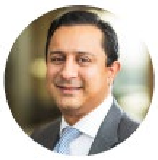
Interest rates are rising, should real estate be concerned?



Indraneel Karlekar, Ph.D., Senior Managing Director, Global Head, Research & Strategy

Arthur Jones, Senior Director, Research & Strategy

Background

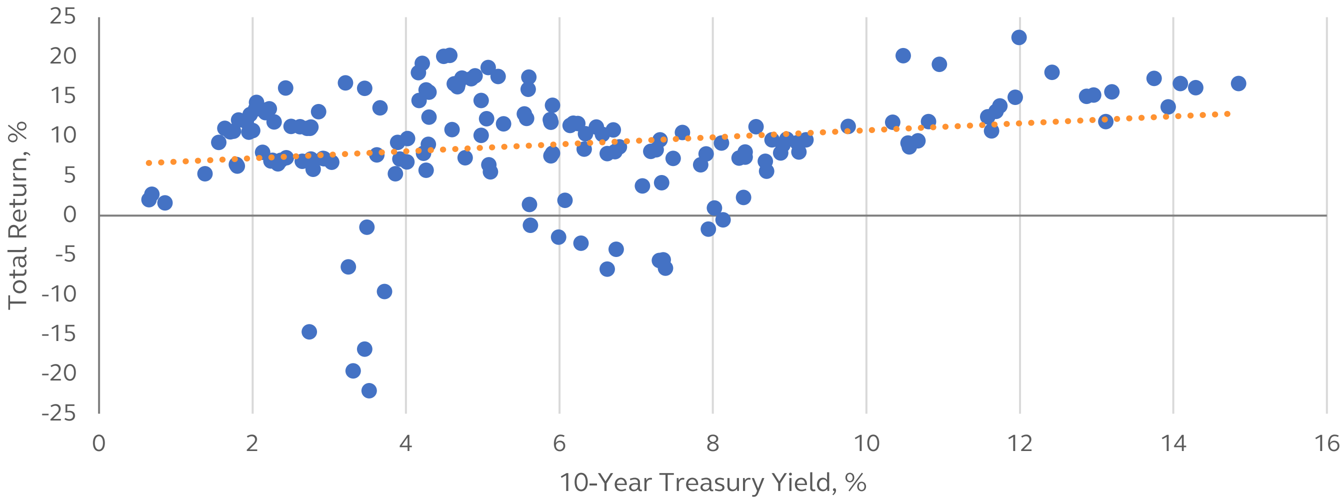
Capital markets are increasingly penciling in a higher interest rate scenario as reflected in a sharp steepening in the Treasury yield curve over the past 30 days. The yield on the 10-year bond has increased by 40 bps over the past 30 days. Despite dovish messaging from the Fed, capital markets anticipate a continued increase in benchmark 10-year yield, which has resulted in elevated volatility in public risk assets as well as growing questions on appropriate risk premia from illiquid investments. Within real estate, publicly traded REITs have reacted positively to the steepening in the yield curve as they anticipate improved earnings. While private real estate markets have not yet provided any meaningful price signals to potentially higher interest rates, some questions that are being asked are:

- Will higher interest rates equate to lower investment performance going forward?
- Which property types are likely to experience the most pain points from higher interest rates?
- Will spreads between real estate cap rates and bond yields widen in response to higher interest rates?

Empirical evidence from 40 years of history

Observations over a 40-year period indicate a broadly positive relationship between property returns and interest rates. Our findings, using NCREIF NPI performance data since 1980, indicate that interest rate increases that occurred during periods of strong economic growth have resulted in higher total returns. Conversely, investment performance has declined when interest rates are lower or fall—particularly during periods of weaker economic growth. Put another way, interest rates do not cause lower returns per se and can, in certain circumstances, signal conditions that might be conducive to higher property returns under favorable economic conditions (i.e., periods of sustained GDP growth and full employment).

