The next leg downwards on the equity market may be driven by fear of recession

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The transaction volume on the Swedish property market has been in an uptrend since mid-2018 and is now close to the absolute historic peak. Both the number of deals and the average deal size are at historical highs. The transaction volume ended up at SEK 26.5 billion in June, which can be compared to SEK 29 billion and SEK 20.4 billion during the same month in 2020 and 2021 respectively. The rolling 12-month transaction volume fell back somewhat from last month's all-time peak to SEK 246.7 billion (down from SEK 249.3 billion).

The number of deals exceeding SEK 80 million ended up at 46 deals in June, lower than the 54 and 57 transactions that took place during the same month in 2020 and 2021. As a result, the rolling 12-month number of deals fell back somewhat to 430 in June (down from the historic all-time-high of 441 deals reached last month). Over the last 15 years the rolling 12-month number of deals has fluctuated within an interval of 320 to 420 deals, only breaching the interval on the downside on two occasions (in 2009 after the financial crisis and in the autumn 2014 during a period of deflation). The May and June numbers are breathing the upper boundary of this interval for the first time. The number of transactions on the property market is a good leading indicator around seven months ahead of the CPI inflation. The breach upwards in the number of deals is likely a reaction to the high-inflation environment that we have now entered.

The institutions have been the single largest net-investors on the property market since the autumn 2021 and were net-buying properties for SEK 69 billion during the 12 months to June. Although Heimstaden's acquisition from Akelius makes up around half of that figure, their net-acquisitions are still in a strong uptrend when adjusting for this deal. The listed property companies have slowed down their net-acquisitions significantly during the last year. The rolling 12-month figure now stand at SEK 15.5 billion, down from SEK 39 billion in September last year. Funds were (along the institutions) among the largest net-buyers on the market early last year, and their rolling 12-month net-acquisitions peaked at SEK 21.9 billion in April 2021 before it fell back to just above the zero mark this spring. In June, however, the figure has picked up again and now stand at just below SEK 10 billion. Several funds have large amounts of committed capital and are now awaiting new market opportunities. Many funds are especially looking at the listed property companies, many of which will likely turn into net-sellers during the coming months and quarters (due to their weak performance on the equity market). Foreign investors have increased their investment activity over the last month (from historically low figures in May) and acquired Swedish properties for just below SEK 22 billion during the 12 months to June. This is, however, still in the lower bound of the interval of SEK 15–35 billion that has prevailed over the last decade.

Leading indicators are pointing at recession

Catella's GDP Macro Index (which is a mix of six leading indicators for the Swedish GDP growth) is indicating a significant economic slowdown ahead. According to the index, the economic growth will keep on slowing to a rate of around 1.3 per cent year-on-year during the third quarter 2022 and then go further down below the zero mark. As a result, the index is indicating an upcoming recession. In fact, it is likely that we already are in a technical recession by the second quarter 2022 with two consecutive quarters of negative growth (the Swedish real GDP contracted by 0.8 per cent quarter-on-quarter during the first quarter). The CPI inflation rate increased to 7.3 per cent in May, driven by a broad range of goods (where food and electricity prices stood out). Catella's CPI Macro Index (a leading index for inflation including a mix of macro indicators/commodities) is indicating that we are close to a short-term peak and that inflation will temporarily fall back towards 2–3 per cent during the summer/autumn 2022 (mainly due to falling year-on-year increases in several commodity prices). After that, however, the index is indicating higher inflation again. However, the model does not include indicators that mirrors the supply chain bottlenecks. It is a risk that the standoff between Russia and the west will lead to further increases in energy and food prices during the autumn, which could result in an inflation over-shoot in relation to the model.

Stagflation is seen as the most probable scenarios according to market participants

In June, Catella conducted a survey among our key clients regarding what macroeconomic scenario they expect for the coming years. Stagflation (the combination of low growth and high inflation) ended up being the most probable scenario for the coming years according to our clients (with around 55 per cent of the answers). This is up from just 5–15 per cent of the answers during the previous three surveys conducted during 2019–2021. In the previous surveys, the most likely macroeconomic scenario according to the respondents was a stagnation/Japanese scenario (with low economic growth, low inflation and low interest rates for years/decades to come).

When asked what property segment that will show the best total return performance in 2022, around one third of the respondents believed in public properties. Stockholm offices came on the second place, while retail properties came ▶

on the third place. Only 5 per cent of the respondents believed that residential properties would outperform the other segments, a staggering decline from the 25–35 per cent recorded in the two previous surveys in 2020–2021. The change in the top-ranking property segments goes rather well in line with the switch in consensus macroeconomic scenario among the respondents. Property segments with stable cash flows that follow the CPI inflation and with slightly higher yield levels that are not that sensitive to increasing financing costs (like public properties and big-box retail/grocery store properties) are expected to outperform in a stagflation scenario due to the combination of weak GDP growth, high inflation and increasing financing cost.

