# Hike, Stop, and Bounce: REIT Performance After Monetary Policy Tightening Ends

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**Monetary policy tightening cycles** typically mark inflection points in the US economy and financial markets. Rising interest rates can create headwinds for financial and real estate markets, and REITs have certainly faced their fair share of challenges over the past two years. With the Federal Reserve (Fed) entering a more accommodative period, REITs are well positioned for a period of outperformance. Historically, they have enjoyed a resurgence in total returns after monetary policy tightening cycles end. In fact, REIT total returns bounced back with impressive performance in the last quarter of 2023. Based on historical experience, the convergence of the wide valuation gap between public and private real estate will likely ensure continued REIT outperformance into 2024. Disciplined balance sheets have also prepared REITs well for market uncertainty and paved the way for potential opportunistic real estate acquisitions and growth.

## Fed Rate Hikes

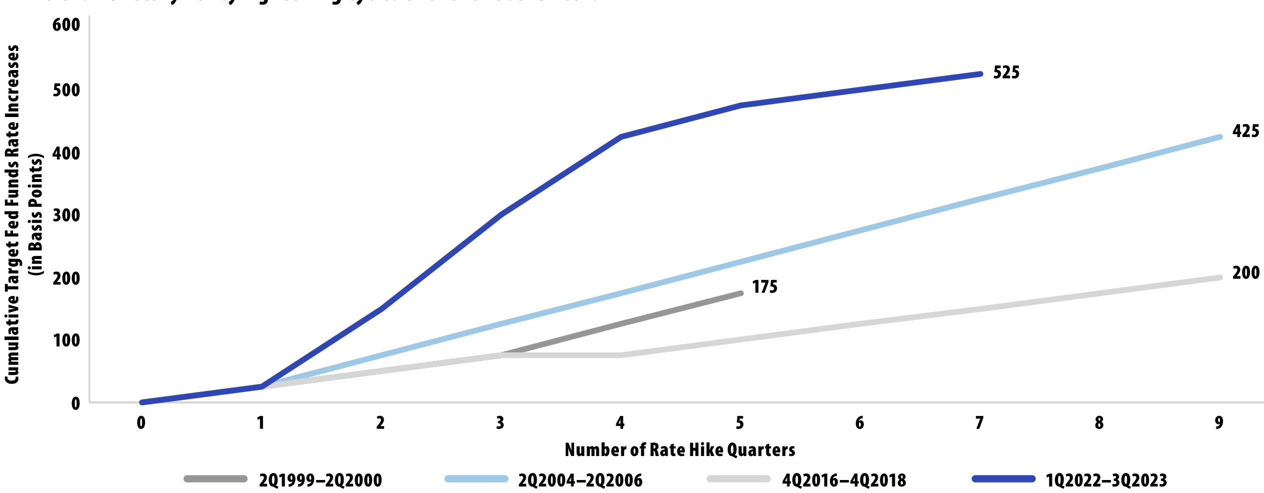
The Fed implements monetary policy to uphold its congressional mandate of promoting maximum employment, price stability, and moderate long-term interest rates. At times throughout its history, the Fed has followed a targeted rate policy as a tool to achieve its objectives. Since 1982, it has targeted the federal (fed) funds rate. The Federal Open Market Committee (FOMC) executes open market operations, tightening or loosening monetary policy by raising or lowering the target fed funds rate, respectively. Policymakers began using forward guidance, or sharing their economic and policy evolution expectations, as an additional policy tool in 1999.

Since the implementation of forward guidance, there have been four episodes of monetary policy tightening. Exhibit 1 displays the target fed funds rate increases and their durations on a quarterly basis for each of the four tightening periods over the past 25 years.

Each set of interest rate hikes was unique with differing financial and economic market backdrops.

