MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

This document is intended for professional clients in accordance with MIFID
N° 157 // **May 6, 2024**

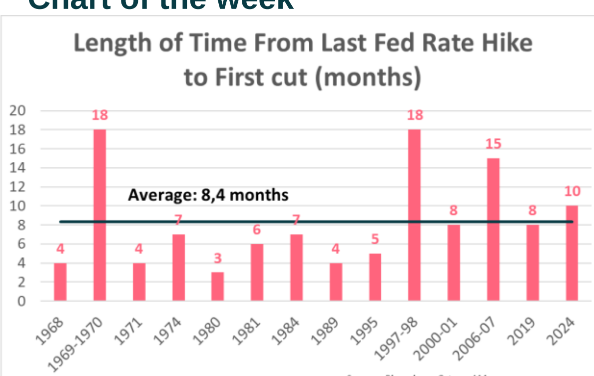
Topic of the week: The commercial real estate crisis in the Eurozone and financial risk

- **The price of commercial real estate in the Eurozone has dropped significantly due to the sharp increase in interest rates;**
- **Structural factors are also at play with the teleworking, online commerce, and the demand for buildings with better energy efficiency;**
- **The outlook, while slightly improving, remains degraded;**
- **For the ECB, commercial real estate represents one of the most significant risks to financial stability in the Eurozone;**
- **Its focus is on real estate investment funds, which represent 40% of the commercial real estate market;**
- **In the event of market stress and significant investor redemption requests, open-ended real estate investment funds (80% of the funds) are exposed to a liquidity risk that could pose a systemic risk to the commercial real estate market and impact the financial stability of the Eurozone.**

Market review: Beyond appearances

- **Fed rules out a rate hike and will slow the pace of QT;**
- **Job growth and wages moderating in the US;**
- **T-note yields dip below 4.50%;**
- **BoJ intervenes in markets to stem yen weakness.**

Chart of the week



The Fed opted for a status quo for the 10th consecutive month at its meeting on April 30th and May 1st. This duration exceeds the average time period between the Fed's last rate hike and its first rate cut, which is typically 8 months.

The Fed is giving itself more time before starting to lower its rates due to higher-than-expected inflation. However, it has made its monetary policy less restrictive by slowing the pace of balance sheet contraction, from June onwards, to $60 billion per month, compared to the previous $95 billion per month.

Figure of the week

9

Source : Bloomberg

It's, in trillions of yen, the estimated amount of the BoJ's interventions last week (unconfirmed by it) to try to stem the yen's decline (5.5 trillion yen on April 29th and 3.5 trillion yen on May 1st).

Axel Botte
Head of Market Strategy
axel.botte@ostrum.com

Zouhoure Bousbih
Emerging countries strategist
Zouhoure.bousbih@ostrum.com

Aline Goupil-Raguénès
Developed countries strategist
aline.goupil-raguenes@ostrum.com

● **Topic of the week**

The commercial real estate crisis in the Eurozone and financial risk

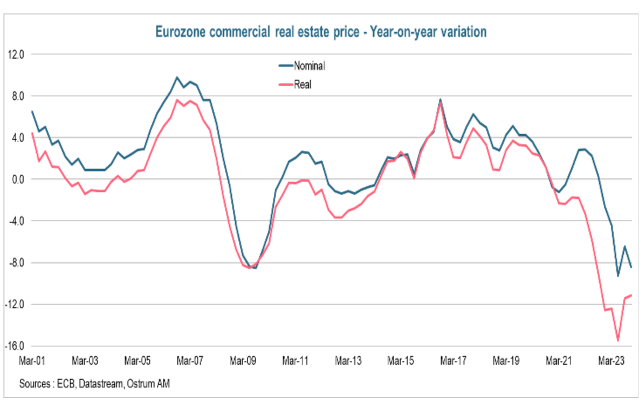
The price of commercial real estate has dropped significantly since 2022 in Europe, as in the United States, due to the sharp and rapid increase in interest rates. The sector is also facing structural changes with the development of teleworking, e-commerce, and the demand for buildings with better energy efficiency. For the ECB, commercial real estate represents one of the most significant risks to financial stability in the Eurozone, given the strong presence of open-ended real estate investment funds.

