CUSHMAN & WAKEFIELD

U.S. Inflation:
Should we be worried?

April 2021

WHAT HAPPENED?

Concerns about inflation have recently been increasing. This gained attention, in part, when the 10-year U.S. Treasury note rallied in early-2021. Inflation matters because it could precipitate (potentially rapid) increases in interest rates at both the short and long-end of the yield curve, a development that has been the most common cause of recession in the post-war era. *There are a number of reasons to believe that fears of this outcome are overstated:*

- At the height of the pandemic, both realized inflation and inflation expectations declined. As upcoming 2021 data is released, the so-called "base effect" will contribute to higher year-over-year changes, but importantly, these reflect what has *already* happened in addition to what is happening *today*.
- The core personal consumption expenditures (PCE) is the Federal Open Market Committee's (FOMC) preferred inflation metric and it rose by only 1.4% year-over-year in February 2021. The Fed has repeatedly emphasized that they are willing to let PCE overshoot their 2% target, particularly to the extent that the labor market has yet to recover.
- Even if inflation does rebound, which is expected to happen as the year progresses, the FOMC may be watching labor force participation and the underemployment rate particularly closely, as the headline unemployment rate is significantly understating labor market damage from the pandemic. This bodes well for "lower rates for longer" and, therefore, liquidity across financial markets globally.
- Some sectors are experiencing either strong or rapid inflation. For example, February 2021 lumber prices are up 25% year-over-year, steel/iron prices are up 22% and shipping costs are up 221%. While these kinds of price increases have effects on manufacturing, construction and supply chain costs, which also tend to be volatile, the impact on headline inflation is constrained and many of these forces are likely to be transient, abating into 2022 as the production side of the economy catches up to demand.
- Much of the recent rally in the 10-year Treasury rate was due to the normalization of long-term inflation expectations. There is no evidence that long-term inflation expectations are becoming unmoored. Five-year, five-year forwards show the market believes inflation of around 2% will be achieved, which is the FOMC's stated inflation goal and reflects an improving economic growth outlook.

WHAT IT MEANS FOR CRE:

- The rise in interest rates thus far has been reflective of better growth prospects. When interest rates rise for "good" reasons, the same underlying dynamics are positive forces for real estate fundamentals.
- The market is signaling that unanchored inflation is very unlikely, and thus rapid changes to monetary policy are also unlikely. Historically low interest rates (even with the recent rally) and high transparency from the FOMC should continue to support valuations of interest rate sensitive assets, including CRE.
- As of February 2021, cap rate spreads remained elevated by an average of 100 basis points (above the long-term average) across property types, with little movement in headline cap rates since December 2019. This indicates an ability to absorb upward movement in the cost of capital without imminent pricing downsides.

CUSHMAN & WAKEFIELD

U.S. Inflation:
Should we be worried?

April 2021

HOW TO PLAY IT

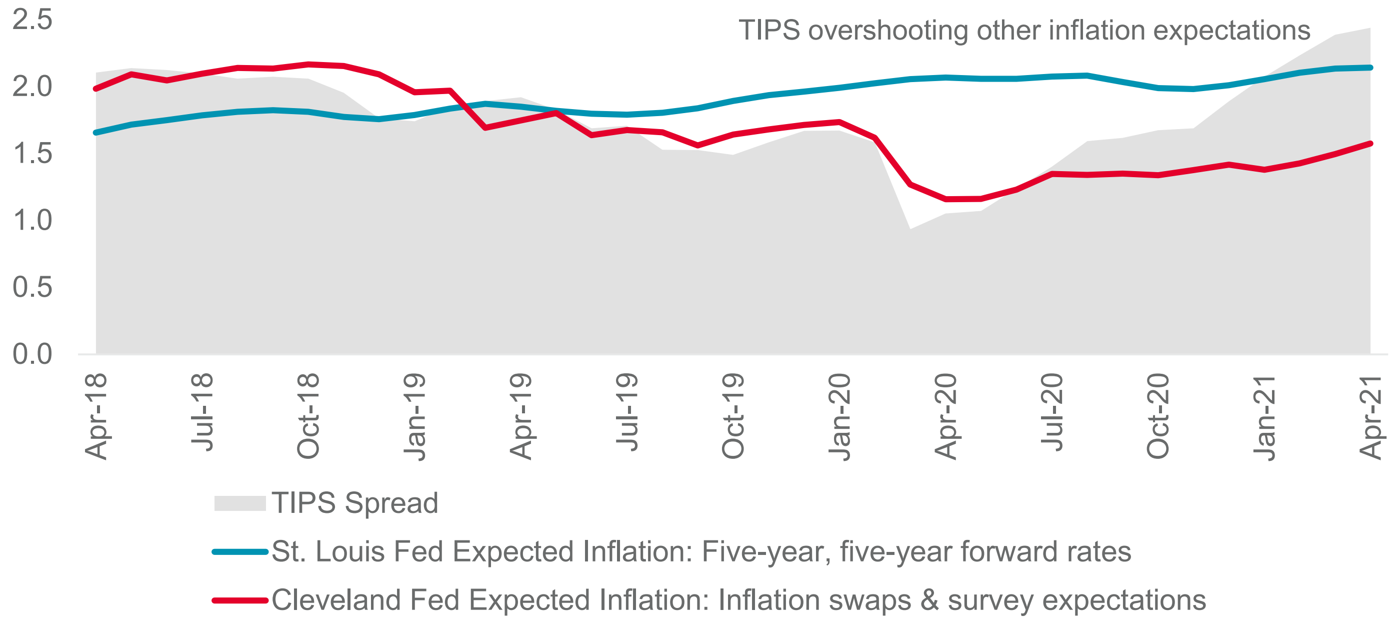
OCCUPIERS

Supply chain and construction costs are rising. Occupiers can expect higher build-out costs and developers can expect higher budgets for inputs. However, the cost of financing will be supported by accommodative monetary policy.

INVESTORS

Better fundamentals within the economy are being reflected in improving inflation data and recent increases in the 10-year Treasury rate. These forces bode well for NOI performance, though it will vary greatly based on product type and local market dynamics, while Fed policy remains supportive of liquidity and pricing.

Market Inflation Expectations



Source: Federal Reserve, Federal Reserve Bank of St. Louis, Federal Reserve Bank of Cleveland

REBECCA ROCKEY
Economist
Global Head of Economic Analysis & Forecasting
rebecca.rockey@cushwake.com

DAVID BITNER
Global Head of Capital Markets Insights
david.bitner@cushwake.com

KEVIN THORPE
Chief Economist, Global Head of Research
kevin.thorpe@cushwake.com