

### Higher Service Costs Shift Tenant Leasing Demand; Tariff Impact Still Forming

**Core momentum signals inflation persistence.** July CPI data showed modest headline price growth, but pressures were more entrenched for core inflation. Overall CPI rose 0.2 percent month over month in July, bringing the annual rate to 2.7 percent; meanwhile, Core CPI increased by 0.3 percent month over month and 3.1 percent year over year. Underlying services inflation points to a stickier price trend that could keep overall inflation elevated. Relatively soft goods inflation suggests that many firms have so far delayed passing tariff costs on to consumers, although some categories have displayed tariff-related increases. If costs begin to filter through further, the combination with higher services inflation could trigger a re-acceleration in prices and complicate the Federal Reserve's timing for a rate cut.

**Service inflation drives diverging tenant trends.** The services-less energy index rose 0.4 percent month over month and 3.6 percent year over year in July as the ISM Services Prices Paid Index reached its highest level since November 2022. Rising input costs and persistent wage growth are driving service prices higher and weighing on sectors with high operating expenses. Discretionary services, such as hospitality and retail, may face greater difficulty passing on higher costs to consumers. In contrast, necessity-oriented tenants and those with lower labor needs are better positioned to absorb rising expenses, reinforcing the investment appeal of assets leased to such operators. Inflation-linked leases will also be important for preserving cash flow. As inflation widens the gap in tenant performance, asset selection will be increasingly critical for commercial real estate investors.

**Quick-service expansion buoyed by cost efficiency.** Food at home prices were up 2.2 percent year over year in July, while food away from home rose 3.9 percent, reflecting pressure from rising labor and input costs. Full-service restaurant prices increased 4.4 percent, compared with 3.3 percent for limited-service establishments, where lower staffing requirements are helping contain expenses. This dynamic should assist quick-service and fast food operators, keeping them more resilient. Meanwhile, full-service restaurants may face greater challenges, particularly those targeting middle-income consumers. The divergence supports ongoing expansion by fast food tenants and should help sustain in-line leasing at high-traffic shopping centers.

#### Medical services rise as new duties threaten higher drug prices.

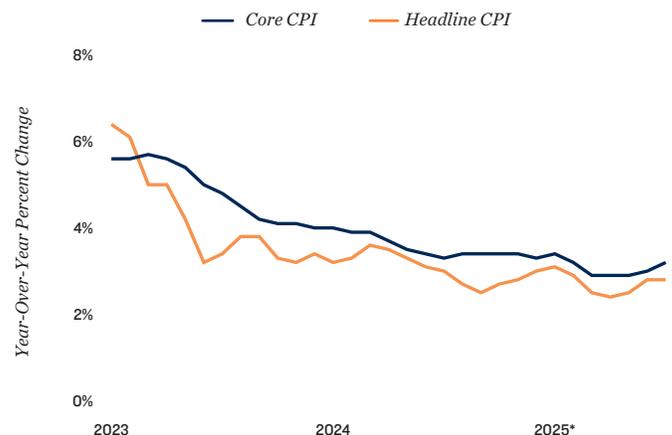
Medical care services rose 0.8 percent month over month in July and 4.3 percent year over year, underscoring sustained wage inflation in the labor-intensive health care sector. Nevertheless, the inelastic demand for most medical services should enable providers to pass on higher labor and business costs to consumers. At the same time, medicinal drug prices declined 0.1 percent on the month and were flat annually, potentially supported by inventory pulled forward in early 2025. Prices may rise as inventories roll over, however, especially with a new 15 percent tariff on pharmaceuticals from the European Union in effect and proposals of up to 150 percent under consideration.

**Tariff headwinds mount.** Many tariff-linked goods, including household furnishings, hardware tools, and video and audio equipment, have seen modest price increases. As inventories turn over, more firms are likely to pass higher costs on to consumers. Tenants with heavy import reliance may shift toward domestic sourcing if available, supporting demand for manufacturing and distribution space. That said, retailers in price-sensitive segments could see slowing sales growth, which may temper expansion plans in the near term.

**2.7%** Increase in Headline CPI Year Over Year

**3.1%** Increase in Core CPI Year Over Year

#### Core Inflation Edges Higher as Headline CPI Holds Steady



\* Through July

Sources: Marcus & Millichap Research Services; Bureau of Labor Statistics; CME Group; CoStar Group, Inc.; Federal Reserve; National Travel and Tourism Office; RealPage, Inc.



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