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Real Estate

Principal®

SPECIAL REPORT

Can commercial real estate beat the current high inflation environment?

AUTHORS

Indraneel Karlekar, Ph.D.
Global Head of Research
& Portfolio Strategies

Arthur Jones
Senior Director,
Research

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EXECUTIVE SUMMARY

- Inflation in the U.S. has risen to levels last seen in the early 1980s raising fears of being entrenched in the post-pandemic economy.
- Elevated inflationary pressures are pushing the Federal Reserve (Fed) to aggressively lift short-term interest rates potentially into a slowing growth environment—conjuring fears of stagflation.
- Although commercial real estate is not inflation proof, it has a compelling record of performing well during periods of higher-than-average inflation, owing to its ability to generate and increase income returns for investors given the nature of leases that are often tied to measures of inflation.
- Investors need to be mindful that not all property sectors, or locations, will offer the same performance or the same hedge against inflation benefits; we recommend focusing on a mix of emerging growth and traditional property types in metro areas aligned with long-term structural drivers that include technology and strong demographic growth profiles.

Inflation is running hot

In 2020, Principal Real Estate produced a paper warning that record fiscal stimulus totaling roughly $6 trillion in direct payments to households and businesses; the Fed's ultra-accommodative monetary policy; and pandemic-related supply chain disruptions could lead to heightened inflation. These three key factors created a surge in consumer activity that helped power one of the fastest economic recoveries on record. In the process, strong household spending and goods shortages generated significant demand side inflationary pressures spilling over into residential real estate.

To put the present situation in perspective, there have been five distinct periods of varying levels of inflation in U.S. economic history since World War II: the post-war era; the Great inflation; the Great moderation, post-Global Financial Crisis (GFC), and post-COVID. These periods are highlighted in Exhibit 1 along with the key factors affecting pricing during each inflationary regime. As discussed in our earlier paper, the Great inflation period, which corresponded to increases in fiscal spending, shifting global monetary policy (i.e., the end of the Bretton Woods system), more highly regulated markets, and disruptions in global trade, remains the only significant period of excess inflation in modern economic history.

EXHIBIT 1: Inflation drivers vary widely by inflationary regime

Impact on inflation: Moderating Neutral Inflationary

	Inflationary regimes				
Factor	**Post-war era 1945–1964**	**Great inflation 1965–1982**	**Great moderation 1983–2007**	**Post-GFC 2008–2019**	**Post-COVID 2020-present**
Monetary policy	Moderating	Inflationary	Neutral	Inflationary	Inflationary
Fiscal policy	Neutral	Inflationary	Neutral	Moderating	Inflationary
Globalization	Neutral	Neutral	Moderating	Moderating	Neutral
Immigration	Neutral	Neutral	Moderating	Neutral	Inflationary
Regulatory environment	Neutral	Neutral	Moderating	Neutral	Neutral
Labor	Inflationary	Inflationary	Moderating	Moderating	Inflationary
Consumer demand	Neutral	Neutral	Inflationary	Moderating	Inflationary
Inflationary enviroment	Neutral	Inflationary	Moderating	Moderating	Inflationary

