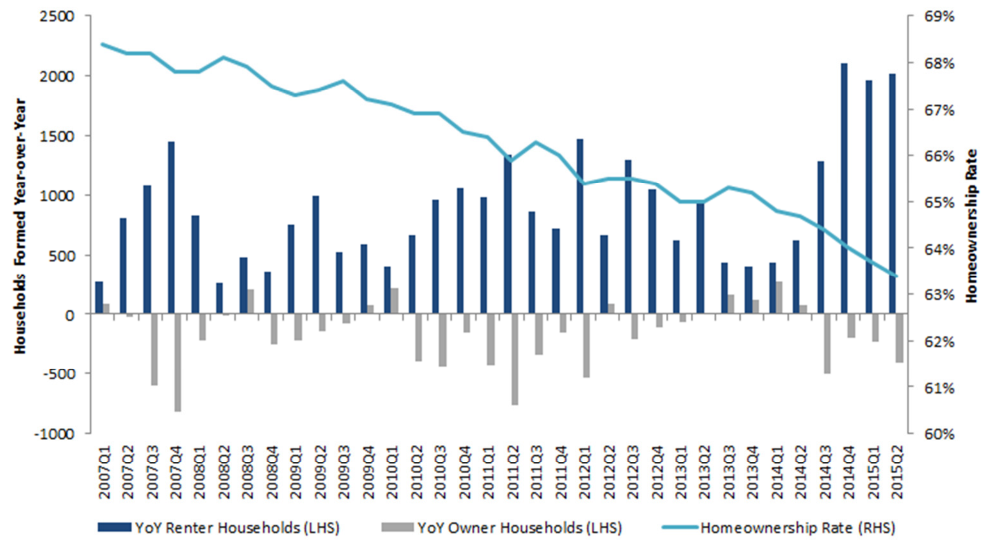
[2] "U.S. Macro Outlook: More Birthdays for the Expansion" https://www.economy.com/dismal/analysis/commentary/255987/US-Macro-Outlook-More-Birthdays-for-the-Expansion/

[3] http://www.freddiemac.com/multifamily/pdf/2014_multifamily_mid_year_outlook.pdf

Exhibit 1 - Annual Renter and Owner Household Formations and Homeownership Rate (2007Q1 - 2015Q2)



Sources: U.S. Census Bureau, Freddie Mac

Multifamily Performance Remains Strong

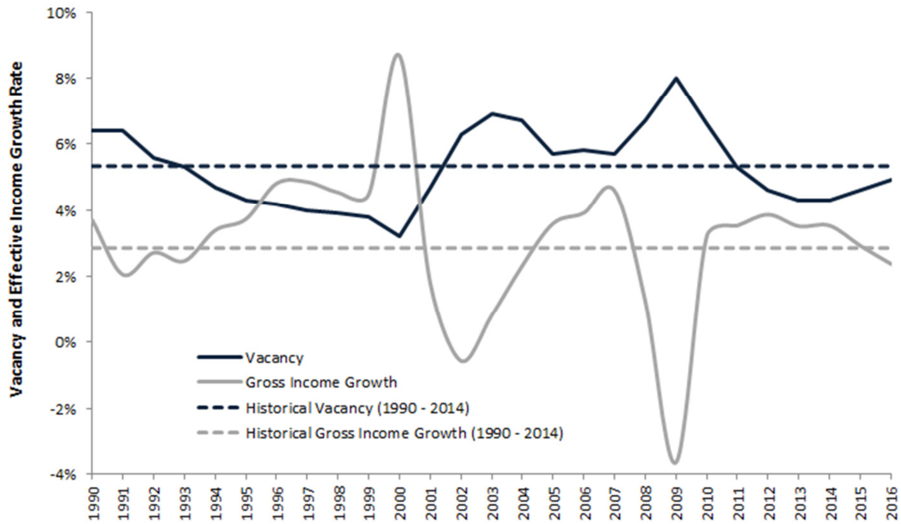
As a large wave of new supply starts to enter the market, vacancy rates will increase but remain below 5 percent through 2016, while gross income growth will dip below the long-run average, temporarily, to 2.4 percent.

The growth in renter household formation over the past few quarters has supported robust multifamily performance. At the end of second quarter 2015, the national vacancy rate remained very close to historical lows, bouncing between 4.2 and 4.3 percent, according to REIS. Rent growth also remained strong, rising 3.7 percent year-over-year.

Through the rest of 2015 and into 2016, supply will start to catch up to demand as a surge in multifamily completions enters the market. Vacancy rates will increase slightly to 4.6 percent by year-end and to 4.9 percent by the end of 2016. Despite the increases, vacancy rates are expected to remain below the historical average of 5.4 percent, as shown in Exhibit 2.

At the same time, rent growth will moderate, mainly in 2016, as new supply is delivered and inhibits landlords' ability to increase rent. As a result of increasing vacancies and moderating rent growth, gross income growth will remain slightly above the long-run average through 2015 at 2.9 percent nationally, but could slip below the average by 2016 to 2.4 percent. Given the strong demand for multifamily units, the decline in gross income growth is not the start of a downward trend but a leveling out from above-average growth seen in the past few years. Strong growth is expected to continue for several years, despite some volatility along the way. Vacancy rates and income growth will continue to converge toward historic norms over the next few years.

