6 February 2023

PERSONAL INVESTMENT MANAGEMENT, INC.

A Tale of Two Forecasts and The Reality of Real Estate

Brian C. Fahey, CFA, M.ECON. & Christopher J. Reedy, MBA, CFP®, CIMA

Outlook

From December 13th to December 28th, the S&P 500 declined in value by 5.88%. From December 29th to the end of January, the S&P 500 appreciated 8.8%. This short-term rally was driven by improving inflation data and a number of economic "green shoots" (signs of economic revitalization).

The Bullish Case

The prevailing bullish narrative is based upon the idea that the Federal Reserve will begin cutting interest rates as early as mid-2023 and achieve the remarkable task of bringing inflation under control without driving the economy into recession. Data in support of this position includes an improving housing market, robust employment numbers and marginally better than feared earnings forecasts.

If the Fed indeed lowers interest rates in the second half of the year as inflation approaches their 2% target, both stocks and bonds should rally. Commentators have referred to this scenario as "Landing on the Hudson", a reference to the 2009 landing of commercial flight 1549 on the Hudson River.

The Bearish Case

Bears argue that a recession has been delayed but remains on the horizon. Their argument assumes that the Fed will not be confident enough to lower interest rates until every factor contributing to inflation has returned to target, even if that means job losses that result in a recession.

Many of the factors that have brought inflation down in recent months, including the US Dollar, industrial commodities and energy costs have begun to move in the wrong direction. Labor costs, historically one of the largest factors of inflation, remain at a level inconsistent with 2% inflation.

Our View

Economy: We conveyed in last month's letter that economic data did not suggest an imminent recession but that recession later in the year is still a risk. That viewpoint hasn't changed. The driving factors remain the trajectory of inflation and the Fed's response.

Equity Markets: In December our models suggested that the S&P 500 was slightly undervalued. Today, our models suggest that the S&P 500 is overvalued. In other words, the recent rally is simply the market oscillating around fair value.

Within this context, there remains a bit of pure speculation in the market. Bed Bath and Beyond, a company we discussed in a recent letter, staged a 300% rally over six days in January ($1.32 to $5.24). The firm defaulted on a loan payment on January 26th and appears to be on the verge of bankruptcy, which will likely wipe out 100% of the value of the equity.

Bond Markets: There has never been a better time to own bonds. Managing duration (something like maturity), will be key to successfully navigating this extremely complex market. But we are encouraged by the opportunity to capture higher yields than have been available in years, with the possibility of price appreciation as well.

TIAA Real Estate

For those without knowledge of, interest in, or access to the TIAA Real Estate account, you get off easy this month and may move on to other things. For those who own TIAA Real Estate, please read on, as we explain our recent decision to reduce our allocation to this investment for the time being.

History

TIAA Real Estate has been an important allocation in our investment models for many years. When interest rates were low after the financial crisis, the real estate asset class delivered better returns than bonds. Since Jan of 2010, TIAA Real Estate has logged a total return of 154%, while the US bond market, (ETF ticker AGG) has returned 23%, assuming all dividends were reinvested. The outperformance, illustrated in the chart below, has been considerable.

The question now is if the tide has turned away from Real Estate and towards bonds.

Assessing the relative attractiveness of real estate to bonds requires applying a consistent analytical framework. Therefore, we look at capitalization rate, which views real estate rental income the same way as coupon payments from bonds.

When you own a building you collect rent, but you do not keep all the rental income. The owner of a building needs to pay for maintenance, property taxes, improvements and a host of other possible expenses that do not apply to bondholders. Net operating income (NOI) is simply the rent check minus

the expenses of owning the building. If you divide NOI by the value of the building, you have the capitalization rate (or "cap rate"). A cap rate is the rough equivalent of the current yield of a bond. By using the cap rate from a real estate portfolio and current yield from a bond portfolio we can examine the relative attractiveness of two distinct asset classes on the same terms.

Determining the cap rate for the TIAA Real Estate account involves some judgement calls, as the fund owns not just buildings outright, but also through joint ventures and a portfolio of real estate related loans and bonds. The most recent 10-Q filings with the SEC (3Q 2022) show net assets of $30,903 million and a net investment income of $280 million for the quarter, which includes income from the joint ventures, loans and bonds held by the fund. This is a cap rate of 3.62%. The figure is crude because it includes rental and investment income, but shareholders are entitled to all income regardless of source.

When two-year Treasuries are yielding 4.23%, a cap rate of 3.62% is less attractive. For TIAA Real Estate to be competitive with short-term bonds there needs to be appreciation in the properties owned by the fund. Further appreciation in the types of commercial real estate owned by the fund (multi-family, industrial, office space, retail) appears to be limited in the short-term.

Commercial real estate is facing the same headwinds as residential; namely, financing is very expensive, and prices of buildings are very high. The cap rates for the sectors mentioned appear to have improved slightly as more attractive alternatives to real estate have emerged. To prove the point, Figure 1 shows the cap rate for multi-family apartment buildings (data from Real Clear analytics, index level) and the yield for two-year Treasuries. Real estate tends to do well when investors need to reach for yield and use commercial real estate as an alternative to safe bonds. When low-risk Treasuries can provide nearly the same yield as real estate, the logical conclusion is real estate prices are too high. Notice that two years ago, the two-year Treasury yielded 0.12%, while the multi-family cap rate was 4.97%. This difference in "yield" helps explain why investors preferred real estate to Treasuries. The difference in yield has now disappeared. The last time the difference in yield between the two investments was this small was just prior to the global financial crisis. We're not calling for anything close to that type of event, but it does seem that the era of significant outperformance of real estate over bonds has ended for now. It's been a good run.

