

Could 2021 Be the Year That Inflation Finally Impacts the Net Lease Market?

Inflation has been a topic far removed from the minds of most net lease investors for some time now. Not since the late days of 2018, when the 10 Year Treasury briefly broke above 3.00%, has inflation been a topic of serious concern among market participants. To the contrary, a wide and pervasive consensus has seemingly formed over the last year that inflation is not a legitimate risk to the net lease marketplace in the near term. The massive headwinds to the United States economy from the COVID-19 pandemic, which has kept the 10 Year Treasury below 1.00% for most of 2021, only reinforced the market's view about inflation.

However, is it time for investors to reconsider this view? With the Treasury pushing to 1.30% in mid-February, could there be more risks to inflation, interest rates, and cap rates on the horizon than market activity has priced into the equation? Before considering that question, it is perhaps best to reflect on the net lease market's performance in 2020.

In March and April of 2020, the outlook for the net lease marketplace looked very bleak. With massive disruptions impacting the retail and office segments, virtually all market participants expected a massive pullback from the 2019 transactional volume of \$80 billion, at an average cap rate of 6.19%. It seemed entirely reasonable to believe that far less capital would flow into the segment, and the capital that did would demand outsized returns to account for the risk.

Yet by mid-2020, a fascinating trend was starting to take place; the capital was actually flowing into the marketplace from private sources at a far more elevated pace than many had anticipated. Buoyed by bank lending, which was still reasonably available, at shockingly low-interest rates in the middle of the 3.00% range, investors were continuing to buy net lease properties, seeking to take advantage of outsized opportunities to generate higher cash on cash returns from cheap interest rates. The capital flows were so strong that 2020 generated \$60 billion of transactions at the same average cap rate of 2019, 6.19%. This was truly an outcome that defied marketplace predictions.

Entering 2021, the conventional wisdom is that these trends will continue. Institutional REITs have largely increased acquisition guidance, and highly demanded assets remain in tight supply, a perfect storm to keep cap rates low. However, there may be a risk brewing in the marketplace that participants are not considering. With the massive fiscal stimulus plans the Federal Government deployed in 2020 (\$4 trillion) and a soon-to-be additional package of another \$1.9 trillion, the economy has seen a deluge of liquidity being pumped in. For context, the American Recovery and Reinvestment Act, the Federal response to the Great Recession, was only \$800 billion; also of relevance is that the entire annual US GDP was \$21 trillion as of Q3'20, meaning that the 2020 and 2021 stimulus packages are injecting a third of a year's GDP into the financial system.

Prior to the current \$1.9 trillion package, the Congressional Budget Office (CBO) already projected that the United States Economy would return to its pre-pandemic level by mid-2021, and employment would return to the pre-pandemic levels in early 2022. Further, there is seemingly a massive amount of "pent up" spending power from U.S. consumers; S&P assesses that the U.S. Consumer Savings Rate rose to 25.80% in 2020 compared to 7.90% in 2019, which equates to \$1.6 trillion.

The twin effects of Federal stimulus and consumer stimulus has the potential to impact economic conditions and lead to the most rapid onset of inflationary conditions that the United States has seen in decades. Such an impact would surely drive interest rates higher in the near term and potentially put upward pressure on Cap Rates. For the net lease marketplace, some of these impacts could be offset if investors place less emphasis on leveraged purchases and the supply/demand imbalance remains steadfast.

Regardless, net lease market participants would be wise to watch these dynamics with a close eye as the year evolves and as the United States comes closer to achieving herd immunity via mass vaccination.

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