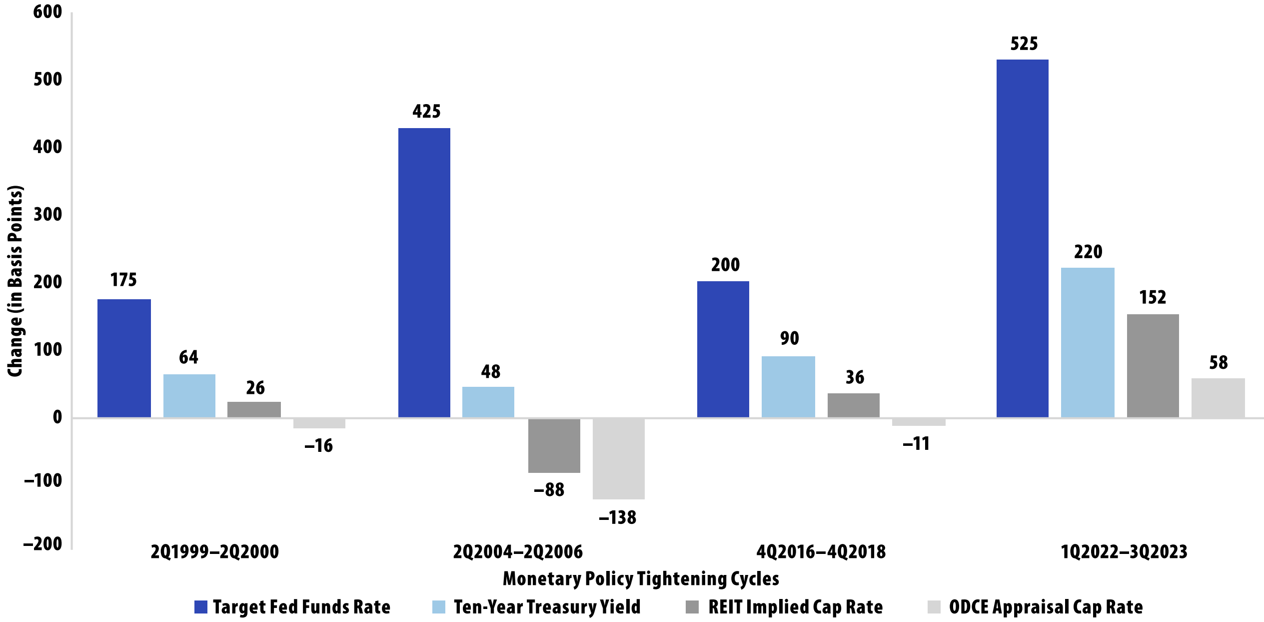
- The FOMC increased the target fed funds rate a total of 175 basis points (bps) between the second quarter of 1999 and second quarter of 2000 in response to the dot-com boom. The tech-heavy Nasdaq Composite Index surged nearly 86% in 1999. It gained an additional 24% by March 2000 but then lost more than half its value by

**Exhibit 1: Monetary Policy Tightening Cycles Over the Past 25 Years**




**Sources:** Federal Reserve Board, Nareit

**Exhibit 2: Rate Changes During Monetary Policy Tightening Cycles**




**Sources:** FRED, Federal Reserve Bank of St. Louis, Federal Reserve Board, Nareit, NCREIF

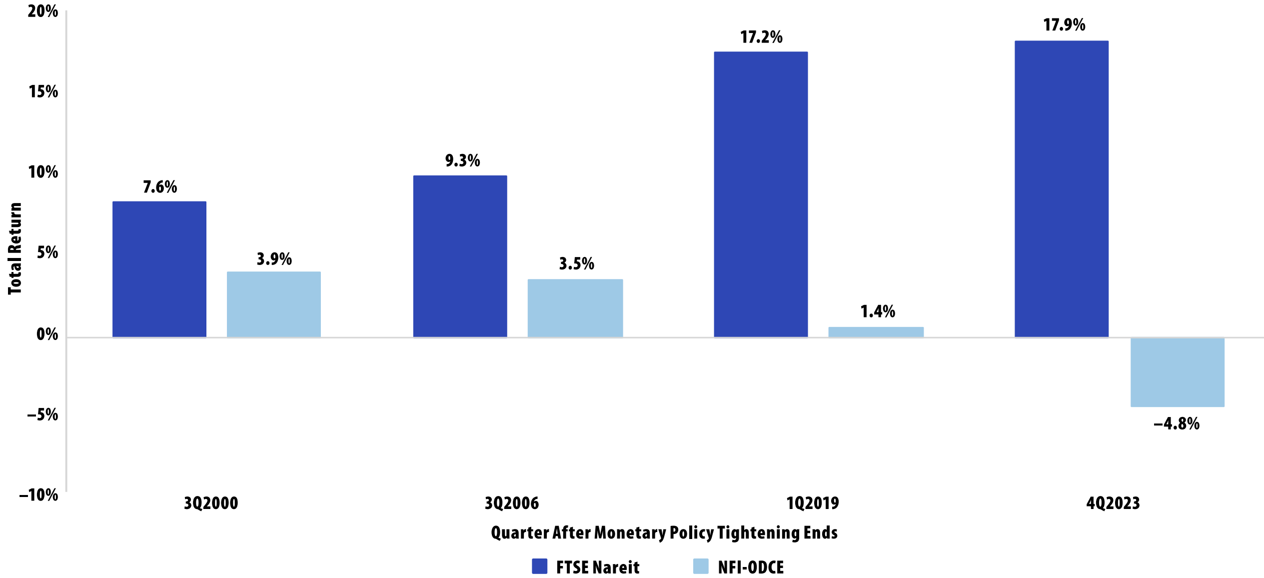
year-end 2000. The bust concluded in Oct. 2002, with the Nasdaq down 78% from its peak.

