

Economic Insights

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Commercial Real Estate: The Other Shoe?

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Even as the economy and financial markets emit clear signals of healing, concerns linger, especially about commercial mortgages. Rising defaults and a lack of easy liquidity have led many observers to wonder if problems in the United States might create something akin to the recent subprime debacle, a “second shoe,” as some people call it. But while there is reason to expect increased defaults in this area and still greater losses going forward, it would, nonetheless, be a mistake to characterize problems in such a way. On the contrary, matters promise to remain contained, and for all the likelihood of future defaults, the yield spreads on these loans, particularly commercial mortgage-backed securities (CMBS), more than compensate for any likely losses.

The fears surrounding this debt have kept CMBS yields high relative to Treasuries, even as other credit spreads have narrowed. Of course, all credit spreads widened late last year and early this year as the credit crisis deepened. Junk bond yields jumped, from 700 basis points (bps) to 2,100 bps over Treasuries, while high-grade corporate yields widened, from 300 bps to almost 850 bps. The yield on ‘AAA’ rated CMBS paper rose, from 30 bps over Treasuries to 1,300 bps, and spreads on ‘A’ rated CMBS paper jumped, from 900 bps to over 4,000 bps. But this spring, as other bond spreads began to shrink, those on CMBS paper did not. Junk bonds fell back by April, to 1,100 bps, and presently stand at 750–800 bps. High-grade corporate bond spreads have come in to 250 bps. But CMBS yields have either held their premium over Treasury yields or extended it farther. The only exception is the ‘AAA’ rated CMBS paper, which has seen its yield spreads decline, from 1,200 bps to 600–700 bps.

Some of this continued pressure on CMBS spreads not only reflects the continued, disappointing default experience but also fears about the future. Overall defaults in all commercial mortgages, including those behind CMBS, rose from only 0.1% of such loans outstanding in early 2007 to 1.0% in 2008, to 2.1% by mid-2009 (the most recent period for which data are available). Delinquency rates have expanded, from 1.5% of loans outstanding in 2007 to 4.5% in 2008, to almost 8.0% in mid-2009. For CMBS paper in particular, defaults have stayed lower than with commercial mortgage credit generally, but they have increased nonetheless, jumping from 0.58% of all CMBS paper outstanding in June 2008 to 0.82% in September 2009 (the most recent period for which data are available).

But even as these defaults and delinquencies have risen, they cannot justify today’s still tremendous yield spreads. Indeed, even if the market’s worst fears on defaults were to come true, such spreads would more than compensate. If, say, defaults were to rise over the next 12 months by the same factor as they have over the last 12 months, to 21%, the lowest quality of these bonds could absorb that loss and still yield, on average, nine or more percentage points over Treasuries. Since that value looks good even in this worst-case scenario, CMBS bonds look especially attractive, knowing that such an extreme eventuality is not especially likely. After all, even after the economic and financial calamity of the past 12 months, overall default rates remain below their records of the early 1990s; and, with the economy recovering, any further deterioration will more likely be muted than exaggerated. Indeed, in the past six months, default rates on commercial mortgages overall have actually come down a touch, from 2.3% at the end of 2008 to the 2.1% figure presently.

Still further, actions by the Federal Reserve and the Treasury to relieve some of the liquidity strain argue against the extreme outcomes for which these securities are priced. In July 2008, for example, the Fed made some higher-quality CMBS paper eligible as collateral for loans under the Term Asset-Backed Securities Loan Facility (TALF), giving this area a source of liquidity that previously was closed to it. In all probability, this TALF action alone explains why ‘AAA’ rated CMBS yield spreads shrank during the past few months, even as lower-quality spreads were held at high levels or expanded farther. Also bringing a form of relief to these markets was when the Treasury just last month allowed servicers and borrowers to restructure loans without tax consequences. Since previously borrowers had to just about



declare bankruptcy to restructure without tax consequences, this change will also bring liquidity to this market by giving both borrowers and lenders ways to relieve trouble without either having to go to extremes or pay a tax penalty.

With these actions in place and the economy improving, there is little reason at all to expect the extreme default and delinquency rates widely feared these days. And since the spreads on these bonds already more than compensate for such extremes, the limited likelihood that they will even occur makes such bonds that much more attractive.

Note: The value of an investment in bonds will change as interest rates fluctuate in response to market movements. When interest rates rise, the prices of debt securities are likely to decline, and when interest rates fall, the prices of debt securities tend to rise. High-yielding, non-investment grade bonds involve higher risk than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities. In addition, bonds may be subject to other types of risk such as credit, call and general market risk.

Milton Ezrati, Partner and Senior Economist and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times*, *Financial Times*, *The Wall Street Journal*, *The Christian Science Monitor*, and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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