COHEN & STEERS

Rising rents matter more to REITs than rising rates

A strengthening economy may drive interest rates higher, but it can also give landlords greater ability to raise rents, which has historically supported attractive REIT returns.

Rising yields with growth a positive combination

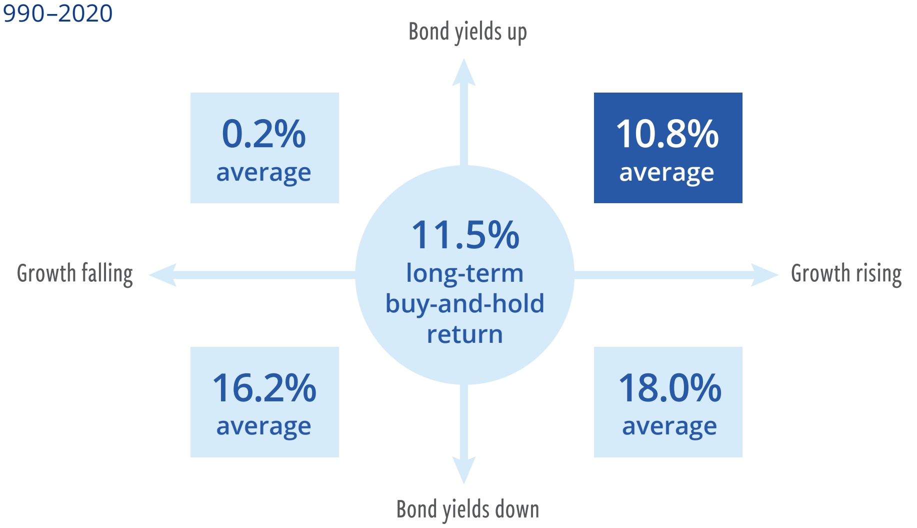
For some investors, there's a perception that you should avoid REITs when rates are rising. Although sharp increases in interest rates may unsettle markets in the near term, history shows that the direction of the economy and job growth tends to have a greater impact on REIT returns than rising rates.

Since 1990, REITs have averaged a 10.8% annualized return in months when both the 10-year Treasury yield and U.S. Leading Economic Indicators were rising (Exhibit 1, upper right quadrant). While long-term interest rates can affect capital costs, an expanding economy typically drives stronger demand, often leading to higher occupancy levels and giving landlords greater negotiating leverage to raise rents. This has the potential to drive higher property cash flows, higher distributions and higher property values.

EXHIBIT 1

REITs have historically performed well when growth and yields are both rising

1990–2020



KEY TAKEAWAYS

Since 1990, REITs have had a 10.8% annualized return in periods of rising rates and positive economic growth

REIT outperformance in the last major rate-hike cycle suggests rates are secondary to an improving economy

REITs offer value, income and diversification potential—characteristics currently in scarce supply and high demand

February 28, 2021. Source: Refinitive Datastream, Cohen & Steers.

Data quoted represents past performance, which is no guarantee of future results. The information presented above does not reflect the performance of any fund or account managed or serviced by Cohen & Steers, and there is no guarantee that investors will experience the type of performance reflected above. Bond yields based on the 10-year U.S. Treasury note. Growth measured by Cohen & Steers' U.S. Leading Economic Indicator (LEI), composed of six cyclical macro factors that have historically signaled turning points in broad economic growth. Annualized total return is the average annualized return earned in each distinct phase of economic growth and bond yields. The buy and hold return is the average annualized return earned over the full sample. See page 4 for index associations and definitions and additional disclosures.

A healthy job market characteristically benefits real estate

After spiking to nearly 15% in April 2020, the unemployment rate has steadily declined, and many of the jobs lost in the early stages of the pandemic have since returned (Exhibit 2). A return to full employment is estimated in 2022. The resulting rise in incomes may translate into greater discretionary spending by consumers. This, along with improved business confidence, may drive demand for all types of real estate. Meanwhile, supply growth has generally remained at low levels. A lack of oversupply coupled with improving tenant demand is typically positive for REIT cash flows.

