MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 107 // **April 3, 2023**

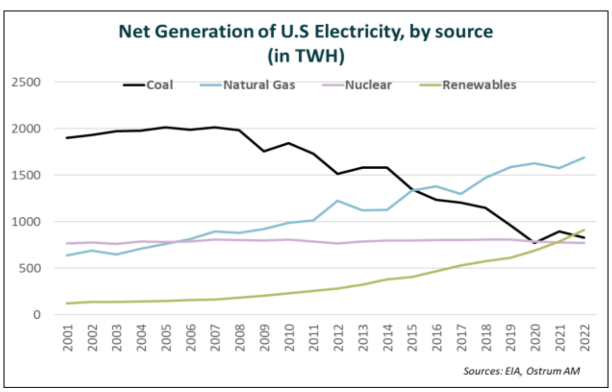
Topic of the week: Commercial real estate in a perfect storm?

- **Turmoil in regional banks, which are highly exposed to commercial real estate, cast doubt on the risk of refinancing for CRE loans this year;**
- **The tightening of credit conditions with the rise in rates is an additional element of tension;**
- **Real estate asset values have started to deteriorate, lagging behind the violent adjustment of REITs and listed real estate early on in 2022;**
- **Very wide spreads, over 900 bp on BBB CMBS, factor in a sharp deterioration in the sector despite reduced default rates.**

Market review: The hope for a return of confidence

- **Euro area: signs of stronger growth and higher core inflation;**
- **The banking crisis is dissipating;**
- **Equities rush towards quarterly close;**
- **Significant decline in rate volatility.**

Chart of the week



For the first time, more electricity has been generated by renewables in the US, surpassing coal. In 2022, renewables produced more than 900 TWH of electricity than the 800 TWH produced by coal.

However, to achieve carbon neutrality emissions targets, the US should increase carbon neutral sources. Natural gas accounts for 40% of electricity production in 2022, while renewables barely exceed 20%, which is comparable to coal (and nuclear).

Figure of the week

340

Source : Ostrum AM

Flows into US money market funds recorded their largest monthly increase since the Covid 19 crisis: more than $340 billion until March 28. This results from fears linked to regional banks but also from the higher yields offered by the latter compared to banks.

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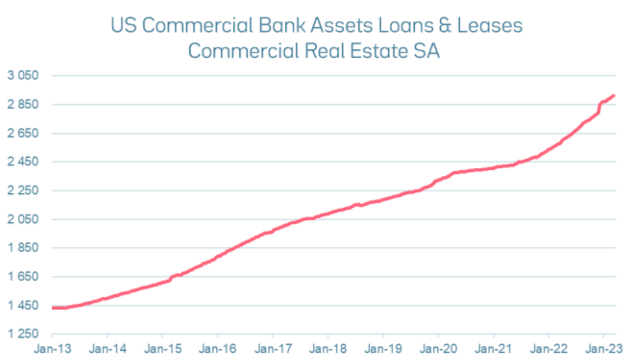
• Topic of the week

US commercial real estate in a perfect storm?

The turmoil in the US banking system raises the risk of a credit crunch. Given regional banks' exposure to commercial real estate (CRE), financial markets are questioning the availability of capital to refinance about $500 Bn worth of CRE debt maturing in 2023. CRE is not a monolith, but appraisal values of property have started to catch-up with falling listed-property assets (REITs, loan funds, CMBS). Delinquency rates remain low and LTV are reasonably low except but the heat is on.

CRE: read-across from regional bank turmoil

After the failures of Silicon Valley Bank and Signature Bank, commercial real estate has attracted renewed scrutiny from financial market participants. Commercial real estate (CRE) is a large $ 20 trillion market (in property value) that involves a lot of debt financing. Commercial real estate loans on bank balance sheet amount to roughly $ 2.9 trillion and the securitized debt market (CMBS) represents around 20-25% of that total.



