Widening credit spreads suggest the investment cycle has peaked

Activity on the Swedish property market has been at record levels since December 2014, and the rolling 12-months transaction volume has remained in the range SEK 140–150 billion until October 2015. This level is much higher than the average for the past five years, which is SEK 112 billion, and is in line with the record volumes of 2006–2007. The market is dominated by funds, private investors and listed companies. During the past six months, the presence of international investors has also increased significantly.

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The market is being driven by strong GDP growth, combined with the extremely low interest rates, good access to financing, low banking margins and risk-willing investors increasingly desperate in their search for yield. Both yields and yield spreads between A, B and C locations have decreased markedly since the beginning of 2013, and are now at historically low levels. The market is hampered by a lack of supply of high-quality properties, and during 2014–2015 volumes have fallen sharply, particularly for public and residential properties. By September, there had not been one single office transaction in the city centre of Stockholm, but this eased considerably in October with two completed transactions – Olov Lindgren's purchase of Törnet 10 and Axfast's purchase of Jakob Mindre 11.

However, there are signs that the investment cycle has already begun to turn. Since the summer, it has become increasingly clear that the global economy is slowing and the stock market recovery in October was mainly driven by expectations of more expansionary monetary policy from central banks in China, the US, the Euro area and Japan. The Swedish Riksbank has limited opportunities to pursue an independent policy, and if the major central banks continue to stimulate, the Riksbank will be forced to follow suit.

We can also see that US credit spreads, i.e. the difference between interest on corporate bonds with high credit ratings and on those with lower ratings, has widened markedly since the summer. While yields for corporate bonds with the highest ratings have fallen in line with government bond yields, yields for bonds with lower credit ratings have risen. This is one factor that reflects reduced risk appetite among investors. Correspondingly, there was a great deal of turbulence on the stock market in late summer. The VIX (a volatility index of the US stock market, which is often referred to as the investor fear gauge) has now returned to historically low levels after a sharp increase in August, but there is a substantial risk that the turbulence will return during the winter.

How will this affect the Swedish property market? There is a clear link between investor risk willingness on the global financial markets and yield spreads on the Swedish property market between A, B and C locations, with the financial markets around a half-year ahead of the property market. The fact that the VIX has calmed down in October indicates that the high level of activity and pricing in the property market may continue until at least the second half of 2016. After that, it is not impossible that a weaker economy, lower risk appetite among investors and reduced access to financing will lead to lower transaction volumes and rising yields, particularly in B and C locations. Continued low interest rates and strong investor demand will create stability for properties in prime locations in the major cities, where the potential for rent growth over the economic cycles is good.

Property as an asset class is generally attractive compared with alternatives such as equities and bonds. As an investor, however, it is important to be careful about what you invest in, and also to be aware of the net operating income, i.e. rents less vacancies and costs, which is what generates return in the long term. Property-specific risk is the greatest risk factor when investing in property; the higher prices become, the more important it is to be cautious about the quality and location of the properties.

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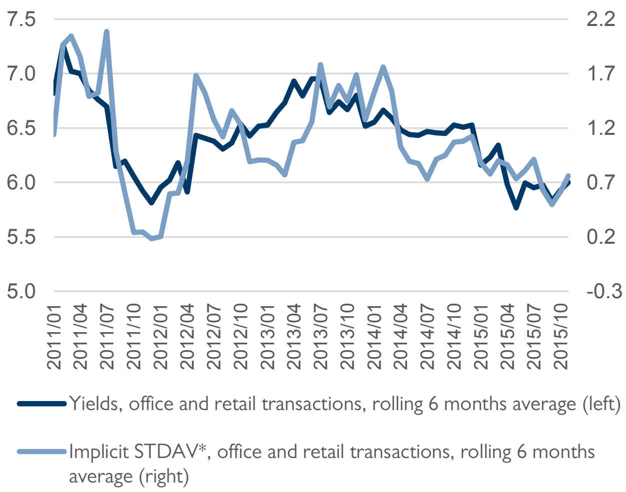
CATELLA

