

BRIEF | Japan | Intelligent Investment

Inflation and Rents – A Complex Relationship

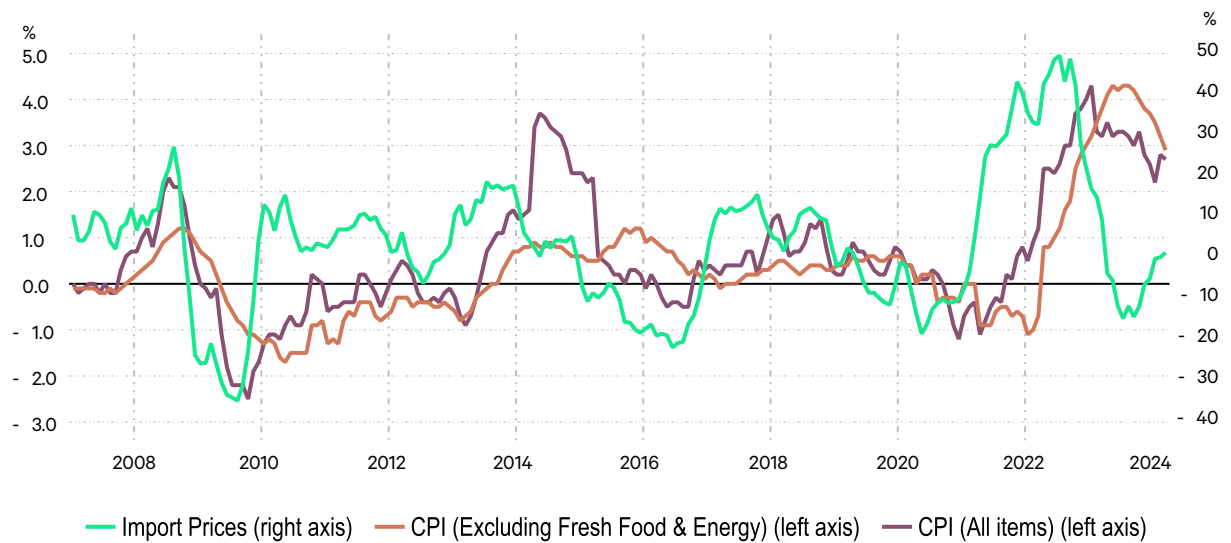
By Hiroshi Okubo, April 2024

Having remained largely stagnant since 2000, logging an annual growth rate of close to 0%, the Japanese Consumer Price Index (CPI) entered a phase of more rapid acceleration in 2022. While inflation has eased somewhat since the start of 2023, the CPI is maintaining y-o-y growth of around 3%. Having targeted a long-term inflation rate of 2%, the Bank of Japan (BoJ) has determined that the current economic situation suggests that this level can be stably maintained, using this as justification to lift its negative interest rate regime at its monetary policy meeting in March 2024. With signs of inflation finally taking root, real estate investors in Japan are now turning their attention to whether inflation may support or enhance rent increases. If the economy enters the phase described by the BoJ as “a virtuous cycle” of a gradual rise of wages and prices, rent growth may potentially exceed the level seen in the past. However, the commercial real estate market is likely to be more significantly affected by shifts in the supply-demand balance of each sector, triggered by supply trends and/or structural changes. This projection is underscored by the trends already observed in the commercial property markets of other countries which have been dealing with levels of inflation exceeding those seen in Japan for a significant length of time.

1. Inflation in Japan reaches highest level in 30 years

Annual inflation in Japan remained below 1% between 1993 and 2021. However, increased fuel prices triggered by supply shortages due to the advent of the COVID-19 pandemic, combined with a steadily weakening yen, saw import prices spike sharply in 2021. In tandem with the resumption of economic activity following the relaxation of measures to contain the pandemic, these factors led to corporations passing on their increased costs in the form of higher prices for goods, resulting in a rise in the consumer price index, albeit somewhat delayed by the increase in import prices. The CPI rose by 3% in October 2022, the sharpest increase for 31 years (excluding months immediately following consumption tax hikes) (Figure 1).

Figure 1: Price trends in Japan



Source: Macrobond. CBRE, April 2024.

Higher inflation rates have also led to higher wages. The “shunto” spring labor negotiation in 2023 saw the Japanese Trade Union Confederation win an average wage increase across all sectors of 3.58%, the highest figure for nearly 30 years. 2024 looks set to top that, with the second announcement of negotiations producing a figure of 5.25%. This sharp increase played a significant role in influencing the BoJ to lift its negative interest rate policy at its monetary policy meeting on March 18th/19th. BoJ governor Kazuo Ueda explained the reasoning behind the decision to lift the negative interest rate policy in a press conference held directly

following the meeting, stating that it “assessed the virtuous cycle between wages and prices, and judged it came in sight that the price stability target of 2 percent would be achieved in a sustainable and stable manner.”

