Real estate and interest rates

How will rising interest rates affect commercial real estate?

Standard Life Investments

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Introduction

Matthew Mowell
Real Estate Investment Analyst (US)

Bill Pekowitz
Real Estate Analyst/ Portfolio Manager (US)

In an eagerly awaited decision, the Federal Reserve (Fed) kept interest rates on hold at its September 2015 meeting, showing caution in the wake of further economic weakness emanating from China. However, if the US domestic economy remains sturdy - and many believe it will - a tightening cycle is likely to commence soon. In raising rates, the Fed is certain to be gentle, perhaps hiking just 15 to 25 basis points at a time. Elsewhere, the Bank of England is the only other major central bank adopting even a remotely hawkish tone, as the UK economy has decoupled from Continental Europe.

Historical evidence shows that real estate delivers a positive total return in periods of economic growth. Given that performance is a function of underlying economic activity, we therefore assess how the asset class will perform against the current backdrop. In doing so, we analyse both direct real estate and listed REITs. They tend to perform in a similar manner over the medium term although short-term financial market volatility tends to affect REITs more.

Executive summary

- Interest rates are widely expected to begin rising in the US and UK, which raises the question of how commercial real estate will perform in a tightening environment.
- We analysed previous cycles to provide insight into how real estate has reacted in the past and determine what we can learn from this.
- While there are some commonalities, particularly with the 2004-2006 tightening cycle, there are unique current characteristics investors must consider.
- Higher interest rates could pose a threat to listed and direct real estate valuations in the short term given increased uncertainty.
- Over the medium term, commercial real estate should continue to post competitive returns versus other asset classes.
- Improving fundamentals, decent tenant demand and rental growth, limited supply, and a persistently attractive yield gap over bonds will continue to support the asset class.

The relationship between interest rates, bond yields and real estate

Firstly, it is perhaps helpful to examine the relationship between bonds, interest rates and commercial real estate (CRE). Changes in the economic environment and subsequent movements in benchmark interest rates affect both real estate and government bonds.

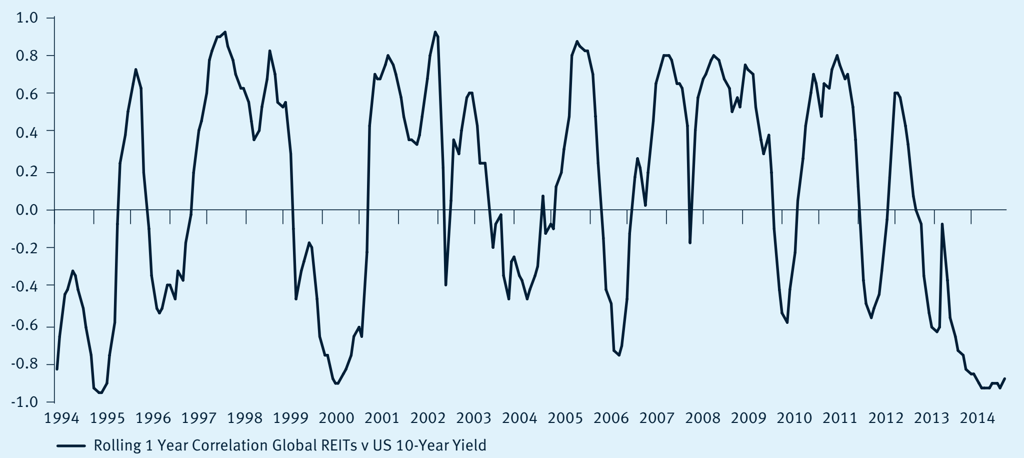
Interest rates and bond prices have an inverse relationship; when interest rates rise, so do bond yields. For real estate, interest rates affect the availability of capital and the demand for investment. These capital flows influence the supply and demand for property and, as a result, affect property prices. If real estate investors foresee increased variability in interest rates or an increase in risk, risk premiums generally widen, putting downward pressure on property prices. A rise in bond yields does not necessary mean that real estate yields will rise in tandem every time, but a relationship between the two does exist.

