Fidelity Connects

Global Real Estate Amid Rising Inflation

Steve Buller, Portfolio Manager

Pamela Ritchie, Host

Announcer: Hello and welcome to Fidelity Connects, a Fidelity Investments Canada podcast, connecting you to the world of investing and helping you stay ahead.

Portfolio Manager Steve Buller joins us today. For Canadian investors, Steve manages Fidelity Global Real Estate Fund.

U.S. CPI data for the month of July has come in at 8.5%. We now wonder if this downward pressure on CPI indicates a more dovish call from the Federal Reserve in September. And today with Steve we look at how this could impact commercial real estate and the REIT market globally.

Additionally today, Steve shares the real estate trends he is following with host Pamela Ritchie and touches on his fund's positioning and investment strategy.

This podcast was recorded on August 10, 2022.

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Pamela Ritchie: Great to see you, Steve. How are you?

[00:01:40]

Steve Buller: Yes, good morning, Pamela. I'm good.

[00:01:42]

Pamela Ritchie: Great to have some time to chat with you today. Okay, let's go straight to that print. It was not as bad as expected. We still have high inflation, there's no question there. I guess, ultimately, how do you look at a print like this? Do you sort of agree with the reaction from equities, for instance?

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Steve Buller: The stock market often is about the expectation game. Since it was slightly lower than expectations, there's a little bit of excitement today. It's still a very high number and in a weird way that's actually good for commercial real estate. As we've seen over long periods of time, that high inflation and real estate is sort of an inflation hedge and we've seen that in the statistics.

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Pamela Ritchie: Fascinating. We're going to talk a lot about commercial real estate, ultimately. Where, ultimately, do you think this might put us in the discussion of where rate hikes go from here? This is the question, isn't it? This is sort of the presage of what Jerome Powell will have to work with in terms of data prints on the way to a September meeting. How many basis points do they move up or not? I mean, it's hard for you to know but I'm just sort of curious how important this data is in that story.

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Steve Buller: In some respects, short-term interest rates are not that important to real estate. It's more what's going on in the longer end of the curve because real estate is a long-term asset and is primarily financed with long-term debt. We actually care more what's going in 10-year JGBs, 10-year bunds or in 10-year U.S. Treasuries more than actually on the short end of the curve.

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Pamela Ritchie: How has the dollar affected some of those overall long-term discussions of how other assets have performed around the world? The dollar's been quite a story for months now.

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Steve Buller: Yeah, the U.S. dollar obviously has been very strong. This is a global real estate fund where approximately a little less than 70%, if you take what's going on with the U.S. and the Hong Kong dollar, assuming the *[indecipherable]* is in U.S. dollars. The other side of it has actually ... whether it's the euro, whether it's the sterling or the yen or the Aussie dollar, that depreciation has somewhat hurt the returns on the fund. Now, I don't make huge country bets versus the benchmark, so then I don't make huge foreign currency bets versus the benchmark. Obviously, on an absolute return basis it does matter but on a relative, it really doesn't.

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Pamela Ritchie: Fascinating. Let's take a look at ... I'm curious about the various elements of the commercial market. There are some areas where there obviously has been lots of movement but there are other areas where there just haven't been that many sales. We were speaking to someone else in another context about other ... there is often a bit of a lag in the commercial area if you just haven't actually had transactions happen.

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Steve Buller: Yeah. With kind of the distortions that we did see in the capital markets, first on the debt side and then on the equity side, what is very common is then a pause occurs where you see a widening of the bid/ask spread between what people are willing to sell a building, what people want to buy a building, and also what their cost of capital is. Especially if they're using quite a bit of debt or on the gearing side, people have to ascertain, well, how much debt can I get? What will that cost? And to some respects that flows into what peoples' ability to pay or will pay for a building or portfolio building is. So there's a pause.

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We've actually, in the last couple of days, talked to a lot of commercial real estate brokers and they're seeing it too in their business, anywhere down between 10 and 20% transactions worldwide in the month of July. I think that will start to sort itself out after a while when the sellers adjust to perhaps a new price and buyers then also know what they're willing to pay. I mean, on average, and there's no average building in the world, but an average building in the world so far this year is down between 0 and 5% in terms of value, depending where it's located, depending what it is. But that's a rough estimate that we think has occurred in the market, the private real estate market.

