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Real estate stocks – beneficiaries of the low-interest environment[1]

Within ***Focus*** we comment on extraordinary market events and analyse capital-market-related special topics.

Real estate stocks have developed splendidly over the last few years.

Thanks to the low interest rate environment and the associated real estate boom, real estate stocks have developed splendidly over the past few years. This year, too, they have made significant gains. In addition to the general development of the stock market and the real estate market in particular, interest rates in particular are a key performance driver for real estate stocks – in many ways. For example, the relative attractiveness of stable rental income suffers when interest rates rise, especially with rising real interest rates. A sustained rise in interest rates due to inflation will lead to rising rental income, but only after a considerable delay. Moreover, in both cases demand for real estate will decline, at least temporarily, due to rising financing costs. Real estate prices are therefore usually under pressure as yields rise. In addition, real estate companies are usually heavily indebted so that rising refinancing costs are an additional burden. Historically, an increase in both bond yields and mortgage interest rates has had a corresponding negative impact on the relative performance of real estate shares or REITs compared with other shares. REITS, short for real estate investment trusts, are listed real estate corporations that own and lease real estate and meet certain legal requirements.

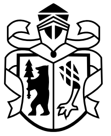
The continuing glut of liquidity has been accompanied by an increasing influence of long-term interest rates on the performance of REITs.

Over the last 10 years, however, there has been a shift in these channels of action. The relative performance of REITs or real estate shares compared to the overall equity market is increasingly reacting strongly to changes in long-term interest rates, while the impact of medium-term interest rates appears to be declining.
The main reason is that the refinancing costs of REITs – medium-term yields are particularly relevant here – have become less important than the positive effects of falling long-term bond yields. This is due to the continuing glut of liquidity from the central banks and the associated investment crisis on the part of investors. With the onset of the hunt for yield in recent years, real estate prices rose as did rents – albeit at a lower rate. In addition, the stable and high dividends from REITs played an increasingly important role in investment decisions. REITs, like other high-dividend equities, have increasingly become an alternative to bonds for investors, competing with the highest yielding bonds (ie the long end of the curve). This increases the sensitivity between the yields of long-term maturity bonds and the development of REITs. The years since 2014 have shown that the positive effects of falling and low long-term interest rates can more than compensate for the negative effects of rising short-term interest rates. At least in the US, sharply falling long-term yields have been accompanied by rising short-term yields. The US yield curve has flattened by more than 250 basis points since 2014. REITs have developed strongly in this environment.

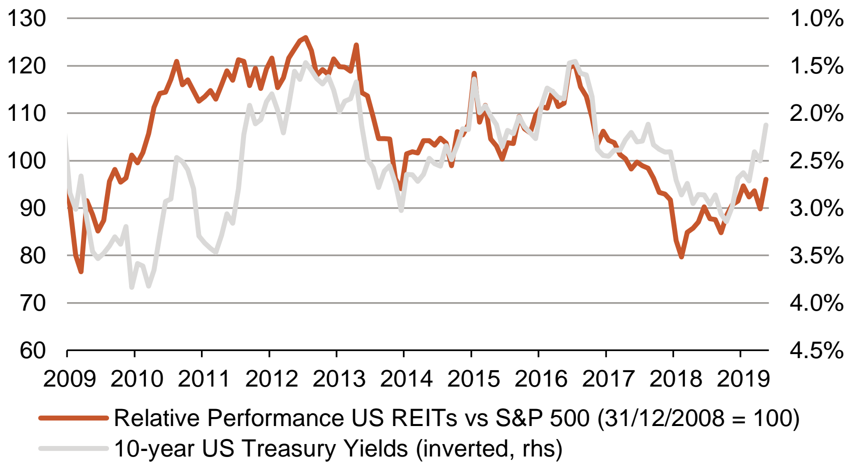
In phases of strongly rising yields, REITs have generally performed worse than equities.

Historically, however, REITs could no longer keep pace with the overall equity market as soon as yields rose significantly. The poorer performance in periods of sharply rising interest rates is due to the higher financial indebtedness of REITs and their status as bond-like securities in view of their high dividend yields. The high dividend yield of REITs becomes relatively less attractive as bond yields rise.

