COLUMBIA THREADNEEDLE INVESTMENTS

3-minute read

How does real estate perform in inflationary environments?

July 2022 | Hans Nordby, Head of Research and Analytics, Lionstone Investments

Historically, real estate has performed well in inflationary environments — particularly in apartment and office sectors.

KEY POINTS:

1. Real estate has shown especially strong income and value performance in inflationary environments.
2. Data indicates that certain property types perform better than others.
3. In the current environment, real assets that post positive returns can be found by identifying areas of significant income growth at city and neighborhood levels.

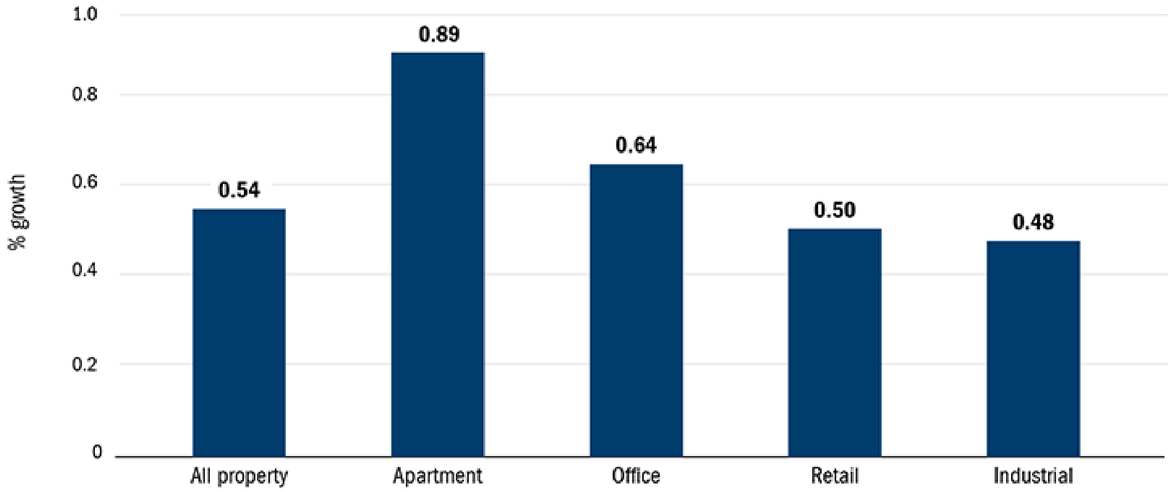
Like in the U.S. economy of the 1970s and 1980s, today's investors are concerned about high inflation, which has sparked increased interest in real estate. Inflation is considered a leading reason to invest in real estate. But is this rationale backed by the data?

Real estate can help offset the impact of inflation

In the long term, real estate and inflation tend to move in the same direction because as inflation pushes up wages, it also increases the flexibility of landlords to raise rents. In addition, higher inflation is associated with a robust economy, which is also supportive of consumers and consumer spending. Historical data supports these observations but suggests that different asset classes within real estate have performed better than others. The Pension Real Estate Association (PREA) published an analysis indicating that between 1979 and 2021, the net operating income of all properties increased 0.5% for every 1% increase in inflation (see chart below). Apartment and office assets performed better relative to other property types, with income gains of about 0.8% and 0.6%, respectively. The apartment sector was likely the most responsive as it had the shortest average lease length and was therefore able to increase rents more quickly.

Some real estate asset classes performed better than others in inflationary environments

Effect of a 1% increase in inflation on growth of same-store net operating income

