The transaction market is now in the midst of a re-pricing where investors are adjusting to a Japan-like scenario with low interest rates for years to come

ARVID LINDQVIST
Head of Research
arvid.lindqvist@catella.se

The activity on the Swedish property market picked up in November and the transaction volume ended up at approximately SEK 13.3 billion, which can be compared to SEK 12 and 7.6 billion respectively for the equivalent months in 2017 and 2018.

The 12-months rolling volume increased to SEK 153 billion in November (from SEK 148 billion in October). The trend of fewer but larger deals that has been visible over the recent quarters remains, however the 12-months rolling number of transactions has picked-up somewhat to 318 deals (from just above 300 deals in October). The correlation between the average financing costs for the major listed property companies and the average yields of their property portfolios have been almost perfect over the last decade – where 100 basis points lower financing costs has resulted in around 60 basis points lower property yields. As a result, the spreads between financing costs and property yields has gradually increased and now stands at historically high levels. It seems like the transaction market is now in the midst of a re-pricing where investors are adjusting to the consensus view of low economic growth, low inflation and low interest rates for years or decades to come. In this process, the spread between financing costs and property yields is declining and we see a pressure downwards in yield levels. Although the equity price development for the listed property companies has moved sideways since September, the equity total return is still up over 60 per cent year-to-date in average. One important factor that has contributed to the sideway development has been the quite positive global macro sentiments that have prevailed during recent months. Up until last week, the trade talks between the US and China where going in a positive direction, while the probability of a hard Brexit declined significantly after the summer. As a result, the broad stock market (OMX Stockholm 30) has outperformed the listed property companies since the summer. The brighter macro sentiments also created an upward pressure on long-term interest rates where Swedish 10-year government bond yields increased from a nadir of -0.42 per cent in August to just above the zero-mark in early December. The equity prices for the listed property companies moves in line with the interest rate development, and higher rates are generally negative for the listed property companies. The Riksbank's planned repo rate increase to zero in December is confusing the market as leading indicators for the Swedish economy are pointing downwards.

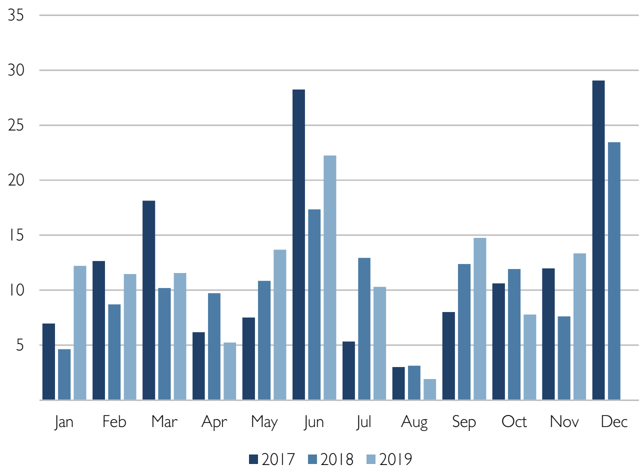
The November PMI figure fell further into contraction territory and activity in the manufacturing sector is at its lowest level since late 2012. In addition, the Swedish households are historically gloomy and employment growth has slowed significantly over the last 12 months. Although the Swedish third quarter GDP growth figures came in at a quite strong 0.3 per cent quarter-on-quarter growth (1.6 per cent year-on-year), GDP growth was revised downwards for both the first and second quarter.