The commercial real estate crisis

Significant drop in prices

The price of commercial real estate in the Eurozone has dropped significantly since 2022, similar to the United States. Over the year, the contraction was 8.4% in the Eurozone in the fourth quarter of 2023, following 9.3% in the second. The decline is comparable to that which occurred during the global financial crisis of 2008/2009.

The drop in prices is even more significant when the inflation effect is removed. In real terms, prices decreased by 11.2% in the fourth quarter, year-on-year, and by 15.5% in the second quarter. These are the most significant contractions since 2001 (the beginning of the series published by the ECB).



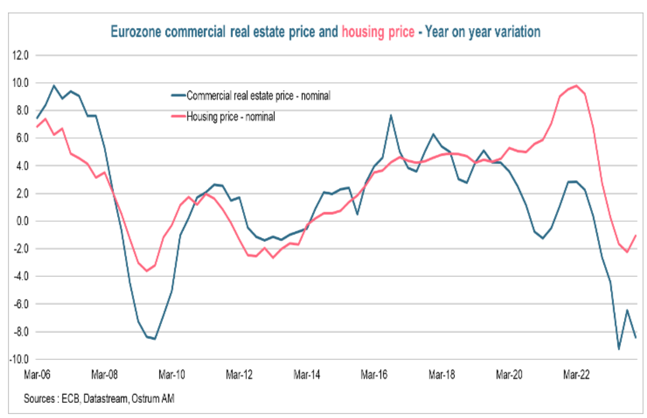
Impact of the sharp increase in interest rates...

This decline is largely due to the significant increase in interest rates that occurred during the period, following the historic monetary tightening implemented by the ECB to combat excessively high inflation. The central bank raised its rates by 450 basis points between July 2022 and September 2023, bringing the deposit rate to a record high of 4%. Bond yields adjusted accordingly, with the yield on the 10-year German bond moving from -0.1% in early 2022 to 3.0% on October 3, 2023, and closing at 2% on December 29, 2023, and then at 2.5% on May 3, 2024.

These sharp interest rate increases directly impact the real estate market as they make borrowing costs higher, thus reducing demand for new loans, which directly weighs on investment in this sector. Furthermore, this sharp increase in interest rates occurred after they had been kept at historically low levels for years, which had encouraged companies to borrow extensively. The adjustment has therefore been abrupt.

… but not only

Like commercial real estate, residential real estate has been impacted by the sharp increase in mortgage rates, but to a much lesser extent, as shown in the following graph. After a significant increase following the Covid-19 crisis, reaching a nearly 10% year-on-year increase in the first quarter of 2022, residential real estate prices have reversed to a decline of 2.2% in the third quarter of 2023 and 1.1% in the last quarter.



This is mainly due to the fact that households have benefited from a strong labor market, with the unemployment rate remaining at historic lows despite sluggish growth in 2023. In addition, housing shortages in certain countries, particularly Portugal, have also contributed to this situation.

Commercial real estate companies have been more affected as they have faced not only the rise in interest rates but also a loss of profitability, as well as structural factors that have had an additional impact on the sector.

Decrease in profitability

The profitability of real estate companies has decreased over the period. This is due to the fact that their business relies on heavy borrowing to finance the construction of buildings. These loans are repaid by the future rents paid by tenants. Due to the sluggish growth in the Eurozone, companies have faced lower demand for rental properties and therefore less rental income to repay their debt. This occurred as the debt service increased due to the sharp rise in interest rates. Profitability also depends on the value of the assets held. As we have seen previously, prices have dropped significantly since mid-2022. The adjustment has been even more significant as valuations were found to be excessive.

Structural factors are at play

Development of teleworking and e-commerce

Since the Covid-19 crisis, businesses have adopted teleworking, resulting in a significant decrease in demand for office space and a marked increase in vacancy rates. The retail sector has also experienced a similar trend due to the growth of online commerce, which reduces the demand for commercial spaces. The cash flow prospects for office and retail property investment, tied to expected rent growth, remain lower than pre-Covid levels, indicating likely structural changes in these sectors.

