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The economy is heading towards a mild recession in 2023, but parts of the property market will benefit when real interest rates fall back again

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The transaction volume ended at SEK 14.0 billion in April, which can be compared to SEK 9.2 billion and SEK 14.5 billion during the same month in 2020 and 2021 respectively. The rolling 12-month transaction volume remains at SEK 243.2 billion, which is in line with the all-time-high level of last month.

The number of deals exceeding SEK 80 million ended at 32 deals in March, compared to 25 and 31 transactions that took place during the same month in 2020 and 2021. The rolling 12-month number of deals ended at 418 in March, which is a level indicating a cyclical peak.

The listed property companies have been through a major correction since November 2021. The equity market started to recover in March but fell back again in April. Since the market peak in late November the listed property companies are down around 31 per cent (compared to minus 13 per cent for the Stockholm OMX 30). The residential/public property companies have clearly underperformed during this time interval and are down around 41 per cent. The equity market premiums have declined significantly during recent months. The average premium to NAV in the 30 of the largest property companies is currently just below 4 per cent. There are, however, large differences between the companies. There are equity market premiums on some of the companies that are focusing on mix commercial, logistics/industrial and/or residential properties (in the latter case if the project portfolios are large and the companies are promising strong growth ahead). Simultaneously, there are discounts for several of the companies with a focus on office and/or retail properties. There are also discounts for some of the companies focusing on residential and/or public properties in the major cities. As a result, the equity market is still indicating somewhat lower yield for segments like mix commercial, logistics/industrial and residential properties in smaller cities (but significantly less so than a month ago).

The institutions were the single largest net-investors on the property market during 2021 (they were net-buying properties for SEK 66 billion during the 12 months to April). Although Heimstaden's acquisition from Akelius makes up more than half of that figure, their net-acquisitions are still in a significant uptrend when adjusting for this deal. The listed property companies have slowed down their net-acquisitions over the last year. The figures have, however, stabilised lately and the rolling 12-month figure now stand at SEK 24 billion. Funds were (along the institutions) among the largest net-buyers on the market during the last spring, and their rolling 12-month net-acquisitions peaked at SEK 21.9 billion in April 2021. Since then, however, the figure has fallen back close to the zero mark. Foreign investors have slowed down their investment activity lately and acquired Swedish properties for SEK 16 billion during the 12 months to April. This is in the lower bound of the interval of SEK 15–35 billion that has prevailed over the last decade. The number of deals done by foreign investors has clearly declined during the last decade as property values have increased.

Stagflation is now turning from a less probable alternative macroeconomic scenario to the main scenario for many actors on the financial markets. The prospect of inflation is scaring policymakers as there are few ways to handle it. Higher policy rates and less asset purchases (or even reductions in the central banks' balance sheets) will lower demand and inflation. This is especially the case in Sweden where households have very short capital maturity and thereby are highly sensitive to higher interest rates. However, high debt levels and low economic growth is a dangerous mix. It can easily spill over to a credit crunch and deep recession/depression if companies (and in the worst case even households) start to default on their debts. If policymakers on the other hand keep their monetary policies loose, consumer prices will keep on increasing and even accelerate through wage/inflation spirals (this usually ends up in a deep recession too). Even before Russia invaded Ukraine, prices had risen to multi-decade highs in many countries. The war exacerbated the problems and has resulted in the largest commodity shock since the 1970s (as Russia and Ukraine are both major commodity producers). Global forecasters have responded by lowering their expectations for economic growth lately. The consensus view for global economic growth is a growth rate of 3.3 per cent in average in 2022 (down from 4.1 per cent in January). The consensus expectation for inflation is 6.2 per cent this year, up from 2.25 per cent in January. IMF has downgraded their forecast for 143 countries during recent months (representing 86 per cent of the global economy).

The most probable scenario according to the political analysts we are following is that the Ukrainian war will evolve into a frozen conflict and go on for years (or maybe even a decade). As a result, the sanctions against Russia will remain, and may even be stepped up if Russia escalates the conflict further. It is likely that the global economy will increasingly be divided into two blocs during coming years, with China and Russia on one side and the EU, the UK, Japan, Australia, Canada and the USA on the other. In addition to the war, the corona outbreak in China (and especially the government's response to it) will have a major impact on the global economy during coming months/quarters. An estimated 300–400 ▶

million Chinese are subject to lockdown measures (estimations vary, these figures are based on ECR Research). Xi Jinping wants to avoid too much unrest in China ahead of his appointment to an unprecedented third term by the end of this year. The consensus among analysts is therefore that Beijing will stick to its zero-Covid policy at least until the autumn. The Chinese authorities are responding to the economic slowdown by new large scale infrastructure projects (financed by even more debt). However, the result of all this is even lower global economic growth and more bottlenecks in the global supply chains (more stagflation).

