USAA Real Estate

How the pandemic is shaping the inflation outlook

Underlying inflation in Europe has become remarkably steady in recent decades. The high inflation that was a feature of the 1970s has remained absent, despite periods of turbulence. Changes to the structure of the economy have ushered in a sustained period of low-price growth. However, the coronavirus disruption has affected both the supply and the demand sides of the economy, raising questions about inflation, the growth outlook and the commercial real estate (CRE) sector.

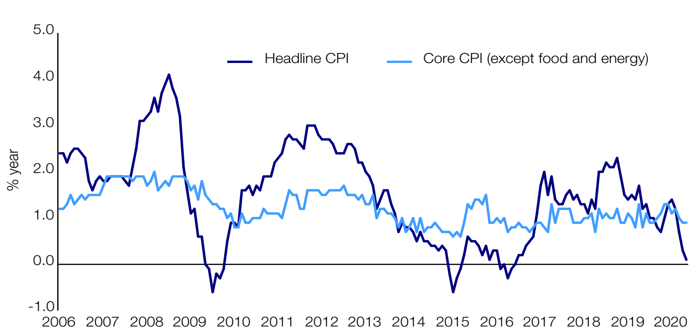
Supply or demand shock

The pandemic has shuttered businesses and constrained production, affecting the supply side of the economy. Output across many sectors has slowed or halted, while areas not immediately impacted are still suffering from disruptions. Historically, disruptions to supply have tended to be inflationary.

This time, the economy has experienced reduced supply and weak consumer demand. Eurozone household consumption fell 4.7 percent in the first quarter, and forward-looking surveys point to muted demand. Consumption patterns have changed dramatically during the pandemic, rendering inflation indices somewhat unreliable. However, headline inflation remained low in June, at just 0.3 percent. Low energy prices have been the principle driver of current deflationary pressure, but the low inflation is robust across most groups of goods and services.

The aggregate effect on inflation should ultimately depend on how these supply- and demand-side dynamics balance out. We are still early in our understanding of the situation, but we can already make some observations about the outlook for inflation and implications for CRE markets, as highlighted in the following.

Eurozone inflation



Source: Eurostat

Cost-push inflation

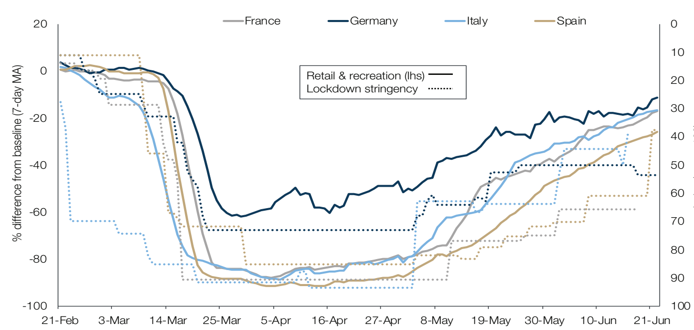
The pandemic has clearly caused disruption to supply-side dynamics. Social-distancing measures will continue to have a significant effect on the cost of supplying some goods and services. However, we have not seen a rapid rise in wages or sharp increases in the price of raw materials.

There is evidence that the pandemic is causing the price of some goods to rise (e.g., food). However, this probably reflects the temporary increase in demand during lockdown periods, rather than a permanent effect on the cost of supplying goods and services.

Pent-up demand

As social-distancing measures are relaxed, it is possible that pent-up demand will lead to a rush in spending, and some inflation. As restrictions continue to be eased, a sharp uptick in consumer spending is likely, as consumers are presented with more opportunities to spend. High-frequency data, such as the Google retail mobility index or the surge in US retail sales in May, support this view.

Eurozone mobility and lockdown stringency



Sources: Google Mobility Report*; Blavatnik School of Government*

However, it is unlikely that pent-up demand will be large enough to lead to sustained price inflation. The potential for further job losses will induce households to keep precautionary savings as a buffer. Household savings have soared since the pandemic hit Europe, rising by €214 billion between February and May to reach an all-time high of €7.3 trillion.[1] This will suppress consumption, making the challenge for fiscal and monetary policies focused on how to stimulate demand and prevent deflation.

