# Is Real Estate an Effective Inflation Hedge?

*European Real Estate Research Quarterly*

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## *Executive Summary*

### ECONOMY

- The recovery in GDP is underpinned by running down lockdown savings, public sector investment and an improved export outlook.
- Surging inflation is temporary—reflecting a reawakened, rather than an overheating, economy.
- Greater economic/labor market slack remains in Europe, relative to the U.S.

### PROPERTY MARKETS

- Commercial property investment is down by a third in Q1 2021 versus a year ago, while preliminary data indicates a Q2 revival is underway.
- Retail investment continues to decline and office capital flows are weak, with investors continuing to pivot toward apartments and logistics.
- Europe was the top destination for real estate capital raised last year.
- Office occupiers are currently more optimistic about the sector than investors are—we continue to envisage that occupiers will demand less space, but of a much higher quality.
- Long-term sector structural trends in demographics, technological change and ESG are key to long-term income growth and therefore capital flows and pricing.

### SPECIAL TOPIC

- Investors seeking long-term insulation from inflation should tilt their portfolios in line with wider societal changes.

## *Economic Outlook*

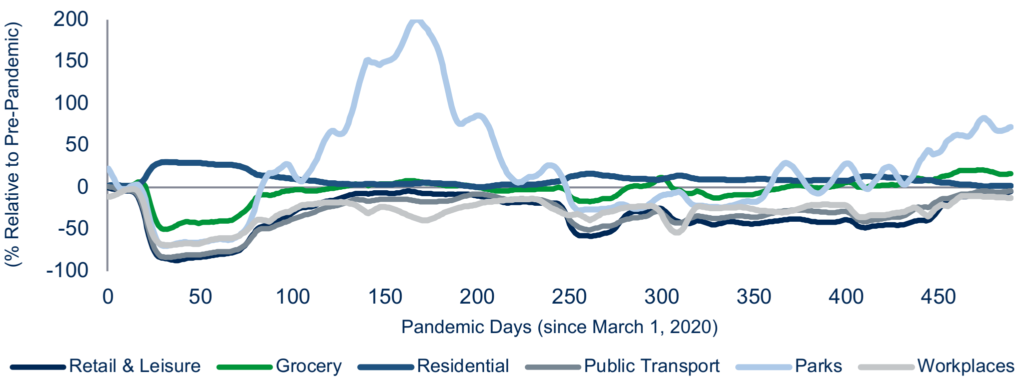
June's IHS Markit Eurozone PMI® Composite Output Index read 59.5, up from 57.1 in May. This indicates that the fastest economic expansion since June 2006 is now occurring. Manufacturing remains robust and services are strong with hospitality and tourism now coming back to life. European corporate expectations for new orders and hiring are now at a 21-year high. While the risk of a medical setback always remains as we leave the pandemic behind, high business optimism bodes well for the sustainability of the recovery for the rest of this year and into 2022.

Oxford Economics have revised up their Eurozone GDP growth expectation to 4.3% per annum for 2021, with a higher 4.6% per annum to follow in 2022. These steady upgrades reflect the strength of recent PMIs, mobility data from Google and Apple (e.g see France below) and other survey data on the up. Oxford Economics anticipate Eurozone GDP recovering to its pre-crisis level in early 2022, underpinned by the consumption of lockdown accumulated savings, public support for investment and infrastructure spending (e.g. the EU recovery fund at over €2 trillion is intended to build a greener, more digital and more resilient Europe), and a brighter export outlook for the trade bloc.

While it still seems scarcely credible that a solution to the global pandemic was found so fast, national variations in vaccination pace, and exposures to more vulnerable business sectors (e.g. tourism) and digital readiness (i.e. the ability to work-from-home (WFH) / e-commerce maturity) mean that while the recovery will be widespread, it will likely not be perfectly synchronized. This is especially true when looking at a context of timing when economic activity returns to pre-pandemic, normal levels. The elimination of such economic slack is more relevant for occupier markets and rental growth prospects, than an arithmetically stronger GDP growth rate from an abnormally low base level.