Source: Principal Real Estate, June 2022

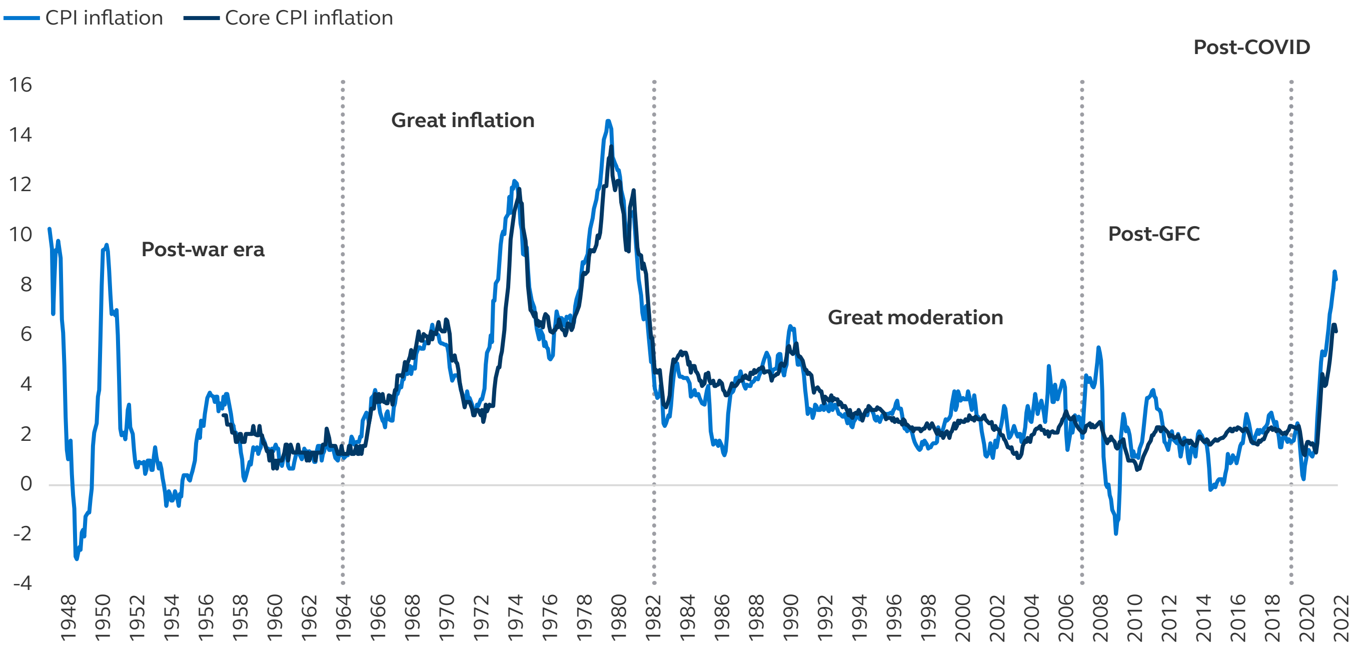
Perhaps most importantly, the 1970s corresponded to a period of low economic growth commonly referred to as stagflation. In the post-COVID period, many of the same—if not more—inflation factors are flashing red, though some are arguably temporary in nature, resulting directly from pandemic-related disruptions. Global trade, for example, continues to be disrupted by China's zero COVID policies despite much of the world returning to normal day-to-day activities. This has created supply-chain disruptions in ports and shortages of physical goods in the U.S. at a time when employment and wage growth have accelerated, supporting robust consumer demand.

Add to that increased geopolitical uncertainty and disruptions to commodity markets caused by the conflict in Ukraine, which have led to a significant increase in oil prices. Massive fiscal support during the pandemic is still making its way through the economy and has been supportive of household spending. A sharp drop in immigration has placed additional pressure on wages at a time when the U.S. demographic picture is one of aging with baby boomers retiring at an accelerating pace. And until very recently, monetary policy was unprecedented in its looseness allowing ample credit to households and corporates alike. No surprise, inflation spiked and is hovering near its highest level since the early 1980s (Exhibit 2).

As a result, the Fed has been forced to abandon its plans to slowly normalize interest rates later when the economy would have arguably reached a self-sustaining expansion. Instead, it has embarked on a more aggressive tightening cycle primarily aimed at curbing inflationary trends, which have proved stickier than initially thought. To accomplish this task the Fed has increased rates three times in 2022 and is targeting a policy rate that could be near 4% by the end of 2023. It has also started to wind down its bloated balance sheet adding further tightening.

EXHIBIT 2: Inflation is running near its 40-year high

CPI for all urban consumers, YOY % chg



Source: U.S. Bureau of Labor Statistics, Moody's Analytics, Principal Real Estate, May 2022

Complicating the Fed's policy decision is that it now appears to be tightening into a weaker economy, which is somewhat at odds with its dual mandate of stable prices and full employment. In a sense, it may indeed face a Hobson's choice where it must raise rates aggressively to combat further price increases, while potentially slowing growth or even causing a mild recession, or otherwise risk allowing inflation to run hot and trigger a more severe and damaging stagflation scenario in which price increases persist and employment and economic activity decline (see box on stagflation on page 4). The latter would certainly have a more severe and long-lasting impact on both growth and commercial real estate performance due to the impact on market fundamentals.

