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Interpretation of the FPRE real estate meta analysis Q2/17

References to FPRE graphics in our text are marked (1) etc.

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"Many export industries have overcome the strong Swiss Franc"

Confidence is returning to the Swiss economy. Many export industries are regaining their competitiveness and the outlook for 2017 and beyond is looking hopeful. There are no concerns at all regarding inflationary pressure in Switzerland; however, the yield curve is gradually moving upwards. Mortgage interest rates remain stable for the time being at a very low level. Revenues in the construction industry remain above average. At the moment is built on stock, which has the character of an advance, that will probably have to be paid back in the future. There has been a change in the trend observed in the owner-occupied sector, as prices for owner-occupied properties have dropped throughout Switzerland. The market for rental apartments is seeing bad omens for the first time. The increase in supply and declining immigration figures are placing the market under pressure. The forecasted economic growth in 2017 and 2018 is optimistic and likely to bring about a pick-up in demand for office space as well as stabilisation in the retail sector on a lower level in the medium term.

Swiss economy regaining its former strength

The confidence on display in the previous quarter is being toned down slightly as positive GDP growth of an average of 1,5 % is forecast for 2017 (previous quarter: 1,6 %). (8, 9)

Credit Suisse economists note that an increasing number of export industries have regained their ability to compete and will likely be able to increase their exports again in 2017.[1] According to SECO, it is also likely that private consumption and government expenditure will also support growth in Switzerland in the coming quarters, which will mainly be attributable to gains in purchasing power due to price cuts and population growth.[2] The outlook for 2018 has likewise been corrected downwards marginally. With average GDP growth of 1,9 % (previous quarter: 2,0 %) sustaining economists' expectations of a clearly positive trend. (8, 9)

This trend is likely to also impact the unemployment rate in the medium term. Although an average rate of 3,3 % (8) continues to be anticipated for 2017, there is currently a greater number of companies planning to create jobs than there are wanting to make job cuts, which is in line with the forecast growth in employment in 2018. Accordingly, the unemployment rate is expected to drop slightly to 3,1 % in 2018 (previous quarter: 3,2 %). (8, 9, 10)

10-year government bonds soon to return to zero

Switzerland remains scarcely affected by inflationary pressure. Nevertheless, an increase of the rate of price is likely to rise slightly this year, mainly due the price of oil at the start of the year. As such base effects are by definition temporary in nature, the inflation rate will probably remain at a low level.

The SNB is making minor adjustments to its inflation expectations compared to the previous quarter. An inflation rate of 0,3 % is expected for 2017 (previous quarter: 0,1 %), while a rate of 0,4 % is expected for 2018 (previous quarter: 0,5 %). (11) The forecast from the economic institutes remains slightly more optimistic, as in the previous quarter, with 0,4 % anticipated for 2017 and 0,6 % for 2018. (8)

Interest rates have risen since the second half of 2016. After the entire yield curve was in negative territory for a period of time in the middle of last year, it is moving

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[1] Credit Suisse Economic Research, Monitor Schweiz, March 2017

[2] SECO, press release dated 21 March 2017

slightly upwards again. (22) The yield on 10-year Swiss government bonds remains unchanged from the previous quarter, still slightly below zero at -0,1 %. (21, 22)

“Interest rate forecasts for 2017 remain at a low level”

Since the SNB is not expected to increase its benchmark interest rate before the middle of next year at the earliest, projections remain low level for 2017, but have moved closer to the 0 % mark in comparison to the previous quarter. 10-year government bonds could return to positive territory of up to 0,5 % (Créa) in 2018. (20) Mortgage interest rates remain at record lows. An interest rate of 1,7 % is expected for 10-year fixed mortgages in February 2017. (23) Accordingly, the reference rate may also fall further from 1,75 % to 1,5 % over the course of 2017.[3]

Construction industry enjoying surpluses brought forward

The construction index of Credit Suisse and the Swiss Contractors’ Association remained at a constantly high level of 144 points in the first quarter of 2017. (17) This means that the revenues forecast for the construction industry for Q1 remain above average. In the building construction sector an increase of 4 % quarter on quarter is expected, while civil engineering is expected to be hit by a drop of 3,4 %. The building construction sector is also forecast to enjoy continued success in 2017. Given the persistently low interest rate environment, real estate will remain one of the few attractive asset classes for investors.

There is, however, a risk in the long run that this construction boom could have a negative impact. The high level of revenue generated in the construction industry could be explained as “build on stock”. Should the interest rate level rise, this could lead to an increase in demand for alternative asset classes to the detriment of real estate investments, until the balance between supply and demand is restored on the real estate market.[4]

“The current construction boom will have a negative impact in the near future”

Owner-occupied sector experiences shift in trend in Q1

After prices for owner-occupied property continued to trend sideways in Q4 2016, there was a change in trend in Q1 2017. Prices across Switzerland fell on average by 3,6 %. This is reflected in a quarter-on-quarter slump in transaction prices of 3,9 %, particularly for single-family homes. The houses in the medium-priced market segment are recording the biggest losses and are being sold at a 5,6 % reduction in comparison with the previous quarter.[5] (46, 47, 48) A similar picture can be seen for owner-occupied apartments. The prices for owner-occupied apartments across all three price segments (low-priced, medium-priced and upmarket) fell by an average of 3,2 % versus the previous quarter. Year on year this represents a much more pronounced decline (-6,8 %). The largest drop was recorded in the medium-priced segment, with prices falling by 9,4 % in comparison with the same quarter the previous year. Only the apartments in the low-priced segment were able to limit declines to 0,9 % year on year.[5] (52, 53, 54)

