APARTMENT CONDITIONS MODERATE

Demand is strong but falling short of supply; rent growth is flat nationally

EMPLOYMENT: Job growth slowed throughout 2023 but remains resilient and stronger than expected. Payrolls should slow further throughout 2024. The unemployment rate remained steady from last month at 3.7 percent as of January 2024, up only 30 basis points (bps) from 3.4 percent a year ago.

VACANCY: Construction levels are at a 50-year peak and have moved vacancy higher. Apartment vacancy rates averaged 6.6 percent in 4Q2023, up from 5.5 percent a year ago. Because of the surging number of completions expected in 2024, we expect the vacancy rate to remain above the historic average, ticking up potentially by 20 bps before moving back down to 5.0 to 5.5 percent nationally over the long term.

SUPPLY: We are in the midst of peak supply levels, with about one million units currently underway nationally, and concentrated in the South and Southeast. Nearly 440,000 units delivered in 2023 and another 672,000 units are expected to deliver in 2024. Slowing permits and starts numbers are pointing to much lower completions in 2025-2026.

DEMAND: Net absorption was strong in 2023 and the total for the year—234,000—was in line with the 20-year historic average. Fundamental demand for apartments should remain strong, given improved consumer confidence, cooling inflation, and a resilient job market. Nevertheless, demand is expected to lag supply in the face of deliveries in 2024, especially with potentially slowing payroll growth.

RENT GROWTH: After enjoying double digit gains in 2022 and a cumulative five-year gain of 31.6 percent, rents are flattening and even declining in some high supply markets like Austin, Phoenix, Atlanta, and Las Vegas. Annual effective rent growth for market rate apartments averaged 0.4 percent in 4Q2023. We expect continued modest rent growth for 2024, likely in the range of 1.0 to 2.0 percent on an annual basis, based on the impact of new construction and slowing job growth.

CAP RATES/SALES TRENDS: Apartment cap rates again rose in 4Q2023, averaging 5.7 percent, an 18 bp rise from last quarter and 63 bps higher than a year ago. Apartment CPPI declined by 8.4 percent YOY. Sales activity in 4Q2023 remains at a low level of $26.9 billion, an annual drop of 50 percent.

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ECONOMY

The U.S. job market has been decelerating steadily since the beginning of 2022. In 2023, the U.S. economy added an average of 225,000 jobs per month, down from an average of 399,000 in 2022. The January jobs report showed a gain of 353,000 positions, a 1.9 percent rise over last year. PNC’s economists expect job growth to slow and the unemployment rate to rise to above 4.0 percent by the end of 2024, resulting in a mild and short recession in mid-2024.

The household survey showed unemployment remaining mostly stable over the last few months at a historically low 3.7 percent in January, up 30 bps from one year ago. The unemployment rate has been below 4.0 percent for two years, the longest period of time since the late 1960s.

The Federal Open Market Committee (FOMC)’s tightening of monetary policy since the spring of 2022 has weighed on economic growth, although the economy continues to expand. The January meeting yielded an unchanged federal funds rate of 5.25 to 5.50 percent; many economists expect the FOMC to hold rates steady in the near term given the slowing labor market, but begin to cut rates in the middle of the year.

Inflation has eased over the past year but remains elevated. The overall consumer price index (CPI) was up 3.1 percent in January from one year earlier. This was down from 4.9 percent in April and a peak of almost 9.0 percent in mid-2022. The core CPI, which excludes volatile food and energy prices and is a better measure of underlying inflation trends, was up 3.9 percent year-over-year in January. This was down from 5.5 percent in May and 6.6 percent in September 2022. Fed officials have stated that they are in no rush to begin lowering rates, but as we are within range of their 2.0 percent target inflation number, we expect them to cut rates in mid-2024.
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APARTMENT MARKET TRENDS

VACANCY
The fourth quarter reflected a jump in vacancy levels, with vacancy for investment grade apartments averaging 6.6 percent, up from 5.5 percent a year ago. This shows a moderation from recent tight vacancy levels, a normalizing trend. While vacancy is close to historic levels, it is beginning to be elevated. Vacancy for all apartments (Census) fell 20 bps to 7.7 percent, 120 bps above the rate from a year ago; however, it is still well below its 20-year average of 10.0 percent.

The second adjacent table shows the effect of lack of supply, with Midwest and Northeast markets having the tightest vacancies. As can be expected, markets in the South and Southeast are experiencing higher vacancies, due to supply outpacing demand. The following two pages outline the ongoing wave of apartment construction and specify those markets currently experiencing rising vacancies (i.e. Atlanta, Austin, Las Vegas, etc.) and likely to cut rents.