Exhibit 2 - Vacancy Rate and Gross Income Growth, History and Forecast



Sources: REIS, Freddie Mac projections

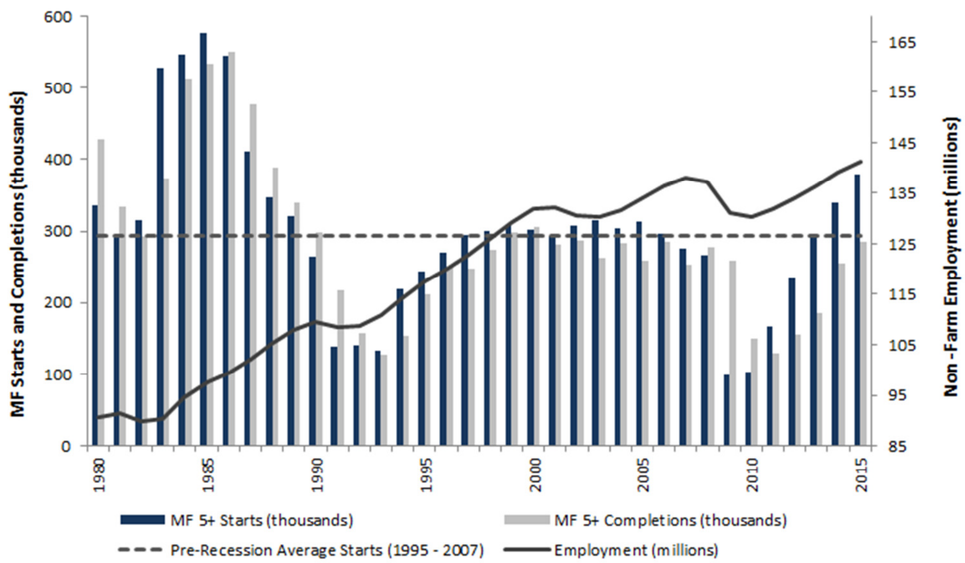
Multifamily Supply Wave Hits the Market

Although multifamily completions have increased steadily since the Great Recession, the magnitude of new supply that has come online so far in 2015 is much greater than anything seen over the past few years. Exhibit 3 shows that the annualized number of completions in just the first half of 2015 was 285,000 units, 35,000 more than were added in 2014.

Moreover, multifamily permits increased nationally by 52,000 year-over-year, surging in the first half of 2015 to the highest level since 1986. However, the surge is in part attributed to an expiring tax break in New York, which drove many developers to obtain building permits before the end of June. Of the 52,000 incremental units, 31,000, or 60 percent, were in three New York counties: Kings, Queens, and New York (Manhattan). The situation in New York City aside, the elevated levels of multifamily construction are a testament to investors' confidence in the multifamily sector.

Increasing multifamily permits indicate that construction starts and completions will remain elevated for several more years. Although demand also will remain elevated, we expect vacancy rates to tick up slightly and rent growth to slow down in the short term, before markets reach equilibrium near historical average levels. (See Section 3 of this report for details on the impact of supply in individual markets.)

Exhibit 3 - Multifamily Starts and Completions (5+ Units) and Employment



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

Property Valuations Exceed Expectations, Interest Rates Remain Low

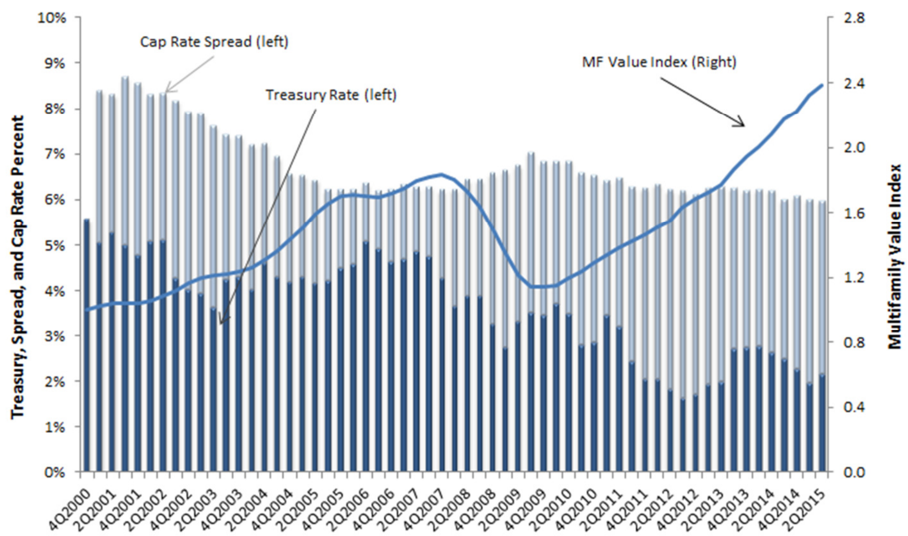
According to Real Capital Analytics (RCA), multifamily property prices increased 15 percent year-over-year in second quarter 2015. Property values have increased on average 15 percent per year since fourth quarter 2010. This growth is propelled by investors' growing appetite for multifamily investments and strong property fundamentals. The increase in capital available also contributes to property price appreciation as more investors are drawn to the high returns. This indicates that investor confidence in multifamily properties remains high, even with the increased construction.

