FLASH NOTE

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THE NORDIC HOUSING MARKET: A SLOWDOWN BUT NO COLLAPSE

After years of strong house price growth, Norway and Sweden both saw price falls in 2017, not because of economic or financial distress, but due to a surge in construction, initially to meet excess demand. In the past, the pace of price gains in Nordic housing markets has given rise to fears of a bubble.

In this note we review the current situation in Nordic housing markets and the factors that led to the correction in house prices in 2017. We then explain why we do not expect a 'hard landing' for Nordic housing markets. In our view prices are more likely to stabilise than decline further.

Norway and Sweden continue to grow faster than the rest of Europe[1], with high confidence levels, strong government finances and declining unemployment. In addition, low interest rates and tight commercial and residential sector supply/demand balances should support the real-estate market in the longer term, in our view. As a result, we expect that any spill-over effects from the recent correction to Norway and Sweden's real economies should be limited. That said, due to the increase in supply of new, high-end apartments and stricter mortgage regulations, there is a risk that the slowdown in the housing market might continue for a while longer.

Our conclusions are that the state of housing markets in the Nordics does not constitute a major threat to the health of Nordic equity markets. Direct exposures to property markets are limited in our investment universe and we do not anticipate meaningful repercussions from the recent correction within this sector in 2018.

Price development: housing market has been buoyant for the past 20 years

House prices in both Sweden and Norway have been on a rising trend for 20 years. In the most recent decade, prices accelerated even faster, mainly fuelled by ultra-low interest rates.

There are numerous drivers behind the buoyant housing markets in Sweden and Norway. Population growth boosted by migration and the urbanisation trend have supported demand while there has been a general supply deficit driven by many years of limited new-build activity. In addition, growth in disposable household income combined with record-low mortgage interest costs have been key drivers.

Figure 1: House prices Stockholm

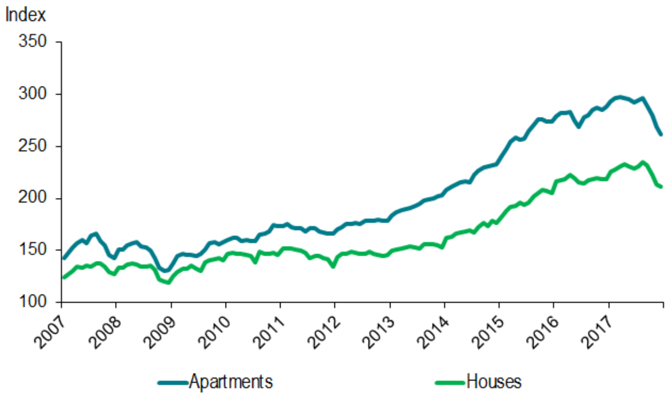
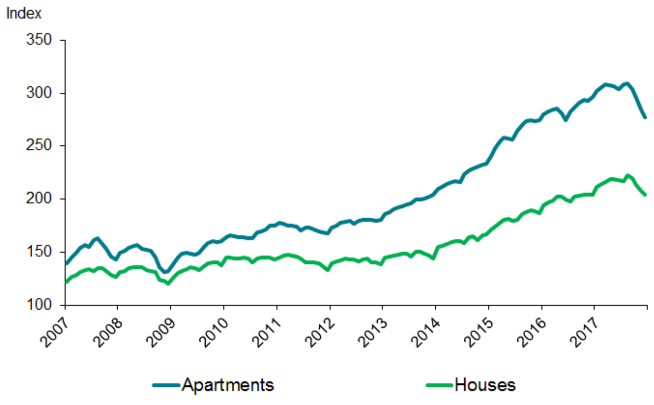


Figure 2: House prices Sweden total



Data through 31 December 2017. Source: Valueguard-KTH Housing Index HOX, Alfred Berg Asset Management. Note: The Stockholm House Price index is based on data from Swedish Mäklarstatistik AB, which compiles data from the Swedish real estate agents. The index gives a very adequate picture of price trends.

