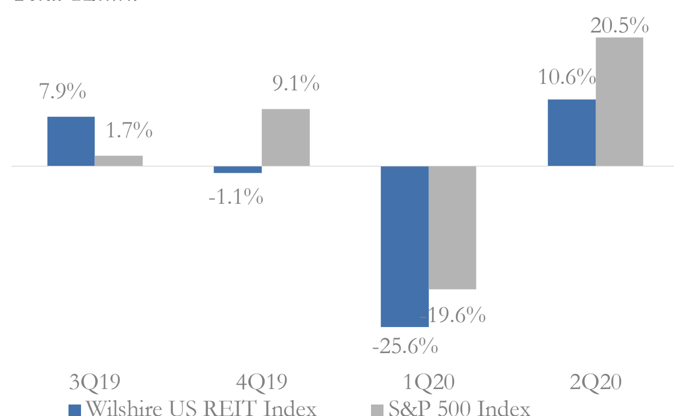
Global pandemic. The third estimate of First Quarter GDP growth was -5.0% and the Federal Reserve Bank of Atlanta projects Second Quarter GDP growth to be -34.7%. According to the Bureau of Labor Statistics, changes in total nonfarm payroll in the past three months were -20,787,000, 2,699,000, and 4,800,000, respectively, an average of -4,429,333 and catastrophically below the average of 67,333 for the 12 months prior. However, since peaking at the end of March at 6.9 million, weekly jobless claims have been declining steadily (and stabilizing at around 1.4 million), a good coincident indicator of the climb back from the Covid-19 related abyss for the US labor market. The 10-Year Treasury Note yield was relatively unchanged from 0.698% on March 31, 2020 to 0.653% on June 30, 2020 as was the spread between the yield on the 3-Month Treasury Bill and the 10-Year Treasury Note declining slightly from 55 bps to 51 bps in Second Quarter.

The Wilshire US REIT Index (Index) was up 10.6% in Second Quarter, trailing the S&P 500 and the Russell 200 Indices which were up 20.5% and 25.4%, respectively; while equity investors were wildly enthusiastic about a V-shaped recovery in the US economy, they apparently had lingering doubts about the commercial real estate that houses it. The advance was broad based with 82 companies out of the 105 constituents of the Index producing positive results; on the opposite ends of the spectrum, the laggards were populated with New York City Office, Hotels and Self-Storage names. Some large, high-profile REITs like Equity Residential, Public Storage, Host Hotels & Resorts and Boston Properties produced negative returns for the quarter.

REITs vs. S&P 500 Index
Total Return



Source: Wilshire Associates.

Sector Performance of the Wilshire US REIT Index
Ranked by Second Quarter 2020 Performance

Sector	2Q20	Trailing 1-Year	Current Yield
Factory Outlets	49.2%	-50.9%	0.0
Retail-Local	27.2	-29.7	2.4
Retail-Regional	19.7	-54.1	10.4
Health Care	18.6	-26.3	5.4
Mfd. Housing	16.0	7.2	2.0
Industrial	12.3	23.8	2.4
Wilshire US REIT	**10.6**	**-12.3**	**3.6**
Diversified	8.9	-15.9	4.9
Apartments	6.2	-16.5	4.0
Hotels	5.6	-46.4	0.1
Office	5.1	-15.7	4.1
Self-Storage	-1.7	-13.0	4.2
Industrial Mixed	-2.5	-26.1	4.9

Source: Wilshire Associates.

The investor optimism behind the sharp rally in the broad equity markets also drove the relative performance of the various property types that comprise the Index in Second Quarter. Interestingly, secular growth sectors like Manufactured Housing, Data Centers (and Towers) and Industrial continue to outpace the Index; only Self-Storage faltered as the threat of supply reared its ugly head during earnings. Traditional property types like Apartments and Office continue to underwhelm as they are inexpensively priced in the public markets but face headwinds (short-term for Apartments (deteriorating pricing power) and longer-term for Office (work from home)).

