MORNING BRIEFING
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Rolling Recession Rolling Over Commercial Real Estate

Check out the accompanying chart collection.

Executive Summary: The urban office real estate niche of the commercial real estate market is increasingly distressed owing to the work-from-home trend escalated by Covid. But the problem is contained to the office districts of big cities, and we expect the fallout to be contained too: Sellers of distressed properties will take losses but find buyers, exposed banks will further increase loan loss provisions, increased M&A activity among small banks may result; but the problem won't domino into a crisis of the banking system or the economy at large. … We detail why with our analysis of data from the Fed. … Also: Dr. Ed reviews "Oppenheimer" (+ + +).

YRI Weekly Webcast. Join Dr. Ed's live webcast with Q&A on Mondays at 11 a.m. EST. You will receive an email with the link one hour before showtime. Replays of the weekly webcasts are available *here*.

Commercial Real Estate I: 'Category 5 Hurricane.' Barry Sternlicht was interviewed on *Bloomberg Wealth With David Rubenstein* on June 28 in New York. The interview with the chairman of Starwood Capital Group will be aired on July 25 at 9 p.m. The highlights were featured in a July 20 Bloomberg *story* titled "Billionaire Sternlicht Sees 'Category 5 Hurricane' Spurred by Fed Rate Hikes."

Sternlicht has amassed his fortune in real estate by purchasing distressed properties during financial crises. He did so during the savings & loan collapse and again during the Great Financial Crisis. He sees similar opportunities now in the commercial real estate (CRE) market for office buildings. Nevertheless, he said, "It's sort of a blackout hovering over the entire industry until we get some relief or some understanding of what the Fed's going to do over the longer term."

Among the companies exposed to this CRE hurricane is Starwood, which has more than $115 billion in assets under management. On July 9, the firm failed to refinance or pay off the $212.5 million mortgage on Tower Place 100 in Atlanta's Buckhead district. The firm is negotiating an agreement with its lenders. Blackstone Inc. and Brookfield Asset Management Ltd. also have stopped making payments on a few of their office buildings.

June's *Trepp CMBS Research* reported that "the commercial mortgage-backed securities (CMBS) market saw a noticeable uptick in delinquencies," during May and June, with the overall CMBS delinquency rate (i.e., percent late by 30 or more days) rising to 3.90% last month led by retail (6.48% down from 6.69% a year ago), lodging (5.35% down from 5.94%), and office (4.50% up from 1.68%) (Table 1, below). The Atlanta area's office-vacancy rate climbed to 22.4% in the second quarter, compared with the US average of 20.6%, according to brokerage Jones Lang LaSalle Inc.

Table 1. Delinquency Rates by Property Type (%)*

	June 2023	May 2023	April 2023	3-Month	6-Month	12-Month
Overall	3.90	3.62	3.09	3.09	3.04	3.20
Industrial	0.42	0.39	0.40	0.37	0.42	0.49
Lodging	5.35	4.25	4.23	4.41	4.40	5.94
Multifamily	1.59	1.46	1.82	1.91	2.17	1.03
Office	4.50	4.02	2.77	2.61	1.58	1.68
Retail	6.48	6.67	6.11	6.23	6.97	6.69

* Thirty days or longer.
Source: Trepp.

Office vacancies are up sharply since the pandemic forced many office workers to work from home. Now many of them want to continue doing so and are resisting returning to their cubicles. Many employers are fine with that and have adopted hybrid schedules allowing workers to come to the office part of the time and work from home otherwise. Many of the employers haven't been renewing their leases, opting instead to move to smaller spaces.

In a CNBC *interview* on November 17, 2022, Sternlicht warned that the Fed's aggressive tightening of monetary policy would depress the economy more than expected. "It's not sustainable," he said. "What they want to do is clearly suicide." In his latest interview on Bloomberg, he said, "You could see 400 or 500 banks that could fail. And they will have to sell. It also will be a great opportunity."

Commercial Real Estate II: How Distressing Is It? Debbie, Melissa, and I aren't distressed about the distress in the CRE market for office buildings. There will be a market for distressed properties. There's lots of cash ready to be deployed in distressed asset funds. Sellers will take their losses, reducing the rate of returns on their CRE portfolios. Many of the banks already have increased their provisions for loan losses.

