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Investigating emerging market economies Reverse REIT-Bond Yield Gap anomalies: a case for tactical asset allocation under the multivariate Markov regime switching model

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ABSTRACT

This paper presents a first time application of a variant of the concepts underpinning the Fed Model, amalgamated with the Bond-Stock Earnings Yield Differential, by applying it to the dividend yields of REIT indices. This modification is termed the yield gap, quantitatively constructed and adapted in this paper as the Reverse REIT-Bond Yield Gap. This metric is then used as the variable of interest in a multivariate Markov regime switching model framework, along with a set of three regressors. The REIT indices trailing dividend yield and associated metrics are the FTSE/EPRA NAREIT series. All data are from Bloomberg Terminals. This paper examines 11 markets, of which the EMEs are classified as Brazil, Mexico, Turkey and South Africa, whereas the advanced market counterparts are Australia, France, Japan, the Netherlands, Singapore, the United Kingdom, and the United States. The time-frame spans the period June 2013 until November 2015 for the EMEs, whilst their advanced market counterparts time-span covers the period November 2009 until November 2015. This paper encompasses a tri-fold research objective, and aims to accomplish them in a scientifically-based, objective and coherent fashion. Specifically, the purpose is in an attempt to gauge the reasons underlying EMEs observed anomalies entailing reverse REIT-Bond yield gaps, whereby their ten-year nominal government bonds out-yield their trailing dividend yields on their associated REIT indices; what drives fluctuations in this metric; and whether or not profitable tactical asset allocation strategies can be formulated to exploit any arbitrage mispricing opportunities. The Markov models were unable to generate clear-cut, definitive reasons regarding why EMEs experience this anomaly. Objectives two and three were achieved, except for France and Mexico. The third objective was also met. The REIT-Bond Yield Gaps static conditions have high probabilities of continuing in the same direction and magnitude into the future. In retrospection, the results suggest that by positioning an investment strategy, taking cognisance of the chain of economic events that are likely to occur following static REIT-Bond Yield Gaps, then investors, portfolio rebalancing and risk management techniques, hedging, targeted, tactical and strategic asset allocation strategies could be formulated to exploit any potential arbitrage profits. The REIT-Bond Yield Gaps are considered highly contentious, yet encompasses the potential for significant reward. The Fed Model insinuates that EME REIT markets are overvalued relative to their respective government bonds, whereas their advanced market counterparts exhibit the opposite phenomenon.

Keywords: Anomaly, Emerging Market Economies (EMEs), advanced economies, Real Estate Investment Trusts (REITs), REIT indices, trailing dividend yields, equity indices, government bonds, nominal government bond yields, Australia, Brazil, France, Japan, Mexico, Singapore, South Africa, the Netherlands, the United Kingdom, the United States, Turkey, quantitative Markov regime switching econometric regression models, tactical asset allocation, reverse yield gap, REIT-Bond Yield Gap, Fed Model, Bond-Stock Earnings Yield Differential (BSEYD), under/over valuation, portfolio management, arbitrage profits, place and evolution of government bonds and REITs, portfolio and asset allocation theories, Modern Portfolio Theory, Post-Modern Portfolio Theory.