Among the four beaten-up property types trading at the greatest discounts to break-up value, investors showed a preference for Retail (particularly grocery-anchored strip centers) and Health Care while mustering up very little enthusiasm for NYC Office and Lodging. Even with the sharp rebound in Retail and Health Care, durable outperformance of these value names will come about only if there is genuine economic growth in the United States; should a second wave (or a rolling first wave) of Covid-19 inhibit economic activity and consumption, growth sectors will continue to lead. Keep in mind that a 50% down quarter followed by a 50% rebound will still leave investors 25% short of their starting point.

Tapping old partners. On May 5, SL Green Realty Corp announced that it has sold a 49.5% interest in a future NYC redevelopment project to the National Pension Service of Korea and Hines Interest LP, partners in their current development, One Vanderbilt Avenue. Commenting on the transaction, Marc Holliday, SL Green's CEO, said, "This joint venture partnership serves as an affirmation of New York City's market resiliency and SL Green's ability to execute its business goals in a demanding climate." On June 29, Hudson Pacific Properties announced that it has sold a 49% stake in its studio properties to funds affiliated with Blackstone, with whom they have partnered in the past on the $3.5 billion acquisition of Equity Office Properties San Francisco Peninsula/Silicon Valley portfolio and on the 2019 acquisition of the Bentall Center in Vancouver, Canada; the transaction includes future development right on the properties. Commenting on the transaction, Victor Coleman, Hudson Pacific's CEO, said, "Our latest joint venture with Blackstone unlocks a portion of the value we've created for our shareholders and provides us with significant capital to grow both our studio and office portfolios."

The SL Green and Hudson Pacific transactions are very similar in that both companies, historically aggressive in pursuing external growth, are selling pieces of their portfolios (existing and pipeline) to prior institutional partners in order to move ahead with their growth. The single digit NAV discounts for the two transactions are reasonable penalties for the two companies to pay considering that their share prices/overall portfolios are currently trading at more than 20% discounts to break-up values in the public markets. Of course, it is easier to occupy the C-suite if you can just issue equity at premiums to Net Asset Values like Alexandria Real Estate Equities and Sun Communities did during the quarter in order to fund developments and acquisitions

M&A. On June 10, Simon Property Group announced that it is terminating its merger agreement with Taubman Centers, Inc. ("TCO") stating that (i) the pandemic had a unique and disproportionate effect on TCO and (ii) TCO failed to mitigate the impact of the pandemic as others in the industry have. Despite the fact that almost every merger arbitrage expert who has studied the documents has asserted that pandemics have been excluded from the "Material Adverse Effect" clause, for Simon, this is almost a riskless strategy to try to get out of an inopportune deal or at the very least force TCO to renegotiate terms. Of course, TCO intends to "pursue its remedies to enforce its contractual rights under the Merger Agreement," the second time in 20 years that the two mall giants have squared off in court, albeit for very different reasons.

Observations from Home – Ben Yang

The National Association of Real Estate Investment Trusts (NAREIT) held its annual REITweek conference in June, with a nearly 40% increase in attendees from last year given the growing interest in REITs…possibly also aided by the ability to "Zoom" meetings from home. Fortunately, the virtual conference was still insightful, with more time spent talking strategy with CEOs and less time squeezing into elevators that, during rush hour, made the subways of Tokyo look downright spacious.

All property sectors are expected to be uniquely impacted by the coronavirus pandemic, some immediately (lodging as travel came to a halt) and the longer-term impact for some uncertain (office if WFH sticks, apartments if renters flee cities and student housing if colleges do not re-open). Less arguable is the continued outperformance of secular winners on one hand (data centers with rising usage and industrial with e-commerce) the coronavirus' damage to the already-flaccid retail REITs on the other, not just the acceleration of on-line spending as everyone hunkered down in late-March but also the mandated closure of non-essential stores and enclosed centers.

