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Inflation resurrected.

What are the implications for real estate?

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Paper for Middleton Advisors by Yolande Barnes

Executive Summary

- The future for the UK, like many advanced economies, is deeply uncertain; especially with regard to inflation, interest rates and the possibility of recession.
- The immediate concern is levels of consumer price inflation not seen since 1983.
- Recent inflation is due to a combination of factors including demand/supply imbalances and raw material price shocks, particularly in the energy sector. While these may unwind in the near. To medium term, the big fear is that inflation will become 'built-in' through the operation of the wage-price spiral.
- Governments and central banks will likely intervene in attempts to avert such a negative feedback loop. These measures, like the recent Bank of England base rate rise, will in themselves be disruptive.
- The cost of living crisis will impact households unequally with those on low incomes experiencing greater impacts than those with higher.
- The concern of wealthier households will be in preserving asset values in an inflationary environment. For those in the housing market reliant on equity rather than borrowing, this will mean a flight to quality. But 21st century 'quality' will be different to 20th century.
- There has been a qualitative shift in demand since the Covid lockdowns of 2020. So quality now is not just about financial performance but also about experience, comfort, convenience as well as environmental and social performance of property.
- Different locations and types of property have emerged as popular post-pandemic must-haves. Environmental and quality of life issues will matter more than they have in the past and become more of a determining factor in real estate values.
- Some types of energy inefficient property may prove problematic as heating and other bills rise. This could cause affordability squeezes in some sectors, particularly when combined with rising mortgage costs.
- The active 'curation' of value in real estate generally will extend to residential property with buyers needing to consider the fundamental, long-term drivers of value.
- Impacts of inflation on residential property are likely to be polarised. We will see winners and losers in terms of performance and demand.
- While the financial drivers of asset price growth have weakened, and even reversed, with interest rate hikes, residential assets have other qualities which households will continue to pay for.
- In past inflationary eras, such as the 1970s, nominal house prices rose, along with other goods and services. In these circumstances, it was only real (inflation adjusted) prices which fell during periods of wider recession.
- It is possible that we could see a similar pattern again. If inflation persists, inflation may devalue borrowing, deflating debt in real terms as it did to mortgage borrowing in past decades.
- It cannot be taken for granted however that inflation is built-in or will become so. Some current inflation-causing factors will dissipate in the near to medium term leading to disinflation or even deflation.
- Land and property can be a safe haven in uncertain times. After all, 'one home' is always worth 'one home'.

Inflation: dead, ghost or waking out of a long coma?

Back in 1996, the economist Roger Bootle boldly announced "The Death of Inflation" in a book of that name. Claims of inflation's demise now appear premature however as the spectre of rising prices looms globally. Are these the last, temporary stirrings of a 20th century ghost or were we fooled into thinking inflation dead when it has merely been comatose for nearly three decades?

Consumer price inflation in the UK has been rising for the past year and is currently running at around 10%. This follows a period or 29 years after 1992 when consumer price inflation (CPI) averaged 2% per annum. The current level of CPI hasn't been seen since 1983 when inflation was falling rapidly in the new Thatcher era after its 25% highs of the mid 1970s. This has led some to fear that we are heading back to a similar era, characterised by oil crisis, recession, falling investment, risk and uncertainty.

It is impossible to argue that there is nothing to be worried about but what exactly are the risks we are likely facing and what does this sudden spike in consumer prices mean for the housing market on top of all the disruption, change and uncertainty created by war, climate change, the Covid pandemic?

How have housing markets and particularly prime housing markets fared in past inflationary periods and will we see a return to the conditions of the 1970s oil crisis days when large historic houses were abandoned, converted and even demolished as they proved too costly to run?

The answers to these questions depend on some understanding of inflation, its causes and effects. This article argues that conditions now and in the immediate future are not the same as past inflationary periods and there are reasons why prime property will remain in demand and house prices will remain on a 'high plateau' – albeit showing little or no growth.

