OAK INVESTMENT MANAGEMENT GROUP

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Inflation and Real Estate

Inflation is the general rise of prices over time. Inflation and real estate interact in a symbiotic way. Obviously depending on the nature of returns whether they are capital value driven or income driven high, low or negative inflation can have different effects, and can be counter-acted by other factors most notably interest rates.

What general inflation hits hardest in terms of value are the elements of value least capable of being re-priced. So a long rental contract will lose value quickly in an inflationary environment (but not necessarily the underlying capital value); mediocre / easily replaceable building will be hard to price in terms of capital value (but not necessarily the recurring short term income derived from occupiers who actually need the space in question). It is an iterative testing of pricing power for an asset concerned, competing against all other asset classes whose price is also going up.

Hyperinflation is distinct from general inflation / deflation as that it leads inexorably to the collapse of a financial system. Whilst it is true that owning a physical asset in such a scenario is better than owning a financial instrument it must be remembered that this is probably only the case for residential real estate, not commercial real estate which in general is also plunged into crisis by an economic collapse.

Deflation, like inflation is also fundamentally an iterative testing of pricing power for an asset concerned, but competing against other asset classes whose price is going down. It is important to know that deflation is really quite rare in nominal terms in absolute terms it is even rarer. It is a sign of serious exogenous (to real estate) issues, as the norm is for a functioning market economy to grow from year to year on average and for the monetary base to expand simultaneously slightly even more than that. As a result more attention (correctly) is given in real estate portfolio construction as to inflation proofing rather than deflation proofing.

But from what we have already seen it is clearly nonsense what is often repeated that real estate *per se* is an inflation hedge. The only hedge against inflation process is reading the market, knowing what it wants intra-temporally. As a result real estate is no different than any other sector that the key to iterative pricing is in the basics: knowing and managing your margins now, reading supply and demand trends correctly going forward.

Dangerous inflation (the kink in the curve between general inflation and hyperinflation) arguably between 4% and 7% is caused principally by the best re-pricing agent in the economy: human labour. Once labour starts to notice that their wages are noticeably eroded, by living costs in the economy then they demand more. Once this starts to two things happen. First, capital takes fright to less labour intensive stores of value (like real estate) decreasing economic activity. Secondly, momentum builds as neither capital nor labour wishes to forgo the first sacrifice until the bitter end. The real problem for real estate in this environment is that it at the outset creates a mini-boom, which is unsustainable as ultimately there is no shield against labour, once provoked, asking for more.

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