Hedging opportunity

Commercial real estate can serve as an effective hedge against inflation

by Jeffrey Kanne and Darob Malek-Madani

The American public and investment professionals grew accustomed to very low inflation that dominated the 13-year period following the 2008 financial crisis — a period that now appears likely to be the exception rather than the rule. Between November 2008 and December 2020, U.S. inflation averaged only 1.6 percent, well below the Federal Reserve's target of 2 percent and less than half of the post–World War II average of 3.5 percent. This extended low-inflation period shaped assumptions and strategies, particularly in long-term investment planning.

Recent high inflation, peaking at 9.0 percent after the COVID-19 pandemic, however, shocked the public out of its low-rate complacency. Despite recent declines, inflation remains above target, and investors may be facing a prolonged environment of elevated price pressures. While it is important to note that the trajectory of inflation remains uncertain and unexpected factors could reverse inflationary pressure more quickly than expected, historical trends indicate investors should be prepared for an extended period of elevated inflation.

Inflation drivers and pressures

While higher rates and the return to regular order in supply chains have helped bring inflation down to a reasonable level, there are structural and policy factors that suggest inflation could persist. During the COVID-19 pandemic, as the Fed lowered interest rates, the M2 measure of the money supply spiked to nearly 90 percent of GDP. It has since fallen substantially in relation to GDP but is still above pre-pandemic levels and substantially higher than pre–financial crisis levels, when it often hovered between 50 percent and 60 percent of GDP, according to the U.S. Bureau of Economic Analysis and the Board of Governors of the Federal Reserve System.

In addition to high money supply levels, consumers and the government continue to spend at higher rates than before the pandemic. Federal budget deficits have expanded significantly and continue to increase year-over-year, while consumers have been saving less and spending more than previous norms, according to the U.S. Bureau of Economic Analysis, personal saving rate, and the U.S. Department of the Treasury federal surplus or deficit. Perhaps most importantly, U.S. supply chains are facing potential disruptions from geopolitical tensions, tariffs and evolving trade policies. While the Federal Reserve is monitoring inflation closely, it may find it difficult to raise interest rates to control inflation if unemployment grows substantially, either through a slowing economy or through the widespread labor displacement from emerging technologies such as artificial intelligence.

Based on analysis and experience, commercial real estate has generally been seen as a hedge against inflation. The underlying premise is that as prices rise across the economy, rents will rise along with them, leading to more income and higher values. While, in theory, stocks or other equity investments outside of real estate should also have higher revenues and eventually higher returns in an inflationary environment, in practice, the relationship is less clear; real estate has historically functioned as an inflation hedge.

- **Lease dynamics:** Sectors that have short lease terms, such as apartments or hotels, can be particularly resilient to inflation because their rental rates will quickly adjust to prevailing rates even as expenses are rising. Even sectors with longer-term leases, such as office and retail, can act as a hedge against inflation because they often have net leases and percentage rent deals that pass through expense increases to tenants and force revenue sharing with owners as costs rise, even if actual rental rates are fixed for years.
- **Supply constraints and replacement costs:** Many commercial real estate sectors, such as urban high-rises or mission-critical industrial facilities, face market or political barriers to entry that allow existing owners to consistently raise rental rates. In an environment with rising construction costs, these dynamics can be magnified and spread even to sectors that have fewer traditional barriers to entry, such as suburban housing.
- **Fixed-rate financing:** Commercial real estate is often financed with fixed-rate debt, which can help magnify increases in value driven by rising inflation while keeping payments fixed even if the Federal Reserve is forced to raise interest rates to fight inflation.

Current fundamentals

Commercial real estate has historically demonstrated strong performance during periods of high inflation, provided that market fundamentals remain stable. The early 1990s stand out as a period of high inflation when real estate did not outperform other asset classes, but this was also a period when commercial real estate was a driver of the economic downturn caused by overbuilding in the 1980s.

Traditional core real estate in the form of the NCREIF Property Index (NPI) and its component parts has substantially positive return correlations with inflation, meaning that when inflation increases, so does the underlying real estate return (see “Total return and correlation with inflation,” below). At the same time, the S&P 500 Index, as well as bond indices, have demonstrated essentially zero or negative correlation over the same period.

Total return and correlation with inflation

	Average annual inflation	NCREIF Property Index	S&P 500	Bond Index	NPI Apartment	NPI Industrial	NPI Office	NPI Retail
Correlation: 1978–2025	1.00	0.36	0.02	-0.10	0.39	0.35	0.30	0.19
Periods with high inflation								
Returns: 1978–1981	10.9%	18%	12%	5%	20%	17%	22%	11%
Returns: 1987–1990	4.5%	7%	12%	7%	8%	8%	3%	11%
Returns: 2021–2022	6.8%	11%	3%	-8%	13%	28%	1%	3%

Sources: NCREIF.org, ICE BofA BBB U.S. Corporate Index Total Return Index Value
Notes: Although real estate cash flows may react with some lag to inflation due to the length of their leases or the terms of expense reimbursement, valuations of properties within the NCREIF Property Index (NPI) are typically adjusted at least annually, so returns in the index should relatively closely follow real-time changes in inflation and other market conditions.