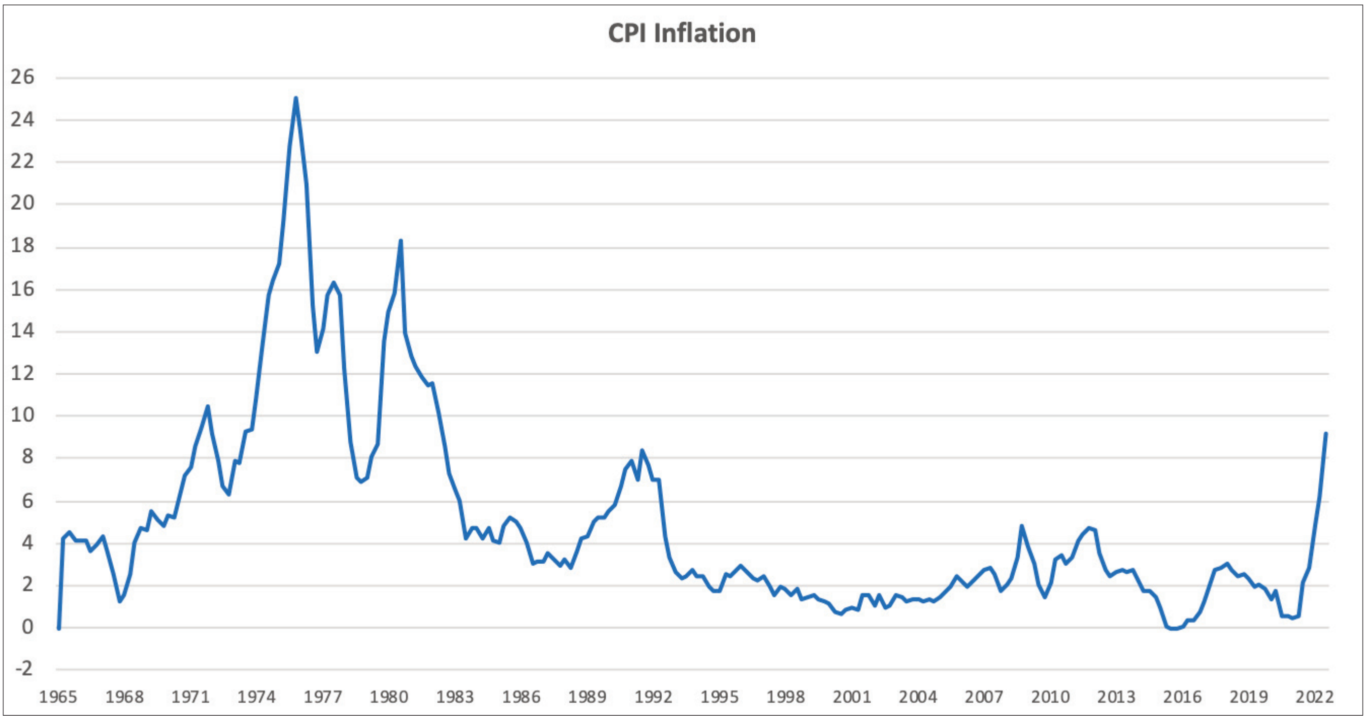

Fig. 1 Consumer price inflation since 1965

Source: Bank of England

The text books tell us that there are three types of inflation:

1. 'Demand-pull' when demand for goods and services exceeds supply

2. 'Cost-push' when raw materials increase in price and companies pass on costs (or squeeze margins)

3. 'Built in' when inflation puts pressure on wages and threatens labour shortages, pushing up costs

It can be argued that we can see all three types of inflation at present. The excess demand caused by pent-up demand and a temporary boost in spending power after Covid lockdowns seems set to dissipate quite quickly. Supply shortages caused by broken supply chains may take longer to mend but may also be seen as temporary.

