

Second half-year 2022

Key takeaways

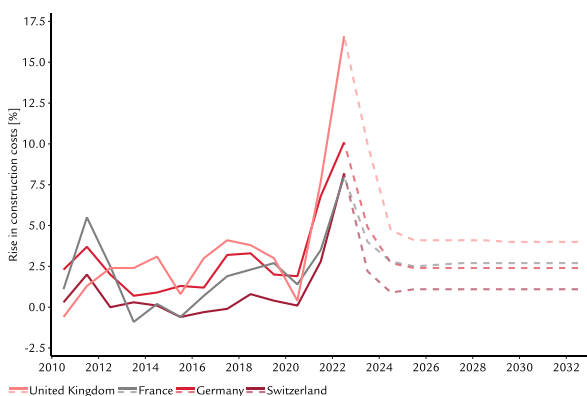
- Inflation and interest rates have picked up markedly and now investors are uncertain about which prices are “reasonable” for real estate investments in this environment. Financing costs have also risen and are reducing performance. **Price discounts are to be expected across the board.**
- **The volume of transactions is set to fall:** securities have regained attractiveness compared to real estate. In the current environment, some investors are not expanding their investment in real estate any further or are reducing their exposure to the sector.
- **A realistic assessment of how to protect real estate against inflation:** while rental income can be increased through indexation and real estate assets protected, not all tenants are able to bear the additional costs in the environment of a mild recession.
- **Fundamental drivers of the rental markets,** such as demographic trends, **are unchanged.** Demand for modern real estate is accordingly persisting or increasing further. However, economic influences on the individual sectors need to be critically monitored.
- **High-quality properties will remain in great demand** and the differentiation between building quality will intensify at the expense of secondary assets.

2040 – what will the property markets of the future look like?

The greatest interest rate movement in years is throwing the real estate market into turmoil. However, it is not just economic events, but structural changes too that are occupying us more than ever. Will we still be talking about sectors in 20 years’ time, or will everything be one? How will the metaverse affect real estate?

Will we really be able to work and shop from anywhere? Will people still be needed in future to provide transport? Will we only build upwards, including the cultivation of food? We are constantly working on these and many other questions and will inform you here how we see things.

Chart focus



Source: BFS, Eurostat, Swiss Life Asset Managers, Macrobond

Construction costs in Europe have risen sharply due to disruptions to supply chains and higher energy costs. This has caused planned and not yet launched project developments to be put back or cancelled entirely. This will have a medium-term impact on supply and, depending on the region, cause it to fall short. At the same time, construction measures for existing properties are becoming more expensive and weighing on the cash flows of investors. Based on our inflation forecasts, we expect construction costs to rise further, although the momentum should subside (see chart).

The Russian war of aggression on Ukraine marks a turning point for the countries of Western Europe. While the easing of containment measures in connection with the pandemic has brought about an upturn in the domestically oriented service sectors, the economic consequences of the war have, for the time being, made themselves felt in significantly higher inflation rates. However, the loss of consumer purchasing power and increased financing costs for contractors and property owners are already casting their shadow in the form of greater recession risks. Full order books in industry and the easing of supply chain problems should continue to support economic momentum in the second half of the year. The labour market data are accordingly still robust for the time being. The greatest risk for European countries remains the supply of energy over the coming winter. Major efforts are underway to gain independence from Russian natural gas as soon as possible.

A new cycle is beginning

Assuming that interest rates remain at a higher level following recent central bank decisions, we expect property prices to fall. In the market, transactions are purportedly being renegotiated at lower levels. Following the transaction prices, valuations across portfolios will also decrease. The speed of this will vary according to the country and valuation method: such changes are more swiftly visible in the UK, while in Switzerland, for example, at least 12 months pass before changes become visible.

Price change unavoidable

It is clear to all of us that prices are changing. This is, on the one hand, due to the fact that valuations must change alongside interest rates if the market is to be considered healthy in economic terms. In addition, the current uncertainty among investors about what is now the “correct price” of an asset is causing them to exercise restraint. Where supply remains the same and there is less demand, a price effect also has to emerge. Moreover, the calculations of asset allocation have changed: real estate is now no longer the only alternative in the current interest rate environment. The focus of investors will therefore shift slightly. And finally, financing costs have also risen, which means that for many investors, investments have become too expensive.

