What REITs Tell Us About The Market's Direction

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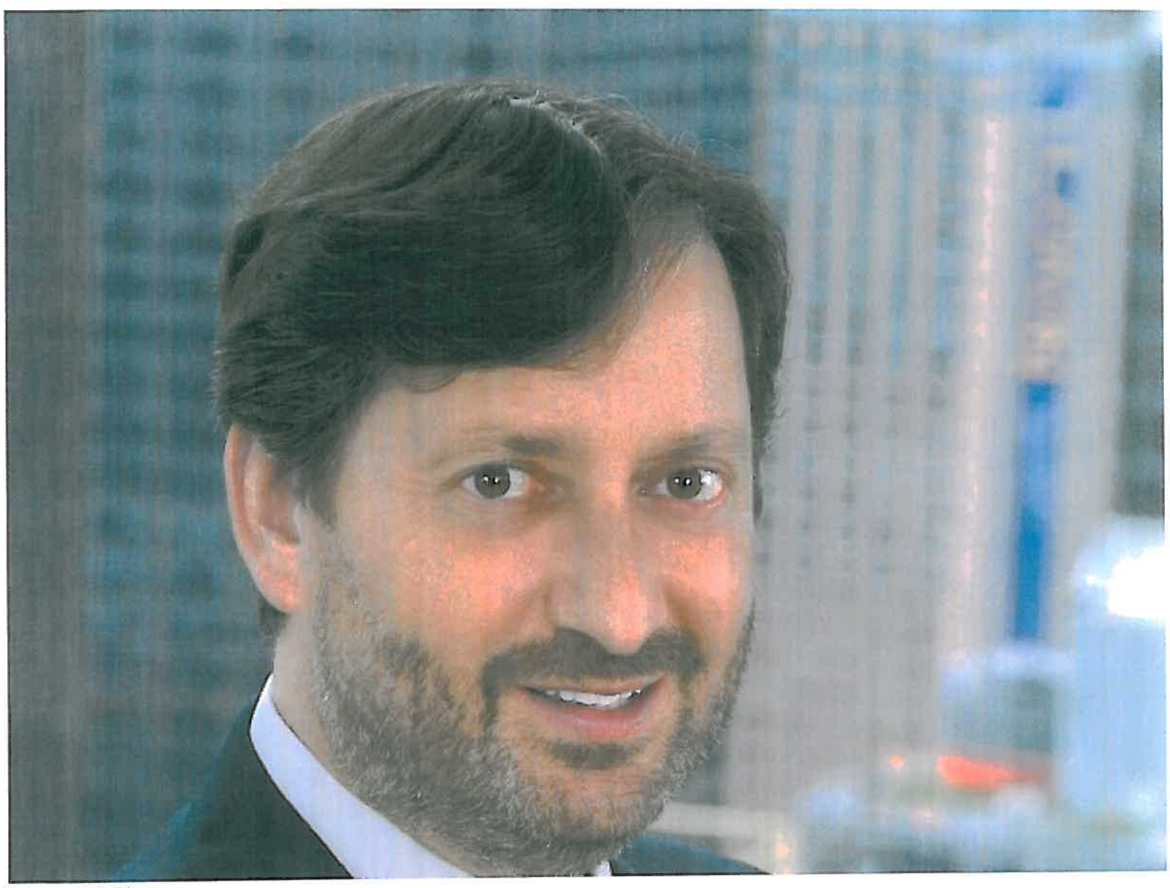

Marc Halle

NEW YORK–For the last two months REITs have begun to outperform the larger US equities market, after being pummelled by investors for two years. Today, despite the previous two months, REITs' story line is well entrenched: they are out of step with the direct real estate market and are so cheaply priced that they are ripe for acquisition. But besides their acquisition potential, is there another lesson to be drawn from their two-year journey? Yes, according to **Marc Halle**, head of Global Real Estate Securities at **PGIM Real Estate**, which is this: REITs are good forecasters of the direction of real estate values and they are indicating that valuations will eventually drop in the private market.

"Directionally, what REITs are telling us is that real estate values may come down a little because of the increase in cap rates and because of the increase in the cost of capital," he tells GlobeSt.com.

Halle says PGIM has prepared its portfolio for some kind of downturn by positioning its assets and weeding out lower-quality assets. But it is not forecasting a downturn based on any particular factor or scenario such as a huge explosion of new development. There is nothing like that in the market, he says.

And in fact, much of the market's direction also depends on the pace of inflation and income growth. "If we have very marginal increases in rates we will likely continue to see NOI or rental growth because the industry has not overshot on supply." On the other hand, if there is a jump in rates, that would likely cause some distress in the market, Halle continues. "It could cause people to reevaluate their exit assumptions."

So how does Halle reconcile these competing economic signals? Simply this, he says: REITs may be good forecasters of the direction of real estate values — but they often get the amplitude of that direction wrong.

"We should absolutely pay heed to what REITs are saying about the market," Halle says. "But I think it is just one piece of a crossword puzzle. It is just one variable that you have to look at when you are evaluating the market."

Here are the rest of the pieces, according to Halle: The real estate markets seem to be in an equilibrium in that supply is equal to demand. There is not a lot of new supply in most asset classes, outside of select markets. Any future new supply will be curbed by the increasing cost of development. Banks have been very reticent to lend like they did in the last cycle for new development. "We always want to be prepared for some kind of downturn, but there is nothing you could point to today other than the length of this economic recovery to signal that there is going to be downturn," he says.

So again, how does Halle square that circle? He offers this half-jokingly: "There's a saying, REITs have predicted four out of the last three recessions."
