The pause we have all been waiting for – attractive prospects for property.

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SESFIKILE CAPITAL
Property Investments

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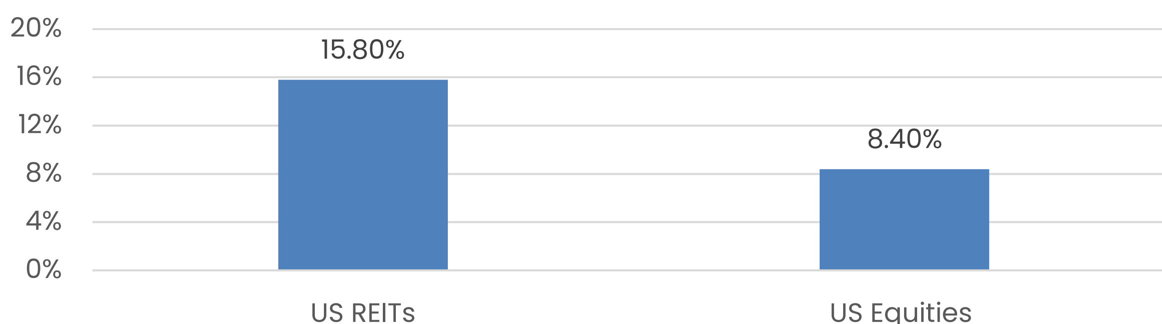
Last night (Wednesday, 13 December), Christmas may have come a bit early for equity markets in general and listed property investors in particular: The US Federal Open Market Committee (FOMC) decided to keep interest rates unchanged at between 5.25-5.5%. This part of the decision was largely expected as Forward Rate Agreements indicated a tiny 3% chance of a hike prior to the meeting. What was unexpected was the dovish stance by Federal Reserve (Fed) chair Jerome Powell. In his short speech, Powell stated that it was unlikely that the FOMC would raise interest rates further. Importantly, the "dot plot," which shows members' expectations of where interest rates could be headed, suggests a cut of 75bps in 2024. This, in addition to dovish Fed comments, sent the US 10-year treasury yields down 0.18% to 3.95% - a rate we had last seen in July 2023, resulting in a global listed property rally. The Fed has certainly paused, and we could even call this the 'Fed pivot'.

This decision and dovish stance are important to listed property as discount rates are likely to be reduced, resulting in higher intrinsic values. From an asset allocation perspective, using historical performance dating back to 1994, REITs tend to underperform global equities when interest rates are rising, and this has happened in almost all occurrences. However, as Chart 1 shows, the end of a rate-hike cycle is typically a very good environment for listed REITs. US REITs (67% of our Benchmark) tend to significantly outperform US equities over the 6-9 months following the end of the hiking cycle.

Chart 1: Average performance of US REITs vs US Equities when the Fed pauses rate hikes



Source: Janus Henderson, Cohen and Steers.

Returns represent average performance of hiking period cycles covering February 1994, July 1999-June 2000, July 2004-August 2006, December 2016-February 2019. US REITs covered higher versus S&P500.

Recent data corroborates this analysis; on 14 November 2023, US headline inflation came in at 3.2%, which was 0.1% lower than expected. This prompted investors to project that the Fed had paused rate hikes. Since then, US REITs have outperformed US equities by 5.13%, and global REITs have outperformed global equities (MSCI World Index) by 3.55%.

Turning to property fundamentals, lower funding costs mean that the companies will be able to refinance expiring loans at rates lower than initially feared, thus mitigating the negative impact of higher rates on forward earnings growth. Furthermore, lower funding costs will likely see investment markets resume towards more normalised levels, thereby allowing REITs to deleverage quicker via asset disposals. Further asset disposals are required in Europe. Plus, a pickup in transactions volumes in the housing market may see sectors like self-storage and smaller industrial units enjoy higher levels of demand. Lastly, expansion activity by well-capitalised REITs is likely to gain traction as acquisition or development yield spreads may once again screen attractive relative to the cost of capital. All these factors point to upside risk to earnings growth prospects, and higher property valuations.

As we write this, the sector is up c.6% year-to-date in USD but still offers attractive value for investors. Balance sheet LTVs (debt-to-asset) ratios are reasonable at 33%, with around 9% of debt expiring in each of the next two years. Global REITs trade at a 17% discount to Net Asset Value (NAV) and offer investors an attractive 4.5% dividend yield, with growth expected to be in the region of 4% for 2024. Barring a severe economic slowdown, a reversion to +5% earnings growth in 2025 onwards is expected. Putting all these factors together, we expect total returns of approximately 10% in USD over the next 12 months.

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