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Property Stocks – Rate Rise Fear Overstated

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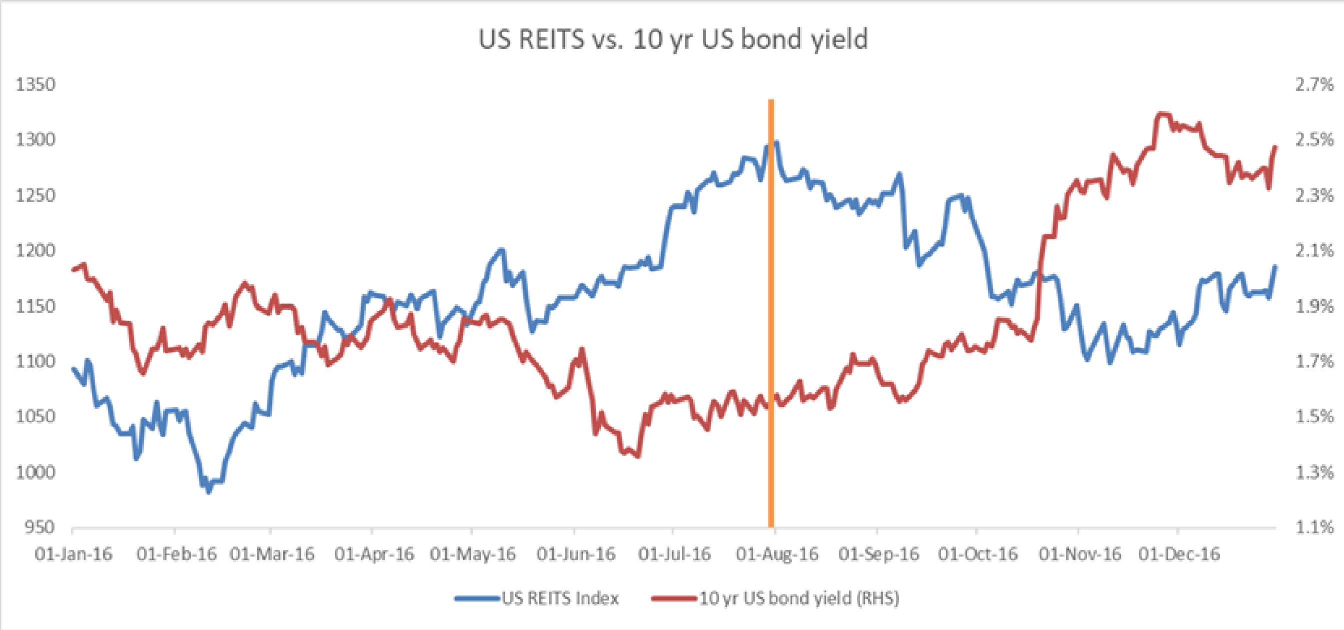
There is a common misconception that rising interest rates are bad for physical property prices and property stocks. Ceterus paribus this fear is valid because higher interest costs should translate to a higher cost of debt, leading to higher required property yields for investment, leading to lower capital values. Put more simply, if the interest burden is higher, then the rental yield from the property needs to be higher to cover that cost, implying a lower capital value assuming rents are constant. In the short term this is often true, as many of the other variables that go into the equation are either viewed as changing more slowly or not duly considered, and there is often a knee-jerk reaction in property stock share prices when interest rates change.

In the 2016 chart below for example, 10Y treasury yields fell 45bps from Jan 1 - Aug 1 2016 on the back of growth concerns globally, driven initially by fears around China, later by Brexit, and continuously by weak global trade, and US REIT stocks performed well over this period, up almost 20%, outperforming the S&P by 11%. Conversely, from Aug 1 - Dec 31, 10Y treasury yields rose 89bps, initially as global growth concerns ebbed and later driven by increased future growth hopes on the back of the new US president, and US REIT stocks fell 8%, underperforming the S&P by 12%.



