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MARKET REVIEW

MAY 2023

COMMERCIAL REAL ESTATE, THE NEXT DOMINO FOR BANKS?

– U.S. banks hold 45% of the $4.5 trillion CRE debt, which is around 9% of total bank assets.

– A growing percentage of CRE debt has come from regional banks so they may bear a disproportionate share of defaults.

– An improvement in lending standards since the GFC should offer better protection against losses.

The recent banking turmoil has heightened investors' focus on banks' exposure to the commercial real estate (CRE) debt market. CRE's falling property values and higher financing costs have sparked concern that the industry's challenges could spill over to the banking system. Property owners that need to refinance debt are facing a more difficult environment with higher interest rates, expectations for reduced bank lending, and a slowing economy. The CRE market faces sizeable near-term debt maturities totaling $728 billion (16% of total loans) in 2023 and $659 billion (15%) in 2024. The potential losses from increased CRE delinquencies and distressed sales may pressure earnings for some banks with higher CRE exposure. Yet, the risk is likely low that a deterioration in CRE loans turns into a systemic problem for the banking industry that could cause widespread pain like the 2007-2009 Global Financial Crisis (GFC).

According to the Mortgage Bankers Association, U.S. banks held 45% of the $4.5 trillion CRE debt outstanding at the end of 2022, which was around 9% of total bank assets. A growing percentage of CRE debt has come from regional banks so they may bear a disproportionate share of defaults given their higher CRE exposure. The 25 largest banks by assets hold 13% of CRE debt, which only comprises 4% of their total assets. Regional and community banks hold 32% of CRE debt, which accounts for a much larger 19% of their total assets. However, CRE exposure among smaller banks is diversified across thousands of financial institutions which might help to mitigate some of the risk. The smallest 4,600 U.S. lenders outside the largest 100 banks hold nearly 20% of CRE debt and they finance smaller properties in a wide range of smaller markets.

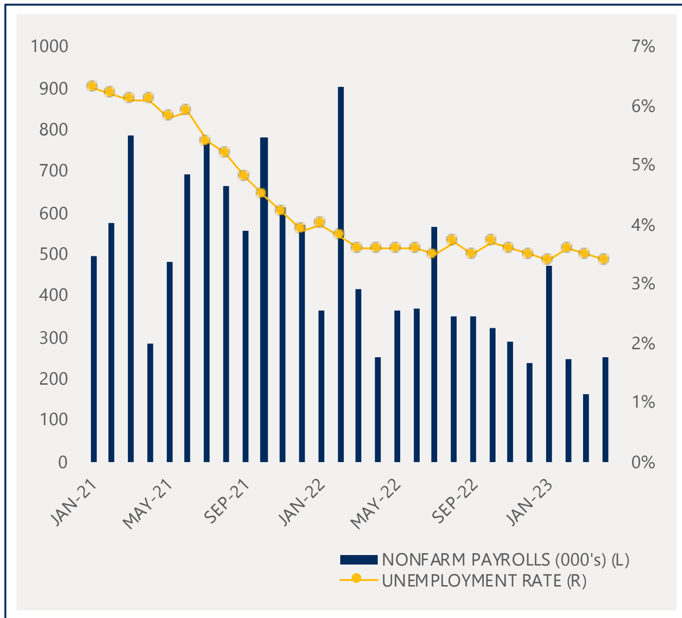
The office sector likely faces the greatest risk due to remote work and weak return-to-office trends creating higher vacancies. According to Kastle Systems' key fob security swipe data covering 2,600 office buildings in 47 states, the average office use in 10 major cities reached a post-pandemic high in February of 50.4% of pre-pandemic levels. Underutilized space is leading some companies to reduce their office space. CoStar Group, a commercial property analytics company, estimates the U.S. office vacancy rate rose to 12.9% in the first quarter, higher than the vacancy peak during the GFC and the highest since CoStar started tracking it in 2000. Office properties account for around 17% of the CRE debt market and only 1.2% of banks' assets, including a meager 0.5% of the top 25 banks' assets and modest 3% of regional and community bank assets.

Vacancy rates in other areas of the CRE market are still healthy. Cushman and Wakefield, a commercial real estate services firm, estimates the vacancy rate of industrial space is low at 3.6% and retail space has a moderate vacancy rate of 5.7% despite the growth in e-commerce. Meanwhile, the rebound in travel has led CoStar Group to project the hotel occupancy rate will improve to 63.8% this year compared to 65.9% in 2019 and 2020's historic low of 43.9%. Rich Hill, Cohen & Steers' Head of Real Estate Strategy & Research, estimates the CRE market has a healthy debt service to coverage ratio (DSCR) above 2.0. Hill said default risk becomes more of a concern with DSCRs below 1.25. Hill estimates 75% of office loans have DSCRs above 1.5 and only 15.5% have DSCRs below 1.25.