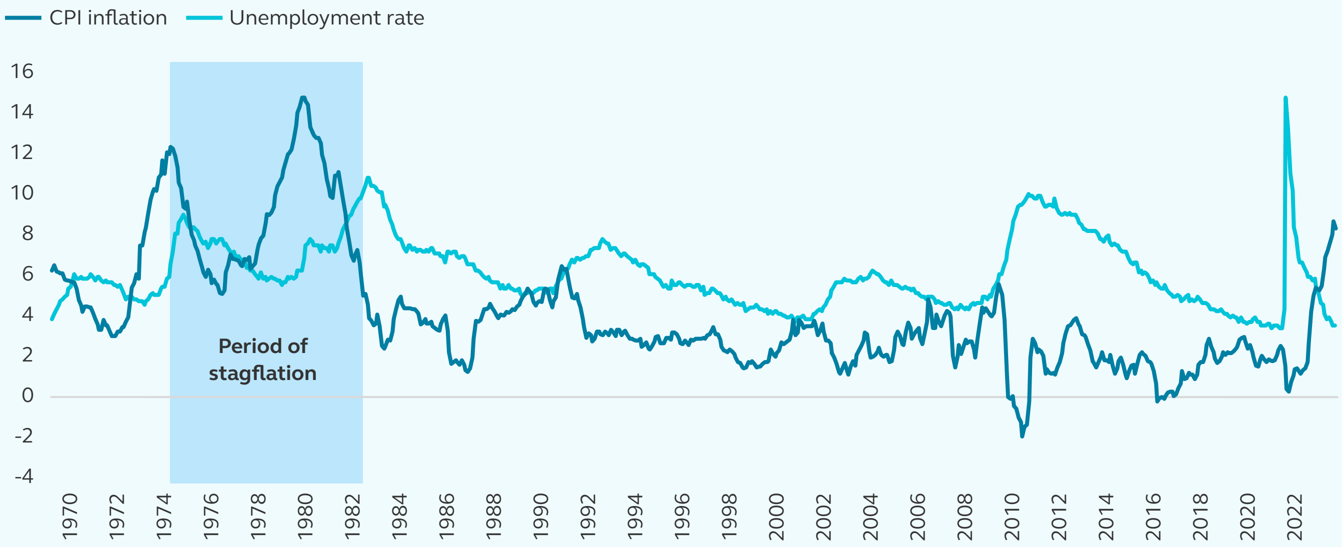
At present, the Fed's policy shift and communications have added volatility to public markets but are yet to have a discernable impact on private equity real estate. While REITs have turned negative on a rolling 12-month basis, the NCREIF National Property index (NPI) for all properties has continued to show robust performance clocking in at 21.9% over the last four quarters as both income and capital appreciation have performed well. Such positive performance is a testament to healthy economic growth over the same period, which has allowed market fundamentals to remain healthy across most property types, as well as record low interest rates and the widespread availability of debt capital that has led to a significant compression in capitalization rates.

Stagflation—evidence from the 1970s suggests challenges for traditional asset classes

A combination of high inflation and slowing growth is causing some investors to revisit the dreaded scenario of stagflation that developed markets last witnessed in the 1970s. A series of occurrences in recent months has brought up parallels with several stagflation catalysts—conflict, surging commodity prices (especially energy prices), lingering effects of a massive fiscal impulse, and supply chain chokeholds that are imperiling the essence of the globalized economy. Stagflation, however, is generally thought to occur during periods of high price inflation and high unemployment. As Exhibit 3 shows, the labor market is markedly tighter than it was during the 1970s, and with a vigilant central bank that is extremely focused on not letting high inflation expectations get entrenched, stagflation is not our base case as yet.

EXHIBIT 3: We are not in a 1970's stagflation scenario…

Inflation and unemployment, %



Source: U.S. Bureau of Labor Statistics, Moody's Analytics, Principal Real Estate, June 2022

Given the interest around the issue, we thought it pertinent to examine the relative performance of different asset classes during the stagflationary period of the 1970s. Traditional asset classes such as equities and fixed income fared very poorly, while commodities—energy in particular—and real estate were better inflation hedges (Exhibit 4).

EXHIBIT 4: Performance of select asset classes, 1970–1980

Year	U.S. house prices	Commodities	U.S. stocks	U.S. bonds	U.S. REITs	U.S. CPI
1970	4.4%	16.0%	-4.6%			5.6%
1971	8.7%	9.1%	9.6%			3.3%
1972	8.4%	30.7%	17.6%		11.2%	3.4%
1973	12.3%	112.6%	-13.6%		-27.2%	8.9%
1974	7.5%	33.1%	-29.2%		-42.2%	12.1%
1975	9.5%	-15.3%	30.5%		36.3%	7.1%
1976	9.8%	15.1%	10.6%		49.0%	5.0%
1977	13.1%	2.1%	-10.3%	3.0%	19.1%	6.7%
1978	19.1%	18.8%	5.6%	1.4%	-1.6%	9.0%
1979	13.1%	56.3%	10.3%	1.9%	30.5%	13.3%
Averages	10.6%	27.8%	2.7%	2.1%	9.4%	7.4%
Average real return	3.2%	20.4%	-4.8%	-5.3%	1.9%	

Source: Bloomberg, NAREIT, National Association of Realtors, Moody's Analytics (Existing Single-Family Home Price), Principal Real Estate, June 2022.

