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Commercial Mortgage-Backed Securities

Bank Failures Portend Capital Rationing in CRE

Increasing dispersion in CMBS as fundamental pressures mount.

CMBS underperformed investment-grade corporate bonds and other structured sectors as spreads widened precipitously following the failures of Silicon Valley and Signature banks. The benchmark 10-year conduit AAA spread widened from 130 basis points to 179 basis points in the first quarter. We are skeptical of the view that recent spread widening presents a technical buying opportunity in the second quarter and believe that the CMBS market's reaction to these bank events reflects an appropriate and evolving fundamental re-valuation of commercial real estate (CRE) risk. Broadly, we continue to maintain minimal exposure but are game planning to be opportunistic should conditions warrant.

Regional banks comprised around 20 percent of all CRE lending in recent years and have held disproportionate market share in construction lending. In previous commentaries, we have cited the risk related to bank lenders failing to support the CRE lending market given interest rate pressures. Subsequent bank failures and the economic and regulatory fallout are material negative catalysts during already challenged times. Transaction volumes remain historically low, with few willing sellers, and arguably even fewer willing buyers. More sellers of CRE loans and properties will emerge in coming months, likely at lower prices, as capital is rationed away from out-of-favor property types. Over $400 billion of CRE loans are scheduled to mature in 2023, providing some price discovery for financing rates and valuations. Property prices are down roughly 5 percent year to date, and 9.5 percent from their peak in July 2022, and market expectations are for meaningful further declines in highly impacted property types, such as Class B office and retail.

Consistent with our post-COVID strategy, we continue to favor senior and near-senior CMBS securities for their high credit enhancement. We remain cautious on structurally subordinated CMBS bonds because of their inherent sensitivity to adverse selection or binary outcomes in the underlying collateral pool. CMBS yields are near post-GFC highs, and our preferred senior and near-senior tranches trade in the 6.5–8.5 percent yield range. With rising economic uncertainty and market complexity, we expect that investable situations with attractive loss-adjusted yields will continue to emerge in coming quarters as the drop in competition for CRE credit flows through capital markets.

By Tom Nash and Hongli Yang

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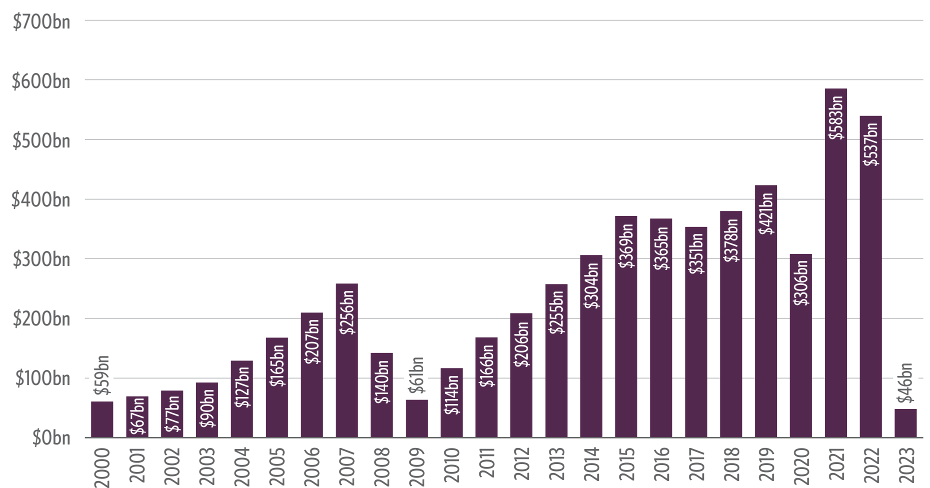
Commercial Real Estate Sales Volumes Have Been Depressed This Year



Source: Guggenheim Investments, Barclays, CoStar, JP Morgan. Data as of 5.3.2023.

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