Source: Bloomberg, Ostrum AM

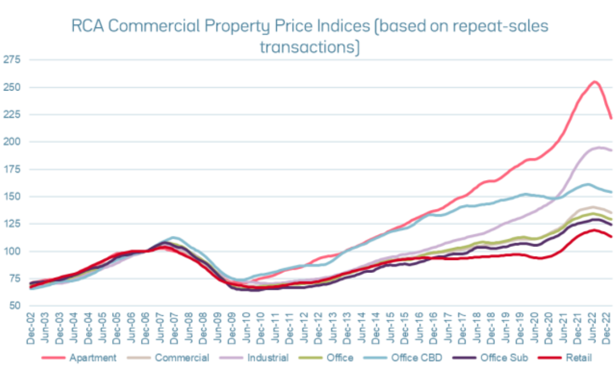
CRE is heavily levered by any standards across asset classes. The reversal of a multi-decade downtrend in long-term interest rates, as the Fed embarks on monetary tightening, has become a challenge in the past 18 months. The financing of commercial real estate requires a lot of expertise in local markets and often involves arm-length client relationships. Large banks don't provide that kind of service to middle-market real estate firms. That is why the CRE exposure of regional banks is under scrutiny at present. Investors need to assess the potential fallout from the deposit outflows from smaller banks and how that affects their ability to lend. Smooth functioning of the securitization market could assuage stress in property financing.

Property valuations: divergent signals

Commercial real estate is not a singular asset class. There are a lot of diverse sub-sectors within the catch-all CRE acronym including multi-family housing, hotels, shopping centers, healthcare units, data centers, cell towers, etc. Even within sub-sectors, office properties located in different regions will face different economic conditions impacting investor returns. Indeed, work from home since the pandemic has hit occupancy rates much more in New York (down to less than 50%) than in southern states where occupancy still hovers around 60-70%.

RCA provides repeat-sales price indices for a range of CRE sectors. During the financial crisis, national CRE prices went down 30% from their September 2007 high. Another price gauge produced by the Federal Reserve points to a 38% collapse in CRE prices between the third quarter of 2007 and the fourth quarter of 2009.

On CRA data, current CRE prices are 9.3% lower than their July 2022 peak. Apartments (i.e., multi-family units) are off the most (-13.1%) whereas industrial buildings are down only by 1.2%. Office prices in central business districts are 4.2% below their peak, slightly worse that non-prime area offices. Retail property is also rolling over on CRA estimates (-4.9% off the cyclical peak). The correction is modest so far but as we will see below, the number of transactions has declined.



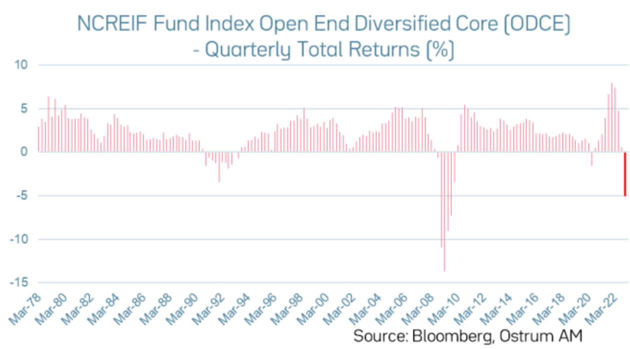
Source: Bloomberg, Ostrum AM

Property is undeniably hard to value. Property professionals often refer to capitalization rates (i.e., the inverse of the rental yield, comparable to a price-earnings ratio for stocks) as the benchmark valuation gauge. But there are alternative ways to assess valuations. Real estate investment trusts (or REITs), which are traded publicly, offer implied estimates of property values which takes account of changes in mortgage interest rates.

There can be huge divides between private valuations and market sentiment derived from REIT share prices. In the third quarter of 2022, office REIT shares were down about 30% year-to-date while private property valuations were still being marked up 2%. A 32% gap is uncommon, to say the least (though broad equity market crash can affect shares as in March 2020). The office REIT index turned down in the fourth quarter of 2022 losing 5% according to the NCREIF Property Index Office.