Many investors are currently concerned that the US has started raising the Fed Funds rate, and that during this tightening cycle property stocks should perform poorly. However, historically this has not been the case (see table below). Over the last 18 years, we've experienced two tightening cycles, and are currently in the third. During the previous two tightening cycles in 1998-2000 and 2004-2007, US REITs rose 27% and 67% respectively, and during the current tightening cycle which started in Dec 2015, US REIT stocks have risen 11%. Clearly a rising Fed Fund rate does not lead to weak share prices.

Period	**Mar 1999 - Dec 2000**	**Dec 2000 - Mar 2004**	**Mar 2004 - Jun 2007**	**Jun 2007 - Dec 2015**	**Dec 2015 - Jun 2017**
Δ in Fed Funds Target Rate (Bps)	175	-550	425	-488	75
Δ in US REITS Index	27%	79%	67%	60%	11%

Historically property stocks have performed well during Fed Funds tightening cycles.

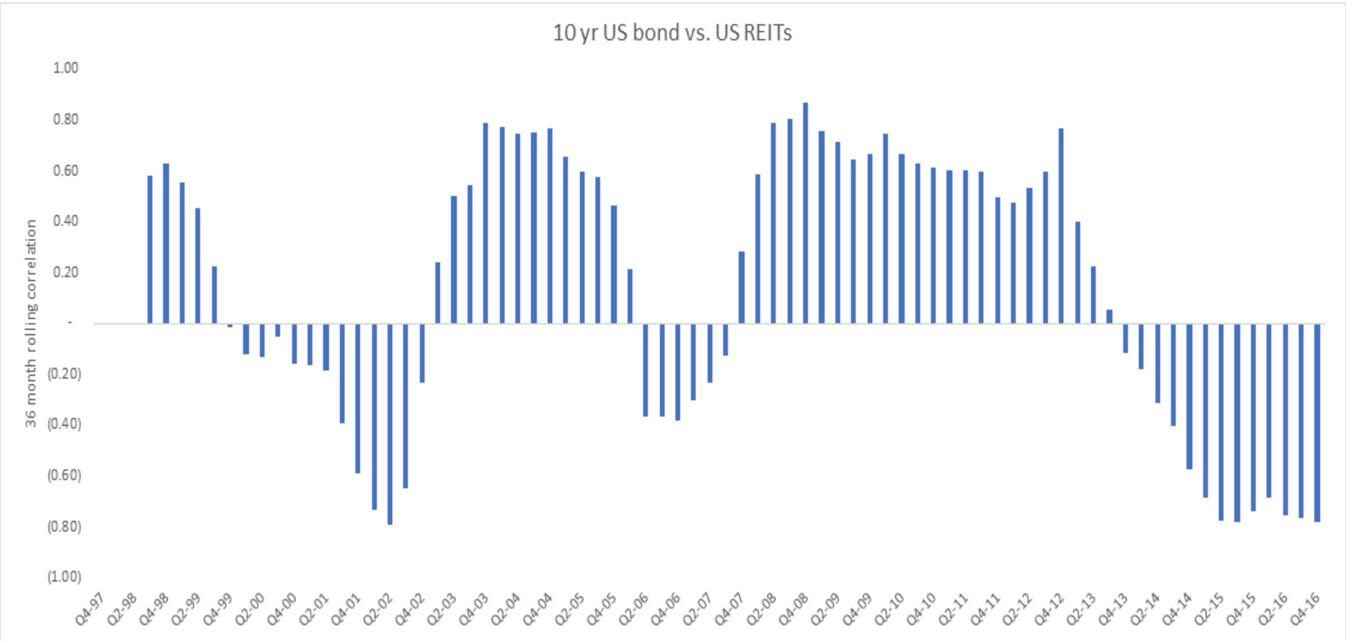
There is no consistent correlation between US REITs and US interest rates over the medium term.

