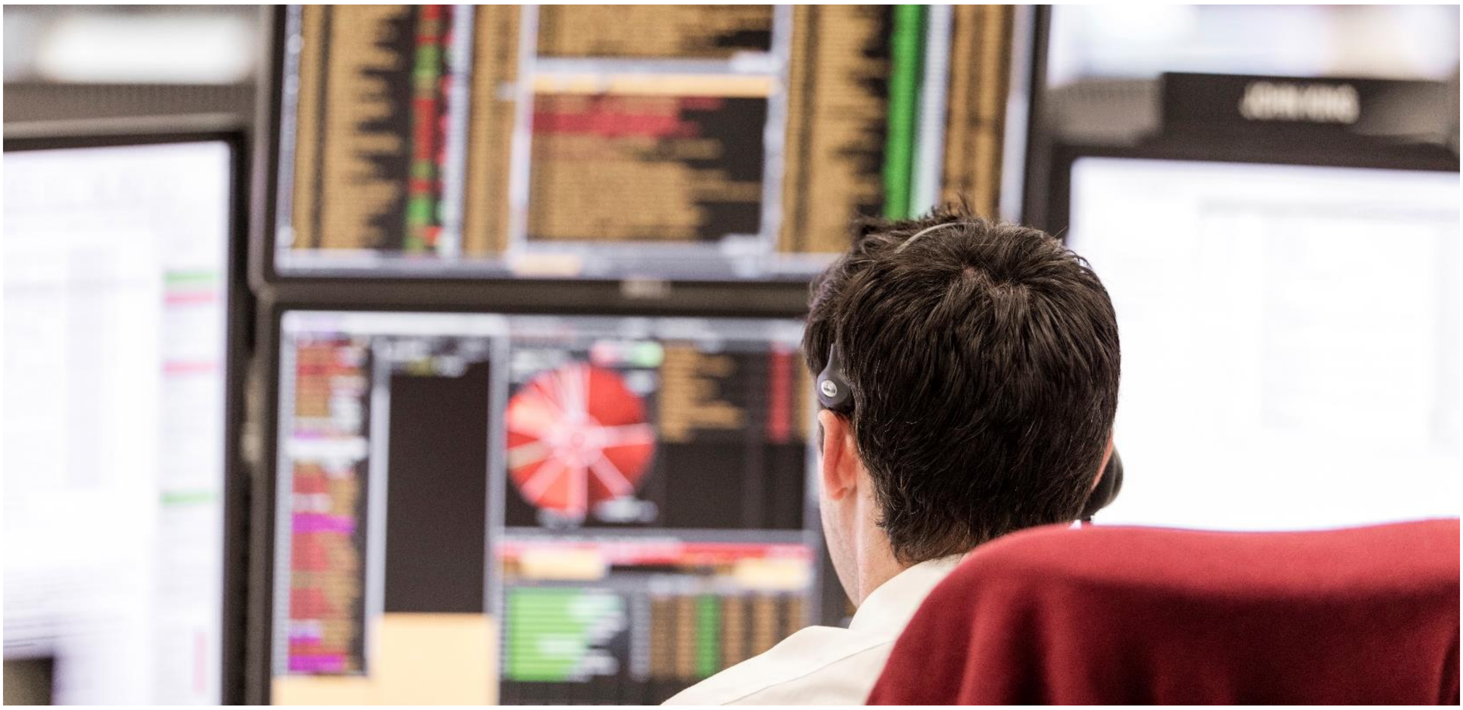
Talking Points

New era? Swiss real estate in an inflationary environment – **June 2022**



In our view, the scope for an increase in policy rates in Europe and Switzerland looks limited, both in terms of timing and magnitude.

Higher costs for building materials and debt financing are challenging the real estate sector.

The tangible nature of real estate and positive rental growth expectations in the occupier market, should support the robustness of the asset class in this more complex macroeconomic environment.

Inflation is back!

After decades of continuously muted inflation figures, real estate investors are now confronted with increased inflation. In this publication, we present our expectations about the future trend in the inflation and interest rate environment and discuss the potential implication of this complex macroeconomic environment for Swiss real estate investments.

Prior to the onset of COVID-19, most developed economies in the world experienced continuously low inflation despite highly expansionary monetary policies from local central banks due to the influence of structural mega-trends (aging society, digitalization, globalization, etc.). The consequences of the pandemic has reshuffled the cards. After paralysis and a long sluggish recovery due to several lockdowns, global economic activity picked up again in the course of 2021. This was supported not only by the gradual exit from the health crisis, but also by the elevated pent-up consumption potential built up during lockdown periods. At the same time, global supply chains have not yet returned to normal. In China, the COVID-19 pandemic continues to cause disruption and provoke large-scale lockdown measures, affecting the manufacturing and logistics capacity of the country's industry. In addition, the recent outbreak of war in Ukraine is creating further uncertainty around the supply of key raw materials such as oil, gas and grain.

