Movement on the mortgage market

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Dear readers

Change is the only constant. The Greek philosopher Heraclitus expounded on this in ancient times. But it is increasingly also true for the real estate and mortgage markets, where digitalization is providing fresh impetus. Nearly two dozen providers now have mortgage products that can be processed partially or wholly online. Applications of digital technologies are also shaking up the structure of the mortgage market. More and more, individual credit processing steps are being unbundled, making them easier to outsource. This creates market potential for both new and established providers. After all, thanks to the era of low interest rates, mortgages have also become interesting for investors, who may not possess the necessary processing capacities and would prefer to use those of a third party. At the same time, stricter bank regulations mean that established mortgage lenders are aiming to reduce their balance sheets, and seeking third-party investors (page 7).

Change is also affecting the factor with the greatest impact on the mortgage market, namely interest rates. The phase of ultra-low interest rates is drawing to a close. This raises the question: what is the optimal hedging strategy? Since this question can only be addressed in a close examination of each mortgage borrower’s individual financial situation, there is no across-the-board answer. Nonetheless, there are guides to help determine the right individual strategy. One such aid is a comparison of long-term Fix mortgages with a hypothetical trend in money-market mortgages, that would ensure that both variants generate the same interest costs. Given this specific interest-rate development for money-market mortgages, borrowers can easily determine whether they anticipate higher interest rates and would thus be better off with hedging (page 9).

Although – or perhaps precisely because – the long phase of falling interest rates is ending, real estate continues to be in high demand. This applies specifically to the year 2018. The necessity of finding alternatives to bond investments, which barely yield a positive return in the current environment, should be most acute this year. Accordingly, we expect demand for real estate to remain high, despite the advanced stage of the property market cycle, and we foresee ongoing growth in prices as well as brisk construction activity. This development results in rising vacancies and a need to align the supply as closely as possible to demand. Our analysis of the three-room apartments currently under development (page 12) reveals that this process is not always optimal, and that it makes little sense to blindly copy the behavior of other investors.

On behalf of our authors, I hope you find our publication informative and inspiring.

Fredy Hasenmaile
Head Real Estate Economics
Mortgage volumes: Decelerating momentum
Switzerland has one of the world’s highest debt ratios for private households. It is particularly worrisome that the figure is continuously increasing. Lately, however, the growth rate of the debt ratio has been below average.

Mortgage market: Digitalization provides fresh impetus
Mortgage lending in Switzerland remains largely in the hands of banks. However, digitalization and the environment of negative interest rates have produced a growing number of new and innovative market players in recent years.

Mortgage loans: Spoiled for choice
Now that mortgage rates have begun to inch upwards again, mortgage borrowers should be thinking proactively about their interest-rate strategy. Besides financial considerations, personal needs and preferences play a decisive role.

Owner-occupied housing

Rental apartments: Neither one nor the other
Smaller apartments are the focus of investor interest. In particular, apartments with three rooms are favored by planners and developers. However, the apartment size that is widely considered the golden mean may not be the perfect solution after all.

Commercial real estate

Real estate investments
Switzerland has one of the world’s highest debt ratios for private households. It is particularly worrisome that the figure is continuously increasing. Lately, however, the growth rate of the debt ratio has been below average.

The level of debt carried by Swiss households has been a concern for some time now. In an international comparison of gross household debt relative to gross domestic product (GDP), Switzerland regularly tops the rankings – along with Australia, Canada, Norway and Sweden. In all of these countries, mortgage debt, which makes up 75%–97% of total private household debt, is responsible for this situation. So a certain amount of apprehension is justified. International analysis shows that long phases of unusually generous bank lending are often followed by major crises. A high level of indebtedness increases an economy’s vulnerability to market distortions such as stress in the banking system or a severe collapse in consumption. Switzerland had its own uncomfortable experience with a real estate and banking crisis in the 1990s. Borrowing is generally conducive to long-term GDP growth, but only up to a certain level of debt, after which the relationship inverts.\(^1\) With a total mortgage debt ratio corresponding to 146% of GDP, Switzerland is already well beyond that threshold.

