ADELANTE Capital Management

REIT VIEW - GLOBAL

Fourth Quarter 2019

Global property securities market total returns (%)

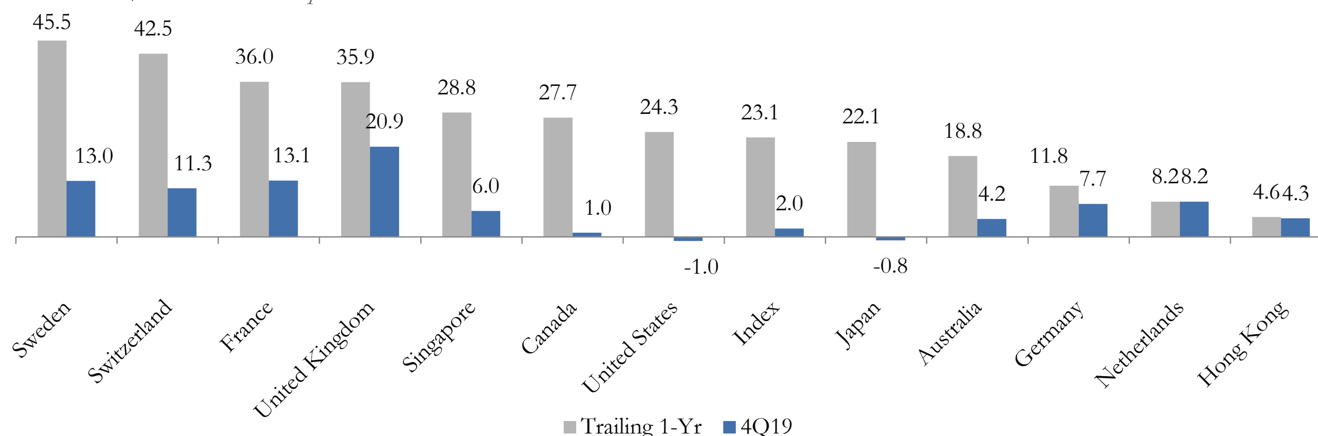
	4Q19	Trailing 1-Year
FTSE EPRA/NAREIT Developed Index ("Index")	2.0	23.1
Asia-Pacific	2.0	17.1
Europe	12.0	27.6
North America	-0.9	24.5
FTSE All World Developed Index	8.8	27.9

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

Monetary policy stimulus continued unabated across the globe during the Fourth Quarter, with roughly 90% of central bank actions entailing rate cuts versus about 85% of such adjustments to the downside earlier in the year and only 35% reductions in 2018. Countries in the Index with central bank rate cuts during the quarter include Australia (-25 basis points/bps), US (-25 bps) and Hong Kong (-25 bps) in October, with Sweden an outlier by raising its benchmark rate in December (+25 bps). Yet the market value of negative-yielding debt moved steadily lower during the quarter, recently $11 trillion after peaking near $17 trillion in August, as the US/China trade negotiations seemingly progressed. Indeed, long-term sovereign bond yields roared higher during the quarter: US 10-year +25 bps to 1.92%, Canada +34 bps to 1.70%, Hong Kong +59 bps to 1.86%, Australia +36 bps to 1.39%, UK +34 bps to 0.83%, Japan +21 bps to -0.02% and Germany +39 bps to -0.19%, to name a few. Global property securities took a breather given this interest rate headwind, despite improving prospects for global trade/growth; save for Europe where the likelihood of a softer Brexit had an outsized positive effect on shares and currency. **The IMF World Economic Outlook growth forecast for advanced economies is expected to remain tepid at 1.7% in 2020, largely based on "rising trade barriers". That is, no recession in sight with growth likely to accelerate if the US and China resolve their trade dispute. At the same time, interest rates are expected to remain benign with the US FOMC expected to sit tight even if inflation breaches its 2% target. Notably, the fundamental outlook for property securities remains intact in a positive-growth/low-rate world.**

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 (57.2 % of Index)	4Q19 Total Return		
	North America	U.S.	Canada
Index Weight	57.2%	54.3%	2.9%
Local Currency (LC)	-1.0	-1.0	-1.1
USD	-0.9	-1.0	1.0

Sources: FTSE EPRA/NAREIT and FactSet.

North America was the only region to deliver a negative total return during the Fourth Quarter, as talk of inverted yield curves and recession morphed into expectations for further economic growth. The odds of recession declined as US-China trade talk seemingly advanced as well as an unexpectedly strong November jobs report (e.g., non-farm payrolls rose 266,000 vs. 180,000 expected, with upward revisions totaling 41,000 for the prior months), which weighed on REITs given their "defensive" characteristics despite expectations that the interest rate environment should remain favorable (i.e., low) for some time. Indeed, the Federal Open Market Committee (FOMC) indicated plans to stand pat in 2020, with projections reduced from prior forecasts: federal funds rate of 1.6% in 2020 (from 1.9%), 1.9% in 2021 (from 2.1%) and 2.1% in 2022 (from 2.4%). FOMC projections for economic growth were unchanged at 2.0% in 2020, 1.9% in 2021 and 1.8% in 2022. Low rates and economic growth are a healthy recipe for operating fundamentals, which point to possible stronger returns ahead; indeed, Citi Research's 2020 REIT total return forecast is 5-10%.

