February 2019

REIT Industry Update

Commercial Real Estate Hits a Pause

After years of outperformance, REITs took a breather in 2018. Amidst expectations of rising rates, REITs finished down -4.64 percent as the 10 year closed at 2.68 percent by year-end.[1] Thus far in 2019, REITs have snapped back, rallying up 12.49 percent with the 10 year hitting 2.70 percent.[2] Meanwhile, private market valuations are holding firm, with Green Street Advisors' Commercial Property Price Index suggesting that values are up a modest 2 percent over the past twelve months. Their data shows commercial property has fully recovered from the 2009 lows, now surpassing the 2007 peak levels by 32 percent.[3] Providing support for real estate valuations are capital markets that remain robust with multiple financing alternatives open. Growth in real estate demand has been sufficient to stabilize occupancy levels in the mid-90 percent range.[4] Steady gains in leasing amidst low supply are translating into solid pricing power for landlords and stable to rising market rents for most subsectors. Overall property-level operating income is expected to grow at roughly a 3 percent annual pace. As a result of the positive fundamentals, REIT earnings should pace in the low-single digit range for 2019.[4] Dividend growth should parallel earnings growth, as current dividend payout ratios remain below historical norms.

Recession on the Horizon?

Recession risk has been on the minds of many market pundits, as this cycle trudges into its late stages. The oft-watched yield curve has inverted at certain points of the curve already, while volatility in the capital markets and the government shutdown weigh on consumer confidence and the economy. Economists surveyed by the Wall Street Journal believe there is a 25 percent chance of recession in 2019,[6] while Guggenheim Partners Macroeconomic and Investment Research expects a recession in 2020.[7]

Irrespective of when a recession might actually hit, REITs are generally well-positioned. While a recession will certainly impact REITs, most REITs have recurring, steady cash flows from a diversified tenant base. Some leases can even grow through downturns given built-in escalators. Furthermore, REITs have worked to improve their balance sheets, providing cushion should they encounter difficult circumstances. In fact, compared to 2007, REITs have dramatically lowered debt to EBITDA from 8x to 5.5x.[8]

1, 5 Bloomberg, 12.31.2018; 2 Bloomberg, 2.5.2019; **3** Green Street Advisors, Inc., Commercial Property Price Index, February 6, 2019; **4** Citi Investment Research & Analysis, Weekly REIT and Lodging Strategy, February 1, 2019. **6** Wall Street Journal, "Economists See U.S. Recession Risk Rising" January 10, 2019; **7** Guggenheim Partners 10 Macro Themes for 2019; **8** Green Street Advisors, Inc., *Heard on the Beach,* January 24, 2019.

The Case for REITs

During the fourth quarter of 2018 equity REITs delivered a -6.73 percent total return compared to -13.52 percent for the S&P 500 Index.[5] Guggenheim Investments LLC feels public real estate offers several benefits for an individual investor's portfolio that are particularly relevant in today's environment:

- REITs may provide attractive current income with the potential for future dividend growth as underlying property cash flows grow over time.
- Real estate provides inflation hedging characteristics as underlying rents, property cash flows, and replacement costs have historically adjusted with inflation over the long run.
- REIT earnings should be relatively resilient during economic downturns as a large portion of rental revenues are derived from contractual lease obligations.

For information on investment products offering REIT market exposure, please contact your financial advisor or visit GuggenheimInvestments.com.

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Index Definitions (Each index is unmanaged and it is not possible to invest directly in any index.) **S&P 500 Index** is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. **Green Street Commercial Property Price Index** ("CPPI") is a time series of unleveraged U.S. commercial property values. CPPI captures the prices at which commercial real estate transactions are currently being negotiated and contracted.

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