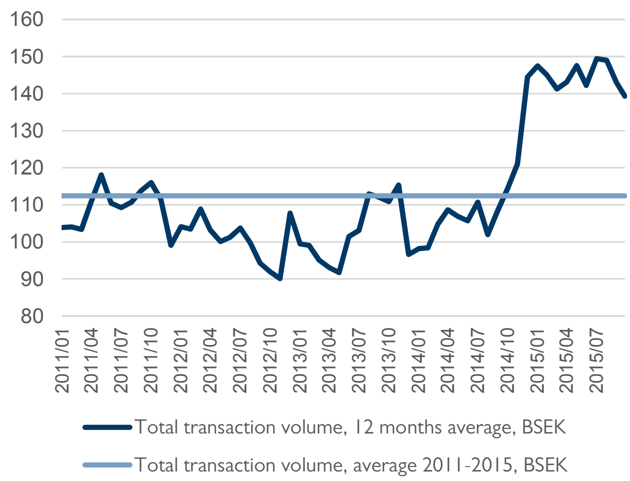
Yields on finalized office and retail transactions**

Yield (%) STDAV in yields (%-points)



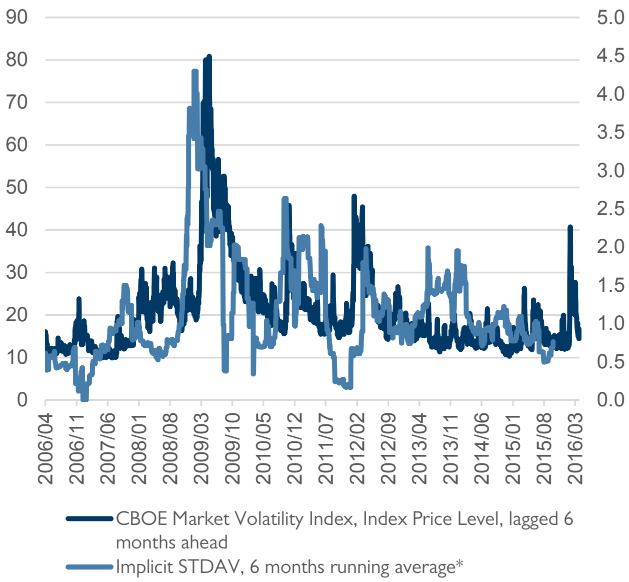
Total transaction volume

BSEK



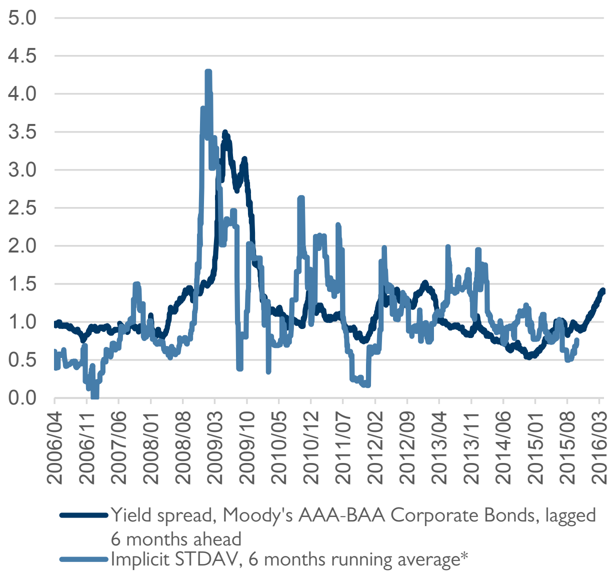
Office and retail yield spread and the VIX

CBOE Volatility Index STDAV in yields (%-points)



Office and retail yield spread and the credit spread

STDAV in yields / Credit spread (%-points)



* Calculated index based on the standard deviation of yields from historical transaction, in combination with measures of the over-all market liquidity.
** Yields are based on historical transactions in Sweden. Yields are either verified or estimated by Catella.
Source: FactSet and Catella.

The average yields on historical office and retail transactions has fallen significantly since the end of 2012. There is a correlation between standard deviation of yields on the Swedish property market and volatility on the US equity market (measured as the CBOE Volatility Index) – where the VIX seems to be a leading indicator for the property market with a 6–9 months' time-lag. Volatility increased significantly on the equity marked during the late summer 2015. If this development resumes, the result may be lower liquidity and higher standard deviation on the Swedish property market from mid–2016 and onwards.