Concerned about rising inflation? REITs may help.

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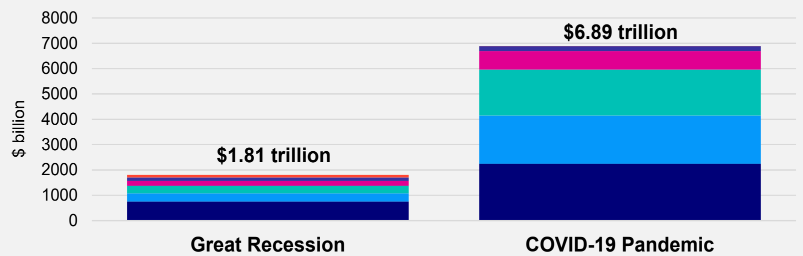
Inflation peaked in the US at 15% in 1981 and has been declining every decade since–until now. Having made a recent low of 0.1% during the pandemic-induced lockdowns last May, inflation has since rebounded to 2.6% and may be headed even higher.[1] The reasons why are clear–massive amounts of fiscal stimulus, an accelerating economy amid rapid uptake of the vaccine and pent-up demand for spending once the pandemic is under control.[2] Not surprisingly, the classical signals of inflation have started to flash yellow. Fortunately for investors, listed real estate (including real estate investment trusts or REITs) can potentially help to minimize the adverse impact of rising inflation.

Below average but clearly rising. At first blush, inflationary worries may seem misplaced. After all, inflation averaged just 1.7% over the last decade.[3] However, many strategists expect it to continue rising in the near term as we lap the economic shock of the shutdowns a year ago.[4] This is especially true since governments around the world have used more than three times the amount of stimulus employed to combat the global financial crisis to fight this pandemic, and they have done so in one fourth the time.[5] In the US alone, the stimulus employed in the last 12 months dwarfs what was used during the Great Recession–and more may be on the way. (See Chart 1.)

Chart 1: Federal spending to combat Great Recession vs COVID-19 pandemic



Great Recession		COVID-19 Pandemic	
2012 Payroll Tax Holiday Extension	$101 billion	Coronavirus Preparedness & Response Act	$8 billion
Economic Stimulus Act of 2008	$140 billion	Families First Coronavirus Response Act	$192 billion
Fannie/Freddie/TARP	$185 billion	Paycheck Protection Program & Health Care Enhancement Act	$733 billion
2010 Payroll Tax Holiday & Other	$303 billion	CARES Act	$1811 billion
Other Miscellaneous	$322 billion	American Rescue Plan	$1900 billion
American Recovery & Reinvestment Act	$755 billion	Proposed American Jobs Plan*	$2250 billion

Source: Congressional Budget Office; Committee for a Responsible Federal Budget, "How Does COVID Relief Compare to Great Recession Stimulus?," 12/22/20; L. Davison, Bloomberg, "What's in Biden's $2.25 Trillion Infrastructure and Tax Proposal," 3/31/21.
*Proposed legislation that has not yet been enacted into law.
Note: Figures reflect 5-year cost estimates.

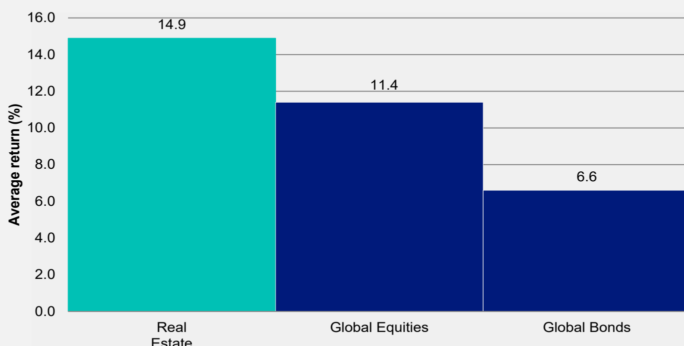
Inflation signals starting to flash yellow. Several inflation indicators have recently started to flash signals to the market. In this regard, future inflation expectations (as measured by the US 5-year forward breakeven) have been climbing steadily from a low of 0.18% last March to 2.62% today.[6] How high will they go? No one knows for sure, but some market strategists believe inflation could just be getting started.[7]

How to hedge inflation. Hedging a portfolio against inflation risk may be easier said than done. The reason why is that many of the asset classes retail investors typically use have no significant correlation with inflation. In this regard, we analyzed the longer term correlations of every Morningstar investment category to inflation. Our observations show that just 7% of the capital in all Morningstar investment categories is allocated to asset classes with demonstrably positive correlations to inflation.[8] These positively correlated pockets include asset classes like real estate, infrastructure,

midstream energy, natural resources and commodities (i.e., real assets) as well as bank loans and high yield bonds. One thing is clear–investors who are concerned about the potential risk of rising inflation may want to consider a strategic allocation to real assets.

Real estate can help. As discussed in our recent white paper, "The Potential Real Benefits of Real Assets: A Case Study," real estate can offer a combination of attractive returns, diversification and yield. Significantly, it can also help to hedge inflation risk. Historically, real estate securities have outperformed global stocks and bonds by a meaningful margin during periods of rising inflation. (See Chart 2.)

