Kara O'Halloran (00:04):

Welcome back to FireSide, a podcast from FS Investments. I'm Kara O'Halloran, director in our investment research team. And today is our halftime show. It is July 7th. We are somehow halfway through 2021. So my team is here. We are in person live in the office with me to go through the highlight reel from the first half of the year and talk about what we can expect going forward.

Kara O'Halloran (00:27):

In the room, we have Andrew Korz, another director on the team and our resident real estate expert. We have Lara Rhame, who if you have listened to the podcast before, you know her and love her by now. She's our chief US economist. And if we're going to keep with our sports theme, we have our coach, the head of our research team, Rob Hoffman.

Kara O'Halloran (00:44):

Hi, everyone.

Lara Rhame (00:45):

Hey.

Robert Hoffman (00:46):

Hello.

Andrew Korz (00:46):

Kara, good to see you.

Robert Hoffman (00:48):

Hello.

Kara O'Halloran (00:48):

Good to see you. Good to be seen, I should say.

Andrew Korz (00:49):

Nice to be here with everyone in person.

Kara O'Halloran (00:52):

Exactly. So let's get into it. When we left things off after the first quarter, we can kind of see this light at the end of the tunnel. Vaccinations had started but we are still a ways off from what we would all consider normal. The theme that we talked a lot about was optimism.

Kara O'Halloran (01:08):

And it's crazy to me at least how it seems like in the last three months, we have really gone almost back to normal, at least here in the US. So turning to what this means in the economy, we're still seeing a really strong economic environment, strong growth rates forecasts and record earnings. It's created a really good backdrop for markets as well.

Kara O'Halloran (01:27):

The S&P 500 is up 15% in the first half of the year in credits. Spreads have basically return to pre-great financial crisis levels and fundamentals are rapidly improving in real estate. There are definitely challenges that come with this new normal, and we will dive into all of those.

Kara O'Halloran (01:45):

But first, let's catch up on how we got here. So Lara, I'm going to ask you to kick us off. I think this is a tough question because so much has happened in the last quarter but just fill us in broadly on what is going on in the economy and how do we get to where we are.

Lara Rhame (01:59):

Absolutely. And Kara, it's great to see you too. This couldn't be better timed. Yeah, first half of the year, I think we really just think about so many tailwinds building upon each other to just push our economy higher to really stratospheric levels of growth. Policy supports. I think it seems again, things are moving so fast like just a memory but we got that third really large physical stimulus package that really hit households in the first quarter.

Lara Rhame (02:37):

Obviously, the vaccines have allowed large flocks of activity to resume. And then you had continued Fed easing and all of that is just combined to push, we don't actually have Q2 GDP numbers yet, but the estimates are for 10% growth in the second quarter. It's just for an economy as mature as ours, don't call it old. Call it mature. That's a really astonishing rate of growth.

Lara Rhame (03:05):

And that's, I think, where we've left off. And just to tickle some thought going ahead, we maybe sort of now turning a corner from that extremely, extremely robust rate of growth. But that's where we are right now, just rock solid across the economy, labor market, housing market, travel and services recovery, consumption, all of it. Business investment is just firing in all cylinders.

Kara O'Halloran (03:31):

Great. And we'll definitely get to what's to come shortly. So Rob, let's turn to credit. This year, high-yield and loans have fell kind of predictable so much that we called our outlook enjoying the ride. It's been kind of smooth sailing. So fill us in on what's going on credit markets.

Robert Hoffman (03:48):

Yeah, building on that theme of predictability, it was interesting in writing the outlook and looking at some of the data. You would think in a market like high-yield or loans looking at the yield effectively of the market at the beginning of the year would be a fairly good proxy for return. However, looking over the past 34 years, there's only been, I think it was five years where the actual return for the year ended up within 2% of the starting yield of the market at the beginning of the year.

Robert Hoffman (04:23):

And what inevitably happens is just something happens. There's movement in rates. There's a risk off trade or a risk on trade and just something causes it to deviate more than that 2%. When we wrote our outlooks for this year including Q1, Q2, Q3, we really just said, "Look, the market seems strong. Growth

seems like it's resuming." We're emerging from the pandemic. Default rates are likely to be really low. And absent some major unknown that knocks everything off kilter, it seems like in an environment when you're going to earn your income and you're probably going to see some spread tightening. And that's almost exactly what's happened.

