

Research Quarterly View Economy & Real Estate



OVERVIEW

While the period of very high inflation is slowly drawing to a close, more and more economic indicators are pointing to a recession. On that assumption, further key interest rate hikes look unlikely, or at most should be modest in scale.

ECONOMIC CLIMATE

Some European economies will stagnate in 2023. This means the period of economic recovery that followed the COVID pandemic is over for now, although further robust growth is forecast for the coming years.

DACH region

In the second quarter of 2023, German economic output shrank by 0.6% year on year – the first quarter of negative growth since the first three months of 2021. The Q2/2021 to Q1/2023 period can therefore be regarded as a recovery phase after the pandemic-induced recession – one which has now come to an end. Many indicators are signalling recession

for 2023. For example, the ifo Business Climate Index remained at a sustained low of 85.8 points in September 2023. Back at the start of the year, many economic research institutes were predicting modest economic growth. As the year has progressed, these forecasts have been scaled back further and further, and today a contraction of around 0.5% is expected. However, a moderate recovery is predicted for next year. Austria is even more severely affected by these recessionary trends and sees an 0.8% contraction in economic output. By contrast, forecasts suggest that Switzerland will remain on its stable growth path. Recessionary trends in Germany are also reflected in an expected slight rise in unemployment.

By contrast, the period of significantly higher inflation appears to be coming to an end. Whereas inflation was still over 6% every month from May to August, it dropped to 4.5% in September 2023. An inflation rate of 6.0% is expected for 2023 as a whole, returning to a significantly lower level of 2.1% for 2024. This is roughly in line with the Maastricht criteria. Producer prices, which have been on a steady

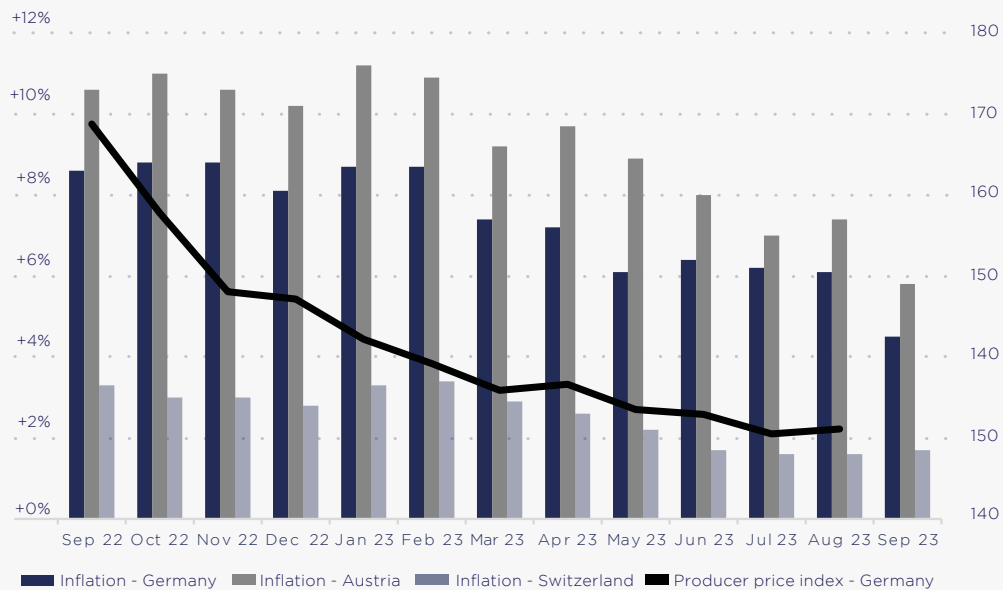
DACH economic growth	2022	2023p	2024p
Economic growth – Germany	+1.8%	-0.5%	+1.3%
Economic growth – Austria	+5.0%	-0.8%	+1.2%
Economic growth – Switzerland	+2.1%	+1.3%	+1.2%
Inflation – Germany	+6.9%	+6.0%	+2.1%
Unemployment rate – Germany	5.3%	5.6%	5.6%

p = Prognosis

Source: IfW Kiel – Economic Outlook Autumn 2023, WIFO Economic Outlook 3/2023, SECO Economic Trends Autumn 2023

downward trajectory since peaking in September 2022, are another sign of lower inflation rates ahead. In August 2023 they were 12.6% below the previous year's figure, marking the steepest ever drop in this indicator.