The steep growth in mortgage debt has to do with certain characteristics of the Swiss market. These include high prices for real estate, the great significance of the rental apartment market, half of which is owned by private individuals, as well as the local tax system, which provides incentives for indebtedness. When the owner-occupied housing market threatened to overheat between 2010 and 2012, politicians reacted by tightening regulation. The federal regulator FINMA raised capital adequacy requirements and the Swiss National Bank introduced an anti-cyclical capital buffer. Another particularly effective brake on growth in mortgage borrowing was the intensification of self-regulation by the banks. The self-regulation measures that were introduced in summer 2012 and heightened in autumn 2014 tangibly reduced the number of households that could overcome the financing hurdles for homeownership. Since then, annual growth in mortgage volumes for private households (cf. Fig. 1) has halved from more than 5% at the beginning of 2012 to 2.57% by the end of 2017.

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\(^1\) See research by Cecchetti and Kharroubi (2012), Arcand et al (2015) and the International Monetary Fund (2017)
This puts nominal growth in mortgage volumes well below the long-term average of 5.36% since 1987. Growth has decelerated due to not only higher capital requirements, but also the tougher amortization guidelines, which aim for a more rapid reduction in the loan-to-value ratio to two-thirds of the collateral value.

In addition to mortgage volumes for private individuals, there are also those for companies, although these make up just one quarter of all outstanding mortgages. In total, the mortgage volumes on banks’ books are likely to exceed CHF 1 trillion by the end of 2018. Despite the reduced momentum in mortgages, the debt ratio, which compares mortgage debt to domestic value creation as measured by GDP, has continued to rise. In some circles, this fact has been repeatedly criticized, with reference to the above-mentioned risks. However, it is no new phenomenon for mortgage volumes to outpace value creation as measured by GDP – this has been the case since 1975 (cf. Fig. 2). In the meantime, mortgages as a percentage of GDP have risen continuously, from 47% to 146%. Determining the level where the debt ratio is still unproblematic and where it tips to become threatening is no simple task. For example, in Switzerland, unlike the other countries with high levels of private household debt, most mortgages have fixed interest rates, which considerably reduces exposure to interest-rate risk.

One possibly relevant measure is trend growth. From an absolute perspective, growth in mortgage volumes is well below the long-term average in both nominal (cf. Fig. 1) and real terms (cf. Fig. 2). Absent some context with economic activity, however, the absolute growth rates are not particularly meaningful. This is why it’s worth taking a look at the debt ratio. It has also been in a rising trend since the mid-1970s: each year, the debt ratio has increased by an average of 2.3 percentage points. Contrary to expectations, the rise in the debt ratio in recent years has exceeded this long-term average, despite reduced growth in mortgage volumes. This was a byproduct of weak economic development. Last year was the first time trend growth in the debt ratio slipped back below the average. This is likely to be the case more often in the future, since the gradual return to increasing mortgage rates is likely to be a serious brake on growth in mortgage volumes and thus aid in limiting the danger of an explosion in credit volumes.
Mortgage market

Digitalization provides fresh impetus

Mortgage lending in Switzerland remains largely in the hands of banks. However, digitalization and the environment of negative interest rates have produced a growing number of new and innovative market players in recent years.

Traditionally, mortgage credit in Switzerland is handled mainly by banks. At the end of 2017, Swiss banks had outstanding mortgage volumes of CHF 973.9 billion. But insurance companies and pension funds are also active in this market. With respective volumes of CHF 36.7 billion (insurance companies, as at 2016) and CHF 14.4 billion (pension funds, as at 2016), however, these are only niche players compared to banks, with market share of just 5.1% at the end of 2016.

There are various factors responsible for the low profile of insurance companies and pension funds in this business. One is that issuing mortgages involves a great deal of administrative effort, for example in risk assessment and processing. For many years, issuing mortgages was not an attractive business below a certain minimum amount, especially for smaller and mid-sized pension funds. Only in the recent environment of low interest rates have insurance companies and pension funds rediscovered the mortgage market, from which they had steadily distanced themselves in the past. In the hunt for yield, investors increasingly appreciate mortgages as an attractive alternative to bonds. While insurance companies had already jumped on the bandwagon in 2014 (cf. Fig. 3), it took pension funds a little longer. Currently, both types of niche providers are reporting significantly higher growth rates than the banks.