More broadly, if you look at the correlation between US treasury yields and US REIT stocks, the correlation moves around substantially if you change the length of time it is measured over (first table) and the actual time period (second table). While there is a negative correlation over the most recent periods, there is a positive correlation over longer periods. The correlation also varies depending on the date, so for instance there was no correlation to speak of during 1995-2000, a positive correlation from 2000-2010, and a negative correlation from 2010-2016.

	Years				
Correlation (quarterly)	**3**	**5**	**10**	**15**	**20**
US REITS vs. 10 yr	-0.67	-0.49	0.27	0.21	0.19
US REITS vs. 2 yr	-0.25	-0.19	0.25	0.19	0.17

Annual correlation	**1995-2000**	**2000-2005**	**2005-2010**	**2010-2016**
US REITs vs. 10 yr US bond yields	-0.01	0.46	0.62	-0.33
US REITs vs. 2 yr US bond yields	0.04	0.40	0.59	-0.28

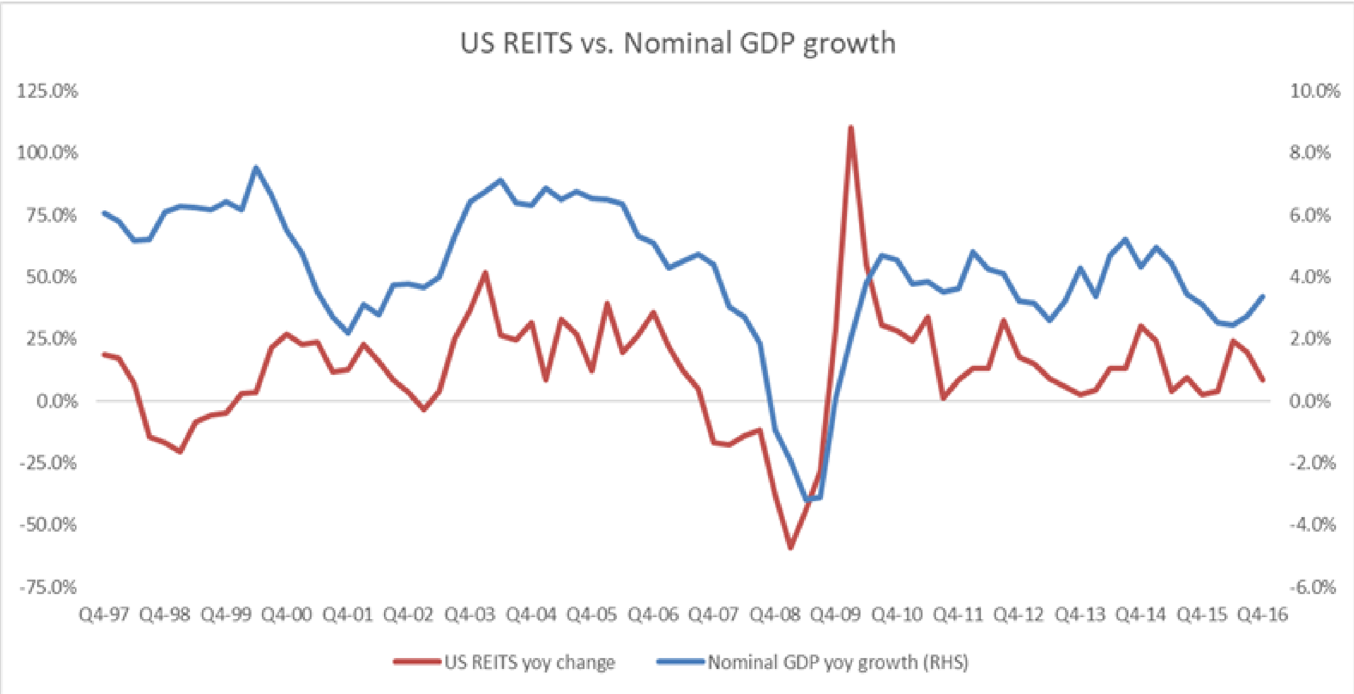
Correlation between US 10Y Treasury Yields and US REITs, 1997-2017

