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Research Briefing | US

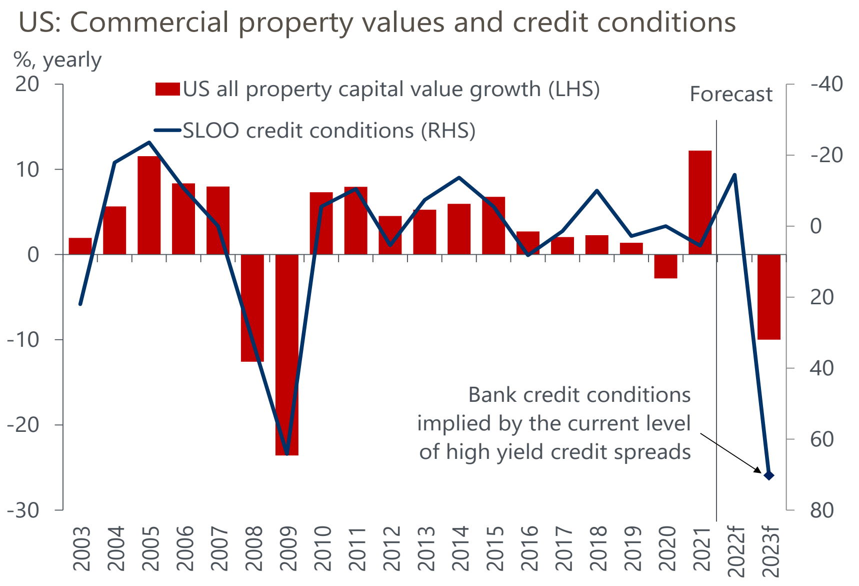
Bank funding turmoil drags down CRE outlook

- **The recent turmoil in US bank funding will likely feed into tighter lending standards to commercial property, dampening the outlook for capital values even further than we had expected. We now expect all property capital values to fall by 10% in 2023 and 5% in 2024.**
- **US commercial property prices are sensitive to changes in bank lending conditions. So the ongoing market correction combined with the importance of regional banks in real estate financing and the role of leveraged non-bank lenders are grounds for a more downbeat baseline forecast.**
- **We think refinancing risk is greatest for offices and retail. The combination of poor capital performance over the past few years and the likely lowering of loan-to-value requirements in the next few quarters will hit transactions and could lead to forced sales.**

The failures of Silicon Valley Bank and Silvergate Capital have kicked off a broader turmoil in bank funding markets in recent weeks. For now, the Federal Reserve's provision of an extra $300bn of liquidity via the discount window, the Bank Term Funding Program, and collateralized lending to FDIC banks have helped to stop the panic from worsening. Now, the key question for real estate investors is the extent to which the fears over liquidity will impact bank lending conditions – the main transmission mechanism into a deeper property market downturn.

Although we are relatively sanguine impact of the turmoil in bank funding markets on the wider economy (at least for now), we think it will have an outsized impact on commercial property. That's because of the nature of the panic, which is concentrated in smaller banks that account for the majority of commercial property financing. These US banks with assets less than $250bn supply around 80% of commercial real estate loans. The impact could stem either directly from reduced bank credit supply, or indirectly via a decline in bank financing for non-bank lenders, which also play a crucial role. But the recent rise in high yield credit spreads – which correlate strongly with bank credit conditions – point to a sharp tightening (**Chart 1**) and weaker outlook for property even if spreads narrow from here as we expect.

