

**BlackRock**

# **Inflation & Real Assets**

Navigating an inflationary environment with real assets

The views expressed are as at July 2021 and are subject to change with market conditions. There is no guarantee that any forecasts made will come to pass.

**Real asset investors have been increasingly focused on inflation. In this paper, we discuss our views on inflation, whether it is transitory and where it will go. More importantly, we will discuss the reasons why real assets may perform well in periods of higher inflation, and tools and strategies real assets investors should deploy in a higher inflationary environment.**

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Real Assets Product Strategy

# 1

## **A powerful restart**

In the U.S., core inflation spiked during the first half of 2021,<sup>1</sup> driven by supply constraints alongside surging demand and stockpiling. Current inflation data is erratic, but we expect a higher inflation regime in the medium term. Government bonds yields will likely remain lower than what was experienced in previous inflationary periods. While yields may move higher from current levels, the overall adjustment will be much more muted than one would have expected in the past, thus resulting in persistently negative real rates. This is currently a regional phenomena, mainly concentrated in the U.S., but may become more prominent globally as the restart broadens.

# 2

## **Keeping up with inflation**

In previous inflationary periods, real estate and infrastructure outperformed other asset classes. This is due to several factors. First, leases and revenue streams are directly or indirectly linked to inflation. When inflation is accompanied by good economic growth, demand rises for real estate space and economic infrastructure. Meanwhile, there is often some form of expense pass through. Further, construction costs tend to rise in periods of inflation, resulting in higher replacement cost and limiting new supply to enter the market. Finally, paying down debt with inflated dollars is beneficial for levered real assets strategies.

# 3

## **Strategies during higher inflationary regimes**

Inflation sensitivity will vary across real estate and infrastructure sectors, and for equity and debt investors. Assets with shorter-term leases or take-or-pay contracts tend to capture the upside in inflation well, and long-term leases and contracts (i.e. power purchase agreements) linked to inflation can provide some form of protection. Floating rate debt can be beneficial to debt investors, whereas fixed rate and longer-term debt benefits equity investors.

<sup>1</sup> U.S. core CPI, or CPI excluding food & energy, increased 4.5% y/y in June, according to the Labor Department.

## Inflation view

# Inflation: the bottom line

## Higher, not runaway

Economic reopening, combined with record levels of fiscal and monetary stimulus, higher production costs and realignment of global supply chains is driving a robust outlook for economic growth and the highest inflation expectations in almost a decade. Inflation should build steadily over the medium term, well above the Fed's 2% target. Supply constraints and surging demand will likely keep short-term inflation more volatile. The BlackRock Investment Institute (BII) sees inflation near 3% in five years, above current breakeven rates, but well below 1970s levels of hyperinflation.

## The “new nominal”

The economic restart will cause inflation pressures to build, but central banks' response will be more muted. This played out through the first half of the year in the United States, and to a lesser extent in Europe. Nominal long-term government bond yields have risen, but less than breakeven inflation rates.

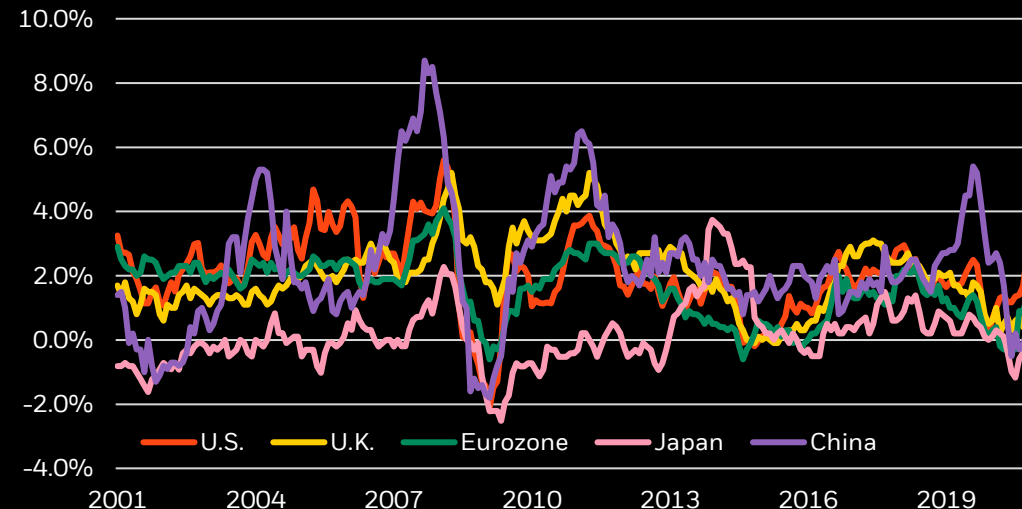
New central bank frameworks aim to overshoot inflation targets to make up for past misses, resulting in a more muted monetary response to inflation pressures than in the past. We see any bond yield rises driven by inflation, rather than policy hikes, making the unique environment that we have called *the new nominal* constructive for equities. We still believe the direction for yields is to go higher, but the overall adjustment will be more muted than what would have been expected in the past based on growth dynamics. Therefore, we expect persistently negative real rates which is supportive for real assets.