In his latest interview, Sternlicht said, “You could see a second RTC.” He was referring to the Resolution Trust Corporation, the government entity charged with liquidating assets of the savings & loan associations that failed in the late 1980s and early 1990s. But what about the hundreds of bank failures that he expects? We think that CRE loan losses and higher regulatory costs will result in a wave of mergers and acquisitions, averting a banking crisis.

After all, hurricanes are local, not national events. In this case, the financial storms are likely to hit the office districts of several urban areas. The loan losses will likely be concentrated among large banks and institutional investors. Suburban office buildings are less likely to be distressed by the work-from-home trend because suburban workers typically live closer to their workplaces than urban workers with long commutes from homes in the suburbs. So small banks may not be all that exposed to loan losses on their suburban office properties.

Commercial Real Estate III: By the Numbers. Now let’s have a closer look at the loan portfolios of the US commercial banks focusing on their exposure to CRE loans. The data are available weekly in the Fed’s H.8 release titled “*Assets and Liabilities of Commercial Banks in the United States - H.8*.” The release shows outstanding loans for the following categories: commercial & industrial, commercial real estate, residential real estate, and consumer credit. Series are also available for large and small banks:

(1) *All loans*. Loans held by banks of all three categories—“all,” “large,” and “small”—have flattened out in recent weeks at record highs around $12.1 trillion, $6.7 trillion, and $4.3 trillion, respectively (*Fig. 1*).

(2) *C&I loans*. Commercial & industrial loans soared during the first few months of the pandemic as companies scrambled to take down their lines of credit at the banks. The Fed’s emergency liquidity facilities and ultra-easy monetary policies in response to the pandemic stopped the panic borrowing, and C&I loans fell during most of 2020 and 2021 (*Fig. 2*). During that period, consumers’ buying binge for goods depleted business inventories and reduced the demand for C&I loans. During 2022 through early 2023, unintended inventory accumulation occurred as the buying binge came to an end, boosting the demand for C&I loans.

Now inventories have been pared back, as reflected by the weakness in C&I loans for all three bank categories in recent weeks. Of course, the tightening of lending standards might also be weighing on C&I loans.

(3) *CRE loans*. During the July 12 week, all banks held $2.9 trillion in CRE loans, with small and large banks holding $1.9 trillion and $0.9 trillion, respectively (*Fig. 3*). These loans have plateaued in recent weeks at these record levels. In other words, so far, the data suggest that banks on average are not adding to their CRE loan portfolios.

(4) *Residential and consumer loans.* Banks of all sizes have $2.5 trillion in residential loans. Small banks' residential loans rose to a record high of $0.9 trillion during the July 12 week, while large banks, with $1.6 trillion in residential loans, appear to have started paring back their holdings (*Fig. 4*). Loans for multi-family properties remain on uptrends for the three categories of banks, though they are starting to look toppy at the large banks (*Fig. 5*).

The same pattern can be discerned in consumer loans. Consumer loans at all banks currently total a record $1.9 trillion, with large and small banks holding $1.4 trillion (a slight downtick from the recent record high) and $0.5 trillion (a record high), respectively (*Fig. 6*).

Data are also available for auto loans at the banks. They are weakening, especially recently and especially at the large banks (*Fig. 7*).

(5) *Provisions for loan losses.* The banks have increased their provisions for loan losses as a result of mounting concerns that the Fed's aggressive tightening of monetary policy might cause a recession. Allowances for loan losses at all the banks have increased $27.0 billion over the past year through the July 12 week to $187.5 billion (*Fig. 8*). That's still below the pandemic high of $220.7 billion during the September 23 week of 2020.

FactSet estimates that the 15 banks in the S&P 500 Banks industry increased their provisions for loan losses to $9.9 billion during Q2-2023, up from $4.9 billion a year ago. On Thursday, Key Bank reported a bigger-than-expected 50% fall in quarterly profits as the lender's provisions for credit losses jumped by 271% to $167 million at the quarter's end from $45 million in the year-ago quarter.

(We monitor the weekly balance sheet of the commercial banks with our two chart books: *Commercial Bank Book* and *Commercial Bank Loans*. They are automatically updated after the data are released on Fridays at 4:15 p.m.)