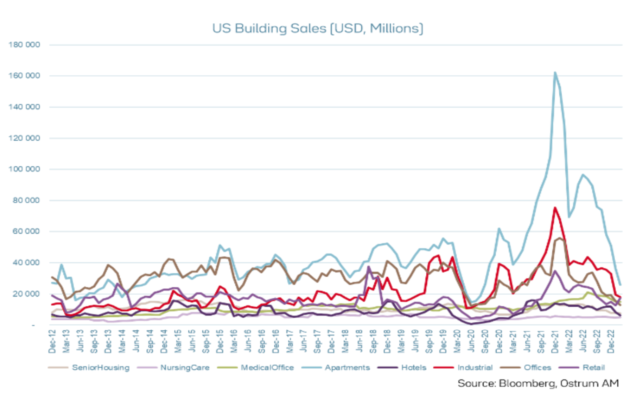
The broad open-ended fund real estate fund recorded negative returns in the fourth quarter as private valuations adjust downwards. This is the first time since 2009, and before that the S&L crisis of the early 1990s, that commercial real estate funds report quarterly losses. Private valuations of retail fell 3.2% in the fourth quarter from (dubious) all-time highs. Just as surprisingly, hotel valuations are recovering in 2022 although prices are still 13.6% off their 2019 peak.

Outflows from real estate funds have made headlines last autumn, which is a weak signal of distress spreading.



Gauging distress in commercial real estate transactions

The signal from listed property funds suggest that parts of the commercial real estate may be faced with distress. However, building transactions are at a low level currently.



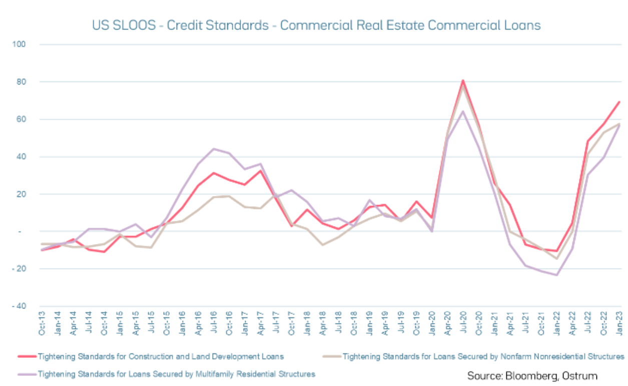
Distressed sales, when owners are forced to sell as in foreclosure procedures for instance, are rare currently as banks have not started foreclosing on problem loans. This creates inertia in the price discovery mechanism and the spread between ask prices and what buyers are willing to pay can stay wide for a while. This explains the gap between private valuations and REIT angst. Property owners tend to remain in denial of changing market conditions in the early months of a correction. The property market cannot clear until sellers accept the reality of lower prices allowing transactions to close. Meanwhile, the pressure from rising interest rates could entice buyers to close part of the spread.

Softer underwriting requirements are reversing as interest rates rise

In the late 2010s, credit standards had been softened to a degree thanks to low interest rates (improving debt service ratios) and declining LTV (due to higher property prices). Interest-only loans have been increasingly popular over the past couple of years. Alternative credit metrics have been adopted as standard practice for bank lending. The debt yield - net operating income (NOI) divided by loan value - has emerged as a key metric for lenders. NOI is property revenue less all operating expenses. Importantly it knocks out financial costs, which can prove inadequate at a time when interest rates increase.

NOI growth was still very healthy in 2022 (+10-11%) allowing for some underwriting at lower NOI growth reflecting expectations of economic headwinds. Inflation operating expenses denting NOI going forward.

According to the Fed's SLOOS study, credit standards on the commercial real estate loans have tightened in keeping with rising Fed funds rates. Tighter standards have weighed on loan demand as reported by banks.



Refinancing amid stressed bank liabilities

The $ 20 trillion worth of commercial real estate is levered to the tune of about $ 4.5 trillion debt outstanding. A rough aggregate loan to value is hence around 25% for the entire CRE sector. REITs and funds invested in high-quality properties may have LTV in the 22-30% range. Small borrowers may pull LTV up to 50-60%, that's what is typically observed in CMBS transactions.

