ADELANTE
Capital Management

REIT VIEW - GLOBAL

Second Quarter 2019

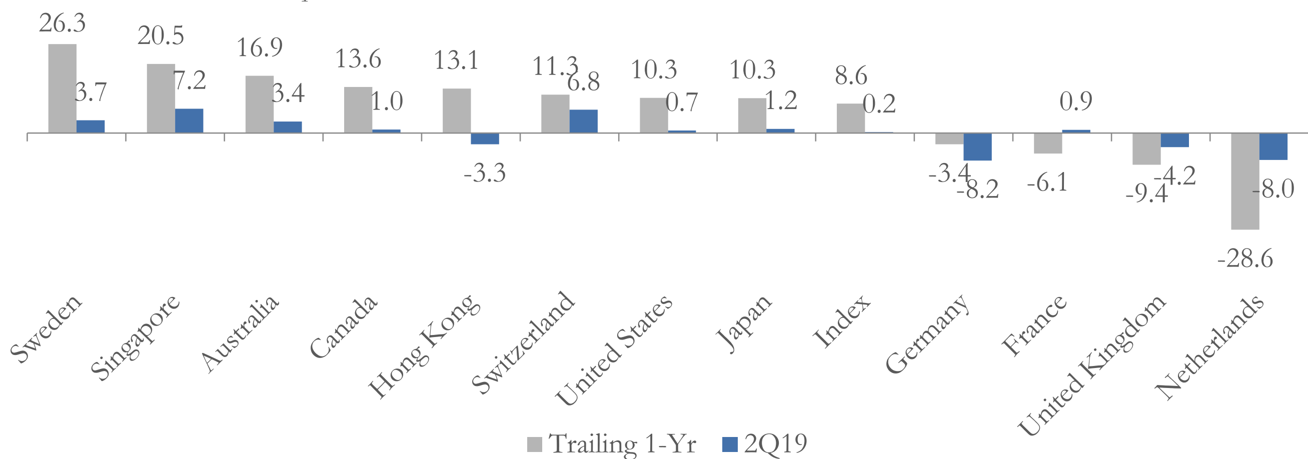
Global property securities market total returns (%)

Index/region	2Q19	Trailing 1-Year
FTSE EPRA/NAREIT Developed Index ("Index")	0.2%	8.6%
Asia-Pacific	0.8	13.3
Europe	-2.3	-3.5
North America	0.7	10.5
FTSE All World Developed Index	4.0	6.3
JP Morgan Global Aggregate Bond Index	3.5	6.4

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

Central bank tightening moved from the back burner to the kitchen sink during Second Quarter, with monetary policy stimulus now served on investors' plate of expectations. A "lower for longer" interest rate environment is typically positive for property securities, given the capital intensive nature of the business (i.e., need to raise/refinance debt) and correlation with capitalization rates (i.e., lower debt costs drive valuations higher). Yet the reasons for the interest rate U-turn have been more inauspicious (e.g., ongoing trade wars, potential real wars, muted inflation and slowing economic growth), which helped put a lid on property returns during Second Quarter; particularly after posting the strongest quarterly returns in nearly a decade the prior quarter. While US investors debate the merits of yield curve inversion-induced recession, it is worth noting that global government bond yields (ex-US) are at all-time lows. Negative yielding sovereign assets stand at a record $11.5 trillion, topping 2016 peak levels, including 85% of government bonds in Germany and 70% in Japan. Yields are positive across the entire maturity spectrum only in the US and UK, albeit the yield curve is inverted in both countries. Yet the US 10-year Treasury yield continues to fall, down 40 basis points (bps) in Second Quarter to 2.01%, which compares to 2.69% at the beginning of 2019. **Global property securities should remain attractive in the current low/falling rate environment, particularly given premium/growing cash flows that REITs can provide in a world increasingly starved for yield.**

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



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

North America (57.1 % of Index)	2Q19 Total Return		
	North America	U.S.	Canada
Index Weight	57.1%	54.1%	3.0%
Local Currency (LC)	0.6	0.7	-1.2
USD	0.7	0.7	1.0

Sources: FTSE EPRA/NAREIT and FactSet.

North America delivered modestly positive returns during Second Quarter. A more benign interest rate outlook and "patient" Federal Open Market Committee (FOMC) to start the year accelerated into market expectations of a benchmark rate cut in 2019. Indeed, the Fed funds futures point to 100% probability the FOMC will cut the short-term federal funds rate this year, thus steepening the partially-inverted yield curve which has historically been a harbinger of economic recession.

US REITs lagged the S&P 500 during Second Quarter (+0.7% vs. +4.3%), likely anchored by several large equity issuances by companies taking advantage of lofty share prices/premium valuations. First Quarter earnings announced in April/May were largely in-line with expectations, with few REITs revising 2019 guidance forecasts given the early stage of the year and uncertain economic outlook. REITs continue to shine as interest rates remain low, given support for real estate valuations, an ability to raise debt capital at historically low costs and in light of their premium/growing dividend yields (3.75% average vs. 1.99% for the S&P 500). A record amount of private capital earmarked to buy/finance real estate remains on the sidelines, estimated at nearly $330 billion with an additional $250 billion in fundraising, considerable dry powder that should provide support for valuations despite what is now the longest (albeit also the slowest) postwar economic expansion in US history.

