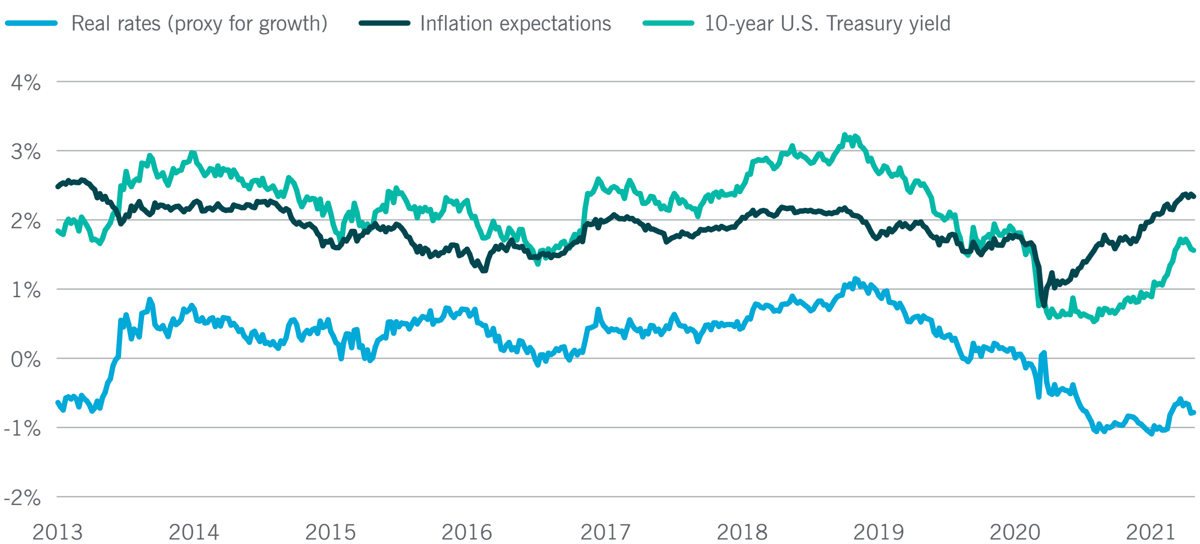
Second quarter 2021

Real estate as an inflation hedge: a sector-by-sector look

It feels like investors have been waiting for (and worrying about) higher inflation for decades, but it hasn't yet materialized. As we emerge from the pandemic-induced recession, however, inflation risks are starting to feel more real. As central banks and other policymakers continue to promote massive monetary and fiscal stimulus, inflation expectations and interest rates are starting to rise (see Figure 1).

Figure 1 – Factors that drove down rates in 2020 are driving them up in 2021



Source: Bloomberg, as of 3/19/21

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At this point, we don't expect widespread inflation, but it is a factor that investors should consider as they approach portfolio construction. The U.S. will likely witness a marked acceleration in year-on-year inflation over the balance of 2021, owing to comparisons to 2020 and supply chain stress as the economy reopens. In Europe, inflation projections have risen, but from a very low base, and projections remain shy of levels that would force the hand of the ECB. Across all markets, there is the risk that supply chain blockages coupled with sharply higher demand from a post pandemic economic bounce could lead to temporary price shocks, but that is unlikely to generate an inflationary spiral. Nuveen's Global Investment Committee views both rates and inflation as more likely to accelerate than to decelerate over the course of 2021 and beyond, albeit not in a way that would derail real estate markets or lead to broader financial tightening.

Rates and inflation as more likely to accelerate than to decelerate over the course of 2021 and beyond

REAL ESTATE IMPLICATIONS

In the past, real estate has been regarded as an inflation hedge, although evidence is mixed and beneficial impacts on real estate can vary according to the type of inflation (e.g., cost-push inflation in recessionary periods are generally not regarded as beneficial to rental growth, while demand-pull inflation associated with bottlenecks and full capacity is associated with booming economies and high levels of occupier sentiment). When thinking about the impact of inflation, the structural trends and market conventions, the impact will differ by country and property type. Here, we offer our views on some of the largest areas of the real estate market.

European logistics

Occupier: Logistics assets are commodity buildings, where letting decisions driven by pure economics with architectural, brand image or wellbeing considerations play only a minor role compared to offices, retail and residential. This leads to relatively standardized lease contracts with usually 5- or 10-year terms and strong indexation clauses, leading to predictable, but in recent years, small annual rental uplifts. A burst of higher inflation would benefit landlords in the short term, topping up income returns, which have been gradually eroded since 2010 due to lower cap rates and only moderate market rental growth. However, rental growth for logistics historically has not kept up with inflation over longer periods of time. If inflation were to be elevated for several years logistics real estate is unlikely to offer a full hedge unless inflation is mainly demand driven and a sign of an overheating economy.

Investment: Strong logistics investment appetite is primarily driven by investor's believing in secular demand drivers and a rotation away from retail. Inflation would have to get out of hand to change that equation markedly.

European offices

Occupier: The rents across Europe are wholly or partly uprated by Consumer Price Index (CPI) inflation and higher inflation would benefit the operating income of landlords. However, were occupiers to face higher costs at a time when balance sheets are stressed, this may encourage some to return space to the landlord at a lease break or expiry. Higher inflation might contribute or add an additional push factor to greater remote working than would have otherwise been the case, encouraging occupiers to reassess their space requirements and create cost saving efficiencies.

Investment: Spreads between office assets and bonds are currently wide across Europe and able to absorb rising interest rates as markets normalize. However, borrowing costs would be impacted through higher swaps, shaving returns.