In real estate markets, and the housing market in particular, specific examples of demand-pull inflation can be seen at work. Demand for housing changed significantly during the Covid lockdowns and there have been demonstrable shifts in. the places and buildings that people want to make homes in. It is perhaps an over-generalisation to say that houses with gardens in good neighbourhoods have become more important to renters and buyers. Changing working patterns means a qualitative shift in demand has gone hand in hand with demand for new and different locations. This means that there have been winners and losers in the housing market which was exacerbated by supply shortages of the right property in the right place. According to Rightmove, some regenerated and heritage locations like Rochdale, Folkestone, Farnham and Altrincham saw residential rents rise by nearly 30% in the year to September 2021 while inner London rents fell by nearly 7% over the same period. London and other cities have rebounded since lockdowns fully ended and more normal service has resumed but still the demand pressures remain on high quality stock in short supply across a variety of desirable locations.

Meanwhile, cost-push inflation is a major threat to the house builder and developer industry, puts real estate operators in jeopardy and threatens the viability of a huge variety of businesses. This clearly threatens recession at a national level but also threatens the health and vitality of local neighbourhoods and the quality of living environments which are such an important part of people's homes. If local businesses like pubs, cafes, restaurants, small independent shops and services are not enabled to survive, this will have a significant impact on the quality of some neighbourhoods.

More problematic but also hopefully temporary are the shortages and extreme price hikes seen in oil and gas markets following Russia's all-out war on Ukraine. They have called into question the security and sustainability of energy provision in the West which cannot be easily fixed in the short term. All of this taken together can, and has, been termed a cost of living crisis which if inadequately addressed risks becoming structural or 'built in' inflation, sparking the destructive spiral of price rises leading to more inflation.

Fig. 2 **The wage-price spiral**

In this worst-case scenario, falling real incomes mean workers, fearing more inflation, then demand higher wages which means higher costs for employers, fuelling cost-push inflation and higher prices which devalues income in real terms and refuels the cycle.

It is highly unlikely that any western government or central bank will fail to intervene in some way at one or several points in this process to avert such built-in inflation. What is less certain is how effective or fraught with unintended consequences these interventions will be.

It is difficult to believe that, as recently as 2015, the UK experienced deflation in two months of that year - when consumer prices actually fell. We had grown accustomed to both low inflation and the accompanying low interest rates, not just in the UK but globally.

In fact, you could say that we had not only grown accustomed but also addicted to low interest rates. Borrowing had never been cheaper than in the period after the Global financial crisis of 2008 (also called the North Atlantic Debt Crisis) when central banks in most of the world's advanced economies reduced rates to all-time extreme lows. Some government bond rates in Germany and Japan, for example, were briefly negative. Now even those countries are experiencing inflation.

The current bout of inflation is a big shock. Some people fear a return to the 1970s and some older commentators even remember this era of price rises, wage spirals and recession, often dubbed 'stagflation' – a lethal mixture of economic stagnation and inflation. But this was a particular product of a peculiar era.

One fear for the housing market is that the cost of living crisis will put further pressure on already stretched housing affordability and that high energy bills could be deeply discouraging to potential owners of large, poorly insulated homes. Some flat owners will also be struck at the large and increasing size of service charges too. Memories have been stirred of a time when important and historic country houses fell into disrepair and disuse and were even demolished because the cost of upkeep could not be borne by the owners.

There is no doubt that these pressures will have significant consequences in some markets but these are unlikely to include country houses. This is because the burden of inflation is distributed unequally and will adversely impact some sectors of society more than others. This is likely to be reflected in the housing market where wealthy owners of big houses are less likely to be affected. Housing markets may become more polarised as a result.

