

Market Views

- Macroeconomics and the Commercial Real Estate Market

October 2022

Turbulent times

Macro Insights

Fear and uncertainty

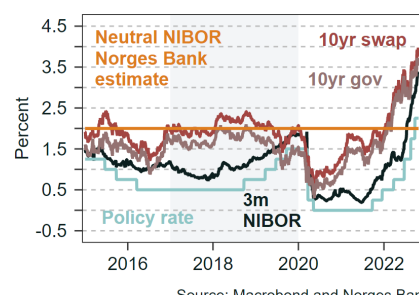
- Unexpectedly high inflation and increasingly aggressive central banks have caused a big jump in interest rate expectations. Fear and uncertainty have also made credit more expensive and less accessible.
- If interest rates peak this winter, there is hope that sentiment will soon lighten and investor activity increase – but it is not down to the central banks alone.
- It is reasonable to expect interest rates and credit spreads to eventually come down from their current levels, yet the new normal will still be higher than what we became used to during the pandemic. This means that the required rates of return on property and other assets will be higher.

Commercial Real Estate

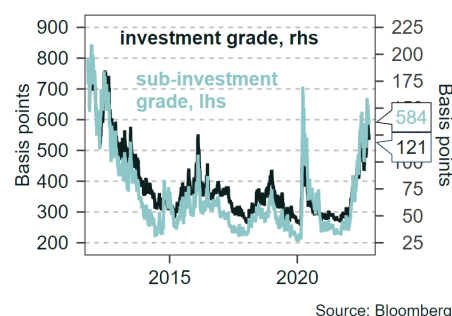
Diverging market views

- We estimate prime yield to be 3.75 per cent. Given the sharp rise in interest rates, yields are likely to increase further in the short term, although it is highly uncertain by how much. In the long term we expect to see prime yields in the range of 3.75–4.25 per cent, based on normal long-term interest rates.
- The transaction market has endured significant uncertainty and low liquidity with hesitance amongst investors. Volumes in the third quarter were 70 per cent down on the same period last year.
- We are seeing deep discrepancies in market views. This is reflected in a bigger gulf between buyers' and sellers' price expectations but also between buyers, with bidding processes this autumn involving a greater range of bids than previously.

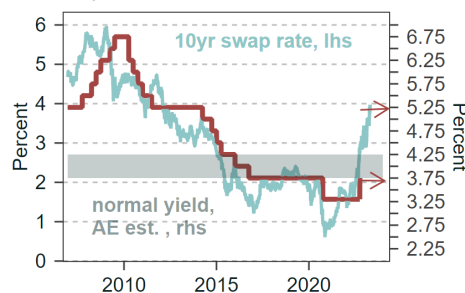
Significant rise in interest rates



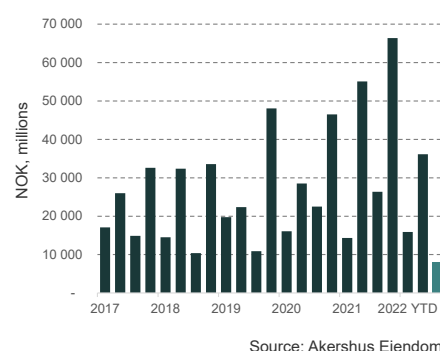
Strong increase in credit spreads



Prime yield at 3.75 percent



Low volume in the transaction market



Fear and uncertainty

The mood in the stock markets was buoyant at the start of the year, and the property market was positively buzzing. Market sentiment has shifted sharply in recent months, however, as unexpectedly high inflation has led to heightened interest rate expectations. Fear and uncertainty have made capital more expensive and less accessible. After a few happy weeks from the middle of July, the stock markets have once again seen sharp falls with property shares down some 40 per cent since the start of the year, according to the MSCI index. Increasingly aggressive central banks have led to further increases in long-term interest rates, and the Norwegian 10-year government bond yield is now 3.7 per cent, the highest since 2011.

A few months ago, the consensus forecast was that the Norway 10-year yield would fall to around 2 per cent over the next two years, but the expectation now is that it will remain above 3 per cent for two years. Yet even though the central banks are planning a further tightening of monetary policy, they are still predicting that interest rates are likely to peak relatively soon. If the Norwegian and US policy rates peak in the next few months, it could improve sentiment in the market, which could in turn encourage more investor activity.

Diverging market views

The transaction market is suffering from considerable uncertainty and low liquidity as a result of higher financing costs and enduring uncertainty around future interest rates. Volumes for the third quarter are 70 per cent lower than last year, and the average transaction value has fallen sharply. We are in the middle of a sharp interest rate hike where some of the increase has been priced into the property market, but not all. Transaction processes in recent months have revealed growing discrepancies between the buyer's and seller's price expectations. This has resulted in higher process risk than just a few quarters ago. There are also big discrepancies between market views, and significant changes in interest rate expectations in a

At least it has happened many times before that the stock market turns when there is a shift in monetary policy. Yet for fear to abate and sentiment to improve, it will probably also require a consensus on the future prospects for interest rates and corporate earnings – and it is not all down to the central banks.