Inflation and producer prices



Source: OECD data, German Federal Statistical Office

Austrian inflation is also on a downward trajectory, although it remains about 1.5 percentage points above German levels. The figure of 5.8% is still far above the 2% target. Inflation in Switzerland has been among the lowest for developed countries throughout the entire high inflation period; at no time has it exceeded 4%. It has been below 3% since March 2023, and consistently beneath the 2% mark again since June 2023.

US

As the world's biggest economic power, the US is often a forerunner for trends elsewhere, meaning it is widely watched for nascent developments and leading indicators. Similar trends regularly unfold in other regions of the western world after something of a lag. The US, too, seems to have emerged from the period of high inflation. An inflation rate of 3.6% is expected for 2023, set to fall to just 2.3% the following year. 2023 also seems to be ending on a

positive note for the US economy, based on good economic growth of 2.2% and stable low unemployment. Real incomes are set to grow by 3.6%, as a result of which strong domestic economic activity is expected.

However, there are indicators and forecasts in the US pointing to an economic slowdown in 2024. As such, only low growth of 0.8% is expected, coupled with a rise in unemployment. As the US has a critical influence on the global economic outlook, a US economic downturn may also have negative effects on other economies and endanger urgently needed economic recovery in Europe.

US GDP	2022	2023p	2024p
Economic growth	+2.1%	+2.2%	+0.8%
Inflation	+6.3%	+3.6%	+2.3%
Unemployment rate	3.6%	3.6%	4.0%
Disposable income	-6.2%	+3.6%	+0.9%

p = Prognosis

Source: The Conference Board Economic Forecast for the US Economy (September 2023)



Global development

The geopolitical situation – which was already fraught due to the ongoing war in Ukraine and an incipient trade war between the US and China – has been further aggravated in recent months. Further geopolitical conflicts – for example in Israel, Niger and Armenia – have arisen, endangering world peace, the basis for prosperity. It is still unclear what impact these conflicts will have on the real economy in areas like supply chain stability, and on commodity prices and availability. However, the global situation today is characterised by tensions and uncertainty, which do not provide a solid foundation for long-term investments.

PROPERTY MARKETS

Property markets regularly follow economic trends, sometimes with a certain time lag and in widely divergent ways, depending on the region and usage type.

DACH region

In the new construction sector, the earliest indicator of recalibration in property markets is the number of building permits issued. Completions typically lag behind somewhat, since building projects, once started, cannot be immediately adjusted to changes in interest rates and construction costs. The slump

in building permits in German housing construction that followed the rapid rise in interest rates was drastic. In the second quarter of 2023, 33.2% fewer permits were issued for dwellings in new residential buildings than in the same period of the previous year; the number of permits issued for dwellings in buildings with three or more dwelling units fell by more than 28%.

The figures for residential completions in 2022 were also published in the most recent quarter. They totalled 258,764, which was marginally higher than the 2021 figure (256,352; +1.0%). Of these, 58% (150,158) were within residential buildings with at least three dwelling units. Once again, this fell well short of the federal government's target of constructing at least 400,000 dwelling units per year.

In September 2023, the German parliament passed the Buildings Energy Act (GEG), known colloquially as the heating act. Under this act, newly installed heating systems must use at least 65% renewable energy from 2024. These requirements have the potential to further raise the cost of constructing new residential properties.

Building permits – Germany	Residential buildings		Dwelling units	
	2023Q2	2022Q2	2023Q2	2022Q2
Total	17,691	30,074	53,853	80,574
Of which 3 or more dwelling units	3,137	4,955	35,177	49,376

Source: German Federal Statistical Office (Destatis)

There are numerous other indicators signalling that the property market is weak by historical standards. For example, the investment volume in residential portfolios in the first three quarters of 2023 was only around EUR 3.9 billion – the lowest figure since 2010. By way of comparison, the investment volume in the

same period of the previous year was about EUR 10.2 billion. Sentiment in the construction industry is also generally negative. For instance, the ifo Business Climate Index for the construction industry is at its lowest level since the height of the financial crisis in January 2009.