## The U.S. leads in growth (and inflation)

Inflation is so far a regional phenomenon, as vaccine rollout has been faster in the U.S. compared to other parts of the world, fueling a fast-paced economic recovery. Many countries are still at or below their inflation targets such as the European Union (1.9% inflation vs. <2% target), Japan (-0.4% vs. < 2% target) and Australia (1.1% vs. 2-3% target).

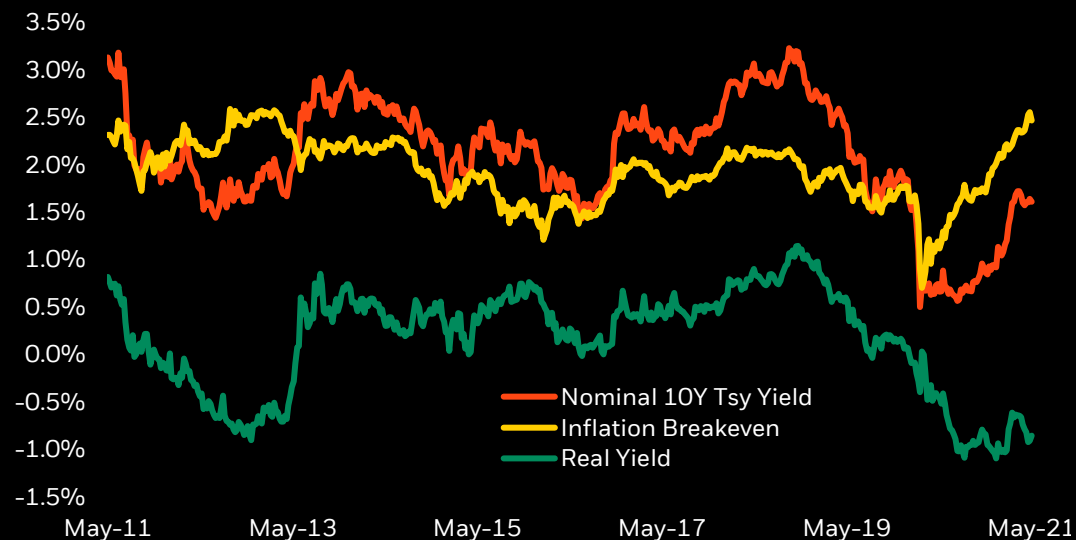
Further, shortages in the U.S. are not occurring in Asia as much. Supply bottlenecks are not present and factories and container ports are functioning well, partly thanks to healthy intra-regional trade. Thus, inflation appears more subdued and will likely continue to be so even as Asian economies reopen. In Europe, inflation has been rising due to supply shortages especially in the hospitality sector, but it is not expected to be persistent.

**Figure 1: inflation is meaningfully higher in the U.S., moderately high in Europe, but still subdued in other economies**



Source: Refinitiv Datastream and BlackRock, as of July 6, 2021

**Figure 2: The “new nominal” accelerates**



Source: BlackRock Investment Institute and Refinitiv Datastream. Data is for the U.S. As of May 24, 2021.