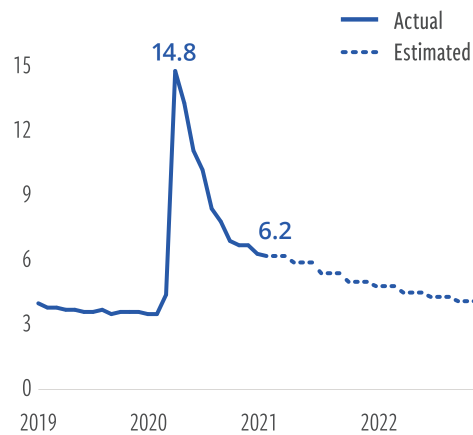
Lease durations can impact a sector's sensitivity to both interest rates and inflation

Real estate sectors tend to have varying sensitivity to economic growth based on lease durations. Property types with shorter lease durations—such as hotels, self storage, apartments, senior housing operating assets and billboards—may benefit more from economic expansion, as landlords can quickly adjust rents to capture rising demand. Other sectors with longer lease durations, such as net lease companies, often have explicit rent escalators tied to a published inflation rate. Consequently, REITs have historically responded favorably to inflation surprises, compared with the negative impact on stocks and bonds. Active REIT managers who understand these differences can position portfolios to potentially take advantage of changes in interest rates and inflation expectations.

EXHIBIT 2

The improving labor market may bolster cash flows for most property types

U.S. unemployment rate (%, seasonally adjusted)



At March 31, 2021. Source: Federal Reserve Bank of St. Louis and Bloomberg. **Data quoted represents past performance, which is no guarantee of future results.** Estimates based on consensus views of economists surveyed by Bloomberg. There is no guarantee that estimates will be realized. See page 4 for additional disclosures.

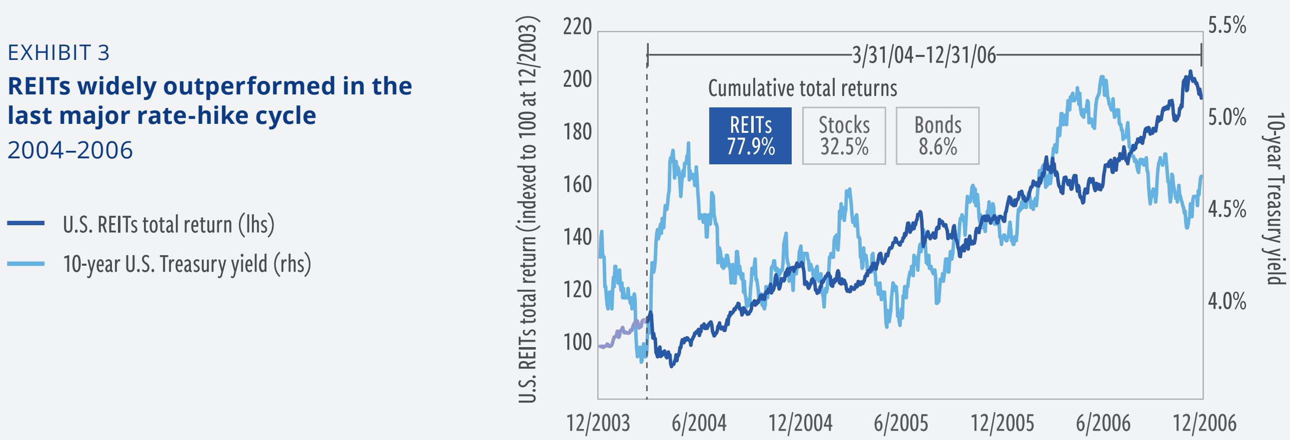
Case study: 2004–06 rate-hike cycle

Between 2004 and mid-2006, the Fed hiked interest rates 17 times (from 1.0% to 5.25%) amid an improving economy (Exhibit 3). Like then, we believe rising interest rates today are not the big story. Instead, progress with COVID vaccines and unprecedented fiscal and monetary stimulus are leading to improving economic conditions and setting the stage for potentially attractive returns for REITs.