Illustration: Real-life portfolio examples

While not all assets follow the same trend, and performance varies by market and sector, our analysis of our own portfolio and our experience through prior inflationary periods suggest a common dynamic in commercial real estate: Development costs have surged due to labor constraints, global supply-chain disruptions, and rising material prices — yet in many cases property values are well below peak levels, offering compelling entry points, especially when compared to current replacement costs. This imbalance between market value and replacement cost reduces the likelihood of new, competing developments in these areas, at least until property values recover. As a result, we believe many existing commercial real estate projects could be well-positioned to be resilient during a future bout of rising inflation. Existing assets are increasingly irreplaceable, offering durable income and the potential for long-term appreciation.

To illustrate how specific real estate assets may be positioned to perform well in an inflationary period, we have summarized below several examples that reflect this dynamic.

The investments examples are solely for illustration of the points discussed herein, and there is no assurance that investments in the mentioned assets have been or will be profitable.

In each of these cases, today's valuations offer entry points well below the cost of new construction, at a time when high interest rates and labor shortages are discouraging new development. That supply gap is a powerful structural advantage for current owners. As inflation pushes up replacement costs and construction timelines, well-located existing assets with stable cash flows will increasingly command premium pricing and attract capital looking for yield and inflation protection.

1. Apartment tower – Jersey City

Year built: 2024
Size: 598 units
Percent leased: 95 percent
Cost to construct: $375 million
Replacement cost: approximately $431 million
Second quarter 2025 value: approximately $415 million

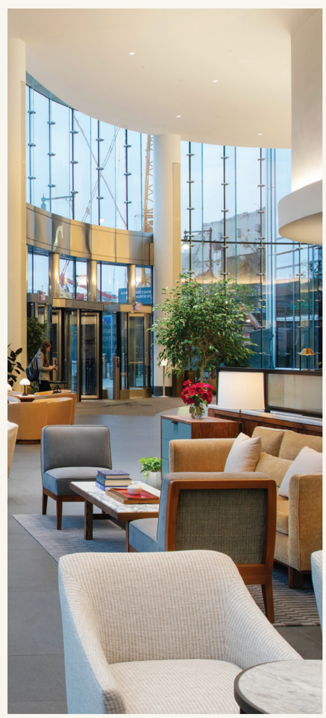
A 60-story phase III apartment tower within a 1,800-unit complex with 27,000 square feet of retail.

2. Apartment tower – Atlanta

Year built: 2023
Size: 370 units
Percent leased: 93 percent
Cost to construct: $194 million
Replacement cost: approximately $249 million
Second quarter 2025 value: approximately $249 million

A 29-story apartment tower completed in 2023, adjacent to vibrant midtown Atlanta.

3. Trophy office – Boston



Year built: 2023
Size: 999,000 square feet
Percent leased: 100 percent
Cost to construct: $991 million
Replacement cost: approximately $1.25 billion
Second quarter 2025 value: approximately $996 million

A 43-story, office tower in downtown Boston, which sits atop a T stop with multiple lines and easy access to the rest of the city, airport, and suburbs. The project has been fully leased to credit tenants since it opened.

Replacement costs based on the original hard cost construction budget adjusted to 2025 values using the Turner Building Cost Index. 2025 land value and soft cost estimates based on 2025 appraisals. Replacement costs do not include any additional value to account for the entrepreneurial profit required by developers. Internal analysis of National Real Estate assets under management valuation and cost data. The reader should not assume an investment in the assets identified was or will be profitable. The investments examples featured in this discussion are provided solely for illustration of the points discussed herein. The particular investments identified and described herein are assets held in National's portfolio, however, they do not represent all of the investments purchased, sold, or recommended by National.

In addition, during two of the three periods of higher inflation since 1978, there have been higher real estate returns than either stock or bond returns. In the third period, from 1987 to 1990, there was higher-than-average inflation but lower real estate returns. This period corresponded with the start of the real estate crash of the early 1990s.

Today, key commercial real estate fundamentals look relatively strong. With the exception of office properties, most sectors have seen increasing or steady occupancy rates along with rising rents and net operating income, according to data by CoStar Group and NCREIF. In addition, high interest rates have discouraged new development, helping to limit future supply and stabilize market conditions for owners.

What is even more important to future return potential than strong fundamentals, however, is that valuations have come down substantially after the past few years of rising interest rates. This dynamic means that today, even recently constructed commercial real estate projects are in many cases valued substantially below replacement cost. These lower valuations result in higher yields and substantial room for inflation-induced rental rate and value increases before new supply will be delivered at scale. This is particularly true given that one source for higher prices in this cycle will be supply-driven disruptions from tariffs and trade negotiations. This is likely to result in construction prices rising faster than wages. In this environment, the owners of existing assets have significant potential to benefit from a relatively long period of rising values without new competition.

Conclusion

Given the anomalous low-inflation decade leading up to the COVID-19 pandemic, many institutional investors may have ignored inflation when creating their investment strategies, but recent experience and a review of history suggest elevated inflation could be more persistent than many expect.

For institutional investors seeking durable income, inflation protection and long-term value creation, we believe commercial real estate has unique potential compared to other asset classes in the current environment. While investors should remain cautious and attuned to sector-specific risks, maintaining a strategic allocation to this asset class may help not only to weather future inflation but also capitalize on the opportunities it creates. ❖

Jeffrey Kanne is president and CEO at **National Real Estate Advisers. Darob Malek-Madani** is head of research and analysis at the firm.