An improvement in lending standards since the GFC should offer better protection against losses. According to J.P. Morgan Asset Management, CRE loans held in commercial mortgage-backed securities (CMBS) have seen a decline in leverage as measured by loan-to-value (LTV) at deal initiation. CMBS LTVs have steadily fallen to around 54% last year, well below LTVs near 70% in the years leading up to the GFC. Prior to the GFC, around half of CMBS deals had an LTV above 70% compared to around 10% or less of deals in recent years. Growth in property values over the years further reduced existing deals' LTVs. For example, Cohen & Steers' Rich Hill estimates that a hotel property financed in 2014 with a 50% LTV could have a current effective LTV around 45% due to the 11.7% cumulative price appreciation in lodging properties since 2014. Lower LTVs provide lenders with more of a cushion before incurring a loss. Lastly, CMBS credit enhancements, such as providing additional collateral or a third-party guarantee, have increased over the last decade which improves deals' risk profiles. CMBS only make up 13% of the CRE market so they are not a perfect representation of trends in the overall market, but they still offer useful insights.

"THE CRE MARKET HAS A HEALTHY DEBT SERVICE TO COVERAGE RATIO (DSCR) ABOVE 2.0."

LABOR MARKET STILL MODERATELY STRONG
JANUARY 2021 THROUGH APRIL 2023



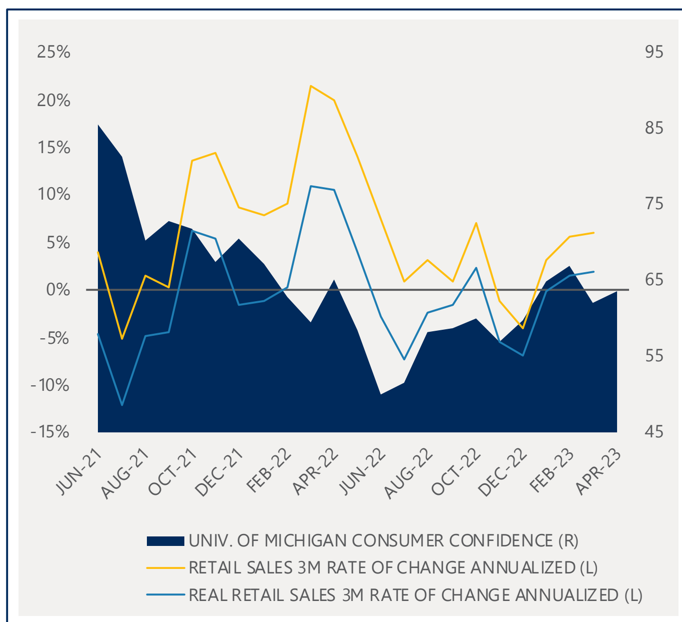
Source: Bloomberg. Past performance does not guarantee future results.

The U.S. economy is still showing signs of resilience as the labor market added a surprising 253,000 jobs in April, compared to the 165,000 job additions in March. Nonfarm payroll additions have averaged a healthy 284,000 per month this year, but are lower than the 399,000 monthly average last year. Despite the moderate labor market slowdown, employment in professional and business services, health care, leisure and hospitality have continued to trend upwards.

The unemployment rate declined to 3.4%, matching the lowest level since 1969. The tight labor market continued to pressure wages, which grew 4.4% from a year earlier, up from 4.3% growth in March.

The labor force participation rate was little changed in April at 62.6%, which remains below the pre-pandemic level of 63.3% in February 2020. Additionally, the number of people not in the labor force but who are actively looking for a job increased 346,000 in April to a total of 5.3 million.

