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Commentary

Market Opinions and Topics of Interest

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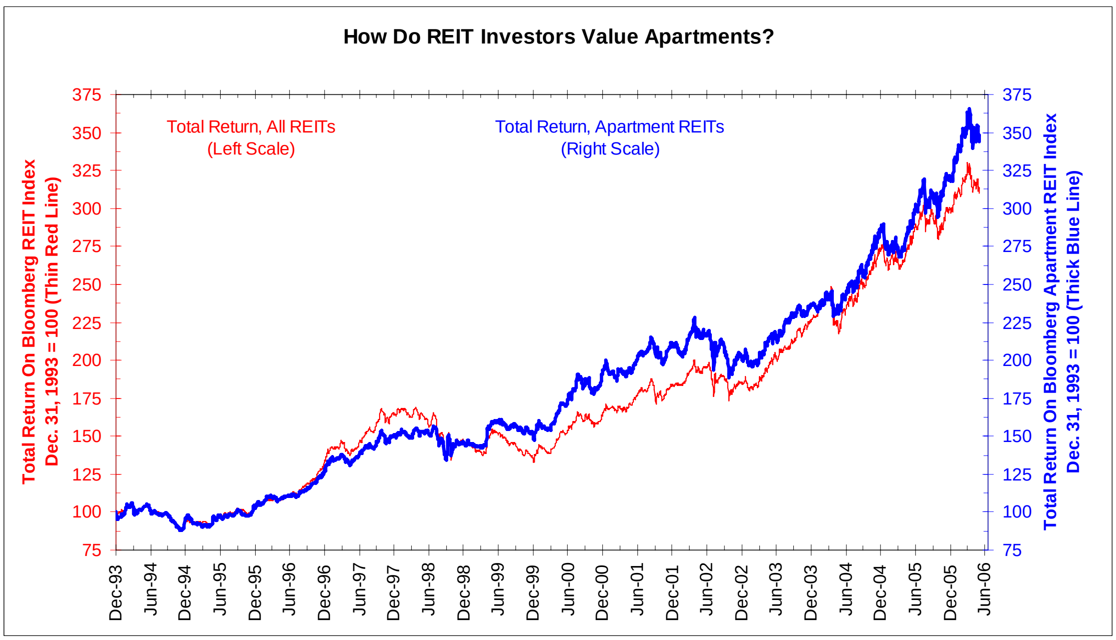
Using REITs to Project Owners' Equivalent Rent

Last Wednesday's CPI data were not greeted warmly by the world's investing community. As detailed in our monthly Inflation Watch, much of the increase in the core number was attributed to Owners' Equivalent Rent. OER comprises 23.442% of the overall CPI (30% of core CPI) and unlike the survey measures used to calculate the remainder of the index, it is an imputed calculation. The Bureau of Labor Statistics estimates the rental value of owned homes.

It is fair to say much of the suspicion surrounding the CPI and its calculation is associated with OER. As mortgage rates fell between 2002-2004 and tenants shifted from renting to owning, the OER measure declined and exerted downward pressure on the CPI.

Can we use market-derived measures to form our own opinion on OER? Let's compare the total returns on two Bloomberg REIT indices, one for all REITs (thin red line) and one for apartment REITs (thick blue line). **Such a comparison should reflect the relative pricing power and income-generating capacity of multifamily property owners relative to all property owners.**