Policy response

The immediate impact of the crisis has been strongly deflationary, but as recovery ensues, observers are concerned the policy response will result in rapid money and credit growth, leading to inflation. The scale of the response has resulted in large fiscal deficits and central bank balance sheets. During the global financial crisis (GFC), eurozone government debt ratios increased from 65 percent of GDP in 2007 to 90 percent in 2012. After years of austerity, the ratio stood at 84 percent at the end of 2019. However, debt levels across the eurozone are projected to increase above 100 percent in 2020.

Germany has announced the broadest stimulus, with a sizeable package combining broad-based demand support, such as a

VAT cut, with sector-specific policies. Meanwhile, the ECB has already put in place a €1,350 billion pandemic emergency purchase programme, and there could be even more stimulus in the future. This contrasts with the slow response following the GFC, with the ECB only launching its asset purchases in 2015.

The same inflation warnings were sounded in the aftermath of the GFC, but those fears were not realised, since monetary stimulus was largely kept within the banking system. However, this time, the policy response is giving a strong push to monetary growth, which is a concern for inflation. Oxford Economics' global credit impulse measure, showing the change in credit, hit its highest level in two decades in April. Meanwhile, world broad money growth picked up to over 10 percent year-over-year in April, from around 6 percent year-over-year at the end of 2019.

The policy stimulus is significantly larger than was implemented after the GFC, but this comes in response to an unprecedented shock. The €750 billion EU Recovery Fund marks a historic step for the bloc, which for decades, even during the GFC, resisted the notion of collective debt. The fund is likely to face hurdles, but this is the first time the EU has agreed to a common fiscal response to a severe economic shock. The fund will provide welcome support, but should the economy recover faster than anticipated, this could create inflationary pressures. Unpredictable factors, such as fast development of a vaccine, would, for example, fundamentally change the growth trajectory and allow inflation to rise faster than expected.

Commercial real estate outlook

One of the biggest questions facing real estate investors is what will happen to inflation. The pandemic has the potential to exert new inflationary forces on the economy, but it is also exacerbating the disinflationary trends that have been a feature of the past decade.

Deflation is often seen as unfavourable for inflation-linked returns, such as real estate. A sustained period of deflation would typically lead to lower income growth and valuations. However, during periods of deflation, income property has one significant advantage: predictable regular cashflows relative to higher risk assets, such as equities. Outright deflation is not impossible, but policymakers are likely to exert maximum effort to avoid this.

Investment opportunity

A period of positive, but comfortably below-target, inflation is a scenario many observers attach greater weight to in the medium term. The period since the GFC has been characterised by persistently low inflation, and yet investors have continued to target real estate. Low inflation and the associated fall in interest rates have served to reinforce the attraction of real estate relative to bonds.

Assuming a continuation of this low inflation, authorities are likely to continue down the path of quantitative easing, keeping policy rates and bond yields very low. As markets recover, this should reinforce real estate's appeal (e.g., healthy cashflow, appreciation potential) to investors and continue to drive high allocations. This will also have important implications for returns. Since the GFC, low inflation has boosted returns by driving yields significantly lower. But, with interest rates already very low, the boost to returns through yield shift is likely to moderate. Real estate still offers a vast amount of diversity, and a significant amount of opportunity, but achieving higher returns in the future is likely to require creativity and skilful investment.

Long term, inflationary pressures will likely provoke a similar level of concern. The scale of fiscal and monetary stimulus will inevitably create some inflationary pressures across several sectors — including risk assets. As the recovery takes hold and investment markets return to their pre-crisis growth paths, one might expect substantially more capital to pursue CRE during what may be a highly inflationary environment (at least in terms of risk-asset pricing), given the substantial amount of liquidity in the system.

The pandemic has dramatically altered the growth trajectory, leaving investors to contemplate a wide array of outcomes. As the recovery ensues, we may find certain CRE sectors are more resilient when faced with inflationary/deflationary pressures. The logistics sector stands out for its ability to benefit from structural changes, such as the growth of e-commerce, and offer inflation-beating income.

The near-term outlook for inflation looks soft; however, the nature of this crisis makes the path to recovery difficult to predict. The jury is still out on the outlook for inflation, but this will be a critical input to the eventual recovery.

Notes: [1] ECB, June 2020

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CORPORATE OVERVIEW

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