The trend of increasing real interest rates are on paus – if resumed, it will likely cool down the property transaction market after the summer

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

Transactions amounting to SEK 14.2 billion took place in April, compared to SEK 6.1 billion and SEK 9.2 billion during the same months in 2019 and 2020. The rolling 12-month transaction volume increased to SEK 167.1 billion, from SEK 162.2 billion in March.

The number of deals exceeding SEK 80 million ended up at 28 deals in April, more than the 14 and 25 deals that took place during the same month in 2019 and 2020. The rolling 12-month number of transactions increased somewhat to 383 deals, just above the long-term average. The single largest deal in April was FAM's acquisition of the Grand Hotel property in Stockholm from Vectura for SEK 3.6 billion (both entities are parts of the Wallenberg sphere). Another large deal was Ursus's acquisition of the two residential towers named Kungsholmsporten from AFA, including 19,000 sq. m. residential area (267 rental apartments) on Kungsholmen in Stockholm inner city. Further on SPP's purchased of two newly built residential properties located in Täby and Järfälla (in the Greater Stockholm region) from JM for SEK 1.3 billion. Emilshus acquired a portfolio of commercial properties located in Växjö from the local owner APP Fastigheter for SEK 1.2 billion. In addition, Blackstone acquired a 12,300 sq. m. Stockholm inner city office property located in Södermalm.

The transaction market has been dominated by institutions and funds during the last quarters. The rolling 12-month net acquisition volume for institutions hit a peak in January 2021 at around SEK 32 billion, which is in line with the previous peaks from February 2016 and July 2017. The institutional volume has, however, fallen back during the spring and stands at SEK 20 billion in April. Funds have instead taken over the driver seat and their rolling 12-month net acquisition volume has increased to SEK 22 billion in April, from SEK 18.2 billion in January. Blackstone and Niam have been the largest buyers within this investor category so far in 2021. The listed property companies' net acquisitions keep on fluctuating around the zero-mark (it was SEK 4.1 billion in April), where Oscar Properties and SBB have been the largest buyers. The activity on the property transaction market is continuously focused on residential rental properties and logistics/industrial properties, where the recent year's increasing trends in both volumes and number of deals continue. The rolling 12-month transaction volume for public properties remain muted at around SEK 15.7 billion, mainly due to a lack of assets as there are many investors that are interested in increasing their exposure within the segment. The rolling 12-month transaction volume for office properties remains in a clear downtrend and stands at SEK 15.2 billion in April, far below the around SEK 40 billion that we saw before the pandemic erupted. Also, the rolling 12-month number of office deals declined somewhat in April to 35 deals from 37 in March. Increasing uncertainty regarding a possible structural shift due to more work-from-home going forward has taken some of the edge of the office transaction market. However, there are still plenty of investors that are interested in investing in prime offices. Blackstone did a major Stockholm inner city office deal recently and there are currently a number of high-quality Stockholm assets out at the market.

The listed property companies have showed a strong development over the last month and the average equity price for 39 of the largest listed property companies has recovered some of the ground it lost in relation to the broad equity market during the first quarter. The average equity price for the 39 listed property companies is up around 11 per cent so far in 2021, compared to 19 per cent for Stockholm OMX 30. There are, however, large differences between the companies and segments. The average equity price for the companies with a logistics/industrial focus is up 17 per cent YTD, just below Stockholm OMX 30. The companies focusing of mix commercial properties and residential/public properties are not far behind, up 14 and 12.2 per cent respectively YTD. By far the weakest performers are the office/retail companies, the average equity price for these companies is up only 1.2 per cent in average YTD.

One important reason behind the strong performance of the listed property companies over the last month is that the trend with increasing long-term interest rates that was present from December up until early-March in Sweden has paused (this trend started already in September in the USA). The Swedish 10-year government bond yields reached a peak of 0.45 per cent in late February. The yield declined to a bottom of around 0.34 on April 9, after which it has increased somewhat to around 0.38 per cent. The US 10-year government bond yield reached a peak of around 1.73 in late March and bottomed out at 1.54 on April 14. It has since increased to around 1.60 per cent. This development has been driven by lower real interest rates. The 30-year US inflation-linked government bond yields (TIPS) increased from -0.39 in early January 2021 to a peak of 0.22 in late February. The 30-year TIPS yield fluctuated in the interval 0.05–0.20 until mid-April before declining to around the zero mark where it has remained until now. Simultaneously the 10-year breakeven inflation rate (calculated based on the difference between real and nominal bond yields) has kept on rising. This is indicating continuously increasing inflation expectations on the financial markets (a trend that has been evident since April 2020).

