GlobalData. TS Lombard

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Macro Picture

THE 'NEXT SHOE' THAT DIDN'T DROP

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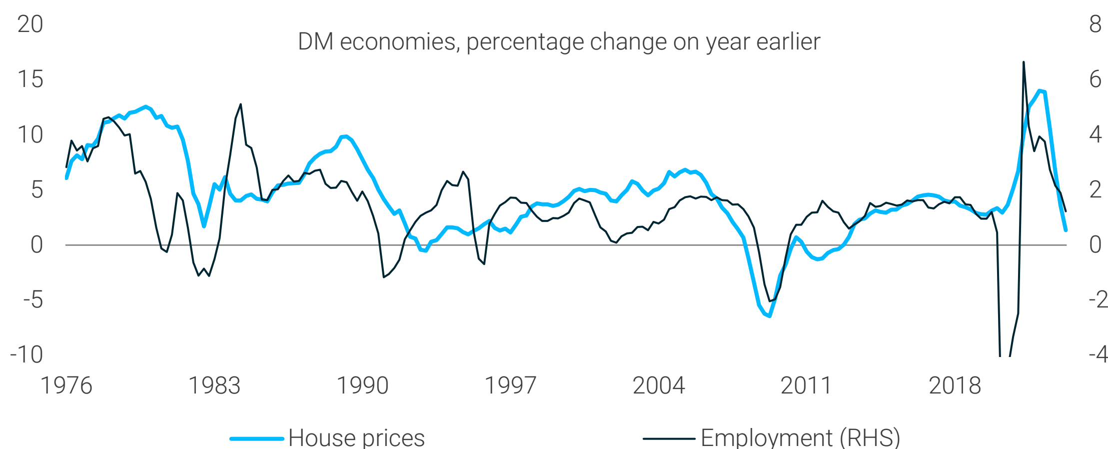
Property markets have made an important contribution to the soft-landing vibe in 2023, supported by the assumption that interest rates won't stay at their current levels for long. With inflation returning to tolerable levels, central banks can avert further pain in the property sector – and potentially the broader economy – by releasing their big monetary squeeze.

Chart 1: Housing *is* the business cycle!



Source: Dallas Fed, IMF, OECD, TS Lombard

SOFT-LANDING VIBES

Global property markets were supposed to be the thing that broke in 2023 and delivered a nasty hard landing. Instead, resilience in the property sector has contributed to the sense that a soft landing is achievable. We identify various reasons for this resilience in both the residential and commercial property sectors. The common theme is an expectation of imminent rate cuts.

STILL C.R.E

While temporary factors have supported the residential property market in 2023, the consensus was always too bearish about the prospects for commercial real estate (CRE), not least once the central-bank backstop was in place. The risk was not a precipitous crash but rather a slow-burn (S&L-style) squeeze on asset returns and bank profitability. That squeeze will continue.

PROPERTY IS THE 'KEY'

Property markets could play a pivotal role in how the global economy performs in 2024. If interest rates remain at current levels, there is likely to be further pain, which would be (somewhat) dangerous for the broader economy. But with inflation returning to tolerable levels, central banks now have an opportunity to head off this destruction – and even deliver an unexpected recovery.

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THE 'NEXT SHOE' THAT DIDN'T DROP

Global property markets were the "next shoe" that didn't drop in 2024 – the expected epicentre of a hard landing that never materialized. Even with interest rates at multi-decade highs, the real estate sector has been more resilient than most pundits expected. Transactions and housing investment plunged, as always happens during episodes of rapid monetary tightening, but nominal property prices did not collapse and there were relatively few nasty macro-financial spillovers to the rest of the economy. This has bolstered expectations for a soft landing in 2024, a sign that the world can tolerate secularly higher levels of interest rates. We identify several reasons for this resilience, especially in the (more important) residential sector: (i) expectations for imminent rate cuts; (ii) a sellers' strike (the result of interest-rate "lock-ins" and homeowner psychology); (iii) various "extend and pretend" schemes, especially in the highest-risk markets (such as Canada); (iv) money illusion (reductions in *real* rather than *nominal* prices); (v) structural sources of demand (remote working and immigration); and (vi) the absence of "forced sellers" thanks to continued strength in labour markets. It should be clear that while these forces have helped the soft-landing thesis in 2023, they do not rule out a hard landing in 2024. Risks persist.

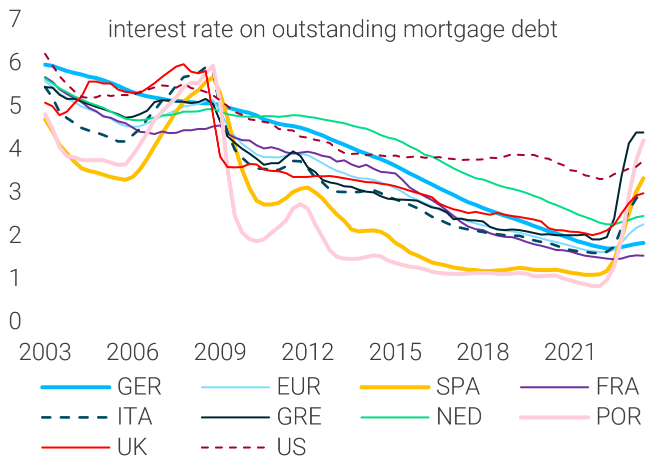
While residential property markets held up surprisingly well in 2023, the commercial property sector seemed to be on the brink of something nasty – especially back in the spring, when there was a "mini banking crisis" in the US and parts of Europe. And there were good reasons to think that CRE was a risk to broader financial stability. Commercial property prices had been growing strongly – including through much of the decade that preceded the pandemic – and the sector had also enjoyed a notable credit boom (both trends that ran counter to what had been happening in the residential sector, which, with a few notable exceptions, had experienced a decade of subdued price gains and continuous deleveraging). CRE had been the main beneficiary of ZIRP and regulatory diversion, with the authorities' attempt at regulating the "systemically important" banks after the subprime crisis only pushing financial risk into new areas of the system – namely, small/regional banks in the US and "non-banks" in Europe. Until the authorities stepped in to provide a backstop, it looked like this financial risk would materialize, creating a dangerous feedback loop between banking-sector stress and existing CRE vulnerabilities. The policy response was successful. While the dangers to the commercial property sector have not gone away, this is now a slow-burn (S&L style) problem, not a "hard landing waiting to happen".

Where does that leave us? It seems clear that property markets – both residential and commercial – have not fully adjusted to tighter monetary policy. A strong "interest rates cannot stay this high for long" sentiment has supported activity in both sectors. If it turns out that proposition was wrong, we should expect further pain in 2024. It is not clear whether this would be sufficient to trigger a hard landing in the broader economy, but we can take some comfort from the fact that the macro-financial imbalances associated with the property sector are modest compared with past cycles. Any recession is likely to be mild, in stark comparison with the 2008 global property crash. But with inflation returning to tolerable levels (albeit still above 2%), there is a decent chance we will avoid this pain altogether. Central banks now have a rare opportunity to avoid a recession completely and even deliver an unexpected economic recovery in 2024 (without restoking inflation). A revival in property markets is one part of the soft-landing thesis that is not already priced in. The long-term outlook for real estate remains favourable – the difficult part was always in the initial transition away from zero rates. We knew the escape from ZIRP would be bumpy, but central banks can ensure the ride is much smoother than we feared.

