Flossbach von Storch
RESEARCH INSTITUTE

MACROECONOMICS 23/01/2025

US commercial real estate and financial sector: The year of truth?

by CHRISTOF SCHÜRMANN

Summary

Hopes of a sustained return to low US interest rates have not materialised. Now protracted risks are threatening the important commercial property market. The dangers are high.

Zusammenfassung

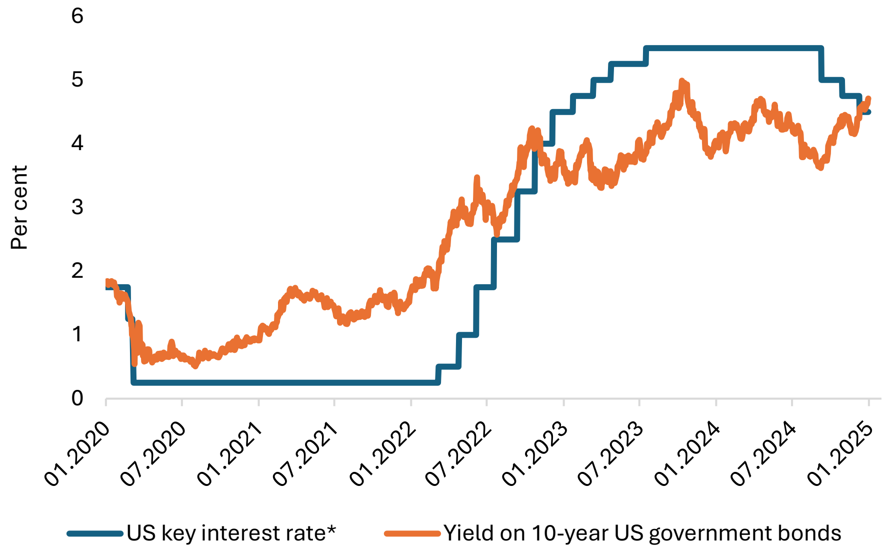
Die Hoffnungen auf dauerhaft wieder niedrige US-Zinsen haben sich nicht erfüllt. Nun bedrohen verschleppte Risiken den wichtigen Markt für Gewerbeimmobilien. Die Gefahren daraus sind hoch.

Survive until 2025 - that was the motto on the property market when central banks around the world began to raise interest rates almost three years ago. The hope at the time was that key interest rates would be lower again this year and with them the longer-term interest rate levels that are important for refinancing. Until then, financiers and property owners would muddle through.

1. long-term dollar interest rates back to interim highs

While the former hope has partly materialised with the US Federal Reserve (Fed) and European Central Bank (ECB) interest rates falling significantly, this does not apply to long-term government bond yields, or only to a limited extent. Yields on ten-year US government bonds (US Treasuries), for example, have risen by more than 100 basis points (equal to one percentage point) at times since September 2024, while the Fed has cut interest rates by 100 basis points in the same period (Figure 1).

Figure 1: US key interest rate and yield on ten-year US government bonds



*Fed Funds Rate, upper band, Source: Bloomberg, Flossbach von Storch Research Institute, as at January 2025. **Historical performance is not a reliable indicator of future performance.**

Long-term US interest rates are thus back at the levels they reached in the course of the Fed's interest rate hikes in the most recent cycle. An extraordinary development that has caught many on the wrong foot. The discrepancy between falling short-term and rising long-term interest rates could be due to the unsound development of US government finances and persistent inflationary pressure.

Anyone who thought that they would soon be able to finance their balance sheet more favourably in US dollars is mistaken. The renewed rise in long-term interest rates is having an impact on numerous submarkets. Issuers of corporate bonds or mortgage borrowers are facing the challenge of having to raise their interest costs, which are closely linked to the yield on US Treasuries with a premium, at a significantly higher cost than hoped. It is to be expected that some will fail. The only question is: how many?

