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Too much capital is chasing too few assets on the property market due to the historically low real interest rates

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The transaction volume summed up to SEK 10.4 billion on the Swedish property market in November, below the SEK 14.9 billion and SEK 16.9 billion respectively that took place during the same month in 2019 and 2020. The rolling 12-month transaction volume has been in an uptrend since mid-2018 but has now fallen back somewhat from last month's record level and now stands at SEK 221.9 billion (compared to SEK 228.4 billion in October).

The number of deals exceeding SEK 80 million ended up at 33 in November, compared to the 37 and 41 transactions that occurred during the same month in 2019 and 2020 respectively. The number of transactions during the last twelve months fell back somewhat to 406 deals (still well above the long-term average). The largest deal in October was Atrium Ljungberg's acquisition of an 31,000 sq.m. office leasehold close to the Globen area in Stockholm from the Stockholm Municipality for just above SEK 1.5 billion. The second largest deal was SBB's purchase of six mix properties (including commercial and residential area) in Sundbyberg and Gröndal from Wallenstam for around SEK 1.2 billion. The third largest deal was Diös' acquisition of five commercial properties located in Skellefteå from Nordvestor Fastigheter for SEK 810 million.

The institutions remain the single largest net-investors on the Swedish property market and have net-acquired properties for SEK 49.7 billion during the last 12 months. However, adjusted for Heimstaden's massive acquisition from Akelius, the institutions have actually reduced their net-acquisitions since the peak in late 2020. Adjusted for the Heimstaden deal, the institutions have only net-acquired properties for SEK 13 billion during the last 12 months. This can be compared to the SEK 32.1 billion for the 12 months to December 2020. However, several Swedish institutions are working to increase their property allocation, but the competition is fierce. The listed property companies increased their acquisitions massively from February until September, when the rolling 12-month figure peaked at SEK 33.2 billion. Their net-acquisitions have fallen back in October/November, however, and now stand at SEK 26.4 billion for the 12 months to November. The listed companies will, however, likely increase their acquisition activity during coming months. The funds have picked up their investment activity in November and are closing in on the listed companies. Their rolling 12-month net-acquisitions now stand at SEK 17.8 billion. However, foreign funds have reduced their net-acquisitions lately. Their rolling 12-month net-acquisitions have dropped from SEK 22 billion in June to SEK 13.4 billion in November. Lots of foreign funds/asset managers are looking at opportunities in Sweden, but the competition within the popular segments (i.e., residentials, industrial/logistics and public properties) is fierce.

The equity prices of the Swedish listed property companies reached an all-time peak on November 19 after a massive one-month increase since the last market bottom in mid-October. The price development has been volatile and trending downwards since then due to factors like the new Omicron version of the corona virus and relatively hawkish comments from the Fed chair Powell. The average equity price for 36 of the largest listed property companies is up 61 per cent during 2021 (compared to 20 per cent for OMX Stockholm 30). The companies focusing on mix commercial properties and logistics/industrial properties have seen the strongest developments, up 79 and 88 per cent respectively YTD. The recent months' development has been staggering, and the average equity price for all the property companies is up fully 25 per cent since the market bottom on October 11. The companies focusing on mix commercial properties and logistics/industrial properties are up 32 and 30 per cent since October 11. This means that the equity market has increased their valuation of the underlying properties by around 15 per cent in less than two months! The average premium to all capital employed for 13 of the largest listed property companies are currently around 21 per cent. However, these companies are mainly focusing on office and retail properties, which are segments that generally are not very loved by the market. A few companies with a clear focus on industrial/logistics or residential properties with a strong growth story are having premiums to all capital employed of up to 175 per cent. Premiums of around 30–50 per cent to all capital employed are common among the listed companies. There are, however, still discounts for some companies with a focus on retail and/or office properties. As a result, the equity market is indicating a massive further decline in property yields during the coming 6–9 months (especially within the popular segments mentioned above). However, the general investor risk ▶

willingness has declined during recent weeks. The broad equity market is down and there has been a sharp sell-off of US junk bonds (bonds with low credit rating). Yield spreads between high and low risk corporate bonds have increased and this heralds higher credit margins for property companies with higher risks in their business models during coming months.

Economic growth is currently strong, but the cycle has peaked, and growth rates are declining. Manufacturing ISM/PMI in both the USA and Sweden have fallen back somewhat from the peaks of the second quarter but remains at historically high levels (at 63.3 and 61.1 respectively). It is only for China that the leading indicators have been fluctuating around the 50-mark during recent months and pointing towards an economic slowdown. Catella's GDP Macro Index (which consists of a mix of six leading indicators for the Swedish GDP growth) is indicating a current growth rate of 4.4 per cent (down from 4.9 per cent in October), and that economic growth will slow down to around 3.9 per cent year-on-year during the coming three-month period. This is a historically high growth rate. Three of the six underlying macro indicators are, however, pointing at further slowdown in growth from mid-2022. The latest Omicron virus version is putting a further spanner in the works, and OECD revised down their growth forecast this week for the G20 economies and warned that the ongoing pandemic could further drive-up inflation while hampering economic growth (one step further towards stagflation).