- In response to an overheating for-sale housing market, the FOMC raised the target rate by 425 bps from the second quarter of 2004 to the second quarter of 2006. According to the S&P CoreLogic Case-Shiller US National Home Price Index, home prices increased at an average annualized pace of nearly 10% from the beginning of 2000 to their peak in July 2006. By February 2012, the housing bubble had deflated by more than 25%.
- Rate hikes initiated from the fourth quarter of 2016 to the fourth quarter of 2018 were an effort to return to normalcy after the significant rate cuts stemming from the global financial crisis. During this time, inflation was not a factor and the employment situation remained solid. The FOMC increased the target fed funds rate a total of 200 bps over a period of nine quarters—the slowest average pace of rate hikes of the four examined cycles.
- The most recent tightening cycle from the first quarter of 2022 to the third quarter of 2023 was a move against accelerating inflation. The Personal Consumption Expenditures Price Index year-over-year change peaked at a 7.1% gain during the rate escalation period; the inflation gauge measured 3.3% at the time of the last rate increase. With an increase of 525 bps across seven quarters, it was the FOMC's most aggressive intervention.

Although the Fed aspires to maintain economic stability, soft landings after periods of monetary policy tightening have proved to be elusive. Each of the first three examined rate hike cycles was followed by a recession. The last time the Fed was able to execute a soft landing after an extended period of strong economic growth was in the mid-1990s. Though it is too early to call a soft landing after the most recent tightening period, economists have become more optimistic that the US may avoid a recession. As of Dec. 2023, the Bloomberg survey report of US economic forecasts placed the odds of a recession in the next 12 months at 50%; it was 70% in Dec. 2022.

Rising interest rates can create headwinds for financial and real estate markets. Exhibit 2 presents changes in the target federal funds rate and ten-year Treasury yield as well as changes in public (REIT-implied) and private (appraisal) real estate capitalization (cap) rates over each of the four examined sets of rate hikes. REIT-implied and appraisal cap rates were sourced from the Nareit Total REIT Industry Tracker Series, or T-Tracker, and NCREIF, respectively. NCREIF appraisal cap rates solely focused

**Exhibit 3: Next Quarter Real Estate Performance After Monetary Policy Tightening Cycles End**




**Sources:** Federal Reserve Board, Nareit, NCREIF

on properties from open-end diversified core equity (ODCE) funds.

The examined rate changes shine a light on the influence of monetary policy tightening on financial and real estate markets. Unsurprisingly, ten-year Treasury yields followed upward trajectories with FOMC rate increases across each of the cycles. Cap rate movements were mixed. Public real estate cap rates increased in three of four instances; private appraisal cap rates increased in only one case. A closer review of the chart reveals that ten-year Treasury yields had the greatest sensitivity to FOMC hikes, followed by REIT-implied cap rates and then ODCE appraisal cap rates. In fact, appraisal cap rates appeared to be somewhat disconnected from market realities. Although real estate total returns were negative only during the most recent tightening episode, REITs, on average, underperformed private real estate during those cycles.