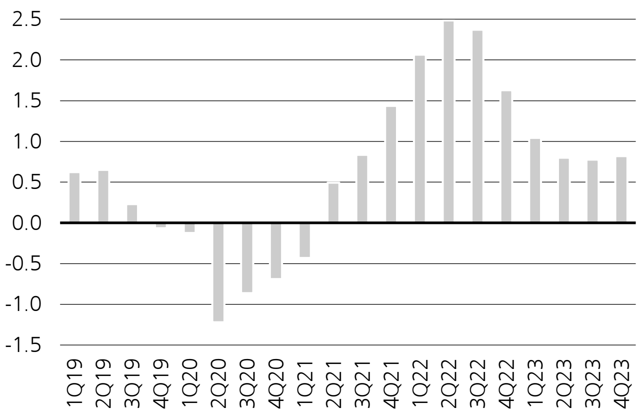
The post-pandemic economic recovery and the still sluggish supply chains are the primary driver for the currently elevated inflation dynamic observed around the world. In marked contrast to the price growth in North America and Europe, the Swiss market has been spared, with an overall price gain of 2.5% year on year in April 2022 (see Figure 1). Nevertheless, these levels of inflation have not been observed for decades, so it is time to assess expected price and interest rate trends and their potential impact on the Swiss real estate investment market.

In Switzerland's specific case, the significantly lower inflation rate compared with abroad and the continued strength of the Swiss franc against the euro, are likely to limit the prospects for significantly higher policy rates.

Challenges for the construction industry

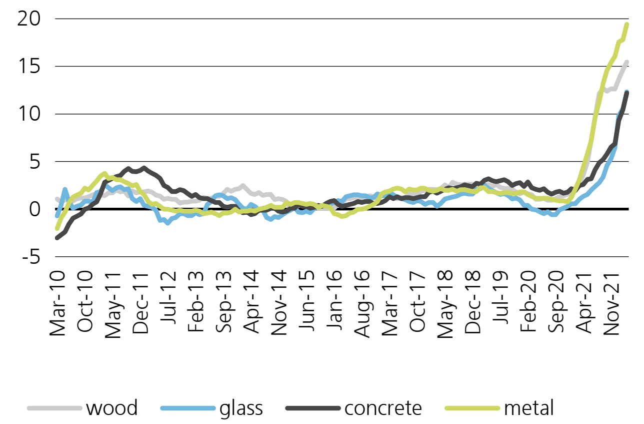
As mentioned previously, although price inflation might soon reach its peak, the current price environment is a challenging one for the players in the Swiss real estate industry. The construction sector is particularly affected, facing either delivery delays and/or significantly higher prices for construction materials (see Figure 2).

Figure 1: Historical and expected inflation in Switzerland
(% YoY)



Source: Forecasts from Oxford Economics May 2022 and Real Estate & Private Markets (REPM), May 2022. Past / expected performance is not a guarantee for future results.

Figure 2: Construction material prices
(% vs. previous year)



Source: PMA; Eurostat; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022

Narrow scope for higher policy rates in Europe

The nature of the prevailing inflation drivers is making it more difficult for central banks to take action. Indeed, higher policy rates can do little to resolve disruptions in global supply chains and geopolitical conflicts. Nevertheless, the increased inflation expectations in the market as well as the cycle of rate hikes initiated in the US, where the emergence of a price-wage spiral can be observed, point to a probable increase in policy rates in the eurozone and Switzerland in the near future.

However, the scope for interest rate hikes on the European continent, both in terms of timing and magnitude, looks rather limited in the current macroeconomic environment. First, inflation is likely to peak in the coming months, according to current estimates by Oxford Economic – an independent consulting firm and supplier of global economic data. This scenario is supported in particular by the gradual fading of substantial base effects from the acute pandemic period. Moreover, still high input prices, which are the primary driver of the surge in inflation, are likely to act as a drag on growth and demand in global economies over time. Thus, far higher policy rates could increase the risk of stagflation, a scenario that every central bank would like to avoid.

