Intelligent Investment

Inflation Interest Rates & the Property Market

REPORT

CBRE New Zealand Research

JUNE 2022

Content

Property is regarded as an effective inflation hedge. Despite this, as inflationary pressures intensified, and money markets responded with increasing interest rates from late 2021, more attention has been given to its probable impact on real estate in this cycle.

This attention partly reflects the broad inflation topic becoming one of the dominant strands of public discourse in the first half of 2022; it also points to the degree of uncertainty around how it will play out in our commercial property market.

Bringing together insights from CBRE's global economic and research team with New Zealand data and analysis, this report considers the inflationary and interest rate environment, its outlook, and by putting a framework around its property market impacts, the prospects for investment performance across the different market sectors.

Inflationary Influences on Property Returns

- Inflation’s direct relationship with property investment returns is weak.
- Indirectly, a negative relationship comes from the link between inflation and interest rates but inflation’s impact on property returns is influenced by its balance with GDP growth, and supply-demand fundamentals.
- Cap rates can be sensitive to movements in interest rates but income growth, and investor sentiment, can trump interest rate impacts on cap rates.

New Zealand’s Inflationary and Interest Rate Backdrop

- Forecasts of New Zealand’s inflation peaking around mid 2022 are based on the RBNZ continuing to aggressively hike short term rates, but this inflationary view places lower pressure on longer term interest rates.
- The OCR is forecast to peak in mid to late 2023 with 150-200 basis points of further increase. Swap and bond rates peak in late 2022, 25-50 basis points above current rates. Barring adverse moves for lending margins, this interest rate outlook indicates only modest further upward pressure on fixed rate debt, with these likely to start easing during 2023.

Real Estate Effects and Outlook

- The supply-demand outlook generally provides a positive platform for income growth except for Secondary CBD office, where we expect extended vacancy and rental pressure.
- Yield margins still look comfortable relative to bond rates. But upward yield pressure is eventuating for investors with a higher reliance on debt (mainly traditional syndicates and more highly leveraged privates).
- Heading into 2022, private investors offered the highest liquidity, syndicates the sharpest pricing for New Zealand assets.
- APAC wide, wholesale funds are increasingly active buyers. Private investors and the listed property sector are also becoming more active. Given that these investor groups were generally pricing property lower during the past two years than syndicates, we expect bids to show a generally softening yield trend this year. This won’t be universal though.
- Investors are prioritising income (stability, certainty, and growth) focused investment strategies. With liquidity concentrated on sectors and submarkets that can deliver these attributes, they will remain more resilient from a pricing perspective with the flipside of higher discounting in sectors, and for assets, that can’t fulfil these requirements.
- The cap rate pressure from interest rates looks transient and the interest rate outlook indicates this burden lifting during 2023. In this environment liquidity may start improving from investors with lower reliance on debt who see the current market impasse as an opening, although the rapidly evolving economic environment and its expected negative impact on occupier demand and rent growth will have an increasing bearing in the next few quarters on the risk and return equation and investor sentiment.

01

Inflationary and Interest Rate Backdrop

Annual CPI reached 6.9% in Q1 2022

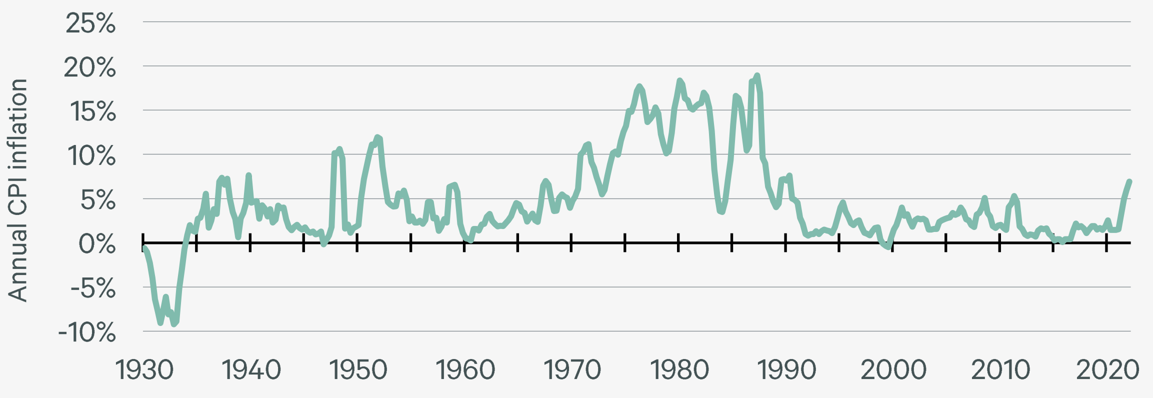
This is the highest inflationary spike since 1990, with CPI averaging 2.1% pa over the last 30 years.

New Zealand's economy has been characterised by distinct inflationary periods. A reaction to the damaging effects of a 20 year era of high inflation in the 1970s and 1980s led to a new monetary policy orthodoxy being introduced in 1989. This emphasised price stability as the primary purpose of monetary policy and led to the prevailing low inflation environment of the last 30 years.

It has been a periodically bumpy ride with occasional inflation spikes, but the current spike is larger and potentially more significant than others during this 30-year period.

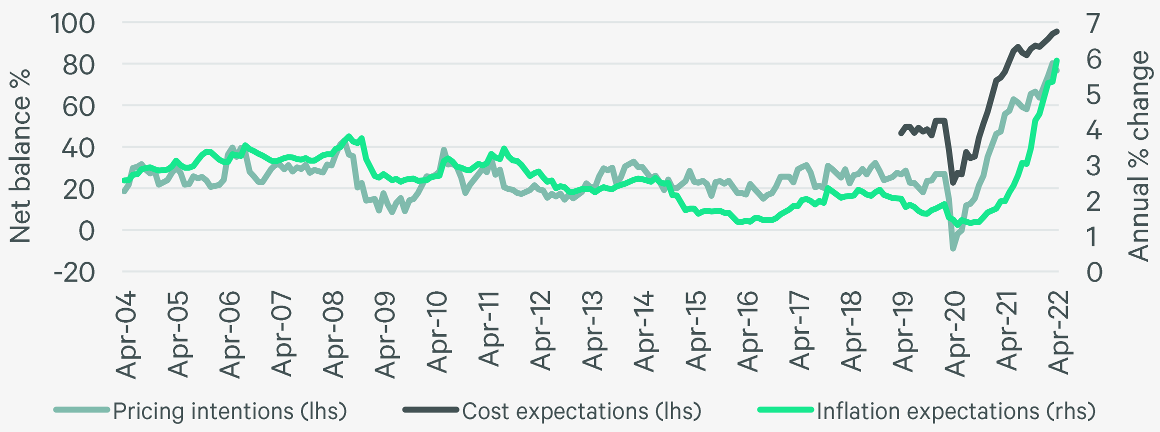
Forward-looking indicators from both business and consumers point to continued pressures. Cost expectations, pricing intentions, inflation expectations are all at, or close to, long term record highs.

FIGURE 1: New Zealand Inflation



Source: Statistics NZ

FIGURE 2: New Zealand Inflation Expectations



Source: ANZ Research, Macrobond

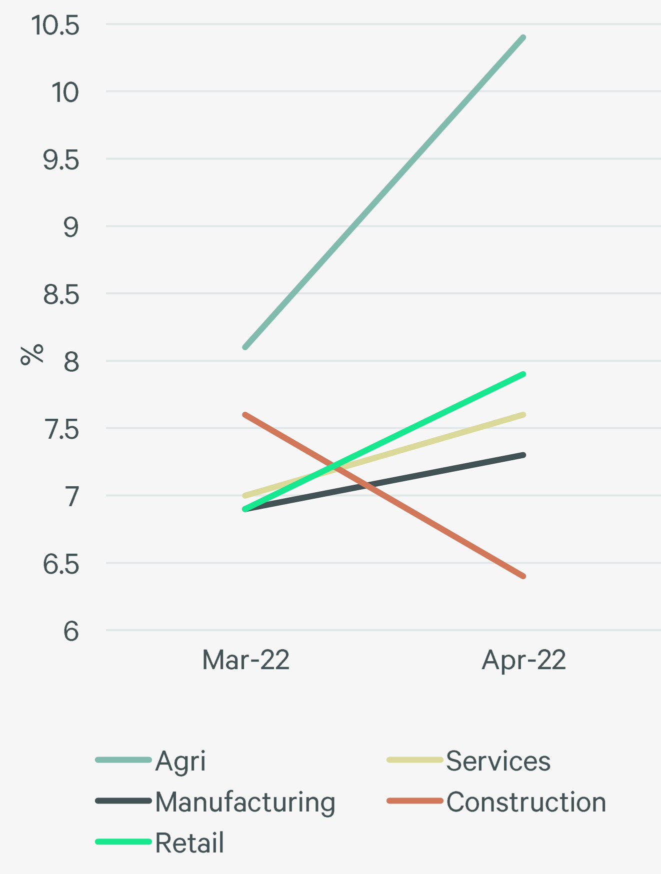
Inflation drivers show industry level nuances

Cost expectations appear to be easing for construction, with the rate of increase for the next three months expected to fall from 7.6% to 6.4% in ANZ's April 2022 survey relative to the March survey.

