J. Safra Sarasin
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Real estate markets feel the pinch

The sharp rise in interest rates in developed markets over the past 18 months is increasingly felt in the rate sensitive real estate sectors in the euro area, Switzerland and the US. House prices have started to drop as households' affordability to buy a home has fallen sharply and the economic cycle continues to soften.

In the euro area, the sharp rise in mortgage rates suggests lower house prices ahead, however, likely mitigated by lower building activity due to significantly higher construction costs. Despite the recent stabilisation in the US housing market, the outlook for the sector remains challenging. With housing affordability at its lowest point since 2006, prices will most probably have to come down further, in particular if the US falls into recession as we expect. The downward adjustment will likely be most pronounced at the higher end of the market, where the supply-demand mismatch is large.

Even in China, the real estate sector struggles to recover significantly as private developers' liquidity conditions remain tight. Concerns about job security and a preference to deleverage by potential homebuyers has caused the nascent recovery in the Chinese real estate sector to run out of steam for now.

On a more positive note, we find that euro area real estate equities are attractively valued. Even in a severe stress scenario, the relative price-to-book discount to the market still looks attractive. While it makes sense to add some real estate exposure, we would tread with caution, given that the highly levered sector still faces substantial tail risks.

This week's highlights

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European real estate

Price adjustments likely to continue

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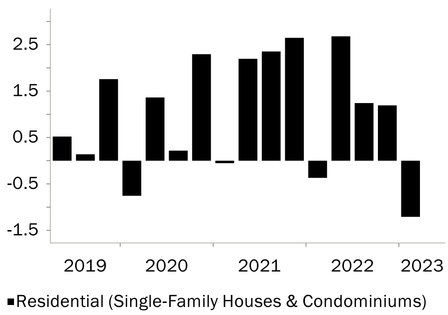
Real estate prices have declined in Switzerland and most euro area countries lately. We calculate that the increase in mortgage rates has reduced household affordability to a degree that would justify further price reductions. However, construction costs have surged as well, which is likely to lead to a severe mismatch between asking and offer prices. As a result, construction activity should fall and rents should increase.

Swiss residential real estate prices fall after a double-digit increase in the past years

This week, the Swiss Federal Statistical Office published the strongest decline in residential real estate prices since the start of the official data series in 2019 (Exhibit 1). Still, this leaves them 17% higher than at the beginning of 2019. Prices declined in Q1 on average by 1.2%; single-family homes by 1.3% and condominiums by 1.1%. Rural areas suffered the most. Prices have declined as mortgage rates have increased by around 1 percentage point since early 2022 for most maturities and despite a jump in construction costs by 8.3% yoy in the second half of 2022 (Exhibits 2 and 3). The Bank of International Settlement (BIS) calculated that at the end of 2022, Swiss house prices were at an all-time high in nominal and real terms as well as in relation to real GDP per capita.

Exhibit 1: Swiss real estate prices

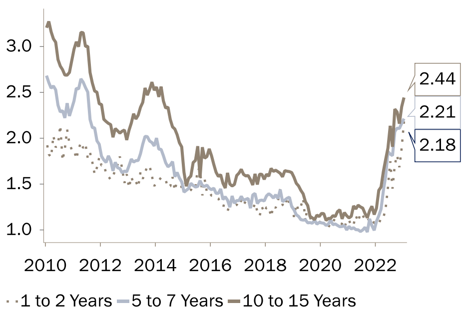
Residential Real Estate Prices, Swiss Federal Statistical Office, in % qoq, latest data 2023 Q1



Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

Exhibit 2: Swiss mortgage rates

Mortgage Lending Rates (Fixed Interest Rates) for Different Maturities in %, latest data January 2023



Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

Exhibit 3: Swiss construction costs

Switzerland, Construction Price Index, in % yoy, latest data 2022 Q3

Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

German real estate prices declined even more than Swiss prices

A similar development can be seen in Germany, where real estate prices peaked in 2Q 2022 already. In 1Q 2023, vdp – the association of German Pfandbrief Banks – reported a decline of 2.3% qoq. Downward price pressures are particularly strong for commercial real estate (Exhibit 4). This is in line with mortgage rates that increased by 2.5 percentage points since early 2022, more than twice the increase observed in Switzerland (Exhibit 5). Construction costs also rose strongly – by 15.1% yoy in March or a cumulative 31.5% since January 2021. It is therefore no surprise that expectations in the construction sector are at an extremely low level (Exhibit 6).

Other euro area countries also show declining prices and low expectations in the construction sector

For other euro area countries, comparable data are published by Eurostat (Exhibit 7) and the BIS only until the end of last year. The above-described trend is the same. After strongly increasing until the middle of last year, prices have declined. Construction activity as measured by the purchasing manager index (PMI) has fallen into contractionary territory (Exhibit 8). Credit growth to households has been falling as a result and is likely to continue given the tightening of lending standards and falling expected loan demand as indicated by the ECB bank lending survey. Credit growth declined to 3.3% yoy in March and even slipped into negative territory in Spain, Ireland and Greece (Exhibit 9).

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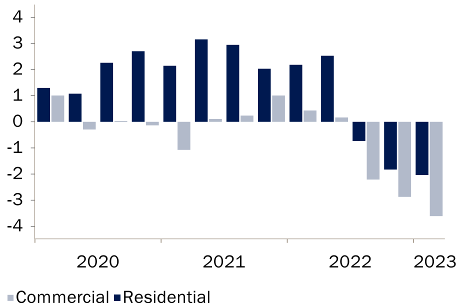
Exhibit 4: German real estate prices

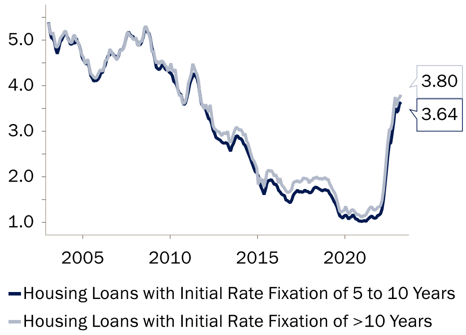
Germany, Real Estate Prices, Association of German Pfandbrief Banks (vdp), in % qoq



Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

Exhibit 5: German mortgage rates

German mortgage rates for new loans to households in %



Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

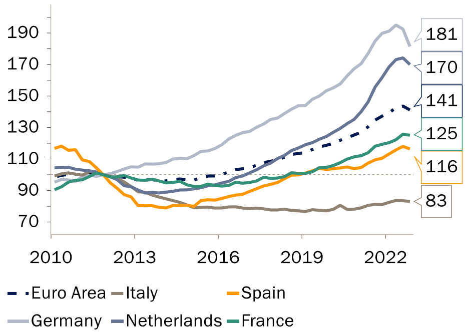
Exhibit 6: German construction costs

Germany, construction costs in % yoy and ZEW construction expectations (balance in %)

Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

Exhibit 7: Euro area real estate prices

Eurostat, House Price Index, 4Q 2011 = 100



Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

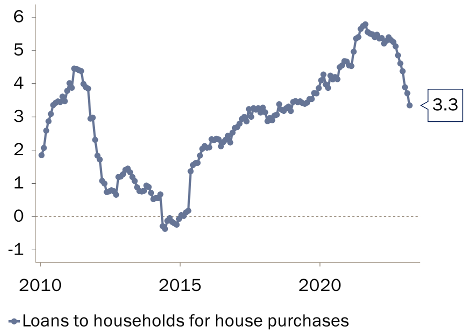
Exhibit 8: Euro area construction PMI

Euro Area, Markit, SA, Construction Sector

Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

Exhibit 9: Euro area credit growth

Euro area, loans in % yoy, latest data 03/2023



Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

We isolate the effect of higher interest on affordability for housing. Lower real incomes and savings would reduce housing affordability further.

Where from here? We explore whether real estate prices have fully priced in higher interest rates or whether further price declines are justified. Treating real estate as a cash flow creating asset, one could simply calculate how the present value of all future rent payments changes for different interest rate levels. The value of a house would then be determined similarly to a long-term bond. For example, if interest rates increase from 2% to 3% or from 3% to 4% bond prices would fall by 15.9% and 14.7% for a 30-year maturity. We doubt, however, that this is how households approach residential real estate prices. Being credit and liquidity constrained, they might instead simply calculate what house prices they can afford given a certain level of mortgage rates.

<u>Example:</u> Affordability calculation

Exhibit 10 on the next page shows our example for a euro mortgage. It would work for all other currencies similarly and could be scaled up or down if monthly annuities, the debt level at the end of the mortgage, and the down payment are changed by the same factor. In our case, we assume that a household can make a EUR 100,000 down payment, can pay a EUR 1,500 monthly annuity, and that it plans to pay down its mortgage to an amount of EUR 100,000 at the end of a 15-year mortgage period. Based on these assumptions, we can calculate the initial absolute interest payment and amortization as well as the mortgage amount that would lead to a residual debt level of EUR 100,000 after 15 years. The sum of the affordable mortgage and the down payment equals the affordable purchase price. In our example, the affordable house price would amount to EUR 435,705 in the case of a 1% mortgage rate and to EUR 407,197 for a 2% mortgage rate which is close to the extent of the interest rate increase in Switzerland. Hence, affordability falls by 6.8% if mortgage rates increase from 1% to 2%. Similarly, if mortgage rates would increase from

1% to 3.5% which is close to the German case, affordability would fall by 15.5% (=84.5/100-1). This is by far less than the observed priced decline so far.

Exhibit 10: Affordable house prices at different level of mortgage rates

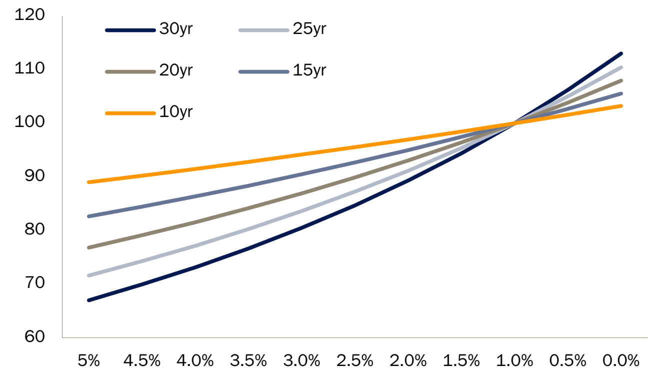
Interest rate p.a.	5.0%	4.5%	4.0%	3.5%	3.0%	2.5%	2.0%	1.5%	1.0%	0.5%	0.0%
Duration in years	15	15	15	15	15	15	15	15	15	15	15
Annuity per month	-1,500 €	-1,500 €	-1,500 €	-1,500 €	-1,500 €	-1,500 €	-1,500 €	-1,500 €	-1,500 €	-1,500 €	-1,500 €
Initial interest payment p.m. in €	987 €	926 €	859 €	785 €	703 €	612 €	512 €	402 €	281 €	147 €	0 €
Initial amortization p.m. in €	513 €	574 €	641 €	715 €	797 €	888 €	988 €	1,098 €	1,219 €	1,353 €	1,500 €
Initial amortization p.a. in % of mortgage	2.60	2.79	2.98	3.19	3.41	3.63	3.86	4.10	4.35	4.60	4.86
Debt after 15 years in €	-100,000 €	-100,000 €	-100,000 €	-100,000 €	-100,000 €	-100,000 €	-100,000 €	-100,000 €	-100,000 €	-100,000 €	-100,000 €
Debt in % of purchase price after 15 years	30	29	28	27	26	25	25	24	23	22	21
Affordable mortgage in €	236,993 €	247,060 €	257,724 €	269,025 €	281,007 €	293,714 €	307,197 €	321,509 €	336,705 €	352,847 €	370,000 €
Down payment in €	100,000 €	100,000 €	100,000 €	100,000 €	100,000 €	100,000 €	100,000 €	100,000 €	100,000 €	100,000 €	100,000 €
Down payment in % of purchase price	29.7	28.8	28.0	27.1	26.2	25.4	24.6	23.7	22.9	22.1	21.3
Purchase price in €	**336,993 €**	**347,060 €**	**357,724 €**	**369,025 €**	**381,007 €**	**393,714 €**	**407,197 €**	**421,509 €**	**436,705 €**	**452,847 €**	**470,000 €**
Purchase price index (1% interest case = 100)	**77.2**	**79.5**	**81.9**	**84.5**	**87.2**	**90.2**	**93.2**	**96.5**	**100.0**	**103.7**	**107.6**

Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

The interest rate sensitivity increases with the length of the mortgage

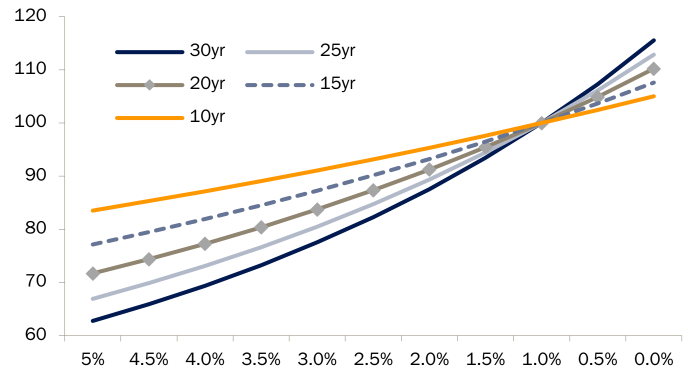
We can now simulate our calculations for different maturities between 10 and 30 years. In Exhibit 11 we do so for our initial case in which the mortgage is paid down to 100,000 when the loan matures. In Exhibit 12, we show results when the mortgage is paid back completely. In general, households become more interest rate sensitive the longer the maturity of the loan and the higher the residual debt level is. This may be one reason why the housing market is more volatile in the US, where 30-year fixed-rate mortgages dominate, than in Europe where typical mortgages are 15 years or less.

Exhibit 11: Affordability indices for different maturities and rates in case of full amortisation of the loan at the end of the mortgage



Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

Exhibit 12: Affordability indices for different maturities and rates in case of 75% amortisation of the loan at the end of the mortgage



Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

Conclusion: European house prices may fall moderately further while new constructing activity declines and rents increase

To conclude – our simulations show for most assumptions that affordable house prices would decline by more than what could be observed in residential European real estate markets so far. In addition, real incomes declined due to the elevated inflation rates of the past two years such that affordable monthly annuities might also be lower than two years ago. Finally, the declining stock and bond markets might have eroded household savings to a certain degree such that down payments are becoming more difficult to achieve. That would lower the affordable purchase price further. Is this compatible with higher construction costs? In theory, yes – as the land price part of the real estate transaction would simply have to take a stronger hit. Is this likely? In practice, no – as potential sellers usually wait for a longer period before lowering their asking price. In that case, house prices might fall only moderately going forward while construction activity and housing supply continue to fall.

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US real estate

House prices remain too elevated

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The decline in residential construction activity appears to have abated. Still, the outlook for the sector remains challenging. While more supply is expected to come online, developers over the last few years have primarily built houses at the high-end of the market, likely creating a mismatch between supply and demand. With housing affordability at its lowest point since 2006, prices will most probably have to come down more significantly for the market to rebalance.

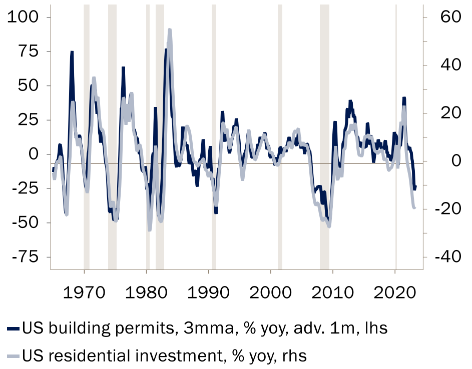
Housing activity appears to have stabilised in recent months ...

The importance of the housing market cannot be overstated: we all need a place to live and our personal wealth is often closely tied to property. For economists, the market is of particular interest as residential fixed investment directly accounts for about 5% of US GDP. However, the significance of the housing market extends beyond that, as it is highly cyclical and tends to provide a lead on where the rest of the economy is headed. Over the past year, house sales, building starts and residential fixed investment have fallen sharply, a reflection of the rapid increase in mortgage rates (Exhibit 1). This decline is roughly in line with the adjustment seen around previous recessions. In recent months, however, new house sales, starts as well as housebuilder confidence have picked up, suggesting that the bulk of the adjustment might lie behind us (Exhibit 2). Still, prices will probably need to come down more significantly for a sustained recovery to take hold.

... reflecting slightly lower mortgage rates and a lack of existing homes to buy

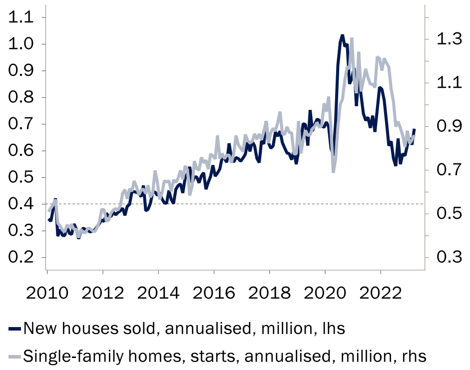
The recent improvement in housing activity can be attributed to two primary factors. First, mortgage rates have stabilised, albeit at elevated levels. As a result, the cost of financing and the affordability of houses are at least no longer deteriorating. Second, the supply of homes remains tight. The number of existing homes on the market is still close to its historical low, largely because the end of the exceptionally-low-interest-rate period has left homeowners dis-incentivised to sell or change properties (Exhibit 3). In fact, approximately half of outstanding mortgage balances were refinanced or refreshed at historical low rates during the pandemic years. Owners who are now looking to move will face increased borrowing costs and higher prices, as current home prices are about 35% higher than they were pre-pandemic. Additionally, the stock of completed new houses available for sale is also very low, and once on the market, they rapidly change hands (although no longer as fast as in the second half of last year). Finally, both rental- and homeowner vacancy rates are either at or close to their historical lows.