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Pamela Ritchie: The private real estate market. Tell us a bit about the various sectors within commercial. We spoke about this before. Has anything significantly changed in terms of the positioning within the fund looking at either industrial, commercial or different parts of commercial?

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Steve Buller: Since we last talked and this year, and I hate to be boring, but the general emphasis on positioning actually hasn't changed that much.

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Pamela Ritchie: That's not boring. That's sticking with the strategy.

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Steve Buller: That is, and especially with real estate being a long-term asset class. I have what I'll call a balanced approach, that is between risk-on and risk-off, between value and growth, between the reopening trade and, lack of a better term, the work-from-home. I'm kind of in the middle. Some of the sectors that are on the reopening are the gaming sector, the assisted living sector, the retail sector, where late last year and early this year we did increase our exposure to that on kind of the reopening trade. But the same time we also still have exposure to the long-term consistent growers, whether it's data centres, whether it's logistics facilities, whether it's the tower stocks, things like that. So this is this balance and we see it in the market where some days ... and it's also in the equity markets but also in the listed global property securities markets ... that one group of them will trade very well, the next day it will reverse. So we're happy right now with kind of this balanced approach.

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Pamela Ritchie: Very interesting. The all-fascinating office discussion. Where are you there? What are your thoughts? Actually, I think I know where you are in terms of positioning there but what do you think?

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Steve Buller: I am underweight office, especially in North America and the U.K., where I think the work-from-home ... or now, I've got to correct myself... it's now the RTO, return-to-office phenomena and we see this in the statistics. It is just static as can be. Somewhere in the mid-to-high 40s% that people are returning to the office. Now, that's measured even over a week. I'm in the office today and I'm finding Tuesdays and Wednesdays the office is quite full because there's this phenomena that we see is that's when people know that they can do in-person meetings, whether internally or externally, that people will be there to actually conduct them.

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Pamela Ritchie: What about Thursdays?

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Steve Buller: Thursdays? Yes, that's blending and we'll see as we get into the autumn time of year where it's more traditional back-to-work. I think you will see this Tuesday, Wednesday, Thursday where people know that they can get people live, people are expected to be in the office. But companies that are offering flexibility, the Mondays and the Fridays, obviously, are the first two days that people are going to beg for that flexibility. Outside of North America, we do own office because in an Asian context, people still are going to the office for work. Very high utilization rate, for example, in Japan, Hong Kong and Singapore. One, because their dwelling sizes are much smaller, so work from home doesn't do that well and secondly, some of it's cultural where people expect that to happen. So we do have exposure to office but less so within the North American kind of U.K. geographies.

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Pamela Ritchie: One of the other pieces of that story is that people want to be in cities to be with people but maybe working from home within the city, that sort of side. So what does that mean for rentals? I mean, we saw actually the inflation print, the rent equivalent pretty stubbornly where it is. What of that dynamic?

[00:09:15]

Steve Buller: You see that phenomena worldwide that in urban areas as we come out – and we hope it's our post-pandemic, whatever, 5.0 it may be – people want to be in urban areas. They want to have the nightlife, they want to have the restaurants, they want the cultural offerings. That doesn't mean that they want to go to the office every day. And that is very much pronounced whether it's in New York City, whether that's in London, whether that's in Sydney, whether that's in Toronto. That phenomena is alive and well. So we do see apartment rental rates in many of these markets actually, given the supply/demand dynamic, up quite a bit and in some respects the only thing limiting it in some markets is whether if there's some rent control. So that's the only thing that, in some respects, is limiting the ability. If you're in a true market-based rental, things like we see in some cities, you're seeing 15% year-over-year type rental increases. That's not uncommon.

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Pamela Ritchie: That's amazing. I mean, you just wonder how sustainable that is. How sustainable is that? You're the person to ask.

