Commercial Mortgage-Backed Securities

A Challenged Backdrop with Increasing Idiosyncratic Risk

We remain cautious on the sector.

CMBS is a sector in which we have always maintained very conservative underwriting standards and have generally stayed senior and defensively positioned. That approach is proving appropriate given the significant headwinds facing commercial real estate (CRE) today. The confluence of higher Treasury rates, increasing risk premiums demanded by CRE investors, and capital rationing away from CRE continues to limit capital markets activity. Interest rates on the CRE loans backing CMBS continue to trend higher: One recent conduit CMBS was backed by loans with a 7.2 percent interest rate, compared to 5.9 percent in early 2023 and 3.4 percent in early 2022. Elevated financing costs discourage new CRE transactions and refinancings, and 12-month CRE property sales volume is approximately 50 percent lower than the prior year, with virtually no price discovery in stressed submarkets, such as the Los Angeles office sector. The percentage of CMBS loans that are delinquent in payment has inched up year over year but remains well below the levels seen during the COVID pandemic.

Unlike most other sectors, market technicals are not providing much support as decreasing demand for CMBS credit risk offsets lower new supply of CMBS bonds. CMBS issuance is down 75 percent year over year, with just $19 billion brought to market in the first half of 2023, compared to $75 billion in the first half of 2022. We are negative on structurally subordinated CMBS as well as office loan exposure, and while we are generally defensive in the sector, we favor senior CMBS securities in the 6.5–8.5 percent yield range, with enough credit enhancement to absorb losses should hard-to-predict property problems arise at challenging points in the cycle.

Property performance dispersion is increasing: Former trophy properties in underperforming markets are being sold or reappraised at 60–80 percent discounts, while other favorably positioned and capitalized properties quietly continue to perform. Year to date, approximately 650 of the 9,500 CMBS bonds outstanding have experienced ratings downgrades, largely related to structurally subordinated CMBS bonds with leveraged exposure to one or more properties experiencing negative credit events, such as the loss of a large tenant. This downgrade wave reminds us that CMBS investor outcomes can vary greatly from deal to deal, and even from tranche to tranche.

By Tom Nash and Hongli Yang

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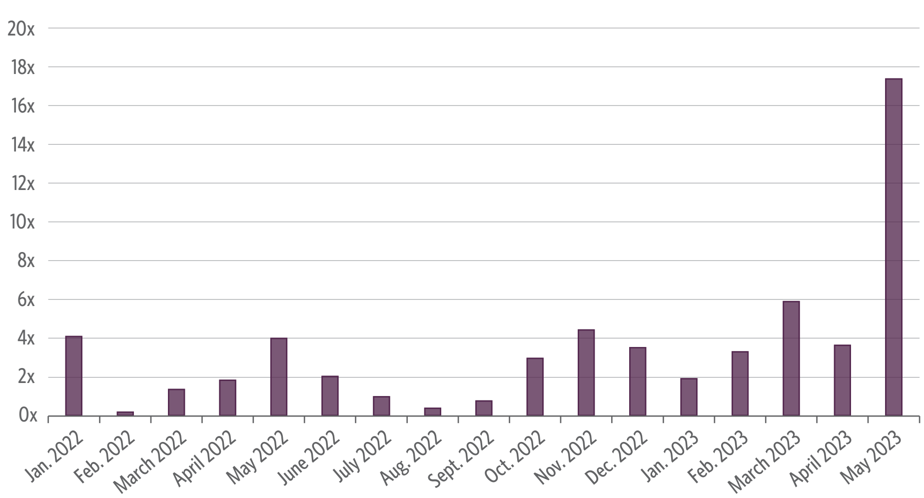
Net Negative Ratings Migration Shows Significant Stress in Commercial Real Estate

Ratio of Downgrades to Upgrades in Non-Agency CMBS



Source: Guggenheim Investments, JP Morgan, CoStar Capital Management, Wells Fargo. Data as of 6.30.2023.

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