Adelante Capital Management

REIT View - Global

First Quarter 2019

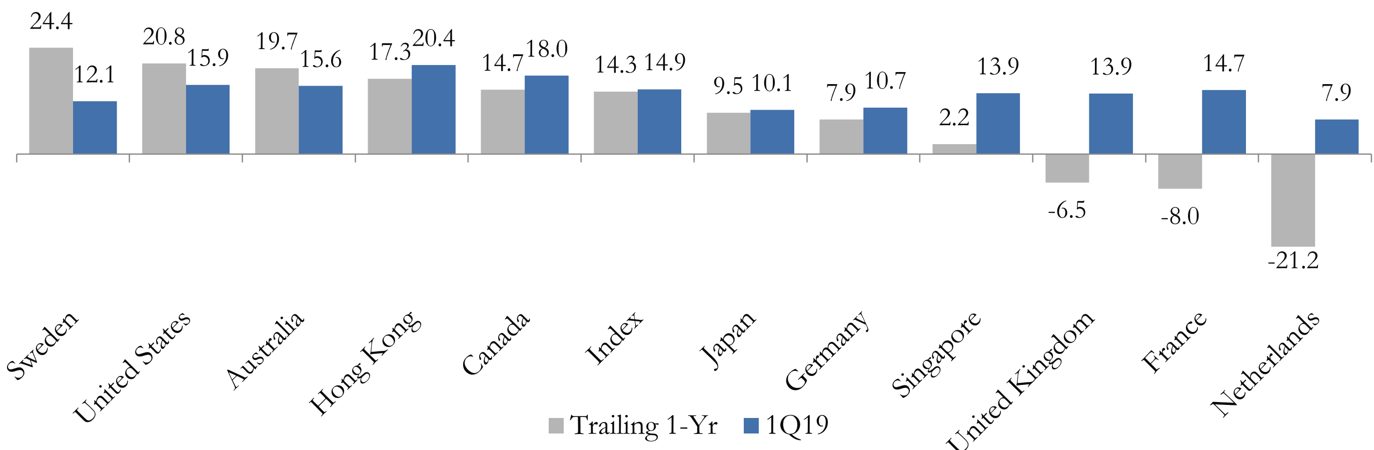
Global property securities market total returns (%)

Index/region	1Q19	Trailing 1-Year
FTSE EPRA/NAREIT Developed Index ("Index")	14.9%	14.3%
Asia-Pacific	14.5	13.0
Europe	11.8	-0.9
North America	16.0	20.5
FTSE All World Developed Index	12.4	3.9
JP Morgan Global Aggregate Bond Index	2.3	0.3

Source: Bloomberg, FTSE EPRA/NAREIT, and FactSet in USD.

Global property securities posted their strongest quarterly returns in nearly a decade, which follows a painful end to 2018 when a looming US/China trade war, plummeting oil prices, Brexit and indiscriminate central bank tightening weighed heavily on investor sentiment. While US/China trade and Brexit remain unresolved, oil prices have appreciated meaningfully to start the year and central bank tightening has moved to the back burner in light of softening global economic growth. Notably, the International Monetary Fund (IMF) lowered its 2019 global growth forecast in January 2019 to 3.5%, from 3.7% in October 2018 which was revised lower from 3.9% in July 2018; the IMF reduced its projection again to 3.3% after quarter end, with 70% of the world economy expected to experience a slowdown in 2019. Within the regions, the outlook for Germany deteriorated the most, as stricter auto emission standards are expected to crimp the country's auto sales. Economic growth in the UK is also expected to weaken further, given the Brexit impasse, while the US should remain atop all advanced economies with strong domestic demand softening the blow of unwinding fiscal stimulus. Growth in Japan is expected to be fairly steady, albeit still tepid, reflecting additional fiscal stimulus to offset a consumption tax bump later this year. **The interest rate U-turn to start the year has boosted demand for global property securities, despite the global economic slowdown that would otherwise dampen demand for most asset classes.**

Performance by Country (% in USD)
FTSE EPRA/NAREIT Developed Index



Source: FTSE EPRA/NAREIT and FactSet in USD for countries representing at least 1.0% of Index weight.

North America (55.4 % of Index)	1Q19 Total Return		
	North America	U.S.	Canada
Index Weight	56.0%	53.1%	2.9%
Local Currency (LC)	15.9	15.9	15.4
USD	16.0	15.9	18.0

Source: FTSE EPRA/NAREIT and FactSet.

North America delivered the strongest returns among the three regions during First Quarter. A more benign interest rate outlook boosted US REITs to start the year, as an unexpectedly more "patient" FOMC indicated no additional benchmark rate hikes are likely this year as GDP growth and inflation fall short of prior forecasts. Rather, the futures market indicated a >60% chance the Fed will cut the short-term benchmark rate later this year (probability has since drifted lower), following a tepid 33,000 jobs created in February (vs. 190,000 expected) and brief 3Mo-10Yr yield curve inversion at quarter end, a presumptive leading indicator to recession. The US 10-year Treasury yield declined 27 bps in First Quarter to 2.41%, which follows a similarly-sized increase for the full year 2018 when US REITs fell 4.9%.