In other industries, most notably in agriculture and retail, cost pressures appear to be intensifying.

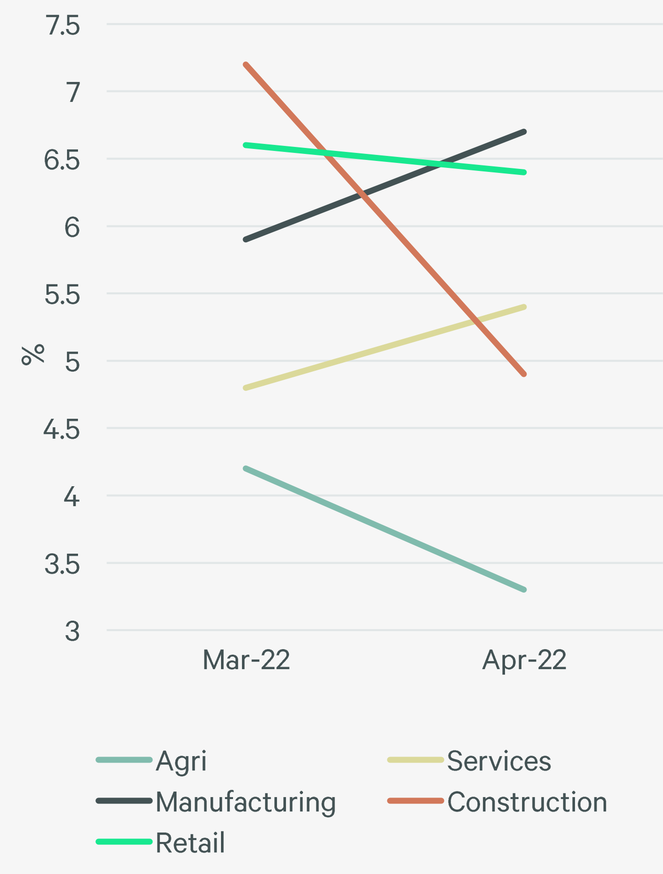
Pricing intentions across the industries show a similar profile to their cost expectations indicating that most firms are looking to pass on their cost increases.

FIGURE 3: Cost Expectations



Source: ANZ Research, Macrobond

FIGURE 4: Pricing Intentions



Source: ANZ Research, Macrobond

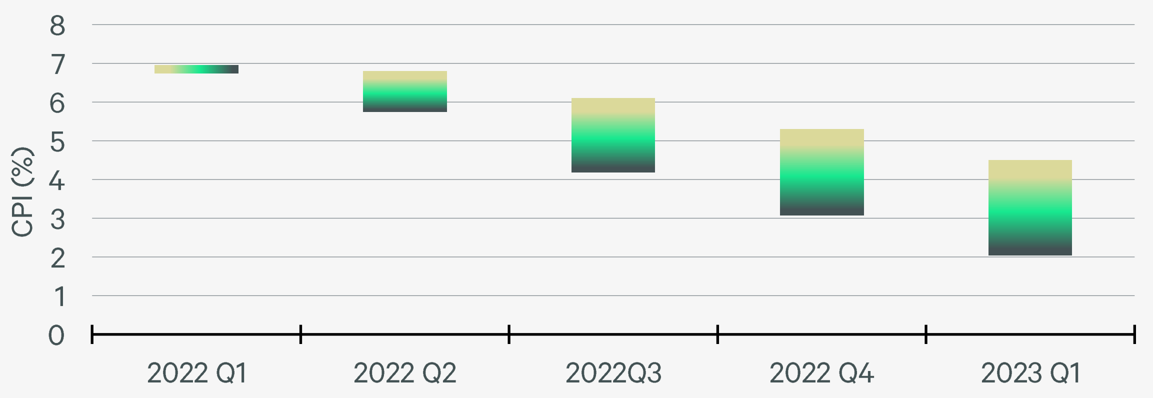
CPI likely peaked in Q1, back in the target band in 2023

The RBNZ's swift and aggressive monetary policy tightening means that, while pressures remain widespread, domestically generated inflation has likely peaked in Q1 2022. Economic forecasts show CPI moderating in the coming quarters.

Although these forecasts are subject to significant uncertainties, by the end of 2023, economists expect that inflation will return to the upper half of the Reserve bank's 1-3% target band.

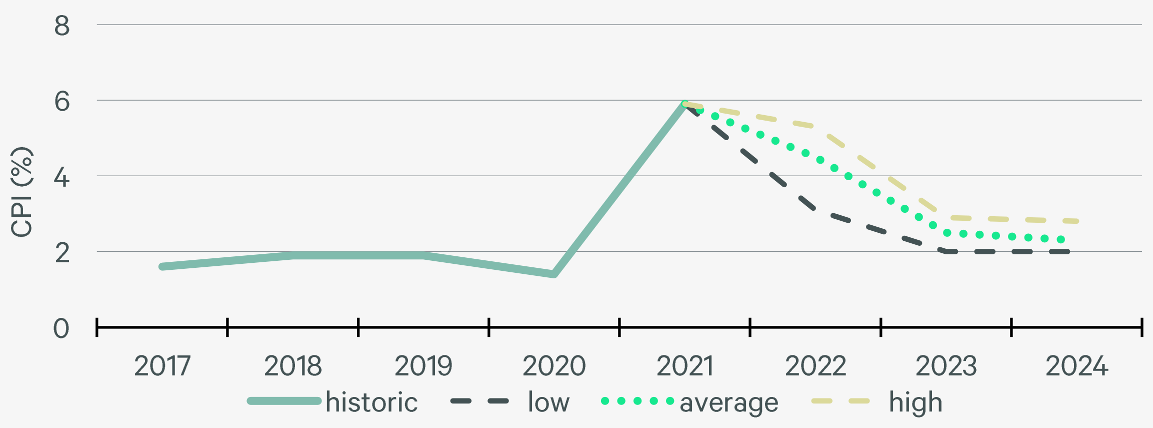
These inflation forecasts are based on the RBNZ continuing to aggressively tighten monetary conditions. It's a fine balance, as the Reserve Bank weighs up the risk of a recession against the risk of inflation spiralling further. But this balancing act seems to be strongly in favour of controlling inflation through a "least regrets approach". Interest rates will likely continue to rise and remain elevated until inflation is not just under control, but there is a reasonable level of confidence that it will stay that way. At the same time, as higher interest rates start to bite into GDP and employment, pressure will be increasing on the RBNZ to provide some monetary relief.