Climate change

The decline in prices is more pronounced in lower-quality assets (non-prime). With less space needed, tenants are seeking smaller spaces and higher-quality buildings (prime), particularly in terms of location and energy performance.

This trend will be reinforced in the coming years with the revision of the European Union directive on the energy performance of buildings, adopted on April 12 by the European Parliament. It will be implemented gradually and aims to introduce new measures to decarbonize the sector. By 2030, 16% of the least energy-efficient non-residential buildings must be renovated, and 26% by 2033. New buildings must be zero-emission by 2030. The directive aims to make the building sector climate-neutral by 2050.

To this end, the European Commission aims to double the renovation rate of buildings by 2033. In 2020, the average weighted renovation rate was only 1% per year. The EC estimates that property owners will need to make additional investments averaging 275 billion euros per year for renovations. This will represent an additional cost for real estate companies.

Recent trend

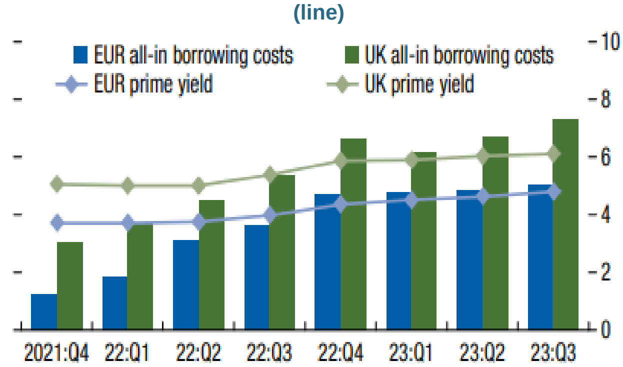
Further decrease in transactions in Q1 2024

In the first quarter of 2024, commercial real estate transaction volumes in Europe decreased for the 7th consecutive quarter: -26% year-on-year, according to MSCI. These have reached their lowest level in 13 years. Investors remain cautious in a context still marked by high interest rates, low growth, and the structural changes at work since the pandemic. The divergence between buyers' and sellers' price expectations continues to weigh on transactions.

Downside risks remain high

In its latest Financial Stability Report (April 2024), the IMF indicates that downside risks in the commercial real estate sector remain high. As shown in the graph below, the yields from holding prime commercial real estate (blue line) are still lower than the cost of financing these acquisitions through debt (blue bars), given the rise in interest rates. This contributes to the decline in prices.

Debt cost in commercial real estate (bars) and prime yields (line)

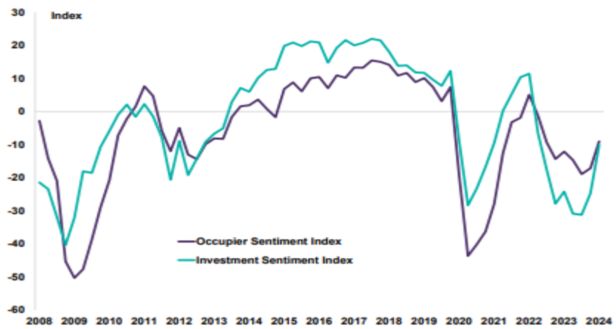


Sources : IMF, Ostrum AM

The outlook is slightly less degraded

According to the latest RICS (Royal Institution of Chartered Surveyors) survey, the sentiment indices in the European commercial real estate improved for the second consecutive time in the first quarter, remaining in negative territory. This is the result of both investors (in blue on the chart) and tenants (in purple).

Sentiment indices of tenants (purple) and investors (blue) in Europe



Sources : RICS, Ostrum AM

The share of respondents considering that the market has reached a floor has increased (36% compared to 30% previously), and those anticipating further deterioration has decreased (31% compared to 52%). However, expectations remain degraded as interest rates are not expected to return to the previously prevailing lows, with growth only beginning to gradually pick up, and structural changes continue to weigh on business prospects.

