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Domestic Focus Gives REITs an Edge Amid Trade Wars

Thomas Bohjalian, Head of U.S. Real Estate and Senior Portfolio Manager

REITs May Offer a Safe Haven From Trade Concerns

With stocks wrapping up their worst month of 2019 in May, real estate investment trusts (REITs) have proven resilient amid escalating trade tensions between the U.S. and China, even delivering a slight gain in the U.S. (Exhibit 1).

We first discussed the implications of a trade war a year ago, saying about REITs that "minimal direct impact on fundamentals, combined with a calmer interest-rate environment, should support better relative performance versus many other equity strategies."(1) Since then, REITs have widely outperformed broad equities after trailing in recent years.

While a protracted trade fight between the world's largest two economies would likely be negative for most risk assets, including real estate, we believe REITs have several factors in their favor that could help them defend better than other areas of the market:

1. **Domestic businesses.** Most real estate companies earn the majority of their revenues from properties within their home market, limiting the direct impact from tariffs. Among the 11 sectors in the S&P 500, real estate is tied with health care for the second-lowest international exposure (Exhibit 2).

2. **Predictable revenues and high dividend yields.** REITs tend to generate relatively steady, growing cash flows from owning and operating high-quality real estate, and they typically pay out nearly all their net income via tax-advantaged dividends, which may be attractive to investors in a time of increased economic uncertainty.

3. **Solid U.S. real estate fundamentals.** A strong job market and rising wages are supporting demand for many types of real estate. While there have been pockets of oversupply in certain markets, we believe new construction has remained generally in balance with demand and most REITs have been disciplined with their use of leverage.

4. **Increasing influence of secular investment themes.** The emergence of new property types over the past decade, such as cell towers, data centers and alternative housing, has shifted the U.S. REIT market to be structurally less cyclical and more tied to long-term growth trends such as the rise of e-commerce and demographic changes. Non-traditional property sectors—those not including office, retail, apartments and industrial—now make up more than half of the U.S. REIT market capitalization.(2)

Exhibit 1: REIT Resilience

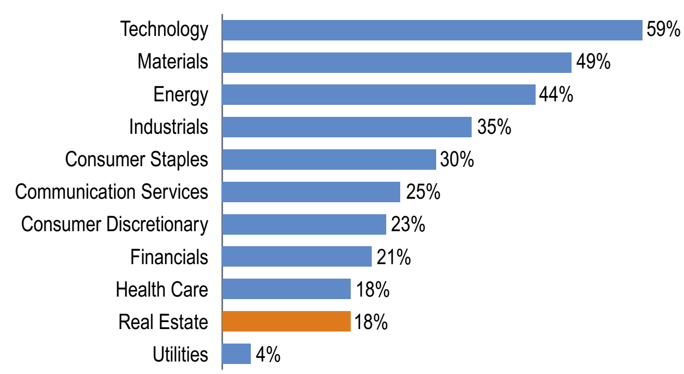
Total Returns (%); Periods of One Year or More Are Annualized

	U.S. REITs	U.S. Stocks	Global REITs	Global Stocks
MTD	0.2	-6.4	-0.2	-5.7
YTD	16.9	10.7	13.2	10.1
1Y	15.3	3.8	8.5	0.3
3Y	7.9	11.7	6.2	9.6
5Y	8.7	9.7	5.7	6.2
10Y	15.2	13.9	11.3	10.6
15Y	8.9	8.4	8.1	7.3
20Y	10.1	5.8	8.9	5.2

At May 31, 2019. Source: Cohen & Steers.

Exhibit 2: REITs Have Little International Exposure

% of Revenues From Non-U.S. Sources, S&P 500 Sectors



At February 29, 2019. Source: Bank of America.

Data represents past performance, which is no guarantee of future results.
See page 3 for index associations, definitions and additional disclosures.

(1) *Real Asset Winners and Losers in a Trade War*, July 2018: cohenandsteers.com/insights. (2) At May 31, 2019, as represented by the FTSE Nareit All Equity REITs Index.

