CATELLA

Continued low real interest rates create floor for property prices going forward

ARVID LINDQVIST
Head of Research

arvid.lindqvist@catella.se

Activity was slow on the transaction market in October, and the transaction volume amounts to around SEK 9.6 billion, compared with SEK 10.6 billion in October 2017 and SEK 12.6 billion in October 2016. The three largest transactions made up nearly the entire transaction volume for the month.

The largest transaction was a property exchange between Atrium Ljungberg and Folksam comprising three office properties in central Stockholm with a property value of approximately SEK 3.7 billion. The second largest transaction was Castellum's divestment of an industry and retail portfolio to Sinoma Fastigheter (a joint venture with Balder, Redito and an undisclosed institution) for approximately SEK 1.8 billion. The third largest transaction was Samhällsbyggnadsbolaget's acquisition of a new construction project with a cultural centre and a hotel from Skellefteå municipality for approximately SEK 1 billion.

There were significant drops in stock markets around the globe in October, and increasingly more investors are starting to question valuations (especially of US-based tech companies) and the global economic development. In 2017 the global economic development was strong, but in 2018 there has been co-variation between several negative factors. The ongoing economic slowdown in China is an important factor. Since 2008, the total debt level in China has increased from slightly more than 160 per cent of GDP to 265 per cent of GDP. This debt level is not extremely high compared to other developed countries (Sweden has a total debt level of approximately 280 per cent of GDP), but the rate at which the debt has increased over the past 10 years is striking. In recent years, the Chinese government has attempted to control and reduce the debt. However, this has coincided with the US government's escalation of the trade war with China (the US has so far introduced tariffs on USD 250 billion worth of goods, which corresponds to nearly 10 per cent to China's total exports). Furthermore, economic growth has been considerably stronger in the US than in other developed countries in the past 18 months, resulting in rising inflation and tighter monetary policy from the Fed (increased interest rates and quantitative tightening). Consequently, the dollar has become stronger as more capital has shifted from developing countries and Europe into the US. The problem for many companies in developing countries is that they have borrowed large sums in US dollars, and the strengthened US dollar coupled with rising interest rates are creating profitability-related problems (Turkey and Argentina have been the canaries in the coal mine). The problems have worsened by China being perceived as depreciating its currency in response to US tariffs, which has further weakened other developing countries' currencies against the dollar. At the same time, world trade growth has decreased during 2018 and leading indicators are pointing to a continued decrease in the coming 6–12 months. In Europe, this weaker global economy can be observed in lowered growth forecasts for the large member countries (especially Germany) as well as worsened export orders sentiments within the manufacturing sector.

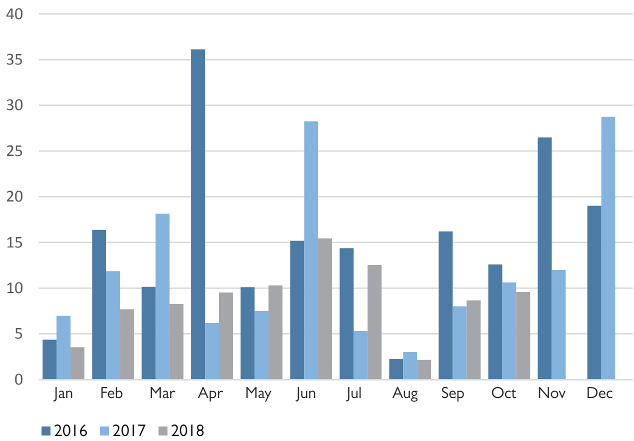
One specific explanation to the weak global stock market development is the gap between the US three month Treasury bill rate and the average dividend on the S&P 500. In 2011–2015, US Treasury bills had an interest rate of around zero, while the average dividend on the stock market was slightly more than 2 per cent. However, interest rates began to rise in 2016–2017 and in the autumn of 2018 the interest rate for US Treasury bills exceeded the average dividend on the stock market. As such, investors suddenly had a risk-free alternative to stocks, properties and corporate bonds.