Regardless of what happens in the very near future, it is also relevant to look at what constitutes normal interest rate levels. It is important to remember that the interest rates we have seen during the pandemic have been ultra-low and adapted for a pandemic economy. Rates in a normal situation will obviously be higher. This means that the required rates of return on property and other assets will be higher than they were during the pandemic. It is reasonable to expect interest rates and credit spreads to eventually come down from their current levels. Yet the sample space is big, and expectations have changed considerably in a short period of time. This has contributed to considerable uncertainty around the value of various assets and the downbeat mood in the markets. It may be that we are nearing a turning point and that market sentiment will soon lighten, but it is exceptionally difficult to predict what will happen next.

short space of time are making it difficult to put a value on commercial property. This is also reflected in this autumn's bidding processes, which have involved a greater bid range than previously.

The yields seen during the pandemic were driven by abnormally low interest rates in an historical perspective. As we see it, yields have begun to rise, and we expect prime yield to increase to 3.75 per cent. Given the sharp rise in interest rates, short-term yields are likely to increase a little more than that, although it is not at all clear by how much. In the long term we expect to see a "normal" prime yield, based on normal long-term interest rates, in the range of 3.75–4.25 per cent.

Fear and uncertainty

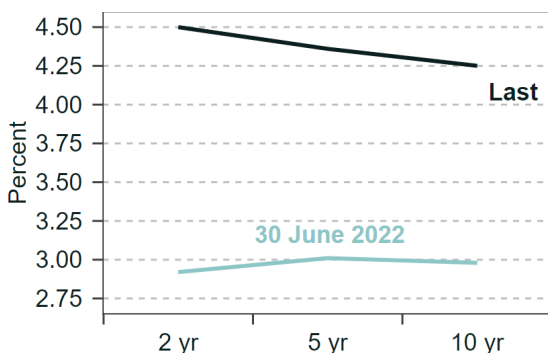
by Kari Due-Andresen, chief economist and head of research - Akershus Eiendom

Unexpectedly high inflation has led to heightened interest rate expectations in recent months. Fear and uncertainty are making capital more expensive and less accessible. We may be nearing a turning point where sentiment will begin to ease, but the road ahead is unusually difficult to map.

The current market

The mood in the stock markets was buoyant at the start of the year, and the property market was positively buzzing. That was then. The war in Ukraine and lockdowns in China sparked a shortage of goods and high inflation, which in turn led to increasing uncertainty and higher interest rates in the first half of the year. Yet activity in the property market remained relatively high until the summer. In the past few months, however, market sentiment has changed noticeably, and fear and uncertainty now prevail. Market interest rates have surged on almost all horizons both in Europe and the US, and the American yield curve has inverted, suggesting recession fears in the markets.

Figure 1: US: government yield curve

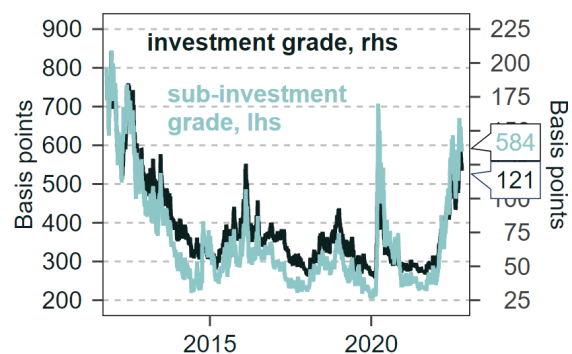


Source: Bloomberg

Volatility in the stock market has increased, and credit spreads in the European corporate bond

market have risen sharply while liquidity has dropped markedly.

Figure 2: Credit spreads, 5-yr generic CDS, Europe

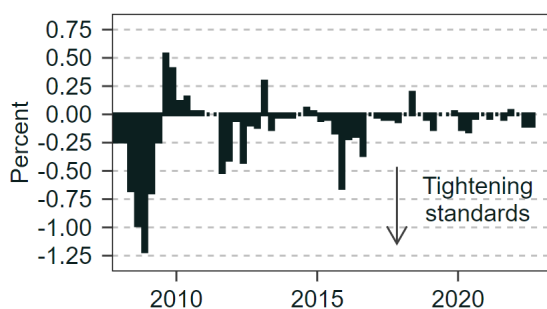


Source: Bloomberg

According to the central bank's lending survey for Q3, Norwegian banks have not yet changed corporate credit practices, but loan conditions have become stricter through higher equity requirements. Furthermore, banks plan to tighten credit conditions for commercial real estate companies over the coming three months. Historically, we have seen over time that banks tend to tighten their lending terms and credit practices in leaner times.