Catella's GDP Macro Index (which is a mix of six leading indicators for the Swedish GDP growth) is indicating a significant economic slowdown ahead. According to the index, Swedish GDP growth will slow down to a rate of around 2.0–2.5 per cent year-on-year during the third quarter 2022. Looking further ahead, the index is indicating a recession in 2023 (the index is though less reliable this far out in the future). In Sweden, CPI inflation increased to 6.0 per cent in March, driven by soaring electricity, food and fuel costs. Catella's CPI Macro Index (a leading index for inflation including a mix of macro indicators/commodities) is indicating that we have now reached a short-term peak in inflation and that inflation will temporarily fall back towards 2–3 per cent during mid-2022 (mainly due to falling year-on-year commodity price increases). After that, the index is indicating higher inflation again (as with the GDP index, however, the index is less reliable this far out in the future). It is also important to notice that the model does not include indicators that mirrors the supply chain bottlenecks. It is a high risk that the bottlenecks will worsen again during coming months due to the Ukraine war and corona related lockdowns in China. The result may be that the CPI inflation rate keeps on over-shooting the levels indicated by the model for another few quarters.

The monetary support was massive in 2020–2021. Six of the major central banks (the Fed, ECB, BoJ, BoE, PBoC and the Riksbank) increased their combined balance sheet by USD 9.6 trillion during the 12 months following February 2020, almost in line with the increase of their combined balance sheet during the entire decade up to February 2020. This policy forced investors out on the risk scale and inflated assets prices like equities and property (there is a strong correlation between the aggregated central bank balance sheet and property and equity prices over the last decade). This process is starting to reverse now when liquidity is removed from the financial markets. The Fed is expected to start to shred up to USD 95 billion a month from its USD 9 trillion balance sheet during the spring 2022. In Europe, there is less upward pressure on wages and core inflation, which means that the ECB is likely to act later and less forcefully than the Fed. Bank of China, on the other hand, is increasing their monetary stimuli due to the fast slow-down in economic growth. All in all, the year-on-year growth rate of combined balance sheet of the six central banks above has declined from USD 9.5 trillion in February 2021 to USD 500 billion in April 2022 and will likely fall below the zero mark during coming months.

For years, Catella has seen a stagflation scenario as the most likely macroeconomic development in the medium term. In our latest forecast (that will be published later this week) higher consumer prices, monetary tightening and lower real incomes for households are dragging down the Swedish economy into a mild recession in 2023. However, lower economic growth will slow down the CPI inflation rate too. If the economy slows down too much, though, there is a high risk that the debt load collapses, and we end up in a global recession and credit crunch. Keeping up economic growth will therefore be seen as more important for central banks than fighting inflation. We are likely already in a situation where price/wage spiral is about to emerge. The US is ahead of Europe, but this process will likely spread throughout the world. According to Catella's main scenario, short-term interest rates will increase fast during coming quarters as the Riksbank increases the repo rate to around 1.25 per cent in late 2022. Long-term nominal interest rates have increased extremely fast during recent months. They will now temporarily fall back in line with the slowing economic growth but follow a long-term increasing trend during coming years. Real interest rates have increased markedly lately but will likely fall back again as central banks will tighten too little to rein in inflation. After that, real interest rates will likely remain low in the short term and not increase until a later stage.

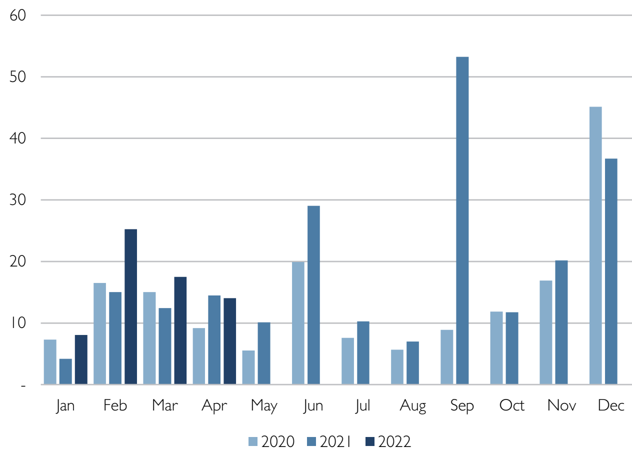
Credit spreads on the bond market have increased somewhat lately but are still at historically low levels. Credit spreads for the listed property companies are currently significantly below the high levels seen during the early phases of the corona crisis in 2020. Less central bank stimuli, lower economic growth and more risk averse investors will produce higher credit spreads going forward. Central banks will likely not be able to reduce credit spreads as they did during the coronavirus pandemic due to high inflation. However, they will not let credit spreads increase to much either as this would jeopardise financial stability and create a credit crunch.

