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HIGHLIGHTS

- Commercial real estate markets have a long history of lagging the economic recovery cycle.
- Prices have already tumbled nearly 40% from the peak and a convincing trough has yet to emerge....arguing for ongoing contractions in CRE construction as 2010 gets underway.
- The steep drop in prices has depleted the collateral value backing CRE loans and securities and has caused delinquency rates to jump. Weak price conditions will continue to pressure default rates higher in the coming months.
- CRE troubles will have knock-on effects to the financial system and broader economy.
- However, the CRE market does not have the size and scope of the residential market to derail the economic recovery that is currently underway.
- Small-sized U.S. banks have a high degree of exposure to CRE loans and securities, leaving them vulnerable to defaults and recapitalization pressures. The same is not true for large banks.

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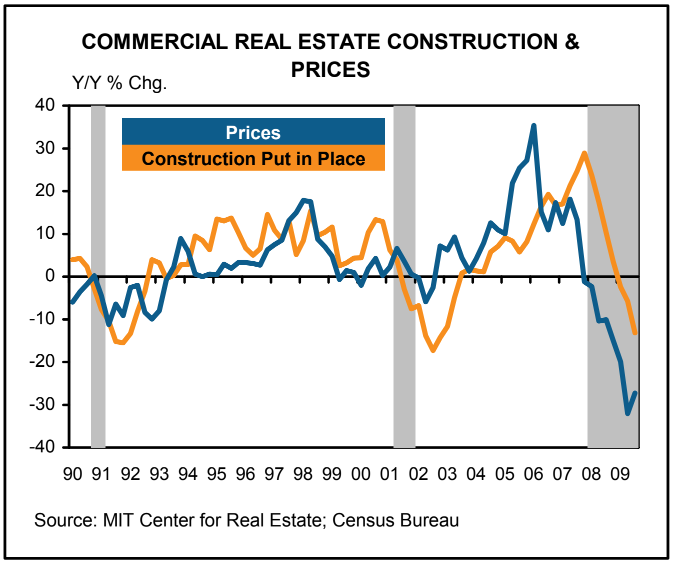
U.S. COMMERCIAL REAL ESTATE IS A SPEED BUMP, BUT NOT A ROAD BLOCK TO RECOVERY

The American economy grew at an annualized rate of 3.5% in the third quarter of 2009, offering convincing evidence that the recession has finally ended. Yet few economists, including ourselves believe it's smooth sailing from here on in. High unemployment, strained household finances and a financial system that is still plugged into the Federal Reserve for life support are reminders of the numerous challenges still facing the economic recovery. And, just to add in another challenge, there is mounting concern that commercial real estate markets (CRE) will snap the economy back into recession. These fears have been fuelled by a near-40% collapse in prices from the peak and a quadroupling in loan default rates in just two years. It's enough to make any investor wonder if the ingredients for yet another financial crisis is in the making. We believe the answer is no.

Commercial real estate usually a few steps behind

The fact that the commercial real estate (CRE) market is in tatters just as the broader economic recovery gets underway is not an anomalous event. It is a market that has historically lagged the economy, in every way, be it construction activity or prices. For instance, following the shallow and short lived 2001 recession, commercial prices did not halt their downtrend for an additional two more quarters, while in the 1990 recession, it took nearly two years following the official termination of that recession for the level or prices to trough. On the construction side, private non-residential structures tend to trough three quarters after a recession ends. Part of the reason for this is that vacancy rates can take a long time to crest, thus not providing a motivated backdrop for new construction activity. For example, in recessions since 1981, office vacancies rates peaked on average nine quarters after the economic recovery was in full swing.



The lagged relationship reflects the long lead times that CRE development requires…from the time it takes to secure financing, to breaking ground, to eventual completion. As a result, a gapping mismatch between supply and demand can emerge when demand conditions suddenly shift. In essence, CRE development decisions are based on market conditions years before the new supply hits markets. On the other hand, demand changes from period to period as the economic environment evolves. Thus, when there is an unforeseen negative shock to demand – such as a recession – projects in the pipeline continue to pump up supply even after demand has long faltered.

