Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Signs of Life in the CMBS Rubble

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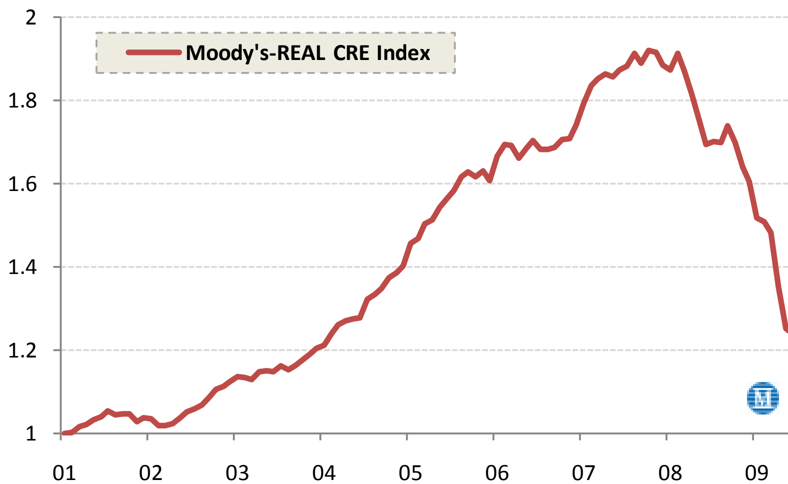
David Gitlitz

TALF arbitrage should end a vicious cycle of frozen markets and falling property values.

Update to strategic view
US BONDS: The CMBS market remains in considerable distress, but the Fed's efforts to support activity are having salutary effects. TALF for CMBS is a near-arbitrage opportunity, offering virtually riskless 20%-plus leveraged returns. With that incentive, a new-issue pipeline is being re-established.
[see Investment Strategy Dashboard]

A near consensus among our clients is that commercial real estate and commercial mortgage-backed securities are the "next shoe to drop," threatening to undo the restoration of financial market stability that has been seen the past several months. But we see signs of life emerging in this sector, suggesting that the worst is likely to be avoided. With the Fed's TALF program offering highly attractive terms to support leveraged acquisition of both legacy CMBS and new offerings, the opportunities being presented could foster a healing process.

While capital markets have overcome the extreme risk abhorrence and volatility seen late last year and earlier this year, CRE and CMBS remain severely stressed. Credit default swaps on CMBS have shown the least narrowing, compared to the universe of risky fixed income categories (see the chart on the following page). Delinquencies on loans supporting CMBS issues are running at about $2 billion per month, with the delinquency rate now above 3%, versus 0.28% in January 2008 and 0.9% late last year. Commercial property values have fallen more than 35% since October 2007, with nearly half of that coming in just the first five months of this year (see the chart at left). This price erosion is intensifying refinancing risk on hundreds of billions of dollars of commercial mortgages. Indeed, this has the makings of a vicious cycle in which the inability to



http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

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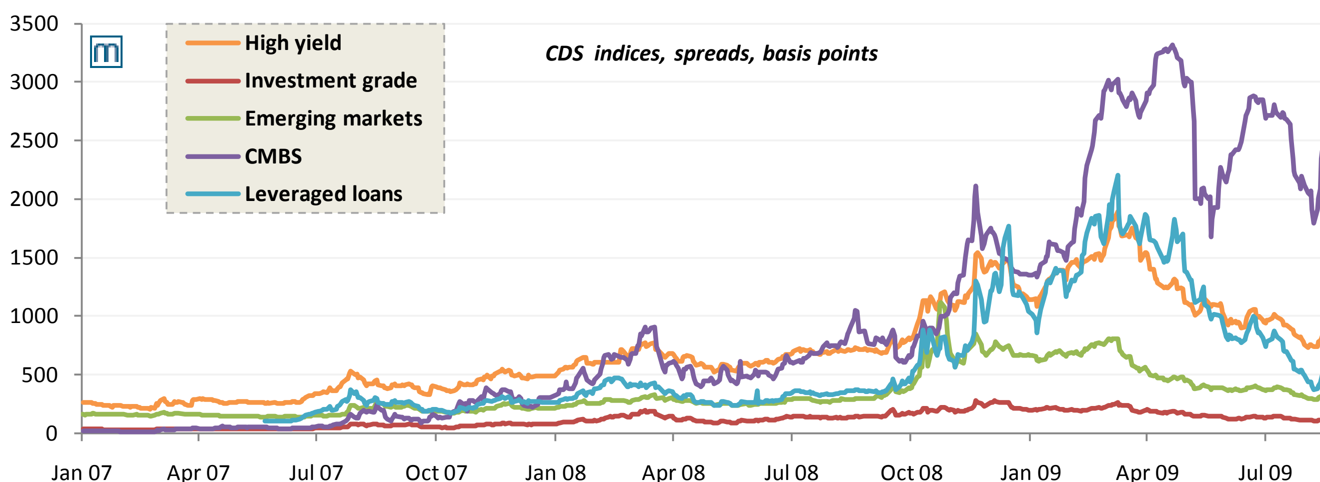
refinance imperils even viable properties, and in turn further worsens credit conditions.

