How a 10-minute speech in the US affected Australian property

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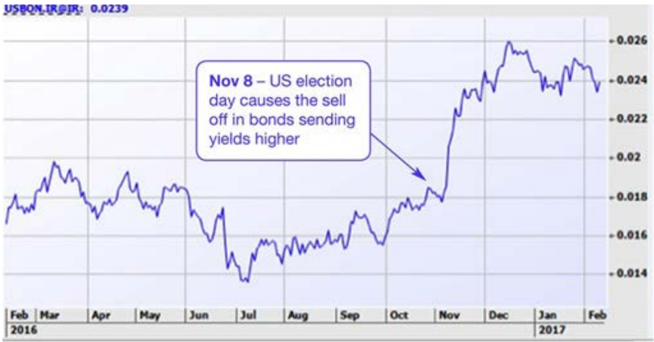
Six months ago, the idea that a 10-minute speech by Donald Trump could impact Australian commercial property was laughable. Not any more. The policies of the new US administration are having a profound impact on interest rates in Australia, especially the 10-year bond rate. And that has implications for AREIT investors.

The following chart shows movements in the US 10-year bond rate over the last 12 months. See that spike in early November? That was the day of the President elect's acceptance speech, which turned investment market opinions on their heads, in just 10 minutes.



Source: Iress 9 February 2017

Defying logic – US equities rally and the bond rate soars

Until that moment, markets took the view that an unlikely Trump victory would spark a sell-off in equity markets and a rally in bond markets. The logic being that risks would rise and safe haven assets (like bonds) would become more attractive, in turn pushing long term bond rates, (which had been slowly rising since July) down. Indeed, in Asia Pacific markets, which were open at the time, that's how it played out.

Then came the speech, which caused markets to forget the conclusions reached over months of steady analysis of the candidate's policies. They turned on a dime. Upon opening the next day, US equity markets rallied and bonds were sold off, causing long term rates to spike rather than fall.

As it turns out, alternative facts aren't solely the preserve of the political arena. Forget the budget deficit and disregard the prospects of a trade war was the message; massive fiscal stimulus and tax cuts would supercharge the stuttering US economy. This was the new logic-defying mantra. Congress had previously refused similar stimulus plans and budget constraints limit the ability to cut income and increase spending. But anyhoo.

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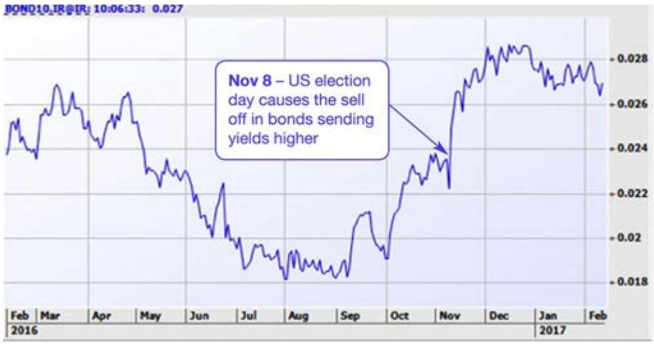

Source: Iress 9 February 2017

Australian bond investors dream wistfully of the US economy

Notice the similarity to the US market from November 8? Forget the fact that the outlook for the Australian economy remains similar to that prior to the US election. Wage growth, along with inflation, remains low; the Reserve Bank is forecasting lower growth; and there are concerns about commodity price reversions and weak budget positions. Not much of this weak outlook is reflected in the local bond market, which has aped US markets despite a different prognosis.

Why the difference? Australian bond investors are less focussed on their own backyard, preferring instead to dream wistfully of US corporate tax cuts and infrastructure spending. Play that out over a few years and it's easy to believe that the US economy is set to grow strongly and inflation will rise. That, at least, is the consensus view. And for those that are sceptical, well, who wants to stand in the way of a speeding train?

Property values are much more important than bond yields

Why does all this matter to the AREIT market? The sell-off in bonds, which has caused bond rates to rise, is tied to weakness in property trusts. It seems the bond market matters because the AREIT market thinks it does.

Research from Citi (26 February 2017) recently studied this topic, analysing the relationship between bond yields and AREIT pricing. It concluded that property values are a more important driver (actually five times more important) than bond yields. The research shows that whilst topical, the reality is that the relationship between bonds and AREIT pricing is "far from stable over time, varying both in strength and direction".

Laser focussed on underlying property cash flows

This vindicates our investment philosophy and strategy. As a dedicated property investment house we're focussed on understanding property assets and markets.

Only through an appreciation of the underlying cash flows that a property generates will you be able to understand value and its trajectory. Bond markets may impact the sector in the short term but over the long term, it is income that matters. For AREIT investors, this is an important lesson in not being distracted by factors, often beyond our control, that seem important whilst they're happening but don't have much impact on long term performance.

After a tumultuous 2016 second half, sector returns have moderated. The 12-month total return from the AREIT sector (to 31 January 2017) was 6.83%[1], approximating to the income return from the sector and no capital growth. After five years of total returns of more than 16% a year, we were probably due for a more sober result. Over the next 12 months, we expect the sector to deliver a total return of around 9%-10%, although, with the market starting to reassess the risk/return outlook in the US, that may prove conservative.

1 As at 31 January 2017. S&P/ASX 300 Property Trust Accumulation Index.

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