SUBDUED CONSUMERS
JUNE 2021 THROUGH APRIL 2023

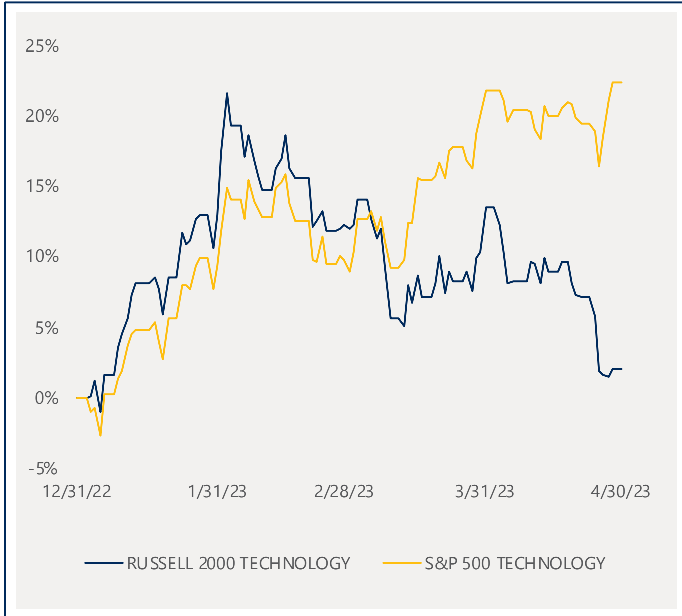


Source: Bloomberg. Past performance does not guarantee future results.

The University of Michigan Consumer Sentiment index increased to 63.5 in April, but remained at a depressed level on par with the reading seen at the tail end of the 2007-2009 Global Financial Crisis. The index has rebounded over the last 10 months after plunging in early 2022 as a slew of economic concerns impacted consumer confidence.

Retail sales growth slowed to 2.3% in March from a year prior, the lowest growth since the decline in sales during the initial months of the pandemic. Gas stations' 13.9% decline in sales were a notable detractor due to lower gas prices. Excluding autos and gas, retail sales were up 5.1%. Shoppers reduced spending on higher price items such as vehicles, appliances, furniture, and electronics amid the slower economy. Tax refunds, which were 10.4% lower than in 2022, were also a headwind for spending. Restaurants stood out as one area where sales remain strong.

SMALL CAP TECH DIVERGES FROM LARGE CAP
YEAR-TO-DATE PERFORMANCE THROUGH APRIL 30, 2023

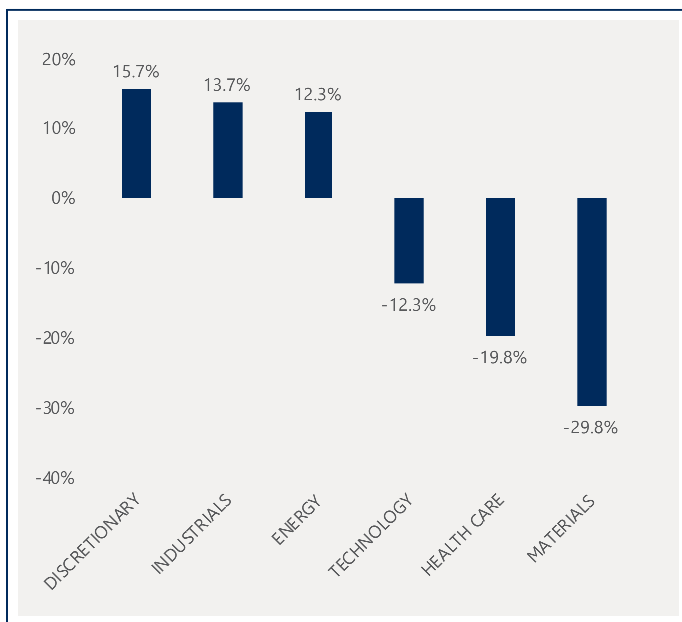


Source: Morningstar. Past performance does not guarantee future results.

Equity markets were calmer in April following the regional bank stress in early March. Investors' concerns about banks' liquidity eased throughout late March and April as banks' borrowing from the Fed's short-term credit facilities steadily declined. Investor focus shifted to first quarter earnings reports which have exceeded analysts' estimates so far. The S&P 500 grinded out a modest monthly gain of 1.56% in April, bringing its gain this year to 9.17%

Performance of mid and small cap stock indexes continued to diverge from large cap indexes with the S&P 400 and Russell 2000 indexes' third consecutive month decline in April. In addition to smaller market cap indexes' higher exposure to regional banks and greater economic sensitivity, weaker performance in smaller technology stocks relative to mega cap technology stocks has been a headwind. The Russell 2000 technology sector's modest performance this year of 2.00% is 20.37% behind the S&P 500 technology sector's strong 22.37% return. This was the largest January through April performance gap between large cap and small cap technology stocks since the late 1990s technology bubble.

EARNINGS LEADERS AND LAGGARDS
Q1 EARNINGS PER SHARE GROWTH YOY



Source: Bloomberg. Past performance does not guarantee future results.

