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Real estate market on cusp of change

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Real estate market on cusp of change

The value of Swiss real estate has soared to heady levels in recent years against the backdrop of a seemingly unending era of low interest rates. However, the COVID-19 pandemic and its repercussions are now bringing an end to this low-interest era. Many real estate owners and market protagonists have not had to deal with challenging situations such as these before.

Specter of inflation is back

Although generous fiscal policy support measures to cushion the consequences of the recent pandemic led to a powerful surge in consumer demand worldwide, pandemic-related lockdowns caused supply chain disruptions that in turn prompted traders and producers to increase their advance orders of input goods. Rather than being a sporadic phenomenon, this has manifested itself globally and on a broad front, as the pandemic effectively synchronized economic acceleration and slowdown phases to an unprecedented extent. No wonder that prices are rising, particularly as availability is currently a more important factor than price stability. Against this backdrop, Russia's invasion of Ukraine and China's zero-COVID strategy are exacerbating supply chain disruptions and threatening to make high inflation rates the new normal.

Interest rate trend reversal represents turning point for real estate too

Last year, the markets were happy to accept the assurances of central banks that inflation was just a temporary phenomenon. But when inflation rates showed no signs of falling toward the year-end, the markets revised their opinions, which led to significant rises in long-term interest rates. Inflation rates at 40-year highs have forced the central bank of the US (Fed) to act rather than lose its credibility altogether, and the central bank of the EU (ECB) will likely follow suit. Generally speaking, rising interest rates are not good news for real estate, as valuations react very sensitively to interest rate changes due to the very long life cycles of buildings. That said, not all constellations are the same here. When rising interest rates are accompanied by powerful economic growth, real estate values can also rise if the effect of higher interest rates is more than compensated by rental price growth. On the other hand, when stagflationary developments make rental price increases impossible or – as in Switzerland – a very sluggish reference interest rate system underpins the development of apartment rents, landlords can only pass on rising financing costs to tenants with a significant time lag.

Reference interest rate in no hurry at all
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How swiftly Switzerland's reference interest rate will start to rise depends primarily on the underlying interest rate scenario. Thanks to our proprietary model for the development of this reference rate, we can predict its behavior relatively accurately for every interest rate scenario. For example, in an extreme scenario involving 15 successive key rate hikes of 25 basis points by the Swiss National Bank (SNB) starting in September 2022, the reference rate would only rise for the first time at the end of 2023 – two years after the interest rate trend reversal. In a more probable scenario of seven increases in the SNB key rate up to 1%, the first increase in the reference rate would not occur until mid-2024. In the other extreme scenario, if the SNB were to raise key rates only slightly to a peak of 0% and then leave them at that level, the first rise would be unlikely to appear on the horizon until the end of 2027. For residential landlords, this would mean a significant delay before they could pass on higher interest rate costs to their tenants.

Buying once again more expensive than renting
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People who own their own home must also prepare to face the winds of change. For the first time in 13 years, buyers of an apartment for their own use have to pay more than tenants renting a comparable apartment. This trend reversal – which is attributable to the strong recent rise in fixed mortgage interest rates – can be expected to endure. While it is true that mortgage interest costs remain significantly lower than comparable apartment rents, the high price of ownership also feeds through into higher maintenance costs. When these two cost factors are combined with others, new owners have now once again been paying more than tenants since the first quarter of this year. This is likely to have a dampening effect on demand for owner-occupied housing. Indeed, the number of such transactions declined noticeably in the first quarter of 2022.

Astonishing rise in construction material prices
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The special effects of the pandemic and the war in Eastern Europe have also left their mark on the construction economy. Even last year, a shortage of key building materials on Swiss building sites was fueling a sharp rise in prices. In October 2021, building construction price inflation stood at 4.6% compared to the prior year, equivalent to the strongest rise since record-keeping began back in 1998. And the cost of construction is only likely to have increased further since then: In recent weeks, the prices of metal products such as reinforcing steel and aluminum have shot into the stratosphere. Long-standing observers of the construction economy are now reporting construction price inflation on an unprecedented scale. While delays to entire projects due to the absence of key building materials have so far been the exception, developers are having to brace themselves for further rises and strong fluctuations in prices and delivery times. Not only does this complicate the planning process, but higher construction costs will also further weigh on real estate investment yields – which are already under considerable pressure. The huge increases in construction prices could prompt some real estate investors to put projects involving fine margins on ice or delay urgent investments in existing housing stock.

High energy costs cause ancillary costs to rocket
page 9

Whereas real estate investors at least have the choice of whether to pull back from an investment or put a renovation on the back burner, landlords have no way of escaping higher ancillary costs. Due to the outbreak of war in Ukraine and the threatened scarcity of energy commodities, the wholesale prices of heating oil, natural gas, and electricity have gone through the roof. That said, landlords have differing degrees of exposure to this development, depending on the type of energy used. For occupants of apartment blocks where fossil fuels still account for some 60% of the total heating bill, the energy price surge in 2022 could mean a rise in heating costs of around 38%. By contrast, the heating energy costs of the average apartment with a heat pump have risen by just 3% and are now a hefty 60% below the cost of fossil-based energy sources. What's more, further price shocks await down the line, as due to the sluggishness of gas price developments for end customers and the regulation of prices for household electricity, Swiss households have yet to feel the full weight of recent price rises. Viewed overall, the huge advantage of heat pumps for heating buildings from the standpoint of running costs must be set against comparatively high investment costs. However, the latter can be amortized all the more quickly against a background of surging prices of fossil-based energy sources. Based on the latest energy prices, the costs of installing an air-water heat pump to replace an oil or gas heating system can now be recouped in just eight or nine years.

Interest rate trend reversal changes "rules of the game" for investment market
page 16

In recent times, the returns on real estate investments have been increasingly reliant on value increases, which are likely to be either non-existent – or at least much lower – going forward. Mirroring the rise in long-term interest rates, the yield premiums of both direct and indirect real estate investments over more secure investments have declined. As the interest rate turnaround gathers pace, real estate investments are likely to continue to lose their appeal, as government bonds or high-quality corporate bonds will become increasingly sought after as alternatives. This will have the effect of "switching off the engine" for further discount rate reductions and automatic value increases. Accordingly, the focus of investors is likely to swing back toward the growth and reliability of real estate income flows.

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Rental apartments: reference interest rate in no hurry at all

With mortgage rates rising, real estate owners must brace themselves for higher financing costs. Based on the most probable scenario, the reference interest rate – sluggish by conceptual design – is unlikely to rise before mid-2024, which will leave the additional financial burden with landlords in the short to medium term.

Landlords confronted with rising interest costs, ...

Rising global inflation rates due to the pandemic and the war in Ukraine have put pressure on central banks, and yield curves have steepened. Fixed mortgage rates have therefore risen strongly in Switzerland too in recent months (Fig. 2). Although we expect this trend to flatten off, Swiss real estate owners can expect to face higher financing costs over the coming years. The question for them is how much rising interest rates will weigh on the net income of their residential investment properties, and how quickly – and to what extent – these extra costs can be passed on to tenants.

... which cannot be passed on to tenants directly

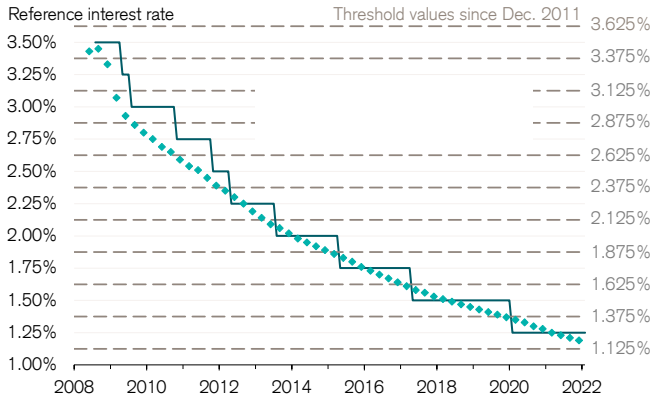
In situations involving a change of tenant, higher interest rate costs can essentially be passed on to the incoming tenant fully if the demand is there. By contrast, the rents of sitting tenants in Switzerland are tied to the reference mortgage rate. The latter is based on an average interest rate calculated by the Swiss National Bank (SNB) for all existing mortgages, published quarterly by the Federal Housing Office. Since launched in 2008, the reference rate has fallen steadily from an initial 3.5% to 1.25% most recently (Fig. 1). By the end of 2021, the underlying average interest rate had fallen further, suggesting yet another decline in the reference rate.