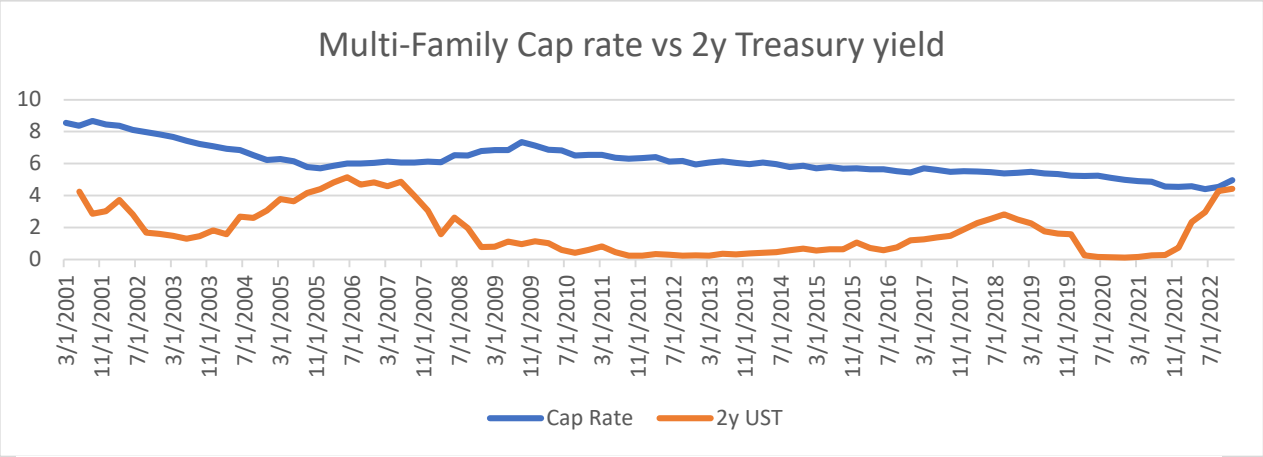

Figure 1 Cap rate data from Real Clear Analytics, source Bloomberg

We are not alone in thinking that real estate is due for a pause. Blackstone, the largest managers of commercial real estate investment products globally, has faced mounting redemptions of its funds, causing it to limit shareholder's ability to sell shares. Other providers of real estate investment products popular with institutional investors and endowments have experienced the same thing. This is not to say that the TIAA Real Estate account is a poor investment. It's not, and the fund has managed to defy economic gravity before. Our point is simply that at this juncture in time, short-term bonds offer similar upside with more limited downside. Using the two-year Treasury as a proxy for short-term bonds, the yield on bonds is at a 15 year high. If the economy manages to achieve a soft landing, short-term bonds and TIAA Real Estate will post similar returns. If a recession materializes, bonds should outperform real estate.

As a result of our analysis, we have lowered the TIAA Real Estate allocation by 50% and moved the proceeds into short-term bonds (the exact fund will vary depending on your plan's investment options). This is the case for clients using TIAA as their sole custodian, as well as those with TIAA and Schwab allocations.

We fully realize that our clients have an understandably deep appreciation for the TIAA Real Estate account. With investing, it is important to be pragmatic and not dogmatic and to avoid emotional attachments to investments. Right now, short-term bonds offer a more attractive return profile than TIAA Real Estate. This is likely to change over time, and when it does, we will reallocate as appropriate.

TIAA Alerts

The way in which TIAA delivers confirmation of changes to portfolios is odd. When we began the process of selling a portion of TIAA Real Estate, clients received a notice that caused confusion.

Client name, followed by, "your transfer order has been placed". Then: "This notice is to confirm that we have received your request for a transfer on" a certain date. The first source of confusion is the term "transfer", which is used in a way that belies the more generally understood definition. For PIM clients, please just know that this term is a substitute for "trade".

The second source of confusion is that the notice states that you have specifically requested a "transfer". Since you did not specifically request changes to your portfolio, and since TIAA knows that PIM places these change orders, it would be natural to become concerned.

Finally, TIAA changes the format and content of these alerts from time to time. When our clients see a notice in a style unfamiliar to them, it gives pause. By all means, if in the future you receive a notice that there has been a change to your TIAA portfolio and something doesn't feel right, reach out to your PIM financial advisor for confirmation that the notice is legit.

Closing Comments

It might be a decent year for investment markets. Things might go sideways. Or we are not finished with inflation and interest rate increases, potentially leading to recession during the second half of the year. The data suggests a second half recession, though not necessarily deep or long-lived. Chairman Powell's more dovish comments this week, which energized equity markets for a couple of days, notwithstanding.

But if forecasting was as simple as understanding a couple dozen economic data points, all investing decisions would always be correct. So, for the moment, we remain slightly defensive. The good news is that being defensive generally means being overweight fixed income, an asset class that appears at present to offer better than average opportunities.

If you have any questions or concerns, please reach out to your PIM Financial Advisor.