

# THE BULLISH CASE FOR REITs

“The land is the only thing in the world worth working for, worth fighting for, worth dying for, because it’s the only thing that lasts”~ Gerald O’Hara, Gone With The Wind

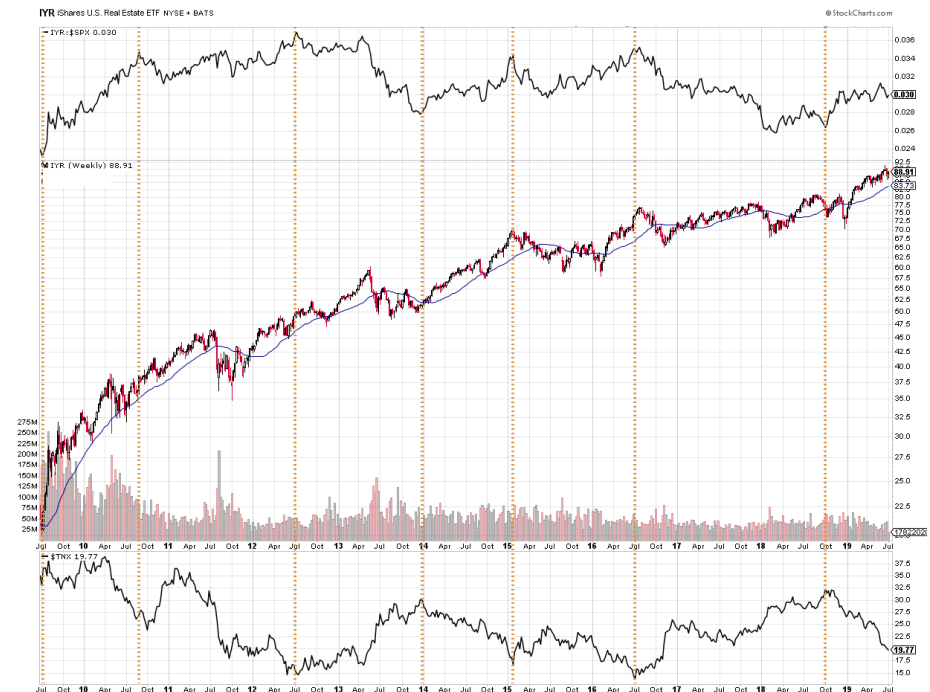
In December 2018, we began to turn more bullish on the REIT sector, particularly in the apartment space. Our view is that there are several factors combining to provide a bullish tailwind to the REIT sector including: declining interest rates, demographics and declining supply growth. We also believe the technical picture is bullish for REITs. We will explore each of these factors as evidence for our bullish thesis.

## REITs As Bond Proxies

REITs are stocks that invest solely in Real Estate in various forms. In the 1970’s the United States government allowed REITs to reduce their tax bills as long as they paid out at least 90% of their cash flow in the form of dividends. For the REITs this resulted in lower tax rates and higher dividend yields. Because of these higher dividend yields, REITs are often thought of as bond proxies in the equity markets. For this reason, REITs typically outperform the broader market when interest rates are falling. Although REITs can still move higher when rates are rising, they typically perform best on an absolute and relative basis when interest rates are falling. To help clarify this relationship, we have included a chart in Figure 1 which shows the relative and absolute performance of IYR compared to the performance of yields on the Ten Year U.S. Treasury Note.

In Figure 1, there are three prices shown. The first is the ratio of the iShares US Real Estate ETF (IYR) relative to the S&P 500 (SPX). The second box shows the absolute price of the IYR alone. The third box shows the yield on the Ten-Year Treasury Note. The orange vertical lines depict the approximate point of trend change for the IYR ratio and the Ten-Year Treasury Note yield. While the absolute price of IYR has generally climbed since 2009, the IYR/SPX ratio has seen several periods of sideways to down movement as yields have climbed. Alternatively, the ratio has seen periods of outperformance as yields have declined.