Reference interest rate reacts with time lag

The latest interest rate rises have changed the picture, however, and can be expected to usher in a trend reversal for the reference rate too. That said, this will only occur after a considerable time lag. The reason for this is the method for calculating the crucial average mortgage rate. As this involves taking into account all outstanding mortgages of all terms, this rate reacts extremely sluggishly, and may therefore deviate strongly from current market rates for new mortgages. Its sluggishness can be illustrated by comparing the very latest market interest rates with their average values for each term (Fig. 2). With the latter, there is either no (10-year fixed mortgage) or only a minimal (5-year fixed mortgage) increase evident, whereas current market rates have shot up by more than 100 basis points since the start of the year.

Fig. 1: Reference interest rate typically lags behind

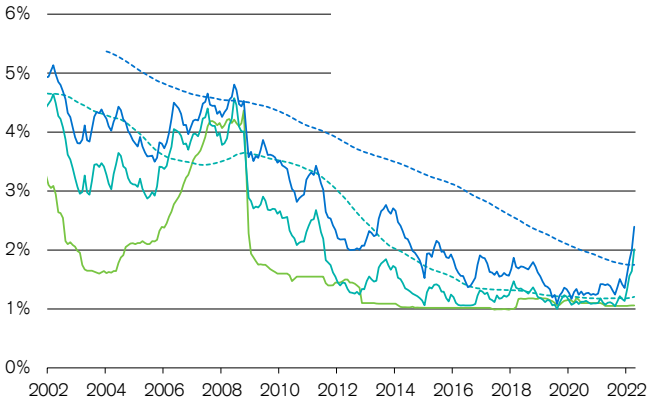
Average mortgage rate and reference interest rate



Source: Federal Housing Office, Credit Suisse — Last data point: 01.03.2022

Fig. 2: Moving averages of mortgage rates react very sluggishly

Development of mortgage rates by maturity (monthly average and 5- and 10-year average)



Source: Credit Suisse — Last data point: 04/2022

Three possible scenarios for interest rate developments

Precisely when the interest rate turnaround will feed through into the reference rate will depend heavily on the extent and tempo of monetary tightening over the coming years. We have therefore conceived three different key rate scenarios for the period up to the end of 2027 (Fig. 3), in order to then estimate the corresponding implications for the reference rate using an econometric model. In the "low" scenario we assume that the SNB will wait until mid-2023 to implement its first key rate hike. The key rate would then finally rise to 0% by mid-2024, but remain at this level until the end of 2027. For mortgage rates, this would mean money market mortgages remaining cheap, with even the prices of fixed mortgages barely rising from current levels. In the "medium" scenario, by contrast, the SNB would first raise its key rate at the end of 2022 and then gradually push it up to 1%, thereby making mortgages of all terms more expensive. Finally, the "high" scenario is a rather extreme scenario in which the SNB raises its key interest rate 15 times successively up to a level of 3%. This would imply significant increases in the costs of all mortgage products by around the end of 2025, with interest rates of all terms then settling at a level above 4%.

Increase in reference rate unlikely before 2024

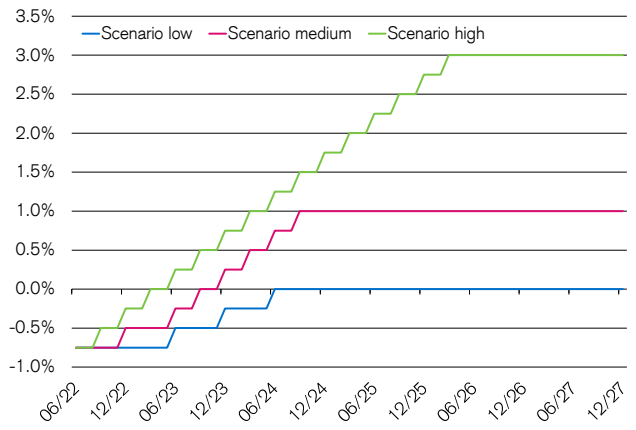
The results of our modeling (Fig. 4) show that an increase in the reference rate is unlikely before mid-2024. Even in the "high" scenario, a first increase would only be communicated in December 2023, and could therefore only be passed on to tenants the following year, as a rent increase can only be pushed through at the next contractual notice date. However, the reference rate would then climb to 3% by 2027, which would theoretically see net rents rise by up to 21% if all reduction requirements in the past were fulfilled. By contrast, with the "medium" scenario – which we see as most likely – an increase in the reference rate from 1.25% to 1.5% would not be communicated until June 2024. Two further rises would then be expected to follow by 2027. Finally, in the "low" scenario the reference rate would essentially languish at its current level for the entire forecasting period, falling just short of the threshold for an initial rise in 2027. Nonetheless, even in this scenario property owners wanting a fixed mortgage solution could face a significant increase in their interest rate burden.

Trend reversal already apparent in market rents

Overall, we believe landlords are facing higher interest costs that can only be passed on to tenants with a time lag. At least in the short term, this will put additional pressure on already declining returns on equity for residential investment properties. At the same time, this finding suggests that investments in residential real estate will offer only limited protection against inflation in the short to medium term. On the other hand, the improved situation in the rental apartment market from the landlord's perspective should act as a counterweight to the additional pressure on yields. After years of downturn, a recovery is now evident in the form of shorter marketing periods and fewer vacancies, with the result that a trend reversal is gradually becoming apparent in market rents too. Indeed, the rental price index of the Federal Statistical Office, which reflects the overall market (new agreements and existing tenants) recorded a year-on-year rise of 1.4% in the first quarter of 2022, its highest rise for eight years.

Fig. 3: Scenarios for the SNB key rate

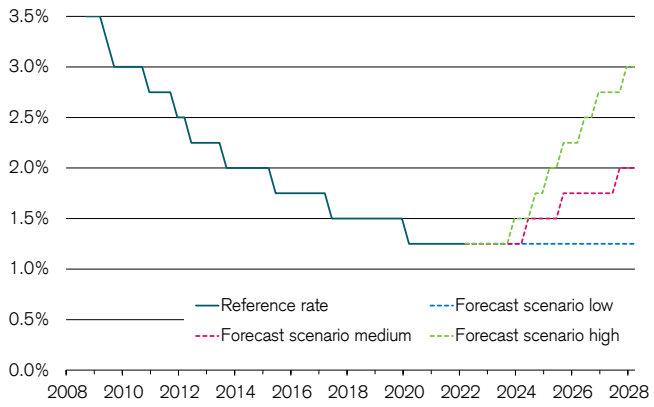
Three scenarios for the development of key interest rate up to late 2027



Source: Credit Suisse Last data point: 01.05.2022

Fig. 4: Reference rate unlikely to rise before mid-2024

Forecast development of reference interest rate – three scenarios



Source: Credit Suisse, Federal Housing Office Last data point: 01.03.2022

Huge rise in construction prices

Global supply shortages as a result of the COVID-19 pandemic and the war in Ukraine have triggered a major surge in the prices of construction projects. However, widespread delays to projects have yet to materialize.

Still no relief in sight

Hardly any sector of the economy has been spared: Over the last two years, global supply chain bottlenecks (Fig. 5) have resulted in delivery delays and huge price rises. The situation deteriorated last year against a backdrop of an almost synchronized global economic recovery as countries began to master the pandemic. The result was long queues outside of freight ports and a shortage of containers. But the hoped-for improvement in the situation looks unlikely to occur soon due to two factors: First, the latest pandemic wave has only reached its interim high in China in recent weeks. China's zero-COVID strategy is weighing heavily on ports and production sites; whole cities have been closed down. Second, the war in Ukraine has triggered more price rises in key commodities such as industrial metals, fossil fuels, and agricultural products.