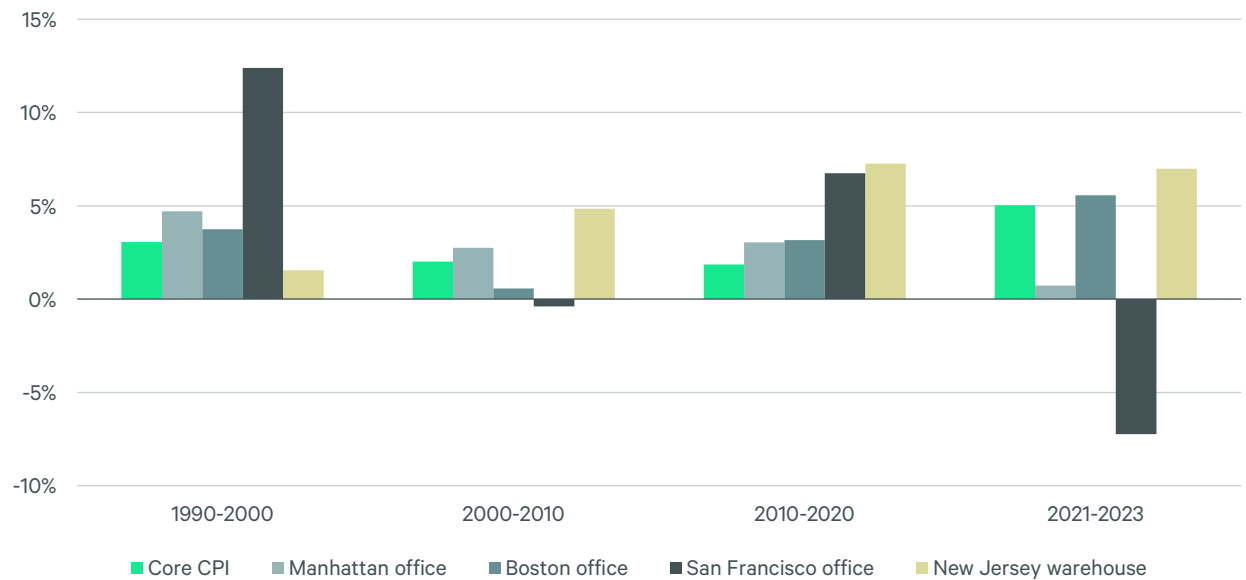
In response to the broadening view that Japan should be able to achieve a stable level of inflation, many in the commercial real estate industry have begun to ask whether this would have any impact on rents.

2. The relationship between inflation and rents in the U.S.

An oft-repeated claim in Japan is that real estate investment is seen in overseas as a hedge against inflation. However, even in overseas markets, there is no consensus as to whether real estate investment functions as an inflation hedge. The fact that most lease contracts in Western countries allow for upward-only adjustment of rents certainly makes rent hikes more common than in Japan. Nevertheless, it is far from guaranteed that rent increases will outpace inflation. An analysis of trends in rents for offices and logistics facilities in the U.S. over the past few decades reveals that no ironclad law governs the extent to which rents rise. Even within the same asset type, rents sometimes outstrip inflation only in certain areas, and even within the same geographical areas, rents sometimes only outstrip inflation in certain periods (Figure 2). This suggests that rather than macroeconomic factors represented by inflation rates, rents are influenced more significantly by the local supply-demand balance caused by, for example, the scale of new supply, strong/sluggish local economic growth, or the structural changes within each property sector, etc. For example, the skyrocketing rents for San Francisco offices observed during the 1990s, which far exceeded CPI, were due largely to the effects of the late-90s dot-com bubble. In contrast, the drop in rents seen for the same offices in the first decade of the 21st century resulted from the bursting of that bubble. The significant surge in warehouse rents observed in the 2010s is likely to have been a result of the expansion of the e-commerce market. While the U.S. (along with other countries) experienced a period of rapid inflation between 2021 and 2023, office rents in Manhattan have not increased by nearly as much as CPI, while those in San Francisco have fallen during the same timeframe. This further underscores the fact that the supply-demand balance of each office market is the key determining factor of rents and, moreover, implies that cost-push inflation, driven by supply restrictions, does not lead directly to rent increases.

