Soaring inflation and negative real interest rates will drive more capital into inflation hedges like property

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The transaction volume ended up at SEK 20.7 billion in February, which can be compared to SEK 16.4 billion and SEK 15 billion during the same months in 2020 and 2021 respectively. The rolling 12-month transaction volume increased to an all-time high of SEK 233.8 billion in February, up from SEK 228.1 billion in January.

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.

The number of deals exceeding SEK 80 million ended up at 39 deals in February. This is well above the 28 and 25 transactions that took place during the same month in 2020 and 2021 respectively. The rolling 12-month number of deals peaked at an all-time-high level in October 2021 (at 417 deals) and has stabilised around the 400-level since then. It is not unlikely that the market will now slow down as it adjusts to soaring insecurity due to the war in Ukraine, soaring inflation and expectations of less central bank stimuli. Catella's main scenario, however, is that real interest rates will remain negative and that will keep on supporting the transaction market as investors are increasingly looking for effective inflation hedges.

The institutions were the single largest net-investors on the Swedish property market during 2021 and they have been net-buying property for SEK 66.6 billion during the 12 months to February. Simultaneously, the listed property companies have slowed down their net-acquisitions since the last autumn. Their rolling 12-month net-acquisitions now stand at SEK 23.7 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 but has now fallen below the zero mark to minus SEK 190 million in February 2022 (they are selling more than they are buying). Foreign investors have also slowed down their investment activity lately. Foreign investors acquired properties in Sweden for SEK 17.4 billion for the 12 months to February. This is in the lower end of the interval of SEK 15–30 billion that has 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). There are, however, several major foreign investors hoovering the market looking for deals.

The listed property companies have gone through a massive correction since late November. Up until late February this was due to increasing real interest rates, but Russia's invasion of Ukraine has created further the market turmoil during recent weeks. The average equity price for 36 of the largest listed property companies is down around 25.5 per cent since the market peak in late November (compared to around 15.6 per cent for the OMX Stockholm 30). The companies focusing on residential, public and industrial/logistics properties are down the most, around 30 per cent in average since late November. This was mainly because these companies had an overall extremely strong development up until the market peak in November and generally looked rather over-priced. The average equity price for 36 companies is down around 4.8 per cent since February 23 (the day before the Russian invasion), compared to 7.9 per cent for OMX Stockholm 30. However, the average equity price for 36 property companies is still overperforming the broad equity market in the longer term and is up around 21 per cent since early 2021 (compared to 5.2 per cent for the OMX Stockholm 30).

The average premium to all capital employed for 12 of the largest property companies has declined from around 12 per cent in early February to just above zero in early March. There are, however, large differences between the companies. There are still equity market premiums on some of the companies that are focusing on mix industrial, well located logistics, residential and/or public properties. 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 no longer indicating a general pressure downwards on property yields. However, the equity market is still indicating somewhat lower yield for mix industrial, well located logistics and residential properties in smaller cities.

Russia's invasion of Ukraine has significantly changed the economic and geopolitical situation for Sweden. Catella is not an expert on analysing political developments, but we are following a number of analysts that are. It is important to have a view of some background to the conflict to outline the likely impact on the Swedish economy and property market going forward. The Russian economy is small considering its GDP. The Russian GDP ▶

in 2021 is expected to be USD 1,770 billion compared to USD 4,210 billion for Germany, USD 1,420 billion for Spain and USD 630 billion for Sweden. However, the Russian economy is huge considering their massive natural resources. Especially regarding oil, gas, and a number of other commodities. Russia stands for around 25 per cent of the global gas production and provides around 40 per cent of EU's gas consumption. Russia is the world's third largest oil producer behind the United States and Saudi Arabia and stands for over 10 per cent of the total global oil production. The Russian regime has not been able to diversify its economy over the last 20 years, and therefore Russia is in a vulnerable position in the long-term when the rest of the world continues their energy transition (towards renewables). However, in the short term, Russia is in a rather strong position (or at least was up until the invasion). Massive fiscal and monetary stimuli ensured that the European economy recovered rather quickly from the coronavirus pandemic and the European economies are dependent on Russian oil and gas to be able to keep up the economic growth. According to the analysts we are following, it is likely that Putin (prior to the invasion) saw this as a good opportunity to restore Russian power in some of the former Soviet Union territories (before Europe moves away from Russian oil and gas).

