

Multifamily 2017 Outlook: Positioned for Further Growth

The multifamily market has enjoyed several years of rapid growth and seems poised to continue to grow in 2017, although at a more moderate pace.

- Slow-but-steady economic growth continued in 2016, which supported strong demand for multifamily rental units. Despite high levels of construction permits and starts, vacancy rates remained flat, while strong demand pushed up rents and gross-income growth above the historical norm.
 - A greater amount of new supply will be delivered to the market in 2017 but most of it will be absorbed, given continued economic growth and strong multifamily fundamentals. Vacancy rates will increase slightly, but still leave room for rent and gross-income growth.
 - The top 10 list of fastest-growing metropolitan areas will see some jockeying for position in 2017, with smaller, more affordable markets making a showing.
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2016 in Review: Another Strong Performance

The multifamily market continued its above-average performance in 2016, in line with most expectations but with some surprises at the metro level. New supply entering the market kept pace with demand as vacancy rates remained flat over the year, as reported by REIS. While expectations for vacancy rates to increase in 2016 did not come to fruition, anticipated moderation in rent growth did take place. Despite the moderation, rent growth remained above the historical average in 2016. Several of the larger metro areas experienced more pronounced slowing than the broader market, such as San Francisco and New York City. Although most metros saw rent growth moderation in the past year, the majority continued to perform above their pre-recession averages.

Economic growth continued to support strong multifamily fundamentals. The labor market improved in 2016 but progress was slower than in previous years. The economy added 2.2 million jobs in 2016 – more than the historical average, but considerably fewer than the 3 million and 2.7 million jobs added in 2014 and 2015, respectively. The labor force participation rate was 62.7 percent as of December 2016, which is only marginally higher than a year prior and lower than the post-recession average of 63.6 percent.

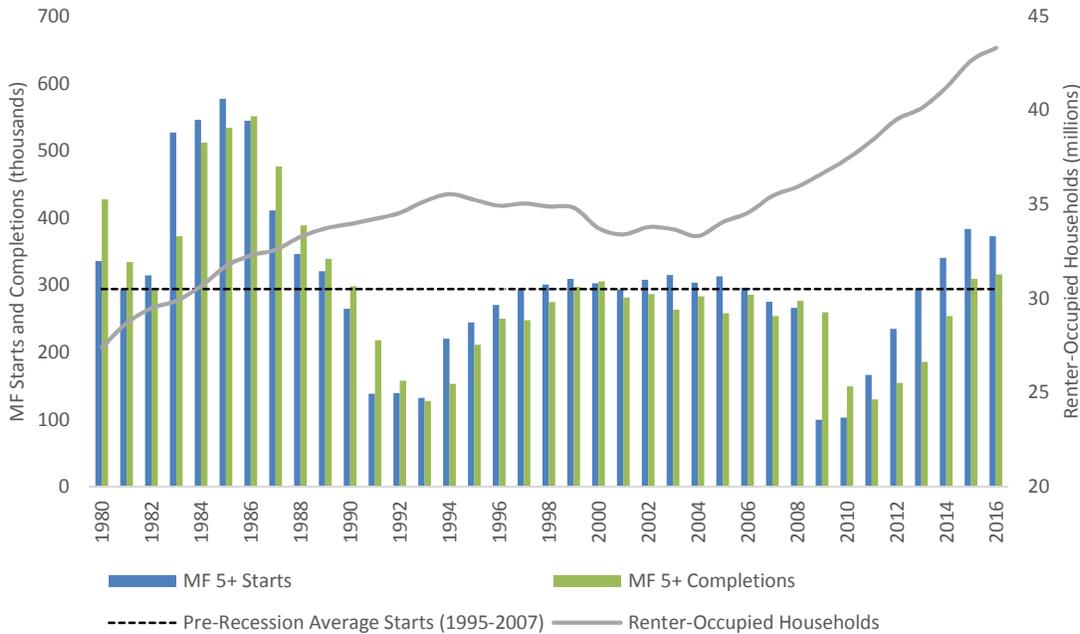
With oil prices tumbling in the beginning of 2016, down to \$27 per barrel, and a strong dollar keeping U.S. exports suppressed, employment tied to these sectors, as well as areas of the country that rely heavily on these industries, saw slower growth throughout 2016. The manufacturing sector contracted in 2016 with a growth rate of -0.4 percent. Since May 2016, oil prices have been between \$40-\$50 per barrel, indicating that prices may finally be stabilizing. Fortunately, not all sectors experienced such poor performance; construction slowed in 2016 but still recorded annual growth of 1.6 percent. Education and health services along with professional and business services grew the most with year-over-year increases of 2.7 percent and 2.6 percent, respectively.

