6 May 2022

LONDON'S BACK

The past two years have been trying times for gateway cities. These places are driven by economies of agglomeration; their greatest virtues stem from the millions of people that they manage to bring together. Thus, the world's response to the pandemic—almost two years of social distancing of varying degrees of intensity—cut against almost everything that makes gateway cities great in the first place. As much as we complain about road traffic, restaurant queues, and sidewalk congestion, these problems are relatively good ones for a city to have. As the pandemic has reminded us, the alternative is far worse.

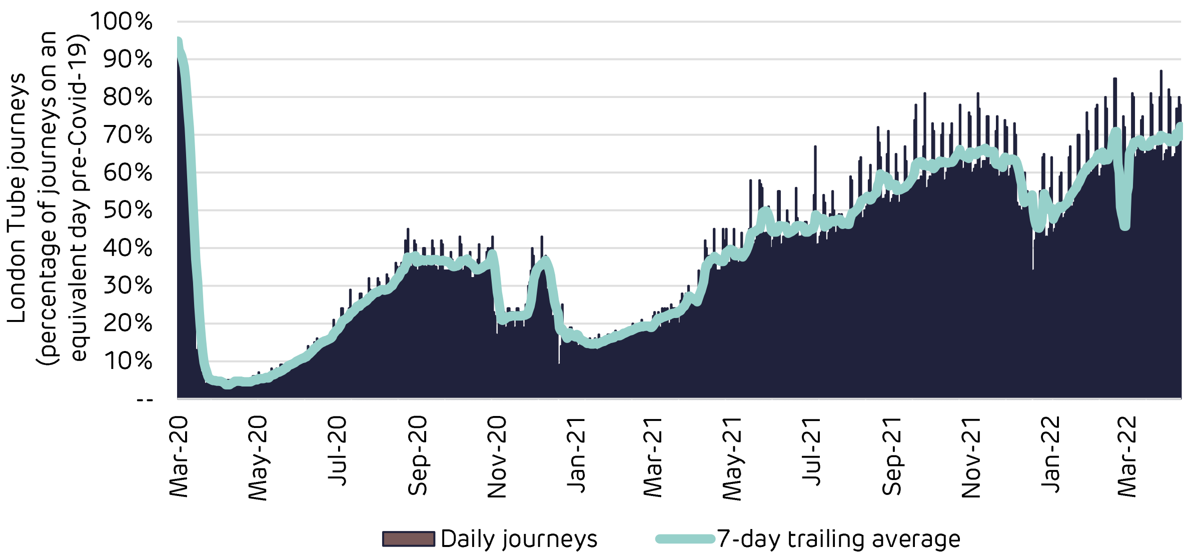
With that lesson in mind, in the last few months, we've felt a sense of relief to once again find ourselves crammed between standing passengers on morning commutes. Indeed, everyday life in London has returned to normality at last. Tube stations and bus stops are packed during rush hour (except on Fridays), and restaurants in our (office) neighbourhood in Fitzrovia have queues out the door during lunchtime. London is back. (See Figure 2 below.)

Our own experiences are corroborated by a few interesting data points.

First, Bloomberg's "Pret Index", which tracks sales at Pret A Manger cafes in various locations around the world, provides a good illustration of how far London's recovery has come. By early April, sales at cafes in London's West End stood at 97% of pre-Covid levels. Sales in Transport for London stations reached 96% of pre-pandemic levels, and sales in the City had reached 81%. Remarkably, Pret sales in London's airports exceeded pre-Covid levels by 20%. London also compares favourably to other major cities by this measure: sales in Hong Kong and downtown Manhattan remained, respectively, at 28% and 59% of pre-pandemic levels.