European retail

Occupier: Retail markets hit by deflationary impacts of the pandemic should benefit from rising inflation as global pent-up demand outstrips supply in some consumer sectors (namely hospitality and apparel), rising prices and improving occupier balance sheets. Inflation linked leases will provide an uplift for landlords albeit retail rental tones continue to rebase because of structural change, resulting in increased over-rent for longer leases.

Investment: In a reverse of logistic drivers, investment appetite for retail is at an all-time low with yield spread between bonds greater than other sectors. As a result, pricing has somewhat disconnected with rising interest rates and borrowing costs remain high because of perceived structural risk.

European housing

Occupier: Deemed (and proven once again) to be one of the more defensive asset classes, largely linked to the granularity of income and necessity of its function, rising (and steady) inflation (from a stronger economy) is complimentary to the sectors maturity and offer. Unprecedented monetary and fiscal stimulus measures, which have undoubtedly curtailed unemployment levels since the pandemic, have supported income levels; whilst a debate around consumer needs, from a space and location perspective are probably having a greater impact than inflation presently. One core element that remains unchanged, however, is the rationale to provide truly affordable housing, to protect against external market driven factors and economic causes of inflation.

Investment: The living sectors continue to record a greater share of investor commitments globally. Across Europe and Asia Pacific, yields have sharpened, in part linked to performance and a growing sector and investor maturity, but more so because of the lower interest rate environment. The recent re-pricing of sovereign debt and inflationary backdrop may provide a ceiling to the tighter spreads in residential pricing and interest rates witnessed, although there was evidence prior to the recent increase in benchmark government bonds that the spread had settled naturally. This should temper any concerns regarding pricing risks for this championed sector in Europe and Asia Pacific.

European commercial real estate debt

Increases in the yield curve will push up the total cost of debt in the European commercial real estate (CRE) market and increase nominal returns to lenders. But movements at the short end of the curve will continue to be much less pronounced so long as markets remain convinced of central banks' determination to keep a lid on overnight rates, limiting the transmission to European debt costs. Higher yields will have a negative impact on risk in the debt market, with rises at the long end of the yield curve negatively affecting underlying capital values through rising investment yields. The potential scale of these increases is still rather modest, though, limiting both the risks to lenders, and the potential to further reduce the appetite of the traditional banking sector for CRE debt.

U.S. commercial real estate

The impact of inflation on U.S. real estate cannot be determined conclusively given the absence of reliable performance data from the last episode of significant inflation. However, real estate should very likely offer a hedge in a rising inflation scenario since the value derives from a real asset. Additionally, the broad real estate sector is pro-cyclical and directly benefits from GDP growth, which economists are now forecasting will trend towards 5% in 2021 for the U.S. Historically, NOI growth is closely related to the prior year's GDP growth, thus to the extent that higher rates or inflation are driven by rising growth expectations, that will translate into additional demand for housing, industrial, office, retail and alternative property types. This slight lag in response to economic conditions is due to the length of real estate leases, which also vary by sector. Consequently, the impact of changes in inflation and the resulting adjustment to rents can vary across property types.

U.S. housing

Residential real estate leases are overwhelmingly short-term, primarily 12 months, thus allowing for relatively rapid adjustments to new price levels. This is consistent across traditional apartment properties as well as alternative housing investments such as single-family rentals and

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student housing. U.S. housing has historically been a low risk sleeve of the CRE universe and its lower expected sensitivity to inflation risk is no exception. Through the pandemic most housing markets and sectors have performed well and are attracting greater investor interest than pre-crisis.

U.S. office

Office properties typically have intermediate- to long-term leases, which places the sector at greater risk. However, CPI-linked leases are not uncommon, which mitigates potential harm. As a pro-cyclical sector though, a growing economy will generate additional demand for office space, applying upward pressure on real rents. The medical office and life science segments face similar inflation risks with longer leases, but have a stronger fundamental operating environment than traditional office, leaving them in a more defensible position.

U.S. industrial

The industrial sector also has intermediate- long-term leases, however many properties already have below-market rents due to the strong rent growth across the sector, even in a low inflationary environment. In a scenario where inflation is driven by outsize economic growth, U.S. industrial is well-positioned to be a major beneficiary as warehouse space requirements expand. The attractive fundamental narrative for industrial would result in more accelerated rent growth and investors are already accustomed to giving credit to below-market rents when valuing the sector.

U.S. retail

The retail sectors have greater risk from rising inflation given the intermediate-term leases and the reliance on retailer operations, which have been challenging in recent years. The grocery-anchored segment offers a unique reprieve: while the grocer anchor often has a very long-term lease, most of the value of the property lies in the small-shop leases, which are much shorter in duration. Greater inflation would improve the grocery anchor's finances while the small-shop rents can adjust relatively quickly. The net lease segment would have a range of impacts subject to the lease structures. Some net lease properties have CPI-linked rents but others do not. This would become a key differentiator in a space with leases exceeding 10-years and is often considered more fixed-income than real estate.

For more information, please visit nuveen.com.

Endnotes

Sources

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All investments carry a certain degree of risk and there is no assurance that an investment will provide positive performance over any period of time. Investing in municipal bonds involves risks such as interest rate risk, credit risk and market risk, including the possible loss of principal. The value of the portfolio will fluctuate based on the value of the underlying securities. There are special risks associated with investments in high yield bonds, hedging activities and the potential use of leverage. Portfolios that include lower rated municipal bonds, commonly referred to as "high yield" or "junk" bonds, which are considered to be speculative, the credit and investment risk is heightened for the portfolio. Bond insurance guarantees only the payment of principal and interest on the bond when due, and not the value of the bonds themselves, which will fluctuate with the bond market and the financial success of the issuer and the insurer. No representation is made as to an insurer's ability to meet their commitments.

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REAL ESTATE

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