PwC-Immospektive

Interpretation of the FPRE real estate meta analysis Q4/19
References to FPRE graphics in our text are marked (1) etc.

Interest rates and the labour market are propping up the real estate market in the weak economic environment

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GDP is still expected to grow by just 0.9 % this year, but the labour market continues to drive demand for space on the Swiss real estate market. Interest rates fell to new lows, boosting the construction industry and ensuring that real estate investments remain hugely attractive. Moderate consumer sentiment means there are very few bright spots for the retail market, although falling inflation should provide a boost to purchasing power towards the end of the year.

Current GDP forecasts at their lowest level since 2012

Uncertainties about the outlook for the global economy continue to escalate. New customs restrictions are stoking the conflict between the USA and China, and the Brexit issue remains unresolved. The situation is being compounded by political and financial unrest in places such as Hongkong and Argentina. The tense mood is increasing interest in the Swiss franc, which has manifested itself in Switzerland mainly through contracting exports and declining orders.[1,2] Overall, this has prompted economists to further downgrade their GDP growth expectations for both this year and next. The forecast for 2019 is significantly lower than in the previous quarter at 0.9 % (Q3: 1.4 %) [8] and even further below the long-term potential growth of 1.6 % to 1.8 % [9].[3] As a result, economic growth will this year slow to its lowest level since 2012. The outlook for GDP growth in 2020 remains slightly more optimistic at 1.5 % [8]. However, the optimism for 2020 is largely attributable to two major sporting events (the Olympic Games and the European Football Championship) whose organising bodies are based in Switzerland.[4] The Swiss real estate market will scarcely be able to benefit directly from these events.

Unemployment rate historically low at 2.4 %

The outlook for the labour market, which has remained positive in 2019 and 2020, offers slightly more optimistic prospects for the real estate market.[3] [8, 9] In June, unemployment fell to its lowest rate since 2001.[5] The forecast is unchanged versus August with a current unemployment rate of 2.4 %, and experts expect only a slight increase to 2.5 % for 2020 [8]. Although employment growth softened slightly in the second quarter of 2019, it is still up 1.2 % year on year.[6] The consensus among experts is still for solid employment growth [10] and a continued low employment rate.[2]

The performance of the financial markets is harming consumer sentiment, meaning that moderate consumer growth is expected overall.[6] Purchasing power is being supported solely by markedly weaker annual inflation [11]. Net immigration across the first three quarters of 2019 remained at its lowest level for ten years [12, 13] and is also unable to significantly boost Swiss consumption.

1 Staatssekretariat für Wirtschaft (SECO), Medienmitteilung vom 5. September 2019: Bruttoinlandprodukt im 2. Quartal 2019: Konjunktur schwächt sich ab
2 SECO, Medienmitteilung vom 17. September 2019: Die Aussichten haben sich eingetrübt
3 Schweizerische Nationalbank (SNB), Quartalsheft 3/2019 September
4 Swiss Life Asset Manager (SLAM), Perspektiven Konjunktur / Oktober 2019
5 Wüest Partner, Immobilienmarkt Schweiz 2019/3
6 Credit Suisse, Monitor Schweiz / September 2019

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Inflation expectations and interest rates down

The upward pressure on the Swiss franc triggered by the uncertainties on the global market and the continuing decline in the oil price are weakening domestic inflation. After the SNB upped its inflation forecast in June on the back of climbing import prices, raising it by 0.3 % compared with March to 0.6 %, the September forecast is down again at 0.4 %. Inflation expectations for 2020 (0.2 %) and 2021 (0.6 %) have also fallen significantly compared with the previous quarter [11].[3,6]

Ten-year government bond below -1 % for the first time

The three-month Libor remains unchanged at -0.8 % [21]. The SNB benchmark rate, which replaced Libor in June 2019, remains unchanged at -0.75 %, meaning that the national bank is continuing its expansive monetary policy. Greater global economic uncertainties have recently pushed Swiss capital market interest rates to new lows. The yield on ten-year government bonds fell below the -1 % mark for the first time in August and stood at -0.77 % in October [21, 22]. The yields on ten-year government bonds of other major economies also recorded a further fall [70].[2] The KOF Swiss Economic Institute at ETH Zurich is also forecasting a contraction in the three-month Libor [20].[7] With the exception of the ten-year fixed interest rate (-0.1 %), mortgage interest rates remained stable versus June [23].