Robert Hoffman (05:15):

One of the things we noted is that if you took our full-year forecast and divide it by two, half way into the year, we're within like 10 basis points of what we forecasted for the annual return.

Kara O'Halloran (05:28):

I wish we could say we were that good [crosstalk 00:05:30] predicting the future-

Robert Hoffman (05:32):

More than willing to admit that there's a lot of luck that has gone into that accuracy because normally something else happens. But that's why we sort of say, it's been kind of predictable. I think the easy predictable call at the beginning of the year was companies are going to do well. Spreads have room to tighten. Markets are strong. And we would expect credit markets to follow suit and that's pretty much what's happened through the first half of the year.

Kara O'Halloran (06:05):

Thanks, Rob. Andrew, take us home with real estate.

Andrew Korz (06:07):

Surely. So similar to what Lara laid out in the beginning, I think when we got to the end of Q1, we talked about Q1 being the sort of calm before the Q2 storm in terms of economic activity coming back. And I think that's exactly what we saw in the real estate market, although it's a bit more nuanced.

Andrew Korz (06:31):

So I would think about the first half in three different segments in terms of commercial real estate. Number one is fundamentals. We all know how crushed certain sectors were by COVID. Retail with people being unable to go out and shop, hotels, people being unable to travel whether for leisure or for business. In Q2, those sectors really bounced nicely.

Andrew Korz (06:59):

Hotel occupancy is within 10% of 2019 levels, and in some markets, it's actually above 2019 levels. It had gotten as bad as 30% of normal levels at the peak of the pandemic. We're seeing air travel comeback. TSA data shows that air travel, the number of people passing through checkpoints is above two million per day for the first time since, I think, March 2020. All that points to really robust recovery in hotels.

Andrew Korz (07:28):

And then retail, the good story is obvious. Initially at the onset of the pandemic, it was all that ecommerce we saw these huge gains in terms of online shopping. But since January this year, retail sales as Lara has pointed out have continued to grow in the back of fiscal stimulus. So retail sales have grown 8% since that time. And ecommerce is up only 1%. What does that tell us? It tells us that a lot of that growth is coming from people getting out there and shopping in brick-and-mortar stores.

Andrew Korz (08:03):

Number two would be sentiment and as I've talked about before, this has been crucial during the entire pandemic, because the future sentiment has really not wavered much since mid-2020. We've seen lenders being available and willing to work with borrowers who are going through trouble rather than send them into distress. We do have a nice sentiment indicator from the real estate roundtable, which basically surveys market participants in various parts of the market on their future sentiment and on their current sentiment.

Andrew Korz (08:39):

And if we look at the past four quarters, when COVID hit, current sentiment plummeted to its lowest level ever. Future sentiment didn't really budge much which was really important like I said in keeping the market intact. And since then, we've really seen a robust recovery in current sentiment along with future sentiment. So I think you have these two tailwinds of both fundamentals of market sentiment really recovering.

Andrew Korz (09:05):

And then the third thing would be transaction activity which we still haven't seen recovered to levels that we would consider normal from 2018 and 2019. We're about five months into the year. We're about 16% below 2019 levels which is a significant amount. As we've seen before in previous recessions, it takes a while. People are clearly still assessing how durable some of these pandemic trends are going to be, and I think we're going to talk a bit about that more later. But you can feel it building.

Andrew Korz (09:38):

So I think this pull through, it takes a while to go from improving fundamentals to market participant's sentiment really recovering. And then finally, the last leg is sort of activity, which is really what I'm looking for as we head into Q3 and into the second half of the year.

Robert Hoffman (09:57):

I don't know if it's related to all that but this weekend, we are staying as a family at the first hotel stay that we will have for the entire pandemic. And next week, I will be taking my first airplane ride of the entire pandemic. So it fits very well into what you're saying on a-

Lara Rhame (10:12):

It sounds like the TSA lives are going to be back for [crosstalk 00:10:15]

Kara O'Halloran (10:14):

Did you get your [inaudible 00:10:15]?

