CATELLA

Strong start of 2019 driven by more dovish central banks – but clouds might be gathering on the horizon

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The transaction activity in February was continuously strong and the volume ended up at SEK 14.4 billion for the month, compared to SEK 12.7 billion and 8.7 billion in 2017 and 2018 respectively.

The largest transaction during the month was Alm Equity's SEK 1,500 million sale of 888 planned rental apartments in the Stockholm region (Sollentuna) to an unknown investor. The second largest transaction was Wihlborgs acquisition of an office portfolio in Lund from Vasakronan, for SEK 1,260 million. The third largest transaction in February was Invesco and Scius Partners' acquisition on a centrally located development property in Stockholm. Swedish institutional investors (like SEB and Vasakronan) keep on offloading office properties in the major cities while listed and private companies remains on the buy side.

The Swedish GDP growth ended up stronger than expected in Q4 2018. The GDP was 1.2 per cent up from the last quarter and 2.4 per cent up from the same quarter last year. The underlying development in the economy remains well in line with Catella's expectations, and growth in private consumption and investments slowed down during the quarter (as a result of the previous 18 months' development on the housing market). The largest positive contributor during Q4 was a strong growth in net-exports as well as an upswing in stock building (a factor that tend to sum up to zero over 4–8 quarters). The declining residential investments reduced GDP growth by around 0.4 percentage points year-on-year during the quarter and is expected to keep on reducing GDP growth by around 1 percentage point year-on-year in Q1–Q4 2019. In a scenario where the global economy keeps on growing at a reasonable pace (and thereby keep up the Swedish exports growth at around 3 per cent year-on year) the Swedish GDP growth is expected to slow down to around 0.5 per cent for the full year 2019 – a relatively mild economic downturn mainly driven by domestic factors.

The equity market has rebound strongly since January. OMX 30 is up around 12 per cent so far in 2018 and has taken back large parts of the fall from October to early January. One of the main reasons to last year's global stock market fall and increasing interest rate margins on the bond markets was the global shift from QE to QT during the second half of 2018 (as described in the previous Catella Market Snapshot). Other contributing factors where higher interest rates, the trade war, slowing global growth mainly due to the slowdown in China, Brexit, and the US government shutdown. Further on, one of the main reasons to the market recovery since January has been investors' expectations of a more dovish Fed going forward as a result of the weakening US and global growth (several of the other major central banks have also followed the Fed in applying a more dovish stance to their policy during recent months). The global slowdown and more soft central banks have resulted in a significant decline in long-term interest rates since last autumn. The Swedish 10 year government bond yield halved from 0.67 per cent in October to 0.31 per cent in late February. Credit margins on the bond market also tend to follow the overall market risk sentiments and have declined significantly from their three-year-peak in January 2019 (according to Moody's index over AAA and BAA rated US corporate bonds). Lower underlying market interest rates, lower credit margins and improved investor risk willingness are factors that have benefitted the Swedish property market and have contributed to the strong start of the transaction year.

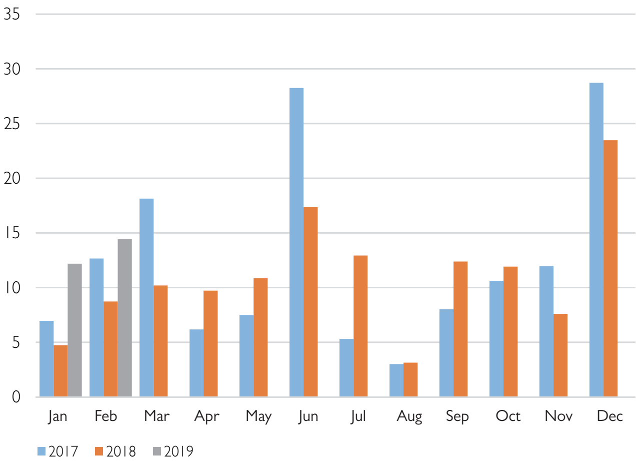
Looking forward, however, the Swedish economy will slow down in 2019 and the office rental market will likely follow suit. Although the Stockholm office market has remained strong during the first months of 2019 new construction of offices has picked up significantly over the last 12–18 months. In the past 3–5 years, new production on the Stockholm office market has only been around 75,000 square metres per year. While new construction has been low, the economy has been strong and office-based employment has grown by an average of 8,000–10,000 people per year in the region. The surplus demand has resulted in low vacancies and strong rental growth in Stockholm CBD and attractive inner city locations. At the same time, new office projects that have been under construction in recent years are now nearing completion. Approximately 175,000 square metres of new office space will be added to the Greater Stockholm market every year up until 2021. At the same time, the economy has hit the capacity ceiling and the unemployment among educated people in the Stockholm region is non-existent. The majority of the population growth of working-age people in the region are immigrants with mostly low or no education, meaning that they lack, in the short term, the means to pursue office-based employment. In addition, the Swedish economy is entering a downturn in 2019 ▶

