ALPINEMACRO
A Unique Mind On The Markets

U.S. BOND STRATEGY

November 21, 2024

Tactically Take Profits On Non-Agency CMBS

- CRE is in a structural recovery, but higher yields and a wave of refinancing next year could lead to spread widening.
- Non-Agency CMBS spreads have overtightened; tactically downgrade to Neutral (3/5).
- Remain Max Overweight Agency CMBS (5/5).
- Favor multifamily housing, high-quality offices, AAA-rated securities, and the 2 to 3-year range of the curve.

The Fed recently published a report highlighting the risks associated with the "extend and pretend" behavior of banks regarding Commercial Real Estate (CRE) loans. Smaller, weaker banks have delayed recognizing CRE losses, raising investor concerns about CRE-linked assets such as CMBS.

Last winter, we predicted CRE prices were in a bottoming process and upgraded non-Agency CMBS to overweight in December 2023 (**Chart 1**).[1] Since then, the sector has delivered 416 basis points of excess returns compared to 235 basis points from the lower-rated IG corporate index. Three key factors contributed to the sector's outperformance:

(1) Limited contagion from office CRE.

(2) Misinterpretation of interest rate risk as credit risk.

(3) Downside risks already priced in.

Recently, non-Agency CMBS spreads have tightened to post-pandemic lows at a time when hopes for near-term interest-rate relief have faded.

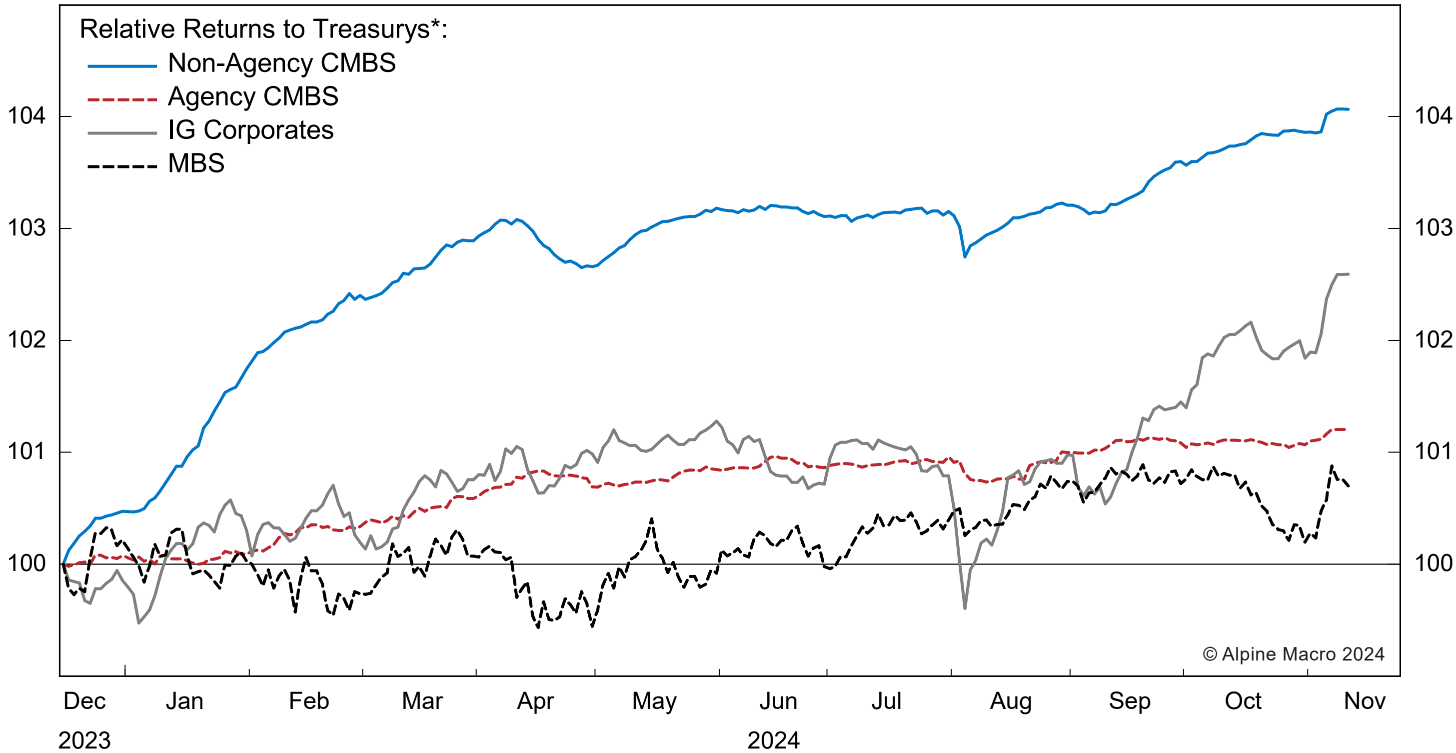
This report updates our view on CMBS. We still believe that a structural upturn in non-Agency CMBS is underway, but recent spread tightening has outpaced the recovery. We recommend profit-taking and downgrading to neutral, with plans to upgrade as valuations improve. We also provide valuation references and discuss subsector preferences.

A Structural Recovery

A confluence of factors over the past several years were particularly damaging to the commercial real estate sector, resulting in the deepest downturn

1 Alpine Macro *U.S. Bond Strategy* "Bond Strategy For 2024 (Part 2)" (December 14, 2023).

Chart 1 Non-Agency CMBS Have Massively Outperformed This Year



*Rebased to Dec 14, 2023=100; when Alpine Macro upgraded non-Agency CMBS; source: Bloomberg Finance L.P.

since the GFC. Some of these occurred during the pandemic, while others emerged during the reopening:

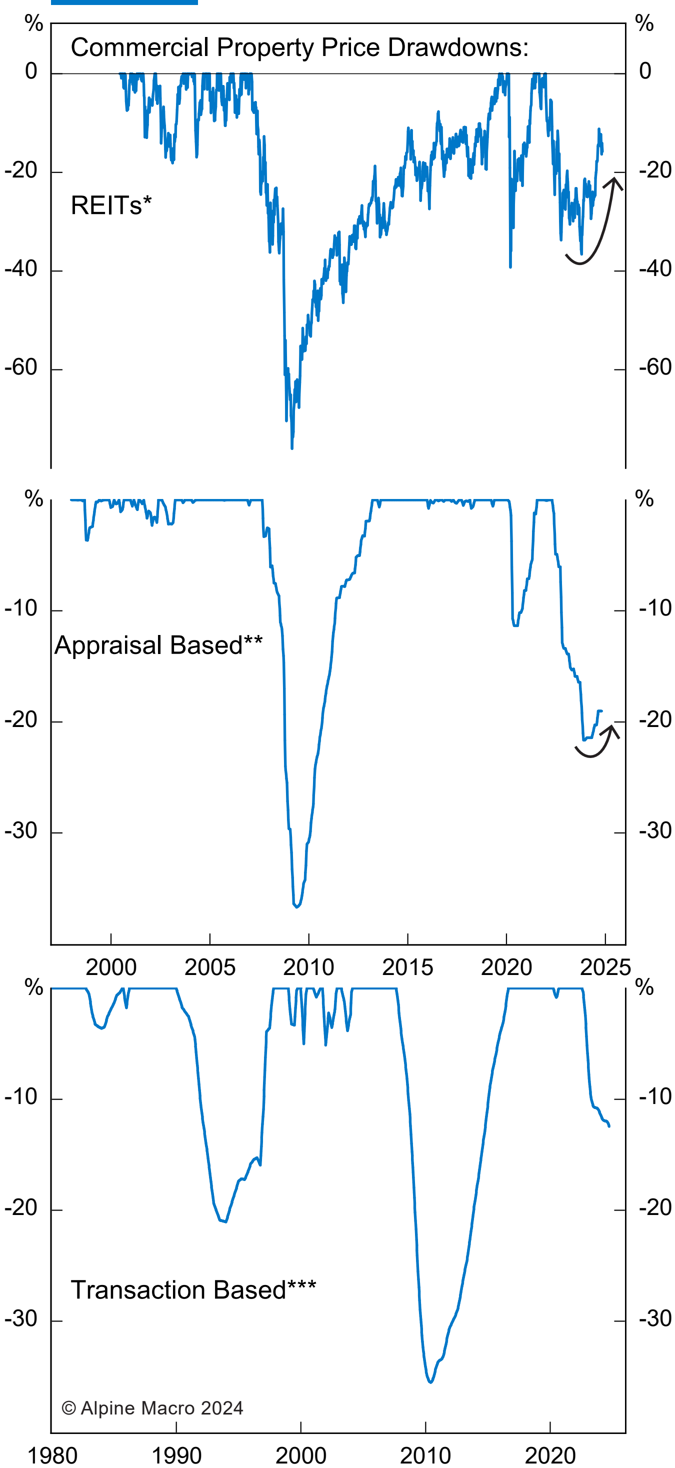
- Social distancing kept people away from public spaces.
- The explosive growth of e-commerce crimped retail demand.
- Both business and leisure hotel demand collapsed as travel was considered a hotbed for virus transmission.
- The advent of remote work dramatically reduced office attendance.
- During the reopening, the burst of inflation put upward pressure on building maintenance costs.
- Higher bond yields made refinancing and raising capital very difficult.

CRE entered a recovery phase in 2024. Deep price adjustments have already occurred, limiting further downside risk. CMBS spreads remain structurally wider than pre-pandemic levels, even though most other bond sector spreads are at or near all-time tights.

Tracking real-time prices is challenging in this segmented, slow-moving market. However, key price measures point to recovery (**Chart 2**):

- **REITs**, as market-traded indices, are the timeliest indicators but do not directly reflect CRE transactions. They have recovered significantly from a 37% drawdown.

Chart 2 CRE Prices Have Bottomed



*ETF: IYR
**Green Street Advisors Commercial Property Price Index
***Flow of Funds data prior to 2005, MSCI RCA CPPI from 2005 onward

- **Appraisal-based indices**, like the Green Street CPPI, are relatively timely but are based on estimates rather than actual transactions. This measure is showing a clear sign of an upturn.

- **Transaction-based estimates** are generally more comprehensive. Examples include the MSCI RCA CPPI and the flow of funds data. Transactions typically dry up during downturns, which is why this measure is slower moving. However, transaction volumes could re-accelerate in 2025 foreshadowing a bottom in prices.

We expect a structural upturn in this sector going forward as headwinds fade. Inflation is returning to target, recession fears have subsided, and the share of remote work has stabilized.

Most importantly, there has been a meaningful response from the supply side. Office construction slowed significantly. Multifamily residential building starts have plummeted, signaling slower future supply. Growth in industrial space has shifted to specialized areas like data centers, which have long-term demand.

The recovery process may be bumpy. However, we expect these challenges to be worked out over time rather than worsen.

Given this structurally bullish backdrop, investors should be tactical with their CMBS allocation, moving between overweight and neutral allocations depending on whether the market pricing is ahead of or behind the actual recovery process.

Spreads Have Overtightened

Near-term, we believe the market pricing for non-Agency CMBS has gotten ahead of the recovery. We recommend booking profits, tactically downgrading to benchmark, and waiting for better entry points to turn overweight again.

The main near-term risk is that the long-hoped-for cyclical Treasury rally has been indefinitely delayed, exacerbating near-term refinancing risk.

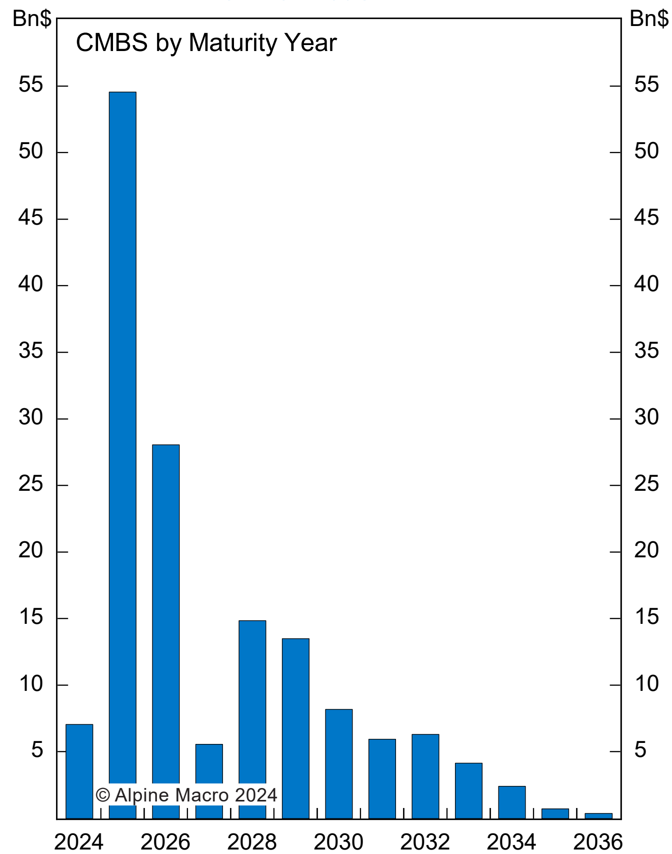
Many CRE properties were funded by loans made at lower interest rates. Some properties now face refinancing hurdles as net operating income will struggle to cover higher interest expense upon refinancing. Normally, this triggers property value markdowns and loan loss recognition, enabling refinancing with smaller loans, lower loan-to-value ratios, and reduced interest burdens.

