CATELLA

# In the short term the property market will benefit from this summer's falling interest rates

## – but in the long term we might be heading for higher inflation and higher long-term interest rates

ARVID LINDQVIST
Head of Research

arvid.lindqvist@catella.se

There was a strong development on the Swedish transaction market during the summer and the combined volume during July and August was SEK 12.2 billion, which can be compared to SEK 8.3 billion and SEK 16 billion during the same periods in 2017 and 2018.

The global macroeconomic landscape has taken a considerable hit in recent months following the escalating trade war between China and the United States (which might also come to include Europe, Japan and South Korea), an anticipated no-deal Brexit in October, political turbulence in Italy and increasing political risk in countries such as Iran, Russia and China/Hong Kong. This year, all the major central banks have made political U-turns and are moving towards more expansive monetary policies (the Fed carried out its first in a series of anticipated interest rate cuts in late July). Global long-term interest rates have fallen considerably during the summer. The global volume of bonds with negative yields has reached nearly USD 17 billion, which represents more than a quarter of the entire global bond market and is an unprecedented amount. Furthermore, in mid-August the 30-year US Treasury bond yield fell below 2 per cent for the first time ever, and the entire Swedish yield curve was negative. In fact, Sweden has now joined a small number of countries (including Germany and Japan) that have issued government bonds on the primary market with a negative yield. The message from the bond market is that it expects a global recession to occur.

The United States' yield curve (the gap between the 2-year and 10-year US Treasury bond yields) inverted in early August, while other parts of the yield curve inverted as early as last spring. However, the gap between the 2-year and 10-year US Treasury bond yields is particularly interesting, as it has been a reliable indicator of all recessions in the United States since the 1960s. However, as was also the case in 2000 and 2006, many analysts are downplaying the importance of the yield curve inversion. They argue that long-term interest rates in the United States are falling because the country's economic growth exceeds global economic growth, and because companies in developing countries are speeding up their repayments of their (considerable) loans in US dollars. It is true that the time between yield curve inversions and recessions has become longer (from approximately five quarters after World War II to approximately two years before the financial crisis) and it is also possible that the yield curve has become a less reliable indicator of coming recessions.

However, regardless of whether there will be a global recession, the world economy is slowing down rapidly. Sweden's GDP contracted between the first and second quarter (as did Germany's), mainly driven by a decline in investments. Although exports decreased, net exports still contributed to GDP growth during the second quarter as imports decreased even more. According to leading indicators for the export sector, there will be a continued slowdown in exports going forward, at the same time as the domestic economy will struggle to contribute to economic growth at all. As such, the Swedish economy will likely be in a recession (defined as a fall in GDP in two successive quarters) when the data for the third quarter is published.

During the past decade, asset prices have generally been positively affected by negative macroeconomic events, as the market has expected more monetary stimulus in response. However, the recent development suggests that this positive reaction function is now weakening. Central banks barely have any fuel left to boost the economy (with the possible exception of the Fed, which pursued monetary tightening until late 2018). Historically, interest rate cuts of approximately five percentage points have been needed in order to counteract a recession, which is currently unfeasible. Most central banks have extremely low interest rates and record large balance sheets from years of buying government bonds and other assets. In other words, we are facing a challenging macroeconomic situation. The stabilization policies that have been pursued since the 1990s are at the end of the road, and the global economy is weakening at the same time as global debt has reached record levels and monetary stimulus is nearly maxed out.

So how do we avoid this downturn that the world economy is facing? We will probably see a paradigm shift in the coming years, after a 30-year period with a neoliberal world economy where globalization and extremely expansive monetary policies have benefited capital at the expense of labour. The low inflation landscape of recent decades was made possible by a combination of macroeconomic factors, including globalization (with increased competition and a subsequent drop in prices and wages), automation and technological advances, relatively tight fiscal policies in Europe and clearly defined inflation goals among the majority of central banks. There are many signs that we will begin to see increased political pressure towards more evenly distributed assets, growth and economic stimulus going forward (as shown by the recent political successes of Elizabeth Warren, Bernie Sanders and Jeremy Corbyn). Furthermore, more and more analysts and politicians are recommending increased economic stimulus directly financed by the central banks (this is called Modern Monetary Theory and basically means that the state is financing increased spending and lower taxes by printing money).

There are indications that the coming years will entail more trade barriers, full capacity utilisation in most of the larger economies, increasing political pressure on central banks to accept higher inflation, and more expansive fiscal policies (in part financed by central banks). This will likely result in higher inflation in the medium term, which allows companies and households to manage their high debts. However, this development is not without its problems. Although continued low productivity, an ageing population and a demographically driven global savings surplus are likely to continue to push down real interest rates in the foreseeable future, the gradually increasing inflation will cause investors to demand a risk premium on bond yields. This could ▶

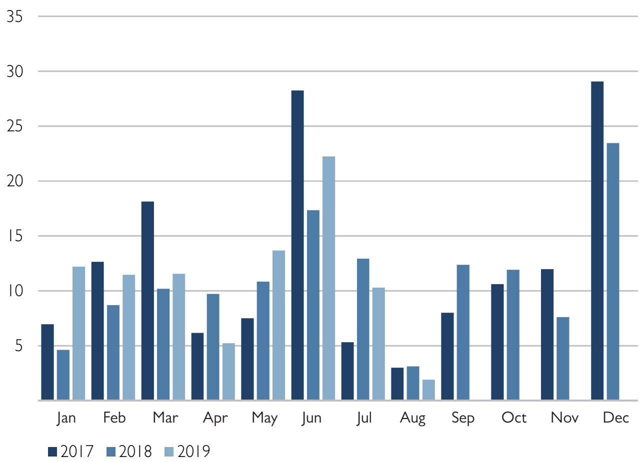
result in higher real interest rates despite low economic growth, which would affect the pricing of all asset types, including real assets such as property.