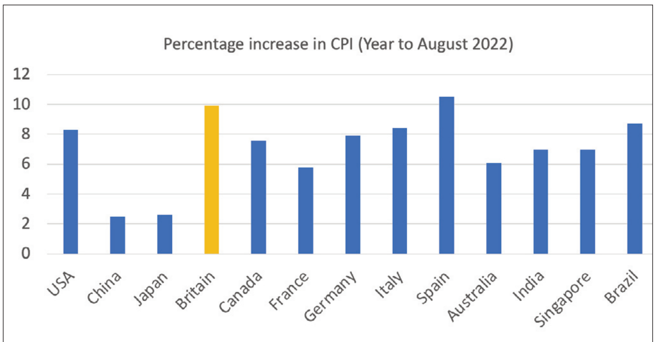

Fig. 3 Consumer price inflation by country
Source: The Economist

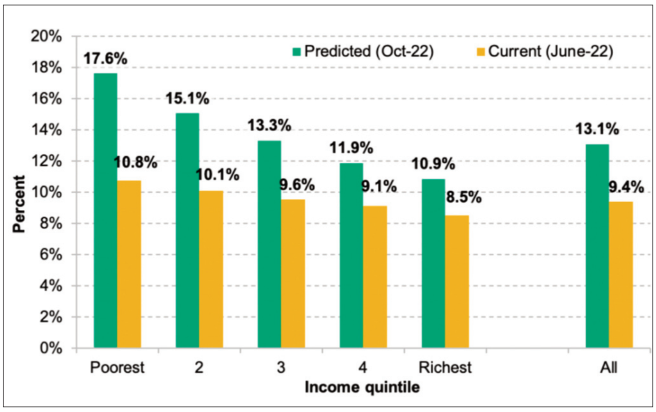

Fig. 4 Inflationary impacts are unequal: predicted inflation for different households
Source: Institute for Fiscal Studies

Over a half of owner-occupiers in the UK now own their homes outright, without mortgages. For them, and for wealthy homeowners, the big issue is how to protect the value of their assets, particularly in times of combined recession and inflation.

The worry for many in the housing market is that, while the halcyon days of falling and low interest rates meant rising and high capital values, rising interest rates will mean falling prices.

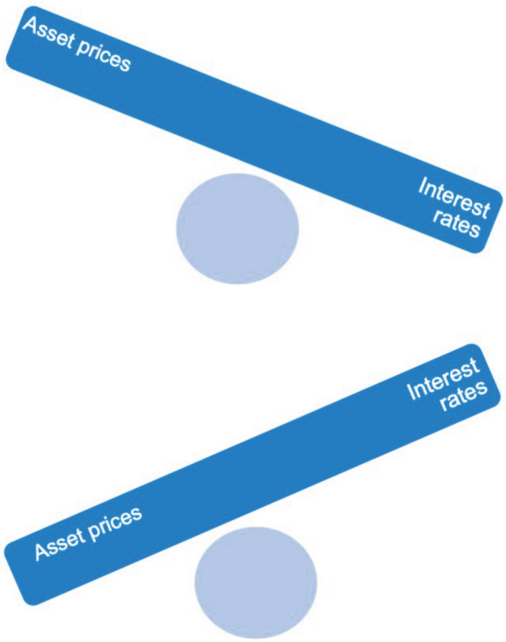

Fig. 5 **The interest rate dilemma**

While markets which are overly reliant on mortgage borrowing at highly geared rates may have cause for concern, those which have been driven by influxes of capital are likely to be more insulated. There is evidence that markets have already been slowing having reached a 'high plateau' around 2016. The mainstream market has been growing well below its long-term, real (inflation adjusted) trend for the last six years. It is as if, sometime in 2014, markets re-calibrated to a new rate of growth. This slower rate perhaps anticipated higher long-term interest rates even as central banks and their quantitative easing were driving base rates to record lows.