Over the last few years, digitalization has brought fresh impetus to the Swiss mortgage market. For one thing, traditional providers began to digitalize their processes, allowing for faster and more efficient progress along the entire mortgage chain. In addition, digital transparency meant that customer segments outside the usual market could suddenly be reached. Accordingly, competition among traditional providers has risen. At the same time, the advance of digitalization opens doors for new players in the market, which is particularly evident in the fast-growing brokerage business. Besides traditional brokers, such as architects and real-estate promoters, there are now digital platforms that serve the same purpose. Some of these come from existing providers, such as online real-estate marketplaces or associations, but some are young, innovative start-ups. The result: a rapid increase in online mortgage volumes to CHF 4 billion last year (as estimated by the Institute of Financial Services Zug IFZ of the Lucerne University of Applied Sciences and Arts, cf. Fig. 4), as well as forced greater transparency among the established providers, that are more likely to collaborate with, and in some cases, acquire a stake in, such brokers today. However, new providers do not only concentrate on brokerage, but find their way into new niches too. One example is crowd-lending, where many (small) investors take on the role of lender; another is brokering secondary mortgages in a peer-to-peer approach.

Given the advance of digitalization and the intensifying competition, established providers are under growing pressure to optimize and expand their business models. As a result, even traditional providers are acting as brokers, for example by bundling mortgage receivables and selling them to third parties. Pfandbrief instruments have provided this type of securitization for decades. In recent years, however, larger banks have begun approaching investors directly. Along the lines of a division of labor, they offer their processing competences to third parties and connect owners of investment properties directly with investors. This development has been encouraged by the stricter liquidity and equity regulations forcing banks to offload credit volumes from their balance sheets and develop new business models.
New investment vehicles with specialized providers

Given the increased broker activities and as a result of heightened investor interest in mortgages, new offers have emerged such as investment vehicles with mortgage loans. Besides traditional mortgage providers, who bring their extensive know-how in risk assessment, object valuation, and processing, there are also new players in the market, who offer outsourcing services. Today, there are already providers who allow investors such as mid-sized pension funds to offer mortgages themselves through “white labeling”. However, the entire lending process is handled by the specialized broker, who remains in the background. So the process of issuing mortgages is likely to become even more standardized and automated in the future – with the goal of being able to detach the entire process chain quickly and simply as required.

Opportunities and risks when unbundling traditional mortgage services

This development presents both opportunities and risks to traditional mortgage providers. On the one hand, they have well established teams and processes so that they can efficiently offer services such as risk management and administration. This makes it attractive for traditional players to complement their range of services with such “white labeling” opportunities. However, in this constellation, Corporate Governance must exercise particular prudence, so that misguided incentives do not arise. This applies to both traditional as well as pure outsourcing service providers. For example, it is intended that investors themselves will be able to select mortgages from a pool, or that the bank will continue to participate in the credit risk by having its own tranche. On the other hand, the current developments heighten the risk of greater competitive pressure. If the division of labor in mortgage processing continues, competition in the individual process steps is likely to increase. This is because the barriers to entry are considerably lower for individual process steps than they are for the entire process chain from advisory services to risk assessment to refinancing. Moreover, there is a risk for new providers that many investors may turn to other asset classes once mortgage rates rise in a lasting way. Then it will be evident which of these new ideas and products will succeed over the long term.

Regulation makes for stable markets

The changing credit environment also raises regulatory questions. Over the last few years, close discussions with regulator FINMA have resulted in banks agreeing to strict self-regulation. One objective of this move is to prevent speculative exaggeration with its far-reaching consequences, such as those observed in the USA during the sub-prime crisis. As an increasing number of providers emerge, the question arises whether and in what form the new players will have to adopt the existing self-regulatory measures.

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**Fig. 3: Niche players make a comeback**
Nominal growth in mortgage volumes with the major provider groups

**Fig. 4: Online mortgage volumes, 2013–2017**
Volumes in CHF m (2017: estimate)

Source: SNB, Swiss Financial Market Supervisory Authority FINMA, Swiss Federal Statistical Office (SFSO), Credit Suisse

Source: e-foresight, Institute of Financial Services Zug IFZ
Mortgage loans

Spoiled for choice

Now that mortgage rates have begun to inch upwards again, mortgage borrowers should be thinking proactively about their interest-rate strategy. Besides financial considerations, personal needs and preferences play a decisive role.

The Swiss economy is humming along again. We forecast economic growth of 2.2% for the full year. The most important growth driver is the dynamic world economy. Moreover, the softening of the Swiss franc against the euro has provided a substantial tailwind for Swiss companies. And inflation has been benign so far too. Long term though, the Swiss National Bank expects inflation to rise above its target, suggesting that tighter monetary policy is ahead. As long as the economic situation in the euro area does not deteriorate unexpectedly, we forecast an initial increase in Swiss benchmark rates from –0.75% to –0.50% in March 2019.