How much of a guide is past performance?

With interest rates providing an important basis for CRE valuations, it seems intuitive a Fed hike would impact performance. But will it really? Data suggests a weak relationship between US ten-year bond yields and US real estate capitalisation rates (the rate of return on an investment property based on expected income), with a correlation of just 30% since 1980. At 55%, the relationship is stronger in the UK, although this is possibly because of the way the index is constructed.

Meanwhile, share prices of listed real estate companies have become increasingly sensitive to bond yields, more often rising as yields fall and vice versa, (see Chart 1), reaching a record high correlation in 2015.

Chart 1: Correlation between global REITs and US Treasury yields

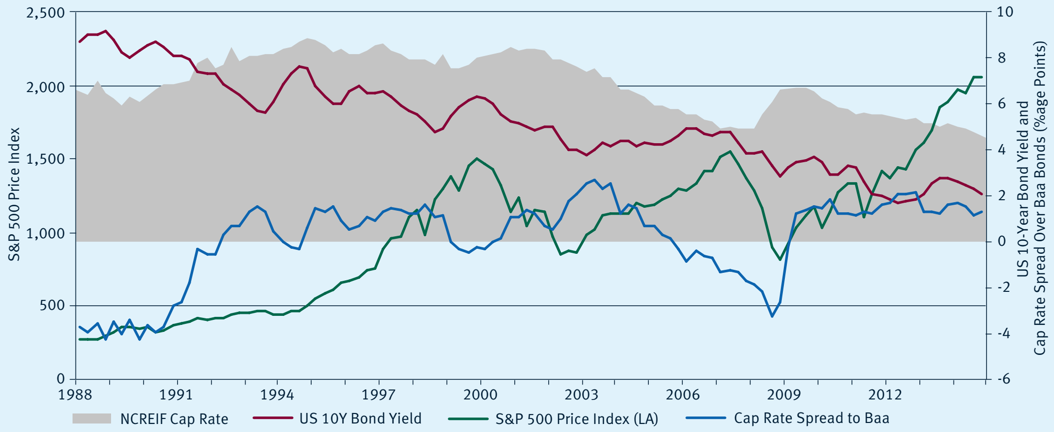


Source: Bloomberg, FTSE EPRA NAREIT, Standard Life Investments, as at 31 August 2015

Ultimately, the link between bond yields and CRE valuations is not definitive and nor is it constant. Since the early-1980s, when inflation was running at double-digit levels, interest rates have trended downward and have generally brought cap rates with them. This is the secular story but real estate is more than just a building. Its investment performance is driven by market fundamentals, as well as by broader capital market trends and investment alternatives. Therefore, each economic cycle has unique nuances that determine real estate's health.

Chart 2 illustrates this point, showing that interest rate changes are important but their impact is sporadic and other drivers play an important role. In the next section, we therefore look for insights from the last 40 years or so, since the advent of real estate performance indices in the US and UK, and evaluate which periods are a useful guide for the outlook today.

Chart 2: Interest rate drivers



Source: NCREIF, Standard & Poor's, Federal Reserve, Barclays, Standard Life Investments

1980s — The perfect storm

In the early-1980s, CPI was in double-digit territory and investors flocked to real estate for its inflation-hedging abilities. Treasury yields soared when the Fed and Bank of England raised bank lending rates to nearly 20% in order to stabilise prices. Meanwhile, cap rate spreads fell into negative territory and remained there for much of the decade.

Furthermore, savings and loans (S&L) banks and Japanese capital flooded real estate with easy credit and well-funded developers destabilising fundamentals. In the City of London, planning regulations were liberalised to allow for 11 million square feet of new space, or 20% of existing inventory. Real estate subsequently faced a perfect storm when the stock market crashed and speculative development overwhelmed the construction market. Struggling credit markets amplified the situation – which would haunt real estate again.

1990s — Dealing with the consequences

As a result, the late-1980s and early-1990s were extremely painful for real estate. US real estate valuations fell 32% cumulatively from 1990-1995, according to NCREIF, as cap rates shot upward. To put this into context, valuations fell 31% during the recent Great Recession. Investors would not quickly forget this long cycle and ignored CRE despite high single-digit yields. In addition, although interest rates declined during the first half of the 1990s, cap rates hardly fell.