Indices used: U.S. REITs: FTSE NAREIT U.S. Real Estate Index All REITs; U.S. stocks: S&P 500 Composite Price Index; Commodities: Bloomberg Commodities Index; U.S. bonds: Bloomberg Barclays Aggregate Bond Index. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index.

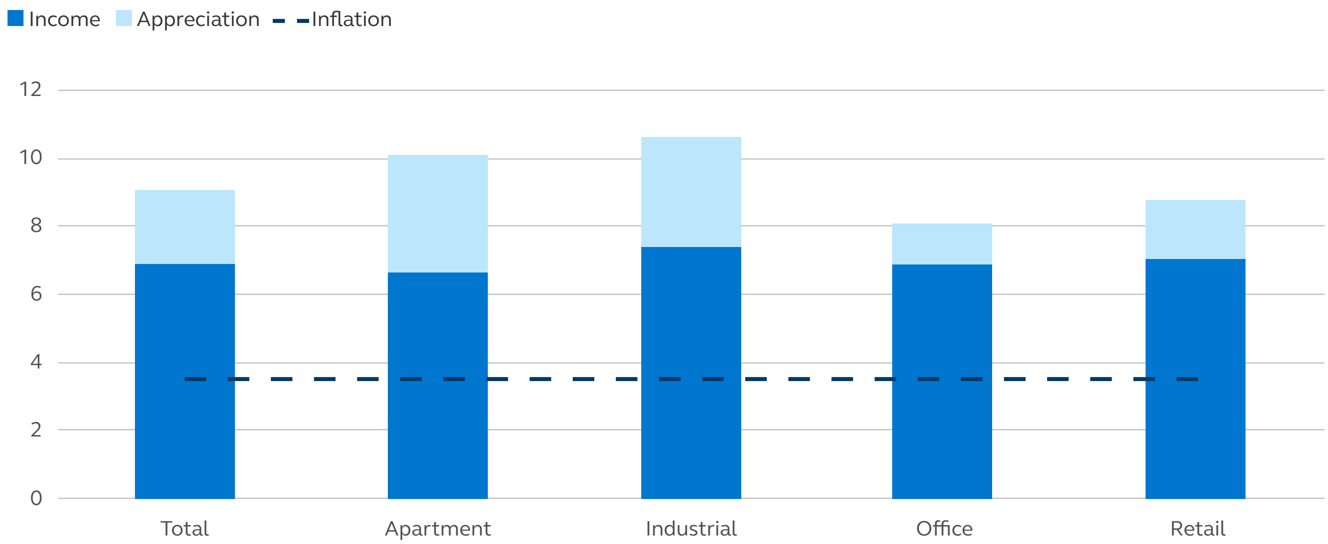
U.S. commercial real estate has a respectable track record of beating inflation

Commercial real estate has long been thought of as an inflation hedge among risk assets. While no risk asset can promise that it is truly inflation-proof, the income producing component of commercial real estate has allowed it to outperform inflation even dating back to the late 1970s.

Since 1978—the first year for which NPI data are available—private equity real estate has offered a total return of 9.2% on an annual basis with a 7% income return (see Exhibit 5). Such steady and healthy income returns are partially the result of a landlord's ability to frequently reset rents on short-term leases, like apartments and underwrite periods of unanticipated inflation by including escalator clauses in longer-term leases, like the industrial sector. Add appreciation of 2.2% and since inception commercial real estate has outperformed inflation (which has averaged 3.5% over the same measurement period) by a total of 570 basis points on an average annual basis.

