COMMERCIAL REAL ESTATE AS AN INFLATION HEDGE

AUGUST 2022

A global hunt for yield has been a primary concern for investors for much of the past three decades as interest rates and bond yields trended lower.

However, the recent inflation spike and upward movement in interest rates and bond yields has reduced the commercial real estate and bond yield spread, raising questions on the relative value proposition.

This report reviews trends in bond yields, capitalisation rates and total returns, and notes that while the commercial real estate and bond yield spread has narrowed, a well leased commercial property with a strong covenant and appropriate rental escalations should provide an inflation hedge and stronger total returns relative to bonds.

DECADES OF COMPRESSION

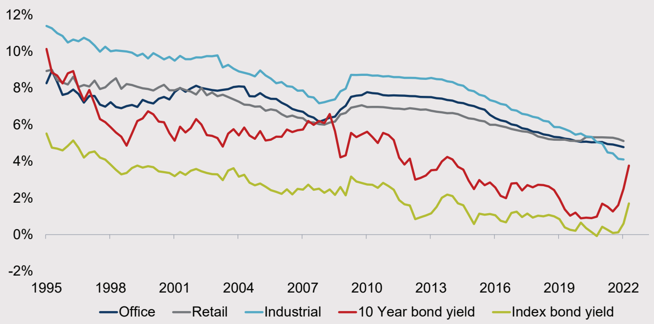

Figure 1: Capitalisation rates and bond yields

Source: Reserve Bank of Australia; MSCI; Cushman & Wakefield

> **“ Since the early 1990’s, bond yield yields have generally been trending lower, with commercial real estate (CRE) capitalisation rates generally tracking them lower, Figure 1 ”**

The CRE to bond yield spread averaging 230 basis points between March 1994 and March 2022. The CRE yield premium, combined with relatively stable, positive economic growth contributed to strong investment demand for Australian CRE. Transaction volume reaching a record rolling annual total of $57 billion for the 2022 March quarter. Key drivers for the downward trend in bond yields were a reduction in inflation expectations as well as economic stimulus through reduced interest rates and quantitative easing. Bond yields reached record lows during the COVID pandemic. The Australian government 10 Year bond yield falling to just 0.6% in March 2020.

However, the post pandemic economic recovery combined with ongoing supply constraints and surging fuel prices due to the war in Ukraine caused inflation to spike and interest rates and bond yield to move sharply higher.

With the CRE to bond yields spread shrinking rapidly, the relative return appeal of CRE appeared to fall also, however, is this the case?

REAL AND NOMINAL YIELDS

A return that is unaffected by unexpected changes in the inflation rate is termed ‘real’, whereas a nominal return is the return before inflation. Bonds with fixed coupon rates, such as 10 year government bonds are nominal, while index bonds have coupons indexed to inflation and offer a real return. Figure 2, highlights the inflation gap between the 10 year government bond (nominal) and the index bond (real). The chart also shows that prior to inflation targeting in the early 1990’s, nominal bond yields were significantly higher than real yields.

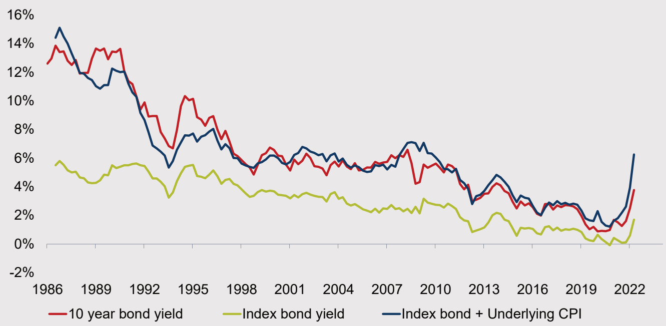

Figure 2: 10 Year government, index bond yields and inflation

Source: Reserve Bank of Australia; Australian Bureau of Statistics; Cushman & Wakefield

> **“ As CRE rents are often indexed to inflation or contain some other form of escalation, CRE yields are also real, so it is more appropriate to compare them to index bonds than nominal bonds. ”**

Figure 3 highlights how prior to inflation targeting from the early 1990's nominal bond yields were well above the Australian office income return, but the office income return to index bond yield spread was positive.

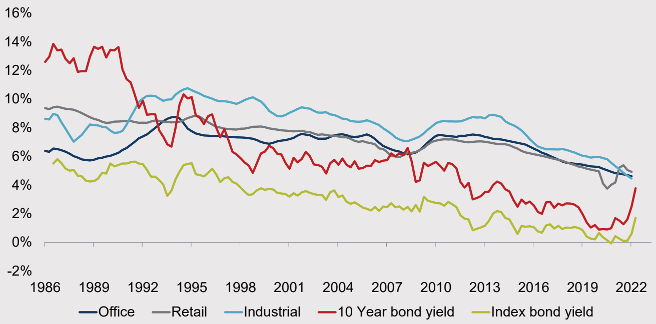

Figure 3: Australian CRE income returns and bond yields

Source: Reserve Bank of Australia; MSCI; Cushman & Wakefield

TOTAL RETURNS AND BOND YIELDS

"As rental escalations are capitalised into CRE returns, total returns can highlight the CRE inflation premium over nominal bond yields."

Since 1985, Australian office total returns have averaged a spread of 3.0 percent and is currently now around 6.0%, Figure 4.

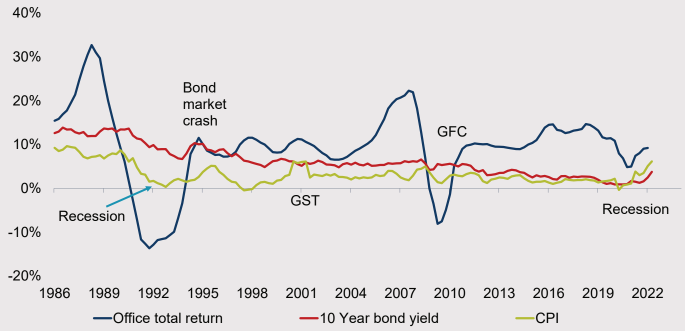

Figure 4: Australian office total returns and bond yields

Source: Reserve Bank of Australia; Australian Bureau of Statistics; MSCI; Cushman & Wakefield

"However, while CRE rent escalations provide a level of inflation hedging, they are not without risk."

Where leases have little or no escalations or where there is vacancy risk, such as during recessions, total returns may suffer.

Interest rates and bond yields have risen with inflation, increasing economic downside risks. However, forecasts generally suggest Australia should maintain positive economic growth. For example, the Reserve Bank of Australia's August 2022 Statement on Monetary Policy predicts gross domestic product growth of 3.2 percent in 2022, 1.8 percent in 2023 and 1.7 percent in 2024.

SUMMARY

While interest rates and bond yields have risen sharply with inflation, narrowing the CRE to bond yield spread, CRE's inflation hedging properties suggest a more appropriate return comparison is with total returns where the spread remains relatively large compared to history. However, not all properties are equal. Investors are likely to focus on high quality, well located properties, with appropriate lease structures and strong covenants.

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