[1] This article is based on a guest commentary published in the Börsen-Zeitung on 1 June 2019.



Relative performance of REITs strongly dependent on interest rates



Source: Bloomberg, own calculations
Period: 31/12/2008 – 31/05/2019, monthly data

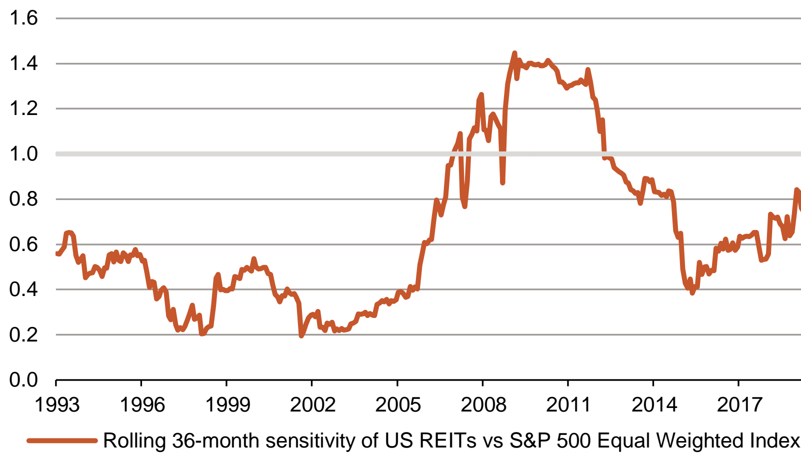
Real estate shares are not fundamentally defensive in nature.

Real estate stocks have a high correlation with the overall equity market. They represent risky assets. They tend to perform worse than government bonds in a recession, but better in an upswing. An environment of higher economic growth and lower unemployment is better for REITs. What is less clear, however, is whether there is also a pattern in the performance of REITs relative to the stock market in relation to certain phases of the economic cycle – ie whether REITs generally react more defensively or more cyclically than the stock market. There are good reasons to assume that REITs should be more defensive than equities: for example, the stable income from rental income, the high pay-out ratio and thus the stable and high dividends. In addition, the proportion of institutional investors with a long-term horizon, such as pension funds or insurance companies, is likely to be higher on average for REITs.

The sensitivity of REITs to equities fluctuates strongly over time.

However, the behaviour of REITs in economic cycles since 1978 does not point to a regular pattern, which could indicate that REITS are fundamentally defensive in nature. In some expansion phases, REITs have outperformed equities, while in others they have performed worse. The same applies to recessions. Thus, how REITs perform compared to equities cannot be explained by the phase of the economic cycle. This is plausible, because the development of the real estate market and the structural development of interest rates play an important role for REITs, as described above. The three-year sensitivity on a rolling basis (also called beta) of the US REITs Index to the equally weighted S&P 500 also shows that the beta of REITs fluctuates strongly over time. For example, the three-year beta of REITs in the phase of the real estate upswing and downswing from 2006 to 2013 was in some cases significantly above 1, but before that it was almost continually below 1. At present it is around 0.7 and thus significantly higher than during the 1980s and 1990s. REITs should therefore be regarded as risky assets that have at least partially lost their former defensive character.

Sensitivity of REITs to equities fluctuates strongly over time



Source: Bloomberg, own calculations
Period: 29/01/1993 – 31/05/2019, monthly data

Real estate stocks are attractive as a portfolio diversifier.

Real estate stocks remain attractive as a portfolio diversifier: the supply of real estate, for example, is catching up only slowly with demand in Germany, while demand in major cities continues to rise. The central banks continue to act cautiously. The hunt for yield due to the global low-interest environment should go on, providing continued support for REITs. This is also backed by the recent drop in the probability of an aggressive US interest rate hiking cycle. The market currently even believes there is a higher probability that the US Federal Reserve will actually cut interest rates than raise them. And interest rates in the euro area are also likely to remain low for some time to come. In addition to the long-term demographic trend towards low inflation, which will be exacerbated by digitalisation, the high level of debt in some peripheral countries of the euro zone also argues in favour of low interest rates, making it difficult for the ECB to raise key rates. As a result, yield increases are unlikely to be particularly high, which in turn should be positive for the further development of real estate stocks.

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