Exhibit 1: Total return and 10-year treasury yields
All property types: Q1 1980 to Q4 2020

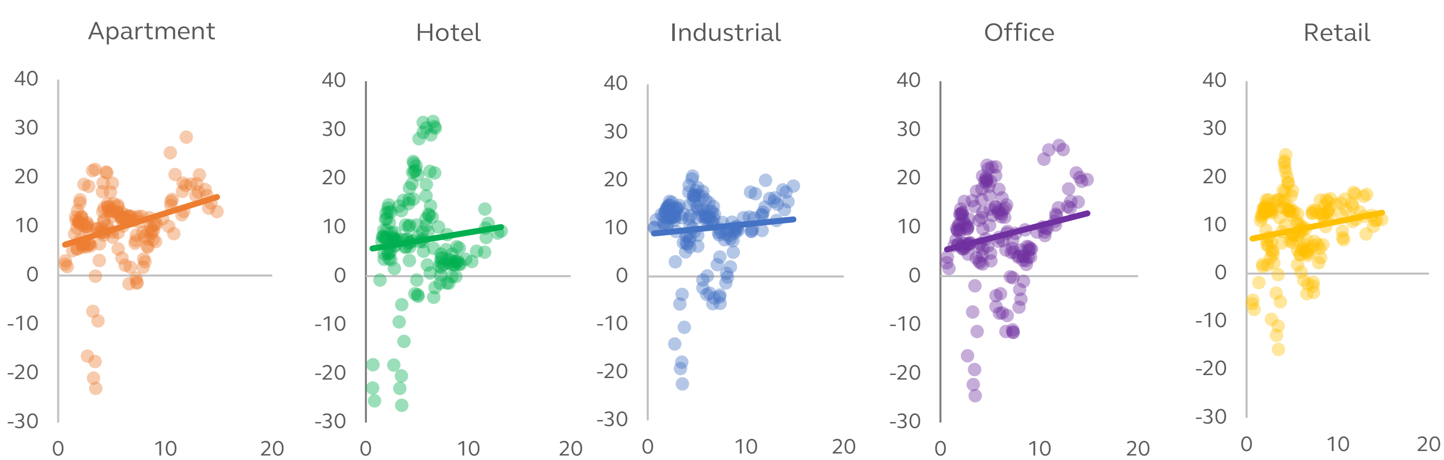


Source: NCREIF NPI, Federal Reserve, Moody's Analytics, Principal Real Estate Investors, Q4 2020

Property type divergences evident

The relationship between returns and interest rates varies by property type, but all sectors exhibit a positive correlation. Apartment has the highest correlation of any property type (0.35), followed by office (0.23). Hotel has the lowest with a correlation (0.09), while industrial has the second lowest correlation (0.11). The relative weaker correlation within these two property types is less a reflection on how well they hold up in periods of higher interest rates, than it is of the dispersion of performance during periods of economic weakness. Put another way, these two property types are the most highly sensitive to swings in economic growth.

Exhibit 2: Total return and 10-year treasury yields, %
By property type: Q1 1980 to Q4 2020



Source: NCREIF NPI, Federal Reserve, Moody's Analytics, Principal Real Estate Investors, Q4 2020

Overall, out of the 164 quarters between 1980 and the end of 2020, the NPI All Property index outperformed the risk-free rate as represented by the 10-year treasury rate 76% of the time. As mentioned previously, apartment had the highest correlation between returns and interest rates, but it has also exhibited the most durability, outperforming treasury yields 81% of the time. Industrial was second, outperforming 81% of the time followed by retail at 68%, office at 67% and hotel at 60%.

Exhibit 3: Distribution of annual returns by relative performance to the 10-year treasury, %*
All property types: Q1 1980 – Q4 2020

Source: NCREIF NPI, Federal Reserve, Moody's Analytics, Principal Real Estate Investors, Q4 2020
*Annual NPI total returns by quarter based on a 12-month trailing average, orange bars represent periods where interest rates exceed total returns, blue bars represent periods where total return exceed interest rates.

Outperformance and underperformance should be put in some perspective. There are three main periods where property returns were lower than the yield on the 10-year treasury.

- First, between Q2 1982 and Q3 1983, which represented the recessions of the early 1980s when Paul Volker—then Fed Chairman—rapidly increased policy rates to suppress the rapid inflation of the late 1970s and early 1980s.
- Second was between Q2 1987 and Q1 1995, following the real estate construction boom and S&L crisis and recession where returns declined and remained subdued for the better part of a decade.
- And, finally between Q4 2008 and Q2 2010 during and following the GFC.