[00:10:21]

Steve Buller: Incomes have gone up, so that's one element of it. People are coming out of the pandemic with quite a bit of savings on that, so those two do support that. Lastly, which is very important, your other option could be to go buy a single family residence or a condo. Where we see mortgage rates around the world gone up that option has also become more expensive. We've seen that in many apartment statistics starting here in the U.S. and also in Europe. The percentage of people that are leaving an apartment to go purchase a residence has actually been falling over the last couple of months. In some respects, it's at very low levels versus the last couple of years. So that means people have the income, they need a place to stay and they will stay in their apartment because they're very reluctant to go pay the mortgage rates and/or the prices that they see in residential dwellings.

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Pamela Ritchie: Been fascinated, like everyone, by the travel story this summer and the leisure opportunities and discussions. Hotels seem to really be having a tough time finding enough people. They're finding people, but enough people to work. A similar story. What does this look like for you going forward? The leisure side of things, the growth.

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Steve Buller: I have moved and *[indecipherable]* risk on an overweight position in lodging stocks worldwide and notwithstanding some of the troubles that airports and airlines are having. I don't want to fly to Toronto at the moment because of the well-known troubles[crosstalk].

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Pamela Ritchie: It's getting better, though, I have to say. It's getting better. But anyway, indeed.

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Steve Buller: The hotel occupancy rate has continued to recover and ADR, average daily rate, around the world, and I'm generalizing hugely, is now above 2019 levels. So people are paying more. What we had is the recovery first started with leisure, the pent-up demand to go do something, to go someplace and what's coming on next is groups, whether it's the small little group, business group, especially with the work-from-home phenomena, people are saying, let's not meet at the office, let's go do an offsite ... or this pharmaceutical company, we haven't had an offsite on this new drug, we need to go bring people in from around the world. So group business is very, very strong in those hotels.

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Lastly is the business transient. As the pent-up demand to go see people in person to do business meetings, especially for sales forces, don't underestimate it. They're usually the highest paying too within a hotel. That's kind of layering on and one reason why we continue to like the lodging industry, even with some recession fears looking out, we think it's a little different this time that you have this post-pandemic, pent-up demand in those three aspects that will compensate for any economic slowdown, if there is any, in the next 12 to 18 months.

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Pamela Ritchie: It's fascinating, as you mentioned, the layering because it's sort of, again, the question of what's sustainable? I mean, can this many people travel for leisure, the summer will end and so on but as you say, all those other things pick up.

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Steve Buller: Yes. Then there's that terminology, term you've probably heard of, "bleisure," the mixing of business and leisure with the flexibility that remote work does offer many people. We see that Sunday nights by far, historically, were the hardest nights to fill any hotel. You talk to many hotel operators, it's not up to the mid-week getting full but it's much better because people are extending their vacations or their weekends, I should say, into Sunday night. So we're seeing more business on that. In the past, you could discount a room anywhere in the world on a Sunday night and no one would show up. Now you're starting to see demand because of this transition, this remote-work transition.

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Pamela Ritchie: That is so fascinating. It's absolutely fascinating. We've talked a little bit around the world generally. Have you made changes to some international areas? I'm talking sort of specifically about the economics of Europe at this point, how that is affecting probably hotel and just many other parts of real estate.

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Steve Buller: One thing with the geopolitical which is, unfortunately, melding into economics and the energy crisis which we feel here in North America but it's much more pronounced in Europe. I actually personally was in Germany two weeks ago where it's very much with the high dependence on Russian gas and their economy is very exposed. Over the last couple of months, I have reduced my exposure to Germany whether it's some German office that I owned and whether it's also some business parks/logistics facilities I've owned and even some residential. I often don't make huge, if you've heard me in the past, geography bets. I've been underweight in Hong Kong for geopolitical concerns and the impact on the economy there but also now in Germany because of the impact of the unfortunate Ukrainian situation.

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Pamela Ritchie: That's interesting. Any other changes? If you can just sort of run over your positioning, which, as you say, hasn't changed a lot but for those that maybe didn't tune in last time, just go through broadly the sectors and the regions.

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Steve Buller: I very much still like the residential market, as we just talked about. The ability to push rents higher based on the demand and supply element and the undersupply aspect and given that construction costs, whether it's the commodity or the supply element and the labour, so to replicate the building you actually need to have higher rents to economically justify new competitive supply in markets. Then you have the time it takes to do it.

