Real Estate: Good Not Great

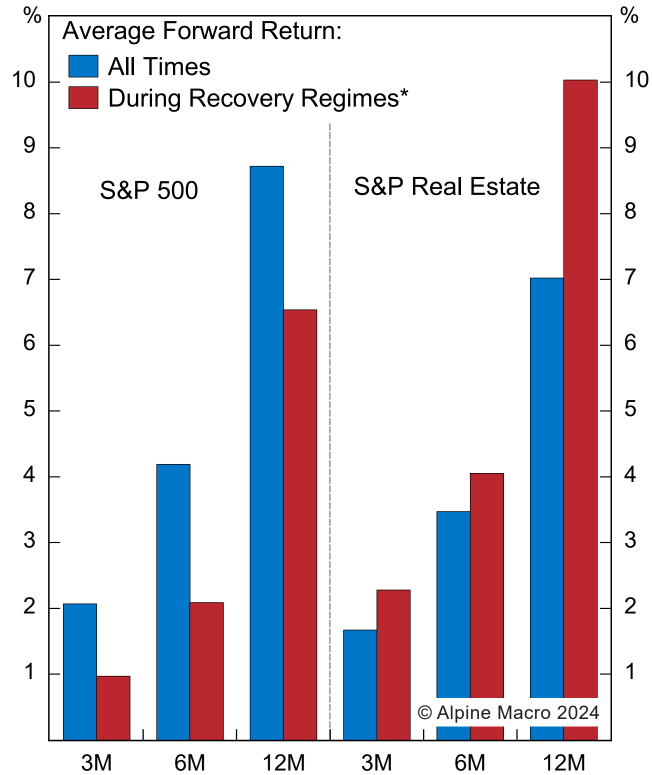
Real Estate often performs at its best during recovery periods of the cycle when policy is easing and profit growth is broadening, however valuation is full and important industries carry idiosyncratic challenges that temper full throated enthusiasm. **We upgrade the sector to neutral within our strategic framework** and continue to monitor the evolution of key drivers to inform a further inflection of guidance going forward.

Early Cyclical Winner

If Real Estate equities are to perform well an easing policy impulse and broadening of corporate profits are the ideal conditions given their early cyclical tendencies. In recent decades, Real Estate has been a standout sector during these periods, which we classify as recoveries within our framework. For the sector itself, it's the most attractive phase across the equity cycle.

In the top panel of **Chart 1** we illustrate the absolute and relative return of the S&P 500 Real Estate Index during previous recovery periods since 2001. On an annualized basis, the forward six-month outperformance for Real Estate averaged nearly 4% through these periods. The sector historically underperforms the index across the full duration of cycles making the degree of outperformance for Real Estate during recovery phases that much more potent.

Chart 1 Recoveries Treat Real Estate Well



*Defined as periods of profit strength and easing policy, data since 2000

The Table Is Partially Set

Real Estate thrives during this phase of the cycle due to the interplay of technical and fundamental factors, and we make the case that these conditions are falling into place but in an uneven manner.

An accommodative growth backdrop coinciding with lower policy rates typically corresponds with