1. SOFT-LANDING VIBES

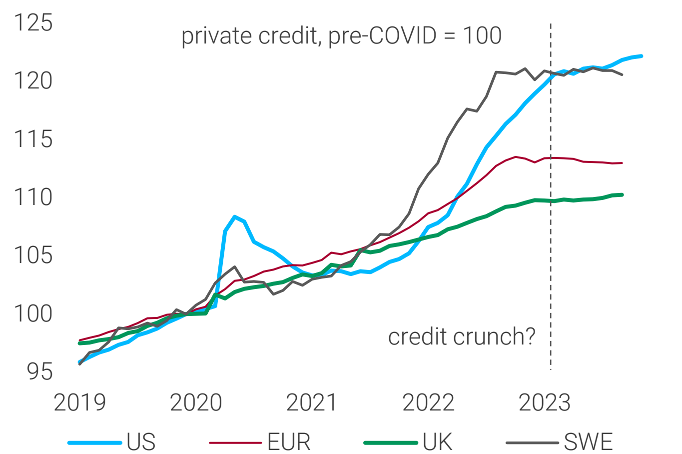
The resilience of global property markets – both residential and commercial – has been one of the more surprising features of the global economy in 2023. If investors had been told two years ago that central banks would engineer one of the most aggressive episodes of monetary tightening in history, many would have anticipated a serious crash. Instead, property markets have contributed to hopes for a soft landing, a narrative that has gained traction in recent months as economists have abandoned their long-standing recession calls. But what explains this resilience? Will it continue in 2024, even if the authorities stick to their plan of "higher for longer" monetary policy? What would a hard landing in the property sector mean for the rest of the economy? And, conversely, if the central banks match market expectations by delivering a series of rate cuts, could the property sector drive a broader reacceleration in the global economy – perhaps even the rekindling of inflationary pressures (which nobody wants to see)? These questions are addressed below. Remember, housing *is* the business cycle!

Chart 2: The monetary squeeze



Source: ECB, BoE, BEA, TS Lombard

Chart 3: Credit creation has stopped

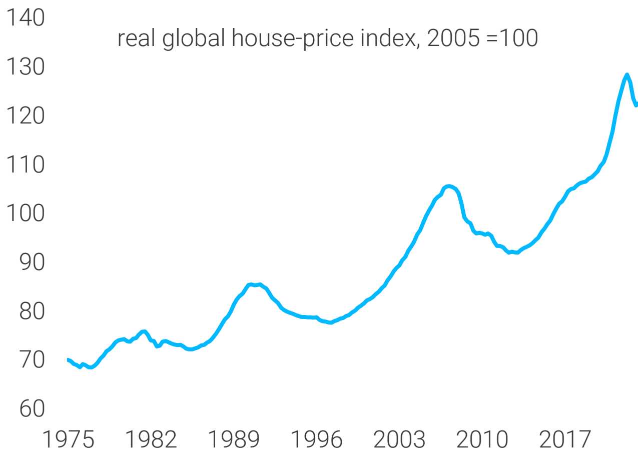


Source: national sources, TS Lombard

Housing and the soft landing

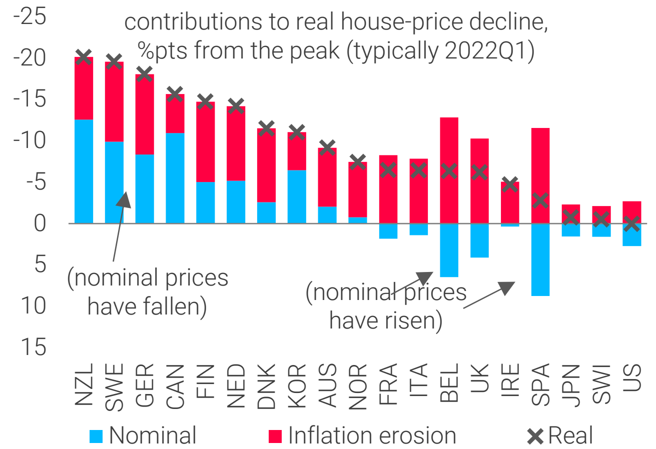
There were always three conditions for a soft landing in the economy: (i) central banks needed to get inflation down to tolerable levels; (ii) there had to be a rebalancing in labour markets, with excess demand for workers destroyed (without large numbers of people being put out of work); and (iii) economies – and the financial system at large – needed to show resilience in the face of rapid monetary tightening. (Or, if higher interest rates did destabilize the system, central banks would need to reverse course before it was genuinely too late.) It is no exaggeration to say that global property markets have helped with all three aspects of this soft-landing narrative. House prices have slowed in a surprisingly orderly way, directly contributing to lower inflation in some parts of the world (notably the US), job vacancies in the construction sectors have plunged – without triggering widespread job losses – and, perhaps most important, the global property sector has not become a source of systemic financial pain. Put simply, we have not seen the scale of real-estate destruction that pundits expected when interest rates hit multi-decade highs.

Chart 4: Global house prices under pressure



Source: Dallas Fed, TS Lombard

Chart 5: House prices down in real terms

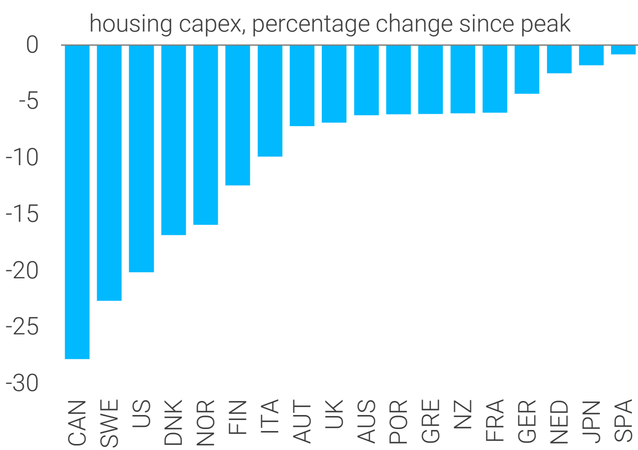


Source: Dallas Fed. OECD, TS Lombard

Why property didn't break

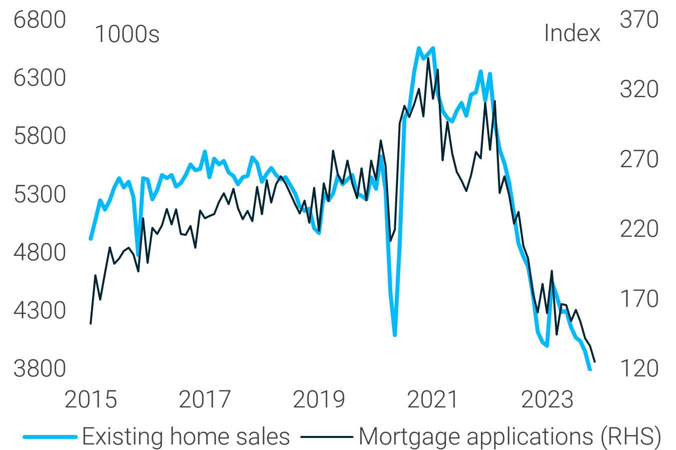
While tighter monetary policy has not caused a collapse in global property markets, it is certainly true that we have seen a discernible impact from higher interest rates – much more so than in many other sectors of the economy. These effects are particularly clear when it comes to the "flow" effects of monetary policy – that is, the impact on *marginal demand*. Not only have higher interest rates made borrowing a lot costlier, but banks have restricted the supply of credit to the economy by tightening their lending standards (presumably because they were worried about the prospect of a recession). The results are clear: property transactions have plunged, sales have dried up, and, as a first-order knock-on effect, there has been a serious hit to global construction activity. Housing investment has slumped. Chart 6 shows that while the largest hit has been in North America, homebuilding has declined everywhere since interest rates started to rise in 2022. Housing investment is part of GDP, so that decline has been a hit to income and expenditure.