As long as Sweden does not fall into a deep recession (with significantly higher vacancies and falling office rents), the Swedish property market will likely benefit more from low interest rates in the coming 12–18 months than it will be disadvantaged by weakened economic growth. Interest rates are one of the most important drivers of the property market, and the correlation over time between the average financing cost of listed property companies and their property yields is more or less perfectly linear. Since the average fixed interest term of ten of the largest listed property companies is approximately three years, any recent changes in underlying market interest rates and interest margins will gradually be reflected in the companies' average financing costs. Indeed, since the end of 2013, the average interest rate of these ten property companies has decreased from approximately 4 per cent to 1.7 per cent, and during the same time period their reported property yields have fallen from 5.5 per cent to 4.2 per cent.

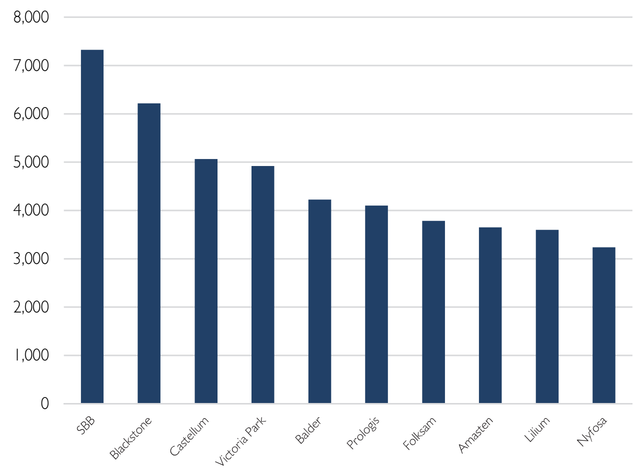
Listed property companies have enjoyed a strong year on the stock market, with a total return of around 45 per cent between January and August, compared to 12 per cent for OMX Stockholm 30. The average premium for listed property companies' shares compared to the companies' net asset value has increased from 13 per cent before the summer to over 20 per cent in August. There is a correlation over time between the premiums of listed property companies and the yields on the property market. Higher premiums will cause companies to invest more in their prioritized property segments, which in turn will push down property yields (with property yields lagging approximately 9–12 months behind the equity market premiums). However, due to increased macroeconomic uncertainty, property companies with a high-risk business model are at risk of facing higher interest rate margins. In addition, a flat yield curve inhibits the profitability of banks and reduces credit growth. Swedish property will likely remain attractive to both Swedish and international investors in the coming 12–18 months. However, due to increasingly selective investors, the downward pressure on property yields will apply mainly to properties in attractive locations in metropolitan and regional cities.

In the long term, there is a significant risk that we will be facing a more challenging macroeconomic landscape with a combination of continued low productivity, weak economic growth, higher inflation, gradually rising long-term interest rates and reduced stimulus from the major central banks. For property investors, this will entail slightly higher market interest rates and probably more fluctuating interest margins depending on the companies' credit rating. Nevertheless, property remains a real asset that can withstand inflation fairly well. Even if investors demand a risk premium on bond yields, the weak economic growth will likely result in continued low real interest rates for a long time to come. Furthermore, low returns on capital also means that households around the world will have to save more for their pensions. These savings create a floor for property prices, as new capital seeking investment opportunities will enter the market as soon as prices begin to fall.

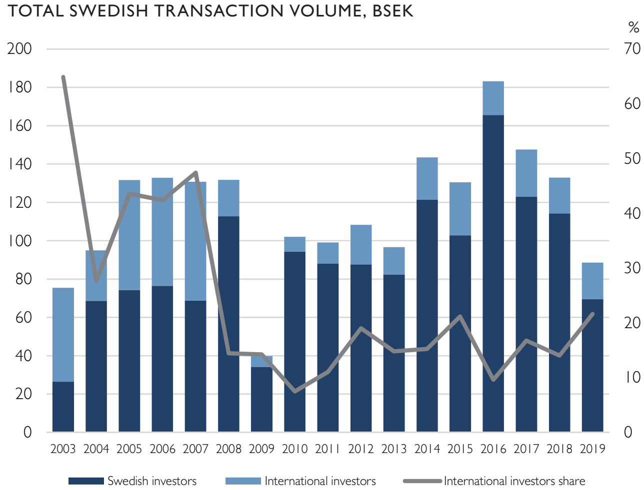
TRANSACTION VOLUME PER MONTH, BSEK




TOP 10 INVESTORS ROLLING 12-MONTHS VOLUMES, MSEK




TOTAL SWEDISH TRANSACTION VOLUME, BSEK




INVESTOR TYPE AND REGION