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REITerating Our Macroeconomic View | June 2012

May was anything but a boring month, though there was very little REIT specific news to report. The MSCI US REIT Index (RMS) declined along with the broader indices, producing a total return of -4.6%for the month. Year to date, REITs are still up +8.8%. This compares with the S&P 500 total return of -6.0% for the month, and +5.2% for the year to date period. In a time when the market prices of our investments are driven more by events outside of their (and our) control, we thought it prudent to take a step back walk through our interpretation of the current macroeconomic environment and examine how various outcomes would affect the REIT universe.

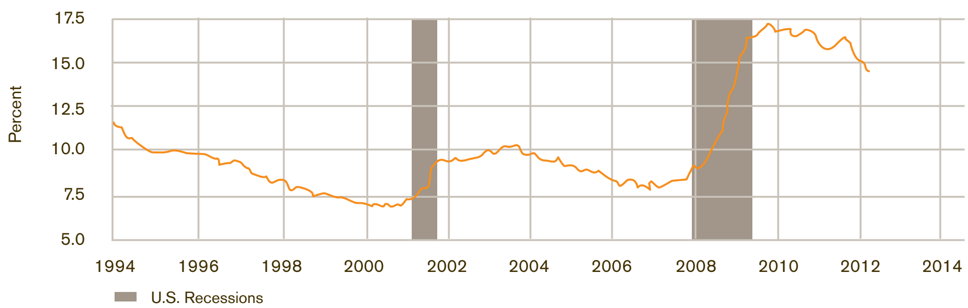
This month we are again flexing the Chilton Investment Team muscle by featuring macroeconomic analysis from our Economic Analyst Sam Rines. He is also the Lead Contributor of *Chilton Currents*, a monthly publication on the Chilton macroeconomic view. Issues of *Chilton Currents* can be found at http://www.chiltoncapital.com/currents/index.html.

Employment and Wages

"US data shows a recovery underway, although not robust enough to maintain itself. Housing prices have stabilized, and housing starts are beginning to show some signs of life at an annual rate of 717,000 after a bottom of 478,000 and off a high of over 2 million. The savings rate, initial jobless claims, and unemployment rate all remain significantly elevated but have been trending positive. Interest rates and inflation expectations remain well within the Fed's comfort zone, and GDP is projected to be robust going forward.

One conundrum of the ongoing economic recovery is the apparent absence of meaningful and sustained job creation. The headline unemployment rate sits at a still elevated 8.1% with a labor force participation rate, 63.4%, the lowest in decades. The 'U6' rate of unemployment, which includes all individuals marginally attached to the labor market and working part time due to economic reasons, has declined over the past year from 15.9% in April 2011 to 14.5% in the April 2012 Bureau of Labor Statistics (BLS) report, as shown in Figure 1. Still, this figure is much higher than the pre-crisis decade average of 8.6%. The BLS report indicated an increase of 115,000 jobs, a number well below the historical norm for this point in the cycle and a sign of some stagnation in the jobs market. An addition of 115,000 represents a decline from 154,000 jobs in March 2012 and 251,000 jobs in April 2011. Another way to look at employment is the Initial Jobless Claims, a measure of the number of people who file for unemployment benefits

FIGURE 1: TOTAL UNEMPLOYED PLUS ALL MARGINALLY ATTACHED WORKERS PLUS TOTAL EMPLOYED PART TIME FOR ECONOMIC REASONS (U6 RATE)



SOURCE: U.S. DEPARTMENT OF LABOR: BUREAU OF LABOR STATISTICS in a given week. A lower number would indicate more people are finding jobs and ending their unemployment benefits. For the week ending May 18, the figure was 370,000, a number that again is worse than what would be expected for a recovery cycle and evidence businesses are still cautious of hiring.

Employment numbers are headline grabbers and garner talk from politicians, but wages and hours worked are signs of the vitality of the economy. According to the BLS April report, the average US worker was on the job for 34.5 hours per week and took home an hourly wage of $23.38. Both of these indicators have trended higher during the recovery. The compounded annual growth rate for hourly wages over the past year has been 1.9%, a number that may sound positive on the surface. However, inflation is currently running at 2.3% for the month of April, as measured by the Consumer Price Index. Therefore, wages are increasing less than the cost of goods for the consumer, causing a decline in discretionary income. Without an increase in discretionary income, it is difficult for consumers to increase consumption and as a result, real GDP.