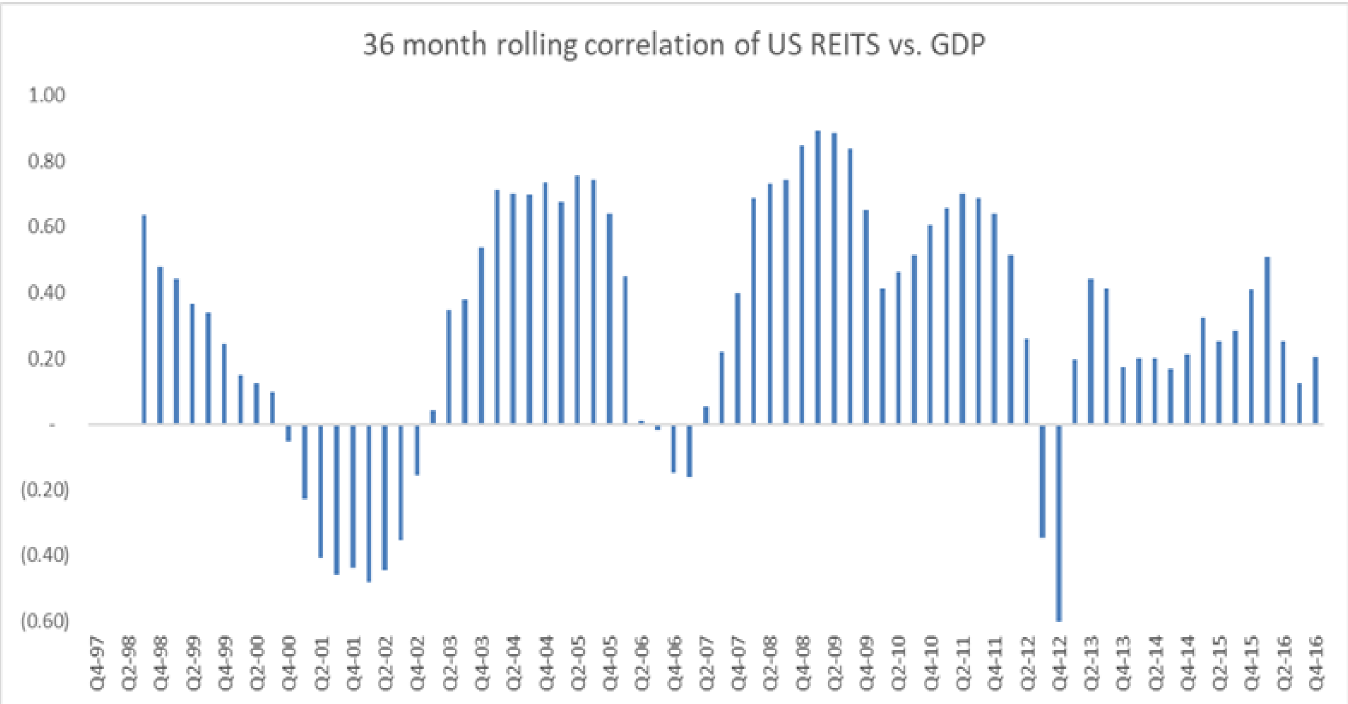


So while rising rates can often have a negative impact on property stocks in the short term, over longer periods the inverse relationship between property stock performance and interest rates breaks down. This is because everything is not ceterus paribus - all other things do not remain equal. Interest rates typically rise on the back of higher inflation, which is often the result of higher economic growth, and stronger economic growth is unequivocally positive for property stocks (see next pages). Property as an asset class is also an inflation hedge, so property stocks outperform many other sectors when inflation rises.