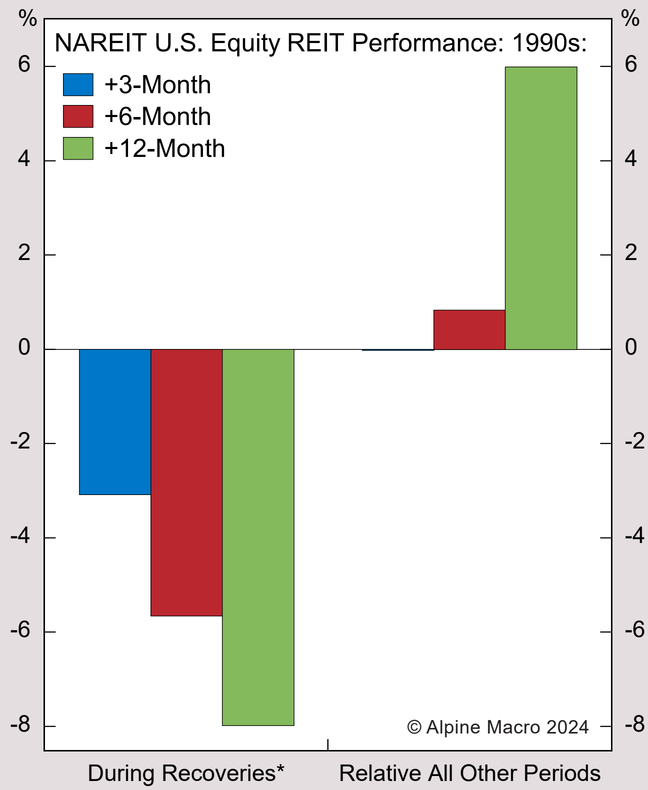
Box 1

While recovery periods have been major tailwinds for Real Estate since their official GICS classification in 1999, other sources suggest performance was spottier in the prior period, although the dispersion was overwhelmingly due to the Tech-based mania fueling other equity segments.

Performance of the NAREIT U.S. Equity REIT Index trailed the S&P 500 by nearly 8% on average in the year following recovery periods during the 1990s. However, relative Real Estate performance was so poor during the decade that this represented a 6% improvement upon all other periods (**Chart 2**).

Barring a full blown mania or stubbornly high intermediate yields, as was the case in the 1990s, we'd expect Real Estate to hold up better through this episode.

Chart 2 1990s: Lost Decade For Real Estate



*Defined as periods of profit strength and easing policy

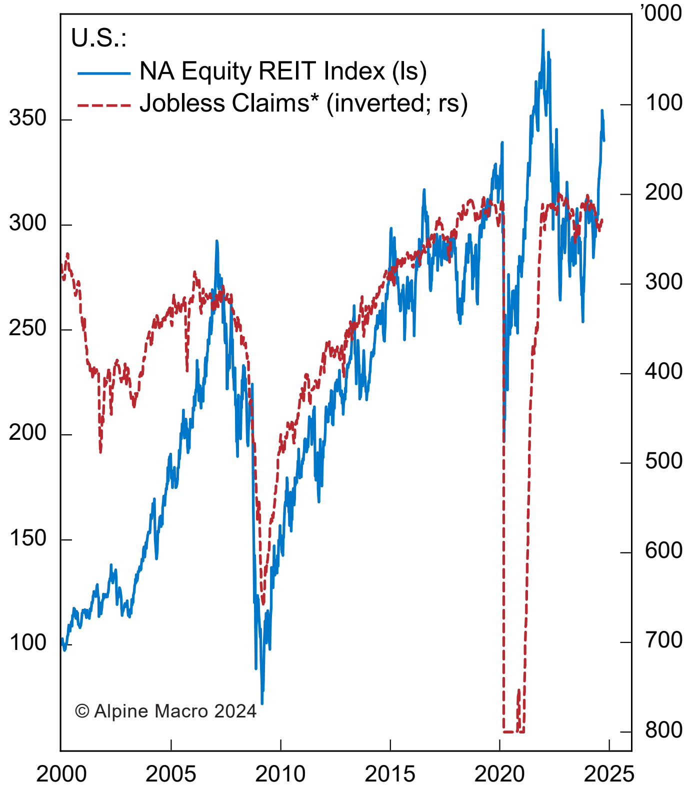
increased demand from consumers for housing, self-storage, and consumer discretionary spend items (travel, communications, retail, etc). The labor market tends to be a leading indicator for this dynamic (**Chart 3**).

There's evidence of this playing out with rental rates outpacing operating expense in Residential categories, and occupancy is high, however there is sogginess in other categories such as Hotels and pockets of Retail and Health Care which continue to "rightsize" their footprint in the post-COVID normalization process. **Chart 4** reflects this dispersion.