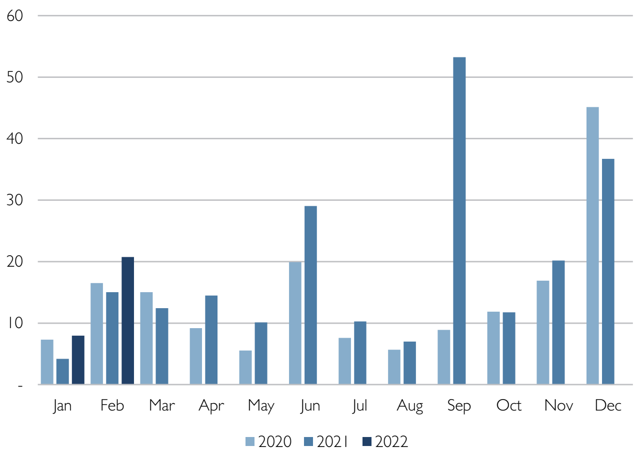
Russia is an autocratic country like Belarus, Venezuela, Syria, and China. These autocracies are run by networks of kleptocratic financial structures, security services and propaganda channels. Putin and his networks of cronies (like the networks of Lukashenko in Belarus and Assad in Syria) are convinced that a regime change will lead to their ruin, imprisonment, exile or even death. This means that there are barely any limits on what these authoritarian leaders are willing to do to stay in power. One example is the Maduro model (named after the Venezuelan leader). Over the last years, Maduro has accepted that his country completely collapsed economically and is almost entirely isolated on the global stage, as long as he remains in power. (It is ironic that the US now are in talks with Maduro to secure alternative oil supply to Russia.) We have seen an even worse development in Syria during the last decade. In addition, it became clear for autocratic leaders around the world from the Arab Spring in 2010–2011 that democratic revolutions can be very contagious and easily get out of control. According to the political analysts Catella is following, Putin was shocked by the democratic revolutions in Georgia, Ukraine and Kyrgyzstan during the last 15 years. He did also brutally crush protests in Russia on several occasions during the 2010s. One major difference between Russia and the other autocratic countries is that Russia is one of the two major nuclear powers. As an effect, it is not an option for NATO to enter a direct war with Russia. The only remaining options are providing Ukraine with weapons and imposing massive economic sanctions on Russia (the big question is when/if the European countries will impose sanctions on Russian oil and gas). However, these sanctions are now really backfiring on the global economy. Prices on all types of commodities are soaring, including energy and food, and starvation in several developing countries will soon be a real threat (Russia and Ukraine together stand for over 25 per cent of the global wheat production). Europe is especially vulnerable in this aspect. The most probable scenario according to the political analysts we follow is that Putin will not back down, and the war will go on for quite a while. Although the economic sanctions may gradually be removed when/if Russia starts to de-escalate, the Western economies will likely be hesitant in doing business with Russia from now on. It is likely that the global economy will increasingly be divided into two blocs with China and Russia on one side and the EU, the UK and the USA on the other side. In other words, the inflation pressure that we see now is most likely not temporary. The price increases can, however, be milder or more severe depending on how long it takes before some type of peace deal/de-escalation of the war is reached.

