DECEMBER 2021

SAVILLS Research

Inflation: Implications for Real Estate

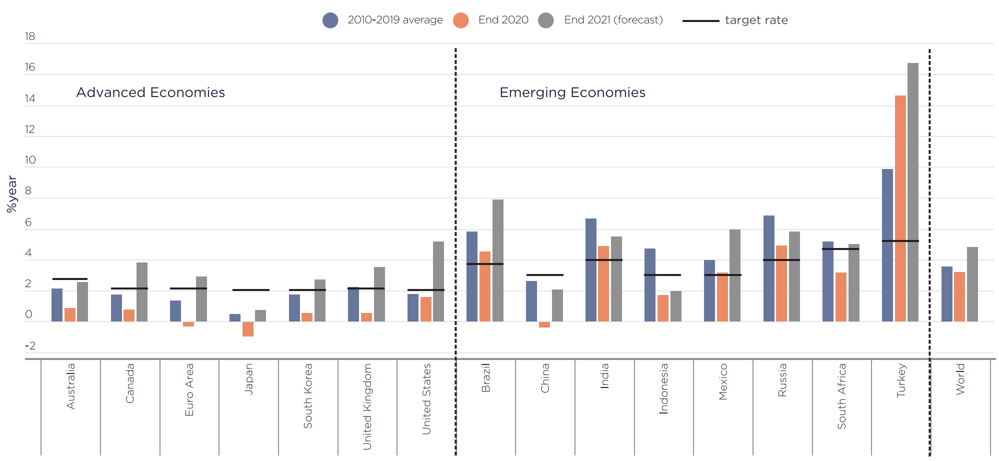
The relationship between real estate and inflation is more nuanced than conventional wisdom suggests

Real estate is a good hedge for inflation. If only it was this simple. Sadly, not all real estate is created equal, and not all inflation is created equal. With inflation rising and economic growth slowing, it is important to understand some of the geographical and sectoral idiosyncrasies that will underpin the relative performance of real estate assets, especially if inflation proves to be less 'transitory' than we're told.

Defined as continuing for only a short period of time, 'transitory' has become the defining adjective used by policymakers to describe the current inflationary environment, and the focal point for an increasingly partisan debate on whether they are right or wrong (for those who follow such things). Inflation 'hawks' point to the massive monetary and fiscal stimulus mobilised in the aftermath of covid-19, and highlight wage data as evidence that inflation is becoming entrenched. 'Doves' caution against repeating past mistakes in tightening policy too fast, while emphasising that inflation is still concentrated in a narrow subset of goods and services outside the direct influence of policymakers.

The sharp rise in inflation has been underpinned by a perfect storm of mostly transitory factors, including the rapid rebound in economic activity, rising energy prices, and supply bottlenecks. These pressures will ease back as the global economy continues to 'normalise' – inflation is a continuous phenomenon, and many of the large price rises linked to supply shortages, such as the cost of shipping, will reverse over time.

While prices are rising globally, inflation pressures are more acute across advanced economies and Latin America

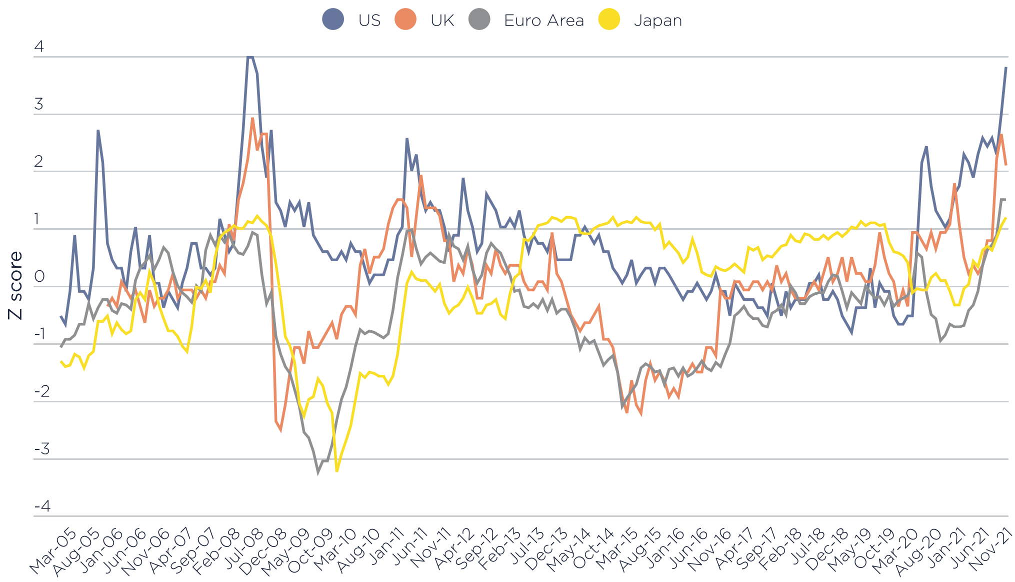


Source: IMF World Economic Outlook, October 2021 (via Macrobond).
Where applicable, inflation targets based on mid/average rates.

