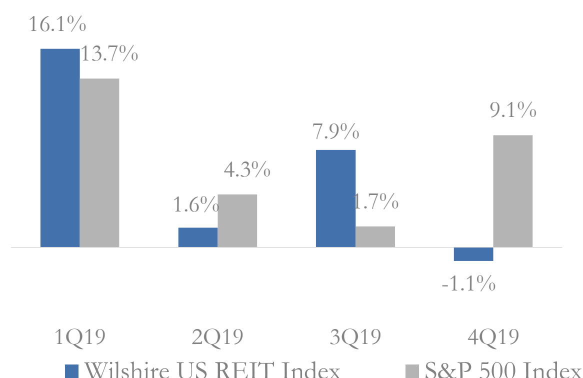
Green shoots. The third estimate of Third Quarter GDP growth was 2.1% and the Federal Reserve Bank of Atlanta projects Fourth Quarter GDP growth to stabilize at 1.8%. According to the Bureau of Labor Statistics ("BLS"), changes in total nonfarm payroll in the past three months were 156,000, 256,000 and 145,000, respectively, an average of 184,000 and in-line with the average of 187,917 for the 12 months prior. Despite all the consternation about the monthly jobs reports, subsequent to the Great Recession, job growth has averaged approximately 2.4 million per annum with very little variability. The 10-Year Treasury Note rose from 1.675% on September 30 to close out the year at 1.919%; economic optimism was also reflected in the spread between the 3 Month Treasury Bill and the 10 Year Treasury Note as it normalized during Fourth Quarter, moving from -16 bps to +36 bps.

The Wilshire US REIT Index ("Index") was down 1.1% in Fourth Quarter, significantly worse than the S&P 500 and Russell 2000 Indices with total returns of 9.1% and 9.9%, respectively; for 2019, the Index returned 25.8% compared to 31.5% and 25.5% for the S&P 500 and Russell 2000 Indices, respectively. In Fourth Quarter, out of the 106 constituents of the Index, 58 securities produced positive returns; the best performing company was Kite Realty (up 23.0%), a shopping center REIT, and the worst performing stock was Taubman Centers (down 22.1%), an A-mall company. For the year, CBL, the beleaguered B-mall company, was the laggard in the group once again while the leaderboard was populated by secular growth stories like Equinix, Prologis, Invitation Homes, Sun Communities and Alexandria Real Estate.

REITs vs. S&P 500 Index
Total Return



Source: Wilshire Associates.

Sector Performance of the Wilshire US REIT Index
Ranked by Fourth Quarter 2019 Performance

Sector	4Q19	Trailing 1-Year	Current Yield
Office	7.2%	29.5%	3.1%
Hotels	4.5	4.2	5.7
Mfd. Housing	2.9	47.1	1.7
Industrial	1.7	47.3	2.5
Retail-Local	-0.3	26.9	4.6
Wilshire US REIT	**-1.1**	**25.8**	**3.6**
Diversified	-1.9	27.9	3.9
Industrial Mixed	-2.6	23.7	3.5
Factory Outlets	-2.8	-21.3	9.6
Apartments	-3.3	26.0	2.9
Retail-Regional	-4.5	-9.0	6.4
Health Care	-7.7	19.2	4.9
Storage	-9.6	13.6	3.7

Source: Wilshire Associates.

With steady job growth and the announcement of a negotiated Phase I trade deal, green shoots sprouted across the risk spectrum as signified by the steepening of the yield curve and investors continued to take tentative positions in both value (Office) and cyclical (Hotels) stocks. Looking back at the trailing 1-year performance, many of the sectors performed in-line with the 25.8% total return delivered by the Index. Notable outliers to the upside were Manufactured Housing and Industrial; Data Center REITs also did well within the Industrial Mixed category. These property types offered steady growth (demand outstripping supply) in an investing world bereft and, as a result, concerns about valuation were secondary (the rich got richer). Retail-Regional (Malls) and Factory Outlets led to the downside, not surprising given the level of store closings both in number and profile (Forever 21). Hotels and Storage suffered from oversupply; Hotels were also afflicted with reduced inbound international travel and high labor costs. Health Care was doing fine for the year until Ventas, one of the mega-caps in the sector, delivered horrific Third Quarter earnings.

Hidden underneath the surface is the disruptive effect of technology on commercial real estate, both positive (Industrial and Data Centers) and negative (Regional Malls and Hotels (pricing transparency)). Apart from, perhaps, Manufactured Housing, no property type seems immune.