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 stagflation scenario. Before Russia's invasion, Catella expected that inflation would temporary fall back during the first half of 2022 (mainly due to lower year-on-year growth rates in several commodities) before entering a long-term uptrend. This temporary decline will likely not play out now. The soaring energy and commodity prices will instead push up inflation throughout 2022. The higher inflation will off course strangle consumers and thereby the economic growth. In addition, 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 make them sensitive to increasing interest rates. The authorities in the Western economies are aware of the fact that we need economic growth to serve these 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. The authorities will likely need to compensate consumers for the higher prices, partly through larger fiscal deficits (this is hard in many countries due to high public debt levels, not in Sweden though) but also through more monetary stimuli. However, monetary stimuli in a high inflation environment are not well 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. What will be most important, economic growth or ▶

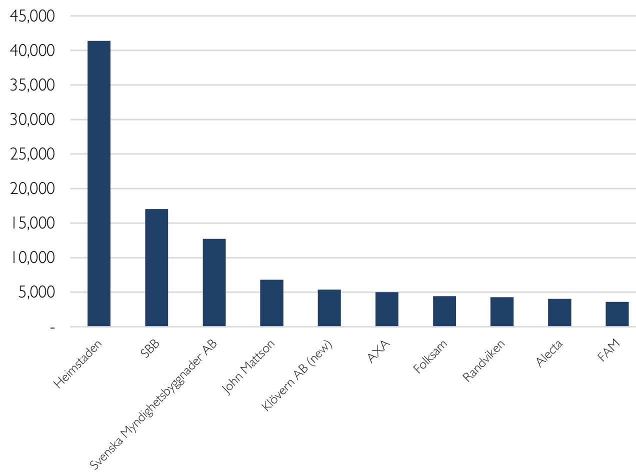
inflation? Catella believes that economic growth will be seen as the more important factor in this case. With today's debt levels in both Europe and the USA, it will be almost impossible to combat inflation without triggering a recession. In other words, central banks may be forced to accept an inflation/wage spiral from late 2022 and onwards.

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 takes off. Simultaneously, economic growth will slow down even more. Real interest rates will likely remain low and not increase until a later stage (low real interest rates are supportive for the property prices). Higher nominal long-term interest rates and somewhat higher credit spreads will gradually push up property yield levels. Central banks will not be able to pull down credit spreads as they did during the coronavirus pandemic due to the soaring inflation. A stagflation scenario (a combination of high inflation and low economic growth) may, however, be quite favourable for property. Property owners will be partly compensated trough inflation linked lease agreements (especially owners of residential, mix commercial/industrial and public properties where rental growth tends to be tightly connected to inflation over time). It is also likely that investors will increasingly look beyond the bond and equity markets to real assets (like property) that can be effective inflation hedges. However, over the last year, we have seen 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 built 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. We are now moving towards a more challenging period on the market when detailed market knowledge will be essential. ■

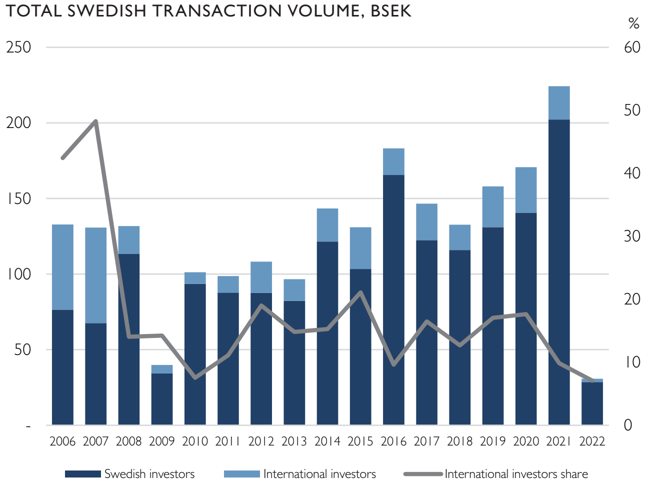
TRANSACTION VOLUME PER MONTH, BSEK



TOP 10 INVESTORS ROLLING 12-MONTH VOLUMES, MSEK



TOTAL SWEDISH TRANSACTION VOLUME, BSEK



INVESTOR TYPE AND REGION