Of the $ 4.5 trillion debt, around 15-20% is coming due every year over the next 5 years. Initial loan maturities cluster at 5 and 10 years, which means that loans coming due in 2023 have been originated in 2013 and 2018 in a much lower interest rate environment. On the bright side, property prices have risen since 2013. Effective LTV has therefore drifted lower over the past decade. Past property price appreciation suggests that most loans will not be underwater upon refinancing. However, LTV could prove problematic for sectors that have gone through significant structural changes – shopping centers as online retailers gain market share or offices faced with the development of work-from-home. Some shopping malls' LTV could be in the ballpark of 90-95% making refinancing harder.

The table below breaks down LTV by CMBS vintage and sectors. Bear in mind that the CMBS market reflects transactions that are more levered than average.

US CMBS - Wtd Avg Mortgage Ratios, Current LTV							
Vintage	Hotel	Retail	Office	Indust	MFam	Other	All
2023	59%	41%	47%	57%	57%	49%	75%
2022	77%	55%	63%	61%	54%	82%	78%
2021	87%	46%	57%	70%	64%	57%	76%
2020	252%	59%	65%	66%	81%	91%	98%
2019	67%	61%	58%	65%	71%	48%	61%
2018	66%	80%	383%	399%	62%	59%	292%
2017	64%	54%	60%	66%	63%	56%	63%
2016	61%	66%	51%	61%	61%	63%	60%
2015	62%	48%	58%	70%	61%	64%	63%
2014	51%	69%	64%	61%	62%	60%	61%

Source: Bloomberg, Ostrum AM

Regional banks are the dominant lending institutions in the commercial real estate sector. For instance, First Republic has the 9th largest CRE loan portfolio (concentrated in the Bay area), and Signature had the 10th largest (New York) before it collapsed, according to Trepp's data.

One should add that a majority of CRE loans are now bullet although amortizing loan deals had been widespread in the years following the 2008 financial crisis. Possibly half of the CRE loans coming due this year sits on bank balance sheets. Other major lenders include insurance companies, and GSEs for multifamily, student housing, and seniors housing. The refinancing risk of property within the GSE remit is minimal. Debt funds, mortgage REITs and the CMBS market will chip in as well. Regarding the office sector accounts for 20% of 2023 maturities at a time when property values are being marked down sharply especially in the battled New York market.

Comparatively, securitization activity has been slow to pick up after being a central piece of the 2008 financial meltdown. That's one of the reasons why CMBS are underrepresented in 2023 maturities. Regulation (Dodd-Frank) requiring CMBS issuers to have skin in the game also slowed the recovery in securitized asset issuance from the mid-2010s. However, CRE loan (and CMBS) issuance has picked up considerably through the recovery from covid. The more recent deals could prove harder to roll in the years to come.

Market participants focus on Treasury yields as a key gauge for refinancing cost. Ten-year note yields have increased around 200 bps from a year ago. Meanwhile, spreads have moved considerably wider at least in the CMBS market. The AAA tranche is pricing about 130 bps over US Treasuries and BBB is north of 900 bps. The CMBS market is hence pricing in a lot of risks. CMBS rated BBB yielding close to 13% represent both a great opportunity for investors given the loss risk and a potential impediment to refinancing. In sum, commercial real estate is inherently a levered asset class, so both financing cost and availability of capital are crucial.

So far, low default rates prevail

Despite widespread financial stress surrounding regional bank failures, delinquency rates remain very low across most CRE sub-sectors. Hospitality is under the most stress with 90-day delinquencies above 4% (January 2023). Foreclosure rates in hotels stand at 1.34. Unsurprisingly, the watch list is extended in the office sector. The largest market segment is the multi-family sector which is underwritten in large part by government-sponsored enterprises. Given the lack of affordable housing in the US, refinancing risk appears minimal. On a regional basis, 90-day delinquency rates are highest (1.2%) in the New York/New Jersey region (due to the dire situation of offices) and Illinois.

