Insights
Asset Allocation

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The Ongoing Case for REITs in the Economic Recovery

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One of the hardest-hit asset classes in the first quarter of 2020 was publicly listed US Real Estate Investment Trusts (REITs). However, the vaccine-driven global economic recovery has lifted the group off its pandemic low to a nearly 90% cumulative return over the past 18 months. REITs have enjoyed strong returns that rival those of US equities thus far during the reopening economy. The question, then, is whether this strong rally has legs.

We believe that a new bull market for real estate may still be in its early days and the asset class still offers strong return opportunity. Despite rising inflation and the expectations for government bond yields to move higher, the current backdrop is favorable for REITs, particularly sectors that are tied to housing, the cyclical recovery, and the digital economy.

For investors who wish to take advantage of opportunities in real estate, we offer the following considerations:

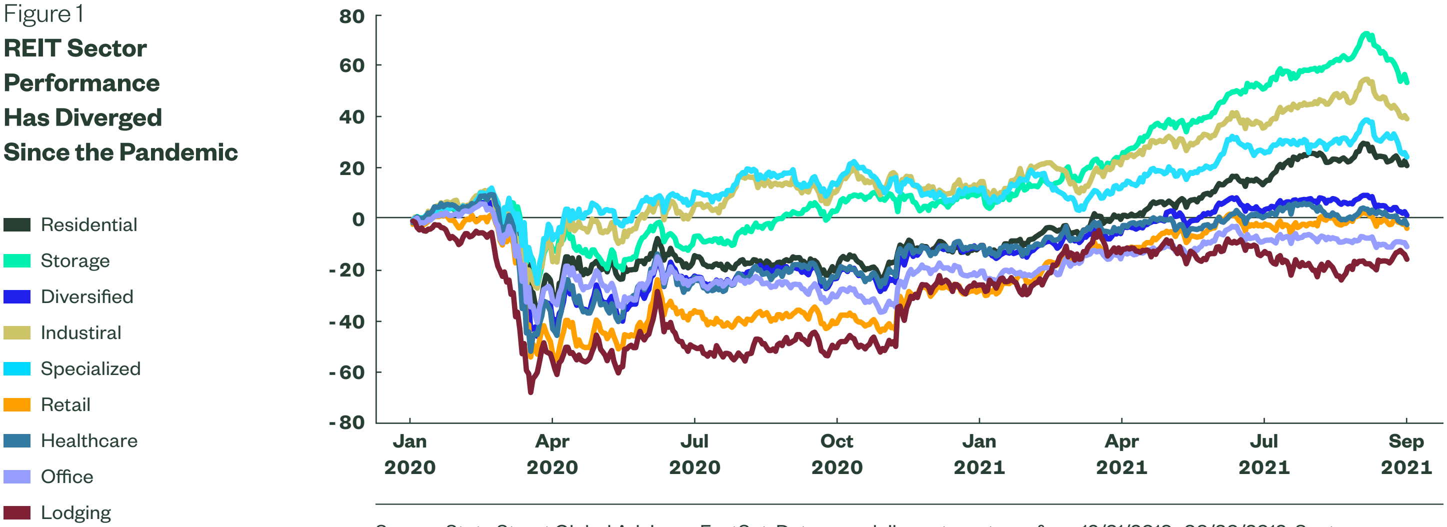
- **REIT sector year-to-date performance has been uneven**
- **Rising rents could continue to boost REIT returns**
- **An uptick in interest rates may not hinder REIT returns**
- **REITs can operate effectively as an inflation hedge**

This piece will discuss each of these considerations in detail.

REIT Sector Year-to-Date Performance Has Been Uneven

Past REIT recoveries have typically lagged rebounds in the broader equity market due to the challenging combination of increasing vacancy rates and falling rents — circumstances that can linger long after economic indicators including GDP and unemployment rates turn the corner. These factors led REITs to relatively underperform equities during the last two US recessionary periods, marked by the internet bubble in 2001 and the Global Financial Crisis. By contrast, as REITs exit the pandemic lows of 2020, the recovery has been an uneven one with significant disparity in performance between various REIT sectors. Industrials, tech-related infrastructure (including data centers and towers), and self-storage have thrived on robust demand, while the office, retail, and lodging sectors have trailed the broader equity market recovery (Figure 1).