There is a strong positive correlation between US REITs and US GDP growth

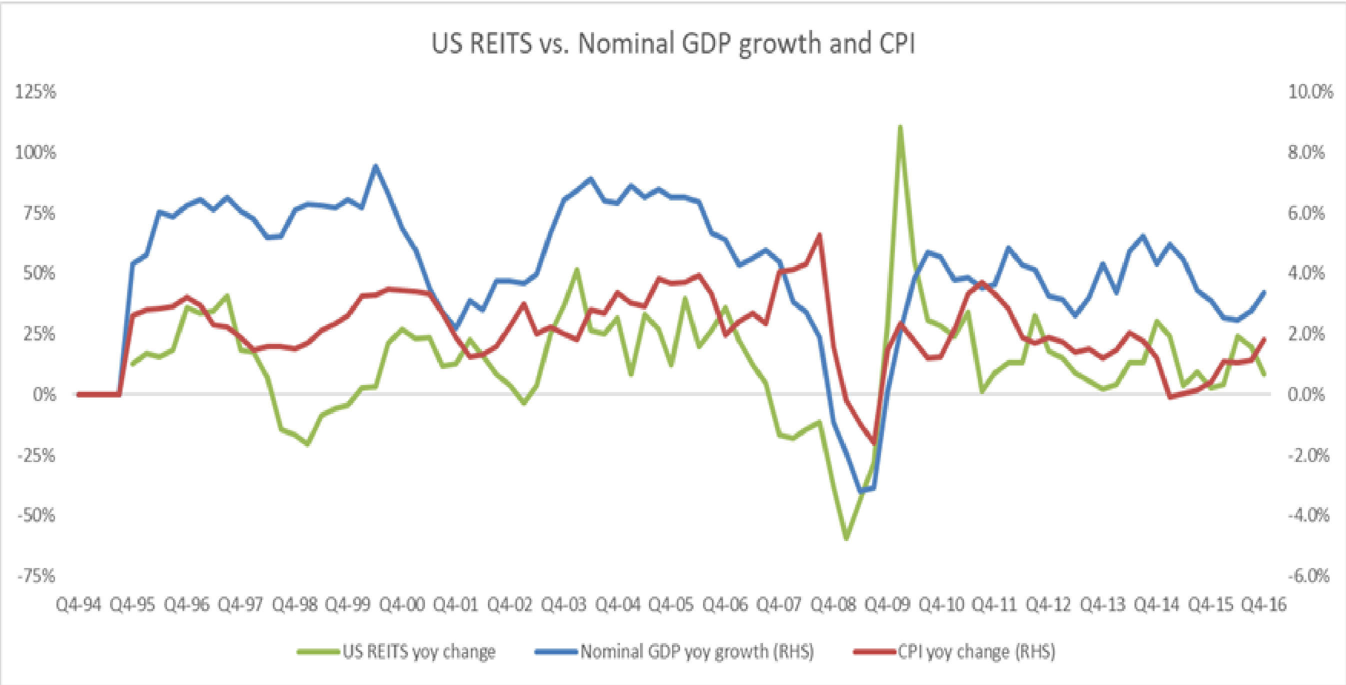
The real estate stock price correlation to nominal GDP growth is pretty consistent, with a few brief exceptions such as when investors piled into unloved property stocks once the Dot-com bubble burst in the early 2000s (see below). Therefore, time spent determining the economic outlook of the countries you invest in is far better spent than pondering interest rates. Higher interest rates as a result of stronger economic growth are not necessarily bad for stocks as we have illustrated above.