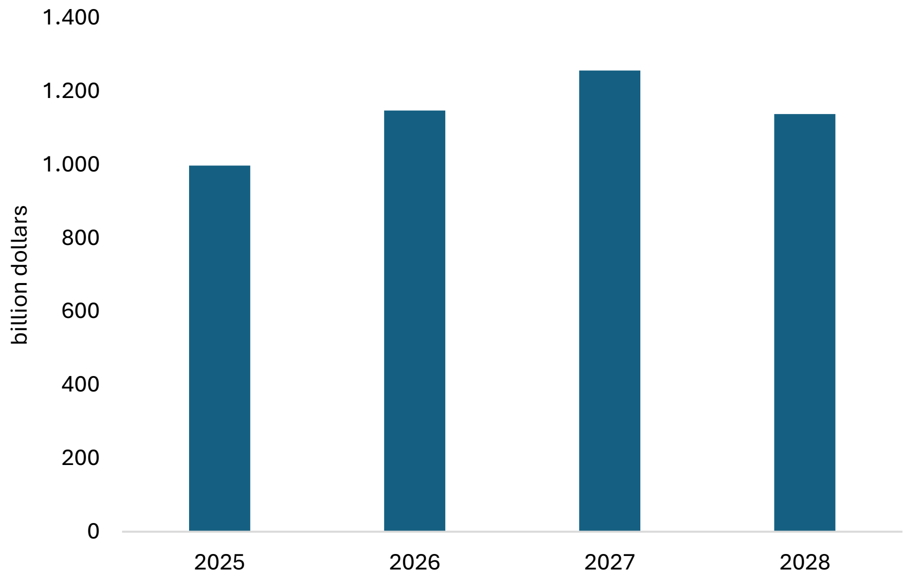
Investors should pay particular attention to one key investment market: the commercial real estate (CRE) market. Numerous transactions by banks and the so-called shadow banking sector, which includes insurers, credit funds, private equity and pension funds, are linked to this market. The average interest rate for CRE loans from banks with terms of five, seven or ten years was around 6.7 per cent in January 2025. Financing via commercial mortgage-backed securities (collateralised commercial property bonds, CMBS) cost between 7.1 and 7.4 percent. In 2021, the average interest coupon was still half of this.

Difficulties with property can plunge the markets as a whole into severe turbulence. Examples include the housing crash in Japan in the early 1990s and the last major financial crisis to date, which began in 2007 and originated in the property sector.

2. high volume of maturing debt

Last late summer, property specialist Jones Lang LaSalle (JLL) warned of a debt tsunami in the US commercial property market. By the end of 2025, 1.5 trillion dollars in loans would be due, a quarter of which would be at risk of default. According to data from Savills Investment Management, six trillion dollars in loans are due in the coming years. Just under half of this was on the books of banks at the end of 2023, just under a quarter was financed by commercial mortgage-backed securities (CMBS) and listed property companies (REITs), and a further 12 per cent by insurers. After almost one trillion dollars in maturities this year, the peak will be reached in 2027 with 1.26 trillion dollars maturing then, according to S&P Global (Figure 2).

