Real I.S. Research News 11 | 2023

Market monitoring: first signs of a trend reversal in 2024

December 2023

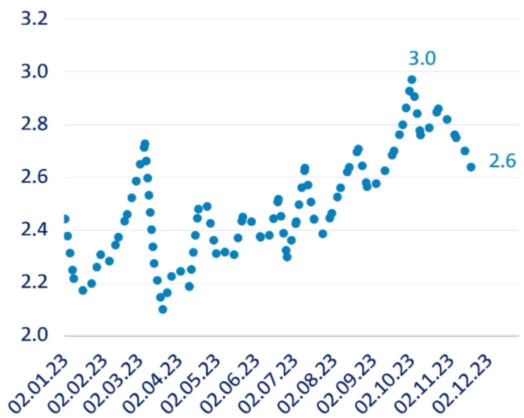
The real estate market is under pressure

The real estate market remains in a difficult phase. The *Handelsblatt* newspaper recently ran the headline *Zinsschock* (interest rate shock), while many market players are talking about a paradigm shift, given the significant rise in interest rates. Although there is no doubt that 2024 will still be a difficult year for the property investment market, positive changes in the market should not be ignored. Indeed, there have been some interesting developments in this respect recently.

Are we about to see a turning point in the economy and interest rates?

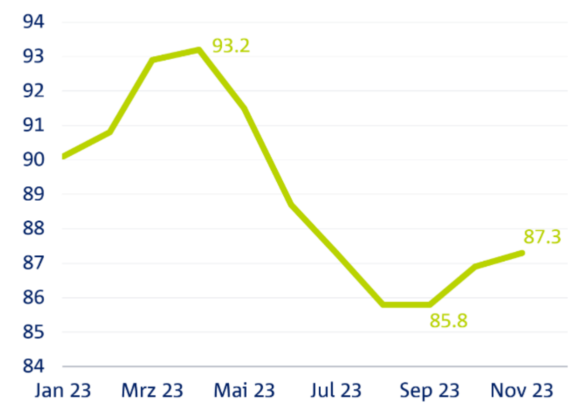
One of the most important determinants of the real estate market is the trend in interest rates. The economy is also of great importance, as it is an indicator of demand for space in the rental market. Moreover, the volume of space on offer and the sentiment of market players must also be taken into account. The latest data for these four selected market drivers is presented as follows (see figures 1/2 and 3/4):

Figure 1: Government bond yields (10y-benchmark-bond for Germany), in %



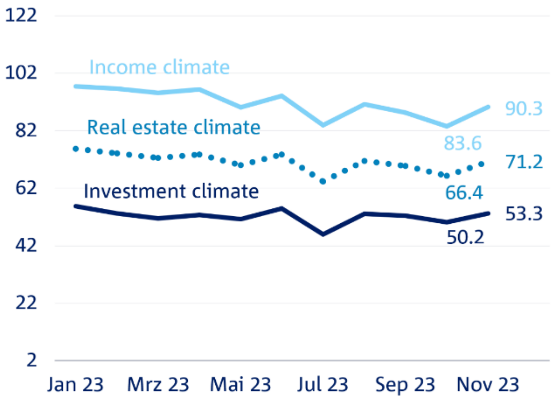
Source: World Government Bonds; Graph: Real I.S.

Figure 2: ifo business climate index, Germany



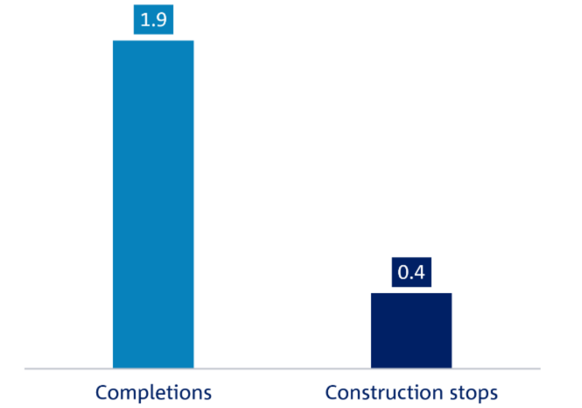
Source: ifo Institut; Graph: Real I.S.

Figure 3: Deutsche Hypo Real Estate Climate
(index; 100 = neutral climate)



Source: Deutsche Hypo; Graph: Real I.S.

Figure 4: Completions and construction stops for German A-cities (office sector, in mio. sqm)



Source: PMA; Graph: Real I.S.

1) Capital market interest rates appear to have passed their peak.

   As a result of falling inflation rates and falling expectations of inflation, the European Central Bank (ECB) has not raised the prospect of any further key interest rate hikes at present. Capital market interest rates (10-year German government bond benchmark yields) have gone down by around 40 basis points from a high of almost 3% at the beginning of October, to their current level of 2.6%.

2) The ifo Business Climate Index indicates bottoming out.

   The leading economic indicator, ifo Business Climate, rose for the second month in a row in November. This could herald an economic recovery in 2024.

3) The Deutsche Hypo Real Estate Climate Index saw an increase in November.

   Although sentiment in the German property market remains gloomy in terms of levels, a ray of hope has recently been seen. The Real estate climate, consisting of the investment climate and income climate components, rose from an index level of 66.4 in October to 71.2 in November. In particular, the income climate (a sentiment indicator for the expected performance in the rental market) recorded a strong outcome in the November survey with an index value of 90.3, up on the previous month's level of 83.6.

4) The supply of new space shrinks due to construction stops and insolvencies.

