Truist Advisory Services, Inc.

Portfolio Perspective – Stay cautious on REITs as headwinds persist

Dylan Kase, CFA
Senior Investment Strategy Analyst
Portfolio & Market Strategy

March 21, 2023

Key takeaways

- We expect tightening credit conditions in the wake of turbulence in the banking sector to weigh on REITs' relative performance as well as the underlying real estate market despite REITs' improved leverage profile since the financial crisis.
- Relative price trends and fund flows from operations, the primary measure of operating cash flow for REITs, have been weak and valuations aren't supportive.
- The diverse sector composition of REITs is a positive given the wide range of characteristics, though certain areas like offices are likely to face continued pressure.
- The weight of the evidence in our work leads us to remain cautious on REITs given our base case of a recession in 2023.

Our take

Real estate investment trusts (REITs) had a rough 2022 on the back of stickier-than-expected inflation, the Federal Reserve's most aggressive tightening cycle in decades, and elevated interest rates. Late in the year and early in 2023, there were signs of stabilization in relative price trends for REITs, but those have since reversed and are nearing the October 2022 relative lows. Importantly, REITs are not a homogenous asset class and have a variety of exposures – including defensive, growth-oriented, and economically-sensitive characteristics – that we view as supportive and able to provide some level of stabilization in a wide range of economic environments. Within REITs, our view is that the office sector will likely continue to be weak given the weakening economic backdrop in the near term and the permanent increase of remote work, which decreases demand for space.

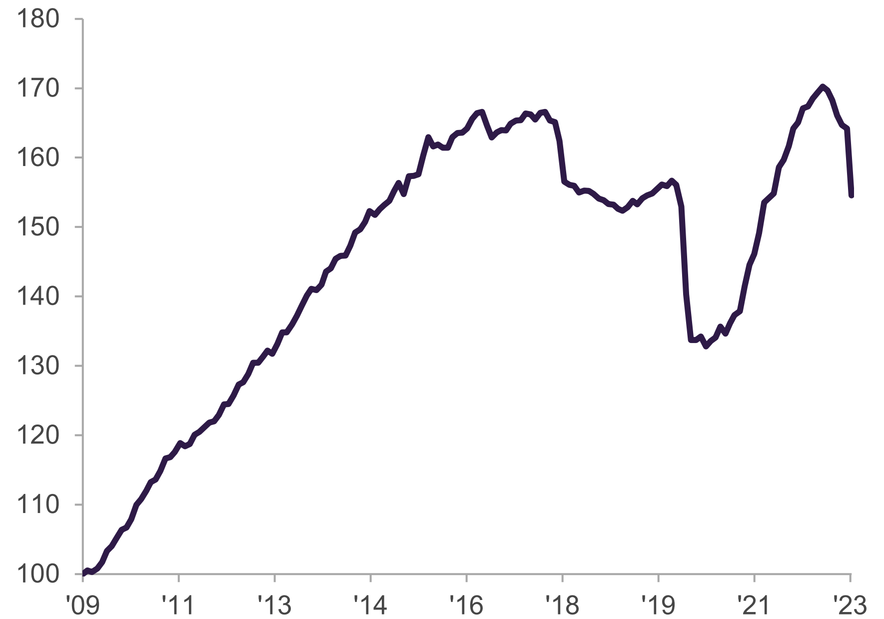
The macro and credit environment are key for REITs due to elevated levels of leverage compared to the broader S&P 500 and their underlying exposure to real estate markets. While the leverage profile of REITs has improved since the Great Financial Crisis, REITs still carry heavier debt levels compared to U.S. large caps generally, which is a unique feature to the asset class. Given our expectations for a tighter credit environment, especially in the wake of the recent turbulence in the banking sector, this is likely to be an overhang on the asset class on a relative basis. Similarly, high levels of inflation generally increase operating expenses for REITs, while higher interest rates tend to increase interest expenses, both of which put downward pressure on margins. Lastly, our base case is for a recession later in 2023, and our research shows that, on average, REITs have lagged the S&P 500 during the six months leading into recession.

Bottom line

The weight of the evidence in our work continues to point to headwinds for REITs. Accordingly, we recommend caution on the asset class. Within REITs, we expect that the office sector will continue to be weak.