Andrew Korz (10:15):

Rob, doing his part for the economy. So we appreciate it.

Lara Rhame (10:19):

But I think a theme that all of us are discussing is how truly unique this expansion has been, especially compared with the last early part of the expansion. Kara, look at default rates in credit. What was the highest they got to in high-yield?

Kara O'Halloran (10:35):

A little over 6%, and now they're back down under 2%. I feel like we're having conversations so early in this cycle. I thought we'd be having these conversations a year from now. It's just everything is moving so quickly.

Kara O'Halloran (10:51):

So let's turn our attention now to Q3. I want to keep this really high level and just really focus on the next three months. Lara, what are you watching?

Lara Rhame (11:01):

So, if we left off the first half with just pretty much exclusively tailwinds, that's starting to change. One of the most obvious shift that we're starting to feel is Fed policy, which is starting to look like it could possibly become a headwind. Should they pare back their quantitative easing, should they start to think about raising rates?

Lara Rhame (11:26):

Keep in mind markets will express this as a headwind before it's actually even happening. So we're just in Q3 watching Fed signals like a hawk. And of course, we've seen higher commodity prices really come through as a lasting piece of this expansion so far, this sort of early stage. And while some of the really acute lumber prices seemed to be fading, it's pretty broad based.

Lara Rhame (11:56):

And finally, labor supply dynamics could provide a little bit of a headwind. All of those things are on the watch list but of course, by far and away, the headline is inflation.

Kara O'Halloran (12:09):

And we will get to that very shortly. That deserves its own section.

Lara Rhame (12:14):

Totally.

Kara O'Halloran (12:15):

So Rob, let's look at your so far very accurate crystal ball. What are we paying attention to in credit for the next three months?

Robert Hoffman (12:23):

I think over the next three months, it's an income-driven return setting aside the fact that we always get hit with an unknown at some point. But if you just look at our expectation, high-yield generates a little under 1.5% return for the quarter just based on income. Loans are a little bit over 1%. Capital

appreciation is going to be really hard to find when you look at things at the index level or for passive investors, there's just not a lot of price appreciation.

Robert Hoffman (13:00):

Spreads could tighten. We can talk more about that. The potential is certainly there for spreads to go tighter. It's not like they're at their all-time-ever tights. And if you really get strong positive euphoria that continues over the course of the quarter, I think that that could potentially generate capital appreciation. But that's not really our base case scenario for looking at index returns in high-yield and loans.

Robert Hoffman (13:26):

I think what propels that, we continue to see improvement and underlying fundamentals, revenue growth, EBITDA growth, strong cash flow growth just given the nature of where rates are which is low. You continue to see really good debt service coverage metrics which is contributing to just these plummeting default rates that we see.

Robert Hoffman (13:50):

You have some forecasters now calling for less than 1% by the end of the year. To me, it's basically as close to zero as you're ever going to get because you always have some idiosyncratic events that happen to companies that inevitably cause defaults that aren't really related to the broader macro economy but are just specific to some company that has a default issue.

Robert Hoffman (14:15):

It's really tough just to go to zero and stay at zero. But the fact that you have some people calling for 65 basis points by the end of year for bonds and loans is really, really low. And then on the supply-demand side for the quarter as we look at it, one of the things that's been notable is that issuance in bonds and loans has been really, really strong. And that's been both issuance related to refinancing activity but also new issuance coming from things like leverage buyouts, mergers and acquisitions.

Robert Hoffman (14:46):

And what we have seen is that demand has been there to buy that new supply. So in the loan market, you've had really strong retail inflows and you've had an incredibly strong CLO creation engine which is the primary buyer of new issue loans in the market. And that continues to be very supportive for loans.

Robert Hoffman (15:07):

On the high-yield side, you haven't really had the retail demand but you just ... Everything from things like some rising stars of companies getting upgraded out of the index to just really consistent demand likely coming from institutional investors and a search for yield given that high-yield had some yield especially compared to investment-grade markets has been there to buy up and support that level of issuance in that market.