Astonishing surge in construction material prices

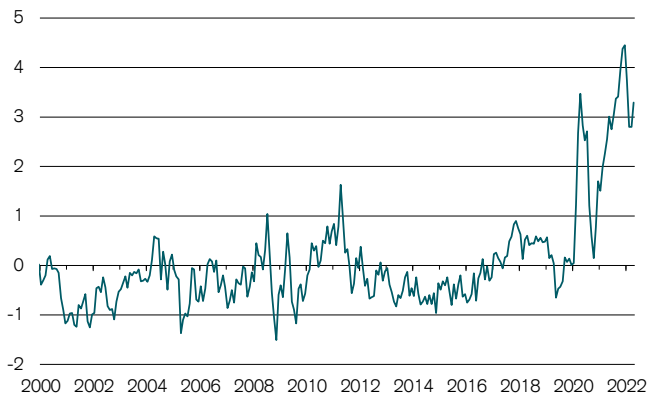
Even last year, a shortage of key building materials on Swiss building sites was fueling a sharp rise in prices. In October 2021, the building construction price index published by the Federal Statistical Office revealed a year-on-year rise of 4.6% – the strongest price rise since record-keeping began in 1998. And the cost of construction is only likely to have increased further since then: In recent weeks, the prices of metal products such as reinforcing steel (+136% compared to 2019 levels) and aluminum (+74%) have shot into the stratosphere (Fig. 6). The cost of fuel and bitumen has also risen sharply. For metals such as steel and aluminum, prices can be expected to remain inflated for some time. On the one hand, China, Russia and Ukraine (steel) rank among the largest producers and exporters worldwide. On the other, metal production is energy-intensive, and China – which accounts for more than half of all global steel production – has started to rein in production in order to achieve its emissions targets.

Planning uncertainty, further pressure on yields

While delays to entire projects have so far been the exception, developers are having to brace themselves for further increases (and considerable fluctuations) in prices and delivery times. As well as complicating the planning process, higher construction prices weigh on real estate investment yields, which are already under considerable pressure. Moreover, higher construction prices could prompt real estate owners to defer any non-urgent investment in existing housing stock. However, in the case of energy-related renovations in particular, it is questionable whether this would be an expedient strategy. After all, tenants are likely to be even more vociferous in their opposition to fossil fuels in the future, as quite aside from their environmental impact they also have a heavy financial impact in the form of rising ancillary costs (cf. page 9 et seq.)

Fig. 5: Sand in the works of supply chains

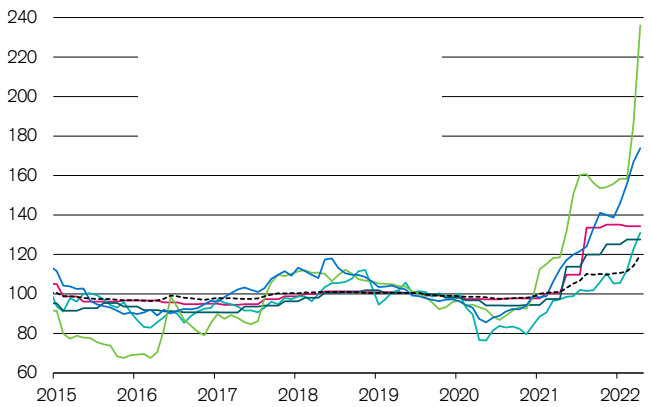
Global Supply Chain Pressure Index (standard deviations from long-term average)



Source: Refinitiv Datastream, Credit Suisse Last data point: 04/2022

Fig. 6: Metal products record strongest price rises

Construction material price indices, annual average, 2019 = 100



Source: Swiss Federal Statistical Office, Credit Suisse Last data point: 04/2022

High energy costs send ancillary costs through the roof

Rising energy prices are causing ancillary living costs to spiral. For occupants of buildings heated with fossil fuels, this could mean a year-on-year rise in ancillary costs of around 38% in 2022. Against this backdrop, the changeover to renewable energy sources can be amortized all the more swiftly.

Pandemic and war send energy prices through the roof

Due to the global economic recovery from the coronavirus pandemic, energy was already becoming significantly more expensive at the end of last year. But with the outbreak of the war in Ukraine and the threatened scarcity of energy commodities, these prices have now skyrocketed. At the end of April 2022, the wholesale prices for heating oil were up 76% on the previous year, while electricity was up 217%, and natural gas by an eye-watering 354%. Whereas rising heating oil prices are felt by consumers directly, the sluggishness of the price of gas and the regulation of household electricity prices mean that Swiss households have yet to bear the full brunt of recent price rises. As network operators have to submit their prices for the following year to the Federal Electricity Commission (ElCom) by the end of August, the price being paid by consumers for electricity in 2022 is only 2.8% higher than last year (Fig. 7).

Cost increase depends on form of energy

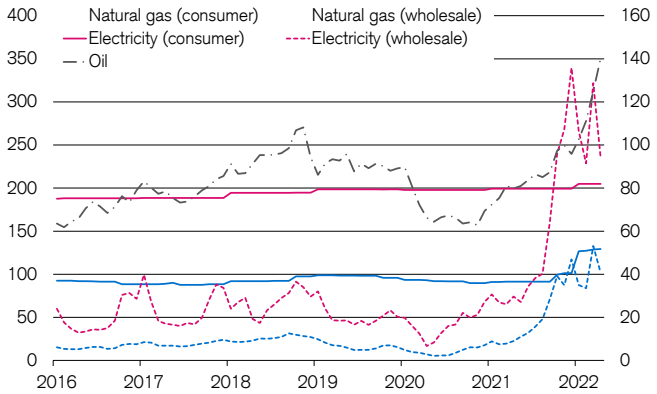
The extent to which homeowners and tenants are affected by rising commodity prices depends not just on the energy efficiency of the building in question and the area to be heated, but above all on the type of energy used. In order to analyze the repercussions of higher energy prices for the ancillary costs of Swiss consumers, we took the average living area of 99 m² to calculate heating energy consumption and the average household size of 2.2 persons to calculate energy consumption for the provision of hot water. Here we have looked at the three most common heating systems: oil heating, gas heating, and electric heat pumps (air-water heat pumps).

60% of Swiss living space still heated by fossil fuels

The amount of Swiss living space heated by oil fell dramatically between 2000 and 2020 (–30%). By contrast, the volume of space heated by gas almost doubled over the same period (+93%), whereas the space heated by electric heat pumps increased more than sevenfold (+646%). However, the latter continues to account for only a modest 20% of total energy usage area (EUA), meaning that 60% of Swiss residential space continues to be heated with fossil fuels (Fig. 8).

Fig. 7: Wholesale prices point to cost explosion

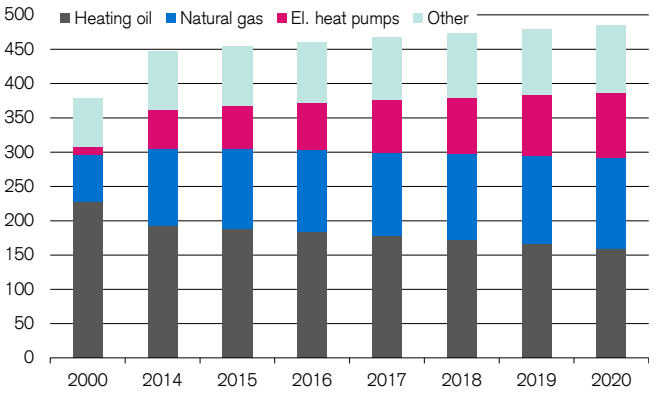
Wholesale and consumer prices of electricity and gas in CHF/MWh (lhs) and for oil in CHF/100 liter (rhs)



Source: Federal Statistical Office, Refinitiv Datastream, Credit Suisse
Last data point: 04/2022

Fig. 8: Fossil-based energy fuels remain dominant

Energy usage area of private households (including vacant apartments, excluding second/holiday homes) by type of facility (in mn m²)



Source: Prognos, Federal Office of Energy, Credit Suisse
Last data point: 2020

Fossil fuels less energy-efficient

Between 2000 and 2020, average annual heating demand per m² fell from around 110 kWh/m² EUA to 87 kWh/m² EUA. However, significant differences emerge from a comparison of the various heating systems. For example, oil-based and gas-based systems typically exhibit a much higher end energy requirement per m² than electrical heat pumps. In the years 2015 to 2019[1], the average annual end energy consumption for indoor heating with oil systems was around 102 kWh/m², compared to 90 kWh/m² for gas systems, while electric heat pumps had an energy requirement of just 19 kWh/m². Alongside the fact that oil and gas heating systems are far more common in old buildings with very poor energy efficiency, this difference is attributable in particular to the higher energy efficiency of electric heat pumps due to their use of ambient heat.