EXHIBIT 5: NCREIF Property Index since inception returns have outpaced inflation

NCREIF property type returns relative to inflation annualized since inception (Q1 1978)



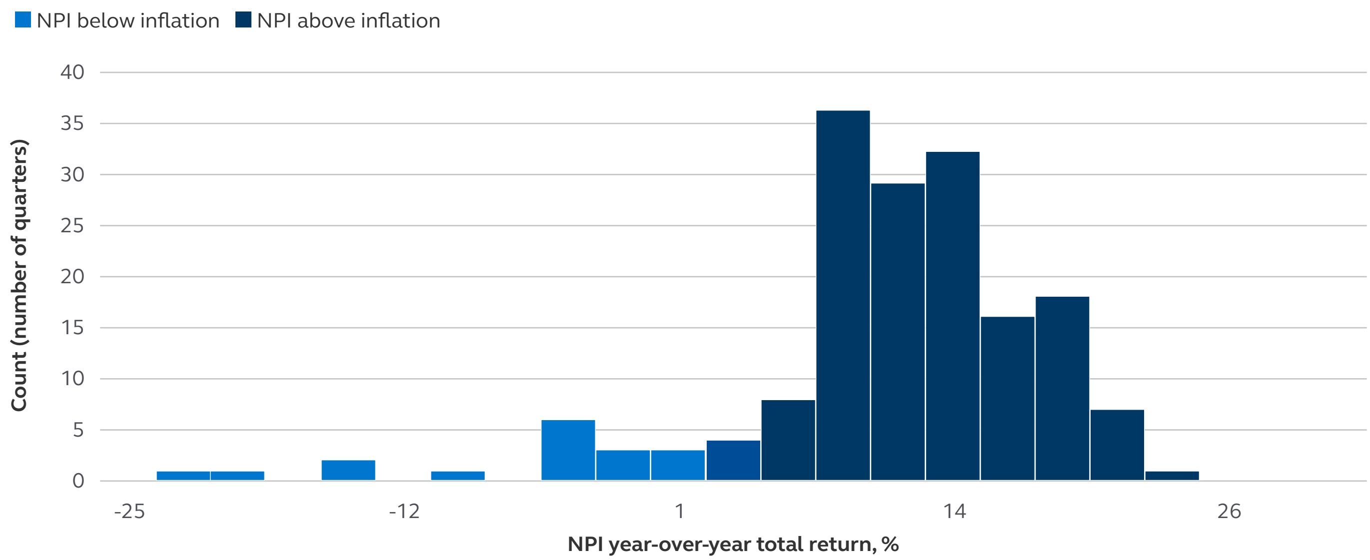
Source: NCREIF NPI, U.S. Bureau of Labor Statistics, Principal Real Estate, March 2022. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index.

Another way to think about commercial real estate's performance relative to inflation is to plot out annual returns relative to inflation historically on a period-by-period basis. Exhibit 6 shows total returns divided into periods where commercial real estate outperformed inflation compared with periods where inflation outperformed. Since 1978, there were two primary periods where NPI returns fared worse than consumer inflation, the first being the period prior to and following the Savings & Loans Crisis (between Q4 1990 and Q1 1994). While inflation was running above its long-term average, the primary culprit was overbuilding during much of the 1980s and the recession following the banking crisis. Between Q4 1990 and Q1 1994 commercial real estate capital values declined by 27.2% and the overall average total return for the NPI was -2.3% on an average annual basis.

EXHIBIT 6: Commercial real estate has historically outperformed inflation

Distribution of annual total returns relative to inflation

All property types, since 1978



Source: NCREIF NPI, U.S. Bureau of Labor Statistics, Principal Real Estate, Q1 2022. Index performance information reflects no deduction for fees, expenses, or taxes. Indices are unmanaged and individuals cannot invest directly in an index.

The second period was the GFC when property returns underperformed inflation from Q4 2008 to Q2 2010. This coincided with a cumulative capital value decline of 30%. The point being that in both cases, underperformance was the direct result of severe balance sheet recessions rather than inflation itself. In total, commercial real estate has been able to outperform inflation 87.7% of the time, which includes periods of high inflation during the late 1970s and early 1980s. This suggests that history is on the side of the asset class in helping provide inflation hedging benefits to a balanced portfolio.

Is this time any different?

The case for U.S. commercial real estate as an inflation resilient asset class is certainly clear based on analysis of historical data. That said, it does not mean that it is inflation-proof and different cycles bring with them unique sets of circumstances. Today we are dealing with a very different set of circumstances than during the prior high inflation environment. For starters, commercial real estate is a far better established asset class than it was in the 1970s and does not necessarily benefit from the same tax-friendly policies that allowed it to deliver robust returns during the early days of the NPI. Moreover, both public and private markets have better developed indices that are more reflective of the real estate universe today than they were 40 years ago. In addition, the asset class has grown enormously in value and in the variety of property sectors now available to investors.