Dispersion of returns among the REIT property sectors was unusually wide in Second Quarter, with Industrial still leading the pack (+10.6%) and Factory Outlets still lagging (-21.2%). Industrial REITs continue to benefit from the relentless growth of e-commerce and resulting need for warehouse space, with recent news that Amazon, Walmart and Target will offer one-/same-day shipping akin to pouring gasoline atop the industrial demand bonfire. Blackstone Group also announced an agreement to acquire Singapore-based GLP's US logistics assets for $18.7 billion during the quarter, topping a competing bid from US REIT Prologis, which helped nudge industrial cap rates lower/valuations higher.

Retail REITs underperformed in Second Quarter, with all subsectors posting negative total returns: Local Retail (-1.7%), Regional Retail (-12.6%) and Factory Outlets (-21.2%). The "halo effect" has become gospel within the retail community, specifically that "opening a physical store increases traffic [and presumably sales] to that retailer's website," while "closing stores causes a drop in the share of web traffic." Yet announced store closures in 2019 have surpassed the total from last year (>7,000 at mid-year vs. ~5,900 in 2018), with forecasts as high as a financial-crisis-topping 12,000 announced closures by year end. High profile casualties announced during Second Quarter include Dressbarn, with plans to close all 650 stores by 2020, and Forever 21, following reports this privately-owned fast fashion retailer with over 500 locations in the US and more than 815 stores globally is on the brink of bankruptcy. Further weighing on Factory Outlets was the sale of four outlet centers at a price significantly lower than implied by the stock market, a 12.6% blended cap rate for centers that averaged nearly $300 per square foot.

Canadian REITs lagged US REITs in Second Quarter on a LC basis, yet outperformed including currency. Economic growth in Canada remains tepid, having experienced the weakest back-to-back GDP growth quarters since the first half of 2015 when oil prices collapsed; +0.4% annualized in First Quarter which follows +0.3% in Fourth Quarter. GDP growth in April moderated from March (+0.3% from +0.5%), unsurprising as this natural resource dependent country may be stuck in neutral for some time as the futures market suggests oil price will remain stagnant in the coming years.

Asia-Pacific (26.5% of Index)	2Q19 Total Return				
	Asia-Pacific	Japan	Hong Kong	Australia	Singapore
Index Weight	26.5%	11.2%	7.6%	4.9%	2.7%
Local Currency (LC)	-0.3	-1.5	-3.8	4.7	7.1
USD	0.8	1.2	-3.3	3.4	7.2

Sources: FTSE EPRA/NAREIT and FactSet.

Asia-Pacific delivered the highest returns among the three regions in Second Quarter, albeit boosted into positive territory by currency as the LC return was negative. Currency was a significant positive contributor to performance in Japan and Hong Kong, following the unexpectedly accommodative FOMC statements which weakened the USD vs. most other major currencies. Currency returns were negative in Australia and New Zealand, however, as central banks in both countries cut their nation's benchmark interest rates by 25 bps during the quarter, with additional easing expected if economic growth continues softening.

Property securities in Japan were negative on a LC basis but ended Second Quarter with a positive USD return, including currency. Despite the negative LC return for the region during the quarter, over two-thirds of property companies in the Index posted positive LC returns as the real estate market remains strong, with ongoing share buybacks and rising office rents; vacancy rate of 1.64% across Tokyo's central five business district is the lowest level in nearly 30 years. Yet tailwinds missed the sails of several stragglers, including Hulic Company and Sumitomo Realty & Development Company which were the worst performers in the quarter, -19.0% and -16.1% respectively. Diversified Tokyo office owner Hulic reported 1Q operating income that was >30% below consensus expectations while Sumitomo Realty (a "Big 3" Japanese real estate developer) continues to compare unfavorably with its peers Mitsubishi Estate and Mitsui Fudosan, on higher leverage and less friendly shareholder steps (e.g., renewed poison pill and no share buyback).

Hong Kong property securities posted the lowest returns in the region during Second Quarter. Hong Kong property securities were weak, with nearly all companies posting negative returns in the quarter. The ongoing trade war between China and the US took its toll on Hong Kong, with economic growth at a standstill despite aggressive fiscal and monetary stimulus from China which lit a fire under share prices in the prior quarter. A proposed but since suspended extradition bill that would have allowed suspects to be transferred to mainland China for trial led to multiple, massive and violent protests, which also took the wind out of the sail of Hong Kong equities during the quarter; Hang Seng Index fell 0.1%. Sino Land Company, a proxy for Hong Kong residential, was the worst performer (-13.3%) on lackluster FY19 earnings guidance and declining core net profit. Link Real Estate Investment Trust, Asia's largest REIT, was atop the performance chart (+6.6%), on a 9.6% increase in the final distribution per unit and 60 million unit buyback program for 2019/2020, return of capital plans announced during the quarter.