Heating costs will rise by 38% in 2022 for fossil fuels, compared to just 3% for heat pumps

The higher energy efficiency of electric heat pumps stands in contrast to the much higher price of this energy source per kWh. Nonetheless, average heating energy costs (indoor heating and hot water) for an apartment of 99 m² using a heat pump stood at around CHF 718 in 2021, or around 48% below the heating costs of an equally large apartment heated with traditional fossil fuels (CHF 1,381 for oil, CHF 1,382 for gas). As a result of the sharp rise in energy prices, this difference has increased to 61% in 2022. Accordingly, residents living in an oil-heated apartment are now paying CHF 1,934 of heating costs, or CHF 1,889 in the case of gas heating, and therefore an average of CHF 530 (+38%) more than in 2021. By contrast, the annual energy costs of a heat pump are currently – in part due to the regulation of consumer electricity prices — up just CHF 20 (+3%) year-on-year (Fig. 9).

Installing a heat pump not cheap

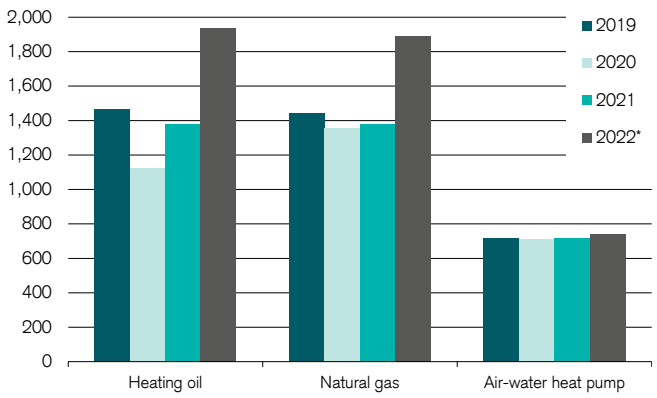
The dramatically lower operating costs of heating a home with a heat pump have to be set against relatively high investment costs, which are considered one of the main obstacles to the transformation of energy systems in existing Swiss building stock. In view of the sharp rises in the prices of fossil fuels, however, the question of the amortization period of renewable energy sources compared to fossil fuels needs to be re-evaluated. For this analysis we looked at renovating the heating system in an average apartment of 99 m², i.e. the net investment cost of the different heating systems along with the corresponding energy and operating costs over the average depreciation period of 20 years. After deducting the average subsidy (CHF 4,325), the investment costs of an air-water heat pump amount to some CHF 30,675, far higher than the CHF 20,000 or so involved in installing a new oil or gas heating system.

Amortization period compared to fossil fuels shrinks significantly

Moreover, users of fossil fuels for heating purposes also incur higher annual costs in connection with maintenance (approximately CHF 550 compared to CHF 150 for an air-water heat pump). Based on average energy prices between 2019 and 2021, this means that the installation of an air-water heat pump compared to an oil or gas heating facility would pay off financially after 12 to 14 years. However, when this calculation is made after the latest energy price increases, the break-even point is brought forward significantly. A heating pump is now cheaper than an oil or gas heating solution after just eight to nine years (Fig. 10), although this analysis does not take into account potential price volatility on the part of fossil fuels or the possibility of generating power independently through photovoltaic sources.

Fig. 9: Oil heating systems hit by largest increase in ancillary costs

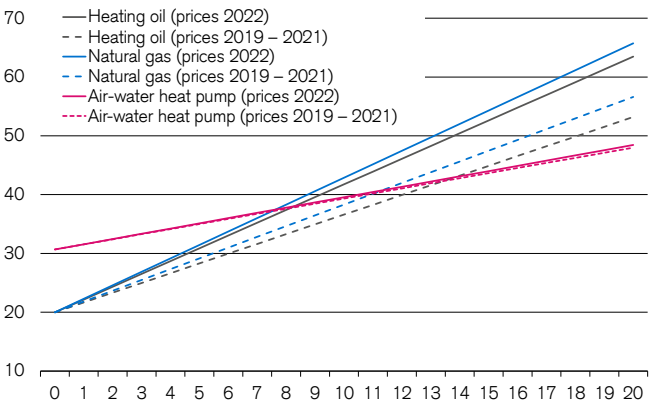
Heating costs of an average Swiss household (99 m² and 2.2 persons) between 2019 and 2022 (*2022: forecast), depending on energy source



Source: Federal Statistical Office, Prognos, EnergieSchweiz, energie.ch, Credit Suisse
Last data point: 2022

Fig. 10: Heat pump costs amortized more quickly by comparison

Estimated total costs of heating system by energy source in CHF 1,000 over a period of 20 years, depending on energy prices



Source: Federal Statistical Office, Prognos, EnergieSchweiz, Credit Suisse
Last data point: 2022

[1] Due to the special effects of coronavirus in 2020, our analysis uses only the average values from 2015 to 2019.

Once again, buying more expensive than renting

For the first time in a long period, purchasers of an owner-occupied home have to pay more than for a comparable rental apartment. This trend reversal is attributable to the recent sharp rises in interest rates on fixed-rate mortgages and is likely to continue.

Homeowners are once again paying a premium

For the first time in 13 years, the overall cost of taking out or extending a mortgage on an owner-occupied residential home now exceeds the cost of renting a comparable apartment. In the first quarter of 2022, owners had to pay a premium of 3.1% to buy their own home. Even as recently as 2021, homebuyers were benefiting from ownership being on average 15.5% cheaper than renting. The sharp increase in interest rates on fixed-rate mortgages is responsible for this rapid trend reversal. The interest on a 5-year fixed-rate mortgage had climbed from 1.1% in early 2021 to almost 2% by the end of the first quarter of 2022 (Fig. 12). In tandem with pronounced price rises, this has resulted in the discount for ownership morphing into an ownership premium within just a few quarters. Conversely, buyers who opt for a SARON (Swiss Average Rate Overnight) mortgage can continue to benefit from ownership working out cheaper than renting.

Surge in interest rates driving the ownership premium

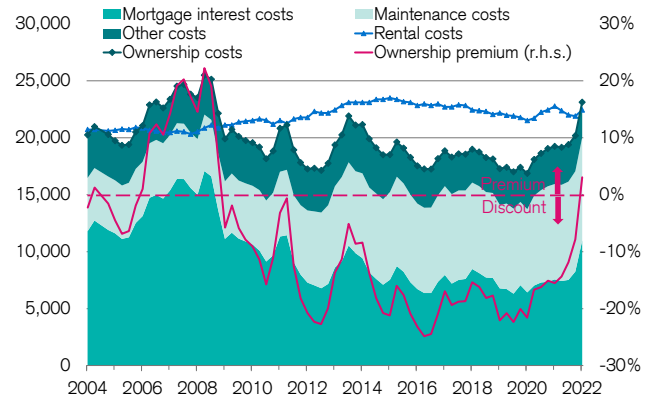
We based the comparison on the advertised purchase prices or rents for an existing apartment with 4.5 rooms. Our calculations were based on borrowings of 80% and a 5-year fixed- rate mortgage. According to our estimates, the full annual cost of an owner-occupied home came in at CHF 23,128. The annual rent for an apartment of the same size would be CHF 22,440 over the same period. Mortgage interest was one of the biggest costs in the first quarter of 2022, coming in at CHF 10,966. While this equates to an increase of 45% since the start of 2021, the interest costs alone remain substantially lower than comparable rents.