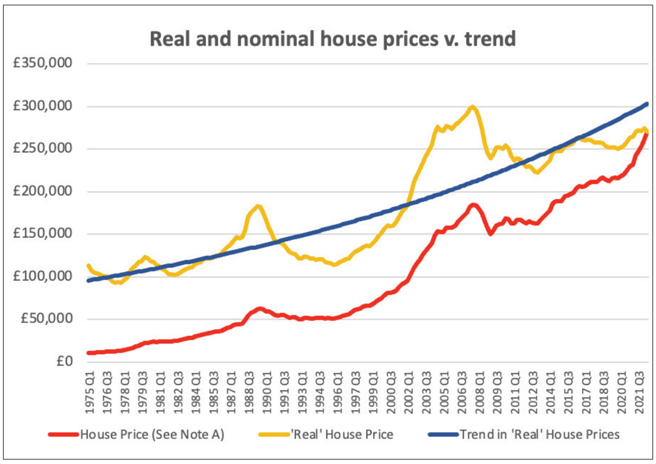

Fig. 6 **Have house prices already anticipated higher interest rates?**
Source: Nationwide Building Society

In the 30 years from 1992 to 2022, the 'Very prime' housing market of central London (Kensington, Holland Park, Notting Hill, Chelsea, South Kensington, Belgravia, Knightsbridge, Mayfair and St James's) saw price growth of 629%. This is not a market dependent on mortgages (fewer than 10% of prime London purchases are geared at the point of purchase) but falling bond market yields were part of the global financial background which meant capital was cheap. Ten-year Government Bonds moved in from 9.2% in June 1992 to 2.08% in June this year. This yield shift alone changed the opportunity cost of money sufficient to contribute 344% of the growth in real estate asset prices over this time.

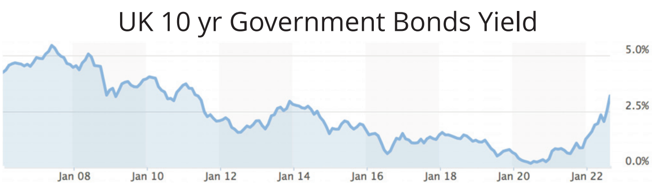

Fig. 7 **Yield shift in global bond markets has helped to drive prime house prices**
Source: MarketWatch