Chart 1: Credit conditions are crucial to the US commercial property outlook



Source: Oxford Economics

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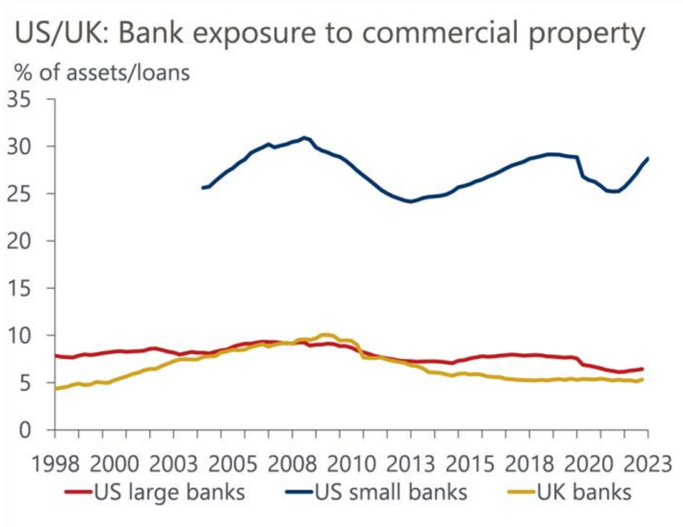
Although liquidity measures are being rolled out quickly, depositor flight is still a major problem for smaller banks and these institutions will need to manage their balance sheets, starting with assets that have the highest risk weights (**Chart 2**).

Chart 2: The role of regional US banks in commercial property financing



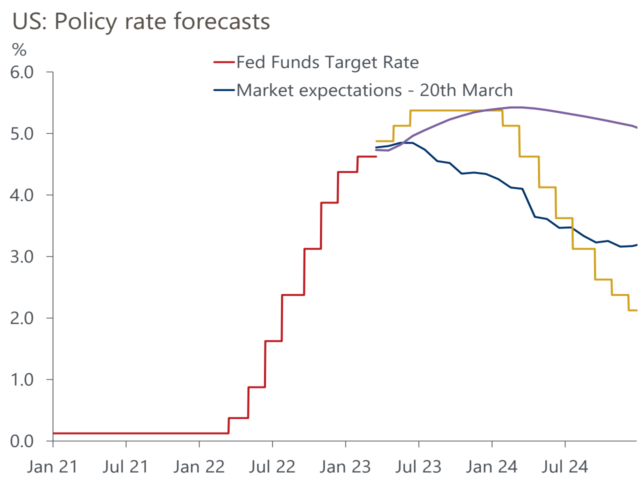
Source: Oxford Economics / Haver Analytics

As a result of this materially worse outlook for real estate finance we will downgrade our forecast to incorporate a peak-to-trough slump in US all property capital values of 15%. That would make the current downturn just under half the decline in 2008-2009 but significantly worse than the 4% correction during the dotcom bust. Although the size of the wider economic shock is far smaller than both of those episodes, crucially, the policy rate environment is very different now.

Don't count on any respite from the Fed

Since this episode began, markets have been quick to reassess the outlook for monetary policy and price in a pause in the rate hiking cycle (**Chart 3**). But we still think the Fed will raise rates by 25bps at each of the next three meetings. In our view policy rates are the primary tool for fighting inflation and headline inflation remains well above the Fed's target. What's more, elements of core inflation are looking very sticky, which makes a compelling case for further rate rises unless there is a deeper and more sustained deterioration in financing conditions.

Chart 3: Market expectations have fallen but we maintain our view of 75bps in hikes this year



Source : Oxford Economics/Haver Analytics

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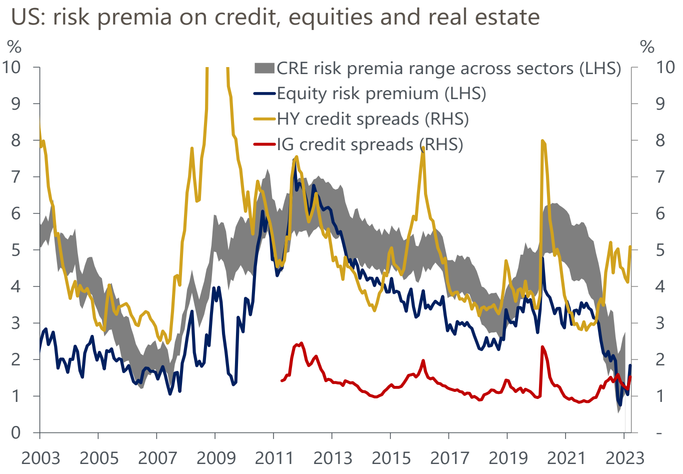
Consequently, we expect the Fed to continue to tighten monetary policy while trying to alleviate liquidity fears in the regional banking sector. This would mean that the recent drop in US Treasury yields will be reversed – at least to some extent – over the next few months. Combined with the generalized rise in risk premia in equity and credit markets, this implies that property yields will likely rise and capital values will suffer more falls (**Chart 4**).