Figure 3: Credit standards, non-fin. companies

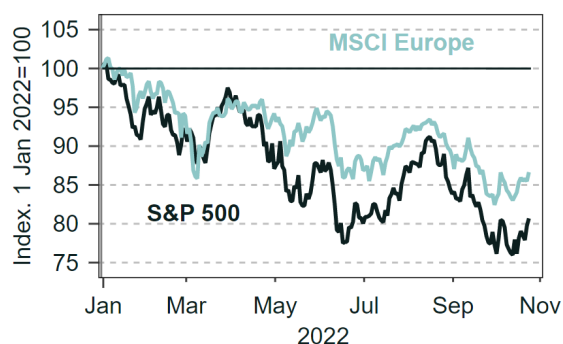
- Norges Bank Lending Survey



Source: Macrobond

Also, many property companies already claim that the banks are being more restrictive, and capital is more difficult to come by in many cases.

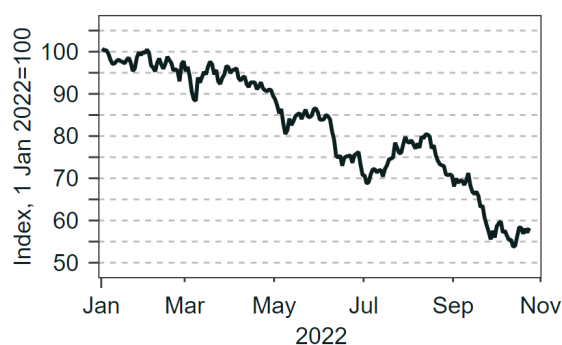
Figure 4: Total return (local currency)



Source: Bloomberg

After a few happy weeks from the middle of July, the stock markets have once again seen sharp falls with some 15 per cent being shaved off the MSCI share index this year. In the US, the S&P index has plunged by around 20 per cent since its peak at the start of the year. According to the MSCI index, European property shares have lost more than 40 per cent of their value since the beginning of 2022.

Figure 5: Europe, MSCI Real Estate

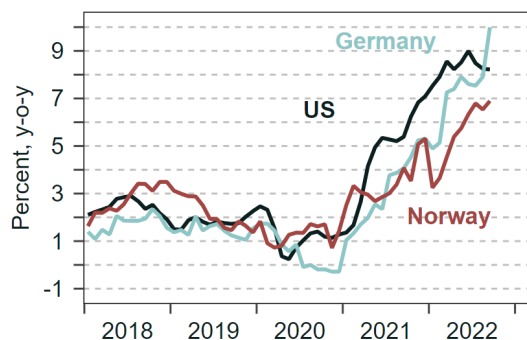


Source: Bloomberg

How did we get here?

What is behind this increase in interest rates and credit spreads and the sombre mood in the markets? It broadly boils down to even higher than expected inflation and increasingly aggressive central banks. Consumer prices have risen at a surprisingly high rate both in Europe and the US.

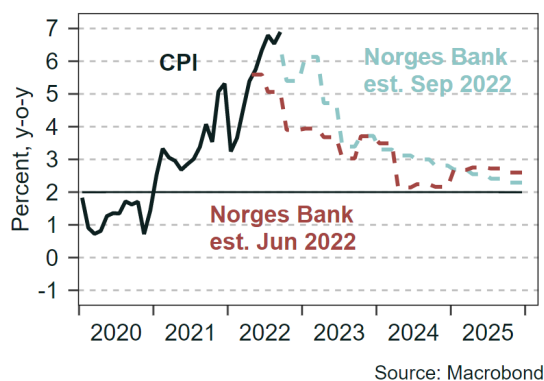
Figure 6: CPI: US, Germany and Norway



Source: Macrobond

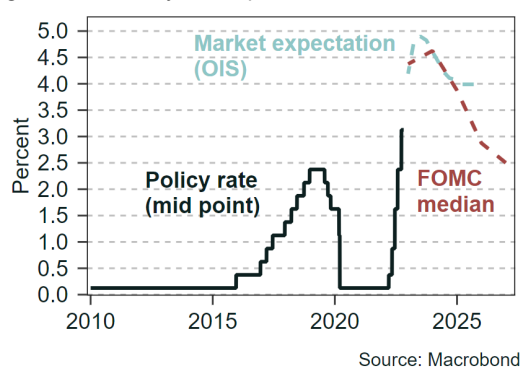
In Germany the 12-month CPI increase has reached double digits, while in the US inflation has been hovering just above 8 per cent. In Norway we expected inflation to peak in July, yet in September the CPI continued to climb to 6.9 per cent year on year. We have not seen consumer prices rise this much since the 1980s. Labour market figures have also been surprisingly strong both in Norway and the US in recent months. US wage growth stands at around 5 per cent year on year, making it one of the key drivers behind the rise in consumer prices. Given the relative robustness of the labour markets, it could take some time before we see additional available capacity, and it now appears that inflation will remain high for longer than previously expected. Norges Bank significantly upped its forecasts for both CPI and core inflation in September.

Figure 7: Norway: CPI, incl. Norges Bank fcst.



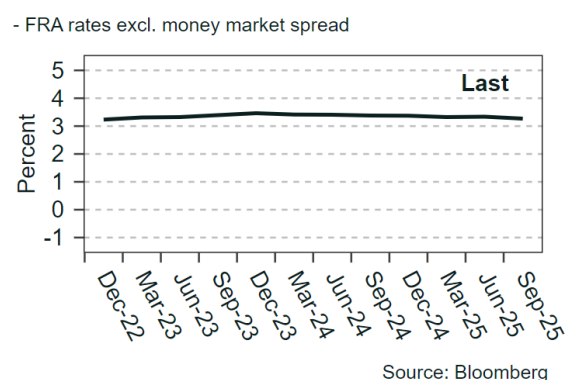
The prospect of higher inflation for longer is making the central banks more aggressive. In September the Federal Open Market Committee ramped up its federal funds rate projection for the coming years. The median forecast from the FOMC's members now implies that the US federal funds rate will peak at 4.6 per cent next year before slowly decreasing towards 2.5 per cent at the end of 2026.

Figure 8: US: Policy rate expectations



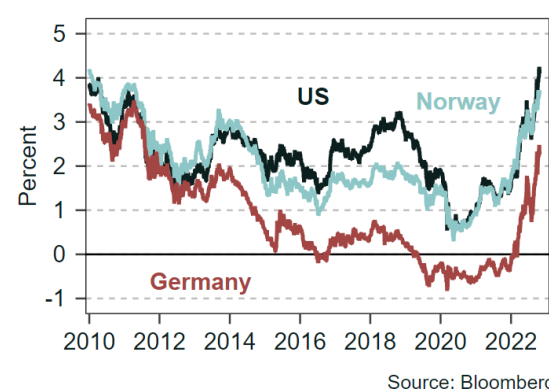
However, the market believes this to be an underestimate and expects the US rate to remain above 4 per cent for the next three years. Norway has also seen interest rate expectations climb in recent months. In September, Norges Bank announced that the policy rate will probably reach 3 per cent by Q1 next year before gradually falling towards 2.5 per cent by the end of 2025. Yet the market pricing suggests that the market is expecting even higher interest rates. FRA rates indicate that the policy rate will rise from its current level of 2.25 per cent to 3.25 per cent by the end of the year before remaining above 3 per cent for the next three years.

Figure 9: Norway: policy rate expectations



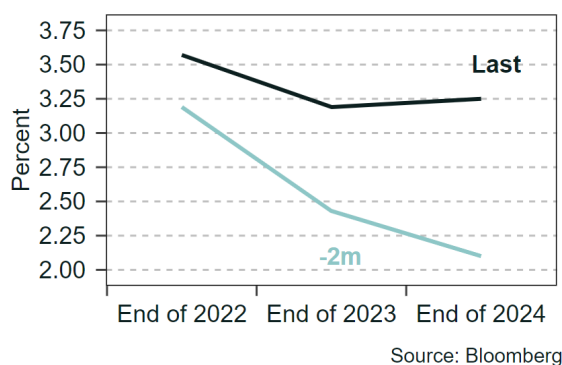
Long-term interest rates have also continued to climb in the past few months. These rates reflect how the economy is expected to perform in the long term. Technically speaking, the long-term interest rate could be broken down into a projected short-term rate in the coming years and a term premium. The term premium reflects the additional payment required by an investor for lending their assets for an extended period. Norwegian long-term interest rates such as the 10-year government bond rate mirror international interest rates, especially US rates, fairly closely.

Figure 10: 10-yr government rates



The Norwegian 10-year government bond rate is now 3.7 per cent, the highest since 2011. A few months ago, the consensus forecast was that the Norway 10-year yield would fall to around 2 per cent over the next two years. This projection has since been adjusted upwards, however. The consensus is now that the Norway 10-year yield will only fall moderately from its current level and remain above 3 per cent for the next three years. The main reason for this is that the central bank is expected to have to keep interest rates higher for longer.