However, this revaluation process has been limited in this cycle. Borrowers and lenders avoided recognizing losses due to uncertainty about CRE's steady-state operating income and speculation that disinflation would eventually lead to lower bond yields and refinancing costs.

Many lenders opted for “extend and pretend.” That is to say, “extend” existing loans that are due and “pretend” that losses haven’t occurred in hopes of refinancing at lower rates later. The bias toward debt extension has snowballed into a near-term maturity wall (Chart 3).

The Fed’s recent paper[2] suggests, albeit with some stale data, that this phenomenon was more prominent at weakly capitalized banks. These banks assigned a 0.9 percentage point lower probability of default to similar distressed loans compared to well-capitalized banks. These practices have crowded out new credit provisions, leading to a ~5% drop in CRE mortgage originations since 2022.

Chart 3 **The Maturity Wall In 2025 Is Enormous**

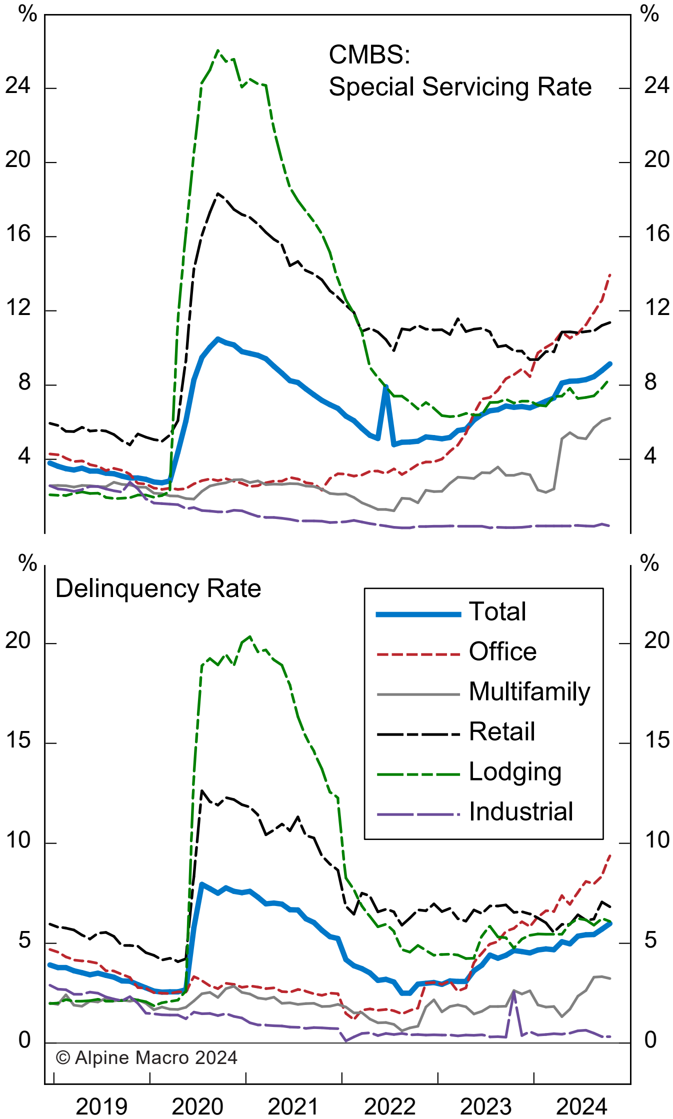


Source: Bloomberg Finance L.P.

We expect significant loss recognition in 2025. Lenders and borrowers have fewer incentives to delay the inevitable as key macro uncertainties resolve. Inflation is stabilizing near 2%, a recession appears unlikely, and the U.S. election outcome – a Republican sweep – is now clear. The recent bond yield rise reflects market expectations for sustained economic growth, rather than a transient inflation shock.

2 "Extend-and-Pretend in the U.S. CRE Market", The Federal Reserve Bank of New York, October 2024

Chart 4 **Special Servicing And Delinquency Rates Continue To Rise**



Source: Trepp

Delinquencies and special servicing rates are rising (**Chart 4**). While much of the weakness is already priced in, unexpected losses may still arise from underwater debt and cause near-term turbulence in the CRE market.

The environment is ripe for specialized investors to pick up bargains on single names. However, this process could temporarily test confidence in the sector's overall recovery and push spreads higher in conduit deals. We recommend being more selective in CMBS assets for now. Investors should look to turn more constructive on the overall sector once this loss recognition process is further advanced.