Property Type	30Day	60Day	90D+	Forecl.	REO	WList	#Obsv
Office	0.09	0.07	0.65	0.05	0.64	17.1	*4 293*
Hospitality	0	0.08	4.06	1.39	0.77	31.33	*2 722*
Resident	0.13	0	0.15	0.05	0	6.38	*45 847*
- Multi-family	0.13	0	0.15	0.05	0	6.42	*44 970*
Health Care	0.21	0	1.06	0	0	9.67	*3 279*
Industrial	0.17	0.08	0.13	0.02	0.11	9.07	*3 339*
All properties	***0.14***	***0.06***	***0.74***	***0.14***	***0.29***	***11.64***	***78 631***

Source: Bloomberg, Ostrum AM, Jan 2023 data

Conclusion

Regional banks, currently under stress with deposit outflows, play a key role in the financing of commercial real estate. Turmoil in the financial sector ignited

concerns about refinancing risk of CRE loans as around $ 500 billion debt comes due in 2023. Private property valuations started to fall in the fourth quarter, long after a slump in REIT share prices and other listed-property (CMBS). Tighter credit standards amid higher interest rates and reduced availability of capital could cause damage to property values and CRE investments. However, CMBS spreads and REIT prices already reflect dire conditions whilst default rates remain low across most sectors.

Axel Botte

Market review

Hope for a return of confidence

The banking crisis is receding, equities end the first quarter with a bang, leading all risky assets higher.

The worst is never certain. The renewed interest in risky assets accompanies an initial lull in interest rate volatility. The financial markets thus give central banks the benefit of the doubt as to their ability to lead the fight against inflation and maintain financial stability. The principle of separability between economic and prudential objectives is in line with the ancestral precepts of Walter Bagehot (1973), who recommended, in order to avoid panic, to lend freely (that is to say without limit) against good collateral at high interest rates. The BTFP, $64 billion in assets to date, is built on this principle. Total Fed interventions have diminished somewhat last week.

Equity markets end the first quarter on a note of optimism. The Euro Stoxx 50 stands at +13% in the first quarter. The selling pressure on banking stocks is fading under the effect of end-of-quarter buybacks (+6% over one week). Meanwhile, AT1s are looking for a new paradigm after the Credit Suisse bailout imbroglio. Growth stocks benefited from the plunge in banks in March. The money markets are still pricing in a significant probability of a rate cut as an insurance against a sudden economic downturn. The US 2-year note yield nevertheless rose back above the 4% threshold. The easing in credit spreads helped financial subordinated debt and high yield to outperform. The iTraxx Crossover is again trading under 450 bps. The Japanese yen (133 yens against the US dollar) depreciated slightly correcting excess pessimism in the market over the past few weeks. The sharp market upswing is no doubt amplified by the quarterly closing flows.

The decline in risk aversion is fueled by evidence of an economic upturn. Activity surveys in Europe and China improved markedly in services in March, overshadowing a slower recovery in the manufacturing sector. The German IFO is showing signs of life. In the United States, the housing sector has also been recovering for several months. US GDP growth is expected to exceed 3% in the first quarter. In China, some banks are already penciling in about 6% growth this year. The flipside of stronger demand is inflation. In the euro area, consumer prices decelerated to 6.9% year-over-year (March) thanks to a colling in energy, but the improvement proved uneven across countries as it depends on local governments' support measures. Core inflation rose to 5.7% from a year ago under the impetus of service prices passing on wage pressures. In the United States, the release of the PCE deflator (5% in February) somewhat alleviates the fears relayed by Jerome Powell at the beginning of the month. On the contrary, worrisome UK price indicators contradict the BoE's blissful optimism about the path forward for inflation.

In global bond markets, the flight-to-safety premium on risk-free assets is fading as the quarter-end close approaches. The Bund yield moved higher towards 2.30% as yields on US 10-Yr notes hover about 3.50%. The easing in liquidity tensions can be seen in the narrowing of swap spreads in the euro area even if absolute spread levels remain historically elevated. The swap spread on the Schatz stands at 77 bp. The reduction in risk aversion has not yet caused significant shifts in global asset allocation. Money market funds continue getting large inflows. In the United States, money market fund inflows totaled more than $500 billion in the first quarter, including $100 billion in the second half of March as deposits fled troubled US banks. The favorable risk sentiment is reviving the trend for flatter yield curves. The US 2-10y spread plunged back to -58 bps. The steepening pressure on the back-end of the curve (10-30 year spread) is also receding. Curve dynamics are similar in the euro area. Inflation break-even points rose by around ten basis points in the euro area, i.e. roughly half of the movement in nominal benchmark bond yields. UK breakeven inflation rates widened by as much as 25 bps last week.