Chart 6: Higher rates have cut housing capex



Source: OECD, TS Lombard

Chart 7: US property transactions have crashed

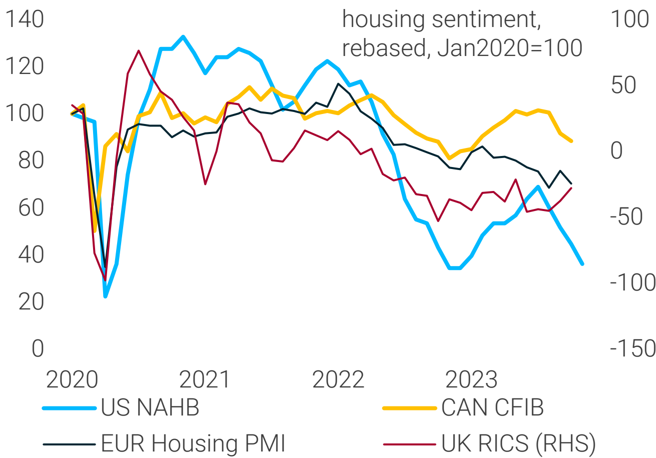


Source: Datastream, TS Lombard

While the flow effects of monetary tightening have materialized in line with expectations, the wider repercussions – especially for broad macro-financial stability – have not been as serious as feared. Nominal house prices have declined only modestly, which has prevented serious "wealth

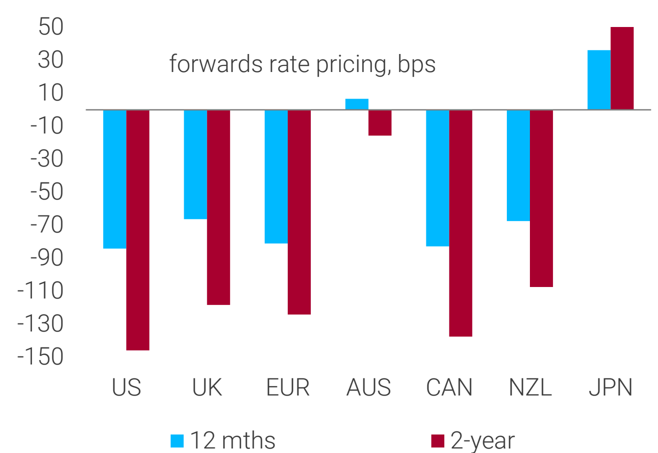
effects" (where falling asset prices undermine confidence/spending) and avoided widespread balance-sheet destruction. And there have been no mass redundancies. Focusing first on the residential property sector – systemically the most important – we see a number of forces that have prevented the sort of housing crash that seemed possible 18 months ago, namely:

Chart 8: There goes the 2023 dead-cat bounce



Source: NAHB, S&P Markit surveys, RICS

Chart 9: Still expecting a policy reversal

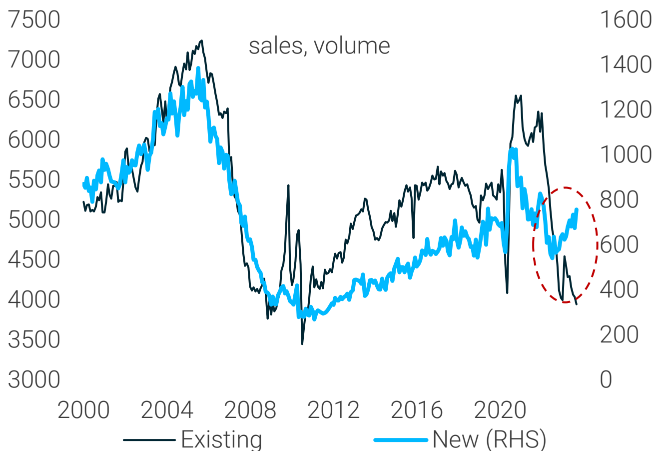


Source: Bloomberg, TS Lombard

1 **Expectations of an imminent policy reversal:** Throughout the global tightening cycle, investors have been waiting for something to break – either in financial markets or in the broader economy. Once that happened, central banks would need to reverse course, which is why bond yields became increasingly inverted. Obviously, inverted yield curves can be helpful for property markets in the sense that the inversion will offset some of the tightness in monetary policy, especially when mortgage rates are set at the long end of the curve (as in the US). But it was not just the level of interest rates that mattered. Psychology played a role, too. We heard plenty of anecdotal evidence throughout the tightening cycle that prospective homeowners in a range of property markets were taking out expensive mortgages in the expectation that they would be able to refinance their loans at lower rates in 2024. While the acceptance of central banks' "higher for longer" mantra briefly undermined that expectation in the late summer of 2023, rate expectations have plunged again since then.

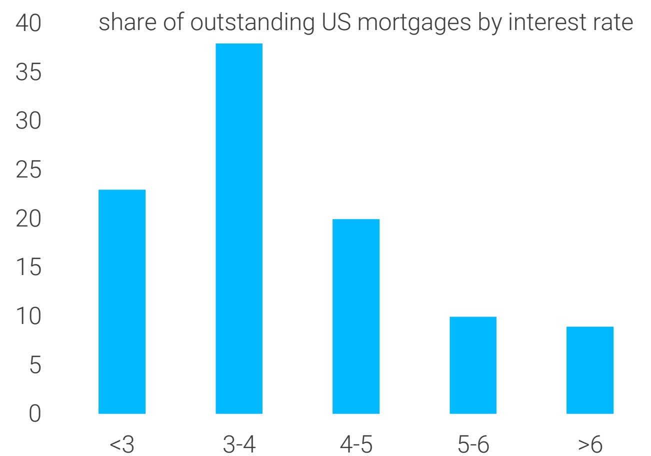
2 **Sellers' strike and rate lock-ins:** While higher interest rates had a clear and obvious impact on the demand for housing, they also had an influence on supply. In markets with a heavy reliance on long-term mortgages – such as the US – homeowners now had a strong incentive to stay in their existing properties rather than move home and have to refinance their borrowing at materially higher rates (they were, in effect, "locked in" to their existing mortgage). Chart 11 (from the IMF) shows that around a quarter of US homeowners are currently paying a mortgage rate below 3%, with another quarter paying 3-4%. This compares with a current 30-year mortgage rate of almost 8%. Obviously, the rate lock-in effect is weaker in markets where mortgage durations are lower or where people borrow on variable terms. But in an environment of falling nominal prices, there can still be a "psychological lock-in", where homeowners think their property is worth more than buyers are offering. We saw this in the UK after the global financial crisis, which is why prices bounced back unexpectedly strongly in 2009 (assisted by the structural supply shortage in the UK).

Chart 10: Builder incentives and mortgage lock-ins



Source: Datastream, TS Lombard

Chart 11: US mortgage lock-ins

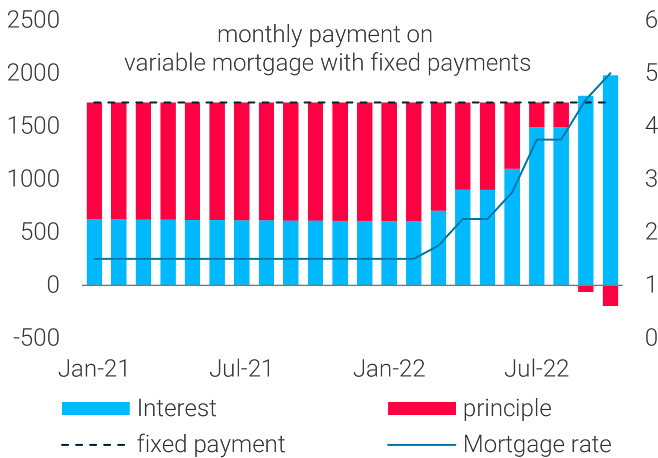


Source: IMF, TS Lombard

3 **Homebuilder incentives:** In some markets – especially the US – homebuilders have used various incentive schemes to support housing demand in the face of significantly higher mortgage costs. One example is the mortgage "buydown", where homebuilders contribute to the borrowers' mortgage costs by, in effect, providing a "teaser rate", which typically lasts one or two years (though these can sometimes be extended to cover the full term of the mortgage). But there are other examples as well, such as homebuilders providing assistance with the costs of closing a new property deal. In all these examples, the incentive scheme is analogous to a latent reduction in the price of purchasing the home, offered as a way to offset some of the impact of higher interest rates and put a floor under demand. We see the impact of these incentive schemes in US data, which, together with mortgage lock-ins, have caused a sharp divergence between sales of existing and new homes (Chart 10).