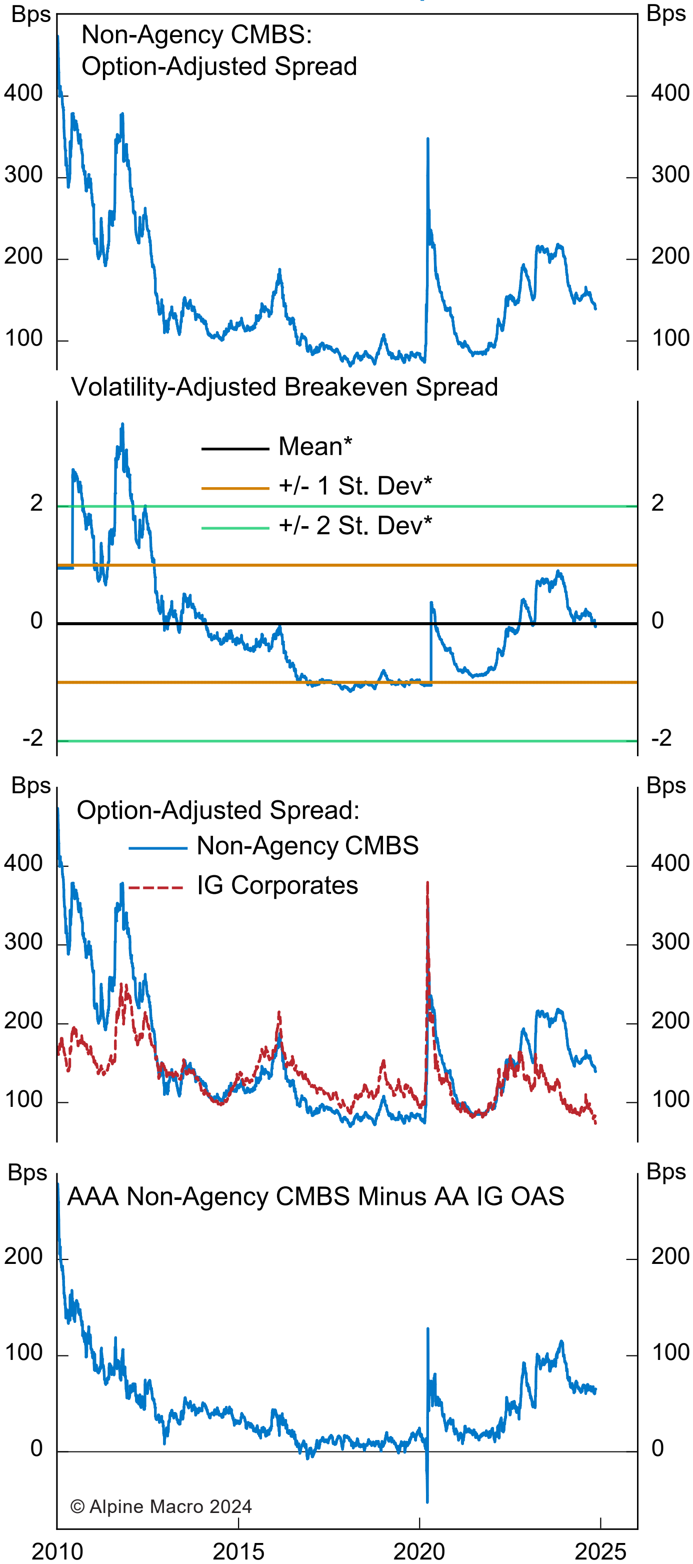
Valuations

CMBS valuations are not expensive by historical standards, but recent spread tightening appears overdone in the context of possible refinancing problems. Non-Agency CMBS spreads have tightened 75 basis points since our December 2023 upgrade, while Treasury yields are up 50 basis points. Compensation for CMBS holders has diminished significantly while refinancing risks have increased. Current spreads provide little cushion against surprises on loss recognition during refinancing next year.

Our preferred valuation metric, the volatility-adjusted breakeven spread, is close to neutral versus the sector's own long-term history (**Chart 5**). However, this measure includes securities prior to the proliferation of CMBS 2.0 in 2014, which saw the sector become considerably less risky. Non-Agency CMBS are one sigma cheap when measured from 2014 onwards, although this measure would capture less history.

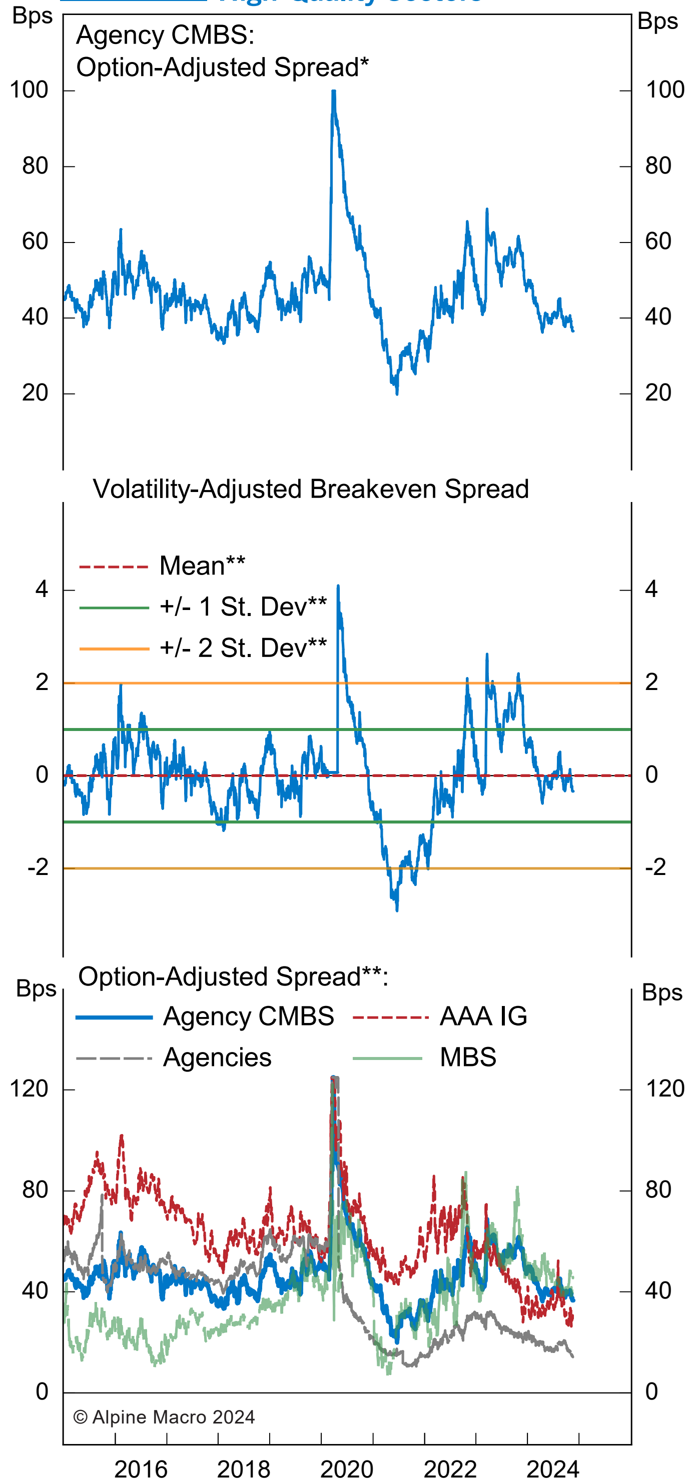
Non-Agency CMBS spreads are structurally cheap compared to IG corporates, offering 28 basis points of excess spread. Prior to the pandemic, CMBS spreads traded through IG spreads. CMBS segments offer a decent amount of spread pickup even versus IG corporate bonds rated a notch below. We expect that, as CRE recovers, CMBS spreads will over time narrow back toward IG spreads.