Interest Rates, Inflation, and the Fed

Inflation and interest rates are central to Federal Reserve policymaking. The Fed has made it clear the long-run target for inflation is 2.0%. At 2.3%, inflation does not cause distress for the Federal Reserve. Economics values expectations about the future, and in some ways, the future matters more than the present. The Cleveland Reserve Bank (yes, it is a real place) estimates inflation expectations, an integral data point for understanding the future course of interest rates. The April 24–25 release showed expected inflation of 1.38% over the next decade and 1.94% over the next 30 years. With expectations anchored below the target of 2.0%, it is unlikely that the Fed will have to raise interest rates to quell inflation in the near-term.

Understanding asset purchases or 'quantitative easing' is essential in order to grasp the interconnectedness of the Fed and interest rates. The Fed has used quantitative easing to affect both the short and long end of the interest rate curve. The long end, especially the 10 year Treasury rate, directly relates to mortgage rates and borrowing costs. The Fed is aiming to keep the entire curve low until the economy shows it can again function on its own as evidenced by two rounds of quantitative easing in addition to 'operation twist', where the Fed rolled shorter term Treasury holdings into the longer end of the curve.

Transparency has not always been a cornerstone of Fed policy, but the Fed has begun to disseminate additional information regarding interest rate expectations and GDP growth rates in its Open Market Committee (FOMC) release. An open Fed creates an additional tool to spur markets in its desired direction. The minutes from the latest FOMC meeting showed the majority of committee members expect the federal funds rate will remain below 1% through 2014. The committee states the projected long-term rate is 4% with the majority of participants (7) agreeing rate increases will not occur until 2014; 4 believe an increase would not be appropriate until 2015.

All of the above is working to keep the curve down. The 10 year Treasury rate declined to 1.6% during May, a historic low. In addition to the Fed's intervention programs, the situation in Europe is also pushing down the rate. The US, considered a safe haven for investors, is blessed with being the world's reserve currency. Because the crisis in Europe has caused a flow of funds to seek a safe place, Germany (the 10 year Bund rate is around 1.2%) and the US are currently the most attractive places to store funds.

This leaves the Fed in a great situation. There is no need to step into the market to keep interest rates low with the Euro crisis causing rates to decline to record lows, the real economy has yet to feel a substantial effect from Europe, and housing has stabilized. Current inflation expectations remain subdued, providing the Fed with the ability to return to easing if the economy does not continue to recover. The evidence points

FIGURE 2: REIT PERFORMANCE IN PERIODS OF RISING INTEREST RATES

Period Start	Period End	Number of Months	Change in Rate (bps)	Annualized Return
Dec. 1971	Apr. 1975	41	242	-3.5%
Dec. 1976	Sep. 1981	58	903	18.0%
Feb. 1983	Jun. 1984	17	357	21.1%
Aug. 1986	Sep. 1987	14	267	4.9%
July 1989	Apr. 1990	10	122	-10.1%
Sep. 1993	Nov. 1994	15	252	-8.9%
Jan. 1996	Mar. 1997	15	132	26.4%
Sep. 1998	Jan. 2000	17	225	-5.1%
May 2003	Jun. 2006	38	177	25.5%
Dec. 2008	Mar. 2010	16	161	29.3%
Aug. 2010	Mar. 2011	8	100	32.5%
AVG. TOTAL		**23**	**267**	**11.8%**
MODERN REIT ERA		**18**	**175**	**16.6%**

SOURCE: BLOOMBERG

to low interest rates, across the curve, for a significant time. Although interest rates are incredibly low and it would be tempting to project rising rates, rates on the US 10 year Treasury rate are more likely to stay range-bound between 1.25% and 2.50% with a tilt towards the lower end until the Fed feels the economy has healed completely."