Exhibit 1: Big contraction in housing market



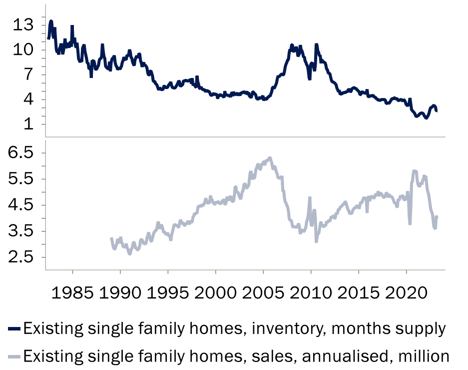
Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

Exhibit 2: Signs of stabilisation



Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

Exhibit 3: A tight supply of existing homes



Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

A lot of houses will come online but they tend to be at the upper end of the market. Developers might struggle to find suitable buyers, which could delay the construction of new and more affordable houses

Amidst elevated prices and tight supply, there has been a surge in construction activity, though bottlenecks have delayed the completion date of these projects. As a result, total housing units under construction, including flats, rose to 1.75 million at the start of the year, the highest level since data collection began in 1970 (Exhibits 4-5). But the problem is that developers have focused on the high-end of the market, with close to 70% of homes sold over the last year above the median house price of around $380k (Exhibit 6). According to the NAR affordability index, the median household can barely afford such a house, and according to the University of Michigan consumer survey, this is one of the worst times to buy a house in about 50 years. There is a good chance, therefore, that these new houses, once completed, might not find a buyer as fast as they have done so far, particularly if the economy slows down, as we expect. In turn, this mismatch between supply and demand is likely to delay the construction of new units

Exhibit 4: A lot of houses are currently under construction

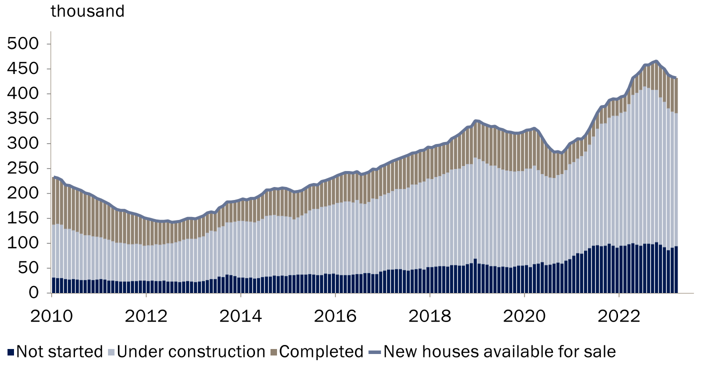


Exhibit 5: Housing units under construction at a historical high

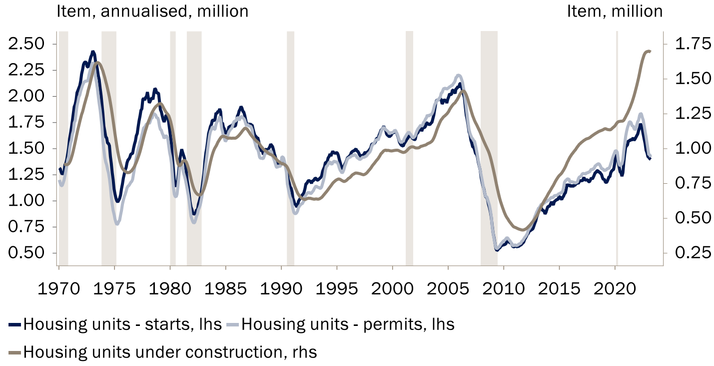
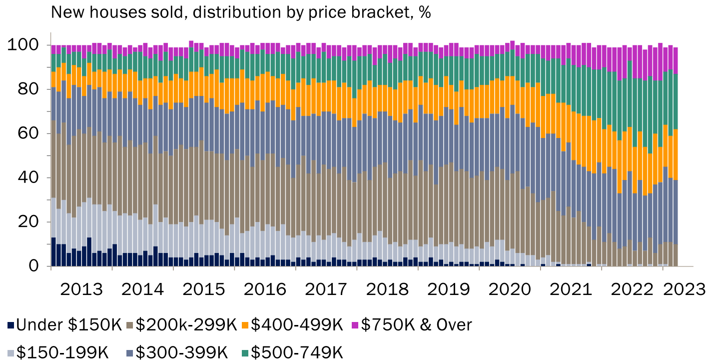
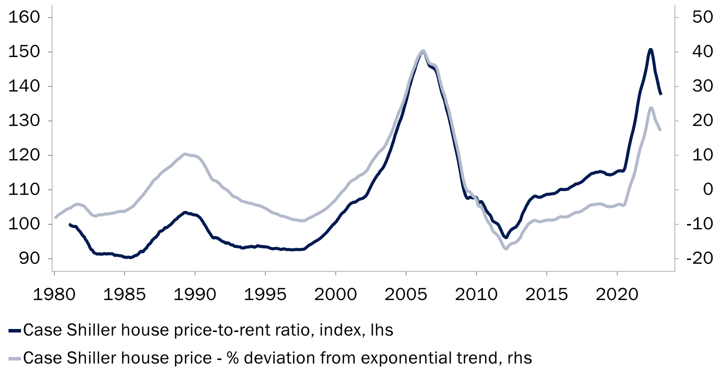


Exhibit 6: Housebuilders are focused on the high-end of the market



Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

Exhibit 7: House prices might have to adjust much more



Source: Macrobond, Bank J. Safra Sarasin, 17.05.2023

Houses remain barely affordable for the median American household. Prices are likely to drop further as more houses come onto the market

Further reductions in house prices may be necessary to achieve equilibrium. While house prices have undergone modest adjustments of around 3-6% from their peak, metrics such as the price-to-rent ratio indicate that prices could still drop by an additional 10-15% from their current levels (Exhibit 6). The market has been relatively dry, with sellers having little incentive to sell and transactions occurring primarily at the upper end of the market (Exhibit 7). However, were the economy to enter a recession later this year, individuals may be forced to move in search of new job opportunities, leading to an increase in the stock of existing homes on the market. Price discounts would be required to attract potential buyers. Similarly, developers and housebuilders, who have increasingly focused on the high-end of the market, will likely need to revise their selling prices downwards.