Chart 5 Non-Agency CMBS Are One Of The Few Non-expensive Sectors



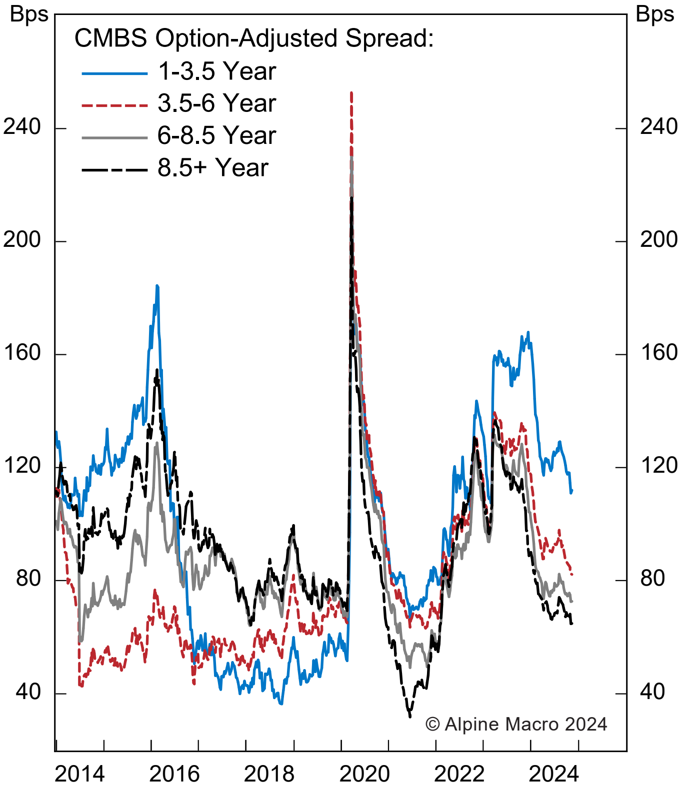
Note: GFC excluded from calculation; source: Bloomberg finance L.P.

Chart 6 Agency CMBS Valuations Are Attractive Versus Other High-Quality Sectors



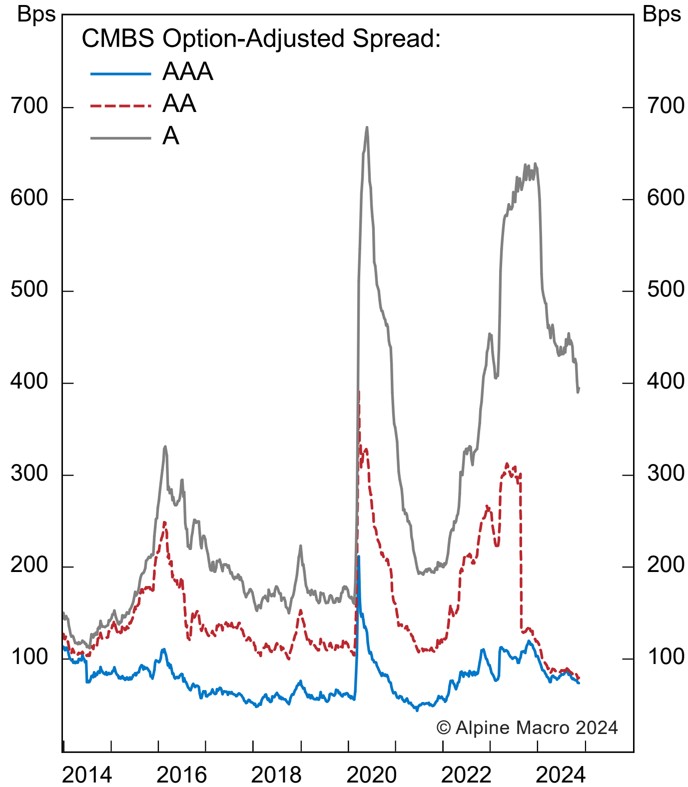
*Truncated at 100
**GFC Excluded from calculation, truncated at 125
Source: Bloomberg Finance L.P.

Chart 7 Pickup Spread At The Front-End Of The CMBS Curve



Source: Bloomberg Finance L.P.

Chart 8 Avoid AA-Rated CMBS



Source: Bloomberg Finance L.P.

Volatility-adjusted breakevens are near neutral for Agency CMBS (Chart 6), which is a safer asset class given agency backing. This sector is comprised of multifamily housing, whose fundamentals will be discussed below.

Along the curve, the front-end offers the highest spread but also embeds the largest risk (Chart 7). Most CMBS have very short maturities due to the approaching maturity wall. Neverthleass, we are hesitant to recommend longer maturities given the substantial loss of spread. We think securities in the 2 to 3-year maturity range offer the best trade-off between near-term refinancing risk and yield.