FIGURE 5: New Zealand CPI Quarterly Forecast Range



Sources: Stats NZ, range of economists' forecasts

FIGURE 6: New Zealand CPI Annual Forecast Range



Sources: Stats NZ, range of economists' forecasts

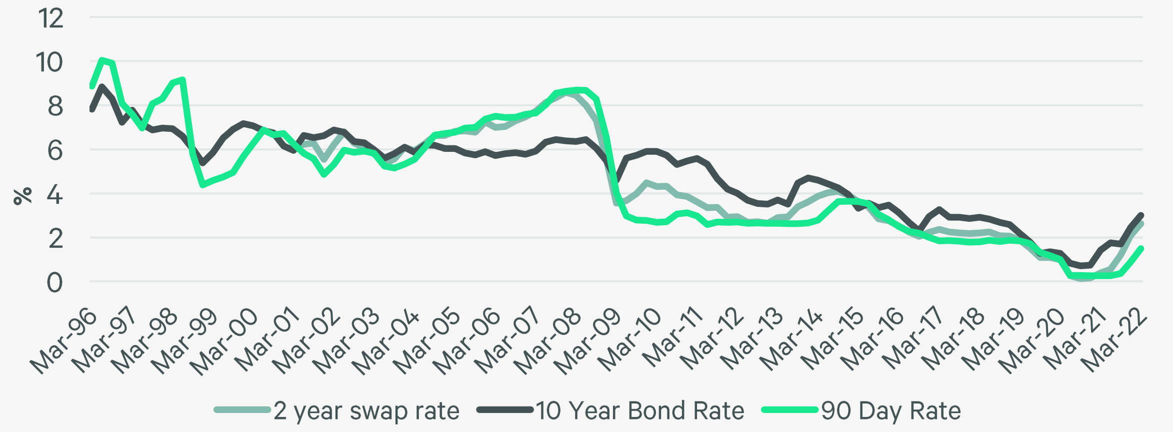
Swap rates bear brunt of wholesale interest rate rises to date

But this is now transitioning to short term rates

Short to long term wholesale rates increased by 200 to 350 basis points over the past 12 months.

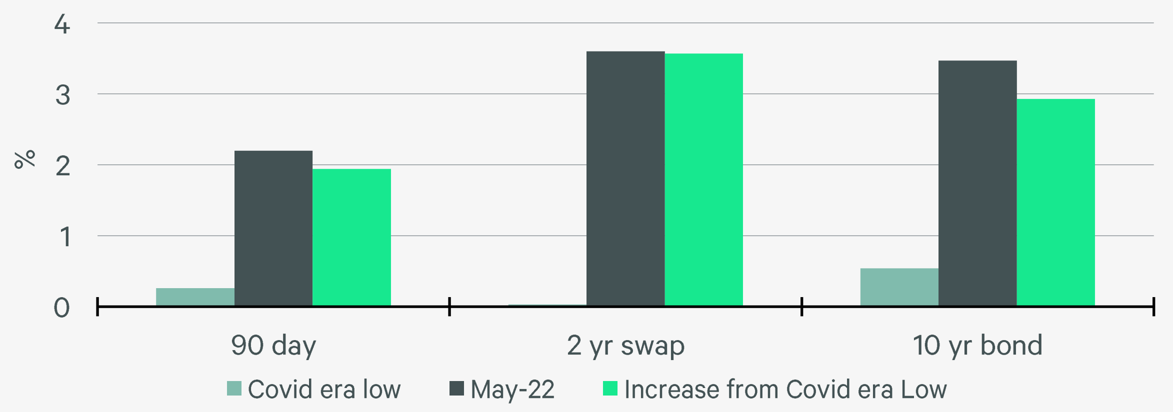
Driven by the emerging expectation from mid-2021 that the RBNZ will hike aggressively to control inflation, the biggest interest rate movement during the past year has been for medium term swap rates which resulted in fixed rate mortgages becoming more expensive.

FIGURE 7: Interest Rate Trends



Source: RBNZ

FIGURE 8: Interest Rate Changes from Covid Era Lows to May 2022



Source: RBNZ

02

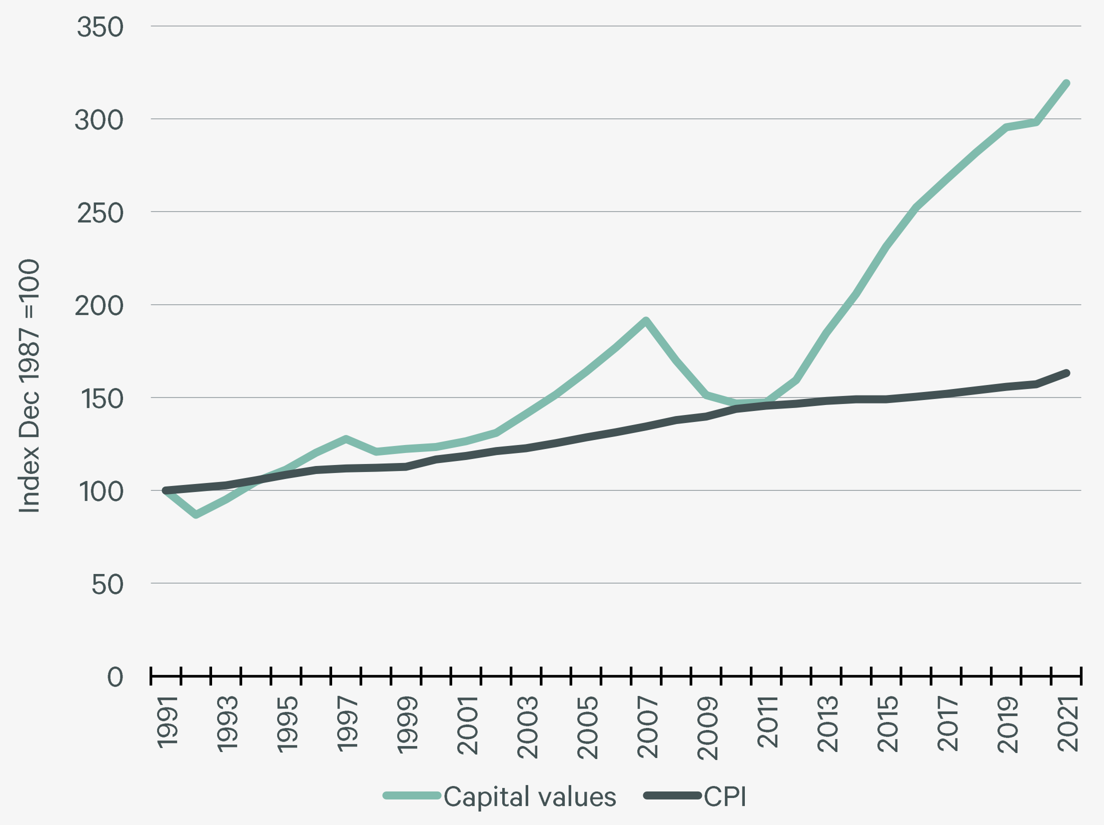
Is Commercial Real Estate an Effective Hedge Against Inflation?

Property outperformed inflation in the long run

But it hasn't been a straightforward relationship and capital value to CPI comparisons don't explicitly address the impact inflation has on commercial real estate returns.

The starting point of comparisons is important. In the post GFC period, commercial real estate had a long run delivering excellent returns with capital values rising well ahead of CPI. Shorter periods of strong capital growth are also evident in the mid 1990s and mid 2000s. However, commercial real estate values weren't immune to the impacts of the GFC and early 1990s recession.

FIGURE 9: Commercial Property Capital Value Growth vs Inflation



Source: CBRE Research,

Framing inflation influences on property – direct & indirect

It is useful to frame inflationary impacts on property in terms of the constituent parts of investment returns. Inflation's impact can be broadly conceptualised as falling into two camps. It impacts income through occupancy and rental growth, and it impacts cap rates.

Income is shaped by the balance of supply and demand, where new development volumes and occupier demand, along with lease provisions, play a major role. Cap rates can be sensitive to movements in interest rates because government bond yields represent the risk-free rate, because of their impact on the cost of debt, or a combination of these two. Income expectations matter for cap rates too. Cap rates are not just about interest rates, income growth, and investor sentiment, can trump interest rate impacts on cap rates.

