

First half-year 2023

Key takeaways

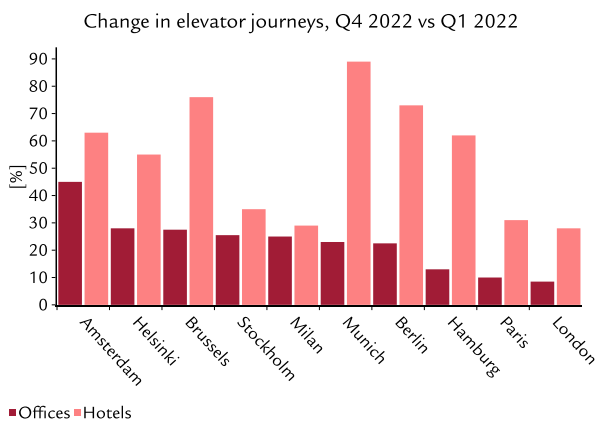
- **Planning security for investors ahead:** The monetary policy tightening cycle is approaching its end. Thus, 2023 is likely to offer more planning security for long-term investors in real estate markets.
- **Strong fundamentals for long-term investors:** Real estate remains a sought-after asset class, as tenant demand holds firm and rental growth continues unabated for good-quality letting space, in many markets also due to inflation indexation.
- **High demand for high-quality investment properties:** The differentiation of building quality will intensify further to the benefit of prime assets.
- **Opportunities for active asset managers:** The changed interest rate environment and high demands from tenants and regulators call for professional expertise to manage every single property. This way, the opportunities of changing needs in the aftermath of the pandemic and in light of ongoing efforts to adapt to structural changes can be translated into additional recurring rental income.
- **Interest rate cycles matter, but structural changes even more so:** Changes in price when interest rates shift are a sign of a functioning market. Focusing on income-generating assets, the structural changes are of greater importance over an investment horizon of 10 years or more, and hence generate performance.

More planning security ahead?

Since March 2022, central banks in the developed world have embarked on the fastest and steepest monetary policy tightening cycle in decades. As a result, interest rates along the yield curve and financing costs rose sharply. Uncertainty regarding the impact on valuations and, at times, a disrupted price building mechanism characterised real estate markets during most of 2022. We expect the tightening cycle to end in the first half of 2023. Long-term sovereign yields already seem to have peaked. If confirmed, more planning security for investors will soon be regained.

European cities are coming back to life, as citizens flow through high streets and shopping centres, commute from home to work, and pursue social activities. This can be measured with high-frequency data on elevator journeys, as provided by KONE, the Finnish producer of lifts. The analysis shows that Amsterdam has experienced the biggest rise in commercial building mobility, whilst in London, people still seem to be in the office less often than before the pandemic (see chart).

Chart in focus



There are two questions on the minds of investors at the beginning of 2023: Firstly, the further course of the war in Ukraine, and secondly, the full extent of the interest rate turnaround. An economic analysis cannot provide an answer to the first question. However, one can try to gauge the further economic impact of the war by making assumptions about the major uncertainty factors of 2022. These key issues include energy supply security in Europe and the future direction of monetary policy. The bulging gas storage facilities, the mild winter and the return of the French nuclear power plants to the grid have prevented a power shortage. After the USA, inflationary pressure is also easing in Europe. This should allow the central banks to soon complete the cycle of interest rate hikes. An expression of the expected mild recession is the inversion of the yield curve. This means that short-term interest rates are above those of investments with long maturities. Finally, the question of the further development of interest rates and thus of financing costs can be answered under the above conditions. In Swiss Life Asset Managers' base case scenario, 2023 offers greater predictability for long-term investment decisions.

New yield levels...

When it comes to real estate investments going into 2023, the search for the “right price” continues. Sellers are holding on to their valuations, and the clearing price has not yet been defined. A rebalancing in yields is expected to take place, as interest rates remain at higher levels than we have experienced in recent years. However, we assume that most movement has already taken place (especially in the UK) or will materialise in the course of 2023. Thus, for investors, this is the time to prepare and be ready for the right opportunities. Real estate investors will be given the chance to make a reasonable calculation between the impact of potentially lower valuations and rising rental income in times of elevated inflation.

...offer opportunities for investors

Real estate investments, i.e. the asset class with its variety of sectors, are still sought-after. Especially as occupier fundamentals remain in place, with an ongoing undersupply of good-quality space in commercial locations, and the view that the economic environment should have a limited effect on tenant demand.

With new price levels being negotiated, long-term investors focusing on strong and lasting income can profit from the changing investment environment. Investment cycles matter for short-term valuations, yet structural changes and a fundamentally strong assets that fulfil all tenant needs and hence generates income, matter even more. This is where performance is achievable.