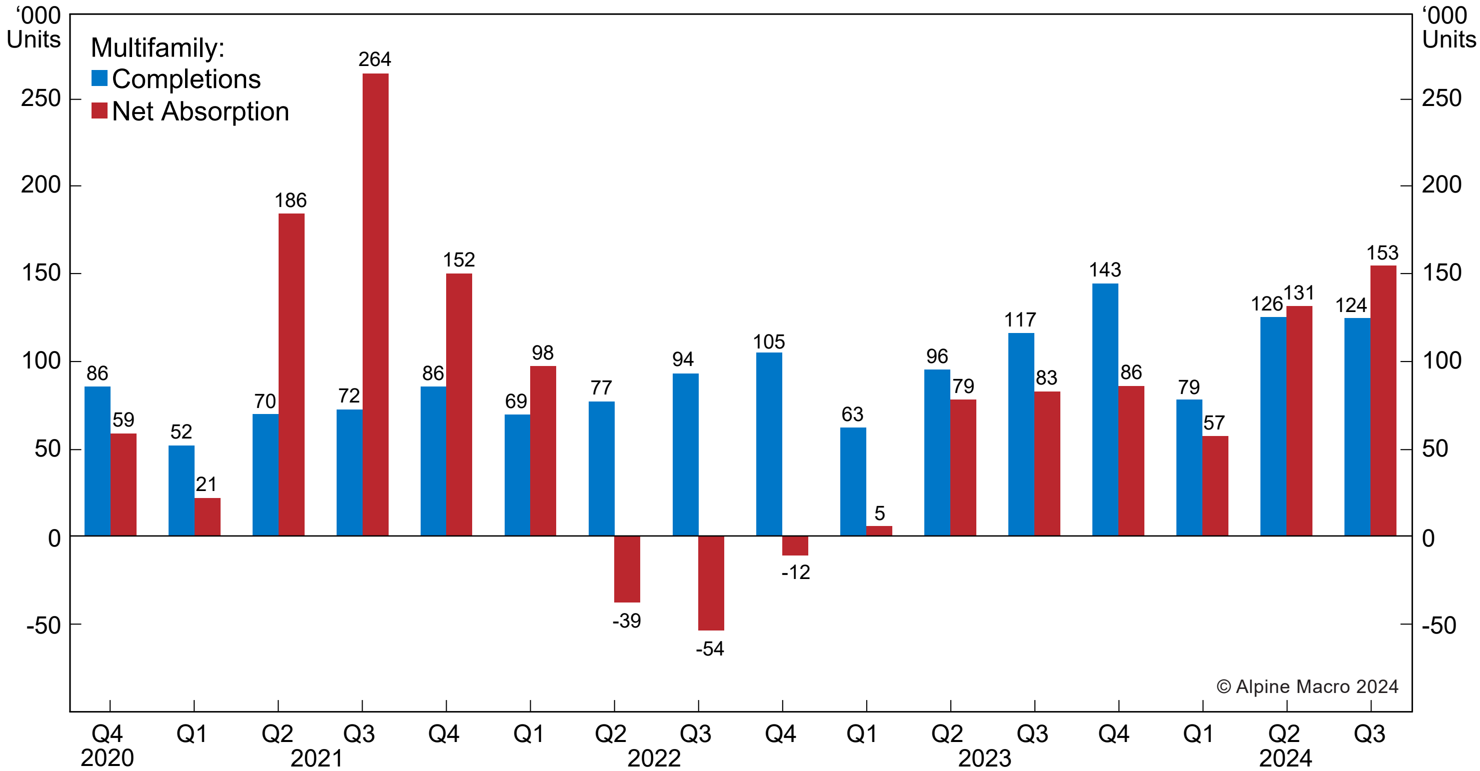
Given near-term risks, we favor AAA-rated tranches. AA-rated CMBS only offer 5 basis points of extra spread and are not worth the additional risk (Chart 8). Single A-rated CMBS present substantial yield pickup but are only recommended for risk-tolerant investors.

Sector Choices

Among the five main categories of CRE properties backing CMBS, we favor multifamily housing. We see gradual improvements in office space and recommend exposure to high-quality office buildings. We are neutral on industrial and retail sectors and advise limiting exposure to lodging.

- The oversupply in **multifamily** housing will be absorbed rapidly in our opinion, despite a sizable wave of deliveries in 2024. New construction

Chart 9 Improving Multifamily Net Absorption Is Encouraging



Source: CBRE Research, CBRE Econometric Advisors, Q3 2024. Based on the 63 markets that comprise CBRE EA's Sum of Markets

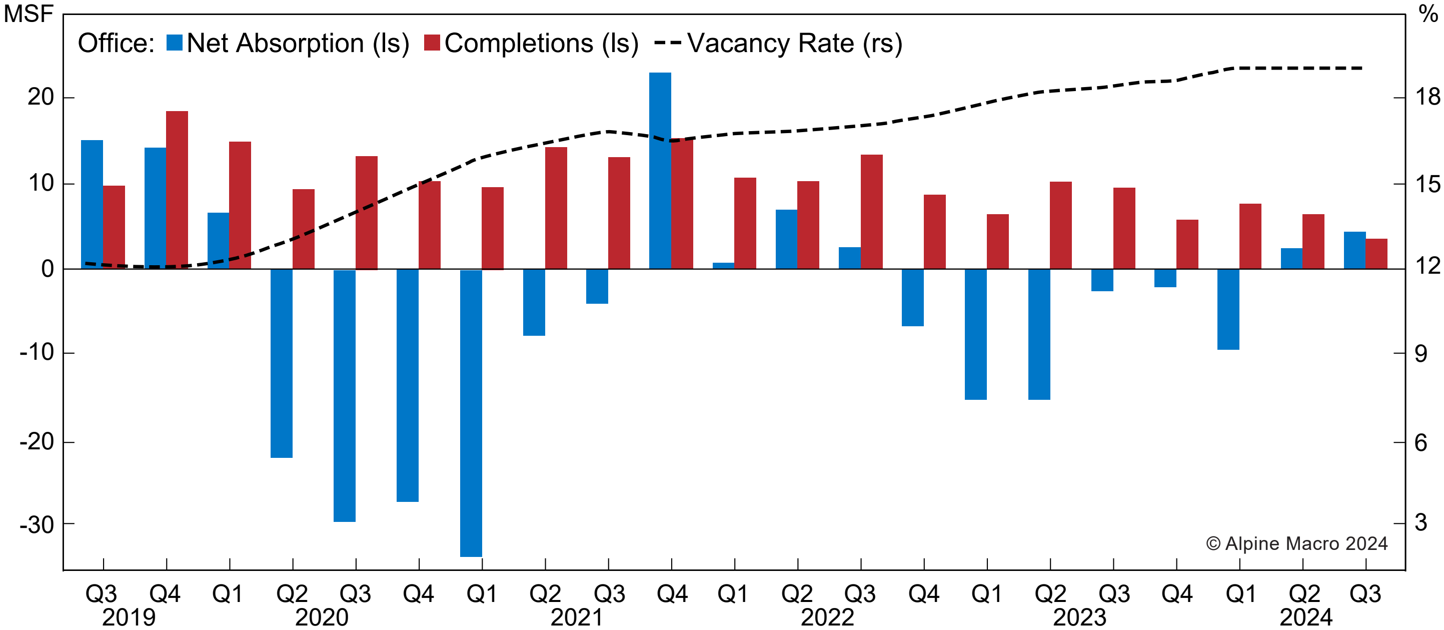
starts have plummeted, setting the stage for a rapid rebalancing of this market. Net absorption has been improving over the past several quarters and is outpacing completions for the first time since 2022 (**Chart 9**).