Despite the volatile 10-year Treasury rate over the past six months, cap rates have remained around 6 percent and are expected to remain relatively unchanged through most of 2015.

Despite the large gains in property prices and volatile interest rates, capitalization rates (cap rates) have remained relatively unchanged at around 6 percent over the past several quarters. According to RCA, transactions completed in the first half of 2015 had, on average, a lower cap rate than transactions in 2014. This results from a combination of high investor confidence and shifting concentration of deals. In the first half of 2015, more transactions were concentrated in fewer markets than in 2014. In 2015, 65 percent of property sales were in metros with an average cap rate below 5 percent, compared to only 41 percent in 2014. In particular, Washington, D.C. saw lower average cap rates and a large increase in volume in the first half of 2015. This indicates that investors remain confident in the area's ability to provide a favorable return, despite the level of multifamily construction. Furthermore, property price appreciation in D.C. increased in the first half of 2015 after a year of no appreciation growth.

Cap rates also remained relatively unchanged in the face of some volatility in Treasury rates this past year, as shown in Exhibit 4. Through the end of 2014 and into the first few months of 2015, the 10-year Treasury dropped 50 basis points (bps) to 1.9 percent. Rates then increased 40 bps to 2.3 percent in July and since then have fallen 10 bps. Cap rates are less volatile than Treasury rates, and multifamily valuations are benefiting from strong investor demand and strong fundamentals. Also, because of the wide cap rate spread of 380 bps, cap rates have room to absorb some interest rate movement.

Exhibit 4 - Multifamily Value Index, Cap Rate Spread and Treasury Rate



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

Furthermore, a rise in interest rates might not translate into a cap rate increase; cap rates and interest rates do not perfectly correlate. Cap rates are affected by several other factors, including inflation, available credit, investors' appetite, and supply and demand dynamics. In the near term, supply-and-demand dynamics is an important driver of property valuations. If new supply outpaces demand, then there will be upward pressure on cap rates.

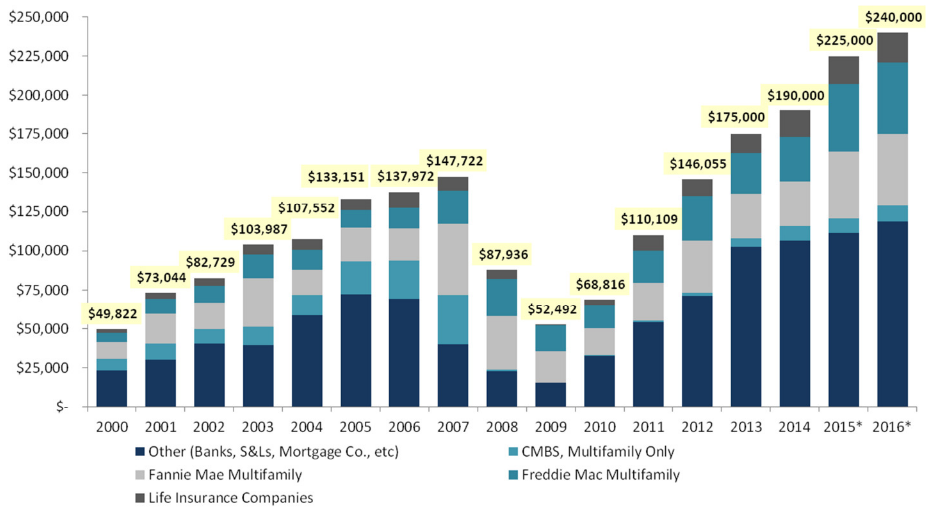
Multifamily origination volume is expected to reach record-setting levels in 2015 and 2016 because of strong fundamentals, low interest rates, increased construction, and impending maturities.

However, because demand is expected to remain robust and keep pace with supply, we project that multifamily cap rates will stay below 6 percent through 2015. This forecast assumes steady employment growth, the 10-year Treasury rate remaining below 3 percent, and spreads continuing to tighten mildly to 300-330 bps.

Origination Volume Spills Over from 2014

The pace of multifamily origination volume remained elevated from the second half of 2014 to the first half of 2015. Most of the same factors are still at play, such as low interest rates, increasing construction, and increasing property prices -- driving the increase in 2015 volume. Another factor is the high volume of loans reaching maturity. As shown in Exhibit 5, the abundant capital will continue to flow into the multifamily debt market as strong fundamentals are likely to persist in the mid-term.

Exhibit 5 - Multifamily New Purchase and Guarantee Volume ($ Millions)



Sources: Mortgage Bankers Association, Freddie Mac
Notes: 2014 and 2015 numbers are projections as of December 2014

Single-Family Market Has Started to Improve

The single-family market continues its gradual strengthening in 2015. The National Association of Home Builders' (NAHB's) Housing Market Index, which surveys builders' perceptions of the current market and their expectations over the next six months, is the highest since November 2005. Existing home sales have also been steadily increasing since the spring and are at the highest level since November 2007 at 5.6 million, annualized. However, many potential first-time homebuyers have stayed on the sidelines, dragging their participation to the lowest level since January. The lack of affordable homes for sale has suppressed the share of first-time homebuyers compared to a year ago. Affordability continued to tighten; median existing home sale prices increased across the nation by 5.6 percent year-over-year in July, to just 5.3 percent below the peak in October 2005.