Construction industry hits new highs

The construction industry is being supported by the low interest rate environment. The economic slowdown and the oversupply in some areas of the building construction sector would normally cause investors to cut back on construction investment. However, the construction index hit a new high (150 points) in the third quarter of this year, a quarter-on-quarter increase of 1.1 %. Forecast revenues in both civil engineering and building construction were also up year-on-year [17].[8]

Residential construction rebounds after declining in Q2

In residential construction, although the decline in the number of building applications and other leading indicators point to a slowdown in construction investment, the picture is distorted by major development projects in the pipeline.[9] After the civil engineering sector in particular raised its revenue forecasts in Q2, residential construction- (+6.6 % QoQ) and commercial construction (+2.9 % QoQ) followed suit in Q3.[8]

Scant supply and high demand are making private homes more expensive

The low interest rate environment continues to favour investments in owner-occupied property. The later a rate hike is expected, the more worthwhile it is to purchase one's own home rather than renting. This is keeping demand high, while supply continues to contract. Institutional investors are preferring to shift construction activity to investment properties, while private purchasers of owner-occupied property face deteriorating sustainability due to rising prices.[10] These were 4.6 % higher year on year nationwide at the end of September, although they fell slightly in Q3 for the first time in five quarters (-0.4 % QoQ).[11]

Prices for owner-occupied property fell slightly by -0.4 % in Q3 only

The moderate decline is exclusively attributable to the reduction in prices for single-family homes (-1.7 %), with smaller falls recorded in all price categories [4, 47, 48]. With the exception of the Basel region, where prices for single-family homes remained stable, these price reductions are also evident on a regional

7 KOF, Analysen 2019, Nr. 3 Herbst
8 Credit Suisse, Bauindex Schweiz, 3. Quartal 2019
9 Credit Suisse, Immobilienmonitor Schweiz / September 2019
10 Zürcher Kantonalbank, Immobilienbarometer, 3. Quartal 2019
11 FPRE, Transaktionspreis- und Baulandindizes für Wohneigentum, Datenstand 30. September 2019

basis.[11] The fall in prices for single-family homes in the previous quarter is only a temporary reduction, however, and does not yet constitute a trend reversal.[5,10] In contrast to the price trend for single-family homes, prices for owner-occupied apartments were up compared with the previous quarter (1.5 %), with the Basel region once again the only one where prices moved in the opposite direction in the previous quarter (-0.7 %). Prices for owner-occupied apartments rose 7.5 % year on year [3, 53 ,54], while those for single-family homes increased by 2.6 %.[11]

Residential rents still on a downward trend despite a temporary rise in Q3

The real estate market is becoming more challenging for investors. Faced with a lack of alternatives, investors are switching to investments in regions with an elevated vacancy risk.[9] The national vacancy rate increased slightly from 1.62 % to 1.66 % year on year, which equates to around 75,000 apartments.[12] Despite the regional oversupply, market rents (transaction rents) for investment properties – both existing apartments and new builds nationwide – increased in the third quarter of 2019 (overall +0.6 %). This represents a year-on-year decline of -0.7 %, however, continuing the general pattern of falling rents [25]. Fewer and fewer market participants expect rents to pick up again anytime soon [30]. The pattern was similar for both existing apartments (+0.7 % QoQ, -0.6 % YoY) and new builds (+0.6 % QoQ, -0.7 % YoY). While there has been regional variation in rents of late, the trend for an increase in Q3 2019 but a decrease compared with the prior-year quarter was evident across the board [26]. The sole exception is the Jura region, which recorded an increase of 0.2 % quarter on quarter and 0.8 % year on year.[13]

Market rents for residential properties are trending downwards, whereas prices are rising

In general, market participants are convinced that prices for multi-family units will continue to rise despite falling rents [31]. The yield differential between core and value-added properties has fallen by an average of 10 bp over the last six months, with Lausanne (-25 bp, min. yield 2.55 %), Zurich (-20 bp, min. yield 2.1 %) and Lucerne (-15 bp, min. yield 2.6 %) recording the biggest drops.[14] With cash flow yields falling, the robustness of rental income is all the more crucial when it comes to achieving target yields. This can be improved in a number of ways such as appropriate portfolio diversification, a focus on the modernisation potential and quality of a property's building structure, or cost optimisation, which UBS summarises as a "resilience strategy".[15] The location alone is no longer enough.[16]