However, transitory inflation can lead to a permanently higher rate of inflation in the future through its influence on expectations. In simple terms, this process works through wages; households, facing an increase in the cost of the goods and services they consume, demand higher wages to ensure that their standard of living does not decline over time. This will be based on their expectation of price rises in the future, but because this is unknown, they lean heavily on the current rate of inflation to inform those expectations. The longer that inflation remains elevated, the more these expectations become entrenched. Businesses, facing higher labour costs, raise their prices by a similar amount to retain profit margins. The result is a wage-price spiral that is self-fulfilling.

Policymakers have a role in controlling these expectations by targeting an explicit rate of inflation in the future. Assuming a (credible) central bank will do all in its power to meet its inflation target, then it follows that expectations of future inflation should converge towards this target. Indeed, in the last three decades, one of the successes of major central banks is that by switching to inflation targeting, expectations have become anchored, and inflation has been kept under control. But recently, expectations have been creeping up.

Expectations for inflation over the next 12 months have risen sharply



Source: Macrobond.
A Z-score indicates the level of a data point relative to its long-term average, in terms of standard deviations. A score of zero implies the current value is equal to the average.

So the question becomes how long can we realistically describe inflation as transitory, and what could be the catalyst for a prolonged period of elevated inflation? If we stop believing that central banks can control inflation, then we no longer have that future anchor on which to base expectations. And this is the crux of the debate – with the hawks arguing that central bankers are too obsessed with the transitory narrative, and that once they do act it will be too little and too late, with inflation becoming pervasive and ingrained in the human psyche.

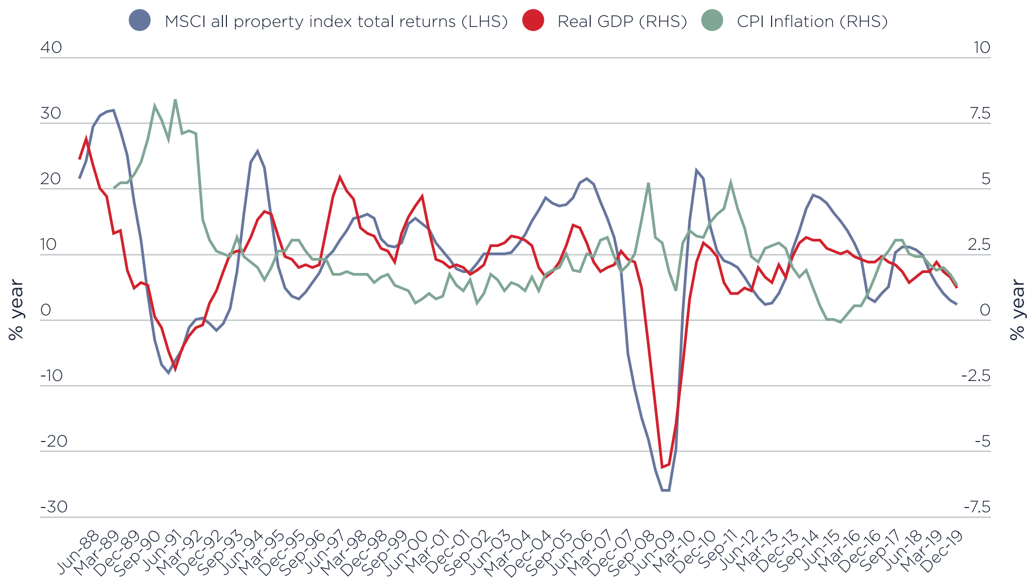
For investors, inflation is bad as it erodes the present value of future returns on any investment. So assets that can provide a protection ('hedge') against inflation will be particularly attractive in the current environment. Equities, for example, generally perform well during periods of rising prices, given company earnings adjust to the underlying rate of inflation (assuming firms have some pricing power). Fixed income products on the other hand – which typically pay a fixed rate of interest on a principle investment – will perform poorly as the purchasing power of that future income stream declines.

The conventional wisdom on Real Estate follows that it is a good hedge against inflation. This is based on the assumption that income growth will adjust to higher prices, while valuations will increase given rising income growth and higher replacement costs. In theory, this should be relevant regardless of the cause of inflation: if higher prices are underpinned by stronger economic growth ('demand-pull inflation'), then this should support real estate demand and strengthen landlords pricing power; or if it is underpinned by increased costs of labour or raw materials ('cost-push inflation'), then it will restrict supply. Higher inflation will also erode the real value of any debt used to finance investments.

However, the evidence is still relatively mixed. In particular, the inflation hedging properties of real estate generally arise through its strong link to economic growth (i.e., demand-pull inflation). However, owners are more exposed to the risks of cost-push inflation – which best characterises the current environment – which can lead to slower economic growth, and therefore reduced occupier demand. Cost-push inflation is also hard to predict – often driven by unforeseen environmental, geopolitical, or economic shocks – and therefore difficult to incorporate in a forward-looking agreement on rents.