From a business perspective a broadening of profits is needed to incentivize companies to further invest into sources of human, physical, and digital capital to power growth. There are mixed results on this front as private investment into structures and industrial equipment have been slowing- and soft data related to capex is weak— yet categories pertaining to information processing are surging.

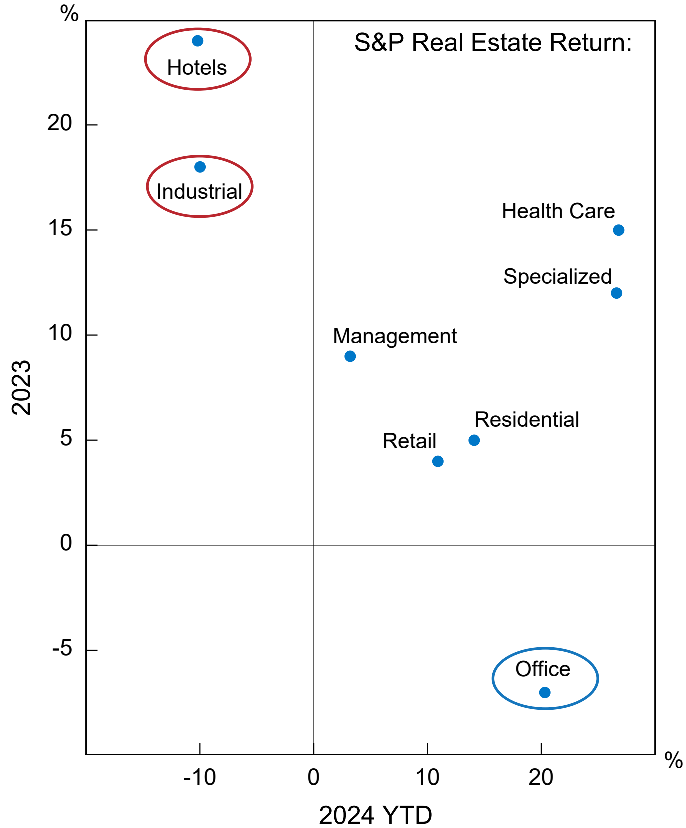
In the **Appendix**, we provide an overview of the specific drivers, developments, and outlook for each of the main industries within the S&P 500 Real Estate sector, highlighting their divergent nature.

Chart 3 Strong Labor Market Drives Real Estate Performance



*Shown as 4-week moving average, truncated to 800000

Chart 4 REIT Shuffling Between Winners & Losers



Foggy Skies This Time Around

As described, Real Estate should normally be viewed as a beneficiary of this stage of the cycle however there are some idiosyncratic considerations that temper what otherwise could be more enthusiasm.

Real Estate is experiencing many of the much-discussed irregularities which make this cycle unique including weaker manufacturing activity relative to robust services, a struggling lower income consumer versus resiliency up the wealth ladder, and disparities in property dynamics across geographies.

We make three main points as they relate to the nuance of the sector as it enters this recovery phase:

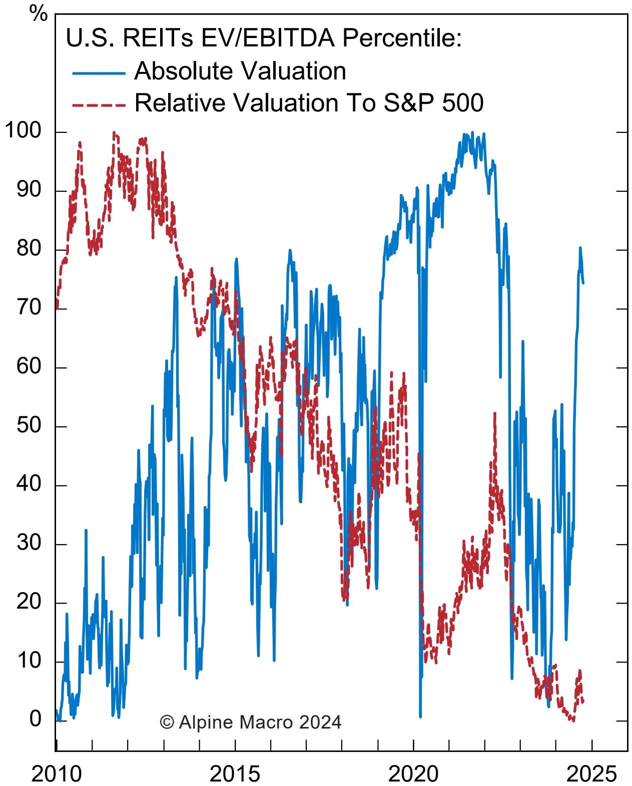
1. Some Segments Are Expensive, But For A Reason