Weaker relative price trends and fund flows from operations

After a rough second half in 2022, REITs started showing some relative stabilization in the late part of the year into early 2023. However, relative price trends have deteriorated recently alongside weaker fund flows from operations. Our view is REITs' margins and fund flows from operations are likely to face continued challenges as elevated inflation and interest rates increase operating and interest expenses, respectively.



Data source: Truist IAG, FactSet. Right chart is monthly as of 2/28/23.

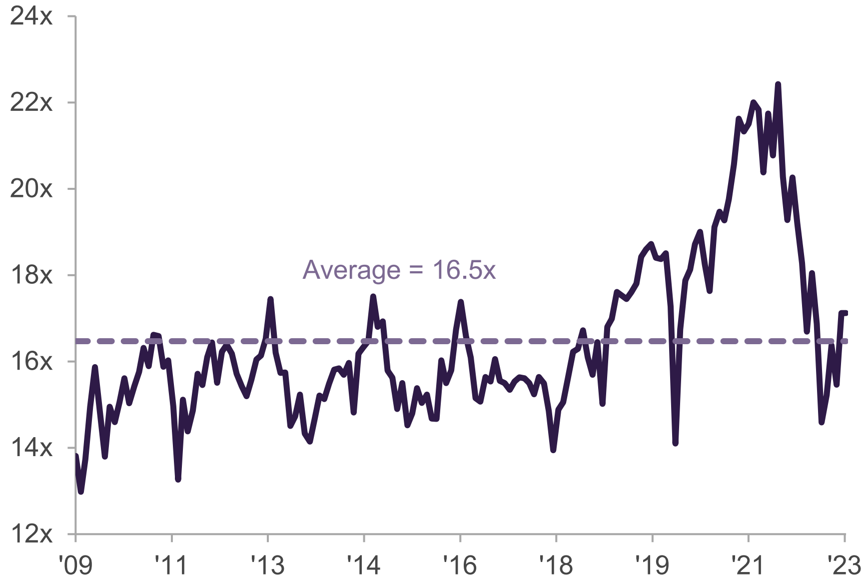
REITs = Vanguard Real Estate ETF.

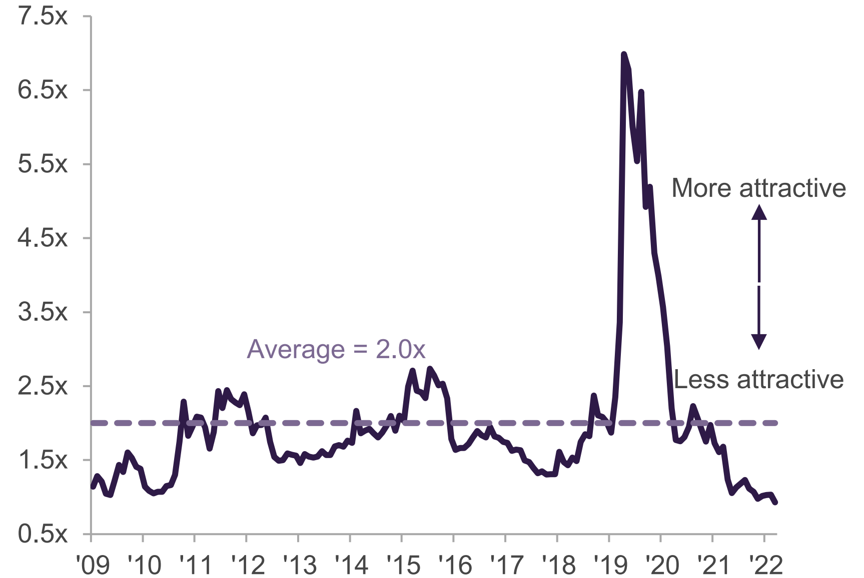
Past performance does not guarantee future results.

Wealth

REITs’ valuations unattractive

REITs’ price-to-fund flows from operations have pulled back after becoming extremely extended in the aftermath of the pandemic; however, valuations based on this measure aren’t compelling. Similarly, a yield-based measure of valuation comparing REITs’ dividend yield to the yield on the 10-year U.S. Treasury is expensive, even when comparing against the pre-pandemic 10-year average and considering the recent moves in the 10-year yield. This is important since investors tend to own REITs for income, and there are now more options offering attractive yields.





Data source: Truist IAG, FactSet. Monthly as of 2/28/23. The dividend income received from REITs isn’t tax advantaged like corporate dividends.