China real estate

Increasing downside risks for the housing sector

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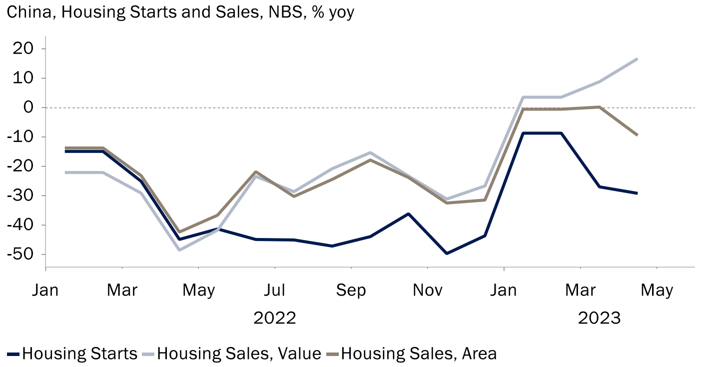
The housing rebound that started at the beginning of the year seems to have run out of steam. Home sales dipped in April, while land sales to real estate developers remain weak. Private developers' liquidity conditions remain tight while potential homebuyers seem rather hesitant to invest in properties as they appear concerned about their job security, their income and the ability of developers to deliver finished homes. While the increase in home sales in Q1 should improve housing starts and investment in the second half of the year, there is an increasing risk that housing investment will not stabilise this year and remain a growth drag.

Q1 housing rebound has now run out of steam

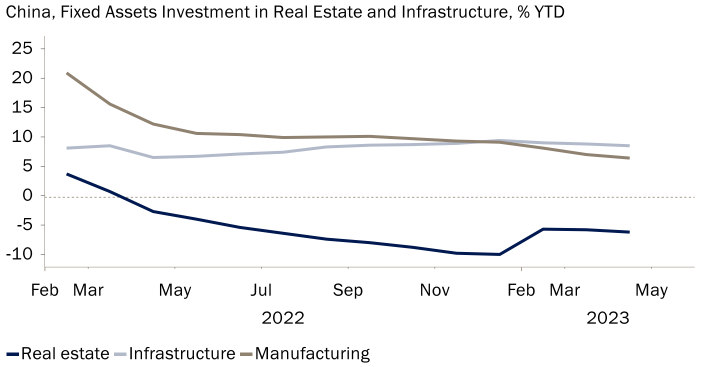
We wrote in early April that the housing rebound was real, but uneven across city tiers and developers. Throughout the month, that rebound seems to have lost steam. Home sales volumes in April dropped for the first time since the beginning of this year (Exhibit 1). Home sales values on the other hand continue to increase, likely because sales have been skewed towards more expensive top-tier cities. After an improvement in housing starts in the first two months of the year, the trend had already reversed by March. As a result, real estate investment remains a drag on growth (Exhibit 2).

Exhibit 1: Housing activity has lost momentum...



Source: Macrobond, Bank J. Safra Sarasin, 16.05.2023

Exhibit 2: ...leading to little improvement in real estate investment



Source: Macrobond, Bank J. Safra Sarasin, 16.05.2023

After the reopening boost, Chinese household confidence requires further improvement in labour market conditions

Why have home sales lost steam? In our view, it is mostly about Chinese households' confidence in their job security and income expectations. While most indicators suggest that hiring intentions have improved significantly, especially in the services sector, the unemployment rate has dropped only slowly, and income growth has remained sluggish (Exhibit 3). With higher household debt than in past housing cycles, homeowners may have chosen to use their excess savings to deleverage, by paying down their mortgages and other loans. As a result, new household loans dropped in April (Exhibit 4). Potential homebuyers in lower-tier cities could also expect that home prices may drop further amidst elevated inventories. The job and income outlook is also gloomier in cities that are industrial- and manufacturing-intensive, given slowing global demand for Chinese exports.

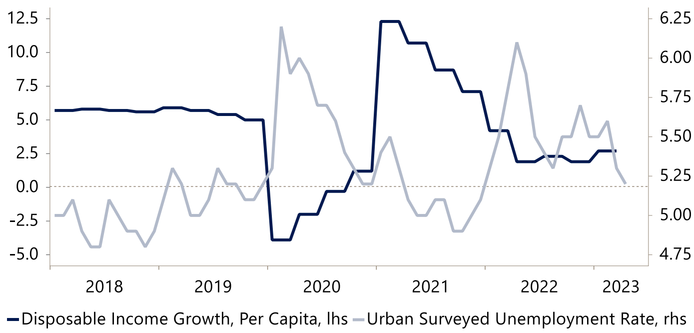
Potential homebuyers also have little confidence in property developers

Potential homebuyers' confidence in real estate developers has not improved much either. While the property policy started pivoting late last year, property developers remain in a difficult position. Even if financing conditions have eased and home sales have picked up, many developers continue to struggle. The default by KWG two weeks ago and Sino-

Ocean Group's coupon payment delay indicate that the sector's liquidity conditions remain tight. Indeed, the sector's dollar bonds are trading at higher credit spreads again. Given the cash constraints, property developers have not managed to purchase more land for future development either. Land sales to developers remained very weak outside of a handful of top-tier cities.

Exhibit 3: Household income growth remains sluggish

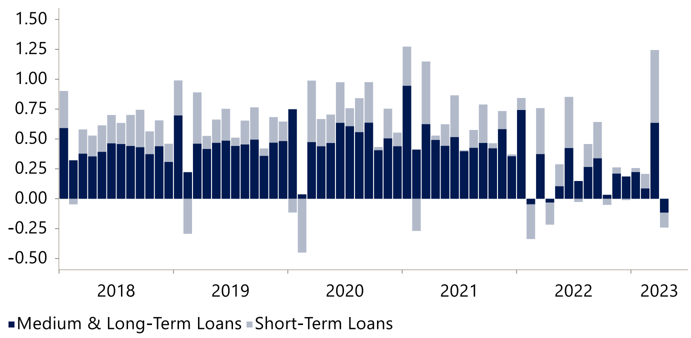
China, Real Household Disposible Income and Unemployment, %



Source: Macrobond, Bank J. Safra Sarasin, 16.05.2023

Exhibit 4: Households prefer to deleverage

China, New Loans to Households, CNY trillion



Source: Macrobond, Bank J. Safra Sarasin, 16.05.2023

There is an increasing risk that housing investment is a drag on growth in 2H

We expect a normalisation of housing activity in the second half of this year in our baseline growth forecast. That essentially means that housing investment should not become a drag on economic growth. The initial home sales boost in Q1 should translate into improved housing activity by Q3. However, the downside risks that housing activity may not stabilise have increased. The current confidence problem is a catch-22 problem. Since the housing sector is such a big part of the economy, and many industrial activities directly or indirectly rely on demand from housing investment, the weakness in housing starts also translates into weak industrial and manufacturing income and employment. These effects are uneven across cities. Top-tier cities tend to be more dependent on the services sector, which is recovering more strongly.