## Keeping up with inflation

# Inflation-linked

Returns from both real estate and infrastructure have positive correlation to inflation, especially when it is combined with high economic growth. Real assets are able to capture inflation through greater income growth due to higher rent growth, occupancy, and increased demand for the underlying good such as electricity. The risk of accelerated expense growth is primarily mitigated through (1) contractual adjustments in leases or contracts, (2) expense pass-throughs, (3) higher replacement costs, and (4) beneficial leverage.

### Annual adjustments in real estate leases

Real estate leases, especially long-term leases for office and industrial, include annual adjustments at a given rate, which is generally influenced by inflation. In Europe and increasingly in the UK, leases often have explicit links to inflation, usually with a cap and collar at 1-3%.

Hotel, self-storage, and (In the U.S.) apartment leases are short-term (daily, monthly and 12-14 months, respectively), which means rents mark-to-market often, keeping up with rising inflation.

### Infrastructure assets' revenue streams explicitly linked to inflation

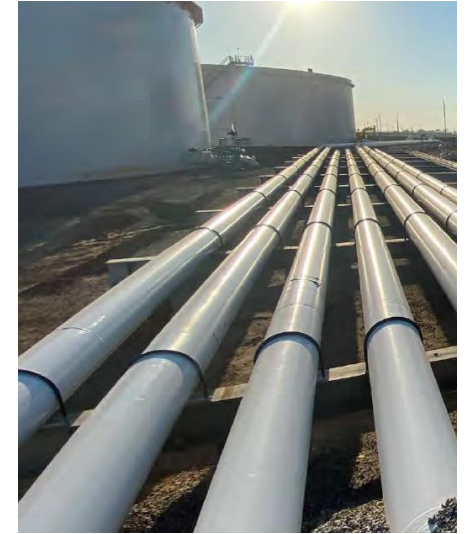
Many infrastructure assets, including the majority of contracted power and utility investments, have an explicit link to inflation through regulations, concession agreements or contracts, providing natural inflation protection. Infrastructure assets have long-term (10-20 years) revenue contracts that are derived from contracted or regulated pricing regimes and are based on subsidies or corporate power purchase agreements (PPA), which may be tied to inflation indicators such as CPI and PPI.

### Higher economic growth = higher demand = price growth

In periods of higher economic growth, there is an implicit inflation linkage in energy and power infrastructure. Increased demand and increased construction costs result in rising price pressure for electricity and natural gas. Increasingly in the renewable energy space, contracts are either set at a fixed price with no inflation indexation or fixed volume. Upside to revenues in either scenario will come from higher volume (demand) or higher prices. Midstream oil and gas investments with take-or-pay contracts also benefit from stronger growth due to higher demand for the underlying commodity.

### Renewable deployment—exception to the rule

Within the renewable energy space, demand for assets is so strong that development remains attractive even as construction costs rise. Production costs for wind and solar energy are falling due to economies of scale and technology improvements, and declining at an even faster rate for less mature technologies that still have lots of technological advancement ahead of them (energy storage, electric vehicle charging infrastructure and green hydrogen are some examples). Higher productivity from these assets may offset any rise in construction costs.



Images for illustrative purposes only.

Keeping up with inflation

# There are some silver linings

## Expense pass-throughs limit inflationary impacts

Some real estate leases are triple net, which means the tenant is responsible for utilities, real estate taxes and insurance, and maintenance, shielding real estate investors from inflationary impacts on these items. These leases are common in retail, industrial, and office in certain markets.

Infrastructure operating and maintenance contracts are typically fixed, so the rate remains the same throughout the life of the contract even when inflation rises—an implicit ‘soft’ protection on the cost side. Nevertheless, labor crunches may still cause operating and maintenance costs to rise for some infrastructure sectors which are more labor intensive.

## High commodity prices have contributed to higher replacement costs

The cost of new construction rises with inflation, increasing the value of existing stock. In real estate, higher lumber costs (+139% yoy as of June 28th) and a labor shortage has caused construction costs to increase, therefore making it more difficult for new supply to enter the market. Much of commercial real estate construction today is centered on industrial and multifamily.

