Schroders

Real Assets and inflation

Resilience, The Rolling Stones and Rates

Why the Rolling Stones are the ultimate real asset investor

Back in 1969 The Rolling Stones wrote 'Gimme Shelter' with these opening lines:

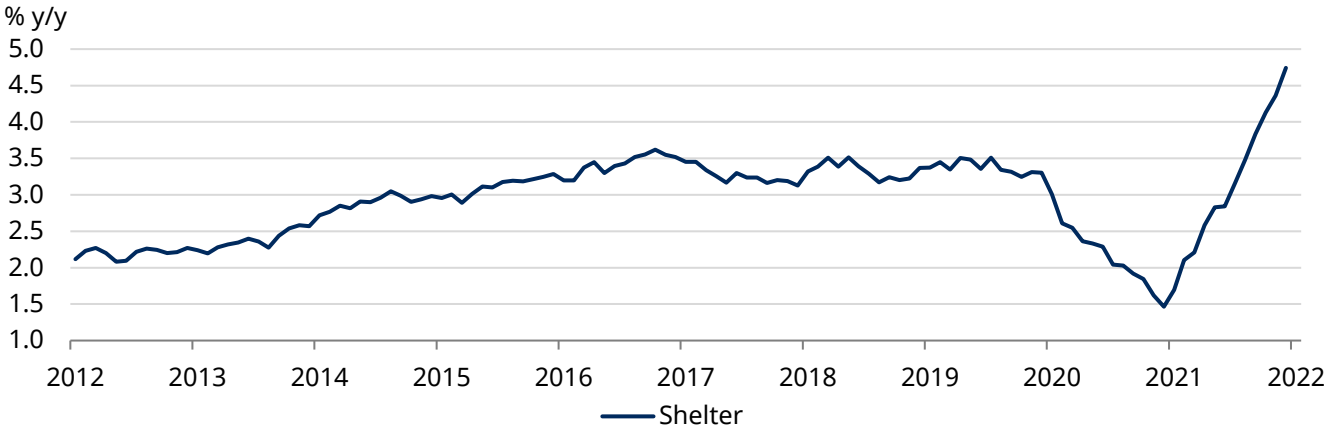
> "A storm is threatening
> My very life today
> If I don't get some shelter
> I'm gonna fade away"

Non discretionary demand

It is clear that the band appreciated how essential shelter (residential) is to every human, no matter your profession or location. It is this basic human necessity that is the key reason housing is included, along with transportation and food, as one of the three largest components of (US) CPI.

Real Estate – the clue is the title

The data below highlights how dramatically the cost of housing has increased since the start of 2021. Owners of residential assets are able to generate a real return, as their cash flows keep up with, and in some cases exceed, inflation levels.



Source: Refinitiv Datastream, Schroders, 2022

It is not just the residential sector that can provide inflation protection, many leases across all types of sub sectors have explicit rental escalators tied to inflation. In the real estate sector there are also leases with fixed escalators or rent reviews at specific times. These all give the landlord an opportunity to ensure their income generates a real return.