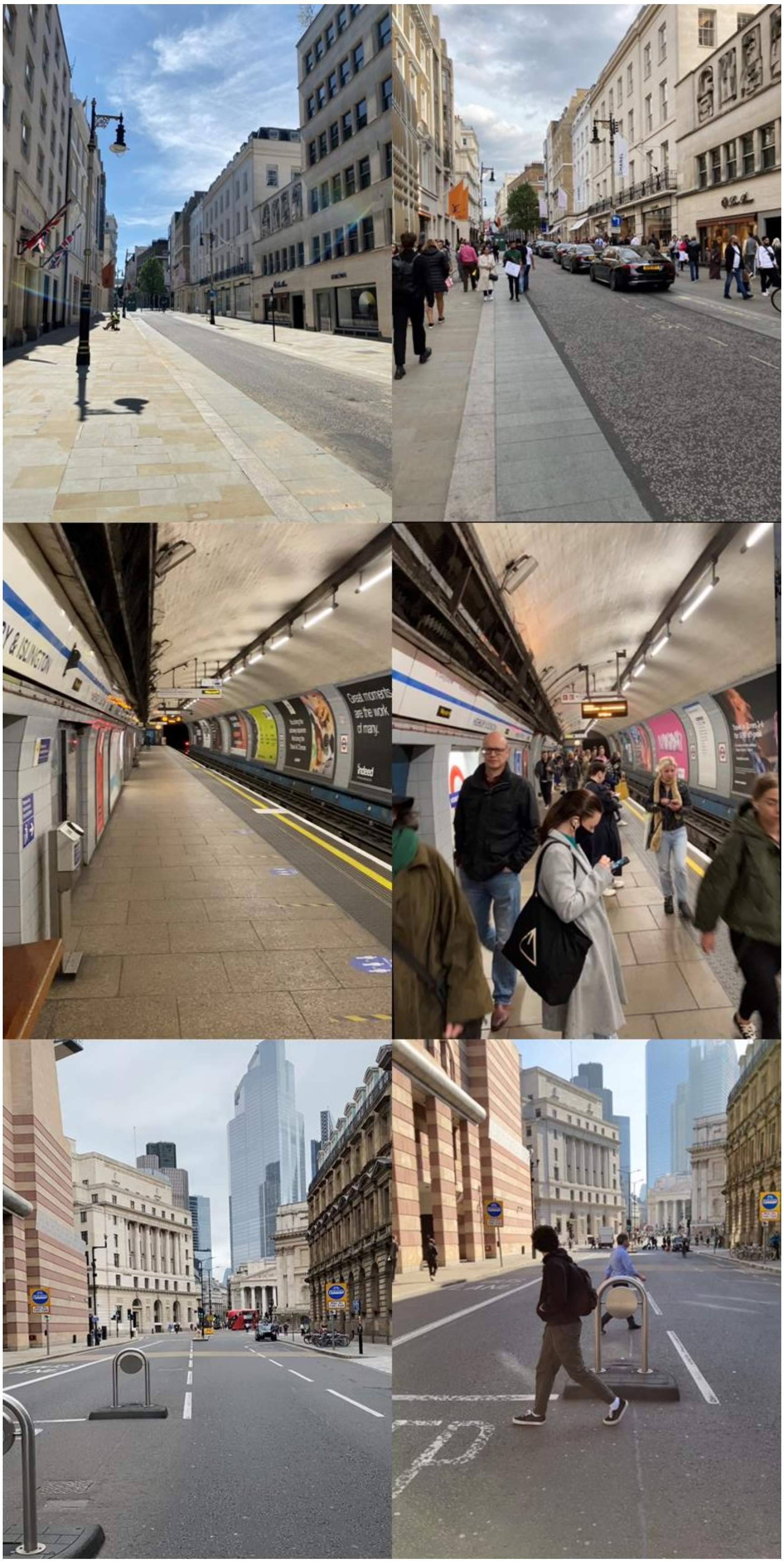
Second, as shown in Figure 1 below, official statistics indicate that the Tube is busy again, too. In recent weeks, Tube journeys (on a weekly average basis) surpassed 70% of their pre-pandemic levels. When you adjust for changed work patterns by looking only at weekend journeys, that figure fluctuates between 70% and 90%.

