Q4 2023 Market Overview

In Heitman's view, during the quarter, US investors became optimistic that the Federal Reserve (the "Fed") would be successful in combating inflation while avoiding a material economic slowdown. This optimism can be rooted in the US Federal Open Market Committee's ("FOMC") shift in communication during the quarter. The FOMC had two meetings during Q4 2023, and the target federal funds rate remained unchanged at both, at 5.25% - 5.50%.[1] Heitman feels the significant news was the commentary provided by Chairman Powell around these releases, particularly the December 2023 release in which his description of current policy was changed to "well into restrictive territory," which we believe emphasizes faster disinflation in the economy and a more dovish stance by the Fed.[2] Additionally, the FOMC is now forecasting three rate cuts during 2024 as opposed to the two cuts forecasted during the September 2023 meeting. The market responded, and the 10-year US Treasury yield markedly dropped during Q4, beginning October 2023 at 4.57% and finishing the quarter 69 basis points ("bps") lower at 3.88%.[3] Additionally, the market expectations for rate cuts as measured by the Fed Funds Futures curve increased over the quarter from approximately three cuts in 2024 to six cuts.[4] These results, coupled with increases in the stock market prices, including REITs, suggest to us that the market currently believes a recession will be avoided.[5]

The Fed seemingly being successful in combating inflation, coupled with increases in stock market prices, suggests diminishing market fears of a recession

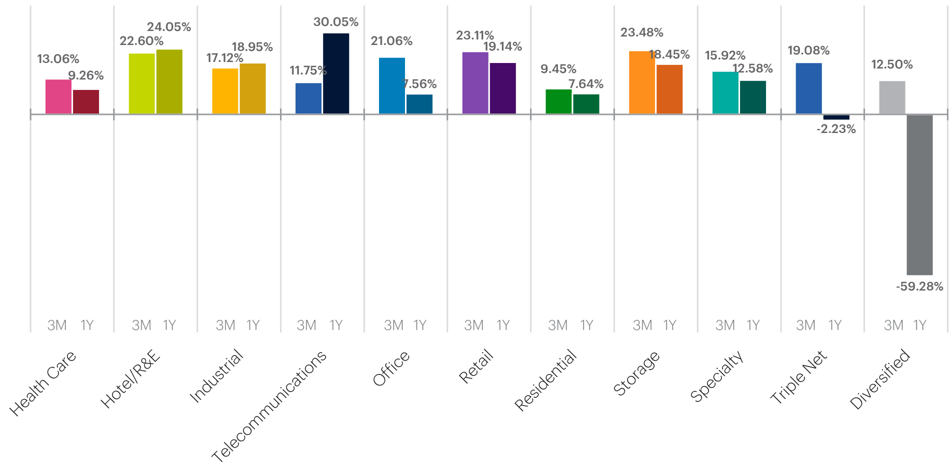
We believe that the economic releases during Q4 2023 also seem to suggest that the economy remains healthy. The US economy was able to maintain positive employment growth, while inflation growth continued to slow.[6] US non-farm payrolls increased by 532,000 during Q4, compared to a 663,000 increase in Q3 2023. Additions in government jobs and the education and health services sectors were noteworthy for the size of their increases. The sectors with negative job growth included trade, transportation, and utilities and the professional and business services sectors. Both sectors have been lackluster over the past six months. As for the Consumer Price Index ("CPI"), the year-over-year growth rate consistently declined over the course of 2023 and this continued during the fourth quarter.[7] The latest reported year-over-year increase in CPI (excluding food and energy) was 4.0% for November 2023, matching expectations as set by Bloomberg. While still above the Fed's desired level, CPI is down from 5.7% at the start of 2023. Other reports that suggest economic growth remains positive include retail's sales control group and Q3 real Gross Domestic Product ("GDP") growth of 4.9%.[8]

REIT Market Review – Q4 2023

During Q4 2023, the FTSE NAREIT Equity Index gained 16.22%.[9] In our view, the REIT market strength was driven by the economic "soft landing" scenario that took hold of the US market in early November, driven by the improved inflation data with limited signs of a material economic slowdown. The strong REIT returns were broad-based, with all sectors generating at least a high single-digit return.

1. 4Q Treasury and FOMC.doc, pages 5 and 6
2. 4Q Treasury and FOMC.doc, page 2
3. 4Q Treasury and FOMC.doc, page 4
4. 4Q Treasury and FOMC.doc, page 1
5. 4Q Treasury and FOMC.doc, page 7
6. US Econ Releases, page 1
7. US Econ Releases, page 2
8. US Econ Releases, page 3
9. All performance is quoted in US Dollars.