More M&A. On October 29, Digital Realty ("DLR") and Interxion ("INXN") announced that they have entered into a definitive agreement to combine their businesses. In an all-stock deal, INXN shareholders will receive a fixed exchange ratio of 0.7067 shares of DLR common stock; based on DLR's closing price of $132.28 on October 28, the offer represents a modest 5.4% premium (although, in all fairness, M&A rumors have fueled some of INXN's recent outperformance) for what is arguably the best remaining independent portfolio of network-dense colocation data centers in Europe. Commenting on the deal, DLR's CEO, William Stein, said, "This strategic and complementary transaction builds upon Digital Realty's established foundation of serving market demand for colocation, scale and hyperscale requirements in the Americas, EMEA and Asia Pacific and leverages Interxion's European colocation and interconnection expertise, enhancing the combined company's capabilities to ensure customers to solve for the full spectrum of data center requirements across a global platform."

Although the deal makes a lot of sense strategically for DLR, continuing its quest to add more network connectivity and colocation services across a global footprint, the stock underperformed its data center peers by 2% on the day of the announcement and continued to lag into year-end; perhaps its impatient investor base was underwhelmed by the lack of immediate accretion. From company meetings after the deal was announced, INXN's shareholders also seemed none too pleased with the deal under the belief that they were losing a small, hidden gem to a data center Goliath (similar to the reaction Chelsea Premium Outlet Center shareholders had to its acquisition by Simon Property Group, many moons ago); with INXN's shares often trading at a premium to its conversion price, the stock market seems to be betting that (i) DLR will have to sweeten its bid or (ii) there will be a topping bid from private equity or (iii) both.

In a less controversial deal, Prologis, Inc. announced on October 27 that it will acquire fellow industrial REIT Liberty Property Trust, also in an all-stock transaction, valuing Liberty at approximately $12.6 billion. With Prologis riding high at a significant premium to Liberty, this was really a simple transaction predicated on a cost of capital advantage; the acquisition was ho-hum, as indicated by the brevity of the investor call subsequent to the announcement. Prologis's share price underperformed for a few days as shareholders feigned unhappiness but in the long run, the attractiveness of the property type and the immediate accretion of the transaction allowed the stock to recover quickly. Business as usual.

Observations from the Field – Luis Sanchez

In 2019, operating fundamentals of office markets were certainly supported by strong demand from tech companies, broadly defined to include hardware, software, search, social media, e-commerce and media; tech hiring is also bleeding into more traditional companies such as retailers and auto companies who are turning to technology to improve operational aspects of their core businesses and to innovate (e.g. digital platforms and self-driving cars). We recently attended investor day events hosted by west coast focused Kilroy Realty (KRC) and New York City ("NYC") focused SL Green Realty (SLG) which highlighted the impact tech companies have had in driving west coast markets as well as their growing influence in other MSAs like Manhattan.

The major west coast markets of the SF Bay Area, Seattle and Los Angeles have long been beneficiaries of growing tech demand with the SF Bay Area enjoying the largest concentration of tech talent of all major US cities. While technology companies remain a vital and still growing part of the SF Bay Area economy, they also been expanding their presence in other markets around the country in order to diversify their footprint and to tap into a broader pool of talent.

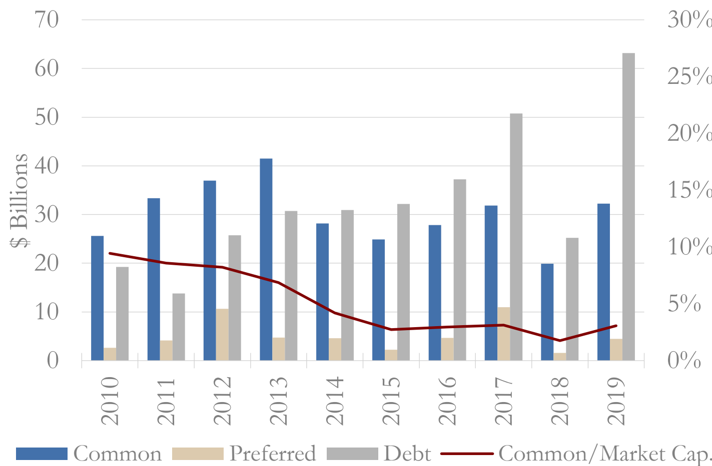
On the east coast, the Boston/Cambridge area has always enjoyed a concentration of tech and life science given its proximity high quality universities and their graduates. More recently, the NYC market has been the beneficiary of a growing influx of tech companies trying to tap into its deep talent pool (NYC has the second highest absolute concentration of tech labor in the US). When Amazon selected Long Island City ("LIC") as one of its two choices for HQ2, access to a large labor pool was as much a part of the equation as the promised tax incentives. Although Amazon did not ultimately designate HQ2 for LIC due to political and populist backlash, it does have a sizable presence in NYC that is still expanding. Facebook and Google have shown the most rapid growth among the FAANG companies in NYC committing to over 2.7 million sf in the second half of 2019 to Hudson Yards and Lower Manhattan (SLG recently announced a 335k sf lease with Amazon at a new redevelopment adjacent to Hudson Yards).