Figure 1
REIT Sector Performance Has Diverged Since the Pandemic



Source: State Street Global Advisors, FactSet. Data uses daily sector returns from 12/31/2019–09/30/2012. Sectors are classified using the S&P GICS definitions.

The recovery in 2021 has led to a resurgence within the rental housing, apartment, and self-storage sectors as home prices have risen at their fastest rate on record, forcing many would-be homebuyers out of the market and returning significant pricing power to landlords.

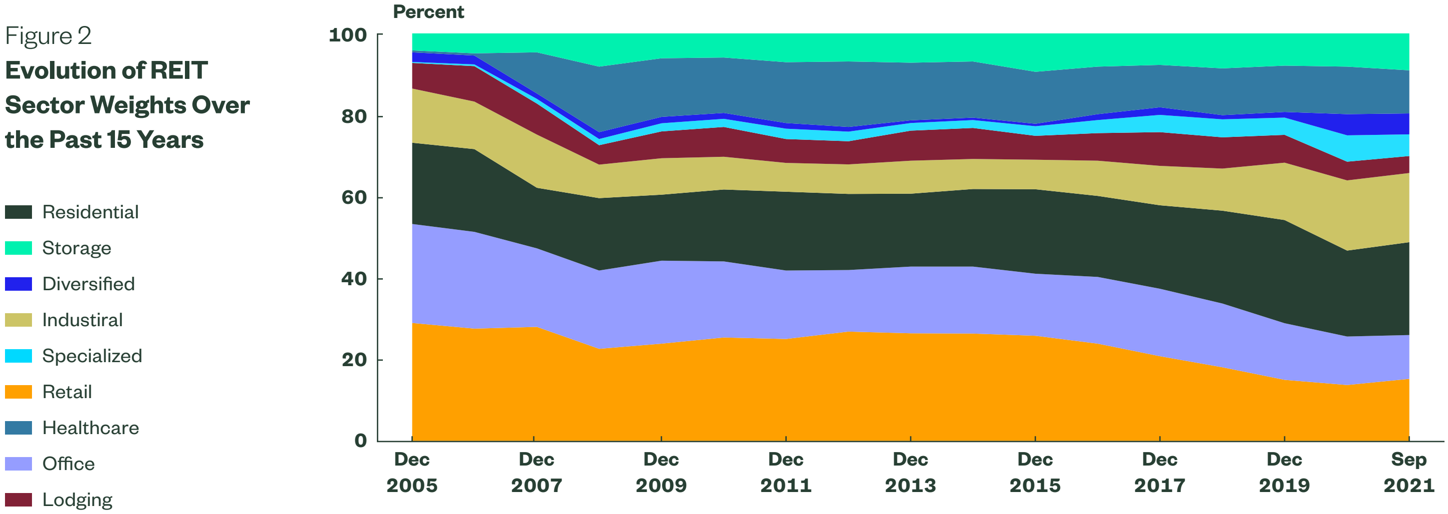
Meanwhile, the industrial, data center, and tower sectors continue to see strong secular demand trends and desire from private capital.[1] The digital economy has experienced increased revenue during the pandemic as businesses continue to expand online platforms and implement faster networks, such as 5G. In addition, the pandemic helped drive the shift from in-person to remote interactions, as well as the rise in e-commerce purchases. This group of sectors may be best positioned to drive REITs higher long after the pandemic has waned.