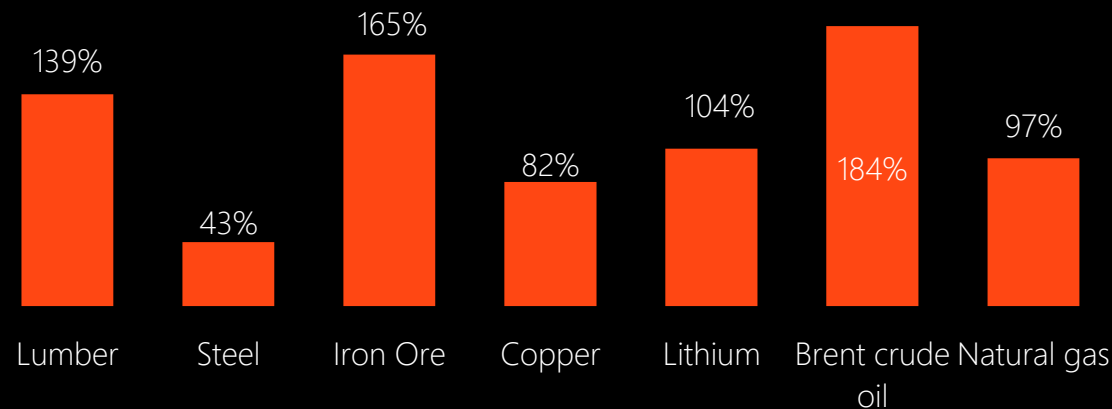
Other construction input prices have skyrocketed, such as steel (+43%) and iron ore (+165% yoy), making construction for infrastructure assets more expensive as well. Anecdotally, the construction of new renewable projects (solar & wind) can be 10-15% higher with the increases in steel prices.

## Unexpected inflation benefits the borrower

In an inflationary environment, debt, even floating rate debt, benefits the borrower at the expense of the lender. Paying down debt with inflated dollars is beneficial for levered real assets. Longer-term fixed rate debt would benefit borrowers the most during persistently higher inflationary environments. As NOI grows with inflation, debt gets paid down at the same interest rate, magnifying the impact of leverage to boost total returns. During periods of lower inflation, as we have seen in the decade post-GFC, floating rate typically benefits the borrower more.

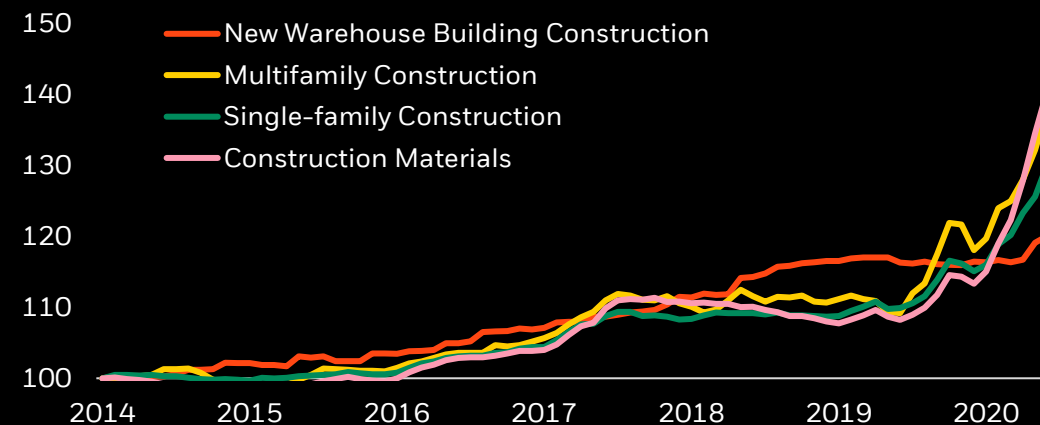
Recent feedback from our capital markets team indicate lending standards are loosening for the most desired sectors, even for construction projects. For debt investors, rising inflation (and rates) would mean investing in more floating rate debt and utilization of leverage.