In Sweden, CPI inflation has increased to 2.8 per cent in October (from 2.5 per cent the month before). In the USA, CPI inflation stands at 6.2 per cent, while it has reached 6 per cent in Germany. Main contributing factors to the higher consumer prices in the USA and Europe are supply chain problems, soaring commodity/energy prices and lack of labour which generate wage increases (especially in the USA). Catella's CPI Macro Index (a leading index for inflation including ten leading macro indicators/commodities) is indicating that the Swedish CPI inflation reached a short-term peak in October and that the figure will now fall back to approximately 1.7 per cent in mid-2022. This is below the Riksbank's target and would reduce pressure on the Riksbank to act (i.e., the repo rate and asset purchases can remain in place for time being). The main driver of the slowing CPI inflation during coming months is the falling year-on-year growth rates in commodity prices. The year-on-year growth rate for Catella's commodity index is down from 69.7 per cent in April to 15.5 per cent in November. However, electricity prices are now soaring, and it is important to note that Catella's model for inflation does not include indicators that mirrors the current supply chain bottlenecks because this factor has not been instrumental for inflation during the last decades (and the model is based on historical correlations).

That was the hard facts. But what is the macro story behind this enormously bullish view on property among investors? Financial markets have adjusted their view of the future trajectory of growth, inflation, and interest rates during recent months. The US two-year government bond yield is a good indicator of the bond market view of the future policy rate development. The two-year bond yield remained within the interval 10–20 basis points between March 2020 and June 2021. In July the yield jumped up to slightly above 20 basis points, where it remained for three months. Markets then started to price in more rate hikes at an earlier stage than central banks said they intended, and the two-year yield soared to a 64 basis points on November 25. Since then, the yield has fallen back to just above 60 basis points. The market still expects rate hikes, but to a somewhat lesser degree that a few weeks ago. Simultaneously the 10-year yields have declined over the last month to 1.43 per cent in the US and to 0.08 per cent in Sweden. In the USA, the yield level is still in the lower bound of the interval 1.40–1.65 per cent that has prevailed since September. However, in Sweden the 10-year yield decline has been more pronounced (it is down from 0.40 per cent in late-October) which is indicating lower expected growth and inflation. One of the most important factors for the pricing on the property market is the long-term real interest rate. One good global benchmark for this is the US 30-year US TIPS yield (inflation linked government bonds). This real interest rate has declined during recent weeks and now stands at -0.56, which is below the (by then) all-time low levels from August 2020. The average property yields on Swedish residential transactions are strongly correlated to this long-term real interest rate. The recent weeks decline in real interest rate can partly explain the strong equity market performance for the listed property companies recently and is indicating still lower property yields on the transaction market during the coming 6–9 months.

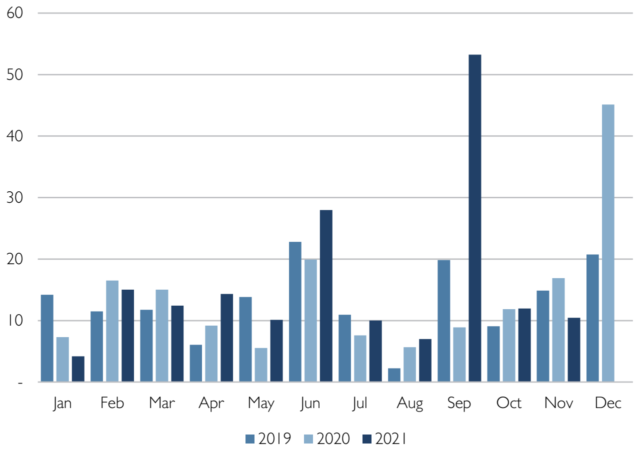
Apart from lowering policy rates close to or below the zero-mark, central banks have also used their balance sheets as a means to stimulate the economy. Six of the major central banks (the Fed, ECB, BoJ, BoE, PBoC and the Riksbank) have increased their combined balance sheet by USD 11.5 trillion since February 2020. This is well above the total USD 10.6 trillion that they increased their balance sheet with during the entire decade from February 2010 to February 2020. The Fed has now stated to taper the purchases and the year-on-year growth rate has declined from USD 9.5 trillion in February 2021 to USD 3.3 trillion in November. The prime target for the asset purchases is to push up asset prices, and that has been very efficient up to now. The broad equity market development (measured as the S&P 500) has moved almost exactly in line with the combined central bank balance sheet during the last decade (with a four-month time lag). The combined balance sheet is now, however, peaking and is not indicating very much higher equity prices ahead. The average yield on the Swedish property transaction market is also strongly correlated to this combined central bank ▶

balance sheet (this is especially the case when looking at logistics/industrial or residential yields). However, the recent years' surge in the central bank's balance sheets has not yet been fully priced on the property market (in contrast to the broad equity market pricing). This may partly explain the massive equity market premiums for the Swedish listed property companies that we currently see.