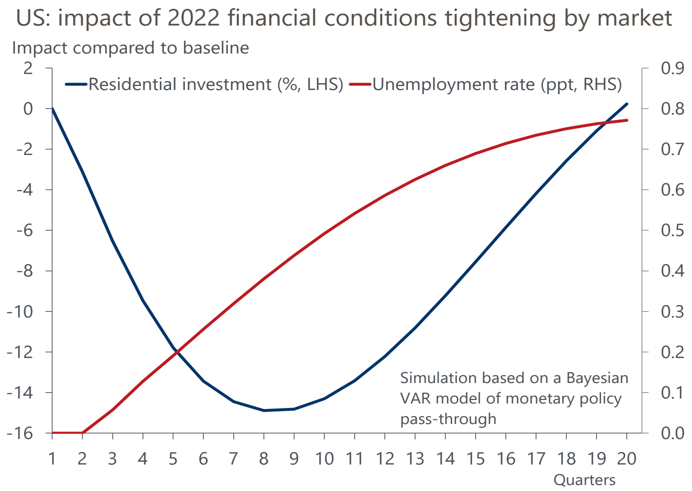
Chart 4: Generalised rise in risk premia will put upward pressure on CRE yields



Source: Oxford Economics/Haver Analytics/RCA

More generally, property is likely to bear the brunt of any monetary overtightening if financial conditions do materially worsen from here. That is because the lag between tightening financial conditions and the impact on property values is the shortest of all the sectors of the economy, whereas the lag in the impact on the labor market – which monetary policy makers observe particularly closely to give them an indication of inflation trends – is the longest (**Chart 5**). In other words, if financial conditions sour, then monetary policymakers might be able to reverse course quickly enough to shield the labor market, but that is a much harder task when it comes to the impact on property because the transmission into values – the impacts on rents comes later – is so much quicker.

Chart 5: The impact of tighter financial conditions on property is a lot quicker than for the labor market



Source: Oxford Economics

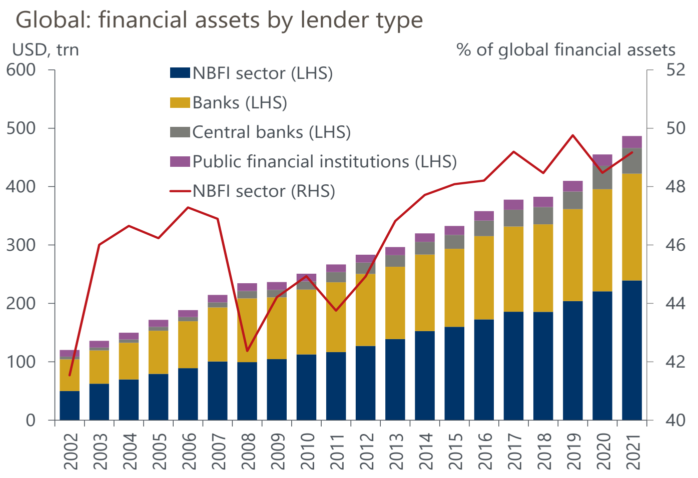
Offices and retail will bear the brunt of refinancing risks

As we have previously noted, any potential tightening in credit conditions is likely to affect offices and retail the most given their worse performance in recent years and, as lenders demand higher LTVs, increase refinancing risks.

Crucially, the biggest refinancing risk is likely to come from non-bank financial institutions, not the more traditional banking sector. These institutions have grown rapidly around the world and now account for almost $240trn of global financial assets, or just under half of total global financial assets (**Chart 6**). They have been key lenders to commercial property, often at higher LTVs than the traditional banking sector.

As the FSB notes, much of the loan growth in this sector has been financed with short-term borrowing presumably from the banking sector. The key downside risk for the property outlook is that banks – facing liquidity constraints – withdraw funding from non-bank lenders who are then forced to sell assets to make up financing shortfalls.

Chart 6: Non-bank lending has grown substantially



Source: Oxford Economics/FSB

So far, the quick actions of the Fed and other central banks to provide liquidity to the banking sector should mitigate this risk. But a funding withdrawal from commercial real estate markets is a key downside risk to our forecast and something we will continue to monitor closely.