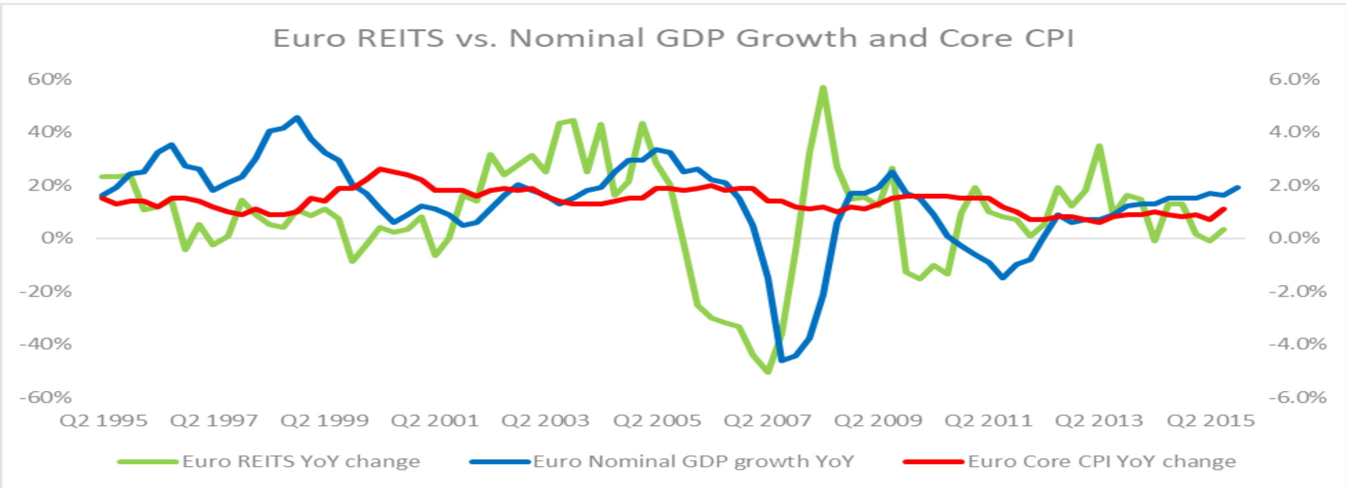


Strong GDP growth and low inflation is a winning combination

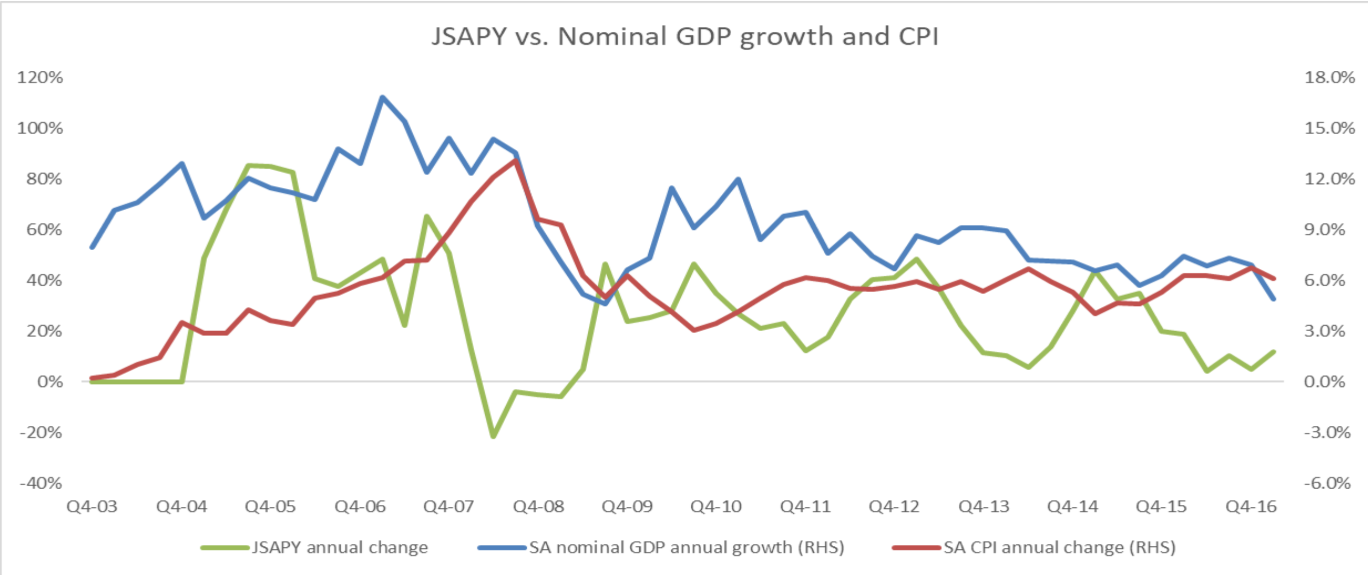
Low inflation reduces the likelihood of interest rate rises, which reduce the chance of short-term stock price corrections. The chart below illustrates this phenomenon clearly. For example, coming out of the GFC, US GDP growth shot up to 4.6% in Q4 2010, while CPI was only 1.2% and as a result the stocks rallied 28% YoY off attractive valuations. Similarly, in Q1 2015 the stocks rallied 24% when GDP growth was at 5% and CPI was marginally negative.



