The Hotel Yearbook 2023

The Uncertainty New Normal

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Goldilocks recession bodes well for future hospitality investment

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Synopsis
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We have endured the mother of all supply shocks (Covid restrictions followed by a European war) but the economic recovery has been swift and this year looks set to see "normal" economic conditions for the first time since the Global Financial Crisis that hit at the end of 2008.

The inflation monster has, for a generation, been nothing more than a folk memory. But it has now returned, and with it, the traditional tools used to tame it, higher interest rates, have reappeared too.

With money again costing money, that old-fashioned approach of making profits in business is again in fashion. The heady days of investors handing over cash to businesses with a plan of simply growing regardless of profitability are long gone. Outside of the technology industry, this looks like good news.

Since the end of the pandemic lockdowns, most businesses and commentators have underestimated the scale and pace of the recovery. Covid lockdowns created the worst recession ever seen during peacetime but globally the recovery has been almost as quick. In nearly all high-income countries the economies now have a higher economic output than they did at the start of the pandemic in early 2020.

After this phenomenal recovery, there are fears about what happens next. The two most important variables, I would suggest, are interest rates and unemployment. And they will act inversely, if one goes higher than expected, the other will be lower than expected. This makes a severe recession unlikely and ensures we do not have an unexpectedly bullish economy.

Starting with the interest rate and inflation outlook, last year's failures will inform this year's actions. Last year, inflation was higher and more persistent than anticipated and central banks reacted late, only pushing up interest rates once inflation was already close to double digits.

Worse for central banks was the type of inflation. Cost-push inflation, driven by post-Covid supply bottlenecks and then supply shocks caused by Russia's invasion of Ukraine, is notoriously hard to contain via interest rate rises.

The good news is that the cost-push challenges are subsiding. Supply chains are normalising and the surge in energy prices caused by Russia's aggression has largely been mitigated. At the end of December, gas prices dipped below those last seen before Russia's invasion in February.

This drop to under EUR80 per MWh from the high of over EUR300 per MWh is transformational for European energy markets and inflation. Not only is energy no longer inflationary but, because of such record highs, the normalisation of pricing is disinflationary.

Rather than persistent high inflation, it looks probable that there will be a rapid drop in inflation. But the days of zero inflation do not seem likely either.

While some economies may see inflation briefly drop to zero as recession bites – this is likely in the UK for example – the consensus view is inflation holding at around the mid-single digits.

Thus, interest rates must be at a similar mid-single digit level to maintain positive real interest rates. A sharp fall in inflation may cause interest rates to be cut a little, but there appears little likelihood of a return to the ultra-loose monetary conditions enjoyed/endured since the GFC.

One of the most bullish forecasters since the end of Covid lockdowns and the start of the recovery has been the global economics team at Goldman Sachs. While they have moderated their outlook in the wake of supply chain issues and the Ukraine war, they remain at the dovish end of expectations for interest rates, inflation and GDP growth.

The consensus is for the US to enter recession in 2023 but Goldman Sachs believes this will be avoided and the US will have a modest GDP growth of 1%. In contrast, a mild recession is expected for the Euro area and the UK.

Interest rates are expected to peak at 3% for the European Central Bank and 4.5% for the Bank of England. As Goldman comments, the upside risk of more persistent inflation is balanced by the downside risk of a deeper recession.

The trade-off between labour and interest rates was at the heart of an analysis by UBS Asset Management. This firm's publication, Panorama – Investing in 2023, said: "investors may be surprised at the resilience of the global economy in 2023".

The cost-of-living increases have presented big challenges for consumers, but the highest earners have a lot of excess savings which they are prepared to keep spending, particularly on services such as hospitality. UBS pointed out that in the US, 60% of consumer spending is accounted for by the top 40% of earners. This is a ratio that survives the journey across the Atlantic to Europe.

The flip of this optimistic outlook is that interest rates will need to go higher and be kept there longer. The rising cost of debt will be a bigger challenge for real estate investors in 2023 than inflation proved for operators in 2022.

Morgan Stanley, in its 2023 Investment Outlook, thinks higher debt costs will create opportunities for distressed or forced selling. But with USD400bn of undeployed capital on the sidelines, distressed pricing will remain muted.

It is Morgan Stanley's leisure team, however, that captures the paradox at the centre of the current forecasting debate. Despite the gloomy economic outlook, consumers seem willing to keep spending on travel.

"Pretty well all of the data we monitor suggests demand for travel and leisure remains robust," said Morgan Stanley's leisure analysts in a pre-Christmas note. "That the slowdown is not yet obviously here, over six months from the spike in energy and food prices, is somewhat surprising."

And there are positive drivers. Some segments, notably the outbound Asian travel market and the conference market, have yet to hit full stride. The end of the nonsensical zero-Covid policy in China bodes well for these recovery tailwinds to gather strength in 2023 and conferences continue to surge way beyond where sceptics forecast.

The post-Covid recovery has also shown how consumers are prioritising travel and hospitality. Partly this is a result of higher-income earners being the main spenders and least impacted by the cost-of-living increases and partly it is the absence of a meaningful rise in unemployment.

Real estate investors were already moving out of traditional sectors such as office and retail due to sectoral challenges. The resilience of hospitality and the strength of its recovery will bring it further into favour.

There are other tailwinds ahead for hospitality in the medium term. The stalling of development means a boost for existing assets and there has been a significant loss of supply at the bottom end of the market. On this latter point, Whitbread, the UK's largest hotelier, thinks roughly 10% of UK independent hotels have closed since the start of Covid restrictions, meaning that the UK room supply currently stands 4% lower than in 2019.

Much has been made of the change in behaviour towards business travel since the Covid lockdowns. Bill Gates infamously forecast that it would be halved – he has been proved spectacularly wrong, thankfully – but many seasoned observers also believe there is a permanent impairment.

If there has been, it has been remarkably slight. STR data shows that weekday hotel occupancy, the critical period for business travel, was just 4% lower than 2019 comparables in the months of September and October 2022.

In December, STR said about business travel that "further gains are needed to reach pre-pandemic levels". But more bullishly it added: "According to consumers, those gains are on the way with combination business/leisure trips representing the biggest increase."

By most measures, it seems this Goldilocks recession will make the environment for hospitality investment stronger. It is time we sent the bears packing.

Andrew Sangster — Owner and editorial director, Hotel Analyst
Andrew Sangster launched Hotel Analyst almost 20 years ago and it has grown into a publishing business that now encompasses a paid subscription service for hotel investors, a reports division and events. More information on these services can be found at www.hotelanalyst.co.uk and see www.op-re.com for the latest event for investors across the operational real estate sector, the Operational Real Estate Festival.

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Andrew Sangster, a leading financial journalist who has spent his career reporting on the sector, launched his news analysis service almost two decades ago. A decade later and it is viewed as the key title in the real estate investment arena for anyone involved in 'hotelising' their real estate. Sarah Sangster, a Business Psychologist in a past life, came on board to help build the Hotel Analyst brand and business. As well as providing an analytical news and report service, Hotel Analyst provides networking opportunities through events for real estate owners, financiers, advisors, brokers and innovators. HA hosts the Operational Real Estate Festival (OpRE). This event is a platform where investors, owners, financiers, operators, advisers, brokers and innovators come together to form the operational real estate deals of the future. OpRE is an evolution of the Hotel Alternatives Event (HAE) founded by Hotel Analyst in 2015. HA has also become a founder and supporter of the Operational Real Estate Investor Forum (OREIF), an invite-only group for investors and operators.

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