Construction Costs

- Higher costs mean lower volume of new projects which benefits occupancy and rents
- Higher development costs lift rents for new projects which can help rent growth in existing buildings

Lease and Rent Review Mechanisms

- CPI review provisions benefit rent growth. Especially relevant in shopping centres and prime office and Industrial
- More general view that rent is a cost of business similar to other costs that go up with inflation
- In gross leases higher inflation driven opex costs have a negative impact on net rents

Bond Rates

- Higher returns from risk free and lower risks assets influence property yields and values

Mortgage Rates

- Higher debt costs influence property yields and values

Economic growth

- High economic growth can exceed productive capacity, raising inflation
- Higher interest rates in response suppress growth, impacting on occupier demand
- In a lower growth environment, many occupiers are less able to weather rental cost increases

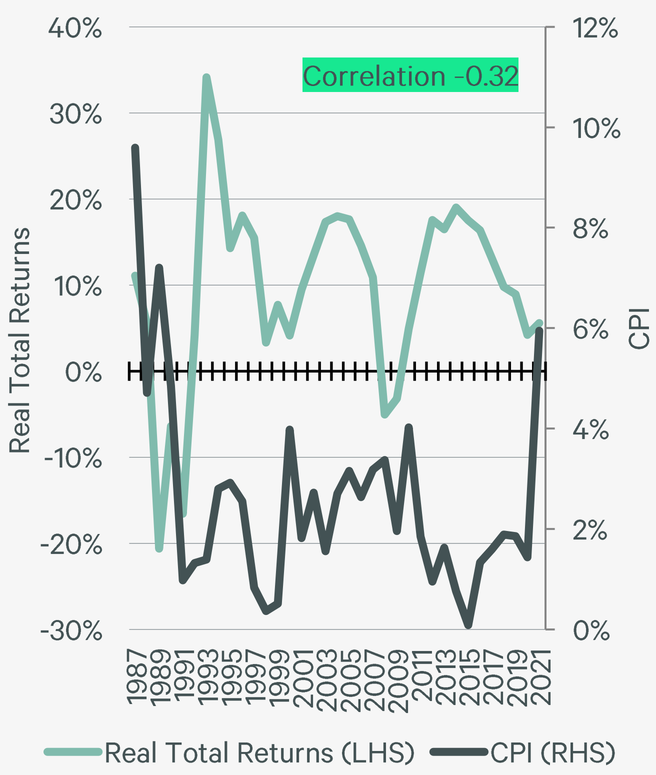
Inflation’s direct relationship with returns is weak

Overlaying Auckland commercial and industrial property returns on inflation doesn’t demonstrate much of a relationship. The correlation is a low .32 and it is negative which indicates that higher inflation leads to lower returns.

There is a more obvious relationship between GDP growth and property returns. It is also a positive relationship; higher GDP growth leads to higher returns.

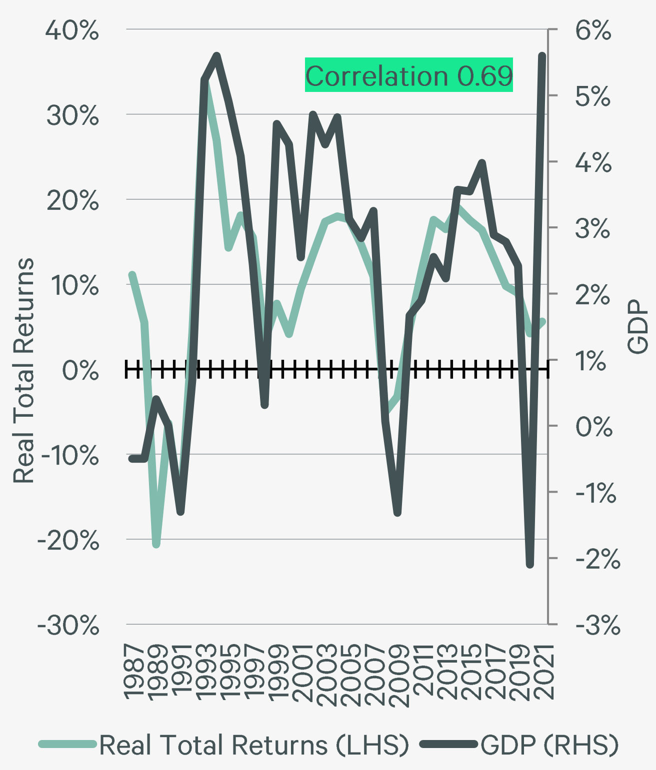
CBRE’s econometric analysis of the US market reveals a similar outcome. Inflation over the last forty years had a negative association with commercial real estate returns, with GDP growth showing a stronger, and positive, relationship.

FIGURE 10: Real Total Returns vs Inflation



Source: CBRE Research, Stats NZ

FIGURE 11: Real Total Returns vs GDP Growth



Source: CBRE Research, Stats NZ

Inflation influences on property

The less than clear relationship between property returns and inflation is because there are different types of inflation and each of these has very different impacts on property returns.

CBRE's econometric analysis of the US market shows that property returns' negative relationship with inflation comes from the link between inflation and interest rates.

The overall impact on real total returns depends on the balance of higher GDP growth and higher inflation overlaying market level supply and demand fundamentals.

Demand pull

- **The economy grows faster than capacity leading to higher inflation**
- **Demand pull inflation can be positive for real total returns due to rising rents, lower vacancy, and rising income growth expectations but…**
- **If inflation continues to build up, a sudden tightening of monetary policy is likely**

Cost push

- **Inflation is mainly due to rising costs (higher import costs, supply constraints, labour market restrictions)**
- **Supply shock/cost push inflation is more likely to have a negative impact on GDP and real total property returns**

Nice inflation

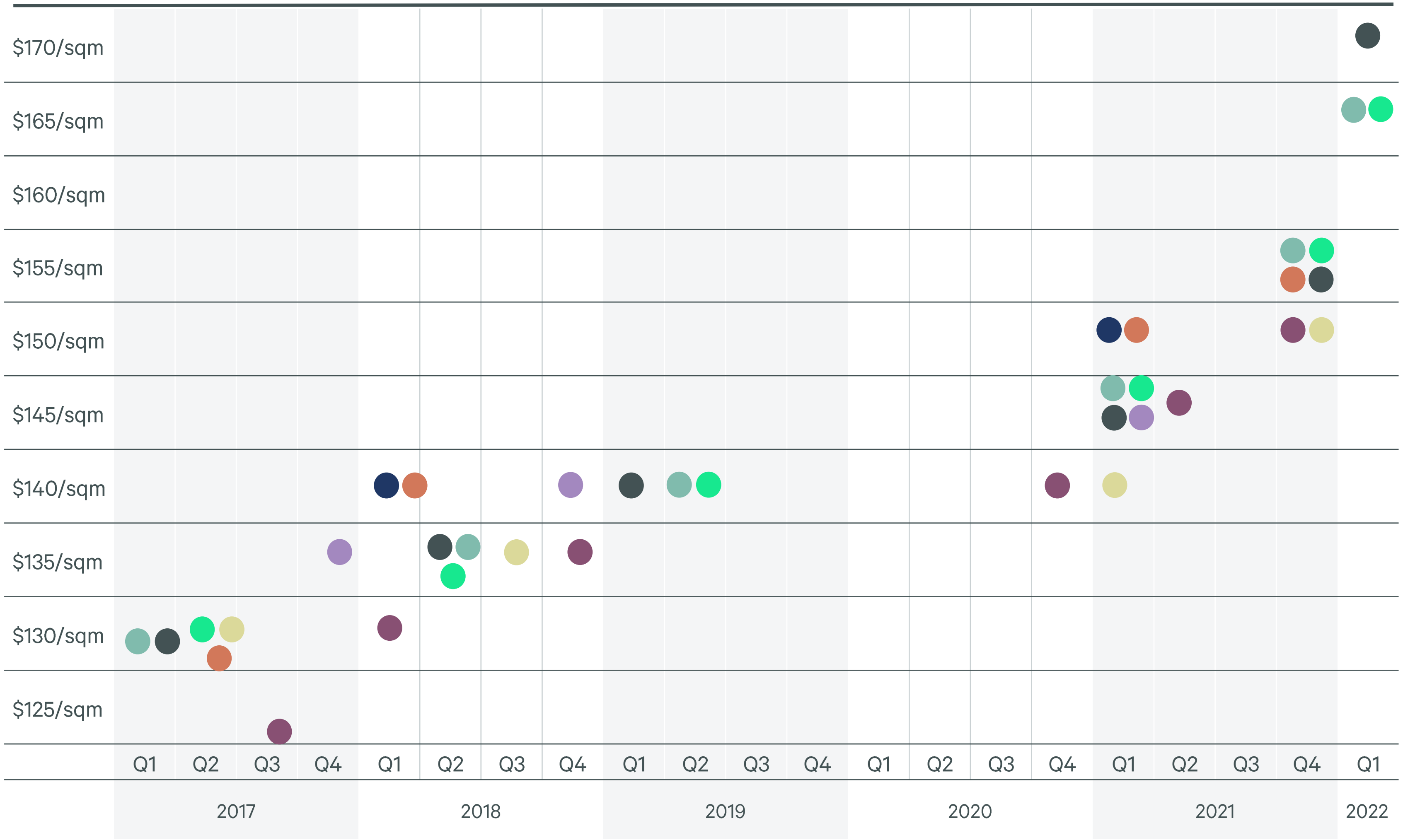
- **"Non inflationary expansion" is where GDP growth is in line with capacity (i.e. good economic growth paired with low inflation)**
- **Nice is highly beneficial for real total property returns**

