ADELANTE Capital Management

REIT VIEW - GLOBAL

Third Quarter 2019

Global property securities market total returns (%)

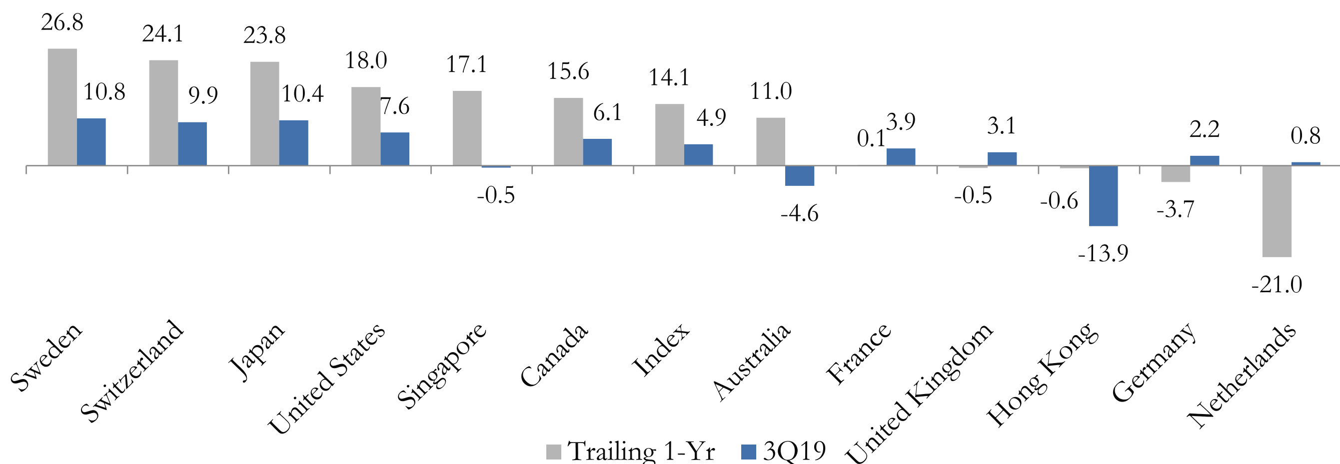
	3Q19	Trailing 1-Year
FTSE EPRA/NAREIT Developed Index ("Index")	4.9	14.1
Asia-Pacific	-0.5	13.9
Europe	4.3	2.4
North America	7.5	17.9
FTSE All World Developed Index	0.6	1.9
JP Morgan Global Aggregate Bond Index	1.2	8.5

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

Monetary policy stimulus took center stage across the globe during the Third Quarter, ostensibly buying "insurance" against "downside risks." Countries in the Index with central bank rate cuts during the quarter include Australia (-25 basis points/bps) and the US (-25 bps) in July, Hong Kong (-25 bps) and New Zealand (-50 bps) in August and the US (-25 bps), Hong Kong (-25 bps) and Eurozone (-10 bps) in September. Roughly 85% of central bank rate adjustments across the globe were to the downside so far this year, compared to only 35% in 2018. Long-term sovereign bond yields are on a similar downward spiral: US 10-year at 1.67% (-140 bps from a year ago), Canada at 1.36% (-107 bps), Hong Kong at 1.27% (-116 bps), Australia at 1.03% (-165 bps), UK at 0.49% (-95 bps), Japan at -0.22% (-35 bps) and Germany at -0.57% (-105 bps), to name a few. Global government bond yields are at/near all-time lows while negative yielding global debt continues to tick higher, recently $17 trillion from $11.5 trillion last quarter. **Global property securities are typically in vogue when interest rates are low/falling, on rising valuations, lower borrowing costs, higher earnings/dividends/cash flows and widening yield spreads versus competing investments. Yet slowing global growth is the primary driver for the accelerating rounds of rate cuts and falling yields, which could eventually weigh on operating fundamentals and share prices for all asset classes if/when demand starts to wane.**

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 (59.0 % of Index)	3Q19 Total Return		
	North America	U.S.	Canada
Index Weight	59.0%	55.9%	3.1%
Local Currency (LC)	7.6	7.6	7.5
USD	7.5	7.6	6.1

Sources: FTSE EPRA/NAREIT and FactSet.

North America delivered robust positive returns during the Third Quarter. The Federal Open Market Committee (FOMC) reduced the benchmark federal funds rate twice during the quarter, on muted inflation and rising fears of US/China trade-induced recession. Committee votes have been mixed, however, given the unemployment rate near historic lows and steady economic growth; the FOMC upped its 2019 GDP growth projection to 2.2% from 2.1%. Yet growth is projected to decelerate to 2.0% to 1.9% to 1.8% by 2022. As such, the odds of another rate cut are high (>70%), tugging capitalization rates lower (i.e., valuations higher) and nudging earnings higher on reduced borrowing costs…a welcome recipe for REITs.

