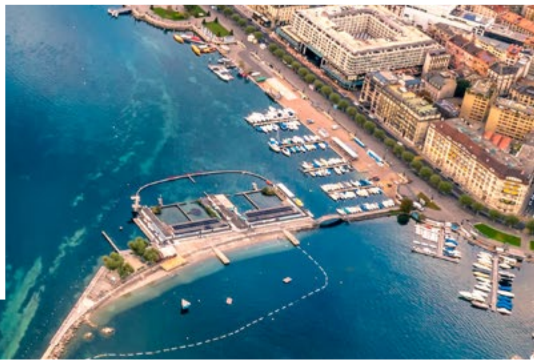

PwC-Immospektive

Interpretation of the FPRE real estate meta analysis Q1/19
References to FPRE graphics in our text are marked (1) etc.

"The Employment market is bolstering the economy"

15 February 2019

The Swiss economy is counting on rising employment and increasing domestic consumption in 2019. Overall GDP growth is expected to amount to 1.7 %. Ten-year Swiss government bonds have turned negative again, which is sustaining the appeal of real estate yields. Although incomes from residential property are falling, owners are struggling to rent out offices and retail properties are facing stagnating revenues, real estate remains a popular asset class in 2019.

Economic growth can no longer rely on growing exports

After surging in 2018, the growth of Switzerland's economy is expected to slow down in 2019. The forecasts have been revised successively downwards since November 2018. The average forecast for GDP growth in 2019 is 1.7 %, which is only average for Switzerland's long-term potential growth (between 1.6 % and 1.8 %, (9)). This is mainly due to falling export growth. Despite a recent slowdown in growth, research institutions are taking a positive view of the future and forecasting solid average GDP growth of 1.9 % for 2020. (8, 9)

The persistently favourable situation on the employment market will also likely prop up the markets. Employment rose again in the second half of 2018 (10), and therefore the unemployment rate fell steadily.[2] This trend is likely to lift the mood of consumers and cause private consumption to rise.[1] For 2019 and 2020 experts expect the unemployment rate to remain low, at 2.5 % and 2.6 % respectively. (8, 9)

Immigration remains persistently low for the time being. This means that one of the most important economic factors is not expected to have any positive effect on the economy. There was one small ray of light in October 2018, however: net immigration was around 9,000 people, which is the highest monthly figure for three years. (12, 13) Immigration from our immediate neighbours also rose in 2018. The immigration of German (+18 %) and Italian (+10 %) citizens rose sharply in the first three quarters of 2018 compared to the previous year.[1] Total net migration for 2018 is estimated to amount to 55,000 people.[3]

Lower inflation and renewed pressure on interest rates

The SNB expects inflation to fall to 0.5 % in 2019 (-0.3 % quarter-on-quarter) and 1.0 % in 2020 (-0.2 % quarter-on-quarter). (11) The decline is mainly due to falling energy prices. Rents will also contribute to falling prices in 2019.[4]

The national bank has now been maintaining negative interest rates for about four years, and its latest decision has done nothing to change this. It is maintaining a target range for the 3M LIBOR of between -1.25 % and -0.25 %. The forecasts for the 3M LIBOR in 2019 remain unchanged

1 Credit Suisse, Monitor Switzerland, December 2018
2 SNB, Quarterly Bulletin, 04/2018, December
3 UBS, Real Estate Focus 2019, 10 January 2019
4 Swiss Life Asset Managers, Perspectives, Economy, February 2019

> “Return to negative interest rates for Swiss government bonds”

at -0.7 %. In 2020 the research institutions expect 3M LIBOR rates to increase slightly to -0.5 % and -0.1 % respectively. (20) Capital market interest rates moved slightly in 2018, but remain near zero. The yield from ten-year Swiss government bonds turned negative again (-0.2 %). (21) The interest rates on long-term mortgage loans moved in the same direction. The interest rate for mortgages fell by 0.1 % to 1.2 % (5 years) and by 0.2 % to 1.6 % (10 years). Experts have kept their forecasts for the interest rates on Swiss government bonds in 2019 and 2020 above zero. They expect yields of between 0.2 % and 0.3 % for 2019 and between 0.5 % and 0.6 % for 2020.[2] (20)

Sideways movement in the construction sector

The construction index is forecasting an almost 4 % year-on-year decline in revenue in the last quarter of 2018. (17) Nevertheless, the outlook for 2019 remains positive for the time being. The construction sector is being buoyed by the continuation of negative interest rates and the slight pick-up in the employment growth.[5]

A somewhat differentiated perspective is required for residential construction. Strong construction activity in recent years and the regional supply surplus of rental accommodation are making investors more cautious. A slowdown was above all observed in the planning of construction projects.