Sector composition has evolved, becoming more top-heavy with exposure tilted towards much discussed thematic drivers including data centers found within the Specialized category. Companies adjacent to this secular growth source comprise ~30% of the index. This comes with a cost, however, as that segment trades at an average EV/EBITDA of 22x relative to 18x in 2019.

2. No Longer Many Bargains To Be Found

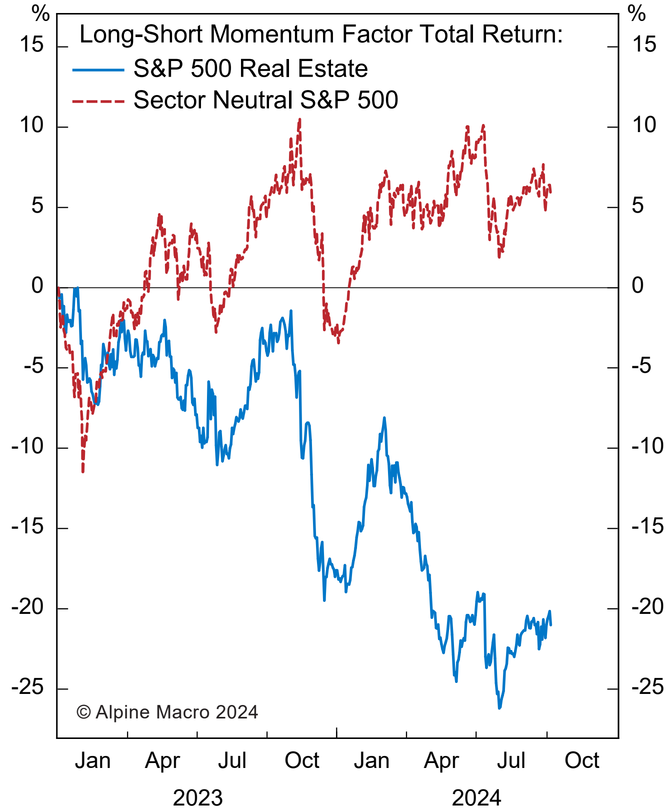
The mean-reversion trade for out of favor segments such as Office and Retail has already run its course, also meaning that fundamentally impaired

Chart 5 Valuation Now Mixed



Source: Bloomberg Finance L.P.

Chart 6 Momentum Is A Non-Factor For REITs



Source: Bloomberg Finance L.P.

segments may not be the basement bargains they otherwise were and should be. The average year-to-date performance for Large Cap REITs that suffered negative returns for much of last year is 33%.

Overall, valuation for the sector is mixed as its cheap on a relative basis to the S&P 500 (4th percentile) although expensive (86th percentile) on a historic basis as shown in **Chart 5**. From an opportunity standpoint, both measures flashed significant value in late-April and the sector has since outperformed by 7%.

3. Lack Of Consistent Leadership

Leadership has rotated very frequently within Real Estate as its produced far and away the weakest Momentum factor performance (-21%) of any sector over the last two years (**Chart 6**). This is consistent across Small Caps, as well, which is a tell-tale signal that investors are unsure of how winners and losers will shake out.