The single-family sector will continue to grow moderately for the remainder of the year. Starts are projected to increase 14 percent in 2015, more than in 2014 but below the 2013 and 2012 levels. As a result, supply will remain on the tight side; even so, home prices will rise a modest 4.9 percent. Although this rate is slower than in the prior three years, it is a sign of a sustainable single-family sector. The single-family market rebound will not detract from the multifamily market's growth. Both housing markets can coexist, given demographic trends and pent-up demand for housing.

Section 2 – Multifamily Market-level Outlook

Renter demand continues to fuel strong market fundamental performance in many metros. Our list of the top 10 markets based on effective income growth, shown in Exhibit 6, includes many familiar markets as well as a few newcomers. Many of the California markets continued to see high growth, with the Bay Area continuing to dominate the top spots. Los Angeles moved into the top 10 again and was joined by San Antonio. Los Angeles's performance has been supported by the end of the port strike along with strong job and income growth. Despite San Antonio's proximity to the oil fields, its economy is expected to continue strengthening, resulting in solid multifamily fundamentals in the short term.

Exhibit 6 - Top 10 Metro Effective Income and Vacancy Forecasts for 2016

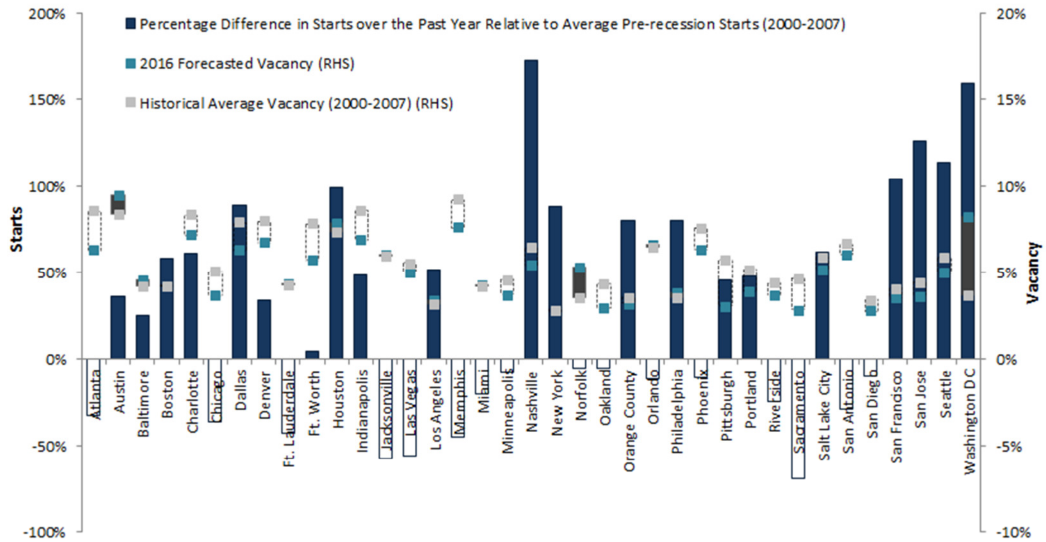
Metropolitan Market	Annualized Growth in Gross Effective Income	Vacancy Forecast
San Francisco, CA	4.6%	3.5%
Oakland, CA	4.1%	3.0%
Sacramento, CA	4.0%	2.8%
San Diego, CA	3.8%	2.8%
Seattle, WA	3.6%	5.0%
Portland, OR	3.5%	3.9%
San Jose, CA	3.5%	3.6%
Los Angeles, CA	3.3%	3.4%
San Antonio, TX	3.2%	6.0%
New York, NY	3.1%	2.8%
United States (top 70 metros)	2.4%	4.9%

Source: Freddie Mac projections

Several markets saw an increase in the ratio of current starts compared to historical averages, but vacancy rates remain below historical average in most markets.

On the supply side, many areas continue to experience above-average construction but below-average vacancy rates, as shown in Exhibit 7. Supply levels have started to moderate in some areas, such as Austin and Dallas, but continued to increase in most markets over the past four quarters. New York, Seattle, and Washington, D.C. experienced the largest increases in supply compared to the prior year. Vacancy rates continued to trend upward for many metros, yet increases were smaller than originally predicted in several areas. The two exceptions being Norfolk and Washington, D.C., which saw larger-than-anticipated increases in vacancy rates because of economic weakening and a large amount of new supply, respectively. On the other hand, despite very high levels of supply in Nashville, San Jose, Seattle, and San Francisco, vacancy rates below the long-run average suggest these markets will absorb the new supply. As new supply comes to the market throughout 2016, vacancy rates for most markets will trend upward; nevertheless, vacancy rates will stay below average in the majority of the markets.