Commercial Real Estate IV: The Fed's Assessment. The Fed's May 2023 *Financial Stability Report* included a review of the CRE credit market. Our conclusion is that a hurricane in that market shouldn't cause an economy-wide credit crunch and a recession. The report observes:

"The shift toward telework in many industries has dramatically reduced demand for office space, which could lead to a correction in the values of office buildings and downtown retail properties that largely depend on office workers. Moreover, the rise in interest rates over the past year increases the risk that CRE mortgage borrowers will not be able to refinance their loans when the loans reach the end of their term. With CRE valuations remaining elevated (see Section 1, Asset Valuations), the magnitude of a correction in property values could be sizable and therefore could lead to credit losses by holders of CRE debt."

The Fed's report includes the following table. Below are some of the key findings:

Table 2. Commercial Real Estate (CRE) Holdings by Investor Type, Q4-2022*

CRE Investor Type	CRE Holdings (trillions of dollars)	Percent of Total CRE Loans Outstanding	Office & Downtown Retail CRE Holdings (trillions of dollars)	Total Assets Held (trillions of dollars)
Banks	2.17	61	0.72	28.5
Category I Banks**	0.28	8	0.10	14.3
Category II-IV Banks	0.34	9	0.11	6.8
Other Banks	1.55	43	0.51	7.4
Life Insurers	0.47	13	0.17	5.4
Holders of Non-Agency CMBS	0.53	15	0.17	—
Other Non-Bank CRE Holders	0.40	11	—	—
TOTAL	3.57	—	—	—

* CRE = Nonfarm, nonresidential real estate, including office and downtown retail CRE.

** U.S. G-SIBs.

Source: Federal Reserve Board, Financial Stability Report, May 2023, p. 17.

(1) At the end of Q4-2022, banks held $2.17 trillion in CRE mortgage assets, or 61% of the total outstanding. The smaller banks held $1.55 trillion, or 43% of these assets. So the latter group of investors is most exposed to potential losses in CRE, though those whose portfolios have more suburban than urban office buildings might be less exposed. Nevertheless, their CRE borrowers may have to refinance their mortgages at prohibitively high rates or renegotiate the terms of their refinancings with their lenders.

(2) The Fed's data show that small banks are in fact heavily exposed to office and downtown retail CRE loans to the tune of $510 billion during Q4-2022. The data don't show how much of the exposure to office buildings is in urban centers versus the suburbs.

(3) In his June 14 *press conference*, Fed Chair Jerome Powell said that the Fed is closely monitoring the CRE sector. He observed: “There’s a substantial amount of commercial real estate in the banking system. A large part of it is in smaller banks.” He expects that there will be losses and he expects that the problem “will be around for some time.” He doesn’t expect that it “will suddenly hit” in a way that causes “systematic risk.” We agree with him.

Movie. “Oppenheimer” (+ + +) (*link*) is an excellent biopic and docudrama about Robert Oppenheimer, who directed the secret Manhattan Project, which developed and built the two atom bombs that were dropped on Japan and ended World War II. The cast is outstanding, starring Cillian Murphy in the title role. Standout performances were also delivered by Robert Downey Jr. as Lewis Strauss and Matt Damon as Lt. Gen. Leslie Groves Jr. Director Christopher Nolan’s achievement is to look beyond the bomb at the man behind it as well as the national and geopolitical implications of the bomb. Also considered are the implications for humanity of creating a weapon of mass destruction that could wipe out creation itself.

Calendars

US: Mon: US M-PMI & NM-PMI Flash Estimates 46.4/54.0; Chicago Fed National Activity Index 0.03. **Tues:** Conference Board Consumer Confidence 99.2; Richmond Fed Manufacturing Index -10; S&P/CSI HPI 20-City Composite Index 1.5%m/m/-2.2%y/y; API Weekly Crude Oil Inventories. (Bloomberg estimates)

Global: Mon: Eurozone, Germany, and France C-PMI Flash Estimates 49.6/49.3/47.2; Eurozone, Germany, and France M-PMI Flash Estimates 43.3/40.3/45.9; Eurozone, Germany, and France NM-PMI Flash Estimates 51.4/53.3/48.2; UK C-PMI, M-PMI, NM-PMI Flash Estimates 52.2/45.9/53.0. **Tues:** Germany Ifo Business Climate Index, Current Assessment & Business Expectations 87.9/93.0/83.0; ECB Bank Lending Survey; Australia CPI 1.0%q/q/5.4%y/y. (Bloomberg estimates)