US REITs led the S&P 500 during the Third Quarter (7.6% vs. 1.7%), widening their lead over the broader market over the past year (18.0% vs. 4.3%). REITs continue to shine in light of their premium/growing dividend yield (3.8% average) in a world increasingly devoid of yield (1.9% for the S&P 500). REITs should also find support based on ~$580 billion of private capital on the sidelines and in fundraising (e.g., Blackstone's latest global real estate fund closed at a record $20.5 billion) and fundamentals which remain healthy (e.g., same-store net operating income growth 3.5% and same-store occupancy 94.8%, above historical averages of 2.9% and 93.7%). Second Quarter earnings announced in July/August were mostly ahead of expectations, as nearly half of REITs raised guidance on better-than-expected results.

Dispersion of returns among the property sectors narrowed but remained wide in the Third Quarter, with Manufactured Housing and Industrial-Mixed still on top (13.6% and 13.4%) and Retail still finding its bottom. While Industrial-Mixed REITs continue to benefit from secular tailwinds (e.g., growth in cloud computing), the sector return was lifted higher following news that data center owner CyrusOne was exploring a sale after receiving takeout interest from private equity investors. Digital Realty Trust was reportedly also eyeing its data center peer, which is typically positive longer term given one fewer competitor in the ring but arguably a near-term drag on shares as investors expect (i.e., wait for) an equity offering to help fund the transaction if the news proves true.

Retail REITs underperformed in the Third Quarter, as Factory Outlets and Regional Retail again posted negative total returns (-2.4% and -1.0%). Third Quarter ended on a sour note for retail property owners as Forever 21 filed for Chapter 11 bankruptcy protection, with preliminary plans to close 350 of its 800 stores worldwide, including 178 of its 549 US locations. REIT exposure to this retailer is modest at <2.5% of rental revenue, with economic risks even lower as closures are concentrated in privately-owned assets, consistent with past retrenchments. Yet even the highest quality REITs are not immune, thus weighing on shares given the need to run faster to keep pace on the store closure treadmill; store closures have surpassed 8,500 this year, vs. only ~5,900 in 2018.

Canadian REIT returns were similarly strong during the Third Quarter, though currency pulled the USD return lower. Economic growth in Canada was better than expected at 0.9% in the second quarter (3.7% annualized), the strongest quarterly growth in two years. Yet underlying weakness persists, notably a decline in domestic demand, which sets the stage for a rate cut by the Bank of Canada later this year…possibly boosting REITs even more. Canadian REITs were also lifted higher following news that Dream Global REIT agreed to be acquired by Blackstone in a C$6.2 billion ($4.7 billion) transaction at an 18.5% premium to the previous close; a welcome surprise but not a reflection of the Canadian economy as Dream's office/logistics assets are located in Western Europe with shares trading on the Toronto Stock Exchange.

Asia-Pacific (24.4% of Index)	3Q19 Total Return				
	Asia-Pacific	Japan	Hong Kong	Australia	Singapore
Index Weight	24.4%	12.0%	6.1%	3.5%	2.7%
Local Currency (LC)	0.7	10.7	-13.6	-0.8	1.7
USD	-0.5	10.4	-13.9	-4.6	-0.5

Sources: FTSE EPRA/NAREIT and FactSet.

Asia-Pacific delivered the lowest returns among the regions in the Third Quarter. Negative contributors to performance included currency, which pulled a positive LC return into negative territory, and Hong Kong, following escalating protests gripping the country. Excluding Hong Kong where the underperformance wounds were largely self-inflicted, the Asia-Pacific return would have been ~500 bps higher.

Property securities in Japan were particularly strong in the Third Quarter, despite the imminent consumption tax hike given negative cash yields and fewer places to park capital. The Japanese real estate developers lagged while the JREITs led during the quarter. Total returns for the developers were positive following solid operating results but landed on the lower side of the performance scale, including Mitsui Fudosan Company (3.1%) and Mitsubishi Estate Company (4.4%). Tokyo office owner Hulic Company was the top performer (27.2%) as first half operating income was ahead of expectations and ~10% higher than a year ago on record low vacancy rates.

Hong Kong property securities posted the lowest return within all regions during the Third Quarter. Hong Kong property securities were especially weak, with all companies in the Index posting (increasingly) negative returns for the second consecutive quarter. Pro-democracy/anti-China protests turned violent during the quarter, despite the government suspending the extradition bill which sparked the demonstrations in the first place. Tourist visits and retail sales have fallen precipitously with odds of recession rising as the protests persist; the Hong Kong government lowered its 2019 GDP forecast to 0-1% from 2-3%, despite concurrently announcing a HK$19.1 billion ($2.4 billion) economic support package to help stimulate growth. Retail landlords have been compelled to drastically reduce rents following several months of sliding sales; real estate services firm JLL suggests retail rents could fall by 10-15% this year. Research firm STR noted hotel occupancy levels have fallen ~30% to <65%, with revenue per available room (a measure of a hotel's operations) ~45% lower. Swire Properties was the worst performer (-21.4%) despite >40% of the portfolio located outside of Hong Kong and first half 2019 results that were above expectations. Yet Swire noted falling demand for office space and rising vacancies in Hong Kong, putting pressure on its forward-looking share price. Indeed, investor selling was indiscriminate for all Hong Kong stocks; the Hang Seng fell 8.6%, worst among all major stock indices, while nearly all property companies posted double-digit negative returns during the quarter.