Robert Hoffman (15:36):

So those are things that I think in the end of the day contribute to a largely income-driven return which really formulates our base case expectation, I think, for what we could expect in Q3.

Kara O'Halloran (15:49):

Yeah, and we've seen high-yield demand turn around a little bit in the last few weeks just as rates have edged lower so we have to see where are we in the quarter or the third quarter with that. And I think one thing I think about in credit is coming into the air, we talked about how it's been really predictable.

Kara O'Halloran (16:04):

To me, the timing of vaccines was the most unpredictable thing. I personally maybe I'm naïve or I'm pessimistic but I didn't think I was going to be vaccinated until December of 2021. April rolls around and I was fully vaccinated. So it's almost that's kind of front loaded, spread tightening and that capital appreciation aspect and also kind of removed a risk for the second half of the year. It's more of a known quantity.

Kara O'Halloran (16:30):

Anyway, moving on, Andrew, real estate, what are you seeing for the next three months?

Andrew Korz (16:36):

Sure, so I'll be quick and I'll give three quick hits here. First, the obvious one is interest rates. Lara has kind of broke down what we've seen in treasuries over the past couple of months. That's been incredibly important for real estate like it's been in pretty much every asset class.

Andrew Korz (16:58):

Lower discount rates, lower debt service that property owners have to pay have really helped prop up property values really over the past decade but especially I think through this crisis. And I think Fed policy and the Fed's reaction to what we see in inflation is going to give us a better idea of what the path of interest rates is going to be going forward, and that's obviously going to have huge impacts for commercial real estate.

Andrew Korz (17:28):

Second would be the sort of compositional shift we're seeing in terms of the consumer. We've already seen kind of the start of it but I think we'll see a more robust switch in Q3 from goods-centered spending to services-centered spending. And people think of that as maybe not necessarily positive specifically for retail.

Andrew Korz (17:57):

But when people think of retail, they think about malls, they think about people going out and buying stuff. That's not necessarily the full picture of retail. A lot of retail is restaurants or hairdressers or gyms. A lot of these services-oriented sectors are really important to retail and they're honestly the parts of the retail sector that have been hit hardest by the pandemic.

Andrew Korz (18:20):

So that's one thing that it's sort of a niche specific to one part of the market, but I think that's really going to start to come through in Q3 as we see this compositional shift.

Andrew Korz (18:33):

And then finally, on construction, we've seen a total bifurcation in terms of construction spending between residential both single family housing and multifamily, and then all other commercial has been sort of the other side of the coin and construction spending is full on there. It's obvious why housing prices are skyrocketing. Multifamily has the best price growth of any sector in commercial real estate. Those are where the returns are, and of course, developers are going to want to go where the returns are.

Andrew Korz (19:06):

I think there's obviously this mad dash for labor and for materials within construction. I've been amused by the memes comparing lumber today to gold and the people who have lumber are the wealthiest people in the country. I think that's kind of amusing. We've obviously seen that come down a bit.

Andrew Korz (19:28):

But input materials and labor, I think, you have the such robust demand from the housing and from the multifamily sectors, it's going to be really interesting to see as fundamentals continue to improve, are we going to get this demand from office, from industrial, from retail to sort of see an uptick in terms of construction spending on those commercial sectors?

Kara O'Halloran (19:57):

And I have to ask, because as I said, we are sitting here in the office and you brought up office, so I imagined that's something that you're watching closely. What are your thoughts on the office sector especially I think a lot of companies are planning to bring people back after Labor Day, so what are you watching there?

Andrew Korz (20:10):

Yeah, definitely. I think I'll speak a little bit to this later in the episode, but broadly, I think you're hearing a lot of companies talk about a hybrid model where it will be office-centric with one to two days flexible. And I think that's certainly a positive for a lot of people and it gives the economy more flexibility in general.

Andrew Korz (20:35):

We've seen people moving to more attractive, cheaper markets because they have that flexibility in their work schedule. I do think it's going to present challenges when people, like you said, finally do start coming back into the office en masse around Labor Day.