Europe's mid-term recovery will also be shaped by the, as yet, unknown damage done to the labor market once job protection/furlough schemes begin to be withdrawn. Accordingly, labor shortages are not likely to cause the same near-term concern in Europe, as in the U.S. Nonetheless, a slowly recovering European jobs market will more likely prevail—and thus the probability of structural shortages leading to ingrained upward wage pressures and subsequent prolonged inflationary pressures seems unlikely.

**MOBILITY DATA: FRANCE**




Source: Google. As of July 2021.

## Economic Outlook

The earlier re-opening of economies was a positive surprise that created its own unintended economic havoc. Shipping and other supply chain pressures have resulted in surging global commodity markets and input producer prices—especially construction materials, which, although moderating, remain high and are negatively impacting development costs. Rising inflation reflects a sleeping economy awakening early by surprise, rather than an overheating economy reaching maximum velocity.

Despite the clearly transitory nature of inflation, in our view, market anxieties have increased with recent 'hawkish' comments from the Federal Reserve (Fed). A 2023 Fed rate signal is sensible—if the expectation was a later hike, that would signal that the recovery was already in trouble. The Fed is the global benchmark for all interest rates, but the European Central Bank will also remain on alert for possible spikes in peripheral bond yields, should early withdrawal of U.S. monetary support hurt parts of Europe which are lagging behind.

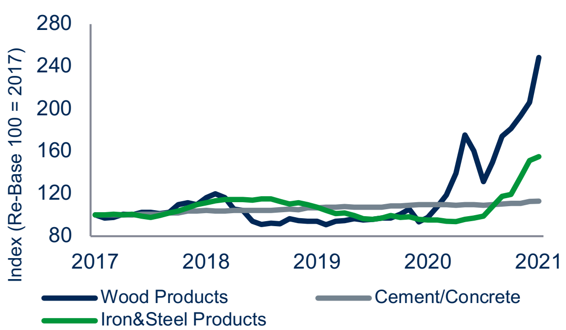
### GDP COUNTRY FORECASTS (% PA)

**ECONOMIC ACTIVITY (% pa)**

| Country | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2021-2025 |
|---|---|---|---|---|---|---|---|
| France | **-8.0%** | 5.1% | 4.7% | 2.4% | 1.7% | 1.5% | 3.1% |
| Germany | **-5.1%** | 3.7% | 4.4% | 1.6% | 1.0% | 0.8% | 2.3% |
| Italy | **-8.9%** | 5.0% | 4.7% | 2.1% | 0.9% | 0.4% | 2.6% |
| Netherlands | **-3.7%** | 2.9% | 3.3% | 2.0% | 1.2% | 1.1% | 2.1% |
| Spain | **-10.8%** | 6.5% | 6.1% | 2.6% | 1.9% | 1.6% | 3.7% |
| Sweden | **-2.9%** | 4.4% | 2.7% | 2.1% | 1.8% | 1.7% | 2.5% |
| United Kingdom | **-9.8%** | 7.7% | 6.2% | 2.1% | 1.5% | 1.5% | 3.8% |

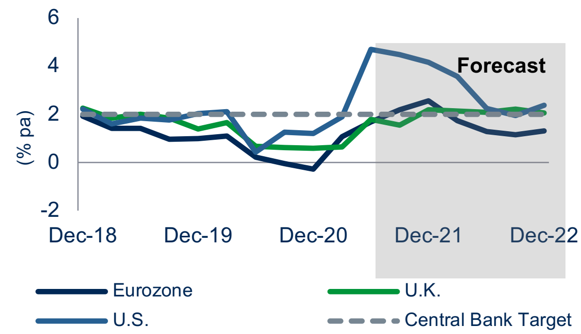
Source: Oxford Economics. As of July 2021.

