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REAL ESTATE'S PUBLIC QUADRANTS:

Increasingly attractive, as most of the risks are already priced in

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The Fed is tightening into a slowing economy

Dark clouds of a recession hang over investment markets with the Federal Reserve continuing to tighten monetary policy. Markets are pricing for Fed funds to approach 4.5% by year end, possibly higher in 2023 moving into restrictive territory. While the yield curve remains ambiguous and corporate credit spreads do not show stress yet, we expect a moderate recession in 2023 under our base case, with job losses of two to three million. As such, the Fed is likely to be tightening into a slowing economy.

Financial conditions have tightened sharply driven by a surge in the cost of debt capital that has weighed on public risk assets. The public quadrants of commercial real estate have felt the brunt of price discovery in the asset class. There is yet little dislocation apparent in private equity real estate valuations due to a slowdown in transaction volumes.

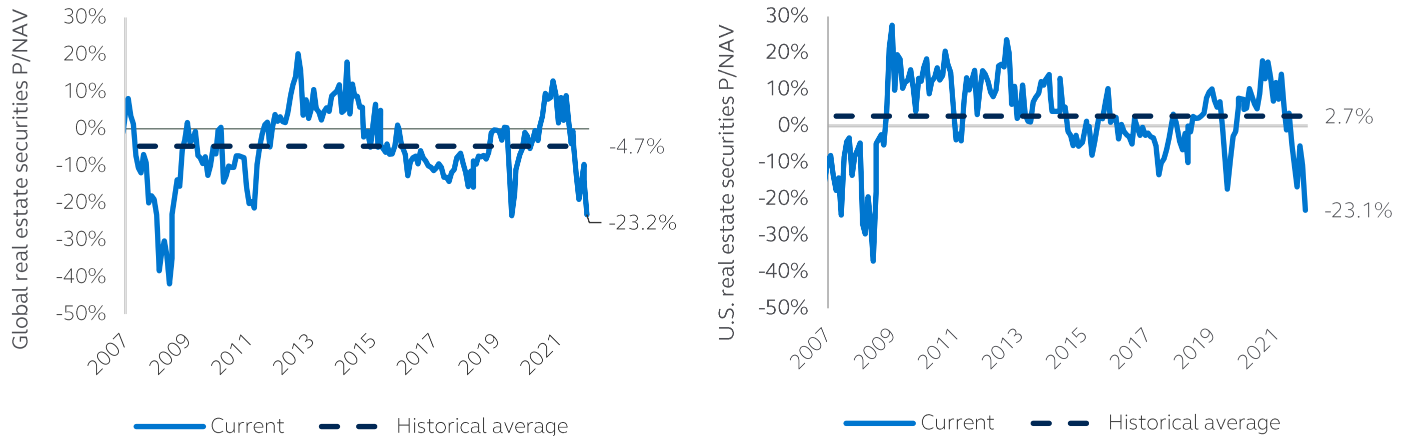
However, the coming quarters may reveal a deterioration in private real estate values consistent with recession expectations and the increased cost of debt. This leaves real estate in a very interesting situation where there is a wide dichotomy in values within public and private equity quadrants of the same asset class.

Real estate's public quadrants are becoming increasingly attractive

Higher interest rates and a looming recession have most negatively impacted real estate's public quadrants setting up intriguing opportunities for investors attracted by the discounts it offers. U.S. REITs have corrected approximately 35% from the peak and currently trade at an implied cap rate of 6%+ and 20%+ discount to NAV (Exhibit 1). In contrast, private real estate as measured by the NCREIF NPI index had an average cap rate of 3.8% as of 2Q 2022. As such, it can be argued that most of the rate risks are likely fully priced in REITs and the corrective phase underway is pricing for earnings deterioration under a moderate recession scenario.

EXHIBIT 1: U.S. REIT valuations are worth taking a look

Listed global REITs: Premium (discount) to net asset value

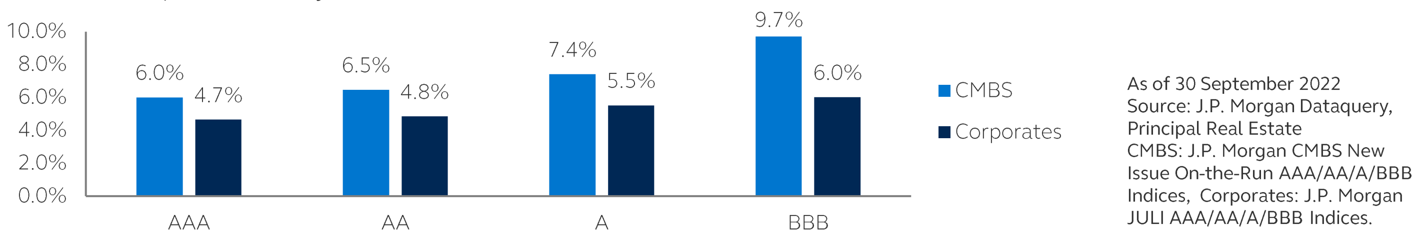


As of 30 September 2022. Source: Principal Real Estate, FactSet, MSCI. The left chart illustrates the weighted average Price/Net Asset Value of the stocks in the FTSE EPRA/NAREIT Developed index. The historical average represents 15 years. The right chart shows the weighted average Price/Net Asset Value of the stocks in MSCI U.S. REIT Index. The historical average represents 15 years.

In public real estate debt, commercial mortgage-backed securities (CMBS) implied credit has slipped in credit quality with equity sensitive "BBB-" trading in line with corporate "B" rated bonds signaling collateral values have likely declined between 15% to 20% pushing yields to a material spread over equivalent corporates. Shorter duration is also a positive in a rising rate environment. We think the level of loss implied is adequate for a modest recession scenario and could offer investors with conviction the ability to climb into some high-quality bonds offering the potential for downside risk mitigation at attractive yields.

EXHIBIT 2: CMBS offers compelling value to corporates

CMBS vs. corporate bond yields



As of 30 September 2022
Source: J.P. Morgan Dataquery, Principal Real Estate
CMBS: J.P. Morgan CMBS New Issue On-the-Run AAA/AA/A/BBB Indices, Corporates: J.P. Morgan JULI AAA/AA/A/BBB Indices.

Picking the trough is never easy, but signs suggest public quadrants are attractive

With public market quadrants, we recognize that it is near impossible to find the absolute trough in values as the economic outlook could continue to deteriorate further. However, we do feel that at current values, much of the economic downside for 2023 appears to be in the price, offering investors the opportunity to tactically begin building some public real estate exposure. In other words, an attractive entry opportunity may be imminent. A severe recession represents the primary downside risk, which could put additional stress on public market valuations. While acknowledging that this is a not a negligible risk, we think investors looking to find pockets of value should take a hard look at public real estate where values are arguably priced for a 2023 recession.

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Index descriptions: The MSCI REIT Index is a free float-adjusted market capitalization weighted index that is comprised of equity Real Estate Investment Trusts (REITs). The index is based on the MSCI USA Investable Market Index (IMI), its parent index, which captures the large, mid and small cap segments of the USA market. The FTSE EPRA/NAREIT Developed Index is designed to track the performance of listed real estate companies and REITs worldwide. The NCREIF Property Index (NPI) provides returns for institutional grade real estate held in a fiduciary environment in the United States. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index.

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