The great unwind: real assets acclimatise to new liquidity environment

Central banks worldwide have started the great liquidity unwind – from ultra-accommodative monetary policy to higher-for-longer interest rates in most major markets. This environment is mediated by global regions and poses divergent re-pricing risk for real assets.

Over the past 15 years, vast central bank monetary stimulus became the norm to support economies through successive exogenous shocks – from the global financial crisis, to the euro crisis, Covid-19 and, most recently, Russia's invasion of Ukraine. The blistering growth of central banks' balance sheet growth is difficult to reconcile with how normalised it became to investors.

In the US, the Federal Reserve's balance sheet[1] ballooned 10-fold in 14 years – from $880 billion in January 2008, before peaking at a whisker under $9 trillion in April 2022. Over the same period, the Bank of England's balance sheet[2] expanded 12.8-fold from £77.7 billion at the end of 2007[3] to almost £1 trillion today, while the European Central Bank's (ECB) balance sheet grew almost six-fold from €1.51 trillion at the end of 2007 to €8.76 trillion at September 2022.[4] In Japan, the Bank of Japan's balance sheet grew by more than six-fold in 14.5 years from 111 to 701 trillion yen by the end of August[5] 2022.

All this balance sheet expansion financed the purchase of government bonds, creating liquidity to cushioned the impact of the crises and promote a faster recovery. Monetary policy was supported by ultra-low interest rates and waves of fiscal stimulus that protected businesses and households. As a second-order effect, this environment created a unique goldilocks period that elevated risk assets ahead of equities and bonds on a relative value basis.

Central banks are now – at varying speeds – shrinking balance sheets at a time when 15 years of QE has translated into persistent high inflation. As financial conditions tighten, high inflation and weakening GDP may create stagflation which pose risks to occupier markets, capital flows and financing for real assets. The outlook will be highly divergent between regions, asset classes and assets yield profile. We expect a deeper bifurcation to emerge where investment demand remains supported for best-in-class assets in sectors underpinned by secular demand drivers (e.g., demographics, urbanisation, technology and climate change), and weakening demand for everything else. The most significant risk to real assets in a recessionary environment with higher-for-longer interest rates is to the re-pricing risk for secondary assets which have not kept pace with evolving tenants' sector-specific requirements.

In the office market, amenity-rich workspace that offers eclectic utilisation options and meet contemporary ESG expectations will remain in high tenant demand, receive ample financing liquidity options and can effectively pass on inflationary pressures to customers. By contrast, commodity-style office space will be less able to pass on inflation and may be unattractive to occupiers even where rent levels are lowered, while refinancing risk will be higher.

In logistics, favourable occupier supply-demand dynamics has supported transmission of higher building and operating costs (e.g., energy, labour, etc) into higher rents for much of 2022. However, this trend is underpinned by consumer demand for which the outlook has worsened, as high cost-of-living and energy prices dampen disposable incomes across several major markets. The emerging environment will likely to translate into a moderation of landlords' ability to pass on inflation, rather than reverse the trend. Logistics performance will be resilient, if not spectacular as we have come to expect in recent years.

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In retail markets, short and long-term structural challenges may worsen, although innovative occupiers and landlords will strengthen the drive to adapt and thrive. Sales growth among retailers will come under pressure in the coming months, as lower disposable incomes keep customers away. At the same time, margins are squeezed as fixed costs continue to rise (e.g., energy, labour and logistics costs). It is a deadly combination but disciplined business plans and landlord-occupier coordination can navigate the headwinds. Those landlords and retailers that work together to reposition retail space with community-capturing events and customer experiences as well as focal points for last-mile logistics will be among the cycle survivors. Elsewhere, investment in digitalised supply chains, end-to-end inventory, fulfilment costs, and customer experience metrics will help retailers respond rapidly to dynamic inflation pressures and sales trends.

FOOTNOTES

1 https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm

2 https://www.bankofengland.co.uk/boeapps/database/fromshowcolumns.asp?Travel=NIxAZxSUx&FromSeries=1&ToSeries=50&DAT=RNG&FD=1&FM=Jan&FY=2013&TD=31&TM=Dec&TY=2027&FNY=Y&CSVF=TT&html.x=66&html.y=26&SeriesCodes=RPQB56A,RPQB58A,RPQB9R8,RPQBV79,RPQB55A,RPQB62A,RPQZ6MO,RPQZ6MS,RPQB59A,RPQZ6MT,RPQB75A,RPQB68A,RPQB67A,RPQBL59,RPQZ4TJ,RPQZ4TK,RPQZ4TL,RPQZP2P,RPQZOQ4,RPQZ4TM,RPQZOQ3,RPQB72A,RPQZ6MW,RPQZ4TN,RPQZ6MX&UsingCodes=Y&Filter=N&title=Bank%20of%20England%20consolidated%20balance%20sheet&VPD=Y

3 https://www.ecb.europa.eu/pub/pdf/other/ecbeurosystembalancesheet2008.en.pdf

4 https://www.banque-france.fr/sites/default/files/medias/documents/classeur1_61.pdf

5 https://www.stat-search.boj.or.jp/ssi/cgi-bin/famecgi2