03

New Zealand Real Estate Responses and Outlook

Inflationary pressures are pushing up industrial new built rents

FIGURE 12: New built industrial rent benchmarks



Industrial Precincts

- Mount Wellington
- Penrose
- Albany
- East Tamaki
- Rose Bank
- Airport
- Wiri
- Westgate

Inflationary pressures are pushing up office new built rents

FIGURE 13: New built office rent benchmarks

Source: CBRE Research,

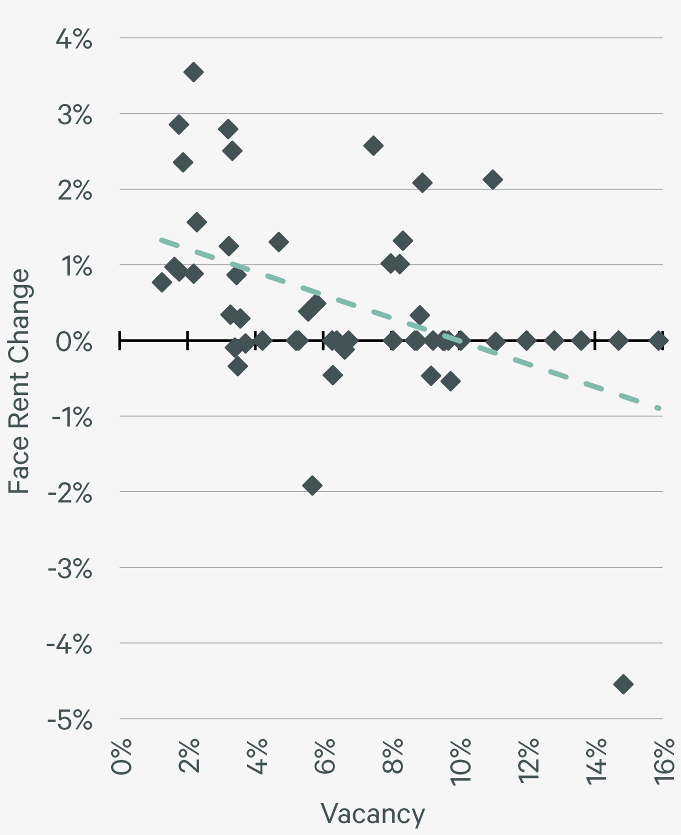
What vacancy rates are associated with rent growth?

In office, vacancy below 10%. In industrial, vacancy below 3%.

While real estate rental markets don't operate based on a fixed equilibrium vacancy above which rents fall and below which rents rise, the long-term trend indicates that Prime office rents tended to increase when vacancy rates were below 10%.

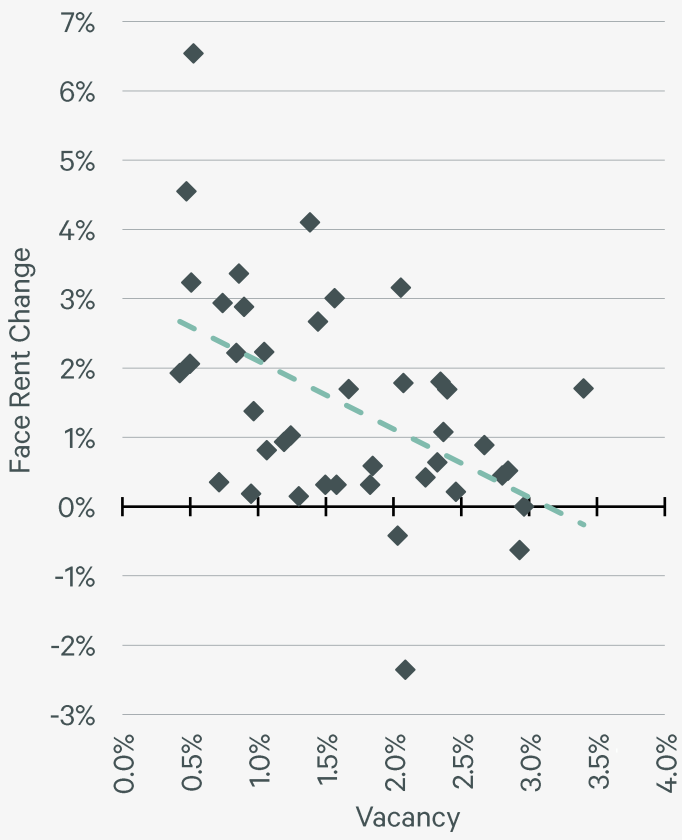
Industrial vacancies have been structurally lower than office with vacancy only rising above 10% for one six month period in the past 20 years. Industrial rents tended to increase historically with vacancies below 3%.

FIGURE 14: **Prime Office - Face Rent vs Vacancy**



Source: CBRE Research

FIGURE 15: **Prime Industrial - Face Rent vs Vacancy**



Source: CBRE Research

Vacancy is tight in many markets

But some also have fairly high supply pipelines.

Vacancy is below 5% in most sectors and outside of Secondary office there is no real area of concern. Vacancy rates generally provide a solid platform for the future.

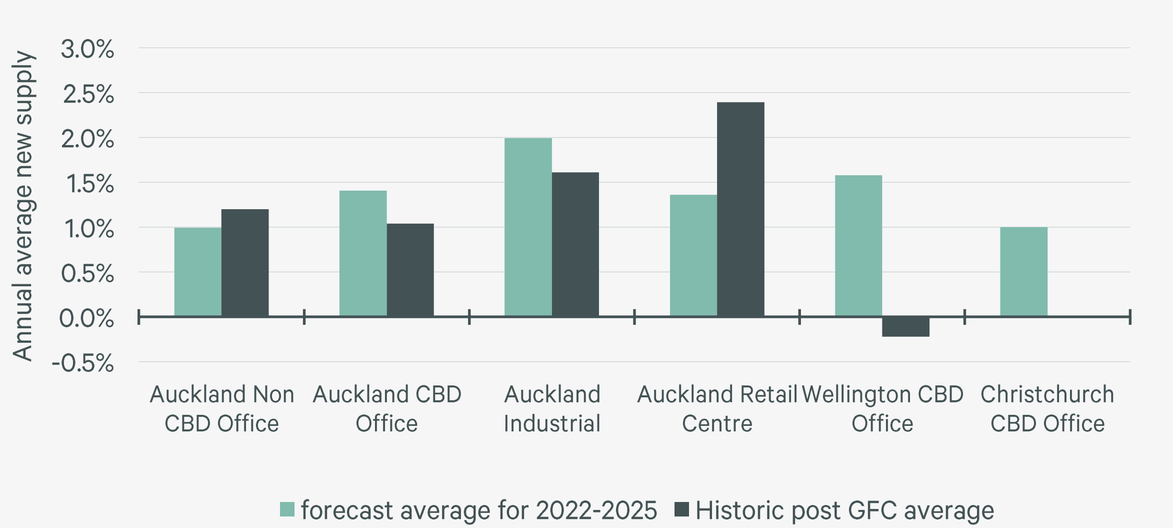
The negative impacts of higher interest rates are leading to downgraded 2022-2023 GDP forecasts relative to a few months ago. Prospects for underlying occupier demand however remain positive. Supply will be a bigger swing factor influencing vacancy and rents. Compared to historic averages, industrial and CBD office stand out as potential areas of concern both in terms of overall pipeline size and relativity to historic averages. We are not bothered about industrial over the next year given the strength of demand although, as supply chain constraints unwind, and eCommerce growth rates return to longer term averages, the spike in warehousing and logistics demand we have seen in the past two years will moderate and likely result in higher vacancies. Some office sectors however are of concern for the foreseeable future.