I very much like the residential market although there is one fear and it's very pronounced. People on the eastern side of Canada well aware of it and sometimes you benefited, but sometimes people don't benefit, is what I call the rent-control element. That is the inability to actually mark rent to where the market would allow them to because of government-type controls. There is increasingly, whether it's at federal levels, whether it's province, state levels or even city levels around the world because of such high increases, that is a fear. You may be not even capture what the market can bear or what inflation is. Those are two of the little bit of the negative cloud that I'm very cognizant of.

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Pamela Ritchie: And that's rental and that's the REIT side of things and it's what you're interested in. It is residential. I just wonder if you can put some of the headlines that we read daily about dropping housing prices in Canada, also in the U.S., because of the mortgage situation. Is there any comment you can just provide? I know it's not the area that you're looking at. You're not going buying single homes. I'm just curious what you think of all that. Will it wrap up? Will it come to an end? Has it been sort of a shock-and-awe situation, it'll be over soon?

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Steve Buller: I mean, similar to what occurred in the commentary we have in the commercial market, the residential market acts very similar when you have this dislocation, that is interest rates and the economy and then there's this pause in residential markets, too. So transaction levels have gone down, the bid/ask spread has widened and then you have people eventually what else, they are forced buyers or sellers. Forced sellers, it could be death, divorce or they need to move, so they become a forced seller and that will set a new price level or a forced buyer, for example, a new family or they've moved, so they need a place to buy. These things eventually connect and then you have new price levels. But I do think there's an underlying demand for housing in many markets around the world, and so I do believe, this is my personal opinion, that I do think there will be, depending on how much it went up, that it won't go down as much as it went up the last couple of years. In the hot markets, whether it's Sydney, Australia, whether it's Vancouver, Toronto, Denver, Colorado, those markets are seeing softening but I don't think it's going to give it all back.

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Pamela Ritchie: It's interesting because, of course, it's what everyone loves to talk about. Anything to discuss on the ESG front? I feel like this ball hasn't started rolling properly in what I've read about sort of buildings and what buildings need to have in order for them to be attractive to people in terms of ESG. Has that begun properly?

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Steve Buller: It has the E factor in ESG. You have seen that being demanded or required by tenants. These things usually start in Europe and we see it most pronounced there. Whether it's an office lease, an industrial lease, or some kind of commercial lease that they're expecting or demanding and a little bit willing to pay or a green building. You see it less so, obviously, on an individual basis, someone renting an apartment or even a hotel room. The future, maybe we'll get there but it'll be very interesting whether people are willing to pay a higher price for something that is certified green going forward. It is starting to slowly come here within North America and around the world, which I expect it will. With higher energy prices that we've seen globally, in many instances it economically makes sense to do these energy-saving projects.

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Pamela Ritchie: Do you like that passive housing stuff? So interesting. I mean, I don't really know whether it makes sense or not but do you watch that? You know what I mean? It's almost like they're insulated houses, they kind of wrap them up and…

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Steve Buller: Yeah, I think you're seeing that. Many countries have tax inducements to help. People say, hey, it has to be green or you're seeing from the top once again that, hey, by this date for us to meet our ESG targets for the Paris Treaty that we need … and commercial real estate, unfortunately, is a huge emitter of CO_2 … that we need to do something and say that these buildings need to become greener over a period of time. So the tenants are demanding it, government demanding it and many landlords … and we see it in the public space because they're larger, they have the ability to do it, they just don't own one building. So you do see them at the forefront.

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Pamela Ritchie: I want to ask your thoughts on the consumer vis-à-vis looking at everything from warehousing, inventory, storage even. How does the consumer sort of hold up at this stage from the way you would be looking at the consumer?

