The strong development for the listed property companies may be an indication that investors are now actively looking for inflation hedges

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The transaction volume ended at SEK 17.5 billion in March, which can be compared to SEK 15 billion and SEK 12.4 billion during the same month in 2020 and 2021 respectively. The rolling 12-month transaction volume increased to SEK 243.4 billion in March, up from SEK 238 billion in April to a new all-time-high level.

The number of deals exceeding SEK 80 million ended at 43 deals in March, compared to 27 and 41 transactions that took place during the same month in 2020 and 2021. The rolling 12-month number of deals ended at 417 in March, in line with the all-time-high level reached in October 2021.

The transaction volume has been in an uptrend since mid-2018, driven by a slight increase in number of deals and massive increase in the average deal size. It is now becoming clear that the uptrend in the transaction volume on the Swedish property market has entered a parabolic trend over the last 12 months (which is occurring when a trend has an accelerating growth rate). It is very unusual for a parabolic trend to go on for long and this often ends in sharp corrections. It is likely that the market will now adjust to the soaring inflation, increasing interest rates, higher credit margins and expectations of a period with central bank rate hikes/tapering. Catella's main scenario, however, is that real interest rates will remain negative and that this will keep on supporting the transaction market as investors are increasingly looking for effective inflation hedges.

Institutions were the single largest net-investors on the Swedish property market during 2021 and they have been net-buying property for SEK 67 billion during the last 12 months. Simultaneously, listed property companies have slowed down their net-acquisitions since last autumn. Their rolling 12-month net-acquisitions now stand at SEK 22.4 billion, down from the peak of 39.2 billion in September 2021. Funds were (along the institutions) the largest net-buyers on the market during the spring 2021, and their rolling 12-month net-acquisitions peaked at SEK 22.4 billion in April last year. Their net-acquisitions fell below the zero mark to negative SEK 190 million in February 2022 (they were selling more than they were buying) but recovered to SEK 1.8 billion in March. Foreign investors have slowed down their investment activity lately. Foreign investors acquired properties in Sweden for SEK 17.3 billion for the last 12 months. This is in the lower end of the interval of SEK 15–30 billion that prevailed most of the time over the last decade. The number of deals done by foreign investors has in fact declined during the last decade (as property values have increased).

For years, Catella has seen a stagflation scenario (the combination of low economic growth and high inflation) as the most likely macroeconomic scenario in the medium term. The current development in Ukraine is further strengthening this scenario as soaring energy and commodity prices have pushed up inflation in most western countries whilst lowering expectations on economic growth. Consumer prices increased by 7.5 per cent in the Euro area in March. The surging inflation was underlined by a price increase of 2.5 per cent between February and March, a record figure. The March inflation in Germany reached 7.6 per cent (a 40-year high), driven by an almost 40-per-cent increase in energy prices. This is a tough figure for the German authorities, which have historically been extremely sensitive to inflation (since the period of hyperinflation during the 1920s). The development is similar in Sweden, although less severe, so far. The CPI inflation ended up at 4.3 per cent in February. Consumer prices will likely increase quicky going forward, especially as the western countries are about to impose further sanctions on Russia as an answer to the atrocities/war crimes committed against civilians in Ukraine. Catella's leading index for CPI inflation is indicating a temporary slowdown in the inflation rate during the coming six months to just below 3 per cent year-on-year. This is mainly driven by lower year-on-year growth rates in a broad basket of commodities (some commodities including energy and food have increased significantly lately while some metal prices are in fact down). However, this is off course dependent on the development of the war and sanctions on Russia. It is not unlikely that inflation will significantly overshoot our model during a few months or quarters before moving down towards the 3-per-cent level (when the base effects of the recent massive price increases are fading out). The high inflation (well above the Riksbank's target of 2 per cent) is of course troublesome for consumers and thereby the economic growth. This was visible in March, when the Swedish consumer sentiments plummeted to the lowest levels since the financial crisis (according to the National Institute of Economic Research).

A major underlying issue is that total debt levels (government, corporate and household debts) in the developed world are at historical highs. In Sweden, especially the household debt levels are extremely high (historically high housing prices is the other side of this coin). Swedish households also tend to have very short capital maturity, which makes them sensitive to increasing interest rates. The authorities in the Western economies are aware of the fact that we need economic growth to serve the current high debt levels. If higher consumer prices slow down economic growth too much, there is a high risk that the debt load collapses, and we end up in a global credit crunch/recession. However, monetary stimuli in a high inflation environment are not in line with the central banks' inflation targets, especially if it is hard to argue that the inflation impulse is temporary. The response of central banks is therefore important. Catella believes that economic growth will be seen as the more important factor in this case. With today's debt levels in both Europe and the USA, it will be almost impossible to combat inflation, with increased interest rates and thus triggering a recession (and a recession would not be good at all in the current geopolitical environment). In other words, it seems like central banks will be forced to accept an inflation/wage spiral from late 2022 and onwards.