Figure 1. REIT Index Relative to S&P 500 and 10 Year Yields

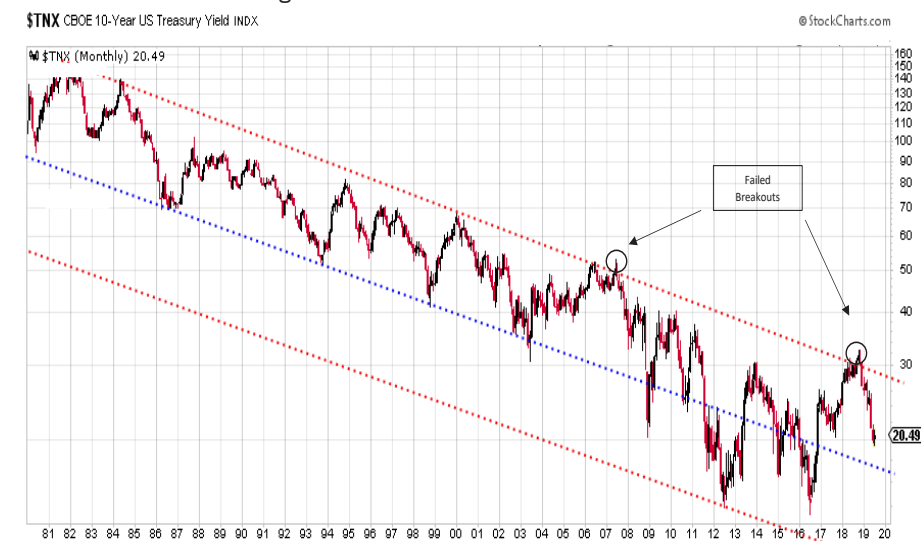


Source: StockCharts.com

Falling Interest Rates

In Figure 2 below, the yield of the 10 Year US Treasury Note is shown on a monthly scale back to 1980. As shown by the channel lines on the chart, the trend for yields has been down over the last 40 years with yields typically moving between the top red and center blue lines. In late 2018, rates seemed to have broken out of the down channel, and most technical analysts began to point at this breakout as a secular change in trend for rates. However, the false breakout turned out to be similar to the 2007 case just before the Great Financial Crisis which ultimately saw interest rates make new lows. While we are not trying to make the case for new all-time low rates here, with the Fed potentially starting a new rate cutting cycle in the back half of 2019 we do believe yields have further downside. This would continue to be bullish for REITs.

Figure 2: Multi-decade 10 Year Yield Channel



Source: StockCharts.com

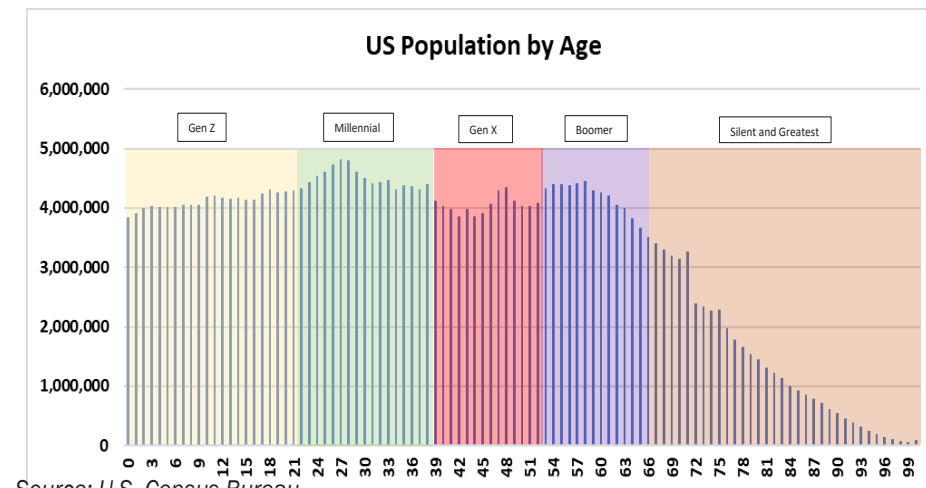
Our Most Favored REIT Group

The REIT group that we currently favor most is the apartment REITs. The major driving forces behind our bullishness in the apartment space are favorable demographics and slowing supply growth. The Millennial generation has pushed out family formation until after age 30 according to several recent studies.<sup>1</sup> Based on this age shift and demographic trends (see Figure 3), the real surge in Millennial family formation shouldn't start for another year or two. While we expect the coming surge in household formation to eventually support the housing market as Millennials start to buy their own homes, we

think that trend is just in the beginning stages.

On the back end of the demographics chart is the Boomer generation, of which a significant portion will be downsizing as they sell their homes and move into rentals. According to the TransAmerica Center for Retirement Studies, Boomers have saved on average \$152,000 for retirement.<sup>2</sup> This will not be enough to sustain them, and many will need to tap the equity in their homes for retirement funds. While this trend will be much more drawn out than the surge in Millennials over the next two years, it does provide some support as the leading edge of Boomers retire and downsize.