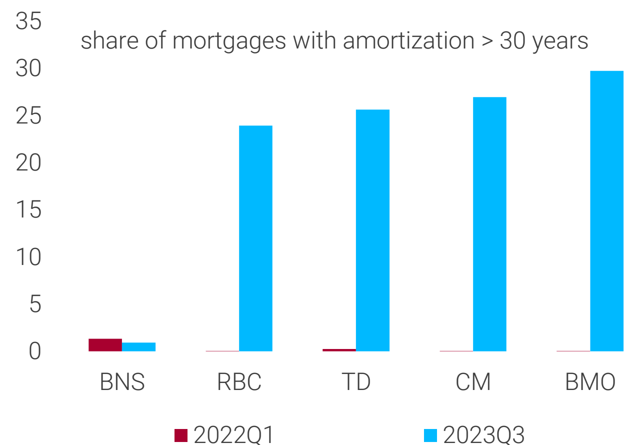
4 **Extend and pretend:** Some housing markets – such as Canada, New Zealand, Norway and various parts of the euro area – seemed particularly vulnerable to higher interest rates. They typically had much higher levels of mortgage debt (having avoided a housing crash in 2008) and a heavy dependence on variable-rate mortgages (after a decade of ZIRP). When we assessed the risks to global property markets in 2022 (see here and here), we thought these were the countries that would buckle first as interest rates rose. Yet even these high-risk markets have not crashed, in part owing to various "extend and pretend" schemes. Canada is the best example of this. While around one third of Canadian homeowners have borrowed at variable rates, many of those loans have fixed monthly payments. When interest rates rise, the homeowner's monthly repayment stays the same, but interest rather than principal repayment accounts for more of that payment. Naturally, there are limits, since at a certain level of rates, interest payments will hit 100% of the monthly payment. At that point (the "trigger"), lenders have three options: they can raise the monthly payment, allow "negative amortization" (principal repayments turn negative – i.e., the mortgages become larger) or extend the duration of the loan. It turns out that Canadian banks have been using a combination of negative amortization and extended maturities to dampen the impact of tighter monetary policy. And we have seen similar schemes in Europe, often with explicit government support.

Chart 12: Canada's negative amortization trigger



Source: Bank of Canada, TS Lombard

Chart 13: Canadian banks 'extend and pretend'



Source: Bloomberg

5 **Money illusion:** Global house prices have been surprisingly resilient in nominal terms but, against a background of high inflation, have fallen sharply in real terms (Chart 5). On one level, this makes the adjustment to lower demand less painful because it can lead to "money illusion" where homeowners do not realize that their real wealth had declined. And if nominal prices are steady, there is unlikely to be negative equity (where house prices drop below the value of the debt that underpinned them), which helps prevent a dangerous feedback loop of falling asset values, deteriorating balance sheets and asset fire-sales. We all remember what happened during the global financial crisis, when inflation was low and all the adjustment happened through nominal prices and balance-sheet destruction. But property prices can sometimes lag demand, so it is too soon to declare the "all clear".

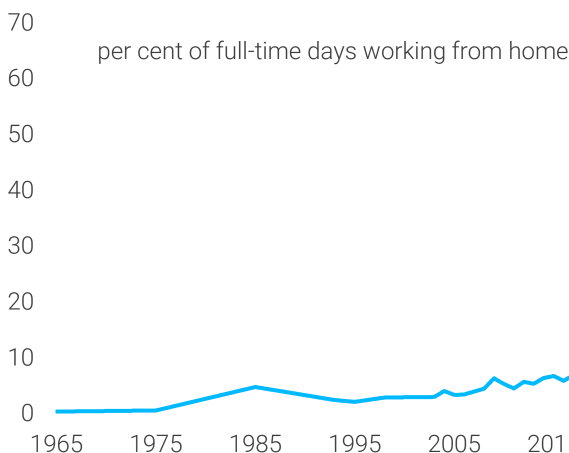
6 **Structural sources of demand:** During the pandemic, the combination of large fiscal transfers and low interest rates fuelled a global housing boom that has unwound as fiscal support has ended and central banks have raised interest rates. Yet the COVID policy response was not the only factor that caused house prices to soar; shifts in consumer preferences played a role, too, particularly the structural increase in working from home (WFH), which triggered a "race for space", as homebuyers were now prepared to pay a premium on living space (particularly in locations that were previously out of reach for regular commuting). Charts 14 and 15 show that these new working patterns have persisted even as other areas of life have returned to normal. According to Federal Reserve research, which analysed regional differences in US housing markets during the pandemic, remote working explains around half of the increase in house prices that happened after 2020. If this analysis is correct, we should expect housing demand (and prices) to settle at higher levels.

7 **Absence of forced sellers:** Finally, resilience in housing markets has interacted favourably with resilience in the rest of the economy. Unemployment has remained low and wages have been growing at a solid pace, which has helped homeowners to service their debts, even in countries with variable rate mortgages. So, we have not seen the "forced selling" that typically happens during more serious downturns, which, in, turn can amplify the recessionary process. Of course, with these sorts of dynamics there is always a "chicken and egg" problem. The obvious question is what happens first – a decline in house prices of a rise in unemployment? History (see Chart 1 on front page) suggests the answer is "it depends". Sometimes, as in 2008, there is such a large bubble in housing that it triggers a recession

when it bursts. But often it is weakness in the broader economy that leads to stress in property markets.

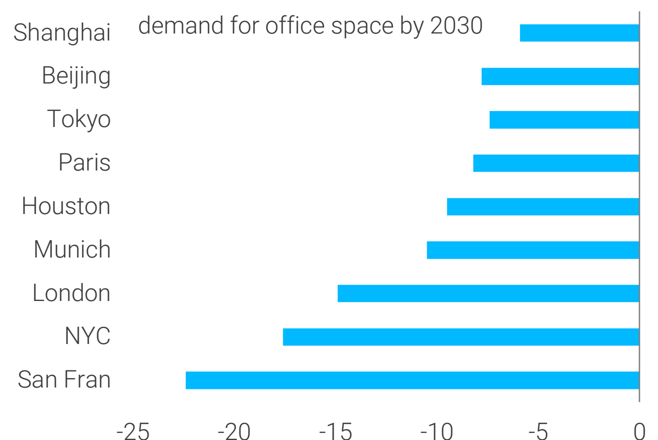
It should be obvious that most of the forces that have prevented a more serious downturn in the residential property market cannot be relied on indefinitely. In fact, the main reason we have not seen a bigger correction is that most of the actors involved – homebuyers, builders, banks and even policymakers – have been operating under the assumption that interest rates will remain at their current levels only for a brief period, with borrowing costs set to plunge over the next couple of years. This is a dangerous proposition, not least because the very belief in imminent rate cuts could be self-defeating, in the sense that resilience in property markets might create precisely those conditions that force central banks to keep interest rates high. And if rates stay high, the whole "extend and pretend" model will eventually unravel, until the situation in property markets becomes unsustainable and delivers broader economic weakness. From our list, there is only one factor that is unambiguously good news for the residential market – the shift to remote working; but even this is potentially bad news for the non-residential property sector.

Chart 14: Remote working is here to stay



Source: wfhresearch.com

Chart 15: Office demand set to plunge

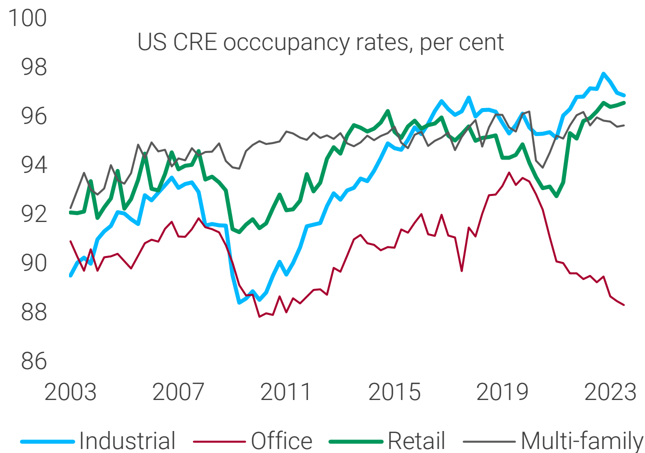


Source: McKinsey (2023)

2. STILL C.R.E

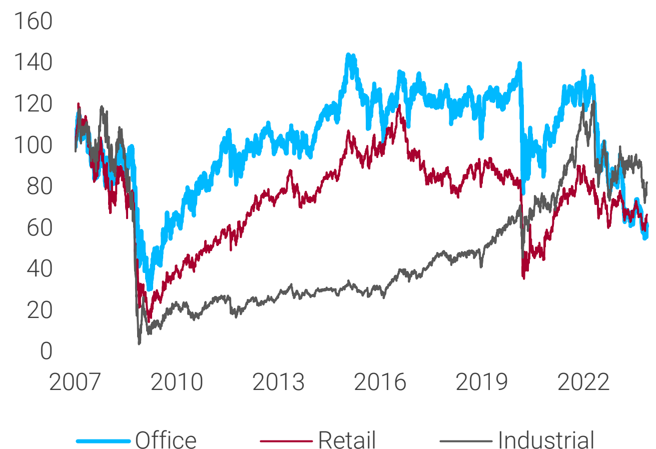
While the residential property sector has fared better than most economists expected 18 months ago, it was the commercial real estate (CRE) sector that became the bigger source of investor angst in 2023, especially following the ruptures in the US banking sector in March. Fortunately, the Fed's aggressive policy prevented a more serious crisis. But the problems in commercial real estate have not gone away, especially as it was one of the areas – in both the US and other developed economies – that benefitted most from ZIRP and a decade of regulatory arbitrage. Like in the residential sector, the assumption that "interest rates cannot stay at these levels for long" seems to have held things together, especially in private CRE, where there is no attempt to "mark to market" (not immediately, anyway). The good news is that even if interest rates remain higher than in the 2010s, CRE poses a slow-burn financial problem rather than being the trigger for another precipitous crash. It could weigh on bank profitability for years, but it is not going to become the source of a systemic crisis. Investors are likely to lose money, particularly in the traditional office sector, but CRE will not be the catalyst for a hard landing, let alone a crash.