Average hourly earnings rose 2.9 percent over the past year – the largest annual gain since 2008. The strengthening wage growth is a welcome sign by many since it's the last major piece of the labor market to recover. Meanwhile, the unemployment rate continued its downward trend. It ended the year at 4.7 percent, down 30 basis points (bps) from the prior year but up from the cyclical low of 4.6 percent in November 2016. Overall, the Federal Reserve judged the labor market to be healthy and cited the recent employment gains as justification for a federal funds rate increase this past December.

Strong labor markets encouraged more household formations in 2016, as shown in Exhibit 1. Through the third quarter, 1.2 million new households were formed– more than the post-recession average of 850,000 per year. Of them, a larger share – 630,000 – rented their homes, keeping demand for rental units at historical highs, largely

due to demographic shifts and lifestyle preferences. But the 590,000 new owner-occupied households represent the largest year-over-year gain in 10 years. The homeownership rate at the end of the third quarter of 2016 was 63.5 percent, down 20 bps from the prior year but up 60 bps from the prior quarter.

Exhibit 1: Multifamily Starts and Completions (5+ Units) and Renter Households



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

To keep up with the rise in renter households, multifamily construction has reached the highest levels since the late 1980s, when tax-code changes spurred the market. Shown in Exhibit 1, multifamily permits and starts have stopped – or paused – their upward trajectory. Permits dropped around 13 percent over the year while starts were down 3 percent. Multifamily completions nudged slightly higher in 2016 – up to 315,000 units delivered in the year, an increase of 2 percent from 2015. While the number of new deliveries is high from a historical perspective, it falls short of expectations, given that multifamily starts have been at or above 300,000 since 2013. Reasons include construction delays because of weather or skilled-labor shortages. In addition, some delays were planned so that delivery would occur during more favorable seasonal or competitive conditions.

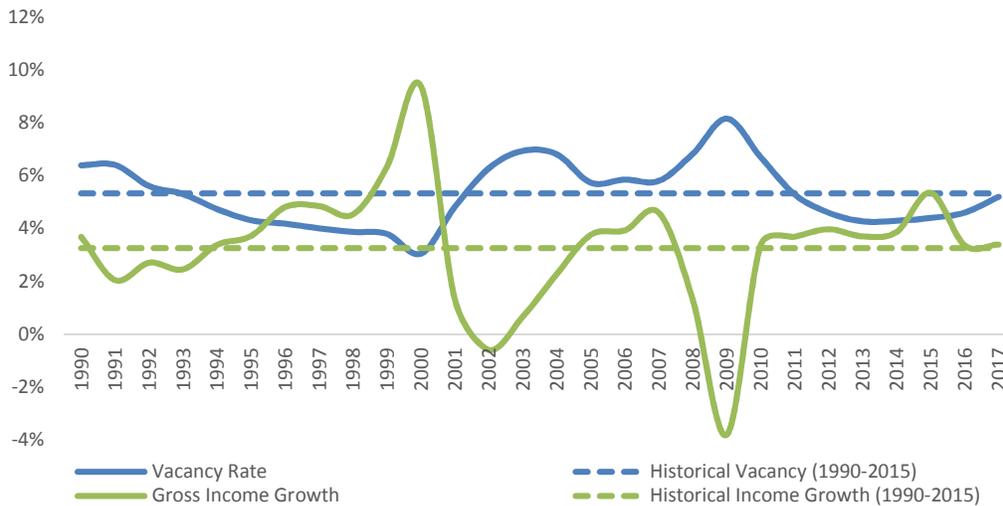
Construction can stay at these levels as demand fuels development. The slowing of construction permits and starts in 2016, however, is a sign that the market is not overheated and developers are adjusting plans responsibly.