Australia property securities declined in the Third Quarter, with currency an outsized drag on USD returns. Currency was more impactful to Australian property returns than the underlying performance of the stocks, as the Reserve Bank of Australia cut its cash rate thrice since June to a record-low 0.75%, further weakening the Australian dollar. Cromwell Property Group (7.3%) and Dexus (-11.7%) bracketed the performance spectrum during the quarter. Cromwell delivered a strong FY19 report, including profit up 11.1% and ongoing execution of its recycling and development strategy, boosting its shares. Dexus also posted solid FY19 operating results, but early signs of moderating demand in the office market likely took some shine off following strong year-to-date performance.

Property securities in Singapore were negative during the Third Quarter. Currency was also more impactful to Singapore property return than the underlying stocks, pulling a positive LC return into negative USD return territory. Mapletree Industrial Trust was the top performer (8.9%) following well-received news the SREIT and Mapletree Investments were jointly acquiring a S$1.9 billion ($1.4 billion) data center portfolio in North America from Digital Realty Trust.

Europe (16.6% of Index)	3Q19 Total Return							
	Europe	UK	Germany	Sweden	Netherlands	France	Switz.	Europe (ex UK)
Index Weight	16.6%	4.3%	4.2%	1.8%	1.4%	1.4%	1.0%	12.2%
Local Currency (LC)	8.6	6.4	6.8	17.5	5.3	8.6	12.4	9.5
USD	4.3	3.1	2.2	10.8	0.8	3.9	9.9	4.8

Sources: FTSE EPRA/NAREIT and FactSet.

Europe posted positive total returns during the Third Quarter, despite the sizable drag from currency. The European Central Bank's (ECB) latest salvo to stimulate the region's tepid economic growth included, as expected, reducing its main deposit rate by 10 bps (to a record low -0.5%, ostensibly compelling lenders to lend) and resuscitating quantitative easing with plans to buy €20 billion ($22 billion) of securities per month starting November 1, with plans "to run for as long as necessary." The Bank of England unanimously voted to maintain its bank rate at 0.75%, yet acknowledged the "appropriate response of monetary policy will depend on the balance of the effects of Brexit on demand, supply and the sterling exchange rate"…which the market interpreted as a looming rate cut regardless of the outcome of Brexit, further weakening the £/$ exchange rate.

UK property securities lagged Europe during the Third Quarter, though still posted a positive return. Brexit remains top of mind given the twice-delayed deadline fast approaching (October 31), though odds of another extension have been rising. Intu Properties was the worst performer among all property companies by a wide margin (-43.7%), despite takeout speculation surfacing as first half 2019 results were terrible (e.g., UK asset values -10.4%, like-for-like rental income -7.7%). Specialty REITs continued posting among the best returns during the quarter, including student housing owner UNITE Group (9.6%), industrial owner SEGRO (8.4%) and self-storage owner Safestore Holdings (6.4%), as operations should be more resilient in most Brexit scenarios. Retail property owners, including the diversified UK majors which have sizable retail exposure, were also solid performers during the quarter. Yet returns remain negative over the past year given secular and/or Brexit headwinds, including Hammerson up 4.2% in the quarter but down 35.7% over the past year, Shaftesbury +9.4%/-3.2%, British Land (48% retail) +5.2%/-5.3% and Land Securities (43% retail) +1.0%/-3.2%. UK retail is not out of the woods, however, as total/like-for-like retail sales were -1.3%/-1.7% in September, all-time lows according to the British Retail Consortium.

German property securities lagged its European peers during the Third Quarter yet managed a positive USD return including the currency drag. Germany is likely to fall into recession given its outsized dependence on global trade/exports as the US-China trade war continues. The World Trade Organization authorized new tariffs on Europe following a ruling Airbus received illegal subsidies over the past 15 years, likely to gum up economic growth even more as the US soon begins imposing new duties. Shares of the residential property owners improved during the quarter, despite this gloomy backdrop, which follows steep declines last quarter on news the Berlin Senate proposed a 5-year rental freeze (Mietendeckel) beginning in 2020, and also despite little clarity on the constitutionality of or contagion potential for this proposal since then. Diversified owner TLG Immobilien was the only property company to post a negative LC return, following poorly-received news it was evaluating a merger with listed peer Aroundtown.

Property securities in Sweden and Switzerland were top performers during the Third Quarter. First half 2019 results were generally solid for property companies in both countries, with non-euro Switzerland also benefiting from the region's risk-off environment and signals the Swiss National Bank may play even looser with monetary policy, despite already-negative interest rates. The Riksbank (central bank of Sweden) unexpectedly announced plans to soon raise its key interest rate…which investors largely ignored given ~30% market-implied odds of a rate cut vs. 0% chance of a rate hike as the Swedish economy is also at risk of recession; second quarter GDP unexpectedly contracted by 0.1%.

Disclosure:

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