CROMWELL PROPERTY GROUP

EUROPEAN INFLATION

RESEARCH BRIEFING NOTE

September 2021

INTRODUCTION

This briefing note examines European inflation. It responds to heightened concern regarding the inflationary outlook and the related consequences for real estate. It defines inflation, explores why it has been rising and its likely future trajectory. The relationship between inflation and real estate is considered. It concludes by distilling the implications for real estate investment strategy.

WHAT IS INFLATION?

Inflation refers to the average rate of price increases over a given period, typically a year. A moderate rate of inflation is considered desirable for growth and stability. Too little inflation may prevent business and consumer spending due to the expectation that prices will fall. Too much inflation creates pricing uncertainty and limits expansionary activity. As a result, most central banks seek to maintain moderate inflation and use monetary policy tools such as interest rates to do so. The European Central Bank (ECB) is currently targeting an inflation rate of just under 2%.

Inflation is viewed as a leading indicator of economic change and rising inflation may signal the end of an economic cycle. A sudden rise in inflation can have a significant impact on investment portfolios and can be damaging if investors fail to navigate it successfully. For this reason, prudent investors should understand the inflationary outlook and be ready to adapt their strategies if necessary.

THE TAKE-AWAYS

Elevated European inflation is a temporary phenomenon resulting from short-term base-effect impacts being; supply chain disruption; a consumer spending rebound; and labour shortages

The medium-term inflationary outlook remains benign and is expected to settle at, or below, the central bank target rates of 2%

The best inflation mitigant is to ensure real estate portfolios comprise well specified, well-located stock suitable for modern occupiers.

WHY HAS INFLATION RISEN?

Over the last 10 years the average annual rate of inflation across the Eurozone was 1.4%[1] and it has been well-controlled by central banks. Eurozone inflation has risen significantly in 2021, as a result of significant economic expansion following the pandemic which created erratic and uneven demand swings, higher energy costs, and supply chain bottlenecks.

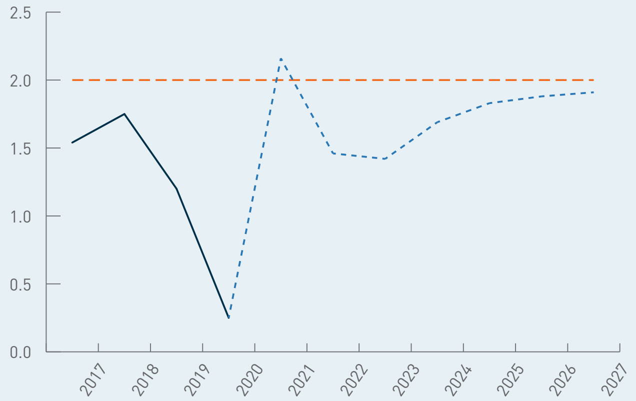
In our view, and in line with most commentators (see Figure 1 and 2), currently high rates of inflation are likely to be short-term in duration. This is based on the following contentions:

- *Base effects* – commodity prices fell sharply in 2020 as European economies contracted. Because inflation measures the rate of growth annually a rapid rise in inflation was always bound to occur if economic growth returned quickly, as has occurred. If prices are maintained or the rate of price growth slows, base effects will reverse. Therefore, to maintain current high inflation rates prices would need to continue rising at the same pace as they have over the last year which we believe is highly unlikely.
- *Supply chain disruption* – factors which inhibit the free-flow of goods such as transportation blockages or materials shortages push prices higher. As supply chains adapt and recalibrate in response to demand such impacts should dissipate quickly. Such recalibration has occurred rapidly in previous periods of elevated inflation and we expect the same outcome this time.
- *Consumer spending* – consumer spending has rebounded strongly since European lockdown restrictions eased which has fuelled inflation. Some of this reflects pent-up demand and some reflects novelty 'revenge spend' which is unlikely to be maintained in the medium term. In addition, the virulent Delta strain is circulating which may constrain some consumer spending growth. We expect consumer spending growth to slow, softening inflationary pressure.
- *Labour markets* – staff shortages have led to rapid rises in labour costs. Many European countries still have generous support packages for the un-employed or under-employed but as these schemes taper down, this should lead to rising labour availability. There is slack remaining in the labour market which government support is currently obscuring. As European travel becomes easier, labour mobility should also improve allowing labour supply and demand to be more evenly matched which will alleviate any pressure to raise wages.