During the last week, however, negative news has emerged regarding the trade war as Washington has hardened its stance towards China and announced new tariffs on Brazil and Argentina. Investors are also generally concerned of that we are in a late cycle economy and that asset prices in general (equities, bonds and property) may be in bubble territory. After all, even if a limited phase-one agreement is concluded between the USA and China, the long term development is most likely heading towards deglobalisation, continuously declining world trade volumes and lower global GDP growth going forward. In addition, Brexit is negative for both the UK and the EU, even if it ends up being a soft version. In addition, domestic demand in Sweden is weak, and will likely remain weak for the coming 12–18 month as unemployment starts to increase because of recent year's low economic growth. As a result, it is not unlikely that the stock markets will hit a temporary peak and enter a risk-off phase within the coming weeks or months. This will likely drive down long term interest rates again and push back capital to the listed property companies in general, and specially to companies with stable non-cyclical property portfolios (like residential and public properties in the major cities). However, concern about the economic slowdown and its effects on the office and retail segments may hamper the development of the listed property companies with focus on more cyclical commercial properties in the major cities. ▶

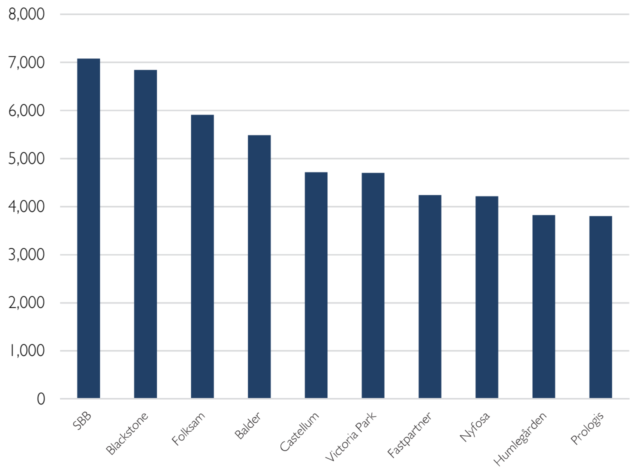
The average premium to NAV for the Swedish listed property companies is currently almost 35 per cent, where equity market premiums are largest in high-risk property segments like office, industrial, retail and residential properties in smaller cities. Premiums are smaller in low risk segments like prime offices and residential properties in the major cities. Currently, there is even a discount on the equity market for prime offices in Stockholm. The equity market is a good leading indicator of where the market is heading. Although the equity market does not indicate lower yields for prime offices, there is a strong demand from yield starved institutional investors for core assets in Stockholm (mainly foreign institutions). Low interests are undermining most pension systems in the world and most funds are increasing the share of alternative investments in their portfolios.

As it looks now, most property investors assume that the economy will be in a Japan-like scenario during the coming decade/decades, with extremely low interest rates, low economic growth and non-existent inflation. As long as the economy does not end up in a recession, the property market will likely perform strongly over the coming 12–18 months, with continuously declining property yields in the larger cities. However, the long-term macroeconomic outlook does not look very promising and the risks are elevated that the market ends up in a major correction if the current consensus scenario in the market (lower-for-longer) does not play out.

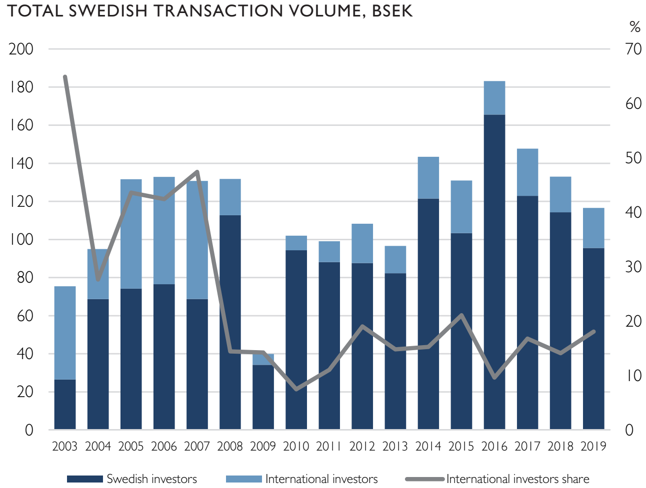
TRANSACTION VOLUME PER MONTH, BSEK



TOP 10 INVESTORS ROLLING 12-MONTHS VOLUMES, MSEK



TOTAL SWEDISH TRANSACTION VOLUME, BSEK



INVESTOR TYPE AND REGION