Figure 2: Debt due in the US commercial property market



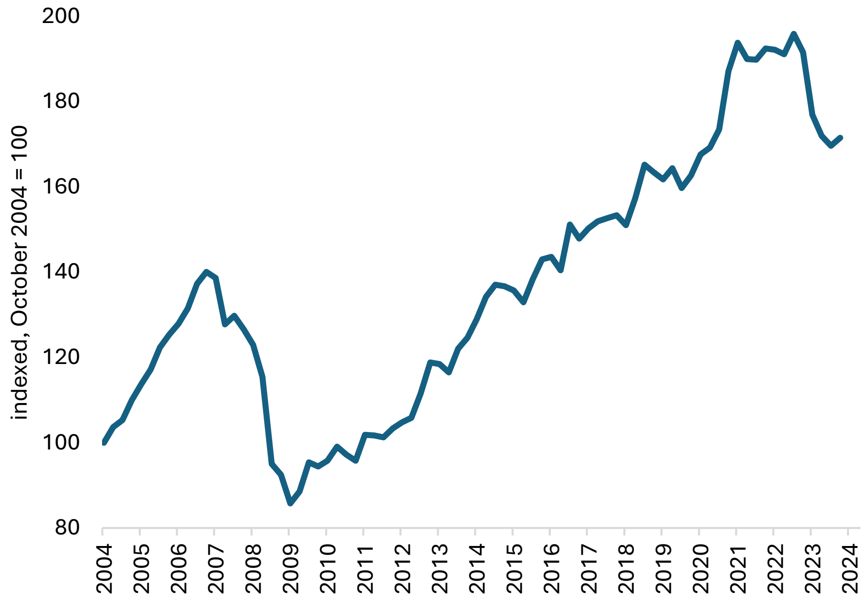
Source: S&P Global, Flossbach von Storch Research Institute, as at January 2025.

New York Life Investments, which manages 725 billion dollars in customer assets, expects an increase in loan defaults. According to New York Life, the values of many older office buildings are in free fall. Sales of office buildings are now only achieving prices 25 to 50 per cent below pre-coronavirus pandemic values. According to estimates, office property prices had fallen by around 35 per cent by the end of last year. The office sector has major problems because "back-to-office" is not the norm.

An analysis of Bloomberg data shows that the value of commercial properties financed with CMBS in US metropolitan areas had fallen by a good 24 per cent by the end of 2024 compared to the previous valuation (financing) date (so-called cut-off), and by almost 50 per cent for offices. According to the data, office properties account for just under ten per cent of all CMBS financing. By far the largest share (54.6 per cent) are multi-family houses that fall under commercial property, which were recently priced almost 16 per cent below their last valuation.

A glimmer of hope: Thanks to the high weighting in the stabilising multi-family market, prices for all US commercial properties recovered from the low in 2024, according to data from the Federal Reserve of St. Louis (Figure 3).

Figure 3: US commercial property prices



Source: Federal Reserve Bank of St. Louis, Flossbach von Storch Research Institute, as of January 2025**. Historical performance is not a reliable indicator of future performance.**

The commercial property specialist Green Street observed a five per cent increase in prices for its universe at the end of 2024. However, the outlook for 2025 is not rosy. This is due to the rise in US Treasury yields. Offices in particular are likely to remain under pressure. According to the rating agency Moody's, the vacancy rate in the USA is at record highs: 902 million square metres are waiting for employees and self-employed people to return - the equivalent of a good 126,000 football pitches.

A price increase, which would also make it easier to collateralise loans, could primarily occur if interest rates remain low. Recently, however, the markets have lost hope that the Federal Reserve will continue to lower key interest rates in the foreseeable future, especially significantly. On the contrary, the first voices are not ruling out interest rate hikes.

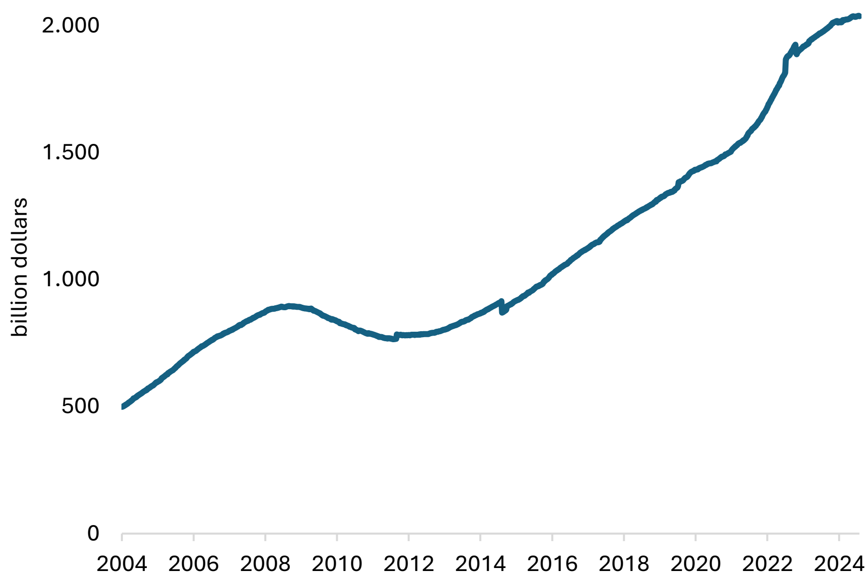
High capitalisation rates lead to lower prices for properties - as is usual for tangible assets. Investors determine the current value based on future income, which is discounted to the present day. If this interest rate rises (plus possibly a risk premium), future income is worth less today than before.

