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REITs and Rates

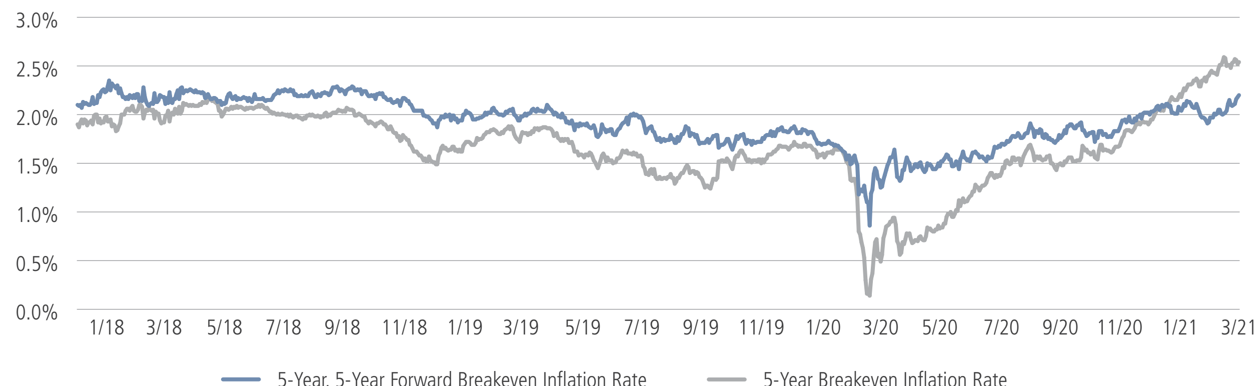
As economies around the world recover from the coronavirus crisis and vaccination programs begin to show a way out of the pandemic, signs of inflation have reappeared—and with them, rising bond yields. With bonds and equities both potentially at risk from this dynamic, we look at the performance of Real Estate Investment Trusts (REITs) across different inflation and interest-rate regimes of the past. Could this unique asset class be a potential safe haven should the economy start to heat up?

Many fixed income investors have experienced substantial losses this year, as U.S. Treasury yields have risen rapidly from less than 50 basis points in August 2020 to their recent high of more than 175 basis points. That is still a low level, however, leaving bond investors braced for more potential downside to come.

Equity markets have generally fared better, with some reaching record highs. Nonetheless, it has been quite a volatile ride, reflecting the very real risk that higher inflation and interest rates pose to the asset class. In general, the stocks that have endured the rockiest time since the start of the year were those that led the recovery in 2020: large growth stocks, particularly in the technology sector. This is most likely because their projected cash flows are weighted further into the future than those of other stocks, making them much more sensitive to changes in discount rates: as rates go up, their valuations tend to come down, just like those of long-dated bonds. We believe that is an especially important dynamic today, because technology growth stocks have become such a dominant driver of the performance of many benchmark equity indices.

The question of whether inflation and Treasury yields have further to climb is a complex one, given the extremely low base set last year and the highly unusual circumstances of the current economic recovery. The growing market consensus—reflecting the outlook of the U.S. Federal Reserve—is for a modest spike in inflation this year to be followed by a period of price growth marginally above the central bank's long-run target of 2%. We can see this in recent Treasury market pricing, which has been preparing for an average inflation rate of more than 2.5% over the next five years, and a long-run rate in excess of 2% (figure 1). This would not necessarily be bad for risk assets, but it could pose further risk to bond markets and the more interest rate-sensitive parts of the equity market.

FIGURE 1. INFLATION EXPECTATIONS HAVE RISEN SUBSTANTIALLY



Source: FactSet. Data as of March 31, 2021. For illustrative purposes only. Nothing herein constitutes a prediction of future economic or market environments. Due to a variety of factors, actual events, including the characteristic of economic or market environments, may vary significantly from any views expressed. **Past performance is no guarantee of future results.**

In this environment, we think investors are increasingly likely to seek out portfolio diversification and the potential for positive real returns in real assets, such as commodities, infrastructure and real estate.

We've written in the past about why we think REITs and other listed real estate securities are an efficient way to get exposure to global real estate return opportunities, and how these returns are fundamentally tied to the price appreciation of land and bricks-and-mortar properties, and also to rental income.[1] The first two are real assets, which are more likely to fluctuate in line with broad inflation; and rents are often contractually reset with a link to an inflation index. For those reasons, we would expect real estate and REITs to deliver positive real return potential over time—and that is what we find in the historical data.

