Macro and Performance Review - QTD

In the June 2022 quarter, the FTSE NAREIT Equity Index ended the quarter down 17.00%, as, in Heitman's view, the triple concerns of rising interest rates, rising inflation and expected recession fears pervaded the market.

According to Bloomberg consensus estimates, a recession is quickly becoming the base case for the US and global economic outlook. The US Federal Reserve and most other central banks are reacting quickly to rising inflation data prints, with the Fed Funds Target Rate rising 50 basis points ("bps") in April and 75 bps in June[1]. This tightening of monetary policy is being conducted as inflation continues to rise, with the US now experiencing over 8% annualized headline CPI rises[2].

The impact of rising rates is now beginning to be felt across the US economy, with industrial activity, business, and consumer sentiment indicators rolling over from buoyant levels. For example, according to the Institute of Supply Management (ISM), June reports have seen the ISM Manufacturing report falling to 53.0 from 56.1.

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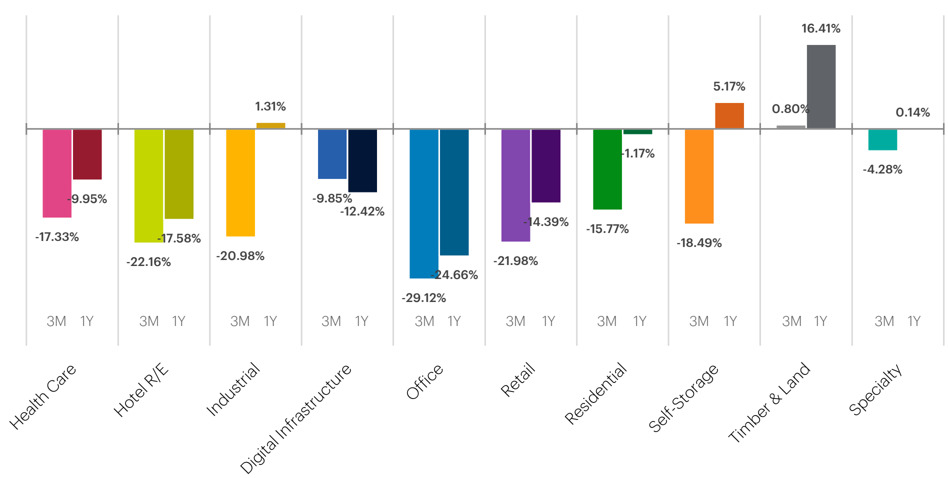
Our view is that the impact of higher rates will moderate inflation in the US over the next six months. Anecdotal observations from investment banks point to signs of supply chain and goods price inflation easing. However, while a recession is not a foregone conclusion, it will be challenging for the Federal Reserve to engineer a soft economic landing.

Over the quarter, the breadth of sector returns was such that only a small number of property types outperformed the benchmark, with specialty performing the best at -4.27%, followed by digital infrastructure at -9.85%, and residential REITs at -15.77%. In Heitman's opinion, all of these sectors have some defensive characteristics. Offices lagged the most at -29.12%, followed by hotels at -22.16%, and retail at -21.98%, as economic growth and recovery forecasts were aggressively pared back, impacting sectors primarily exposed to business and consumer sentiment. Elsewhere, logistics -20.98%, healthcare -17.33%, and storage -18.50%, were in the middle of the pack.

FTSE NAREIT EQUITY REITS PERFORMANCE AS OF 6/30/22



1. US Federal Reserve, Bloomberg
2. Bloomberg

Outlook

The recent pullback in REIT pricing around the world is, in our opinion, at odds with the solid operating performance of the REITs in our coverage universe. Rising rates, however, are impacting the sector via expectations of a higher cost of capital, lower availability of that capital, as well as weakening rent growth and potential tenant bankruptcies.

Capitalization rates in private markets are starting to increase in response to these changes, as evidenced by our discussion with our Heitman colleagues and real estate brokers. Certain property types, such as industrial real estate, are in negative leverage situations, where financing costs are higher than underlying property yields. Listed markets, in our opinion, have been quick to factor this into stock market valuations. As a result, our portfolio positioning reflects a preference of property types where leverage positively supports underwriting assumptions.

Additionally, we have a preference where pricing power exists in lease structures and supply and demand balances. Those markets and property types that can pass through inflation or where replacement costs cap potential supply are favored. Hotels, traditionally defensive grocery-anchored retail, and long lease assets fit in this category.

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The upcoming mid-year reporting season will provide the investment team with further insight into the state of the property, leasing, capital markets, and management guidance on the state of operations will be a critical factor to watch. As a result, we continue to balance the portfolio positioning around "re-opening" cyclical sectors and stocks with identifiable catalysts and strong secular economic, demographic, and technology-related tailwinds.

As of June 30, 2022, according to Heitman estimates, the US REIT market was trading at a 9.2% discount to NAV, 5.5% implied cap rate and 3.6% dividend yield.

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