Demand kept pace with supply, holding vacancy rates relatively flat over the past year. With more competition entering the market, rent growth moderated in 2016 from the cyclical peaks of 2015 but remained above the historical average. Rent growth was softer at the high end of the rent spectrum in several markets that saw an explosion of new, luxury inventory, namely New York City, San Francisco, and San Jose. Rent growth in these areas will remain suppressed but only temporarily as new supply is absorbed and rent growth reverts back to its long-run averages.

2017: “Moderation” Is the Word

The multifamily market will continue to grow in line with the historical average in 2017. Employment growth is expected to remain near 2016 growth levels and demand for multifamily units to stay strong due to lifestyle preferences and demographic trends. At a national level, multifamily completions are expected to be higher in 2017 than in 2016 but will continue to enter the market at a disciplined rate. As a result, vacancy rates will increase modestly in 2017 and are expected to breach 5 percent for the first time since 2011, although remain below the historical average. With employment growth higher than population growth and wages rising, demand for multifamily units will remain robust. Rents will grow at a pace in line with 2016’s rate and remain above the historical average in 2017, as shown in Exhibit 2.

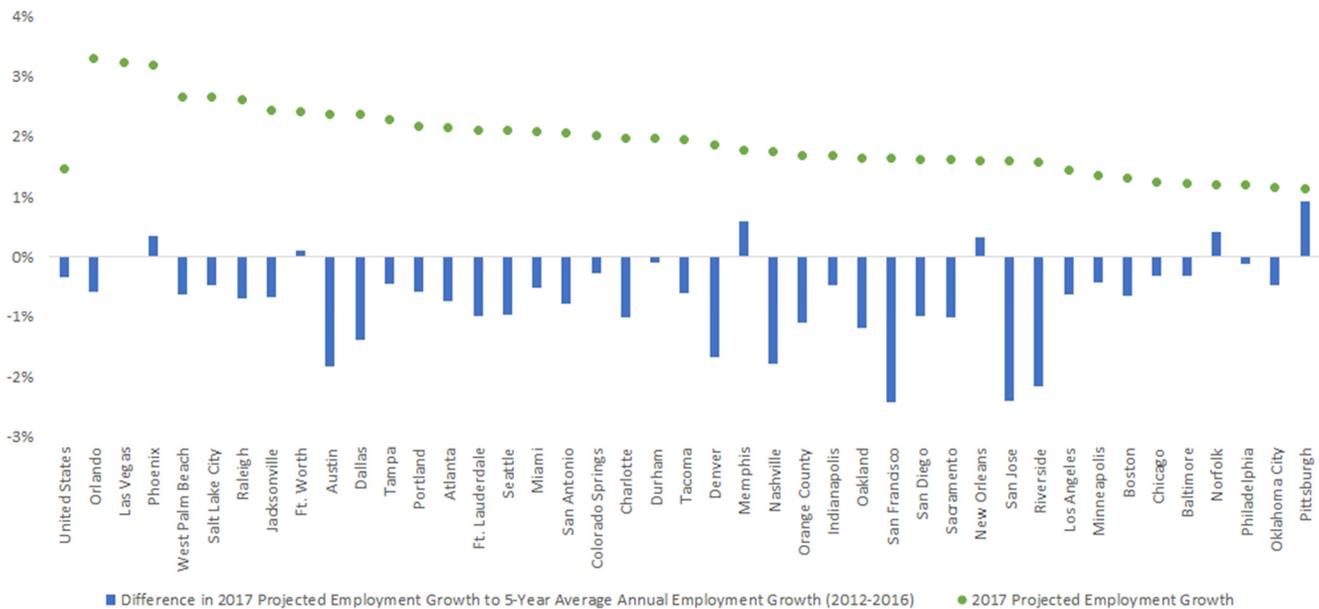
Exhibit 2: Vacancy Rate and Gross Income Growth, History and Forecast



Sources: REIS, Freddie Mac projections

At the metro level, many markets will produce strong job gains in 2017, but most will moderate from the five-year post-recession average, as shown in Exhibit 3. Moderation will be greatest in San Francisco and San Jose, which started to cool in 2016. Metros with the highest expected job growth are Orlando, Las Vegas, and Phoenix – all in the Sun Belt, a strengthening region characterized by a warmer climate and a relatively lower cost of living, which attracts people from across the country.