Lower property prices reduce the collateralisation options. This makes refinancing more expensive in addition to the already higher long-term interest rates.

3. banks under pressure

Smaller US banks, which have massively expanded their commercial property lending business in recent years, are under particular pressure (Figure 4).

Figure 4: Commercial property loans of smaller US banks*



*Small domestic commercial banks are defined as all domestic banks that are not among the 25 largest banks.
Source: Federal Reserve Bank of St. Louis, Flossbach von Storch Research Institute, as at January 2025.

According to the International Monetary Fund (IMF), the key risk indicator for banks is book losses on securities in the held-to-maturity (HTM) category, which also includes commercial property securities. According to the United States Generally Accepted Accounting Principles (US GAAP), book losses (or book gains) can be found in two categories: HTM and available-for-sale (AFS). HTM securities are classified as held-to-maturity investments. AFS securities are recognised in the "available for sale" class.

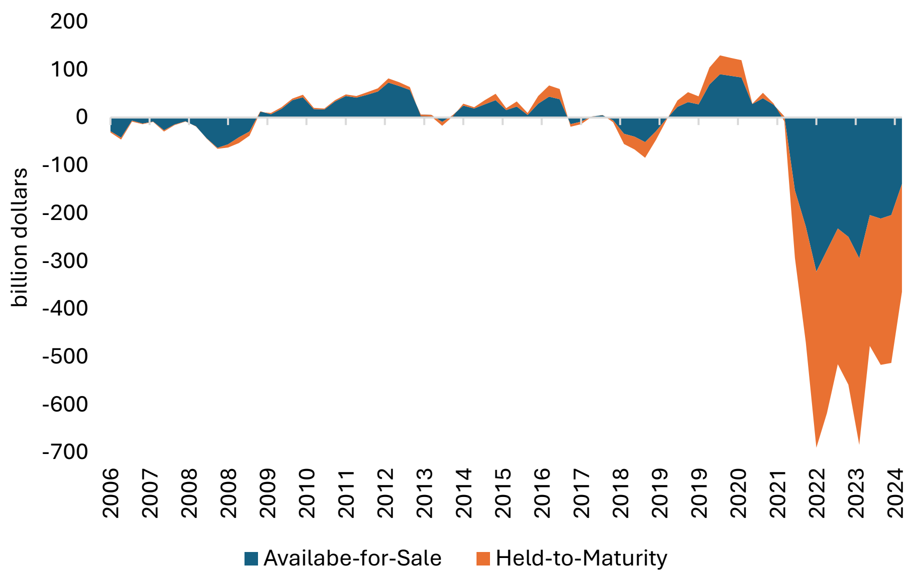
AFS investments are valued close to market value in the balance sheet; any differences between book value and market value are recognised in other comprehensive income (OCI), a subsidiary balance in the traditional income statement. The result of this OCI is immediately recognised in equity, but not initially in profit or loss.

HTM assets must be recognised at amortised cost. They only change the equity (and in turn the income statement) of a financial group after a sale. Differences between market value and book value are the rule, meaning that investors will find either hidden reserves or hidden liabilities within this category.

