Due to the recent weeks' turbulence on the financial markets Catella has postponed the publication of Credi Q1 2020 until April 1st to have more accurate responses on the credit survey. We are instead publishing the following market comment.

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The upcoming recession will likely result in a repricing on the property market

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The upcoming recession will likely result in a repricing on the property market – but there are good potentials for a strong rally when the market turns around.

The spreading of the Corona virus (the Covid-19) in Europe and the USA has been a game changer on the financial markets. Both S&P 500 and most European markets have entered bear market territory (a drop of more than 20 per cent since the previous peak) and the economic activities are slowing down to standstill in most European countries. Manufacturing PMI in China dropped to 35.7 in February, which is below the lows during the financial crises. Retail sales, investments and industrial production has tumbled in China, and data suggests that GDP declined by around 13 per cent during the first two months of 2020. Kenneth Rogoff (Harvard professor and pervious IMF chief economist) believes that the odds are 90 per cent that the global economy is already in recession (defined as an annual growth rate of below 2.5 per cent). It is quite likely that global GDP will contract during the first half 2020, and you need to have a quite positive scenario to count in any growth at all during the second half of the year. The FTSE All World index has dropped 22 per cent since February 20, which is the fastest sell-off for at least 30 years (probably much longer). Stockholm OMX 30 is down 32 per cent since the peak in February 20, while the equity price for ten of the largest listed Swedish property companies are down 39 per cent on average during the same period*. These ten companies traded at an 11 per cent discount to NAV in average last Friday (March 13).

The CBOE Volatility Index (VIX) increased to over 75 late last week, which is close to the all-time high of just above 80 in November 2008 (it has fallen back to around 58 on Monday). This is an indication that the market is expecting extremely high equity market volatility going forward and is indicating extreme risk-off on the financial markets. This is visible on the corporate bond markets where we are heading towards a quite severe credit crunch. Junk bond funds have seen large outflows and US high-yield bond risk premiums (over the Treasury yield) have climbed sharply. The yield spread between high and lower rated investment grade bonds has also increased markedly lately, as the market is becoming very picky when it comes to risk. Companies with high risk in their business models on the Swedish property market will likely have problems to refinance their debt going forward (and their debt will be significantly more expensive than before in any case). Money has flowed into safe assets and the US 10 year Treasury yield fell to an all-time low of 0.41 per cent on March 10, while Swedish 10 year government bond yield declined to an all-time low of -0.53. Long term government bond yields have increased since then, however, and 10 year US and Swedish bonds now stand at 0.77 and -0.09 respectively. The higher bond yields are partly due to declining liquidity on the US Treasury market (market volatility has also soared over the last week on the Treasury market). The Fed has responded by unveiling a multitrillion dollar liquidity operation and a policy rate cut to zero to calm down the market stress. Liquidity has also slumped on the US mortgage bond market to levels not seen since the financial crisis (this is quite concerning as this use to be the world's second most liquid market after Treasuries), and higher mortgage costs are punishing US households. Another factor behind the higher government bond yields is that recent weeks' losses on the stock market have resulted in margin calls where large investors need to sell low-risk assets to cover losses (yields are increasing when they are selling off bonds, the gold price

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has also declined as a result of this). The ECB and the Riksbank (and several other central banks) have also injected significant amounts of liquidity and have/or are announcing simulative measures. As a result some investors expect a temporary bounce-back on the equity markets during the coming days/weeks.

Goldman Sachs has looked into the 27 bear markets on the US equity market that have taken place since the 1800s. The average price fall was 38 per cent and it took an average 60 months to return to previous peak. For the previous "event-driven" bear markets (the Corona virus can be considered an event), the average price fall was 29 per cent and the old peak was reached in 15 months. It seems like the underlying reason for the heavy market response this time is more than just the economic effects created by the Covid-19. Equity multiples were at record highs a few weeks ago (especially in the USA) as a result of more than 20 years of falling inflation, expansive monetary policies and falling interest rate. What really terrifies the market may be the mix of record high debts, a broadly inflated asset bubble throughout asset classes/ geographies, and a global recession during the first half of 2020. Over the last year up until two weeks ago, central banks in the advanced economies had cut their policy rates at the fastest pace since the financial crisis to counter an overall slowing global economy – and this was before the impact of Covid-19. The markets fear that the Covid-19 is the trigger that push the global economy in a deflation spiral and that it collapses under its record high debt load.

