Real estate, real estate income and inflation

From Dr. Roger Stettler, Reto Bernet, 7.12.2021

After a long phase of low to negative inflation, fears of inflation have also arisen in Switzerland in recent weeks and months. This is particularly the case against the backdrop of rising inflation rates in important economic areas such as the United States, the European Union and the United Kingdom (Figure 1). In order to develop an optimal financing strategy in an inflationary scenario, it is crucial to consider the impact of inflation on real estate investments, income from these investments and financial instruments.

Figure 1: Inflation rate September (annualised)

	Inflation rate Sept 2020	Inflation rate Sept 2021
United States	1,4%	5,4%
United Kingdom	0,5%	3.1%
European Union	-0,3%	3.4%
Switzerland	-0,8%	1,0%

Real estate and inflation

The nominal value of a property is determined by the development of the (nominal) rent and the discount rate. In addition to the interest rate environment, the discount rate is also dependent on the risk premiums. In this article, the change in rental income will be covered in more depth.

The behaviour of rents in relation to inflation depends on the structure of the

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rental contracts and thus the local legal framework - this is also the reason why empirical findings from abroad can only be transferred to the situation in Switzerland to a limited extent. For example, analyses from the USA from 1978 to 2016 show that the rental income from retail space is 102% protected against inflation, but income from residential space only by 56%. The reason is that in the US market, contracts for retail space are usually linked to inflation, while those for residential properties are only partially linked.[1]

Rent adjustments in Switzerland

In Switzerland, too, the dependency between inflation and rent is strongly

[1]https://economics.mit.edu

dependent on the type of property (see Figures 2 and 3). For both residential and commercial properties, there are possibilities to adjust prices in case of increasing inflation, especially for commercial properties. However, all market participants today lack experience in dealing with rent increases during an ongoing contract. Uncertainty is therefore to be expected, at least in an initial phase, until inflation expectations have been consolidated among all market participants and inflation-linked rent increases can be realised without any problems.

Figure 2: Possibilities to increase rents: Residential properties

a. Service charges (heating, maintenance, fees, etc.): Effective (100%)
b. Rent: - For index-linked rent (minimum term 5 years): up to 100% inflation - For ordinary tenancy agreements: • 40% inflation • Plus 0,5-1,0% p.a. „general price increase“ • Additional rent increase in case of rising mortgage reference interest rate

Figures 3: Opportunities for rent increases: Commercial properties (offices, warehouses, etc.)

a. Service charges (heating, maintenance, fees, etc.): Effective (100%)
b. Rent: Inflation-indexed contracts with 80-100% index rent are typical.
d. Further adjustment possibilities unusual

Inflation or stagflation

Historically and in the present, very different forms of inflation occur:

These range from "benign" inflation, in which price increases are a reaction to over-utilised production factors, e.g. full employment prevails and the economy grows in real terms. In such an environment, rent increases are easier to implement, since the economic actors are used to rising prices and wages and the expansion of the economy reduces distributional conflicts.

This is to be distinguished from "stagflation", where a price increase is accompanied by poorly utilised production factors, e.g. high unemployment, at the same time. This can be due to supply shocks (e.g. oil price shocks of the 1970s, currency crises), regulation (e.g. minimum wages not in line with labour productivity, tax increases) or monetarisation of public debt, crop failures (in the case of agrarian societies) and/or structural problems of the economic system. In such an environment, it is much more difficult to implement rent increases, as the purchasing power of all stakeholders is already under pressure and an oversupply of rental space is to be expected, especially in commercial and industrial properties as well as more upmarket residential space.

So investors who want to position themselves in terms of inflation need to be precise about whether they are assuming "benign" inflation or stagflation.

Nominal interest rates and inflation

In the discussion, interest rates and inflation are often mixed up with each other, or in the case of rising inflation it is "automatically" assumed that interest rates will rise. Historically, a correlation between inflation and interest rates can be observed, especially in the USA. However, since the financial crisis of 2008, this correlation has effectively been suspended in Europe.

Interest is nothing more than a market price for capital. This applies to all the building blocks of an interest rate - both the risk-free interest rate and premiums and discounts for risk premiums and maturity. This market price is a result of supply and demand, whereby at the short end of the yield curve in particular the market price is significantly influenced by central bank transactions (both on the demand and supply side). There is the possibility that, against the background of the considerable debt burden of state actors, interest rates will remain low, at least at the short end, even in an inflationary environment - this scenario was used by various states after World War 2 to reduce real government debt.[2] This process is called "financial repression".

Depending on the scenario realised, a real estate investor is confronted with a very different interest rate situation at an identical inflation rate.

Residential properties are per se well hedged against rising interest rate increases by the possibility of rent increases due to a rising reference interest rates. However, today's market players lack experience in dealing with rising nominal rents during a tenancy.

«Interest rates and inflation are often mixed up in the discussion.»

Especially in case of rising interest rates, combined with an environment of high vacancy rates, an adjustment of rents is challenging.

Financing structure

Leverage is usually one of the main characteristics of property investments. The positioning of debt on the yield curve influences the interest rate risk profile of the overall portfolio.[3]

Some market participants recommend taking out long-term fixed-rate mortgages in an environment of rising inflation. This recommendation is implicitly based on two key assumptions:

1) That the forecast of rising interest rates is not fully taken into account in the yield curve, i.e. the steepness of the yield curve is too low

[2] Thus, in the period 1946-1976, the nominal interest paid by Great Britain was lower than the rate of inflation in 24 out of 30 annual periods. https://obr.uk/box/post-world-war-ii-debt-reduction/

[3] For an in-depth discussion see „Opportunities and peculiarities in the Geneva mortgage market“

2) That rising inflation is indeed associated with rising interest rates

Consequently, a long-term interest rate hedge makes sense if one's own forecast anticipates an environment of actually rising interest rates and this in combination with a yield curve that did not yet include an expected interest rate increase sufficiently.

Long-term financing also stabilises cash flow planning: If earnings can only be increased with a delay - for example due to an unfavourable economic situation or low inflation expectations - then long-term financing can bridge the time period until the situation returns to normalcy.

Conclusion

In terms of rental income, Swiss real estate generally offers good protection against inflation due to contractual practices and legal circumstances, whether for residential or commercial properties. However, this only applies if inflation is accompanied by a positive economic development and the rent increases can actually be realised without vacancies on the property.

An investor can also hedge his situation by taking out long-term financing, unless he assumes that inflation and nominal interest rates will be decoupled. This long-term connection is particularly useful in the case of a low risk capacity, i.e. above all a high loan-to-value ratio of the properties and low surpluses from rentals.

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