Chart 16: Vacancy rates are rising in office space



Source: Bloomberg

Chart 17: REITs have adjusted lower



Source: Datastream, TS Lombard

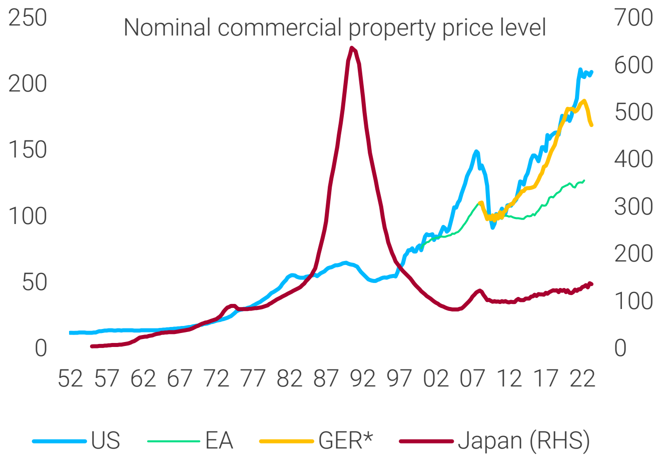
The crisis that didn't happen

Back in March, it looked like central banks' rate hikes had finally broken something in the financial sector. Silicon Valley bank had failed following a run on its large (uninsured) depositor base, which, in turn, triggered widespread deposit flight across many smaller regional American banks. But it wasn't just US banks that were under pressure; tensions also flared up in Europe, where the authorities were forced to intervene by forcing a merger between Credit Suisse and UBS (while there was also considerable market anxiety about Deutsche Bank). As investors turned their attention to the "unrealized losses" on banks' balance sheets (the result of higher interest rates destroying the value of their fixed-income investments), equity values plunged and the banking sector began to show signs of systemic market stress. For some commentators – and, more important, policymakers – this was an eerie reminder of what had happened in 2008. And with the PTSD from the subprime crisis still strong, the authorities reacted forcefully: the Fed injected huge amounts of liquidity into the system and established new lending facilities that allowed banks to borrow funds without taking a haircut on their government bond holdings (which were valued at par). As it turned out, the radical policy response was highly effective. It took all the urgency out of the situation, turning a bank run into a slow-motion "bank jog".

Financial risk is viral

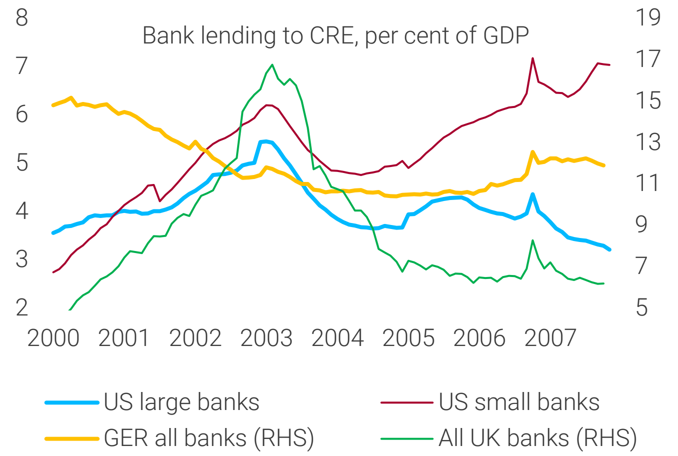
The March "mini banking crisis" focused investor attention on the nexus between small US banks and CRE. Facing higher funding costs, the banking industry would restrict its lending to CRE, which would intensify the pressure on a business that was already vulnerable to higher interest rates. Worse, some parts of the CRE market – particularly the office and retail sectors – were facing acute structural issues, with the remote-working trend set to push up vacancy rates and undermine rental returns. (This structural reduction in the demand for CRE was the flipside of the structural increase in demand for residential properties.) But as we explained at the time, the tensions in CRE were also part of a broader theme: the reversal of a decade of ZIRP and "regulatory diversion". Low interest rates had not only helped to inflate commercial property prices during the 2010s, but the authorities' post-2008 focus on regulating the large, systemically important banks had pushed credit creation into less-regulated sectors, namely smaller/regional banks in the US and "non-banks" in Europe. Financial risk is viral – it mutates to avoid regulation. Higher interest rates had exposed new dangers.

Chart 18: The commercial property boom



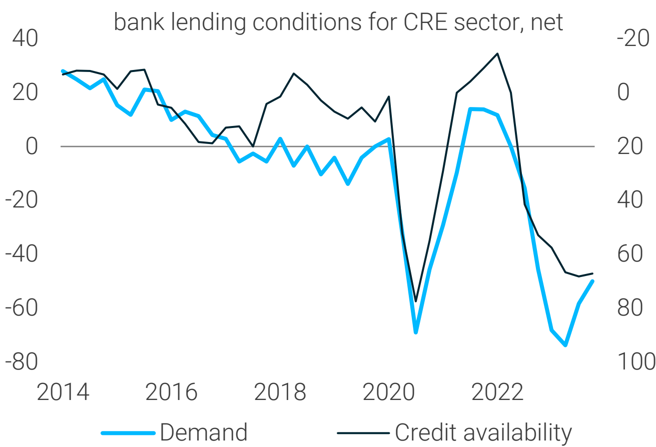
Source: BIS, TS Lombard, *office only

Chart 19: CRE credit boom?



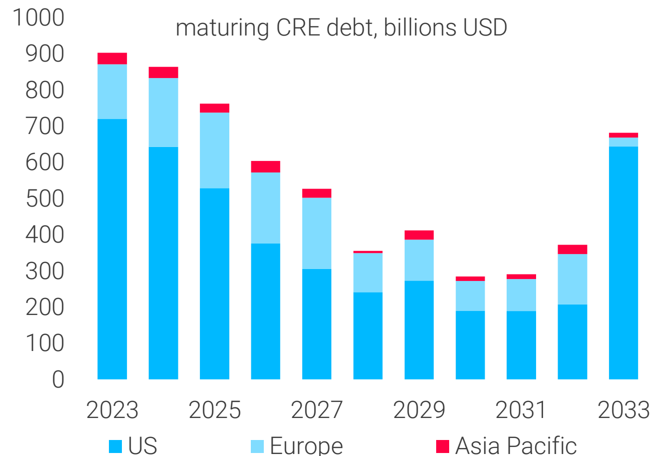
Source:

Chart 20: US banks restrict CRE credit lines



Source: Federal Reserve, TS Lombard

Chart 21: The looming maturity wall



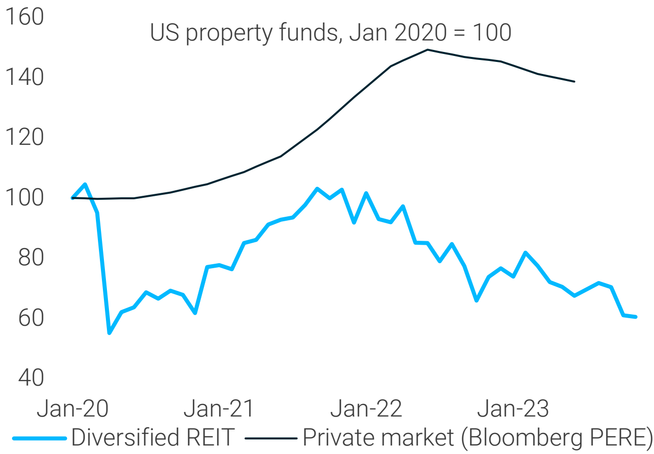
Source: IMF, TS Lombard

Pressures persist

While anxiety about another 2008-style crisis always seemed overdone, the vulnerabilities in commercial property have not gone away. In the US, bank lending standards have remained tight, vacancy rates have continued to rise, and many companies are facing significantly higher interest costs as they roll over their debts in the coming years. Chart 21, based on IMF data, shows that US CRE companies face a "maturity wall" of more than US$1.5trn over the next three years, in addition to the US$700bn that was due to mature in 2023. Some of these borrowers are likely to struggle, which will raise default rates and could undermine the profitability of the US banking sector for years to come. While official Fed figures on CRE delinquency rates have remained low, some private data collectors – which can be timelier – have reported a notable deterioration. The good news is that in the US, this is mainly a problem for the smaller regional banks, where most of the CRE exposure now lies. A systemic banking crisis seems unlikely. But it does raise the prospect of another slow-burn S&L-type problem, such as the US banking system experienced

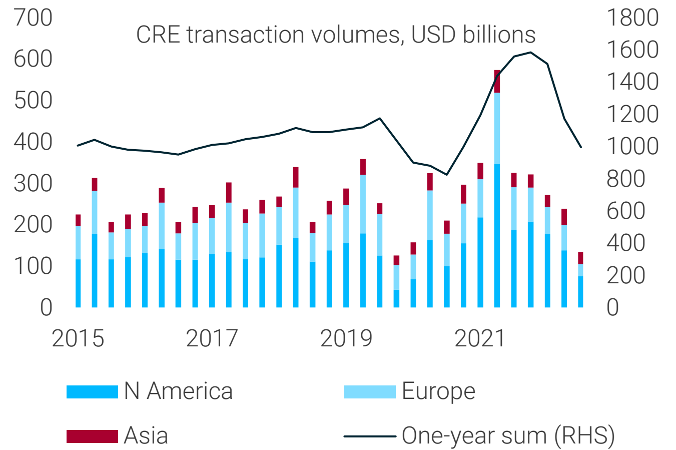
during the 1980s and early 1990s. Indeed, if interest rates remain secularly higher than in the 2010s, we could see a long period of small-bank failures and banking-sector consolidation.

Chart 22: Private property funds yet to adjust



Source: Bloomberg, TS Lombard

Chart 23: CRE transactions have dried up



Source: IMF, TS Lombard

Non-bank exposures

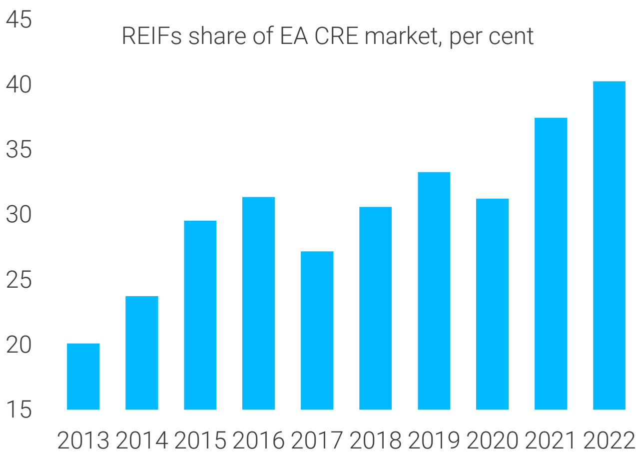
Of course, the banks-CRE nexus is not the only threat to macro-financial stability. The commercial property sector also receives funding from other sources, including real estate investment trusts (REITs), private markets and other "non-bank" investors. REITs are issued by companies that own and run property pools (or real-estate related assets). They trade on public markets and, like stocks, provide dividends to investors (based on rental returns). REITs values have already fallen significantly since the start of the monetary tightening cycle in 2022, with the office sector hit particularly hard (Chart 17). Yet there is also a significant pool of CRE capital that does not trade in public markets, with investors instead taking direct ownership of real estate assets and net asset values (NAVs) determined by periodic (often annual) appraisal. Chart 22 shows the marked divergence between public and private CRE valuations, based on the widening gap between the Bloomberg PERE index (a proxy for the private market) and the S&P 600 diversified REITs index. This suggests there is still a significant part of the CRE universe that has not yet adjusted to the new reality of higher interest rates and deteriorating real-estate returns, especially those parts of the sector that do not have to "mark to market". One worry, voiced by the IMF in its latest GFSR, is that when this delayed adjustment happens, it could be sharper and faster than expected, with knock-on effects to the banks and institutional investors that have exposure to these funds.

CRE risks in Europe

Non-bank exposure to commercial property has increased particularly sharply in Europe; indeed, the ECB recently identified this as one of the main vulnerabilities to higher interest rates. According to ECB data (Chart 24), real estate investment funds (REIFs), which include both REITs and some private markets, now account for around 40% of euro area CRE, up from 20% in 2013. These funds are to be found mainly in five countries (Germany, Luxembourg, France, the Netherlands and Italy), which account for most of the growth in the sector. The evaporation of transactions in these markets could be the harbinger of much steeper price declines to come, especially as buyers tend to revise down their bid prices faster than sellers drop their asking prices (van Dijk et al. 2020). Like the IMF, the ECB is concerned about the "liquidity mismatch"

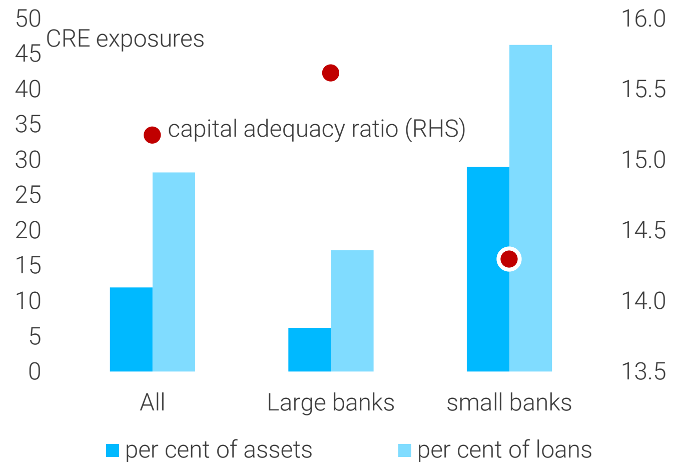
between REIF assets and their redemption terms, which could set off a vicious spiral of asset fire-sales and price declines. Facing heavy redemptions, these funds would need to sell the underlying property asset – which, in stressed markets, would happen only at prices far below their appraised values. The irony is that this is just another example of regulatory diversion. The European authorities did a good job of regulating their systemically important banks, but a decade of NIRP pushed risk-taking elsewhere. And countries like Germany, which avoided a domestic banking crisis in 2008, have been among the main "beneficiaries" of the bubble.

