REITs, CRE and falling interest rates

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The relationship between changes in interest rates and REIT/commercial real estate (CRE) values has long been debated by industry professionals. The frequency and volume of the debate historically has intensified in periods of rising rates. However, the precipitous decline in 10-year Treasury yields from an 8 November 2018 level of 3.24% to a 23 August 2019 level of 1.53% has prompted a different discussion. The debate is now focused on the outlook for REITs/CRE in a falling interest rate environment.

REITs can exhibit positive performance despite a bear shaped yield curve if other conditions are present

Despite a Bear/Steepening yield curve in 2003 and 2009, REITs delivered strong total returns. We believe this is explained by the fact that both years followed periods of severe market sell-offs (the collapse of the tech market and the global financial crisis). An unfavorable yield curve notwithstanding risk assets, including REITs, enjoyed significant appreciation. In addition in 2005 and 2006 despite the yield curve being in a Bear/Flattening cycle, REITs generated strong returns. We believe this is explained by strong capital flows into REITs and CRE. More than 30% of all fund flows into REIT mutual funds between 1999 and 2006 occurred in 2005/2006.

Are falling interest rates uniformly positive for REITs/CRE?

We believe the first question that should be asked is why are rates falling? In our view there are a number of contributing factors to the 171 basis point decline in 10-year yields between 8 November 2018 – 23 August 2019. As with rising interest rates the drivers of falling interest rates is essential in evaluating the impact of falling rates on REITs/CRE. Given the economically sensitive nature of CRE, we believe, all else being equal, a significantly slowing economy would likely be a negative for REIT/CRE values, particularly if we were to experience a recession. As CRE tends to be a lagging indicator, it is likely there would be a gap between declining economic activity and declining CRE operating fundamentals.
How do different REIT subsectors perform during a falling rate cycle?

REIT subsector performance under rising/falling interest rate environments is a bit more nuanced than looking at REITs as a group.

- Despite very strong REIT sector performance, short duration leases and a Bull/Steepening yield curve in 2001 hotel REITs declined significantly as economic activity contracted following the bursting of the technology bubble. This result is not surprising given the economic sensitivity of the hotel industry. The reverse happened in 2009 as the economy was recovering from the global financial crisis. Hotel REITs were the second best performing REIT subsector behind enclosed malls in 2009;

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