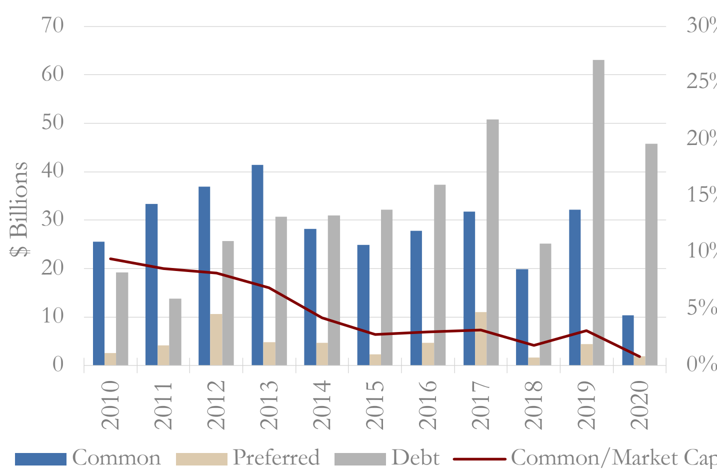
Rent collection from shuttered tenants was a key topic in all retail meetings, with enclosed (but also closed) malls expected to land at the bottom (10-30% range) and grocery-anchored retail likely to fare better (50-70%). Indeed, supermarkets have shined bright with restaurants closed and food still an essential ingredient of life; grocers were also able to satisfy the mad rush on toilet paper - vertical integration at its finest!

Despite the inevitable rent shortfall, the retail REITs offered little-to-no rent abatement in the initial (though unlikely last) round of closures, only short-term deferrals for smaller tenants. Compensation to owners came in the form of lease extensions, rent bumps, easing use restrictions and/or eliminating co-tenancies. Yet the longer the pandemic persists and businesses grapple with closing-opening-closing again cycles, the more retailers are expected to throw in the towel. Indeed, store closures and bankruptcies are already trending towards historically high levels in 2020, which has weighed heavily on retail REITs. And while the public REITs generally own the highest quality and best locations compared to private owners at a time when quality and location will separate the winners and losers, there are few silver linings in the devolution facing physical retail. Vacancies are rising and market rents are falling alongside sales. The good news is that retail REITs have prepped for a looming recession during the historically long/10+ year economic recovery leading into the pandemic (selling weakest assets and reducing leverage), so survival is assured for most and brighter days lie ahead when the coronavirus tempest passes.

Clogging in the pipes. According to NAREIT, $6.6 billion in equity capital was raised in Second Quarter 2020, a bit more than the $5.8 billion raised in the prior quarter but significantly less than the $12.7 billion raised a year ago in Second Quarter 2019; with many REITs trading at significant discounts to Net Asset Values and private markets not fully reflecting the underlying commercial real estate distress, there was very little reason for the majority of the companies to come to market.

Almost all of the activity took place in the issuance of secondary equity (there were 14 offerings totaling $6.1 billion during the quarter, on par with $4.3 billion issued in the prior quarter but way below the $11.9 billion issued a year ago). There was only one issuance of preferred equity totaling $0.5 billion compared to $1.5 billion issued in the prior quarter and $0.7 billion issued a year ago. Needless to say, there were no IPOs.

Historical Offering of Securities
2010 – 2020

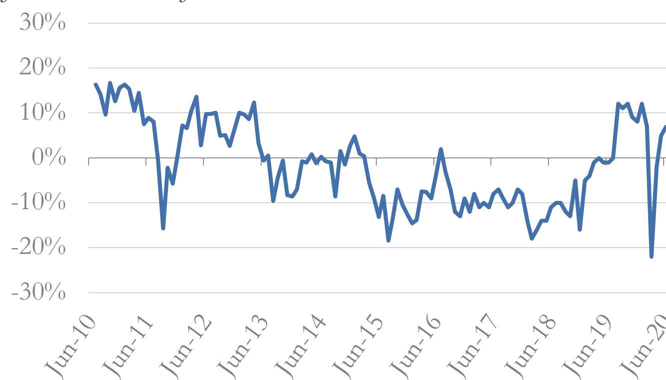


Sources: S&P Global Market Intelligence, NAREIT 2020.

