LIVING THOUGHTS
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REAL ESTATE, THE VACCINE AGAINST INFLATION?

Covid-induced supply bottlenecks have been a dominant theme throughout the year and caused a pick-up in inflation to levels not seen in decades. The main central banks in Western economies are arguing that the shock is mainly transitory. However, transitory does not necessarily mean 'short lived' and some forecasters are now considering a scenario in which inflation and upward pressure on wages could last. Therefore, investors need to anticipate this trend and its potential impact on their portfolio by investing in inflation-proofed assets such as gold or inflation-linked bonds (ILBs), but also real estate.

Key findings

- With current negative real yields, our analysis is showing that real estate is a very good option for investors to protect themselves from inflation.
- To optimize inflation protection, investors should focus on locations with structural mismatch between demand and supply

IS REAL ESTATE A GOOD INFLATION HEDGE?

With the surge in inflation, the value of an investment tends to decrease over time. Indeed, if inflation is structurally high, the real return of an investment (defined as the difference between return and inflation) could be negative. Developing strategies to hedge against a rise in prices can help a portfolio thrive when inflation hits the economy.

Usually, an inflation hedge involves investing in an asset that is expected to maintain or increase its real value over a specified period. Although real estate is often named as one of the best protection against a rise in prices, there is no clear correlation between annual inflation and real estate returns. Indeed, as the impact of a rise in prices will depend on whether investors/landlords can pass inflationary pressures to tenants, the induced impact will depend on the cause triggering inflation. Demand-driven inflationary pressures are benefiting CRE returns as strong economic growth is lowering vacancy, increasing almost automatically demand for real estate and income growth expectations. On the other hand, a price increase induced by the supply side could hurt real estate investment as it can be harder for landlords to push through rent increases. Supply side pressures, similar to the current environment, are then historically more difficult to hedge for investors.

The current shock on prices is induced both by demand (from the accumulated forced savings during the pandemic) and by the supply side. Indeed, the supply bottlenecks on specific components (i.e. microchips) spread to energy, transport and, finally, to most goods and services. Moreover, the uneven recovery across sectors is also the cause of frictions in the labour market and triggered sustained wage pressures. This implies that investors need to develop more specific strategies to protect their investment against inflation.

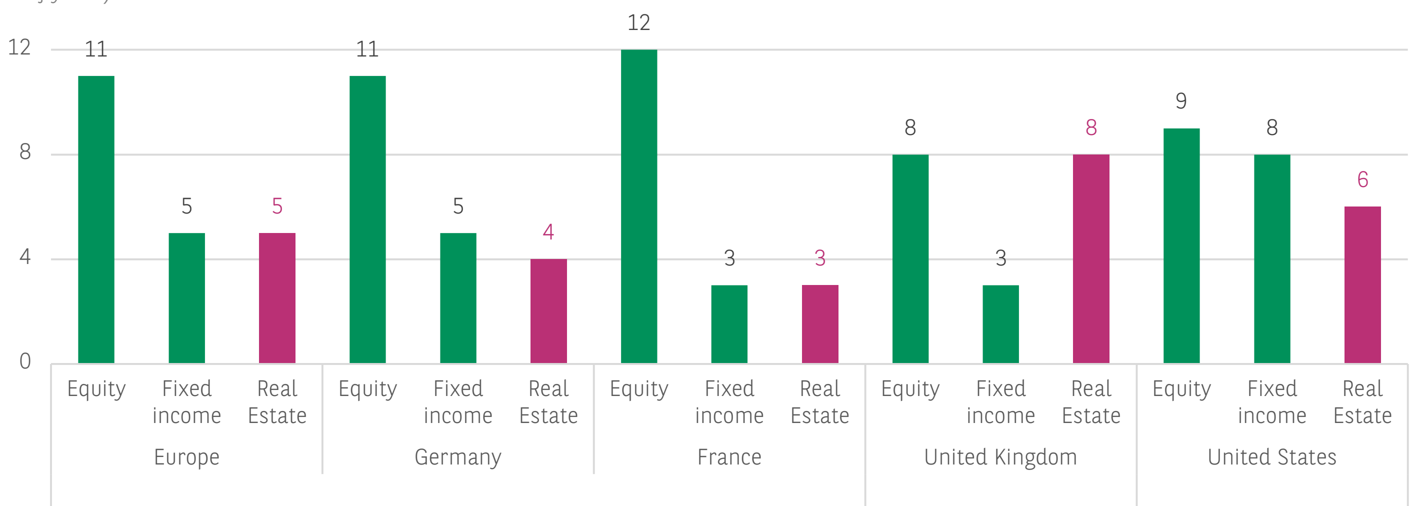
REAL ESTATE IS THE BEST OPTION GIVEN THE CURRENT MARKET CONDITION

The capabilities of each asset class to deliver higher returns than inflation is important for investors. Indeed, the higher the certainty of generating a positive real return over a certain holding period, the more appealing the asset class is for investors. By comparing the real return received for a given holding period, we can calculate the number of years investors needs to outperform inflation.

In Europe, real estate provides a positive real return earlier than equities (5 years for real estate vs 11 years for equity). It means that, since 2000, there has been no 5 years period where real estate did not deliver a positive real return. Fixed income also provided a positive real return for holding periods higher than 5 years. In Germany and France the results are very similar with strong inflation hedging skills for real estate. In the US, real estate also has the best hedging skills, although the time to hedge is slightly longer. Using even longer time series in the US, back to 1980, does not significantly alter these results. In the UK the results are not as strong, which might be a result of rents usually not being indexed.

Overall, both real estate and fixed income appear to have strong hedging capabilities against inflation. However, in the current context and with current negative real yields, we can infer that real estate should be the best option for investors to protect themselves against inflation.

Figure: Minimum holding period to have a positive real return (2000-2020)



HOW TO BUILD AN INFLATION-HEDGE REAL ESTATE PORTFOLIO IN THE CURRENT ENVIRONMENT?

As demonstrated, real estate has a competitive advantage compared to the other asset classes as, most of the time, rental values are indexed to inflation. However, market rents do not always follow inflation and when resetting the rent at the renewal date, this will impact the rental growth and the effectiveness of the inflation hedge. Therefore, investors have to choose their assets carefully, based on the local economic environment and sectorial dynamics.

For market rents or prices to follow or even to outperform inflation, the market should be undersupplied and the economic environment should be strong for tenants. Indeed, signs of a constrained supply are a good place to start with when looking at inflation-hedging assets as the mismatch between supply and demand enables rental growth to outpace inflation over long periods.

For example, offices located in the city centres should continue to experience a positive level of rental growth, as the current supply is limited and the demand for high quality and well located offices is still strong. Sectors driven by a strong demand should also be able to offset potential losses from inflation. For example, the logistics market, driven by the rise of e-commerce, is expected to outperform inflation. With the rise of the number of households, sectors such as healthcare or residential are also expected to experience a strong interest and to have above inflation rental growth.

The rise of inflation might also have a strong impact on government bond yields. Indeed, as inflation is eroding the purchasing power of a bond's future cash flow, investors might require a higher yield to compensate the risk. Quantitative easing program might also come to an end as keeping inflation low is one of the main targets of Central banks.

On the one hand, the real estate risk premium is currently at a historical high and can absorb the shock of increasing bond yields. On the other hand, financing costs might also increase, slowing investors appetite for real estate. However, as market conditions and fundamentals are still strong, real estate yields are unlikely to react in the medium term. Therefore, assuming that interest rates will stay relatively low and that real estate yields consequently will be rather stable, inflation and the prospects of higher rental values will be the main drivers for appreciation going forward.

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