Market changing rapidly

Real estate players have seldom waited so desperately for the publication of the latest real estate data. The data already available from the first quarter of 2022 barely reflects the present situation. On the contrary, transaction volumes in Europe were at their highest in a long time in the first quarter. At EUR 73.1 billion, they marked the fourth strongest start to a year and were 24% up on the first quarter of 2021. Initial figures from RCA show that at EUR 53.2 billion, the second quarter was already considerably lower and indeed 22% down on the same period in 2021. We assume that the geopolitical tensions and interest rate movements are only partially reflected in the transaction volumes. We also expect investors to focus on high-quality assets in the present environment. This means that only marginal changes will be evident in the data available, which for the most part pertain to prime rents and prime yields. However, the polarisation of properties between “prime” and “secondary” will increase further so that greater impacts will be felt among the secondary assets (with regard to location, standard, ESG requirements and the like).

The office is here to stay

Another point being made regarding commercial real estate at present is that inflation will curb price movements as rental income could also be adjusted due to indexation. While this is fundamentally correct, it will only be partially implementable in practice in the environment of a mild recession. Tenants also need to be able and willing (if other properties are available) to pay the increased rents due to indexation. However, generally speaking, fundamental data for tenant demand have not definitively changed. The discussion continues in the office sector as to how much space will be needed in the future; the office nevertheless remains a place of encounter and exchange. Many tenants are currently even more concerned about the sustainability aspects of an office building and optimum public transport connections. While the average development of prime rents was positive in 2021, we expect a slight flattening over the following years.

Light at the end of the tunnel?

The retail sector is continuing to feel headwind. Although prices were already adjusted at real estate level in the past, above all, the higher inflation will inhibit consumers from buying much more than the bare necessities. On the other hand, according to PMA the average investor preference (i.e. focused on different strategies) has improved somewhat, so that there is more faith again in new retail formats, and the opportunity to reposition retail space is also being considered. However, we continue to expect a relatively flat movement in terms of rents and yields.

Logistics: yes, but...

The logistics sector is also affected by higher costs. For one thing, companies in the industrial and logistics sector are particularly dependent on energy prices and the economic environment. Moreover, some are operating with relatively small margins that have fallen further due to higher inflation. We therefore expect demand to hold up due to the continued growth in e-commerce and re-shoring activity but no longer as strong as assumed in the past. This is correspondingly reflected in our rent forecasts and, in combination with higher yields, should lead to lower performance figures than previously assumed.

Housing for old and young

The lower dependency on economic developments will be noticeable for real estate in the residential and healthcare sectors. However, here too prices will fall due to the interest rate movements and a polarisation in terms of quality will emerge. It is precisely when investors bank on this security and demand accordingly increases that the wheat is separated from the chaff. Furthermore, owing to increased inflation the discussion concerning affordability is also set to gain new momentum and regulation to increase further. The supply of skilled staff remains the key challenge for operators of establishments in the healthcare sector.

Are the travel blues coming?

Many Europeans have decided in 2022 to catch up on trips missed out on due to the pandemic. The lack of airport staff and higher inflation now appears to be somewhat dampening this anticipation. While we expect trips booked for 2022 to be embarked upon, activity is likely to recede again somewhat thereafter.

Figure 1: Consumer confidence and retail turnover

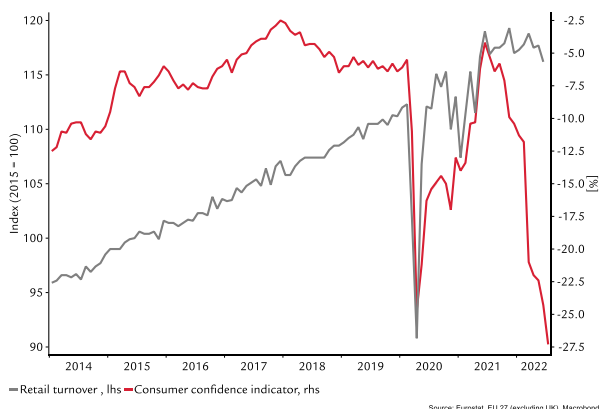
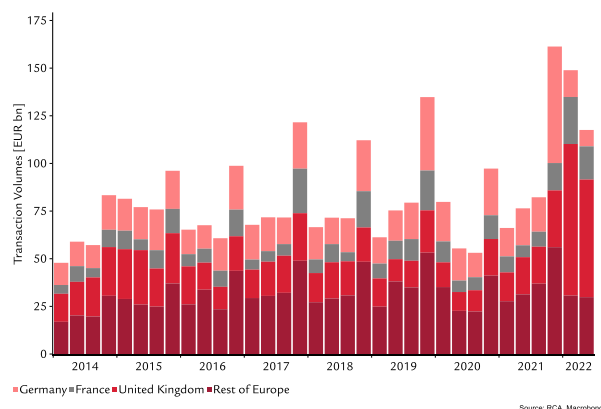


Figure 2: Transaction volume over time



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