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The Corona outbreak may be a game changer for the Swedish property market

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The transaction volume remains high in February with a deal volume of SEK 15.8 billion (compared to SEK 8.7 and SEK 11.5 billion during the same month in 2018 and 2019 respectively). The rolling 12 months volume picked up to SEK 163 billion, higher than the full-year volume of SEK 158 billion in 2019.

Over the last 9–12 months, the transaction activity on the Swedish property market has been concentrated to well-located office properties in Stockholm and large property portfolios throughout the country. The largest deals during February was DWS's acquisition of Solna United from Skanska for SEK 3.3 billion, KLP's purchase of the office property Princeton from Hemsö/Sveanor for SEK 2.6 billion and Willhem's acquisition of a residential portfolio from Riksbyggen for SEK 2 billion.

The spreading of the Corona virus (the Covid-19) outside China has been a game changer on the financial markets over the last week. Manufacturing PMI in China dropped to 35.7 in February, which is below the lows during the financial crises and some analysts even expect negative GDP growth for the first quarter (which would be the first time since the Cultural Revolution). This is important as China now stands for around 20 per cent of the global economy (PPP adjusted). During last week, the FTSE All World index dropped 13 per cent (wiping out six months of gain and almost USD 6 trillion), which is the largest sell-off since the financial crisis in 2008. In addition, the S&P 500 entered the quickest market correction since the Great Depression in the 1930s, and was down over 11 per cent. Stockholm OMX 30 was also down 11 per cent during last week, although it temporarily rebounded during Monday morning before the slide continued. CBOE Volatility Index (VIX) increased to its highest level since the autumn 2015 (from an index level of around 15 to over 40), which is an indication that the market is expecting surging equity market volatility going forward. Money has flowed into safe assets and the US 10 year Treasury yield has fallen to an all-time low of just above 1.0 per cent, while Swedish 10 year government bond yield has declined to -0,36, (closing in on its nadir of -0,42 from August 2019). Junk bond funds have also seen large outflows and US high-yield bond risk premiums (over the Treasury yield) have climbed sharply over the recent days. Equity prices for the listed Swedish property companies where down around 9 per cent down over the last week. The impact on asset prices from the current risk-off mode creates tighter credit conditions and could be compared to a Fed rate hike of perhaps a 0.25–0.5 percentage points or more.

ECR Research has looked into previous periods of epidemics. Although there are generally large sell-offs on the markets as the epidemics peak, the recoveries also tend to be strong. During the 2003 SARS outbreak, the MSCI China Index was down almost 9 per cent, but tree months later it was up 30 per cent. During the 2009 Mexican swine flu pandemic (which infected 10–20 per cent of the global population and killed between 150,000 to 575,000 persons), the MSCI Mexico Index was up 25 per cent three months after the peak of the crises. The market may be in a panic mood now and it is not unlikely that shares are currently oversold. If that is the case, it is reasonable to expect a heavy market rally during the coming week/weeks (if the contagion is limited in the USA and Europe).

However, it seems like the underlying reason for the heavy market response this time is more than just the economic effects/the uncertainty created by the Covid-19. Equity multiples are at record highs (especially in the USA) as a result of more than 20 years of falling inflation, expansive monetary policies and falling interest rate. Analysts are now adjusting their earnings expectations significantly downwards for the major listed companies in both the USA and Europe. What really terrifies the market may be the mix of record high debts, a broadly inflated asset bubble throughout asset classes/geographies, and a quickly evolving global recession during the first half of 2020.

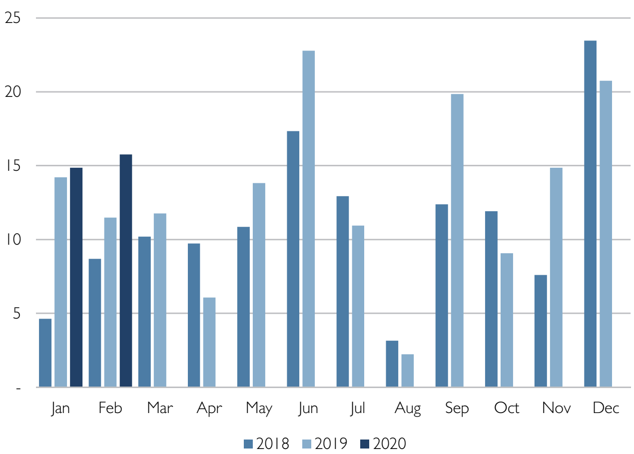
One major problem is that central banks are seriously low on ammunition. Over the last year, central banks in the advanced economies have cut their policy rates at the fastest pace since the financial crisis to counter an overall slowing global economy – and this was before the impact of Covid-19. The market expects a 50 basis points of Fed rate cut in March, and it is not unlikely that the Fed will lower its policy rate all the way to zero over the coming 12 months (from today's level of 1.50–1.75 per cent). The second problem for the major central banks is that the Covid-19 crises constitutes a combined supply and demand shock. Lower policy rates and asset purchases are not effective tools to counter weaknesses in global supply chains and the lack of input components/workers in factories. Up until now, the central banks' major way to stimulate the economy has been through propping up asset prices, thereby strengthening the balance sheets for companies/households so they can take up more debt (and hopefully use the debt to invest in productive machinery, R&D and education). However, there is a risk that debt levels and asset prices are now so high that further rate cuts/asset purchases are no longer effective. In that case, the development on the financial markets could quickly spill over into a ▶