Exhibit 3: Employment Growth in 2017 Compared to the Average Annual Growth 2012-2016



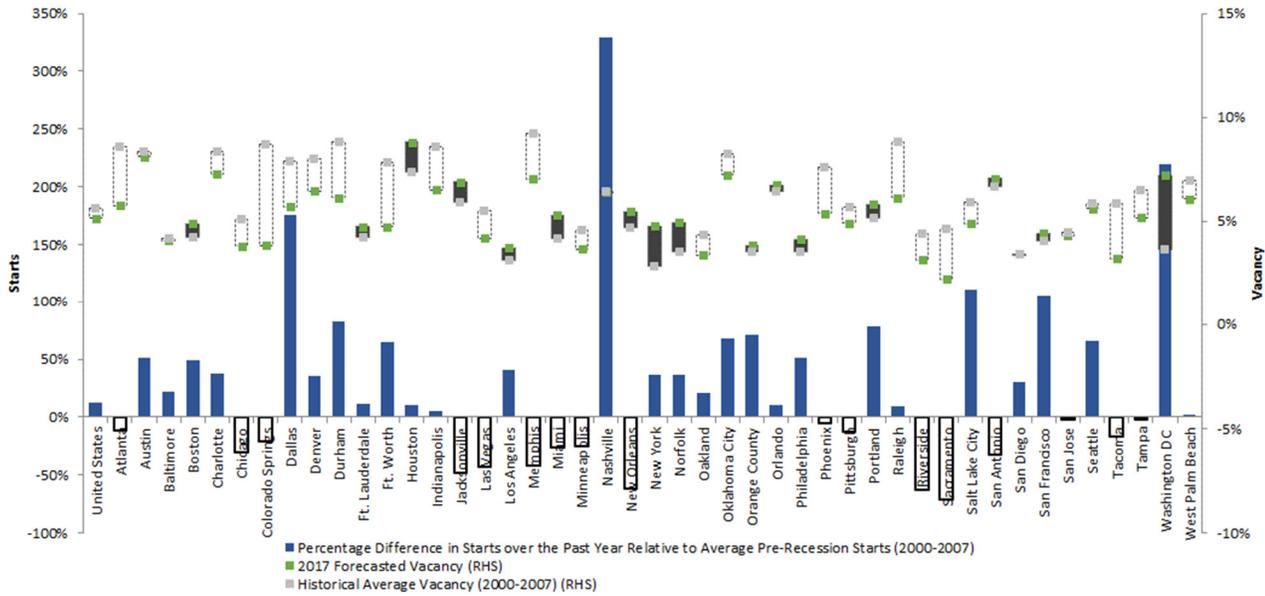
Sources: Bureau of Labor Statistics, Moody's Analytics projection

Construction starts in many markets will remain elevated compared to the years leading up to the Great Recession. Whether this is good or bad news depends on the market's current vacancy rates. As shown in Exhibit 4, areas with below-historical-average vacancy rates are better poised to absorb new supply without significantly disrupting multifamily performance. However, areas with increased new supply and above-historical-average vacancy rates can expect slower absorption and potential negative impacts on multifamily fundamentals.

Nashville; Washington, D.C.; and Dallas have the highest level of construction starts compared to their historical averages. Washington, D.C. remains of particular concern because of elevated construction despite a large gap between the expected 2017 vacancy rate and the historical average. However, Washington, D.C., in this analysis refers only to the District of Columbia and does not include the surrounding Virginia and Maryland suburbs, which are experiencing below-average new supply and a smaller gap in vacancy rates. Likewise, New York City includes only the five boroughs and not the surrounding suburbs in New York and New Jersey, which are experiencing higher supply but not as high a spike in vacancy rates. This trend of downtown areas receiving high levels of new, luxury supply is being played out across the country and will result in higher vacancy rates and lower rent growth in those central areas.

