Global REITs: near-term interest rate obsession and longer-term opportunity

November 2023

The last 18 months have been hard for real estate investors. But with interest rates peaking across several developed markets, combined with robust fundamentals, the tide looks to be turning.

Having corrected sharply in 2022, global real estate investment trusts (REIT) are now offering attractive return potential, relative to broader equity markets. They also offer an enticing valuation compared with the direct real estate market. An attractive entry point is therefore emerging for REITs. However, we believe an active investment approach is important, given the dispersion of returns and the need to be nimble.

Rate-hiking cycle ending…

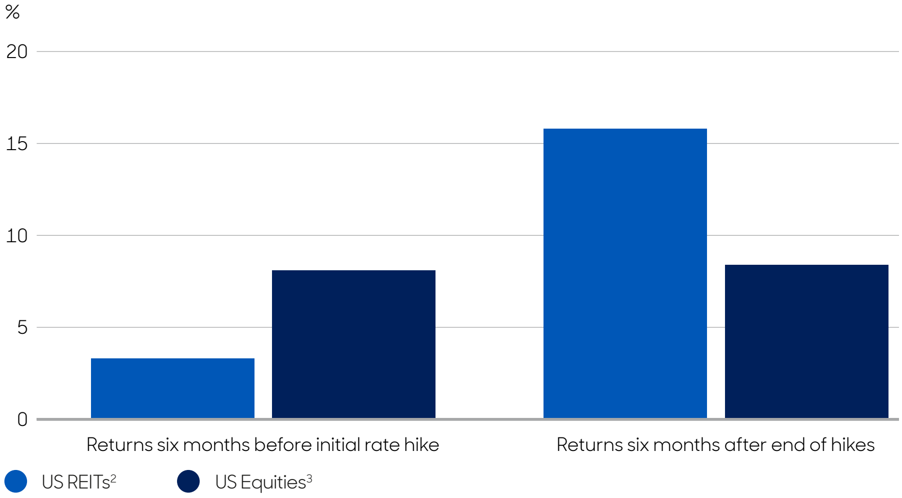
Over the last couple of years, we've seen a globally coordinated effort by central banks to aggressively contain rampant inflation. However, signs of divergence are emerging, as various authorities start to take stock of the long and variable lag effects that have yet to be felt in the world's economy. Indeed, the US Federal Reserve (Fed) and Bank of England have paused rate increases, while the European Central Bank continues to hike. At the same time, China has cut rates, while Japan has loosened its yield curve control policy. With inflation moderating and economic demand showing modest signs of weakening, we're now closer to the end game. This suggests the next phase of central bank policy (pivot and hold) will be the market's focus.

…REITs set to perform well

Central banks appear to be making progress in tackling inflation from decade-level highs to more moderate levels, but it remains well above target. The narrative has shifted to a 'higher-for-longer' strategy as global economies remain resilient, despite rates in restricted territory. This sharp increase and expected elevated duration have weighed on interest rates. They've also affected income-oriented sectors because of their perceived financing risk and relative attractiveness. Indeed, listed real estate has lagged, but investors are now closer to the end of the hiking cycle. The abrdn Global Macro Research team expects inflation to continue to decelerate into 2024. Its baseline forecasts point to a mild recession around the middle of next year in the US. This compares with the Eurozone, which is very close to, or already in, recession. Our house view calls for the Fed to start cutting interest rates in mid-2024.

Following this pivot, REITs have historically performed well, relative to broader equities and private real estate (as shown in the chart below). That's because of the correlation between bond yields and real estate valuations. The two asset classes share similar characteristics, such as long duration and predictable cashflows. On a relative basis, REITs also tend to outperform other listed equities after a rate-hiking cycle. For instance, after the 1973 bear market (which shared many similarities with the 2022 sell-off) and a pivot from the Fed in December 1974, we found the listed real estate sector returned 59% in the following 12 months. This compared with 36% for the wider equity market. Similarly, in the 12 months after the global financial crisis, the listed real estate sector soared 74%, compared with 49% for equities.

Average returns during hiking period cycles[1]



[1] Returns represent average of hiking period cycles covering February 1994–March 1995, July 1999–June 2000, July 2004–August 2006, and December 2016–February 2019.

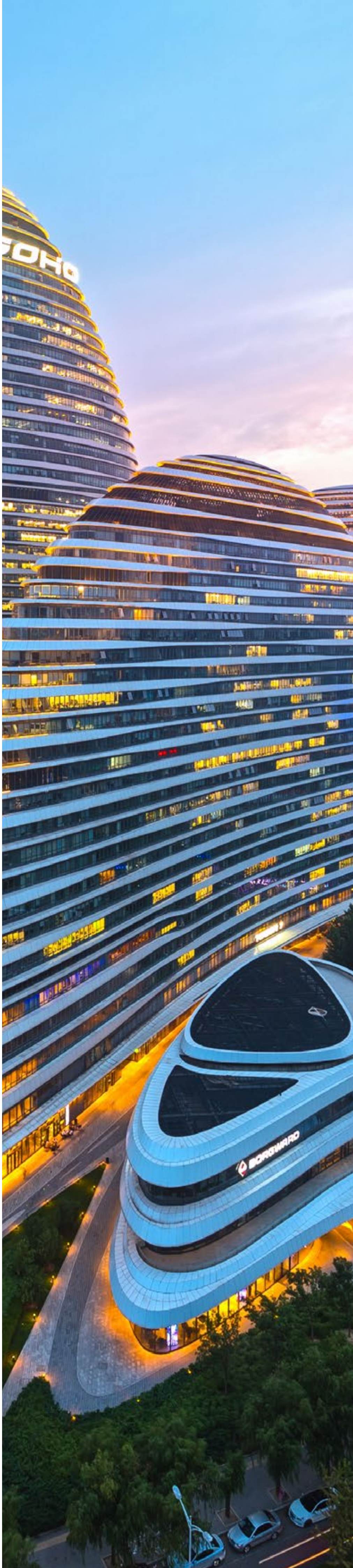
[2] U.S. REITs are represented by the FTSE Nareit All Equity REITs Index. Returns shown are average non annualized total returns.

[3] U.S. equities are represented by the S&P 500 Index. Returns shown are average non annualized total returns. For illustrative purposes only. No assumptions regarding future performance should be made.

REITs valuations have been faster to adjust than direct real estate

Listed REITs are more liquid vehicles than direct real estate and tend to anticipate moves in the direct market. Our research suggests that listed real estate leads the performance of the direct market by between six and nine months. Since 2022, share prices for global REITs have underperformed global equities by over 20%, while most direct proxies suggest more limited declines of roughly 10%. The leading nature of public REITs means it's likely they will anticipate the turning point in direct real estate valuations and move ahead of the rebound in the direct market.

Currently, market pricing for listed real estate implies an asset value correction of 15-40% across various sectors. Most listed vehicles have derated significantly and are trading at large NAV (net asset value) discounts. The largest discounts on Continental Europe can be found in the lodging (e.g., hotels) and retail sectors. In the US, life science, lodging and private rented residential apartments are most negatively priced. Europe is plagued more by balance sheet concerns than the US. That said, listed REITs tend to exaggerate direct valuation moves on the way up and on the way down. We believe this provides mispricing opportunities for select sub-sectors/stocks that have been sold-off indiscriminately.



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