Andrew Korz (20:51):

I've had a few instances where we've had meetings with half people in the office and half the people on Zoom, and it can be very challenging to have an equal, balanced conversation between the people who are working from home and the people who are actually in the office.

Andrew Korz (21:08):

And I think that's just one of the many issues that you just can't predict until you actually try these models. So I think there's a lot of uncertainty there still. Obviously, the office sector, you have really long lease terms so property owners have time and companies have time to gauge what the ultimate impacts are. But I think Q3 is going to give us a nice primer on what to expect there.

Kara O'Halloran (21:35):

So we'll be watching closely.

Robert Hoffman (21:36):

It'd be interesting to see if we get a whole another wave of technology spending come September when everybody goes into the office. And it's like, "Well, I need a new camera. I need new headphones."

Kara O'Halloran (21:50):

Yeah. We all adjusted to the work-from-home tech and now Andrew can't get his computer to work in the office. He comes in every morning.

Andrew Korz (21:54):

My monitors don't work. It's true.

Kara O'Halloran (21:59):

I hope our IT people are coming back to the office. That's all I'll say. We need some help over here. [crosstalk 00:22:04] Oh, my gosh, yeah. They always happened.

Lara Rhame (22:07):

Love you, guys.

Kara O'Halloran (22:09):

Lara, you called your outlook zooming in on inflation. So, let's do just that. I feel like inflation is dominating every single conversation we're having lately. CPI searched to 5% in May, as we expected given some of those base effects. But we're also seeing huge contributions to pricing pressures from things like food and new and used cars. And inflation, I think, will rightfully still be center stage for at least the next quarter, maybe beyond that.

Kara O'Halloran (22:38):

So specifically, what are you watching when it comes to inflation?

Lara Rhame (22:42):

I think here is where it's important to draw the distinction between some of the technical base effects that drove second quarter inflation, those year-on-year calculations just through the roof. When we had in the second quarter of 2020 at the real epicenter of the shutdown, plunging airplane ticket prices and hotel prices and many of the factors that just were so driven by the shutdown falling 80%, when those just re-normalize, it causes the year-on-year calculation in the subsequent year to really surge.

Lara Rhame (23:19):

So that is the effect that has largely washed out of the data in the second quarter. We may still see some lingering but that's largely done. And I think in the third quarter, we can really now look to get a clearer picture of more lasting trends higher in prices. And this is I think something to your point, I think inflation come right now from multiple places, and that is what is particularly concerning.

Lara Rhame (23:49):

One of them is supply disruption causing acute price increases, and used car prices is a really notable example of that. I think it was May we had used car prices, or it was April, had used car prices rise 10% in one single month. That alone caused a really sharp, contributed several tenths to the headline monthly gain, but that's likely not going to last. That's an acute moment in time and we don't expect that type of inflation to continue.

Lara Rhame (24:26):

Nevertheless, you get enough of those sort of creeping in month-by-month and you're seeing overall inflationary prices, and the consumer level phase in the household rise. We see food prices have remained elevated. That's both the restaurants and at home in particular. And now given the recent rise in oil prices, we will likely see gasoline prices increase as well.

Lara Rhame (24:48):

So, what does all of that do? That causes households to start expecting inflation to continue to rise in the future. And we're starting to see some of those consumer expectation surveys reflect higher prices or price expectations. And then that causes people to want higher wages at a time when we're seeing a really notable shortage of labor already.

Lara Rhame (25:18):

So, you add the fact that you have nine million job openings, we need bodies to come into the labor force and people are looking at rising prices and saying, "Well, I want to get paid more to reenter the labor force." All of that is adding to wage pressure that which is the very important other side of the coin to these high CPI numbers.

Lara Rhame (25:46):

So, for that reason, the laundry list of what we're watching for inflation includes the next several months of CPI data which will really have some of those technical factors stripped away. We need to watch commodity prices because we're really seeing from a wide variety of commodities. We're seeing price pressures there. And then wage pressures have been something that we probably haven't really focused in on for a long time really.