The shifts in industry leadership illustrates this point. Retail, Office, Storage, and Health Care have been among the biggest beneficiaries this year after enduring significant weakness in 2023. Alternatively, Hotels and Industrials are now middling after having enjoyed strong post-COVID reopening bursts.

Yielding Relief

Real Estate performance exhibits the second strongest negative correlation to the 10-year U.S.

Chart 7 Real Estate Benefit From Lower Yields

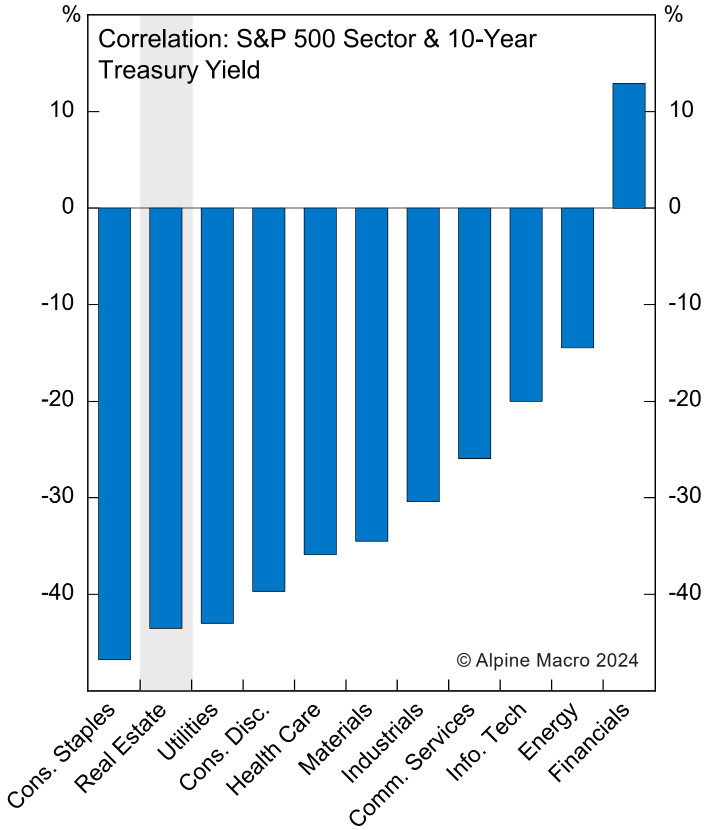
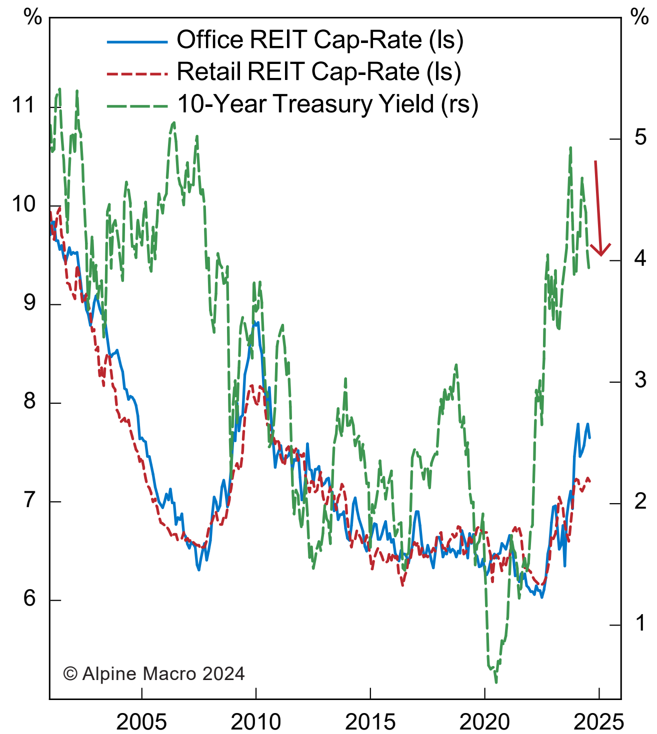


Chart 8 Yields ↓ = Cap Rates ↓ = Values ↑



Source: Bloomberg Finance L.P.