Change in prices	Purchase prices in EUR/m ²		Rents for new-build properties in EUR/m ²	
	2023Q2	2022Q2	2023Q2	2022Q2
Berlin	-4.1%	+15.6%	+10.6%	+5.6%
Hamburg	+0.7%	+4.3%	+5.0%	+3.9%
Munich	-2.4%	+6.7%	+2.4%	+1.9%
Cologne	+5.2%	+8.9%	+13.9%	+2.1%
Frankfurt	-4.8%	+5.0%	+1.1%	+1.2%
Stuttgart	0.0%	+6.1%	+0.6%	+1.8%
Düsseldorf	-7.8%	+8.5%	+9.5%	+0.7%
Vienna	+9.0%	+13.6%	-0.7%	+4.5%
Zurich	-3.1%	+7.8%	+3.3%	+0.7%
European peers				
Brussels	-2.1%	+4.3%	0.0%	+3.7%
Prague	+5.6%	+6.9%	+8.1%	+1.6%
Copenhagen	-9.9%	+7.6%	+4.4%	+7.1%
Paris	-2.0%	+0.1%	0.0%	+0.7%
Luxembourg	-4.2%	+9.1%	0.0%	+3.4%
Warsaw	+5.2%	+12.6%	+2.2%	+6.9%
Madrid	+15.5%	+1.4%	+12.9%	+1.4%
Stockholm	+1.4%	+2.5%	+8.3%	+8.1%
London	-1.5 %	-10.9 %	+7.8 %	+18.5 %

Source: RIWIS, Catella residential market overview, 2023

A heterogeneous picture of the property market in the DACH region emerges from the table. Firstly, we can see that rents are increasing across all locations. This applies not only to the top seven German locations shown here, but also to Germany as a whole. As such, the average net basic rent (exclusive of heating) in Germany was up 2.1% year on year in August 2023. Purchase prices tell a different story, however. They rose in Hamburg and Cologne, stagnated in Stuttgart, and fell in Berlin, Munich, Frankfurt and Düsseldorf. Demand fell considerably in the latter group of cities, due in particular to higher interest rates and building costs. This also led prices in many sub-markets to edge lower. In the cities where prices rose, these effects were counteracted by new arrivals.

The effect of falling purchase prices and lower property values applies across Germany. The house price index fell by 9.9% year on year in the second quarter. The drop of around 10.7% for existing buildings was significantly greater than for new builds, where prices were down by around 4.8%. This is the steepest downturn ever in this indicator.

Given that this pattern was observable both in Austria

and Switzerland, and also in other European markets, the problem is not just a domestic one. Nevertheless, the market situation has changed considerably for property investors compared with the 2010s.

US

Since the property market in the US is far less regulated than in Europe, rental and purchase prices in the US provide a relatively undistorted picture of the relationship between supply and demand in the housing market. Consequently, there are locations in the US where not only purchase prices but also rents are falling. This is largely the result of previous excessively high immigration expectations and the effect of the pandemic. In some areas, large amounts of new residential space were added for that reason, greatly expanding supply. When the temporary increase in demand proved not to last, this resulted in a new market equilibrium at a lower price level. Reasons for the fall in demand may include weak fundamentals for locations, such as economic weakness and low skill levels in the local population. Such locations include the likes of Boise, Idaho, and Phoenix, Arizona.



Conversely, there are also locations in the US that are growing strongly due to their fundamental strength. These are centres that will establish themselves as robust economic locations due to the slowly shifting dynamics of the US economy. In particular, these trends involve migration by businesses and highly qualified employees away from the major cities of California and New England. To date, locations in the Sun Belt have been the main beneficiaries, such as larger metropolitan areas in Texas, Florida, North Carolina, South Carolina and Tennessee.

This is also reflected in the ranking of the five fastest-growing metro areas, four of which are in the Sun Belt.

Average change in metro area	Rents – multifamily YoY
Top 5 by rent growth	
Odessa, TX	+11.4%
Midland, TX	+10.9%
Goldsboro, NC	+10.1%
Decatur, IL	+10.0%
Santa Fe, NM	+9.1%
Others	
Miami, FL	+1.2%
Dallas-Fort Worth, TX	-0.8%
Phoenix, AZ	-2.4%
US average	+1.0%

Source: Co-Star

CAPITAL MARKET AND FINANCE

Whereas the 2010s were a low-interest decade, from mid-2022 the leading western central banks started to increase their key interest rates, driven by high inflation. Key interest rates, credit market interest rates and bond yields typically correlate with each other, with key interest rates generally setting the standard.