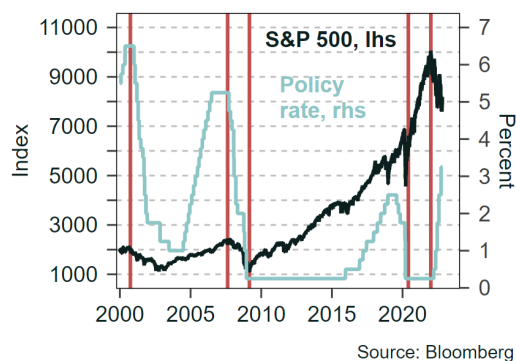
Figure 11: Norway 10-yr government rate, Bloomberg consensus



Future prospects

As mentioned above, central banks are planning a further tightening of monetary policy, although they are predicting that interest rates are likely to peak relatively soon. If policy rates in Norway and the US peak in a few months' time, then what? There may be reason to expect market sentiment to improve somewhat, which could in turn encourage more investor activity. At least it has happened many times before that the stock market turns when there is a shift in monetary policy.

Figure 12: Fed policy rate vs. S&P500



However, there have been varying reasons for the shifts in monetary policy and renewed fortunes for the stock market in the past two decades. Not one situation in the last twenty years resembles that which we currently find ourselves in. For fear to abate and sentiment to improve, it probably requires a consensus on the future prospects for interest rates and corporate earnings. So even if monetary policy changes, there is still a risk that market sentiment will remain sour, e.g. if the war in Ukraine were to take a new and even more serious turn. However, if sentiment lightens, it will

probably cause spreads in the credit market to contract and both the stock market and property market to ease up.

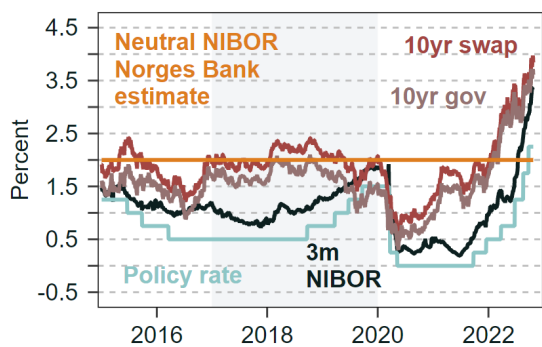
What it would then be reasonable to expect when it comes to financing costs is rather difficult to predict. Credit spreads in the period 2017–19 could serve as a guide, since that spell was considered fairly normal in the real economy both at home and abroad. If this is anything to go by, credit spreads would be slightly higher than last year, but in the case of European corporate bonds it would still represent a halving of the spreads from their current levels.

What will happen to market interest rates once policy rates have peaked? As we have already mentioned, both short and long-term market rates are expected to remain relatively high in the coming years. This, however, rests on the central banks' forecasts for a mild recession with stubbornly high inflation. If it turns out that the economy is unable to withstand the high interest rates as well as the central banks are predicting, and unemployment rises faster and inflation comes down as a result, we might see quicker interest rate cuts.

Regardless of what happens in the very near future, it is also relevant to look at what constitutes normal interest rate levels. It is important to remember that the interest rates we have seen during the pandemic have been ultra-low and adapted for a pandemic economy. Rates in a normal situation will obviously be higher. This means that the required rates of return on property and other assets will be higher than they were during the pandemic.

So, what constitutes normal interest rates? As previously mentioned, the Norwegian economy found itself in what we can describe as a fairly normal climate in the period 2017–19. Interest rate levels during this period can therefore serve as a reference.

Figure 13: Norway, interest rates



Source: Macrobond and Norges Bank

We could also take a look at various estimates to try to work out what constitutes normal interest rates for the Norwegian economy. Norges Bank recently calculated that a normal 3-month Nibor is likely to be around 2 per cent. The bank also estimates that a normal spread between the policy rate and 3-month interbank rate is probably in the region of 30 basis points, which implies a normal policy rate of around 1.7 per cent. A normal level for long-term interest rates can be determined by adding a term premium to

the short-term interest rate. The size of the term premium is more difficult to work out, however. In the period 2017–19 the average spread between the 3-month Nibor and the Norwegian 10-year government bond was 0.5 percentage points. Using this figure, a normal rate level for the government bond would be around 2.5 per cent.

It is reasonable to expect interest rates and credit spreads to eventually come down from their current levels. Yet the sample space is big, and expectations have changed considerably in a short period of time. This has contributed to considerable uncertainty around the value of various assets and the downbeat mood in the markets. It may be that we are approaching a turning point and that market sentiment will improve, but it is difficult to predict what will happen next.