US REITs lagged the S&P 500 during the Fourth Quarter (-1.0% vs. 9.1%), as recession odds ticked lower and investors boarded the "risk on" train. REITs lagged the broader equities market on fading recession fears, while underlying sector returns largely mimicked this shifting investor sentiment during the quarter.

The "defensive" property sectors were the worst performers, including Self Storage (-9.6%) and Health Care (-7.7%), in light of the improved economic outlook. New supply has also been a multi-year headwind for both sectors, culminating in health care REIT Ventas, Inc. reporting miserable operating results for its senior housing portfolio, with same-store net operating income (SSNOI) down 5.0%; Ventas shares fell 19.9% during the quarter. Self-storage owner Public Storage has also been less nimble navigating the challenging supply picture, notably posting the worst (-0.9%) SSNOI growth in the sector which dragged shares 12.3% lower during the quarter.

Property sectors more levered to economic growth were the top performers, including Office (6.9%) and Industrial (5.5%) REITs. New York landlord SL Green Realty Corp. was the top performer among all office owners (13.5%) as its ~30% discount to net asset value, ongoing share buybacks, dividend increase, successful leasing and investor conference were well received by the investment community. Industrial REITs continue to be on a tear, with online sales growth (and resulting need to warehouse goods in transit) during the holidays reaching record levels.

All retail sectors declined during the quarter, including Regional Retail (-4.6%), Factory Outlets (-2.8%) and Local Retail (-0.2%). Healthy forecasts for holiday spending provided no comfort for retail owners, as the spending growth was expected to come online at the expense of physical stores. CBL & Associates' decision to suspend its common AND preferred dividends through 2020 could be the first of several mall owners to reduce cash distributions to preserve capital, which points to little upside anytime soon; CBL shares fell 18.6% in the quarter.

Canadian REIT returns were similarly weak, though currency pulled the USD return into positive territory. Despite the negative local return, dispersion of performance was unusually wide (e.g., -7.3% to +8.9%). Nearly half of the companies posted a positive local return, which suggests macro was a less impactful driver of performance during the quarter. Yet economic growth continues to weaken while policy statements from the Bank of Canada have resulted in tightened financial conditions. There was no change to the overnight rate vs. expectations of a rate cut, boosting currency yet indicative of a tough outlook in the coming year.

Asia-Pacific (24.6% of Index)	4Q19 Total Return				
	Asia-Pacific	Japan	Hong Kong	Australia	Singapore
Index Weight	24.6%	11.7%	6.2%	3.6%	3.0%
Local Currency (LC)	1.1	-0.2	3.7	-0.1	3.1
USD	2.0	-0.8	4.3	4.2	6.0

Sources: FTSE EPRA/NAREIT and FactSet.

Asia-Pacific delivered a respectable total return in the Fourth Quarter, driven by performance in Hong Kong and Singapore as well as outsized strength in the Australian dollar. Currency was a positive contributor to the USD return despite modest Japanese ¥/$ weakening during the quarter, which follows a robust currency contribution earlier in the year on expectations of new fiscal stimulus which would alleviate pressure on the Bank of Japan to further loosen monetary policy. While the local return in the region was positive, violent protests in Hong Kong and catastrophic wildfires in Australia are taking the wind out of the tourism – and economic growth – sails in both countries.

Property securities in Japan posted a negative return in the Fourth Quarter, unsurprising given the consumption tax hike that took effect on October 1 which likely shifted spending into the prior quarter. The large cap JREITs and developers generally lagged during the quarter, including Sumitomo Realty & Development Co. which was the worst performer (-7.8%) despite strong results and record low 1.7% vacancy rate for its Tokyo office portfolio. Yet shares drifted lower following its poorly received July announcement that it was investing in India, its largest overseas investment since the 1990s, which seemingly signaled a lack of opportunities in Japan and in other developed markets. Tokyo office owner Hulic Co. was the top performer for the second consecutive quarter (19.9%) as results affirmed the company's outlook for record profit by year end.

Hong Kong property securities posted the strongest local return during the Fourth Quarter, despite the country entering its first recession in a decade. The strong performance for property securities marked a reversal from earlier quarters when returns significantly lagged on increasingly violent anti-China/pro-democracy protests. Third quarter GDP contracted 3.2% which follows a 0.5% decline the prior quarter; expectedly bad news that was more than reflected in prior share prices. Wharf Real Estate Investment Co. was the top performer (11.8%), ostensibly a reversion from negative earlier year results given ownership of retail properties located in areas impacted by the ongoing protests. Indeed, luxury brand Louis Vuitton announced plans to close its store in Wharf-owned Times Square mall in Causeway Bay, following Wharf's decision to hold firm on rents. Retail sales have increasingly fallen since protests began in March, recently down over 25% with several luxury brands reporting sales declines of nearly 50%.