The modern REIT era began in 1993 with the Umbrella Partnership (UPREIT) in the US, allowing large real estate companies to access the public market in a tax-efficient manner. This was the start of the current market, with large, vertically integrated and professionally managed real estate companies.

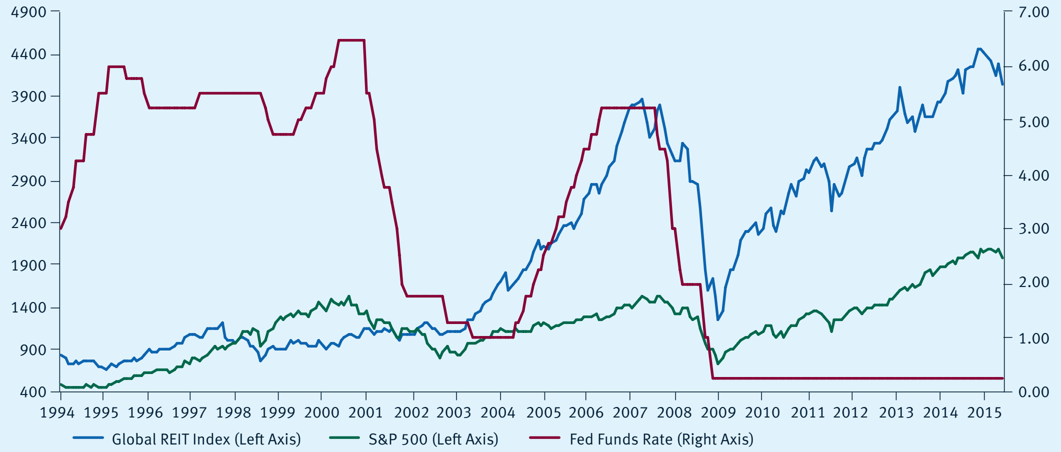
From 1993-1995, the Fed increased interest rates from 2.9% to 6.1%. During that same period, global listed real estate (outside the REIT regime) returned -12.1%. US REITs kept pace with the global average but this may have been because a number of REITs used their currency to finance acquisitions of portfolios that were still dealing with the ramifications of the S&L failure and US real estate crash. Therefore, this cycle may not be comparable to current conditions, where REITs are an established asset class.

2000s — The millennium market

In the early-2000s, the technology bubble burst as investors grew tired of profitless firms. The Fed quickly cut interest rates to support growth. This caused long-term bond yields to fall and cap rate spreads to widen globally. With fewer alternatives, investors began to move back into real estate and from 2001-2003 the positive correlation between interest rates and yields worked in real estate's favour. Interestingly, fundamentals were strong and rents rose because of higher inflation and demand from expanding businesses.

From 2004-2006, the Fed undertook a tightening cycle that represented its most aggressive effort in the past 25 years, increasing interest rates from 1% to 5.25%. Despite this large increase, these years also represented a 'Goldilocks' (not too hot and not too cold) environment for commercial real estate. Indeed, listed real estate generated total returns of 76% versus a 14% gain for the S&P 500 Index (see Chart 3).

Chart 3: Listed property performance during last tightening cycle



Source: Bloomberg, Federal Reserve, as at 31 August 2015

Overall, strength in the real estate market was down to three key factors.

(1) The Fed increased rates because of a strengthening global economy, which led to business expansion and some demand for new floor space. In turn, this supported higher rents and net operating income growth.

(2) The pace of new construction remained relatively in check, allowing supply and demand to remain in balance and benefiting existing landlords.

(3) Possibly most importantly for asset prices, liquidity was on the rise globally, with a sizeable chunk finding its way into real estate markets in the form of easier borrowing standards, commercial mortgage-backed security loans and a tolerance for higher debt levels.