Diverging market views

av Sindre Vesje Bråtebæk og Erik Mikael Johnsen - Akershus Eiendom

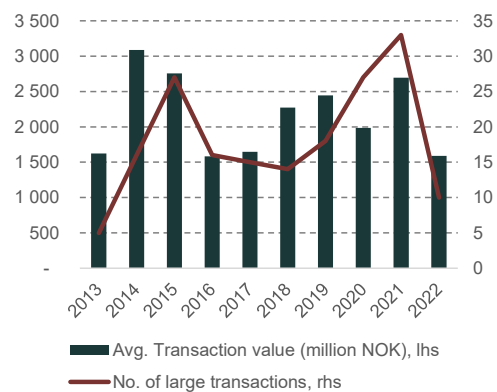
The transaction market has endured considerable uncertainty and reduced liquidity this autumn. We are in the middle of a sharp interest rate hike where some of the increase has already been priced into the property market, but not all. According to our observations, prime yield is currently 3.75 per cent with upward pressure. However, it is difficult to determine what the correct yield will be going forward. The concept of a “normal” yield, based on established, normal interest rates, can come to be especially important in an unpredictable interest rate market.

Low liquidity and conflicting market views

In June we began to see the contours of a challenging autumn ahead for commercial property sales. Inflation and interest rate prospects have worsened since then. Investors are now holding back, and liquidity in the market is lower as a result of higher financing costs and enduring uncertainty around future interest rates. Transaction volumes in the third quarter are likely to be around 70 per cent lower than in the same period last year. With almost as many transactions (72 in 2021 compared with 65 in 2022), the average transaction value was also considerably lower. This is partly due to there being fewer large transactions (above NOK 1 billion). In the year to date only ten NOK 1+ billion transactions have been recorded compared with 33 in all of last year. The combined value of the large transactions is also down from NOK 89 billion last year to NOK 15.9 billion this year. This represents a markedly lower average transaction value for the largest transactions than in previous years. The proportion of international

investors has fallen from 23 per cent peak last year to 9.9 per cent so far this year. The average international share of transactions was 18.7 per cent between 2017 and 2021.

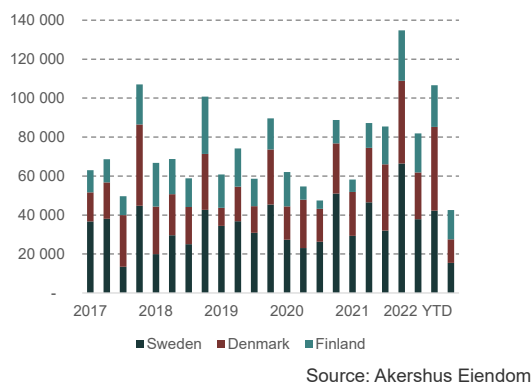
Figure 1: Fewer and smaller large transactions



Source: Akershus Eiendom

Transactions volumes in the other Nordic countries have also fallen, and even though sales were healthy in the first half of the year, the third quarter has been the weakest in several years.

Figure 2: Quarterly transaction volume in the Nordics, million NOK



Transaction processes in recent months have revealed growing discrepancies between the buyer's and seller's price expectations. This has resulted in drawn out transactions and significantly higher process risk than just a few quarters ago. Given the current volatile macroeconomic backdrop, it has proved difficult to determine exact market values. Not only does this often cause a gulf between buyer and seller; it also leads to disparate market views and valuations amongst buyers. This is reflected in the greater range in offers made this autumn compared with bidding processes before the summer. Major and rapid changes in interest rate expectations combined with unpredictable economic prospects make it difficult to put a value on commercial property.

Nervous credit market

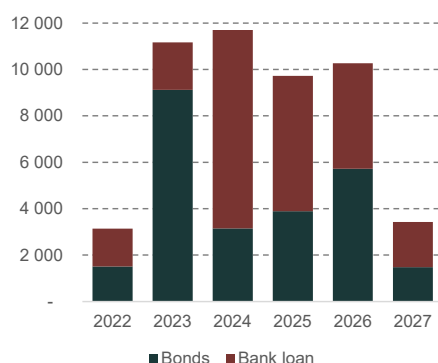
Norges Bank has imposed three double interest rate rises since June and has warned of further increases before rates are expected to peak some time this winter. Swap rates have increased by 190 basis points since the start of the year, and credit spreads in the bond market and the banks' risk premiums have risen sharply. In combination this is resulting in significantly higher financing costs for companies in need of external capital. Union's bank survey points at combined borrowing costs for new five-year bank loans of 6.08 per cent, of which the 5-year swap rate makes up around 3.6 percentage points. This means combined borrowing costs are now 232 basis points higher than in the fourth quarter of 2021. According to Norges

Bank's lending survey for the third quarter, the banks have not yet announced any changes to credit practices, but they have tightened the equity requirement. In the coming three months, the banks expect a certain tightening of credit standards for commercial property. The signals we receive from the market suggest the funding situation is demanding, and that some banks are perceived as closed for business, even to good and long-standing customers. Increasing yields and falling property values could make the banks even more restrictive when issuing new loans and refinancing in the times ahead. It is turning into a vicious circle, in other words.