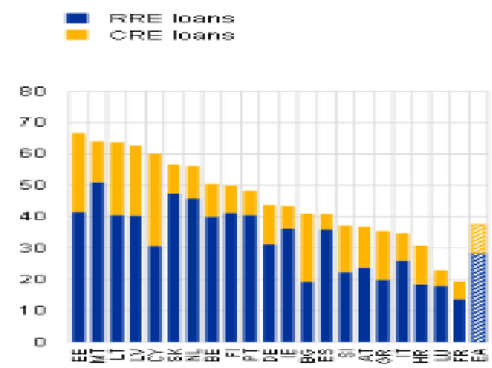
Financial risk of the commercial real estate crisis

According to the ECB, commercial real estate is one of the main risks to the financial stability of the euro area. Luis de Guindos, Vice President of the ECB, reiterated this during the press conference on March 7th.

Exposure of European banks is quite limited

In its latest Financial Stability Review (November 2023), the ECB indicates that the exposure of European banks to commercial real estate is quite limited, representing approximately 10% of bank loans in the Euro area, compared to 30% for residential real estate loans. In March, Luis de Guindos cited a figure of about 5% for bank loans exposed to commercial real estate. The overall exposure of banks is therefore relatively limited, and commercial real estate alone cannot lead to a systemic crisis. However, the ECB notes that it can play an amplifying role in the event of broader market stress. Nevertheless, there are divergences between countries, as shown in the following graph. Banks in the Baltic countries are the most exposed.

Exposure of banks to residential real estate (blue) and commercial real estate (yellow) - as a percentage of loans, Q4 2022



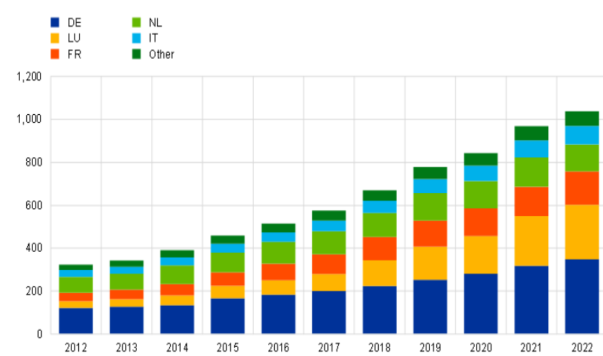
Sources : ECB, Ostrum AM

Furthermore, specialized commercial real estate institutions are inherently more exposed compared to banks with a broader positioning. This is the case for certain German institutions notably. Compared to the 2008 crisis, banks have increased their capital and can thus absorb more losses than in the past.

Higher exposure of real estate investment funds

In its Financial Stability Report, the ECB indicates that the risk related to commercial real estate is more pronounced in the non-banking sector, specifically in real estate investment funds. Their net asset value tripled between 2012 and 2022 to reach 1,040 billion euros. These funds are concentrated in Germany, Luxembourg, France, Netherlands and Italy.

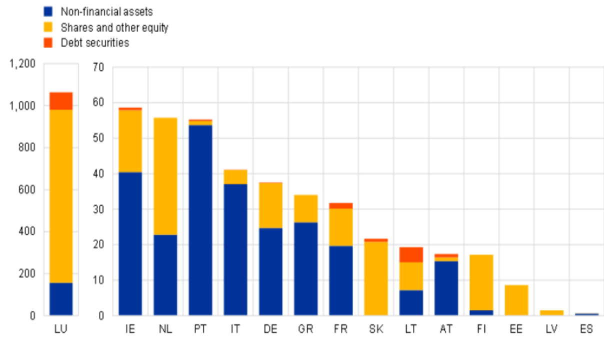
Net asset value of real estate investment funds in the Euro area - In billion euros



Sources : ECB, Ostrum AM

These real estate investment funds represent 40% of the commercial real estate market in the Eurozone. This share is higher in Ireland, the Netherlands, Portugal, and Luxembourg.

Share of real estate investment funds in commercial real estate by country - In %



Sources : ECB, Ostrum AM

The risk specifically lies within open-ended real estate investment funds, which represent 80% of these funds. This stems from their intrinsic characteristic, given that their assets, based on real estate, are inherently illiquid, unlike their liabilities (institutional and individual investments). In the event of market stress, open-ended investment funds may face massive and rapid redemption requests from investors. Forced asset sales to meet these demands would amplify the decline in commercial real estate prices. Given the importance of investment funds in this market, they pose a systemic risk to the commercial real estate market, which could impact the financial stability of the Eurozone.