The bond market has shifted its view towards recession during recent weeks

However, the bond market has begun to indicate a shift in the consensus view during the recent weeks, from a stagflation scenario to fear of an upcoming global recession. Both long-term and short-term interest rates have increased significantly during 2022. The Swedish 5-year swap rate went from 0.25 per cent in late August 2021 to 3.14 per cent in mid-June. The 3 months STIBOR rate went from the zero mark in March to 1.65 per cent in mid-June. Since then, the 5-year swap rate has fallen back around 60 basis points to 2.56 per cent and the 3-months STIBOR is down around 40 basis points to 1.24 per cent. The same development has been the case for the Swedish and US 10-year government bond yields. These yield levels reached peaks of 2.05 and 3.50 per cent respectively in mid-June. Over the last two weeks, however, these bond yields have declined by 50–60 basis points to 1.52 and 2.90 per cent respectively. The US yield curve (10-year minus 2-year government bond yields) has fallen back to just above the zero-mark again. The yield curve inverted briefly in April; a bond yield-curve inversion is a historically strong leading indicator of an upcoming recession. In addition, the 10-year break even inflation, which is indicating the bond markets' view of the average US inflation over the coming 10 years, has declined significantly recently (from just over 3 per cent in late April to 2.33 per cent now). This is the lowest level since September 2021, just before the major central banks made U-turns and admitted that the high inflation rates where most likely not transitory. All in all, it seems like the market consensus was firmly in the stagflation camp during the spring/early summer but has now shifted towards a scenario involving an outright global recession (which may also involve a debt crisis due to the record high global debt levels).

Rising real interest rates are brining havoc to the equity market

The lion share of the last six months' interest rate increase has been due to increasing real interest rates. This has been extremely negative for the property market. The 30-year US inflation linked bond yield (TIPS) increased from about -0.60 per cent in December last year to just over 1.0 per cent in mid-June. Since then, it has fallen back somewhat but still remain at around 0.9 per cent. This massive 160 basis-point-increase has been a major reason behind the brutal bear market for property stocks. Since the market peak in late November the listed property companies are still down more than 50 per cent in average, compared to around 19 per cent for the OMX Stockholm 30. The residential/public property companies have clearly underperformed and are down over 60 per cent. The market drop since the all-time peak in November has been sequential, with large drops followed by partial recoveries. Each recovery has resulted in a new sub-peak at a lower level than the previous peak. The first partial recovery was between mid-December to early-January, the second was between early-March to early-April and the third was taking place during May. The ups and downs on the equity market has been well in line with the development of the long-term real interest rate (the 30-year TIPS yield). Since the last equity market sub-peak in late May, the listed properties are down 28 per cent in average and the logistics/industrial property companies are the worst performers, down 35 per cent in average. This bleak development is also visible on the bond market. Credit spreads for the property companies have increased massively lately, and it is very challenging to refinance bonds at the moment. Banks have also become significantly less accommodative in their lending lately and are to large extent focusing on existing clients.

The equity market premiums have dropped like a stone during this period. The weighted average discount to NAV for 29 of the largest property companies is currently more than 34 per cent. There are, however, large differences between the companies. There are still some equity market premiums on a few companies that are focusing on mix commercial, logistics/industrial and big-box retail/grocery store properties. There are major discounts on almost all other companies with a focus on office, retail, residential and/or public properties, regardless of whether they are focusing on the major or smaller cities. As a result, the equity market is now indicating higher yield levels in almost all property segments, except for logistics/industrial properties and big-box retail properties in non-prime locations (where the equity market is indicating yield levels in line with book yields).

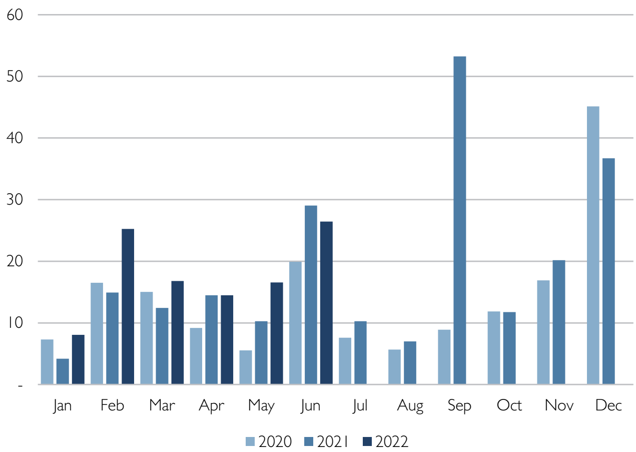
The next led downwards may be driven by fear of recession

