Follow The Money With REITs

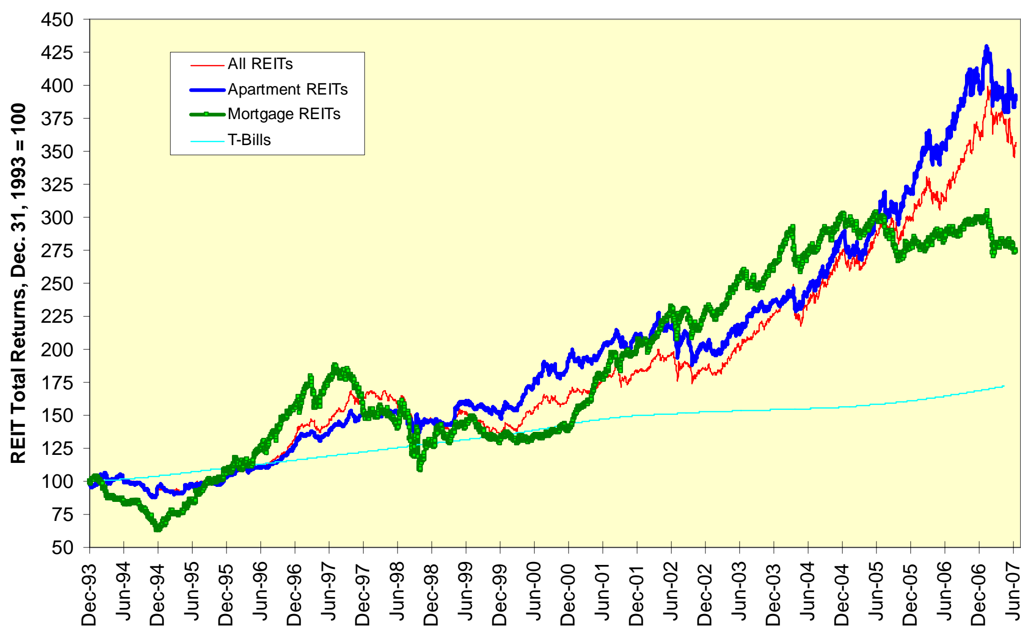
Traders have a certain conceit in wondering, "What is the market telling us?" The answer, quite possibly, is nothing. Not only do we have numerous markets and therefore numerous messages, but the purpose of markets is not to broadcast anything to you in high-quality digital sound; it is to measure the instantaneous conditions applicable only for today.

Still, the analysis of those measurements and the course they have taken over time can prove useful in divining future conditions. Moreover, certain markets can be demonstrated as leading others statistically. The trick is knowing where to look for these leading relationships and how to distill useful information from raw data.

Real estate investment trusts (REITs) trade like stocks and allow individual investors to hold claims against the rental income, capital appreciation and other cash flows of commercial real estate. They come in a wide array of specialties, from office buildings, to warehouses, hotels, healthcare facilities, shopping malls and the two specialties discussed below, apartment REITs and mortgage REITs.

Apartment REITs, as the names suggests, own multifamily dwellings and allow individual investors to have some of the benefits of being a landlord while passing the day-to-day headaches of property management to someone else. Nearly all of us have rented property at one phase or another of our lives and, in homage to Groucho Marx, shudder at the thought of having someone like us as tenants. Mortgage REITs make loans to commercial property developers without holding an equity interest in those properties. The comparative total return picture for apartment REITs, mortgage REITs, all REITs and three-month Treasury bills is presented in Chart 1.

Chart 1: A Market Of REITs, Not A REIT Market



Own Or Rent?

National policy is and has been since World War II to encourage homeownership. The thought is homeowners take greater care of property and are more stable members of the community. To further this policy, the federal government allows for the deductibility of mortgage interest against taxes and has created two mortgage-lending monsters, Fannie Mae and Freddie Mac, to funnel investment flows into residential real estate. These government-sponsored enterprises are at the heart of a gigantic system of mortgage securitization that is the largest single fixed-income market in the country, even larger than U.S. government debt.

