Effect of Interest Rates on Real Estate

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Low interest rates creating a possible real estate bubble

In September 2019, the European Central Bank (ECB) was forced to lower rates further into negative territory to record lows, while simultaneously introducing fresh stimulus. These measures were initiated to overcome protracted weakness and sluggish inflation in the Eurozone. Consequently, the ECB had stated that interest rates would persist at lower levels for an extended period and that it would raise rates only after inflation reached “sufficiently close to, but below, 2 per cent”.

Over the past few years, interest rates across various countries / regions (especially in Europe) have fallen into an earlier unfathomable negative territory, leading to low mortgage rates on real estate. Given the inverse relationship between the interest rate and real estate market, the persistently low (and currently negative) interest rates have catalysed real estate valuations in Europe to elevated levels. In some European markets, valuations have reached close to or surpassed pre-debt crisis levels, raising concerns over an asset price bubble.

On the back of surging asset valuations, German real estate companies have borrowed heavily, issuing EUR 17 billion or almost half of the sector’s bonds in Europe in 2019. The debt-driven real estate sector in Germany poses a risk to asset valuations, in our view. Recently, Bundesbank, Germany’s central bank had stated that real estate in some of the country’s cities is overvalued. In September 2019, an arm of the ECB asked 11 countries to pursue regulations and tax measures to control asset prices and ensure affordable housing. With some European cities mulling rent controls and higher property taxes, we think increases in both, rental and valuations may be curtailed going forward.

The curious case of Japan

Any prolonged delay in the interest rate reversal may not pull the Eurozone out of low GDP growth trajectory, probably impacting long-term real estate market prospects as well. As a case in point, we look at how the real estate sector in Japan has fared in the past decade amidst tepid interest rates and sluggish GDP growth. We note that the real estate sector in Japan is tied to additional encumbrances such as weakening demographics, shorter duration of real estate investments, natural calamities and geopolitical risks.
Over the past decade, Japan has faced sluggish GDP growth rate and stagnating loan rates. However, since 2012 the policies of Japanese Prime Minister Shinzo Abe aimed at enhancing public infrastructure spending in a bid to boost the economy and inflation, have resulted in a surge in real estate prices. We do not believe these trends to be sustainable, given our expectations that weak economic growth and stagnating loan rates may impact the prospects of Japanese real estate in the long-term. Accordingly, prices are likely to revert to flat or negative trajectory over the long-term in the developed Asian country. Reflecting the real estate sector’s dependence on long-term economic growth, the persistently low interest rates may indicate a stagnating economy, thereby hurting real estate valuations.

**Are investors better off investing in bonds?**

Investors fear that failure to rapidly drive growth in the economy and inflation may force the ECB to retain rates at low levels, probably causing a real estate valuation bubble in key countries in the region. On the other hand, an eventual improvement in GDP growth and inflation would provide the ECB with leeway to raise rates. Although a rate raise may make rates more sustainable in the long-term, the central bank would risk impacting an already weak European economy in the near-term.

However, we reckon that the weaker-than-anticipated Eurozone inflation in February 2020 should put any potential move towards interest rate reversal in jeopardy. Moreover, the impact of weak economic growth and the eventual impact on inflation amidst the coronavirus (COVID-19) scare may deter the ECB from raising rates in the foreseeable future.
Given current circumstances, we reckon that such rate increases are farther away and only possible over the medium-to-long-term. Instead of large rate raises, the central bank may prefer marginal increases in rates, which would be more prudent for sustainable economic growth and real estate valuations.

The expansionary monetary policy adopted by the ECB, along with high demand for real estate in countries such as Germany is expected to drive cap-rate compression in some real estate sub-segments in those countries. In our view, the German real estate sub-segments such as office are likely to witness cap-rate compression; the positive momentum for property prices is likely to continue while a corresponding jump in rental income may not be as forthcoming. Given our expectations that interest rates are unlikely to grow significantly in the medium-term, we believe that bond yields in the country are likely to remain subdued as well. Moreover, with the economy unlikely to show any notable improvement in the near-term and with interest rates too remaining under pressure, we opine that any improvement in bond yields seems unlikely.

![Germany Prime Office Yield (%) and Yield Spread (bps)](chart)

With bond yields currently in negative territory, investors who desire consistently positive returns at relatively lower risk are likely to remain attracted to real estate rather than equity. Since real estate still offers positive yields of 2-3% in Germany, we reckon that a potential investor may be better off making investments in real estate, rather than investing in bonds or equity. Although yields have been decelerating, the largely rising yield spreads (vs. 10-year bond) have made real estate an attractive investment avenue.