It is also the case that the way we view and use commercial real estate has shifted since the late 1970s. While commercial real estate demand has traditionally been predicted by changes in employment, consumer spending patterns, and global trade, the way we live, work, and play is very different today. Though COVID-19 was responsible for some of the speed at which these changes occurred, most of these trends were in place long before the pandemic began.

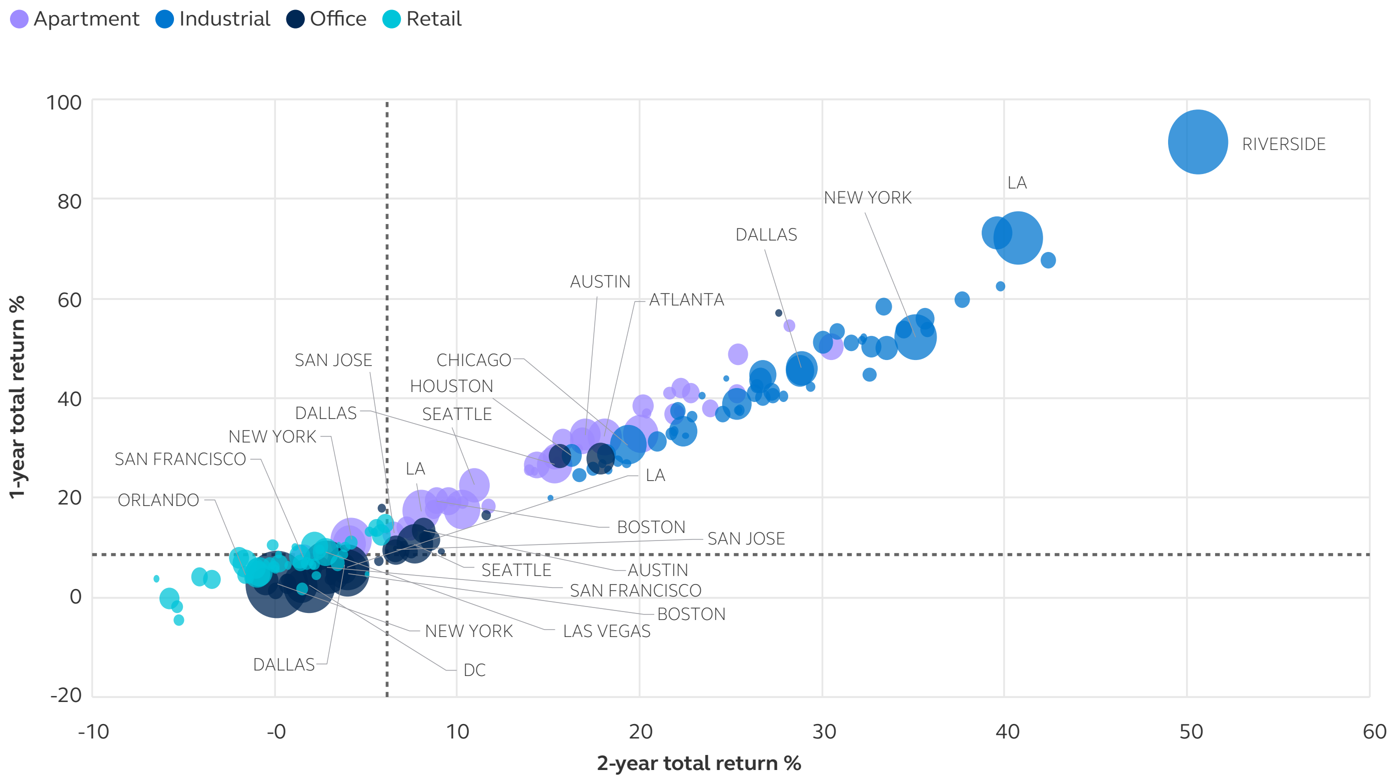
The office market is a good example of this, where the sector accounted for roughly 40% of the NPI just before the dot.com bust in 2001, demand for office space has slowed dramatically over the past two decades. The office sector now accounts for just 28% of the index, reflecting a shift in tenant usage and investor preference. Today—more than two years after the onset of the pandemic—office utilization is just under 45% of its pre-COVID level, according to data from Kastle Systems. Alternatively, the rise of e-commerce and shifting housing demand have resulted in respectable performance for residential and warehouse properties ranging from market fundamentals to investment returns.

