PwC-Immospektive

Interpretation of the FPRE real estate meta analysis Q2/19
References to FPRE graphics in our text are marked (1) etc.

"Labour market not yet feeling the effects of the economic slowdown"

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The economic slowdown abroad has hit Switzerland harder than previously assumed. Experts have reduced their GDP growth forecasts for 2019 on a monthly basis, to the extent that they currently average 1.4%. The labour market and consumer sentiment are lagging behind this trend and are still benefiting from the above-average economic environment in the past year. In the office space market, demand for space is expected to rise further thanks to the strong labour market. Residential rents, by contrast, are stagnating as a result of continued attractive construction activity and the increasing vacancy problem.

The economy is weaker than expected

In the first four months of this year, the global economy weakened more markedly than expected one quarter ago.[1] Since February, the GDP forecasts for Switzerland for 2019 have been continuously revised downwards and currently stand at an average of 1.4% (Q1/2019: 1.7%), with some experts now forecasting growth of only 0.9% to 1.1% [8].[2,3] Economic growth is thus below the long-term potential growth in Switzerland (1.6% to 1.8%, [9]). In addition to political risks, which already intensified at the end of 2018, the economic slowdown in Europe and China is responsible for the downturn.[4] As a result, international demand for Swiss goods has declined, slowing domestic exports and investment.[5] At 2.5%, export growth in the current year is expected to be lower than it has been since 2015.[4] Experts nonetheless predict that the global economy will soon regain momentum. Economic forecasts for 2020 remain stable at around 1.9% [8].[5]

The economic slowdown can already be noticed in weaker employment growth [10]. The unemployment rate, meanwhile, remains low. It has declined steadily in the current year, standing at 2.4% in April. In the medium term, however, the economic slowdown will also affect unemployment.[6,7] An unemployment rate of 2.5% is expected for 2019, and 2.6% for 2020 [8].

Consumer sentiment is positive thanks to the current employment situation and the renewed increase in immigration [12,13]. Meanwhile, although the economic outlook and employment growth trends for the current year are limiting wage growth, real wages should increase due to low inflation forecasts. Overall, consumption growth could experience a slight upturn in 2019.[4,7]

1 Schweizerische Nationalbank (SNB), Quartalsheft 1/2019 März
2 Swiss Life Asset Manager (SLAM), Perspektiven Konjunktur Mai 2019, April 2019, März 2019
3 Fahrländer Partner Raumentwicklung (FPRE), Metaanalyse Immobilien Schweiz 2Q/2019
4 Credit Suisse, Monitor Schweiz, März 2019
5 SECO Medienmitteilung vom 14. März 2019: Schwächere Weltkonjunktur bremst Exporte
6 SECO Medienmitteilungen: Die Lage auf dem Arbeitsmarkt, Februar 2019, März 2019
7 SECO, Konjunkturtendenzen, Frühjahr 2019

Inflation and interest rates remain low

At present, the slowdown in investment activity and low key interest rates in the most important currency areas are leading to falling inflation expectations in Switzerland.[1] Continued oil price declines and the lack of upward revaluation in most components of the national consumer price index are also causing a weak inflation outlook.[4] For this reason, the Swiss National Bank in March reduced its inflation forecast for 2019, from 0.5% at the end of 2018 to 0.3% at present [11].[1]

> “Interest rates have dropped back below zero”

The 3-month LIBOR remained unchanged at -0.7% in March 2019 [21] and no increase is expected for the time being.[4] While at the end of 2018 experts were still assuming a medium-term LIBOR increase (-0.3% for 2020), this expectation aligned almost completely with the current interest rate in the second quarter (-0.6% for 2020) [20]. The forecasts for ten-year bonds have declined even more sharply. For 2019, they have slipped back to the zero range (-0.1% to 0.3%) and are not far from it for 2020 (0.1% to 0.6%) [20]. The interest rate for a ten-year government bond is currently -0.3%, which also represents a decline compared with December 2018 (-0.1%) [22].[3]

Moderate outlook for the construction sector despite temporary high

In the first quarter of 2019, the Credit Suisse construction index rose for the first time in five quarters. Although the revenue decline compared to the previous year is -1%, it represents a much more promising situation than in the previous quarter [17].[3] Building construction revenue is expected to rise by 5.5% and civil engineering revenue by 1.4% compared with the previous quarter.[8]

> “Growth prospects for rental housing construction are limited”

Despite the positive trend, only limited potential is expected for building construction. This is because economic growth has slowed recently and the oversupply is slowly but surely dampening the willingness to invest. While the outlook for building construction appears rather poor, the opposite may be said for civil engineering. High order volumes point to a continuation of the recent positive trend. In addition, high investment sums are expected for the growth-related expansion of the road and rail network.[8]

Good atmosphere for high-end owner-occupied residential property

In the first quarter of 2019, transaction prices for owner-occupied residential property rose by an average of 1.7%. The increase is thus less dynamic than in the previous quarter (1.9%). Owner-occupied apartments saw the third consecutive price increase (1.5% in Q1/2019). Remarkably, the price increase is mainly due to the price performance of apartments in the high-end segment (2.7%). Owner-occupied apartments in the low (+0.9%) and mid-range (+0.3% [53]) segments developed comparatively weakly in the first quarter of 2019 [54]. The same ratio can be seen for single-family homes (+1.9%) [48]. In the high-end segment,