The Financial Stability Committee made recommendations in 2017 to address this liquidity risk, but no improvement was observed in 2022. The committee has recently reviewed these recommendations.

Conclusion

The sharp and rapid increase in interest rates and the structural changes at play, such as the development of teleworking, e-commerce, and climate change, are weighing on the commercial real estate market. For the ECB, this market represents one of the greatest risks to the financial stability of the Eurozone. While the exposure of banks is quite limited, the same cannot be said for real estate investment funds, which represent nearly 40% of the commercial real estate market, the majority being open-ended funds. In the event of market stress and significant investor redemption requests, these investment funds are exposed to a liquidity risk that could pose a systemic risk to the commercial real estate market and impact the financial stability of the Eurozone.

Aline Goupil-Raguénès

Market review

Beyond appearences

The Fed rules out a rate hike despite inflation as employment moderates. Risky assets rebound.

The accommodative stance of the Fed always resurfaces at some point. For better or for worse. The persistence of elevated inflation is postponing the timing of expected rate cuts, but it does not call into question a cycle of monetary easing that is conditioned on the US policymakers' "confidence" in continued disinflation. In fact, the monetary easing has already begun through the balance sheet policy. This sounds like falsely hawkish rhetoric. The calm in the bond market, with the T-note yield back below 4.50%, is beneficial to risk assets. Jerome Powell's remarks also provide an opportunity for Japanese authorities to intervene in the yen. The Japanese currency is trading below 154 yen to the greenback. The Bund yield is easing towards 2.50% in parallel with the T-note rally, alleviating pressure on sovereign spreads. Credit remains stable. High yield spreads are narrowing, despite a less supportive fund flow picture. Positive quarterly earnings reports in the US technology sector are enough to spur equity markets higher towards Friday’s close. The abrupt changes in direction during US stock market trading sessions are again a sign of extensive use of 0DTE options.

The FOMC maintained the status quo on interest rates at 5.25-5.50%. Disinflation is slowing down, but Jerome Powell rules out further monetary tightening. Conversely, the balance sheet will shrink less rapidly from June onwards. The Fed’s Treasury portfolio will decrease at a $25 billion monthly pace instead of the $60 billion previously. The Fed will thus be able to reinvest more of its portfolio proceeds. The MBS portfolio will continue to amortize up to a maximum of $35 billion per month, but all MBS maturities will be reinvested in Treasury securities. The Fed aims to rebalance its portfolio into government securities while maintaining a relatively more restrictive bias on mortgage credit conditions. Meanwhile, the US Treasury will maintain April auction sizes for the May to July period. Net T-bill issuance will be negative to the tune of $300 to $400 billion due to favorable tax receipts in April and the inversion of the yield curve. The US Treasury also announces a $2.5 billion weekly debt buyback program that will commence at the end of May. Regarding economic activity, job creation slowed to 175k in April. The unemployment rate remains below 4%, but several surveys (JOLTS, NFIB, ISM services) confirm a reduction in excess labor demand. Labor costs remain problematic, especially as commodity prices have tightened over the past month. Inflation is also weighing on consumer confidence. In the Eurozone, inflation remained steady at 2.4% in April. The rebound in energy prices is offset by a deceleration in service prices (3.7%).

The volatility of interest rates remains elevated, but the outcome of the FOMC meeting has reversed upward pressures on yields. Positioning surveys indicate a moderately bullish sentiment. Put-call ratios no longer indicate a strong directional bias. The 10-year T-note yield has retraced lower from 4.70% to below 4.50% after the job report. This may be a sign that data will regain some importance after the FOMC meeting. The Bund concurrently fell below 2.50%, a level that still attracts investor interest. Sovereign spreads are easing. The OAT is trading at 48 bp, with net flow balances favorable in May before S&P's decision at the end of the month. The Italian BTP also shrank to around 130 bp against the Bund. The upcoming issuance of a new BTP Valore provides support to the Italian government bond market.