Since the Libor rate will stay in negative terrain after an increase of this size, interest rates on Flex-rollover mortgages are unlikely to rise in the next 12 months, but should stay at their ultra-low levels. In contrast, we expect interest rates on Fix mortgages with medium and long maturities to rise by another 30–50 basis points in total over the next 12 months (cf. Fig. 5). As in the past, the further track will be marked with both upward and downward volatility.

Even if interest rates on Fix mortgages stay low in historical context, despite a rising trend, mortgage borrowers should take time to consider whether a Libor mortgage or a Fix mortgage makes more sense in the years ahead. A historical comparison shows that with few exceptions, Fix mortgages are more expensive than Libor mortgages over the entire term of the loan. For example, a 5-year Fix mortgage was only cheaper than a Libor mortgage between 1986 and the end of 1989, and again briefly in 2004 and 2005 (cf. Fig. 6). A 10-year Fix mortgage would also have been the better choice at the end of the 1980s though not in 2004 and 2005. So from a purely financial perspective, a Fix mortgage only makes sense at a few particular times, and even then the right maturity must be selected.

Nonetheless, there is some justification for Fix mortgages. The trend at the end of the 1980s illustrates this amply. Borrowers with a variable-rate mortgage, at that time the most common product, were confronted with a rapid and massive increase in interest rates of nearly 8%. So variable and Libor mortgages always come with the risk of substantial volatility in interest rates. Not every borrower wants to, or can, financially handle such sudden and sharp increases, to say nothing of the nerve-wracking stress that such a burden brings with it. In this respect, Fix mort-
gages can act like a kind of insurance, offering protection from financial stress in exchange for a premium.

Today’s situation, in which the premium for a 10-year hedge is historically low, it could certainly make sense to switch temporarily into a Fix mortgage. As part of a break-even analysis, we observed to what extent Libor mortgage rates would have to rise in order to make a Fix mortgage with a term of ten years the cheaper financial option (cf. Fig. 7). If Libor mortgages rise earlier or higher, or fall later, than depicted in the chart below (indicating a stronger economic recovery and/or higher inflation), choosing a 10-year Fix mortgage would be the better strategy. In contrast, if Libor mortgages increase later or slower, or fall earlier, than depicted in the chart (indicating a weaker economic recovery and/or inflation), then a Libor mortgage would be the better choice over the next ten years. Depending on their own assessment of interest-rate developments, mortgage borrowers can decide for themselves, based on this comparison, which strategy is best suited to their needs.

In the current environment, any switch into a Fix mortgage should not be postponed too far into the future. Interest rates on Libor mortgages should remain at their very low levels for some time to come, because only when benchmark rates break above zero will this work through to higher rates on Libor mortgages. Meanwhile, however, interest rates on Fix mortgages will continue to rise (cf. Fig. 8). At the beginning of May 2018, the difference between a Libor mortgage (3-month Libor) and a 10-year Fix mortgage was just 0.57 percentage points, very low from a historical perspective. Our current forecasts suggest that this spread will widen to 0.93 percentage points by April 2019. If Libor mortgages subsequently rise, as our scenario suggests they will in spring 2020, the spread to 10-year Fix mortgages would widen further to 1.43 percentage points. So if borrowers wait too long to change products, the risk increases that the original savings from staying in a Libor mortgage will be wiped out by the following higher interest rate on Fix mortgages.

Since the choice of a mortgage depends not only upon financial aspects, but also upon the borrower’s specific personal needs and preferences, it is vital to review these personal requirements and needs with a mortgage specialist. In the current environment, and given the uncertainties surrounding the future course of interest rates, it makes sense to combine various mortgages and terms in order to optimize the mix of security and flexibility.

Does a Fix mortgage make sense today?