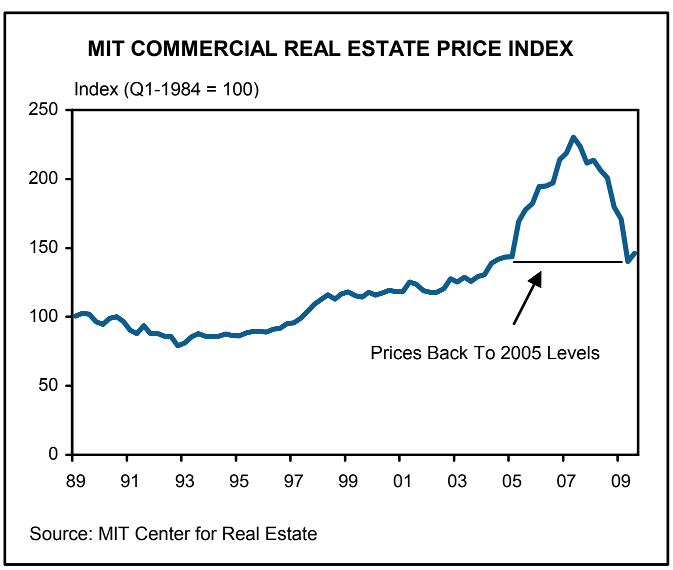
A convincing trough still needs to form

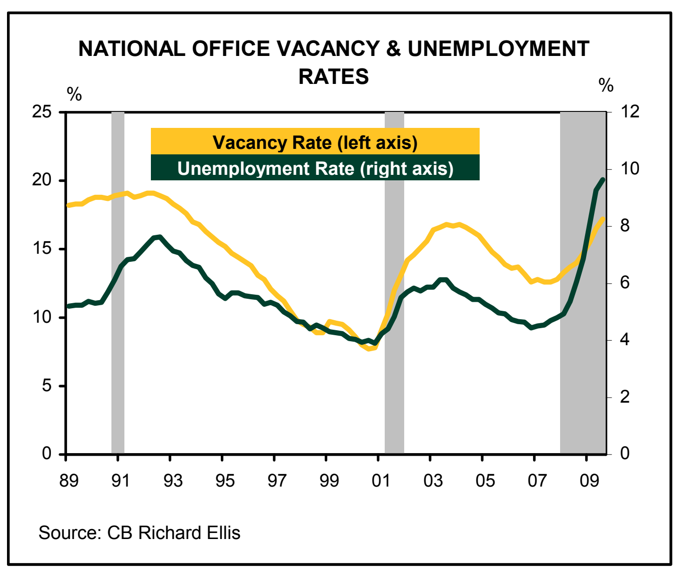
While the existence of oversupply in the commercial real estate market in the early stages of this post recession cycle is not abnormal, the extent to which prices have tumbled certainly is. Prices have dropped by 36% since the peak in mid-2007, more than any other period on record. However, this followed a massive 60% run-up in prices from the start of 2005. Even the overheated housing market didn't pull off a price gain of that magnitude over that short a time frame. The good news is that CRE prices have now returned to the levels seen before these spectacular jumps, suggesting that much of price-froth has been removed, and the third quarter saw a small rebound in prices. However, the bad news is that we have yet to see convincing evidence that a trough in prices has formed and we think it likely that there will be some overcorrection on the downside, given the slim prospects for a hard and fast economic recovery to quickly soak up supply.

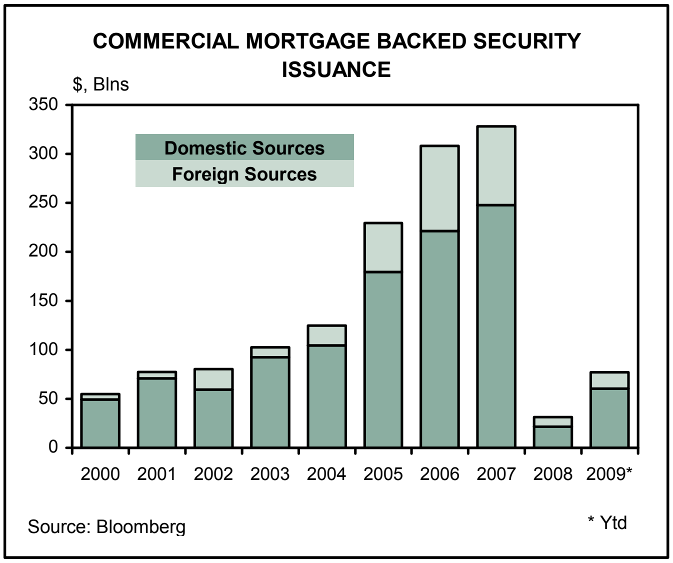
Specifically, the slow recovery we anticipate in the job market in 2010 and 2011 does not bode well for demand of new office and industrial space, especially considering that supply for both of these sectors was still expanding until the third quarter of 2008, nearly a full year after the recession was underway. In addition, even though capacity utilization (CAPU) rates within the industrial sector have recently edged up, they remain far lower than any other period following a recession and are, in fact, at the lowest level in the history of the data (1958). There is typically about a one year lag from when CAPU turns to when industrial construction also turns. We are likely to see even longer lags this time given the unprecedented degree of slack embedded in the industrial market. The picture on the retail side looks a little more promising considering that supply started contracting in 2007. However, since we expect new housing construction to remain below demographic requirements over the next two years, it's not a strong argument for a resurgence in retail outlets to service new suburbs. In addition, consumer finances will remain strained under a slow job recovery and the substantial losses of wealth during the recession. We anticipate the pace of consumer spending growth will be well shy of that typically seen in recovery phases, which again does not argue for a ramp-up in retail space.

