GUGGENHEIM

Commercial Mortgage-Backed Securities

Balancing Negatives and Positives

We favor CMBS transactions backed by quality assets, strong sponsorship, and structural protections.

CMBS spreads widened in the third quarter in sympathy with broader fixed-income credit markets: JP Morgan CMBS Index 10-year conduit AAA bond spreads ended the third quarter at 147 basis points, compared to 132 basis points for the second quarter and 72 basis points at year-end 2021. The first order effect of wider spreads and higher volatility has been a decrease in issuance: non-Agency CMBS year-to-date issuance of $91.5 billion was down compared to $97.5 billion for the same period last year, as owners holding properties with stable cash flows have a reduced incentive to refinance or transact given higher interest rates and lower clarity of execution in today's more volatile capital markets.

A number of cyclical and secular pressures are affecting commercial real estate (CRE) values. Higher interest rates have already increased borrowing costs and will increase the cap rates used to value CRE assets. Office space demand is being challenged by a shift to hybrid work patterns, while more operationally intensive real estate businesses like lodging could face higher expenses from inflationary pressures. These challenges are affecting credit availability. The most recent Federal Reserve Senior Loan Officer Survey on Bank Lending Practices shows tightening commercial real estate lending standards and decreased aggregate demand for CRE loans. For the same reasons, competition from non-bank lenders has also faded materially.

On the positive side, real estate operating performance has recovered since 2020, and operating cash flows are more than adequate to cover debt service across the CMBS universe. The debt service coverage ratio for all conduit CMBS bonds ended the quarter at 2.20x, up from the 2020 trough of 1.84x. The 60+ day delinquency rate is now 3.5 percent, versus the summer 2020 peak of 6.5 percent.

Global repricing of fixed-income assets has led to wider spreads and higher yields. Active managers doing fundamental credit analysis on CMBS are better positioned than in the last 15 years to explore opportunities to source bonds backed by stabilized collateral at attractive spreads as well as historically high spread premiums for transitional property-backed bonds. We continue to favor select CMBS transactions backed by quality assets with strong sponsorship and structural protections, with a focus on AA to BBB- rated single asset-single borrower and CRE-CLO securities.

By Tom Nash and Hongli Yang

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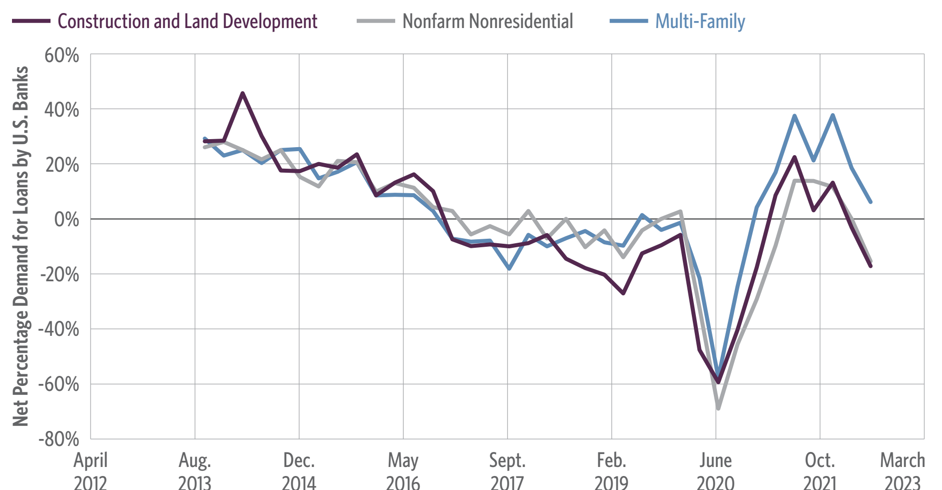
Aggregate Demand for CRE Loans Has Decreased



Source: Guggenheim Investments, Board of Governors of the Federal Reserve System, data as of 6.30.2022. Note: A negative reading indicating that a net share of banks reported weaker demand for loans, and a positive reading indicating that a net share of banks reported stronger demand for loans.

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Investing involves risk, including the possible loss of principal. Investments in fixed-income instruments are subject to the possibility that interest rates could rise, causing their values to decline. High yield and unrated debt securities are at a greater risk of default than investment grade bonds and may be less liquid, which may increase volatility. Investors in asset-backed securities, including mortgage-backed securities and collateralized loan obligations ("CLOs"), generally receive payments that are part interest and part return of principal. These payments may vary based on the rate loans are repaid. Some asset-backed securities may have structures that make their reaction to interest rates and other factors difficult to predict, making their prices volatile and they are subject to liquidity and valuation risk. CLOs bear similar risks to investing in loans directly, such as credit, interest rate, counterparty, prepayment, liquidity, and valuation risks. Loans are often below investment grade, may be unrated, and typically offer a fixed or floating interest rate.

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