The transaction volume on the Swedish property market has been in an uptrend since mid-2018 and is now at an absolute historic peak. The number of deals is at a cyclical peak and the average deal size is historically high. In the short term, lower economic growth, less central banks liquidity and high long-term real interest rates (compared to the last 12–18 months) will take its toll on the transaction market. Transaction volumes and the number of deals will likely fall back during the second half of 2022. Buyers are facing high spot market interest rates/credit margins (compared to the last 12–18 months), while seller are having capital and interest rate maturities of around 3 years in average (i.e. they are still benefitting from extremely low financing costs). The result is that it becomes harder for buyers and seller to meet up and the result is that liquidity is declining on the property market. However, Catella expects central banks to tighten too little and too late to rein in inflation. As a result, long-term inflation expectations will increase, and long-term real interest rates will decline below the zero mark again. This is a rather good macro environment for real assets like property.

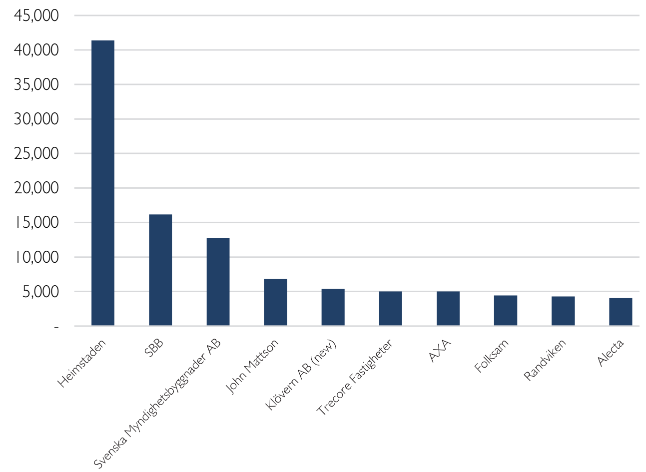
There are, however, major differences in how effective the property segments are in a stagflation environment. Segments with low yield levels like residential and public properties in major/regional cities, ▶

as well as prime offices and logistics, will be hard hit by the higher financing costs. For many of these properties, financing costs may soon be higher than the actual property yields, making rental growth the only parameter that prevent the assets from generating negative leverage. In addition, not all segments are having market rents that move in line with inflation. Segments with rental markets that are tightly connected to the real GDP growth over time (like prime offices in Stockholm) are not benefitting at all from a stagflation scenario. In addition, these segments also tend to have low yield levels, and are therefore sensitive to increasing financing costs. When it comes to residential rental properties, the picture may become complicated as higher shelter costs for low- and middle-income families is politically sensitive. There is a risk that rent levels will not keep up with inflation if we end up having CPI inflation rates that remain over the 3-per-cent level for an extended period. In addition, over the last two years (2020–2021) there has been a major oversupply on the residential market which may hamper rental growth for newly built apartments. The parts of the market that will likely perform best in a stagflation environment are segments with somewhat higher yield levels, limited new supply and market rents that follow CPI inflation (like industrial/logistics, public, grocery store, big-box retail and mix commercial properties).

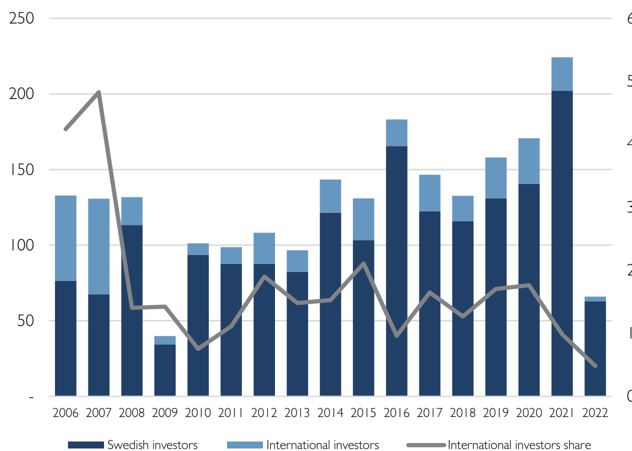
TRANSACTION VOLUME PER MONTH, BSEK



TOP 10 INVESTORS ROLLING 12-MONTH VOLUMES, MSEK



TOTAL SWEDISH TRANSACTION VOLUME, BSEK



INVESTOR TYPE AND REGION