> “Residential construction is cooling”

The number of new homes approved in the third quarter of 2018 was down 20 % year-on-year. Planning permission applications have fallen to a similar extent over the same period of time. As a result, revenues in the residential construction sector declined by about 8 % in the fourth quarter of 2018 (compared to the same quarter in the previous year).[5] (16)

Increased prices in the luxury ownership segment

Owner-occupied property prices rose 1.9 % quarter-on-quarter in the last quarter of 2018. This development was mainly driven by catch-up effects in the long-troubled luxury segment. Prices for luxury single-occupancy houses rose 3.1 % quarter-on-quarter, while for freehold apartments they rose by as much as 5.0 %. In contrast, a sideways movement in prices can be observed in the lower and mid-range segment for the fourth quarter of 2018. (48, 54) Mid-range freehold apartments have become more affordable in almost all regions for the first time in six quarters. The prices of single-occupancy houses in the low and mid-range segments fell quarter-on-quarter for the fourth time in succession, by 0.9 % and 1.5 % respectively.[6]

> “Freehold apartments may lose value in real terms in 2019”

Most market participants expect the prices of single-occupancy houses to increase in 2019. The situation for freehold apartments is more varied. (51, 57) UBS expects home ownership prices to increase only slightly overall in 2019. At the same time, the experts are expecting positive inflation and continuing economic growth, which should ultimately represent a step towards the gradual, real devaluation of residential property.[3]

Pressure on the income side for multiple-occupancy houses

The pressure on the income side is increasing for investment properties in the residential sector. Residential rents have fallen again throughout Switzerland. In the fourth quarter of 2018 there was a decrease in rents for old properties

[5] Credit Suisse/Swiss Contractors’ Association Construction Cost Index, Q4/2018

[6] FPRE, transaction price and building plot indices for owner-occupied property, data as at 31 December 2018

“Residential rents are falling in all regions”

(-1.7 %) and an even more pronounced decline for new ones (-2.4 %) in comparison to the preceding quarter. These reductions can be observed throughout Switzerland. The sharpest declines were suffered in rural regions (southern Switzerland: -4.8 %, Alpine region: -4.2 % and eastern Switzerland: -2.3 %), but the urban regions of Zurich and Basel also suffered reductions of around 2 %.[7] (25, 26)

At the same time, the number of empty apartments remains high. While around 75,000 units stood empty at the end of the year, by the end of 2019 this figure is expected to increase to around 80,000. This should finally represent a peak in vacant apartments, with no further increase due to the fall in planning applications. Not all Swiss institutional investors are likely to be affected equally by the increase in vacancies. Because their investment is focused on urban centres and conurbations, they are only exposed to a vacancy rate of well below 1 %.[3] Absorption times in 2019 will be longer for those who have ventured out into peripheral areas. The yield requirements in the residential property sector remain low. The average real discount rate applied by the major valuation companies for multiple-occupancy houses in the best areas of Zurich is currently 2.18 %. (34) Residential property is still a very attractive alternative investment to government bonds.

Office rents benefiting from rising employment

The office market benefited from the strong growth of the economy in 2018. Market rents for office space rose again in the fourth quarter of 2018. Compared to the preceding quarter, rents based on the actual rental contracts concluded rose 3.8 %. The strongest increases (4.2 %) were observed in the urban regions of Geneva and Basel, as well as +4.4 % in the smaller office space market of eastern Switzerland, which is dominated by SMEs.[7] (35, 36, 37) The current growth in employment is creating new jobs. The vacancies index rose steadily throughout 2018. The IT and real estate sector stood out on account of a strong increase in vacancies. (10) The increase in supply is not behind us yet, however. Persistently low interest rates and a shortage of alternatives are still favouring the development of new office spaces. New construction has tended to decline in urban centres in recent years. On the other hand, there has been a sharp increase in building permits in peripheral areas. The volume of planning applications for conversions is also growing. Throughout Switzerland, the experts from Credit Suisse are currently measuring a supply ratio of 4.9 %.

“Renting out office space in peripheral areas remains a challenge”

The absorption of space is expected to be boosted during the next few quarters by the ongoing growth of the economy. Nevertheless, the modest demand is not sufficient for the space on offer, and renting it out remains a challenge (outside urban centres in particular).[8] One ray of light for the marketing of office space is offered by SMEs, which are an important driver of growth in employment and also generate demand in semi-urban and regional centres in addition to urban centres.[9]

[7] FPRE, real estate price indices, investment property index series, data valid as at 31 December 2018
[8] Credit Suisse, Office markets recovering from their core outwards, December 2018
[9] HSLU, SME office rental monitor 2018

Retail revenue was influenced by the weather

The strength of the economy in 2018 did nothing to help consumer behaviour. Swiss retail revenue rose by just 0.4 %. This does not come as a surprise. Low pay growth and a slight increase in inflation caused consumers' purchasing power to fall for the second year in a row. The weather was a very influential factor in 2018. The warm weather was favourable for the leisure and DIY segment, but also other non-food sectors. Some fashion retailers suffered and were forced to sell much of their winter clothing below normal price. Overall, the clothing segment suffered a substantial 9 % loss of revenue. This is not entirely due to the weather. Zalando gained further market share, and online retail now makes up 10 % of the market. The food segment performed well again, however, with revenue growth of 1.5 %. In 2019, purchasing power is expected to rise again in Switzerland for the first time in two years.

> "Online retail reaches market share of 10 %"

On account of these factors, Credit Suisse is expecting nominal revenue growth of 1.3 % in the retail sector and a slight 0.3 % decline in revenue in the non-food segment compared to 2018.[10]

Grocery stores can be observed returning to communities and suburbs in response to the growth of online retail and changed shopping patterns. The trend is towards suburban stores with a wide range of products. This is presumably due to increased mobility. People want to shop on their way to or from work or school in order to save as much time as possible. This is fuelling demand for space for local shops.[11]

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[10] Credit Suisse, Swiss retailers facing international competition, January 2019

[11] HSLU, Local shops trendy again, 03/12/2018

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