

Real Estate House View

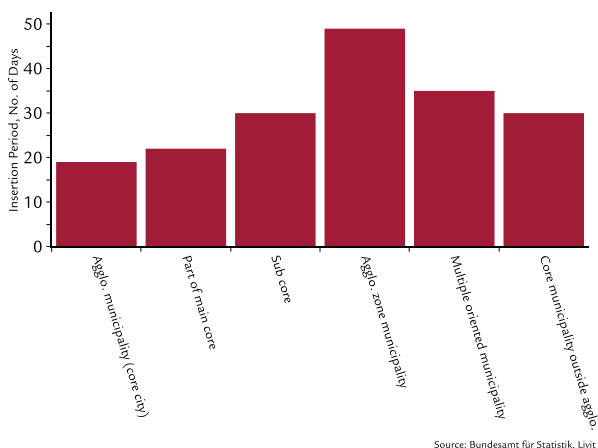
Switzerland

Second half-year 2019

Key takeaways

- **Demand for Swiss real estate investment remains high:** the low interest rate environment is keeping demand up while vacancy rates in residential markets are increasing
- **Asset selection is key for investment decisions:** spread between quality assets and locations remains noticeable
- **SNB has identified imbalances on mortgage and residential markets as well as risk of substantial price corrections:** this concluded in an agreement with financial institutions on stricter handling of mortgages for income properties
- **Performance of Swiss real estate expected to be more or less stable:** but the market is being impacted by a slowing economy, lower immigration and changes in retail and office segments

Chart in focus



Demand for apartments in core cities is high and stable. 1 and 2-room apartments in particular are being advertised for substantially shorter periods than larger ones. The average posting period for a 1-room apartment in Zurich is only eight days according to our research – whereas 4-bedroom apartments were advertised for 16 days on average in the first half of 2019. Agglomeration municipalities also report high demand due to their proximity to cities. By contrast we see some pressure in outlying communities, where it is taking considerably more time to find new tenants due to time-consuming commuting and a relatively high supply rate.

Growth dynamics in Switzerland have slowed in the first half of 2019: being a small and open economy, it is particularly hard hit by tensions in global trade policies. More than 80% of its electrical and mechanical engineering industry products are exported. In the second quarter of 2019, the Manufacturing Purchasing Managers' Index fell below the 50 points mark, which is defined as the borderline between growth and contraction. The recent strengthening of the Swiss Franc's external value is problematic for Swiss exporters, while final domestic demand is set to moderate after a strong start to the year. Government consumption is unlikely to repeat its strong contribution to growth seen in the first quarter of 2019. Private consumption should be supported by rising real earnings and growing evidence that monetary policy will remain accommodative for a prolonged period. Net migration – a prominent growth factor over the past decade – decreased by a third compared to the peak years 2013 and 2014, and counts for approximately 50,000 migrants per year.

High transaction levels

Against the backdrop of a slowing economy and rather flat interest rates, we have witnessed only a few significant developments in the real estate markets. Due to the currently favourable interest rate environment, the Swiss real estate market activity is still quite buoyant at a high level. However, whereas MSCI reports an increase in the total return to 6.1% from 5.8% in 2018, IAZI has reported a decrease to 5.3% (from 6.3%). The difference can only partially be explained by differences in the benchmark portfolio. The MSCI Index seems to be driven by the high demand that is pushing down yields while driving up capital growth and transaction prices. This development will be closely monitored. In theory, when flat interest rates occur and income decreases due to less dynamic economic growth, total returns would be expected to remain rather flat. The increase in total return confirms our view: transaction activity is expected to persist at a high level as interest rates stay low.

SNB & banks reach agreement

The Swiss National Bank (SNB) monitors the latest developments of residential markets and has registered a build-up of imbalances on mortgage and residential markets – with associated risks for financial stability.

SNB estimates the risk of future substantial price corrections as particularly high, despite the slight decrease in prices observed in 2018. Since 2008, transaction prices have risen much more than rents, resulting in historically low initial yields. This, combined with an increase in vacancy rates, could trigger a price correction in the residential investment segment – particularly if interest rates increase. As a result, SNB has forced banks to react and to align processes: it has imposed tighter restrictions for the granting of mortgages for investment properties in the residential sector. With this in mind, stock selection and active asset management remains key for investors.

Construction activity still high

The intense construction activity is expected to continue – there is no sign of any relaxation. Construction permits for rental apartments grew by 1.5% in the first quarter of 2019 compared to the previous year, according to Wüest Partner (WP). The supply of complete apartments is outstripping the additional demand. Therefore – in an environment of a slowing economy and lower immigration – the vacancy rate is about to increase while rents are set to decrease further (WP expects -1.9% in 2019). Peripheral areas currently have higher vacancy levels than urban areas. Another important differentiating factor is apartment size. It is essential in investment decisions to consider the spread between good and poor property assets in different locations.

Commercial markets are resistant

Due to their stable and unvarying standing, office markets are currently less in the spotlight of public discussion. Demand is relatively constant, although less central sites and larger spaces are still more challenging to let. This is considered the “new normal” rather than the exception. Overall, we will closely monitor the development and sustainable implementation of co-working spaces. To note here is also an uptake in pharma and IT sectors looking for vacancies. Small spaces are in especially high demand in large cities. There are no major changes in the retail sector since the last publication: consolidation of space is ongoing, prompting the question as to how vacated space should be used most efficiently.

Chart 1: Production of rental apartments

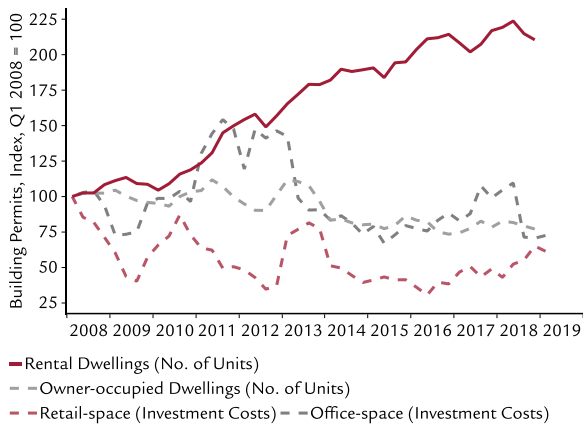
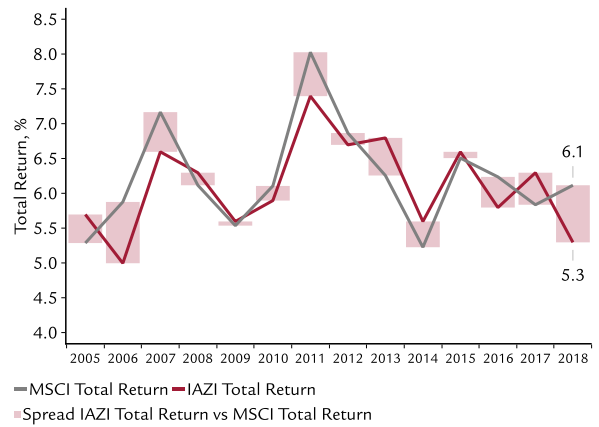


Chart 2: Difference in total return MSCI vs IAZI



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