This interest rate tightening cycle ended with the global financial crisis and the aggressive policy responses employed to stabilise the global economy. Near-zero interest rates caused yields to plummet and the search for return in riskier assets caused cap rates to follow suit – again reinforcing the connection between long-term bonds and CRE pricing.

Where are we now?

Given where we are today, with the Fed set to raise interest rates, it is perhaps most sensible to draw parallels with 2004. CRE yields remain relatively attractive, while cap rates in the most prominent markets are at record low levels although risk premiums remain extremely wide. Although policy uncertainty has increased volatility among liquid assets, history has taught us that interest rates do not always lead direct CRE pricing and performance. Some factors suggest that yields could remain stable or even decline further.

What has been very noticeable is that cash buyers with a long-term strategy are targeting the world's most important cities, such as London, Paris, and San Francisco. Meanwhile, accelerating credit markets are assisting value-added buyers. Fundamentals are also compelling, at least in the US. Supply growth remains muted, at 2.2% in the office market, amid what many believe will be a period of prolonged employment expansion. Globally, tightening by the Fed is less likely to influence CRE risk premiums. Varying monetary policies and growth rates have caused the correlation between US Treasuries and other major long-term bond issuers to deteriorate.

These factors exert slight downward pressure, or at least anchor, yields as the Fed commences with what it has suggested will be a modest tightening cycle. This is not to say that the era of appreciation-driven performance will accelerate. The greatest period of yield compression is probably behind us. As previous cycles have shown (see Chart 4), bond market movements do not always determine each real estate cycle. Looking forward, the best performance will come from assets with the best income growth upside, including those from supply-constrained markets with an upbeat economic outlook. Low yields suggest investors have priced in much of this growth, so achieving greater profit requires creativity. Active fund managers must therefore focus on asset management and repositioning existing properties to bolster income.

Chart 4: Yield compression cycles

	Barclays Capital US Govt/Credit	CPI	NCREIF	S&P 500 Index	T-Bills (90 day)	US GDP
1979 – 1981	3.61%	11.44%	18.59%	12.80%	12.58%	0.85%
1983 – 1987	2.20%	3.51%	11.07%	14.88%	7.68%	5.00%
1990 – 1992	2.09%	3.62%	-3.29%	13.13%	5.53%	1.84%
1995 – 1999	6.92%	2.25%	12.00%	27.86%	5.19%	4.31%
2003 – 2007	4.32%	2.80%	15.54%	14.31%	3.04%	3.00%
2010 – 2014	4.43%	1.59%	12.63%	15.05%	0.08%	2.14%

Source: Barclays, US Bureau of Labor Statistics, NCREIF, Standard & Poor's, Federal Reserve, Standard Life Investments

That said, liquidity has improved in recent years, unlike the mid-2000s, and increased regulation should keep lenders from returning to extremely lax lending practices. As such, while there is a favourable outlook for real estate fundamentals, and we believe positive returns are likely, we do not expect outperformance to match the last cycle in the US and UK.

Meanwhile, unlike other periods, economic activity in a number of markets appears to be diverging, requiring different monetary policies. Indeed, while the US and UK contemplate raising interest rates, Europe, China, Japan, Canada and Australia are considering easing policy. This will likely limit upward pressure on the long-end of the yield curve due to currency fluctuations, thereby reducing potential upward pressure on cap rates. Additionally, global investors may have opportunities to invest in markets that benefit from lower rates and a search for yield (as we have seen in Europe this year). This would offset the pressures that could occur in markets with rising interest rate regimes.

Conclusion

If, as expected, the Fed and Bank of England follow a path of gradual policy tightening, higher interest rates could pose a threat to listed and direct real estate valuations in the short term. This is due to the increased uncertainty that may accompany policy shifts and questions about potential cap rate movements.

Over the medium term, commercial real estate should continue to post competitive returns versus other asset classes. Asset values should be resilient under gradually increasing rates as rents maintain their improvement as the UK and US economies expand. The current pace of new construction supports this trajectory. Continued high levels of global liquidity will also support asset prices. Credit markets are functioning in major economies and, although lending standards are unlikely to return to pre-crisis levels, there is enough breadth and depth to sustain values in today's world.

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