Treasury yield of any sector within the S&P 500 (**Chart 7**), meaning that a pivot away from "higher-for-longer" should be a tailwind for the group even if some of this has already been priced in.

The impact of yields on Real Estate equities are transmitted primarily *via* three mediums: 1) funding costs, 2) cap rates, and 3) opportunity cost, or relative valuation.

The jolt higher in yields at the breakneck pace of 2022-2023 provided a historically poor environment for Real Estate from a funding perspective as the sector is purposefully dependent upon leverage, trailing only Utilities in average net debt-to-EBITDA. Since 2022, total interest costs for S&P 500 Real Estate components have spiked 54% putting significant downward pressure on interest coverage and taking a larger bite out of pre-tax earnings.

Meanwhile, higher rates put upward pressure on capitalization (cap) rates, or the yield of a property's net operating income relative to its market value. All else equal, higher cap rates depress the market value for properties and projects. As shown in **Chart 8**, cap rates across a variety of Real Estate industries spiked in 2022 alongside U.S. Treasury yields, with the national average across all equity REITs moving from 4.5% in Q4 2022 to over 6% more recently. This movement pushed the market value of REIT assets lower relative to debt (**Chart 9**).

Finally, Real Estate is often heralded for offering the highest dividend yield of sectors in large part due to the regulatory requirements governing their structure. When yields on competing assets are low it induces more interest to Real Estate from the yield-sensitive investment community whereas an abundance of yield can steer them elsewhere, including money markets and fixed income.

Verdict: The transition from a period of zero interest rates (ZIRP) and quantitative easing to a sharp hiking cycle paired with balance sheet tightening was a perfect storm for Real Estate equities over the last two years, and that's before considering well-publicized commercial real estate dislocations.

Simply put, it can't get worse and we're now in the early stages of enjoying a moderate level of relief.

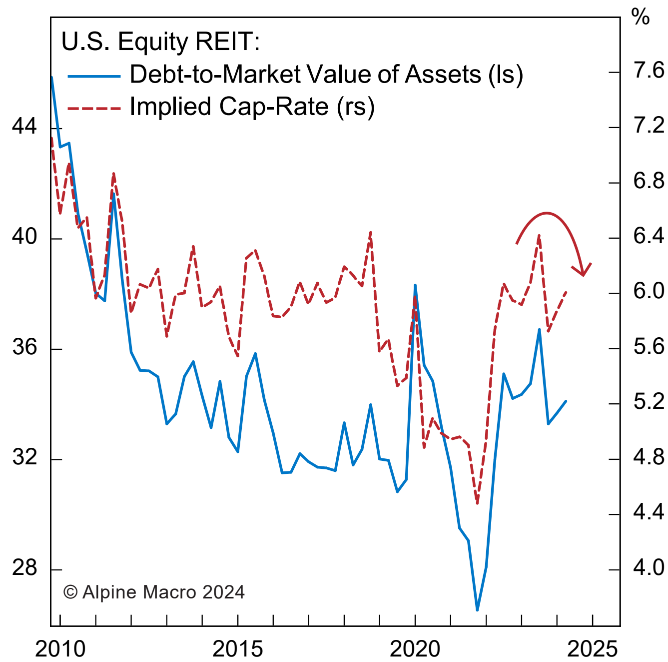
Conclusion: Good Not Great

The bottom line is that Real Estate remains well positioned, overall, to benefit from easing policy and a broadening of profit growth although performance is likely to be scattered across certain industry groups which exhibit fundamental tailwinds while the mean-reversion "juice" has been squeezed from more vulnerable segments.