Chart 2: Real Estate Performance During Periods of Rising Inflation



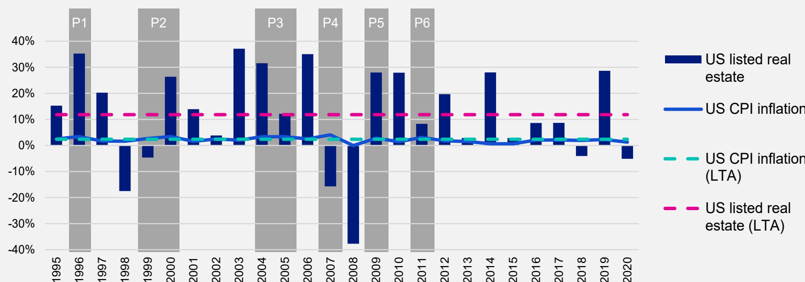
Source: Invesco Real Estate, MSCI, FTSE EPRA Nareit, and Bloomberg using data from January 1, 2003 - December 31, 2020.
Total returns shown in USD. Annual update with latest available data.
Periods of world inflation acceleration include January 1, 2004 – December 31, 2004, January 1, 2006-December 31, 2007, January 1, 2010-December 31, 2011 and January 1, 2016 - December 31, 2017. Note: Real Estate is represented by FTSE EPRA Nareit Developed Index; Global Equities is represented by MSCI World Index and Global Bonds is represented by Bloomberg Barclays Global Aggregate Index.
An investment cannot be made directly in an index. For illustrative purposes only. Past performance is not indicative of future results.

Real estate can provide an effective hedge against inflation for a variety of reasons. For example, in an inflationary environment, the rising cost of land, labor, materials and borrowed capital can cause developers to increase the price of new properties. In addition, these rising costs can raise the economic threshold for new development, which in turn can limit the amount of new supply coming to market. This tightening of supply often gives landlords the pricing power needed to raise rents to tenants. Furthermore, many commercial leases (especially in the office and industrial sectors) have rent escalators that are explicitly tied to inflation. This means that landlords can benefit from automatic rent increases, regardless of whether the inflation was expected or unexpected. Not surprisingly, listed real estate has historically delivered positive returns during periods of above average inflation. (See Chart 3.)

Chart 3: Listed Real Estate as Potential Inflation Hedge

Performance in different inflationary environments

Listed US real estate performance and US CPI, 1995-Q3 2020



US listed real estate annual returns during periods where inflation surpassed the long-term average

	Period	US CPI	US Real Estate
Long-term average	Last 30 years	2.4%	**8.0%**
Period (1)	1996	3.4%	**10.3%**
Period (2)	1999-2000	3.1%	**11.8%**
Period (3)	2004-2005	3.3%	**17.3%**
Period (4)	2007	4.1%	**15.8%**
Period (5)	2009	2.8%	**-16.3%**
Period (6)	2011	3.1%	**14.3%**

Note: CPI reflects CPI-Urban Consumer, All Items indexed to 1982. Analysis relates to US listed real estate performance, represented by the FTSE NAREIT All Equity Index and includes all property types. LTA=Long-term average, 1990-2020.
Source: Invesco Real Estate using data from the U.S. Bureau of Labor Statistics, Moody's Analytics, and FTSE Nareit as of January 2021.
Past performance is not a guide to future returns. An investment cannot be made directly in an index.

Economic growth as a key driver. Diving a bit deeper, real estate returns are often closely tied to economic growth. In particular, periods of higher inflation are typically marked by higher economic growth, which in turn can drive increased demand for commercial real estate that enables landlords to push through rent increases. This ability to raise rents can offset rising property ownership costs associated with inflation. In addition, growing rents can enable REITs to increase their distribution streams and tend to support rising share prices. This is especially true for property types with relatively shorter lease terms like hotels, self-storage, apartments, single-family rentals, student housing and manufactured homes. Even property sectors with longer lease terms can benefit from the mark-to-market effect upon lease renewal in an inflationary/faster growth environment. Other property sectors also offer fixed price bumps over the life of lease. Of course, active real estate fund managers can adjust the average lease duration of their portfolios to take advantage of changes in both inflation and economic growth.

Conclusion. Inflation in the US has been subdued since the global financial crisis. Yet the Fed has recently adopted a more dovish approach that could allow inflation to run above target in the aftermath of persistent inflation shortfalls.[9] Investors who are concerned that the fiscal and monetary stimulus employed in response to the pandemic could result in higher inflation may want to consider a strategic allocation to REITs.

Sources

1. Bloomberg, 4/14/21. Inflation is represented by the US Consumer Price Index (All Urban Consumers).
2. C. Benz, Morningstar, "The Best Inflation-Fighting Investments for Retirees," 4/9/21.
3. Bloomberg, 4/14/21; C. Benz, Morningstar, "The Best Inflation-Fighting Investments for Retirees," 4/9/21.
4. A. Hunter, Capital Economics, "US Consumer Prices: Weakness in core inflation unlikely to last much longer," 3/10/21.
5. Z. Cassim, et al., McKinsey & Company, "The $10 trillion rescue: How governments can deliver impact," 6/5/20.
6. Bloomberg, 4/14/21.
7. R. Farr, Merion Capital Group, "Only the Beginning for CPI," 4/13/21.
8. Morningstar Direct, 4/8/21. Morningstar category correlations analyzed for the 20-year period ending 12/31/20. Inflation is represented by the US Consumer Price Index (All Urban Consumers).
9. J. Powell, Board of Governors of the Federal Reserve System, "New Economic Challenges and the Fed's Monetary Policy Review," 8/27/20.

About Risk:

Investments in real estate related instruments may be affected by economic, legal, or environmental factors that affect property values, rents or occupancies of real estate. Real estate companies, including REITs or similar structures, tend to be small and mid-cap companies and their shares may be more volatile and less liquid.

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