Post GFC, Wellington's office market shrunk due to earthquake impacts. The Wellington market is starting to experience a material supply phase. Auckland's supply cycle continues with a number of sizeable buildings completing in the next three years. In both these markets, we expect good demand for well-located new built and refurbished space but some existing buildings will be under extended vacancy and rental pressure. Christchurch looks healthier given its vacancy and recent absorption trends.

FIGURE 16: December 2021 Vacancy Rates

Source: CBRE Research

FIGURE 17: Forecast vs Historic New Supply



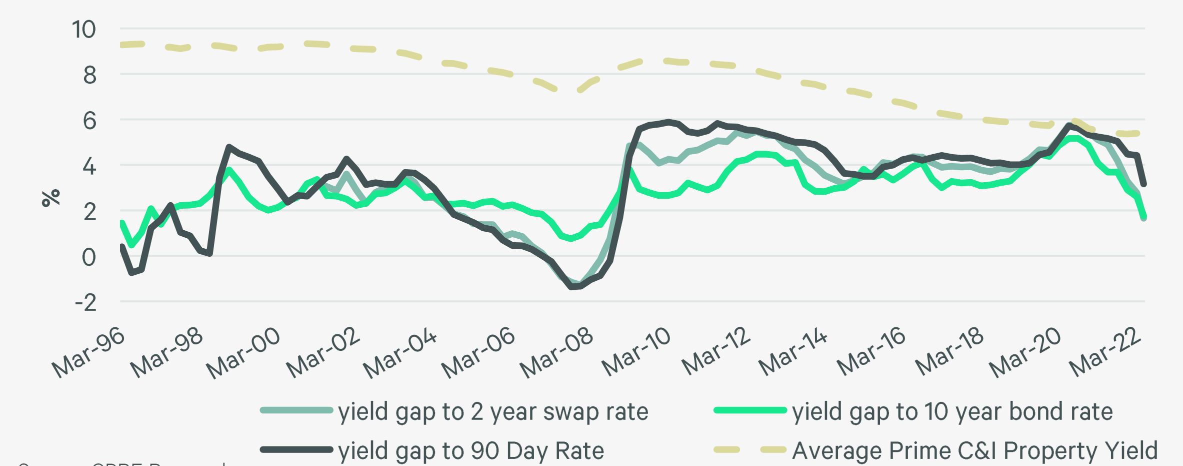
Source: CBRE Research

Interest rates place pressure on yields but the case for rising yields is not even across the market

Despite progressively lower yields over the past decade, the magnitude of interest rate falls resulted in yield margins well above long term norms until late last year. Average Prime NZ yields (for the combined office, retail and industrial indicative series, there are benchmarks below this) currently provide a 190 basis point margin over 10 year NZ government bond rates, down from 300+ for much of the past decade. The average margin pre GFC was 230 basis points, narrowing to as little as 75 basis points leading up to the GFC when property yields were firming substantially in an environment of high and rising interest rates. The still healthy looking differential of 90 day bills and swap rates compared to pre GFC property market peaks obscures the increase in lending margins above these wholesale rates. For investors heavily reliant on debt leverage, the pressure on yields is real from higher mortgage rates.

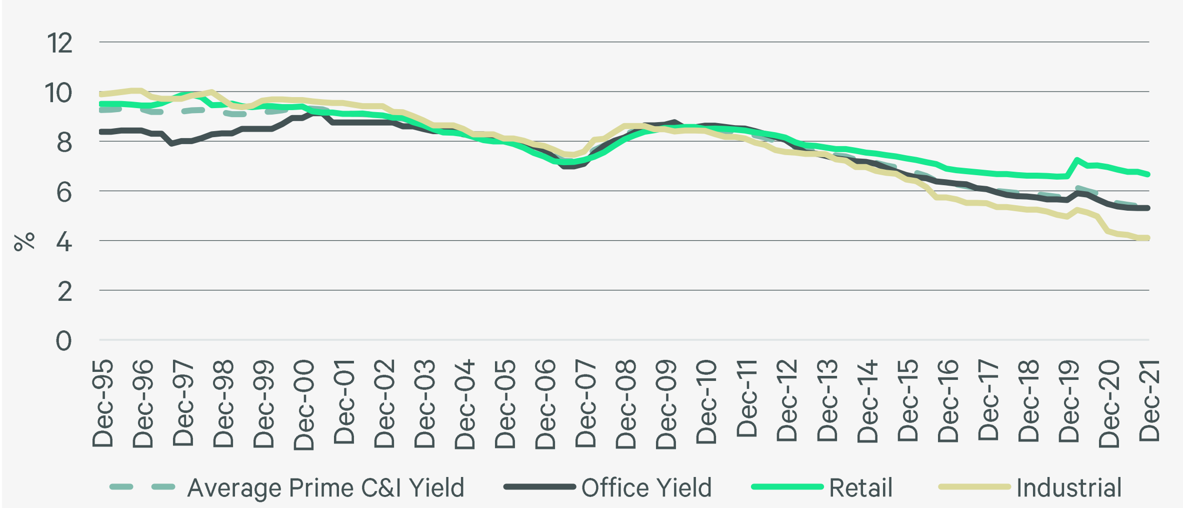
The interest rate pressure is not spread evenly across the sectors. More than ever, there is significant difference between cap rates across office, retail and industrial, with a spread of 270 basis points compared to 50 basis points at the onset of the GFC. This will influence how these sectors respond to higher interest rates although occupancy and income growth expectations and the risks around these also differ from sector to sector and will have a bearing on investor appetites and their attitude to price.

FIGURE 18: Interest Rates vs Yields



Source: CBRE Research

FIGURE 19: Sectoral Yields



Source: CBRE Research

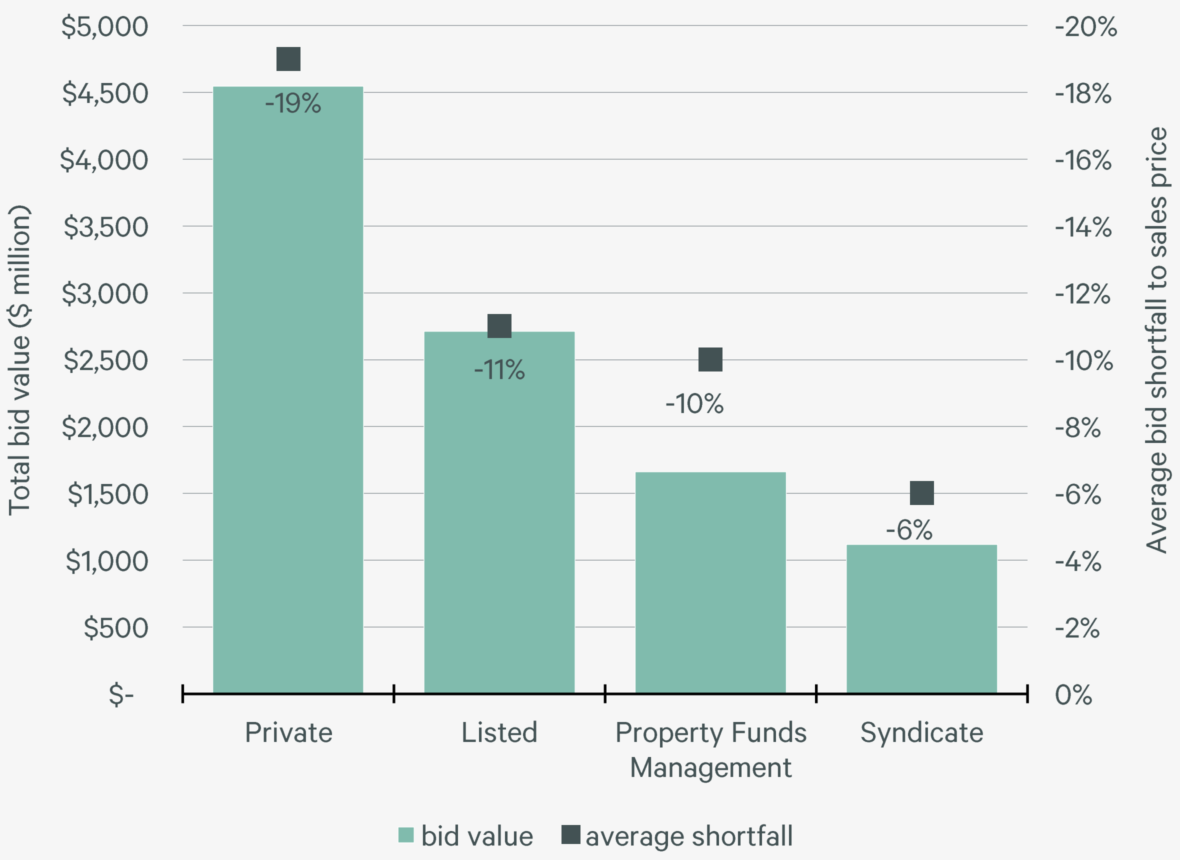
Heading into 2022, private investors offered highest liquidity, syndicates sharpest pricing

