

# Investment Strategy Bulletin

## Swiss real estate: A house of cards?

Investment Solutions

19 April 2022

### Key takeaways

- Amid high prices and the prospect of rising interest rates, Swiss authorities are warning of a possible house price correction
- The current market looks very different to that of the late 1980s, when the last housing bubble burst
- Our expectation that Swiss interest rates will peak at a low level also stems the longer-term refinancing risk in mortgage markets
- We prefer exposure to broader European real estate, where we see particular opportunities in the logistics and residential sectors

**Is Swiss housing poised for a fall? Recent warnings of a correction from the central bank and financial regulator come amid high prices and the prospect of rising interest rates. Yet we see no imminent risk of a bubble bursting. For investors keen to diversify holdings, while retaining an inflationary hedge, we prefer exposure to European over Swiss real estate.**

Swiss real estate has had a stellar run. Prices of houses, apartments and investment properties (mixed-use buildings that include residential units) have all risen sharply in the past decade (see chart 1, page 2). Over the same period, Swiss listed real estate funds have more than doubled in value. The run-up in prices has been driven by depleted housing inventory, rising demand and very low mortgage costs, especially after long term Swiss interest rates turned negative in December 2014. The Covid-19 pandemic has sparked further demand for housing ownership, while a flight to safe haven assets denominated in Swiss francs from international investors has benefited the sector further.

Now, amid high valuations and the prospect of rising interest rates, warning bells are sounding. From September, banks must hold more capital against mortgage lending, at the Swiss National Bank's (SNB's) recommendation. In late March, SNB Vice Chairman Fritz Zurbrugg warned that vulnerabilities in residential real estate and mortgage markets had risen, and that a house price crash risked a credit crunch and broader economic damage. On 5 April, the Swiss Financial Market Supervisory Authority (FINMA) echoed these sentiments when it warned: "A correction of the real estate markets poses a concentration risk for our economy as a whole, and particularly for highly exposed institutions."

**Important information:** Please read the important information at the end of the document.

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## Assessing bubble risks

Do buoyant valuations constitute a bubble? There are certainly precedents. The last Swiss real estate crisis in the late 1980s was triggered by oversupply and speculation, followed by a market crash as interest rate rises hit home. Before the crisis, a construction boom had driven residential supply to outstrip demand. Prices rose rapidly due to speculation, with investors buying buildings at yields below interest rates and selling them rapidly at profit. When interest rates rose from 5% in 1988 to 8% in 1990, it triggered a wave of forced selling. Swiss investment property prices halved in value between 1991 and 1998.

Today, there are concerns over affordability and a rise in demand for 'buy-to-let' assets. House prices are around seven times average Swiss incomes, versus around five times in the 1980s, their highest level in over 40 years<sup>1</sup>. Prices are also high relative to annual rents. In absolute terms, they have risen more than 80% in the last 15 years, according to SNB calculations, making Switzerland one of Europe's most expensive real estate markets.

Low rates have certainly attracted yield-hungry investors. Yet many classic indicators of a bubble (excess supply, speculative buyers) are absent. Supply in both housing and apartments continues to sharply lag demand. Planning activity for new residential apartments slowed in the second half of 2021, even as population growth, spurred by net migration, continued. The Swiss mortgage market is highly regulated, and the Swiss Bankers' Association estimates the average home loan to value is 60%, giving a 40% cushion before owners would enter negative equity. In the last crash, prices fell by around 25%.

<sup>1</sup>Source: UBS Swiss real estate bubble index, 3 February 2022

Dynamics in residential real estate have certainly changed in the wake of the pandemic. Demand has risen for large apartments, second homes, and houses on the outskirts of urban centres, although demand for city-centre properties is also now back to pre-crisis levels. In the coming year, we believe demand could shift again, as would-be buyers start contemplating an imminent rise in interest rates. This could spur interest in more affordable apartments.

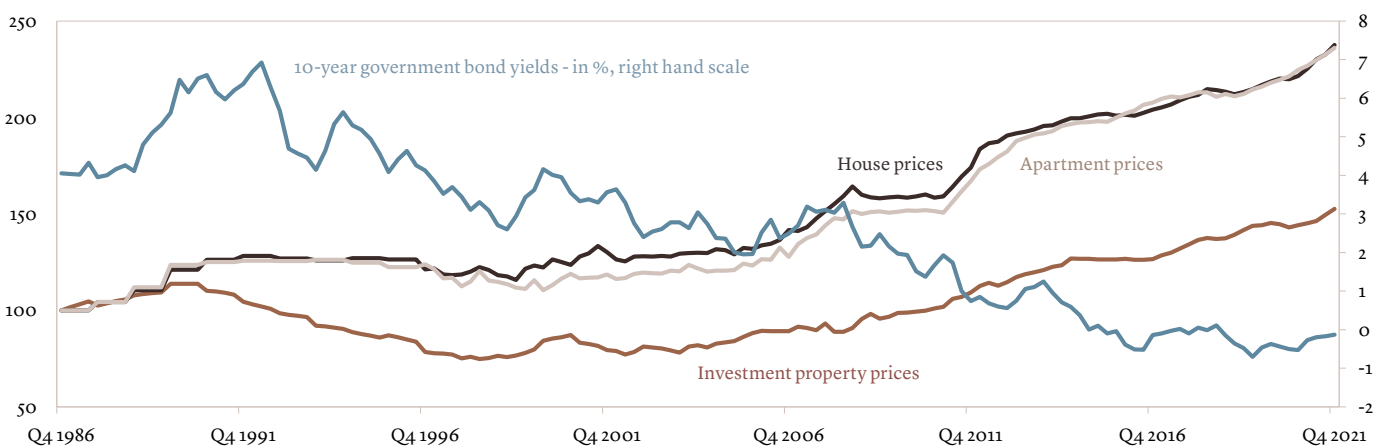
## What will happen when rates finally rise?