Transaction volumes to pick up again

The PMA Survey of Investor Preferences as of Q1 2023, in which investors are asked whether they want to invest less, the same, or more in each respective sector, shows that the attractiveness of logistics, residential and office sectors has decreased over the year. The impact on retail was not as significant; this sector has already been going through structural changes and has adapted, such that investors expect less of a correction or are even beginning to see low price opportunities. The current sentiment is visible in transaction activity. According to RCA, transaction volumes in Europe across all property were 25% lower in 2022 than in 2021, largely driven by Q4 volumes which were muted relative to previous years. With a clearer view of interest rate developments, we expect transaction volumes to pick up during the next couple of months.

Fundamentals remain strong

With the cycle of interest rate hikes expected to be completed soon, and the economic outlook set to be stable, demand for letting space remains strong. Declining transaction prices are contrasted by largely stable letting markets and continued historically low vacancy rates. This holds true across all commercial sectors – especially since practice shows that inflation indexation in leases (i.e. adjustment to the inflation rate) can be enforced at least once in many cases. The high demand for good-quality space is also the reason why we are observing increasing rents while vacancy rates are almost unchanged. As far as the housing market is concerned, the shortage of space in almost all large European cities is the main reason for the upward trend in rents while ongoing population growth is driving demand.

The office as an anchor

The discussion continues in the office sector as to how much space will be needed in the future; the office remains a place of collaboration, encounter and exchange. More than before, tenants are concerned about the sustainability aspects of an office building and optimum public transport connections. We expect European office rents to increase by around 2.0% p.a. until 2027. This rental growth is based on higher inflation (i.e. higher construction costs, hence a slowdown in supply) and continuing tenant demand.

Is retail coming back?

With inflation reaching very high levels, the impact on consumer spending is currently the biggest uncertainty when it comes to the retail sector. Yet as described previously, the picture looks rather positive, as investor sentiment improved in Q3 2022 and so has consumer confidence. This can be supported by relatively stable rental growth of around 1% p.a. up to 2027. Finally, there might be light at the end of the tunnel and new opportunities in store in the sector.

Logistics: all about reshoring?

As the logistics sector has seen the fastest drop in prime yields over the last two years, corrections due to higher interest rates may be more pronounced. Overall, the sector is still in good shape given the rethinking of supply chains in Europe following the pandemic and the outbreak of the war in Ukraine. Discussions on the “end of globalisation” are having the biggest impact here. This means that all companies will start to gain independence from individual suppliers, although it does not mean that everything will be re-shored to Europe. While the focus here is also on location, picking the right operator should not be neglected.

Residential with further tailwind

Higher interest rates are also leading to higher mortgage rates, hence demand for rented apartments has once again increased, especially in countries such as the UK and other home ownership-oriented countries. It is a rather crisis-resistant sector and faces constant supply shortages. At the same time, we are watching rent developments closely, as higher inflation rates also have an impact here. Indexation for rents is not straightforward, as higher rents meet limited supply and thus political interventions in the market might resurge.

Figure 1: Yield movement in the office sector

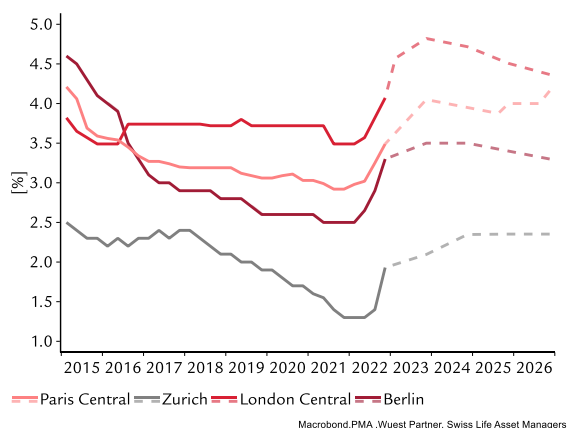
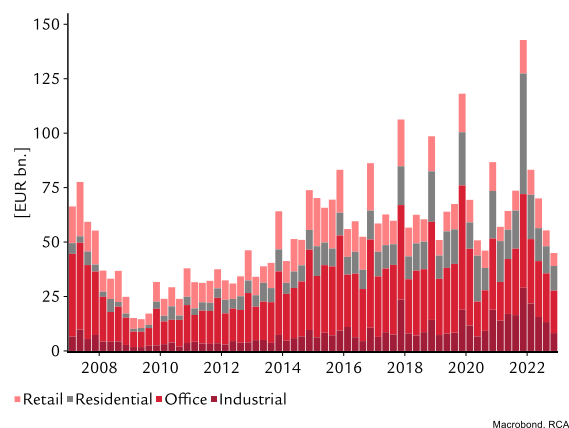


Figure 2: European transaction volume



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