Figure 3: Commodity prices – Year-on-Year Growth (USD)



Source: Trading economics and BlackRock. Year-over-year percent change as of June 28, 2021

Figure 4: Pricey construction inputs limit new supply (U.S. price indices)

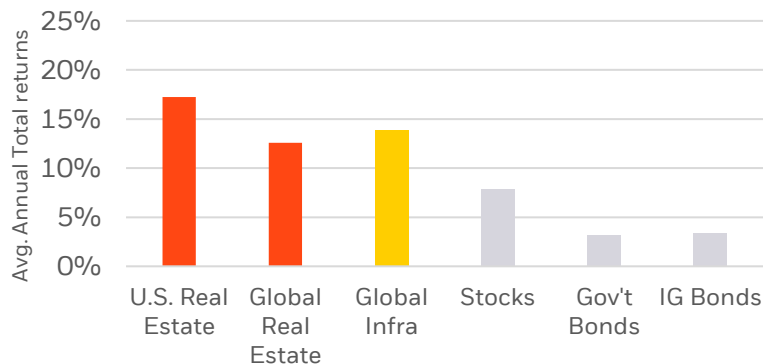


Source: BLS, Federal Reserve of St. Louis (FRED), and BlackRock, as of May 31, 2021. Indices used are a part of the Producer Price Index: (1) New Warehouse Building Construction Index, (2) Net Inputs to Multifamily Residential Construction, Excluding Capital Investment, Labor, and Imports, (3) Net Inputs to Single Family Residential Construction, Goods Less Foods and Energy, (4) Construction Materials

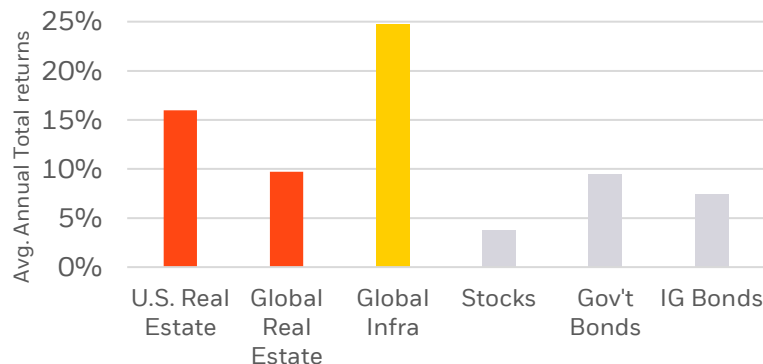
Keeping up with inflation

# Real assets have historically outperformed in inflationary environments

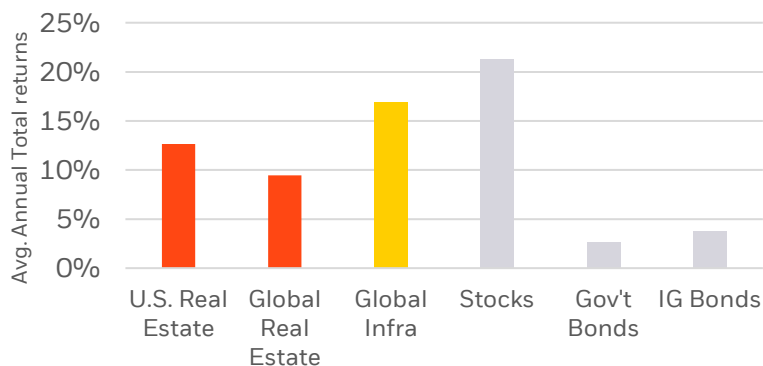
## High growth / high inflation



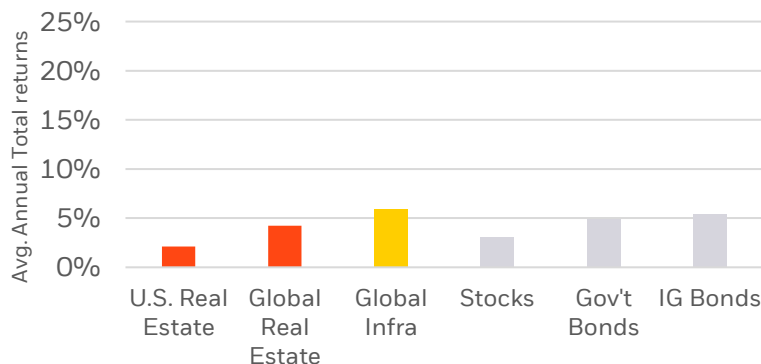
## Low growth / high inflation



## High growth / low inflation



## Low growth / low inflation



The charts show average returns in different regimes over the past 20 years.