[8] Credit Suisse, Bauindex Schweiz, 1. Quartal 2019

prices have recently risen by 3%, while they have developed less positively in the low (+1.6%) and mid-range (+0.4% [47]) segments. For 2019, the majority of market participants expect the prices of single-family homes to rise, but expect the prices of owner-occupied apartments to stagnate [51, 57].[9]

Residential properties face difficulties on the income side

Due to the continued modest yields on the bond market (-0.3% for ten-year government bonds), real estate investments remain very attractive.[3,10] This is despite the fact that uncertainties on the income side are increasing for investors. In particular, the rising vacancy rates in peripheral locations are becoming more and more noticeable.[11] Last year, around 10% fewer applications for building permits were submitted for multi-family units compared with the average for the last five years.[12] The vacancy situation is also forcing landlords to improve the quality of their properties. For this reason, in addition to the location of properties, the focus is now increasingly on the quality of the floor plans of rental spaces.[10]

> **“Residential properties remain in demand despite falling rents”**

As a result of rising oversupply and increasing vacancy rates, residential rents for investment properties fell sharply in 2018. Although rents for old and new apartments developed equally positively in the last quarter (+0.6%), they remained below the previous year’s level at 2.2% for old and 3.7% for new apartments. Clear regional differences can be observed. For instance, rents in southern Switzerland fell by 2.1% in the first quarter of the year, while they rose by 1.7% in the Jura region [25].[13] Although most rents have recovered slightly in the past quarter, market participants expect further declines in rents [30]. According to experts, however, prices for residential properties will continue to rise [31], especially as real estate continues to yield comparatively good returns. In the second quarter of 2019, the average real discount rate for a new residential property in a prime location in Zurich was 2.14% [34].[3]

Recovery in the office space market

In the case of office real estate, it appears that the low point of falling rents and yields has passed.[14] Transaction rents for office space increased by 13.4% compared to the previous year [35], with an increase of 3.2% in the first quarter of 2019 alone. During the same period, rents rose the most in the Lake Geneva region (4.1%) [36].[9] The increase in rents is due to employment growth, which benefited from the above-average economic situation in 2018. The job vacancy index continued to show an upward trend at the end of 2018. The IT sector in particular has seen a sharp increase in vacancies. The financial and insurance sector, on the other hand, is down 11% on the previous year with a decline in vacancies [10]. As a result of the increase in employment, the demand for space has increased and rents have stabilised after a five-year downward trend.[10]

> **“Office space market remains difficult in the agglomerations”**

The additional demand for office space fuelled by the economy is particularly concentrated in central locations, where the volume of space advertised has recently fallen by around one fifth. However, supply ratios are rising again. New construction activity has gained momentum thanks to the economic upswing. The expansion of new space is concentrated in particular in the agglomerations, where there are still building land reserves.[4] According to Wüest Partner, the supply ratio at the end of 2018 was 6.8% [39]. Nevertheless, experts are more optimistic about the outlook for office rents than they were six months ago. [41].[15]

[9] FPRE, Transaktionspreis- und Baulandindizes für Wohneigentum, Datenstand 31. März 2019
[10] Credit Suisse, Schweizer Immobilienmarkt, März 2019
[11] ZKB, Immobilienbarometer 1. Quartal 2019
[12] UBS, Real Estate Focus 2019
[13] FPRE, Transaktionspreis- und Baulandindizes für Renditeliegenschaften, Datenstand 31. März 2019
[14] JLL, Büromarkt Schweiz 2019
[15] Wüest Partner, Immo-Monitoring 2019/1

Scepticism remains high in the retail space market

Scepticism prevails in the retail segment. In the past half year, investors' yield requirements have increased not only outside the centres (average net initial yield for Class A properties at 3.9%), but also in high-street locations (average net initial yield for Class A properties at 2.8%). A slightly positive trend can only be observed in the inner-city areas of Basel (2.7%), Berne (2.9%) and Lugano (3.3%), where the net initial yields fell by around 15 basis points compared with the summer of 2018. Yields in the southern Switzerland region remain stable (average net initial yield for Class A properties at 4.2%).[16]

Tenants' demand for space is weak. Although the growth in retail space has stabilised in the last two years due to the low level of construction activity, around one third more vacant retail space has been advertised compared with the average for the last ten years.[15] Last year, around 42% of all non-food chains closed individual stores, while only just under 19% expanded. This trend can generally be seen in almost all non-food retailer segments. The clothing business is hardest hit. In addition, smaller and medium-sized municipalities are more affected by the loss of stores than are inner-city areas.[17] However, hairdressers, opticians and other service providers may well expand.[10] Food retailers already had to learn some years ago how to adapt to the market by optimising their stores when foreign competitors increased the pressure on the Swiss market by opening branches (e.g. Aldi and Lidl). This makes the sector more resilient today.[18] The owners of retail space in the non-food segment now have to show adequate flexibility in the design of space and contracts for existing tenants, as there are no alternatives.[12]

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15 Wüest Partner, Immo-Monitoring 2019/1
16 PwC Real Estate Investor Survey, Volume 9, März 2019
17 Van Dijk Consultancy & Immocompass, Retail Marktbericht Schweiz 2019
18 Credit Suisse, Retail Outlook Januar 2019