Global Markets Daily: The Cross-Asset CRE Recovery Will be Long and Winding (Viswanathan)

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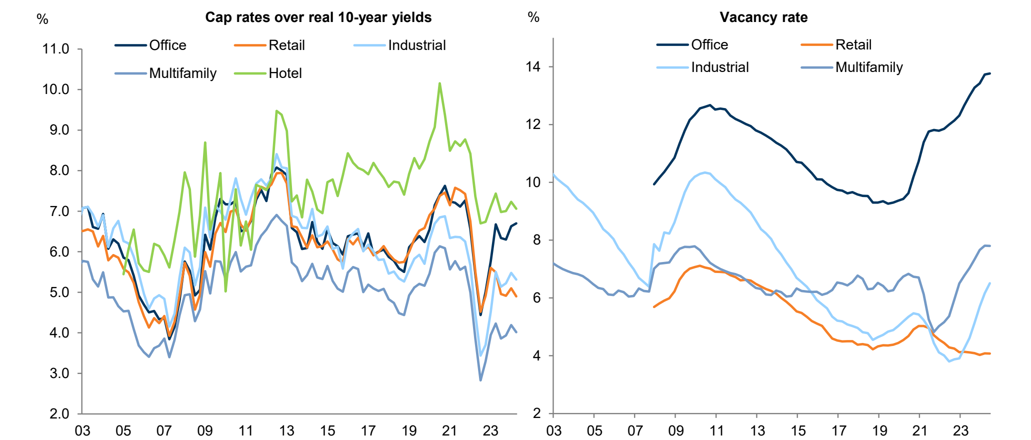
- While the year-to-date performance of publicly traded commercial real estate-related assets has been strong, a decent valuation gap remains relative to pre-COVID levels. Closing this gap will likely be a lengthy process, in our view. Fundamentally, the challenges facing the commercial real estate market – shifting trends in utilization, a mismatch of funding needs and credit availability, and high funding costs – have not wholly disappeared.
- Now that the first leg of compression in the risk premium on commercial real estate assets is behind us, we think security selection will be paramount for investors, going forward. Across property types, we continue to prefer retail and hotel exposures and remain cautious on industrial properties, a view that we like expressing in the single asset/single borrower commercial mortgage-backed securities market. From a cross-asset standpoint, we think the gap between the on-the-run CMBX BBB- index spreads and HY REIT unsecured bond spreads, which reflects some investor segmentation between the structured credit and corporate credit markets, has room to narrow.

The Cross-Asset CRE Recovery Will be Long and Winding

Commercial real estate (CRE) remains a key risk factor for investors across financial markets, with impacts felt across equities, corporate credit, structured credit, and private markets. That said, commercial real estate assets have posted a decent albeit uneven recovery in valuations over the past year. In today's *Global Markets Daily*, we argue that the road ahead remains long and winding, with security selection poised to provide more 'alpha' opportunities than broad trends.

From a macro perspective, we think commercial property valuations are getting closer to their bottom. Using cap rates (i.e. the ratio of a property's net income over its price) as a measure of valuations, we find that their gap vs. real 10-year yields is narrowing, albeit still with some room to run (left panel of Exhibit 1). This gives us comfort that the headwind from rates is starting to be priced by the market. Moreover, while vacancy rates continue to rise across property types, we think that the worst is behind us (right panel of Exhibit 1). For context, a paltry construction pipeline should help slow vacancies for industrial and multifamily properties, while for office properties our economists' anticipate that vacancies will rise only gradually, by 3%, through 2030. While we would caution that dispersion remains elevated in property performance across different sub-markets, we think the opportunity set for property investors is becoming more promising, particularly with bank financing remaining a viable option for borrowers.