[1]OECD (2018), Gross domestic product (GDP) indicator.

Figure 3: House prices Oslo

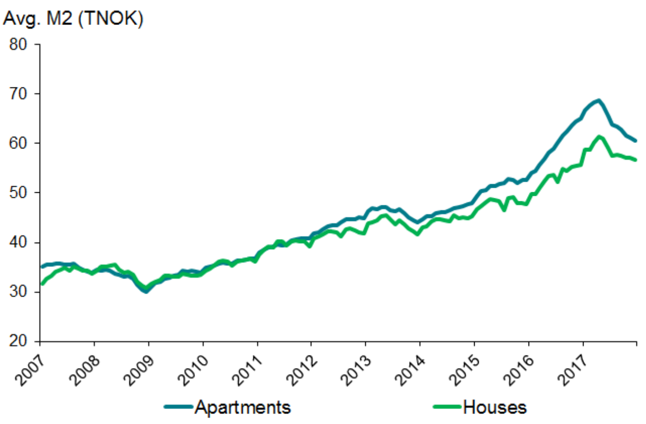
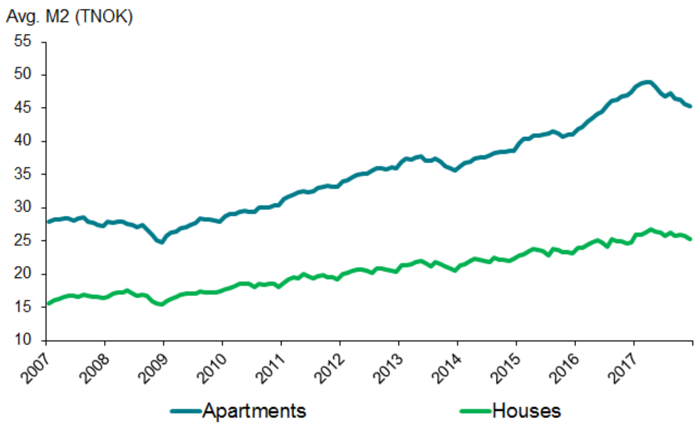


Figure 4: House prices Norway



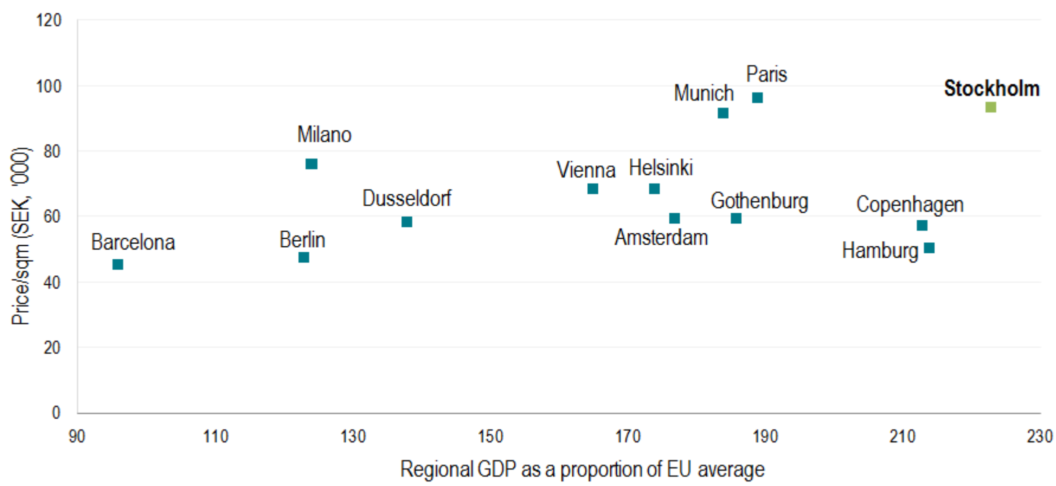
Data through 31 December 2017. Source: Ma crobond, Alfred Berg Asset Management. Note: Avg. M2 (TNOK) equals average square meters in thousand NOK.