### COMMODITY PRICES: CONSTRUCTION MATERIALS




Sources: US FRED. As of July 2021.

### CONSUMER PRICE INFLATION




Source: Oxford Economics. As of July 2021.

## Capital Markets

Real Capital Analytics (RCA) reports European investment totalled €53.3 billion in Q1 2021. This is down by one third on the same period a year ago. With the exception of a few minor markets (i.e. Denmark and Ireland), Q1 deal flow was sluggish across the board. However, preliminary CBRE data suggests a rebound in Q2 data is already underway, with the highly transparent U.K. leading the way.

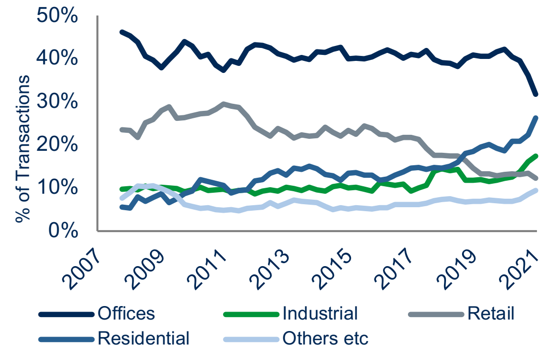
Through Q1 2021, RCA investment data shows retail investment continues to decline to a record low (12% of deals), and office capital flows weakened (30% of deals compared to a norm of around 40%). Instead, investors continue to pivot toward residential (26%) and logistics (17%).

Relative European REIT sector pricing currently reflects the long-term sector trends. These are broadly most favorable for logistics, residential and self-storage (associated to both), but are a considerable headwind to the hotel and retail sectors. The listed market consensus on the office sector is currently neutral. Perhaps this actually reflects a heavily bifurcated outlook, dependant on building quality (see Office Sector section).

Subject to local property market supply side characteristics (including the planning/permitting process, competing land uses, population density, topography, and the availability/cost of development finance), these structural trends are the key drivers of long-term property income growth (see Special Topic section). Accordingly, investor capital flows and pricing prospects, at both the market and asset level, are heavily dependent upon these same trends.

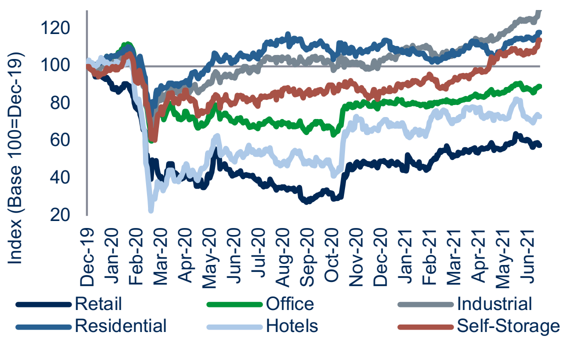
According to the INREV Investor Intentions Survey 2021, €51 billion was allocated to European non-listed real estate funds during 2020. While that is lower than the €73 billion raised in 2019, Europe is the top destination for capital with 41% of total global capital raised! For the first time since the inception of this survey, insurance companies were the largest capital source (37%) for European property. Pension fund allocation to Europe has continued to gradually fade, down from 50% in 2015 to below 30% of capital raised last year. Domestic European capital sources (67%) remain the dominant force in this survey and funds are still by far the preferred investment vehicle type (39%).

**EUROPEAN CRE INVESTMENT VOLUMES**



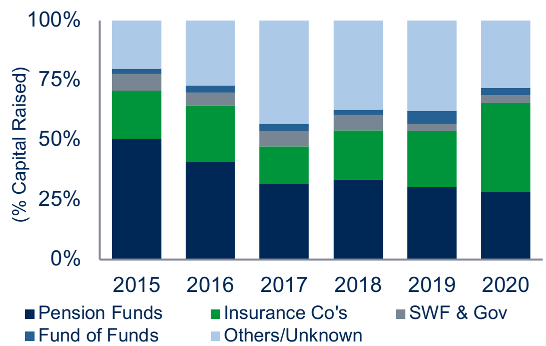

Source: RCA. As of May 2021.