The four regimes are based on GDP and inflation with hurdles at 2.5%; therefore, if GDP and inflation are both above 2.5%, the returns in that year is included in the upper left chart.

Both private real estate and infrastructure equity perform well during the three of four regimes. More importantly, both asset classes outperformed traditional asset classes during high inflation periods (top two charts)

The key takeaway here is that real assets outperform traditional asset classes during high inflation environments.

Source: Bloomberg, Barclays (Investment grade: US Agg Bond; Gov't bonds: US Gov't Agg TR), NCREIF (U.S. Real Estate: NPI), MSCI (Global Real Estate); EDHEC (Infrastructure: All equity) and S&P (Stocks: S&P 500); as of December 31, 2020 (annual data since 2001). **Past performance is not indicative of future results.** You cannot invest directly in an unmanaged index. High growth periods are when U.S. GDP > 2.5% and high inflation periods are when U.S. CPI > 2.5%.

## Strategies

# Focus on what you can control

Inflation, interest rates and rents or rates are determined by the market and cannot be controlled by investors. Thus, it is best to focus on what one can control when structuring deals and building portfolios.

## Term & structure

**Shorten leases.** Focus on sectors with shorter lease terms such as hotels, (US) apartments and self-storage. During periods of higher inflation, shorter lease terms would allow rents mark-to-market more often, thus benefitting the investor. While longer-term, take-or-pay contracts for midstream investments could also offer some degree of explicit inflation protection as revenues rise with higher demand driven by better economic growth (and inflation).

**Annual bumps in-line with inflation.** Long lease or contract terms with bumps in line with inflation are preferred. Most infrastructure assets have long-term contracts with annual bumps linked to inflation, making it a natural hedge (midstream and renewable power).

**Expense pass throughs.** Assets with triple net leases or some amount of expense pass throughs would be more attractive to keep up with inflation as investors are protected from rising expenses.

Infrastructure assets typically have fixed operating and maintenance contract, shielding investors from inflationary impacts on the cost side. Some examples include midstream and renewable power (wind and solar).

## Asset characteristics

**Low supply.** Assets located in low supply markets will likely benefit from a high growth and inflationary environment given the lack of new competition to the market. Inflation should limit new supply overall, but the impact will be more meaningful in low supply markets.

**Accelerating trends are more important.** Many real estate property types and infrastructure sectors do well in inflationary environments, with some minor differences. However, what is more important than the inflation topic are the accelerating trends of e-commerce driving industrial real estate, migration to less dense areas boosting suburban apartments, and digitization driving data center demand. In addition, decarbonization continues to drive demand for renewable energy as carbon credit prices have increased (+61% YTD) in anticipation of EU regulations expanding to other sectors such as shipping and construction. ESG is a prevailing theme that will likely last for years to come, and therefore, asset selection would benefit from incorporating these considerations.

## Debt term & structure

**Fixed & long-term.** Levered assets with longer-term fixed rate debt would benefit in an inflationary environment, as debt gets paid down with inflated dollars over time. As income catches up with inflation (through annual bumps linked to inflation, higher revenues from increased demand in the underlying commodity, or by marking up leases to market and occupancy gains), the amount of debt remains the same, which gets paid down with inflated dollars.

**Higher LTV.** Asset prices should continue to rise with inflation due to higher income and higher replacement cost as it gets more expensive to develop new assets. In this case, it would be beneficial to the owner to adopt higher levels of leverage to boost returns over time. However, higher LTV increases risk.

**Floating for debt investors.** Interest rates are expected to trend higher, although at a more muted pace compared to inflation. Investors of floating rate debt would benefit from rates trending higher.

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