Improving confidence will not be easy

To improve potential homebuyers' confidence in the near term, we think that the government and regulators will need to step in to help improve confidence in the developers. While the government does not have to directly help struggling private developers in obtaining liquidity, it could nudge state-owned banks to take bolder steps in supporting these developers. Potential homebuyers need to see more good news, such as the completion of previously unfinished projects. The wider economy also likely needs more fiscal support to get through the industrial weakness. Such support could also be positive for households' income and the job market outlook, and eventually help lift demand for homes.

Euro area real estate equities

Priced for a big margin of error

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The euro area real estate equity sector is attractively valued on every measure. Even in a severe stress scenario, in which house prices and the book value of the sector drop by 35%, the relative price-to-book discount to the market still looks attractive. Furthermore, if yields were to stay at current levels, refinancing costs would rise to the equivalent of 30% of earnings in 2024. But even if earnings were to decline by 30% as a result of higher rates, the sector's relative price-to-earnings ratio would remain well below its long-term average. Valuations thus strongly argue in favour of adding euro area real estate exposure and suggest substantial upside in a benign macro scenario, with rates coming down. Yet, while we think it is reasonable to cautiously add real estate exposure, we would still warn against an all-in approach, given that real estate is by far the most levered sector in the European equity universe and thus faces substantial tail risks if a more pronounced economic downturn were to play out.

While US real estate has underperformed for years, euro area real estate has started to decline sharply in 2020

While the US real estate sector has been a serial underperformer over the past 10 years, the sector in the euro area has only started to suffer substantially after the initial stages of the pandemic in 2020. This followed a rally which lasted more than a decade, driven by structurally declining rates, but has more recently turned into a massive hangover.

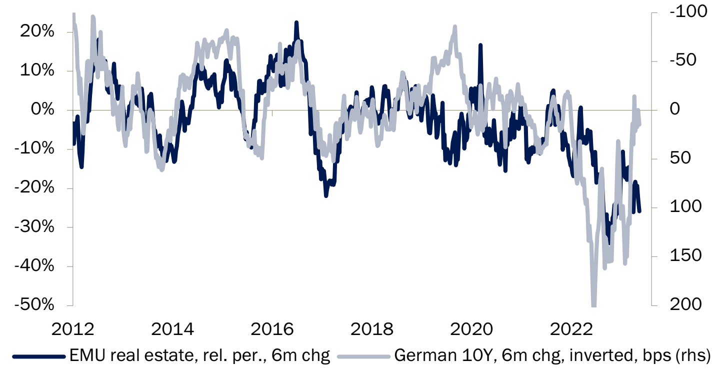
The euro area real estate sector has been hit hard by rising rates, now trading at the lowest relative to the market in 20+ years

Euro area real estate has underperformed the broader euro area market by 65% since 2020, with a sharp acceleration in its relative decline when rates started to rise in 2022 – predominantly driven by German real estate names. The sector is now trading at the lowest relative pricing to the market going back at least 20 years – including the global financial crisis and its aftermath (Exhibit 1). It's not only relative pricing which looks attractive after this 3-year long sell-off. The recent stabilisation in German Bund yields would also suggest that the sector has seen the worst and is ripe for a rebound (Exhibit 2). This obviously begs the question whether it is the right time to add real estate exposure.

Exhibit 1: Euro area real estate has been in parabolic decline

Source: Refinitiv, Bank J. Safra Sarasin, 16.05.2023

Exhibit 2: The rise in rates in 2022 has hit the sector hard



Source: Refinitiv, Bank J. Safra Sarasin, 16.05.2023

The asset and liability side of real estate companies' balance sheets are under pressure, with earnings likely to decline as well

We believe that there are good reasons to remain cautious. Yet we acknowledge that valuations are looking attractive, even in a severe stress scenario. In order to shed some light on valuations and tail risks, we look at the three channels through which higher rates affect the viability and profitability of real estate firms: (i) lower asset values (house prices), (ii) rising financing costs as well as re-financing risks and (iii) a squeeze in earnings.

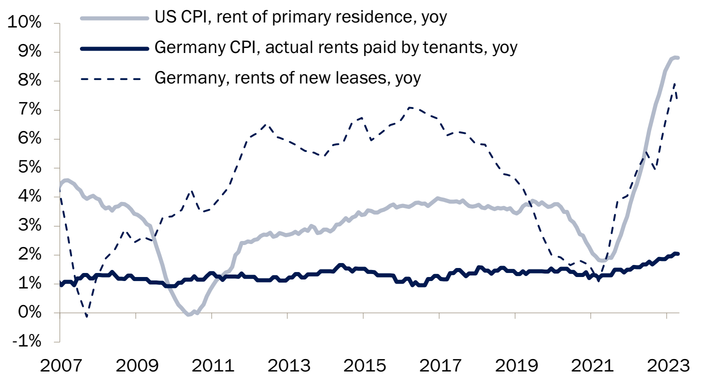
The German real estate sector has been instrumental for the recent underperformance

With regard to house prices, we think it makes sense to focus on German housing to draw some conclusions for the euro area, given that German real estate dominates the euro area equity sector and has been instrumental in its recent underperformance.