Offsetting this hooray-for-housing approach over the years was the Federal Reserve. Prior to the removal of its Regulation Q interest rate ceilings in the early 1980s, the Federal Reserve could quash housing on a whim by pushing short-term interest rates over what savings & loans could by law pay. The removal of those interest rate

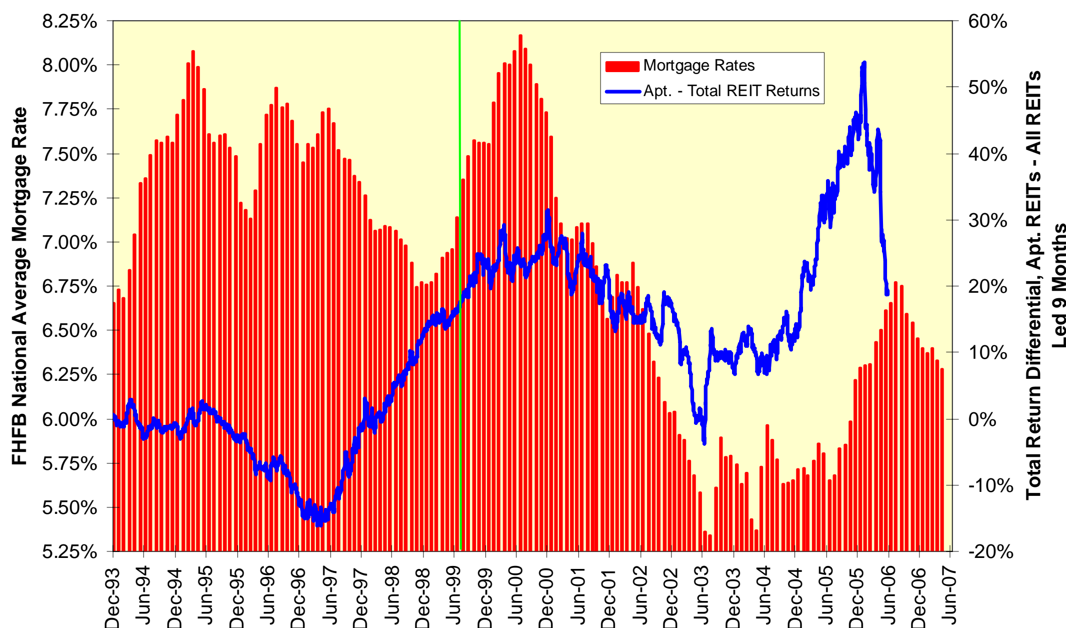
ceilings and the development of the mortgage derivatives market ended the Federal Reserve's ability to slow the economy by disrupting the housing sector. We have had two minor recessions since; the first coincided with the 1990-1991 Persian Gulf War and the second with the bursting of the technology bubble in 2001.

But what the Federal Reserve once took away, they could also grant. That bursting of the technology bubble in 2001 led to fears the U.S. would follow Japan into a deflationary recession. Thus the federal funds rate, which had been 6.50% in 2000, was lowered to a multi-generational low of 1.00% in 2003, and not raised to what could be considered a neutral level until late 2005. This stimulated the housing market by lowering mortgage rates and produced a large shift out of tenancy into homeownership as anyone who could fog a mirror could get a mortgage.

The drive lower in mortgage rates shifted marginal tenants into first-time homeownership. As illustrated in Chart 2, mortgage rates led the relative performance of apartment REITs relative to all REITs by nine months on average; this tendency became especially pronounced after the Federal Reserve adopted what has been called a "risk management" approach to monetary policy in mid-1999. As mortgage rates started to rise from their 2003 lows, marginal tenants stayed tenants and apartment REITs began to outperform once more.

Interestingly enough, as the troubles of the sub-prime mortgage lenders became apparent in late 2006, the relative performance of apartment REITs collapsed. Not only did this indicate that first-time homeowners were not moving back to apartments, it has enormous macroeconomic impact as we shall see below.