"If we stop believing that central banks can control inflation, then we no longer have that future anchor on which to base expectations."

UK property returns display much stronger correlation with economic growth than inflation



Source: MSCI, Macrobond.

The mixed historical evidence highlights another issue – not all real estate is created equal. Instead, there are key idiosyncrasies across geographies and sectors that affect the inflation hedging properties. Given that supply is very slow to respond to market forces, the most important factors are the underlying strength of demand, as well the flexibility of lease agreements – including the typical lease term and the use of regular index-linked adjustments to rent.

The perfect lease in the current environment would include regular index-linked rent increases, based on the prevailing inflation rate, as well as clauses allowing the pass through of any costs to the tenant. In the absence of these properties, then shorter lease lengths provide more flexibility to renegotiate rents, although landlords need pricing power, which is underpinned by the prevailing level of demand. The least attractive proposition is a long-term, fixed rent agreement.

Analysing lease conventions for prime commercial sectors across a selection of major investment centres globally – based on a relatively simple review of three key characteristics – highlights some notable differences that will impact the level of inflation protection afforded by real estate.

Benchmarking Prime Commercial Real Estate based on inflation protection

Source: Savills Research. Darker shading implies a stronger hedge to inflation.

Benchmarking system based on a combination of three components to give an indication of the level of inflation protection from an owners perspective – typical lease length, share of lease agreements with explicit index-linked rental adjustments, and vacancy rates as a proxy for the strength of underlying occupier demand (current levels and direction of travel for next 3 years).

From a regional perspective, Europe provides the best inflation hedge in comparison with North America or Asia Pacific. This is underpinned by the widespread use of indexation, which is quite unique to European real estate, and differentiates the region from its global peers. This means that the average lease term is less important given automatic rental adjustments. Within the region, the industrial sector stands out given the strength of underlying demand, while favourable supply and demand dynamics also make Amsterdam an attractive proposition.

The London office market does not use indexation by convention, but rather periodic rent reviews, typically every five years. In turn, higher levels of vacancy will reduce landlords pricing power, and long lease terms also make for a poor comparison with major European cities. It is more common for lease agreements to include the pass-through of costs to tenants, such as full repair and insurance (FRI), however this will not protect future income from inflation. While the industrial sector is not too dissimilar, strong demand is encouraging landlords to opt for open market rent reviews in the expectation that rental growth in the market will exceed inflation (assuming market sentiment doesn't reverse). The retail sector is slightly different, with the application of indexation more common, although limited by cap and collar conditions. Turnover clauses can also provide a link to inflation, but only assuming sales volumes are not hit by higher prices.

The US markets are not too different to London; rental escalation during the lease term is typically fixed, and therefore income is at risk to a sustained period of unexpected inflation. Agreements also tend to be long term – particularly for offices, where the vacancy rates are also elevated, stacking up poorly against other global cities. In Toronto, while lease conventions are similar to the US, lower vacancy rates suggest demand conditions are more favourable.

"The perfect lease in the current environment would include regular index-linked rent increases, based on the prevailing inflation rate, as well as clauses allowing the pass through of any costs to the tenant."

In the Asia Pacific region, the use of indexation is also infrequent (with fixed rent escalation more prevalent), but lease lengths are also usually shorter than international counterparts – typically around 3-5 years. This means that rent reviews will be more frequent, although the degree to which landlords can increase the rent will be determined by pricing power. In turn, demand conditions differ across major cities and across sectors – vacancy rates tend to be higher in office and retail compared with industrial (similar to the global trend), and are much lower in Tokyo compared with other markets such as Shanghai and Singapore. Shanghai retail leases, much like many other cities globally, often include a turnover linked component.

In Dubai, lease agreements typically include fixed rent escalation clauses rather than indexation, which would suggest that real estate is more vulnerable to a surge in unexpected inflation, especially considering high and rising vacancy rates (with the exception of the major shopping centres) and shorter lease lengths.

Outside the prime commercial sectors considered here, the residential sector can also provide a good protection against inflation risk. Indexation is again more common in Europe, and the combination of short lease lengths (often 1-2 years) and multiple tenants provide frequent opportunities to adjust rents. Leased hotels can also typically provide a strong inflation hedge through very long lease terms (up to 25 years) which are traditionally index linked to inflation (although cap and collar conditions can limit protection).

Ultimately, whether higher inflation proves to be a transitory phenomenon or not is in the lap of the gods (or maybe the central bankers). But whether the hawks or doves are proven right, transitory as a concept will be replaced, presumably, in a short period of time. But inflation is ever present, and so is the risk it poses to investment returns. Real estate can help mitigate that risk, although it is misguided to stop there, because even our relatively simple analysis shows, differences across sectors and geographies can have a major impact on the degree to which future returns can be insulated from inflation.

Research

Oliver Salmon
Global Capital Markets
Savills World Research
oliver.salmon@savills.com