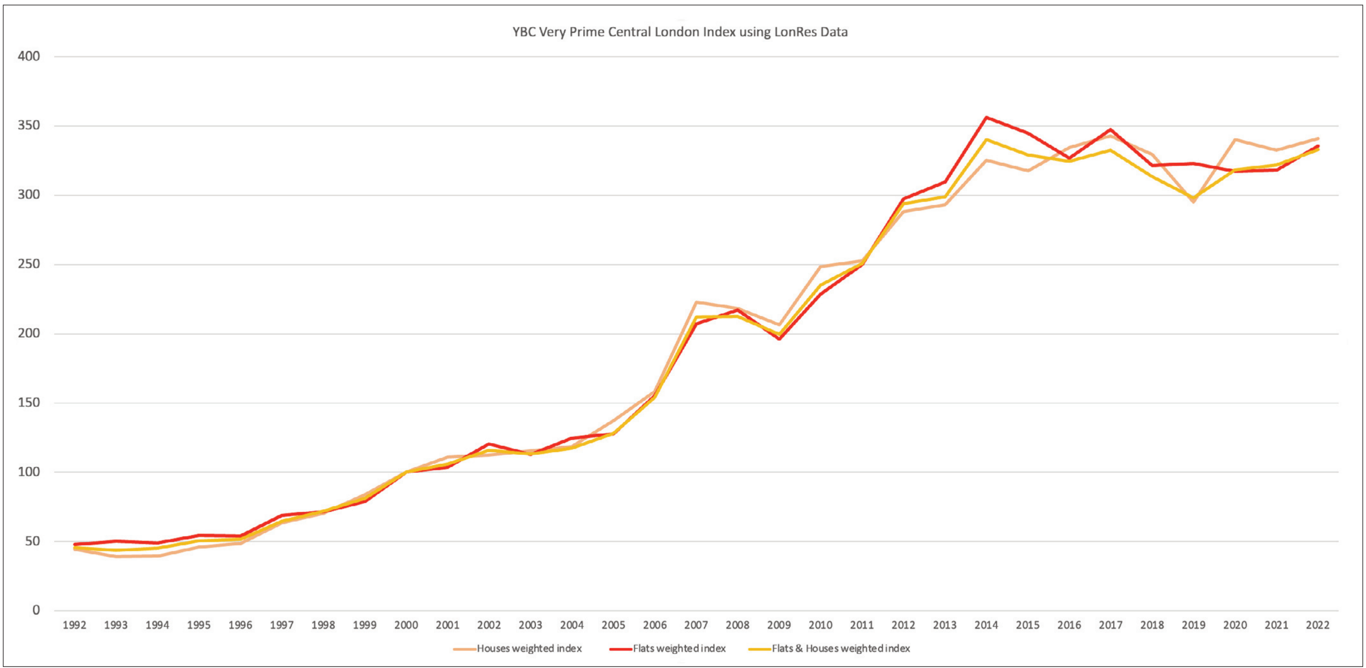

Fig. 8 More than half of Prime HPI due to falling interest rates Source: YBC and LonRes data

For the wealthy, the emphasis is now not on growth but on the preservation of asset value. This is where the composite nature of housing: not only as an asset, but also a consumer good and service, an 'all-in-one' commodity becomes important.

In past eras of high inflation, house prices have also risen like other goods and services. In the 1970s, nominal house prices rose even when inflation and interest rates were hitting records highs. Indeed, it was only inflation that stripped out value during recessionary periods.

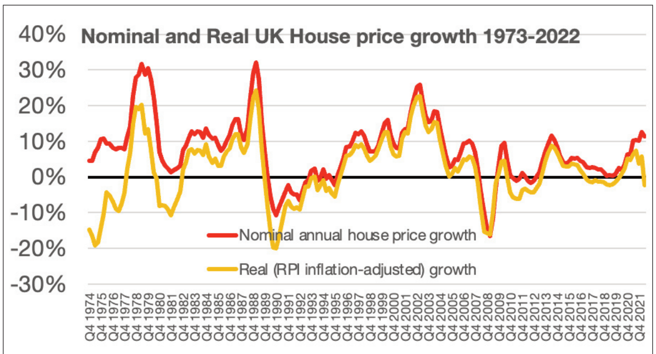

Fig. 9 High CPI doesn't necessarily mean no HPI
Source: Nationwide Building Society, ONS

At the same time, 'money illusion' paid back borrower's mortgages inasmuch as inflation had the effect of devaluing mortgage borrowing and enabling the early repayment of loans. This will only apply again if wage rises keep up with or exceed inflation rates though.

Prospects for the future.

There are reasons to be reasonably optimistic – or at least not deeply pessimistic – for real estate in general and high-quality assets in particular over both the near term and longer term. The possible inflation-hedge quality of real estate has already been outlined. But also relevant to the prime market is the global attractiveness of freehold title when sterling is weak and consequently UK property looks cheaper of the global stage.

Meanwhile, interest rate hikes, perhaps similar to those already enacted by the Fed in the US, will not take interest rates anywhere near the levels of the 1970s and 1980s. We know we are in a fundamentally low interest rate environment when we consider 4% to be high...