Despite the evident pressures in the market, a Fed announcement in May that legacy CMBS would be eligible as collateral for TALF loans sparked a rally of more than 20% in 5-year triple-A rated CMBS (based on default swap indices). The market fell back sharply last week in the face of a renewed spike in general risk aversion, but the Fed program should help keep a bid under the market. Under TALF, the Fed provides non-recourse loans to fund leveraged acquisitions of asset-backed securities (see "TALF -- The Fed Gets One Right" March 6, 2009). With CMBS, an investor can borrow $85 to purchase $100 worth of assets, with the 15% haircut representing his only downside risk. 5-year triple-A CMBS currently are yielding about 7%. The interest rate on the loans, for 3-year or 5-year terms, is set at either the 3-year LIBOR swap rate plus 100 bp, or the 5-year LIBOR swap rate plus 100 bp. The CMBS program should provide leveraged returns exceeding 20%, even if an investor insures the at-risk haircut portion with credit default swaps. In fact, this arbitrage opportunity may go some way toward explaining the lingering wide spreads in CDS on CMBS.



The first TALF CMBS sale went off last month, involving about $670 million in legacy triple-A securities, at a 3-year fixed rate of 3.03% and a 5-year fixed rate of 3.87%. In this initial CMBS operation, no new loans were on offer. In the operation planned for next month, however, some $3 billion in new issues are expected, with the bulk originating with real estate investment trusts, including Vornado Realty, one of the largest REITs in the US, coming to the table with a $600 million offering. These will be the first new issues in the $700 billion CMBS market this year, after originations peaked at $230 billion in 2007. Reportedly, the pipeline of pending deals now totals about $30 billion. The Fed's announcement this week that it would extend the program for new-issue CMBS through June 30 next year (the original expiration date was this year-end) should help support additional issuance. With TALF offering a financing safety valve, we think there's a good chance that the vicious cycle of frozen financing and falling property values can be arrested.

Additional relief for the CMBS market could come from a pending Treasury Department decision that would allow loan servicers to renegotiate loan terms prior to default without the tax penalties currently imposed. The penalties can be severe, including a 100% "prohibited transactions" tax on transactional net income. With more than $154 billion of CMBS loans coming due by 2012, this change to ease mortgage restructuring could be critical to avoiding a wave of defaults. Treasury has already issued guidance to relax the same rules as they apply to *residential* MBS, and it would be consistent with other steps it has taken the last two years to

avoid having tax rules exacerbate financial distress, including rules affecting construction loans and loan syndications. But at a hearing before the Joint Economic Committee last month, Treasury Secretary Tim Geithner was noncommittal about the change, saying the department had not made a judgment yet on "whether the guidance is necessary, appropriate or possible."

As wounded as the CMBS market has been, it's worth noting that securitization only represents about 20% of the total commercial mortgage universe. That compares with subprime mortgages, which saw more than 80% of the nearly $2 trillion in issuance distributed through highly leveraged securitization, and thus represented a much larger risk when that market collapsed. The largest share of commercial mortgages, about $1.8 trillion, is held in the form of whole loans on the balance sheet of the banking system. About 7% of the banks' commercial mortgage holdings are currently delinquent. The 19 "systemically critical" institutions covered by the "stress test" completed by the Fed in May hold more than $600 billion in CRE loans. The Fed estimated that under the "more adverse scenario," which would see real estate values continue to fall dramatically through 2010, cumulative losses to the banks would come to about 8% of their total CRE portfolio. A senior Fed official told us that while the banks' CRE exposure was a source of concern and was being monitored on an ongoing basis, the adverse scenario for CRE losses at this point was not considered a systemic risk. Indeed, several other asset classes -- including credit card loans, second/junior lien mortgages, and first lien mortgages -- were rated as posing greater risk.

While we view the Fed's participation in CMBS as important to improving market function and helping promote stabilization, it should not be overlooked that that such activities are a key rationale for the Fed maintaining its ultra-easy policy posture which has witnessed such a massive balance sheet buildup. As long as CRE remains in distress, the Fed is unlikely to seriously consider implementing an exit strategy and beginning the normalization of its stance. Thus this is another glaring example of the dilemma currently confronting the central bank, as its efforts to support this market unavoidably exacerbate the already considerable inflation risks it is courting.

BOTTOM LINE: The CMBS market remains in considerable distress, but the Fed's efforts to support activity are having salutary effects. TALF for CMBS is a near-arbitrage opportunity, offering virtually riskless 20%-plus leveraged returns. With that incentive, a new-issue pipeline is being re-established.