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Equity REITs strengthened in January, up more than 10%

BY LORETTA CLODFELTER

Equity REITs advanced 10.7 percent in January, according to the FTSE Nareit Equity REITs Index, amid a broad-based stock market recovery. The S&P 500 Index rose 6.3 percent in January, and the tech-heavy Nasdaq Composite increased 10.7 percent.

REITs declined by about 25 percent in 2022, but many industry experts believe they are well positioned to perform strongly in 2023.

"Despite the macroeconomic and geopolitical stress points dominating the headlines, our outlook for the global commercial real estate market continues to be constructive," noted Andrew Duffy, CIO and Senior Portfolio Manager with Ranger Global Real Estate Advisors, LLC, in an interview with IREI. "Real estate fundamentals and earnings growth remain strong amidst an environment characterized by low supply in many sectors, paired with high construction costs. While global capital markets continue to experience periods of fixation on non-

fundamental factors, we believe that REITs are well-positioned to perform as investor attention turns back to fundamentals as uncertainty and the resulting volatility have likely peaked."

With the Federal Reserve calling for a 25 basis point increase in the target federal funds rate on Feb. 1, it seems the Fed is beginning to slow down on its tightening efforts to curb inflation.

"Inflation has demonstrably peaked, even before the economy has experienced the full –lagged – impact of the Fed's tightening measures thus far," said Duffy. "The Fed is closer to the end of its tightening process than the beginning, which means that it's also closer to its first rate cut when it realizes that the economy needs stimulus. We appear to be at or perhaps just past the point of peak pessimism – an inflection to just marginally less bearish sentiment would be positive for stocks. Having already sold off as much as it has, the market might be pricing in a worse scenario than we get – suggesting upside for REITs as they have historically performed well during longer periods of rising rates as they are generally characterized by accelerating economic growth – which is good for commercial real estate." Duffy added that a favorable scenario for commercial real estate is enough GDP growth to give landlords pricing power, but not enough growth to justify development of new space – thus virtually no new supply.

The strongest performance in January was seen in the lodging/resorts sector, up 17.1 percent. Other notable gains were recorded by industrial (up 13.7 percent), data centers (up 13.2 percent) and healthcare (up 12.8 percent).

"The adverse impact of rising interest rates on REITs has been already priced in," according to Iman Brivanlou, head of income equities at TCW and lead portfolio manager of TCW's global REITs products. "It seems that the market has forgotten that real estate was historically considered an inflation hedge – real assets. The space as a whole offers a positive long-term risk/reward, with parts of it being outright compelling."

Looking ahead, Duffy predicted the potential for outperformance in property types with higher growth outlooks and differentiated demand drivers such as data centers, cell towers, industrial/logistics and single-family rental homes.

"The 'digital economy' has been bolstered by the pandemic-induced hybrid working environment driving more demand for data centers and cell towers," said Duffy. "The 'Amazon effect' has driven last-mile fulfillment to support expedited delivery, increasing demand for industrial and logistics space to accommodate demand from ecommerce. In a post-pandemic era, we favor owners of single-family rental homes as the migration from metro centers to suburban locations continues to evolve."

On the flip side, Duffy said there could be weakness in property types that are highly correlated to GDP growth, such as discretionary retail and CBD office buildings.

"As the disruptive impact of ecommerce continues, discretionary retail's role in the new retail paradigm of omni-channel is yet to be determined," said Duffy. "The work-from-home and work-from-anywhere trend appears to be at least semi-permanent, which is eroding demand for office space and putting downward pressure on rents."

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