Strategy Indicators

Global Stock Markets Performance (*link*): The US MSCI index rose 0.7% last week for its eight gain in 10 weeks, and moved further out of a correction to end the week at 6.6%

below its record high on December 27, 2021. The US MSCI ranked 17th of the 48 global stock markets that we follow in a week when 21 of the 48 countries rose in US dollar terms. The AC World ex-US index underperformed with a 0.7% decline, and remains in a 13.9% correction from its June 15, 2021 record high. EM Latin America was the best performing region with a 1.6% rise, ahead of EMEA (0.2%), EM Eastern Europe (-0.2), and EAFE (-0.6). EM Asia was the worst performing region last week with a decline of 1.9%, followed by BIC (-1.2), and EMU (-0.8). Belgium was the best-performing country last week, with a gain of 6.9%, followed by Argentina (6.2), Jordan (4.0), Colombia (3.7), Brazil (2.8), and Israel (2.8). Among the 13 countries that underperformed the AC World ex-US MSCI last week, the 4.5% decline for the Netherlands was the biggest, followed by those of New Zealand (-3.9), Pakistan (-3.7), Taiwan (-3.4), and China (-2.7). Looking at 2023's performance so far, the US MSCI is up 18.6% as its ytd ranking rose one spot w/w to 15/48. The AC World ex-US's ytd gain of 10.1% is trailing the US's, with 37/48 countries now in positive territory. EM Eastern Europe is the best regional performer ytd, with a gain of 28.7%, followed by EMU (18.3), EM Latin America (17.8), and EAFE (12.0). The regional laggards so far in 2023, albeit with gains: BIC (0.5), EM Asia (5.2), and EMEA (5.9). This year's best ytd country performers: Greece (50.1), Argentina (46.4), Ireland (32.3), Hungary (31.1), and Poland (29.9). Here are the worst-performing countries of the year so far: Pakistan (-29.1), Turkey (-13.5), Finland (-9.4), Hong Kong (-8.9), and Malaysia (-8.8).

S&P 500/400/600 Performance (*link*): All three of these indexes moved higher w/w. LargeCap rose 0.7% w/w, but trailed the 1.6% and 1.2% gains for SmallCap and MidCap. At Friday's close, LargeCap finished the week at 5.4% below its record high on January 3, 2022, MidCap moved further out of a correction to end at 7.0% below its record high on November 16, 2021, and SmallCap improved to a 14.3% correction from its November 8, 2021 record high. Twenty-six of the 33 LargeCap and SMidCap sectors moved higher for the week, down from 32 rising a week earlier. SmallCap Energy was the best performer with a gain of 6.0%, ahead of SmallCap Financials (5.7), MidCap Energy (5.2), MidCap Financials (4.0), LargeCap Energy (3.5), and LargeCap Health Care (3.5). Among the biggest underperformers for the week were LargeCap Communication Services (-3.0), LargeCap Consumer Discretionary (-2.3), MidCap Tech (-1.9), SmallCap Tech (-0.9), and LargeCap Real Estate (-0.5). Looking at performances so far in 2023, LargeCap, with a gain of 18.1%, remains well ahead of MidCap (11.3) and SmallCap (8.6); 26 of the 33 sectors are now higher ytd compared to 17 several weeks earlier. The top sector performers in 2023: LargeCap Tech (43.8), LargeCap Communication Services (35.5), LargeCap Consumer Discretionary (33.2), MidCap Tech (24.8), and MidCap Industrials (23.9). Here are 2023's biggest laggards: MidCap Utilities (-7.9), SmallCap Financials (-7.1), LargeCap Energy (-4.1), LargeCap Utilities (-3.0), and SmallCap Utilities (-2.4).