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Steve Buller: What we see, and this is also talking to many of my people here at Fidelity, the consumer, except the lower-end consumer, is still doing okay. Obviously, energy prices, mortgage prices, rental prices have all gone up, so it leaves a little less money in the pocket. But many of the middle class to upper middle class have money saved from the pandemic. We're seeing then on the retail side, it's a very interesting phenomena. Store openings, whether it's in Europe, whether it's in North America, they're still okay. The tenant really wants to increase the unit size because there was a deferral or a delay during the pandemic. If their sales are flattening, remember, they need more unit growth to compensate for that. Not to say that that can't be problems down the road because I always joke, there's a cycle in retailers, they have same store growth, then they have unit growth and then they have some bankruptcy. So we're now in the unit growth aspect of it, which is actually beneficiary at this moment for retail landlords.

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On the logistics and industrial side, e-commerce sales are flattening out. They couldn't keep up at the same come-toward pace that we saw with the pandemic demand. That's not to say they're declining the amount of total sales. On the logistics side, and well-publicized Amazon came and said, you know what, we have a few too many distribution facilities and we're going to slow down that pace. But you know what? There's also another story behind it which is supply chain and also people instead of just-in-time inventory, just-in-case inventory, which is then stored in a logistics facility. So we still see pretty good demand worldwide for logistics facilities.

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Pamela Ritchie: So fascinating. There's lots of discussion, as you know, between moving from the goods to the services, which we've seen, obviously, and you've discussed lots of ways that capitalize on that through real estate. I was wondering how that affects sort of the goods story.

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Steve Buller: The goods story but remember, it's not just goods for retailers, it's goods for manufacturing or in the system that many people ... that I can't manufacture this widget because this screw is somewhere in China. Oh, I need to store instead of one screw that I'm going to use today, I need to store 10 screws so I have enough. And yes, screws aren't a great example here but it needs to be then stored in a warehouse someplace.

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Pamela Ritchie: A large widget of some sort.

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Steve Buller: A large screw.

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Pamela Ritchie: So, Steve, do you see a trend where commercial real estate is converting partially or even fully to residential condo-type dwellings?

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Steve Buller: Yeah, I do think that's the future but then you also have to look at the economics that real estate has a wonderful ability to convert itself to uses that make sense as long as someone makes money in the process of doing it, that is, you have the ability to pay for an old office building, you can do the time and the money to convert it to residential and then still make a profit. That HBU, or higher and better use, is ongoing since the beginning of time. I think it will go on but then it needs to have the price of this stranded asset, this office building, has to be low enough and the price of the residential, you can eventually sell it or rent it for has to be high enough that someone can make money in it. And so you will see some of that but it will be slower than you would imagine.

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Pamela Ritchie: This conversion of office, maybe other commercial as well, are we talking decades or years here?

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Steve Buller: Oh, decades, definitely. In many old towns, whether it's Boston here where I live or Toronto or Montreal, old warehouses have been converted into offices but that took decades and hundreds of years. It's been repurposed for a higher and better use. So it will occur but someone has to make money in doing it too, and someone made money converting it to those offices that people wanted over the past decade for the technology firms.

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Pamela Ritchie: Of course. Steve, are there any concerns with defaults given higher short-term interest rates? Is lending still fairly liquid?

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Steve Buller: That's a great question because we talk about the fundamentals a lot here and the fundamentals still ... what we see in talking to a lot of companies, at least looking forward six months is okay to pretty good when we talk to companies in the listed real estate sector. Obviously, next year, whatever happens in the economy will depend.

The capital side of the business where we did see the biggest disruption, and real estate is a capital-intensive industry, that's where the cost of capital did go up. Now it's actually starting to go down with long-term interest rates slightly going down, credit spreads normalizing. This could be an opportunity. I mean, I go back to the global financial crisis which was a capital event that disrupted commercial real estate greatly. Here we had a minor, earlier this year, cost of capital change and is it now at the margin going the other way a little bit?

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Pamela Ritchie: Interesting.

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Steve Buller: That is an opportunity. I don't want to say the statistics don't bear it out that global property stocks are highly interest-rate sensitive but they do have a capital side and if capital starts to flow freely again, that will be beneficial.

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Pamela Ritchie: That is fascinating. So interesting to speak with you. Thank you. We always get a true sort of look at the world through some of your thoughts. Steve Buller, thanks for joining us. Enjoy the rest of your summer.

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Steve Buller: Great. Thank you.

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