Chart 24: Property funds have grown in Europe



Source: ECB, TS Lombard

Chart 25: US small banks are exposed

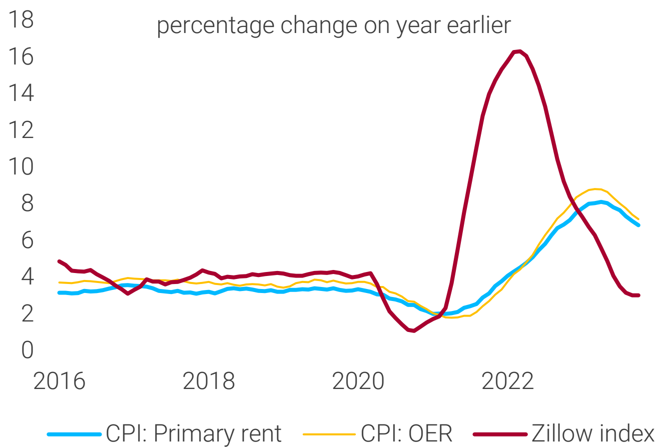


Source: IMF, TS Lombard

3. PROPERTY IS THE 'KEY'

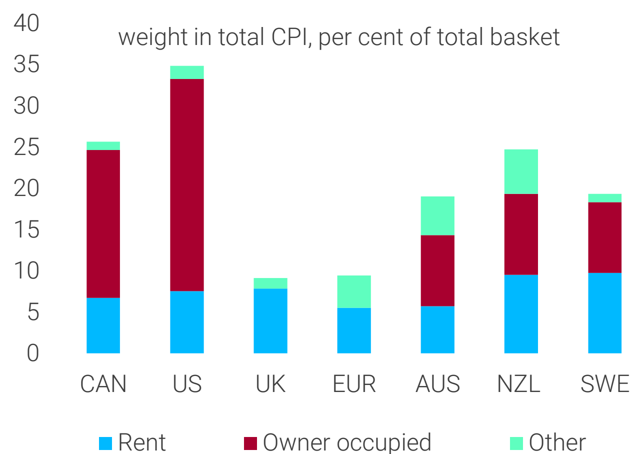
While property markets – both residential and commercial – have remained more resilient than many commentators feared, our analysis suggests this is because they have not yet fully adjusted to higher interest rates. There is still the risk of more pain in 2024, which could amplify any further deterioration in the broader economy. We are not out of the woods yet. The good news, however, is that if even those risks materialized, we would still be looking at recessions that are likely to be mild compared with the past. That is because, in contrast with the situation before previous property-market meltdowns, private-sector credit growth has been relatively subdued and there has not been a serious misallocation of resources in the wider economy. Commercial property is closer to a "bubble" than is the residential sector, but it would have relatively muted consequences for the rest of the economy. Conversely, it is important to remember that all the current vulnerabilities in real estate derive from one main factor – high interest rates. With inflation now dropping quickly, central banks have an opportunity to dodge further trouble in the property sector and even deliver an unexpected economic recovery. Nudging rates back down to more "neutral" levels could secure the soft landing, without restoking inflationary pressures.

Chart 26: Pent-up US disinflation



Source: Zillow, BLS, TS Lombard

Chart 27: Housing – influence on CPIs

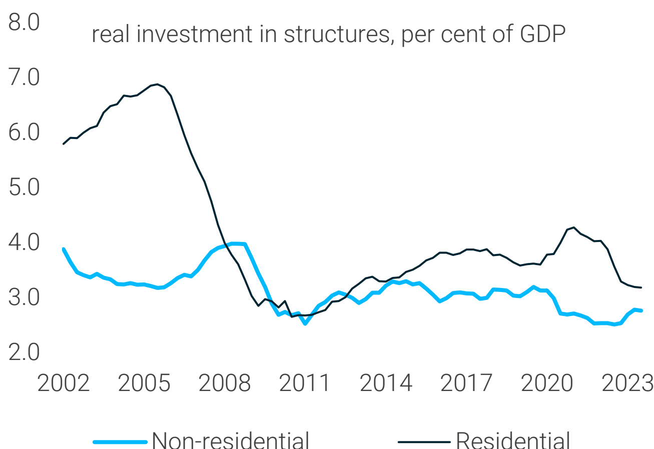


Source: Bank of Canada

Still a risk of recession

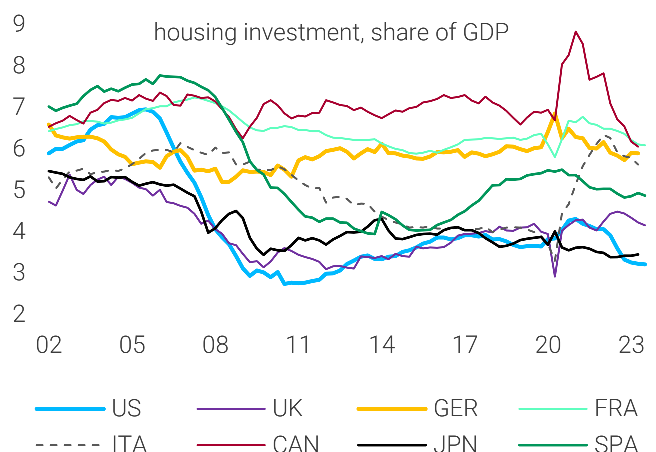
Sellside economists have started to abandon their recession calls, with the resilience of property markets contributing to those revisions. Nominal house prices have held up well, which has avoided "wealth effects", kept balance sheets intact and prevented forced selling. And in markets like the US, where there were acute pandemic shortages of labour and building materials, housing completions have consistently lagged housing starts, which has supported employment in the construction industry. But it seems premature to rule out a hard landing entirely. Labour markets have been looking shakier of late and even if the property sector is not the trigger for a true recessionary dynamic to take hold, it could play the role of amplifier – with pain in property markets interacting with weakness in the broader economy. Ultimately this is a question of whether central banks have already overtightened monetary policy. And while the US seems to have been resilient in the face of rapid interest-rate hikes, the same cannot be said about Europe. As we explained in a previous Macro Picture, the European economies were not only in a weaker starting position (with no discernible post-COVID boom), but the ECB and the BoE have also delivered a larger monetary squeeze than the Fed. A large amount of short-term debt leaves Europe vulnerable, and it is likely than we have not yet seen the full impact of higher rates.

Chart 28: CRE less systemic than residential RE



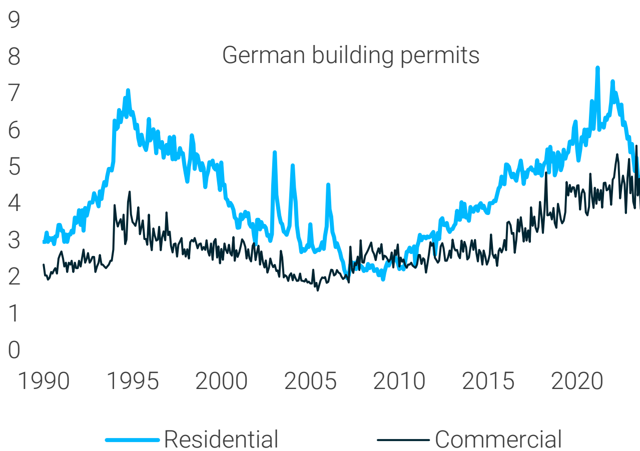
Source: BEA, TS Lombard

Chart 29: Canada, France and Germany exposed?



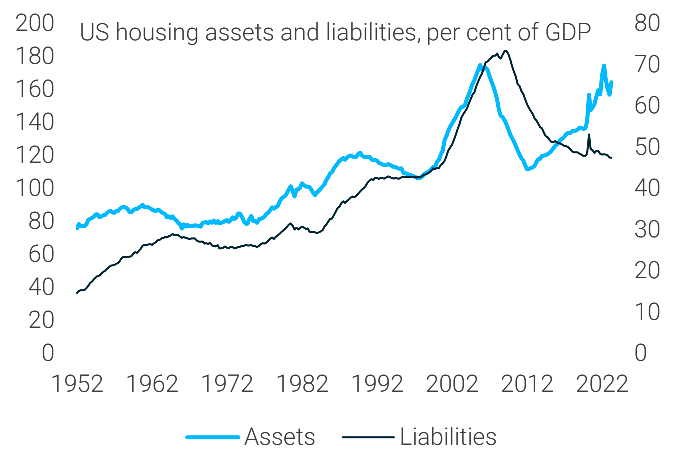
Source: OECD, TS Lombard

Chart 30: German property exposures



Source: Bundesbank, TS Lombard

Chart 31: An unleveraged asset bubble?



