While the fundamentals remain strong for investors, there are signs that rental markets are at a turning point. Real rents are still climbing, but at a slower pace now that vacancy rates are ticking up. Returns to rental property investors remain healthy, but the influx of high-end supply has begun to dampen financial performance in many prime urban locations. Meanwhile, conditions in the vastly undersupplied low-cost segment continue to be extremely tight.

**RENTAL HOUSING’S ROLE IN THE ECONOMY**

Rental housing is an increasingly important contributor to the US economy. According to Bureau of Economic Analysis estimates, households spent $519 billion on rent alone last year, accounting for 2.8 percent of GDP in 2016—up substantially from the 2.2 percent share averaged during the boom years of the 2000s. Indeed, renters’ real aggregate housing expenditures climbed a strong 3.2 percent annually in 2006–2016, and drove 58 percent of the growth in domestic personal housing consumption over the decade.

With the sustained strength of rental demand and sluggish recovery in single-family construction, over a third of housing starts are now intended for the rental market. This is a larger share than in any year since 1974. Before the recent run-up in multifamily construction, rentals accounted for only about one in five new homes started in a single year. Among multifamily properties, the share of starts intended for the rental market was 93 percent in 2016. Among single-family homes, 4.9 percent are now being built as rentals, significantly higher than the 2.2 percent share averaged in the 1980s and 1990s.

Investments in new multifamily housing have also helped to drive the economy. The multifamily share of private domestic investment in new permanent residential structures grew from just 11 percent in 2000 to nearly 20 percent in 2016. The Census Bureau estimates that the value of private multifamily construction put in place (including labor, materials, soft costs, taxes, and profits) exceeded $62 billion in the 12 months ending in August 2017, similar to multifamily activity near the peak of the housing boom. In sharp contrast, the value of new single-family construction remained nearly 50 percent below the 2006 peak.

**ROBUST GROWTH IN RENTAL SUPPLY**

Unprecedented growth in renter households—totaling nearly 10 million between 2006 and 2016—fueled one of the fastest rental construction recoveries in history. After hitting a low of just 90,000 units in early 2010, the number of rental housing starts peaked at a 408,000 unit annual rate in early 2017. While this represents the highest volume in any four-quarter period since the late 1980s,
recent production of new multifamily units (which make up the lion’s share of rental construction) is still slightly below the 420,000 unit annual rate averaged since 1960. Growth in single-family rentals averaged some 390,000 annually from 2006 to 2016, supplementing new construction in meeting the sharp increase in demand.

Although the national recovery has been robust, the pace of growth in multifamily construction varied widely across markets. Over the latest cycle from 2010 to 2016, multifamily starts added 15 percent or more to the multifamily stock in fast-growing metros such as Austin, Charlotte, Nashville, and Raleigh, but as little as 1 percent in slow-growing areas like Cleveland and Providence. The largest increases in multifamily supply occurred mainly in the South and West, where production was still catching up with rapid population growth.

Overall, however, construction activity has begun to moderate (Figure 20). Indeed, multifamily starts are down 9 percent year-to-date through October 2017 on a seasonally adjusted basis. The slowdown was first evident in 2016 when permitting fell in nearly half of the nation’s 50 largest markets. The five markets with the most multifamily stock in fast-growing metros such as Austin, Charlotte, Nashville, and Raleigh, but as little as 1 percent in slow-growing areas like Cleveland and Providence. The largest increases in multifamily supply occurred mainly in the South and West, where production was still catching up with rapid population growth.

While Completions Are Still on the Upswing, Starts of Rental Units Have Slowed

With rental demand soaring, the national stock of vacant rental units shrank from nearly 4.5 million in mid-2010 to just 3.2 million in 2016. As a result, the rental vacancy rate fell sharply from 10.8 percent to 6.9 percent in the third quarter of 2016. However, the national vacancy rate rose to 7.2 percent in the third quarter of 2017, suggesting the rental market is at a turning point.

Even so, multifamily construction in many locations was still strong by historical standards. In the year ending August 2017, multifamily starts in nearly half of the nation’s 100 largest metro areas exceeded their annual averages in the two decades leading up to the housing peak (1986–2005). In 26 of these areas, multifamily starts were up by more than 50 percent. Moreover, starts in several markets where multifamily construction had not fully recovered by 2017—including Jacksonville, Riverside, and Sacramento—remained on the rise.