A breakdown of bidding activity totalling circa $11 billion across 99 bids for local CBRE run sales campaigns during 2020-2021 indicates that Private investors, Institutional investors (LPVs and wholesale funds) and Syndicates have dominated purchaser demand in the lead up to the current phase of increasing interest rates.

Syndicates have been pricing property the sharpest, with an average shortfall 6% below the final transaction price (e.g. when syndicates bid for a property but were not the successful party to buy it, their pricing on average was 6% below the successful bid). Institutional buyers, on average, were pricing property 10-11% below purchase price, with privates being more opportunistic at nearly 20% below.

The interest rate environment has an increasing bearing on who the marginal buyer will be over the coming year. More highly geared purchasers are finding that the increasing cost of debt is impacting their ability to price property at mid to late 2021 levels and this is shifting their pricing accordingly. To what extent this will result in market price movements depends on the weight of capital from lower leveraged investors.

FIGURE 20: CBRE NZ Sales Campaigns 2020-21: Bid Strength by Investor Type



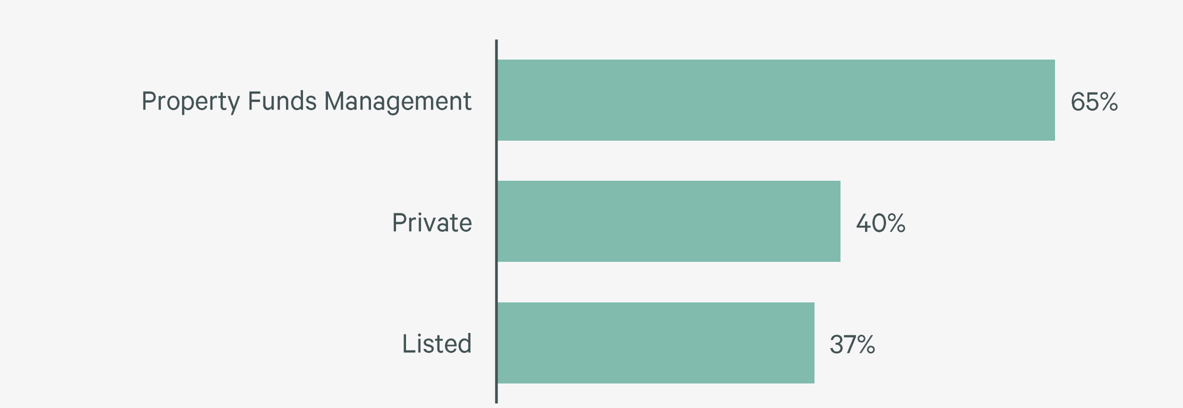
Source: CBRE Capital Markets

Investor demand is prioritising core and core plus opportunities

At the APAC level, Wholesale Funds (Property Funds Management) are emerging as an increasingly prominent buyer group in 2022 with 65% of CBRE Capital Markets professionals in our May survey indicating increased levels of inquiry and buying intentions from this group compared to the end of last year. Private investors and the listed property sector are also becoming more active at the APAC level. Given that these investor groups were generally pricing property lower during the past two years than Syndicates, we expect bids to show a generally softening yield trend.

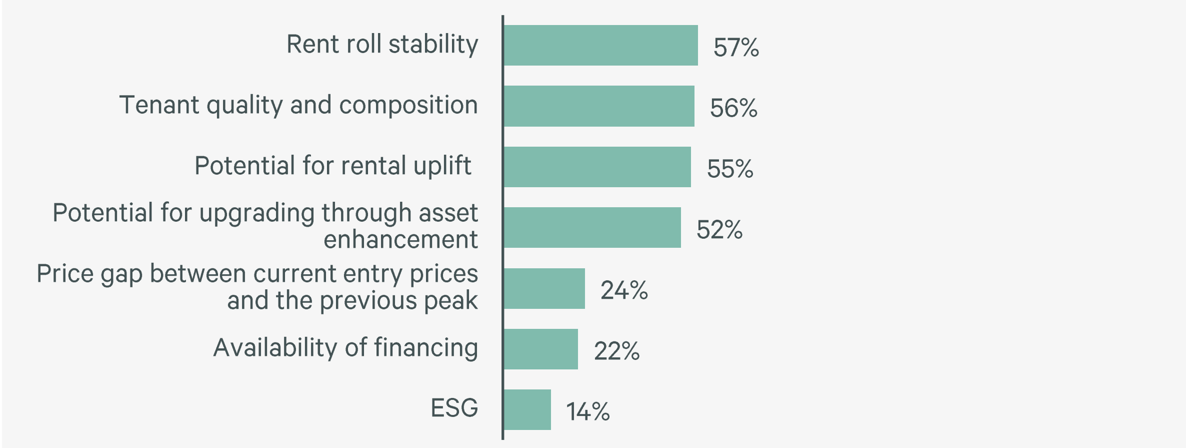
Investors are also prioritising income (stability, certainty, and growth) focused investment strategies which has implications on pricing for the sectors and submarkets that can deliver these attributes. This implies focus on core and core plus sectors although value add opportunities offering an ability to capture rent growth in parts of the market benefitting from higher occupier demand also offer good investment potential. With liquidity concentrated on these, they will remain relatively resilient from a pricing perspective with the flipside of higher discounting on sectors and assets that can't fulfil these requirements.

FIGURE 21: APAC Investor Groups Showing Higher Buying Intentions Compared to Q4 2021



Source: CBRE APAC Cap Rate Survey, May 2022

FIGURE 22: Factors Considered by APAC Investors When Evaluating Acquisition Opportunities