Exhibit 7 - Multifamily Starts and 2016 Forecasted Vacancies Relative to History

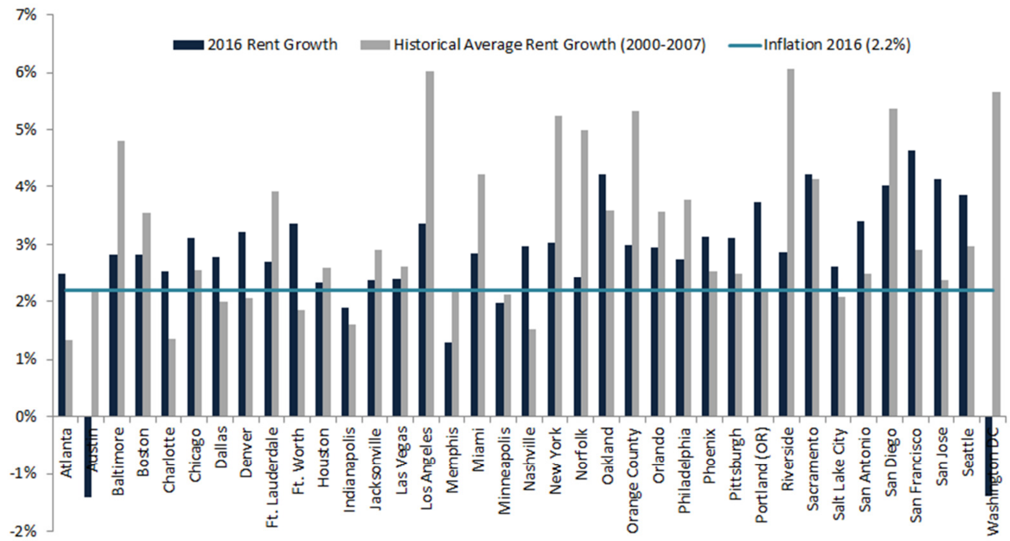


Sources: REIS, Moody's Analytics, Freddie Mac projections

Rent growth will remain above the historical average through 2016 for the majority of the metros, as shown in Exhibit 8. Fort Worth, San Antonio, and San Jose are outperforming expectations for 2015, thanks to stronger-than-anticipated demand. Meanwhile, forecasts call for lower rent growth in other areas than originally anticipated for 2015, by as much as 1.8 percent in Washington D.C., Boston, Riverside, and Baltimore. Furthermore, Washington, D.C. and Austin are forecast to see lower rents; the large amount of new supply coming online is pushing vacancy rates up and suppressing landlords' ability to raise rents. However, not all metros that miss their expectations are weakening or overbuilt. In Riverside, for example, rent growth underperformed slightly, but is still expected to be in line with the national average. Some areas that are gaining a lot of supply (Nashville, San Jose, Seattle, and San Francisco) are also experiencing higher-than-average rent growth, further enabling them to absorb the new supply.

In 2016, rent growth in the majority of metros is expected to slow down. Still, the majority of metros will remain above historical averages and the expected inflationary target of 2.2 percent.

Exhibit 8 - Rent Growth Forecasts for 2016 Relative to History



Sources: REIS, Freddie Mac projections

Potential major headwinds facing some markets are oversupply – Washington, D.C. and Austin – and the impact of low oil prices – Houston.

Several individual markets are expected to experience some headwinds in the short term. The two biggest threats are concentrations of new supply and falling oil prices. At the national level, oversupply is not a major concern because fundamentals are projected to remain strong in the near term whereas oil prices will have a mixed impact, with some jobs lost but others gained. For some markets, however, these headwinds could adversely affect multifamily fundamentals.

The two markets at greatest risk of oversupply are Washington, D.C. and Austin. As shown in Exhibits 7 and 8, Washington, D.C. has extremely high levels of new supply. Vacancy rates are well above long-run average and rent growth is not only significantly below the long-run average, but negative. The addition of supply in Austin has started to abate recently from the sky-high levels seen in the past few years, but vacancy rates continue to climb above the long-run average and rent growth continues to decline to negative levels.

The sensitivity analysis[4] that we reported earlier this year, assessing the potential impact of new deliveries in a couple of markets, revealed that job growth is essential to maintain a healthy absorption rate in any market. As long as employment continues to grow, new supply will have minimal impact and only short-term effects on multifamily fundamentals in these markets. Therefore, weakening multifamily performance will be muted in D.C. and Austin as long as their job growth remains

[4] "A Little Bit Country, a Little Bit Rock 'n' Roll": http://www.freddiemac.com/multifamily/pdf/little_bit_country_little_bit_rock_n_roll.pdf . While the paper focused on Austin and Nashville, the findings hold for any market experiencing high levels of supply.

strong. Furthermore, despite the high levels of supply and softening fundamentals, investors continue to invest in these areas. The short-term slowdown is not enough to deter investors.

In addition to some risk of oversupply in Houston, this metro could face additional headwinds from falling oil prices. Because of the metro area's heavy reliance on the oil industry, the market has seen a slowdown in employment growth. Based on Moody's Analytics forecasts, job growth in Houston is expected to be positive but below the national average until the end of 2016. However, Moody's prolonged-low-oil-price scenario predicts that job growth could be more severely curtailed and turn negative by the end of 2015. This downturn will be short, lasting only a few quarters before returning to above-average growth by the end of 2016. Meanwhile, multifamily starts in Houston have remained consistently above the historical average around 20,000 units, annualized, over the past several quarters.

We published a research paper[5] earlier this year in which we modeled a shock to the Houston market based on low oil prices. We found that it would take much more pronounced negative job growth plus a much higher level of multifamily starts than seen today to significantly impact the multifamily sector. As we stated in our analysis, a combination of new supply coming online and slower employment growth will cause vacancy rates to increase and rent growth to moderate, but nowhere near as much as during the Great Recession, much less the oil bust of the 1980s. Because Houston has diversified its economy since the 1980s, the metro area will see a slight slowdown but can absorb a fair amount of job losses in the oil sector.