Upside to our base case would come from materially lower yields lower cap rates, while stronger than expected profit growth pushes demand for rents and leases higher. Downside risks would include higher than expected intermediate yields, pushing up the cost of capital, and a downturn in the labor market putting pressure on consumption.

The balance of risks and full valuation lead us to advocate a neutral strategic weight for the sector. From an industry standpoint, we prefer Senior Housing Health Care, Management, and top-tier Office exposure relative to Residential and Hotels. Within the Specialized space, prefer companies partnering with hyperscalers through interconnection and colocation of data center services as opposed to Towers.

Chart 9 Turn In Yields To Boost Market Value



Source: Bloomberg Finance L.P.

S&P 500 Real Estate companies with preferred exposure include: **DLR US, EQIX US, CBRE US, BXP US, WELL US, VTR US**

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Appendix 1 Industry Group Preference Matrix

Industry	Cap Weight	Average Weighted Concentration*	Drivers, Developments, and Determinants	Valuation (+/-)	Technical (+/-)	Alpine Rating
Health Care	12%	38%	Secular growth from aging U.S. population, especially relevant in senior housing (SHOP) where occupancy demand outpaces supply. Cyclical upside from top-line rent growth paired with expanding margins given slower wages and maintenance expense	-	N	+
Hotel & Resort	1%	100%	Group & business travel increasing but leisure trends negative. Q2 U.S. outbound international travel was 119% comparable 2Q19 levels but inbound international just 88% of 2Q19 comps. Natural disasters (Maui wildfires) have been a headwind Upside if leisure travel rebounds but higher rents, wages, insurance/tax expenses are headwinds	N	-	-
Industrial	10%	100%	Single-name industry with U.S. concentration generating above average (~8%) growth tied to warehouse and logistic build-out. Potential upgrade in rental rates as below-market leases reprice Upside in shift to logistic services but execution a risk. Upturn in manufacturing would be supportive for occupancy	+	+	N
Office	1%	100%	Better and broader corporate earnings growth supports better leasing environment (U.S. office leasing +30% yoy) with companies preferring to lure talent to office with carrot (perks) as opposed to stick (mandates) Vacancies and rent recovery more advanced in Northeast (NYC) than West Coast and Midwest	+	+	+
Management & Development	6%	50%	Segment to benefit from improved leasing and capital market backdrop, supporting deals and CRE service demand which comes with lower execution risk than development Residential leader making push for double-digit growth from international markets and digital	-	N	-
Residential	13%	16%	Multifamily strength given favorable rent > own pricing dynamics and resilient labor market supporting wages and occupancy. New developments and continued rent raises are tailwinds Risks in overbuild Sunbelt from lower rates making ownership more affordable. Potential political risks from building.	N	+	-
Retail	13%	30%	Dual-track demand characterized by weakened lower income consumer, but resilient upper income shoppers supports properties in denser/wealthy locations Downside risks include weaker consumer or increased bankruptcies-neither our base case	+	N	N
Specialized	44%	12%	Data centers drive the hype but not all exposure is alike. Favor interconnection relative to brick-in-mortar exposure which comes with greater obsolescence risk. Tower at risk of lower capex from telecom giants- 5G refresh cycle pushed to CY26 Storage should benefit as lower rates induce homebuying, office leasing, and moving	N	N	N

*Average Weighted Concentration calculated as Herfindahl-Hirschman Index expressed in percentage terms.
+ indicates favorable, N neutral, and - unfavorable

Investment Recommendations				
Strategic Recommendations (6 - 12 months)				
Recommendations	**Open Date**	**Performance**		**Active Return**
		Vehicle	**S&P 500**	
Long S&P Industrials	5/29/2024	11.77%	8.73%	3.04%
Long S&P Utilities	6/12/2024	14.61%	5.68%	8.93%
Long S&P 600	6/24/2024	7.94%	5.22%	2.72%
Short S&P Materials	7/24/2024	5.36%	5.61%	0.25%
Long Regional Banks (KRX)	8/21/2024	0.20%	1.97%	-1.77%

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