



REIT Investors: RioCan Real Estate Investment Trust Will Feel the Pain of Rising Bond Yields

Description

RioCan Real Estate Investment Trust ([TSX:REI.UN](#)) is Canada's largest real estate investment trust (REIT) in the country. It has a fantastic yield and has had a relatively stable stock price over the past five years.

The company's stock has traditionally performed similar to that of a bond with a long-term average price hovering around some median level. There has been some underlying volatility relating to the housing markets, interest rates, and bond yields.

I'll be taking a deeper look at how bond yields affect REITs, and why these are important to consider when thinking about adding a REIT or some real estate-related asset group to your portfolio.

REITs are essentially substitutes for bonds

Income investors—those looking primarily for a stable yield—will look to asset classes such as bonds and real estate first. Both asset classes have an underlying asset base (either real property financed by debt or corporate/government debt obligations) from which they are able to obtain the yield they are looking for.

The reality is that as bond yields rise (and they have been rising since the U.S. election), government treasuries and highly rated corporate bond yields become more attractive to yield-seeking investors. The benchmark 10-year U.S. treasury yield is currently 2.34% (as of November 18), rising from 1.83% at end of day November 1. That's a tremendous increase of 51 basis points, or more than one-half of a percent in fewer than three weeks.

Typically, a 28% increase in the treasury yield would take months to achieve in the absence of a large shock, but this is the current environment we are now in.

This increased treasury bond yield has been filtering into corporate bonds, increasing yields across the board. As the risk-free rate increases, the yield on all bonds must increase accordingly.

REIT earnings inversely related to bond yields

We are now seeing corporate bonds “invading” territory once dominated by REITs, and this poses a very bearish long-term outlook for REITs, considering the yield of a REIT is inversely related to bond rates.

As bond rates climb, borrowing rates also climb as banks increase lending rates to compensate for the fact that money has become more expensive, meaning the REITs will only be able to recoup yield by raising rents—something that can be quite difficult due to leases of different lengths that essentially limit the REIT’s ability to increase its revenue in step with its costs.

This rise in bond rates thus hits REITs twice. The projected future earnings decrease with the combination of rising borrowing costs and locked-in future revenues, and increased bond yields mean many income investors will pull their money out of the REIT market and put it into bonds, resulting in natural downward pressure on REIT prices.

Increased volatility of debt means increased REIT volatility

Housing volatility has historically been quite low, but it may be showing signs of increased volatility. The volatility of REITs as an asset class is directly related to the volatility of its underlying assets and debt base. As a REIT’s underlying debt becomes more volatile, so too will its stock price, increasing the risk to income investors, perhaps above the threshold investors would be willing to accept.

In short, I am maintaining a wait-and-see approach to REITs and will look to see where bond yields move from here in the coming quarters. Whether the Federal Reserve raises its benchmark rate or not will be another indicator to assess next month.

CATEGORY

1. Dividend Stocks
2. Investing

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1. TSX:REI.UN (RioCan Real Estate Investment Trust)

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