Exhibit 7 displays total returns by property type and metro area over the past two years relative to inflation. While it is clear that industrial properties have outperformed inflation on both a one- and two-year trailing basis, office and retail properties have displayed more mixed results due to secular headwinds. The residential sector has also performed well due to shifting demand for housing and an increase in Central Business District (CBD) to suburban migration during the lockdowns as workers sought more space for both work and family life.

EXHIBIT 7: Recent performance relative to inflation is determined by demand*

Total returns by metro area and property type

2-year vs. 1-year annualized return (%)



*Size of bubble reflects market value

Dashed lines indicate annual CPI inflation

Source: NCREIF NPI, U.S. Bureau of Labor Statistics, Principal Real Estate, Q1 2022

When we look at property sector performance over the past 40 years, strong underlying demand drivers, market fundamentals, and asset selection are far more important than interest rates and inflation. Investors need to carefully evaluate the potential for sustained demand on both a cyclical and structural basis when considering portfolio construction. As Exhibit 7 illustrates, both apartment and industrial assets have performed particularly well, despite a high inflation environment, while headwinds for office and retail remain challenging to landlords and, in turn, investors.

Inflation and property outlook

We are currently in the most elevated inflationary environment since the early 1980s. While both inflation and central bank policy shifts have vexed capital markets and impacted returns for traditional assets, the same cannot be said for private equity real estate yet. Performance-to-date has outstripped high inflation, thanks largely to the healthy performance of structurally-driven residential and industrial property types. While income growth has been solid, the past 24 months have been marked by a notable increase in capital values.

As inflation and interest rates are concerned, there is some hope we are at least approaching a peak, but we are not there yet. Though economic growth appears to be slowing, the most recent CPI print for May of 8.5% was disquieting to say the least. As a result, the Fed will keep up the pressure, in particular on price increases, by pushing its target rate to between 3.5%-4.0% by the end of 2023, which should help wring out some pricing pressures, albeit at the cost of slower economic growth. Consensus estimates have inflation falling to 5.5% by the end of 2022 and 2.9% by 2023, which should relieve some strain even though with moderately higher interest rates and within a slower growth environment.[1]

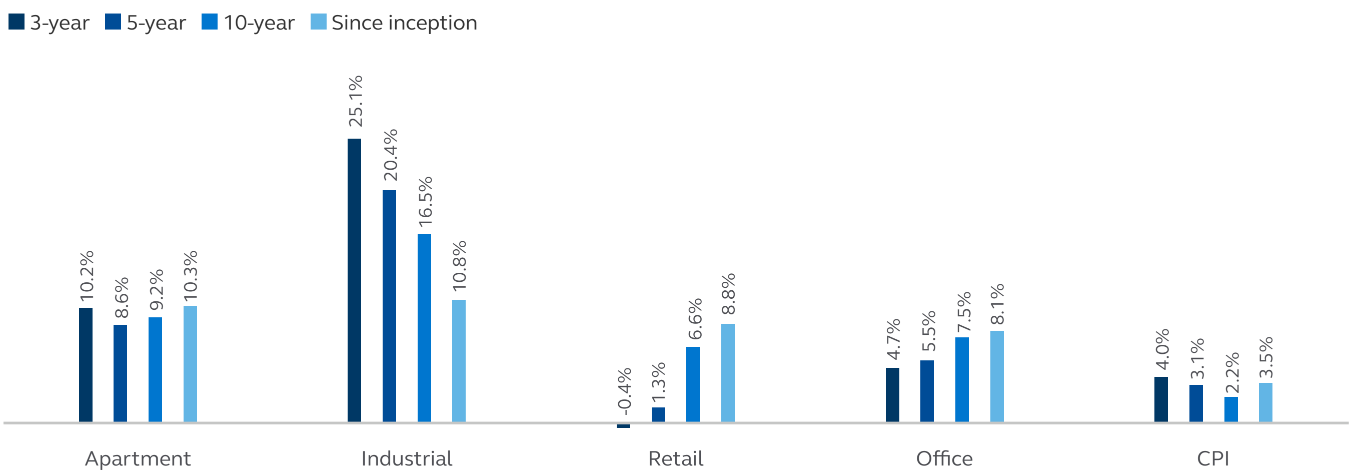
But to hedge against the cyclical challenges that will invariably accompany slower growth and labor markets, we suggest portfolio construction should revolve around Principal Real Estate's "DIGITAL"[2] themes and markets, which take advantage of strong underlying migration trends and shifting demand for commercial real estate that focuses on emerging consumer trends, the increasing use of technology by consumers and businesses, and the re-orientation of global trading links. While we feel that today's high inflationary environment will ebb, investors who are on the forefront of embracing existing and emerging secular trends could be able to build resilience into their portfolios.