Another factor complicating the picture is that we are now seeing several technical indicators pointing an upcoming recession within around 18 months. To start with, the US yield curve inverted for two days in early April. Yield curve inversions have over the last 50 years been an extremely strong leading indicator of an upcoming recession. However, it was the 2Y–10Y yield curve that inverted, while the 3M–10Y is still in an uptrend since hitting a nadir of -0.53 in August 2019. This was around 6 months before the coronavirus pandemic erupted (which is a very strange/almost scary coincidence). The 3M–10Y yield curve now stands at 1.89 per cent. It is very unusual that the 2Y–10Y and 3M–10Y yield curves move in different directions, and this time it may be because the market is expecting the Fed to raise rates quite forcefully during the coming 12 months (and perhaps trigger a recession by going too far). Another technical factor is that Catella's residential price model is indicating a price decline in the interval 3–18 per cent during the coming 12 months in the Stockholm region. The model for the residential price development is based on four sub-indicators. These are the rolling 12 months construction project start-ups in relation to the turnover on the market (the number of apartments that are being sold), the equity market development (FTSE Sweden), the CPI inflation rate and the 10-year Swedish government bonds yields (trend adjusted). In 2018, residential prices fell by 11 per cent year-on-year. The probability for a larger price fall during the coming 12 months is around 30 per cent (in this case it would be the worst price decline since 1993). The most probable development for the coming 12 months, however, is a price decline within the interval of 3–18 per cent year-on-year. The probability for an outcome within this interval is over 80 per cent. This may trigger a recession within 12–18 months due to lower private consumption and residential investments. Over time the residential price in Stockholm has proven to be a strong leading indicator of the Swedish GDP growth.

The listed property companies went through a massive correction from November up until early March. However, the equity market bottomed-out in early March and the listed property companies have performed strongly since then. It seems like we may now be out of the correction phase for this time. The average equity price for 32 of the largest listed property companies is up around 7 per cent since the day before the Russian invasion of Ukraine (February 23), this can be compared to just below the zero mark for the OMX Stockholm 30. The companies focusing on logistics/industrial properties and mix commercial properties have shown the strongest performance, up around 12.5 and 9 per cent respectively. The weakest performance has been the companies focusing on residential/public properties, up only 3 per cent (better than the broad equity market though). The office/retail companies have performed a little better, up almost 6 per cent. However, since the market peak in late November the listed property companies are down around 16 per cent (compared to minus 8.5 per cent for the Stockholm OMX 30). The residential/public property companies have clearly underperformed during this time interval too and are down just shy of 22.5 per cent.

The average premium to NAV in the 30 of the largest property companies is currently around 33 per cent. There are, however, large differences between the companies. There are equity market premiums on some of the companies that are focusing on mix industrial, well-located logistics, residential and/or public properties (especially if the project portfolios are large and the companies are promising strong growth ahead). Simultaneously, there are discounts for several of the companies with a focus on retail and/or office properties. As a result, the equity market is still indicating somewhat lower yield for mix industrial, well-located logistics and residential properties in smaller cities.

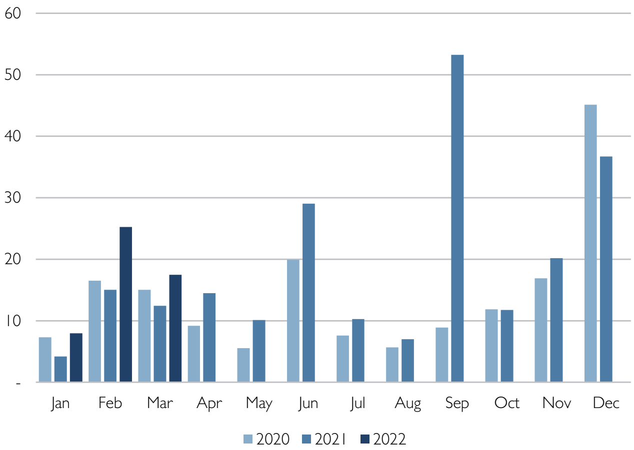
The strong development for the listed property companies during the recent month has occurred despite the fact that the long-term real interest rates (measured as the US inflation linked 30-year treasury bond yield) has increased 39 basis points since March 8, from -0.30 per cent to 0.9 per cent now. Higher long-term real interest rates are generally not good for property related assets. This is especially the case for residential properties (where yields tend to be tightly correlated to the real interest rate). Higher real interest rates are resulting in higher property yields (and lower property values). In line with this, it is not surprising that average equity market performance for the listed companies focusing on residential/public properties has underperformed the other listed property companies lately.

