Prerequisites for property investments remain strong, but location plays an increasingly important role

Macro fundamentals for property have improved during the spring of 2017. Long-term interest rates have fallen since the end of 2016, while leading indicators for the industrial sector signals stronger growth in industrial production and exports for the remainder of 2017. Catella, however, expects this to be a temporary recoil in the market. The property market most likely peaked at the end of 2016 and is currently in a distribution phase, which means that the market is balancing near its peak.

The transaction volume of the Swedish property market reached record levels at the end of 2016 and early 2017, with a rolling 12-month transaction volume of more than SEK 180 billion. However, in April the rolling 12-month transaction volume decreased considerably to SEK 152 billion. This decrease was partly a result of Castellum's acquisition of Norrporten from April 2016 no longer being included in the rolling 12-month volume, but also of uncertainty regarding new tax regulations.

Although we have had transaction volumes at record levels up until March, the market has changed a lot over the past 12–18 months. Since the end of 2015, credit sentiments have worsened (despite an increasingly expansive monetary policy), with increasing credit margins and more limited access to credit among smaller investors that lack a strong track record. At the same time, the market has been fairly one-sided and mainly driven by Swedish private and listed property companies and institutions, all of which prioritise commercial properties in good locations in large cities as well as residential and public properties. Furthermore, several of the listed property companies have upgraded the quality of their portfolios, and there has been clear selling pressure of properties combined with relatively few buyers outside the prioritised locations.

There is a strong correlation over time between average property yields for commercial property transactions and GDP growth as well as long-term interest rates. The correlation with GDP growth is negative and lags approximately one year. In other words, stronger GDP growth during one quarter will signal decreasing property yields four quarters later. The correlation with long-term interest rates is positive and does not lag, meaning that higher long-term interest rates coincide with higher property yields within the same quarter. Sweden's GDP growth peaked in 2015, while lower growth in 2016 combined with higher long-term interest rates coincided with increasing average rolling 12-month property yields (for retail and office properties) from its lowest point of 5.6 per cent in February 2016 to 6.1 per cent in December 2016. This increase was mainly a result of more commercial property transactions being carried out outside the larger cities (in many cases these were poorly performing retail properties).

> "The average rolling 12-month property yield for retail and office property transactions decreased to 5.9 per cent in April.

However, during the spring of 2017, this development appears to have changed. Long-term interest rates have fallen since the end of 2016, while leading indicators for the industrial sector signals stronger growth in industrial production and exports for the remainder of 2017 (which means that GDP growth seems to hold up better than expected). In addition, the inflation figures for March were a disappointment for the Swedish Riksbank, which decided to continue their purchase of assets throughout the second half of 2017. Although access to credit is still limited for smaller actors, these macroeconomic factors push down property yields as well as the yield gap between A, B and C locations. The average rolling 12-month property yield for retail and office property transactions decreased to 5.9 per cent in April, while yields for office properties are back at historically low 5.2 per cent.

Catella expects this to be a temporary recoil in the market. The property market most likely peaked at the end of 2016 and is currently in a distribution phase, which means that the market is balancing near its peak. Since last autumn, the fundamental macroeconomic prerequisites for the property market have changed and there are many indications that the fourth quarter of 2016 was a turning point in the market. During this quarter, it became clear that global inflation and long-term interest rates were no longer steadily moving downwards, and that we would probably see higher rates in the coming years. Furthermore, the Swedish economy reached its full capacity utilisation during 2016, meaning that the country is in the same phase of the economic cycle as the United States and Germany, among others. This means that the growth rate of wages is bound to increase gradually and that GDP growth is moving towards it potential growth rate (which is defined by growth in labour force and productivity). All other things being equal, this means that we are headed towards a combination of slightly higher inflation and a shift down in GDP growth towards approximately 2 per cent. This means that Sweden will move from a 10-year period of strong, domestically-driven GDP growth combined with an imported low inflation and low long-term interest rates, to a macroeconomic environment with weaker GDP growth, higher inflation and somewhat higher long-term interest rates. Although the Riksbank currently pursues a very expansive monetary policy, higher global inflationary pressure will likely result in a less expansive policy over time.

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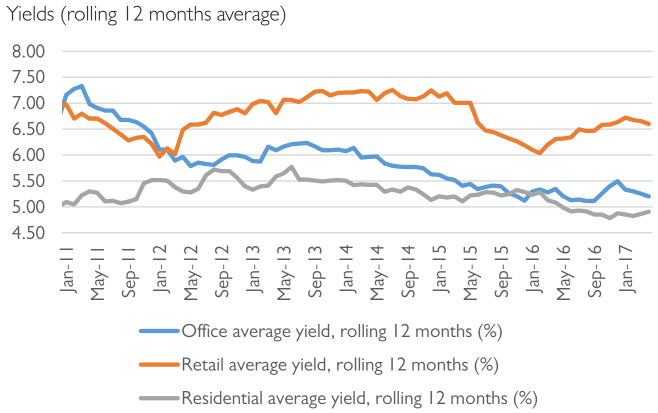
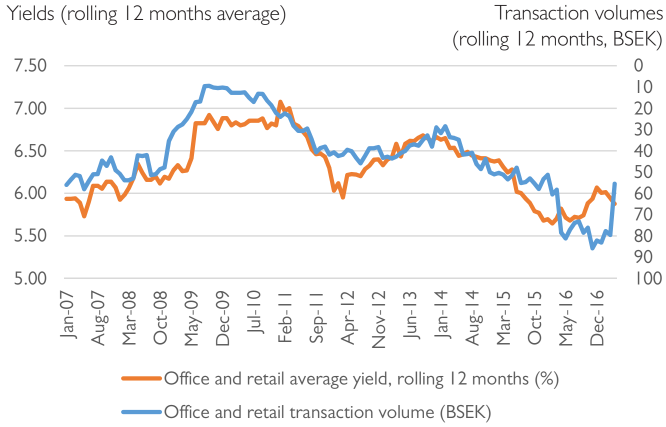
Furthermore, there are indications that Sweden’s growth engines might be slightly different going forward. Private consumption and investments in the housing market have been the driving forces of growth in Sweden in recent years. The Stockholm region alone has generated half of Sweden’s GDP growth since the early 2000s, and the three metropolitan regions have dominated as growth engines. This development is to a large extent a result of increasing housing prices and an expansive monetary policy, as well as increasing household debt. However, as new construction of housing is increasing noticeably at the same time as Sweden’s financial supervisory authority is working towards reducing the growth rate of Swedish household debt, it is not unreasonable to expect stabilising housing prices in the years to come. Moreover, Sweden’s industrial sector is performing well, which will benefit industry-heavy regions that to a significant extent are located outside the larger cities.