REITs = Vanguard Real Estate ETF

Past performance does not guarantee future results.

Wealth

Wide dispersion in REITs' sector performance

The sectors within REITs have a wide variety of exposures – including growth-oriented, defensive, and economically-sensitive characteristics. The diversity of this asset class is a positive as it can provide some stabilization in a wide range of environments; however, on a net basis, we remain cautious. Office REITs, which have been challenged with the rise of remote work, have continued to lag, and we remain cautious on this area of the market.

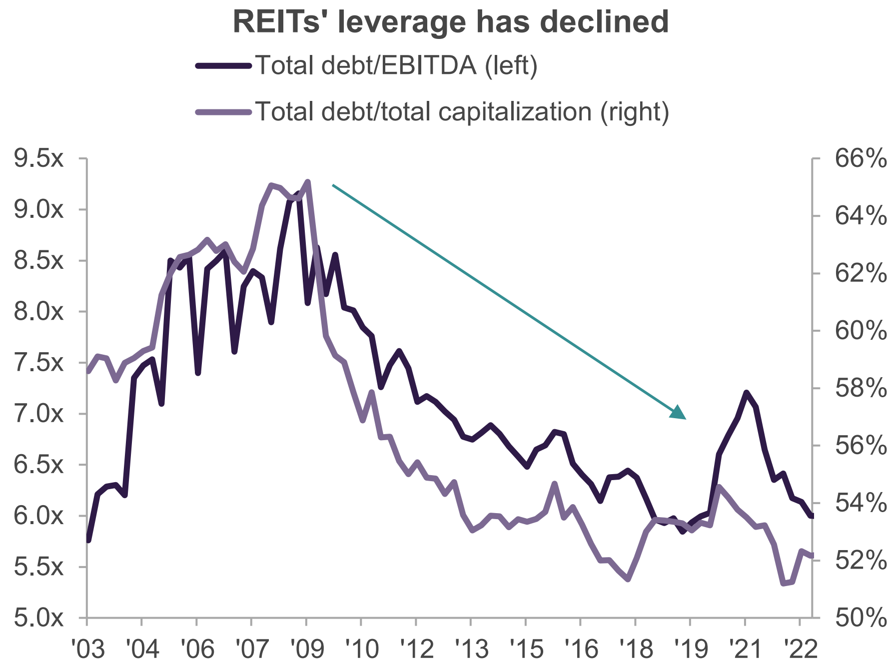
Data source: Truist IAG, Morningstar, Standard & Poor's. Data as of 3/17/23.

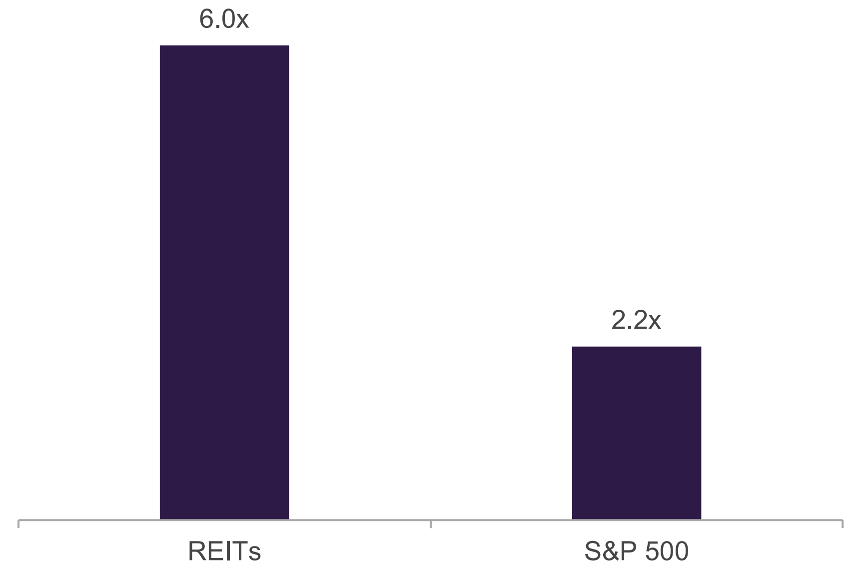
Sectors represented by the sector total returns on the Dow Jones U.S. Select REIT index.

