Principal Asset Management℠

Principal Real Estate

Commercial real estate under higher inflation and interest rates

Why the interaction between inflation and real rates matters more than either variable alone

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The recent rise in Treasury yields - reflecting a combination of higher term premia and firmer inflation expectations - has unsettled markets and revived concerns about a repeat of the post-pandemic repricing in commercial real estate (CRE). A month ago, we examined the implications of a 5% 10-year Treasury yield for CRE. Now that it's here, we take the next step: considering how the asset class has historically performed across inflation and real-rate regimes, and what that record implies for investors today.

CRE has built a reputation as an inflation hedge due to its strong and consistent record of stable income returns. That is broadly true over long horizons, but the label is incomplete. Performance depends not simply on the level of inflation or interest rates, but on their direction, the speed of change, credit availability, and the underlying health of the economy.

KEY TAKEAWAYS

- The most challenging environment for CRE and other risk assets is one in which inflation is falling while real interest rates are rising.
- Even in that regime, private CRE has historically produced positive average total returns, supported by income.
- When capital appreciation is under pressure, NOI growth and balance-sheet resilience become increasingly important.
- The current environment differs from 2022 because credit remains available, but return dispersion is likely to widen across assets, markets, and managers. Avoiding underperformers that blow up track records will be as important as picking the winners.

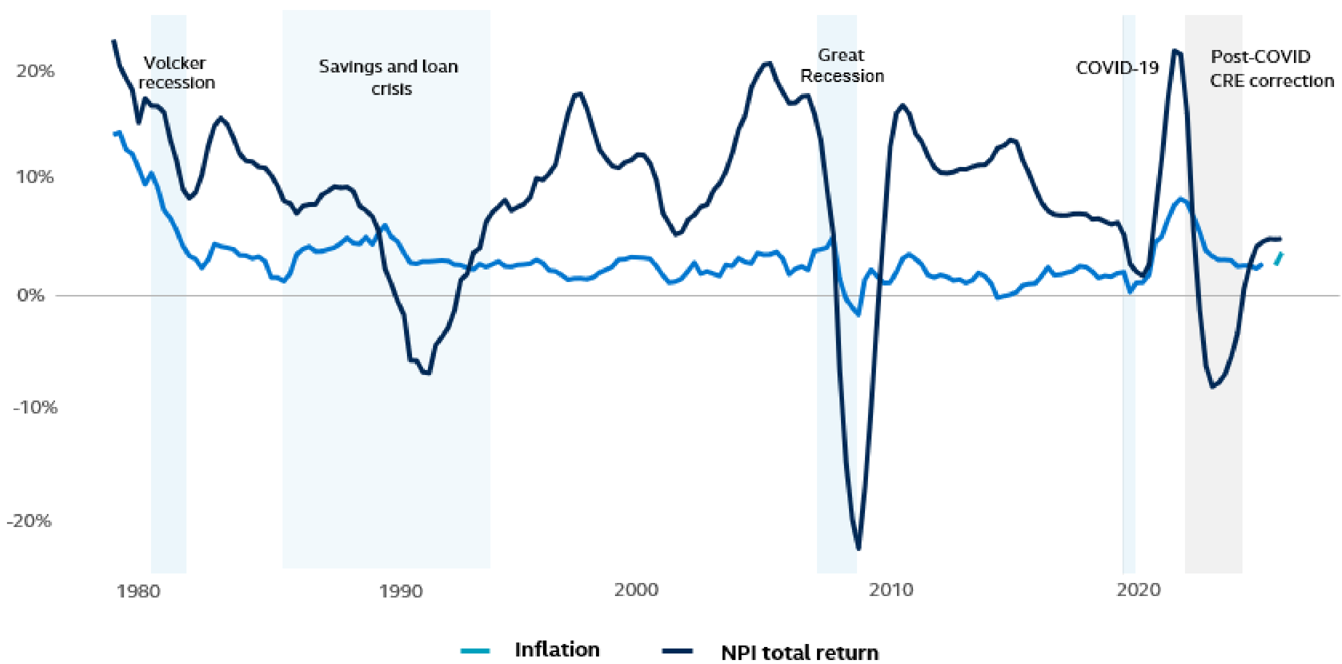
CRE's inflation-hedging record

CRE's inflation-hedging characteristics arise primarily through income. Contractual rent growth (often tied to inflation), periodic lease resets, and the ability to reprice space can allow cash flows to adjust as prices rise. The transmission is neither immediate nor uniform: long leases can delay rent resets, while weaker demand or heavy new supply can limit pricing power. Even so, the long-run record is favorable.