**EUROPEAN REIT: LISTED SHARE PRICE**




Source: Bloomberg. As of July 8, 2021.

**EUROPE: REAL ESTATE CAPITAL RAISED**




Source: INREV. As of April 2021.

## Occupier Market

### OFFICE SECTOR

Europe's vacancy rate increased from roughly 6%, to around 7.5% in the year to Q1 2021. Take-up equated to 3% of existing stock over the same period, down from around 5% per annum in recent years. Mobility data proves that physical occupancy was only at a fraction of the level suggested by these remarkably resilient rental market statistics. Yet only marginal softness in prime office rents has occurred so far (-1% per annum to March 2021).

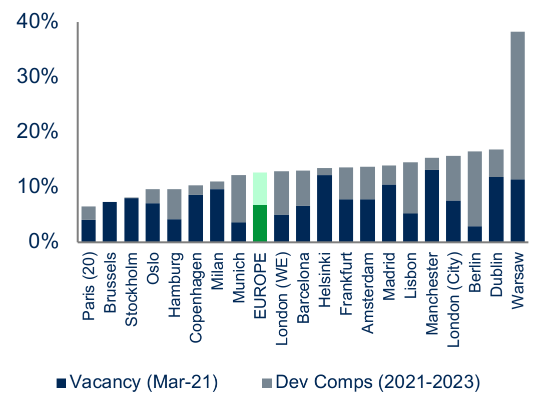
Despite mass WFH, video conferencing successes, the benefits of face-to-face contact via a centralized high quality office building is steadily re-establishing itself. This probably explains why a March 2021 KPMG CEO survey saw a huge sentiment swing, from nearly 70% last August, to less than 20% of corporate chiefs now expecting to downsize their footprints.

We continue to envisage a post-pandemic occupier 'flight to quality', with tenants looking for less, but higher quality buildings. This is due to lingering virus fears, a productivity drive to maximize "In-The-Office-Days" (ITODs) collaboration/meetings, and most significantly the corporate shift toward to all things "E" in ESG. Only the most modern office space is flexible and 'green' enough to accommodate all three of the much more stringent occupier needs.

Most European cities are already chronically undersupplied with high quality modern space, with a sub 10-years old stock vintage of just 15% on average. Milan, Madrid, Amsterdam, Copenhagen, and Helsinki are the most severely under provided with modern space, but the issue is widespread. The mid-term income growth prospects for the best quality, most sustainable office accommodation have actually been increased by the pandemic, not reduced.

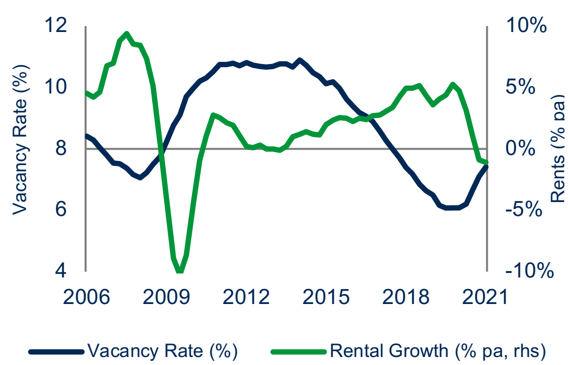
The recent spike in producer and input prices very much includes construction materials. As saw mills and steel foundry capacity ramp back up, cost increases and material shortages are likely to ease next year. With an order backlog, prices will only ease in part. This means development cost increases and construction start delays will likely only further exacerbate shortages of modern 'top spec' space.

**EUROPEAN OFFICE: VACANCY AND DEVELOPMENT**




Source: Cushman & Wakefield. As of May 2021.