Additional yield compression in the office space market

The expansion of office space has recently been concentrated in the agglomerations, where there are still building land reserves. Construction of office space has now slowed, however, with the investment volume in Q3 around 14 % below the long-term average.[9] Despite this, progress in the initial letting of new rental spaces still under construction shows that demand for office space remains strong, not least among providers of co-working spaces.[17]

Rents for office space were 13 % higher year on year in September

Market rents (transaction rents) for office space rose in the previous quarter for the sixth time in succession (+3 %), finishing September 13 % higher year on year [2, 35, 36, 37]. The positive momentum is evident in all regions, but is most pronounced in Basel and Central Switzerland. At cantonal level, the canton of Lucerne recorded the biggest year-on-year increase of 17.5 %, while rents in the canton of Zug were the furthest below this

[12] Bundesamt für Statistik, Datenstand 1. Juni 2019
[13] FPRE, Transaktionspreis- und Baulandindizes für Renditeliegenschaften, Datenstand 30. September 2019
[14] PwC Investor Survey, Volume 10 / Oktober 2019
[15] UBS, Auf Kurs bleiben: Resilienzstrategie im fortgeschrittenen Immobilienzyklus, 15. Mai 2019
[16] Schweizer Immobilienbrief, Ausgabe 287 / 8. Oktober 2019
[17] JLL, Büromarkt Profil Zürich, Q2 2019

level at -5.8 %. Rents in urban cantons tended to post the highest increases.[13]

Investor demand for office properties in urban centres has stabilised somewhat overall, and rents for core real estate have remained largely stable since the spring. Yield compression to below the 2.5 % threshold in Zurich (2.4 %), Zug (2.5 %) and Geneva (2.5 %) shows that these cities remain preferred locations for investment, however. The strongest yield compressions can be observed in the opportunistic segment, with yields for such properties in the cities of Zurich and Geneva moving 10 or 20 basis points closer to the core segment respectively since March 2019.[14]

Yields in the retail space market are not falling

The pressure on store-based retail continues to manifest itself in cautious investor behaviour. “We are going to have to take a hit of 10-20 % – even up to 30 % in extreme cases – on retail rents, at least in the short term. The sector looks set to stabilise in the medium term,” a Swiss retail investor told PwC. Developments in the digital domain continue to dominate the market. Online shopping is eroding the importance of the traditional supply chain involving wholesalers, vendors and retailers. Stores require less and less floor space. City-centre spaces therefore need to be increasingly repurposed, with enhanced food options, collection points and more flexible opening times playing an ever more crucial role in revitalising city centres. Office spaces are just as important when it comes to breathing life into an area, since they increase footfall. Bustling city centres are especially important for service providers such as hairdressers or nail salons, whose services cannot be offered online. Developments in the retail space market will therefore focus on the usage mix and on spaces that can be adapted to meet specific needs.[18]

New concepts will revitalise city centres

Yields for retail spaces remained largely stable between our survey in March and the most recent one in October. Yields for value-added real estate contracted by an average of 10 basis points to 3.33 %, while the average yields for opportunistic (3.92 %) and Class A (2.81 %) real estate were down 3 basis points on the values recorded in the spring. In high street locations, experts expect the strongest yield compressions in Lucerne (-15 basis points) and Zurich (-10 basis points), with Zurich still exhibiting the lowest yields at 2.4 %, followed by Geneva at 2.5 %. Basel was the only city to see an uptick in yields for Class A properties, recording a rise of 10 basis points compared with March 2019 (2.8 %). Otherwise, only the city of Zurich recorded higher yields, for value-added (+10 basis points to 3.1 %) and opportunistic (+5 basis points to 3.6 %) properties. The greatest yield compression overall was for value-added properties in the city of Lucerne, which fell by 25 basis points. In terms of retail space rents, however, experts are expecting a decline in all major Swiss cities.[9,14]

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[18] NZZ am Sonntag, Mit Yoga Kundschaft anziehen, Ausgabe vom 18. August 2019