For the majority of the metro areas, vacancy rates in 2017 will remain below the historical average, implying there is room for more supply to be absorbed. In an increasing number of metros vacancy rates will meet or exceed their historical averages in 2017. However, the vacancy rate remains less than 5 percent in many of these areas, including Boston, Los Angeles, New York City, San Francisco, and San Jose. These areas typically experience very low vacancy rates because of strong demand for multifamily rental units and construction limitations. Therefore, although their vacancy rates are above the historical average, these areas are considered fully occupied by industry standards.

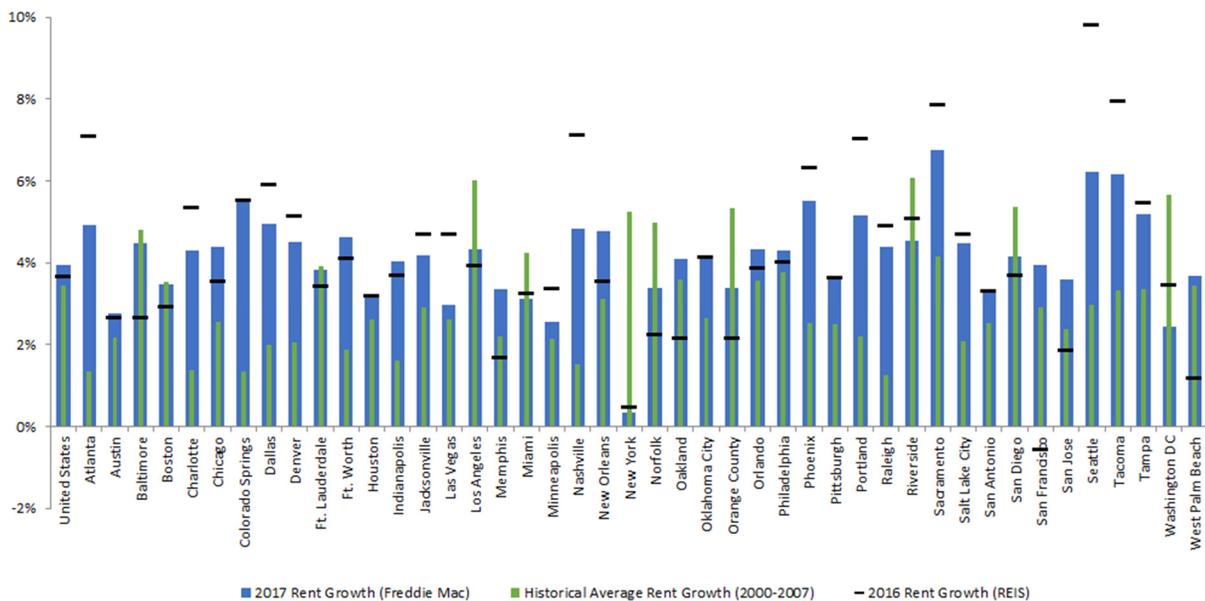
Exhibit 4: Multifamily Starts and 2017 Forecasted Vacancies Relative to History



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

Expected rent growth in 2017 will be mixed across the metros, as shown in Exhibit 5. The greatest moderation will occur among areas that previously have seen the highest levels of growth – such as Atlanta, Nashville, and Seattle – as they start to return to their historical averages. Meanwhile, rents in the Bay Area – Oakland, San Francisco, and San Jose – will rebound in 2017 as new supply is absorbed and vacancies tighten. New York City, on the other hand, will see suppressed rent growth over the next year as a large amount of new supply is expected to hit the market.

Exhibit 5: Rent Growth in 2017 and 2016 Relative to History



Sources: REIS, Freddie Mac projections

Taking all of these metrics into account, the top 10 markets based on gross-income growth in 2017 will be a mix of West Coast favorites and secondary and tertiary markets, as shown in Exhibit 6. As new supply hits the markets, more areas with strong rent growth will also see vacancy rates increase. Several areas with strong rent-growth forecasts in 2017 did not make the top 10 list for income growth because of rising vacancy rates, including Dallas, Atlanta, and Nashville.