**EUROPEAN OFFICE VACANCY & TOP RENTS**




Source: Cushman & Wakefield. As of May 2021.

## Occupier Market

### RETAIL SECTOR

During much of 2020, household consumption shifted online and toward food and other daily necessities. As the vaccine rollout has gathered momentum, Europe's physical stores have reopened this year. With accumulated lockdown savings behind them and a significant pent-up demand to spend, household consumption is now expected to focus on discretionary goods and services (e.g. clothing, footwear, health, restaurants, travel and tourism).

Consumer confidence stands above average in most locations through June 2021. Of the larger European economies, confidence and thus the likely propensity for households to loosen the purse strings was strongest in the Netherlands, U.K. and Italy.

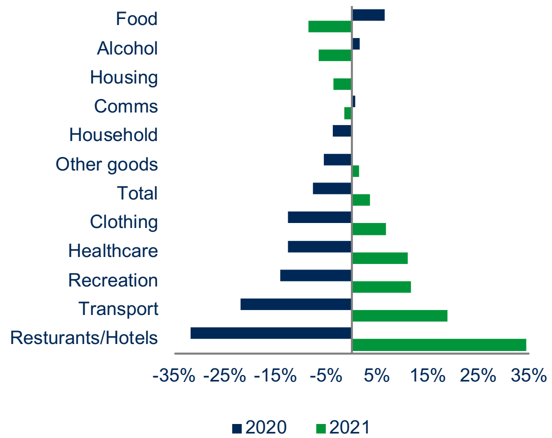
Despite the rapid vaccine miracle, a pandemic exit infection wave is inevitable. Commentary around the risk of retrenchment and salvation for battered operators will focus on knowing that the link between new cases and deaths is definitely broken.

Retail real estate has been undergoing a prolonged period of structural change with the shift toward online retailing. This is very advanced in the U.K., but just beginning in Spain and Italy. The pace of online adoption has been accelerated by the pandemic. While this will fall back a little on store reopenings this summer, a step change has occurred, and we believe this secular trend has a decade or longer to run across Europe.

Because human society is built upon gregarious interaction, physical retail does have a future. Yet, for now, stock selection risk remains elevated for comparison retail and therefore this retail category is largely the preserve of opportunistic investors.

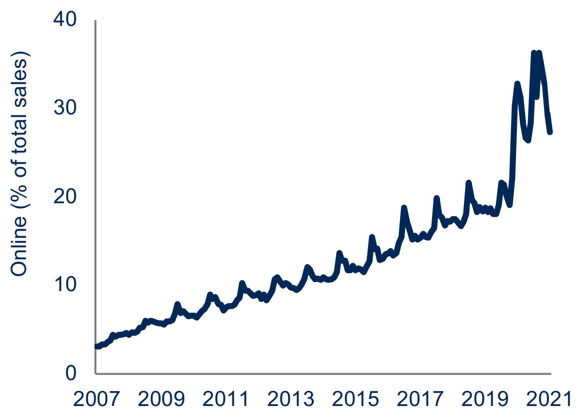
Grocery retail remains resilient, but not immune, to online growth. This is because low margins and high delivery costs will remain a challenge for operator profits, especially mass-market food, rather than highly affluent locations able to absorb high delivery charges. Robotic pickers solve this in part, but the real world practicalities of autonomous vehicles delivery remain more distant than the technology itself.

**GERMAN HOUSEHOLD CONSUMPTION (% PA)**




Source: Oxford Economics. As of July 2021.

**U.K. ONLINE RETAIL**




Source: Office For National Statistics. As of June 2021.

## Occupier Market

### INDUSTRIAL SECTOR

The pandemic and associated lockdowns have accelerated e-commerce adoption and logistics occupier demand, defying unprecedented economic contractions. With e-commerce adoption (from both consumers and retailers themselves) at widely varying rates of maturity across Europe, this secular trend has a decade, or possibly longer, to run and will underpin tenant demand for distribution space for years to come.