Additional expenses on top of interest costs

However, homeowners incur additional expenses. Maintenance costs amount to 1% of the value of the property, which adds a further CHF 9,078. Moreover, there are also tax aspects such as imputed rental value and mortgage interest tax relief, opportunity costs in the form of investment alternatives for the owner's deposit, and risks such as financial cluster risk and the short-term illiquidity of the property. That said, homeowners can also profit from the property's long-term increase in value. Once all these factors have been factored in, the total cost of ownership in the above calculation amounts to CHF 23,128 (Fig. 11).

Fig. 11: Buying a home currently more expensive than renting

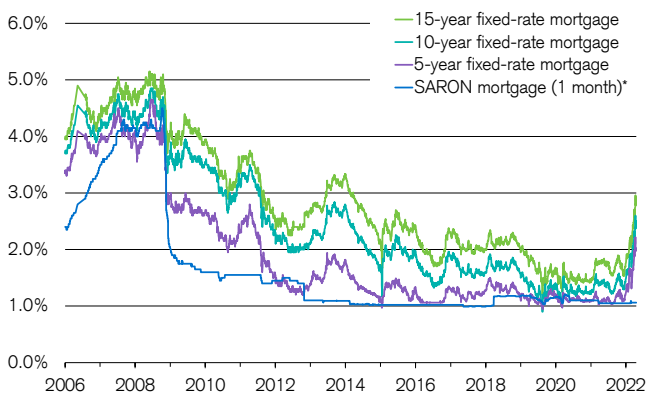
Financial burden: comparison between an owner-occupied home and a rental apartment, taking all the relevant cost factors into account



Source: Credit Suisse, Meta-Sys; Last data point: Q1/2022

Fig. 12: Sharp rise in interest rates on fixed-rate mortgages

Trend in mortgage interest rates in %;



* interest rate on a SARON mortgage from 21.9.2020; previously: flex rollover mortgage (3-month LIBOR)

Source: Credit Suisse Last data point: 20.04.2022

Generally on ownership premium prior to 2009

Owing to low mortgage interest rates following the outbreak of the financial crisis at the end of 2008, it became a commonplace that the financial cost of buying a residential property was lower than that of a comparable rental apartment. Historically, however, a premium was generally payable for home ownership. This premium averaged 29% between 1993 and 2008, with data unavailable for earlier periods. The ownership premium is justified by the greater scope for personal design preferences available to homeowners. This generally results in a slightly higher standard of development in owner-occupied properties. For many owners, it is worth paying a premium for the liberty of living within their own four walls.

Further rise in ownership premium is likely

Interest rates for fixed-rate mortgages have also been trending upwards during the course of the second quarter (Fig. 12). While we only expect a limited increase in the next 12 months after the recent sharp uptrend, the average mortgage rate in Q2 will nonetheless exceed that of the preceding quarter. It is therefore unlikely that owning a home will become cheaper than renting in the near future, even though mortgage rates generally remain at a modest level. Figure 13 shows how the premium for owning a home could change depending on the trend in interest rates. Our calculations are based on un-changed house prices and residential rents.

Interest in home ownership is declining, but there is still a demand overhang

Thus, it has become more expensive for new homebuyers to buy than to rent a property. However, in terms of the imputed affordability, which is generally calculated at 4.5% or 5%, nothing has changed for prospective homebuyers. While the ownership premium therefore does not have a detrimental effect on the number of potential homeowners, some are likely to be put off by the higher financial costs in actual terms. This will probably dampen demand for owner-occupied residential property. At the same time, given the decline in new building activity and the very limited number of properties available on the market, we still expect to see excess demand and a continued uptrend in property prices.

Home ownership still tends to be cheaper for existing owners

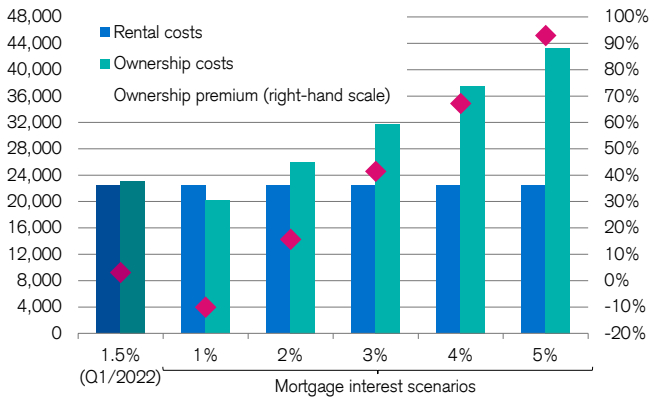
For many existing owners, little will change in the short term. The majority of homeowners have fixed-rate mortgages. According to the latest figures from 2020, fixed-rate mortgages account for 82% of the total mortgage volume in Switzerland (Fig. 14). Thus, many households are likely to have fixed their mortgage rates over several years and will continue to benefit from the low financial costs of owning their homes for some time yet.

Well-positioned thanks to affordability calculations and rapid amortisation

However, existing homeowners have to bear in mind that they will also face higher mortgage costs once their fixed-rate mortgages come to an end. Accordingly, it is advisable to set aside reserves now in order to cover higher mortgage rates in the future. Existing homeowners are generally in a good position and have the financial means to tolerate an interest rate of 4.5% or 5% according to banks' affordability calculations. In addition, in accordance with the tighter amortisation rule that has been effective for several years, the loan-to-value ratio has to be reduced from 80% to 66.7% within 15 years. For this reason, rising mortgage rates should generally not pose any problems for the vast majority of owners.

Fig. 13: Mortgage rates are the decisive factor

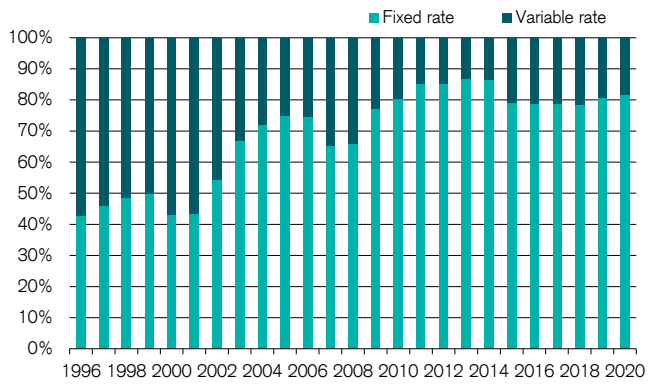
Estimated cost of ownership according to interest rates (5-year fixed-rate mortgage) compared to rents, as at Q1 2022



Source: Credit Suisse, Meta-Sys Last data point: Q1 2022

Fig. 14: More than 80% of owners have fixed mortgages

Mortgages in Switzerland by type of rate, shares in %



Source: Swiss National Bank, Credit Suisse Last data point: 2020

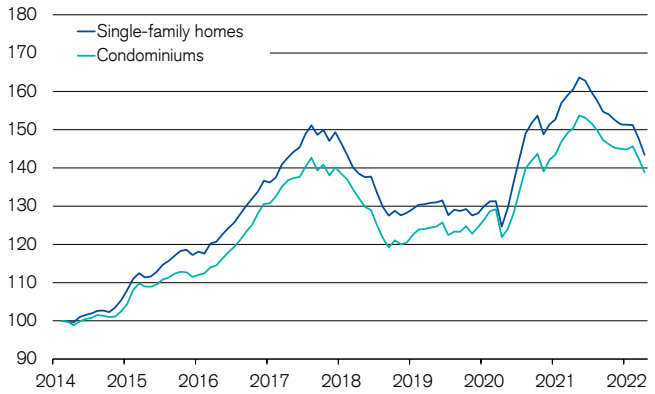
Owner-occupied housing

Rising interest rates erode interest in home ownership

The demand indices for residential property have declined noticeably since the start of the year, namely by –4.1% for condominiums and –5.2% for single-family homes. This has been driven by the sharp rise in fixed mortgage interest rates. For example, the interest rate for a five-year fixed mortgage has risen by more than 80 basis points (0.8%) over the same timeframe, with the increase for a 10-year fixed mortgage amounting to more than 105 basis points. Over the coming 12 months too, a further slight rise in interest rates should be expected. On the other hand, mortgage rates remain at a manageable level, and demand indices are still well above their pre-pandemic levels even after their recent decline.