Since 1980, private CRE total returns have exceeded inflation in most periods, including many episodes of elevated price growth and interest rates. The clearest exceptions have occurred during major economic or capital-market dislocations—notably the savings and loan crisis, the Global Financial Crisis (GFC), and the post-pandemic repricing over the past several years. The first two were balance-sheet recessions in which real estate was closely tied to the underlying stress. The latest correction differed in that it focused primarily on fiscal and monetary policy shifts.

Exhibit 1: CRE returns consistently outperform inflation

NPI total return and inflation, annual % change



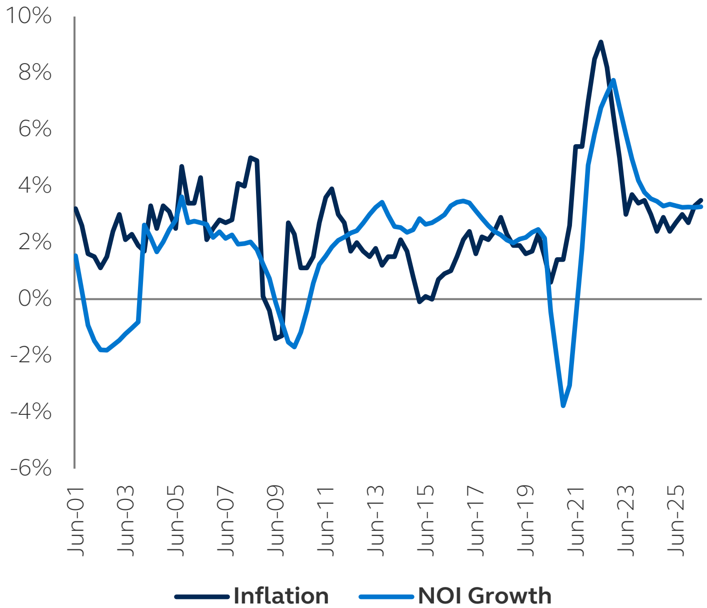
Source: NCREIF NPI; U.S. Bureau of Labor Statistics and U.S. Bureau of Economic Analysis via FRED; Principal Real Estate, Q2 2026.

Why the latest correction was different

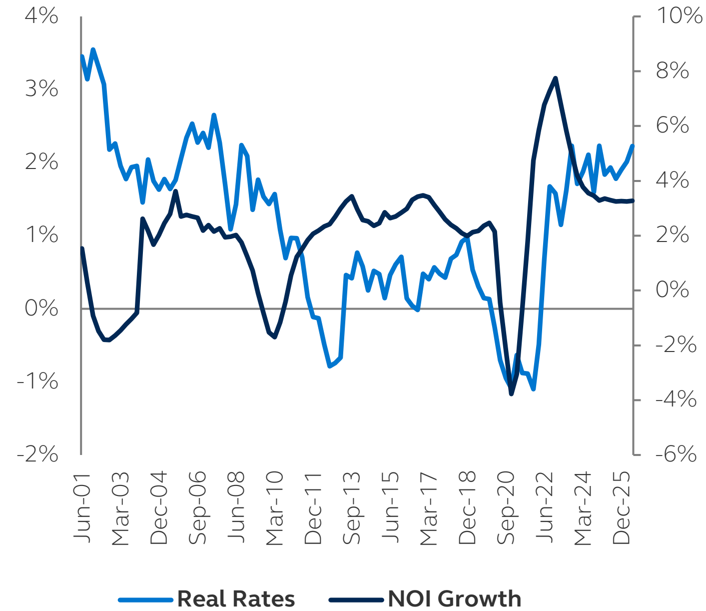
The post-pandemic downturn occurred while economic growth, employment, and consumer spending remained comparatively resilient. Its proximate cause was an abrupt inflation and concomitant shift in monetary policy. Inflation in the U.S. accelerated from roughly 2% before the pandemic to about 9% by mid-2022, while the 10-year Treasury yield briefly exceeded 5% intraday in October 2023. As an inherently leveraged asset class, CRE was particularly sensitive to the sharp rise in interest rates at a time when NOI growth was decelerating from historically robust levels. This upended underwriting assumptions, reduced transaction activity, and contributed to an approximate 20% decline in private CRE capital values from their peak across all property types between 2022 and 2024, according to the NCREIF NPI.