Conversely, it has been a difficult time for the office sector, as delays in employees physically returning to the office has led to lower utilization rates and headwinds to leasing and transaction activity. There are signs of gradual improvement, such as a pickup in turnstile traffic in New York City,[2] but the timing has proven hard to predict. As for bright spots, companies in technology, advertising, media, and information (TAMI) industries are increasing their workforce and expanding life science research and development facilities in tandem. However, overall, the index weight of the office sector has sharply declined from nearly 24% to approximately 11% over the last 15 years.

Retail sectors such as malls, shopping centers, and outlets were facing challenges prior to the pandemic, and those longer-term structural forces have only been exacerbated. These headwinds have resulted in the weight of the retail sector declining the most since 2010, shedding almost 14%, but still accounting for about 15% of the total index.

In general, when looking at the composition of the Dow Jones US Select REIT Index, the landscape has significantly changed over the last 15 years with sector percentages shifting towards housing and the relatively new and growing areas related to the digital economy, at the expense of retail and office (Figure 2). The residential sector currently occupies the largest weight in the index at nearly 23%, while the industrial sector has steadily grown over the last decade, more than doubling in size to over 17% at the end of last quarter.[3]

Figure 2
Evolution of REIT Sector Weights Over the Past 15 Years



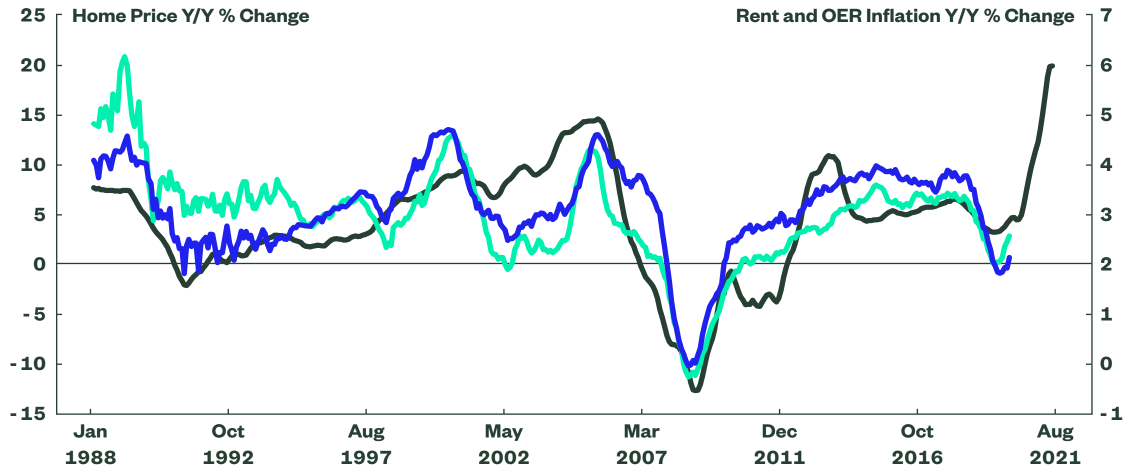
Source: State Street Global Advisors, FactSet. Index used is the Dow Jones U.S. Select REIT Index. Sectors are classified using the S&P GICS definitions.

Rising Rents Could Help to Bolster REIT Returns

The current cyclical recovery has created a strong tailwind as the economy continues to reopen. Historically, economic growth has resulted in rent inflation across REIT sectors. Since rent inflation is one of the key offsets to rising yields for REITs, it is important for investors to understand the timing between improvements in economic growth and hikes in rent from landlords. In the past, ballooning home prices have been a leading indicator for rents. This bodes well for rents, given today's real estate environment, in which the combination of strong demand, limited supply, historically low mortgage rates, and record household saving rates have lifted the S&P CoreLogic Case-Shiller National Home Price Index to an annual rise of nearly 20% in August, marking the highest annual rate of growth since the index began in 1987. According to a study by the Federal Reserve Bank of Dallas, gains in home prices typically feed into rent inflation with an 18-month lag,[4] and while rent inflation has already turned the corner, the record gain in home prices suggest rents are primed to continue to surge, further supporting REIT returns (Figure 3).

