Five hypotheses on Swiss real estate and rising inflation

By Andreas Hitz, Dr. Roger Stettler, 06.05.2022

Real estate investors are currently uncertain about the effects of the sharp rise in inflation - also in Switzerland - and the increase in long-term interest rates for real estate investments. Currently, we can observe two main aspects:

a. Rising long-term interest rates

Since the beginning of the year, long-term interest rates in Switzerland have risen significantly. As of January 3, 2022, the 10-year SWAP was 0.13%. As of May 5, 2022, the respective rate stood at around 1.30%. This increase is unprecedented in recent history in terms of both speed and magnitude. Internationally, comparable movements in long-term interest rates were observable in the most important currencies (EUR, USD and GBP).

However, short-term interest rates hardly changed over the same period. In the US, the short-term Fed Fund Rate was raised for the first time since December 2018 on 16 March 2022. On May 4, 2022, there was a further increase to 0.75-1.00%. It is currently impossible to predict when and how much short-term interest rates will rise in the Euro and CHF area, although many investors expect a first rate hike in mid to late 2022, or in 2023 for Switzerland. It is worth noting, however, that the accuracy of interest rate forecasts has been very low historically.

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As of end of April 2022, the Swiss yield curve is thus very steep and the difference between the 3-month SARON and the 10-year SWAP stands at about 200 basis points.

Figure 1: Inflation rates (annualized)

	Sept 2020	Sept 2021	March 2022
United States	1,4%	5,4%	8,4%
United Kingdom	0,5%	3.1%	7,0%
European Union	-0,3%	3.4%	7,8%
Switzerland	-0,8%	1,0%	2,4%

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b. Inflation continues to rise in all major economic areas

Even before the conflict in the Ukraine, both the US and Europe suffered from high inflation. The supply shocks triggered by the war (supply chains with lower efficiency, rising energy prices, rising prices of commodities, etc.) are expected to lead to a further increase in inflation while lowering potential growth. In the case of Switzerland, inflation has so far been lower than in the Euro area, probably due to a combination of measurement issues and a partial compensation of increased import prices by the strengthening Swiss franc.

The low short-term interest rates in connection with high inflation result in a negative real return on low-risk fixed-income products of considerable magnitude. Even at the long end of the - presently very steep - yield curve (10 years), the current real yield in CHF is -0.9%.[1]

What action is now required from real estate investors? For a discussion of the interest rate sensitivity of rental income, please refer to our respective publication.[2] The debate regarding the possible impact of rising interest rates on the value of real estate shall not be the focus here. The historical evidence in this regard is very heterogeneous and there are indications that the development of the real economy plays a considerably more meaningful role than the development of interest rates.[3]

We want to outline five hypotheses, which are actionable.

1) High inflation in construction cost drives up prices in real estate portfolio
2) Short-term financing is extremely attractive, structural contribution is an important income driver in portfolio
3) Early termination of fixed-rate mortgages in combination with an increase in the loan-to-value ratio is becoming very attractive
4) Provisions in rental agreements are becoming more important and can directly influence property performance
5) An environment of higher interest rates and high inflation can exert upward price pressure on prices, if the volatility of the situation calms down

1. Inflation in construction costs is driving up prices and is higher than inflation

Existing properties compete with new buildings in the rental and ownership market. Especially in the case of increased demand for space (migration, rising demand for housing per person), the price should be significantly influenced by the costs of new buildings.

Significant construction cost inflation had already set in in Switzerland in 2021. Construction inflation in the period

[1] Calculated with an inflation rate of 2.4% (LIK March 2022) and 1.3% SWAP 10 years.
[2] Real estate, real estate income and inflation, 07.12.2021
[3] In the aftermath of the 2008 financial market crisis, for example, a real collapse in real estate prices could be observed in southern European countries and Ireland as interest rates fell, while prices rose in Sweden, Norway, Switzerland and Germany, for example, with similar interest rate developments.

from October 2020 to October 2021 was 4.6%, more than 3 percentage points above the inflation rate reported for the Swiss economy at the time.[4] The current market sentiment report, which is characterised by supply bottlenecks and increases in factor costs, suggests that construction prices have risen further in the meantime. Additional energy regulations are also driving up prices in various cantons.