## REIT Return Bounce

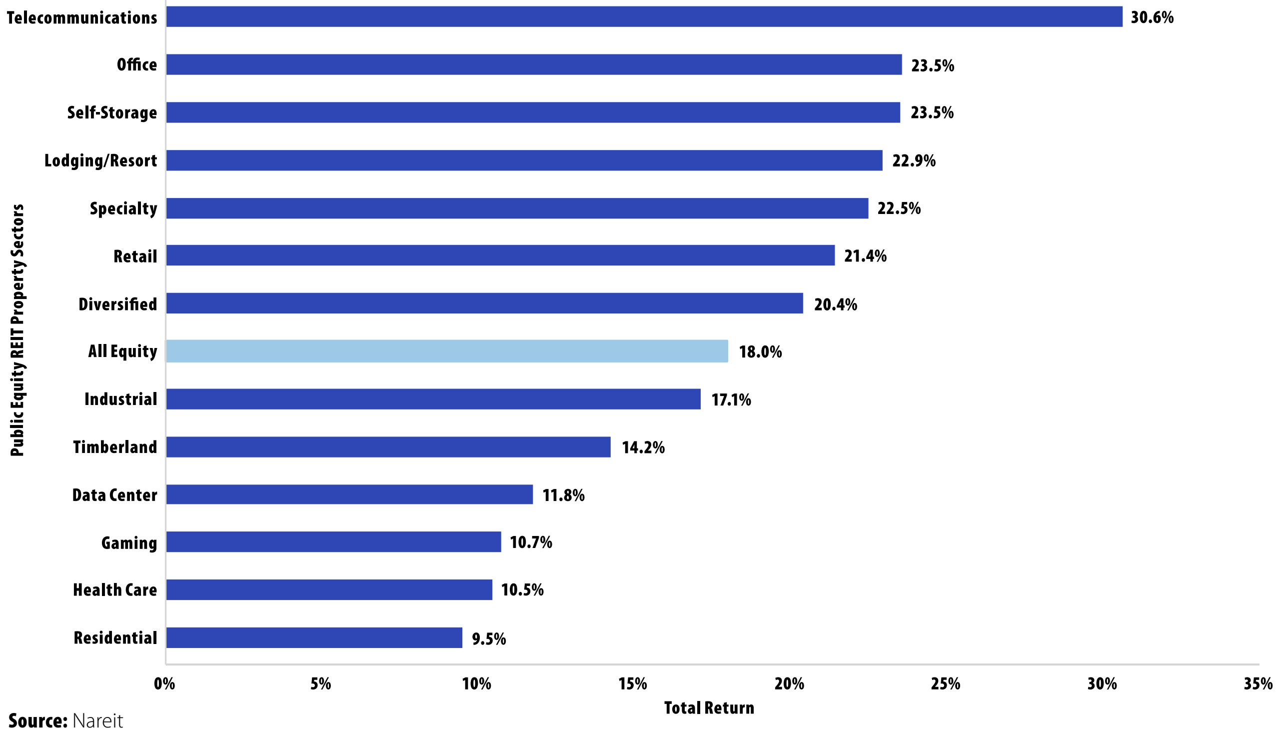
REITs may have tended to underperform private real estate during FOMC rate hikes, but they have historically enjoyed a resurgence in total returns after monetary policy tightening cycles end. Exhibit 3 shows public and private real estate total returns in the quarter after tightening periods ended. Public equity REIT and private equity real estate performances were measured by the FTSE Nareit All Equity Index (FTSE Nareit) and NCREIF Fund Index—Open End Diversified Core Equity (NFI-ODCE), respectively.

In each of the four rate hike cycles, public equity REITs outperformed private real estate in the quarter after monetary policy tightening ended. On average, the FTSE Nareit outperformed the NFI-ODCE by 12.0%. Over the past 25 years, the bounce in REIT total returns has gotten stronger and private real estate performance has weakened, resulting in expanding REIT outperformance through time. The most recent return spread for the FTSE Nareit less NFI-ODCE was 22.7%.

Each of the 13 public equity REIT sectors also posted solid total return performance in the quarter after the most recent set of rate hikes. Exhibit 4 shows FTSE Nareit total returns for each of the public equity REIT property sectors in the fourth quarter of 2023, as well as the aggregate FTSE Nareit total return.

With the exception of one, all the REIT property sectors posted double-digit total returns in the fourth quarter of 2023. Telecommunications, which includes cell towers, posted the highest gain, at 30.6%. The residential sector had the lowest increase, at 9.5%; its total return was

**Exhibit 4: Public Equity REIT Property Sector Performance in 4Q2023**




**Source:** Nareit

dragged down by the apartment and single-family home subsectors. Although quarterly performance for the data center sector placed in the bottom half of sectors, it had the highest total return of the year, at 30.1%.

Ranking second among the sectors, office performance was notable in the last quarter of 2023. Although surprising to some investors, the strong performance likely reflects growing sentiment that not all office investments should be painted with the same brush. REITs tend to own high-quality, well-located properties with excellent amenities that remain in demand. Although remote work has become a permanent fixture in the modern workplace, it is not expected to undermine the importance of the office for many firms.