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Figure 2: Core CPI in the US and rents by asset type and area



Source: Macrobond, CBRE, April 2024

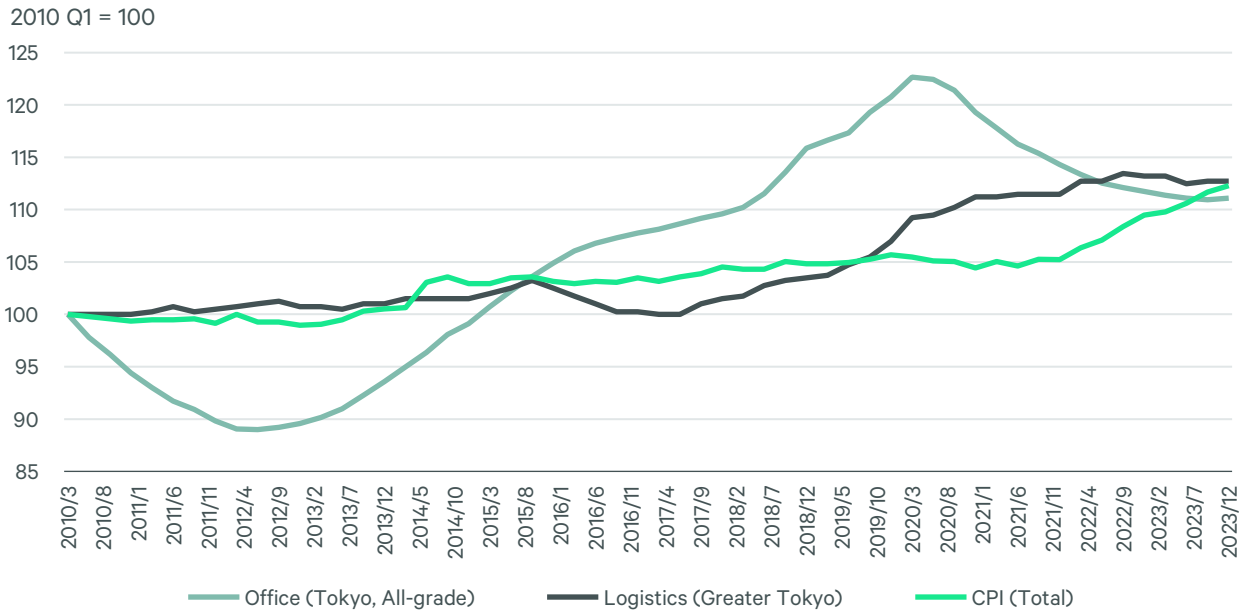
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3. Rent trends for Japanese commercial real estate

CBRE’s analysis of rents for offices and logistics facilities, which are the top two asset types in terms of investment volume in Japan, shows that Tokyo office rents have been decreasing since 2020, and Greater Tokyo logistics rents have seen only a modest rise (Figure 3). These trends have been particularly prominent since 2021, despite the sharp rise seen in CPI. This suggests that in Japan, as was the case in U.S., factors other than inflation are exerting a strong effect on rents. It should also be noted that thus far, the inflation seen in Japan falls squarely within the “cost-push inflation” bracket, driven by rising import prices, including surging fuel costs.

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Figure 3: Office and logistics rents and CPI trends

