INVESTING

Rate jump not indicative of REIT yield

While the world has entered an interest rate upcycle, in the next year or so, rate rises won't necessitate a similar increase in real estate yield, writes Victor Yeung.

VICTOR YEUNG
is chief investment officer of Admiral Investment.

The United States Federal Reserve raised interest rates by 25 basis points at its March meeting and it was widely anticipated the central bank would increase interest rates again at its June meeting. There is, however, a lower level of consensus over the next rate rise, with economists pointing to lower oil prices and lower inflation. According to Bloomberg, the market is currently pricing in one additional rate hike before the end of the year. At the long end of the curve, the market expects the 10-year US Treasury rate to increase by about 20 basis points. In other words, while we agree the world has entered an interest rate upcycle, the rate of increase remains manageable, especially at the long end of the curve, which is the most relevant measure when pricing other securities.

The Australian office market has been doing well since the beginning of this year. Sydney's Exchange Centre, home of the Australian Securities Exchange, was sold to a Hong Kong registered group. The transaction shows an initial yield of about 4.5 per cent, which is a historical low. The rental yield of suburban and lower-grade office assets has dropped from over 7 per cent to around 6 per cent. In addition, the Australian residential market has risen 14 per cent so far this year.

The key for real estate is whether the speed of rental increases can be maintained. Hong Kong has gone through multiple real estate cycles, most recently between 2003 and 2007, but also in the mid-1990s when real estate rent and prices continued to rise even though interest rate were also increasing. We do not think it is in any government's interest to hike at a speed that hurts the long-term growth rate of the global economy.

Thus, the ultimate question is whether Hong Kong has enough demand to justify a continued rise in rents. Overall, real estate supply continues to be muted, except in selected areas such as hotels or office space in Kowloon East. Developers and investors are still targeting various new office nodes, suggesting at least some investors remain confident in the medium-term growth of the wider Hong Kong office market.

The economic outlook, especially for retail sales and tourist arrivals, has also gradually improved from

2015 in Hong Kong. While retail rents are reported to still be falling, many news stories merely reflect that leasing contracts are being renewed to the current market level, which can be 20 per cent to 30 per cent lower than the peak recorded in around 2012. Market rents today, when compared to a year ago, are falling by a much smaller margin, as much of the previous excess has been corrected.

Incrementally, Hong Kong's ability to withstand interest rate increases has been higher today than it was two years ago. The same cannot be said for Australia, with weak consumer demand leading to some retailers pulling back from major shopping centres.

Furthermore, the yield spread between Asia-Pacific real estate and the US dollar government rate remains healthy when compared to historical precedence. According to the GPR/APREA Asia Pacific REIT (real estate investment trust) Index, the dividend yield of all Asia-Pacific REITs was 4.7 per cent in 2007, which is in line with the dividend yield of 4.6 per cent to 4.7 per cent between 2013 and 2016.

In 2007, however, the 10-year US government bond rate was between 4.5 per cent and 5 per cent, meaning the yield spread between Asia-Pacific REITs and the US dollar government rate was around zero. Investors back in 2007 were willing to take on the additional risks of owning real estate without any compensation in yield. Presumably, this meant investors expected the price growth in real estate would provide enough compensation.

Currently, the yield gap between Asia-Pacific REITs and the 10-year US government bond rate is about 200 basis points, which is wide by historical standards. This means investors are only accepting real estate assets when they are compensated by a higher cash income, and it reflects the collective wisdom of investors in the past several years as they did not assume the ultra-low interest rate was going to be permanent. The current yield gap represents some buffer to withstand interest rate increases. Thus, in the next year or so, interest rate increases will not necessitate a similar rise in real estate yield. We believe the yield gap will first shrink before real estate yield needs to increase.

Figure 1: Yield comparison between REITs and 10-year government bonds

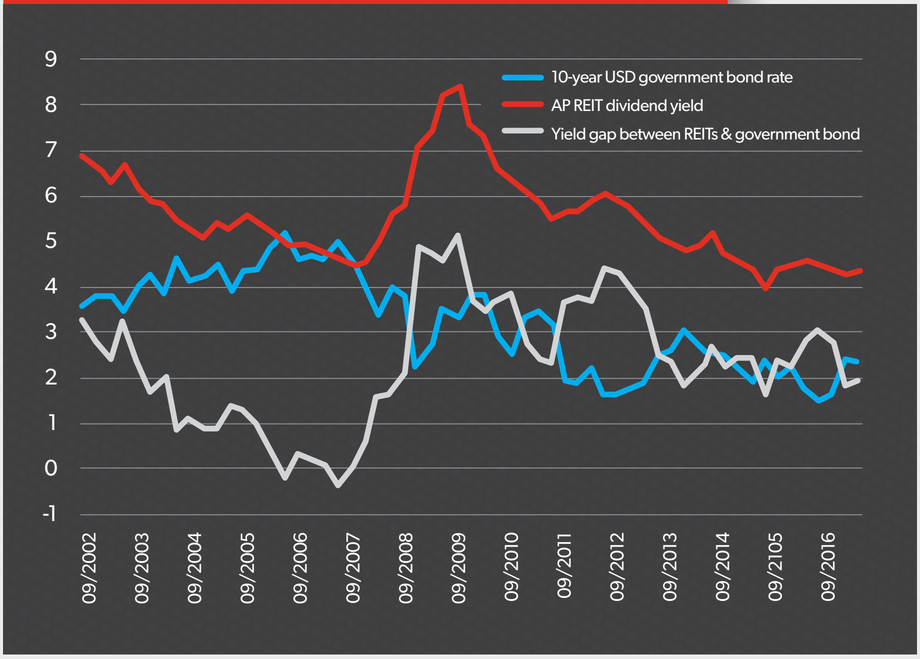

Figure 2: Yield gap between REITs and 10-year government bonds remains healthy

Source: Admiral Investment