EASING MAINLY AT THE HIGH END

With rental demand soaring, the national stock of vacant rental units shrank from nearly 4.5 million in mid-2010 to just 3.2 million in 2016. As a result, the rental vacancy rate fell sharply from 10.8 percent to 6.9 percent in the third quarter of 2016. However, the national vacancy rate rose to 7.2 percent in the third quarter of 2017, suggesting the rental market is at a turning point.

Vacancy rates for professionally managed apartments in multifamily buildings are even lower. RealPage, Inc. reports a vacancy rate of 4.5 percent in the third quarter of 2017, comparable to those at the peak of the housing boom in 2006. Vacancy rates were under 4.0 percent in more than 40 of the 100 markets tracked, and under 3.0 percent in 16 markets.
But there are signs that conditions are loosening. According to the US Census Bureau, the vacancy rate in multifamily buildings with 5 or more units rose 0.9 percentage point in the third quarter from a year earlier, to 8.5 percent, indicating some easing in that segment. RealPage also reports that the apartment vacancy rate rose by a full percentage point in the year ending in the third quarter, with increases in 95 of the 100 metro areas tracked.

Underlying this shift is growing softness at the high end of the market. In the Class A segment where rents average $1,700 per month, the vacancy rate hovered near 6.0 percent in the first three quarters of 2017—up from around 4.5 percent a year earlier. This is the highest vacancy rate reported since 2011, and the highest rate for any property class.

Newly constructed high-end apartment properties became more difficult to fill last year. According to the Survey of Market Absorption, 10 percent of rentals completed in 2015 and priced at more than $2,450 remained vacant after 12 months. In contrast, only 2 percent of units with rents below $1,250 were still unfilled within one year (Figure 21). Apartment absorption rates fell most in the principal cities of metro areas, where most new supply has come online. In contrast, absorption rates were up in suburban and non-metro markets, where fewer new rentals have been added.

Demand for mid-market (Class B) rentals, which rent for $1,180 a month on average, has also begun to ease. The vacancy rate in this segment ticked up by a full percentage point to 4.6 percent in the third quarter of 2017. While the rate remains relatively low, this increase indicates that softness in the high-end market is beginning to affect mid-market conditions. Nearly 90 of the 100 apartment markets tracked by RealPage reported a year-over-year increase in Class B vacancies in the third quarter.

Meanwhile, the vacancy rate in the lowest-cost segment of the professionally managed market (Class C) was down to just 3.3 percent in the second quarter of this year—its lowest reading since 2001—before jumping back up to 4.1 percent in the third quarter. Despite this uptick, Class C vacancy rates were at or below 3.0 percent in nearly half (46) of the 100 metros tracked by RealPage.

With rents for Class C units about a third lower than the market average, tightness in this segment indicates both ongoing demand for modestly priced rentals as well as a persistent shortfall in supply. Broader measures of vacancy rates that include all rentals confirm these conditions. For example, 2016 American Community Survey data show that vacancy rates for less expensive units (with contract rents below the area median) were below those for more expensive units in 42 of the nation’s 50 largest metros. Indeed, 14 large metros reported rates in the lower-cost segment at or below 5.0 percent last year, compared with just 3 metros in 2006. The tightest conditions were in Los Angeles, Portland, San Francisco, and Seattle, where vacancy rates for low-cost rentals were under 3.0 percent.

Tight conditions are also evident in certain rental structure types tracked by the Housing Vacancy Survey. For example, vacancy rates in buildings with 2-4 units—which tend to be older and less expensive—held at 7.0 percent in the third quarter of 2017. Rates for single-family rentals, however, declined to 6.2 percent in response to strong demand and limited inventory.

**RENTS STILL UNDER PRESSURE**

The CPI index for rent of primary residence, which covers the broadest range of rental property types, was up 3.9 percent in the year ending September 2017. Although only a modest gain from the previous year, this increase is still noteworthy because it marks yet another year when housing costs have risen faster than the prices of non-housing goods (Figure 22). Rent increases were highest in the West (5.5 percent) and South (3.5 percent), held steady in the Midwest (at 2.9 percent), and slowed somewhat in the Northeast (from 2.9 percent to 2.6 percent).