Fig. 15: Residential property demand indices by segment

index: February 2014 = 100



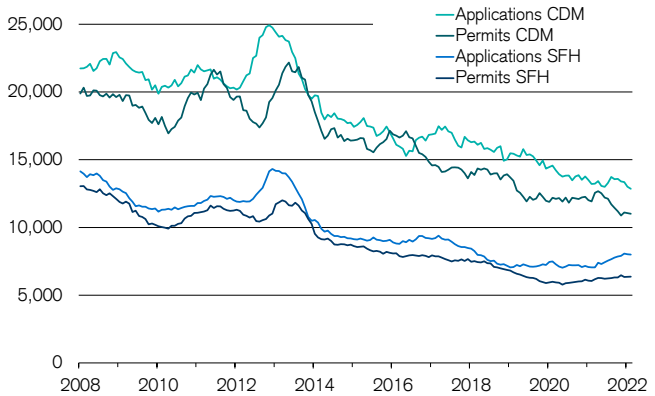
Source: Realmatch360 Last data point: 04/2022

Newbuild activity too low

Construction activity in the owner-occupied housing segment continues to decline. Over the last 12 months, a mere 11,005 condominiums were approved for construction. This represents a further decline in building permit issuance of 7.7% over the last year. Nor is any trend reversal in the offing, as planning applications are likewise negative to the tune of 2.7% over the same period. The picture for single-family homes is different: With building permits issued for 6,370 single-family homes, approval volumes are up 5.3% in this segment. Over the same period, planning applications are up as much as 13.5%. However, this increase cannot compensate for the decline in condominium construction activity.

Fig. 16: Newbuild planning applications and building permits

Number of residential units, single-family homes (SFH) and condominiums (CDM)



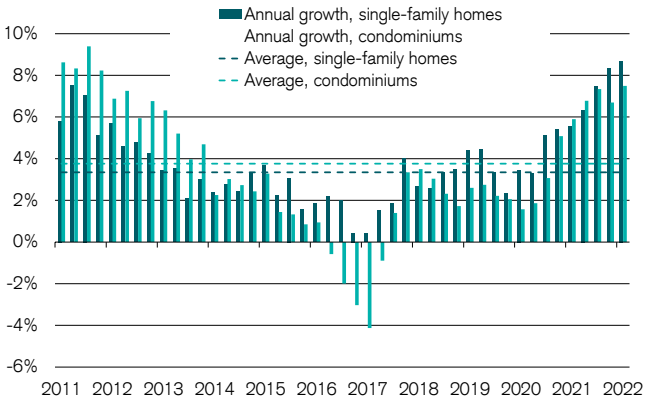
Source: Baublatt, Credit Suisse Last data point: 02/2022

Growth in residential property prices accelerates further

Despite the waning interest in home ownership, demand continues to far outstrip available supply. Nothing is likely to change in this respect over the next few quarters. The persistent demand overhang is reflected in very high and indeed accelerating price growth. Within the last year, prices have risen by 7.5% for condominiums and by 8.7% for single-family homes. Residential property prices are likely to continue to rise over the next few quarters, but we expect price momentum to slacken noticeably against a backdrop of higher interest rates for fixed mortgages.

Fig. 17: Price growth for residential property of medium segment

Annual growth rates; dotted lines: average 2000–2021



Source: Wüest Partner Last data point: Q1/2022

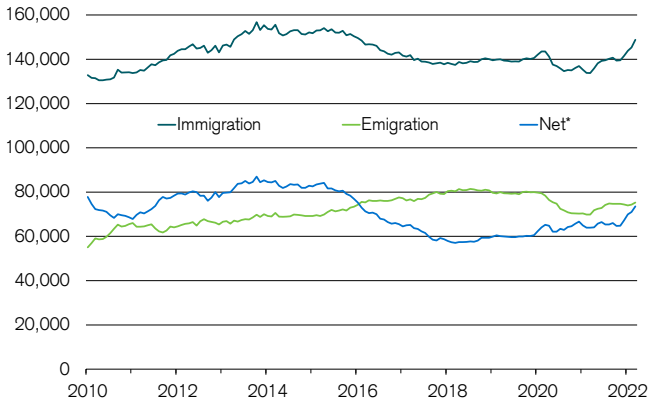
Rental apartments

Rental apartment demand boosted by strong immigration

The rental apartment market has been characterized by brisk demand thanks to a strong recent economic recovery and the higher importance attached to the home generally in the wake of the coronavirus pandemic. Immigration numbers are also up as a reaction to the large number of vacant positions. Switzerland recorded net migration of 73,500 persons over the last 12 months – a level not seen for more than six years. Immigrant numbers have risen sharply, while the number of emigrants is still lower than in the years prior to COVID-19. Moreover, these statistics do not include the influx to date of 50,000 refugees from Ukraine, who are adding to the vibrant demand for housing.

Fig. 18: Net migration of foreign residential population

Moves to/from Switzerland and net migration, moving 12-month averages:



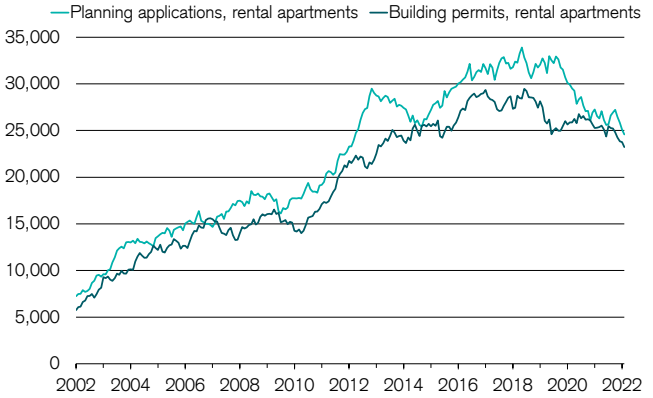
* Net migration, excluding registry corrections
Source: State Secretariat for Migration, Credit Suisse — Last data point: 03/2022

Planning of new rental apartments at 10-year low

Over the last 12 months, more than 2,000 fewer rental apartments received planning permission compared to the previous year. In other words, the ongoing decline in rental apartment construction dating back four years is set to continue. Nor is construction activity likely to bounce back any time soon, as the number of submitted planning applications has fallen to a ten-year low. There are various reasons for the greater restraint being shown by developers: First, there are still a number of regional supply overhangs. Second, finding suitable land on which to build is becoming increasingly difficult. Third, the intensification of self-regulation in 2020 also made it more difficult to raise finance. This problem is unlikely to have improved given recent interest rate rises.