5. **Less pressure from interest rates.** Peaking economic growth and increased global uncertainty mean that bond yields are unlikely to move significantly higher, in our view. Meanwhile, the Federal Reserve has struck a more dovish tone in recent months and other central banks are keeping interest rates low, which could serve as a potential tailwind for REITs globally.

6. **Record dry powder in private real estate funds.** Private real estate funds have been raising capital faster than they can put it to work, creating a bottleneck of capital. With private equity funds currently sitting on more than $300 billion in dry powder targeting real estate, we believe this could provide support to REIT valuations.[(1)]

…But Not All Real Estate Will React the Same

While we believe U.S. REITs in general are well positioned for a trade war, we expect some sectors to feel the impact more than others, underscoring the potential value of active management.

Greater impact:

- **Mall and shopping center owners**—which are already struggling due to rising retailer bankruptcies and lower sales productivity as more sales shift online—would likely be among the most affected by tariffs, as higher input costs could hurt retailer margins, potentially pushing retailers already teetering into bankruptcy. We expect lower-quality malls and power strip centers (those anchored by big-box retailers) to be more impacted than Class-A malls and grocery-anchored shopping centers.

- **Hotel companies** are generally more sensitive to slowing economic growth, as rents reset every day based on current supply and demand. Also, global luxury brands have higher international exposure than many other real estate companies.

- **Industrial REITs** have some direct exposure to trade, especially through properties in major port cities. However, U.S. industrial demand is largely domestically driven by the massive need for logistics capabilities. And trade concerns haven't dampened interest from private investors such as Blackstone, which recently doubled its U.S. industrial holdings with an $18.7 billion acquisition of assets from Singapore-based GLP.

Lesser impact:

- **Data centers** and **cell towers** have little exposure to tariff effects, as they are driven primarily by the need for technology infrastructure to support the growing digital economy. If an extended trade war increases recession risk, data centers could be susceptible to a slowdown in corporate spending, since development tends to be a significant driver of their earnings growth. Some cell tower companies have exposure to emerging markets, and the U.S. ban on Huawei will likely require additional spending from tower tenants to replace China-made networking equipment with approved suppliers. However, we do not expect this to impede the infrastructure investments being made to expand 4G cellular coverage and roll out 5G networks in the coming years.

- **Rental housing** should be largely unaffected, in our view, as new households are being created faster than new housing supply is coming to market. Manufactured housing REITs in particular may be insulated, supported by a growing retirement population and a near-total lack of new supply.

Key Takeaway

We believe investors looking to position their portfolios more defensively for a trade war and a maturing economic cycle should consider that real estate is largely a domestic play, with solid fundamentals, attractive yields and access to strong secular growth themes. While investors should be mindful of valuations after the strong run in share prices, we believe U.S. REITs remain fairly priced overall relative to broad equities, considering the strength of the U.S. real estate market and the appeal of assets with defensive characteristics.

(1) At March 31, 2019. Source: Preqin.

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Index Definitions

An investor cannot invest directly in an index and index performance does not reflect the deduction of any fees, expenses or taxes. U.S. REITs: FTSE Nareit All Equity REITs Index contains all tax-qualified REITs with more than 50% of total assets in qualifying real estate assets other than mortgages secured by real property that also meet minimum size and liquidity criteria. U.S. stocks: S&P 500 Index is an unmanaged index of 500 large-cap stocks that is frequently used as a general measure of stock market performance. Global REITs: FTSE EPRA Nareit Developed Real Estate Index is an unmanaged market-capitalization-weighted total-return index, which consists of publicly traded equity REITs and listed property companies from developed markets. Global stocks: MSCI World Index is a free-float-adjusted index that measures performance of large- and mid-capitalization companies representing developed market countries.

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Hong Kong: +852 3667 0080
Tokyo: +81 3 4530 4710
London: +44 207 460 6350