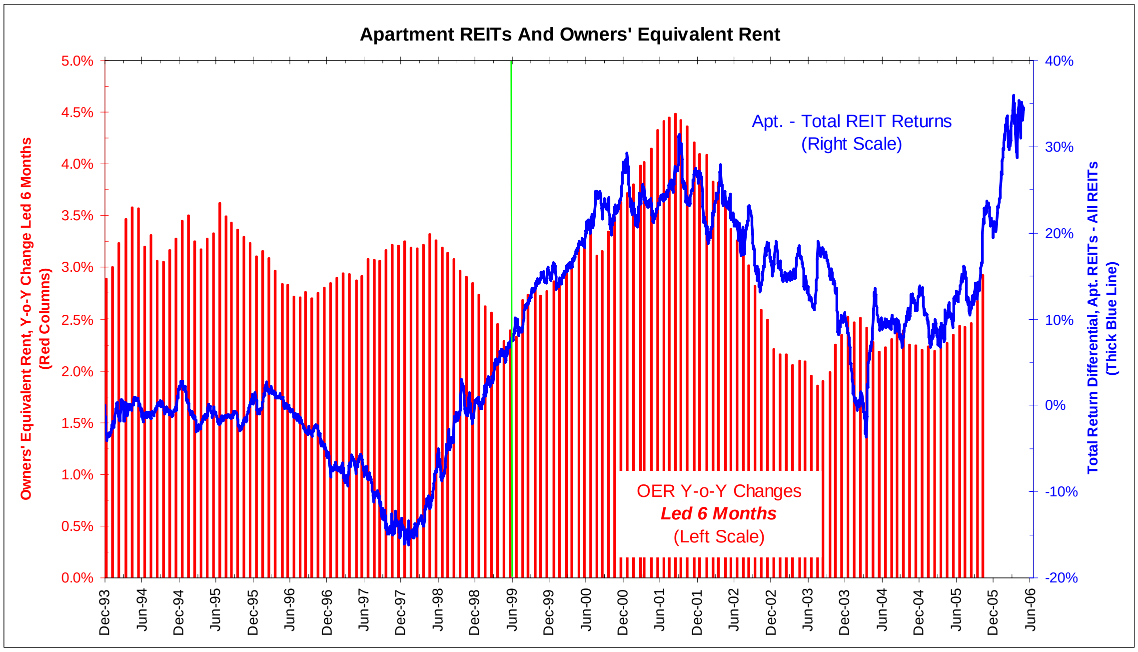


Relative Returns and OER

That the apartment REIT index has outperformed all REITs over a long period of time is something of a surprise. Does this relative performance provide us with any information on OER and its whereabouts?

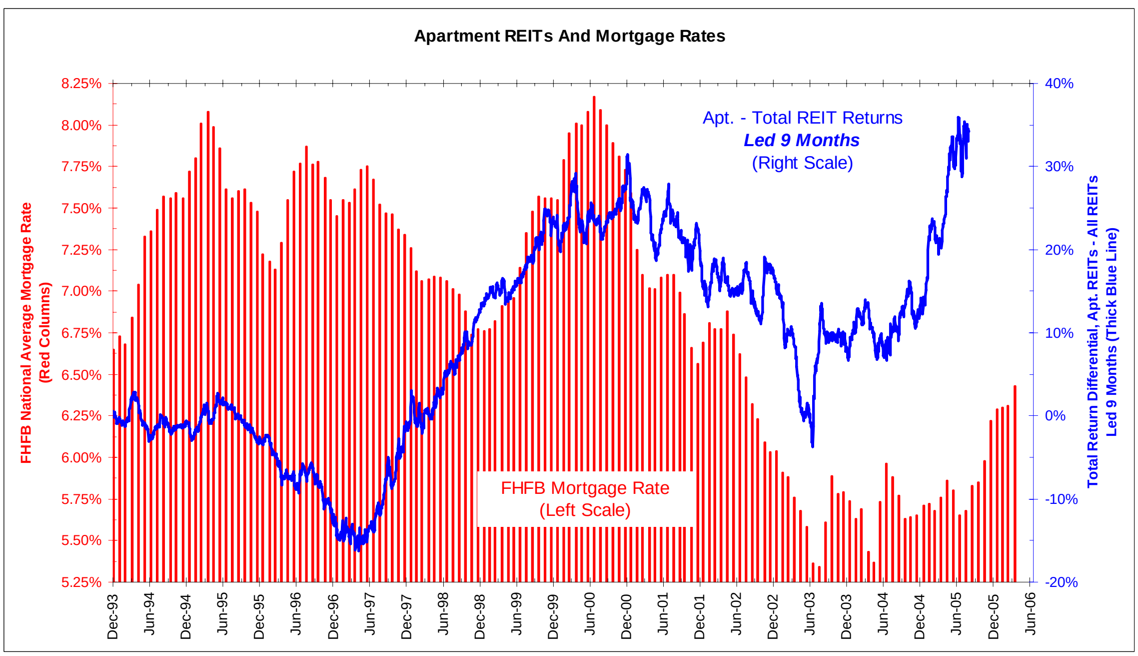
If we take the difference in the two return streams (thick blue line, following page) and map it against the year-over-year changes in OER led six months (red columns), we see a close relationship after the Federal Reserve began raising rates in 1999 (vertical green line). This demarcation roughly coincides with Alan Greenspan's adoption of a risk-management approach to monetary policy, something we have commented on often.

If the recent burst of outperformance by apartment REITs is any indicator, we should expect OER to surge higher in the coming months. Last Wednesday's CPI-related unpleasantness may be the first in a series.



More in The Pipeline

To compound matters, the very campaign of higher interest rates designed to suppress inflation will exacerbate the OER problem. The Federal Housing Finance Board's national average mortgage rate (red columns) leads the REIT return differential by approximately nine months. **As mortgage rates rise, renting becomes more attractive relative to owning and rents rise accordingly.**



Conclusion

If mortgage rates are rising and lead apartment REIT outperformance, which in turn leads the year-over-year changes in OER, we must expect upwards pressure on the CPI. Even those who do not live in a world of strong opinions might be given to saying, "No way out."

The cottage industry of pundits who explain every economic datum may try to spin this one and play the "not as bad as expected game." Fine; we all need to make a living.

However, we should remember the Federal Reserve seized on the artificially low OER readings to justify its so-far successful war on deflation in 2003. Symmetry would suggest they may feel forced into raising rates too often in their fight against the forthcoming high OER readings. This raises the danger of tightening one time too often.

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