Figure 1. Daily Tube journeys have nearly recovered to pre-pandemic levels[1]



[1] ONS

Figure 2. Spot the difference: a workday in London, 2020 vs. 2022



FLARES, BOHO AND INFLATION: THE 70S ARE BACK AGAIN

How we got here

After a decade of chronic underemployment and cramped economic growth, it's not surprising that advanced economies had mostly forgotten what high inflation felt like. Memories are short, and other macroeconomic problems loomed much larger during these years. As high-income countries clawed their ways out of the Global Financial Crisis, their economies never approached conditions that anybody could have characterised as "overheated". Instead, most economic recoveries were tepid and drawn-out, consuming the better part of the twenty-first century's second decade.

In many places, low inflation was part of this package of broader economic malaise. From 2010 to 2019, annual inflation averaged 1.8% in the US and 1.4% in the Euro Area. In the decade before the GFC, from 1997 to 2006, annual inflation averaged 2.5% in the US and 2.0% in the Euro Area.[2] (The 1980s, by comparison, saw annual rates of inflation of 5.8% on average in the US.) Price levels were probably suppressed by several different forces in the last decade, including weak demand, itself a product of lacklustre structural growth. Ultimately, this was a period of so-called "secular stagnation": advanced economies confronted persistent shortfalls in aggregate demand, which could not be remediated by (further) interest rate cuts and which resulted in below-potential output levels. In theory, this condition was deflationary—weak aggregate demand should tend to constrain upward pressures on aggregate price levels—and the actual history of this period appeared to confirm as much.

Thus, when policymakers scrambled to insulate their economies from the effects of the pandemic, excess inflation struck them as a palatable risk that probably wouldn't materialise anyway—or, as Jerome Powell said in January 2021, "far away and unlikely". Eyeing the history of the last decade, Powell worried instead about the "serious risks to the economy" posed by "inflation that is persistently too low". Advanced economies, he (and many others) believed, were threatened by too much slack, not too much tightness. As Charles Evans, the president of the Federal Reserve Bank of Chicago, commented in March 2021: "This isn't the 70s. We've had trouble getting inflation *up*." Evans's remarks capture the paradigm that guided policymakers in the West through the last several years.

Where we are now

Of course, "getting inflation up" has not been a problem for months now. As price levels have pushed higher in the US, the UK, and Europe, it has become increasingly evident that elevated inflation is neither a mere artefact of history nor an obviously "transitory" phenomenon. (In November 2021, Powell told Congress, "I think it's probably a good time to retire that word.") Indeed, the inflationary equilibrium that ruled the first decades of this century was not destined to rule forever, as we suggested in our February 2020 letter ("Lower for Longer, but Lower for... Forever?"). While it remains too early to proclaim the death of that equilibrium, it is clearly dormant today, and we think it could well remain that way for at least a couple of years. In the 1970s, a series of exogenous shocks (including a war that set off disruptions in global energy markets) collided with pre-existing structural and demographic trends and imprudent policy choices to bring about significantly higher inflation in the medium term. Evans is right that we are no longer in the 1970s. Still, that decade and the present moment resemble each other in ways that we find increasingly difficult to ignore.

Start with the latest exogenous shock to the world economy: the outbreak of war in Ukraine. Over the last two months, the war has sent commodity prices soaring, especially in the UK and Europe.

[2] The UK is somewhat of a special case: inflation there averaged 2.1% from 2010 to 2019 and 1.7% from 1997 to 2006. The depreciation of the pound during most recent decade contributed to higher import prices in the UK.

European energy markets—which had already witnessed a year of steep price increases—have been hit particularly hard by the fighting in Ukraine, largely due to Russia's status as the world's largest exporter of natural gas. European natural gas prices have increased by a factor of five year-on-year and about 30% year-to-date. Many other commodities have seen prices spike, too. Combined with additional pressures on price levels, including tighter labour markets and an outpouring of pent-up demand accumulated during the pandemic, higher commodity prices have pushed up broad-based measures of inflation in virtually all advanced economies. The latest figures, taken in March, indicate that annual inflation has reached 7.5% in the Euro Area, 7.0% in the UK, and 8.5% in the US. Even in Japan, the paragon of deflationary stagnation, inflation is projected to approach 2% later this year. (From 2000 to 2019, Japan averaged 0.1% annual inflation.)