Exhibit 2: NOI growth will drive performance in an inflationary environment

Inflation vs. NOI growth, y/y % change



Real rates (lhs) vs. NOI growth (rhs), y/y % change



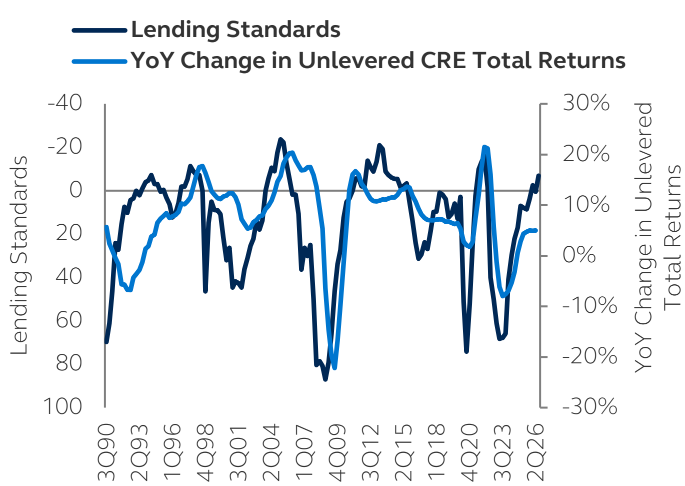
Source: Green Street; Bloomberg; Principal Real Estate, Q2 2026.

More recently, geopolitical developments, tariffs, and other policy changes have again placed upward pressure on consumer and producer prices, creating downside risks to growth. The combination has renewed investor anxiety about inflation and interest-rate uncertainty. The resemblance to 2022 is real, but incomplete.

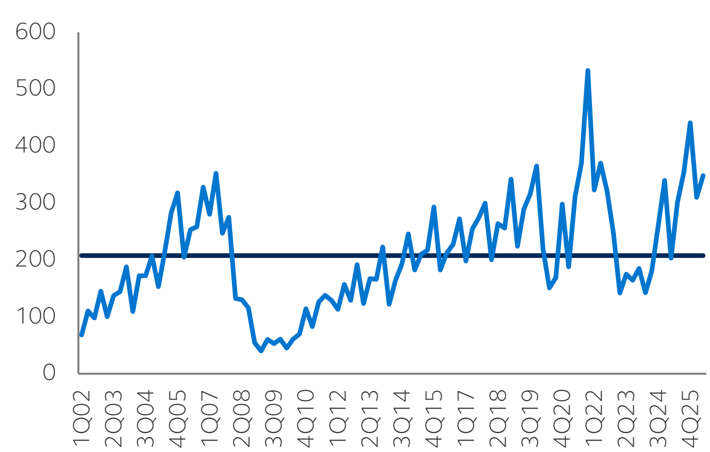
In contrast, CRE debt markets remain open, liquid, and competitive, and the banking system and corporate sector are in stronger condition than they were ahead of prior balance-sheet recessions. Credit availability does not insulate valuations from higher discount rates, but it can reduce the risk of forced sales and disorderly repricing. In practical terms, CRE values are likely to remain highly sensitive to the functioning of debt markets: when financing is available on workable terms, valuations tend to be better supported; when liquidity contracts, pressure can intensify quickly.