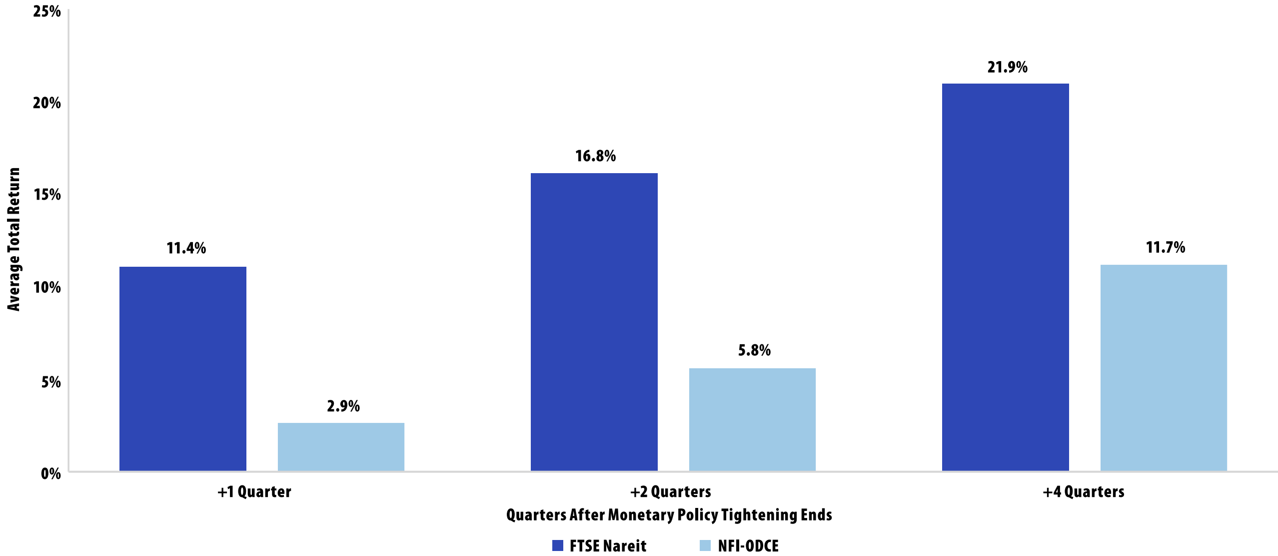
The Aug. 2023 Survey of Business Uncertainty, jointly run by the Federal Reserve Bank of Atlanta, the University of Chicago Booth School of Business, and Stanford University, reinforced the importance of offices for collaboration, innovation, knowledge transfer, and mentorship. It sampled senior executives regarding the past, current, and future states of remote work in the US. The survey found that remote work is anticipated to increase modestly by 2028 with 72.6%, 16.3%, and 11.2% of full-time employees expected to be in fully in-person, hybrid, and fully remote roles, respectively. These results highlight senior executives' expectations that offices will continue to play a vital role in business.

## More Gas in the Tank?

With strong performance in the fourth quarter of 2023, do REITs have more gas in the tank for 2024? Exhibit 5 displays average total returns for the FTSE Nareit and NFI-ODCE after monetary policy tightening cycles ended. The analysis includes the first three rate hike cycles since 1999 and examines one-, two-, and four-quarter post-cycle performances. It excludes the most recent tightening period because of a lack of data to calculate the two- and four-quarter total returns.

Across each of the post-cycle time horizons, REITs, on average, outperformed private real estate. While past performance may not be indicative of future results, the wide valuation divergence between REITs and private real estate will likely ensure continued

**Exhibit 5: Public and Private Real Estate Performance After Monetary Policy Tightening Cycles End**




**Sources:** Federal Reserve Board, Nareit, NCREIF

REIT outperformance into 2024. The gap between REIT-implied and private appraisal cap rates has been stubbornly slow to close. As of the third quarter of 2023, the most recent data available, the spread was 216 bps. With the perspective that REIT-implied cap rates move to private appraisal cap rates, all else being equal, closing the REIT-implied–appraisal cap rate gap would require REIT gains of more than 50%. Though this valuation adjustment represents an extreme scenario, further material valuation gains are likely on the horizon for REITs.

## 2024 REIT Tailwinds

In 2024, REITs are anticipated to benefit from three tailwinds.

- REITs have typically enjoyed strong absolute and relative total returns after monetary policy tightening cycles end. With the Fed entering a more accommodative period, REIT total returns are poised for a period of continued outperformance.
- The divergence between REITs and private real estate valuations will likely converge in 2024. This convergence is expected to ensure REIT outperformance relative to private real estate, thus making REITs an attractive option for investors.
- Though a higher interest rate environment may continue to create challenges for real estate, disciplined balance sheets have prepared REITs well for market uncertainty and paved the way for opportunistic real estate acquisitions and growth.

Potential total return outperformance, attractive pricing with converging valuations, and solid balance sheets increase the investment appeal of REITs. Public equity REITs provide an important tactical advantage at this point in the real estate cycle. ■

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