Past performance does not guarantee future results

REITs' leverage has fallen since the Great Financial Crisis

Leverage for REITs, as measured by total debt/EBITDA, has fallen to 6.0x from a peak of 9.2x during the Great Financial Crisis. However, leverage is still much higher than it is for the S&P 500, and tighter credit conditions are likely to weigh on REITs more than on U.S. large cap stocks.





Data source: Truist IAG, FactSet. Quarterly data as of 12/31/22. EBITDA stands for earnings before interest, taxes, depreciation, and amortization

REITs = Vanguard Real Estate ETF

Past performance does not guarantee future results.

REITs tend to lag leading into recession

Our base case is a recession later in 2023. Looking at both median and average total returns over the last four cycles, REITs have tended to lag the S&P 500 as the economy has headed towards recession.

6-months prior to recession		REITs (%)	U.S. large cap equity (%)
1/1/1990	6/30/1990	-8.0	3.1
9/1/2000	2/28/2001	6.8	-17.8
6/1/2007	11/30/2007	-16.1	-2.3
9/1/2019	2/28/2020	-6.7	1.9
Average		**-6.0**	**-3.8**
Median		**-7.3**	**-0.2**

Data source: Truist IAG, Morningstar, NBER.

REITs = Dow Jones U.S. Select REIT, U.S. large caps = S&P 500.

Past performance does not guarantee future results.

Disclosures

Advisory managed account programs entail risks, including possible loss of principal and may not be suitable for all investors. Please speak to your advisor to request a firm brochure which includes program details, including risks, fees and expenses.

Truist Wealth is a name used by Truist Financial Corporation. Banking products and services, including loans, deposit accounts, trust and investment management services provided by Truist Bank, Member FDIC. Securities, brokerage accounts, insurance/annuities offered by Truist Investment Services, Inc. member FINRA, SIPC, and a licensed insurance agency where applicable. Life insurance products offered by referral to Truist Insurance Holdings, Inc. and affiliates. Investment advisory services offered by Truist Advisory Services, Inc., Sterling Capital Management, LLC, and affiliated SEC registered investment advisers. Sterling Capital Funds advised by Sterling Capital Management, LLC. While this information is believed to be accurate, Truist Financial Corporation, including its affiliates, does not guarantee the accuracy, completeness or timeliness of, or otherwise endorse these analyses or market data.

The opinions and information contained herein have been obtained or derived from sources believed to be reliable, but Truist Financial Corporation makes no representation or guarantee as to their timeliness, accuracy or completeness or for their fitness for any particular purpose. The information contained herein does not purport to be a complete analysis of any security, company, or industry involved. This material is not to be construed as an offer to sell or a solicitation of an offer to buy any security.

Opinions and information expressed herein are subject to change without notice. TIS and/or its affiliates, including your Advisor, may have issued materials that are inconsistent with or may reach different conclusions than those represented in this commentary, and all opinions and information are believed to be reflective of judgments and opinions as of the date that material was originally published. TIS is under no obligation to ensure that other materials are brought to the attention of any recipient of this commentary.

Comments regarding tax implications are informational only. Truist and its representatives do not provide tax or legal advice. You should consult your individual tax or legal professional before taking any action that may have tax or legal consequences.

Investments involve risk and an investor may incur either profits or losses. Past performance should not be taken as an indication or guarantee of future performance.

TIS/TAS shall accept no liability for any loss arising from the use of this material, nor shall TIS/TAS treat any recipient of this material as a customer or client simply by virtue of the receipt of this material.

The information herein is for persons residing in the United States of America only and is not intended for any person in any other jurisdiction. Investors may be prohibited in certain states from purchasing some over-the-counter securities mentioned herein.

The information contained in this material is produced and copyrighted by Truist Financial Corporation and any unauthorized use, duplication, redistribution or disclosure is prohibited by law.

TIS/TAS's officers, employees, agents and/or affiliates may have positions in securities, options, rights, or warrants mentioned or discussed in this material.

Asset classes are represented by the following indexes. An investment cannot be made directly into an index.

S&P 500 Index is comprised of 500 widely held securities considered to be representative of the stock market in general.

The Dow Jones U.S. Select REIT Index tracks the performance of publicly-traded REITs and REIT-like securities and is designed to serve as a proxy for direct real estate investment.

©2023 Truist Financial Corporation. Truist, the Truist logo and Truist purple are service marks of Truist Financial Corporation. CN2023-5530371.1EXP03-2024

Wealth