Figure 3: US Population By Age

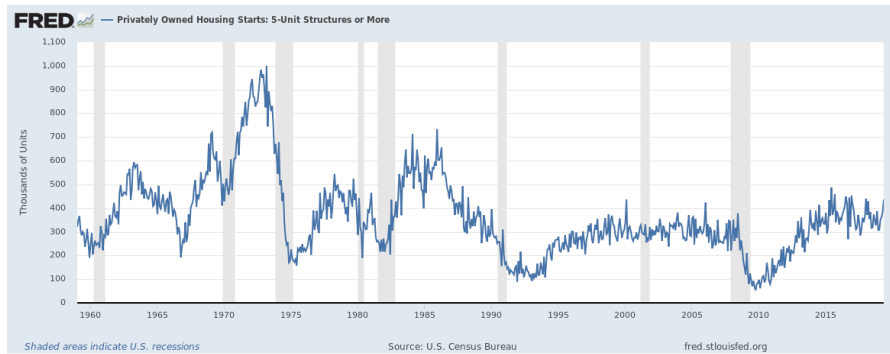


Source: U.S. Census Bureau

Slowing supply growth in multifamily housing also supports our thesis for apartment REITs over the next couple of years. Data from the Federal Reserve shows that growth in multifamily construction rose from 2010 to 2015, but has stalled and slightly declined since 2015. Builders have started to shift their attention more to single family homes instead of the multifamily apartment units. Combined with the demographic support discussed above, we see this as a supporting factor for apartment rental rates.

According to data collected from FactSet, valuations are a little stretched above their 5-year average with the forward Price/Funds From Operations (P/FFO NTM) coming in around 21.7X against a five year average of 20.4X. Price/Book (P/BK) is currently 3.3X vs. the 5 year average of 2.75X. These valuations, while a little higher than the 5-year average, are well below the 5 year highs. Yields continue to be attractive at 2.8% vs. the current yield of the S&P 500 of 2.0%.

Figure 4: Multifamily Housing Starts

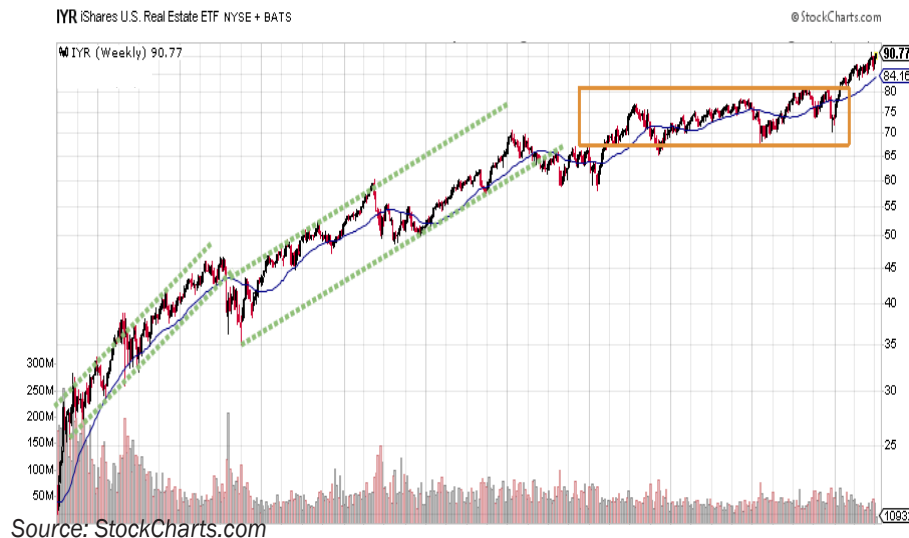


Source: U.S. Census Bureau, Federal Reserve

Technical Analysis

A basic look at the technical analysis of the iShares REIT ETF in Figure 5 shows a couple of interesting things that support our positive outlook for the sector. After rising in upward sloping channels from 2009 to the end of 2014, IYR entered a multiyear consolidation box in 2016 and stayed there until the recent breakout in early 2019. Not coincidentally, this also coincided with the approximate timeframe that interest rates were rising as shown in Figure 1. In early 2019, IYR broke out of the consolidation zone, retested the zone and moved higher. This is what we would want to see in a bullish breakout. Adding credence to the breakout is fact that the 30-week moving average moved from mostly flat for 3 years to upward sloping, supporting the new uptrend.

Figure 5: REIT Index Technical Analysis



Source: StockCharts.com

Conclusion

Late in 2018 we began turning bullish on REITs due to the decline in rates that we saw on the horizon and the way that REITs often perform as bond proxies. We still believe that there is further runway for REITs to outperform as the Federal Reserve is indicating that they are about to embark on a new rate cutting cycle. We also see the technical set up as favorable for REITs as they recently broke out to the upside from a multi-year consolidation zone. Due to demographic trends and supply demand factors we view the apartment REITs as our best way to gain from the favorable set up in the REIT sector for at least the next year or two.

Sources Cited:

- 1a) Jeanette I. Rice, CBRE, Demographic Impact On U.S. Multifamily Market, May 20, 2019.
- 1b) Kristen Bialin and Richard Fry, Pew Research Center, Millennial Life: How young adulthood today compares with prior generations, February 14, 2019.
- 2) Alix Langone, Money Magazine, This Chart Shows How Much Millennials, Gen X and Baby Boomers Have Saved For Retirement. See How You Compare, April 3, 2019.

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