Figure 3
Residential Rents Are Set for a Steep Climb

- S&P/Case-Shiller US National Home Price Index, NSA
- Owners' Equivalent Rent of Residences in US City Average, NSA
- Rent of Primary Residence in US City Average, NSA



Source: State Street Global Advisors, US Bureau of Labor Statistics, S&P Dow Jones Indices LLC. Monthly data as of 09/30/2021. NSA refers to non-seasonally adjusted.
S&P/Case-Shiller US National Home Price Index [CSUSHPINSA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CSUSHPINSA, October 26, 2021.
US Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: Owners' Equivalent Rent of Residences in US City Average [CUUR0000SEHC], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CUUR0000SEHC, October 26, 2021.
US Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: Rent of Primary Residence in US City Average [CUUR0000SEHA], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/CUUR0000SEHA, October 26, 2021.

An Uptick in Interest Rates Are Not an Obstacle to REIT Returns

As the second year of the new bull market unfolds, factors including a stronger economy, rising rents, low cost of capital to fuel M&A activity, and favorable supply and demand trends all point toward a sustained recovery for REITs.

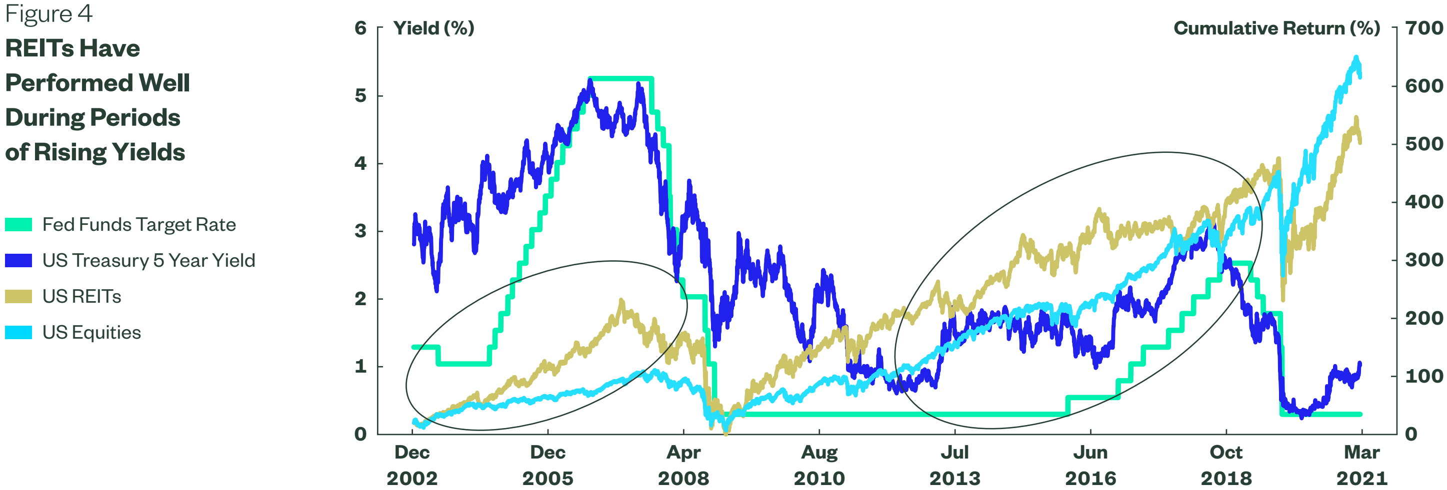
While these factors suggest there is more upside for REITs, a healthy job market, an improved economic outlook, and a less accommodative US Federal Reserve (Fed) may pressure bond yields higher, raising questions from investors about the sensitivity of REITs to escalating interest rates. Higher US Treasury yields can negatively affect the yield spread advantage that REITs typically hold over government bonds, leading many investors to believe that they should shun REITs as rates rise. This, however is a misinterpretation; when examining past periods of increasing yields, we find that investors would have missed out on robust returns if they abandoned REITs based on this theory (Figure 4).