The critical question now is whether these conditions will last. While some observers continue to hold out hope that price levels will cool off once supply chains normalise and energy prices stabilise, there are reasons to think that advanced economies will continue to see elevated levels of inflation, even after the most visible inflationary pressures of the present moment recede.

Where we're heading

First, looking at the medium term, we think it's worth remembering that even a one-off increase in sector-specific prices may result in a sustained period of broad-based inflation. As producers (of all types of goods) respond to higher input costs by raising prices, workers may move to offset higher living costs by raising their own prices (i.e., demanding higher wages). Higher wages should then boost demand, leading producers to implement further price increases. Yet that would mean even higher living costs for workers, who would again demand higher wages in turn. As this cycle repeats and inflationary expectations move higher, price levels would spiral upwards, until some shock or policy intervention interrupts. Though it remains contested, many economists reckon that the inflation of the 1970s was ignited by this type of dynamic.

It is far from clear that the current situation will follow a similar trajectory. A great deal hangs on policy choices. Central bankers now seem worried enough about inflation that they will probably try to avoid the mistakes made in the 1970s by their predecessors, who refused to tighten monetary policy until it was much too late. (This was partly due to their fears about the downturn that such a tightening would likely cause.) But whether central bankers will actually manage to act quickly and forcefully enough remains an open question. Either way, it's not reassuring that the main barrier standing between our current situation and truly rampant inflation is a policy regime that would, by design, curb growth and potentially trigger a recession.

Looking even further ahead, we think inflation could remain elevated (relative to the previous decade's levels) for structural reasons: insofar as the low-inflation equilibrium of the last decade was driven by stunted aggregate demand, as the secular stagnation theory posits, that equilibrium could be entering its final days. Several forces are likely to pull up demand in the next few decades.

Most significantly, governments and corporations are increasingly committed to phasing out fossil fuels and replacing them with carbon-free energy sources. This transition will require a tremendous amount of investment. A recent study by McKinsey figures that it would cost the world $3.5 trillion per year in additional capital spending on energy and land-use systems over the next 30 years to achieve net-zero status by 2050. ($3.5 trillion represents 4% of global GDP in 2019.) It remains unclear whether governments will actually undertake all of the necessary investments to attain this goal, but it looks increasingly likely that many will try. As spending on the energy transition accelerates in the next decade, inflationary pressures should further intensify.

Spending is set to increase in other domains, too, including defence and manufacturing infrastructure. The Biden administration's annual budget proposal for 2023 calls for $773bn in discretionary funding for the Department of Defense, a 9.8% ($69bn) increase on the amount spent in 2021. Uncharacteristically, even Germany has now pledged to allocate €100bn to a special defence fund aimed at bolstering its military. These sums are themselves significant, but their real importance lies in what they signal. As economic power and military might become less concentrated in the hands of a few Western superpowers, and as a more multipolar world order therefore emerges, we will likely confront a more volatile and hostile geopolitical environment than the one that has prevailed since the fall of the Soviet Union. That type of environment will inspire greater investment in military capabilities by governments aiming to reinforce national security. It will also inspire greater investment in domestic production infrastructure by private firms seeking resilient supply chains. These efforts appear to have already begun. As they continue, they will tend to be inflationary, too.

Inflation may not stay quite as high as it is today for very long. Even if inflation in advanced economies falls from its current levels, though, it could nonetheless settle somewhere well above the sub-2% rates that were typical in the last two decades. This would represent a major departure from the status quo to which we have all grown accustomed. Investors, businesses, and policymakers will all need to adapt.

