Commercial Mortgage-Backed Securities

Shrinking Supply

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Late-cycle loan market competition is putting pressure on CMBS issuers, but opportunities remain to position defensively.

First quarter overall issuance in private label CMBS (including CRE-CLO) fell 11 percent compared to the same period last year. The drop was primarily due to declining new issuance for conduit and single asset/single borrower (SASB) loans. CRE-CLO issuance continues to rise and has made up for some of the shortfall, but a competitive loan market continues to pressure this sector. Conduit originators have been unable to remain competitive with the loan-to-value (LTV) ratios and spreads offered by debt funds, real estate investment trusts, and insurance companies. As such, we expect the conduit market share to drop again in 2019. The one area of strength, CRE-CLO issuance, is shaping up to come in on the high end of expectations with a 37 percent increase over the same time last year, aided at this point in the cycle by the relative attractiveness of their shorter weighted average lives (WAL).

The limited supply on the new issue front has been a driver of the spread tightening across all asset types in CMBS as investors have fewer options to put money to work. The credit curve has also flattened dramatically, with the basis between BBBs and AAAs approaching the levels last seen in the third quarter last year, leading us to believe there is not much room left in the rally down the credit stack (see chart, top right).

We currently see attractive relative value between CRE-CLOs and corporate CLOs. At the AAA and AA rating level, managed CRE-CLOs and broadly syndicated loan (BSL) CLOs currently offer similar spreads. CRE-CLOs are used to finance loans on collateral managers' balance sheets, while BSL CLOs are arbitrage vehicles created for collateral managers to collect fees and CLO equity returns. When adjusting CRE-CLO for the shorter WAL they exhibit, these bonds looks particularly attractive. Single A-rated CRE-CLO bonds also look attractive even with the tighter spread because of the shorter WAL, higher credit enhancement, and sponsor risk retention (see chart, bottom right). We continue to position defensively and prefer short WAL securities such as seasoned high-quality conduits, senior interest-only bonds, CRE-CLOs, and short-dated SASB structures.

Spreads Between Conduit BBBs and AAAs Have Recovered

Source: Guggenheim Investments, J.P. Morgan. Data as of 5.31.2019.

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With Shorter Weighted Average Lives, CRE-CLOs Appear Attractive

Type of Security	AAA	AA	A	BBB	BB
Managed CRE-CLO	130 bps	185 bps	230 bps	285 bps	Retained
Static CRE-CLO	100 bps	170 bps	205 bps	270 bps	Retained
CLO - BSL	134 bps	185 bps	275 bps	375 bps	650
CLO - MM	160 bps	260 bps	370 bps	475 bps	850+

Source: Guggenheim Investments, Bloomberg. Data as of 5.31.2019.

We currently see attractive relative value between CRE-CLOs and corporate CLOs. At the AAA and AA rating level, managed CRE-CLOs and BSL CLOs currently offer similar spreads, despite having shorter WAL. A shorter WAL profile can offer better mark-to-market protection in the event of a correction.