GUGGENHEIM

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

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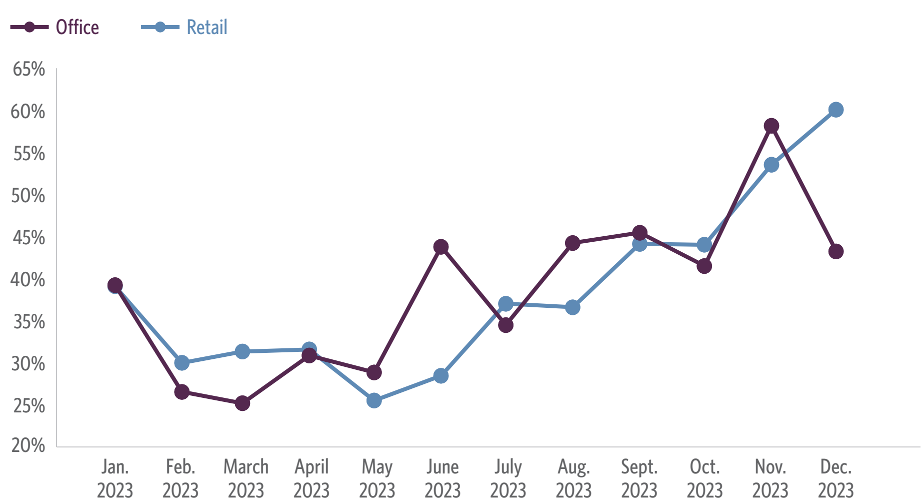
Office and Retail Properties in CMBS Continue to Struggle

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



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