Key interest rates

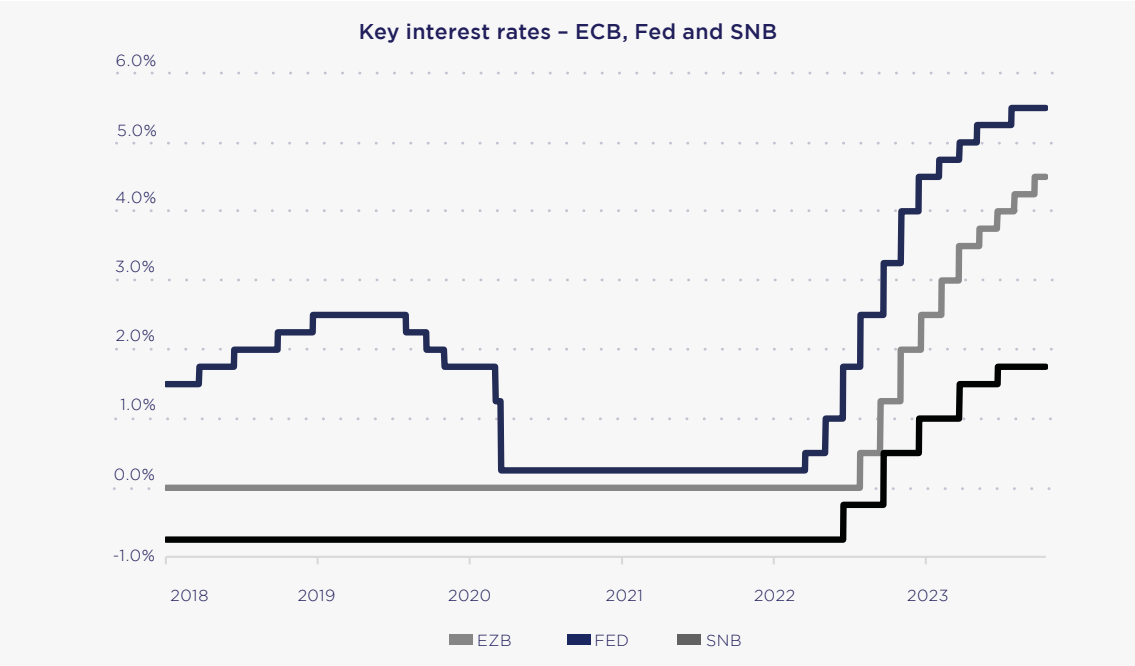
From mid-2022, key interest rates were raised by all western central banks in order to combat high inflation rates. By September 2023, the Fed had reached a level of 5.5%, and the ECB 4.5%. The Fed recently paused its rate tightening cycle, while the ECB made further 25-basis-point hikes in July and September. Interest rates are expected to trend sideways for the rest of this year and next. The ECB has left its future course open, while in September the Fed refrained from further tightening, and there are also early signs that its committee will again keep the rate unchanged at its next meeting in November. Smaller central banks such as the SNB also chose not to change their

key interest rates in September, since the target of keeping inflation under control is viewed as having been met.

The ECB will probably keep its current interest rate steady until inflation in the eurozone has returned to its 2% target. Only then will it be possible to start lowering interest rates without damaging the central bank's credibility. In the US, key rate cuts could be realistic in the near future for a number of reasons. Firstly, inflation there is considerably lower than in Europe. In addition, the central bank can also carry out economic policy. Since US presidential elections are coming next year, a degree of political pressure to clamp down harder on recessionary tendencies cannot be ruled out. As, unlike the ECB, the Fed has a mandate that includes growth and employment targets alongside monetary stability, it is very likely to soften its interest rate policy when the economic data deteriorates. Analysts expect a US federal funds rate of 4-4.25% for the end of 2024.

However, a return to a low-interest-rate policy like that which prevailed up to mid-2022 is unlikely, since

from a long-term perspective that was an historical anomaly. What is more likely is a return to a key interest rate of around 2–3%.



Source: ECB, Fed, SNB

Different asset classes

All asset classes are in competition for potential investors. The decisive criterion for evaluation and selection is the respective yield, alongside additional factors such as volatility and qualitative risks (e.g. legal certainty). For example, cryptocurrencies such as Bitcoin and Ethereum were among the highest-yield asset classes in recent years, although high volatility and the absence of statutory regulation such as investor rights and investor protection limit their attractiveness. In contrast, government bonds have very little volatility and are adequately secured, but

only offer low yields. Share and property yields sit somewhere in the mid-range.

The table shows rapid growth in all asset classes compared in the period of the fourth quarter of 2022 to the third quarter of 2023. Yields for low-risk investments in government bonds have increased significantly; however, in the case of these investments pegged to nominal interest rates, this was also strongly driven by inflation. Asset classes such as property and shares do not necessarily follow suit to the same degree.