Core markets, such as New York City, Oakland, and San Francisco, will fall off the top 10 list in 2017 as they work on absorbing the new, high-end supply. Meanwhile, some of the secondary and tertiary markets that have moved up are areas with little new development and, as a result, rent growth now is catching up. Growth at this level is viewed as temporary and not sustainable in the long-run; it will revert to historical averages as the new supply is absorbed. Long-run economic trends will continue to favor the core markets because of their ability to attract and retain jobs.

Exhibit 6: Top 10 Metros by Gross-income Growth for 2017

Metropolitan Market	2017 Annualized Growth in Gross Income	2017 Vacancy Rate
Sacramento	6.4%	2.2%
Seattle	5.9%	5.6%
Tacoma	5.8%	3.2%
Portland	4.9%	5.8%
Colorado Springs	4.7%	3.8%
Phoenix	4.5%	5.4%
Tampa	4.4%	5.2%
Chicago	4.4%	3.8%
Jacksonville	4.3%	6.9%
Los Angeles	4.2%	3.7%
United States (top 70 metros)	3.4%	5.2%

Source: Freddie Mac projections

Sacramento gains the top spot as growth expands west from the Bay Area to take advantage of affordability. The onslaught of demand has allowed landlords to raise rents as new construction plays catch-up. The Pacific Northwest fills the next three spots, with Tacoma benefiting from Seattle’s overflow. Vacancy rates will rise in Seattle and Portland as new supply is added to these markets, but strong demand will allow landlords to increase rents enough to offset higher vacancy rates.

Some of the smaller markets on the list, such as Colorado Springs, Phoenix, and Tampa, will see strong rent growth in 2017 because increased demand outpaces supply, allowing landlords to raise rents at a quick pace. As these areas have emerged from the Great Recession, they have added jobs and experienced population growth but have not had as much of an increase in multifamily construction as many other areas have had. As developers fill the need for supply in these areas, multifamily performance will return to historical norms.

Two surprising entrants are Chicago and Jacksonville. Both metros made the top 10 because of low vacancy rates with moderate-to-high rent-growth expectations. Chicago will be a wild card in 2017 as the city and the State of Illinois continue to work out fiscal issues. Although the impact on multifamily demand could go either way – for example, less motivation to own and less new development could be offset by fewer people moving into the area – vacancy rates are expected to remain tight, boosting rental-income growth expectations. Jacksonville, on the other hand, continues its climb out of the Great Recession trough and has not yet hit its cyclical peak. Vacancy rates remain high but are expected to decrease in 2017 as strong demand brought on by a growing job market and relatively little new supply will push vacancies down and rents up.

All in all, the multifamily market outlook is positive – but a number of headwinds could affect the market’s course. The underlying fundamentals that have been driving multifamily rental housing demand over the last several

years will remain strong through 2017 while the market continues to moderate from the cyclical peak. Employment growth will be slower than in 2014 and 2015 but will remain above population growth in 2017. New supply will continue to be elevated in 2017, pushing vacancy rates toward historical averages. Demand will remain strong due to demographic changes and preferences for renting. Absorption of new units in some areas will take longer than in prior years, hindering landlords from increasing rents at the prior few years' rapid pace. Certain other factors could have meaningful impacts on the multifamily market this year – a rising-interest-rate environment being an important one – baseline forecasts are for continued strength in the market.

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

Contacts

Multifamily Investments, Research & Modeling Team

Steve Guggenmos

Steve_Guggenmos@freddiemac.com

571-382-520

Sara Hoffmann

Sara_Hoffmann@freddiemac.com

571-382-5916

Kevin Burke

Kevin_Burke@freddiemac.com

571-382-4144

Jun Li

Jun_Li@freddiemac.com

571-382-5047

Xiaojun Li

Xiaojun_Li@freddiemac.com

571-382-4967

Vincent Lu

Vincent_Lu@freddiemac.com

571-382-5178

Cheng-Ying (Anita) Yang

Cheng-ying_Yang@freddiemac.com

571-382-3286

Wen (Chelsey) Xiao

Wen_Xiao@freddiemac.com

571-382-4838