In mid-2003, US Treasury yields began to move off their lows as the economy continued to recover from the 2001 recession. In June 2004, the Fed embarked on a two-year interest rate hiking cycle, which helped to push the 5-year US Treasury yield up more than 3% from trough to peak. Despite the rise in Treasury yields, REITs performed very well due to strong economic growth, a healthy real estate market, and rising inflation, and cumulatively returned just north of 100% over this period, far outpacing U.S. equities which returned 33%.

A more recent example took place in mid-2012 as 5-year US Treasury yields rose from their post-Global Financial Crisis lows and steadily increased over 2.5% before peaking late in 2018. During this time, the Fed increased interest rates to an upper range of 2.5% as the economy improved and the unemployment rate dropped to 5%. REITs once again generated solid cumulative returns in excess of 60% over the period, exhibiting that increase in yields, historically, has not been an obstacle for returns.

Furthermore, as government yields are still recovering from depressed levels, REITs currently hold a sizeable yield spread advantage over US Treasury bonds which should help mitigate the impact of climbing rates and position REITs well in the current environment.

Figure 4
REITs Have Performed Well During Periods of Rising Yields



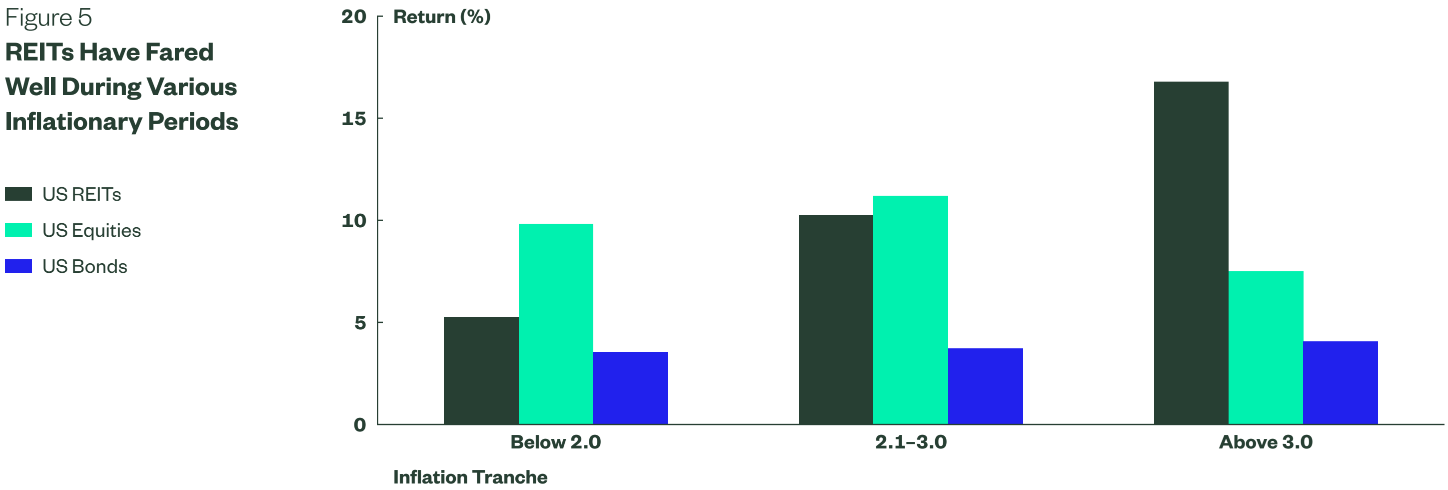
Source: State Street Global Advisors, FactSet. Data uses daily returns from 12/31/2002–09/30/2021. US REITs is represented by the Dow Jones U.S. Select REIT Index. US Equities is represented by the S&P 500 Index.