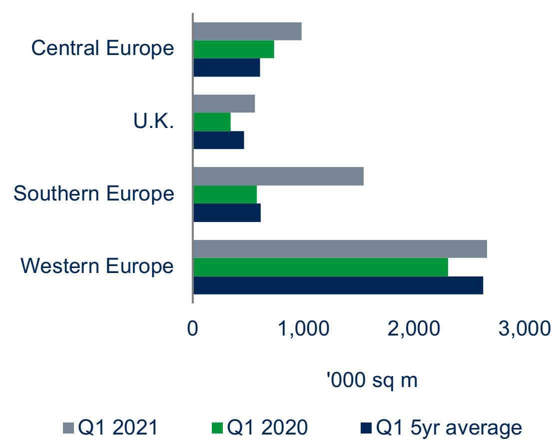
JLL reported that quarterly take-up hit a record high in Q1 2021, exceeding the five year Q1 average by 30%. Quarterly take-up records were exceeded in numerous markets including Germany, Spain and Poland. The proportion of space taken for the purpose for e-fulfilment continues to grow, representing 22% of Q1 2021 take-up (up from 14% in the last five years).

Amid the backdrop of strong demand, available space is tight. JLL reports that overall vacancy is still below 5% (for the 13th consecutive quarter), creating supply imbalances in most markets. BNP Paribas Real Estate note that in the Netherlands, particularly low availability in key logistics hubs has inevitably pushed occupier demand into non-traditional and less established secondary logistics markets.

Development is skewed to a build-to-suit setting and is not significantly alleviating space pressures. However, an uptick in speculative development was seen in Italy, the Netherlands and the U.K. (compared to Q1 2020).

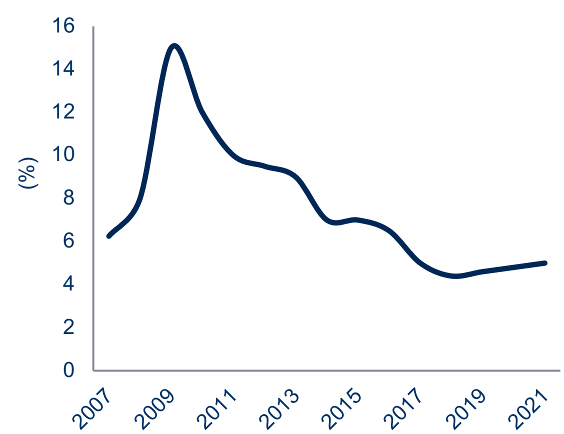
The excess of demand over supply is fuelling rental growth, with year-on-year average logistics rental growth of 3.2% p.a, its highest level since 2018. Favorable growth conditions are set to continue with sustained occupier demand, and while development is rising, it remains insufficient to ease tight vacancy rates.

**EUROPEAN LOGISTICS TAKE-UP**




Source: JLL. As of May 2020.

**EUROPEAN LOGISTICS VACANCY**




Source: JLL. As of May 2020.

## *Occupier Market*

### RESIDENTIAL SECTOR

According to the OECD, average European house prices increased by 1.8% during Q1 2021. This drove the annual house price inflation rate to 6% per annum, its fastest since March 2007.