The declining real interest rates seem odd with the overall macro environment that has improved significantly over the last months. Market sentiments are extremely strong and economic growth is roaring (especially in the USA). The US economy grew by 6.4 per cent at an annual pace during the first quarter, driven by a 10.7 per cent annual growth rate in personal consumption. Authorities have now started to relax pandemic restrictions as 29.5 per cent of the population is now fully vaccinated. Consumers are now starting to feel more confident about the economic and pandemic outlook, creating a massive injection into global economic growth during the rest of 2021. Consumers around the world built up around USD 5.4 trillion in additional savings during the pandemic, amounting to around 6 per cent of the global GDP (in the USA the corresponding figure is around 12 per cent). The Euro area ended up in a double dip recession during the first quarter after the 0.6 per cent quarter-on-quarter decline. Forecasts are, however, pointing at a strong recovery from now on and the ECB is expecting GDP to grow by 4 per cent for the full year 2021. In Sweden, the Economic Tendency Survey increased massively in April to 113.4 from 105.8 in March, driven by the manufacturing and retail sectors. The Statistics Sweden's GDP Indicator indicates a real GDP growth rate of 3.5 per cent in March and Catella's Swedish Macro Index is indicating a real GDP growth rate of around 4 per cent during the autumn.

The surge in demand comes at a time when years of under-investments in the developed economy makes the supply response less dynamic. Companies are now seeing major supply chain bottlenecks and higher commodity prices. Warren Buffett recently announced that the US economy was "red hot" and that he was seeing ongoing substantial inflation. Input prices are increasing, and companies can increase consumer prices too. In addition, the macroeconomic consensus view among investors on the financial markets is now quickly shifting towards expectations of higher inflation that is persistent. As a result, more money is being shifted into inflation hedges like commodities, which in turn is resulting in even higher inflation ahead. Simultaneously the Fed has clearly announced that they now have an output-based approach instead of the previous more pre-emptive forecast-based one. This means that they will not cool down the economy until actual inflation figures have been above the target for a good while. Many analysts expect double digit annual growth rates in the US economy during the rest of 2021, which will likely be combined with continuously monetary expansion from the Fed and other major central banks. (Bank of Canada did actually taper their asset purchases recently, but they are standing quite alone in the developed world.)

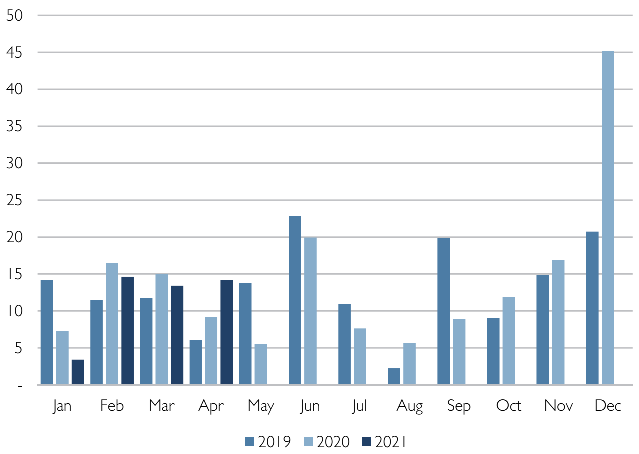
It is quite reasonable that inflation expectations increase in this macro environment. However, why do real interest rate decline when the growth picture looks so strong? One explanation could be that the markets do not expect the global economy to tolerate higher interest rates. Global debt levels among governments, corporations and households may simply have increased too much. In the longer term, there is good empirical evidence that steadily higher debt levels in an economy tend to generate increasingly lower economic growth. The long-term real interest rates are a measure of an economy's ability to grow over time. When the potential growth rate decline, so do the real interest rates. The current economic upswing is to a large extent due to fiscal stimuli in the major developed economies (mainly the USA). However, the fiscal multiplier (the ratio of change in economic output arising from a change in government spending) has had a tendency to be very low if not negative in the Western economies during recent decades. The extra debt that the governments are taking on to stimulate their respective economies through tax cuts and benefits are generally only resulting in short-term gains in economic growth (look for instance on Trump's tax cuts in 2018). In this case, the result would be continually weak real GDP growth in most developed economies after a short growth spurt in 2021 and early 2022. The increasing inflation expectation is, in this scenario, an indication that the major central banks (and especially the Fed) will continue with extremely expansive monetary policies and perhaps even move towards a full monetarisation/cancelation of debts. As a result of this, more and more investors see 1970-style stagflation (continuously low real GDP growth but higher inflation) as a realistic macroeconomic scenario going forward.

