Cracks in the wall - by Bill Pastuszek

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I usually write a market update this time of year and have a look at industrial and office markets. Conventional wisdom rated 2022 as a transitional year with “blue skies forever” optimism largely gone. After the shock of the COVID shutdown and the dramatic rebound, new realities have set in. More balance and perspective replaces endless optimism. As if skyrocketing inflation and the Russian Invasion of Ukraine weren’t enough, we now have the first quarter of 2023 to contend with.

With respect to economic behavior as it relates to real estate and valuation, the post-COVID era continues to challenge and surprise. Informed observers are looking at the cracks in the wall of financial stability with concern. How serious are those cracks in that metaphorical wall that separates order from chaos?

What about the banking system? Inflation has been problematic and just doesn’t want to go away. Despite the Fed’s efforts, there don’t appear to be easy solutions. Some colossally dumb banking has created a crisis that, while shakily now under some control, could escalate.

What happened? Very simplistically, it goes to how banks manage their investments. In the now-gone low interest rate environment, banks bought long-term, now low-yield, instruments. Ordinarily this is realized as a loss on paper. In the case of the failed bank, depositors clamored for their money aided by the internet and caused the bank to have to sell those investments. As the losses were actual, a condition of insolvency was created that forced the government to take over the bank.

The question on everyone’s mind: Is my money safe? I offer no sage advice on this. Anecdotal information suggests there is much concern and funds are getting moved against the hopefully unthinkable.

The government seems to indicate that all funds should be safe. How that carries out in the event of a full scale crisis is not entirely clear. Prompt high-level action seems to have headed off the worst case scenario so far. A wise person stated: “we can’t afford in this high inflation environment to keep our money under mattresses.”

An Axios newsletter informs us that “FDIC guarantees bank deposits of up to $250,000—a figure most of us weren’t thinking all that much about until a week ago, when regulators guaranteed all customer deposits, even those above a quarter-million dollars, at two failed banks. Now lawmakers, academics, and some in the financial industry are debating whether the FDIC limit, which hasn’t been raised since 2008, needs to be increased—or abolished altogether.

Axios goes on to say: “regulators stirred up some murkiness when they decided to protect all depositors at Silicon Valley Bank and Signature Bank, with the aim of stemming a serious systemic risk to the financial system.” Another question: given that the U.S. has many smaller banks, will their safety be “guaranteed?” How much will this crisis affect their ability and willingness to do business?

How is CRE affected? Clearly higher interest rates are affecting lending originations and also existing loans. Expect to see more special assets activity. Some property owners that have properties still experiencing COVID effects may be ready to move on.

Let's take office markets. Office markets are experiencing what could be termed long COVID, i.e., three years after the shutdown, it's becoming more apparent that office space demand has trended very differently from other asset classes. (This is not as true for asset classes, like retail and lodging, whose demise seemed certain during the height of COVID, but which have rebounded.

The office sector is under some scrutiny. Given the longer lease terms prevalent in the office sector, several sources suggest that the real shakeout is yet to come as tenants come up for renewal and react to the reality that there are fewer bodies to occupy formerly sufficient spaces. Although much office can be repurposed for alternative uses, this trend is not necessarily easy or quickly done.

As leases come up for renewal and tenants now can act on the experience of the last several years in terms of space flexibility and alternatives to the traditional office models, the reality of the effects of COVID will hit home.

So too with apartments. A recent CoStar news piece tells us that "U.S. apartment sales may end this year's first quarter at the lowest level in more than a decade as higher interest rates slowed demand." In sum, sales are lagging. CoStar notes that the most recent sales quarter saw the lowest volume in the past decade; the second lowest was the second quarter of 2020 which was right after the shutdown. "Apartment sales began slowing last year as the Federal Reserve pushed interest rates up to tame inflation. Some potential buyers haven't been able to make the numbers work with interest rates that roughly doubled." So, while still a favored class, even multi-family is showing the strain.

It's not unreasonable to expect to see increasingly more hesitancy on both the investment grade side of CRE and downstream. Lenders are going to be laser focused on the ability to repay, rather than on forecasts of asset appreciation.

Strange times indeed. Are the small cracks in the wall of economic stability able to be patched over or will they widen? They are likely to get stranger.

[Suggested Reading: Charles Kindleberger, Manias, Panics, and Crashes: A History of Financial Crises, Seventh Edition 7th ed, 2015.]

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