Unlike 2018 when US REITs were especially volatile and lagged the broader market to start the year, based on rising rate expectations and REITs missing out on tax cut-fueled earnings growth party, US REITs bested the S&P 500 in First Quarter (+15.9% vs. +13.7%). Guidance forecasts for 2019, delivered with Fourth Quarter earnings in February, were generally solid with REIT earnings growth more comparable to other corporates this year as the outsized impact of last year's tax cuts lapses. REITs are also attractive in a "lower for longer" interest rate environment, with a record amount of private capital earmarked for real estate providing support for commercial real estate valuations, further bolstering the investment case for REITs despite investor "late cycle" angst.

All US REIT property sectors delivered positive returns in First Quarter, led by Industrial (+22.4) and Office REITs (+19.8%). Industrial REITs continue to benefit from secular tailwinds, notably the steady rise of e-commerce and the unrelenting need for retailers/e-tailers to "store" merchandise closer to the consumer. Yet the robust total return to start the year followed a particularly weak end to 2018 when Industrial REITs lagged the overall REIT market (-11.4% vs. -6.9% in Fourth Quarter 2018), given little progress in resolving a brewing US/China trade war which would disrupt supply chains and weigh on global growth if unresolved. Greater flexibility from both sides, including extension of a March 1 tariff deadline, has breathed life back into the Industrial REITs in early 2019. Office REITs rebounded following a difficult 2018, given increasing concerns about high capex costs, as deep discounts to net asset values and M&A renewed investor interest in the sector; Cousins Properties announced a merger with Tier REIT in March, valuing the latter at a 15.6% premium to the prior day's closing share price.

Relative returns for Retail lagged in First Quarter, including Factory Outlet (+5.3%) and Regional Retail REITs (+9.7%). Physical retail remains under pressure, with store closures in 2019 outpacing what ended up being a tough year for bricks & mortar in 2018 when retail REITs posted among the worst returns for the year. Local Retail REITs outperformed in First Quarter (+18.6%) as the early crop of 2019 store closures has been concentrated in malls. An active transaction market continues to shine a light on unwarranted public market discounts of lower quality retail assets, including community and power centers, the owners of which delivered the best returns in the quarter.

Canadian REITs lagged US REITs in First Quarter on a LC basis, yet outperformed in USD including the currency impact of a strengthened CAD. Canada's GDP growth started the year better than expected (+0.3% m/m in January; +1.1% annualized), lowering odds of recession following anemic +0.1% growth in the prior quarter (+0.4% annualized). While oil prices remain below levels reached in 2018, the >30% appreciation in First Quarter has provided an unexpected and welcome lift to the oil-dependent Canadian economy.

Asia-Pacific (27.0% of Index)	1Q19 Total Return				
	Asia-Pacific	Japan	Hong Kong	Australia	Singapore
Index Weight	26.9%	11.1%	8.5%	4.7%	2.5%
Local Currency (LC)	14.7	11.1	20.7	14.6	13.2
USD	14.5	10.1	20.4	15.6	13.9

Source: FTSE EPRA/NAREIT and FactSet.

Asia-Pacific delivered strong absolute returns in First Quarter, with all property securities in the benchmark posting a positive LC and USD total return. The impact of currency was mixed, with the JPY and HKD detracting (given weakness vs. USD) and AUD and SGD adding to quarterly returns.

Hong Kong property securities were the clear leader in First Quarter, across all regions. Strong performance was seemingly indiscriminate, with >20% quarterly returns more the norm than the exception. Fiscal and monetary reflation tools in China intended to stimulate/offset slowing domestic growth (US trade induced or not) lit a fire under Chinese and Hong Kong securities, real estate and other. Hang Lung Properties, owner of diversified assets in Hong Kong and retail properties in China, took the top spot in the quarter. The company's ~50% discount to net asset value after announcing FY18 results was too hard to ignore, given strong onshore luxury retail sales which has renewed leasing activity at its centers. Henderson Land Development, diversified owner/developer in Hong Kong and China, was another top performer, given similar dynamics that boosted peer Hang Lung (e.g., ~45% discount, renewed leasing, China stimulus).

Australia property securities performed in-line with the Asia-Pacific average in First Quarter, though a strengthened AUD pushed the USD return nearly 100bps higher. Retail property owners did not have many G'Days in the quarter, as weakening retail sales and store closures in 2018 continued into 2019, punctuated by Woolworths' quarter end announcement that it would close 30 Big W department stores in the coming years. Owners of primarily retail property, including largest retail AREIT Scentre Group, packed the total return caboose with lagging returns. Shares of Vicinity Centres, 2nd largest retail landlord in Australia, flat lined on a LC basis as planned asset sales have been delayed, portfolio valuations have declined and the company's CFO resigned. AREITs diversified by property type (i.e., less retail) and/or geography fared better, as values continue to rise (cap rates fall) for industrial and office properties in light of solid operating fundamentals.