The big question now is whether or not the equity market has hit the bottom? Up until mid-June, the stagflation scenario was the consensus macro scenario among market participants and the equity market expected high inflation, low economic growth and high/increasing nominal interest rates over the coming years. In addition, the consensus view was that the major central banks would be less accommodative during coming years due to the high inflation pressure, which would lead to higher credit margins for the property companies going forward. This macro backdrop was extraordinary tough for companies focusing on low yielding, residential properties in major cities. Residential rents tend to follow the rolling four-year inflation over time as rent levels are negotiated between the tenants' association and property owners. As a result, it will take at least 3–5 years for residential rental growth to adapt to macro shift from a low to a high inflation environment. In addition, residential properties in both large and small cities have also seen a massive yield shift during recent years and property segments with low yield levels tend to ▶

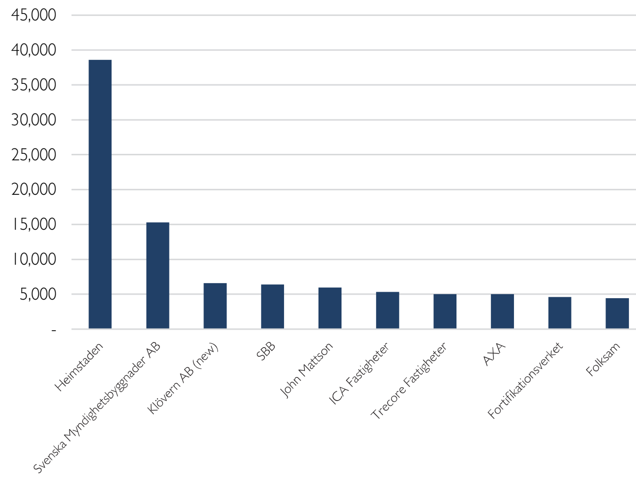
be very sensitive to increasing financing costs. Finally, the massive inflow of capital into the residential segments has also stimulated new production which in turn has created over-supply of newly produced rental apartments in a large share of the Swedish municipals. The stagflation scenario is though also for prime office and retail properties, but the listed companies focusing on these segments have been extremely punished by the equity market since the coronavirus erupted (retail properties have been unloved by the market ever since 2016) and have had major equity market discounts to NAV for years. It is likely that the market is now entering a new phase where the fear of an upcoming recession is added to the long-term expectation of stagflation. In the recession/debt crisis scenario, long-term interest rates could fall back quite significantly in the short term (although a stagflation scenario will likely result in a trend of gradually increasing nominal interest rates in the long-term). The result of the recession/debt crisis scenario would be sharply falling economic growth, higher unemployment, declining household consumption, more bankruptcies and increasing vacancies for commercial property owners. The outcome of this scenario is also a sharp fall in office market rents, especially on the volatile Stockholm submarkets.

The discounts to NAV for the listed property companies focusing of office/retail properties have been large for years. It seems like the equity market has already discounted higher vacancies and falling market rents in their current pricing of these companies. For the industrial/logistics and mix commercial properties, however, this is not the case. A number of these companies are still having premiums to NAV and they have benefitted from the market expectations that these property segments have good abilities to sustain a stagflation scenario (with market rents that follow CPI inflation and property yields that are not that sensitive to higher financing costs). It is not unlikely that the next leg downwards on the equity market will be driven by fear of an upcoming recession. In this phase we could very well see more of an impact on the previous market darling within the logistics/industrial and mix commercial segments. ■

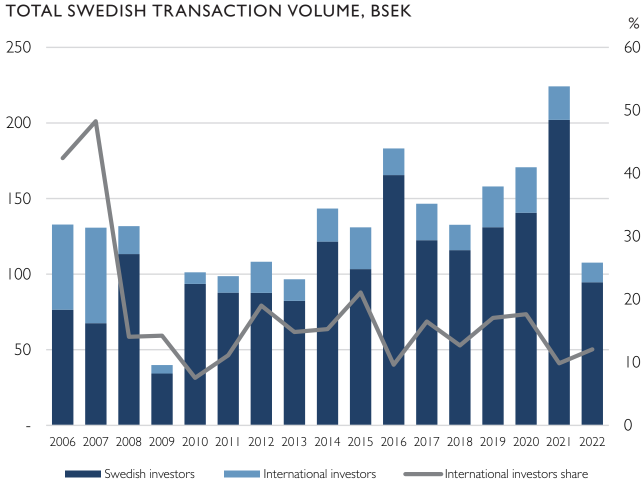
TRANSACTION VOLUME PER MONTH, BSEK



TOP 10 INVESTORS ROLLING 12-MONTH VOLUMES, MSEK



TOTAL SWEDISH TRANSACTION VOLUME, BSEK



INVESTOR TYPE AND REGION