Passive leads the way. According to AMG Data Services, net flows out of dedicated real estate funds, excluding ETFs, totaled $1.9 billion in Second Quarter 2020 compared to $0.5 billion in the prior year. REIT ETFs also saw significant outflows of $2.3 billion in Second Quarter 2020 compared to outflows of $0.3 billion in the prior year. There doesn't seem to be much interest in bargain hunting in REITs by either the fast money, as represented by ETFs, or by investors in dedicated real estate funds.

Flows into US and Global mutual funds registered in Japan totaled $0.7 billion in Second Quarter 2020 compared to outflows of $0.4 billion in Second Quarter 2019.

Premium/Discount to Net Asset Value
REIT Universe
June 30, 2010 to June 30, 2020

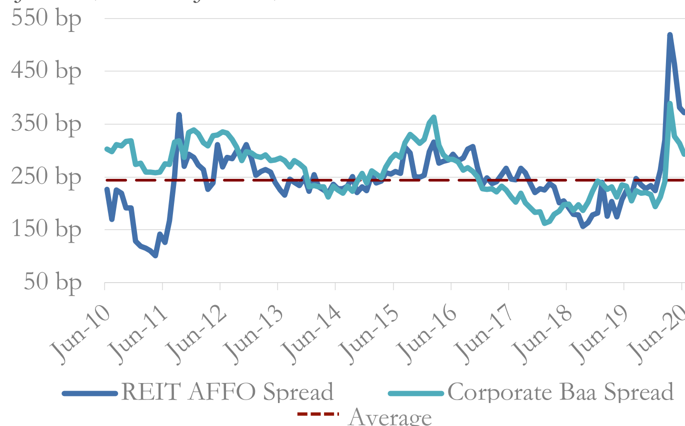


Sources: Adelante Capital Management and Green Street Advisors.

Risk premium on par with the ten-year average. While not at the bargain basement spreads of 520 bps found at the end of First Quarter, the risk premium for owning commercial real estate, as represented by the spread between REIT cash flow yields and the riskless rate of return, stands at 372 bps and still trades well above the 10-year average of 244 bps. Assuming that we can return to the cash flow potential of the high quality commercial real estate owned by REITs, investors are being highly compensated for the risk.

Corporate Baa spreads also settled during the quarter but, unlike the risk premium for REITs, the current spread of 293 bps rests only marginally above the 10-year average of 261 bps. The fact that the credit spreads for the REITs' tenancy trades so much better than the cash flow spread of their landlords makes no sense until one takes into account the heavy hand of FOMC intervention; with the promise of Jerome Powell's back stop, corporate debt is certainly enjoying a privileged status vis a vis REITs.

Spread Comparison
REIT Cash Flow and Corporate Baa Yields vs.
10-Year Treasury Note Yield
June 30, 2010 to June 30, 2020



Sources: Adelante Capital Management and Green Street Advisors.

Outlook

PELLEY: Fair to say you simply flooded the system with money?

POWELL: Yes. We did. That's another way to think about it. We did.

PELLEY: Where does it come from? Do you just print it?

POWELL: We print it digitally. So as a central bank, we have the ability to create money digitally. And we do that by buying Treasury Bills or bonds for other government guaranteed securities. And that actually increases the money supply. We also print actual currency and we distribute that through the Federal Reserve banks.

PELLEY: In terms of size, Mr. Chairman, how does what the Fed is doing right now compare to the unprecedented action it took in 2008?

POWELL: So the things we're doing now are substantially larger. The asset purchases that we're doing are a multiple of the programs that were done during the last crisis. And it's very different this time. In the last crisis, the problems were in the financial system. So they were providing support for the banking system. Here, really, the problems are in what we call the real economy, actual companies that make and sell goods and services. And what's happening to them is that many of them are closed or just not having any revenue.

And we're trying to do what we can to get them through this period where they're perfectly good companies that have had, you know, sound financial condition as recently as February, but now they have no business. And they have fixed costs. So we're trying to help them get through that period…

PELLEY: Has the Fed done all it can do?