For these reasons we foresee a benign medium-term inflationary environment.

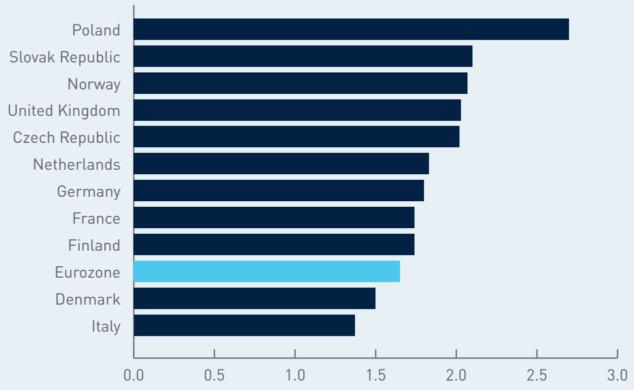
[1]Source: Oxford Economics (7/09/2021)

Figure 1 - Eurozone inflation forecast against ECB target (CPI%)



Source: Oxford Economics (16/09/2021)

Figure 2 - Eurozone CPI inflation (five-year annual growth rate, 2022-2026, %)



Source: Oxford Economics (16/09/2021)

HOW DOES INFLATION IMPACT REAL ESTATE?

Rising inflation can be both positive and negative for real estate. Real estate has traditionally been seen as an effective hedge against rising prices with the right asset, in the right location, supported by the right fundamentals offering positive rental value growth able to offset inflation.

The downside is that higher inflation typically leads to higher interest rates which leads to the cost of capital also rising. It is harder to secure affordable debt in an economy experiencing rising prices. Yields on gilts and equivalent government-backed bonds will rise, putting upwards pressure on real estate capitalisation rates. The higher the inflation rate, the harder it is for investors to capture rental growth at or above inflation meaning that the value of income streams could fall.

The upside for real estate investors is that inflation generally leads to higher property values. For example, rising inflation increases building material costs. Coupled with higher borrowing costs this makes new construction less financially viable which limits the supply pipeline and increases the value of existing product. As inflation is associated with economic expansion, higher inflation should coincide with rising occupier demand. Whilst there is more pressure to protect income by increasing rents in this environment, this should be achievable for quality product if businesses are growing.

In the living sector, higher inflation typically leads to increasing rental values as higher mortgage costs encourage more households to rent rather than to buy. Rising demand stimulates landlords to raise rents. This feedback loop combined with the non-discretionary nature of housing costs explains why the living sector is considered defensive when inflation is elevated.

WHAT ARE THE INVESTMENT STRATEGY IMPLICATIONS?

The long-term effects of the COVID-19 pandemic and its structural economic impacts will take time to emerge. The ECB has committed to keeping interest rates low until the economy has fully recovered and is achieving its target inflation rate.

In our view inflation is unlikely to remain elevated for long and should soon normalise to at or below the ECB's target. We are not overly concerned about the threat inflation currently poses to European real estate. This view aligns with the financial market expectations and the messaging from the ECB and other central banks which foresee inflation falling next year.

Should inflation remain elevated, investors are likely to shift to real estate sectors perceived as more defensive such as logistics and living. In a higher risk environment these sectors would be viewed as providing more resilient returns through stronger rental income whilst maintaining long-term value. That said, real estate performance has historically shown a relatively weak correlation with inflation so a holistic collapse in capital values would be highly unlikely.

Overall, we believe the key to mitigating inflation risk is to ensure that real estate portfolios comprise well specified, well-located stock suitable for modern occupiers. Such product will be more resilient in periods of higher inflation and better able to protect, create and grow income throughout the market cycle.