The primary bond market recovered somewhat last week. Sovereign and supranational issuance totaled €14bn last week thanks the EU bond deal (€6bn). The emerging debt market is also open for Costa Rica and Poland for instance. In credit space, weekly bond issuances of financial debt, mainly covered bonds from issuers outside the euro area, and non-financial issuers, reached €9 billion each. The primary activity is also returning to high yield, in particular for the highest-rated names (BB+). Other transactions suggest improved sentiment as well.

Volatility remains high on synthetic credit indices. The iTraxx crossover has tightened by almost 70 bps since the launch of series 39. Spreads on the Euro IG (172 bps against Bund) tightened significantly last week with an outperformance of subordinated debt securities and hybrid bonds. Cocos also participated in this rally.

As regards equity markets, the banking crisis is visibly receding. The major global indices are up anywhere between 2 and 4% over the past week. Shanghai is slightly lagging behind. Cyclicals are driving the rebound in the US market, while the rise in European markets is less uniform with some defensive sectors and banking in the lead. The flows do not seem to support renewed optimism in Europe.

The foreign exchange market remains less lively, not very volatile with a barometer, the Japanese yen, which fluctuates inversely, risky assets. The next decisions of the BoJ should revive the appreciation of the yen.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	03-Apr-23	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	2.67%	+14	-55	-10
EUR Bunds 10y	2.24%	+2	-47	-33
EUR Bunds 2s10s	-42.9bp	-13	+8	-22
USD Treasuries 2y	3.99%	-1	-87	-44
USD Treasuries 10y	3.41%	-12	-54	-47
USD Treasuries 2s10s	-58.5bp	-12	+32	-3
GBP Gilt 10y	3.42%	+5	-43	-25
JPY JGB 10y	0.39%	+7	-6	+3
€ Sovereign Spreads (10y)	**03-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	50.16bp	-1	+0	-4
Italy	184.19bp	+1	+4	-29
Spain	102.15bp	-1	+1	-6
Inflation Break-evens (10y)	**03-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	2.48%	+5	-33	-7
USD 10y Inflation Swap	2.56%	+6	-16	+4
GBP 10y Inflation Swap	3.91%	+17	0	+0
EUR Credit Indices	**03-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	170bp	-14	+22	+3
EUR Agencies OAS	76bp	-6	+6	-3
EUR Securitized - Covered OAS	89bp	-6	+10	+5
EUR Pan-European High Yield OAS	497bp	-40	+63	-15
EUR/USD CDS Indices 5y	**03-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	85bp	-11	+8	-5
iTraxx Crossover	444bp	-48	+43	-30
CDX IG	77bp	-7	+5	-5
CDX High Yield	470bp	-34	+34	-14
Emerging Markets	**03-Apr-23**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	484bp	-19	+37	+32
Currencies	**03-Apr-23**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.089	0.880	2.426	1.8
GBP/USD	$1.240	0.936	3.041	2.6
USD/JPY	JPY 132	-0.499	2.753	-0.8
Commodity Futures	**03-Apr-23**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$84.8	$7.0	-$0.5	0.01
Gold	$1 989.9	$33.2	$133.4	9.09
Equity Market Indices	**03-Apr-23**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 106	3.24	1.50	6.9
EuroStoxx 50	4 307	3.42	0.29	13.5
CAC 40	7 346	3.78	-0.03	13.5
Nikkei 225	28 188	2.59	0.93	8.0
Shanghai Composite	3 296	1.38	-0.96	6.7
VIX - Implied Volatility Index	19.38	-5.92	4.81	-10.6

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

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