Australia property securities posted flattish local returns in the Fourth Quarter, with currency driving USD returns meaningfully higher. Currency has been unusually volatile during the year, contributing positively to USD returns by over 4% which follows a nearly 4% drag the prior quarter. Yet currency had a more modest -0.2% impact for the full year as the Reserve Bank of Australia kept pace with its US central bank peer, both with three rate cuts totaling 75 bps in 2019. Diversified owner Mirvac Group maintained its torrid pace during the quarter (+10.4%) and ended the year among the top performers in the Asia-Pacific region (+47.3%), on development completions, solid fundamentals and recent build-to-rent initiatives, all supported by a strong balance sheet. The ongoing wildfires are estimated to cost between A$3-13 billion which would drag GDP 0.25-1% lower for the year, albeit conditions could worsen, potentially pushing the country into its first recession in nearly 30 years.

Property securities in Singapore were positive during the Fourth Quarter. City Developments led the way (+14.7%) following strong residential pre-sales on rising foreign buyer interest. Yet not all SREITs contributed. CapitaLand Mall Trust (-2.7%) reported negative rental reversions on softening sales, while CapitaLand Commercial Trust (-1.1%) continues to drift lower given its high (~10%) exposure to co-working tenants and inherent risks.

Europe (18.2% of Index)	4Q19 Total Return							
	Europe	UK	Germany	Sweden	Netherlands	France	Switz.	Europe (ex UK)
Index Weight	18.2%	5.1%	4.5%	2.1%	1.5%	1.6%	1.1%	13.1%
Local Currency (LC)	7.3	12.5	4.6	7.5	5.1	9.8	8.0	5.3
USD	12.0	20.9	7.7	13.0	8.2	13.1	11.3	8.5

Sources: FTSE EPRA/NAREIT and FactSet.

Europe posted particularly robust local and currency returns during the Fourth Quarter. The twice-delayed Brexit deadline was again extended during the quarter, now set for no later than January 31, 2020. Yet the UK general election in mid-December resulted in a landslide Conservative majority in Parliament, thus lowering the odds of a no-deal Brexit and disruption that would otherwise result…which was welcome news to the listed property and currency markets. Notably the British £/$ exchange rate rose nearly 8% during the quarter, propelling USD returns for UK securities even higher.

UK securities were especially strong, with currency returns topping local returns for more than one-third of property companies during the Fourth Quarter. The UK's largest listed residential property owner Grainger had historically strong share performance (+38.4%), following better-than-expected earnings results, acceleration of its private rented sector strategy and greater clarity that should arise as the Brexit deadline approaches. Yet not all UK property securities participated in the rally, as fundamentals continue to deteriorate in the retail sector. Intu Properties, owner of several top shopping centres in the UK and Spain, was the only UK property company to deliver a negative total return (-17.6%) on the secular headwinds facing retail (e.g., online growth at the expense of physical stores), high/rising leverage and following news that the company hired advisers to help fix its balance sheet, which led to speculation that a massively dilutive equity raise was coming.

German property securities posted solid returns during the Fourth Quarter, yet still lagged its European peers as the country teeters towards recession. Regardless of whether the country falls into technical recession, the German economy remains on wobbly footing with GDP growth of only 0.1% in the third quarter, which follows a 0.2% contraction in the prior quarter. The export-heavy country may be hard pressed to deliver more robust economic growth anytime soon, given lingering trade uncertainties as the US and China are among Germany's largest trade partners. The German auto industry is also several steps behind the steady rise of electrical cars, recently estimated at 5% share of new car sales yet forecasts top 30% by 2025, which could weigh heavily on jobs/economic growth given the country's dependence on the gasoline-powered automotive industry. Yet despite this mediocre economic backdrop, mergers and acquisitions took center stage during the quarter. Diversified owner TLG Immobilien was atop the total return charts (17.4%) following a binding agreement to be acquired by listed peer Aroundtown; though the stock was the worst performer the prior quarter when news of a potential combination first surfaced. Residential property owner ADO Properties found itself at the bottom of the total return charts (-12.6%), following holding company ADO Group's obligation to reduce its share ownership in ADO Properties following ADO Group's merger with Adler Real Estate…as well as ADO Properties subsequent offer for Adler Real Estate whose ownership in ADO Properties resulted in its merger with ADO Group in the first place! A-D'OH!

Property securities in Sweden continued their strong performance during the Fourth Quarter (13.0%), once again besting most European countries and landing atop the total return charts for the full year (45.5% vs. Europe 27.6%). The Riksbank (central bank of Sweden) raised its benchmark rate by 25 bps to 0.00%, the first of several countries to navigate its way out of negative interest rate territory, as the country's soft economy is forecast to be less soft in the coming year(s). Swedish property securities mostly shrugged off this interest rate headwind, while also benefiting from the strong currency return that resulted from the aforementioned rate hike; the Swedish Krona/$ exchange rate rose 5% during the quarter.

Disclosure:

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