Net migration patterns among the major metros[6] can be useful in understanding the housing needs and demand in certain areas. Exhibit 9 shows the annual net migration by metro area along with the year-over-year employment growth in 2014. It reflects a population shift from some of the larger, northern cities to the growing Sun Belt cities. The top five cities to which people moved in 2014 are Houston, Dallas, Phoenix, Atlanta, and Miami. The bottom 5 cities are Chicago, New York, Memphis, Philadelphia, and Salt Lake City. For the most part, metros with higher net migration experienced greater job growth than other metros.

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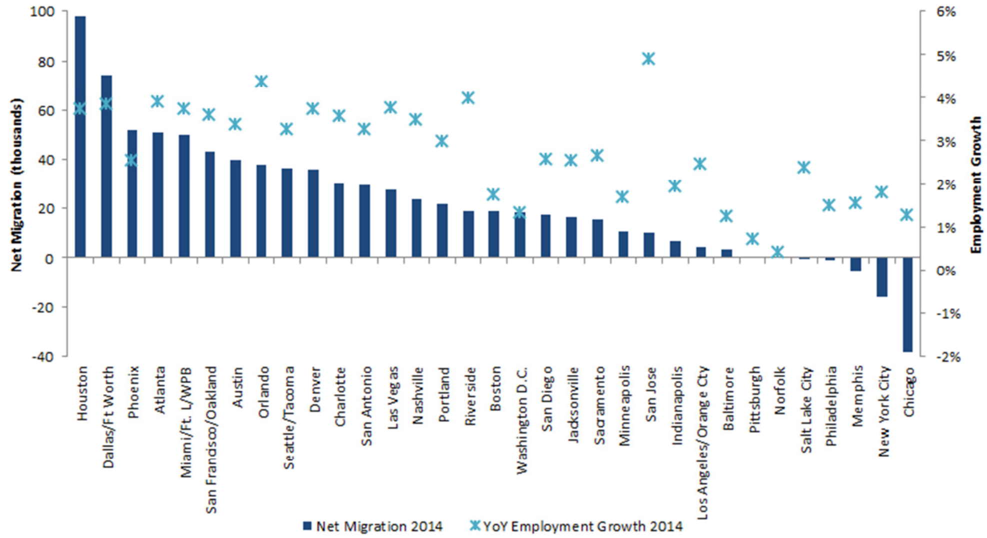
[5] "Oil Price Impacts and Multifamily Housing": http://www.freddiemac.com/multifamily/pdf/oil_price_impacts_multifamily_housing.pdf

[6] For this analysis, we report on the entire MSA instead of dividing some of them into metro divisions, outer, exurbs, or core as we do in Exhibits6, 7, and 8.

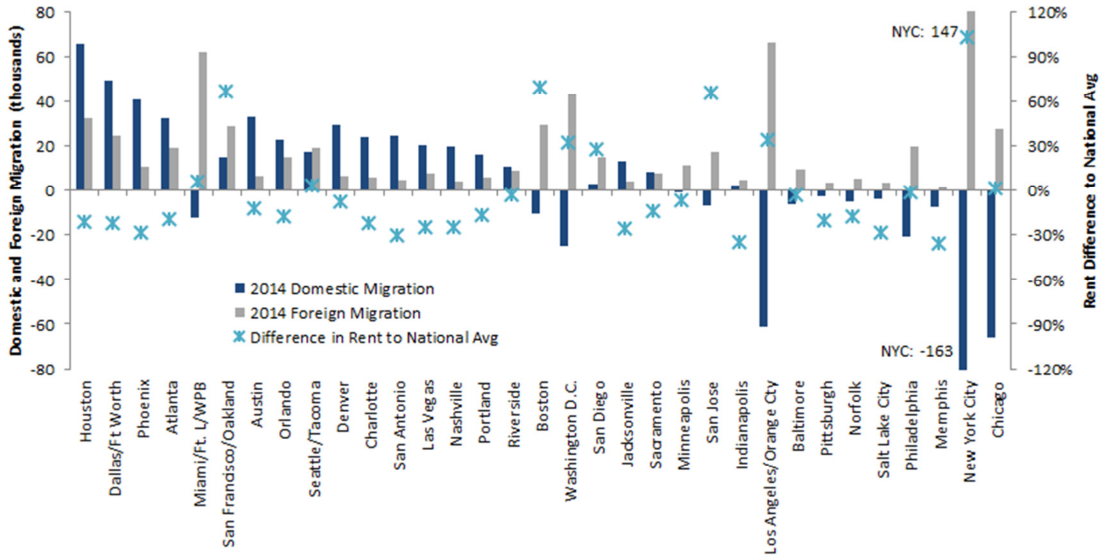
Exhibit 9 - Net Migration and Employment Growth in 2014



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

Exhibit 10 breaks out net migration by domestic and foreign migrants by metro. Domestic migration was the main source in those metros with relatively high net migration, except in Miami and San Francisco, where foreign in-migration prevailed. Markets with lower net migration were dominated mostly by foreign migration, except for Jacksonville and Sacramento, which saw domestic migration make up the majority of net migration. Many of the major cities realized negative domestic migration, including New York City (-163,000); Chicago (-66,000); Los Angeles (-61,000); Washington, D.C. (-25,000); and Boston (-10,000). Some of these metros experienced enough foreign migration to keep their net migration positive, highlighting the importance of international migration. The multifamily markets in these large metros continue to perform well in part because of the large inflow of foreign migrants into these cities.