Sweden and Norway were among the few countries that did not materially suffer major house price declines during the global financial crisis. Prices quickly resumed their upward trend when central banks began to reduce interest rates in 2008 and accelerated as interest rates fell further.

Residential property prices in Stockholm in a European context

It is interesting to note that residential prices have a strong correlation with regional GDP per capita levels across Europe. As is illustrated in the graph below, prices in Stockholm are high on an absolute level. However, one should also remember that the Stockholm region is one of Europe's most affluent.

Figure 5: Residential Prices versus regional GDP



Data through 31 December 2017. Source: Carnegie Research. Note : Price/sqm (SEK, '000) versus each city's GDP as a proportion of EU average.

What caused the housing slowdown?

The recent concerns about the Swedish housing market originated when prices began to decline in August, particularly in Stockholm. In Norway, house prices have been on a weakening trend for even longer, since mid-spring 2017. The downturn in both Norway and Sweden is mainly concentrated in metropolitan areas where the construction of new apartments is at its most prolific and debt-to-income ratios are the highest.

Historically, house price declines have often been triggered by higher interest rates, but that is not the case this time. Instead, the fall in prices has mainly been driven by a supply and demand imbalance and tighter mortgage regulations.

1) Supply increases in high-end segment

The weaker prices are not a consequence of changes in fundamental demand. We believe the downturn is primarily driven by the increase in supply within the high-end property segment and tighter policies limiting mortgage credit. High prices, especially in central urban locations, have led to an increase in the supply of new housing, which in turn is pushing prices down.

It is important to highlight that many new properties in Sweden are in high-end projects that most home buyers cannot afford. It appears there is currently a mismatch between the type of (mostly luxury) apartments produced and the people demanding them, which we believe should correct itself over time via adjustments in construction processes and discounts on rents and purchase prices. In any case, it is unlikely that the recent years of high-intensity construction will eliminate the long-term shortage of housing in both Sweden and Norway.

2) Tighter mortgage regulation and stricter lending standards

Tighter financial regulation has also had an impact on the housing market, mainly via policies that directly target mortgage lending. Norway tightened limitations on mortgage lending in early 2017 while in Sweden, higher amortisation requirements based on debt-to-income ratios will enter into force in March 2018.

Restrictions are substantial in both countries. However, the potential impact on the economy is larger in Norway as the regulations are harsher. In addition to mortgage value limits, there is a 40% deposit requirement on second homes in the Oslo area. This is limiting the buy-to-let market that had been an major driver of higher residential prices in and around the capital city.

In Sweden's case, there has over a longer period been a concern that house prices, and especially apartment prices, have boomed too far relative to the pace of economic growth, which would point to a 'healthy' correction being needed. In Norway, house prices are generally better aligned with the fundamentals of the economy, although – as in many capital cities – prices in Oslo are something of an exception and thus can be expected to decline somewhat further.

The million-dollar question is: will the market stabilise or correct further?

We believe house prices are more likely to stabilise than to decline further.

1) Macroeconomic indicators support a stable housing market

The overall macroeconomic environment is favourable in both Sweden and Norway. The global economy is enjoying a synchronised cyclical upturn, which benefits both these countries' export-driven economies. Strong GDP growth, falling unemployment and expansionary fiscal and monetary policy have led to robust growth in disposable incomes, while household savings are also high, especially in Sweden.

The banking systems in both countries are well capitalised with generally sound lending practices. In addition, strong public finances in both Sweden and Norway would act as a 'buffer' should there be a threat of a future economic 'hard landing'. Monetary policy will likely only be tightened slowly with low interest rates in Sweden and Norway expected to persist this year, keeping the cost of capital low.