However, there are a number of technical factors that may explain parts of the current stabilisation in the long-term real interest rates. To start with, the US 10-year government bond yield followed a parabolic curve pattern for the six months up to March 2021 (with an exponential growth rate). This pattern is often not sustainable, and yields tend to dump when it breaks the parabolic curve. As the yield curve steepened very fast it became appealing for market participants to source money for the short term and lend it for the long term at higher interest rates. This process is putting a downward pressure on long-term interest rates. Further on, an additional amount of roughly USD 1,000 billion has flowed into the US economy over a short period of time as the US Department of the Treasury has implemented the current fiscal stimulus measures (this money was previously ►

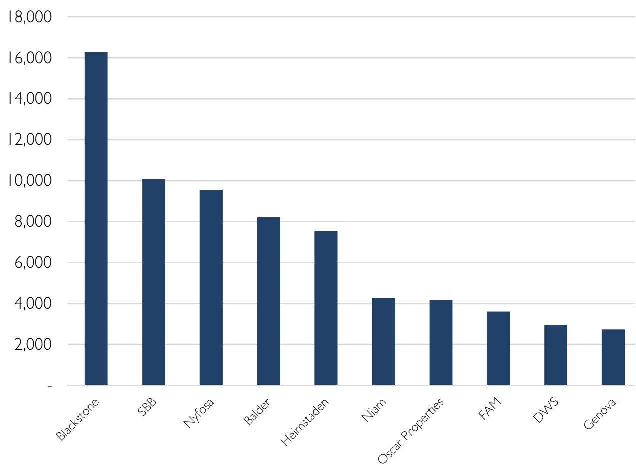
at a bank account at the Fed). This is increasing the liquidity in the economy and is pushing down both short- and long-term interest rates. If these technical factors can explain major parts of the stabilisation, the trend of increasing real and nominal interest rates will likely resume in a matter of weeks or months. If real interest rates keep on increasing, this will trickle down to the property transaction market and cool down the transaction market sometime after the summer.

Residential, logistics/industrial and public properties are quite effective inflation hedges and can cope with higher nominal interest rates relatively well – as long as the higher interest rates are due to higher inflation – as the rental incomes within these property segments tend to follow inflation. Increasing real interest rates are, however, not positive for these segments at all as it leads to higher financing costs that are not compensated for by higher rental incomes. Prime office rents, on the other hand, tend to follow GDP growth quite well. If we have a healthy economic recovery where stronger long-term economic growth drives up the real interest rate, prime offices can still manage quite well as they get compensated through stronger rental growth. If nominal interest rates keep on increasing, the crucial question for the property sector is whether this is due to higher inflation or if real interest rates will end up higher as well?

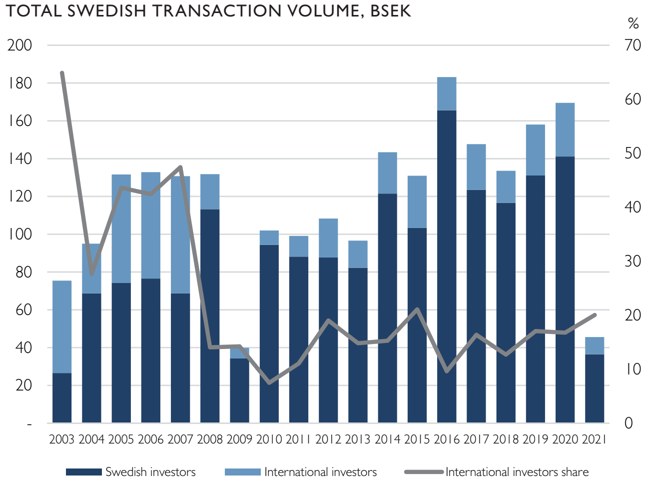
TRANSACTION VOLUME PER MONTH, BSEK



TOP 10 INVESTORS ROLLING 12-MONTH VOLUMES, MSEK



TOTAL SWEDISH TRANSACTION VOLUME, BSEK



INVESTOR TYPE AND REGION