How can commercial real estate investors mitigate inflation in their portfolios?

Though there is little any asset manager can do to entirely avoid inflation, by pivoting toward the stability of real assets, including commercial real estate, investors can potentially preserve real investment performance. The U.S. is arguably in a better situation globally—particularly compared to those in Europe who are heavily dependent on Russia for its energy needs—to wring out inflation over the next 12 to 18 months. That said, we believe both near- and longer-term performance may be enhanced by investing in property sectors that exhibit both high correlation to inflation as well as strong structural demand drivers.

We believe it is important for investors to focus on property types that are best positioned to exhibit strong structurally-driven demand and real rent growth—particularly in an above average inflationary environment. As shown in Exhibit 8, apartments and industrial have been most effective at mitigating inflation given the structurally resilient demand, which is amplified by lease structures that can help landlords.

EXHIBIT 8: U.S. property type annualized total returns versus inflation
1978 - 2022



Source: NCREIF, Moody's Analytics, Principal Real Estate, June 2022. Inception = Q1 1978

[1] Wall Street Journal Economic Survey, April 2022, https://www.wsj.com/articles/recession-risk-is-rising-economists-say-11649592002?mod=article_relatedinline

[2] DIGITAL: Demographics, Infrastructure, Globalization, Innovation & Technology

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Cyclically sensitive property sectors are likely to come under pressure in a slower growth and high inflation scenario. As a counterbalance, we recommend adding property sectors that have structurally resilient growth and leases that reset more often, which allows owners to readjust pricing. Appropriately diversified portfolios with a mix of short-term and mid-to longer-term leases—particularly those with CPI escalators—stand a better chance of keeping pace with and even exceeding inflation. Exhibit 9 contains a snapshot of the sectors investors could consider in building a portfolio.

EXHIBIT 9: Inflation and real estate: Some considerations for investors

Demand profile: ● Strong ● Neutral ● Weak

Property type	Structural demand	Cyclical demand	Lease duration	CPI linkage	Investor demand
Data centers	● Strong	● Strong	Mid	Mid/Strong	Strong
Hotel	● Neutral	● Neutral	Short	Strong	Weak
Business	● Neutral	● Weak	Short	Strong	Weak
Leisure	● Neutral	● Strong	Short	Strong	Weak
Industrial	● Strong	● Strong	Short/Mid	Strong	Strong
Life sciences	● Strong	● Strong	Long	Mid	Strong
Medical offices	● Strong	● Neutral	Long	Mid	Strong
Office	● Weak	● Weak	Mid/Long	Mid/Weak	Weak
Residential	● Strong	● Strong	Short	Strong	Strong
Retail	● Weak	● Neutral	Long	Weak	Varied/Weak
Neighborhood & Community	● Neutral	● Strong	Long	Weak	Varied/Weak
Malls	● Weak	● Neutral	Long	Weak	Varied/Weak

Source: Principal Real Estate, June 2022

Conclusion

U.S. commercial real estate can potentially provide investors different options to mitigate against the elevated levels of inflation that are likely to persist over the short-term. While no property type offers a perfect hedge, we believe resiliency in demand and the structure of leases can go a long way in creating the type of portfolio that may provide shelter against high inflation. From a relative perspective, data from the 1970s—which was one of high inflation and slow growth—does suggest that real estate fares better than traditional assets in preserving real returns. In a relative value world, that may be a good place to be in for real estate as well as for balanced investors looking for options to mitigate against elevated inflation.

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Exhibit 4 indices used: U.S. REITs - FTSE NAREIT U.S. Real Estate Index All REITs - is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs; U.S. Stocks - S&P 500 Composite Price Index (U.S. stocks) – 500 widely held common stocks that measures the general performance of the market; Commodities - Bloomberg Commodities Index - is a broadly diversified commodity price index; U.S. Bonds - Bloomberg Barclays Aggregate Bond Index - is a broad based, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. **Exhibits 5, 6, 7, 8** index used: NCREIF National Property Index - is used to analyze the performance of commercial real estate and used as a benchmark for actively managed real estate portfolios.

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