German rent increases are capped, putting the burden on prices to adjust in order to bring the rental yield back in line with financing costs

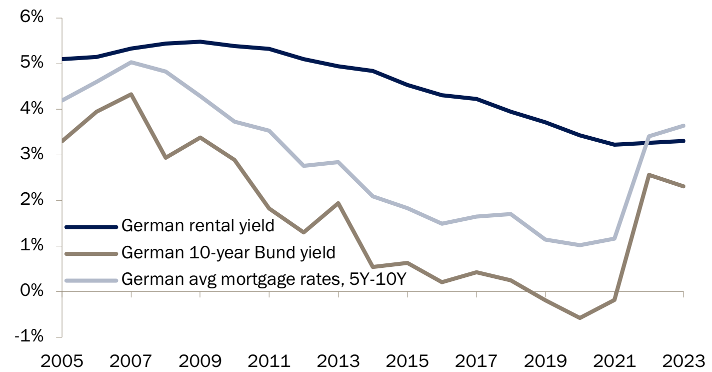
As is the case in many European economies, and as opposed to the US, German rents are subject to rent control measures, capping the pace at which rents can grow over time. As a result, rent inflation in the German CPI basket has barely moved over the past two years, just recently touching 2%, while US rents for primary residencies have shot up by 8.8% over the past 12 months (Exhibit 3). Why does this matter? Rents determine the rental yield at a given property value and hence whether a property investment is economically viable or not. While US landlords have been raising rents in line with rising mortgage costs, German landlords could only do so for new leases, while rents on existing leases are capped. Hence, the rental yield in Germany has barely moved since the beginning of 2022, while mortgage rates have surged and moved above the rental yield for the first time in 20 years (Exhibit 4). Even though rents are set to rise over time, as tenants are moving houses and landlords use the flexibility they have for existing leases, the adjustment will likely be quite drawn out, with German house prices falling for many more months if not years.

Exhibit 3: German rent inflation has barely moved for existing rents



Source: Refinitiv, Bank J. Safra Sarasin, 17.05.2023

Exhibit 4: Mortgage rates are now above the rental yield



Source: Refinitiv, Bank J. Safra Sarasin, 17.05.2023

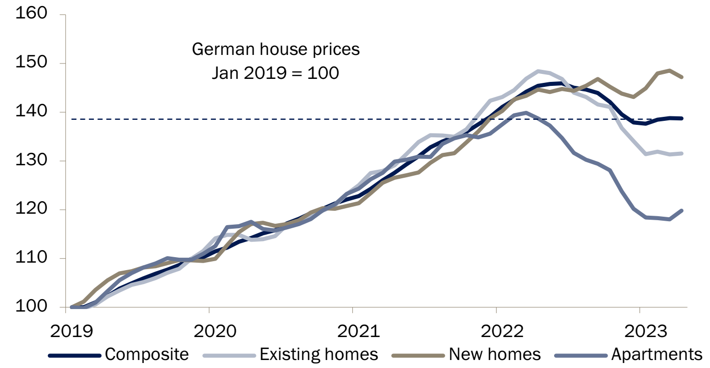
So far, German house prices have seen a moderate 5% decline

So far, house prices in Germany have dropped by a relatively moderate 5% from their peak in June 2022, falling back to December 2021 levels (Exhibit 5). This has barely been accounted for on balance sheets, rendering current price-to-book valuations as overly attractive.

In order to re-establish the long-term gap between rental yields and mortgage rates, house prices would have to drop by 35%

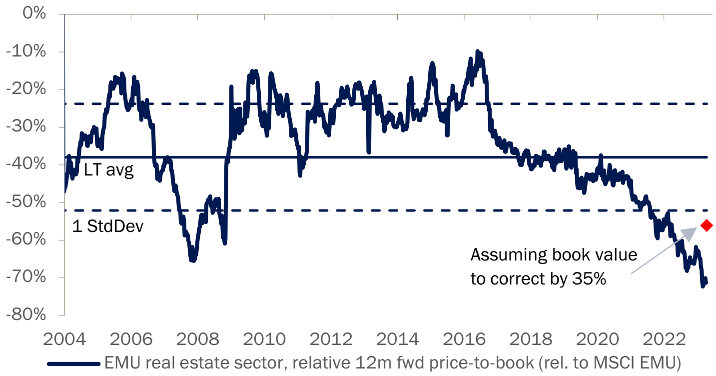
In order to find out if the current price-to-book discount of the real estate sector to the broader euro area equity market would disappear in a severe "stress test", we derive the necessary drop in house prices, required to raise rental yields to levels such that their typical spread to mortgage rates (160bps over the past 20 years) is re-established. We assume that rents as well as mortgage rates remain unchanged, which makes the scenario more severe than likely in reality. This implies a rise of the rental yield to 5.2%. That would require a house price correction of 35% vs today's level. Applying this 35% correction to the book value of the real estate sector, it still remains very attractively valued against the rest of the market (Exhibit 6), suggesting a substantial buffer to absorb asset price corrections.

Exhibit 5: German house prices are down "only" 5% from their peak



Source: Refinitiv, Bank J. Safra Sarasin, 16.05.2023

Exhibit 6: Real estate PBs are low, even if house prices drop further

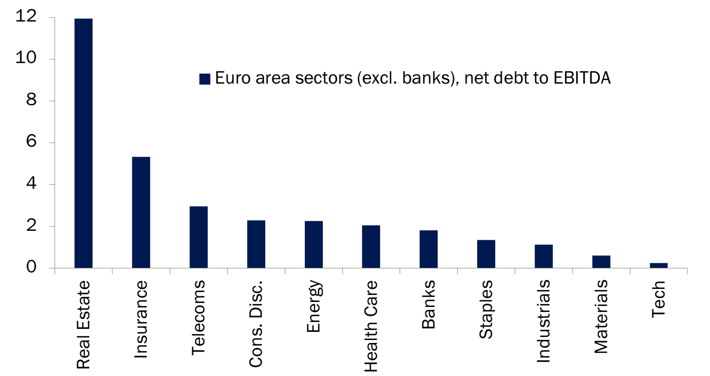


Source: Refinitiv, Macrobond, Bank J. Safra Sarasin, 16.05.2023

Leverage is the highest in 20 years, well above other euro area sectors, posing a tail risk in a more severe downturn scenario

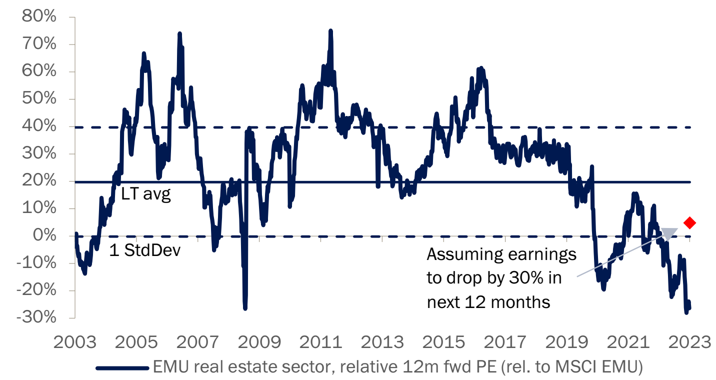
The second pressure point and the one which makes us cautious against adding too much exposure, despite visually attractive valuations, is leverage. Real estate is by a large margin the most levered sector (ex banks) in the euro area (Exhibit 7). Its net debt/EBITDA ratio of around 12x is not only high compared to other sectors, it is also at a 20-year peak and well above the levels pre-GFC. In a severe macro downturn, it is hard to predict how credit markets would react and if funding would be available against a real estate portfolio which could be difficult to value. This may force the most levered names to sell assets at a sharp discount to their book value and has the potential for severe repercussions.

