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Economics Group

Special Commentary

Apartment Market Outlook

While apartment market fundamentals have softened somewhat, job growth remains strong enough to support continued household formation growth. Absorption remains strong from a historical standpoint and rents are still rising solidly.

The apartment market has lost a bit of momentum this year. Demand for rentals has softened somewhat compared to the fairly robust pace hit last year and net completions have slowed to their slowest pace since 2016, an indication new apartment construction likely peaked in 2018. On top of this, apartment property price appreciation has moderated. The double-digit price gains registered throughout the majority of the expansion have now cooled to a below-9% pace this year, reflecting growing caution from investors. That's not to say the apartment market is about to fall off a cliff. Even with softer tenant demand, landlords appear to have no trouble raising rents, which climbed 3.6% over the past year nationwide, the fastest increase since 2016. Furthermore, the vacancy rate recently fell to 5.8%, which matches the cycle low hit in 2014.

Still-solid yet more moderate demand for apartments is also to be expected given that overall economic growth is slowing. Real GDP rose at a better than expected 1.9% pace in the third quarter, largely a result of a sturdy rise in consumer spending. A pullback in business investment, however, remains a major drag on overall growth, and the recent loss of momentum appears to be tied to slower global growth resulting from the trade standoff with China. Still, the economy remains in fairly solid shape, with real GDP growth moderating to a pace roughly on par with the pace averaged over the past decade. Underpinning the solid trend in consumer spending has been solid monthly job gains. Yet hiring appears to have lost some steam recently, and since demand for apartments closely follows job growth, it is not all that surprising that net absorption has also moderated this year. Lower mortgage rates and generally more favorable home-buying conditions have also likely persuaded some renters to pursue homeownership, a move some undoubtedly delayed last year due to higher borrowing costs.

Figure 1

![Figure 1](image1)

Source: CoStar, Inc. and Wells Fargo Securities

Figure 2

![Figure 2](image2)

Source: CoStar, Inc. and Wells Fargo Securities

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.
Household Growth Getting Back on Track

While net absorption has moderated, we expect demand for rentals to remain fairly solid in coming years. Household growth, which is a fundamental driver of housing demand, has made a great deal of progress recovering from its post-recession collapse and now appears to be back on track with prior norms. Estimates of new household creation vary by source and tend to be inexact, but we estimate new household growth to be running at roughly 1.2 million per year, a trend which we expect will more or less hold for the next decade. The Harvard Joint Center for Housing Studies (JCHS) projects an increase of 12.2 million new households between 2018 and 2028, which equates to 1.2 million new households per year. For context, according to the decennial censuses, there were 11.6 million households formed in the 1980s, 13.5 million in the 1990s, and 11.2 million in the 2000s. The recent improvement comes alongside nearly a decade of strong and steady job growth which has helped those forced into alternative living situations—such as living with parents or friends—to reengage with the housing market, usually beginning with renting an apartment.

Figure 3

Estimates of Annual Change in Households

Source: U.S. Department of Commerce, EIA, Harvard Joint Center for Housing Studies and Wells Fargo Securities

Digging deeper, there are two cohorts expected to drive this projected increase in households: those aged 35-44 and 65 & older. The increase in the 35-44 cohort will clearly be a boon for homeownership as the sheer volume of Millennials enter their prime home-buying years. Homeownership is usually brought on by life milestones such as marriage and starting a family. Even with this transition, apartment living is unlikely to fall out of fashion for a number of reasons.

First, lower birth rates have led to smaller households, which generally allows renters to remain in apartments for longer periods of time. As recent history has demonstrated, the Millennials largely prefer a more cosmopolitan environment with ample access to shopping, entertainment and nightlife as well as proximity to their professional and personal networks. The proliferation of smartphones has also alleviated some of the hidden costs of city-living, as online-based services such as Uber, Amazon and DoorDash have significantly augmented access to transportation, retail and dining. Given that the lion share of new apartments constructed over this cycle have been amenity-rich luxury units concentrated near the city center, many renters will likely continue to find value in living in urban areas and choose to rent for longer. Moreover, there continues to be a shortage of affordable entry-level homes in the suburbs, which means even those who want to trade the balcony for a backyard may increasingly find it difficult to do so.

