REIT mangers keeping an eye on interest rates

By Winston Sammut
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Property investors are keeping an eye on bond and interest rate movements. *LOUIE DOUVIS*

In previous interest rate cycles, movements in monetary policy have generally coincided with peaks and troughs in property markets.

The housing market, particularly in Sydney and Melbourne, is slowing in the absence of any upward movement in official cash rates.

This has occurred in part due to tighter lending conditions by the banks responding to moves by the Australian Prudential Regulation Authority (APRA), introducing new risk weighting classifications for different loan purposes and types.

As an example, a significant amount of previously classified home loans have been reclassified as investment loans attracting a higher risk weighting.
Other changes to loan types and terms, repayments and valuation ratios are ongoing and impact across all lending markets. At the same time, short-term commercial rates have also increased with short-term bank bill rates trading around 2 per cent.

In recent times, long-term bond yields in the US and Australia have risen. The movement in US rates is seen as significant with the US benchmark 10-year bond now trading above 3 per cent on a sustained basis for the first time since May 2018, touching new seven-year highs.

The rise in US rates follows continued strong economic data as well as the lowest unemployment rate, 3.7 per cent for some 50 years. This stronger US data and US Federal Reserve rhetoric has resulted in markets increasing the risk premium on financial assets.

Domestically, economic data has remained positive while the RBA has maintained the official cash rate at 1.50 per cent.

At this stage the Fed has signalled the era of accommodative monetary policy is over and is gradually increasing the official interest rate.

Markets are building in a further increase by the Fed of 0.25 per cent at its December 2018 meeting and two more 0.25 per cent increases in the second half of the 2019 financial year, taking the Fed Funds rate to 3 per cent by June 2019.

The market expects US 10-year bonds to increase to circa 3.5 per cent by the end of 2019. Markets are also aware of the real possibility of a faster moving Fed should inflation pick up, as they move to that elusive and yet to be determined "new neutral" monetary policy setting sooner rather than later.

The outlook for domestic long-term bond yields remains largely unchanged, in that they will continue to be influenced by movements in US bond yields.

Looking out over the next 12 months, Australian 10-year bonds are likely to move upward in line with US rates, to settle around the 3 per cent level, currently 2.6 per cent, although the cash rate is likely to remain lower for longer.

Having regard to the yield of the Australian Real Estate Investment Trust (A-REIT) sector currently sitting at around 5.3 per cent with a potential to grow to around 5.5 per cent over the next 12 months, the sector's yield differential of 2 per cent to 2.5 per cent over our 10-year bond rate is considered attractive and supportive of the sector.

An additional attraction for the A-REIT sector also stems from the prospect of continued merger and acquisition activity.

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