The cost of bond finance has spiked over the course of the year, and liquidity in the bond market is now very poor. In Sweden credit spreads above the Stibor reference index have doubled – in some cases even tripled – for most property companies this year.

Within the commercial property market in the Nordics, there are NOK 700 billion in outstanding bonds, of which around NOK 80-100 billion mature each year. The limited Nordic banking market is not large enough to absorb these maturities, if the liquidity in the bond market does not return. In Norway, more than NOK 9 billion worth of commercial bonds held by the syndicates are due to reach maturity next year. This would not pose a problem in a normal market, but with a fall in property values because of increased yields and a stagnant bond market, it can potentially pose a refinancing risk. On the other hand, the bond market may have resumed normal service again by next year, despite higher interest rates. Liquidity may have returned and credit spreads come down markedly. What actually happens will largely depend on the prospects for interest rates and company earnings.

Figure 3: Maturing loans amongst syndication sponsors, NOK millions. Loans making up more than 20% of the property value



Source: Akershus Eiendom

Valuations in an uncertain market

It is easy to calculate an agreeable yield estimate at times of yield compression and high liquidity. The buyer meets or exceeds the seller's price expectations, and the sale is recorded as having been completed. When interest rates are rising and liquidity is low, it becomes an altogether more complicated exercise. Yield estimates must be based on a combination of close market monitoring, calculations based on prevailing interest rates, and knowing which transactions were never completed.

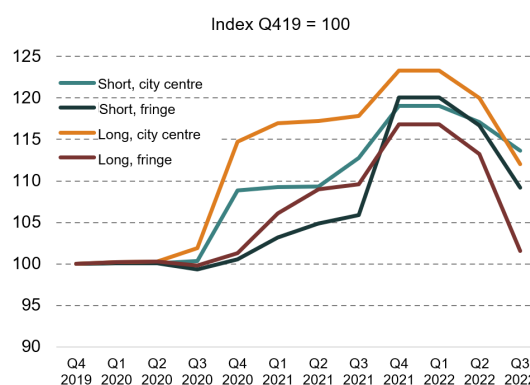
In light of the current market situation, especially the recent interest rate rises and financing costs, Akershus Eiendom has upped its prime yield forecast from 3.30 per cent to 3.75 per cent for the best office properties in Oslo. Yield forecasts for other property segments have also been raised:

- Office space Oslo fringes: 4.25% 4.75%
- Logistics: 4.25% 4.75%
- High street: 3.30% 3.75%
- Bergen: 4.00% 4.50%
- Stavanger: 4.25% 4.75%
- Trondheim: 4.25% 4.75%

Office Office rents in Oslo have soared along with rising interest rates. This has offset some of the falls in value during the autumn, albeit not everything. The impacts at the end of Q3, according to our valuation index, vary greatly.

Every property segment has fallen in value, but properties with short leases, especially in central Oslo, have seen the smallest value changes because of the sharp rent rises. According to our market parameters, central properties with short leases have lost 5 per cent of their value since the peak in Q1 2022. The value of properties with long leases along ring road 3, which are more sensitive to interest rate fluctuations, has fallen more sharply yet remains slightly above pre-pandemic levels. We are also seeing that properties in the value-add segment are particularly attractive. This could drive up value above and beyond the valuation index below:

Figure 4: AE valuation index as of October 2022



Source: Akershus Eiendom

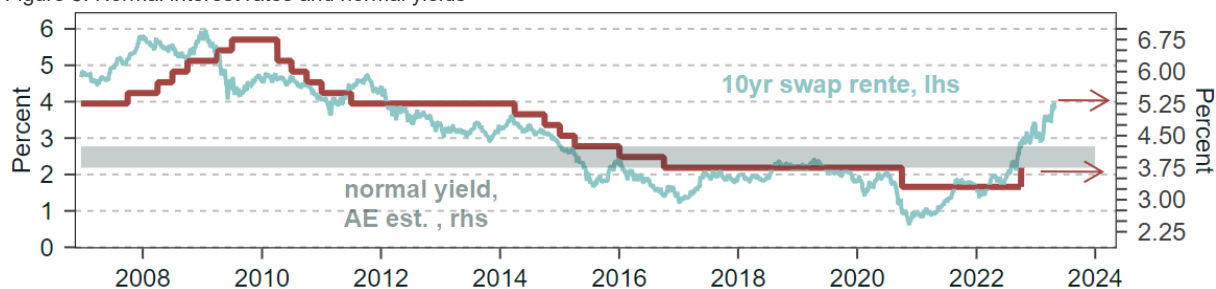
The big question is what happens next. The answer depends on the prospects for revenues and financing costs.

Normal interest rates and "normal" yields

We are in the middle of a sharp interest rate hike, where some of the increase is already reflected in property values, but not all. Over time we have seen strong covariance between long-term interest rates and yield on commercial property. In recent months, however, long-term rates have risen far more than yields. According to our observations, prime yield is currently 3.75 per cent. However, it is difficult to determine what the correct yield will be in the times ahead.