With job growth in some of the historical office using FIRE sectors being sluggish, markets able to attract tech companies will be beneficiaries. Those include not only large MSAs such as the SF Bay Area and NYC, but also other, smaller, markets such as Austin, Atlanta, Boston, Charlotte, Dallas, Nashville and Seattle where REITs also have a presence. There seems to be no end to the tech diaspora.

Capital issuance follows share price appreciation. According to NAREIT, $21.3 billion in capital was raised in Fourth Quarter 2019, less than the $34.2 billion raised in the prior quarter but significantly more than the $8.3 billion raised a year ago in Fourth Quarter 2018 when many of the REITs were trading at discounts to Net Asset Values. Most of the capital activity took place in the issuance of unsecured bonds (there were 31 offerings totaling $13.9 billion during the quarter, about half the $25.8 billion issued in the prior quarter and 3x the $4.5 billion issued a year ago). There were 15 secondary equity offerings totaling $5.8 billion during the quarter, on par with the $7.0 billion issued in the prior quarter and the $3.7 billion issued a year ago.

Note that the above data does not take into account equity issuance by at-the-market ("ATM") programs, a low-cost alternative; now that more REITs are trading above NAV, expect heightened activity on the ATM front, although, with leverage levels already low across the group, use of proceeds will be a point of emphasis for investors.

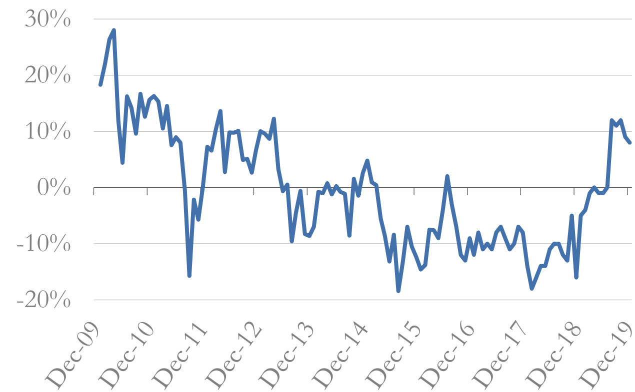
Historical Offering of Securities
2010 – 2019



Sources: S&P Global Market Intelligence, NAREIT 2019.

Stemming the tide. According to AMG Data Services, net flows out of dedicated real estate funds, excluding ETFs, totaled $6.5 billion in 2019 compared to outflows of $11.6 billion, $9.0 billion, $5.5 billion and $6.1 billion in 2018, 2017, 2016 and 2015, respectively; REIT ETFs saw inflows of $4.4 billion compared to flows of -$3.8 billion, $1.9 billion $2.2 billion and -$0.2 billion in 2018, 2017, 2016 and 2015, respectively. Flows out of US and Global mutual funds registered in Japan totaled only $0.8 billion compared to flows of -$7.7 billion, -$10.7 billion, $17.9 billion and $8.2 billion in 2018, 2017, 2016 and 2015, respectively.

Premium/Discount to Net Asset Value
REIT Universe
December 31, 2009 to December 31, 2019

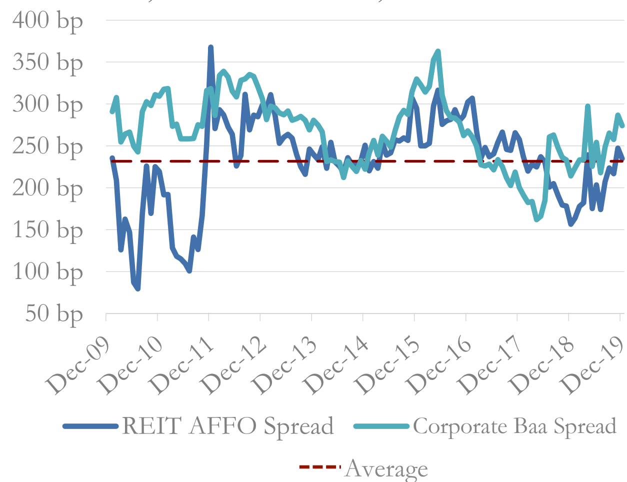


Sources: Adelante Capital Management and Green Street Advisors.

Risk premium on par with the ten-year average. The risk premium for owning commercial real estate, as represented by the spread between REIT cash flow yields and the riskless rate of return, trades on par with the 10-year average of 232 bps. While the cash flow yield for REITs increased due to the natural growth of the business (combined with slight share price depreciation), the yield on the 10-Year Treasury Note has increased and, as a consequence, the spread between REIT cash flow yields and the 10-Year Treasury Note yield has gone down 10 bps sequentially from last quarter to 225 bps. Despite the increase in the 10-Year Treasury Note yield, however, REIT investors are still being appropriately compensated.