If opting for a product change, don’t wait too long

The optimal combination of security and flexibility

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**Fig. 7: Many reasons to choose a fix mortgage at present**

Break-even scenario, in which the cost of a Libor mortgage is equal to that of a newly signed 10-year Fix mortgage

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**Fig. 8: Planning a switch to Fix? Don’t wait too long**

Spread 10-year Fix mortgage to Libor mortgage; 05/2018 – 04/2019: Credit Suisse forecast; from May 2019: scenario

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Source: Credit Suisse
Owner-occupied housing

Demand somewhat cooler but still high

Demand for condominiums and single-family dwellings has leveled off since the beginning of the year. This is probably due to the gradual rise in interest rates on Fix mortgages as well as the recent increase in prices for owner-occupied housing. Higher prices narrow the field of potential buyers due to the tougher imputed financing requirements. Compared to previous years, however, demand remains at a high level. Thanks to economic acceleration and mortgage rates that are still very low in a historical context, demand should remain strong over the course of the year.

Project pipeline remains sparse

The number of building permits issued for owner-occupied housing units has fallen further year-on-year. Over the last 12 months, permits to build nearly 14'200 condominiums (~2.0%) and 7300 single-family homes (~7.4%) were issued. In both segments, the increase in the supply has been well below the average since 2002. For condominiums, at least, the number of building permits has stabilized over the last half year. Nonetheless, this is unlikely to work through to the number of finished objects before 2019. Hence the supply of new condominiums remains below current potential demand.

Solid growth in prices for owner-occupied housing

Prices for owner-occupied housing stagnated in the first quarter of 2018. Compared to the previous year’s quarter, however, they show a solid plus of 3.6% for condominiums and 2.7% for single-family dwellings. The revived price momentum thus remains below the average rate of price growth since 2000. Prices rose most sharply around Zurich as well as in the catchment areas of Lucerne, Basel, Bern and Lausanne. Thanks to healthy economic conditions, ongoing low mortgage rates and a decline in new building activity, we expect prices to continue to head north in the coming quarters. Nonetheless, the pace is likely to be somewhat slower than in the recent past.
Rental apartments

Neither one nor the other

Smaller apartments are the focus of investor interest. In particular, apartments with three rooms are favored by planners and developers. However, the apartment size that is widely considered the golden mean may not be the perfect solution after all.

Once, there was eager demand for whatever was built in the rental apartment market; those days are gone. Rising vacancies testify to a growing oversupply. So investors are making efforts to better align the supply of apartments to the market and current tenant needs. Given the generally acknowledged trend towards smaller households, investors had shifted their focus to smaller apartments, as evidenced in a construction emphasis on two- and three-room apartments (cf. Fig. 13). Since 2013, the number of smaller housing units brought to market has increased steadily, and accelerated further in 2015. Most investors lack the courage to deliberately break away from established patterns and reconsider the current focus on three- and four-room apartments. However, since they still want to offer smaller apartments, they are increasingly concentrating on three-room flats since this appears to be a good compromise.

As production of rental apartments remains at a very high level, there are many three-room flats currently under construction. In purely numerical terms, the three-room has overtaken the four-room as the most-produced apartment size. More than 30% of new objects are currently three-room flats. However, this may be near the limit. In the belief that three-room apartments can meet the needs of small households as well as households of several persons, many planners and developers began to orient their projects towards this apartment size.

But is an apartment with three rooms really the ideal solution? Isn’t it rather the case that this apartment size does not meet the needs of a family seeking a roomy home, nor the desire of a young couple to rent a flat for the most affordable price? Wouldn’t a mix of two- and four-room apartments be a better alternative? Or perhaps a strict focus on small apartments with one and two rooms in the major agglomerations? After all, for a family with two children, a three-room apartment is generally one room too small, and for small households, such a flat is often too expensive, especially in urban areas where prices are high.

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**Fig. 12: Highest vacancies reported in three-room flats**

Vacancy rates by number of rooms (rented and owned)

![Vacancy rates by number of rooms](https://example.com/vacancyRates.png)

**Fig. 13: Construction activity shifts to small apartments**

Net increase by number of rooms, 2010 – 2015

![Construction activity shifts to small apartments](https://example.com/constructionActivity.png)

Source: SFSO, Credit Suisse
When considering how many three-room apartments may be needed, developers seem to be consistently over-estimating the market’s absorptive capacity. Three-room flats are not moving as well on the rental market as one could wish. Not only are vacancies highest for this category, they are also increasing most rapidly (cf. Fig. 12).