Furthermore, a resilient labor market and falling vacancy rates should bode well for rental income. As single-family homes remain expensive to own, the knock-on demand has a positive effect on multi-family housing, which relies on rental income.

- **Office** fundamentals are also improving. Net absorption turned positive this year while vacancy rates have stabilized (**Chart 10**). At the same time, completions continue to decline as the sector digests the structural drop in office space demand following the pandemic. Remote work has largely stabilized around 2 to 3 days in the office per week. This provides clarity on the long-term demand for office space. The most encouraging signal is the continued decline in sublease space availability.

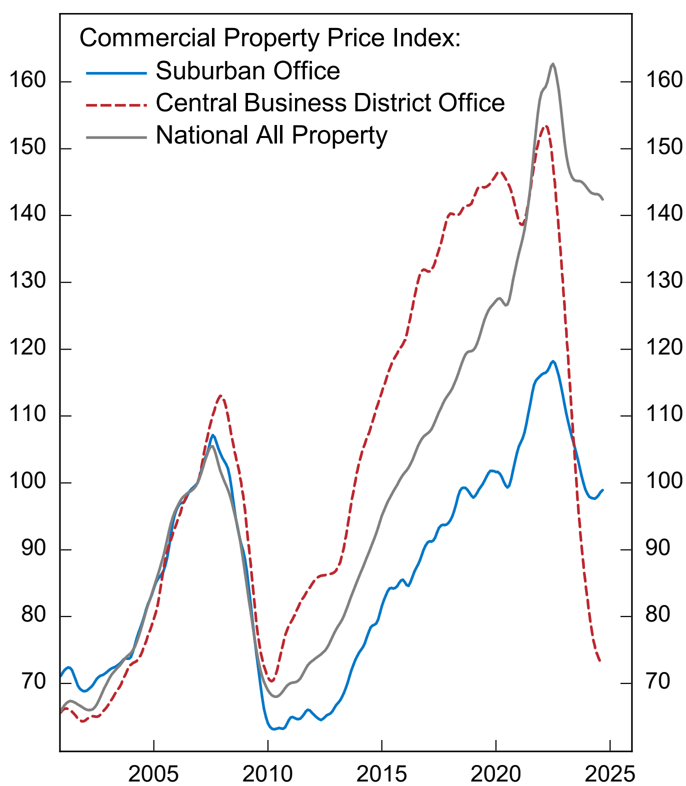
Some of the office buildings will become obsolete and we only recommend high-quality offices until next year's refinancing wave comes to pass. The stabilization of remote work has provided a lot more clarity on the long-term viability of various properties. A bifurcated office market helps higher-quality office space shed contagion risk. Suburban office prices have troughed and are recovering (**Chart 11**). Central business district office prices have fallen by over 50%, a decline

Chart 10 Office: Lower Completions And Higher Net Absorption



Source: CBRE Econometric Advisors, Q3 2024

Chart 11 Suburban Office Prices Have Bottomed While CBD Continues To Sink



Source: MSCI RCA CPPI

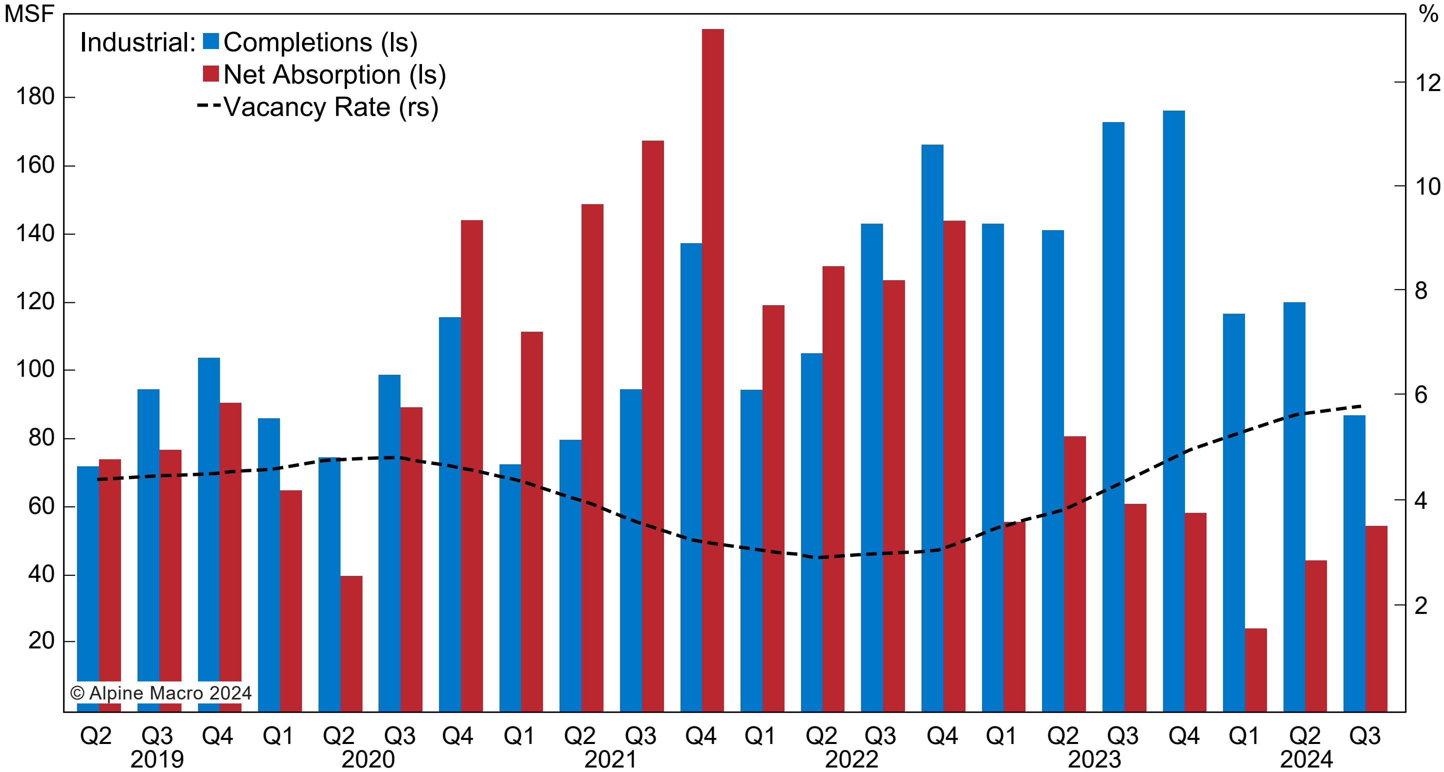
worse than the GFC, but they remain downtrending. We still advise caution with respect to lower-quality offices.

