Australian property – an inflation hedge

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25 June 2018

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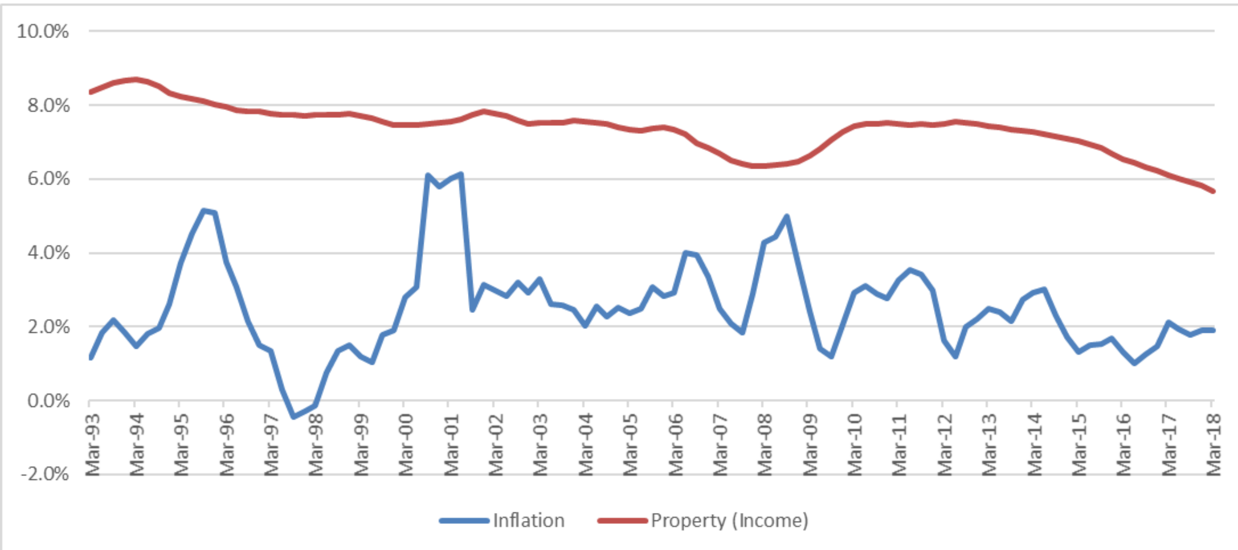
The risks facing long-term investors may be categorised into two parts: systematic risks and unsystematic risks. Unsystematic risk is a type of uncertainty which comes with a company or industry you invest in. Systematic risk generally includes uncertainties inherent to an entire market, such as interest rates, economic recession, wars and inflation.

Inflation, as a type of systematic risk, has been widely recognised as one of the principal concerns of long-term investors. However, a range of assets can be included in a portfolio which may partially protect investors.

Recently, expectations for rising inflation have emerged following sustained low interest rates and low unemployment in Australia. Property can protect investors against inflation as inflation impacts both current rents as well as property expenses. Thus, property can create a hedge against inflation.

On the one hand, inflation may push up the rental rate on new leases, but it may also reduce net rents as all expenses increase. However, if a landlord passes these expenses to a tenant as an offset, then the landlord will be protected.

Chart 1: Annual Property Income Returns and inflation (CPI?) to 31 March 2018



Source: MSCI/IPD, RBA

On the other hand, rental agreements generally have fixed annual increases, or it relates to the CPI increases. Therefore, it may create a margin for the property investor when the inflation rate rises slowly. It is another way for property investors to lower inflationary impacts.

Chart 1 shows the returns of direct property income compared with inflation over 25 years to 31 March 2018. Note the property returns from direct property have been consistently higher whilst maintaining a low level of volatility.

Furthermore, inflation has an impact not only on asset class returns directly via rents, expenses and net rental income but also via valuations.

Changes in inflation affect nominal interest rates which, in turn, will impact on the capitalisation rate applied in property valuations. On the assumption real interest rates will be relatively stable when inflation rises, then the nominal interest rate should be expected to rise by an equivalent amount. This has an impact as capitalisation rates rise which, in due course, reduces valuations.

A return adjusted for inflation, known as a real return, is the true measure of increased-purchasing power gained from an investment. Investors are advised to be wary of any returns not meeting the rate of inflation lest they risk shrinking the investment's real future value.

Table 1 shows real returns over 25 years to 31 March 2018 generated relatively-high real returns.

Table 1: Real Returns of property over 25 years to 31 March 2018

	Australian Listed Property	Australian Direct Property	CPI
25 years	5.4% pa	7.7% pa	2.5% pa

source: S&P/ASX, MSCI/IPD, ABS

Inflation is often embedded in lease agreements as landlords seek to keep rent levels rising in real terms. The value of retail sales often increases with inflation so that tenants tend to be tolerant of rents rising in line with inflation. In office properties, salaries often rise with or above inflation, so rents rising at the inflation rate are also more likely to be tolerated.

How quickly inflation affects net rents, or the time lag to capture the impact on current rent, depends on the structure of leases, which varies with property types. Investment in property can be made in syndicates, funds and on the stock exchange in AREITs.