The European market screens well on these metrics currently.



South Africa property stocks do not look attractive on these metrics unfortunately



South African inflation is now higher than nominal GDP growth, which last happened during the Global Financial Crisis (GFC), a period where the stocks performed poorly. The bull market that this sector has experienced since 2009 could well be drawing to a close.

South African property stocks have had a great run over the last 10 years on the back of significant expansion and development in the physical property market; a growing REIT industry; and currency tailwinds from offshore expansion. However, the macro tailwinds over that period of generally decent economic growth and benign inflation have eroded more recently.

Nominal GDP growth has been declining since the third quarter of 2016, while inflation only recently came back to within the upper end of the 3% -6% target range in the second quarter of 2017. The net effect is that South Africa is technically in a recession, having posted two consecutive quarters of negative real GDP growth.

This negative real growth environment, together with an oversupplied property market, do not bode well for South African property stocks. As such, we would encourage investors to look for more promising property markets internationally.

Proviso: While these macro drivers give us a good indication of demand, they do not take into account the supply or the myriad of other factors that determine movements in the physical markets, and nor do they take account of valuations or sentiment in the stock market which influence stock performance materially. The aim of this report to warn investors against becoming bearish purely on the basis of rising rates, and instead focus on the relationship between interest rates and economic growth. If rates are rising due to strong economic growth, then property stocks should perform well.

Glacier Research would like to thank Rob Hart and Ryan Cloete for their contribution to this week's Funds on Friday.

Rob Hart, B Bus Sci (Fin)

After graduating from UCT in 1995, Rob moved to Hong Kong where he joined Morgan Stanley's equity research department. He ended up staying there for 12 years, leaving as a Managing Director while heading up the Hong Kong strategy and regional property, conglomerate and gaming teams. In 2008 he moved to Singapore to become a portfolio manager at Sansar Capital, a USD3bn hedge fund, to run a property-focused long-short strategy. Following strong performance, he moved to Ivaldi Capital in 2013, continuing to run a similar strategy as a stand-alone fund at this platform company. After 20 years abroad, Rob decided to come back to Cape Town in 2016, and joined Fairtree to help create the Fairtree Global Real Estate Prescient Fund.

Ryan Cloete – CA(SA), BComm (Law & Accounting), BComm Honours (Accounting)

After completing his accounting honours and law degree, Ryan worked in the Banking & Capital Markets division of PwC Johannesburg, obtaining extensive exposure to the banking sector. He then worked in the Asset Management division of PwC Los Angeles, before joining Fairtree in 2014. Ryan initially joined Fairtree as the financials and real estate analyst, and over time, increasingly shifted his focus to real estate. In this capacity, he serviced both long-only and long-short mandates covering listed real estate securities in South Africa, UK, Europe and the US. He then helped create the Fairtree Global Real Estate Prescient Fund, of which he is co-portfolio manager. In addition to this, he assists in managing a Global Real Estate Long-Short portfolio, and South African Real Estate Long-Only portfolios as part of our multi-asset funds.