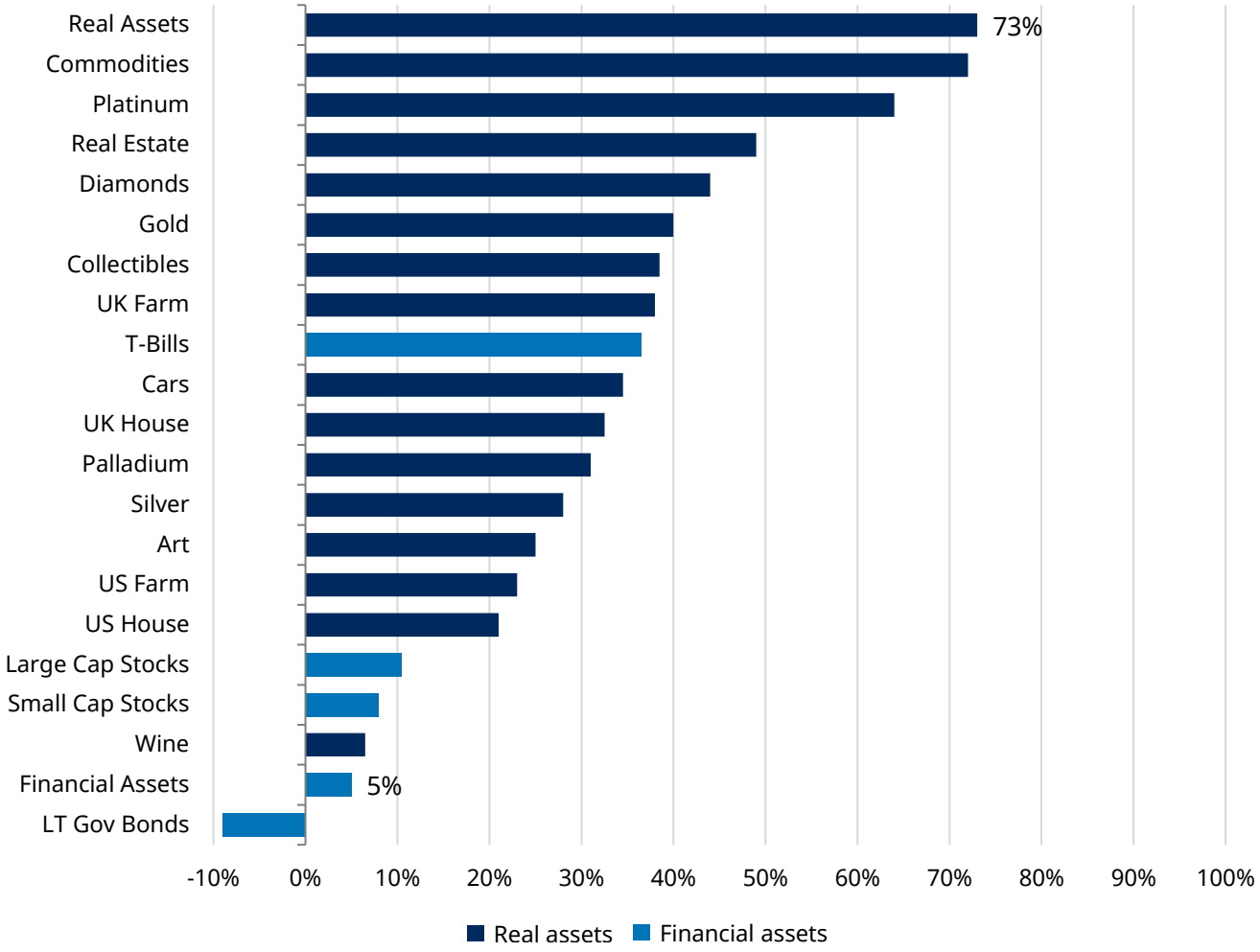
Historical inflation protection

The essential nature of many real assets, such as residential (everyone needs a place to live), healthcare (everyone gets sick at some point) or data centres (everyone communicates digitally) is one of the reasons why investors have historically been protected from inflation.

Bank of America analysed the correlation of various asset classes with US CPI from 1950–2020 and stated that "real assets are a hedge against inflation … diversify portfolios … are scarce". This is a strong endorsement from a research piece spanning 7 decades. The data supporting their report is below, interestingly the chart heading clearly indicates where they believe you can find inflation protection:

Long real assets, short financial assets

Correlation of real and financial assets with US CPI inflation between 1950–2020



Source: BofA Global Investment Strategy, Global Financial Data, Bloomberg, United States Geological Survey, USDA, Shiller, Savills, ONS, Spaenjers, WWW International Diamond Consultants Ltd, ArtPrice.com, Historic Auto Group.

Note: Real Assets calculated as the equally weighted average of commodities, real estate, and collectibles; Financial Assets calculated as the equally weighted average of large cap stocks and long-term government bonds.

Real returns

Schroders also carried out similar research, looking back to 1973 to determine which asset class returns exceeded inflation. The link to the full report is here. The table below again demonstrates that Real Estate Investment Trusts (REITs) can provide investors with real returns during all types of inflation (low and rising, high and falling etc.).

Inflation regime	Rate of occurrence		US treasuries		US equities		US REITs		Commodities
Low (<3%) and rising	24%	🟡	57%	🟢	90%	🟢	69%	🟢	67%
High (>3%) and rising	26%	🔴	47%	🔴	48%	🟢	67%	🟢	83%
High (>3%) and falling	26%	🟢	80%	🟢	76%	🟢	80%	🔴	37%
Low (<3%) and falling	23%	🟢	84%	🟢	81%	🟢	79%	🔴	28%

Past performance is not a guide to future performance and may not be repeated. The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested.

Not all real assets are created equally

At a recent conference in the US we met with owners of all types of real estate such as, residential, industrial, hotels, offices, retail, data centres, self storage, healthcare, student accommodation etc. This was a great reminder as to the long term trends impacting the real asset market.

