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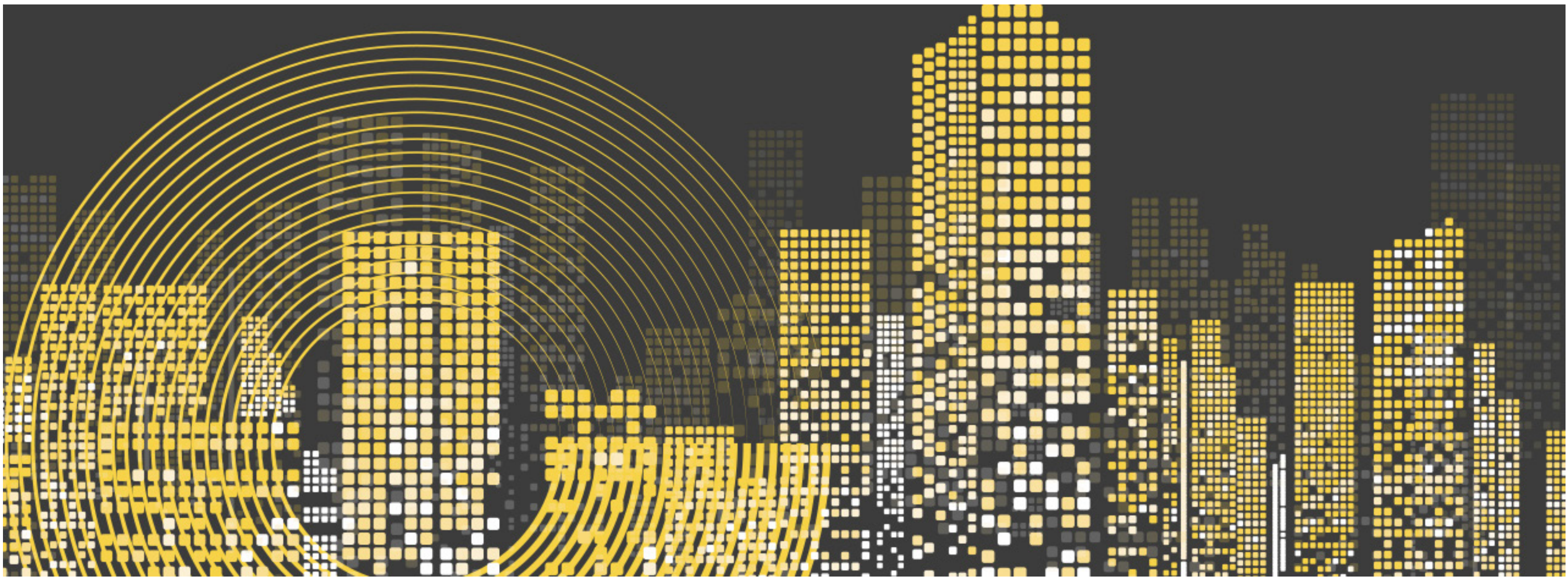

BF direkt
Unternehmensgruppe

No Sign of Softening Property Prices

Despite the deteriorating economic situation, the inflation keeps lingering on a high level. Prices in Germany increased by 7.5% in July when compared to the same period last year. Although there is mounting evidence that the price growth will gradually slow down in the months ahead, the ECB recently started to raise its key lending rates. Does that mean that long-term interest rates will keep going up and that terms of financing will become yet more restrictive in the real estate industry? Not necessarily, because it depends on what sort of expectations are already factored into the interest rates.

Lending rates for mortgage loans of medium- and long-term maturity have already gone up by about 2 percentage points since the beginning of the year, pushing those prospective buyers out of the market who are no longer able to shoulder financing arrangements as planned. However, the effects of the muted demand as well as the growing appeal of alternative fixed-interest asset classes have only had a modest impact on real estate prices so far. According to the price database of the Empirica consultancy firm, the growth of property prices may have slowed in the medium term; but there is no sign yet suggesting that property prices in Germany as a whole are softening. Among the primary reasons for the price stability are probably the persistently strong demand for housing and the rising construction costs.

Yet another calamity is already looming: With its key lending rate hike by 50 basis points on 21 July 2022, the ECB ushered in the end of its accommodative monetary policy. Market players expect to see another two interest increases and an ECB deposit rate of around 1% before the end of the year. The prospect of such a development is raising fears of a further deterioration of financing terms in the real estate sector. However, decisive for the trend in interest rates are not so much the measures taken by the central bank but primarily the expectations among market players. We need to bear in mind that interest rates already started to climb rapidly in the beginning of the year—long before the key rate increase—in response to the (anticipated) high rate of inflation. Inversely, key lending rate hikes do not necessarily imply that market interest rates will keep going up in sync.

The expectations of market players actually tell a different story: While short-term interest rates have continued to go up, long-term interest has been declining for several weeks. For instance, the yield on 10-year German government bonds dropped from nearly 1.8% in mid-June to 0.8% at the last count. The rates reflect the expectations that prices will keep soaring in the near term and necessitate key lending rate hikes. They contrast with the apparent expectation of slower inflation rates and a less restrictive ECB policy in the longer term.

The implicit inflation expectations manifest on the bond market are matched by signs that the inflation is likely to slow in the medium and long term. However, the inflation expectations of private households—especially in Germany—have noticeably increased lately. In June, the inflation average expected for the next five years went up from 5.3% to 5.4%.

Interest Rate Development

The 10-year interest rate swap, having stood at 2.22 percent at the beginning of the month, declined to 1.76 percent over the course of July. This means long-term interest rates were about fifty basis points lower than the previous month. By contrast, short-term interest rates jumped up during July. The 6-month Euribor rose from 0.238 to 0.631 percent. Analogously, the 3-month Euribor increased from -0.176 to 0.238 percent.

Outlook

If, despite all obstacles such as a looming recession or intolerable risk mark-ups on government bonds of countries like Italy, the ECB were to opt for a swift and resolute tightening of its monetary policy in the coming months, it could curb even the inflation expectations among private households. In this case, yield rates at the long end of the interest curve would be unlikely to exceed recent high-water marks. It could prolong the trend of slowly declining long-term interest rates in the eurozone, and thereby improve the terms of financing for real estate loans while reviving demand for real estate. Our conclusion: Despite the interest rate reversal, there is no sign for a trend reversal in the real estate sector that would include softening property prices!