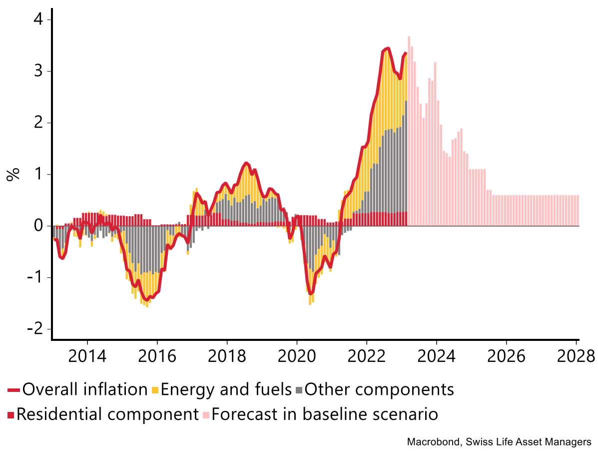
# Real Estate House View
## *Switzerland*

*First half of 2023*

## Key takeaways

- **Real estate-specific factors are dampening the effect of the turnaround in interest rates.** In Switzerland, interest rates have risen sharply. However, Swiss real estate investments definitely remain attractive as there are a number of mitigating factors, including the current economic environment.
- **Cost of living adjustment retains purchasing power**: Indexation is standard for business rents. As a result, average increases of 2.8% are already permitted for existing rental contracts apart from 2022. This will limit the risk of loss in the coming years, even in a persistent slightly inflationary environment.
- **2023 is the first milestone in several rent increases:** The reference mortgage interest rate is set to rise gradually over the next few years, starting in mid-2023. This will result in significant additional returns, as the majority of apartment rents can be increased by three percent or more in each step.
- **Market rents follow suit:** In addition to adjustments for existing rents, the labour market and the associated strong net immigration (32% above the average of the past eight years) as well as the low level of residential construction are fuelling the property market. Market rents will therefore continue to increase in 2023 and beyond.
- **Long-term view crucial:** if the economic environment accommodating the property market persists, real estate investments will remain attractive over an investment horizon of three to five years.

## Chart in focus




While consumer prices rose by 2.8% year-on-year in 2022, net rental growth for residential property amounted to only 0.3 percentage points. More volatile components, such as energy prices, were key drivers. Stable residential rental income was thus significantly below overall inflation. Are owners now facing a loss in value? No, as owners can pass on inflation at a rate of 40% for apartments and 100% for commercial space as a rule. If the mortgage reference interest rate rises, another 3% is added to apartment rental contracts. So this year will see a milestone for homeowners and landlords.

A noticeable slowdown in economic momentum is emerging at the beginning of 2023. However, Switzerland will not experience a recession in 2023. We expect average growth in real gross domestic product to come to 0.7%. In particular, the economic slowdown has hardly affected the labour market. Based on the current unemployment rate of 1.9%, we are expecting a slight increase in 2023 to 2.1%. Demand for office and commercial properties thus remains buoyant. The inflation cycle will peak in the first quarter of 2023. By mid-year, the inflation rate in Switzerland is set to drop below 2% again, thus falling within the target range of the Swiss National Bank (SNB). As a result, the SNB's monetary policy tightening is also coming to an end.

## 2023: Start of a series of rent increases

Swiss law protects purchasing power in order to keep real estate investments attractive: Long-term leases – the norm for commercial space – are generally indexed at 100%, while for unlimited rental contracts – the norm for apartments – a cost-of-living adjustment of 40% is permitted. Even more important, however, is passing on the increased mortgage interest rate through the mortgage reference interest rate. This will increase gradually from this year, and each step allows for a three percent increase for contracts with a lower level. This is raising high expectations in the market for 2023 and the following years.