Source: Fed, TS Lombard

The threat is a mild recession

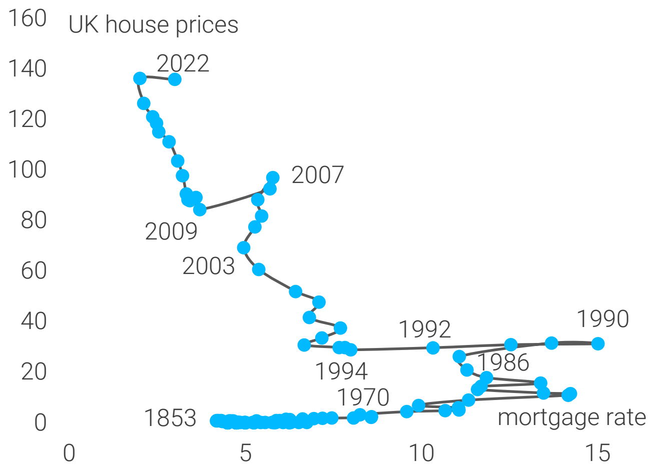
The good news is that we are looking at a potential recession that is likely to be mild compared with previous hard landings. There are two reasons for this. First, much of the direct effect of weaker housing activity has already happened. As we explained in Section 1, construction activity, housing transactions and real-estate investment have already fallen significantly; if they stabilize at current levels, the hit to GDP growth will start to fade. The second reason not to expect a deep recession is that the potential for large spillovers from property markets to the rest of the economy is relatively limited, especially compared with the situation in the early 2000s. Credit growth has been subdued and there has not been a large reallocation of resources – either in terms of jobs or investment – to the global property sector. This is very different from what happened ahead of the subprime crisis, where there was a lengthy period of rapid credit growth (particularly in the riskiest parts of the mortgage market), significant homebuilding and rapid employment growth in the construction and real-estate services sectors. The bursting of the global housing bubble in 2008 triggered a long period of balance-sheet repair. To the extent there was any misallocation of resources during the ZIRP era that preceded COVID-19, it was concentrated in the CRE sector – and the macro footprint of that sector is limited (Chart 28).

Source of a revival?

Ultimately, the risk for property markets is all about the level of interest rates. If central banks stick to their new "higher for longer" mantra, even in an environment of deteriorating economic growth, then the sector will inevitably face further pain. But with inflation now coming down quickly, the odds of having to keep interest rates at their current levels have greatly diminished. At a minimum, this gives central banks space to cut interest rates quickly should labour markets start to crack. This, in turn, reduces the threat of a nasty feedback loop between real-estate markets and the broader economy – it makes the hard-landing scenario "less hard". But it also improves the prospects of avoiding a recession altogether. In fact, if central banks reverse course soon, cutting rates back to neutral before "something breaks", they could even drive a recovery in property markets, which would become the source of a wider reacceleration in global activity in 2024. US housing activity has been particularly sensitive to interest rates over the past 18 months, but we should expect similar sensitivities in Europe – particularly as lower interest rates

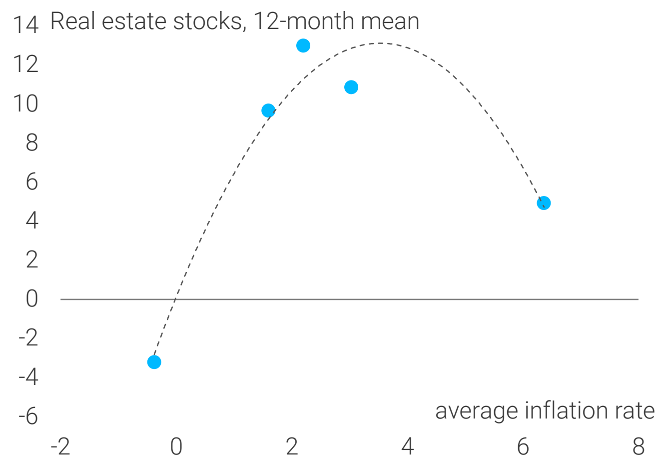
would immediately reduce the squeeze on existing homeowners. It is important to point out, however, that we are not talking about reigniting an inflationary boom in housing markets. Even with modest reductions in rates, borrowing costs would still be high versus pre-COVID norms.

Chart 32: House prices and mortgage rates



Source: BoE, TS Lombard

Chart 33: Inflation good for RE – up to a point



Source: Steve Hou at Bloomberg

Long-term bullishness

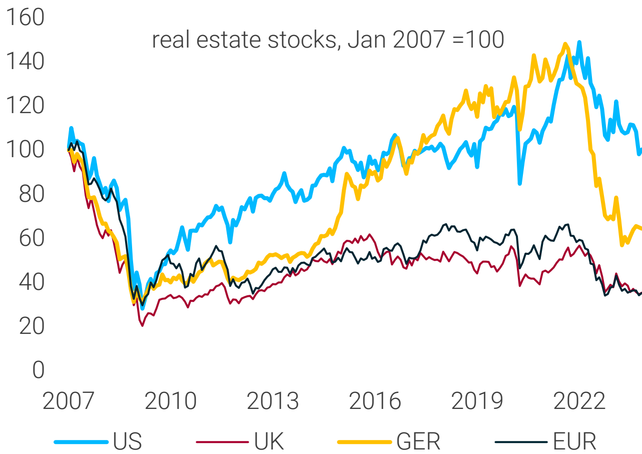
There has been a lot of talk about whether the financial markets are "already fully priced" for a soft landing. But this is clearly not the case in property markets, where stock prices are discounting the distinct possibility of further pain (as is the case in small cap equities). So early rate cuts and a confirmed soft landing could trigger a notable relief rally – even if they do not reignite the COVID bubble. We have always believed that the long-term outlook for real estate markets is favourable. Sure, interest rates are likely to stay higher than in the decade before COVID, but real estate performs well in a reflationary macro environment (which is what we continue to expect for the 2020s as a whole). Chart 32, based on long term UK data, which have the longest available history, shows there have been many periods when house prices and interest rates have been uncorrelated (e.g., the 1970s, the 1980s, much of the 1990s and even the early 2000s). And Chart 32, based on analysis by Steve Hou at Bloomberg, shows that real estate stocks perform better with rising inflation, up to a 4% inflation threshold, which is the point at which central banks typically become overly aggressive. For us, the recent uncertainty for property markets was all about the "bumpiness" of the transition away from a world in which investors had expected interest rates to remain at zero forever. But if inflation continues its recent descent, allowing an early policy pivot, that transition could prove easier than we feared.

Bottom line

Tighter monetary policy has delivered a powerful squeeze on global real estate markets, with property transactions, investment and construction activity hit particularly hard. Yet the broader impact of this correction – including the spillovers to other parts of the economy – has been much less pronounced that many pundits feared. Property prices have been stable in nominal terms, and there is no sign (yet) of serious financial stress or "forced selling" among homeowners. A number of forces have combined to prevent a more serious crash, including: (i) expectations of an imminent policy reversal; (ii) a sellers' strike and mortgage rate lock-ins; (iii) homebuilder incentives; (iv) various "extend and pretend" schemes; (v) money illusion; (vi) low unemployment; and (vii) new structural sources of housing demand. The worry is that most of

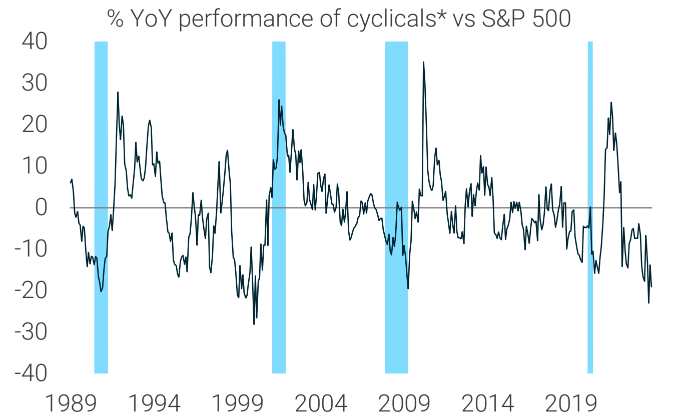
these explanations are tied to a common theme: the assumption that interest rates will remain at their current levels only for a brief period. Since this runs counter to central banks' policy guidance, it seems premature to rule out further pain for property markets in 2024. The good news, however, is that we are still talking about a risk scenario that would produce only a mild recession compared with past cycles. And now that inflation is on a swift descent, there is a good chance we will avoid this pain altogether – as long as central banks pivot soon. The path away from ZIRP was always going to be bumpy, but maybe it will be less bumpy than we assumed.

Chart 34: No soft-landing priced in here



Source: Datastream, TS Lombard

Chart 35: Soft landing would boost some equities



* median of banks, retail, homebuilders, autos & smallcap

Source: Druckenmiller recession indicator, Datastream

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