Exhibit 1: CRE cap rates have moved close to real yields, though vacancy rates are broadly rising
Market cap rates over real 10-year yields (left panel) and vacancy rates (right panel) for the main CRE property types



Source: RCA, CoStar, Goldman Sachs Global Investment Research

Against this backdrop, CRE assets have rallied on a year-to-date basis across asset classes, though no markets have fully caught up to their pre-COVID levels (Exhibit 2). As a testament to the improving risk environment, spreads have compressed across the ratings spectrum, with HY REIT unsecured bonds tightening by 50bp vs. IG REITs and BBB- rated cash CMBS tightening by 280bp vs. AAA rated cash CMBS. Moreover, CMBS issuance is on track to double last year's volume on a gross basis, though originations have largely been focused on refinancings rather than new acquisitions, and spread volatility on the synthetic CMBX indices has declined to the low end of its post-COVID range.

Exhibit 2: Valuations of commercial real estate across the capital structure have rallied but remain below pre-COVID levels
Relative value of spreads for HY/IG REITs, BBB-/AAA cash CMBS, BBB-/AAA on-the-run CMBX, and Bloomberg P/E ratio for the S&P 1500 REIT index (shown in inverted terms for consistency)

Index	Current	Year-to-date change	Change since Jan 2023	Change since Jan 2020	10-year percentile rank	10-year history
Bloomberg IG REITs OAS	103	-17	-41	5	15	
Bloomberg HY REITs OAS	331	-67	-77	18	60	
AAA Cash CMBS spread	76	0	-2	14	49	
AAA OTR CMBX spread	98	-19	-29	21	57	
BBB- Cash CMBS spread	685	-281	212	436	84	
BBB- OTR CMBX spread	589	-31	-6	239	75	
S&P 1500 REITs P/E	38x	+3x	+5x	-3x	89	

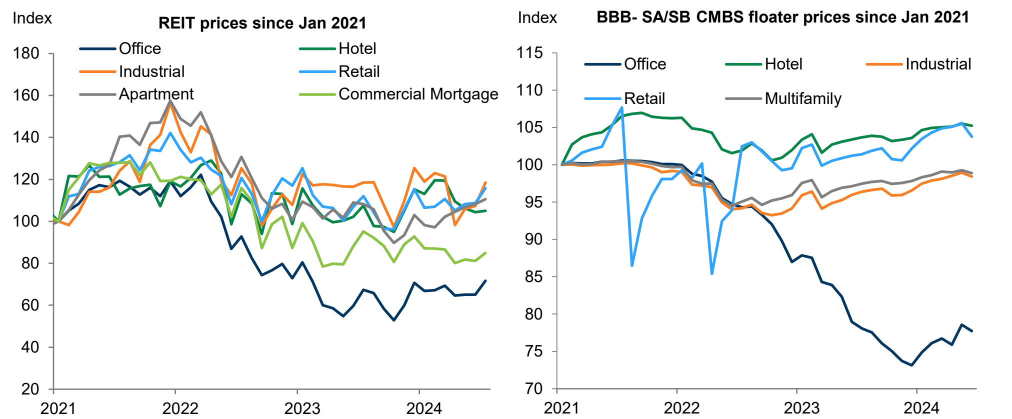
Source: Bloomberg, S&P Dow Jones Indices, Goldman Sachs Global Investment Research

CRE market returns remain highly dispersed, lower volatility notwithstanding. As evidenced through the equity market in Exhibit 3, hotel REITs are outperforming the broader REIT sector, while office REITs and commercial mortgage REITs are lagging.

This picture is consistent with the CMBS market, where bonds tied to hotel and retail collateral have outperformed. Similarly, the mediocre performance of commercial mortgage REITs mirrors the more subdued tightening of CRE CLOs (which are frequently issued by commercial mortgage REITs) vs. the broad CMBS market.