2) Household finances are very strong

Another concern is that the downturn in residential prices might have an adverse impact on consumption growth. Although debt levels have risen significantly over the past few years, household savings have remained relatively high for a long time. Sweden has an aggregate household savings rate of more than 15%, which is very high both historically and by international comparison. The Norwegian savings rate is lower and has been declining in recent years, which makes Norway more vulnerable to changes in household spending.

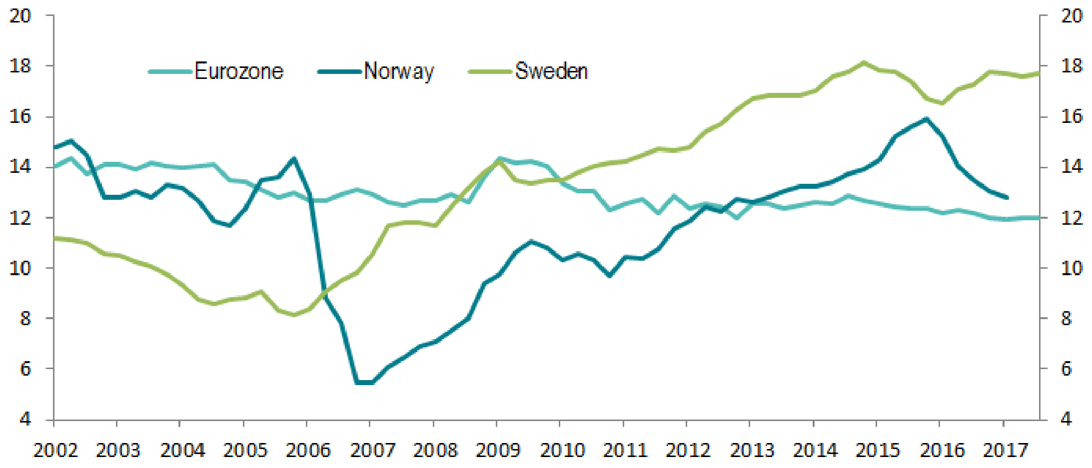
Since interest rates are likely to remain low and unemployment is falling, we believe that for the foreseeable future, Swedish and Norwegian households' high savings ratio and debt servicing ability (interest costs in the context of disposable income) is likely to limit the risk of a large price correction.

3) Resilience to a slowdown in construction

Residential construction has been key driver of economic growth in both Norway and Sweden. Looking ahead, the contribution to GDP growth from residential investments will be smaller, but we expect this to be counterbalanced by improving export conditions, a supportive global growth trend and higher public spending.

One major difference between Norway and Sweden is the higher proportion of home ownership in Norway. Sweden has a much larger rental market with about half of all newly-constructed flats being rentals. In Norway, there is a limited supply of rental apartments but a large buy-to-let market. In Sweden, however, the buy-to-let market is non-existent, mainly due to regulation, which makes demand more stable. Norway's larger proportion of home ownership makes its economy more vulnerable to a slowdown in new construction.

Figure 6: Household Saving Rate (%)



Data through 31 December 2017. Source: Macrobond. Gross household savings rate 2002-2017.

Alfred Berg: A Nordic real-estate specialist

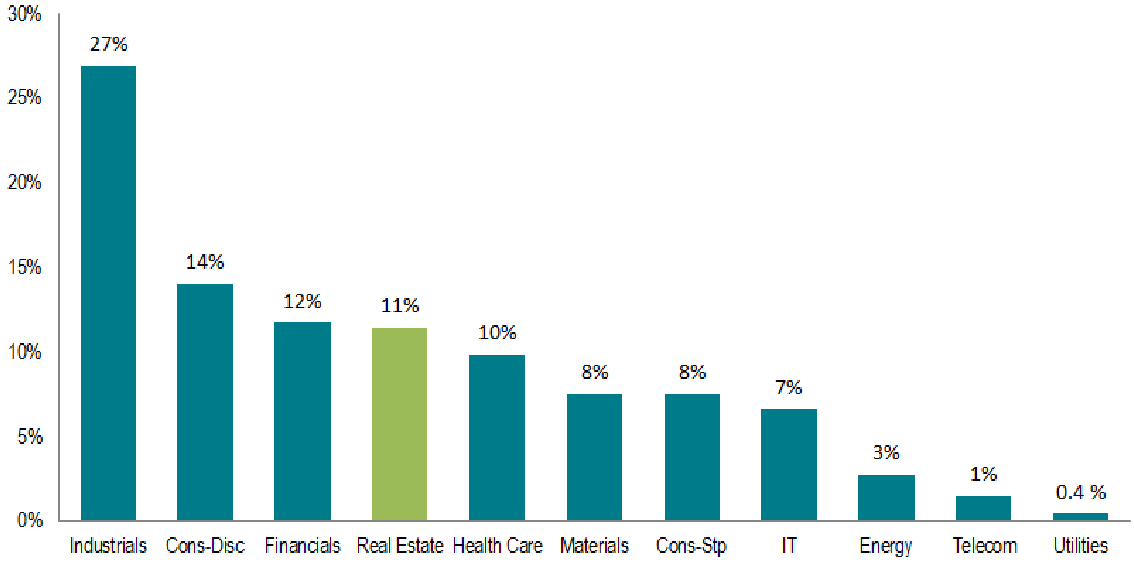
Alfred Berg Asset Management has a long tradition and expertise in Nordic real-estate investments managed in Stockholm by Senior Portfolio Manager, Jonas Andersson, who is also a member of the Nordic Small Cap equities team.

The Alfred Berg Nordic Real Estate flagship fund has a six-year track record, with an average annual return of 20%[2] . The fund is mainly comprised of stocks with commercial real estate exposure in the Nordic region. The local commercial property market is strong, with good tenant demand, low supply and low financing costs. We expect rents to increase further and higher value for commercial properties during 2018, especially in Sweden. Direct exposure to the currently soft owner-occupied residential market makes up less than 4% of the fund.[3]

A closer look at risk exposure in the Nordic Small Cap universe

We screen listed Nordic small cap companies in the real estate and construction segments that have exposure to the housing market, mainly within the more stable rental market.

Figure 7: Breakdown of Nordic small-cap investment universe by sector



Data through 31 January 2018. Source: BNP Paribas AM, Carnegie Small CSX Return Nordic Index.

2 Past performance is not indicative of future performance.
3 Alfred Berg Nordic Real Estate flagship fund exposure as of 31/01/2018.

Among the listed Nordic construction groups, only Skanska has an international profile; most of the others are purely local. Peab is a play on Sweden, Letho is a play on Finland, and Veidekke is a play on Norway, while NCC is more pan-Nordic.

Home-builders have the most direct exposure to a housing market correction. JM and Oscar Properties have Swedish exposure, while Selvaag is a play on Norway. Bonava is less exposed, as 38% of its business lies outside the Nordics in Germany, Russia and the Baltic countries.

In addition, there are various companies whose business depends on residential construction activity such as building materials supply and installation firms. Byggmax, a building materials retailer in Sweden, is by far the most exposed to housing market conditions, followed by window fabricator, Inwido, and kitchen solutions specialist, Nobia.

Within the Nordic equity small cap strategy, while we have limited exposure to companies in the construction sector, including residential property builders, we mainly have exposure to commercial real-estate segments that continue to offer good opportunities given the undersupply of attractive locations. The strong upward trend in commercial rents during the past two years has yet to feed through to the stock of contracts in the coming years.

The investments in the above fund are subject to market fluctuations and the risks inherent in investments in securities. The value of investments and the income they generate may go down as well as up and it is possible that investors will not recover their initial outlay, the fund described being in risk of capital loss.