Fig. 19: Rental apartment planning applications and building permits

Number of housing units, moving 12-month totals



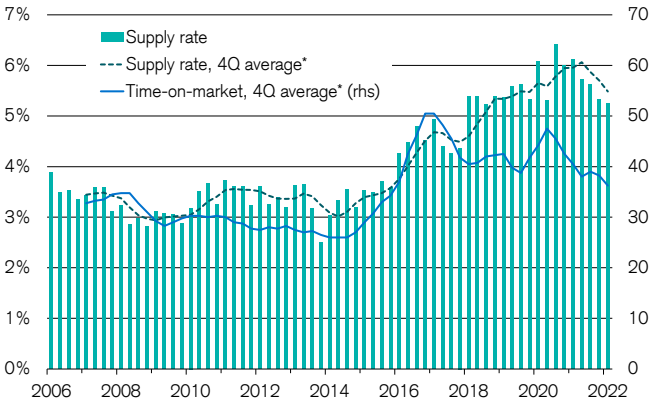
Source: Baublatt, Credit Suisse — Last data point: 02/2022

All signs point to recovery

The rental apartment market is currently characterized by a rise in demand and a simultaneous decline in supply. This pronounced "pork cycle" heralds the end to the downturn in the user market dating back many years, with its rising vacancies and declining advertised rents. All the signs now point to recovery: The vacancy rate started to fall in 2021, the supply rate is now following suit, and the average time-on-market has shrunk to its lowest level since 2015. In rural and tourist municipalities in particular, the market has gained considerable momentum. Accordingly, a trend reversal in rents has become established. The market recovery can be expected to continue, with only an economic collapse posing a credible threat.

Fig. 20: Supply rate and time-on-market of rental apartments

Supply rate as % of existing housing stock, time-on-market in number of days



* Moving average over four quarters
Source: Meta-Sys, Credit Suisse — Last data point: Q1/2022

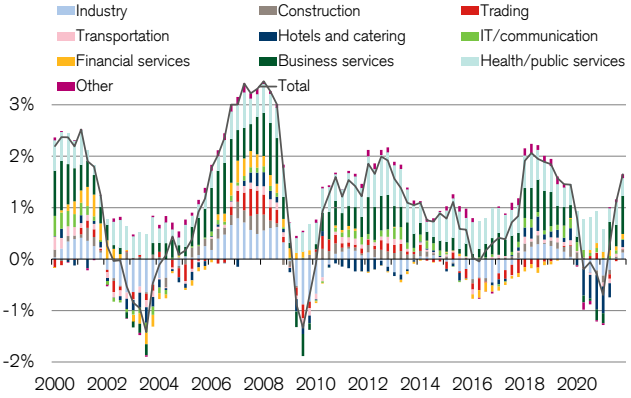
Commercial real estate

Demand strengthening on back of positive employment growth

Following a temporary decline in overall employment, annual employment growth was comfortably positive again in the fourth quarter of 2021 at 1.65%. The strongest growth was recorded by corporate services and the healthcare/public services area. For the sectors heavily reliant on office activities, employment growth was as much as 2.4%. The demand for office space has therefore picked up, particularly as a number of companies that have refrained from renting new premises since the start of the coronavirus pandemic were clearly unable to wait any longer. By contrast, how much space has been relinquished in rental agreements due to home working is not yet precisely quantifiable. But this will clearly be a factor.

Fig. 21: Overall employment growth by sector

Annual change in the number of employees (full-time equivalents), in %



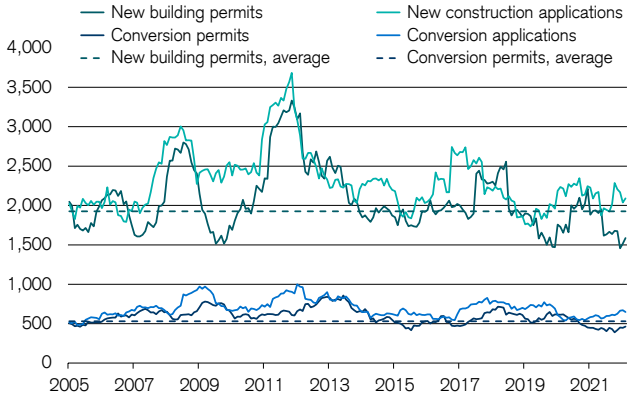
Source: Federal Statistical Office, Credit Suisse — Last data point: Q4/2021

Reticence in newbuild activity in office property segment

At CHF 1,586 million, the latest 12-month total of building permits issued for office projects was as much as 18% or so below its long-term average. Investors are therefore clearly being rather more circumspect with their office property investments, holding back from new projects for as long as uncertainty persists with regard to the need for future space. Only conversion applications have picked up strongly over the last six months, having been above the long-term average since September 2021. This restraint on the part of investors is likely to be one reason why no excessive imbalances are likely to build up in the Swiss office property market. When viewed in regional/local terms, however, a number of major supply overhangs and shortages are apparent.

Fig. 22: Planned expansion of office space

Building permits and planning applications, moving 12-month total, in CHF mn



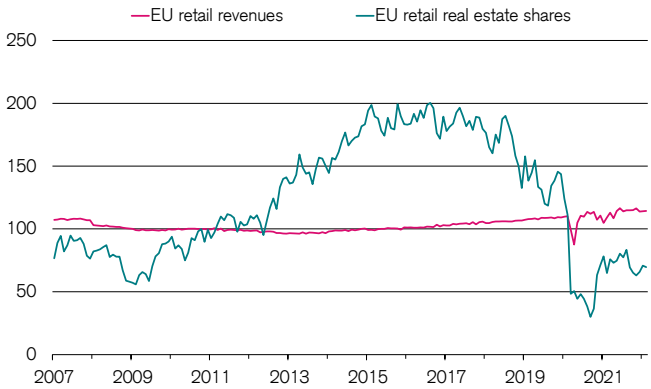
Source: Baublatt, Credit Suisse — Last data point: 02/2022

Retail property shares suffer badly from lockdowns

With shares of real estate companies focusing on shopping centers and other retail space in the European Union (EU) already having fallen sharply since 2016, the start of COVID-19 lockdowns in March 2020 led to a further slump in prices of 57% within the space of just a month. These shares have clawed back only a limited amount of the lost ground. Although EU retail revenues exhibited solid growth even during the pandemic, the situation faced by bricks-and-mortar retailers has been challenging. In particular, both revenues and margins have been eroded in the face of even stronger online competition against a backdrop of the pandemic. This phenomenon is inevitably feeding through into low demand for retail space, and retail landlords are feeling the pinch accordingly.

Fig. 23: Retail real estate shares and retail sales

Total return retail REITs and EU retail sales (indices: 10/2010=100)



Historical performance data and financial market scenarios are not a reliable indicator of future results.
Source: Datastream, Credit Suisse — Last data point: 28.02.2022

Interest rates a game-changer

After years of ultra-low interest rates and strongly rising real estate values, the interest rate turnaround has picked up in Switzerland too. This should gradually stifle value increases and switch the focus back to revenues.

Capital growth has kept real estate returns high up until now

Swiss real estate investors can look back on several very successful years, with investments also generally holding up well during the coronavirus crisis. Only in the case of hotels, office property, and retail property were certain reverses suffered in the first year of the pandemic. By contrast, the total returns on residential investment properties actually rose in the last two years, achieving a high 7.6% on average in 2021 (Fig. 24). However, returns have recently been increasingly reliant on growth in property values. From 2002 to 2014 – when the Swiss National Bank first introduced negative interest rates – the net cash flow yield (NCF yield) accounted for an average 78% of the total return on residential investment properties. The NCF yield has amounted to just 45% in the period since, and in 2021 reached a nadir of 3.0%.

Inflation – the death knell for TINA?

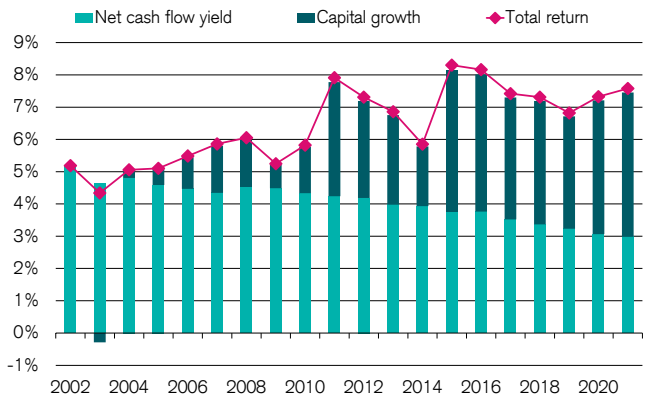
The high value increases of recent years reflect the attractive yield premiums at which real estate investments have traded. For real estate funds, these premiums compared to 10-year government bonds were in the range of 250 to 350 basis points (bps) for years (Fig. 25), and were around 100 bps higher still for direct investments. During this period, the mantra was TINA ("There Is No Alternative"). However, the yield curve has steepened sharply in recent months due to the inflationary trend and prospects of an imminent turnaround in monetary policy. Whereas the yield on 10-year CHF government bonds was in negative territory as recently as late 2021, it breached the 1% mark in May 2022. The real estate yield premium declined accordingly, and now sits at around 150 bps (real estate funds) and 250 bps (direct investments). As the interest rate turnaround gathers pace, properties with net yields of 2.5% or less are likely to lose their appeal, as government bonds or investment-grade corporate bonds will increasingly offer an alternative.

