The Moral Equivalent Of Rent

Who finds the money? When you pay the rent?
Did you think that money was heaven sent? --- The Beatles, "Lady Madonna"

College students looking for a fun summer job might want to silkscreen some t-shirts with "Bureau of Labor Statistics" emblazoned on the front and the motto, "Oh, yeah! Prove it!" on the back. They are sure to be hot sellers amongst economists, bond traders and assorted lunatics who somehow believe their own personal cost of living is increasing more than the 3.5% rate calculated by the BLS.

As last Wednesday's savage selloff on the release of higher than expected CPI data indicated, the CPI numbers have now moved front and center, perhaps ahead of the monthly employment situation report, in the List of Important Things We Should Worry About [insert frowny-face icon here]. Owners' equivalent rent (OER) is the largest single component of the CPI at 23.442%. This measure is not calculated by survey and traced forward over time as are life-sustaining items such as Pop-Tarts; it is calculated by BLS economists and statisticians as an estimate of what homeowners could receive in monthly rental.

During the recent housing boom fueled by low mortgage rates and expansive lending policies OER was under downward pressure. As tenants moved from apartments to houses they placed downward pressure on rentals and upward pressure on home prices. Now that mortgage rates and delinquencies are on the rise, we should expect the process to reverse and for rental rates to rise relative ownership costs.

The implications of this shift for OER and thus for CPI are quite negative. Given the high standards to which Federal Reserve Chairman Benjamin Bernanke is held, (translation: he can't away with Greenspan's smoke-and-mirrors stuff) he will have to respond with a continued stream of interest rate hikes to avoid being labeled as soft on inflation.

REIT Market Confirmation

We can use the real estate investment trust market to substantiate the claims made above. If mortgage rates do in fact lead shifts from tenancy to homeownership and if rents rise and fall in response to those shifts, we should see the relative performance of apartment REITs rise and fall accordingly. Apartment REITs, after all, should be valued at the pass-through value of their rents. While there are quite literally tens of thousands of apartment buildings not part of any REIT, they all are exposed to the same rental factors.

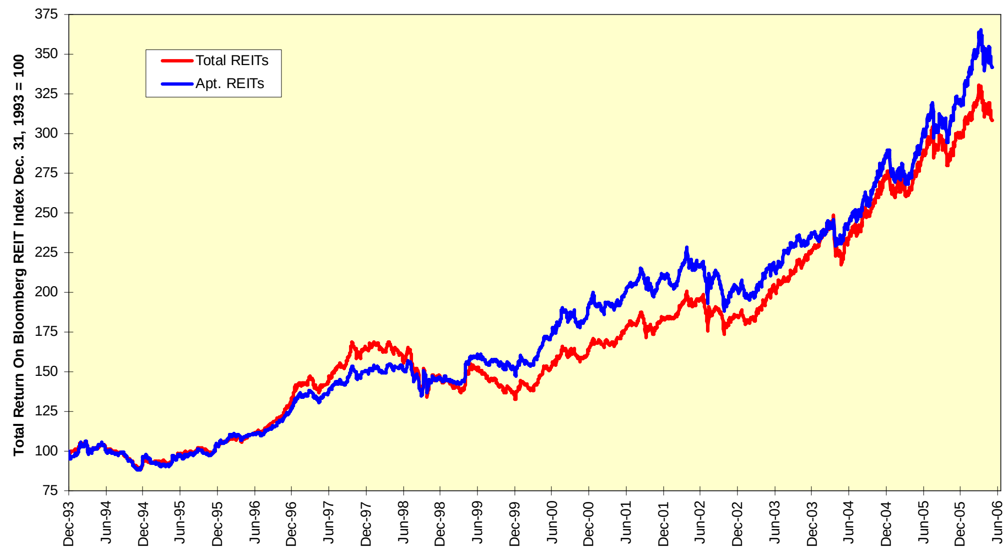
If the value of apartment REITs relative to all REITs rises and falls in relationship to mortgage rates, it should lead the oh-so-suspect measure of OER. If it does, will all those conspiracy theorists cease and desist in their caterwauling over government statistics? To ask the question is to answer it.

Bloomberg has an index of apartment REITs, the members and weights of which are listed below. We can compare the total return of this index to the total return of Bloomberg's index of all REITs.

Name	Weight
Equity Residential	23.4%
Archstone-Smith Trust	18.9%
AvalonBay Communities Inc	14.5%
Apartment Investment & Management Co	7.8%
Camden Property Trust	7.1%
United Dominion Realty Trust Inc	7.0%
BRE Properties Inc	5.1%
Essex Property Trust Inc	4.6%
Post Properties Inc	3.2%
Home Properties Inc	3.0%
Mid-America Apartment Communities Inc	2.1%
American Campus Communities Inc	0.8%
GMH Communities Trust	0.7%

Education Realty Trust Inc	0.6%
Associated Estates Realty Corp	0.4%
BNP Residential Properties Inc	0.3%
American First Apartment Investors Inc	0.3%
Roberts Realty Investors Inc	0.1%
Century Realty Trust	0.1%
Maxus Realty Trust Inc	0.0%
Presidential Realty Corp	0.0%