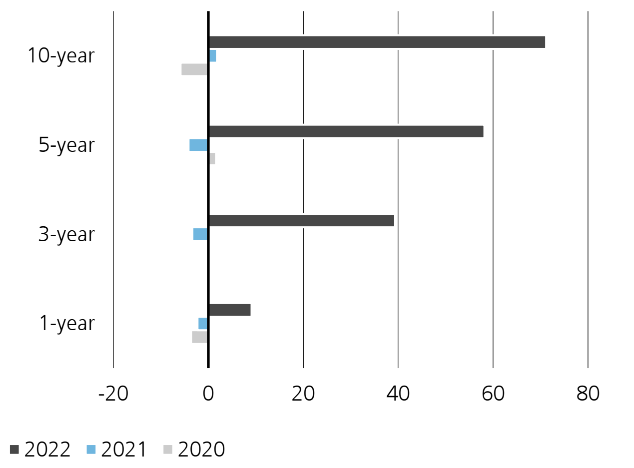
It is not only the disruptions in the supply chains that are driving up the prices of such inputs, but also the current high energy prices that are making the production costs of such materials more expensive. This environment is driving up project planning risks and potentially delaying ongoing construction projects.

Financing costs have also increased

Although Swiss policy rates have so far remained unchanged at -0.75%, medium-term and long-term yields on the financial market have already climbed in reaction to higher inflation expectations. At the time of writing, the yield on the 10-year Swiss government bond was trending at about +70 basis points.

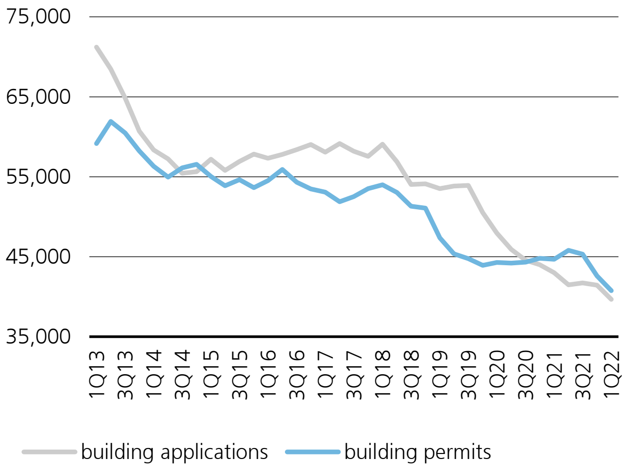
Accordingly, there is an upward trend in the interest rates charged on the Swiss mortgage market (see Figure 3). Although the absolute level of financing costs remains moderate by historical standards, the average interest on a 10-year mortgage in March 2022 was about 70 basis points higher than a year earlier. This is putting pressure on the positive performance contribution of debt financing for investments in the real estate market. However, in the case of Swiss indirect investment products such as listed real estate funds and investment foundations, this impact must be put into perspective as these structures are exhibiting moderate to no leverage (legal maximum 33% leverage ratio).

Figure 3: Increase in mortgage rates by contract term (as of end-March, basis points vs. previous year)



Source: Schweizerische Nationalbank; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022.¨

Figure 4: Planning activity in the Swiss residential market (12-month sum, number of residential units)



Source: Bauinfo 1Q22; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022.

Real estate with protection mechanisms against inflation

Recent macroeconomic developments are creating a more complex market context for Swiss real estate investments from a construction and financing cost perspective. However, the real estate asset class offers important trump cards in an environment of increased inflation.

In addition to the tangible nature of real estate, which provides long-term inflation protection through land and property price movements, the income component of the sector also has protective features against inflation. This inflation protection, which occurs through the adjustment of rental income, is often not perfect in terms of timing and extent. But it contributes to the resilience of the asset class in inflationary times. Specifically, up to 40% of the growth in the national consumer price index can be passed on to residential tenants. In addition, commercial leases are often indexed to the national consumer price index (CPI) with annual adjustments. Rents can also be adjusted to market rates in the event of a change of user.

Rental growth prospects are brightening

For owners of multifamily properties in particular, recent developments in the occupier market point to a positive outlook in the case of new leases. While absorption potential remains very robust thanks to dynamic levels of immigration, planning activity for new residential properties is still slowing (see Figure 4). The current increase in construction and financing costs (see page 2) is likely to exacerbate this trend, at least in the short term. As a result, a renewed decline in Swiss residential vacancy rates and further rental growth in the sector can be anticipated in 2022.

Good commercial properties also with positive outlook

Compared to the multifamily sector, the occupier markets for commercial real estate are currently facing further uncertainty. In the retail space market, the growth of online retail is continuing to take its toll, while the office market is facing the emergence of new workplace concepts post COVID-19. The trend in the various segments of the commercial real estate sectors is increasingly heterogeneous.

In the individual local office markets, for example, modern properties in established and highly accessible business districts are seeing dynamic leasing activity, while properties in secondary locations are feeling the effects of the consolidation trend in demand. In the retail space market, areas with a focus on grocery retailing and everyday consumer goods are almost unaffected by the online retail trend.