Performance of various asset classes	2022Q4	2023Q1	2023Q2	2023Q3
DAX	12,114	13,924	15,629	15,387
Dow Jones	28,726	33,147	33,274	33,508
Interest rate – German government bond (10-year)	1.36%	2.14%	2.34%	2.59%
Interest rate – US government bond (10-year)	3.10%	3.82%	3.65%	4.14%
Bitcoin	19,845	15,426	26,201	25,475

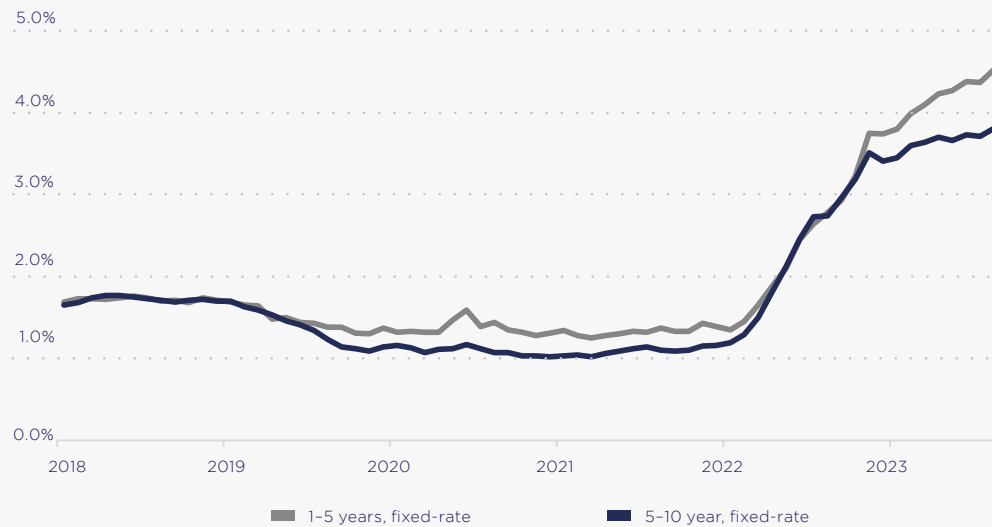
Source: finanzen.net, closing prices on 31/03, 30/06, 30/09, 31/12; Banque centrale du Luxembourg

Property finance

The volume of property finance has slumped significantly with the sharp rise in interest rates. In the case of private households, one particularly significant factor is the scarcity of liquid reserves, which makes it impossible to follow through on planned purchases and new builds in the short term. After a tempora-

ry peak in lending to private households for housing construction of around EUR 32 billion in March 2022, new loans collapsed in response to the rise in construction and interest costs. Since September 2022, it has been around EUR 15 billion per month, roughly the same in nominal terms as the monthly volume in 2013.

Effective interest rate for housing construction loans to private households – new business

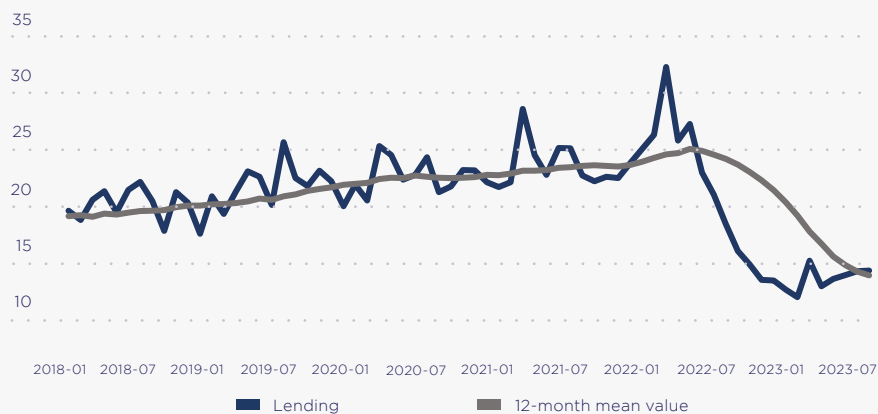


Source: Deutsche Bundesbank

If interest rates remain at this high level or continue to climb in the mid-term, this will create problems for many follow-on loans. In the case of loan agreements that once featured low interest rates, the adjustment of conditions at the end of the tied period may cause

liquidity problems for numerous borrowers. Loan defaults will become more likely, which would be accompanied by realisation of collateral in specific cases and by lower stability and less new business across the market.

Lending for housing construction to private households



Source: Deutsche Bundesbank

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