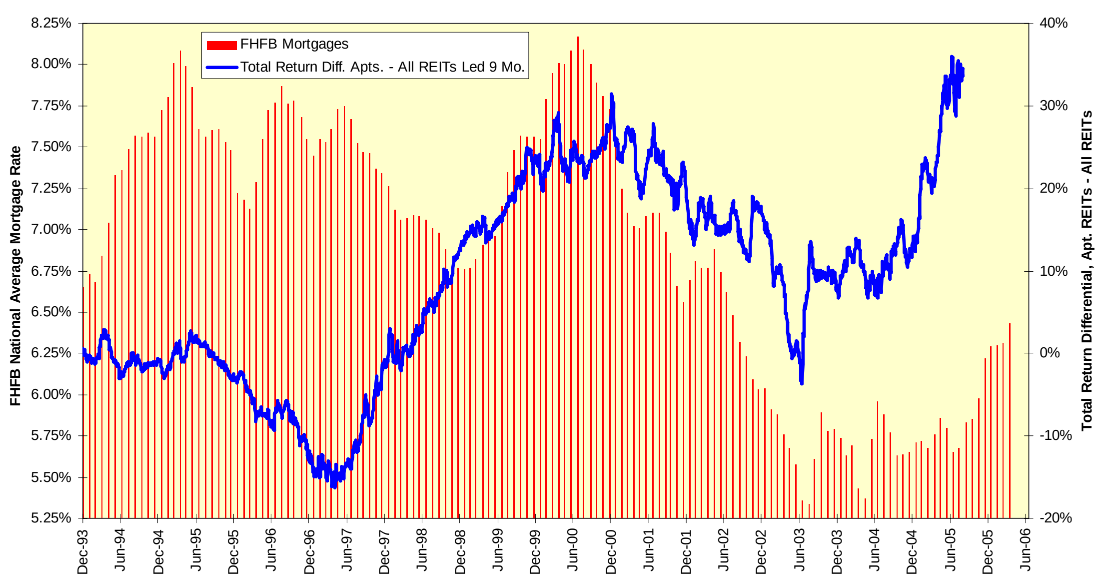
How Do Apartment REITs Compare?



As an aside, both indices have provided solid returns to their investors since their exception; the total return on apartment REITs is essentially the same as the total return on the S&P 500 since the end of 1993, and it has been achieved with less volatility.

Now let's compare the difference in the total returns between these indices to mortgage rates. The Federal Home Finance Board's national weighted average for resold homes' mortgages will be used as a measure of mortgage rates.

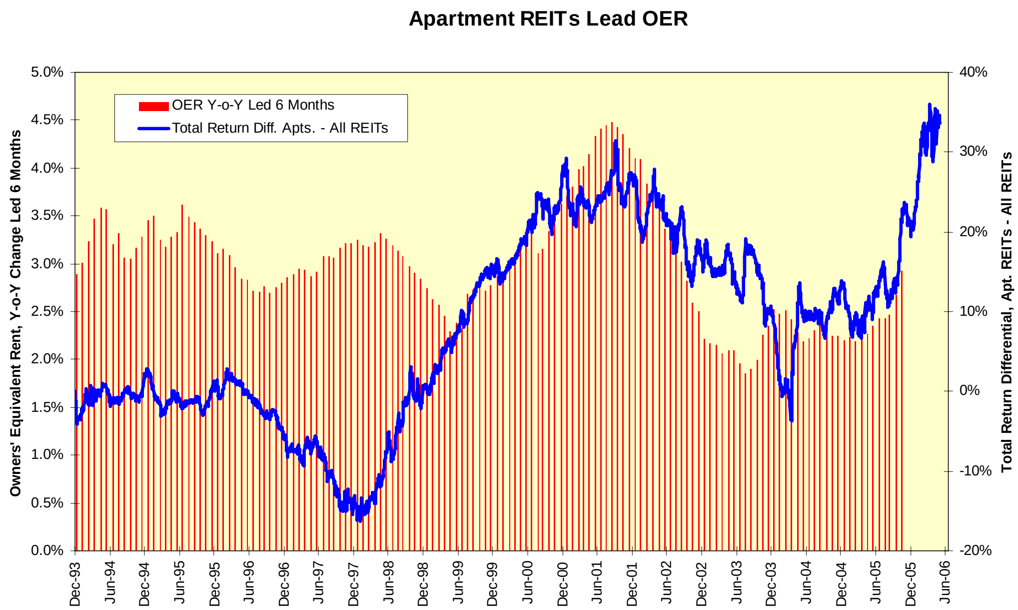
Apartment Rents Capture Higher Mortgage Rates



The changes in mortgage rates lead the REIT return differential by nine months on average; the relationship became especially pronounced from late 1998 onwards as a large stock of higher-rate mortgages became economic to refinance. As mortgage rates plunged and as tenants moved to ownership, the apartment REITs underperformed REITs in general. Now as mortgage rates are rising, we should expect apartment REITs to continue their outperformance of other REITs.

The OER Connection

Now let's compare the changes in OER to this REIT return differential. Changes in OER are led by the relative return on apartment REITs by six months on average; once again the relationship tightened after 1998. If the apartment REITs continue to follow mortgage rates, as suggested above, higher OER readings will follow stronger apartment REITs. It appears inescapable inasmuch as anything in finance ever is.



If 23.442% of CPI is poised to rise by virtue of perfectly logical trends in mortgage rates confirmed by the relative valuation of apartment REITs, we are going to see higher CPI numbers in the months to come. Unless those pesky non-core items of food and energy start to decline, we will see higher core readings and last Wednesday's experience may become drearily common.

Maybe I should start selling t-shirts that say, "Daddy Fudged The CPI, And All I Got Was This Lousy T-Shirt."