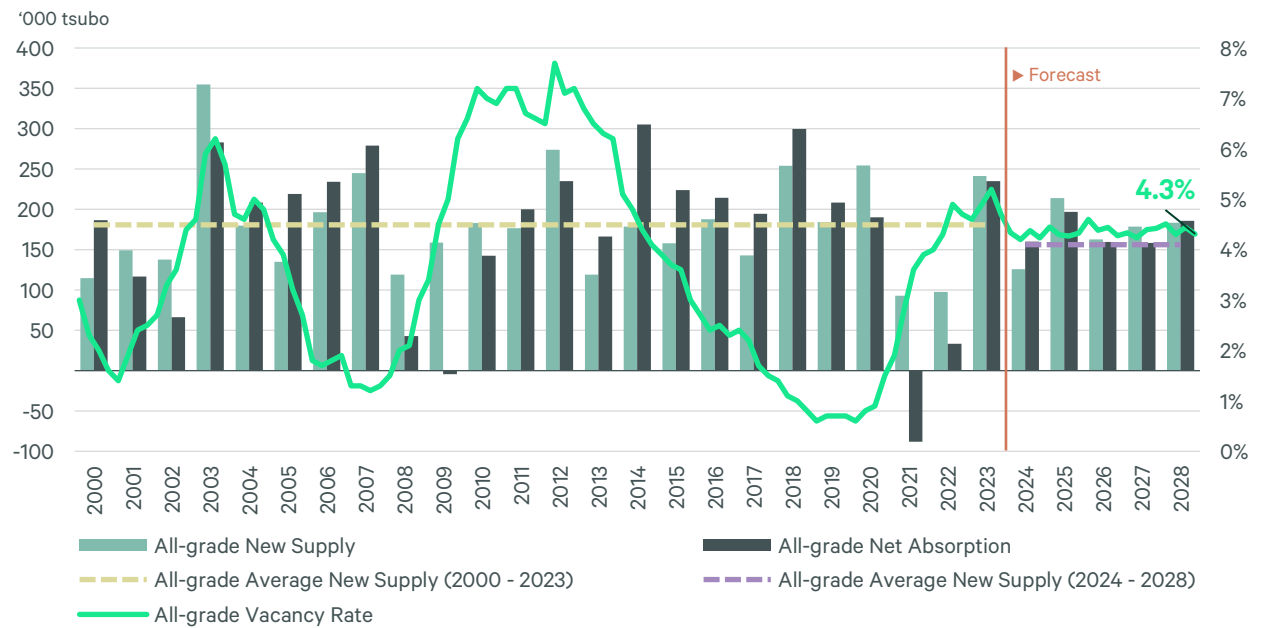


Note: Rents are assumed achievable new rents at each point in time
 Source: Macrobond, CBRE, April 2024

The proliferation of remote working following the onset of the COVID-19 pandemic led to many Tokyo office tenants reducing their floor space. This pushed up the vacancy rate from 2020 onward, causing market rents to decline. Demand for office space recovered strongly in 2023 as workers returned to the office following the end of the pandemic, with several companies that had downsized looking to expand their office space once more. In addition, amidst a very tight labor market, many corporations looked to relocate to offices which would give them a competitive advantage in attracting and retaining employees.

As new supply volume in 2023 outstripped net absorption, however, the vacancy rate has remained high (Figure 4). With significant new supply slated for 2025, the vacancy rate is unlikely to fall significantly in the short term. While the average market rent for Tokyo offices increased in Q4 2023 for the first time in three years, the market has become increasingly polarized, with rents rising in buildings whose vacancies have been filled, but falling in those still saddled with available spaces. This imbalance is a result of the individual specifications of each building in terms of location, age, and facilities, providing further evidence that inflation is far from the sole factor required to drive up market rents.

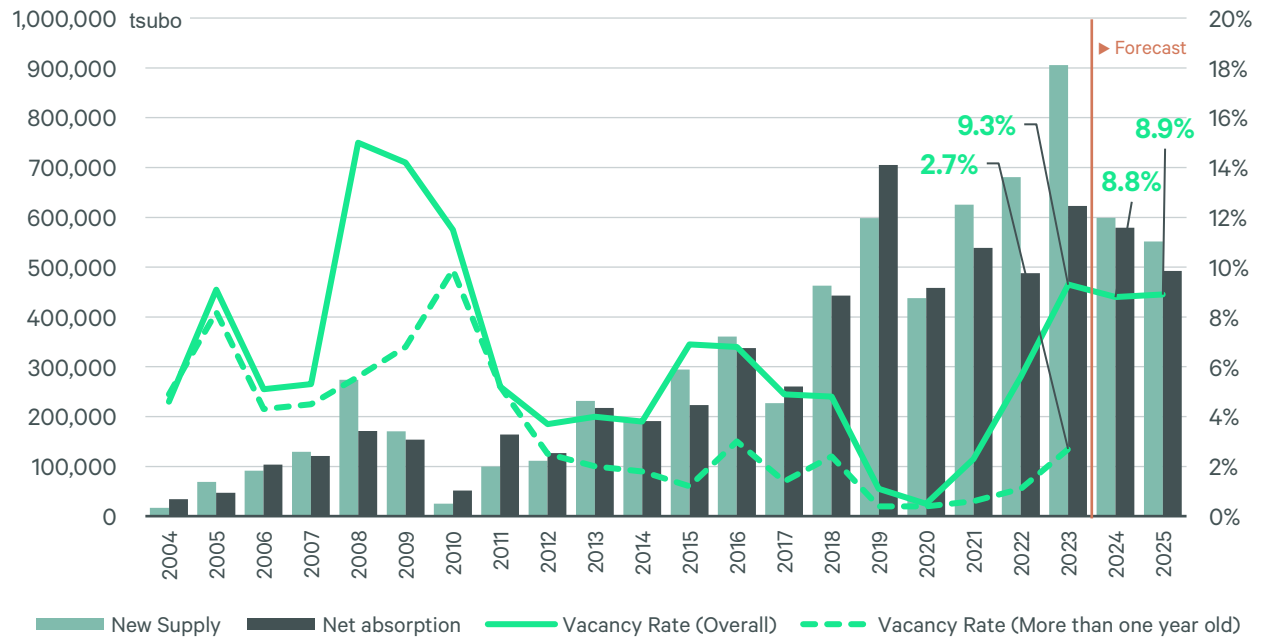
Figure 4: Supply-demand trends in the Tokyo office market