Lara Rhame (26:15):

The entire last expansion, we had a very, very tight labor market. The unemployment rate was at 3.5% going into the pandemic. And even then, we saw some wage pressure rising. It did not have any impact on overall inflation. So this time around, it feels like it could really be different. It's moving faster.

Lara Rhame (26:38):

And I think in the Q3 outlook on my wage article, I have a graph showing wages of some of the areas of employment which are traditionally the lowest paid like leisure and hospitality workers, truck drivers, transportation workers, and those temporary business services jobs, janitorial services, et cetera. Those three categories, now keep in mind, that's almost 40% of our entire labor force. So, those three categories are right now seeing wage growth that is two to three times higher than pre-COVID levels.

Lara Rhame (27:16):

So, when you start to see some significant wage pressure on an area that may not be the highest paid area, but it certainly is the largest share of our economy, that's something you really, I think, have to pay attention to and watch very closely. So, the June data showed some of that pressure easing. But in Q3, boy, I think that's really under my microscope for sure.

Kara O'Halloran (27:45):

I want to talk about the impacts of inflation on markets. Rob, walk us through what you're paying attention to in credit given this inflation narrative.

Robert Hoffman (27:55):

As you think about inflation as the impact in credit markets, I think about it in two different ways, and one way is from a headline market level. So, how does the loan market do in a period of higher inflation? And hard part of that is that normally when we think about higher inflation, when we think about rising rates. And very recently, that hasn't necessarily played out. We've actually seen rates fall 20 or 30 basis points off their recent highs.

Robert Hoffman (28:26):

If we assume the normal narrative which is inflation eventually induces higher rates and you look at the market like the loan market where loans are based off of floating rates, today LIBOR, tomorrow SOFR, the market tends to do very well in a period of rising rates because you don't have duration risk.

Robert Hoffman (28:48):

When you think about the high-yield market, you have a fixed rate. So, you have theoretically duration risk. And so if you enter a period of rising rates, you would tend to think of fixed rate markets as being ones that are penalized by rising rates or inflation.

Robert Hoffman (29:05):

However, the high-yield market, because it has its high of the yield basically provides cushion. And what we see historically is that rising rates don't really tend to impact the high-yield market negatively. And in fact, if we continue to get a period of inflation which results in higher rates but that's being driven by fundamental growth, that tends to outweigh that negative duration impact to high-yield. And that market also tends to do well in periods of rising rates.

Robert Hoffman (29:35):

So, my first view is from the market perspective, how are they impacted by inflation. Both high-yield and loans tend to be positioned fairly well. And that's obviously in stark contrast to invest in grade markets where it's investment grade corporates or sovereign debt that really have a lot of duration impact and they tend to not do as well.

Robert Hoffman (29:56):

The other side of the coin is fundamentally at the company level, how do companies do. And that's where deep bottoms-up fundamental analysis is really, really important because in both markets, you could have lumber producers that are doing really, really well because they're getting much higher rates on the lumber than they're selling than ever before.

Robert Hoffman (30:16):

But at the same time, you might have a company that manufactures windows that are made out of wood and suddenly, they're getting slammed and they might have three to six-month pass-throughs on prices. But price has skyrocketed in a matter of 15 days and suddenly, they're totally caught.

Robert Hoffman (30:34):

The same thing with ... Historically, there were a lot of companies that produce products derived from oil. And the mismatch of timing from when oil prices go up and commodity prices rise and ethylene and polyethylene and polypropylene to like when you're actually making a cup that's made out of one of these products can cause huge issues for companies, and then certainly things like labor cost.

Robert Hoffman (31:00):

So, it really requires a deep analysis of looking at companies for how they might be exposed to these, and does it cause any kind of deep fundamental company issue? So, there, you're going to be all over the map and it's really just kind of depend and it's going to company by company. But those are the broad two ways that I would think about inflation flowing through the credit markets and some of the things to pay attention to as we potentially enter a period of rising or sustained or peaking inflation.

Kara O'Halloran (31:32):

Yeah. And I'd add a third to that too. I think you talked about the market level, but even taking a step even further back just if we do have unexpected spikes in ... If the market has written off the inflation narrative or decided it's transitory and then we do have a spike in inflation or we have a spike in interest rates and a broad risk of sentiment, then that's definitely going to impact credit as well.

