

Commercial Mortgage-Backed Securities

Selectivity Remains Key in CMBS

CMBS rallies but remains rich relative to other sectors.

Though near-term market technicals are positive, CMBS fundamentals remain challenged. Lower interest rates portend improved returns for owners of well-positioned buildings, but lower rates do little to improve the outlook for fundamentally challenged or overlevered assets. For example, owners of affordable housing will see margin compression as regulated rent growth fails to offset increasing maintenance and insurance costs. Lower-quality malls continue to struggle given changed shopping patterns, and office demand remains structurally and permanently below available supply, causing some office properties to become essentially obsolete.

As of December 2023, 6.5 percent of loans backing conduit CMBS were in some stage of special servicing or workout, up 0.3 percent from the prior quarter as more properties are now under duress.

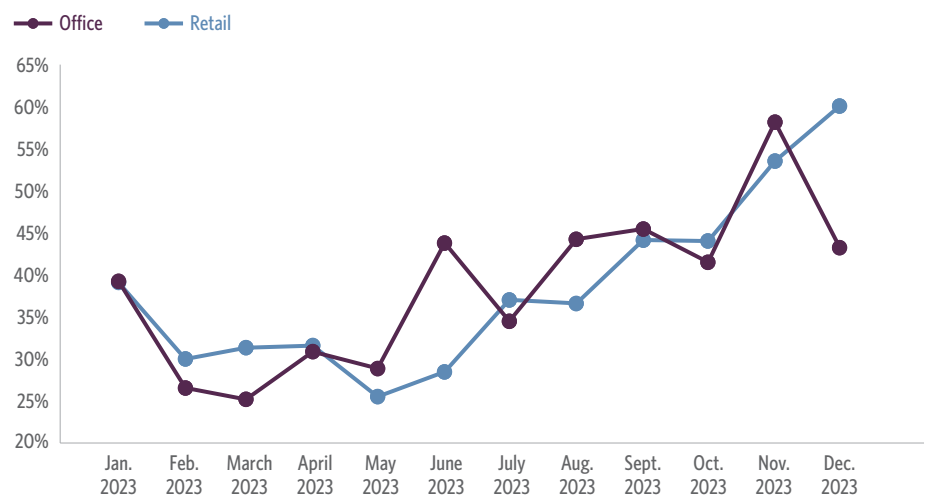
Perhaps of greater concern, the prices achieved on distressed sales have been declining. The loss severity rate, defined as the percentage of loan balance lost upon the liquidation of an underperforming CMBS property, has been increasing in recent months around property types that are operationally intensive, such as retail, and/or are at risk of obsolescence, such as office properties. We are in the early innings of this commercial real estate cycle, and we recommend maintaining a highly selective approach to CMBS investing, focusing on securities that can withstand a meaningful increase in stress without losing principal and deliver returns that compensate for the incremental risk and complexity inherent to this sector at this time.

By Tom Nash and Hongli Yang

The loss severity rate, defined as the percentage of loan balance lost upon the liquidation of an underperforming CMBS property, has been increasing in recent months around property types that are operationally intensive, such as retail, and/or are at risk of obsolescence, such as office properties.

Office and Retail Properties in CMBS Continue to Struggle

Six-Month Average Loss Severity for Office and Retail Properties in CMBS



Source: Guggenheim Investments, Morgan Stanley. Data as of 12.31.2023.

This material is distributed or presented for informational or educational purposes only and should not be considered a recommendation of any particular security, strategy or investment product, or as investing advice of any kind. This material is not provided in a fiduciary capacity, may not be relied upon for or in connection with the making of investment decisions, and does not constitute a solicitation of an offer to buy or sell securities. The content contained herein is not intended to be and should not be construed as legal or tax advice and/or a legal opinion. Always consult a financial, tax and/or legal professional regarding your specific situation.

This material contains opinions of the authors, but not necessarily those of Guggenheim Partners, LLC or its subsidiaries. The opinions contained herein are subject to change without notice. Forward-looking statements, estimates, and certain information contained herein are based upon proprietary and non-proprietary research and other sources. Information contained herein has been obtained from sources believed to be reliable but are not assured as to accuracy. Past performance is not indicative of future results. There is neither representation nor warranty as to the current accuracy of, nor liability for, decisions based on such information.

Investing involves risk, including the possible loss of principal. In general, the value of a fixed-income security falls when interest rates rise and rises when interest rates fall. Longer term bonds are more sensitive to interest rate changes and subject to greater volatility than those with shorter maturities. During periods of declining rates, the interest rates on floating rate securities generally reset downward and their value is unlikely to rise to the same extent as comparable fixed rate securities. 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.

Guggenheim Investments represents the following affiliated investment management businesses of Guggenheim Partners, LLC: Guggenheim Partners Investment Management, LLC, Security Investors, LLC, Guggenheim Funds Distributors, LLC, Guggenheim Funds Investment Advisors, LLC, Guggenheim Partners Advisors, LLC, Guggenheim Corporate Funding, LLC, Guggenheim Partners Europe Limited, Guggenheim Partners Japan Limited, and GS GAMMA Advisors, LLC.

© 2024, Guggenheim Partners, LLC. All Rights Reserved. No part of this document may be reproduced, stored, or transmitted by any means without the express written consent of Guggenheim Partners, LLC. GPIM 60482