Exhibit 3: CRE credit markets are open and liquid

Senior Loan Officer Opinion Survey



Total loan originations, 2001 quarterly average = 100

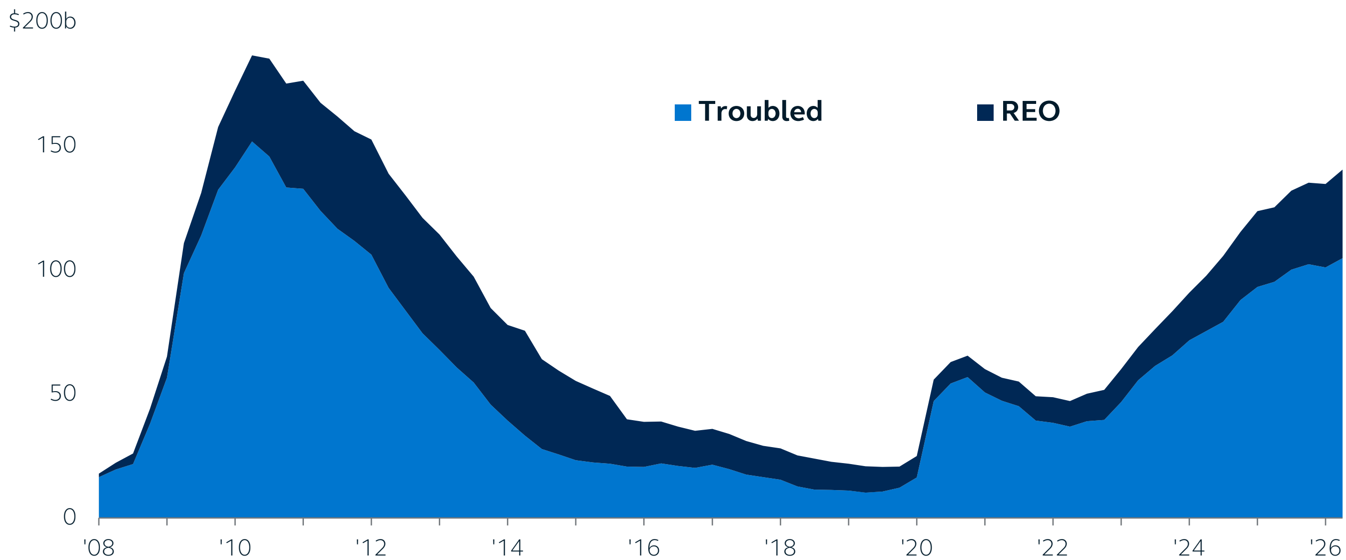


Source: Federal Reserve, NCREIF, MBA, Principal Real Estate, Q2 2026.

This is not to suggest that distress will not increase; it will. We had previously argued, however, that distress is a lagging indicator, as it peaks only after property valuations trough and we maintain that view. Going forward, lenders are likely to be less willing to extend or modify loans absent a credible path to improving valuations through fundamental net operating income (NOI) growth. As a result, we would expect fewer modifications, higher delinquencies, and an increase in foreclosures. According to Real Capital Analytics, outstanding distress currently stands at $104.5 billion, the highest level since Q2 2012. While that figure may appear alarming, distressed sales accounted for just 3.3% of transaction volume in Q2 2026, well below the nearly 20% peak reached in 2010.

Exhibit 4: CRE distress is building, but remains well below the GFC peak

Troubled assets and REO have risen to their highest level since 2012; cumulative balances in $ billions through June 2026



Source: RCA, Principal Real Estate, June 2026.

