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CIO Viewpoint

The case for real estate amid rising rates and inflation

Investment Solutions

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US monetary policy makers are concerned about investors' 'fear of missing out' (FOMO). If house buyers expect prices to keep rising, the market risks developing into a bubble. As interest rates rise to combat inflation, we expect the global property boom to cool. Slowly shifting investor appetite will nevertheless leave select real estate markets, especially in European rented commercial and logistic property, as a partial hedge against inflation.

The warning against 'FOMO' came on 29 March from the Dallas Federal Reserve. "Real house prices can diverge from market fundamentals when there is widespread belief that today's robust price increases will continue," it wrote. Since the start of the pandemic, US house prices have risen by 35% on average, according to data from the property site Zillow, cited by the Dallas Fed. It measured five consecutive quarters of "exuberance" in house prices through the end of September 2021.

In the US, some clear developments have pushed house prices higher: rising consumer savings through the Covid lockdowns, experiences of working from home, cheap credit, shortages of labour and building materials. Longer-term pressures such as a limited supply of housing and high rents have exacerbated demand for homes.

Real estate matters in managing monetary policy and understanding its impacts. Housing services, including rents, make up more than one-fifth of the Fed's consumer price inflation calculations. This forms part of the Fed's mandate for financial stability. The pandemic further accelerated the trend to higher prices. While fast-rising prices do not in themselves indicate a market bubble, they do add to the headwinds faced by the Fed while managing the challenges of engineering a slowdown through 2024. Higher mortgages combined with the rising cost of living will gradually price buyers out of the market, and undermine household incomes and savings. Rising inflation will make new developments more expensive, and so reduce their profitability.

The US market is not unique. Housing markets in France, Germany, the UK and Switzerland have all shown similar characteristics in the wake of the pandemic, according to the Dallas Fed's research. Each market has recorded a lack of housing supply, in part created by a shortage of labour and building materials, with historically high demand following the pandemic and falling vacancy rates. These are not the conditions of a classic housing bubble.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- Central banks are warning of potential housing market bubbles. Rising property prices add to the monetary policy challenge of cooling economies
- High consumer savings, plus post-pandemic labour and material shortages exacerbate prices. These are not the conditions of a classic housing bubble
- Central banks expect rising interest rates to increase mortgage costs, slowly pricing buyers out of markets
- We maintain our overweight exposure to European real estate, much of which is inflation-indexed.

Central banks' remits to slow economies by curbing inflation are starting later in the economic cycle than in the past, nevertheless, growth, job markets and household savings in the US and Europe remain above average trends, following two years of exceptional government and monetary support. While the Fed started its hiking cycle in March, we expect the European Central Bank to raise interest rates by 25 basis points in late 2022, once its asset purchase programmes end in the third quarter. We then see the ECB increasing its benchmark rate by 25 bps each quarter through 2023.

The ECB's most recent Financial Stability Review, published in November, warned that the "risks of price corrections over the medium term have increased substantially." As in other markets, a lack of labour, higher consumer savings and demand coupled with supply chain shortages are all contributing to the price gains, the ECB said. The residential markets of France, Germany and the Netherlands were particularly over-priced, the report found.

Offices and logistics

If inflation increases rents and supports real estate investments, it depends on landlords' ability to pass on higher costs to tenants. With some economies and firms continuing to encourage working from home, office occupation rates have not returned to their pre-pandemic levels.

Some 70% of European rents are indexed to inflation. In the office market, companies can usually support a rent rise. In the retail sector, it is more difficult. After the pandemic, retail tenants tend to be in an even weaker economic position as they were already struggling against structural competition from e-commerce.

In the US in 2021, inflation translated into a 17% increase in rents for logistics property, according to one measure. In Europe, where inflation remains lower, rents for such real estate rose more than 7%. The UK recorded a 15% rise. As with everything in real estate, much depends on location. In the US, we expect growth in the office rental market to be limited, or even negative in expensive locations such as New York. On the other hand, demand for commercial space rented by life science or technology firms is still high and should prove more resilient.

In Europe, high street retail rents have risen since June 2021, while rental growth in shopping centres continues to fall. This suggests that European prime retail markets are more attractive to investors, and maintain the ability to pass on the costs of rising inflation to their tenants. Tenants are already paying premiums for property that meets higher environmental standards. Less than 2% of 'Grade A' European office space is sitting vacant, for example, compared with 6% for the wider market.

In Switzerland, around 90% of the office market is linked to inflation with the offices highest rated on environmentally sustainable criteria still the most sought-after. We expect the Swiss National Bank to start raising rates shortly after the ECB, either in December 2022 or March 2023, and then to increase rates quarterly, to bring the policy rate to 0% by September 2023 or December 2023. The spread between residential real estate funds dividend yields and the Swiss 10-year government bond is shrinking as rates rise, and investment is slowing in the direct market. We analyse the Swiss real estate market in more detail in our latest investment strategy bulletin.

Boom with a view

Globally, investors looking for portfolio diversification in a low rate context turned to real estate for yield. Historically, real estate investments also perform well in inflationary cycles. Real estate continues to provide some cushion from rising prices while low levels of commercial property supply and strong demand mean that we do not expect to see a fall in valuations over the coming year.

Real estate remains an important part of our asset allocation and our portfolios carry an overweight exposure to European property. We prefer Europe, especially the commercial logistics sector, and residential, because so much of the market is inflation-indexed. While year to date, shares in listed European real estate in logistics, offices and residential have declined, the retail sector recorded a gain of more than 5%.

Prices of residential property have risen since the pandemic thanks to limited availability, and listed real estate companies are trading at a higher discount to their net asset values (NAV) than in the past. That leaves room for some catch-up. Within the different European property sectors, office and retail spaces are currently trading at discounts of around 25% to NAV, considerably higher than their average of the past 15 years.

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