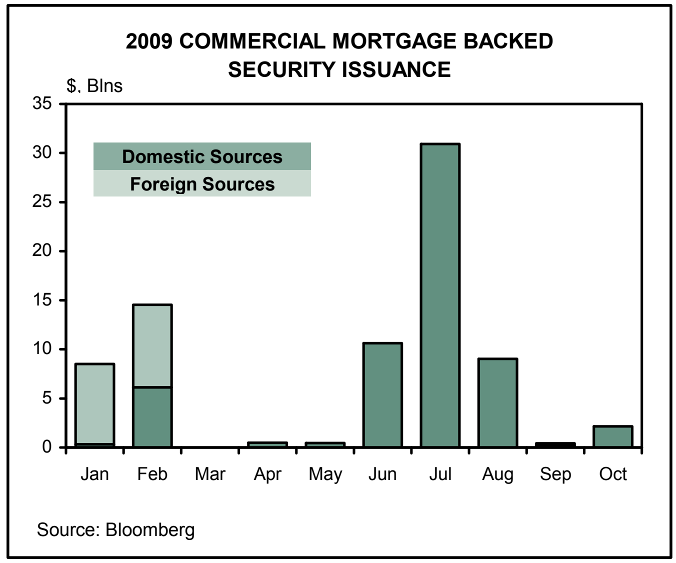
Box 1: What is CRE?

CRE is the development and management of a broad class of properties including industrial buildings, large apartment complexes, office towers and retail space. Common to all CRE are extensive construction projects and income generation through rental fees. As well, each sub-component of CRE is driven by distinct factors. Industrial and office space are linked to conditions in the labor market, as companies use properties to house employees and capital. New housing developments and household consumption drive the demand for retail space. Multi-family housing complexes are linked to conditions in the housing market.