- The **industrial** segment was very much in demand and expanded quickly after the pandemic. However, the rapid pace of completions has led to some indigestion in 2024, with a rising vacancy rate and falling rents. Net absorption seems to have stabilized for now, and construction has slowed (**Chart 12**). It remains to be seen how long this sector will need to turn the corner, although further downside will be limited as long as the economy remains strong.

- We are neutral on **retail** space. Construction and leasing remain muted, with gradual rent growth supported by a resilient U.S. consumer.

- For **lodging**, the post-pandemic leisure boom is over, and occupancy levels are weaker compared to 2023. A strong dollar remains a sizable headwind for inbound U.S. travel.

Chart 12 Supply Is Rebalancing Industrial Space



Source: CBRE Econometric Advisors, Q3 2024

Investment Conclusion

We remain structurally bullish on CMBS with CRE prices having bottomed and supply adjusting to a new post-pandemic normal. However, the recovery process in CMBS will likely be bumpy as losses are recognized and transaction volumes rise. In the near term, market discounting has likely gotten ahead of the underlying recovery of the sector.

Contrary to most sectors, CMBS does not necessarily benefit from a stronger economy as a refinancing wall pushes up against higher Treasury yields. We feel that it is prudent to downgrade non-Agency CMBS to neutral on a tactical basis, following recent spread tightening. We plan to increase allocation to this sector again when spreads re-widen.

We remain overweight in Agency CMBS as a way to pick up yield while remaining up-in-quality. Supply is likely to tighten in the coming quarters given the lack of construction starts.

Within CMBS, we recommend AAA-rated securities. More risk-tolerant investors should also consider single A-rated CMBS. For tenor, we recommend the front-end of the curve for yield pickup but avoiding anything with less than one-year maturity to reduce refinancing risks. For property types, we favor multifamily and high-quality offices.

Henry Wu
Chief Quantitative Strategist

Alpine Macro U.S. Bond Allocation (Duration: At Benchmark)

1-5 Scale; 3 Represents Benchmark	Allocation Score	Comments
Treasurys	2	
Spread Product	4	
Spread Product Composition:		
IG Corporates	3	Avoid AAA; favor upper-end of BBB
High-Yield	3	
Agency CMBS	5	
Non-Agency CMBS	~~4~~ 3	Favor AAA
Government-Related	4	Favor Local Authorities and Agencies
ABS	4	Favor up-in-quality, favor sub-prime autos
Agency MBS	4	
Municipals	4	Favor highly-rated taxables in the belly, and BBB non-taxables at the long end

Note: The allocation score presents Alpine Macro's recommended weighting relative to benchmark. It is based on a five-point scale, with "1" being "maximum underweight", and "5" being "maximum overweight". A benchmark weighting is represented by "3". The underweights and overweights across bond sectors notionally sum to the overall recommendation for spread product versus Treasurys. Our benchmark is the Bloomberg Barclays U.S. Aggregate Bond Index, augmented with High-Yield Corporates and Municipal bonds.

Historical Returns

	Excess Return to Treasurys (Bps)			Total Return (Bps)			Option Adjusted Spread (Bps)				
	Past 5 Days	Past Month	YTD	Past 5 Days	Past Month	YTD	Latest	Past 5-Day Change	Past Month Change	YTD Change	Duration
Barclays Aggregate	-12	4	92	15	-131	207	34	2	0	-10	6.1
Treasury Index				27	-129	121	0	0	0	0	5.8
IG Corporate	-23	32	289	3	-124	350	77	3	-4	-28	6.9
AAA	-31	-11	162	-12	-216	15	30	2	1	-12	10.1
AA	-27	11	176	-4	-157	178	40	3	-1	-12	8.0
A	-25	18	247	1	-136	309	64	3	-2	-26	6.9
BBB	-21	49	349	7	-105	421	95	3	-6	-32	6.7
High-Yield	-31	81	583	-7	19	901	265	12	-20	-85	3.0
BB	-29	67	427	-4	-2	721	159	10	-16	-62	3.3
B	-37	74	483	-14	21	814	253	18	-22	-84	2.7
CCC	-24	146	1214	0	85	1570	543	11	-64	-286	2.9
ABS	7	28	130	26	-15	458	48	-3	-10	-20	2.7
Government Related	-12	3	100	14	-117	252	44	1	-1	-6	5.3
Domestic Agency	6	9	42	28	-52	317	9	-1	-4	-9	3.2
Foreign Agency	1	7	71	26	-75	323	20	0	-1	-10	3.6
Sovereign	-63	-24	200	-37	-211	160	124	8	3	-6	8.3
Local Authorities	1	39	188	31	-137	196	57	-1	-4	-17	7.6
Supranationals	2	-1	31	29	-90	286	8	0	0	-5	3.6
MBS	-24	-18	47	6	-150	189	46	5	3	-4	6.0
CMBS	8	25	244	39	-85	453	88	-1	-4	-38	4.1
Non-Agency	9	33	367	38	-63	610	140	0	-6	-63	3.7
Agency	7	18	121	39	-106	298	37	-1	-3	-12	4.5
Municipals*	-19	127	-17	24	-32	167	-77	3	-21	-8	6.1

*YTW used instead of OAS

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