In Fourth Quarter, the Corporate Baa spread decreased 6 bps to 268 bps, on par with the 10-year average of 267 bps.

Spread Comparison
REIT Cash Flow and Corporate Baa Yields vs.
10-Year Treasury Note Yield
December 31, 2009 to December 31, 2019



Sources: Adelante Capital Management and Green Street Advisors.

Outlook

> Consistent with its January 2019 Statement Regarding Monetary Policy Implementation and Balance Sheet Normalization, the Committee reaffirms its intention to implement monetary policy in a regime in which an ample supply of reserves ensures that control over the level of the federal funds rate and other short-term interest rates is exercised primarily through the setting of the Federal Reserve's administered rates, and in which active management of the supply of reserves is not required. To ensure that the supply of reserves remains ample, the Committee approved by notation vote completed on October 11, 2019 the following steps:
>
> • In light of recent and expected increases in the Federal Reserve's non-reserve liabilities, the Federal Reserve will purchase Treasury bills at least into the second quarter of next year in order to maintain over time ample reserve balances at or above the level that prevailed in early September 2019.
>
> • In addition, the Federal Reserve will conduct term and overnight repurchase agreement operations at least through January of next year to ensure that the supply of reserves remains ample even during periods of sharp increases in nonreserve liabilities, and to mitigate the risk of money market pressures that could adversely affect policy implementation.
>
> These actions are purely technical measures to support the effective implementation of the FOMC's monetary policy, and do not represent a change in the stance of monetary policy.
>
> *Statement Regarding Monetary Policy Implementation Federal Reserve Press Release – October 11, 2019*

The kabuki theater of President Donald J. Trump's impeachment continues apace in Washington D.C. On January 15, the House of Representatives voted along mostly party lines (one Democrat, Representative Collin C. Peterson of Minnesota voted no) to send to the Senate two articles of impeachment against President Trump: (i) abuse of power and (ii) obstruction of Congress. This follows a lengthy delay by House Speaker Nancy Pelosi which she defended on ABC News' *This Week* stating, "what we accomplished in the past few weeks is that we wanted the public to see the need for witnesses." Now that Senate Leader Mitch McConnell's wait (for something he didn't want) has ended, the trial will finally begin and could fill the legislative agenda for several weeks. All that being said, the outcome of the trial is all but assured (on PredictIt, the odds that the Senate will convict Trump in his first term is only 10%) so it is hard to see what the impeachment process has accomplished for the Democrats except (i) energize the Republican base for President Trump and (ii) make the State of the Union Address on February 4 must see TV; after all, Donald Trump is still the odds on favorite to be the GOP nominee (92%) and the 2020 presidential winner (50%).

Only 1.2 miles away from the aforementioned vote by the House of Representatives in the Capitol Building, President Trump was signing Phase I of the trade deal with China in a crowded East Room of the White House. Regardless of how one views the substance of the agreement, two of the largest economies of the world reaching a trading détente must be viewed as a positive, especially as the contraction in US manufacturing was threatening to contaminate the far larger non-manufacturing activity. On the following day, the Senate passed the revised North America Trade Agreement by a thumping 89-10 vote, prompting the President to state, "I did the biggest deal ever done in the history of our country yesterday in terms of trade and that was the second story to a total hoax. Today we just had passed the USMCA. It's going to take the place of NAFTA, which was a terrible deal, and the USMCA will probably be second to this witch hunt hoax, which hopefully everyone knows is not going anywhere."

While the December 13 announcement of the Phase I of the trade deal with China may have fanned the flames of a robust Fourth Quarter risk rally, it may have been the FOMC that provided the kindling when it announced in October that it will start buying Treasury bills in an effort to shore up funding markets, the non-QE QE that Jerome Powell was quick to deny by stating, "Growth of our balance sheet for reserve management purposes should in no way be confused with the large-scale asset purchase programs that we deployed after the financial crisis." The Fed Chairman doth protest too much, me think (apologies to Queen Gertrude). Whatever the transmission mechanism, if any, the non-QE QE certainly has accompanied rising asset prices; Deutsche Bank found that a 1% increase in the Fed balance sheet was equivalent to a 1% increase in the S&P 500 Index since the start of the program. Causation? Correlation?

While there will certainly be political fireworks going into the election, volatility may be subdued in 2020 for two reasons. One, the President will most likely want to consolidate his "America First" political/trade gains, highlighting his accomplishments in search of a second term (frankly, there are not that many places left in the world to bully, except perhaps Europe). Just as important, to operate above the political fray, the FOMC is probably sidelined for the next 12 months as well. However, with risk assets roaring out of the gate to start the new year, it might be time to start thinking about the "known unknowns" and the "unknown unknowns" that could derail the rally. Two "known unknowns" come to mind: Iran and higher inflation/rates (the former more a risk for the S&P 500 and the latter for REITs). As for the "unknown unknowns…"

Disclosure:

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