Revenue increases once again in focus

Whereas the surge in long-term interest rates immediately led to corrections in the values of real estate funds (cf. below), we are not expecting a slump in direct real estate yields. While it is true that the discount rates relevant to the valuation of investment properties are likely to pass their nadir next year at the latest due to rising interest rates, they tend to behave extremely sluggishly (Fig. 26). Furthermore, the market values of residential investment properties are likely to be propped up by the recovery of the user market (cf. page 14). In the past, real estate investments have sometimes exhibited value increases in phases of moderately rising interest rates too (Fig. 24). Nonetheless, total returns are likely to be significantly lower over the coming years, which should once again switch the focus more toward revenue streams.

Fig. 24: Strong capital growth for apartment blocks in recent years

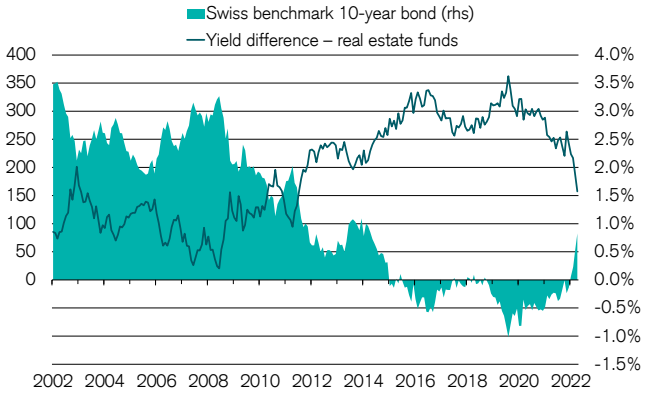
Return components of Swiss residential investment properties



Historical performance data and financial market scenarios are no reliable indicator of future results.
Source: MSCI, Credit Suisse Last data point: 2021

Fig. 25: Yield premium of real estate investments slumps

Real estate fund distribution yields compared to 10-year CHF government bonds, in bps



Historical performance data and financial market scenarios are no reliable indicator of future results.
Source: IAZI, Refinitiv Datastream, Credit Suisse Last data point: 04/2022

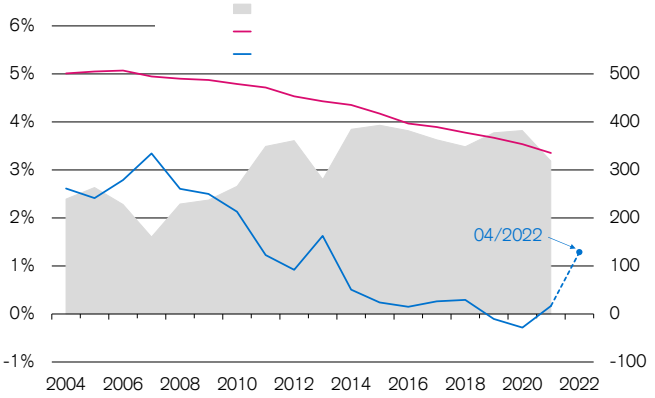
Real estate investments

Valuation "reserves" shrink

Against a backdrop of ultra-low interest rates, the discount rates that determine the valuation of real estate have declined continuously in recent years. For the properties of listed real estate funds, these stood at an average 3.4% in 2021. However, discount rates have not declined to the same extent as the risk-free interest rate, and therefore still contain a certain "hidden reserve". Nonetheless, the discount rate could rise for the first time in 2023, and the lower the starting point, the greater the effect of a rise. All other things being equal, an increase of a full percentage point over several years starting from a level of 3% would result in a 22% lower valuation for a typical residential investment property.

Fig. 26: Discount rate

Average discount rate of Swiss real estate funds and interest rates developments



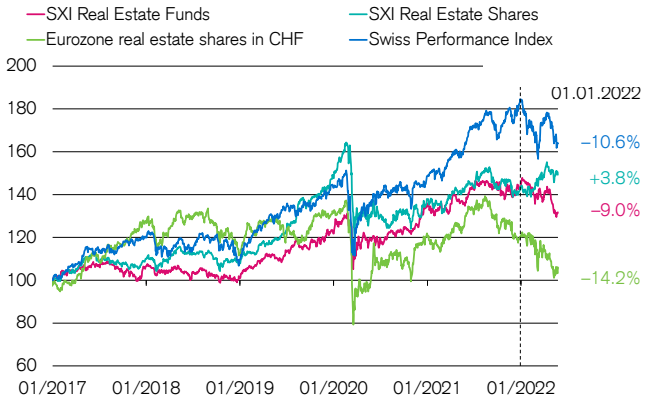
Historical performance data and financial market scenarios are no reliable indicator of future results. Last data point: 04/2022
Source: Annual reports of real estate funds, Refinitiv Datastream, Credit Suisse

Listed Swiss real estate investments exhibit defensive qualities

Rising long-term interest rates and poor market sentiment have weighed on the performance of real estate funds over the year to date (–9.0%). However, they have outperformed both the broad Swiss equity market and European real estate stocks (–10.6% and –14.2% respectively). Sales triggered by investment ceilings having been reached due to heavy losses on equities and bonds are likely to have acted as a drag on real estate funds. By contrast, despite corrections in May, Swiss real estate shares have performed positively (+3.8%). A double safe-haven effect is likely to have manifested itself here: International investors are looking to both the Swiss franc and real estate for investment security.

Fig. 27: Performance of indirect real estate investments

Total return, index: January 2017 = 100



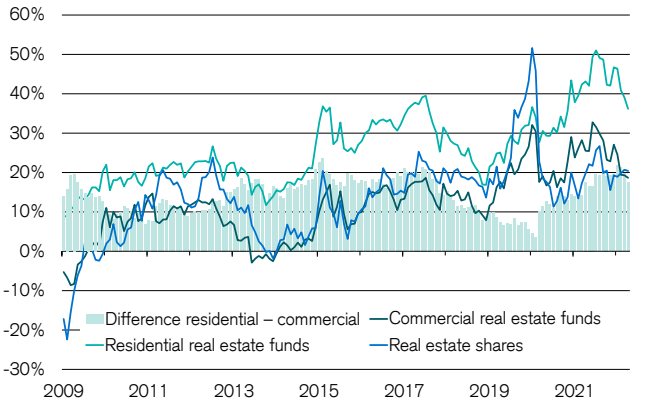
Historical performance data and financial market scenarios are no reliable indicator of future results.
Source: Refinitiv Datastream, Credit Suisse Last data point: 24.05.2022

Higher interest rates weigh on real estate fund premiums

Rising interest rates are also weighing on the premiums to net asset value that real estate investors are prepared to pay on the stock market. In the case of real estate funds, these premiums briefly exceeded the 50% mark in 2021 and still amounted to 36% at the end of April, before then declining further in May. The premiums of commercial real estate funds (18.6%) and in particular real estate shares focusing on commercial property (20.4%) have likewise proved relatively robust. The latter offer better protection against inflation and hence greater stability as their rental agreements are often index-linked.

Fig. 28: Premiums of real estate funds and real estate shares

As % of net asset value, excluding mixed real estate funds



Historical performance data and financial market scenarios are no reliable indicator of future results.
Source: Refinitiv Datastream, Credit Suisse Last data point: 04/2022

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