self-enforcing deflation spiral – resulting in a deep global recession. Governments cannot accept this. Although the political landscape has become very polarized in most countries, politicians will probably be forced to act at some point. Italy has already unveiled a stimulus package amounting to around 0.2 per cent of GDP and Hong Kong has announced helicopter money (all residents over 18 years receive a cash handout of USD 1,200 to stimulate the economy).

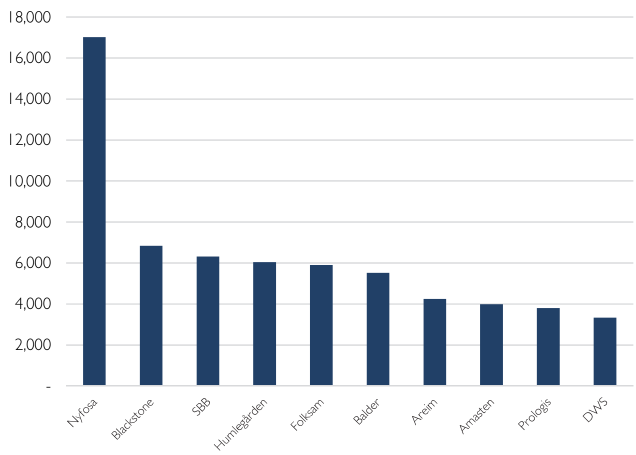
The question is how this macro development will impact the Swedish property market. Listed property companies, Swedish institutions, and foreign funds (both core and opportunistic funds) have been the main drivers on the transaction market during the last 9–12 months. The Swedish listed property companies have been focusing on commercial, residential and public properties in secondary locations in the major cities and in smaller cities (relatively high-risk property segments). Swedish institutions and foreign core funds on the other hand have been focusing on well-located properties in large and regional cities (low-risk property segments). Investors have been focusing on building volume and there have been substantial portfolio premiums on the market. The recent week's equity price decline for property companies has had the largest impact on companies with high risk in their business models. The recent week's development on the US high-yield bond market also indicates that credit spreads are on the rise. Credit spreads will likely increase also for Swedish property companies with high risk in their business models, which is a normal effect when the market enters a risk-off phase. As long as the risk-off mood persists on the financial markets, investors that focus on high-risk property segments will be less competitive and less able to do deals – which will result in lower transaction activity and lower prices in secondary locations in major cities and in smaller cities. Foreign investors tend to focus on their respective core markets when the financial markets become turbulent. As a result, there is a clear risk that we will also see lower transaction activity in the prime end of the market. However, prime property segments will always be an attractive alternative to government and corporate bonds when interest rates are declining.

The long-term development depends largely on how severe and long lasting the economic effects of the Covid-19 will be. If the spread is quickly contained the major central banks will likely keep on stimulating the economy and asset prices may recover quite fast. However, there may be long-lasting effects anyway. There is a quite high possibility that multinational companies will start to reconsider their global supply chains because of the virus outbreak in combination with the recent years' geopolitical tensions and trade war. If this results in a broad trend of de-globalization, the current market consensus that inflation will remain low forever may be seriously challenged.

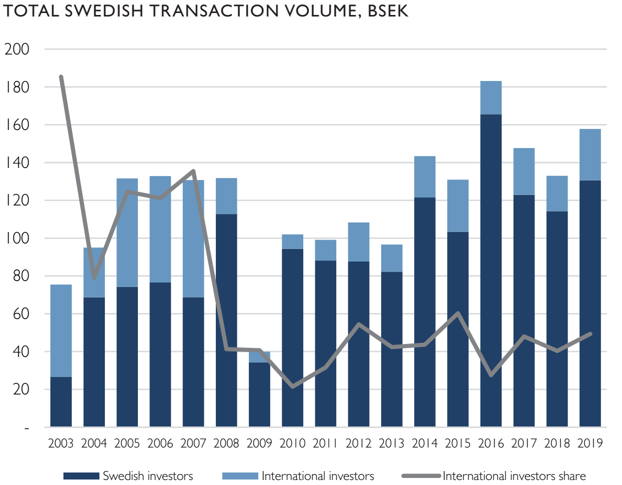
TRANSACTION VOLUME PER MONTH, BSEK



TOP 10 INVESTORS ROLLING 12-MONTHS VOLUMES, MSEK



TOTAL SWEDISH TRANSACTION VOLUME, BSEK



INVESTOR TYPE AND REGION