EXHIBIT 3

REITs widely outperformed in the last major rate-hike cycle

2004–2006



February 28, 2021. Source: Bureau of Labor Statistics and Morningstar Direct.
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REITs well positioned for the current environment

As investors adjust asset allocations for the shifting market environment, we believe REITs today are especially appealing for several reasons:

Vaccine-driven recovery

Just as COVID upended the REIT market in 2020, we believe real estate could directly benefit from vaccine distribution and the massive fiscal stimulus introduced in the past year—even as rates rise. In particular, property types that were disproportionally affected by social distancing measures, including hotel, retail and office, stand to benefit directly from the economic reopening.

We believe REITs offer attractive value in what historically has been the most advantageous stage of the business cycle

Early-cycle winners

REITs have historically delivered their most substantial returns—both in absolute terms and relative to broader equities—in the early stages of economic recoveries. We believe the current early-cycle phase has the potential to extend over the next couple of years, given 1) the amount of fiscal stimulus and 2) the likelihood of the Fed maintaining very low short-term interest rates into 2023 as it seeks to achieve "broad and inclusive maximum employment."

Attractive valuations

U.S. REITs' earnings multiple of 20.8 is at a –2.7x discount to the broad equity market's price-to-earnings ratio of 23.5. That compares favorably with REITs' –0.2x average discount since 2002.(1)

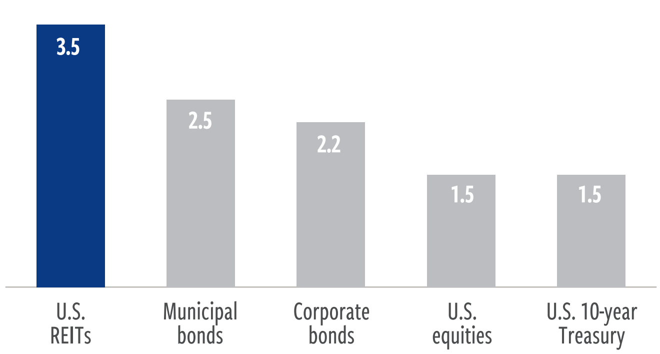
Offering a current yield of 3.5%, REITs have historically provided steady dividend growth that has outpaced inflation. We believe dividends could continue to grow in the coming years. Sectors that benefited from COVID dynamics continued to increase their payouts throughout the pandemic, and sectors most impacted by travel restrictions (other than hotels) could see a resumption in dividend growth in 2021.

Further adding to their appeal, since 1990, REITs have had a 0.58 correlation with broad equities and a 0.21 correlation with bonds, indicating the potential to improve a portfolio's risk-adjusted returns.

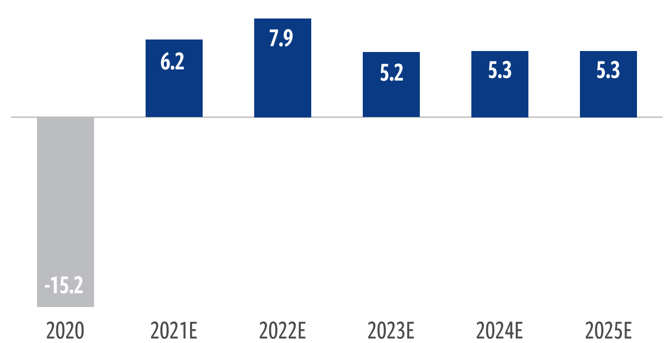
EXHIBIT 4

REITs' dividend growth estimates highlight a strong recovery

Asset class yields (%)



U.S. REITs' dividend growth estimates (%)



At February 28, 2021. Source: Bloomberg, ICE BofA and Cohen & Steers.

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(1) U.S. real estate represented by Cohen & Steers coverage universe of U.S. real estate companies. U.S. equities represented by the Russell 3000 Index.

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Index Definitions / Important Disclosures

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