How will the global development affect the Swedish economy and property market? Sweden is facing a domestically driven economic downturn that will likely slow down GDP growth in Q3 and Q4 of 2018. The reason for the downturn is the past year's falling housing prices. There is a delay of approximately one year between the development on the housing market and its effects on GDP. In Q3 and Q4 of 2018, the slowdown in new construction of housing is expected to reduce GDP growth by approximately 1–1.5 percentage points year-on-year. Furthermore, there is a strong correlation between housing price development and household consumption/net savings (savings minus new loans). This correlation also has around a one year delay. Households will likely become more careful in the second half of 2018, increasing their savings and reducing their consumption (a behaviour that is reinforced further by the falling stock market in past weeks). There are already evident signs of this in the monthly data for household consumption, which is signalling zero growth since the summer (although this is partly a result of falling automobile sales following new tax regulations). In addition, revenue growth in the restaurant sector has fallen rapidly in the past 12 months and is currently negative year-on-year. In other words, Sweden's economic growth is slowing down, but falling new construction of housing is mitigating the oversupply of newly constructed flats (and its negative effect on housing prices). Housing prices will likely continue to fall by approximately 5 per cent until mid-2019, after which the balance between supply and demand appears to improve. However, there is still a downside risk as a weaker economy coupled with amortization requirements might initiate a self-reinforcing downward spiral where the economy and housing market pull each other down.

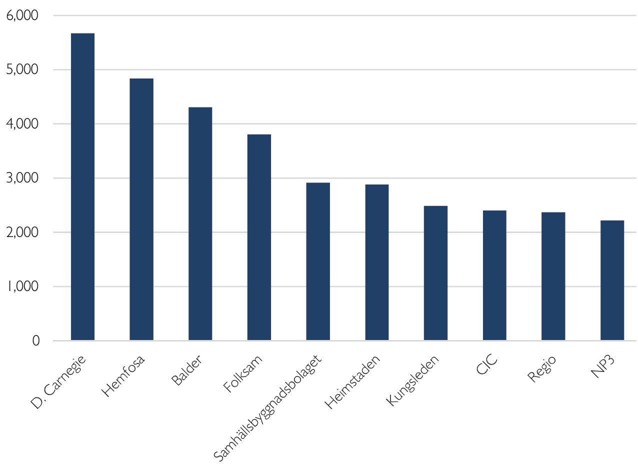
However, it might be too soon and too pessimistic to assume that there will be a global economic downturn as early as in 2019. It is unlikely that either the Fed or the Chinese government will accept a large economic slowdown, as this would likely result in their economies collapsing under the weight of their debt. Instead, the most probable development is that a weaker stock market will cause the Fed to hold back further tightening of their monetary policy (or in extreme cases, to reverse past measures). Unemployment in the US is at a record low and wage increases have just started to gain momentum. As wages go up, it is possible for consumption to increase and stimulate the economy a bit longer. It is very likely that the Fed will attempt to inflate away the high debt levels during the coming years. There is, of course, also a considerable risk that both the Chinese and the US governments misjudge the development and exacerbate a global economic downturn.

The direction going forward for the Swedish property market is a combination of weaker economic growth, gradually higher interest rates from the large central banks and less supporting purchases of securities. For property investors, this means slightly higher interest rates and probably a higher gap in interest rate margins between companies with different credit ratings. However, the low economic growth will likely entail continued low real interest rates for an extended period of time. Low real interest rates (which means low returns on investments) will result in households around the world having to save more for their pensions. This capital will create a floor for property prices going forward. As prices fall, new capital in search of investment opportunities will quickly enter the market. Well-consolidated investors with good access to credit and good knowledge of properties will likely be able to find good investment opportunities on the Swedish property market in the years to come.

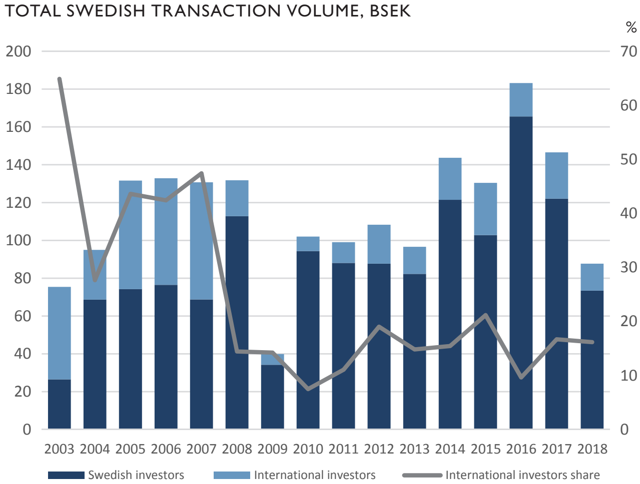
TRANSACTION VOLUME PER MONTH, BSEK



TOP 10 INVESTORS ROLLING 12-MONTHS VOLUMES, MSEK



TOTAL SWEDISH TRANSACTION VOLUME, BSEK



INVESTOR TYPE AND REGION