December 16, 2015

Today, the Fed officially commenced “lift off” by announcing a 25bps increase in the federal funds rate, the first such increase in nearly a decade. Further, they signaled four additional 25bps increases over 2016. The increase was based upon the, “Considerable improvement in labor market conditions this year and [their confidence that] inflation will rise, over the medium term, to its 2% objective.” The equity markets have responded with a rally of over 200 points in the DJIA and the Ten-Year Treasury rate has stayed flat at 2.3%. CMBS markets are largely unchanged with the new issue benchmark holding steady at swaps + 138 bps, which is slightly tighter than the beginning of the month but at levels unseen since 2012. Trading has slowed dramatically as we head into the Christmas week.

While 2015 CMBS issuance was flat YOY, at just under $100 billion, it was approximately 25% lower than consensus estimates. Estimates for 2016 issuance are modesty greater at $110 billion. CMBS spreads have remained stubbornly wide to recent (2013 and 2014) levels at swaps + 130-140bps at year-end; the “new normal” consensus is for AAA spreads to be range bound between swaps +100bps and +130bps. CMBS outstandings, at around $600 billion, are essentially flat as new issuance is keeping pace with maturities. Delinquencies have continued to decline and real estate fundamentals are healthy, generally speaking. The volatility that has significantly impacted the high yield credit markets this month has not had a meaningful impact on CMBS thus far.

Themes we are watching in 2016. There are several factors that will put pressure on CMBS in 2016 which we believe will create meaningful and event-driven opportunities, particularly in the “legacy” CMBS market, among them:

- Continued global “macro” volatility. While unrelated to our asset fundamentals, it can have a large impact on price;
- Continued increases in interest rates. While the impact has been positive today, what will another 100bps of rate increases do to spreads in 2016?
- The “Wall of Maturities.” Over 40% of the CMBS market contractually matures over the next two years (from the generally “higher leverage” vintages of 2006 and 2007) which is creating overhang, a dampener on spread tightening, increased volatility and buying opportunities;
- “Risk Retention.” Risk Retention rules (requiring investors to own a greater portion (5%) of the bottom of the CMBS capital structure for at least five years) will be adopted at the end of 2016 and will create new dynamics and likely more expensive rates for borrowers (and potentially better returns for CMBS investors); and
- Dealer Liquidity. New regulations are increasing the capital charges for dealers holding CMBS and other such investments. This trend should benefit “real money” investors that are not leverage-dependent and have a longer-term investment strategy.

Overall, real estate fundamentals feel solid and gradually improving, equity valuations feel a touch high, and for us, CMBS continues to represent a secure, asset-backed, cash-flowing vehicle through which to capture excess returns resulting from the market dislocation and volatility that we anticipate in 2016.

Best wishes for the holiday season and for 2016. May your portfolios expand and your returns exceed expectations!

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