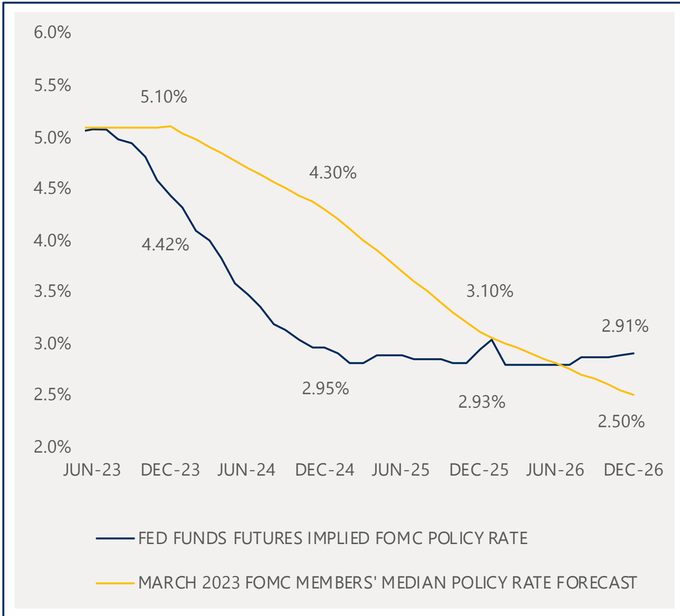
More than half of S&P 500 companies have reported first quarter earnings. Earnings are on track for a 4.52% decline compared to analysts' forecast for a steeper 8.06% contraction. Positive earnings growth in consumer discretionary, industrials, energy, and financials sectors were offset by double-digit percentage earnings declines in materials, health care, and technology. Net income and operating margins were slightly better than analysts' estimates, but declined year over year as higher costs continue to pressure margins.

Analysts' projected earnings recovery in the second half of this year might be in jeopardy as earnings estimates continue to be revised lower. Earnings are forecast to decline 7.2% and 0.6% in the second and third quarters, respectively.

Sales are holding up better than earnings with 3.11% growth versus analysts' estimate for 2.09% growth. Materials, energy, and technology were the only sectors with negative sales growth. Sales are projected to produce meager growth in the coming quarters amid the slowing economy.

FIXED INCOME

FED POLICY RATE EXPECTATIONS
MAY 2023 THROUGH DECEMBER 2026



Source: Bloomberg. Data as of 5/5/23. Past performance does not guarantee future results

On May 3, the Federal Open Market Committee (FOMC) voted unanimously to raise the U.S. policy rate by another 25 basis points to a range of 5.00% to 5.25%, its highest level since 2007. Some commentators described the decision as a "dovish hike," suggesting it was the final interest rate increase of the current hiking cycle that began in March 2022.

In his post-meeting press conference, Fed Chairman Jerome Powell signaled a willingness to pause rate hikes at the FOMC's mid-June meeting, indicating that "future policy actions will depend on how events unfold." In its meeting statement, the central bank dropped the phrase "some additional tightening may be appropriate" from its official guidance.

Market participants expect roughly 200 basis points of Fed rate cuts by the end of 2024 based on fed funds futures pricing in the first week of May. On the other hand, Fed officials project a much slower pace of policy loosening over the next 18 to 30 months. The expectations of markets and policymakers converge around a policy rate of 3% in December 2025.

YIELDS AVAILABLE IN U.S. BOND AND STOCK MARKETS
JANUARY 2010 THROUGH MAY 2023

Source: Bloomberg. Data as of 5/5/23. Past performance does not guarantee future results.

Although the Fed's rate hike cycle and subsequent increases in market interest rates over the last 14 months have been painful for fixed income investors, they have also likely created a much stronger set of expected future returns. Nominal yields available in the broad investment grade U.S. bond market are significantly greater than existed for the entire period spanning the end of the Global Financial Crisis to the conclusion of the pandemic-driven period of maximum policy accommodation in early 2022.

The current yield-to-worst on the Bloomberg U.S. Aggregate Bond Index of roughly 4.3% is more than double the S&P 500's indicated dividend yield of 1.7%. For most of the periods spanning 2012 to 2016, and 2020 to 2022, the U.S. equity market's dividend yield either roughly matched, or eclipsed the broad U.S. high-quality bond market's yield.

Below investment grade U.S. corporate bond index yields surged from under 4% in mid-2021 to between 8% and 10% in recent months. The spread (or yield differential) between high yield and investment grade bond indexes of similar maturities is only slightly above long-term averages, however, suggesting credit market stress remains contained despite recent banking sector turmoil.

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NOT A DEPOSIT	NOT FDIC INSURED	MAY LOSE VALUE	NOT BANK GUARANTEED
NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY			