FINANCE
Incrementum AG

Staying Ahead in a Fast-Paced Environment

For this article, we were asked to elaborate on our view on the impact of rising interest rates on real estate investments. After a general introduction to current topics, we will outline what we consider critical factors for this popular asset class in the newly changed interest rate environment.

Article by
Stefan Kremeth
CO-FOUNDER & CEO,
INCREMENTUM AG

Article by
Dr. Christian Schärer
PORTFOLIO MANAGER,
INCREMENTUM AG

One year ago, when the war in Ukraine broke loose, energy prices soared, and financial markets crumbled. Interest rates went up and are still increasing. Stagflation was one of the keywords used excessively by the media and even by economists. Stagflation is a business cycle characterised by slow growth, high unemployment, and inflation. For economic policymakers, this combination is challenging to manage, as any attempt to correct one of the factors may aggravate another. However, one year later stagflation is still nowhere to be seen and as often, things develop differently than predicted by the masses; the term "stagflation" was sent back to sleep, at least for the time being and seems to have disappeared from the media altogether. Instead, today's buzzword is "soft landing".

We will see in what direction economies went in twelve or twenty-four months. However, we can learn from the old "Austrians" that *societies and economies with constantly unbalanced budgets and accompanying market interventions inevitably lead to a consistent misallocation of resources*. Over time, the loss of purchasing power due to a lack of budgetary discipline is significant and during the last twelve months, global economies suffered heavily from this effect. At times inflationary pressure can be pushed back on the timeline, but eventually, an outbreak is unavoidable. Therefore an investment strategy tailored to one's needs and which helps to diversify inflation makes enormous sense.

Balanced and cash-flow-producing strategies have proven resistant and shown impressive inflation diversification potential. Furthermore, those who can afford to invest in real estate and physical precious metals and want to add them to their portfolio can expect an additional diversification effect, maybe leading to lower volatility but not necessarily any better long-term performance.

MODERATION IS THE ORDER OF THE DAY

Volatility always seems to be an issue, and as inconvenient as it may seem for investors, volatility nevertheless represents an intrinsic part of investing, and any investor should know that. We usually tell our private clients that volatility is a price to pay for any consistent long-term performance. Now, many people would like to see a fully insured society with its economy in total equilibrium, which on top of everything- is tailored to the needs, fears, etc., of each individual. But unfortunately, this is not realistic. Just as we cannot always expect perfect solutions from science, we cannot expect our society, the state, monetary policy, individual politicians, fellow human beings, doctors, teachers, gurus, family members, friends, and acquaintances to always have the adequate and tailor-made solution ready to address the problems of each individual. How should that be possible? Economic cycles come and go, economic crises come and go, political cycles come and go, and political crises come and go. This

may seem unreasonable, out of date, exhausting and at times unfair, but it is nevertheless constantly the case that all sorts of crises affect our daily interactions. Societies and their financial markets are pretty complex systems, and complex systems are unfortunately not always fair or in balance.

> "SOCIETIES AND THEIR FINANCIAL MARKETS ARE PRETTY COMPLEX SYSTEMS, AND COMPLEX SYSTEMS ARE UNFORTUNATELY NOT ALWAYS FAIR OR IN BALANCE."

Even the best political system, economic theory, and investment approach have their limits and cannot answer all the questions, identify all the unknowns (hence the name) and take into account the complexities and interdependencies of politics, the macroeconomic environment, central bank policies and scientific innovation, to name but a few. Against this backdrop and for purely common sense reasons, it seems arbitrary to us to focus on one asset class, or even worse one single asset.

Karl Popper pointed out more than 80 years ago that science can never produce absolute truths but rather approaches the truth in constant processes (also thanks to trial and error), i.e. every theory is only considered 'good' until it can be replaced by a new, better and tested one. Now we all know that theories often leave out certain aspects; the developers of such theories deliberately limit themselves to core topics and usually do not claim to be all-encompassing. So when investing, we should keep that in mind and not expect the impossible from any investment or other theory.

After this introduction, let us focus on the main topic of this article- real estate and the impact of higher interest rates, opportunities and threats to this asset class.

Over the last few decades, real estate investments have enjoyed immense popularity against low or negative interest rates and steady economic growth. Prices knew only one direction - up. However, the newly changed interest rate landscape has also left its mark on the real estate market. The days of continuously rising valuations are over, at least for now. *Moderation is the order of the day.*

THE DISCOUNT RATE

Our thoughts relate to the market for investment property. For owner-occupied residential real estate, some arguments are less relevant because not only economic factors play a role in respective purchase decisions. Rising interest rates influence the performance of investment property in three ways. Firstly, raised financing costs and declining relative attractiveness due to higher yields on alternative investments (bonds) harm price levels.

In addition, *the discount rate is the most critical factor influencing the valuation of an existing real estate portfolio*. Real estate companies and pension funds use the discount rate to determine the present value of their portfolios. This rate is usually derived using models and is conceptually based on a risk-free interest rate (yield on long-term government bonds). In addition, the general real estate risk and property-specific surcharges are considered when determining the discount rate. *Steadily falling discount rates have been the main driver of rising valuations in recent years.* Accordingly, real estate portfolios have appreciated significantly. For example, the largest Swiss real estate company, "SPS", has recognised more than CHF 1 billion as income from revaluations since 2017. Therefore, the need for adjustment due to this newly changed interest rate landscape will likely not be insignificant. However, due to the inertia and long-term nature of the real estate market, *the impact of these adjustments will probably only become apparent over the coming years*. From an investor's perspective therefore, there is no reason to rush into investing in existing real estate portfolios.

EXCITING OPPORTUNITIES FOR DISCIPLINED INVESTORS

For real estate to become more attractive again from an investor's perspective, property yields must rise (significantly). This means that property prices must fall and/or rents must rise. Rents for space in commercial properties are determined by supply and demand. Here, both the economic environment and structural factors impact pricing. Because of current trends in the labour market (home office) and retail trade (online shopping vs stationary retail), *high-quality offers in central locations will likely remain in demand*. On the other hand, properties in geographically peripheral regions and properties of inferior quality will become significantly less attractive. As a result, the market will become increasingly differentiated again in the future.

Regarding investment strategy, the time for "buying and holding" is also over in the real estate market. An active strategy that focuses on quality and valuations seems more promising. It is essential to monitor current trends on the demand side. Structural changes are occurring due to demographics (immigration and urbanisation), the labour market (home office) and shopping habits (online vs stationary retail). This structural change is likely to accelerate further.

Nevertheless, selected real estate investments are to remain interesting. This is because they may offer a diversification contribution *and deliver significant cash flows based on a reasonable valuation*. This opens up exciting investment opportunities in the medium and long term for disciplined investors with experience who can handle investments in non-liquid asset classes. **EG**

For further information, please visit:
www.incrementum.li