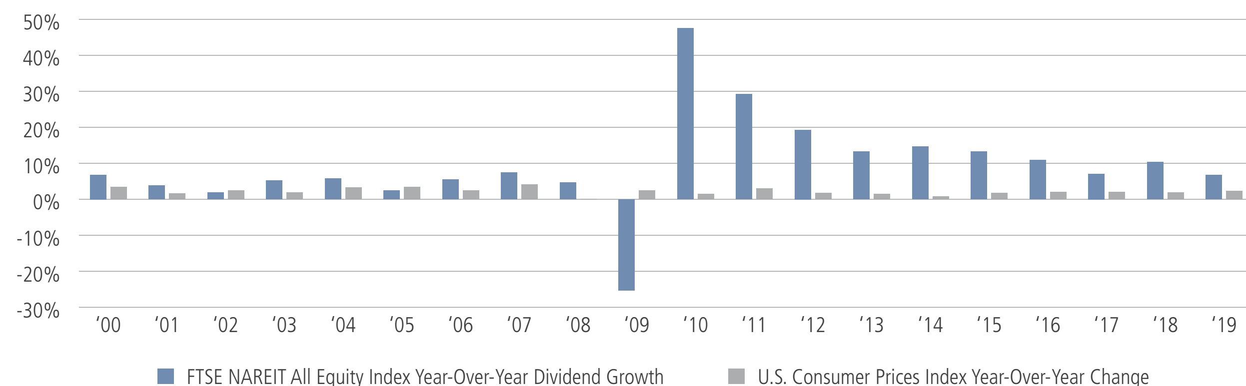
Figure 2 shows 20 years of dividend growth for the FTSE NAREIT All Equity REITs Index of U.S. real estate securities. It has outpaced inflation in every year except 2009, where we see the aftermath of the Great Financial Crisis, which originated in the real estate sector. In the decade since, REIT dividend growth has outpaced inflation substantially. Even if we start with the slump in 2009, REIT dividends have grown by almost 250%, whereas those nine years of inflation amounted to less than 25%.

In the second chart we see that price fluctuation rarely erased that consistent real income advantage. Between 1991 and 2020, the FTSE NAREIT All Equity REITs Index outpaced inflation every year except 1998 – 1999, 2007 – 2008, 2018 and 2020. If we start with the slump of 2007 – 2008, the REITS Index still more than doubled in value over the next 14 years, while inflation was less than 30%.

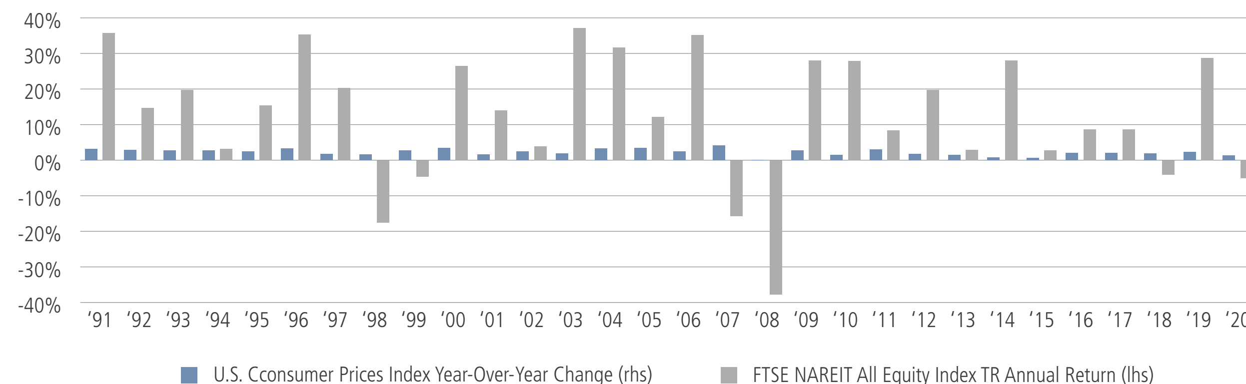
[1] Jones, Shigekawa, Kwang and Tiltman, "The Growing Case for Global REITs" (September 2020), at https://www.nb.com/transfer?URL=insights/the-growing-case-for-global-reits.