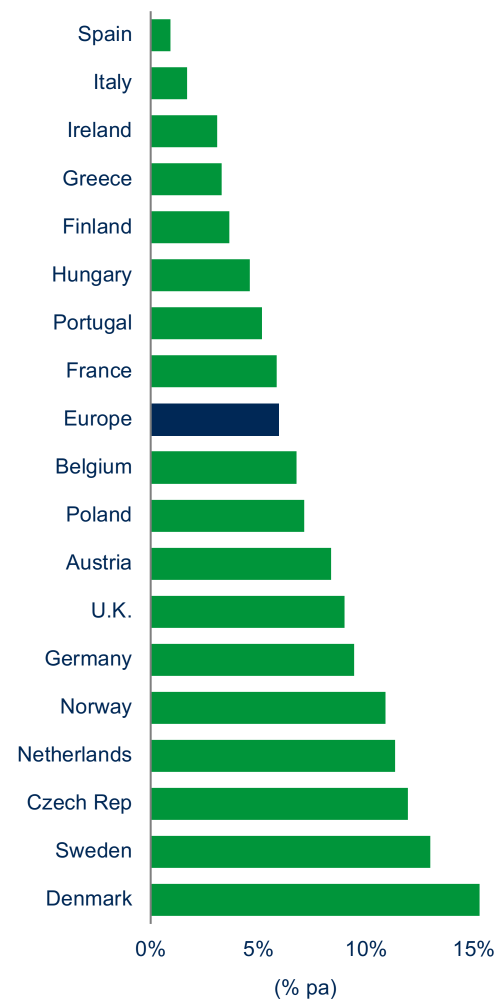
Double-digit house price increases occurred in Denmark, Sweden, Czech Republic, Netherlands and Norway—up 10-15% pa. Market conditions were noticeably cooler in Italy and Spain where prices climbed around 1-2% pa.

Unprecedented pandemic economic contractions meant governments stepped in to support households, through policies such as job protection schemes, temporary removal of transfer taxes, and mortgage holidays, generating the above house price increases. Pandemic exit risks remain, with damage to European labor markets still unknown until businesses can fully reopen.

According to a Maru/Blue survey conducted on behalf of RE/MAX Europe, 30-40% of Europeans have recently (or are) considering a housing move and around 60% are confident in the ongoing strength of the market. The report states that the pandemic search for greater 'livability' (e.g. affordability and proximity to amenities such as green spaces, local shops, schools and public transportation), plus larger properties able to accommodate WFH.

Investing into the private rental sector (PRS) and/or build-to-rent (BTR) should focus on locations where demographic demand consistently outpaces local construction capacity.  Further, where the local house price rent ratio (HPR) tends to be above 25x, the typical term of a First-time-Buyer's mortgage, a higher financial incentive to continue to rent should also exist (e.g. Sweden, Germany, Norway and the U.K.).

**EUROPEAN HOUSE PRICES (Q1 2021)**



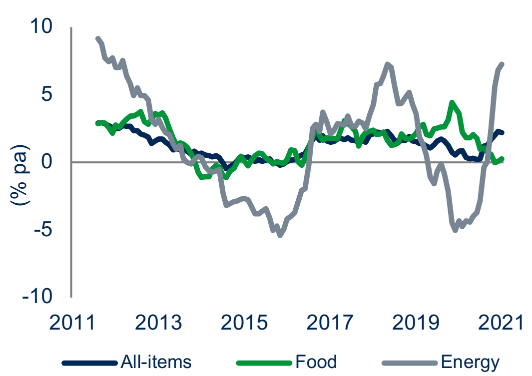

Sources: MSCI. As of April 2021.

## *Special Topic*

### IS PROPERTY AN INFLATION HEDGE?

As commodity price spikes are ‘one-off’ and Euro labor markets remain fragile, we expect recent inflationary pressures to subside. Others are more hawkish—especially as central banks loosen inflation targets—and are seeking investments offering a hedge against inflation.

**EUROPEAN INFLATION**




Source: MSCI, Oxford Economics. As of July 2021.

Gold is often cited as a classic hedge, but isn’t its rationale as a ‘safe haven’ in times of crisis and lower inflation? Index-linked government bonds are a perfect inflation hedge, but they are expensive and have a relatively small market. In equities, investors can pick individual companies whose revenues and costs are inflation linked (potentially REITs), or are commodity producers (energy and metal production). As for real estate, there is no observable correlation between CPI and property rental growth.