which likely will result in a slightly increasing unemployment rate (which mainly affects unskilled working-age people). This means that the expected growth of office-based employment is expected to fall back to just above 4,000 people per year. This will, in turn, increase the risk of corrections in the rental market and will likely result in weaker rental growth over the next five years. This development will be particularly apparent for less efficient office properties in non-prime locations that lack good transportation options, where vacancies might increase while interest among investors declines. As rental growth slows down to zero, value growth will follow suit and property total return will decline towards the underlying historically low yield levels.

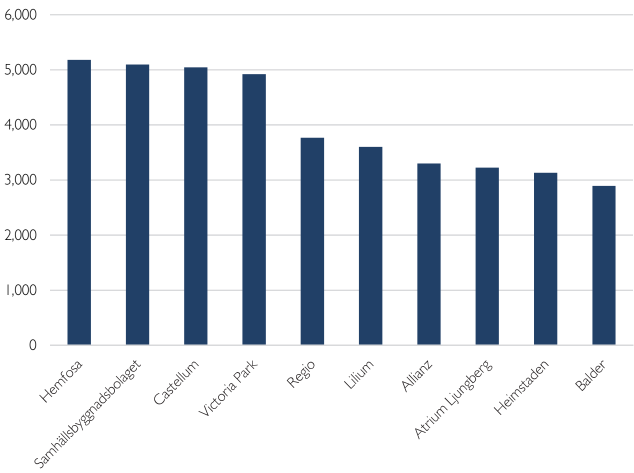
Here two scenarios for the global economy becomes relevant for the future development on the Swedish property market. In the first scenario the US economy slows down to (or slightly below) the potential growth rate of around 1.8 per cent year-on year during the rest of 2019. The Fed would in this case remain dovish and perhaps even start a new programme of QE. This will push investors further out on the risk scale and compress credit spreads further on the corporate bond market. In this macro environment the Riksbank will be able to pursue a continuously expansive policy to counterbalance the slowing domestic economy. Property total return would still move towards the underlying yield levels as rental growth slows down (as the case for further yield compression is limited). The property companies' interest rate costs would, however, remain low or even decline further which would keep up transaction volumes and keep down yields on the property market.

A second, more probable, scenario is that the current dovish Fed and the recovering stock markets underpins a relatively healthy US GDP growth during the rest of 2019 (around 2–2.5 per cent year-on-year). In this scenario the Fed will pause for a while and then pick up the gradual monetary tightening after the summer with gradually higher interest rates and further balance sheet reductions. The Riksbank will in this case need to follow the Fed and pursue a less expansive policy too. Weaker Swedish GDP growth and lower rental growth for commercial properties will in this case be combined with higher credit margins and slightly higher underlying market interest rates (as above-trend growth and increasing inflation in the USA are pulling up European long-term interest rates). In this scenario the equity prices for the listed property companies are about to pass cyclical peak with gradually lower highs and lows. However, the weak economic growth will probably entail continued low real interest rates for an extended period of time, which will make property a continuously attractive asset class for private and institutional capital.

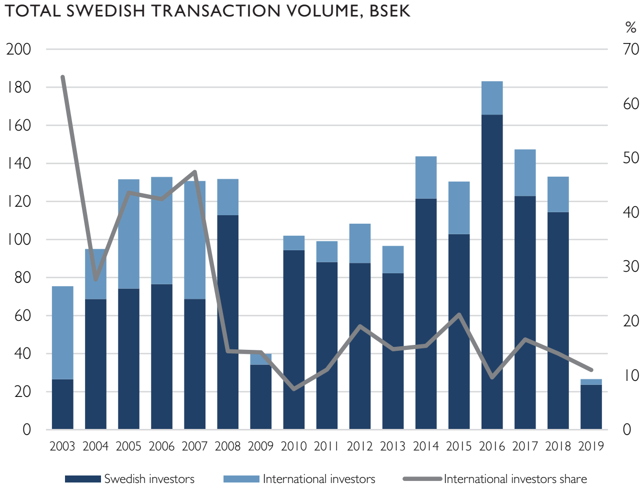
TRANSACTION VOLUME PER MONTH, BSEK



TOP 10 INVESTORS ROLLING 12-MONTHS VOLUMES, MSEK



TOTAL SWEDISH TRANSACTION VOLUME, BSEK



INVESTOR TYPE AND REGION