A drop in prices for owner-occupied property was observed across Switzerland. The prices for single-family houses are down compared to the same quarter in the previous year, particularly in the Lake Geneva region (-8,5 %)[5] (50) as well as in more rural areas such as the Jura (-6,3 %), the Alpine region (-7,5 %) and southern

„Prices for owner-occupied properties decreased by 3,6 % in the entire country“

Switzerland (-7,4 %). The lowest price drops versus the previous year were recorded in the urban regions of Basel and Zurich, at 3,1 % and 3,2 % respectively.[5] (49) The same regions also recorded the biggest losses in the owner-occupied apartments category. In comparison with the same quarter the previous year, prices fell in the Lake Geneva region by 8,3 % (56), in the Jura by 7,7 %, in the Alpine region by 9,3 % and in southern Switzerland by 8,8 %.[5]

[3] Raiffeisen, Residential real estate in Switzerland – Q1 2017
[4] Credit Suisse and the Swiss Contractors‘ Association, The Swiss Construction Index, Q1 2017
[5] FPRE, transaction price and building plot indices for owner-occupied property, data as at 31 March 2016

Negative omens in the rental apartment market

The residential investment property market finds itself in an unfavourable situation. Not only has the increase in supply over the years exerted pressure on rents, but lower immigration has also proven to be a detrimental factor. The supply of rental apartments has grown by approx. 54 % since 2013. This growth has been observed in every region. There are, however, certain regions that have been affected more by this increase in supply than others, e.g. the cantons of Aargau and Solothurn. This increases the difficulty of being able to market properties and the risk of the property standing vacant for owners.[6] There has also been a negative impact from the demand side. In 2016, only some 60,000 people immigrated into Switzerland (12), which constitutes the lowest figure since the introduction of full freedom of movement in 2007. Thanks to the currently improved economic outlook, the decline immigration is likely to stabilise once again in 2017.[7]

These trends are having a huge impact on the rental apartment market. In the first quarter, market rents throughout Switzerland fell once again by 1,6 %.[8] (25) The Jura and Alpine regions, which suffered the largest drops in rents in the previous quarter, have made a recovery in the current quarter and are the only regions to record positive growth quarter on quarter. The other regions recorded losses ranging from 1,6 % to 1,9 % quarter on quarter, with the two major regions of Basel and Zurich being hit the hardest, at -1,9 % and -1,8 % respectively.[8] (26)

> *“Missing alternatives support the market in 2017”*

Owing to the continuing construction boom in Switzerland, the rents in the new-build segment in particular are being impacted more than for old buildings. In comparison to the same quarter the previous year, rents in new buildings fell by 2,1 %.[8] It is also unlikely that the low existing rents will rise in the near future, as there is a very good chance that the reference interest rate will decline further in 2017. This would result in rent reductions in existing rental contracts and the situation faced by owners would worsen further.[6] In addition to this, investors will probably not be able to rely on the tailwind offered by declining capitalisation rates in 2017. The higher inflation forecasts combined with the more difficult absorption of rental apartments are leaving hardly any scope for a further reduction in initial yields and capitalisation rates. Given the monetary policy in Switzerland and Europe there will continue to be a lack of alternative investments in 2017 and a significant correction in the rental apartment market cannot be expected, despite the negative omens.[7]

Office market hoping for stronger economy

The office property market experienced a very difficult 2016. In addition to the increase in oversupply, 2016 also saw a downturn in the economy and stagnating employment rate growth. In 2017, the demand for office space may recover slightly due to economic growth.

The first quarter, however, has not turned out to be very positive at the moment. Market rents for office spaces are posting a loss of 4,7 % versus the previous quarter.[8] Comparing this with the same quarter the previous year presents an even bleaker picture, as rents have fallen by a total of 7,9 %. (34)

> *“Office rents decreased by 4,7 %”*

[6] Wüest Partner, The Swiss Real Estate Market 2017 | 1
[7] Credit Suisse, The Swiss Real Estate Market 2017, March 2017
[8] FPRE, market rent and building plot indices for investment properties, data as at 31 March 2016

“The downward dynamic of the retail sector is weakening”

One exception here is the Lake Geneva region, where rents have increased by 2,6 % over the last twelve months.[8] (36) We do not expect supply to fall in 2017; however, it is likely that it will stabilise at a high level. This can be particularly attributed to the restrained investment in major cities, namely in Zurich and Geneva. As vacancies and falling rents have now taken root in the rental apartment market, the office space market may become more appealing and lead to the creation of overcapacity.[7]

Stabilisation in the offing for the retail sector

The Swiss retail sector has suffered greatly over the last two years. However, is an end to this downward trend in sight? Forecasts for 2017 show that market rents for retail space are likely to be reduced further.

Experts at Credit Suisse, however, are already noticing a slowdown in this downward momentum, with it even slowing down significantly in some segments. An improvement in the economy in 2017 could result in retail revenues stagnating, which would represent a stabilisation in comparison with recent years. Nevertheless, a more dynamic recovery is still not in sight.[7] Shopping centres in particular have had to battle declining sales density in recent years, mainly driven by online trade, shopping tourism and, above all, the huge increase in retail space. The space available within shopping centres has practically doubled over the last 15 years. The increase in retail space has, however, dropped off significantly in recent years and could likewise help the market to stabilise.[9]

The stadium project in Aarau is a good example of how difficult it is at the moment to generate reasonable returns with a shopping centre. In order to finance a share of the costs required to build the stadium, HRS planned to build a shopping centre in the surrounding area. At the start of May 2017, however, HRS announced that building a shopping centre would no longer be profitable due to changes in the market. The alternative solution proposed by the developer was to cross-finance by constructing three new high-rise apartment buildings.[10]

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[9] UBS, Real Estate Focus 2017
[10] Immobilien Business, Aarau: HRS puts forward „Plan B“ for stadium project, 04.05.2017