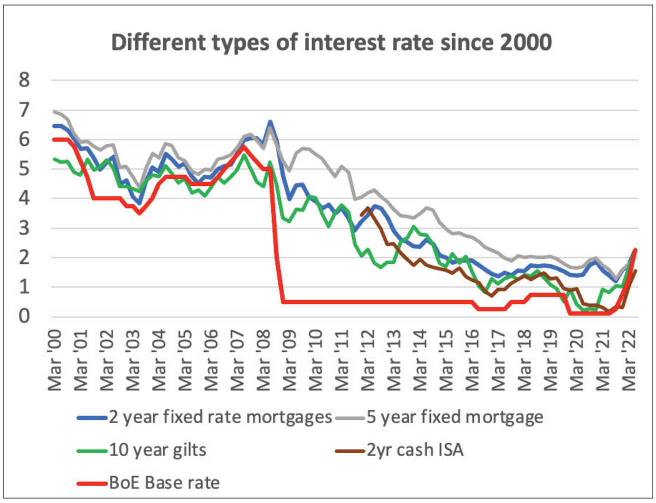

Fig. 11 Not all interest rates are the same
Source: Bank of England, ONS

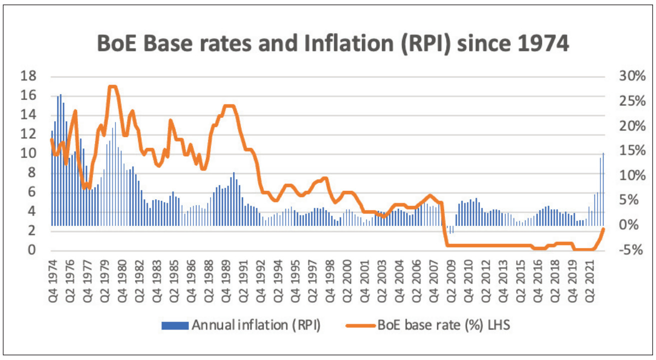

Fig. 10 Interest rates are still very low by historic standards
Source: Bank of England, ONS

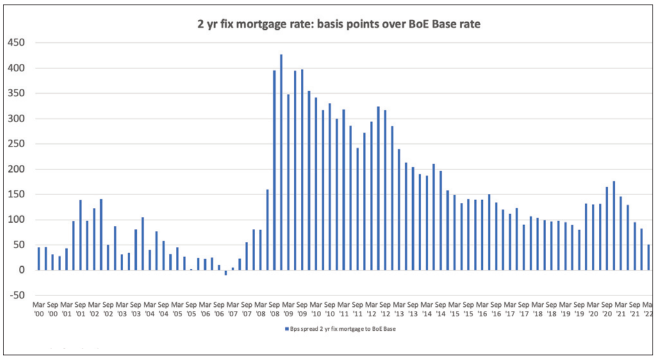

Fig. 12 Real estate has been 'cushioned' against bank rate rises (until now)
Source: Bank of England, ONS

There is also the issue as to how much future interest rate hikes have already been discounted by the market. Bank of England base rates have not borne a close resemblance to other types of interest rate – or indeed property yields and cap rates for quite a while. This leaves a 'cushion' between central banker's actions and the response of real estate (and other) markets.

In the long term, housing markets, including prime markets are likely to be very different in the 21st century compared to the 20th century. Not withstanding its current death throes, inflation is likely to be relatively low – although it may become more volatile, swinging between periods of inflation and deflation in the face of fluctuating shocks and risks.

Ultimately, populations in the advanced economies – and now others like China – are aging. The global search for income to pay pensions will continue so demand pressure on fixed income assets like bonds will likely keep real interest rates/ cap rates/ yields/discount rates relatively low compared to. the past. Residential property, as a service that everyone needs, will likely remain a hot ticket item in the hunt for value. But there will be winners and losers in a polarising market. Stock selection will matter a great deal; the wrong property of the wrong type in the wrong place will not perform and owners may be left with stranded assets. But, for those who take care, get it right and add value, there will still be rewards. This does mean that property ownership is likely to become a much more active and hands-on investment in future and owners will need to deal with more frequent volatility, risk and uncertainty.

Overall, real estate, and particularly residential, could prove to have some inflation-hedging properties. After all, even in the most inflation-riddled economies like Zimbabwe, Venezuela and Argentina, there are huge benefits to owning and controlling a homestead. One home will always be worth one home, whatever happens to economies, inflation or currency values.

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