S&P 500 Sectors and Industries Performance (*link*): Seven of the 11 S&P 500 sectors rose last week, and six outperformed the composite index's 0.7% gain. That compares to a 2.4% gain for the S&P 500 a week earlier, when all 11 sectors rose and five outperformed the index. Energy and Health Care were the best performers, with gains of 3.5%, followed by Financials (3.0%), Utilities (2.4), Consumer Staples (1.6), and Industrials (0.9). Communication Services was the worst performer, with a drop of 3.0%, followed by Consumer Discretionary (-2.3), Real Estate (-0.5), Tech (-0.1), and Materials (0.6). Looking at 2023's performance so far, the S&P 500 is up 18.1% ytd, with just three sectors still outperforming the index but nine now higher for the year, up from seven a week earlier. The best ytd performers: Tech (43.8), Communication Services (35.5), and Consumer Discretionary (33.2). These are 2023's worst performers: Energy (-4.1), Utilities (-3.0), Health Care (0.1), Consumer Staples (1.7), Financials (2.9), Real Estate (4.2), Materials (7.7), and Industrials (11.5).

S&P 500 Technical Indicators (*link*): The S&P 500 rose 0.7% last week, but was mixed relative to its moving averages. It weakened relative to its 50-day moving average (50-dma) and improved against its 200-day moving average (200-dma). The index was above its 50-dma for a 17th week and its 200-dma for an 18th week. It had been above its 200-dma for eight weeks through early March in its longest positive 200-dma streak since it was above for 81 straight weeks through January 2021. The S&P 500 slipped to 4.5% above its rising 50-dma from 4.8% a week earlier, but is down from a 20-week high of 5.4% above its rising 50-dma in mid-June. That compares to a 20-week low of 3.6% below at the beginning of March, a four-month low of 10.6% below at the end of September, a 23-month high of 8.7% above the index's rising 50-dma in early August, and a 27-month low of 11.1% below its falling 50-dma in June 2022. The index had been mostly trading above its 50-dma from late April 2020 to early April 2022; in June 2020, it was 11.7% above, which was the highest since its record high of 14.0% in May 2009. That compares to 27.7% below on March 23, 2020—its lowest reading since it was 29.7% below on Black Monday, October 19, 1987. The price index closed Friday at a 22-month high of 11.4% above its rising 200-dma, up from 11.3% above its rising 200-dma a week earlier. The S&P 500 is well above its 26-month low of 17.1% below its falling 200-dma in June 2022. That compares to 17.0% above in December 2020, which was the highest since November 2009 and up from the 26.6% below registered during the Great Virus Crisis on March 23, 2020—the lowest reading since March 2009. At its worst levels of the Great Financial Crisis, the S&P 500 index was 25.5% below its 50-dma on October 10, 2008 and 39.6% below its 200-dma on November 11, 2008. The 50-dma moved higher for an 18th week, and the 200-dma rose for an eight week but has risen in just 20 of the past 61 weeks.

S&P 500 Sectors Technical Indicators (*link*): All 11 S&P 500 sectors are trading above their 50-dmas, unchanged from a week earlier. Nine sectors have a rising 50-dma, up from eight a week earlier, as Health Care turned up in the latest week. These two sectors are the only members in the falling 50-dma club: Consumer Staples and Utilities. Looking at the more stable longer-term 200-dmas, the positive club improved to 10 members w/w from eight as Health Care and Utilities turned up w/w. Energy is the only sector still trading below their 200-dma. The rising 200-dma club expanded w/w to all 11 sectors as Energy's 200-dma turned up.

US Economic Indicators

Leading Indicators (*link*): Leading indicators continued to plunge in June, while coincident indicators was unchanged at May's record high. The Leading Economic Indicators (LEI) fell in June for the 15th straight month, sinking 0.7% m/m and 9.8% over the period—the longest losing streak since 2007-08—to the lowest level since July 2020. Leading indicators is biased toward the goods economy. In June, six of the 10 components contributed negatively, two contributed positively, and two—the average workweek and real core capital goods orders—were unchanged. Over the six months through June, the LEI dropped 4.2%, steeper than the 3.8% drop over the previous six-month period through December. The report noted, "Rising interest rates paired with persistent inflation will continue to further dampen economic activity." The biggest *negative contributors* to June's LEI once again were consumer expectations (-0.21ppt) and the new orders diffusion index (-0.21), followed by the interest rate spread (-0.17), jobless claims (-0.13), building permits (-0.12), and the leading credit index (-0.04). Meanwhile, the positive contributors were stock prices (+0.20) and real consumer goods orders (+0.01).