Based on historical covariance, the current 10-year swap rate is consistent with a prime yield of 5.25 per cent, all other things being equal.

Figure 5: Normal interest rates and normal yields



Source: Macrobond and Akershus Eiendom

Yet this does not mean that the yields will rise to these levels. Over time it would be reasonable to expect interest rates and yields to move in lockstep, but in the short term the correlation is far from 1:1, and covariance can fluctuate considerably. It is worth noting that the yields seen during the pandemic were unnaturally low as a result of unnaturally low interest rates. If we were to estimate a normal yield in the long term, we would need to look at what the levels were during more normal periods in the Norwegian economy. 2017–19 is one good example. Prime yield stood at 3.75 per cent in this period. Another approach is to look at what can be deemed normal interest rate levels and subsequently at what historical covariance suggests is a normal yield. As described in the macro section, Norges Bank estimates that a normal 3-month Nibor rate is around 2.0 per cent. On that basis, we can assume that a normal 10-year government bond rate would be around 2.5 per cent. Based on historical covariance between long-term interest rates and prime yield, a normal yield would thus be around 4.25 per cent. With this in mind, a normal yield would be somewhere between 3.75 per cent and 4.25 per cent in the longer term.

In the shorter term we expect the interest rate surge to cause yields to rise a bit further from their current levels. Given the turbulence in the markets and considerable uncertainty around the economic prospects, it is very difficult to estimate how much yields will rise and what would constitute a normal yield in the times ahead.

Rents, vacancies and yields - how will they affect valuations?

As well as the rent forecasts discussed previously, we also need to address the office analysis from last month's Market Views. In that analysis we describe very high demand for office space during 2022, including in the third quarter. Figures from Arealstatistikk show that we have to go back to 2012 to find similar volumes of new leases in the first quarters of the year. Market rents in Oslo have risen by up to 15 per cent, both in the city centre and in selected ring road 3 locations. The supply side in the office market is so tight that even with lower economic growth next year, we expect to see a slight increase in rents in the most central areas.

Expected rent increases have played an important part in many investment scenarios as interest rate trajectories began to steepen. By being confident about rent rises during the hold period, investors have been able to defend higher exit yields than entry yields. This is entirely in line with the interest rate forecasts over the past year. It has become increasingly difficult to predict both interest rates and general economic prospects in the past few months. Expected yield, vacancy rates and market rents all depend on the assumptions we make about factors such as employment, inflation and interest rates. The forecasts for all of these have changed significantly over a short period of time.

Next we will look at some of the parameters discussed earlier in the analysis and apply them in an imagined example as follows:

- Office property of a high standard in an area that could generate prime yield in Oslo
- Weighted average unexpired lease term (WAULT): 3 years
- Lease status: Fully leased. Leases signed in the past three years.
- Market rent (average): NOK 5,000

Figur 6: Sensitivity table

Office property Oslo city centre, 3 year WALT, contracts signed last three years, market rent NOK 5 000

	Market rent							
	-15 %	-10 %	-5 %	Current level	5 %	10 %	15 %	
3,25 %	99	104	110	115	121	126	132	Expected normal yield given normal interest rates
3,50 %	92	97	102	107	112	117	122	
3,75 %	86	91	95	100	105	110	114	
4,00 %	81	85	89	94	98	103	107	
4,25 %	76	80	84	88	93	97	101	
4,50 %	72	76	80	84	88	91	95	
4,75 %	68	72	76	79	83	87	90	
5,00 %	65	68	72	75	79	82	86	
5,25 %	62	65	68	72	75	78	82	

- With a further 5 per cent increase in market rent by the start of next year, the specimen property will see its value rise by 5 per cent.
- If yield increases from 3.75 per cent to 4.00, the value will fall by 6 per cent.
- A 50 bp yield increase will reduce the value by 12 per cent, and a rent increase of 15 per cent is needed to make up for it.

Conclusion

The transaction market is now unusually slow, burdened by high financing costs and much uncertainty about the future. There are often significant discrepancies between property valuations – not only between buyer and seller but also between bidders. Market psychology shows that no one wants to be the “first mover” in an uncertain market. The market may ease up this winter if interest rates peak and as market rents and vacancy rates begin to provide more clarity about earnings prospects.

In any case it is important to remember that the

yields seen during the pandemic were driven by abnormally low interest rates. As we see it, yields have begun to rise, and we expect prime yield to increase to 3.75 per cent. Given the sharp rise in interest rates, short-term yields are likely to increase a little more than that, although it is not at all clear by how much. In the long term we expect to see yields in the range of 3.75–4.25 per cent.

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