FIGURE 2. REITS HAVE DELIVERED POSITIVE REAL RETURNS IN MOST YEARS

REIT dividend growth versus inflation, 1991 to 2019



Annual returns versus inflation, 1991 to 2020



Source: Bloomberg, NAREIT, S&P Global Market Intelligence. For illustrative purposes only. Nothing herein constitutes a prediction of future economic or market environments. Indexes are unmanaged and are not available for direct investment. Investing entails risks, including possible loss of principal. **Past performance is no guarantee of future results.**

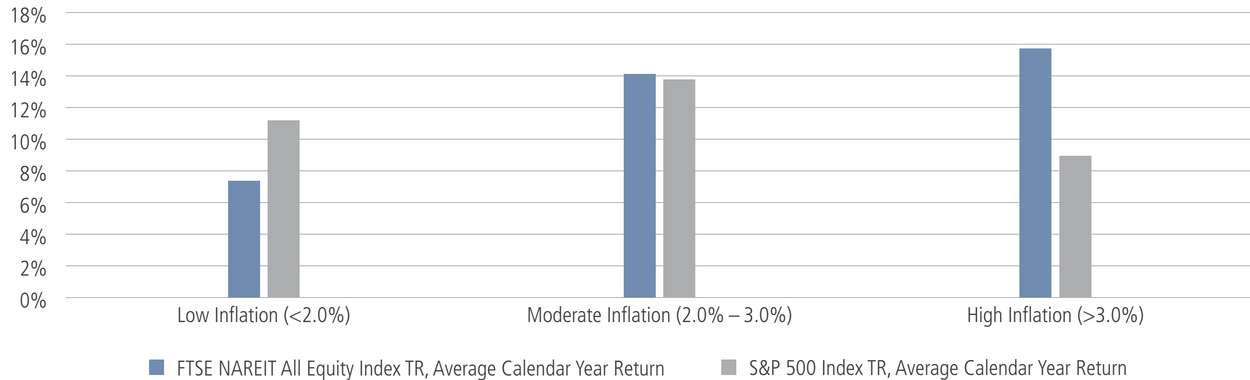
We don't believe that this is solely about the inflation sensitivity of the real estate asset class. The active management of real estate assets by the companies that own them makes a big contribution, as does the generally conservative use of leverage in the sector. But inflation does appear to be a significant tailwind. In the 12 calendar years since 1991 when inflation was less than 2%, the average return of the REITs Index was 7.4%. If we take out the extreme year of 2008, that average rises to 11.5%. But the average return for the 18 calendar years when inflation was above 2% was 16.5%. Periods of higher inflation appear to have benefitted REITs.

It is true that many other companies in the equity markets offer exposure to real assets, from the factories and machinery of the industrials sector and the commodities of the materials sector to the consumer goods of the staples sector. They also have management teams trying to make the best of those assets. Do REITs get more of a tailwind from inflation than these other stocks?

It appears that they do. Figure 3 compares the average calendar-year performance of the FTSE NAREIT All Equity REITs Index and the broad S&P 500 Index in three different inflation environments over the past 30 years, and the data supports the claim that REITs have done better than the broad equity asset class when inflation has been higher.

During this period, REITs outperformed in seven of the 12 calendar years with low inflation, in seven of the 12 calendar years with moderate inflation, but in five of the seven years with high inflation. Moreover, the two years in which they underperformed during high inflation were 1990 and 2007, which were both periods of specific stresses in the real estate sector.

FIGURE 3. REITS HAVE TENDED TO OUTPERFORM THE BROAD EQUITY MARKET DURING PERIODS OF HIGHER INFLATION
Average calendar year returns, 1990 to 2020