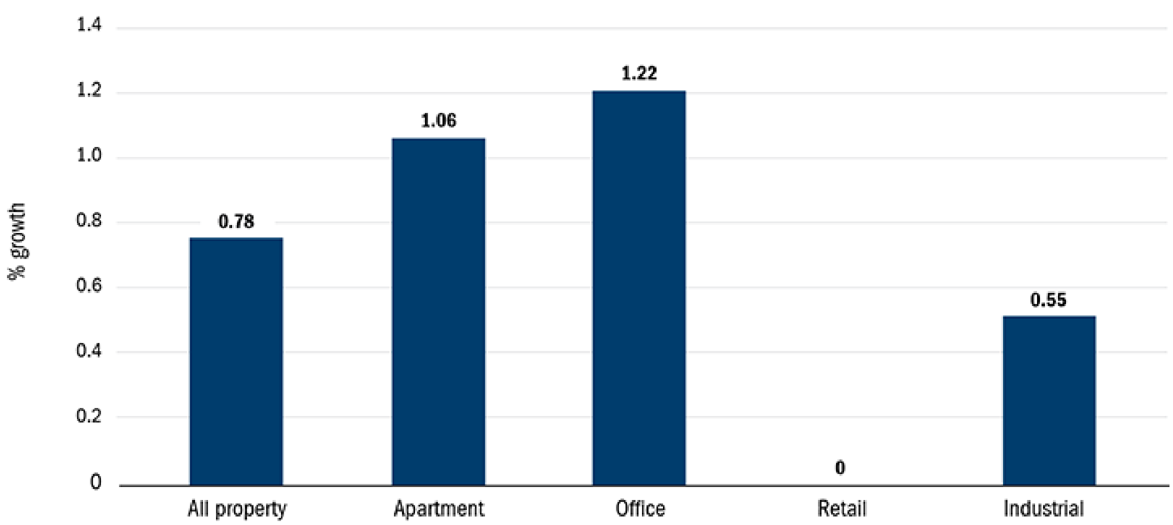


Note that this is a historical effect.
Source: PREA, NCREIF – PREA Quarterly, Fall 2021

PREA found an even stronger relationship between growth in property value and inflation, with office buildings and apartment values gaining 1.2% and 1%, respectively, for each 1% increase in inflation (see chart below). Industrial assets also posted gains in value. To the extent that institutional investors find an asset class that provides an offset to the impact of inflation and positive investment results, they may bid up that asset class.

Growth in property value has had a strong relationship with inflation, but there are differences among property types

Effect of a 1% increase in inflation on property value (1979–2020)

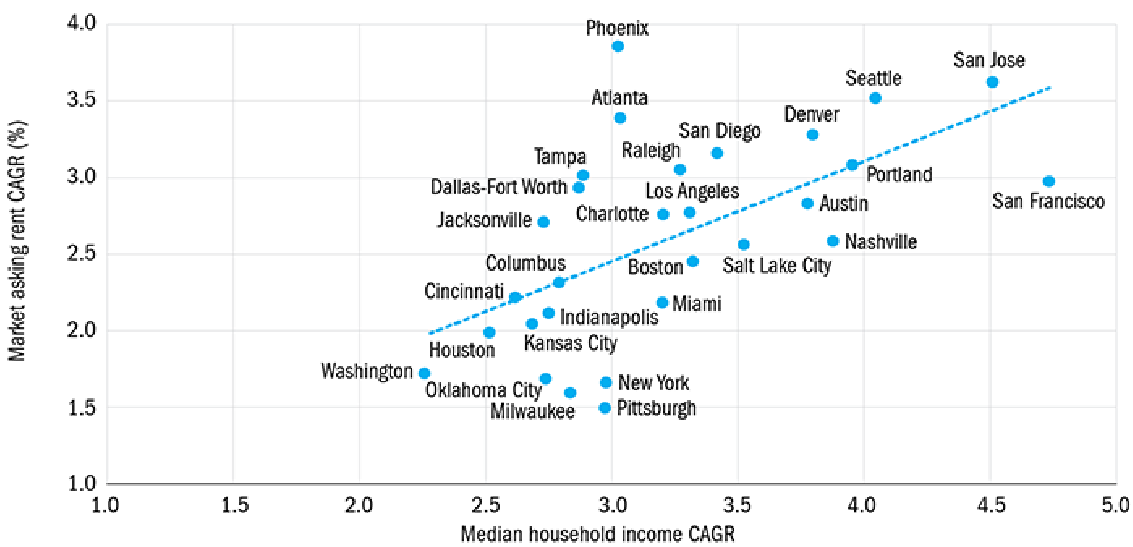


Source: PREA, NCREIF – PREA Quarterly, Fall 2021

Higher investment resolution to combat inflation

Like almost everything else in real estate, even the relationship with inflation is a function of location. In other words, each property is different, and not every location will perform as well in an inflationary environment. Our analysis (see chart below) indicates that the real assets that could perform best are those that are tied to certain U.S. cities, which have the potential to outperform in terms of job growth and in-migration, and where the digital economy is strongly rooted. In those areas, in the decade leading up to the pandemic, apartments posted rent growth that was highly correlated with the median household income growth at the metro level. This occurs as tenants — commercial and residential — experience increased income.

Cities with higher income growth paid higher rent (2009–2019)



Source: Lionstone Investments

In this environment, real estate investors have the potential to benefit from high-quality assets, with a steady income stream, and which offer yields that are attractive relative to other traditional — more expensive — inflation hedges. The asset class offers investors strong fundamentals and diversification from current volatility in global stocks and bond markets. Lionstone believes that the real assets that can offset the impact of inflation within the asset class can be found by identifying areas of significant income growth at the city and neighborhood level. This is consistent with our approach to active and selective investing, which focuses on opportunities within 17 cities in which we invest, with high concentrations of highly productive jobs without the high-cost structures of gateway coastal cities.

ABOUT THE THOUGHT LEADER

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As head of Lionstone's Analytics and Research team, Hans Nordby is responsible for leading the firm's proprietary analytics and data-driven research platform. He joined Lionstone in 2020, bringing more than 20 years of industry experience to the firm. He is a graduate of the University of Minnesota and holds an MBA from Indiana University.

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