Higher for longer, and possibly longer –

What's the impact on REITs?

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In September, the US Federal Reserve Bank (Fed) kept interest rates unchanged at 5.25%-5.5%. The Fed has hiked rates 11 times since March 2022, only pausing twice over that period. In his speech, Fed Chair Powell stated, "Recent indicators suggest that economic activity has been expanding steadily. Job gains have slowed in recent months but remain strong, and the unemployment rate has remained low. Inflation remains elevated." In this short and direct speech, Powell twice stated that 2% remained the long-term inflation target and that they would be willing to hike rates further to achieve this goal. We would characterise this as a hawkish pause. On the other hand, the European Central Bank hiked rates by 25bps but cited concerns about the Eurozone economy, indicating that they may have reached the end. Furthermore, the Bank of England paused on rates and delivered a hawkish tone like the US Fed. Finally, on the domestic front, our local SARB kept rates unchanged, which was a sensible action given that CPI, at 4.8% for August, had already reached the 3-6% goal. Recent central bank moves were widely expected; however, as central bankers belted out hawkish tones, market participants were forced to adjust their bond yield expectations up. With respect to interest rates, we can no longer rule out further rate hikes beyond 2023, and interest rate cuts maybe further out and shallower than initially envisioned or hoped.

Again, our focus is on the impact of these central bank actions on global listed property. Recent company earnings results confirm our expectations that cap rate increases are largely behind us, indicating that sizable downside risk to valuations is unlikely. Loan-to-value (LTV) ratios have ticked up slightly to 34% but will likely end the downcycle below 40%. Importantly, given staggered debt expiries of c.9% per annum for the next 24 months, refinancing risk is not a major concern in aggregate, even in higher leveraged regions such as Europe. This does not mean we will not see some deeply discounted capital raises to shore up balance sheets in Europe.

Despite a better-than-expected outcome, what we cannot downplay is that a 'higher for longer' scenario may result in property companies slashing their earnings growth projections as debt is refinanced at significantly higher rates. Between 2015 and 2021,

REIT Funds-From-Operations (FFO) growth far outpaced inflation due to strong top-line rental growth, yield-enhancing developments or acquisitions, and the benefit of refinancing debt at lower levels sequentially every year. Top-line growth is still reasonable, but we will see a reversal of the other two growth drivers going forward.

In addition, secondary effects of higher-for-longer should also be considered. The US also faces an imminent expiry of the pause/ moratorium of student loan repayments, which will affect disposable incomes. REITs with tenants linked to discretionary consumer spending, such as 'fashion heavy' malls may fare even weaker than initially expected. Furthermore, at a 30-year mortgage rate of 7.88%, already weak home sales velocity may stall further. Recent research by UBS indicates a 64% correlation between home sales volume and storage demand, and this drop could impact an already challenging environment for self-storage operators. Although wage growth and employment levels have been resilient, tighter financial conditions will have a negative impact on corporate expansion plans and hiring intentions, thus dealing another blow to an already fragile office property market with vacancies above 2008 global financial crisis levels. Lastly, a looser labour market will weaken the bargaining power of employees, leading to lower wage growth, thus impacting apartments already seeing elevated levels of supply.

None of the information above spells good news for REITs. However, what is always an important consideration is what current valuations are discounting. At a circa 20% discount to Net Asset Value and 5% dividend yield, we see good value in global listed property where current prices provide investors some margin of safety. The sector has discounted these issues a bit more. Furthermore, although higher funding costs will hamper earnings growth, we still expect growth of 4% for 2024 and a reversion to the long-term average growth rate of 5-5.5% thereafter. Putting these things together, we believe total returns of 12-14% in USD over the next 12 months are achievable.

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