In addition, very good retail locations on prominent shopping streets are still in high demand both on the investment market and rental market. In contrast to the market average, these market segments have robust rental growth expectations. After a correction in pandemic year 2020, rents in the prime segment of the retail space market in Zurich and Geneva significantly recovered and, according to data from Wüest Partner, experienced a year-on-year increase of over 9% (Zurich) and respectively around 20% (Geneva) in 1Q22.

Real estate asset class expected to be robust

In the previous paragraphs, we explained that the current high inflation dynamic in Europe and Switzerland is primarily being driven by disruptions in global supply chains and high commodity prices. Inflation is likely to peak soon, with the still high level of input prices weighing on economic activity. In our view, the scope for higher policy rates in Europe and Switzerland looks limited, both in terms of timing and magnitude, given the current macroeconomic environment.

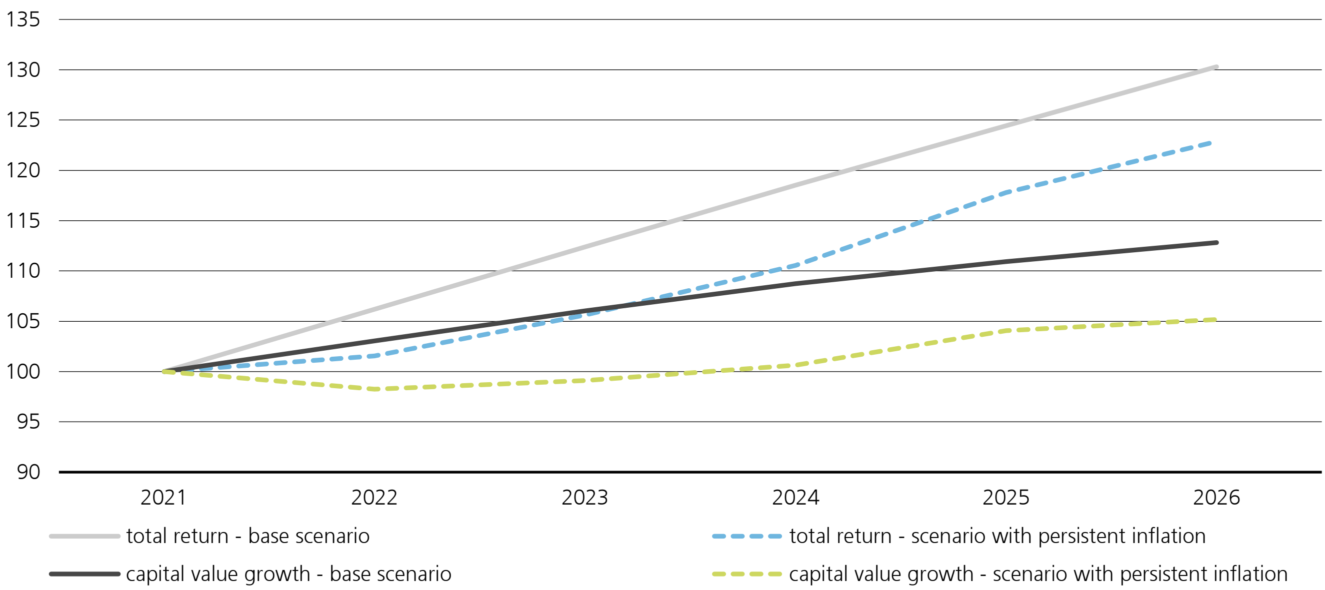
We have also noted that the real estate asset class offers protective mechanisms in an inflationary environment thanks to its tangible asset nature and regular rent adjustments. Added to this, current rental growth expectations for Swiss rental apartments and future-proof commercial real estate are robust.

These factors are fundamentally positive for the outlook of the Swiss real estate asset class. Nevertheless, uncertainty about the future direction of the macroeconomic environment is currently very high. Contrary to our expectations, inflation might not lose momentum so quickly and may remain at a high level for a longer period of time.

Oxford Economics has compiled forecasts on the potential impact of such a macroeconomic environment on the performance of direct Swiss real estate investments (see Figure 5). The results show that the capital value appreciation component is likely to be weighed down by higher inflation and interest rates in the short term before a recovery occurs in the second part of the five-year forecast horizon. On the other hand, the income yield component should prove robust over the entire period, which should support the resilience of overall performance.

Figure 5: Performance index of direct Swiss real estate investments by macroeconomic scenario

(100 = level at the end of 2021, mixed sectors, at property level, without leverage)



Source: Independent scenarios and forecasts from Oxford Economics May 2022; UBS Asset Management, Real Estate & Private Markets (REPM), May 2022.
Comment: Performance is from MSCI/Wüest Partner Index. Past / modeled / expected performance is not a guarantee for future results.

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