Chart 2: Apartment REITs And Mortgage Rates

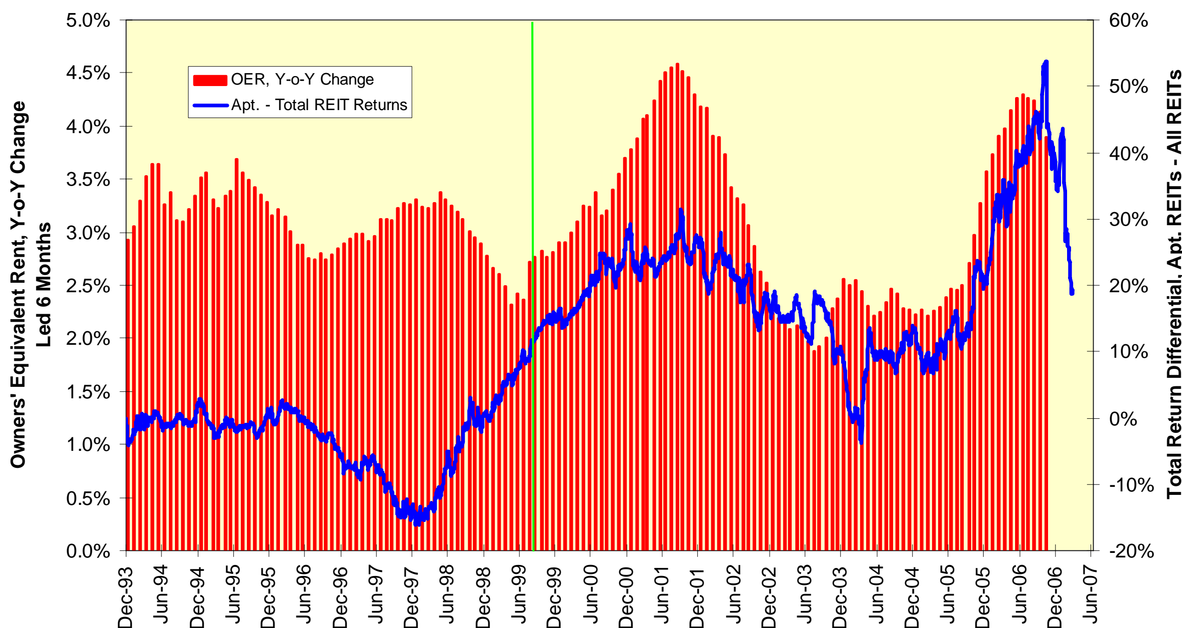


The Moral Equivalent Of Rent

Few government calculations arouse conspiracy buffs as much as those surrounding the various inflation indices. While some numbers are measured directly – the Bureau of Labor Statistics will send surveyors to grocery stores to compare prices on canned goods, for example – others are inferred and adjusted. The price of personal computers is adjusted hedonically for improvements in productivity. And in the biggest calculation, housing costs are measured by what is called owners' equivalent rent, or OER. This arcane measure actually accounts for more than 23% of the Consumer Price Index.

OER is a calculation of what homeowners could receive in rent for their houses if they were placed on the rental market each month. While that may sound nonsensical to many, it really is not. OER is the opportunity cost of homeownership. As tenants shifted into homeownership, rental rates plunged and OER growth rates fell by 2003, so much so they contributed to fears of deflation. And here is where the REIT market may be telling us something. Changes in apartment REITs' relative performance lead changes in OER by six months on average.

Chart 3: Apartment REITs And Owners' Equivalent Rent



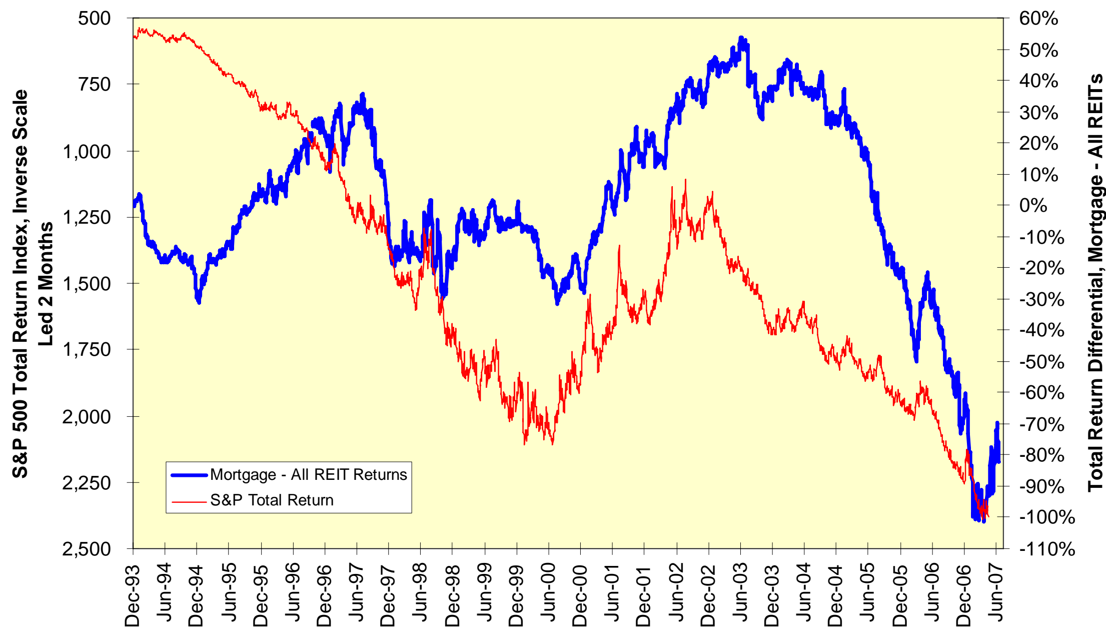
The chain of causation is complete. Mortgage rates lead changes in relative apartment REIT performance by nine months, which in turn lead OER changes by six months. As the Federal Reserve responds to inflation data, its monetary policy decisions are influenced by the decisions of prospective first-time homebuyers whether or not to remain apartment dwellers.