FTSE NAREIT EQUITY REITS PERFORMANCE AS OF 12/31/23



Merger and acquisition activity slowed during Q4 2023, which we believe is attributed to the 10-year yield, which reached 5% in mid-October. Public-to-public deals continued, with Healthpeak Properties, Inc. and Physicians Realty Trust agreeing to merge to create a $21 billion diviersified healthcare company that includes medical office and life sciences.[10] In other transactional activity, Digital Realty Trust, Inc. announced a development joint venture with Blackstone Inc. valued at $7 billion, with Blackstone making an initial contribution of $700 million.[11]

According to Bloomberg data, $5.3 billion of equity issuance was announced during Q4 2023.[12] No single equity issuance dominated in North America during the quarter, but the region saw what can instead be characterized as mid-szed, at-the-market offerings. We continue to believe that public REIT's more diverse access to capital along leverage capacity will provide the opportunity to take advantage of external growth opportunities, which may emerge in the difficult bank lending environment.

Within REITs, the best-performing sectors for Q4 2023 included storage (up 23.5%), followed by retail (up 23.1%), and hotels (up 22.6%). The residential sector lagged the most, up 9.45%, followed by digital infrastructure, which was up 11.75%.

We believe the strong self-storage sector performance was likely driven by speculation that lower interest rates would fuel an improved home sales market, which would in turn improve mobility and self-storage demand. Retail performance was driven by malls, Simon Property Group, Inc. and Macerich Co, which we believe can be attributed to the reversal in the bearish view of REITs caused by the prospects of Federal Reserve rate cuts. The strong hotel sector performance can also be viewed in this same context, in our opinion.

The residential sector, while generating a positive return, lagged on a relative basis driven by Sunbelt apartments, Mid-America Apartment Communities and Camden Property Trust, which are facing elevated supply and the prospects of deteriorating lease economics.[13] Regarding data centers, we believe the "junk rally" caused by the "soft landing" economic narrative resulted in a flight away from these high-quality and higher growth companies.

10. Reuters, 30 October 2023
11. Green Street Advisors, 7 December 2023
12. Bloomberg, Inc., data retrieved 8 January 2024
13. Green Street Advisors Research, December 1 2023

Outlook

In line with previous quarters, the outlook for US REITs remains mixed. In our view, valuations are attractive compared to private real estate appraisals and broad equities, but now appear less attractive versus fixed income following the strong market rally during Q4 2023. We believe the market will continue to be data-dependent in assessing the effectiveness of the restrictive monetary policy on maintaining the improved inflation readings and to the extent the policy damages economic growth.

Regarding sectors, we believe data centers, open-air retail, and senior housing remain fundamental bright spots. Data center space demand is positioned to grow due to the increasing use of artificial intelligence, with continued power availabilities limiting supply.[14] Open-air retail REITs continue to experience strong leasing given the shortage of high-quality infill shopping centers, with additional demand from curbside pickup required for omni-channel e-commerce.[15] Senior housing will likely remain the sector with the highest growth due to continued age demographic driven demand accompanied by low supply.[16]

We believe larger industrial tenants have slowed leasing decisions due to lower goods consumption and recession fears. Additionally, outsized rent growth in recent years has caused rent affordability issues. However, the market remains strong by historical standards to date, with the exceptions of a few markets, in our view. The slowdown in the self-storage sector is also being closely watched as home sales velocity slows and lives normalize post-pandemic. However, the decline in home mortgage rates may result in an improved existing home sales market and increase mobility.[17] The residential sector is mixed, with Sunbelt apartment markets facing supply pressure and the impact of weakening age demographics, which currently favor the single-family rental and manufactured housing sub-sectors.[18] The office sector remains the weakest sector, in our view, given the continued increases in market availability due to weak tenant demand and difficult debt financing markets. However, the office sector comprises less than 5% of the index.

Overall, Heitman remains focused on the opportunities presented in these volatile markets by focusing on stocks with identifiable catalysts and strong secular trends that are underappreciated by the market. We continue to focus on higher-quality assets and strong balance sheets while taking risks where lower-quality opportunities arise.

The outlook for REITs remains mixed; we continue to focus on higher-quality assets and strong balance sheets while taking risks where lower-quality opportunities arise

14. Green Street Advisors Research, 30 November 2023
15. Green Street Advisors Research, 4 December 2023
16. Green Street Advisors Research, 1 December 2023
17. Green Street Advisors Research, 5 December 2023
18. Green Street Advisors Research, 1 December 2023

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