In periods of high inflation, real estate tends to perform well. The bigger question is what will happen to the market when rates actually start to rise, in late 2022 or more likely 2023. In the late 1980s, the income generating part of the market was hit hardest; this time, worries centre on homeowners who acquired properties thanks to rock-bottom interest rates, and may struggle to service rising mortgage payments at a time when food and fuel bills are also rising sharply. Yet here too, we believe a credit crunch does not look imminent. In recent years, buyers have taken out more long-term, fixed mortgage rates (see chart 2, page 3), pushing any refinancing risk some years into the future.

When considering the possibility of a longer-term credit crunch, much depends on the rate outlook. We expect the SNB to lag the European Central Bank in its tightening cycle, given lower inflation and a desire to stem the franc's rise. We foresee rates rising from -0.75% currently to around zero by end-2023, and for now, do not expect long-term rates to rise much above zero. While we could still see a house price correction in the

### 1. Concrete gold

Evolution of Swiss real estate prices, in %, rebased to 100 in Q4 1986



Sources: Bloomberg, Centre de Formation et d'Information Immobilière (CIFI)

coming years, heralding a return to longer-term measures of affordability, a continuation of interest rates significantly below long-term averages should stem the longer-term refinancing risk in mortgage markets, and thus the impact on the banking sector and broader economy.

Meanwhile, the appeal of Swiss residential property investment is waning. The spread between real estate funds' dividend yields and 10-year government bonds is normalising as rates rise, and now stands around 1.61%. Given strong demand and reliable incomes, listed Swiss real estate funds often trade at chunky premiums to their net asset values (NAVs) – currently a 46.4% premium for residential funds. Such valuations look steep, while market dividend yields of 2.3% also look comparatively low versus history.

### A different picture for commercial and retail

Beyond the residential market, Swiss real estate dynamics look very different. Retail has suffered from years of oversupply, which peaked in around 2016, and started to rise again in March 2020 as the pandemic hit. We remain cautious on this sector. Our view on the office market remains constructive, particularly for centrally placed, high quality office buildings. About 90% of rental contracts are automatically indexed to inflation. Rental growth returned in 2019 after a period of oversupply, and the only office market where we expect rents to fall in the coming months is Basel. While vacancy rates have risen from 5.5% to 5.8% in 2021 following the pandemic and increased demand for working from home, we expect vacancies to be largely offset by strong job creation boosting demand, and small and medium-sized enterprises retaining existing office space. Commercial real estate funds trade at much lower

premiums to NAV (around 12%) than their residential peers and offer yields of around 3.4%. Within portfolios, we hold a very limited exposure to Swiss real estate, which has been increasingly concentrated in the commercial space over the past two years.

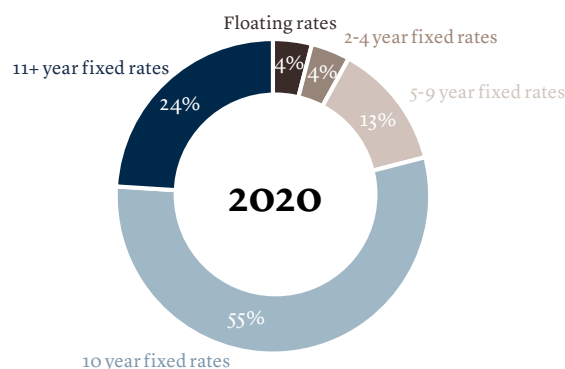
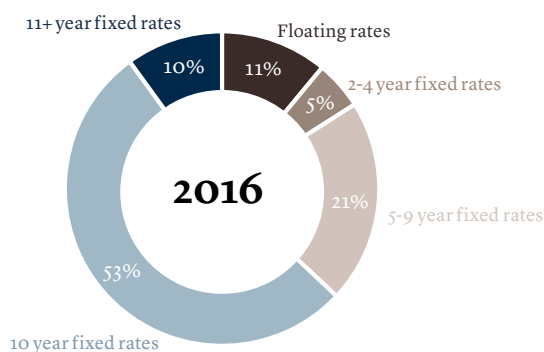
### Diversification benefits – we favour European real estate

That said, we value the yield opportunities offered by real estate, and particularly its role as an inflationary hedge in the current environment. Within portfolios, we favour a small overweight to European real estate, where we see particularly strong rental growth opportunities in the logistics space (industrial buildings, factories etc) – where rents are more or less fully indexed to inflation – and in the residential sector. A shortage of supply helped European logistics rents rise 7.2% in 2021, with particularly strong gains in the UK and some German regional markets. In the residential space, a persistent gap between supply and demand has led to price increases, especially in large, urban markets. For commercial buildings, rents are 70% indexed to inflation on average, offering a decent inflationary hedge. Here, 6% vacancy rates are not negligible, but remain just 2% for very high quality offices. Meanwhile, listed European real estate companies trade at discounts of around 20% to NAV, higher than their 14% historical average, offering plenty of catch up potential. Europe also has the benefit of diversifying exposure across many different markets with their own dynamics, and for Swiss-based investors, to assets not tied to the fate of the domestic economy.

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## 2. Long-term fix

Composition of Swiss mortgages written in 2016 and 2020



Source: MoneyPark

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