Kara O'Halloran (31:55):

But as you said, it's not. The actual baseline inflation numbers are not necessarily a negative.

Robert Hoffman (32:01):

I mean, look, everything is certainly kind of priced to perfection, so to the extent the market really get surprised by something related to inflation that's not expected. You have the potential to create volatility because of that, because I think right now, the general belief is that it's manageable. And if for some reason if you evolve to maybe it's not manageable, you could see a big reaction in markets.

Lara Rhame (32:29):

Well, and I just want to fill that quick gap between why we are seeing some building inflationary pressures but long-term yields are so, so low. And it's really the difference of time horizon. I think when we look at a lot of these factors, we think about the fact that we could very well face ... I think we could very well face a mini cycle of inflation which could last four quarters, six quarters of elevated price pressure.

Lara Rhame (32:53):

But long-run inflation expectations, the 10-year treasury, they are thinking that inflation in 2031 or over the next 6 to 10 years is going to be manageable. That's why you've seen long-run inflation expectations around 2% which is right where the Fed wants them. And I think that right now, we're seeing the 10-year treasury dominated by a lot of other factors like quantitative easing.

Kara O'Halloran (33:22):

Andrew, real estate and other real assets are really one of the first places that people go when they are concerned about inflation. But talk us through some of the impacts on the actual asset class on commercial real estate.

Andrew Korz (33:34):

Sure. Just to quickly follow up on Rob's point, I think we should do a whole episode on polypropylene.

Kara O'Halloran (33:40):

I think I'm going to tap out on that one. I'll leave Rob to host. I don't even think I can say that.

Robert Hoffman (33:48):

I was a chemical analyst in my previous life.

Andrew Korz (33:51):

That was not on my podcast bingo cards. So quickly on real estate and inflation, you're absolutely right that generally speaking, it's seen as sort of hedge. And that's a complicated topic certainly, and it has a mixed history if we look back over the decades.

Andrew Korz (34:14):

But you can generally think of owning a property as sort of a hybrid between a bond and a stock where you do have an element of contract, somewhat stable and consistent income, which gives it a bond-like attribute. And at the same time you also have, depending on the strength of the economy, you could have vacancy rates on a property go up or down based on the local economy. You could have contract rents obviously go up or down based on the strength of the sector. And that gives it this equity quality where you have some variation or uncertainty in terms of the income that you're getting.

Andrew Korz (35:03):

So, it acts as a hybrid between the two. And I think the nice thing about real estate is that generally speaking, properties are able to raise rents when inflation comes and inflation can push up prices on Capex items which obviously certain properties need more than others. Certainly, it can increase interest rates which can increase the debt service for the property owners.

Andrew Korz (35:31):

So as inflation comes up, the idea is that property owner is able to increase rents to keep up with inflation. And therefore, property values can continue to deliver positive real returns over inflation.

Andrew Korz (35:46):

Now again, we certainly have seen some differing outcomes in this sphere. In the 1970s and '80s, theory prices and rents were highly correlated to inflation. So if you look at the chart during the '70s and '80s, we obviously had much higher inflation than we've seen recently. Property values broadly kept up with inflation and actually values went up in real terms.

Andrew Korz (36:14):

Over the past 20 or 30 years, we haven't seen the same type of inflationary periods that we saw in the '70s and the '80s, so it's a bit more nuanced. But if you do look at a time series over the past 20 years, commercial real estate rents, broad national rent levels are 0.34 correlated to changes in the CPI.

Andrew Korz (36:38):

So, there's certainly a positive correlation there. It's not so high that there's a one to one, inflation is up 5%, rents are up 5%. It's not necessarily that one to one and certainly there are differences in terms of different property sectors. But broadly speaking over history, there has been some positive correlation between rents and ultimately property prices and inflation levels.

Andrew Korz (37:03):

The other part of that is that we're really seeing this right now with input prices with wages. As inflation goes up, you tend to see input prices obviously and potentially wages coming up which makes constructing new buildings more expensive. And so you had this stabilizing effect where the higher costs to construct a building result in lower supply and therefore, boost the value of existing properties.