Exhibit 10 – Domestic and Foreign Migration and Rent Compared to National Average in 2014



Sources: U.S. Census Bureau, Moody's Analytics, Bureau of Labor Statistics, REIS, Freddie Mac

The domestic migration patterns seen in 2014 are similar to those experienced pre-recession; people are drawn to warmer climates with more affordable housing and stronger economies. As Exhibit 10 also shows, many markets with high domestic migration have lower market-rent levels compared to the national average.

Domestic migration patterns in 2014 are similar to pre-recession patterns; people are moving away from the major cities toward smaller, more affordable areas that have stronger economies.

Of the five most expensive metros by market rent, only the San Francisco metro area saw positive domestic migration. However, that growth was entirely in Oakland, which has cheaper housing options than its West Bay neighbor. San Diego and Seattle were the only other metros in the analysis with rents above the national average and positive domestic migration.

Lower rents do not necessarily mean higher in-migration. Areas including Memphis and Norfolk have very affordable housing compared to the rest of the nation but also have negative domestic migration -- and weak economies. But areas with low rents and stronger economies, including Phoenix and San Antonio, saw decent migration patterns. Therefore, people are not just attracted to warmer places and more affordable housing, but also to strong economies with job-growth potential.

These patterns shed light on how migration will influence housing needs. For instance, knowing that foreign migrants tend to be drawn to larger cities would benefit developers' investment decisions. Also, understanding that many low- and moderate-income families are forced to move to more affordable areas indicates the need for more affordable housing in larger metro areas.

Section 3 – Multifamily Investment Index Outlook

The Investment Index has been declining over the past two years due mainly to stronger growth in property prices compared to NOI.

According to the Freddie Mac Multifamily Investment Index, the multifamily property investment environment moderated, nationally, over the past several quarters. The Investment Index measures the relative value of investing in multifamily properties at the national level as well as in select major metros. The Index was introduced in our 2013 Mid-Year Outlook[7] and was updated in 2014 with a sensitivity analysis. This year's update focuses on the changes in the market environment and how they affect the Index. In addition, the number of metros covered has been expanded.

Much like a single-family affordability index measures conditions for potential buyers, our Index measures conditions for buyers of multifamily properties. It considers factors important to property investors, including net operating income (NOI), mortgage rates, and property prices. Each factor affects the Index differently; increasing mortgage rates and property values lower the Index reading, while increasing NOI raises the value. The combination of conditions produces a simple measure of relative market conditions.

The Index value has been steadily declining, mostly because property values are rising faster than NOI. At the national level, property values have grown 10.2 percent in the past four years, whereas average NOI growth during the same period was 3.9 percent. NOI, despite being robust, has struggled to keep pace with the strong growth in property values.

Despite some volatility in interest rates, the cost of funding has remained in the vicinity of 4 percent over the past few quarters. As a result, the Investment Index value has been declining. At the end of second quarter 2015, it was near the historical average, as shown in Exhibit 11. This does not necessarily signify market weakness. Rather, it indicates fewer investment opportunities now than in the years that immediately followed the Great Recession. The Investment Index views the multifamily investment market like investors would gauge the equity market: Strong cash flows that are undervalued are most favorable. Also, individual properties will differ from the overall Index as favorable opportunities continue to exist, given the market's potential for revenue growth.

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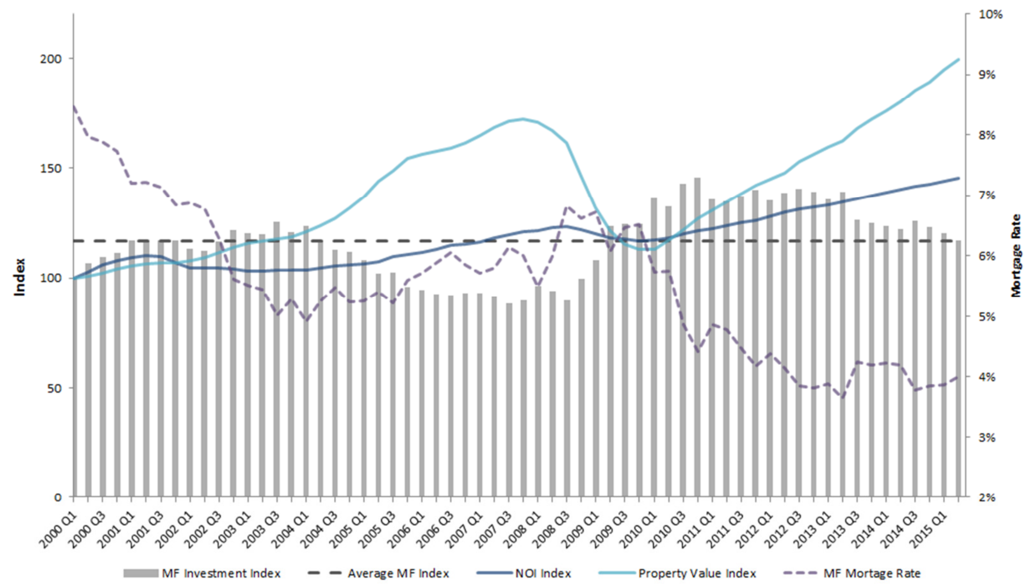
[7] "Multifamily Mid-Year Outlook 2013"
http://www.freddiemac.com/multifamily/pdf/multifamily_mid_year_outlook.pdf