HOTELS IN THE AGE OF HYBRID WORKING

The internet has already changed the lodging sector in meaningful ways. Hotel websites made it easier for customers to transact directly with sellers. Online travel agencies (OTAs) allowed buyers to sort thousands of competing products and compare prices. Airbnb pulled millions of new suppliers into the market, and pricing algorithms helped operators squeeze more revenue out of their rooms. Yet amid all that innovation, the industry's core product—the hotel room itself—was left fundamentally unchanged by the internet. Such a change is now overdue, and we think that aparthotels suggest a path forward.

The rise of remote work

Workplace practices are evolving in ways that permit both business and leisure travellers to stay at their destinations for longer durations. This is directly tied to the rise of remote work. Within the last two years, two developments converged: (1) the internet made it possible to work remotely, and (2) the pandemic brought about the actual adoption of remote work. Together, these changes will tend to reduce the number of work hours spent in office buildings and increase the number of work hours spent in other physical spaces, including homes and data centres (in a certain sense)—and perhaps also aparthotels.

Over the last decade, new information technologies have made it vastly easier for white-collar workers to communicate and collaborate without being physically co-located. Perhaps most importantly, cloud computing, mobile broadband and high-powered mobile devices have enabled workers located anywhere to share and retrieve digital files as long as they have an internet connection. As companies abandon on-premises servers and move to the cloud, their workforces are no longer chained to particular workplaces. (This is partly why office tenants are demanding more flexible leases.) In addition, mobile phones have largely replaced landlines, and many meetings are conducted via increasingly high-quality videoconferences, with participants sitting thousands of miles apart. In short, internet-enabled information technologies have given rise to a world where many workers can do their jobs without spending five days a week in the office.

Although technology made remote work possible in the first place, the pandemic actualised that possibility by changing organisational cultures and normalising remote work, at least on a hybrid basis. This shift is likely to last, partly because most workers do not want to return to offices full-time. A recent survey of 10,000 white-collar workers found that 86% want to permanently work from home at least two days per week.[3] Employers are now coming around to this idea, too. According to research by the economists Jose Maria Barrero, Nicholas Bloom, and Steven Davis, about 40% of all paid workdays in the US (including those of workers who cannot work from home) are currently remote. This level has stayed roughly flat throughout the past year, suggesting that the ebb and flow of the virus is no longer the main force dictating work-from-home patterns. Barrero expects the post-pandemic remote work equilibrium to settle somewhere between 30% and 40% of total workdays.[4] No matter where exactly that equilibrium ultimately settles, it is clear that remote work is here to stay in at least some capacity.

Longer stays will require a different type of hotel product

The rise of hybrid work is likely to have a lasting impact on the lodging industry. As white-collar workers spend more workdays outside the office, leisure trips and business trips could both become longer. We think that aparthotels are well placed to meet the specific demands that lengthier stays would generate.

Start with leisure trips. As white-collar workers continue to work remotely at least two days per week, trips that would previously have spanned a single weekend could easily be stretched to six-night vacations, with travellers working from "home" in their vacation destinations for two days on each end. These "hybrid tourists" will want a non-traditional hotel experience. Since they will be working during large portions of their stays, hybrid tourists will spend more time in their hotel rooms than conventional vacationers do. As a result, at the margin, they will probably care more about room size than high-touch services. More broadly, to the extent that hybrid tourists will maintain their regular work lives during their travels, we would expect them to demand the sorts of practical conveniences that they would enjoy at home, not the amenities provided by conventional hotels. Aparthotels cater to precisely these demands.

Business travellers could also embrace longer stays. Provided that some fixed total amount of travel must be done in the first place, it is considerably more efficient for business travellers to take fewer, but longer, trips. This tends to lower the frictional cost (not to mention the carbon footprint) of travel by reducing the amount of time and money spent on transportation. In the past, these efficiencies could not be captured easily: it was too disruptive for employees to spend long periods of time away from the main office. Remote work has changed this. As companies adjust their travel policies to capture these efficiencies, business trips should grow longer. Thus, business travellers may increasingly demand the same amenities that hybrid tourists will want: spacious, remote-work-friendly rooms. Again, aparthotels specifically cater to this type of demand.