Assuming constant land costs, this inflation directly affects the price of new buildings. Indirectly, it also raises the price of existing properties as substitute products.

High construction cost inflation thus increases the (nominal) value of the existing substance. New buildings and renovated properties in particular are likely to benefit from this. This effect is smaller for older properties, as future investments still have to be made in nominal terms. For real estate investors, therefore, the construction cost inflation is more relevant than the "normal" inflation rate. Also, the construction cost inflation is currently significantly higher than the reported inflation rate.

2. Speculation on structural contribution is attractive

The steepness of the yield curve makes short-term financing much more attractive for investors who are willing and able to take risks. Never before in the last five years has this strategy been so attractive. Long-term refinancing is currently only worthwhile if a sharp rise in the yield curve is expected. Today, we observe a dichotomy in the market: professional investors with extensive experience focus mainly on short-term financing. Less experienced, smaller investors, on the other hand, tend to conclude long-term (10 years or longer) financings. At the moment, there is virtually no demand for medium-term financing (3-8 years).

«Currently, short-term financing is very attractive from a risk-return perspective.»

From our point of view, short-term financing is currently very attractive from a risk-return perspective, provided an adequate risk capacity. If necessary, part of the structural contribution can be used to moderately increase liquidity. This provides a reserve in the event of a sharp rise in the SARON rate.

3. Refinancing becomes more attractive

In an environment of negative interest rates, prepayment penalties for the early termination of a mortgage loan were prohibitively high. As a result of the rise in the yield curve, it is currently possible to exit long-term fixed-rate mortgages at much more moderate prices. Today, customers could even

[4] FSO, Construction Price Index

receive a discount payment from their financing institution if they terminate a fixed-rate mortgage. At the same time, the inflation rate today is significantly higher than the mortgage interest rate. It can therefore be worthwhile to increase a mortgage and invest the funds obtained in other - less inflation-sensitive - investments. We are currently observing an increase in demand for the early termination of mortgages with a simultaneous increase in the loan-to-value ratio.

4. Details in rental agreements are becoming more significant

Due to the prolonged low inflation environment, neither proprietors nor tenants have paid much attention to lease terms in recent years. In particular for commercial and retail properties, these include the defined terms for rent adjustments, e.g. the proportion of the increase in the LIK (the Swiss metric for consumer price development) that can be passed on to the tenant[5]. Further, this encompasses the standards used (effective and/or flat-rate) for ancillary costs in housing. Some proprietors have already started to increase ancillary cost accounts in order to avoid difficulties with excessive retroactive claims for ancillary costs due to increased energy costs.

In the lower price segment in particular, ancillary costs account for a significant proportion of the gross rental price. We therefore expect to see more conflicts over ancillary costs in the coming months and years.

5. Uncertainty and fluctuation of interest rate is the main issue, not the actual interest rate level

Today's wildly fluctuating interest rates and rising inflation could trigger uncertainty among buyers and sellers of real estate as well as among lenders and borrowers.

Daily fluctuations in the SWAP rate of sometimes more than 15 basis points make calculation challenging and fluctuations in the real interest rate make adequate valuation difficult. Similarly, natural persons in Switzerland in particular have not yet become accustomed to an environment of higher inflation rates. There are currently indications that the liquidity of the Swiss market is therefore declining. This is in contrast to the U.S., which is further along in both the interest rate and inflation cycle and where the real estate market remains highly liquid - real estate prices have surged 19.2% in the last 12 months in an environment of rising interest rates.[6]

A decrease in interest rate change (volatility) and a stabilization of inflation expectations could be the driver of a renewed strong upward movement in the real estate market.

[5] National consumer price index, published monthly by the Swiss Federal Statistical Office

[6] S&P CoreLogic Case-Shiller U.S. National Home Price NSA Index, Comparison March 2022 with March 2021.

Conclusion and outlook

Switzerland has not experienced a comparable environment with high inflation rates for over 25 years. Thus, when it comes to dealing with inflation, there is little know-how and experience among current market participants. At the same time, there are numerous opportunities in such an environment, especially if the current situation of negative real interest rates becomes permanent. As long as demand for residential and commercial property remains strong and construction inflation stays at the current high level, there are more opportunities than risks for real estate owners and the chance of further substantial nominal price increases is intact.

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