According to RealPage, the year-over-year increase in nominal rents for professionally managed apartments was 2.7 percent in the third quarter of 2017, continuing the slowdown from 4.0 percent a year earlier and 5.6 percent two years earlier. However, trends vary widely across apartment property types. At one extreme, a flood of
new construction brought annualized rent gains for recently built units down to just 1.1 percent in the third quarter (below the rate of inflation in non-housing goods). Rent increases for high-rise properties—which have the highest average rent of $1,890 per month—were also modest at only 1.1 percent. Meanwhile, rents for units in low-rise structures rose 3.1 percent, reflecting the strong demand for lower-cost housing.

Rents for single-family homes (including condos) rose steadily for seven years, with growth hitting a high of 4.4 percent in early 2016, before slowing to 2.8 percent in mid-2017. Much of the slowdown was at the high end (units renting for more than 25 percent above median), where rent growth dropped to just 1.9 percent. Meanwhile, though, rents for low-end single-family units (renting for at least 25 percent below median) climbed by a strong 4.4 percent.

THE GEOGRAPHY OF RENT GROWTH

Annual rent growth in some 70 of the 100 apartment markets tracked by RealPage slowed in the third quarter of 2017 compared with a year earlier (Online Figure 4). Even so, nominal increases in almost three-quarters (73) of these markets still outpaced the 1.3 percent inflation in non-housing goods prices, with nearly one in five reporting strong growth above 4.0 per-
cent. Most of the areas with rapidly rising rents—including Las Vegas, Orlando, Sacramento, and Seattle—are located in the West and South. Other prominent metros in these two regions also had rent gains over the past few years, but these increases have either moderated (Dallas, Riverside, and Sacramento) or slowed considerably (Austin, Nashville, and Portland).

Meanwhile, nominal rent growth in the Midwest and Northeast has remained slow to moderate, with only a handful of markets reporting annual increases above 3.0 percent over the past year (including Cincinnati and Minneapolis). In contrast, several metros in these regions—Bridgeport, Dayton, Des Moines, Pittsburgh, Providence, Syracuse, and Wichita—posted nominal rent growth that lagged behind general inflation.

Within metro areas, rent increases in once low-cost neighborhoods have been especially large. In the 100 metro areas tracked by Zillow, rents in lowest-tier neighborhoods in 2012 were up sharply by mid-2017 in metros with the highest population growth (Figure 23). In Denver and Houston, for example, annual rent increases in the lowest-cost neighborhoods exceeded those in the highest-cost neighborhoods by more than 2 percentage points. In metros where the population was either stable or declining, however, rents grew slowly across all neighborhood types.

**STRONG RENTAL PROPERTY PERFORMANCE**

The rental property market has been among the best-performing sectors of the economy. The National Council of Real Estate Investment Fiduciaries (NCREIF) reports that nominal growth in net operating income (NOI) for investment-grade properties averaged some 7.7 percent annually in the seven years ending in the third quarter of 2017, compared with just 2.8 percent annually on average in 1983–2010. These strong gains reflect high occupancy rates as well as rising rents. With apartment occupancy rates falling and rent growth slowing, however, NOI growth moderated to a 3.8 percent annual rate in the third quarter—still outpacing the national rate of inflation and in line with historical averages.

Solid growth in operating incomes allows property owners to reinvest in their units. According to the National Apartment Association, real improvement spending per unit more than doubled from 2010 to 2016 (Figure 24). Owners of large apartment properties invested $1,480 per unit on average in 2016, or roughly 10 percent of gross potential rents, up from about 8 percent per year on average between 2001 and 2015.

There is also little sign that single-family rentals are returning to the owner-occupied market. According to the latest American Community Survey, growth in the total number of single-family rent-
als (both attached and detached, and including vacant units) was essentially flat between 2014 and 2016, and increased only slightly (by 0.6 percent) in 2015–2016. However, recent growth in occupied single-family rentals remained strong in fast-growing markets of the West and South, including Austin, Charlotte, Denver, Houston, Orlando, and Phoenix.