At the other end of the spectrum, the largest contributions to household growth over the next few years is expected to come from those aged 65 & older. A significant portion of this segment falls in the younger “empty nester” and “active adult” categories who are by and large healthier than previous generations and have no need for assisted living or nursing care facilities. The abundance of 485 star apartment units brought to market recently will be a viable option for downsizing Baby Boomers who prefer the latest appliances, amenities and abundance of restaurants and cultural
attractions of downtown. Furthermore, while there has been a wave of independent living senior housing development in Sun Belt cities such as San Antonio, Atlanta and Palm Beach, there has generally been a shortfall in the Northeast and Midwest where a high concentration of Baby Boomers call home. Contrary to popular belief, this cohort is somewhat less likely to move, even if their children and grandchildren have done so. Apartments left vacant by younger generations will increasingly serve as a suitable housing option, although many will need to be upgraded. There has also been an increase in age-restricted apartment communities, targeting active adults.

**Apartment Complex: Are We Overbuilt?**

On the supply side, multifamily building continues at a fairly robust pace, but the huge wave of apartment construction of recent years has likely crested. Even as apartment construction downshifts, there is still a significant number of units in the pipeline, and we expect activity to remain elevated. On a year-to-date basis, starts are running roughly even with last year’s pace, while permits are up 7.5%. With permits still lofty and showing few signs of falling significantly, we anticipate a 1.8% gain in multifamily starts for 2019 and a slight 0.3% decline in 2020. Although modest, this represents about 380,000 new units in each year, slightly ahead of the 375,000-unit averaged since 2014.

The yawning divide between building permits and starts likely reflects lenders eyeing new multifamily projects with an increasing amount of skepticism. Overall, multifamily lending has pulled back since late 2015, after the Fed issued a warning to lenders of potential oversupply issues. Now, a decade into the current cycle, lenders and developers are appropriately concerned that potential projects, which often take years to complete, might deliver into a recession.

While some caution is warranted, there is ample evidence the apartment market can absorb more supply. Nearly every measure of apartment vacancies remains near record lows and the vast majority of construction has been confined to the largest metro areas. Since 2010, roughly 50% of all multifamily building permits were issued in the 15 largest metro areas. Amazingly, 20% of all multifamily permits during that time were in just three metros: New York-North Jersey, Dallas-Fort Worth and Los Angeles-Long Beach.

There is also additional capacity to absorb apartment units in rapidly growing secondary markets, which continue to reap the benefits of the affordability migration. One clear beneficiary is Salt Lake City, where there are currently 7,500 new units under construction (10.9% of total inventory). It’s not hard to see why apartment inventories are expanding so rapidly. Utah posted the nation’s third fastest population gain in 2018, fueled by exceptionally strong job growth and rapid in-migration. Hiring is fueled by the state’s burgeoning tech sector, which has multiplied thanks to the region’s relative affordability compared to other growing tech hubs, home to a growing cluster of cloud computing, big data and software firms.
For many of the same reasons, Boston is also currently undergoing an apartment boom. The over 20,000 units currently under construction in Boston is somewhat astounding given the high construction costs in a dense, coastal city in the Northeast. Still, soaring employment growth in the biotech industry and a steady stream of young renters from the region’s numerous top-tier universities have fueled an almost insatiable demand for apartments. 2018 was the strongest year for net absorption in Boston in over a decade.

**If You Build It, They Will Come**

Elsewhere, the Sun Belt continues to dominate in terms of fastest growing apartment stocks. Miami, Charleston, and Fort Lauderdale currently have a massive number of rental units under construction, each in excess of 7% of total stock. Charlotte, Nashville, Austin and Orlando continue to top the list for new construction. The rapid accumulation of apartment units has left many concerned that demand could eventually peter out and these markets would be swamped with vacant units. These worries do appear to be somewhat warranted. Vacancy rates in Charlotte and Orlando have been gradually trending higher, and while the vacancy rate in Austin has fallen in recent years, it remains above the national average of 5.8%. With even more units expected to be delivered in coming years, it is hard to imagine vacancy rates in these markets reversing course in a meaningful way anytime soon.

