SESFIKILE CAPITAL
Listed Property Investments

Date: 1 September 2021

What happens to Global REITs when inflation becomes persistent?

Central banks around the world attempted to lessen the economic impact of the Covid-19 pandemic by implementing fiscal and monetary policy to stimulate demand. None more than the US Federal Reserve (Fed) that quickly cut interest rates (Fed Funds rate) to zero in 2020 and initiated its quantitative easing (QE) program to stabilise financial markets, and increase money supply by acquiring $120bn of Treasuries and mortgage-backed securities per month. As the US and the global economy recovers investors have turned their attention to higher inflation, driven in part by a spike in commodity prices, base-effects and record stimulus. The Fed's preferred measure of inflation is the Personal Consumption Expenditure (PCE) index, which rose 3.6% y/y in July, more than 2x the 1.5% rate reported in January 2021. With that, central banks, largely led by the Fed, have stated that elevated inflation is likely to be 'transitory'; simply meaning they will tolerate higher-than-target rates for a few quarters with a view that it will subside back towards 2% thereafter.

Our interest in the topic really lies in analysing how inflation affects global property returns. More specifically, what will the impact be if inflation is sustained and not transitory as the Fed has indicated. From a property fundamentals perspective, real estate values have at least protected investors against inflation over time. As inflation rises, key inputs such as higher labour and materials costs result in higher replacement values and in consequence in-place asset valuations. On the income side commercial real estate (CRE) leases are often linked to local CPI or have 'rental bumps' in the form of annual escalations between 2 and 4% per annum in over 85% of the world's real estate markets. Accordingly, global developed market REITs have achieved dividend growth of 3.0% per annum on average over the past 10 years outpacing average inflation (G8) of 1.7% over the same period. In the current environment, sectors with strong fundamentals and pricing power such as industrial, single family residential, manufactured homes and self-storage are better positioned to raise rents and achieve inflation beating cash flow growth. On the contrary, sectors with weak fundamentals and high vacancy rates such as malls and offices will find it challenging to achieve any sort of rental growth in our view.

In the medium term, stronger economic growth and higher inflation is often accompanied by higher interest rates with tapering of QE being the prelude to the hiking cycle. Investors have recently been focused on any signals the Fed may provide in the attempt to forecast the timing and quantum of the tapering of their QE program. Fed Chairman Jerome Powell sent his strongest signal yet at the Jackson Hole Economic Symposium held on the 27 August that the Fed could begin tapering QE this year.

W sesfikilecapital.com
T +27 11 684 1200
E sescap@sescap.co.za
F +27 86 619 5265
A 2nd Floor, 18 The High Street
Melrose Arch, Johannesburg
South Africa
2076
P Suite 334, Private Bag X1
Melrose Arch, Johannesburg
South Africa
2076

SESFIKILE CAPITAL
Listed Property Investments

However, this was accompanied by a dovish discussion on the transitory nature of inflation, as well as comments that US unemployment "is still much too high". He further stated that "the timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate lift-off, for which we have articulated a different and substantially more stringent test". In more basic language, the Fed will take a long time to hike rates.

So, what happens to global listed property returns when central banks are hiking rates? We studied nine periods over the past 15 years in which the Fed hiked rates and found that global property tends to underperform general equities during the interest rate hiking cycle but then outperforms in the subsequent four-to-six-month period. As is often the case, if interest rates are rising because of the strength of the underlying economy, rental growth accelerates as supply fails to keep up with rising demand. Consequently, increased cash flows may outweigh the negative effect of any increases in interest rates. From a sector allocation perspective, we have seen wide bifurcation in performance between sectors and it is often advantageous to increase exposure to shorter lease-duration sectors such as hotels, apartments, and self-storage where rents (or room rates) can be adjusted almost instantaneously – in effect quickly responding to higher demand or higher costs. In contrast, sectors with longer leases such as healthcare and net-leases, which have +10 years' lease expiry profiles, could underperform at this point in the cycle.

As we look forward, we call on Mark Twain's words "history doesn't repeat itself, but it often rhymes". We are likely to be at the onset of an interest rate hiking cycle that will be preceded by tapering and, barring new Covid-19 variants, we could see bond yields gradually move higher. Global REITs have delivered 22.9% USD total returns year-to-date versus global equites at 18.3% and although we remain constructive on the sector's fundamentals, we see increased intra-sector volatility over the next few quarters, allowing us to take advantage of mispriced opportunities.

Anil Ramjee
Global REIT Analyst
Sesfikile Capital