What happens now depends on how long it takes to contain the virus spread in Europe/the US and how quick and large the stimulus measures from the authorities materializes. If the virus is contained within a quarter or so and the government/the Riksbank responds with significant coordinated stimulus (the measures announces so far may be a good start), there will likely be a powerful equity market recovery during the early autumn. Even if this rosy (and perhaps unlikely) scenario plays out, the Swedish economy will still end up in a deep recession with a full year negative GDP growth of perhaps 2–3 per cent, an CPI-inflation close or below the zero-mark and long term Swedish government bond yield at -1.0 per cent or so. Prime office rents in Stockholm are tightly correlated to the GDP growth (which in turn is tightly connected to the growth in office bound employment) and rent levels have been driven significantly above fundamentals since 2015. Even in this positive macro scenario we will likely see office market rent declines of at least 20 per cent or so in the Stockholm CBD during the coming 9–12 months (we are still very early in the process so it is hard to have an exact figure). Vacancies will increase and co-working companies will likely be one of the first office tenant segments to end up in serious financial problems (it is not impossible that that will happen as soon as in a few weeks). New production of offices will also decline markedly, which will be a positive factor for the rental market in 2021–2022 (due to the falling supply). Although prime office market rents are expected to decline quite substantially

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the property companies' NOIs remain stable as long as bankruptcy rates do not increase significantly among tenants (average rents are currently significantly lower than market rents due to the recent years' strong market rent development). We are, however, already getting signals from the market that tenants are seeking ways to postpone parts of their rental payments. In this respect it is crucial that the authorities can provide fiscal assistance, loans and credit guarantees to companies to prevent major bankruptcies.

Listed property companies, Swedish institutions, and foreign funds (both core and opportunistic funds) have been the main drivers on the transaction market during the last 9–12 months. The Swedish listed property companies have been focusing on commercial, residential and public properties in secondary locations in the major cities and in smaller cities (relatively high-risk property segments). Swedish institutions and foreign core funds on the other hand have been focusing on well-located properties in large and regional cities (low-risk property segments). In general, investors have been focusing on building volume and there have been substantial portfolio premiums on the market. The recent development on the US high-yield bond market indicates that credit spreads are now increasing fast also for Swedish property companies (especially for the ones with high risk in their business models). As long as the risk-off mood persists on the financial markets, investors will be less able/willing to do deals – which will result in low transaction activity all over the market. However, prime property will always be an attractive alternative to government and corporate bonds when interest rates are extremely low.

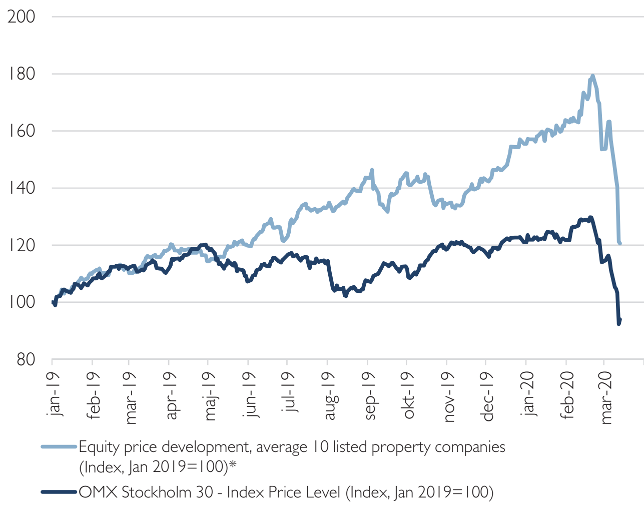
It is currently impossible to say how long it will take before we are trough this and the economy starts to recover. It is however likely that we will see massive fiscal stimulus going forward all over the developed world. It is also likely that central banks will pull out all the stops to stimulate the economies through further rate cuts (if possible), QE, yield curve control and/or direct helicopter money. When the market finally turns, however, economic growth will be strong (due to the catch-up effect), credit margins will fall back again and interest rates will remain extremely low (central banks will most likely keep on stimulating the markets a good while after the recovery has taken hold). The effect will likely be a historically strong rally on the property market – at the moment, however, it is impossible to say if that will happen in 3, 12 or 24 months. ■

*Atrium Ljungberg, Castellum, Diös, Fastpartner, Fabege, Hufvudstaden, Klövern, Kungsleden, Wallenstam and Wihlborgs.