Healthy investor appetite has driven up the real prices of investment-grade apartment properties by 9.3 percent annually over the past seven years. Real Capital Analytics data indicate that real apartment prices stood 24 percent above their 2007 peak in mid-2017 (Figure 25). Prices for properties in highly walkable central business districts are particularly high, up 84 percent from their previous peak. Properties in highly walkable suburbs have also appreciated rapidly, exceeding the previous peak by more than 40 percent. Although much slower to recover, rental property prices in more car-dependent suburbs still surpassed previous peaks by 13 percent by mid-2017.

The apartment property market is, however, cooling. Prices declined slightly for the Midwest and Northeast regions over the past year. And while prices in several metros in the West and South (including Atlanta, Los Angeles, Nashville, Phoenix, San Diego, Seattle, and Tampa) continued to climb through mid-year, prices in several others (Charlotte, Houston, Orlando, and San Jose) declined in real terms.

NCREIF estimates show that the total return on investment in the multifamily sector, including net income and appreciation in property values, exceeded 10 percent annually from late 2010 through early 2016. But with price appreciation slowing, ROI ramped down to a still respectable 6.2 percent in mid-2017. Investor appetite nonetheless remains strong, with CBRE reporting historically low capitalization rates for multifamily assets in nearly all markets and tiers in the first half of this year.

**MULTIFAMILY SALES VOLUME SOFTENING**

According to Real Capital Analytics, the annual volume of large apartment purchases (prices of $2.5 million or more), net of dispositions, hit a record high of $169.6 billion in the third quarter of 2016 in real terms, a 30 percent increase from the previous peak in the second quarter of 2006. By mid-2017, though, deal volume edged down to 148.1 billion, with declines in both international and institutional/equity fund investments. More than half (63 percent) of net acquisitions came through private domestic sources, while 33 percent were through institutional and equity funds. The shares of REITs and foreign investment were small by comparison, in the 5–6 percent range.

With pricing at or near all-time highs and limited inventory on the market, large apartment deals in five of the six major metro areas tracked by RCA—Boston, Los Angeles, New York City, San Francisco,
and Washington, DC—slowed in the first half of 2017 from a year earlier. The exception was Chicago, where net sales continued to pick up. Large purchases of high- and mid-rise apartment buildings also rose in non-major metros.

Investors and lenders alike appear more cautious at this stage of the cycle. According to a recent Federal Reserve survey for the third quarter of 2017, bank loan officers on net reported weakening demand for loans secured by multifamily residential structures, while also reporting more stringent lending standards—the ninth consecutive quarter of tightening.

Nevertheless, the Mortgage Bankers Association reports that the volume of multifamily loans outstanding (including both originations and repayment/write-offs of existing loans) hit a new high of $1.2 trillion in nominal terms in early 2017, a 9 percent increase from a year earlier and a 44 percent jump from early 2011. Federal lending sources were responsible for fully two-thirds of the net increase in debt financing over the past year. Banks and thrifts have also steadily expanded their lending, raising their share of mortgage debt outstanding from a quarter in 2011 to about a third.

Despite signs that the rental market may be cresting and that investors are facing greater headwinds, measures of credit risk remain low overall. Only 0.15 percent of all FDIC-insured loans secured by multifamily residential properties were in noncurrent status (90 days past due or in nonaccrual status) in the second quarter of 2017, down from 0.23 percent a year earlier. According to Moody’s Delinquency Tracker, the noncurrent rate for commercial mortgage-backed securities (60 days past due, in foreclosure, or REO), though higher, was still a modest 2.8 percent in August 2017.

**THE OUTLOOK**

After seven years of tightening, rental market conditions have begun to ease in many metro areas. So far, most of the slack is at the upper end of the market and in core urban areas, where most new rental units have come online. However, supply pressures may be lessening in the moderately priced segment as well.

While this does appear to be a turning point, the extent of any potential slowdown depends in large part on the strength of future rental demand. The most likely scenario is that renters will still account for about a third of household growth going forward, which would make for a soft landing from current market conditions. But if the downshift in renter household growth is more significant, the impact on markets would be more negative.

Whatever the short-term outlook, there will be ongoing need for lower-cost rental housing. Now that the high end is saturated, developers may turn their attention to the middle-market segments. But given the challenges of supplying lower-cost units amid high and rising development costs, government at all levels will have to find new ways to facilitate preservation and expansion of the affordable stock. The housing industry must also play its part in fostering innovation to meet the nation’s rental affordability challenges.