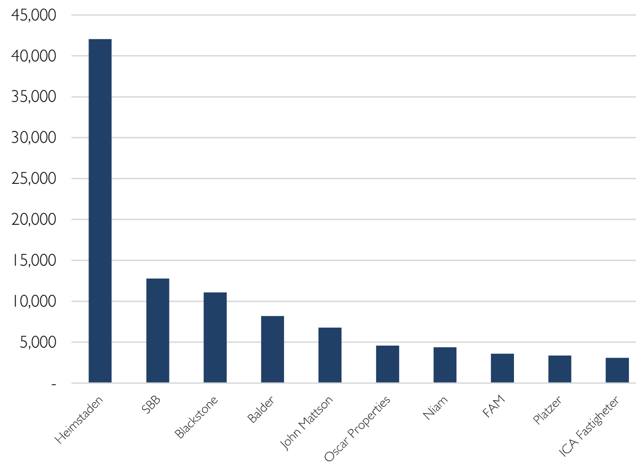
All in all, the lower expected global economic growth has muted the policy hike expectations somewhat. However, the reality is still that global inflation pressure is historically high. In addition, the inflation is supply driven, which is the worst form of inflation as it strikes right at the weakest households (which increases social tension). This starts to become a real problem for the major central banks because they cannot reduce their stimuli very much without creating turmoil on the equity and bond markets. However, the bond market is pricing in that the central banks will sort-out this balancing act. The 10-year break-even inflation rate (the difference between real and nominal government bond yield) has fallen back significantly during recent weeks. From 2.73 per cent in mid-November to 2.44 per cent now. In other words, the markets expect that inflation will be elevated for a few years and then fall back below the Fed's target of 2 per cent (the Fed is following an inflation index that are around 30 basis points lower that the CPI, which is indicated by the break-even rate). It is easy to question the predicting power of the bond market, however, because the market is so disturbed by the central banks' asset purchases.

According to Catella's main scenario, inflation and nominal interest rates will follow a gradual uptrend from 2022 until the next recession. Real interest rates will likely remain low and not increase until a later stage (low real interest rates are supporting for the property prices). The global economy will end up in a period of stagflation (a combination of high inflation and low economic growth). This scenario is quite favourable for property. It is likely that investors will increasingly look beyond the bond and equity markets to real assets (like property) that can be effective inflation hedges. However, we are now seeing clear signs that too much capital is chasing too few assets on the property market. The supply of newly produced residential rental apartments is now soaring. We will likely see a major over-supply and higher vacancies for newly-build apartments with high rent levels in the major/regional cities in 12 months' time or so. In addition, there are clear signs that market rent levels are declining for industrial and logistics properties, driven by increasing supply of new buildings with low rent levels. ■

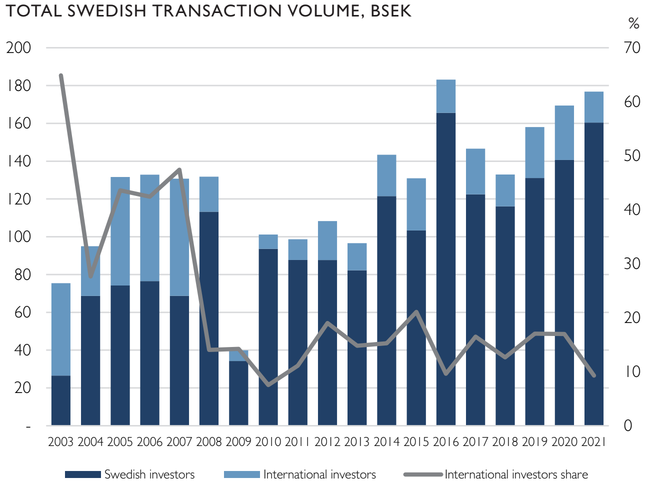
TRANSACTION VOLUME PER MONTH, BSEK



TOP 10 INVESTORS ROLLING 12-MONTH VOLUMES, MSEK



TOTAL SWEDISH TRANSACTION VOLUME, BSEK



INVESTOR TYPE AND REGION