In credit markets, flows remain favorable, resulting in lower new issue premiums. The low volatility environment persists in credit markets, with asset swap spreads capped within 80 bp. The high yield market, however, has seen some profit-taking, while the primary market is now more active with 4 to 5 transactions per week. Spreads on speculative-grade bonds have nevertheless narrowed during the week, as seen in the 8 bp decline in the iTraxx Crossover index. As for equities, corporate earnings have boosted U.S. indices, especially in megacap space. Apple's share buyback plan accompanies the strong performance of other major stocks. Growth stocks also respond positively to less dynamic job creation.

Furthermore, the Bank of Japan has finally intervened to stabilize its currency, which reached 160 against the dollar. The Ministry of Finance took advantage of the FOMC meeting to repurchase yen worth $23 billion. The Japanese yen is now trading around 153.

Axel Botte

Main market indicators

G4 Government Bonds	06-May-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.9%	-6	+3	+50
EUR Bunds 10y	2.46%	-8	+6	+43
EUR Bunds 2s10s	-44.7bp	-2	+3	-6
USD Treasuries 2y	4.8%	-18	+4	+55
USD Treasuries 10y	4.48%	-13	+8	+60
USD Treasuries 2s10s	-31.4bp	+5	+4	+6
GBP Gilt 10y	4.22%	-10	+17	+69
JPY JGB 10y	0.9%	+1	+2	-25
€ Sovereign Spreads (10y)	06-May-24	1wk (bp)	1m (bp)	2024 (bp)
France	48bp	+1	+1	-5
Italy	131bp	-1	-2	-36
Spain	77bp	+0	+0	-19
Inflation Break-evens (10y)	06-May-24	1wk (bp)	1m (bp)	2024 (bp)
EUR 10y Inflation Swap	2.25%	-3	+1	+11
USD 10y Inflation Swap	2.59%	-4	-1	+18
GBP 10y Inflation Swap	3.74%	-4	+1	+20
EUR Credit Indices	06-May-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Corporate Credit OAS	112bp	+0	+0	-26
EUR Agencies OAS	57bp	-2	-4	-13
EUR Securitized - Covered OAS	62bp	-1	-3	-17
EUR Pan-European High Yield OAS	356bp	-18	-5	-43
EUR/USD CDS Indices 5y	06-May-24	1wk (bp)	1m (bp)	2024 (bp)
iTraxx IG	53bp	-2	-1	-5
iTraxx Crossover	306bp	-6	+6	-8
CDX IG	50bp	-1	-1	-6
CDX High Yield	337bp	-8	+1	-20
Emerging Markets	06-May-24	1wk (bp)	1m (bp)	2024 (bp)
JPM EMBI Global Div. Spread	375bp	+33	+35	-9
Currencies	06-May-24	1wk (%)	1m (%)	2024 (%)
EUR/USD	$1.077	0.485	-0.792	-2.4
GBP/USD	$1.258	0.111	-0.616	-1.2
USD/JPY	JPY 154	1.691	-1.255	-8.3
Commodity Futures	06-May-24	-1wk ($)	-1m ($)	2024 (%)
Crude Brent	$83.7	-$3.5	-$6.4	9.5
Gold	$2 318.2	-$17.5	-$20.9	12.4
Equity Market Indices	06-May-24	-1wk (%)	-1m (%)	2024 (%)
S&P 500	5 128	0.55	-1.47	7.5
EuroStoxx 50	4 963	-0.37	-1.04	9.8
CAC 40	8 026	-0.77	-0.44	6.4
Nikkei 225	38 236	-0.58	-3.08	14.3
Shanghai Composite	3 141	3.15	2.33	5.6
VIX - Implied Volatility Index	13.81	-5.86	-13.85	10.9

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

Asset management company regulated by AMF under n° GP-18000014 – Limited company with a share capital of 50 938 997 €. Trade register n°525 192 753 Paris – VAT : FR 93 525 192 753 – Registered Office: 43, avenue Pierre Mendès-France, 75013 Paris – www.ostrum.com

This document is intended for professional, in accordance with MIFID. It may not be used for any purpose other than that for which it was conceived and may not be copied, distributed or communicated to third parties, in part or in whole, without the prior written authorization of Ostrum Asset Management.