In 2016, apartments with three rooms already had the highest vacancy rate. Last year, the vacancy rate rose to 1.76%, further widening the gap to the average vacancy rate for all sizes of apartments, which stands at 1.44%. A reversal of this trend is nowhere in sight. A sample of some 3000 rental apartments under construction reveals that the share of three-room apartments here is 39%, even higher than the percentage of recently finished objects. An increasing number of investors are apparently betting on this apartment size and have not yet noticed the problems in finding tenants. Outside major centers, in particular, three-room flats function less well. In institutional investor portfolios, these apartments cause the greatest shortfall of rental income outside the major cities. Difficulties in renting these flats are also becoming more obvious in marketing efforts. In virtually all of the construction projects in our sample, the occupancy rate was lowest among three-room apartments – and usually by a wide margin. Rising vacancies in flats with three rooms are thus inevitable, even though smaller apartments would be expected to move more quickly. In contrast, the two-room flats, which were the second most common size in the sample, are doing well on the market. So real estate investors would be well advised not to blindly copy existing apartment mixes.

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Rental apartments

Still no trend reversal in immigration

The robust economic environment is timely for the rental apartment market, since a better employment outlook should give a boost to demand, which has been fading in recent years. Net immigration continued to decline in the first quarter of 2018 – partly because the economy in the European Union (EU), the largest source of immigrants to Switzerland, is also solid and the unemployment rate in the EU is falling. Compared to the previous year’s quarter, net immigration fell by around 10%. While immigration was largely stable (~1.1%), emigration increased significantly (+7.0%).

Planning applications for a record-high 33’700 rental apartments

Last year’s slightly lower figures for planning applications and building permits suggest that even in the rental apartment market, the sky is not the limit. The planning applications submitted in the first quarter of 2018 illustrate, however, that investors are not about to abandon investment properties. The number of planned rental apartments over the last 12 months is now 2000 housing units higher than at the same time a year ago. Over the last 12 months, planning applications for around 33’700 rental apartments were submitted – a new record high.

Rent prices remain under pressure

The continued surge of construction activity against the backdrop of depressed demand is exerting increasing pressure on landlords in many regions outside the centers. Concessions on rental prices are more often required to avoid longer-term vacancies. The index of rents offered showed negative annual growth rates again in the first quarter of 2018, ranging from –0.3% (Homegate) to –2.0% (Wüest Partner). The increase in the rental price index from the SFSO, which depicts the average rent costs for Swiss households, recently slackened a bit (still +0.6%). This most likely reflects the cut in the reference interest rate to 1.5% as of June 1, 2017.
Commercial real estate

Office property: Rent prices stabilizing

The stagnation in the office space supply at the end of 2017 and the pick-up in demand as a result of the broadly supported economic upturn in Switzerland have helped to ease the marketing environment. This easing is expressed in a sideways movement in office lease prices in the markets of the major centers in the fourth quarter of 2017, for example in Zurich (+0.6% quarter-on-quarter) and Geneva (−0.1% quarter-on-quarter). Given the ongoing positive economic conditions, which will continue to stimulate demand for office space, the stabilization of the Swiss office market should continue throughout the coming quarters.

Retail property: Ongoing low planning activity

Despite improved consumer sentiment, the situation for Swiss retailers is very challenging. The far-reaching structural change resulting from the growth of e-commerce weighs on margins for bricks-and-mortar retailers and reduces demand for retail space. The resulting crisis in the Swiss retail market has made investors cautious. Since the end of 2013, planning activity for new retail space has been well below the long-term average. Due to ongoing difficulties in this market, we do not anticipate any new stimulus for the construction industry in the near future.

Hotel business: Demand is on the rise again

After a long phase of stagnation, the number of overnight stays in Switzerland has been headed north again since the beginning of 2017. The appreciation of the euro makes Swiss hotels more attractive to European tourists, a key demand segment in this business. In previous years, the strong franc had heavily impacted overnight stays in mountainous areas, while there was an increase in overnight stays in the centers thanks to city tourists and business visitors. At present, both markets are profiting from the recovery in demand: in the centers, overnight stays increased by 6.5% year-on-year and in the tourist areas by 7.8% year-on-year (March 2018).
Real estate investments

Returns on real estate investments still attractive

Despite interest rates inching up at the longer end, Swiss real estate investments remain an essential portfolio component given their attractive returns compared to other investment alternatives. At the end of March, the yield spread between direct investments in investment properties and 10-year government bonds was just below 350 basis points (bp). Among indirect investments, Swiss real estate funds display excess yield of 260 bp and real estate shares a full 360 bp. Since the first domestic increase in benchmark rates is unlikely to occur before the first quarter of 2019, Swiss real estate investments should remain attractive for the near future.