Exhibit 3: In both the equity and CMBS markets, hotel assets have outperformed and office assets have underperformed

Prices for equity REITs (split across office, retail, apartment, industrial, and hotel REITs) and commercial mortgage REITs indexed to January 2020 (left panel) and BBB-rated SA/SB floaters (right panel)



Source: Bloomberg, Goldman Sachs Global Investment Research

We think the path forward for the public CRE market will be less exuberant at prior valuations vs. the prior twelve months. Instead, we think that security selection (particularly in CMBS and CRE CLOs) will be critical given the wide range of properties, loans, and sponsors in the market. Over the near term, we prefer retail and hotel SA/SB mezzanine bonds, while taking a more cautious stance on industrial SA/SB bonds. Moreover, we think the spread gap between the CMBX 17 BBB- index and the Bloomberg HY REITs unsecured bond index presents a relative value opportunity given the former's strong credit profile, reflecting (to some extent) investor segmentation between the structured credit and corporate credit markets. We think that this opportunity is more attractive in the on-the-run CMBX series versus older, off-the-run series, such as CMBX 14, which are thornier given elevated exposure to central business district offices.

TRADE IDEAS

Best Trade Ideas Across Assets

For pricing and a list of previous recommendations, please visit our Trade Ideas page.

1. Receive SGD 2Y SORA OIS vs. pay a basket of global 2Y rates, opened on April 14, 2023, at -8bp, with a target of -100bp, and a stop of 40bp, currently trading at -9bp.
2. Stay short EUR/INR, opened on January 12, 2024, at 90.91, with a target of 88, and a stop of 93, currently trading at 90.75.
3. Stay long a basket of Pemex 1–3-year maturity bonds, opened on January 25, 2024, at 0%, with a total return target of 10%, and a revised stop of 1%, currently trading

at 5.35% (Fabius).

4. Stay long 2y IGBs (FX-unhedged), opened on February 29, 2024, at 7.02%, with a target of 6.50%, and a stop of 7.30%, currently trading at 6.82%, tracking potential profit/loss: +2.2% (+3.2% bond, -1.0% FX).
5. Stay short USD/EGP, opened on March 8, 2024, at 0%, with a revised total return target of 10%, and a revised stop of 6.5%, currently trading at 8.33%.
6. Receive CZK 5Y5Y versus EUR 5Y5Y, opened on April 15, 2024, at 149bp, with a revised target of 80bp, and a revised stop of 115bp, currently trading at 97bp.
7. Receive 1y1y vs 1y AUD OIS, opened on April 19, 2024, at -0.33, with a target of -0.75, and a revised EOD 5bp trailing stop, currently trading at -0.43.
8. Stay long MSCI South Africa (MXZA) vs. MSCI EM ex-China (EMXC), opened on May 16, 2024, at 1.48, with a target of 1.65, and a stop of 1.33, currently trading at 1.49.
9. Stay long 9Y POLGBs (2033s) on an FX-unhedged basis (versus the EUR), opened on June 21, 2024, at 5.69%, with a target of 5.15%, and a stop of 5.95%, currently trading at 5.50%, tracking potential profit/loss: +2.7% (+1.9% bond, +0.8% FX).
10. Stay long USD 6m1y A+25bp payer vs. short 6m2y A+32.5bp payer, opened on June 27, 2024, at 0.00, with a target of 0.15, and a stop of -0.10, currently trading at -0.01.
11. 5s10s TIPS curve steepener, opened on July 5, 2024, at 0.00, with a target of 0.15, and a stop of -0.09, currently trading at +0.01.
12. 7s10s SOFR/UST swap spread steepener, in 0.75:1 weighted form, opened on July 5, 2024, at -0.16, with a target of -0.10, and a stop of -0.20, currently trading at -0.17.
13. 6m 2s5s A+5bp/A+30bp curve cap spread, opened on July 12, 2024, at 0.05, with a target of 0.15 and a stop of 0.00, currently trading at 0.06.
14. Pay 1y1y on NZD 1y/1y1y/2y1y swap fly, opened on July 19, 2024, at -1.00, with a target of -0.60 and a stop of -1.20, currently trading at -1.16.
15. Pay 5y on CAD 2s5s10s swap fly, opened July 26, 2024, at -0.53, with a target of -0.30 and a stop of -0.65, currently trading at -0.52.

Disclosure Appendix

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