The prerequisites for properties remain strong, although going forward the segment will probably not be viewed as the only asset type that can produce stable and attractive returns. It is currently attractive to invest in stable cash flows from commercial properties outside the large cities, where competition is considerably lower than in the large cities. Commercial properties in the best locations in the larger cities as well as residential property and public property in growth cities are also likely to have a good development over time, even though competition and prices for these properties are high at the moment. The most noticeable risk is found in other property types and in other locations. The current rent expectations are perhaps too optimistic for office properties in B and C locations in the larger cities, and the rapidly increasing supply of residences might lead to problems for newly built residential property with high rents in small cities or in less attractive locations in the larger cities.

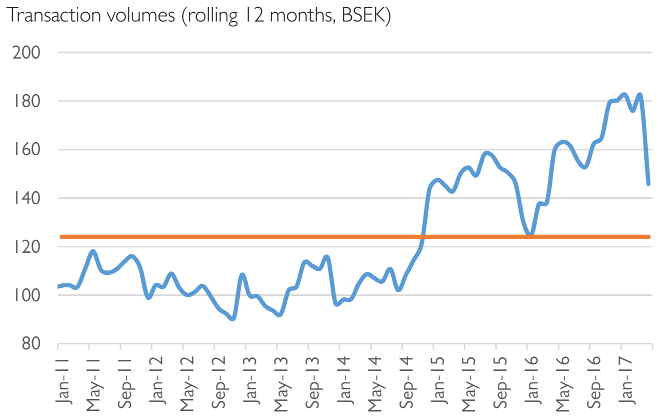
Office, retail and residential yields, rolling 12 months



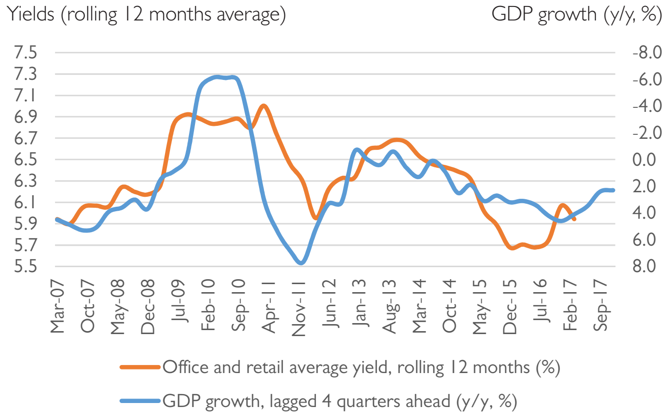
Office and retail yields and transaction volume



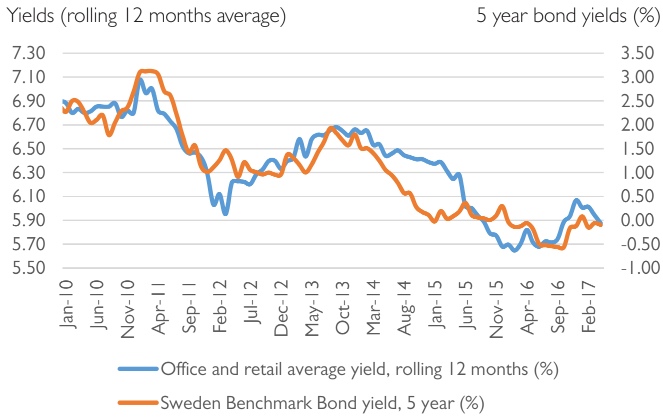
Transaction volume, all market



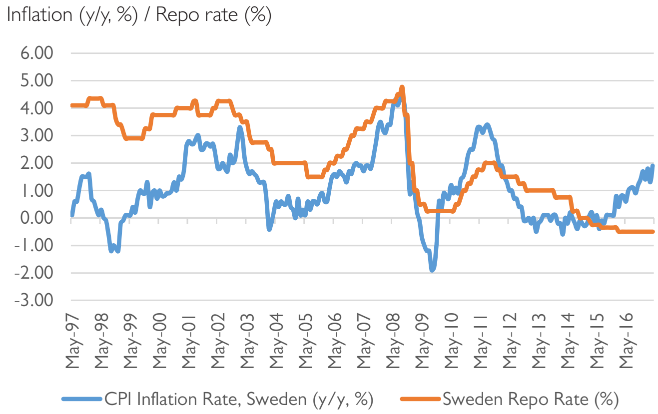
Office and retail yields and GDP growth



Office and retail yields and long-term interest rates



Swedish inflation and the Riksbank's repo rate



Source: Catella and FactSet

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