The pandemic has led to a clear acceleration of trends that were already present in markets, such as e commerce and working from home. These long term, structural issues have continually weakened the pricing power owners of assets such as retail and offices have. Therefore, the ability to pass on inflationary increases to tenants in these buildings is severely limited.

Low levels of demand and high amounts of supply are a toxic combination for any market. We believe that certain sub sectors will continue to see challenged operating environments over the medium to long term. Therefore, it has never been more important to select the right type of real estate to own.

Who has pricing power today?

The concept of investing in Global Cities is predicated on pricing power. Focusing on locations where economic growth is consistently the strongest means that landlords maximise their chances of passing on increased costs to their tenants.

It is clear that there are certain sub sectors which are characterised by very low levels of supply. For example, obtaining planning permission, in cities, to build data centres, warehouses, self storage or student accommodation is incredibly difficult. Yet the demand for these types of assets continues to grow.

Sectors with pricing power – Distribution Warehouses

Sectors losing pricing power – Shopping Centres

Sectors with pricing power – Data Centres

Sectors losing pricing power - Offices

Inflation reduces supply

The pricing power in certain sub sectors is set to increase as the cost of raw materials reduces the amount of construction starts. A number of companies we have met with recently highlighted the low levels of future supply.

There are two key reasons for the lack of new inventory entering the market. Firstly, the pandemic led to an initial slowing in new supply as sites were shut down. Secondly, dramatic increases in the costs of raw materials and supply bottlenecks have resulted in lower margins for developers.

Whilst this is frustrating for developers the silver lining is that it increases both the value and the demand placed on existing assets.

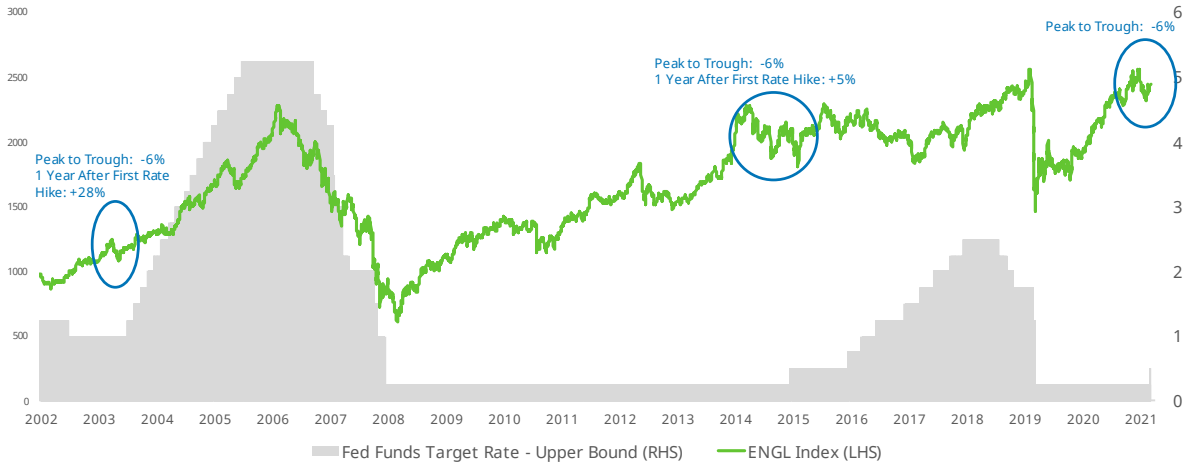
Real Assets and interest rates

Many investors worry about the impact rising interest rates will have on the real estate sector. However, history demonstrates that this should not be a cause for concern. At the start of the last two rate hiking cycles the global REIT sector has finished with positive total returns.

Inflation and rates concerns

Global REITS vs. Fed Funds Rate

During the past two Fed Funds rate hike cycles, the first raise clears the overhang on real estate stocks



Source: Bloomberg, March 2022. Historical trends should not be solely relied upon to predict future results.

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Pricing power and 'mission critical'

To maximise the protection that real assets can offer investors during periods of inflation there are two key ingredients that we look for. Firstly, does the landlord have pricing power? Do they own assets that have growing demand and low levels (or zero) of supply. Secondly, are the assets crucial to the tenants that lease the space or can they find another building easily?

In the key Global Cities competition for land is strong and supply of available space is low resulting in pricing power for landlords.

Without pricing power investors will realise that:

> **"You can't always get what you want"**
>
> *(Rolling Stones – 1969)*