Exhibit 7: The most levered sector in the euro area equity universe



Source: Refinitiv, Bank J. Safra Sarasin, 16.05.2023

Exhibit 8: PEs would remain cheap even if earnings take a 30% hit



Source: Refinitiv, Bank J. Safra Sarasin, 16.05.2023

If interest rates stay at current levels, the sector would have to digest a 30% hit to earnings. But PEs would still look attractive

Assuming a more benign outcome, we evaluate the impact of higher financing costs on earnings over the coming 18 months. Around 14% of the sector's debt matures by the end of 2024. Assuming that refinancing rates remain roughly 2%-points above the levels observed over recent years, the additional interest cost generated would cut earnings by around 30%. Once again, "stress-testing" relative sector PEs with these assumptions, the current valuation discount of around 30% to the market, would rise to roughly zero. Given that the sector has historically traded at a 20% premium to euro area equities, it seems more than reasonably priced on PEs as well, even if rates remain elevated (Exhibit 8).

Valuations suggest that real estate is priced for a lot of downside, arguing for cautiously adding exposure to the sector

Bottom-line, quite a severe scenario for house prices and for earnings appears to be priced in the euro area real estate sector. We would thus cautiously add exposure given the substantial upside potential if rates were to drop without a significant macro slowdown. Yet, we caution against adding too much risk, given the tail risks which stem from the sector's substantial leverage.

Economic Calendar

Week of 22/05 – 26/05/2023

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 22.05.2023						
JN	01:50	Core Machine Orders MoM	May	mom	--	-4.50%
	01:50	Core Machine Orders YoY	May	yoy	--	9.80%
Tuesday, 23.05.2023						
GE	09:30	German Manufacturing PMI	May	Index	--	44.50
EU	10:00	Eurozone Manufacturing PMI	May	Index	--	45.80
UK	10:30	UK Manufacturing PMI	May	Index	--	47.80
US	14:30	Philadelphia Fed Non-Manuf.	May	Index	--	-22.80
	14:30	US Manufacturing PMI	May	Index	--	50.20
	16:00	New Homes Sales MoM	May	mom	-3.40%	9.60%
	16:00	Richmond Fed Manufact. Index	May	Index	--	-10.00
Wednesday, 24.05.2023						
UK	08:00	UK CPI YoY	Apr	yoy	--	10.10%
	08:00	UK Core CPI YoY	Apr	yoy	--	6.20%
US	13:00	Mortgage Applications	May	wow	--	-5.70%
	20:00	FOMC Meeting Minutes				
Thursday, 25.05.2023						
FR	08:45	Business Confidence	May	Index	--	102.00
	08:45	Manufacturing Confidence	May	Index	--	101.00
US	14:30	Chicago Fed National Act. Index	May	Index	--	-0.19
	14:30	Initial Jobless Claims	May	1'000	--	--
	14:30	GDP Annualised QoQ	1Q S	qoq	1.10%	1.10%
	14:30	Core PCE QoQ	1Q S	qoq	--	4.90%
	16:00	Pending Home Sales	Apr	mom	--	-5.20%
	17:00	Kansas Fed Manuf. Activity	May	Index	--	-10.00
Friday, 26.05.2023						
UK	08:00	Retail Sales Ex Auto Fuel MoM	Apr	mom	--	-1.00%
	08:00	Retail Sales Ex Auto Fuel YoY	Apr	yoy	--	-3.20%
US	14:30	Personal Income	Apr	mom	0.40%	0.30%
	14:30	Personal Spending	Apr	mom	0.40%	0.00%
	14:30	PCE Core Deflator MoM	Apr	mom	0.30%	0.30%
	14:30	PCE Core Deflator YoY	Apr	yoy	4.50%	4.60%
	17:00	Kansas City Fed Services Act.	May	Index	--	7.00

Source: Bloomberg, J. Safra Sarasin as of 17.05.2023

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	0.97	-1	-65	5.4
German Bund 10 year (%)	2.45	17	-13	1.5
UK Gilt 10 year (%)	3.96	16	29	-0.1
US Treasury 10 year (%)	3.63	17	-24	2.8
French OAT - Bund, spread (bp)	59	1	4	
Italian BTP - Bund, spread (bp)	187	-4	-28	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	11,438	18.0	-0.1	9.7
DAX - Germany	16,163	11.5	2.1	16.1
MSCI Italy	861	8.3	0.0	14.0
IBEX - Spain	9,213	10.4	0.3	14.0
DJ Euro Stoxx 50 - Eurozone	4,367	12.5	1.6	17.8
MSCI UK	2,219	10.7	0.2	5.4
S&P 500 - USA	4,198	19.2	1.7	10.1
Nasdaq 100 - USA	13,835	26.7	3.4	26.9
MSCI Emerging Markets	978	12.5	0.1	3.1

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.90	7.5	0.8	-2.2
EUR-CHF	0.97	5.4	0.0	-1.6
GBP-CHF	1.12	6.7	0.3	0.3
EUR-USD	1.08	7.0	-0.7	0.6
GBP-USD	1.24	7.7	-0.4	2.7
USD-JPY	138.3	10.2	1.9	5.5
EUR-GBP	0.87	5.4	-0.4	-1.9
EUR-SEK	11.38	6.7	1.0	2.0
EUR-NOK	11.75	10.0	1.4	11.9

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	101	13.1	-1.5	-10.3
Brent crude oil - USD / barrel	76	36.7	0.9	-10.3
Gold bullion - USD / Troy ounce	1,963	13.7	-2.6	7.6

Source: J. Safra Sarasin, Bloomberg as of 17.05.2023

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