REITs Can Act as an Effective Inflation Hedge

While headlines have focused on near-term inflationary pressures and monthly consumer price index (CPI) spikes, longer-term inflation expectations continue to rise and consumers anticipate higher prices in coming years. The latest Federal Reserve Bank of New York's Survey of Consumer Expectations for September revealed both short and medium-term inflation expectations moved higher for the 11th consecutive month, hitting the highest reading since the series' inception in 2013. The survey's median one-year ahead expected inflation rate reached 5.3%, while the median three-year ahead rate rose to 4.2%.[5] Furthermore, market-based probabilities generated by the Federal Reserve Bank of Minneapolis at the end of September were pricing in nearly a 40% chance that the average inflation rate will exceed 3% over the next five years.[6] These expectations, along with CPI recently surging to an annual rise of 5.4% in September, could mark a structural shift towards higher inflation that would present investors with a challenge they have not needed to position for in decades.

Historically, an allocation to REITs has helped investors to counter inflation risk and preserve their purchasing power (Figure 5). REITs offer investors the unique blend of inflation protection and potential for capital appreciation and current income. Over the past nearly three decades, REITs have often outperformed equities and bonds in periods of moderate and higher inflation, while also delivering competitive returns in periods of lower inflation.

Figure 5
REITs Have Fared Well During Various Inflationary Periods

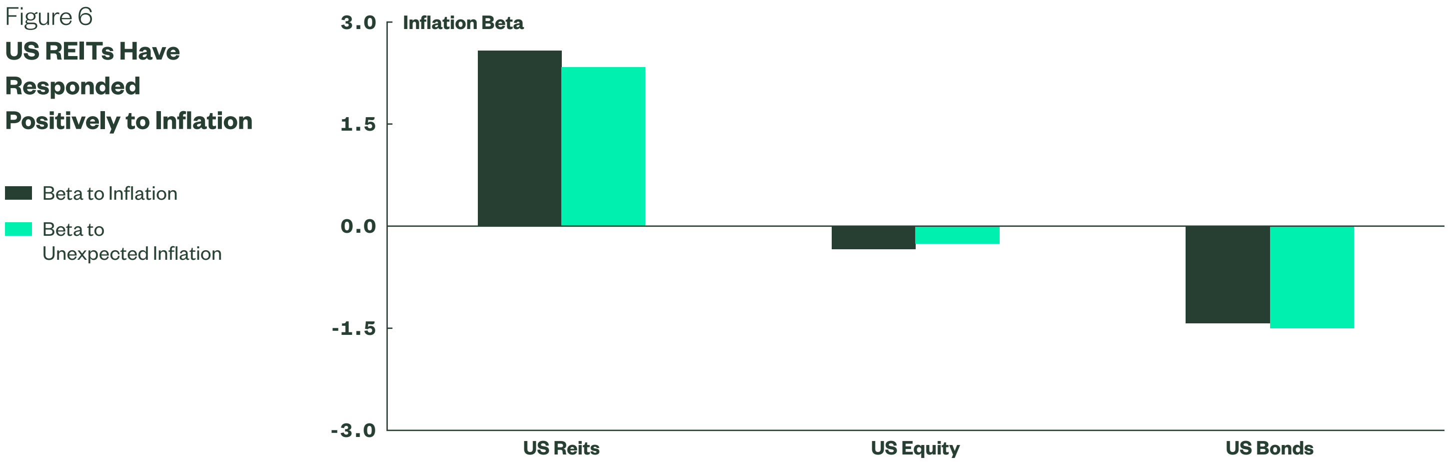


Source: FactSet, State Street Global Advisors. Data shows average annual real returns adjusted for inflation from 1991–2000. US REITs is represented by the Down Jones U.S. Select REIT Index. US Equities is represented by the S&P 500 Index. US Bonds is represented by the Barclays U.S. Aggregate Bond Index.