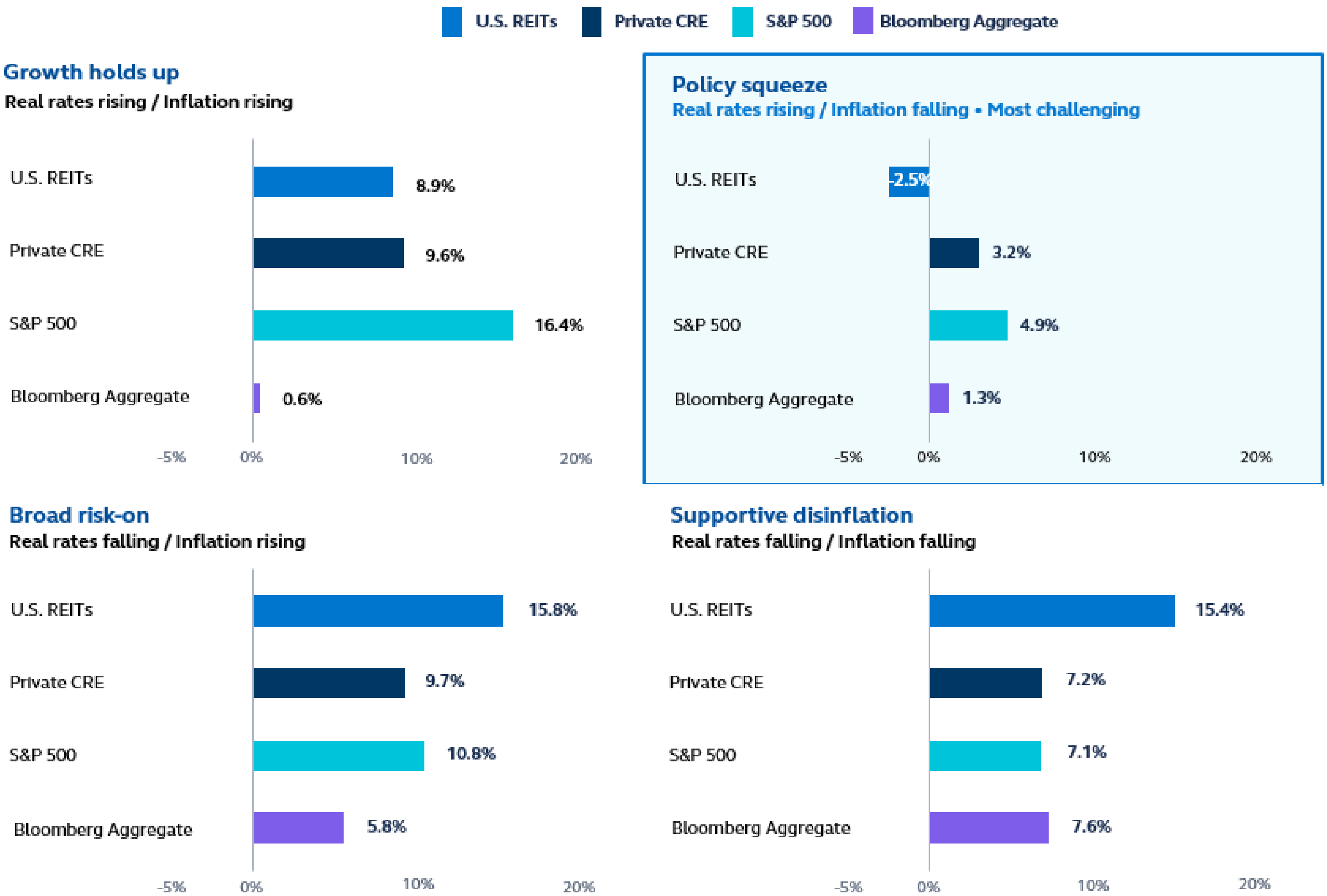
Four inflation and interest rate regimes

Regime definition: *We group observations into four directional regimes according to whether inflation and real interest rates are rising or falling. The chart reports average trailing four-quarter total returns within each regime from 1999 through Q2 2026.*

The most challenging regime across the four asset classes is one in which inflation is falling while real interest rates are rising. This environment typically emerges late in a tightening cycle, when inflation begins to moderate but monetary policy remains restrictive. As inflation declines faster than nominal interest rates, real borrowing costs increase, placing additional pressure on economic activity. While higher real rates help bring inflation under control by dampening demand, they can also slow growth more than intended if policy remains restrictive for too long. The result is a combination of slowing nominal growth and elevated discount rates, which weighs on demand, capital flows, and asset valuations. Rate-sensitive assets such as listed REITs tend to react first, but private-market valuations also come under pressure as transaction activity slows and appraisals adjust to higher financing costs and required returns. This is exactly what occurred over the past several years, even as other risk assets moved to all-time highs.

Exhibit 5: Returns behave differently across inflation and real-rate regimes

Average trailing four-quarter total return, 1999 to 2Q26



Source: NCREIF NPI, Nareit, Bloomberg, Principal Real Estate, Q2 2026. Shared scale in every quadrant; returns shown in percent.

Private CRE has nevertheless been relatively resilient in this regime. Across the 20 quarters since 1999, characterized by rising real rates and falling inflation, private CRE generated an average trailing four-quarter total return of +3.2%. Capital appreciation often turned negative, but income was generally sufficient to keep the average total return positive. That pattern underscores the importance of durable NOI growth when valuation support weakens.

Losses are not impossible, however. Historically, the most severe CRE value declines have coincided with balance-sheet recessions, forced deleveraging, and impaired credit creation. Risks remain including exceptionally tight corporate-credit spreads (albeit stronger credit quality), elevated equity valuations, concentration in AI-related investment, and renewed inflation pressure—but these represent potential sources of repricing rather than evidence of faultlines in the economy's financial balance sheet. Corporate-credit markets remain liquid, issuance is strong, and today's financial system begins from a materially stronger position than it did before the GFC. The substantial repricing already absorbed since 2022 also provides a better valuation starting point, although outcomes will vary widely by sector and asset quality.

Investment implications

The broader lesson is that inflation and interest rates are poor stand-alone predictors of CRE performance. Their interaction—together with the pace of policy change, credit availability, and economic conditions—matters more. The asset class has historically provided meaningful inflation protection in most regimes, but that protection is least reliable when real rates are rising as inflation slows.