Finally, supply-driven considerations should also make the aparthotel model increasingly attractive to operators and investors in the coming several years. In the past year, labour shortages have posed challenges to many conventional hotel operators: 47% of European operators reported that they have had to "reduce service levels to cope" with "staff availability issues".[5] Aparthotel operators also struggled with labour shortages, but only 17% have had to adapt by reducing service levels. That gap is largely explained by the fact that aparthotels provide lower-touch, and therefore less labour-intensive, service levels in the first place. This could represent an increasingly powerful advantage going forward.

[3] https://www.bloomberg.com/news/articles/2022-02-14/just-3-of-white-collar-workers-want-a-full-office-return
[4] https://www.bloomberg.com/news/articles/2022-01-18/work-from-home-is-becoming-a-permanent-part-of-how-jobs-are-done
[5] Savills

Labour markets in advanced economies could well remain tight for the foreseeable future. Aggravated by Brexit, the service-sector labour market in the UK is particularly constrained, with government statistics now indicating 400,000 hospitality job vacancies. To recruit workers, service-sector employers will inevitably raise wages, passing higher input costs along to consumers as much as possible. Conventional hotels, with their greater labour requirements, will probably need to raise rates more than aparthotels. Meanwhile, as inflation erodes real wages, budget-conscious travellers may look for cheaper lodging options. Even regular travellers, with established brand loyalties, may be willing to try new products to save money. That bodes well for upstart aparthotel operators.

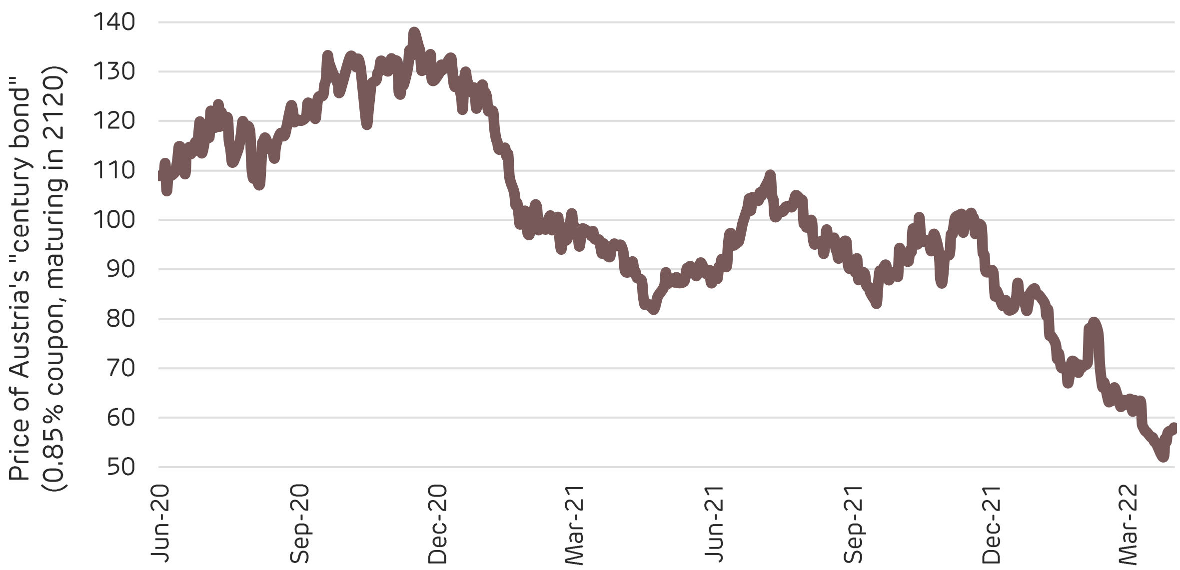
INFLATION PREPARATION

Mike was in the US with his family for the holiday break, and on a last-minute drive to the store, was picking up a couple of missed items off the Christmas dinner list. Naturally, he went to Publix. After picking up the customary free cookie for his son, Mike headed to the checkout knowing full well that regardless of what items he picked up there was no escaping Publix for less than $100 (the same logic applies to Target, for that matter). Baking soda? 100 bucks. Two bottles of wine? 100 bucks. Half year's worth of groceries? 100 bucks. You can therefore understand Mike's mix of consternation and disbelief in realising that 150 is simply the new 100.