**Miami and Nashville are case studies.**

Miami is perhaps the clearest case of a market which may soon suffer from a supply overhang. It has seen more units delivered in the past three years than in the prior 15 years combined, and even more are on the way. This past year the metro saw record levels of net absorption alongside strengthening employment growth. The recent wave of apartment building is being driven to a large extent by the movement of young professionals back into the city. But even with robust demand, the vacancy rate continues to track higher. With 16,300 units under construction, Miami may have some trouble absorbing the coming wave of supply even as employment and population growth continue to outperform national averages.

Nashville, on the other hand, offers a compelling example of how fears of overbuilding may be slightly overblown. Nashville continues to rank as one of the nation’s fastest growing job markets—nonfarm payrolls have risen at a 3% or better pace every year since 2010. To accommodate such rapid job growth, more than 35,000 apartments have been completed since 2010 and another 8,000 are under construction. A few years ago, demand was lagging behind the mountain of apartment buildings dotting the downtown skyline. As the vacancy rate drifted up to a cycle high of 9.4% in late 2017, annual rent growth slowed from more than 6% to below 2%. In short, the rapidly expanding stock of apartments has cooled rent increases and allowed the Nashville housing market to retain its affordable status, which has long been a key draw. Affordable rents likely contributed to Amazon’s selection of Nashville for its Operations Center of Excellence as well as Alliance Bernstein’s decision to relocate their headquarters from Manhattan. Together, those
two companies will bring over 6,000 new jobs to the area and position the region to better compete for relocations from other high-tech firms. This in turn will ultimately keep rents steadily trending higher over the long term.

A similar story appears to be playing out in Charlotte and Austin. Charlotte has close to 11,200 units under construction and has delivered over 45,000 units over the past decade. Even with the vacancy rate trending higher, rents have recently picked up to a 4.4% annual pace. Higher rents would clearly work against the influx of young, well-educated job seekers who have deepened the talent pool and enhanced Charlotte’s ability to land corporate relocations such as Truist and Honeywell. In a similar vein, Austin has roughly 13,300 units under construction, more than at anytime since 2014. But with rents rising at a blazing 3.9% pace and major tech companies such as Apple and Google investing heavily in the area, demand should remain relatively strong.

The Apartment Market is Not Without Risk

Nationwide, apartment rents continue to outpace wage gains and inflation, a consequence of subdued residential development. For example, the rent of primary residences index, a subcomponent of the CPI, has risen 3.7% over the past year. Rents rising ahead of inflation is not out of line with prior norms, fueling strong demand for apartment properties. Income growth has remained sluggish throughout most of this cycle, which has increasingly fueled calls for rent control in many large apartment markets. Most gateway markets already have some form of rent control in place. New York City, Oregon and California are the latest examples of state and local officials imposing stricter limits on rent increases. However, placing a ceiling on rent growth may ultimately work to dissuade investors and developers from pursuing projects in certain markets and exacerbate the very problem it seeks to solve.

Overall, above-average rent growth and high occupancies continue to fuel an epic rise in apartment property prices. Even as valuations have recently shown signs of moderating, prices continue to rise at an impressive 7% pace as demand for apartments remains intact. Underpinning this demand, however, has been historically strong job growth, which is now moderating. Broadly speaking, one of the largest contributors to employment growth for the past decade has been the tech industry, which has relied on a seemingly endless wellspring of venture capital. Tech-heavy apartment markets such as the Bay Area, Boston, Denver and Austin, have also been indirect benefactors of the ample flow of venture capital, which presents a clear downside risk if it were to dry up. The tech sector is also increasingly important in many secondary markets. While employment growth has held up relatively well, some high profile Initial Public Offerings have recently run into trouble, which might be a harbinger of tougher times in private funding markets, and ultimately for apartment markets with disproportionate exposure to the tech sector.

**Figure 9**

**Shelter Costs vs. Core CPI**

**Figure 10**

**Apartment Effective Rent Growth: Q3-2019**

Yr/Yr vs. Q/Q Annualized, Bubble Size Reflects Stock

Source: U.S. Department of Labor, CoStar, Inc. and Wells Fargo Securities