Source: CBRE, April 2024

Occupier demand for logistics facilities also remains robust. With leasing activity continuing to be driven by the expansion of e-commerce platforms and moves to improve the efficiency of logistics networks in response to the “2024 problem”, net absorption in Greater Tokyo in 2023 reached its second-highest level since records began. However, as in the office sector, new logistics supply has exceeded net absorption in Greater Tokyo for three straight years from 2021 to 2023, with further robust supply scheduled in 2024 and 2025 (Figure 5). For this reason, the Greater Tokyo vacancy rate for the logistics sector in the next two years is likely to remain at or around the 9% figure from the end of last year.

Figure 5: Supply-demand trends in the Greater Tokyo logistics market



Source: CBRE, April 2024

4. Office and logistics rents in Japan in an inflationary environment

The Tokyo office market and the Greater Tokyo logistics market are slated to receive new supply that is expected to outstrip net absorption over the next couple of years. For this reason, CBRE forecasts rents to remain largely stable or fall slightly in the short term.

In the event that leasing of this new supply proceeds well and vacancy rates drop, however, and the economy enters the phase of “a virtuous cycle of wages and prices” targeted by the BoJ, rents may potentially be raised at rates that exceed previous levels. For wages and prices to sustain their gradual rise, companies must be able to pass on their increased costs to the consumer in the form of higher costs for products and services. Amid such an economic environment, companies could also be more willing to accept rise in rents than before.

In the case of logistics facilities in particular, rent increases have been limited even amidst a tight demand-supply balance. For example, in 2020, although the vacancy rate for large-scale multi-tenant logistics facilities in Greater Tokyo remained at a historical low of 0.5% for pretty much all year, growth in rent was limited to 3.4% in 2019 and 4.0% in 2020, with the years before and after recording much lower rises. These

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trends reflect an economic environment in which raising rents was extremely difficult, as both consignors and logistics firms sought to restrict costs wherever possible given the difficulty in raising prices for their services and/or products. Should this macroeconomic environment change, however, and regular price hikes become the norm, then rents for logistics facilities, particularly those that meet tenant needs, should also rise consistently. Conversely, if this does not happen, there is a concern that development may stall in areas where modern logistics facilities are still lacking, especially with the construction costs expected to remain high for longer.

Compared to the office sector, the logistics sector may see higher rent increases implemented more quickly. As logistics facilities generally take just 18 months to two years from the start of construction to completion, only properties due to come on stream before the end of 2025 have been more or less confirmed. Plans beyond that point are susceptible to fluctuations in construction costs and the supply-demand balance. The current spike in construction costs will likely result in a shrinking volume of new supply in 2026. If that is the case, then continuing strong demand should suppress vacancy rates and place upward pressure on rents.

On the other hand, office developments tend to be grander in scale, with over 70% of current projects in the pipeline being “large-scale offices”, featuring at least 10,000 tsubo of rental office space. Such developments generally take three years from the start of construction to completion. Furthermore, as most of these large developments are redevelopment projects, they also involve the planned demolition and removal of previous buildings, pushing the total timeline out to between four and five years. This means that most projects due for completion by around 2028 had already commenced construction as of March 2024 and are likely to be completed according to schedule. While CBRE forecasts rents to bottom out in 2026 as new supply eases, the rent increases that follow are unlikely to greatly exceed the previously observed pace. This assertion is based on the robust supply slated for 2027 and beyond, together with the fact that, of the major corporations currently occupying rental office premises, there are several that are waiting for the redevelopment of their own buildings to be completed before leaving. If these factors result in heightened concerns over a loosening of the supply-demand balance, then even stable inflation is unlikely to be enough to drive rents up by any significant margin. As previously mentioned, the Tokyo office market is currently polarized depending on location and specifications. Going forward, regardless of inflation trends, there will likely be buildings where rents will be raised, while there will also be buildings where rents will have to be lowered to attract tenants.

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