Australia property securities were strong performers in Second Quarter, though dragged 120 bps lower by weakened currency; a reversal from last quarter when a strengthened AUD boosted USD returns by 100 bps. All shopping center owners posted negative returns, including largest retail landlords Scentre Group -7.7% and Vicinity Centres -4.0%, as retail sales unexpectedly fell at the start of Second Quarter; -0.1% in April vs. +0.2% expected. AREITs diversified by property type and/or geography continued to fare better, particularly companies with residential exposure (Mirvac Group +14.7% and Stockland +10.5%) as Australian home price are stabilizing, following an 11% peak-to-current decline, and forecast to increase by 5% in 2020 given expectations of an additional rate cut later this year and another in 2020, despite cash rates already at historic lows.

Property securities in Singapore were strong during Second Quarter. Nearly all companies and sectors were strong performers, including largest retail owner CapitaLand Mall Trust (+12.0%), likely attributable to SREITs offering a premium yield in a falling rate environment.

Europe (16.5% of Index)	2Q19 Total Return						
	Europe	UK	Germany	Sweden	Netherlands	France	Europe (ex UK)
Index Weight	16.5%	4.4%	4.1%	1.7%	1.5%	1.5%	12.1%
Local Currency (LC)	-2.6	-1.9	-9.5	3.7	-9.3	-0.5	-2.3
USD	-2.3	-4.2	-8.2	3.7	-8.0	0.9	-1.1

Sources: FTSE EPRA/NAREIT and FactSet.

Europe again lagged the other regions during Second Quarter, posting the only negative return despite the slight boost from currency. Economies throughout the Eurozone remain under duress, as trade and geopolitical tensions continue to weigh on export growth and manufacturing in the region. As such, European Central Bank (ECB) President Mario Draghi was more dovish than expected at the recent June meeting, keeping key rates unchanged but revising forward guidance through at least mid-2020; now unchanged from prior expectations of the first post-crisis interest rate hike within the next year. Quantitative easing is also back on the table, whereby the ECB could restart its bond-buying program, which sent prices higher and yields lower. The Bank of England (BoE) has taken a similarly cautious view, lowering its near-term economic growth projections for the UK and citing a willingness to provide monetary stimulus in the event of a no-deal Brexit. Given the strengthening Euro (€) and weakening British Pound (£), currency positively/negatively impacted USD returns for European/UK securities during the quarter.

UK property securities slightly outperformed Europe on a LC basis during Second Quarter, but meaningfully underperformed including currency. The UK's separation from the European Union (EU) remains no closer today than when the Brexit referendum was voted for in June 2016, despite the twice-delayed deadline of October 31 approaching. Prime Minister Theresa May resigned, given her inability to get a Brexit deal through UK Parliament, with her successor expected to face similar obstacles; the EU is unwilling to renegotiate the withdrawal agreement, raising the odds of a "no-deal" (no transition period) Brexit. Despite the Brexit shadow still cast over the UK economy, several property sector themes persist. Retail continues to post among the lowest returns in the UK, as consumer spending has been conspicuously weak (e.g., worst June for retail sales since the 2009 financial crisis), with pundits blaming cold weather and tough comparisons following the World Cup and royal wedding a year ago. Headwinds from Company Voluntary Arrangements (CVAs, or court administered restructuring path to reduce rents) and administrations (i.e., insolvency) also persist, with Arcadia retail group the latest to seek/achieve rent reductions within its portfolio of 570 UK stores. Outsized negative returns from all retail owners, including Intu (-30.1%) and Hammerson (-19.4%), more than offset the positive returns delivered by specialty REITs with brighter outlooks during Second Quarter, including those that should be largely unaffected by Brexit (e.g., student housing owner UNITE Group +5.9%) and others that could benefit from the resulting disruption (e.g., industrial owners SEGRO +5.9% and Tritax Big Box REIT +6.2%). Amsterdam/Paris-listed Unibail-Rodamco-Westfield was not immune from the retail carnage (-8.6%), despite its two London malls being among the most productive in the world (both at £1.1 billion total sales). Office owners also lagged in the quarter, particularly the diversified UK majors that have meaningful investment in the retail sector: British Land Company (48% retail, 49% office) down 9.4% and Land Securities Group (43% retail, 48% office) 9.6% lower.

German property securities were the biggest laggards in Europe during Second Quarter. Share prices for German residential property owners fell materially following news the Berlin Senate has proposed a 5-year rental freeze (Mietendeckel) beginning in 2020, a potential blueprint for other cities despite the constitutional hurdles. Europe's largest economy continues to suffer given its dependence on global trade, deriving nearly 50% of GDP from exports when the largest importers of German manufacturing are attempting to negotiate a trade agreement (US/China). ADO Properties was the worst performer among the European (ex-UK) companies (-25.8%), given its pure play exposure to Berlin residential and unexpected changes in the C-suite (i.e., CEO, CFO and COO all leaving).

Disclosure:

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