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Winter 2019

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REIT Outlook and Top Real Estate Issues to Watch in 2019

by Calvin Schnure

The new year is likely to be good for real estate, with solid job growth, consumer spending, and business activity driving demand for nearly all types of commercial real estate.

But investors should temper their expectations. While conditions in commercial real estate markets held up well through the end of 2018, the economy entered 2019 buffeted by crosswinds of many sorts, including signs of slower global growth, trade frictions, stock market volatility, and a deadlock in negotiations over the Federal budget. There are growing concerns, as well, related to the age of the expansion, which has included significant increases in commercial property prices and rising construction activity.

The outlook for REITs and commercial real estate remains bright, however. Many positive factors offset these risks. Let's take a look at the main issues for macroeconomic fundamentals for 2019, and what they mean for real estate investment in the year ahead.

Macroeconomic Outlook

The economy was robust in 2018, with a growth rate of 3% through the third quarter and monthly job growth averaging 220,000 new jobs, the highest since 2015. This above-trend pace of economic growth is due in part to a boost from tax cuts in 2017. Growth is likely to slow as the tax stimulus wanes, and also as interest rates inch higher and the global economy slows. Growth closer to 2–2.5% is more sustainable over the long run.

The expansion is likely to continue through 2019, however, as the economy does not show the main warning signs that have preceded nearly every downturn over the past 70 years: overheating, overbuilding, or excessive debt growth. Inflation moved higher in early 2018, with the core PCE [personal consumption expenditure] deflator (the Federal Reserve's preferred inflation measure) moving above the Fed's 2% target. But inflation pressures cooled in the second half of the year, running at a 1.5% annual rate. Rising construction activity has been matched by growing demand for commercial space, keeping vacancy rates moving down and rents rising. Both borrowers and lenders have been cautious about debt growth, and overall debt levels are actually lower than in prior cycles.

Several wildcards, as mentioned above, are at play, including trade frictions, stock market volatility, and the government shutdown (still in effect as of late January). These are more likely to prove bumps in the road, however, rather than triggers precipitating a crisis and recession.

Financial Markets Outlook

Financing conditions should remain favorable for both commercial real estate markets and economic growth in 2019. Interest rates moved higher in 2018, but are likely to level off in coming months. Last year's increases in short-term rates were driven by Federal Reserve's moves raising the target for overnight rates to a range of 2.25–2.5%, a full percentage point higher than at the end of 2017. Recent statements by Fed officials, however, have emphasized rates are near a neutral position, and suggest further increases may not be needed, especially given the tame inflation trends.

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Long-term rates also moved higher in 2018. The yield on the 10-year Treasury note rose briefly above 3% in October and November, for the first time in five years. Rates subsequently retreated, in part due to a flight to quality as stock markets declined early in the year, but also in recognition that the Fed's tightening cycle may soon end. It would not be surprising to see rates move higher again as conditions stabilize, especially as the large federal deficit fuels Treasury borrowing needs. Any such increases are likely to be modest, however, as the global economy remains in a low-inflation, low-yield environment, which will translate into financing rates favorable for real estate.

Commercial Real Estate Markets and REITs

Moderate economic growth, favorable interest rates and a rough balance between construction and rising demand provide a healthy backdrop for commercial real estate and REITs in 2019. Several sectors are worth a close look in the year ahead.

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The apartment sector has been buoyed by households seeking to rent rather than buy in the decade since the housing crisis. While apartment construction has ramped up in recent years, shortages of both homes for sale and apartments for rent still exist in nearly every major city. This reflects pent-up demand from the housing crisis, as millions of people remain doubled-up with roommates or family members and may now be interested in renting a place of their own.

This shadow demand for rental housing has resulted in new construction being leased fairly rapidly in the months after projects are completed. In fact, the main barrier to stronger rent growth in such a tight market has been lack of affordability, as household incomes have barely kept pace with rents. A robust job market that boosts wages will be an important ingredient in future rent growth. Rent growth was solid in 2018, rising 3.6% over the four quarters ending in Q4/2018. Rising rents and high occupancy rates bode well for apartment REITs.

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The office sector may be poised for a rebound in 2019. Demand for office space has been weak over the past few years relative to employment trends. Total leased office space has risen about 1% per year since 2012, according to data from CoStar, while employment in office-using sectors (finance, professional and business services, information services) has grown 2% per year. Changes in the office work environment, with more shared work space and cubicles instead of individual offices, account for some of the weakness in demand, as well as the spread of WeWork and other office-sharing arrangements. Given limits on how many workers can be squeezed into a given amount of space, however, at some point net absorption will realign with job growth, which could result in an upturn.

In addition, some of the weakness in demand for office space has been a lingering effect of the financial crisis, when firms let workers go but did not reduce the amount of office space they leased. It took several years for these "hidden vacancies" to be absorbed. That process has been completed, and more tenants will soon need to lease additional space as they hire new workers.

The retail property sector in 2018 was focused on releasing space following a spate of retailer bankruptcies in 2017. Many property owners have made good progress, including REITs that own regional malls, as these higher-quality properties are much in demand. Still, store closures left their mark on same store net operating income (SS NOI). SS NOI growth slowed (on a four-quarter change basis) from 3.3% in Q4/2016 to 1.1% in Q4/2017.

The retail property sector enjoyed a rebound in 2018, however, as tenant sales picked up and retailers learned the importance of having a physical location as well as internet sales. As a result, SS NOI growth picked up to 2.1% through Q3/2018, and occupancy rates moved higher as well, to 95.4%. (Data on REIT operating performance, including earnings, SS NOI, occupancy rates and other results are available for download from the Nareit T-Tracker® at www.reit.com/data-research/reit-market-data/nareit-t-tracker-quarterly-operating-performance-series.)

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The industrial sector has benefited from rising online sales, as this sector includes the logistics facilities used to ship purchases made on the internet. Industrial rent growth has been strongest among the main property groups, averaging 6% or more for the past four years.

And the industrial boom is far from over, as demand for logistics space continues to rise with online sales. There is also less scope for new construction, as most of the large open spaces near population centers and transportation hubs have been already developed. New facilities will rely on infill locations, including multistory warehouse and logistics facilities. These constraints on supply will keep rents on an upward path, making industrial REITs an attractive choice in 2019.

Looking Ahead

The economic expansion in the aftermath of the financial crisis has had many surprises, one of which has been how long this period of growth has lasted. Indeed, the economy is on track to set a new mark this summer for the longest expansion on record. We can't anticipate what negative news may arrive this year, but the economy shows few signs of the typical late-cycle imbalances that have preceded nearly every downturn, including overbuilding, overheating, and over-indebtedness. This suggests the durability of the real estate expansion may surprise us yet again in 2019.