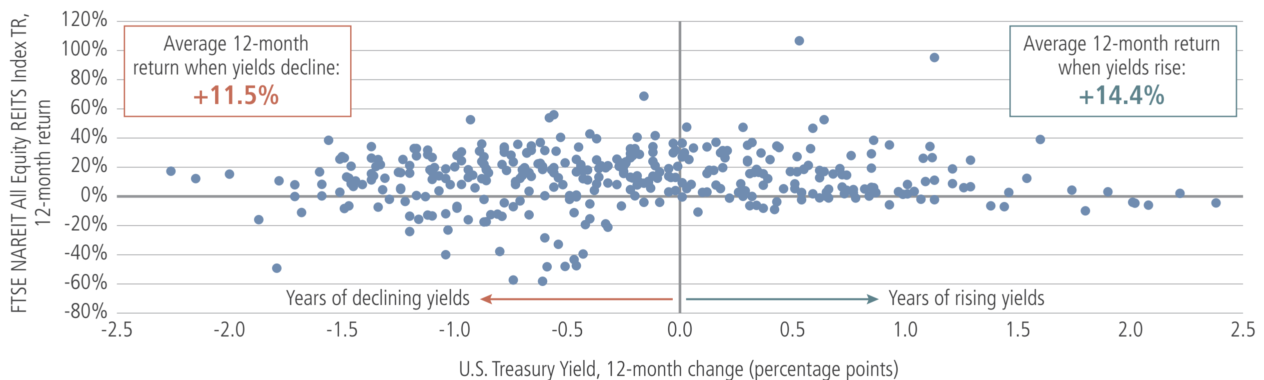


Source: FactSet, Neuberger Berman. Inflation is measured by the calendar year change in the U.S. Consumer Prices Index. For illustrative purposes only. Nothing herein constitutes a prediction of future economic or market environments. Due to a variety of factors, actual events, including the characteristic of economic or market environments may vary significantly from any views expressed. **Past performance is no guarantee of future results.**

Rising prices are one thing, but rising interest rates are another. In our view, much of the recent volatility in fixed income and equity markets has come, not so much from inflation expectations themselves, but from what they imply about the direction of central bank rates, bond yields and discount rates. It's therefore worth asking what sort of effect changes in interest rates have tended to have on REITs.

Figure 4 takes the 364 discrete 12-month periods between January 1990 and March 2021 and looks at the return to the FTSE NAREIT All Equity REITs Index and the change in the level of the 10-year U.S. Treasury yield for each of those periods. As we move left to right across the threshold from periods of declining yields to periods of rising yields, the REITs Index returns bunch up into the top half of the chart. Large 12-month drawdowns have been rare in rising-yield environments, and the average return has been almost three percentage points higher than when yields have declined.

FIGURE 4. REITS AND RATES: PERFORMANCE HAS BEEN BETTER WHEN YIELDS WERE RISING
364 discrete periods of 12-month trailing return and yield change, January 1990 to March 2021



Source: FactSet, Neuberger Berman. Data as of March 31, 2021. For illustrative purposes only. Nothing herein constitutes a prediction of future economic or market environments. Due to a variety of factors, actual events, including the characteristic of economic or market environments may vary significantly from any views expressed. **Past performance is no guarantee of future results.**

We also looked at the relationship between REIT returns and the change in the two-year Treasury yield. Here we found an even stronger positive tailwind from rising yields. Returns to the FTSE NAREIT All Equity REITs Index were positive in 85% of the 12-month periods during which the two-year yield rose, and the average return in those periods was 15.1%, almost five percentage points higher than the average return during periods of declining two-year yields.

We find this interesting because the two-year yield is much more sensitive to changes, and expected changes, in the central bank rate—which, generally speaking, is in turn closely linked to inflation expectations.

Last year, the U.S. Federal Reserve announced a new policy that now sees it targeting a long-run average inflation rate of 2% rather than a current rate of 2%. It recently reiterated that policy and its willingness to withhold tightening measures until high inflation is clearly evident in the data. That has led to a steepening of core government yield curves, as longer-dated yields have risen on inflation expectations while shorter-dated yields have been anchored by this commitment to accommodative policy.

This dynamic is generally considered to be supportive of risk assets, including equity markets. As our data suggest, it has also been positive for REITs in the past.

The heightened volatility in equity markets that we have seen this year has been around doubts about the commitment of central banks to accommodative policy—or worse, fear that they might lose control of inflation and be forced to raise rates quickly and substantially in order to rein it back in. Our findings on the relationship between REITs returns and the two-year U.S. Treasury yield suggest that this scenario may not be especially harmful for REITs—indeed, it could even be a tailwind.

We think that is likely due to the inherent inflation sensitivity of the REITs asset class. In our view, it is yet another reason to consider an allocation to REITs now that inflation and interest rates are generally expected to rise.

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INDEX DEFINITIONS

The **S&P 500 Index** is a capitalization weighted index comprised of 500 stocks chosen for market size, liquidity, and industry group representation. The S&P 500 Index is constructed to represent a broad range of industry segments in the U.S. economy.

The **FTSE NAREIT All Equity REITs Index** contains all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property that also meet minimum size and liquidity criteria. It is part of the FTSE NAREIT U.S. Real Estate Index Series, which is designed to present investors with a comprehensive family of REIT performance indexes that spans the commercial real estate space across the U.S. economy. The index series provides investors with exposure to all investment and property sectors. In addition, the more narrowly focused property sector and sub-sector indexes provide the facility to concentrate commercial real estate exposure in more selected markets.

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