POWELL: Well, there's a lot more we can do. We've done what we can as we go. But I will say that we're not out of ammunition by a long shot. No, there's really no limit to what we can do with these lending programs that we have. So there's a lot more we can do to support the economy, and we're committed to doing everything we can as long as we need to.

PELLEY: What would the Fed's next steps be, potentially?

POWELL: Well, to begin, the one thing we can certainly do is we can enlarge our existing lending programs. We can start new lending programs if need be. We can do that. There are things we can do in monetary policy. There are a number of dimensions where we can move to make policy even more accommodative. Through forward guidance, we can change our asset purchase strategy. There are just a lot of things that we can do.

Excerpts from 60 Minutes Interview of Jerome Powell – May 17, 2020

For those traders not monikered Day Trader Dave (David Portnoy/Barstool Sports), the sharp rebound in risk assets has come as something of a surprise given the double-digit rates of unemployment and GDP decline as well as a sharp increase in corporate bankruptcies. As a way of explanation, Michael Darda, an economist at MKM Partners, presciently proffered the idea of a "price/liquidity ratio" for the S&P 500 Index comparing it to a broad measure of money supply. Relying on Milton Friedman's thesis that money growth and its velocity will be the ultimate driver of demand in the economy, with Jerome Powell's monetary shock and awe overwhelming slowing velocity, Darda suggests that the equity markets may just be anticipating the V-shaped recovery to come.

Thus far, liquidity seems to be trumping the virus even as we are seeing a resurgence of new cases with more states reopening (equity investors are taking great comfort from widely distributed charts showing declining mortality rates). During a video conference on July 6, Dr. Anthony Fauci confirmed that the average age of new coronavirus cases has dropped by 15 years as it spreads to the Sun Belt (hence the lower mortality rate) but cautioned that the virus could still put the younger infected "out of action for weeks at a time," which may be why the hospitalization rate is tracking the rise of new cases. If the young infected become part of the "propagation of the disease" to their parents and grandparents, expect the mortality rates to tick back up as well; at the very least, real-time mobility data is showing that headlines are having a dampening effect on economic activity.

While the monetary powers of someone who traffics in the fiat currency should never be underestimated, fiscal stimulus is the wild card as we approach the end of Fiscal Package Three. According to a recent report by Evercore ISI, disbursements from PPP, stimulus checks and unemployment insurance (UI) have thus far totaled $1.040 trillion but the only active program is UI, primarily in the form of the Federal Pandemic Unemployment Compensation (FDUC), the incremental $600 weekly payment that is going to all UI recipients, and FDUC is set to expire before July 31. Congress comes back from recess on July 20 so it will have only two weeks to negotiate the details of Fiscal Package Four. Despite unsavory headlines of undeserving PPP loan recipients and two straight months of better than expected employment reports, most pundits expect something to pass but the form and substance is unclear. Although the Republican leadership in the Senate is posturing fiscal discipline, neither party will likely want to play Scrooge with the upcoming elections. Party on Garth. Party on Wayne.

Disclosure:

Adelante Capital Management, LLC ("Adelante") is a registered investment adviser with the SEC. This report is for informational and professional purposes only, cannot be distributed without express written consent, and does not constitute advice, an offer to sell, or a solicitation of an offer to buy any securities and may not be relied upon in connection with any offer or sale of securities. The contents of this report should not be relied upon in making investment decisions. The information and statistical data contained herein have been obtained from sources that we believe to be reliable but in no way are warranted by us as to accuracy or completeness. The accompanying performance statistics are based upon historical performance and are not indicative of future performance. The types of investments discussed do not represent all the securities purchased, sold, or recommended for clients. You should not assume that investments in the securities or strategies identified and discussed were or will be profitable. While many of the thoughts expressed in this report are stated in a factual manner, the discussion reflects only Adelante's beliefs about the financial markets in which it invests portfolio assets. The descriptions herein are in summary form, are incomplete and do not include all the information necessary to evaluate an investment in any investment or strategy.