## Key drivers: Residential construction in the grip of a pork cycle

The current economic environment is accompanied by record immigration, based on the strong labour market. The number of foreign immigrants in 2022 was 32% above the average for the past eight years. This is fuelling demand for housing and is coming up against a decline in residential construction. The trend towards a housing shortage will thus continue in 2023 and beyond, as residential production is too rigid to react quickly enough to the abrupt rise in demand. This cyclical deficiency phenomenon is also known by another name: the pork cycle. In the case of pigs, it refers to the time needed for breeding, while in the case of building, it is the time needed for permits and construction. In view of the decline in production, it must be assumed that market rents will continue to rise in the coming years at a similar rate to 2022 (see Chart 1).

## Construction costs reaching a peak

The national construction market will also be dampened in 2023 by higher costs and interest rates for debt financing. However, construction cost inflation is likely to have passed its peak, as shown by the slower increase in the second half of 2022. Lower construction activity will also result in less demand for goods and labour, which should lead to a slowdown in 2023. Before the end of 2022, the Swiss Contractors' Association's production cost index for building and industrial construction fell by 8.5% compared to the previous quarter, while that of apartment buildings (stone/concrete) fell by 3.7%. We expect the burden in this area caused by higher construction costs to ease in general, and planning security for developments and investments in 2023 and 2024 should thus improve.

## Return expectations remain high

According to the KPMG Real Estate Sentiment Index, 90% of survey respondents continue to rate central locations as having positive price potential. For this reason, we can expect continued high rental demand in the current economic environment and attractive returns compared to government bonds (see Chart 2). This applies to all types of use. For retail use, according to the CBRE, top locations continue to be highly sought after by national and international brands, particularly in the luxury segment. The same applies to catering: Central locations, where (office) workplaces are also located, are likely to continue to benefit.

**Chart 1: Market rent development responds to lower residential production**

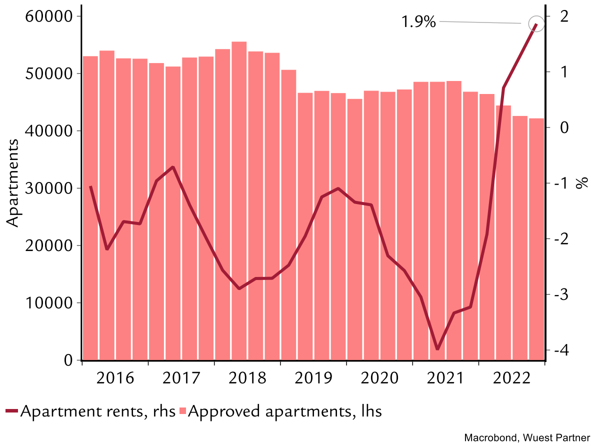
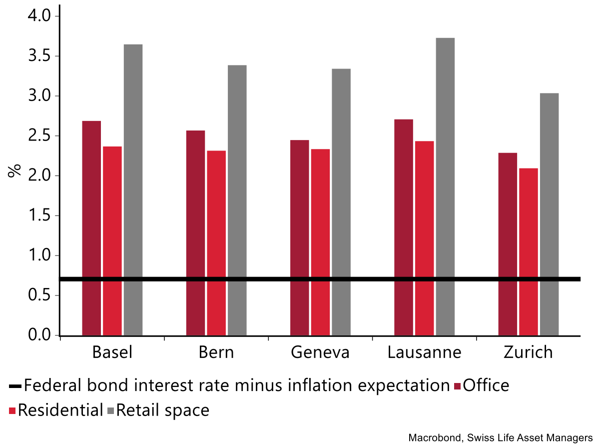



**Chart 2: Expected prime net return by sector, average for 2023 to 2026**




# Authors

**Swiss Life Asset Managers**

**Robert Kuert**
**Real Estate Research Analyst Switzerland**
robert.kuert@swisslife-am.com

**Marc Brütsch**
**Chief Economist**
marc.bruetsch@swisslife-am.com

**Francesca Boucard**
**Head Real Estate Research & Strategy**
francesca.boucard@swisslife-am.com

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