Property securities in Japan lagged in First Quarter, pulled lower in USD by a weakened JPY, which follows 2018 when performance bested other regions and was boosted by currency. Central Tokyo office vacancy remains historically low, estimated at <2% for all grades, following a multi-year trend of economic expansion and rising broad-based demand. In a reversal from last year, performance for the Japanese developers (which continue to trade at significant discounts to net asset value) was strong, including Mitsubishi Estate, Mitsui Fudosan and Sumitomo Realty & Development, given the companies outsized exposure to Tokyo office where rent growth is expected to be robust (e.g., 5-10%) in light of the tightening office market. Performance for the JREITs was weaker, albeit still positive despite the currency drag, as steady and defensive become less appealing vs. peers with more juice (developers) in the early-2019 risk-on environment. An impending increase in the consumption tax (to 10% from 8%) may have also taken some wind out of Japan's economic growth sails, despite fiscal stimulus expecting (hoping?) to offset this coming drag.

Property securities in Singapore also lagged the Asia-Pacific peer group in First Quarter. Retail was unsurprisingly a drag on performance, as the quarterly return would have been ~80 bps higher excluding largest retail owner CapitaLand Mall Trust. Shopper traffic in the SREIT's properties declined 0.9% in 2018, which is typically a prelude to falling sales and, eventually, rents. M&A was the highlight of the quarter, as CapitaLand Limited announced an agreement to acquire Ascendas-Singbridge in mid-January; the news was well received with CapitaLand shares marching steadily higher and ending the quarter as a top performer.

Europe (17.6% of Index)	1Q19 Total Return						
	Europe	UK	Germany	Netherlands	France	Sweden	Europe (ex UK)
Index Weight	17.1%	4.6%	4.7%	1.7%	1.5%	1.7%	12.5%
Local Currency (LC)	12.8	11.3	12.7	9.8	16.7	17.3	13.4
USD	11.8	13.9	10.7	7.9	14.6	12.1	11.1

Source: FTSE EPRA/NAREIT and FactSet.

Europe participated in the global property securities rally during First Quarter, but lagged the other regions. Softening economic growth compelled the BOE and ECB to jump on the global central bank dove bandwagon, boosting European property stocks in the quarter. Yet the ongoing maze of political issues (e.g., Brexit, protests in France, upcoming European Parliament elections, brewing US/European trade war) may have put less fuel on the central bank-induced-rally fire compared to other regions. The EUR weakened vs. the GBP in the quarter, driven by expectations on how Brexit plays out, such that currency negatively/positively impacted USD returns for European/UK securities.

UK property securities underperformed Europe during First Quarter, yet outperformed in USD including currency return. Brexit remains the key risk in the UK, as Prime Minister May was thrice rejected from passing a separation agreement with the EU through Parliament. With the original March 28, 2019 separation deadline looming, the EU offered a brief extension as a "No Deal" (no transition period) Brexit would end up harming all sides; the UK would be unencumbered from EU regulations overnight, disrupting the pricing and availability of basic necessities and, possibly, opening the door to martial law if rioting ensues. The path towards an orderly Brexit remains as uncertain as was the case when the UK voted to leave the EU nearly 3 years ago (June 2016 referendum), with political infighting to continue following another extension to October 31. Although performance was varied within the UK, a few themes persisted. Owners of retail properties continued to lag along with the wave of retailer CVAs (Company Voluntary Arrangements, a court administered restructuring that disadvantages landlords given reduced rents that typically result), pushing retail yields higher and real estate values lower. Retail owners Intu and Capital & Regional were the worst performers with both posting rare negative returns in a market that lifted nearly all boats, as retail headwinds compelled both to cut their dividends. Hammerson, Shaftesbury and Capital & Counties also lagged, as discretionary shopping likely took a back seat to stockpiling basic necessities ahead of a potential Brexit-induced recession. UK office owners outperformed, as leasing and operations have been resilient despite the years-long Brexit overhang. Specialty REITs were the clear leaders in the UK, as demand remains strong and could be enhanced in a disruptive Brexit scenario (e.g., industrial and storage REITs).

German property securities slightly lagged Europe during First Quarter. Germany narrowly avoided technical recession in 2018, posting 0.0% GDP growth in Fourth Quarter following -0.2% the prior quarter. Yet the country may not be out of the recession woods just yet, despite the latest IMF projection of 0.8% GDP growth in 2019; only Italy (which ended 2018 in recession) is expected to fare worse among advanced economies, up 0.1% this year. Recently implemented and stricter worldwide emissions standards have taken a heavier toll on the German economy, given the resulting disruption in auto sales. Yet the performance of German property securities overall was dragged nearly 100 bps lower by Aroundtown SA, a diversified property owner, whose 0.0% return was seemingly attributable to weaker-than-expected forward guidance.

French property stocks were particularly strong in First Quarter. Owners of secondary retail assets continued to lag given the unremitting headwinds facing bricks & mortar, putting downward pressure on retail property values. Excluding retail, French property stock returns would have been nearly 80bps higher than the already country-topping quarterly result. Recent IMF projections of 1.3% GDP growth in 2019 (from 1.5% in 2018) suggest France will face a more modest, though still steep, economic slowdown compared to its European peers, bolstering the relative investment case for select French property securities this year.