The two booking categories played only a subordinate role up until the early decades of this century. This changed with coronavirus and the turnaround in interest rates: presumably to conceal losses from lower market values. After a record high of USD 2,795 billion at the end of 2022, the HTM assets of US banks as at 30 September 2024 stood at USD 2,350 billion, a good 140% higher than in the summer of 2020, or 14 times higher than at the low point in 2008.

Book losses from HTM and AFS investments have fallen from USD 684 billion to USD 364 billion within one year as at 30 September 2024 (Figure 5).

Figure 5: Book value gains or losses at US banks in the available-for-sale and held-to-maturity securities categories



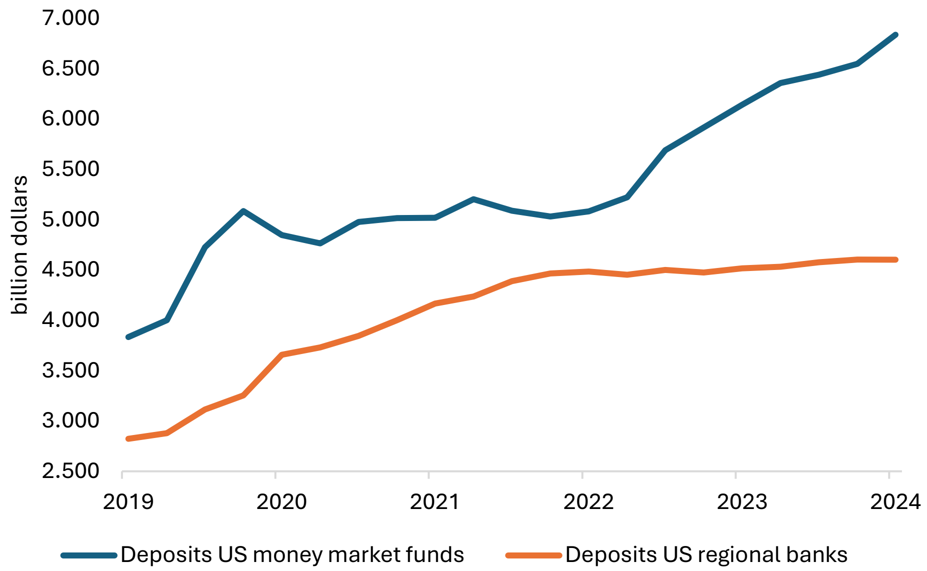
Source: FDIC, Flossbach von Storch Research Institute, as at January 2025.

However, this reduction comes at a time of significantly falling capital market interest rates, which had increased the prices and valuations of existing investments. The recent significant reversal in long-term interest rates is likely to increase book losses by a three-digit billion amount. The Federal Deposit Insurance Corporation (FDIC) should have calculated data for the end of 2024 by the end of February or mid-March at the latest.

[Major US banks book losses from HTM securities] particularly high absolute , led by Bank of America. Its losses also declined to [just under USD 86 billion] (as at 30 September 2024). Major Wall Street banks have good capital buffers, which puts the risks from book losses into perspective.

Funding, i.e. financing via customer deposits, which plays a less important role at the major banks, but all the more so in the US regional banking sector due to a lack of access to the capital market, is generally more difficult. Deposits have been stagnating there for years. The reason: money market funds are often more lucrative for investors in the wake of higher interest rates because they offer higher returns. Deposits are also growing significantly here (Figure 6).