Returns on REITs have displayed a strong correlation with inflation, as property values typically increase during inflationary environments. Additionally, many lease and rental agreements are tied to inflation, with rent escalators built into contracts, helping landlords to keep pace with swelling costs. The backward-looking structure of these escalators causes a recognition lag that varies among REIT sectors. REITs with shorter duration agreements or income streams, such as hotels and apartments, can adjust quicker to economic changes and have a higher sensitivity to inflation than those sectors such as healthcare and offices.

Overall, REITs have demonstrated high historical sensitivity to both realized inflation and unexpected inflation, as measured by inflation beta. The unexpected beta to inflation of 2.3 means that for every 1% that inflation beat its prior-year forecast, REITs positively responded by generating a 2.3% return, even as higher-than-expected inflation had a negative impact on stocks and bonds (Figure 6).

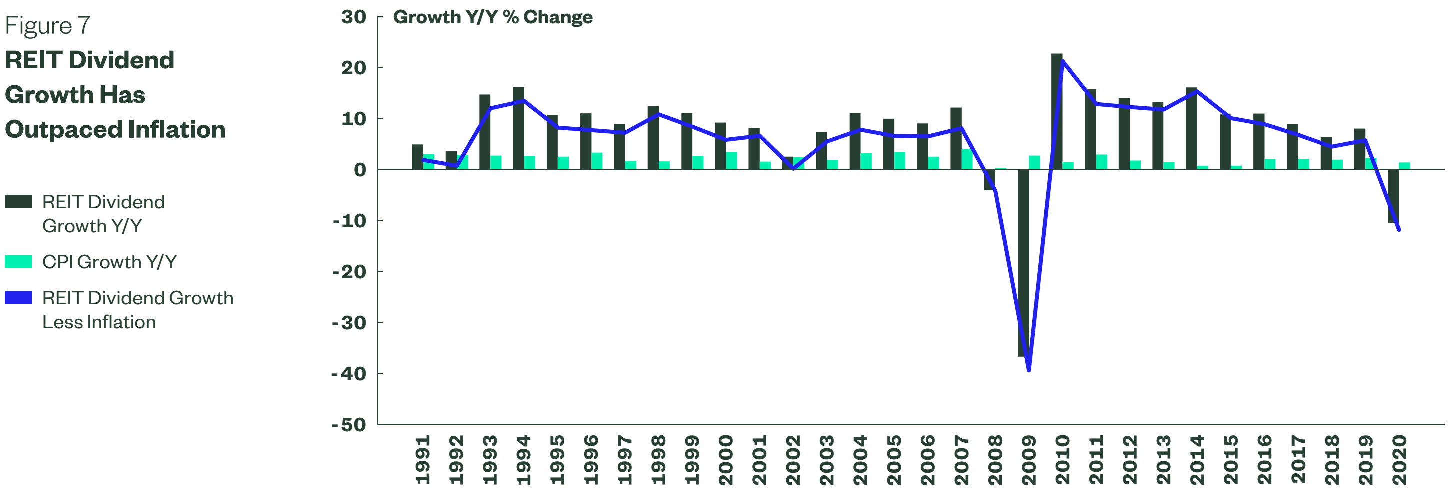
Figure 6
US REITs Have Responded Positively to Inflation



Source: State Street Global Advisors, FactSet. Data uses quarterly real inflation adjusted returns from 12/31/1991–09/30/2021. US REITs is represented by the Down Jones U.S. Select RET Index. US Equities is represented by the S&P 500 Index. US Bonds is represented by the Barclays U.S. Aggregate Bond Index. Inflation is represented by CPI, non-seasonally adjusted. Unexpected inflation is calculated by taking the difference between the realized inflation rate (Q/Q change in CPI) and the lagged quarterly 1 year ahead median CPI estimate from the Federal Reserve Bank of Philadelphia Survey of Professional Forecasters.

Additionally, the income component of REITs has helped offset inflation with dividends that historically have increased at a faster pace (Figure 7). Dating back to 1991, REIT dividend growth has outpaced inflation, with the exception of the Global Financial Crisis and the onset of the global pandemic of 2020. This reliable stream of income has afforded investors the ability to improve a portfolio's inflation protection without sacrificing return expectations.