**U.K. RENTS & INFLATION CORRELATION (2011-2021)**

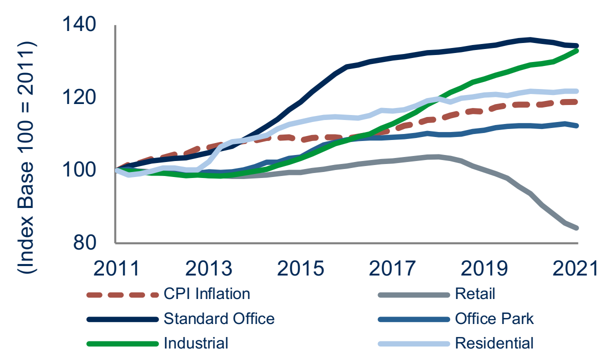
| %pa | Retail | Offices | Ind | Other | All |
|---|---|---|---|---|---|
| Correlation | 0.17 | -0.62 | -0.31 | 0.19 | -0.20 |

Source: MSCI, Oxford Economics. As of July 2021.

Property is not a ‘hedge’ in the true sense of the word like a financial instrument such as a Treasury Inflation-Protected Securities or Index-Linked Gilt. But, intuitively, a longer-term link between property rents and general price inflation should exist. In other words, accessed via direct ownership or indirectly via pooled private property funds or listed REITs, property rental income and thus prices should tend to rise with economic activity and therefore general prices over the longer term. This means real estate can offer insulation against rising prices over the long term, but it is not a short-term hedge.

Investing in real estate for the long term is normally the preserve of the genuine core investor. Their strategies are largely about selecting assets in location and property sectors where the structural trends are most favorable. These long trends are primarily demographic, technological and ESG in nature. Because the long-term income growth prospects are best where these are tailwinds rather than headwinds, the scope for inflation protection will similarly vary. These have all been apparent in property rental growth data for some time, well before the pandemic.

**MSCI U.K. RENTS –V- CPI: INDEX**




Source: MSCI, Oxford Economics. As of July 2021.

We can thus expect residential and logistics income to protect against inflation over the  mid to long term, but not from retail and hotel rents. While offices appear to have offered the best inflation protection over the past decade, the data is distorted with office rents recovering from a post-Global Financial Crisis trough over the past decade.

Looking ahead, we see the most modern ultra-flexible and sustainable office buildings still able to offer investors inflation insulation, but do not believe that will be the case for more average quality office assets, where the pandemic has likely accelerated occupier requirements and thus functional obsolescence. While property is not a hedge for inflation, it can clearly offer strong protection. Investors seeking long-term insulation from inflation should tilt their portfolios in line with wider societal changes.

## *About the Team*

Barings Real Estate's research team is structured by sector and geographic expertise, with efforts led by Philip Conner in the U.S. and Paul Stewart in Europe. The team has a diverse background covering various industries, asset classes and countries, which is complemented by an analytics function enhancing the team's ability to collect, augment and analyze data to inform better decision making.

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Baring Asset Management (Asia) Limited, which is licensed by the Securities and Futures Commission of Hong Kong to carry on regulated activities Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities), Type 5 (advising on futures contracts) and Type 9 (asset management) in Hong Kong in accordance with the requirements set out in the Securities and Futures Ordinance (Cap 571);

Barings Japan Limited, which is registered as a Financial Business Operator (Registration No. 396-KLFB) for Type II Financial Instruments Business, Investment Advisory and Agency Business, and Investment Management Business with the Financial Services Agency in Japan under the Financial Instruments and Exchange Act (Act No. 25 of 1948);Baring SICE (Taiwan) Limited, an independently operated business (Business license number: 2008 FSC- SICE- Xin- 030; Address: 21 F, No.333, Sec. 1 Keelung Road, Taipei 11012; Taiwan Contact telephone number: 0800 062 068); or

Baring Asset Management Korea Limited, which is authorized by the Korean Financial Services Commission to engage in collective investment business and is registered with the Korean Financial Services Commission to engage in privately placed collective investment business for professional investors, discretionary investment business and advisory business.