None of the information contained in this document should be interpreted as having any contractual value. This document is produced purely for the purposes of providing indicative information. This document consists of a presentation created and prepared by Ostrum Asset Management based on sources it considers to be reliable.

Ostrum Asset Management reserves the right to modify the information presented in this document at any time without notice, which under no circumstances constitutes a commitment from Ostrum Asset Management.

The analyses and opinions referenced herein represent the subjective views of the author(s) as referenced, are as of the date shown and are subject to change without prior notice. There can be no assurance that developments will transpire as may be forecasted in this material. This simulation was carried out for indicative purposes, on the basis of hypothetical investments, and does not constitute a contractual agreement from the part of Ostrum Asset Management.

Ostrum Asset Management will not be held responsible for any decision taken or not taken on the basis of the information contained in this document, nor in the use that a third party might make of the information. Figures mentioned refer to previous years. Past performance does not guarantee future results. Any reference to a ranking, a rating or an award provides no guarantee for future performance and is not constant over time. Reference to a ranking and/or an award does not indicate the future performance of the UCITS/AIF or the fund manager.

Under Ostrum Asset Management's social responsibility policy, and in accordance with the treaties signed by the French government, the funds directly managed by Ostrum Asset Management do not invest in any company that manufactures, sells or stocks anti-personnel mines and cluster bombs.

Final version dated 06/05/2024

Natixis Investment Managers

This material has been provided for information purposes only to investment service providers or other Professional Clients, Qualified or Institutional Investors and, when required by local regulation, only at their written request. This material must not be used with Retail Investors.

To obtain a summary of investor rights in the official language of your jurisdiction, please consult the legal documentation section of the website (im.natixis.com/intl/intl-fund-documents)

In the E.U.: Provided by Natixis Investment Managers International or one of its branch offices listed below. Natixis Investment Managers International is a portfolio management company authorized by the Autorité des Marchés Financiers (French Financial Markets Authority - AMF) under no. GP 90-009, and a public limited company (société anonyme) registered in the Paris Trade and Companies Register under no. 329 450 738. Registered office: 43 avenue Pierre Mendès France, 75013 Paris. Italy: Natixis Investment Managers International Succursale Italiana, Registered office: Via San Clemente 1, 20122 Milan, Italy. Netherlands: Natixis Investment Managers International, Nederlands (Registration number 000050438298). Registered office: Stadsplateau 7, 3521AZ Utrecht, the Netherlands. Spain: Natixis Investment Managers International S.A., Sucursal en España, Serrano n°90, 6th Floor, 28006 Madrid, Spain. Sweden: Natixis Investment Managers International, Nordics Filial (Registration number 516412-8372- Swedish Companies Registration Office). Registered office: Covendrum Stockholm City AB, Kungsgatan 9, 111 43 Stockholm, Box 2376, 103 18 Stockholm, Sweden. Or,

Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. Germany: Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Senckenberganlage 21, 60325 Frankfurt am Main. Belgium: Natixis Investment Managers S.A., Belgian Branch, Gare Maritime, Rue Picard 7, Bte 100, 1000 Bruxelles, Belgium.

In Switzerland: Provided for information purposes only by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich.

In the British Isles: Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258) - registered office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER. When permitted, the distribution of this material is intended to be made to persons as described as follows: in **the United Kingdom**: this material is intended to be communicated to and/or directed at investment professionals and professional investors only; in Ireland: this material is intended to be communicated to and/or directed at professional investors only; **in Guernsey:** this material is intended to be communicated to and/or directed at only financial services providers which hold a license from the Guernsey Financial Services Commission; **in Jersey**: this material is intended to be communicated to and/or directed at professional investors only; in the Isle of Man: this material is intended to be communicated to and/or directed at only financial services providers which hold a license from **the Isle of Man** Financial Services Authority or insurers authorised under section 8 of the Insurance Act 2008.

In the DIFC: Provided in and from the DIFC financial district by Natixis Investment Managers Middle East (DIFC Branch) which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients or Market

www.ostrum.com