Figure 7
REIT Dividend Growth Has Outpaced Inflation



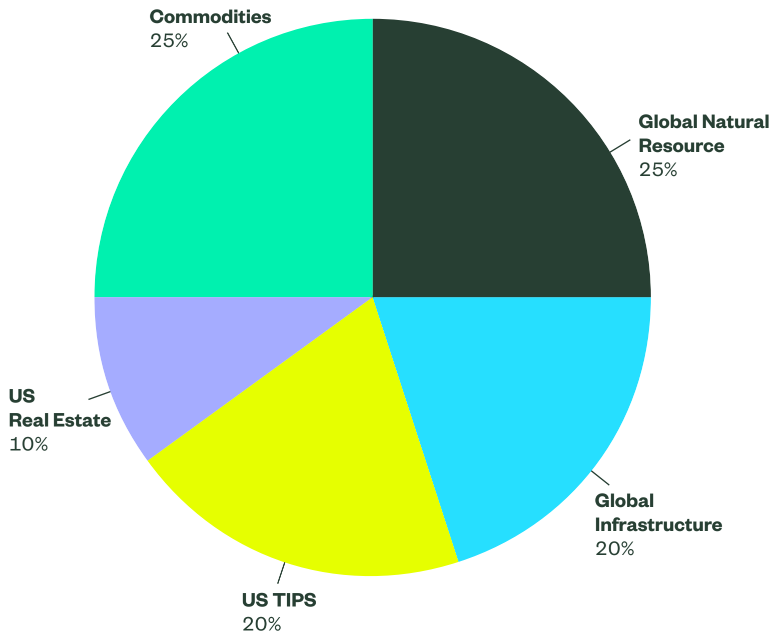
Source: National Association of Real Estate Investment Trusts, NAREIT ©.
NAREIT Equity REIT Dividend Growth calculation uses monthly data from 1991–2020.

State Street Global Advisors' Real Asset Strategy Can Help Position Portfolios for the Prospect of Inflation

As the market evolves, investors should continue to position their portfolios with diversified assets that can improve inflation sensitivity and augment risk-adjusted returns. REITs historically have performed well in both rising rate and inflationary environments, and appear poised to deliver long-term portfolio benefits alongside reopening momentum and medical progress towards addressing the COVID-19 virus.

State Street Global Advisors offers investors a seasoned, diversified multi-asset strategy that combines exposure to a broad array of liquid real asset securities. The Real Asset Strategy is expected to perform best during periods of increasing inflation or rising unexpected inflation. The Strategy is meant to be a complement to traditional equity and bond assets, providing further diversification, attractive returns, and a source of income in a low-yielding environment. For complete information, please contact your State Street representative.

Figure 8
State Street Global Advisors Real Asset Strategy



Source: State Street Global Advisors.

Endnotes

1 S&P Global Industry Classification Standard (GICS) classifies Data Centers and Towers within the Specialized sector.

2 Source: MTA turnstile data and Goldman Sachs Equity Research as of September 22, 2021.

3 Dow Jones US Select REIT Index using S&P GICS sector classifications.

4 Xiaoqing Zhou and Jim Dolmas, "Surging House Prices Expected to Propel Rent Increases, Push Up Inflation," Federal Reserve Bank of Dallas, August 24, 2021, https://dallasfed.org/research/economics/2021/0824?d=1&s=tw.

5 Center For Microeconomic Data, Survey of Consumer Expectations, "Inflation expectations," Federal Reserve Bank of New York, Accessed October 14, 2021, https://newyorkfed.org/microeconomics/sce#/inflexp-1.

6 Federal Reserve Bank of Minneapolis, "Current and Historical Market-Based Probabilities," Accessed October 14, 2021, https://minneapolisfed.org/banking/current-and-historical-market--based-probabilities.

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of September 30, 2021 and includes approximately $59.84 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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