Real estate shares leave real estate funds in the dust

After posting a relatively disappointing performance in 2017 (+10.1%) compared to real estate shares in the eurozone (+28.4%) or the Swiss Performance Index (SPI, +19.9%), Swiss real estate shares have seen solid growth since the beginning of 2018. Total returns of 2.7% exceed those of European real estate shares (0.0%). The latter had a significantly sharper reaction to rising long-term interest rates at the beginning of the year. On the other hand, Swiss real estate funds have lost some ground over the year to date (–3.3%). The outlook for higher interest rates is likely to dampen investor enthusiasm for these products due to their bond-like nature. On top of that is the pressure on rental income, which is increasingly shifting from commercial space to the residential segment.

Commercial real estate funds more attractive again

After a correction at the beginning of the year, agios on Swiss real estate funds have stabilized at a high level (24.3% at May 11, 2018). In terms of the risk-return profile, the appeal of commercially oriented real estate funds has increased – chiefly due to stabilization on the market for office space that coincides with increasing challenges in the rental apartment market. This shift of risks is expressed in a declining agio spread between products with commercial focus and residential property funds. While this spread widened to over 20 percentage points at times in 2017, it now stands at some 12.6 percentage points.
Risk warning

Every investment involves risk, especially with regard to fluctuations in value and return. If an investment is denominated in a currency other than your base currency, changes in the rate of exchange may have an adverse effect on value, price or income.

For a discussion of the risks of investing in the securities mentioned in this report, please refer to the following Internet link: https://research.credit-suisse.com/riskdisclosure

This report may include information on investments that involve special risks. You should seek the advice of your independent financial advisor prior to taking any investment decisions based on this report or for any necessary explanation of its contents. Further information is also available in the information brochure “Special Risks in Securities Trading” available from the Swiss Bankers Association.

Past performance is not an indicator of future performance. Performance can be affected by commissions, fees or other charges as well as exchange rate fluctuations.

Financial market risks

Historical returns and financial market scenarios are no guarantee of future performance. The price and value of investments mentioned and any income that might accrue could fall or rise or fluctuate. Past performance is not a guide to future performance. If an investment is denominated in a currency other than your base currency, changes in the rate of exchange may have an adverse effect on value, price or income. You should consult with such advisor(s) as you consider necessary to assist you in making these determinations.

Investments may have no public market or only a restricted secondary market. Where a secondary market exists, it is not possible to predict the price at which investments will trade in the market or whether such market will be liquid or illiquid.

Emerging markets

Where this report relates to emerging markets, you should be aware that there are uncertainties and risks associated with investments and transactions in various types of investments of, or related to, issuers and obligors incorporated, based or principally engaged in business in emerging markets countries. Investments related to emerging markets countries may be considered speculative, and their prices will be much more volatile than those in the more developed countries of the world. Investments in emerging markets investments should be made only by sophisticated investors or experienced professionals who have independent knowledge of the relevant markets, are able to consider and weigh the various risks presented by such investments, and have the financial resources necessary to bear the substantial risk of loss of investment in such investments. It is your responsibility to manage the risks which arise as a result of investing in emerging markets investments and the allocation of assets in your portfolio. You should seek advice from your own advisers with regard to the various risks and factors to be considered when investing in an emerging markets investment.

Alternative investments

Hedge funds are not subject to the numerous investor protection regulations that apply to regulated authorized collective investments and hedge fund managers are largely unregulated. Hedge funds are not limited to any particular investment discipline or trading strategy, and seek to profit in all kinds of markets by using leverage, derivatives, and complex speculative investment strategies that may increase the risk of investment loss.

Commodity transactions carry a high degree of risk and may not be suitable for many private investors. The extent of loss due to market movements can be substantial or even result in a total loss.

Investors in real estate are exposed to liquidity, foreign currency and other risks, including cyclical risk, rental and local market risk as well as environmental risk, and changes to the legal situation.

Interest rate and credit risks

The retention of value of a bond is dependent on the creditworthiness of the Issuer and/or Guarantor (as applicable), which may change over the term of the bond. In the event of default by the Issuer and/or Guarantor of the bond, the bond or any income derived from it is not guaranteed and you may get back none of, or less than, what was originally invested.

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