Andrew Korz (37:35):

So that's sort of how we see commercial real estate and it's acting as an inflation hedge. And then the one other thing I wanted to point out was along Lara's points about potentially seeing an inflation mini cycle. One thing that I'm really watching is apartment rents. And they've really diverged from house prices. So, we've seen this huge surge in house prices. They're up almost 15% year-over-year.

Andrew Korz (38:03):

And generally, if you look at the chart, apartment rents have really been highly correlated to housing prices over history. That is totally diverged over the past year. We've seen the rent part of the CPI, has risen 2% year-over-year. That's the lowest since the wake of the financial crisis. At the same time, the housing prices are absolutely skyrocketing.

Andrew Korz (38:29):

If we look at rent of apartments and what they call owner's equivalent rent which is basically how they calculate the cost of housing and the CPI, those two combined to comprise 30% of the CPI. I think something has to give at some point. Either you're going to see housing prices come back down, or you have to see rents tick back up. I don't think we can have this environment that we're in now where rents are so low and housing prices are still skyrocketing.

Andrew Korz (39:03):

So that's something I'm really watching from a broad macro inflation perspective. You do have this giant chunk of the CPI that's related to shelter and right now, there is just this giant divergence that I think something is got to give there. So that's sort of how I'm looking at commercial real estate and its connection to inflation.

Kara O'Halloran (39:27):

So, we're all paying very close attention to inflation in the next quarter, but I have to bring back the sports analogy one more time. I'm from Philly. We love an underdog. So, what is one dark horse thing

that you're all watching that's not inflation? And we're going to keep it quick. If I had a whistle, I would call you on time. So, lightning round.

Kara O'Halloran (39:46):

Lara, you can kick us off again.

Lara Rhame (39:47):

Sure. I think labor supply, how many people are coming back into the labor force after leaving during the pandemic.

Kara O'Halloran (39:54):

All right. Rob?

Robert Hoffman (39:55):

For credit markets, I would say spreads. Now, it's a little bit of a cop out because spreads are very much related to returns. So, it's like, "What are you looking at in the market?" "The return. If it goes up, things are good. If it goes down, things are bad." But I think that spreads are, it's going to give us a good indication of you can get these periods of time where the equity market is freaking out a little bit but the credit markets don't really care. And you can really monitor that through spreads.

Robert Hoffman (40:19):

So, if the equity market sell off but spread stays tight, and credit markets show their resilience because they don't really care about these longer term trends that are more important for equities but less important for credit fundamentals. I think spreads can be a very good predictor or really cue to what's going on within credit markets.

Kara O'Halloran (40:38):

Andrew?

Andrew Korz (40:38):

I think office. And obviously, office is probably the most interesting sector in real estate right now. I'm going to be watching how companies and workers do with some of these hybrid models and I think it impacts other sectors as well. Does business travel come back? That's going to be huge for certain markets in terms of the hotel sector. It's going to be big for urban apartments as well. If young people don't have to come into the office, they won't be quite as keen on living in super expensive urban apartment buildings.

Andrew Korz (41:17):

So, I think the office sector right now and the work culture is the biggest thing to watch for me.

Kara O'Halloran (41:24):

Perfect. You're about to get cut off on time but we all did it.

Andrew Korz (41:28):

Play off music.

Kara O'Halloran (41:30):

Lara wins that round. She followed directions very-

Lara Rhame (41:35):

I got to make my answers longer.

Andrew Korz (41:37):

Lara really doesn't like to talk.

Kara O'Halloran (41:40):

Thank you all so much for joining me. All of our Q3 outlooks will be posted on FSinvestments.com, so be sure to check them out. And we will back shortly to wrap up the year, which is crazy. But thanks all.

Robert Hoffman (41:52):

Great. Take care.

Andrew Korz (41:52):

Great. Take care.

Lara Rhame (41:54):

Bye.

Announcer (42:02):

This podcast is brought to you by FS Investments. If you found this helpful, subscribe to get new episodes as soon as they're available.