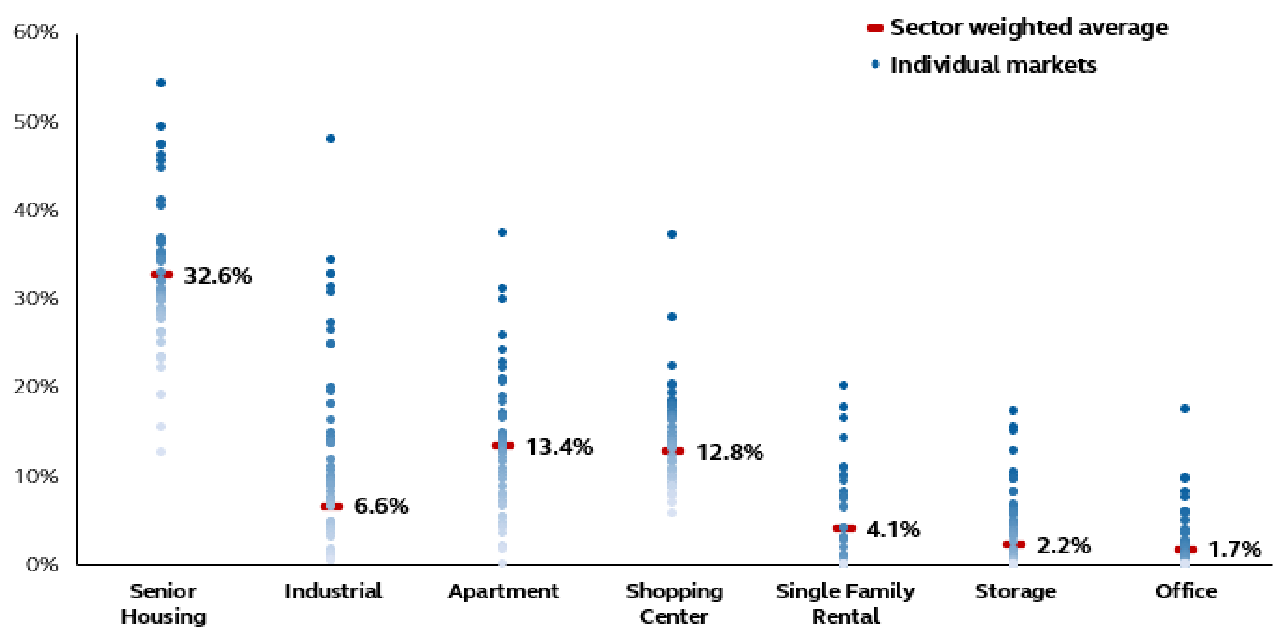
- **Prioritize durable NOI growth.** Assets with pricing power, contractual rent growth, limited new supply, and manageable capital needs should be better positioned to offset valuation pressure.
- **Protect the balance sheet.** Leverage, refinancing exposure, and near-term debt maturities matter more when rates are volatile, even if credit remains available.
- **Expect wider dispersion.** Sector, market, asset, and manager selection should drive a larger share of relative performance than in a broad-based recovery.
- **Treat income as the first line of defense.** Headline returns may remain muted if negative capital returns offset part of the income return, but stable cash flow can continue to provide an important cushion.

Our base case is not a repeat of the post-pandemic correction, but neither is it a return to the low-rate environment that preceded it. Income should remain resilient, while durable NOI growth without excessive balance-sheet or capital-expenditure risk is likely to distinguish the strongest assets. Many properties and markets will continue to benefit from an early-cycle environment characterized by rising rents and values. Others, however, may face a cycle that never fully materializes.

Dispersion has always existed and always will, but for much of the past three decades, the market has not needed to focus on it. In broad-based recoveries, even relative underperformers often produced attractive returns, while in downturns, even strong assets struggled to generate positive performance. The V-shaped recovery following the GFC further muted these distinctions. Today is different. For the first time since the aftermath of the S&L crisis, avoiding the losers that can derail long-term performance may be just as important as identifying the winners. Alpha is earned, not given.

Exhibit 6: Recovery from the trough has been uneven across sectors and markets

Senior housing has led, while office and storage remain near trough values; sector-weighted averages and individual top 50 markets through Q2 2026



Source: Green Street, Principal Real Estate, Q2 2026.

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