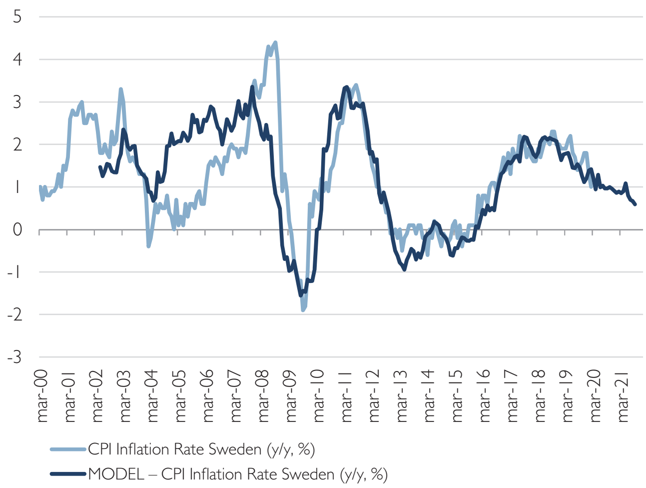
Charts on next page ▶

Market development and indicators

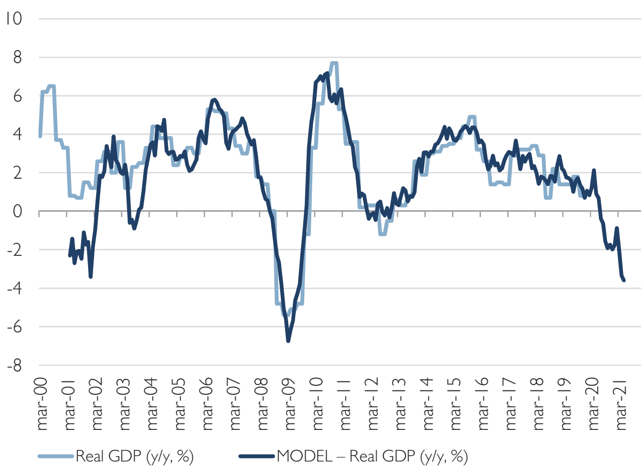
EQUITY PRICE DEVELOPMENT (INDEX, JAN 2019=100)*



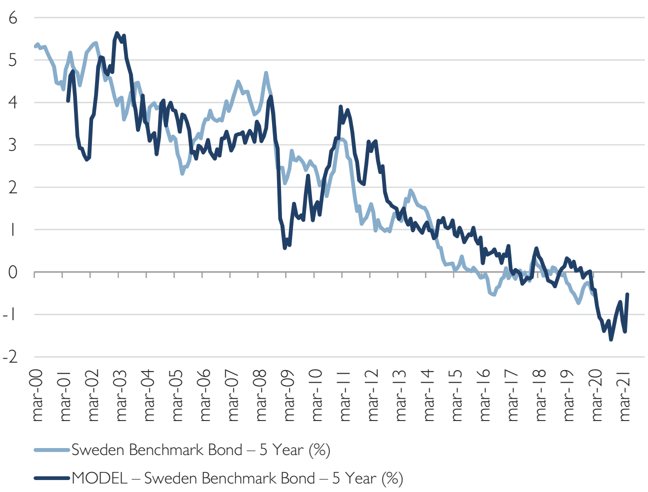
LEADING INDICATORS, CPI-INFLATION (Y/Y, %)



LEADING INDICATORS, GDP GROWTH (Y/Y, %)



LEADING INDICATORS, SWEDISH BENCHMARK BOND – 5 YEARS (%)



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