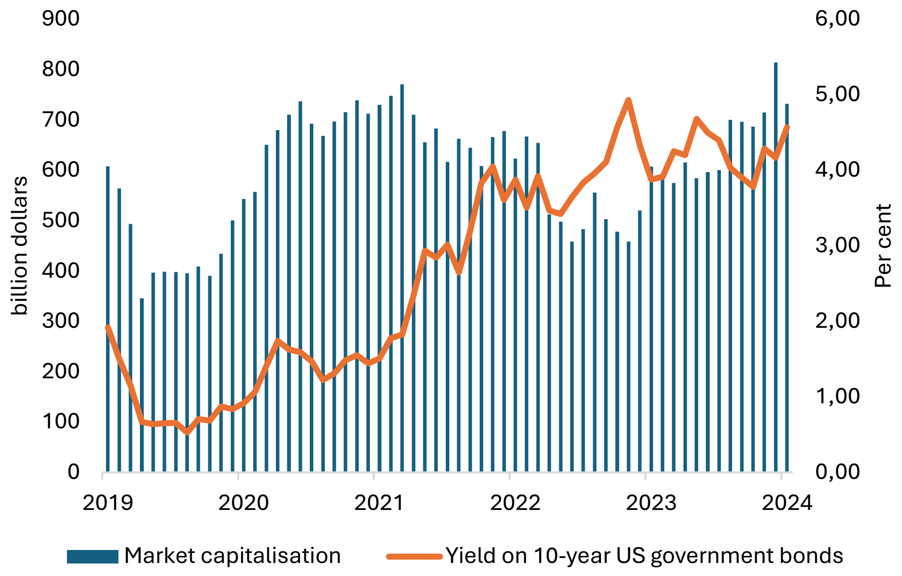
Figure 6: Deposits with US money market funds and US regional banks



as at 1 July 2024, US regional banks: 146 institutions, source: Federal Reserve of St. Louis, Bloomberg, Flossbach von Storch Research Institute, as at January 2025.

Market capitalisations in the US regional banking sector have also moved in line with the expectations of interest rate cuts and the yields on long-term US government securities. Hopes of an easing on the interest rate front drove the values to their old interim high from the beginning of 2022 in November 2024, but they have recently slumped again - with long-term yields rising in parallel and hopes of further interest rate cuts by the Federal Reserve falling (Figure 7).

Figure 7: Market capitalisation of US regional banks and US yields



146 institutions, monthly, source: Bloomberg, Flossbach von Storch Research Institute, as at January 2025. **Historical performance is not a reliable indicator of future performance.**

4. payment arrears increase

The higher long-term interest rate level will not only increase book losses again, make refinancing and recoveries in the value of properties serving as collateral more difficult, but will also further dampen payment behaviour.

The payment arrears of US banks for owner-occupied commercial property rose in the third quarter of 2024. The default rate for commercial property loans secured by non-owner-occupied properties also increased slightly for banks with total assets of more than 100 billion dollars and now stands at just under five per cent. Default rates of up to three per cent are generally considered acceptable.

According to the FDIC, the number of banks on its "problem list" continues to rise, most recently to 68 institutions. According to the FDIC, the weak demand for office space is leading to falling property values: "The rise in interest rates in recent years is impacting the repayment and refinancing options of office and other CRE borrowers." The delinquency rate on loans for non-owner occupied commercial property has reached its highest level since the third quarter of 2013.

Loan arrears for US office properties financed with CMBS rose to a record level of eleven per cent in December November. This puts them 0.3 percentage points above their previous highs during the 2008 financial crisis, according to US property data provider Trepp. Since the autumn of 2022, arrears have increased almost sevenfold - faster than ever before. This does not even take into account arrears on loans where interest is still being paid but repayments are no longer being made or will not be until further notice.

The major US bank Wells Fargo, for example, expects losses of up to three billion dollars from its loans for office properties. According to the rating agency Fitch, CRE problem loans for non-owner-occupied properties are approaching the level of the last financial crisis with a volume of almost 21 billion dollars.

Conclusion

With Donald Trump in the Oval Office, optimists are expecting a tailwind for the US economy. Tax cuts and deregulation should support the economy, which in principle should also help the commercial property market.

However, interest rates are the decisive factor. If Trump does not contain the high US deficits and inflation picks up again, the already difficult financing situation for US commercial property and offices in particular could worsen, affect the banking and shadow banking sector and lead to a crisis that spills over to other markets.

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