The rises in vacancy are due to the 50-year supply surge. Given that almost 962,000 units are under construction, we expect investment grade vacancy rate to temporarily rise to between 6.0 and 7.0 percent. Owners and operators will be challenged as they work to increase lease traffic and fill those units. In place residents are facing a choice between a renewal rent that may be more than a brand-new apartment when factoring in a concession.

Looking ahead to 2025 and 2026, completions will drop dramatically as permits and starts slow. Because of tailwinds supporting the multifamily market, such as long-term demographic trends and mid- to long-term financial/inventory/interest rate issues with the for-sale housing market, vacancy is likely to remain near 5.0 to 5.5 percent nationally over the long term.

SUPPLY
Apartment construction is at a cyclical high, with about 440,000 units delivered in 2023. The number of multifamily permits (5+ units, apartments, condos, etc.) grew significantly between 2020-2022, leading to this surge of completions. These deliveries have helped satisfy a chronically undersupplied market. Although some markets are experiencing some oversupply, on a national basis, apartment supply is at last reaching normal historic levels necessary to meet new demand, which is estimated at 300,000 to 400,000 units annually. More supply availability in the short term, however, is impacting vacancy and rents.

Permits and starts are slowing dramatically. Should they continue to decline, completions should taper off beginning in 2025-2026.

High levels of new construction concentrated in a handful of markets in the Sunbelt continues to warrant caution. The table above lists markets with the highest construction levels and inventory growth rates so that we can identify potential areas of concern that could signal market softness. Most the markets in the list show rising vacancy rates of more than 100+ bps from a year ago and all show quarterly rent declines. It is important to note that while the South claimed 51 percent of the nation’s new apartment supply, it claimed 56 percent of net demand.

DEMAND
Apartment demand has been strong in 2023, with the net absorption for the year totaling 234,000 units. The fourth quarter’s demand number (58,200 units) was surprisingly high, considering fourth quarters are typically slow leasing seasons. This non-seasonal jump was the third-best fourth quarter in 25 years, behind only 2020 and 2021.

We expect new supply to overtake demand as the market takes time to lease the overhang of new units that delivered in 2023 and the new units projected to deliver in 2024. Further acceleration in apartment absorption is expected in 2024, but it will fall short of the number of deliveries, further pressuring rents and raising vacancy in some markets.
APARTMENT CONDITIONS MODERATE

RENT GROWTH
After double-digit gains last year, annual effective rent growth for the nation in 4Q2023 flattened, ranging from 0.2 to 0.7 percent, averaging 0.4 percent. Nevertheless, the cumulative rent gain between 2018 and 2023 was 31.6 percent.

The Midwest and the Northeast regions led the way with the strongest rent gains, while surging supply in the South and parts of the West are leading to rent declines. Phoenix, Austin, and Atlanta, as well as a handful of other markets are experiencing rent declines. Given the amount of new supply expected to deliver this year, as well as some reports of continued slow leasing activity, we expect these rent declines could become more severe and widespread, with the high supply markets identified on page 4 likely adding to the list of rent declines.

On a national basis, we expect annual rent growth to moderate to 1.0 to 2.0 percent in 2024. Third-party data sources estimate that annual rent growth will range from 1.2 to 2.3 percent through 2024, slightly higher than our expectations. Low supply or stable markets in the Midwest and Northeast could see continued robust rent growth.

APARTMENT SALES TRENDS

Apartment deal volume fell by 50 percent year over year and now stands at $26.9 billion including student housing. Deal activity remains depressed from pre-pandemic levels. The Garden sector continued to lead the way, with $16.4 billion in sales.

Cap rates for the apartment sector have been increasing for over a year and averaged 5.7 percent in 4Q2023. This was an 18 bp rise from last quarter and 63 bps higher than a year ago. Along with downward pressure on property prices, this suggests that cap rates will increase further for the remainder of the year and into 2024, to between 5.5 and 6.0 percent. Industry experts believe the cap rate peak will take place in 1Q2024 before moving back to the mid-5.0 percent range by the end of 2024.

Property prices for the apartment sector declined by 8.4 percent in December 2023, the second-steepest drop of all property types after office, as evidenced by MSCI RCA’s CPPI index. However, the apartment CPPI was flat from last month and remains 17 percent above the April 2020 level, when the pandemic’s impact was first apparent in pricing. This suggests the current rate of deceleration is a return to a more normalized trend over the long term.
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