However, why have especially the industrial/logistics and mix commercial property companies performed so strongly during the last month when real interest rates have increased? The US 10-year break even inflation rate (the market's expectation for the average inflation over the coming decade) has in fact declined somewhat during the last weeks (from 2.94 per cent in early-March to 2.84 per cent now). This is an indication that investors have been less, not more, concerned about inflation lately. Increasing nominal interest rates, higher real interest rates and stable/lower inflation expectations should not be positive for property at all. However, Fed has been a key player on the US government bond market during recent years and is one of the largest owners on the market for inflation-linked government bonds (the TIPS market). Expectations of reductions in the Fed's balance sheet are having a major impact on the pricing of these bonds, pushing up real rates in line with or more than the nominal rates (although the actual inflation expectations may in fact remain high or even increase). The strong development for the listed property companies may be an indication that many investors are now actively looking for inflation hedges.

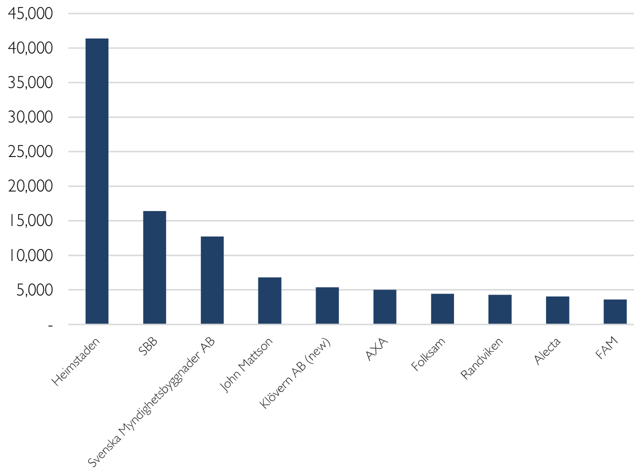
According to Catella's main scenario,

short-term interest rates will remain rather low for a few quarters combined with reasonable but slowing economic growth. However, long-term interest rates will gradually start to increase as inflation expectations take off. Simultaneously, economic growth will slow down even more. Real interest rates will likely remain low and not increase significantly until a later stage. However, higher nominal interest rates and higher credit spreads will push up property yields. Central banks will not be able to reduce credit spreads as they did during the coronavirus pandemic due to high inflation. A stagflation scenario (a combination of high inflation and low economic growth) may, however, be quite favourable for property as investors look beyond the bond and equity markets to real assets (like property). There are, however, major differences between the property segments in how effective they are as a hedge to inflation. Segments with rental markets that are tightly connected to the real GDP growth over time (like prime offices in Stockholm) are not benefitting at all from a stagflation scenario. In addition, these segments also tend to have low yield levels, and are therefore sensitive to increasing financing costs. Market rents for industrial/logistics, public and mix commercial properties tend to follow the CPI inflation relatively well. For logistics properties, market rents have trended downwards during the last five-year period. That is mainly because recent years' declining yield levels/increasing property prices have facilitated new production projects with gradually lower rent levels. Construction costs are now soring and there is a growing pressure upwards on properties yields. This will likely put a lid on supply, which in turn may be positive for market rental growth for logistics properties. When it comes to residential rental properties, rent levels have been following the rolling four-year average inflation rather well over the last 20 years. However, this is a period when inflation has been below 2 per cent most of the time. Higher shelter costs for low- and middle-income families is politically sensitive and there is a major risk that rent levels will not keep up with inflation if we end up having CPI inflation rates that remain over the 3-per-cent level for an extended period. In addition, over the last two years (2020–2021) there has been a major oversupply on the residential market. All in all, 129 of 290 municipalities had oversupply on their local residential markets over the last two years (2020–2021). The oversupply is relatively small in growth cities, while it is significant in many smaller cities. In addition, these segments too (as well as prime offices) tend to have low yield levels and are therefore sensitive to increasing financing costs. ■

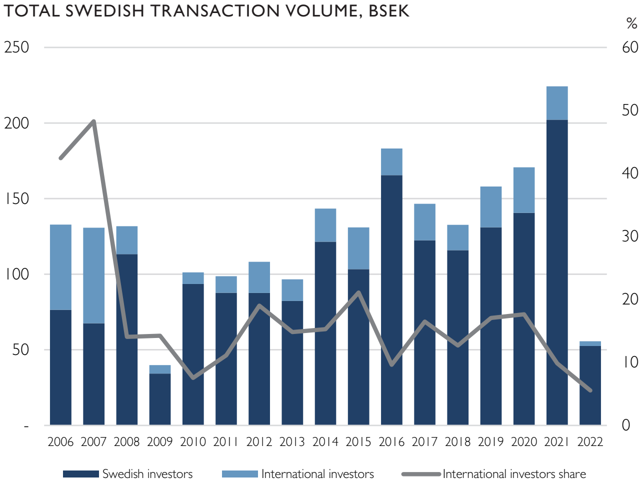
TRANSACTION VOLUME PER MONTH, BSEK



TOP 10 INVESTORS ROLLING 12-MONTH VOLUMES, MSEK



TOTAL SWEDISH TRANSACTION VOLUME, BSEK



INVESTOR TYPE AND REGION