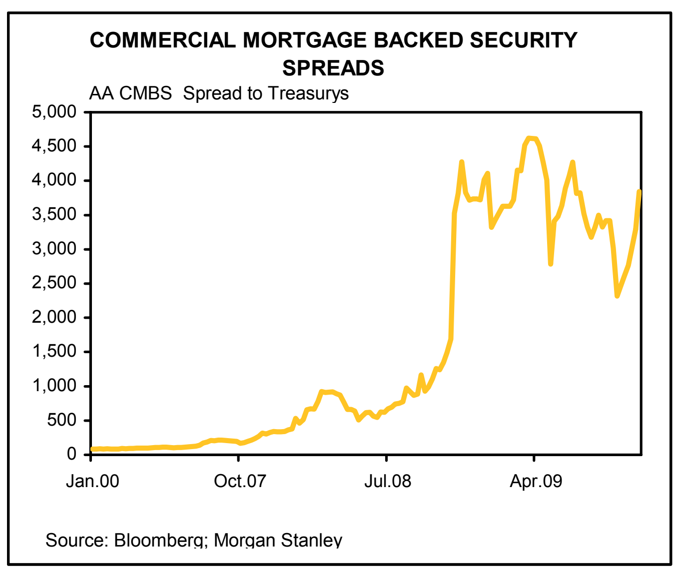


The trickle down effect to financial institutions

The steep drop in CRE prices (and the possibility that the trough hasn't even been formed yet) has depleted the collateral value backing these loans and securities and has caused delinquency rates to jump to 8% of CRE loans in Q2 2009 from a mere 1% in Q2 2006. Likewise, spreads on commercial mortgage backed securities (CMBS) are elevated and new issuance has dropped off immensely. To get a feel for the size of this problem, bank loans and CMBS account for nearly 70% of CRE financing. This is why the Federal Reserve allowed high quality commercial mortgage backed securities to be included in the TALF program in mid 2009, as an attempt to "restart the market for legacy securities and, by doing so, stimulate the extension of new credit by helping to ease balance sheet pressures on banks and other financial institutions".[1] This strategy appears to have provided some relief to the CMBS market, with new issuances jumping up by a total of $50.5 billion over the June to August period. However, there has already been a marked drop off since then with next to no issuance in September and a mere $2 billion in October. So, the Fed may have won part of the battle, but not yet the war. To make matters more pressing, the Federal Reserve estimates that up to $500 billion in CRE loans will mature annually for the next few years. Weak price conditions could prevent many property developers and managers from repaying these loans, forcing them to either extend financing or default. Given the current credit environment it will be extremely difficult for this volume of loans to find refinancing, pressuring defaults higher.

Implication

The CRE troubles will have knock on effects to the financial system and broader economy. The direct impact to real GDP growth will be reflected in the potential for CRE construction to contract throughout 2010 and into 2011. In addition to this, there is a secondary financial dimension. The deterioration in CRE loan quality will slow the recovery in the financial sector, which could be another hiccup into the flow of credit to households and businesses. This would particularly be the case if some banks (likely small ones) are forced into bankruptcy, thereby reducing the supply of funds available for those unable to access capital markets. Poor loan quality for such a large asset class will hurt attempts to improve bank loan loss reserves, raise further capital



adequacy concerns, and impede the profitability of banks – again impacting credit flow in the economy by keeping banks focused more on risk aversion and recapitalization.

CRE is not on the same scale as the residential market

So the trillion dollar question now becomes, does the CRE market pose the same systemic threat to the economy and financial system as the residential mortgage market did? We think not.

First, the two markets differ greatly in size and scope. IMF data indicates that CRE loans and securities make up about 10% of these asset among U.S. banks, compared to 36% for residential loans and securities. Likewise the CRE market has a smaller international reach, representing just 5% of total loans and securities in U.K. banks and 7% among Euro area banks. In both of these markets, residential loans and securities are 3-4 times greater – and that's after much paring back during the global financial crisis. If we look beyond just U.S. banks, to include CRE holdings by all investors (i.e. insurers, pension funds), the market size amounts to $3.5 trillion, compared to a $12 trillion residential mortgage market.

Second, the structure of the debt in the U.S. is less concentrated in systemically important institutions. CRE loans make up a disproportionately large share of assets among smaller banks, at 28% [2]. Within larger banks, the CRE share dwindles to just 9% of total assets. In contrast, prior to the credit crunch, large banks held 23% of their assets as residential mortgages, so when trouble started in the housing market the big 'systemic' institutions were much more vulnerable to losses then they are now. In a similar vain, CRE has almost no link to government sponsored enterprises (GSE's) such as Fannie Mae and Freddie Mac, whereas about 40% of the residential mortgage market was tied in some way to these massive GSE's. So while the concentration of losses in the small banking sector could linger and prove difficult to isolate as the necessary recapitalization will be more widespread than a handful of Wall Street firms, it does not have the long reach to the financial sector and broader economy as the turmoil that beset the residential mortgage industry. As such, the feedback loop to the financial system and broader economy should be more limited under the CRE market woes relative to the size and scope of the residential market.

Conclusion

Weakness in commerical real estate markets and its financial implications are a headwind to the economic recovery, but unlikely to draw the economy back into a recession. Despite the bleak outlook for CRE, a broad range of sectors from manufacturing to residential housing are showing signs of improvement, and it is normal for CRE to lag following a recession. It is for this reason that we had already embedded in our forecasts (see QEF, September 2009) ongoing contractions in non-residential construction activity next year despite the fact that an economic recovery will be well underway.

The concentration of CRE loans in smaller banks and a smaller securitized market greatly limits the threat of another systemic financial crisis. Further, the Fed has been keenly aware of the troubles posed by CRE for some time, and has taken step to address them through the TALF program. As well, the Treasury and Federal Reserve are actively engaged with banks seeking solutions to the challenges presented by CRE. So, while the economic recovery is underway, the many troubles in the CRE market serve as a reminder that it is not full speed ahead.

ENDNOTES

[1] Board of Governors of the Federal Reserve System, Press release, May 19, 2009.

[2] Federal Reserve Board, Flow of Funds