Got Yield? Real Estate Does

In a 180-degree shift, the Federal Reserve went from raising rates in December, with the possibility of more in 2019, to extolling the virtues of patience. Long-term rates fell leaving yield-hungry investors scrambling. Conversely, private commercial real estate continued to offer attractive income along with the potential for income growth. Real estate is now well-positioned to provide income-oriented investors a means to offset the decline in yields confronting them from traditional fixed income sources.

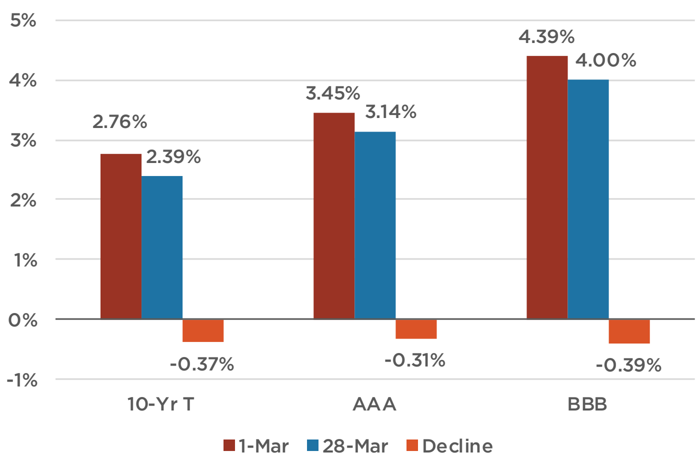
Fed Whiplash

The Fed continued its whiplash inducing reversal of monetary policy at its March FOMC meeting, switching from a gradual rate hike policy in December to a wait and see approach. The Fed has indicated no rate hikes this year, subject to changes in future economic data. With the Fed not sure which way the economy is going to go, it is going to wait and see. The policy reversal reveals two things: first, the Fed apparently was caught off-guard by the magnitude of slowing in global and domestic economic growth, and, second, the fragility of equity markets also seemed to be a surprise. The Fed's response to December's equity market volatility signals that it now considers itself to have a third and unofficial mandate – don't destabilize the financial markets.

Yield Diet

Because of the Fed's action (or inaction), as well as fixed income markets giving more weight to the reality of slowing economic growth, yields have been trimmed significantly. In less than 30 days, 10-year Treasury rates declined by more than 13% from 2.76% the beginning of March to 2.39% on March 28th. Not to be outdone, corporate bond yields also declined materially in short order. AAA yields declined by more than 9.0% from 3.45% the beginning of March to 3.14% on March 28th. BBB's yields also declined substantially over a short period of time declining 8.9% to 4.0% from the beginning of March to March 28th.

US Bond Yields



Source: Moody's Treasury

To put the impact of these declines in perspective, for every $1 billion in capital, the decline in BBB's yields cost investors $3.6 million in annual income – in less than 30-days. For investors dependent on fixed income to meet their liabilities, this is painful especially when considering that by definition fixed income offers no opportunity for income growth.

How Low Can They Go

Yield driven investors should be asking, "How low can they go?" and "How low can we tolerate in our portfolio?" To understand how low yields can go we need to briefly look at what is currently driving rates lower – slowing economic growth. U.S. economic growth continued to quickly come down from its economic sugar high as we anticipated. GDP growth was cut in half in two quarters declining from an impressive but fleeting 4.2% in the second quarter to 2.2% in the fourth quarter. Employment growth, while still healthy, also has declined materially.

ARA Research in Brief

Germany's economy continues to slow. Its purchasing manager's index is not only below the crucial 50 level which indicates expansion, it fell dramatically and unexpectedly in March.

While it is difficult to know the true GDP growth rates for China, growth is likely slowing more than the official numbers show given the dramatic stimulus measures the Chinese government is implementing.

Japan's economy contracted in the third quarter and only modestly expanded in the fourth quarter continuing its struggle to avert recessionary readings.

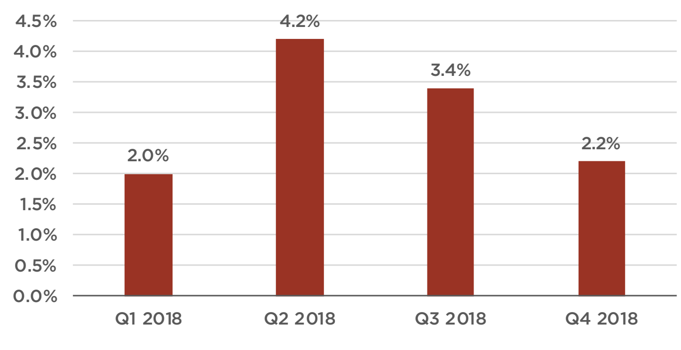
Not surprisingly, yields on foreign sovereign debt declined. Yields on 10-year German and Japanese sovereign debt slipped back into negative territory.

Fulfilling Its Role

While fixed income yields tumbled, real estate yields remained relatively stable. As a result, the spread between the yield offered by real estate and the yield on 10-year Treasuries increased to nearly 200 basis points. The value of the 200 bps premium increases further when one remembers that this is 200 bps over a 2.4% reference rate for an 80% premium. Although rates appear to have stabilized and have inched back up slightly, longer-term potential for meaningful increases remains uncertain as long as the global economic situation is uncertain. However, unlike bonds, real estate income continued to increase as rent growth and increasing occupancy supported income growth.

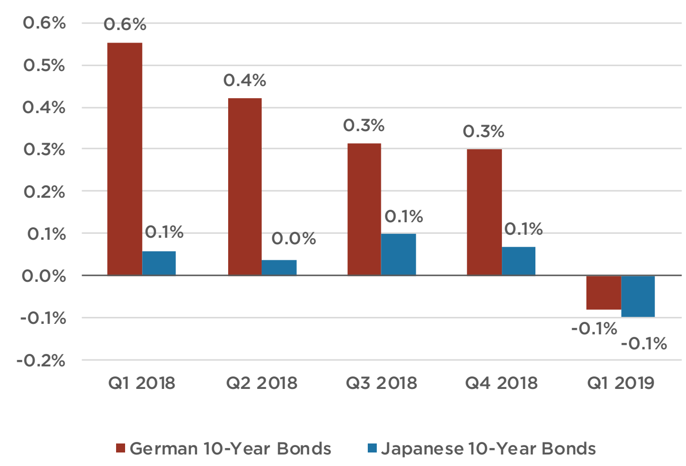
Investors searching for alternative more stable sources of income can turn to real estate as it continues to fulfill its roles of providing favorable yield premiums and income growth. Private real estate can provide an income ballast in the storm of declining yields, yield curve inversions, and weakening growth.

2018 GDP Growth



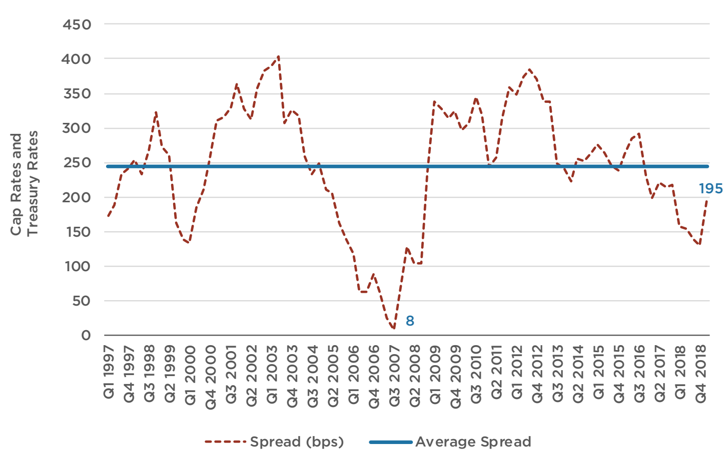
Source: BEA

Global Bond Yields



Source: OECD

CRE vs. Bond Yields



Source: NCREIF, Treasury

Disclaimer

Forward-Looking Statements

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