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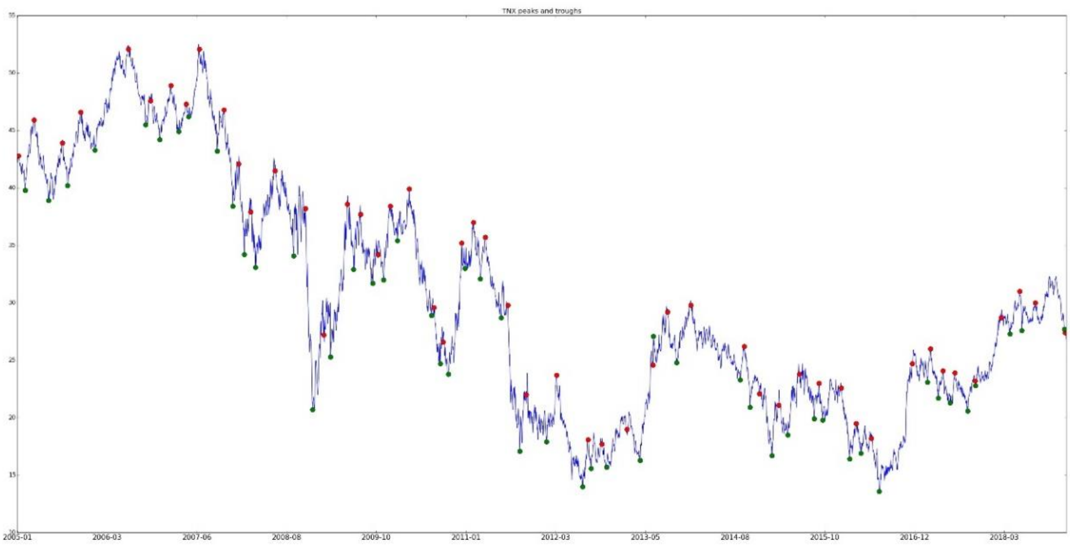
Long-term interest-sensitive assets: pair-trading REITs/ banks

Markets hold to the common wisdom that REITs are sensitive to long-term interest rates. In the last decade, REIT stocks declined when the market expectations were for rising interest rates. Inversely, rising interest rates are considered beneficial to banks.

In the course of developing a trading strategy that will alternate between those two types of assets, we explored how, in fact, REITs and banks reacted to changes in interest rates.

A methodological hurdle for such an examination is how to divide the periods into periods of rising and declining interest rates, without falling into subjective or arbitrary decisions (such as a period in which a rise of over XXXX would be a rising interest period, even if there is a long period of decline contained in this period).

For this period we used a physics peak-finding algorithm that maps the local peaks over the 10-year government bonds curve (TNX) (red markers in the chart), using the SciPy. Signal python library. The troughs were defined as the minimum between any two peaks (green markers in the chart). The period from peak to trough is defined as a period of decline, and, conversely the period from trough to peak is defined as a period of rising interest rates.



We calculated the cumulative returns for the periods of rising interest rates and for declining interest rates, as summarized in this table, which tracks REITs and banks performance up to 31/12/2018 in 3-time frames:

30/6/2006-31/12/2018	REITs	banks
rising rates	85.01%	917.12%
declining rates	6.16%	-91.01%

30/6/2008-31/12/2018	REITs	banks
rising rates	45.62%	947.04%
declining rates	39.23%	-85.06%

30/6/2010-31/12/2018	REITs	banks
rising rates	4.84%	895.18%
declining rates	116.57%	-81.13%

It is interesting to note that REITs performed well both in rising interest rates regimes, and in declining interest rates regimes, dependent upon the time frame. Banks' sensitivity to interest rates regimes is much higher, and consistent: banks have performed abysmally during periods of declining interest rates, and extremely well during periods of rising interest rates.