A Commercial Break

REITs have been outstanding investments for some time, with annualized total returns equivalent to those for the S&P 500 from the end of 1993 onwards. But mortgage REITs have stagnated since the end of 2004, the period when interest rates started to rise. As equity REITs, those which take an ownership stake in properties, accelerated, the relative performance of mortgage REITs moved into what any technical analyst would recognize in Chart 4 as a waterfall decline followed by an abrupt upward bounce.

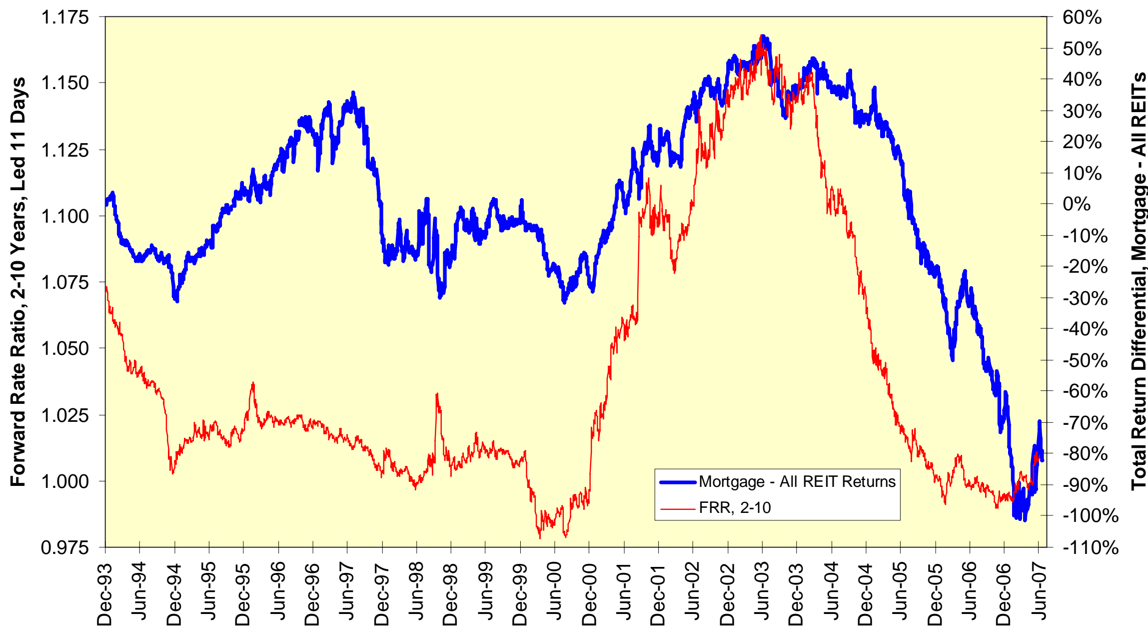
If the business of lending money to property developers was a relatively poor one, did the economy suffer as a result? Hardly; both the economy and the stock market prospered during this period. In fact, total returns for the S&P 500, plotted inversely in Chart 4, actually followed the relative decline in mortgage REITs by two months. This should not be surprising at all. In a strong economy, equity should outperform debt, and so long as debt is underperforming equity in the forward-looking mortgage REIT market, the world should do just fine.

Chart 4: Mortgage REITs And U.S. Equities



If commercial mortgages are interest rate-sensitive instruments affected by the shape of the yield curve, should we expect the relative performance of mortgage REITs to lead the yield curve itself? The answer, seen in Chart 5, is an unqualified, "Yes." The yield curve is measured by the forward rate ratio between two and ten years, the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself. Change in the relative performance of mortgage REITs lead changes in this forward rate ratio by 11 days on average.

Chart 5: Mortgage REITs And Treasury Yield Curve



There we have it, a group of markets telling us something. It is not the state of the stock market, or the residential real estate market, or the commercial mortgage market or Federal Reserve policy we need to look at in isolation from each, it is the relationships between all of these markets taken together.