Coincident Indicators (*link*): The Coincident Economic Indicators (CEI) index was flat in June at its record high, posting only one decline during the past 12 months and climbing 1.8% y/y. It exceeds its previous record high, just before the pandemic, by 2.5%. Three of the four components of the CEI rose in June, with industrial production once again the one outlier: 1) *Real personal income less transfer payments* (+0.08ppt) rose for the fourth time this year, by 0.3% in June and 0.9% ytd, to a new record high and is up 11.3% from its April 2020 bottom. 2) *Payroll employment* (+0.04) in June was a surprise on the downside, expanding only 209,000, the weakest since December 2020, while there were downward revisions to both May (to 306,000 from 339,000) and April (217,000 from 294,000) payrolls, for a net loss of 110,000. Government payrolls remained on a steep uptrend, adding 60,000 jobs last month, led by state & local governments. 3) *Real manufacturing & trade sales* (+0.04) remains in a volatile flat trend, climbing 0.3% in June—to within 1.3% of its record high recorded during January 2022. 4) *Industrial production* (-0.11) unexpectedly fell in June, once again led by a sharp drop in utilities output, with manufacturing also contributing to the decline. *Headline production* sank 0.5% last month, weaker than the consensus forecast of no change, while May's decline of 0.5% (vs -0.2%) was more than double the preliminary estimate.

Regional M-PMIs (*link*): Two Fed districts have reported on manufacturing activity for July—New York and Philadelphia—and show *manufacturing activity* (to -6.2 from -3.6) contracted at a faster pace than in June as activity in the Philadelphia (to -13.5 from -13,7) region continued to contract at a fast pace while New York's (1.1 from 6.6) expanded at a slower rate than last month. *New orders* (-6.3 from -3.9) fell at a faster pace in July, as billings in the Philadelphia (-15.9 from -11.0) area fell at the fastest pace in three months, while New York (3.3 from 3.1) orders held steady. *Employment* (1.9 from –2.0) showed factories hired for the first time in five months, albeit at a slow pace, as hirings at New York (4.7 from -3.6) factories posted the first gain since the start of this year, while Philadelphia (-1.0 from -0.4) factories continue to fluctuate just below the breakeven point of zero. Looking at *prices-paid* indexes, the Philadelphia (9.5 from 10.5) measure held steady, not far from April's 8.2 reading—which was its lowest since mid-2020—while New York's (16.7 from 22.0) posted its lowest reading since August 2020. The former was at a recent high of 83.6 in November 2021, while the latter was at a record high of 86.4 in April 2022. *Prices-received* indexes were mixed: New York's (3.9 from 9.0) eased to its lowest reading since July 2020; it was at a record high of 56.1 in March 2022. Philadelphia's measure moved up for the second month to 23.0, after falling from 37.6 last November to -7.0 this May—which was the weakest since April 2020. It was at a record high of 65.8 in November 2021.

Existing Home Sales (*link*): "The first half of the year was a downer for sure with sales lower by 23%," noted Lawrence Yun, NAR's chief economist. He went on to say, "Fewer Americans were on the move despite the usual life-changing circumstances. The pent-up demand will surely be realized soon, especially if mortgage rates and inventory move favorably." *Existing home* sales have been volatile around recent lows, falling three out of four months through June by 3.3% m/m and 8.6% over the period to 4.16mu (saar), following a 13.8% surge in February. Sales are down 18.9% y/y. *Single-family* sales dropped for the fourth successive month in June, by 9.3% over the period to 3.72mu (saar), after a 14.2% jump in February. These sales were 18.8% below a year ago. *Multi-family* sales fell during three of the past four months, by 2.2% both in June and over the three-month period, to 440,000 units (saar), though they are up 7.3% ytd. These sales contracted

20.0% from a year ago. Regionally, sales in June rose in one region, stayed flat in another, and fell in two, with all still posting double-digit declines versus a year ago. Here's a tally: Northeast (+2.0% m/m & -21.5% y/y), Midwest (0.0 & -19.5), West (-5.1 & -22.7), South (-5.4 & -16.2). Total *housing inventory* at the end of June was 1.08 million units, unchanged from the May level but down 13.6% from last June's 1.25 million units. "There are simply not enough homes for sale," Yun noted. "The market can easily absorb a doubling of inventory. Limited supply is still leading to multiple-offer situations, with one-third of homes getting sold above the list price in the latest month." At $410,200, the median existing home price in June was the second-highest price ever recorded since January 1999—when NAR began tracking the data.

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