Source: CBRE APAC Cap Rate Survey, May 2022

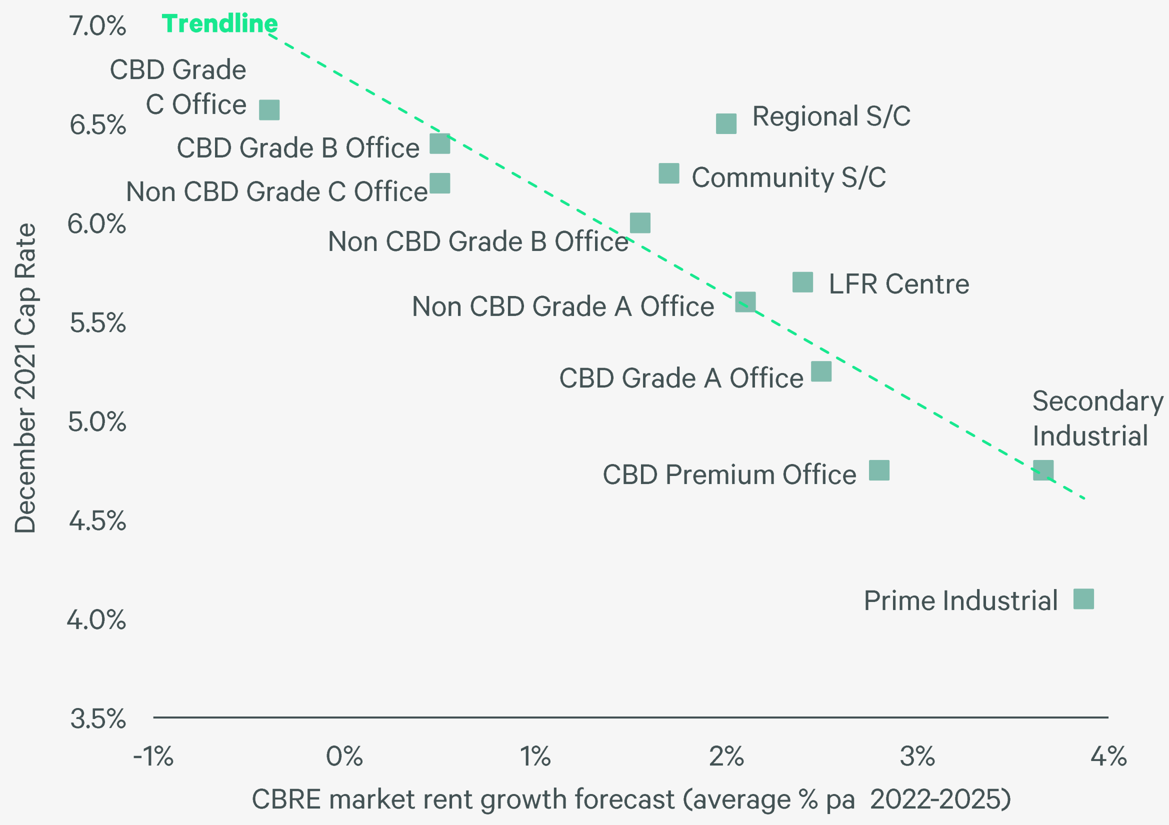
Sectoral risk and return will influence cap rate outcomes

The market is exhibiting a wide array of sectoral risk and return prospects. The trend line in Figure 23 aligns with broad expectations of an efficiently functioning market, showing that lower cap rate markets will provide higher rent growth and vice versa. However, given CBRE's view on the rental outlook some sectors don't seem to fully compensate for their December 2021 cap rates through sufficiently high rent growth.

Prime CBD office and Prime industrial appear relatively pricey. Although there is justification on risk premium grounds with the weight of capital placing increasing emphasis on lower risk rather than maximum return potential, given their low yields, they remain exposed to interest rate pressure.

Retail will likely surprise on the upside given stronger trading conditions than many give it credit and, although catchment conditions at the asset level are key, retail cap rates will likely remain resilient during the next year. On the other hand, low quality CBD office looks relatively overpriced given its rental prospects and is exposed to more significant upwards cap rate adjustments.

FIGURE 23: Cap Rates vs Outlook for Rent Growth



Source: CBRE

OCR should peak around mid to late 2023, swap and bond rates in late 2022

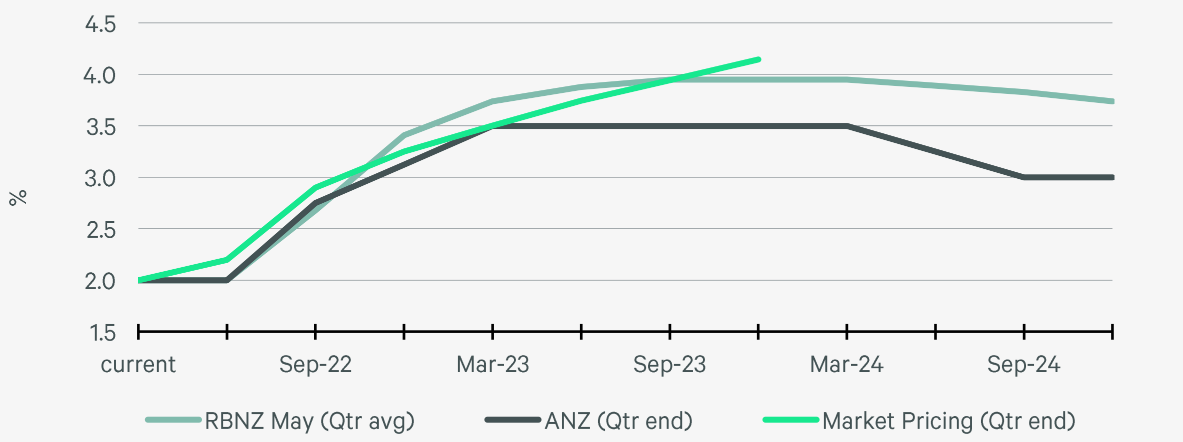
Which should give relief to fixed mortgage interest rates and cap rates next year.

Inflation peaking in the first and second quarters of 2022 is predicated on aggressive OCR hikes taking the heat out of domestically generated inflation. The endpoint however is not yet clear, with expectations ranging from 3.50% to around 4.00%; 150 to 200 basis points higher than in May 2022. Neither is the shape. The RBNZ indicates an extended period of peak OCR in contrast to economists who see room for interest rates moderating in 2023, as inflation is brought under control and as pressure increases to counter the economic and social fallout from the higher rates.

Bond yields and swap rates are close to their peak. Economist forecasts indicate only 25 to 50 basis point rises in the next few quarters based on moderating medium-term inflation expectations, with rates starting to fall by mid-2023. This points to only modest further upward pressure on fixed rate debt and indicates easing interest rate pressure on cap rates as 2023 unfolds.

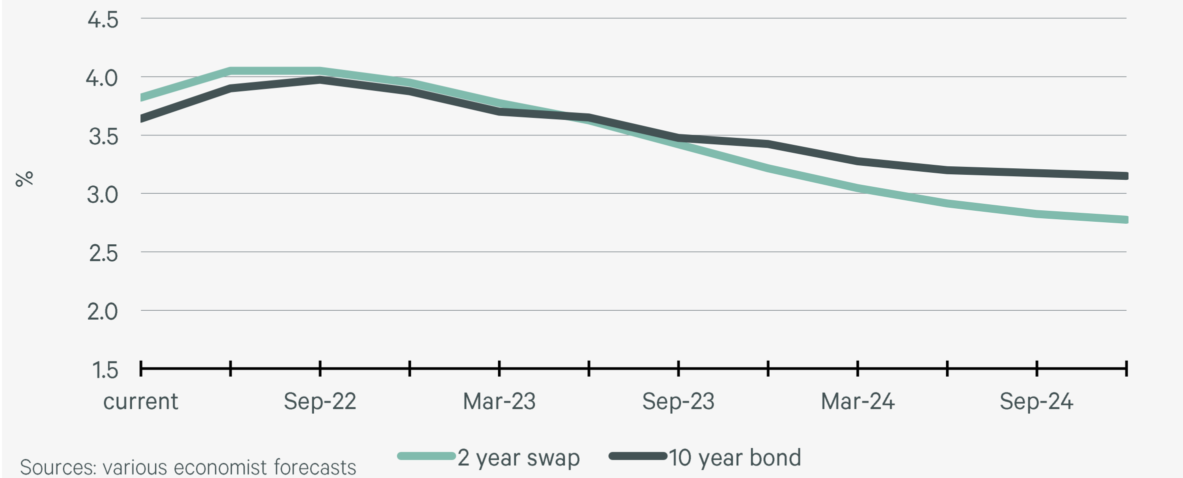
In this environment liquidity may start improving from investors with lower reliance on debt who see the current market impasse as an opening, although the rapidly evolving economic environment and its expected negative impact on occupier demand and rent growth will have an increasing bearing in the next few quarters on the risk and return equation and investor sentiment.

FIGURE 24: OCR Outlook



Source: ANZ Research

FIGURE 25: Long Term Interest Rate Outlook



Sources: various economist forecasts

Contacts

Zoltan Moricz
Head of Research, New Zealand
zoltan.moricz@cbre.co.nz

Shang Du
Research Analyst, Wellington
roger.du@cbre.co.nz

Brent McGregor
Executive Chairman, Head of Capital Markets
New Zealand
brent.mcgregor@cbre.co.nz

Matthew St Amand
Managing Director, Head of Capital Markets
Wellington
matthew.stamand@cbre.co.nz

Tim Rookes
Managing Director, Head of Capital Markets
Christchurch
tim.rookes@cbre.co.nz

CBRE