CLARION PARTNERS

Private real estate as a hedge against inflation

OPTIMISTIC OUTLOOK AMIDST RISING INFLATION

The U.S. economy has strong momentum heading into 2022, driven by extraordinary monetary and fiscal stimulus programs, record levels of job growth, robust consumer spending, a strong housing market, and the encouraging development of vaccinations and antiviral treatments. Moreover, President Biden just signed a $1.2 trillion bipartisan infrastructure package, while another proposed $1.75 trillion "Build Back Better Act" is under discussion in Congress. Moody's Analytics currently forecasts U.S. real GDP to grow by 4-5 percent next year, another strong pace after a robust 2021.

There are potential downside risks to our outlook. The pandemic is not over. New COVID variants and waves might emerge, leading to disruptions of the global economic recovery. Furthermore, in responding to high inflation, the Federal Reserve has begun to taper and plans to raise the federal funds target rate in 2022, which could discourage borrowing and consumer spending.

Inflation has been a top concern for investors over the past several months. In June, the U.S. Consumer Price Index (CPI) spiked to 8.6 percent year-over-year, the highest level in over 40 years. A strong and synchronized global demand recovery has caught many distributors and retailers by surprise. Supply chain disruptions, labor shortages, increases in rents, and a general surge in energy prices have all contributed to the current high inflation rate, which has no immediate solutions in sight.

REAL ESTATE HAS PERFORMED WELL DURING PERIODS OF ELEVATED INFLATION

It is well-documented that real estate can — at least partially — hedge against inflation. For one, landlords generally have the ability to raise rents under better economic conditions, which in turn increases property value. Second, many real estate leases have contractual rent bumps that are often linked directly to annual inflation rates. And third, higher inflation suggests higher replacement costs, including construction materials, labor and land parcels. Such factors make new development projects more expensive, which should limit new supply and give more room for existing assets to grow rents and appreciate in value.

Historical precedent suggests and Clarion Partners believes that private real estate can effectively hedge inflation. An analysis of the 43-year history of the NCREIF Property Index performance under different economic scenarios suggests that private real estate total returns were strong during the years of high/medium real GDP growth and high/medium inflation. The latest case in point was the 12-month period through Q3 2021, when the annual real GDP growth rate and inflation rate were 4.9 percent and 5.4 percent, respectively, and the NCREIF Property Index returned a robust annual rate of 12.1 percent.

High real GDP growth indicates stronger demand for commercial space, while favorable supply and demand market conditions typically allow landlords to increase rents. Private real estate has typically performed weak when real GDP growth was

Private real estate total returns under different economic scenarios in 1978–2020

	Low real GDP growth (1st quartile)	Medium real GDP growth (2nd or 3rd quartile)	High real GDP growth (Top quartile)	Average
Low Inflation (1st Quartile)	2.1%	10.6%	16.2%	7.2%
Medium Inflation (2nd or 3rd Quartile)	10.8%	9.1%	11.8%	10.1%
High Inflation (Top Quartile)	3.9%	11.8%	13.2%	9.3%
Average	4.3%	9.9%	12.6%	

Source: PREA Quarterly Fall 2021, Clarion Partners Investment Research, November 2021. Note: Private real estate is represented by the NCREIF Property Index, an unlevered core U.S. real estate performance benchmark..

low and inflation was either very low (recession) or very high (stagflation). Clarion Partners expects GDP growth to remain elevated in 2022, therefore, we do not believe that the current economic expansion resembles either of these two scenarios.

STRONG OVERALL PROPERTY FUNDAMENTALS

Overall U.S. property fundamentals have been strong, powered by industrial, multifamily, and life sciences. The top-performing industrial/warehouse sector has been driven by ongoing supply chain disruptions and inventory rebuilding as well as the continued e-commerce boom. With record levels of demand and a historically low vacancy rate of 3.6 percent, strong rent growth will likely persist for the foreseeable future. Multifamily fundamentals were remarkably resilient during the pandemic and have continued to strengthen throughout the recovery, with vacancy rates averaging 2.9 percent, the lowest level since 1994. Robust job growth and a significant rebound in household formation, especially from the Millennial and Gen Z populations, are expected to drive rental demand in 2022 and beyond As research and development along with venture capital funding into life sciences has continued to accelerate, so too has demand for specialty life sciences real estate. The outlook for this increasingly high-performing alternative property sector is driven by powerful long-term demographics and health care needs.

Conversely, the pandemic continues to challenge traditional office arrangements, with at least some elevated level of "work from home" (WFH) highly likely to persist. We expect the office market to begin to recover in 2022, albeit at a slow pace, as more workers return to the office. The retail sector has showed some signs of improvement, particularly in infill neighborhood and community shopping centers, which have benefited from the recent suburbanization push and housing market boom.

Geographically, the Sun Belt and fast-growing secondary metros have continued to outperform the largest coastal markets. Housing affordability, business friendly policies, and no/low income taxes appear to attract both household in-migration and business relocations, both of which are accelerating in 2022. Environmental, social, and governance (ESG) investment strategies focused on social impact, sustainability, and diversity are expected to be pursued more broadly going forward.

INCREASING PORTFOLIO TARGET ALLOCATION TO REAL ESTATE

Overall, privately owned, high-quality real estate with durable income streams offers relatively attractive yields amidst global market volatility. Sophisticated investors have continued to favor real estate investment due to its relatively high current income, lower historic volatility, and portfolio diversification benefits. Real estate has typically had low/negative correlations with stocks and bonds. A recent survey indicates that institutional investors have increased their real estate target allocation from 10.7 percent in 2021 to 11.0 percent in 2022. Negative real interest rates are greatly accretive to total returns, and attractive financing is readily available for high-quality properties and development projects. As a result, cap rates (real estate yields) are expected to remain low but still relatively more attractive than those of many fixed-income alternatives.

2022 will mark the second year of this new real estate market cycle after double-digit total returns for the NCREIF Property Index in 2021. Demand is expected to continue to improve across most markets and property sectors, as rising occupancy and higher effective rents should drive higher net operating income and thus allow real estate to effectively hedge inflation. Barring unforeseen circumstances, the private real estate sector should perform well in 2022.

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Corporate Overview

Clarion Partners has been a leading U.S. real estate investment manager for 40 years. Headquartered in New York City, the firm has offices in major markets throughout the United States and Europe. With $75.9 billion in total assets under management as of March 30, 2022. Clarion Partners offers a broad range of both debt and equity real estate strategies across the risk/return spectrum to its more than 500 domestic and international institutional investors.

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