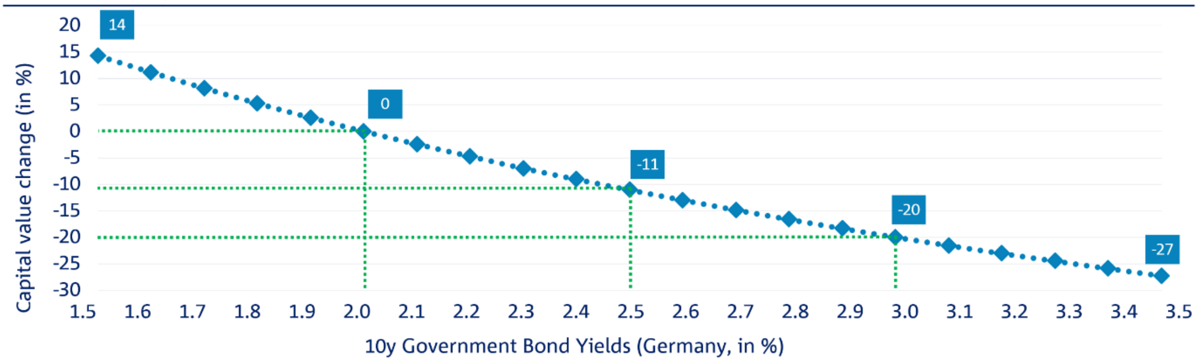
   The latest news on ongoing construction projects shows the expected trend: in view of the rise in interest rates and the fall in prices, property developers are increasingly running into difficulties and are having to stop their development projects or, in some cases, file for insolvency. While this is difficult for these companies and for the construction industry, it can have a positive impact on the rental market. For example, a current analysis by real estate researcher PMA of office properties in major German cities (‘A’ cities) estimates that around 440 thousand sqm of office space will not be completed for the time being. As a result, it will not be available on the market in the coming years. To put this figure into perspective: building completions totalling 1.9 million sqm are expected for the seven ‘A’ cities in 2023. In this light, 440 thousand sqm is a considerable reduction in supply. More construction stops are likely to be added in 2024. The shrinking supply of available space will have a positive impact on expected rental growth over the medium term.

Real estate prices keep falling now

Despite the positive news outlined above, real estate prices will continue to fall for the time being. This trend will last until property once again offers a fair risk premium (= yield premium) compared to risk-free government bonds. There are various approaches to determining this fair risk premium. One method is to reach an approximate figure for the fair risk premium through historical yield spreads. Looking back at a long period of history (30 years), office real estate in Germany ('A' cities), for example, has posted an average risk premium of 150 basis points compared to government bonds. For the past 10 years, the risk premium has been around 300 basis points. In view of the ECB's extremely expansionary monetary policy, the past ten years can certainly be described as an exceptional situation. At present, the average initial yield for office property in 'A' cities is around 4% and the yield on 10-year government bonds is 2.6%. This puts the risk premium at 140 basis points, which is close to the lower end of the historical ranges described above. If the fair risk premium were 150 basis points from the market players' viewpoint, only a moderate price correction would be necessary until more buyers would appear on the investment market again.

This static view can also be converted approximately into a dynamic view, in which the expected price performance can be derived for various interest rate scenarios. Figure 5 shows the resulting price change expected for office real estate in Germany, at various interest rate expectations. This analysis is based on the assumption that the risk premium expected by investors is 200 basis points. At an expected interest rate level, real estate prices would then fall (or rise) until the yield spread (risk premium) between property yields and government bond yields was back at 200 basis points (assuming rents remain the same). Let us take, for example, the interest rate expectations of BayernLB's research department, which forecasts a fall in capital market interest rates to 2.5% in the course of 2024. In that scenario, the potential price correction for office properties in Germany still expected in 2024 would be 11%. If capital market interest rates were to fall to 2%, the price correction still to be expected would drop to zero.

Figure 5: Government bond yield scenarios and implicit capital value change for office (German A-cities; assumption: fair risk premium of 200bp, constant rents)



Source: World Government Bonds; Graph: Real I.S.

Loan prolongations at higher interest rates result in more transaction activity

When discussing the fair risk premium expected by market players, one aspect must not be ignored. Even if there are more potential buyers again in the market at initial yields of between 4 and 4.5% for top office properties, i.e. yields that were last seen on the market 10 years ago, matching sellers must also be in the market. If possible, however, sellers will wait for a better environment for selling. They will postpone their sales efforts to subsequent years or continue to hold the properties in their portfolios. But there are also factors suggesting that the pressure to sell will increase. One of these factors is the historical interest rate trend. Capital market interest rates were trending downwards until 2022. A drastic drop in interest rates was seen particularly in the period 2014/2015. Yields on 10-year German government bonds fell from around 2% at the start of 2014 to 0.1% in April 2015, a decline of 190 basis points in just 16 months (see figure 6). Given the very favourable financing conditions, there was a strong surge in transaction volumes on the investment market. The loans taken out in this market phase to finance property purchases, were often fixed for a 10-year term and will now have to be prolonged in 2024 and 2025.

At the current interest rate level, financing costs will then be 150 to 200 basis points higher on average than 10 years ago. As this will significantly change expectations for the performance of real estate, this could result in more properties being sold. This trend is likely to drive transaction volumes in the coming years.

Figure 6: Government bond yields (10y-benchmarkt bond, Germany)

Source: World Government Bonds; Graph: Real I.S.

Conclusion: we should keep an eye on signs of a trend reversal

A swallow does not make a summer. Nevertheless, there are now increasing signs of a turning point in the investment market over the course of 2024. Even if transaction volumes will no longer reach the high levels of previous years in the foreseeable future, this would still be a positive signal for market participants.

Kind regards

The Real I.S. Research team

Your contact

Marco Kramer
Real I.S. AG
Research and Investment Strategy
marco.kramer@realisag.de

Disclaimer