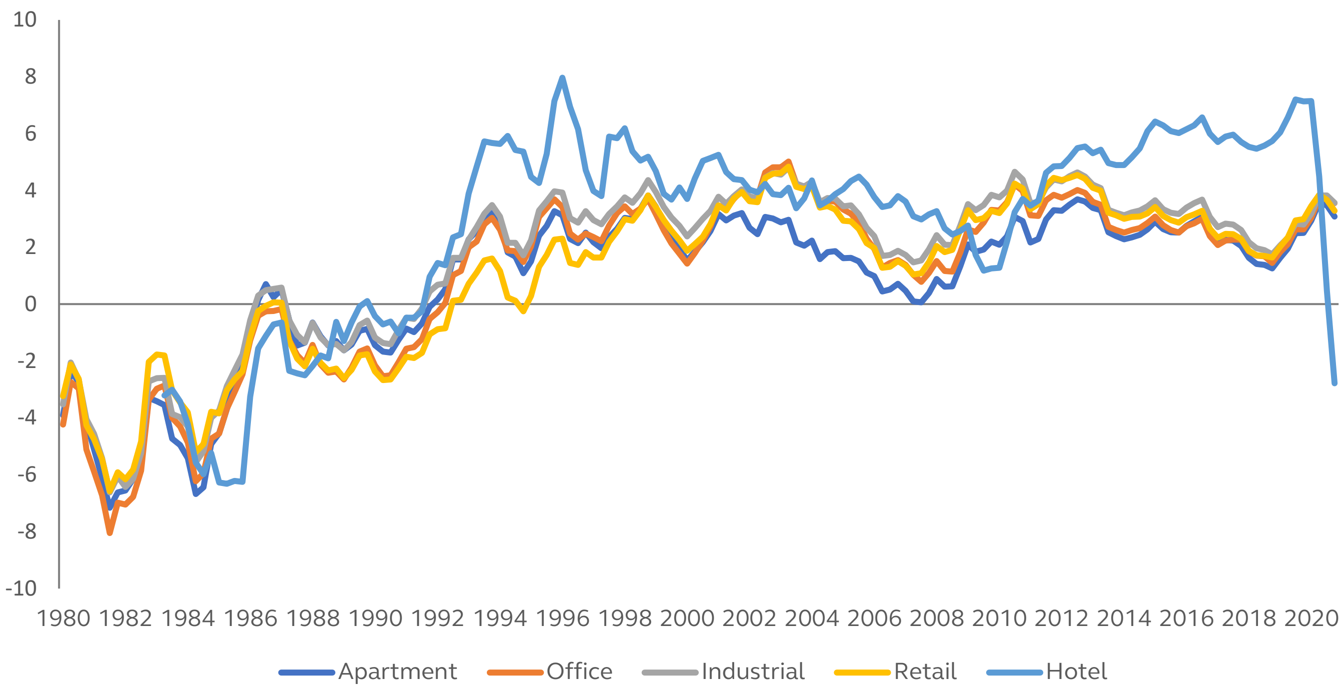
In all instances, these were periods of subpar economic or space market fundamental performance, which had little to do with the levels or movements of interest rates per se.

Will spreads widen if bond yields continue to move higher?

An examination of this question needs to be at a property level given the dispersion in performance shown earlier as well as expectations of NOI growth going forward. At a base level, we expect that a sustained increase in interest rates is likely to see investors require a higher risk-premia from property types where NOI growth is expected to stay pressured (i.e., rent growth outlook is challenged). In such property types, we expect cap rates may move out in response to higher interest rates as compensation for increased investor risk.

At this point, we believe CBD office, hotels, large format retail and luxury, urban multifamily are most vulnerable to a sustained increase in interest rates given our outlook for softer (or even negative) rent growth. Conversely, we believe industrial, suburban office, multifamily, and niche property types with strong structural growth drivers such as data centers, cold storage, single family rentals, and manufactured housing are better positioned to absorb a sustained increase in interest rates given our outlook for strong rent growth.

Exhibit 4: Long-term spreads by property type, ppt*



Source: NCREIF NPI, Federal Reserve, Moody's Analytics, Principal Real Estate Investors, Q4 2020

*Hotel performance data from 1983; all other property types from 1980

Risk Considerations
Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk**.**

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