Impact on REITs

Though we believe that rates are going to stay low for the foreseeable future, we are mindful of the risks associated with rising rates. Because REITs are a yield-oriented asset class, a rise in rates is considered to have a negative impact. However, a look at historical data on the performance of REITs during a time of rising rates shows that this notion may not be warranted. Figure 2 displays the 11 periods in which the 10 year Treasury rate trended upward since the creation of the NAREIT All Equity Index (Bloomberg: FNER) in 1972. In those periods, the average annualized return of REITs was +11.8% and the average change in the US 10 year Treasury rate was 267 basis points. Looking at the modern REIT era (post-1992), there were 6 periods of rising rates. Those periods had an annualized return for REITs of +16.6% and an average change in rate of 175 basis points.

Research from JP Morgan corroborates the findings in Figure 2 and takes the data one step further. According to JP Morgan, the average REIT total return for the first month after a spike in the US 10 year Treasury rate of more than 2 standard deviations has been -7% in the 6 such instances since the start of the Modern REIT Era. However, the average return for the following 12 months was almost +15%, indicating investors returned to the asset class after the initial rate spike. Therefore, though we would prefer that an increase in rates be gradual, a sudden spike would only be a temporary drawback to our positive outlook on REITs for the next 3–5 years.

We have completed extensive analysis on various scenarios for what the impact of rising rates would be on future REIT performance. Based upon our analysis, dividend growth in our portfolios should average 8% annually between now and 2016. Assuming no change in multiples over this period (a scenario which we view as unrealistic), internal rates of return would average 11.7%. We stress-tested our models assuming a conservative rise in the US 10 year Treasury rate from the current level of 1.6% to 3.0%. Under this scenario, investors would still witness internal rates of return of 7.6% annually. Only when the US 10 year Treasury rate goes above 4% were positive returns threatened, which would require a move beyond the 175 bps average we have seen since the start of the Modern REIT Era in 1992. However, as Mr. Rines illustrated above, we believe rates will remain range-bound and anchored until the economy has completely healed.

A Unique Real Estate Cycle

Historically, rising rates have been associated with better economic conditions. Since commercial real estate can be viewed as a look-through to the health of the overall economy, this helps to explain the positive performance in periods of rising rates shown in Figure 2. The current real estate cycle is unique relative to cycles we've been through over the past forty years because so many fundamental factors are working in favor of the REITs with only modest economic growth. The lack of new supply has been such a powerful buoy to commercial real estate fundamentals that it has more than made up for lackluster demand. For the first time since 2007, a few REIT CEOs are actually describing "landlord conditions" unfolding in a variety of property types, namely apartments, lodging, storage and, more recently, luxury malls and San Francisco office. "Landlord conditions" occur when owners of real estate are witnessing pricing power, although it can be present in varying degrees. Not far behind these property sectors is the industrial sector, where rising net absorption of space has helped move the rent needle to such a degree that landlords now estimate positive rent spreads occurring later this year. Outside of San Francisco, office is the laggard. However, central business district (CBD) office is vastly outperforming suburban office.

The Search for Yield is Only Part of the Reason REITs Are Attractive

While REIT valuations appear elevated today upon first glance, we believe it is for fundamental, justified, and sustainable reasons. Low interest rates have helped bring down yields and lift stock prices. The outperformance of real estate stocks relative to the S&P 500 over the past 10 years is attributable to many factors. The better equity REITs are upgrading the quality of their portfolios to primary metro areas, improving balance sheets by laddering debt maturities well into the future, and practicing solid financial disciplines and risk controls on external growth initiatives such as acquisitions and new development. Simultaneously, with historic low dividend payout ratios, internal growth is aided with the reinvestment of excess cash flows back into the business. The major risk factors remaining are the pace of the economic recovery and the elevated volatility in stock prices. As articulated above, interest rates appear to be in check for the foreseeable future, thus making equity REITs a sensible addition to both retail and institutional portfolios looking for income and growth but with a long term investment horizon.

Please feel free to forward this publication to interested parties and make introductions where appropriate.

Previous editions of the Chilton REIT Outlook are available at www.chiltoncapital.com/publications.html

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RMS: 1182 (5.31.2012) vs. 1087 (12.31.2011) vs. 1000 (12.31.2010) vs. 792 (12.29.2009) vs. 933 (9.30.2008) and 1330 (2.7.2007)