As we discussed in the second section of this letter, inflation and higher interest rates are showing up everywhere, and it's all quite a shock compared to what we've all become used to over the past decade. As price levels continue to rise, investors must figure out how to adapt their portfolios to weather the storm.

Inflation has a complicated and mixed relationship with real estate performance, so rather than wade into the already full debate, we instead wanted to reiterate why we think our portfolio and our thematic strategies are well-placed to outperform during such a period of higher-than-expected inflation. We also noted in previous reports that interest rate increases would cause a considerable amount of pain in assets of particularly long duration. After all, "a lot can happen in Austria in a century".

Figure 3. When "lower for longer" takes on a whole new meaning[6]



[6] Borse Frankfurt

So, indeed, we **did** plan[7] for[8] this[9].

In our flexible office investments (operated by our platform company, Clockwise), higher inflation will probably translate into higher operating costs, just like it will for virtually all other companies. However, our flexible office business model—which involves month-to-month contracts, with rates re-set on an annual basis—enables us to pass along higher operating costs onto our customers, at least in part, especially given that we supply a product that tenants regard as critical to their operations. In fact, we have successfully increased desk rates in several of our office buildings within the last few months over and above inflationary cost increases.

Our residential investments (operated by our platform company, Ocasa) are also positioned to withstand inflation. Our products cater to middle-income workers, who are particularly likely to see meaningful wage growth during a period of high inflation. Current labour market conditions in the UK are, by recent historical standards, extremely tight at the low to mid end of the income distribution. Indeed, the bottom half of earners in the UK saw their wages increase by 4-7% year-on-year in 2021, while top-decile earners saw zero nominal wage growth; in 2017, wages for both groups increased by about 3%. This could be a signal that the coming years will help to reverse previous decades of an increasing share of national income accruing to top earners. All told, if broader inflationary pressures continue to push up wages for Ocasa's tenants, we should be able to help offset our higher operating costs by matching annually the rising price levels with rent.

Similar considerations apply to tenants that occupy best-in-class office buildings in gateway cities like London, even if leases aren't short in duration. As we have discussed in previous letters, in recent years, rent costs have reduced to a small fraction of a prime-office tenant's employee outlays (typically 5-10%). High-quality office space plays an important role in helping occupiers attract and retain high-value workers, and blue-chip tenants are unlikely to jeopardise valuable human capital to avoid the comparatively trivial costs imposed by slightly higher rents. The best rents at Liverpool Street Station are now over £90 per square foot, a level that had previously been reserved for Mayfair. We believe that prime-office tenants will tolerate modest, inflation-driven increases in rents, especially when those increases are tied to overall growth in the cost of building materials.

Overall, as we look ahead to our next fund, investors will be focused on investing in ways to help shield them from the negative effects of inflation and increased interest rates over the coming years. We believe that by investing in "re-setting real estate" that has "short but sturdy" leases and income is the best way to achieve those goals.

[7] July 2018. "We should therefore expect the market will start to understand the benefits of owning well-managed and multi-let assets with shorter duration income profiles, in comparison to single-let, long duration assets…"

[8] February 2020. "…contrary to conventional wisdom about interest rates remaining lower for longer, there is an accumulation of evidence that also supports inflationary pressures in the near to medium term. As a result, we have been focused on creating high cash flow yields in our assets while continuing to develop the operational capacity required to manage high-quality, short-duration income that grows if we see these inflationary pressures come into play."

[9] May 2021. "…if we can position our portfolio to materially outperform in a persistently rising-rate environment, where the prospects of the largest firms and many of today's Tech Leaders looked considerably less rosy, then we will have protected our investors from what we believe to be two large and yet under-appreciated risks over the coming years."

Michael Kovacs

Adam MacLeod

Evan Garnick