Exhibit 11 - Freddie Mac Multifamily Investment Index for the National Market (Base = 2000Q1)



Sources: Freddie Mac, REIS, RCA CPPI™, National Council of Real Estate Investment Fiduciaries (NCREIF), American Council of Life Insurers (ACLI)

The Investment Index for most markets that we can track is near historical averages, except for New York City and San Francisco, due mostly to a large run-up in property prices.

At the metro level, we see a large dispersion in investment opportunities across the markets. Exhibit 12 shows the current Index value, the historical average Index value, annualized property price growth, and annualized NOI growth for each market. The most insight can be gained by comparing trends within a market, rather than across the different markets. The majority of markets are within plus-or-minus 2 percent of their historical averages. Furthermore, these markets follow the national trend of property prices growing much faster than NOI. However, a recent run in property prices in New York City and San Francisco has pushed the Index value well below the historical average. At the same time, the Index remains 11.2 percent and 5.8 percent above the historical average in Philadelphia and Phoenix, respectively. Among the 13 markets tracked, Washington, D.C. stands out for the lowest property price growth and less than 1 percent NOI growth.

Exhibit 12 - National and Metro Investment Index Relative to Historical Average

Metro Name	Investment Index as of 2015Q2	Historical Average Index	Relative to Historical Average	Average Property Price Growth (Annualized): 2013Q1 - 2015Q2	Average NOI Growth (Annualized): 2013Q1 - 2015Q2
National	117.2	116.6	0.51%	10.2%	3.9%
Atlanta	119.5	121.2	-1.38%	14.1%	4.4%
Chicago	108.5	112.8	-3.84%	10.7%	3.5%
Dallas	119.8	120.6	-0.66%	9.6%	4.7%
New York	81.1	102.4	-20.76%	19.1%	3.9%
San Francisco	80.6	93.1	-13.34%	14.2%	6.8%
District of Columbia	100.5	103.5	-2.84%	4.7%	0.7%
Los Angeles	105.4	109.7	-3.94%	10.0%	2.6%
Seattle	111.7	111.4	0.31%	9.0%	6.6%
Austin	111.0	110.7	0.23%	9.3%	3.7%
Orlando	118.5	115.5	2.62%	9.0%	3.9%
Philadelphia	133.1	119.7	11.17%	7.4%	3.1%
Houston	129.8	126.8	2.34%	9.9%	5.0%
Phoenix	128.1	121.0	5.84%	9.0%	4.4%

Sources: Freddie Mac, REIS, RCA CPPI™, NCREIF, ACLI

The Index can be used to perform a sensitivity analysis, but is not intended for specific forecasting. Exhibit 13 displays the Index at the national level for various mortgage rate and NOI growth scenarios. The values reflect the assumption that property prices will grow at a historical average (from 2000 through second quarter 2015) annualized rate of 4.8 percent. Under most scenarios, the Index remains below the current level, as indicated with red shading. The Index value is higher in scenarios with low mortgage rates and strong NOI growth.

Exhibit 13 - Scenario Analysis for National Investment Index

Sensitivity Analysis	Annual NOI Growth (%)										
Mortgage Rate (%)	-1.0%	0.0%	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%	4.0%	4.5%	5.0%
5.30%	95.34	96.30	97.26	97.75	98.23	98.71	99.19	99.67	100.15	100.64	101.12
5.00%	98.62	99.62	100.61	101.11	101.61	102.11	102.61	103.10	103.60	104.10	104.60
4.70%	102.08	103.11	104.14	104.66	105.17	105.69	106.20	106.72	107.23	107.75	108.27
4.30%	106.98	108.06	109.14	109.68	110.22	110.76	111.30	111.84	112.38	112.92	113.46
4.00%	110.89	112.01	113.13	113.69	114.25	114.81	115.37	115.93	116.49	117.05	117.61
3.70%	115.02	116.18	117.34	117.92	118.51	119.09	119.67	120.25	120.83	121.41	121.99
3.30%	120.88	122.11	123.33	123.94	124.55	125.16	125.77	126.38	126.99	127.60	128.21

Sources: Freddie Mac, REIS, RCA CPPI™, NCREIF, ACLI

In the short term, several factors will affect the Investment Index. The high level of new supply will affect property prices and NOI. Interest rate increases will affect property prices and mortgage rates. While we know directionally how these individual impacts will affect the Index, the net effect of the combination of factors is not obvious.

Conclusion

Multifamily performance in the first half of 2015 was as robust as in 2014. The wave of new supply that has started to enter the market will have an impact on performance for the rest of 2015 and through 2016. Overall, fundamentals will remain strong but more moderate than in recent years. Favorable demographic trends and an improving economy will continue to generate robust demand for multifamily properties. Dispersion across individual markets continues, but high supply or economic headwinds in some markets will not derail stable growth of the national multifamily market.

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